

Today's Notes:

## **1. When Will Real Growth Return (Chris Berry, MBA)**

When Will Real US Economic Growth Return?

In the wake of The Great Recession, many were left wondering what the economic global landscape would look like during the recovery. Emerging markets such as China and India seemed to power through the recession with relative ease, while economies in the West, particularly North America and the Euro Zone, were hammered and continue to struggle today with moribund economic growth. If you listen to government statisticians, it would appear that the U.S. economy is back on track, growing with job creation. However, with wages stagnating, structural unemployment and underemployment high on a historical basis, and excessive inflation in food and energy prices, the "man on the street" will tell you a much different story.

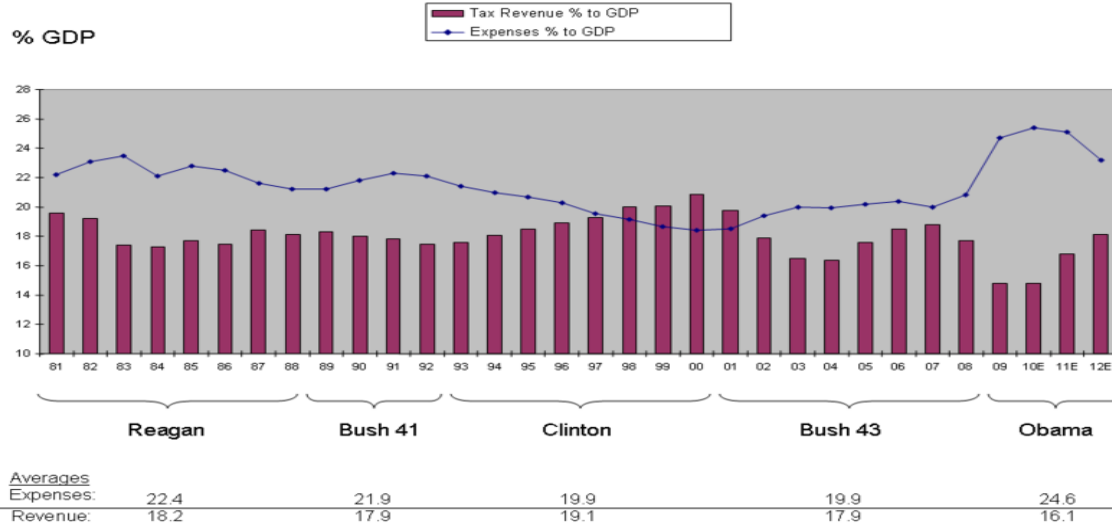
Have you filled up your gas tank recently? The impact government statistics have over the everyday aspects of our lives and how they can drive markets – adding to volatility and uncertainty, is particularly concerning. This data influences interest rates and currency exchange rates, which are inextricably tied to inflation data through prices at the pump and ultimately the grocery store.

This disconnect between government statisticians and our citizenry poses a much bigger question, one that I've been debating for some time. The question is this:

**Is a return to real economic growth a reality?**

When I say "real" I'm referring to the idea that a dollar invested in a project yields more than a dollar in returns over time after adjusting for the insidious tax of inflation. Economic growth is measured by gross domestic product (GDP) which combines consumption, investment, government spending, and net exports to get a picture of the size of an economy and its trajectory. What I find most troubling is the fact that in the United States as well as in the Euro Zone an increasing portion of GDP is accounted for by government spending. The chart below shows the differential between US government receipts and disbursements, or put more simply the difference between tax revenues and expenditures. The difference between these two amounts is accounted for by government spending through debt issuance.

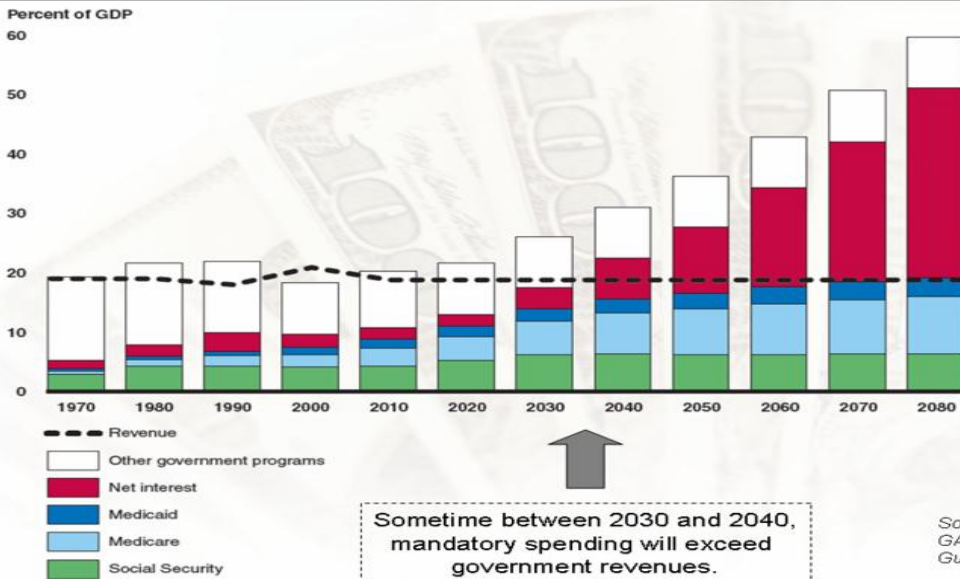
## Federal Tax Revenue & Expenses as % to GDP (FY 1981 – 2012)



Source Data: Congressional Budget Office, 2011 Budget

Additionally, the chart below projects “mandatory” spending including Social Security, Medicare, Medicaid, and net interest on the debt. Tax rates will no doubt have to rise to pay for these promises and obligations, providing a drag on real economic growth in the future.

## The Risks of Growing Entitlement Spending

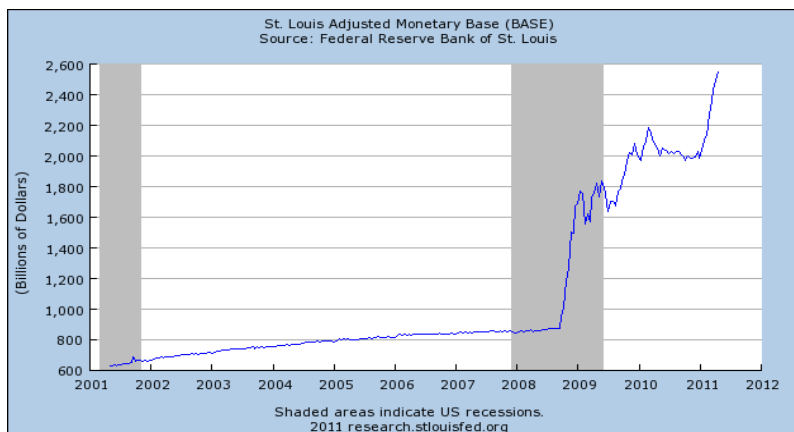


Source: GAO Citizen's Guide 2007

In an attempt to dig out of the deep hole in which we found ourselves after The Great Recession, Keynesian economic ideology prevailed and trillions of dollars of stimulus has been unleashed upon the economy. In fact, despite claims that the American Recovery and Reinvestment Act of 2009 was supposed to pump only \$787 billion into the US economy, a 2009 study conducted by the CBO and Joint Committee on Taxation and reported by the Heritage Foundation shows the price tag to be closer to \$3.27 trillion when service on the debt is included in the equation.<sup>1</sup> This will ultimately need to be paid back.

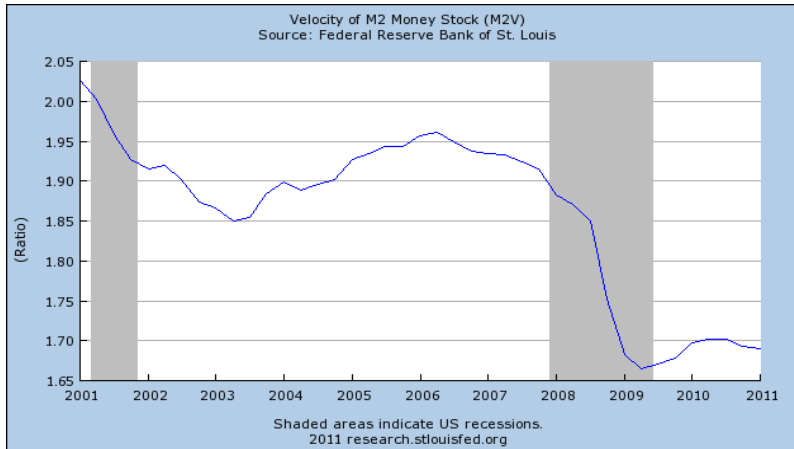
Whether this will stimulate real growth or not is an open question – I would argue that it has not. In the United States consumption accounts for 70% of GDP historically. But I also wonder whether this consumption measure also measures a rising quality-of-life? I think not and many people are waking up to this realization today. In other words there is consumption and then there is consumption.

When the Federal Reserve ends QE II in June, as scheduled, what will this do to GDP growth and interest rates in this country? Part of our "consumption" has been financed for the last 30 years by cheap money and low interest rates – but we will need to find other avenues to long-term economic growth in the absence of these Keynesian "crutches." We are in fact, "all Keynesians now."



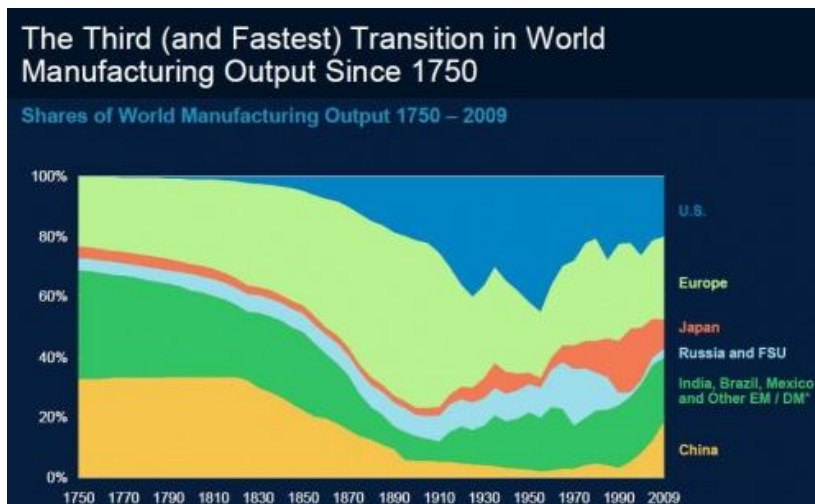
Quantitative Easing has played a role in the utter explosion in the US monetary base. However.....

<sup>1</sup> <http://blog.heritage.org/2009/02/12/true-cost-of-stimulus-327-trillion/>



....the increase in the amount of money, meant to stoke a little inflation and hence economic activity (growth) has utterly failed.

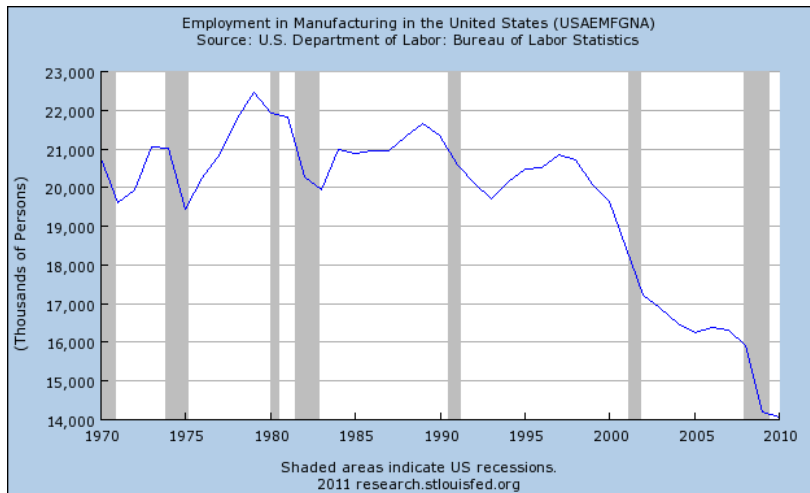
If spending and consumption fall, something else (investment or net exports) has to pick up in order for GDP to continue to grow. With the shrinking in our manufacturing base in this country over the last 30 years (though the US is still the largest manufacturer in the world), it would not appear that exports are set to increase appreciably despite the long-term decline of the US dollar.<sup>2</sup>



At left, a chart showing the global share of manufacturing output since 1750. The trend in the US is one of a shrinking overall percentage. As the overall percentage of manufacturing output has fallen in the US, this has had predictable consequences on employment in the sector. (See next chart below).

Source: Morgan Stanley, 2010

<sup>2</sup> A cheap dollar is thought to spur exports by making US goods “cheaper” relative to those of other countries.



Similarly with GDP's investment component, while the Obama administration has earmarked trillions of dollars in stimulus funds (based on the analysis we mentioned above), it's now debatable whether this has stimulated economic growth. Further, much of the stimulus money was printed with a mandate that it be paid back in the future. Every debt is eventually somehow repaid. The \$14.33 trillion in national debt that the US taxpayer is currently facing is not immune to this immutable law. This debt overhang is another factor that must negatively affect US GDP growth in the coming years.

Though debatable, I always viewed the quality-of-life dynamic as a zero sum game in the global context. This means that one person's increase in quality-of-life is another person's loss. As per capita quality-of-life is on the upward trajectory in the Emerging World and incomes are on the rise, absent technological breakthroughs in US productivity, quality-of-life in other parts of the world (namely the West) must fall. After all, there's only so much natural resource "stuff" to support this rising quality-of-life.

What makes the growth phenomenon in the Emerging World so interesting is that it does not appear to be fomented by debt in the same way that growth in the United States has been. This could be changing though, based on this Wall Street Journal article from October 2010.



To be clear, these emerging economies face economic problems of their own. The absurd amount of leverage in the Chinese banking system comes to mind.<sup>3</sup> However, this Morning Note focuses on Western financial imbalances and what to do about them to ensure renewed and healthy economic growth. Economic problems in emerging markets, though serious and posing risks to the global economy are another Note for another day.

To get a sense of the wealth disparity between East and West, take a look at [this Google chart](#) showing per capita GDP on a PPP basis from 1980 in select countries. Clearly, emerging economies have a lot of catching up on a per capita basis. This chart shows the upside (if there really is one) of debt-fueled consumption and growth. Debt financing tips growth over at some point as the same dollar of debt eventually produces less growth.

Now, examine [this chart](#) showing GDP growth on a PPP basis for the same group of countries. Looking at GDP growth rates tells a different story – one where the emerging world is growing faster than the West. How can GDP growth rates in western economies be sustained if not by debt-fueled consumption as in the past three or four decades? My conclusion: they can't. Debt fueled consumption probably doesn't work anymore.

As the West endures a multi-year phenomenon of deleveraging out from underneath mountains of Federal, State, and private indebtedness, it remains to be seen whether or not "real economic growth" will be something our children and grandchildren will experience one day.

It bothers me when I hear people pontificate about problems and failings and not offer solutions. As slow growth, debt, and inflation decimate our national and personal collective balance sheets, it appears more important than ever to take control of your own financial destiny. This is why we believe in Discovery Investing; it's one way that

<sup>3</sup> <http://www.businessweek.com/news/2011-03-08/china-at-60-risk-of-banking-crisis-fitch-gauge-signals.html>

we think you can increase and preserve wealth in the face of the multiple economic and financial obstacles facing our future. All wealth begins with a great discovery. With Social Security payments sure to decline and an ever increasing percentage of the US federal budget going to entitlements which do not encourage economic growth, the onus is on you to find these discoveries and help to preserve and proliferate your legacy for your loved ones.

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