portfolio construction CONFERENCE
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Due Diligence Forum Research Paper

POSITIONING PORTFOLIOS IN A DELEVERAGING WORLD

Magellan Asset Management

After an extraordinary 15 years of economic expansion in the developed world - primarily driven by the continued willingness of households to consume more than they earn - the level of household debt relative to income has reached levels where its continued growth is highly unlikely. With household consumption accounting for approximately 70% of GDP in most developed countries, deleveraging presents a significant challenge to the level of economic growth in these economies over the next 15 years. This paper seeks to discuss this challenge and how to position portfolios in light of it.

With appropriate regard to historical context, the 15 years leading to the financial crisis of 2007/2008 were an extraordinary period of global economic growth, particularly for major economies such as the United States, the United Kingdom, Australia, and many European nations. This extraordinary period was coupled with substantial increases in asset prices, and thus a commensurate rise in household wealth. However, the Global Financial Crisis could quite possibly materially change the course of history, causing the medium term future to be materially different from the recent past. Investors must consider the possible impact of this on investment returns over time.

The rise in household debt

From the end the last major global recession in 1992, the world experienced an extraordinary period of economic prosperity and growth through to 2007. This was driven by debt fuelled household consumption in many of the major developed world economies (this was particularly the case in economies like the United States, the UK, Spain and Australia). The prodigious growth in consumption over the period was primarily driven by significant growth in household debt, both relative to GDP (Figure 1) and to household income (Figure 2). Growth in debt was facilitated by unprecedented free flow of credit, low interest rates, and was supported by the wealth effect of increasing asset values.

Household debt, relative to both GDP and household income, rose to historically high levels in the US, UK and Australia. Consider that in the US, household debt as a share of disposable income grew as much between 2000 and 2007 as it had the prior 25 years.[1] Commensurate with this, savings rates also declined, continuing a trend of the prior two decades. Figures 2 and 3 provide examples of this from Australia and the US, which are representative of the trend experienced in much of the developed world.[2]

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Figure 1: Household debt as a percentage of nominal GDP

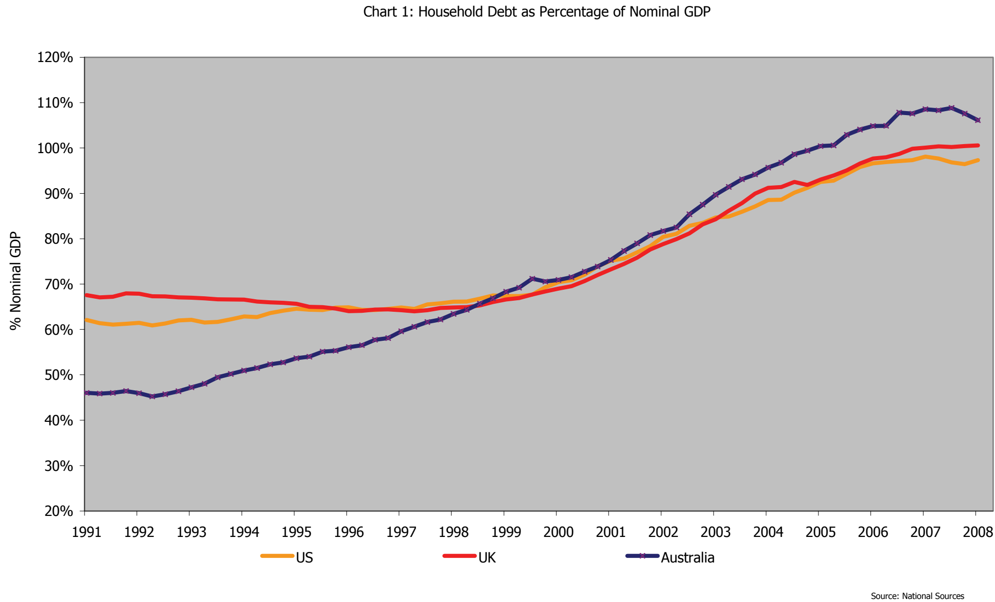

Figure 2: Household debt as a percentage of disposable income

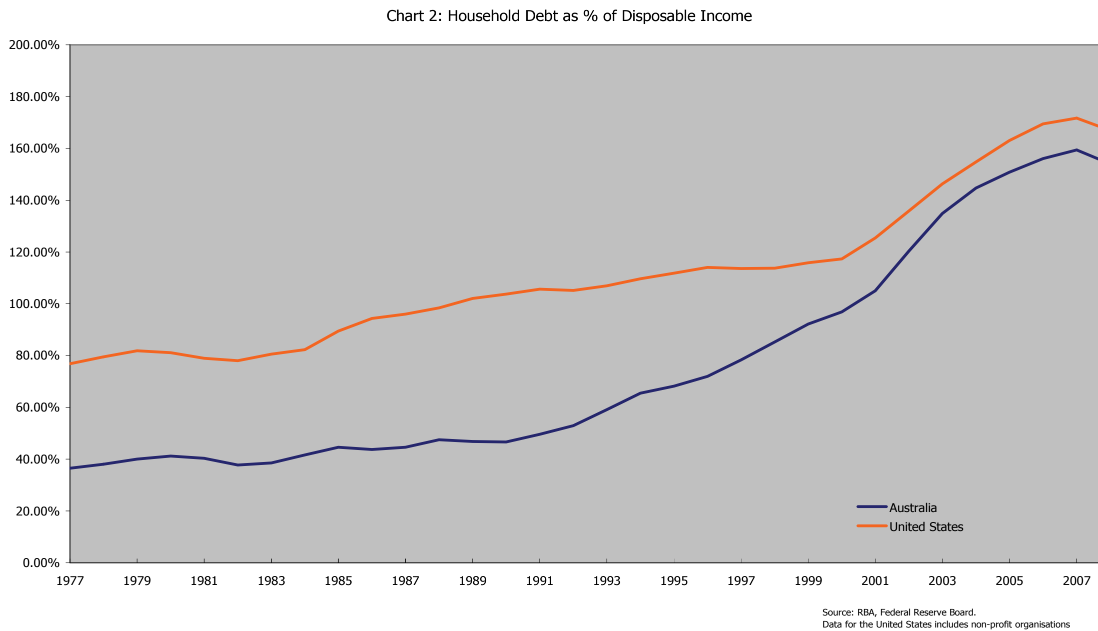

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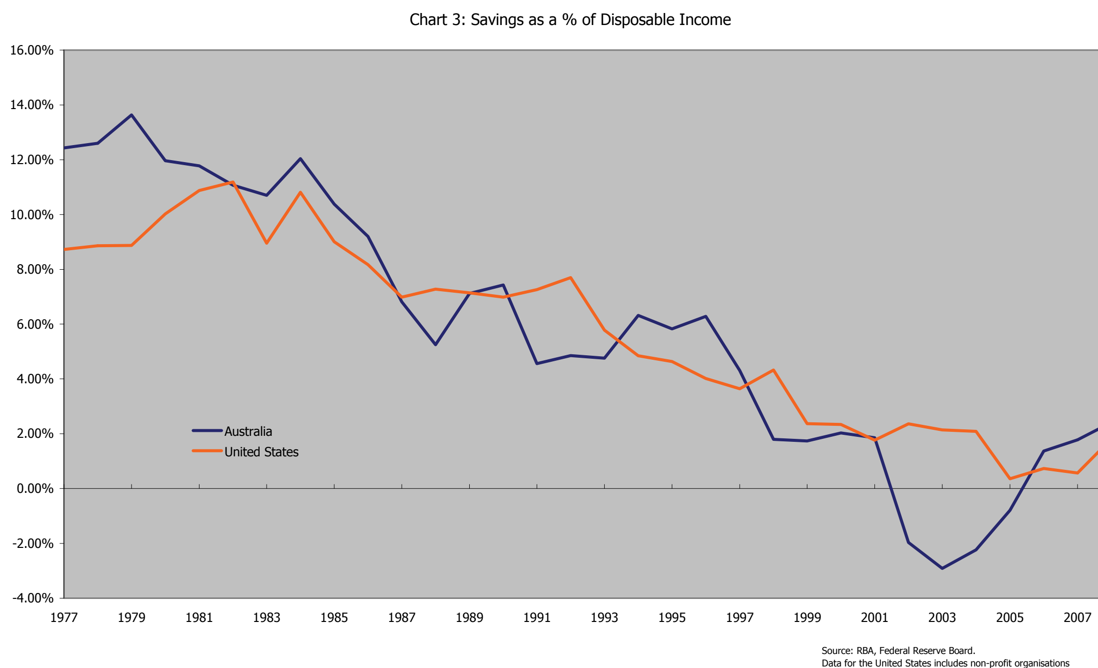
Figure 3: Savings as a percentage of disposable income



With consumption accounting for approximately 70% of GDP in most developed nations[3], the fact that households spent in excess of their disposable income provided significant stimulus to economic growth since the early 1990s. As can be seen below in Figures 5 and 6 below, this economic growth provided strong asset price growth, most significantly in real estate but also in equities.

The effect of household debt levels on house prices

The notable exceptions to the trend of increased indebtedness and reduced savings were Germany and Japan which, contrary to their developed-world peers, have been deleveraging at the household level for a number of years. Figure 4 shows household debt as a percentage of GDP for Germany, Japan, Australia and the US since 1992.

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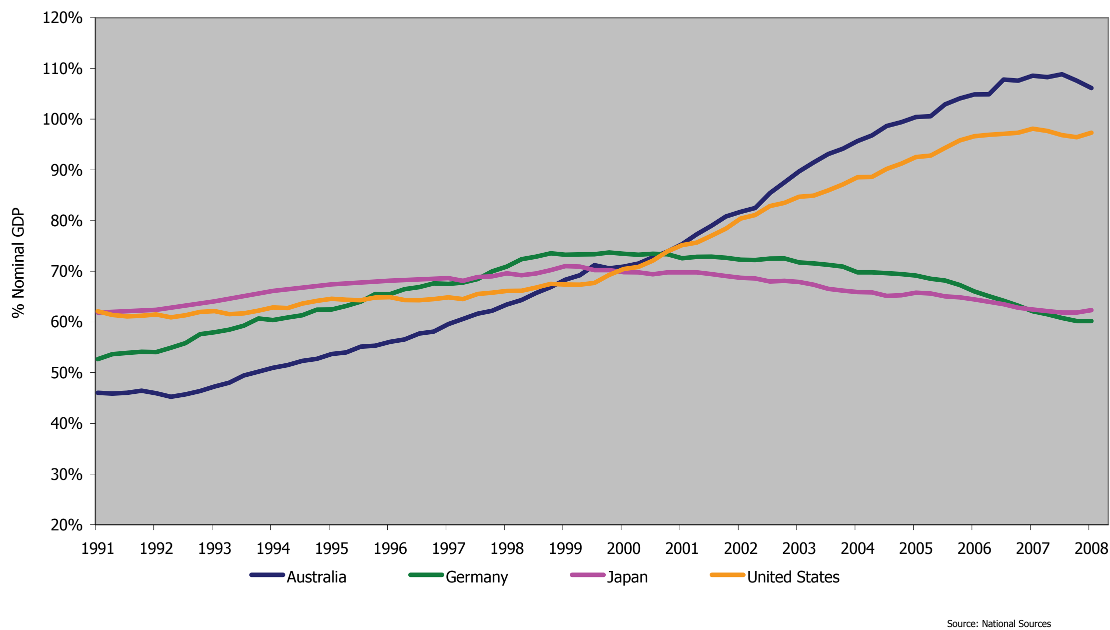
Figure 4: Household debt as a percentage of nominal GDP



Figures 5 and 6 show national property prices in Australia, Germany, Japan and the US across the same period, illustrating that property prices in Japan and Germany stagnated or declined over the period while households increased savings and deleveraged. Conversely, the rise in real house prices in economies that increased household leverage over the past decade was significant with the largest price rises in the UK (178%) Ireland (165%), Spain (156%), Australia (140%), Sweden (134%) and France (130%)[4].

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Figure 5: National property prices (Index 1992 = 100)

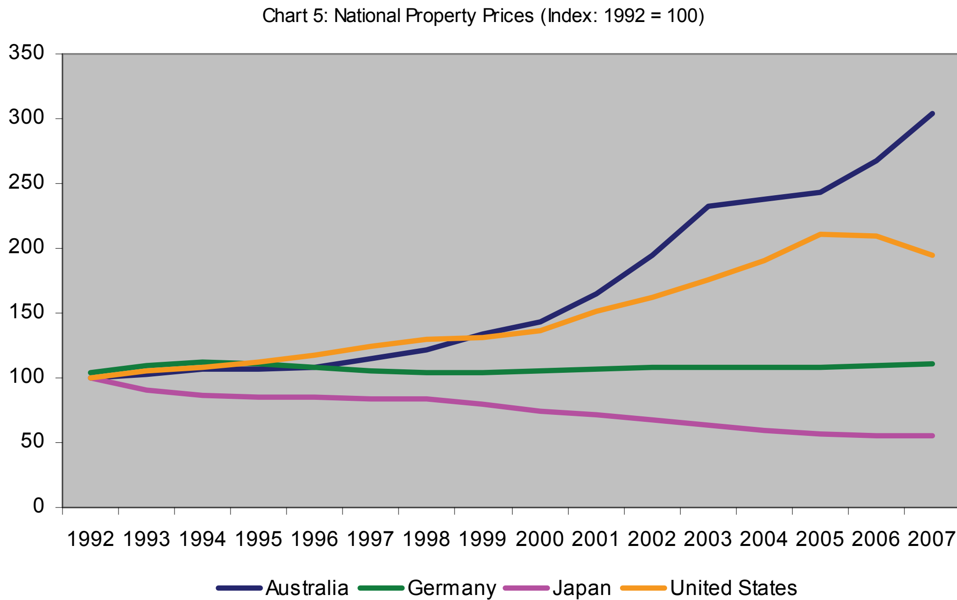
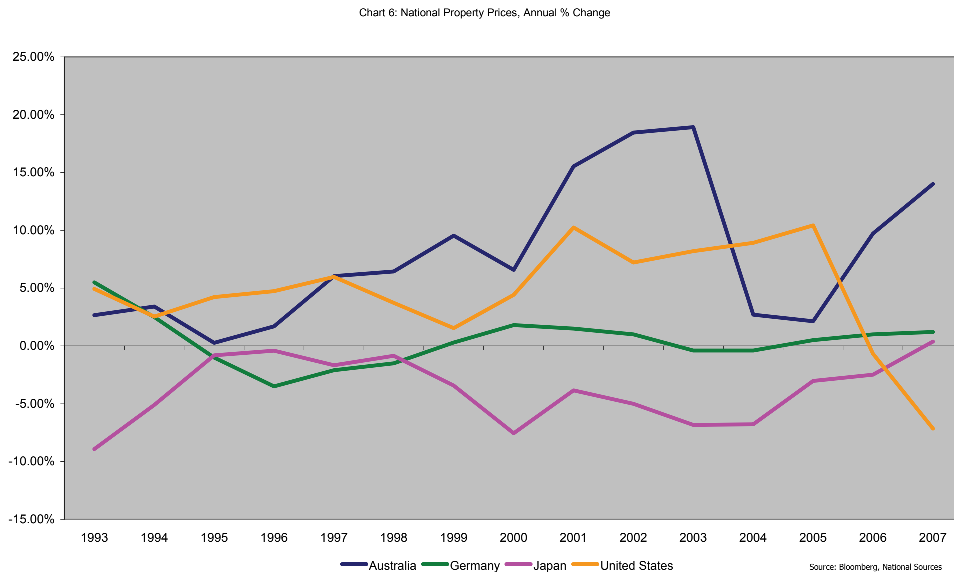


Figure 6: National property prices – annual percentage change



The effect of household debt levels on GDP growth

There is a strong correlation between the rate of increase in household debt and GDP growth. Figures 7 and 8 show the growth in GDP for Germany, Japan, Australia and the US since 1992, illustrating that that both Japan and Germany – which deleveraged over the period – grew at materially lower rates than Australia and the US. It is also worth noting that during this period, the

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economies of Japan and Germany (as major exporters) benefitted significantly from the rise in household leverage of other rich nations, which may suggest a period of household deleveraging could be even more severe on GDP growth for economies running large current account deficits.

Figure 7: National GDP (Index 1992 = 100)

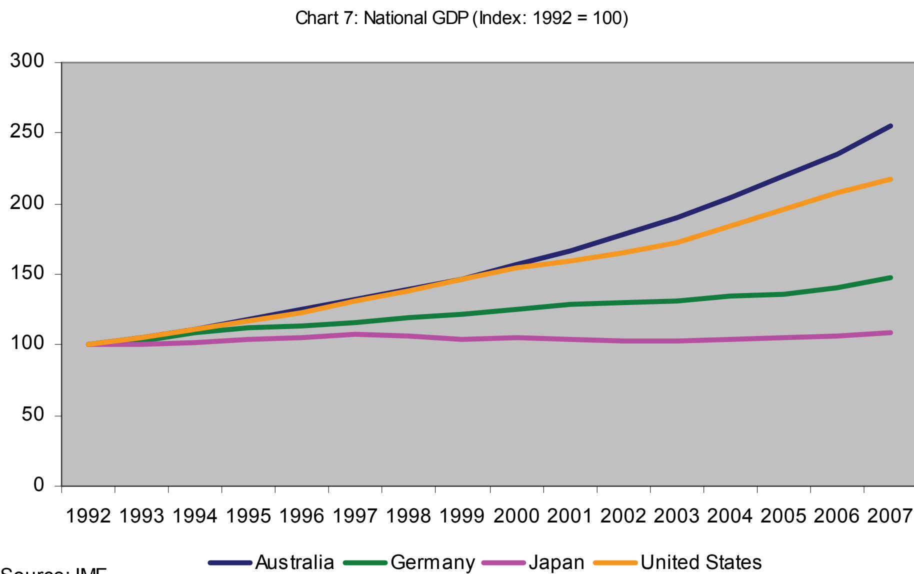
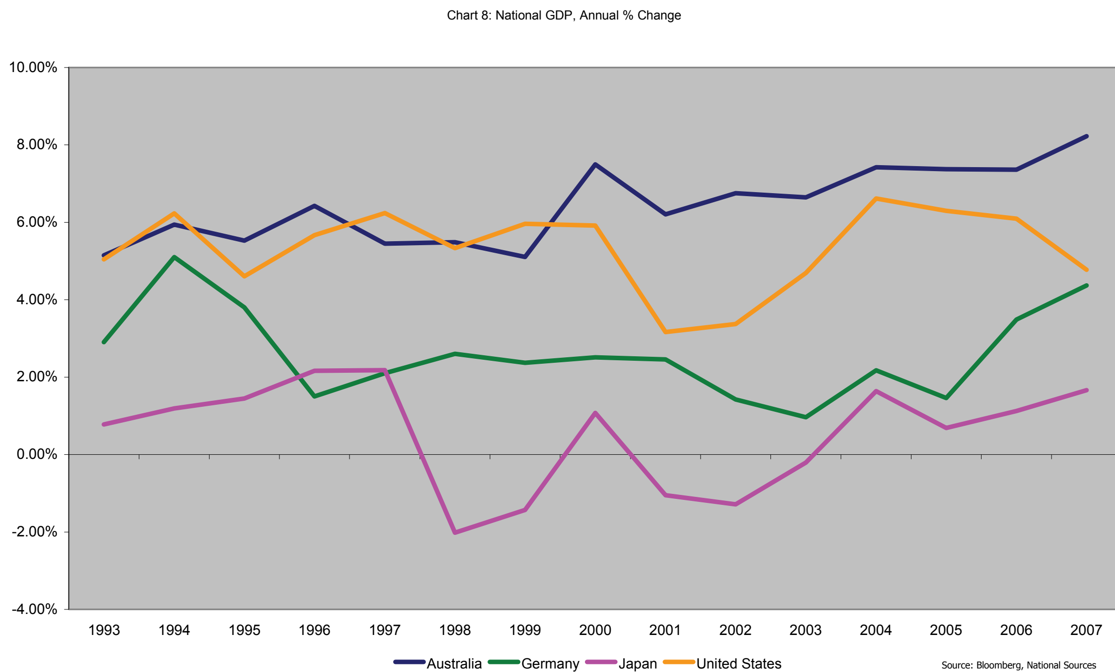


Figure 8: GPD – annual percentage change



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Now for the hangover?

The consumption bubble that developed in the majority of the rich world was funded largely by the savings of the emerging economies, both through large current account surpluses and a significant increase in savings rates following the Asian Financial Crisis of 1997-1998, illustrated in Figures 9 and 10 below. These savings have kept interest rates low (through a willingness to purchase sovereign foreign debt) which has in turn driven down interest rates and encouraged consumption in the rich world. This has caused two key outcomes:

1. The consumer in the majority of the rich world has entered this economic downturn with the highest level of debt relative to income on record (Figure 1 and 2 above)

2. Massive global savings imbalances (Figure 9 and 10 below)

Figure 9: Current account balances – percentage of GDP

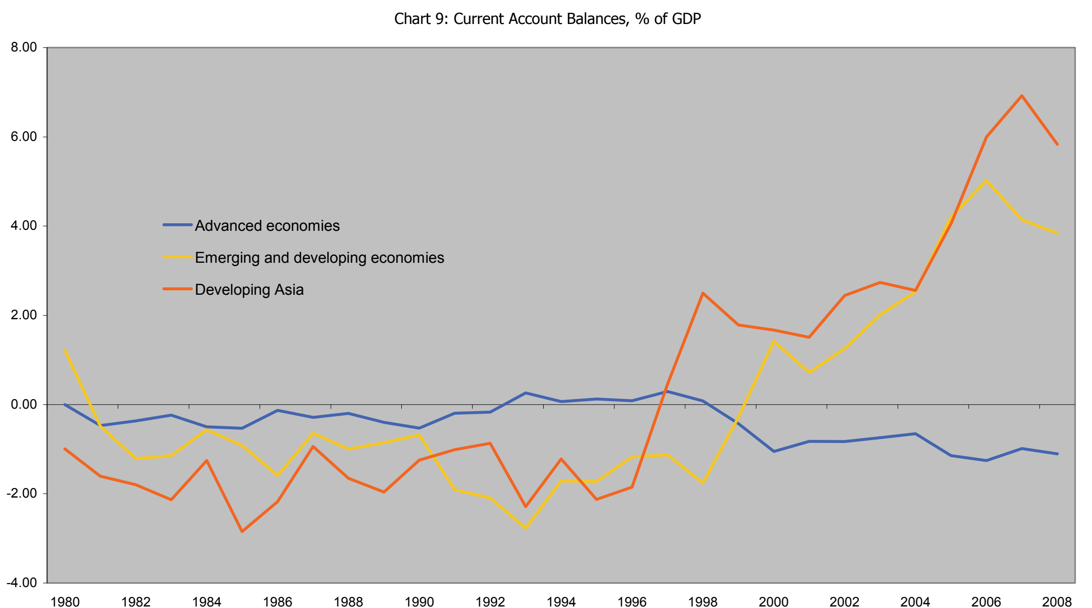

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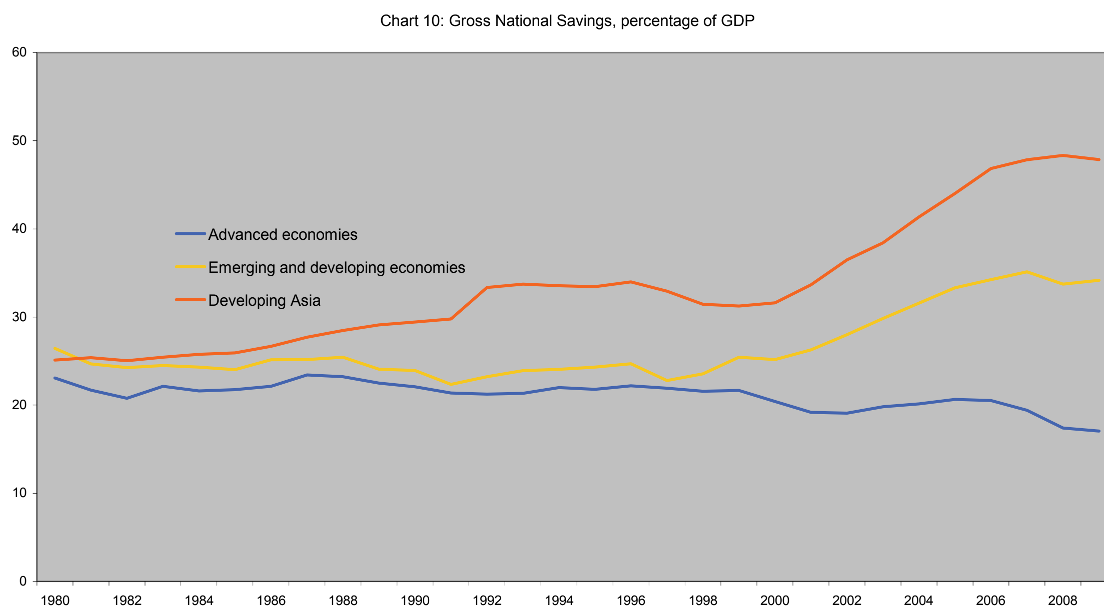
Figure 10: Gross national savings – percentage of GDP



Unwinding Consumer Debt

The Global Financial Crisis is likely to have a long lasting effect on consumer behaviour in many of the world's major developed economies. As a result, the rate of growth in household leverage is almost certain to decline over the next decade, which will almost certainly impact economic growth and asset prices.

The speed and scale of this rebalancing process is difficult to predict and therefore the extent of the slowdown in the level of economic growth is also difficult to forecast. There are realistic scenarios where households deleverage themselves in absolute terms (i.e. the rate of household debt to household income declines) leading to a prolonged period of very low economic growth (such as the situation which happened in Japan). There are other realistic scenarios where the rate of increase of household leverage slows down, which is likely to lead to a less severe slowdown in economic growth. Consider, for example that in the US, a decline in household debt-to-income ratios by 5% will translate to a similar increase in household savings (McKinsey[5]), resulting in a reduction of over $US 500 billion in spending, or just under 1% of US GDP – a clearly significant impediment to ongoing economic growth.

The only alternative to increased savings as a means of reducing household debt-to-income ratios is a material boost in real household income. However, given real incomes in the US barely increased between 2000 and 2007[6] despite sustained economic prosperity, it can be considered unlikely that highly geared household balance sheets will be saved by significant increases in real household income.

More frugal households in major developed nations represent a significant structural risk to global economic growth in coming periods, and while there may be offsetting factors such as productivity

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improvement and sensible government policy, investors should give considerable thought to tempering expectations for asset returns over the next 10 to 15 years, as households reduce consumption to be more closely aligned with income.

Deleveraging presents not only challenges to asset prices but also to businesses reliant on the developed world domestic economy for ongoing growth. While some business will prosper (due to market share growth, efficiency improvements, beneficial M&A activity, etc), many businesses will not benefit from the same economic tailwind seen in recent history.

Investors should carefully consider the impact a slowdown in consumption and economic growth will have on underlying businesses and, importantly, should avoid extrapolating past recoveries in consumption spending that have taken place subsequent to past recessions as it is likely this may well prove to be excessively optimistic.

Correcting global savings imbalances

With the developing world funding a consumption bubble in many rich-world nations, significant global savings imbalances developed between nations. While global savings can remain unbalanced for a period, eventually debts must be repaid, resulting in capital flows from the rich-world to the developing world.

Asian households have very conservative balance sheets, with household debt in those economies less than 50% of GDP[7], while much of the rich world has a household debt burden of greater than 100% of GDP. Additionally, while household consumption is 50% to 60% of GDP across most of Asia (in line with most developed nations), China is a major exception and household consumption actually declined between 2000 and 2008, falling from 46% to 35% of GDP over the period[8].

The growth of the consumer in the developing world has been well documented and clearly represents a significant opportunity for emerging economies to become more self-sufficient for economic growth (rather than heavily relying on exports). This is particularly the case in China, where considerable growth in household consumption is a near-certainty over the medium term due to significant urbanisation and the ongoing emergence of a major middle-class of consumers. This is likely to increase domestic consumption and materially contribute to rebalancing of global savings, most apparently through a reduced current account surplus.

As these global savings imbalances are reduced over time, the growth in the consumer class in the developing world is likely to be a major driver of global economic growth and a significant opportunity for global businesses that can export to (or operate in) these markets. Clearly Muhtar Kent, Chairman and Chief Executive Officer, Coca-Cola Company, understands this opportunity: “by 2015, some 700 million new consumers will be ascending to the middle class. That’s two markets the size of the US added to the world economy in less than a decade.”[9]

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Portfolio construction implications

An extended period of deleveraging is likely to lead to reduced economic growth which is in turn likely to translate into lower levels of absolute return for real estate and equities. This may be confronting, given the leverage-propelled growth of both over the past 15 years.

Investors should consider the following when constructing portfolios:

- Returns in businesses predominantly dependent on economic growth in the developed world may well be materially lower than has been the case over the past 15 years.

- Returns from real estate may also be materially lower in a deleveraging environment.

- While passive and benchmark-aware strategies may appear attractive due to low cost and inconclusive evidence on active funds management, investors in a lower return environment must now consider if exposure to the major stock market indexes in the developed world (i.e. S&P 500, FTSE and Nikkei) will deliver investment returns that will meet the requirements of many investors.

- A lower-return environment also makes manager selection more important than in the recent past; alpha becomes very valuable as it is likely to occupy a higher percentage of total return. Naturally, investors should also consider that the fees payable to active management are worth the skills received in return.

[1] See Chart 3 and McKinsey Global Institute, March 2009, “Will US Consumer debt reduction cripple the recovery?”
[2] Most notably Canada, Britain, and New Zealand. For further detail see The Economist, 7 April 2005, “The shift away from thrift”
[3] National data can be obtained from the ABS (Australia), BEA (United States), ONS (UK)
[4] Barclays Capital. Global Economics Fixed Income Research November 24, 2008. Data also sourced from The Economist. Data for 10 years ending December 2007, global weighted average over 10 years was 90.6%.
[5] McKinsey op. cit.
[6] Ibid.
[7] The Economist, 26 June 2009, “Shopaholics Wanted”
[8] Ibid.
[9] Remarks made to London Business School, 28 May 2008. Sourced at www.coca-cola.com

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