



Turbulent Teens Ahead?

What Might The Next Decade Bring For The Economy And The Financial Markets?

Executive Summary

After a tough decade, what should investors look forward to—or fear—in the next 10 years? Will the stock market go back to its usual historical return of about 10%, versus zero in the decade just past, or should investors expect something higher or lower, and why? Will returns be strong and steady as they were for most of the 1980s and 1990s, or will the volatility of the past couple of years continue? Is a solid bounceback from the Great Recession likely, or might the U.S. face a double dip? Now that the worst of the financial crisis of 2008–09 seems to be over, will we be crisis-free for many years or might another type of financial or economic crisis hit us next decade?

This white paper looks at history to attempt to answer these questions about the future. Among the findings are:

- ◆ When dividend yields, P/E ratios and inflation have been about where they are now, returns over the next 10 years have been in the high single digits: below average, but much better than those of 1999–2009.
- ◆ The decade might get off to a solid start. Although the data are not decisive yet, there are signs that a revival of the labor market and U.S. economy might be at hand.
- ◆ A bigger problem might await the middle of the decade, as the current slack in the economy gets taken up and baby boomers start to retire in large numbers. GDP growth is likely to slow as labor force growth stalls dramatically compared with the past several decades. Slow growth combined with large debts from the current crisis might set the stage for another crisis, especially if issues related to energy, healthcare and other entitlement costs are not addressed.
- ◆ Higher taxes might well put a further damper on economic growth, but based on a simple comparison of growth before and after the Reagan tax cuts, the loss of growth might not be as dramatic as some fear.
- ◆ Memories of the crisis of 2008–09 might change investor behavior. That could mean that the risk premium embedded in stocks will be higher in the future, muting returns; knowing that rapid losses are possible, investors might be more willing to sell at the first sign of trouble, increasing volatility.
- ◆ Although investors will still need alpha, management of risks might become much more important than management of returns. Financial products that seek to manage risk while providing the potential for upside returns (e.g. variable annuity contracts) might gain favor with investors.
- ◆ There are many reasons to be nervous about the future, but as long as the fundamental drivers of productivity remain strong, as they have for decades, and policymakers summon the will to find bipartisan agreement to solve economic problems, as they have in the past, there is also reason for hope.

Ed Keon, *Managing Director*
December 31, 2009

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What Might The Next Decade Bring For The Economy And The Financial Markets?

As 2009 and this never-named decade draw to a close, it is tempting to look back wistfully at how much better the U.S. economy and financial markets looked in 1999. The U.S. was at peace. The stock market had just enjoyed its best 20-year returns ever (almost 18% per year), and over that same period both government and corporate bonds had delivered average annual returns greater than 10% (6%-plus adjusted for inflation), among the best returns ever. In what became known as “The Great Moderation,” economic growth had been remarkable steady and inflation had gradually dissipated since the early 1980s. The federal government enjoyed a budget surplus. When Y2K fears turned out to be vastly exaggerated, it was tempting to think about the markets and the economy in the words of the 1988 song, “Don’t Worry, Be Happy.”

In less than three months, however, tech stocks would crash, and in the summer of 2000, the broad market would begin a nasty correction. A series of corporate and financial scandals revealed unethical and corrupt behavior by many previously-celebrated business people. The tragic events of 9/11/01 would lead to two long, bloody and costly wars, as well as cause basic changes in the way Americans work, play and travel. Global growth fueled a sharp increase in oil and commodity prices, followed by a dramatic correction. House prices boomed and then busted, starting the steepest and longest recession since the 1930s. Stock returns have been negative this decade, with gold, commodities and Treasuries among the big winners. As of late 2009, emerging markets seem to have resumed their robust growth, while the U.S. and other developed economies are limping along. Unemployment is 10% in the U.S., with little hope that it will drop back to a full employment level below 6% any time soon. The federal government is on track for a record deficit of about \$1 trillion or so, with large deficits expected to continue for many years, especially as baby boomers retire and demand their Social Security and Medicare benefits. The public mood is sour, angry and confused.

So what might the next decade bring? Might the fact that the party of 1999 led to a decade of tears suggest that the despondency of 2009 might portend a decade of bliss? Or perhaps we face another weak decade to offset the whole 20-year period of strong results?

Of course, no one knows what the future will hold. Some event no one can yet imagine might turn out to be the most important driver of the economy and financial markets over the next ten years. Yet investing is inevitably about the future. We know that the value of a risky asset is the present value of its future cash flows, discounted at an appropriate rate. The trouble is, we don’t know for sure either what the cash flows will be or what the right discount rate is, so we have to guess...ah...I mean estimate. When we aggregate returns to the asset class level, we can estimate long-term average returns using fundamental factors such as valuations and projected earnings growth. Our team will indeed do so soon, relying on well-established historical patterns for sound underlying investment and economic ideas.

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This white paper will also attempt to look into the future, but will try to forecast the investing environment and the pattern of asset returns more than the precise level of returns. We think that this matters a lot, because the type of investment strategy likely to be rewarded can be determined by the market environment. For example, from 1982 through 1999, the stock market went up every year but one (1990, down a mere 3.2% per Ibbotson). Sure, the crash of 1987 was traumatic, but stock prices actually went up in 1987 overall. A simple buy and hold strategy worked very well, and created little anxiety. In contrast, the 1930s saw three of the worst years in stock market history, (1930, -25%; 1931, -43% and 1937, -35%) and four of the best (1933, +54%; 1935, +48%; 1936, +34% and 1938, +31%) according to Ibbotson. If you bought stocks in August 1929 and held through April 1942, your total return was -50%. Buy and hold was a flop. But those lucky enough to have sold in 1929 and bought in 1933 tripled their money over the next four years. Is the big rally from the March 2009 lows the start of a new bull market like that of 1982 through 1999, or might we face continued turbulence, such as occurred in the 1930s? Should investors plan to just buy and hold or stick with some other sort of mechanical asset allocation strategy, or should they plan and prepare for and perhaps even profit from continued volatility? We know that we cannot predict future events, but based on historical patterns, how might recent events and current conditions influence the future?

The second issue we will attempt to address is the real growth prospects for the U.S. economy over the next decade or so. In the short run, asset returns have little or no correlation to economic growth. But over the very long run, profits tend to grow at the same rate at which the economy grows and stock prices tend to go up by the same amount that profits grow. Since we are attempting to look ahead a decade, U.S. GDP growth over that period is likely to be relevant to financial asset returns. Over the past 60 years, sharp recessions have tended to be followed by sharper recoveries. From 1946 through 2008, the U.S. economy grew at an average real rate of about 3.3%. But after the sharp recession of 1957–58 (the quickest drop of any post-war recession until 2008–09), the economy snapped back quickly and averaged about 5% annual growth from the low of 1958 through early 1968. Is the next decade likely to be as vigorous as that, more like the post-war historical average or something worse than that? How have economic policies influenced GDP growth in the past, and how might likely changes to those policies influence future economic conditions? What challenges are policymakers likely to face over the next decade?

To address these issues, we will first look back. How did we get here? What were the forces that generated the fine economic and financial market performance of the 1980s and 1990s? Why were equity returns so poor in this past decade? What were the forces that set the stage for the financial crisis of 2008 and the Great Recession?

A Brief History of Stocks: 1979–2009

In considering how the next decade might look, it may be helpful to examine how the economy and financial markets looked in 1979, before the Great Moderation began. (I remember that year well. I earned my Masters degree, got married, and launched my adult life.) In brief, 1979 was a time of great turmoil, with few hints of the wonders to come. The second OPEC oil shock hit. Inflation and interest rates were sky high. The top marginal income tax rate was 70%. Jimmy Carter was President, and in August, Paul Volcker became chairman of the Federal Reserve. In November, the Iran hostage crisis began. Japan was an ascendant economic power and seemed destined to dominate global manufacturing, as U.S. auto, steel and other industries seemed unable to compete. Microsoft was a tiny business that did not yet offer an operating system; the IBM PC had not been invented yet. GDP growth was very weak, and a recession loomed in 1980. It seemed to many as though the best days of the U.S. had passed.

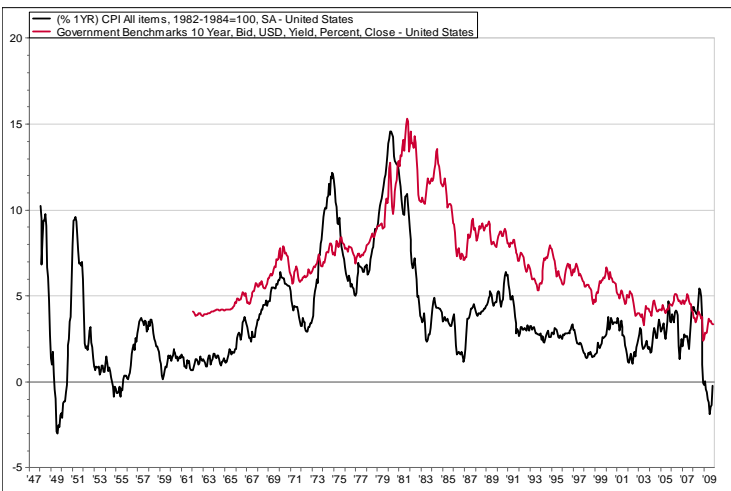
The 1980s did indeed get off to a rough start, with even higher interest rates and inflation and a double-dip recession before starting rapid growth in 1983. (By the way, for both Republicans and Democrats who are worried about President Obama's economic policies and performance, please recall that at the same stage of the Reagan presidency in Q4 1981, GDP fell over 4% and would fall another 6% in Q1 1982.) Before 1982 had ended, however, the stock and bond markets had begun the long bull market that lasted into the beginning of the 21st century. Why were returns so good for so long after the gloomy start? And might the gloomy 2009 outlook similarly lead to a long bull market?

Stock returns have two components: dividends plus the change in price. The change in price also has two components: the change in earnings times the change in what investors will pay for those earnings, the P/E multiple. In practice, the P/E multiple is largely driven by investor confidence or lack thereof. But analytically, the P/E is determined by the prevailing rate of interest (if rates are high, P/Es tend to be low), the long-term expected growth rate of earnings (though this changes very slowly over time, faster expected growth means higher P/E) and the extra return required by investors to hold riskier assets such as stocks (the risk premium; the more risk-averse investors are, the lower the P/E). In 1979, the dividend yield was high, almost 6% and the P/E multiple was quite low by historical standards, under 10x. That is, high inflation had led to high interest rates, and the gloomy economic backdrop of the time had resulted in low investor confidence and a very low P/E.

In the early 1980s, Fed Chairman Volker pursued an aggressively tight monetary policy designed to crush inflation out of the system. The Fed funds rate (near zero today) hit 20%. Unemployment soared, but eventually the plan worked, helped in no small part by the increased supply, reduced demand and much lower prices for oil. Inflation and interest rates began a long, fairly steady decline, as shown in Figure 1. Meanwhile, the P/E ratio (Figure 2), which generally moves in the opposite direction of interest rates, began a long ascent, rising in fact to its highest levels ever in the late 1990s and the early part of this decade. Investors went from morose to exuberant. In the 1980s and 1990s, the U.S. won the Cold War as the Soviet Union collapsed. U.S. technology companies not only became big drivers of productivity and economic growth, but also restored confidence in U.S. business acumen. Except for the early 1990s, economic and earnings growth was strong and remarkably steady. Every market dip turned out to be a buying opportunity. Investors projected that this happy combination would continue, so risk premia shrank and P/Es exploded.

Fig. 1

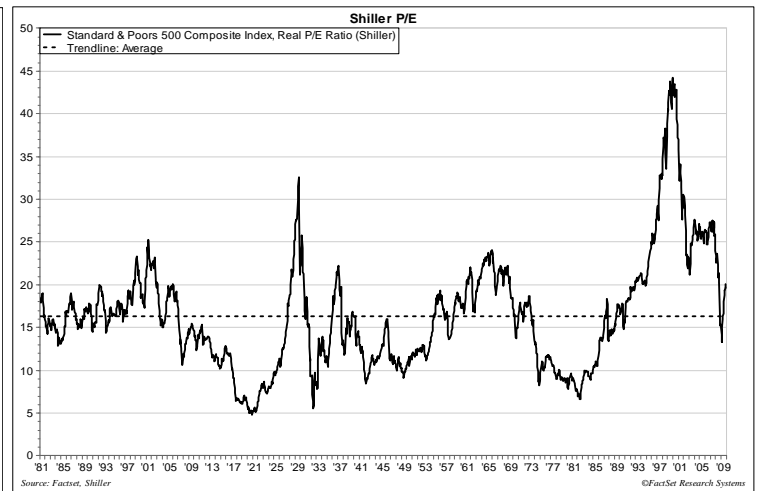
Inflation and Interest Rates Fell Steadily After 1982



Source: FactSet

Fig. 2

The P/E Ratio Went From An Historic Low In 1981, To A Record High In 1999



Source: FactSet, Shiller

Analytically, the 18% average equity returns of the 1980s and 1990s (almost double the long-term average) had three main drivers, which, for simplicity’s sake, we might think of as contributing roughly equally to the great returns:

- ◆ The initial dividend yield was high, almost 6%;
- ◆ Average earnings growth was solid, more than 6%; and
- ◆ P/E ratios soared from low to high levels, contributing about 6% to average annual returns.

That is, the rough current conditions and weak outlook in 1979 were reflected in low asset valuations and low prices. Moving from miserable conditions to wonderful conditions of relative peace and prosperity in the late 1990s resulted in a huge boost to asset valuations (P/Es). In retrospect, investors perhaps should have realized in 1979 that things would get better one day, and that stocks were selling for bargain prices. Likewise, in 1999 investors perhaps should have realized that their love affair with stocks was “too hot not to cool down.” But in both cases, it’s a lot easier to see this after the fact than it was at the time. Recall that Alan Greenspan’s famous “irrational exuberance” speech was made in December 1996, more than three years before the market peaked. If you sold after his comments, you missed a heck of a run.

Said another way, initial conditions matter a lot for future equity returns. Figure 3 provides the data, displaying average annual returns over the following 10 years as a function of high, medium and low readings on dividend yield, P/E and inflation. When current conditions are poor and prices and valuations are low, historically, they tend to get better. There is no guarantee that they will get better, and the timetable for improvement might be years or even decades. On the other hand, when everything looks great and stocks are priced for perfection, chances are that something will go wrong at some point, even if we don’t know what or when. High valuations increase the risk for poor returns, and low valuations increase the opportunity for good returns. If we examine the reason for the poor returns of this past decade, we could consider the same drivers as we did for the 1980–99 returns, based on initial conditions at the end of 1999 and subsequent events:

- ✦ The initial dividend yield was low, about 1%;
- ✦ Earnings growth was weak and hit hard by the Great Recession. S&P 500 earnings in 2009 will not be much different from what they were in 1999; and,
- ✦ The P/E ratio shrank from record high to about average levels, detracting from returns.

Fig. 3

**Historically Initial Conditions Have Been
Good Indicators of Future Returns**

Level	Range	Annualized 10-Year Ahead Equity Return
Dividend Yield		
High	5.3%+	13.50%
Medium	3.7 - 5.2%	11.80%
Low	Under 3.7%	7.70%
Dec. 2009 level: Low, 2.1%		
P/E		
High	17+	7.40%
Medium	12-16.8	10.30%
Low	11.9 or less	15.30%
Dec 2009 level: High, 20		
Inflation		
High	3.9%+	14.90%
Medium	1.65 - 3.8%	10.30%
Low	1.6% or less	7.80%
Dec. 2009 level: Medium, 1.9%		

Source: Shiller, Ibbotson/Morningstar

Of course, unpredictable events have a big influence on financial market returns. Would stocks have done better this decade had 9/11 never happened, oil prices not spiked and housing not boomed and busted, leading to the financial crisis and the Great Recession? Almost certainly, the answer is yes. But from the perspective of the future outlook from here, the key is that initial conditions have been a very important driver of future returns. Prices were so high in 1999 and valuations so stretched that almost any shock was likely to lead to a correction. Even if we could not have predicted the events of this decade, we should have been prepared for weak returns given the unfavorable initial conditions.

As 2009 draws to a close, the economy is recovering, interest rates and inflation are historically low and earnings appear likely to recover strongly in 2010. But the dividend yield is fairly low by historical standards, about 2%, and P/Es (measured in different ways) are about equal to or above their historical averages. We do not face the headwind of super-high valuations, as we did in 1999, but we do not have the tailwinds of low valuations. Short-term interest rates simply don't have any place to go but up, and inflation can't move much in either direction in a way likely to be good for the economy and the equity market. Our initial market conditions are not terrible, but they are not close to the level that has typically

preceded big bull markets. Figure 3 suggests that returns in the next decade are likely to be better than 1999–2009, but might struggle to hit historical averages.

What Caused The Great Moderation?

On December 2, 2009, Macroeconomic Advisors (MA) published a thoughtful piece titled, “The Great Moderation: What Caused It and Is It Over?” They cite a 2004 speech by then-Fed Governor Ben Bernanke in which he attributed the markedly less volatile U.S. economic growth beginning in 1984 to better policy, a more stable economic structure (more services, globalization, improved inventory management) and “good luck.” MA finds some support for better monetary policy, in the sense that inflation expectations have been lower and stable for many years now after the elevated levels of the 1970s. Yet when they model how the economy of the 1980s and 1990s might have responded to some of the economic shocks of earlier times, they conclude that the Great Moderation was largely due to fewer and less-dramatic shocks, i.e. good luck. Was that luck pure chance, or, as so often happens, did the economy help make its own luck?

MA argues that the likely driver of good luck was better information technology, which helped deliver smoother productivity growth and reduced the odds of excessive inventory accumulation and subsequent destocking/recession. They further argue that the big GDP drops of 2008 and early 2009 are not outside the statistical possibility of what we could have expected even with the lower average level of GDP variability since 1984. They hopefully conclude, “The technological basis for the smaller shocks means that the prognosis for the continuation of the Great Moderation is much greater than you might think.”

Although we all hope that MA is correct, and that solid steady growth will soon resume, let’s consider another possible explanation for the solid economic performance of the 1980s and 1990s: fiscal and tax policy. This might be especially important, because there is a strong possibility that the lower marginal tax policies of the past 30 years might soon change. If lower taxes lead to significantly stronger, more consistent growth, might higher taxes lead to lower, more erratic growth? As an empirical matter, how much have marginal tax rates influenced economic growth?

Marginal Tax Rates and Economic Growth: The Historical Record

What are the best economic policies for long-term economic growth and stability? Like many other things over the past generation, this seems to have become a highly politicized question. Republicans have generally favored lower tax rates and deregulation. Democrats have tended to favor more progressive taxation and more government services. Republicans will often cite the “unprecedented growth” that followed the Reagan tax cuts. Democrats will point to the strong growth of the Clinton years despite higher tax rates on higher earners as proof that their approach is superior. Yet in critical moments for the past 30 years, economic policy has been relatively bipartisan. In the crisis of the past few years, the Bush administration pushed a stimulus bill and the TARP legislation through Congress and supported aggressive and creative actions by the Fed to do “whatever it takes” to stabilize the financial system and the economy. The Obama administration also supported the Fed and TARP and created its own stimulus program. One might honestly debate the merits of various components of the plans, but faced with a crisis both a Republican and Democratic administration followed somewhat the same playbook.

Whatever their public rhetoric, both parties have historically tried to find ideas that worked for the economy regardless of their origin. The notion that tax cuts might invigorate the economy was conceived and first executed by the Democratic Kennedy administration. The 1986 tax reform law that cut the top marginal tax rate to 28% and eliminated many deductions was first conceived by a Democrat, Sen. Bill Bradley, before being enthusiastically embraced by President Reagan and the Republicans.

The Bush tax cuts are due to expire at the end of 2010. President Obama said during the campaign that he would let them expire for top earners. Further tax increases for higher-income Americans have been proposed to help pay for healthcare. Some states have sharply higher tax rates for upper-income Americans. There has been some talk of eliminating the cap on wages subject to Social Security taxes, which would result in a big tax increase for high earners. Would higher taxes on high earners kill economic growth, as Republicans claim, or would it not matter, since growth was just fine under Clinton, the tax rates we would revert to?

A former colleague of mine would always say that when you tax something, you get less of it. The underlying economic rationale of lower marginal tax rates has been that lower rates make additional work pay better at the margin, encouraging more work effort. Economists call this the substitution effect. If we choose to work X hours at a tax rate of 40% and the tax rate goes down to 30%, we will substitute work for leisure, because extra work now provides a big benefit.

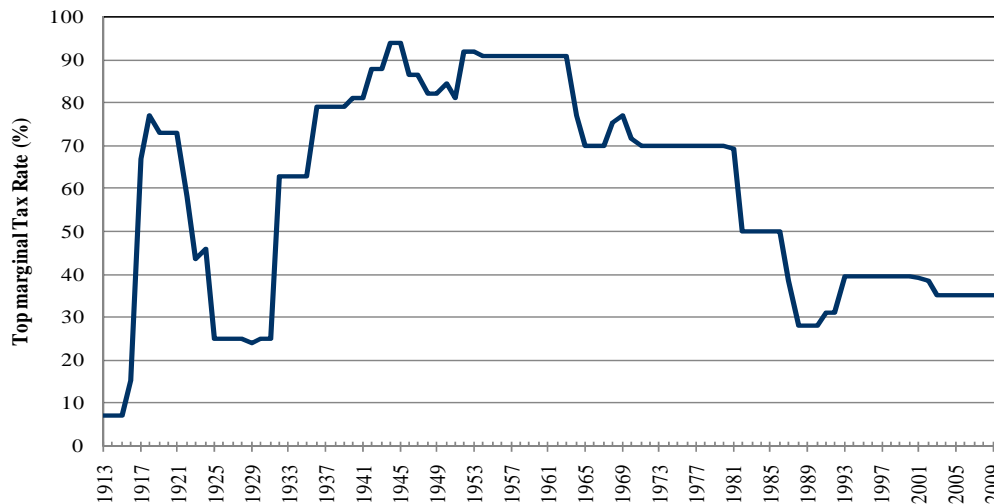
On the other hand, economists discuss the “income effect,” which says that we act so as to preserve our current income. In that case, a lower tax rate might result in less work, because one could obtain the same income with fewer hours worked. A tax increase might result in greater work effort, since higher earnings would have to work more to preserve their after-tax income and lifestyles.

So which effect is more powerful? A 2004 paper by Edward Prescott, “Why Do Americans Work So Much More Than Europeans?” argued that the answer to that question was lower marginal tax rates in the U.S. That is, the substitution effect dominated the income effect. If that is correct, then higher marginal tax rates would reduce work effort and possibly hurt economic growth prospects.

Figure 4 shows the top marginal tax rate in the U.S. over time. Prior to the first Reagan tax cut (the Kemp-Roth bill, 1981) the top marginal rate had been 70% or higher since the 1930s, and it had been over 90% throughout the 1950s. Granted, there were very few folks who paid the top rate (\$400,000 was really big bucks in the 1950s: Ted Williams, the highest-paid baseball player, earned \$125,000 in 1959), but those who did kept less than a dime for every dollar they earned over \$400,000. The Kemp-Roth tax cut dropped the top rate to 50%, and the Tax Reform Act of 1986 (sponsored by two Democrats, Sen. Bradley and Rep. Richard Gephardt, often referred to as the second Reagan tax cut) dropped the top rate to 28% while eliminating many deductions and exemptions. The first tax cut, signed by President Reagan in August 1981, was not exactly an overnight success (as noted above, the U.S. was in a steep recession in Q481 and Q182), but by 1983, a vigorous recovery was underway that some observers attribute to the Reagan tax cuts. Indeed the 1980s tax cuts have influenced policy to this day. The top rate has risen and fallen modestly, but it has been below 40% since 1986. The timing seems propitious. Did the lower marginal tax rate cause the solid and steady economic growth since 1983, the Great Moderation?

Fig. 4

**The Top Marginal Income Tax Rate Fell In 1981
And Has Stayed Below 40% Since 1986**



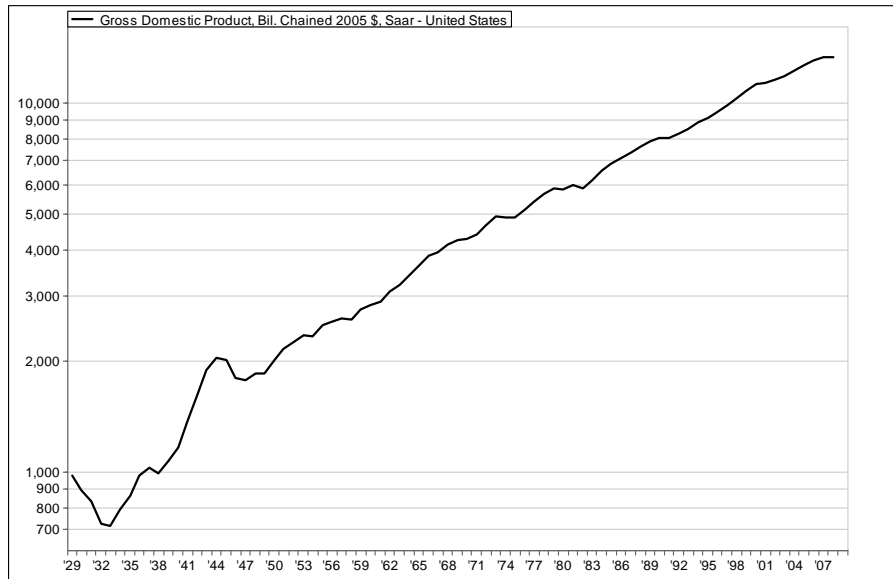
Source: IRS

As a very simple test, let's consider how much faster economic growth has been since the 1981 tax cut compared with the same length period prior to the cut, encompassing the stagflation 1970s, the high-tax 1950s and hippy 1960s. From 1981 through 2007 before the recent recession started, the economy grew at an average annual rate of 3.0%. In the same-length period prior to 1981, starting in 1954, the economy grew at an average annual rate of 3.5%. No, that is not a typo. The U.S. economy grew at a somewhat slower pace in the lower-tax era starting in 1981 than it did in the high-tax era that immediately preceded it. This result is somewhat sensitive to exactly when we start and end, but dropping the recession year 1982 and starting our analysis in 1955 makes the comparison 3.4% in the high-tax era versus 3.2% since the start of 1983. It doesn't change the basic conclusion that growth in the lower-marginal-tax era has been no higher than and perhaps a bit lower than in the prior high-tax era. How can that be? What about the "unprecedented growth?"

A 2001 study by the Heritage Foundation was at the top of the first page when I Googled "Reagan unprecedented growth." In a section titled "How Did Reagan's Policies Affect Economic Growth?" (which contained the phrase "unprecedented economic growth"), the report compares GDP growth from 1983 through 1990 (3.5%) with that of 1973 through 1982 (1.6%) and 1950 through 1982 (3.6%) and notes that "the Reagan boom restored the more usual growth rate." From a rhetorical perspective, it is hard to call something unprecedented that merely restores the status quo ante. But it also compares growth starting from the beginning of a recovery in 1983 to a peak in 1990 with a period that starts at a peak (1973) and goes through a trough in 1982 (the second year of Reagan's presidency). Any comparison of a trough to peak is going to beat a peak to trough by definition. Figure 5 provides a simple graphical way to consider this issue. It displays U.S. real GDP (\$2005) on a log scale since the 1920s. GDP has grown steadily since the late 1940s. Although the little dips in this graph were dramatic at the time, the economy has generally made steady progress whether the top marginal tax rate was high or low.

Fig. 5

The U.S. Has Had Steady Growth Since The Late 1940s



Source: FactSet

The fact is that the economy recovered quite vigorously from the double-dip recession of the early 1980s. President Reagan's policies probably helped significantly in that recovery. But the recovery from the recession of 1957–58 was much more vigorous, about 5% over a decade as noted above, despite a 90% top marginal tax rate. Economic cycles happen under Republicans and Democrats, when marginal taxes are high and low. Presidents probably get too much credit when times are good and too much blame when times are tough. Economic policies matter short term, but might not be the dramatic drivers of long-term growth that proponents claim. President Reagan had many successes, restoring American confidence, presiding over the end of Cold War and many other things. But to claim that his policies created “unprecedented growth” is simply inaccurate. Toward the end of his second year in office, the economy enjoyed a strong recovery, as we would usually expect after a nasty downturn, though not quite as vigorous as the recovery that started in 1958.

If low marginal tax rates did not cause the steady economic growth and great stock returns of the 1980s and 1990s, does that mean that going back to higher marginal rates won't matter and might even help? No. As the study referenced above, other academic research and common sense suggests that when you tax something you get less of it, and when you cut taxes you get more of it. Sharply higher marginal tax rates might ultimately prove necessary to pay for essential services, yet odds are they will decrease work effort and increase tax cheating. But if the lower tax regime of the past 30 years did not result in measurably faster growth, it seems to me that it is hard to prove that higher tax rates will automatically result in substantially lower growth.

So What Has Determined Economic Growth?

What did explain the slightly faster growth of the pre-1981 period compared with the more recent period? It wasn't productivity growth, which was 2.2% on average annually from 1954 through 1981 versus 2.1% since then; given the difficulty of measuring productivity, that looks like a draw. The answer is simple: from 1954 through 1981, the U.S. labor force grew at an average annual rate of 2.3%, whereas from 1981 through 2008, it grew at an average annual rate of 1.5%. In both periods, the workforce grew faster than the population (1.3% in earlier period, 1.0% in the latter). Hours worked grew somewhat more slowly than the labor force both before and after 1981 (1.5% and 1.2%, respectively), as part-time work became more commonplace; technically it is hours worked that drives output and GDP. The big gains in the labor force were driven by two factors: the baby boomers started entering the labor force in a big way in the 1960s, and women entered the workforce in much greater numbers in the decades after World War II. In 1950, fewer than 34% of women worked outside their homes. By 1980, that figure was 51.5%, and by 1998, it hit almost 60%, but it leveled out at about that rate. The labor force grew a bit more slowly after 1981 because the peak impact of these two big demographic changes had passed by then.

It's worth noting that the overall average level of productivity growth was about the same in the pre- and post-PC/computer/internet era. Perhaps MA is correct that information technology leads to steadier growth, but the level of growth was about the same before and after the IBM PC. *It suggests that as long as the broad consensus in the U.S. remains supportive of the factors that drive productivity—education, innovation, the rule of law, infrastructure, capital investment, etc.—then growth can be strong under a variety of economic and policy regimes.*

If the key driver of economic growth over the past several decades has been the growth of the labor force, then what can we expect for the decade to come? The Bureau of Labor Statistics (BLS) just released its long-term labor force projections, estimating that the workforce will grow by less than 1% per year through 2018. With unemployment at 10%, a labor shortage will not constrain growth for at least a few years. Almost as many Americans have lost jobs in the Great Recession (7 million) as BLS expects to enter the labor force (net, about 8 million) by 2018. If productivity growth stays at about 2%, real GDP growth could average almost 4% for five years without hitting major labor constraints. As painful as recessions are, and this one has been especially painful, the idle resources they create can increase future growth potential as they are put back to work. It's a lot faster, cheaper and easier to reopen a closed production line than to build a new one. It's much easier to rehire an experienced employee than it is to recruit and train a new one. I think the U.S. can achieve that growth without major inflation pressures. As I discussed in a November 2009 piece, "Is Inflation Likely to Accelerate?" an oversupply of labor is likely to keep wages and prices low for at least a few years.

Nevertheless, by the time we get to the second half of the coming decade, labor shortages might well develop, especially in critical areas such as healthcare. By 2015, about half the baby boomers will be at least 62 years of age, at which time they can begin to collect reduced Social Security benefits. Although actuaries will tell the boomers that waiting until normal retirement age (which is scheduled to slowly rise) makes financial sense, if boomers suspect that Social Security will go broke some day, they may grab the cash as soon as possible. Before the next decade ends we could see some real stagflation: slower growth with higher labor costs and inflation.

In February, the Fed published its first long-term U.S. economic growth projection, estimating growth of 2.5–2.7% from 2011 through 2017. While entirely consistent with the slower growth of the labor force, that's

about 0.7% per year slower than the post-war average GDP growth and about half a percentage point slower than the average rate over the past 30 years. I suspect that the Fed's estimate will turn out to be too conservative for the first half of this decade. It seems hard to imagine as we struggle with the legacy of the Great Recession, but eventually, the power of the business cycle is likely to reassert itself as it always has in the past. Idle resources will be put back to work and growth will probably be above average for a while. But as we peer into the demographic conditions likely to prevail in the middle of the decade—baby boomers retiring in large numbers, labor force growth stalling—2.5% might be a bit optimistic for growth in the latter half of the decade.

How Might Slowing Economic Growth Influence Stocks?

A reduction in GDP growth from the 3–4% level typical since the 1940s to 2–3% starting in a few years might not seem like much. Yet if that's correct the rates of returns on stocks will likely fall short of historical averages for two reasons: earnings growth is likely to be slower than it has been historically, and the average P/E ratio (which is a function of growth) is likely to be lower than it has been for the past few decades. U.S. firms might be able to grow earnings faster than the U.S. economy grows by selling even more outside the U.S. than they do today. The much faster growth of emerging markets offers some hope, but the base is currently small. Europe and Japan, two big sources of U.S. company sales, have even worse demographic issues than the U.S. and might face even slower growth.

To summarize the discussion in this section, although the U.S. enjoyed remarkably steady GDP growth from 1983 through 2007, coinciding with an era of lower marginal tax rates and deregulation, as a matter of fact, the level of growth was actually about the same as or slightly below that of the era that preceded it. Although we believe that higher tax rates might well hurt the economy and reduce work effort to some degree, the historical record does not necessarily indicate that higher tax rates in and of themselves will have a huge impact on growth. Tax policy is less important, in our view, than maintaining the policies that have supported solid productivity growth for the past 60 years: a strong education system, an environment that fosters innovation, strong legal and financial institutions, etc. Although there is always room for disagreement on how to sustain or improve these pillars of productivity, there is solid bipartisan support for keeping them strong.

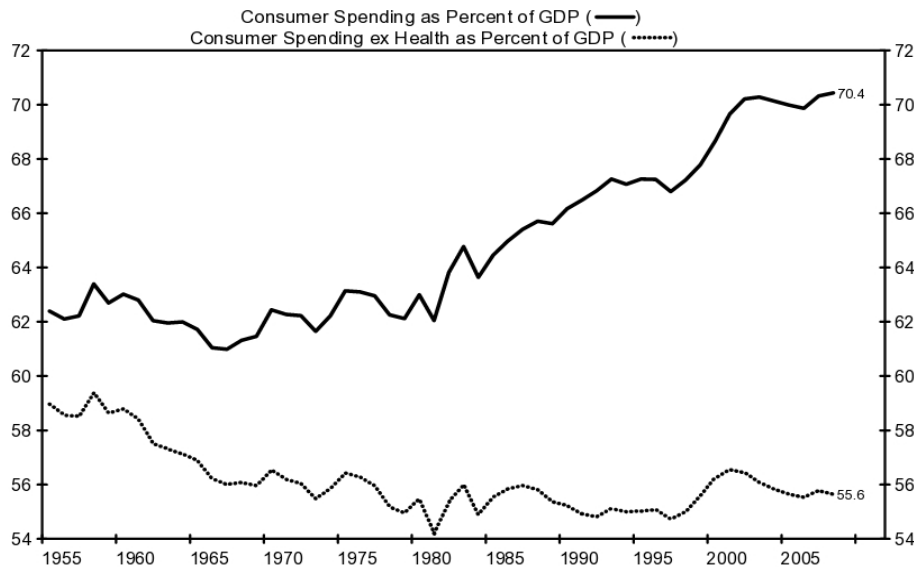
In addition to productivity growth, however, U.S. GDP growth for the past six decades has been assisted by favorable demographics, as baby boomers, especially women, entered the work force in large numbers. This howling tailwind for growth is about to diminish to a light breeze as baby boomers start to retire in larger numbers. For the next few years, the huge slack in the economy caused by the Great Recession will be taken up, and labor is likely to remain fairly cheap and plentiful, we think. But by the middle of the next decade, we fear that growth could slow again, and it might stay slow for a long time, even as scarcer labor becomes dearer, inflationary pressures rise and entitlement costs incurred by those aging boomers start to hit.

A Passing Thought On Healthcare

As long as we are delving into contentious issues, I might as well add a comment about healthcare. A discussion of the details of healthcare reform is far outside the scope of this paper. But I would like to insert a small economic point. According to *Time*, the American Consumer was one of 25 people to blame for the financial crisis, spending too much money on too many frivolous things and saving too little. As a result, consumer spending rose from about 62% of GDP to about 70% of GDP in a generation. The trend is shown clearly in the top line of the graph in Figure 6. But the bottom line of Figure 6 sheds a somewhat different light on this: it represents consumer spending on everything besides healthcare as a percentage of GDP. This number is actually a bit below where it was in the virtuous 1950s when savings rates were relatively high. All of the steep jump in consumption is due to healthcare expenses. Rather than big-screen TVs and trips to Vegas, we've been frittering our money away on CAT scans and colonoscopies, which doesn't seem quite so frivolous or nearly as much fun. Healthcare is steadily crowding out spending on other things. Efforts to control healthcare costs seem to have generated great controversy and appear to have been watered down in the bills under discussion. But the economic reality is that healthcare costs cannot continue to rise much faster than incomes indefinitely; that is a mathematical certainty.

Fig. 6

U.S. Consumer Spending Has Risen Mostly Due To Healthcare



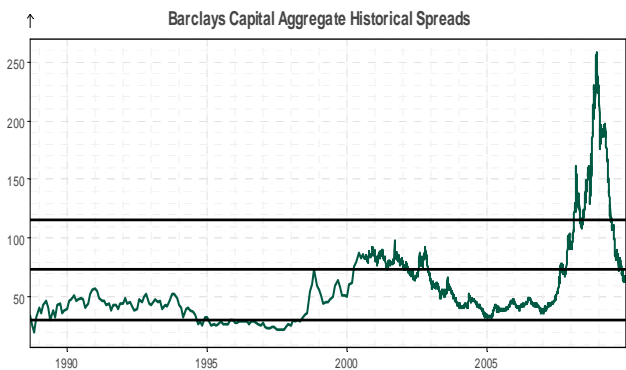
Source: TD Newcrest, John Aitkens, February 2009

What Caused The Great Recession? Is It Safe Now?

No look ahead can fail to consider the dramatic events of the past two years. How did we fall from the Great Moderation to the Great Recession? Are the problems fixed, or are we still vulnerable? Will growth pick up soon, as it typically does after severe recessions?

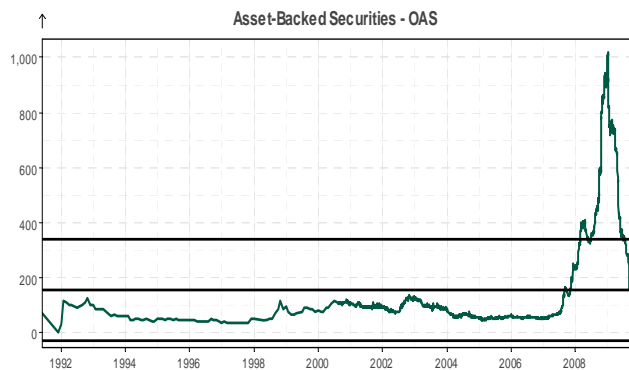
As discussed in an October 2008 piece, “The Financial and Economic Crises of 2008: How Did We Get Here, and How Might We Get Out?”, the first key to understanding the Great Recession is to realize that a global credit bubble drove the housing bubble rather than the other way around. If irrational demand for housing was to blame, one would have expected lenders to tighten terms offered to frenetic buyers as the bubble neared its peak. Instead, credit terms eased in 2006, even as the bubble began to burst in some parts of the country. Also, as Figures 7–14 show, spreads on all risky credit products narrowed to historical lows in 2005–07, suggesting it was a general credit bubble rather than one limited to subprime or even mortgages.

Fig. 7



Key Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change
Left U.S. Aggregate - OAS	63.215	19.690	258.139	73.171	42.473	2.218

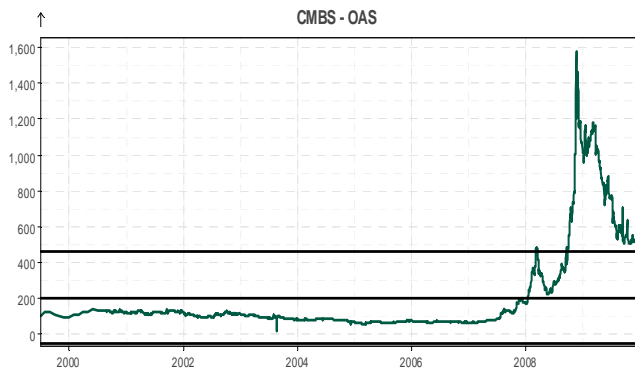
Fig. 8



Key Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change
Left Asset-Backed Securities - OAS	126.07	0.00	1018.41	155.83	183.50	9.18

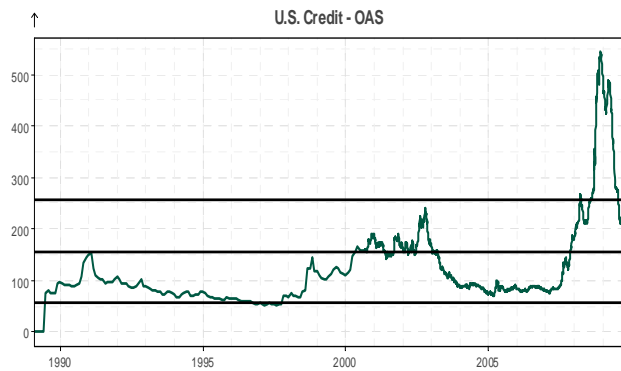
Source: Barclays Capital

Fig. 9



Key Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change
Left CMBS: Enisa Eligible - OAS	508.06	12.83	1581.37	201.13	259.02	14.83

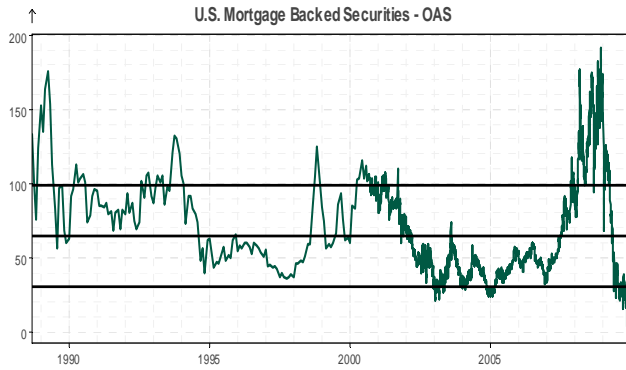
Fig. 10



Key Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change
Left U.S. Credit - OAS	174.69	0.00	545.04	156.13	99.28	3.46

Source: Barclays Capital

Fig. 11



Key Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change
Left U.S. Mortgage Backed Securities -	8.96	2.26	11/24/2009	191.78	12/03/2008	64.73 33.95 5.04

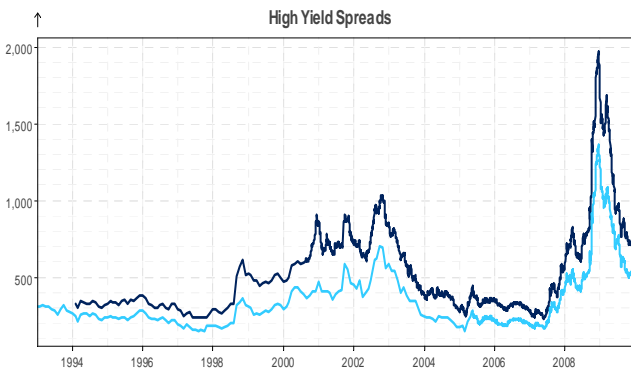
Fig. 12



Key Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change
Left Global Emerging Markets - OAS	348.971	129.775	05/23/2007	1058.015	10/27/2001	322.98186.65€ 8.588

Source: Barclays Capital

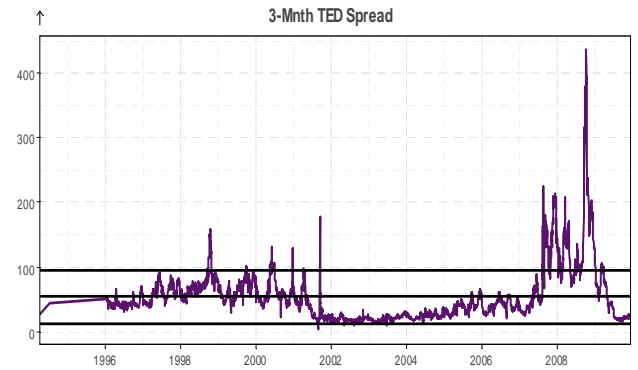
Fig. 13



Key Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change
Left U.S. Corporate High Yield - OAS	684.924	232.645	05/23/2007	1971.217	12/16/2001	608.23325.41€ 12.793
Left U.S. High Yield Ba - 2% Issuer Cai	505.315	145.501	07/31/1997	1361.657	12/16/2001	416.18279.671 15.420

Source: Barclays Capital

Fig. 14



Key Axis Name	Last	Minimum	Maximum	Mean	SD	SD Change
Left U.S. 13-Week Bill On-the-Run Proj	23.26	2.84	08/27/2001	437.53	10/10/2008	53.96 41.83 7.76

As we documented in that 2008 piece, the bubble blew to its gigantic size because the increase in the U.S. trade deficit from about \$100 billion to \$800 billion from 2001 through 2007 (to buy oil and Chinese products especially) resulted in a huge global increase in demand for fixed-income products. That demand was already high, as aging and wary baby boomers and the institutions that serve them rotated from stocks to bonds. There are always two sides to a trade. If I want to buy a bond, someone else has to go into debt. With demand for bonds so high, banks and brokerage firms cranked up mortgage factories to meet the demand for debt products with mortgage-backed securities, even if product quality was low. As Fed data show, banks ate their own cooking, and mortgage-related products became a bigger part of their balance sheet.

Looking back on it now, it might seem clear that the Fed or some other central government body should have stepped in around 2004 or 2005 to rein in the mortgage market. (Indeed, looking back on it now and suggesting how the key players at the time should have done it differently is becoming a sort of national

pastime, the mother of all Monday morning quarterbacking.) But Alan Greenspan had made it clear many years earlier that he did not believe that it made sense for the Fed to deliberately try to prick bubbles, but rather to clean up after them when they burst. President Bush had clearly run for reelection as both a free marketer and a believer in expanded home ownership (a view shared by key Democrats). The country had become highly dependent on real estate as a source of jobs, economic growth, wealth and ready cash. Pricking the bubble would not only have been against the clearly stated beliefs of the people in charge, it would have been deeply unpopular across the political spectrum and within the country. It is always impossible to prove a negative, as the architects of the frantic efforts to save the financial system from ruin and the country from Great Depression II are discovering. Efforts to prick the housing bubble in early 2005 because we would risk a global collapse in 2008 would have seemed absurd.

The Great Recession Started Like Many Other Recessions, Then Exploded Into Panic

The Great Recession had several distinct phases. At the beginning, it was similar to many other recessions. The country had suffered an oil price shock (although we seem to have forgotten what a big role the oil price spike played in starting this recession), draining purchasing power from consumers and hurting industries dependent on cheap oil, such as automakers. In addition, years of overbuilding had created a housing glut, a classic inventory accumulation similar to what we have seen in many other recessions. House prices had started falling nationally in 2006 according to the Case-Shiller index, but by late 2007 price drops accelerated, ending consumers' abilities to borrow freely against home equity. Stressed consumers, excess inventory and oil shocks were nothing new, so the recession started at the beginning of 2008 seemed much like many other recessions.

What made the Great Recession more ominous was the second phase: an old-fashioned, full-scale financial panic. Credit spreads, the difference between the yields on risky bonds and safe bonds issued by the Treasury had been at record-low levels in 2006 and the start of 2007. But by the middle of 2007, spreads started to widen, at first just back to more normal levels (*please refer again to Figures 7-14*). By late 2007 and early 2008, however, credit spreads started to widen dramatically, especially on anything mortgage-related. A few astute and fortunate souls had foreseen the fall of subprime and made a lot of money on the short side. But on average the financial industry was heavily long mortgages and depended on the value of that capital not just for their profits but for their solvency. As house prices continued to fall sharply in 2008, investors started to realize just how dependent and interconnected the financial world was, and the prices of the shares of some financials started to fall rapidly. If your capital starts to shrink because the value of the assets you hold falls temporarily, you can usually raise money to restore your capital position, and some firms did so. Unfortunately, Bear Stearns had simply too much mortgage exposure and acted too late to save itself. But with a big assist from the Fed, JP Morgan bought Bear, and for a while, stability was restored.

Unfortunately, the underlying problem was not solved. House prices continued to fall. And more investors discovered that it was not just subprime and adjustable-rate mortgages that were in trouble. Almost any mortgage written after 2004 was in danger of going under water, with the mortgage worth more than the underlying asset. Loss estimates started rising dramatically. And investors realized that it was not just residential mortgages that were in trouble. As the recession deepened, those loans made at record-low spreads in 2004–07 to commercial real estate, corporations, emerging markets and others seemed much riskier. By the summer of 2008 spreads on all products shot up as investors started to price in a “worst-case scenario.” Some analysts calculated that investors were pricing in implied bond default rates that were higher than actual defaults in the depths of the Great Depression. Not only did spreads leap higher and prices of

bonds plunge, but uncertainty about how bad the recession would get made even high-quality bonds hard to trade, as firms hoarded cash to try to survive. Liquidity vanished, and a full-blown panic started to set in during the summer of 2008.

After Lehman Fell, Another Great Depression Became A Real Possibility

That panic reached its climax when Lehman Brothers went bankrupt on September 15. To their horror, investors realized that many (probably most) major financial firms were technically insolvent. That is, their liabilities were worth more than their assets. It didn't take a genius forensic accountant to pore over a lot of arcane books and records to figure this out. Conservative financial firms operated with a leverage ratio of about 10:1. That is, they started with say \$100 million in capital, then borrowed and loaned out \$1 billion. More aggressive firms had leverage ratios of 30:1 or higher. The higher the leverage is, the greater the profit, as long as everything runs smoothly. If the loans you make earn 2% more than the money you borrowed to make the loans, in the 10:1 example above, the gross profit is \$20 million, a solid 20% return on capital. But with 30:1 leverage, the profit is \$60 million, a 60% return, enough to pay some mighty nice bonuses. But a conservatively run bank at 10:1 leverage is technically broke if the value of the loans it makes (its assets) falls by 10%. Note that this applies even if all loans/credits are being paid in full and on time; if similar credits now require higher rates, then, in theory the old credits are worth less and should be marked down, though the rules vary by type of credit and institution. An aggressive bank at 30:1 goes broke if its loans fall by just 3%. Well, at the height of the crisis, even high-quality (non-Treasury) bonds/loans were worth at least 10% less than they had been in 2007. Poorer-quality fixed-income portfolios were down 40–80%.

So even conservative firms with high-quality portfolios were close to insolvent; in practice, if every U.S. and European financial firm had had to market their portfolios to the highly stressed, illiquid market that existed in the days and weeks after Lehman fell, even the strongest probably would have had to admit that they were close to being technically insolvent, i.e. broke. Prior to Lehman, most financial firms probably figured that the government would arrange a merger or bailout for them if they really got into trouble, as had happened to Bear. But after Lehman, they feared that everyone might be allowed to fail.

Knowing they were technically broke, and fearing that nearly every major bank was broke, many banks feared lending to anyone, including one another. Banks usually loan one another short-term money at about the T-bill rate or just a few basis points more. In August 2001, the TED spread, as it's called (Figure 14) hit a record low of under 3 basis points (0.03%). On October 10, 2008, it hit a peak of 437 basis points (4.37%), fully 150 times the low and more than 10 times the level that had prevailed just 15 months earlier. To try to put this in context, imagine if your credit card interest rate went from 15% to 150% in 15 months. It would certainly put a crimp in your access to credit and willingness to borrow/spend. If banks fear that other banks might fail, the rational response is to limit exposure to them in any way possible. The spike in the TED spread in October meant that banks feared that almost anyone could fail. If the TED spread had continued to spike, it would have been a signal that banks were prepared to reduce transactions with other banks to the bare minimum, just as banks and investors had done with Bear and Lehman in the days before they failed. Simply trading stocks with these firms became risky, since in the few days between the trade and cash settlement a bankruptcy means that the funds are frozen, as sums transacted with Lehman remain to this day. So if the financial crisis had gotten worse, the transactions that banks might have wanted to limit could have included not processing certain transactions from other banks. People might not have been able to use ATMs from banks other than their own, or might not have been able to cash paychecks. A fast-moving downward spiral of public panic might have ensued, as more people recognized (as bankers and policymakers knew)

how perilous the situation had become. Bank runs might have led to numerous bank failures in quick succession, straining the resources of the FDIC and then the Treasury to contain them. A 1930s-like scenario of cascading bank failures and another Great Depression could have resulted from the panic spreading from bankers to the general public. However much they might be criticized today, policymakers managed to quell the bankers' panic and avoid panicking the general public.

Historians someday might be able to tell us how close we came to that descent into chaos in the days and weeks following Lehman's failure. Some terrific books (e.g. David Wessel's *In Fed We Trust* and Andrew Ross Sorkin's *Too Big To Fail*) have documented the frantic actions taken by policymakers, bankers and others to prevent collapse. Somehow, what they did worked. Some of the most reviled actions of the crisis, taken in the period after Lehman, seem to have saved the day, even if they were imperfect and are heavily second-guessed now. The rescue of AIG and its counterparties, aggressive injections of liquidity by the Fed, the passage of TARP, the force-feeding of TARP to the biggest institutions and other actions combined to ease the worst of the financial crisis by the end of 2008. Spreads on most instruments peaked in October or November. The stock market didn't bottom until March 2009, and high unemployment and the economic crisis continued throughout 2009. But the worst of the financial crisis had passed by the end of 2008, and further imperfect actions taken in early 2009 have so far prevented the panic from returning. Ironically, the success at preventing a public panic might be part of the reason for public anger today. Not realizing how close the nation came to collapse, and seeing that things are not nearly as bad as they were in the Depression, folks might think that policy actions were unnecessary or even harmful.

Yet the financial panic itself ushered in the third phase of the Great Recession, the sharp drop in real economic activity in Q408 and Q109. The actions taken by institutions and individuals to survive included a dramatic deleveraging and retrenching. Household and business budgets were slashed. New lending and borrowing plummeted and existing loans were paid down. The drop in GDP from peak to trough in this recession has been the steepest since the Depression, although it is still not close to being in the same league as the Depression. The economic conditions of late 2008 and 2009 are the worst that many Americans have ever experienced.

Technically, The Recession Is Probably Over, But It Doesn't Feel Like It To Many Of Us

The fourth phase of the Great Recession is underway as I write: the slow and painful recovery. Technically, the recession probably ended in the summer of 2009, since GDP was positive in Q309 and looks to be positive in Q409, thanks in part to aggressive federal spending. But for many Americans, unemployment or the fear of it is more important than GDP. Although the November reading showed a slight dip, the unemployment rate remains at 10% and more jobs are being lost than created. History suggests that the recoveries following financial crises tend to be slow, and even optimistic forecasters project a recovery much slower than might normally be expected following such a steep recession. Fed purchases of mortgage-backed securities and Treasuries are scheduled to end next year along with other programs designed to stimulate activity. Of course, forecasters of all types have had a poor record over the past few years, but so far it looks as though economic activity is recovering at a modest pace compared with the rapid recoveries that followed the steep recessions of 1957–58 and 1980–82.

Efforts to mitigate the Great Recession as well as the sharp reduction of tax revenues have also left an uncomfortable legacy: very high federal budget deficits. Although deficits can change rapidly (remember a decade ago when it looked like we might actually pay off the national debt due to huge surpluses?), it seems

fair to say that high deficits will continue for years, perhaps throughout the decade to come unless substantially new spending and tax policies are adopted. So far, the Treasury has been able to fund these deficits without having to pay substantially higher interest rates. But it strains credulity to believe that trillions of dollars can be borrowed over the next several years without having deleterious effects on the nation's economic health. Now might not be the ideal time, but in the not-too-distant future a serious attempt at limiting deficits is likely to be required. As it happens, this effort might hurt short-term growth prospects and asset prices. But to ignore the problem increases the possibility of another financial crisis, including the unlikely but scary prospect of a U.S. sovereign debt default.

Despite The Reasons For Worry, Might 2010 Surprise On The Upside?

A slow recovery with big deficits as outlined above is our base case for 2010. But there is a chance that we are being overly cautious. The key, we think, is the labor market. The November report was better than expected in every dimension. The December report, due January 8, 2010, might actually show job gains for the first time in two years. If it does, or if the next report does, it is possible that the basic forces that put resources back to work in every economic cycle might be starting to turn positive. Just as in a vicious cycle, bad outcomes lead to worse outcomes, a turn in employment can help spending, which can lead to inventory accumulation, more employment, higher housing prices, etc. Further, if growth turns out to be better than the 3.2% planned by the administration, then the Federal deficit will likely be lower. Also, fear of future tax increases in calendar 2011 will likely lead to acceleration of income to calendar 2010, helping increase taxes paid and reducing the deficit in fiscal 2010 (ending in October) and perhaps early fiscal 2011, which includes the last two months of 2010. If so, the upward pressure on Treasury bond rates and interest rates in general might not be as intense as now projected. We will be watching the data carefully over the next couple of months. If the recent trends of better employment (initial claims for unemployment look like a downward "V"), industrial production and other indicators continue to show sharp improvement, the decade might get off to a much better start than expected, improving the odds of avoiding bigger problems later in the decade

How Might The Great Recession Change The Investment Outlook and Investor Behavior?

How does the Great Recession influence our views of the economic and financial market outlook for the next decade? The first key thing is that it happened. That is, a few years ago I would have said that the odds that a severe financial crisis could occur and nearly drag the U.S. into a Depression would have been close to zero. In the Great Moderation, recessions had been short and shallow. I thought we generally had made progress in taming the business cycle. I argued that greater stability should logically be rewarded with a P/E ratio above historical averages. I was wrong. Minsky was right. Stability led to complacency about risk, which led to risky behavior that ended in tears. Investors might have short memories, but my guess is that at least some of the lessons of the Great Recession will linger. High equity valuations and excessive leverage are dangerous. During the boom years the book *Dow 36,000* argued that an equity risk premium was unnecessary, that stocks were just as safe over the long run as bonds. I doubt that we will see this argument made again soon. Risk premia should be higher now that we know that another Depression could happen. That will likely constrain valuations and limit outsized returns. In addition, having experienced a financial crisis and seen its dramatic influence on asset prices, investors might be more likely to run for the exits at signs of significant stress, raising future volatility.

History Suggests That Another Financial Crisis Could Hit In The Next Decade

One of the fascinating reads stemming from this crisis is Reinhart and Rogoff's *This Time Is Different: Eight Centuries of Financial Folly*. They identify commonalities in financial crises over the centuries. Time after time, they find, investors and political leaders make the mistake of thinking that they are smarter than those who went before and won't fall prey to the crises of the past. Alas, pride often goes before a fall.

Reinhart and Rogoff include a table (17.1) in their book that summarizes worthwhile predictors of financial crises. Among the best predictors of a banking crisis is a rapid rise in real house prices. As Homer Simpson might say, "Doh!" Among the predictors of other types of financial crises such as rapid inflation or currency crashes are high levels of government debt (uh-oh), a banking crisis (hmmm), high current account deficits and, well, you get the picture. We are not out of the woods. The nation has dodged a bullet for now, but the historical record documented by Reinhart and Rogoff suggests that the actions taken to pull us out of this crisis might have left us vulnerable to another one of some sort in the not-too-distant future. As they note on page 289, "policy makers must recognize that banking crises tend to be protracted affairs. Some crisis episodes (such as those of Japan in 1992 and Spain in 1977) were stretched out even longer by the authorities by a lengthy period of denial. Fiscal finances suffer mightily as government revenues shrink in the aftermath of crises and bailout costs mount."

What's Next?

What has our look back taught us about what might lie ahead for the financial market and economic environment? Here are our basic ideas:

- ◆ The higher volatility and below-average equity returns of this past decade are likely to continue. We do not think that the relatively placid, long, steady, strong bull run of the 1980s and 1990s is likely to come back any time soon. Quite simply, with an initial dividend yield of only 2% and valuations that are not low by historical standards, the initial conditions are not conducive to a prolonged bull market. Memories of the Great Recession and low levels of current inflation will likely prevent the sort of big run-up in P/E ratios that helped drive superior stock returns during the Great Moderation. Our guess is that equity returns in the next decade will be comfortably positive, but erratic;
- ◆ After a recovery from the Great Recession over the next few years, we suspect that economic growth for the second half of the next decade is likely to be significantly below the 3.3% post-war average, simply because the rapid labor force expansion (combined with solid productivity growth) that drove historical economic performance will be much slower once the unemployment rate moves closer to full employment. Higher marginal taxes might put a further damper on growth, but our analysis of the historical record suggests that this need not be nearly as big a factor as some fear;
- ◆ Although growth in emerging markets might be quite strong, slower growth in the developed world will likely lead to slower earnings growth compared with history. Slower growth might put pressure on valuations, hurting P/E as well as E;
- ◆ The next few years are likely to be challenging, but despite our longer-term worries, there is a chance that the start of the new decade might actually be fairly rewarding for investors. Although we think that there is the possibility of a soft patch in mid-2010 as public expenditures slow, in time pent-up

demand, inventory accumulation and the fading memory of the Great Recession might lead to some decent and perhaps surprisingly strong growth in 2010 overall. The business cycle has not been repealed, and despite the financial crisis stronger-than-expected growth might well emerge after this sharp recession. The labor market is key, and we will be watching the next several employment reports especially carefully;

- ♦ As we approach the middle of the decade, however, we think that substantial dangers await. If we are right that good growth will eventually follow the Great Recession, then slack in the system will be taken up. If markets behave themselves, baby boomers might rebuild their portfolios and decide to retire to escape higher taxes and get their share of Social Security while they can;
- ♦ The rising dependency ratio combined with huge federal budget deficits over the next few years could set the stage for another crisis around mid-decade. That crisis could involve inflation, a plunge in the dollar, a spike in Treasury bond yields (and a plunge in T-Bond prices), another recession or some combination of the above;
- ♦ The oil price surge played a dual role in the Great Recession. The outflow of dollars to oil producers led to recycling in fixed-income products that helped inflate the credit bubble. And the oil spike in 2006–07 sapped consumer purchasing power and helped get the recession underway. Yet 37 years after the first OPEC oil shock, the nation still does not have a credible, comprehensive energy policy to make us less vulnerable to these shocks. As the global economy recovers and demand increases, the same supply/demand pressures that hit a few years ago are likely to recur; and
- ♦ By the middle to latter parts of the next decade, entitlements (especially healthcare costs) are going to put extreme pressure on the federal budget. Yet both parties have exacerbated the problem by adding entitlements while shouting down the opposite sides attempts at reform. Democrats scuttled President Bush's attempts to partially privatize Social Security, and now propose to add an entitlement to universal healthcare. Republicans added a new prescription drug entitlement, and now seem to deride any attempt to contain healthcare costs as pulling the plug on Grandma. At this point, however, it looks as though the political environment is too poisonous to produce serious solutions to the fundamental issues of entitlements and energy.

As much as he was derided for saying it, John McCain was right when he said during the past Presidential election campaign that the U.S. economy is fundamentally sound. That does not mean that we have conquered the business cycle, but it does mean that we have the basic building blocks required for good productivity and economic growth. The U.S. has plenty of innovative entrepreneurs, a fine educational system, ample capital, good (if somewhat creaky) infrastructure, the rule of law, strong governmental institutions etc.

Yet the events of the past few years suggest that we have gotten a bit complacent and reactive. Since World War II, the U.S. has been on a roll, and despite this lost decade, still stands as the most powerful nation on earth. But there is no divine law that says this must continue. Indeed, Paul Kennedy's *Rise and Fall of The Great Powers* finds plenty of examples of once-dominant nations that took their good fortune for granted and fell from grace. Some of the issues that felled other powers—war, debt and corruption—might someday bring the U.S. down as well. We have not had the will or the willingness to compromise and sacrifice that it would take to solve some rather glaring problems we've known about for decades: energy and entitlements.

We lacked both the foresight and the will to head off the credit and housing bubbles that drove us into the Great Recession.

I suspect that the Great Recession has provided a wake-up call to millions of American families, prompting a reevaluation of spending, saving, planning and basic priorities. Alas, so far, the political system seems to be more intent on avoiding responsibility and assigning blame. That suggests to me that further crises and volatility lie ahead. I wouldn't be shocked to see a strong start to the new decade, as idle resources find work and the business cycle works its wonders. If growth is robust over the next few years, it will provide resources to tackle energy and entitlement issues, if the political system can find the will and a way to address them. As noted above, in both the recent and distant past, there has been a history of bipartisan cooperation on economic matters, despite the sometimes strident rhetoric. Further crises are quite possible, but if policymakers focus on possible sources of future instability, especially the rapid rise in U.S. sovereign debt, rather than trying to fix the causes of the past crisis, there is hope.

So if I'm correct that the pattern of equity returns over the next decade will be solidly positive though volatile, looking more like 2007 - 2009 than 2004-06, more like the 1970s or 1930s than the 1980s and 1990s, how should investors prepare their portfolios? Of course, finding investment managers who can add value and generate alpha will be important. But for many investors, both institutional and individual, I suspect that the management of risk will be more important than the management of returns, an observation Benjamin Graham made in the 1930's. Institutions are adjusting to the new requirements of the Pension Protection Act and liability-driven investing. Individuals are trying to find true diversification, having discovered in 2008 that correlations for risky assets can rise far above historical averages during periods of extreme market stress. I suspect that variable annuities will gain favor, since they provide a way to participate in upside potential while seeking to limit downside risk. As much as derivative products have been shunned as "weapons of mass destruction," my guess is that certain derivatives may become more important as investors discover their value as a way of potentially limiting or focusing risk exposures. The investment environment might favor the nimble rather than the inflexible. Providing income while protecting against inflation, creating capital gains while limiting downside risk, and designing a portfolio to survive possible currency swings, as well as financial, economic, political and other crises will be a daunting task in the decade to come. None of us will consistently get it just right. But we will do our best to develop the tools, techniques, policies and procedures to help our clients survive and prosper in the new "Age of Turbulence."

Ed Keon
Managing Director
December 31, 2009

Derivatives - A portfolio's investments in derivatives may rise or fall more rapidly than other investments. For some derivatives, it is possible for the portfolio to lose more than the amount it invested in the derivative instrument. The use of derivatives may not succeed for various reasons, including unexpected changes in the value of the derivatives or the assets underlying them. The use of derivatives may accelerate the velocity of losses in a portfolio.

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