The healing game

The developed world suffered through the sharpest contraction in economic activity since the Great Depression during the credit crisis-inspired recession of 2008-2009. In response to the financial crisis, U.S. policymakers pulled out all the stops (both fiscal and monetary) to try and offset the collapse in private sector demand associated with balance sheet deleveraging. The remedial effect was to bolster near-term growth prospects, backstop the banking system and help stabilize global financial markets. While the initial impact was largely cyclical in nature, evidence is emerging that these efforts are now contributing to a broader structural healing of the economy and markets. This “healing game” has implications for the way that investors should view both the opportunities and risks within portfolios going forward.

From cyclical to structural
On the surface at least, there is little to suggest that the economic outlook has been altered that much on a structural basis over the past several years. After all, real GDP growth in the U.S. has ranged between just 1.8% and 2.4% over the past three years—a surprisingly narrow band for a post-war recovery—and is unlikely to move much outside that band this year either. But while growth may appear similar on a quantitative basis, there are important qualitative differences that point to this structural healing of the U.S. economy. This is not only a function of aggressive policy responses, but also a reflection of the resilient and dynamic nature of the U.S. economy. Consider the following:

• The balance sheet deleveraging process appears to have progressed more rapidly in the U.S. than in other areas of the developed world—at least in the private sector. The ratio of personal debt to disposable income has fallen from a peak of 135% in 2007 to just 110% currently, while nearly $1 trillion in fresh capital has been injected into U.S.-based financial institutions. This suggests that much of the growth impact from private sector deleveraging is now behind us.

• Although private sector deleveraging efforts are well-advanced, the federal government is now in the process of fixing its own balance sheet. Yet, despite the additional fiscal austerity that will ultimately be needed, we estimate that the year 2013 is likely to be one of maximal fiscal drag and that the adverse impact of fiscal policy on growth will also wane after this year.

• The Congressional Budget Office just slashed its deficit estimates by over $200 billion for the 2013 fiscal year, and also lowered its projections for 2014–2023 by about $620 billion. While much of the improvement is admittedly cyclical, it does reflect the extent to which the economy is on firm enough footing to absorb this level of fiscal consolidation.

• There has also been a compositional shift in the growth drivers over the past three years. Initially at least, the recovery had been underwritten by federal government largesse with the impact concentrated in selective rate-sensitive sectors. The recovery has since broadened and deepened, however, with the private sector increasingly leading the way as rate-sensitive sectors such as durable consumer goods and housing are responding increasingly to the ultra-low interest environment (see Fig. 1).

Playing the back nine
These positive economic developments, however, may also mark the beginnings of a “pivot” in the extraordinary monetary policy support that has made the healing game possible. A normalization of monetary policy will clearly take years to carry out. However, Fed Chairman Bernanke has started to signal that the Fed is already discussing tapering asset purchases either this year or next. An end to asset purchases will eventually follow, as will a higher federal funds target at some point much further down the road. Regardless of when this occurs, investors are now operating in a very different environment than the one that has prevailed since 2009. To borrow a simple
golf metaphor: With the sun now out and the winds having shifted, we will need to play the “back nine” a bit differently than the “front nine.” The near-obsessive focus on both safe haven and income-oriented investments must continue to give way to a more balanced approach that selectively embraces growth. Keep the following in mind:

- **Implement tactical asset allocation.** Asset class return dispersion has increased substantially this year, and selectivity within asset classes will remain important (see Fig. 2).

- **Reduce excess cash balances, and fully invest equity portfolios.** Despite the sharp rerating of U.S. equity markets over the past three years, multiples should continue to grind higher as structural growth prospects continue to improve.

- **Turn to cyclical stocks in the U.S.** Investors that retain high dividend-focused equity portfolios should implement a program to shift to relatively cheap cyclical sectors.

- **Shift emphasis from income-focused investments.** Recent market action following more balanced commentary from Ben Bernanke illustrated that defensive “high-dividend” equities and other income-focused investments could begin to lag as the Fed gradually “pivots” on monetary policy.

**Conclusion**

The deleveraging of balance sheets has progressed at a steady pace in the U.S. since the end of the financial crisis—especially within the private sector. And while it is far from complete, this does suggest that the economy is now on firmer footing and more able to withstand the impact from fiscal drag. This broader healing also means that investors must change the way they position portfolios going forward as the healing game progresses. Keep in mind that selecting the right golf club is every bit as important as how well you swing it … whether from the tee, the fairway, the green, the bunker—or even the rough.

**Let’s talk about it**

The above was taken from CIO Wealth Management Research’s **UBS House View**, “Ice-skating Through the Markets,” (June 2013). To obtain a copy of this report and discuss how its research insights might bear on your portfolio, please contact a UBS Financial Advisor.