The $1.7 trillion exit - where to from here for the US?

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Central banks and governments launched massive stimulus and rescue packages in 2009 to stave off a Great Depression and to stabilise the financial system. Government spending and central bank assistance in the US and UK amounted to a whopping 70%-90% of GDP last year. These numbers include all stimulus packages, bail-outs and government guarantees for bank deposits in the US and UK. Not only is the US government running a huge budget deficit, but intervention by the US Federal Reserve (the Fed) has resulted in a $1.7 trillion injection into the US economy. The cost of government intervention has been high. However, the liquidity boost helped to stabilise asset prices and the financial sector. The US housing market is also on the mend, thanks to the Fed buying mortgage-backed securities on a massive scale. Housing in the US has become much more affordable for the average household and prices are no longer falling.

Sovereign default risk has become a concern to market participants with Greece and Dubai debt levels under scrutiny. With signs of a global economic recovery under way, some investors expect interest rates to go up in the US and since the middle of January markets have started to look soggy. Investors are nervous that central banks will start raising rates and that asset prices will fall sharply as a result of this monetary tightening. Concerns over debt levels have also overshadowed markets. How do the US authorities exit from the $1.7 trillion stimulus and pay back the mountain of debt? This will be a key issue for the next 12 to 18 months. The "patient" is still on life support – when will the US Federal Reserve pull the plug? Essentially there are three scenarios:

1. **The US authorities repay their debt over time.** This would mean that the Fed starts offloading the securities it has bought, selling government treasuries and mortgage-backed securities into the market. Effectively, the central bank withdraws money from the financial system and together with government, becomes a much smaller player in the economy. The housing market looks set to recover, so there may be an appetite again for mortgage-backed securities. The selling of securities raises interest rates and the repaying of debt is a long process that would lead to extremely low economic growth. A key risk would be falling asset prices.

2. **The US authorities deflate their debt.** Deflating or lowering the real value of debt can be achieved by creating inflation and/or letting your currency weaken against other currencies (depreciate). The US authorities have a huge amount of debt to service, fortunately all dollar denominated. Hence, it's beneficial to create some inflation and to have a weaker dollar, as it helps to lower the value of debt over time. The challenge is to create a moderate level of inflation that satisfies everyone. The US has no debt in foreign currencies; therefore, the debt is only a problem for the creditor nations who hold the paper.

3. **The US authorities default.** This would mean that the US does not repay the interest on its debt and/ or the capital sums involved. As improbable as it sounds, in 1840 ten US states chose not to pay their debts. Of course, if this were to happen today, it would lead to markets crashing. Fortunately, this scenario is highly unlikely. Greece as a nation has spent half of its independence in some form of default.

We believe that a combination of scenario one and two is likely. If the US only focused on repaying debt, it could take many years to get rid of its financial liabilities. History also suggests that when countries go through a period where their debt relative to GDP starts shrinking, they actually end up having below average economic growth. The road to financial and economic health is painfully slow. Usually when the focus is on debt repayment, savers get rewarded in the form of higher interest rates. Currently there's no incentive for people to save in the US. Positive interest rates would actually encourage savings. However, we don't expect interest rates to go up in the US over the next two years, as the authorities need a stronger economy and higher inflation to help them repay their debt.

Premature to be concerned about US rate hikes

The monetary authorities will only increase US interest rates when inflation becomes a concern. Money supply in the US is growing at 2% and depending on which measure you use, inflation is running between 1.5% and 3%. So debt deflation hasn't caused a massive inflation problem yet. Inflation is only likely to become an issue once the US has enjoyed at least four consecutive quarters of 4% real growth. When strong growth has been established, unemployment will taper off and wages and house prices will start rising significantly. Under such circumstances, the US Federal Reserve could start selling mortgage-backed securities, reducing the value of its liabilities. Clearly, this will take some time to happen and we believe that it's premature to be concerned about the US hiking rates.

Expect lower rates of return, but there are opportunities to outperform the market

The US already seems to be following a combination of the first two scenarios. The authorities' actions are helping to stabilise asset prices. However, it's not a great environment to generate high returns because if one can't gear (borrow), one can't earn an additional return. We believe the dollar's depreciation, particularly against the euro and against the yen, is largely over. Emerging markets should deliver reasonable growth, which is generally positive for emerging market equities. However, countries such as Brazil, China and India's stock markets have run too hard, pricing in very high levels of future growth. The valuations of some South African shares also look stretched.

We favour stocks that have exposure to the high growth emerging market story, but have the low developed market rating. Essentially this means that we prefer stocks with a low rating, but which have strong underlying earnings growth because of the positioning of the businesses. Many of the stocks that we are very excited about happen to be listed in the developed world, but they have strong exposure to emerging markets. We have taken advantage of these opportunities through our international allocation. There are also stocks with similar criteria listed in South Africa such as MTN, Standard Bank and British American Tobacco. Local equity valuations require stronger commodity prices, higher earnings growth rates than forecast, and sustained low interest rates. We see more risks in domestic oriented companies than foreign oriented companies listed on the local bourse.

We expect select quality equities to outperform bonds and cash over the next few years. Despite tough conditions, there are opportunities to outperform the market. We are confident of producing moderate inflation-beating returns over the long term, despite potential near-term setbacks.

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