MV Capital Management Thought Content Series: Markets in Transition

The Price of Illusory Growth

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How the mighty are fallen, seemingly by the day. Whether the personal scandal of some prominent celebrity in the field of sports, politics or the media establishment, or the business malfeasance of a trusted corporate name with blue chip pedigree, we citizens are the unfortunate witnesses to ceaseless revelations of wrongdoing on the part of the privileged and famous. No wonder that poll after poll validates the sinking esteem we have for our national institutions in all walks of life.

The latest act in this sad vaudeville of disrepute is Toyota, long regarded as the bluest of blue chips in the global manufacturing sector. Toyota's fall from its lofty Valhallan heights as the world's pre-eminent automaker is a tale of short-sightedness and bad decision-making in and of itself – as simply delineated as a medieval morality play. Sacrificing legendary quality on the altar of market share, losing one's soul for the sake of a few basis points of ephemeral bragging rights – this is a tale of human folly we know all too well.

Indeed there is a larger story here, one that explains why we continue to call this series of commentary pieces "Markets in Transition". This transition is not just some cyclical rotation of economic ups and downs – for example out of financial institutions and homebuilders and into some other industry sector with promising growth. There is some of that, to be sure. But the big-picture transition is about something else entirely: it is about the complete and utter breakdown of a business model that logically led to Akio Toyoda's teary appearance before the U.S. Congress to apologize for the deaths resulting from his flagship company's decision to relax its famously stringent quality standards in favor of gangbuster market share growth. That business model has left plenty of debris along the way, from Enron's spectacular fall in the early years of the last decade to the predatory hucksterism of mortgage lenders like Countrywide to the risk-heedless cramdowns of trillions of dollars worth of junk paper peddled as investment-grade securities by the Olympian gods of Wall Street. That business model has lost whatever validity it once had, and our economy needs a new one if growth – real, not illusory growth – is to resume. Where is that *vox clamantis in deserto* - the voice crying in the wilderness as a harbinger of that which is to come?

Sometimes it doesn't seem like that old business model is broken at all. Wall Street's performance in 2009 showed how quickly one can bounce back from disaster when hundreds of billions of dollars are showered on you. As long as the denizens of Wall Street are out there doing what they always do – baying for higher quarterly earnings and punishing any companies that don't scrape together every last iota of growth from quarter to quarter, heedless of the economic, environmental or social cost – as long as that's still the business law of the land then what, really has changed?

In fact a great deal has changed, it's just that we don't see that change reflected in the headlines every day. But here it is. The business model that eventually led to Akio Toyoda's walk of shame before Congress had its antecedents in the early years of the Great Bull Market of 1982-2000. It was all innocent enough at the time. In an environment of rapidly declining interest rates (from the stratospheric levels of the early 1980s), falling inflation and at the same time doing away with financial regulations like caps on interest rates and restrictions on interstate banking, financial institutions discovered the allure of growing the consumer sector of the economy through making it ever-easier to borrow money and buy things. For the better part of the entire time since the Second World War personal consumption had accounted for about 65% of US GDP, year in and year out. That changed radically during the bull years.

From the mid-1980s to the latter years of the 2000s personal consumption expenditures (PCE) climbed from 65% to 72% (which in GDP terms amounts to an economic shift of trillions of dollars). Consumer spending was always a larger piece of the GDP pie in this country than elsewhere (western European nations typically have about 55% of their economic output represented by consumer spending). Americans are shoppers by nature. But the whole business model of the Great Growth Market was to make that number even higher. Banks devised new credit market instruments whose sole purpose was to get people to spend more money on more things during more hours of every calendar day of every year. Some of these credit innovations were aimed at people – from ubiquitous credit cards to zero-percent financing for durable goods like cars and washing machines, interest-only mortgages and all the rest of it. Those credit innovations fueled the demand side. But the banks also fed the supply side. "Speculative grade" credit instruments, otherwise known as junk bonds, were the perfect institutional counterpart to the new retail credit market. Companies that 20 years earlier would never have been approved for bank credit lines were able to tap the junk bond market for financing and, with the new capital, find some niche of the growing consumer goods and services market to fill. So the seemingly virtuous circle was complete – people could borrow more money to buy more things, and companies could raise enough money to build and supply the things that people wanted to (or didn't even know they wanted to) buy. And the financial institutions happily supplied both sides of this equation and kept the wheels of the consumer economy well-oiled.

Now, there's nothing inherently wrong with the model we just described. But for this model to be sustainable in the long run the prosperity of the nation must be on a continual upwards trend. US household incomes grew nearly continuously from the 1950s through the early 1970s, then stagnated for a few years, then resumed the upward trajectory in the 1980s and the 1990s. But as the '80s and '90s wore on the growth in household income partly concealed a disturbing underlying trend: in many industry sectors actual per capita wages were not advancing much at all in real terms. The rise in household income was due more to the growth over this period of dual-income households than a real appreciation in the earning power of individual Americans. Which on the one hand was fine – indeed, households had more money to spend when two incomes were at work for them, and that made Americans more able to consume more things. But at some point the dual-income household ceased to be a growth phenomenon and simply settled into stasis. From the end of the 1990s to the end of the 2000s real household income was essentially flat. But the borrowing continued – and the level of borrowing rose so that by 2008 the ratio of average household debt to average household income was 133%, a historic high.

Here's where we come back to the morality tale. That business model of the 1980s and 1990s had been successful – so successful, in fact, that the expectation of permanent growth embedded itself firmly into our business and financial culture. But those levels of growth could no longer be achieved – not in an economy where the actual real income that people went out and earned every day was not only not improving, but in many sectors was actually starting to decline. Wall Street kept demanding growth, and those who were doing well by the system – from stock option-laden CEOs and top executives to professionals who could bill $500 an hour or more for a wide range of professional services – had no desire to be the one left standing when the music stopped. So: corners were cut, standards were lowered and laws, such as they might actually exist, were sidestepped with the help of powerful lobbyists and clever legal minds to finesse the actual letter of the law.

Not everybody cut corners and sacrificed integrity to hit those growth targets – but enough decision-makers in enough institutions did so that the problem became systemic. It was "systemic" in the sense that the system itself encouraged bad behavior – and at the same time the governance model transitioned from governmental regulatory oversight to the concept of "self-regulation". Conventional wisdom formed around the idea that regulation was bad – a hindrance rather than a protection and the less of it the better. This conventional wisdom was entrenched in the institutions that brought the financial house of

cards down in 2008. Over a year later the hangover from this conventional wisdom showed itself once again in the faulty gas pedals and myriad other problems besetting Toyota.

And that, in the end, is why the business model truly is broken and, surface appearances of normalcy notwithstanding, is unlikely to power another sustained economic growth run. Our economy is spent on the bubbles that were ultimately the only energy source for this model. Wall Street may have earned record profits last year, thanks more to generous handouts than to any innate brilliance on the part of its movers and shakers, but the model that Wall Street built has lost its luster and so has the Street itself. Already the financial institutions sector accounts for a smaller chunk of the economy than it did three years ago – and you can expect that to shrink even further. So back we turn to that voice crying in the wilderness, showing us a glimpse of that next growth model. How will we recognize it when we see it? That is the question, not only of the year but of the decade.

With warm regards,

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