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Looking at the lost decade and beyond

It remains to be seen whether the U.S. will follow in Japan's footsteps and continue an economic slide

SUMMING IT UP

William Rutherford

Much has been written about the lost decade of Japan, which has now become two decades. Now the United States has lost a decade of its own, which hopefully will not also become two decades.

In the 1980s the Japanese economy became overheated: the Nikkei index reached nearly 40,000 but eventually collapsed. Today it stands at about 11,000. The low point of the Nikkei of the last 20 years was about 7,500. In spite of massive spending efforts by the government and near-zero interest rates, Japan has never recovered. Even now, the Japanese economy appears to be headed lower, and deflation seems more likely than inflation.

In the 1990s, the U.S. economy became overheated gyrating from highs to lows to highs under the Greenspan Federal Reserve. Finally, the bubble burst and the economy suffered its greatest setback since the Great Depression. The response of the Federal Reserve was to keep interest rates very low for a very long time. The Fed feared deflation, and Greenspan wanted more than anything to be renamed Federal Reserve Chairman. With interest rates low, every segment of the economy took on leverage. With a government policy that wanted everyone to be a homeowner, housing was inflated. With very little supervision, toxic financial instruments grew to enormous proportions along with spurious banking practices.

For its part, Japanese borrowing by 2008 reached 172 percent of its GDP, according to the CIA, as the government sold bonds to finance giant stimulus programs. The borrowing percentage is even higher today. Interest rates continue to be nearly zero. These are the conditions in the U.S. today. Will we fare any better than Japan?

The decade of the '90s ended with the sharpest drop in the U.S. economy since the Great Depression, eclipsing the drop of the beginning of the decade. The Dow Jones industrial average has suffered a 9.3-percent drop in the past decade, the first time the market has dropped over a 10-year period since the Great

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Depression. And that doesn't count the losses in purchasing power caused by inflation, or the effect of taxes on returns. The S&P and NASDAQ fared even worse, down 24 percent and 44 percent, respectively. The dollar retreated almost 13 percent during this time, so overall it has been a very bad decade for investors. In the meantime, commodities such as oil increased 210 percent in price, while natural gas declined. Metals, led by goal's 279-percent jump, generally soared.

Being in the right sector of the market was important but also required nimbleness. Technology stocks, for instance, are down 52 percent for the decade in spite of a 63-percent increase last year. Consumer goods were up 37 percent in the decade, in spite of the collapse of the automobile industry. Health care was up 21.7 percent in the decade and financials were down 20.6 percent as many banks collapsed or had to be propped up by the government.

Homeowners saw their home values fall while the cost of a pair of jeans at Gap soared 20 percent, the cost of a Big Mac jumped 10 percent, and a year in college rose 10. No wonder people felt less wealthy and feared the future. Job losses mounted.

The government's massive stimulus program and spending may not have lifted the boat, but may have prevented it from sinking further.

We can expect more of the same from the government. It will borrow massive amounts to fund programs and leverage itself beyond any previous measure. Like Japan, U.S. will borrow more than its GDP, and interest rates will remain low. Will the U.S. also experience another lost decade, or will there be a divergence? Is today a historic buying opportunity or will there be doldrums? We have many problems ahead of us.

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absorbed, and as I have said before, we cannot begin a recovery until house prices stabilize. Unemployment remains stubbornly high and may go higher, although there is some evidence of business hiring. Commercial loans must be rewritten or commercial property will suffer the same fate as homeowners. Banks may have to absorb yet more losses, and they know it. Banks have been hoarding money to save themselves, at the expense of other businesses. The commercial lending market has not stabilized, and must do so for any recovery.

Consumers are still de-leveraging their balance sheets at the cost of spending, although Christmas spending was stronger than most expected. Profits will recover as businesses continue to cut costs dramatically. Employment will follow, but we need some more top-line growth, which means consumer spending. With interest rates low, the dollar remains under pressure, but this helps export growth. The question is whether investors will continue to buy U.S. treasuries in the quantity they are being offered. And, by the way, how much of the debt is actually being sold, and how much is the government simply printing money to pay creditors? There are many questions to be answered before we can know our future path, and by the time we answer them it will be too late to act.

What we can see is that during the last disastrous decade, those investors who had a prudent asset allocation of 50 percent bonds, 25 percent stocks and 25 percent international stocks, and who stayed the course, and who invested $1000 per month with annual rebalancing, saw their portfolio rise 250 percent against the 24-percent loss of the broad market. That isn't a bad result for slow and steady.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the nation's leading separate account managers. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com.