



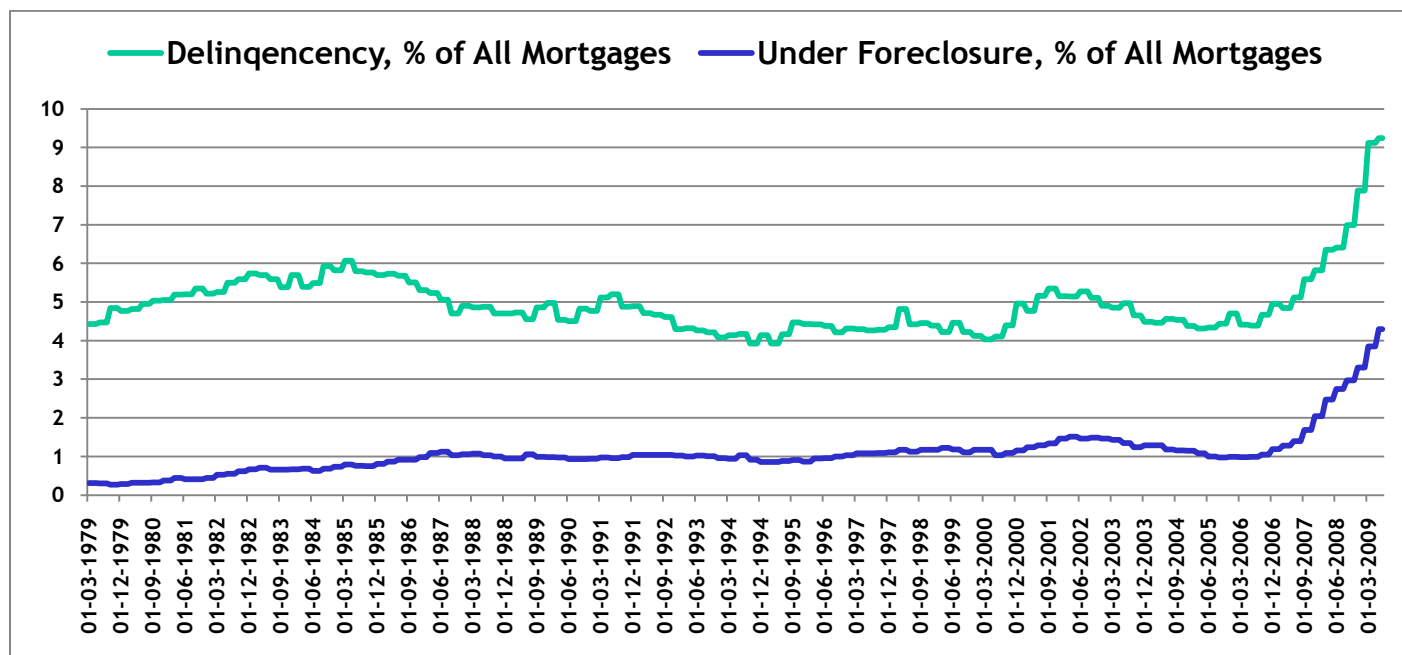
Where is the pent-up demand?!?

Saxo Bank Research Note September 2, 2009. Chief Economist David Karsboel

Please tell me!

Yes, we respect the momentum in stocks. Yes, we can see the stimulus - both monetary and fiscal. Yes, there might be “cash on the sidelines”. Yes, frightened fund managers might be chasing their benchmarks. Yes, the recession has been long and deep. Yes, housing has become so much cheaper. Yes, earnings have already dropped a third. **Yes, we can!**

But please tell me where the pent-up demand is? Show me how the roasted demand-pigeons will fly into the mouths of the priced-for-perfection equities. The rally in equities seems to imply that Western consumers have set aside thousands of dollars and Euros in every one of the bubble years. But if that is the case, why are they continuing to default on their debt obligations? Indeed, why are they spending less and less and paying off more and more of their debt? Why are “cure rates” (i.e. the share of delinquent mortgages that begin generating cash again) on even prime mortgages collapsing? According to the Fed, 6.49% of all US bank loans and leases are now delinquent - the most since 1985, when data began.



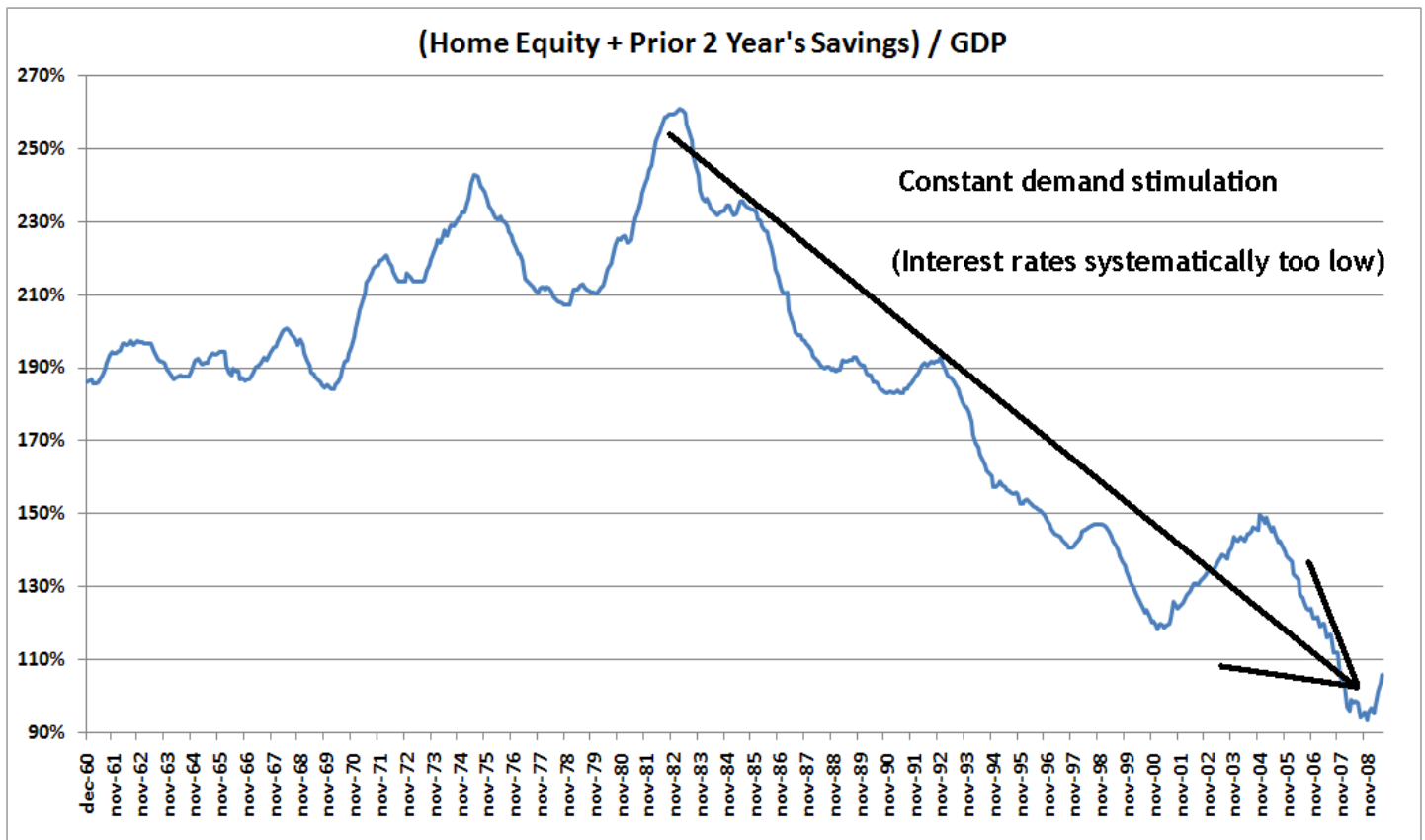
Source: Bloomberg

To me, it looks like the consumers have finally hit the wall where there is essentially no pent-up demand left. After decades of systematic and constant demand stimulation via artificially low interest rates and the emergence of the “demand-driven economy” (as if there ever was any such thing!), we have succeeded in borrowing so much from future demand that our present GDP has

been overstated by 10-30%. How many resources have been put to use in order to make American consumers push their excessive debt-financed consumption to new highs? How many malls, shopping centers, financial intermediaries, debt extension companies and SUV dealers have been set up for which there is no long-term use? And by how much has that overstated prior GDP figures, since these types of companies were mal-investments and need to be written off?

Pent-Up Demand

There is no fixed definition of pent-up demand - the demand that Keynesians assume will be released if rates are cut enough - but if we assume that it consists of the last two years of savings and the home equity, the following picture emerges:

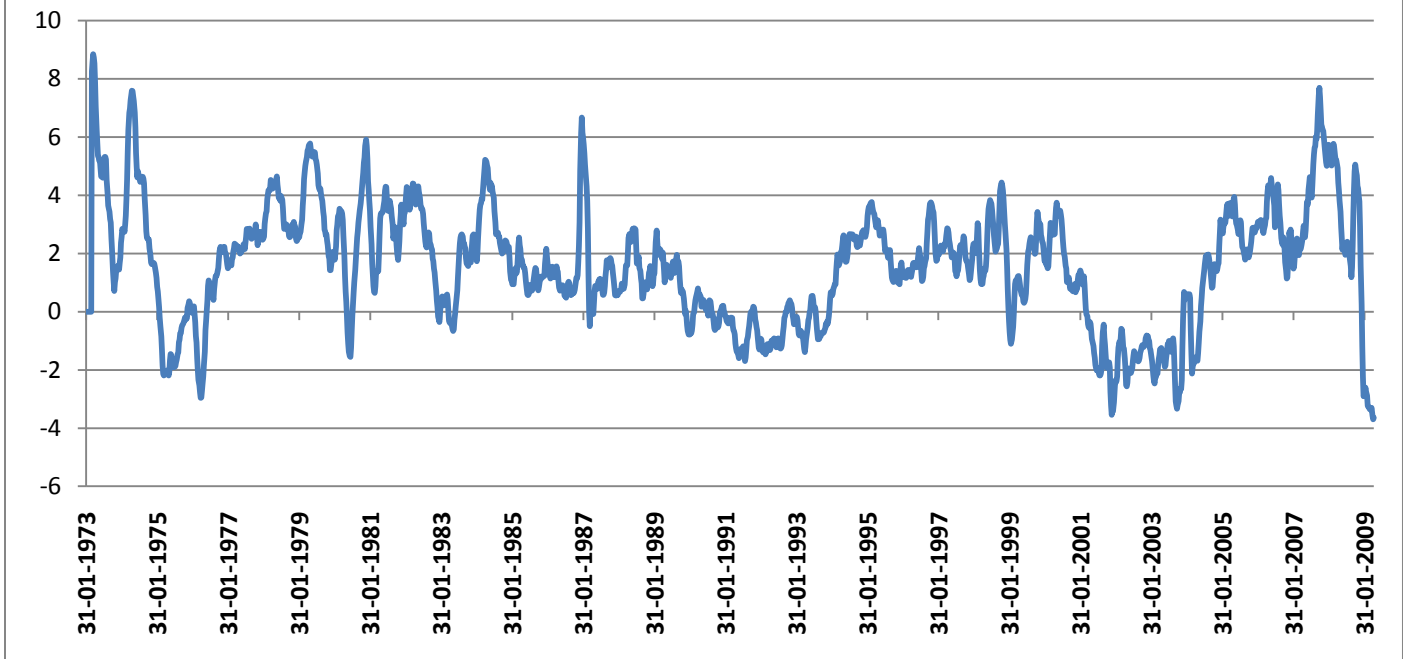


Source: Bloomberg + Saxo Bank Research

Note, how much pent-up demand policy-makers could unleash in 1982 by cutting rates or taxes. The total pool was more than 250% of GDP. Today, as a result of persistently low savings rates and massive home equity extraction, the total pool of pent-up demand is below 100% of GDP - and only rising due to a higher savings rate in recent quarters. In other words, the pent-up demand by this definition has never been lower since 1960.

This is why the Keynesian central bankers can't sleep at night: Their eternal demand-stimulation does not work any longer. The pent-up demand is non-existent (by historical standards) and therefore cannot be released, even if rates are aggressively cut. Total bank lending has dropped almost 6% from the top in late October 2008. That has never happened before. The picture is the same in the Eurozone and (of course) in Japan:

US Banks: Commercial and Industrial Loans and Leases YoY



Bank credit is being reduced because de facto insolvency is widespread in the financial system and because there is no effective demand for new credit. As long as consumers are frightened of being laid off, the savings rate will stay high and probably approach the level of the 60s and 70s. Too many consumers have become painfully aware of how much they have depended on credit lines from the bank system and how much that means in today's world.

Demand is going to disappoint

The Keynesians never get tired of telling us that 70% of GDP is consumption. This is obviously a misleading statement - as if we can consume ourselves rich. If we want growth in the Western economies, this percentage has to come down and investment and savings should be higher. This is the only long-term solution to the extreme difficulties that we are confronted with. Only by growing our capital base will we be able to increase production and growth. It is time we learn from the Chinese or simply look in the history books and be inspired from how the economy of our ancestors could grow even though they didn't consume 70% of their income immediately.

The future economy of the Western countries will be investment-driven - if driven at all. Unfortunately, it also means that the companies that are most dependent on consumption will be underperforming in the years to come. Demand is permanently impaired and will not come back to 2007 levels soon.

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