



Weekly Market Commentary

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Highlights

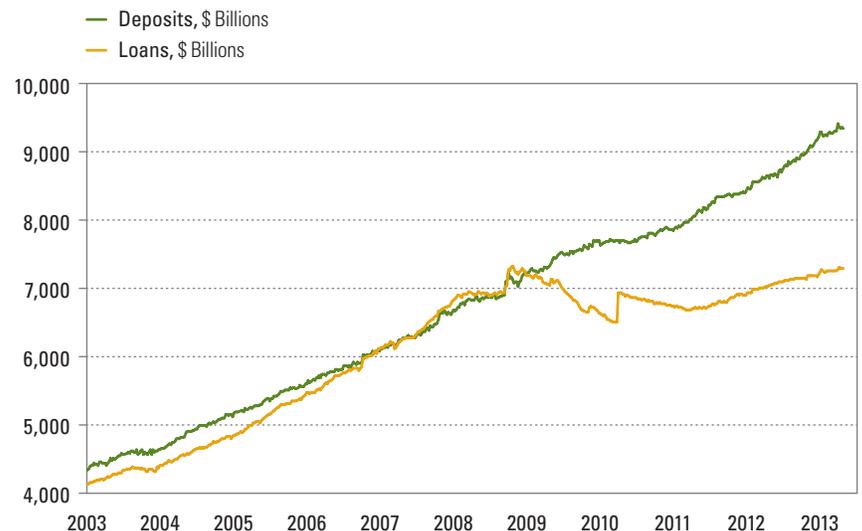
After waging a war on debt for the past several years, it may be the war on debt itself that may be bad for growth.

Borrowing for the Future

A recently detected error in a study by Harvard economists Reinhart & Rogoff has garnered much attention in the financial press lately. The study had initially concluded that once a country exceeded a 90% debt-to-gross domestic product (GDP) ratio, the pace of economic growth slowed sharply. The corrected data reveal that growth slows as debt-to-GDP rises, but at a pace not meaningfully different than at other round numbers. The study raised the issue of whether large amounts of debt are really bad. After waging a war on debt for the past several years, it may be the war on debt itself that may be bad for growth.

Credit, or the ability to borrow, has earned the honor of being recognized as the underlying force for growth of the past 250 years. Industrialization is often cited as the source of growth and massive improvement in GDP per capita since the mid-1700s. This is true, but what made industrialization possible? The answer, of course, is the expansion of credit to businesses and individuals who employed it productively. European colonialism in the 1600s and 1700s expanded international trade and fostered the creation of financial markets that then supported and enabled industrial growth in the 1800s and 1900s. As credit became more plentiful, economies began to grow more rapidly, and living standards improved.

1 Unprecedented Gap Between Saving and Borrowing

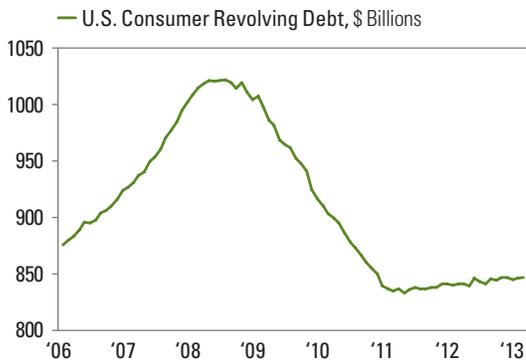


Source: LPL Financial, Federal Reserve 05/06/13

We may be shunning debt in the wrong places.



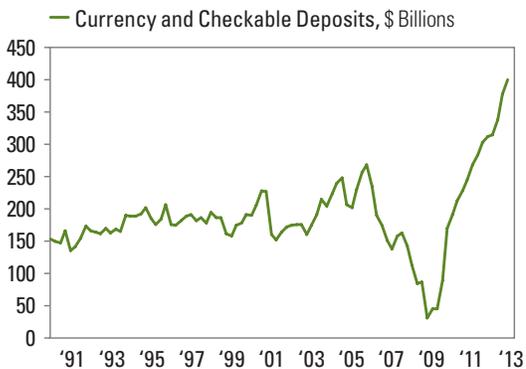
2 Consumer Credit Card Debt Growth Has Flatlined



Source: LPL Financial, Federal Reserve 05/06/13

Given their high cash balances, businesses have less need to borrow to spend; however, they are hesitant to even spend their cash.

3 U.S. Businesses Accumulating Cash Rather Than Spending It



Source: LPL Financial, Federal Reserve 05/06/13

The return of U.S. R&D to pre-recession levels has not materialized.

It may seem odd to praise taking on debt in the current environment. Certainly, too much debt is a bad thing for anyone. But too little can be equally disastrous. Lack of spending and investment can become a self-reinforcing downward spiral for an economy. Borrowing can be a good indicator of growth. The pace of loan growth is often a precursor to spending and hiring that drives growth and the markets. Where we see borrowing, we see hope for a brighter future.

Unfortunately, we may be shunning debt in the wrong places. While the U.S. government continues to accumulate debt, corporations and consumers have largely avoided borrowing. The preference for savings over borrowing can be seen when looking at banks' balance sheets. Banks are not lending at the pace deposits are growing. There is an unprecedented gap between bank deposits and loans, as you can see in [Figure 1](#).

While borrowing by individuals for home and auto purchases has started to revive over the past year as the Federal Reserve (Fed) has pushed down financing rates to unprecedented levels, consumers have been hesitant to use their credit cards [[Figure 2](#)]. This has resulted in core consumer spending tracking the meager pace of income growth.

Given their high cash balances, businesses have less need to borrow to spend; however, they are hesitant to even spend their cash. In total, U.S. businesses over the past 20 years have typically kept between \$150 and \$250 billion in cash, or currency and checkable deposits, on hand. Currently, that total is double that average and continues to soar, as you can see in [Figure 3](#).

Importantly, research and development (R&D) spending is weak. The return of U.S. R&D to pre-recession levels has not materialized. The 2013 *R&D Funding Forecast* created by *R&D Magazine* using data from the *National Science Foundation's National Patterns of R&D Resources* data indicates that, even before accounting for the looming sequester, total U.S. R&D investment in 2013 (most of which is conducted by businesses) is expected to decline in real dollars, with growth of only 1.2% compared with an inflation rate of 1.9%. Lack of investment can become a self-reinforcing downward force on growth.

We will be watching the March 2013 consumer credit report due to be released this week on Tuesday, May 7 for signs that borrowing may make a comeback and drive innovation and growth. If not, the pace of economic and earnings growth may remain weak or even weaken further and imperil recent gains. ■



IMPORTANT DISCLOSURES

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

International and emerging markets investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

Credit Risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

This research material has been prepared by LPL Financial.

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