

# Hoisington

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## Quarterly Review and Outlook *Second Quarter 2003*

### Is the Bull Market Over For Bonds?

“The bull bond market is over” has echoed repeatedly over the past several years. Currently, the pundits presume that monetary policies here and abroad will successfully reflate the global economy, but, failing that, fiscal policy is ready and able to do the heavy lifting. We doubt that governmental policies are in a position to reflate. Monetary policy must be capable of generating a sustained borrowing and lending cycle, and the economy must at least go through a period of debt repayment or “cyclical debt deflation” before a renewed borrowing and lending cycle can begin. At this juncture even a mild debt deflation would have significant repercussions. Looking at historical precedent, monetary policy did not work in similar debt deflation situations in the 1930s, nor in Japan in the 1990s. Today, staunch advocates of the power of monetary policy have doubts, including Milton Friedman, the founder of the modern school of monetary economics, who stated that rigid monetary targeting might be ineffectual.

Fiscal policy is no more potent than monetary policy. Current evidence is that since the first quarter of 2000, the Federal budget has swung from a surplus of \$223.2 billion annual rate to a deficit of \$275.3 billion annual rate, the largest net federal stimulus since the Korean War. Yet, the economy has languished.

### Another False Dawn

Several short-term developments have given rise to the view that at long last the economy is making the turn to sustainable above-trend growth. These include: (a) the economy’s ability to post occasional gains in isolated recent economic indicators, (b) the rise of stock prices over the past several weeks, (c) a decline in the dollar in 2003 that will presumably

boost exports and retard imports, (d) a lack of a full-blown deflation and announced reflationary policies, (e) the belief that a July tax cut including federal rebate checks will boost consumer spending to produce higher growth. These short-term developments are no more important now than in the past when similar forecasts of an upturn in the economy were just as widely proclaimed.

The U.S. economic problems remain structural rather than cyclical. Fundamentally and simply, the private sector is too deeply in debt (Chart 1). All major measures of consumer leverage are worse now than at year-end. The increased borrowing has coincided with a further depletion of pent-up demand for vehicles and homes. To establish the basis for healthy long-term growth, the economy needs to repay debt (at least cyclically) without such debt deflation leading into price deflation. Unfortunately, for the economy, the debt deflation, which frequently leads price deflation by several years, has yet to happen. If we are correct that the expected benefits from monetary and fiscal policy will prove to be fleeting and modest, then the persistent nature of the economy’s problems will become much more apparent.

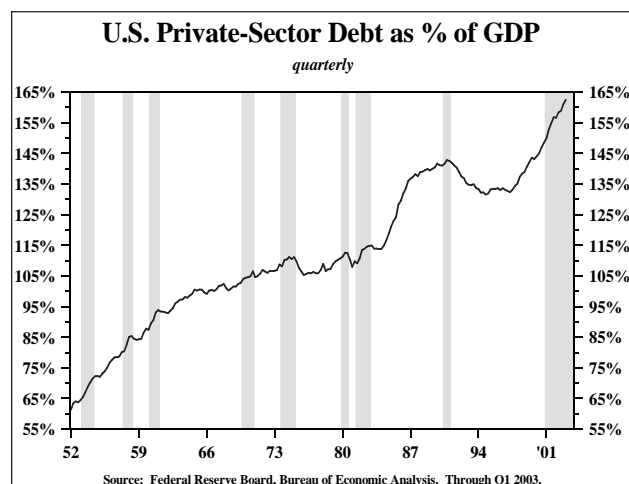


Chart 1

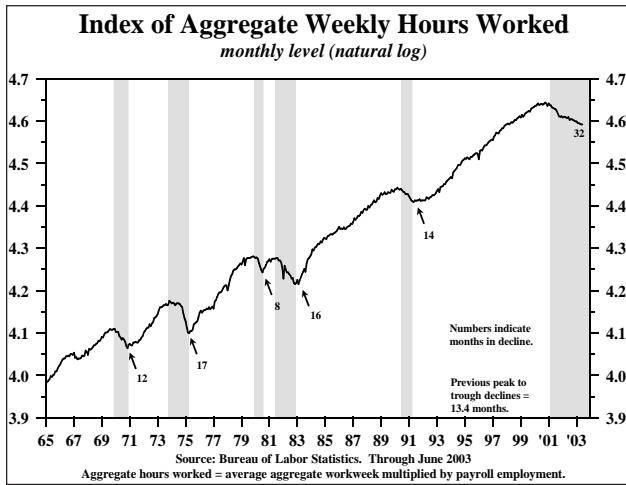


Chart 2

## No Jobs

The most disconcerting aspect of the current economy is that job and other labor indicators continue to deteriorate as they would in a recession. After a record setting 28-month downturn, 3.1 million private sector jobs have been lost. Firms have also been reducing hours for those who remain on the job. The impact of these dual developments is clear in the reduction in the index of aggregate hours worked (Chart 2). As of June, this index has been in a sustained downturn for 32 months, eclipsing the previous record setting 16-month decline during the 1981-82 recession.

On the surface the weakness of hours worked may seem inconsistent with eight consecutive quarterly gains in real GDP. Importantly though, unit volume,

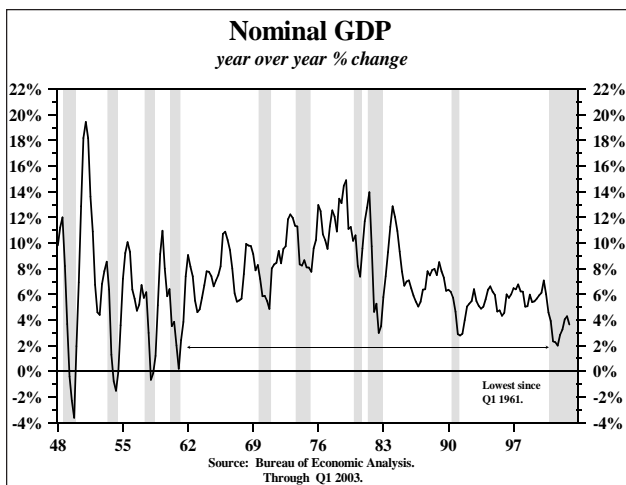


Chart 3

or real GDP, has risen due to price-cutting and expenditure control, not top-line economic growth, or nominal GDP. Nominal GDP has gained less than 4% over the past twelve months. In the second quarter nominal GDP probably inched ahead at less than a 3% annual rate. Such a lowly pace barely exceeds the slowest growth of the past four decades (Chart 3). Without top line growth, firms lack the resources to hire, spend for capital projects, and engage in routine corporate activities.

## Debt Deflation Still Lies Ahead

The past five decades produced seven episodes with two or more quarters of net debt repayment or “cyclical debt deflation.” One instance was a prolonged strike against General Motors that spilled into the “Credit Crunch” of 1966. All others were associated with six twentieth century post-war recessions. Contrary to the pattern in the twentieth century, this first recession of the twenty-first century has not yet resulted in a moving of funds from spending to debt repayment. Indeed, the economy has continued to become increasingly leveraged. In the latest quarter, U.S. private sector debt surged to \$1.62 for every \$1 of GDP, a sharp 3.7% higher than just a year ago (note Chart 1). This suggests that the process of mal-investment or over-investment in the private sector is continuing. At the margin, the problem is the continued acquisition of depreciable goods by consumers, which has been funded by the issuance of mortgage debt rather than by current income. This continued equity take-out of record mortgage refinancing has resulted in homeowners’ equity dropping to a record low 55.2% in the most recent quarter.

While corporations have not added leverage to their balance sheets, neither have they been able to reduce debt. This suggests that corporations have moved very slowly in their efforts to rationalize the huge excess stock of non-productive plant and equipment they acquired in the 1990s or write off the worthless good will on their balance sheets created by over-priced acquisitions made from 1995 to 2000. The ratio of total debt to net worth of non-financial corporations equaled the interim peak of 53.2% set one year ago (Chart 4). Thus, corporations still face the process of allocating a portion of future income streams to debt reduction.

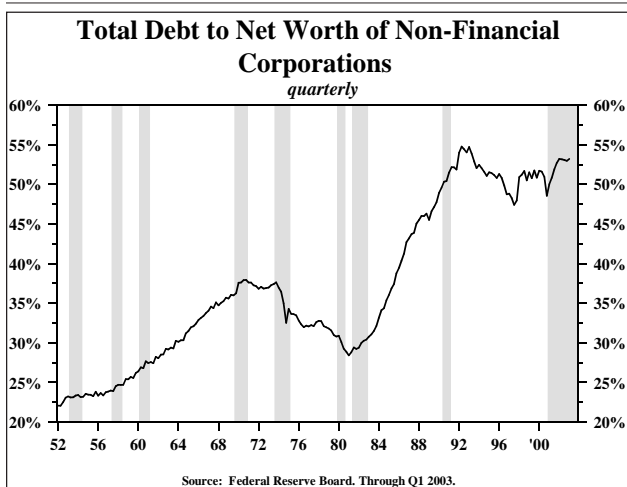


Chart 4

## Problems of Debt Deflation

When both businesses and consumers begin to divert funds from spending to repayment of private sector debt, the effects will be profound. First, the core inflation rate will be driven down from its current 1.2% pace. During and after the post-World War II recessions the core personal consumption expenditures deflator fell by an average of 2.9%. Second, interest rates will be forced lower. This phenomenon will reflect notably the normal relationship of lower inflation and weak credit demand, but also the attempt by the Federal Reserve to bolster economic activity.

However, a third and more serious problem could arise. This process of debt repayment (in the context of the current low level inflation) could drive the economy into a mild deflation that would lead to two additional consequences: (1) the increase in the purchasing power of money, and (2) the reduction in the underlying value of assets. Such a squeeze, however, would make the record levels of debt extremely difficult to manage. Borrowers would then have to pay off loans in dearer, rather than cheaper dollars to which they have been accustomed. Difficulties would also be intensified by erosion in their asset values.

## Fiscal Policy's Last Hurrah

While most economists are extremely optimistic that the July 1 tax cut will give the economy a great boost in 2004, our analysis indicates that the effect is likely to be far more modest than is generally

recognized. The tax cut of 2004 amounts to 1.6% of GDP, a seemingly rather sizeable figure considering the economy grew at a meager 2% annual rate over the latest four quarters. When aid to the beleaguered state and local governments is included, the net federal stimulus for next year rises to 1.8% of GDP. One could simplistically add this figure to the economy's current growth rate and reach the happy conclusion that GDP might rise by 3.8% in 2004. Such an approach would be incomplete.

State and local governments—facing the largest budget deficit relative to GDP since the end of World War II—are in the process of taking various economically restraining actions, such as hiking taxes, increasing expenditures, and even reducing their work forces. The extent of these restraints appears to be equivalent to 0.6% of GDP. Thus, the net benefit from the federal tax cut and the aid to states, less the restraining actions by the state and local governments, amounts to only 1.2% of GDP. Experience with prior tax cuts indicates that easily 40% of the funds from the tax reduction could be saved, rather than spent. Savings can take the form of money market purchases, stocks or bond investments, acquisition of bank deposits, or debt repayment. Thus, the net rise in GDP could be reduced to 0.8% for 2004.

Even if this optimistic 60% expenditure of the tax cut by consumers is realized, the ultimate gain in GDP will still not be large. If the 2001 and 2002 tax cuts are a pattern, the import leakage from whatever is spent will amount to 0.4% of GDP. Thus, the net effect of the tax cut might be to push the growth in GDP higher by a net of 0.4%. Based upon the estimated 1.5% rise in real GDP growth in the first half of this year, GDP would move into the vicinity of 2% next year. Under this scenario, faster growth would occur in the first quarter, but the economy would languish for the rest of the year. Such a rate of expansion would be insufficient to cut into the current high levels of joblessness or unused plant capacity.

What may not be generally recognized is that the July tax cut is, for all practical purposes, fiscal policy's last hurrah. The budget deficit for 2004 will be between \$450-\$500 billion. The option of increasing the deficit beyond that level would seem to be extremely unwise in view of the long-term negative consequences of the debt buildup at the federal level. It is also difficult to imagine how advocates of a \$600

or \$700 billion Federal budget deficit would find many followers if we are correct that the so-called, great fiscal stimulus packages since 2000 prove to be largely ineffective.

## **The Global Economy- - Still Leaning on the U.S.**

One constant in the global economic landscape is that the United States, with all its problems, is still being required to support the rest of the world. In the latest four quarters, real domestic demand in the United States rose by 2.6%. Much of this growth was registered in the second and third quarters of 2002. Since then, U.S. domestic demand has been considerably slower. In the latest four quarters, the growth in the fifteen largest economies outside the U.S. was 2%, and a punier 1.4% in the Euro 12. The U.S. economy leads the rest of the world by two to three quarters. Since the U.S. growth softened in late 2002 and early 2003, the domestic demand in key foreign economies should move much lower over the second half of 2003. The tax cut and the increased imports associated with it should serve to boost foreign domestic demand modestly in 2004, but to levels that are no better than in the latest four quarters. As such, unused labor and capital resources should continue to rise in foreign economies in 2004, thus continuing disinflationary forces abroad.

The dependence of foreign economies on the United States is also evident in the flows of U.S. exports and imports. From their monthly peak through April, U.S. exports of goods slumped by 14.6% while U.S. imports have eased only 3.0%. When considering the effect of the tax cut, U.S. imports of goods could easily reach a new record. In spite of the recent weakness of the dollar, the ongoing inflow of lower priced foreign goods will continue unabated. While the dollar has fallen 18.3% from its peak against major currencies, the drop against all currencies was only 9.3%, and this was after a 34% appreciation from 1995 to the peak in 2002. While countries with stronger currencies have the luxury of raising export prices to the United States, they are unlikely to be willing to do so since they will

lose market share to China's lower cost producers where the yuan has been pegged to the dollar. Thus, the increased imports should occur in a disinflationary setting.

## **The Case For Still Lower Treasury Yields**

Our best judgment is that the heroic efforts of monetary and fiscal authorities will become wanting. Their best laid plans will be thwarted by a failure of the transmission mechanism of public policy. Debt deflation, the slow, but inevitable, repayment of debt will inexorably subtract sufficient funds from the spending stream to thwart their best stimulative efforts. The result will be an ever-increasing shortage of yield, and the longest-dated, highest quality securities will be the most sought after as short term rates languish near zero. Already at 1%, the Fed funds rate, which is the anchor to the Treasury yield curve, suggests that in normal circumstances the curve in ten and thirty-year maturities would yield 2.6% and 3%, respectively. However, 1% is not the end of the easing cycle. The inability of massive government deficits and monetary stimulus in Japan during 1990-2000 highlights the problem to engender nominal growth in the face of excessive debt levels.

The gradual paydown of record private debt levels is a multi-year problem, and will not impact every quarter negatively; thus the feelings of optimism, like now, will arise from time to time. The accumulation of a fifty-year borrowing binge in which every dollar of income is added to and supplanted by a dollar of debt is maturing. Debt paydown will begin robbing the income stream, creating weaker demand and hindering stimulation efforts of monetary and fiscal policy. Sluggish nominal growth, fewer jobs, and lack of yield all seem to be part of the permanent landscape of the future. The drop in yields from 9.2% at the peak of 1990 to 4.6% presently is about 50%. We expect a similar percentage decline over the next few years, thus from the 1990 levels, we view the bull market in long bonds only about half over.

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