

Hoisington

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Quarterly Review and Outlook

Fourth Quarter 2009

Hard Road Ahead

The U.S. is facing a long and difficult road as it attempts to correct the over-indebtedness and wasteful expenditures of the past two decades. Both current and historical research help us to understand where we are in the continuing economic crisis, and to put it in perspective.

The brilliant U.S. economist Irving Fisher first highlighted the fact that an economy's debt level could have a deleterious impact on economic growth if it is, in fact, excessive. At \$3.70 of debt for every dollar of GDP, U.S. debt is excessive (Chart 1). Fisher pointed out that the unwinding of debt levels results in prolonged economic distress, and we certainly agree. In 2009, the book [This Time is Different—Eight Centuries of Financial Folly](#), by Reinhart and Rogoff, shed new light on the role of debt by compiling a database that looked at financial crises in 66 countries over a period of 800 years. The main standard in explaining more than 250 crises studied is whether debt is excessive relative to national income, even though

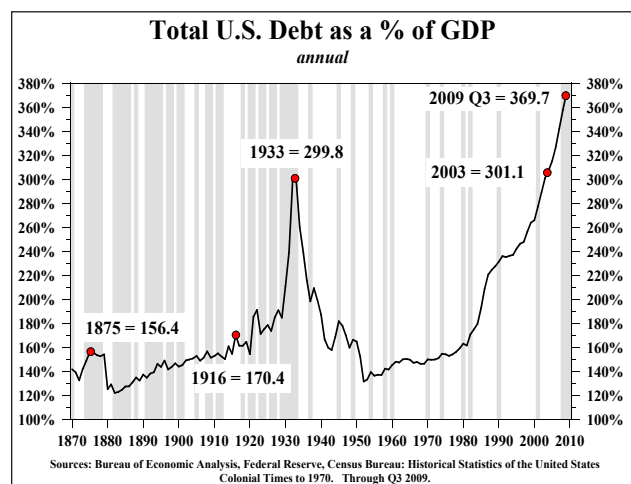


Chart 1

idiosyncrasies apply in each case. They reiterate that this old rule (excessive debt) continues to apply, and this time is not different.

Research and the Deflation Risk

We glean five important factors from this work that pertain to our present situation. First, financial imbalances occur when aggregate domestic debt is excessive relative to income, regardless of whether the government or private sector is accumulating the debt. Once debt becomes excessive, countries do not grow their way out of the problem; they must go through the time consuming and often painful processes of debt repayment and increased saving.

Second, whether the domestic debt is externally or internally owed is not as critical as the excessiveness of the debt.

Third, government actions, even involving sizeable sums of money, are far less helpful than they appear. As the book states, "Infusions of cash can make a government look like it is providing greater growth to its economy than it really is."

Fourth, Reinhart and Rogoff cover countries in debt crisis with a host of different conditions, such as growth and age of population, political regimes, technology status, education, and other idiosyncratic features. Nevertheless, economic damage as a result of extreme over-leverage has remarkably similar results, whether the barometer of performance is economic output, the labor markets, or asset prices.

Fifth, further increasing leverage to solve

the problem only leads to greater systemic risk and general economic underperformance.

The real question for financial participants is whether all these influences result in inflation or deflation, and the authors' research details both outcomes. As is widely feared here in the U.S., they outline that many countries have had the right circumstances and mechanisms to inflate away their debt overhang, and, in fact, have done so by debasing their currency. Those particular circumstances are not currently present in the United States.

According to Reinhart and Rogoff the norm is that *major* economic contractions lead to deflation. Importantly, they call our present economic circumstances the "second great contraction."

Thus, not only has the historical "qualitative" research on the subject of deflation chronicled the deflationary impulses emanating from over-indebtedness (Fisher's 1933 "Debt-Deflation Theory of Great Depressions"), but also modern "quantitative" methods have now essentially confirmed this conclusion. Over-indebtedness and major contractions lead to deflation.

Debt Overwhelms Monetary Policy

It has been more than a year since the Federal Reserve began a massive expansion of Federal Reserve Bank credit, from \$1 trillion to \$2.2 trillion, flooding the banking system with reserves. This unprecedented action naturally raised inflationary fears since it was assumed that this was the beginning of a monetary creation process which would eventually lead to job and income growth, excessive expenditures, and finally massive price increases.

If the economy were not in the throes of writing down bad debts that were caused by a massive decline in asset prices, it is possible that the money supply (M2) in response to this increase in reserves could have expanded by \$4 trillion, or

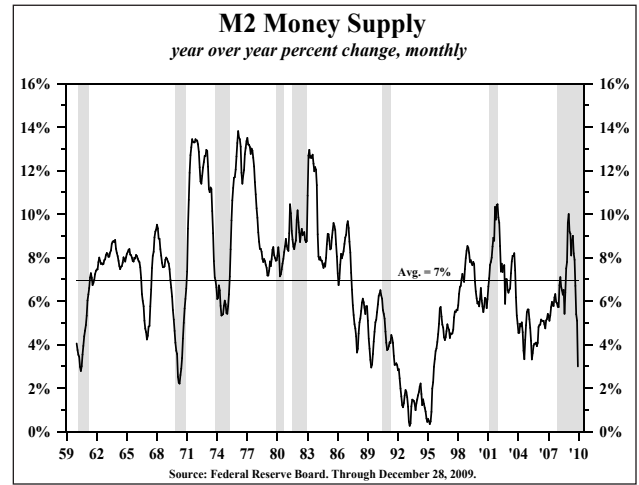


Chart 2

96%. According to the late Nobel prize winning economist Milton Friedman, an increase in M2 of that magnitude would have been highly inflationary. However, M2 did not explode. Instead, in the past twelve months this aggregate has risen only 3%. This is less than 1/2 of the average growth rate over the past fifty years (Chart 2).

If, as Friedman assumed, the velocity of money is stable ($MV=GDP$) then nominal GDP expansion in the ensuing quarters can be expected to grow about 3%. If prices rise about 1.5%, then real GDP growth would also rise about 1.5%, which is far below the level of growth needed to employ new labor force entrants and existing unemployed or to more fully utilize our present unused capacity in our factories. In the last six months the growth rate of M2 has slowed to near zero. If this pattern continues, it would be rational to expect GDP to grind to zero with no change in the price level.

The very first step toward an inflationary cycle has to be to get the monetary aggregates expanding vigorously. That cannot be accomplished with the Fed "printing money", i.e., adding more reserves into banks that cannot or will not make loans. The reason this process has not begun (and will not for a time) is the overhang of excessive indebtedness and asset price depreciations. No one needs to borrow, or has the resources or balance sheet to borrow, and banks are busily writing off bad debt. Irving Fisher warned of that process (note our Third Quarter 2009 quarterly letter).

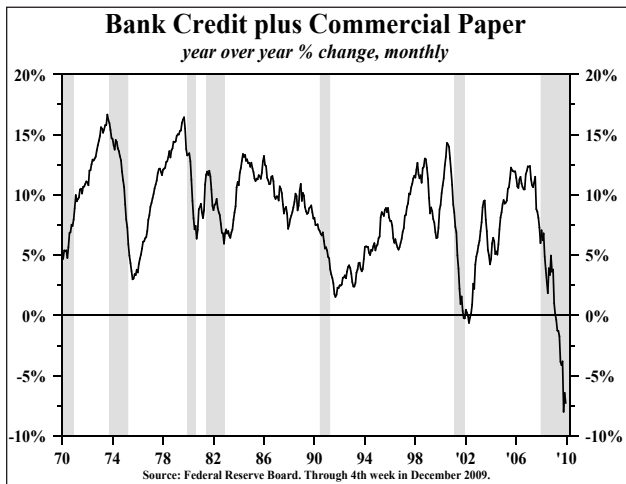


Chart 3

Over-indebtedness Creates Excess Supply

Despite the concurrent developments of little money growth and declining loan growth (Chart 3), the fear nevertheless remains that an inflation surprise might be just around the corner. The reason to discount this notion is that excessive debt has contributed greatly to a flat, or perfectly elastic aggregate supply curve. A country's inflation is determined by the interaction of aggregate supply and demand. Friedman wrote that a large increase in money in the hands of the non-bank public would be inflationary because he assumed a normal upward sloping aggregate supply curve (Chart 4). In this case the aggregate demand for goods (depicted as the demand curve Line A) would shift outward to Line A1, and thus prices would naturally rise. You will note what happens to prices if a demand curve B is intersecting the

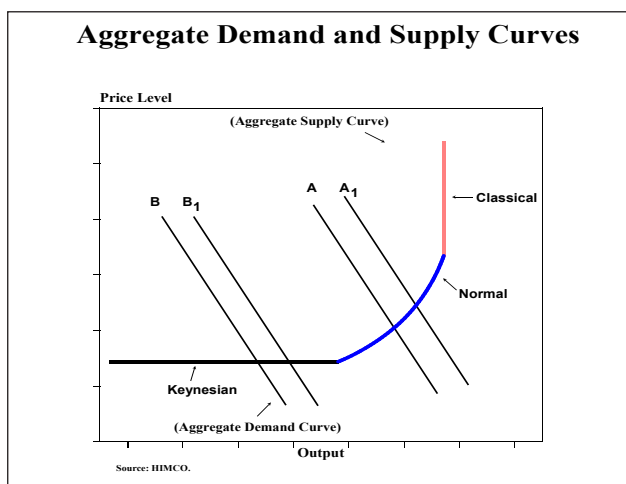


Chart 4

supply curve in the so-called Keynesian range where it is flat. If aggregate demand increases to B₁, prices do not change.

Whether the supply curve is in a flat, normal, or upward sloping position depends on the extent of excess resources in the economy. Today it is obvious that the U.S. economy has plentiful excess resources, so any increase in demand will result in little price change. This will be the case until our unemployment rate of over 17% (the U6 measure) drops by a considerable amount and we begin to use our factories well above our current 68% utilization rate.

Thus, our current economic circumstances guarantee there will be no surprise inflation. Employing those who are out of work and fully utilizing our resources will be a slow process. More importantly, it will take time to get the monetary engine reignited. Banks will have to begin lending and people and companies will have to determine that prospects are good enough to take the risk for expansion and investment. It will take years for these processes to get started because of our over-indebtedness and falling asset prices.

The consequences of excessive debt are already painful at the household level. The civilian employment to population ratio, a highly important barometer of the average household's standard of living, fell to 58.2% in December, the lowest reading in 26 years and down from a peak of 64.7% in April of 2000 (Chart 5). Thus, the standard of

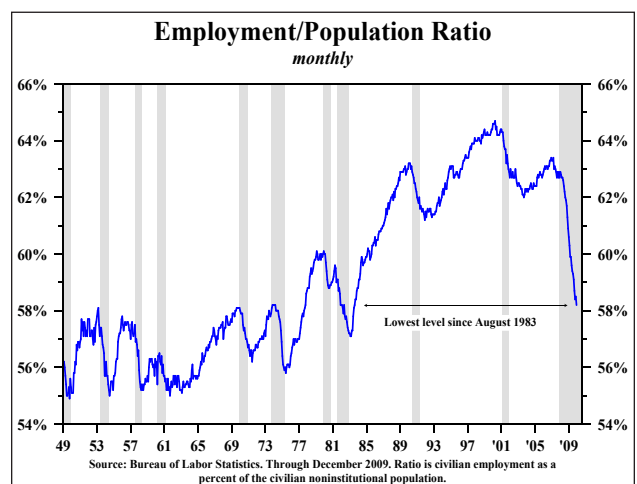


Chart 5

living has worsened as the debt to GDP ratio has marched steadily higher. With debt to GDP still rising, a further deterioration of the standard of living is inescapable.

Debt and Fiscal Policy

Deficit spending only provides a transitory boost to the economy. It initially raises GDP, as it did in the second half of 2009, but then the effect dissipates and later is reversed, as financial resources available to the private sector are reduced. In a separate research study Rogoff and Reinhart write, “At the height of Japan’s banking crisis in the 1990s, repaving the streets in Tokyo became a routine exercise. As a result, Japan’s gross (government) debt-to-GDP ratio is now nearly 200% and a drag on what once was a vibrant economy.” Our present high deficit situation suggests that taxes will rise (including those of state and local governments), depressing economic activity further. In addition to the expiration of the 2001 and 2003 tax cuts, the Obama administration is proposing substantial taxes on financial institutions to pay for the cost of the financial bailout. Since the tax multiplier is high, this will reinforce the drag on economic activity from the lagged effects of deficit spending.

Treasury Bonds

Since 1990 Treasury bond yields have steadily moved downward in line with a more benign inflationary environment (Chart 6). Those yearly declines in yields continued last year with an average interest rate of 4.07% versus 4.28% in 2008. Obvious sharp reversals have occurred in their downward trend due to shifts in psychology reacting to generally transitory factors, as we saw in 2009. To remain fully invested in long Treasuries in this high volatility environment requires a simple discipline based on the academic literature which demonstrates that over time bond yields move in the same direction as inflation (Fisher equation).

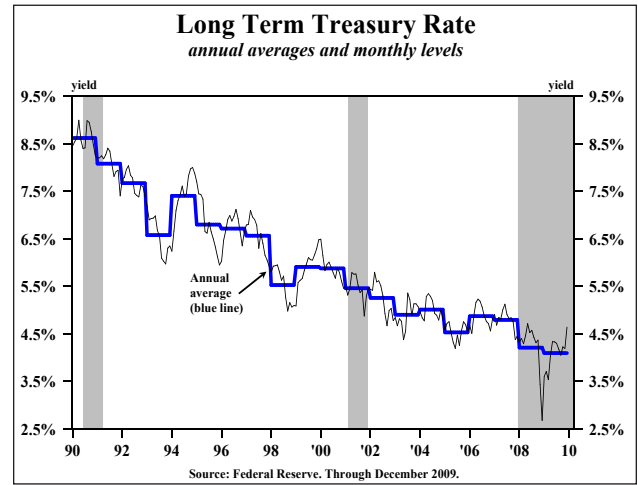


Chart 6

Presently, we view the inflationary environment as benign because: 1) the U.S. economic system is overleveraged and academic research confirms that this circumstance leads to deflation; 2) monetary policy is, and will continue to be, ineffectual as efforts to spur growth are thwarted by declining asset prices, loan destruction, and adverse regulatory influences; 3) the federal government’s spending spree will necessarily cause taxes and borrowings to rise, further stunting any economic growth. These factors ensure that inflation will be quiescent. Interest rates easily can and do rise for short periods, but remaining elevated in a disinflationary environment is contrary to the historical experience. We are owners and buyers of long U.S. Treasury debt.

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