

# Hoisington

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## Quarterly Review and Outlook

Fourth Quarter 2015

### A Weak Finish to a Disappointing Year

The economy was supposed to fire on all cylinders in 2015. Sufficient time had passed for the often-mentioned lags in monetary and fiscal policy to finally work their way through the system according to many pundits inside and outside the Fed. Surely the economy would be kick-started by: three rounds of quantitative easing and forward guidance; a record Federal Reserve balance sheet; and an unprecedented increase in federal debt from \$9.99 trillion in 2008 to \$18.63 trillion in 2015, a jump of 86%. Further, stock prices had gained sufficiently over the past several years, thus the so-called wealth effect would boost consumer spending.

The economic facts of 2015 displayed no impact from these massive government experiments. The broadest and most reliable measure of economic performance – nominal GDP – decelerated. The 3% estimated gain registered in 2015, measured by the year ending quarter, was down from 3.9% and 4.1%, respectively, in 2014 and 2013. In fact the gain in nominal GDP in 2015 was less than the gain for any year since the recession. The two components of nominal GDP also decelerated in 2015. Real GDP slowed to 2%, down from 2.5% in the prior two years, and the implicit price deflator rose by 1% compared with a 1.4% and 1.6% rise in 2014 and 2013, respectively. All of the above economic measures were expanding at, or near, their weakest yearly growth rates in the final quarter of 2015, indicating that the economy possessed little forward momentum moving into 2016.

Personal consumption, the largest category of nominal GDP, decelerated to an estimated 3% rise in the latest twelve months, down from 4% at year-end 2014, the smallest year end annual increase since immediately after the 2008-09 recession. The faltering consumer pattern occurred despite a significant lowering of credit standards that accelerated automotive lending. The percentage of total auto loans in the subprime category hit a ten-year pre-crisis high in the third quarter, according to the New York Fed. In addition, the Affordable Care Act has caused health outlays to surge. Excluding these two special circumstances, consumer spending was notably weak, providing additional confirmation that the so-called wealth effect remains elusive.

Other important economic indicators reported outright contractions last year. Industrial production slumped 1.4% over the first eleven months of 2015, with a drop of 2% outside of the automotive sector. Only about 10% of private

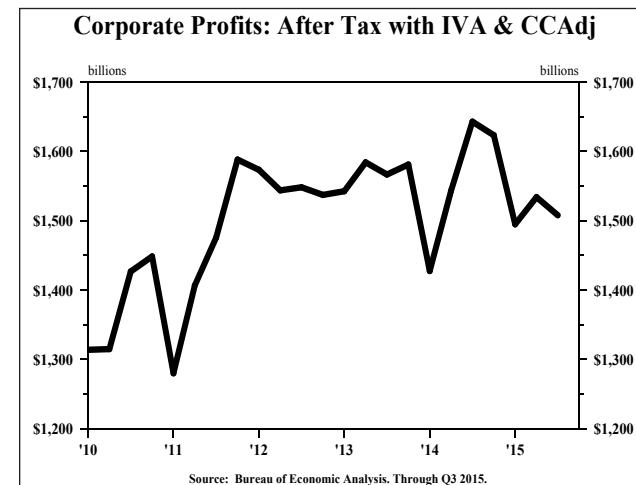
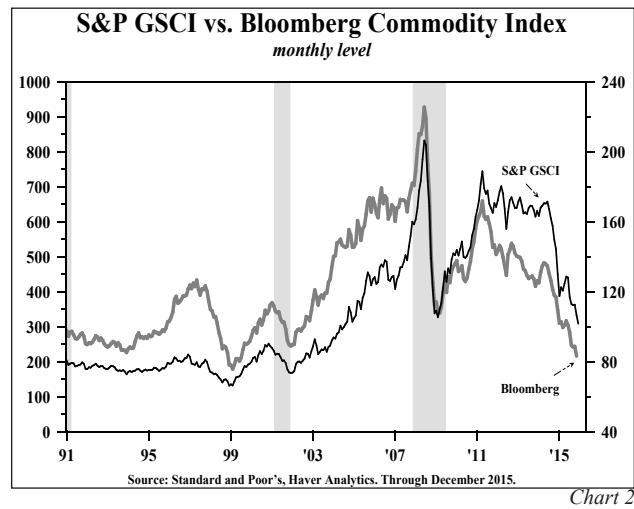


Chart 1

payroll employment is accounted for in the manufacturing sector. This fact distorts the true impact of this critical part on GDP. According to the Federal Reserve Statistical Release on Industrial Production, the industrial sector accounts for about one quarter of real GDP on a value added basis. The importance of this sector to corporate profits is considerably greater. Not surprisingly, corporate profits registered year-over-year declines in the latest two quarters available. According to the BEA, corporate profits in the latest quarter were below the level reached in the fourth quarter of 2011 (Chart 1). The profits picture is a worrisome portent for 2016 since it has fallen prior to all the economic contractions since 1929, albeit it has also had a few false signals.

The 2015 global picture was just as disappointing. By some measures, worldwide economic growth was the poorest since the last recession. Reflecting the depth of the underperformance, world trade was essentially flat for the first time since 2009. Commodity prices, a sensitive and impartial barometer of global final demand, dropped sharply. At the December lows, the S&P GSCI Commodity Index was 59% below the April 2011 peak and at the lowest point since December 2004. The alternative Bloomberg Commodity Price Index, which is reweighted largely based on futures contract volume and includes gold, slumped to the worst level since 1999 (Chart 2). As in the



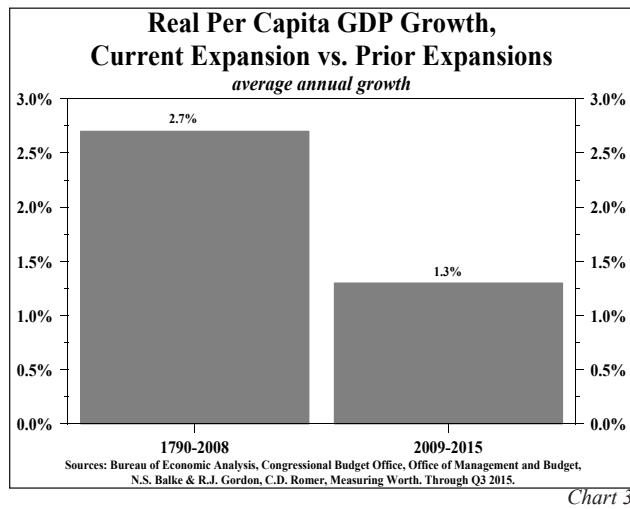
United States, economic growth was ebbing in Japan, China, Canada, Australia, Europe and virtually all of Latin America as the books closed on 2015. As an indication of the Chinese problem, the Yuan has recently dropped to the lowest level since 2011. Thus, the global economy confirms that the entry point for 2016 is fragile.

### Empirical Evidence on the Counter-productiveness of QE and Forward Guidance

Since the introduction of unconventional and untested monetary policy operations like quantitative easing (QE) and forward guidance, an impressive amount of empirical evidence has emerged that casts considerable doubt on their efficacy. The historical facts regarding the grand experiment by the Federal Reserve Open Market Committee (Fed) are worth considering.

The trend in economic growth in this expansion has been undeniably weak and perhaps unprecedentedly so. Real per capita GDP grew only 1.3% in the current expansion that began in mid-2009; this is less than one half the growth rate in the expansions since 1790 (Chart 3).

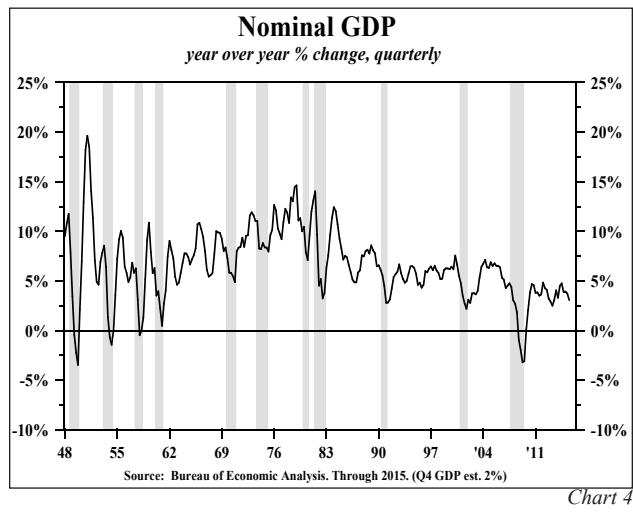
Based on their theoretical expectations of QE, the Fed and multilateral economic agencies (such as the International Monetary Fund) constantly projected that economic growth would



accelerate significantly and that inflation would return to the 2% level targeted in the Fed's dual mandate. These forecasts widely and consistently over-estimated both real growth and inflation.

The study "Persistent Overoptimism About Economic Growth" by Kevin J. Lansing and Benjamin Pyle and published in the Federal Reserve Bank of San Francisco Economic Letter of February 2, 2015 systematically examined the Fed's forecasting record. Specifically, Lansing and Pyle examined the real GDP projections made four times per year by the Fed that began in November 2007. Their overall conclusion reads: "Since 2007, Federal Open Market Committee participants have been persistently too optimistic about future U.S. economic growth. Real GDP growth forecasts have typically started high, but then are revised down over time as the incoming data continue to disappoint." Even Mrs. Yellen in her December press conference admitted the Fed's models were not working.

Central banks in Japan, the U.S. and Europe tried multiple rounds of QE. That none of these programs were any more successful than their predecessors also points to empirical evidenced failure. The pattern is shown in year-over-year growth in U.S. nominal GDP (Chart 4). Three weak transitory mini growth spurts all reversed, and the best rate of growth in the current expansion was weaker than the peak levels in all



of the post 1948 expansions.

Several academicians have found that the data does not validate the efficacy of QE and forward guidance. In a paper presented at the Fed's 2013 Jackson Hole Conference, Robert Hall of Stanford University and Chair of the National Bureau of Economic Research Cycle Dating Committee wrote "an expansion of reserves contracts the economy."

Negative interest rates would have the same non-productive characteristics as QE and forward guidance.

### A Causal Mechanism Explaining the Counter-Productiveness of QE and Forward Guidance

This empirical data notwithstanding, a causal explanation of why QE and forward guidance should have had negative consequences was lacking. This void has now been addressed by "Where Did the Growth Go?" by Michael Spence (2001 recipient of the Nobel Prize in economics) and Kevin M. Warsh (former Governor of the Federal Reserve), a chapter in a new book *Growing Global: Lessons for the New Enterprise*, published in November 2015 by The Center for Global Enterprise.

The Spence and Warsh point is that "the post-crisis policy response" contributed to and helps to explain the slower economic growth during the past several years. Their line of reasoning is that the adverse impact of monetary policy on economic growth resulted from the impact on business investment in plant and equipment. Here is their causal argument: "...QE is unlike the normal conduct of monetary policy. It appears to be qualitatively and quantitatively different. In our judgment, QE may well redirect flows from the real economy to financial assets differently than the normal conduct of monetary policy." In particular, they state: "We believe the novel, long-term use of extraordinary monetary

policy systematically biases decision-makers toward financial assets and away from real assets.”

Quantitative easing and zero interest rates shifted capital from the real domestic economy to financial assets at home and abroad due to four considerations:

First, financial assets can be short-lived, in the sense that share buybacks and other financial transactions can be curtailed easily and at any time. CEOs cannot be certain about the consequences of unwinding QE on the real economy. The resulting risk aversion translates to a preference for shorter-term commitments, such as financial assets.

Second, financial assets are more liquid. In a financial crisis, capital equipment and other real assets are extremely illiquid. Financial assets can be sold if survivability is at stake, and as is often said, “illiquidity can be fatal.”

Third, QE “in effect if not by design” reduces volatility of financial markets but not the volatility of real asset prices. Like 2007, actual macro risk may be the highest when market measures of volatility are the lowest. “Thus financial assets tend to outperform real assets because market volatility is lower than real economic volatility.”

Fourth, QE works by a “signaling effect” rather than by any actual policy operations. Event studies show QE is viewed positively, while the removal of QE is viewed negatively. Thus, market participants believe QE puts a floor under financial asset prices. Central bankers might not intend to be providing downside insurance to the securities markets, but that is the widely held judgment of market participants. But, “No such protection is offered for real assets, never mind the real economy.” Thus, the central bank operations boost financial asset returns relative to real asset returns and induce the shift away from real investment.

Additional empirical evidence, cited by Spence and Warsh, supports these fundamental arguments. From 2007 to 2014 gross private investment registered extremely substandard growth. Growth in nonresidential fixed investment fell substantially below the last six post-recession expansions. Spence and Warsh calculate that S&P 500 companies spent considerably more of their operating cash flow on financially engineered buybacks than on real capital expenditures in 2014; this has not happened since 2007. According to them, during the past five years, earnings of the S&P 500 have grown about 6.9% annually, versus 12.9% and 11.0%, respectively, from 2003-2007 and 1995-1999. Inadequate real investment means demand for labor is weak. Productivity is poor, which in turn, diminishes returns to labor. According to a Spence and Warsh op-ed article in the Wall Street Journal (Oct. 26, 2015), “... only about half of the profit improvement in the current period is from business operation; the balance of earnings-per-share gains arose from record levels of share buybacks. So the quality of earnings is as deficient as its quantity.”

### **Do Decision Makers Need to Understand the Transmission Mechanism?**

It is quite possible that corporate decision makers do not understand the relationships that cause QE and forward guidance to redirect resources from real investment to financial investment. It is also equally likely these executives do not understand that this process reduces economic growth, impairs productivity and hurts the rise in wage and salary income. But, does a lack of understanding of economic theory by key market participants render the causal relationships invalid?

Spence and Warsh elegantly argue corporate executives do not need to know these fundamental relationships. Here is their key passage: “Market participants may not be expert on the transmission mechanism of monetary policy, but they can deduce that the central bank is

trying to support financial asset prices. The signal provided by central banks might be the essential design element.” Real assets market participants simply need to know that the central bank does not offer such protection. In other words, the corporate managers merely need to realize that one asset group is protected and the other is not.

### The Asymmetric State of Monetary Policy

Our assessment is that monetary policy has no viable policy options that are capable of boosting economic activity should support be needed. In fact, the options available to the central bank, at this stage, are likely to be a net negative. This, however, does not mean that conventional and tested monetary operations that are designed to restrict economic activity and inflation are ineffectual. In fact, standard restraining operations remain effective. Monetary restraint may even be more effective than historically because of the extreme debt overhang of the U.S. economy. The increase in short-term interest rates that the Fed has thus far achieved is small, but public and private debt stands at 375% of GDP, far above the historical average of 189.4% from 1870 to 2014. Thus, the higher cost reverberates much more significantly through the U.S. economy.

The extremely high level of debt suggests that the debt is skewed to unproductive and counterproductive uses. Debt is only good if the project it finances generates a stream of income to repay principal and interest. There are two types of bad debt: (1) debt that does not generate income to repay interest and principal (Hyman Minsky, “The Financial Instability Hypothesis”); and (2) debt that pushes stock prices higher without a commensurate rise in corporate profits (Charles P. Kindleberger, *Manias, Panics and Crashes*). When the composition of debt is adverse, less flexibility exists for the end users of the debt to absorb the higher costs engineered by the Fed. Even if this is not the case, the small increase in the federal funds rate serves to shift both money growth and velocity downward, which has the

effect of weakening nominal GDP at a time when it is already slow and decelerating.

Prior to the Fed’s December rate hike M2 grew at annual rates of 5.3% and 5.6%, for the three and six month periods, respectively. Subsequent to the Fed’s change in policy, three conventional monetary influences have turned more restrictive. First, in the reserve maintenance period ending January 6, the monetary base, as measured by the Federal Reserve Bank of St. Louis, dropped \$258 billion, versus the reserve period immediately prior to the Fed rate hike. Consequently, the base was at the lowest level since October 2013, when the Fed was still executing QE3. The base, as measured by the Federal Reserve Board, registered a slightly larger contraction of \$294 billion. Second, the Federal funds rate rose by about 0.25%, from roughly 0.125 to 0.375%. Third, the short to intermediate Treasury note yields rose relative to the ten-year and thirty-year Treasury security yields. Thus, the yield curve between the two-year and ten-year Treasury notes as well as the between the two-year note and thirty-year treasury bond flattened considerably.

All three of these actions will, in time, serve to lower M2 growth and reduce the velocity of money. The absorption of reserves places downward pressure on M2 growth, while the higher short-term rates encourages households and businesses to minimize transactions balances. The higher short- and intermediate-term yields encourage households to save a little more by spending less. The flatter yield curve reduces the earnings potential of the depository institutions, which, in turn, reduces the lending directly and M2 indirectly. Thus, the Fed tightening could serve to push M2 annual growth toward 5% or below. If velocity continues to remain in the persistent 3% downward trend, nominal GDP’s growth rate could fall to 2%, a third lower than in 2015. This leaves little room for a sustained acceleration in either real growth or inflation.

The flatter yield curve is also a reliable leading indicator of economic activity, as well as the above-mentioned source of monetary restraint. A rise in short-term rates relative to the long ones is an indication that investors expect economic activity and/or inflation to fall in the future. Such an expectation is consistent with the likely trends in M2, velocity and nominal GDP.

### Treasury Bond Yields

With the trajectory in the nominal growth rate moving down, U.S. Treasury bond yields should work lower, thus reversing the pattern of 2015 and returning to the strong downtrend in place since 1990. In the United States, ten- and thirty-year yields are considerably more attractive than in virtually all of the major industrialized countries (Table 1). At year end 2015, the U.S. thirty-year Treasury bond yield was 154, 176 and 240 basis points higher, respectively, than in Germany, Japan and Switzerland. The U.S. thirty-year Treasury yield was even 88 basis points higher than in Canada. These wide differentials indicate that ample downside still exists for long-term U.S. Treasury bond yields to decline since the attractive U.S. yields should incent global investors to continue to move funds into the United States.

A firm dollar should serve to depress price levels in the United States and restrain

the already low pace of domestic inflation. A stabilization of the oil price around current levels could cause the year-over-year increase in the consumer price index (the base effect) to move up from 0.4% currently to around 1.2% this winter, since oil prices will not be as much of an offset to government controlled prices such as medical care, utility bills, taxes or artificially calculated prices captured by home owners' equivalent rent. This base effect of oil on the CPI, however, will reverse in the late spring and summer and be reinforced by a firm dollar that will have a much more lasting effect on domestic inflation. Moreover, the 34% rise in the dollar from May 2011 has not been fully captured in the imported non-oil prices which have only declined by a mere 3.4%. The pipeline of foreign goods for the U.S. is likely to be filled with lower priced goods for a considerable time. The minimal adjustment of non-oil import prices relative to the higher dollar indicates that the damage to the trade balance and corporate profits is far from complete. Thus, poor foreign business conditions will continue to be a drag on domestic economic activity while depressing inflation.

The firm dollar will remain a restraining force on economic activity and should cause the year-over-year increase in the CPI to reverse later in the year. Under such circumstances, lower, rather than higher, inflation remains the greater risk. Such conditions are ultimately consistent with an environment conducive to declining long-term U.S. Treasury bond yields. In short, we believe that the long awaited secular low in long-term Treasury bond yields remains ahead.

Global Interest Rates					
	10 Year Yields	Spread from U.S. 10 Year Yields	30 Year Yields	Spread from U.S. 30 Year Yields	
1. U.S.	2.27%		3.02%		
2. Canada	1.38%	0.89%	2.14%	0.88%	
3. Sweden	0.97%	1.30%	2.27%	0.75%	
4. Netherlands	0.79%	1.48%	1.58%	1.44%	
5. France	0.98%	1.29%	2.00%	1.02%	
6. Austria	0.89%	1.38%	1.75%	1.27%	
7. Germany	0.62%	1.65%	1.48%	1.54%	
8. Taiwan	1.01%	1.26%	1.73%	1.29%	
9. Switzerland	-0.12%	2.39%	0.62%	2.40%	
10. Japan	0.25%	2.02%	1.26%	1.76%	

Through December 2015. Source: Bloomberg.

Table 1

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