

Hoisington

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Quarterly Review and Outlook

First Quarter 2016

2015's Surging Debt

The striking aspect of the U.S. economy's 2015 performance was weaker economic growth coinciding with a massive advance in nonfinancial debt. Nominal GDP, the broadest and most reliable indicator of economic performance, rose \$549 billion in 2015 while U.S. nonfinancial debt surged \$1.912 trillion. Accordingly, nonfinancial debt rose 3.5 times faster than GDP last year. This means that we can expect continued subpar growth for the U.S. economy.

The ratio of nonfinancial debt-to-GDP rose to a record year-end level of 248.6%, up from the previous record set in 2009 of 245.5%, and well above the average of 167.5% since the series' origination in 1952 (Chart 1). During the four and a half decades prior to 2000, it took about \$1.70 of debt to generate \$1.00 of GDP. Since 2000, however, when the nonfinancial debt-to-GDP ratio reached deleterious levels, it has taken on average, \$3.30 of debt to generate \$1.00 of GDP. This

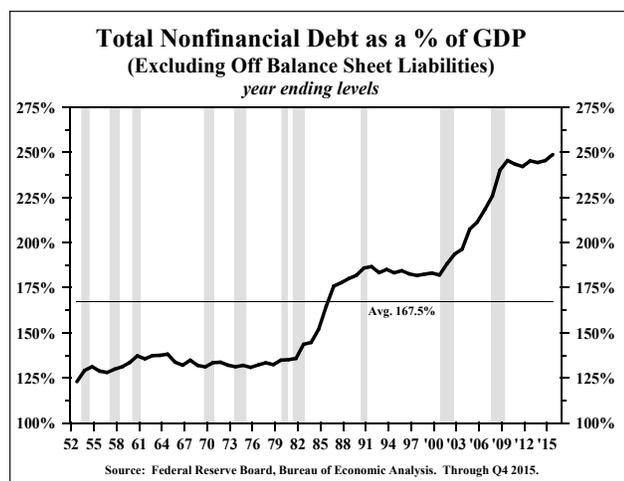


Chart 1

suggests that the type and efficiency of the new debt is increasingly non-productive.

Most significant for future growth, however, is that the additional layer of debt in 2015 is a liability going forward since debt is always a shift from future spending to the present. The negative impact, historically, has occurred more swiftly and more seriously as economies became extremely over-indebted. Thus, while the debt helped to prop up economic growth in 2015, this small plus will be turned into a longer lasting negative that will diminish any benefit from last year's debt bulge.

Unfavorable Trends in Nonfinancial Debt

Nonfinancial debt consists of the following: a) household debt, b) business debt, c) federal debt and d) state and local government debt.

Households. Household debt, excluding off balance sheet liabilities, was 78.3% of GDP at year-end 2015, more than 20 percentage points above the average since 1952. However, this ratio has declined each year since the 2008-09 recession.

Credit standards were lowered considerably for households in 2015 making it easier to obtain funds. Delinquencies in household debt moved higher even as financial institutions continued to offer aggressive terms to consumers, implying falling credit standards. Furthermore, the New York Fed said subprime auto loans reached the greatest percentage of total auto loans in ten years. Moreover, they indicated that the delinquency rate rose significantly. Fitch Ratings reported that the 60+ day delinquencies for subprime auto asset-backed securities jumped to over 5%, the

highest level since 1996. Prime and subprime auto delinquencies are likely to move even higher. According to the Fed, 34% of auto sales last year were funded by 72-month loans. With used car prices falling on an annual basis, J.D. Power indicates that the negative equity on auto loans will hit a ten-year high of 31.4% this year.

Despite the lowering of credit standards, the ratio of household debt-to-GDP did decline in 2015, primarily due to mortgage repayments. However, the apparent decline in household debt is somewhat misleading because it excludes leases.

The Fed website acknowledges the deficiency of excluding leases by pointing out that personal consumption expenditures (PCE), compiled by the Bureau of Economic Analysis (BEA), do include leases. With leases included, the change in consumer obligations can be inferred by using the personal saving rate (PSR), which is household disposable income minus total spending (PCE). If the PSR rises (i.e. spending is growing more slowly than income) debt is repaid or not incurred. Indeed from 2008 to 2012 the PSR rose from 4.9% to 7.6%. However, since 2012, the saving rate has declined to 5.0% (at year-end 2015), implying a significant increase in debt obligations. The consumer did, in fact, increase borrowing last year by \$342 billion even though the household debt as a percent of GDP declined. The household debt-to-GDP ratio dropped from 82.0% in 2012 to 78.3% in 2015; however, excluding mortgages consumers have actually become more leveraged over the past three years with non-mortgage debt rising from 17.9% to 19.5% of GDP.

Businesses. Last year business debt, excluding off balance sheet liabilities, rose \$793 billion, while total gross private domestic investment (which includes fixed and inventory investment) rose only \$93 billion. Thus, by inference this debt increase went into share buybacks, dividend increases and other financial endeavors, albeit corporate cash flow declined by \$224 billion. When business debt is allocated to financial operations, it does not generate an

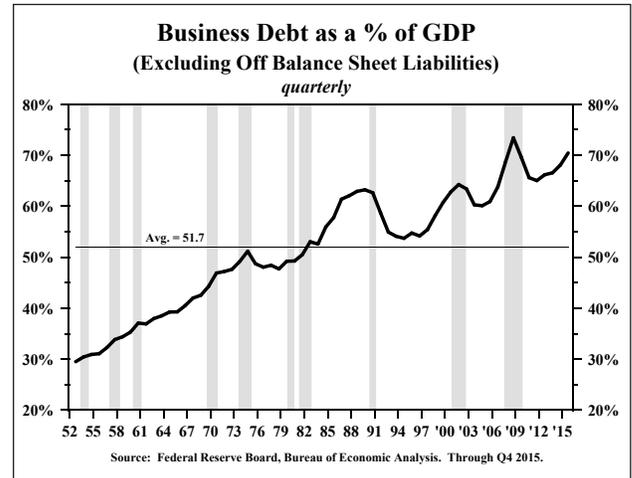


Chart 2

income stream to meet interest and repayment requirements. Such a usage of debt does not support economic growth, employment, higher paying jobs or productivity growth. Thus, the economy is likely to be weakened by the increase of business debt over the past five years (Chart 2).

In 2015 the ratio of business debt-to-GDP advanced two percentage points to 70.4%, far above the historical average of 51.7%. Only once in the past 63 years has this ratio been higher than in 2015. That year was 2008, when the denominator of the ratio (GDP) fell sharply during the recession. Importantly, the ratio advanced over the past five years just as it did in the years leading up to the start of the 2008-09 recession, and the 2015 ratio was 3% higher than immediately prior to 2008.

The rise in the debt ratio is even more striking when compared to after-tax adjusted

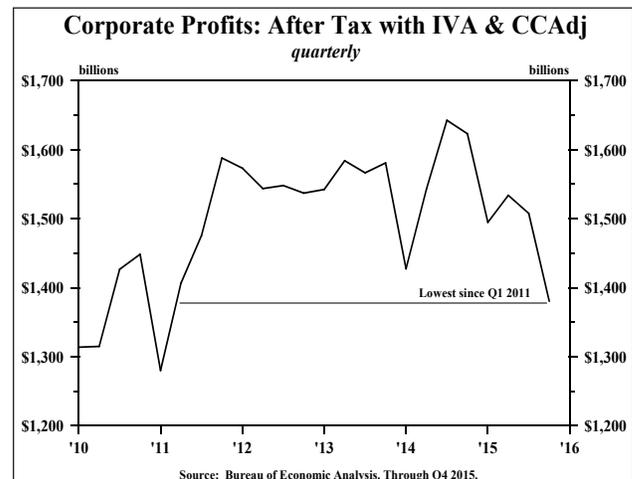


Chart 3

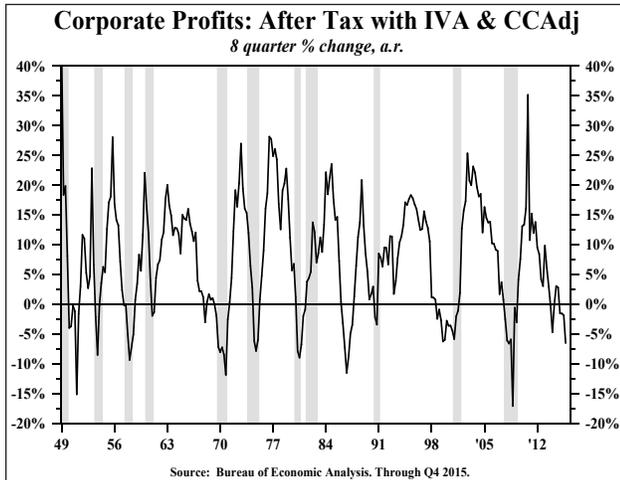


Chart 4

corporate profits, which slumped \$242.8 billion in 2015. The 15% fall in profits pushed the level of profits to the lowest point since the first quarter of 2011 (Chart 3). In the past eight quarters profits fell 6.6%, the steepest drop since the 2008-09 recession. On only one occasion since 1948 did a significant eight quarter profit contraction not precede a recession (Chart 4).

The jump in corporate debt, combined with falling profits and rising difficulties in meeting existing debt obligations, indicates that capital budgets, hiring plans and inventory investment will be scaled back in 2016 and possibly even longer. Indeed, various indicators already confirm that this process is underway. Core orders for capital goods fell sharply over the first two months of this year. Surveys conducted by both the Business Roundtable and The Fuqua School of Business at Duke University indicate that plans for both capital spending and hiring will be reduced in 2016.

U.S. Government. U.S. government gross debt, excluding off balance sheet items, reached \$18.9 trillion at year-end 2015, an amount equal to 104% of GDP, up from 103% in 2014 and considerably above the 63-year average of 55.2% (Chart 5).

U.S. government gross debt, excluding off balance sheet items, gained \$780.7 billion in 2015 or about \$230 billion more than the rise in GDP. The jump in gross U.S. debt is bigger than

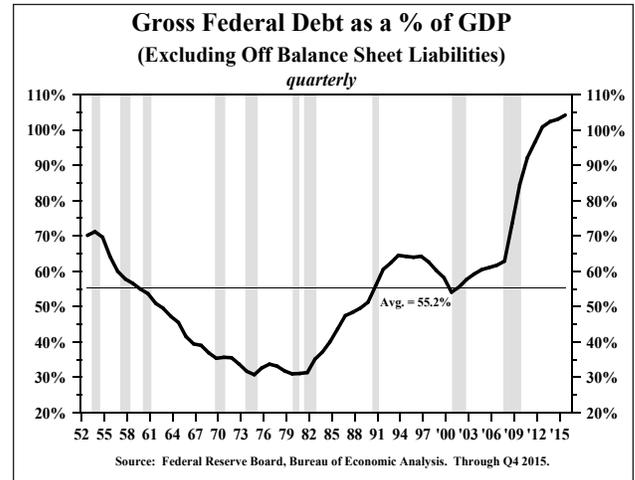


Chart 5

the budget deficit of \$478 billion because a large number of spending items have been shifted off the federal budget.

The divergence between the budget deficit and debt in 2015 is a portent of things to come. This subject is directly addressed in the 2012 book *The Clash of Generations*, published by MIT Press, authored by Laurence Kotlikoff and Scott Burns. They calculate that on a net present value basis the U.S. government faces liabilities for Social Security and other entitlement programs that exceed the funds in the various trust funds by \$60 trillion. This sum is more than three times greater than the current level of GDP. The Kotlikoff and Burns figures are derived from a highly regarded dynamic generational accounting framework developed by Dr. Kotlikoff. They substantiate that, although these liabilities are not on the balance sheet, they are very real and will have a significant impact on future years' budget deliberations.

According to the Congressional Budget Office, over the next 11 years federal debt will rise to \$30 trillion, an increase of about \$10 trillion from the January 2016 level, due to long understood commitments made under Social Security, Medicare and the Affordable Care Act. Any kind of recession in this time frame will boost federal debt even more. The government can certainly borrow to meet these needs, but as more than a dozen serious studies indicate this will drain U.S. economic growth as federal debt moves

increasingly beyond its detrimental impact point of approximately 90% of GDP.

State and Local Governments. The above federal debt figures do not include \$2.98 trillion of state and local debt. State and local governments also face adverse demographics that will drain underfunded pension plans. Already problems have become apparent in the cities of Chicago, Philadelphia and Houston as well as in the states of Illinois, Pennsylvania and Connecticut; the rating agencies have downgraded their respective debt rankings significantly over the past year. More problems will surface over the next several years. The state and local governments do not have the borrowing capacity of the federal government. Hence, pension obligations will need to be covered at least partially by increased taxes, cuts in pension benefits or reductions in other expenditures.

Total Debt

Total debt, which includes nonfinancial (discussed above), financial and foreign debt, increased by \$1.968 trillion last year. This is \$1.4 trillion more than the gain in nominal GDP. The ratio of total debt-to-GDP closed the year at 370%, well above the 250-300% level at which academic studies suggest debt begins to slow economic activity.

Over-indebtedness Impairs Global Monetary Policy

The Federal Reserve, the European Central Bank, the Bank of Japan and the People’s Bank of China have been unable to gain traction with their monetary policies. This is evident in the growth of nominal GDP and its two fundamental determinants - money and velocity. The common element impairing the actions of these four central banks is extreme over-indebtedness of their respective economies. Excluding off balance sheet liabilities, at year-end the ratio of total public and private debt relative to GDP stood at 350%, 370%, 457% and 615%, for China, the United States, the Eurocurrency zone, and Japan, respectively.

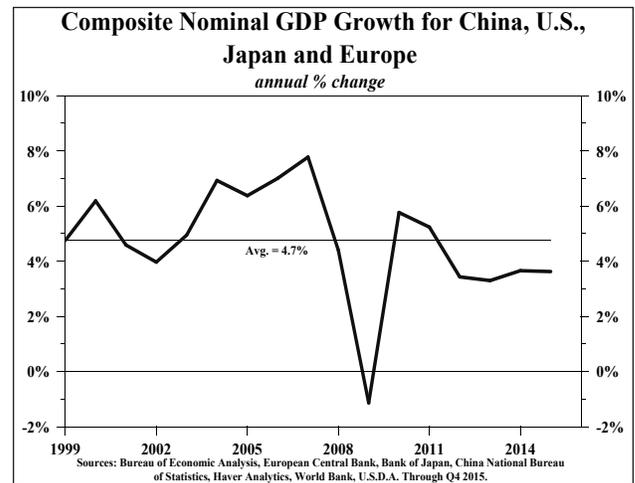


Chart 6

The debt ratios of all four countries exceed the level of debt that harms economic growth. As an indication of this over-indebtedness, composite nominal GDP growth for these four countries remains subdued. The slowdown occurred in spite of numerous unprecedented monetary policy actions - quantitative easing, negative or near zero overnight rates, forward guidance and other untested techniques. In 2015 the aggregate nominal GDP growth rose by 3.6%, sharply lower than the 5.8% growth in 2010 (Chart 6). The only year in which nominal GDP was materially worse than 2015 was the recession year of 2009.

Since nominal GDP is equal to money (M2) times its turnover, or velocity (V), the present situation becomes even less rosy when examining the two critical variables M2 and V.

Money Growth. Utilizing M2 as the measure of money, the growth of M2 for China, the United States, the Eurozone and Japan combined was 6.9% in 2015, almost a percentage point below the average since 1999, the first year of available comparable statistics for all four (Chart 7). Historical experience shows that central banks lose control over money growth when debt is extremely high.

Velocity. Velocity, or the turnover of money in the economy ($V=GDP/M2$), constitutes a serious roadblock for central banks that are trying to implement policy actions to boost economic

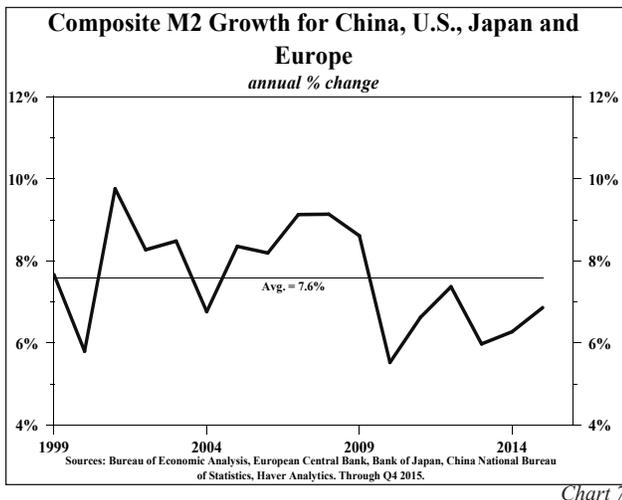


Chart 7

activity. Velocity has fallen dramatically for all four countries since 1998 (Chart 8).

Functionally, many factors influence V , but the productivity of debt is the key. Money and debt are created simultaneously. If the debt produces a sustaining income stream to repay principal and interest, then velocity will rise since GDP will eventually increase by more than the initial borrowing. If the debt is a mixture of unproductive or counterproductive debt, then V will fall. Financing consumption does not generate new funds to meet servicing obligations. Thus, falling money growth and velocity are both symptoms of extreme over-indebtedness and non-productive debt.

Velocity is below historical norms in all four major economic powers. U.S. velocity is

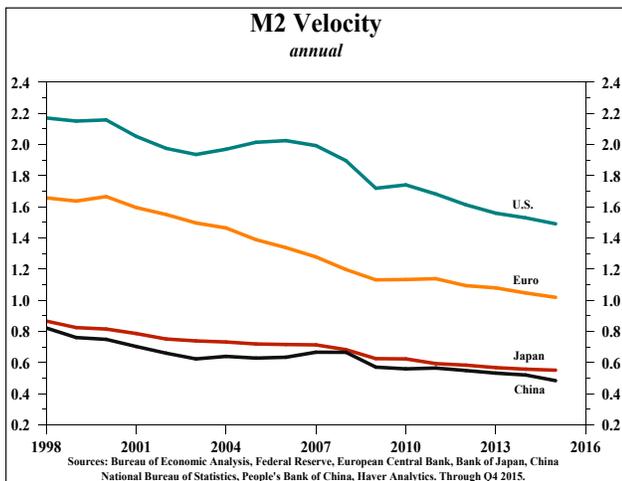


Chart 8

higher than European velocity that, in turn, is higher than Japanese velocity. This pattern is entirely consistent since Japan is more highly indebted than Europe, which is more indebted than the United States. Chinese velocity is slightly below velocity in Japan. This is not consistent with the debt patterns since, based on the reported figures, China is less indebted than Japan. This discrepancy suggests that Chinese figures for economic growth are overstated, an argument made by major scholars on China's economy.

Outlook

Our economic view for 2016 remains unchanged. The composition of last year's debt gain indicates that velocity will decline more sharply in 2016 than 2015. The modest Fed tightening is a slight negative for both M2 growth and velocity. Additionally, velocity appears to have dropped even faster in the first quarter of 2016 than in the fourth quarter of 2015. Thus, nominal GDP growth should slow to a 2.3% - 2.8% range for the year. The slower pace in nominal GDP would continue the 2014-15 pattern, when the rate of rise in nominal GDP decelerated from 3.9% to 3.1%. Such slow top line growth suggests that spurts in inflation will simply reduce real GDP growth and thus be transitory in nature.

Accordingly, the prospects for the Treasury bond market remain bright for patient investors who operate with a multi-year investment horizon. As we have written many times, numerous factors can cause intermittent increases in yields, but the domestic and global economic environments remain too weak for yields to remain elevated.

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