

Hoisington

INVESTMENT MANAGEMENT COMPANY

6836 Bee Caves Rd. B2 S100, Austin, TX 78746 (512) 327-7200
www.Hoisington.com

Interim Update and Comment

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Growth Recession

Federal Reserve Chairman Ben Bernanke said in a recent television interview that economic growth was not “self sustaining.” This description also applies to an economy that is in a classic growth recession. A growth recession is characterized as an economy where GDP grows but the unemployment rate also moves higher.

A close look at the U.S. economy bears out Chairman Bernanke's description. The economy has been expanding for 17 months, yet both the labor force participation rate and the employment to population ratio stand at new cyclical lows and beneath the cyclical lows of the prior expansion. This is an unprecedented development (Chart 1). For the past 19 months, the unemployment rate has been above 9%, underscoring the harshness of labor market conditions. The employment to population ratio, which is a better measure of labor market conditions than the unemployment rate, was at the cyclical low of 58.2% in November,

matching the lowest reading since 1984.

In addition to the increase in the number of unemployed, the quality of jobs remaining in the system is also falling. 478,000 full-time jobs were lost in November, increasing the six month loss in this most important employment category to 1.6 million (Chart 2). Part-time employment rose by 878,000 over the last six months, offsetting part of the loss in full time jobs, but substituting part-time for full-time employment lowers household income.

The U.S. has 15.1 million unemployed persons and another 11 million underemployed or marginally attached to the labor force. The latter is measured by the broad or U6 unemployment rate which stood at 17% in November. Not surprisingly, with this excess labor, the 12 month increase in average hourly earnings fell to a new cyclical low of 1.6% in November. A record 43 million persons receiving food stamps confirms the economic distress.



Chart 1



Chart 2

Monetary Policy Remains Ineffective

Operations by the Federal Reserve, including the start of the second round of quantitative easing (QE2), have increased bank reserves by approximately \$1 trillion since the latter part of 2008. Virtually all of this gain is held in excess reserves at the Federal Reserve Banks earning very close to 10 basis points. In other words, the Fed has provided substantial new reserves to the banks and they have, in turn, deposited the funds back with the Fed.

Reserves are not money unless banks turn them into loans and deposits. Loans are made based on bank capital, which continues to erode because of loan write-offs due to increasing delinquency and default. The bulk of the problem loans are in the residential and commercial real estate. Additionally, the private sector does not have the balance sheet capacity to increase borrowings because their debt ratios are at or near record levels.

Many consider QE policy to be on a successful path because the psychology of its orchestration has boosted the stock market, thereby creating a wealth effect. However, QE has also set in motion unintended consequences. The same factors that have boosted equities have also lifted commodity prices and mortgage rates, both of which are damaging to economic activity.

Commodity loans can be financed at 1% or less. This encourages speculative buying of commodities for inventory, thereby causing food and fuel price increases. For household's of average means, funds for discretionary purchases are quickly drained. This is especially evident since the pump price is now at or above \$3 a gallon. A 30-year mortgage rate approaching 5% only serves to accelerate the downward pressure on home prices - the main source of household wealth. In short, higher stock and commodity prices are not a net gain in current circumstances.

In the past twelve months M2 has risen 3.1% versus the 110 year average growth of 6.6%. If the velocity of money is unchanged in the next year, nominal GDP will rise by 3%. If inflation stays at the less than 1% pace, then real growth will be a paltry 2% in 2011. In the aftermath of failed financial innovation and private sector deleveraging, velocity of money has historically declined. Thus, real GDP may rise less than 2% next year. Either way, the unemployment rate will continue to rise. Fiscal policy influences GDP through the velocity of money. Thus, the new tax compromise may serve to stabilize velocity, but if it passes it will provide limited stimulus to the economy since most of the package is just an extension of existing tax rates, not a reduction in tax rates from current levels.

The Tax Compromise - a Minimal Boost

The tax compromise reached on December sixth between President Obama and the Republican leadership is in many respects like QE2. It plays to psychology but does little to improve fundamental economic conditions. The psychological benefit is that it ends the uncertainty of what tax rates will apply to 2011 and 2012. However, the lower tax rate only applies to these two years and thus, it does not constitute a permanent extension of the current tax rates. Substantial scientific economic research indicates that large responses to tax rate changes only occur when households believe that their permanent income has changed. Also, the contents of the tax compromise are designed for political impact rather than economic effect.

Social security tax rates are cut by 2%, an amount equaling \$120 billion. This is a positive for the economy but the benefit is much smaller than it appears at first blush. Of this amount, \$60 billion replaces the Making Working Pay outlays of 2009 and 2010. The cut in social security taxes does not exempt the wage earner from income taxes and this transitory boost to income may not be fully spent because of concerns of employment and income in the current environment. Such a cut is really no different that the rebate stimulus measures

already unsuccessfully tried by Presidents Ford, Bush, and Obama.

The extension of unemployment benefits carries an expenditure multiplier of close to zero, meaning that there is no net boost to the economy. Historical experience indicates that accelerated depreciation will have a very limited impact until late in 2011. The accelerated depreciation will serve to pull 2012 capital outlays into 2011 in order to take advantage of the benefit. Thus, the net boost from the total package to GDP growth is not much more than 0.5%. This minimal short term benefit will be lost over time since the package increases aggregate indebtedness which is the main structural problem of the U.S. economy. Significant research indicates overindebtedness leads to economic deterioration, heightened systemic risk and, in the case of major contractions, deflation.

State and Local Government Drag

When the state legislatures return to work in January, they face combined deficits in the vicinity of \$280 billion. At this stage, most of the quick fixes and rainy day funds have already

been exhausted. Deficits of this magnitude mean that cuts in spending and higher taxes are likely outcomes. In November, state and local governments cut 11,000 jobs, pushing the employment level in this sector back to the 2007 level. This will be an ongoing theme.

Bond Yields

The bond yield moves in the same direction as inflation about 70% of the time annually, and the correlation is even higher for longer periods of time. While there are numerous episodes when they have not lined up for shorter-time spans, this relationship is one of most stable in macroeconomics. The 30 year bond yield is currently well above 4% yet inflation is less than 1%, resulting in roughly a 3% real yield. The real yield has averaged about 2% over the last 140 years, suggesting value at these levels. The US inflation rate will continue to fall as the economy remains in a growth recession. In time (possibly soon!), this will produce lower long term Treasury yields.

Van R. Hoisington
Lacy H. Hunt, Ph.D.