

Hoisington

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Quarterly Review and Outlook

First Quarter 2019

Downturn

The slowdown in U.S. economic activity that started in 2018 has continued into 2019, as confirmed by deteriorating indicators in cyclical bellwether sectors like autos, housing and capital spending, as well as other broad economic aggregates. This has now been acknowledged by the FOMC and recognized in the market, as revealed by declining yields in high grade money and bond markets. These developments reflect the unfolding of the following two major economic theorems:

(1) Federal debt accelerations ultimately lead to lower, not higher, interest rates. Debt-funded traditional fiscal stimulus is extremely fleeting when debt levels are already inordinately high. Thus, additional and large deficits provide only transitory gains in economic activity, which are quickly followed by weaker business conditions. With slower economic growth and inflation, long-term rates inevitably fall.

(2) Monetary decelerations eventually lead to lower, not higher, interest rates as originally theorized by economist Milton Friedman.

The unifying feature of both theorems is that they are cast in a dynamic, rather than static, framework.

Theorem 1: Government Debt and Interest Rates

In the past twenty years, gross government debt as a percent of GDP advanced dramatically in all major economic areas of the world – the U.S., the euro area, the U.K. and Japan. Yet, long-term

government bond yields dropped sharply in all four areas. This result contradicts the view that the supply of government debt determines long-term risk-free yields. In microeconomic models and standard supply/demand analysis, increasing the issuance of debt could push yields higher. Quite possibly in the very short-run heavy issuance of government debt has this presumed effect, but it is not the ultimate determinant of long-term risk free rates.

The Fisher equation ($i = r + \pi^e$) is one of the pillars of macroeconomics, and it defines the long-term risk-free rate as being equal to the real rate plus expected inflation. This means that any short-run increase in yields caused by greater supply is eventually reversed by deteriorating economic and inflation fundamentals. Undoubtedly, government debt will rise sharply relative to GDP over the next several years. This increased debt level will weaken economic activity, thus inflation, pushing long-term yields lower, thereby continuing the now almost three-decade long trend to lower long-term Treasury yields. The empirical evidence is clear. In the past two decades, the government debt-to-GDP ratio rose by 45%, 119%, 15% and 63% in the U.S., Japan, the euro area and the U.K., respectively, unprecedented amounts for any peace time period. At the same time, government bond yields dropped 285, 235, 380 and 400 basis points, respectively (Charts 1, 2, 3, 4).

Despite a current gross debt-to-GDP ratio of 106% and a CBO estimate of 110% in seven years, there are currently strong recommendations for even larger deficits and higher debt-to-GDP ratios. One such recommendation emanates from the spring 2019 edition of *The Brookings Paper on Economic Activity* by Lukasz Rachel and Lawrence H. Summers (we will refer to as RS) entitled “On falling neutral real rates, fiscal policy, and the risk

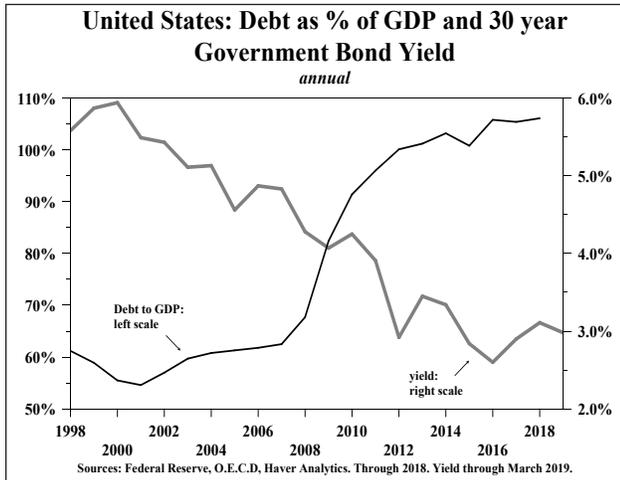


Chart 1

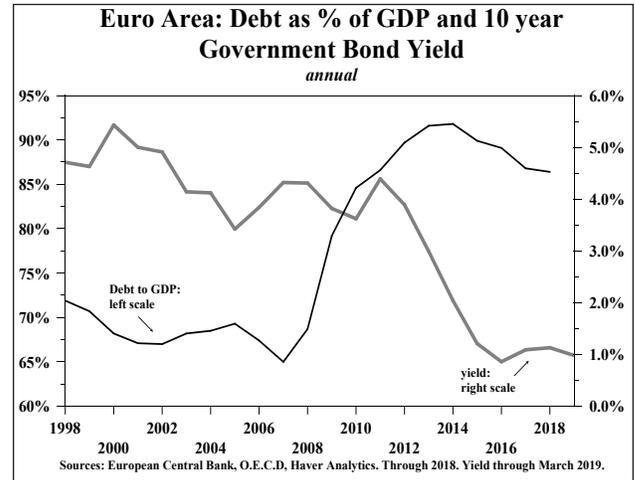


Chart 3

of secular stagnation.” From other sources there is a more pernicious recommendation regarding fiscal expansion which revolves around Modern Monetary Theory.

The Brookings Paper. The Brookings study starts with the point that stimulative monetary policy options are now inefficacious. RS write that the Fed could take steps to boost private indebtedness, but this might lead to a crisis. Additionally, negative interest rates could be engineered, but that would bring along a complex maze of technical and financial problems. With monetary policy sidelined, RS contend that fiscal policy must do much more to contain chronically weak demand, or as they term it “secular stagnation.” They take the low levels of interest rates as a sign that fiscal policy has done too little in the “high income countries” and that is why interest rates are so low. To remedy the problem,

they recommend substantially larger fiscal deficits.

Three considerations suggest the RS thesis will not work as advertised. (1) Many historical case studies, including findings from Japan and the U.S., do not support the RS thesis. (2) There exists an insufficiency of national saving (private and government combined) to fund greater deficits without sharply reducing investment in plant and equipment and/or consumer spending. (3) The production functions in the high-income economies indicate that greater use of debt will result in weaker real GDP growth, further restraining the standard of living, via the law of diminishing returns.

(1) Case Studies: Japan and the United States. The RS thesis stands in stark contrast with the Japanese experience. Government debt-to-GDP jumped from 52% in 1988, to 80% in 1998, to 200%

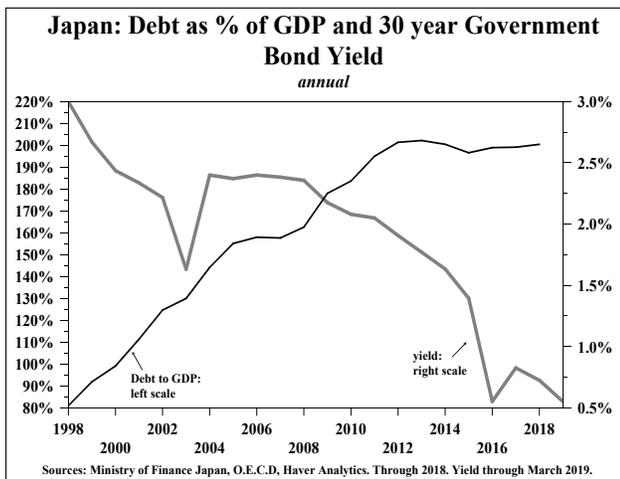


Chart 2

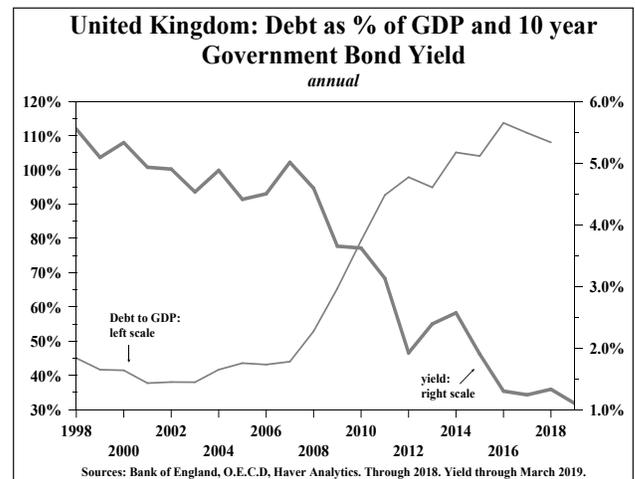


Chart 4

in 2018, an all-time high, including periods of war. Japan has had four recessions in the past ten years. Moreover, they may be entering a fifth recession in 2019. Presently, 30- and 10-year JGBs are yielding 0.5% and -0.1%, respectively. Apparently massive government spending did not help.

The same holds true in the United States. In the past 20 years, the government debt-to-GDP ratio surged by 45 percentage points. This debt level relative to GDP was the highest on record, with the exception of war times and immediate post-war years. If such a large increase in federal debt was supportive of economic activity, the economy would have grown above trend. Instead, growth was far below trend. In the past two decades, real per capita GDP growth in the U.S. was 1.2% per annum, 37% less than the average from 1790 to 1997.

Recent U.S. fiscal policy actions have included a massive corporate tax cut, a household tax reduction and a major bipartisan increase in federal spending. Last year, this stimulus lifted the GDP growth rate in the second quarter. However, by the fourth quarter the stimulus was hard, if not impossible, to detect in the broad economic aggregates. This experience indicates that the Keynesian government multiplier assumptions still taught in most textbooks are simply not working to the significant degree in which they are described. In his 2007 textbook, *Macroeconomics: A Modern Approach*, Robert Barro noted that the government spending multiplier is essentially zero. This further explains the empirical truth that large government debt and indebtedness leads to lower, not higher, interest rates. Borrowing is indeed much greater, but large indebtedness eventually slows economic growth as resources are transferred from the highly productive private sector to the government sector. The slower growth diminishes inflation, thus long-term rates inevitably fall despite greater issuance of debt obligations by the government. The 2018 pattern is consistent with econometric studies that show that large increases in government debt boost the economic growth rate for a few quarters, but the overall effect is negative by the end of three years.

(2) Insufficiency of saving. At the end of

World War II, in one of his last speeches before his death, John Maynard Keynes argued that the U.S. economy would be entering an “underemployment disequilibrium” unless the U.S. continued running the large deficits of WWII. This was consistent with the major tenets of his macroeconomics that deficits should be used to combat over-saving (which leads to under consumption). Secular stagnation is basically the rebirth of the over-saving theory. However, after WWII the U.S. balanced the budget, contrary to Keynes’s recommendation, and the economy boomed, permitting the U.S. to rebuild and open U.S. markets to the world’s exporters. What Keynes missed is that the national saving rate averaged over 10% during WWII, and the U.S. had a strong balance sheet. The private sector drew down their saving, and this propelled the economy higher. In 2018, the national saving rate was 3%, less than half the long-term average since 1929 and one-fifth the level of 1945. There is no excess saving to be drawn down (Chart 5).

(3) Declining marginal productivity of debt. When a factor of production is overused, real GDP follows the law of diminishing returns. With debt accelerating even faster under the RS thesis, the marginal productivity of debt should contract further, creating the same pattern evident in the U.S., the U.K., Japan and China. Diminishing returns is a non-linear concept, which means more is not more, it is less. In 2017 and 2018, the GDP generating capacity of debt for all reporting countries was 17.4% lower than 10 years ago. Declining debt productivity suggests that as expansionary measures,

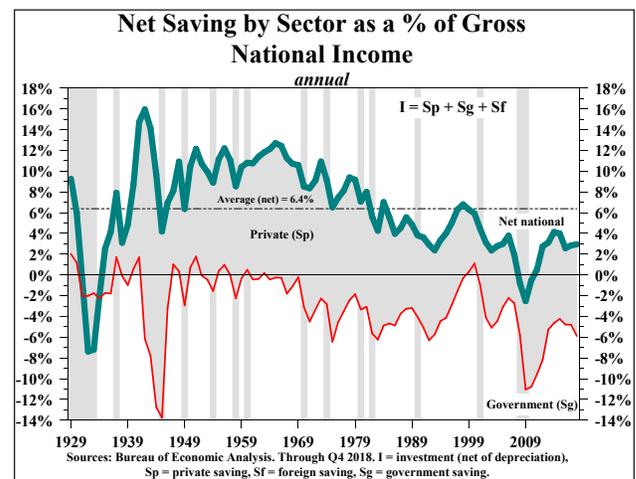


Chart 5

both monetary and fiscal policy have run their course (Table 1).

Modern Monetary Theory (MMT). When Federal Reserve Chairman Ben Bernanke appeared on 60 Minutes on CBS in early 2009, he said that quantitative easing was effectively printing money. This was incorrect. Thus, in late 2010 when Dr. Bernanke returned to 60 Minutes, he admitted he misspoke. Bernanke’s textbook, *Macroeconomics*, written with Dr. Andrew Abel of Wharton and Dr. Dean Croushore of the University of Richmond, states that M2 (or money) equals the monetary base (mb) times the money multiplier (m). They present algebraic proof that while the Fed can influence m by changing reserve requirements, they cannot control it and thus, under existing laws, the Fed does not have the tools/mechanisms necessary to “print money”. They could and did change the level of the monetary base by purchasing U.S. and agency securities, and indeed the base quadrupled in QE 1, 2 and 3. However, they could not control m, which fell from 9 to 3, and M2 growth remained generally subdued.

Under existing statutes, Fed liabilities, which they can create without limits, are not permitted to be used to pay U.S. government expenditures. As such, the Fed’s liabilities are not legal tender. They can only purchase a limited class of assets, such as U.S. Treasury and federal agency securities, from the banks, who in turn hold the proceeds from this sale

in a reserve account at one of the Federal Reserve banks. There is currently, however, a real live proposal to make the Fed’s liabilities legal tender so that the Fed can directly fund the expenditures of the federal government – this is MMT – and it would require a change in law, i.e. a rewrite of the Federal Reserve Act.

This is not a theoretical exercise. Harvard Professor Kenneth Rogoff, writing in *Project-Syndicate.org* (March 4, 2019), states “A number of leading U.S. progressives, who may well be in power after the 2020 elections, advocate using the Fed’s balance sheet as a cash cow to fund expansive new social programs, especially in view of current low inflation and interest rates.” How would MMT be implemented and what would be the economic implications? The process would be something like this: The Treasury would issue zero maturity and zero interest rate liabilities to the Fed, who in turn, would increase the Treasury’s balances at the Federal Reserve Banks. The Treasury, in turn, could spend these deposits directly to pay for programs, personnel, etc. Thus, the Fed, which is part of the government, would be funding its parent with a worthless IOU. In historical cases of money printing, the countries were not the reserve currency of the world, as the U.S. is today. Thus, the entire global system could be destabilized in very short order if this were to occur.

There would be no real increase in services or money since very little time would lapse before people realized increasing inflation was not increasing real purchasing power. If the government responded by issuing more central bank legal tender, the inflationary process would become self-perpetuating, and as was the case in numerous historical instances this would lead to hyper-inflation. Moreover, the central bank would have no capability of reducing the money supply. All they could offer would be the zero maturity, zero interest liabilities of the government, but there would be no buyers. This would mean that hyper-inflation would be difficult to stop.

		(2007, 2008 avg.) Ratio of GDP to Debt	(2017, 2018 avg.) Ratio of GDP to Debt	% change
		A	B	C
1.	Euro Area	0.45	0.38	-16.9%
2.	United Kingdom	0.43	0.36	-17.0%
3.	Japan	0.32	0.27	-16.7%
4.	United States	0.44	0.40	-7.8%
5.	China	0.71	0.36	-49.0%
6.	All reporting countries (aggregate)	0.48	0.42	-17.4%

Source: Bank of International Settlements. * China adjusted based upon "A forensic examination of China's national accounts," Brookings Institute on March 7, 2019, by Wei Chen, Xilu Chen, Chang-Tai Hsieh (University of Chicago), and Zheng (Michael) Song (Chinese University of Hong Kong). ** China's economy is about 12 per cent smaller than official figures indicate and its real growth has been overstated by about 2 percentage points annually in recent years*.

Table 1

Theorem 2: Monetary Deceleration

The great U.S. economist Irving Fisher provided us with the equation of exchange ($M2 \cdot V = GDP$) which states that money times its turnover (velocity) is equal to nominal GDP. The Federal Reserve has virtually no control over the velocity of money, but it can influence the monetary and credit aggregates. It is somewhat ironic that the Fed pays little attention to these important variables in its policy discussions. The Fed's main focus has been on the highly disputed Philips curve which has been empirically and theoretically shown to be an unreliable guide to policy. Further, in recent years they have paid increasing attention to the esoteric so-called neutral interest rate which cannot be directly observed or contemporaneously measured. With this misdirection in emphasis, the Fed has once again steered the U.S. economy toward recession. The Fed's influence on the economy is through changing interest rate levels (the "price effect") and influencing the growth of the monetary aggregates (the "quantity effect").

The Fed's actions over the past four years fit a pattern that has many precedents in economic history. The reserve aggregates, such as the monetary base and excess reserves, peaked in the summer of 2014 (Chart 6). The policy rate has been raised nine times, with the first increase in December 2015. The year-over-year growth in M2 and bank credit peaked in October 2016 and then

decelerated sharply thereafter. Meanwhile, the velocity of money fell sharply. Also, symptomatic of the monetary restraint, the yield curve flattened dramatically, with parts of the curve inverting. Moreover, the fall in the monetary base resulted in an unprecedented contraction in world dollar liquidity that led to monetary decelerations in Europe, Japan and China and from there to a synchronized global economic slowdown. Historically, many lags of two years can be found between the peak in M2 growth and the peak in economic activity.

Market Implications

The parallels to the past are remarkable, but there appears to be one fatal similarity – the Fed appears to have a high sensitivity to coincident or contemporaneous indicators of economic activity, however the economic variables (i.e. money and interest rates) over which they have influence are slow-moving and have enormous lags. In the most recent episode, in the last half of 2018, the Federal Reserve raised rates two times, by a total of 50 basis points, in reaction to the strong mid-year GDP numbers. These actions were done despite the fact that the results of their previous rate hikes and monetary deceleration were beginning to show their impact of actually slowing economic growth. The M2 (money) growth rate was half of what it was two years earlier, signs of diminished liquidity were appearing and there had been a multi-quarter deterioration in the interest rate sensitive sectors of autos, housing and capital spending. Presently, the Treasury market, by establishing its rate inversion, is suggesting that the Fed's present interest rate policy is nearly 50 basis points too high and getting wider by the day. A quick reversal could reverse the slide in economic growth, but the lags are long. It appears that history is being repeated – too tight for too long, slower growth, lower rates.

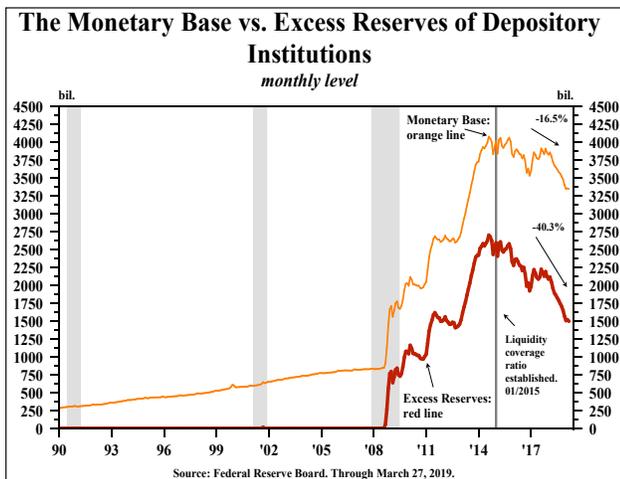


Chart 6

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Lacy H. Hunt, Ph.D.

The Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. The Bloomberg Barclays Bellwether indices cover the performance and attributes of on-the-run U.S. Treasuries that reflect the most recently issued 3m, 5y and 30y securities. CPI is the Consumer Price Index as published by the Bureau of Labor Statistics. S&P 500 is the Standard & Poor's 500 capitalization weighted index of 500 stocks. You cannot invest directly in any index. The Bloomberg Barclays indices, CPI and S&P 500 are provided as market indicators only. HIMCO in no way attempts to match or mimic the returns of the market indicators shown, nor does HIMCO attempt to create portfolios that are based on the securities in any of the market indicators shown.

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