THE BEAT GOES ON

The first quarter saw another drop in the stock market of approximately 10% before rebounding at the end of the quarter. The S&P 500 ended up 1.35%, the Dow up 2.2% and the NASDAQ was down 2.43%. The market has been flat in April/May so far. The bond market measured by the Barclay’s US Aggregate Bond index was up 3.03% in the first quarter.

The same themes exist that have existed for a while. The global economy has slowed down and continues to struggle. GDP in the U.S. grew only 0.5% in the first quarter. This means we can expect growth of 2.0%-2.5% in 2016 unless something dramatic happens. Central banks are still providing stimulus to their economies by lowering interest rates to the point that some are negative, like Japan. Japan is trying to avoid another recession. Top line growth of U.S. companies has been flat for some time due to the slowing global economy and the stronger dollar. Profit margins are down but companies continue to beat earnings estimates because analysts have been lowering estimates for two years. Energy stocks and financials have been moving the indexes one way or the other depending on the movement of the price of oil. Oil could be at $60 per barrel by the end of 2016. The causes of the slow global economy are too-much debt and low interest rates.

The “Bond King” Bill Gross had some interesting observations in a Barron’s article on April 11, 2016 entitled “Why Rates Must Rise”. Selected comments are as follows:

You have taken central bankers to task for impotence and ignorance, among other sins. In particular, you have written that Fed Chair Janet Yellen and others are ignorant of the harm done by their policies “to a classical economic model that has driven prosperity.” Just what did you mean, and what sorts of dangers do we face?

The Federal Reserve was created in 1913. President Nixon took the U.S. off the gold standard in 1971. For the past 40-plus years, central banks have been able to print as much money as they wanted, and they have. When I started at Pimco in 1971, the amount of credit outstanding in the U.S., including mortgages, business debt, and government debt, was $1 trillion. Now it’s $58 trillion. Credit growth, at least in its earlier stages, can be very productive. For all the faults of Fannie Mae and Freddie Mac, the securitization of mortgages lowered interest rates and enabled people to buy homes. But when credit reaches the point of satiation, it doesn’t do what it did before.

Central banks believe that the historical model of raising interest rates to dampen inflation and lowering rates to invigorate the economy is still a functional model. The experience of the past five years, and maybe the past 15 or 20 in Japan, has shown this isn’t the case.

So where does that leave our economy?

In the developed financial economies, as a bloc, lowering interest rates to near zero has produced negative consequences. The best examples of this include the business models of insurance companies and pension funds. Insurers have long-term liabilities and base their
death benefits, and even health benefits, on earning a certain rate of interest on their premium dollars. When that rate is zero or close to it, their model is destroyed.

To use another example, California bases its current and future pension payments to civil workers on an estimated future return of 8% or so from bonds and stocks. But when bonds return 1% or 2%, or nothing in Germany’s case, what happens? We’ve seen the difficulties that Puerto Rico, Detroit, and Illinois have faced paying their debts.

Now consider mom and pop and other people who read Barron’s. They are saving for retirement and to put their kids through college. They might have depended on a historic 8%-like return from stocks and bonds. Well, sorry. When interest rates get to zero—and that isn’t the endpoint; they could go negative—savers are destroyed. And savers are the bedrock of capitalism. Savers allow investment, and investment produces growth.

Are you suggesting a recession looms?

No. I see very slow growth. In the U.S., instead of 3% economic growth, we have 2%. In euroland, instead of 2%, growth is 1%-plus. In Japan, they hope for anything above zero. What governments want, and what central banks are trying to do, is produce, in addition to minimal growth, a semblance of inflation. Inflating is one way to get out from under all the debt that has been accumulated. It isn’t working, because with interest rates at zero, companies and individual savers sense the futility of taking on risk. In this case, the mint eater doesn’t explode, but the system sort of grinds to a halt.

It doesn’t look like anything is grinding to a halt around here. You can see gorgeous golf courses from one window and a yacht basin from the other.

This isn’t the real economy. It is Disneyland and Hollywood. It is finance-based prosperity, based on money that doesn’t produce anything anymore because yields are so low.

Even in a negative-rate environment, as in Germany or Switzerland, banks and big insurance companies have little choice but to park their money electronically with the central bank and pay 50 basis points. But an individual can say “give me back my money” and keep it in cash. That’s what would make the system implode. I’m not talking about millionaires or Newport Beach–aires, but people with $25,000 or $50,000. Without deposits, banks can’t make loans anymore, so the system starts to collapse.

Let’s say Yellen steps down and President Obama appoints you the new head of the Fed. What would you do differently?

What you’re really asking is: What is the way out? The way out is a little bit of pain over a relatively long period of time. That is a problem for politicians and central bankers who are concerned with their legacy. It means raising interest rates and returning the savings function to normal. The Fed speaks of normalizing the yield curve but knows it can’t go too
fast. A 25-basis-point increase [in the federal-funds rate] in December had consequences in terms of strengthening the dollar and hurting emerging markets.

**Will the Fed raise rates this year?**

Yes, as long as the stock market permits it. They have to normalize interest rates over a period of two, three, four years, or the domestic and global economy won’t function. In today’s world, normalization would mean a 2% fed-funds rate, a 3.5% yield on the 10-year bond, and a 4.5% mortgage rate. Would this create some pain? Of course. Housing prices probably would stop rising, and might fall a bit. The Fed has to move gradually.

**What will be the 10-year Treasury yield at the end of 2016?**

Close to what it yields now. I expect the Fed to raise rates once or twice this year. That would put the fed-funds rate at 1%. Does the 10-year deserve to yield 1.90% with fed funds at 1%? Yes, so long as inflation is 2% or less. If the Fed raises rates, the euro and yen could weaken. That would mean rates in Europe and Japan don’t have to go negative, or to extreme lows. In a sense, the Fed is driving everything. But it can’t raise rates too much without threatening a country like Brazil, whose corporations have tons of dollar-dominated debt.

**What will the global economy look like in five or 10 years?**

Structurally, demographics are a problem for global growth. The developed world is aging, with Japan the best example. Italy is another good example, and Germany is a good, old society, too. As baby boomers get older, they spend less and less. But capitalism has been based on an ever-expanding number of people. It needs consumers.

Another thing happening is deglobalization, whether it’s Donald Trump building a wall to keep out Mexicans, or European nations putting up fences to keep out migrants. Larry Summers [former secretary of the Treasury] has talked about secular stagnation, or a condition of little or no economic growth. At Pimco, I used the term “the new normal” to refer to this condition. It all adds up, again, to very slow growth. The days of 3% and 4% annual growth are gone.

Hoisington Investment Management also has some very good observations about debt and its effect on GDP. Their comments from the “Quarterly Review and Outlook First Quarter 2016” are as follows:

**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. 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 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.

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 income stream to meet interest and repayment requirements.

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%.

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

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. 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. 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, constitutes a serious roadblock for central banks that are trying to implement policy actions to boost economic activity. Velocity has fallen dramatically for all four countries since 1998.

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 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.

Conclusion

Bill Gross points out that the Fed must raise interest rates slowly so that retirement plans, companies and savers can achieve returns from fixed income investments that result in growth in the economy. Hoisington points out that the amount of nonfinancial debt has not been invested into business operations but instead into financial operations that do not generate an income stream to meet interest and repayment requirements.
Art Laffer, the father of the “Supply Side Economics”, pointed out recently that too much debt to GDP, high interest rates or low interest rates slow the economy down. We find ourselves in this conundrum with high debt and low interest rates. It is going to be difficult to get out.

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