

Hoisington

INVESTMENT MANAGEMENT COMPANY

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Quarterly Review and Outlook Second Quarter 2020

Enormous Challenges

Four economic considerations suggest that years will pass before the economy returns to its prior cyclical 2019 peak performance. These four influences on future economic growth will mean that an extended period of low inflation or deflation will be concurrent with high unemployment rates and sub-par economic performance.

First, with over 90% of the world's economies contracting, the present global recession has no precedent in terms of synchronization. Therefore, no region or country is available to support or offset contracting economies, nor lead a powerful sustained expansion.

Second, a major slump in world trade volume is taking place. This means that one of the historical contributions to advancing global economic performance will be in the highly atypical position of detracting from economic advance as continued disagreements arise over trade barriers and competitive advantages.

Third, additional debt incurred by all countries, and many private entities, to mitigate the worst consequences of the pandemic, while humane, politically popular and in many cases essential, has moved debt to GDP ratios to uncharted territory. This insures that a persistent misallocation of resources will be reinforced, constraining growth as productive resources needed for sustained growth will be unavailable.

Fourth, 2020 global per capita GDP is in the process of registering one of the largest yearly declines in the last century and a half and the largest

decline since 1945. The lasting destruction of wealth and income will take time to repair.

Synchronicity

The World Bank indicates that a record 92.9% of the world's countries are in recession in 2020 (Chart 1). This level is well above the previous high recorded in the Great Depression of 83.8%. It also exceeds the highs registered in 1914 at 70%, 1918-1921 at 70%, and 2008-09 at 61.2%. There have been 14 global recessions from 1871 to 2020. The percentage of the world's economies in recessions was generally not highly coordinated, with an average of 54.3%. Based on an examination of these four previous periods of high synchronicity where the economic results are observable, a conclusion can be drawn regarding our present situation.

Recessions are either deeper or longer lasting when a very high percentage of the world's economies are contracting rather than when they are centered on a limited number of countries. The

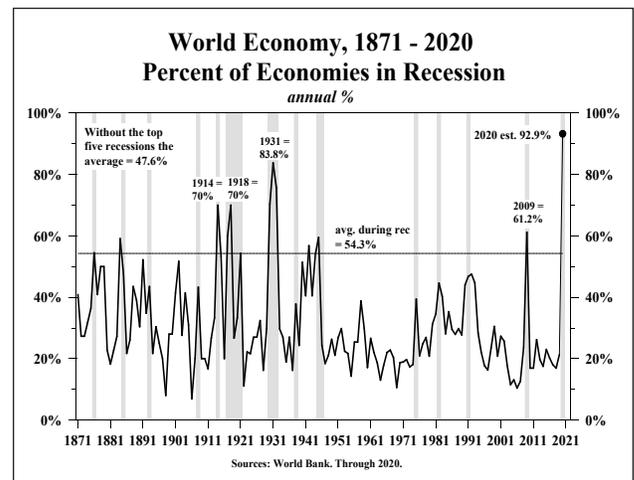


Chart 1

recession in 1914 is contrary to the rule and is the sole exception as the slump lasted less than a year. It was truncated as World War I started in August of that year, resulting in an immediate upturn in world output. The other three high synchronicities meant deeper and or longer contractions.

World Trade Volume

Expanding world trade for the past nine decades has been a powerful engine of economic growth. Since 1929 world trade grew by an average 4.8% per annum, three times greater than the 1.6% annual growth in global real GDP (Chart 2). The Organization for Economic Cooperation and Development (OECD) estimates world trade volume will contract by a dramatic 15% in 2020, the largest drop since 1945-46 and the third largest fall since 1930.

With so little of the world left untouched by the 2020 world-wide contraction, no countries appear able to provide a meaningful leadership role in moving the world economy forward by expanding trade relationships. In addition, it appears that present economic distrust might encourage efforts to erect trade barriers that aim to boost domestic growth.

Unproductive Debt

Total domestic nonfinancial debt, excluding off balance sheet liabilities such as leases and

unfunded pension liabilities, surged to a record 259.7% of GDP in the first quarter of this year, 11.4 percentage points higher than the 2009 level when Lehman Brothers failed. Confirming economic research regarding diminishing returns of the overuse of debt, each dollar of debt generated only 38.5 cents of GDP in the first quarter of this year. This result is defined as the marginal revenue product of debt (MRP_D), which is down from 40 cents at the end of 2019 (Chart 3). Each dollar of debt has generated only 13 cents of GDP growth for the past four quarters, compared with less than one-half of the 26.5 cents generated during the final four quarters immediately before the recession that started in late 2008.

Due to slower reporting of debt in major foreign economies a comparison between the U.S. total nonfinancial debt situation with that of its major trading partners for 2020 is not yet possible. Anecdotal information, however, indicates that the debt overhang worsened in virtually every major economy, with both Japan and China taking on more total new debt in absolute terms than the larger U.S. economy.

Gross government debt estimates for year-end 2020 are available from the International Monetary Fund. These figures do not include unfunded government liabilities and as such understate the magnitude of the problem. These statistics indicate simultaneous deterioration for the major economies. The gross government debt

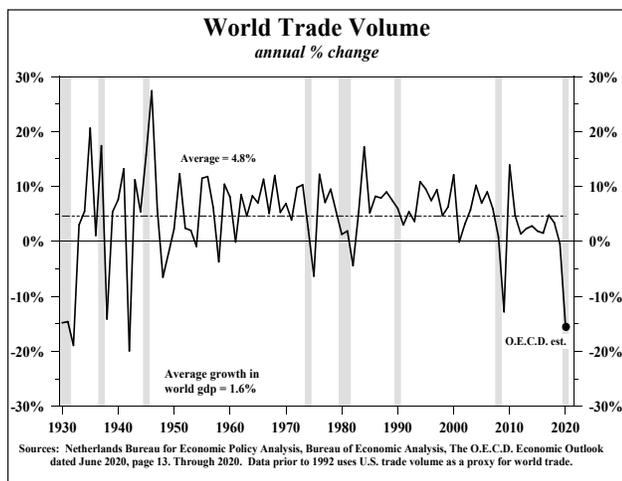


Chart 2

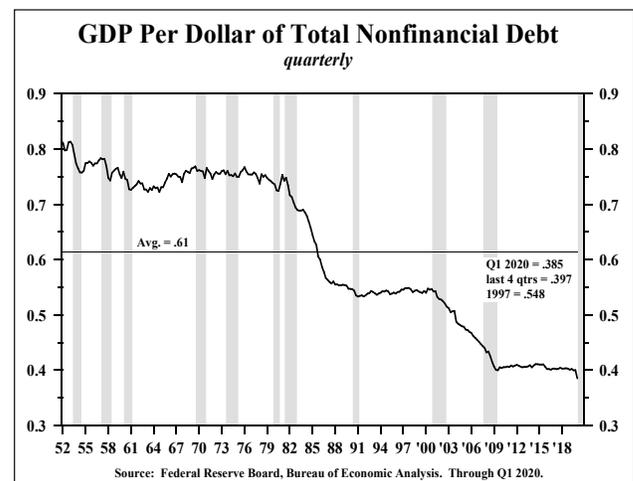


Chart 3

to GDP ratio for the U.S., Japan, Italy, France, and the UK each are jumping to new all-time records, far above the levels at the end of 2019 (Chart 4). China is excluded as it guarantees provincial and other debt, rendering their series not comparable.

The rising debt levels and subsequent result of falling MRP_D will produce two major macro-economic consequences. First is diminishing returns, a conclusion that is derived from the production function. This idea is that unless offset by the contribution from technology, demographics or natural resources, the overuse of debt will lead to a further weakening economic growth, thereby placing downward pressure on inflation. When examining each of these categories one cannot find any optimism for growth. Technological innovation continues to be evolutionary rather than a revolutionary nature. There appears to be limited new sources of raw materials. Recent demographic numbers available from Japan, indicate in 2019 the population declined 0.2% equaling the all-time low. In view of the adverse effects of the pandemic, other major countries are likely to experience a weakening demographic trend. A recent Brookings Institute study posits the pandemic will lead to 300,000-500,000 less births next year. For 2019, population growth in the U.S. and the world, was already the slowest since 1918 and 1952, respectively.

The second macro-economic effect of weaker MRP_D will be the continued downward pressure on the velocity of money. Many factors influence money velocity, but a strong long-term

relationship has been evident between the trend in the MRP_D and velocity since the economy became heavily over-indebted in the late 1990s. Since the peak in velocity in 1997, velocity fell 34% as MRP_D decreased 29%. This is a very close relationship in view of the large number of influences on velocity. Upcoming developments will be an excellent test of this relationship as M2 has grown at a 23.8% rate in the latest twelve months, the fastest since 1943. We expect velocity to drop sharply in the second quarter then rebound in the second half of the year but not sufficiently to offset the fall in velocity in the first half. In 1934, Irving Fisher wrote that the velocity of money falls in heavily indebted economies. We believe that Fisher's finding will be correct because his view is supported by the evidence and the rationale that the huge additional debt added this year will not generate an income stream to repay principal and interest. Accordingly, the reopening rebound in the economy underway will falter, leaving the economy with a huge output gap. Extreme indebtedness in the corporate sector is a micro-consideration that also supports this view.

Corporate Debt

The U.S. business sector continues to ignore Benjamin Graham's dictum for sound corporate financial management: sell company shares when stock prices are high and use the proceeds to pay off debt and buy shares when stock prices are low by issuing debt. In the first quarter, corporate debt jumped to a record 48.7% of GDP, more than 300 basis points higher than during the Lehman crisis

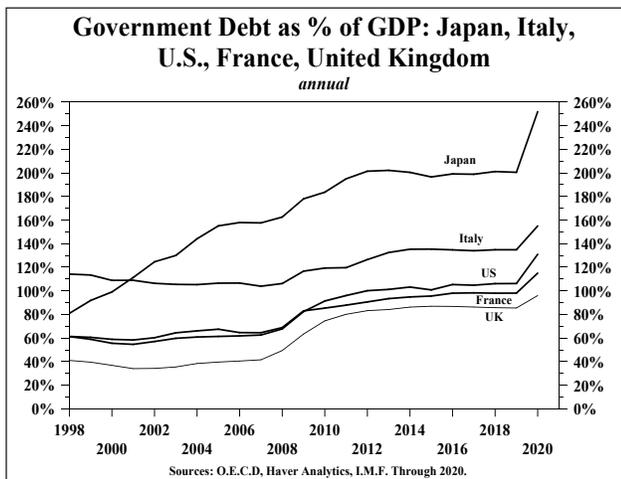


Chart 4



Chart 5

(Chart 5). Contrary to the widespread forecasts for a capital spending boom, the year over year growth in real private fixed investment peaked in 2012 and since then, the trend has been decelerating significantly downward. In the first quarter, real private fixed investment was negative for the first time in ten years. The surge in corporate indebtedness coincided with a profits recession that was evident even before the coronavirus hit. Real corporate profits after tax with IVA and CCA, which were unchanged from 2012 at the end of 2019, fell in this year's first quarter to the lowest level in nine years. The situation will be considerably worse after the figures are tabulated for the spring quarter. The stressed corporate income statement and balance sheet circumstances strongly indicate that the reopening rebound in capital spending will simply not have staying power.

Except for the very short run, the Federal Reserve's lending operations for the corporate bond market are a negative for economic growth. The BOJ (Bank of Japan), ECB (European Central Bank) and the People's Bank of China (PBOC) have all been buying corporate debt of failing entities for more than a decade with the BOJ doing so for more than 25 years. These operations have provided a fleeting lift to economic activity, but at the end of the day they resulted in misallocation of credit, poor economic growth and disinflation/deflation. By keeping failing players in the game, this prevents the process Joseph Schumpeter called "creative destruction" as well as "moral hazard", thereby eliminating these critical factors that make free market economies successful. When central banks sustain failing businesses, resources are tied up in nonproductive firms and therefore unavailable for new firms that can contribute to economic growth.

Domestic and Global Growth Since 1871

We calculate that U.S. real per capital GDP will register the largest yearly decline since the recession that occurred immediately after the end of World War (Chart 6). There is a highly important different initial condition currently when compared with the decline in the 1940s. As a consequence of

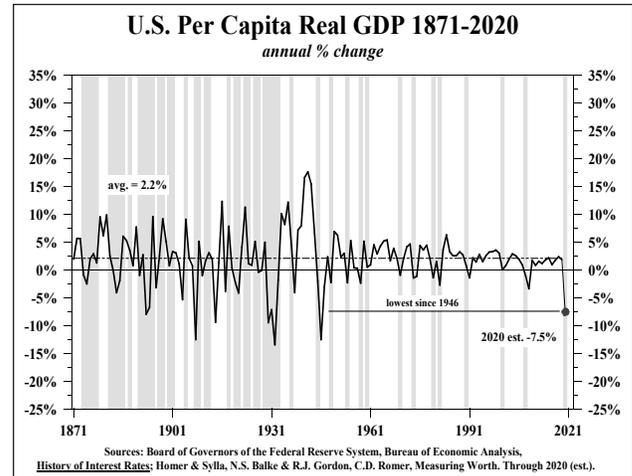


Chart 6

the circumstances of World War II, a surge in private saving occurred that enabled the U.S. to pay off the debt overhang of the 1920s and 1930s and also fund huge war related budget deficits of WWII.

This chart indicates that there are five yearly contractions that were greater than this year, three of which were in the 1930s. Our per capita real GDP 2020 forecast is in line with the median forecast of the FOMC participants at the June 2020 meeting for a 5.5% real GDP decline from fourth quarter to fourth quarter.

The cycle dating committee of the National Bureau of Economic Research (NBER) has determined that the U.S. in 2020 is in its 28th recession since 1870. Recessions in the U.S. have occurred every 5.35 years on average. Reflecting many diverse business cycles for other countries of the world for most of the past 150 years, global recessions have been marked only 14 times and have averaged 10.7 years apart. Thus, the World Bank calculation that the global economy in 2020 is in recession adds a major new dimension to the NBER's calculation about the U.S. and indicates the gravity of economic circumstances.

The World Bank estimates that global real per capita GDP will decline 5.2% this year (Chart 7), on an annual basis, the largest drop since the end of WWII, which was greater than any other year in the past 150 years. No single year in the 1930s fell more than in 1945-46 but large back-to-back contractions were not repeated when WWII ended.

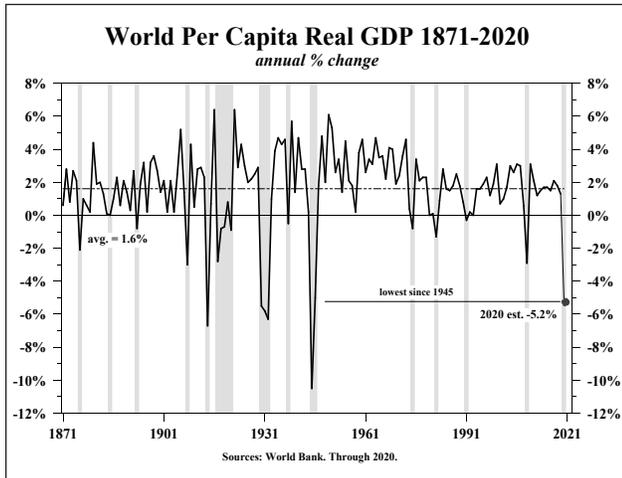


Chart 7

Research

The pandemic will eventually run its course and when that happens economies will register a noticeable improvement. However, the adverse consequences of an unsurpassed increase in new debt will remain for years to come as there currently exists a record domestic and global debt overhang from previous borrowing. Four great past economists – Eugen Bohm Bawerk, Irving Fisher, Charles Kindleberger and Hyman Minsky – all captured the two-edged nature of debt being an increase in current spending in exchange for a decline in future spending unless the debt generates an income stream to repay principal and interest. Using rigorous statistical techniques, contemporary economists such as Kenneth Rogoff, Carmen Reinhart, Alan Taylor, Anja Baum, Cristina Checherita-Westphal, Philipp Rother and others have documented the deleterious effects of high debt levels on economic growth. Included in this work is evidence that the detrimental effect of the debt on GDP per capita increases as the debt level rises. Significant research indicates that the adverse consequences start as low as a 67% gross debt to GDP ratio. In other words, the relationship between debt and economic growth is non-linear, just as is the law of diminishing returns.

Deflationary Gap

Assuming a large percentage gain in economic activity in the second half of this year, the Fed, the World Bank and many economists project that there will still be a substantial gap between potential and real GDP. In economic theory, this is called a deflationary gap. At the end of the three worst recessions since the 1940s, the output gap was 4.8% in 1974, 7.9% in 1982 and 6.4% in 2009. The gap that existed after the recession of 2008-09 took nine years to close. This was the longest amount of time to eliminate a deflationary gap. Even when the gap was closing over the last decade, the inflation rate continued to trend downward, remaining near or below 2%. This indicates that there were even more unutilized/underutilized resources than was captured by the magnitude of the gap. Considering the depth of the decline in global GDP, the massive debt accumulation by all countries, the collapse in world trade and the synchronous nature of the contracting world economies the task of closing this output gap will be extremely difficult and time consuming. This situation could easily cause aggregate prices to fall, thus putting persistent downward pressure on inflation which will be reflected in declining long-dated U.S. government bond yields.

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Disclosures

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