

Hoisington

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Quarterly Review and Outlook Second Quarter 2021

Too Much Debt

In highly indebted economies, additional debt triggers the law of diminishing returns. This fact is confirmed when the marginal revenue product of debt (MRP) falls, where MRP is the amount of GDP created by an additional dollar of debt. In microeconomics, when debt is already at extreme levels, a further increase in debt leads to an increase in the risk premium on which a borrower will default suggesting that the bank or other lender will not be repaid. As the risk premium rises, banks are often unable to price this additional cost through to their private sector borrowers thus the loan to deposit ratio of the banks falls. Combining both the falling MRP with a declining loan to deposit (LD) ratio, results in a reduction in the velocity of money. In terms of the impact on monetary activities, a drop in the LD ratio means that more of bank deposits are being directed to the purchase of Federal, Agency and state and local securities in lieu of private sector loans. The macroeconomic result is that funds are shifted to sectors that are the least productive engines of economic growth and away from the high multiplier ones. More than thirty years ago, Stanford Ph.D. Rod McKnew demonstrated that the money multiplier, referred to as “m”, is higher for bank loans than bank investments in securities. The money multiplier, which is money stock (M2) divided by the monetary base should not be confused with the velocity of money. The latest trends strongly support McKnew’s analysis. In June, after the

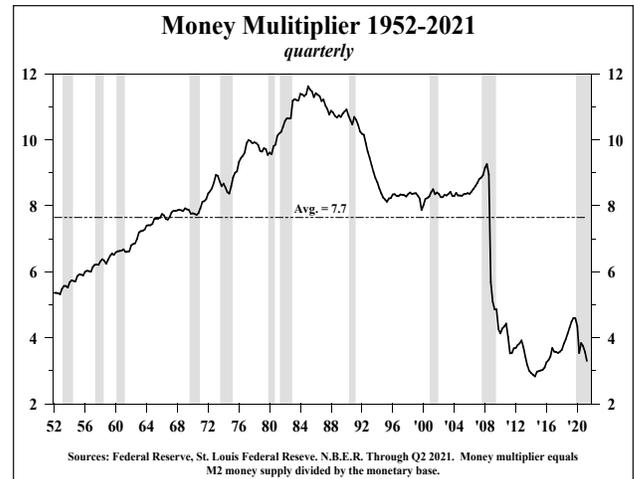


Chart 1

unparalleled monetary and fiscal actions, m is estimated to be 3.2 in the second quarter, less than one-half its post 1952 average of 7.7, and just barely above the all-time low (Chart 1).

The linkage between the LD ratio and money velocity was first identified by Howard Benz, Director of the Fixed Income Strategies at Raymond James, Inc.

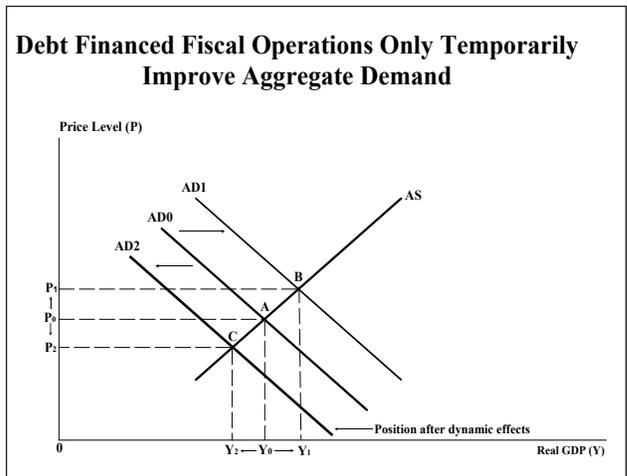


Chart 2

This is an important insight since Aggregate Demand (AD), i.e., nominal GDP, by algebraic substitution, equals money times velocity. As velocity falls, then the AD curve simultaneously begins to retreat back to, or below, where it stood prior to an exogenous monetary or fiscal stimulus. Thus, the AD2 curve prevails, with equilibrium at point C (Chart 2). The price level at P2 and real GDP2 are lower than where they started at P0 and Y0.

The benefit of the debt financed fiscal operation goes away under the weight of the debt. First, there is the evidence of diminished returns, which is derived from the overuse of a factor of production, which is the same as saying the government debt financed multiplier is negative. In other words, one dollar of government debt financed operations, at the end of the day, will reduce GDP by more than a dollar, therefore, the economy is worse off. Increasing deficits in an overindebted economy slows growth after a brief transitory acceleration.

Empirical Record

In Chart 3, the close relationship between the velocity of money and the MRP of public and private nonfinancial debt is readily apparent

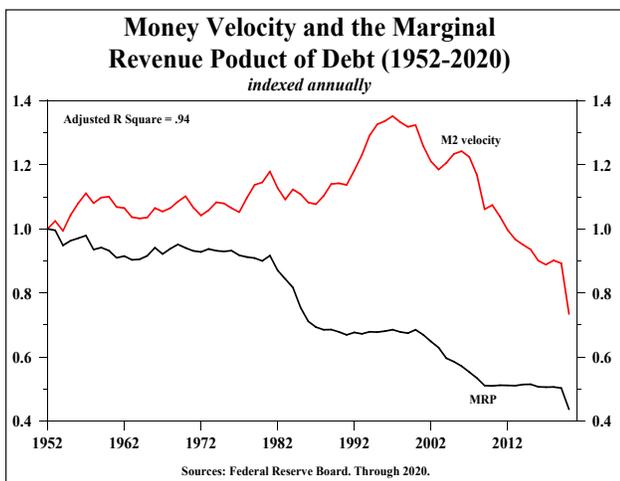


Chart 3

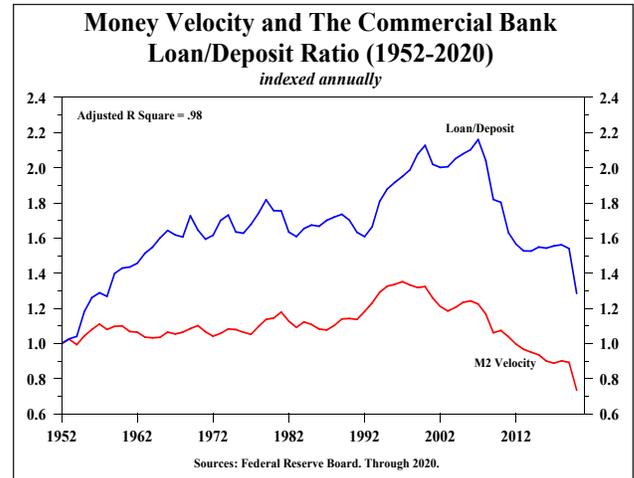


Chart 4

from 1952 through 2020. Comparable data is not available prior to 1952. The adjusted correlation of determination (R2) is highly statistically significant at 0.94. While money velocity statistics are available before 1952, nonfinancial public and private debt is not on a consistent basis. Thus, the graph contains the entire sample of available data. To place money velocity and MRP on the same scale, we indexed both series to 1 in 1952.

In Chart 4, a similarly strong association for the same sample period is found to exist between money velocity and the LD ratio of all commercial banks, both indexed to 1 in 1952. The R2 is 0.98. The weakness in the LD ratio, as well as the money multiplier, confirm that the banking system is not in a position to assist the Fed in achieving their goals for economic activity and inflation. The obstacle for both variables to function normally is the massive debt overhang. There is an assertion that whenever the Fed creates reserves (i.e., Fed liabilities), banks can be counted on to put those reserves to use since they are like a “hot potato.” The decision by a bank to reach an agreement with a private sector borrower is a much more intricate process in which the risk premium is at the core.

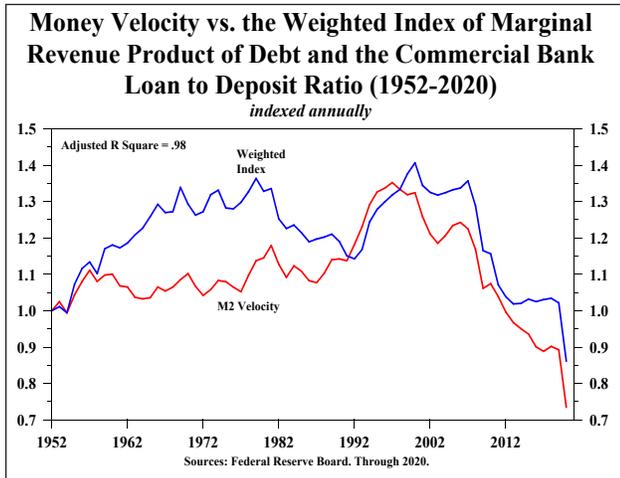


Chart 5

In Chart 5, money velocity is related to an equally weighted average of MRP and the LD ratio. In this case, the R2 is also 0.98. This provides strikingly strong evidence that debt financed fiscal operations only shift the AD curve outward for a limited period of time, just as aggregate analysis indicates it should.

These strong statistically observable relationships are noteworthy because many transitory factors influence money velocity. Yet, even with multiple factors at work, the hypothesis is confirmed by nearly seven decades of data. This long period includes the shift from a fixed exchange rate standard in 1971 to floating currencies, as well as many different corporate and personal income tax rates regimes, frequent political changes, significant changes in all key demographic factors, vast technological change, and a dramatic deregulation of the U.S. banking system in the early 1980s. Major changes also occurred in the shadow banking system with the emergence of hedge funds and a broad array of new shadow banking entities. But, in spite of these vastly different initial conditions, the critical role of MRP and the loan to deposit ratio in determining money velocity remain steadily and strongly apparent.

Two of the greatest monetary economists were Irving Fisher and Milton Friedman.

Friedman’s analysis was based on the equation of exchange ($M \times V = GDP$) that was originally developed by Fisher. Friedman called Fisher “America’s greatest economist.” Friedman, whose statistical work was based on the time period from the early 1950s until the early 1980s, believed money velocity was stable, although not constant. During that span he was correct, however, due to archival research that resulted over a much longer time period of data, Friedman’s view is not correct. Fisher, working with less data than Friedman and far fewer resources than are available today, did not share Friedman’s critical assumption. Fisher originally believed that velocity was stable, however, as more evidence became available he wrote, in a 1933 article in *Econometrica*, that velocity declines in highly indebted economies. The research presented in this article is consistent with Fisher’s view that debt is 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. Thus, Fisher is correct. Friedman’s famous phrase that “inflation is always and everywhere a monetary phenomenon” would only hold if the central bank’s liabilities were legal tender. But, for that to happen the Federal Reserve Act would need to be rewritten and that is very unlikely, even more so in front of the Congressional elections in 2022.

Monetary and Fiscal Policy Capabilities

From the 1950s into the 1980s, the economics profession almost universally believed monetary and fiscal policy to both be powerful influences on business conditions. The main issue was which of the two were stronger in explaining fluctuation in economic activity. In 1963, the Commission on Money and Credit (CMC) first published a lengthy book on the monetary/fiscal policy debate, more commonly referred to as the Ando–Modigliani/

Friedman–Meiselman debate (Albert Ando, Franco Modigliani, Milton Friedman and David Meiselman). Also called the AM/FM debate, from the main instigators' initials and sometimes jokingly called the "radio stations debate," it was mandatory reading for all macroeconomists at the time. The U.S. economy then was very lightly indebted, with the massive debt of the 1920s and 1930s paid off by the austerity of World War II. In this debate there was virtually no mention made of the role of debt in economic fluctuations.

Today, the best evidence suggests the following: (1) monetary and fiscal actions are largely impotent in stimulating economic activity due to the massive debt overhang in the U.S. and most major foreign economic powers; (2) while taking on more debt does produce a fleeting benefit for economic growth, such actions embroil the economies deeper in a debt trap; (3) central bank tools have the capability of restraining economic activity, as was illustrated by tightening actions from 2016 to 2018; (4) fiscal restraint would temporarily diminish economic growth, but if it could be sustained, the debt overhang could be worked off and in time the economy would recover. However, in a democracy it is highly unlikely that a program of fiscal austerity would even be proposed and if taken, surely not sustained. At the first sight of transitory weakness, the body politic would demand an easing of the restraint. These four conclusions are consistent with McKinsey Global Institute's 2010 study of highly indebted advanced economies from 1900 to 2008.

In the McKinsey study cases, austerity was followed because they either occurred in the pre-Keynesian and pre-monetarist period when major increases in debt was not an option either because of the prevailing gold standard or economic orthodoxy. In some cases, debt overhangs were allowed to burn out over a long

period of time, or the austerity was imposed by the international marketplace, something that is not likely in the current setting. After the debt crisis and panic of 1873, there was no heroic response as the U.S. was on the gold standard and federal budgets were balanced. In the following two very difficult decades, the debt problem "burnt itself out" to use the phrase of the late MIT economist Charles Kindleberger. Contrast this case with Japan since its debt bubble became apparent in 1989. There are almost too many heroic efforts to count, but based on the outcome of the U.S. case of 1873, it appears that Japan would have long exited the problem if they had done nothing at all. However, modern democracies demand action even if the solutions only make matters worse.

Lower For Longer

The current economic growth and inflation rates of 2021 will be the highest for a very long time to come. The main obstacle to a return to sustained growth in the standard of living, extreme over-indebtedness, was dramatically worsened by the multiple rounds of fiscal stimulus which has caused the temporary improvement in economic growth and inflation in the second quarter. No pathway out of this trap exists as long as the overreliance on debt remains the only tool of monetary and fiscal policy. The situation is no different in Japan and Europe. Thus, while long Treasury yields can increase over the short run, the fundamentals are too weak for yields to stay elevated. More debt does not cure a subpar economy mired in a debt trap. Given the above, our view is that the trend in long-term Treasury yields remains downward.

Hoisington Investment Management

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