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Quarterly Review and Outlook
Second Quarter 2024

Monetary and Fiscal Extremes

Amidst a widespread deterioration in the economic landscape, it is crucial to underscore the current detrimental roles of monetary and fiscal policy. The sharp deceleration in detrended real M2 money supply growth, a fundamental cause of aggregate economic fluctuations, is a stark reminder of the past. Prior to nine of the ten recessions since the early 1950s through the start of the Pandemic, monetary restraint has consistently reduced inflation, economic activity, and short- and long-term bond yields.

The worsening fiscal policy condition, as measured by the existing status of negative net national saving (NNS), reinforces the contractionary influence of monetary restraint. The premise of J.M. Keynes, founder of the Keynesian school of economics, was that excessive saving is the cause of major economic downturns. When individuals do the right thing (i.e. save for future needs and contingencies) consumer spending is insufficient to prevent economic slumps, which Keynes called the "paradox of thrift." Negative saving, however, means that Keynes' paradox no longer applies because no surplus exists. Thus, Keynes' solution of enormous deficit spending to drive the economy disappears. Indeed, it suggests just the opposite. Deficit spending must be reversed or net national investment, a requirement for future growth, will not exist.

These extreme monetary and fiscal conditions occur at a highly inopportune time as they follow a declining twenty-year trend in the growth of the standard of living. As measured by the average of real per capita GDP and GDI, U.S. living standards have been eroding significantly for seven and one-half decades, falling from 2.2% per annum in 1971 to 1.3% in 2023, a loss of 41%. The Fed has the tools to reverse the monetary restraint, but the process will prove painstakingly slow. The fiscal imbalance may not be reversible since the budget deficit was not reduced significantly in the current economic expansion for the first time since the end of World War II. Moreover, neither major political party is offering a plan to address the prospect of significant budget deficits for years to come.

The Clarity of Detrending

Detrending, an indispensable and often overlooked aspect of economic analysis, takes on particular significance when analyzing the economic impact of the equation of exchange. Algebraically formulated by Irving Fisher in 1911, the equation of exchange states that money (M) times velocity (V) equals GDP (MV = GDP), with each of the components reflecting both cyclical and secular trends. An advancing economy requires an increase in net usable liquidity to facilitate the absorption of changes in the four factors of production - technology, capital, labor, and natural resources. When the Federal Reserve/Treasury Accord, reached in

1951 and fully implemented in 1953, ushered in floating Treasury rates, real M2 grew at an average of 2.9% while velocity (V2) declined on average -0.2% with a steady state growth (SSGR) in real M2 of 3.1%. SSGR would need to be greater than the trend rate of increase in real M2 to compensate for the drop in V2. If subtracting SSGR from the actual real M2 rate of increase rate equals zero, the economy is on a noninflationary path of trend economic growth. An above-zero reading would signal that the rate of increase in nominal GDP would move above the trend, resulting in either faster inflation, economic development, or a combination of the two. At the same time, a below zero reading would point to subpar economic conditions with either falling inflation, real growth, or a combination of the two. The necessity of detrending economic indicators cannot be overstated, as they provide crucial insights into assessing the future direction of economic activity.

Monetary Results

During the last four years, real M2 and real other deposit liabilities (ODL) fluctuated from highly stimulative/inflationary to extremely restrictive/disinflationary. Based on the annualized growth rate, detrended real M2 swung from slightly above zero in late 2019 to a post-1950 peak of 5.6% during 2021 to a deeply negative -2.6% in the last 48 months (Chart 1). Detrended real ODL's pattern was similar, but the 2021 peak was a higher 6.6%, and the latest 48-month decline was 80 basis points deeper (Chart 2). The contraction in detrended real M2 and real ODL were amongst their most severe for their relative time periods of available data. ODL, which is reported weekly rather than monthly for M2, accounts for 4/5s of M2 and constitutes the primary source of funds for lending to bank customers. The waning influence of currency

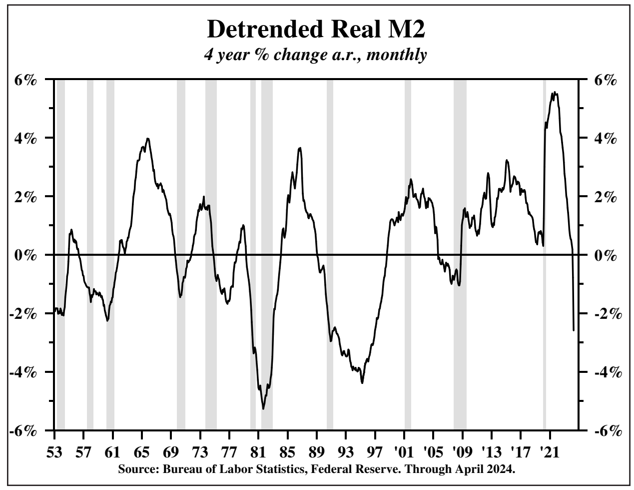

Chart 1

in M2 suggests that ODL is better at capturing the thrust of monetary policy than M2.

Detrended real M2 and real ODL illustrate the massive swing in monetary conditions since 2019. The monetary surge in 2020-21, which led to near double-digit inflation rates, confirmed that accelerating inflation is essentially a monetary phenomenon. The money growth will ultimately again demonstrate that disinflation is also a monetary phenomenon. The last four years also point to the harm caused by such massive swings in monetary growth. The surge of monetarily induced inflation in 2020-21 resulted in a falling standard of living for most of the U.S. households who could not protect themselves from rapid inflation. Applying the monetary

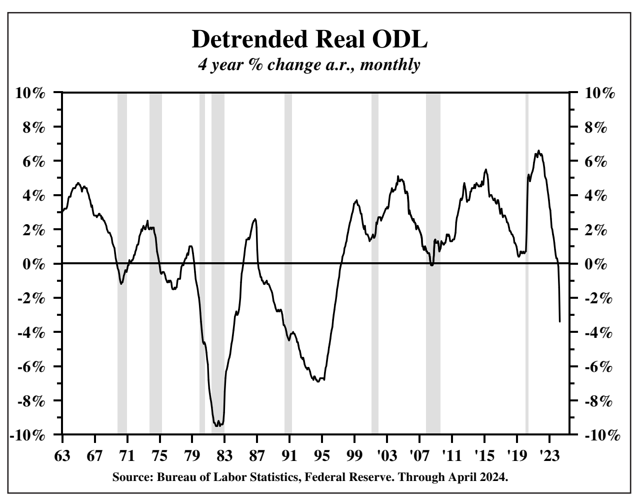

Chart 2

restraint necessary to contain the monetarily induced price surge will lead to subpar economic growth which will harm the same households because of reduced labor market opportunities. The U.S. unemployment rate has already risen 21% (from 3.4% to 4.1%). These lessons from the past, particularly the consequences of extreme monetary policies, provide invaluable insight into understanding the causes of business cycles and their attached but leading financial cycle.

A Declining Government Expenditure Multiplier

On the fiscal side, negative NNS fell to $-143.8 billion in the first quarter of 2024 (Chart 3), a rare development. The current negative NNS occurred because the federal budget deficit (dissaving) exceeded household, corporate, and foreign saving. With the emergence of negative NNS, the federal financial situation has created a significant restraining influence on U.S. economic growth.

From 1970 to 2024, the gross U.S. Government debt to GDP (GGD) ratio surged from 39.5% to 123.7%, with about one fourth of this advance occurring since 2019 (Chart 4). Academic scholars in the early 2000's

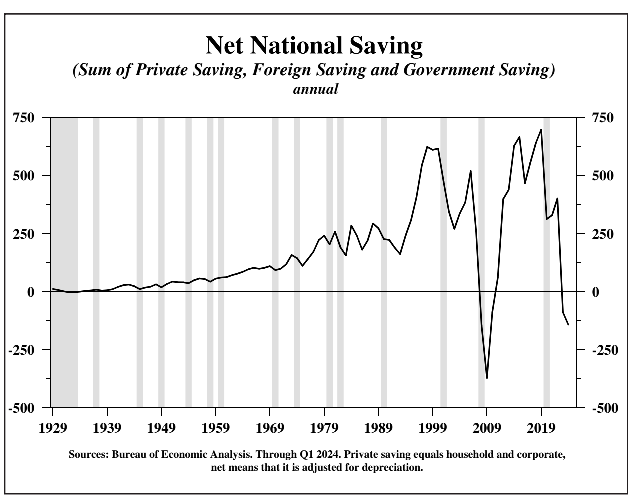

Chart 3

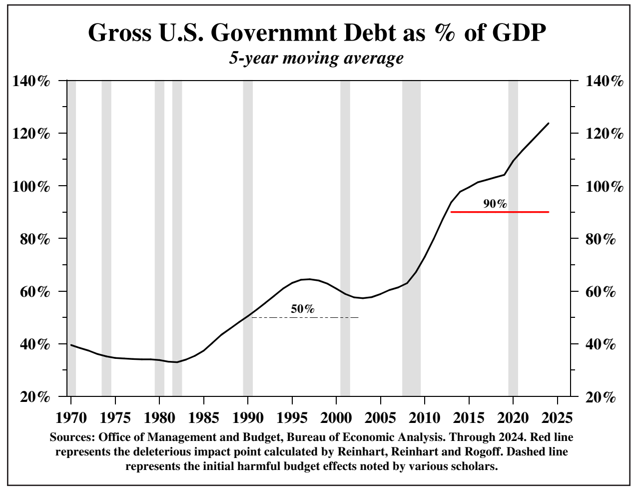

Chart 4

began publishing research on the increasingly harmful effects of government indebtedness on economic growth. Since then, the damaging effects of this building debt overhang have been further documented. As the twenty-year moving average in the GGD ratio has increased since 1970, growth in the real per capita standard of living has fallen significantly, only interrupted by fleeting cyclical episodes (Chart 5). This chart and the underlying data confirm the econometrics of Reinhardt, Reinhardt, and Rogoff (2011), who found that economies lose one-third of their trend real GDP per capita growth when the GGD ratio rises above 90% for more than five years, a stiff hurdle accomplished eleven years ago (Chart 4). Scholarly research also shows that the effects of harmful debt become more significant as the

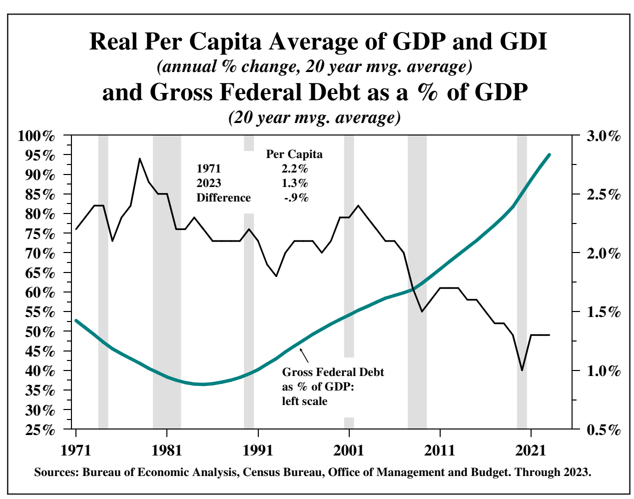

Chart 5

GGD ratio increases. Our research indicates this nonlinear relationship reflects the work of the law of diminishing returns on the overuse of debt capital.

The strong inverse correlation between the GGD ratio and the standard of living since 1970 indicates that the U.S. government expenditure multiplier is negative and has become increasingly so as the GGD ratio has constantly set new records. The situation of negative NNS indicates the multiplier will decrease even more. The coming economic downturn will automatically enlarge the budget deficit even if no new government programs are enacted. As the budget deficit mounts, the transitory economic growth benefits will become increasingly brief while the longer-term deleterious effects will become more pronounced. While the Fed could revert to the pandemic-era operations, it would presume they have no learning curve or understanding of the adverse consequences of the rapid inflation trauma they caused, and which persists. Also, the Fed would not have grasped the great perils of yielding their independence to fiscal policy during the Pandemic.

Cyclical Indicators Forecasting Slump

The average real GDP and GDI per capita growth fell meaningfully below the paltry twenty-year trend growth rate in the first quarter. Three of the six monthly cycle dating indicators of the National Bureau of Economic Research (NBER) have revealed a shift from expansion to contraction. They are household employment, real manufacturing and trade sales, and industrial production. The Quarterly Census of Employment Wages (QCEW) of 11 million institutions recorded an extremely sharp cyclical deterioration in the third and fourth quarters of 2023. Confirming the QCEW, household employment was nearly unchanged in the last 12 months, with a significant loss in full-time jobs. Real personal expenditures for goods fell in the first half, with significant weakness in durable goods. Despite AI spending, the dominant monthly component of capital spending (shipments of nondefense capital goods, excluding aircraft and adjusted for inflation) turned down in the second quarter. The critical measures of housing demand set new lows this year, and average hours worked in June fell below the levels when the economy entered the 2001 and 2007 recessions. Reflecting poor business conditions in the Euro Area, China, Japan, the UK, other trading parties, and the strong dollar, the high multiplier real trade deficit was 8.6 % worse in May than a year ago. Cyclical economic deterioration and constrictive monetary and fiscal factors point to a weaker economy, less inflation, and lower Treasury bond yields.

Hoisington Investment Management

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