



Lacy Hunt: The secular bond bull market is not over! May 11, 2017

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Erik: Joining me next on the program is Dr. Lacy Hunt, Chief Economist for the Wasatch-Hoisington Treasury Bond Fund.

Dr. Hunt, I'm so excited to get you in the program because we've had so many notable people calling for the end of the 35 year secular bull market in bonds, and a lot of guests we've had in the this program haven't really wanted to take sides on this issue. I think you're not going to have that problem because you have a very strong view. So, is the secular bull market in bonds really over? And if not, why not? And particularly, I know in the slide deck that you send us, there's an excellent slide showing the velocity of money that's been in freefall, not just since the great financial crisis, but really since the late 90's. So, how does that play into the story, and how does it relate to your expectations for the continuance of this bond market?

Lacy: My view is that the secular low in long treasury bonds is not at hand- doesn't mean that rates cannot go up, they have gone up quite a number of times since 1990 when this bull run started, but they're not going to be able to stay up. The economy is too fundamentally weak.

The main consideration for believing that the trough is not at hand, is that nominal GDP growth and also the inflation rate is not yet at its secular low. There have been many transitory swings that will continue to be transitory swings, but the critical factors that determines the nominal GDP of both working lower experiencing considerably slower growth and money supply, and at the same time the velocity of money is in a major downtrend.

In 1997, \$1 of new M2 growth increased GDP by \$2.20, and the first quarter of this year, it was down to \$1.42. This reflects the fact that we have too much of the wrong type of debt. There are many other influences in velocity, but that's the critical factor. I think it's important to remember that the velocity of money is very volatile. The old secular low was reached at 1.2 in 1946, and that was the year in which we saw the daily, weekly, and monthly lows in the 30 year bond yield. Now, if that is the key factor, not the only factor, but the key factor, which is driving the velocity of money downward, then velocity is going lower because in Europe, which has debt to GDP ratio 100 percentage

points higher than the U.S. velocity is at one and in China and Japan, which are also more indebted than the United States, velocity is around 0.5 to 0.6.

And we're on a path toward higher indebtedness, and as long as that path continues, the velocity of money will continue to drop. Monetary policy will be ineffective, and it will bring nominal growth and the inflation rate down and move us toward the ultimate secular loan rate. So, rates can go up for any one of a number reasons as they have done on a ten occasions since 1990, but the economy is too over-indebted for the rates to rise and stay up.

Erik: I know that you are a big fan, as I am, of Hyman Minsky. We were just talking to Professor Steve King last week about Minsky's work, but I know in a recent interview you did for Real Vision, you contrasted Minsky's work with Kindleberger, and I was not as familiar with Kindleberger, so please tell us about Kindleberger, and specifically what did his work predict based on this huge amount of debt that we have, and I would refer listeners specifically to the charts in pages 9, 11, and 14 of your chart book, where you're looking at various different forms of debt as a percent of GDP.

Lacy: Well, as it happens, I had an acquaintance with both Minsky and Kindleberger. I heard Minsky in the early 70's when I was in the Fed. I presented at the same session at the Kennedy Foundation symposium on reagonomics and in inflation, stagflation in the early 1980's, Minsky and I were on the same panel. And I heard the financial instability hypothesis. As it happened, Kindleberger was in the audience, and I had an opportunity to chat with him at length after my paper. My feeling is that Kindleberger is the deeper, broader thinker. His work, which is contained in several different places, but most notably in his book *Mainas, Panics, and Crashes*, which has been sustained after his life by his colleagues at MIT is really an outstanding guidepost to understanding debt. And Kindleberger felt that extreme over-indebtedness has a threefold impact on markets. As the debt becomes excessive, it leads to over-trading.

"Over-trading" is an old timey term, it's in *The Wealth of Nations*, and it means that the debt accumulation pushes asset prices, whether it's real-estate, or commodity, or stocks to levels that are well beyond what is supported by the underlying fundamentals. This process, as Kindleberger made clear, can go on for a long period of time. Eventually, it leads to a phase called "discredit", that's also an old timey term, found in the Adam Smith *Wealth of Nations*, and he chooses that term very wisely, because in discredit, a very few select investors see the imbalances and overtrading, the disparity between prices and underlying fundamental value, and they sell the assets, and they pay off their loans, hence the term "discredit". And the final phase is what Kindleberger called "revulsion", another old timey term, and he used a metaphor of a large group of people crowded into a small room with one exit, and they all smell the smoke at the same time.

And I think that Kindleberger's view is more comprehensive. They are alike in a sense that both of them are following in the tradition of Irving Fisher and others who felt that the Great Depression and a number of other similar circumstances had been caused by extreme over-indebtedness. By the way, that view, which has been out there for a long time, has generally been ignored by the mainstream. Ben Bernanke, in this book *Essays in the Great Depression*, acknowledges the views of Fisher, Minsky, and Kindleberger, and he says that to accept them, one would have to be willing to accept the proposition that people would do foolish things, in other words, become excessively over-indebted, and Bernanke goes on to say that, "As for me, I will push the rational model as far as it will go." In other words, he rejects them not because the data is flawed, or the argument is flawed, but simply because it implies irrational behavior. As someone who's been in the financial markets for a long time, that's not a problem for me.

Erik: Yeah, we certainly have plenty of irrational behavior. So essentially, the picture here is too much total debt on every level, whether it be sovereign debt, corporate debt, household debt, and you know, a lot of people have commented on this saying that we're in uncharted waters, but I look at this chart you have on page 15 of your Chart Book- to me it tells a very different story. I don't think we're in uncharted waters, I think we're sailing straight into 1990's Japan, and if you look at world GDP on page 17, that chart looks pretty scary as well. So, is it true that where we are is basically where Japan was in the 90's? And does that mean we are looking at decades of economic stagnation across the entire western developed world, the way Japan has seen in the last couple of decades?

Lacy: I think that our results will mirror Japan over time, certainly not on a quarter to quarter or annual basis, but they're public and private debt is just under 600% of GDP. Our total public and private debt is about 373%. They've tried to solve an indebtedness problem by taking on more debt. There are many many examples of what has happened to extremely over-indebted economies. For example, I've included a broad bibliography of very modern studies, including an important 2012 paper peer review was written by Carmen Reinhart and Ken Rogoff joined with Benson Reinhart, an outstanding study.

There has been important recent work by Allen Taylor, also by a number of people in Europe. There is also work that's been done historically. For example, the leader of The Enlightenment, David Hume- his famous paper on public finance, written in 1752 reaches the conclusion that when a state has mortgaged all of its future liabilities, the state, by necessity, lapses into tranquility, languor, and impotence. And there was Irvin Fisher's 1933 paper on the consequences of extreme over-indebtedness, including pointing out that one of the factors that will happen will be that the velocity of money will

be very weak, and so there has been a tremendous amount of work. It's just generally speaking been ignored.

One excellent summary was published in 2010 by McKinsey Global Institute. They looked at 24 advanced economies that became extremely over-indebted. The indebtedness brought on a panic year, such as 1929, 1873, 2008, and they followed the process through to completion. It's a very long process, and what it shows is that an indebtedness problem cannot be solved by taking on additional debt. McKinsey says specifically that multi-year sustained rise in the savings rate, what they term austerity, is needed to solve the problem, and of course, as we all know, in modern democracies, that option doesn't seem to exist. So, we try to continue to use what has failed, and while we get transitory improvement in economic activity, the longer term trend is to weaker and weaker economic performance.

Erik: Another factor that fascinates me, and I know that people watching Japan saw this decades ahead of time, but nobody really took it seriously, was the impact of demographics on their economy, and of course we're later in our cycle, but as you show very nicely on page 21 of your chart book, we've had very low fertility rates on a relative basis, persisting in the United States really since the 1970's. So, how much lag time is there between the birthrates and when there is an economic effect felt and does that effect come in waves, is it all at once? How does this demographic function that we see on page 21 come to affect the real economy?

Lacy: I think that the better graph is page 20, which compares the population growth in the U.S. and Japan, and what is forgotten is that four decades ago, population growth in Japan was stronger than the United States. People were writing articles and books under the general topic Rising Sun Economics. From that advantage in population growth of several tenths of a percentage point in the '70's Japan's population is now declining. Our growth is still positive, but it was only 0.7% last year, which was the slowest growth since 1936/1937. And in addition, we have a baby bust, and we have a household formation bust, and what's basically happening is that there are certain social changes.

Population is always a function of view, beliefs, social morays, and so forth, but our economy is increasingly under-performing, and this shown in page number 22, which is a graph of ten year moving average of the growth rates and real disposable personal income. Historically, we've grown at 2.1%, we're currently growing at only 1% over the last ten years. It's been remaining very depressed now for almost seven years, and the longer that this persists, it conditions some of these population variables, not the only factor at work, and then the population or the demographic factors become weaker and then that feeds back into the downward spiral in the growth rate.

The chart on page 22 is very interesting because it helps to confirm some of the recent academic research, which shows that when economies become extremely over-indebted, we've passed those thresholds for some time now, the economy loses about one-third of its growth trend. In other words, if the growth trend was three, we dropped down to two, but as chart 22 indicates, we're currently growing at one-half of our trend, which is also supported by some of the academic research that indicates this debt begins to move to extremely high levels; the relationship between debt and growth is not linear, and right now it looks like that we're losing about a half of our growth against trend, which is a very negative factor. And, it's consistent with the fact that the velocity of money is declining, productivity growth is deteriorating, population growth is, and the other demographic factors are worsening. This is a downward spiral that's not going to be reversed unless we deal with the indebtedness problem, and there's no effort to do so.

Erik: If I assimilate the views that you've shared with us so far, you're basically saying that we've got too much debt that is preventing the economy from growing. That means that we cannot afford higher treasury yields, we have to be in a low interest rate environment because the economy could not afford to service its debt at higher interest rates, and the demographics are not going to help us get out of this pickle, and to me this brings a paradox into view, which is, you know, if we pretend that the U.S. Treasury debt was, I don't know, \$400 quadrillion, instead of \$20 trillion. Obviously, that paper would be worthless, because it would be impossible for the government to ever repay it. So, it seems like what we're saying is the reason rates have to stay low, and therefore the value of treasury bonds has to increase is because we're moving closer to the point where they eventually become worthless because they're unserviceable, and of course they could always be services in nominal terms, but in terms of real purchasing power, I would contend that we may already be at the point where this debt cannot be paid back without inflating away its value. So, am I correct to see that as a paradox? And how does that eventually get resolved?

Lacy: Of this debt, if you include the debt that we have extended to the foreign sector in the banks, and there's some reason to at least be aware of those sums, because a lot of the bank lending as to foreign entities and economies that are extremely over-indebted, but I would say that there's approximately \$20 trillion of debt that will mature in the next two years. A lot of debt is key to liber or other floating rates; the bank's lending is, of course, relatively short-term, and these debt figures do not include the leases they should, and they will have to include them beginning in 2018.

So, we have roughly 20 trillion dollars of debt that will mature in two years since the low point last year, the rates were up about 100 basis points across the curve, so 100 basis points times \$20 trillion of short-term debt, that

means the annual interest expense in two years will rise \$200 billion, but last year nominal GDP growth was only \$530 billion. In other words, it's a massive drain, and that will remain the problem for the present and for a number of years, maybe even decades to come. That's been the problem in Japan and Europe. They've had improvements in economic activity due to a variety of transitory factors. Markets think that this is the long awaited cyclical upturn- the rates rise, the interest expense rises very dramatically, and then that truncates the recovery. Now, at the end of the day, when we reach a point of impasse, economists call that the "bang point", and the bang point would be signaled by a tremendous flight into real assets- you would see the commodity prices surging, the value of the dollar declining. I don't believe that that day is at hand, because global demand growth is too weak, especially nominal GDP growth in the U.S. In addition, the U.S. economy is not as indebted as its major trading partners- European debt is significantly greater, Japan is in even worst shape, and so on a long-term basis, in terms of debt comparison, the U.S. has the cleanest dirty shirt, and so that serves to retain an underlying value of the dollar. We'd have to see a reversal in those conditions, which means that the bang point is not at hand.

Erik: To my astonishment, it seems that Janet Yellen's inclination for dealing with all of this, is to take us to negative interest rates, and of course, Europe has already been there. So, I have several questions for you about negative interest rates, but I want to start with just the mechanics of this, because I feel like I'm missing something. I've heard quite a few experts, including yourself, say, you know, it would be very difficult to engineer negative interest rates in the U.S. Treasury market, and I feel like I'm missing something, because we've had zero coupon treasury bonds for a long time. It seems to me, you sell a zero coupon bond for a premium above par, and you've got a negative yielding instrument. What am I missing here?

Lacy: Well those, though, have an effective market yield. In fact, the yield of maturity there on the zero coupon bonds are higher than on the coupon bonds. You just don't receive payment every year, and so for long-term investors, such as us here at Hoisington Management, we're interested in the total rate of return, and so that's not a problem. But, here is the difficulty- right now of course Mrs. Yellen is raising rates, and in the process of raising rates, they're contracting the monetary value, they're slowing the rate of growth and M2, they're slowing the rate of growth in bank lending, they're causing a contraction in the credit aggregates. In other words, they're taking steps to slow the economy right now, which means that economic performance will be even worse. In other words, the debt fundamentals are being reinforced by a very restrictive monetary policy, and of course, to slow down in the reserve monetary and credit aggregates is occurring alongside a continuing very sharp drop in the velocity of money.

So, if the Fed, let's say, theoretically were to want to go to negative interest rates, and they needed to hold in there for any length of period of time, what they would have to do is they would have to call the currency in. And, in fact, there have been a number of proposals from academicians who can see this as a potentiality. In fact, there have been some modest steps toward that. Europe has eliminated the 500 Euro note. So, if you were to, for example, go to negative interest rates, the firms that have big campuses and security and so forth, instead of holding short-term paper that's with a negative yield, they'll hold currency. And eventually, in time, although it's very cumbersome to do so, individuals would hold currency. And so to make the policy workable for more than just a limited period of time, you'd have to call in the currency, and that, of course, would require a lot of changes, legislative changes in the United States, I don't know about elsewhere in the world, but I don't think it would be well received. And, in the final analysis, it would be very very harmful, because for all economies and all times, investment in plant equipment, physical investment must equal saving out of income, and if you do not provide people an incentive to save, then there will not be sufficient funds to invest in plant equipment, growth will become even weaker, and the standard of living will fall more rapidly, the demographics will deteriorate. So, it would be, in my view, a very unfortunate pathway to go down. There would be serious problems for the money market mutual funds for a lot of the smaller community banks and credit unions and so forth, but even in time, negative interest rates would undermine the financial intermediary process, and it would be very difficult for the big banks and insurance companies. It's not a palpable long-term solution in my view.

Erik: I couldn't agree more with that, and it seems to me that the unintended consequence of sustained negative rates, I mean it affectively undermines the whole model of providing an incentive to save and invest, and I think that the most important social contract that we have in society is pensions- we tell the people that actually work hard for a living, "Look you've got to trust us that smart finance guys like us are overseeing the system that's going to protect your financial security and your retirement," and if we have negative interest rates, I mean, am I missing something, or is it impossible to avoid a pension crisis?

Lacy: No, you've got it exactly right, and I would add this- I think that quantitative easing has had serious, unintended consequences. When quantitative easing was unveiled, the Fed said that one of the objectives was to support higher stock prices in the hope that this would create a wealth effect, which would boost consumer spending. Well, the wealth affect never materialized, it never has materialized, it's a theoretical concept that's not supported by the empirical facts, too few people own enough stocks to really change their consumption behavior, but when the Fed said they wanted a high stock market, that was a signal to the corporate managers that financial investments are preferred to real investments, and so what has been

happening as a result of the unintended consequences of quantitative easing, is that firms have engaged in financial engineering, buying back their shares, buying the shares of others, paying higher dividends with debt that they've acquired, rather than investing in plant equipment. Last year was a classic example that business debt rose to a record percentage of GDP, higher than ever in...any time in the past, including the '08 and '09 peaks business debt was up \$700+ billion in investment, and plant equipment, inventory actually declined \$21 billion. That's the problem with theories of grand design, theories of grand design, it's impossible to anticipate the unintended consequences. It's better, when change is needed to make marginal adjustments so that if you have to reverse them because of these poor results, you're able to do so.

Erik: Several people have suggested that the solution to all of this is a so-called "debt jubilee," where the government either prints a whole bunch of money, whether it be Treasury money or Fed money that is used to pay down, either national debt or, in some models that have been suggested, there's a massive handout of printed money to the general populace with a requirement that they have to use it to pay down debt. Are these things realistic, or are they just the pipe dreams of the over-indebted?

Lacy: No, those programs are not really realistic, and moreover, they would require massive law changes. Let's say, the Treasury started printing currency...Well, what would that paper be? Would it be an asset or a liability? Well, it's a liability of the Treasury. It would be a zero maturity liability of the U.S. Treasury. Well, to issue that obligation, the debt statute laws would have to be rewritten, and I think it would be very difficult to do that, because it is a liability. In addition, the Federal Reserve could not fund that on an unmatched basis, because the Federal Reserve Act requires that the assets of the Federal Reserve equal the liabilities. So to go along that path, you would then need to rewrite the debt statute laws. You would need to rewrite the Federal Reserve Act, and then after you did that, the country would be a banana republic, and if we got into an inflationary situation, we would never be able to control it. I hope we wouldn't go down that path, but conceivably you could pass the legislation and do it. I would think it would be a very sad day for the country if we did that though.

Erik: So, how do you see this ending then? The problem is too much debt on every level; debt jubilee isn't going to solve it; the demographics are not going to solve the problem, they're going to make it worse. How does all of this end, I mean, do Japan-a lot of people talked about the lost decade that had become two lost decades; I'm not sure if we're pushing three lost decades, but the way things are looking...how does this ever end?

Lacy:

Well, we could get lucky, something of a great magnitude- in essence, this is what happened in the past in a couple of instances. In the 1820's and 1830's, we took on a lot of debt to finance the early canals, steamship lines railroads- it was over-investment, over consumption. The panic year was 1838. Martin Van Buren was president, he didn't know what was going on. By this, the country languished very badly for 11 years, and then gold was discovered in California, led to a huge surge in national income, people were very careful how they spent their income. We paid off the debt of the 1820's, 1830's, and the economy recovered.

In 1873, we had another panic year brought on by too much debt that financed the railroads- remember we built the central line first and then the northern and southern routes, a lot of feeder road industries that supplied the railroads over-expanded and it was over-investment, over-consumption. The panic year hit. Grant was no more knowledgeable of what was going on than Van Buren had been in 1838. We had no central bank, the government continued to balance its budget. We had a prolonged period of austerity, but by the early 1890's, the problem had been solved, and we began to go on our merry way.

Now, if you use that example- of doing nothing, Kindleberger called it "letting it burn itself out," and just, let's say, Japan had followed the "let it burn itself out" rule starting from 1989, they would be out of their problem, but they tried to solve the indigenous problem going to ever higher levels of debt, and they are still in the quagmire today.

In WWII, we were in very dire circumstances, we really had only the most marginal of recoveries from the Great Depression. Unemployment rate was still in its mid-teens. When we entered WWII, the bond yield was about 2%, which was reflective of how poor business conditions were, but as we entered WWII, there was a dramatic surge in our exports. We took over markets of our allies- they couldn't supply them. We also supplied our allies with war materials and other items. We had mandatory rationing, the saving rate went up to 25%, 26%, 28%, and we paid down the debt of the 1920's and 1930's. We had the great post war boom because we had a clean balance sheet, which the three instances that I gave you, the 1838, 1873, 1929 illustrate the validity of McKinsey's finding. You solve an indebtedness problem by austerity, and McKinsey defines austerity as the significant, sustained multi-year rise in the saving rate, and that does not appear to be likely for the stage of our modern democracy.

So, we just have transitory spurts in economic activity that don't last very long, and we basically grind lower, and that's really essentially the finding that Hume came to the conclusion- remember that Hume was one of the greatest minds of mankind, without him The Enlightenment would not have been possible, and so, we're basically on that path, unless we have the will to

deal with it, and apparently, we do not. Take one of the problems that we have- the government we have right now is approaching 107% of GPE. Without any new initiatives from the current administration, current congress, Federal debt is going to be up to around 125% in the next two decades, more or less, because of promises that have been made under Social Security, Medicare, and the Affordable Care Act, and so we're moving the debt levels higher, whether we want to or not. So, if we are going to try the same result, try the same policy path, we're going to get more of the same result.

Erik: And of course, Reinhart and Rogoff's work tells us that 100% debt to GDP tends to be a tipping point, after which, it's very difficult to return.

Lacy: Actually, their most recent study, the one with the greatest amount of detail and documentation finds that when government debt exceeds 90% for five consecutive years, you lose about a third of your growth rate, and we did that in 2012. 2016 government debt exceeded 100% for five consecutive years, and we're now moving higher. There was an outstanding study published by the European Central Bank by Rother and Checherita- Dr. Rother's head of the fiscal affairs department of the European Central Bank- they found that when government debt rises to these high levels, the negative relationship between debt and economic growth becomes non-linear. In other words, the depressing effect of the debt becomes even greater in higher levels of debt. And I'm afraid that we're seeing evidence of that. And in fact, I mentioned that earlier when we were discussing the trend in real disposable personal income on a per capita basis.

Erik: So, your prescriptions for what the solution should be would be to stop trying to solve the problem of too much debt with more debt and to increase savings rates. We're not doing either of those things, and government policy is quite officially, essentially increasing debt, trying to encourage more borrowing and lending, because they think that's what's going to stimulate the economy. So, we're doing exactly the wrong thing, and we're doing more of it and a time when we're already too far down this road. What do you see this resulting in? Are we looking at decades of economic stagnation as Japan has seen for the last 20 years? How long can it go on, and how do you see the story playing out, let's say over the next 20 years for the United States and for the rest of the West?

Lacy: I think that we're on a path toward gradually weaker economic growth. There'll be spurts, transitory periods of economic activity, our hopes will be raised, but we'll not be able to foresee it at our traditional rates of economic growth. Our demographics will deteriorate, standard of living will deteriorate, which they're already doing, unless we collectively can address the indebtedness problem, and quite frankly, there seems to be no interest in doing so.

Erik: Now, the U.S. dollar remains the world's reserve currency, and I would argue that's because there simply is no alternative to the U.S. treasury market in terms of a liquid and deep enough bond market to absorb central bank sized capital flows. There are a growing number of people around the world, particularly Sergei Glasyev, an economic advisor to Vladimir Putin, and his whole de-dollarization campaign, where he basically asserts that Russia should try to get rid of the U.S. dollar and encourages as many countries as possible to dump the dollar in favor something, maybe another system, that is not so indebted. Do you think that there's any realistic viability to that leading anywhere, or is that just propaganda?

Lacy: Well, the real problem is that, based on my numbers, if we used total public and private debt, including the debt owed to us by the foreign sector and the debt of our financial institutions, using that comparison globally, our debt figure is about 373% of GDP, and the figure is about 470% in Europe and 590% in Japan, it's about 390% in China, and I don't know the number for Russia, but I think they're far more indebted than we are. So, there's no economic area that is less indebted than we are. Germany has good numbers individually, but of course they are part of the European currency zone, which is significantly more indebted than we are. So, there's just no real viable alternative at the present time, maybe in due course, one will immerge, but it's not at hand.

Erik: We thank you for what has certainly been a very sobering interview. We didn't get time to get to all of your charts in this excellent chart book. Our registered users have the link in their research roundup email to download the chart book. I know that these charts came from your quarterly reports, where there's quite a bit more accompanying commentary that explains the charts we didn't get to. Would it be possible for our listeners who want read more of your work to get a copy of those reports, and if so, how can they do so?

Lacy: Yes, we make those- our quarterly letters available as a public service, and if you go on our website www.hoisingtonmgt.com, send us your contact information, we'll be glad to add you to the quarterly distribution list.

Erik: Hoisington has over \$3 billion in assets under management. The flagship resale product is the Wasatch-Hoisington U.S. Treasury Fund that is a no-load mutual fund that's available to all investors. For our institutional audience, you also act as a fixed income investment advisor to pensions, insurance companies, and so forth. And so for our institutional audience, if you'd like to find out more about Dr. Hunt's advisory services, you can contact Hoisington through their website. Patrick Ceresna and I will be back as Macro Voices continue right here at Macrovoices.com