Written by
Brian J. Pretti CFA, CFP®
Partner & Chief Investment Officer
Capital Planning Advisors

CAPITAL INSIGHTS

Economic Briefing • May 2015

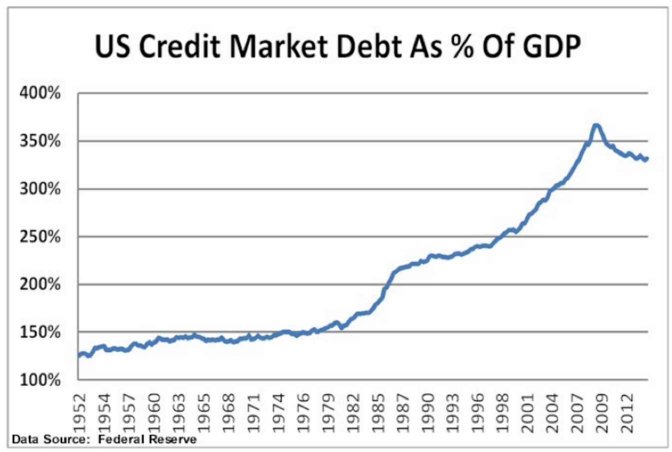
Giving Credit Where Credit Is Due

In the prior economic cycle of 2003-2007, one question we asked again and again was, "is the US running on a business cycle or a credit cycle, which one is it?" Of course that question was prompted by a series of data we have tracked for decades. Data that tells a very important story about the character of the US economy. That data series is the relationship of total US credit market debt relative to US GDP.

Let's try to put this in English. What is total US credit market debt? It is an approximation for total debt in the US economy at any point in time. It's the sum total of US Government debt, corporate debt, household debt, state and local municipal debt, financial sector and non-corporate business debt outstanding. It very much captures the dollar amount of leverage in the economy. GDP is a very straightforward number, the sum total of the goods and services we produce as a nation. So what we are looking at is how financial leverage in the economy relative to the growth of the actual economy itself has changed over time. What is clearly most important is long term trend.

From the official inception of this series in the early 1950's until the early 1980's, growth in this representation of systemic leverage in the US grew at a moderate pace point to point. Liftoff occurred in the early 1980's as the baby boom generation came of age. We believe two important demographic issues help explain this change. First, there is an old saying on Wall Street. People do not repeat the mistakes of their parents, they repeat the mistakes of their grandparents. From the early 1950's through the early 1980's, the generation that lived through the Great Depression was largely alive and well, and able to "tell" their stories. A generation was taught during the Depression that excessive personal debt can ruin household financial outcomes. Debt relative to GDP in the US flat lined from 1964 through 1980. As our GDP grew, our leverage grew in commensurate fashion. Dare we say we lived within our means? To a point, there is truth to this comment.

Alternatively, from the early 1980's onward, we witnessed an intergenerational change in attitudes toward leverage. Grandparents that lived through the Depression were no longer around to recite personal stories. The Baby Boom generation moved to the suburbs, bought larger houses, sent the kids to private schools, financed college educations with home equity lines of credit, and carried personal credit balances that would have been considered nightmarish to their grandparents. The multi-decade accelerant to this trend of ever increasing systemic leverage relative to GDP? Continuously lower interest rates for thirty five years to a level no one ever believed imaginable, grandparents or otherwise, which is where we find ourselves today.



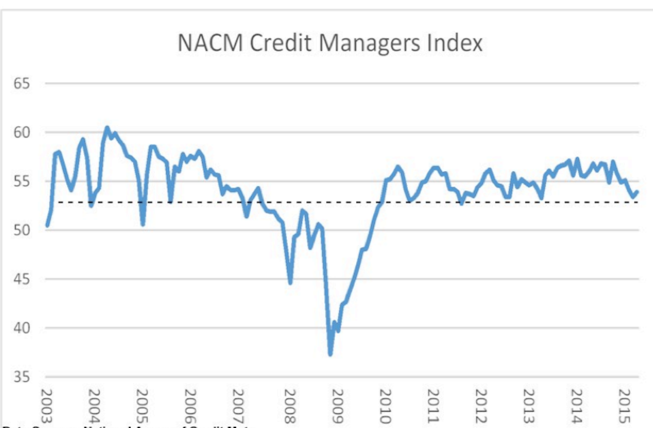
Why have we led you on this narrative? For the same reason we believe the chart immediately preceding has been so important to our big picture analysis over time. The fact is very simple. Increasing leverage has been a key underpinning to total US economic growth for decades. Debt has grown much faster than GDP since 1980. For three and one half decades now, in very large part, expanding system-wide credit is one very important economic horse that has driven the economy.

Don't let the preceding chart fool you. Although US total debt relative to GDP has fallen since the peak of 2008, in absolute Dollar terms, US total credit market debt has actually increased from $50 to $60 trillion over this time. A lot of the relief you see above has come in the form of defaults on mortgages and corporate debt. Moreover, US Federal debt has grown from $8 trillion to close to $18.5 trillion since January 1, 2009, very much offsetting the deflationary pressures of private sector debt defaults. To suggest that credit expansion has been a key support to the real US economy is an understatement.

Giving Credit Where Credit Is Due Continued from page 1

By no means are these comments on leverage in the US economy new news, why bring it up now? We believe it is very important to remember just how meaningful credit flows are to the US economy now because a key indicator of US credit conditions we monitor on an ongoing basis has been deteriorating for the last six months. That indicator is the current level of the National Association of Credit Managers Index.

As per the National Association of Credit Management (NACM), the Credit Managers Index is a monthly survey of responses from US credit and collections professionals rating factors such as sales, credit availability, new credit applications, accounts placed on collection, etc. The NACM tells us that numeric response levels above 50 represent an economy in expansionary mode, which means readings below 50 connote economic contraction. For now, the index rests in territory connoting economic expansion, but the index is also sitting quite near a 6 year low. We've been here before in the current cycle as the economy has moved in fits and starts in terms of the character of growth.



In our April monthly discussion, we spoke of the slowing in the US economy in the first quarter of 2015. We highlighted the Atlanta Fed GDPNow model that turned out to be very correct in its assessment of Q1 US GDP. While the Atlanta Fed was predicting a 0.1% Q1 GDP growth rate number, the Blue Chip Economists were expecting 1.4% growth. When the 0.2% number was reported, it turns out the Atlanta Fed GDPNow model was virtually right on the mark. As of now, the Atlanta Fed GDPNow model is predicting a 0.8% GDP number for Q2 in the US (the Blue Chip Economists are expecting a 3.2% number at present).

Now is the time to keep a close eye on credit expansion in the US. A slowing in the macro US economy along with a slowing in credit expansion intimated by the NACM Credit Managers Index is a yellow light for overall US growth. A drop below current levels in the NACM numbers would heighten our sense of caution regarding the US economy. Again, for now it's simply a yellow light warning.

Although no two economic cycles are ever identical in character, fingerprint similarities exist. At least for the last two to three decades, the "rhythm" of credit availability and credit use has been one of those key similarities. Although we know past is never a guaranteed indicator of the future, the NACM Credit Managers Index was an extremely helpful indicator in the last cycle. As the chart shows us, this index dropped into contractionary territory (below 50) in December of 2007. In the clarity of hindsight, that very month marked the onset of the Great Recession of late 2007 through early 2009.

Again, for now we are looking at a yellow light for both credit expansion and the US economy. A further drop through the lows of the last six years in the Credit Managers Index would not be a good sign, but we are not there yet. As always, we believe achieving successful investment outcomes over time is not about having all of the right answers, but rather asking the correct questions and focusing on key indicators. September of 2015 will mark the 7 year point of the US Fed sponsoring zero percent short term interest rates in the US. If this unprecedented Fed experiment was not at least in part aimed at sparking US credit expansion, then what was it all about? The zero percent interest rate experiment is likely to come to an end soon. The important issue now becomes just what will this mean to US credit expansion ahead? Credit expansion that has been a key underpinning to domestic US economic growth for literally three decades now. We believe the NACM Credit Managers Index in forward months will reveal the answer. We're simply giving credit where credit is due.

Capital Planning Advisors™

Written by
Brian J. Pretti CFA, CFP®
Partner & Chief Investment Officer
Capital Planning Advisors

Lawrence A. Hansen Partner & CEO
Brian J. Pretti CFA, CFP®, Partner & Chief Investment Officer
Jim Wilson Partner & President
Michael Sollazzo, Esq., CPA (INACTIVE), Partner & Advanced Planning Counsel

Sacramento
(916) 286-7650
Walnut Creek
(925) 524-2800
Roseville
(916) 290-9180