CAPITAL INSIGHTS

ECONOMIC BRIEFING • MAY 2016

WANTED: DEBT OR ALIVE

As we've discussed many a time, our belief is that we are currently living through a very special economic and financial market cycle. Never have we experienced negative interest rates in the global financial sector. Never have we seen Central Banks print money virtually at will. Never in the history of Federal Reserve data have we seen US GDP growth rates as low as we are now experiencing in an expansion after a recession. Yet a bit away from the headlines of the day is another data point we believe helps explain, in part, the current cycle and poses important questions about what may lay ahead. Never have we seen major economy combined public and private debt levels relative to their respective GDPs as elevated as we see today. In this discussion, we will look at each major sector of the economy, its balance sheet makeup, what this has meant in the current cycle and why meaningful global system- wide leverage will be very important to economic outcomes in the years ahead.

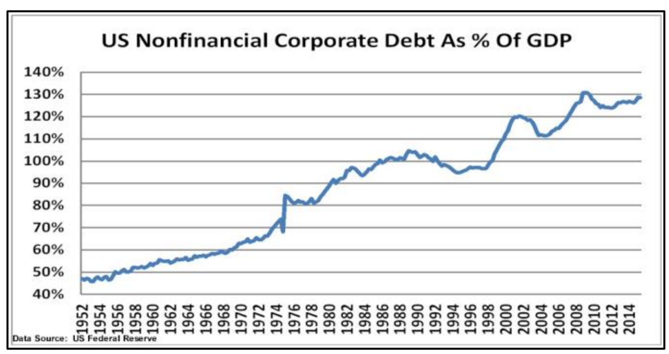
We will start by talking about the difference between non-financial sector debt and financial sector debt. The term "non-financial sector debt" is used to refer to the aggregate of debt owed by households, government agencies, non-profit organizations, or any corporation that is not in the financial sector. Financial sector debt is therefore debt owed by corporations in the financial sector. It is important to understand that the US financial sector serves very much an intermediary function, essentially attempting to earn some type of a use of funds over cost of funds yield spread. Do corporations in the financial sector really borrow money to invest in productive and long lasting business? No. They borrow money to lend it, so in one sense looking at financial sector debt can be considered "double counting" when trying to analyze the influence of leverage on an economy. We will only consider non-financial sector debt in this discussion.

Finally, leverage/borrowing can be a wonderful thing. Being able to earn a return in the real economy above the cost of financing the operations and growth of a business is every entrepreneur's dream. This is classic "productive debt" – it is invested to provide a sustainable cash flow stream to ultimately pay down the debt and provide a return to the borrower. Unproductive debt is often seen in uses such as immediate consumption, as opposed to longer term investment. Carried to an extreme, unproductive debt can be financially destructive. Before looking at the major sectors of the US economy, a few big picture comments on total US non-financial sector debt.

Remembering our definition above of US non-financial sector debt, total indebtedness in 2015 rose just over $1.9 trillion. US nominal GDP rose $550 billion. That's about $3.50 in new debt for every $1 new dollar of GDP, which is not out of line with what has happened in recent history. In fact, it has taken on average over $3 of new non-financial sector debt to generate an additional $1 of GDP since 2000. The question is, "Is the assumption of debt in the current cycle becoming less productive?" Let's look at the major components of the non-financial US economy to see.

NON-FINANCIAL CORPORATE DEBT

It just so happens that the US non-financial corporate sector has taken on the largest amount of total debt ever seen as we currently rest at record levels. The chart below looks at this sector's historical debt to GDP ratio. The only reason we do not rest at a record is GDP (the denominator in the ratio) was so depressed at the last peak in 2008.



The key has been that so many corporations have been afforded a once in a lifetime chance to refinance and issue new debt at historical low rates. They would have

WRITTEN BY: BRIAN J. PRETTI CFA, CFP®
TERRY CHUI CFA, CFP®
Capital Planning Advisors

WRITTEN BY: BRIAN J. PRETTI CFA, CFP®
TERRY CHUI CFA, CFP®
Capital Planning Advisors

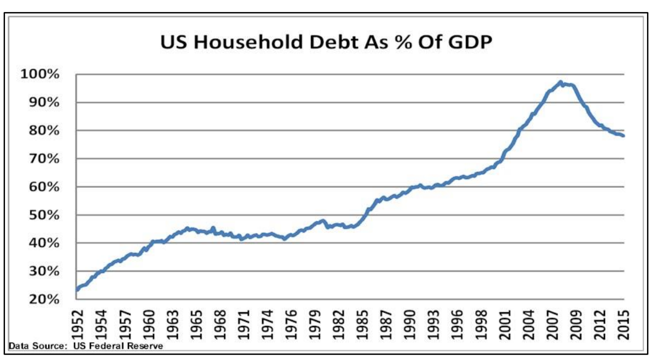
to be crazy to not partake in this seminal event, courtesy of the US Fed.

Make no mistake about it, the majority of US corporations are in very good financial shape. The important message here is not levels of debt, but just how the additional corporate debt has been deployed in the current cycle. Example: In 2015, US non-financial business debt rose just shy of $800 billion. Yet business spending on inventory, capital expenditures, fixed assets, etc. rose under $100 billion. So what happened to the rest of this capital not used for operations? Two primary areas were stock buybacks and increased dividends. More importantly, the debt used for buybacks and dividend increases was not used for plant and equipment investment, ultimately supporting longer term employment and productivity growth.

Does this help explain why stock prices have ascended so strongly in the weakest real US GDP recovery on record since the 1940's?

US HOUSEHOLDS

Clearly, a good number of US households came out of the last economic cycle with impaired balance sheets due specifically to mortgage debt. However, as you'll see in the chart below, household debt relative to GDP has come down meaningfully in the current cycle. Although households are in much better financial shape today, we need to remember that outright debt defaults primarily related to real estate, rather than prudent debt pay down, drove a good portion of this reduction in debt levels relative to GDP you see in the chart. Additionally, with the Fed setting interest rates at zero, we have seen an increased use of cash in residential real estate transactions, further compressing the largest of US household debt – mortgages.



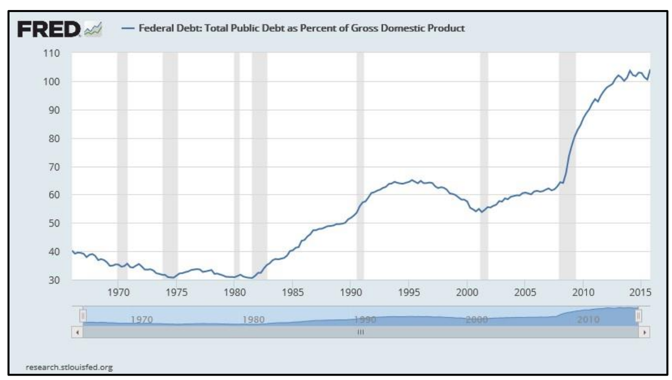
Although household real estate lending has not been reckless in the current cycle, we do see some anecdotes of prior cycle excesses today. Subprime auto lending is again driving a good portion of car sales. Subprime auto loans today have reached the highest level of total auto loans in ten years and defaults on this paper have reached the highest level in twenty years.

Households really became debt saturated in the prior cycle and have not been the driving force in total debt expansion in the current cycle. They have been repairing their balance sheets, especially the boomers approaching retirement.

Does lack of continued acceleration in US household debt relative to the economy (GDP) help explain the slowest growth in personal consumption of any cycle in recent memory?

US GOVERNMENT

Levels of government debt and associated entitlement issues are nothing new as being key topics for the current and forward US economy. In early 2009, US Government debt totaled close to $9 trillion. Today that number is $19 trillion. As can be seen in the chart below, US Government debt as a percentage of US GDP has grown meaningfully in the current cycle to levels really never seen in the modern period.



What has allowed the Federal Debt to balloon without consequence up to this point has been the lowering of interest rates by the Federal Reserve, but this low rate environment will not be the case forever. In looking at productive use of debt versus less productive uses, much like the US corporate sector, what has this government sponsored leverage expansion financed? Sorely

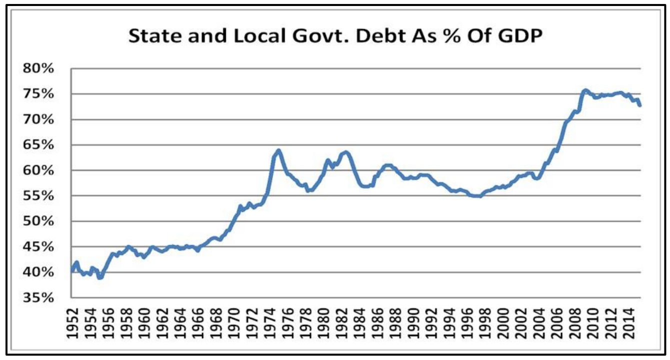
WRITTEN BY: BRIAN J. PRETTI CFA, CFP®
TERRY CHUI CFA, CFP®
Capital Planning Advisors

needed long term infrastructure projects? An upgrading of the US electrical grid? Better education for the next generation (no, we don't mean student loans)? No, no and no. The bulk of US debt expansion has gone not only to pay for ongoing government expenditures such as defense, but has also been used for a meaningful increase in "transfer payments" to US citizens (think Social Security and Medicare cost increases, sharply extended unemployment benefits, a threefold increase in Social Security disability benefits since 2009, the cost of Obamacare (ACA), food stamps, HARP, job training, and corporate subsidies such as solar energy, just to name a few). Since 2008, these transfer payments have increased $800 billion annually. This debt expansion may have been viewed as "necessary" due to the Great Recession, but it has not created opportunities for longer term productivity or employment increases.

Lastly, we need to remember that the data above covers only what is termed "on balance sheet" US Government debt. So what is off balance sheet? This would include Medicare, Social Security and other future entitlement obligations. The net present value of these items has been estimated at a staggering $60 trillion and is nowhere to be seen in the chart above.

STATE AND LOCAL GOVERNMENTS

State and local governments deserve a bit of special mention as well because pension obligations are already starting to simmer and promise to come to a full boil in the years ahead. Looking at the chart of state and local government debt relative to US GDP, we need to characterize these municipalities as being "relatively prudent" in the current cycle. The flat to declining ratio since 2008 tells us municipal debt has grown at just a bit slower pace than the US economy as a whole, but we can also see that in the years prior to 2008, debt levels relative to the economy went up significantly. Why? First, we were in a period of low interest rates, but the key was that the real estate boom created significant new revenues for cities, municipalities and states in the form of taxes and fees. As usual, these accelerating cash flows were borrowed against as if they were never to change. Yet change they did.



As we stated, pension, benefit and entitlement obligations loom large for state and local governments that can barely afford to take on additional debt. Although this has been a key topic of debate for years, the long contemplated issues are slowly coming to the front page. Chicago, as well as the State of Illinois are facing funding issues now. They are not alone as close behind is the City of Houston and States of Connecticut and Pennsylvania. A multi-state teamsters fund recently announced that it believes it has funding only through 2025, revealing that this is not simply a government issue ahead. We are convinced it will move to the front page in the next down cycle.

We believe what we see in this data helps explain a good portion of what we are seeing in the current cycle, which is much higher stock prices, yet tepid real macro-economic growth. The bulk of employment gains in the current cycle have been low and minimum wage service sector positions. Accompanying the weak economic growth has been half century growth rate lows in consumption. We need to remember that debt is essentially taking "tomorrow's consumption" and moving it into today. Servicing that debt over time means future capital needs to be allocated to pay down the debt, as opposed to investment.

All of this is to say that although accelerating debt helped underpin the US economy for almost a decade and a half now, ultimately we will reach a level that puts a constraint on future growth. Are we at that level now? Is this why we have a US economy struggling to move ahead? These are the questions we are wrestling with daily. And lest you think this is an issue specific to the US, not at all. Perhaps the scariest thought of all is that these issues are not specific to the US. In fact, the US has the lowest debt to GDP ratio among its large economy

WRITTEN BY: BRIAN J. PRETTI CFA, CFP®
TERRY CHUI CFA, CFP®
Capital Planning Advisors

brethren Japan, China and Europe, all of which are struggling to achieve historical rates of economic growth at a time where the debt on their balance sheets have ballooned to historic highs. How this will play out in the months and years ahead will be interesting to see, but it will no doubt affect world economies and stock markets, perhaps in a dramatic fashion as there will ultimately be a reconciliation of government balance sheets.