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Quarterly Review and Outlook

Fourth Quarter 2020

Still Bullish

Investing in a 30-year U.S. Treasury bond at a paltry yield of 2.4% on December 31, 2019 appeared to be a poor investment choice, particularly since it was the lowest year-end yield since the inception of the 30-year bond in 1977. However, in a short 12 months the 30-year U.S. Treasury realized a 20% return compared with a 18.4% return in the S&P 500 and a 7.5% return for the Bloomberg Barclays Aggregate Bond Index. A similar context existed at the end of 2020 as the yield stood 75 basis points lower at 1.65%, another record year end low. Presently, the overwhelming judgment of market forecasters is that interest rates will rise throughout 2021 owing to the expectation that additional fiscal stimulus coupled with an easy monetary policy will create an inflationary cocktail as pandemic related shutdowns lessen. The essence of the decision at Hoisington Management to maintain a bullish stance on long U.S. Treasury yields is not whether rates can rise, since it happens transitorily every year, but whether they can stay elevated. Provided there are no major changes by Congress to the Federal Reserve Act, we believe it is prudent to expect that long dated U.S. Treasury rates will eventually gravitate to lower levels as inflation continues to recede.

The rationale for this apparent contrary stance is as follows. First, the massive void in economic activity and destruction of wealth created by the virus and related shutdowns of businesses in the U.S. and abroad will take years to fill. Second, U.S. fiscal multipliers are generally negative, rendering much government spending counterproductive in terms of stimulating economic growth. Third, monetary policy becomes much less impactful since the debt overhang was massive before the pandemic and is now even worse, not just in the United States but in virtually all parts of the world.

The Void

The Department of Labor reports that the number of people unemployed totaled 10.736 million at the end of 2020. They also noted that individuals working part time because of slack work or business conditions or those who could not find full-time employment totaled nearly 6.170 million. The Economic Policy Institute notes that continuing claims for all unemployment assistance are 17 million above a year ago and that 26.1 million workers are either unemployed or had a drop in hours or pay because of the pandemic lockdowns. The BLS JOLTS report documents in November 2020 there were only 6.527 million job openings in the U.S. The gap between unemployed and available jobs is wide.

The ever insightful economist David Rosenberg recently noted a few more statistics which reflect the magnitude of the devastation over the last 12 months: 1) government benefits now account for nearly 20% of total personal income; 2) one in four households haven't been able to meet their monthly bills since March; 3) one in 15 homeowners are in some sort of loan forbearance relief plan; 4) 75% of the government stimulus went to debt paydown and saving; 5) one in three households dipped into savings or retirement accounts over the past year and one in six has borrowed from a family or friend to cover bills. Additionally, it should be noted that the National Multifamily Housing Association found that over three quarters of households made full or partial rent payment for the month ending December 6th, down almost 8% versus last year. Specific industries are reporting catastrophic declines as typified by the National Restaurant Association warning that “more than 500,000 restaurants are in free fall.” The same might be said of other entertainment venues and service industries. The severity of the downturn has decimated many small businesses and they may not survive in their former state. As is also the case for office buildings, shopping centers, convention facilities and airlines.

GDP measures new output, but it has no capability of subtracting from the output measure the destruction of wealth caused by the pandemic and the economic shutdown response. Achieving the level of precrisis activity will in fact require years, owing to the wealth destruction. This economic point was clearly made more than a century ago by French economist Frederic Bastiat (1801-1850) in his essay “Ce qu'on voit et ce qu'on ne voit pas” (English: "That Which is Seen and That Which is Not Seen"). Economics in One Lesson (1946), written by Henry Hazlitt (1894-1993), did much to publicize the work of this French economist.

For Hazlitt and Bastiat, the essence of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists of tracing the consequences of that policy not merely for one group but for all groups. One component of this argument was the fallacy of the broken window. If a brick is thrown through the window of the bakery and breaks it, the baker will have to replace the window and, in the process, GDP will be boosted. However, the wealth of the baker is reduced because the baker had to reduce other assets or components of their wealth to replace the window thus the economy is worse off than if no damage was incurred. Therefore, if this were not true then economic prosperity could be achieved by breaking each other's window. The GDP measure fails to register this loss of wealth.

Government Multipliers

During the fiscal year ending 2020 the federal government ran a deficit of $3.13 trillion, nearly 218% above the $984 billion deficit recorded in fiscal year 2019. This percent increase is nearly identical to the deficit increase in 2009 of 208% as a response to the Global Financial Crisis. Post-election estimates for the 2021 deficit have centered around $3.1 trillion, similar to the preceding year. Despite the fact that much of the expenditures by the federal government are useful to provide a cushion from lost income and output, the size of the outlays has created some concern regarding future inflation. That particular debate can revolve around the macroeconomic effects of fiscal stimuli (fiscal multipliers). The Journal of Monetary Economics published an article in 2012 by Ethan Ilsetzki, Enrique Mendoza, and Carlos Vegh that has contributed considerable insight and serious scholarly evidence on this debate.

While their work clearly displayed the difficulty of trying to isolate fiscal multipliers, they did discover that the macroeconomic impact of the expenditure shock depends on four key country characteristics. First, industrial countries respond with a positive multiplier. Second, economies operating under flexible exchange rates have a negative multiplier. Third, countries that are open to trade have a negative multiplier. Fourth, the government spending multiplier is sharply negative in highly indebted countries. They point out that the definition of highly indebted is central government debt exceeding 60% of GDP, a condition that is met by most of the major economies of the world.

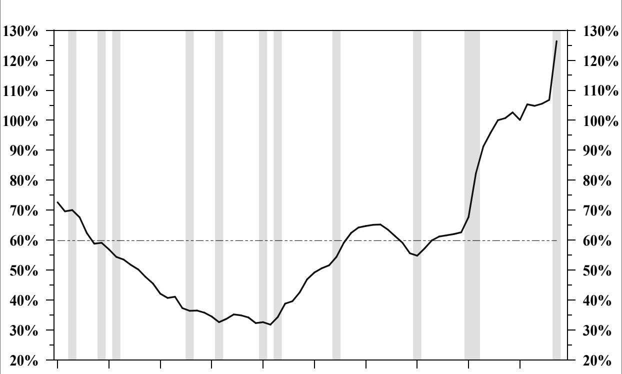
Additionally, the composition of expenditures may play an important role in assessing the effect of fiscal stimulus. The last point regarding the type of expenditure is important, suggesting that not all government spending is created equal. Investment in physical infrastructure, health, education and other similar programs can provide a long-term boost to GDP according to their work.

Considering the above criteria as it applies to the U.S., it is our conclusion that U.S. fiscal multipliers are in fact negative for non-investment type of spending. First, the United States is obviously a developed country. That is a positive. The U.S. however meets all of the other three constraining features: The U.S. operates with flexible exchange rates, it is a relatively open economy with respect to trade and is highly indebted. Note the U.S. government debt as a percentage of GDP is not 60% but 127% (Chart 1). On balance, therefore, non-investment expenditure multipliers appear to be negative. This indicates that a sustained strong macroeconomic response from our large federal government deficits should not be expected. Sizeable debt financed Federal fiscal operations in 2009 and 2018 produced only transitory spurts in economic activity. Also, these failed fiscal efforts occurred under the leadership of both of the major political parties. This indicates that the weak multipliers are not the result of political leadership, but the nature of the debt financed operations. Government funding is derived from taxing and borrowing from their citizens. This process reduces the resources of the private sector which provides productivity growth expanding the economic 'pie.' The transfer of resources to the federal sector can result in a misallocation of resources reducing overall productivity and growth for the entire economic system.

Debt Drag

Total public and private debt in the United States rose last year to 405.9% of GDP, up from 365.9% of GDP in 2019 (Chart 2). As of December 31, 2020, total government debt securities outstanding amounted to $27 trillion, up from $23 trillion dollars in December 2019, a nearly 19% increase in the calendar year. Previous studies have indicated that the productivity of debt tends to decline with the overuse of that particular factor of production (Chart 3). When debt capital, like any other factor of production, is overused its marginal revenue product declines. This serves as a persistent drag on economic activity that restrains growth despite the best efforts of monetary and fiscal policy. The decline in the marginal revenue productivity of debt, due to the pandemic, must now operate with even weaker demographics around the world. The pandemic resulted in considerably lower marriage and birth rates which will have negative long-term consequences for domestic and global

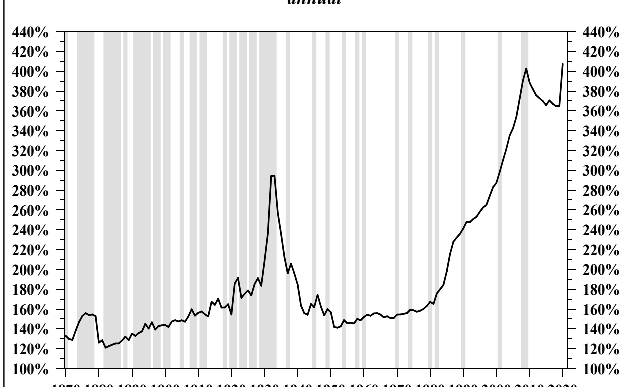
Gross Federal Debt as a % of GDP
annual



Sources: C.B.O., U.S. Treasury. Through 2020.

Chart 1

U.S. Private and Public Debt as a % of GDP
annual



Sources: Bureau of Economic Analysis, Federal Reserve, Congressional Budget Office. Census Bureau: Historical Statistics of the United States Colonial Times to 1970. Through Q3 2020. 2020 is average of Q1, Q2 and Q3.

Chart 2

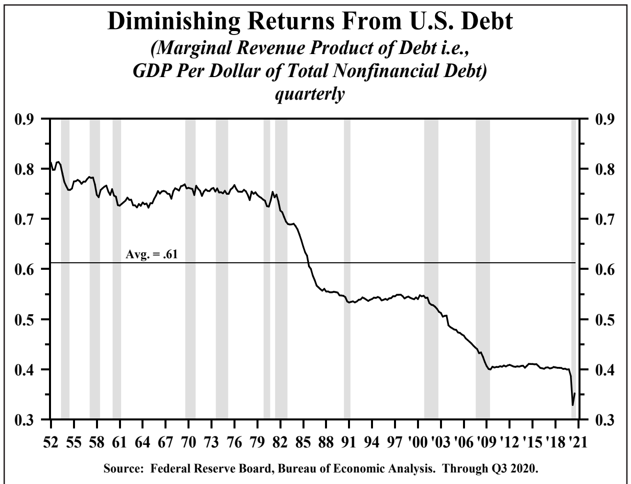


Chart 3

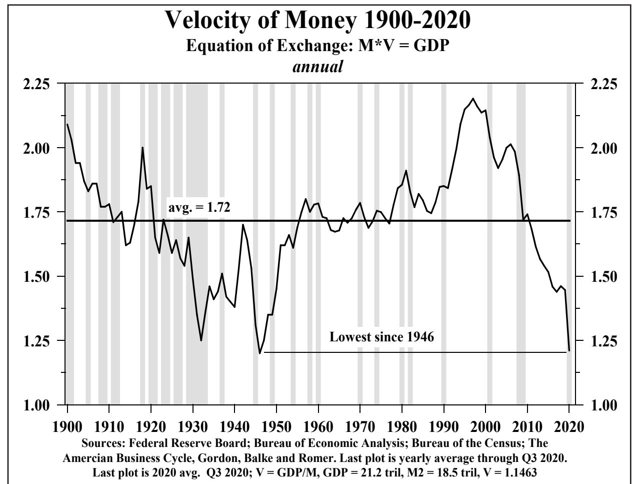


Chart 4

growth. Based upon the universally applicable production function, the capability of achieving historical rates of economic growth will be even more difficult in the years ahead.

Monetary Policy

The Federal Reserve acted promptly and aggressively to the downturn in economic activity caused by the virus and economic shutdowns. They quickly lowered the Fed Funds rate from 1.5% to zero. In addition, they began purchasing $80 billion of Treasury securities and $40 of mortgage securities a month. As a result, the monetary base and Federal Reserve Bank Credit jumped by an unprecedented 38.6% and 64%, respectively, resulting in a 19.4% yearly average increase of M2. By comparison in 2019, the monetary base, Federal Reserve Bank credit and M2 had registered annual changes of -9.3%, -7.9% and 5.1%, respectively.

The housing sector benefited substantially from these policy actions, with the thirty-year conventional mortgage yield dropping to an all-time low in December of 2.71%, almost 100 basis point below the year earlier level. The rate decline caused mortgage refinancings to increase about 113% over the year providing significant funds for consumer spending and investment. However, the lower rate structure reduces the revenue and income of many financial intermediaries.

Despite this sectoral benefit from the easier monetary policy, the macro-wide effects were contained as the velocity of money fell 17.7% in 2020 with velocity for the year averaging an estimated 1.2, the lowest level since 1946 (Chart 4). With velocity falling, funds available for financial investment surged as did prices in many asset markets. The drop in velocity, however, is consistent with the sharp decline in the marginal revenue product of debt and suggests no long-lasting inflationary consequences from the 2020 surge in M2.

In sum, considering economic destruction placed on individuals and small businesses by the virus and its resultant shutdowns, the fact that fiscal expenditures have a negative multiplier on macroeconomic conditions, the debilitating impact on growth of excessive debt and the restriction of the zero bound on monetary stimulus, a secular inflation cycle is not at hand. Since inflation is the primary determinate of the yield on long dated U.S. government debt, it remains our judgement that the bull run in 30-year U.S. Treasurys is continuing.

Hoisington Management

Disclosures

The Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities. The Bloomberg Barclays Bellwether indices cover the performance and attributes of on-the-run U.S. Treasurys that reflect the most recently issued 3m, 5yr and 30yr securities. CPI is the Consumer Price Index as published by the Bureau of Labor Statistics. S&P 500 is the Standard & Poor's 500 capitalization weighted index of 500 stocks. You cannot invest directly in any index. The Bloomberg Barclays indices, CPI and S&P 500 are provided as market indicators only. HIMCo in no way attempts to match or mimic the returns of the market indicators shown, nor does HIMCo attempt to create portfolios that are based on the securities in any of the market indicators shown.

Returns are shown in U.S. dollars and net of management fees and include the reinvestment of all income. The current management fee schedule is as follows: .45% on the first $10 million; .35% on the next $40 million; .25% on the next $50 million; .15% on the next $400 million; .05% on amounts over $500 million. Minimum fee is $5,625/quarter. Existing clients may have different fee schedules.

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