



Excessive Indebtedness: A Global Problem

by Lacy H. Hunt, PhD

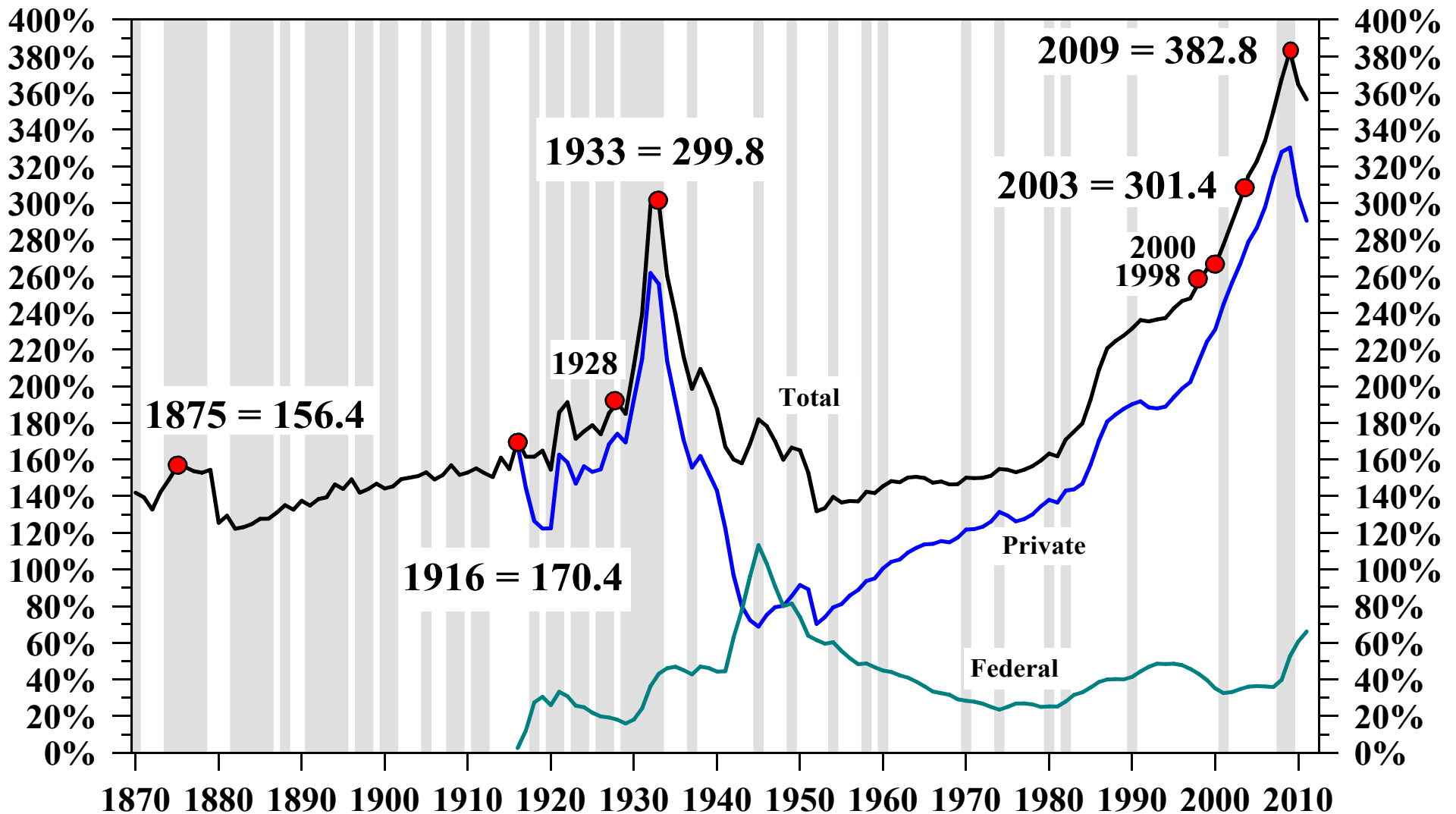
Presented To:

2012 Strategic Investment Conference

6836 Bee Caves Road ▪ Building 2, Suite 100
Austin, Texas 78746
512-327-7200 Fax 512-327-8646
www.Hoisington.com

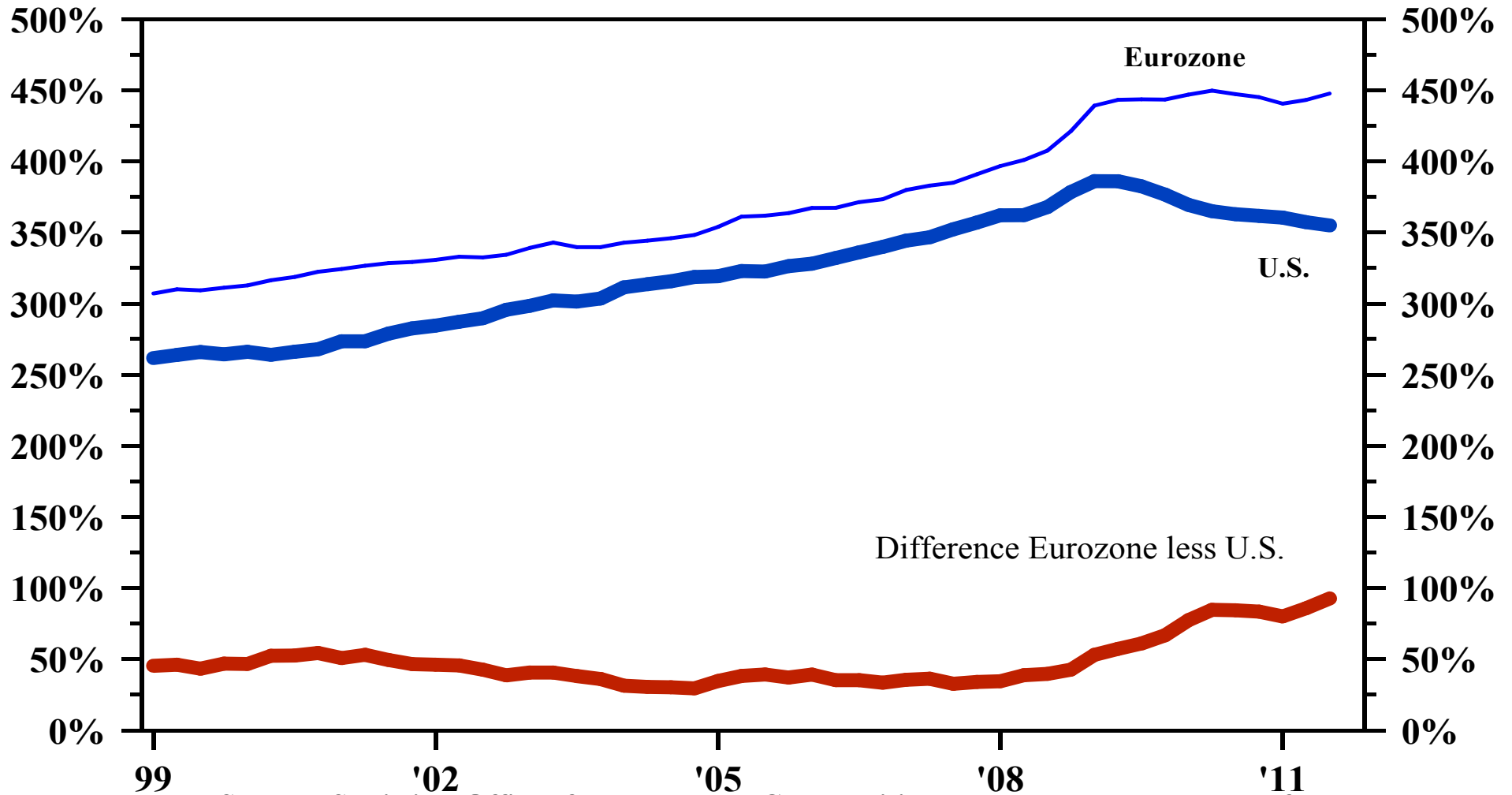
U.S. Debt as a % of GDP

annual



Sources: Bureau of Economic Analysis, Federal Reserve, Census Bureau: Historical Statistics of the United States Colonial Times to 1970. Through Q4 2011.

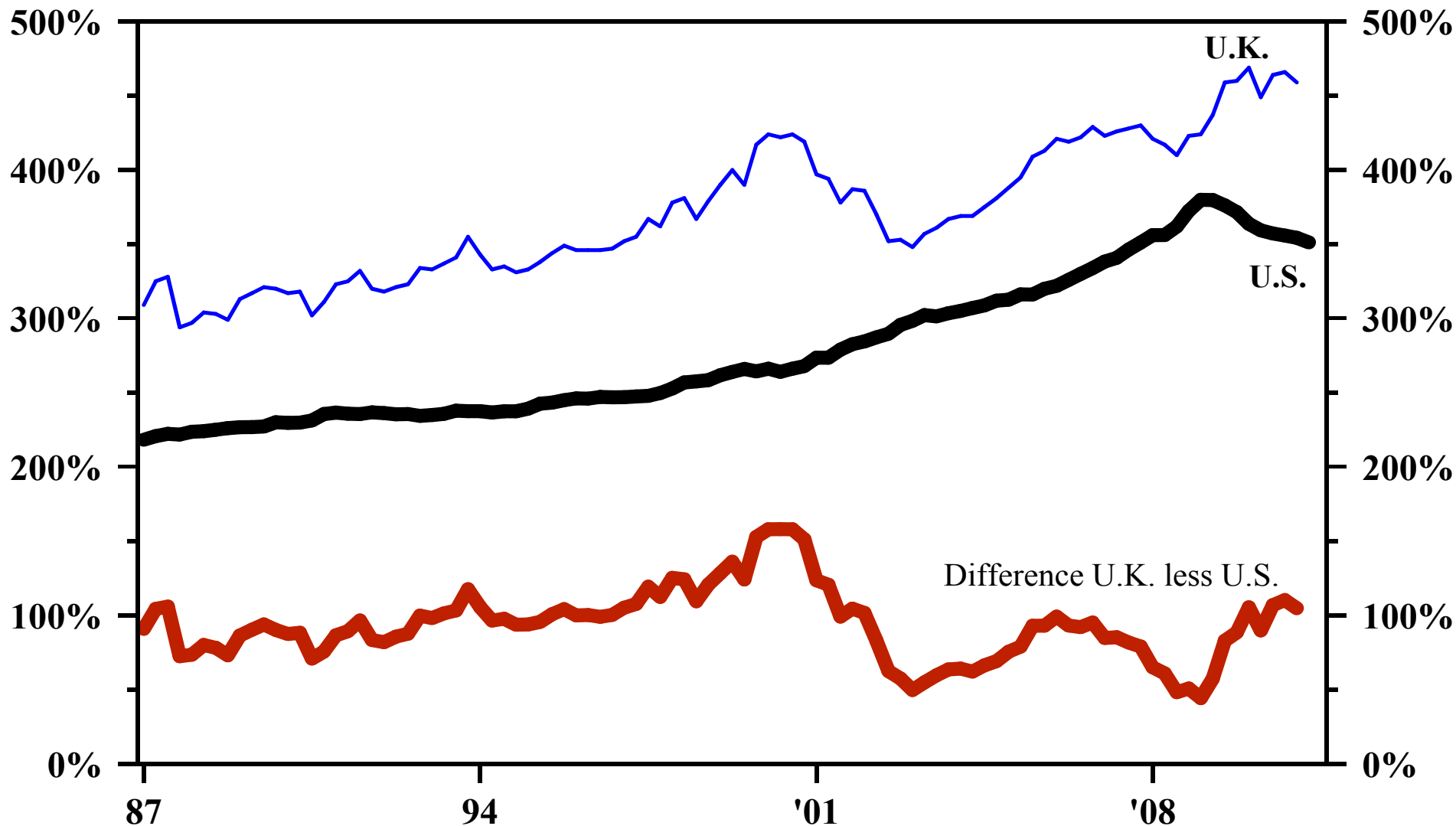
U.S. and Eurozone Total Debt Outstanding as % GDP *quarterly*



Source: Statistical Office of the European Communities, Federal Reserve, Bureau of Economic Analysis. Eurozone through Q3 2011, U.S. through Q3 2011.

U.K. and U.S. Total Debt as a % of GDP

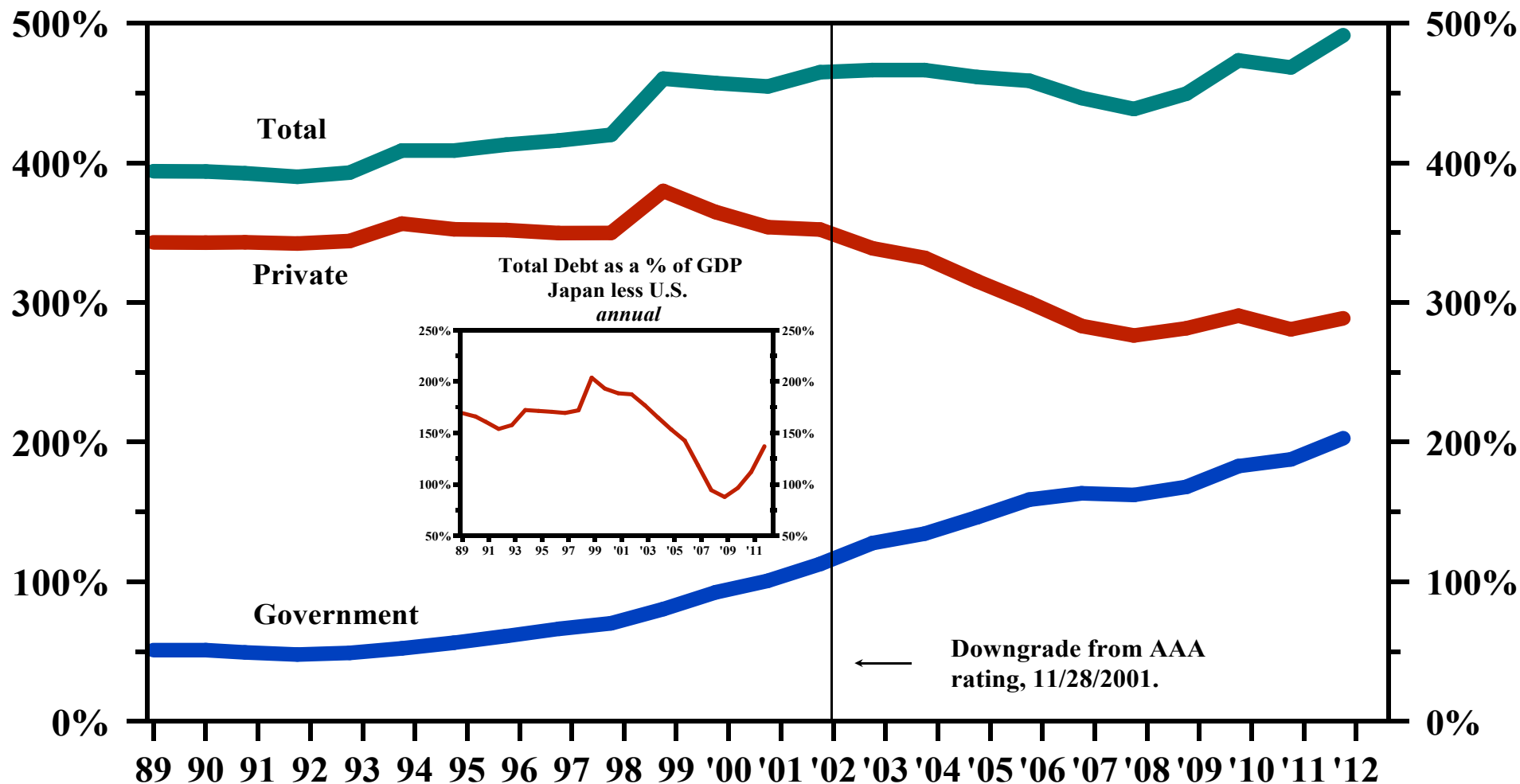
quarterly



Source: Office for National Statistics, Federal Reserve, Bureau of Economic Analysis. U.K. through Q1 2011, U.S. Through Q2 2011.

Japan: Total, Government, and Private Debt as a % of GDP, 1989 - 2011

annual



Source: Bank of Japan, Cabinet Office. Through Q3 2011. Data before 1998 estimated from McKinsey Global Institute.

Debt and Economic Activity: Conventional vs. New View

Beginning with Irving Fisher (1933) and A. G. Hart (1938), there is literature on the macroeconomic role of inside debt. Hyman Minsky (1977) and Charles Kindleberger (1978) have in several places argued for the inherent instability of the financial system, but in doing so have had to depart from the assumption of rational economic behavior. *Footnote:* I do not deny the possible importance of irrationality in economic life: however, it seems that the best research strategy is to push the rationality postulate as far as it will go.

Ben S. Bernanke (2000). *Essays on the Great Depression*, pages 42-43.

“The evidence is more consistent with the view that problems related to household balance sheets and house prices are the primary culprits of the weak economic recovery. King (1994) provides a detailed discussion of how differences in the marginal propensity to consume between borrowing and lending households can generate an aggregate downturn in an economy with high household leverage. This idea goes back to at least Irving Fisher’s debt deflation hypothesis (1933).”

Federal Reserve Bank of San Francisco Economic Letter January 2011. Atif Mian University of California Berkeley, Haas School of Business and Amir Sufi, University of Chicago Booth School of Business.

“When a country’s gross government debt rises above 90% of GDP, the median growth rates fall by one percent, and average growth falls considerably more.”

Growth in the Time of Debt, NBER, Kenneth Rogoff and Carmen Reinhart.

“Debt is a two-edged sword. Used wisely and in moderation, it clearly improves welfare. But, when it is used imprudently and in excess, the result can be a disaster. For individual households and firms, overborrowing leads to bankruptcy and financial ruin. For a country, too much debt impairs the government's ability to deliver essential services to its citizens.” Debt turns cancerous when it reaches 80-100% of GDP for governments, 90% for corporations and 85% for households.

The Real Effects for Debt by Stephen G. Cecchetti, M. S. Mohanty and Fabrizio Zampolli. September, 2011. Bank for International Settlements, page 1.

Debt and Other Economic Components to GDP: China vs. U.S., 2011

		China	U.S.
1.	Officially reported government debt to GDP	16.3%	99%
2.	Hidden liabilities	144.0%	n/a
3.	Total debt including hidden liabilities	160.0%	99.0%
4.	Personal consumption expenditures as a % of GDP	30.0%	71.
5.	Investment as a % of GDP	70.0%	16%
6.	China's growth target for 2012	7.5% <small>Would be slowest in 22 years.</small>	n/a

Source: Mckinsey Global Institute, Bureau of Economic Analysis.

“The fact that it is well-insulated from outside markets does not mean that China's finances are crisis-proof. The system can be disrupted by purely internal factors, as it clearly has been in the past.”

Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise by Carl E. Walter and Fraser J.T. Howie (John Wiley, 2011), page 207.

China's growth is in danger of decelerating rapidly and without much warning.

China 2030, Building a Modern, Harmonious, and Creative High-Income Society, The World Bank, Development Research Center of the State Council, the People's Republic of China.

4 Archetypes of the Delevering Process

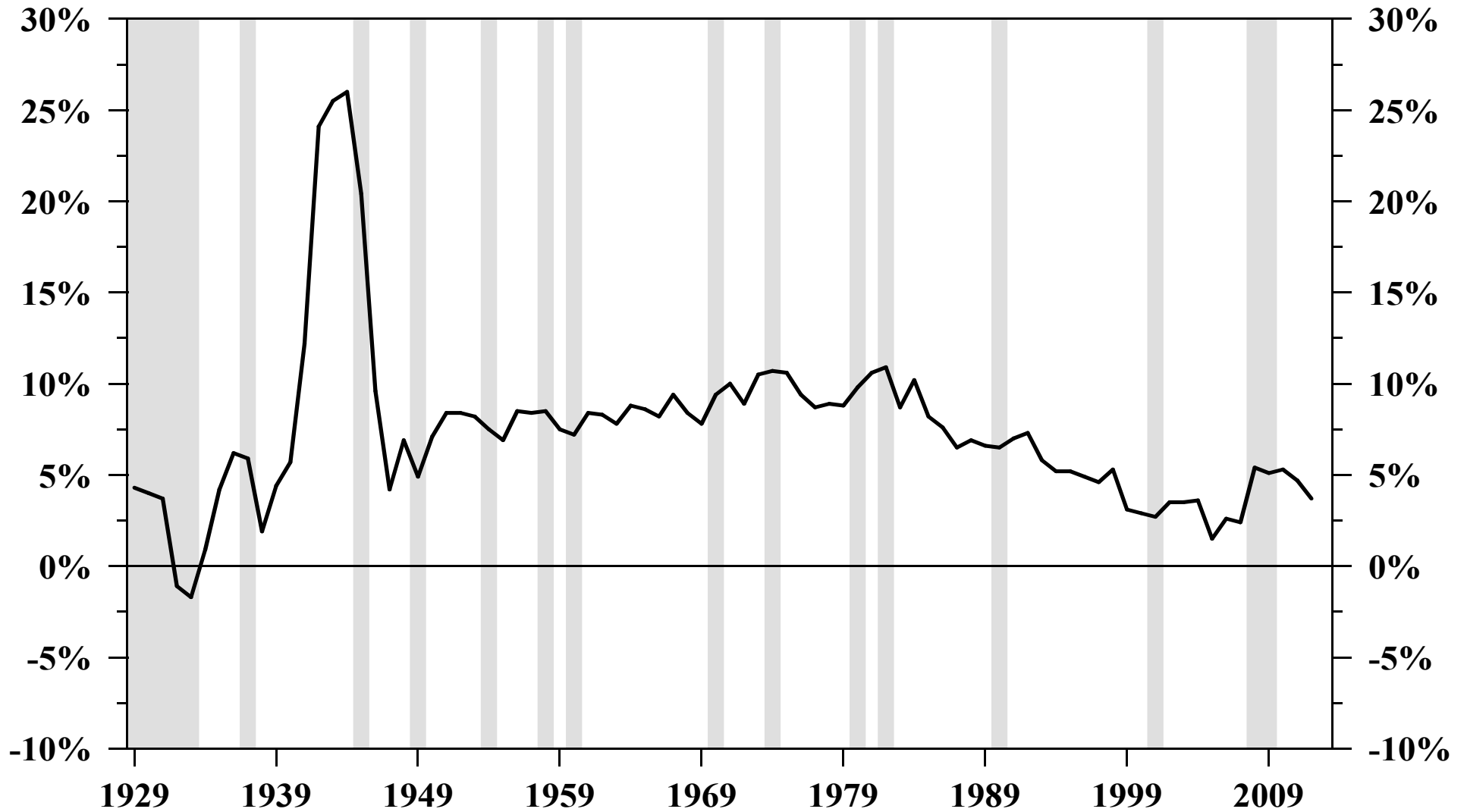
1. “Belt Tightening”. The most common delevering path.
2. “High Inflation”. Absence of strong central banks, often in emerging markets.
3. “Massive Default”. Often after a currency crisis.
4. “Growing out of debt”. Often after an oil or war boom.

Referring to types 2, 3, and 4, “they were relatively rare and occurred in conditions that are not present today in the mature economies....This record suggests that today’s mature economies are most likely to deleverage through a belt-tightening process.

Source: McKinsey Global Institute. Debt and deleveraging: The global credit bubble and its economic consequences, page 39. December 2010.

Personal Saving Rate

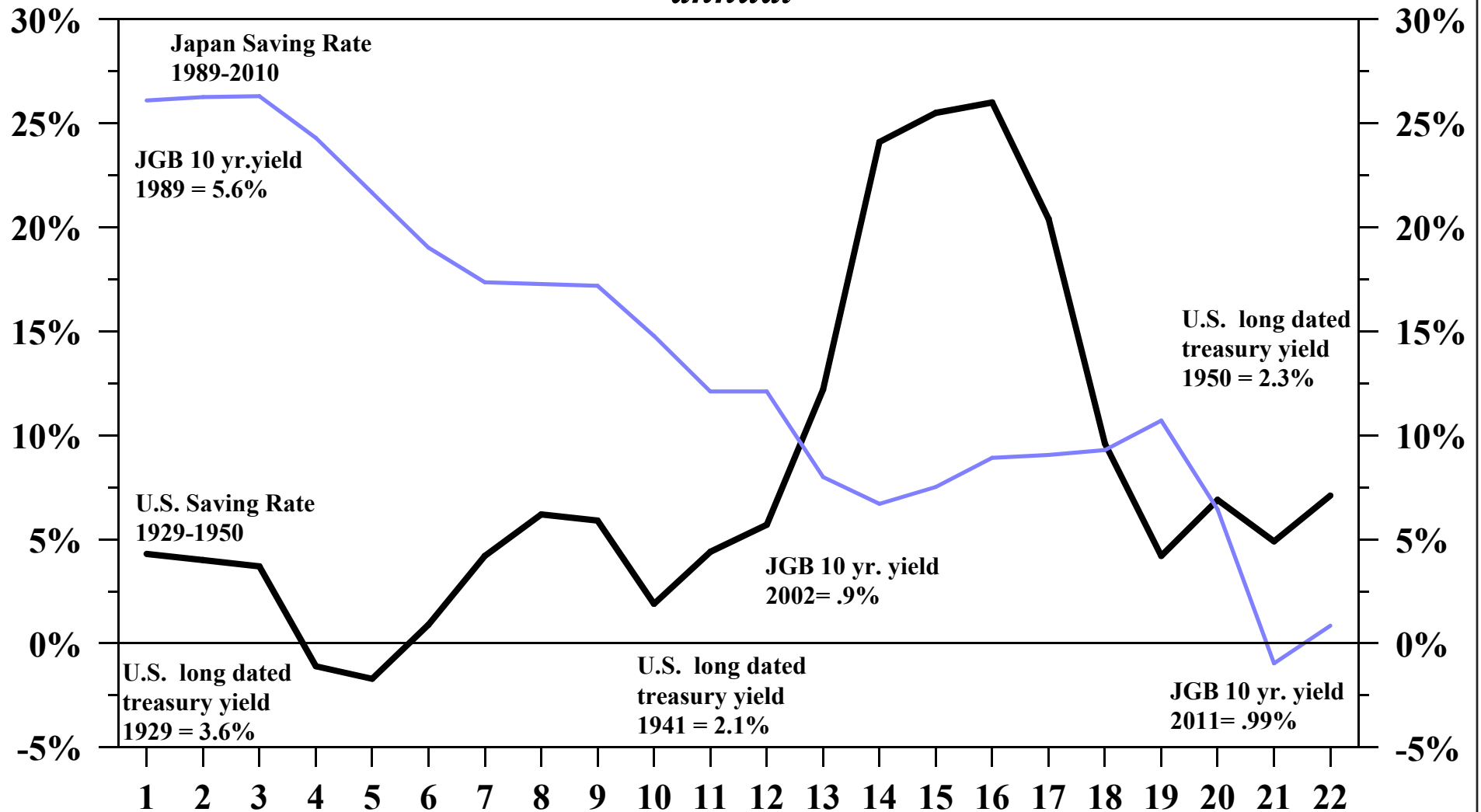
annual



Sources: Bureau of Economic Analysis. Through February 2012.

Saving Rate: Japan 1989 - 2010 vs. U.S. 1929 - 1950

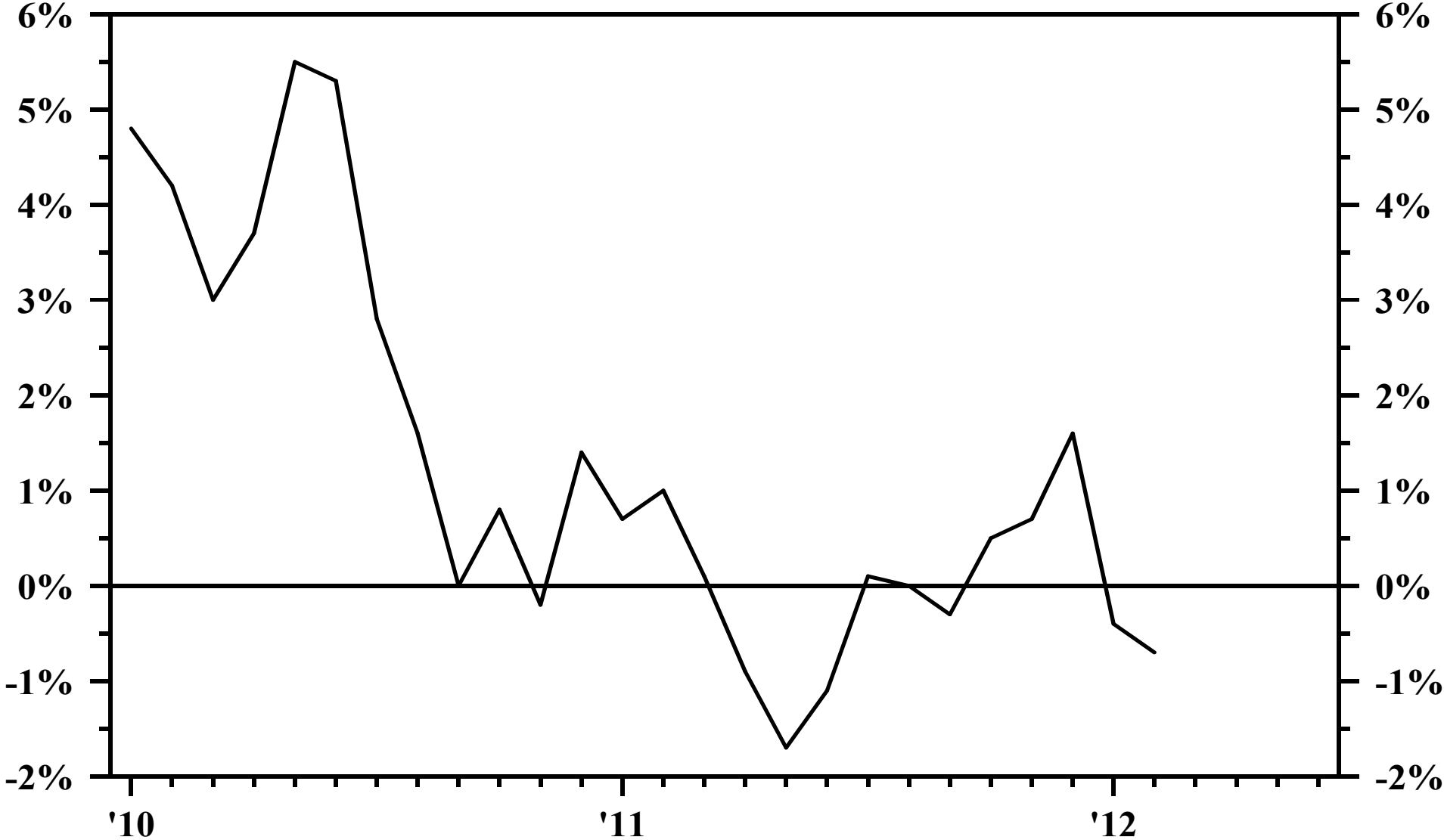
annual



Sources: Cabinet Office of Japan, Bureau of Economic Analysis.

Real Disposable Personal Income per Capita

3 month % change, a.r.



Source: Bureau of Economic Analysis. Through February 2012.

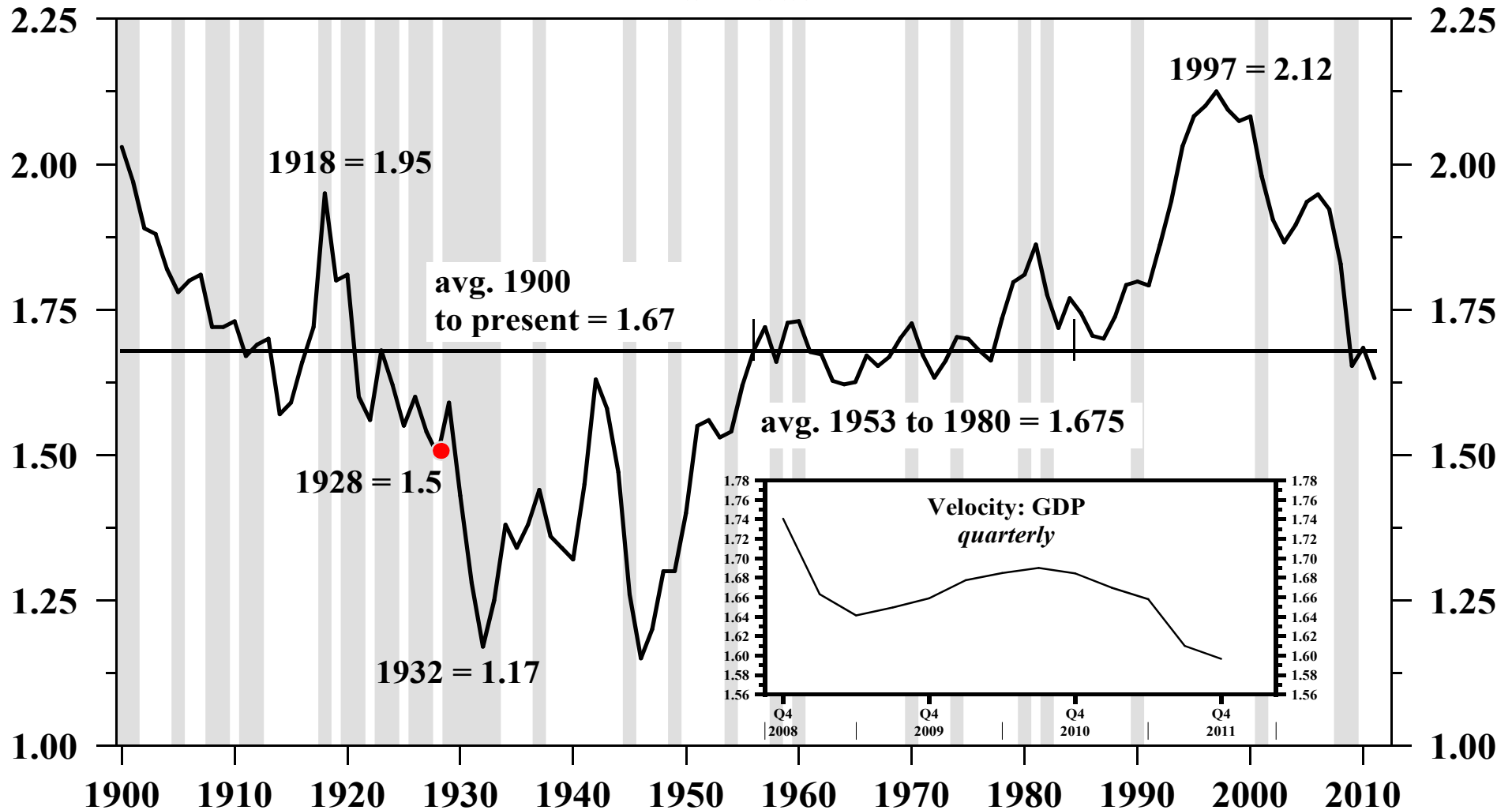
QE1, No QE and QE2: Critical Market Values Positive Responders to Inflation/Risk

		QE1 Change	No QE	QE2 Change	No QE	QE3 (SWAP)
1.	S&P 500	36.4%	-9.0%	24.1%	-5.6%	12.9%
2.	Dow Jones Global Stock Index	48.4%	-8.0%	22.4%	-12.7%	11.1%
3.	Gasoline	30.3%	-8.6%	36.8%	-5.5%	19.3%
4.	10-year break even yield	1.1%	-1.5%	1.0%	-0.6%	0.7%
5.	Dollar (DXY)	-4.6%	2.3%	-10.4%	5.5%	0.8%

Source: Federal Reserve, Bloomberg, Haver Analytics, NYMEX, Standard and Poors, Moodys. Through Q1, 2011.

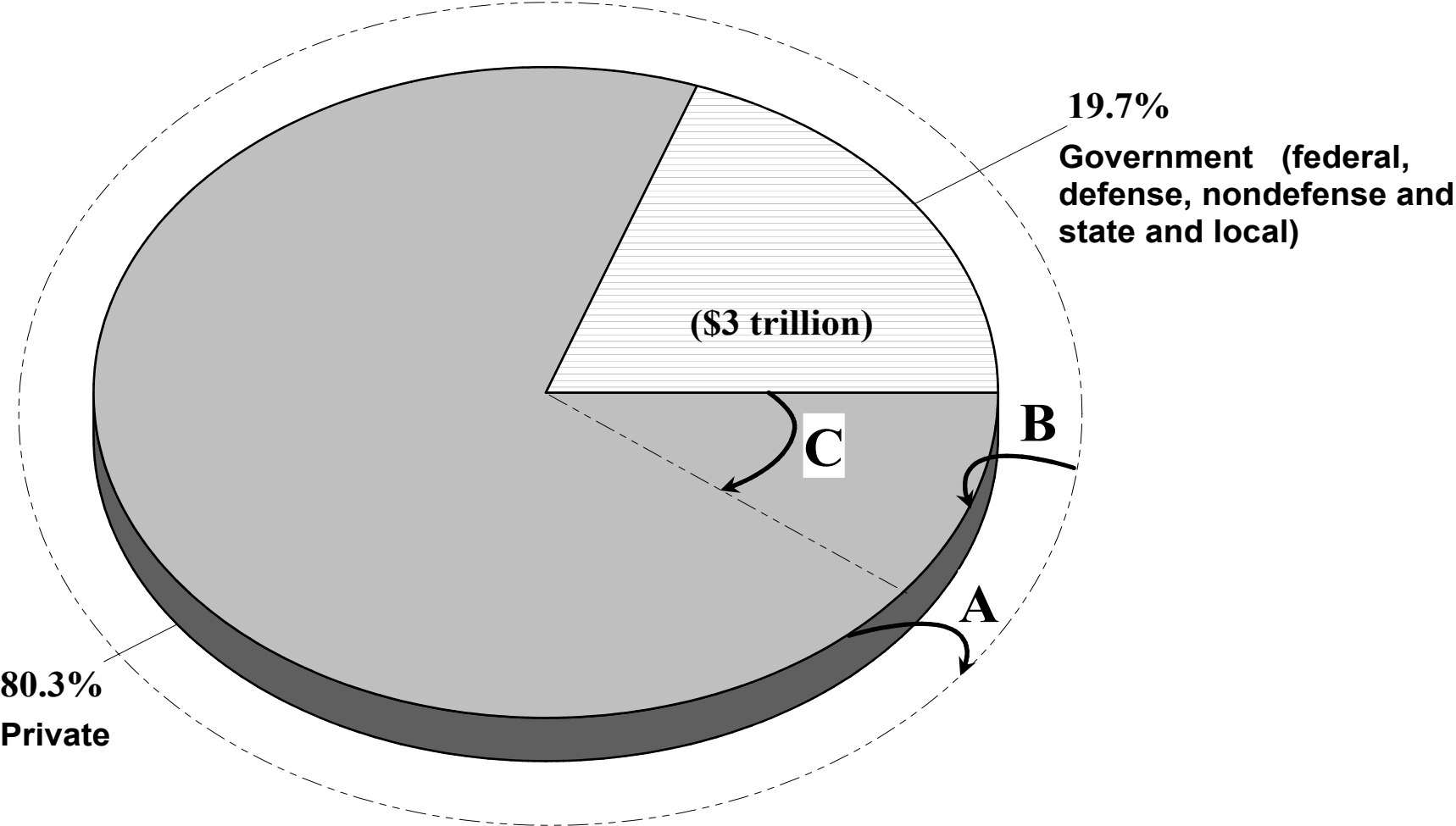
Velocity of Money 1900-2011

Equation of Exchange: $GDP(\text{nominal}) = M * V$
annual



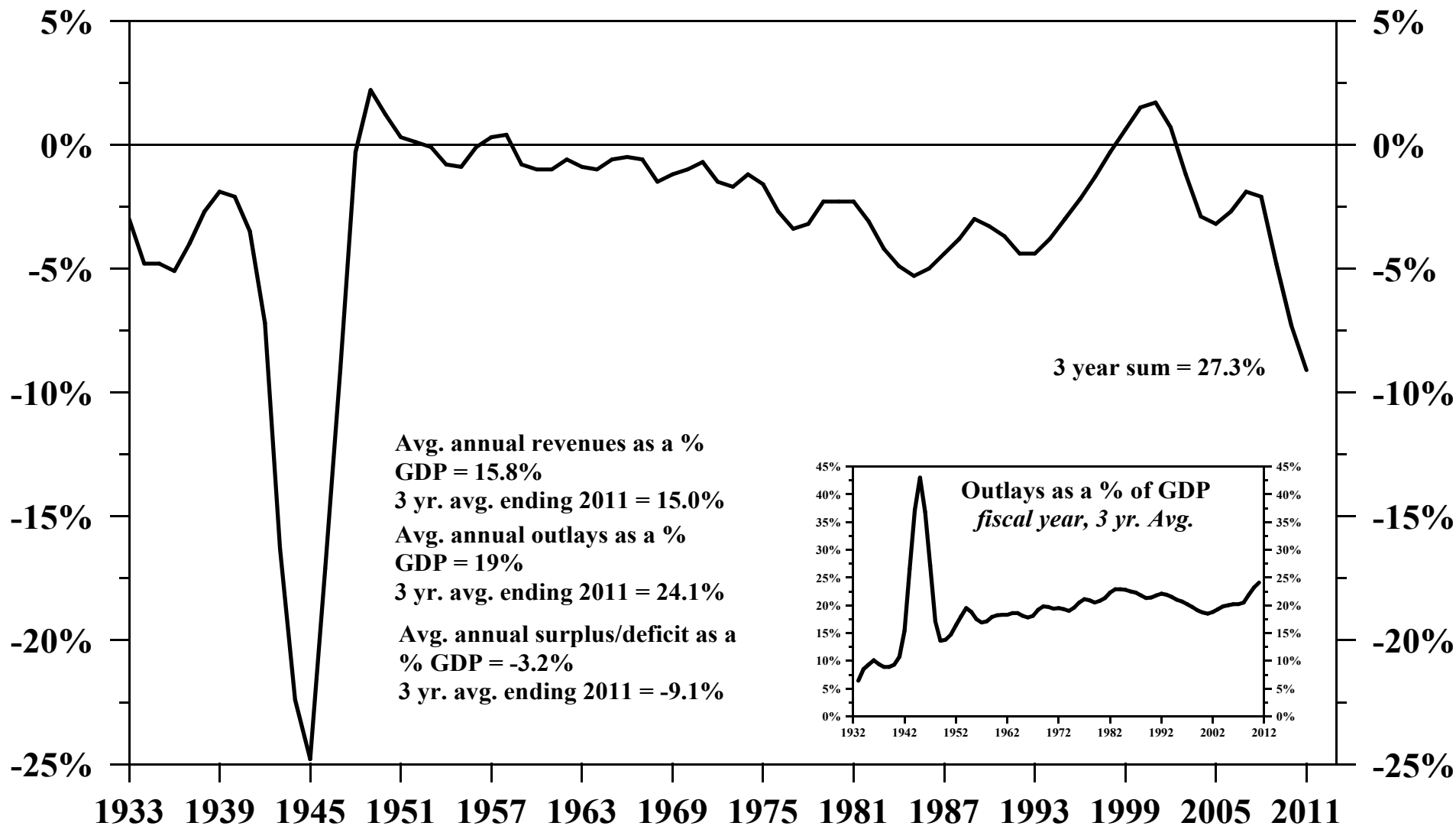
Sources: Federal Reserve Board; Bureau of Economic Analysis;
 Bureau of the Census; Monetary Statistics of the United States. Through Q4 2011.
 Q4 2011; $V = GDP/M$, $GDP = 15.3$ tril, $M2 = 9.6$ tril, $V = 1.59$

Composition of \$15.3 Trillion GDP in Q4 2011



Federal Surplus/Deficit as a % of GDP

fiscal year, 3 year average



Sources: Congressional Budget Office. Through 2011.

Federal Outlays Toward 40% of GDP?

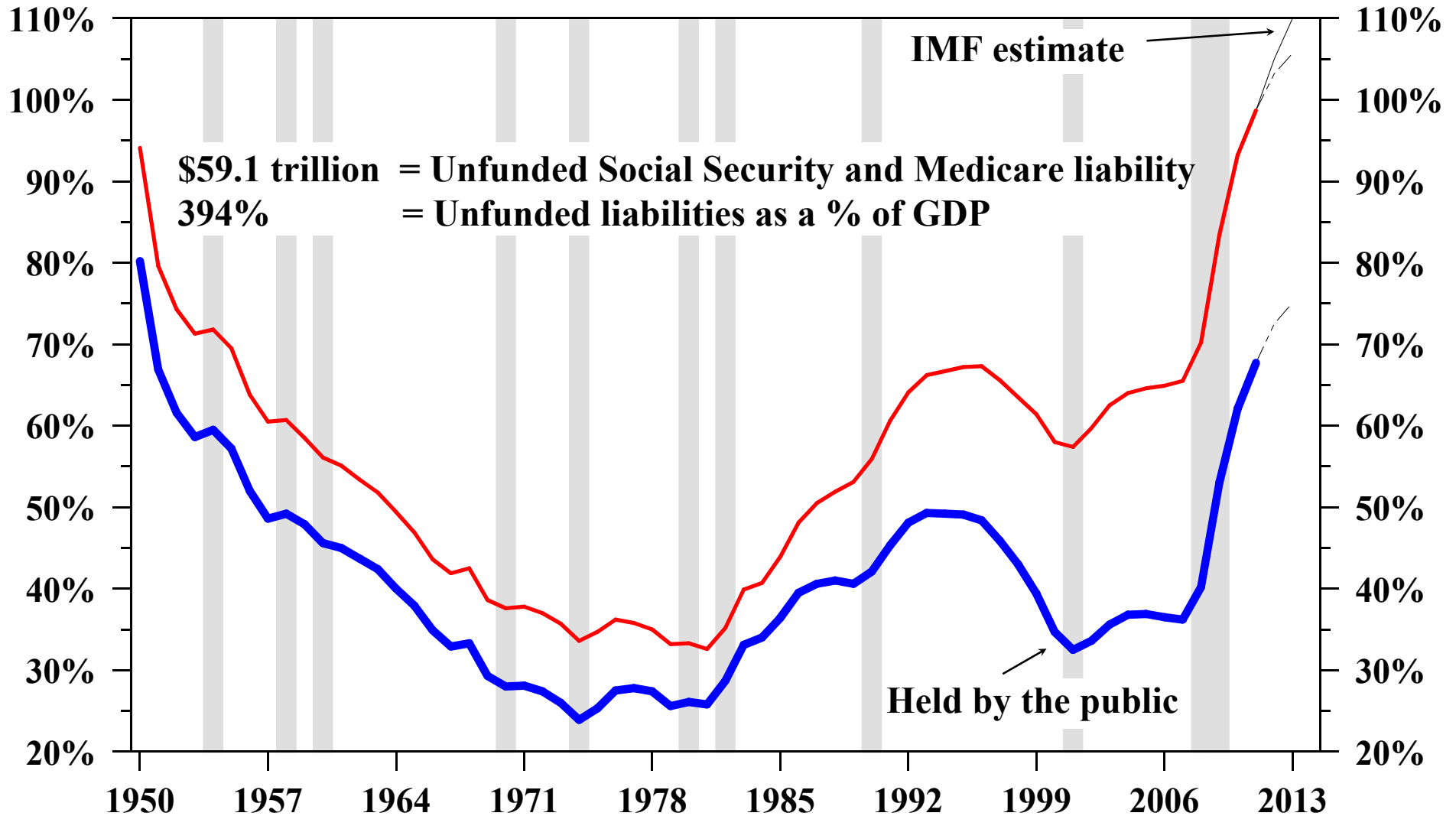
Dr. Barry Eichengreen of the University of California at Berkeley estimates that after 2015 federal outlays as a percent of GDP are headed to 40% over the next quarter century without major structural reforms in Social Security and Medicare. For Dr. Eichengreen this means that the current law cannot remain unchanged in spite of the lack of political will to deal with the issue.

“The United States will suffer the kind of crisis that Europe experienced in 2010, but magnified. These events will not happen tomorrow. But Europe's experience reminds us that we probably have less time than commonly supposed to take the steps needed to avert them. Doing so will require a combination of tax increases and expenditure cuts.” He goes on to point out that, “At 19 percent of GDP, federal revenues are far below those raised by central governments in other advanced economies with spending on items other than health care, Social Security, defense and interest on the debt having shrunk from 14 percent of GDP in the 1970s to 10 percent today, there is essentially no non-defense discretionary spending left to cut. One can imagine finding small savings within that 10 percent, but not cutting it by half or more in order to close the fiscal gap.”

Barry Eichengreen, Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System, Oxford University Press, 2011.

Gross Federal Debt as a % of GDP

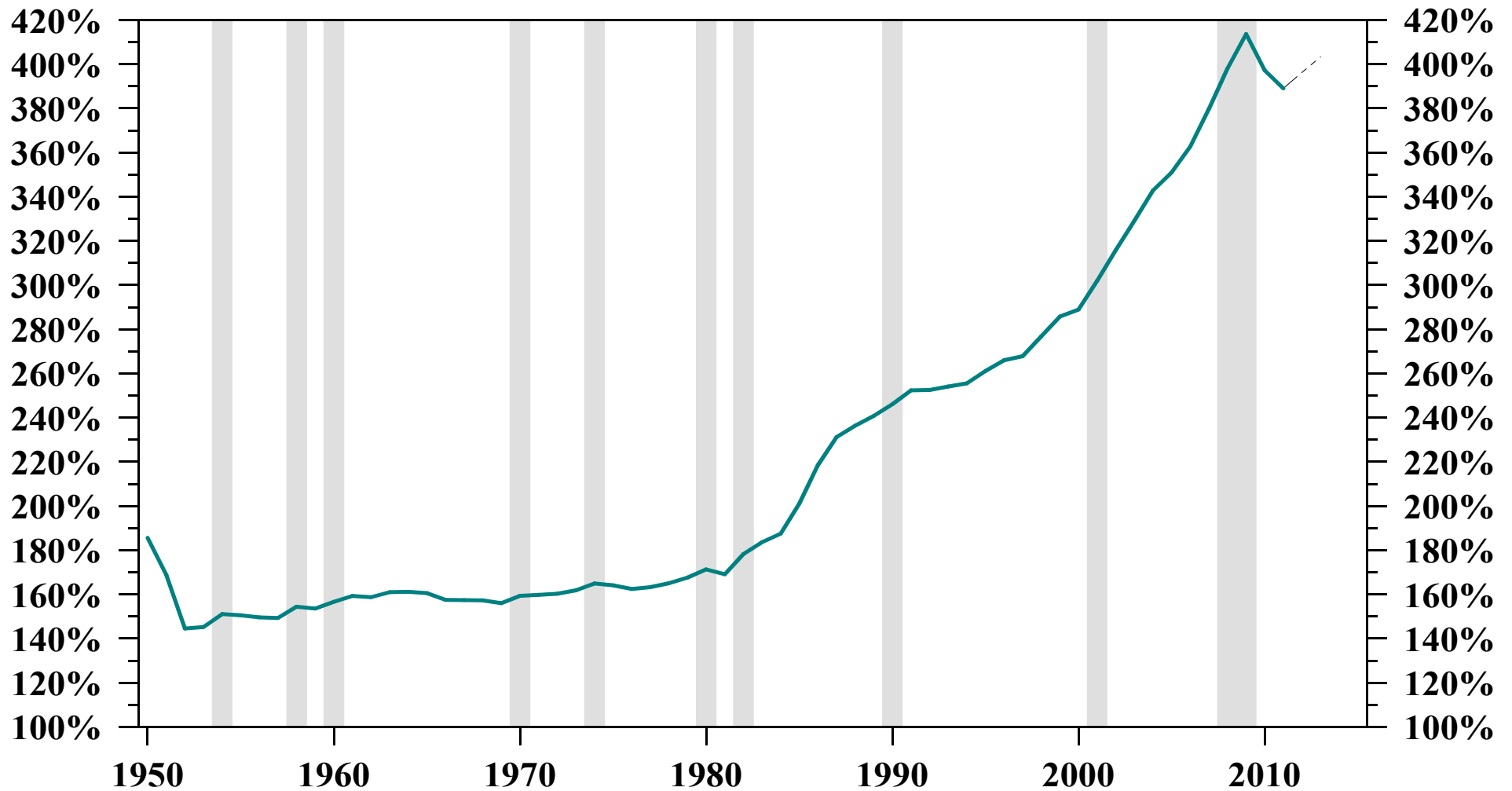
annual



Sources: Office of Management and Budget. Through 2011. CBO and IMF estimates through 2013.

U.S. Debt as a % of GDP

*including gross federal debt
annual*



Sources: Bureau of Economic Analysis, Federal Reserve. Through Q4 2011. IMF estimates through 2013. Private estimated unchanged from 2010 levels.

Unfunded Government Pension Liabilities in Europe

In 2009, the ECB commissioned a report of the unfunded state sponsored pension plan liabilities in 19 of the 27 EU member countries, with 11 members in the Euro currency zone and 8 non currency zone members. The starting point for the data in the study is 2006. Based on that stipulation, the unfunded liabilities of the 19 EU member countries were about five times their GDP, which is where the US stood according to a study with the starting point five years later in 2011.

**Source: Pension obligations of government employer pension schemes and social security pension schemes established in EU countries - Final Report, Research Center for Generational Contracts, Freiburg University, By order of the European Central Bank
Christoph Müller, Bernd Raffelhüschen, Olaf Weddige, January 2009**

Twenty Year Periods with a Negative Risk Premium

		<i>Stocks</i>	<i>Bonds</i>	<i>Stocks less Bonds</i>
		<i>1.</i>	<i>2.</i>	<i>3.</i>
<i>1.</i>	1874-1894	4.4%	5.4%	-0.9%
<i>2.</i>	1928-1948	3.1%	3.9%	-0.8%
<i>3.</i>	1991- 2011	7.8%	8.0%	-0.2%

...The inflation rate, the dividend yield relative to the yield on Treasury bonds, and the P/E ratio suggest that we are coming into a time when stock returns will be considerably diminished relative to the return on bonds...Over very long periods of time stocks must outperform bonds, because investors must be rewarded for riskier assets, and we will experience again in the future conditions that warrant higher prospective returns in stocks...the baseline conditions must change, a process that May result in an extended period when bond returns will equal, or even exceed, returns on stocks.

Estimating the Stock/Bond Risk Premium An alternative approach. The Journal of Portfolio Management, volume 29, number 2, winter 2002. Lacy H. Hunt and David M. Hoisington

Source: Standard and Poor's, A Half Century of Returns on Stocks and Bonds by Fisher and Lorie, History of Interest Rates; Homer & Sylla, N.S. Balke & R.J. Gordon, C.D. Romer, Robert Shiller - Yale University, Peter L. Bernstein Inc., HIMCO.