The U.S. economy appears to be on a steadily declining path to recession and disinflation/deflation. This may seem improbable in the face of record year-over-year growth in nominal GDP over the past decade (Chart 1). Additionally, the U.S. has experienced record stock prices, record confidence levels, a steady upward march of coincident economic indicators and the lowest unemployment rate (3.7%) reported in the past 49 years. These statistical measures, along with many others, however, carry no weight regarding future economic activity. Monetary policy has played a major role in determining recessions. But, unlike the past, the government's debt level has reached such extreme heights that, like monetary policy, it is also serving to restrain economic growth going forward. An analysis of these factors leads to the inescapable conclusion that a bumpy landing is in store for the U.S. economy.

**Monetary Policy**

Eight policy interest rate increases in short

![Nominal GDP](chart1.png)

![World Dollar Liquidity](chart2.png)

rates and a 30%, or nearly $1 trillion, reduction in excess reserves of the banking system appears to have had little impact on U.S. growth, as of yet. True, the interest sensitive sectors – autos and housing – have ceased expanding and are currently a slight drag on overall output, but overall consumption, which represents about 70% of GDP, has remained relatively steady.

With lags, the impact of Fed policy, however, has a broad reach. As noted in past quarterly letters, Fed policy determines world dollar liquidity. That liquidity is palpably shrinking around the world where debt productivity is considerably lower than in the U.S. As such, the erosion of dollar liquidity should weaken foreign economies before the monetary restraint is visible domestically (Chart 2). The symptoms can be seen in emerging markets with declining equity prices and in locations where the cheap money policy of the past has encouraged dollar borrowing. These markets are now facing rising interest costs and a more expensive dollar, making repayment difficult.
Significantly, U.S. monetary restraint has caused a similar slowdown in local currency money growth around the world (Charts 3.a, 3.b). Additionally, velocity in Japan, the Euro area and China has been declining secularly since the late 1990s, as debt has become increasingly less productive. Since money times velocity (i.e. its turnover) determines GDP in all countries, this cumulative global economic slowdown should impact U.S. economic activity.

In the U.S., monetary actions have already begun to impact the critical indicators, such as the money and credit aggregates, while simultaneously lowering the term spread and reducing the profitability of banks and others who borrow short and lend long. The annual growth rate in money supply (M2) has slowed to 4%, well below the 6.6% annual rate of expansion since 1900. Loans and leases funded by banks and commercial paper have dropped to a 2.5% three-month annualized growth rate (Chart 4), and the asset growth of banks has ceased to expand this year. Another symptom of monetary change, the term spread which is derived from the yield curve, is now clearly re-enforcing the restrictiveness of Fed policy.

**Yield Curve**

A great deal of analysis has been done on this subject. Recently, San Francisco Fed economists conducted a study on various spreads in the treasury market. Using monthly data from January 1972 through July 2018, they looked at each spread and predicted whether the economy would be in recession 12 months in the future. The study found that the ten year-three month (10y-3m) spread was the “most reliable predictor” in signaling a recession. One of their conclusions, however, was that while the risk of recession might be rising, the flattening of the 10y-3m yield spread does not currently signal an impending recession. They also correctly pointed out no causality. The spread at the time of the article was +100 basis points (bps), or 1%. As recently as late August, the spread was down to the low 70s, but, quite volatile, it has recently reversed higher.

An examination of this spread since 1953 is quite revealing (Chart 5). There is the presumption that it is necessary for the curve to invert prior to recessions, primarily because all inversions have
a restrictive monetary policy, the flatter term spread significantly impacts all depository and other financial institutions that are borrowing short and lending long, as their profitability is eroded. When the major costs (net interest margins, overhead costs and the risk premium, or costs associated with the possibility of a borrower default) are considered, the easiest option is to reset the risk premium for loans. This plus increased competition typically leads to credit mistakes, even though late cycle ebullient business conditions seem to justify the lower risk premium. Such holding of risky assets has not ended well for lenders or investors in both pre and post-World War II business cycles.

**Fiscal Policy**

Just as monetary policy is directed toward slowing growth, fiscal policy is similarly aligned. Large budget deficits can be associated with strong growth and higher inflation. Present circumstances, however, preclude that eventuality as the prodigious level of government debt had accumulated to 106.4% of GDP, or $21.516 trillion, at the end of the 2018 fiscal year. Academic studies have centered around the proposition that government debt roughly in excess of 90% of GDP for a period of five years slows economic growth. Already at 106% of GDP and having been above 90% GDP since 2010, it is understandable and easy to conclude that past and current fiscal policy will be contractionary from this point over the long run. This past year, the enormous increase in debt added to economic growth, however, this also added to the already onerous debt burden, meaning it will act as a drag on future economic growth.

In just the past 12 months, the amount of federal debt expanded by $1.271 trillion. This is not to be confused with the increase in the deficit which totaled only $804 billion. Over the past five years, the deficit is up by $2.977 trillion, whereas the total government debt has risen by $4.777 trillion, a difference of $1.80 trillion. How does this happen?Simple. Elected representatives have decided that certain sums of money that are spent (therefore

been followed by recessions. As this chart reveals, if this yield spread is still positive but falls below +40 bps, there is a more than reasonable possibility of a decline in economic activity. The spread is quite variable, but at +73 bps, which it was in August, is close to the +40 bps level which would signal an outright recession. Two more 25 bps hikes in the Federal Reserve target rate may be sufficient to move it to a full recession signal.

This flattening of the term spread, is consistent with monetary theory. There is a supportive connection between the flattening of the term spread and the Federal Reserve action of reducing total reserves in the banking system. Thus, it is the Fed reduction in reserves that causes major flattenings to occur; the movement of the curve is a symptom of a restrictive monetary policy. This reserve action is, as mentioned, also consistent with slow money and credit growth. The Fed, not surprisingly, acknowledges the curve flattening, but says it is “one of many indicators” (true but hardly a comfort). In 1989 and 1999, the Greenspan Fed said the curve inversion was not relevant and the economic outlook remained strong. This may have been one of the main reasons the Fed did not see the 1990-91 and 2000-01 recessions until they were long underway. The Bernanke Fed also explained away the yield curve inversion prior to the collapse of Lehman Brothers at the start of the 2008 recession.

In addition to signaling the effectiveness of
paid by borrowed funds) are in fact “investments” rather than “expenses”. These items include certain transportation expenditures, federal loan programs, social security/military/civil service payments where benefits are in excess of tax collections, and a host of other items. It is material. Over the next five years, the Congressional Budget Office (CBO) projects the deficit will expand by $5.661 trillion. If federal debt continues to rise in excess of the deficit by the same amount as the past five years, then total debt outstanding will reach $28.9 trillion in 2023, compared with the CBO’s projected GDP estimate for that year of $24.6 trillion. Debt therefore will reach 117% of a total year’s income / output of the U.S. economy in just five short years.

An analysis of the interconnectedness of the economy, or what is referred to as the circular flow of the macro economy, reveals another factor, over and above the government debt problem, that will enhance the impetus for economic activity to slow. For all economies, what is produced equals what is spent, which in turn equals what is earned (i.e., GDP equals Income). Based on this circular flow proposition, algebraically, national saving must equal physical investment (S = I). Investment is critical to the growth of productivity. Productivity plus labor force growth determines potential economic growth rates. Therefore, to get an investment boom, greater national saving is required. Herein stands the problem. Government deficits are not saving, but dissaving, reducing the total saving available for investment (Chart 6). Since 1929, net national saving has averaged 6.4%, but with increasing government deficits (dissaving) over the past 17 years, the national saving rate has dropped by more than half to about 3%. It is important to note that the projected increase in federal debt from $21.4 to $28.9 trillion will, all other things being equal, further reduce net national saving from approximately 3% to 2% or possibly even zero. Thus, investment would be forced downward, continuing to erode productivity, unless, of course, consumer saving were to rise. But, if consumer saving were to rise, this would reduce consumer spending and economic growth, undermining the incentive for more investment. This is a recipe for semi-recessionary economic conditions, regardless of monetary mistakes. Indeed, both fiscal and monetary policy are guiding U.S. economic growth slower.

The response by policy makers to this eventuality is a guess, but a higher interest rate policy does not appear to be an option. From the standpoint of an investment firm that started in 1980, when 30-year bond yields were close to 15%, the current 30-year treasury rate at 3% seems ridiculously low. In the near future, at 1.5%, the 3% yield will seem generous (Chart 7).

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