On My Radar: He Ain’t Heavy, He’s My Brother

April 29, 2016
By Steve Blumenthal

The road is long
With many a winding turn
That leads us to who knows where
Who knows when
But I’m strong
Strong enough to carry him
He ain’t heavy, he’s my brother

So on we go
His welfare is of my concern
No burden is he to bear
We’ll get there
For I know
He would not encumber me
He ain’t heavy, he’s my brother

“He Ain’t Heavy, He’s My Brother,” by The Hollies (1969)


Last week we looked at structural issues. Specifically, the oversupply glut of 3 billion workers competing for the work that 800 million workers were doing before the internet opened the world to the emerging market supply chain. Think China’s massive infrastructure build out – the excess manufacturing and labor capabilities and also think about Korea, Singapore, Taiwan and India. Fifteen dollar per hour wages are not going to fly when there are people doing the same thing for $15 per day.

The big consumers are the developed countries and some of the biggest consumers (well, you and me) are here in the U.S. But older we get and the demographic winds require more savings and less spending. We already bought a lot of the stuff.

Last week I promised you a “Cliffs Notes” version of Lacy Hunt’s latest letter as well as some thoughts from Gary Shilling. They are two of my favorite analysts. So let’s jump on in and make this week’s letter a quick and to the point read. Grab that coffee and find your favorite chair.

**Included in this week’s On My Radar:**

- Lacy Hunt
- Gary Shilling
- We Are Heading Towards Negative Interest Rates

Lacy Hunt
Here are a number of bullet point highlights from Hunt’s April letter:

- The striking aspect of the U.S. economy’s 2015 performance was weaker economic growth coinciding with a massive advance in nonfinancial debt.
- Nominal GDP, the broadest and most reliable indicator of economic performance, rose $549 billion in 2015 while U.S. nonfinancial debt surged $1.912 trillion.
- Accordingly, nonfinancial debt rose 3.5 times faster than GDP last year. This means that we can expect continued sub-par growth for the U.S. economy.
- The ratio of nonfinancial debt-to-GDP rose to a record year-end level of 248.6%.
- During the four and a half decades prior to 2000, it took about $1.70 of debt to generate $1.00 of GDP. Since 2000, however, when the nonfinancial debt-to-GDP ratio reached deleterious levels, it has taken on average, $3.30 of debt to generate $1.00 of GDP.
- This suggests that the type and efficiency of the new debt is increasingly non-productive.
- Debt is always a shift from future spending to the present.
- Thus, while the debt helped to prop up economic growth in 2015, this small plus will be turned into a longer lasting negative that will diminish any benefit from last year’s debt bulge.
- Household debt was lower.
- Last year, business debt, excluding off balance sheet liabilities, rose $793 billion, while total gross private domestic investment (which includes fixed and inventory investment) rose only $93 Thus, by inference this debt increase went into share buybacks, dividend increases and other financial endeavors, albeit corporate cash flow declined by $224 billion.
- When business debt is allocated to financial operations, it does not generate an income stream to meet interest and repayment requirements. Such a usage of debt does not support economic growth, employment, higher paying jobs or productivity growth.
- Thus, the economy is likely to be weakened by the increase of business debt over the past five years.
- In 2015, the ratio of business debt-to-GDP advanced two percentage points to 70.4%, far above the historical average of 51.7%.
- Only once in the past 63 years has this ratio been higher than in 2015. That year was 2008.
- The jump in corporate debt, combined with falling profits and rising difficulties in meeting existing debt obligations, indicates that capital budgets, hiring plans and inventory investment will be scaled back in 2016 and possibly even longer.
- Indeed, various indicators already confirm that this process is underway.
- U.S. Government gross debt, excluding off balance sheet items, reached $18.9 trillion at year-end 2015, an amount equal to 104% of GDP, up from 103% in 2014 and considerably above the 63-year average of 55.2%.

SB here: I’d like to make special note of Lacy’s next point:

“The divergence between the budget deficit and debt in 2015 is a portent of things to come. This subject is directly addressed in the 2012 book The Clash of Generations, published by MIT Press, authored by Laurence Kotlikoff and Scott Burns. They calculate that on a net present value basis, the U.S. government faces liabilities for Social Security and other entitlement programs that exceed the funds in the various trust funds by $60 trillion. This sum is more than three times greater than the current level of GDP.”

- They substantiate that, although these liabilities are not on the balance sheet, they are very real and will have a significant impact on future years’ budget deliberations.
According to the Congressional Budget Office, over the next 11 years, federal debt will rise to $30 trillion, an increase of about $10 trillion from the January 2016 level, due to long understood commitments made under Social Security, Medicare and the Affordable Care Act.

Any kind of recession in this time frame will boost federal debt even more.

More than a dozen serious studies indicate this will drain U.S. economic growth as federal debt moves increasingly beyond its detrimental impact point of approximately 90% of GDP.

Over-indebtedness Impairs Global Monetary Policy: The Federal Reserve, the European Central Bank, the Bank of Japan and the People’s Bank of China have been unable to gain traction with their monetary policies.

Excluding off balance sheet liabilities, at year-end, the ratio of total public and private debt relative to GDP stood at 350%, 370%, 457% and 615%, for China, the United States, the Eurocurrency zone, and Japan, respectively.

Lacy concludes:

Our economic view for 2016 remains unchanged. The composition of last year’s debt gain indicates that velocity will decline more sharply in 2016 than 2015. The modest Fed tightening is a slight negative for both M2 growth and velocity.

Additionally, velocity appears to have dropped even faster in the first quarter of 2016 than in the fourth quarter of 2015. Thus, nominal GDP growth should slow to a 2.3% – 2.8% range for the year. The slower pace in nominal GDP would continue the 2014-15 pattern, when the rate of rise in nominal GDP decelerated from 3.9% to 3.1%.

Such slow top-line growth suggests that spurts in inflation will simply reduce real GDP growth and thus be transitory in nature.

Accordingly, the prospects for the Treasury bond market remain bright for patient investors who operate with a multi-year investment horizon. As we have written many times, numerous factors can cause intermittent increases in yields, but the domestic and global economic environments remain too weak for yields to remain elevated.

Source: Hoisington Quarterly Review and Outlook

Gary Shilling

The above section was long with a lot of data. Gary is smart thinking with a solid long-term record of getting the major themes right. I share a high-level summary of his thinking from his latest letter. You can subscribe to his research letter here (to be clear, I have no financial affiliation with Gary. Just a fan.)

Back Where We Started: We believe the pessimism over the economic outlook and nervousness in financial markets was overdone early this year, but so too is the more recent euphoria. The U.S. economy will probably continue to grow at about a 2% annual rate, better than most developed countries but constrained by ongoing financial deleveraging, deceleration in China and worldwide excess capacity, especially in commodities with the resulting price weakness. The economies and finances of emerging countries will remain under pressure while deflation looms and the dollar is likely to strengthen.

Monotonous slow growth would be breached on the downside if oil prices collapse to our $10 to $20 per barrel target and precipitate financial woes and global recession. On the other side, voter frustration in North America and Europe over the past decade of no real income growth, shown by the rise of populist politicians, may spur economic growth via fiscal stimuli. (Source: Gary Shilling)

We are hearing more and more about fiscal stimulus. That day remains postponed.

Gary suggests several tradable ideas in his letter. With many of them, I concur. As noted above, he is bearish on
oil and commodities in general. He too feels interest rates are heading lower. I remain in that camp. To that end, as was noted in Wednesday’s Trade Signals post, the Zweig Bond Model remains in a buy signal. (NOTE: NOT A RECOMMENDATION TO BUY OR SELL ANY SECURITY. Talk with your financial advisor about investment suitability.)

We are Heading Towards Negative Interest Rates

To this end, zero real interest rates predict zero real returns and negative real interest rates predict negative real returns. Research Affiliates puts it this way:

- For long-term investors, risk is more about failing to meet wealth accumulation goals than about short-term changes in the price of their portfolios; thus, the more appropriate measure of risk is the estimated probability of reaching or failing to reach the desired or needed long-term real return level.
- Given the new NIRP environment, **investors may wish to look beyond a traditional 60/40 portfolio to a portfolio holding substantial allocations in non-U.S. equities, alternatives and credit.** (Emphasis mine.)

Negative interest rates penalize savings. Savings lead to investment and investment to productivity and growth.

We need tax reform and we need infrastructure investment and this is only something that our elected officials can initiate. Expect more of the same for now. Watch for movement on the fiscal front. Specifically, lower taxes and infrastructure spend.

Stick to the plan.

Have a great weekend!

Steve

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Stephen Blumenthal founded **CMG Capital Management Group** in 1992 and serves today as its Chairman and CEO. Steve authors a free weekly e-letter entitled, On My Radar. The letter is designed to bring clarity on the economy, interest rates, valuations and market trend and what that all means in regards to investment opportunities and portfolio positioning. **Click here** to receive his free weekly e-letter.

A Note on Investment Process:

From an investment management perspective, I’ve followed, managed and written about trend following and investor sentiment for many years. I find that reviewing various sentiment, trend and other historically valuable rules-based indicators each week helps me to stay balanced and disciplined in allocating to the various risk sets that are included within a broadly diversified total portfolio solution.

My objective is to position in line with the equity and fixed income market’s primary trends. I believe risk management is paramount in a long-term investment process. When to hedge, when to become more aggressive, etc.

Trade Signals History:

Trade Signals started after a colleague asked me if I could share my thoughts (Trade Signals) with him. A number of years ago, I found that putting pen to paper has really helped me in my investment management process and I
hope that this research is of value to you in your investment process.

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