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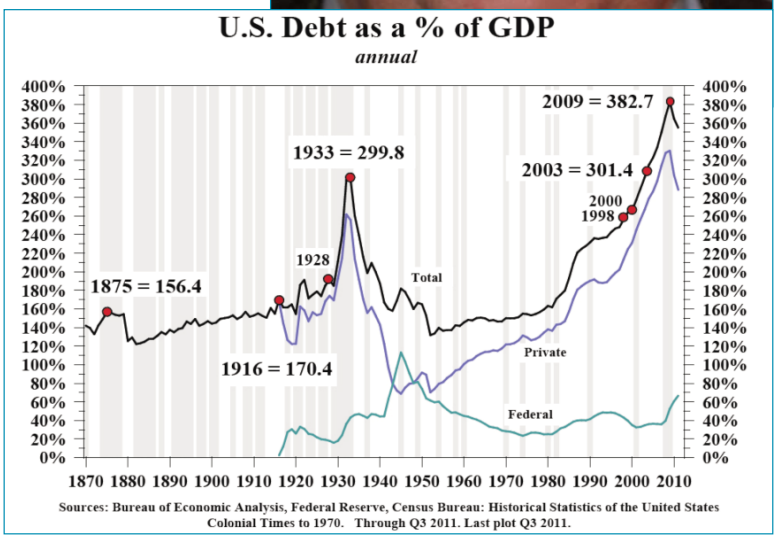
Face The Music

Road Back To Prosperity Is Through Shared Sacrifice, Says Lacy Hunt

Last time Dr. ***Lacy Hunt****, the chief economist at Austin, TX-based* ***Hoisington Investment Management*** *was interviewed in these pages, in July, 2009, the rebound in stocks from their crisis lows was only months old – yet he remained firmly in the bull camp – on bonds. As it turns out, Lacy, and the entire portfolio management team at Hoisington, led since the firm's founding by* ***Van R. Hoisington****, couldn't have been proven more right: Rates, which "couldn't go lower" have continued to sink. Much to the benefit of Hoisington's institutional clients and investors in the* ***Wasatch-Hoisington U.S. Treasury Fund****, which the firm sub-advises. When I gave Lacy a call earlier this week, he – always a gentleman and a scholar – patiently explained not only why he's still bullish on long Treasuries, but why there's simply no easy exit from the debt morass in which the whole economy, public and private, is trapped. Listen in.* ***KMW***

Happy New Year, Lacy. And thanks for sending all those charts to background me for our conversation. I have to say the first one stopped me – showing debt as a percentage of U.S. GDP all the way back to 1870? What data goes back that far?

Dr. Robert Gordon at **Northwestern University** has been very helpful to me, recreating a lot of



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Charts Courtesy
Hoisington Investment Management Co.

data. The National Income and Product Accounts (NIPA) from the Bureau of Economic Analysis (BEA) only start in '29. But NBER (the National Bureau of Economic Research) funded two studies, one by **Christina Romer** and the other by Robert Gordon, to estimate the nation's GDP back to 1870. So we have those data sets. They're not identical, obviously, but what most economists do, including me, is use an average of the Romer and the Gordon estimates, which seems to work out pretty well.

Still, I suspect most folks looking at a line on a chart interpret it as "historical fact" instead of as an estimate based on spotty data on the workings of a very different economic environment.
Well, what the profession is saying is that economic propositions need to be tested and verified over as complete a sample as possible. Admittedly, some of these earlier periods, you didn't have a central bank; you didn't have an income tax; you had various political regimes; sometimes you were on the gold standard, sometimes you were off. The point is, most people feel that these institutional differences shouldn't obscure the verifiable observation of basic economic relationships. So you want to test this over as much time as you possibly can and I think that's a reasonable proposition. Anyway, that's my approach, and that's increasingly the approach in the profession.

"Fisher ... is saying something entirely different. He's saying that the insufficiency of aggregate demand is a symptom of excessive indebtedness and what you have to do to contain a major debt event – such as the aftermath of 1873, the aftermath of 1929, the aftermath of 2008 – is you have to prevent it ahead of time. You have to prevent the buildup of debt."

I was just noting that what we actually know about the economy in days gone by is lot squishier than terms like "data sets" or lines on charts seem to imply. But clearly, observations over short times can be misleading.
Absolutely. Take the subject of debt. If you confine your analysis to post-war period, you only have one major debt-dominated cycle and that's the one we're currently in – and have been in for a number of years. But if you go back far enough, you have three more. You have the 1820s and 1830s. You have 1860s and 1870s and then you have 1920s and their aftermath. Sometimes it's essential to take your analysis back as far as you possibly can.

Sure. Doesn't your second chart, on the velocity of money [page 4], show how none other than Milton Friedman was misled into thinking that it was a constant because he only looked at post-war data?
That's correct and, in fact, I was misled along with him because I was also doing analysis based on the post-war data. Friedman's period of estimation was basically from the 1950s to the 1980s. Well, if you look at the velocity of money in that time period, it's not a constant, but it's very stable around 1.675. So if you tracked money supply growth then, you were going to be able to get to GDP growth very well. Not on an individual quarterly basis, but even the individual quarterly variations were not that great. Until velocity broke out of that range after we deregulated the banking system. Now, velocity is breaking below the long-term average and it's behaving exactly like **Irving Fisher** said, not like Friedman said, absolutely.

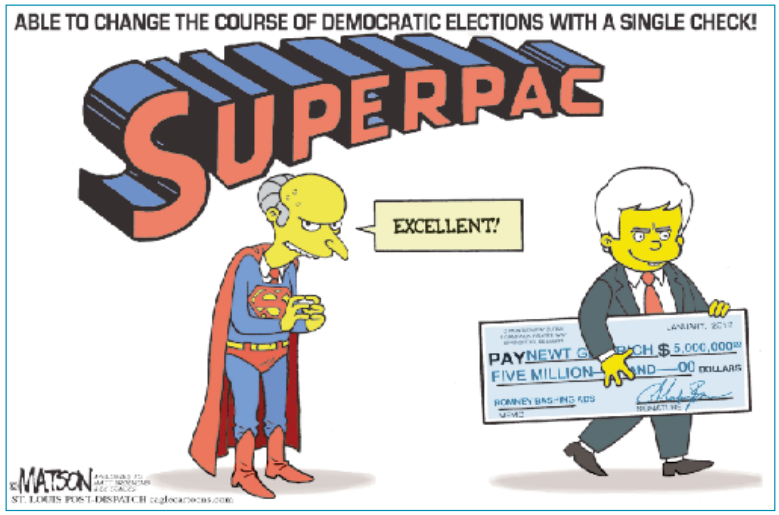
What a perfect example of the difference your frame of reference can make.
Yes, Friedman even said Fisher was the greatest American economist, and I think that is correct. Fisher had a broader understanding of the economy in a very, very critical way and in a way that I don't think either Friedman or **John Maynard Keynes** understood it, and even a lot of

contemporary economists, such as **Ben Bernanke**. Keynes and Friedman both felt that The Great Depression was due to an insufficiency of aggregate demand and so the way you contained a Great Depression was by your response to the insufficiency of aggregate demand. For Keynes, that was by having the federal government borrow more money *and spend it* when the private sector wouldn't. And for Friedman, that was for the Federal Reserve to do more to stimulate the money supply so that the private sector would lend more money. Fisher, on the other hand, is saying something entirely different. He's saying that the insufficiency of aggregate demand is a symptom of excessive indebtedness and what you have to do to contain a major debt depression event – such as the aftermath of 1873, the aftermath of 1929, the aftermath of 2008 – is you have to *prevent* it ahead of time. You have to prevent the buildup of debt.

And that your goose is cooked if you don't you cut off the credit bubble before it overwhelms the economy?
Yes, and Bernanke is thinking that the solution is in the response to the insufficiency of aggregate demand. That was Friedman's thought. That was Keynes' thought and most of the economics profession has traditionally thought the same way. They were looking at it through the wrong lens. Fisher advocated 100% money because he wanted the lending and depository functions of the banks separated so we couldn't have another event like the 1920s.

You're saying that Fisher argued *against* fractional reserve banking?
Yes, and so did the people that more or less followed in Fisher's footsteps, principally **Charles Kindleberger** and **Hyman Minsky**. Minsky felt that the way you prevented a major debt deflation cycle was to keep the banks small.

Prevent them from ever becoming too big to fail in the first place?
Right. Don't let them merge. You don't want them to get big. I actually gave a paper with Minsky once, in 1981, in which he advocated that position. Kindleberger was very precise in *"Manias, Panics, and Crashes,"* when he said that when you have a small credit problem, or many small problems, some say, you don't want the Federal Reserve to respond. Because if the central bank comes in and bails out a small problem, then that will be a sign to those who



want to take more risk that they don't need to be cautious – they can always count on the central bank to come in and bail them out. If they do, Kindleberger said – and this was in '78 – then the future crisis will be even greater. "A free lunch for speculators today means that they're likely to be less prudent in the future. Hence, the next several financial crises could be more severe."

Too bad nobody paid attention.
So we came along and we bailed out Long-Term Capital Management in the late 1990s.

Not to mention the banks that got in trouble in Latin America in the early '80s, the entire S&L sector in the early '90s –
Absolutely. You could even include the bailout of Chrysler in 1980, because that was a signal to the automobile companies and to their unions: "Do what you want. If you get in trouble, the U.S. taxpayer's behind you." But the Chrysler bailout and the LTCM bailout were very small. I mean, LTCM was a $3 billion problem. That's a quaint number today. Yet the Fed came in with all its big guns blazing. They used monetary policy to ease the pain. A debt buildup was already underway, but the Fed greatly facilitated it and encouraged it. So, it seems Fisher and Kindleberger and Minsky were right. The only prudent way you can deal with these huge debt problems is to prevent them from building up in the first place. The response after the fact matters some, but it's not the route you should go.

That's great, in theory. Except that it *is* the route we went. Once again, we didn't prevent the excessive buildup of debt, so

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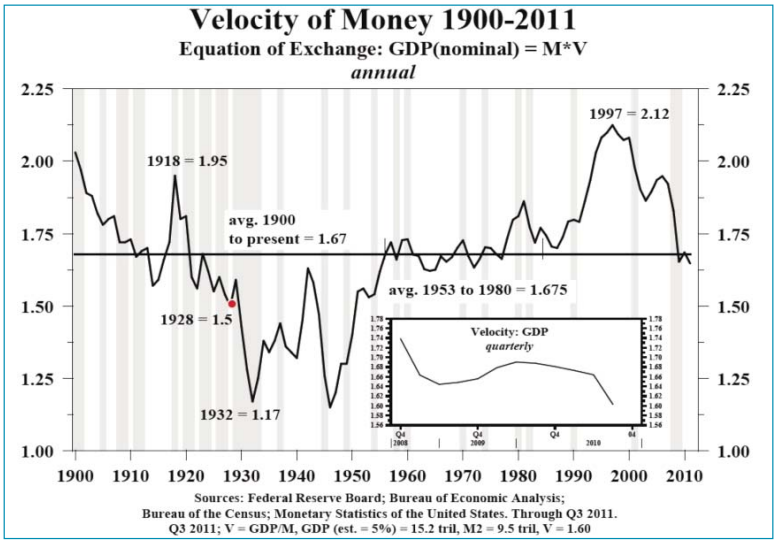


now we have to deal with pressing deflationary forces.
That's why Fisher wanted to segregate the lending and deposit-taking functions of the banks.

Does that sound a mite like Paul Volcker, daring to suggest banning the banks' speculative proprietary trading activities – and getting nothing but grief from the industry for his efforts?
Well, that's right. Fisher couldn't get it done, either. And warned that we would do it again. I had a brief acquaintance with Kindleberger; I didn't know him well, but I knew him and he was helpful to me. He taught **Ken Rogoff**. And, in fact, *"This Time, It's Different"* is really a quantification and verification of a lot of the qualitative themes that Kindleberger expressed. My sense was that Kindleberger thought that once the economy got into overtrading, there was no one who was going to stand in its way.

Policy Responses: Letting It Burn Out & Others

The moral hazard problem is that policy measures undertaken to provide stability to the system may encourage speculation by those who seek exceptionally high returns and who have become somewhat convinced that there is a strong likelihood that government measures will be adopted to prevent the economy from imploding – and so their losses on the downside will be limited. A 'free lunch' for the speculators today means that they are likely to be less prudent in the future. Hence the next several financial crises could be more severe. The moral hazard problem is a strong argument for nonintervention as a financial crisis develops, to reduce the likelihood and severity of crises in the future. Will the policymakers be able to devise approaches that penalize individual speculators while minimizing the adverse impacts of their imprudent behavior on the other 99% of the country?

Charles P. Kindleberger (1978). ***Manias, Panics, And Crashes: A History of Financial Crises***, pages 204-205.

Over-trading?
That was the old-timey term that Kindleberger used. He said there are three phrases of behavior as you move toward manias, panics, and crashes. The first phase is over-trading, where you start buying assets at prices far beyond their fundamentals. People enjoy this phase, because initially it boosts income and raises wealth and so forth. So it becomes very irrational. Then you get to what he called the discredit phase, where the smart people start pulling their funds out. Then you get what he called revulsion. The classical economists used those terms: Over-trading, discredit, revulsion. As I said, I got the impression from Kindleberger that once you get into that overtrading phase, there's no one who is going to stand in the way of it.

Why stand in front of a freight train?
Especially when it doesn't seem to be in anyone's interest to stand there. Regulators, banks, companies, investors, everybody's having a good time; profits are being made, employment is strong.

So we've just seen.
No one dealt with the credit excesses in the subprime market, until the crisis hit. And no one dealt with the excessive speculation in the financing of the railroads in the middle of the 19th Century, or in the financing of the canals and turnpikes and steamship lines in the 1820s and 1830s. Nor did anyone step in to try to stop the foolishness that was going on in the 1920s.

Kindleberger took it all the way back to the tulip mania, and I'd venture that wasn't the first time in human history when an auction market got out of hand.
That is correct. Absolutely. You push things beyond their fundamental value. But this isn't the conventional economic view of debt and it's important. I sent you some quotes contrasting conventional wisdom with this newer understanding.

I noticed you picked something Bernanke wrote to illustrate conventional wisdom –
I chose that Bernanke quote [box page 9] because Bernanke addressed the Fisher - Kindleberger theme in the early part of this century – and that's when we really needed Bernanke to say something and to do something. But as you can see, Bernanke rejected Fisher and Kindleberger in his book, *"Essays*

on The Great Depression." And notice that he doesn't reject Fisher because he says Fisher's data is flawed. He doesn't reject Fisher because Fisher's argument is flawed or Kindleberger, either. He rejects them because an excessive buildup of debt implies *irrational* behavior.

Well, hello!
That's the world I live in. You, too, probably.

To mention that what can seem rational on an individual level can be irrational when an entire economy does it.
We see it all the time, every day of every week. And yet Greenspan's rejection of the danger of an excessive buildup of debt in his book put him in a different mindset, not just in evaluating the events of the 1930s, but when it came to understanding what was going on in the early part of this century, up to 2006 and '07. Because he thought he could respond to a debt problem and contain it. But that was not at all what Fisher taught. Fisher said you have to prevent a debt deflation ahead of time. That's a very powerful, critical, difference. What Fisher is saying is that once you get into this extremely over-indebted situation, and the prices of assets begin to fall, these two "big bad actors," those are the terms he used, control all or nearly all other economic variables. Then, if you attempt to respond to the problem by leveraging further, it's counterproductive. That's the term Fisher used in one of his letters to FDR expressing concerns about deficit spending.
One of the newer quotes I sent [page 9] is from **Stephen Cecchetti**, a former director of research for the New York Fed. A Cal Berkeley Ph.D., a very serious economist. It's from a paper he gave at Jackson Hole shortly after Bernanke spoke about holding a special two-day meeting of the Fed. Here's what Checcetti said, "Debt is a two-edged sword. Used wisely and in moderation, it clearly improves welfare." In other words, when banks engage in their traditional business and consumer lending, it improves. There's no question about that. But when they lend imprudently in excess, the result can be a disaster for individuals, households, firms. And "Over-borrowing leads to bankruptcy and financial ruin for a country. Too much debt impairs the government's ability to deliver essential services to its citizens."

I noticed that Cecchetti even specified how much debt becomes cancerous.
That's right. I like his use of that medical term.

Twenty Year Periods with a Negative Risk Premium

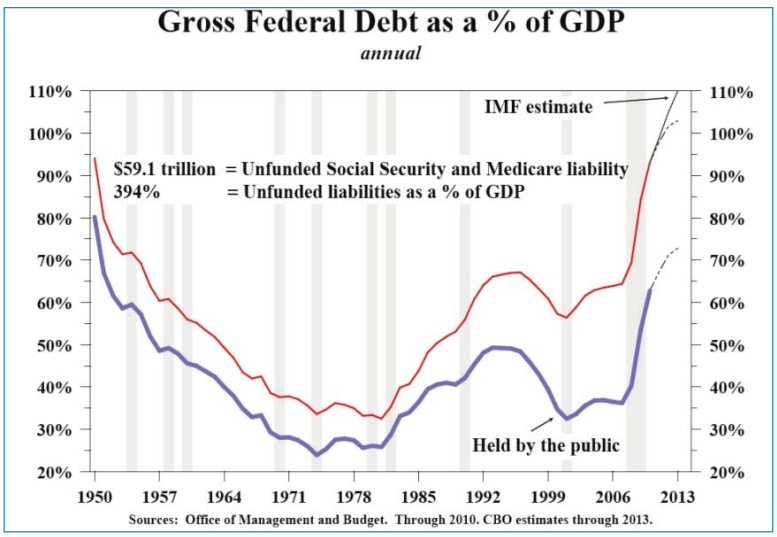
		Stocks	*Bonds*	*Stocks less Bonds*
		1.	*2.*	*3.*
1.	1874-1894	4.4%	5.4%	-0.9%
2.	1928-1948	3.1%	3.9%	-0.8%
3.	Q3 1991- Q3 2011	7.6%	10.0%	-2.4%

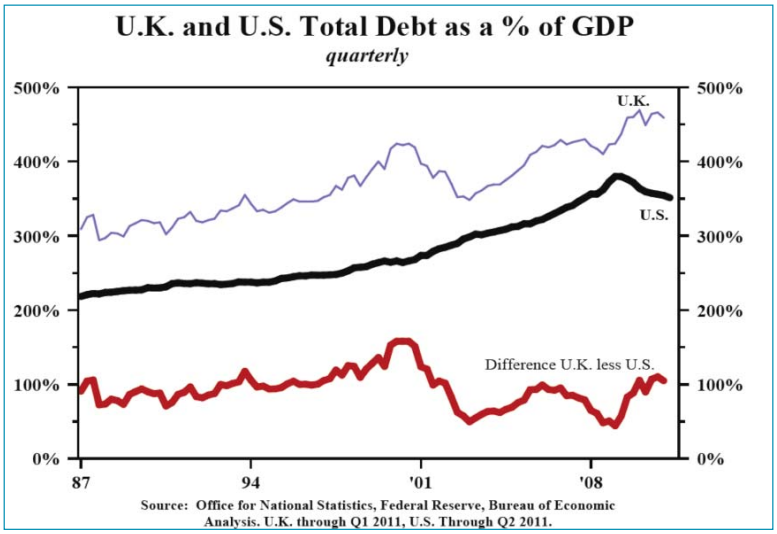
...The inflation rate, the dividend yield relative to the yield on Treasury bonds, and the P/E ratio suggest that we are coming into a time when stock returns will be considerably diminished relative to the return on bonds...Over very long periods of time stocks must outperform bonds, because investors 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

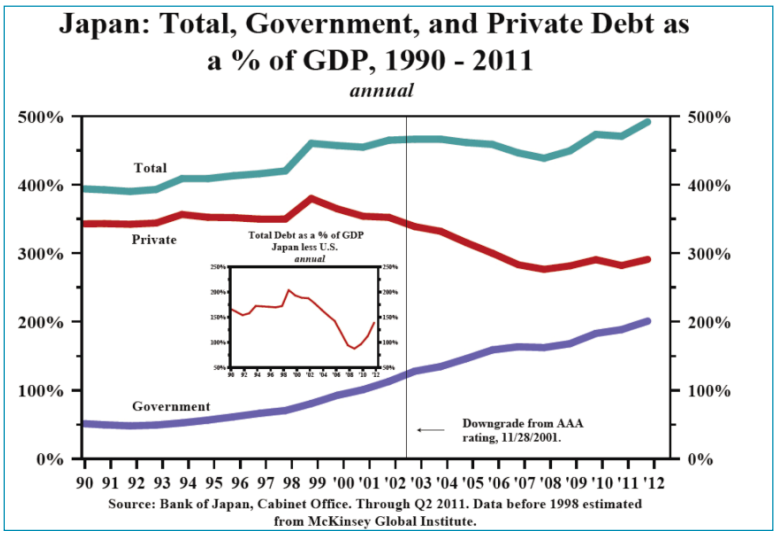
Source: Standard and Poor's, A Half Century of Returns on Stocks and Bonds by Fisher and Lorie, History of Interest Rates; Homer & Sylla, N.S. Balke & R.J. Gordon, C.D. Romer, Robert Shiller - Yale University, Peter L. Bernstein Inc., HIMCO.

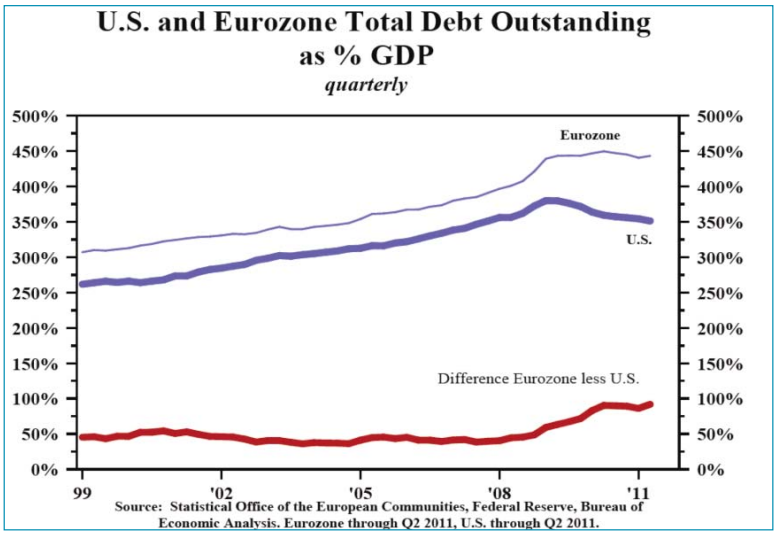
And the level of government debt he specifies is consistent with what **Carmen Reinhart** and Rogoff wrote in their paper for the NBER called *"Growth in a Time of Debt."* They found that after you get above 90% of debt to GDP that you lose 1% off the median growth rate, and even more off the average growth rate. So it's clear that debt plays a major role in the economy. Most of the time, it is a benign factor, but you get these irregular intervals in which debt builds up excessively. And, once it has built up excessively, it's a controlling influence for a *long* time. Plus, you cannot *solve* that over-indebtedness problem by getting deeper in debt. That's the problem.

True, but you *can* postpone it a while –
The point is that it doesn't really matter whether you're using the Federal Reserve's









monetary tools to get the private sector to leverage up or whether you're engaged in deficit spending at the federal level to try to address the insufficiency of demand. Both tacks take you in the wrong direction. Now, what we're beginning to understand – at least with regard to governments, because we have known this is true for the private sector for a long time – is that there comes a point in time at which additional debt is no longer available. That's where a lot of countries in Europe are. And that is probably where we're going in a number of years. We're not there now, but that's where we're headed. We spent $3.6 trillion last year at the federal level. We borrowed around 35% of that and we had tax revenues to cover around 65%. Some of the European governments are trying to borrow more than that ratio, and it's being denied to them. Reinhart and Rogoff call that the "bang point." When that happens, your spending levels then have to fall back to your tax revenues. That's where we're headed unless we correct the problem. It's obviously going to get greater, because we have built-in guaranteed increases in our obligations under Social Security and Medicare. That's why I also sent you a passage [box, page 11] from *"Exorbitant Privilege,"* by **Barry Eichengreen**. He's a Yale Ph.D., taught at Harvard many years, Cal Berkeley. In the last three years, federal outlays have averaged 25% of GDP, which is the highest three-year period since 1943 - '45, when we were in a multi-continent war. What Dr. Eichengreen is saying is that federal outlays are going to go to 40% of GDP within 25 years, without major structural reforms.

Just based on the programs in place and demographics?

Yes. To him, that means that the current laws cannot remain unchanged and I agree with him. I don't think you can transfer an additional 15 percentage points of GDP to the government. There's no practical way that we can do it. But the political process doesn't seem to want to respond in advance, so it's very difficult to see how this is going to work out in any salutary way.

Let's put some numbers on this. The first chart you sent me [page 1] shows total public and private debt in the U.S. approaching 400% of GDP.

Yes, that's the conventional approach, using publicly held federal debt as the measure of govern-

ment debt. But that, in my opinion, is really not appropriate. The more appropriate measure is really gross federal debt. [chart page 5].

And the difference is that the gross figure includes debt held in intra-government accounts?

That's correct. But what Dr. Eichengreen is saying, and I agree, is that even that gross debt number is not really sufficient because we've *also* got $59 trillion, at present cost, of unfunded liabilities in Social Security and Medicare. We have about $52 trillion of current debt, public and private, the way I measure it. We have about $15 trillion in annual GDP. So if you substitute the gross government debt for the privately held debt and if you use the IMF's projections for the increase in gross government debt going forward and you assume private debt-to-GDP stays flat, well, we're going to new peak debt levels in the next several years.

And we're not the only nation in this fix.

The situation in Europe is worse. I put together some charts that are interesting; took a lot of effort, anyway. If you look at U.K. debt, public and private [chart, page 6] it's 100 percentage points higher than in the U.S. The Japanese debt [chart, page 6] is approaching 150 percentage points higher. The Eurozone, just the countries in the Euro currency zone, have got about $62 trillion in current debt equivalence (chart, page 6). They only have $14 trillion of GDP equivalent. So they've got about $10 trillion dollars more of debt than we do and $1 trillion less of GDP. I have another little piece of information on that score that's interesting: Their unfunded liabilities also appear to be greater than ours. A study published in 2009, but really based on data from 2006, called "Pension Obligations of Government Employer Pension Schemes and Social Security Pension Schemes Established in EU countries," by Freiburg University, which was commissioned by the **European Central Bank**, showed that the unfunded pension liabilities of the EU member countries studied amounted to about five times their GDP. And the report only covered unfunded liabilities in 19 of the 27 EU member countries – 11 members of the Euro currency zone and 8 non-currency zone countries. Now, Europe had a big recession, too, in 2008, which opened the gap further. So their unfunded liabilities are about five times their GDP, whereas in the U.S., they are about four times. The debt problems in Europe are at an advanced stage relative to where they are here. Also, their demographics are much worse than ours. So we've got this situation, if you accept what Fisher said about debt controlling all other economic variables in a debt deflation, then the levels of indebtedness in the U.S. and Europe are also playing a heavy hand in the foreign exchange markets.

How so?

While there's nothing salutary about the U.S. situation, we're not in as an extreme position as are some of the other major areas of the world, Europe, Japan, the U.K.

You're implying that the dollar is like the best house in a lousy neighborhood?

Yes, if you think of foreign currency movements being determined like a beauty contest, if you've got 10 ugly contestants, the least ugly wins. This tends to support the value of the dollar for no meritorious reason; it's simply comparative valuation.

True, and not terribly good news for U.S. companies trying to compete on a global basis.

No, especially not because this recovery – such as it is – since the middle part of '09, has been heavily influenced by exports.

The percentage of GDP growth attributable of late to exports is really eye-popping.

It is. While exports have been growing at 10% per annum, consumer spending has been growing at only 2% per annum.

China's Potential Debt Woes

China's model has produced super growth, lustrous office towers, massive and grand new airports and other visible signs of wealth and success. But, beneath this glamorous veneer, the growth model is flawed and fragile. Substantial and unknowable risks are accumulating in the Chinese banking system. "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.

Utilizing micro- and macroeconomics as well as psychology, biology (contagion), and politics a model is developed to identify booms that bust. This framework applies to recent as well as distant boom/busts. "Although China appears to be in the midst of an unsustainable boom, the timing of a bust is extraordinarily difficult to predict."

Boombustology by **Vikram Mansharamani** (John Wiley and Sons, 2011), page 237.

Sources: Bureau of Economic Analysis. Through November 2011.

That's positively un-American!
Export growth has been just under 50% of the cumulative gain in GDP. It really has been the driving force. But now, income is trending down overseas. And, in international trade flows, income is four or five times more powerful than price effects. So the spreading recessions in Europe and Japan and elsewhere are going to knock down the demand for our exports – and the fact that the dollar is rising serves to worsen that trend.

The Delevering Process: Four Archetypes

1. "Belt Tightening". The most common delevering path. Episodes where the rate of debt growth is slower than nominal GDP growth, or the nominal stock of debt declines. Examples are Finland '91-'98, Malaysia '98-'08, U.S.'33-'37, S. Korea '98-'00.
2. "High Inflation". Absence of strong central banks, often in emerging markets. Periods of high inflation mechanically increase nominal GDP growth, thus reducing debt/GDP ratios. Examples are Spain '76-'80, Italy '75- '87, Chile '84- '91.
3. "Massive Default". Often after a currency crisis. Stock of debt decreases due to massive private and public sector defaults. Examples are U.S. '29-'33, Argentina '02- '08, Mexico '82- '92.
4. "Growing out of debt". Often after an oil or war boom. Economies experience rapid (and off-trend) real GDP growth and debt/GDP decreases. Examples are U.S. '38- '43, Nigeria '01- '05, Egypt '75- '79.

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

Wonderful. I can't help but note, though, that it's pretty ironic that we're talking about Irving Fisher's reputation as an economist being rehabilitated now, when he destroyed it himself by being so wrong about Crash in 1929.
True, but that in itself is instructive. He did make some outrageous statements that were totally incorrect and it greatly damaged his stature. No one was really willing to listen to him, although his work was there and so were a series of letters that he wrote to FDR. But he was our best and he was just so wrong that people could never look at him the same way after the Crash. It probably was frustrating for him. But, Fisher actually was a very modern guy, in some ways. **Richard Thaler**, the co-founder of behavioral finance, wrote an interesting paper a decade or so ago called *"Irving Fisher: Modern Behavioral Economist."*

I'll have to dig it out. [link]
It's an interesting paper. In economics, there are two conditions: Equilibrium and transition. The economics profession mainly teaches equilibrium economics; the general presumption is that we're at equilibrium most of the time. Transition, we know it occurs, but transition is considered the short, uninteresting phase. Equilibrium is the long, interesting phase. That's the way it's taught. But in actuality, what we're learning is what Fisher understood long ago: The transition is long and equilibrium is short. We move toward equilibrium, but usually we achieve equilibrium only on the way to another transitional phase of disequilibrium. The economics profession has used the analogy of an airplane. When it's on the tarmac, it's in equilibrium. Then, as it takes off and climbs to an altitude of 40,000 feet, it's in transition, relatively uninteresting. Then you're at equilibrium again at 40,000 feet, until you return to the tarmac. So conventionally, you're at equilibrium most of the time, either at 40,000 feet or on the tarmac. But for Fisher, the equilibrium phases were short and the transition phases were long. I think that's where the profession is headed, certainly the way I'm thinking about it.

In other words, economic equilibrium is not a very stable state?
No, we hit equilibrium on the way to another disequilibrium. If you're looking, for example, at my velocity of money chart [page 4], you can see that one period, from the early '50s to the early '80s when it hovered around 1.67. But in most of the other instances shown, we're either moving above it or we're moving below it. We cross it, but we don't spend much time there. I think the reason we had that post-war period of stable velocity is that there was not a really substantial buildup of debt and we had a heavily regulated banking system. Once we deregulated the banking system and allowed the massive buildup of debt, the velocity of money started taking off. But then it turned down in '97, just

as it had turned down in the early 1920s.

Why? We certainly kept borrowing –
It wasn't that we weren't taking on more debt. We were, but the debt that we were taking on was becoming more and more counterproductive. We were getting less bang for the buck. The downturn in the velocity of money after 1997 was actually a signal that we were in a potentially troublesome period. One of the things that Fisher specifically cited was that when you get into this highly over-indebted situation, one of the variables that is controlled by that debt overhang is the velocity of money. The Fed has been able to increase money supply growth but their efforts at simulating GDP – except during some brief intermittent episodes – have been thwarted because the velocity of money is trending down. It's now falling below the 111-year average.

And when you look at velocity on your chart going back to 1900, it sure looks like the time it spent in equilibrium was the outlier, not the norm.
It does, and Fisher understood that.

What little reading I've done about Fisher says he was unusually talented and energetic, despite some weaknesses typical in the period, like being a fan of eugenics.
Very true. **Paul Samuelson**, who disagreed with a lot of what Fisher had to say, said that Fisher's doctoral dissertation was the greatest one ever written – and it was on transition and equilibrium. Fisher gave us the formulas for all the price indices we're currently using. People forget that. **James Tobin** said he was our leading expert in index numbers. He invented the distributed lag. Joseph **Schumpeter** said that Fisher had the keenest intellectual mind of anyone he ever met. Schumpeter was no slouch, in his own right. Fisher even invented the Rolodex. But he didn't see The Great Depression coming. By the way, neither did Keynes.

True enough, and he lost a bundle. So what did Fisher miss?
Why Fisher missed the Depression call is instructive. It was because at that point he assumed that the U.S. economy was dominated by cyclical forces. As we went through this business cycle, we'd have a brief period of bad times followed by an extended period of good times. Yes, the period of bad times could be a little unsettling, but it didn't last too long and then we would have another extended period of good times. But what Fisher later wrote was that once an economy becomes extremely over-indebted, this normal business cycle model that everybody believes to be what controls the situation really becomes inoperative in the traditional sense. The business cycle attempts to work, but it can't, against the strong secular forces of excessive indebtedness. Like Keynes, Fisher was a big investor and, of course, he was wiped out by the events of the late 1920s, early 1930s. But he later made that statement that the extreme over-indebtedness controls all or nearly all other economic variables. It appears to control the risk premium, too, as that table [page 5] I sent you shows. We've now had three 20-year periods: 1874 to 1894, 1928 to 1948, and the last 20 years, in which the risk premium stayed negative. I didn't have the final official numbers to include last year's Q4, but it doesn't change the picture, I'm pretty sure.

So you're saying investors get risk-averse in severe downturns?
My point is that we know that, over the long run, you have to have a posi-

Debt and Economic Activity

Conventional 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.*

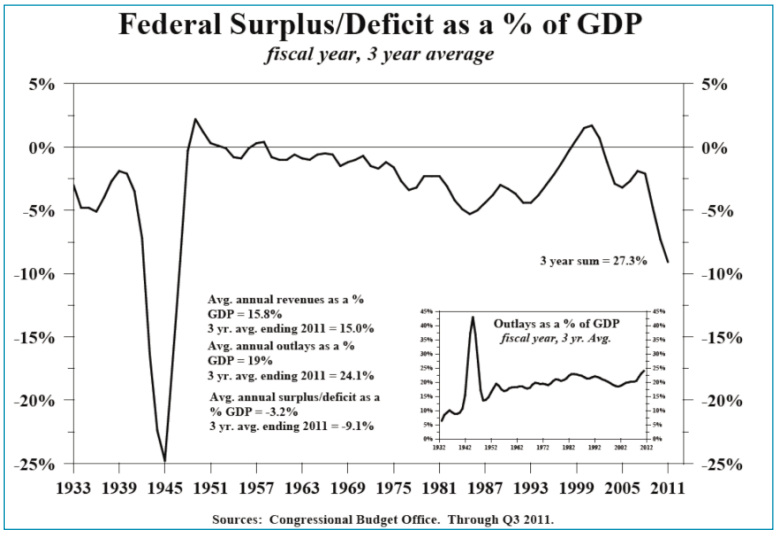
Vs. New View

The U.S. economic recovery has been weak. A microeconomic analysis of U.S. counties shows that this weakness is closely related to elevated levels of household debt accumulated during the housing boom. 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.*

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.*



tive risk premium, stocks have to outperform bonds, because investors must be rewarded for holding riskier assets. But after the extreme buildup of debt in the 1860s and the early 1870s, risk-taking was not rewarded. After the extreme buildup of debt in the 1920s, for 20 years risk-taking was not rewarded. And for the last 20 years, it hasn't been rewarded either. So my table may be instructive. We don't *know*, because we don't have a lot of experience, but if Fisher is correct, and if we try to solve our current problems by getting deeper in debt, then what Fisher is saying is the additional indebtedness doesn't make us stronger, doesn't increase our options. It makes us weaker, reduces our options. So risk-taking may not be rewarded going forward. This is where we're hamstrung by our lack of sufficient data to evaluate. But what data we have suggests that if we proceed along the path of over-indebtedness, risk-taking will not be rewarded because the economy is going to perform very poorly.

Is there perhaps a glimmer of hope in the fact that the earlier instances you cite lasted roughly 20 years, and this one is already 20 years old?

Well, they all came after major buildups of debt. The panic years were 1873, 1929 and 2008, but if you go back and look at my first chart [page 1], in the first instance, we had this massive buildup of debt that was complete by 1873. The panic year was 1875. The debt-to-GDP ratio peaked in 1875 because the denominator, GDP, collapsed. Then in the second instance, the debt buildup was complete by '29. The debt-to-GDP ratio peaked after the fact in 1933, because GDP declined. And the same was true in 2009. The debt-to-GDP ratio peaks a year or so after the panic, because you've got the denominator in this ratio. But what's interesting is that after the 1875 peak, you don't go above it until 1916. You don't go above the 1933 peak until 2003. So once you get these periods of extreme over-indebtedness, it takes a *very* long time to resolve them.

And it's usually not a lot of fun.

No. That's why I sent you those quotes from a great study by the **McKinsey Global Institute** Study [page 8], listing what they call the Four Archetypes of the Delevering Process. What it boils down to is that austerity is required in about 75% of the cases. Either you do it yourself or it's imposed upon you. They do address the possibility of "growing out of debt" and they cite the case of the U.S. in World War II and a couple of other instances. But to my way of thinking, the U.S. during WWII was also an austerity case. If you look at my chart of the personal savings rate back to 1929 [page 8], you can start to see that what really brought us out of the Great Depression were our exports. Our allies' countries were being disrupted by actual fighting and they had manpower shortages. So we were selling them everything that we could produce – but meanwhile, our people could not spend the income we were receiving.

Right, there was rationing and tremendous austerity on the home front. So the only thing that people could do with the money they were making was buy war bonds.

That's correct. And that's what they did – look at the personal saving rate. We're not getting that same response here. The saving rate went up for a while, but it's now back to 3.5%. We're essentially back where we were when the recession started.

It's more than a little perverse to pull for another world war to pull us out of this mess. Wasn't the debt deflation in the 19th Century simply cured by the passage of time?

In the earlier case, the excessive indebtedness just burned itself out. That was the title of Kindleberger's chapter on policy responses: "Letting It Burn Out and Other Devices." I sent you an excerpt from that, too. [page 4] You might do better to just let it burn out. Everybody rejects that as being too harsh; "How could you possible advocate that?" But it might be better.

Sure, like a forest fire. But that argument isn't very strong in today's highly interconnected economy. We're not facing any isolated conflagration.
Well, you hear that argument, but I'm not sure that I buy it. I think the world was very interconnected in the 1920s and I really see a lot of parallels. We don't have good data outside the United States, but we do know that a lot of the commodities-producing countries took on a lot of debt to finance commodities production back then.

So vendor financing wasn't invented during the internet bubble.
Not at all. And the problems in the late '20s started, I believe, in the commodities producing countries. The first country to devalue in the late '20s was the Dutch East Indies, a huge commodities producer. Then it was Australia. Both had expanded very substantially with debt. Then there were a number of other devaluations and, finally, in '31, the British devalued. In the meantime, we stayed on the gold standard and so everybody that was devaluing against the U.S. dollar. Their incomes were declining, which undermined our exports and then the price considerations went against us so we started losing our exports. Then, between April of '33 and January of '34, we had about a 60% devaluation. That helped us, compensatorily, to regain some of the markets that we had lost, and everybody stood still for that, because we were still sort of operating under the rules of the gold standard game. But then, in '37 and '38, the gold bloc countries finally devalued; we lost some of the gains we had made and the economy fell back. So there *was* a great deal of international interconnectedness in that period. But what this also shows is that the markets deal with the serious problems first and then they move on to the next most serious and so on. So this whole process could be much longer and more persistent than many people believe. Particularly because, if we continue to try to solve the over-indebtedness problem by taking on more debt, that ultimately creates more problems than it solves.

That's sure what's going on in Europe.
The Europeans have two problems. No. 1, they've been financing themselves short. They have an enormous rollover problem and a lot of the folks who have lent to them don't want to extend those loans. In addition, the folks that don't want to extend their loans are being asked to make even bigger loans and so, the borrowers are not really responsive. Do you know **John H. Cochrane**?

Haven't had the pleasure –
John Cochrane is at the University of Chicago, a very serious economist.

He has the AQR Capital Chair, if I'm not mistaken –
Yes. He was president of the American Finance Association, a very serious academician. What he has pointed out is that the real value of government debt must equal the discounted value of the stream of future surpluses. If you think about that, *any* asset has to be equal to the discounted value of its future revenue stream. So, what you've got in the present value formula is the discounted stream of future flows and then your discount rate. Well, Cochrane's argument is that at the point in time that the markets lose confidence that there is a future stream of revenues to pay off the debt, to service the debt, then the discount rate will move up sharply. It doesn't matter what monetary or fiscal policies are, the discount rate explodes. That's what's really happening in Europe. The investor cannot see a viable revenue stream to service the existing debt levels. I don't think that we're at that point here yet, but we could be. I hope we have some time. Perhaps, because Europe is in a graver situation, indebtedness-wise than we are, it's buying us some time. But we don't seem to be willing or able to, we don't seem to have the political will to deal with our problem.

Certainly not if you listen to what we've

Federal Outlays Heading 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.

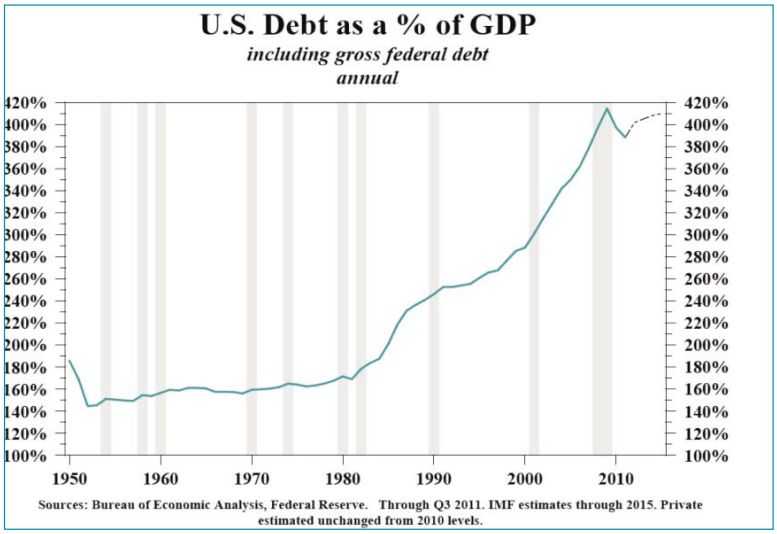
"The United States will suffer the kind of crisis that Europe experienced in 2010, but magnified. These events will not happen tomorrow. But Europe's experience reminds us that we probably have less time than commonly supposed to take the steps needed to avert them. Doing so will require a combination of tax increases and expenditure cuts." He goes on to point out that, "At 19% 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% of GDP in the 1970s to 10% today, there is essentially no non-defense discretionary spending left to cut. One can imagine finding small savings within that 10%, but not cutting it by half or more in order to close the fiscal gap."

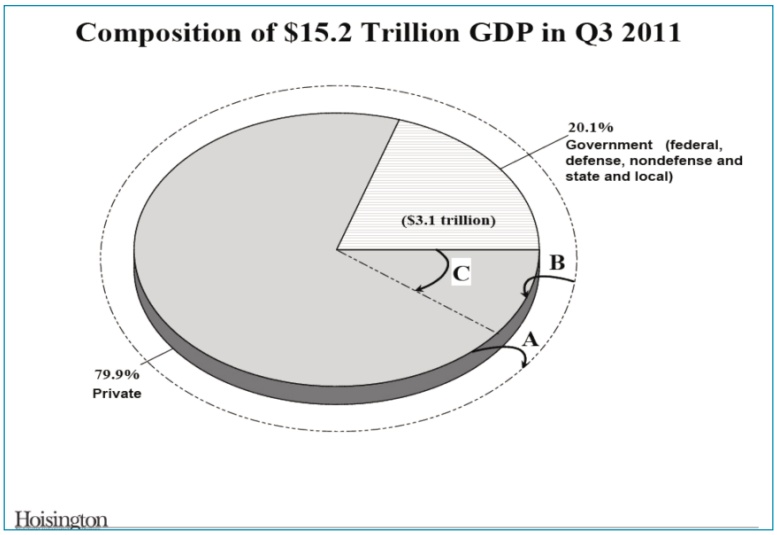
***Barry Eichengreen, Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System**, Oxford University Press, 2011*

heard so far in terms of campaign rhetoric.

Part of the problem is that these are serious matters and to solve them, it's going to require a lot of sacrifice by a lot of people. That's why I really like that Eichengreen quote. The thing is, no one wants to have austerity. We all enjoy the good life. We don't want to have to raise taxes; that's unpleasant. We're going to have to change the benefits tables for Social Security and Medicare. We're going to have to cut discretionary spending – even though it has already been cut substantially. Right now, the four main components of the federal budget are Social Security, Medicare, Defense and interest payments on the debt. By the end of this decade, if market rates are unchanged –

Quite an assumption.





Yes, but at these rates, by the end of the decade, the three top components of the budget will be Social Security, Medicare, and interest; that's according to the Congressional Budget Office projections. If you hold market interest stable through 2030, by then interest payments will absorb 35% of the budget. If the market interest rates go up by two percentage points, that adds about $300 billion a year to our deficit. By the way, that's why you hear it said often that one of the solutions is to inflate our way out.

That's supposedly the easy alternative, at least politically.

But I don't think you can do that because your debt is 350% of GDP. If you get an inflationary process going, interest rates will rise proportionately with inflation. So, if inflation goes up 1%, in time, interest rates will go up 1%. But your debt is 350% of GDP. If the inflation rate goes up, you will *not* get an equivalent rise in GDP, because what we've learned is that in inflationary circumstances, a lot of folks can't keep up. In fact, most of your modest and moderate income households will not keep up.

Not good, considering that "the 99%" are already restive with reason.

That's correct. We saw this in a microcosm in 2011. The Fed engaged in quantitative easing; they got the inflation rate up temporarily, but the main effect was to reduce real income. So, if you try the inflationary route, you're not going to be able to inflate your way out of debt trouble. This other variable, your interest expense, is going to rise proportionately with inflation, and your GDP won't keep up. Many will lag behind and that will worsen the income or wealth divide. So inflation is really not a potential savior in the current situation. Which then forces you back to the conclusion that the only viable way out is austerity, although no one wants it.

Suppose one of Europe's Hail Mary passes actually miraculously works, and the Chinese decide to lend them a ton of dough?

I'm not an expert on China. But I did spend some time there earlier in my career, and I don't think the situation is that stable. I sent you a quote from the book, *"Red Capitalism"* by **Carl Walter** and **Fraser Howie** [page 7]. Carl Walter is a pretty serious observer, Stanford Ph.D., has lived in Beijing for about 20 years, speaks Mandarin. His basic point is that the government has forced the banks, which they

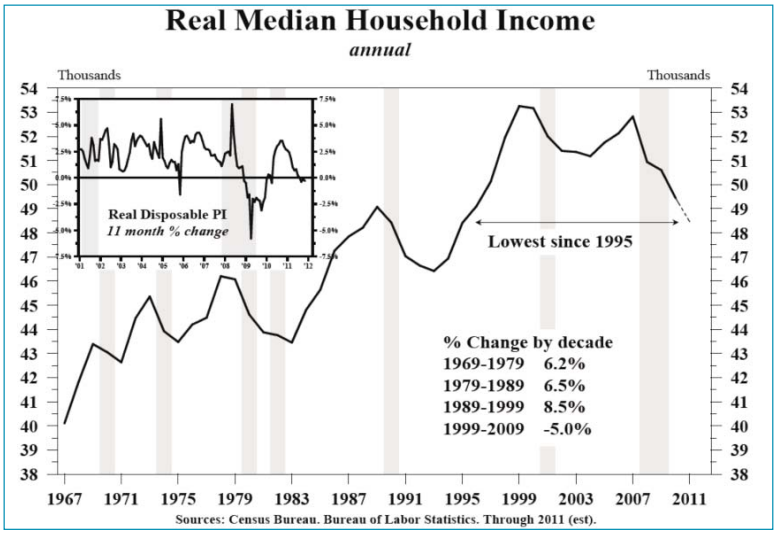
control, to make loans to the provincial governments for all of these expansion projects. There's now a great deal of excess capacity and the projects are not generating sufficient cash flow to service the high levels of debt that the banks have extended. We're reaching the point at which the banks will have to be recapitalized. We had an episode of that in the late '90s when the Chinese banks needed to be recapitalized and the government had to shift expenditures into bank recapitalization. That caused the Asian economic crisis. Now there's some evidence to suggest that China will have to recapitalize the banks again and when it does that, it will produce economic weakness in China that will reverberate around the world. So the Chinese may be more of a problem than a solution.

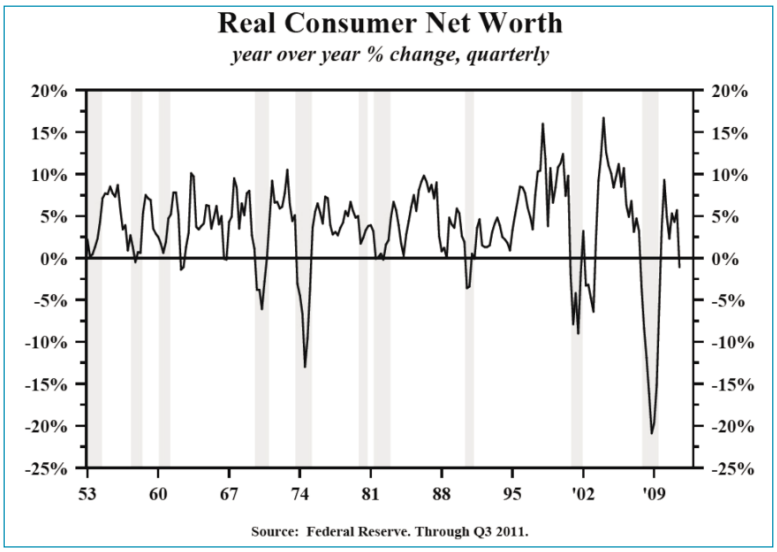
I suppose all this means you expect a recession this year?

Well, consumer spending will slow this year very dramatically from a very weak base. We had a decline in real disposable income in 2011. GDP rose, but GDP measures spending, not prosperity. In 2011, as is often the case, when inflation rises, households initially try to maintain their standard of living. So in the face of rising inflation and trailing wages, which was the story in 2011, families resorted to increased credit card usage or to drawing down their saving. But in addition to a decline in real disposable income in 2011, we also saw a net decline in net worth [lower chart, page 13]. And a year-over-year decline in net worth has been associated with the start of all the recessions since 1969.

It's certainly not a good thing, in terms of consumers' ability to spend —

Exactly. Consumers need to bring their savings back up into alignment with more normative levels, which suggests a severe headwind to consumer spending this year. Exports, we've already talked about; there's not a good outlook there for what has been our most dynamic sector. Capital spending, I think, is going to be extremely weak this year. We're going to see a net decline, principally because the accelerated depreciation rules, which were in effect, expired on Dec. 31. Up until then, you got 100% depreciation. Since Jan.1, you only get 50%. We've seen this happen many times in the past. Firms look as far as they can into the future and move those expenditures forward in order to take advantage of the accelerated depreciation. So it's reasonable to believe that we're going to see a considerable falloff in capital spending this year. Then you've got the government sector. We've got a $1.3 trillion deficit according to the latest projection from the CBO. In real terms, government purchases of goods and services will decline slightly this year, mainly because of defense cuts. Non-defense, at best, will be flat. How could we have a worse situation than with a $1.3 trillion deficit and a decline in real government purchases of goods and services at the federal level? It's hard to imagine how it could be worse.





Well, toss this in: State and local spending isn't going to fill that gap.

No, you probably saw the statement from New York Gov. **Andrew Cuomo** that the situation has deteriorated in New York. About half of the state governments either have deficits that they must address for the remaining six months of

the current fiscal year, or they'll have deficits in the new fiscal year. Now, that's an outward improvement. But the state budgets do not include the unfunded liabilities of their pension plans. Last year was another in which their investment returns did not match their actuarial assumptions, so those pension plans are in worse shape now than they were a year ago. How is that problem going to be rectified? Either you have to cut the benefits, or you have to get additional funds from the state and local governments. The only way *that* can be achieved is by cutting other programs or raising taxes. So the state and local governments will remain a drag. Guess what? We are looking at a recession in 2012.

And that means what, for the markets?

Let's look at the last chart in the package I sent you, the long-term Treasury rate going back to 1871 [page 14]. We had 10 or more years in the late 19th Century and early 20th Century when long Treasuries got to 2% or less; those were in the aftermath of the huge buildup of debt in the 1860s and 1870s. In 1941, as you can see on the chart, long Treasuries were at 2% again, then Pearl Harbor came along. Another way of looking at this is that, since 1871, long Treasuries have averaged about 4.3%. The inflation rate has been about 2.1%, 2.2%; so you had a real return of about 2%. Notice, too, that in the period from the rise of the Iron Curtain to its fall, interest rates averaged about 6% and the inflation rate was 4%, so you had a real rate of 2%. In the earlier global market period from 1870, the interest rate was around 2.9% and the inflation rate was 0.9%. So your real rate gravitates towards 2%. If we go towards zero inflation over the next several years, that's saying to us at Hoisington Management that the long Treasury will eventually get to 2%.

All the way down to 2%?

Rates have done that in Japan for a lot of the last 15 years. Getting there will not occur in a straight line. It will be in a very frustrating pattern. We'll see a lot of volatility and there will be some episodes where it will look like the trend toward lower rates will be interrupted. It may well be interrupted for intermittent periods of time. To put this in another way, if you asked me to write down all of the reasons why interest rates could rise, I couldn't list them all. There are *a lot* of reasons why interest rates could rise over the short run. In this generally poor economic environment, there will be some time periods when the data will get a little bit better. There may be massive portfolio selling from time to time. There may be expectations that problems in Europe or elsewhere are being solved. There are a whole host of seasonal and other factors that can intervene. But as long as the United States is confronted with these various structural factors, interest rates can rise – but they really can't stay up for very long. They ultimately have to go back down. We're in a gradual process toward lower rates. Five or 10 years down the road, we will end up thinking about is this as a period of low interest rates. And its volatility won't seem too important after the fact. But I can assure you it *will* be important during the interim.

Especially if you have to worry about little things like portfolio returns –

Absolutely, because as you go lower in yield, each basis point has a larger and larger price effect.

The math is pretty plain, although it escapes a lot of people.

It is. Of course, this is our bread and butter. Did you see the returns in our fund last year?

How could I miss them? You did blindingly well, not just against your peers, but the universe. Up well over 30%.

The mutual fund that we sub-advise, the **Wasatch-Hoisington Treasury Bond Fund**, actually is up over 41%. The institutionally managed account was up slightly in excess of 40%. It was a volatile process, a nerve-wracking process, getting there and I don't anticipate going forward it will be any easier.

What are you doing?
We've basically been long, but we've gradually, over the last several years, increased the percentage of our portfolio in zero coupons. They've performed *very* handsomely. They've had volatility, but they've done very well and if rates go lower, it's clear that the best performance will come from the zero coupon bonds, because they don't entail the reinvestment risk.

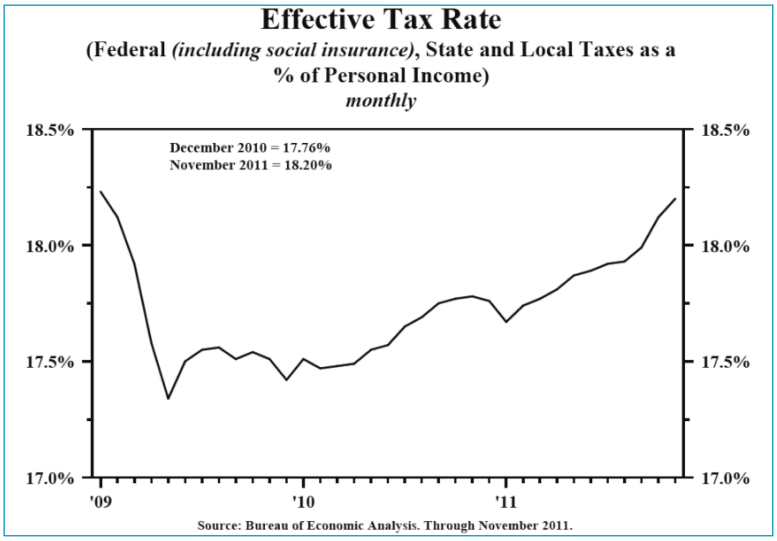
That couldn't have been more of a contrary position a year ago. And it still is.
Yes. "Rates are going higher. They can't go any lower; they're at all-time lows." Or so they say.

Well, that depends on how far back your chart goes, as you've demonstrated.
That's exactly right. All you have to do is look back to 1941. But it specifically boils down to the following situation. The critical thing for us is that the economy's extreme indebtedness is a deterrent to growth. It's not a positive for growth. What the classical economists said is true: What creates prosperity is the hard work, creativity and ingenuity of individuals and businesses. Your prosperity does not come from governmental financial transactions.

Nor, from highly leveraged purely financial transactions, no matter how many transpire per second in the private sector.
Absolutely. I agree with that. I don't know whether you ever read **David Hume**'s essay written in 1752, *"A Public Credit."*

I believe I did, but a *very* long time ago.
Hume is among the 10 greatest intellects of mankind. His treatise on human nature, of course, is what he's remembered for the most; Adam Smith said that Hume was the greatest intellect that he ever met, and Smith knew all the great figures of the Enlightenment. At any rate, the point Hume makes in "A Public Credit" is that when a government has mortgaged all of its future revenues, the state lapses into tranquility, languor, and impotence. And he discussed various historical situations. Hume died in 1776, not long after reading Smith's "Wealth of Nations", which was also published in 1776. What we are seeing today is that Hume was correct – and some of the intervening smaller thinkers were not. I'll tell you another little thing. **Immanuel Kant** said that it was Hume that opened his eyes to the reality of the world.

Turning back to interest rates. Why do you suppose real rates have gravitated to 2% for so long?



I suspect, and I don't know this, but I suspect it's because that may be the very long-term average increase in productivity or real income. I've tried to verify that, but it's only a guess. Excellent question. It may be that the factors of production in the long run earn about the same, but I don't know. We do know that productivity is in that range, over a very long period. Whether they exactly equilibrate or not, I don't know. But they seem to be pretty similar over the long haul. They're certainly not similar over the short run. I don't want to give anyone that impression.

Maybe the short-term volatility is telling us something about the capriciousness of human nature –
Absolutely. Maybe it's a sign that there are very significant emotional elements in our decision making process. We try to be rational and to make considerate judgments, but in the final analysis may have limited time. We may have to make decisions based upon rules of thumb or generalizations. Decisions are overly hasty, emotional.

Your charts also show that ideas about how low rates can go depend on perspective. What period you are looking at.
Yes. If you came into the market in 1991, these rates are extremely low. If you came in in 1971, they're even lower. If you look at the sweep of history in both the United States and around the world, these rates are low, but *not* at all-time lows. That's an important consideration. It's equally important to understand the conditions that produce the low rates as well as the condi-

tions that produce the high rates. For the time being, the trend in rates is still downward. We are approaching the point at which long Treasury portfolio maturities will have to be changed, but we're not there yet.

So what will it take to make you shorten maturities?

That's a very great question. We need to see a fundamentally different policy response. There are things that could be done in the realm of fiscal policy to change the outcome, if we were to use our knowledge correctly. Now, before I describe what we could do, let me say that it's hard to visualize how this could happen right now, but maybe that could change going forward. So what do we know? Well, No. 1, we know that the government expenditure multiplier is, at best, zero and maybe slightly negative. By that I mean if we increase deficit spending, although you can get a transitory boost in GDP for a few quarters, at the end of 12 quarters, there's no gain in GDP. But you do shrink the private sector, increase the government sector, and you take on a higher level of debt, which makes the economy still weaker. So the deficit spending, if we continue that, that will continue to weaken the economy. If we could reduce the deficit spending – although it would reduce economic growth over the short run – over the long run it would revive the private sector. The tax expenditure multipliers, however, are quite large. They're between -2 and -3. By that I mean, if you raise the marginal tax rate by a dollar, you will lower GDP by $2 to $3 after about three years. If you cut the marginal tax rate by a dollar, you will raise GDP by $2 to $3 at the end of three years. But there is also a third component of the federal budget – the so-called tax expenditures, or what are more commonly called the loopholes.

Or the root of most the evil in the tax code –

Well, in the '86 legislation, as Martin Feldstein at Harvard pointed out, we had a revenue neutral bill in which we lowered the marginal tax rates and eliminated the loopholes. We brought the tax expenditures down from 10% of GDP to 6%, which is where they are today. But yet, the economy responded more to the reduction in tax rates than to the elimination of loopholes. Now, I don't know of any studies that confirm this, but it suggests that the multiplier on tax expenditures is considerably less than the multiplier on tax rates.

Which stands to reason, since they benefit only specific minorities.

It probably is because in some cases these loopholes especially in the corporate code, can go to a very few. But let's take the biggest tax loophole on the household side, which is the mortgage interest deduction. We've done a lot to stimulate housing in the United States – and what we've gotten is overproduction and clearly a negative multiplier. To move forward, it's clear that we need a program of mutual sacrifice. There are going to have to be tax changes and expenditure changes. It seems to me, the better thing to do is to start scaling back as rapidly as possible the future promises that have been made under Social Security and Medicare. To have shared sacrifice, we should eliminate the loopholes. I, personally, am in favor of elimination of all the loopholes in both the personal and corporate tax codes. But I don't know how that could be achieved – there are so many beneficiaries and the whole system is designed to support those loopholes.

Not to mention all the tax attorneys you'd be throwing out of work.

True, but to keep the economy growing, we need some reduction in the marginal tax rates. And it could be done, while lowering the deficit, because of the higher multiplier on tax rate changes, in a way where the cuts in spending and the elimination of loopholes are greater in terms of dollar volume than the reduction in the marginal tax rates. So we *could* deal with the debt situation. We don't have the option that **John Kennedy** had in the early 1960s or **Ronald Reagan** had in the early 1980s, where we had sluggish growth and just responded by cutting the tax rates, so the economy improved over time. We don't have that option because we're so heavily indebted. We've got to do it in a comprehensive sense in which we lower the budget deficit initially, and we achieve that by cutting spending, eliminating the loopholes, and then we provide some offset through a reduction in the marginal tax rate. If we move in that direction, then ultimately the economy would begin to work out some of these difficulties. I haven't seen the political will to move forward. But this basic approach is very similar to some of the provisions in Bowles-Simpson, and this is the direction in which we have to go.

And we probably need political campaign finance reform first, so good luck!

Everyone is a special interest. But we don't want the tax codes to incentivize investments

that are not consistent with the most productive use of capital. What we really want is tax codes that are neutral in terms of the allocation of the country's goods and resources. That would produce a better net result, but there are *many* who benefit from the existing structure and they're going to fight the changes as hard as they possibly can. This is not a case where we lack the technical knowledge to deal with our problems. There's a lack of political will or political cohesiveness to deal with the problem.

What about the private sector? You mentioned earlier that Minsky wanted to keep banks small. We've only let them grow larger. We've made no real progress in delevering the private sector since the crisis–

No, and we've got to deleverage. I don't think it really matters whether we deleverage in the private sector or the government sector. The fact is, we're going to have to deleverage in both in order to clear the way for prosperity. After all, isn't that in the final analysis what we want to achieve? But we're not doing that. The real median household income right now is where it was in the late 1990s. We've had no improvement in the standard of living, even though the debt-to-GDP ratio has risen about 100 percentage points. The problem is not solely in the government sector. It's not solely in the private sector. It is the aggregate problem, the aggregate over-indebtedness, which is the key.

Have you adjusted your portfolio positions at all for this year?

Not yet, we still have a very long duration portfolio. If the situation changes, we hope to be able to be flexible enough to react to it and we're prepared to react. But we don't think that situation is immediately at hand, though nothing can be taken for granted. In economic analysis, there are two things that are important. First and foremost, you have to have some understanding of how the world works and then you have to evaluate the incoming data in terms of the way in which the world works. Responding to the individual indicators, at Hoisington Management, we don't think that works. The indicators have to be interpreted in light of a more fundamental structure. What's very difficult about bond management is that the short-term trading is really dominated by these whole hosts of psychological and behavioral characteristics, which are very difficult to sort out. But the bond market, in our opinion, does move toward equilibrium, though the process is slow and torturous. To know when you're moving toward equilibrium and in which direction the equilibrium exists, requires this broader understanding of the fundamental economic relationships. That's what we try to do.

You're saying you try to stay focused on the big picture? Not react to each blip in the data?

Yes, and the thing about it is, it's counter-intuitive. You might assume that we'd have greater knowledge about the short run and less knowledge about the long run. But in our approach, the only knowledge that we think we have pertains to these longer term fundamental considerations, not to the short-term trading. So we're looking at the world through an entirely different prism.

So short term moves are just noise?

Yes, and trying to sort out the short-term noise is an impossible task. Our approach at Hoisington Management is that you cannot react to these short-term swings. If you do that, you'll generally be buying at the wrong time and selling at the wrong time.

Words to the wise. Thanks, Lacy.

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