The Long & Short of It

Quarterly Newsletter
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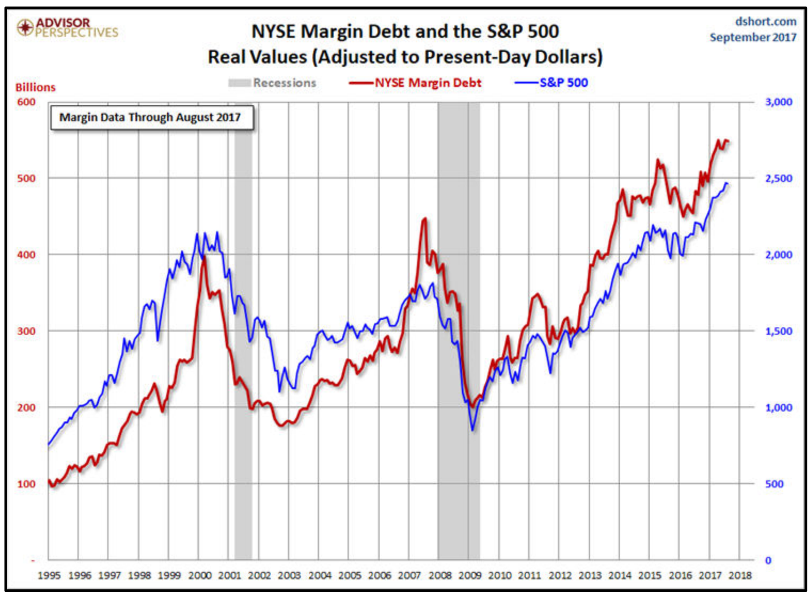
At its most fundamental level, debt is an income statement event serviced with payments to cover the interest. But a financial crisis transforms debt into a formidable balance sheet challenge. In this newsletter, we explore what today's rising debt levels mean for the market and our investments.

All Roads Lead Back to the Fed

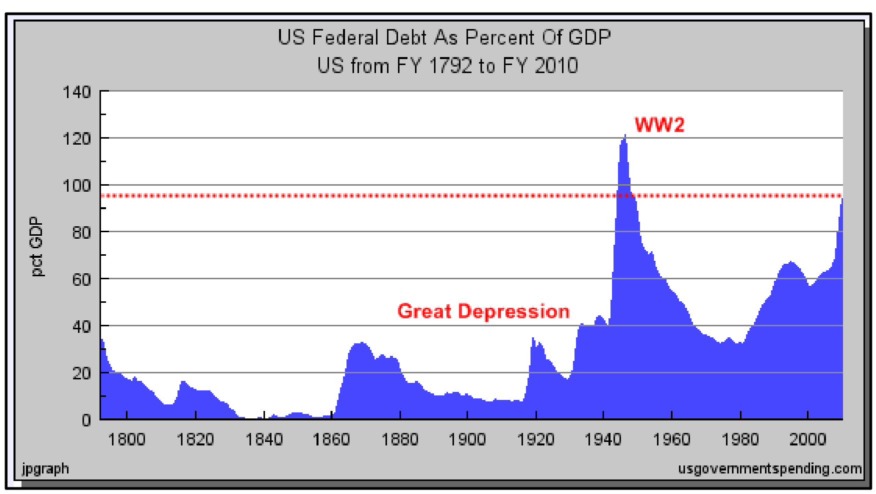
With inflation remaining below targeted levels, questions abound over why the Federal Reserve continues to raise interest rates and slow down access to credit. Does this stem from leftover political pressure to abandon the long-time zero interest rate policy? Is it a reaction to the new presidential administration reducing business regulations, which might encourage faster economic growth? Does the Fed believe that Europe, China, and Japan's monetary stimulus programs will continue driving foreign capital to the US economy and lead to overstimulation? Or more cynically, is it just promoting the myth of a hot economy to foster as much activity and confidence as possible?

The Fed recently debated stock price levels even though this is not officially part of its "inflation and employment" mandate. In its July meeting, some members expressed concern that a bubble is forming. Per the meeting's minutes: "a couple of participants noted that **favorable macroeconomic factors provided backing for current equity valuations.** [Since]…recent equity price increases did not seem to stem…from greater use of leverage by investors.…**these increases might not pose appreciable risks to financial stability**" (emphasis ours). But is that really the case? Time for a closer look at debt levels.

In keeping with the overall increase in the S&P 500, margin debt has risen about $350 billion since 2009. However, US government debt has nearly doubled in the same period, growing by $9.1 trillion and ballooning from 73% to 103% of GDP. Most surprisingly, US corporations have added about $10 trillion in debt since 2008, 62% more than in the eight-year period leading up to the '08-'09 financial crisis. Consumer debt has recently rebounded above its 2008 levels as well, though housing debt comprises a smaller percentage of consumer debt than in 2008. Altogether, it appears that debt levels have grown by a sizable $20 trillion since 2008.



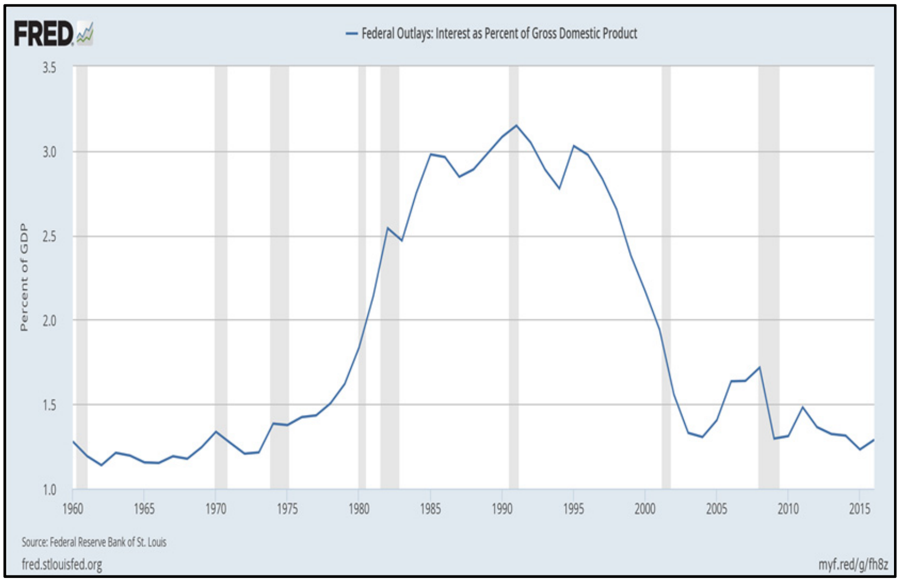
What has this rise meant for GDP, the most basic measure of activity in the economy? If GDP had held steady (i.e., 0% growth) from its 2008 level through 2016, cumulative GDP would be roughly $117 trillion. Thanks to a slight bit of growth, cumulative GDP was $143 trillion. In other words, $20 trillion in additional debt resulted in only $26 trillion of additional GDP—a staggeringly low one-to-one ratio.



We would expect GDP to rebound much more significantly from its 2009 lows, even without credit creation. But it has been a challenging decade for organic domestic wealth, with the vast majority of recent economic "growth" driven solely by increased debt—something we all know does not go on forever. In the next recession, lenders' eyes will move from the income statement to the balance sheet only to find higher debt-to-asset ratios than before, and the elephant in the room that can no longer be ignored: a government balance sheet similarly encumbered, and most importantly, unable to provide a backstop of assets as it did in the 2008 crisis.

Economic Cruise Control

Interest rates are so low that the incentive to borrow remains strong. Overall growth of debt aside, no single category of borrowing has truly blown up. Regulators remain careful about letting lending get out of control. Significantly, the interest burden on government, corporations, and consumers remains unremarkable by historic standards. The chart to the right demonstrates that the percentage of GDP used to pay interest on the national debt is roughly 40% below 1980 levels, even though overall debt today is approximately 3.5 times larger. Thus, the large amount of debt on balance sheets is largely overlooked and the focus remains on the low interest burden. This economic expansion should continue until the Fed responds to an inflation problem or an exogenous event shocks the economy, either of which would force income lower and interest rates higher, making debt service burdensome.



Speed Bump

So, is there a bubble ahead? Perhaps the answer lies in how investors determine valuation. During times of stability, investors discount future cash flow estimates to derive valuation; during times of economic crisis, they gravitate toward simple multiples like price-to-earnings (P/E) or price-to-book value (P/BV). The S&P 500's current P/E ratio of 25 is high compared to its historic mean of 15. When discounting future earnings that grow modestly at remarkably low interest rates, it's very easy to justify a P/E ratio of 25. This high multiple could theoretically be sustained as long as investors believe interest rates will not increase much over the next 20-30 years. But historically, interest rates have sustained at higher averages than today. Demographic changes also suggest higher interest rates in the late 2020s and 2030s as the labor force growth rate recovers from suppression by hordes of retiring baby boomers. An extraordinarily stable, slow growth "zombie" economy supported by new debt and very low interest rates may be the case for 5-10 more years, but the market's current "low interest rates forever" outlook is at odds with most demographers' long-term projections.

The holidays are nearly here, a time when tranquility and bull markets thrive. As the market climbs ever higher, we will remain nimble, rotating out of what has become overpriced and too fashionable into what is solid and temporarily out of favor. We sweat the details on these individual holdings to mitigate risk so our clients can have greater exposure to the most profitable asset class—and still sleep peacefully at night.

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