ADVISOR PERSPECTIVES

Lacy Hunt: Keynes was Wrong (and Ricardo was Right)

By Robert Huebscher
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Underpinning the Obama administration's economic policies is the work of John Maynard Keynes, the legendary British economist who called for large fiscal and monetary interventions to counter the Great Depression.

On this critical issue, Keynes was wrong, says Lacy Hunt.

The quantitative easing and fiscal stimulus efforts that, as a result, we see today around the globe are misguided, according to Hunt, who is an internationally renowned economist with Texas-based Hoisington Investment, an institutional fixed income manager. He spoke on April 22 at the Strategic Investment Conference in San Diego, hosted by Altegris Investments and Millennium Wave Investments.

In addition to discussing the failings of Keynesian economics in the context of current monetary and fiscal policies, Lacy offered some forecasts for asset class returns.

Challenging conventional wisdom

Macroeconomic conventional wisdom currently has three major tenets, Hunt said: first, current monetary and fiscal measures will stimulate economic growth and ultimately produce inflation; second, our debt problems are behind us, or at least should not deter policymakers from aggressive spending; and third, economic growth will cause the current account deficit to balloon, driving the dollar down, and inflation and interest rates up.

Citing his own firm's research and that of prominent academics, Hunt challenged all three of those tenets.

Key to understanding Hunt's arguments is a 2002 study he and his colleagues at Hoisington conducted. It showed that the risk premium – the excess return of equities over risk-free Treasury Bills – has varied significantly over the last 140 years. It averaged 3.5%, but for different 10-year intervals it ranged from -8.5% to 20%.

The researchers identified three explanations for the variation in the risk premium – one of which was previously unknown. First, higher dividend yields, relative to the Treasury yield, produce greater risk premia. During bull markets, the differential of dividend yields over Treasuries has been as high as 250 basis points, but today it is at negative 200 basis points.

"On the current income side, you are giving up quite a bit to be an equity investor," he said.

Second, lower starting valuations, as measured by conventional P/E ratios, lead to higher risk premia. The long-term P/E ratio, measured over the 140 years he studied, was 15, but today it is 24. Hunt confirmed this finding using Tobin's Q-ratio. (He did not use Shiller's P/E ratio, which normalizes earnings by averaging them over the trailing 10 years, since he would have had ten fewer years of data to analyze.)

The third and most critical factor, which was Hunt's original contribution to the literature, is inflation. Unlike the dividend yield and starting valuation, its value is not known in advance. Higher inflation rates are good for equities, because firms have pricing power and bonds "get killed," he said. Inflation, he said, averaged 1.5% over the period he studied, so values above this produce higher-than-average risk premia.

With dividend yields and starting valuations at ominous levels for equities, what is the outlook for inflation? Before discussing Hunt's answer, let's look at one aspect of his analysis that is critical to his thinking.

Debt and growth

Debt is the greatest long-term threat to economic growth, according to Hunt. To measure it, he calculated the ratio of federal, household and corporate liabilities to GDP. Today, that ratio is 370%, well above its previous high, which occurred during the throes of the Great Depression. This measure had already reached an excessive level in 1998, when the ratio was 260%, Hunt said.

Has this made us better off?

"The answer is unmistakably clear," Hunt said. "We are worse off." The standard of living in the US has not risen since the early 1980s, nor has the overall level of employment. "Financial transactions have not created jobs or prosperity," he said. "They have undermined the situation."

If aggregate over-indebtedness is indeed the problem, Hunt asked, how can we cure it by taking on more debt?

"We can't," he said.

Over-indebtedness, however, has been the result of recent policy decisions to counter financial crises. Those crises, which included the Long Term Capital Management failure, the 2001 recession, the deflation scare of 2003 and the most recent recession, were viewed by the Fed as owing to a lack of liquidity. The Fed's injection of liquidity, according to Hunt, merely allowed the economy to lever itself up again.

“This is a self-defeating and unsustainable process,” he said. “It is a process that will end badly.”

The best economic research, Hunt said, supports his position. Economists from Irving Fisher, a contemporary of Keynes, to Carmen Reinhart and Ken Rogoff have shown that whoever borrows the money – governments, corporations or individuals – aggregate indebtedness sets off a chain reaction that leads to economic deterioration, systemic risk and deflation. Reinhart and Rogoff are co-authors of the recently published book, *This Time is Different*, which argues that the debt-to-GDP ratio is the primary determinant of a country’s economic health.

“Supplying liquidity buys a little time,” Hunt said, “but it undermines the long-term capacity of the economy to grow.”

Monetary Policy

Hunt challenged the general perception that the Fed is increasing the money supply in a manner that will lead to significant inflation.

The Fed’s balance sheet has indeed doubled, he said, but that has not translated to economic growth or inflation because the velocity of money has slowed to offset that increase. Hunt noted that M2, the broadest measure of the money supply published by the Fed, has grown an average of 6.6% annually since 1900. Over the last year, however, it has grown by a mere 1.2%, and that rate may go lower, according to Hunt. “This is not high enough to sustain economic growth,” he said.

Slow money supply growth was caused by an unprecedented decline in bank lending, Hunt said. Seven decades ago, Fisher predicted that in times of excessive leverage banks would be reluctant to lend and consumers would be reluctant to borrow. That is what happened.

“In excessively indebted periods, monetary policy becomes impotent,” Hunt said.

Fisher is perhaps best known for his law of exchange:

$$GDP = M \times V,$$

where GDP is the gross domestic product, M is the money supply, and V is the velocity

This equation illustrates the interplay between money supply, the velocity of money and economic growth. If, as is now the case, money supply increases but velocity decreases, there will be no growth in the economy.

What ultimately determines inflation, however, is not the money supply growth or the velocity of money, Hunt said – it is the relationship between aggregate economic demand (GDP) and aggregate economic supply. Supply represents the cost of doing business, which in the US is 70% wages, 10% raw materials, and 20% insurance, taxes and a host of other factors. The intersection of demand and supply determines the level of prices in the economy.

Excess supply, relative to demand, is deflationary, and that situation is evident today across a range of economic indicators, including unemployment, industrial production, and wages.

Keynes assumed that “the government could grow the GDP without changing the price level,” Hunt said. In other words, he assumed government could increase the demand for goods and services without decreasing the cost of supplying those goods.

Today’s conditions show that Keynes was wrong, Hunt said. Government policies like quantitative easing, while perhaps temporarily increasing demand, have had the insidious effect lowering supply. We see this in declining wages and employment, both of which are deflationary.

Fiscal policy

Fiscal policies, Hunt said, do not influence GDP or economic growth. Either the money supply or the velocity of money must increase for GDP to grow.

David Ricardo, the early-19th century English economist who, among his other contributions, developed the law of diminishing returns, provided the framework for Hunt’s reasoning. If the government engages in deficit spending, according to Ricardo, it doesn’t matter whether they fund that spending by borrowing or taxing. The net result will be a transfer of assets from the private to the public sector, not an increase in economic growth.

Imagine the economy as a pie, with a 79% slice representing private sector spending and the other 21% being the government’s share. If you increase the government’s slice of the pie, according to Ricardo, the size of the pie doesn’t increase in the long run. The private sector segment, which is more productive than the government, simply gets smaller.

Economics professors have taught Keynes and ignored Ricardo, Hunt said, “but statistics have confirmed that Ricardo was right and Keynes was wrong.”

Studies have shown that the multiplier for government spending – such as the recent $787 billion fiscal stimulus – is less than one. Hosington’s most recent quarterly report cites research showing that in the post-Korean War period the spending multiplier was zero. During World War II and the Korean War, the spending multiplier was 0.6, meaning that a

$1 rise in government spending would lift the economy as a whole by 60 cents while reducing private spending by 40 cents.

Major tax increases are coming, Hunt said, including the expiration of the Bush tax cuts and new taxes imposed by the recently passed health care legislation. He estimated that those hikes will total $2 trillion over the next decade. A study by Robert Barro of Harvard showed the tax multiplier is -1.1 and another study by Christina Romer said it is -3.0. Romer is now a presidential advisor. Using the Barro and Romer multipliers, we should expect a contractionary force of between $2.2 and $6 trillion on economic growth over the next ten years.

"The policy mix of substantial increases in spending and increases in taxes means you are going to contract aggregate demand," Hunt said. "It does not create growth; it sends you in the opposite direction."

Japan's history, unsurprisingly, validates Hunt's thesis. Its debt-to-GDP ratio has grown from 50% in 1989 to almost 200% today. The general perception was that its fiscal policies should have been stimulative, yet Japan remains in serious trouble, he said. Nominal GDP is where it was 16 years ago and employment has not risen in nine years.

Asset class forecasts and the value of the dollar

Hunt's firm manages $4.5 billion in bonds, and he expects yields to go lower over the next several years, consistent with his forecast for deceleration in M2 growth, low economic growth and low inflation. He is bullish on long-term bonds, and in the first quarter his fund had a longer duration that exceeded the Barclay AGG index's.

In an email exchange, I asked Hunt whether he could envision a scenario in which real interest rates (i.e., TIPS rates) rise, potentially above nominal rates, which would imply that inflation expectations remained low or negative. Such a scenario could arise, for example, from an oversupply of Treasury securities relative to demand or from an increased perceived sovereign debt risk.

Hunt said he doubts that would happen, citing the fact that the real rate has historically been strongly mean-reverting to 2% over the long term, even though it is volatile over the short term. Over the past 30 years, the real rate has been well above the mean, he said. "This would not have surprised Fisher because inflation expectations adjust very slowly to actual inflation," he said. "Thus the nominal rates have not yet adjusted to the drop in inflation of the past three decades."

Over the long term, the value of a country's currency depends on its current account deficit. At its worst, our deficit was 7.5% of GDP, and it is now 2.5% of GDP, better than it has been since 1997. Hunt forecasts a strong dollar, since he believes the ineffectiveness of both monetary and fiscal policy will cause imports to decline and move the current account deficit to zero. He cautioned that the value of the dollar over the short-term depends on factors that are "too complex to understand."

"Markets covey no meaningful information over the short run and economic conditions prevail over the long run," he said.

As for equities, his view is dim, given the low dividend yield, high P/E ratios, and his deflationary forecast. "In the current environment, you are not being paid for taking risk," he said.