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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Last Friday, instead of writing this newsletter, I was in a jury deliberation room discussing the proximate cause of an elderly woman's incontinence. So, on Sunday, I was kind of surprised to receive an email from someone taking issue with something I had written in Common Cents. After all, I hadn't written one on Friday.

It seems there is a darn good reason why I do what I do for a living, as opposed to working for NASA. You see, the previous week, I had speculated what would happen if the sun were to explode. While I correctly stated it would take 8 minutes for the explosion to hit us, if the debris were moving at the speed of light., I was spectacularly wrong in assuming the earth would heat up prior to that.

According to the reader:

> The "heat" you mention cannot travel faster than the speed of light. We would enjoy our 8 minutes just fine.
>
> It is part of the electromagnetic field, which cannot travel faster than light. You would not feel the heat until there was heat.

Of course, he was right, and I felt sort of foolish about it, really. Duh. However, he didn't take issue with the rest of the piece, which was about margin debt, and how the amount of money flowing into stocks will ultimately slow because this accumulation of debt can't continue at its current pace. In fact, I ran into him at the grocery on Tuesday morning, and he said something along the lines of margin debt being more scary to him than the sun exploding.

He also said in regards to my gaff: "Come on, man, that is like Astronomy 101." Duke graduates, huh?

This got me to thinking: there are so many things to worry about in the world today, you would go nuts if you took all of them down to their worst case scenario, literally nuts. Now, part of this is due to the interconnected nature of the world; information is almost instantaneous, and the various news media has a lot of space to fill. So, just about every problem is magnified to make sure there is enough output in order to sell ad space.

The more sensational a story is, good or bad, the more 'ink' it gets. This is particularly true in the United States, where clicks, shares, and likes often drive what hits the headlines, as opposed to the actual newsworthiness of the items. To that end, the landing page of the al.com website, arguably the largest news media outlet in Alabama, has a man in overalls, with no shirt, wearing a tool belt, and standing in front of a work shed prominently displayed.

With all that is happening in the world, why would this be on the front page? But for the almost irresistible urge to click on the story to find out more? After that, I can toggle over to an article about Todd Gurley, and why the Georgia Bulldogs suspended their star player, or how Auburn fans should expect a close game against Mississippi State this weekend.

I suppose it is escapism of some variety, or perhaps the average American either doesn't care about other stuff or is simply ignorant. Maybe it is a combination of the two.

Inside this issue:

There are no shortcuts when it comes to getting out of debt.

Dave Ramsey

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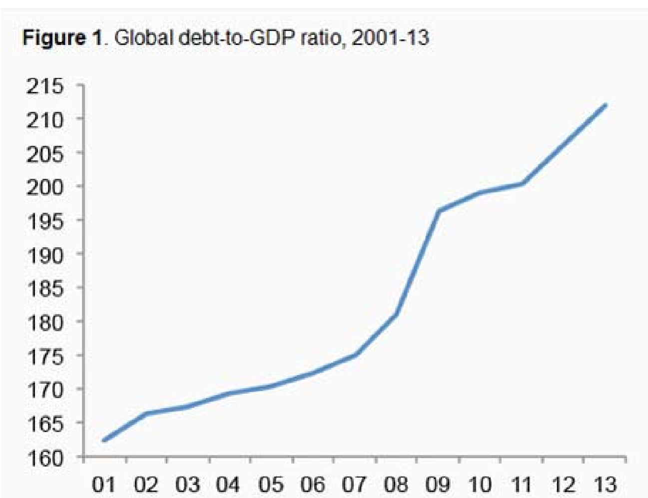
That doesn't change the fact there is a lot wrong, or seemingly so, happening right now. The situation with the Islamic State is worrisome to me, as is the Ebola situation. I am also curious as to why Kim Jong un hasn't appeared in public in over a month; did the military throw a coup? We don't know. Heck, this morning, the Koreans lobbed a few artillery shells at one another, but that didn't make a lot of headlines here. Then there is the collapsing eastern European economy, brought on by sanctions against Russia and plummeting energy prices. This will have ripple effects throughout western Europe, and already has.

Venezuela is about to implode, and the Argentines either can't or won't pay back their debt. This is an issue less because of the debt itself, as opposed to a foreign entity basically giving a US court its, um, shoe size in regards to a financial transaction within the United States. The unrelenting drought in the western US has had, and will continue to have, a major, negative impact on agricultural output, particularly cattle prices. So much so, some industry experts are predicting it might take decades for the US beef industry to fully recover. You know, that hits my pocketbook.

Then there are the financial markets. I won't sugarcoat it: the world is awash in debt. Lost in the news in the United States, what with the Kardashian shenanigans and NFL scandals, was something called the Geneva Report, which is an annual assessment of things sponsored by the Centre of Economic Policy Research, the UK's equivalent to the Conference Board.

Here are some of the juicier bits:

> Contrary to widely held beliefs, the world has not yet begun to delever and the global debt-to-GDP is still growing, breaking new highs (see, for example, Figure 1.1). At the same time, in a poisonous combination, world growth and inflation are also lower than previously expected, also – though not only – as a legacy of the past crisis. Deleveraging and slower nominal growth are in many cases interacting in a vicious loop, with the latter making the deleveraging process harder and the former exacerbating the economic slowdown. Moreover, the global capacity to take on debt has been reduced through the combination of slower expansion in real output and lower inflation.



> *The sponsors' conclusion?*
>
> This report is clear in its outlook: the policy path to less volatile debt dynamics is a narrow one, and it is already clear that developed economies at least must expect prolonged low growth or another crisis along the way. We hope and expect this Geneva Report to make a considerable contribution to the discussion around de-leveraging policy

Yeah, you are reading that chart correctly: total global debt to GDP is about 215%, and has increased significantly, again significantly, since the 2008 financial crisis, which was caused by, that's right….too much debt. Hmm. My friend, the Duke graduate from the grocery store, was also worried about debt.

Now, with this all said, are we poised for another financial system crisis? At this point, I would say probably not, and it would likely stem from Europe or China in any event. However, when you consider the growth of global indebtedness has far outpaced economic growth, you can come to the following conclusion: the global economy is basically using its leverage very poorly. Why? Well, if the world were using leverage appropriately, economic growth would outpace the growth in debt, which the chart suggests isn't happening, as debt relative to GDP has exploded since 2008.

Now, before we start to badmouth debt, remember it isn't a bad thing. If I can borrow money at 3% in order to earn

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5%, that is a good trade, and I should tack on as much debt as I can as long as I can make that spread. Sure, debt will continue to grow, but it will shrink as a percent of overall output. When debt exceeds growth, it inhibits the ability to borrow in the future for more productive initiatives. Further, it means an increasing amount of the borrower's current output goes to service the debt assumed for past activity, as opposed to investing in future growth.

Since the financial crisis, governments have maintained high levels of deficit spending, without significant growth to show for it. Yes, the US annual deficit has shrunk considerably; however, the growth in its accumulated debt continues, and has grown significantly higher as a percent of GDP. Consider the following chart I cooked up with data from Bloomberg:

Year	US Nominal GDP billions $	Outstanding US Treasury Debt billions $	Debt Growth Less GDP Growth billions $
2008	14,718.60	10,699.80	
2009	14,418.70	12,311.35	1,911.45
2010	14,964.40	14,025.22	1,168.17
2011	15,517.90	15,222.94	644.22
2012	16,163.20	16,432.73	564.49
2013	16,768.10	17,351.97	314.34
INCREASE	$ 2,049.50	$ 6,652.17	$ 4,602.67

This is sobering stuff. Why? It suggests the US Treasury has borrowed an additional $6.652 trillion since the end of 2008 (the financial crisis), which has resulted in an increase of $2.050 trillion in economic activity. That is a difference of $4.603 trillion. *To be fair this all started well before 2008, going back to 2000 or so.*

While the annual numbers have improved, significantly, the Treasury has still borrowed MORE money than the economy has grown each year.

Put another way, every dollar the US Treasury has borrowed since 2008 has resulted in about 31 cents in US output. How does this happen? Seriously, IF we were employing leverage correctly? I mean, according to the chart, it would appear as though the aggregate US apparatus has eaten $4.6 trillion over the last 5 years. Yummy. Where did it go?

Apologists would argue the economy would have shrunk that much more but for the deficit spending. Maybe and even perhaps; however, spending $6.652 trillion to earn $2.050 trillion is an awful transaction, just horrible. You can go broke doing this type of stuff. It boggles the mind we would do this, let alone the remainder of the world, but here we are. As an aside, I sincerely doubt Keynes had this type of chart in mind.

Therefore, it is absolutely imperative, whoever wins the 2014 and 2016 elections puts everything else aside in favor of a pro-growth economic policy. From stem to stern, we need to focus on expanding our economic output, and significantly, even if it means putting pet and politically popular initiatives aside. If we don't, we will have an enormous debt overhang, which will slow economic growth moving forward….we will continue to eat money, albeit at a lesser rate, until the next recession, when we pick things back up again.

Hey, this isn't the end of the world, but this is most certainly in my thinking when I tell folks to think 2% GDP growth and 7% S&P 500 returns for the foreseeable future, and by that I mean "until further notice." You know, as I tell my kids when something doesn't go their way: "the sun will still come up in the morning."

To me, that is a much simpler prediction than speculating what will happen if and when the sun explodes.

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