Insights & Observations, 1st Quarter 2016

On February 1, the Treasury Department reported that the U.S. national debt reached $19 trillion. With U.S. gross domestic product (GDP) at $17.9 trillion in 2015, our national debt now stands at just over 106% of GDP ... or nearly $60,000 for every person (adults and children) in America.

After six years of decline, the U.S. budget deficit is expected to rise in 2016 to $544 billion from $439 billion in 2015. As a share of the economy, the deficit will come in at 2.9% of GDP. While revenues are expected to increase by 4% in 2016, outlays are expected to increase by a whopping 6% ... or triple the rate of inflation.

The Congressional Budget Office projects that in 10 years the budget deficit will reach 4.9% of GDP. The culprit: entitlement spending.

A new paper by business school professors at the University of Chicago and the University of Minnesota found that 7% of financial advisors have been disciplined for misconduct.

It's everywhere, not just in small firms. It is pervasive.

Amit Seru, Booth School of Business – WealthWatch (3/1/16)

The report estimates that conflicts of interest likely cost $17 billion in losses annually for working-class and middle-class families. Most of the investments involved in reported misconduct were insurance products. About half of the advisors found to have committed misconduct were fired, but 44% were hired by another firm within a year.

According to the Tax Policy Center, a nonpartisan research group, just over 45% of American households will pay no federal income tax for the 2015 tax year. Some of the highlights:

- Those in the bottom 40% of the income spectrum will end up getting money *from* the government.
- The richest 20% of Americans will pay about 87% of all federal income taxes.
- The top 1% of Americans will pay almost 44% of all federal income taxes.

According to the Federal Reserve, the net worth of U.S. households and nonprofits reached a record $86.8 trillion in the fourth quarter of 2015. The report credits the rise in home equity, as home prices have been recovering while mortgage debt has been growing slowly. Households also have a record $10.7 trillion in checking, savings, and certificates of deposit.

The Federal Housing Finance Agency estimates that home prices rose 5.8% last year. Also, according to CoreLogic, 4.4 million homes still have negative equity ... back in 2009, more than 12 million homes were *underwater*.

More people are working as independent contractors, with the number of workers in *alternative arrangements* increasing to 16% from 10% just a decade ago. About 17% of women and 15% of men work under such arrangements. While headline job growth has been encouraging, the steep increase in alternative arrangements questions the quality of such employment gains.

> **Workers in these alternative arrangements often find themselves with erratic schedules, spotty earnings and few benefits.**
>
> **Sussman/Zumbrun – WSJ (3/25/16)**

Here are some of the findings from the Employee Benefit Research Institute's recent annual report:

- About half of retirees are forced to retire early because of health or personal problems.
- Only 27% of retirees actually work beyond their normal retirement age.
- More than half of American workers have less than $25,000 set aside for retirement.
- Only 48% of workers have attempted to calculate how much money they will need in retirement ... even less have considered social security strategies or future healthcare costs.

The McKinsey Global Institute reports that global debt grew by $57 trillion from 2007 to 2014 to a total of $199 trillion. After the Great Recession, many assumed the world would gradually begin the process of deleveraging ... or reducing debt levels. Instead, after zero-based interest policies (ZIRP) and quantitative easing strategies, the major economies of the world find themselves awash in debt – with public debt-to-GDP ratios at record levels.

Stimulus programs were put in place initially to provide liquidity and guard against deflation. But these programs have actually encouraged consumers and businesses to borrow more, while the U.S. government went on a spending binge of trillion dollar deficits. The irony here is that this enormous buildup of debt may actually induce deflation.

> **In other words, while Mr. Bernanke and Ms. Yellen were trying to prevent deflation, the federal government was engineering its cause, excessive debt. And the Fed abetted the process by purchasing trillions of dollars of government paper, aka quantitative easing.**
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> **George Melloan – WSJ (3/7/16)**

The Federal Reserve is in a difficult position as it attempts to normalize interest rates while the economic cycle is moderating. Corporations, for example, are struggling to grow top line revenue and profits are being squeezed. Low interest rates have encouraged companies to increase debt levels, and many used this money to buy back stock. This *financial engineering* has levered balance sheets and helped companies maintain or enhance shareholder profits.

> **As investors pressure corporate heads to focus on repaying debt, and profit expectations roll over further, it's almost inevitable that we'll see hiring slow significantly. Slowing payrolls growth, in turn, is likely to keep the Fed's rate normalization contained.**
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> **Rick Rieder, BlackRock's CIO Global Fixed Income (3/23/16)**

Low interest rates are hurting insurance company profits, and long-term care insurance is one of the products that has suffered the most. Eight million Americans own long-term care policies, and many are facing premium increases of more than 50% since the financial crisis.

Genworth, a leader in the industry, was recently downgraded by S&P's Ratings Services due to reduced profitability. Originally, many of Genworth's policies were priced under the assumption that the company would earn 7.5% annually on invested premiums, but new premiums are only generating 4% returns. Genworth estimates its cumulative losses on long-term care policies at more than $2 billion.

We've been conducting a prolonged experiment in monetary stimulus, and the impact on savers is one of the great unintended consequences.

Steven Kandarian, MetLife Chief Executive – WSJ (3/20/16)

Global growth is made up of two components: *growth of the working population* and *growth in output per worker*. Aging demographics have reduced the rate of growth in the working population. Output per worker, or productivity, has experienced the worst decline in more than two decades.

For all of 2015, productivity growth averaged 0.7%, compared with 0.8% in 2014. Productivity growth has averaged 1.2% since 2007, and was at 1.7% from 2003 to 2007. If productivity growth had been 1.7% last year, U.S. GDP growth *would* have more than doubled to just over 4 percent.

The fact that so much of the weakness in growth is due to productivity and demographics suggests that the debate over how to expand monetary and fiscal policy is misplaced. Outside-the-box proposals to stimulate economies, such as printing money to finance deficits, are fascinating theoretical exercises. But the message of the job market is that monetary policy is already succeeding. Raising global growth will require fixing productivity, and that's a tougher task than simply opening the monetary and fiscal taps.

Greg Ip – WSJ (3/30/16)

Two earner families are considered the backbone of the American middle class. During the six years through 2014, the number of two-earner families declined, while the number of single earner families increased by 2.6 million and the number of households with no earners increased by nearly 5 million.

Research by the Hamilton Project and the Urban Institute found that when families (with children) making between $20,000 - $50,000 attempt to have a second earner go back to work, the *effective tax rate* on the extra earnings is between 50% and 80% - when you factor in lost benefits.

This phase-out of the ever increasing array of benefits has created a "working-class trap" instead of a "poverty trap"

that is increasing inequality and keeping the income of households lower than they might otherwise be.

Lawrence B. Lindsey, CEO Lindsey Group – WSJ (3/4/16)