ALTERNATIVE PERSPECTIVES

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Z.1 Flow of Funds Analysis

A View Through the Flows of the Economy

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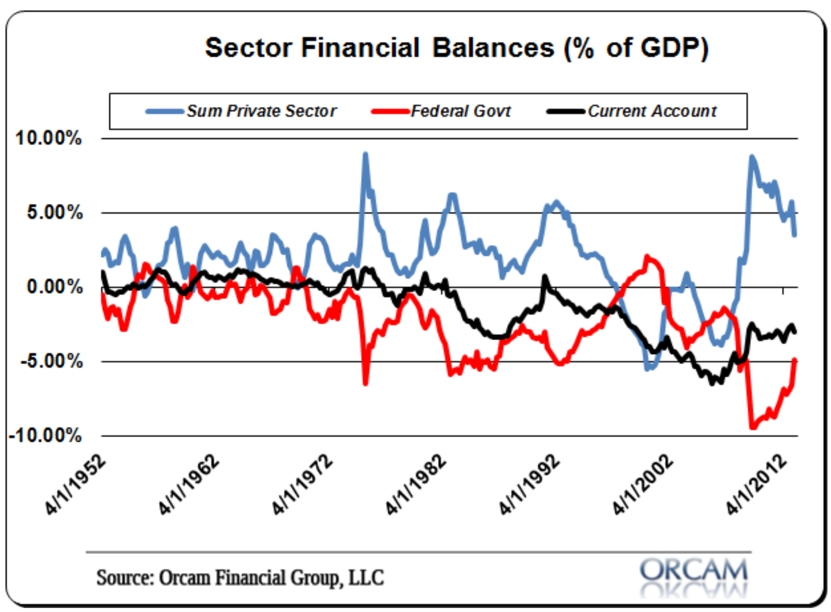
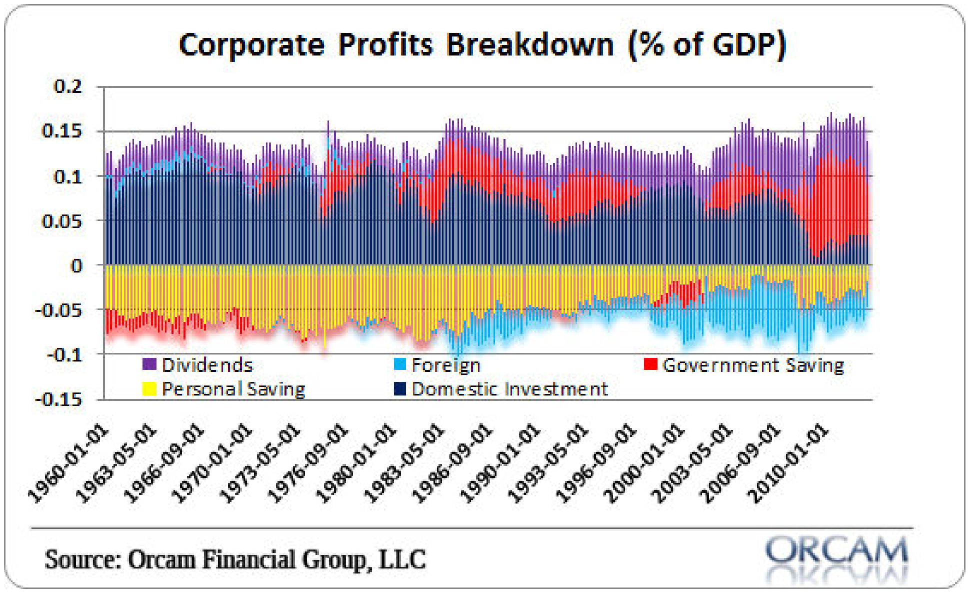
> **"To write it, it took three months; to conceive it three minutes; to collect the data in it all my life."**
>
> **F. Scott Fitzgerald**

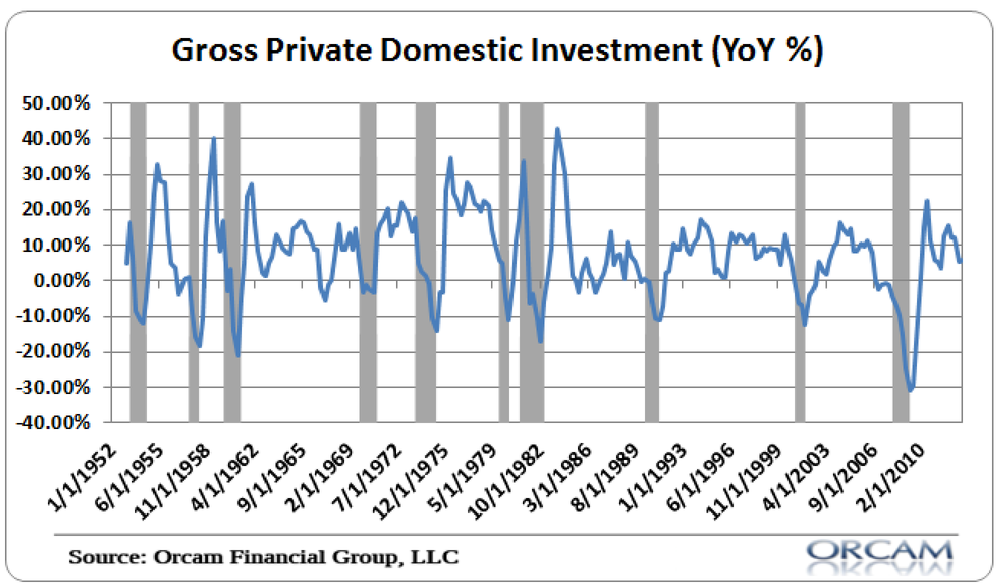
There is no report in the USA that is more important than the Federal Reserve's Z.1 Flow of Funds report. It provides us with the broadest understanding of the flows through the economy and the current state of balance sheets across the spectrum of economic participants. But you won't hear much about it in the mainstream media due to its enormous complexity. In my opinion, this is one of the starting points for a sound macro approach and the only way to properly digest what is currently occurring in the economy. Although it's an ex-post (rear view) look at the economy, it is so all-encompassing in its view that one simply cannot ignore it.



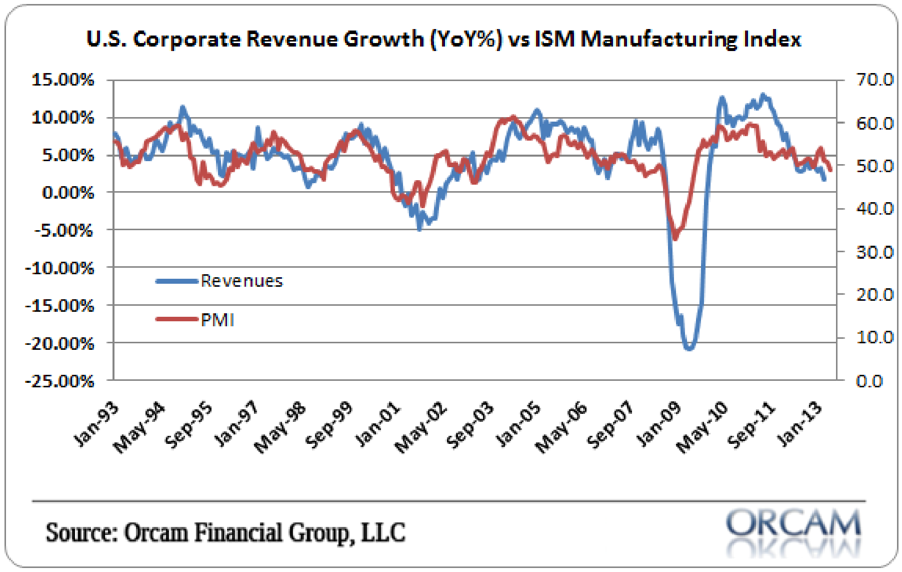
So what is it telling us? The data shows one very strong trend that has developed in the first quarter of the year—the federal government's substantial reduction in spending. As you can see in the chart to the right the federal government's deficit is the non-government's surplus. That is, when the government spends, someone in the non-government is the recipient of that flow of funds. This has been very important in recent years as private investment has declined. Why you ask? If you look at the image to the right we can see the historical breakdown of corporate profits as a % of GDP. We know from basic accounting that **Profits = Investment – Household Savings – Government Savings – Foreign Savings + Dividends.** Historically, profits have been driven by domestic investment. But the housing bust put a massive hole in domestic investment and left consumers exceedingly weak. The result has been a weak recovery in private investment. The main reason why profits have boomed since the bust is because the government has run a massive deficit. That red section in the above chart shows just how important this has been to overall profits. The dark blue section above and the chart below show the growth in private investment. As you can see, the contribution is weaker than it has been historically.



This could be a potential problem for the US economy in the coming quarters. In order for profits to continue expanding and justify higher and higher market prices we need to see some other sector pick up the slack that is being lost from the government's spending.

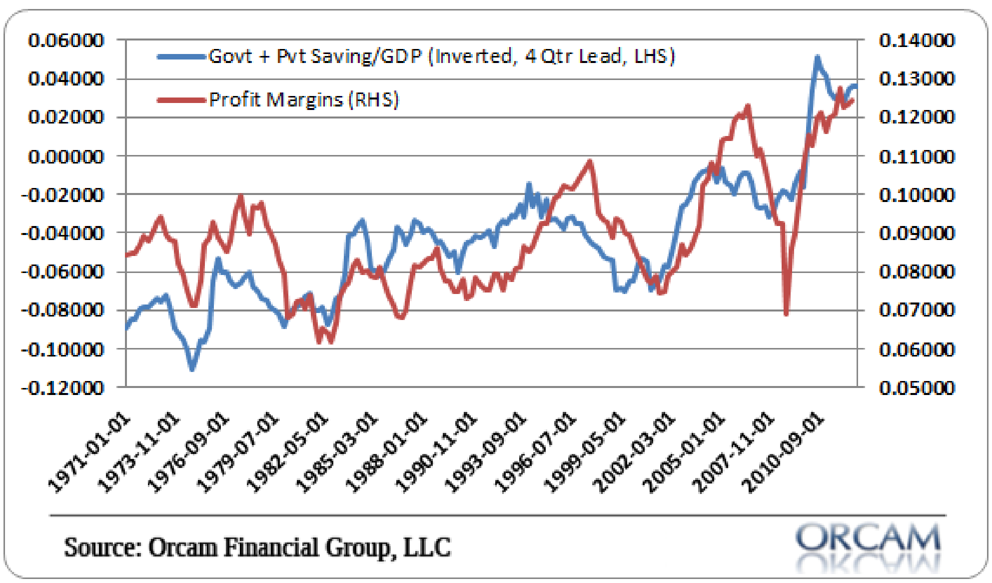


That means we either need to see households save less (take on more debt), dividends expand sharply, the foreign sector to turn closer to a surplus or we need to see private investment and capital expenditures by corporations pick up. Given the pace of change in these sectors it's extremely disconcerting to see the deficit declining as rapidly as it is.



And ultimately, it's all about profits here because profits will steer hiring and hiring will steer the strength of the consumer. If we don't see a pick-up in private investment we're very likely to see profit margins come under pressure. This is also confirmed by the chart above which shows revenues relative to the ISM Manufacturing Index. The trend is very weak. Obviously, profit margins are the difference between sales and expenses so the decline in sales creates a substantial margin risk. Corporations might meet this problem with further cost cuts (layoffs primarily), and that has the potential to create a snowball effect.

In order to further express how important the deficit has been in recent years it's also helpful to look at the government's deficit plus private saving as a percentage of GDP when compared to margins. As you can see in the chart to the left the two mirror each other very closely. This means the expansion in profit margins has been driven by a propensity for households and the government to dissave. If households don't offset the government's lack of spending we'll see that blue line turn sharply south.



Conclusion

This is the power of understanding macroeconomics from such a sophisticated perspective. We can analyze and conceptualize the entire US economy through understanding a few basic and concise understandings. Obviously, these understandings are extremely complex, but when summarized succinctly they tell a very neat little story. And that story is one of downside risk in the profits story.

Of course, that doesn't mean equities are destined to decline from here. We could very well see a greater fool environment develop, we could see further multiple expansion or we could see a boom in private investment or household debt bubble that resembles 2004-7 in many ways. But I would guess that the odds say we're closer to the end of the profit expansion cycle than we are to the beginning and that means the tables are shifting a bit. I wouldn't turn exceedingly defensive here, but I do think we need to monitor this situation very closely in the coming quarters.

I've been very bullish from a core strategic perspective for years now and I am closer to tempering that view than I have been for a long time. If my indicators begin to blink "recession" then we need to be prepared to move to a more cautious positioning. For now, I think the message remains one of balance. Chasing returns and failing to remember that bonds and alternative assets can provide superb hedges against equity risk is something that would be imprudent at this juncture in the cycle. Let's not turn exceedingly fearful just yet, but let's also not forget that this is no time to be chasing the greater fools into an all equity weighting.

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