



Z.1 Flow of Funds Analysis

A View Through the Flows of the Economy

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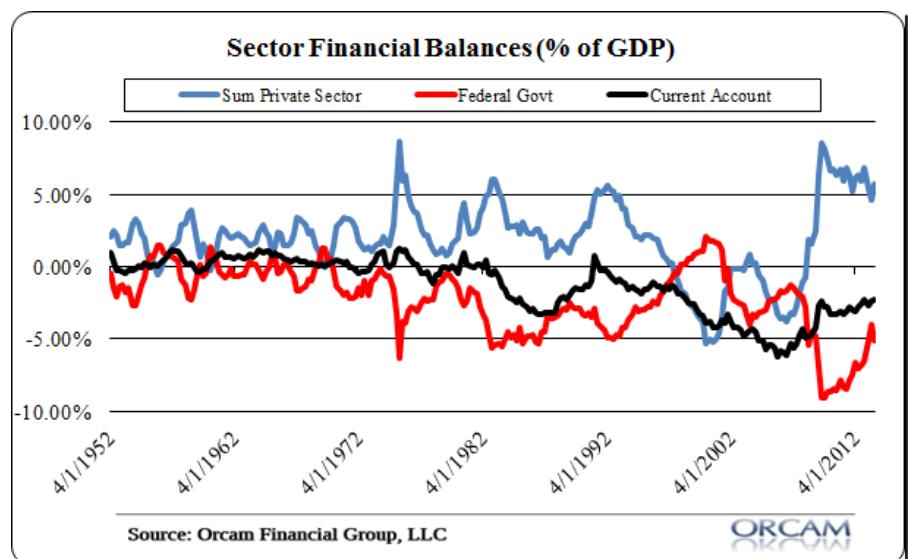
The Federal Reserve's Z.1 Flow of Funds report is among the most important financial documents that is released every quarter. It provides us with one of the most comprehensive macro looks into the economy that we can find. This month's report shed some light on the story of US economy and where we might be headed.

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

F. Scott Fitzgerald

I generally like to look at the global macro picture of the US economy before diving into the more important details. The 3 sector view of the US economy gives us a snapshot of the health of the private sector. As you can see in the chart to the right the US private sector has been running a very healthy surplus as a result of the US government's budget deficit and the improving trade balance.

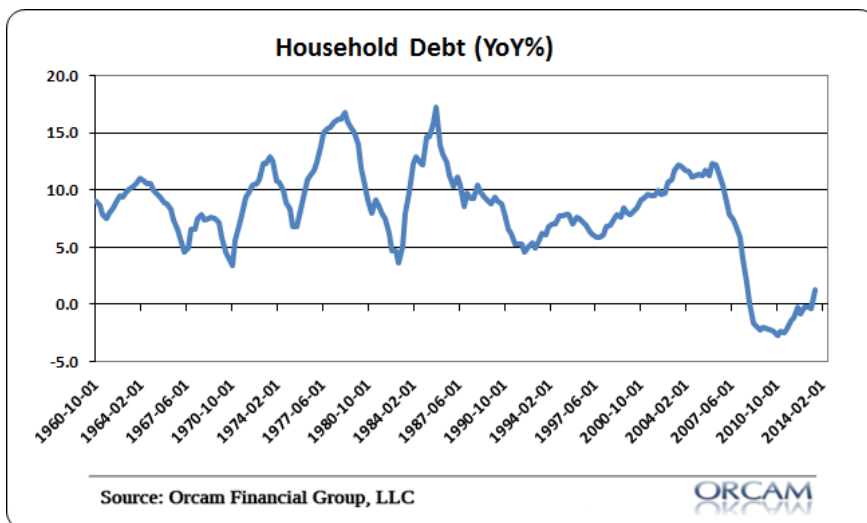
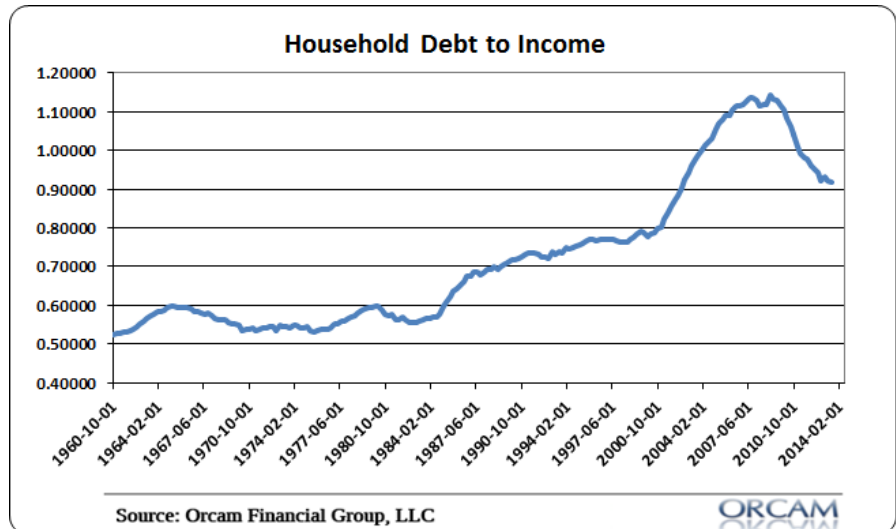
But the 3 sector model doesn't provide us with a comprehensive perspective of the health of the private sector. In order to really understand what's driving the US economy we need to dive deeper.



If we look at just the private sector component of the 3 sector model we can begin to build out a broader understanding of the health of the private sector.

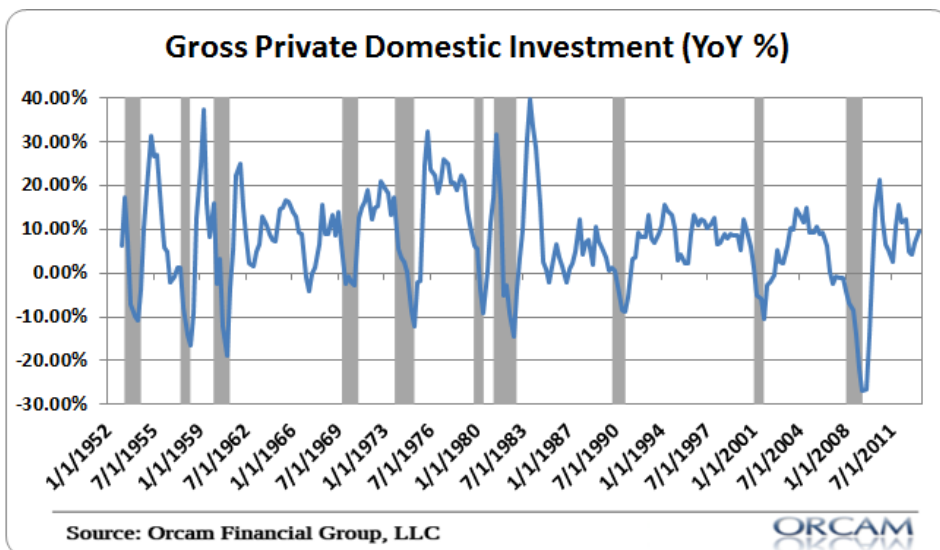
Over the last 5 years the US economy has been mired in a household credit crisis following the housing bubble. The lack

of demand for credit meant that the economy was unusually sluggish as consumers were resistant to taking on debt to finance new expenditures. The government's deficit bolstered households as they underwent this de-leveraging process. As you can see in the chart above the household debt to income ratio has improved substantially in the last 5 years as the de-leveraging has unfolded. This is a good sign.



Most importantly, Q3 2014 showed the first year-over-year increase in household debt since 2008. This is a hugely important shift in the US economy and signifies much healthier household balance sheets than we've seen in recent years.

If we move to the corporate sector we see a bit of a different story. Corporations have been one of the stronger components of the US economy in recent years. Gross private domestic investment has remained robust over the entirety of the recovery. The latest reading just under 10% year over year growth is far from being consistent with a recession and points to a very



healthy corporate sector. The balance sheet of the corporate sector has remained extremely healthy despite the household sector's weakness. This is one reason why US equity markets have been resilient in recent years.



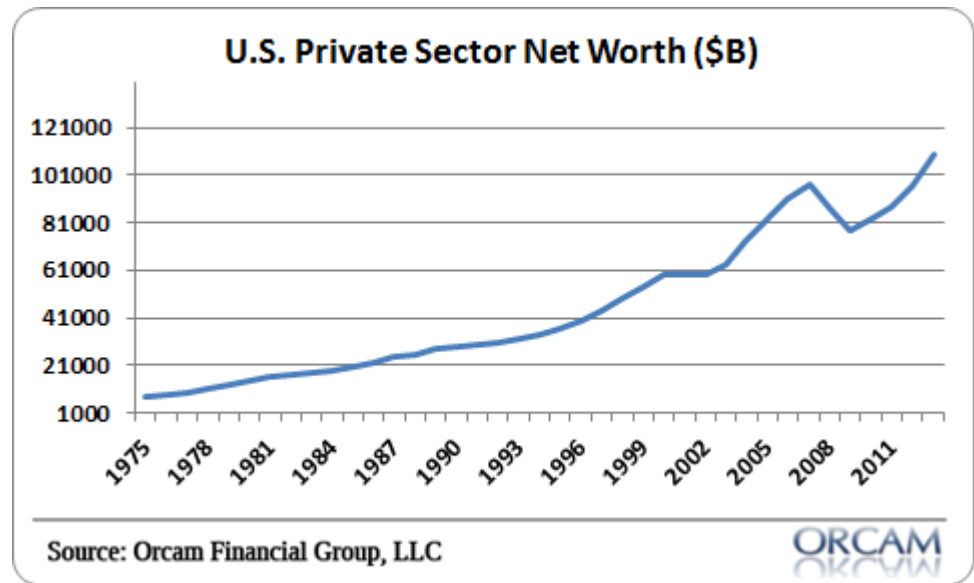
The health of the corporate sector is most obvious in record profits, but can also be seen in the high levels of corporate cash. Corporate cash as a % of GDP is at its highest level in 60 years. If corporations begin to deploy cash as households improve we could begin to see a much stronger economic environment in the coming years. The health

of the corporate sector has been a key component of the US economic recovery and continues to look very healthy.

All of this has driven the broad improvement in the private sector as a whole over the years. The recovery out of the credit crisis has been a long process, but it looks like we've finally turned an important corner and the private sector is really starting to re-leverage now. This is all at a time when private sector net worth has surged to all-time highs and as a result aggregate balance sheets are healthier than they have been in a long-time.

Overall, the Fed's Z.1 report shows that the economy is much healthier than a lot of people think. We've made enormous progress over the last 5 years from a historic crisis. As we enter 2014 I see extremely healthy balance sheets in the corpo-

rate sector and improving balance sheets in the household sector. There's still some work to be done, but we're moving in the right direction. Most importantly, this means the Fed's "tapering" is likely to be less impactful than many presume as the private sector has started to run with the baton and generate the organic growth that it has generally achieved.



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