ALTERNATIVE PERSPECTIVES

Macro Strategy & Research

March 11, 2014

Z.1 Flow of Funds Analysis

A View Through the Flows of the Economy

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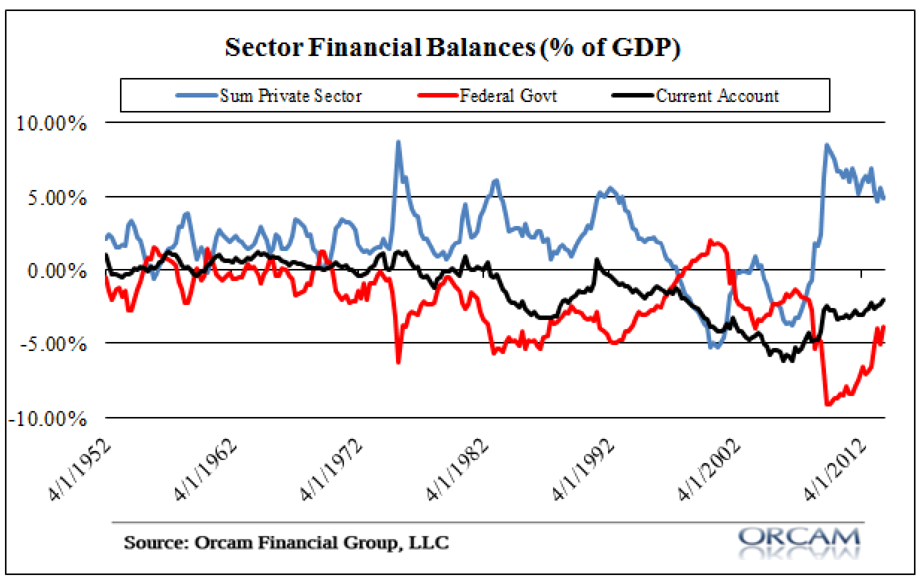
"To write it, it took three months; to conceive it three minutes; to collect the data in it all my life."

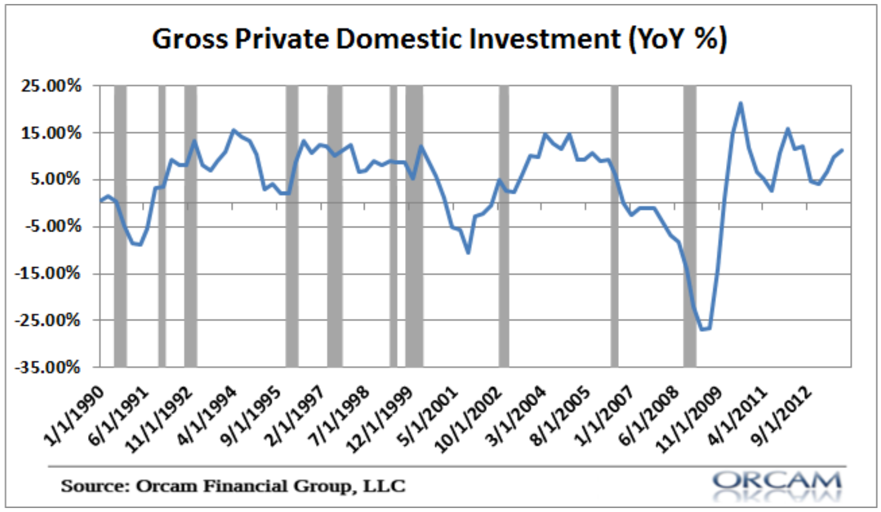
F. Scott Fitzgerald

The Z.1 Flow of Funds report is in for the fourth quarter. This report, issued by the Fed, is one of the most comprehensive views of the economy. And while it's an ex-post (after the fact) view of the state of the economy it provides us with a tremendously helpful look into the state of affairs.

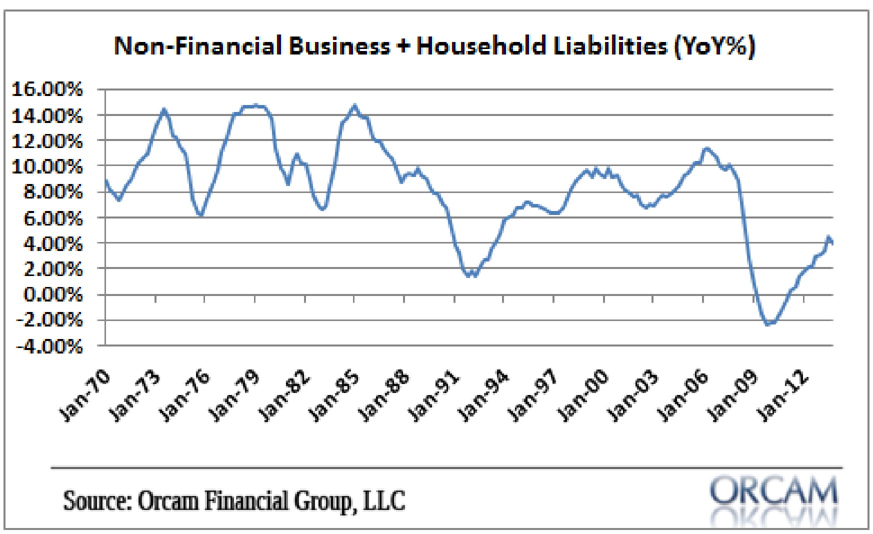
When I review the flow of funds report I always start by looking at the sectoral balances via the 30,000 foot view. The chart at the right shows the 3 sector model with the private sector, government sector and the foreign sector. The USA is a persistent current account deficit nation so that means that the private sector will only be in a net surplus position when the government is in a net deficit position. The size of the private sector's current surplus position is a result of the expansion in the budget deficit which has directly increased the net saving of the private sector.



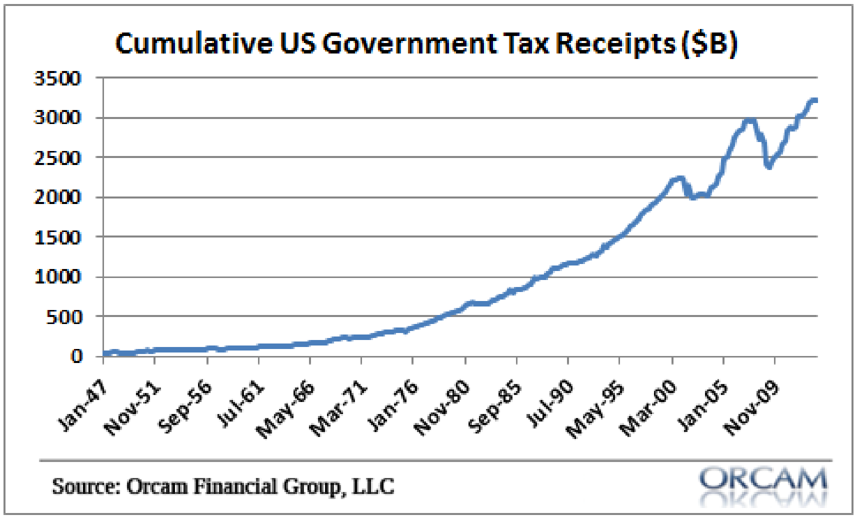
As I have discussed many times before, this government deficit was crucial in providing the income and financial assets to the private sector at a time when it was de-leveraging. But that position has changed quite dramatically in recent quarters as the private sector has started to lever up again.



While the government's deficit is the non-government's surplus, we also have to be mindful of the private sector's position because the vast majority of private sector saving occurs inside of the private sector itself. In particular, the key driver of saving (in both financial and non-financial terms) is domestic investment. As you can see in the chart above domestic investment has grown at a moderately healthy clip in recent quarters. Q4 showed a 11.2% growth rate which was the highest rate of growth since 2012. The state of corporate America is quite strong. And that also happens to be where we've seen most of the re-leveraging come from in recent quarters.

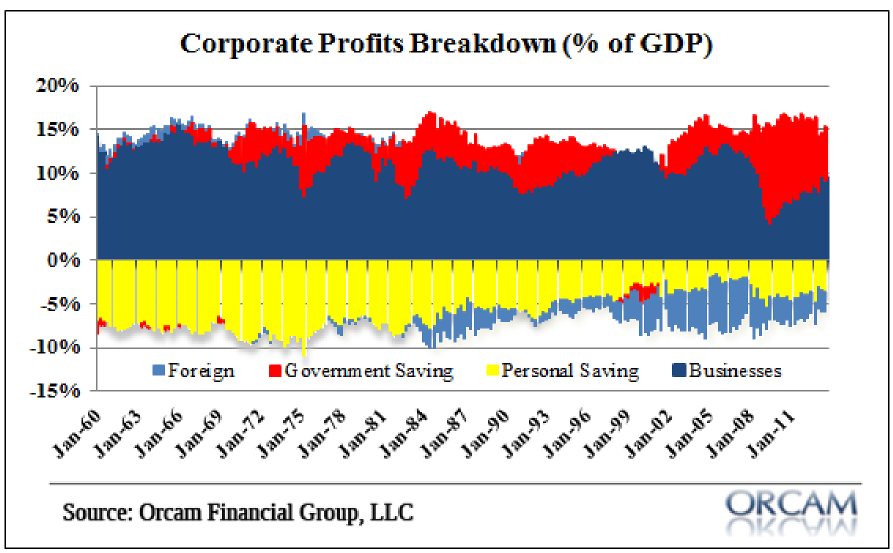


While households have been de-leveraging leading to weak aggregate demand, the government has re-leveraged and corporations have been able to take advantage of low interest rates and high levels of government spending to pad their balance sheets. As a

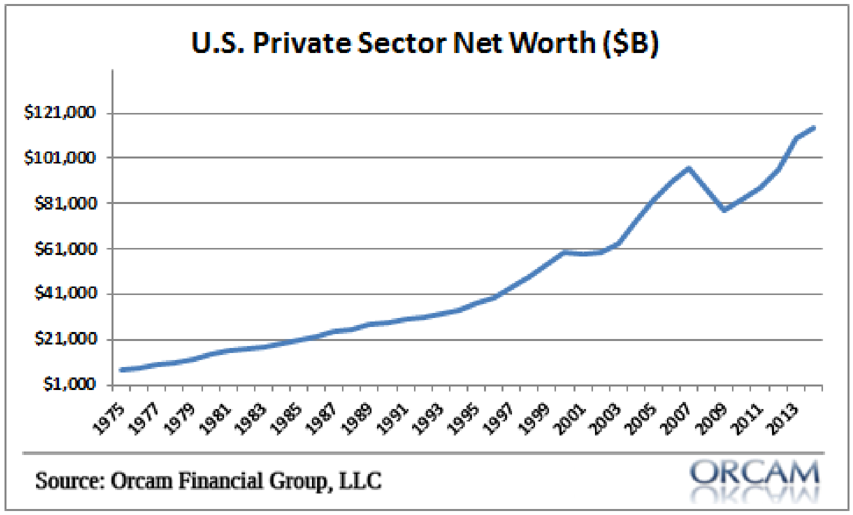


result we've actually seen a fairly modest rate of overall re-leveraging in the private sector. So it's not just the government that is levering up.

And this brings me to one of the more important insights from the Flow of Funds report. If we know that corporate profits are the sum of Investment – Household Savings – Government Savings – Foreign Savings + Dividends, then how come the corporate profit picture has held up in the fact of a declining deficit and deleveraging households? We can again refer to the importance of the private investment picture. After all, historically, private investment has been the key driver of profits and in the last two years, corporations have expanded investment at an average rate of 9.65%. What's even more interesting though is that corporate dividends have expanded by 30%. It might sound counterintuitive to think of dividends as a profit source, but it's important to note that dividends are not accounted for as an expense at the corporate level (because they are distributed profits) and so they flow right to the household level and are either saved or spent. Therefore, dividends add to corporate profits. And when we look at the aggregate level of corporate spending via investment and dividends in the last few years the corporate profits picture begins to make a lot more sense. Indeed, it has been corporations who have mostly picked up the baton and run with it in the last few years.



This can be seen in the chart to the right in the dark blue bars. Clearly, business spending has steered this ship.



The aggregate view of all of this is that the state of the US economy is much better than many would like to think. In fact, corporate America continues to look very strong even if the consumer is still moderately weak. We often think that the consumer drives the economy, but we also neglect the fact that corporations are enormous spenders as well. The result of this is the picture above where US private sector net worth is at an all-time high. Not surprisingly, in an environment where the corporations are strong so too are share prices.

All of this does raise a new concern in the coming years. While I remain cyclically bullish I do think that the next recession is likely to come at the hands of corporate America. That is, when the corporate spending freezes then so too will the economy. So I'll be paying particularly close attention to the drivers of private investment and corporate spending. When we begin to see weakness in that data we'll know that the probability of a tail-risk event is increasingly high, as is the case in all recessions. Stay tuned.