Economic & Market Update, June 2016

The Rise of Donald Trump from an Economic Perspective

By Richard Morey

At Secure Retirement we are officially agnostic from a political perspective. Half of our staff leans Republican while the other half leans towards the Democrats. In reality, we tend to be fairly independent. But as a company we respect the rights of our clients to hold whatever views they prefer.

We are not, however, agnostic when it comes to the economic implications of politics and politicians, and I will tell anyone at any time what I think on this topic. In this report I will attempt to analyze why I believe a candidate as unusual as Donald Trump is the presumptive Republican nominee from a purely economic standpoint.

Many of my Democratic friends would say Trump has arisen because he appeals to racist tendencies in his base. Now history shows that masses of working class people in most nations do tend to be susceptible to attacking other groups when they feel their livelihoods are threatened. I'm not in a position to analyze the race and related social issues, but I certainly can shed light on why so many working class people feel they are economically threatened.

Please note we cannot say how Donald Trump would actually improve the plight of the working class, as he has not given details or anything resembling a comprehensive plan. But his supporters are responding to the basic idea that something is terribly wrong in the U.S. economy and he intends to change it. If you believe the status quo is completely broken, you don't really need all the details to try something different.

The following facts will probably surprise many of our readers. Those who live in Northern California happen to reside in perhaps the most affluent area of the country. Our economy is dominated by technology and, to a lesser extent, biotechnology, which are the two brightest spots in the U.S. economy. The East Coast is also doing fairly well, with Wall Street to Washington D.C. awash in money. The rest of the country, not so much.

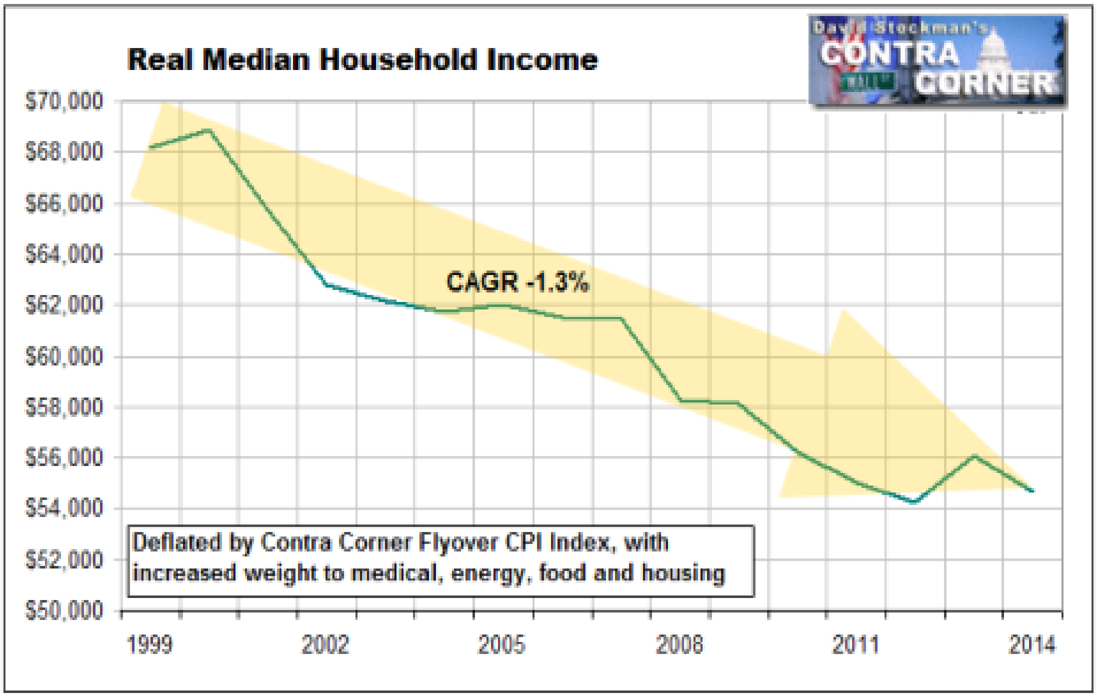
A recent survey from the Federal Reserve asked consumers how they would pay for a $400 emergency. Almost half said they would either have to sell something, borrow it, or that they simply couldn't come up with the money. <u>Almost half of our citizens do not have $400 for an emergency!</u> Another survey showed 62% of our citizens could not cover a $750 expense. In other words, over half of our citizens are basically flat broke.

One reason the media hasn't figured this out yet involves the way government statistics are distorted, specifically inflation. The Fed says inflation is running too low, as it has been averaging just under 2% over the last several years. But this dramatically underestimates the actual rate for middle and lower income people. This is because they spend more of their income (over 65%) on four categories: food, medical, housing and energy. And these four categories have seen price increases of closer to 4% a year since 2000.

KEY TAKEAWAYS

- When we correct for underreported inflation, combined with stagnant wages, over the last 15 years average workers have seen their purchasing power plummet by 20%.
- Businesses are not investing in growing or even maintaining their companies. This reduces worker opportunities.
- To maintain their standard of living, workers have taken on too much debt.
- The end result is that working class voters are fed up with the status quo. Hence their support for Donald Trump (and Bernie Sanders) who promises to upset that apple cart.

When we put in this more accurate figure for the real inflation average workers have suffered, we see in the chart below that wages for non-supervisory workers have been dropping for years. In fact, the real purchasing power of the average worker has dropped by a stunning 20% over the last 15 years.



From an economic perspective, this is why Donald Trump is the Republican nominee. It's also the reason Bernie Sanders has been so competitive on the Democratic side. Working class people are rebelling against the status quo, as it hasn't been static for them but a slow and steady deterioration of their standard of living.

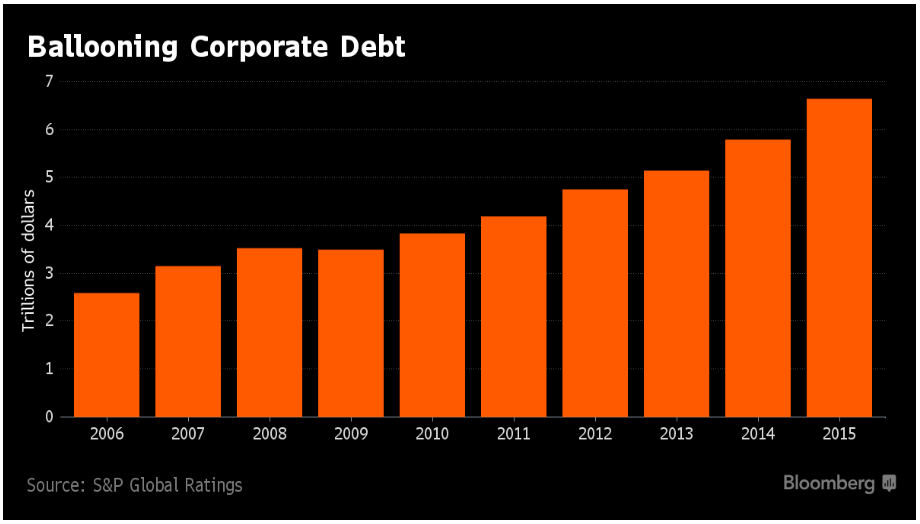
Another way to view this deterioration involves looking at capital expenditures. Workers need their employers to invest money into expanding (or at least maintaining) their companies. Here is what David Stockman wrote upon the release of April's capital expenditure numbers:

"Needless to say, the rate of capital investment profoundly impacts the competitive position of flyover zone workers versus the rest of the world. Yet today's release on April orders and shipments for core manufacturers CapEx (less defense and aircraft) not only documented that this so-called recovery is rolling over; it actually nailed our indictment of Fed policy to the wall.

Orders and shipments are now **down nearly 12% and 10%**, respectively, from their September 2014 cycle high. You can't call double-digit declines evidence of escape velocity. But here is the more startling thing. Manufactures' CapEx today is no higher than it was in the spring of 1999!

Yes, $4 trillion worth of Fed money printing ago (when its balance sheet was less than $500 billion) the monthly rate of capital spending in nominal terms was higher than it is today. And in inflation-adjusted dollars, it has descended into the sub-basement."

Over the last few years corporate America as a whole has not even been investing enough into their businesses to cover depreciation. This means the infrastructure of our businesses is, overall, not only not expanding but is eroding. This is particularly troubling when you consider the next chart which shows that total corporate debt has doubled in the last seven years:



With this explosion of debt, you would expect companies must surely be investing a huge amount into expanding their businesses. However, the total increase in debt is almost identical to the total amount companies have spent buying back their own stock. Instead of expanding their companies, and thereby expanding opportunities for their workers, companies are essentially hollowing out their businesses to enrich their top executives and owners. (From an investment standpoint the fact that approximately 75% of all this new corporate debt has been loaned to companies with shaky finances - i.e. the loans are "junk bonds" - is a very dangerous fact.)

Although the presidential candidates rarely if ever mention debt, in reality there is no way to even begin to address our economic woes without figuring out how to grow without going deeper and deeper into unsustainable debt. Dr. Lacy Hunt of Hoisington Investment Management recently spoke on this topic:

“The traditional business cycle model said that recessions are brought on by rising interest rates and rising inflation. However, when economies are extremely over-indebted, the economies can turn down under the weight of the debt. We’ve seen four recession in Japan in the last seven years with interest rates at zero and inflation negative.”

“Debt becomes very problematic when it does not generate an income stream to replace future interest. Even more problematic is when the debt causes asset prices to rise when corporate profits are falling. Debt can cause a downturn as opposed to inflation and interest rates.”

"With corporate debt rising while companies are in a profit recession, it means the average American is not doing that well. The standard of living is the same as 20 years ago, and I think that’s why people don’t feel good about things.”

This has lead to numerous ills for the country, Hunt said, including "fewer job opportunities, the highest number of people on food stamps in history, and a record percentage of young adults living at home."

“These are all manifestations of the fact that debt has restricted the growth in economic activity and the consequences are very real for many, many households in the country,” Hunt said.

When asked what average investors should do to make it through the downturn, Hunt had one reply: "Stay out of debt."

You will notice I have not even attempted to give solutions to the serious plight of middle and lower income Americans. The reality is that the economic challenges facing our working citizens are extremely complicated and difficult to solve. The problems have been building for several decades by now; if the solutions were obvious or easy they would have already been implemented. This doesn't mean they cannot be solved, as they most assuredly could be. However, I'm fairly skeptical that either political party will understand let alone address these challenges any time soon. But the problems are very real for most of our citizens, and they are beginning to get fed up with their leaders for failing them for so long. Hence we get Donald Trump who promises to upset the economic apple cart.

Economic Update

The U.S. and world economy continue to struggle, having peaked (at a historically low level) in the fall of 2014. The largest surveys of business done each month are called "Purchasing Managers Indexes" or PMIs. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. Below is the summary of the PMIs for May for China, Japan, the Eurozone and the U.S. (A PMI above 50 indicates expansion; below 50 indicates contraction):

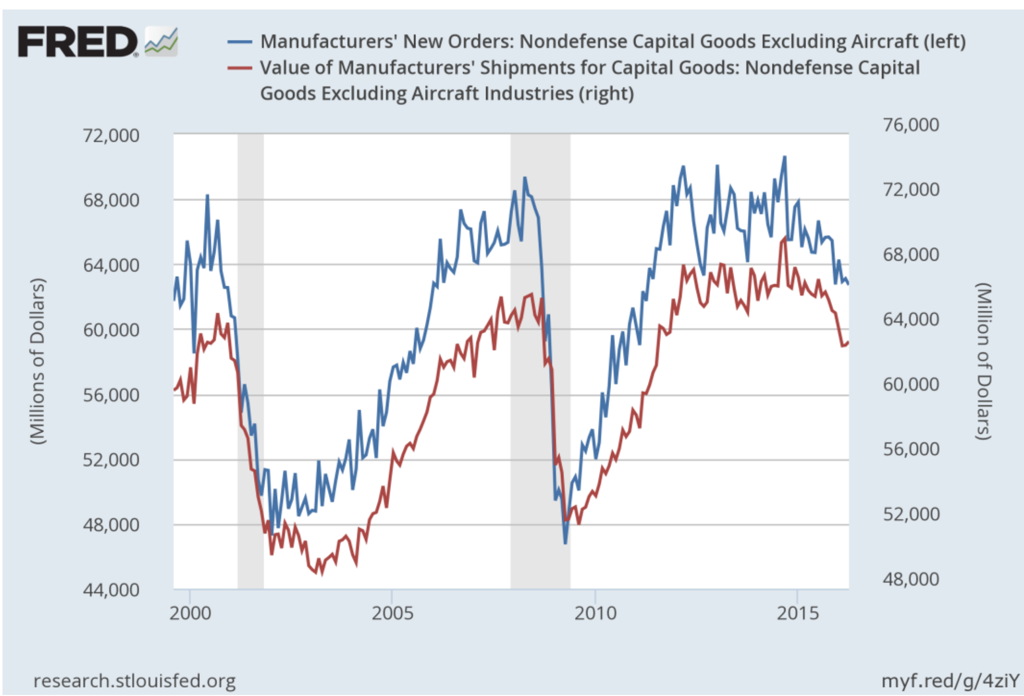
The Caixin Manufacturing PMI in **China** stood at 49.2 in May of 2016, down from 49.4 in April and slightly below market consensus. It was the weakest reading in three months as output fell fractionally while new orders shrank for the first time since February. Job shedding persisted across the sector, with the rate of reduction remaining close to February's post-global financial crisis record. Meanwhile, weak demand conditions underpinned further falls in both purchasing activity and inventory holdings.

The Markit/Nikkei Final **Japan** Manufacturing PMI came in at 47.7 in May of 2016, compared to the flash reading and the final figure in April of 47.6, respectively. It was the fastest decline since January 2013 as output dropped the most in 25 months while new orders contracted at the sharpest pace in 41 months. Meanwhile, new exports orders shrank at the fastest pace since January 2013. Manufacturers cut back on input buying for the third month running while employment remained in growth territory, though at a slower pace.

The final Markit **Eurozone** Manufacturing PMI came in at 51.5 in May of 2016, unchanged from the preliminary estimate and slightly down from 51.7 in April. It is the lowest figure in three months as output eased, new business growth slowed to a 15-month low and employment expanded at a slower pace.

The final Markit **US** Manufacturing PMI came in at 50.7 in May of 2016, slightly up from 50.5 in the preliminary estimate but down from 50.8 in the previous month. **It is the lowest figure since September of 2009 as output fell for the first time in more than 6-1/2-years**, new work expanded at the slowest pace since December last year.

The following chart shows the trajectory of U.S. business new orders(top blue line) and sales (bottom red line). As you can see, both peaked in 2014 and have now fallen fairly sharply:

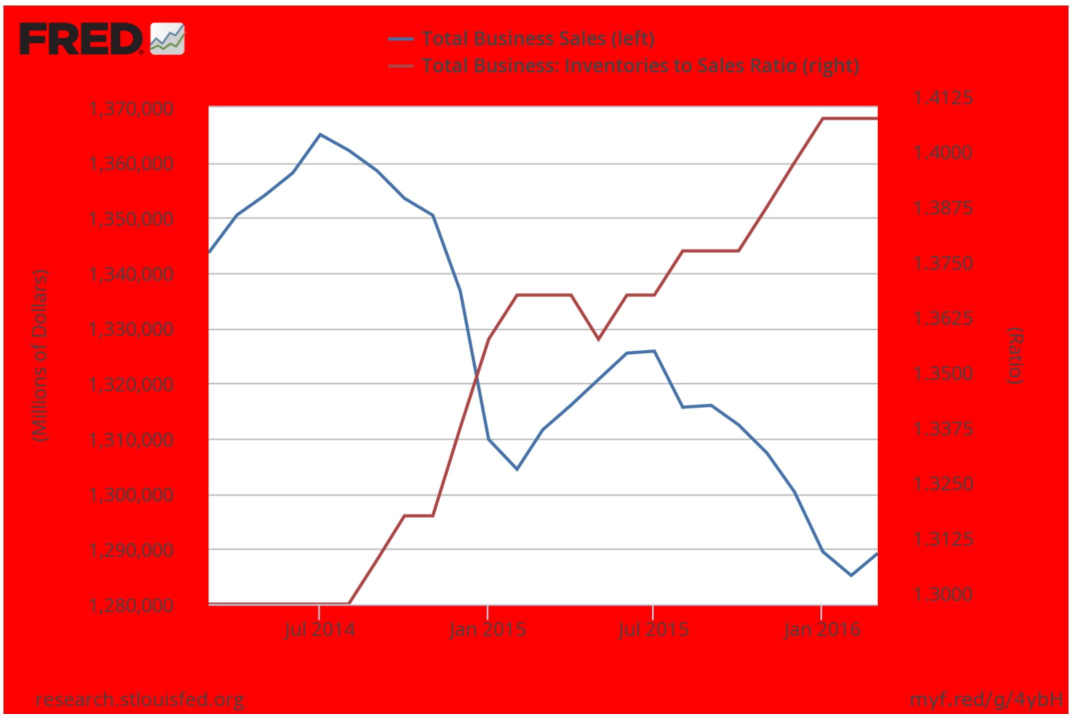


As I was writing this report on May 1, the three following headlines were in the news:

- US Manufacturing Weakest Since 2009: "No Comfort For Those Looking For A Rebound"
- Construction Spending Collapses - Worst April Since 2009
- GM, Ford US Auto Sales Tumble In "Bellwether" Month Of May

The remarkable thing about our economy is that it has been on the edge of recession for so long without tipping clearly to the downside. Normally economies hit "stall speed" when they grow at 2% or below, after which they turn negative. But our economy has basically been stuck around stall speed for the better part of the last six years. While I have not found a sound explanation for this very unusual phenomenon, most likely the overall increase in total debt - even if most went into unproductive purposes like stock buybacks - has seen enough trickle into the real economy to keep our nose just above the water level. Of course, an increase in debt involves pulling spending forward from the future to the present. Then in the future spending must be curtailed to pay down the debt. We have already done this, which means the future must be getting close to the present!

Finally, if you wanted to pick exactly one phenomenon that causes recessions, it would be when business sales drop and inventories of unsold goods rises. The following chart shows business sales have gone down approximately 6% since July of 2014 while unsold inventories have risen 8%. With sales falling, at some point businesses will stop producing more and we will be in recession. Shortly thereafter they will begin laying off workers, and approximately 3-5 months later the Bureau of Labor Statistics will notice the unemployment rate spiking.



Stock & Bond Market Update

The Stock Market

Since next month we will be sending out our detailed quarterly reports, this market update will be brief.

The stock market went down 11% to begin the year but then rebounded and ended May up approximately 3% for the year. That's the good news for stock investors. The bad news is that the stock market has not made anything now in the last 15 months. The very bad news is that corporate earnings have fallen over 18% since the fourth quarter of 2014. With earnings falling while stock prices go sideways, this means stocks are becoming more and more over-priced.

While the financial media usually speak about stock prices based on their analysis (or lack thereof) of earnings, a much more historically accurate measurement is to look at stock prices versus corporate sales or revenue. This is because earnings can be, and are, massively manipulated by companies to make them look better. Sales, on the other hand, are difficult to manipulate without committing a felony. By the end of May, stock prices are now higher relative to sales than at any time in the history of the U.S. stock market.

So basically nothing has changed for the stock market, except corporate earnings continue to fall and corporate debt continues to balloon. While I still cannot predict when, stocks will end up 40-55% lower - just to get back to normal valuations. If I was overweight stocks I would be very concerned as the summer progressed, and downright scared of the arrival of the fall season which is the time most severe stock market declines have occurred.

The Bond Market

May was the first month this year in which the broad U.S. bond market did not rise. However, while the entire bond market went flat, longer-term Treasury bonds actually gained nearly 1% in May. This tells us a lot about the economy and bond markets.

First, the reason bonds cooled off was due to the Fed threatening to raise interest rates in either June or July. This put pressure on shorter-term bonds whose yield and therefore prices are most closely associated with the short-term rates influenced by Fed rate hikes.

Normally the Fed raises rates when the economy is expanding rapidly and they are attempting to slow it down lest inflation get out of control. In this case the opposite is the case, as the economy is clearly slowing down overall. In reality the Fed desperately wants to raise interest rates as soon as possible, before the economy slows down further or enters recession. They need higher rates before it's obvious we're in a recession so they can then lower rates to try to show they are doing something to ameliorate the next downturn.

If this sounds somewhat nonsensical, you are perceiving the situation clearly! The bond market also sees through these Fed machinations. Longer-term bond prices always go down the most when interest rates are going up, yet they went up this month as the Fed said they'll probably raise rates soon. Why? Because the bond market knows the economy is not recovering but is increasingly at risk. Therefore, the Fed will end up lowering rates again, back down to 0%, long before they raise rates enough to drive down long-term bond prices.

Barry Goodman is the lead manager of an excellent mutual fund called Catalyst/Millburn Hedge Strategy Fund. His team uses in-depth quantitative analysis to continuously monitor over 150 stock and bond markets worldwide. Last week he shared that their research currently shows long-term Treasury bonds as the most attractive investment in the entire world. This is our largest investment at Secure Retirement, so we obviously concur.