Economic & Market Update, June 2017

This Time is Different

By Richard Morey

My job requires me to listen to the financial media each day. Over the years, I have noticed the ideas expressed become increasingly irrational as stock market bubbles expand. We hear the same themes every time a bubble is created. A common theme is that stocks really aren't overpriced, as they are going to increase their earnings so much in the next year or two they will look reasonable once we take those huge earnings into account. Then we have the old tried and true approach of taking one positive monthly economic number, out of context, and inferring this shows the entire economy is on solid ground. Another theme is that "this time is different," and the fact stock prices are grossly inflated really isn't a problem because (fill in the blank).

While it truly is never different this time in that overpriced stocks always come tumbling down, one thing is clearly different this time. This is the sad fact that, this time, we can find absolutely no objective facts supporting the idea stocks aren't in a bubble and won't come crashing down.

Right now, the stock market is in one of the two largest bubbles in history. The other was the "dot.com" bubble which burst in 2000. But back in the late 1990s we could at least have made a rational case for stocks continuing to go higher for many more years. Technology companies were creating revolutionary new products, and this was just beginning. Their products and services had the potential to dramatically increase productivity in our economy – one of the absolute keys to long-term economic success. Plus, since many of their products and services were new, we had no way of knowing just how much they might transform the economy in a profitable manner. In other words, you could make the case "this time is different," and stocks which appeared more overvalued than any other time in history would turn out to be reasonably priced as those companies continued to see their earnings skyrocket.

In addition, in the late 1990s the economy was doing well, with no real clouds on the horizon (at least in the United States). And despite the well-known farce of seeing companies with a new web site but no earnings go public and instantly be worth billions, the larger tech companies were incredibly profitable. Each quarter their earnings reports would show massive profit growth, only to be eclipsed the next quarter, and the next.

While one could have made a rational case "this time is different" and the stock market in general, and the tech market in particular, would continue to roar, of course this was monumentally wrong. Before all was said and done, the tech-heavy NASDAQ index crashed down 83% from its all-time high!

Today the situation is quite different, as there is literally no rational justification for this stock market bubble – none. But we'll go through what we're hearing in the financial media attempting the impossible task of proving stocks are not grossly overpriced and will continue to rise forever.

From the election until mid-March the justification involved the "Trump reflation trade." This was the notion the new Trump economic policies would sail through Congress and usher in a golden era of U.S. economic growth. Although we can easily explain why the economy could not possibly expand substantially had all these policies been enacted, from the beginning it was fairly obvious few, if any, of these policies would ever get passed into law by Congress. Everything we have seen since Inauguration Day has proven this thesis to be true.

By April the idea Congress would enact new, sweeping, business-friendly laws was fading fast, so the financial media quickly began to look elsewhere for justification for stock prices. They found three numbers in May which filled the bill. The first was corporate earnings for the first quarter. Through the first quarter, corporate earnings shot up 23% year-over-year. Clearly corporate America has turned the corner into amazing profit growth justifying higher stock prices? Actually, not at all. The earnings growth was largely due to the fact energy company earnings had been decimated when oil prices began to plunge in 2014. Oil was at $107 a barrel in June of 2014 but then collapsed down to $26 a barrel by February of 2016. Since last year oil prices have nearly doubled. So a year ago energy sector earnings were extremely low, and their dramatic rebound by last quarter accounts for most of the overall increase in corporate earnings. But in order to extrapolate this forward we need to assume oil prices are going to double again. Anyone who studies oil markets each day like we do at Secure Retirement knows this is highly, highly unlikely. In fact, we haven't found one expert in oil markets who believes oil prices are poised to rise substantially from here anytime soon.

The corporate earnings growth we saw in the first quarter is an example of taking economic results out of context and then projecting these deceiving ideas forward. Here's what we see in context. For the year (through the first quarter of this year) the S&P 500 earned $111.72 a share. Through the second quarter of **2014**, these same companies earned $111.83 a share. So for the last 2 ¾ years, there has been absolutely no earnings growth. During this time period stocks have risen 25%, and they were severely overpriced back in 2014! We therefore have one question for the financial media: exactly what justifies that 25% stock market increase?

This brings us to the second number being trotted out to show the economy is now just beginning to rebound. In April, industrial production rose 2.2% from the previous April. This number was trumpeted as proof the economy was truly building momentum. Again, not so much. First, industrial production was still down 1.5% from 2 ½ years ago. In fact, it is still below where it was 10 years ago. The small bump up this quarter was due primarily to two sectors. First, the energy sector returned with a vengeance. Again, in order for this to continue we need to see oil prices go up, even though the return to near full production in shale drilling itself is likely to help take prices back down.

Second, over the last year we saw auto production exceeding the exceptionally high level reached over the last 2-3 years. This, however, has already ended, as evidenced by the fact Ford recently announced they are laying off 10% of all their workers. We won't go into detail here, except to note the auto industry (along with the energy sector) has been the largest contributor to economic growth since 2010. But it is falling quickly and looks like it will soon crater. Used car prices are dropping, just as millions of leased vehicles are coming on the market, and used car prices are the barometer for how well new auto sales will go. Ford doesn't lay off 10% of its employees when the future looks rosy.

The third number which was heralded as proof the economy is rebounding was the employment report. For the month of May, the Bureau of Labor Statistics says the economy added 211,000 new jobs. In this report we're not going to tear this number apart, showing how most of the new jobs created were low-paying, part-time "gigs." Instead, we will skip directly to the reality of the employment market. This reality is found at the Social Security Administration where they collect employment taxes. As a result of this collection process, they know fairly precisely how many hours people are working.

It makes no difference to the employment market, whatsoever, how many new jobs are created. Meaning can only be found by looking at how many hours people are working, and how much they are being paid. Since 2010, the U.S. workforce has increased the number of hours worked by **.23%** a year, i.e. less than one-quarter of one percent. For context, from 1965 through 2000 the number of hours worked increased by 1.97% a year.

We have now covered the three items the financial media is touting as "proof" the economy is on solid ground and companies are going to earn so much money their future profits will end up justifying their high prices. Those three numbers are all they have, and all three fall apart with a little context and peeking just under the surface.

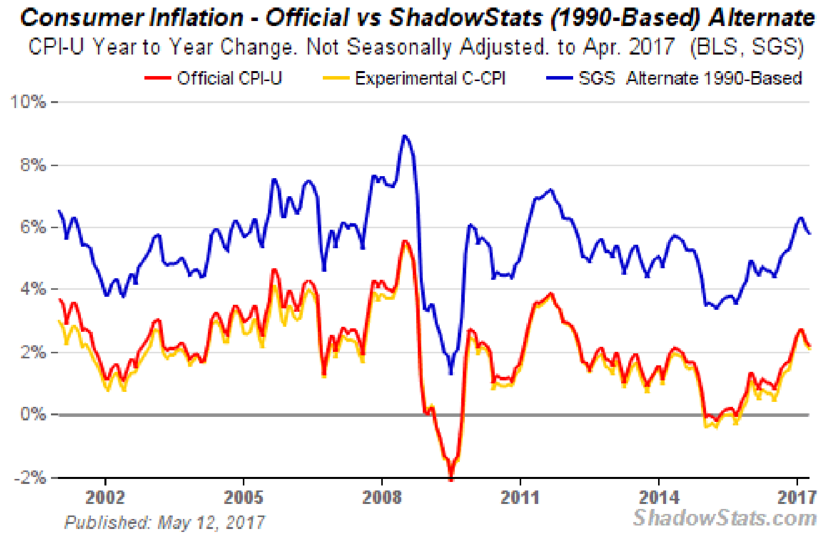
Now let's look at economic and market reality. First, keep in mind our views here in Northern California can end up completely skewed. If I just look around where I live the economy looks somewhere between pretty good and flat-out great. The same could be said for those living in New York City. But the reality is very different for the vast majority of our citizens who do not live in one of the few areas where the economy is truly doing quite well. Here is that picture:

For the nation, according to the Bureau of Economic Analysis, the economy grew 1.6% last year – the lowest since 2009 – and then expanded by only .7% annualized in the first quarter of this year. While our economy is expanding slow enough such that it is now barely distinguishable from recessionary levels and has only grown around 2% a year since 2010, I have been somewhat puzzled by something. The narrative has been the economy has been growing steadily, the employment market is sound, and we're basically on the right track. Yet for the majority of our citizens who don't live in a few select cities the data points towards a no-growth economy and jobs market. For example, a study conducted by the Federal Reserve recently showed 44% of working age adults could not come up with $400 in an emergency. Another survey by CareerBuilder found 75% of all our citizens live paycheck to paycheck at least some of the time. Over a quarter of our *employed* adults do not earn enough to pay their basic expenses like food, shelter and utilities. The problems are worst for young people. According to a recent study by the Pew Research Center, for the first time in more than 130 years, Americans ages 18-34 are more likely to live with their parents than in any other living situation. A full one-third of 18-34 year olds are now living at home. While I'm sure most of these kids do love their parents, I'm even more sure they are not living at home because they prefer to stay in Mom and Dad's basement. They are living there because they cannot find a job paying enough for them to live independently – even with roommates.

Those are shockingly large numbers of our citizens who clearly are not seeing growth in their financial lives. If the economy is growing, even at an anemic average rate of 2% a year, we should not have so many of our citizens falling behind.

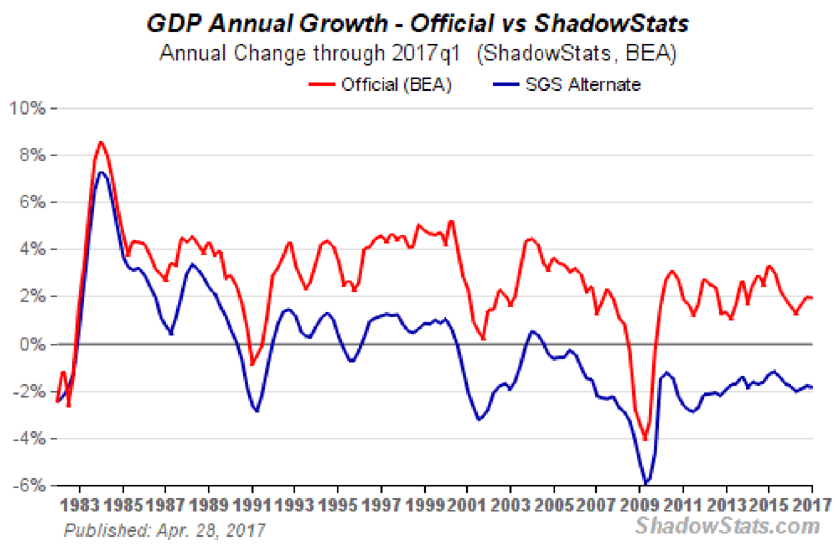
Researching this topic I found a web site called "ShadowStats.com." The site is run by an economist named Walter J. "John" Williams who I have found to be someone who fully and objectively researches his topics. His research on inflation is particularly solid. In the early 1980s the Bureau of Economic Analysis changed how they calculate inflation, then they made additional changes in 1990. Their purpose each time was to lower the inflation figures. This has numerous benefits for the government. First, Social Security and other government pensions are indexed to inflation, meaning recipients receive more money if inflation is higher. The government wants to pay out less, so lower inflation helps government deficits. Secondly, economic or GDP growth is reported after inflation. This means they first calculate the total economic growth, then they subtract the inflation number to get the "real" growth number.

Mr. Williams went back and recalculated inflation based on the calculations the government used in 1990 and compared them to the inflation rates based on today's method. The chart below shows the results. As you can see, the brown line showing current inflation is running at around 2% a year. But the blue line shows inflation is presently at 5.75% based on the 1990 calculations.



This 5.75% number is interesting because it coincides with other independent research I have seen in which middle-class citizens were asked how much they spend on all their basic necessities versus how much they spent the previous year.

What does this mean? The following chart shows GDP or overall economic growth if we simply insert the inflation calculations the government used until 1990 (as GDP is calculated as nominal growth minus inflation). As you can see (the blue line), using the 1990 inflation numbers *the United States has been in recession since late 2004.*



Since 2010 wages have grown at approximately 2.5% a year. But if, due to inflation, consumers have to spend 5.75% more a year to maintain the exact same standard of living, this means they are falling behind by 3.25% a year. This explains the sad data above about 44% of our citizens being unable to come up with $400 in an emergency, three-quarters of our workers living paycheck-to-paycheck, and a third of young adults still living at home. And it definitely explains why consumer debt surpassed its all-time high last month. The fact delinquencies on all this consumer debt are now rising sharply is a bad harbinger of things to come. If you have less money every month and year, after accounting for real inflation, the only way you can maintain your lifestyle is to borrow more money. This is not a picture of a solid, rebounding economy.

The Immediate Future

You can see many signs when we are approaching a recession (though as shown above we never left the last recession if we calculate inflation the way it was done in 1990). Of all the warnings, the single most accurate is the growth of business lending.

Michael Snyder is an economist who has discussed the topic of business lending as *the* number which shows us when we are entering a recession. Here are excerpts from an article he wrote on May 21 entitled ***The Tens of Millions of Forgotten Americans That The U.S. Economy Has Left Behind:***

"Just about everywhere you look, businesses are struggling and stores are shutting down. Yes, there are a few wealthy enclaves where everything seems wonderful for the moment, but for most of the country it seems like the last recession never ended.

In a desperate attempt to stay afloat, a lot of families have been turning to debt to make ends meet. U.S. household debt has just hit a brand new all-time record high of 12.7 trillion dollars, but we are starting to see an alarming rise in auto loan defaults and consumer bankruptcies. This is precisely what we would expect to see if the U.S. economy was moving into another major recession.

In fact, we are seeing all sorts of signs that point to a major economic slowdown right now… Over the past five decades, each time commercial and industrial loan balances at US banks shrank or stalled as companies cut back or as banks tightened their lending standards in reaction to the economy they found themselves in, a recession was either already in progress or would start soon. **There has been no exception since the 1960s. Last time this happened was during the Financial Crisis.**

Now it's happening again – with a 1990/91 recession twist.

Commercial and industrial loans outstanding fell to $2.095 trillion on May 10, according to the Fed's Board of Governors weekly report on Friday. That's down 4.5% from the peak on November 16, 2016. It's below the level of outstanding C&I loans on October 19. **And it marks the 30th week in a row of no growth in C&I loans.**

Perhaps we will be very fortunate and break this pattern that has held up all the way back to the 1960s.

But I wouldn't count on it…

Here's the bottom line: unless there is a sharp rebound in loan growth in the next 3-6 months – whether due to greater demand or easier supply – **this most accurate of leading economic indicators guarantees that a recession is now inevitable**.

We are way overdue for a recession, the hard economic numbers are screaming that one is coming, and the financial markets are absolutely primed for a major crash.

As Americans, we tend to have such short memories. Every time a new financial bubble starts forming, a lot of people out there start behaving as if it can last indefinitely.

But of course no financial bubble is going to last forever. They all burst eventually, and now the biggest one in U.S. history is about to end in spectacular fashion."

The Solution

Yes, there are solutions to our problems. As I have shared in previous reports, GDP or economic growth is actually simple to calculate, as growth can be determined by adding the growth in the number of total hours worked + increases in productivity – inflation.

As we saw above, growth in total hours worked has plummeted down to around ¼ of 1% annually, approximately one-eighth the longer-term growth rate. And this will be difficult to reverse unless we open up our borders and start importing huge numbers of immigrants. Since we can all probably agree this will not happen anytime soon, this leaves us with productivity growth.

Productivity measures how much workers produce in an hour. Like hours worked, productivity growth has dropped dramatically. Solid or normal productivity growth runs at around 3% a year. Since 2010 this has been cut in third, running at 1%. Unfortunately, it has been going down further, and in 2016 productivity actually went negative, dropping .2%. This is a very rare and troubling development.

Without growth in the number of hours worked, growth in productivity is the ***only*** other way for the economy to grow. It is therefore not surprising to see the Fed lamenting over our lack of productivity growth each month, wringing their hands trying to figure out why it is dropping and how to turn it around.

A research firm called *720 Global*, run by the superb economist Michael Lebowitz, published the best article I have ever found on this topic last month, entitled ***The Death of the Virtuous Cycle***. Mr. Lebowitz kindly gave Secure Retirement permission to send this report to our clients, and we have included this article with this month's report. In summary, this article pinpoints the cause of our productivity problem, which is the fact we are not saving enough money and businesses are not investing sufficiently into their companies to increase productivity. He then explains the governmental actions which could address this problem. Unfortunately, he also describes how and why our government's current actions are not only not helping but are exacerbating the problems.

Summary

Despite the financial media's constant declarations the economy and corporate earnings are now ready to take off, not one single point they make withstands even the most basic scrutiny. They are completely wrong. Instead of finally turning the corner towards solid, sustainable growth, the next fork in the road leads to a dead end, i.e. recession. Before the public is told we are in another recession, the stock market will already be dropping. Based on every single measure of stock valuations that has shown a correlation with subsequent moves of over .90, the stock market is *basically guaranteed* to end up at least 40-50% lower than it is today. A 50% crash in stock prices would actually not make stocks cheap, as this level of losses would be required to get stocks just back to average valuations. We would have to see a drop of approximately 60% for stocks to be even modestly undervalued. Given the truly historic risks we see today all around the world, I am afraid (for the vast majority of investors) the market has as good a chance of losing 60% as it does losing "only" 40%. Very hard times are waiting for investors. Although we still cannot even guess what will kick it off, or when it will begin, every day brings us one day closer to that inevitable outcome. And signs the end is approaching keep getting more pronounced each week.

You may have noticed I did not even mention the word "bond" in this report, even though the majority of our investments are now in high-quality bonds. But there is little need to delve into the bond market in this discussion, as every single point made will drive longer-term, safe bond prices higher. Given the severity of both the economic problems and the stock market bubble, we are fairly sure our clients will end up, to say the least, surprised at how much our accounts go up as this unfolds. Surprised, but quite pleased.