Economic & Market Update, May 2016

Objectivity

By Richard Morey

The Economy

This month we'll first take a quick look at the U.S. economy from a purely objective standpoint, using data solely taken from government agencies. Employment is continually brought up as the proof our economy is doing fairly well. According to the Bureau of Labor Statistics (BLS), the U.S. economy has added approximately 14 million new jobs since the bottom of the last recession. This is also the number our current administration touts as proof the U.S. economy is doing well.

There are two problems with this view. First, since 2009 the population of the U.S. has grown by 16.5 million people – according to data from the Bureau of Labor Statistics. For many decades, at least 66% of those people would have jobs, meaning 11 million of the 14 million new jobs presumably went to people who immigrated to the United States. This leaves 3 million new jobs for people who were here in 2009.

Unfortunately this is probably not correct. There is a little known – or at least discussed – aspect of the BLS employment report called the "birth-death adjustment." This is a monthly guess the BLS makes as to the number of new employees who were hired by new businesses, minus the number of employees who lost their jobs as companies went out of business. I say it's a guess, because nobody at the BLS talks to any of these businesses or employees; they simply pull a number out of thin air and add it to the number of new jobs. I know this sounds irrational, but this is exactly what they do. For the last 7 years the BLS has been adding an average of over 50,000 new jobs from these alleged new businesses hiring people.

Fortunately we do not have to guess as to the real number. The Gallup company did a study as to how many businesses were starting versus quitting last year. Here is what their CEO said regarding the results of this study:

"We are behind in starting new firms per capita, and this is our single most serious economic problem. Yet it seems like a secret. You never see it mentioned in the media, nor hear from a politician that, for the first time in 35 years, American business deaths now outnumber business births.

The U.S. Census Bureau reports that the total number of new business startups and business closures per year — the birth and death rates of American companies — have crossed for the first time since the measurement began. I am referring to employer businesses, those with one or more employees, the real engines of economic growth. Four hundred thousand new businesses are being born annually nationwide, while 470,000 per year are dying."

KEY TAKEAWAYS

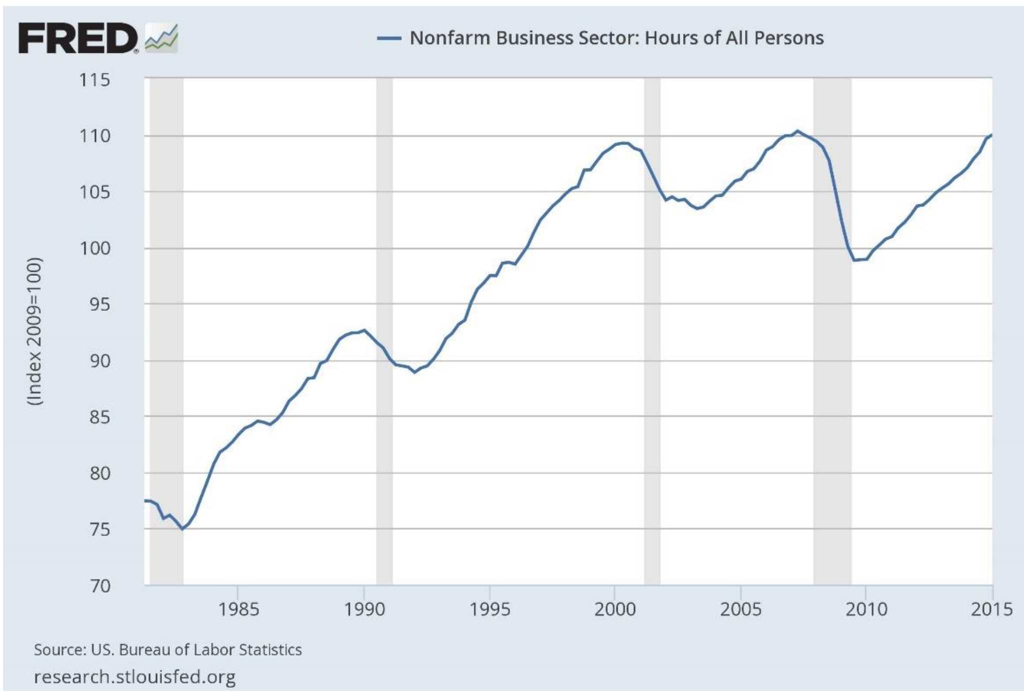
- The employment numbers reported each month by BLS (Bureau of Labor Statistics) do not add up to the "thriving" employment picture the government would like us to believe.
- The number of 14 million new jobs since 2009 is not that healthy when accounting for the 16.5 million population increase in the same time period. Historically, 11 million of those 14 million jobs would be absorbed by those new people.
- New jobs "created" since the 2009 time period have paid workers less, with many part-time vs. full-time employment (51% of U.S. workers earn under $30,000 per year).
- The economy is anemic-GDP (Gross Domestic Product) was 0.5% for the 1st Quarter of 2016 (normal growth measured at 3-3.5%).

TAKEAWAY: THE NEXT TIME YOU HEAR OR READ ABOUT THE U.S. EMPLOYMENT SITUATION OR OVERALL ECONOMIC HEALTH, PLEASE REMEMBER TO GET THE FULL STORY.

At an average of 50,000 new jobs claimed per month for seven years, this comes to 4.2 million jobs the BLS has said have been created by new companies – minus those who lost jobs from failed companies. But the only extensive study on this topic showed this number should be something less than zero new jobs.

If we subtract 4.2 million from the 3 million new jobs above, we see the total number of new jobs for people who were living in the United States in 2009 is not only not 14 million, it is a loss of 800,000 jobs. That is the objective view on our employment picture.

But once again, I am afraid it gets worse. According to the BLS, if you look at the actual number of hours worked instead of the number of alleged jobs, we see that from the year 2000 through 2015 the number of total hours worked in the United States has only grown by 1%! This fact is so mind-boggling I had to see it to believe it, but below is the chart from the Bureau of Labor Statistics:



During this time the population increased by 38 million people (according to the Census Bureau) and basically no more hours are being worked?! I would imagine our readers may now begin to understand why it bothers me so much when I hear people in the media talk so often about how the employment picture is such a bright spot in the U.S. economy, while I (and the objective data) have instead called it a disaster.

Finally, let's look briefly at the wages and salaries employees are receiving. According to the BLS, wages and salaries increased by 2.3% year-over-year in March. While hardly stellar, this does not tell the full picture, as salary increases for the highest paid employees have been increasing strongly while the wages for middle and lower-income workers has stagnated. In fact, since 2009 the income of the average U.S. worker has fallen when adjusted for even the modest inflation we have had. One of the most stunning statistics is that 51% of our workers now make less than $30,000 a year (from Social Security Administration data). Wage and salary growth has basically flat-lined for the last four years at 2%, which is approximately 40% lower than it averaged before 2008.

Turning from employment to the overall health of the economy, the broadest measure of the economy is Gross Domestic Product or GDP. According to the Bureau of Economic Analysis (BEA), in the first quarter of this year the economy expanded by only one-half of one percent. The growth rate fell every quarter last year.

Now economic growth of ½% is obviously quite low, but the BEA could also report GDP on a per capita basis, measuring how much the economy is expanding per person. This would account for population growth. This statistic shows the economy shrank in the first quarter, dropping .3%. So while the average citizen's share of the pie has indeed now begun to shrink, the picture is much bleaker for the 37% of the population that rents instead of owns their own home. This is due to the fact that GDP is adjusted for inflation. While prices of many things have not been rising much recently, rents have been going up dramatically. Since rent is the largest expense for these households, their share of the economic pie is shrinking dramatically.

Summary

Despite these seriously worrying trends in our economy, there is still no "smoking gun" proving we are either already in or assured to soon enter the next recession. There is certainly a relatively high probability 2016 will go down as the year we re-entered formal recession, but the economy may instead continue to just barely grow. It is not growing enough to account for population growth, but it might expand enough to avoid a technical recession. Still, from the standpoint of over half of our citizens we are already in a recession.

The Stock Market

In some respects last month was one of the strangest months I have ever seen for the stock market. On the surface this sounds odd, as the U.S. stock market barely moved in April and has now made approximately 1% so far this year. The strange phenomenon involved corporate earnings. Most companies reported their earnings in April, and compared to April of 2015 they fell nearly 10%. Further, this was the sixth quarter in a row in which actual corporate earnings (according to Generally Accepted Accounting Principles or GAAP accounting) dropped.

When you consider that stocks began this quarter more over-valued than at any time in history other than at the end of the dot.com bubble in 2000 (depending on how you do this analysis, though every valid analysis shows the years 1929, 2000, 2007 and right now are the most over-priced periods in the history of our stock market), rapidly falling earnings should be the "death knell" for stocks. This is particularly the case when you consider the drop in earnings has now been accelerating quarterly since the end of 2014.

Now history and reality says stocks in a severely over-priced market experience dramatic losses when earnings tumble. They did not do so in April for several alleged reasons.

1) Corporations continued to borrow massive amounts of money to buy back their own stock. This is indeed a "valid" reason as to why stocks go up, as the corporations doing the buying don't care how much they pay. In fact, the higher the price goes as they are buying the happier they are, as a primary reason a company borrows money to buy back stock is to enrich their top executives whose compensation is directly determined by how high the stock price is.

   We have discussed this topic in the past so I won't go into details here. Suffice it to say this lasts until the spigot is suddenly turned off. At some point lenders will decide it is not prudent to lend companies money to back stock. Recent government reports on lending indicate this may have begun in the first quarter.

2) In January and February investors were deeply concerned about China. After years of an historic increase in debt, their economy has slowed down dramatically. This is inevitable whenever you try to slow the creation of new debt and is particularly inevitable when you also have an overhang of bad debt from the past binge. But it almost appeared as if the Chinese leaders realized they would be wise to stop piling more debt onto their mountain of bad debt.

Then in the first quarter they decided to take the opposite approach, with debt exploding by nearly a trillion dollars in three months – the largest quarterly figure ever. They borrowed to buy massive amounts of oil and other commodities, to pump more money into real estate development, and who knows where else all this new money went (foreign real estate comes to mind)? This was surely the reason stocks began to rebound in February and have not yet gone back down.

However, on the first day of May we received the early results from their debt extravaganza, and it's not pretty. Both their manufacturing sector, services sector, and imports and exports continue to either decline or stagnate. And now they have another $1 trillion of new debt weighing them down going forward.

3) Finally, investors remained at least semi-convinced the Fed will protect them from stock losses. In April the market decided the Fed probably won't raise interest rates until December – if then. The Fed's favorite measure of inflation dropped back below 1% in March, so they clearly have cover to avoid raising rates until further notice.

   Investors clearly believe ultra-low interest rates means stock prices cannot go down. While this will indeed remain true for as long as enough people believe it to be so, history certainly does not support this notion. Over the last 100 years the correlation between the Fed funds rate and stock prices is essentially zero. And yes, we have had time periods in which interest rates were similar to today, and stocks did not do well.

The Bond Market

Similar to the stock market, bonds did not do much in April, ending slightly higher than they began. The bond market's performance thus far in 2016 has been impressive. It shot up in January and early February as stocks fell, which was to be expected. Perhaps more impressive is that they have continued to rise overall, albeit much more slowly, as stocks have rebounded. Bonds went down modestly in early March and late April but then rebounded each time soon thereafter.

Right now we have a near ideal situation for high-quality U.S. bonds. The economy has ground back down to a halt, the Fed's favorite inflation measure is falling, and the recent lull in concerns about global economic and market risk is highly unlikely to continue.

Timing

Long ago we gave up attempting to guess when the stock market will go down anywhere close to its fair value. However, we do know that, based on their current prices and earnings, stocks would have to fall approximately 50% to be around fair value from an historic perspective. We also know the relationship between stock prices and corporate revenues and profits always has, and always will, eventually reassert itself.

We are also nearly as certain our accounts at Secure Retirement are positioned to perform better than we originally anticipated whenever stocks fall and risk strikes the economy and markets.

So with the caveat that this is simply a guess, I hereby predict this summer is highly likely to be a difficult time for the stock market. Yes, central banks probably have a few more insanely dangerous things they can and likely will attempt to keep reality at bay. But I think an increasing number of investors, and I know a quickly escalating number of analysts in the financial media, are beginning to question the efficacy of central bank experiments. This certainly makes sense given the undeniable fact they have not actually worked year after year.