Economic & Market Update, May 2017

It's Not the Economy, Stupid!

By Richard Morey

The U.S. Economy

For the first quarter, the Bureau of Economic Analysis reported our economy (GDP) grew 0.7% annualized. After growing only 1.6% in 2016, it appears the economy has slowed further. In fact, for the last 6 quarters economic growth has averaged only 1.55%. As usual, even this does not tell the full story of our difficulties, as GDP is not adjusted for population. While the population grew at the smallest rate since 1937 last year, it did increase .7%. This means approximately half of the growth we've seeing in GDP can be largely explained by a growing population.

Some of the largest concerns involve areas which had previously been a few of the fastest growing areas of the economy. Auto sales have been the brightest spot in our economy since 2010. But over the last 12 months sales have dropped 5%, while the default rate on the barrage of sub-prime auto loans given out in recent years is spiking. From 2010-2014 the employment numbers were massively boosted by two categories: retail workers and restaurant/bar employees. The restaurant industry is now in recession, with both traffic and revenue going negative. On the retail front, so far this year 2,880 retail stores have closed, a faster rate of closures than we had in 2008. And the number of additional retailers threatening or expected to declare bankruptcy keeps increasing.

As we hear all the time, consumer spending equals 70% of our economy. With wages stuck at near no growth while several key expenses such as rent and healthcare keep rising much faster than the published inflation numbers, consumers continue to fall behind. As a result, credit card debt has continued to expand, reaching beyond the $1 trillion mark first "accomplished" in 2007. More worrisome is the fact late payments and delinquencies on credit card debt are beginning to rise quickly.

Last year the economy grew at its slowest pace since 2009. In fact, in nominal (non inflation-adjusted) terms the economy was below the points reached in the 1990-1991 and 2000-2002 recessions. In other words, the only reason the economy was not officially declared a recession last year was that the government measured inflation to be unusually low. Looking at all of the data (except measures of optimism related to the new administration), the economy is weak and getting weaker.

The Stock Market

Clearly the stock market has not gotten the memo about the economy. There is an old saying I've probably heard a thousand times which says the stock market hates uncertainty. Since the election surveys of economic uncertainty have been the highest ever recorded, yet the market has apparently decided uncertainty is now a good thing?

The strangest example of this phenomenon involves the South Korean stock market. Anyone paying attention to the news knows there is a not-insignificant chance the U.S. may attack North Korea at any time. Should we do so, there is a reasonable chance North Korea will retaliate. Their first target would be to obliterate Seoul, the capital of South Korea. So in the face of a nearly unimaginable risk to their very existence, and obviously their economy, their stock market has been going up? How much would their stocks be worth if North Korea turned their corporations' facilities into rubble?

Here in the United States our situation is not as dire, but on what basis are stocks rising? The economy has slowed down below 1% annualized growth, while corporate earnings have fallen back to where they were at the end of 2011 to early 2012. Corporate revenues are even worse.

There are three primary answers to this the question as to why stocks have continued to rise:

1) The first answer for a long time has been central banks and their quantitative easing (money printing), along with zero percent interest rates. But here in the U.S. the Fed is now doing the opposite. The same

is not true, however, for the rest of the world. In the first quarter the Bank of Japan, European Central Bank and Bank of England printed another $1 trillion, while China created another $1 trillion in new debt. At the end of the day, there is a very good chance this is the real reason why stocks have continued to rise here in the U.S., as in our interconnected world economy, a trillion dollars printed in one place tends to spill all over the world.

Assuming this is correct, stock investors should be more than a little concerned at how quickly the Chinese authorities appear to be pulling back now on additional debt creation. They have a new man in charge of this effort to reduce their debts, and he appears to be much more serious than his predecessors.

2) The second answer involves all the economic optimism we've heard about since the election. Surveys of both businesses and consumers' views on the economy have all shot straight up. This has noticeably not, at least yet, had any impact on their spending and investing plans.

   The first problem with all the optimism about the economy based on new pro-business legislation from the Trump administration is that none of the legislation has been passed. A second problem is there is a good chance none of it will ever pass. The final problem is you cannot create economic growth with massive amounts of new government debt when one of the largest problems holding growth back is the fact you have far too much debt.

   If everything President Trump has said he wants passed were enacted into law, the government debt would increase approximately $10 trillion over the next decade. This is on top of the $10 trillion the deficit is expected to increase if not one new penny is added to the current trajectory, and the $20 trillion of debt we already have today. That's $40 trillion of government debt in 10 years, or over 200% of GDP! Keep in mind anything over 75% debt to GDP basically guarantees economic stagnation - at best. And there are some absurdly rosy scenarios built into those numbers, i.e. the reality is almost certainly to be even larger debts. Finally, the baby boom generation is retiring at a rate of 10,000 persons *per day*. This trend will go through 2029 meaning we will then be facing by far the largest crisis regarding debt in our nation's history, as we will be looking at tens of trillions of additional debt due to Medicare and Social Security for all the retirees. In other words, we desperately need to figure out how to begin dramatically reducing our government debt right now, not planning to double it over the next decade. Actually we should have done this 16 years ago, first with the Bush and then the Obama administrations.

   This debt "bomb" is the likely reason none of the Trump stimulus/tax plans will ever actually occur. While the Republican leadership would be happy to spend our way into oblivion, the House Freedom Caucus consisting of 30-40 Republicans (membership is essentially anonymous) have spent the last 8 years promising their constituents they were going to stop the government from creating more debt. Without them, the Republicans would need Democratic votes to pass anything. While the Democrats as a group would also be happy to increase our debts trillions more, they will not vote for anything Donald Trump wants done.

3) Investor Fear of Being Left Behind

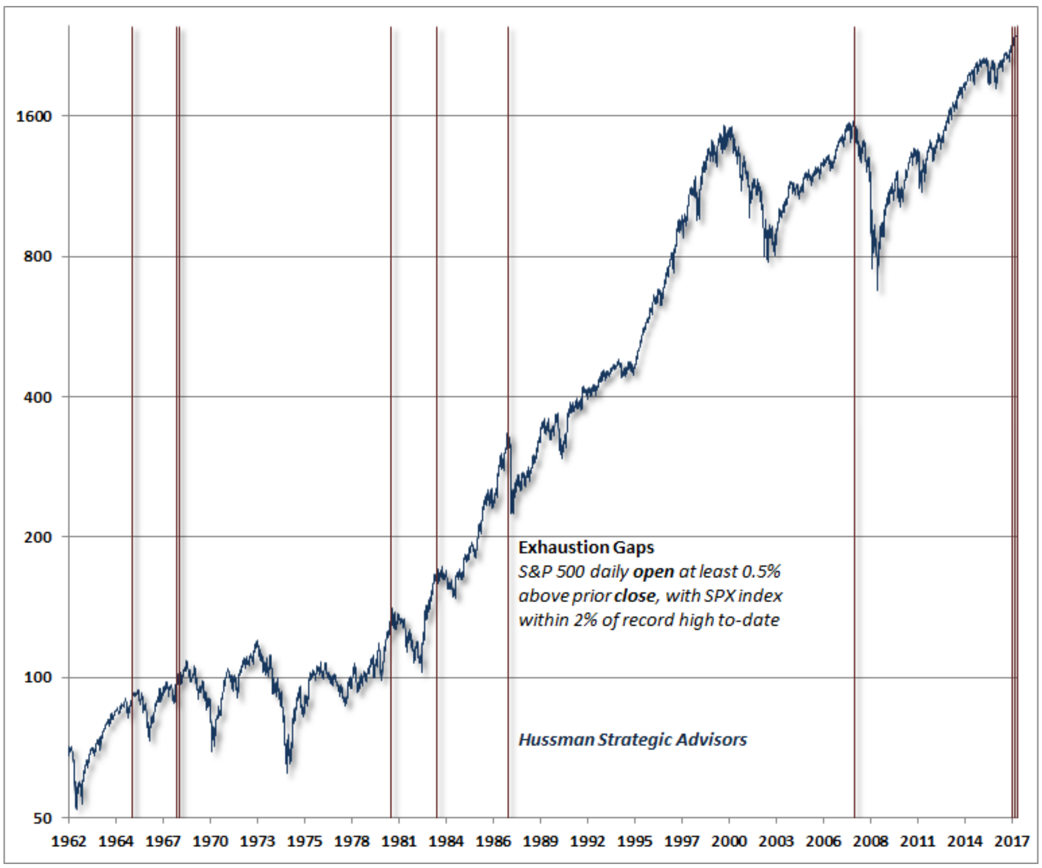
   It appears we are now entering the stage in which investors throw out the last shred of rationality regarding the stock market, with fear of missing out trumping any and all objective facts. We are seeing signs of this daily as companies announce their quarterly "earnings." Unfortunately the financial media is actively aiding and abetting the poor investors who have now decided it's finally time to go into stocks before they miss out on the never-ending gains they are guaranteed to receive.

   I could go through dozens of corporate earnings reports to highlight how absurd the market has become, but Twitter really summarizes the situation we find ourselves in today. Twitter recently announced their first quarter earnings. They added millions of new users but their revenue dropped 8% year-over-year. This is the worst possible combination, as more users means more expenses while lower revenue means even more losses. However, Twitter's report showed their "earnings" were far higher than expected, and their stock ended the day up 8%.

But in reality they had no earnings, as they once again lost money. Their great earnings were due to excluding a list of major expenses. They even subtracted the interest on their loans before announcing their earnings, as if their debt is going to magically disappear someday.

So a company which has always been losing money sees their sales drop by 8% in a year *at the height of their popularity*, and their stock goes up? That's crazy, yet it is only one of many such examples we have seen this quarter. These are typically signs the end for a stock market bubble is approaching.

Looking at the broad U.S. stock market, last week we saw something which has only occurred 7 times since 1962. This was a "gap up" on the stock market, which is when stocks open the day over 1/2% above their previous closing price, when the market is already within 2% of its highs. Gaps up are a very good sign for stocks if they occur when stocks are underpriced. But if stocks gap up when the stock market is within 2% of its high, the result has been negative for the stock market, quickly, every time in the last 55 years. You can see this in the chart below (from www.hussmanfunds.com):



When analyzing the value of the stock market to determine if it is under or over-priced, we look at measures that have been the most historically reliable (i.e. those measures which have a .90+ correlation with actual subsequent S&P 500 returns). If you do this analysis right now you find the smallest expected loss for the stock market going forward is 46%, while the largest expected loss is 62%. Please note this analysis assumes stock values only fall back to their historic averages, i.e. it does not look at how much stocks would have to lose to make them less expensive than normal. (Details showing the correlations between all measures of stock valuation and subsequent stock market performance can be found at www.hussmanfunds.com.)

In summary, right now it is simultaneously one of the most difficult times ever to be out of the stock market *and* one of the worst times ever to join the maddening crowd! This is simply the nature of bubbles. If it was easy to avoid buying into bubbles, and if it was obvious to most investors they were acting irrationally, then the bubble would not be able to exist. Fortunately, for us anyway, the signs the end of this massive stock market bubble is getting closer and closer are now piling up weekly.

One final thought on the stock market involves the nature of those who are willing to buy stocks. In order for stocks to go up you must have buyers willing to pay higher prices. It appears as if the last group of investors willing to pay nearly any price may have recently jumped aboard the bandwagon. When this occurs, the only group of buyers remaining are the "value investors," i.e. those who will only get into stocks when they believe prices are fair or, more commonly, inexpensive.

The Bond Market

In contrast to the stock market, the bond market has behaved fairly reasonably so far this year. With rare exceptions, the bond market rises and falls based upon how the economy is actually performing. Bonds were going down earlier this year as investors were sure the economy was going to finally begin to expand meaningfully. This sentiment was fed not only by hope regarding the new administration but by the Fed proclaiming they needed to raise interest rates more quickly, ostensibly to slow the economy down before it got out of control, growing too quickly! That view was dashed fairly quickly, as shortly thereafter we found the economy expanded at less than 1% annually in the first quarter. For the year, the bond market has now risen modestly, up 1.5% year-to-date.

Going forward, the bond market will most likely meander around, though rising modestly overall, in our current environment. That being said, we fully expect longer-term bonds, particularly government bonds or Treasuries, to roar in price one more time. Clues come from Fed Chair Janet Yellen. At the end of one of her recent reports she shared that, according to current Fed models, the proper rate of interest during the next recession could be a *negative 7 to 8%!* Now we definitely do not believe even the Fed members would be crazy enough to drive rates down to a negative 7-8%. What she was, however, attempting to prepare us for are rates of -2% or so during the next recession.

In this report I won't go into detail as to why this would be insane, except to say that every single reputable economist in the world over the last several hundred years said negative interest rates would obviously be so destructive to an economy as to be absolutely unthinkable - until the Bank of Japan and European Central Bank implemented them a few short years ago. However, along with starting up the printing presses once again, in Yellen's report she essentially told us they will indeed implement negative interest rates here in the United States the moment they realize we are in recession. This day will probably arrive much sooner than most presently expect.

This would certainly seem to contradict the Fed's action of raising rates twice in recent months. But we know the Fed is actually only raising rates so they can more easily begin lowering them as recession approaches. If they are concerned about an upcoming recession - something they will never, ever admit until we are clearly in one - those concerns certainly are warranted. Had the Bureau of Labor Statistics measured inflation at 3.1% or above last year, we would already officially be in recession. I know of a number of respected economists whose research shows the way the BLS measures inflation regularly underestimates the real inflation numbers to keep payments for things like Social Security down and to "goose" the GDP number (which is reported as growth minus inflation).

The Fed has basically admitted they are raising rates now so they can more easily lower them when needed. You can also infer it from the fact they claim they are "data dependent," meaning they act based on the economic data as it comes in. But they raised rates in March on the same day the Atlanta Fed lowered first quarter GDP estimates down to 1% (before lowering it below 1% shortly thereafter). During recessions the Fed tries to lower rates a good 4-6%. When you begin at 0%, this does make it difficult to achieve. If, or when, the Fed does drive rates down below zero, long-term government bonds will go up over 40% in price. This is not a prediction but arithmetic.