Economic & Market Update, November, 2014

What I Would Have Done

By Richard Morey

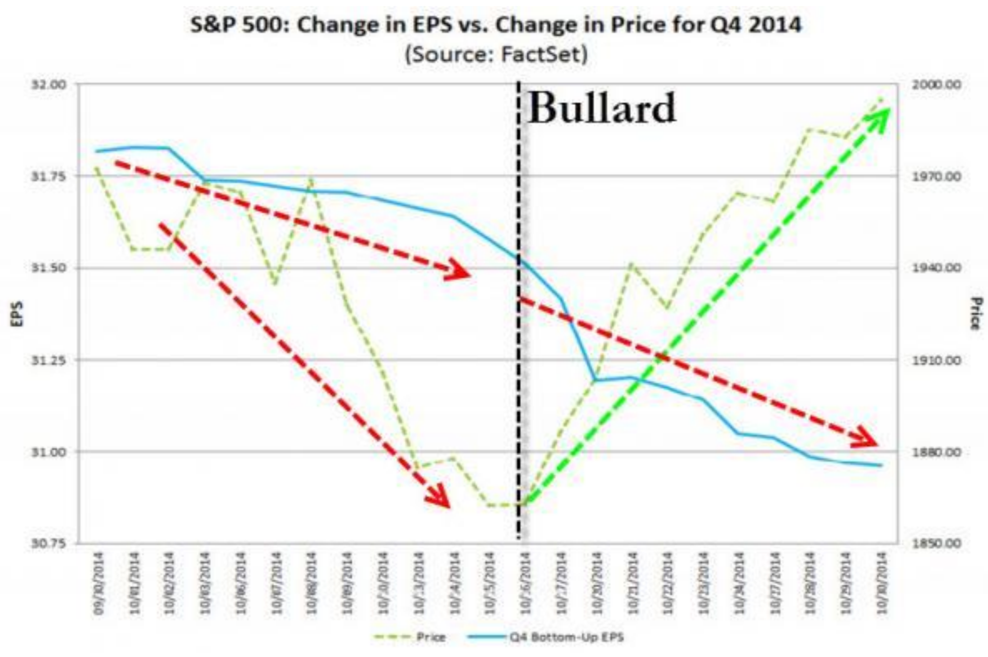
This month I am going to first share a short update on the state of our economy and markets before turning to the main topic which will be a discussion of what we could have done since 2009 to heal the U.S. economy.

October appeared to be a very strange month for the markets, though for students of market history not particularly surprising. In the middle of the month stocks started to go down fairly sharply, dropping 5.7% from October 1 to October 16. Many reasons were given, with worldwide economic weakness being the number one culprit. The Eurozone economy remains in tatters and appears to have entered a third recession. Japan's economy, which contracted by 7% in the second quarter, truly is hopeless. And China, which had been the growth engine in the world for the last five years, is slowing down more and faster than most expected. From one angle none of the above was really news, as it certainly is not new information.

However, the markets have not been moving based on fundamentals, i.e. the economy and business profits, for a long time. Instead, they have been moving based on psychological factors in general and blind faith in the Federal Reserve Board in particular. Investors decided some time ago that risk could not appear as long as the Fed continued to print money. But with the Fed stopping the printing presses in late October, investors looked at the real world economy and were (correctly!) frightened by what they saw. Stocks therefore went down and bond prices went up.

Then on October 16 the stock market turned around and went right back up. What changed? Certainly nothing in the world or U.S. economy. Corporate earnings also did not surprise to the upside, as many of our largest companies reported disappointing results for the third quarter. Exactly one thing changed. On the morning of October 16 James Bullard, the President of the St. Louis Federal Reserve Board, appeared on the Bloomberg financial channel and said the Fed may need to keep printing money. And like heroin addicts who had been cut off from their drug only to find access restored, stock market investors celebrated and the market shot up. I happened to be watching Bloomberg when Bullard spoke and saw stocks turn around literally the moment he made that statement.

The following chart shows corporate earnings announcements – the blue line going down – and the stock market – the green dotted line. The black line going through the middle is the moment Bullard spoke:



For anyone who still doubted that stocks have gone up almost solely based on the Fed printing money, this should have settled it. Unfortunately for the stock market going forward, the Fed did indeed stop printing money near the end of the month – at least for now.

Then the day after the Fed stopped printing money here, stock markets around the world jumped up further when Japan announced they are now going to print an unlimited amount of yen. I had almost decided to write this entire report on Japan, as their economic situation isn't difficult – it is absolutely hopeless. Their economy has grown at approximately 1% for the last 20 years, during which time they have borrowed themselves into a hole from which they will not recover. Every year for the last five their government has spent over twice as much as they bring in from taxes. And it's getting worse every year. Government debt becomes problematic when it reaches 100% of a country's Gross Domestic Product (here in the U.S. our debt is right around the 100% mark). Japan's government debt is 250% of GDP, growing at nearly 10% a year. It is absolutely impossible for them to pay off this debt.

Unlike the United States, Japan has a long history of printing money. From 2001-2006 they embarked upon a massive yen-printing program. Their economy did grow modestly for a while before crashing back down. This has been the final result of money-printing whenever it has been tried throughout history.

I said it is absolutely impossible for Japan to pay off its debt, but this may actually be wrong. Having researched Japan's upcoming demise for some time, last year I concluded they will indeed pay off every yen of their <u>quadrillion</u> yen government debt. They will never have the tax revenue to pay it off, but most (95%) of their debt is owned by their own people. As a result, there is no way they will ever tell all their retired people they have already spent their money and cannot possibly pay it back. Instead, they will simply print all the yen needed to return the money. Printing up to a quadrillion yen is guaranteed to lead to a collapse of the yen. In economics and investing people like me are never supposed to use the word 'guaranteed,' and rarely 'collapse.' But in this case the yen truly is guaranteed to fall very, very far over the next 1-3 years – so far it will indeed be a collapse.

What will this do to the Japanese people? They have to import over 60% of everything they consume in Japan. With a crashing yen, this means everything they buy will skyrocket in price. So they will indeed receive all the yen they have saved (all of which was then loaned to their Government to fund their huge annual deficits), but the yen they receive will only buy perhaps half as much stuff.

We can already see how their nation's upcoming economic failure is hurting their people. In September, consumer spending plunged 5.6% while incomes fell over 6% - in one month! And this was before the yen fell dramatically in October. Japan is dead, with only the autopsy remaining.

Given this, why in the world would investors around the world be excited when they announced last week they are going to increase their yen printing to truly fantastic levels? For one reason – investors have been hypnotized into believing the only thing that matters is printing money. With the U.S. Fed stopping our printing last week, investors were thrilled to learn another country was going to print even far more than we had been doing. Unfortunately, economic reality tells a completely different picture. As the yen collapses nobody can accurately forecast the global ramifications. But we can be reasonably sure it will be horrendous for China and perhaps even worse for Europe. With a crashing yen, everything made in Japan will go on sale to foreign buyers, thereby crushing the two largest economies dependent on their own exports, aka China and Germany. Here in the United States we should fare better than perhaps any other country, though having the rest of the world in serious decline and historic turmoil will at least put us into more than a mild recession. In fact, the demise of the yen only looks positive for exactly one main asset class – U.S. Government bonds. (Gold should also soar, even though it went down last week when Japan decided to finally jump all the way off the cliff. This, however, should be a fairly short-term phenomenon for gold, as unlimited money printing and the financial crisis/turmoil it creates is the perfect recipe for large gains in the price of gold.)

Every year since 2007 one group has been awarded the annual prize for the most accurate macroeconomic predictions. This is the economic research team at Societe Generale, a French bank and financial services firm. Their star student of Japan is Albert Edwards, who now says the one key fact that will most likely be the cause of the upcoming bear market for stocks is the chart of the yen versus the U.S. dollar. A few weeks ago he predicted the end was near for the central reserve bank-led stock market bubble, and the idea central banks can solve all problems by printing money, and that it would begin soon after the yen surpassed 110 to the dollar. It closed on October 31 at 112.

In my estimation the best hedge fund manager in the country is Kyle Bass, the founder of Hayman Capital. Mr. Bass made 600% in 2008 when he shorted subprime mortgages. Mr. Bass also expects the falling yen to be the cause of the next shoe dropping on the fundamentally challenged world stock market and economy. If you want to learn more about Japan's impossible economic situation – and why it was so amazing and laughable stock investors were excited last week when Japan announced their historic new yen-printing program – simply click on the following link to see a talk Mr. Bass gave at the University of Chicago: http://media.chicagobooth.edu/Mediasite6/Play/f15d95d054e8442ab0cc1c60321383101d.

In the introduction to this report I stated October's market action was not surprising to students of history. As the month progressed I was very much reminded of 2000 and 2007. Remembering those times, as stocks were dropping mid-month I thought they might very well end up returning to their highs before beginning their inevitable eventual descent. Then I read Dr. John Hussman's weekly report on October 27 entitled *Fast, Furious and Prone to Failure*. In that report he had charts showing the stock market in 1929, 1972-73, 1987, 1999-2000, 2007 and 2013-2014. In each case stocks initially dropped a good amount after hitting their highs, but then they went straight back up. In each of the previous five instances they then dropped dramatically, losing 89%, 45%, 36%, 40% and 54% respectively.

So in each of the worst bear markets since 1929 the downturn began with a month just like the one we had in October. This of course does not prove October was the beginning of the end for the current bull (bubble) market, and I gave up trying to predict the timing some time ago! Since the market went up because the Fed was printing money, it would make sense the beginning of the end might occur the month the Fed stopped printing money. We will indeed have a severe bear market for stocks, if not an outright crash, before we are through this cycle. Only time will tell if it actually began in October.

Recommendations for the U.S. Economy

Our regular readers know I have been quite critical of the way our economy has been managed over the last several years. If "the proof is in the pudding" this criticism has indeed been warranted, as this is the weakest recovery coming out of a recession since the Great Depression:

- The real (inflation adjusted) income of the average household is ***8% lower*** than it was in 2007
- New jobs are paying **25%** less than the jobs lost since 2008-2009
- We have the lowest percentage of people employed in over 40 years
- **40%** of workers are earning less than $20,000 a year. This basically means 40% of our workers are being paid $10 an hour – or less for many who hold multiple part-time jobs
- **50%** are earning less than $30,000 a year
- First time homebuyers are at a **30 year low**
- Between 2008-2012 Social Security Disability recipients grew by **20%**
- "Food Stamps" usage between 2007 -2013 has risen by **80%** (<u>21,320,000!!!</u> additional people need assistance)

While I have shared information like this regularly, I have never told readers what I would have done differently. Is there a better path we could take? Fortunately the answer is a resounding "yes," though it will probably take another crisis before we have the will to make the needed changes.

So without further ado, let's turn the clock back to January of 2009. For purposes of this discussion, I am Larry Summers, our new President Obama's lead economic advisor who basically ran the U.S. economy in 2009-2010. Here is what I would have recommended:

1) **Banking**

   As I have shared many times in these reports, there are two ways to deal with a financial crisis. A country can either expend vast amounts of money to prop up failed banks or allow them to fail. We chose the first approach, first bailing out our major banks through Congress before passing the baton to the Federal Reserve Board. The Fed opened up their coffers, lending unlimited amounts of money to the banks at basically no charge; then the Fed proceeded to buy over a trillion dollars worth of mortgages from the banks. We never heard how many of those mortgages were purchased below their fair market value. At one point in 2010 I counted over 15 ways in which the Fed was subsidizing our major banks.

   Throughout history, nations who bail out their banks during and after a financial crisis have two outcomes. First, their government debt explodes – just as ours did. Second, their economy grows, on average, at just over 1% a year – <u>for the next 22 years!</u> In stark contrast, nations who do not bail out their banks find their economy growing again at pre-crisis rates in less than three years on average.

   So I would have restructured our banks in January of 2009. This means they would have been turned over to FDIC to resolve. To cover their massive losses, those who had loaned money to the banks would have lost that money, and those who owned their stock would have lost that money. Fortunately, the bank losses were approximately equal to the amounts they had borrowed from investors, so no taxpayer money would have been needed to clean up the banks.

   Next I would have asked Congress to reinstate the Glass-Steagall Act. This was a very short law originally passed in 1933 governing what banks are allowed to do. It was repealed in 1999. The charge to repeal it was led by Larry Summer's mentor, Robert Rubin, who was at the time President

Clinton's Treasury Secretary, and then carried to the finish line by Mr. Summers himself who succeeded Rubin as Treasury Secretary. The other half of this ill-conceived action were Senate Republicans, particularly Senators Phil Gramm and Jim Leach. (Once again, one of the few bipartisan efforts involved doing whatever the largest Wall Street banks wanted.)

Glass-Steagall said any bank that receives customer deposits was not allowed to engage in activities involving market risk. They could not trade for their own accounts, i.e. invest in all kinds of risky ventures. They couldn't buy stocks, sell or buy credit default swaps, or make any of the hundreds of risky trades they do all day long as we speak. They also couldn't own or operate hedge funds, insurance companies, mutual funds, etc. They could do exactly two things: 1) receive customer deposits and 2) lend out that money to qualified borrowers.

What impact would this have had on our financial system and economy? First, keep in mind we did not have one financial crisis between the time Glass-Steagall went into law and the time it was repealed. When banks are allowed to take any amount of risk they want, sooner or later they will lose so much money they will have to be bailed out or they will lose the money in their customers' savings and checking accounts.

The main impact reinstating Glass-Steagall would have had involves the primary purpose of banks – lending. If you have listened to the Fed over the last six years, they originally claimed the purpose of all their actions, such as printing nearly $4 trillion, was to increase lending. How has this worked out? As of last month, our banks had the lowest percentage of their total assets loaned out in many decades. In other words, all of the Fed's efforts have utterly failed to accomplish the number one goal. This is hardly a surprise, as banks can make much more money making risky trades and engaging in risky lines of business than they can lending money.

In stark contrast, if we had restructured the banks in accordance with Glass-Steagall, lending money is the only way banks could have made profits. As a result, they would have been heavily motivated to do just that.

Another ramification of these changes is that the banks would have had much lower profits. It would have been great for the U.S. economy, both in terms of increased lending – especially to smaller businesses – and in terms of avoiding future financial crises. But it would have been terrible in terms of allowing bank executives to receive their millions of dollars in yearly bonuses. I think this is a trade-off we could live with!

2) Employment

With the banking system cleaned up and focused solely on what we want them to do, i.e. protect customer deposits and lend money out to qualified borrowers, my next recommendations involve the job market. The first thing I would have recommended would be a huge program to rebuild our nation's infrastructure, such as bridges and roads. I know we would have had to go deeper into debt to do this, but this is one type of government debt that can pay for itself over time. This is due to the fact that good infrastructure improves business efficiency in the nation.

A huge infrastructure program would also have been great for the most troubled sector of the job market – construction. We lost a huge number of good-paying construction jobs from 2008-2010. A shockingly high number of these workers proceeded to go on long-term disability through the Social Security Administration. As a result, these ex-workers are now going to be paid for the rest of their lives by taxpayers.

The next recommendation involves small businesses. I have been continually shocked and dismayed by how little attention is paid to small businesses. Politicians talk about their importance all the time, yet neither party ever does much of anything at all to encourage them. This despite the fact approximately two-thirds of all new jobs are created by small businesses. In early 2009 there was exactly one discussion in the White House involving help for small businesses. One of the advisors recommended paying for some or all of the salaries of all new employees hired by small businesses for some period of time, or to give small businesses a tax break for all new hiring. Larry Summers immediately said this does not work to encourage hiring, and the topic was dropped from consideration based on that one incorrect statement. Having run a small business for the last 12 years, I know for a fact subsidizing small business hiring would lead to more hiring. Along with infrastructure spending, this is one of the very few types of government spending that pays for itself, as the new employees pay taxes, the better small businesses succeed and hire more people who pay taxes, etc.

Partly because we did nothing to encourage small businesses, we now have the lowest percentage of our citizens starting small businesses in the entire history of our nation. And by history I mean since the Declaration of Independence was signed. Considering small businesses are the engine for jobs growth, this is, in my estimation, a huge blunder.

3) Housing

In 2009 I heard one idea, from Dr. John Hussman who is one of the best economists in the country, to support the housing market. This idea was to have homes facing foreclosure appraised and then have the outstanding mortgages lowered to this amount. This alone obviously would have transferred all the losses to the banks. To make this fair and productive, the banks would then have been given a share of all the price gains in the house going forward. For example, if a home was appraised at $200,000 with a $300,000 mortgage, that mortgage would have been reduced to $200,000. But if the house was then sold in the future for $400,000, the lender would have received between 50-65% of the price gains, which in this case would have been $200,000. If the bank received two-thirds of those gains, combined with the $200,000 mortgage repayment, that bank would ultimately receive $333,333 on their $300,000 loan. (The amount of the gains the banks would get versus the homeowner would have varied based on how much the loan was reduced. I'm sure all homeowners would not qualify for this program, which is one of many details that would have needed to be worked out.)

How would this outcome have compared to what we did (i.e. basically nothing)? First, millions of homeowners who were foreclosed upon would have been able to keep their homes, while over time the banks would have received all of the amounts loaned back, plus a modest profit. As a result, home prices would not have fallen as far. Plus, the millions of families who were foreclosed upon would have been in much better financial shape, thereby able to spend more money and draw less in government aid such as Food Stamps. Related businesses, such as furniture stores, as well as all the jobs in the mortgage and real estate markets, would have done much better, leading to fewer layoffs and bankruptcies.

This proposal probably sounds odd to most readers, but the positive ramifications would have been quite large. And while I have just given a very short outline, Dr. Hussman actually worked out all the details and sent them to Congress – where it promptly died.

4. Monetary Policy (i.e. the actions of the Federal Reserve Board)

Had we restructured the banking system, worked to support the growth of solid "breadwinner" jobs, and taken much of the pressure off the housing market, the Fed would not have thought they needed to do everything possible to prop up the banks. They not only would not have needed to print one penny, but they could have started to raise interest rates in 2011. This is a very important issue. By keeping short-term interest rates near zero, trillions of dollars of income due to savers – mostly retired people who have money in CDs and money market accounts – has been lost. In other words, the Federal Reserve Board has essentially transferred trillions of dollars from elderly, mostly middle-class savers, to the banks. Had these savers received reasonable interest, they would have had trillions of dollars more to spend. This would have led to a better economy.

Keeping interest rates artificially low has other negative consequences. When money is basically free to those closest to the spigot, i.e. the largest banks who can borrow billions from the Fed, much of the money ends up in non-productive ventures and companies. This leads to asset bubbles, such as the internet and general stock market bubble of the late 1990s, followed by the housing bubble, and now another stock market bubble. If interest rates were instead based on market forces, weak companies would not be able to get funding. When a bubble is forming, having money go towards large numbers of non-productive ventures appears to lead to economic expansion. But when the bubble bursts, those ventures and the companies involved go bankrupt, leading to a more vicious recession. So artificially low interest rates leads to massive misallocations of capital which then result in bubbles followed by crashes.

Another major mistake we have made involves the role of the Fed versus the role of Congress. As you can see above, everything I would have recommended involved Congress, not the Fed. However, without a functioning Congress the Fed decided they would try to fix everything in the economy. But the Fed can't fix any of our major economic challenges, as all they are supposed to do is control short-term interest rates. Instead of demanding Congress do its job, the Fed decided to tell the public they could solve all our problems by printing money. This is, unfortunately, nonsense, as there is not one instance in economic history in which printing money accomplished the original goals the Fed had for this program.

So my final recommendation would have been for the Fed Chairman to go to Congress and tell them to do their job. Then the Fed would not have embarked upon reckless, unproven policies that have served only to give the public – especially the investing public – the mistaken notion the Fed is going to solve our economic challenges. They cannot.

Summary

When economic history is written in the future, I believe the lesson will be the same one that has been written after nearly every financial crisis over the last 800 years. When you have a financial crisis you can sacrifice either the banking system that caused the crisis or you can sacrifice sound economic growth going forward. From another perspective, you can either protect the wealth of those in finance or the prosperity of the entire nation. A nation's financial system is like blood in the body. When it does not circulate properly the entire body suffers. When the financial system is structurally flawed, bodies like the Fed can try all kinds of manipulations to attempt to keep moving forward. However, without a properly structured financial system these attempts fail, and in the process the financial gymnastics and unproven experiments create further problems.

The good news is that our country could restructure our financial system any time we wanted to do so. We had a golden opportunity to correct our broken banking system in 2009, as the public was demanding positive change. Instead we did everything conceivable to maintain the status quo. I am reminded of a quote from Jean-Claude Juncker, the President of the European Commission. When discussing how to deal with the Eurozone's enormous problems, he said, "We all know what to do, we just don't know how to get re-elected after we do it." While I'm far from sure our politicians actually know what to do, as most seem to be almost economically illiterate, the point is solid. To get our nation's economy back on track we will eventually need economically wise political leaders who care more about our people than the next election.

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