Economic Update, October 2017

Debt and More Debt

By Richard Morey

Quarter after quarter we have said the U.S. faces an almost existential economic question. The question we face is: Does economic growth follow from the increase in companies and workers producing more and better goods and services, or is economic growth caused by increasing debt? Obviously the way the question is asked, everyone would say increasing productivity is the answer, yet **everyone** in our government, i.e. Congress, the administration, and the Federal Reserve Board, clearly believes the second. Let's look at the evidence to discover the answer.

First let's recap a little economic history. Over the last 700 years, nearly every economic crisis in the world has been caused by economies which saw their debt shoot through the roof. Just as notably, there has only been one country - in 700 years - which had its debt skyrocket and didn't result in an economic crisis (Great Britain after they borrowed a fortune to create the largest empire in the world). Specifically, countries which accumulated over 275% of total debt relative to the GPD (one year of all economic output) found their economy hampered until the debt levels came down (almost always through a crash).

Earlier last year Lacy Hunt of Hoisington Asset Management presented the "scorecard" on world debt:

"The Federal Reserve, the European Central Bank, the Bank of Japan, and the People's Bank of China have been unable to gain traction with their monetary policies…. Excluding off balance sheet liabilities, at year-end the ratio of total public and private debt relative to GDP stood at 350%, 370%, 457% and 615%, for China, the United States, the Eurocurrency zone, and Japan, respectively…. The debt ratios of all four countries exceed the level of debt that harms economic growth. As an indication of this over-indebtedness, composite nominal GDP growth for these four countries remains subdued. The slowdown occurred in spite of numerous unprecedented monetary policy actions—quantitative easing, negative or near zero overnight rates, forward guidance and other untested techniques."

To me, the amazing thing is that I haven't found one economist or politician who has directly addressed the facts presented above to try to disprove them - yet our politicians and financial "experts" have continued to stoke the greatest debt bubble in our nation's history. Always keep in mind we had the worst recession since the Great Depression in 2008-2009, and it was caused entirely by too much bad debt - mortgage debt in that instance. Our "solution" has been to binge on greater and greater amounts of debt, this time not just in mortgages but in every aspect of our economy.

How can it be that we have embarked on such a dangerous road, one about which we have 700 years of history proving it ends in tears? The answer is sad but simple. Creating more debt is really easy, while getting out of debt leads to (at least) short-term economic pain. For example, the government can create another trillion dollars of debt on their computers in a few minutes. Large companies can borrow another $10 billion quickly and at low rates. And we all know how easy it is to get another credit card at home. **But there are always economic consequences for these actions.**

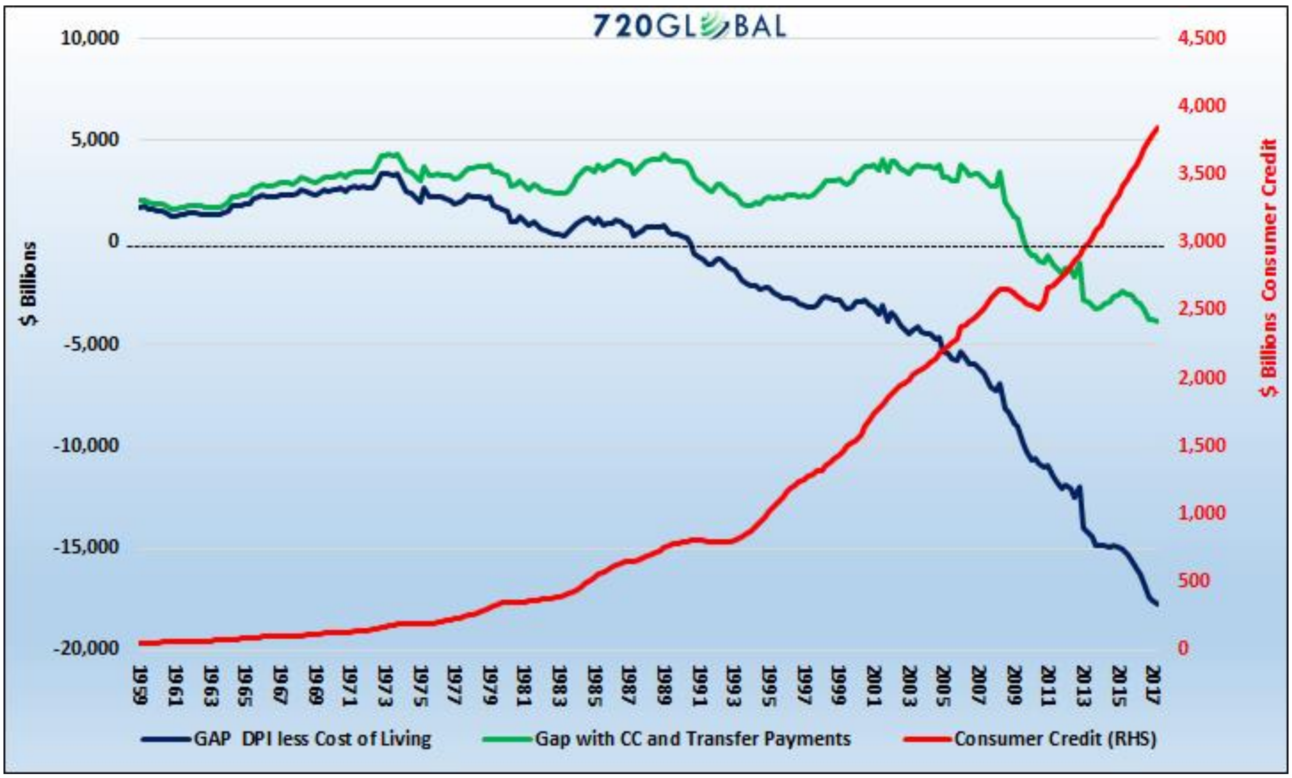
We're now going to look at some of these consequences in two charts. When I saw the first chart it actually hurt my heart, as it illustrates the daily financial problems of millions and millions of our citizens. The chart was presented by Michael Lebowitz in an article entitled "The Illusion of Prosperity" on September 27. The data comes from the St. Louis Federal Reserve and Lance Roberts.

The blue line on the chart shows the disposal income of our citizens. A positive number means our average worker (median) has some money left over after paying for all the essentials such as food, clothing, housing, and medical care. On the chart you can see the average worker in our country could no longer cover his or her basic expenses around 1990, and that this trend has gotten much, much wore since then.

The green line shows how much money our average worker has if we include consumer debt (credit card debt, car loans, student loans, etc.) and transfer payments from the government (such as food stamps, welfare, medical benefits, etc.). Finally, the red line shows the growth in personal debt.

The chart shows our average worker has only been able to maintain his or her standard of living since 1990 with increasing amounts of debt. And even with another dramatic surge in debt, since 2009 this average worker must still borrow more and more just to meet basic expenses.

Nearly 70% of all our economic growth is consumer spending. But at this time consumer credit, i.e. debt, combined with government transfer payments, funded by new government debt, account for an amazing 43% of all consumer spending. This means almost one-third of our alleged economic growth is directly funded by new debt.



Here is Michael Lebowitz's summary: "These charts clearly illustrate that the U.S. consumer has steadily relied on increasing amounts of debt to maintain an artificial standard of living. Through the use of credit, personal and government, U.S. households have pulled future consumption forward. The weight of those outstanding obligations serves as a wet blanket on current and future economic growth.

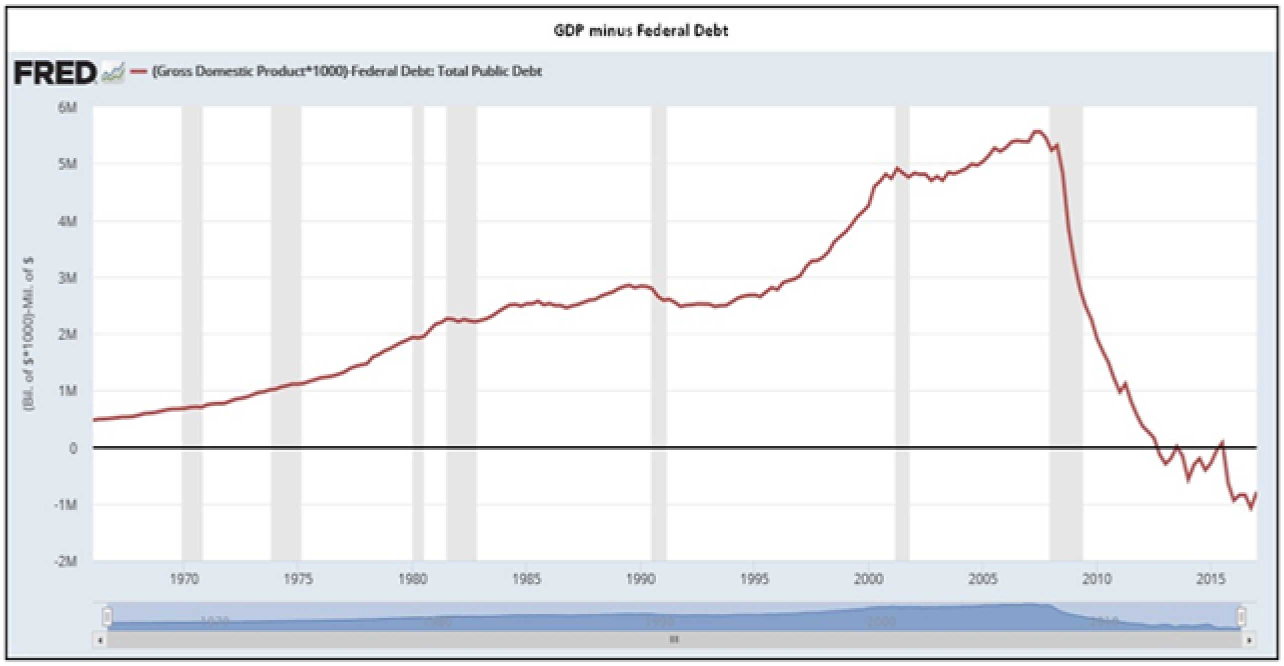
The financial crisis in 2008 fractured the economy in ways that are clearly evident today. **Addressing the troubling debt burden has been postponed through extraordinary stimulus, but the problem has only grown in size. This proves that a debt problem cannot be solved by using more debt."**

My summary of this data would be as follows. That chart shows that the average household in the United States cannot pay their monthly bills without borrowing money each and every month. This is a sign of a deeply troubled economy.

Our second chart comes from the Baker & Company Advisory Group, from an article published on September 28, entitled *The U.S. economy is not as solid as it appears - statistical anomalies hide profound weakness.*

In the article they simply ask if debt should be included as income. For example, if you borrowed $10,000 on an American Express credit card, would you include this as an additional $10,000 of income on your income tax return? Obviously, you wouldn't. Yet when we calculate economic growth we include money the government borrows and then spends.

The following chart, with the data taken once again from the St. Louis Federal Reserve Board, shows total economic growth in the U.S. minus the effect of increasing federal government debt.

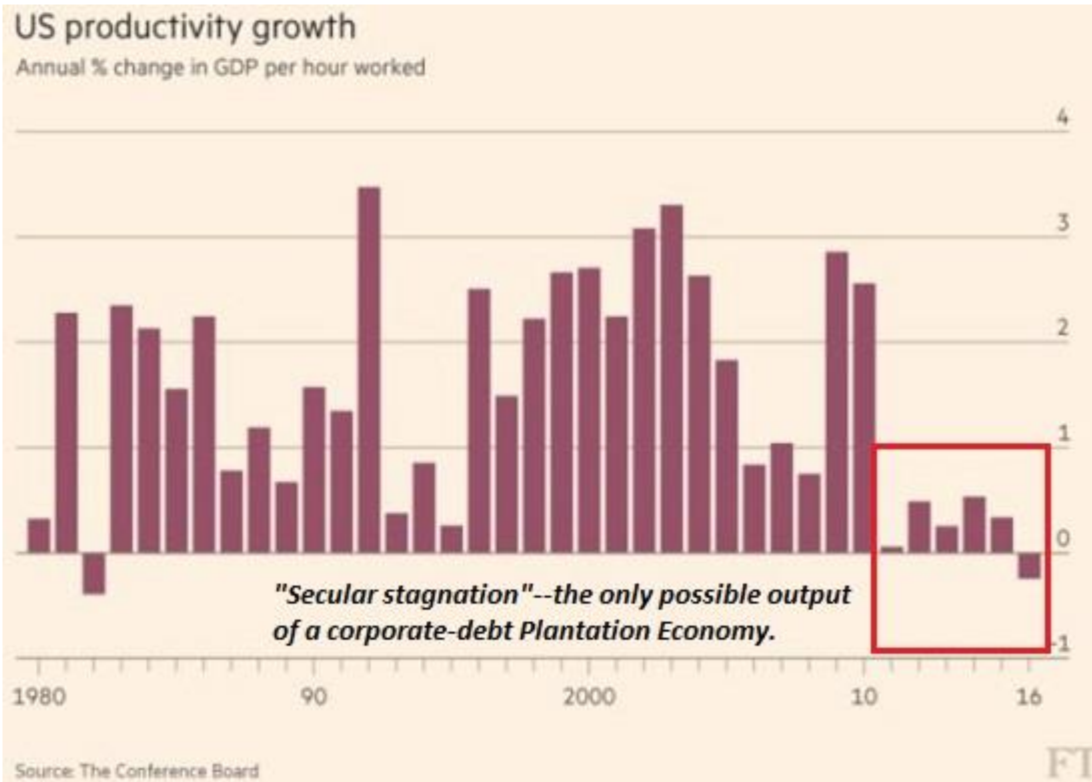


Here is their summary of this data: "The government has always borrowed and spent money but actual GDP has grown as far back as the Fed has data. That is until 2008. Then something in our economy broke. Since then it appears the economy has been in what would be considered a depression but masked by the huge Federal Government stimulus borrowing... Does that chart look like the data of a self-sustaining recovery? It if were sustaining, the slope would be rising as it was prior to 2008. It continues to decline and is therefore anything but self-sustaining. In economics, deficit spending has long been called "Fiscal Stimulus." Since 2008, this artificial stimulus has averaged 7.45% of GDP.... without the artificial stimulus created by spending the proceeds of newly issued debt, our GDP has declined an average of 7.45% each year since 2007!

... In conclusion, I believe the U.S. economy is in a depression masked by debt. I further believe there is no indication we have had an actual recovery of the actual economy. These observations could inform intermediate and long term strategies. I am not using these observations as a timing tool, but rather as a depth finder for assessing risk when the next crisis unfolds or when market participants realize the emperor, not only has no clothes, he maxed out his credit cards buying them."

Next we'll look at productivity. As I have shared numerous times in these reports, debt in and of itself is not bad for an economy - if, and only if, it is used productively. Productive debt is borrowing and spending which leads to enough economic growth to eventually pay off the debt and leave some profit behind. I haven't found one knowledgeable person, in the government or private sector, who has argued our massive spike in debt in recent years could be construed as "productive." Instead, the debt is just being used to fill in the gap between the lifestyle the middle class used to have and what they would like to continue to enjoy.

As I have also shared numerous times, productivity is the one absolutely key word when discussing real economic growth. Growth is literally defined by two numbers: growth in productivity and growth in the number of hours worked. With an aging population and backlash against immigration, we will be lucky to have 0% growth in the number of hours worked over the next decade (the government estimates .3% yearly growth from hours worked). This means all our growth must come from increases in worker productivity. The chart below shows how that's going:



If you listened to the news talk shows over the weekend, you would have heard our economic leaders, Steve Mnuchin and Gary Cohn of Goldman Sachs and the Trump administration, talking about how their proposed tax cuts will turn this whole thing around. Unfortunately, this is not only unlikely but flat-out impossible. First, the budget Congress is debating to pass calls for a maximum of $1.5 trillion in new debt over the next 10 years from the tax cuts. If you crunch the numbers, you see this would entail fairly small tax cuts. Then there is the concern the bulk of these cuts would go to the wealthiest individuals and corporations. Since these are the people and companies who already have more money than they currently want or need to spend, getting them more through lower taxes does not stimulate the economy.

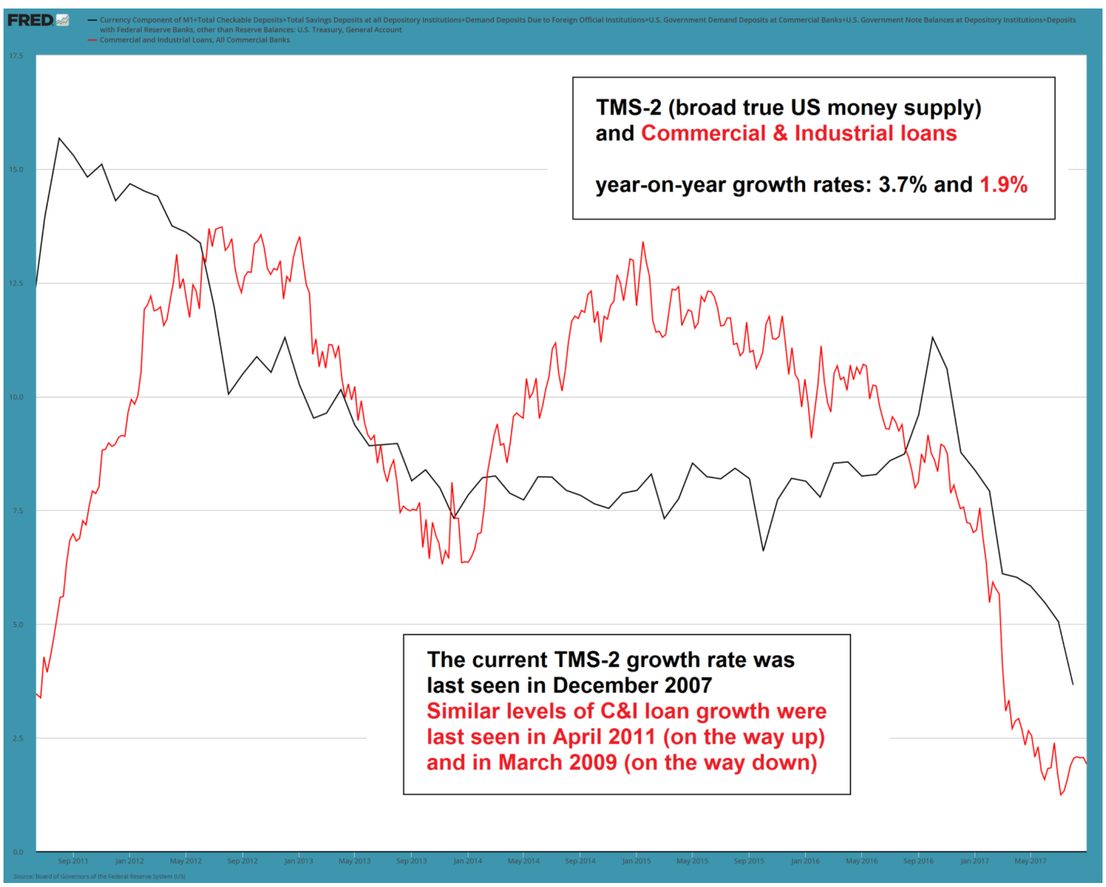
But the biggest reason why any tax cuts which *may* end up passing sometime next year will have no positive impact on the economy involves, once again, debt. Whenever total government debt to GDP exceeds 90%, any tax increase - of any size and composition - cannot stimulate the economy. As of this moment we are at 110% debt to GDP (when you do an honest calculation of this figure), and our government debt has grown by $1 trillion a year over the last 3 years. In sharp contrast, the much, much, much larger Reagan tax cuts of 1981 may have moved the needle on the economy, but when they were passed our total debt-to-GDP was 25%. Times have certainly changed in terms of debt, which determines the effectiveness of tax cuts.

When Will We Enter the Next Recession?

Thus far we have described why the economy is weak, deeply troubled, and basically unable to grow more than around 1% a year - at most. However, most of our clients would really like to know when we will enter the next recession, as this will be the time when the stock market plunges and when our accounts should do exceptionally well.

Just like it is nearly impossible to time the stock market, predicting when the economy will finally go below zero is comparably difficult. That being said, unbeknownst to the vast majority, recent developments may be pushing us into recession very quickly. Those developments involve the Federal Reserve Board. They have been raising short-term interest rate. Historically, whenever the Fed starts to raise rates they "push" the economy into recession. But an even larger danger involves their recent decision to stop reinvesting the proceeds from the government bonds they own when they come due. This means the government will now have to borrow this money from the private markets. This lowers the amount of money in the economy and the amount of money loaned out to businesses. The Fed is just starting this new program to withdraw the money they printed from the economy. **If they continue beyond January, the U.S. economy will be in recession.**

Of all the pictures we can present showing just how fragile the economy is right now, the one that follows is the most dangerous. It shows business lending (red line) and money supply growth rates (black line). As you can see, both of these are basically falling off a cliff right now. If the Fed continues to pull money from the economy, both of these go negative near the beginning of the year. This equals recession.



Summary

As described earlier, our economy now consists of approximately 70% (debt-funded) consumer spending. Over the last 12 months consumer spending has risen 1.5%, while income growth has increased a paltry .6%. Both of these are a fraction of what they would be in a healthy, growing economy. Consumers have been borrowing more and more money just to pay their monthly bills, and anything extra is also being funded with more debt. Even as they have reached their highest debt level in history, consumer spending has only grown 1.5%. Now they are essentially "maxed out." And simultaneously we have the Fed, which has probably been the only entity keeping the ship semi-afloat, reversing course to remove money from the economy? While we cannot therefore proclaim a recession is imminent, we can barely imagine a scenario more likely to create one.

Every time I write an economic report I hope it will be the most pessimistic I ever have to prepare. Unfortunately, we keep going in the same misguided direction, with the same sad results. On the bright side, there are of course sensible solutions, but I don't know of politicians even giving the slightest consideration to them. Suffice it to say, the necessary changes will require a complete rethinking of our fiscal and monetary policies. I'm afraid this will not even be considered until we are in the depths of the next recession. Due to the largest creation of debt we've ever seen, the next recession will probably be the worst anyone who wasn't alive in the 1930s will have ever experienced.