

Economic Update, April 2016

Central Bank Theories are Wrong

By **Richard Morey**

Over the last few years I have read many thousands of pages analyzing monetary (Federal Reserve/central bank) policy around the world. I've rarely written about the details, instead focusing on the larger picture current Fed policies are almost completely ignoring. That larger picture is the fact they do not properly account for the explosion of debt and the dangers this creates for markets and economies.

This month we'll actually look directly at orthodox monetary policy to see how broken it truly is. Keep in mind our current Fed Chairperson, Janet Yellen, is a labor economist by trade. No, she has never held a job in the private business world, but I'm sure she has read a lot about the private sector jobs market.

Unfortunately, the theories she is using to guide economic policy in this country are wrong.

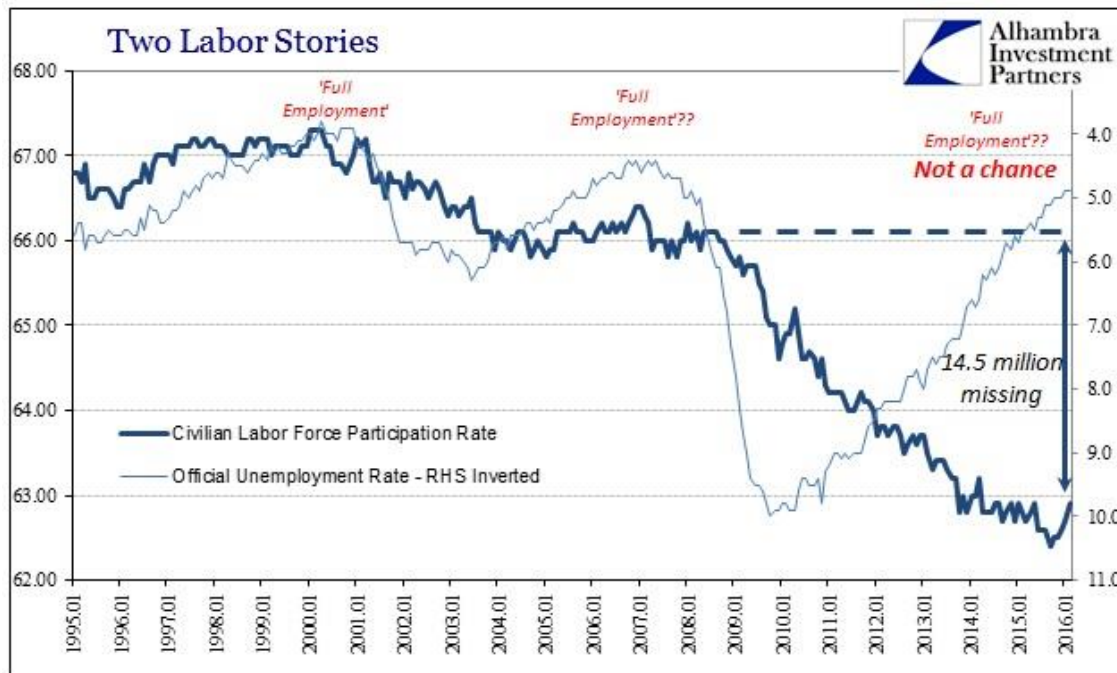
The theories in question are called the "Phillips Curve" and "Okun's Law." Orthodox economic theory says recessions can only occur due to an external shock to the system. In 2008, these "external" shocks were banks such as Lehman Brothers going bankrupt. When a large external shock occurs, economic growth turns negative, leading to a spike in unemployment. Then as the economy recovers, employment and economic growth as measured by GDP pick up (Okun's Law says the economy grows 3% for every 1% drop in unemployment). At some point we then reach "full employment," meaning pretty much everyone who wants a job has a job. As we reach that point, wages start to rise because employers have to offer higher pay in order to attract new employees in a tight job market. This leads to inflation or an overheated economy (defined by the Phillips Curve). The Fed then raises interest rates to slow the economy down. This is the gospel according to orthodox economics these days.

In general, all of this makes some sense. The problem is that the theories the Fed uses "prove" mathematically that GDP, wage growth, and inflation must be must higher now that the unemployment rate has fallen. In fact, at 5% unemployment, we are now basically at "full employment." According to the Fed theories, this means the economy must be growing at well over 3% a year, wages must be growing rapidly, and inflation must be over 2%. If all three of those statements are not true, then something is terribly wrong with the Fed's key theories. So let's see the scorecard:

- 1) In the 4th quarter of last year the economy grew at 1.4%, and in the first quarter of this year the first estimate shows growth plunging down to .7%.
- 2) From January of 2015 through February of 2016 total wages grew approximately 2%. At our alleged "full employment" this number should now be well above 4%.
- 3) In terms of inflation, the Consumer Price Index only rose 1.02% from February of 2015 to February of 2016.

Clearly the Fed's theories aren't describing the actual economy these days, and it's not hard to spot the problem. The chart at the top of the next page shows the "Civilian Labor Force Participation Rate" in the dark line. This is the percentage of U.S. citizens ages 25-54 with a job. This number collapsed in 2008, but it has not recovered. The light line is the unemployment rate on an inverted scale, i.e. a low unemployment rate is higher on the chart. The chart shows that, at an unemployment rate of 5%, with a long-term average participation rate of 66%, there would be 14.5 million more people with a job in our country. Where did these people go? Keep in mind they aren't old enough to retire, as this just measures workers ages 25-54. Did over 14 million of our citizens just decide work was overrated and it would be more fun to spend all day watching television or playing video games? No, this is not what occurred. Instead, the obvious answer is that the unemployment rate is actually not 5% but somewhere around 10%. If we were to plug in a 10%

unemployment rate to the Fed's equations in the Phillips Curve, we would most likely see they compute with economic growth of 1-2%, inflation at 1%, and total income growth of 2%, i.e. our current economy.



Actually none of this indicates the Phillips Curve or Okun's Law are incorrect. But it does prove either they are wrong or the Fed has no idea how to understand the labor market. Keep in mind the head of our Fed is a labor economist, so she must either be one of the worst labor economists in the world or a very good liar. How else could she possibly be so wrong on the one thing the Fed is most focused upon, i.e. the unemployment rate? She does occasionally mention the labor force participation rate problem but basically says she is perplexed by its message. (Note: Key ideas, and the above chart, were inspired by reports originally written by Jeffrey P. Snider of Alhambra.)

But it gets worse. Mike Shedlock recently (3/28/16) wrote a report describing the growth of part-time and independent contractor jobs in the U.S., entitled *Gig Economy Take II: Nearly Entire Increase in Employment Since 2010 is in Gigs!* In that article he shared the following numbers which were taken from the Bureau of Labor Statistics, i.e. the people who bring us the official employment numbers:

Total Employment Statistics

1. Total employment in December 2010: 139,301,000
2. Total employment December 2015: 149,929,000
3. 2010 part-time employment: 13,930,100
4. 2015 part-time employment: 23,988,640

So over the last five years total employment has increased by 10,628,000 workers. Of those, 10,057,540 were less than full-time jobs. This certainly explains why wage growth has continued to be so anemic.

Rather than try to tear apart their flawed theories, we may perhaps gain more insight into the Fed from listening to what they actually say. In January, in relation to mounting concerns about China's economy, the head of the San Francisco Fed John Williams said: "We've built in a weakening path for China. I don't see

that as a significant risk to the forecast for the U.S. economy – **China doesn't affect the US market that much at all.**"

Then in March Williams said: "We have a domestic mandate...but that said, we understand that we're in a global economy so **what happens in Brazil or China has a huge impact on the U.S.** in terms of our inflation and employment goals."

So in January China doesn't affect the U.S. much at all and in March they have a huge impact on us. What changed? Absolutely nothing. Sadly, Williams may not even be in the top three of Fed officials in terms of spouting nonsense.

Finally, perhaps the scariest implication of the Fed's theories would be if one of their ideas is actually correct. This is the notion all recessions are caused by external shocks to the system. After a recession the economy is always supposed to revert to its longer-term potential. Now keep in mind this theory is almost certainly wrong – unless you consider internal increases in debt to be an external shock. But if they are correct, this means the paltry economic growth we have seen in recent years is the "new normal." Yes, at some point we will have an external shock large enough to drop us back into recession, but even in "good times" our economy is presently structured to achieve only minimal growth. And the benefits of that growth no longer inure to the benefit of ordinary workers.

Please note this is only a shorthand description of some of the Fed's mistaken ideas. As alluded to earlier, I believe the far larger mistake is failing to recognize the empirical fact that economies can never return to sustainable growth levels once they hit "peak debt," defined as the level at which the economy can no longer grow because too much of the nation's resources are needed to make interest payments, and too much of these resources are tied up in companies that are so over-indebted they will never be able to succeed. Not only does the Fed have nothing theoretical to say on this topic, but in practice their actions are *only* designed to encourage companies and individuals to increase their debt. You cannot fix an economy that enters into a financial crisis caused by too much bad debt by massively increasing bad debt! This will be the lesson the history books tell us we (hopefully) learned from today's monetary policy mistakes.

Speaking of corporate debt, last week Standard and Poor's bond rating agency released the most negative report on junk bonds I've ever seen. They reported that the average corporate bond is now in "junk" status. This means U.S. corporate bonds are now weaker than they were at the bottom of the 2008-2009 financial crisis period. Over the last four years, 75% of all new corporate bonds issued were rated junk. This was over a trillion dollars worth of new junk bonds. As I have shared in recent monthly economic reports, the dollar amount of junk bonds (and leveraged loans which are "junk bank loans" to companies) now far exceeds the amount we had in subprime mortgages in 2008. During the next recession these loans will go into default en masse, leading to huge losses for banks and, especially, for retired investors who own junk bond funds.

Now we'll quickly look at the state of the U.S. economy. Clearly it's not doing very well, with the rate of GDP now growing at 1% over the last six months. Since 2% is considered "stall speed," i.e. so slow we are in danger of going backwards into recession, we are definitely in danger right now. In recent months we have shared many of the details, so in this report I will just give the highlights:

- Business sales have dropped by over 5% from their July 2014 peak.
- Capital goods sales, which are business investments in new plants and equipment, are down 7% from their high in 2015.

- Core Durable Goods Orders (Ex-Transports) dropped 0.5% year-over-year. Durable goods are products, such as household appliances, machinery, or sports equipment, that are not consumed or destroyed in use and can be used for a period of time, usually three or more years. This extends the durable goods **losing streak to 13 months**. This is the **longest streak in the history of the series with no recession**. All segments of durable goods fell month-over-month in February.
- Retail sales dropped .1% in February. Total consumer spending has inched up only .1% each of the last three months.
- With business sales, capital goods, durable goods, and retail sales dropping, unsold business inventories have now ballooned beyond the level first breached when Lehman Brothers imploded to begin the financial crisis in 2008.
- Industrial Production plunged 1.8% year-over-year - *the fastest pace of collapse since May 2008 and a level that has never not produced a recession*.
- In February the larger services sector finally fell into contraction. This could be the final straw that drops the U.S. economy back into recession this year.

Summary

In the first quarter the economy went from poor growth to essentially no growth. While it's still too early to tell, the falling trajectory of the data points to a fairly high probability we are either already in a recession or will soon return to one.

While Yellen and the financial media continually claim the U.S. economy is actually doing well, they actually only point to one allegedly positive statistic – a low unemployment rate. If we exclude the 14.5 million “invisible” workers without jobs, the fact workers are not getting sufficient wage increases, or the fact the new jobs being created are part-time, I suppose one could say the employment market is positive. But those facts are real, and the employment market is far, far from positive at this time.

The World Economy

Anyone who listened to Fed Chairperson Janet Yellen speak recently heard her say the U.S. economy is actually doing quite well, but we are being pulled down by the rest of the world. This is half true, which is more accurate than normal for Yellen.

During January and February it looked as if investors worldwide were perhaps beginning to lose their faith in central banks. Japan upped the ante on monetary madness by instituting negative interest rates, and their markets rebelled. Over the last six years, whenever a central bank did something – anything – stocks went up. But in February when Japan's central bank started charging their banks for some of the money they keep on reserve, Japanese stocks rose for only three days before falling back down. Attempting to defend their central bank experiments in parliament, their central bank leader Hiroki Kuroda was practically yelled into submission. It turns out the Japanese politicians are facing some serious negativity from their constituents regarding their experimental monetary policies. This isn't surprising. Japan has been engaged in questionable monetary policies for well over 20 years now, during which time they have had 11 rounds of quantitative easing, i.e. printing money. Yet throughout this entire time their monetary experiments have failed to stimulate the real economy and financial prospects of its citizens. Their response was, unfortunately, predictable. Instead of questioning policies that have failed for over two decades, they decided the obvious best course of action was to do a great deal more of the same! The result: a return to recession, though one could certainly make the case they never actually exited the recession that began throughout the world in 2008. As I was writing this report they released the Industrial Production numbers

for February which showed a 6.2% plunge – the largest drop since their March 2011 earthquake and tsunami.

With global stock markets falling into a bear market by mid-February, i.e. down over 20% from their 2015 highs, central bankers around the world rushed into action. The European Central Bank and its head Mario Draghi did not disappoint markets. He lowered their benchmark interest rate a bit further into negative territory, to a negative .4%. But the main program he announced was to begin buying investment grade corporate bonds. Short-term this could be a game changer for European stocks and corporate bonds. The interest European corporations have to pay on their loans is now destined to drop even further. In fact, if the trend continues we could see a situation in which some of their corporations will now be able to borrow money, pay no interest at all, and then be required to return less than the original loan amount.

In this report I'm not going to catalog all the potentially devastating outcomes this policy may have on the European economy. In short, it could lead companies on shaky financial ground to be able to borrow massive amounts of money for nothing. Goodbye capitalism!

While the ECB's new policies may lead to (short-term) gains for their stocks, we need to keep in mind the actual reason central bankers such as the ECB are engaging in these experiments is to spur more lending. The most immediate problem with this approach is that it hasn't worked, at all. Since the ECB began its money-printing extravaganza in early 2015, lending to Eurozone businesses has flat-lined instead of increasing. It turns out many of their over-indebted companies are choosing not to pile on more debt regardless of the interest rate.

Perhaps the largest economic problem in Europe is that many of their largest banks remain insolvent, i.e. they are worth less than nothing. These banks are not that interested in making more loans to companies who may never be able to repay the principal – especially when interest rates are so low the companies pay the banks almost no interest. If you are looking for one of those “external shocks” that could plunge the U.S. economy into recession, major European banks collapsing should be high on your list of concerns. Their largest banks have invested heavily in troubled Southern European countries and emerging market countries who are totally dependent on commodity prices. While we will never know how troubled European banks are until a few days before they go bankrupt, the problem is huge and not improving. Negative interest rates throughout Northern Europe may be the final dagger in the heart of their banks.

Then we have China. It would take an entire book to begin to describe all the actions their central bank and government have been taking to try to counter their sinking economy. For the last 18 months China has announced a new program two or three times *a week!* This deluge of monetary experiments is, to say the least, quite odd, as their newest program consistently moves their economy in the exact opposite direction of the previous plan. On a Monday they will announce a program to spur more lending to build more infrastructure, and then by Thursday they will unveil a program to squash this same type of lending. Some seem to view their consistently contradictory actions as a sign of their in-depth knowledge of all things economic. Others, including your advisors here at Secure Retirement, see their actions as being increasingly desperate and illogical. We firmly believe we are correct in this assessment, and here is some of the proof.

China experienced growth levels rarely seen in the history of the world for many, many years. Unfortunately, much of this growth was the result of unheard of debt creation. Their local governments and real estate developers were basically given a blank check by their federal government to borrow and spend any amount they wanted. The predictable result was that they built more than was economically justified. Just one example of this can be seen in the more than **60 million** empty apartments already built, or the

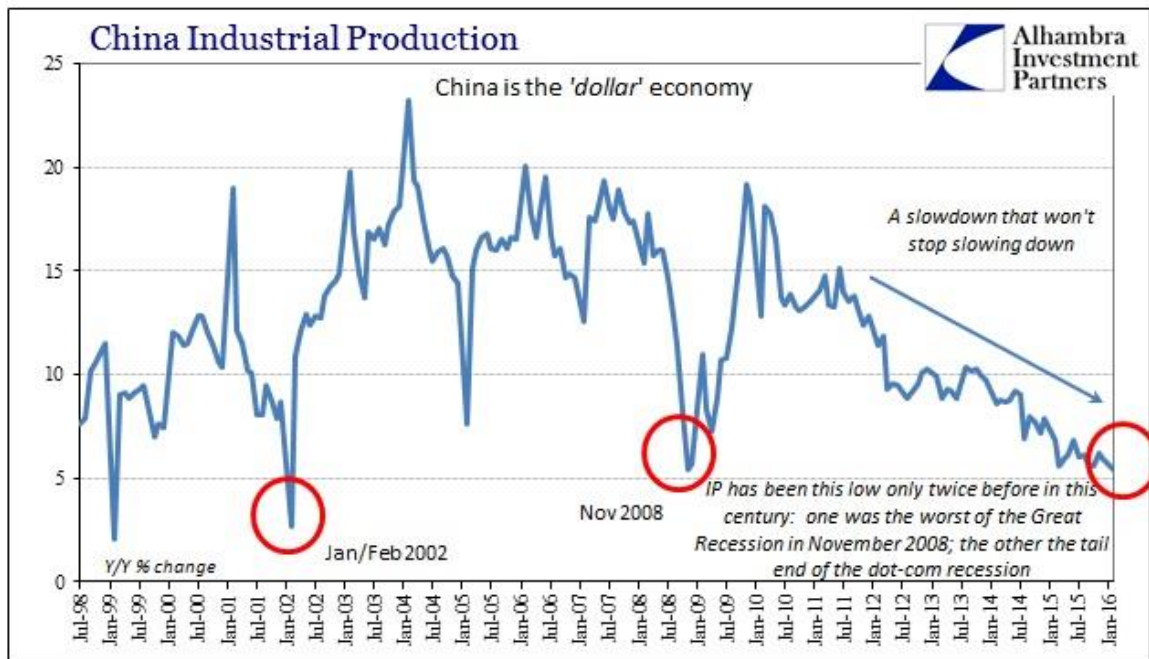
entire “ghost cities” they have built. Having overbuilt throughout their country, and having in the process increased their nation’s total debt by over 400% in six short years, the ship has already sailed as to whether or not they are going to have a financial crisis. (That may be the only ship sailing from China these days, as Chinese shipping has collapsed over the last 18 months.)

With a financial crisis already now fully “baked in the cake,” the remaining questions are 1) when will they have the crisis? and 2) what will this do to the rest of the world economy and markets? I’m afraid I do not know the answer to the first question, but the second one is easy. The details won’t be obvious until their meltdown is underway, but the world economy absolutely cannot withstand a plunging Chinese economy without leading directly to a severe worldwide recession.

If you happen to be one of the unfortunate people who regularly watch the stock market channels, i.e. MSNBC, Bloomberg and/or Fox business news, you undoubtedly have noticed their guests rarely, if ever, believe China has an inevitable financial crisis coming. Instead, most give equal weight to the Chinese government’s description of what is and will occur. They believe China is going through a transformation in which they dramatically lessen their dependence on manufacturing and exports in favor of a U.S. style economy focused on domestic consumer spending.

The first time I heard about this idea I nearly burst out laughing. Their phenomenal economic growth has been built almost exclusively on manufacturing. But now their factories have the capacity to produce much, much more than the world wants or needs. As a result, many of their manufacturing companies are losing a lot of money every month, and many of these companies are huge, employing many, many thousands of people. Here’s the problem with their alleged transition away from manufacturing to consumer spending. If their citizens lose their manufacturing jobs, how are they going to get the money to spend more?

Before looking at how well their citizens are doing at turning China into a consumer spending instead of a goods-producing society, let’s see just how far their manufacturing economy has fallen thus far. The following chart shows the trajectory of Chinese manufacturing, which remains the core of China’s economy.



That chart pretty much speaks for itself. The bulk of China's economy has been going down since the beginning of 2010 or over six years (and counting). In fact, their latest export report showed they crashed **25% year-over-year**. In an economy inextricably tied to manufacturing, in which they have thousands of large companies way over-indebted, exports falling by 25% is shockingly bad.

This export report came out right when stocks began their rebound. The narrative was that it now looks as if China's problems are lessening, and/or that their central bank has everything under control. I can barely believe the TV analysts can say this with a straight face!

Next we'll look at how they are transitioning to a consumer spending economy. From the beginning I considered this an absolute pipe dream. Yes, the day may dawn when their services and retail spending sectors will be the primary driver of their entire economy. But that day will not be this day; chances are it *might* be established a decade from now. But again, we do not have to make guesses based on theories, as we can see the actual numbers. The following chart shows Chinese retail sales. Just like with manufacturing, retail sales growth in China has been falling for years



Summary of International Economies

I realize the preceding was a lot of gloom and doom, but those are the facts in the real economy. The fact is the most likely ending for the Chinese, European and Japanese economies is financial crisis. Of course, I still have no idea when crisis will hit. What I am becoming more and more sure of each week is that the world economy is likely to end this year in a recession – if we're not already in recession.

In closing, I must give Ms. Yellen her due. She is woefully ignorant about the state of employment here in the United States, a remarkable indictment when directed towards a labor economist. On the other hand, in her role she almost has to pretend our economy is doing pretty well. In fact, one could make the case a Fed chairperson is required to be upbeat unless the economy is actually collapsing on the day he or she speaks.

But she is correct that the state of the world economy is deeply troubling. World trade is literally crashing, and we have a bona fide trade war going on in response. The previous engine of world economic growth, i.e. China, is floundering worse than at any time in decades. Japan is now in almost perpetual recession, and the

Eurozone is on the thinnest of ice. Europe would be in deep trouble even if they did not have a nightmare migration problem confronting them, which they do. And most troubling of all, the easy way out of all economic problems, which is to dramatically increase debt, no longer works because the world is already awash in bad debt. Yet central banks keep upping the ante on the same policies that got us into this dire situation. I'm reminded of the old saying that the first thing you should do when you find yourself in a hole is to stop digging!