Economic & Market Update, February 2018

No, Nothing Has Fundamentally Changed

By Richard Morey

January was certainly an interesting month. The stock market had a great month in January before tumbling over 600 points on the Dow on February 2. Some of our clients were surprised to see that our accounts also went down that day. Aren't our accounts designed to go up when stocks go down?

The answer remains an unwavering "yes," but not every day. For example, the long-term government bond market goes up approximately 75% of the time stocks go down. (This is one of the strongest negative correlations in the markets.) But it also means long-term bonds go down with stocks approximately 25% of the time. This occurs when the stock market goes down because risk is hitting the bond market. Obviously long-term government bonds (Treasuries) do not go up when stocks are falling *because* the bond market is going down!

Before looking at the actual data, we'll first outline what the markets are thinking today. The belief is the economy finally really is taking off. Everything is clear sailing ahead, due to tax cuts and a reduction of federal regulations. Their actual evidence for this conjecture is still somewhat flimsy, as 4th quarter 2017 economic growth (GDP) came in at a modest 2.6%. Still, they are sure this is just the beginning of an economic renaissance.

This is bad for the bond market. If the economy begins to overheat, the Fed will begin to raise short-term rates more quickly to try to cool it off. More importantly for our accounts at Secure Retirement, if the economy truly is starting to shoot up, inflation must begin to rise much faster. Rising inflation expectations is the one thing that brings down long-term Treasury prices. Once again, the current data does not back up these concerns, as core inflation (CPI) rose only 1.8% in the 4th quarter, while the Fed's preferred measure of inflation, called Personal Consumption Expenditures or PCE, rose only 1.5%. This is substantially below the Fed's target of 2%, but the markets are just sure the economy is going to take off right away and inflation will come back in force.

The bond market began to suffer early in January, as this economic growth and inflation story began to gain momentum. Then the stock market finally jumped on the bandwagon. Although economic growth is good for stocks, if the Fed responds by raising short-term rates too quickly, they nearly always overshoot. Higher rates bring the economy down too far, we enter a recession, and stocks come crashing down.

Reality

No, the market's views, which were quite bad for long-term bonds in the last month and stocks in the last week, are completely wrong. This is not hard to prove with only a quick glance at the actual numbers from the Bureau of Economic Analysis (the agency which calculates economic growth or GDP).

First we must put the last few months of the economy in context. Last year we had the largest losses in U.S. history due to natural disasters. Total losses, due mainly to the two terrible hurricanes followed by the fires in Northern California, were well over $300 billion. When buildings and cars are destroyed in a natural disaster, those losses are not subtracted anywhere when calculating economic growth. But when money is then spent to replace or repair them, those expenses all go into supposed economic growth. (Yes, this is nonsensical, as proven by economic studies showing you cannot create great economic growth by breaking every window in your country!)

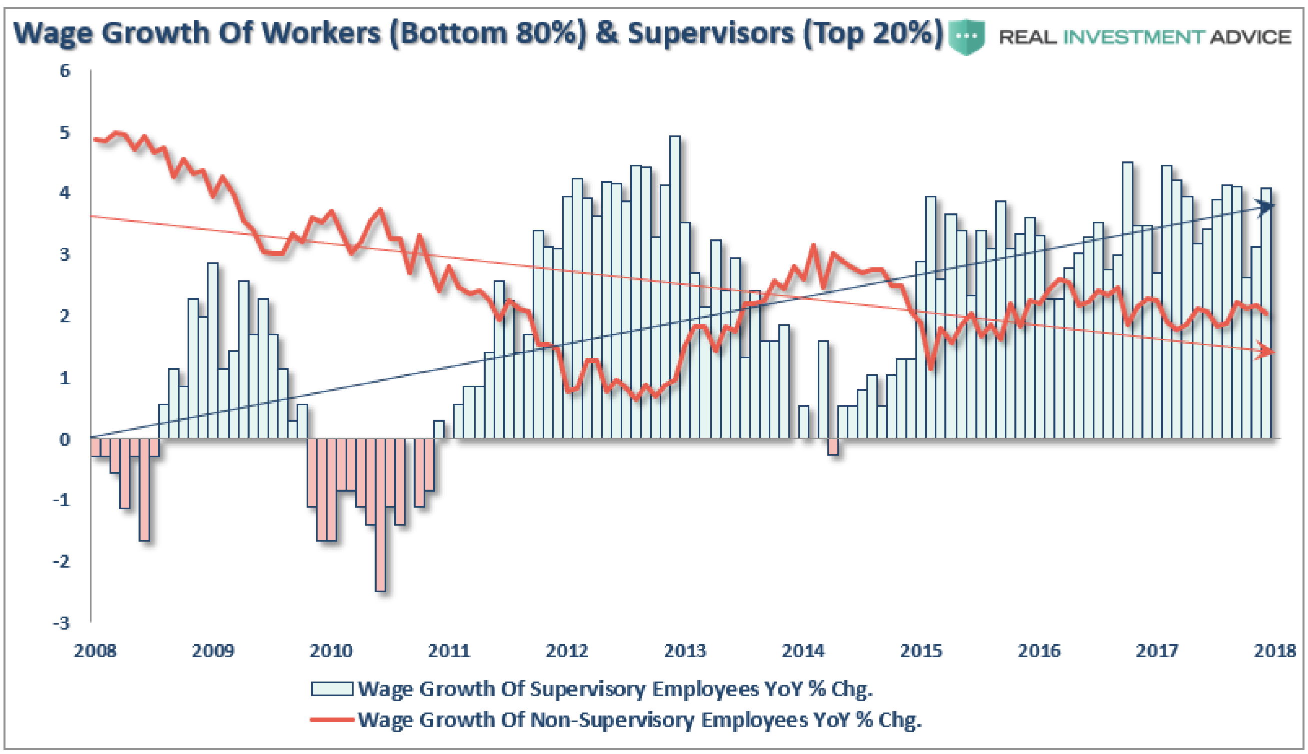
Now let's look at 4th quarter GDP. Throughout the first three quarters of the year, auto sales were slowly but steadily falling. Then in the 4th quarter they jumped up, as up to one million vehicles were destroyed in the floods caused by hurricanes. As a result, 4th quarter GDP increased by 1.2% due to growth in the auto industry – an industry that had been subtracting from GDP all year until the hurricanes hit. We see a similar but smaller bump up in spending related to home repairs needed after the hurricanes and fires.

This category added .2% to the GDP number. If we begin with total GDP of 2.6% and subtract the two categories directly related to disasters, we see the underlying economy grew a paltry 1.2% in the fourth quarter.

This is pretty much what we would have expected from previous years, in which the 4th and then 1st quarters are quite weak, followed by rebounds in the 2nd and 3rd quarters. But since the 4th quarter appeared to be reasonably solid (though 2.6% is hardly great growth), the market quickly decided the economy is now poised to explode higher. No, it isn't, for reasons explained below.

Then we had the final nail in the coffin proving the economy and inflation were preparing to roar. This was the wage growth data which came out on Friday, February 2. Wage growth has been the missing element in the Fed's fervent wish to pretend the economy has finally recovered. With 70% of U.S. economic growth determined by consumer spending, it's difficult to claim the economy is going to fully recover when wages aren't going up.

But on February 2 we learned wages (average hourly earnings) rose 2.9% year-over-year. Again, this is not a huge jump, but certainly respectable. But, once again, a little context shows wages are not truly recovering. The chart below shows one problem with this new wage growth theory. The bars show the wage growth for supervisors, while the red line shows the growth for all the regular workers. As you can see, wage growth for 80% of employees, the non-supervisors, continued its slow decline of the last two years.



But the largest hole in the wage growth story involves something called "average weekly earnings," i.e. the size of paychecks. Last December the average worker made $919 a week. In January the average worker made only $917 a week. Note this included the supervisors whose wages are rising nicely, which means the average worker saw a noticeable reduction in their paychecks. How can hourly earnings go up when wages are going down? The answer is that employees worked fewer hours.

When you look at these payroll numbers in context, we certainly do not see any meaningful recovery in wages. Now I fully understand why the bond market would be quite scared if wages were rising rapidly, as this is the number one cause of increases in core inflation. But it isn't happening, nor will it occur anytime soon.

So we've seen how the current economic and wage growth stories break down with even a little context. Now let's examine the forces at play which will determine the trajectory of the economy (and therefore wages) going forward.

The big story here involves consumer spending. Of course, since it accounts for 70% of economic growth, one could say this is always the big story. The mainstream financial media is, of course, touting the recent increase in consumer spending as a sure sign the economy is poised to take off.

Consumer spending did grow substantially last quarter – a healthy and rising 3.8%. But this was not due to increasing incomes, as income did not go up very much for 80% of workers (see chart above). A better gauge of consumers' ability to spend is something called "real disposable personal income" which measures how much additional money consumers actually have to spend. This only went up 1%, which is a very anemic level.

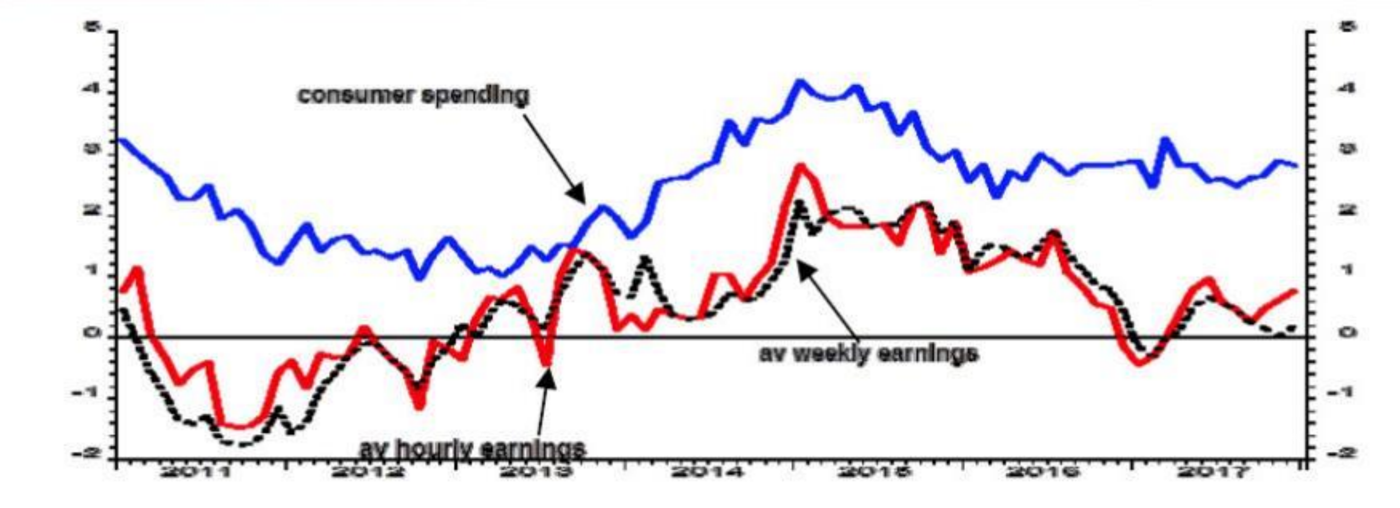
If consumers have only 1% more money to spend, how did consumer spending grow 3.8% last quarter? The answer is simple – they borrowed on their credit cards or took money out of their savings. Both of these activities reduce the total savings rate.

The recent drop in the savings rate has been accurately described as "shocking." Last month it dropped to the lowest level since the 1930s. (There was exactly one exception, which was one quarter in 2005 when people were madly taking out new home equity loans to spend.)

If we kept the savings rate constant, i.e. consumers did not use their credit cards for extra spending, 4th quarter economic growth would have come in at **six tenths of one percent**.

The chart below puts both consumer spending (blue line) and wage growth (red line) together. It illustrates why this alleged economic growth miracle will soon be ending. Consumer spending is far outstripping wage growth. But consumers are now "tapped out," meaning they now have record credit card debt (surpassing $1 trillion last year for the first time).

Real wage growth is close to zero while growth in consumer spending remains robust (yoy%)



Source: Datastream

Summary

We obviously were not at all surprised to see the stock market coming back a bit to reality recently, though it is still quite close to its all-time high. What was surprising, and disheartening on a very short-term basis, was the fact stocks were going down because the markets were concerned the bond market was going to experience large losses due to increasing economic growth and inflation.

By the end of last week, i.e. February 2, interest rates had risen 4 standard deviations above their one year average. Since 1965 this has happened exactly zero times! This comes from Lance Roberts at www.realinvestmentadvice.com. Lance goes on to note several of the points I mentioned above, such as that the apparent economic growth has been due to the disaster spending combined with new consumer borrowing. He also notes how there is still $10 trillion of global bonds with a negative interest rate. With the rates on our government bonds now higher, we should soon see global investors flooding back into our country to purchase our bonds, driving down their yields and up their prices.

But most importantly, our longer-term government bonds or Treasuries rise or fall based on inflation expectations. These expectations rise when the economy is rebounding and plummet when the economy falls.

As soon as the data in this report begins to come to the attention of the markets, bond prices – especially for longer-term bonds – will quickly turn around. Then as we finally approach the next recession they will roar. Then our accounts will indeed do precisely what they are designed to do. The stock market will come crashing down, while our bonds and hedged funds deliver large gains.