Secure Retirement
Peace of Mind is Real Wealth

January 2020

Economic Update, January 2020

The Fed vs Reality

by Richard Morey

A Quick Review of 2019

Last year was the slowest economic growth for the world since 2009. Here in the United States, we end the year with the ex-consumer U.S. economy in recession. Consumer spending has been the ***only*** thing keeping us from tipping over – or rather crashing – into full recession. Retail sales, however, dropped from late August through October. In November, it came in with .2% growth, but we see a more dangerous picture in consumer spending by looking at the losses or no increases in all categories of discretionary consumer spending in the latest data. The growth was in gas prices, medical expenses, and food. When consumers spend less on everything they *decide* (versus being forced) to purchase, this is, by definition, a weakening consumer sector.

Total business spending, industrial production, manufacturing, total corporate profits and profit margins, all ended the year in recession, with all continuing to decline over the last six months or more. You can't have the entire corporate *and* consumer sectors in contraction without being in recession. Based on the retail sales data since August, it appears we may have fallen off towards the downside last fall. It all depends on consumers, though they are the last to realize we are in recession.

Businesses see first, and they were shrinking their operations, battening down the hatches as it were, all year in 2019. I suspect 2020 will give us the opportunity to see for ourselves, once again, which leads the economy, a contracting business world or rising consumer spending? Many of us are sure we already know the answer to this question. Of course, with consumer spending having had a flat tire in late August, the better question is now what happens when the entire business sector of the economy is contracting and then the 69% of GDP called consumer spending shifts into reverse? Going 100 miles an hour, on roads which haven't been maintained. We may find out fairly soon.

That's Not What I Heard on Television?

I know that description of the economy is the opposite of the mainstream view. On my television, the economic news sounds remarkably stable and positive, and nearly every measure of stock investor enthusiasm is spiking near all-time highs.

How do we decide who is correct, i.e. the economy is poised to grow, or it has now ceased growing for this cycle? In this article we will explore both sides of the argument. In my defense, I would like to state it is inherently difficult to make a sound presentation for the view the economy is poised for growth. It's an almost impossible argument to make rationally. Instead, we will look at how we got to the situation we find ourselves in today, in which completely irrational economic and financial beliefs are spouted daily as obvious consensus facts. They are the consensus, but they are based on no relevant facts.

My thesis is that, in economics, we can use real, actual facts to make our case. These are numbers everyone essentially trusts to be accurate and objective. Many, including myself, rail against the stupidity of the Fed's actions and statements. Nobody I know of, including myself, criticizes the Bureau of Economic Analysis or Bureau of Labor Statistics. They are the best, most trusted bean counters in the world.

Of course, it does take them up to three years to have completely reliable results, and they end up making huge adjustments along the way. This is always, and especially, the case when it comes to economic turning points. We can also certainly argue about several of the key components included, and not included, and their weightings, when computing GDP and inflation. Still, we all basically trust their numbers are comprehensive and not adulterated too purposefully (except to keep inflation low to minimize Social Security payments).

My goal is to use the published data to pinpoint, within one quarter, when we actually enter(ed) recession. That presentation will be sent to clients later this month. In this report I will discuss our economy and markets from a very broad perspective.

Combined with the data in our next report, mostly in the form of charts, graphs, and a few simple little equations, we are in hopes clients will gain a clear understanding of where we all stand as 2020 begins.

The One Counterbalance to our Argument: The FED

The reason we're being given today as to why the economy and stock market can no longer fall, regardless of inflated prices and mountains of debt, are the two words "the Fed." The reason why, I am told throughout the day on Bloomberg, "this time different is time," and all the rules, principles, and proven theorems of capitalism, finance, and economics no longer apply is called **central bank money-printing**.

In reality, this isn't even close to an original reason why today's bubble, like all others, is supposed to be justified. I don't believe Rome was the first nation to try to stimulate the economy by printing more money, and I seriously doubt we're the last who will try this desperate and dangerous measure. It has always been an easy, alluring "fix" for nations who can print their own money when faced with debt bubbles. Print it up and pay it off – what could go wrong?

A Financial Crisis is the Answer to that Question

A reading of economic history would have a clear answer to the "what could go wrong" question regarding "printing money."* Printing money to confront a debt crisis is an ingenious way to make the bubble – and ensuing losses – larger and larger. The overall economic outcome, however, is the same regardless of whether or not money printing is the preferred monetary response to a debt bubble. "Larger and larger" is not better when it comes to debt bubbles.

As a rule of thumb, history tells us all debt bubbles lead to financial crisis. All of them. The broad U.S. economy will follow the trajectory of the private economy, and nothing the government can do can change the arc of that trajectory – especially when the economy is burdened with excessive debt.

Fed manipulation can, however, clearly extend the time until we get to the falling side of the chart. The ensuing fall is then increased by the additional increase in debt. You can think of it like a ball swinging from side to side, in which prices, and nearly all economic facts, all settle back to their original state. This state would be the stock market based solely on long-term corporate revenue and earnings performance, and an economy in which debt-dependent growth was stripped out of the GDP calculation. I'm afraid the surgery which will be required to remove the debt bubble part of corporate debt will make some quarters of coming GDP scary-looking numbers.

The Outcome of Too Much Money Printing

If you print *too much* of your own money, history, and simple logic, show inflation will eventually roar. The question, of course, is how much is too much to print? Those who crossed the line in the past found trust was ultimately lost in their currency, which leads to an immediate, massive loss for everyone who owns that currency.

*We include in our definition of money printing all Fed actions which increase the money supply by increasing the Fed's balance sheet. Where does the money come from when the Fed balance sheet increases, i.e. they buy bonds from Wall Street? That is what we call money printing, regardless of any other details.

This is a fairly large "wrong" from a monetary policy perspective. When your currency collapses relative to other currencies, everything you import skyrockets in price. This is the hyperinflation economists worry will result if we print too much.

At the same time, money printing used to finance larger amounts of debt is nearly guaranteed to be deflationary – in your own economy. All "debt liquidation events" are, by definition, deflationary. When a debt bubble bursts, the parts of your economy where the debt isn't being repaid see prices plunge. When your debt bubble is centered in corporate debt, this means the prices of everything produced inside your economy drop.

What would happen if we had a currency crisis, leading to skyrocketing import prices, combined with an internal, corporate-based debt liquidation event here at home, leading to falling domestic prices – at the same time?

Don't Ask that Question

For the first time in my career, I have found a question whose answer is so negative I would rather not talk about the risk it would entail. You can see our concern in the fact we may invest up to 25% in our defensive growth portfolio in precious metals, especially gold and gold-related funds. I studied the impact of owning gold in a currency crisis live when Turkey's currency collapsed two years ago. Gold was the one single thing which fully protected its owners.

Hopefully we won't get to the currency collapse stage, in the near term anyway. I do, however, see that as the likely, almost inevitable, outcome of current monetary policy if taken to the extremes presently planned by the Fed.

The Fed's Best Argument

It is best not to underestimate the size of the experiment the Fed is willing to undertake to prevent or combat the next recession. One thing our central bankers believe is that Japan proves you can have no growth for 20 years, increase your debt beyond anything imagined in previous human history, and get away with it. The fact Japan has gotten away with it for over 20 years is the one fact on the Fed's side of the argument.

All the best monetary economists in the world see the Fed is taking the exact wrong lesson from looking at Japan. The "no growth for over 20 years" part of the sentence is where the focus should be, not on the fact Japan had the largest government debt explosion in recorded history without ceasing to exist! Functioning with a debt bubble is like putting on concrete shoes to go out to work. You can see this in the fact productivity has plummeted to the lowest level in our nation's history. Keep in mind productivity is one-half of total economic growth (with the other half being the increase in the total number of hours worked).

Reality vs Belief in Fed Omnipotence

When stocks get insanely overpriced, there is always one prevailing story presented to convince people "this time is different." Today it's that the economy and markets can now be levitated forever by central bank money-printing. Yet throughout human history, when it comes to money and investing, it never, ever has been truly different. There are *always* reasons given for bubbles, or they couldn't grow. **They all pop.** Every investor should repeat that statement like a mantra at least once a day.

The details vary every single time, but the outcome of historic bubbles is an historic crash. We could be a day or a year from now until that crash, but at this point the extent of the ensuing losses for stocks and corporate bonds is going to be staggering. All you do is look at the amount of debt and understand that the higher the level of debt, the higher the amount of losses. Also know that, just as debt has skyrocketed exponentially, the ultimate losses have skyrocketed exponentially in lockstep. This will soon bring our economy to its knees. Double the movement down in bad debt and you get the stock market's performance from now until we turn the corner from recession, which is likely to be severe enough to earn the moniker depression before we ultimately pull out of it. (Note to Congress: We will grow again, through new business creation and the entrepreneurial spirit of our people – not through ceding control of our economy and markets to whoever has the most money to buy your votes.)

Our Side

I'm certainly not the only one who can still do arithmetic. Fears of a financial catastrophe, sparked by our lower quality corporate debt, is shared by every major international monetary policy body. This includes dozens of current and former central bankers at the Bank of International Settlements. Some of them almost make me sound optimistic. Or ask our nation's best monetary economist, Dr. Lacy Hunt. If you listen closely, you can almost hear every reputable economic expert on debt muttering about the calamity coming to our debt markets, economy, and perhaps even the integrity of the global financial system itself (hopefully for a short time period only should this occur).

The Stock Market

I expect it's worth noting that commercial banks are buying long Treasury bonds, en masse, right now as individual investors are buying stocks as fast as they can. This doesn't prove anything in and of itself, but it actually should stop those stock investors in their tracks when the entire commercial banking industry is fleeing from the direction they are running! Unfortunately, the individual investors won't figure out the right direction until they are plummeting to their financial demise.

I know that was a bit melodramatic, and my purpose truly isn't to scare anyone. Personally, I view what is coming as the natural outcome of greedy people investing based on that greed. Fear always follows that experience.

Unfortunately for NBC, Fox, & Bloomberg listeners, we can prove we are seeing the creation of a hideous cocktail for stocks. We have prices at the tippy top of history – rivaled now only by the tech-led stocks of 2000, and surpassing 1929 for number two on that dubious list. **At the same time, our entire corporate and business sectors ended the year in both an earnings and profit margin recession.**

What do you suppose has happened throughout history whenever highest-ever prices collided with falling earnings and profit margins? If you do that study, you will end up with a much greater respect for the "gravity" of profits when determining stock prices, versus the emotional fancy of investors consumed by alternating bouts of greed and fear.