Economic & Market Update, January 2018

By Richard Morey

In the last year the financial media has, once again, gotten excited about economic growth. As you'll see below, it's difficult to find supporting evidence for this optimism. However, beginning in late 2014 the economy was going down noticeably, and last year we did start moving somewhat in the right direction. Why?

China New Credit (Debt) Created Each Year since 2008

Year	$ billions	Y/Y %
2008	$990	30.0%
2009	$1,615	63.2%
2010	$1,711	5.9%
2011	$1,827	6.8%
2012	$2,079	13.8%
2013	$2,395	15.2%
2014	$1,613	-32.6%
2015	$1,647	2.1%
2016	$1,805	9.6%
2017	$3,641	101.7%

Since 2008, China has accounted for approximately one-half of all economic growth in the entire world. This growth was funded by debt, as you can see in the chart above. In the last decade, new debt in China has increased over $20 trillion or nearly twice their entire GDP. This is the largest explosion of debt in the history of the world.

Now look at what happened in 2017. Total new debt doubled in China last year, and this is all you need to know to understand why the world, and U.S., economy had an uptick. In previous reports we explained why Chinese leaders know they must reduce their debt yet increased it through the roof last year. (The large increases began in mid-2016 and ended in late summer last year.) In October they had their 5-year party Congress at which they re-elected their leadership, and President Xi wanted to be certain their economy would be growing.

Of course, the moment the election was over, President Xi and Co. are now faced with a terrible dilemma. They have to try to slow down new debt creation without plunging their economy into a severe recession. If they succeed, they will be the first country in the history of the world to do so successfully. Considering their debt binge is the largest ever, their prospects do not look promising. But they must and will try to reduce their debt. As China reduces new debt – undoubtedly in fits and starts – this will now be a headwind to world economic growth.

The U.S. Economy

With the driver of world economic growth on debt overdrive last year, we would have expected the U.S. economy to do quite well. It did go up some, but the underlying economy remains weak, right on the edge of recession. For the rest of this section I'm going to quote from a recent interview with Dr. Lacy Hunt, the Chief Economist of the Hoisington Investment Management Co. (from an interview with The Financial Repression Authority).

If you calculate the average growth rate in the expansions since 1790, this is a long-running expansion, but it's the slowest (since 1790!) and in the last 10 years the household sector lagged very, very badly.

In other words, our economy's growth since the recession in 2008-2009 has been the slowest in over 200 years. In fact, over the last ten years our economy has "grown" at almost exactly the same rate it did from 1930-1939. These are not Dr. Hunt's or my opinions, as they were calculated by simply adding up the government's economic growth numbers since 2009.

Why has this economic expansion been the weakest in over 200 years? Dr. Hunt explains: *I think the main element suppressing growth is the heavily leveraged U.S. economy. We have too much public and private debt, and this debt does not generate an income stream for the aggregate economy.*

A related problem involves the impact of the Federal Reserve Board's quantitative easing programs in which they printed nearly $4 trillion: *Quantitative easing caused the corporate executives to switch funds from real capital investments into financial investments through the paying of higher dividends, buying shares of their own companies, and buying back their shares from others. While this type of action does produce a higher stock market; it does not generate a higher standard of living… I think that's the principal problem. Business debt last year reached a record high relative to GDP (as companies have borrowed lavishly and used the proceeds to buy back their own stock).*

Dr. Hunt also addressed the two topics we hear daily in the financial media arguing the economy is actually now sustainably expanding. These involve the employment picture and tax cuts (to now be followed by an infrastructure bill):

Virtually the entire world believes that the United States is experiencing large job gains. But the rate of growth in payroll employment on a 12-month basis peaked at 2.4% in early 2015, and for the last 12 months has sunk to 1.4%. What is even more critical – if you look at just the expansion and don't include the recessions since 1968 – is that the average growth in employment in an expansion year was 1.9%. And in the last 12 months, we are half a percentage point under that figure. Yet, given these numbers, there is an erroneous perception that the employment gains are strong… If we go back to the 12 months ending November of 2015, real average hourly earnings were up about 2.5%. And in the latest 12 months, real average hourly earnings gained a miniscule 0.2%. With the average worker carrying far, far too much debt, a raise of 0.2% in their hourly earnings puts them further and further behind. Considering consumer spending equals nearly 70% of our economy, this is a serious problem.

And regarding tax cuts and possibly infrastructure spending, Dr. Hunt says: *Here's my attitude: the new federal initiatives, whether tax cuts or infrastructure, will not provide a boost to the economy if they are funded with increases in debt – and that's where we're at. And by the way, it's been that way for some time. If you go back to 2009, we had a one-trillion-dollar stimulus package that was said to be inflationary and was going to boost economic growth, but yet we still had this very poor expansion and little inflation except for intermittent bouts here and there…*

I will say this: when you have a debt-financed infrastructure program or tax cut, there will be pockets within the economy that will benefit, but the aggregate economic performance will not benefit and so fiscal policy, as I see it, is not really going to be helpful. The risk is that the debt buildup will add to the problems.

On this topic, I would add that the only way the recent tax cuts would lead to economic growth would be on the corporate tax cut side, if companies used savings from lower taxes to invest in their businesses. Unfortunately, tax cuts only lead to investment if there was a blockage to begin with. If businesses weren't investing in expanding because they lacked access to money, then giving them more money could indeed lead to increases in business investment and, therefore, productivity, hiring, etc. But this is absolutely not the case today.

Why aren't companies investing in their businesses? There are two primary reasons. One is that they look at consumers and see they are over-indebted and are not seeing their wages rise. Plus, any increases in income consumers are getting are being more than consumed by increases in healthcare costs. If their customers cannot buy more, why would a company want to plow money into expanding? Secondly, corporate executives have realized their personal profit is dependent not on the longer-term growth of the company but on the short-term movement of their stock price. Investing in growing your business can take years to bear fruit, while buying back your own stock increases earnings this quarter. Over the years, regulatory changes have now incentivized corporate executives to ignore the long-term in favor of cashing out today.

Those who claim the corporate tax cuts will lead to a boom in business investment have simply been making that claim with no proof or reasoning behind it. That is because there is no path by which these tax cuts will lead to such investments. They will therefore not lead to increased hiring or economic growth. And those who claim the companies will now raise their workers' salaries because their companies will owe less in taxes surely must be joking!

In the rest of the interview Dr. Hunt examines the flows of money in the economy. The short summary is that money supply, the velocity of money or how often it changes hands, and business lending, are all pointing towards a slower economy this year. Combined with the Fed now starting to remove some of the money it printed while simultaneously raising short-term interest rates, we should expect little or no economic growth in 2018.

Before moving on I would like to share a positive view as to how our nation could proceed to increase productivity and therefore economic growth. Dr. John Hussman recently wrote: *If our policy makers are interested in boosting long-term structural U.S. GDP growth, they should be providing direct and targeted tax incentives for real investment, education, research & development, and other factors that could, over time, increase our nation's productive capacity. Instead, they've opted for a giveaway to corporations and wealthy individuals, which will likely expand the deficit while doing virtually nothing for economic growth.*

I fully agree with that statement but would also state that this is the view the Democratic Party *should* pursue, but typically doesn't due to special interests. From a Republican Party standpoint, productivity and therefore economic growth could be enhanced by removing the obstacles to the creation and success of new businesses, while simultaneously removing the obstacles which prevent failing companies from going out of business. In other words, remove the roadblocks to fair capitalist competition. Again, special interests seem to regularly thwart Republicans from pursuing these attempts in favor of "crony capitalism." This is defined as an economic system characterized by close, mutually advantageous relationships between business leaders and government officials. I'm afraid this is the system we have today, as most members of Congress, from both parties, embrace and encourage it.

In other words, all is not lost. Our country can once again grow sustainably, once our elected officials are no longer owned by special interests but begin working – based on sound economic principles – for the good of the entire nation. Unfortunately, we will not even have the opportunity for this to occur until the next, historically difficult, recession forces a groundswell of the public demanding these types of changes.

When Will We Enter Another Recession?

A recession is generally defined as two or more consecutive quarters in which the economy (GDP) goes negative. GDP can be calculated by adding growth in the number of labor hours worked with increases in productivity. We can view economic growth from two perspectives. Structural growth is the baseline of labor plus productivity. At this time, based on demographics, the growth in the number of hours worked in our economy is 0.4% a year. Productivity has been averaging 0.6% a year. Combined, this means the economy now has a baseline growth rate of 1% a year. That is very close to nothing, i.e. recession.

The other part of economic growth is the cyclical aspect. When the economy is expanding, the unemployment rate drops, and this raises the growth in the number of hours worked. **Economic growth typically increases when the unemployment rate starts high and begins to fall.** As more people are then put back to work, this increases the number of hours worked. Since 2010, one-half of all our economic growth has been due to the unemployment rate falling. But it now is reported at 4.1%, which is a low number.

On the productivity side, productivity increases (through business investment) when the savings rate is rising and we begin with a positive trade situation, i.e. we are exporting more than importing. However, at this time both are in the exact wrong position. This means we are basically through with the cyclical phase of growth which has pushed the economy from the 1% baseline to just over 2% a year since 2010.

Summary

In this report we have examined how our economy (and indeed the world economy) is ultimately being pulled down by too much non-productive debt. This debt siphons money away from the economy, and at the debt levels we now have – including consumers, corporations, and the government – there simply aren't enough resources left for sustained economic growth. And as we discussed above, as we begin 2018 we are back to a baseline of a meagre 1% potential economic growth.

But we still haven't answered the question as to when we will enter the next recession? When will we go from 2% or so, to 1%, to negative? Unfortunately, this is one of those mysteries comparable to knowing when the stock market will finally come tumbling down. In fact, these are really the same topic.

At some point, either because of an unforeseen geopolitical or economic shock to the system or simply because their views turn negative at the same time, corporate executives will see enough problems on the horizon to act. Concerned they will not be able to meet next quarter's earnings estimates, or the next quarter's (even using their "creative" accounting methods), they will start to liquidate all the bad acquisitions they have made in recent years. They will also simultaneously "liquidate" all the workers they possibly can.

The next recession will probably be the worst any of us has ever seen, due to the historic amount of bad debt now clogging our entire system. In addition, the misguided incentives CEOs and other top executives function under these days will exacerbate the next recession. As soon as CEOs decide the next step is down, they will do everything possible to dump all their losses onto their financial statements at once. It doesn't really matter if they lose $2 a share or $0.20 a share, a loss is a loss. What matters is that they get back to reporting positive numbers as soon as possible. The bigger the losses they show during the downturn, the easier it is for them to show positive numbers going forward.

For those still paying attention, you will notice I still haven't answered the question! I know the economy will be slowing in 2018, receding back to its (pitiful) 1% of baseline growth. But predicting when it will turn negative – enough to overwhelm the government's attempts to keep it looking positive through their statistical games – seems to be beyond the predictive powers of anyone I have found. The next recession will likely appear to emerge "out of the blue." The sooner it arrives, the less overall suffering our nation will experience. At this point, that date should be approaching in the not-too-distant future. Stay tuned.