Economic Update, July 2017

The Big Picture

By Richard Morey

This report may be the pinnacle of my pessimistic economic views. I recently came across a report from a financial writer named Michael Snyder who presented some stunning numbers. He listed GDP or overall economic growth in the United States during the decade of the Great Depression and then the last ten years. Here are those numbers and a few comments from Mr. Snyder:

> "The following are U.S. GDP growth rates for every year during the 1930s…
>
> 1930: -8.5%
> 1931: -6.4%
> 1932: -12.9%
> 1933: -1.3%
> 1934: 10.8%
> 1935: 8.9%
> 1936: 12.9%
> 1937: 5.1%
> 1938: -3.3%
> 1939: 8.0%
>
> **When you average all of those years together, you get an average rate of economic growth of 1.33 percent.**
>
> That is really bad, but it is the kind of number that one would expect from "the Great Depression."
>
> **So then I looked up the numbers for the last ten years…**
>
> 2007: 1.8%
> 2008: -0.3%
> 2009: -2.8%
> 2010: 2.5%
> 2011: 1.6%
> 2012: 2.2%
> 2013: 1.7%

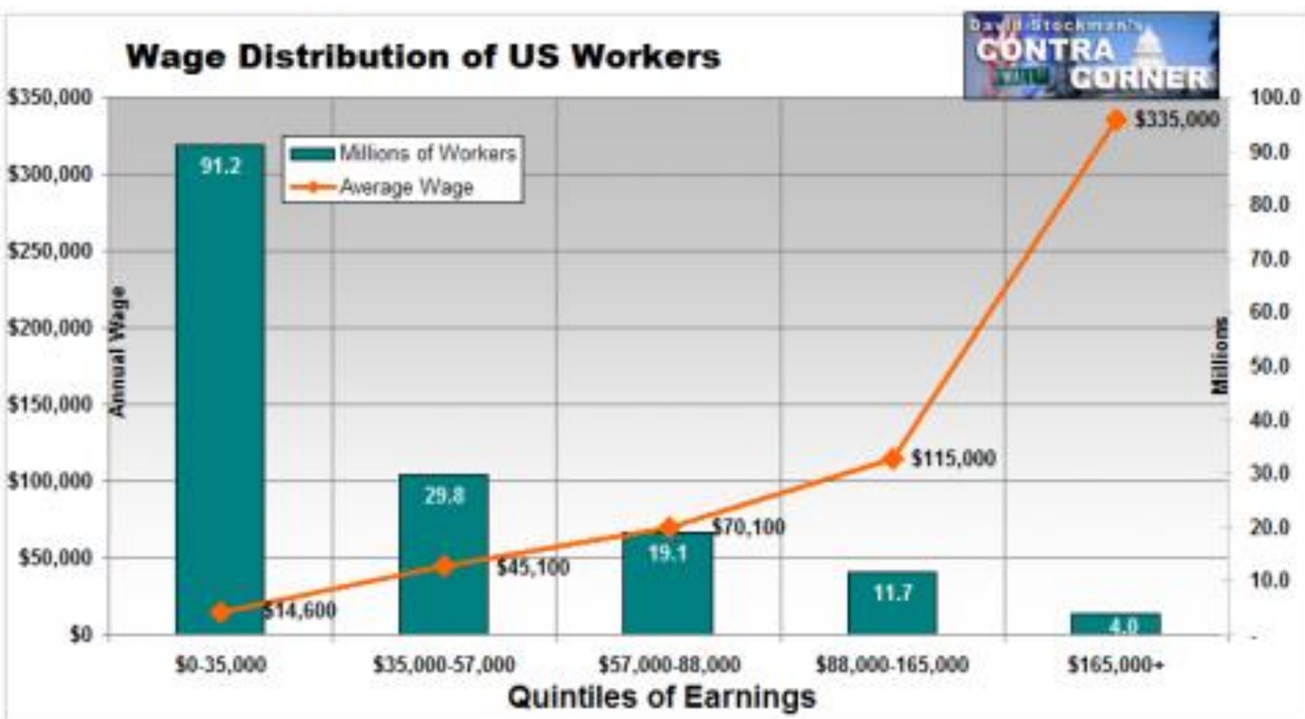
2014: 2.4%
2015: 2.6%
2016: 1.6%

<u>When you average all of those years together, you get an average rate of economic growth of 1.33 percent.</u>

…Of course, the mainstream media continues to push the perception that the U.S. economy is in "recovery mode", but the truth is that this current era has far more in common with the Great Depression than it does with times of great economic prosperity."

When I first saw those numbers they did not seem to correspond to actual experience. We know the Great Depression was a time of horrendous suffering. In contrast, while the recession of 2008-2009 involved much financial pain, we did not see huge bread lines, unemployment over 25%, and runs on huge numbers of banks. However, the overall growth of our economy has indeed been as weak this last decade as it was in the 30s.

You can see our economic problems most clearly when you look at wages. While the top 10%-20% of workers continue to see solid wage growth, the picture is dire for the majority of workers. We currently have approximately 156 million employed people in the U.S. As you can see in the chart below, ***91.2 million of these workers make less than $35,000 a year, with an average income of $14,600.*** This means 58.5% of our workers make an average of $14,600 for an entire year. While these people do have jobs and are not frequenting bread lines ala 1932, they are also clearly doing quite poorly. (Of course, these days bread lines have been replaced with Food Stamps, which 43 million of our citizens are now receiving.)



Making sense out of all these numbers is actually not that difficult. In the 1930s we had a huge, multi-year crash, but it was followed by dramatic increases in economic growth. In this last decade we had a much smaller crash, but it has been followed by the weakest "recovery" in over a century.

In both cases the cause of the original crashes was the same, i.e. too much debt. But this time around we responded to the crisis by ***dramatically increasing debt***. Since 2009 total government and corporate debt has essentially doubled, while consumer debt recently surpassed the historic high first reached in 2008.

We are essentially in a "catch-22" situation economically. Had we not unleashed more and more debt, the recession of 2008-2009 very likely would have led to a bona fide depression. However, by responding to a problem created by too much debt with much, much more debt, we have pushed the problem forward without addressing it. In other words, the real reckoning in which we have to face the consequences of our debt bubble has not yet occurred.

Of course, economic history (over the last 700 years) has shown you can never return to previous levels of growth until you do resolve over-indebtedness. Countries who bail out their banks and increase government debt in response to a financial crisis grow, on average, just over 1% a year – for the next 20+ years! In 700 years there have been essentially no exceptions. In addition, in almost all cases these countries also experience much more frequent recessions. This is where the U.S. has strayed from history, as we are now approaching the longest time on record between recessions. What's different this time?

The answer is, once again, debt – combined with the largest central bank experiments in history designed to keep the debt rising. Never before has a nation (world) responded to a debt crisis by increasing debt as much as we have. The Institute of International Finance has been warning about global debt levels for several years. Their most recent report covering the first quarter was the most troubling to date. It showed global debt hit a new all-time high of $217 trillion, or over 327% of global GDP. Centuries of economic history has shown nations essentially stop growing, and usually have a financial crisis, when their debt to GDP level exceeds 275%. Now the entire world is over that line!

Extreme debt levels can now be seen in the U.S., the Eurozone, and Japan. But China truly stands out. Wolf Richter, one of the better economic minds, recently summarized China's debt boom with a few data points:

- Since 2005, roughly one-half of all new debt in the world has been created in China.
- Ten years ago, China accounted for approximately 5% of total debt worldwide. This number is now 25%.
- In the last ten years, total (nonfinancial) debt in China has gone from about $3 trillion to $22 trillion.
- Last year alone, new debt in China exceeded $3 trillion or approximately 30% of their nation's entire GDP. (The real number may be closer to $4 trillion or 40% of GDP.)

The Chinese central government officials are vividly aware of the dangers involved in creating the largest debt explosion in the history of the world. As a result, they are trying to slow it down. Unfortunately, they face two obstacles:

1. Whenever they slow down normal bank lending, borrowers simply move to "shadow banking" to get their loans. Most of this shadow banking is done by the banks themselves, but the loans are categorized differently. China now has over 30% of their GDP in essentially unregulated shadow banking. I won't go into detail here, but suffice it to say this is outrageously dangerous.

2. Debt-based growth is a lot like addiction. It speeds up the economy almost immediately and therefore "feels good." However, the moment the debt increases stop, the economy drops down, typically to a weaker state as the interest and principal for the debt must be repaid. The Chinese

> leadership is scared of their debt bubble, but they are even more scared of stopping the barrage of new debt as the economy will likely fall far and hard.

Even though our present-day political and economic leaders believe increasing debt is the only viable path to follow, some of the finest thinkers in our history thought the opposite. For example, Thomas Jefferson was so against government debt he wished it had been outlawed from the beginning. Jefferson said, "I wish it were possible to obtain a single amendment to our Constitution. I would be willing to depend on that alone for the reduction of the administration of our government to the genuine principles of its Constitution; I mean an additional article, **taking from the federal government the power of borrowing."**

When Will This Debt-Fueled "Recovery" End?

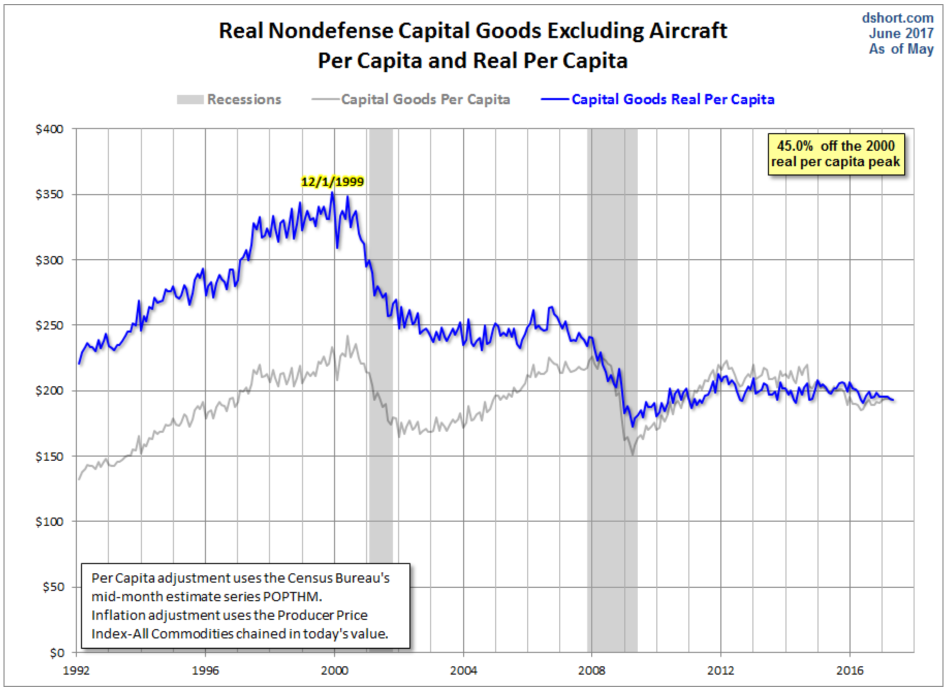
This is the question we are asked most often by clients. I wish I knew the answer, as any investment manager who knew the timing could make all their clients very, very wealthy. While we do not know precisely when, we can identify the tell-tale signs of the end.

From one very real perspective the answer as to when we will re-enter recession is…. last year. In last month's report, we detailed how the government has changed how they calculate inflation over the years to dramatically lower the reported inflation. If we ignore inflation and just look at total economic growth (called nominal growth), 2016 was one of the worst five years for our economy since World War II. Alternatively, as we showed last month, if we used the 1990 inflation calculations, the U.S. has now been in recession every day for the last 10 years.

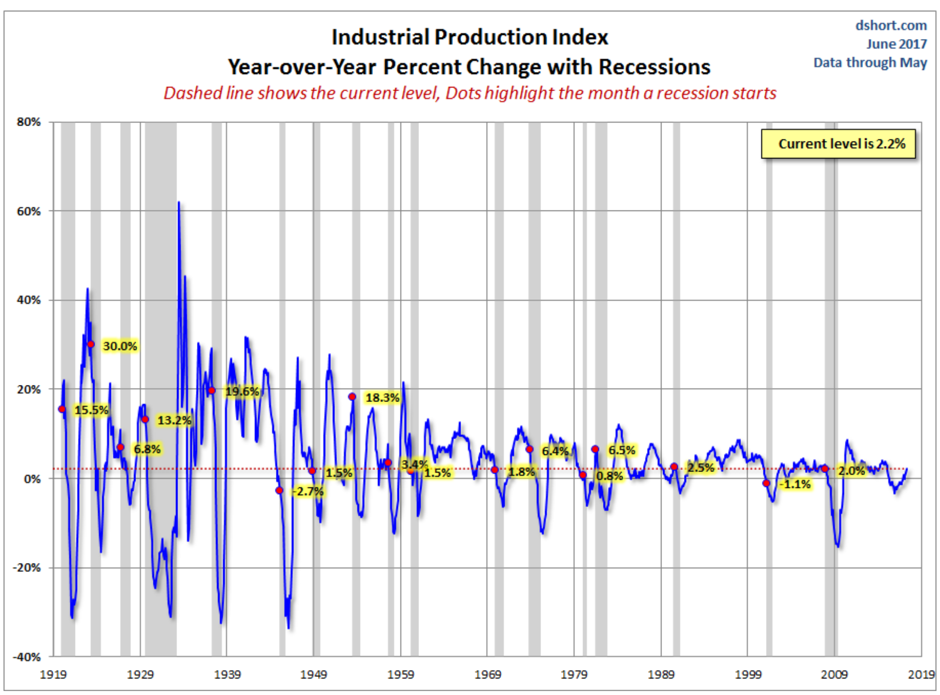
But using the government's numbers, let's look at the current state of the economy. We'll just focus on the biggest economic factors. Consumer spending accounts for over two-thirds of U.S. economic activity. In the first quarter consumer spending grew a miniscule .3%. Keep in mind "good" consumer spending increases by 6% or more, a level we haven't seen in many years. Obviously it is difficult for consumer spending to thrive when nearly 60% of our workforce makes less than $35,000 a year and averages less than $15,000 a year.

Housing is another of the largest aspects of the economy. Pending home sales decreased 0.8 percent in May, having also fallen in April. Pending home sales are now 1.7 percent below a year ago.The key to home sales has always been first-time homebuyers, but the number of those purchasing their first home fell to a **three-decade low** last year. Again, when most of our young people are making well under $30,000 a year while home prices are back to their all-time highs, they simply cannot even consider buying a new home. In fact, for the first time ever, more 19-34-year-olds are living with their parents than in any other situation. In other words, young people are now finding it impossible to rent an apartment, let alone buy a house.

Next we'll look at durable goods. These are sales of the more expensive goods which are typically used for three or more years. In May durable goods fell once again, dropping 1.1%. The chart on the top of the next page shows durable goods sales peaked at the end of 2012 and have flatlined or deteriorated since. Most troubling is the fact they are down a whopping 45% from their high reached **17 years ago** on a real, per capita basis.



Another key area is industrial production (which includes all manufacturing). The chart below, from Advisorperspectives.com, shows the year-over-year percent change in Industrial Production since the series inception in 1919. They note the current level is lower than at the onset of 10 of the 17 recessions over this time frame of nearly a century.



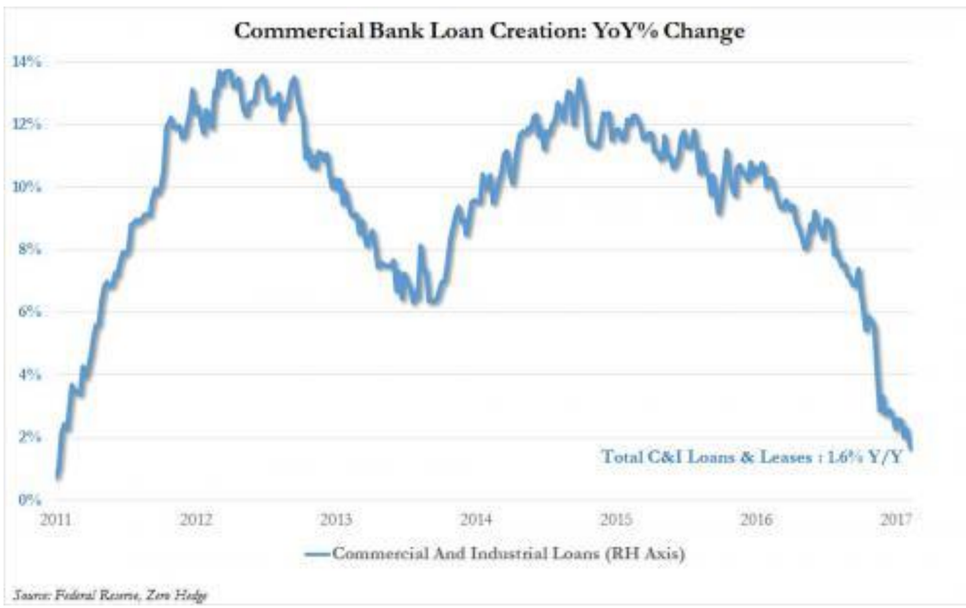
Auto sales have been the strongest part of our economy since 2010. However, they have dropped for four straight months. Here are the numbers for the largest companies for May: Ford: **-7.1%** (-4.7% expected), GM: **-5.8%** (-2% expected), Fiat Chrysler: **-7%** (-5.9% expected), Nissan: **-1.5%** (1.5% expected), Toyota: **-4.4%** (-4.2% expected), Honda: **-7%** (-5.3% expected). With millions of cars coming off of leases this year, auto sales should continue to decline for the foreseeable future.

Now admittedly I could find some data showing the economy expanding. Capital expenditures have been rising this year, and wages have been inching up. What I cannot do is create a picture of economic health and anything resembling solid growth.

What will bring us from stagnation into clear-cut recession? Again, the economy never left the last recession for 80% of our population. Instead, they continue to experience slow but consistent decay in their financial lives. The remaining 20% are doing well, especially those at the very top. But again, what will drive us clearly into recession for the entire country?

There are three possible answers to this question.

1) As described above, our over-indebted economy is entirely dependent on more and more debt to stay above water (if only just barely). This is why the following chart is, by far, the scariest for the U.S. economy. This chart shows the state of lending to businesses:



That one chart screams we will be in recession right away, if we aren't already back in one.

2) If the Eurozone, China, Japan or the emerging markets stumble (further), we all go down together.

3) Finally, the economy is now being held up primarily, if not entirely, by the public's psychological view that it might get better soon or isn't doing that poorly. The moment the public becomes despondent about our prospects, this alone will rein in consumer spending enough to push us right into recession.

Summary:

Today every single solid economist sees our over-indebtedness and knows how it will end, most likely much sooner than later at this point. As Bill Gross, one of the best bond investors in our nation's history, recently stated, "Our highly levered financial system is like a truckload of nitro glycerin on a bumpy road." And we will not be reaching a paved road anytime soon.