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Precisely Where is the Economy Today, & Where is it Going?

by Richard Morey

Only the size of the consumer, being 70% of GDP, and its resilience (so far) have given an allure of a solid economic backdrop. Looking at the economy's increasingly poor breadth, it actually is not looking that healthy beneath the surface. Once cutbacks in capital spending and construction spending morph into reduced hirings and sluggish, if not negative, employment readings, the impact on the consumer will be that much more evident. At that point, everyone will be throwing in the towel and calling for recession…

- David Rosenberg

Where are We Today?

When looking at the economy, and markets, near the end of any business cycle, it's best to be vigilant. The next recession will be accompanied by some breathtaking jumps in market volatility. (This is why we will be using a shorter-term approach to investing, as needed, until the bottom.) We therefore would really like to know, as precisely as possible, where we are today, which direction various parts of the economy are moving, and the moment the economy as a whole begins to contract. I know that last part is a tall order, but we may have found the best resource to make the call. This is the economist David Rosenberg of Gluskin Sheff in Canada. Mr. Rosenberg sells his daily and weekly analysis to others, like me. While I'm prohibited from any extensive quoting, **here is my summary of the most relevant points in his *Economics and Strategy* report from September 27:**

In Europe, their combined numbers for manufacturing and services fell to 50.4 in September. This is basically no growth, as anything over 50 is considered expansion, while below 50 is recession. German manufacturing is now in serious recession, falling to 41.4 in September. Plus, in France the trajectory of the numbers is also going in the wrong direction. Europe is teetering on a dangerous peak. Mr. Rosenberg also expressed serious concern that European authorities may have a very difficult time this next time around. That should concern anyone when you consider what happens if they fail.

Asia is also experiencing some serious problems. Like Germany, exports are the lifeblood of South Korea, which saw their exports drop by 21% year-over-year in September. World trade is clearly going down sharply.

Looking at our economy, the picture Mr. Rosenberg sees bears almost no resemblance to what I hear on television in the financial news each day. A major view running through Mr. Rosenberg's findings involves consumer spending. This is the major focus, as this is the only thing holding the economy up. Business spending is either down or insufficient to cover proper upkeep, while real estate construction is also now dropping. Again, the only thing holding us up is the consumer.

Unbeknownst to most otherwise informed people, it turns out consumer confidence dropped substantially in September. In New York, consumer confidence fell over 20% just last month, which was the largest one-month drop ever. The "expectations" component of consumer spending also fell sharply. According to Mr. Rosenberg, this number actually does lead to real consumer spending. If so, the final piece holding our economy up may soon be falling down. All the surveys regarding purchasing plans by consumers have been falling sharply this summer. The lag between lower spending expectations and reduced consumer spending could be as short as one month.

Perhaps even more surprising is Mr. Rosenberg's concerns about the employment picture. People said jobs were harder to get last month (10.9% drop), and expectations of better employment conditions fell 12%. Income expectations fell similarly.

If any of those indexes or surveys are accurately predictive, these could be the first real signs of recession. Specifically, if the decline in consumer spending expectations we saw this summer materialize this fall, we will be in recession before fall ends.

In addition to all the surveys of future economic expectations, we now have several major areas of the economy already in recession. *To quote Mr. Rosenberg*….

"We have a series of rolling recessions in the data right now. Looking at the year-on-year numbers, I see residential construction at -3.2%, exports at -1.7% (pretty big swing from +5.2% a year ago), -4.3% for nonresidential business expenditures (was +4.9% a year back). And business capex growth (business spending on their facilities, equipment, technology) is +2.7%, not even enough to cover depreciation and showing a significant pattern of slowing – from +8.6% in Q1 2018 to +7.2% in Q2 to +6.4% in Q3 to +5.0% in Q4 to 3.3% in the first quarter of this year and, as mentioned, now down to just +2.7%."

The above last paragraph should give most pause before gushing about our economy today. Keep in mind the numbers Mr. Rosenberg gives are the best, most current found anywhere. Those in the last paragraph are all from the Bureau of Economic Analysis, which also put second quarter GDP at 2.0% (GDI at 1.8%), and falling. Again, I'm not sure where the optimism on our economy comes from. I can't find it in the numbers the government is putting out.

Of course, nobody can compete with misinformation better than the financial media, especially when the stock market is involved. Here is a fact we are unlikely to hear the financial media share with the investing public. We are told, every day since the stock market opened, to focus upon a company's earnings. Our final surprise is that before-tax corporate profits peaked at just under $2.2 trillion in the second quarter of 2014, and are now at $2.1 trillion. Who would have ever thought you could have a bull market for stocks during a time period in which corporate earnings fell for five years?

Summary

If you look at the numbers, you see the real estate market is, if anything, now pulling our economy in the wrong direction. You also see business spending falling, and falling, and falling. This leaves us with exactly one thing holding up an historically debt-saturated economy, and overpriced stock market. This is called consumer spending. Mr. Rosenberg and I see exactly the same picture, though his current view is much more granular than mine has ever been. Consumer spending is what we watch to see when it first starts contracting. Until then, the economy and markets are likely to shake, in many directions. But it won't be falling until the consumer taps out. It looks as if the consumer may have fallen to the mat in September.

Where are We Headed?

The short answer is recession. This is where an economy always ends, before beginning a new business cycle of expansion, followed by recession, etc.

The major question involves the severity of the next recession. Different types of recessions are associated with different amounts of economic contraction or difficulty. In order to try to figure out just how severe the next recession will be, it's instructive to first consider the causes of the different types of recessions.

If you think about it, you can understand why the economy would tend to keep going in the same direction, more or less, most of the time. Something has to change, obviously, or anything moving will keep going the same direction. There are two types of changes to an economy that can and do lead to recessions.

The first is a huge category called "external shocks." In this case, something outside the domestic economy brings it down. If the external shock is big enough, it can bring even an otherwise healthy economy into recession. An example of an external shock would involve the fallout we would experience if the Eurozone and/or China had a financial and/or market crisis. A trade war is a big external shock which often ends in recession, or worse. Emerging market economies collapsing due to a shortage of U.S. dollars would be an external shock leading to a recession here. In the past, an oil shortage was the external shock most people worried about. The good old days!

The second cause of recessions is much more frequent, at least in the U.S. economy since WWII. These recessions are caused by central bank mistakes, combining with human greed to form a dangerous cocktail. It's not a new cocktail, but time-tested throughout the history of banking. The mistake is for a central bank to keep interest rates so low for so long that they create a debt bubble which bursts.

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Even before central banks, economies regularly saw periods when commercial banks lowered interest rates and expanded their lending dramatically. This coincided with exuberance and optimism on the part of borrowers. For hundreds of years, this type of banking cycle appeared everywhere a banking system was established. It led to growth, followed by a period of contraction when so many of the debts turned sour and weren't repaid. This is the history of financial crisis through the centuries. Once we had central banks, they have essentially been able to create debt bubbles at will.

Once-upon-a-time, the Fed saw its primary role being to "remove the punch bowl" before lenders and borrowers got sick on too much debt. They would raise interest rates to slow the debt growth down. This led to more shallow, usually short, recessions. But since Greenspan, the Fed decided they would not only keep the punch flowing and the party going, but would begin pouring pure alcohol into the punch! Over-indebtedness on a national level has been studied extensively. We know what it does, and it isn't pretty.

The numbers say we have a corporate debt bubble today, with corporate America more indebted than any time in our nation's history. In addition, the quality of that inflated debt is the lowest ever. This means corporate America is both the most indebted ever, and the debt is the shakiest on record. Consumer debt (credit card, auto, and student debt) is in a similar bubble. At least we don't have a mortgage debt bubble this time, but becoming severely over-indebted in the entire business sector of the national economy is a guarantee a financial crisis is coming.

The fact our corporations are more over-indebted than any previous time in U.S. history is undisputed, yet most of the economists who I otherwise consider reputable don't seem to see it clearly or understand the implications. I'll never understand how this is possible, but it has been in every bubble in history. To get an historic bubble, you must have your leading economists remain blind to the true danger involved. And if the financial industry was filled with voices who actually saw a bubble building, it would pop immediately.

Fortunately, this time around I do know perhaps a dozen of the best economists in the world who see exactly what I've been describing to clients for some time. The ending is crystal clear. The best analysis ever done shows the stock market will end up going down around 65%. Dr. John Hussman's stock valuations are, essentially, a mirror of what will be occurring in the real economy. A 65% loss in stocks corresponds to a recession between our mortgage crisis and the Great Depression in severity.

Unfortunately, I can do the statistics Dr. Hussman uses to make that prediction, which means I can see how it is possible we could see losses of up to 75%. This corresponds with what you would find if we had a debt bubble exploding around the world at the same time. The picture in the real economy would be comparably difficult, i.e. closer to 1930 than 2008 in terms of GDP losses.

> Of course, it didn't have to be this way, but when a central bank, business owners, and consumers, decide the words debt and prosperity are synonyms, you get what we have today. Throw in the near certain external shockwaves from Europe and China falling nearly simultaneously with us, and you get an idea as to why I am so concerned regarding this next recession.

Warren Buffett has said, *When the tide goes out, you see who was swimming naked.* Corporate America, it will soon be seen, decided to start a very large nude beach.