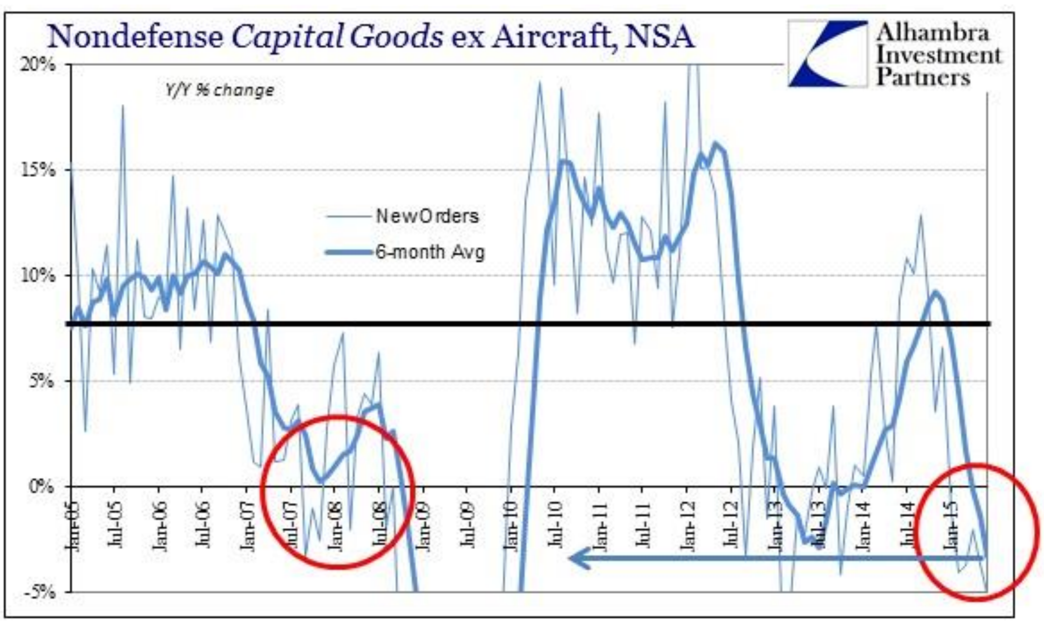
Economic and Market Update, August, 2015
By Richard Morey

Pulling on a Rubber Band

Just when we thought the world of investing and economics could not get more off-balanced, the narrative becomes even more bizarre. Many believe the Fed is planning to raise interest rates, something they do in only one scenario – when the economy is growing "too fast" which may lead to inflation. Instead of negating this with words, we will use charts showing the "growth" of every major area of the U.S. economy. (Charts from our friends at Alhambra and the Federal Reserve.)

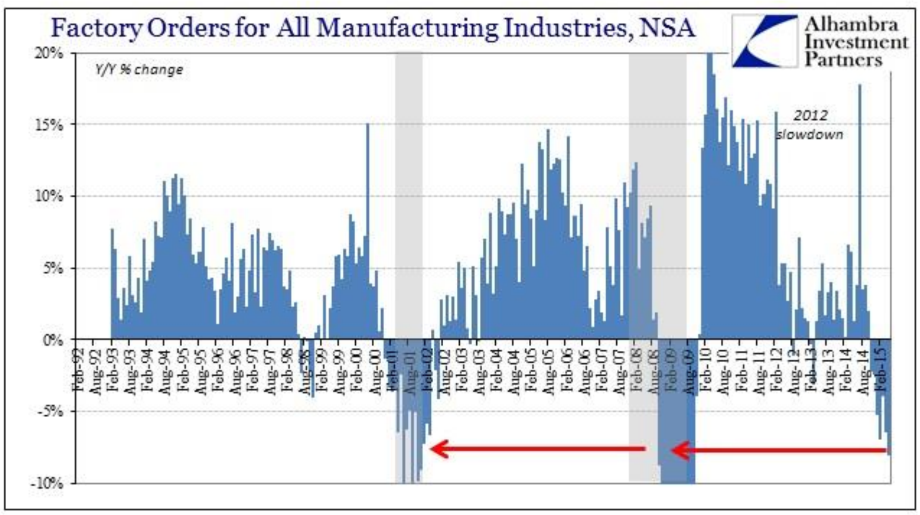
First let's look at retail sales, as nearly 70% of our economic growth is calculated based on consumer spending:

Next we'll look at capital goods spending, which are the "big-ticket" items businesses purchase:

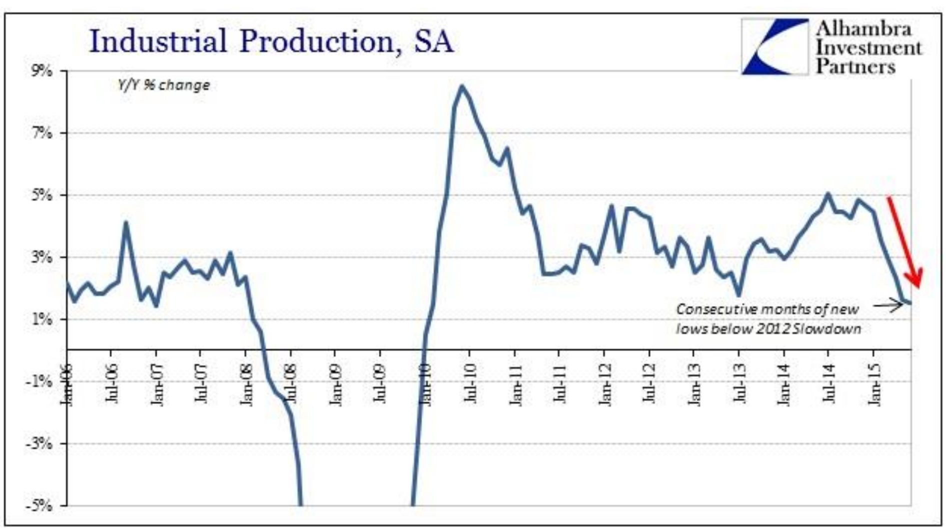


The following chart shows wholesale sales, down 7% year over year:

Here are factory orders, down 7% year over year:

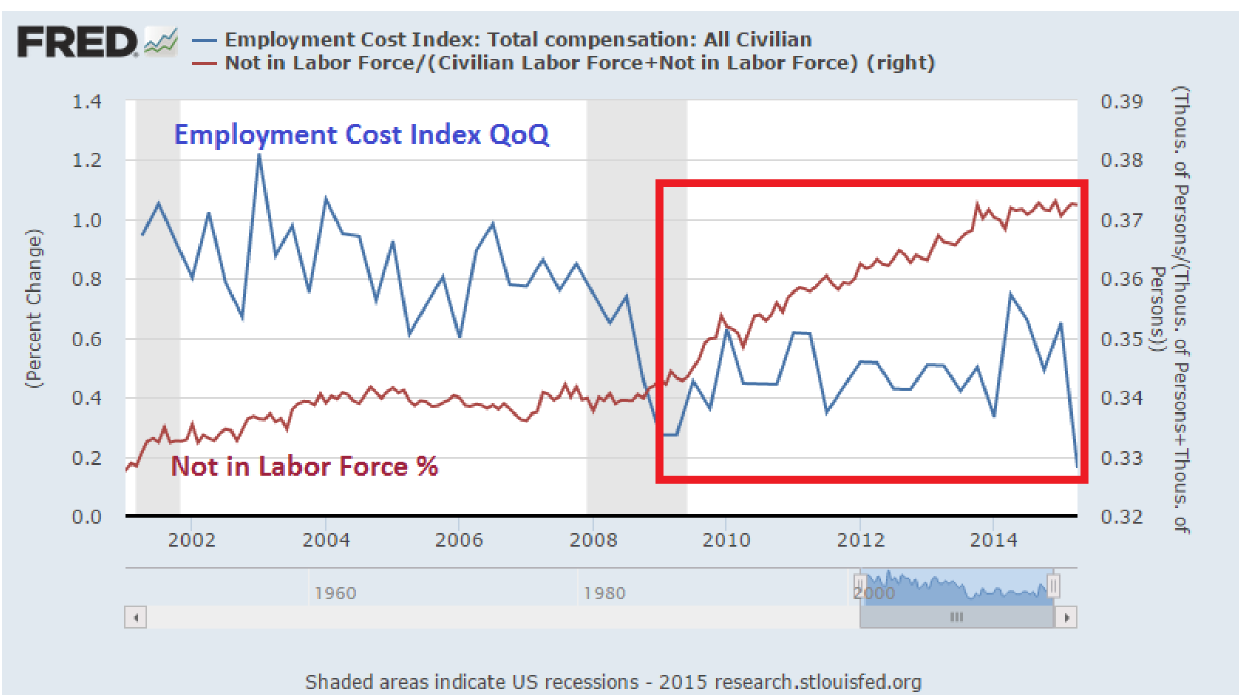


Industrial production shows the same trajectory:



On the other hand, we do hear the housing market and employment are strong. The following chart on new home sales shows they have now indeed increased – to what would normally be considered recessionary levels:

Then we have employment, the one topic the Fed focuses upon to explain why they need to raise rates to slow down this surging economy (sarcasm). The following chart from the Fed shows the percentage of "workers" who are not presently working (red line) and the growth of wages for those who are working (blue line). The percentage of workers who are no longer even trying to find a job is higher than at any time in decades, while wage growth has now gone down to the lowest level since the Fed started keeping track.



Those charts show the current state of the U.S. economy. We could add more, including for example exports, capacity utilization, food stamp usage and other transfer payments, etc., etc. They would all show the same picture. That picture shows a very weak economy with huge structural problems. The only thing that would make this picture even worse would be to include the same charts from China, Japan and Europe.

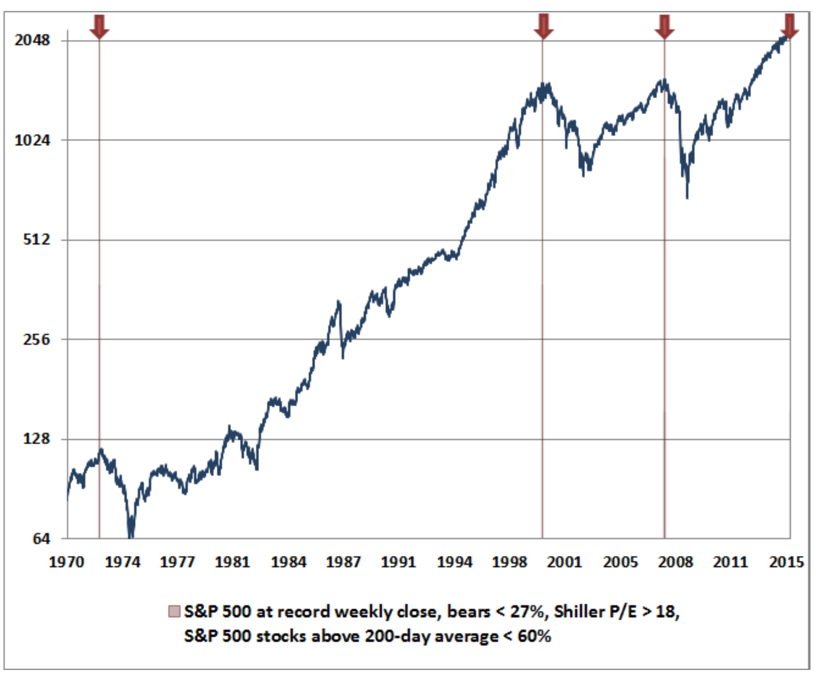
Since all the above charts are made using data from the Fed, and they show the U.S. economy has either completely stalled or already entered recession, why in the world is the Fed talking about raising interest rates to slow down the economy? There is exactly one reason. If we enter the next recession with interest rates at 0%, the Fed will have nothing they can do to say they are saving us. Instead, their policies will finally be blamed for the non-recovery they have engineered through their experimental monetary policies. In other words, they desperately need to raise rates as soon as possible so they can then lower them. While nonsensical, it does make as much sense as believing printing trillions of dollars would improve our economy.

The Stock Market

Corporate earnings have now gone down over 16% in the last six months, as revenues have gone from very weak growth to contraction. Yet stocks remain more overpriced than at any time other than the end of the tech bubble in 2000. Combining these facts with the state of the U.S. and world economy, the stock market definitely should be plummeting. But investors as a whole remain complacent, nervous but confident the Fed and the financial engineering occurring throughout corporate America will allow stocks to keep rising.

However, under the surface the stock market is breaking. First, the Dow Jones Industrial Average has actually gone down 1% since the end of last November. And while the technology and biotech markets have had good gains, nearly all the gains are occurring in a smaller and small number of stocks. This is a key point. In a “good” stock market, i.e. one poised to go up further, nearly all stocks rise. But when a large swath of stocks start to descend even as the indexes as a whole don’t decline or continue to rise, this is usually the beginning of the end for a bull market.

In keeping with this month’s use of charts, the following one from Dr. John Hussman shows the four times since 1970 in which we had stocks severely overpriced and over 40% of those stocks had not risen overall for over six months. These circumstances have existed exactly three times before today, in 1972, 2000, and late 2007. In each instance the stock market proceeded to crash 50% or more very soon thereafter. Right now is the fourth instance.



The Bond Market

Most likely all of our readers know the safest U.S. bonds go up when the economy is weak and/or stocks go down, so the preceding pages should make one optimistic on high-quality bonds at this time. However, most investors have heard, many times, that bond prices go down when interest rates go up. Since the Fed is planning to raise interest rates soon, doesn't this mean bond prices are going to go down?

Definitely not. Yes, short-term bond prices will go down a bit if the Fed raises short-term rates. But long-term bonds would love to see the Fed hike rates. Perhaps investors need to have their shorthand method of predicting bond prices changed to the following: Bond prices go down when interest rates go up, unless economic growth is tepid and inflation is low, in which case they rise fairly dramatically. I realize this is not exactly a catchy phrase, but it does explain our current situation.

Intermediate and long-term bond prices are not determined by the Fed's short-term interest rate. Instead, they are determined by economic growth and inflation. As shown above in the first sets of charts, economic growth is, at best, weak. Inflation recently flat-lined and is now actually going down. (Yes, bonds also go up when stocks drop, but this factor is not nearly as large as economic growth or inflation. Consider it more of a nice bonus to owning the safest investments when investors get scared.)

The reason longer-term bonds will rise – either immediately or over a few months – if the Fed raises rates is that raising rates in a weak economy will weaken the economy even further. (It will also likely lead the stock market to drop precipitously.) This will drive bond prices higher, which is why the bond market hopes the Fed raises rates, as much and as soon as possible.

Summary

The title of this report is *Pulling on a Rubber Band*. The rubber band is the stock market. It has definitely taken a lot of patience and investing fortitude to continue on a prudent course in the current market environment. Even though the stock market as a whole has made little this year, the riskiest areas of the market have continued to deliver high returns. Since this has been going on for so long now, I'm sure many investors across the country are finally "throwing in the towel" on safety, opting instead to join the sheep in the stock market as they are headed for slaughter. But the fact the stock market has not yet dropped is absolutely not a reason to jump in! To the contrary, the further you pull a rubber band, the more certain one can be it will snap back with more and more force. For the stock market, this force will be larger and larger losses. The longer it goes before snapping back, the larger the ultimate losses will be. Whenever this occurs, stock investors will lose all the gains they have received since 2010. In fact, they may end losing all the (very modest) gains from stocks all the way back to 1997.

In stark contrast, the safest U.S. bonds will be the big beneficiary as this transpires. And while it has definitely tried my personal patience watching (some) stocks continue to rise, if I had my retirement money in stocks I would be on pins and needles as we approach September and October – the months stock market crashes have typically occurred.