The State of the Economy in the New Year

Financial Crisis on the Horizon?

By Richard Morey

As our regular readers know, I have been skeptical of the U.S. and world economy for some time. At the end of every single year since 2010 central bankers, politicians, and talking heads in the financial press have proclaimed the coming New Year would be the one in which the U.S. economy finally “takes off.” And every single year their predictions turn out to be completely wrong, with the economy barely growing.

There are two primary reasons why our economy still has not gotten back on track. In 2008-2009 we had a <u>debt crisis</u>, i.e. a financial crisis caused by too much debt. Our response, and indeed the response of the four largest economies in the world (the U.S., Eurozone, China and Japan), has been to <u>dramatically increase debt</u>. In fact, since the debt crisis, total worldwide debt has exploded, increasing over 50% in a few short years!

I am basically certain the economic history books will someday highlight what should be obvious to any rational person – when you have a financial crisis caused by too much bad debt, increasing that debt by a huge amount is not the correct response.

The second reason the U.S. economy (and the world economy) has not gotten back on track involves the actions of central banks. Since 2009 central banks, with the U.S. Federal Reserve Board in the lead, decided the holy grail of economic growth was to print trillions of dollars of new money. We do not need a future history book to know the fallacy of this approach, as printing money has been tried by numerous countries since the Roman Empire. History shows it has <u>never</u> lead to sustainable economic growth, though it usually has lead to large, unexpected economic problems.

This report’s title, *Financial Crisis on the Horizon*, follows from these two facts. We had a financial crisis in 2008-2009. Instead of facing and correcting the problems, we not only fixed nothing but added a massive amount of fuel to that bad debt fire. As a result, we should expect another crisis – one that may be substantially worse than the last one. Now U.S. citizens may take exception to that statement, as our economy does not look like it is teetering on the edge of another crisis. But read on, as the other three largest economies in the world are in much worse shape than they were in 2008, with each one new problem away from entering a full-blown crisis. As described below, anyone who believes the U.S. economy can withstand a collapse in any of the other largest economies is living in a delusionary bubble.

The U.S. Economy

Anyone who just read that introduction and listened to the most recent revision of the U.S. 3rd quarter GDP (Gross Domestic Product which is the total of all goods and services purchased in the economy, and the number everyone uses to decide if the economy is growing) would have to think I am crazy! That revision claimed the U.S. economy grew by 5% in the third quarter. Even though most mainstream economists expect fourth quarter GDP to be weaker, the economy would still have grown by over 3% in 2014. While once upon a time this would not be noteworthy, in today’s world U.S. economic growth over 3% would indeed be considered a victory and a sign our problems are finally in the rearview mirror.

However, anyone who analyzes this 5% GDP growth number the Bureau of Economic Analysis (BEA) put forth a few weeks ago is, to say the least, a bit skeptical. The BEA revised their 3rd quarter numbers twice, and each time they lowered the savings our citizens had – by a total of 20%. They then added that money to consumer spending, thereby increasing GDP by $140 billion. If you study how they came up with these numbers, you would find they did not make this revision based on any new data – they simply reduced consumer savings and <u>arbitrarily</u> decided consumers spent an additional $140 billion.

Without these revisions, GDP would have been 2.5% in the 3rd quarter, not 5%. And keep in mind estimates for 4th quarter GDP are falling. But it gets much worse the deeper you dig into the BEA numbers. Nearly all of the increases in consumer spending (over 90%) went into exactly one category – healthcare spending. Does anyone actually believe large increases in health insurance costs are good for the economy? If your insurance premiums increase 15% in a year, does this lead to large increases in new jobs, or does it divert money from consumers' pockets that could be spent in ways that would be indicative of broad-based economic growth?

All of this highlights some serious problems with using GDP as the true measure of economic performance. One problem involves how the calculations – and particularly the revisions – are "massaged" to overstate economic growth. Another problem is that the GDP numbers measure all spending in the economy equally. So a new government program that happens to be completely wasteful, or increases in health insurance premiums, adds exactly the same amount to GDP as companies investing that amount to grow their businesses. GDP also does not consider the source of the money spent. When consumers save money and then spend it, this is counted exactly the same as when they borrow the money to spend. However, in the real world all spending is definitely not created equally. Money obtained through employment, and money spent starting or expanding businesses, is money that is indicative of economic growth. On the other hand, money that is simply borrowed and spent, or money that is flat-out wasted, is money that reduces economic growth. This does not mean we should not attempt to calculate a GDP number (preferably one that is not revised to achieve a predetermined outcome). What it does mean is that this should be one of several numbers we consider when attempting to understand the state of the economy.

What other numbers should we focus upon? I can think of four that, combined, will give us a much clearer picture of the state of the economy. The first, and by far most important, indicator of the real state of the economy is <u>earned income</u>. If the economy is truly growing, our citizens should be making more money. Of course, the economy as a whole could be growing, but all of the gains could be going to business owners instead of workers. This is definitely occurring to some extent. But keep in mind over two-thirds of our economy consists of consumer spending. If consumers have less money to spend, the economy simply cannot therefore be growing. And even if the economy showed robust "growth," but all the proceeds of said growth were going to business owners, it would be difficult to say this growth is meaningful for the country.

Focusing on earned income as the key number to indicate economic growth (or lack thereof) has, in addition to being by far the most meaningful number, one other huge advantage over a number such as GDP. This advantage is that it can be measured fairly precisely and easily. By law, we all have to pay payroll taxes on earned income, and the IRS knows how much they are receiving in payroll taxes. So this is a number politically motivated players cannot manipulate (at least without flat-out lying).

With earned income as the best indicator of the state of the economy, how is the United States economy progressing? Since 2007 real median household income has <u>declined by 8%</u>. It has dropped 2.3% since 2010 and, most troubling, income has collapsed by 10% over the last fourteen years. These numbers come from the Federal Reserve Board (FRED), so it is safe to say we can trust they are not overstated as the Fed is doing everything possible to try to make the economy appear better, not worse. While we won't have the numbers for 2014 for a few weeks, to date it looks as if our citizens once again did not make more money, and may have continued to lose. <u>If your citizens are making less money, your economy is not healthy!</u>

The other three numbers we should focus on to determine if the economy is growing would be:

- New business creation. This has cratered, and over the last three years fewer new businesses have been started than at any time in the history of the United States (based on the number of businesses in relation to total population).

- Capital expenditures. This is money spent to expand current businesses and start new ones. When businesses are spending money to expand their businesses, this is a very good indicator of economic growth. Unfortunately, capital expenditures have basically flat-lined in the U.S. for several years. But this is about to change, as it will definitely drop dramatically in 2015. Nearly one-third of all capital expenditures in the country have been in the energy sector, particularly in fracking. With the collapse of oil prices, energy companies are now slashing their capital expenditures for 2015.

- Debt levels. This last factor to use when looking at the state of the economy is trickier, though still useful. It is tricky because some debt is indicative of growth while some indicates economic problems. For example, a company that borrows money to expand can be a positive indicator, for if the money is used wisely and the business grows the economy expands. On the other hand, if money is borrowed to enable a person or company to spend more today without leading to higher income in the future, the borrowing is simply taking away from future growth. Because of this, I would not use debt as an indicator of current economic growth, though it can be a key to the future.

Employment

Along with GDP, the other number people focus on when trying to ascertain the state of the economy is employment. The reporting I heard this year on employment sometimes made me think we have an alternate universe in which our media and policymakers are living, divorced from the real world. The November jobs report was a perfect example of this. For November, the Bureau of Labor Statistics (BLS), i.e. the group that puts forth the employment numbers, said our economy added 321,000 new jobs. Combined with gains from previous months, the media characterized this as perhaps the best jobs market in 15 years.

This is insane. If you read their November employment report, the actual number of new jobs created in November was a <u>negative 270,000!</u> How did they achieve this miracle of adding 321,000 new jobs when their own surveys showed a loss of 270,000 jobs? They did a “seasonal adjustment,” adding approximately 600,000 new jobs. These were not 600,000 living, breathing people who got a new job. No, this was simply a number they added in. Now the way the BLS calculates their numbers is quite complex, and many of their assumptions do make some sense. But at the end of the day, the adjustments they make render the number they release pretty close to meaningless.

There is a very easy way to resolve this dilemma, which would be to simply look at payroll taxes. The media says we have had the best jobs growth in 15 years in the last year, yet payroll taxes have been basically flat. What meaning does employment have for the economy if people aren’t making any more money? According to the BLS, a person who works 10 hours a month at minimum wage is employed and the same as someone working full-time earning enough money to support a family. Even worse, if that part-time employee has two jobs and is working 20 hours a month at minimum wage, that person is counted twice!

I recently read an article from Contra Corner, the economic and market web site created by David Stockman. After serving in Congress, Mr. Stockman became the Director of the Office of Management and Budget before becoming one of the founders of Blackrock, one of the largest financial companies in the world. I consider David Stockman to be one of the best economists in the world. The article was entitled “It Just Ain’t So – The Recovery Narrative Skewered and Debunked,” and it began with the following questions regarding the jobs market:

- If the jobs market is so good, why is the labor participation rate (the percentage of working age people who have a job) at a 30 year low of 62.8%?
- Since 2007 the number of working age Americans has risen by 17 million, while the number of employed has risen by less than 1 million, but the unemployment rate is still the same.
- Why would almost 14 million working age Americans leave the labor force since 2007 if the economy is booming and jobs plentiful, with 1.2 million leaving in the last 12 months?
- Why would payroll tax receipts be flat over the last year if millions of new jobs have been created?
- If the country has really added 8 million jobs since 2010, how could real median household income FALL by 2.3%?

So no matter what headline employment number is released each month by the BLS, and no matter how excited commentators and markets are about the wonderful state of employment growth, I continue to maintain we have an employment crisis in the United States. Unfortunately this crisis has been over 20 years in the making, and solutions are neither obvious nor easy.

Many of the facts and figures stated above originate from the Federal Reserve Board itself, which begs the question as to why Fed Chairperson Janet Yellen says the economy looks sound? There are two good answers to this question. First, Chairperson Yellen is the same person who looked at the economy in mid-2008 and was confident we would have good growth in 2008 and 2009! Given this, I continually marvel at why investors have put blind faith into her thoughts and words. The other answer as to why the Fed ignores most of their own numbers is that they know they have painted themselves into a dangerous corner. They know the world economy is slowing markedly at this time, and they know our economy will not be able to hold up if the rest of the world re-enters recession (or in the case of some economies go deeper into recession or even depression). The way the Fed responds to a recession is to lower interest rates, but the rate the Fed controls (called the Fed funds rate) is already close to 0%. They therefore really, really need to raise rates asap so they can then lower them when we go back into recession. But they cannot raise rates if the economy is already so weak the increase would lead directly to recession. As a result, they believe they need to tell everyone the economy is doing well now so they can begin raising rates.

The U.S. Economy in 2015

Given all the above, what are our predictions for the U.S. economy in 2015? First, let’s assume the rest of the world doesn’t exist. In that case, my best guess is we continue to muddle through, with GDP growth of 1.5-2.5%. My second best guess is a return to recession, though on our own merits I would not expect a severe recession. The third possible option, also known as the one nearly every single analyst in the business media believes, is for the economy to really take off in 2015. Of course this is the same expectation they have had every year since 2010, only to turn out wrong each and every year. I would give this option perhaps a 5% chance of occurring – which clearly indicates I am an optimist by nature!

One of the largest concerns I have for the U.S. economy in 2015 involves the price of oil. Let’s first debunk the ludicrous statement I’ve heard from many economists – including our esteemed Fed Chairperson Janet Yellen – that lower oil prices will clearly be a boost to GDP. Simple arithmetic shows this is nonsense. Let’s say an average driver spends $400 less this year on gas at the pump. Money spent at your gas station is counted towards GDP. So if that driver spends every penny of savings on other items, GDP would not move at all. But if he or she saves some of this money, or uses it to pay off some debt, lower gas prices lead to lower GDP. This is indisputable.

Arithmetic aside, the recent crash in energy prices is more than a little troublesome for our economy, from numerous angles. First, all of the new jobs created in the United States since 2008 have come from the five states in which fracking has become a major industry. If you subtract those five states, the total number of jobs created is less than 0! (according to the Bureau of Labor Statistics) Plus, jobs in energy are high-paying jobs, while the majority of the jobs being created outside the energy industry are predominantly low-paying.

From an even broader perspective, the $300–$400 billion overall annual economic gain from the oil & gas boom has been greater than the average annual GDP growth of $200–$300 billion in recent years—in other words, the economy would have continued in recession if it were not for the unplanned expansion of the oil & gas sector. **(**From a research report from the Manhattan Institute for Policy Research, summary at www.zerohedge.com on 12/23/2014.)

Finally, and perhaps most importantly when considering the implication of the energy price collapse on our economy in 2015, energy prices typically drop dramatically when the economy is headed towards recession. This makes sense, as the primary reason energy prices have plummeted is lack of demand. (No, prices have not gone down because supply has skyrocketed, as the total worldwide supply of oil has only increased marginally over the last three years.) Energy is a key component of economic activity, and when demand for energy collapses it has always indicated the economy is contracting rapidly.

Still, if the United States was the only country in the world, this report would not be titled *Financial Crisis on the Horizon*, as the crisis concerns come from overseas.

The Rest of the World

In our December *Economic & Market Update* entitled *Currency Wars* we outlined the serious problems now confronting the Eurozone, Japan and China. Most of these concerns have been with us for many months or years and have been analyzed in previous reports. I will therefore just give a synopsis of each.

The Eurozone

In 2009 a financial crisis erupted in Europe, as numerous of the Eurozone countries had unsustainably high government debts, banks were basically insolvent, and the Eurozone economy was in tatters. The imminent collapse phase of their ongoing crisis apparently ended on July 26, 2012 when Mario Draghi, the head of the European Central Bank, said he would do "whatever it takes" to make sure the Eurozone survived intact.

Since that time very little has changed. The Eurozone as a whole continued to contract in 2013, falling .4% for the year. But everyone was excited when it grew a higher-than expected .3% in the 4th quarter of 2013. Those hopes were dashed in 2014 as several Eurozone countries went right back into recession. Government debt levels remain unsustainably high, and many of their largest banks remain close to insolvency. But most importantly, the lives of their citizens have not materially improved – and they were in dire straits back in 2012. Throughout Southern Europe they have an entire generation of young people who are basically being sacrificed – young people who have never had a job and have no prospects. For example, youth unemployment is over 50% in Spain and over 40% in Italy.

Then we have poor Greece. By one measure a full 60% of Greek citizens are now living in poverty, and nearly 60% of their young people are unemployed. The rest of the Eurozone first bailed them out in 2010, but it will be nearly impossible for them to ever pay back the money they owe.

When looking at Europe I have oftened wondered how long their citizens would be willing to continue living under dire circumstances before they finally revolt and demand real change. It seems they have been unwilling to demand change because the beaurocrats who run the European Union have been so adept at scaring citizens into believing any large changes would be even worse than the status quo. But when the status quo means the majority of your populace is in poverty as is the case in Greece, there must be a breaking point in which people will take the leap into the unknown. It now looks as if the answer to the question as to how long the Greeks will accept the status quo is until January 25 of this very month. There will be a Greek election on that day, and at this time polls shows the winner is likely to be Alexis Tsipras of the Syriza party. Mr. Tsipras is calling for real change. He says his party wants to stay in the Eurozone, but on their terms. These terms are diametrically opposed to those dictated by the European Union. Mr. Tsipras wants to renegotiate the terms of the money they owe the European Union. He simultaneously plans to demand the European Union continue to lend Greece more money at very favorable terms. (Note: These statements <u>do not</u> mean I agree with much of the Syriza party's radical platform – though I do agree the Greeks need to take a different course and, unfortunately, this is the only major party calling for change.)

The European Union's stance is that this would be totally unacceptable. As a result, if Mr. Tsipras does win the election on January 25, we could end up seeing the first country leave the Eurozone. Although the Greek economy is relatively small, the ripple effects should they leave could be momentous. If they simultaneously decided to negate the loans they have already received, the other countries and banks in the Eurozone would lose $322 billion Euros. While not a huge sum for an economy the size of the Eurozone, it could doom the head of the European Central Bank's (Mario Draghi) plan to begin printing fresh Euros to purchase government bonds throughout the Eurozone. Even though the economic results of the two countries that have printed huge sums to buy government bonds, the United States and Japan, have been <u>at best</u> tepid, European markets and indeed world markets have much of their hopes for 2015 pinned on having Draghi begin printing money. Should Greece default on its loans, it is unlikely Germany would agree to such purchases.

Perhaps most importantly, if Greece leaves the Eurozone it may open the door for other countries to leave. The fastest-growing political parties in several Eurozone countries are already campaigning on a platform that calls for an exit. If the Eurozone should disintegrate, the world will be plunged into a financial crisis that will make our debt crisis of 2008-2009 look like a lovely walk in the park.

Japan

The Japanese economy is dead, with a 0% chance of getting through their problems without a cataclysmic financial crisis. Economists generally consider government debt to be problematic, i.e. a drag on economic growth, when it reaches 100% of the size or GDP of the nation's economy. In the United States our debt to GDP ratio is now modestly over 100%. But Japan is approaching 250% debt to GDP. This number is growing dramatically, as they spend at least twice as much money as they receive in taxes each and every year. They cannot possibly ever repay this debt. Their problems are compounded by the fact their aging population means they have a smaller percentage of their populace working each year as more people retire and are not replaced by new, younger workers who pay taxes.

I stated they cannot possibly repay their debts, but this is not precisely correct. They are actually going to repay every yen they borrowed (almost all of which came from their own citizens) by printing all the yen they borrowed and handing it back to their retirees. This is not some future scenario but is happening right now, as they are currently printing all the money they owe and all the new debts they are accumulating (which comes to 10% of their entire GDP every year).

When they unveiled this unprecedented money-printing scheme a few months ago I was almost shocked to hear our financial media discuss this plan as if it had a chance of ending well for Japan. This is not hard to figure out. If you print up to a quadrillion yen (that's a one followed by fifteen zeros), the value of your currency crashes. Now Japan is a country that has to import much of what they consume. A crashing yen means the prices their citizens have to pay for all these imported goods will skyrocket. The end result will be that their citizens are going to find their standard of living roughly <u>cut in half</u>.

Japan has been printing money and going deeper and deeper in debt for well over two decades. Their Prime Minister Abe was elected, and recently re-elected, based on the platform that their economy has hardly grown at all in over 20 years because they simply were not doing enough of what they had been doing all along. Now they are going "all in," and I am afraid the results to date have been completely predictable. The yen is falling sharply in value, their citizens' incomes are falling rapidly, and their economy has returned once again to recession.

Japan is the third largest economy in the world. When everyone wakes up to the fact they must collapse due to their impossible debt load, this will drag the entire world economy into a severe recession.

China

Now we come to the wild card in this troubled picture – the Chinese economy. While all the major economies have seen an explosion of debt over the last two decades, China has broken the world record. Total debt in China was approximately $1 trillion (U.S. dollars) in 2000 and ended last year at an astounding $25 trillion! History may show they made a terrible mistake in 2008. Their economy had been roaring for many years, based on export growth that was expanding by 15-20% or more every single quarter. When the financial crisis hit the West, their exports were clearly in serious danger. To keep their economy growing, they embarked on the largest government stimulus program the world has ever seen. They told their banks and all levels of the government to start building – immediately. They built freeways, airports, millions and millions and millions of new houses and apartments, and even entire cities where none had previously existed. (Today it is estimated they have over 50 million new homes and apartments vacant.) And their economy did, of course, continue to grow.

At the time they were building, most thought they knew what they were doing. Unfortunately, you simply cannot invest that much in real estate that quickly without creating massive amounts of bad investments and a real estate bubble.

By 2013 the Chinese real estate bubble was surely much more extreme than ours was by 2007 and probably rivaled Japan's in the late 1980s. Given the fact every bubble in economic history has burst and lead to massive losses, I have expected a similar fate for China. However, if any country can avoid this fate it *might* be China. This is due to two advantages they have over other economies. First, other areas of their economy continue to grow. At least, they *might* be growing, though trusting any numbers coming out of China is difficult since they pretty much admit they make the numbers up in advance. Secondly, we do know their government has several trillion dollars in reserve which they can and will use as needed to bail out their banks should real estate prices collapse.

As a result of these positives, I would not want to bet heavily against the Chinese being the first to create an asset bubble and come out relatively unscathed. Still, chances are their real estate market will indeed collapse. A few weeks ago I read a report written by the government official in charge of infrastructure development in China. This is one of their leading economic minds and an official government spokesperson. He said roughly half of the money they have invested in infrastructure since 2009 was "malinvested," i.e. wasted! If correct, this would equate to losses of $3 to $5 trillion. In addition, if those losses were being realized, the value of all real estate in China would be dropping. Combined, their real estate collapse would be much more severe than what we experienced in 2008-2009. This will probably occur. However, given the trillions of dollars China has in reserves, they may be able to put off their problems for several years. Of course, that time frame will move up quickly should the Eurozone and/or Japan implode first.

Impact on the United States

So we have major problems in the other largest economies in the world. A financial crisis is not just a possibility but a certainty in the case of Japan. In the Eurozone and China, the probability of a full financial crisis probably exceeds 90% (each). I certainly never thought I would write sentences like those two in my lifetime, but then I never would have believed the world would respond to a debt crisis by increasing total worldwide debt by 50% in the following 5-6 years.

As described above, if the rest of the world did not exist I would not be optimistic about the U.S. economy at this point, but the word 'crisis' would not come immediately to mind. We have severe debt problems of our own, massive unfunded future liabilities for Medicare and Social Security, and a job market that has been deteriorating for many years. But left on our own we might have time to address these admittedly large challenges. And to paraphrase Winston Churchill, the United States always chooses the right path – after we have tried every other one!

Of course, whether we can and would successfully confront these problems over time if the rest of the world did not exist is, obviously, a moot point. In November Fed Chair Janet Yellen spoke as if the rest of the world has no impact on our economy, which I'm sure she knows is absurd. Nearly one-half of all the sales of our corporations are outside the United States. When Japan, the Eurozone or China have a financial crisis we will definitely be in at least a pretty serious recession. If two hit at the same time, that recession could be historically severe.

Then there is the largest wild card, which are the credit default swaps our largest Wall Street banks have sold insuring against risks all over the world. Nobody on this planet has any idea which financial problem in the world will be the one that leads to *trillions* of dollars of losses from these contracts, but we do now know who will be on the hook for the losses. In a rare show of bipartisanship, Congress recently passed a bill funding the government. This bill included a provision making it so the riskiest of all the credit default swaps can now be held in the part of the banks covered by FDIC insurance. In other words, us taxpayers will legally be responsible if and when Wall Street banks lose trillions of dollars guaranteeing against losses in the Euro, a drop in Japanese bonds, or nearly any other major financial risk that exists.

Conclusion

The Bank for International Settlements is called "the central bank of the central banks." It is an organization whose members are 20 of the leaders of central banks around the world. Their last quarterly report was actually quite similar to this report. My version is much more blunt, as I do not have to consider political ramifications, but the principles were pretty much the same. In other words, my dire description of the U.S. and world economy is not actually out of the mainstream. Yes, the mainstream media and Wall Street banks would say our views are completely wrong, but the central bankers in charge in most countries other than the U.S., Japan, the Eurozone, and China, believe the conclusions presented in this report.

I wish the central bankers from the four largest economies were correct and our problems would have been healed by time. But when you are walking down the wrong path, you do not get closer to your destination the further you walk.