IT BECOMES CLEARER

The question: Why has growth in the United States failed to return to its post war rate? For 10 years our economy has struggled to fully recover its long-term annual growth rate of 3% to 4%. We muddle along and occasionally reach 2%.

The recession was severe. Government efforts to restart faster growth have, it is said, worked well in the past. Our Federal Reserve has repeatedly assured us its money policies and interest rate cuts would work to stimulate consumer spending and business reinvestment. Reference to their success at taming prior recessions was their justification to continue the same policies. Clearly those tactics are no longer working . . . if in fact, they ever did.

Harvard professor N. Gregory Mankiw offered five theories for our consideration:

1) Bad Data. We are using measures that don't capture quality improvements or new products very well. Nonetheless, Americans think the *whole* economy is their top concern, based on day-to-day living.

2) A Hangover. Many feared the worst during the Great Recession. Anxiety lingers and with it a reluctance to spend or invest.

3) Secular Stagnation. The slower population growth and reduced demand for investment creates an economy with too little demand and inhibits full employment.

4) Slower Innovation. Earlier generations saw, in very short order, electricity, indoor plumbing, the auto, air travel, etc. These were life changing, unlike the smart phone or social media.

5) Policy Missteps. Increases in taxes during the last decade had a strong negative effect at a critical time. The initial stimulus (QE) was followed by an attempt to shrink the deficit – with higher taxes.

Dr. Mankiw allows it's probably a bit of each and likely he's right.

What most have not done, though, is step back and look at far larger events at work over the 70-odd years since the end of World War II. The current status of those events, coupled with the credit crisis stemming from them, has created a perfect storm that near guarantees subpar growth for years to come. There are solutions but Congressional courage is lacking.

For the 70 years since World War II ended, Economics professors have struggled to be viewed and treated as authors and teachers of a hard science. Near every undergraduate and graduate economics program focuses intensely on math, on predictive models, on even more complex math, on measuring, on graphing. That's what science does so the Economics profession followed suit.

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Since then, endless seldom-read papers in even more ignored Journals are filled with some of the most complex mathematics in vogue. Models, they believed, were the answer. The economy could be managed with the models and the data in them that they would collect.

Time and observation has led me, at least, to abandon the approach I was taught and adopt a more behavioral approach. It has almost no math. It does not claim it can predict human economic behavior. What it does do is borrow from many other disciplines – whatever lends insight to man's basic nature. It makes very few predictive statements and has no solidly established working models that I am aware of. This flies in the face of Keynes and his followers who insist, still, that you can model something as complex as 300+ million Americans implementing our economy. The most committed to this concept is our own Federal Open Market Committee – our Central Bank – the Fed.

The question that still arises, though, is why are the Fed and all its economists so sure the tools they still use will, and in fact must, work? The answer, I believe, is in the very reasons they seldom if ever, did. Nudge things along? Sure. Drive the overall economy with policy models? No.

It is my view that the academic bias of the Fed often led them to confuse correlation with causation. I hope to make that point in this *Quarterly Outlook* because it lies at the root of why we are still in recession, never left, and won't without massive policy change.

WE HUMANS

I devoted a number of *Quarterly Outlooks* to casual exploration of human behaviors. These topics included

- how and why our lizard brain is still hard at work;
- how we deal with fear of the unknown;
- why groups form and how they act;
- why a group average opinion is often a better one than a few experts';
- what parts Chaos Theory and Bioeconomics play; and
- the idea of complexity – where order and chaos collide.

These points drew from disciplines well outside economics and my limited skills in these areas allowed only a superficial view. The point, though, was that we humans are very complex, but with a very common core. I spent that time in the *Weeklies* and *Quarterlies* because we were all trying to figure out the New Normal, the new economy. Something was different. We were all watching each other behave differently. I now feel we were watching the leaves, not the trees. In that search for some New Normal, it became clear yet again that

- we will always look out for ourselves first if "serious" becomes "critical." Heroes are born in that moment and are the exception that proves the rule;
- we seldom make truly rational decisions;
- we need the tribe of others;

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- o we adopt the characteristics of the cohort we are in; and
- o we blame.

The list of common attributes is a long one. We most often blame, though. We blamed the banks for the Great Recession. We blamed our elected officials for not "fixing" the mess. We blamed each political party for its particular failures. We blamed excess debt. We blamed immigration, NAFTA, Europe, China and most anything we could find for extending our recession. And through the last 7 years, the New Normal became the No Recovery. We were as junkies trying to get clean by blaming anyone but ourselves.

For 7 decades, we experienced a unique time in our nation. For 7 decades, the economic trends were so embedded, so heavy with upward pressure, that *any* model was predictive. **Events were the master, not policy**. With rare exception (one, I think), even recessions were mild and, to my mind, self-correcting, notwithstanding periodic (and sometimes useful) nudges from the Fed.

I have made the case that time cures most economic ills, thus falling myself a bit into the same trap as the Fed economists. They thought they were modeling, predicting and, accordingly, driving an economy. I thought time was a major cure, a major driver. In fact, it was self-sustaining and self-destroying. They were confusing the reality that their models were only correlated to the times with the assumption that the policies their models suggested were causal. What were these self-sustaining and ultimately self-destroying events?

Some unique aspects of the last 70 years may include these:

- o it was a time of a young population back from the war and eager to work and find normal again, this included the massive post-war home building boom;
- o incomes rose steadily across near all wage levels as the economy recovered from the war years and many prior-rationed goods became much in demand;
- o an abundance of new products appeared – <u>an abundance</u>;
- o the credit card was born to pay for it all;
- o tax law favored home ownership for minimal equity;
- o the working spouse joined the labor force bringing in more monthly cash for debt service;
- o auto leasing meant lower monthly payments, freeing yet more funds;
- o multiple car (and home) families became normal for many, including the flippers, as Barney Frank made his case for accepting what became known as liar loans;
- o advertising grew to a mind-melding art form to fuel the need for gratification;
- o instant gratification became a right – TV said so;
- o electronic toys, gadgets and tools eased work loads;
- o the Internet let all know all immediately;
- o it was a time of leaders: Eisenhower, Kennedy, Truman, Marshall, Johnson, Nixon, Volcker, Reagan;
- o it was a time of Nixon's Equals Rights Bill when women in the labor force began the trip through the glass ceiling;

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- o major government projects such as the Race to Space or the Interstate Highway System employed millions . . . and made millions for many;
- o Communism fell, tax cuts under Kennedy, computers for all – each boosted consumption;
- o active Civil Rights law under Johnson and others finally began to enfranchise millions.

These trends grew, one from another, self-supporting and then creating newer trends yet again.

Behind it all was our debt. It fed the spending. The borrowing showed others how it could be done. That tired phrase, Conspicuous Consumption, was born.

Important to the entire process was the Boomer population, which followed closely on the heels of the Silent generation. Those that fought the War began this high level growth in consumption. Boomers picked up as the older War generation slowed and as there were so many more Boomers, the positive trends we've listed grew even stronger.

The New Normal is simply the departure of those who made that old, powerfully growing economy. We may blame them for near all of our current issues.

They borrowed and spent while the economist mapped and measured this rising trend of economic growth. Extrapolating it was to be expected, it was so clear, so obvious. They predicted nothing, created nothing, modeled only an existing reality. They came to think their policies caused it while we now see it merely reflected it. We believed them when they said it was all under control, was self-sustaining, was an era of New Prosperity. Well, it was, for a while, but through no cause or insight of their own.

I think of Boomers in groups. The top income decile is still spending. This is the group on cruise vacations, the group with two or more homes; the group so well off financially they simply don't see the rest of their age group. They are a major part of the paltry 1.5% to 2% growth we see.

The bottom decile or two is out of the consumption game completely. With small pensions, very depleted savings and rising health costs, they are trying to dial down the spending behavior that marked them just a decade or two ago. They borrow, but to live, not to spend. They still have a great deal of debt.

The great middle is in play. They have some cash, some credit and little patience. They, too, are remembering the way it was, but they, too, are satiated on many fronts. What, at 50, 60 or 70, do they need? What goods? A new cell phone?

As a united whole, they reflect the weak sales patterns we see, reflect the angst over medical costs and the "muddle" economic cycles of weak recession and weak recovery. Populism, indeed. It can come to some surprising results – as England has discovered.

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There remain some 270 million other Americans beyond the Boomers. The Silent generation (over 70) is just an advanced version of today's Boomers. The huge Millennial group is debt heavy and cash light. Cost cutting is making the 45-64 cohorts behave like the Boomers: Stop spending, save and hunt for income. So much for a third phase for now, for anything like the 7 decades we have seen. It will come, of course, but not soon.

You begin to see new, common behaviors. As a group, these humans, these Boomers, are downsizing their cars, homes – and expectations. It's made easier because their peers are doing it also. They are now openly looking out for themselves, seen in sharply new political attitudes and a greater emphasis on staying healthy by taking personal responsibility for it.

They are not just older; they are scared and scarred. This change to caution, to what some call a Frugal Future, is not temporary because they know time is not on their side. They are now as they will be.

RECESSIONS

To read all the data, one would assume severe recession is now inevitable. Industrial Production is down, Capital Spending is still declining, both Services and Goods sectors are showing much slower job growth and all that surplus capacity is creating goods deflation of a high order, worldwide. Into that, one is not surprised to see the personal savings rate now touching a 10% growth rate and nearly 10% overall. (Shadow Stats)

Household debt growth, though, is near 2.7% annualized. Contrast that with debt growth rates of 12%, 17%, or even 20% coming out of prior recessions.

No, Fed efforts not withstanding, all the money printing and rate cutting they have conjured up cannot and will not offset new, deep secular trends to save, not spend, avoid debt and sharply limit even small discretionary spending.

The analysts are focused on a shortage of skilled workers and the ultimate inflationary impact – as am I. The bigger problem, though, is that excess capacity and the debt behind it. For the record, <u>non-financial</u> sector debt relative to GDP just hit a record high of 250% of GDP. Talk of delevering in <u>this</u> space hasn't even begun. Any strain on this debt load is, frankly, beyond the ability of the capital markets to deal with, to say nothing of their new regulatory snake pit. Looking for a massive increase in profits from a new wave of consumer spending to be used for debt service is, well, corporations are kidding themselves. Oh, there will be winners – those that survive merger fever or bankruptcy, but significant sales volumes, whether shared by 2 companies or 20, is a long shot. Mergers and ensuing efficiencies in size now create growth. . . and job loss.

The downward pressure on rates is substantial and yet even with ultra-low rates, debt service is strained. Do you see why the Fed has been so very wrong every time they claimed zero rates were about to trigger a recovery? Pushing on a string, indeed.

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Not having had a normal recession, it seems clear to me a normal recovery is not likely. The brick wall of the end of the Boomers and all of their prior attributes at the same time as the worst debt cycle in decades makes a perfect storm. Toss in bad policy from Washington, beggar-thy-neighbor politics and the same debt problem worldwide and you end up with the Frugal Future. Welcome to 1990 Japan.

Which leaves the question: Yet another Great Recession?

In the era since WWII, recessions lasted around 4 quarters. This one lasted 7. The previous 10 recessions saw peak to trough declines of -1.9%, average. This one saw a peak to trough decline of -4.2%.

It took an average of 4 quarters for the last 10 recessions to recover to prior highs and the range was 2 quarters to 7 quarters. This one? It took 14 quarters to recapture prior levels and I don't see us as "recovered."

Past recessions were typically (80%) characterized by inventory cycles and sharp rises in wages. Hire, produce, overstock, sell it down, restock – textbook cycles. This took place primarily in the then dominant manufacturing sector where labor and goods could be "sticky" in any given trend. The Service sector has far greater agility in pricing, hiring and has the added benefit of limited physical "inventory."

So as we look back we see the usual Fed move was to cut rates thus making it easier to borrow and so stimulate investment and consumer borrowing. Do this 10 or 12 times, model the obvious and you see how the Fed got off the tracks on this last recession – they missed the obvious and went with what had apparently worked in the past. (Data: D. Rosenberg)

To answer the question:

> We are now in a "recession" but of an unique kind. It is one of very, very low growth. It lacks the problems of typical recessions (so far) such as excess inventory or sharply rising wages. It is mild, now, and likely to be with us longer. Again, as Japan, we are mostly rich, living well, but with wide divisions of income . . . and no real growth.
>
> As I write this I am struck with the black-white choice – either we're in a recession or in a recovery. Which is it, Jim? May I say neither? How does Stagnation sound?
>
> May it continue? Of course. Will election results influence all that cash and consumer borrowing power? Yes, but nothing like the last 70 years in terms of staying power. That level of growth will come again, but not until the Millennials begin to seriously spend like their predecessors did. What to do for investing? Safety and income at a reasonable price. It can be done and it will be volatile, price wise, but alternatives are far riskier.
>
> It all makes some sense when viewed with the demographic landscape weighted in. Look to Japan for our future, absent major changes. To my mind the Fed is out of

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bullets, out of the game and still likely, if not guaranteed, to do something totally wrong. The actions I expect include forcing a further depreciation of the dollar. More on their likely moves in the *Weeklies* to come. Suffice it to say it will be wrong, again. Their job, to remind us all, is to provide overnight settlement of member bank accounts. Run the Nation? Sure, as long as Congress continues to wimp out of doing it.

A postscript: Some great research on the economy comes from the St Louis Federal Reserve Bank. I have read their monthly *Bulletins* on and off for almost 50 years because they provide some useful insights. Occasionally you get a bombshell. In a recent paper we got one. Federal Reserve Board Governor and President of the St. Louis Federal Reserve Bank, Jim Bullard, says *the entire exercise of Fed guidance and planning for interest rate increases is a complete and utter waste of time*. He says that forward guidance is counterproductive and credibility destroying. To quote Ben Hunt: **"This is the President of the St. Louis Fed saying that everything the Fed has been doing for the last four years is just a bad joke. The Emperor has no clothes."** Make it more like 10 or 15, Ben. In any case**,** capitulation from one of the best minds who, with that statement, has effectively resigned his influence on Fed policy.

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