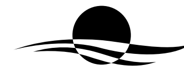
# Growth STRATEGIES



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## IN THIS ISSUE: UNEASINESS

Seven in 10 Americans say the country is on the wrong track. Americans are unhappy, worried and pessimistic (see below), and their spending is down.

But consumer sentiment is up (University of Michigan), consumer confidence is up (Conference Board), and spending plans are up (our own Consumer Demand Index).

What accounts for this dichotomy? Perhaps it could be the normalcy bias, a desire for "normalcy" so strong as to feed a willingness to overlook contrary evidence. Or perhaps, in the first case, our uneasiness is an example of the "wisdom of crowds", the fact that in aggregate, opinions of a wide cross-section of people are more accurate than those of experts.

What is my feeling/opinion/assessment? Frankly, I'm uneasy. My first four items illustrate why, but for some balance and countervailing perspective, I end on a positive note.

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## 1 — AMERICANS ARE UNHAPPY, WORRIED, PESSIMISTIC

The protracted and uneven recovery from the Great Recession has led most Americans to conclude that the US economy has undergone a permanent change for the worse, according to a new national study by scholars at Rutgers University. Seven in 10 Americans now say the recession's impact is permanent, up from half in 2009 when the recession officially ended. Among key findings:

- Despite sustained job growth and lower levels of unemployment, most Americans do not think the economy has improved in the last year or that it will in the next.
- Just one in six Americans believe that job opportunities for the next generation will be better than for theirs; five years ago, four in 10 held that view.
- Roughly four in five Americans have little or no confidence that the federal government will make progress on the nation's most important problems over the next year.

Much of the pessimism is rooted in direct experience, according to authors of the report. Fully one-quarter of the public say there has been a major decline in their quality of life owing to the recession, and 42% say they have less in salary and savings than when the recession began.

The public also paints an extremely negative picture of American workers as unhappy, underpaid, highly stressed, and insecure about their jobs.

One of the reasons the public does not see the economy as having improved is that many remain under tremendous financial stress, according to the Rutgers study. Six in 10 Americans describe their financial condition negatively: as only fair (40%) or poor (19%). One-third report being in good shape; just 7% describe themselves as being in excellent financial health. Many report significant losses in the Great Recession. Just 30% say they have more in salary and savings than they did before the recession started, while less than a third say

they have the same, leaving 42% who report having less today than five years ago.

Americans are also pessimistic about the future. Only a quarter think economic conditions in the United States will get better in the next year, and just 40% believe their family's finances will get better over the next year. Consequently, most do not see themselves getting back to where they were any time soon. The report found the public sharply critical of Washington policymakers.

## 2 – THE ECONOMY GETS A DOWNGRADE

The updated budget and economic outlook recently released by the nonpartisan Congressional Budget Office (CBO) contained good news for corporations, but bad news for the rest of the economy. According to Harry Stein of the Center for American Progress, the CBO now estimates that the economy will grow even slower than it expected in its previous economic outlook.

Additionally, it now expects that wages and salaries will comprise a smaller portion of that reduced economic pie. The report suggests that troubling long-term trends in our economy are getting worse. Middle-class wages have been stagnant for over a decade. Overall employee compensation – including health and retirement benefits – has fallen to its lowest share of national income in more than 50 years, while corporate profits have climbed to their highest share over that time.

Yet while corporate profits are higher than ever, corporations are paying a much smaller portion of the total federal tax burden than they did in the past (about 10% today, vs. 30% in 1953).

While this is not an immediate emergency, since the annual budget deficit is very low right now, deficits will become unsustainable in the future, according to the CBO. And there is an ongoing economic crisis for middle-class and low-income families right now: stagnant wages are not keeping up with rising expenses. American productivity has increased, but those gains are not making it to low-wage workers, or even those making wages in the middle. The CBO report suggests that this problem is only getting worse.

## 3 – THE GREAT DELEVERAGING THAT NEVER HAPPENED

For several years, media headlines have been filled with references to a "deleveraging," or a reduction in the level of US debt. But while the US *financial system* has indeed made significant strides in reducing leverage and US banks are better capitalized, there has been no deleveraging in the broader economy. Consider these three points, courtesy of BlackRock investment strategist Russ Koesterich:

1. **US household debt remains high.** Thanks to a significant write-off in mortgage debt, US consumers have modestly reduced their debt burden. By most measures, however, household debt levels are still too high. The past several years have witnessed a huge surge in student and auto loans. And overall, US household debt still stands at 103% of disposable income.

2. **Fueled by cheap credit, corporations have been adding new debt.** Since the third quarter of 2010, corporate debt has increased every quarter. Over the past six quarters, corporate debt has been growing at an average annualized rate of around 9.5%, well above the pre-crisis average of 7.5%.

3. **Federal government debt has exploded.** Outside of debt held by the Social Security Trust Fund,

federal debt has risen by roughly $7.3 trillion over the past six years, an increase of 140%.

The net result is that during the period of so-called "deleveraging," non-financial debt has increased by roughly $9 trillion. Even after normalizing for GDP, non-financial debt has actually risen significantly since the financial crisis. Six years ago, notes Koesterich, non-financial debt was around 227% of GDP. Today, it's at a record 250%.

Does rising non-financial debt matter for the economy and for investors? Long-term, the answer is yes; a high and growing debt burden has several implications for the US economy: slower growth, a persistent headwind for consumers and vulnerability to even a modest rise in interest rates (this is particularly true for the federal government).

## 4 — THIS IS AN ECONOMIC RECOVERY?

This does not look like an economic recovery.

- Wages have been stagnant since the *start* of the supposed recovery in 2010. Real household income has fallen by 7%.
- The economy has added a few million jobs, but 11 million people have permanently left the labor market.
- The Federal Reserve balance sheet was $900 billion before the 2008 financial crisis; today it stands at $4.4 trillion. The correlation between the Fed printing $2.4 trillion and the third stock bubble in the last 13 years is self-evident (stock market valuations have been higher only three times in history: 1929, 1999, and 2007).
- Regular, average Americans are not participating in the markets' gains. They have instead parked record levels of cash ($10.8 trillion) in no-interest bank and money market accounts. Thus, the true purpose of quantitative easing is revealed: not to save Main Street but Wall Street.
- The real housing market for real people is worse than it was in 2009. The national home price increase (25% just since 2012!) has been centered in the usual speculative markets, aided and abetted by the Fed's easy money. Flippers have accounted for over a third of all home sales.

Mortgage rates have been falling for the past year, home builders have been reporting soaring confidence about the future, and the National Association of Realtors keeps predicting a surge in home buying any minute now. Yet as analyst James Quinn points out, mortgage applications are in free fall, new home sales are at 1991 levels, and existing home sales are falling. Home prices have peaked and are beginning to roll over. The Wall Street hedge funds are all looking to exit stage left. Young people are saddled with over a trillion dollars of government issued student loan debt and millions of older sub-prime borrowers have been lured into more auto loan debt. Home sales will be stagnant for the next decade, he predicts.

### THIS WILL NOT END WELL

Crashes are coming, concludes Quinn. Quantitative easing will cease come October, unless the Fed and Wall Street can create a new "crisis" to cure with more money printing. By every valuation measure used over the last 100 years, he writes, stocks are overvalued by at least 50%. By historical measures, home prices are overvalued by at least 30%. Ten-year Treasuries are yielding 2.4%, while true inflation is north of 5%. With real interest rates deep in negative territory, the bond market is even more overvalued than stocks or houses. These simultaneous bubbles have been created by the Federal Reserve in a desperate attempt to keep this debt-laden ship afloat. Their solution to a ship listing from too much debt was

to load it down with trillions more in debt. The ship is taking on water rapidly.

We had a choice, says Quinn: "We could have bitten the bullet in 2008 and accepted the consequences of decades of decadence, frivolity, materialism, delusion and debt accumulation. A steep sharp depression which would have purged the system of debt and punishment of those who created the disaster would have ensued. The masses would have suffered, but the rich and powerful bankers would have suffered the most. Today, the economy would be revived, saving and investing would be generating needed capital for expansion, and banks would be doing what they are supposed to do – lending money to businesses and individuals. Instead, the Wall Street bankers won the battle and continue to pillage and loot the national wealth while impoverishing the masses.

"Discontent among the masses grows by the day. When the stock, bond and housing bubbles all implode simultaneously, all hell will break loose in this country. It will make Ferguson, Missouri look like a walk in the park."

I fear he may be right; so like I said, I'm uneasy.

## 5 – WHAT'S RIGHT WITH AMERICA

For some balance and countervailing perspective, I end on a positive note: "What's Right with America," courtesy of Joseph Quinlan, US Trust.

1. The US is the largest and most productive economy in the world, one of the only where GDP is higher today than before the economic crisis. The American economy accounts for almost one fifth of global GDP, produced with only 4.5% of global population.

2. The US remains a global leader in manufactured goods. US manufacturing output was $2.1 trillion in 2013, up 21% from its 2009 low.

3. The US is among the largest exporters of goods and services in the world. Exports are up to $196 billion per month, after they dropped to $124 billion per month in April 2009.

4. The US remains the world's favorite destination for foreign direct investment. A vast and wealthy consumer market, a large skilled labor pool, a transparent rule of law, and lately, cheap energy costs – all continue to draw capital from around the world.

5. America is home to the world's top global brands, including every one of the top 10: Google, Apple, IBM, Microsoft, McDonald's, Coca-Cola, Visa, AT&T, Marlboro, Amazon.

6. The US remains the world's technology leader. US spending on IT technology as a share of the global total remained steady from 2006 to 2012 at about 33%. Western Europe's share declined from 29 to 25% over the same period; Japan and China's combined share stayed around 16%.

7. The top-ranked universities in the world are in the US, including 6 out of the top 10 and 30 out of the top 100.

8. The US dollar is still the world's top reserve currency. Approximately 61% of global central bank reserves are US dollars, a share that's remained stable in the post-crisis years.

9. The US is the fifth most competitive economy in the world, trailing only Switzerland, Singapore, Finland and Germany. Top research universities and innovative capabilities have kept the US a major competitive economy, even after the financial crisis.

10. The US is an energy powerhouse. The US will surpass Saudi Arabia as the world's leader in oil production by 2015.