

Hitting The Wall...And Bouncing Back

May 2016

Producing these Armchair perspectives requires reading a lot of economic, financial and political articles, essays and books. Even though these thoughts are considered “from the armchair,” they wouldn’t be worthwhile or relevant if not based on what is going on in the world. You have to at least “watch the game” to opine on the performance of team owners, managers, coaches and players. With this in mind, what’s surfacing in the Armchair’s field of vision lately?

For one, it’s pretty interesting to see so many people suggesting that our equity market is peaking. Former Federal Reserve Governor Richard Fisher recently suggested that when the Fed raises rates again we can expect worthwhile stock market pain. It has also been reported that billionaire investor Carl Icahn is much more short the market than his historical average. And at the recent annual Sohn Investment conference for hedge funds, former George Soros partner and world-renowned market timer, Stanley Druckenmiller, said it was time to short stocks and go long gold.

A lot of the negative sentiment seems to be emanating from the inability of Federal Reserve monetary stimulus to revive the economy beyond the annual 2% GDP growth we’ve been aspiring to since the 08/09 recession. Early on in this new world order of central bank stimulus, numerous people warned that the effort was not going to produce sustainable growth, but instead lead to more bubbles in search of a pin.

The latest bubble to be pricked has been the minerals commodity market. With China on a post 08/09 monetary stimulus induced economic tear, and overall global monetary policy extremely loose, we created bubbles in all manner of minerals markets, like iron ore, coal, oil, gas and copper. The recent pinpricks in these markets have caused economic pain in Russia, Venezuela, South Africa, Australia, the Middle East and the US domestic oil patch.

Stepping back for a view of the forest, we notice that after the pinprick of the U.S. dot.com bubble, we had a recession (01/02). And then after the pinprick of the U.S. housing bubble, we had another recession (08/09). Why would this latest domestic oil and gas bubble pop not also take the U.S. into another recession?

Theory suggests that lower gasoline (oil) and electricity (gas) prices should actually be economically stimulating, a natural counter balance to the domestic oil patch contraction. Consumers have more money in their pockets to spend, which is good news for an economy that is supposedly 70% driven by consumption. This may be why we have yet to see a recession. But wait, something odd seems to be happening.

The biggest quarterly GDP growth we’ve seen since the 08/09 recession surfaced in the 2nd and 3rd quarters of 2014, just before the domestic oil patch bubble popped. Since peaking above 4% in Q2 and Q3 of 2014, GDP growth has averaged a paltry 1.36% over the last six quarters, with the last two quarters coming in below 1%.

The conclusion at this stage seems to be that the domestic oil and gas capital expenditure and investment boom was much more economically stimulating than post boom consumer spending. So

Armchair Economic Perspective
Hitting The Wall...And Bouncing Back
May 2016

how would we expect the consumer to behave when rising oil and gas prices lead to rising gasoline and electricity costs? You can be assured that oil and gas prices will again rise.

One interesting perspective seems to answer the question of why consumers haven't gone willy nilly silly with their spending. It suggests that because the average consumer is earning wages no different from what they earned 10 or more years ago, they have been hanging on by their financial fingernails for a long time.

While wages have stagnated, the cost of basic living expenses—particularly food, shelter and health care—has grown measurably. The majority of Armchair readers are shielded from this phenomenon. But let me share a little anecdotal experience.

I have a second home in a small Texas town of about 3,400 residents. It's a typical rural community, where a whole lot of median, if not below average, wage earning families reside. Several months ago, I got a note from the city, which also happens to be our electricity provider via contract with a local electric cooperative. The city was raising my electricity rates markedly. Why? It was not because of the need to build more power generation capability or more/better infrastructure to transport the electricity to my house. Instead, my rates were going up because 30% of the town's residents could not afford, or would not afford, to pay their electricity bills.

Thirty percent of residents could not afford, or would not afford, to pay their electricity bills? That was a shocker to learn. Could this be the case across all of rural America? Given that this small town is in Texas, one of the most vibrant economies of the last decade, odds seem high this is a problem more widespread than we may want to believe.

When we top 10% to 1%, or what Peggy Noonan is now calling, "the protected class", get put out from all this talk about income inequality and a living wage, realize that a good portion of the population can't afford to pay basic living expenses.

Another example—about a year ago *The New York Times* reported that 86% of people who signed up for Obamacare were getting subsidies from the federal government to pay their premiums. Eighty-six percent of these people (over 10 million) can't pay their health insurance premiums? Who are these people?

We read a lot these day about the shrinking middle class. It is obviously shrinking because the cost of basic living has been rising considerably more than wages. Within this context, it's easier to understand why there are political efforts to raise the minimum wage significantly. **But do we have a minimum wage problem, or do we have a problem creating enough jobs that pay more than the minimum wage?**

It is unfortunate that our federal government has dropped the hot potato directly into the Federal Reserve's lap to "stimulate" the economy. Maybe this handoff occurred because the current administration realized their legacy could be \$1T annual budget deficits across eight years in office. Who would want that in the history books? No matter the actual reasons why the buck now stops at the Federal Reserve, it is becoming increasingly obvious that monetary stimulus is no longer capable of enabling the growth this country and its citizens need.

Armchair Economic Perspective
Hitting The Wall...And Bouncing Back
May 2016

Because we are in an election year, the unfortunate reality is that the possibility of any productive economic policy reform is, at minimum, 12 months away. And even if meaningful structural reforms can be enacted (a big if), it will likely take several more months before we see the effects in our economy. The best-case scenario seems to be that IF we get immediate PRODUCTIVE economic reform out of our next presidential administration, it will not be until some time in 2018 that we can hope to see better economic circumstances.

Between now and then it appears we're going to be adrift in the monetary stimulus ocean. If the Fed does raise interest rates before we get productive economic policy reform, there could be a number of other bubbles that find a pin. Real estate could be ready for round two. And the tech market unicorns, those private venture-backed companies valued over a \$1B, could also be another bubble that finds a pin. (Actually, this may have just started.)

But what would productive economic policy reform look like?

A big clue to our problem is the inability for wages to rise. One of the biggest reasons wages aren't rising is because our economic productivity isn't rising. Economic productivity is different than worker productivity. Economic productivity is more about how well our economy is doing relative to our employment situation. Historically, rising economic productivity puts more wages into the pockets of workers. So why has our economic productivity stagnated, so much? Why can we only aspire to 2% GDP growth? There are likely several impediments, but let's look at one that's quite telling

A 2012 Heritage Foundation essay on educational spending stated that from 1970 to 2012, student enrollment in public schools rose 7.8%. During that same period, the number of public school teachers increased by 60%, while the number of non-teaching staff positions (administrators) rose by 138%.

You think as an "industry" education is more productive today than it was in 1970? Did algebra, geometry, chemistry and American history change so measurably that we needed all these extra teachers? And did this 7.8% increase in students create so much paperwork that we needed to increase the number of administrators by 138%?

This is not a unique circumstance. Similar metrics exist throughout the public sector and all over the private sector, as well. What is causing such a decline in our economic productivity? It seems obvious. It's coming from the growth in government regulation.

Our economic productivity is not growing because we're spending too much time and too much money complying with the ever-growing number of rules coming out of the Washington of Oz. Want to escape the black hole of economic decline? Want to bounce back productivity, wages and economic growth after hitting the wall? Then it's time to reduce regulation and scale back the way-too-heavy hand of government.



Douglas A. Leyendecker
713-862-3030
doug@armchaireco.com