INTERVIEW

Stephanie Pomboy: A Grim Outlook for the Economy, Stocks

MacroMavens' founder says investors ignore data that proves the financial crisis changed everything.

By LESLIE P. NORTON
August 20, 2016

For some time, Stephanie Pomboy, an economist and the founder of MacroMavens, has pushed a provocative theory that a crisis-chastened U.S. consumer would retard global growth. That is why a U.S. recovery has taken so long to take off, and why Japan and Europe look set to embark on more rounds of quantitative easing.

An avid reader of Shakespeare, Pomboy appreciates the comic and tragic dimensions of the markets—the giddy optimism for the second half of the year, and the potentially disastrous consequences of excessively low rates. As stocks teetered at new highs, we phoned Pomboy in Vail, Colo., where she lives when not in Manhattan, to hear her latest views. They aren't rosy: Investors and policy makers are deluding themselves that we will soon return to a pre-financial crisis framework. Things have changed, she says, which means expectations for economic growth in the second half are far too optimistic. And today's low rates could cause another financial crisis, bankrupting pension plans, putting retirees at risk, and hurting stocks.

Barron's: *You like to focus on the consumer—and plot U.S. consumer spending as a percentage of GDP versus world trade. Why?*

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"Everyone is looking for a significant second-half rebound for earnings and GDP—when the clouds will part and the sun will come out. I strongly believe that won't happen." —Stephanie Pomboy *Photo: Morgan Rachel Levy for Barron's*

Pomboy: What ignited and supported the entire era of globalization was the spendthrift U.S. consumer; economies have been totally reliant on trade to U.S. consumers. This once-in-a-generation asset deflation will fundamentally change behavior, just as the Depression changed an entire generation's attitude about spending and saving.

Obviously, the burden of proof is on me, because for 20 years the consumer has reliably borrowed from China to buy their tube socks. Post-crisis, the consumer has clearly pulled back. How many months did we have disappointing retail sales numbers that no one could explain? They'd say it's too hot, too cold, there's Brexit. But what's really causing this slowdown in spending is that the post-crisis consumer is determined to save, and do it the old-fashioned way. Historically, when rates go down, people save less. In this cycle, things have completely reversed. Over the same stretch of time that the two-year note has gone from 4% to 1%, the savings rate has doubled. There are mountains of evidence to support my thesis. But every Wall Street analyst and the Fed is using the pre-crisis analytical framework to look at an economy that is fundamentally challenged.

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How will the world economy fare, anchored by a consumer who looks like this?

This is the struggle. This is why we have seen these desperate monetary policy actions around the globe. As U.S. consumption slowed in the aftermath of the crisis, global exporters that relied on trade

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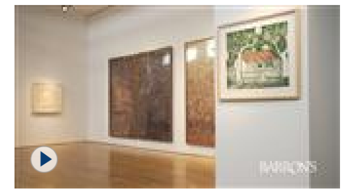

with the U.S. scrambled to gather a larger share of the shrinking pie by debasing their currencies. But these policies started creating bubbles in their own economies. So now they've focused on boosting growth domestically, which is why you hear so much isolationist rhetoric today.

It doesn't sound like a bad strategy for emerging markets to focus on internal growth.

It's funny—this is exactly what we admonished they should do for years, chastising countries like China for relying too heavily on exports to the U.S. But now that they are taking the difficult steps to do it, we write them off as toast. But that disconnect pales in comparison to the one that finds U.S. investors bemoaning the slowdown in global trade—which is a function of the U.S. consumer's downshift—while clamoring for consumer discretionary stocks in their portfolios! This will lead us to the next phase in global economic policy—fiscal stimulus funded by helicopter money. [The late economist Milton Friedman asserted that a central bank could create inflation and economic growth by dropping money from the sky, which was subsequently referenced by former Fed chief Ben Bernanke in a 2002 speech.]

Where, when, and how will helicopter money begin?

Japan is the most natural place for it to start, but Japan isn't dramatically different from the U.S., the U.K., or Europe. We're all dealing with an aging population. This is another great flaw in the logic of monetary-policy makers. They've pushed rates to and below zero in an effort to boost growth. But they did so against a population that is aging and needs more than ever to get returns on what they've set aside. By lowering rates, they've actually intensified the saving urge.

The statistics bear this out. Over the last four years, U.S. nominal GDP growth has gone from 4.3% to 4.1% to 3% to 2.4%. The deflator, the inflation we are supposed to be targeting, went from 1.9% to 1.6% to 1.5% to 1.1%. What greater proof do you need that lower rates aren't helping and, to the contrary, are making things worse? Growth and inflation are slowing, and it has to do with this aging demographic. Add the emotional and financial scares from the housing-bubble bust, and policy makers have really got it ass-backwards. They're taxing the economy, not stimulating it.

So what happens?

Clearly, QE [quantitative easing, in which a central bank like the Federal Reserve buys government bonds to lower interest rates and increase the money supply] isn't doing the job. The markets anticipate another Fed rate hike. We never should have raised rates in the first place. The question is, how quickly do they reverse? More QE isn't the solution. But policy makers aren't ready to concede defeat. So, the Fed will abandon rate hikes and eventually re-up QE in some form. I do see helicopter money getting here, but that kind of fiscal stimulus has a substantially longer fuse. You've got to come up with a proposal, get everyone to agree, enact it, implement it. There will probably be some risk-off move that causes the Fed to panic and an interim QE attempt to calm the markets before we get that helicopter in the air.

Bernanke acknowledged at the depth of the crisis that monetary policy isn't a panacea, and ideally there would be a fiscal stimulus. Consumer-spending growth peaked right after the fiscal stimulus—the tax rebates—wore off. You are still stealing growth from the future. But at least it's doing something. Current policy is setting us backwards.

Is it possible that you're too negative? Stocks are hitting new highs and recent economic data seem reasonably sturdy.

The July payroll number was a barnburner on the upside. But that report is the exception. Jobless claims, the NFIB small business survey, the employment component of both the ISM manufacturing and nonmanufacturing surveys—they all suggest things are rolling over [getting worse]. Importantly, the No. 1 input into hiring—corporate profits—has posted five consecutive quarterly declines, which suggest employment growth will follow. Employment is going to look a lot softer over the next six months.

The presumption supporting equity prices is that all the bad news we've seen this year has been due to anomalies—the lagged effect of the strong dollar and weaker energy prices as well as Brexit. Everyone is looking for a significant second-half rebound for earnings and GDP—when the clouds will part and the sun will come out. I strongly believe that won't happen, in large part because of inventories. Inventory accumulation has been explosive.

What's caused this growth in inventories?

It isn't because companies ramped up production. Companies aren't using cheap capital to increase production and capital expenditures, but are lavishing money on shareholders instead. They bought the lie that consumer spending would turn up any moment, and produced at the same pace. Now they find themselves with a monster inventory overhang. Inventory-to-sales ratios across a variety of industries—manufacturing, machinery, autos, wholesale—are at the highest level since 2009. In prior inventory liquidation cycles, nominal GDP growth is cut in half during the liquidation phase. As for profits, we're starting with five negative quarters and we haven't even begun the inventory liquidation cycle. So the second half will be a real eye-opener.

In your view, today's too-low rates will cause the next financial crisis. Describe it.

In the past rates that were too high were the trigger. Not this time. No. 1, we have basically bankrupted corporate and state and local pensions by having rates at these repressive levels. If you lay on top of that a decline in equity prices, there will be a scramble to plug holes in pensions. Obviously if a state or local government has to divert funds to plugging its pension, it won't build more roads. The corporate sector has the luxury of kicking the can down the road, and because their spending has been on buybacks, not plants and equipment, the economy would suffer less. For S&P 1500 companies, the pension deficit is roughly $560 billion, but for state and local governments, it's $1.2 trillion. According to the Center for Retirement Research, if you used a more conservative discount rate, the unfunded liability would go to $4 trillion.

No. 2, you're pushing consumers to the brink as they try to save enough for retirement at zero rates. You're already seeing a reluctant return to credit-card usage, a clear sign of distress—they are charging what they previously paid with cash. The credit-card delinquency rate is picking up.

What can policy makers do?

Stop pushing rates down. Create a fiscal stimulus focused on boosting demand by giving people high-quality jobs. Obviously, the quality of the recovery has been subpar, with a lot of part-timers and waitresses and whatnot. Obamacare didn't help because employers cut people's hours [so they wouldn't have to offer health benefits]. Any pro-growth fiscal policy that would get companies hiring again would be hugely positive, because you aren't going to change a generational mindset to save more.

What do you see for the economy and the stock market?

The consensus is forecasting GDP to more than double in the second half, from 1% to roughly 2.5%. We are far more likely to stay in the 1% area or go lower. Nominal GDP growth for the full year should average around 2%. It is currently 2.4%. This will trigger a major move to risk-off: When it becomes clear that the weakness in the second half, and in 2015 and 2014 before that, wasn't temporary. Investors and the Fed all presumed that the pre-crisis economic framework was still intact. Five years of steadily decelerating growth and inflation demonstrate things are fundamentally different.

Perception and reality are furthest apart on the consumer discretionary stocks, where people doubled down, unaware of the monster inventory overhang. The correction will drag down most of the market. We could easily go back to the 2009 lows. I could see 2017 being a pretty nasty year.

So what are you positive about?

Because economic growth won't be a catalyst to push rates higher, I continue to like government bonds. Look for a re-pricing of credit risk with the spreads between investment-grade and junk bonds widening out. We'll also have a renewal of QE in the U.S. and are seeing it elsewhere. And as Fed tightening goes out the window and the dollar sells off, we'll have another meaningful leg up in gold.

Thanks, Stephanie.

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