United States: Economic Analysis

At time of writing, August 2017, the S&P 500 is hitting record highs; the VIX is plummeting to new lows; and U3 unemployment is at pre-Great Recession levels. A populist president is in the White House, partisanship is bringing Washington to a standstill, and the national media is fixated on Russian interference in the election. All the while, the Federal Reserve is tightening monetary policy, while politicians promise fiscal stimulus and tax reform.

The election of Donald Trump on November 8th 2016 kicked off a stock market rally. The Washington outsider campaigned on an ambitious populist agenda that appealed to workers from the rust belt, alienated the coastal elites, and appalled Washington insiders. Many pundits believed the Trump Whitehouse would mark the return of bilateralism, domestic manufacturing, wage growth, and inflation. The stock market acted accordingly.

Unfortunately, so far the great dealmaker president and his Goldman Sachs alum cabinet have been unable to get any of their agenda past the political establishment. With this backdrop, let's examine the pulse of the world's largest economy.

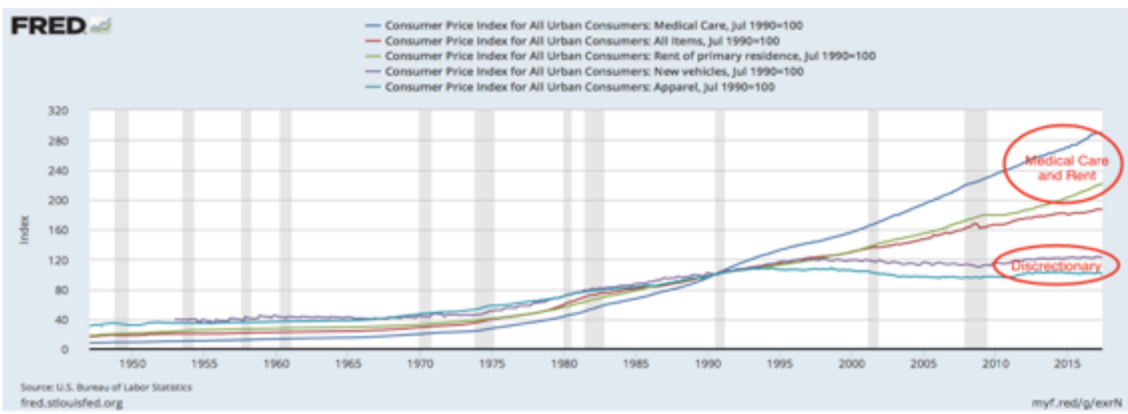
The American Consumer

Roughly seventy percent of America's $18.57 trillion GDP in 2016 can be attributed to personal consumption expenditures. With the government in gridlock and headed towards another debt ceiling showdown, the consumer's ability and willingness to spend will ultimately determine the trajectory of the US economy, central bank policy and the performance of financial markets.

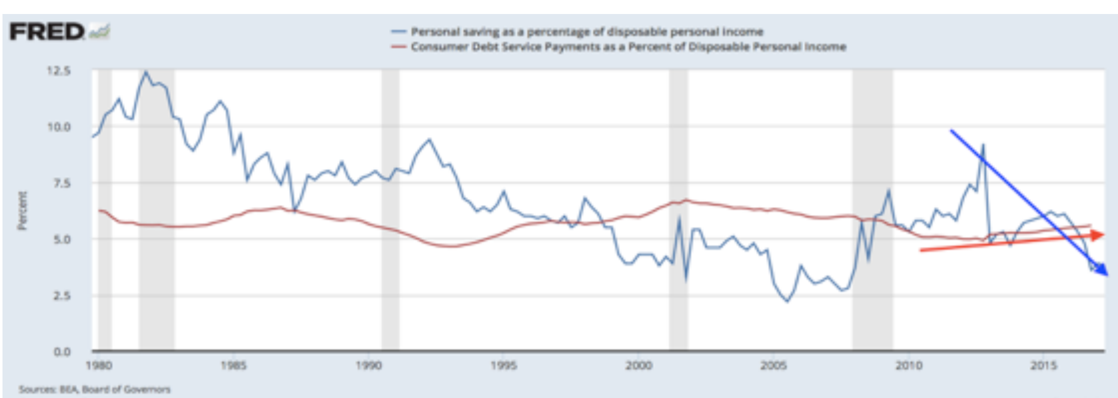
The mainstream narrative is that strong U3 unemployment translates to a healthy consumer and that wage growth and inflation are imminent. However, the bankruptcies ravaging the retail sector and America's rejection of mainstream politicians during the last political cycle are just two signals of an economy that is not firing on all cylinders. While financial and political pundits are scapegoating Amazon for the retail apocalypse and Russia for Donald Trump's election, they are either completely missing or dismissing economic indicators that provide a more coherent explanation.

Calling into question the mainstream narrative, a weak employment to population ratio and subpar earnings growth conflict with the often-quoted U3 unemployment statistic. The employment to population ratio has never recovered to its 1990s highs and currently sits at mid-80s levels. The same can be said of average hourly earnings growth, which peaked in the 80s and has been in a downtrend since before the Great Recession.

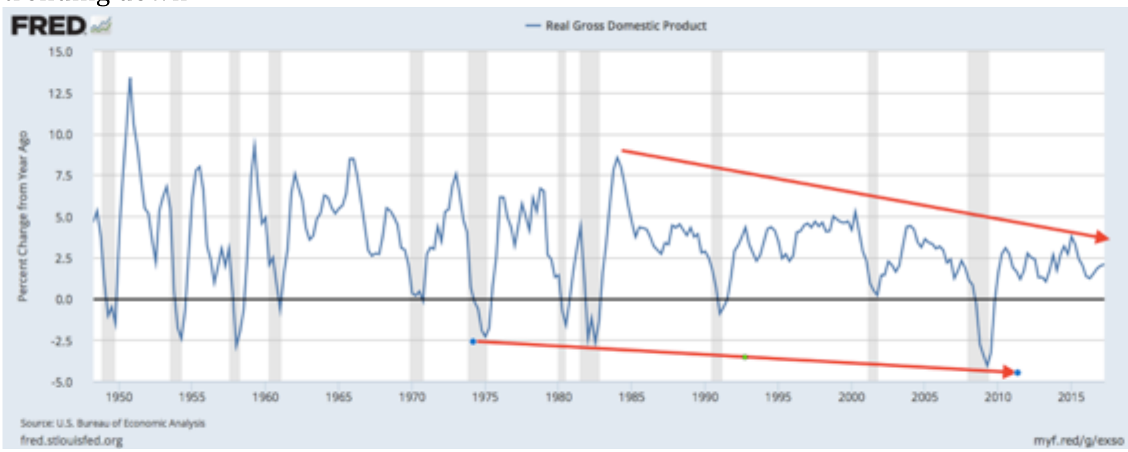
Further, confounding to the lives of American workers, voters, and consumers are Consumer Price Indices showing that the cost of necessities like rent and healthcare is outpacing cost increases in discretionary items like vehicles and apparel. Politicians have debated the causes at length, but the bottom line is that the average American is spending more of their paycheck on the necessities of life and has less money left over for the indulgences that drive the consumer economy.



The effect of flat lining wages combined with increased cost of living is starting to negatively impact American's personal finances. This is demonstrated by shrinking savings rates and increasing debt levels, both of which are approaching pre-Great Recession levels. What makes this trend disturbing is that both statistics are deteriorating in an ultra low interest rate environment and with the Fed in tightening mode there is little hope for improvement.

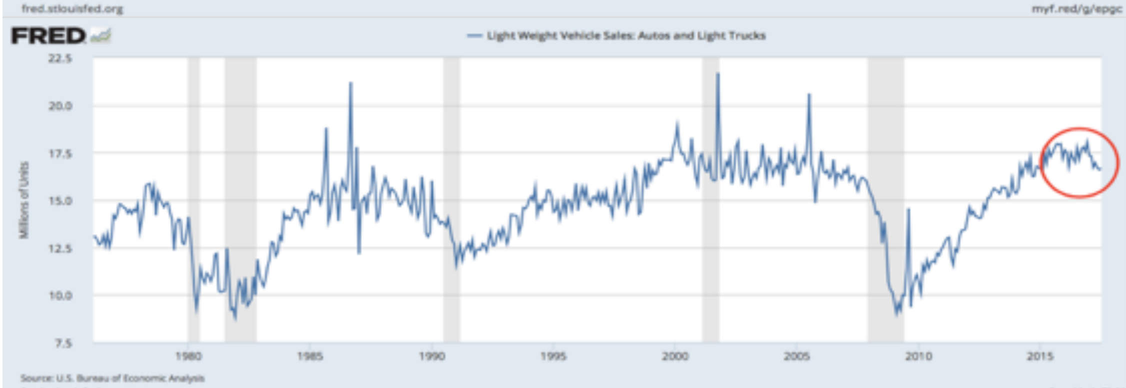


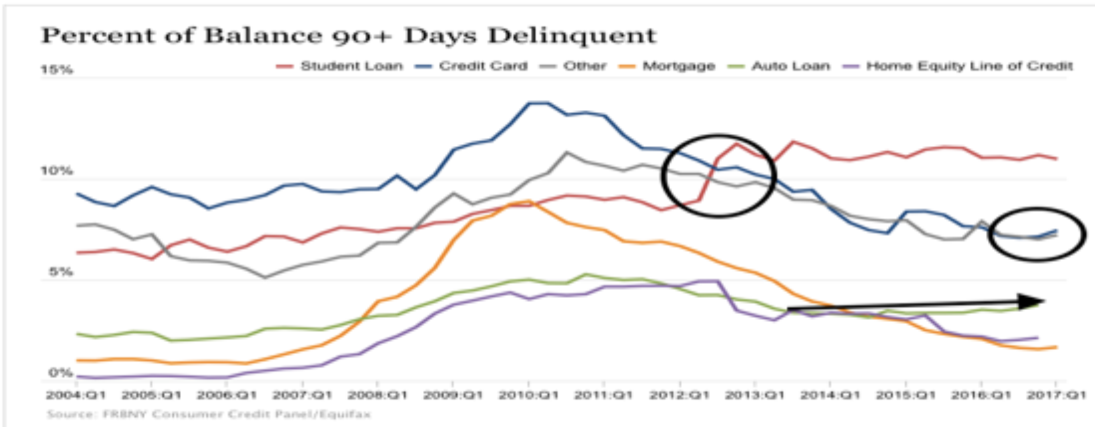
The impact of flat wages, under/unemployment, increased cost of living, higher debt levels, and decreased savings rates is starting to decay American demographics and dampen GDP growth. America's birth and fertility rates are plummeting and so is household growth. Under these conditions, it's no surprise that GDP growth is almost none existent and trending down.



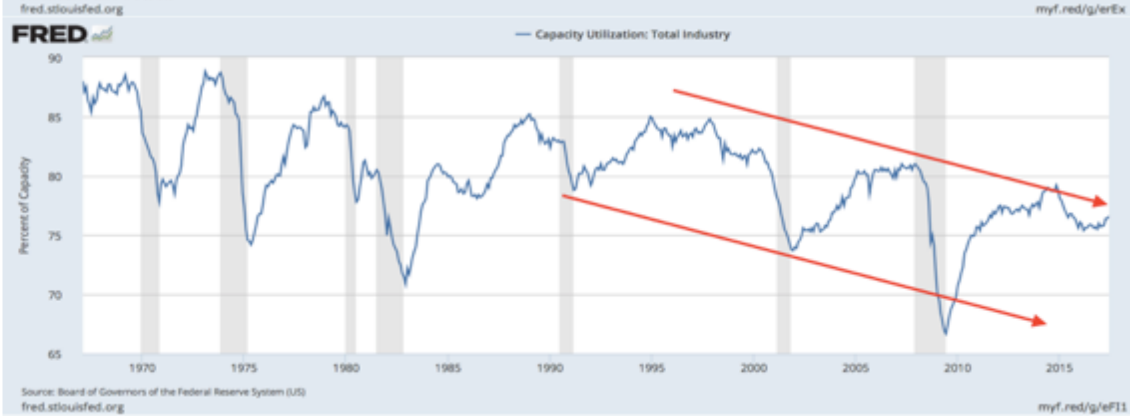
Corporate America

American businesses are starting to feel the impact of tapped-out consumers and slumping GDP growth and are responding accordingly. Retail sales growth recovered sharply post-Great Recession but has been trending down since 2011. Propped up by government incentives, lax credit standards, and an accommodative Fed, auto sales recovered sharply after the Great Recession, but are now starting to falter. Delinquencies on auto loans are also starting to rise, which is especially concerning considering Fed tightening impacts the front end of the yield curve, which these loans are most sensitive to.





A stubbornly high inventory to sales ratio is yet another indicator signaling tapped out consumer demand. Interestingly, it is accompanied by a slumping capacity utilization rate and plummeting capital expenditures. Demonstrating that, despite their best efforts to slow down production, corporate America cannot keep up with slumping demand. It's no surprise that wage growth is almost nonexistent under these conditions, however it is surprising that the S&P 500 and Dow Jones are at record highs.

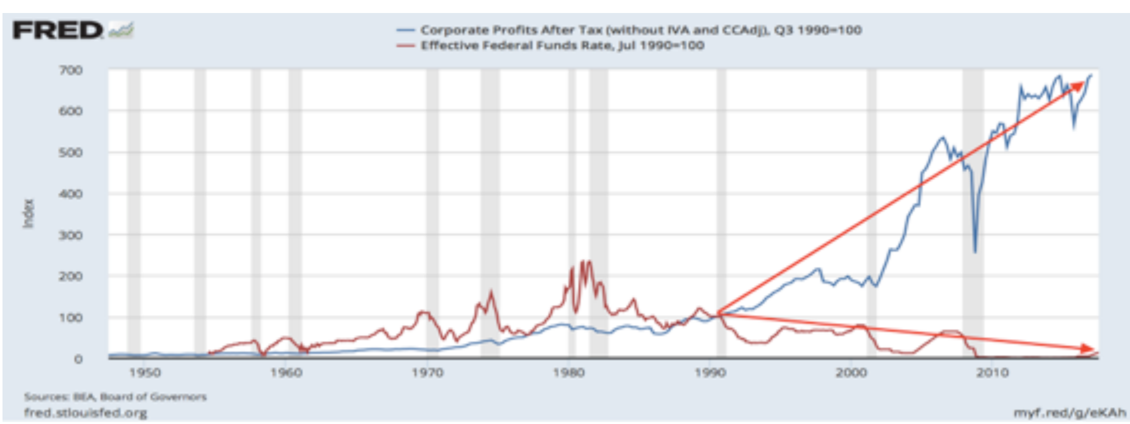


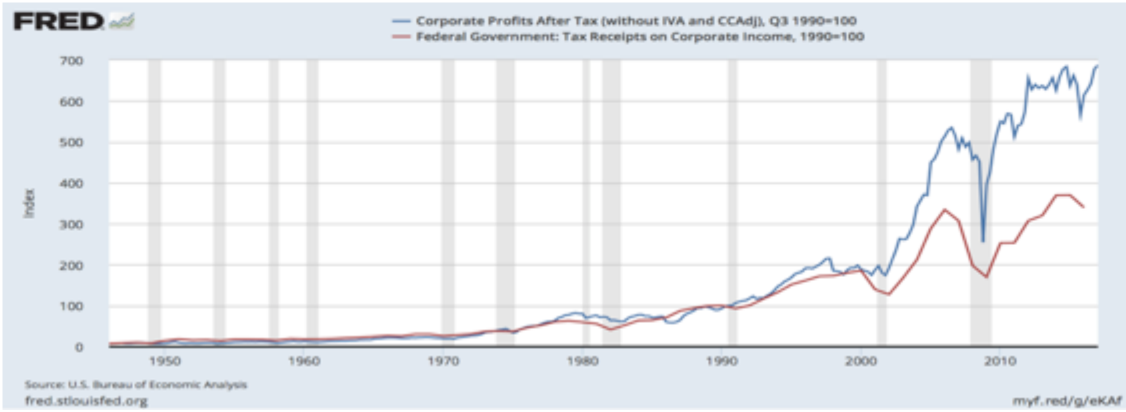
Manufacturing Buying Policy: Capital Expenditures
Source: Institute for Supply Management & Quandl.com

<u>It's The Fed, Stupid</u>

With Lehman Brothers collapsing and the fear of contagion spreading through the financial system, the Fed acted decisively, dropping interest rates, providing emergency loans to "too big to fail" institutions, quantitative easing, and other broad based programs designed to inject liquidity into the financial system. A system collapse was avoided and the American economy started to recover. Yet, ten years since the start of the crisis, it is clear that while disaster was avoided, it has not been a broad based recovery. The American economy is battling the impacts of weak wage growth, increased debt, decreased savings, slumping retails sales, and corporate underinvestment while the stock market is hitting record highs and volatility is at record lows.

Falling interest rates, reduced capital spending, and stagnating wages have translated to a spike in corporate profits. Interestingly, the link between corporate profits and government tax receipts broke down in the early 2000's and accelerated significantly post-Great Recession. This indicates that financial engineering, enabled by low interest rates, is likely more responsible for the growth in profits rather than improvements in productivity.





The most fascinating pattern to emerge post-Great Recession is the link between the S&P 500 and the Fed balance sheet. The fall in the S&P 500 stops as the Fed announces QE1 in the fourth quarter of 2008 and for the next 8 years, the S&P 500 tracks the growth of the Fed's balance sheet. The trend is finally broken when the S&P 500 breaks out post the election of Donald Trump. With the Fed in tightening mode and talking about reducing its balance sheet, one has to wonder if a mean reversion is in store.

<u>It's Time To Admit It…</u>

No matter how much media pundits and politicians talk about a recovery, it is clear that the average American has not recovered from the Great Recession. Arguably, they are worse off and corporate America is starting to feel the pinch. This explains why inflation is consistently undershooting despite years of unprecedented interventions and accommodative interest rate policy. Now the Fed is forced to abandon its inflation target and raise interest rates in a sluggish economy. With the consumer on life support, inequality and populism peaking, it is only a matter of time before they are forced change course. This will not end well. It is time to get ready for a bumpy ride.