SNAP

This was to have been the third in a series on the New Economics. The failure of our leaders and both Fiscal and Monetary policy to restart the U. S. economy is now apparent to all. Events of the day led me to postpone the third piece and address instead likely next events.

I wrote this piece with three thoughts in mind:

1. The United States produces some of, if not *the* best economic data in the world. The collection, scope and analysis are superb. It is also mostly data of an economy that hasn't existed for decades. We still measure what was once largely an industrial, inventory driven, semi-isolated economy. Today, services and technological leverage dominate.
2. The 11th century monk mentality of economists wearies me. Ever eager to turn humans into scientific models, they propose their economists' guild cures for problems that only they seem able to define, using the aforementioned data. Why monks? Well, the monks of that time felt prayer was the only answer to things they didn't understand, such as plagues, war wounds and sterile livestock. Economics is not math, not physics – it is, at best, a study of human behavior at the most elemental level – need fulfillment.
3. Basic human needs, to my mind, reflect at least two elemental drives:
   a) we are, physically, not much more than expendable containers to move humanity's DNA forward – the rest is what we call civilization and
   b) we genetically assume, <u>must</u> assume, all perceived "patterns" are real and we further assume the worst from patterns. Had we not, over the millennia, we simply wouldn't be here today. Was that snap of a twig a friend? A tiger? Did I hear a snap here in these woods before . . . what do I know?

The snap in the woods today is whether yet another recession has begun. There is little doubt factories around the world are slowing, consumers have significantly reduced spending and "austerity" is the word. Globally, we are back to levels last seen two years ago.

From our political leaders we hear that this pause is the result of Japan's earthquake interrupting supply chains (we can relate, have written about downstream issues around car production – but only relate) and weather, of course. Note the implication – the economy allegedly was well under way to recovery, but outside elements slowed it. Well, it wasn't well under way. Enough work has been done by others to show it was barely alive, barely a 2% economy, and even that was not Stimulus created. More likely it was our organic or core growth rate alone. It seems to me this pause is no more than further evidence of an inherently weak economy, short on confidence and not proof it was interrupted. It remains a viable, weak recovery. What's marvelous is that it dealt with weather, supply chains and the other excuses.

The end of the Stimulus will, I suspect, pass without much fanfare although many worry it is still desperately needed. I suggest instead that our core growth is that 2%-ish number. Higher growth, 3% or 4%, will come only after consumers' balance sheets improve.

The jump in food and fuel did short circuit what little consumer optimism there was but, again, new high levels of demand didn't cause the jump and short of blockading the Suez, prices should settle here. Look to the traders of both food and fuel for most of the price volatility.

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I would propose we Americans are not undecided in our optimistic/pessimistic behaviors of late. I think we would like to be optimistic, but would also like to know first what that snap in the woods was. We know a pattern of danger has been established of late – jobs, wages, debt, our leaders, and we sit here waiting for clarity – what is it, can we move on—is it safe to act?

Which takes me, anyway, back to the idea that an organic, immutable growth rate in this country is 2%-ish. Add credit for leverage and you get 3%, maybe 4%. Take credit away, tax heavily, let the population age and you head for 0%.

But, you say, what of all those trillions? Surely they had some impact? Yes, they did:

1. They produced superb spread, not risk, profits for banks, likely preventing the failure of some – which is too bad.
2. They allowed U. S. investors to chase higher yields in other countries, exacerbating those countries' inflation issues. (This continues when all we offer is 1/10 of 1%.)
3. They continued the devaluation of our dollar.
4. They created strength in our export sector just as the rest of the world paused its buying.
5. They created an explosion in commodity prices and trading.
6. They provided low cost money to large businesses needing to cut labor with automation.
7. They fed the unemployed for a time, and hired a new layer of Federal workers.

Nowhere do I find that those trillions created provable job growth beyond new layers of Federal bureaucracy.

Into that framework, then, we see countries around the world trying to cope with our Tsunami of money into their economy. Their balancing act is very tricky; if they tighten their money – raise rates locally – they run the risk of falling into another recession – and the world is further attracted to high rates there. If they don't tighten, they run the risk of too much money chasing too few goods – inflation. Mix in Greece and its near-worthless sovereign debt on bank balance sheets globally and one is likely justified in freezing, standing stock still and waiting for a clue as to what's next.

Freezing has spilled into domestic politics. The ideological battle between the parties is as much chest thumping as it is ignorance of what to do. We consumers, seeing this globally and excessively here at home, are not inclined to make any kind of wide-spread, long-term commitment. Consumer confidence is thus a reflection of foreign economies and that snap in our woods.

And we have it easy. The Eurozone and its massive established entitlement system is starved for liquidity. With austerity it's current "out" from debt issues, inflation likely and growth far less likely, most of Europe faces, well, in Greece's case, at least, a depression for years, default and blame for triggering other problems. These include significant damage to banks and ultimately, failure of the Euro.

Here in the frozen U. S., in contrast, we have:

1. stable credit markets growing more so;
2. available credit – and tougher standards;
3. growing money supply – liquidity;
4. low rates and likely to remain so;
5. currently weak economic data creating a "low bar" for future comparisons;

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6. endless Black Swans weathered well. We have dealt well (economically) with Libya, Egypt, weather, Madoff, Tsunami, EU bailouts and the like. We <u>are</u> resilient.

The "all patterns are bad" we have encoded in our genes isn't allowing much room for some significant positives as noted above. Yes, It's easy to see how discouraged an unemployed worker can be; of course he hears the snap differently – he has to. But what of the rest of us? What now?

Perhaps a few near term forecasts, based on our organic growth and current failure to see positive patterns will help:

1. Continued dollar debasement because of our debt and all that entails for exports, etc.;
2. A fractured Euro for lacking social unity and the core strength of a single economy, in the end neutral to good for us (and very good for those kicked out as they can now devalue independently);
3. An over-valued China/Asia because inflation there is requiring a serious slowing and soon, a serious buying opportunity from the fallout;
4. Citizens of China, India, etc. are far too familiar with regime change, hyper-inflation and monetary corruption, so gold goes higher;
5. Barriers to capital flowing between countries will increase as nations fight internal inflation battles;
6. Our debt, bought not by China, but by us as we age, accept slower growth and become more and more defensive with our wealth;
7. Diminished inflation after this current blip – it has a few quarters to run yet;
8. Slower corporate earnings growth rates, <u>but</u> coupled with low inflation, justification for existing and modestly higher stock prices because future earnings and dividends are worth more in a period of low inflation;
9. Jobs go only to high-wage, high-skill positions and to lowest-wage, lowest-skill workers. Women, with faster rising educational goals, will supplant many middle-wage/middle-age men who, frankly, seem reluctant to retrain;
10. Inflation remains tolerable. The public has to have access to more money to chase goods. More money comes generally from wage gains or easy credit and neither is immediately likely. <u>Anticipated</u> severe inflation, a twig snap followed by many more of an inflationary type, will cause people to be rid of money as fast as it's acquired. This is an increase in the velocity of money which is, effectively, an increase in the supply. A loss of confidence in our money, accordingly, is inflationary. So far, not an issue.
11. Retail sales will level off around the same 2% <u>aggregate</u> rate driven by the haves who, with newly rich Asian and South Americans, are carrying this sector and mostly at the high-ticket end. The have-nots won't spend until home prices begin to rise nationwide. Obviously, pockets of exception will persist. For now, their near-zero wage gains mean near-zero sales growth. I note even the domestic haves are pausing in their spending; I suspect having easily weathered 2008-2010, they are alert to the end of their reserves. All in all, slower, even for the haves.

Solutions to our debt exist. Between 1945 and 1980, inflation ate away the majority of our war debt. British debt, for example, fell from 200% of GDP to 130% by 1955. Savers, lacking alternatives in the recovery period, deposited money in banks and bonds. Banks lent to the government (bought

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government bonds) below the level of inflation. This is easily done if you "cap" – put a ceiling on government bond interest rates. Savers were repaid on withdrawal with money worth less than what they put in. Savers took this (slow) hit and the Treasury balance sheet improved. Why would savers take the hit? According to a Peterson Institute study, exchange controls (5-prior) and very high bank reserve requirements were the reason. Add in a cap or ceiling on what banks may charge on loans and you have debt reduction over time without severe austerity or severe service cuts. We are headed, in my view, exactly this way. (It is this point that also makes high-yield stocks, higher than interest on Treasuries, attractive. Add a rising dividend from that stock and the case gets better.)

It's called repression and our domestic debt load went from 116% of GDP to 66% in the 10 years after World War II – in spite of, I might add, some hefty tax rates.

According to *The Economist*, we could move to a budget surplus by 2013. How? We are a rich, liquid country awash in entrepreneurial spirit. We still have a sound balance sheet, and are still <u>able</u> to grow, thanks to force of law and contract. We have the will and the talent. Frozen in indecision, threatened by a bureaucracy that strangles innovation, we all clearly see both our choices and the barriers.

Ironically, the weak economies of Europe are farther down the repression road. Basel 3 rules on higher bank capital are in play. Greece is the test tube: European banks are under severe pressure to roll over Greek debt. China, well, China does it by fiat. Free flowing capital is on its way to a sharp reduction.

We muddle through with frozen leadership. Our organic growth runs on momentum, some deep-seated individual patterns of life that we know work. The new discovery for many is how primitive these life patterns are. We are coming to see, I think, that all human life depends on agriculture, mining and maybe some simple manufacturing. Less important, we are recognizing, are such things as finance, real estate, Disneyland and a 54" flat screen.

Until we know better, yes, patterns must be assumed to be bad. Of late, many deadly patterns have appeared and, yes, regrettably every snap was heard in that context. A surprising number of people latch on to any trivial good news as proof of a new "normal" growth pattern returning, ignoring, I think, the fact that evidence is scant. I think this explains much of the recent excess focus on sprouts of positives in a forest of negatives – and a whistling-past-the-graveyard mentality in stock prices from those leaps of hope. In this period of discovery, we also had to face a pattern that has developed almost without our awareness. This pattern (with plenty of missed snaps) is loss of individual liberty which we yielded to our leaders. We traded it for wealth, for assured security in the woods. Now leaderless, in spite of words to the contrary, we face what Justice Brandeis said, . . ."You can have democracy or wealth in the hands of a few, but not both."
We need look no further than the Arab Spring for confirmation.

Clearly our leaders chose wealth. Democracy is still up for grabs.

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