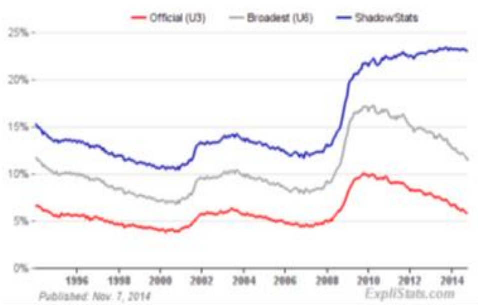
"Real macro numbers" in fiat money, fiat government era

How to invest when CoverGirl's makeup starts to run and the anti-free market policy cocktail keeps getting spiked S&P 500: 2,073.8 (11/26/14)

November 2014

Unemployment rate -- U3, U6, & Shadowstats



Civilian labor force participation rate

Quarterly real US GDP vs. real S&P 500 sales

"Economic reality 101" revisions will keep coming

With the US unemployment rate down to 5.8%, the dollar strong, the oil price collapsing, the federal deficit allegedly shrinking materially, the recent Q3 real GDP growth upside revision (shenanigans), and the S&P 500 reaching all-time highs despite QE cessation, what's not to like, investors?

Arguably there is a not such a pretty economic/financial face that lurks just beneath widespread government statistics "Mascara," i.e., those statistics that the mainstream media often finds worthy of wider dissemination. Illustrative examples of eyewash as well as underreported economic developments abound. Some examples follow:

- A 5.8% U3 unemployment rate (left graph above). This is not thanks to a vibrant job market, but due to politically expedient shrinkage in the reported size of the civilian labor pool (as reconstituted in the ShadowStats rate), faulty tabulation of employment gains (corporate birth/death assumption illusions), and shrinkage in full-time jobs as replaced by low-paying, part-time jobs lacking benefits. The much less discussed, sharp decline in the civilian labor participation rate (middle graph above) is more indicative of the lacking job-related vigor of this so-called economic recovery.
- Inflation tabulation chicanery. Massively understated CPI inflation not only artificially boosts real GDP and productivity growth, but it lowers cost of living adjustments for government transfer payments. Doubts continue about how representative of consumption cost reality CPI-based inflation readings are. This is fueled by the sustained disconnect between consumers' sense of inflation and what the government reports. Consider, for example, how much electricity costs, food costs, insurance costs, healthcare costs, tuition rates, and communication costs (and the associated government taxes) have been increasing over the past four to five years; does two or three times the low single-digit annual CPI index's rise sound reasonable? Well, there's a good reason for it: the CPI has mutated from an inflation tally in the early 1970s that measured a stable basket of consumer goods to a "substitution exercise." In plain English: if steak got too expensive, it was withdrawn from the measured consumption basket and replaced with hamburger. Also, hedonic adjustments, or arbitrary quality enhancement-based price modulations, entered the CPI inflation reduction fray (Bill Gross once called the US CPI an "haute con job"). Most importantly, the CPI consumption basket is not even close to reflecting actual spending on "big ticket" outlays. Below a case in point from early 2013 that arguably has even greater validity amidst the Obamacare rollout:

> "Another stunning example is found in health insurance costs, which is a major line item for most families. According to the BLS, we can all breathe easy on that front because their "Health Insurance Index" increased a mere 4.3% (total) in the four years between 2008 and 2012. Interestingly, over the same time, the Kaiser Survey of Employer Sponsored Health Insurance showed that the cost of family health insurance rose 24.2% (5.5 times faster). But even if the BLS had reported higher costs, it wouldn't have made much of a difference in the CPI itself. Believe it or not, health insurance costs are assigned a weighting of less than one percent of the overall CPI. In contrast, the Kaiser Survey revealed that in 2012 the average total cost for family health insurance coverage was $15,745, or almost one third of the median family income." www.europac.net/commentaries/inflation_propaganda_exposed; http://www.bls.gov/cpi/cpifact4.htm

- Reminiscent of the divergence in fiscal year (per end September) 2013 between the reported federal deficit and the increase in total public sector federal debt, a relatively benign $486bn federal government deficit was trumpeted by the CBO for fiscal year 2014, yet the total federal debt outstanding over the same period rose by a whopping $1.086trn, a striking $600bn difference (www.treasurydirect.gov/NP/debt/search?startMonth=09&startDay=30&startYear=2013&endMonth=09&endDay=30&endYear=2014)! If management of a public owned corporation subject to GAAP engaged in such reporting deception, not to mention the failure to account for new unfunded corporate retirement-related benefit obligations (trillions of new unfunded Medicare and Social Security obligations are piled up yearly by the federal government), both the government and the shareholders would likely be firing executives, imposing fines, declaring lawsuits, and possibly much worse.

- The much touted, sustained, double-digit corporate EPS growth since the 08/09 recession belies the fact that the S&P 500 Index's (Corporate America's) real sales are still below the level achieved in Q4:97 (right graph on preceding page)! Obviously, outsourcing, reduced cap ex, laxer asset valuation accounting, historically unprecedented, deficit spending-fueled net margins, financial repression-generated low interest rates, and debt incurrence-based stock buybacks to leverage EPS beyond income are not a recipe for sustainable corporate earnings -- much less GDP -- growth.

More fiat policy-based growth headwind ahead?

President Obama recently signed an unconstitutional (Article 1, Section 8, Powers of Congress; http://press-pubs.uchicago.edu/founders/tocs/a1_8_4_citizenship.html) executive amnesty order that effectively legalized 4m to 5m illegal aliens with a stroke of a pen. The illegal immigrant constituency has grown robustly since the passage of the 1965 Hart-Celler Act, and it is already broadly availing itself of welfare benefits that were historically reserved for US citizens (www.washingtonexaminer.com/report-42-percent-of-new-medicaid-signups-are-immigrants-their-children/article/2556114).

Moreover, very few illegal immigrants make enough money to pay income taxes (www.americanthinker.com/blog/2014/11/obamas_deceitful_claim_illegals_will_pay_their_fair_share.html). And our byzantine tax code, this time via "earned income tax credits (EITC)," paradoxically promises to further redistribute wealth -- at American and legal immigrant taxpayer expense -- to people that came here illegally and that have little or no earned income history with the IRS:

> "Most households of illegals have very low income, and pay little in taxes. For example, in 2011, roughly 22% of immigrant households -- both legal and illegal -- were classified as living in poverty. In contrast, only 13% of American households were in poverty.
>
> However, once illegal immigrants are enrolled in the tax system, they would be entitled to EITC payments. The payments may be huge, and will rise each year.
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> According to IRS, parents with three or more children would receive up to $6,143 in 2014 if they earn less than $46,997. A family with two kids, and an income of $20,000, would receive $14,590 in taxpayer funds this year alone. Parents who earn less than the threshold would get $3,305 if they have one child, and $5,460 if they have two children." (http://dailycaller.com/2014/11/20/obama-u-s-taxpayers-must-pay-for-illegals-children/?print=1)

The "greenlight" signal that such an executive decree sends to countless millions of other impoverished, would-be immigrants around the world to also cross the porous American southern border to pursue US-based amnesty and welfare benefits is arguably the real strategic story. Amnesty on such a massive, unconstitutional scale promises to structurally expand hugely deficitary US government spending; to further strain local healthcare, schooling, and police resources; to increase the burden on tax-paying Americans, especially as only about 53% of all Americans pay federal income taxes (http://dailycaller.com/2014/11/23/obamas-amnesty-will-cost-22000-per-us-college-grad/); and, last but not least, to negatively impact the fate of chronically long-term unemployed Americans, especially those in bigger metropolitan areas, where unemployment rates for minorities are frequently in the 20% plus range (www.thedailybeast.com/articles/2014/11/21/legal-but-still-poor-the-economic-consequences-of-amnesty.html). Clearly today's immigration is vastly different from that of a hundred years ago. A century ago, i.e., in a pre-welfare state era, immigrants, economically speaking, came to America based on their enterprise, their assets, and their ability to contribute to a rapidly growing industrial powerhouse that lacked labor, both unskilled and skilled.

President Obama's "diktat" also markedly increases the odds of the Democratic Party reaching an unassailable Electoral College position in upcoming presidential elections in the not too distant future; clearly, a one-party state renders a functioning democracy impossible and it also typically impoverishes a nation (www.steynonline.com/6439/the-merger-of-the-party-and-the-state).

In addition, executive amnesty threatens to further erode the increasingly wobbly key tenant of a republican form of government, namely the Separation of Powers/Checks and Balances doctrines enshrined in the Constitution for the purpose of restraining despotic tendencies of powerful politicians in any branch of government. The framers, for historical reasons, feared an imperialist president more than anything else.

Separately, healthcare costs related to the ongoing, redistributionist, Constitution-contorting Obamacare rollout are soaring (www.washingtontimes.com/news/2014/oct/28/obamacare-sends-health-premiums-skyrocketing-by-as/), negatively impacting disposable income for the majority of employed Americans. This holds especially true for the younger, healthier generation, which is facing rapidly rising mandated healthcare premiums and/or expanding deductibles, and eventually threatening fines for refusing coverage (http://dailycaller.com/2014/06/18/private-health-exchange-obamacare-hiked-health-care-costs-for-young-adults/).

The GDP and income growth chilling impact of this legislation is being felt both in consumers' reduced non-healthcare spending capacity and in full-time job formation/availability terms, as companies, in an effort to avoid Obamacare inclusion, continue to morph full-time positions into part-time jobs while smaller concerns endeavor to keep the payroll count under 50 employees.

On the strategic job formation vitality front, and post midterm elections, the unelected regulatory agency which reports to the executive branch known as the EPA is seeking to implement unprecedented federal control over water property that extends way beyond regulation of navigable waters that the *legislative* branch has constitutional jurisdiction over (http://thehill.com/blogs/blog-briefing-room/energy-environment/224471-business-boiled-over-epas-water-rule):

> "The EPA's effort to redefine its authority over creeks, ponds, and wetlands is written so broadly that it could put millions of new miles of rivers and streams under federal control, along with ditches, puddles and dry creek beds.
>
> Such a change would be a major impediment to commerce, as businesses could suddenly need permits for all manner of routine activities like building fences or digging ditches, they charge. The effort by the EPA and the Army Corps of Engineers would muddy the waters for landowners and others already confused over whether they need permits, representatives said."

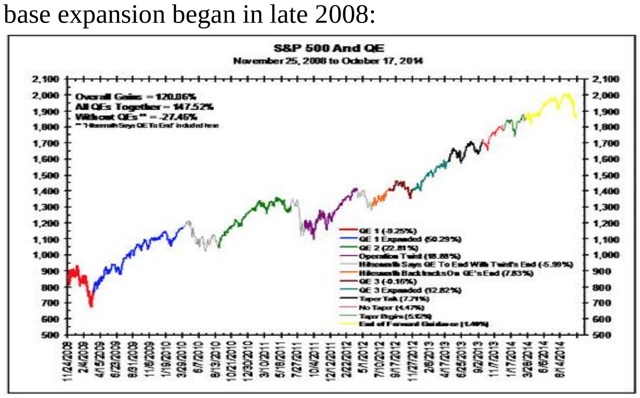
Bottom line: property rights and incentives stand to take it on the chin, yet again, if the EPA muscles through with this. Needless to say, this would negatively impact economic activity, investment, and hiring in businesses as far reaching as housing, construction, mining, energy exploration, and farming. Call it another potentially sizable drag on economic growth … even as it promises to increase the secular scarcity (and value) of vital assets in the energy and ag patches.

Lastly, outstanding student loans, which have risen 67% to $1.3trn since Obama became president (http://research.stlouisfed.org/fred2/series/SLOAS) thanks largely to continued rampant tuition inflation fueled by politically-driven federal government subsidies, are problematic. This is all the more true as the job market for young adults has largely remained in the doldrums. The millennials, born between 1980 and 2000, are America's biggest population cohort (27.8% of the US population vs. boomers' 23.7% share; www.npr.org/2014/11/18/354196302/amid-the-stereotypes-some-facts-about-millennials). This generation has found it "harder to move out of their parents' basement," not to mention to purchase big ticket items such as cars and homes, which typically fuel GDP growth. Call it a very substantial, generational hindrance to the economy with "fiat policy roots."

All said, it appears that the economy, the shrinking free market sector, and the body politic are being increasingly negatively impacted by the bitter policy harvest of sustained fiat government (the declining fortitude of the Constitution), by the cronyism it nourishes, and by the unparalleled monetary base expansion which has enabled this free market capital denuding policy trajectory to continue and to flourish in the first place. As such, one could be forgiven for subscribing to the conviction that our ever more entrenched fiat government system cannot long sustain itself without ever more fiat money or balance sheet expansion by the Federal Reserve.

Is more US QE inevitable?

Clearly, an upwards trending US stock market has shown itself to be very QE-dependent since unchartered monetary base expansion began in late 2008:



http://davidstockmanscontracorner.com/qe-added-9-trillion-in-equity-wealth-or-32-of-the-current-sp500-level-jpmorgan-finds/

Will it be any different today? How long can the Fed take its balance sheet expansion punchbowl away? This regards both the Fed's well-established "stock market put" as well as the same institution's increasingly ingrained monetary ease reflex to any sign of an economic downdraft.

Given the cyclically overdue US recession -- the current, highly artificial, QE/deficit spending-based "expansion" is very long in the tooth, historically speaking -- the refrain "it's not if but when," as regards more QE, appears to ring true. This is all the more apt if our geriatric expansion is overlaid on sustained weakening of the rule of law and the integrally associated property rights, incentives, and liberty. (http://dkanalytics.com/wp-content/uploads/2016/10/11-Gold-update-March-2014.pdf, p.2, right hand column, third bullet; and http://dkanalytics.com/wp-content/uploads/2016/10/10-Global-ag-assets-January-2014.pdf, p.1, right hand column, first bullet.)

In the interim, the Bank of Japan is taking a further, very resolute page out of former Fed Chairman Ben Bernanke's "helicopter solution manual" in that the BOJ has committed to expanding its balance sheet aggressively; never mind that decades of "QE-Keynesianism" has failed to revive the moribund Japanese economy.

http://davidstockmanscontracorner.com/why-japans-money-printing-madness-matters/?utm_source=wysija&utm_medium=email&utm_campaign=Mailing+List+AM+Tuesday

Given the current nearly 200 BP yield differential between 10-year government bonds in Japan (0.42% yield) and America (www.bloomberg.com/markets/rates-bonds/) coupled with a pronounced historical Japanese penchant for Treasuries, one could argue that, as of January 2015, the BOJ will be initiating an "overseas QE4 of sorts" for the Fed. The BOJ's newest iteration of decades of unsuccessful balance sheet expansion is not only doubling down on utter policy failure, but is the unrivalled equivalent of roughly 15% of Japanese GDP, or some $735bn p.a. at current exchange rates.

While this unprecedented Japanese QE, if sustained, looks set to further depress the yen's valuation, possibly trigger Korean and Chinese countermeasures, and help fuel higher Japanese equity valuations thanks to pension fund-based portfolio reallocations (www.forbes.com/sites/jonhartley/2014/11/02/bank-of-japan-announces-more-quantitative-easing-the-next-chapter-in-abenomics/), it will debatably also help fund US federal deficits, which in turn will underpin low US interest rates. When pooled with a historically unprecedentedly lax ECB monetary policy, the greenback's Velcro straps-fastened leg braces look sturdy, at least for the moment, i.e., prior to a "real macro numbers reset" moment in the US.

Moreover, lax monetary policy overseas will help suppress, for the time being, domestic inflation, thereby going against the grain of the Fed's oft-repeated de facto policy goal of 2% plus inflation, i.e., of the government variety (neither price stability nor setting the monetary framework for productivity-based deflation are central bank doctrines or investor credos any longer, yet the same investors eagerly commit funds to secular growth companies, which are the ultimate deflation plays!). Plus, a "divorced from fundamentals" strong dollar will also begin to depress foreign earnings translation of S&P 500 companies while potentially adding to export-based economic growth weakness.

Meanwhile, financial repression has wrought huge asset bubbles and yield deprivation, resulting in near historically high or outright unprecedented valuations of junk bonds and Treasuries alike. Investor and bank balance sheets are obviously laden with "yield deprivation relief" assets. Overbuilt, poor profitability vertical markets such commercial retail real estate and oil shale & gas are replete with such investor return and return of capital risks. These assets offer markedly poor risk-return tradeoffs, especially when juxtaposed against historical default experience on the one hand and very low relative and absolute yields on the other hand. (www.theburningplatform.com/2014/05/25/retail-death-rattle-grows-louder/; http://davidstockmanscontracorner.com/looking-for-a-crash-catalyst-try-60barrel-blow-out-in-the-energy-junk-bond-sector/comment-page-2/)

Inevitably, the aforesaid -- especially in the funnel of a materially weakening economy -- will cause considerable asset impairment/asset writedown charges that will also engulf the balance sheets of fractional reserve member banks. Perhaps such an occurrence will prove to be "the QE4 trigger," a currency debasement initiative that could well eclipse any previous rounds given the tremendous growth since 2008 in both worldwide debt and in counterparty risks related to interest rate sensitive derivatives; the BIS has tabulated $563trn in notional value thereof, or 7.5x 2013 world GDP. (www.bis.org/statistics/dt21a21b.pdf)

Strategic asset allocation implications:

If our conviction about the true weakness of the US economy is correct, then a return to overt QE by the Fed, sooner rather than later, is a good bet. With the Fed onboard, we stand to experience a synchronous, possibly unmatched global central bank monetary base expansion. This is thanks to a global policy consensus that doubling-down on Keynesian policies financed by QE is the best trajectory for an anemic, debt-hobbled, misallocated global economy, historical evidence and common sense that say otherwise be damned.

Clearly, such a policy sustains the fiat government, fiat money regimes that rule the roost and are becoming increasingly rich beneficiaries of cronyism while real median household income continues a decline to multi-decade lows. Commensurately, policy efficacy is likely "spelled" differently by our increasingly aloof policy makers/politicians; suffice it to say it hasn't proven to be a "wealth of nations" trajectory for the society as a whole.
Which brings us to our strategic portfolio allocation bottom line: in a world in which currency debasement is the preferred policy tool, long-term investors should consider stout satellite positions in both real money (physical gold and silver) and in scarce, vital real assets such as dense energy and ag investments. Such assets bode well for long-term purchasing power preservation and capital gains potential. This is thanks to strategically constructive supply/demand dynamics and to attractive valuations.

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