EPIC
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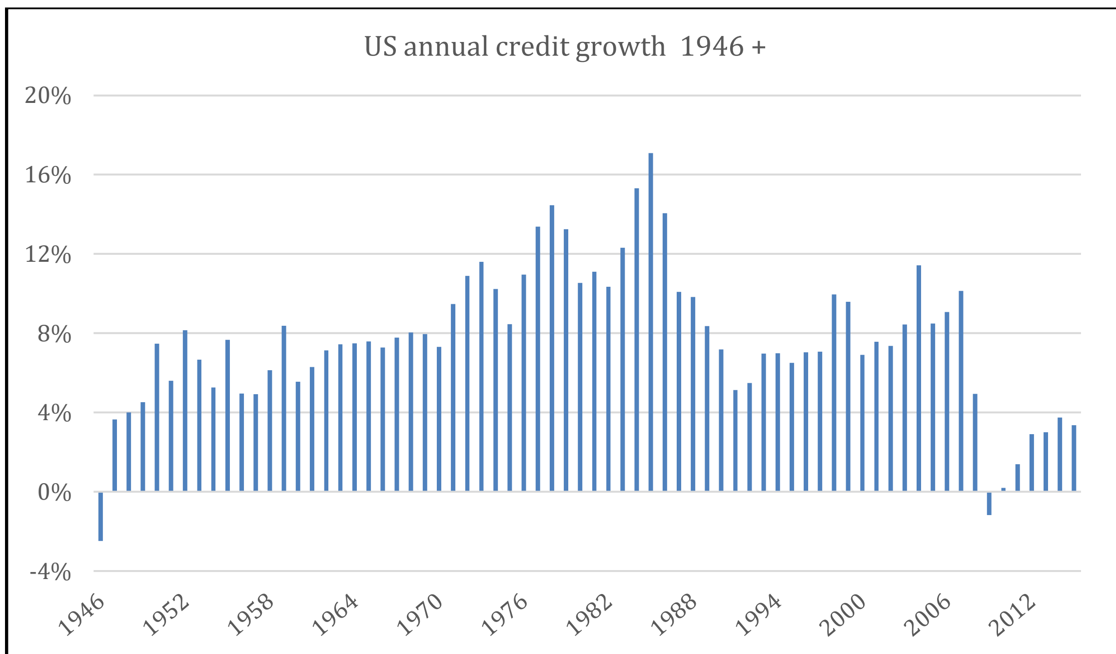
No Credit, No Growth

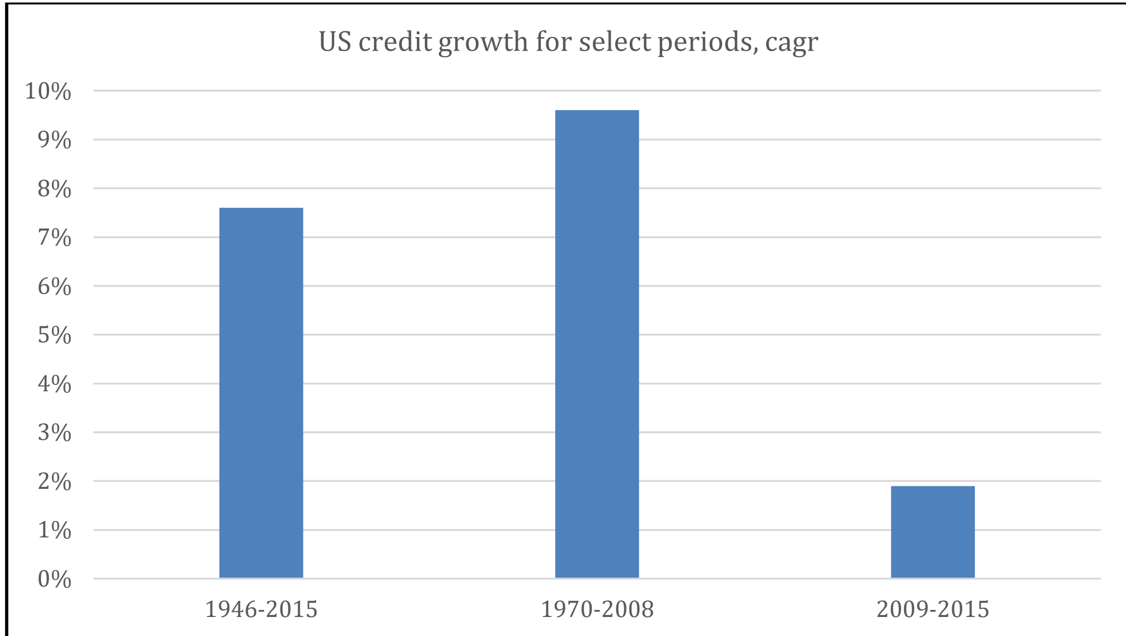
We offer up a matching set -- seven years of credit expansion, and seven rolling periods of economic growth. These sevens are not lucky numbers.

Let's begin with domestic credit -- the total amount of debt in our economy -- and the rate of change for that measure. Shown below is annual credit growth in the US, post WWII. Things start off slowly; 1946 saw a credit contraction and severe recession as the war machine shut down. In 1947, credit growth was just under four percent. In every year thereafter, total credit grew by four percent or more, until 2009.

Since then, for seven years running, not a single year has produced credit growth of four percent. What was once a floor is now a ceiling.



We can re-arrange these numbers for greater clarity. Over the past 70 years, credit growth has compounded at 7.6 percent per annum. In the credit boom from 1970 to 2008, the rate was 9.6 percent. And after 2008, the boom turned to bust, averaging just 1.9 percent.



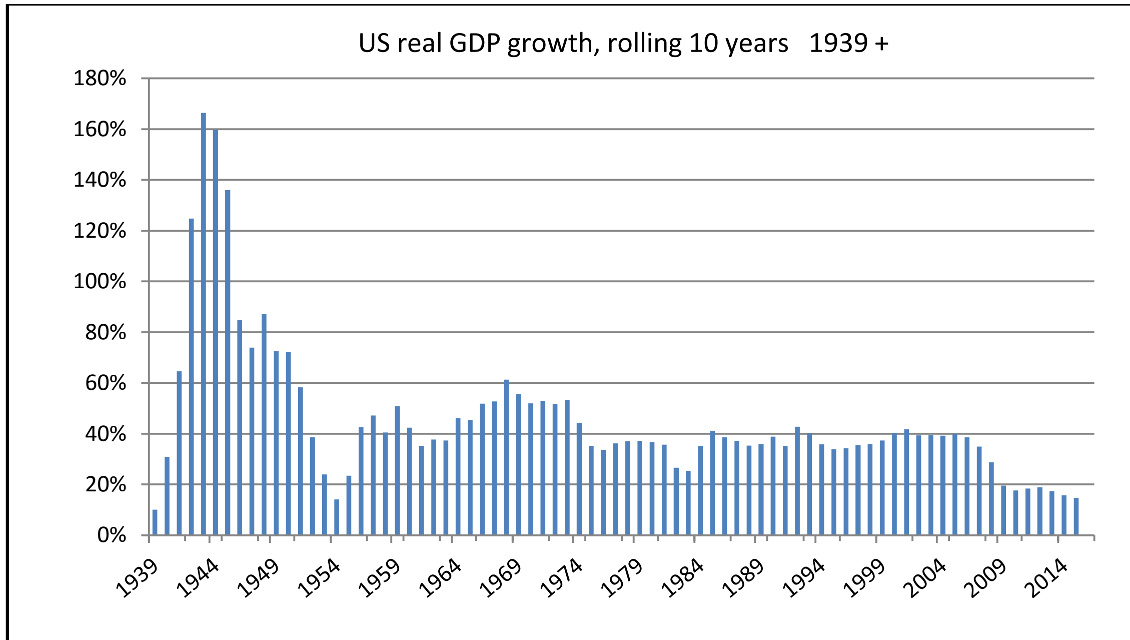
It gets worse. Essentially the entire growth in credit since 2008 -- nearly eight trillion dollars -- can be accounted for by an increase in federal debt. Any additional debt taken on by large and small non-financial businesses has been offset by a decline in household and financial industry debt. US government share of total credit has risen from 14 percent to 25 percent in the same timeframe. This is the worst form of debt expansion, in that it does not finance new business formation, innovation, or housing activity. Rather, it funds bloated government, transfer payments, and interest on our national debt.

For seven years the Federal Reserve held short-term interest rates near zero. And for seven years we have endured anemic credit growth. If low interest rates are meant to produce easy money, where has the money gone? Whatever the Federal Reserve is doing, it is not working.

If capital is the lifeblood of a healthy economy, credit is a key component of that capital. It exists in most everything we touch and see in our daily lives -- from the houses and apartments in our neighborhoods, to our cars, shops, medical centers, and workplaces. If a business itself was not at some time funded with credit, its physical location -- the land and building -- most likely was.

What should we expect from our economy in an era of slow credit formation? Exactly what we have experienced.

The chart below depicts cumulative growth of Gross Domestic Product (GDP) for rolling 10-year periods, dating back to the end of the Great Depression. The purpose of this formulation is to smooth out the peaks and troughs in any given cycle, presenting a clearer picture of secular trends. Since 1939, there have been nine periods when 10-year cumulative GDP growth was under 20 percent -- the periods ending in 1939, 1954, and the last seven years.



Certainly the Great Recession of 2008 and 2009 plays into this. Yet we are supposed to recover with big rebounds from deep troughs -- the rubber band effect -- as seen after severe downturns including 1982, 1974-75, and almost all prior recessions of the past half century. Following the 1982 recession, the weakest growth over the next seven years was 3.2 percent. Since the start of the current expansion, the strongest year of growth is only 2.5 percent. The last time we enjoyed three percent annual growth was 2005, now over a decade past.

Something is going horribly wrong.

Far from exhausting all possible explanations and remedies, we provide two alternatives, which neatly fit into opposing points of view.

The optimistic view is that the Federal Reserve blew it. How's that for optimism?

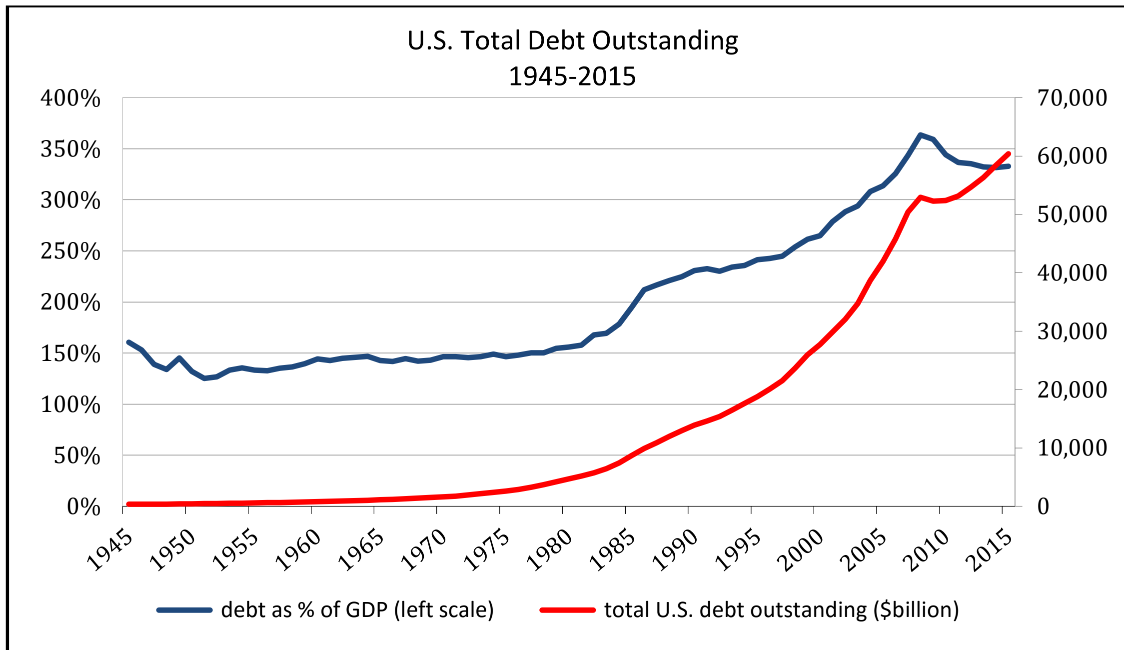
The Fed's mistake was over-playing its hand, lowering short-term rates from five percent to three percent, to one percent, to zero. Diminishing returns set in, and the benefits of lower borrowing costs were exhausted. Credit formation never gained traction. And there is always the other side of a trade. Zero interest rates simultaneously pinched banks and insurance companies. It hurt small businesses, newly-formed households, and savers -- all ready to consume numerous goods and services -- who suffer for the lack of business loans, mortgages, and adequate interest income.

Time for more optimism. The Fed can correct its error, raising short-term rates to one percent or higher. It should also stop fighting the last war by easing bank regulation, including capital requirements. This would still be considered accommodative policy in our world of two percent growth and two percent inflation. Matter of fact, in most expansions such a low benchmark rate would be considered bordering on reckless behavior.

Undoubtedly, a troubling consequence of higher rates would be a strengthening dollar. Not that the average citizen should worry about increasing his purchasing power, but our multi-national businesses would certainly find reason to gripe. It's not easy winning in a global marketplace when your overseas competitors enjoy a foreign exchange advantage. But this is no intractable problem. At the same time the Fed is raising rates, corporate tax reform should be enacted. This reform would lower tax rates and allow overseas profits to be freely re-patriated into the US, creating a level playing field for US multi-nationals. In all likelihood, the benefit of tax reform would more than offset the pain of a stronger dollar. The US would re-establish itself as the world's dominant -- and responsible -- economic superpower. Capital would flood into the US, credit would flow, and our economy would prosper. Problem solved.

The pessimistic view is much simpler, just without the happy ending. It holds that the great economic boom from 1982 through 2007 was fueled by an unsustainable expansion of credit. It was great fun while it lasted, but the party is over. And the reason it's over is that our economy has reached credit saturation -- we simply cannot take on more debt, earn a reasonable return on that debt, comply with the interest burden, and continue the credit cycle ad infinitum.

Total US debt as a percent of GDP rose from 158 percent in 1981, to a peak of 364 percent in 2008. Since then, it has slipped back to 333 percent. Even adjusted for our larger economy, total debt in the US has more than doubled since 1981. No one knows for sure when we have reached the tipping point -- perhaps the heady days of the mortgage bubble were an absolute top -- but odds are, we are pretty close.



If we are indeed approaching credit saturation -- if there is little room for debt expansion -- and the quarter-century boom that ended in 2007 was stoked by credit, then the slow growth of the past decade was no aberration. It is a new norm.

Unlucky, or just the facts of life, that would be unwelcomed news.

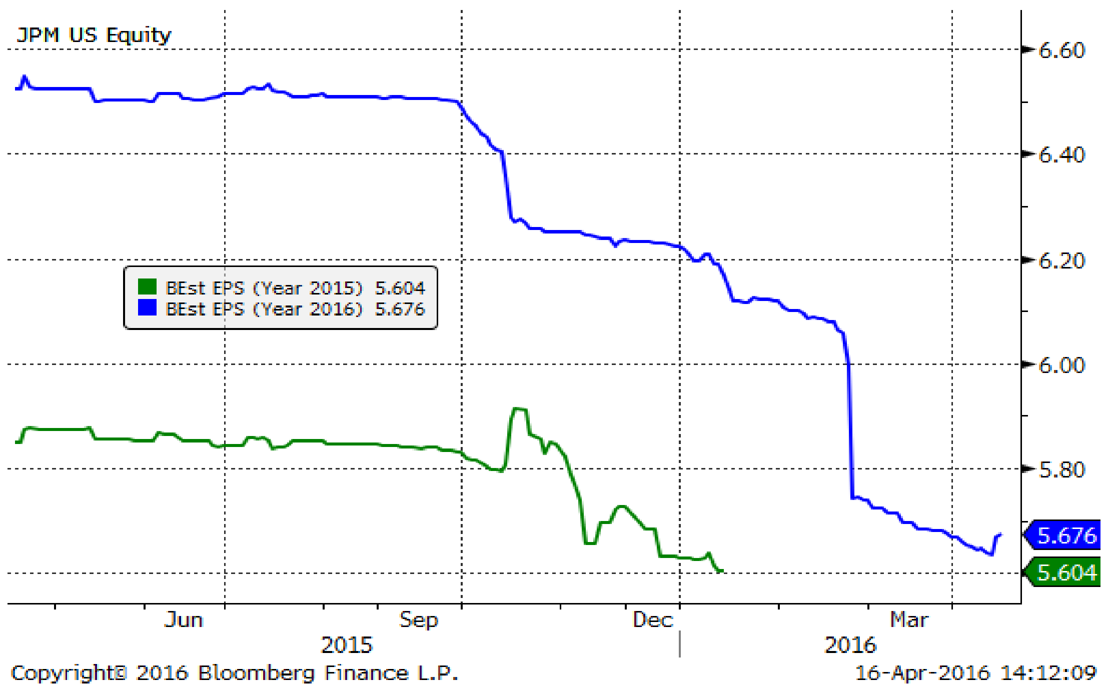
Anatomy of an Earnings Beat

If first quarter corporate profits go according to form, we will soon be hearing that some 70 percent of widely-traded companies reported positive earnings surprises. To clarify, that means adjusted earnings per share topped consensus estimates from Wall Street analysts.

It seems an impressive feat, especially in the face of a weak economy and declining corporate profits. Upon further reflection, maybe it's not so impressive.

Here's a case in point:
Displayed below are the consensus estimates for J.P. Morgan Chase 2015 and 2016 earnings per share (EPS), tracking these estimates over the past year.

J.P. Morgan Chase consensus EPS estimate timeline for 2015(lower line), 2016



We don't need a finance degree to see that the trend is down, that the bank's profit expectations are sinking. At the same time, J.P. Morgan can now boast of five consecutive quarterly earnings 'beats'; that is, reported earnings above expectations.

Is this the new math?

Here's how the trick works…

On January 1, the consensus estimate for J.P. Morgan's first quarter earnings per share was $1.54. By the second week of April, just before profits were reported, the estimate had fallen to $1.25. So when J.P. Morgan announced earnings of $1.41 per share, it was received as a positive surprise, also known as a profit 'beat'.

Never mind that earnings are lower than the estimate from three months earlier, or that year over year profits fell 12 percent. Those are just pesky details.

And we can perform a back-of-the envelope projection: At its current pace, early in the next decade J.P. Morgan will surpass 30 consecutive quarters of earnings 'beats', while its net income drops to zero.

Now that would be a real feat.

They Said It

Reprinted from The Wall Street Journal March 7, 2016
From a speech at the University of Chicago Booth School of Business by Larry Summers, Harvard economist and former U.S. Treasury secretary:

With respect to private investment, tax reform is critical.

Permit me an analogy here. Imagine that you are running a library and that there is a substantial volume of overdue books. You might offer amnesty to get people to return the books. You might announce you will never offer amnesty, so people will take fines seriously and return the books. Only an idiot would put a sign on the door saying, “No amnesty now, but we’re thinking hard about amnesty for next month.”

You laugh, but American corporations have $2 trillion-plus overseas. If they bring that cash back right now, they pay 35 percent. If you’ve picked up any newspaper in the last seven years, you’ll know that Congress has been actively debating changes to that policy -- for seven years. Just like the sign on the door of the library saying they’re thinking about amnesty for next month. It would be hard to conceive a policy better designed to keep that cash outside the US and not invested in the US than the policy we have pursued. That’s why I stress business tax reform as important for economic growth.

Excerpted from The Wall Street Journal April 5, 2016:

In California, Gov. Jerry Brown signed a law raising the minimum wage to $15 by 2022. In New York, Gov. Andrew Cuomo signed a law that will set a $15 minimum wage in New York City and its suburbs by 2021, and eventually set a statewide $15 wage floor for other parts of the state.

Mr. Cuomo predicted the wage increase in New York would resonate nationally.
“We want economic fairness, we want economic justice and we want it now,” he said. “People are angry, yes. Not only in this state but in this nation.”

Speaking at a signing ceremony in Los Angeles on Monday morning, Mr. Brown said having a minimum wage that allowed a worker to support his family was about “living in a moral community.”

“Economically minimum wages may not make sense,” he said. “But morally and socially and politically they make every sense, because it binds the community together and makes sure that parents can take care of their kids in a much more satisfactory way.”

Excerpted from The Washington Post April 6, 2016
By Jeffrey R. Immelt, chairman and chief executive of GE.

We at GE were interested to read comments Monday by Sen. Bernie Sanders (I-Vt.), who told the New York Daily News editorial board that GE is among the companies that are supposedly "destroying the moral fabric" of America. The senator had been asked to cite examples of corporate greed at its worst. Somehow that got him to talking about us.

GE has been in business for 124 years, and we've never been a big hit with socialists. We create wealth and jobs, instead of just calling for them in speeches. We take risks, invest, innovate and produce in ways that today sustain 125,000 U.S. jobs. Our engineers innovate every day to build hardware and software solutions that meet real-world challenges. Our employees are proud of our company.

The senator has never bothered to stop by our aviation plant in Rutland, Vt. We've been investing heavily (some $100 million in recent years), hiring and turning out some of the world's finest jet-engine components in Vermont since the 1950s. The plant employs more than 1,000 people who are very good at what they do. It's a picture of first-rate jobs with high wages, advanced manufacturing in a vital industry.

Elsewhere in Vermont, GE Healthcare employs more than 340 men and women in South Burlington. Yearly, GE does about $40 million worth of business with dozens of suppliers of parts and services across Vermont. Nationwide, we have 200 GE plants, including 15 that were built in the past five years -- all with the aim of making GE the world's premier industrial company.

Sanders says that he is upset about GE's operations abroad -- as though a company that has customers in more than 180 countries should have no presence in any of them. He never mentions that we are one of the United States' prime exporters, annually selling in excess of $20 billion worth of American-made goods to the world. Nor does he mention that our sales around the world support our manufacturing base here at home, along with the thousands of U.S. companies in our supply chain.

We are competing globally with foreign companies whose governments care whether they win and support them in innumerable ways. U.S. companies continue to wrestle with an outdated and complex tax code that puts them at a distinct competitive disadvantage. Sanders has stated many times that GE pays no taxes. Repeating a lie over and over does not make it true. We pay billions in taxes, including federal, state and local taxes. The U.S. tax system has not been updated in 30 years and isn't designed for today's economy, which is why we support comprehensive tax reform -- even if it raises our tax rate.

It's easy to make hollow campaign promises and take cheap shots in speeches and during editorial board sessions, but U.S. companies have to deliver for their employees, customers and shareholders every day. GE operates in the real world. We're in the business of building real things and generating real growth for a nation that needs it now more than ever.

Tidbits..

Federal Reserve reduces expectations for interest rate hikes in 2016, following bond market rally.
European Central Bank announces further interest rate cuts, plans to expand Quantitative Easing by purchasing corporate debt.
Japan's move to negative interest rates leads to surprising Yen strengthening.

Central banks' grand experiment produces moving targets, unwelcomed results.

International Monetary Fund issues report backing negative interest rates, believes policy supports demand and price stability.
Blackrock, world's largest money manager, sees negative rates as punishing savers, undermining growth.

Pick one, just not the one full of Washington bureaucrats with no skin in the game.

Argentina reaches settlement with holdout creditors, ending 15-year legal battle.

'Vultures' outlast Kirchner government, win big payday.

China sets 2016 growth target at 6.5 to seven percent, indicative of slowest growth in decades.
US economy grows at half-percent rate in first quarter, worst in two years.

SunEdison, once high-flier solar energy company, files bankruptcy.
Sports Authority, sporting goods retailer owned by private equity firm, files bankruptcy.
Apparel retailer Pacific Sunwear of California follows suit.
Aeropostale, teen clothing chain, expected to file bankruptcy.

Too many big boxes in US retail, too many small boxes as well.

US oil and gas rig count drops to 70-year low, down 75 percent from 2014 high.

Marriott International wins 14 billion dollar takeover battle for Starwood Hotels.
Sherwin-Williams to acquire Valspar for 11 billion dollars in consolidation of paint business.
Alaska Air Group outbids JetBlue Airways, to acquire Virgin America airline for 2.6 billion dollars.

Venture Capital firms raise new funding at fastest pace in 15 years.
Global corporate share issuance falls to seven-year low in first quarter of 2016, while merger activity maintains strong pace, at six times the level of share issuance.
Short interest in US equities reaches highest ratio in seven years, indicative of investor skepticism and future buying power.

Surprisingly favorable supply-demand dynamics for equity markets.

Tesla Motors receives overwhelming pre-order interest in its new mid-priced electric car.

US jobless claims hit four-decade low as job market improvement continues.

Wage gains likely to follow, a double-edge sword for investors.

In face of Federal Reserve rate hike, 30-year mortgage rates fall to lowest in 14 months.

Source:
Barclays
Blackrock
Bloomberg
Federal Reserve
International Monetary Fund
The Wall Street Journal
The Washington Post