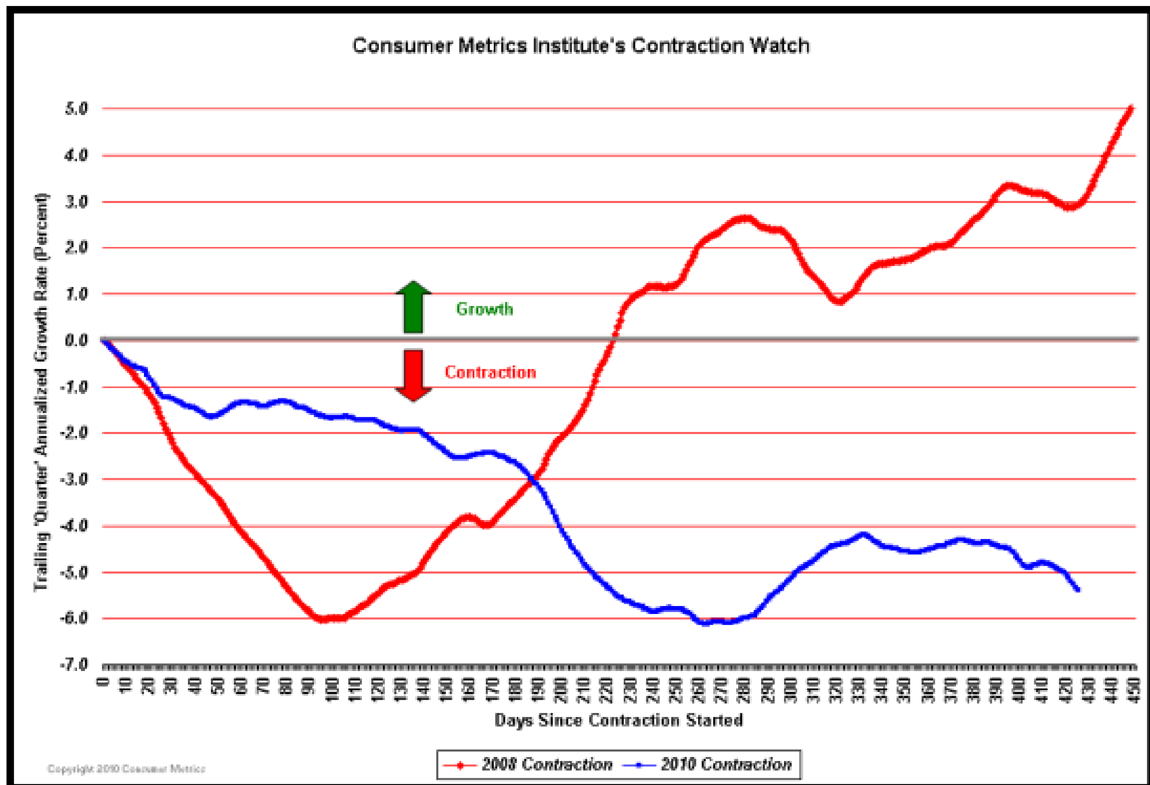
Consumer Metrics Institute Members News

March 13, 2011: Glaring Disconnects and Tsunami Riding Black Swans

It is telling that we recently had to expand, yet again, the horizontal time scales on our Contraction Watch chart. The chart now covers 15 months, and by the look of things we are probably not done with the lateral extensions. The behavior of the consumers that we track has changed materially from what they were doing in late 2008 and early 2009, and the recent extension of the chart makes that behavioral change even more glaring:



It is reasonable to ask what has changed. Ironically, the answer is that little has changed in the real-world "Main Street" economy -- to our consumer's eyes the economy has not improved in ways that are obvious and credibly sustainable.

An example of the disconnect between "Main Street" and the "financialized" world followed by the media was prominent on the front page of Friday's "The Wall Street Journal" (WSJ), when the lead paragraph of the story under the headline "Families Slice Debt to Lowest in 6 Years" ran like this:

"U.S. families -- by defaulting on their loans and scrimping on expenses -- shouldered a smaller debt burden in 2010 than at any point in the previous six years, putting them in position to start spending more."

Up to the comma, we have no problem with the story. In fact, even the post-comma comment may fairly represent historically reasonable consumer debt/income ratios (reported to now be 116% -vs- the peak level of 130% experienced in 2007). But it misses the key point -- the desire (or real-world ability) on the part of the vast majority of non-elite consumers to stop or reverse the deleveraging trend.

The article in Friday's WSJ went on to explain that with "the help of rising stock prices, the decrease in debts put average household net worth at $505,000 at the end of 2010, up 5.1% from 2009, though still well below the peak of $595,000 in the second quarter of 2007, before housing prices plunged."

Although the numbers quoted above are certainly statistically accurate, we are living in a world where there is an increasing gap between the mean and the mode (the value of the arithmetic average and the actual real-world level of the "mid-point" consumer). And with respect to the statistically correct observations:

-- For the vast majority of non-elite consumers rising stock prices have not, in fact, offset the continued decline in the value of their principal asset (their home).

-- The $90,000 (15.1%) of wealth lost per household since 2007 is substantial and lingering.

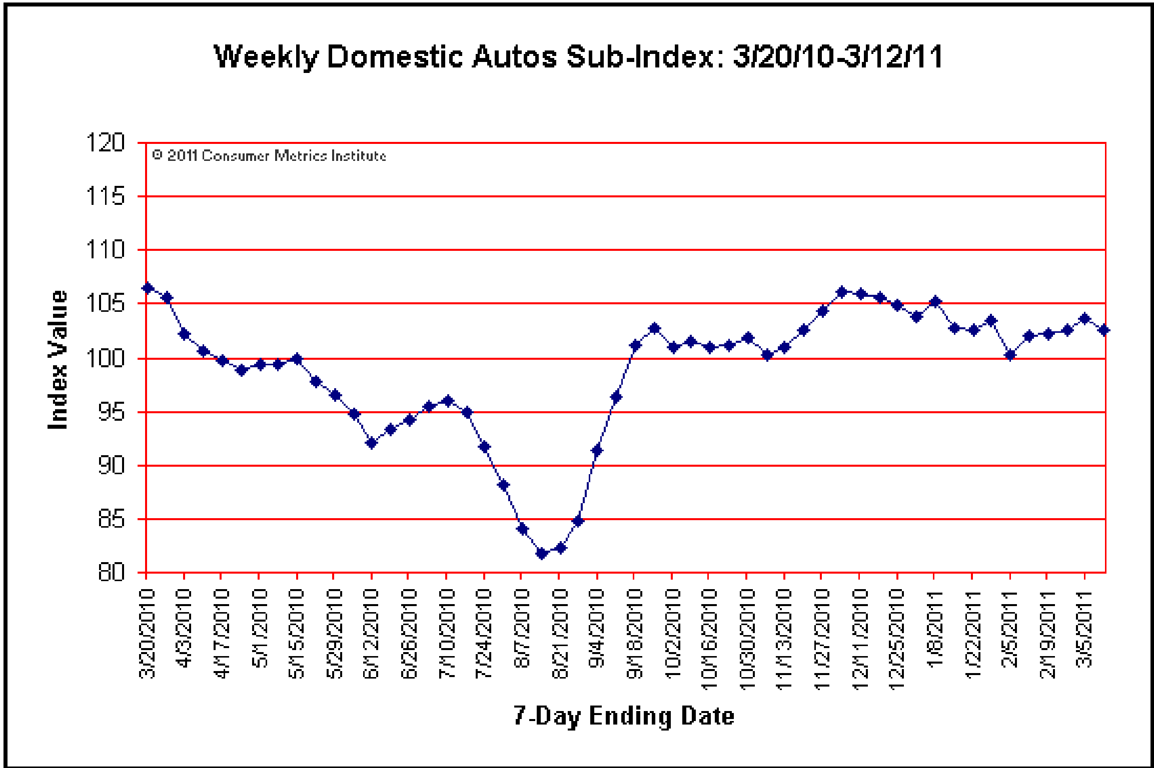
-- A significant number of non-defaulting mortgage holders continue to have negative home equity values, and perhaps even negative net worth.

-- The consumers who have improved their debt load principally by "defaulting on their loans" are in no position to take on new loans despite squeaky clean debt/income ratios -- even should they be inclined to re-experience the joys of overwhelming debt so soon.

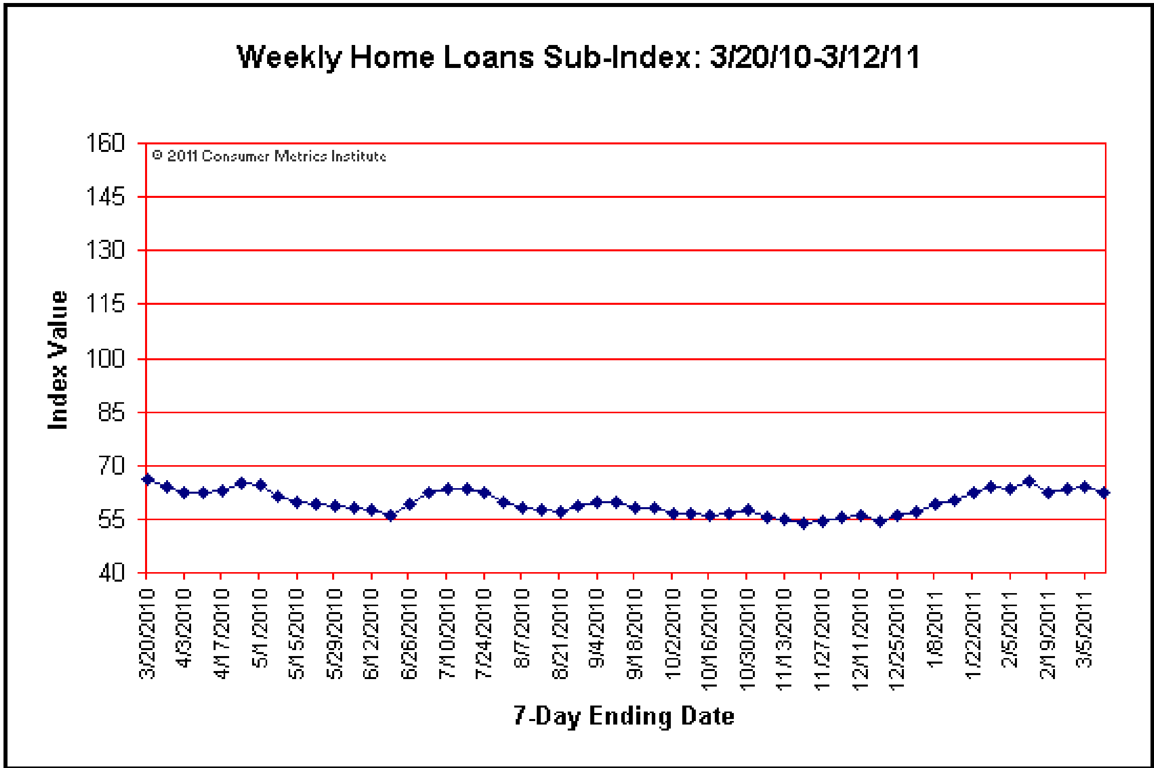
-- Real "Main Street" income levels remain essentially stagnant, and the portion available for discretionary spending (income less the rapidly inflating essential food and gasoline costs) is not likely to be expanding anytime soon.

-- Demographics alone would indicate that a growing portion of the population will be in a deleveraging mode for the foreseeable future.

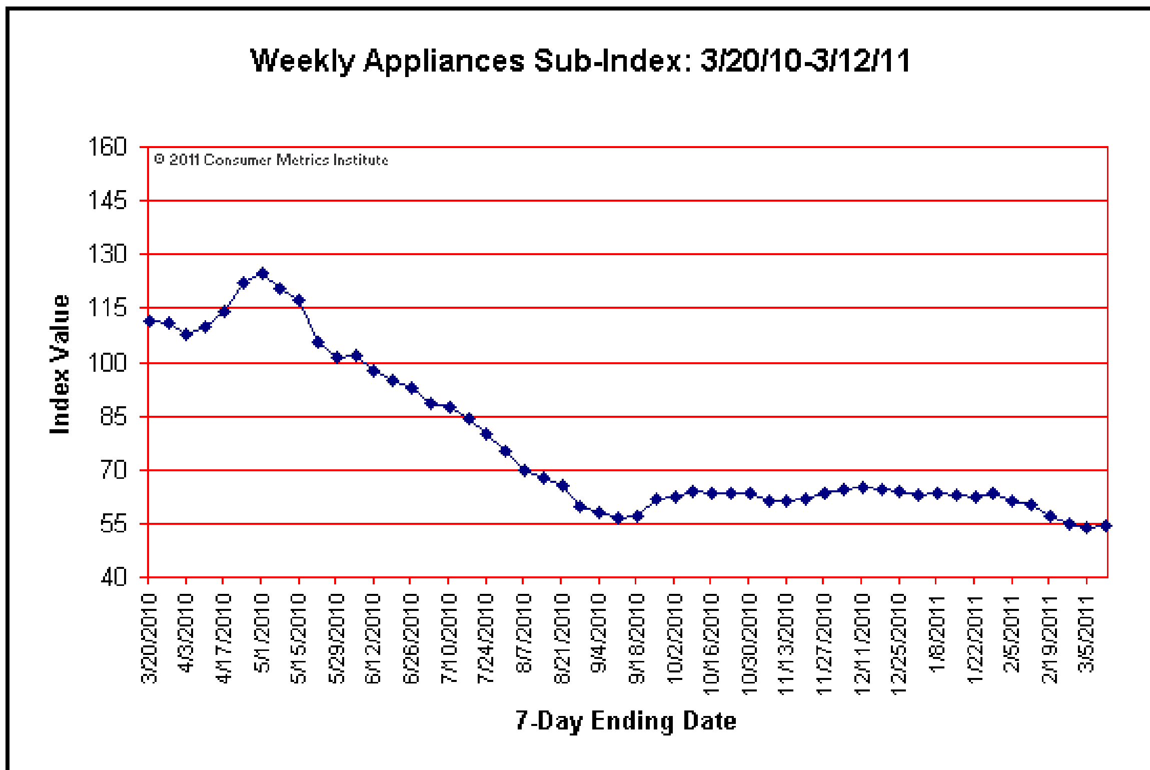
This doesn't mean that all forms and purposes of credit will be permanently deleveraging. Even in recessionary times automobiles will continue to wear out, consumers will continue to need them, and most will use some level of credit to obtain them:



But homes can last a lifetime, and the demand from our consumers for new loans for new residences is showing few consumers with both the ability and inclination to "start spending more" in any major way:



And although it is convenient to assert that the housing sector is no longer a relevant part of the economy, unfortunately it remains so for former construction workers and their colleagues in the appliance and home improvement industries:



The irony of "this time it's different" is that we don't discover any truly meaningful differences until it's too late.

Tsunamis and Black Swans

The past few days have brought us a number of questions as to whether the Sendai tsunami is a "Black Swan" in Nassim Taleb's sense of the term. While it is true that the mathematical treatment of the damages caused by earthquakes and/or the resulting tsunamis is non-Gaussian -- and therefore difficult for conventional "risk management" technologies to deal with -- the event is not likely to be a Taleb "Black Swan" for at least two reasons:

-- It is an anticipated event, particularly by the Japanese people. A "Top Ten" 100-year seismic event is by definition expected roughly every decade. A Taleb "Black Swan" is by definition unanticipated -- and more precisely, beyond the means to be forecast-able.

-- As horrific as the human suffering (or economic impact) may be, the greatest damage is localized to the area around Sendai. If current estimates of the total damages ($100 billion) are

accurate, it represents between 2% and 3% of the Japanese GDP. The similarly horrific 2005 U.S. hurricane Katrina was also localized, and the U.S. economy was able to absorb the $81 billion in damages (a more modest 0.6% of GDP) without catastrophic nationwide impact, although much of the human suffering and displacement has remained.

To truly qualify as a civilization threatening "Black Swan," an earthquake, tsunami, storm or volcano would need to surpass anything witnessed in the past several thousand years. Mt. Vesuvius did horrific local damage to Pompeii, but the Roman civilization did not fall. Krakatoa probably left a measurable impact on the world economy, but it can not compare to the Great Depression. On the other hand the Toba super-volcano of 70,000 years ago made most of a continent un-inhabitable for thousands of years (as did the Yellowstone super-volcano 600,000 years earlier). In fact, the Toba event may have left a measurable impact on our human DNA, since some scholars believe that only a handful of the humans then living ultimately survived the eruption.

But less dramatic, yet still civilization killing "Black Swans" have occurred regularly, and they most often have taken the shape of climate change -- specifically extended droughts (also complicit to some extent in the U.S. Great Depression) -- or epidemics, both of which can be exacerbated by unsustainable population levels.

Yet Taleb's main expectations for the source of any 20%-of-GDP scale "Black Swan" are economic and financial -- with the un-forecast-able aspects exemplified by the relative novelty of rampant securitization (and derivativation) within the human experience. How close Bear Stearns and Lehman Brothers came to causing a "Black Swan" we may never know. But we may all be safer living downwind from Yellowstone than near a downdraft from Wall Street.

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