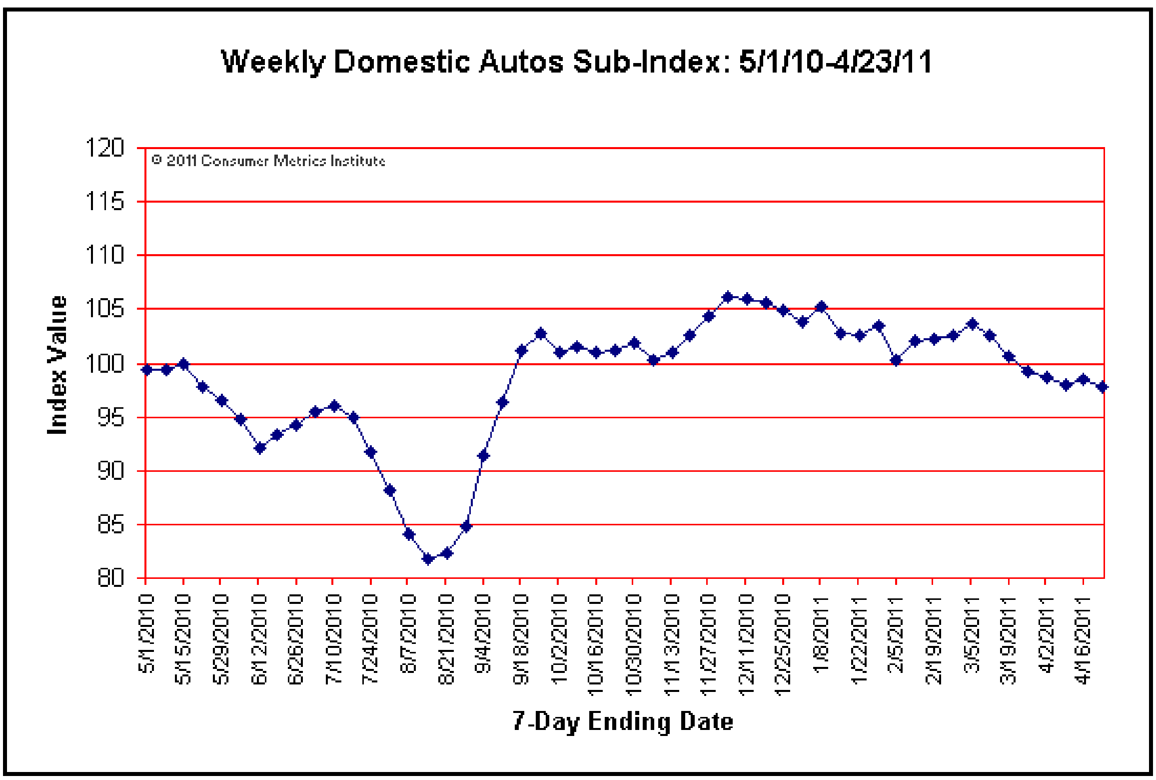
Consumer Metrics Institute Members News

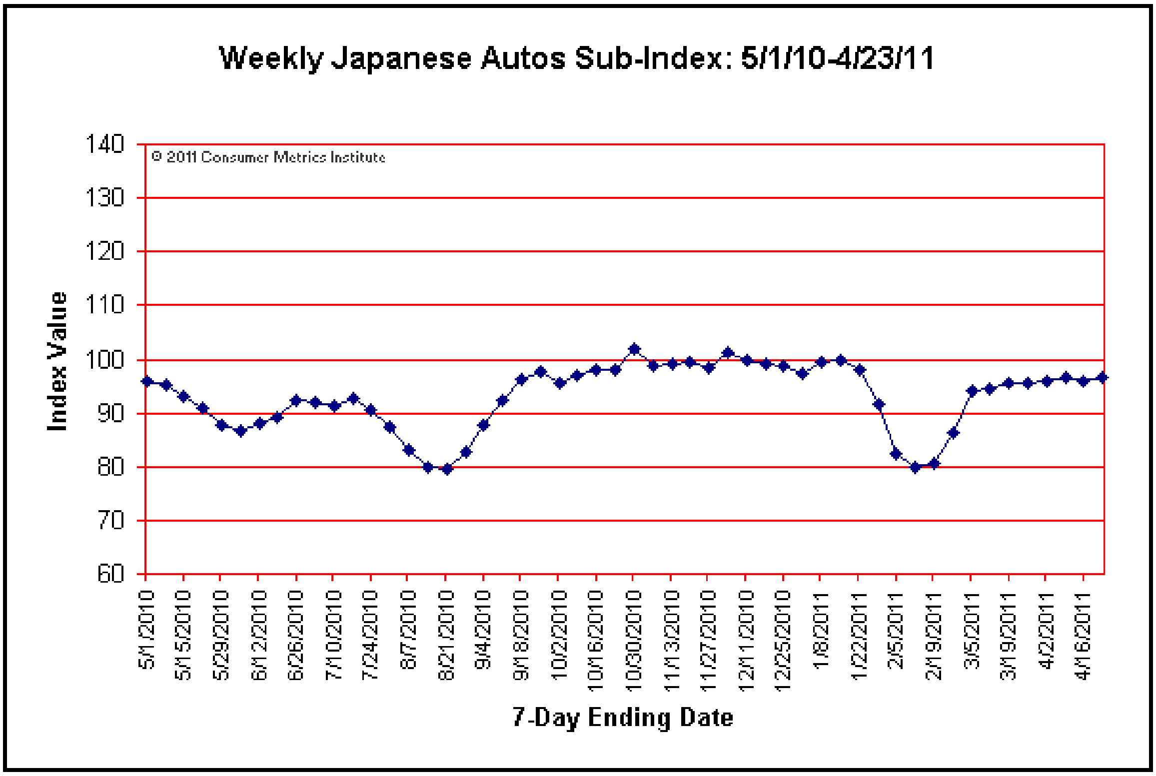
April 21, 2011: Making Sense of Our Indices, Plus Regime Changing Debt/GDP End-Games

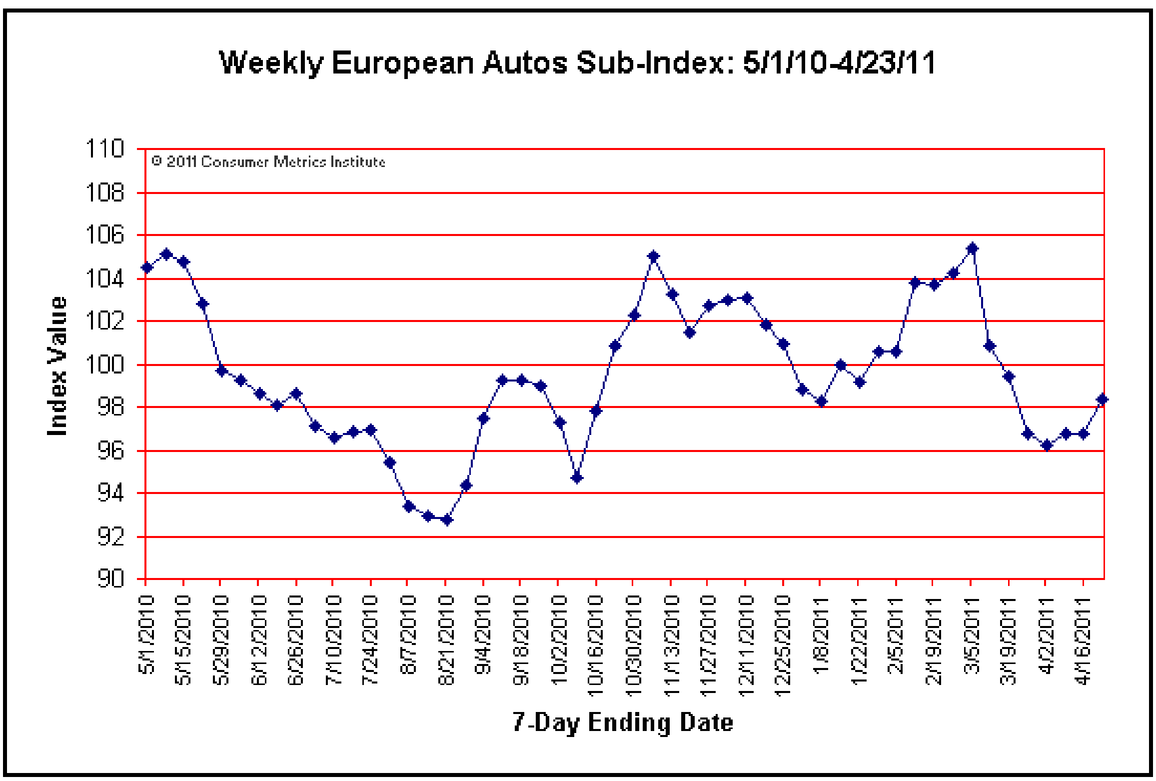
As our fully weighted Daily Growth Index continues to set new historical lows on a daily basis, it is useful to step back to look at a broader range of our data for a better understanding of what is happening -- including those glimpses of cross-currents in the data that show that not all Americans are sharing the same economic experiences.

Let's start with something that nearly all American consumers deal with 8 to 10 times during their lifetime: the Automotive market. If we start with our Domestic Auto Sub-Index, we can see that for the past 6 months the Domestic badges have generally shown modest lower-single-digit year-over-year growth:



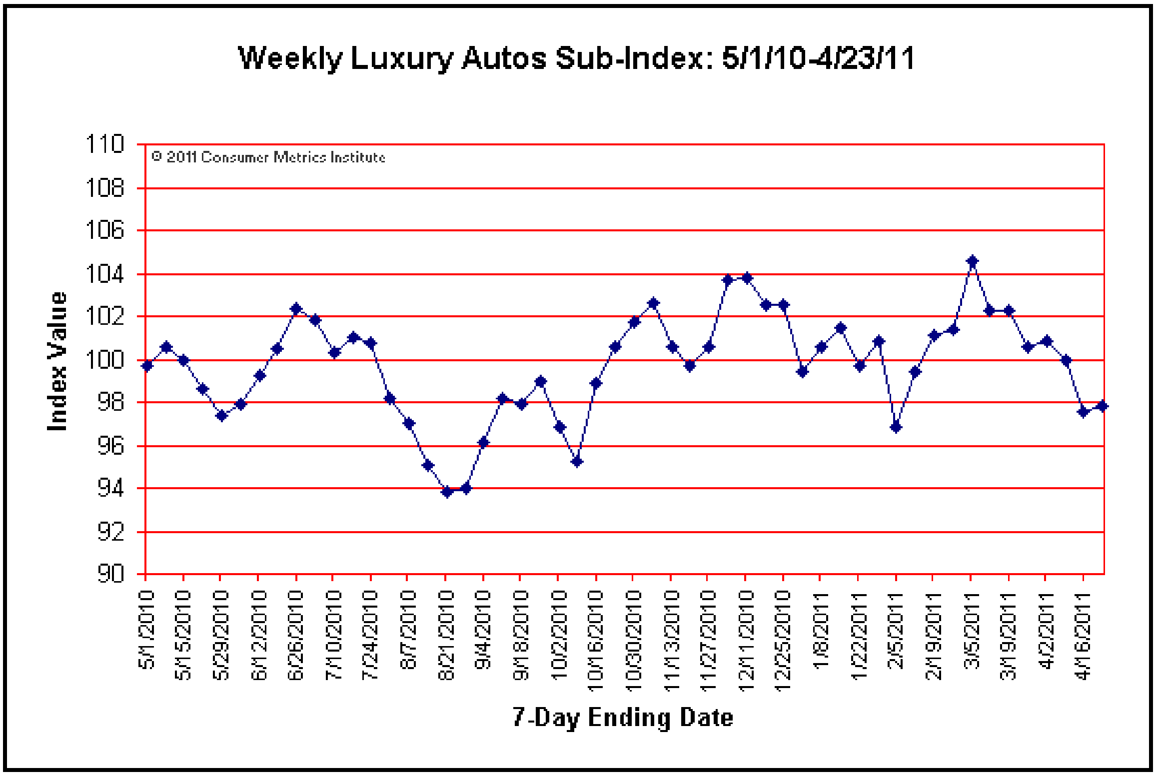
What's interesting is how those brands have fared when compared to their Japanese or European competitors over the same time span:

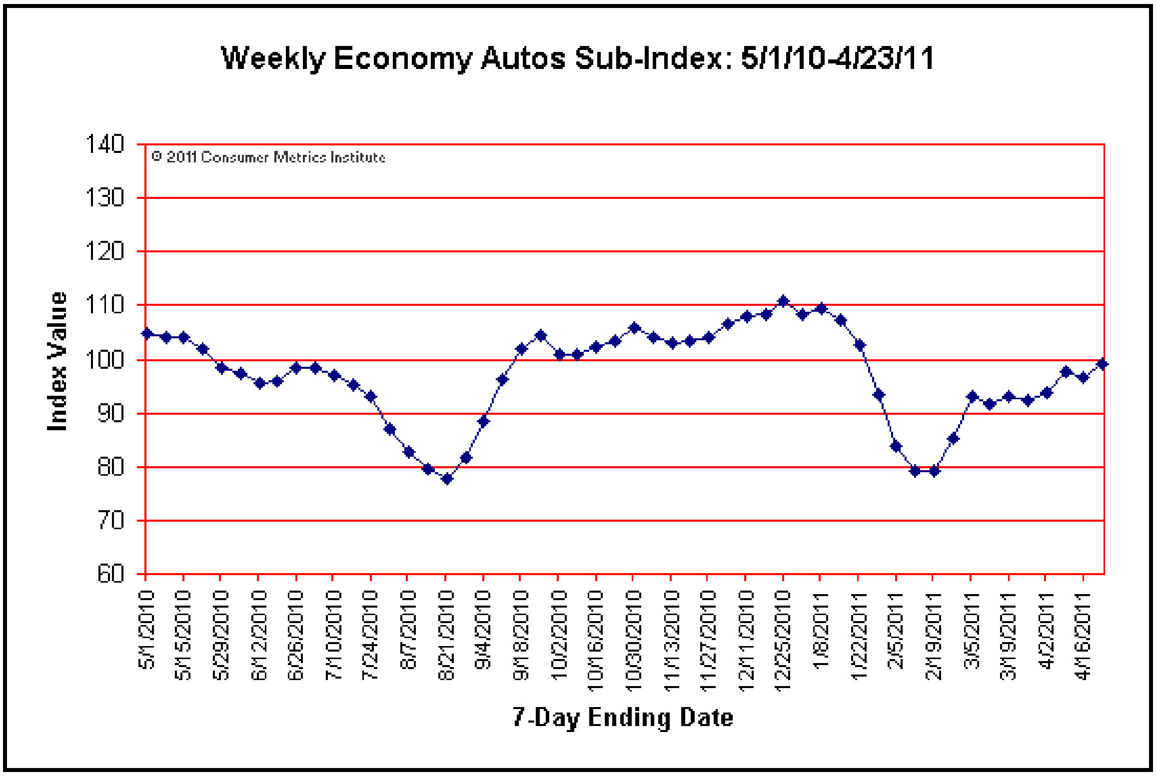




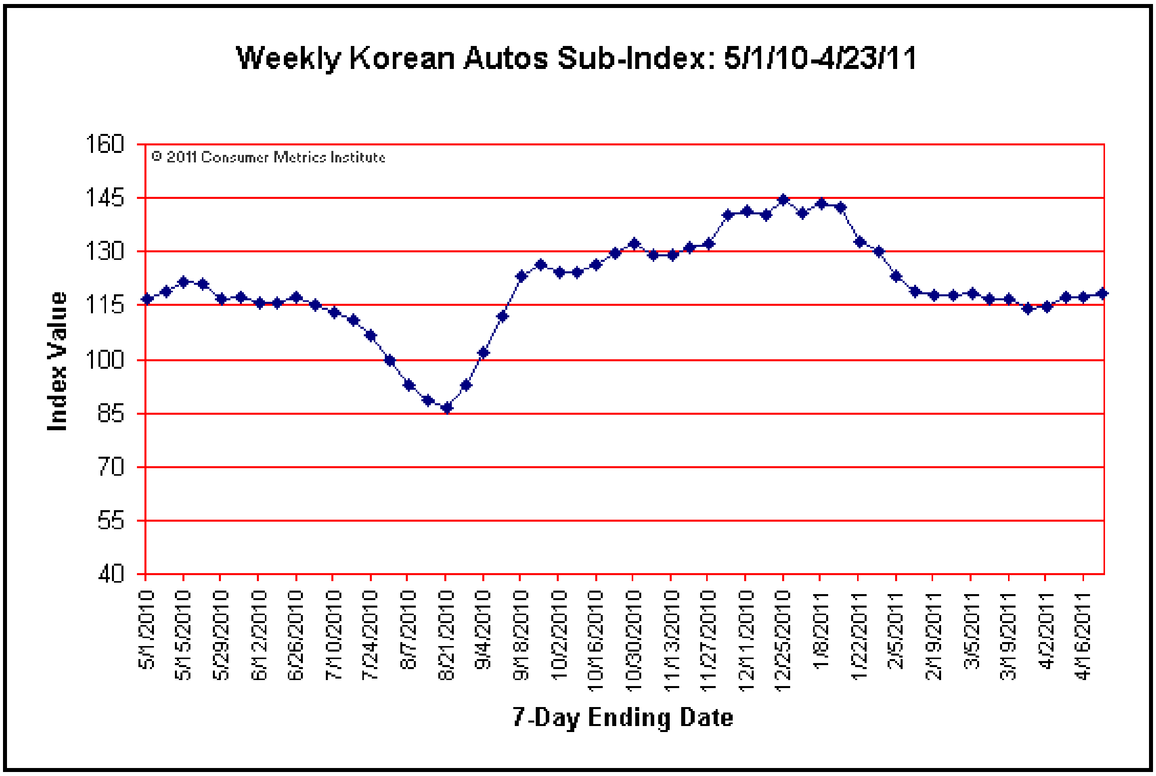
Generally, the performance of the Japanese manufacturers has been weaker over the past six months, and particularly since the first of the year. Meanwhile consumer demand for the European brands over the past six months has been noisy (although on a higher resolution scale), and the year-over-year change in average demand for those European cars lies somewhere between the domestic and Japanese labels.

Perhaps the more socially telling charts are for the Luxury brands and the "Economy" manufacturers -- where the lower volume Luxury traffic has been understandably noisy but statistically neutral, while consumer demand for the Economy brands has softened materially since the first of the year:



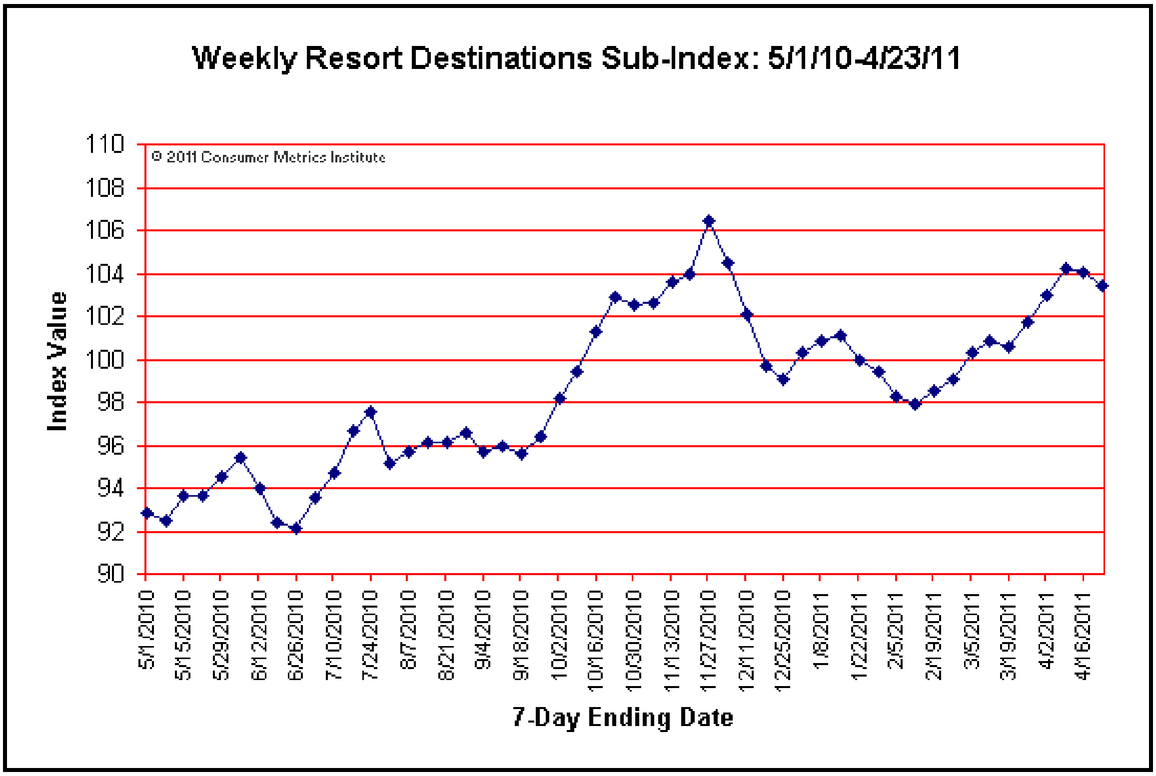


As we have mentioned before, we find the Korean manufacturers to be interesting, because the age demographics of those brands tends to be much younger than the corresponding demographics for the Japanese cars. This one data series has been in year-over-year growth for the past several years (except for the brief August 2010 drop that was an inverse reflection of the year earlier "Cash for Clunkers" sales spike):



The continued strength of the Korean cars represents a market share shift of some consequence. That shift may well be the result of several converging factors, including the aforementioned demographics, price point protections from currencies pegged to the dollar, and down-sizing (or down-scaling) caused by a continued weak employment picture.

If we look to recent consumer demand for summer vacation options, family trips to Resort Destinations (e.g., Disneyland) seem to be preferred over more up-scale Cruises or credit requiring Recreational Vehicles:


Weekly Resort Destinations Sub-Index: 5/1/10-4/23/11
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Index Value
110
108
106
104
102
100
98
96
94
92
90
5/1/2010
5/15/2010
5/29/2010
6/12/2010
6/26/2010
7/10/2010
7/24/2010
8/7/2010
8/21/2010
9/4/2010
9/18/2010
10/2/2010
10/16/2010
10/30/2010
11/13/2010
11/27/2010
12/11/2010
12/25/2010
1/8/2011
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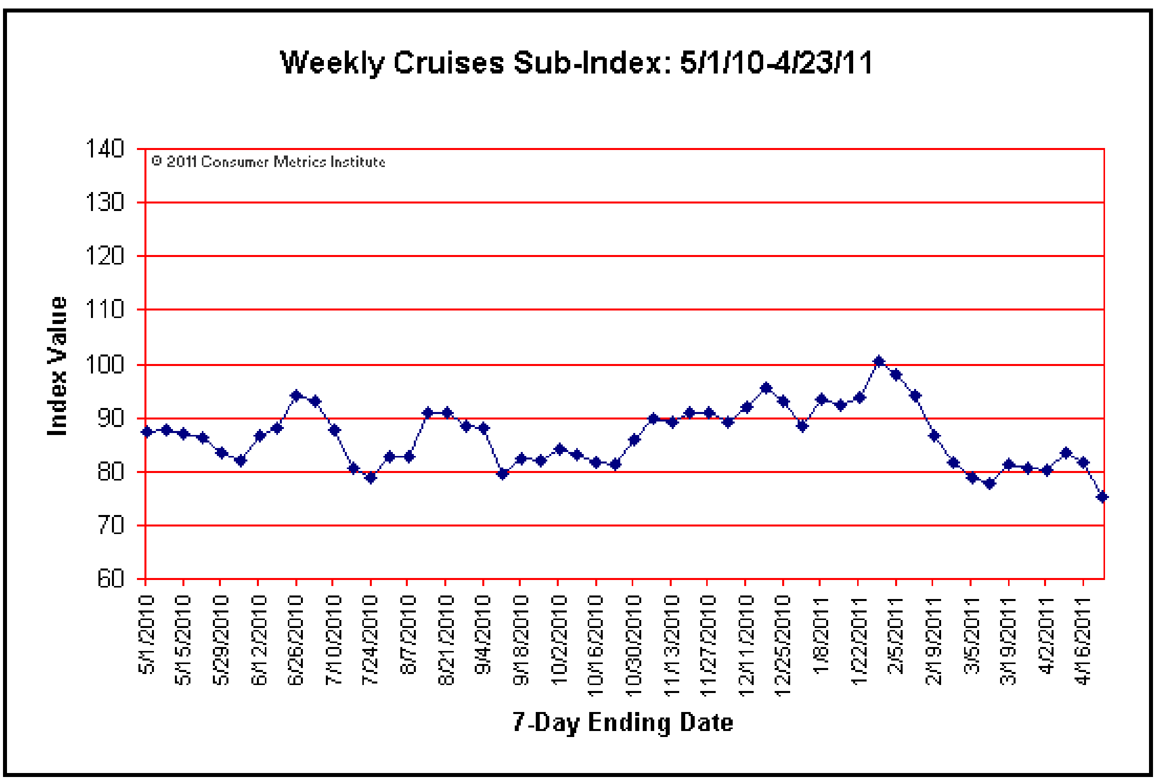
4/16/2011
7-Day Ending Date


Weekly Cruises Sub-Index: 5/1/10-4/23/11
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Index Value
140
130
120
110
100
90
80
70
60
5/1/2010
5/15/2010
5/29/2010
6/12/2010
6/26/2010
7/10/2010
7/24/2010
8/7/2010
8/21/2010
9/4/2010
9/18/2010
10/2/2010
10/16/2010
10/30/2010
11/13/2010
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12/11/2010
12/25/2010
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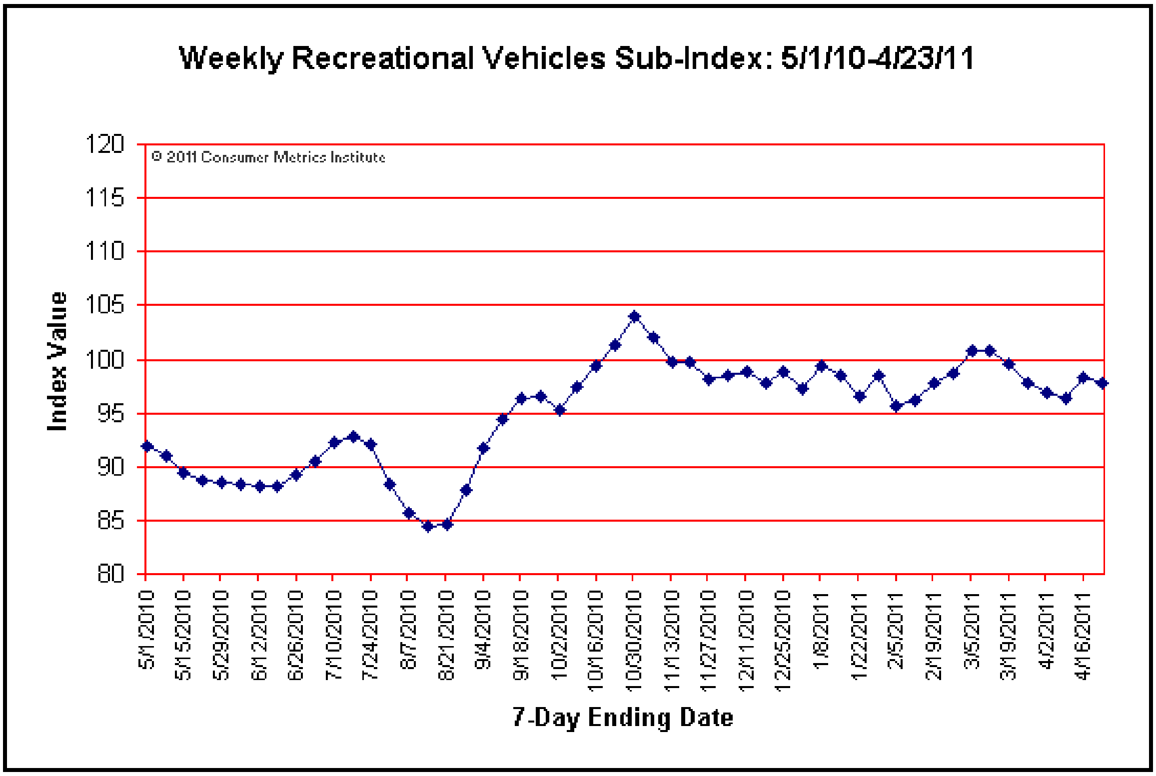
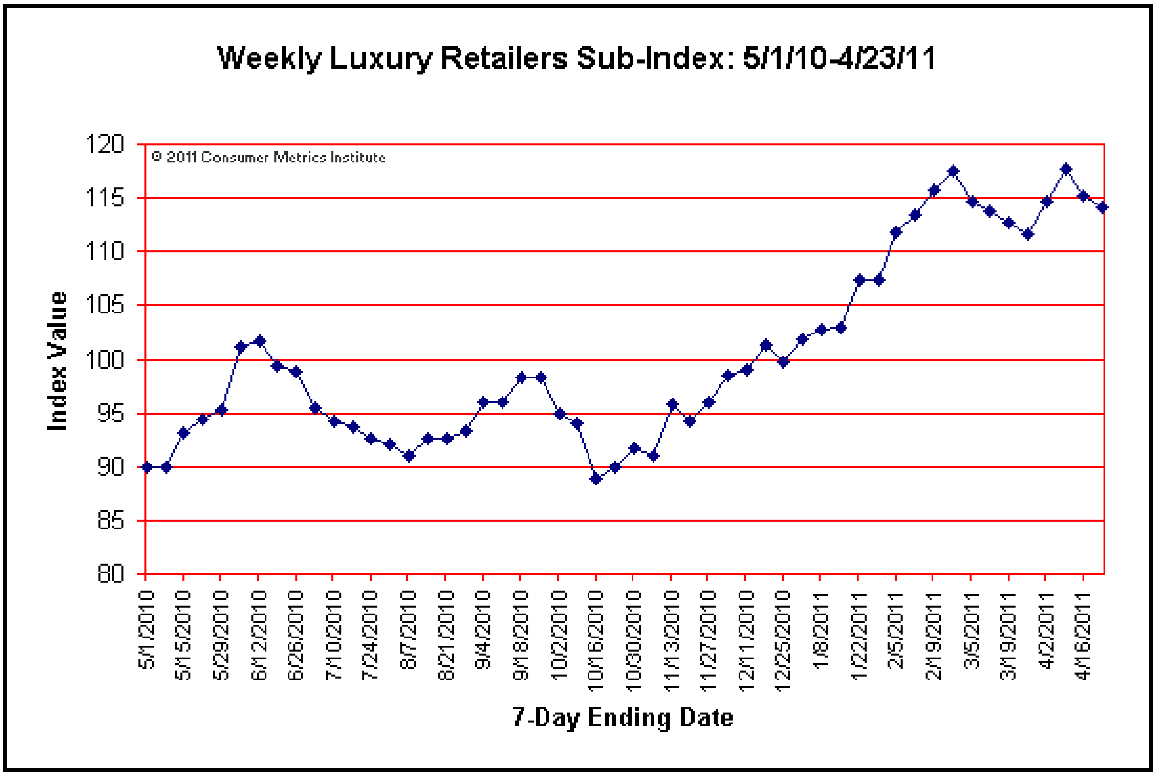
7-Day Ending Date



It should be pointed out that the purchase of an automobile or recreational vehicle is a primary mechanism for rehabilitating damaged credit ratings, since "sub-prime" loans for those types of purchases has never gone away. Former mortgage owners who have recently found themselves either living "rent-free" or in down-sized residences can usually still find ways to procure new or used vehicles.

And finally, retailing is clearly showing the kinds of cross-currents indicative of continued turbulences in the consumer economy. Contrast, for example, the year-over-year transaction volume trends for Luxury Retailers, mall anchoring Department Store Chains, and Discount Retailers:


Weekly Luxury Retailers Sub-Index: 5/1/10-4/23/11
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Index Value
120
115
110
105
100
95
90
85
80
5/1/2010
5/15/2010
5/29/2010
6/12/2010
6/26/2010
7/10/2010
7/24/2010
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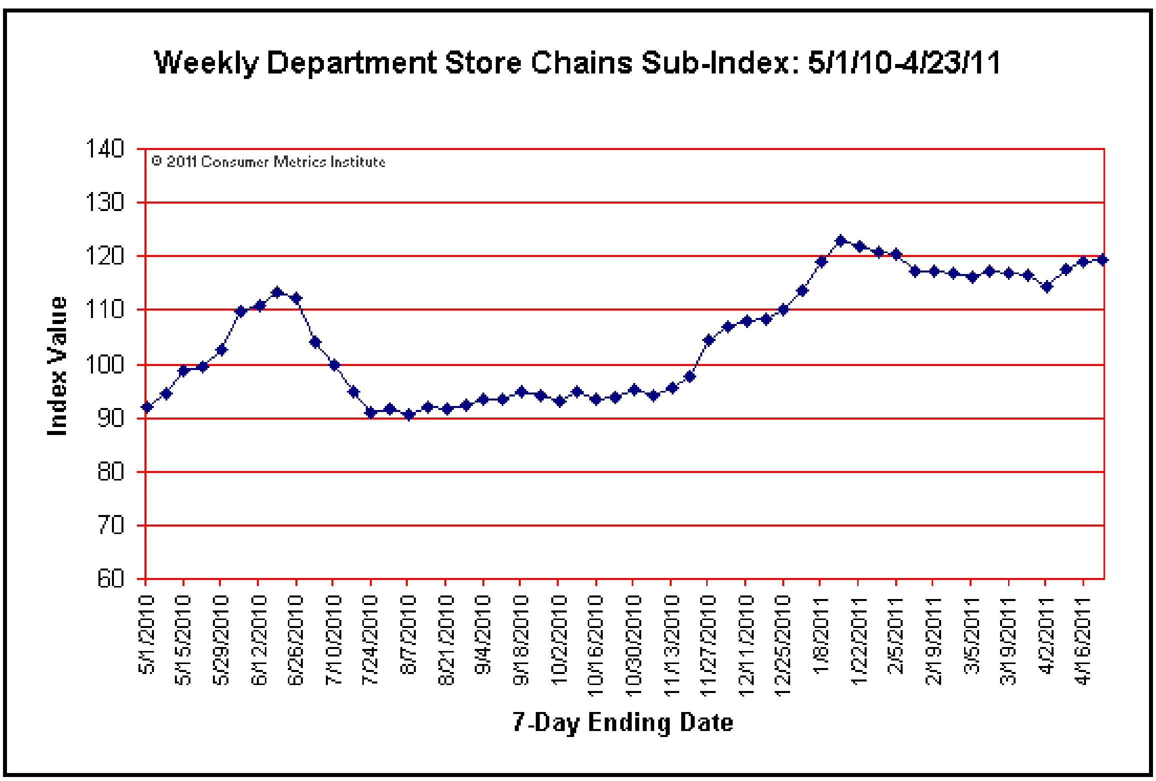
4/16/2011
7-Day Ending Date


Weekly Department Store Chains Sub-Index: 5/1/10-4/23/11
© 2011 Consumer Metrics Institute
Index Value
140
130
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5/1/2010
5/15/2010
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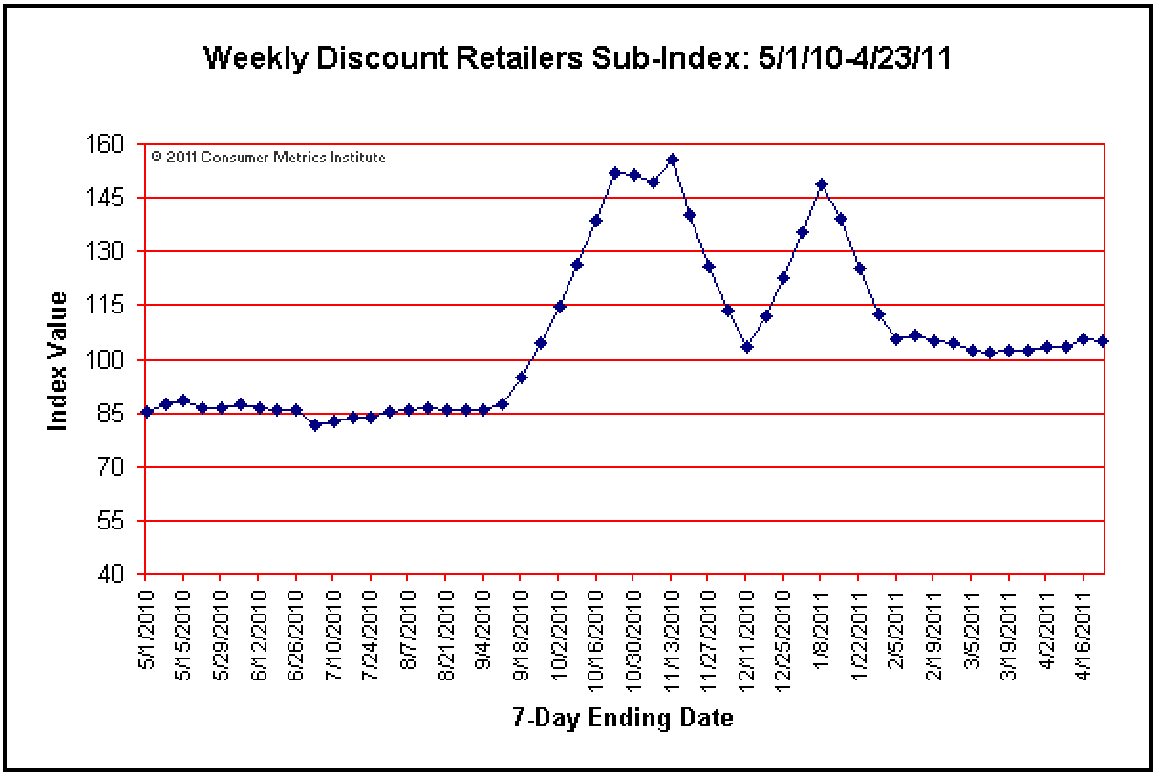
7-Day Ending Date



Clearly for the past six months the transaction volumes at all three classes of retailers have shown year-over-year growth, but the higher end merchants have generally fared better -- perhaps as an indication that the "recovery" is being felt differently among different socio-economic strata.

"Unthinkable" Regime Changing Debt/GDP End-Games

In a recent post we stated one of our fundamental beliefs: that real-world economics are really an art of what is politically possible. In that same commentary we outlined several "unthinkable" debt/GDP ratio improving end-games which are politically viable simply because they involve only a creative Federal Reserve and a compliant Treasury -- and hence don't require regime changing legislation, constitutional restructuring, political upheavals, or cultural revolutions.

There are other solutions that are unthinkable given the present "regime" -- the current composition of the U.S. congressional, executive and judicial branches of government. We can classify those changes into two broad categories: those that conceivably could be initiated after only one more electoral cycle by extending recent political trends, and those that would require a more radical political upheaval on the scale of Andrew Jackson's or Franklin Roosevelt's election.

We will start with those solutions that lack current political viability but are arguably only one more election cycle from becoming actionable:

-- **Simpson-Bowles to the Rescue**

The "National Commission on Fiscal Responsibility and Reform" (AKA Simpson-Bowles, after commission co-chairs: former Republican Senator Alan Simpson and former Clinton White House Chief of Staff Erskine Bowles) was a Presidential Commission created in early 2010 to identify "... policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run."

Sadly the Commission was rigged from the start to fail procedurally *by requiring that an ultra-majority of 14 of the 18 total members (75%+) approve the full set of recommendations for further congressional consideration (without modifications) and on a single up-or-down vote*. The fact that the actual congressional standard three-fifths super-majority (60%+) of the commission members (11 of the 18 total members) was inadequate to send the recommendations to Congress without modifications was not an accident -- it was instead a cynical pre-programmed kill-switch designed to prevent the need for hard decisions before the next elections.

What was most surprising about the Commission's final plan was that it gored essentially every sacred cow in Washington. The Commission produced a 66-page PDF report that is actually readable by lay people. The plan, as outlined in the report, consists of six broad initiatives: discretionary spending cuts, tax reform, health policy revisions, the reformation of "other" mandatory policies, Social Security changes and "process" reforms to ensure that subsequent back-sliding does not occur.

Anything that gores that many sacred cows can't be all bad, and even from our agnostic perspective it is as good a starting point as any for serious negotiations about ways to stabilize the U.S. debt/GDP ratio.

But just as the highly polarizing Affordable Care Act (AKA "ObamaCare") was unthinkable just two election cycles ago, a Simpson-Bowles scale solution to the American debt/GDP ratio is demonstrably unthinkable now -- without a clearly stated political mandate and (more importantly) single party control of the White House and Congress (ala 2008). But given the countercyclical sea-change generated by the 2010 election, that situation could change significantly after just one more electoral cycle.

-- **Constituting Fiscal Responsibility**

Although Simpson-Bowles dedicates a section of their report to "Process Reform" initiatives designed to prevent back-sliding on the country's resolve to fix its debt/GDP ratio, those reforms have been characterized as ranging from pathetic to the outright deceptive (an example of the latter might be institutionalizing a revised CPI methodology that some critics have called a thinly disguised attempt to understate the inflationary adjustments required in Social Security payment formulas). Among the truly pathetic process reforms is a call for "... Congress and the President to remain vigilant to ensure the budget remains on a course to ... a stable debt to GDP ratio."

Given the sainted wisdom of John Maynard Keynes and fiscal consequences that can be deferred for at least a generation, we feel that asking politicians to "vigilantly" abstain from deficit spending is far beyond utterly futile -- it is Kafkaesque. The framers of the United States Constitution (and its first 10 amendments) saw the need to enshrine a series of guarantees that they felt should not be left to mere political vigilance. Should fiscal discipline now be placed among those guarantees? Certainly several foreign governments (including Germany and Switzerland) and 49 of the 50 American states think so, by including in their constitutions restrictions on unbridled deficit spending.

As a recent example, Germany's constitution was amended in 2009 to introduce a "Schuldenbremse" (debt brake), that applies to both their federal government and their states. After 2015 the German federal government will be forbidden to run a deficit of more than 0.35% of GDP, while after 2019 the German states will not be permitted to run any deficit at all.

The difficulty with any such attempt to legislate fiscal discipline is the need to provide for emergencies. A genuine military threat would presumably be a recognized emergency that waives budget balancing requirements. But what about natural catastrophes on the scale of the Sendai earthquake and tsunami? Or more problematically, a multi-year economic slowdown?

The 2009 German Schuldenbremse specifically provides for emergencies such as a natural disaster or an economic crisis. Dick Lepre has studied a number of such fiscal rules and as he wrote in his call for a national "Council of Fiscal Sustainability":

"We know from the experience of the very many countries - eighty nations as of 2009 - that have introduced so-called fiscal rules that two issues are key: The rule needs to be credible, and it needs to be flexible. For instance, the United Kingdom put its fiscal rule in abeyance when it found that it was not sufficiently flexible to deal with the extraordinary economic environment of 2008/9."

In the United States the populist Tea Party has proposed a Balanced Budget Amendment (BBA) to the United States Constitution in their "Contract From America." It is not unlike an earlier BBA proposed after the 1994 congressional elections by the then incoming Republican majority's "Contract With America." That earlier generation's BBA cleared the House of Representatives and twice came within one vote of passing in the Senate (and missed on a third occasion by only three votes).

Is it politically plausible that the Tea Party could pull off (after one more electoral cycle) what the 1994 Republicans could not?

A number of other less draconian approaches are possible, ranging from Lepre's "Council of Fiscal Sustainability" to the Cato Institute's "Balanced Budget Veto" mechanism. Although such approaches are highly flexible in their implementations, they arguably represent tougher "sound-bite" material than the conceptually simpler German Schuldenbremse or "Contract From America."

(Regardless of cleanliness or flexibility, devoted Keynesians will generally oppose any form of budgetary shackles, and they will adamantly resist any constraints that cover single fiscal years. They will argue that any budget balancing must be based on a full business cycle, with stimulating deficits occurring during the contraction phase and offsetting surpluses cooling off the subsequent expansion. One problem, of course, is having the political resolve to cool off expansions by generating the compensatory surpluses. Or given the reverse sequence of first building surpluses that can subsequently be used during contractions, the problem is having the political resolve to not lower the surplus generating tax rates. Unfortunately for the Keynesians, if real economics is the art of the politically viable, their solution only works during the contracting half of the business cycle.)

-- **Avoiding the Avoidable**

One of Keynesian economist James K. Galbraith's criticisms of Simpson-Bowles (as presented to the Commission) was that the current deficits were primarily caused by the financial crisis, and that absent the financial crises there would be no debt/GDP ratio problem worthy of attention. Let's avoid the circular chicken-and-egg causation logic and instead humor Mr. Galbraith by looking at ways to avoid future generations of financial crises.

The "Financial Crisis Inquiry Commission" (FCIC) might be a good place to start. Their full final report was issued on January 27, 2011, and it runs (including dissenting views and footnotes) 662 pages of sometimes heavy reading. For those of you who don't have a couple of days to slog through it, we have excerpted the Conclusions and Chapter 1 into a 37 page PDF that should be required reading for serious investors.

At the risk of spoiling a good read, their first several conclusions were that the "financial crisis was avoidable" and that it resulted from "widespread failures in financial regulation and supervision" and "dramatic failures of corporate governance and risk management at many systemically important financial institutions."

And we would add: a willful disregard for the lessons of history. Let's be clear here: we're not talking about mere recklessness, we're dealing instead with the premeditated dismantling and malicious eradication of any institutional memories of those lessons while in hot pursuit of the greater greed.

The FCIC is often called the "Angelides Commission" after its chairman, Phil Angelides. This is something of an homage to the Pecora Commission, which performed a similar investigation some 80 years earlier -- with startlingly similar conclusions. Although it's fashionable to assume that we're really a whole lot smarter now, recent history indicates that perhaps Ferdinand Pecora, Carter Glass and Henry Steagall were not total idiots.

If the financial crisis was avoidable, the easiest way to have done that would have been to leave the "Banking Act of 1933" (Glass-Steagall) on the books. From a lay perspective, Glass-Steagall simply said that you could be a depository bank, or you could be an investment house, but you couldn't be both. Pecora, Glass and Steagall assumed that there would be an inherent conflict of interest (that no amount of regulatory "vigilance" could prevent) when an ethically ambiguous bank was entrusted with banking deposits that allowed them to leverage their capital in such a way that they could underwrite speculative financial products that, in turn, would earn them origination and/or trading fees. Pecora, Glass and Steagall actually did not assume anything -- they had seen it happen before their very own eyes.

Glass-Steagall was dismantled in several steps, starting in 1980 and culminating in the "Gramm Leach Bliley Act of 1999" (Gramm Leach Bliley). The FCIC cited the demise of Glass-Steagall 19 times as a primary cause of the financial crisis. In the end, Glass-Steagall protected the American financial system for 66 years -- but it took only 8 years for Gramm Leach Bliley to bring it to its knees. Gordon Gekko would be proud.

Furthermore, if we assume that there are ethically impaired people out there, the cleanest way to deal with them is to create unambiguous and impenetrable "fire-walls" between them and fiduciary funds. Unlike the "Dodd Frank Wall Street Reform and Consumer Protection Act" (Dodd Frank), Glass-Steagall required no regulatory commission. Why? Because it was so simple: you were either a depository bank or you weren't -- there were absolutely no gray areas. And if you were caught with your fingers in the wrong till, you lost your livelihood -- something deliciously akin to the ancient Arabic treatment of pickpockets.

Back to our fundamental premise -- that real-world economics are really an art of what is politically possible. Is it plausible that a new Glass-Steagall could be implemented without recourse to a Jacksonian or Rooseveltian scale of regime change? Unfortunately there are at least two reasons to think not:

-- The populist Tea Party is focused almost exclusively on tax, deficit and sovereign debt issues. In this regard they have not yet tapped into a potentially even greater sense of betrayal that is simmering within the electorate over the state of the economy and its root causes in the greed of the financial crisis. Without that specific mandate there is probably no political will to take on Wall Street.

-- The opposition is well entrenched, well funded and very well connected -- very much like Nicholas Biddle.

Coming soon: "Unthinkables" from Jacksonian scale regime changes ...