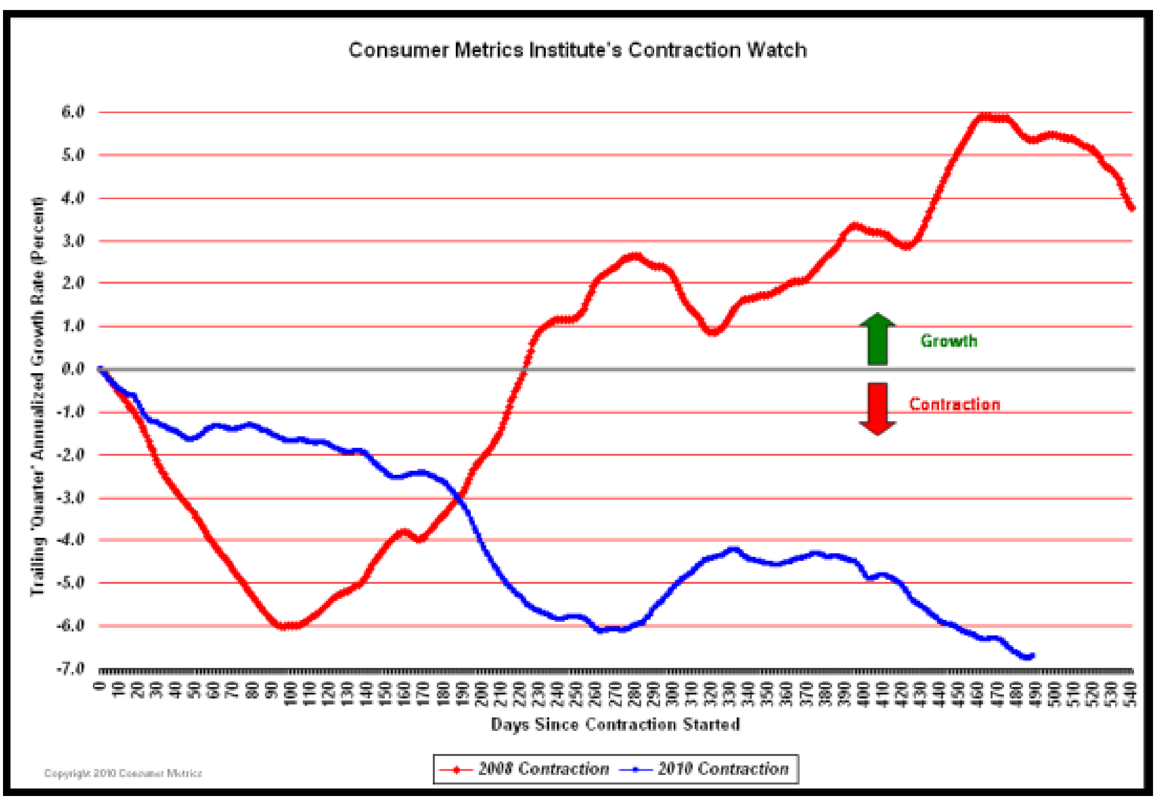
Consumer Metrics Institute Members News

May 14, 2011: Continued Weakness in Consumer Demand; Unthinkable De-Financialization

Our Daily Growth Index has continued its descent into record depths of contraction, reaching the year-over-year level of decreasing consumer demand of -6.68% on May 12, 2011. There are several key aspects of that decline that lurk beneath the raw contraction rate**:**

-- The numbers are *year-over-year against already contracting consumer demand last year*. At mid-May 2010 our measurements of consumer demand for discretionary durable goods were already showing a -1.8% slowdown compared to May 2009 -- meaning that the compounded two year movement is well in excess of -8.5%.

-- The new record low of -6.68% should be viewed in the context of previous records**:** the lowest level reached during the "Great Recession" was the then record -6.02% set on August 29, 2008; while the most recent new record "bottom" was -6.13% set on October 4, 2010. The new record exceeds the 2008 low by 10%, and the 2010 "bottom" by over 8%**:**



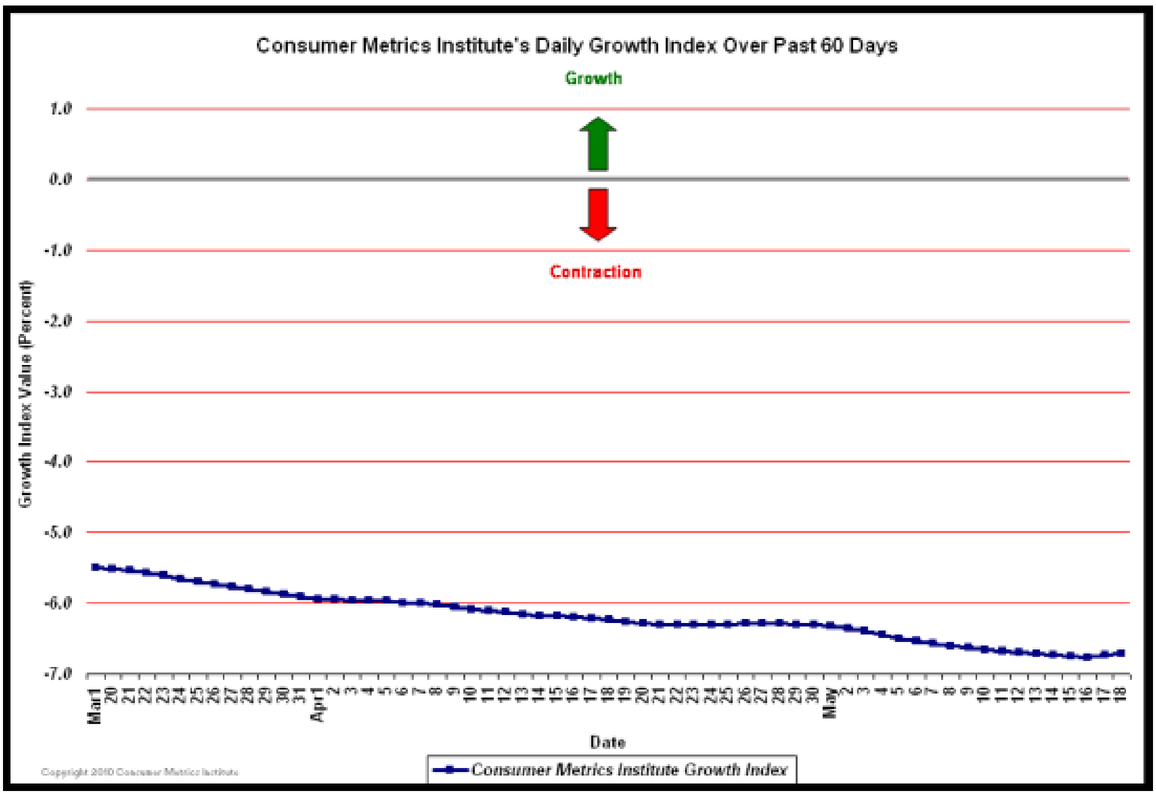
-- Because our 'Daily Growth Index' is essentially a moving average of a trailing 91-day 'quarter' in our 'Weighted Composite Index', it can be tilted lower by either sharp downward blips in the 'Weighted Composite Index' or more prolonged weaknesses. For the record, the new 'Daily Growth Index' lows are not being caused by extraordinarily low daily 'Weighted Composite

Index' numbers (which were actually lower in mid-March 2011), but rather by unrelenting day-after-day 'Weighted Composite Index' values in the 92 to 94 range.

-- This in not a short term effect similar to the 7-month consumer belt tightening that we saw from the summer 2008 through early 2009. The current persistence suggests that consumers have come to terms with the need for a longer term frugality -- perhaps not wishing to repeat the premature "green shoots" optimism of early 2009.

-- To our eyes the above chart shows no visible signs of imminent recovery.

We also publish a chart plotting the daily progress of our 'Daily Growth Index' over the past 60 days**:**



During the "Great Recession" we were concerned when we had to change the scale of the above graph several times to keep the line from dropping out of view -- doing it for the "last" time in late August, 2008. We fear that a deja vu moment may happen sooner than we might have hoped.

De-Financializing the Economy

Over the past few months we have explored a number of ways to address the current U.S. debt/GDP ratio. The problem facing most main-stream economists (and certainly the ones at the Federal Reserve) is that their Keynesian textbooks have taught them that at some "tipping point" the growth rates of the numerator and the denominator of that ratio become inexorably linked, making the ratio unfixable through normal (i.e., relatively painless) means. Given that scenario, the textbooks offer only three logical (albeit painful) central bank induced options to deal with the ratio**:**

-- Cataclysmic deflation that reduces the numerator's debt by triggering massive defaults and another "Great Depression";

-- Cataclysmic hyperinflation that vastly expands the denominator's nominal GDP (but simultaneously wipes out the nest-eggs of a large block of voters);

-- Or, muddling through an unending Japanese style recession that simply kicks the debt/GDP ratio "can" further down the road.

Given only those three options, most politicians would opt for the Japanese solution, while insisting that they have chosen the course of least pain for the electorate. Someone more cynical might suggest that one or more of the first two options will ultimately happen, but only after the financial elite (or oligarchy) have fully isolated themselves from (or fully hedged against) the consequences.

That logic assumes a preservation of the political and economic status quo -- the preservation of which, in fact, is what restricts us to only the above limited set of three logical options.

The Unthinkable Options

In contrast, we have premised that once all the logical options prove unsuitable, something previously "unthinkable" will happen. In several recent articles we have explored potential "unthinkable" solutions to the U.S. sovereign debt problem, including some that were mundane, some more imaginative, others requiring modest regime change, and yet more that involve radical regime changes. The latter "unthinkable" options involve a political sea change similar to those that the U.S. already experienced in the wake of the 1832 and 1932 elections. It has happened before and it is likely to happen again**:** Andrew Jackson was elected on 1832 by promising to abolish the U.S. central bank and the practices that enriched the financial elite at the expense of the general populace**;** and Franklin Roosevelt was elected in 1932 by promising a "New Deal" that radically changed the role of government in the financial industry (and the lives of "Main Street" Americans). In both cases the new agendas would have been "unthinkable" to their presidential predecessors.

In this context of a post-regime-change America we have assumed that the political wherewithal would exist to balance the U.S. budget at about 21% of GDP (the Simpson-Bowles target). Doing that requires sucking over 14% of the 2010 GDP from the economy through a combination of Federal spending cuts and tax increases, a drop in GDP that would meet the clinical definition of a depression. Obviously some form of non-deficit-generating and offsetting GDP stimulation needs to be found, perhaps adding 3% excess annual GDP growth to the economy over the same 5 year time span that the budget balancing is implemented.

Given a U.S. economy that is (for now) limping along at a 1.75% annualized growth rate, where would an excess 3% growth rate come from?

At its simplest level the numerator in the sovereign debt ratio problem involves only the U.S.

Federal debt, while the GDP denominator obviously also includes the private economy. For this reason the level of U.S. private debt (while alarming to some) is not currently the cause of the political angst in Washington. In fact, during the "Great Recession" the private sector has been busy deleveraging, and the private debt/GDP ratio had been improving even before the consequences of mortgage defaults became material. It is plausible then that a judicious expansion of private credit could again provide the necessary economic stimulation without exacerbating the Federal debt -- breaking the "inexorable link" conundrum mentioned above. But how is more debt ever a good thing?

Bad Debt -vs- Good Debt

Debt is bad only if it is net unproductive. If it is used to build factories that can easily pay off their loans it is a very legitimate financial tool. On the other hand, when it is used to maintain otherwise unsustainable lifestyles it is clearly unproductive -- whether the debt is incurred by governments, commercial enterprises or spendthrift consumers.

(The productive use of governmental debt was often ignored by John Maynard Keynes, as when in 1936 in his **The General Theory of Employment, Interest and Money** *he famously stated that governments could stimulate economic investment by filling "old bottles with bank notes, bury them at suitable depths in disused coal mines ... and leave it to private enterprise to dig the notes up again." Keynes went on to explain that "digging up bank notes is not so different from 'gold mining' and would equally serve as a way to consume excessive savings." Even as he was writing those words it could have been argued that the Roosevelt administration's deficit spending on economically unproductive public works and relief was not materially reversing the course of the Great Depression. It was only the post-1938 spending that created new jobs in new munitions factories -- many of which remained highly productive in other capacities for decades after World War II -- that brought the country back to prosperity.)*

Good debt is supposed to be distinguishable from bad debt during an underwriting process. This is the process by which a lender qualifies a loan applicant for a loan, and presumably assigns an interest rate on the grounds of the likelihood of repayment. During this process a prudent lender will be forced to make judgments about how productive the loan will be. This can be a hard, if not daunting, task -- but it is essential to mitigate the risks being assumed by the lender. Or is it?

The Easy Path to Mortgage Risk Reduction

Commencing in the late 1960s the financial industry invented a much easier way to mitigate the risks of a mortgage loan to its lender. In essence the mortgage would be pooled with similar loans, and the resulting aggregate pool could then be sold off to many investors as security shares that could be traded on financial exchanges. The incentive for banks was clear and simple**:** they could keep the origination and servicing fees generated by the loans while handing off the non-performance risks entirely to investors (and ultimately through the Federal National Mortgage Association (AKA Fannie Mae) to the taxpaying public).

Conceptually this meant that the risk of any single bad mortgage would be shared by many investors, with the open market value of the resulting securities serving as the primary risk assessment tool. This was a creative strategy that in practice should:

-- Increase the availability of mortgages to the general public, and

-- Reduce the risks of mortgage defaults within the financial industry.

Unfortunately, based on the hard evidence experienced over the past few years the "securitization" of mortgages has failed miserably on both of these objectives -- and for a number of reasons:

-- The securitization process itself obscured the underwriting risks inherent in the underlying mortgage instruments, making appropriate market assessments of the risks impossible.

-- The opacity of the underlying risks encouraged underwriting neglect -- some mandated by the U.S. Department of Housing and Urban Development (HUD), some encouraged by the moral hazard of governmental guarantees, and some the result of premeditated fraud.

-- The securitization spawned a number of derivative instruments (including credit default swaps) that effectively increased the financial industry's leverage of those securitized mortgages by at least an order of magnitude -- to the point where systemic ("Black Swan") risks far outweighed the lending community's original mortgage default exposure.

-- When mortgage based securities are no longer profitable investors will simply no longer buy them -- and the funding for large portions of the mortgage industry will grind to a halt.

-- When coupled with massive amounts of Federal Reserve liquidity, the cheap and readily available mortgages promoted a real estate bubble that suckered large numbers of consumers into (now) clearly ill advised levels of life style enhancing (and non-productive) personal debt.

-- Securitization may protect lenders from the occasional aberrant mortgage, but it cannot protect investors from the resulting systemic risks to the financial industry as a whole. By analogy to the nuclear power industry, this risk mitigation process bypassed the need to measure the toxicity of a particular asset (e.g., a spent nuclear reactor fuel rod) by grinding it up and dispersing it across the countryside.

-- Furthermore, from a macro-economic standpoint it could be argued that the resulting "financialization" of the economy resulted in the mis-allocation of capital away from more traditionally productive (i.e., job creating "Main Street") investments.

Expanding the Economy the Old-Fashioned Way

Back to our question**:** how do we judiciously re-expand private sector credit enough to grow the economy by the excess 3% annually necessary to avoid a Simpson-Bowles induced depression?

To do that we probably need to have a Jacksonian or Rooseveltian reformation of the financial industry, that largely re-instates the "hard work" underwriting done by generations of bankers before securitization made it seemingly unnecessary. We know of rural small-town bankers who never abandoned their underwriting standards and who have always held their own whole mortgages. Those bankers have not gotten obscenely rich at the expense of the local populace, and some of them have yet to foreclose on any of their homeowners. They simply never participated in the "securitization" and "financialization" of America.

Maybe the small town bankers we know should be running the Treasury and the Federal Reserve.

In any event, a sufficiently clever Federal Reserve could easily prevent a Simpson-Bowles depression by using some form of monetary QE-x to inject 14% of the GDP into the economy -- moderately spurring inflation but not actually increasing the debt on the Federal Government's balance sheet. The only problem, of course, is that they have already done that -- and thanks to the financial industry status quo the money never made it all the way to "Main Street."

What is probably also needed is a Jacksonian scale reformation that largely de-financializes the economy, returning investment monies to new "Main Street" factories or job generating small businesses. Unfortunately, such reforms will remain "unthinkable" until someone with Franklin Roosevelt's disdain for the financial status quo enters the White House.

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