24th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies

GLOBAL AND NATIONAL RECOVERY PROSPECTS

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Topics Covered in this Presentation

I. A short detour past the contractionary regulation argument and secondary market liquidity.

II. How extraordinary monetary intervention, however necessary, ultimately masked the true magnitude of the global savings glut (*i.e.* interest rates were destined to fall anyway) and distorted price discovery.

III. The real obstacles to U.S. and global growth:

(a) The U.S. employment situation is poorly understood; labor slack is still very much present.

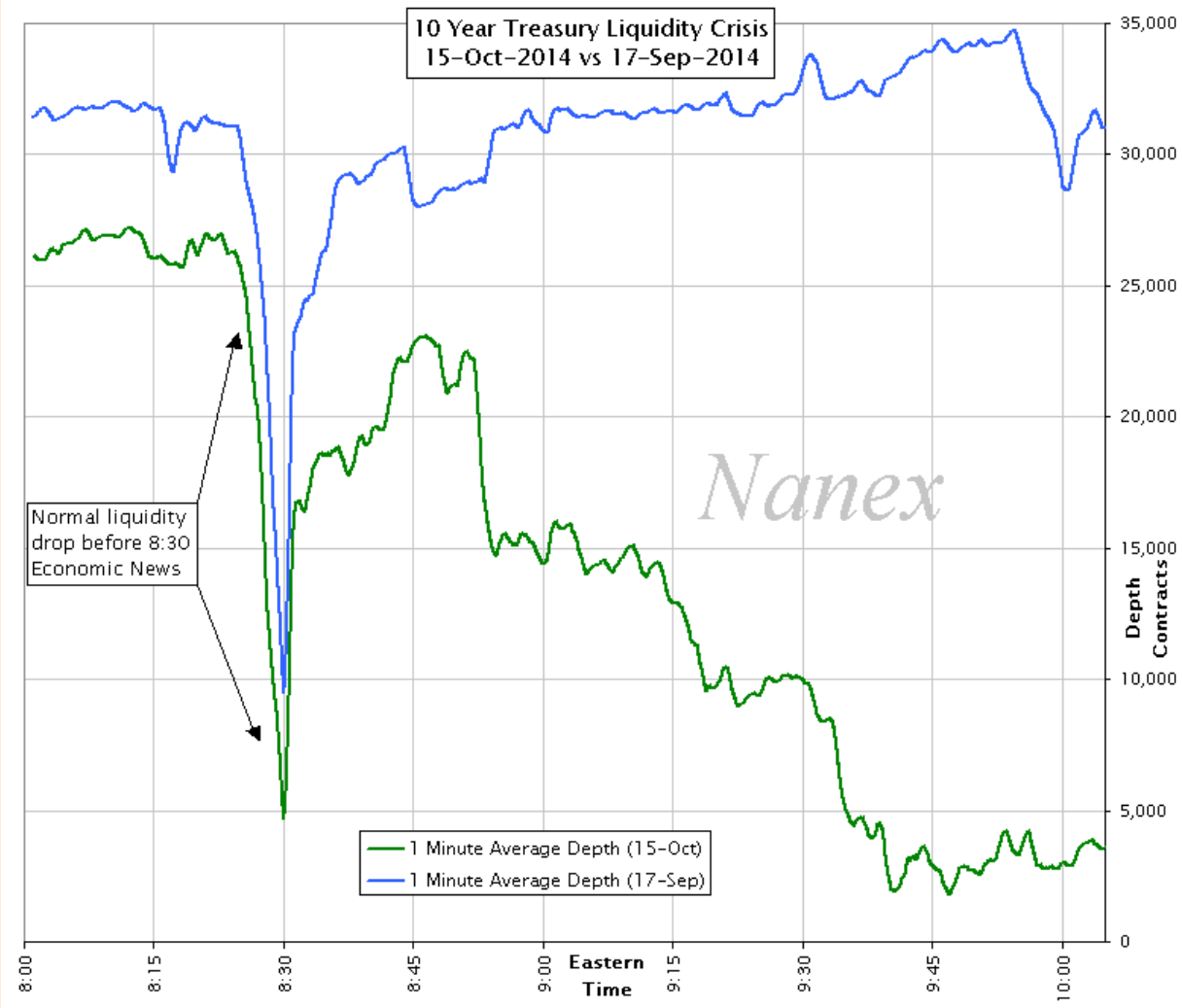
(b) U.S. households are still deeply in debt on a nominal basis.

(c) Deflation is not a transient problem in the U.S., it will resume in Japan and will not be sustainably reversed by QE in Europe…but the biggest problem ahead is China.

(d) The U.S. housing sector – which, until recently, was really the only supporter of core inflation – has not experienced a normal recovery (despite apparent price recovery) and sustained prices increases are not likely to be sustainable in the absence of other supporting factors.

IV. Global oversupply of labor, productive capacity and capital and blocked price channels – the global underpinnings of secular stagnation.

The Contractionary Regulation Argument "Poster Child:" The Bond Market Flash Crash of October 15, 2015 – TWELVE MINUTES OF TERROR



On October 15, 2014, the U.S. treasury bond market experience in intra-day flash crash. From 9:33am to 9:45am bond prices rocketed higher and yields plummeted by some 35 basis points on the 10 year bond as liquidity "mysteriously" vanished. Within a few hours, prices reverted almost entirely to the levels at 9:33am that morning. This move has been variously cited by leaders of financial institutions (Dimon), their lobbying and trade groups (SIFMA) and some analysts and economists as being attributable to overly restrictive capital and liquidity regulation.

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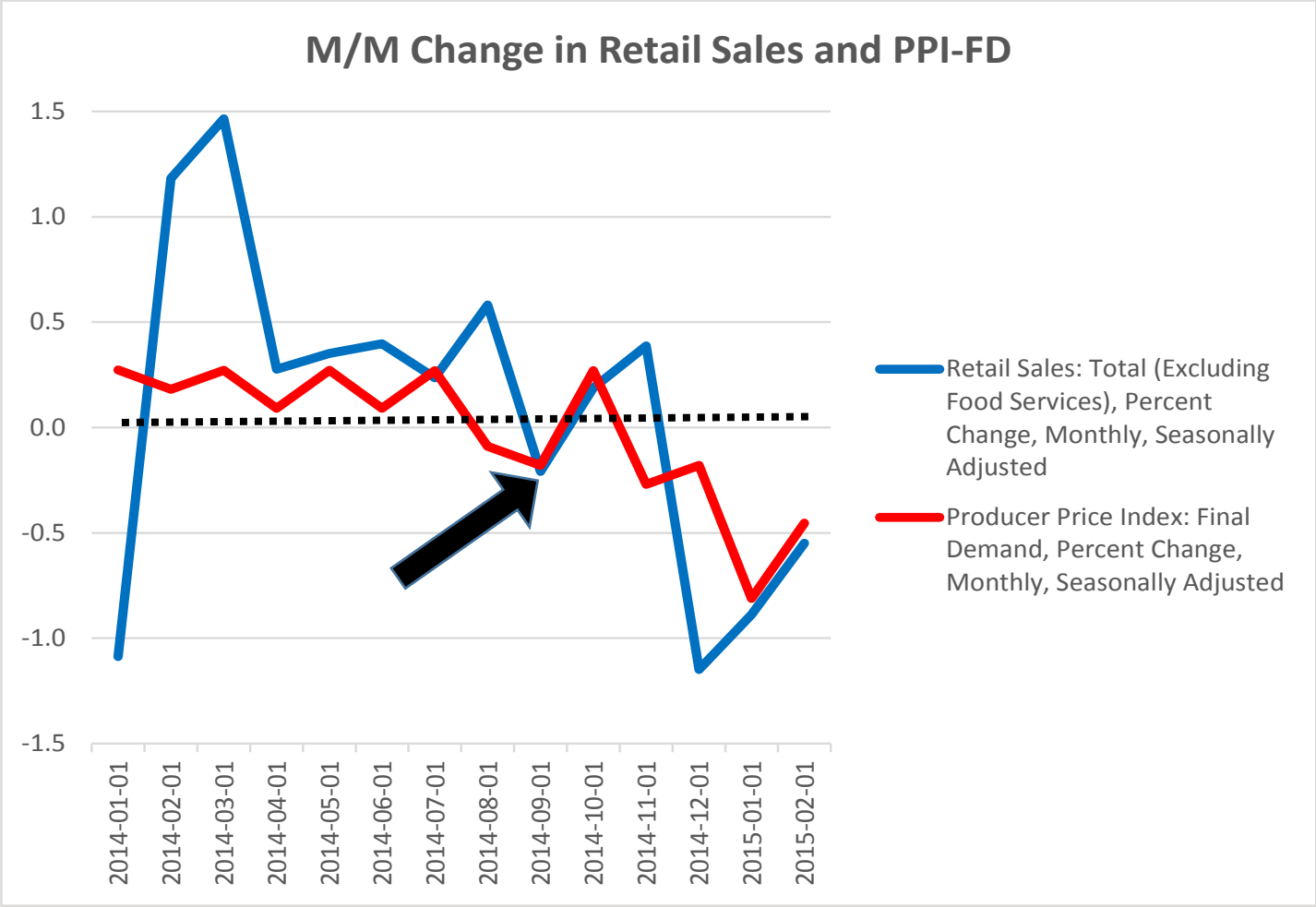
The Contractionary Regulation Argument "Poster Child:" The Bond Market Flash Crash of October 15, 2015 – TWELVE MINUTES OF TERROR

The "mini-flash crash" was precipitated by two unexpectedly weak releases of economic data that morning, September retail sales and PPI-FD both turned negative on a M/M basis in what was apparently a foreshadowing of far larger decline's to come. Treasury futures trading programs reacted to this news and the trading that immediately followed and the number of sellers evaporated.



Source: Federal Reserve Economic Data; FRB St. Louis

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The Contractionary Regulation Argument "Poster Child:" The Bond Market Flash Crash of October 15, 2015 – **TWELVE MINUTES OF TERROR**

- But was this the "once in 3 billion years event" or a "warning shot across the bow" to the market and regulators, as J.P. Morgan's Dimon stated last week? Is regulation that pushes SIFIs into risk-free or less risky holdings causing dealers to abandon their market making function, particularly in the case of more risky sectors of the credit market?
- That large financial institutions seek to remain large, universal, leveraged and free to pursue profit where they can find it, is not worth debating. That government insured depositories with access to a lender of last resort aren't fond of the regulation that has proceeded from Dodd-Frank is equally indisputable.
- The Contractionary Regulation argument is, for the most part, a red herring.

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The Contractionary Regulation Argument "Poster Child:" The Bond Market Flash Crash of October 15, 2015 – **TWELVE MINUTES OF TERROR**

- The backstory behind the recent versions of the CR argument is interesting:
  - The financial services sector was originally trying to sell a story that primary market liquidity would be detrimentally impacted by stronger regulatory capital and liquidity requirements.
  - That argument having been disproven since 2012 by the unprecedented availability of capital to creditworthy issuers, has been supplanted by the claim that re-regulation of the banking sector will result in horrific instances of secondary market shutdown which occurrences would ultimately feed back into the new issuance market as investors would no longer be satisfied with after-market liquidity.
  - And this carefully crafted argument has been being advanced by SIFMA and the industry for some time, especially via SIFMA's Treasury Borrowing Advisory Committee (TBAC) which issued a response to questions from Treasury on market liquidity in a in July of 2013 report[1].
  - The recent comments by Dimon and SIFMA are practically "Galt-ian" in tone: ***Continue on this regulatory path and we will take our marbles and either shrink assets or go home.***

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[1] *"Assessing Fixed Income Market Liquidity," Presentation to TBAC, July 2013*

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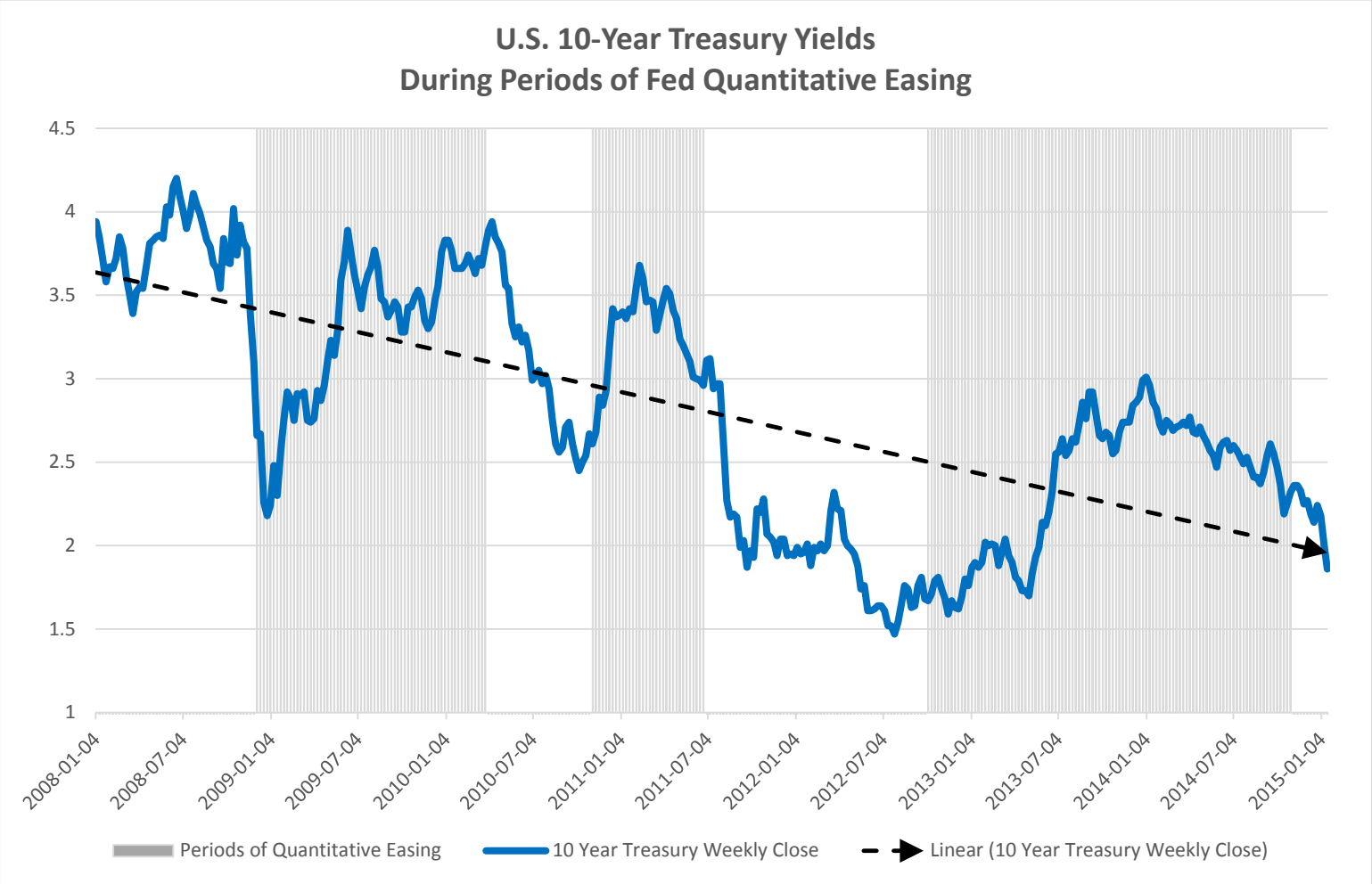
The Fed's Zero Interest Rate and Quantitative Easing Policies may have had Less Impact on Long Term Interest Rates than is Commonly Believed

Treasury rates have fallen since the Global Economic Crisis, but has monetary policy been the reason why?

And why have U.S. long rates counterintuitively risen during every one of the three periods of quantitative easing?



Source: U.S. Department of the Treasury

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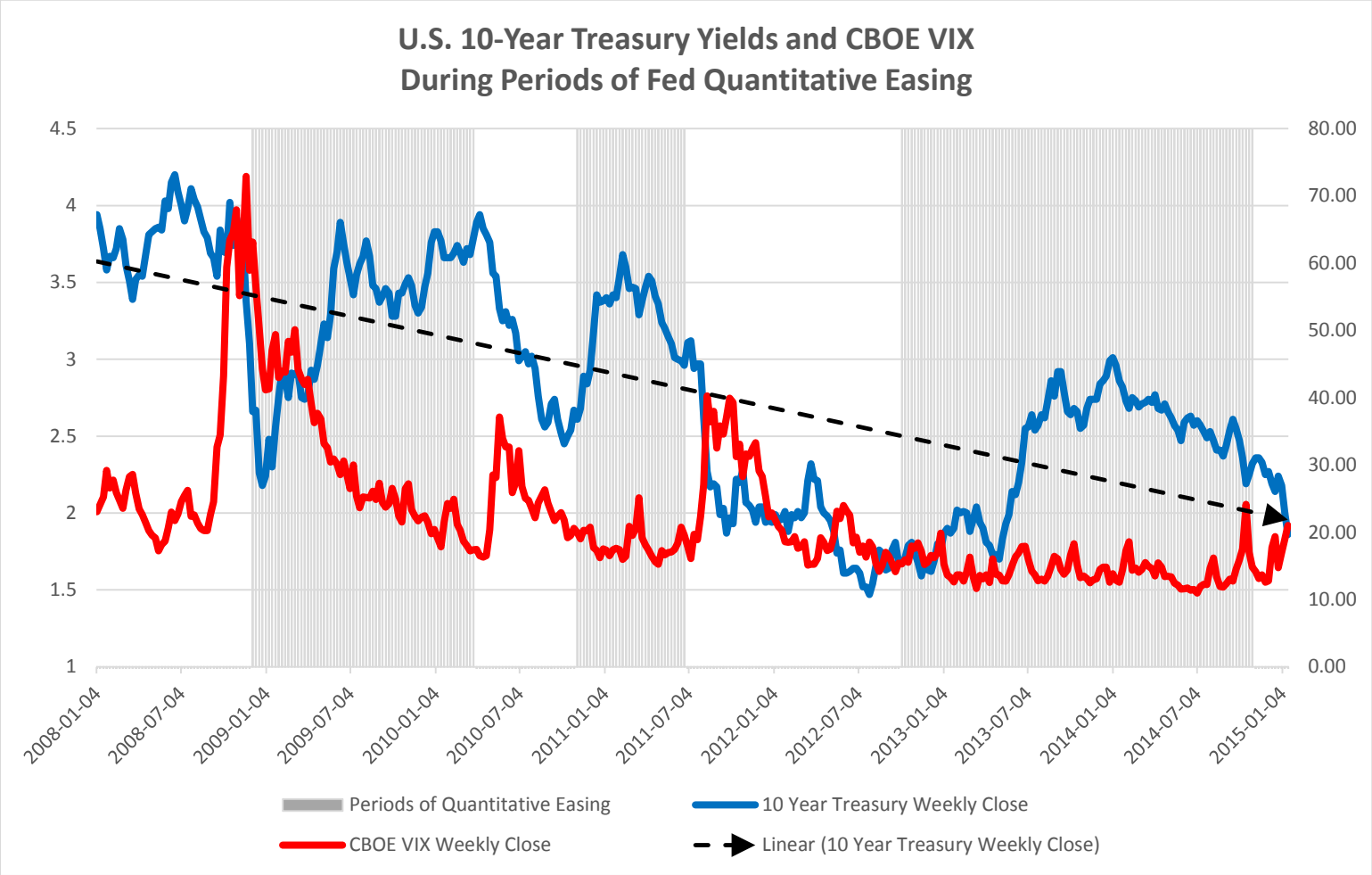
While QE has calmed asset markets, global capital glut/weak aggregate demand has driven rates.

Equity markets stabilized and rocketed higher during periods of QE, but volatility returned thereafter. Has monetary policy reached its limits of effectiveness?



Source: Federal Reserve Economic Data; FRB St. Louis and U.S. Department of the Treasury

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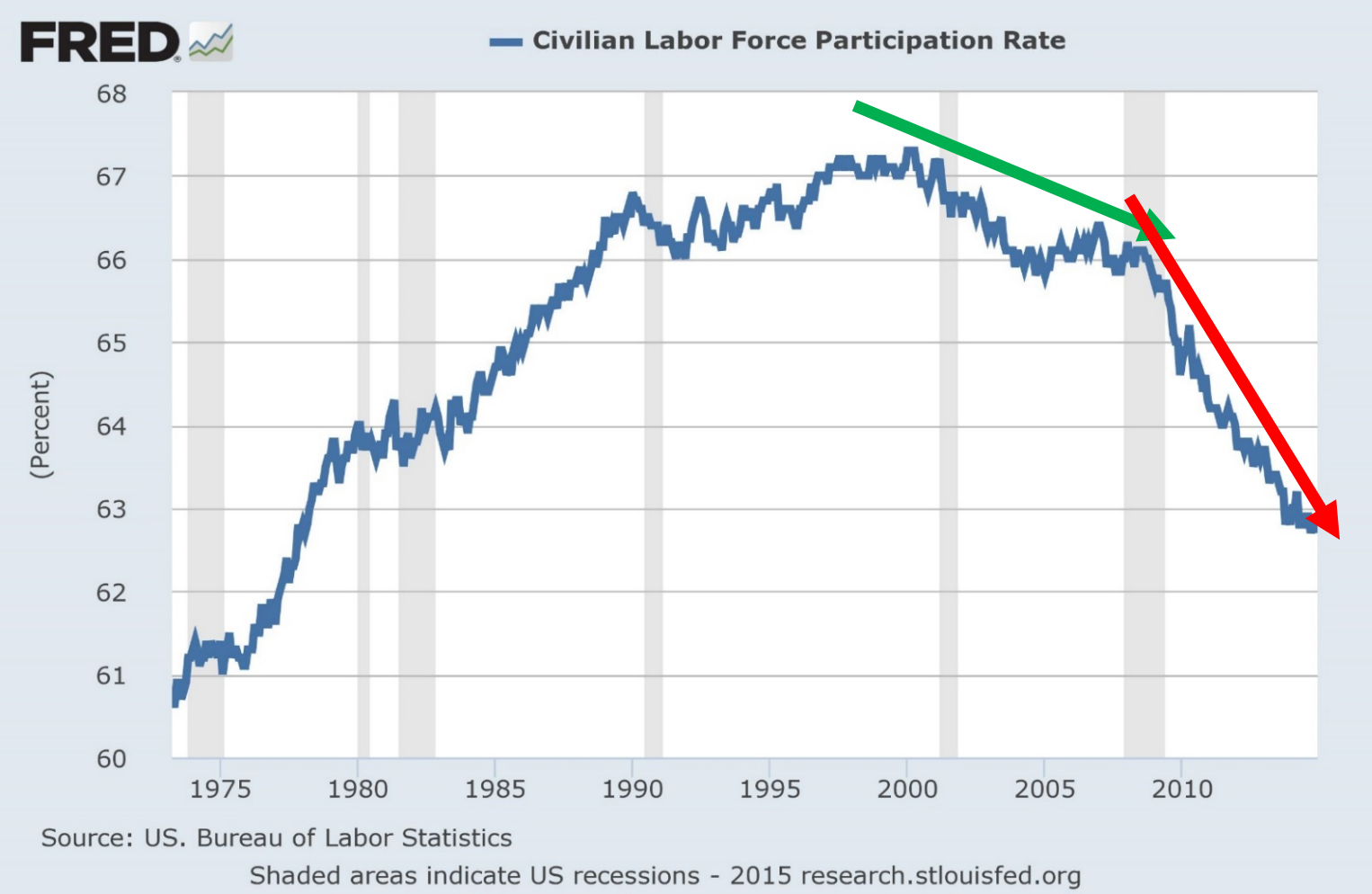
The U.S. Employment Situation Indicates Serious Secular Problems

Demographic forces are overemphasized as the principal culprit behind LFPR decline. The collapse of the debt driven economy and the Great Recession were more significant factors.



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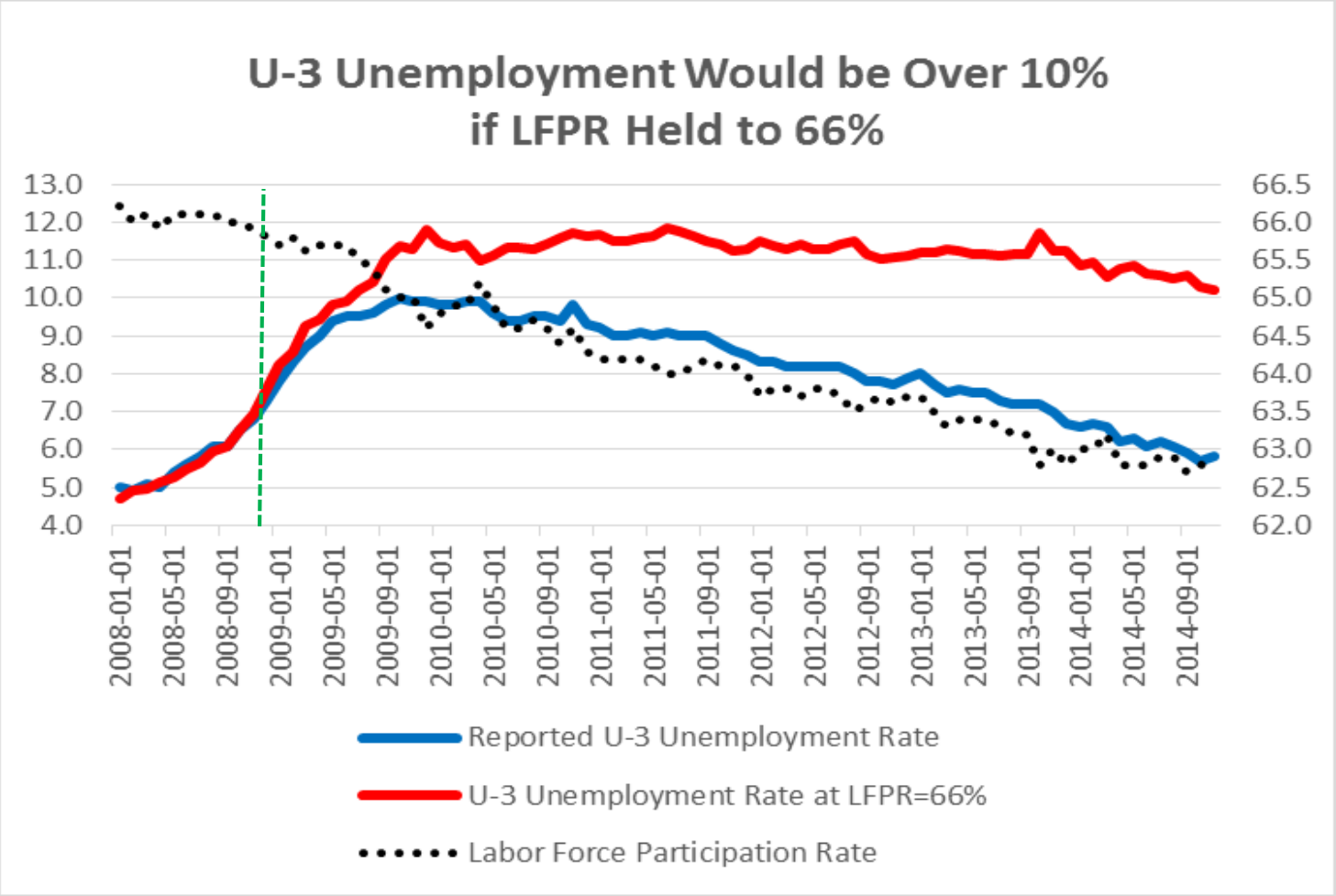
As a consequence of the substantial post-2008 decline in the Labor Force Participation Rate, the U-3 unemployment rate should have diminished relevance in analysis and policy-setting:



Source: U.S. Bureau of Labor Statistics

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The U.S. Employment Situation Indicates Serious Secular Problems

The U.S. has experienced increasing wage polarization and changing rates of formation of higher wage jobs (currently 64% of total private sector; average hourly wage $28.60) and lower wage jobs (currently 36% of total private sector; average hourly wage $16.38). Since the Great Recession low wage jobs have been created at a rate significantly higher than their total number relative to all jobs.

High Wage and Low Wage Jobs as of March 2015

	Number of Jobs	Hourly Wages
HIGH WAGE JOBS		
Goods Producing	19,547	26.05
Wholesale Trade	5,903	28.35
Transportation and Warehousing	4,745	22.91
Utilities	558	36.98
Information	2,782	34.64
Financial Activities	8,083	31.31
Educational Services*	3,463	24.62
Healthcare*	14,952	27.34
Professional and Tech*	8,562	38.33
Management of Companies*	2,203	37.55
Other services	5,625	22.28
Totals and Weighted Averages	76,423	28.60
LOW WAGE JOBS	-	-
Retail Trade	15,591	17.28
Social Assitance*	3,439	15.52
Administrative and Waste Services*	8,776	18.80
Leisure and Hospitality	15,055	14.23
Totals and Weighted Averages	42,861	16.38
Total	119,284	

* All data is as of March 2015, escept for wage data in the starred sectors, which is from February 2015.

Source: Bureau of Labor Statistics

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The U.S. Employment Situation Indicates Serious Secular Problems

Low-wage jobs tend to also be low-hours jobs (and, from a job-creation-count perspective, it should be noted that many are jobs held by multiple job holders). The resulting annual incomes in low wage sectors are very weak. In the leisure and hospitality sector in particular, annual incomes are not much more (after taxes) than the total of unemployment benefits plus food stamps that long-term unemployed workers previously received before those benefits were withdrawn in 2014. As a result, the impact of the creation of such jobs on consumer spending and GDP is minimal.

Low Wage Jobs

	Hourly Wages	Hours per Week	Imputed Annual Income	Number of Jobs
Retail Trade	17.28	31.40	28,214.78	15,565.00
Social Assistance*	15.52	29.60	23,888.38	3,431.50
Administrative and Waste Services*	18.80	34.90	34,118.24	8,766.80
Leisure and Hospitality	14.23	26.20	19,386.95	15,042.00
Weighted Averages and Totals	**16.38**	**30.15**	**25,674.03**	**42,805.30**

* All data is as of March 2015, except for wage data in the starred sectors, which is from February 2015.

Source: Bureau of Labor Statistics

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The U.S. Employment Situation Indicates Serious Secular Problems

Rather than focus on the raw job creation count and the U-3 unemployment rate, we should be looking at aggregate payroll growth and relative wage growth. The data reveals three important phenomena in this regard:

A) Wage growth is flowing disproportionately to the 17.5% of workers whose jobs are classified as supervisory; and

B) Aggregate payroll growth was seen largely in the low wage categories during 2014. High wage payrolls lagged. In H1 2015, aggregate payrolls have been practically flat.

C) Put in the context of the size of the employable population, the pace of job creation itself is nothing to write home about.

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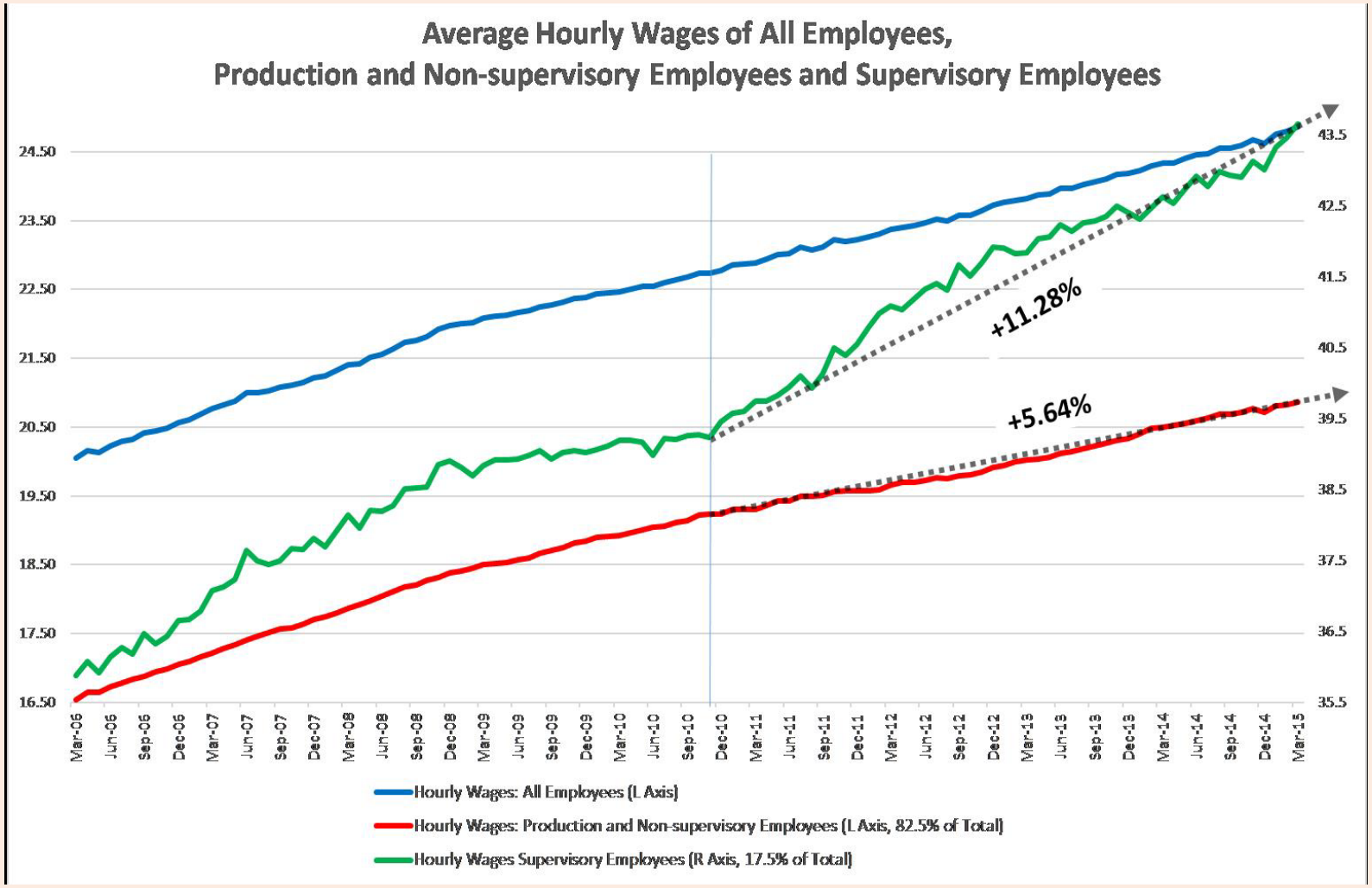
The U.S. Employment Situation Indicates Serious Secular Problems

A majority of the reported inter-month change in the rate of hourly wage growth is not broad based but, rather, reflects fluctuations in the wages of the top 17.5% of employees. **Moreover, *since November 2010, hourly wages of such supervisory employees grew at nearly twice the rate of those of the lower 82.5% of all employees, the so-called Production and Non-supervisory cohort.*** The sluggish growth in cumulative labor productivity from 2011 through 2014 may be related to this trend, among other things.



Source: U.S. Bureau of Labor Statistics

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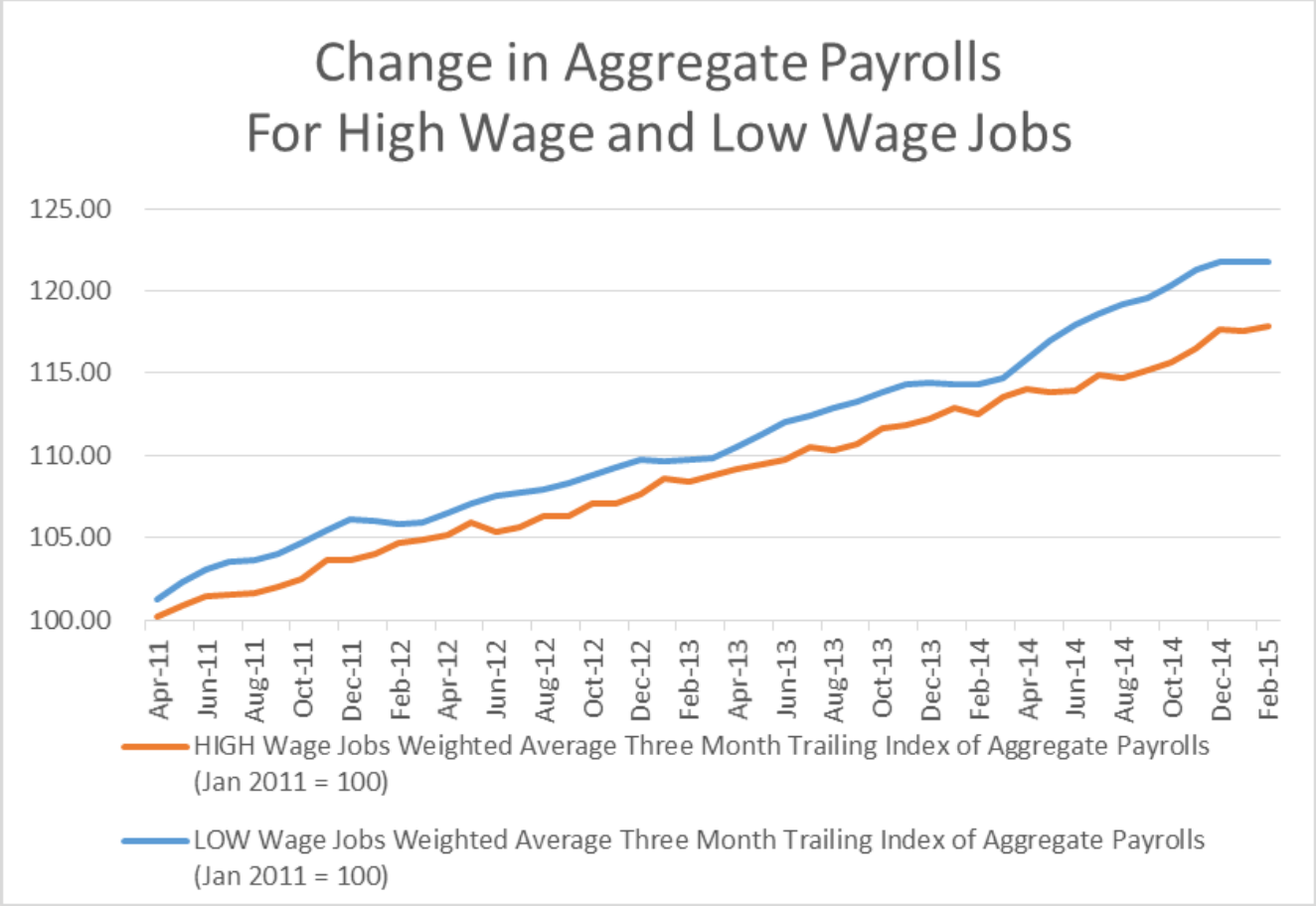
The U.S. Employment Situation Indicates Serious Secular Problems

Beginning in Q2 of 2014, aggregate payroll growth in high income sectors began to flatten while that of low wage sectors accelerated (Aggregate Payrolls = jobs x hours x wages/hour). There was a bit of catch-up in H2 2014, but beginning in December 2014 all aggregate payroll growth stalled (which could be partially seasonal).



Source: U.S. Bureau of Labor Statistics

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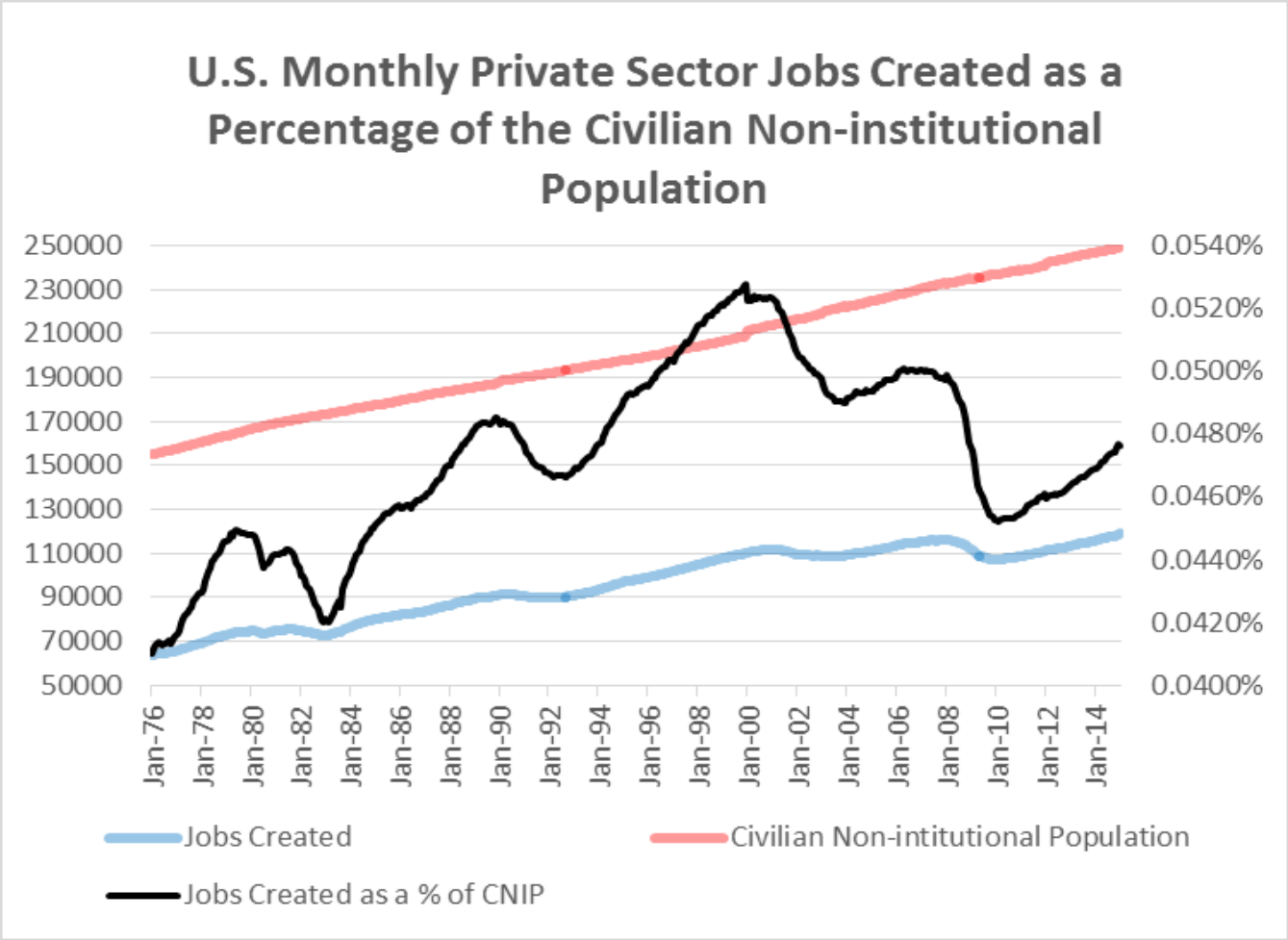
The monthly rate of job formation, as a percentage of the employable population, has strengthened since 2010. But it is still nowhere near the pace prior to the recession and is below any pace recorded from the end of 1994 through the end of 2008 (and, with the exception of the recession of the early 1990's, since early 1988). Prior to the 1980's participation in the labor force by women was at far lower levels, hence the lower rates in the graph at right.



Source: U.S. Bureau of Labor Statistics

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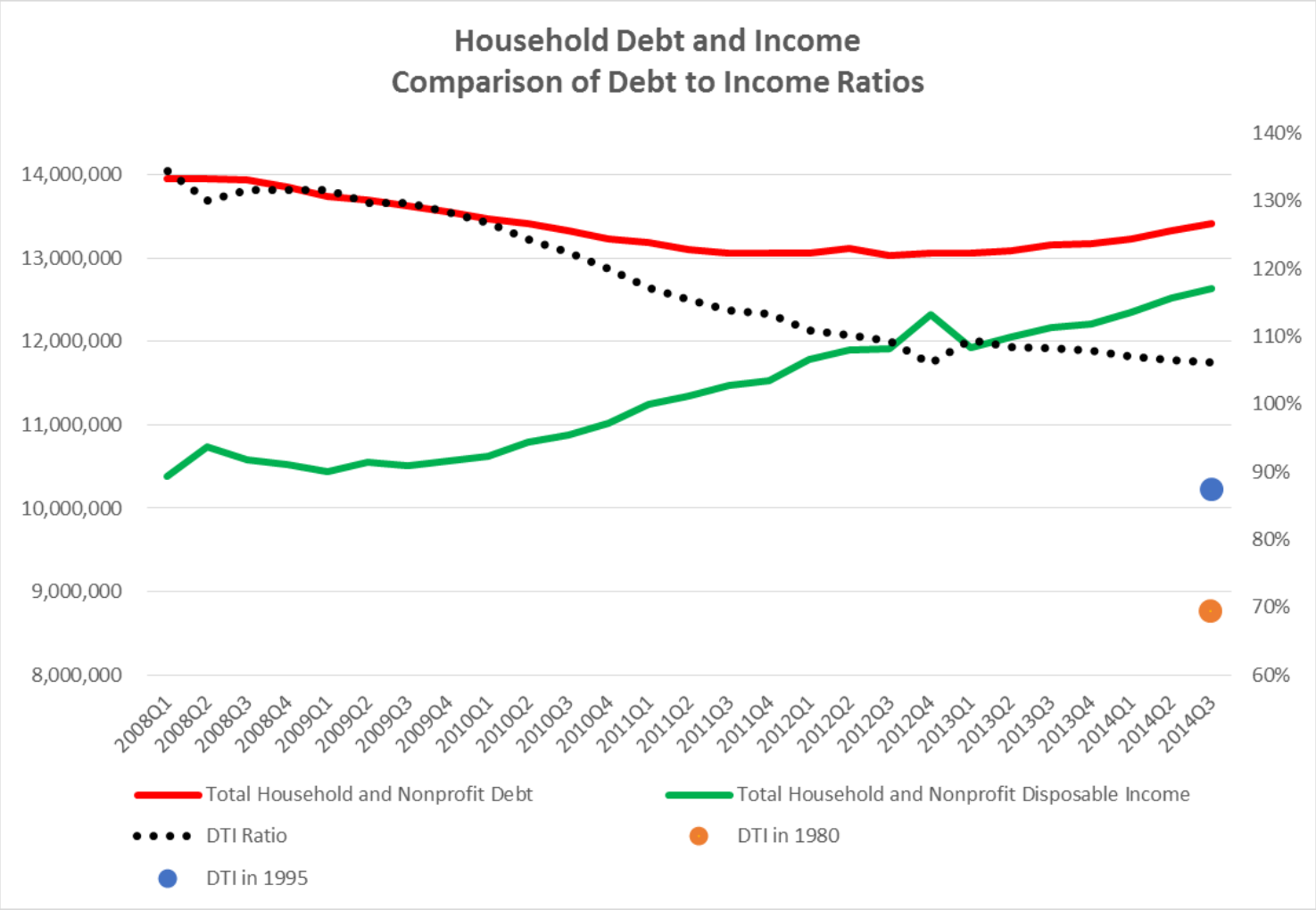
Household Debt is Still a Problem – Just Well Masked

- In nominal terms, household debt has only fallen by 4% since the peak of the credit bubble.
- Comparisons of debt to GDP are misleading, given how little of increased GDP is flowing to household sector (labor).
- Equally misleading are debt service ratios, which are lower today only because of zero interest rate policy and the global capital glut.
- The best we can do is to analyze debt to disposable income (imperfect because the income gains have not necessarily gone to those most indebted).
- DTDI has fallen to 106% from 134% - yet is still far from earlier norms.



Source: Federal Reserve Economic Data; FRB St. Louis

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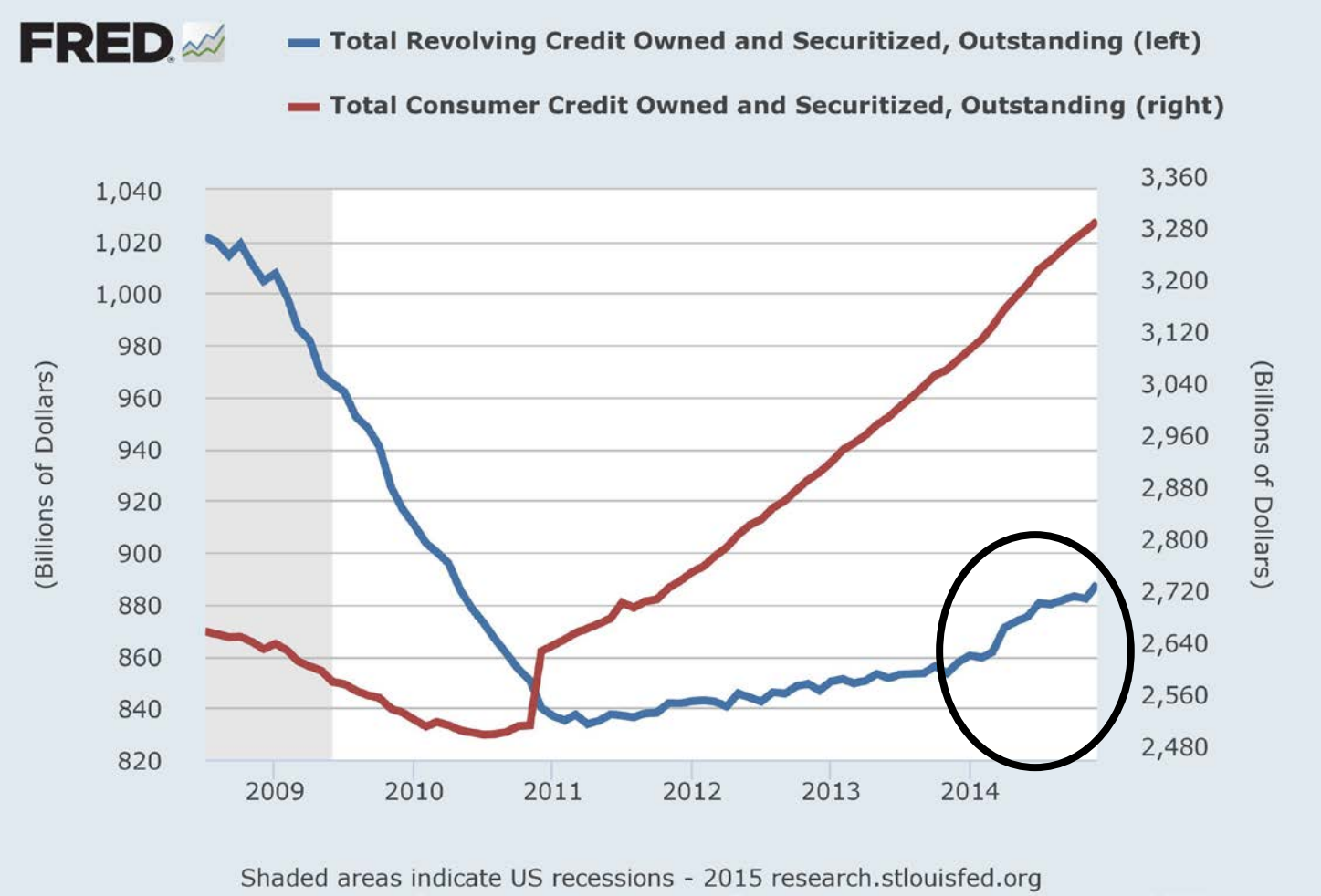
Household Debt is Still a Problem – 2014 and Revolving Consumer Credit



- After falling from its mid-2008 bubble-era peak, **consumer credit has skyrocketed past its former high by about 22% through Q3 2014**.
- The increase in aggregate consumer credit since its Q3 2010 low equals about 24% of the increase in GDP during the same period.
- Most of that increase was in auto and student loan balances.
- But **in 2014, the U.S. saw a spike in credit card balances which had previously remained fairly flat**. This could be confidence induced spending, of course, but it could also be banks loosening credit to households that have seen no real improvement in wages and are trying to make ends meet.

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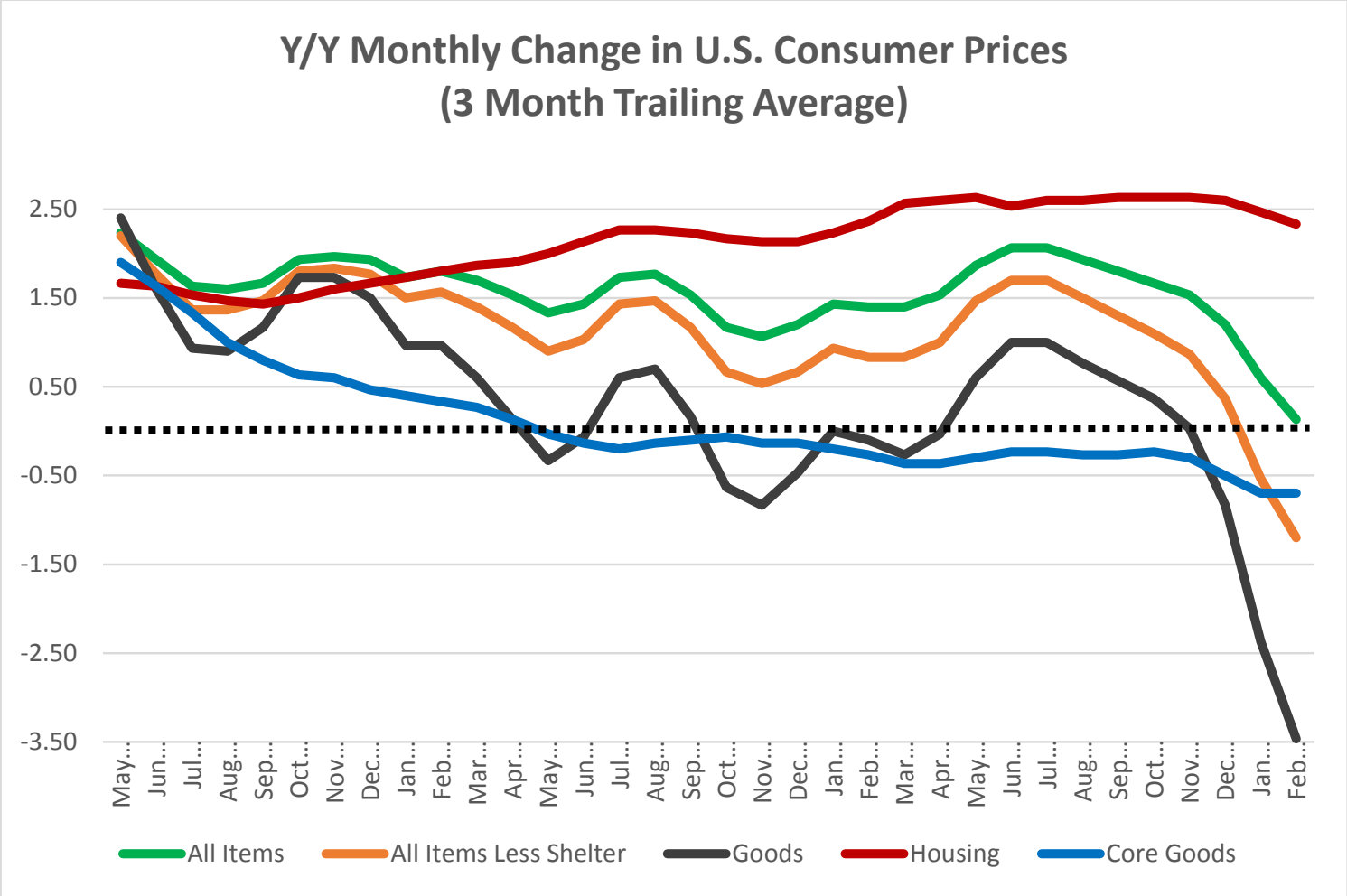
U.S. Disinflation is Limited Chiefly by Housing

- The U.S. has seen inflation at rates below the FOMC's target 2% rate for two years. ***The core goods portion of the CPI has been negative for nearly two years.*** Inflation in all items other than shelter deteriorated markedly in the second half of 2014, well before the oil collapse.
- In the U.S., the housing sector rents (and owners' equivalent rents) have for nearly two years been the only thing keeping U.S. inflation above other developed economy averages, and housing inflation is now beginning to subside.



Source: U.S. Bureau of Labor Statistics

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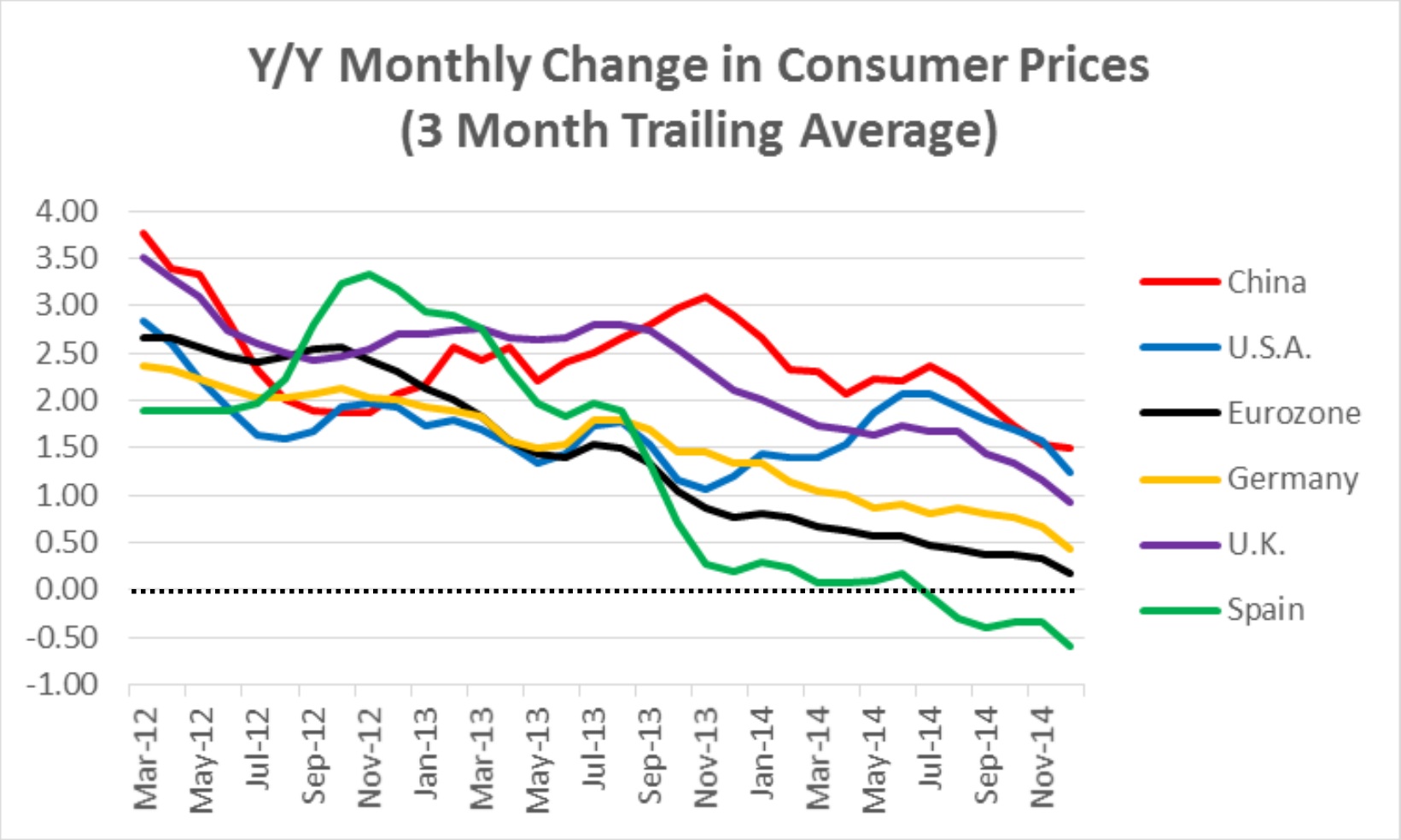
Disinflation/Deflation is a Global Phenomenon Effecting all the Developed Economies as well as China and some other Emerging Nations

- There is some expectation that the collapse of the price of crude oil and other input commodities will prove transient. But the fact remains that price trends in final production, and many services, have been negative for some time – aggregate consumer prices as well.
- **Japan** – deflation's canary in the coal mine – experienced short lived reflation connected with its massive devaluation of the yen under Abenomics. But, Japan is expected resume deflating.



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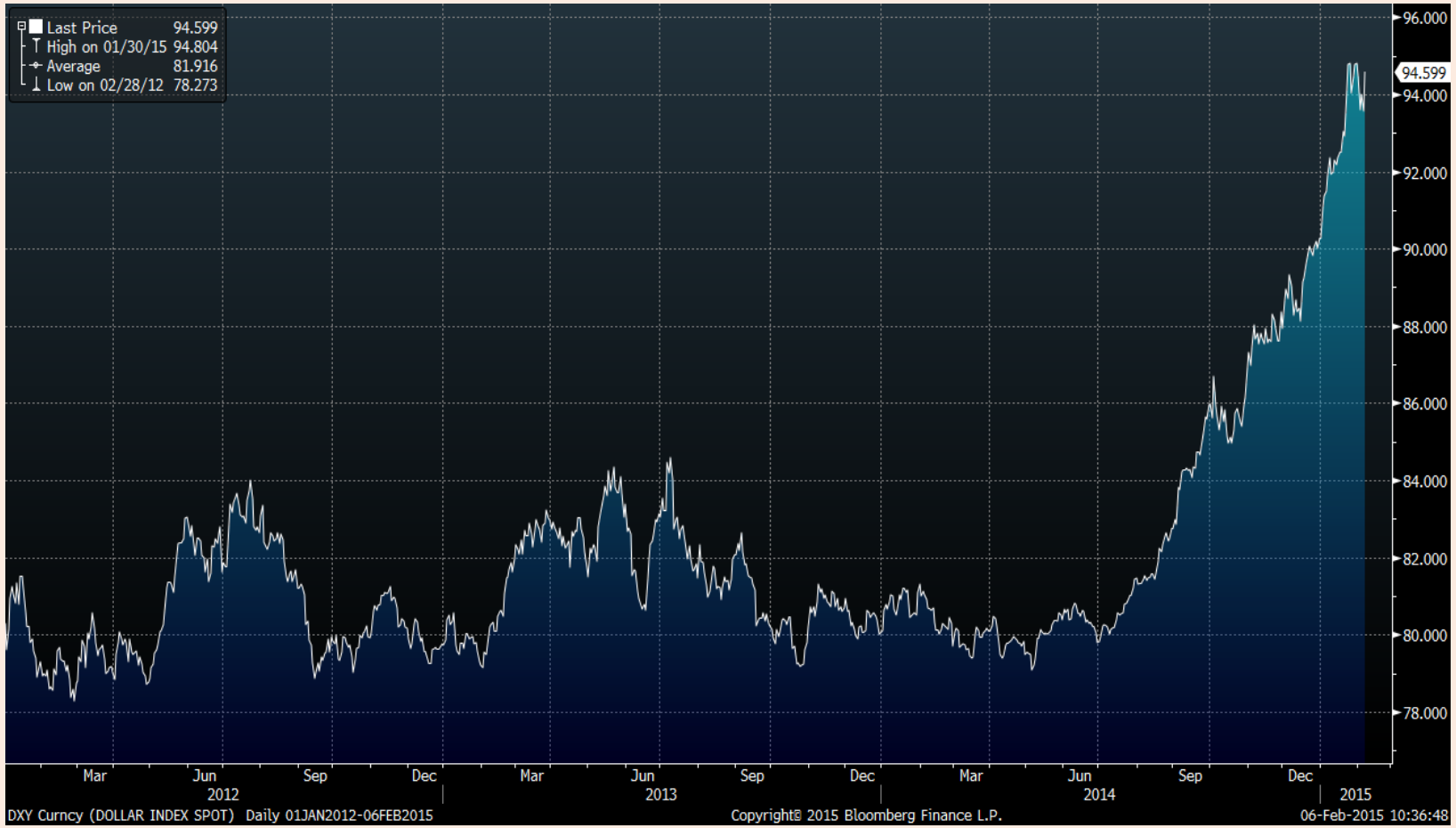
The Strong U.S. Dollar will Import Further Deflation and Limit Growth

- Weak global aggregate demand in an age of oversupply of labor, capacity and capital, has been the problem all along. In H2 2014 competitor nations began to scramble aggressively for more of a share of the inadequate demand by pursuing policies that led to massive devaluation against the US$.
- Japan and the Eurozone are pursuing extensive QE, while China is pursuing stimulative policies, widening the trading range of the RMB, and is not unlikely to become more aggressive in its policies that impact RMB/US$ valuation.



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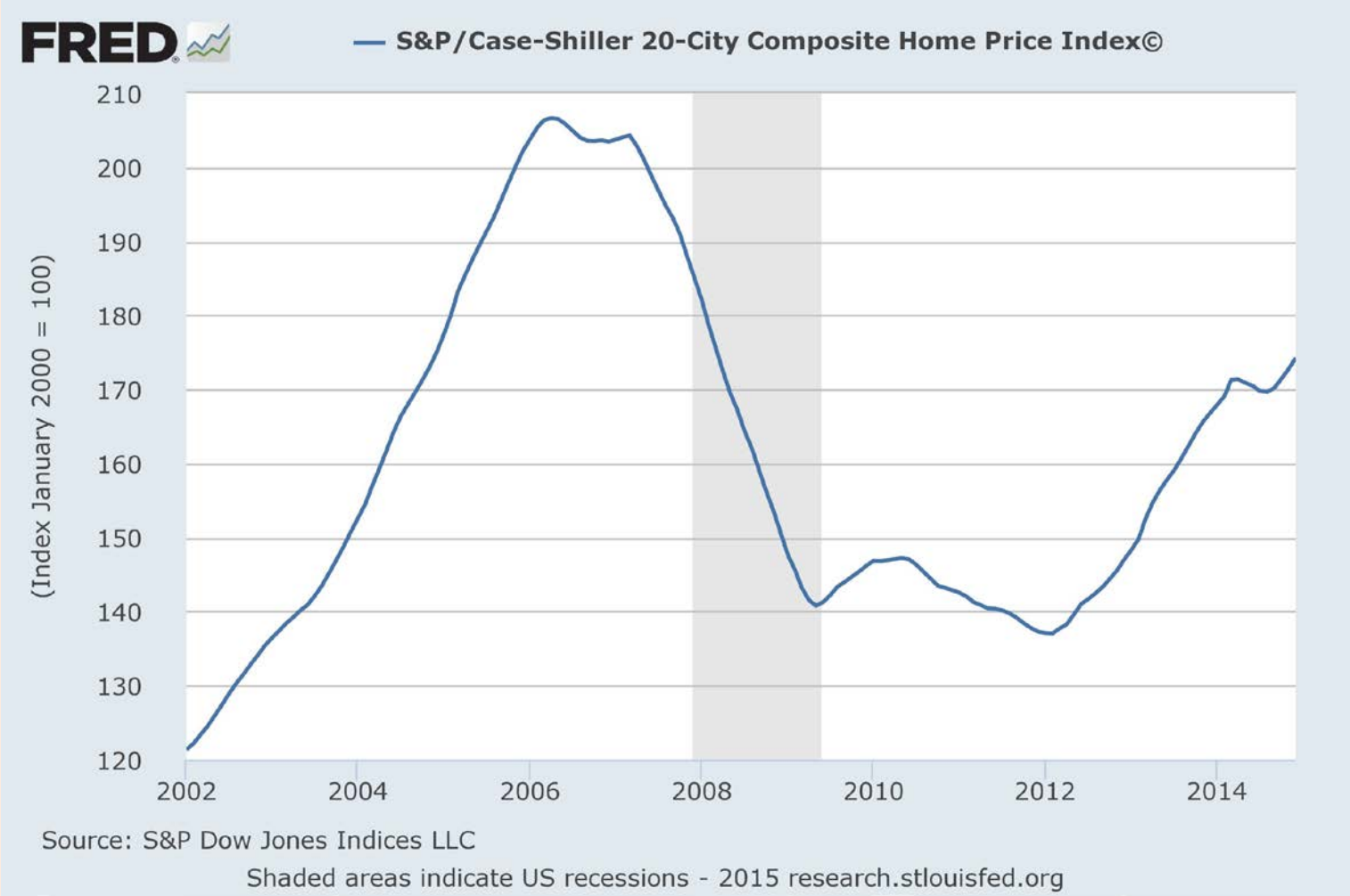
The Recovery in U.S. Owner Occupied Housing Prices Since 2012

From a crisis low in early 2012, U.S. housing prices have experienced nearly continuous recovery of over 54% of the value lost from 2006 through their nadir.

That long-term record-low interest rates have fueled much of that price growth is impossible to deny. That housing prices (as evidenced by the bobble in prices during the QE "taper tantrum" in the bond market during late 2013) are reactive to hikes in prevailing interest rates can hardly be ignored.

But there is more to this story than just interest rates…



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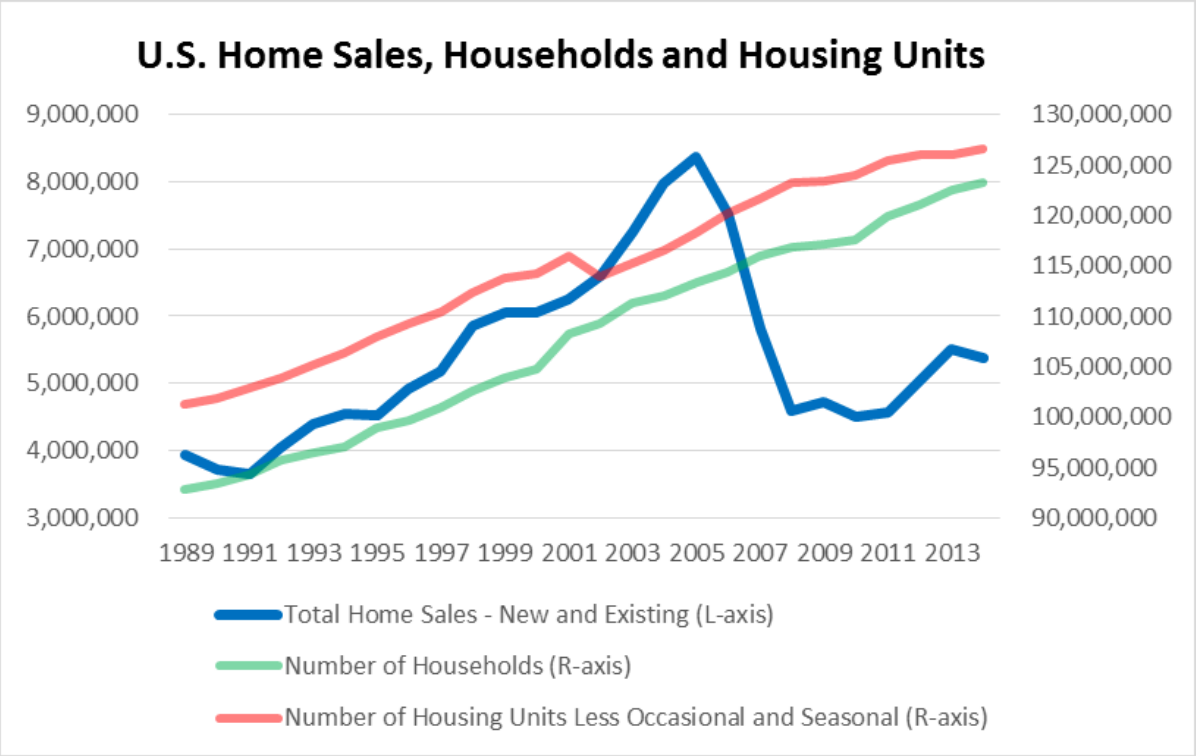
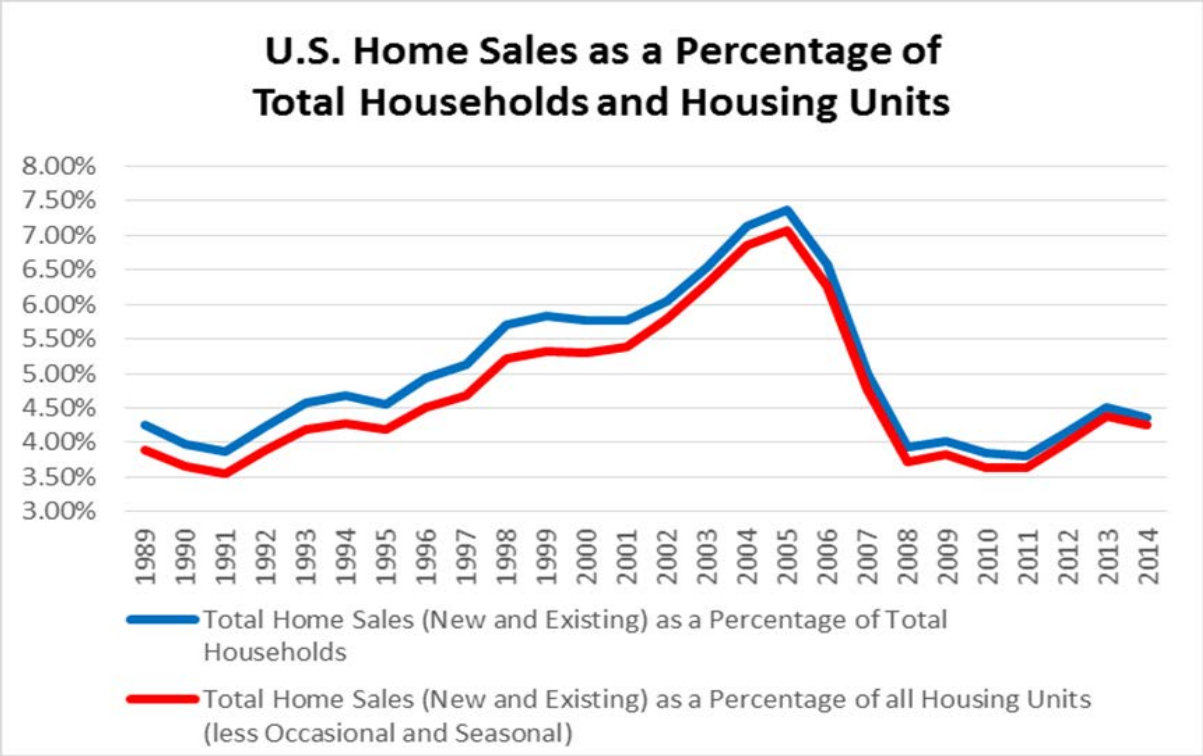
Demand for U.S. Housing has not Recovered Nearly as Much as Prices

Aggregate new and existing home sales volume expanded only 17.7%, cumulatively, during the three years that prices increased (2012 – 2014). Y/Y volume actually fell from 2013 to 2014. And cumulative sales growth is even lower when adjusted for growth in the number of households or housing units.





Sources: U.S. Census Bureau; National Association of Realtors, U.S. Federal Reserve Bank of St. Louis

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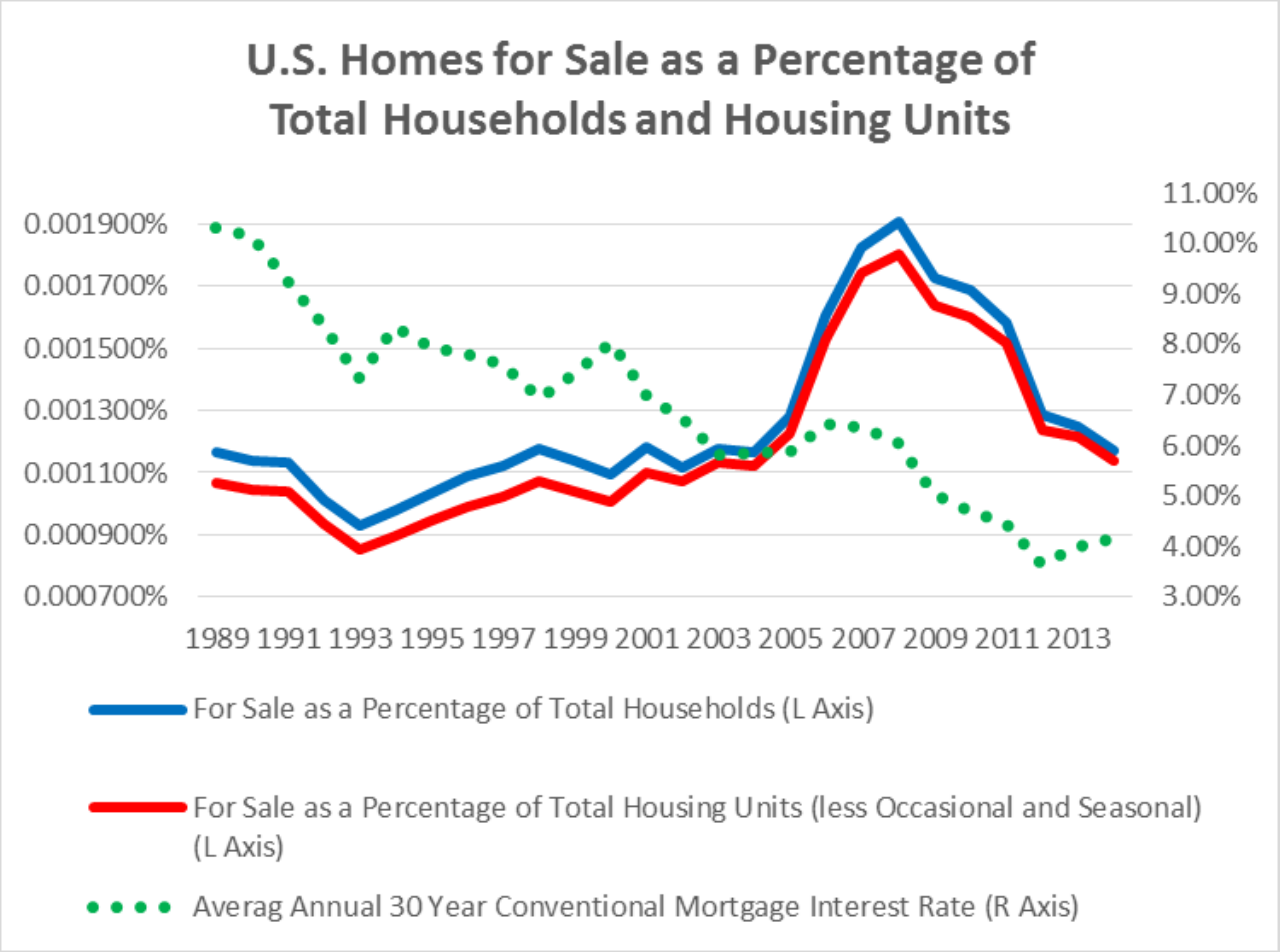
The Number of Homes for Sale, Relative to the Total Number of Households or Housing Units, has not Recovered at all – Despite Low Interest Rates

One would think that low interest rates alone, as a generator of higher home prices, would have drawn more buyers and sellers into the market.

Instead, the number of existing homes for sale, as a percentage of (a) the total inventory of homes and (b) the total number of U.S. households, continues to decline.



Sources: U.S. Census Bureau; U.S. Federal Reserve Bank of St. Louis

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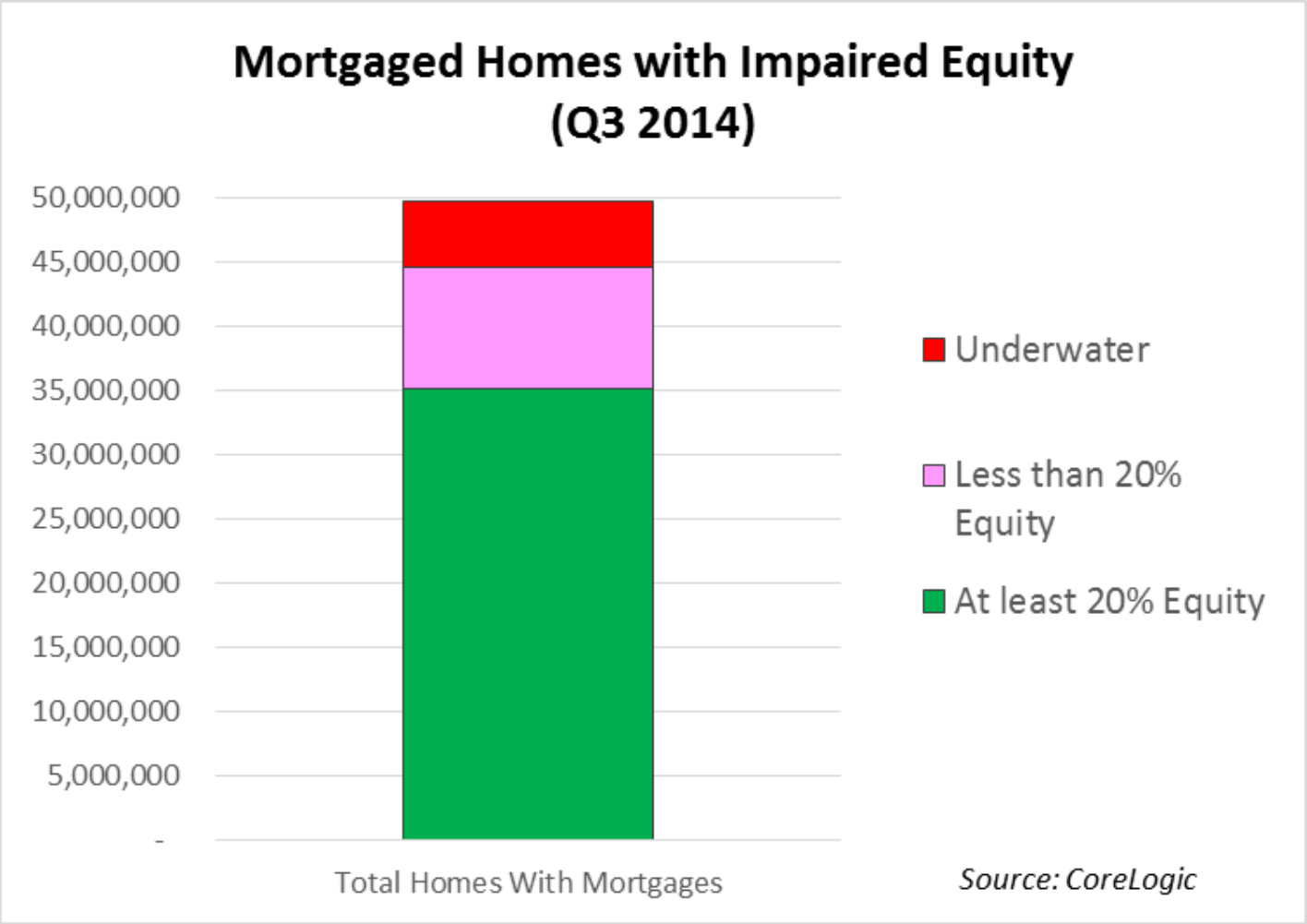
Home Prices are Rising Due to a Shortage of Supply, Not Robust Demand

Here's why:

- Even with the recovery in U.S. home prices, just under 30% of homeowners with mortgages either remain underwater or have insufficient home equity to trade an existing home for a new residence;
- An unknowable number of homeowners who have 20% or more of their home's value in equity, cannot qualify for a new mortgage for income or other reasons.



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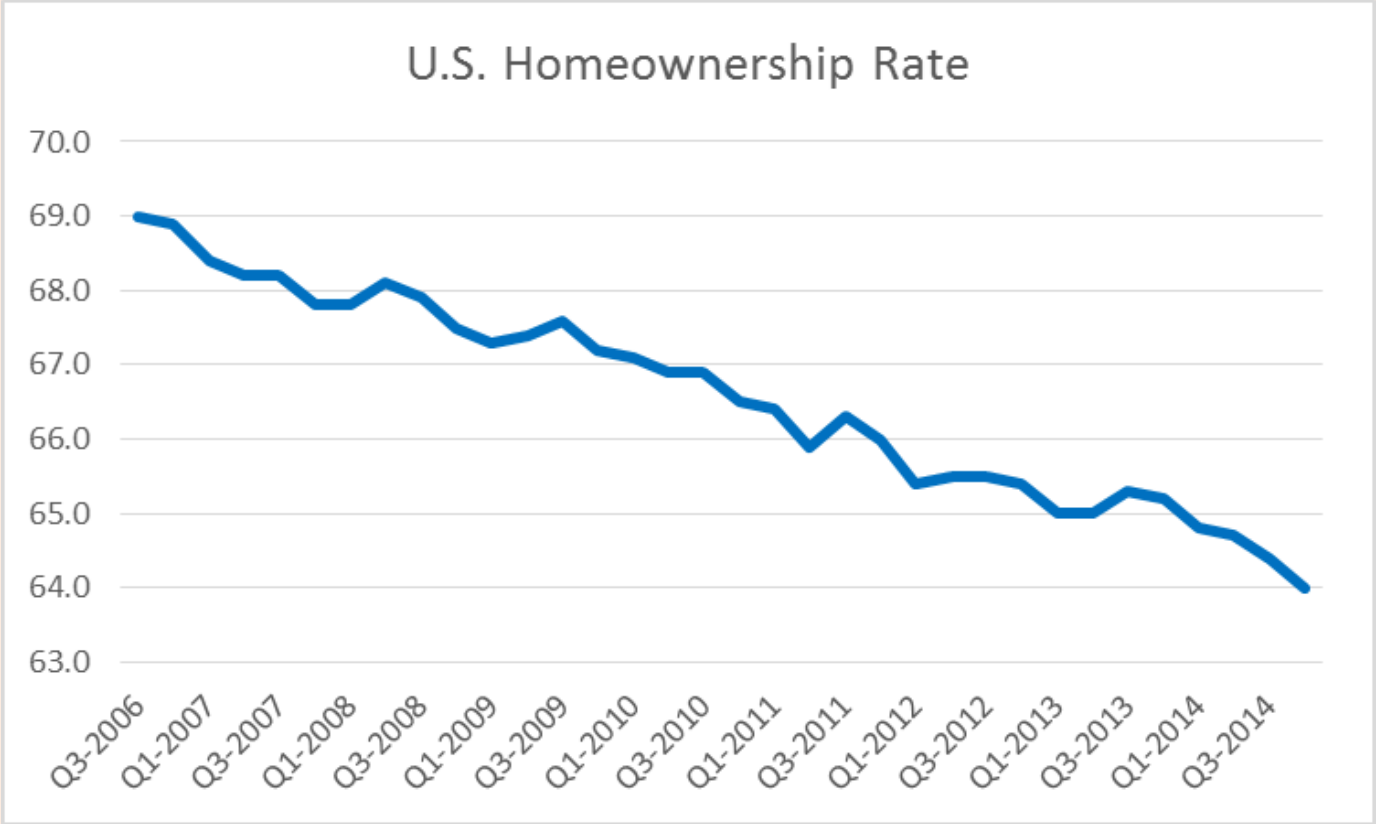
Those who Must Sell or Default, and Cannot Buy, are Forced to Rent

With short supply of homes for sale, the Homeownership Rate in the U.S. therefore continues to fall. But with supply artificially choked off, home prices have risen nevertheless. In the absence of rising incomes, this produces increased unaffordability which, in turn, forces even more American households into the rental market and….



Source: U.S. Census Bureau

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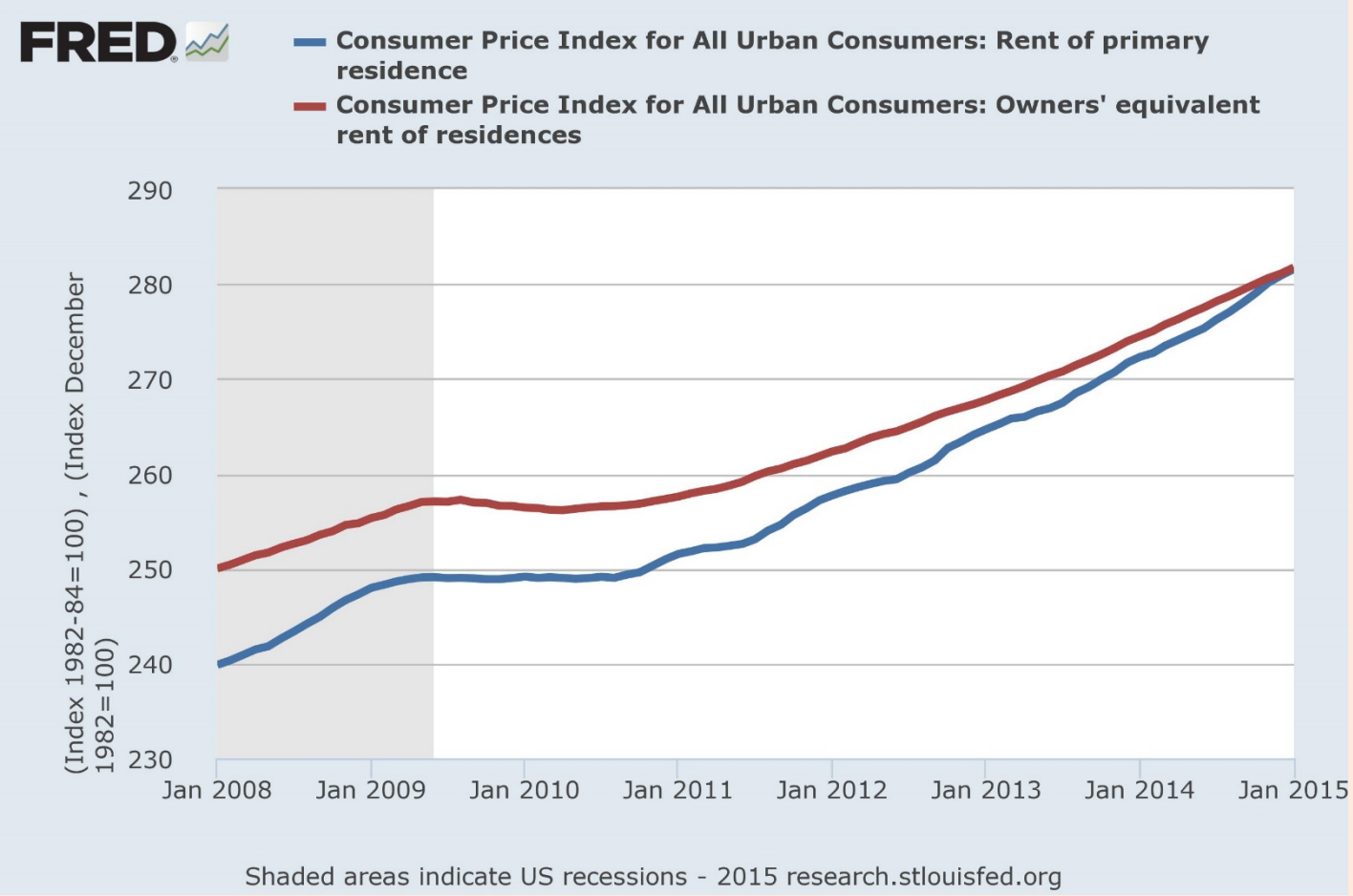
New Entrants to the Rental Market Continue to Apply Upward Pressure to Rents (both Primary Rents and Owners' Equivalent Rents)

Thus, the dislocations in the U.S. owner-occupied housing market raise issues of true price discovery in the rental market as well.



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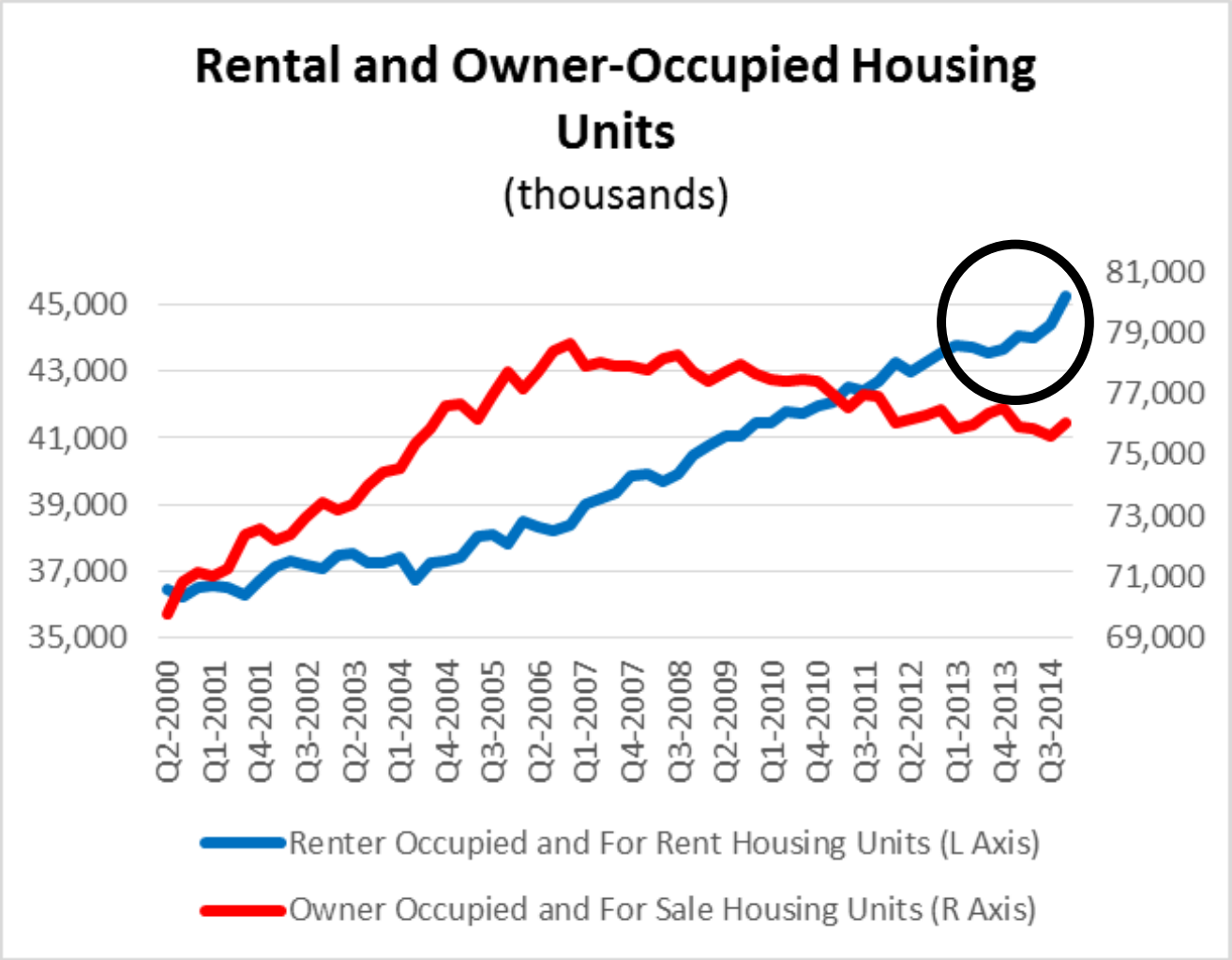
Rents are Rising Despite the Addition of Nearly Five Million Rental Units Since the Great Recession

Rental unit inventory has been growing steadily – up by approximately 5 million units since 2008. Recently, rental development has spiked considerably. Owner occupied home inventory has declined by approximately 1.5 million units since the Great Recession as obsolete units are not being replaced and some single family units have been converted to rentals.



Source: U.S. Census Bureau

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Conclusion

- Discussing a global savings glut, without understanding (a) the derivation thereof, and (b) the dimension, magnitude and historical uniqueness of the circumstances that have given rise to present-day global imbalances, leads to – at the least – incomplete policy prescriptions and – at worst – incorrect policy.
- Discussing secular stagnation in endogenous terms may yield significant truths. But ignoring exogenous factors underpinning domestic stagnation can result in policy detours through a sea of red (or at least "pink") herrings (education gaps, demographics, malaise, etc.).
- The present era of oversupply, coupled with blocked or impaired capital and price channels, is an historical anomaly that a century of economic thinking could not have contemplated based on observations of prior eras.
- Oversupply is not merely a reflection of inadequate demand. It is a condition wrought by the imperative of hugely labor-rich nations to find employment for their people and the desire of hugely rich nations to preserve asset wealth.

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