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Why Does a Great Economy Need Financial Aid?

By Lance Roberts *Thu, Feb 13, 2020*

'Artificial interventions have allowed the stock market to remain detached from underlying profitability. This guarantees poor future outcomes for investors,' writes our guest columnist, a strategist for RIA Advisors in Katy, Texas.

In President Trump's "State of the Union Address" last week, he talked up his achievements in the economy and the markets, including:

- Low unemployment rates
- Tax cuts
- Job creation
- Economic growth
- Record-high stock markets.

While he can claim credit for most of the items on this list, his claim of record-high stock prices undermines the rest of the story. Let me explain.

The stock market should reflect actual economic growth. Corporate earnings are derived primarily from

- Consumptive spending
- Corporate investments
- Imports and exports

Economic activity should therefore determine the price investors are willing to pay for the earnings being generated.

For the majority of the 20th century, this was indeed the case. Corporate earnings reflected economic activity. The economy grew at 6.47% annually and earnings grew at 6.68% annually. Since investors will pay a premium for earnings growth, the S&P 500 grew at 9% annually over that same period.

But economic growth has been running below the long-term average since 2000. The economy has grown at just 2% annually since 2007.

Artificial stimuli

If that's true, why is the S&P500 Index at a record deviation from that growth? A decade of accounting gimmickry, share buybacks, wage suppression, low interest rates, and high corporate debt levels explains it.

If consumer spending is strong, *and* unemployment is near the lowest levels on record, *and* interest rates are low, *and* job creation is high, why is the economy growing at only 2%? Why do we need deficit spending and Federal Reserve need to provide "emergency measures" to prevent the markets from crashing?

Because, otherwise, the economy would be in recession.

In GDP accounting, consumption is the largest component. Our high rate of consumption has come from growing debt, however. Government spending (transfer payments such as Medicaid, Medicare, disability payments, and SNAP or food stamps) all contribute to the calculation.

But it is impossible to "consume oneself to prosperity." Transfer payments may boost GDP, but they produce nothing and drive up the national debt. If the economy were "the strongest ever," wages and tax receipts would be rising. Instead, since peaking in 2012, tax receipts have declined to recessionary levels.

The inevitable reversion to the mean

These artificial interventions have allowed the stock market to remain detached from underlying profitability. This guarantees poor future outcomes for investors. The markets can "remain irrational longer than logic would predict," but not indefinitely. Peaks (and subsequent reversions) in the profits-to-GDP ratio have been a leading indicator of severe corrections in the stock market over time.

Investors may hope that as long as the Fed supports asset prices, the deviation between fundamentals and fantasy won't matter. But investors are paying more today than ever for each $1 of profit, and history suggests it will not end well. Asset prices will eventually reflect the underlying reality of corporate profitability.

There's political risk for President Trump in taking too much credit for an economic cycle that was well into recovery before he took office. Rather than tout the economic numbers and financial asset prices, he should use that strength to end the government spending-binge and return the country to fiscal discipline.

Politicians, over the last decade, could have used the liquidity injections, near-zero interest rates, and surging asset prices to refinance the welfare system, balance the budget, and prepare for the next downturn. Instead, the U.S. economy will enter the next recession with a $2 trillion deficit, a $24 trillion national debt, and a $6 trillion pension gap.

Donald Trump criticized "Yellen's big fat ugly bubble" before he took office, but he has bet his presidency on the stock market. He's likely to regret it.

A longer version of this blogpost, including charts, can be found here:
https://realinvestmentadvice.com/sotm-2020-state-of-the-markets/