The Renaissance Paradox : Mainstream America's Delusion with Economic Recovery

What you need to know about what Wall Street doesn't want you to know!

By Joshua Enomoto | JYE Financial

Financial journalist and former CNN anchor Ali Velshi was often fond of describing the next several years of America's future as a potential "New Economic Renaissance," citing advances in natural gas and crude oil production, as well as a housing recovery. Not to be left out of course is the dramatic rise in the equities sector, specifically the large capitalization companies that constitute the major indices such as the Dow Jones Industrial Average and the S&P 500. If only partisan politics would get out of the way, Mr. Velshi reasons, then we could truly realize the catalyst we are sitting on. “There is no impetus for Congress to do the right thing,” he lamented last year. “They choose career and self-preservation over the good of the country, and that frustrates me to no end.”

But is it merely politics that is capping the economy's potential? While there's no doubt that partisan bickering has sidelined important developments, such as the Keystone Pipeline project which according to a State Department environmental report concluded that it will not have a big impact on carbon emissions, it's difficult to make a case that Washington acrimony is the Hoover Dam to nationwide prosperity. First, political gridlock is hardly new and past administrations have had to deal with enormous challenges irrespective of the fluctuations in macro-economic cycles. The argument that the Obama administration is uniquely argumentative with the Republican party may be true based on a number of embarrassing incidents that have occurred under his office's watch and his ever eroding popularity, both within the United States as well as international powers that have routinely challenged the White House's authority. However, do party lines always dictate economic performance? The greatest boom in stock market valuation occurred during the double terms of President Bill Clinton, a Democrat if there ever was one, while the severest financial collapse in modern history happened at the tail end of George W. Bush's administration, in many ways assuring that the perceived anti-business Democrats would once again wrest control of the executive branch.

Second, it's not clear that the economic engines that Mr. Velshi referred to will actually perform as intended. For instance, the natural gas revolution that is supposed to arise via hydraulic fracturing, colloquially known as "fracking," has several critics, primarily citing cost inefficiencies. According to information provided by Green Tech Media, conventional natural gas production may have peaked during the mid-1990's, raising concerns about the higher costs associated with newer extraction methods negating profitability, and the uncertainty of readily available fuel supplies. Also, despite the nominal increases in domestic natural gas production, its spot price, or the price found in the open market, has only soared : even though some of the price increase is understandable due to the statistically anomalous weather patterns that were experienced during this recent winter season, a single incident does not account for the wide breadth of the amplified market trend.

Even if political acrimony could be completely excised, what exactly would that accomplish? Is the acrimony responsible for the 47 million Americans that are on food stamps, roughly 16% of the entire population? Has Obama's executive orders, or the residual policy ghosts of George W. Bush that always seems to haunt the liberal "blogosphere," rendered the millions who are looking for work permanently unemployable? If Mr. Velshi's assertions were true, a collective hug fest and a random singing of Kumbaya by members of Congress is all that would be necessary to get us on that Renaissance track! But time after time, we come to the realization that key economic metrics, dismal as they are, are even worse when dismissing the government's creative accounting. Much worse, in fact, for certain indicators such as the labor market, where a Forbes report suggested that real unemployment stands at 14.3%, a far cry from the official rate that meanders around the 7.5% mark.

As far as housing is concerned, the heavily touted recovery by mainstream publications such as Money magazine have operated under a false mathematical premise. According to their April 2013 edition, which ran with the unambiguous headline, "HOUSING IS BACK," the financial publication cited price increases, some as high as 23% in Phoenix and 17% in San Francisco, as well as sales volume rising in 69 of the top 100 markets, with 35 showing double-digit gains. Notwithstanding their open admission that 2014 will likely be a "transition year" due to forecasted instability in the short-term picture, the editors of Money magazine appear to take considerable liberties as to what the term "recovery" means. Citing mere price increases are irrelevant unless those nominal prices are compared against the average purchasing price of those millions of Americans who suddenly found themselves underwater. It's journalistically irresponsible to state that the Phoenix market lifted 23% without also revealing how far it collapsed under the real estate bubble. Otherwise, we're not only comparing apples to oranges : we're just comparing apples, period. Percentages have a strange way of saying everything and nothing, hence the expression "lies, damned lies, and statistics."

One must further take exception at the term "sales volume." Volume is another fancy metric that is often touted by biased parties attempting to sway a particular discourse in their favor, but in reality, the term has very little meaning outside of proper context. Real estate volume has elements in common with the volume metrics cited in commodities trading. In both cases, they establish a running record of the nominal transactions that were conducted, but not much else. In order to gauge which entities are executing the transactions, as well as the net number of "completed transactions," or transactions that result in the transfer of ownership of an asset, we must reference what commodities traders call open interest. This is critical in establishing the overall sentiment of the market.

If we were to conduct an "open interest" analysis for the real estate sector using data provided by the Department of Housing and Urban Development, we would see that most of the aforementioned sales volume is recently occurring within segments of the population that already own real estate. The metric that few in the mainstream talk about, purchasing trends for first-time buyers, is actually quite bleak. Wealth concentration, a distinct problem within the stock market where a majority of public equity shares are owned by a small minority of Americans, is also prevalent in the housing market.

Are politics responsible for this financial dichotomy as well, where a recovery in either property or security related investments are only enjoyed by an elite few and the rest of middle-class America are left fighting for the crumbs? Hardly! Forward guidance and protocol, whether provided by a Democrat or Republican, can hardly exert that much leverage towards the fundamental fissures that malign the current economic infrastructure, one that substantially threatens any substantive resurgence.

Words, as we know, are cheap. Actions speak profoundly and carry infinitely greater weight. If the government could talk its way out of its problems, surely it would! What better tool, should such a ridiculous concept exist, to utilize in order to extract what so many people believe is utterly impossible? When the money flows, no one is the wiser. If there are criticisms, they would swiftly be drowned out by the quiet complacency of a heartily employed constituency. In most corners of politics, there are only winners when the economy itself is the biggest one of all.

But once the money pot dries up, guards are instantly raised. Daniel Kahneman and Amos Tversky, in their work, "Prospect Theory," quantifies the unbalanced emotions people experience during moments of financial decline. Their study revealed how individuals are much more upset by prospective losses than they are pleased by equivalent gains, an unsurprising conclusion especially in the current political environment, where some of President Obama's ardent supporters have noticeably kept their distance. It stands to reason, then, that if an artificial stalemate was the only impediment to robust economic growth, that path would have been the first one chosen.

Instead, we may have found ourselves in an ironic plot twist, a fiscal M. Night Shyamalan story before he himself lost the plot (*Lady in the Water*, anyone?). Actually, we have no need to become that existentially vague but must simply come to the realization that it is the dog that chases the tail, not the other way around. The empty talk and scripted posturing by both sides of the Capitol Dysfunction is a natural byproduct of desperation, a painful acquiescence that the last bullet has been expended but not painful enough to cease the transaction of moral integrity for a perceived allotment of time, or at least enough of it to survive another election year.

Nearly six years removed from one of the worst stock market collapses in the history of the United States, how much more can the government do? On surface level, this may sound like a ridiculous question, and perhaps it is. Nevertheless, the question remains and one that should not be confused for Washington apologetics. The government has bailed out some of the nation's mainstays, such as General Motors and American International Group. Even private firms, such as J.P. Morgan, were instrumental in bringing together a workable solution to the banking crisis, which saw centuries-old Lehman Brothers, an investment firm that first started business a decade *before* the American Civil War, go belly up. And not to be outdone of course is the Federal Reserve, the starlet of an ongoing fiscal drama that is resigned to play a bipolar character in front of an equally demented audience.

Whether the Fed is a private corporation conceptualized by the Rothschild bloodline or less sinisterly, an organization without a clue is beyond the scope of this paper, an interesting diversion that may be debated at another point in time. The psychosis that I reference is something more terrifyingly rational, if not outright mundane. All of the monetary policies that the Fed pursues follows an accounting logic, that is, a duality in every transaction. Like the stock market, every action has two sides, a buyer and a seller. For the Fed, which is charged with maintaining economic stability primarily through the regulation of monetary supply, it must accept the reactionary impulse for every action committed.

The quandary that has been apparent for those with knowledge of the subject is the over-commitment by the central bank to aggressively attack a crisis that is seemingly part human frailty and manifest destiny. Ben Bernanke, the chairman of the Fed who presided over the housing and banking collapse, wrote in his dissertation decades earlier that the visceral agony of the Great Depression could have been avoided had liquidity been forcibly injected into the system, restoring confidence in the dollar precisely at a time when there was none. History obviously shows that the U.S. did not undergo such coercions, allowing businesses and banks to fall under the weight of stock market speculation gone awry.

But with the modern variety of a deflationary crash now on the global agenda, Mr. Bernanke stood on the crossroads of history, his history. Seldom do economists get a chance to take what amounts to a very theoretical discipline and apply it to the real world : arguments about the "could-haves" and the "would-haves" can precipitate indefinitely, especially on a contentious (read vague) subject such as the Great Depression, a historical relic that very few today can relate to from personal experience.

A paradox within the great central bank was not that they were tasked with finding a solution to the country's problem, which is a violation of free market capitalism and of the core principles of the Efficient Market Hypothesis (the scriptural edicts of today's banking community), but rather, that the Fed employed the very tactics that precipitated the crisis in the first place. The argument that government should stay out of the free markets is a legitimate one and certainly, the extracurricular activities authorized by the executive branch has reverberated consequences into our current fiscal environment. However, that does not account for the majority of the problem.

That people across the global divide love speculation is materially undeniable. Gambling is one of humanity's oldest institutions and the Las Vegas casino industry does well regardless of the economy. Speculation is at the root of virtually all market run-ups and collapses, distorting the price dynamics of everything from tulips to gold bullion. Typically, this leads to individual ruin, a tragedy that is only absorbed by those that participated in the speculation.

The problem becomes endemic when speculation is nationalized. It's one thing when your gardener gives you advice on the "next big thing." It's quite another when economists, analysts, or even the Fed chairman himself proclaim that the markets will continue moving higher, that we have transitioned into a paradigm where sound investment principles of the past are no longer relevant. While the caveat has always been to never trust the advice of any one person or entity, it's difficult not to sympathize with the general public's perception : these are, after all, the experts in the field of finance. Plus, their message of untold wealth and riches align perfectly with the innate desire in all of us to speculate.

But speculation alone cannot initiate a market bubble. Somehow, that exuberant greed must be financed. Enter the fractional reserve banking system. Under such a system, the maintenance of money flow is executed by a network of banks reserving a fraction of funds into a physical reserve while loaning out the rest, creating an environment where the monetary supply at any given time is never fully backed by physical reserves. Instead, the monetary supply is **backed by the flow of money**, that is, the confidence of our financial system rests on the public's acceptability of it, a concept I refer to as the "trust quotient." Critics dismiss the idea of fractional reserve banking as a clever way of saying "money printing." That conclusion, though somewhat over-simplified, is absolutely correct.

Everyone benefits so long as everyone pays their bills. For example, in exchange for getting internet and cable services, we would write a check to the provider company. The company would trust that we can make good on the check ; otherwise, society would be forced to regress to a cash-basis system where transactions are limited only to the exchange of "real money," not its derivative instruments.

Unfortunately, the amount of derivative instruments outnumbers the real money supply that is available to redeem the derivatives. The Fed offered a temporary solution by increasing the monetary base in exchange for long-term assets such as 10-year Treasury notes. But if the bond market collapses due to higher interest rates undermining the value of older, issued bonds that feature a lower yield, the biggest loser would be the Fed! Since the composition of their balance sheet is primarily made up of longer-term assets, a spike in rates would undermine the fragile balance between their assets and liabilities.

The Fed has no easy choices. In my opinion, former chairman Ben Bernanke saw the writing on the wall as he attempted the first round of monetary stimulus to mixed results. Yes, there was a measure of success in terms of the liquidity that was added and the placebo effect that it had on the everyday citizen that the government was doing everything in its power to prevent a full scale meltdown. That the United States and the rest of the free world never saw that meltdown is a tribute to the efforts of Mr. Bernanke. But somewhere down the line, perhaps in late 2010 or early 2011, when commodity prices were blowing through the roof, the stark realization that there would be no palatably easy answers must have been evident to all participants aboard. Knowing this, the chairman pulled out all the stops to get some semblance of market stability before he would quickly and judiciously exit front and center. I have to believe that even an intellectual of his standard must have been surprised by the robust reaction of the large cap equities sector, a miraculous gift that enabled him to retire a champion and enter into the public speaking industry carrying a hefty premium.

Janet Yellen may not turn out to be so lucky. The circumstances she faces would define a bloody stalemate as victory, so far removed is the successor to the throne from achieving the substantive stability that Mr. Bernanke failed to institute. At this juncture, the Fed has three viable options, one of which isn't really an option but more of a safety valve :

- Stay the course, tapering down their monetary stimulus as prescribed and hoping that interest rates don't rise sharply to the point of upsetting the compositional balance of their books.
- Abandon the course, choosing instead to add to their balance sheet with the purpose of reinvigorating the labor market.
- Accept the consequences of monetary intervention by writing off any imbalances on the books, which would entail de-facto "money printing."

Of the three, the Fed has chosen to stay the course, Bernanke's parting gift to his compatriots. It just has very little chance of working without setting off the landmines of either cost inflation or rapid decompression of economic activity. If interest rates rise, the Fed would have to address the liabilities on its book against a declining asset base. The liabilities would have to be settled in cash, which may entail some form of dilution of the monetary supply to lessen the obligation's burden. If somehow interest rates stay relatively the same, but the labor market continues to underperform, then a further injection of liquidity would be necessary in order to prevent a collapse. This would only raise the stakes higher at a time when the stakes are already high enough.

One thing that we can note with absolute clarity is that no government policy or lack thereof is preventing an economic renaissance from occurring in the United States. Rather, there are myriad obstacles including political acrimony, but mostly comprising of fundamental, mechanical, and cultural vulnerabilities that have not yet fully manifested itself. The nation's priority is to prevent that manifestation, which certainly would require bipartisan cooperation, a theme that Mr. Velshi has consistently argued in favor of.

Sadly, mere cooperation is not enough. The government would require a comprehensive effort on attacking the multiple holes in the American economy, necessitating adjustments to tax laws, corporate governance, non-economic expenditures (ie. military industrial complex), pension liabilities, and healthcare costs, to name but a few. Even if special interests and lobbyists allowed for such "unpalatable" actions to be taken, that would still not account for market risk, or the reactionary behavior of the investment community. Bonds could collapse, taking the Dow with it, threatening not only the compositional asset base of the Federal Reserve, but also initiating capital flight, the movement of money away from American infrastructure.

There are no easy answers...

This concludes the free sample of our e-book, "The Renaissance Paradox," which will be available at **BullishMoney.com** in May 2014.

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