Opinion **Equity valuation**

US economy is dangerously dependent on Wall Street whims

The Federal Reserve faces pressure to keep cutting rates to keep asset prices high

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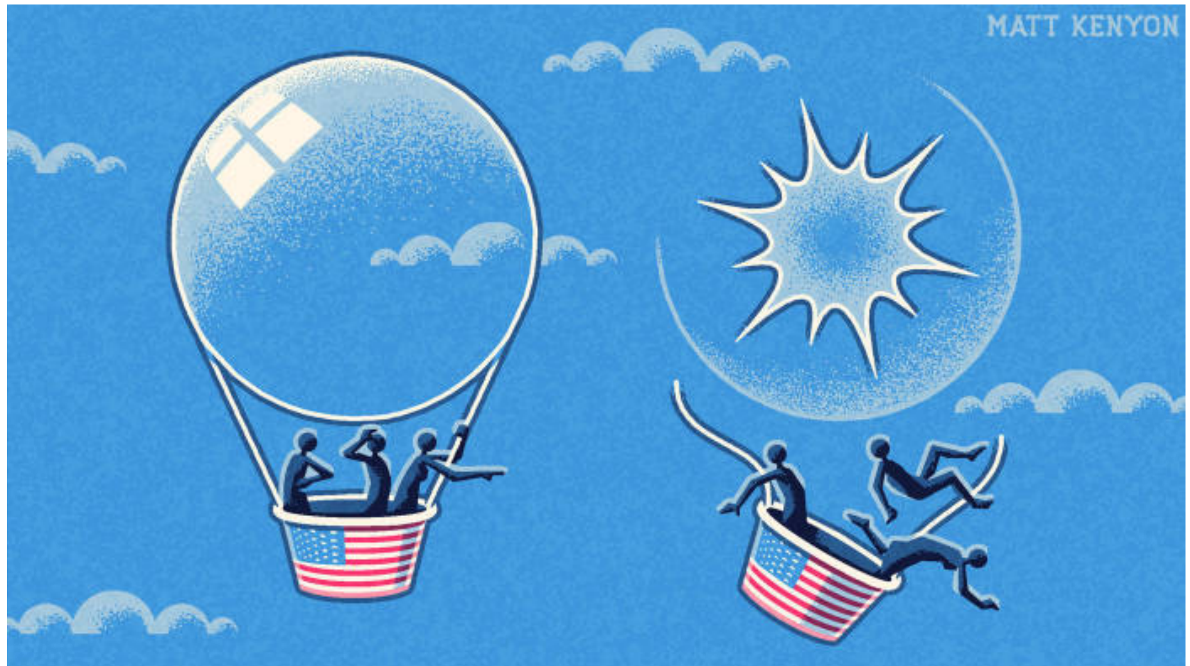

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Watching the markets these days is like watching the seven stages of grief — shock, denial, anger, bargaining, depression, testing and, finally, acceptance. We clearly have not reached that last stage yet. This isn't really about coronavirus — that was simply a trigger for a correction I have long expected. The US is in the longest economic recovery cycle on record, with mounds of global debt, falling credit quality, and decades of low interest rates driving asset prices to unsustainable levels.

The reluctance of investors, politicians and central bankers to

accept that is not just an example of the natural human tendency to put off pain. Rather it is something scarier and more factual. The truth is that the US economy is now dependent on asset bubbles for survival.

This was sharply quantified in a recent edition of financial analyst Luke Gromen's weekly newsletter "The Forest for the Trees". About two-thirds of the US economy is consumer spending. But people's spending patterns are not based on their income alone. Our personal consumption is also linked to our expectation of wealth held in assets like stocks and bonds.

What's stunning is how utterly dependent American fortunes have become on the inflation of those asset prices. Mr Gromen has calculated that net capital gains plus taxable distributions from individual retirement accounts are equal to 200 per cent of year on year growth in US personal consumption expenditure.

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That does not necessarily mean that people are pulling money out of their retirement accounts to buy hand-sanitiser, bottled water and face masks. But Mr Gromen argues that it does mean that US gross domestic product "cannot mathematically rise if asset prices are falling".

No wonder the US Federal Reserve cut rates by 50 basis points last week. The move came with a predictable risk of spooking the market — and it did so. The S&P 500 fell nearly 3 per cent that day.

But the fundamental risk of inaction was deemed greater.

Central bankers are clever people. They know that they cannot fix pandemics or political dysfunction with monetary stimulus. But in the US more than anywhere, they have found themselves in an unenviable position: managing an economy that has, over the last several decades, and particularly since 2008, depended on low interest rates to push up asset prices. That in turn has made it less obvious to consumers (and voters) that average real weekly earnings for the bottom 80 per cent are at about the level they were in 1974, and that the things that make people middle class — healthcare, education, and housing — have become unaffordable.

Seen in this light, President Donald Trump's disingenuous attempts to equate the fortunes of Wall Street with those of the country at large make a kind of grim sense. The value of the S&P 500 is less a gauge of the broad health of US corporations or consumers than it is of the wealth of a few tech firms and value of the 2017 tax cuts. The latter accounted for two-thirds of the aggregate rise in corporate profits between 2012 and today.

But share price increases represent a disproportionate amount of the income tax paid by the top 5 per cent of earners, who pay 60 per cent of income tax receipts. Given the importance of asset price increases in both tax receipts and GDP growth, it is hard to imagine a world in which the Fed won't keep cutting rates indefinitely. Live by the market, die by the market.

It did not have to be this way, and this situation did not develop overnight. The US built an economy that is dangerously dependent on the whims of Wall Street little by little, since the 1970s onwards. It is the result of policy changes driven by both Democrats and

Republicans.

Among them was the 1982 rule that allowed share buybacks in specific conditions, even though this had once been considered market manipulation; and the decision to provide favourable tax treatment to stock options, which allowed already fortunate people to profit from the rising valuations of companies they worked for. The most fundamental change was the shift from defined benefit pensions to defined contribution 401(k) plans, which has linked the future of so many Americans, in a Faustian way, to the fickle fortunes of the market.

All of it was supported by the myth that share prices are the ultimate indicator of what was happening inside a company, and ultimately, an economy.

I don't think that's really been true for a long time, something underscored by last week's death of former General Electric chief executive Jack Welch. He came to represent the rise, and ultimately, the fall of shareholder focused capitalism. After the 2008 crisis it became clear that GE's share price under Welch had been artificially bolstered by debt and leverage.

Welch eventually rejected shareholder "value" as the "dumbest idea in the world". I can only hope that this market downturn will force more people to come to the same conclusion. How much longer can we run an economy driven so disproportionately by financially engineered asset bubbles? The next few weeks and months may give us the answer.

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