The Next Recession Looms Large

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Summary

- The Fed has tried everything they can to keep this expansion afloat.
- Their only choice now is recession now or recession later.
- Which will they choose?

Currently, economists and market watchers roughly fall into two camps: Those who believe that the Federal Reserve must begin raising interest rates now so that it will have enough rate cutting firepower to fight the next recession, and those who believe that raising rates now will simply precipitate an immediate recession and force the Fed into battle without the tools it has traditionally used to stimulate growth. Both camps are delusional, but for different reasons.

Most mainstream analysts believe that the current economy can survive with more normalized rates and that the Fed's timidity is unwarranted. These people just haven't been paying attention. The "recovery" of the past eight years hasn't been just "helped along" by deeply negative real interest rates, it is a singular creation of those policies. Since June 2009, when the current recovery began, traditional economic metrics, such as GDP growth, productivity, business investment, labor force participation, and wage growth, have all been significantly below trend. The only strong positives have been gains in the stock, bond and real estate markets. We have had an "asset price" recovery rather than a bona fide economic recovery. This presents unique risks.

Asset price gains have been made possible in recent years because ultra-low rates have driven down the cost of borrowing, encouraged speculation, and pushed people into riskier assets. Donald Trump was right in the presidential debate when he noted that the whole economy is "a big fat ugly bubble." Any rate hike could hit those markets hard across the financial spectrum and can tip the economy into contraction. Look what happened this January when the market had a chance to digest the first rate increase in

10 years. The 25 basis point increase in December 2015 led to one of the worst Januarys in the history of the stock market. Since then, the Fed has held off from further tightening and the markets have treaded water. There is every reason to believe that the sell-off could resume if the Fed presses ahead.

Our current "expansion," which began in June of 2009, is 88 months old and is already the fourth longest since the end of the Second World War (post-war expansions have averaged 61 months) (based on data from National Bureau of Economic Research and Bureau of Labor Statistics). But although it is one of the longest, it has also been the weakest. Despite fresh optimism nearly every year, we have not had a single year of 3 percent GDP growth since 2007. More ominously, the already weak expansion is beginning to slow rapidly. GDP growth has been decelerating, averaging just 1% in the past three quarters (Bureau of Economic Analysis). And while hopes were high for a significant rebound in Q3, as has been the pattern all year, rosy estimates have recently been sharply reduced.

Typically, rate-tightening cycles start in the early stages of a recovery when the economy is still gathering momentum. As I have argued before, a rate tightening campaign that begins in the decelerating tail end of an old and feeble recovery is bound to unleash problems.

So I agree with those who believe that rate hikes now will bring on recession, but I disagree that we should keep rates where they are. They believe we need to keep the stimulus pedal to the metal… and when that's not enough, to cut a hole in the metal and push harder. I believe that despite the short-term pain that will surely follow, we need to raise rates now to break the addiction before it gets worse.

The "keep rates at zero camp" argues that global economic developments have made traditional GDP growth nearly impossible to achieve. These believers in "the new normal" fear that the Fed is mistakenly waiting for growth that will never come. Larry Summers, the leader of this group, recently argued in the Washington Post that the Fed will never be able to raise rates enough in the short term (without plunging the economy into recession) to gather enough ammunition to effectively fight the next recession. In his view, to raise rates now would be to risk everything and get nothing.

Summers knows that central bankers now do not have the caliber of bazookas that their predecessors once carried (Bernanke was able to slash interest rates over 400 basis points in a few months). So he advocates continued stimulus until newer means can be

developed to head off the next recession before it develops. (He promises to reveal those new ideas soon… really).

Given all the economic realities that central banking has attempted to suspend in recent years (such as the antiquated belief that lenders should be paid to lend rather than being charged for the privilege), it's no great stretch for them to consider the next big leap and call for an age of permanent expansion.

To do this they must short-circuit the business cycle, which up until now has regulated prior monetary mismanagement. Rather than being some naturally occurring process, the business cycle actually results from artificially low interest rates. Mistakes are made during the booms, when rates are held artificially low, and are then corrected during the bust, once those rates are allowed to normalize. Ironically, the busts are actually the benign part of the process, and should not be resisted, but embraced. But to mitigate the short-term pain associated with actually correcting those mistakes, central banks typically opt to paper them over for as long as possible. The problem is that this time the papering over process has gone on for so long, and involved a record amount of paper, that correcting the mistakes now will necessitate a recession so severe that it is unthinkable. The only apparent "solution" is to make sure one never arrives.

To do so, the Fed must replace the "ups and downs" of the economy with the "ups and ups." This futile process will likely involve the Fed intervening directly in the equity markets (by actually buying shares), or in the real estate market (by buying properties or making loans) or into the consumer economy by directly distributing money to citizens. But since contractions are necessary and healthy, especially when markets have gotten ahead of themselves, attempting to short-circuit them does more harm than good. Yet despite how crazy such a policy sounds, Yellen just suggested that she thinks it's not only a good idea, but that the Fed is already giving it serious study. Given the damage our crazy monetary policy has already inflicted in the past, one can only imagine what kind of devastation awaits.

Just this week the International Monetary Fund issued a report about the dangers of global debt growth, which has reached $152 trillion, or roughly twice the size of global GDP. They noted that the growth of private debt has recently led the upswing. With negative rates actually paying some companies to borrow, should this be a surprise? And while it's nice that the IMF raised a red flag, it's pathetic that their only proposed solution is to call for governments to increase public debt through fiscal stimulus (based on what should now be the debunked theory that deficit spending creates growth).

Even more pathetic is Alan Greenspan's attempt on CNBC this week to blame the current low growth economy on Congress, and its failure to rein in entitlements. Greenspan is correct in his determination that "the new normal" results from the plunge in productivity gains that is a function of drops in savings and capital investment. But he can't absolve the Fed. Had they not monetized the ever growing federal deficits, or kept interest rates artificially low for so long, market forces would have forced cuts in entitlement spending years ago. These actions, originated with Greenspan himself, enabled Congress to repeatedly kick the can down the road.

According to Greenspan, to spare the public the pain of higher interest rates, the Fed has no choice but to hold its nose and accommodate any level of debt Congress chooses to accumulate. But the ability to pursue unpopular policy is precisely why they are supposed to be politically independent. What good is an independent central bank that simply helps incumbents win reelection?

Given that the Fed has already unsuccessfully exhausted so much firepower, it is unfortunate that it never seriously questions whether their policies are actually harmful. Modern economists simply can't imagine that throwing ever more debt on the back of a weak economy actually prevents it from recovering.

I think it's high time the Fed finally moves rates well into positive territory. The next recession has been on its way for years, and it will arrive no matter what the Fed does, if it's not already here. Sometimes reality hurts, but fantasy can be more damaging in the long run.

The real choice is not between recession now or recession later. It's between a massive recession now, or an even more devastating one later. Either way, there is no Fed policy that will be able to fight it. But that is not because the Fed is out of bullets, but because it never had any real bullets to fire in the first place. All it had was morphine to numb the pain as the wound festered. Now is the time to bite the bullet, endure the pain, and allow the wound to actually heal. This will also allow us to finally bury the idea of a new normal, enjoy a real recovery with all of its traditional benefits, and actually make America great again.