Where's the Beef? "Lies, Damned Lies, and Statistics"

JOHN MAULDIN | May 4, 2016

I have long been a critic of government inflation statistics. Not so much with regard to the methodology they use, but because the measure of "average" inflation across the broad economy doesn't really describe the inflation that the majority of Americans experience. I've written about that at length in several letters.

Now my good friend Ron Arnott, along with his associate Lillian Wu, presents us with a research paper that lays out what inflation actually looks like for most Americans – and the picture is not pretty. The authors demonstrate that inflation in the main four categories – rent, food, energy, and medical care – has been running at roughly 3% since 1995, significantly more than the 2.2% the BLS data yields – especially when you think about the compounding effect. In the 20 years since '95, that 0.8% differential has compounded to over 20%, which has to be deflated against incomes. When you look at the stagnant income growth of the middle class and then reduce that income by 20%, rather than by the official inflation rate, it is not hard to grasp why significant majorities in both political parties are pissed off (to employ a technical economics term). Quoting from Rob and Lillian's paper:

> Since 1995, households have expected inflation to be, on average, 3.0%, whereas realized inflation has been around 2.2%, leaving an inflation "gap" of almost 0.8%. What explains this gap? The following is our hypothesis. The four "biggies" for the average American are rent, food, energy, and medical care, in approximately that order. These "four horsemen" have been galloping along at a faster rate than headline CPI. According to the BLS definition, they compose about 60% of the aggregate population's consumption basket, but for struggling middle-class Americans, it's closer to 80%. For the working poor, spending on these four categories can stretch to as much as 90% of total spending. Families have definitely been feeling the inflation gap, that difference between headline CPI and inflation in the prices of goods they most frequently consume.

This paper is one of the most powerful indictments of central bank policy that I have read in a long time (even if the authors didn't intend it to be that). It reinforces my contention that the models central banks create and the data they base those models on are inherently flawed. And those flaws are compounded because the banks' manipulation of interest rates (the price of money) is perversely doing the opposite of what they think it should do. This is going to cause more mischief and economic pain during the next recession than any of us are prepared for or can even imagine. Seriously, we're going to have to restructure our expectations and strategies for our portfolios to deal with what I think is developing into a policy error of biblical proportions.

And on that happy note I think I will just go ahead and let you read Rob and Lillian's essay without further comment.

I had a long talk yesterday with my friend Murat Koprulu, emerging-market strategist type hedgie for Mariner Capital in New York. He is writing a book called *The Gig Economy*, based on his research into young people and their approach to working. He echoed some of the same themes that Rob's paper does: younger and middle-class workers are getting squeezed. More and more young people are working multiple part-time gigs and are developing a very different lifestyle than their parents or grandparents were accustomed to. That dream job they hoped to get when they went to college is there; it just doesn't pay enough to let them live in, say, New York City. And when they leave New York, the pay drops.

As I peer into our economic future, I don't see it getting significantly better in the next 10 years. Oh, there are things a government could do to begin to turn things around, but I don't see anybody in government willing to do those things. They keep trying to micromanage the economy and run people's lives, and then when things don't improve much, they think we need more of what didn't work. The magic blue-pill "fix" for middle-class growth is not going to be manufactured by government. The world, and especially the US, doesn't need lower rates and quantitative easing, it doesn't need another government program. What we need is productivity and income, and those come from the marketplace. There is a role for government, but it is to be the referee that ensures a fair game, the sheriff that makes sure that everybody plays nice in the sandbox, the regulator that is there to make sure that crony capitalism and insiders don't drive the creators out of business with unfair practices.

I will get off my soapbox and go back to my inbox. You have a great week. I get to have lunch with Peggy Noonan and listen to her speak tomorrow, which I'm greatly looking forward to. I'm sure she will help us ponder what in the wild, wild world of sports politics this coming presidential election contretemps going to look like, given the participants. Oh my, I will have a few more things to say about that in this weekend's letter.

Your wondering how I got this busy analyst,

John Mauldin, Editor
Outside the Box

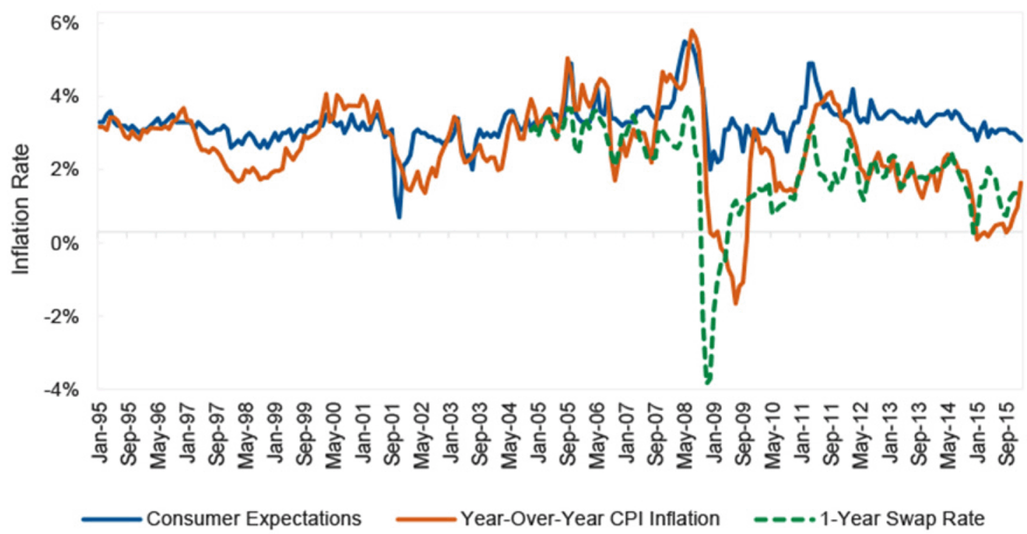
Where's the Beef? "Lies, Damned Lies, and Statistics"*

By Rob Arnott and Lillian Wu

The price of beef has been soaring over the past five years – up 80% cumulatively at the end of December 2015 – but you'd never know it by looking at the official U.S. Consumer Price Index (CPI), which is up 7%, or 1.4% a year, over the same five-year span, and therein lies our beef. The developed nations of the world, are supposedly living in a low-inflation environment, at risk of tipping over into the abyss of deflation. That's what the folks at the U.S. Bureau of Labor Statistics (BLS) tell us. And they should know, right?

Well, maybe not. Surveys suggest that the average American's daily experience may be quite different. One-year consumer inflation expectations have been consistently higher than trailing and realized inflation over the last 20 years, and higher than more recent market-based inflation expectations, measured by one-year swap rates. **Figure 1** shows how this divergence has grown larger since the financial crisis, suggesting the average household might have been feeling even greater pain during the recovery process than has been believed.

Figure 1. Consumer Inflation Expectations versus CPI-U and One-Year Inflation Swaps, 1995–2015



Source: Research Affiliates, LLC, using data from Federal Reserve Bank of St. Louis FRED database.

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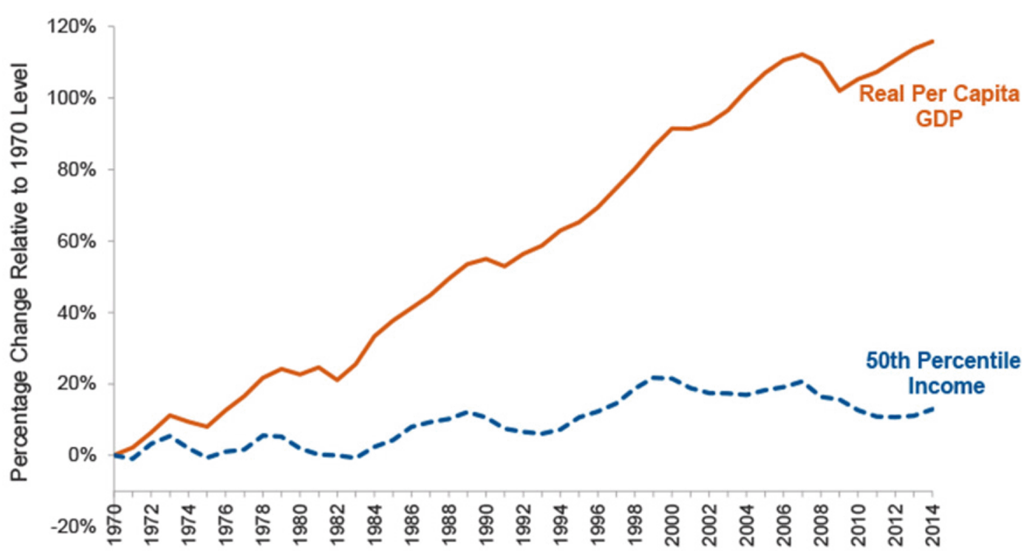
Since 1995, the average year-over-year inflation rate for energy has been 3.9%, for food, 2.6%; for shelter, 2.7%; and for medical care, 3.6%. If we strip out all other items and recalculate the index based exclusively on these four components, we find the average rate has been about 2.9%, right in line with households' expectations. Let us be provocative. If inflation – as experienced by the average American – is higher than official BLS "inflation," then what exactly is the BLS statistic measuring?

It looks like the BLS thermometer is broken! Whatever temperature they show us, the actual temperature is higher, as experienced by the average American family. For instance, the reported CPI inflation over the past 10 years ending December 2015 was about 1.9% a year. If we focus on the "big four" over the last decade, the inflation that Americans experienced was about 0.5% more. Let's call this 0.5% difference a "measurement bias." Paradoxically, the inflation measures for these four categories are produced by the same people who assemble the CPI. Other sources peg the gap as being considerably larger.

These considerations have a direct bearing on our prosperity. How much real growth, for example, has occurred in the past decade? Officially, GDP has grown 1.4% a year, over and above inflation. Over the same period, the U.S. population has grown by 0.9% a year. Thus, real per capita GDP has risen by a scant 0.5% a year. Subtract the 0.5% measurement bias – probably a conservative estimate – and the average American has experienced zero growth in personal spending power over the past decade. With wealth and income concentration, if the average is flat, then median per capita spending power must be lower. Comparing 2015 with 2005, this feels about right. The official statistics do not.

The Great Recession begot a 5% reduction in U.S. real per capita GDP from the peak of 2007 to the trough of 2009. In the wake of the market collapse, major central banks around the world eased monetary conditions in lockstep with the Fed. It took nearly six years for U.S. real per capita GDP to regain its prerecession peak. This herculean task was achieved through massive spending and relentless borrowing from the nation's current and future income. Has it worked? As always, it depends on whom you ask. We are deeply skeptical of claims that these massive interventions have helped. Real median household income has fallen by 4% since 2007, despite the "recovery" following the Great Recession! Comparing today to 1970, **Figure 2** shows that real per capita GDP is up by 110% – more than doubling over the last 45 years! Yet, the median American has experienced less than one-fifth of this growth.

Figure 2. Percentage Change in Real Per Capita GDP Relative to 1970 Level



Source: Research Affiliates, LLC, using data from WhiteHouse, Global Financial Data, and U.S. Census Bureau, Bureau of Economic Analysis.

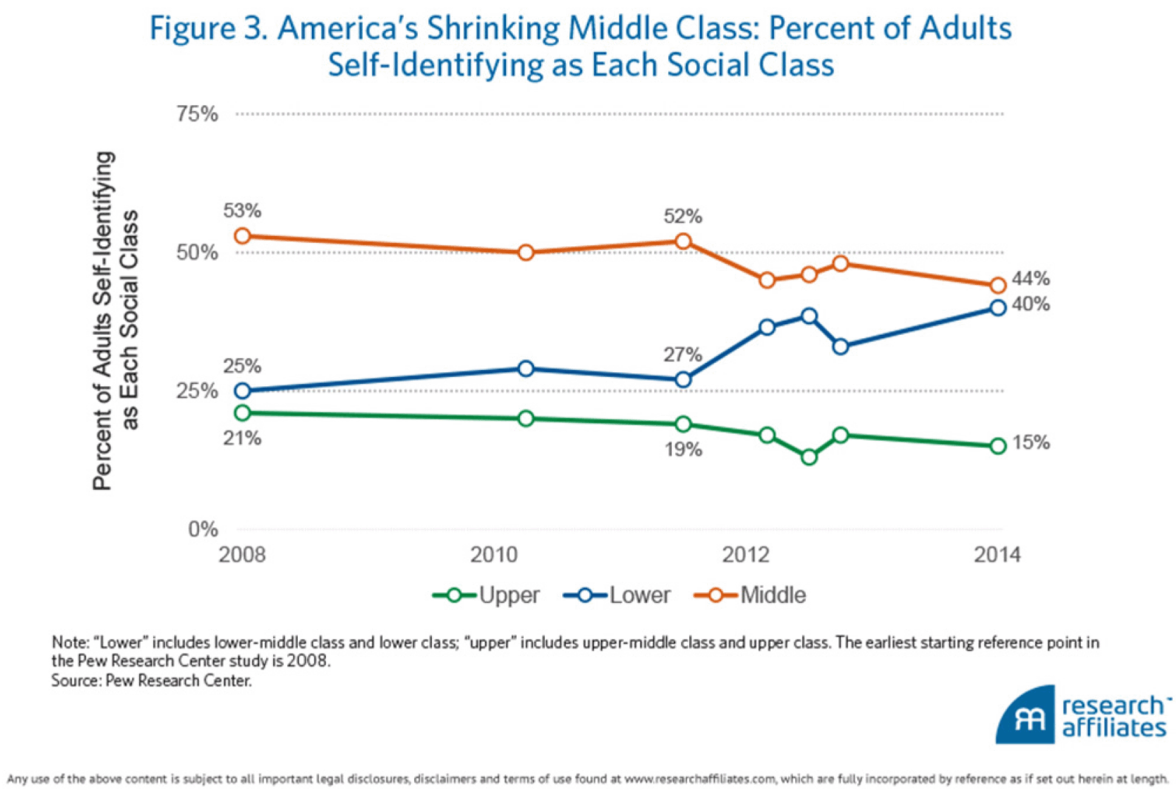
Middle-class Americans are struggling, as are middle-class Japanese and Europeans. Easy money, asset purchases, and negative interest rate policies of central banks across the developed world are intended to ignite the "animal spirits" of the private sector. Are they instead *stifling* economic and wage growth? Are they stimulating asset hoarding and bubbles, which fuel widening gaps between the haves and the have-nots, and feed class resentment? Are they leaving inflationary pressures unchecked and hollowing out opportunities for the middle class? These are provocative suggestions, which go against neo-Keynesian theoretical dogma, but they fit the objective evidence we see all around us. Sometimes common sense trumps theory.

Former Fed Chairman Ben Bernanke was quite candid in saying that zero interest rates and quantitative easing were intended to create a "wealth effect." He wanted asset values to rise so the affluent would spend more, so the economy could boom. He achieved the first of these: asset values rose. But who owns assets? The wealthy. What this "stimulated" is a growing gap between the haves and the have-nots: the wealthy got wealthier. That's redistribution, *backwards*. Then, in a towering act of hubris and hypocrisy, the central bankers collectively deny they played any role in widening the income and wealth disparity, or in hollowing out the middle class. Ouch. But although the rich began to spend more, the impact on the economy was limited. If the rich mostly buy more *assets* (i.e., stocks, bonds, real estate, art, collectible cars, rather than "new stuff" that needs to be manufactured), doesn't that just fuel more bubbles?

And let's not forget the *downside* of bull markets. The benefits to the rich of accommodative monetary policy are short lived. The values of the assets they own soar, but the forward-looking returns on those assets crater. (Notice how hard it is to find a liquid mainstream market that offers *real after-tax* returns much above zero these days.) Then, net of spending and charitable giving, their wealth dissipates assuredly and rapidly, recycled into the economy with no assistance needed from the Pikettys of the world. The wealth of the richest is fleeting, typically dissipated by the third generation (Arnott, Bernstein, and Wu, 2015).

Worse, lousy forward-looking returns also afflict the young and the shrinking middle class. The future returns on their pension assets are horribly low, but the average American must prepare for retirement *now*, not later when the artificial policy-induced bull market ends and prices settle to more sensible levels. As a result, they invest their hard-earned money in the S&P 500 and hope for the best. Unfortunately, hope is not a strategy. To add insult to injury, their kids have essentially zero incentive to invest for the future or to buy (not at today's prices!) those self-same assets from their parents to help transform them into goods and services their parents can consume in retirement. Zero-interest rate policies have crushed the opportunities and incentives for the middle class – and their kids – to save and invest.

The middle class is getting squeezed from every direction and is sadly disappearing. In 2008, according to Pew Research Center, 53% of adults considered themselves middle class. A scant 6 years later in 2014, as *Figure 3* illustrates, that number had dropped precipitously to 44%. At this rate of decline, in 30 years there'll be no middle class left! For the class warriors, don't worry, be happy – the self-identified upper class has shrunk from 21% to 15% in that same 6-year span, so they'll be gone in just *15 years*!



We're being deliberately provocative; we do not expect this to happen because pendulums swing both ways. But this particular swing of the pendulum is profoundly disturbing and is doing a lot of damage to what was once called "American exceptionalism."

New business start-ups suffer too. Individual investors hesitate to fulfill their dreams of beginning their own businesses – home to the majority of our economy's jobs – because they don't know the cost of capital. Near-zero interest rates aren't available to them, and the future cost of capital is unknown but presumed to be higher. The prospective regulatory regime three to five years hence is shrouded in mystery too. Corporations, like investors, are deeply wary about long-horizon investments with uncertain prospects. Why plow funds into long-term risky business ventures when low-risk (but, of course, high-priced) stock is available for buybacks and can be funded with near-zero-rate financing? The endgame is that the economy stagnates and the middle class slowly slips underwater. Is this speculation or fact? January 2016 was one of only a few months since the Great Depression with no IPOs.

The fears surrounding the global economy and the calls for negative interest rates highlight the uncertainty surrounding the near future. When central banks finally step away from overt market interventions, however, capital market valuations will presumably revert to the levels that would prevail in the absence of intervention. Does anyone think that will mean higher price levels? Didn't think so. Accommodative monetary conditions inflate asset prices into asset bubbles that sooner or later *will* seek their fair value. If the interventions are artificially propping up asset prices, the average investor is justifiably wary. If fair values are lower, the good news is that, after the one-off adjustment, forward-looking returns will once again be sensible.

Big Brother cannot take care of us. Only we can do that. Big Brother is us; the government is us. If we think a bureaucrat can take care of us better than we can take care of ourselves, or cares more about us than we care about ourselves, we're deluded. The more we think we can offload our own responsibility for self-reliance – the longer we take to look under the bun and ask, "Where's the beef?" – the more we invite our elite leaders to continue with the interventionist policies that have inflicted so much damage already.

* Benjamin Disraeli (1804-1881) served twice as Britain's prime minister and famously described the three kinds of deception, hierarchically from least to worst, as "lies, damned lies, and statistics."

Reference

Robert D. Arnott, William Bernstein, and Lillian Wu. 2015. "The Myth of Dynastic Wealth: The Rich Get Poorer." *Cato Journal*, vol. 35, no. 3 (Fall):447–485.

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