The Two Americas: Why, now more than ever, inequality must be confronted to protect economic stability.

The systemic risks facing today's bull run can be traced back to the escalation of inequality.

To kick off 2018, I decided to pass along an article published over Medium.com originated by the well-respected investment research firm 13D. The article, which was published back in October of 2017, contends that a political solution is required to address the economic imbalances affecting both the real and financial economy. Ordinarily I prefer to stay away from political topics, as I do not want to alienate readers. In addition, we are all bombarded daily by opinionated news sources who are more qualified than I to opine on these issues. In this case however, the article merely acknowledges what many of us already know. As citizens, it is up to us to confront the unpleasant facts occurring in society and ultimately work towards compromise. I hope you enjoy.

The Two Americas: Why, now more than ever, inequality must be confronted to protect economic stability.

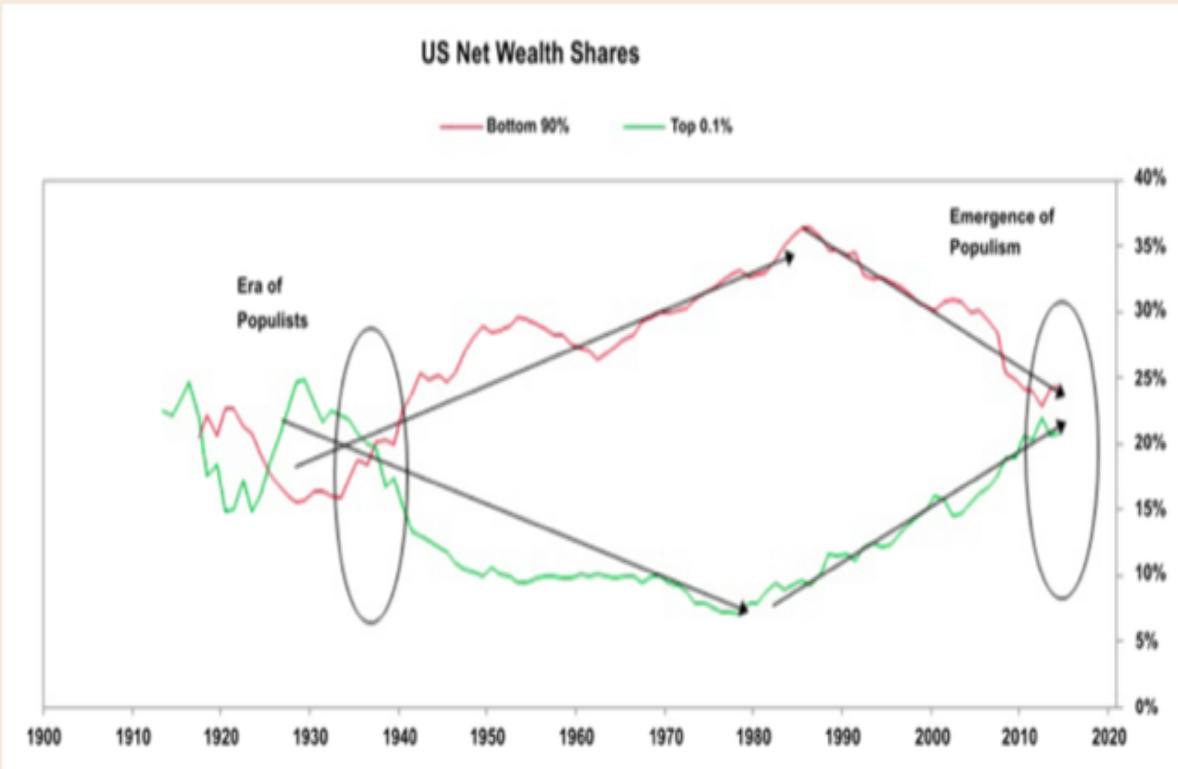
The following article was originally published in "What I Learned This Week" on October 26, 2017.
By 13D Research

"Average statistics camouflage what is happening in the economy, which could lead to dangerous miscalculations," Bridgewater's Ray Dalio wrote in a note released on LinkedIn this week. He was urging policymakers to consider inequality in their decision making. "We broke the economy into two economies — that of the top 40% and that of the bottom 60%," he went on. The top 40% averages ten times the wealth of the bottom 60%. Only a third of the bottom 60% saves any of its income. Only by understanding the bifurcation of America can the Fed "run an appropriate monetary policy."

With inequality most-often presented as a moral issue, it is easy to underestimate the economic urgency of Dalio's plea. **Most, if not all the systemic risks facing today's bull run can be traced back to the escalation of inequality.** Inflation has remained stubbornly low as globalization and automation deprive the bottom 60% of wage-negotiation power. Household debt has spiked above pre-Global Financial Crisis (GFC) levels with few signs of moderation on the horizon. Meanwhile, for the top 40%, wealth accumulation is driving an ever-aggressive search for yield in a low-growth world — the helium inflating the "everything bubble". And **these risks are maturing against a**

backdrop of intensifying socio-political instability — a class divide that could derail American progress and competitiveness.

The consolidation of wealth in the hands of the few has run unabated since the 1980s, as the following chart from Dalio illustrates:



Source: Ray Dalio, LinkedIn

Not surprisingly, this consolidation of American wealth is also manifesting in key central bank measures of economic health. Stubbornly low inflation has been dubbed by policymakers, including Janet Yellen, as the great "mystery" of 2017's bull run. The historical inverse relationship between unemployment rates and inflation rates — the Phillips Curve — has broken down. Wages have stayed low despite low unemployment. The Bank for International Settlements (BIS) believes they've identified the reason for the gap: globalization, which has progressed hand-in-hand with technology.

As the labor pool has expanded, labor's wage-negotiation power has declined, especially in advanced economies where labor compensation was higher pre- globalization. Simultaneously, cheaper labor and technological efficiency has led to cheaper goods. As a result, consumption fueled inflation has been suppressed. Yet, central banks have held fast to their inflation targets. Therefore, **they're fighting a force they can't control and neglecting what BIS views as the real risk: asset inflation.**

With globalization and technology suppressing wages, corporate profits have risen. As we explored in WILTW January 19, 2017, corporate profits skyrocketed from 2% of gross value added in 1984 to 15.7% in 2014. This has resulted in more wealth distributed to business stakeholders. For one example, **CEO compensation, inflation adjusted, increased 937% between 1978 and 2013.**

The problem is, as Dalio puts it: "If you give rich people more money, they probably won't spend much of it…motivated by the extent of their unmet needs and desires." In turn, the wealthy have concentrated more and more capital into future-focused investments, whether stocks, bonds, real estate, or the education of their children.

This dynamic exacerbates inequality on two fronts. First, **the vast majority of the bottom 60% don't own stocks or bonds, meaning market inflation is just the 40% making the 40% even richer.** Meanwhile, as necessities like housing and education inflate, the bottom 60% must accumulate more debt to provide for their families. **At $12.84 trillion, or roughly two-thirds of GDP, U.S. household debt is now higher than pre-GFC.** According to the IMF, lower-income households have increased their share of that total debt. Not surprisingly, necessities are the reason why: **mortgages and student loans account for 80% of the bottom 60%'s debt:**

Average Balance Sheet by Income Group (2016 USD, K)

Top 40%				Bottom 60%			
Total Assets	**$1,698K**	**Total Debt**	**$180K**	**Total Assets**	**$180K**	**Total Debt**	**$38K**
% Stocks	*27%*	*% Mortgage*	*72%*	*% Stocks*	*12%*	*% Mortgage*	*63%*
% Bonds	*8%*	*% Student*	*5%*	*% Bonds*	*4%*	*% Student*	*17%*
% Cash	*6%*	*% Auto*	*5%*	*% Cash*	*7%*	*% Auto*	*8%*
% Real Estate	*31%*	*% Credit Card*	*2%*	*% Real Estate*	*54%*	*% Credit Card*	*4%*
% Autos	*2%*	*% Other*	*16%*	*% Autos*	*7%*	*% Other*	*9%*
% Bus Equity	*21%*			*% Bus Equity*	*8%*		
% Other	*5%*	**Net Worth**	**$1,517K**	*% Other*	*7%*	**Net Worth**	**$141K**

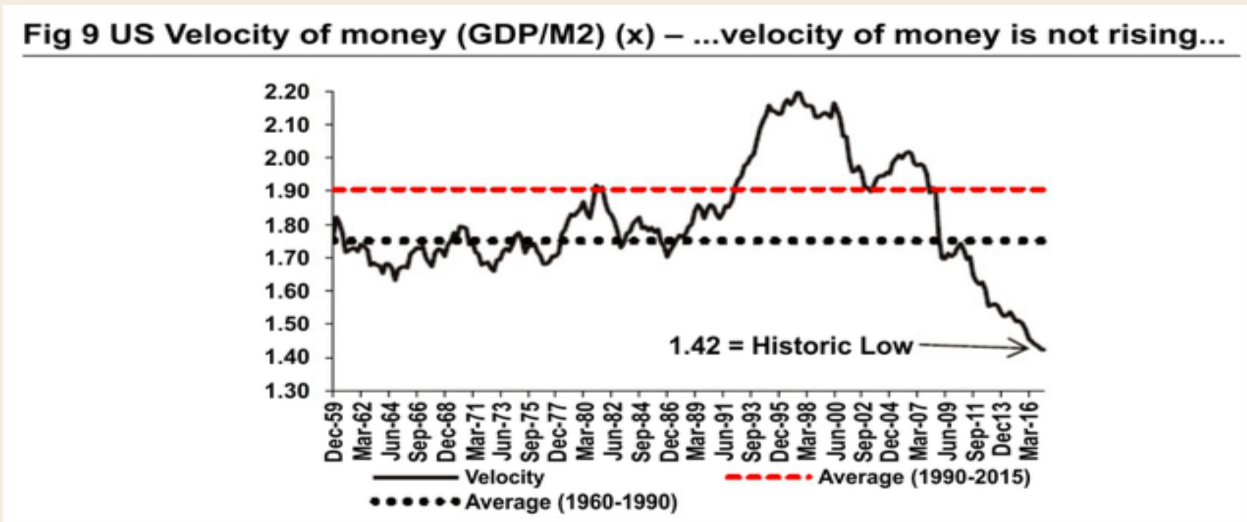
More debt in student loans and higher interest rate consumer credit

Assets of bottom 60% more concentrated in housing and autos

Source: Ray Dalio, LinkedIn

By incentivizing investment, QE only contributed to the problem. Buybacks are a key example. Since 2009, U.S. companies have piled on cheap debt—the median debt level at U.S. corporations now exceeds the level just prior to the GFC. Instead of investing that capital on increased wages or R&D, corporations spent a record $3.8 trillion on share buybacks. According to Artemis Capital Management, **40% of earnings-per-share growth and 30% of stock market gains since 2009 can be attributed to buybacks.** And as equity prices have spiked, more Americans have been pushed out of the market—**the percentage of U.S. adults that own stocks hit a 20-year low of 52% in 2016,** according to Gallup.

This is not just a problem for the 60%. First, many corporations obscured fundamental weakness through buybacks — the IMF warns that 22% of U.S. corporations are at risk of default if interest rates rise, a “zombie” threat we dissected in WILTW *August 24, 2017*. Second, the more wealth the 40% accrues and the more they park that wealth in assets, the less capital is moving through the system. **Capital velocity is at a historic low:**



Source: Macquarie Research

This capital stagnation is a key driver of what many have dubbed “the everything bubble” — the steady, unabated inflation of nearly all asset classes. The less capital shifts in and out of assets, the more volatility is suppressed. And the longer volatility is suppressed, the more price discovery erodes and the more asset values become divorced from fundamentals. Again, buybacks demonstrate how QE exacerbated this problem. As Artemis writes:

*“The trillions of dollars spent on share buybacks are equivalent to a giant short volatility position that enhances mean reversion. Every decline in markets is aggressively bought by the market itself, further lowering volatility…**A dangerous feedback loop now exists between ultra-low interest rates, debt expansion, asset volatility, and financial engineering that allocates risk based on that volatility.”***

Artemis estimates that over $2 trillion in “financial engineering strategies” are now pegged to low volatility. In addition, passive investing has flourished due to low volatility — in a world in which stock prices don’t fluctuate, active managers can’t beat indexes. The question is: When an inevitable market shock causes volatility to spike, will all these strategies sell at once and crater markets?

Which brings us to the primary risk posed by escalating inequality: social and political instability. As economist Andy Xie wrote for *The South China Morning Post* earlier this month: **"The most likely cause for the bubble to burst would be the rising political tension in the West.** The bubble economy keeps squeezing the middle class, with more debt and less wages. The festering political tension could boil over." The "rigged system" has already buoyed populism and led to Donald Trump's election. From executive and legislative branch dysfunction to protests and violence in the streets, we've seen a progressive escalation of instability. Unless policymakers look past the averages and author policy that addresses the struggles of the 60%, the end game is predictable.

The Fed is struggling to articulate policy that could address inequality. The White House and congress are collaborating on tax reform that appears likely to benefit the 40% at the expense of the 60%. Meanwhile, emerging technologies, from AI (Artificial Intelligence) to robotics and the IoT (Internet of Things), threaten to only further weaken the negotiating position of labor. **Ray Dalio is right: U.S. policymakers need to wake up now.**

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Sincerely,

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