The Wealth Shock And Confidence

In a cruel slap of reality to Baby Boomers' collective face, Joni Mitchell was right in her 1970 *Big Yellow Taxi*: "You don't know what you've got till it's gone." A generation and indeed a civilization raised based on rising wealth levels thought it had everything figured out; it would own the two of the great asset classes available to individuals, equities and real estate, and ride them off into the proverbial sunset.

This is what Americans were taught to do, to take charge of their own lives and to embrace the risk of the markets. After all, defined-benefit corporate benefit plans have been disappearing since the birth of the defined-contribution 401(k) plan in 1980, and anyone who believes in the largest defined-benefit plan in human history, Social Security, will get exactly what they deserve for their foolishness. Moreover, the de facto official policy of the U.S. government since the collapse of Long Term Capital Management in 1998 had been to do whatever was deemed necessary for the short-term health of these asset markets. Dubbed "the Greenspan put," the Federal Reserve systematically lowered short-term interest rates to inflate first a stock market bubble in the late 1990s and then a real estate bubble in the early 2000s. Small wonder investors began to feel they could accumulate vast sums of wealth smoothly over their lifetimes.

The inevitable collapse of the credit bubble in 2007 and the economic devastation it wrought by late 2008 (see "Wall Street Armageddon," January 2009) led to an unprecedented collapse in household net worth in data compiled by the Federal Reserve in its Flow of Funds report.

Wealth

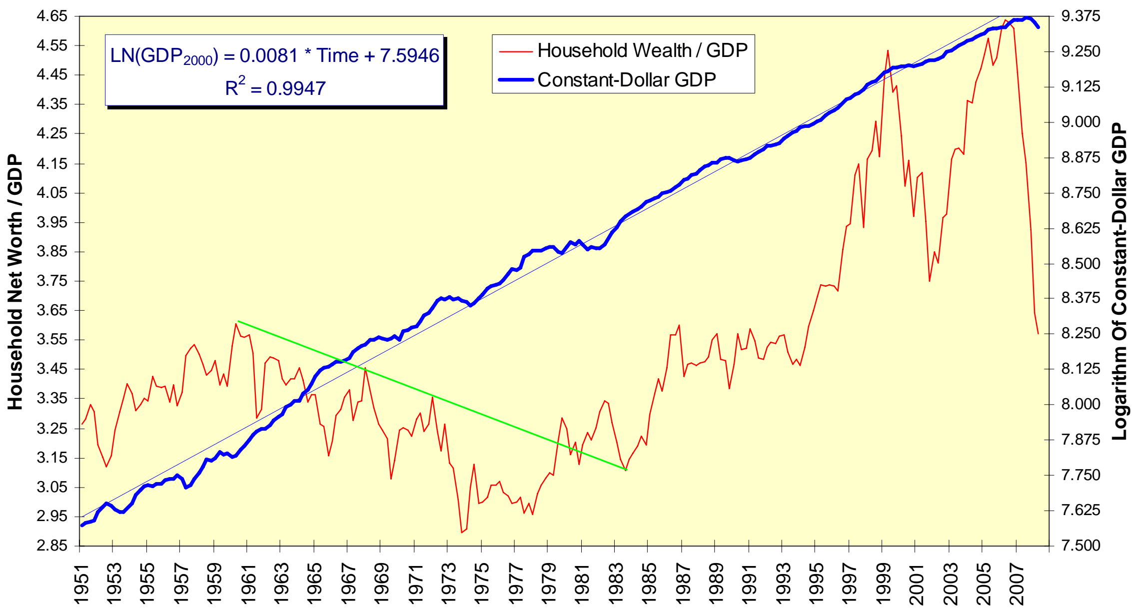
Wealth is an odd concept. It is best defined not as an accumulation of money; Adam Smith showed how wrong that was on the national scale in his 1776 *Wealth of Nations*, but rather as the capacity to consume. That capacity to consume must be related somehow and in some way to the capacity to produce, which goes a long way to explaining why the global experiment of having Asian and Middle East capital-surplus nations finance American consumption indefinitely was an accident waiting to happen for all parties involved.

Wealth also is distributed unevenly by its very nature. On a life-cycle basis, most of us start out with little, accumulate wealth over time via savings and investment and then expect to convert those assets into consumption at the end of our lives. And as much as it may infuriate the egalitarians and class-warriors amongst us, the Lorentz curve, or cumulative distribution of wealth across the population is skewed toward concentration. In language they would understand, some are indeed more equal than others.

Finally, wealth is far more a relative than an absolute concept. In terms of capacity to consume, everyone reading this is wealthier than Louis XIV; alright, you do not have a palace at Versailles, but he did not have electricity, a car, a computer, decent medicine or any of the other thousands of attributes of modern life we take for granted. But we regard him, and he himself, as wealthier because he was relatively far better off than his subjects and most of us lack a similar relative self-image.

Wealth And Output

If we take household net worth, a stock concept, and divide it by GDP, a flow concept, we can see in Chart 1 how much it has moved higher and lower over time. Contrary to popular imagination, it declined erratically for the quarter-century between 1960 and 1985, as highlighted with the green line. It was only after the Reagan tax cuts, the taming of runaway inflation and the absorption of Baby Boomers and women into the labor force that the ratio rose into the stock market peak of 2000.



Did its subsequent violent fall, rebound and second fall change the overall trend of constant dollar GDP? Over the long-term, the best explicator of the logarithm of constant-dollar GDP is time itself; a simple ruler will produce an r-squared, or percentage of variance explained, in excess of 99%. Is there any other reason to utter the most dangerous words in market analysis, “it is different this time?”

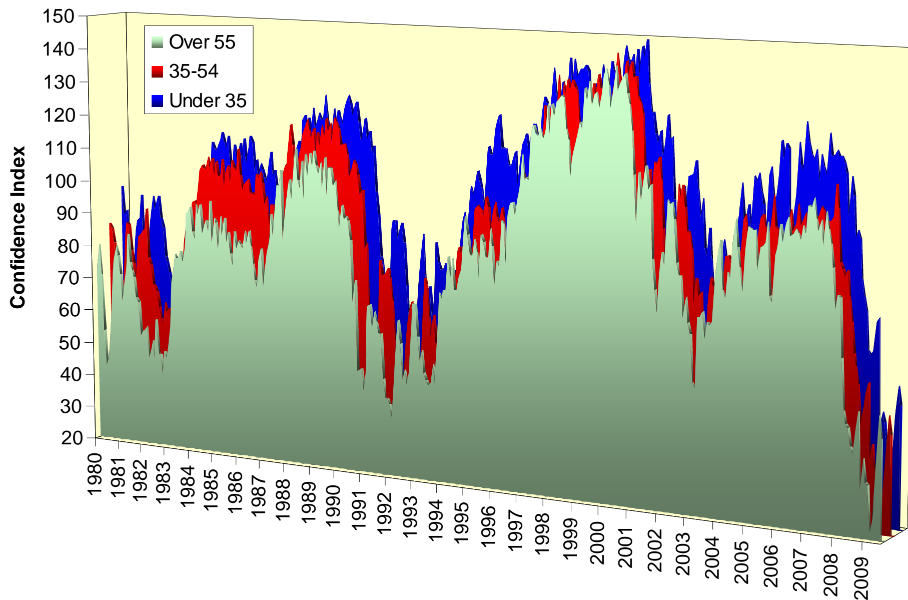
Confidence

The role of mass confidence is a metaphysical topic in economics. We can state with a fair amount of certainty as Keynes did with his references to “animal spirits” investors only turn into entrepreneurs when they become more risk-seeking; we can state with equal certainty individuals increase their savings rate when they are less confident and when their assets have been shot out from under them (see “To Save or Not to Save,” November 2008). But beyond that, the connections can become very tenuous. In the short-term, the commonly followed indices of consumer sentiment, such as those provided by the Conference Board or the University of Michigan, tend to follow changes in wealth rather than lead economic indicators such as retail sales.

We should be careful, though, in dismissing weak relationships out of hand when one of the indicators is distorted beyond its historic norms. Who, for example, paid attention to various mundane indicators of credit stress before they ticked higher in 2007 and started destroying markets as diverse as municipal bonds, auction rate preferred securities and asset-backed commercial paper in 2008? The present downturn in household net worth could produce enough of a confidence shock to affect macroeconomic behavior. The long-term relationship is different, as discussed below.

The Conference Board divides its consumer confidence numbers into age cohorts; the general path of these confidence numbers in Chart 1 since their inception in 1980 tends to follow, as noted above, the course of household net worth. Here Timbuk3 got it wrong: The song should be, “The past is so bright I gotta wear shades.”

Chart 1: Consumer Confidence By Age Cohort



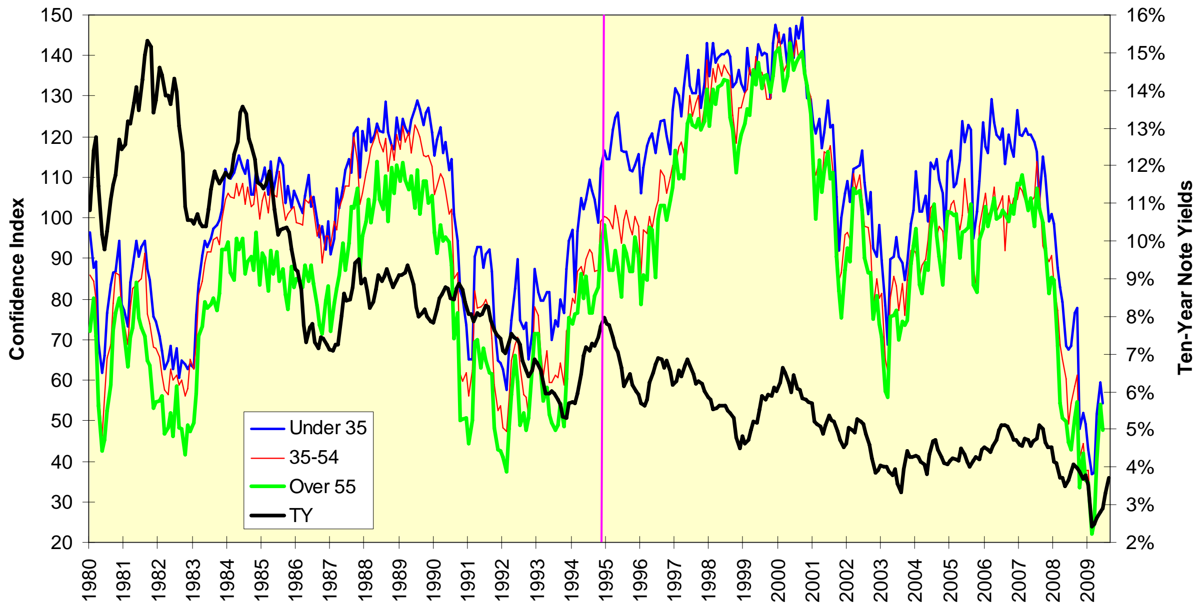
The responses across age cohorts tend to rise and fall together, but there is a persistent and unsurprising bias toward relative optimism in the Under-35 group. As Churchill is alleged to have said, "If you're young and not liberal, you have no heart. If you're old and not conservative, you have no mind." The magnitude of the gap in confidence between young and old tends to expand during the boom times; this was true during the mid-1980s, the mid-1990s and during the 2006-2007 bull market.

Money and Politics

If we map these confidence indices against monthly averages for both the S&P 500 and ten-year Treasury note yields, we can see a change in behavior at the end of 1994. This is no accident; it marked the huge Republican Congressional victories in 1994 and the beginning of the Clinton administration's move toward the economic center. It also marked the upside breakout in equities; who knew by the peak of this boom in March 2000 that September 1996 levels would be revisited by early 2009?

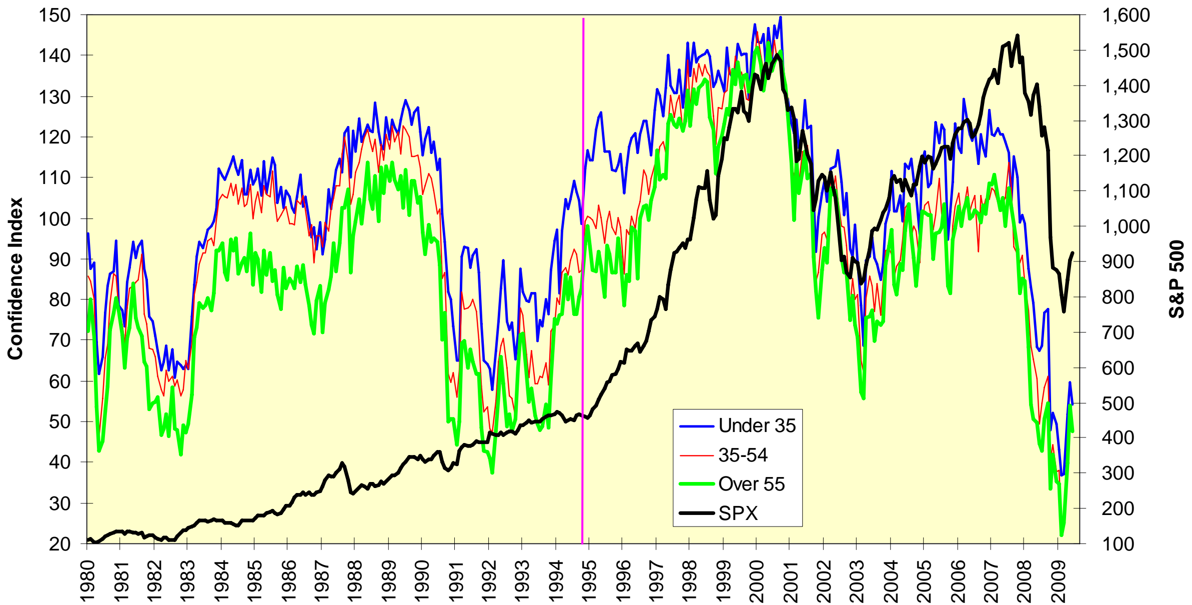
As we can see in Chart 2, Treasury yields had exhibited a modest positive correlation prior to 1995. That correlation broke entirely afterwards as yields declined even when the economy firmed and confidence rose. This long-term decline in long-term rates turned out to be one of the great economic mysteries of our age; no matter what the U.S. government did to abuse its creditors, it became increasingly able to borrow ever-greater sums at ever-lower costs.

Chart 2: Consumer Confidence Vs. Ten-Year Note Yields



The opposite relationship applies between confidence levels and the S&P 500. The relationship between confidence and equity markets was virtually non-existent prior to 1995; it then switched into a much more direct relationship with a long lead time afterwards. Confidence measures rose in 1993-1994, well before the stock market rose and peaked in 2006, well before the stock market peaked in late 2007.

Chart 3: Consumer Confidence Vs. S&P 500



We can explain these differing relationships by the two policy developments noted above, the 1994 elections and the introduction of the Greenspan put in 1998. The dual consensus for fiscal sobriety and monetary ease led to a general feeling amongst investors the government was their partner in a lifelong quest for wealth accumulation. Whose confidence would be lowered by that?

Going Forward

All things come to an end eventually; we now recognize the asset bubbles created by ever-lower short-term interest rates have a nasty habit of bursting. Even more important, the consensus for fiscal sobriety disappeared first during the Bush years and then in a tsunami of federal spending during the start of the Obama presidency.

The result is a set of shattered confidence levels. The Under-35 cohort, the key group for household formation and entrepreneurship, has had to endure two devastating bear markets inside of its formative decade and has seen the long-term upwards move of real estate prices come to an end rather spectacularly. Can the U.S. rely on this cohort to emerge as greater risk-takers or, as was the pattern for the generation that came of age during the New Deal, will they turn into a generation that asks not what they can do for their country, but rather what their country can do for them?

The Over-55 cohort suffered a smaller drop in confidence levels as they had a shorter distance to fall, but they, too, will experience a change in behavior as a result. Retirees and near-retirees who once believed they had provided for themselves now think differently about putting their investment funds at risk.

We can look back on the 1995-2006 period as Europeans did for the period between 1900 and 1914: *La Belle Époque*. Europe has yet to restore to its former relative glory. Similar and much longer periods of regret followed the collapse of the Roman Empire – we call it The Dark Ages – or after the collapse of various Chinese dynasties or Arab caliphates. Anyone who believes we can restore ourselves quickly and without a prolonged period of relative deprivation should ask themselves why they learned the following bit of doggerel as a small child: "All the king's horses and all the king's men, couldn't put Humpty together again."