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Who is Right: Wall Street or Main Street?

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Wall Street is in a panic, supposedly worried about a rising dollar, slowing Chinese growth, plummeting oil prices, a U.S. recession, and increasing interest rates. While these supposed rationales are more cover stories than real reasons, this panic caused stock prices to fall by 12% between year-end 2015 and February 11th, hitting a low not seen for two years. And as Wall Street jitters caused a flight to safety, 10-year Treasury yields fell by 20 bps and mortgage spreads widened by 100-200 bps. In addition, nervous lenders pulled back on mortgage origination growth, especially for commercial mortgage-backed securities (CMBS), and loan proceeds fell by 5-10%.

Yet while Wall Street is in a complete tizzy, Main Street continues to move forward: consumer confidence remains largely unchanged near its historical average; the economy continues to add jobs at a healthy pace; wages are growing faster than inflation; unemployment claims are low; the unemployment rate and the duration of unemployment are falling; and consumer spending remains solid. Thus, while Wall Street fears apocalypse, Main Street merrily dances onward.

This disconnect raises the question, "Who is right: Wall Street or Main Street?" Our bet is firmly on Main Street. As Paul Samuelson once famously noted, "To prove that Wall Street is an early omen of movements still to come in GNP, commentators quote economic studies alleging that market downturns predicted four out of the last five recessions. That is an understatement. Wall Street indexes predicted nine out of the last five recessions! And its mistakes were beauties."[1] That is, a coin flip is no worse at predicting recessions than is Wall Street. And nothing has changed since he made this observation in 1966. Over the last 65 years, the S&P 500 Index has declined by more than 5% in a month 46 times, and by more than 10% in a month nine times, while there have only been seven recessions, of which six saw declines in the S&P Index over the first six months.

Wall Street is driven by very different factors from those that drive Main Street. Wall Street is comprised of people who "do something" almost constantly with their investments. That is, if they

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[1] Samuelson, Paul (September 19, 1966), "Science and Stocks," Newsweek, p. 92

make no trades for days, weeks, and months, they will be fired. This is a notable contrast to Main Street, which rarely focuses on their investments.

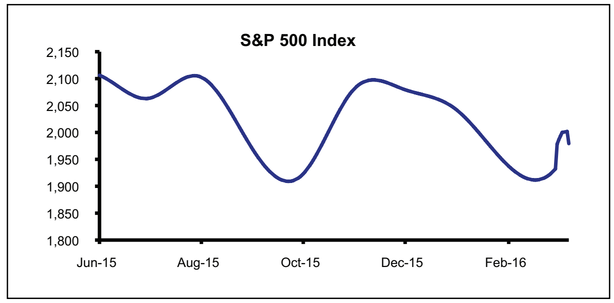
Start with Wall Street's supposed concern about slowing Chinese growth. First, declining Chinese growth has been slowly evolving over the past decade, and is not a surprise. Further, 7% growth in the Chinese economy today represents more economic activity (e.g., production and sales of shirts, shoes, cars, etc.) than was generated by a 10% growth rate just 8 years ago. China has many problems, but it has not stopped adding economic activity.

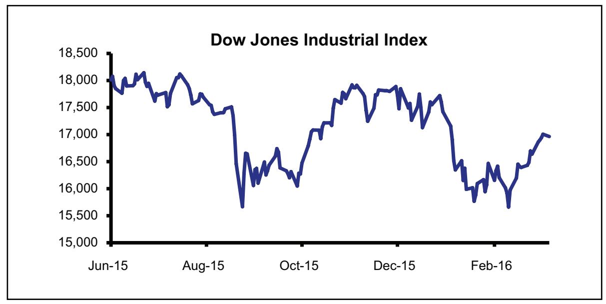
Some on Wall Street respond by saying that at a lower growth rate, Chinese socio-political stability is at risk. While this may be true, we defy anyone to demonstrate that they understand China's socio-political stability. After all, China was socio-politically stable even as Mao massacred nearly 100 million people, and later during the total insanity of the Cultural Revolution, as well as during the government's unfathomable imposition of the one-child policy. If China did not devolve into social chaos in the wake of these events, it is hard for us to believe that a 6.7% growth rate (versus 7.1%), will cause a revolution.

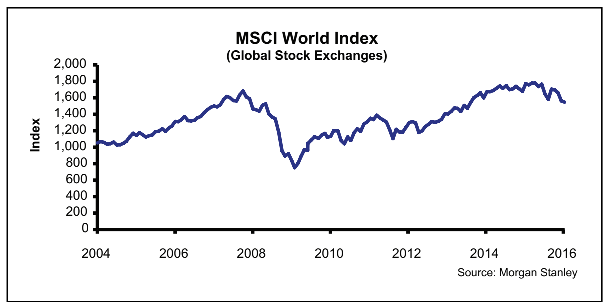
As to Wall Street's supposed concern about the strengthening dollar crippling the U.S. economy, it is essential to understand that the dollar's strength is a result of the strength of the U.S. economy, much like high prices for Bruce Springsteen and Paul McCartney concert tickets reflect their popularity. And just as these high ticket prices serve to mute — not eliminate — the demand for their concerts, so too the strengthening U.S. dollar mutes — not eliminates — economic growth. Thus, Wall Street is confusing a sign of strength with an external factor which kills growth. And while Wall Street worries about a rising dollar, Main Street is ecstatic at the thought that they can finally afford a European vacation this year.

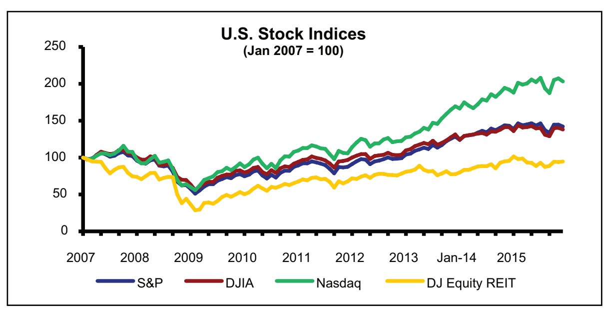
As to Wall Street's supposed concern that the precipitous decline in global oil prices will trigger a U.S. recession, the truth is that on net, it puts about 75 bps of GDP in U.S. pockets. To put this in perspective, the decline in oil prices is equivalent to roughly half of annual per capita U.S. real GDP growth during the recovery. Thus, in marked contrast to Wall Street's panic over declining oil prices, Main Street revels in the fact that they have nearly $130 billion of additional annual spending power.

Of course, not everyone equally benefits from this decline, with obvious losers being those invested or employed in the energy sector. Largely invisible to Wall Street is the fact that the benefits of declining oil prices are heavily concentrated among those in the lowest half of the U.S. income distribution, whose energy usage is a relatively high percentage of their income, and whose exposure to









energy asset prices is essentially zero. This is in marked contrast to Wall Street's customer base, namely those in the upper 10% of the income distribution, whose relative energy utilization is small and whose exposure to energy assets is relatively high.

We are frequently asked, "Why aren't consumers spending their petro savings?" The simplest answer is: they are! The best research on spending patterns since the decline in oil prices indicates that 85-95% of petro savings have been consumed, with the remainder being saved (that is, being held to consume later). One need only look at robust auto sales (particularly for larger autos and light trucks), and double-digit RevPAR increases in both Orlando and Vegas for evidence that consumers are spending their petro savings.

As to Wall Street's obsession about a 25-75 bp increase in interest rates by the Fed, such rate increases only matter to those Wall Street firms whose leveraged profitability hinges on such small changes. In fact, for many Wall Street residents, such movements are a matter of life and death, but for Main Street residents, such amounts are rounding errors. Most Main Street residents have no idea what a "bp" is, and sleep soundly at night because they believe Judge Judy is a member of the U.S. Supreme Court. In contrast, most residents of Wall Street are oblivious of Judge Judy.

Wall Street lives on the razor's edge of "fear versus greed," nervously watching other Wall Street denizens in order to rush through the exit before others. In contrast, Main Street focuses on basic questions such as, "Do I have a job? Do I have increased purchasing power? Can I afford a car, a vacation, or the daily necessities?" These basic Main Street questions rarely overlap with the obsession on being the first to act when greed swings to fear, and the answers are largely good to neutral, even as Wall Street has shifted from greed to fear.