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Unmasking the Tipping Point for the next U.S. Financial Crisis

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Abstract:

The risks of the next U.S. Financial Crisis are increasing. Many Americans are fearful of the very negative financial impact of the next crisis especially since it could occur so soon after the negative impact of the Covid Pandemic on the economy. Financial safety nets are weak. The scope of the crisis includes decreasing values of assets, a recession caused by government policies, decreases in the value of existing bonds, and significant social stress fueled by political polarization after the 2022 midterm elections.

We believe the solution to the fear begins with knowledge and a logical approach to assess key risk signals that open the door to formulate and implement actions that can effectively reduce the negative effects. This paper introduces a new risk index, which is called the Economic Crisis Index™. Five national policies and issues are identified as signals of changing risks. A review of policy actions and economic trends in the first two quarters of 2022 verifies that the risks of a crisis are increasing and nearing a tipping point from the post midterm election to mid-2023 period. Ironically, in the 1780s James Madison declared that financial and economic crises were increasing stress, which threatened the stability of the U.S. In that case, the political struggles were primarily between “the class with property and the class without property.” Much has changed in 240 years, but history has a strange habit of repeating itself unless appropriate early actions are taken.

A list of financial information references is provided in the Appendix. These references provide potential information that practitioners and individuals can review, consider, and discuss with their financial resources to devlop the best solution(s) for their situation.

Key Words:

Risks of financial crises, the Economic Crisis Index, signals of changing risk, midterm elections, bipolarization, fear and stress

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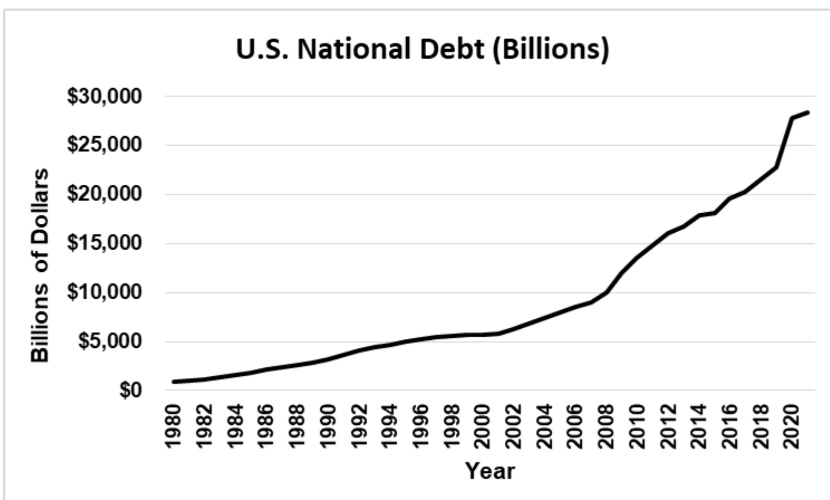
INTRODUCTION

Media news stories appear almost daily on deteriorating economic and financial conditions. Practitioners and individuals are frightened that the next financial crisis will negatively affect them. The problem with such stories is that they increase fear, provide limited knowledge of the signals that risks are increasing, and lack logical approaches to track and monitor key risk trends. This paper seeks to increase knowledge by adding new risk measurements, identify key national policies and issues that signal changing risk, and provide potentially useful sources of information to make informed decisions on action plans to mitigate the increased risks of inflation for different financial assets..

EXISTING KNOWLEDGE AND RISK SIGNALS

Many professionals view increased national debt as the "poster child" of the pending crisis. In 1980 the U.S. government debt was $908 billion, as shown in the U.S. National Debt (Billions) Chart. On Monday October 3, 2022, the U.S. Treasury Department announced that the U.S. national debt passed $31 trillion (or $31,000 billion) dollars.



Source: U.S. Department of the Treasury Fiscal Data, "The Debt to the Penny," Accessed December 12, 2021.

The ratio of U.S. government debt to gross domestic product (GDP) is currently 120.75%. Similar ratios in other nations have historically preceded significant economic system downturns.

Nomura Bank's Cassandra Model of Financial Crises ranked the United States as the Number One Country in the world with the highest financial risk score for a future financial crisis. The Cassandra Model of Financial Crises is based on five early warning signs: the ratio of private credit to GDP, the debt-service ratio, real equity prices, real property prices, and the real effective exchange rate. Nomura claims that Cassandra has correctly signaled two-thirds of the past fifty-three crises in forty countries since the early 1990s. Other top-risk economies include Japan, Germany, Taiwan, Sweden, and the Netherlands. All the top-risk economies face similar risks, but at varying levels, in this time period.

This commentary goes beyond the reasons cited to unveil a specific tipping point when multiple risk factors will converge. It also stresses a call to action between now and the tipping point to track and monitor a

comprehensive series of national policy points, gather information, and prepare appropriate financial plans to change rising risk patterns.

Unless the risk patterns change we believe the tipping point will begin in the fourth quarter of 2022 after the November 2022 midterm elections, regardless of international events. The size and scope of the financial crisis will reach be known by mid-2023.

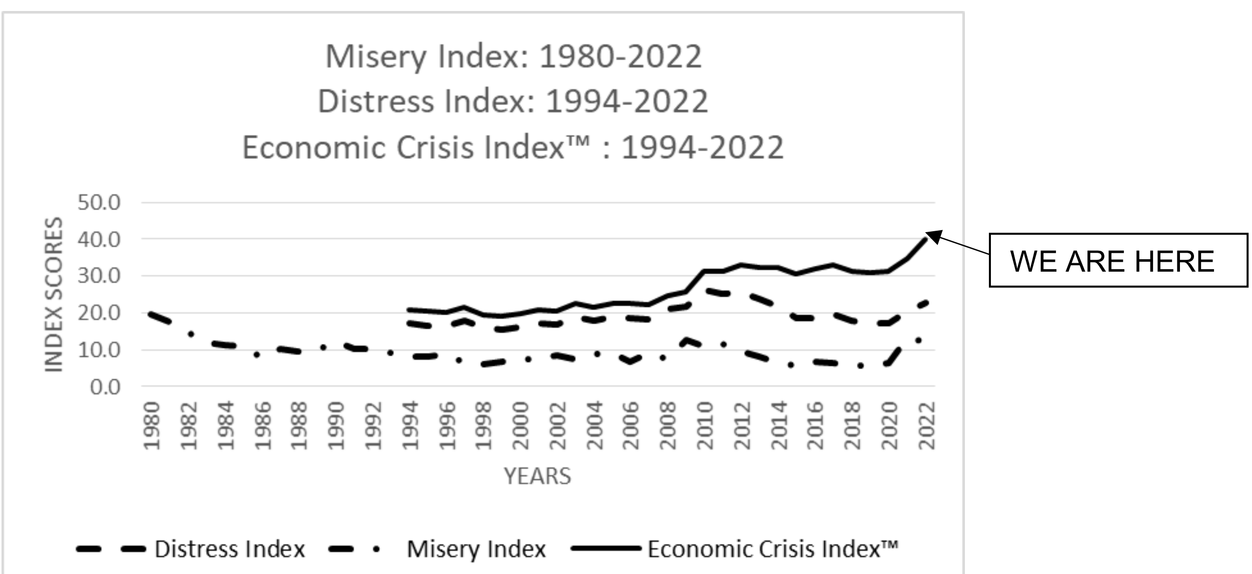
A NEW RISK INDEX: THE ECONOMIC CRISIS INDEX™

In the 1960s Arthur Okun created an economic indicator for President Lyndon Johnson. The Misery Index indicated how the average American was doing economically. Unfortunately, it is no longer possible to accurately compare today's Misery Index calculation with the index measures prior to the 1980s. In this section we explain why the incompatibilities occurred and recommend a new index be officially used to track how average Americans are doing economically. The new index, which we call the Economic Crisis Index, provides a metric to track the consequences of national policies.

The Misery Index is the sum of the U.S. unemployment rate and inflation rate. The U-3 series is the "official" unemployment rate series, and the CPI-U series is the "official" inflation rate. Unfortunately, the Misery Index masks the true value of the suffering that currently exists in the U.S. economy. A stronger measure is the Distress Index, which includes disoouraged workers using the U-6 unemployment rate, which the BLS began reporting in 1994, and a 1980 consumer-based inflation rate. An even more accurate measure of suffering is the Economic Crisis Index, which is calculated by adding displaced workers (i.e. those who are discouraged for more than a year and are not counted by the BLS) to the Distress Index. In 2022 the *Distress Index is shown to be 10.6 index points higher than the Misery Index*. The 2022 Economic Crisis Index is a staggering (29.9) index points higher than the Misery Index. The statistical consistency of the Economic Crisis Index increases the accuracy of comparisons of risk done over time.

Sources: [CPI-U, U-3, U-6 (FRED)], [CPI-ALT and Displaced Workers (ShadowStats.com)].

This historically high 40.1 Economic Crisis Index for the U.S. in 2022 and the 195 risk score from the Cassandra Model substantiate that the risk of a financial crisis in the U.S. National Economy has risen to critically high levels. This pattern becomes far more serious as the nation, highly polarized, proceeds with midterm elections in 2022 and newly elected legislators take office in early 2023 at a time of global turmoil.



Sources: [CPI-U, U-6 (FRED)], [CPI-ALT and Displaced Workers (ShadowStats.com)].

FIVE RISK DRIVERS TO WATCH

Some economic historians believe that the root cause of the past five U.S. financial crises and the pending U.S. financial crisis is the central government's pursuit of a full-employment and low-inflation economic

environment. This governmental goal is unachievable and unsustainable. Yet a low-unemployment and low-inflation economic objective is embedded in the Employment Act of 1946 and the Full Employment and Growth Act of 1978. Today, the FED, Treasury, Congress, Executive Branch, Federal Deposit Insurance Corporation (FDIC), and Securities and Exchange Commission (SEC) are collaborating to achieve this unachievable outcome. In addition, they are simultaneously rushing to instill Diversity, Equity, and Inclusion (DEI); accelerate Control Climate Change (CCC); and Environmental, Social, and Governance (ESG) performance standards in the U.S. economic system prior to the 2022 midterm elections.

Looking downstream, we foresee that the FED will expand its newly adopted Modern Monetary Theory (MMT) policy framework, which has the potential to destabilize the monetary system and even disrupt current U.S. capitalism in a financial crisis. With the terms for three Governors of the seven Board of Governors expiring and two of twelve Regional Federal Bank Presidents open to be filled, a more politicized FED is likely to emerge before or soon after the midterm elections.

Based on our decades of research and recent discussions with other academic colleagues and financial and economic experts, we offer a "checklist" of key national policies that signal the rising risks of financial crisis. The policies are summarized in five specific areas for tracking and monitoring throughout the remainder of 2022. We urge you to follow the patterns and milestones of the issues as signals that a tipping point for a financial crisis is approaching.

(1) National Debt and Taxes

Trillions of dollars of new debt financing and increased taxes add to the debt load and decrease the marginal revenue product of debt. The debt flood gates will open when the President and the Secretary of the Treasury convince legislators to abolish the debt ceiling and increase business and personal taxes.

(2) Contractionary Monetary Policies

Supply-side factors, such as decreasing inventories and supply chain disruptions, are outside the policy scope of the FED. They will increase inflation regardless of the FED's contractionary monetary policies. The FED's decision to reduce its massive Asset Purchase Programs prior to increasing interest rates shortens the timeline and raises the cumulative interest rate increases needed to decrease future inflation. Rising prices for commodities, including energy, offset the effectiveness of contractionary FED policies due to their elasticity. Most of the current inflationary pressure involves highly inelastic commodities almost immune from interest rate or price changes. This puts the FED in a very difficult economic situation to solve. Equity market volatility varies as the FED's Federal Open Market Committee and Board of Governors determine the actual number of interest rate hikes, timelines, and magnitude of the targeted cumulative FED rate increases in 2022.

(3) Value of U.S. Dollar

The FED enacts global money-market policies to stabilize the U.S. dollar. Challenges to achieve a stable and stronger U.S. dollar mount as cryptocurrencies are more frequently used for international transactions outside the banking system and initiatives to strengthen the EURO by the European Central Bank. Increased scrutiny of international financial transactions by the IRS slow down and decrease the use of the U.S. dollar in the global banking system. Significant price increases for gold and like commodities result as the value of the U.S. dollar declines relative to other currencies.

(4) New Banking and SEC Regulations

New regulations, which are being openly discussed in early 2022, launched on multiple levels before the midterm elections. The Securities and Exchange (SEC) and FDIC expand their regulatory functions to include equity, diversity, environmental, and social compliance. Restrictions on portfolio construction for federally sponsored retirement plans, such as 401K accounts, are implemented by newly appointed officials. The Internal Revenue Service (IRS) is given the authority to examine all banking accounts. New appointees to the FED Board of Governors and Regional Banks rush to open bank lending to households and businesses that do not meet established default risk criteria. The FED stands ready to be the "lender of last resort" for increases in national debt needed to pay for fiscal stimulus programs and banks with low scores on their Financial Stability Reports. Banks, including Bank of America, offer low or no interest loans to households that do not meet historical qualification standards and are underrepresented in the bank's lending portfolio.

(5) Belief and Trust

Basic beliefs, trust, and confidence unravel. The U.S. dollar weakens as a domestic and global currency because people doubt they will be able to exchange it for goods and services in the future. People lose trust and confidence in the ability of the U.S. government to serve and protect all people. Questions about the quality of family life during an ongoing pandemic, the effectiveness of hybrid learning, and the abilities of businesses to hire needed employees remain unanswered. Political polarization reaches new levels during the midterm elections. Decisions by the Supreme Court become increasingly controversial and political, legislation grinds to a standstill in Congress, and the President is held accountable by both sides of the political and social spectrum for not meeting their agendas.

MID-2022 REVIEW OF CRISIS RISKS

In the first quarter of 2022 we assessed that increasing risks of financial crises in the fourth quarter of 2022 would reach a tipping point. As the U.S. economy nears the end of the third quarter of 2022, we systematically reviewed our thinking, key indicators, and checklist of risk signals to verify if our earlier findings were accurate. As shown below, we tracked events that indicate increased risks of a crisis. The timeline for the tipping point remains in the nine month period from the midterm elections to mid-2023 unless corrective actions are taken to change the risk patterns.

Updates for the past two quarters include these items:

- The U.S. national debt to GDP ratio, which passed 120 percent in early 2022, is now projected by Statista to rise beyond 130 percent in 2026. This rising debt trend is consistent with the U.S. retaining the number one financial risk score for a country using the Cassandra Model from Nomura Bank.
- Gross Domestic Product decreased by 1.6 percent in Q1 and by 0.9 percent in Q2. The U.S. economy is now offiically in a "recession."
- The levels of inflation and unemployment raised the Economic Crisis Index for the U.S. from 40.1 level in Q1 to 41.6 as the U.S. enters Q3. The Misery Index and Distress Index values also rose.
- Tracking and monitoring of the five key national policies and issues cited above as risk signals yielded the following:

  (1) National Debt and Taxes
  As noted earlier, national debt continues to rise at an alarming rate, raising financial risks. Significant tax rate increases are also being finalized by the administration. In the second week of June Secretary of the Treasury Janet Yellen reported to the Senate Finance Committee that the FY 2023 budget would result in a four trillion dollar increase over the next decade. The budget includes a series of new minimum taxes for individuals, businesses, and international corporations. The magnitude of the tax and revenue increases being proposed are unprecedented. If approved, the U.S. would have the highest tax rates in the Developed World.

  (2) Contractionary Monetary Policies
  Inflation, the unspoken downside of MMT, gained momentum due to a series of miscalculations. These often cited policy mistakes follow.

    a) In February EUCB President Lagarde stated "the massive U.S. government stimulus is one reason why Europe is on a less aggressive monetary path than the FED." In other words, too large a stimulus package put the U.S. on a path to higher inflation than the EU.

    b) Allianz Chief Economist Mohamed El-Erian said that calling inflation "transitory" was an historically bad move which delayed taking early and less aggressive monetary policy actions.

    c) In June Treasury Secretary Janet Yellen stated "she was wrong last year when she said that inflation only posed a small risk." The June inflation report showed a forty year high of 9.1 percent.

    d) The FED raised its discount rate 0.75 percent for the second consecutive month in July 2022. The four FED rate increases in 2022 now total 2.25 percent.

  (3) Value of U.S. Dollar

Goldman Sachs recently noted certain countries are aggressively targeting stronger currencies in a “reverse currency war.” These policies threaten to trigger swings in the value of the U.S. dollar and other dominant currencies, upend the finances of international companies, and shift the burden of inflation around the world. Such actions are not historically consistent with past currency wars that favored exporters during periods of inflation.

(4) New Banking and SEC Regulations
The FDIC and SEC have continued to increase the importance of diversity, equity, and inclusion in their regulatlions. The primary activities in the last six months have focused on the distribution of the SEC’s Diversity Assessment Report and the FDIC’s revised Diversity, Equity, and Inclusion Strategy Plan. These reports set “non-conformance” standards and consequences for social fairness that are now being activated. For example, Sustainalytics recently published 2022 Environmental, Social, and Governance (ESG) rankings for corporations. Based on its social and governance metrics Tesla ranked 42nd of 83 among comporations scored in its sector. Yet, based on the new SEC guidelines, Tesla was delisted from the S&P500 ESG. Additional suspensions of stock trading and/or loans for “non-conforming” entitites are expected to follow.

(5) Belief and Trust
The Pew National Election Study measures trust and belief in the government. In 1958 Pew reported that belief and trust in the government was 75 percent. The June 2022 survey reported that belief and trust in the government was down to 20 percent. Today, 29 percent of Democrats and Democratic-leaning independents say they trust the government compared to 9 percent of Republicans and Republican-leaning independents. Polarization across party lines seems certain to intensify during and after the 2022 midterm elections.

CONCLUSION

These findings and others not only signal rising risks but raise the potential that the U.S. is fast approaching a point of no return. The pain of inflation and the implementation of the national policies cited above point toward a financial crisis encompassing recession, currency, equity, and bond markets, in a deeply polarized society.

Recession and increased social media coverage of the midterm election results seem increasingly likely to fuel the risks of increased social disruptions on the local, state and national levels. The midterm election outcomes may be the first considered unaceppable by all sides of the political spectrum.

A list of possible information references that individuals and practitioners can review, discuss with their financial advisors, and take appropriate actions are found in the Appendix. At this time, the size and scope of the upcoming financial crisis have the potential to be substantial, but the final outcomes remain uncertain.

APPENDIX

The following is provided for informational purposes only. Copy any URL you are interested in and paste it in your browser to view the information.

Inflation has diverse impacts on different asset sectors. See:

https://blogs.cfainstitute.org/investor/2021/07/19/myth-busting-equities-are-an-inflation-hedge/

Financial sources agree that there are several different ways to hedge against inflation. See:

https://www.investopedia.com/articles/investing/060916/top-5-ways-hedge-against-inflation.asp

https://money.usnews.com/investing/articles/best-investments-to-hedge-against-inflation

https://www.kiplinger.com/personal-finance/banking/savings/savings-bonds/604266/the-inflation-hedge-youve-never-heard-of

https://www.cnbc.com/select/where-to-put-your-money-during-inflation-surge/

https://money.usnews.com/investing/stock-market-news/slideshows/stocks-that-are-good-inflation-investments

Timing is always important when considering investment changes. The potential exists that the best inflation investments are behind us. Such an opinion is discussed in this reference (written before August inflation data). See:

https://seekingalpha.com/article/4529737-its-over-for-best-inflation-investments

Asset categories, including some active Exchange Traded Funds (ETFs), often trend with other assets patterns. See:

https://money.usnews.com/funds/etfs/rankings/systematic-trend

https://www.cnbc.com/2022/05/11/in-a-market-sell-off-when-everything-else-is-hitting-the-fan-these-etfs-look-to-help.html

https://fknol.com/etf/list/trend-following.php

Bonds are the most common fixed asset securities and returns are affected by inflation with one exception. Information on inflation's impacts on fixed asset securities and Treasury Protected Securities (TIPS) can be found using these links. See:

https://www.investopedia.com/ask/answers/021615/how-does-inflation-affect-fixedincome-investments.asp

https://www.treasurydirect.gov/indiv/products/prod_tips_glance.htm

Information on other asset classes that provide potential protection against inflation can be found in this reference. See:

https://www.kiplinger.com/investing/mutual-funds/602983/5-best-mutual-funds-to-fight-inflation

Precious metals, including gold, silver and platinum, potentially increase in value as inflation increases. See:

Gold: https://www.investopedia.com/articles/basics/08/invest-in-gold.asp

Gold ETFs: https://etfdb.com/etfs/commodity/gold/

Silver ETFs: https://etfdb.com/etfs/commodity/silver/

Platinum ETFs: https://www.investopedia.com/etfs/top-platinum-etfs/

International currencies, such as the Swiss Franc, can provide potential hedges against a declining dollar in high inflation periods. See:

https://etfdb.com/etfs/currency/chf-swiss-franc/

There are a number of real estate asset possibilities. One area, apartments, has been especially noted. See:

https://www.investopedia.com/articles/real-estate/071916/top-5-apartment-reits-2016-eqr-av

Last but not least, higher interest rates, driven by FED increases in discount rates, potentially increase the value of interest bearing savings accounts including Money Market Accounts and Certificates of Deposit. See:

https://www.bankrate.com/investing/inflation-hedges-to-protect-against-rising-prices/