Economic & Market Update

April 1, 2919

We're with Albert Edwards, Now More than Ever

This month I'm going to present thoughts from the economic forecaster considered the most accurate in the world. This would be Albert Edwards, the large French bank Societe Generale's top global strategist. Mr. Edwards recently won an award as the best global economic forecaster in the world for fourteen straight years.

While Mr. Edwards tends to be correct more than others each year, his primary thesis involves his predictions for the U.S. and world economy, and stock and bond prices, at the end of this business cycle. That is the last day the economy is falling at the bottom of the next recession.

Mr. Edwards believes our central bank has been following the Japanese central bank's playbook. He therefore expects the ultimate path for the United States economy can be found by looking at what has occurred in Japan.

This means we will have continually falling interest rates and, eventually, deflation. Mr. Edwards put forth this thesis in 1996. Since first presenting his long-term forecast, interest rates have fallen to their lowest levels ever in Europe and the United States. That's two very big correct calls in Mr. Edwards' win column.

Those who really understand what Mr. Edwards is saying would have a whole lot of their money in long-term Treasuries. If Mr. Edwards is or, rather, continues to be correct, long-term Treasury bond prices will go through the roof. (This means we should make a lot of money at Secure Retirement.)

At the end of this article you'll see summaries of three of Mr. Edwards' reports from the last year. In order to understand his views, you need to understand what has actually been going on in monetary policy in the United States. Looking just at the reported facts, I would say the direct end result of Fed monetary policy theory and practice is an economy with the largest debt bubble in history, encompassing historic highs in government, corporate, and consumer debt. This economy would also have the highest level of debt inequality, as the policies we have followed have led, directly, to a severe redistribution of wealth to the very tippy top.

The monetary policies in question are those which keep the price of money at the lowest possible level while dramatically increasing the amount of money available. This is guaranteed to lead to bubbles – somewhere. And the more you do it, the bigger those bubbles become. Popping asset bubbles is very damaging to the real economy, yet it is the direct result of Fed policy since Greenspan. Do you suppose it was just an accident their policies also led to a very predictable explosion in income inequality?

With vast amounts of very cheap money available, corporations have gorged themselves on debt – beyond the previous high in terms of the total amount of debt relative to the size of the economy. All-TIME HIGH. Let that sink in, and then guess what is going to happen next.

When they write the economic history of this bizarre time period, here at the end of the largest asset and debt bubbles in world history, I hope it reads something like:

"Back in 2020, the public rose up against a Federal Reserve Board whose policies had led to the lowest wage growth, lowest productivity growth, and the slowest overall economic growth since World War II, and tied for first place in the history of the country in terms of wealth inequality.

"The fact they were tied with 1929 in terms of wealth inequality should have, it seems in respect anyway, set off alarm bells in investors' heads, but due at least partially to the din of hearing the same perspective all day every day, most apparently couldn't even recognize the warning bells going off all around them.

"To have suffered the lowest growth rate since World War II for over ten years and to have simultaneously gone into more debt than at any time in history, added insult upon injury.

"The overarching Fed policy of encouraging cheap and readily available debt was removed in favor of….. (fill in the theory you think will replace the Fed's destructive policies)."

The basic problem with Fed policies is that they have "broken" capitalism. When you translate the policies of historically low interest rates with historically high amounts of money printed into existence, one effect on the economy is to keep all the weaker companies competing – for a time anyway – with the better companies. It's called capitalism, and when your competition can't really go away, i.e. go bankrupt, then it's hard for the good companies to make as much profit as they should, or to take market share from the weaker competitors. But it's these companies, i.e. the best, which end up creating the most jobs and wealth for the economy.

Instead of simply refereeing a fair playing field where the best companies succeed and others fail, our Fed decided all companies would stay in business. It's how they decided to "rescue" the economy in 2009, i.e. by making so much money available so cheaply that nobody else would go out of business. They provided nearly unlimited, nearly free money to our corporations. It's hard to go bankrupt when your investment banker says you can issue a bond and borrow another $10 billion – at historically low long-term rates!

The only downside is that capitalism rests on the bedrock of fair competition, and Fed policy removed anything resembling fair competition from our marketplace. Of course, without properly-functioning capital markets, we have had very low revenue growth, productivity growth, and overall economic growth. It sure seems to me this should be self-evident, yet I don't hear anyone on television talking about it.

The same policies also led to frenzied stock buybacks, in which owners of our corporations decided to use the companies' money to increase the amount of the company owned by current owners. I haven't sorted out all the implications on this topic, but it would have been nice had this money been invested in their domestic operations.

Since Fed Chair Greenspan responded to the Long-Term Capital Crisis in 1998, what we see today is the clear and, to me anyway, obvious result of the monetary and regulatory system Greenspan, Bernanke, Yellen and company created. Low wage growth, low productivity growth, low overall economic growth, massive debt and, wait for it, nearly all the growth in wealth going to the very top. Who could argue with such brilliant policies? And how could you hide it from nearly the entire public for so long? This won't change until we change Fed policies.

As a whole, in the broadest economic terms, Fed policies have led to the scarce resources of our economy being spread out, artificially through monetary policy, among the winners and the losers in corporate America. Everyone who plays gets showered with money. Everybody wins, if you're a publicly traded corporation, when you massively increase the amount of money available while dramatically lowering the cost. Then when it comes crashing down you will find more weak companies than you've ever imagined. Or, as Warren Buffet has said, "When the tide goes out you see who was swimming naked." Well, when the tide goes out this next time, we're going to see it truly was mostly "naked capitalism."

Personally, I hope and pray enough central bankers have been trained as to how to respond so this next time we don't have an existential threat to our entire banking system like we did in 2008. I'm semi-confident the financial system will remain standing! Our economy, on the other hand, is going down hard.

On a bright note, there are much better economic paths to follow than those we've been led down by the Fed. They involve much, much less central bank intervention, not more. <u>Successful central bank policies are characterized by an abundance of prudence, both in overseeing the financial system and in never interfering unnecessarily in the markets</u>.

Central banks cannot control the economy, at least not in a way that benefits the citizens. When they act, since Greenspan, their actions have done exactly one thing, which is to enrich the wealthy – essentially transferring the wealth of the nation to the very top. Again, good job. They have succeeded, probably beyond the wildest dreams of their masters on Wall Street.

The best policy is for the Fed to stop interfering in the economy. Economic growth is directly caused by new business creation and productivity growth. The Fed can never determine those better than a competitive, fair business climate can.

This doesn't mean the government itself should not have a say in the market structure, but it absolutely means it is not the Fed's place, at all, to decide who wins and who loses, and by what amounts. To the contrary, the social contract we have, between corporations and workers and retirees, must be determined by Congress. The Fed should have nothing to do with it.

Today, the all-consuming focus upon the Fed, and all its policies, distorts financial markets such that the necessary structural changes in our economy can't even be considered. Corporations have captured Congress, while Wall Street has captured the Fed.

I wonder how those two facts are likely to play out if tried in any economy? I'd take a wild guess and say one would end up with the greatest level in wealth inequality in history, which is what we have today. Okay, we're tied with 1929, which everyone seems to ignore as a random, trivial fact. I beg to differ, and can prove core economic similarities between 2019 and 1929 pretty convincingly from a number of perspectives based solely on reported economic results.

My monetary policy right now would be fairly simple. First, when what you are doing has created and continues to exacerbate the problem, stop. Make sure you are ready to implement every single measure to keep the system from collapsing. But also make sure the losses fall on those responsible, i.e. no taxpayer money protects financial institutions from having all their stock and bondholders wiped out. We'll protect the system from that starting point, but the first and absolutely necessary step will be to let every company fail that is going to fail, and not have the losses transferred to the taxpayers. <u>Their bondholders must lose every single penny before they get a penny.</u>

In financial regulation, simplicity should be the one guiding principle. Bailing out failed banks is the single, number one biggest mistake a central bank can make. Having read the results of her studies, I think we can say this has been conclusively proven by Dr. Carmen Reinhart. When you bail out your banks, growth in your economy slumps, on average, for more than the next 20 years. Our central bank did just that, and our economic growth rate crashed down to the lowest level since World War II – for over ten years. Yet nobody at the Fed lost their jobs, and their policies continue unchallenged. Amazing! The mainstream economic and corporate world certainly has a solid grip on public opinion when it comes to monetary policy. Any sane person might want to consider alternatives to our current policies.

We should return the Fed to its original, main purpose, which was simply to provide liquidity to banks which had a severe mismatch between long-term mortgage loans they had made and short-term obligations they had called bank accounts. Called a "run on the bank," the Fed was to step in and, when the bank could prove they had sufficient collateral, lend that bank enough money to continue to operate. Further, the interest the government was to charge on these loans was to be "onerous," meaning above market rates, in order to punish the bank for having made the mistakes that led to the run on their bank.

So, the first job of the Fed is to keep banks with sufficient assets afloat when they find themselves starving for short-term funding. Related is the responsibility to keep the financial system itself from imploding during a financial crisis. For example, the greatest risk the system faced in 2009 was due to a shortage of U.S. dollars available to European banks, who basically wouldn't have been able to open their doors one day, I believe in March of 2009, if they had been required to settle everything in scarce dollars. The Fed stepped in and injected something like $4 trillion into the European system, beginning that very day, and it worked perfectly. It stopped that particular panic, and it shouldn't have cost us anything as we were simply swapping our currency for theirs for short time periods.

Notice that nowhere above does it mention the Fed is supposed to bail out banks with taxpayer money, through any method, because they aren't to do so – ever.

The only other (primary) action I would take would be to put all the smart people who work for the Fed to the task of figuring out what the markets themselves are saying interest rates should be. Then I would set the short-term rate accordingly. That's literally all I would do.

If we want to try to stimulate the economy, that now becomes the job of Congress – ***as it always has been!*** That is where it belongs, while the Fed's efforts to stimulate growth simply lead to massive amounts of money being shot into corporations and the accounts of the ultra-wealthy in our country. Whoever was closest to the "spigot" when the Fed printed over $4 trillion swallowed the profits on this torrent of money. They also leveraged it in a hundred ways.

We must first stop feeding this deadly beast of an apparent, Fed-controlled economy and markets. The Fed of course can't hold things up forever, but if their primary purpose has been to enrich the very wealthiest, they have already succeeded beyond any master's expectations. Then when things come crashing down, the Fed plans to come to the rescue, pursuing the exact same goals as they lead us to further ruin. I know that sounds melodramatic, but I believe it is literally accurate.

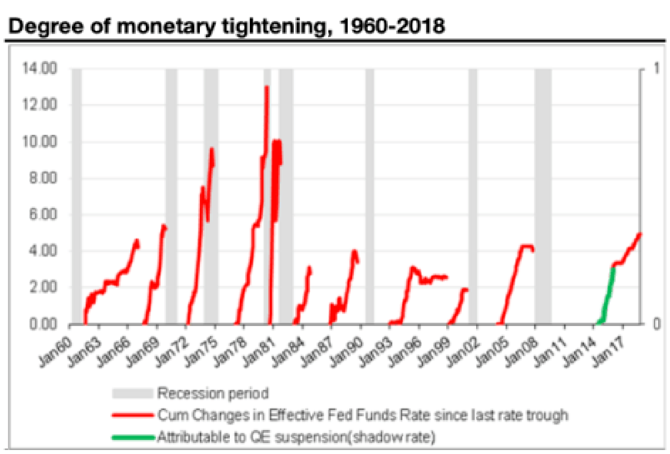
You can understand why the first job of a sane Fed would be to stop everything the current Fed is planning to do in the next recession. For now, I think one can make a very solid case that our new Fed Chairman Jerome Powell has been prudent thus far in his short tenure. Of course, I'm hardly naïve enough to hope he will completely change from driving down the middle of the huge Fed highway which is the only avenue of thought that has been considered in monetary policy – or at least given a voice – since Greenspan. To the contrary, the Fed is going to pull out all the stops this next time around. That's how we get to the crazy notion Mr. Edwards writes about that the yield or interest rates on our 10-Year government bonds falling to ***a negative*** 1% by the bottom of the next recession.

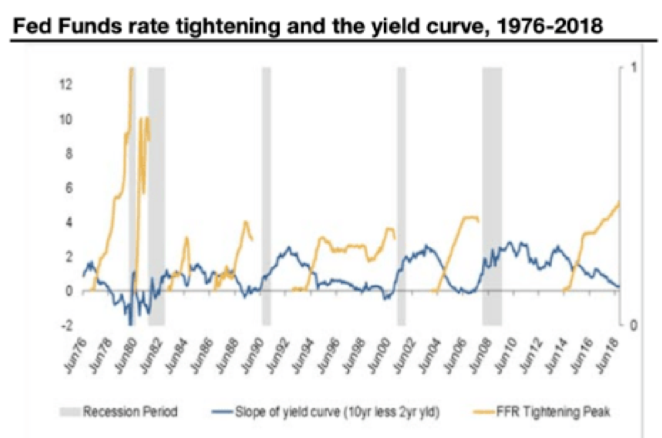
Anyone who understands current Fed policy knows this is, if anything, understating just how far the Fed will go to maintain the status quo. It's not their money, so they'll print up any amount, $5 trillion, $100 trillion, lower interest rates any amount, do whatever it takes to maintain the status quo. Until somebody stops them, we will likely get the same, or worse, economic results.

Instead, perhaps we might consider letting the market take the lead in determining the cost of money, and restoring ultra-prudent monetary policies and banking regulations such as we had in times since World War II when productivity growth was much, much higher in our nation.

Of course, those listening to his investment advice have, in many cases, become impatient with Mr. Edwards over the last several years – even though he never said he knew when the iceberg would end up capsizing the world economy and markets. That being said, last year Mr. Edwards began to see a recession right up ahead. In November he wrote:

"Our very own Quant guru, Solomon Tadesse, did some really interesting work back in May this year (2018) showing that the Fed's monetary tightening was already close to what would historically trigger a recession. Here are the charts on that:





Source: SG Cross Asset Research/Equity Quant

Mr. Edwards perhaps stands out in the clarity of his recognition that waves of losses from bad debt drive down interest rates. We rarely find anyone who understands what drives interest rates. Yet anyone who investigates quickly discovers interest rates plummet during severe debt liquidations. It's hard to raise prices when you and a lot of your competitors are going out of business. It's hard to have high oil prices when economy activity, and therefore miles driven, plummets. And it's hard to sell a house for a higher price when the number of people selling their homes from losing their jobs swells the number of homes for sale in your area. In other words, prices go down. This is literally the nature of debt liquidation events, which means deflation is basically the known result of debt bubbles. There are certain exceptions, but then we have to get into theories of inflation. Another time, as right now inflation isn't a threat.

The size of the debt liquidation event, i.e. losses on debts of all kinds, is tied directly to the amount of deflation it creates. Combined with a Fed practically itching to try even larger monetary experiments, definitely including negative interest rates, it's a safe bet interest rates will indeed soon reach all-time lows. This means it's also quite clear long-term Treasury bonds are poised to roar.

It is, by the way, also quite clear that the very concept of negative interest rates is just as crazy today as it was known to be, by every respectable monetary policy theorist who ever lived, until Bernanke took over orchestrating our demise. What we don't yet know is how long the public will take to demand an overthrow of current Fed policy.

I think monetary policy is difficult for some to understand because there are around a million "weeds" which can be thrown up to throw one off the scent. For myself, I follow that scent exclusively by going where the actual reported economic data has lead us, from the moment Greenspan walked onto the scene through today.

With no further pontification, here are excellent summaries of three of Albert Edwards' reports, from February and November of last year and February of this year. The reason Edwards is the most accurate economic forecaster, year after year, is due to the fact his understanding of the core principles which govern economics is right at or near the top.

SocGen's Edwards: Investors are 'stoned on free money'

The following three articles were written by Tom Eckett (www.investmentweek.co.uk)

22 February 2019

Société Générale's bearish strategist Albert Edwards has warned the investment community is "hooked on monetary opioids" provided by central bankers over the past decade.

In his latest investment note, the permabear noted that every major central bank has played a part in injecting another "dose of euphoria" into its "market patch".

The Federal Reserve, he said, was the most "visible and dominant dealer" of all, by deciding to put its foot on the interest rate brake in January just a month after signalling plans to raise rates twice in 2019. Markets are now pricing in a rate cut.

However, it is not just the Fed. As Edwards highlighted the European Central Bank, the Bank of Japan and the People's Bank of China all loosened policy in January.

"What we see is a market zig-zagging down the street in befuddlement after being given yet another quick fix by the central bank dealers in easy money.

"Having got the investment community hooked on monetary opioids, the central banks are making it clear that they will be there for the addicts if the withdrawal symptoms get too severe.

"Free money is now the drug of choice and the central banks have basically declared it legal and readily available."

The permabear warned the problem with the central bankers' strategy is investors are becoming "detached" from the investment landscape, which "could easily prove fatal."

He added equity portfolios would be the key area that would be "crushed" by the deteriorating economic cycle, with investors' senses now numb to the risks.

"The US is [in fact] gripped by an epidemic of stoned pedestrians stepping into traffic," he continued. "The same might be said for investors befuddled by QE, for the risk is they are about to step off the sidewalk in front of a rapidly deteriorating economic cycle.

SocGen's Edwards: 'Fragile' US economy will be exposed when Trump's 'sugar rush' tax reform wears off next year

08 November 2018

Société Générale's bearish strategist Albert Edwards has warned the US economy is set for an "unpleasant" turn once US President Donald Trump's stimulus package wears off in 2019.

… the bearish analyst noted how investors have "gorged" themselves on his tax reform.

US equity markets have been in a euphoric state since President Donald Trump passed his historic Tax Cuts and Jobs Act reform, which saw corporation tax cut from 35% to 21%.

He added Trump's fiscal stimulus was ill-timed for where the US economy is in the economic cycle but "perfect" for the electoral cycle.

"People either love or loathe Trump. He is like Marmite," Edwards said. "But you have to be wary when biting into Marmite because it might not be what it seems! The same is true regarding the robustness of the US economy."

Edwards pointed to the US Philadelphia Semiconductor index, which failed to reach a new high in September, as a "clear warning to investors."

"When the semiconductor index makes a lower high at the same time as the S&P 500 makes a higher high, it is usually time to retreat to a defensive position because it suggests that the economy is slowing fast and hence a bear market is on the way."

Despite the strong business confidence, the permabear warned there was a "subdued" pace of business investment in the US. If the sluggishness persists once Trump's US tax reforms have worn off, Edwards said the "underlying fragility" of the economy would be revealed, adding the "aftertaste" would not be pleasant.

"If this is as good as it gets, what happens next year when the sugar rush of fiscal expansion begins to wear off? "

SocGen's Edwards: 10-year Treasury yields will fall to -1% in the next recession

Will converge with European and Japanese 10-year yields

01 February 2018

Société Générale's bearish strategist Albert Edwards has told Investment Week he believes US 10-year Treasury yields will fall to as low as -1%, as he warned of "double bubble trouble" in US markets.

Edwards previously forecast that US 10-year yields will fall below zero but told *Investment Week* these could go as low as -1% in "the depth of the next recession" as they converge "totally" with Japan and Germany.

"Sound ridiculous? German 10-year yields were -0.2% last July," he added.

On Monday, rising inflation expectations caused a sell-off in the global bonds markets with spreads in US 10-years widening to 2.73%, the highest point since April 2014.

Although Edwards predicted yields to widen beyond 3% first, he said they would drop into negative territory as the US and Europe would "flip" over into outright deflation and central banks would adopt even more extreme measures such as negative interest rates and "helicopter" money.

SocGen's Edwards: We are now just one recession away from Japanese-style outright deflation

Edwards said: "We had negative 10 years in most 10-year government bond markets in Europe some 18 months ago and in Japan. The US was the outlier then.

"In the next global downturn, US 10-year yields will converge totally with Japan and Germany. It will be another deep downturn because of the credit and asset bubbles that global quantitative-easing (QE) has pumped up."

Furthermore, the bearish analyst said he expected the market crash to come a lot quicker than investors were expecting as the US now had "double bubble trouble" with bubbles in both corporate and consumer debt.

He said the Federal Reserve's "easy-money" policies, which has driven household wealth to fresh highs, coupled with the savings ratio falling during the same period, had fueled an "unsustainable credit bubble."

"Just like 2007, this is another economic boom fueled by an unsustainable credit bubble that will inevitably blow up with a rooky Fed Chairman [Jerome Powell] in place."

In SocGen's annual Global Strategy Presentation, Mr. Edwards said it was Bank of Japan action, quantitative tightening (QT), or the fear of recession itself as the three factors which could trigger the next crash.