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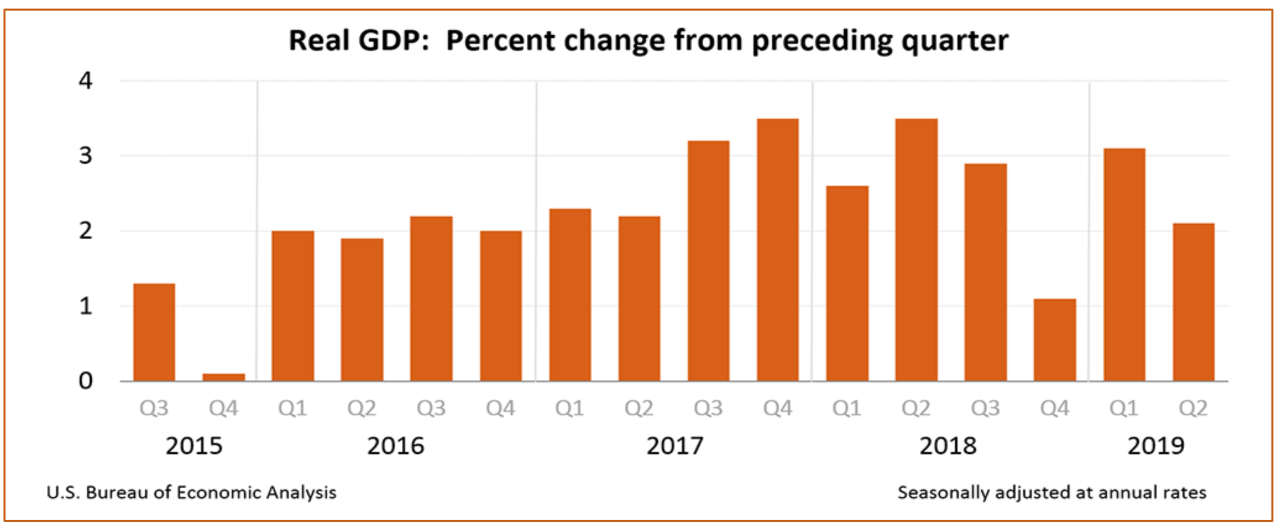
Economic Update, August 2019

One Big External Shock

by Richard Morey

Every day, I hear from intelligent people that "the economy is doing great." As you can see in the chart below, GDP supposedly grew at 2.1% in the second quarter. Since economic growth *averaged* over 3% throughout most of our history, I'm not sure how to respond. Since 2017, the economy has grown over 3% four quarters, and below 3% six quarters. This is definitely better than it did in 2015-2016. However, when did 2% growth become really good?

GDP peaked back in the second quarter of 2018. Except for a one-time, one-quarter bump from the tax cuts that showed up in the first quarter numbers of this year, the trend isn't up. And no, the tax cuts have no further stimulative effect on the economy. It was a one-shot, I think they say $1.4 trillion, gift to corporations that led to *one quarter* at 3.1%. That was one expensive quarter for whoever pays our nation's bills!



Recession Warnings are Increasing, in Number and Intensity

The chart on GDP above actually doesn't tell us much at all. Perhaps the next few quarters will turn back up. To attempt to predict the next few bars on that graph, we need data on the areas of the economy that typically go down early in any recession. We want data that covers the broad economy and has a high correlation with recessions which followed. You then "weave" the data on all the relevant, nationwide economic statistics into a picture showing the likelihood of a recession, and the likely severity. This picture is ideally "drawn" in probability theory, and the results are expressed in probabilities. This is the way it has to be in an area in which perfect prediction of any future event is impossible.

I don't know of any economist who has actually been able to create anything resembling a crystal-clear picture of where the economy is headed in the next few months. There are, however, a number of key economic indicators that have had a high correlation with subsequent recessions. Right now several of these indicators, including some of the really big ones, are dropping quickly towards recession levels or are already at those levels. Despite what I hear on television every day, the broad economic data has been deteriorating all year.

Here is a short list of the recession warnings:

Warnings Related to Industries

The first four warnings are related to four large industries, which are either indicating a falling economy (manufacturing, construction, and transportation) or are simply in trouble such that they are a guaranteed drag on GDP (agriculture).

- Last week manufacturing results came in, right at recessionary levels. Any reading below 50 means we are in a manufacturing recession, and we came in at 50.4, the third month in a row hovering above contraction. According to Trading Economics, "the latest reading indicated the slowest overall expansion in the manufacturing sector since the height of the financial crisis in September 2009."
- In the latest reading (June), overall construction spending nationwide fell 1.3% year-over-year.
- All forms of transportation, including truck and air freight, have declined so far this year. Relative to most other economic statistics, this one has a fairly high correlation with actual recessions.
- The agricultural sector of our economy is hurting. The floods which hit Nebraska obliterated whole areas of what had been extremely rich farmland. Add in the trade war in which China is stopping importing our agricultural products, and you have a drag on GDP. While agriculture is no longer a huge percent of GDP, when it has a severe recession, this does bring down overall economic growth for quite a few states.

Warnings Related to Macroeconomics

- The first involves something called Gross Domestic Income. This is all the income earned in the entire country. Gross Domestic Product and Gross Domestic Income are measuring the same thing, just from different angles. The point is that GDI is just as valid a measure of economic growth as GDP. If the same quality of data was used to compute each, the result would be the same for both.

  In his latest quarterly report, in discussing how GDI has been performing, Dr. Lacy Hunt said the last reading on GDI showed it rose "a very meagre 0 .76% annual rate in Q4 2018 and Q1 2019."

  Keeping in mind that GDI is another way to measure economic growth, simply not the one the Fed likes to talk about, and considering it has been growing at less than 1% for at least six months, you can see why Dr. Hunt went on to note that, "...prior to the severe recession in 2008, GDI led GDP, just as presently, a clear warning sign."

- A more certain way to judge the state of the economy comes from tracking down how we stand in the velocity of money and the growth of the money supply. Since GDP equals velocity x money supply growth, if either goes negative, the economy is by definition contracting. The growth rate of both velocity and money supply have been dropping sharply this year, ***which is exactly what you would expect if manufacturing, transportation, and construction were falling, in concert with all the other warnings discussed in this report.*** Even worse for the economy, in his monthly report Lacy explained how any modest upswings we've seen in velocity and the money supply were due to one-off months or quarters. But in total, they have both fallen so far this year that they are moving directly towards recession. Always keep in mind that if one falls into negative territory, by definition the economy is contracting.

If the next few readings on velocity or money supply show a drop even half as much as they have thus far this year, we will officially be in recession. This is a fact, or accounting identity.

- Another very large economic measure is called Real Disposable Income, which is the growth in the amount of money consumers have to spend each month. You can see why this is a good indicator of the upcoming state of the economy. The warning is also clear. In the latest month (June), disposable income was below where it was 18 months ago.

  That last sentence certainly doesn't correspond to what I've heard on television all year. Their voices have told me a hundred times that the consumer, whose spending equals approximately 65% of the economy or GDP, has plenty of money (due to all those jobs they have, I suppose) to spend.

  Most people on the financial channels on television cannot seem to understand that when real disposable income goes down – which it typically never does outside a recession – for 18 months, and consumer spending doesn't go down accordingly, the only other answer is that the difference was made up in additional debt.

- Consumer Debt. This is our next warning flag, and it's a big one. Consumers exceeded all-time highs in all types of consumer debt, except mortgage debt, some time ago, and continue to extend those highs. Breaking previous debt levels is the one thing the broad U.S. economy has been capable of achieving.

  I wonder if the consumer's ability to take on more debt is likely to ever become exhausted? Can you increase your debt levels forever, paying over 20% annual interest on much of it, without having your real income increase, indefinitely? If the answer is 'no,' the U.S. economy is in trouble.

  If that isn't a warning sign, I'm not sure what is. At the very least, it sounds strange to characterize the U.S. consumer as "strong," which is exactly what I have heard over and over this year. How can they be strong when one can easily prove all the consumer spending increases this year have been due to the increase in revolving credit card debt, mostly to consumers already heavily indebted. If that's a strong consumer, let's hope we never see a weak one!

- Yield Curve Inversion. (Defined as when the interest on long government bonds pay less than the interest on short bonds; i.e. when long rates are lower than short rates.) The yield inversion got some press when it first inverted some months ago, but then seems to have been forgotten. Lacy, however, hasn't forgotten inverted yield curve's perfect record in predicting recessions. To again quote from his monthly report:

  "The spread between the three-month Treasury bill rate and the yield on ten year or long-term Treasury bonds has inverted for the eleventh time since 1921. In all the previous ten inversions, recessions followed."

  That's a fairly simple, clear recession warning that has never been wrong, and the inversion doesn't appear likely to go away until we are already in, or going inevitably into, recession.

Corporate Debt

The final warning gets top billing, as it involves what will become the epicenter of the coming economic and market meltdown. It's called low-quality corporate debt.

Any objective observer would have to call low-quality corporate debt a huge bubble, as it now easily exceeds all previous amounts in U.S. history as a percentage of GDP. The corporate debt bubble is so big even the Fed keeps warning it could bring us down in a dangerous manner. Keep in mind debt doesn't even exist in Fed theory, yet the corporate debt market risks are so large, you can't miss them. The Fed has accurately pointed towards leveraged loans and collateralized loan obligations (CLOs) as perhaps the scariest risks our financial system faces today.

The weakest, and most dangerous, parts of the corporate bond market, centered in CLOs which sit at the pinnacle of jaw-dropping risk, are a combined multi-trillion dollar market. They will one day be taken out back and shot, with some of the funds used to trade them closing down, as every investor wants their money back and nobody will buy them.

The Fed should be scared of this, because it is going to happen. CLOs may not end up being the first domino to fall in the coming financial collapse, but they will end up falling – a shockingly large amount. With no other trade problems with China, or European banking and corporate debt problems – CLOs would still end up with massive losses, for our own corporate debt bubble is also unsustainable. We now have the riskiest corporate lending the country has ever seen (as shown by the overall credit quality of all U.S. corporate debt), combined with the most corporate debt in history relative to GDP. I can't imagine that combination will end very well, regardless of the next tweet on trade or Fed rate change murmur.

For once, I agree with the Fed. I expect the real economic downturn to be fully confirmed the month the leveraged loan index suffers large losses, and groups of CLO's start to lose twenty to thirty percent in one month. That has an extraordinarily high probability of occurring – I'd guess around 99% probability before all is said and done.

Sooner or later, this lovely economic party will end, and when it does the losses in the lower-grade corporate debt market will mirror the largest wave of corporate bankruptcies since the 1930s. I consider this outcome a given at this point.

What Causes a Recession?

As you would expect, quite a lot of research has gone into attempting to answer this question. Generally speaking, there are two causes. One involves central bank mistakes. It now appears likely the next recession may be caused by central bank tightening.

Central Bank Mistakes

From one angle, I know it sounds ridiculous to say Fed tightening, or raising of interest rates, is the likely cause of the coming recession, as the Fed only raised interest rates from around 0% to around 2.25%. However, in context you can easily see how that was actually far too high, assuming the goal was to extend the current business cycle, i.e. delay recession.

One thing I rarely hear discussed is the fact that, according to some of the best economists, the Fed's withdrawal of the money when bonds the Fed had previously purchased came due and had to be repaid by the Treasury Department, combined with the 2.25% interest rate increase, was equivalent to around a 5% interest rate increase. Effectively tightening by 5%, from a starting point of 0%, in the weakest economic expansion since at least 1950, should drop us into recession fairly predictably.

Keep in mind, it takes over 9 months for any change in the Fed funds rate to even reach the economy. This means we won't even begin to feel the effects of the Fed's last rate increase last December until this fall. That will in fact be the first time the full effect of the Fed's tightening will hit the economy. Given the weakness in the domestic and world economy, it's unlikely we will make it much longer before the Fed's tightening lands us in recession.

I do have to wonder if Yellen and Powell did this on purpose? If so, I applaud their intelligence and cunning! Most likely, it's just another example of a broken watch being right twice a day. Of course, this means the Fed will probably get a good amount of blame for the coming recession, which is also a great outcome. They deserve the primary blame for the cratering of economic growth in this country since 1987, and near complete blame for creating three massive bubbles, the third of which appears to be getting closer to ending, in disaster, each month.

We need the next recession to happen as soon as possible. The now longest-ever economic expansion, which has had the lowest economic growth, and productivity growth, since at least 1950, is built on debt. Trillions of dollars of this debt will ultimately be lost. In order to limit the losses, we need the bubbles to pop asap.

External Events are the Other Causes of Recessions

The statement recessions (not caused by monetary policy mistakes) are caused by outside, usually unexpected problems which tip the economy into recession, is basically assumed to be correct by most these days.

There are, of course, thousands of external events which can negatively affect the trajectory of your economy. Always keep in mind our economy is now, it appears, structurally weakened such that it cannot grow more than 1.8% a year, no matter what, unless the unemployment rate continues to drop to historic lows. Since unemployment doesn't stay low forever, this means the very best our economy can do, by its structure, is 1.8%. This consists of 1.2% in growth in hours worked and .6% a year in productivity growth. This is all that is possible, given the constraints placed upon the economy over the last 30 years, by Fed policy and Congress. We need to keep this in mind, because one of these days the dam of artificially-hidden risk will begin to break, and we won't have far to fall to be in recession.

In previous reports, we have explored a wide array of huge external risks which could land us in recession. The fact European banks are literally bankrupt, with several of the largest teetering on the edge of actually going away, is a large enough external event to push us over the edge quite easily. European corporate bonds are now the largest bond bubble in world history. All bubbles pop. Whenever the European corporate bond market begins to collapse, nearly every major bank in Europe won't be bankrupt only on paper. No, we're talking they won't be opening their doors tomorrow morning type of situation. The financial fallout from even one of the largest European banks going under suddenly are pretty scary for several, if not all, of our largest Wall Street firms.

In May I attended a conference at which four of the top European economists were on a panel discussion entitled: "Will the Eurozone Continue to Exist?" One of the three believe Germany will leave first, while the other three believe Italy will leave first. All four were certain the eurozone will cease to exist during the next recession. That is one huge external shock pretty much guaranteed to plunge the entire world into a recession. The eurozone ending is, I believe, not the end of the world, until you consider the eurozone will be dissolving because the losses in European bond markets are so big every bank is completely insolvent. Countries will then jump ship to attempt to protect their own banking systems.

Another huge external event that could bring us down in a moment involves the $9+ trillion in U.S. dollar-denominated debt emerging market economies have in their corporate bond markets. Right now, the Fed is draining dollar liquidity – in a huge way – from the world currency markets. Lacy Hunt discussed this in his most recent quarterly report, in a section looking at the large drop in money supply growth and the Fed's response to date: “The weakness in the base (of money supply growth) flowed into world dollar liquidity (WDL), which contracted at an unprecedented 0.9% annual rate from 2015 to the present. This drop is far outside the range from 1960 to 2008 (or before quantitative easing) when WDL grew a much faster 8.2% per annus. Thus, Fed operations continue to drain liquidity from foreign markets at a time when a synchronize economic downturn is evident in all major economies of the world.”

A severe shortage in dollars, when you have over $9 trillion of emerging market debt denominated in dollars, can lead an entire emerging market economy to crash to the ground in about a month or so. If one of them does, this could cause ripples in other parts of the world financial system which could easily lead to a crash in ours. Or perhaps it would simply tip the entire world economy, including us, into the long-awaited global recession.

While we could easily come up with a few dozen such external events that could push us into recession, one event stands out above all others in being the most likely to get us over the edge of low growth and into the throes of the next recession. In fact, I would say this one external event almost guarantees a recession – larger than what I had originally anticipated. This external event is called…

A Trade War with China

Having thought a great deal on this topic, I cannot think of one external event “better” than a trade war to kick off the next recession. This one external event “Trumps” all the others because it involves the two largest economies in the world very actively attempting to knock the other into recession. Talk about a tough headwind! And it’s not like the Chinese are the easiest of opponents, in a war in which they say they would basically die to win. While I don’t believe much of what they say when it comes to trade and economics, I believe they are likely being forthright when they say they will never, ever back down. This will be their stance until at least the election.

This is an outrageously dangerous situation for the United States. Supporters of the Administration say China is taking severe hits to their economy. I believe this is probably true. The problem for the Administration is that the Chinese only have to wait 15 months to have the problem, potentially, disappear. I’m almost certain a Joe Biden Administration, for example, would beg the Chinese for an unconditional cease-fire in the first few hours in office.

All China has to do is take whatever they have to suffer for another 15 short months. If they have to inject an extra one or two trillion dollars’ worth of yuan into their system to prevent an economic meltdown, they’re ready to do just that.

This makes perfect sense from their perspective. They have been making hundreds of billions of dollars a year due in part to the trade structure we have had which involves our companies being cheated each day, week, month and year. Our companies went along with it because any CEO who got a big deal going in the Chinese market found himself showered with huge stock option gains. The fact that the deal nearly guaranteed a Chinese competitor was going to end up with all your company’s intellectual property and could then compete with you, at a lower cost, on your own products, meant nothing to CEOs who are in that position for three years and make most of their money from short-term stock market gains.

I have a bad feeling that this short-term perspective has made it extraordinarily easy for our opponent China to defeat us – over and over and over – for more than 20 years.

Getting back to the topic at hand, there is less than a 1% chance – much less – that China will give one little inch on trade, at least before the election. Take that prediction to the bank. If they did seem to make an agreement, I guarantee you they won’t honor anything in that agreement that goes against their bottom line.

President Xi has to project strength right now, particularly with the protests in Hong Kong. Plus, their official newspapers known to contain Xi's voice, or that of his top economists, have said they will easily withstand any short-term problems, but they will never submit to the U.S.'s attempt to treat China like some subservient colony. No, they decide how their economy is going to be run, not the United States. If we don't like it, they assure the nation China will win any war because they'll never give up against the imperialists.

Statements like those are wildly popular in China right now. I could go on, but the point is there is a 0% chance China gives in to anything, at least before the election.

Given this, I am actually surprised the Administration has decided to continue the fight. Of course, if Trump wins re-election, and his trade people wage the war and win in the first two years after the election, then they will have succeeded.

Trade and Politics

This is one instance in which all of us should really, really hope for the same thing. We need to have a fair trade relationship with China, and I'm pretty sure the only way to get there involves the nastiest trade war ever seen. But we need it, and we should have done it 20 years ago, or any year therefore. Unfortunately, the Trump Administration really needed to win the war fast, before the upcoming threat of not getting re-elected gave the Chinese all the power in the negotiations. This means either President Trump gives up and admits defeat, or there will be a trade war, at least on and off, through the election. If Trump is re-elected, this trade war will then escalate.

The end to the China trade story is that it will almost certainly push us all into recession. Europe will then implode to a scary amount. We'll all survive, but in hindsight this will be seen as a remarkably dangerous time to have a trade war between the two largest economies, both of whom were teetering on the edge of historic asset and debt bubbles ready to explode.

My longer-term readers know that I always keep a strict 'non-political' perspective as an investment manager. I've always felt putting forth my personal views and opinions on politics would be disrespectful to my clients. They have hired me to protect and grow their money, not to try to convince them I'm correct about politics if they disagree.

My job is to see the economy and markets clearly, and invest accordingly. I am always ready to share what I find when doing research, regardless of which political party may like or dislike what the facts tell us. I say all this because the next few statements involve politics. Personally, I agree with having the trade war. If I were a Democratic candidate for President, I would tell the world right now that, if elected, I would have Peter Navarro – our main trade negotiator, in reality if not title, in our current trade war – as the lead trade negotiator with China if elected. In other words, not only are we not ending the trade war, we are going to unleash the toughest opponent who is currently fighting the war for us through the Trump Administration. I believe any Democrat who adopted this position would be putting country above politics. This is how we're supposed to act in a war, but most don't understand that a trade war is a whole lot like a war. Whole industries can get obliterated (think soybean farmers, as one of many current example).

In the end, if we were to win, this is one case in which much of the winnings would be a boost to average workers in our country. We really do need to win, from every rational economic perspective, and if Xi knew we would continue the fight regardless of which party wins the next election, this would give us a huge advantage in this war.

Trade Summary

I listened to four of the best international economists in the world discuss the trade war in May. All four said we have no chance of getting a single real concession by China before the next election.

Had our initial tariff strike happened to have brought down their corporate debt bubble in the first year of the war, China would have had to sue for peace to stay alive. But by the time the re-election came into sight and they hadn't come tumbling down, Xi knows they've won if Trump loses. Xi therefore just wants to inflict as much damage as possible on our economy so Trump will lose the election. Given their size, and the fragility of our economic situation, I would expect China to win this battle. Then the score will be in the neighborhood of China: 100; The United States: 0.

Conclusion

The summary is that many primary economic indicators are all turning down – many decidedly. This isn't surprising, as the Fed raised rates and removed liquidity far more than our weakened economy could withstand. This is their "mistake" already just beginning to push us into recession, though it doesn't even get fully in place, restricting growth, until another month or two.

The previous round of Fed tightening has been slowly pushing us into the looming recession. That process now appears to be accelerating, which is precisely how multiple rounds of interest rate changes, and large reductions in the money supply, play out. When the tightening occurs at ¼% increases over a period of two+ years, the results take a long time to see. We're just now beginning to feel most of those Fed rate increases, and the results are beginning to appear in all the data in this report. At some point it goes from a mild pulling back of economic activity to severe losses, in the economy and risk markets.

Then we have external events which can cause recession. Perhaps the single largest external event that could throw us into severe recession, and Europe into a financial abyss, would be a trade war between the U.S. and China. For better or worse, that is exactly what is happening.