

Economic Update, April 2015

The Invisible Hand of God

By Richard Morey

Adam Smith was a Scottish economist and philosopher who is often called “the father of modern economics.” Published in 1776, his book *The Wealth of Nations* is considered one of the most important books in the development of capitalism. In Smith’s works he occasionally used the phrase “the invisible hand of God” to describe how a free market leads to socially desirable outcomes for a society. Religious connotations aside, the idea free markets naturally lead to the best allocation of resources and overall economic success is one of the most important fundamental principles of economics.

Unfortunately, in recent years this “invisible hand of God” has now been replaced by the very visible hand of central banks. Instead of allowing the markets to determine prices, central banks around the world, and our Central Bank led by Janet Yellen here in the United States, have assumed the role of God in the “invisible hand” metaphor.

Of all markets, perhaps the most important is interest rates. The cost of money determines where and how much money flows in an economy. Here is what occurs when a free market determines interest rates. When an economy is booming, there is a great demand for money. Businesses are confident they can generate large profits if they borrow money, so they compete with each other for this money. Consumers are confident they will get raises going forward, so they compete with each other to borrow more today. This naturally drives up interest rates. On the flip side, when the economy is slow, businesses and consumers demand fewer loans, as they doubt they will be able to generate new business in the case of companies or increase their income in the case of consumers. As a result, the interest lenders are able to demand is lower.

The Federal Reserve board has eliminated this process entirely, arbitrarily setting interest rates at approximately 0% over the last six years. Now given the fact we have had the lowest level of economic growth in the U.S. coming out of a recession in history, if the free market was in force interest rates would indeed be low today. But they certainly would not be 0% for short-term institutional money, also known as the Fed Funds rate.

The idea to let the market determine interest rates is quite controversial. An alternative approach would be to have the Fed follow a rule which incorporates real economic and market data, such as the Taylor Rule that would require the central bank to raise interest rates by more than one percent for each one-percent increase in inflation. This idea actually has a chance to become policy in this country. In fact, after the current stock bubble bursts I expect it may be implemented. It would essentially prevent the Fed from keeping rates artificially low to create asset bubbles to mask underlying economic problems.

Unlike the members of the Fed, I actually believe capitalism is the best economic system, as the economies with free markets have clearly outperformed those in which the government attempts to control them. The one caveat is that the markets must truly be “fair,” meaning the richest and most connected corporations and individuals cannot be allowed to use their wealth and influence to rig markets in their favor.

When central banks distort the single most important variable in economics, which is the cost of money, huge imbalances spring up in that economy. When they then print trillions of dollars of new money, these imbalances become historic. This is particularly dangerous in our current financial system in the U.S. in which we have a small number of huge Wall Street banks who now know they can take any amount of risk with no regard to the consequences – as they will be bailed out by the government when their risky investments turn south. These banks have one huge advantage over everyone else in that they can borrow essentially unlimited amounts of money from the Fed for practically nothing.

Now if the U.S. economy was growing strongly this situation would lead to an explosion of loans to businesses hoping to expand. However, our economy certainly hasn’t exhibited strong growth, so businesses have little interest in expanding. But with money for free to the huge banks, they have definitely been

lending and investing trillions of dollars. Instead of being lent out to spur business growth and therefore economic expansion, this money has been used to speculate on financial assets. When interest rates are set artificially low, we always have massive amounts of money “mal-invested.” This simply means the money flows to companies and financial entities who would never qualify for loans if the cost of that money was not kept artificially low.

When the history books are written on this time period, the first paragraph is likely to read something like the following: “In 2008-2009 we had a financial crisis caused by too much bad debt in the U.S. housing market. Instead of addressing the underlying problems, the U.S. and indeed entire world economy responded by *increasing total worldwide debt by nearly 50% over the next seven years*. Most economists now agree the correct response to a crisis caused by too much debt is not to dramatically increase debt.”

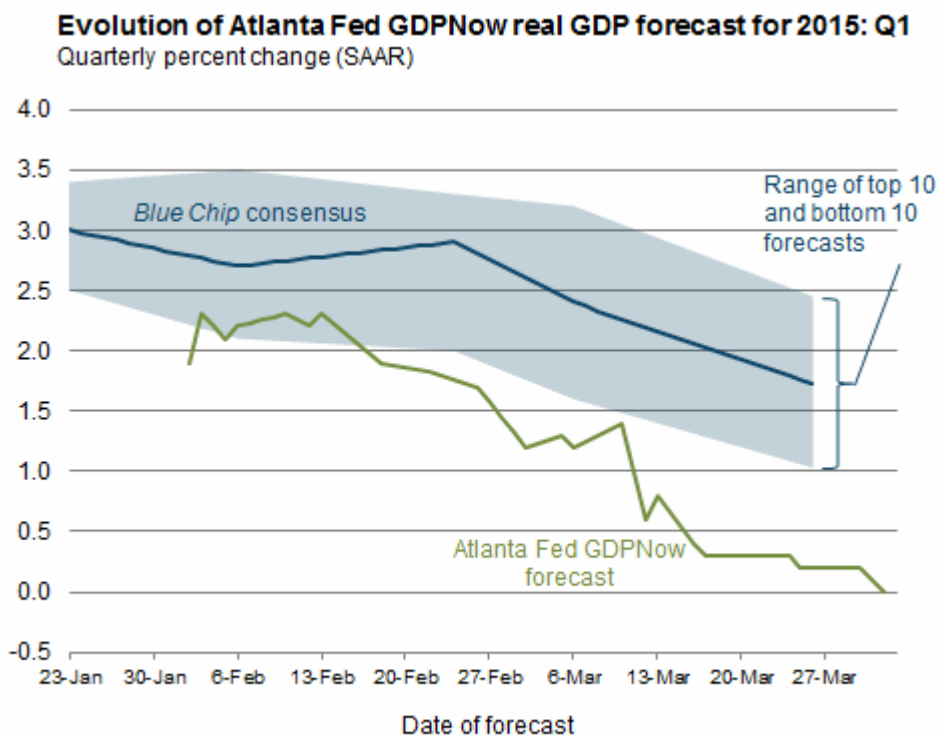
The idea you cannot successfully respond to a debt crisis with much, much more debt is obvious to anyone with common sense. You might therefore wonder why in the world we have chosen this course of action? The answer makes perfect sense when you consider the nature of debt. When you increase debt, your economy, as measured by Gross Domestic Product or GDP, definitely grows immediately with each dollar of new debt. When money is borrowed it is spent, and GDP defines economic growth purely in terms of how much money is being spent. By the spring of 2009 our economy was in danger of falling into a depression, and one way to prevent this was to dramatically increase debt immediately. The government therefore began borrowing and spending well over a trillion dollars extra each year beginning in 2009. The Fed also lowered the amount they charge the largest banks to nothing, ostensibly to incentivize businesses and consumers to resume their debt binge.

When none of the above worked to get our economy growing soundly, the Fed decided to begin printing trillions of dollars of new money. Called quantitative easing, this was an experiment designed to be used only in an emergency. The fact the Fed continued printing money for five years, only ceasing (or pausing?) last October, and the fact they still have interest rates at 0% and are scared to death to raise them a measly $\frac{1}{4}$ of 1%, tells you everything you need to know about the success of these experiments. They have not worked and actually cannot work to spur genuine economic growth because our government and Fed did not address the underlying problems that got us into this mess in the first place.

We had two primary problems: 1) Too much debt, at that time too much mortgage debt, and 2) as a result of recklessly pouring trillions of dollars into an overpriced housing market, our largest banks were insolvent, i.e. bankrupt. But instead of dealing with this fact, at the behest of the current Administration and with the approval of Congress, the Fed began the most aggressive experiment in our history to funnel money to the Wall Street banks.

I would cynically, but I believe accurately, say the Fed’s actions since 2010 have been exclusively designed to protect Wall Street banks – to the detriment of the main street economy and the vast majority of our citizens. Giving the “too big to fail” banks access to unlimited amounts of free money should have been enough to get them back to solvency, but given the depth of the hole they were in the Fed also decided they needed to buy trillions of dollars worth of bonds from the banks. This is the mechanism through which the Fed’s money-printing/quantitative easing took. To date I have never found anyone who has calculated how much the banks made from the Fed when they sold their bonds to them in exchange for freshly minted money, but it is safe to assume the banks got a very good deal on those sales.

This brings us up to date. Now let’s look at the “scorecard,” i.e. how the economy is doing as a result of the Fed’s extraordinary measures. The Federal Reserve Bank of Atlanta has recently created what they are calling “GDPNow.” Using the same data the Bureau of Labor Statistics uses to calculate economic growth or GDP each quarter, GDPNow updates our progress daily. The chart below shows how the U.S. economy is presently performing:



As you can see, the economy is falling fast. As of April 1, it is now projected to have not grown at all in the first quarter of this year. It is worth noting that in 2013 the Fed projected GDP growth to be 3% in 2015. In fact, every single year since 2010 the Fed says solid growth is right around the corner, and each and every year they turn out to be completely wrong. If the trend continues, we will be in recession shortly. This should not come as a surprise. The real shocker is our economy has not had another recession since 2009. Throughout history, countries that respond to a debt crisis like we had in 2008-2009 by refusing to restructure their bankrupt banks, opting instead to dramatically increase debt, have always had subpar growth going forward and an abnormally high number of recessions thereafter. While we have had the slow growth, we have somehow managed to avoid another recession for over five years. I suspect it is due to the massive amount of new debt and money that has been printed. While this has not been able to actually revive the economy, it appears it has been just enough to keep us growing – at approximately one-half the normal rate.

That being said, the scorecard for the Fed's emergency measures is not good. Income has been stagnant for over 80% of our workers (with only supervisory and management positions seeing wage growth) and we have the lowest percentage of working age adults actually employed since the early 1970s when women were entering the workforce en masse. Given that nearly 70% of our economy is based on consumer spending, this combination doesn't bode well for us. And not surprisingly, consumer spending has now gone down for three straight months. Finally, without ever getting back to even average economic growth, according to the Fed itself our economy is now going down fairly quickly, as shown in the chart above.

If this was the entire story we might be able to give the Fed a pass. While economic growth has been anemic and may now be ending, at least the economy has been eking out a little growth. But this isn't even close to the whole story. Actions have consequences, and in this case the Fed's extraordinary actions are creating extraordinary unintended consequences. As stated above, when the largest banks can get virtually unlimited money from the Fed for nothing, much of that money ends up going to non-productive companies and ventures. They can't lend out the trillions of dollars of free Fed money to qualified businesses hoping to expand or consumers who will be able to repay the debt because there aren't enough of those types of borrowers. So they lend and invest the money wherever they think prices might rise.

Before proceeding we should mention the United States has not been the only country that has distorted the free market and grossly expanded non-productive debt and investments. To the contrary, the other three largest economies in the world have gone even further with their extraordinary monetary measures. The debts and non-productive loans and losing investments are actually much, much larger in the Eurozone, Japan and China.

One recent morning I decided to make a list of all the markets in the world in which we now have over \$1 trillion in losses “embedded.” This means the losses are now guaranteed to occur at some point going forward. Here’s the current list:

Emerging Markets

- Dollar denominated debt

United States

- The stock market
- Oil and gas high-yield bonds
- Credit default swaps sold by Wall Street banks

Europe

- The stock market
- Government bonds
- Bank losses on bad loans
- Credit default swaps sold by their largest banks

Japan

- The stock market
- Government bonds

China

- Real estate (prices)
- Real estate mortgages
- Losses in their shadow banking system
- Local government loans
- Manufacturing oversupply
- The stock market

That’s 16 markets in the world basically guaranteed to lose at least a trillion dollars – each! Even worse, in several of these markets we are talking about not just a trillion in losses but many trillion. Even worse is the fact that as soon as the losses begin in earnest in any one of the 16 markets, this will trigger the losses in most if not all the other markets.

While it is not possible to know how this will unfold, we can tell where the problems will first occur, i.e. which dominoes will first fall. It probably won’t be in stock markets. Instead, the fall will most likely begin in credit markets (or related currency markets). Stock markets can continue to rise with no regard to rationality or economics in the short to intermediate term, as investors dominated by emotions (i.e. the vast majority of investors) can and do ignore economic reality for a long time. But credit markets have inherent limits. When companies and/or governments can no longer make the interest and/or principal payments due on their loans, they default on those loans and the money is lost.

Here is our best “guestimate” of the likelihood each market is to be the spark that burns down this malignant economic edifice central banks and governments have built:

- 1) As you can see from the list above, China has the most markets in peril. With 75% of their citizens' net worth invested in real estate, falling real estate prices will trigger trillion+ dollar losses in real estate prices, consumer and business debt on real estate, local government losses and shadow banking losses (the massive amount of money that has been loaned outside the formal banking system).

Real estate prices are now falling in China. In fact, they are now dropping faster than our real estate market dropped which precipitated our financial crisis. Prices fell 5.2% year over year in January and 5.6% in February. Keep in mind the Chinese government is even less trustworthy than ours when it comes to the veracity of its publicly-reported economic numbers, so prices could and probably are falling even faster.

- 2) Manufacturing oversupply in China. Along with real estate, China's economy depends on manufacturing. And like bridges, apartments, and entire new cities, they have built an amazingly large number of new factories. With the entire world economy inching closer and closer to not just low growth but actual contraction, Chinese manufactures are left with a massively large number of factories and fewer and fewer sales.

This item is connected to a huge, disturbing risk. The best economic forecaster in the world, Albert Edwards of Societe Generale, wrote in his preview report for 2015 that Chinese companies will have to keep all their factories going full-speed this year. With lower prices and lots of debt to service, they will have to try to make up the difference with volume. This means they will be dumping huge amounts of manufactured goods and materials on a world slowing down and therefore needing and wanting less of what they are selling. This means prices of everything they produce will be going down. As a result, according to Albert Edwards this will lead to a "tsunami" of deflation washing over the West this year. If you look at the inflation data for the U.S. so far this year, Mr. Edwards is once again turning out to be spot on. Prices of a host of goods, including nearly all natural resources and industrial materials, are plummeting. The huge, disturbing risk is deflation, as falling prices are a hallmark not of recessions but worldwide depression.

(One of the strangest economic occurrences is the fact some central banks, particularly the Japanese and Eurozone central banks, say they are printing money to combat deflation. This is quite odd given the fact that *printing money causes deflation!* When trillions of new euros, yen and dollars are printed, businesses that would and should go bankrupt are still able to get loans. This means they continue to produce goods and services, competing with other companies and driving prices down.)

- 3) Emerging market debt. Developing countries in Asia, Central and South America, and Eastern Europe have borrowed approximately \$4.5 trillion from Wall Street banks. Since that time, the U.S. dollar has appreciated approximately 25% versus their local currencies. This means those who borrowed all this money have presently lost over \$1.1 trillion on these loans on the currency move alone, as this is the approximate amount of additional money they now owe on these loans since the dollars with which they must repay the loans have risen in value.
- 4) Government bond losses in the Eurozone. We have all heard about the problems confronting Greece. They have approximately \$350 billion in debt, and even the European Central Bank admits those who own that debt may lose 95% of their principal. When they had their first bail-out in 2011 nearly all of these loans were transferred from Eurozone banks to the taxpayers in the Eurozone.

However, Greece is not alone. In fact, over \$2 trillion worth of Eurozone government bonds are now guaranteed to lose money because they are paying "negative interest." This means that if you lend these governments money, they promise to not pay you a penny in interest and then give you back less than you loaned them. This bizarre situation highlights how far they have strayed from any semblance of a free market.

While Eurozone government bonds are definitely in jeopardy – or at least terrible investments – their banks are perhaps in even worse shape. Eurozone banks remain stuffed with bad loans, mostly real estate loans for which the borrowers are not making their payments. One estimate is that their banks still have over \$2 trillion of “bad” loans on their books.

- 5) The Japanese government bond and currency markets. As we have discussed in some detail in previous reports, from an economic standpoint Japan is already deceased. They now have nearly 250% debt to GDP, exploding further as we speak. For many years some of the brightest economic minds have been certain the inevitable demise of Japan’s economy would unfold through a collapse of their government bond market. This makes sense on the surface, as who in their right mind would lend a bankrupt government more money and receive far less than 1% as compensation? The answer to that question is the Bank of Japan, as they are simply printing all the money needed to cover their new debts and pay interest on their current ones.

As a result, some years ago I concluded Japanese government bonds are unlikely to ever lose a yen, as their central bank will simply print all the new yen needed to repay the loans (over one quadrillion yen and growing daily). Instead, the losses will come from the yen itself. When you print your currency with crazed, wild abandon, your currency falls in value. At this time it takes approximately 120 yen to equal one U.S. dollar. While this is a rise of 20% versus a year ago, this is just the tip of the iceberg. Before all is said and done the yen is nearly certain to drop a further 50%-75%, and possibly more. In other words, the yen is going to crash.

While my list of severely troubled markets is long, it definitely is not exhaustive. In fact, if I had to bet, I would wager the actual initial cause of the next wave of losses hitting world, and U.S., markets will be something not on my list. With the world central banks having printed over \$11 trillion and with the entire world debt having exploded by nearly 50% in only six short years, there are many obscure channels through which financial institutions have (mal)invested that money. For example, some very high-level economists say the historic economic imbalances described in this report will come unglued due to shortages in something called the repo markets. These are complicated markets I won’t even try to explain here. Suffice it to say, due to the historic imbalances, there are many, many ways for the world economy and markets to come toppling down.

Summary

First I would like to highlight one of the few markets in the world not included in the list of those with trillion+ dollar losses coming. This is the highest-quality U.S. bond market, especially U.S. government bonds, aka Treasuries. This is because our Treasuries are the largest, most certain beneficiaries of the culmination of the losses in the other markets. When any of these troubled markets begin their losses, many of those who sell out of them in fear will rush to purchase the safest investments in the world. Odd as this may seem given our nation’s current difficulties, the entire world continues to view our Treasuries as the most trusted place to protect your money. Despite a lot of evidence to the contrary, this does make sense, due not to any prudence on our part but solely due to the pathetic state of the Eurozone, Japan and China at this time.

I am reminded of the old saying, “It’s not nice to mess with Mother Nature.” Similarly, it’s not prudent to distort the most important variables in any capitalist system, namely the cost and amount of money. Along with all the other economic imbalances the world has created, we have long ago passed the point of no return. Most and probably all those trillion dollar losses are coming. I obviously cannot tell you exactly when these losses will be realized, but they have in fact already occurred.