Economic Update, July 2016

Brexit & the State of the Economy

By Richard Morey

We'll begin with the biggest macroeconomic news in the last several years, the "Brexit" vote in which the citizens of Great Britain voted to leave the European Union. Before the vote, basically every single leading economic "expert" in Europe said a vote to leave would be a horrible, horrible decision. Several said it would lead to an economic "apocalypse." Once the voters decided to leave, these experts said they had voted to leave based on ignorance, fear and/or racism. In one voice they proclaimed the economic result would be terrible for Great Britain.

I do agree with them that leaving the European Union will be hard for Great Britain in the short-term. Their economy is heavily dependent on finance, as London is the "Wall Street of Europe." Plus, the uncertainty regarding how this divorce will unfold will surely lead many companies and investors to put plans to expand in Great Britain on hold. Finally, there is a chance the Eurozone member countries will try to punish Great Britain, by only accepting harsh trade agreements with them, in order to scare other members away from leaving.

However, on a longer-term basis I believe the British made the correct decision for their economy. This is due to the fact the Eurozone is a failed experiment. When it finally unravels and the euro is no more, all of the countries in the European Union will likely suffer an economic decline far, far worse than what Great Britain now confronts. This is a topic I did not hear one of the elite economists mention in their furor over the Brexit vote.

Why will the Eurozone fail? The best explanation I have found comes from Dr. John Hussman. Here are excerpts from his *Weekly Market Comment* of June 27:

> **Brexit and the untenable structure of the European Union**
>
> As long-time followers know, I've often expressed concern over what I see as an untenable structure underlying the European Union. There's certainly merit in promoting flexible trade among European nations, and in the ideal of a common European identity. But the additional fact is that Europe is virtually unequalled in its economic and cultural dispersion. It includes some of the strongest but also weakest economies in the developed world, with diverse languages and deeply-held cultural identities that are immediately invoked by the names of each country - the United Kingdom, France, Italy, Germany, Greece, Sweden, Ireland, Poland, Spain, and many others. These individual national identities are not unanimously seen as insignificant relics, and it is a source of greater discord, not less, to imagine that they don't exist. Nor is it reasonable to assume that the same fiscal and monetary policies are appropriate to all of them.
>
> Probably the most poorly structured element of the EU in this regard is the euro, which binds many (though not all) of these members together under a common currency. A stable common currency requires that its member states pursue common fiscal policies, and presumes that a common monetary policy is appropriate for all of them. This has been a disaster for Europe. The clearest symptom of this untenable structure is the European Central Bank under Mario Draghi. The blindly frantic "anything it takes" monetary dysfunction promoted by the ECB has enabled the development of massive sovereign debt burdens, Humpty Dumpty banks (with Deutsche Bank being the most leveraged among major institutions, and Credit Suisse not far behind), and negative interest rates across Europe, with the ECB now buying the bonds of even private corporations.

> … My own concern with the structure of the EU is primarily focused on the misguided structure of the common currency, and the underlying requirement for fiscal and monetary harmony that it imposes on countries that desperately need the flexibility to pursue substantially divergent policies. Those constraints have brought Greece close to a depression, while at the same time shoveling default-prone sovereign debt onto the balance sheets of European banks and the ECB.
>
> Compared with what might result from the exit of another major EU member, Britain actually has a relatively easy course over the next two years (which is the period over which existing agreements with the EU will be renegotiated, and can be extended by the EU if necessary). There is every reason to expect provisions that are mutually beneficial to each side to be preserved. The transition will be substantially eased by the fact that many of these provisions have broad public support in Britain across a wide range of sectors. Despite protests that "everything has gone back to square one," it's not as if all of those mutually beneficial provisions have suddenly gone up in flames and have to be redrafted from scratch. The discord will be among provisions that have "political" features; those that might benefit one group within Britain versus another.
>
> Any country that shares the euro as a common currency would have a more difficult exit course, because currency uncertainties would suddenly be introduced, disrupting a wide range of securities and private contracts. That's not to say that Brexit will be easy, but the main risk of Brexit is actually the risk of a domino effect that might encourage defection of *other* EU members, particularly those that share the euro. Also, some EU members, particularly Germany, look at the unrestrained behavior of the European Central Bank with increasing dismay. If Europe experiences another round of economic weakness, there may be increasing strains on this passive acceptance by Germany, which is currently required to preserve the euro.
>
> The dignity of a united European identity can survive without forcing each member country into an inappropriately identical fiscal, monetary and political shoe. Think of the EU, in its current ill-structured form, as a kind of Ponzi scheme, and Britain as the guy who just asked for his money back. There are undoubtedly greater prospects for near-term disruption after last week's vote, but the hallmark of a Ponzi scheme is the attempt to use progressively greater distortions in order to preserve a structure that is fundamentally unsound and increasingly bankrupt. Of any large country that could leave the EU, Britain was the best first mover. I have no immediate concerns about a domino effect, but if one was to emerge, my view is that the exit of Germany, France, and the Nordic countries would be preferable to the exit of Greece, Italy, Spain, or Portugal. It would be better to leave the euro intact and capable of steep devaluation among the weaker members than to sustain a system where the stronger and larger members of the euro become even more deeply entrenched in its flaws.

Next consider the views of George Soros. Now I have regularly and strongly disagreed with Mr. Soros' views on European economics and politics (particularly his views on Eastern Europe). However, I have never questioned his ability as an investor, and his phenomenal investment success was based on his accurate reading of macroeconomics. Here are excerpts from an Op-Ed he wrote for Project Syndicate after the British vote to leave the European Union:

> **The catastrophic scenario that many feared has materialized, making the disintegration of the European Union practically irreversible…**
>
> That process is sure to be fraught with further uncertainty and political risk, because what is at stake was never only some real or imaginary advantage for Britain, but the very survival of the European project. Brexit will open the floodgates for other anti-European forces within the Union. Indeed, no

sooner was the referendum's outcome announced than France's National Front issued a call for "Frexit," while Dutch populist Geert Wilders promoted "Nexit."

Moreover, the UK itself may not survive. Scotland, which voted overwhelmingly to remain in the EU, can be expected to make another attempt to gain its independence, and some officials in Northern Ireland, where voters also backed Remain, have already called for unification with the Republic of Ireland…

But the implications for Europe could be far worse. Tensions among member states have reached a breaking point, not only over refugees, but also as a result of exceptional strains between creditor and debtor countries within the eurozone. At the same time, weakened leaders in France and Germany are now squarely focused on domestic problems. **In Italy, a 10% fall in the stock market following the Brexit vote clearly signals the country's vulnerability to a full-blown banking crisis – which could well bring the populist Five Star Movement, which has just won the mayoralty in Rome, to power as early as next year.**

That is where we are today. All of Europe, including Britain, would suffer from the loss of the common market and the loss of common values that the EU was designed to protect. **Yet the EU truly has broken down and ceased to satisfy its citizens' needs and aspirations. It is heading for a disorderly disintegration that will leave Europe worse off than where it would have been had the EU not been brought into existence.**

Summary

Unlike the vast majority of European economic "experts," I did not expect a vote to leave to lead to immediate economic problems. I do expect Great Britain to suffer economically in the short to intermediate term, most likely entering a recession in the next few quarters (at the latest). But the very real and much larger danger is that Soros is correct about Brexit when he said "**The catastrophic scenario that many feared has materialized, making the disintegration of the European Union practically irreversible."** For the world economy that will indeed be a catastrophe. However, it is one the Europeans need to occur – and the sooner the better – because they will then be able to rebuild their economies without having the noose of the euro around their collective necks.

The Economy

Anyone who objectively studies the state of the U.S. economy can only conclude it reached a (weak) highpoint in the fall of 2014 and has been steadily deteriorating since that time. Probably not coincidentally, this was when the Federal Reserve Board stopped its quantitative easing program, i.e. stopped printing money.

I read an article recently by one of the best economic minds in the country (Jeff Snider of Alhambra Partners) titled "Why I Keep Repeating Myself." The article discussed why he keeps saying the same things about the economy (and markets), over and over and over. I have often felt the same way. The reason we keep repeating is that the economic trends continue to go…..down…..very…..slowly. If you study economic history, you will find this is extremely unusual. Perhaps the most comprehensive measure of economic activity is total business sales. Typically when sales begin to decline and unsold inventories begin to accumulate, companies pull back their activity quickly and sharply until their inventories sell and demand for their goods is clearly on the mend. We then go directly into a recession. But this time has been very different. Business sales peaked in August of 2014 and have slowly but steadily fallen since, dropping 5% over the last 19 months. Total business sales have now fallen back down to where they were in April of 2013. So for over two years we have basically had no business growth in the United States.

Here are a few other pieces of economic data showing this slide:

- Industrial production has now declined for nine months in a row. We have **never** seen this happen outside of a recession in all of U.S. history. This of course makes sense, as falling sales must lead to falling production of goods to sell.
- U.S. factory orders have been dropping for 18 months in a row. Again, companies order less when their sales are falling.
- U.S. commercial bankruptcies have risen on a year over year basis **for seven months in a row** and are now up 51 percent since September.
- The delinquency rate on commercial and industrial loans has been rising since January 2015. This is a topic we never hear mentioned in the financial media, but it is critical. The percentage of companies now unable to make loan payments has risen approximately 50% year-over-year. Throughout history this has occurred when one thing is emerging – a recession.
- The shipping industry has been dropping dramatically. In fact, The Cass Shipping Index which measures all forms of domestic shipping, including trucking, railroad and commercial air shipping, has been falling on a year over year basis for 14 consecutive months.
- Federal tax receipts and state tax receipts usually both start to fall as we enter a new recession, and that is precisely what is taking place right now.
- As we know, the Fed has consistently pointed towards the employment market as a sign the economy is actually doing relatively well. Yet the Federal Reserve's Labor Market Conditions Index has been falling for five months in a row.
- According to Challenger, Gray & Christmas, layoff announcements at major firms are running 24 percent higher this year than they were at this time last year.
- The number of temporary workers in the United States peaked and started falling precipitously before the recession of 2001 even started. The exact same thing happened just prior to the beginning of the 2008 recession. So would it surprise you to learn that the number of temporary workers in the United States peaked in December and has fallen dramatically since then?

(Numbers courtesy of Michael Snyder.)

Summary

From certain angles the economy actually began to slow down in 2011. However, beginning in the fall of 2014 the economy started to decline from every angle. Our GDP (Gross Domestic Product) numbers that are the single pieces of data used to determine if the economy is growing or contracting have managed to remain above zero, but much of the positive inputs to GDP consist of large increases in health care spending. For example, half of the weak growth in the first quarter was due to increased health care spending. Another of the largest positive contributors to GDP has been increases in rents. But both of these are categories that do not indicate a positive direction for the economy but are leading instead to the continued difficult financial plight of average citizens. While increases in these categories are keeping the overall GDP numbers positive, when it comes to actual production our economy is already in a recession.

Having our primary economic indicators go down for over a year and a half without having the entire economy shrink, i.e. go into recession, is unprecedented. Given that we are now proceeding outside of economic history, we can only conjecture about the cause of this phenomenon. Personally I believe it is likely due to the Fed's historically unprecedented monetary experiments. Printing over $4 trillion clearly has not "fixed" the U.S. economy, but enough of that money may have trickled into the broad economy to keep it above water – though just barely.

That being said, the economy's slide downward continues unabated, and one more modest headwind will probably, finally, put us back into a recession. Brexit could turn out to be that one additional headwind. Unfortunately, there are dozens of other large economic problems around the world, any one of which would be sufficient to plunge the entire world economy into what may turn out to be one of the worst recessions in recorded history.

I have been accused of being too negative in recent times, and one client asked me to always try to include one positive thing to say about the economy in each of these monthly reports. This came to mind last week when Alan Greenspan was being interviewed on CNBC. Greenspan was, of course, the Chairman of the Federal Reserve Board from 1987 to 2006. During most of his tenure he was widely considered to be the greatest economist in the world, gaining his the nickname "the Maestro." Personally I always found his economic theories, to say the least, flawed, as they were based on ever-increasing debt levels to create asset bubbles which inevitably burst. But I have also noticed Fed Chairmen and Governors do tend to get a lot smarter when they are no longer on the job! At least they seem to be a lot more honest.

On television last week Greenspan said:

"This is the worst period I recall since I've been in public service. There's nothing like it, including the crisis — remember October 19th, 1987, when the Dow went down by a record amount 23 percent? That I thought was the bottom of all potential problems. This (our current economic situation) has a corrosive effect that will not go away." Later he said, "We are in the very early days of a crisis which has got a way to go." Then he was asked if there wasn't something positive he could say about our economy today, to which he replied, "I'd love to find something positive to say." But he could not think of one thing to say. Instead, he went on to say it will probably take a financial catastrophe to wake people up to the fact we need to take a different financial path. That's actually also the most positive thing I can think of to say, i.e. after an inevitable economic plunge the public may demand the changes we need to begin to move the economy forward sustainably.