# Economic & Market Update, June 2018

***The Times They are a Changing***

**By Richard Morey**

This morning, on the last day of May, I pulled up the financial news and saw the following headlines:

> *Trump Imposes Steel, Aluminum Tariffs On EU, Canada And Mexico*
>
> *EU Rages At "Unacceptable" US Tariffs, Vows Retaliation "In Coming Hours"*
>
> *Deutsche Bank Crashes After Fed "Secretly" Put US Operations On "Troubled" Watchlist*
>
> *Goodbye Rajoy: Basques To Vote Against Prime Minister, Assuring New Spanish Government*
>
> *Housing Rebound Dies: Higher Rates Spark New, Existing, & Pending Home Sales Slump*
>
> *Loonie, Peso Plunge As US Unveils Global Steel, Aluminum Tariffs*
>
> *Savings Rate Tumbles Back Near Record Lows As Americans Spend More Than They Make For 28th Month In A Row*

And those were just the headlines on the first page, on one day! Trouble is brewing around the world. A few short months ago all the financial headlines were proclaiming the long-awaited victory, which they called a "global synchronized economic recovery." As we explained in our January and February reports, it was all a mirage based on massive expansion of debt in China in 2016 spreading out into the world economy, combined with the largest disaster spending in history here in the United States. But China was already reducing their new debt creation, while the disaster recovery money was being spent quickly here in the U.S. As a result, the economy was bound to peak in January before going right back down.

This is indeed precisely what has occurred. This week the Federal Reserve Board lowered first quarter GDP (their main gauge of economic growth) down to exactly the low rate it has averaged since 2010. But the most troubling developments are now occurring overseas.

The Fed has been raising interest rates here in the U.S. They began at the end of 2015 and have slowly been increasing short-term rates 1/4 of 1% two or three times a year. It has now gone from essentially 0% to 1.75%, expected to hit 2% later in June. Yes, that is still low, but given the debt-riddled world economy hanging onto growth tenuously, at best, this is already creating serious problems.

The main problems involve emerging market economies. This is a somewhat complicated topic, and I'll try my best to simplify it. In "good" times investors in the U.S. lend or invest trillions of dollars into emerging markets, roughly described as all economies except Europe, China, Japan and the U.S. When interest rates go up in the U.S., the dollar begins to go up relative to those emerging market currencies. When this occurs, all those trillions of dollars of investments lose money. Investors then begin to pull their money out of emerging markets, which leads their currencies and markets to come crashing down.

This has already begun to occur in several emerging market countries. It hasn't yet gotten the media's attention, but it should. History is littered with worldwide financial downfalls that began with small countries seeing their currency crash.

Then we have Europe. They had a sovereign debt crisis in 2012. Countries in Southern Europe were looking insolvent, i.e. bankrupt, and it appeared the Eurozone might dissolve as a result. The head of their central bank, Mario Draghi, "fixed" the problem with one sentence, saying he would do "whatever it takes." That turned into a multi-trillion Euro program of buying every bond (debt) not nailed down throughout Europe. Of course, this actually did not address the real problems related to the fact the economies in Northern Europe are not presently compatible with those in the South. They also have growing wealth inequality throughout Europe similar to what we are seeing here in the U.S.

As a result, the recent Italian elections were won by right-wing *and* left-wing populist parties. Many fear they will eventually want to leave the Eurozone. At the very least they are likely to demand substantial changes to the financial structure of the Eurozone - changes the elites who run it are absolutely dead-set against. Now Spain has a new Prime Minister, and there is a reasonable chance a "Euro-skeptic" populist party may take over the Spanish government.

Whatever you think of George Soros, the fact is he knows quite a lot about the structure of the European financial system. Last week Soros came out and said Europe is re-entering their financial crisis, and he is far from confident it will not ultimately lead to the dissolution of the Eurozone.

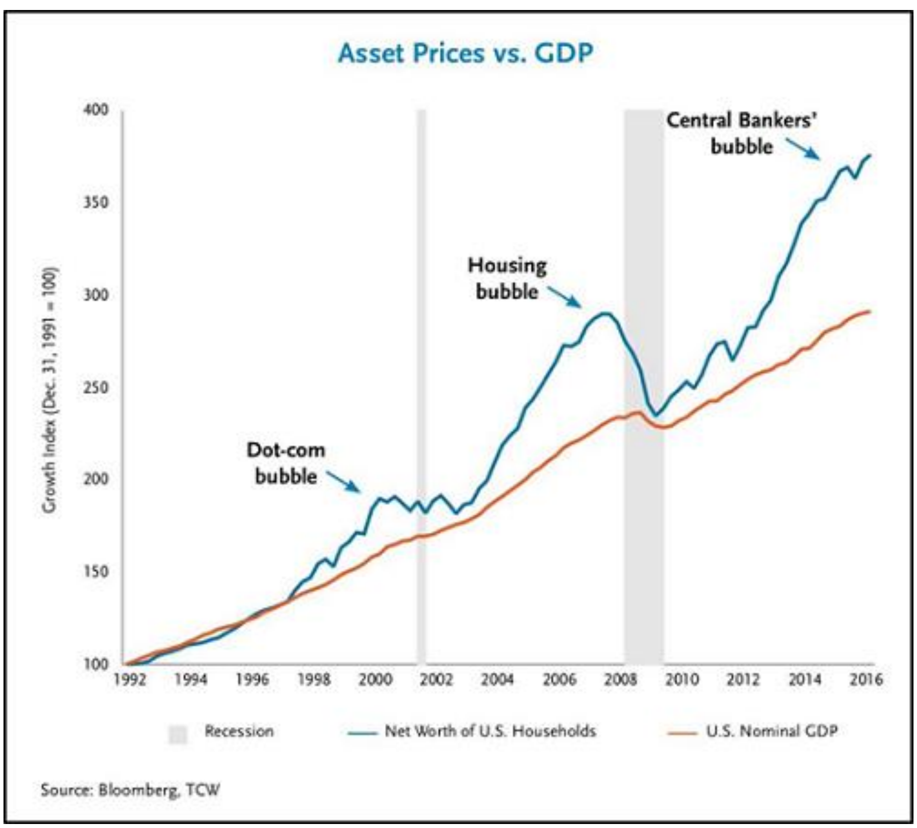
Then we have the Trump administration's ongoing efforts to redo our trade agreements, which could lead to a trade war - or not, depending on the moment you turn on the news. Then we have China's precarious situation in which they continue to try to reduce their amazing amount of debt without plunging their economy into severe recession.

Yes, all these concerns have existed now for quite some time, but the fact they are popping up with increasing regularity is different from what we saw in 2016-2017.

**Summary**

Throughout world history, the severity of financial downturns has been directly related to one thing: when economies have too much debt they eventually come crashing down. The world is now more over-indebted than at any time in the last 700 years. This will have profound implications for investments.

The chart below highlights where markets are headed. The red line is U.S. economic growth, while the blue line is the value of assets in the U.S. Ironclad economic law says those two must be the same line over time. The red line representing economic growth will be going down, not up, in the near future. Notice how far the blue line, which particularly represents the stock market, will be falling to "catch up" to economic reality.



When the history of this time period is written, the central theme will undoubtedly involve the danger, and absurdity, of central banks around the world printing nearly $15 trillion and actually believing this would lead to sustainable economic growth. Every reputable economist could have told us you cannot print your way to prosperity, as economic growth is entirely dependent on actual work and productivity. In retrospect, we now know printing nearly $15 trillion can lead to huge stock bubbles, though all the market's gains will ultimately disappear into thin air just as all the money was printed up out of nothing.

Given the central role central bank money-printing has had in the markets and economy since 2010, we decided to reprint below excerpts from one of the very best articles we've seen on this topic. The key point is that the markets have levitated because central banks were printing money, yet by the end of this year they are finally going to begin to reverse what they have done. The U.S. is already doing this, and by year's end the entire world, on balance, will be in retreat on the money-printing front.

## The End Of Stimulus? (And The Start Of The Crash?)

What the most important chart in the world is predicting

by Chris Martenson, Friday, May 25, 2018, from www.peakprosperity.com

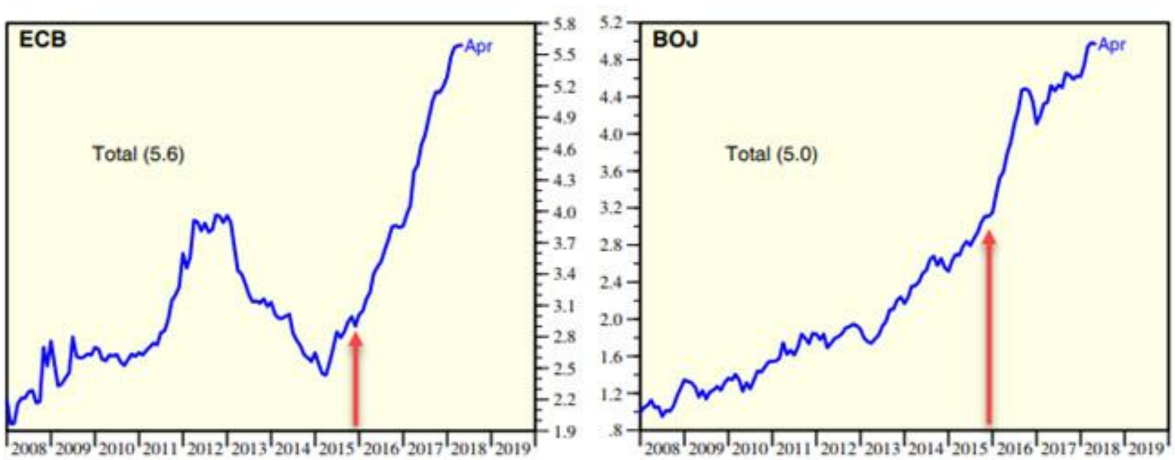
Back in January of 2016 we saw what appeared to be, and in my opinion should have been, the end of the Everything Bubble blown by the word's central banking cartel.

The carnage started in the emerging markets. Highly-leveraged positions and carry trades began to unwind. That's a fancy way of saying that all the big, sophisticated investors -- who were busy borrowing heavily in countries with cheap money (the US, Japan, and Europe) and using that debt to speculate in markets offering higher yields (junk debt, emerging markets, stocks, etc.) -- began to reverse their trades.

It quickly devolved into a “Sell everything!” scramble. We saw the dollar spike and stocks fall -- with emerging markets taking the full brunt of the carnage as their stock markets rapidly fell into bear territory, their currencies fell, and their bonds were destroyed. Until...

Very early one morning in February of 2016 everything U-turned and rocketed higher. Suddenly and magically, the panic was over. This wasn’t the invisible hand of the market at work; it was the very-visible hand of central bank intervention.

With the benefit of hindsight, we now have a clear picture of what happened. The central banks huddled together, a bold (desperate?) plan was hatched, and key printing presses around the world were sent into overdrive. In the months to follow, the European Central Bank (ECB) and the Bank of Japan (BoJ) went on a record-breaking money printing spree:




The red arrows in the charts above mark this moment when the “markets” were saved.

Or, more specifically, when the portfolios of the ultra-wealthy were "saved," as the assets within were boosted higher (yet again) by the central banks printing money from thin air.

**Addicted To Money Printing**

So what caused the weakness in early 2016 that spooked the system so much? The central banks themselves.

After many years of force-feeding stimulus into the global economy to create a "recovery", the central banks have become increasingly concerned that asset prices have become too dependent on said stimulus. So in late 2015, the banks took their feet off of their monetary gas pedals for a bit to see what might happen.

They were hoping that the markets could be gradually weaned off of their stimulus dependence with few ill effects. They wanted to engineer a "soft landing," where if prices declined, they'd come down gradually and not too much.

That didn't happen.

Instead, the cheap-money-addicted markets instantly started expressing massive withdrawal complications.

To re-acquaint you with how quickly things were devolving back then, these are news headlines pulled from an article I wrote back in the middle of January 2016:

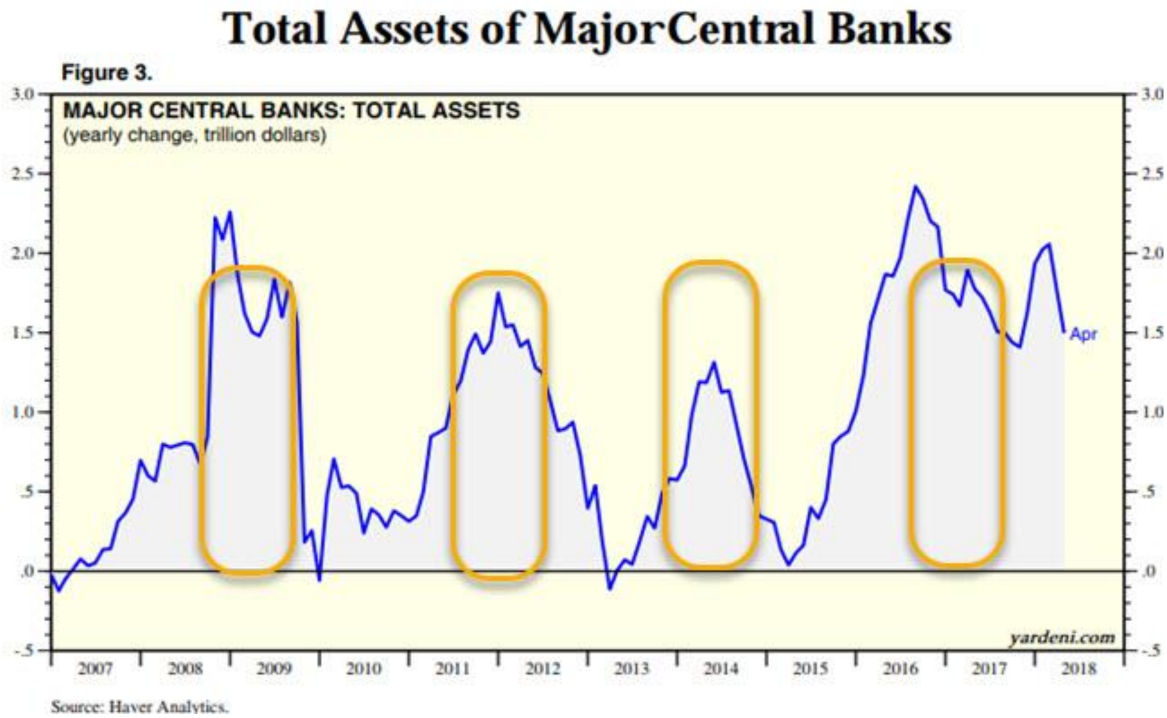
- Wal-Mart closing 269 stores, 154 in the US.
- Business inventories to sales at new cycle highs
- U.S. freight volume falls for first time in almost three years
- US retail sales fall 0.1% in December
- Empire State index weakens to recession lows.
- South African rand hits new all-time lows in 2016
- Brazil’s Real Falls Sharply Against Dollar
- Brazil Unemployment Rate Rises to 9%
- Canadian Dollar Hits 13 Year Low Against US Dollar
- U.S. Energy Junk Bond Spreads At Record Width
- Nigeria’s Currency Plummets On Open Market
- Mexico’s Peso Hits New All-Time Low
- Chinese Stocks Enter Bear Market (again)
- European Stocks Enter Bear Market

Sound familiar at all? It should. These sound exactly like the headlines in the news today, here in May of 2018.

We are still paying the price from 2008, when the central banks committed a massive error by not allowing the markets and their bad debts to actually clear. Yes, it would have been acutely painful; but we would have been through the worst within a year or two and in the process restored the system to a much healthier and sustainable state.

Instead, the bad actors were protected (and rewarded!) and the root fundamental problems were literally 'papered over,' left to continue to fester unobserved ever since. Similarly in early 2016, the central banks once again committed the same sin by rescuing everything with another wall of fresh, thin-air money.

To drive home how much, below is a chart showing the yearly change in world central bank balance sheets. The relative ‘area under the curve’ of each major period of money printing gives us a sense of the scale. To help you eyeball it, I’ve placed similar-sized orange rectangles in each area. Key to note is that central money printing has been increasing -- not decreasing -- the further out we've gotten from the Great Financial Crisis:




If we've been in "recovery" for years now, as the central banks have been touting, then why has 2016-2108 seen the most stimulus ever injected into the system?

History has taught us that we should trust our leaders' actions far more than their words. And their actions at this time indicate panic.

What is it that has them so worried? We should all ponder that question long and hard. I'm convinced that they know as well as we do that, once the over-inflated "markets" created by the central banks can no longer be sustained at their current nose-bleed heights, the damage will be extraordinary and unstoppable.

**The End Of Stimulus? (And The Start Of The Crash?)**

The pain of the 2008 crash will seem like a mere flesh wound compared to the devastation the next deflationary wave will wreak.

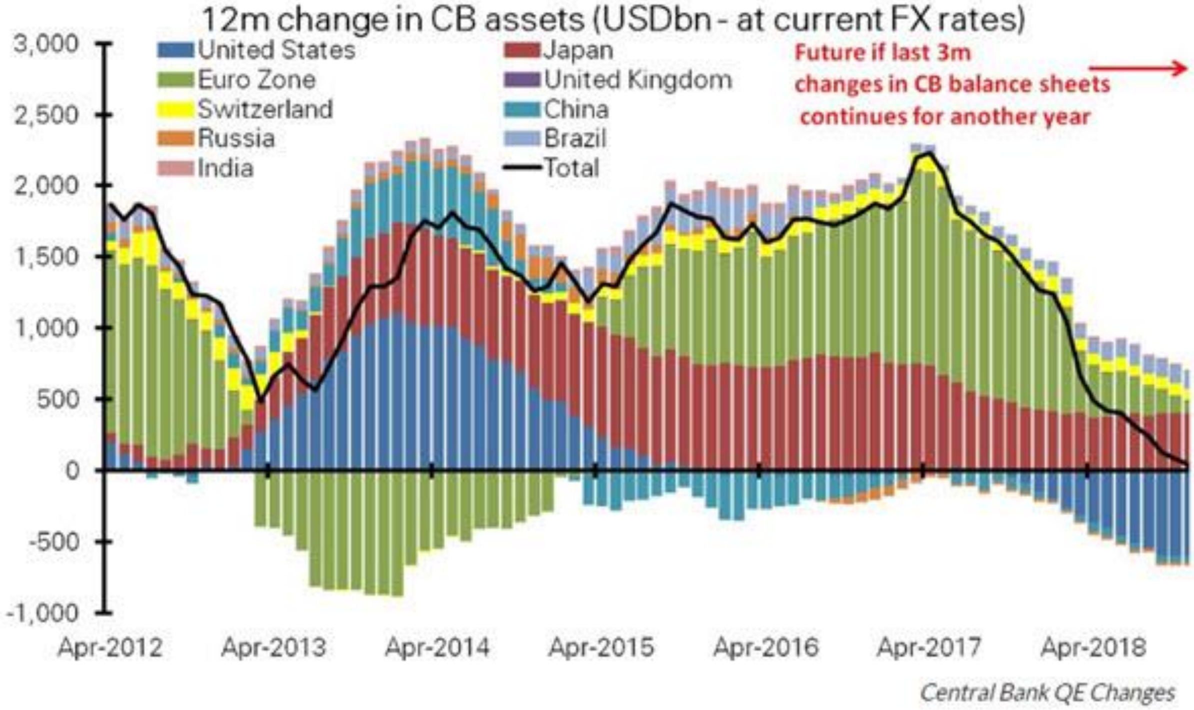
Of course, the central banks have no interest in seeing that happen and will, once more, do all they can to "rescue" the markets.

But will they act in time? More to the point, given all of their very public commitments to raising rates and reducing their balance sheets, *will they allow a market correction to happen in the near term* (presumably, so they can ride to the rescue soon after as "saviors")?

Politically, the prospect of showering even more wealth on the 0.001% is going to be a tough sell. This is especially true in Europe -- in Italy, Greece and Spain where the populace is suffering mightily already and is in no mood to further enrich the ultra-wealthy.

So it would seem that the central banks, at least publicly, have to stick to their stated plans to reduce their levels of money printing/balance sheet expansion.

As of right now, they are on track to end worldwide stimulus in early 2019, when their collective net change in assets will dip below $0 for the first time in many years:




Given the importance of central bank purchases and market interventions, the above chart is probably the most important one in existence for divining where financial asset prices are headed.

If global monthly stimulus indeed drops to $0, then *Watch out below!*

Who knows if the future will plays out anything like the projections given above? The central banks have proven weak-kneed at every tiny moment of market wobbliness. To date, they've chosen to print and print and then print some more at every opportunity where the "markets" might have corrected.

But we all know that this charade cannot continue forever. Sooner or later it has to stop. Given the blow-ups we're now seeing in the emerging markets, there's clearly serious trouble brewing somewhere in the system.

When today's Everything Bubble bursts, the effect will be nothing short of catastrophic as 50 years of excessive debt accumulation suddenly deflates.