## Economic & Market Update, May 2018

### *Thoughts from a Great Economist*

**By Richard Morey**

This was an exciting month for me personally, as I discovered a rare gem – an economist who is fact-based, clear-seeing, and trustworthy. His name is Dr. Tuomas Malinen, the CEO of GnS Economics Ltd. and an Adjunct Professor of Economics at the University of Helsinki. He is also a Vice Chairman of EuroThinkTank, a group of professionals studying the future of the eurozone. GnS sells economic data and insight, primarily to large European corporations. Below are excerpts from three of their recent reports.

The first report we'll consider looks at where the massive financial losses will occur in the next recession. The last time we had a financial crisis, in 2008-2009, the problems were centered on the mortgage market. This time around the losses will explode in all kinds of corporate debt, both here and around the world.

Corporate debt has ballooned out of control, not just with larger companies, but with smaller companies as well. In its Global Financial Stability Report of April 2017, the International Monetary Fund (IMF) said 20% to 22% of U.S. corporations will default on their debt in the next recession. In China that number is expected to be closer to 40%, with Europe somewhere in between. These are staggering numbers. If one-fifth to one-quarter of our corporations of all sizes cannot even pay the interest on their loans, we will have a wave of bankruptcies and job layoffs not seen since the 1930s. Yet this is exactly what the IMF says will happen, and the IMF is notoriously over-optimistic.

> **Zombies and the End of the 'Global Synchronized Recovery,'** by Tuomas Malinen, PhD.
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> Several economic indicators have turned to the south at the beginning of this year. They clearly indicate a slowing economic momentum. This is something that was not supposed to happen. The tax cuts by president Trump and the long-awaited recovery of Eurozone should have carried us to a new phase in global growth. At least, that is how the narrative went.
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> In June 2017, we warned that the global economic expansion is on its final leg and that signals from China and the US indicate a slowing economic momentum. We showed that China is closing the limits of its growth model because its investments are turning increasingly unproductive and its credit has grown at an unsustainable rate for several years. In the US, the credit impulse was in a clear decline which, in a mature business cycle, tends to foretell of an economic downturn. But the business-friendly policies of president Trump, the economic stimulus ahead of the 19th National Congress of the Communist Party in China and the "liquidity tsunami" launched by global central banks kept the global economy humming till the end of the 2017.
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> At the beginning of this year, everything changed. China started to actively curb its excessive credit creation, the quantitative tightening of the Fed started in earnest and the geopolitical risks re-surfaced. Thus, the main pillars of the "global synchronized recovery" started to falter. However, the main trigger of the sudden slowdown is likely to come from the zombified global economy.
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> **Central banks and zombies**
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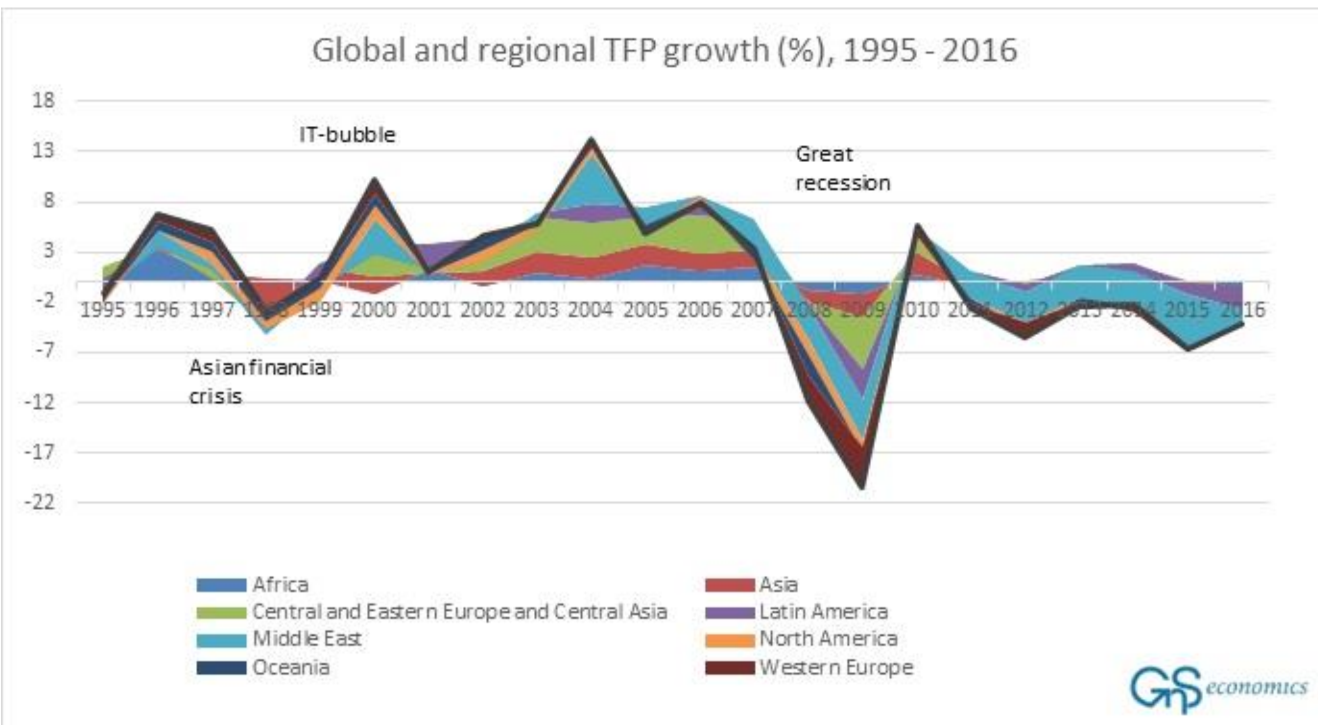
> In September 2017, we warned that the unorthodox central bank policies have created an ever-growing number of unprofitable "zombified" firms. A zombie company is a firm that is unable to cover its interest payments from its operating profit (stricter criteria also exist). The zombie firms

survive if credit is plentifully available at a cheap price. After 2008, the global central banks created such an environment with very low interest rates and quantitative easing programs.

What the zombie firms do is that they crowd out the birth of new productive firms. A recent study shows that while the *Outright Monetary Transactions*, or OMT -program, launched by the European Central Bank in 2012, improved the health of the banks on the periphery of Eurozone, those banks extended their loans mostly to low-quality borrowers to which they had a pre-existing lending relationship. This is understandable because if these companies would have failed, they would have taken the banks with them. However, this also greatly increased the number of the zombie firms and obstructed the creation of healthy new firms by diverting bank lending to the 'zombies'. Moreover, the credit misallocation and market distortions created by the OMT program collapsed the overall productivity in industries where the fraction of the zombies was high. The historical example of Japan shows that if the ailing firms are provided with cheap credit, the job creation is depressed and the overall productivity growth is hindered.

The 'zombification' of the world economy is visible in productivity growth. Since 2008, the total factor productivity (TFP) has been in constant decline except the minor increase in 2010. This is the longest decline in TFP ever seen. We can safely assume that the zombie companies, created by the central bank policies, are the main source for this.




Global (back line) and regional growth of total factor productivity (%) from 1995 to 2016. Source: GnS Economics, The Conference Board

### The recovery that never happened

The "global synchronized growth" was nothing more than a pipe dream driven by the unsustainable credit expansion in China and the equally unsustainable bond buying operations by the global central banks. The fact is that the world economy never really recovered from the financial crisis. This is the simple message of the feeble productivity growth.

> The central banks pulled all the stops in their efforts to prevent the financial crisis from turning into global deflation. They succeeded, but at the same time they created an unsustainable recovery which gave birth to the hordes of the ailing zombie firms fed by the excess credit and liquidity. The zombie companies cannot survive when the interest rates rise and this is exactly what happened when the Fed enacted its QT-program. Dollar liquidity started to withdraw and Libor-rates started to rise creating a global liquidity and credit shocks.
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> Therefore, we are likely to face a dramatic slowdown in global growth during the coming quarters, followed by a worldwide wave of corporate defaults ending the "global recovery" narrative which has been supporting the asset markets lately. Thus, the bull market will end and over-valued capital markets are in a serious risk of a crash as we warned in December. Asset market crash would ignite a global financial crisis and lead the world economy to a depression. No one probably thought that a *zombie apocalypse* would be quite something like this, but we should start to prepare for it nonetheless.

The "zombie" companies he describes will be the first to go bankrupt in the next recession, laying off all their employees. In addition, they have been key to the historic drop in productivity we've seen since 2010. Without productivity growth it is difficult for an economy to expand. And when you get the combination of negative productivity with low unemployment, the next step is always a recession.

This next article began with an academic discussion as to how and why policy-makers consistently miss the largest economic problems. The answer is that their theories completely ignore both debt and the negative impact of downturns in the financial sector. Since over-indebtedness has caused nearly every severe recession and depression in the last 700 years, this is a rather large blind spot! The excerpts below discuss GsN Economic's views on the current state of the economy, risks, and how and when it will implode.

> **Manias, Crashes and Economic Policy: The Blind Spots of Economic Forecasting,** by Tuomas Malinen, PhD
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> In addition to markets crashing under their own weight, there are three developments which can currently be seen leading to a sudden financial shock:
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> 1. The over-indebtedness in China,
> 2. The tapering and *quantitative tightening* of the central banks, and
> 3. The diminishing momentum of the US economy.
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> We have written several pieces on the global role and risks of China (see below). The principle is that China has supported the global economy by a massive and unsustainable credit stimulus enacted through its centrally controlled financial sector. The main point is that the tightening by both China and the central banks may lead to a sudden reversal in the over-bought asset markets.
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> The business-friendly policy of president Trump has given a prominent boost for the US economy. A reasonable argument can be made that without Trump, the US might already be in recession. Many real economic and soft indicators, like domestic investments and business sentiments, are now at high levels indicating a rising economic momentum. However, something is not right in the US economy. I, among others, have been waiting for the recovery in the expansion of credit in the US in the wake of revigorated business investing. This has not happened. The Figure below presents the annual growth rates of the total bank credit and commercial and industrial loans. Currently, both are in a clear decline. It is notable that whenever their growth rates have simultaneously declined rapidly (the annual decline of combined growth of more than 5%), the economy has either already been in a

recession or the recession has started in the following year. In 2017, their combined growth rate fell by 8.4 percent. In addition, the *credit impulse* of the US economy has continued to decline. These are rather clear recessionary signals.

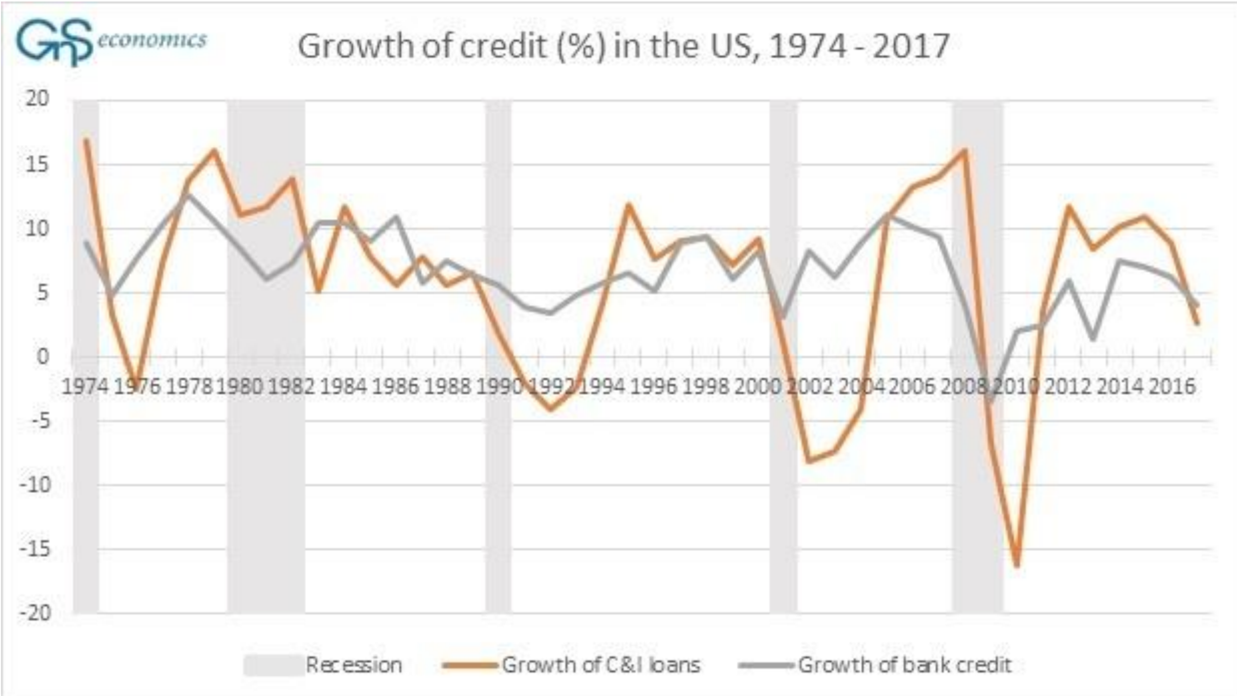


Figure. Annual growth of total bank credit and commercial and industrial loans (%) in the United States. Source: GnS Economics, Fed St. Louis

A historical analog from the 1920's shows what can happen if the real economy gives way under an over-bought asset market. When the US economy and corporate profits turned the corner after a massive asset price boom in early 1929, the stock market crash that started the Great Depression was only a few months away. Whether we are facing a similar situation now remains to be seen, but caution is warranted.

**The end is nigh?**

I (we) think that China is the key for the global economy, and that the turn for the worse could be much closer than many think. With the effectiveness of debt stimulus at a deep decline, and debt levels steeply rising, China is facing a choice between two stark options: to allow for a recession now or a much worse crisis later. I (we) are keen to bet for the former. More so, as president Xi would probably like to have a booming economy during the 100th year celebration of China's communist party in 2021.

When China starts to remove its debt-stimulus (or it becomes ineffective), it will take away a key support for global growth. Global macroeconomics indicators will start to tumble followed by dwindling corporate profits. The overbought asset markets with diminishing central bank support is likely to catch the drift quickly (the high-yield market is my 'favorite' for the actual inflection point).

With the global central banks and China planning to tighten, 2018 looks a lot like a year when the *market economy* finally returns. For the artificially propped asset markets, it means a crash.

This report reminded me of a conversation I had with Dr. Lacy Hunt a few months ago, in which he said the key to understanding how the economy will unfold can be found by looking at the growth rate of all bank lending in the U.S. If the money supply goes negative, by definition we are in a recession. With the

Fed now removing money from the economy through their short-term interest-rate increases and Quantitative Tightening in which they will be removing over $400 billion of the money they previously printed over the next year, the only way the economy can continue to grow at all is if bank lending increases to offset the Fed's actions. But bank lending was growing at a rate of 11% in late 2015 and is now down to 3%. This means the economy is perched precariously at the edge of recession right now. I know this is diametrically opposed to the mainstream view, but I do take solace from the fact that this alternative view happens to be based on absolute economic fact. Our economy is completely dependent on a continually growing pile of debt, and without it we come crashing down. This is a certainty.

### China

In the last two years, much of Dr. Malinen's research has focused on China. Like many others, he expects the impetus for the next worldwide economic downturn will come from China's historic debt bubble. Here is a summary of these concerns:

> **The World Economy on the Brink**, by Tuomas Malinen, Ph.D (from GsN's third quarter report, 2017):
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> To put it bluntly, and to simplify a bit: since 2008, the world economy would not have grown without China.…The main problem is that debt share to GDP runs very high in China. In addition, the latest reports put the size of non-bank financial debt, or the *shadow banking* sector of China, at a massive $37 trillion dollars. The rapid increase in the assets of the shadow banks occurred during 2016, when China launched its major stimulus program. This more than doubles the level of private debt in the Chinese economy, thus raising its GDP-share to more than 500%. It is obvious that, by any standards, this is not sustainable.
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> Where has all the money gone? The simple answer is: into a growing volume of unproductive investments. China's current level of fixed asset investment is preposterous. A reasonable figure for a fast-growing developing economy would be 20-40%. China has been putting 80% of their entire yearly GDP into fixed assets (these include bridges, roads, airports, apartments, factories, etc.).
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> **Forecasts:** We estimate that the likelihood of a serious correction or crash in the asset markets is 80% for the next 12 months (note: this was written last September).
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> **Conclusion:** The current boom has been achieved through unsustainable credit stimulus in China and massive (tsunami-like) asset purchase programs by the central banks. These all but guarantee a massive correction ahead. This late-cycle boom is a mirage, and the longer it lasts, the deeper the hole will grow.
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> The situation in the asset markets, and thus in the world economy, looks good, but it is only good until it suddenly is not. The artificially propped asset markets can turn a corner extremely fast. When the correction in the asset markets commences, it will likely be swift and brutal. If the central banks are unable to stop it, the asset markets will crash thus starting a global depression… The manipulated and debt-fueled world economy is on the brink, and all that is needed for it to fall is a push.