Economic & Market Update, November 2016

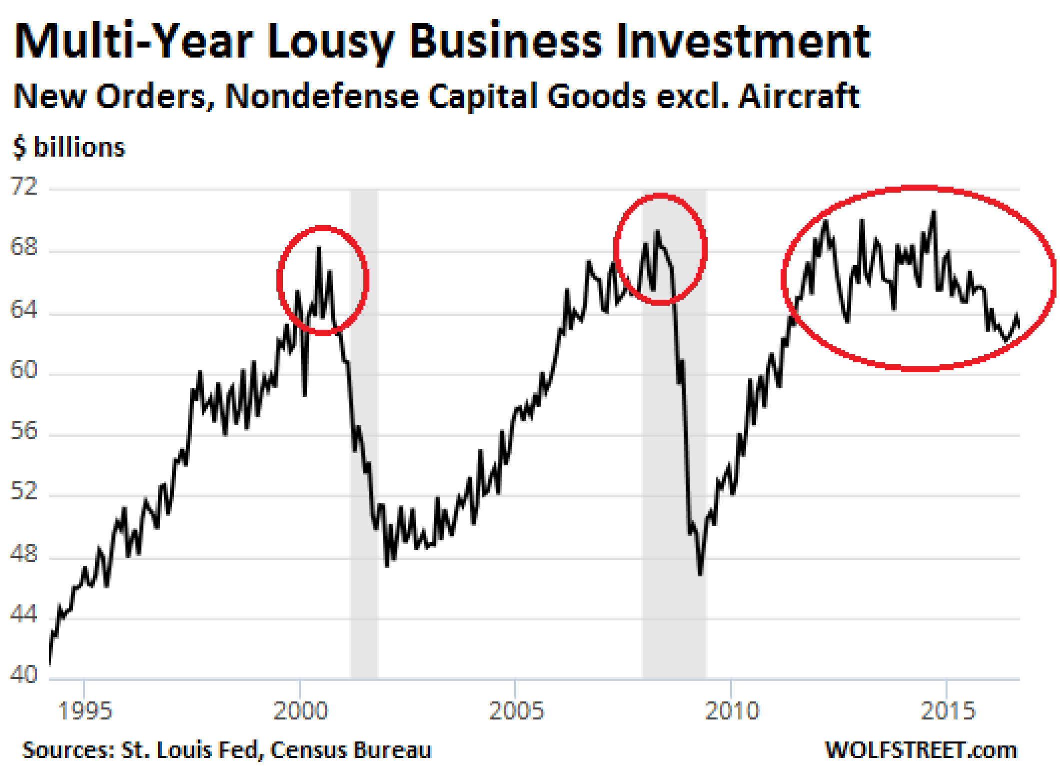
Does History No Longer Apply?

By Richard Morey

This month we'll attempt to figure out why the economy is not following history. But first we'll give an update on the third quarter Gross Domestic Product (GDP) report. While we do not give much credence to initial GDP numbers, as they are always dramatically lowered months after we actually enter a recession, they are a somewhat useful shorthand way to see how the economy is doing. For the third quarter, GDP came in at 2.9%, which was much better than the 1% trend of the first half of the year. However, even the always-optimistic mainstream financial media was not impressed. This is because almost all of the positive surprises were due to an increase in soybean exports and inventory growth, i.e. companies made a lot more products not yet sold. The other main contributor was healthcare spending which continues to roar. Personally I do not believe this should even be included in GDP, as dramatic increases in healthcare costs is a serious economic problem, not a plus. Since increases in soybean exports and inventories are hardly long-term signs of broad-based economic strength, the +2.9% number did not excite anyone. To the contrary, purchases by consumers rose only 2.1%. This may not sound bad on first blush, but in reality consumer spending typically rises around 2% *at the bottom* of the average recession. Then we have business investment which was, once again, weak. This is our topic for this month's report.

How Can You Explain this Chart?

The following chart from the Federal Reserve Board of St. Louis shows total investments into U.S. businesses. The truly remarkable point is not that it has been going down since 2011, as we have seen the economy has indeed been weakening since it first awakened from the Great Recession of 2008-2009. The remarkable point involves history. For over 150 years, every recession in the U.S. followed a completely predictable pattern. Business investment goes down right before we enter a recession. We have never had a decrease in business spending that was not almost ***immediately*** followed by a recession. Business investment then continues to plunge during the recession, after which it shoots straight back up.



Before giving my explanation we'll summarize the views of the economist who presented this chart. His name is Wolf Richter. The article was published on October 27 on his web site *Wolf Street* and was entitled: **Why is this economy not yet in an official recession?** Here are excerpts from Mr. Richter's thoughts:

> "What if it's **really** different this time? What if eight years of radical monetary policies have altered the way things work to such an extent that the normal economic patterns no longer apply, that the economy has entered far into a new territory where ultra-cheap credit sloshes around, and where – instead of short, sharp recessions that clean out the cobwebs and help economic actors slough off excess debt at the expense of creditors – we get years of quagmire interrupted by mild declines and false-hope rises, even as the debt burden continues to grow and grow to suffocate all hopes at economic growth?
>
> There have been plenty of symptoms of this. Here is one more: business investment – which plays an outsize role in economic growth. And it just booked its worst September since 2010.
>
> The Census Bureau reported today that orders for durable goods – products and equipment designed to last over three years….excluding defense and aircraft, fell 3.6% year-over-year (not seasonally adjusted).
>
> This sort of decline in business spending has now become the rule. Until recently, some of it was in part due to the oil-and-gas industry's cutbacks. But they have now mostly run their course. New money is pouring into the industry. The rig count has been rising for months. And executives are swearing up and down to their investors and creditors that the "worst is behind us." So the year-over-year decline in September was hardly the fault of just the oil & gas industry.
>
> And the decline has become a pattern that doesn't match the prior patterns of declines.
>
> The chart shows 22 years of orders for nondefense capital goods excluding aircraft – the approximation for business investment. Orders surged before recessions and formed a clearly identifiable peak either just before the official recession began (2000) or after it began (2008). Then orders plunged as companies struggled with their debts or restructured them, often in bankruptcy court, and they curtailed their investments in equipment for a while. Sometime near the end of the recession, companies began again to buy more capital goods, and orders rebounded sharply for years. You have to go back all the way to September 2010 to find lower business investment!
>
> None of the data in this article is adjusted for inflation. So inflation adjustments would make the multi-year decline in business investment look much worse.
>
> This is what is different now: Cheap credit and excess liquidity allow companies to pile on more debt – often to buy back their own shares or buy out each other – and trudge on while yield-desperate creditors fork over ever more money. But where is this record amount of borrowed money not going? Capital goods. Hence the drag on the economy – but without pushing the economy into an official recession though it keeps teetering on the edge.
>
> So what if this teetering economy, burdened by a record amount of debt, got sideswiped by one more thing?
>
> New orders for motor vehicles and parts rose 2% year-over-year, "a sign of steady consumer spending," as the media called it. Since the Financial Crisis, new vehicle sales jumped every year to set a record in 2015. But this year, sales have been flat. In September, they declined. In October, they're expected to fall 7% year-over year.

> Automakers are throwing large incentives into the market to create demand. But inventories on dealer lots are piling up and dealers are cutting their orders. Earlier in October, [Ford announced plant closings and layoffs] to achieve production cuts. Other manufacturers will follow. In turn, they'll cut orders to their suppliers. But the survey-based Census data for September durable goods hasn't quite caught up yet with this new reality.
>
> A "car recession," as the industry is calling it, impacts the economy in many ways: raw materials, manufacturing, employment, transportation (rail and truck), finance, etc. It hits GDP via consumer spending and other components. Booming auto sales have been a big pillar under the otherwise shaky economy. But that pillar is now beginning to crumble too."

While I agree with everything in Mr. Richter's article, I believe he missed the largest single factor which explains why business investment has been declining for several years without the economy falling into actual recession. That reason is called Chinese debt.

Exploding debt levels throughout the entire world are, without doubt, the reason why the economy has deteriorated, year after year, without plunging back into recession. It's actually almost impossible to enter recession when debt is increasing dramatically, as every new dollar borrowed and spent increases current economic activity. Led by the Federal Reserve Board and their "zero interest rate policy" or ZIRP, here in the United States corporate debt has exploded to the highest level in history. Government debt is also well above its all-time high. Consumer debt has come down – slightly – though it remains far, far above historic levels.

Knowing we do not have recessions when debt is increasing, the Fed has apparently decided the obvious answer is to do whatever is needed to keep debt rising forever! Of course, everyone in the world with even a little bit of economic knowledge knows this idea is insane. Once debt exceeds a certain level, more and more of the new debt ends up going to companies who will never repay it. Ultimate losses then start to pile up higher and higher. As a result, the longer, and larger, the bad debt pile is allowed to accumulate, the more severe the resulting recession. This will be our experience here in the U.S. sooner or later, and the longer it takes the more losses and the more severe the resulting recession.

What has changed in the last year involves Chinese debt. According to Chetan Ahya of Morgan Stanley, in the last twelve months Chinese debt has increased by a mind-numbing ***$4.5 trillion.*** The Chinese economy has annual economic activity of approximately $10 trillion, so they increased their debt by 45% of their economy in one year. And this was after total debt in their entire country had the largest explosion in world history, going up 400% in the previous six years.

You simply cannot put something like this into any historical perspective to determine what history might say about it because nothing like this has ever occurred. That being said, we are quite confident this is, to say the least, not sustainable!

How and why did the Chinese government allow this to occur? A year ago the Chinese economy was dropping rapidly. Chinese banks had more money loaned out than *all the banks in the United States and Europe combined.* Some very knowledgeable debt analysts believed up to 20%, and possibly more, of all those loans were "bad," i.e. would never be repaid. This means their banks were looking at several trillions of dollars worth of losses. Their economy would enter a full-fledged recession, and many millions of their citizens who were certain their investments were actually backed by the government would find out their life savings had vanished. So in response to a looming debt crisis, the Chinese government decided the best medicine was to generate *another $4.5 trillion* in new debt – much of which will also undoubtedly never be repaid.

How has this kept the U.S. from entering recession? We live in a world economy in which Chinese growth (or the opposite) is guaranteed to push or pull all the other economies along with it. While modest changes in Chinese debt wouldn't be enough to stave off a U.S. recession, $4.5 trillion added to the world economy certainly is enough to keep our head above water – though just barely. Of course, the rest of the world hardly tightened their debt belts. Total debt in the U.S. shot up $2.2 trillion in the last year, while it grew by $870 billion in Japan and $550 billion in the Eurozone.

Summary

The exact same debt explosion which has kept the economy on the verge of recession without actually entering one once again ballooned in the last year. Unfortunately, since debt increases beyond a certain, prudent level lead to even more losses whenever the next, inevitable recession arrives, this is not good news. While many aspects of today's world economy are truly different, the negative impact of a debt bubble will never disappear.

The U.S. Election

Since we will have a new president before our next monthly report, we thought we would answer the most common question clients have for us these days. How will the results of the election impact the markets? This is actually easy to answer. If Hillary Clinton is elected, basically nothing changes domestically, as her policies are similar to those of our current President Obama. Assuming the Republicans continue to control the House of Representatives, this means not one single bill the new President Clinton proposes will have the slightest chance of being passed.

While a Clinton win does not immediately lead to any changes that should affect markets, there is one silver lining we can see to the continuation of the dysfunctional government we have had since the Republicans took over the House in the 2010 mid-term elections. Despite the best efforts on the part of the Federal Reserve Board, at some point we will enter a new recession. When that day dawns, the banks and all of corporate America will experience severe losses. If accompanied by an international economic crisis – particularly if this involves the potential and inevitable dissolution of the Eurozone – our banks will again have massive losses. They will then demand another bailout. But unlike 2008 when a Republican administration was able to coerce the House into approving bailouts, this time it definitely won't happen. This would result in a much more severe recession in the short-term. However, if failed companies are not bailed out we would finally be able to clear out the dead weight, i.e. the bad debt, in our economy so we could then start to rebuild on more solid footing.

Then we have a potential President Trump. If Donald Trump wins, we are highly likely to see the stock market begin crashing quickly. For the first time in my life, we would have a President who was actually *trying* to get the market to crash. Mr. Trump and his political advisors – especially his top economic advisor Carl Icahn who is presently 149% short the U.S. stock market – know stocks are in a bubble which must eventually pop. They also know it would be greatly to a President Trump's advantage to have it pop right at the beginning of his presidency, as this would then allow him to blame President Obama. Plus, he could then point to the bottom when judging how well the economy performed under his watch. Now I cannot say for certain the stock market would begin its inevitable crash the day Donald Trump is elected President, but it surely would begin shortly thereafter.

Analyzing how our economy itself would perform over the next four years under each candidate might be a useful report to write. However, it would likely be a wasted effort, as predicting what candidates will attempt to do if elected is nearly impossible. Politicians have a distinct tendency to tell the electorate what they think they want to hear or will get them elected, not what they actually intend to do. In addition, the President of the United States has far less impact or control on our economy than most people believe.