Economic & Market Update, September 2017

An Interesting September

By Richard Morey

Historically, the fall is when most stock market crashes have occurred. I've never heard a convincing reason why this is the case, and it could be a coincidence. But this fall is shaping up to be a very dangerous time period.

Before looking at the United States economy and markets, we're going to take a look at the country which has been driving the world economy since 2008 and most definitely over the last nine months. This country is China, which has accounted for over half of all world economic growth since the Great Recession.

The growth of debt in China is staggering and has never been seen before in the history of the world. In 2008 they had a total of $8 trillion of debt. Today that number is over $35 trillion. To put this in perspective, here in the U.S. our banks have approximately $18 trillion in debt. So their banks have loaned out twice as much money in an economy approximately half the size of ours.

The most dangerous parts of China's economy involve real estate prices and corporate debt. Looking just at corporate debt, we see it has soared to $18 trillion. Again to put this in perspective, the Financial Times estimates corporate debt in the United States has skyrocked all the way up to $8.4 trillion. This is, by far, the highest level of corporate debt we have ever had, yet it isn't even half as much as China has accumulated.

Figuring out anything related to China's economy is, to say the least, difficult. Nothing their goverment says can be trusted, and the sheer size of the economy makes conclusions hard even if an analyst is truthful. But if we had to pick one person to listen to, that person would be Charlene Chu.

One of our favorite financial analysts, Wolf Richter, wrote this about Charlene Chu recently (August 17, 2017 at www.wolfstreet.com): "In a recent interview with the Financial Times, Ms. Chu said, 'Everyone knows there's a credit problem in China, but I find that people often forget about the scale; it's important in global terms.' Back in 2011, when she was still a China banking analyst at Fitch Ratings, she went out on a limb with her radical estimates that there was much more debt than disclosed by the central bank, particularly in the shadow banking system, that banks were concealing risky loans in off-balance-sheet vehicles, and that this soaring opaque debt could have nasty consequences. Her outlandish views at the time have since then beome the consensus.

And this pile of debt is in much worse shape than officially acknowledged, she says in her latest report, cited by the Financial Times. She's now with Autonomous Research. She figured that by the end of 2017, bad debt in China could hit $7.6 trillion.

Or about 68% of GDP! It would take the bad-debt ratio to an astronomical 34% of all loans, and way above the 5.3% that the authorities are proffering. And the authorities - the government, the central bank, supported by the state-owned banks - are now pulling all levers to keep this under control."

If a country loses 68% of their GDP in bad loans, i.e. loans which are never repaid, this would be one of the largest economic crashes ever seen (outside of losing a war). According to Ms. Chu, this is now inevitable for China, as this is the amount of money which has ***already*** been lost in reality. It will never be repaid, though she says she has been "impressed" with China's ability to manage to keep hiding these losses for so long.

There are two reasons I begin this month's report on China. First, the world economy has grown somewhat more than anticipted in recent months, particularly in Europe. This is, however, a temporary illusion due to

Chinese politics. The 19th National Congress of the Communist Party of China begins on October 18 of this year. This Congress is held every five years, at which they select their leaders for the next five years. President Xi and the other current leaders know they have an unmanageable debt problem. With so much bad debt weighing down their economy, if left alone the economy will sink before ultimately crashing. There is only one sure way to keep this from happening in the short-term, and this is to create more debt. Therefore, in mid-2016 the Chinese banks once again opened up the spigots on new loans, especially to the large State-Owned Enterprises. The fact these huge companies are the ones who already have the majority of the bad debt did not matter in the least, as being so large they were able to absorb the bulk of the new money the government wanted to push into the economy. And push they did. By the first quarter of this year, new lending in China reached an annualized rate of $4 trillion or over a third of their entire GDP!

Two years ago the Chinese government's head of infrastructure spending announced that around half of all the money they had spent building roads, bridges, airports, railroads, etc., etc., etc..... had been wasted. One can only guess as to how much of their recent lending binge was lost the moment it went out the banks' doors.

But it "worked," as the Chinese economy has picked up and is now on a glide path of the reasonable growth needed to make sure the current leadership stays in power after the upcoming Congress.

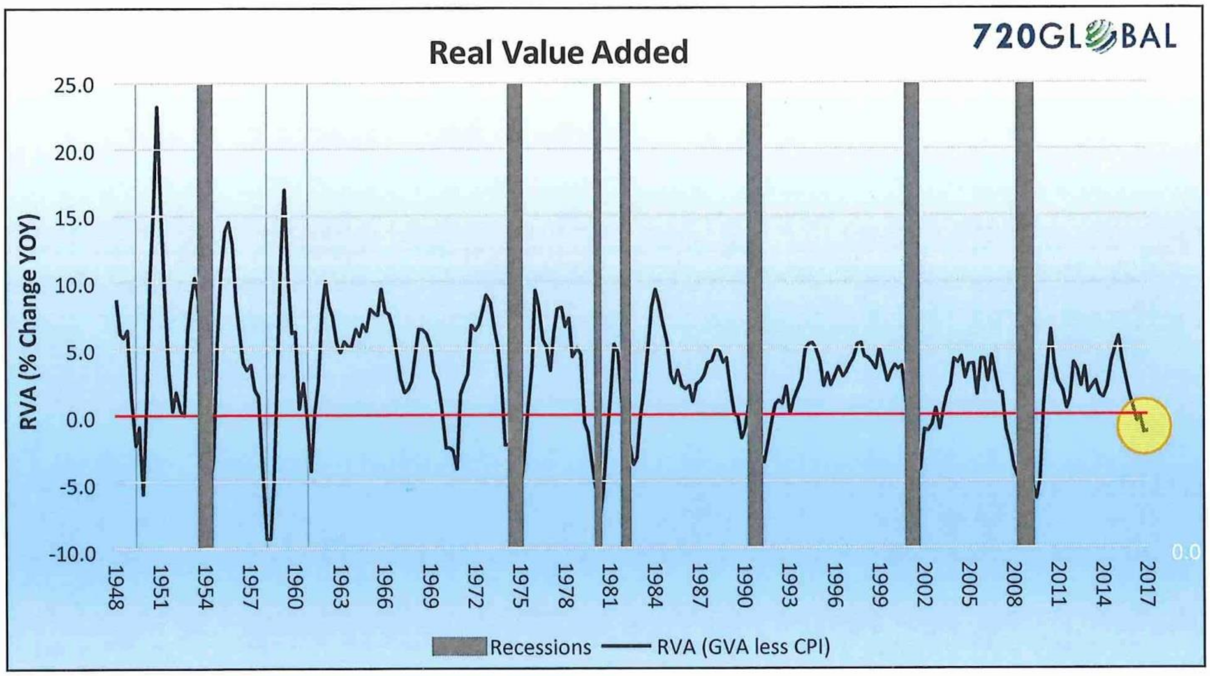
We live in a world economy, so another explosion of new debt in China over the last nine months spilled over to the rest of the world as Chinese companies purchased huge amounts of raw materials and other goods and services. This is the reason Europe has looked a bit better economically this year, and it has surely helped the U.S. economy somewhat.

The second reason we begin with China this month is that their lending spree has now ended. So the tailwinds we have been experiencing economically will now turn into headwinds. Given China's outsized impact on the world economy, this could easily turn into a hurricane.

In addition, over the weekend President Trump stated the United States should cease all trade with any country doing business with North Korea. Since approximately 80% of trade with North Korea involves China, President Trump was essentially declaring total trade war with China. Now this doesn't mean this will happen, but the administration's lead Chinese trade negotiator, Peter Navarro, is a hardcore anti-China intellectual, and President Trump himself has spoken many times about punishing China for unfair trade practices. Should the North Korean problems lead to a trade war with China, the world economy will come crashing down, worse than at any time in our lifetimes. Considering all the above, President Xi's statement over the weekend, when he called the world economic situation "grim," sounds quite accurate. (Personally I doubt we end up with a trade war with China, though this cannot be counted on.)

Turning our attention to our economy, Michael Lebowitz at 720Global recently sent us a very interesting chart on our economy. The chart, which can be seen below, shows something called "Real Value Added." The concept is actually fairly simple to grasp. For example, if you purchase $100 worth of wood, $20 worth of other materials and pay someone $30 to build a chair, you have spent $150. If you sell the chair for $200, you have created $50 of economic value. This is Gross Value Added. Real Value Added is the same thing adjusted for inflation.

Since 1948 Gross Domestic Product or GDP and Gross/Real Value Added have tracked each other very closely, i.e. they are essentially measuring the same thing. Since 1948 there have been 277 quarters of data, and Real Value Added has been negative right before, during or immediately after every recession. We have not always gone into a recession when it goes negative, but it has gone negative in each recessionary time period.



Data Courtesy: St. Louis Federal Reserve (FRED)

Of course, one measure of the economy does not guarantee we are either now in a recession or will soon enter one, though any measure with such a good track record of spotting recessions over 68 years is certainly worth noting. This is particularly the case when the economy has been so very weak for so long without fully entering recession. The U.S. economy has been on the verge of recession for years, and it should not take much to push it over. That final push could easily come from the recent destruction of our fourth largest city, Houston, in Hurricane Harvey. I won't even take the time to refute the absurd notion I've heard in the financial media that this terrible event will be good for the economy. When the wealth of the nation is destroyed, the economy suffers.

Alternatively, the final push may come later this fall or early winter, due to either Congress or the Federal Reserve Board. Congress has until the end of this month to raise the debt ceiling and fund the government. This morning I had written an analysis concluding they were likely to "kick the can down the road" on all the large spending and deficit issues. Then it was announced President Trump has teamed up with the Democrats to temporarily raise the debt ceiling and keep the government going until December 15. Therefore we'll simply change the dates of the possible decisions and battles from the end of September to December 15.

Almost every financial analyst is sure Congress will raise the debt ceiling and fund the government with no major problems. I'm confident these will occur, but not without difficulty. The House Freedom Caucus consists of 30-50 Republican House members (membership is anonymous). Their leaders have insisted they will not vote to raise the debt ceiling over $20 trillion unless they get large spending cuts enacted. At the same time, the "moderate" Republicans in the House have said they will consider almost no cuts, as they prefer a "clean" raise of the debt ceiling. In order to accomplish this without Freedom Caucus votes, they would need to ignore the more conservative Republicans in favor of working with Democrats. This would be a potential nightmare for the Republicans politically - a nightmare President Trump may have entered into today by pushing off these decisions until December with Democrats' support.

Having spent weeks studying the various potential ramifications of all these endeavors, instead of going through all the possibilities and details, we'll just skip to the conclusion. In summary, the debt ceiling will be raised, or suspended indefinitely, though probably not without political war breaking out. The government may be funded by the end of the year, it could shut down for some time as the various factions battle over spending priorities, or - more likely - they will simply do short-term funding until the next election to keep the doors open without deciding anything or making any changes.

But tax reform is simply not going to happen in any meaningful way, shape or form. This means the two largest planks of Donald Trump's economic platform, i.e. repealing Obamacare and tax reform, will have both failed. Perhaps they will get something done on infrastructure next year, but the basic political reality is that we are not going to see anything positive for the economy coming out of Congress anytime soon. Instead, we are looking at political war or, at best, gridlock.

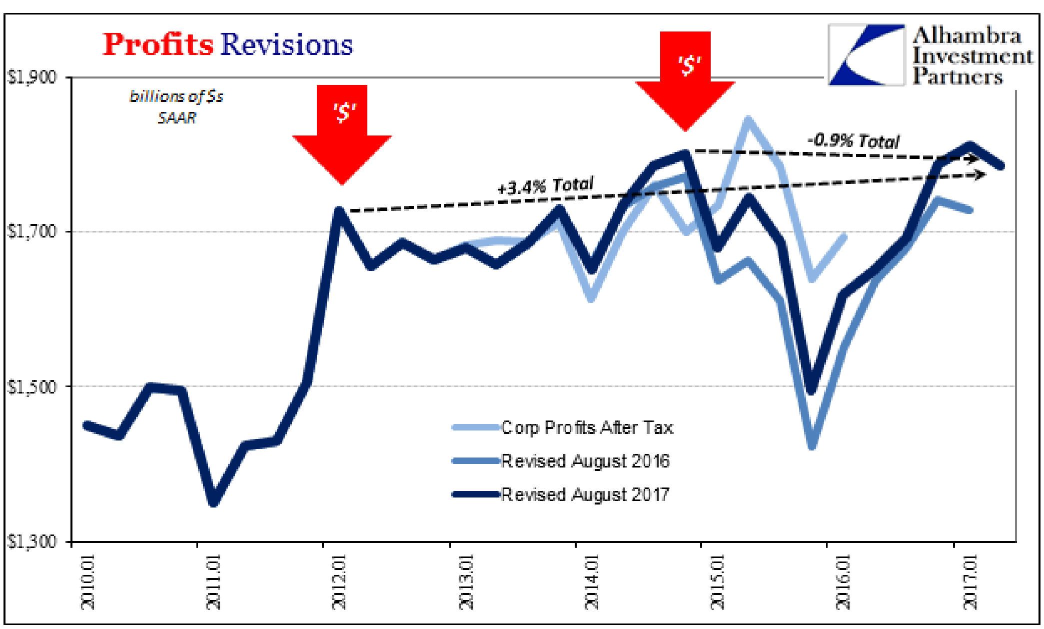
Finally, keep in mind I may be too optimistic in this assessment of Congress and our fiscal situation. They certainly could fail to raise the debt ceiling in a timely fashion or close down the government for an extended time period. Either of these outcomes could push the world financial markets into a nosedive and/or the U.S. economy into recession.

The Stock Market

While our regular readers undoubtedly understand the stock market is in an historic bubble, destined to pop at some point going forward, the financial media continues to "help" most investors understand stocks are, at most, fairly valued if not a little underpriced. Until fairly recently, their rationale was that investors knew the new Trump economic policies would sail through Congress, leading to a new, eternally bright economic future. With this idea broken (along with any chance Congress will pass anything substantial on the economic front), they have retreated to their old standby, claiming corporate profits are soaring and therefore stocks are not overpriced.

The chart bellow shows U.S. corporate profit growth in recent years. Since 2012, corporate profits have grown at approximately one-half of one percent a year. Considering "normal" earnings growth is 5-6% a year, this is obviously not good. It's even worse when you consider corporate earnings remain .9% ***below*** where they were in the fourth quarter of 2014.

Of course, the financial media only looks at the portion of the chart from late 2015 through the first quarter of this year. They fail to mention the severe drop just preceeding that time was caused by the price of oil, and therefore energy company earnings, collapsing, and the rebound was simply oil returning to its current level just under $50 a barrel. Ignoring the oil plunge and (partial) rebound, we see basically no earnings growth in corporate America in over 5 1/2 years. Yet the stock market has risen dramatically over this time period.



In addition to a bump in oil prices and therefore oil and gas company earnings, one other development occurred over the last year which brought corporate earnings all the way up to where they were in 2012 (sarcasm intended). As Jeff Snyder from Alhambra noted: "Corporate net cash flow rose (revised) in later 2016 not because of any economic upswing following the 2015-16 near recession, but instead as labor utilization *was cut back*. The only way in which cash flow to Corporate America seems able to grow is when those companies do what is worst for the economy. It has become almost a zero sum game."

Normally the stock market doesn't rise when corporate earnings are faltering. To the contrary, with no earnings growth for many years, reason would dictate stocks would sell for at least a modest amount below historic valuations. **This would mean the stock market would drop by over 60%.**

Something else clearly must be going on, and this "something else" continues to be investors' blind faith in the Federal Reserve Board to protect them from all losses. Benjamin A. Smith, writing for the Lombardi Letter, recently addressed this topic:

"In essence, the market has become less about earnings growth and more about Central Bank liquidity. This is dangerous for two distinct reasons.

First, unless the Fed remains fiscally accommodative and active with asset purchases, the bubble will burst. In the meantime, the stock bubble keeps getting much larger and more expensive. The higher it goes, the more violent the unwind when the Fed removes the training wheels.

Second, there's an assumption that the Fed actually knows what it's doing. It's assumed the Fed's economic models are correct and that it's in control. Both of these assumptions are dubious. The fact is, we're in the midst of the greatest economic experiment ever devised. The Fed's balance sheet has gone parabolic since the U.S. Housing crisis, which it's attempting to unwind with unpredictable results. Interest rates were never this low for this long The list goes on and one, but it's important to understand that we're actually living in extraordinary economic times...

What Does This Mean for the Stock Market?

The market melt-up on low volume should be a warning sign for investors. The lack of selling means that everyone is herded on the same side of the market, riding the tidal wave of Central Bank liquidity until it stops working. It's reminiscent of the Tech Bubble, when everyone knew most internet stocks were bogus. But investors didn't care, because they thought they could sell their positions before the market crashed.

The problem with that mentality is that after nine years of dip buying, the next dip could be the one that doesn't come back. Investors are conditioned to believe the Fed has got their back. The belief is that if the market strays too far, the Fed will step in and stem the tide. But will it? That's a very dangerous assumption being that it didn't stop the 2001 and 2008 crashes from happening. The Fed is a critical player, but it's not omnipotent."

Of all of the Fed's theories, the single one to which they cling most dearly is called the Phillips Curve. This theory attempts to explain the relationship between employment and inflation. It is the key theory the Fed follows. Given this, one might have thought the market would have been shaken last week when the top economist at the Philadelphia Fed, Director of Research Michael Dotsey, released a report showing the Phillips Curve doesn't work. Of course, blind faith in the Fed is presently so strong, and so blind, it cannot be shaken simply because their cornerstone theory is proven to be wrong.

Dr. John Hussman has also proven the Phillips Curve, and several other key Fed theories, are incorrect. In his weekly Market Commentary of August, 7 entitled: ***Estimating Market Losses at a Speculative Extreme***, Dr. Hussman wrote:

"Look. The models that central bankers use are not somehow classified or hidden from the economics profession, nor has the discipline been deprived of the ability to examine the often weak empirical evidence behind them. Central banks possess no concealed, mysterious knowledge that is somehow obscure to mortals. If anything, one might question whether some FOMC governors have ever carefully examined historical data at all, given that many of their propositions can be refuted by even the most basic scatterplot...

One thing should be clear: *policy makers have not become "smarter."* What they have become, with each bubble-crash cycle, is more reckless and arrogant in their willingness to extend speculative financial conditions by encouraging yield-seeking, compressing prospective future investment returns, amplifying the destructive consequences that inevitably result, and ironically, using those same consequences to justify fresh intervention."

Dr. Hussman then ends with a statement we fully agree with at Secure Retirement:

"I fully recognize that during a period of reckless speculation, substantial but temporary rewards are often available to those that embrace the most reckless behavior. Still, I've correctly anticipated the collapses of prior speculative episodes, and the likely extent of the accompanying market losses. Our discipline has adapted in ways that will better tolerate extreme valuations in future periods where market internals remain generally favorable. Meanwhile, despite our challenges in the advancing portion of this bubble, the cycle isn't over till it's over. I've learned that the criticism of "being defensive too early" has little bite by the time a collapse wipes out 7-14 years of market returns (in excess of Treasury bill returns), as the 2000-2002 and 2007-2009 declines did. I have every expectation that the completion of the current cycle will do the same. Having established a constructive or leveraged market outlook after every bear market decline in over three decades as a professional investor, I am equally convinced that there will be strong investment opportunities on the other side."

The Bond Market

As always, the picture for the highest quality bonds, particularly U.S. government or Treasury bonds, looks brightest when prospects for the stock market are bleakest. And with stock prices at obscene levels, with years of no earnings growth, in a deeply troubled world economy, the picture could hardly be darker for the stock market. We do not know when the stock market will crack, but it will, and the results will be historic losses.

As that occurs, Treasury bonds should roar, once again, along with a few other assets specifically chosen to benefit during a stock market crash. Anyone who has been watching the markets every day in recent times has seen these relationships remain fully intact.

Another relationship which remains intact is the Fed's iron adherence to their mistaken theories and practices. This means they are certain to return to lowering interest rates and buying bonds the moment they can no longer claim the economy will soon turn the corner into solid growth. Instead of looking at all their past actions and realizing they haven't worked but have exacerbated our nation's economic problems, they will undoubtedly assume they were completely correct all along but simply did not do enough. Combined with a recession and stock market crash, this should take yields on the 10-Year Treasury bond down to 0%, and probably negative. As this occurs, longer-term Treasuries should rise 30-40% in price, and possibly more. Since this is our largest investment at Secure Retirement, we should do quite well.