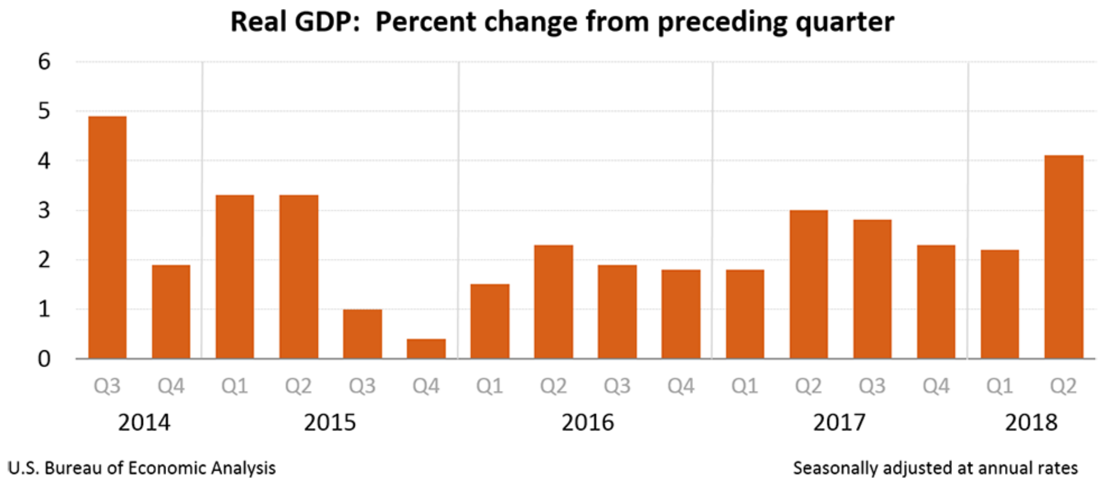
Economic & Market Update, August, 2018

Is the Economy Now Growing Robustly?

By Richard Morey

Since second quarter growth as measured by GDP came in at 4.1%, most in the financial media looked at that number and assume we're finally doing great here in the United States. That truly is a joke, and not a funny one.

First, just a little bit of history. The chart below shows GDP growth each quarter since 2014. Notice the economy supposedly grew nearly 5% back in the third quarter of 2014. Note also that any reading around 2% or lower was, historically, a clear sign recession was approaching, yet the average growth rate has been little over 2% for years now.



We have seen the same story over the over since 2009. GDP has a quarter, or even a few quarters, of decent growth, followed each time by a drop back down close to recession. I guarantee you this time will be no different. The only real change will come when the next downturn turns into an actual recession.

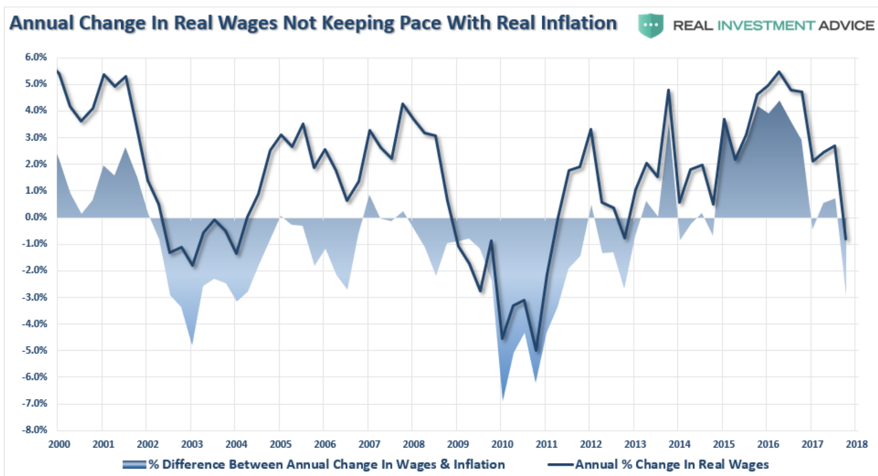
Each time the economy appears to do better, different reasons are given as to why happy days are finally here. Most believe the economy had a decent quarter due to the tax cuts and other changes in governmental policy, and some of this assessment is likely accurate. Companies have brought hundreds of billions of dollars back from overseas since the taxes due on money made overseas were lowered. Plus, they have some additional money from lower taxes on their U.S. profits. Yes, they are using the vast majority of this money to buy back their own stock – an activity that does nothing to expand their businesses, or the economy. Still, it is likely at least some extra money did trickle into their actual businesses which would give the economy a bump. But the economic benefit of bringing back the profit from overseas operations was, for the most part, a one-time phenomenon which should be nearly over by now.

Most likely a much larger cause of a better quarter involved the escalating trade wars. To quote Lance Roberts from realinvestmentadvice.com:

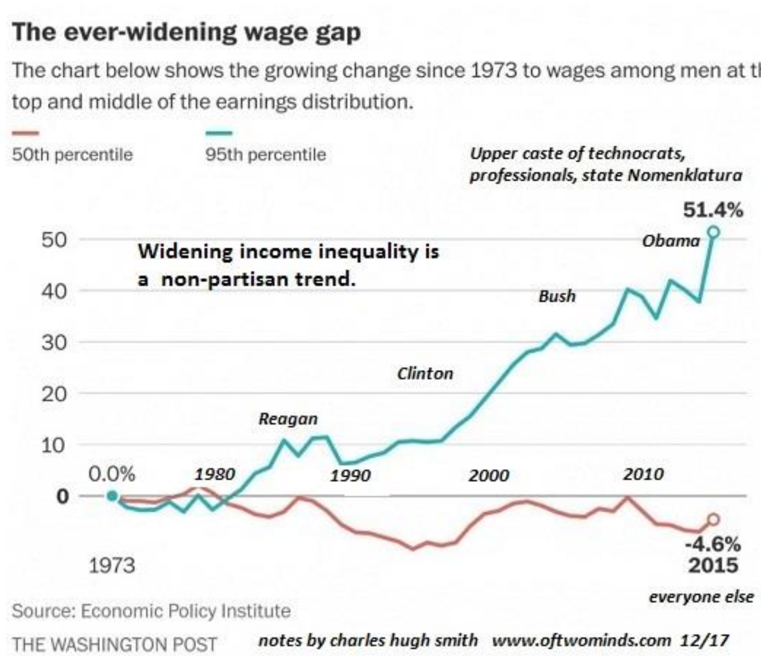
*"An **unusually large number of one-off factors appear to have boosted 2Q GDP, many of which are directly related to escalating trade concerns**. As companies and countries race to secure supplies that*

*may become expensive later on, **exports have surged and inventories have swelled.** If these trends are one-time adjustments (and our economists believe they are), **the 'payback' in 2H could be significant. Enjoy the 2Q GDP number, which may be the last best print for a while."***

Then we have the "skunk in the woodpile" called the real earnings of average workers which continues to sink. The chart below shows how wage growth after inflation fell dramatically from early 2016 through 2017. With consumers with more credit card, auto, and student loan debt than they have ever had, I cannot see how they can possibly increase their spending in this scenario. They are as close to being at "max" level for debt as they've ever been, and their paychecks each month are buying less even as the interest payments on their loans have been steadily increasing since the end of 2015. And their spending is 70% of the economy. Add all that up and see if the picture looks more like a picture of health or some very serious headwinds for the economy.



Please note you may sometimes hear wage growth is finally picking up. However, nearly all the gains go to those with the highest income. The chart below shows that wages for the workers in the middle in terms of income have seen their paychecks fall, after inflation, for a shocking 45 years, while the workers at the 95th percentile have seen wage growth of over 50%.



Of course, in point of fact the initial calculation of GDP is the least accurate. Before the end of the year we will have two more revisions of second quarter economic growth. As more data becomes available, we are likely to see it wasn't as good as stated last week. Either way, growth of 4.1% for a quarter is hardly noteworthy, at least when the economy isn't shackled by overwhelming debt.

At the same time, there are a whole host of growing concerns about the viability of the economy going forward. First, the rest of the world is not participating. Japan has gone down the furthest thus far, having seen its economy contract .6% in the first quarter.

Then we have Europe. The next chart shows the quarterly growth rate of the Eurozone since the third quarter of 2015.

Growth in the Eurzone has slowed to 1.4% annualized over the last six months. In reality, the Eurozone never recovered from their (sovereign) debt crisis of a few years ago. They just put a huge, multi-trillion Euro bandage on it. In the process, they have created a gigantic monster of bad debt, much of which the Central Bank then proceeded to buy at insanely high prices. When their Central Bank finally begins to stop buying every bond not nailed down throughout the Eurozone, all things being equal their bond markets will collapse. They will have major bond markets – some of the largest in the world – in which nobody will buy a bond within 20% of its current price. Italian government bonds come to mind. And in a few trillion Euro more examples, bonds issued by many European financial institutions, Deutche Bank comes to mind, will become basically worthless. The losses for many of their largest banks will most likely be complete, i.e. they will be discovered to be insolvent during the next recession.

Of course, I'm sure Draghi will jump back into gear to guarantee everything. But as the recession becomes real, his words will no longer carry any weight. He cannot guarantee all the losses which occurred the day the money was mal-invested. They are way too large to be fixable through simply printing more money.

It would be quite valuable if central bankers would learn it is impossible to reduce the negative impact on an economy due to bad debt by printing money, or by lowering interest rates below what the market would determine on its own. Both of these actions do exactly one thing – they make it so debt blows up even larger, and larger, and larger. China (in their unique way), Japan, the Eurozone and the U.S. have all done it to a staggering amount. I guess they were following the "go big or go home" philosophy of monetary experiments, because they did, by far, the biggest experiments in history. And the one certain end result of their interventions was to blow the biggest debt bubble in history. It has been the financial equivalent of giving children dynamite to play with.

If anything, the news is even more troubling for the smaller emerging market economies. Their companies have borrowed many trillions in U.S. dollars, and the dollar has been rising relative to many of their currencies. This increases the size of their loans, meaning they have to pay more of their currency every day to repay their loans.

In addition, much of their growth has come from selling to China, so a faltering Chinese economy drags their sales down making it even harder to repay their debts which increase every day their currency falls relative to the U.S. dollar.

I've written extensively about China's economy since 2008, and they have done what everyone has done. You could almost say they have done it in style. While the largest monetary experiments ever seen in the U.S., Europe and Japan were focused primarily on preserving banks and investors, in China they created even more debt, easily the most dramatic increase in debt in the history of the world – at least for a major world economy. And the way they've done it is completely different, as instead of being thrown out into the financial system for "financialization," their money went straight into building real stuff. An amazingly large amount of real stuff.

Unfortunately, it appears they built a lot of real estate and infrastructure they don't need and can't afford. In fact, they have a huge number of companies who cannot pay back the interest on their loans, let alone the principal. At the end of the day, they have done what everyone else has, which is to make so much money available for companies to borrow that an unacceptably large number of losses are inevitable.

The Chinese are responding to this in ways unique to their situation. However, it is quite similar to the way Mario Draghi, as head of the Eurozone, guaranteed everyone in Europe the Central Bank would print any amount of money to guarantee debts in the Eurozone would not incur losses. China does the same thing through the President and balance sheet of their country. When you begin with several trillion U.S. dollars you've earned selling cheap stuff to United States consumers, your government can make pretty strong guarantees to its people from a financial perspective. In this case, the Chinese government has, in general, said it will bail out any financial entity in the country if they believe this is in the best interest of the overall economy. They began with nearly four trillion dollars in mid-2014, and most recently this has fallen to $3.11 trillion. That is a sharp drop, but having $3 trillion dollars still gives their government a good amount of money with which to try to bail out and restructure their financial system when their tsunami of lending losses come to shore.

I do, however, recall reading a fairly convincing report by Jeff Snider at Alhambra Investments stating China needs something like $1.5 trillion in reserve at all times in order to facilitate their global trade. But at least they would still have $1.5 trillion for bailouts. If their plan, described below, works, they will never have a panic that would consume their $1.5 trillion in extra reserves quickly.

All the charts I've seen of China's economy in the last week show it dropping noticeably. Their companies have large interest payments on their debts, so they must either have good growth, or borrow more money. China's government leaders attempting to control their economy know all this. Their idea has been to monitor the industries and companies with unsustainable debt levels and then decide if they are worth saving. If they think it's valuable to the economy, they will bail it out. If not, they won't. They have begun and hope to expand this program of weeding out the weak companies while forgiving the better ones. If the market never panicked this perhaps could work. It would be the first time in world history a credit (debt) bubble did not end up collapsing down on the economy, but it could happen. Their economy would definitely slow down substantially for some period of years, but if their plans work they might be able to avoid the massive financial suffering that has accompanied every other debt bubble in world history.

Personally, I'm betting against China's government's ability to control their debt situation. The best estimates I have found say up to 40% of their corporate debt will ultimately be lost. Their corporate debt presently equals approximately 170% of GDP. With GDP at $11.2 trillion dollars, this puts their potential losses from corporate debt at $7.6 trillion dollars. This is a jaw-dropping amount of losses. Then we have to add in the losses from their shadow banking system. This is money that has been loaned out but not accounted for in official totals, even though almost the loans have gone through their state-controlled banks. We'll estimate the plethora of shadow banking investments at 150% of GDP. This could give us another $5 trillion of losses. Combined, we get potential losses in China of $12.6 trillion or 112% of GDP. That is called a nightmare.

On top of that rather daunting picture enters a possible trade war with the United States! This could derail their fragile system, built as it is on a mountain of debt – much of which is, to put it mildly – troubled. This should scare China – a lot. It probably helps explain why China's stock market dropped over 20% recently as the trade war talk was gathering steam. I would think one of the hardest jobs in the world right now would involve serving as the top government official in charge of finances in China. It would be a miracle if they get out of this without a harrowing panic that reveals those $12.6 trillion in losses all at once instead of over the next 5-10 years as they hope to achieve. A tremendous amount depends on that, but I would only give them perhaps a three or four percent chance of succeeding.

I don't know how this will all play out in China. It is at least obvious they won't be the engine for global economic growth for the foreseeable future.

In other words, the world economy is in trouble. And in this highly interconnected world, it is impossible for the United States' economy to flourish when the rest of the world weakens. This is one reason why I can make the guarantee the economy will not be "taking off," but that the next leg for the economy will be the dreaded recession central banks have printed nearly $20 trillion to try to avoid. No, we still cannot say *when* this next recession will finally arrive. We only know each day brings it a day closer. We also know there are an unusually high number of potential problems which could trigger it.

When the talking heads in the financial media actually take a moment to consider the economy could go down again, they focus almost exclusively on a few of those problems. The largest topic they consider these days is a trade war. You may have noticed I have not spent a great deal of time explaining all the potential ramifications of a trade war. There are so many unknowns regarding world trade it is nearly impossible to even guess how this will play out. The best statement I've heard was from an analyst who said the winner of any trade war is the country that loses the least. In this particular case, that "winner" is likely to be the United States, and I would much, much rather have our hand than China's in this game. But if we should manage to bring China to their knees, the impact on the entire world – and the United States – would be truly devastating. China has been responsible for 30-50% of world growth (the total varies yearly) since 2009, so inflicting damage on their economy in a trade war is certainly not good for any country's economy, at least in the short-term.

This does not mean I am therefore against everything the Trump administration is attempting on the trade front. Many if not most of our trade agreements have done a lot of harm to U.S. workers. Keep in mind our trade agreements were nearly all written by our large multi-national corporations, and one of their objectives has been to keep wages low in the United States. They have done a great job for themselves, with negative consequences for the economy as a whole and workers in particular. Lest this sound like hyperbole, keep in mind the Trans-Pacific Partnership (TPP) trade agreement pursued by the Obama administration before being canceled by President Trump was created by our corporations with such secrecy even members of Congress were not allowed to read it until right before it was to go into effect. And even then, they were only allowed to read it in a private room and not allowed to take notes! Whether this agreement would have helped or hurt our broad economy, this certainly shows how undemocratic our trade deals have been.

In summary, I am not against attempting to address some of the many problems our trade deals have caused our citizens (who don't happen to be owners of a multi-national corporation). At the same time, I am aware of how trade wars can, and usually do, lead to large and quite negative unintended consequences. If our nation, and world, were not sitting on the "time bomb" described below, I would applaud renegotiating our trade agreements. However, given the historic risk described below, this is a particularly dangerous time to tackle a problem which is quite dangerous in the best of times.

As I'm sure all of our longer-term readers know, the "time bomb" we're talking about involves the fact we now have more debt than at any time in history. We've already discussed the debt situations in Europe, China, and emerging markets in this report. Right now you can clearly understand the broad outline of what is going to occur in the world economy and markets over the next few years by looking at the corporate debt levels around the world.

We have discussed the topic of debt many, many times in these reports, so this time I thought to give the view of an economist named Chris Martenson whose research appears at www.peakprosperity.com. Mr. Martenson recently said:

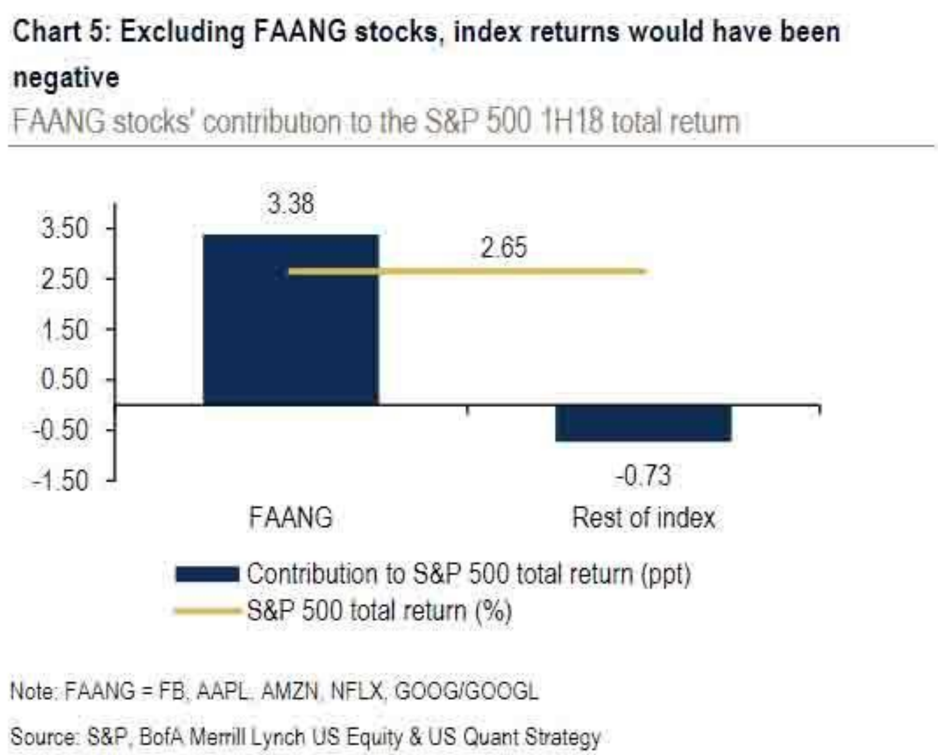
Here's why people need to be concerned (about our debt levels). Credit (i.e. debt) cycles, when they blow up, are really, really destructive… 2008 to 2009 was very destructive. Instead of realizing the error of their ways, they went for a third (debt bubble, the first of which burst in 2001-2002). *This is the most comprehensive credit cycle that we have seen. Remember, bubbles have two things that they need. Number one, a good story that people can believe in and, of course, it's a false story. Number two, ample credit. That's what the Fed and central banks of Japan and Europe have done. They just flooded the world with credit. Now, we have bubbles everywhere. When these burst, it will be the worst bursting in anybody's lifetime because we have never seen anything like this.*

These days I am actually hearing views like this expressed more and more often. For example, Nick Panigirtzoglou of JP Morgan recently expressed similar views, and I have read the same basic realization stated by a few analysts from other large institutions including Morgan Stanley, Bank of America and Goldman Sachs. Several of the major European investment banks (most notably Societe Generale, UBS, and Deutche Bank) have analysts who see the real problem we face is too much debt. And for the last five years, the Bank of International Settlements, i.e. the "central bank of the central banks," has been loudly telling anyone who will listen a debt crisis of epic proportions may be developing. (Of course, the Wall Street and European investment banks would never dream of telling this truth to the bulk of their customers, and only a tiny minority of their top economists will ever admit the truth about our debt "time bomb," at least publicly.)

Debt bubbles end in tears for the vast majority of investors, and for every economy that creates one. When the debt level becomes too large, **it becomes impossible** for that economy to ever grow at a solid level sustainably until the debt has been resolved, i.e. until the losses come due when companies and individuals cannot pay the money back. This is the main reason we can guarantee it will not be different this time. The world is now more over-indebted than at any time in world history. There is no way out other than admitting the losses, which means thousands of companies go out of business, laying off all their workers. The only remaining question is precisely when the debt bubble will burst, and where all the losses will occur.

The Stock Market

The U.S. stock market rose sharply throughout most of July. This was not overly surprising. As expected, corporate earnings reports came out strong. The most noticeable change in the stock market involved the FAANG stocks. This consists of Facebook, Apple, Amazon, Netflix, and Google. The chart below shows that the S&P 500 index rose 2.65% in the first half of the year. But without those five stocks it would have lost .73%!

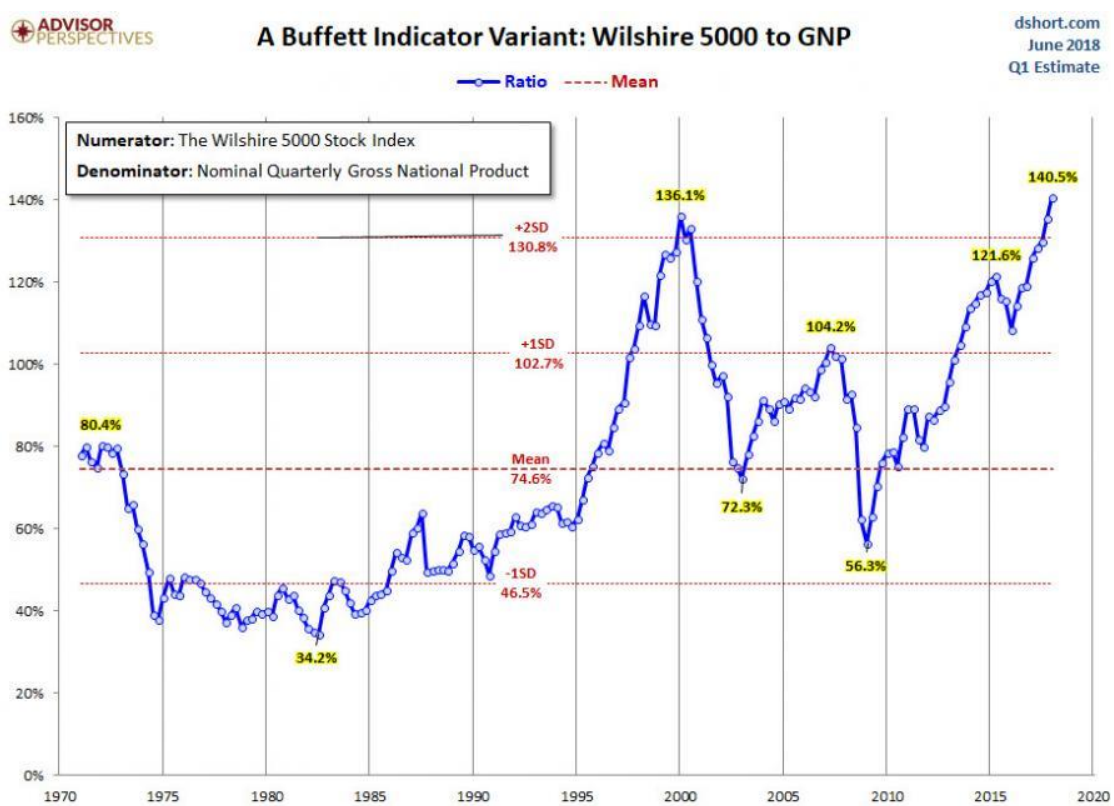


It would be an understatement to say this is not a good sign for a market. Something similar has happened several times in history, including in the 1960s when investors decided they could safely invest all their money in the "nifty fifty," which included the largest 50 companies in the country. After those stocks eventually came crashing down, the same phenomenon occurred in the late 1990s with a handful of tech stocks including Cisco, Intel, Microsoft, Hewlett-Packard, and Dell. The NASDAQ index they dominated then had the biggest crash in market history, losing 83% from 2000-2002. Now we have the FAANG stocks which, miraculously, investors have come to view as the *safest* investments to own.

The change in July involved two of those five stocks, i.e. Facebook and Netflix, both of which fell over 20% from their highs. This does not necessarily mean the end of the bull market for stocks is imminent, but when investors do lose faith in these stocks, it is highly likely they will lose faith in the entire stock market.

As discussed in the section on international economies, the news is much more negative outside the United States. Their stock markets continue to reflect this fact, as international stocks have dropped over 3% so far this year.

Finally, the chart below is an updated version of what is called "The Buffett Indicator." This is Warren Buffett's preferred way to spot when stocks are in a bubble. It simply takes the total value of all stocks divided by the size of the entire economy. As you can see, according to this indicator the stock market is now the most overpriced ever. The previous high was reached in January of 2000, right before the tech market crashed 83%, accompanied by a 55% decline for the entire stock market.



The Bond Market

U.S. bonds dropped modestly in July. For the year, the entire bond market has gone down 1.8%. Bonds lost 2.25% in January and February and have bounced around monthly since that time. It's safe to say the bond market is looking for direction. Bonds drop when it looks like the economy is strengthening, then shortly thereafter signs of underlying weakness appear again and bond prices rise. The same thing happens regarding trade issues. In a trade war, increasing tariffs lead to higher import prices and therefore inflation. This drives down bond prices. But trade wars also lead to recession, which drives bond prices up.

We expect bonds to continue to bounce around with little direction until the recent, short-term bump in U.S. economic expectations passes. But as we approach the next recession, which will be the largest and most dangerous since the 1930s, the highest quality bonds, i.e. Treasuries, are nearly certain to roar in price.

I can assure you there will be very few investments that will not plummet in value – or at least fall down hard – during the next recession. U.S. Treasuries will most likely rise in tandem with the fall in the economy, with the largest gains occurring around the time the economy hits bottom. Typically, Treasuries rise in price to the extent the economy falls. As a result, we would expect 30-Year Treasuries to gain 40%, and likely more, during the next recession.

Yes, we do know of several sophisticated investment strategies that should make as much as 50% or more during the next recession. But in terms of pure safety, Treasuries will not be at risk unless our nation is in a depression I would not like to consider, and right now I am not concerned along these lines. Other that this type of scenario, i.e. a severe depression, at this time I would continue to trust the safety of Treasuries over any other asset in the world.

All that being said, we are always preparing for different potential scenarios which could unfold, and we are vividly aware of the fact the coming havoc in the world economy is likely to lead to many very surprising outcomes in the markets. Personally, I could foresee a situation in which a person should have nearly all their money in gold or other precious metals, real estate, and any other valuable tangible items. Part of my job is to attempt to envision any and every seriously risky outcome for investors, then make a plan to, first and foremost, protect our clients' money should that outcome unexpectedly come to pass, and, secondly, to profit as much as possible whenever this can be safely achieved.

At this point we're not much concerned about the surprising things which will occur but about making sure we are prepared for the initial storm waves of the coming debt crisis. I'm afraid this next one will make us look back fondly on the mortgage crisis, and we first and foremost want to have every safety measure in place when it reaches shore.

The opportunity for, we hope and expect, much more substantial profits from selecting the right combination of safe investments, will come once we are clearly in recession. Actually, it should build throughout the next recession, peaking right near or shortly after the bottom.