Economic Update, April 2018

The 2nd Longest, and Weakest, Recovery in History Approaches the End

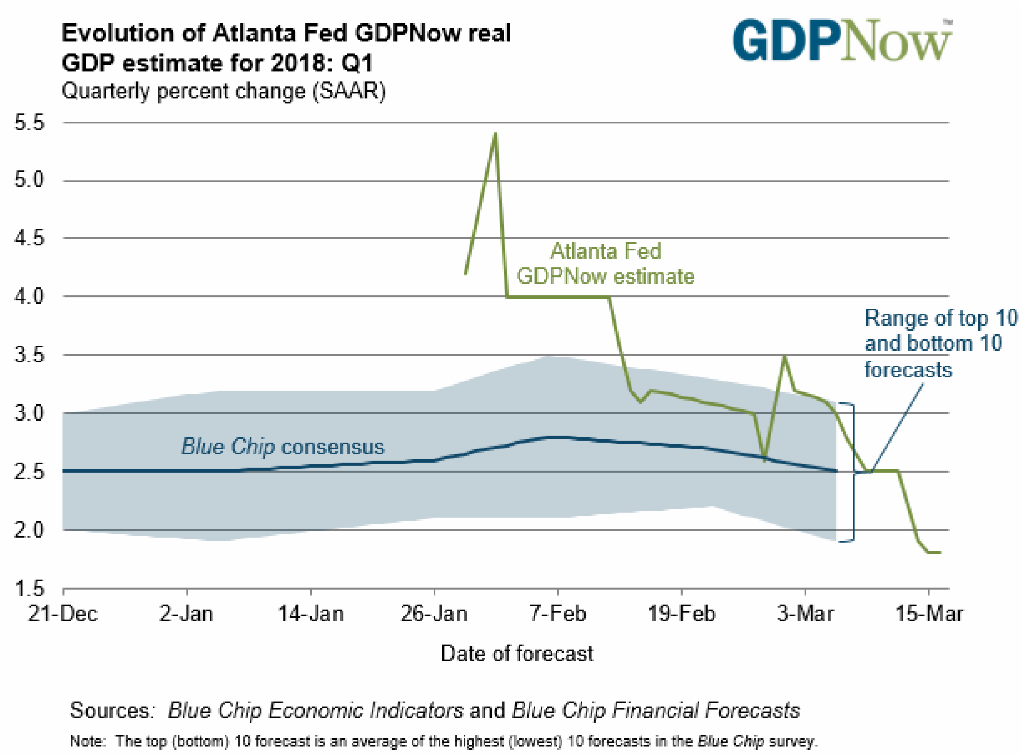
By Richard Morey

This will go down in history as the most unlikely economic "recovery" ever seen. This has been the weakest recovery since ***1790***, and simultaneously the second longest time since a recession in U.S. history. These two things do *not* go together. Previously, a weak economy has always led to more frequent recessions. We "should" have had a recession in 2011, 2013, or at least by 2015. And we have flirted with recession numerous times, but each time the economy came back to just above the water line.

While unprecedented, we do now know why one of the weakest economies in history has not landed us in recession. Since 2010 the world's central banks have printed over $15 trillion. This led to the largest increase in corporate debt in world history, with consumers not far behind.

Whenever you have an explosion of debt, an increasingly large amount of the money turns out to be "mal-invested." This means the debt should not have been created because the recipient will end up not repaying the principal. The larger the debt bubble, the larger the ensuing losses and accompanying economic downturn. Since this is the largest debt bubble in history, this should tell us what to expect during the next period of economic contraction.

Now that the stimulative effects of the (largest ever) disaster-related spending from the hurricanes and fires late last year are over, and China is no longer expanding debt at a jaw-dropping rate, the economy predictably began to come to a screeching halt in the first quarter. By the end of January, the Atlanta Federal Reserve Board's "GDP Now" showed the economy growing at nearly 5.5%. By mid-March, this had plummeted all the way down to 1.8%.



Once everyone in the Houston area had replaced their cars from hurricane damage, and the other excess money from the disasters and China's recent debt binge had been spent, the economy went straight back down to where it has essentially hovered for years.

In addition to the disaster money from late last year, it does appear consumers decided to have a great holiday season last year, as consumer spending was unusually strong last November and December. But looking beneath the numbers you could see pretty much all the additional spending was paid for with credit cards. As soon as this occurred, consumers found themselves "tapped out," and they stopped their debt-fueled spending in the first quarter. Since getting out of debt takes a lot longer than creating it, the 70% of the U.S. economy dependent on consumer spending is unlikely to return to strength anytime soon.

With the excited belief the economy is now preparing to roar in our rearview mirror, we are now back to attempting to determine when we're likely to go into recession. Since this could easily end up being the worst recession we've ever seen, from an investment position this is a very important question. It is, however, quite difficult to predict, as so many factors enter into this equation. That being said, several very strong signs have been coming into view since January.

The Federal Reserve Board

The largest "sign" has actually been in evidence for well over a year. At the end of the next recession, the Fed will be seen as the cause. Actually, Donald Trump will probably reap the blame in the media initially, but history will show the Fed to be the primary culprit.

The length of the "recovery" is undoubtedly due to the Fed (and other central banks) printing trillions of dollars (and yen, euros, and yuan). However, the scary severity of the next recession will also be due to this massive, unheard-of monetary experiment.

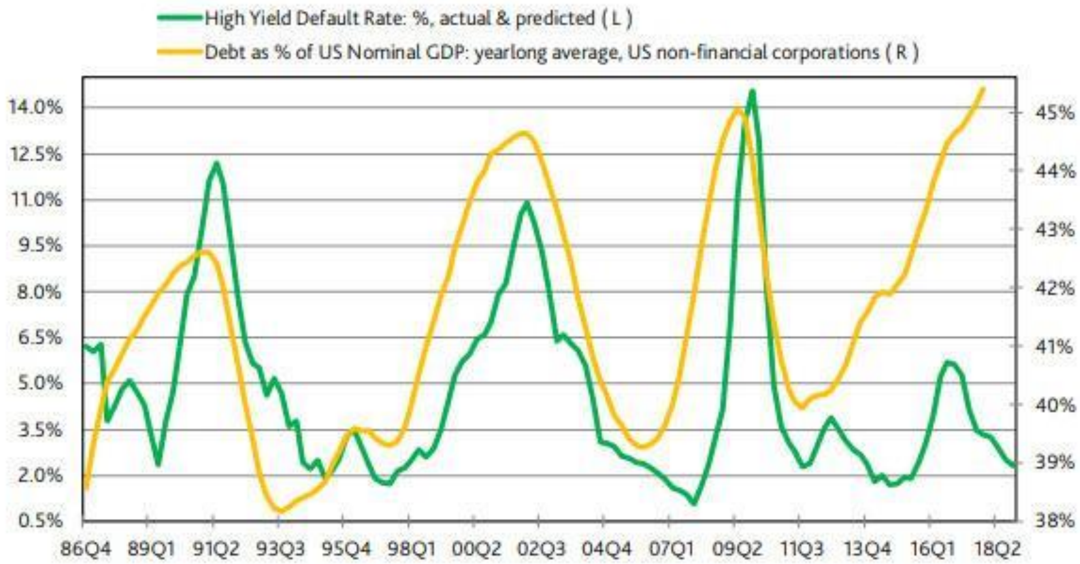
But now the Fed continues to raise short-term interest rates while simultaneously throwing away (literally) some of the money they previously printed each and every month. So the Fed is now doing the exact opposite of what kept the economy, barely, afloat.

Keep in mind the Fed is proceeding very, very slowly. They are raising interest rates only ¼ of 1% every three months, and they are only removing $30 billion (increasing $10 billion a month every few months) a month of the money they printed. While they are moving slowly, the economist David Rosenberg recently pointed out that since 1950 the Fed has raised short-term interest rates 13 times. In ten of those episodes we went into recession, while the others led to crises in emerging market economies.

Another warning was recently issued by William White, former chief economist of the Bank of International Settlements, who warned that the current situation is as dangerous as 2008:

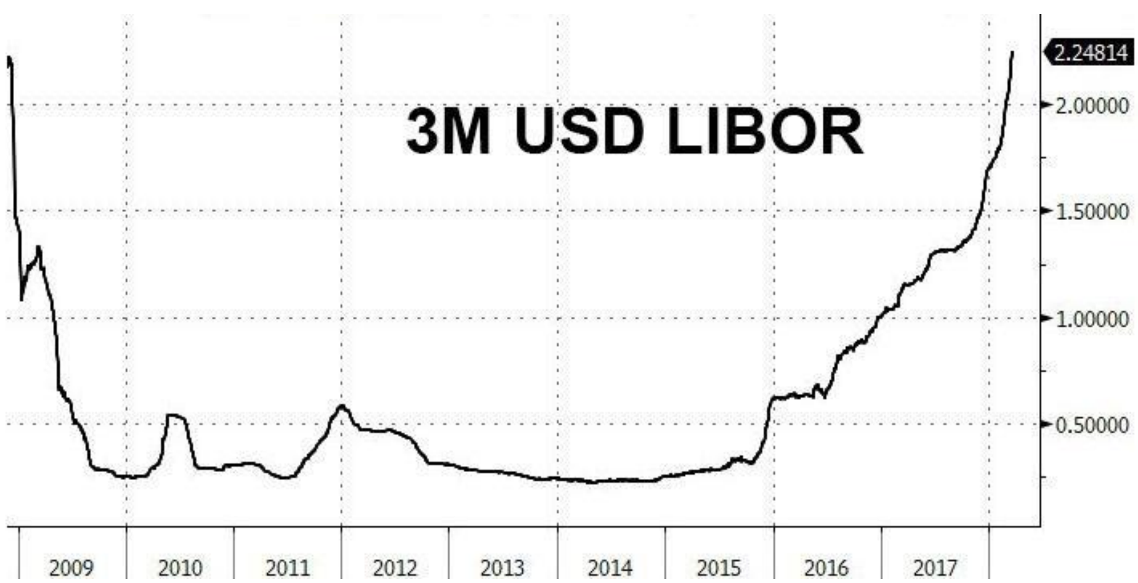
> "White, now at the Organization for Economic Co-operation and Development **(**OECD**),** believes successive economic recoveries have been so reliant on debt that interest rates cannot rise to prior cycle levels, and hence there is a downside bias in each successive cycle. In particular, the extreme monetary policy measures taken since 2008 have inflated yet another credit bubble. As the Fed now tries to normalize rates with an eye on the real economy, unemployment and inflation, it will find that the newly inflated credit system is unable to tolerate even moderate rises in rates.
>
> A familiar concern here is that rising rates would destroy the countless number of "zombie companies" which only exist thanks to low interest rates. This was highlighted in a recent report by Moody's, which "certainly seem concerned that although credit markets have shrugged off sky-high corporate debt levels, the Q1 slowdown in GDP and business sales may begin to re-engage the disturbing relationship below." (This comes from www.zerohedge.com. Zero Hedge has become the "go-to" place for economic data and insightful market information. While I often vehemently disagree with much of their social and political commentary, they present an encyclopedia of valuable economic data and analysis.)

Figure 2: Recent Default Rate and Its Projected Trend Defy Record Ratio of Corporate Debt to US GDP
sources: Moody's Analytics, Federal Reserve



The chart above should scare policymakers, and investors, like no other. The yellow line is total non-financial corporate debt, and the green line shows the percentage of companies not paying back their debt, i.e. basically going bankrupt. As you can see, those two lines track each other fairly closely, yet today they are at their largest divergence ever. We can all be nearly certain the yellow line, i.e. debt levels, will not be going down on their own. Corporate debt levels go down when companies default on their debt. With companies more over-indebted than ever before, this means the coming wave of bankruptcies will lead to a massive economic, and market, crash once again.

This wave of corporate bankruptcies may soon begin in earnest. This is due to the fact that interest rates for corporate loans are primarily determined by Libor rates (the Intercontinental Exchange London Interbank Offered Rate which serves as the first step to calculating interest rates on various loans throughout the world). Below is a chart showing what has recently occurred in Libor rates. Notice they have now spiked to where they were at the end of… 2008:

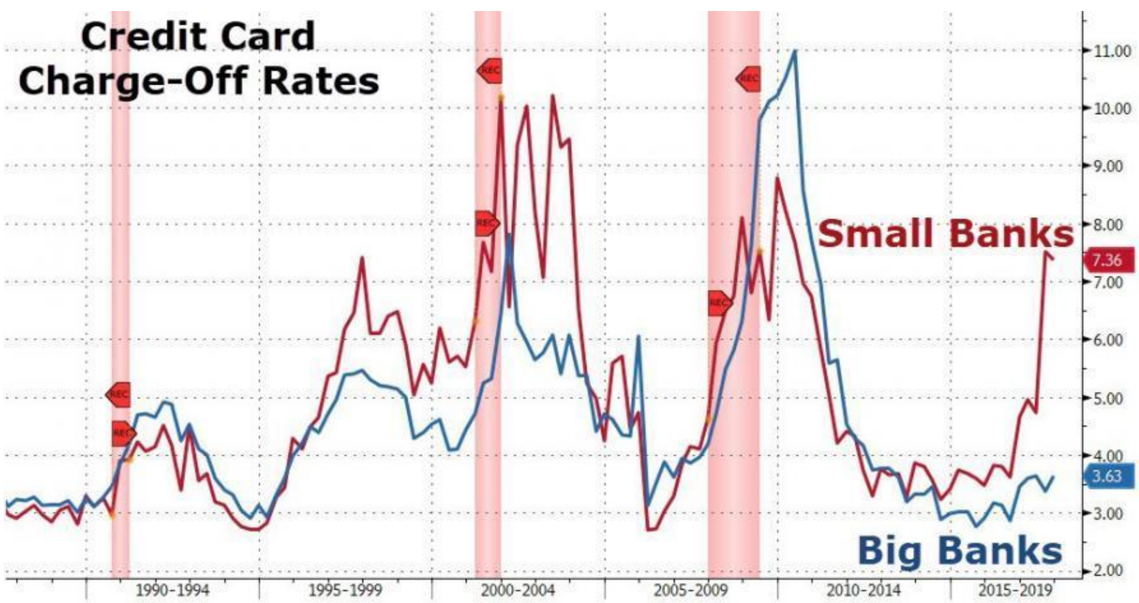


Jonathan Garner, Morgan Stanley's Chief Strategist for Asia and Emerging Markets, told Bloomberg that the **rising Libor rates is a bigger concern right now than a more hawkish Federal Reserve, and in fact, is "the story of the year."**

Garner told BloombergQuint in an interview.

> "What I think is really interesting is that in the private LIBOR markets, the USD Libor has already moved far more aggressively than Fed Funds. If you look at 6M USD Libor, it's actually reached 2.375%, whereas the Fed is likely to raise Fed Funds by a quarter of a point to 1.75%. So the interest rate that really determines corporate costs has already experienced a very significant increase. Unless the Fed is in some ways super dovish, I think we're already looking at a significant tightening of monetary policy in the US and, in addition, China is tightening monetary policy at the same time. This joint tightening is a key reason why we are so cautious on markets."

On the consumer spending side of the economic equation, the picture is deteriorating right before our eyes. The next chart shows the rate of consumers defaulting on their credit card debt:



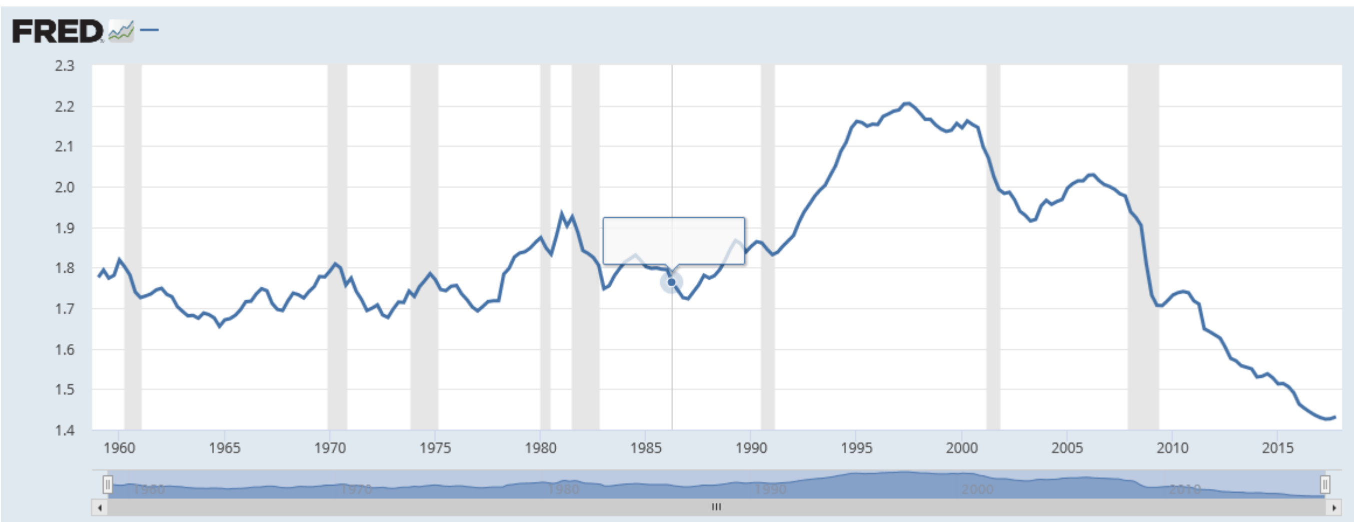
As you can see in that chart, small banks are now experiencing losses on their credit card business last seen in ***early 2009.*** In a recent article in the Wall Street Journal, Robert Hammer, chief executive of credit card industry consultant R.K. Hammer, says, "The small banks' experience is simply a leading indicator of a downturn to come. In the run-up to the last recession losses accelerated for small banks before they did for big ones."

Looking at that chart, economist Albert Edwards of investment bank Société Générale stated, "Not much surprises me or shocks me nowadays, but I was truly gobsmacked by the surge in charge-offs and delinquency rates on credit card loans made by smaller US banks."

Edwards further noted that "clients always want to know if they should worry NOW?" His answer to that is "yes they should" as there are "very worrying signs that yet another Fed-inspired credit bubble is beginning to burst", and not just in the surge in small bank delinquencies. (Also from Zero Hedge, 3/20/18, "Why Albert Edwards Thinks "NOW Is The Time To Worry.")

In mid-February I had a conversation with Dr. Lacy Hunt, the Chief Investment Officer of Hoisington Investment Management, previously Chief Economist of the Dallas Federal Reserve Board. Lacy reminded me of a key economic fact (as opposed to opinion). The economy contracts when the money supply contracts. The Fed is now actively removing money from the economy. This can only be offset by an increase in lending, but now growth in corporate and consumer lending is dropping dramatically. Based on facts, it appears we are headed down.

For full disclosure, we need to add that the economy is in recession when the money supply contracts unless the reduction in the money supply is fully offset by an increase in the velocity of money, which measures how often money changes hands. However, while the money supply has continued to grow, albeit at lower and lower rates, the velocity of money has already crashed to a rate not seen since the Great Depression. Here is the chart showing the velocity of money, from the Federal Reserve Board (last updated March 28, 2018).



A Trade War?

Given the fact our economy, and the entire world economy, is more over-indebted than at any time in history, and the fact the severity of a recession is directly proportional to the level of bad debt that has accumulated beforehand, the coming recession will almost certainly be the worst since the 1930s. But it could actually be worse, in which case we could have a depression instead of "just" a severe recession. This could result from a trade war.

It would take an entire book to even begin to explain all the potential ramifications of a trade war. Personally, I doubt we will have one. Thus far the administration's statements and planned actions on this front do not appear to be irrational. The United States is being represented by Wilbur Ross, Secretary of Commerce, and Peter Navarro, the President's top trade advisor. Now if I studied the economic views of Mr. Ross and Mr. Navarro in detail, I'm sure I would disagree with many of their views. However, I do know they are quite knowledgeable regarding trade, and I definitely know I would hate to be in a position to negotiate against Wilbur Ross! Thus far, the bulk of the trade demands they are making of China sound reasonable. Regardless of one's political persuasion, numerous aspects of our trade relations with China (and Europe, Japan, etc.) appear to be grossly unfair to our nation and should be corrected.

When confronted with the potential risks if a true global trade war should erupt, Mr. Ross recently said he is certainly aware of the risks, but you cannot confront any problem without also confronting risk. On our side, as long as we are attempting to correct glaring trade problems, I do believe they should be addressed.

On China's side, keep in mind they export three times as much to us as they import from us. So a trade war with us would hurt them three times as much as it would us. Plus, they typically appear to act based on their economic self-interest, so it seems unlikely they will respond in a manner which leads to an escalating trade war.

But this doesn't mean the market's recent worries over a potential trade war are unwarranted. The administration's attempts to renegotiate trade *probably* will proceed rationally and not lead to war, but if it does the results could, and most likely would, be catastrophic for the world economy. The risk is that what begins as reasonable trade requests could spiral into a trade war nobody wants.

Summary

As longer-term readers of our reports already know, we hope the U.S. economy goes into a recession as soon as possible. The longer it takes, the more economic suffering our citizens will end up having to experience. This is due to the fact that more bad debt piles up every day this alleged recovery continues. The larger the pile of bad debt, the more corporate bankruptcies we will have at the end, leading to a massive wave of job losses, personal bankruptcies, etc.

We are thereby heartened by the facts in this report indicating a recession may soon be on the horizon. Please note this is quite different from the devastating impact of a potential trade war. We do not want this, for our country or the rest of the world, as it would lead to tragic and unnecessary suffering, for literally billions of people.