Secure Retirement
Peace of Mind is Real Wealth

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Economic Update, February 2020

Will the Coronavirus Be the Pin Which Pops the World Debt Bubble?

by Richard Morey

Throughout the first three weeks of January, Jeff and I discussed the impact of the Coronavirus on the economy and markets almost daily, coming up blank each day. Viruses are so unpredictable, how can anyone know how they will affect markets?

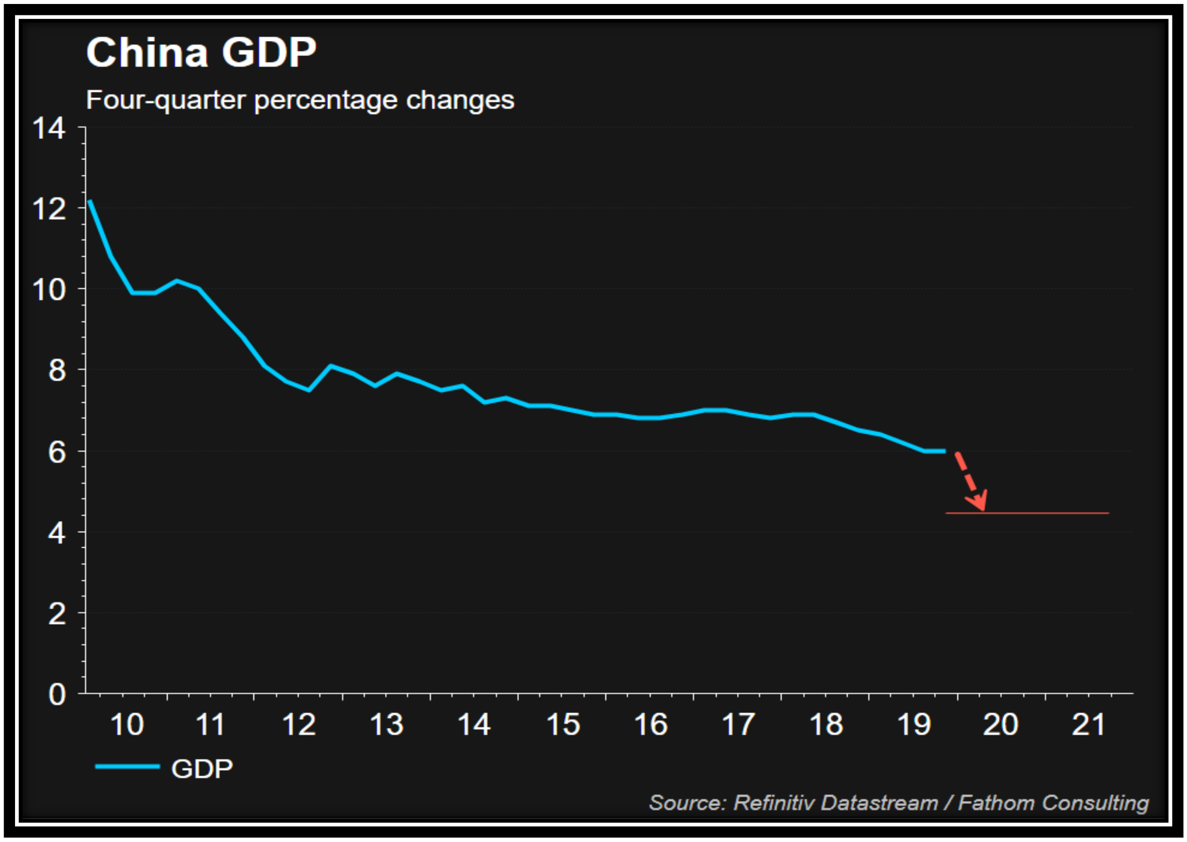
Then in late January I had a conversation with a client living in France who has an economics and finance background. She had been studying this question and found quite a few experts who had explained how this virus is already leading to a very sharp drop in Chinese economic activity. This was *after* their growth rate had fallen to its lowest rate in 30 years last year.

The backdrop for this sudden halt of Chinese economic activity is that since 2008 they have created the largest debt bubble in the history of the world, with total bank loans more than double that of the United States – whose economy is twice as large and whose debt is also an historic bubble! (This title of "largest debt bubble in world history" is shared by Japanese government debt, though this is in its own category and not an immediate concern – to me anyway – as an investor.)

In short, the answer is a very clear "yes," the Coronavirus is an existential threat to all the bubbles around the world. China has been, by far, the largest engine of economic growth in the world since 2008, during which time it created its "thousand-year" debt bubble. At the very least, this contribution to world economic growth is, for now, over.

> Here is a summary of China's economic situation from Bloomberg, who said China's economy could slow to around 4.5% annually this quarter:
>
> *That's a drop from 6% in the final period of 2019 and the lowest since quarterly data that begins in 1992. Most of China's provinces said before the virus became widespread, they're expecting slower economic growth in 2020, with at least 22 out of 31 major cities, provinces and autonomous regions cutting their targets as of January 21, according to their work reports which lay out plans for this year.*

The chart on the following page shows China's reported economic growth rate from 2008, with the red line being a reasonable, if not optimistic, next step down for the Chinese economy. With an historic debt bubble waiting to explode…



After this conversation with my client in France, the stock market fell for the next six trading days due, at least in part, to the Coronavirus concerns.

Does this doom the global economy?

I don't know. Probably. But there is a scenario in which this all blows over quickly. If they get a vaccine almost immediately, they will give it to every person in the country in about 48 hours. Then let's say the virus disappears, and the negative impact in China quickly dissipates before their corporate and/or real estate debt bubbles pop.

That could happen, although when writing that last paragraph it sounded a bit far-fetched to me. For example, the scientists who make vaccines say it's completely impossible to make a vaccine that quickly. While it remains an unpredictable virus, this may very well turn out to be the blow that fully opens the door into severe recession. This should be troubling to markets, and in the last week of January we had one day in which the Dow Jones Industrial Average dropped over 600 points. For the month, stocks continued to rise strongly during the first half of the month before losing most or all of those gains by the end.

We have to keep in mind that the world economy slowed to its lowest point since 2009 last year – *before the Coronovius*. If this virus turns out to be as serious as it may be, we go down.

Update on Our Corporate Debt Bubble

Once again, this month I say the place to spot the end of our corporate debt bubble, and to confirm we have entered recession, is by monitoring the status of the lowest grade of U.S. corporate debt (rated CCC). The other market we must monitor is that of packages of the lowest rated corporate debt, known as Collateralized Loan Obligations (CLO). At last check, these markets were falling sharply.

We are fortunate at Secure Retirement to be closely connected to PIMCO (through Jeff Warren and his PIMCO-dominated Income Portfolios). I say fortunate because that company is the largest repository of knowledge about bonds in the world. I have therefore asked PIMCO to share their most current research on the following topics:

1. Changes in the prices of both the CCC and CLO indexes
2. CLO collapses (equivalent to the mortgage-backed blow-ups when certain Collateralized Debt Obligations had 100% losses in 2008)
3. The percentage of downgrades versus upgrades in the B and below-rated categories.
4. The percentage of downgrades/upgrades in the BBB market, and any downgrades of particularly large issuers (as a few such downgrades could collapse the CCC and CLO markets).
5. Total losses in corporate bonds, broken down by rating.

Using PIMCO's data to track these five factors, we should be able to definitively state when the economy is in a position in which we are, without doubt, going down for the count. Until then, anything can still happen, short-term.

Summary

It certainly appears our thesis of recent months that we may have entered recession last September is looking more and more likely to end up being accurate. Adding the Coronavirus to a fairly quickly slowing world economy, with debt bubbles everywhere you look, is a dangerous brew.

When we can prove our corporate debt bubble is collapsing, our readers will be the first to hear. I'm still thinking July, but I may be overly optimistic, or perhaps I've gotten used to being patient!

The Stock Market

Whenever possible, I'll likely say everything I think about the stock market by quoting Dr. John Hussman. This particular economist has always had a prominent place when it comes to researching and avoiding risk.

I have often followed Dr. Hussman from an investment standpoint, though we parted ways in 2010 or 2011 when he kept to his out-of-favor approach while I searched for more attractive risk-controlled investments.

That being said, Dr. Hussman has turned out to be correct in his assessment of the future of the stock market more than anyone else alive. He doesn't just turn out to be right – he typically turns out to be precisely correct by the end of any business cycle. Since we are almost certainly right at or near the end of this one, I suggest investors follow Dr. Hussman's work carefully right about now!

Without further ado, here is Dr. Hussman's view of the future returns available to investors going forward from today (from *Whatever They're Doing, It's Not "Investment"*, February 2020; the full article can be found at https://www.hussmanfunds.com/comment/mc200130/):

> *At the market open of Friday, January 24, our estimate of likely 12-year nominal total returns for a conventional passive investment portfolio (60% S&P 500, 30% Treasury bonds, 10% Treasury bills) fell to just 0.04% annually, below even the previous record of 0.34% set in August 1929. This extreme reflects the combination of record equity market valuations and depressed interest rates. That's not an "equilibrium" situation. It's a combination that joins insult with injury, creating weak prospects for the future returns of passive, diversified buy-and-hold strategies, across the board.*
>
> *Understand this. The more glorious this bubble becomes in hindsight, the more dismal future investment returns become in foresight. The higher the price investors pay for a set of future cash flows, the lower the return they will enjoy over time. Investment is not independent of price. Whatever they're doing, it's not "investment."*

In other words, the most accurate economist in the world, whose analysis is all done using unchallenged and unparalleled probability theory, says investors today face a situation so bleak it is now worse than investors faced in August of 1929. And this guy has never been wrong. Looks like it's time to buy more long Treasuries and gold.