Economic Update, January 2017

Optimism versus Reality

By Richard Morey

The first draft of this report was focused on the United States economy and political situation. Right now it is very difficult to focus elsewhere when our nation is faced with such an unprecedented political firestorm – a storm which changes practically by the minute, has a cast of thousands, and an ending that no one could possibly guess at this point in the program. Given the size of our nation, events in our country always have profound ramifications for the world economy, so focusing on the U.S. is certainly warranted. That being said, we're going to begin with China and Europe, as these two areas of the world economy are facing crises our great grandchildren will probably read about in their history books in the future.

China's Hard Landing

As we have shared with our readers many times over the years, nearly every serious financial problem in world history has been caused by exactly the same phenomenon, which is when nations have an explosion of debt. The new debt initially leads to rapid growth, which ends with asset prices going through the roof in bubbles. This has ***always*** then ended with a crash, as a sizeable portion of the debt which was created turns out to be have been made imprudently. As the tide turns, the size of the losses turns out to be commensurate with the size of the original bubble. This leads us to China, the nation which has now experienced the creation of the greatest debt bubble in history.

Here are some excerpts from a paper on China which was written last year by Kyle Bass of Hayman Capital and reprinted at www.valuewalk.com. I became familiar with Mr. Bass in 2007-2008 when he was in the process of proving our housing and mortgage markets were bubbles preparing to burst. As you can see below, last year Mr. Bass said Chinese real estate prices were a full 60% above the highest bubble point our housing market reached before our financial crisis in 2008. (Since he wrote this Chinese housing prices exploded another 20-30% higher in the remainder of 2016!):

> "No matter how one analyzes the available data, China's economy has already started to experience a hard landing. Consider that China's National Bureau of Statistics reported that China's migrant population (defined as Chinese people who have left their hometown to seek employment or education elsewhere in the country) decreased by 5.7 million people in 2015. This was the first reported decrease in 30 years. This abrupt reverse migration is noteworthy because it signals a slowdown in urban labor opportunities for Chinese workers and could undermine the Chinese urbanization process that has been one of the key pillars of China's economic growth over the past few decades. The following charts illustrate additional evidence of China's hard landing.
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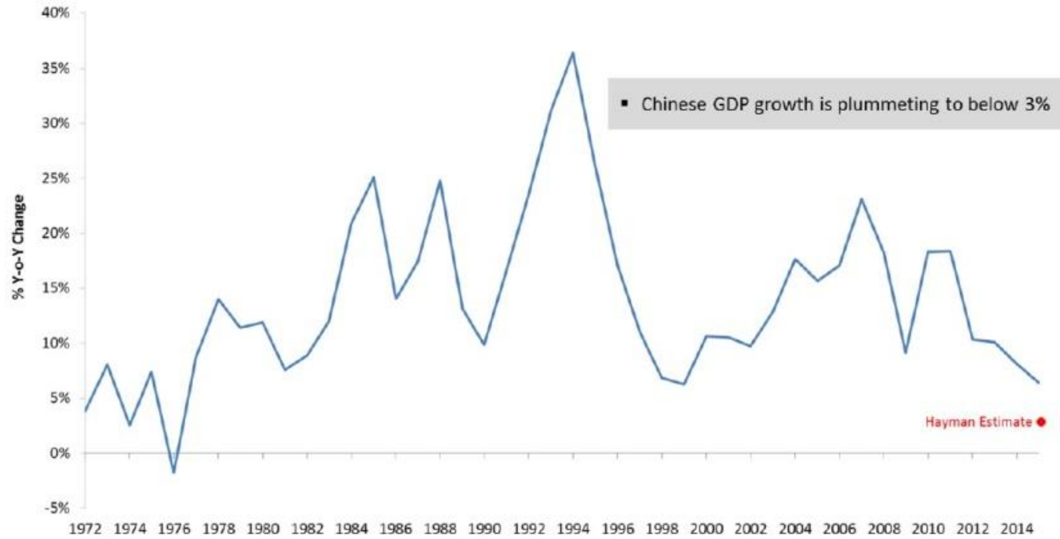
> **China hasn't seen it this bad in the last 40 years… Yet Yellen doesn't see a "significant downturn" in China…** (The chart on the next page shows China's economic growth since 1972. Please note the figures are not those issued by the Chinese government, as the official numbers are entirely fictitious. In fact, the leader of China's government basically admitted they make up their GDP numbers when he stated he never even looks at his government's GDP reports when considering how the economy is performing.)



Source: CEIC and National Bureau of Statistics of China.

The Largest Banking System Experiment in World History

China has allowed (and encouraged) its banking system to grow into a gargantuan $34 trillion behemoth (a whopping 340% of Chinese GDP), from $3 trillion in 2006. For context, consider what the United States banking system looked like going into the Great Financial Crisis of 2007-2009. On-balance sheet, the US banking system had about $1 trillion of equity and $16.5 trillion of banking system assets (100% of US GDP). If non-banks and off-balance sheet assets are included, it would add another $12.5 trillion to get to about 175% of GDP. US banks lost approximately $650 billion of their equity throughout the GFC. We believe that Chinese banks will lose approximately $3.5 trillion of equity if China's banking system loses 10% of assets. Historically, China has lost far in excess of 10% of assets during a non-performing loan cycle (The Bank for International Settlements estimated that Chinese banking system losses throughout the 1998-2001 cycle exceeded 30% of GDP). We expect losses in this cycle to exceed prior cycles. Remember, 30% of Chinese GDP approaches $3.6 trillion today…

In fact, Chinese residential real estate investment as a percentage of GDP, which peaked in 2013, was **the second highest in global history**, only after Spain in 2006, and 60% higher than the US peak in 2005.

"Consider the past quarter century: a credit boom in Japan that collapsed after 1990; a credit boom in Asian emerging economies that collapsed in 1997; a credit boom in the north Atlantic economies that collapsed after 2007; and finally in China. Each is greeted as a new era of prosperity, to collapse into crisis and post-crisis malaise." – Martin Wolf, Financial Times

That was written in February of last year. Last January and February the U.S. and world stock markets went down over 10% due to fears of a slowing China. So how did China respond to this situation in 2016? They responded by ratcheting up their debt creation dramatically. In fact, total new debt in China expanded by over 13% in 2016, the most ever, eclipsing the previous record set in 2015. This newest explosion of debt "worked," as their housing bubble reignited, with residential home prices shooting up another 20-30% depending on the size and location of the city. Then in December a state-owned newspaper stated: "China's economic downturn is just now beginning, and will last a long time," and that "China has passed its economic boom period, in which many problems were hidden but now will gradually surface."

At the end of the day, China will probably end up with the largest losses relative to the size of their economy in history. This makes sense, as they have created the largest bad debt bubble in history. Their leadership knows this but is hoping and praying to keep the bad debts from tumbling until they have a foreign country or countries to blame.

From that perspective Donald Trump could be the answer to their prayers. He has basically been calling for a trade war with China, and the person he has selected to deal with China, Peter Navarro, is one of the most anti-Chinese of all our business leaders. Mr. Navarro is very intelligent and knowledgeable, and he appears to have an in-depth understanding of how our relationship with China has hurt U.S. workers and average citizens. He also has some very interesting ideas as to how to renegotiate this relationship.

I have not studied Mr. Navarro's views enough yet to state what I think about his selection to determine our trade relations with China, but I would not be surprised to discover he is an excellent choice from a longer-term perspective. However, from a short-term view this could be a nightmare. If we do end up with a trade war with China and we "win," this means China has to recognize losses totaling, most likely, approximately 30% of their GDP. **This is six times the losses we suffered in the U.S. in 2008-2009**.

Of course, at the end of the day it really will not matter whether or not the U.S. pushes China off the ledge or they fall from their own weight. Those losses are real and are not going to magically disappear. The only questions involve exactly when the bills come due and whether the bursting of China's debt bubble thrusts the world into a severe recession or something far worse.

Europe's Ongoing Crisis

Right behind China on our list of jaw-dropping economic concerns comes Europe. Last year I read reports by founders of the Eurozone itself who now say this monetary union was a mistake which is now guaranteed to dissolve. The markets can ignore "Brexit," and despite the protestations of nearly all European economists I certainly did not think Great Britain would suffer from voting to leave that sinking ship. And they can even ignore the dissolution of Italy's government and looming bankruptcy of its banking system – for a while anyway. But when the Eurozone itself breaks apart and the Euro is no more as a currency, the world economy will truly get to see what a real financial crisis looks like.

Unfortunately, 2017 may be shaping up as the year Europe's ongoing financial crisis comes to a head. The anti-Euro parties throughout Europe have been gaining ground in almost every election for the last two years. This year we will finally get to see if one or more of the parties calling for leaving the Eurozone actually takes power. If Geert Wilderns wins in Holland in March, or Marine Le Pen wins in France in May, or Beppe Grillo wins in Italy later this winter (all three are presently either competitive in polling or leading – with Geert Wilderns currently holding a double-digit lead in most polls), we could easily look back on 2017 as the year the world economy came unraveled, because it will – for a finite but excruciating time – when the Euro ceases to exist as a currency.

The United States Economy

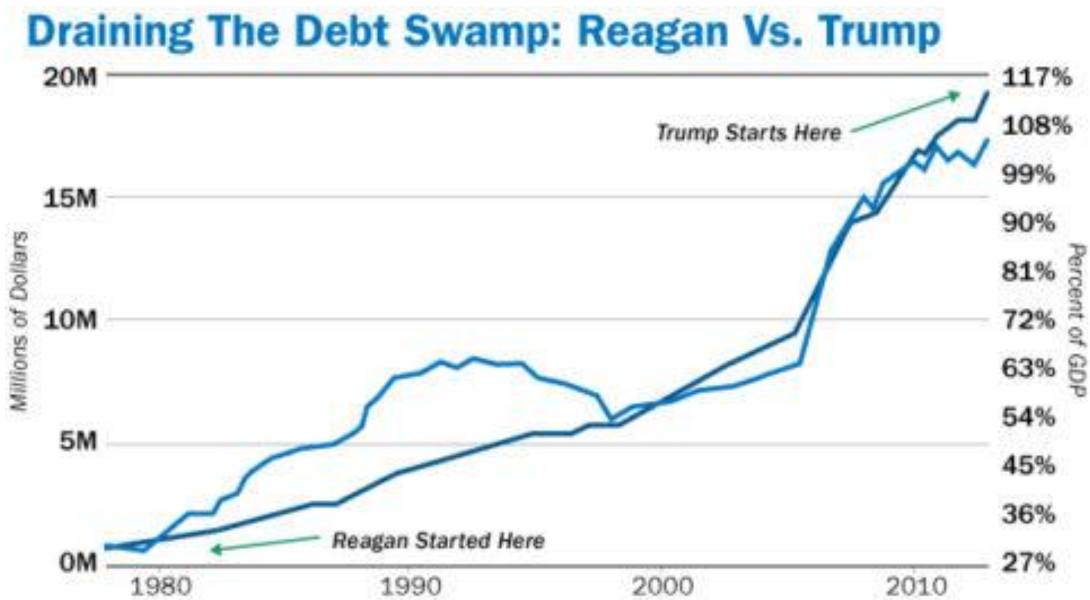
Consumer optimism hit a 15 year high in December. While optimism and hope are, I believe, essential ingredients to a happy personal life, when they fly in the face of reality the results tend to be disappointing. In this article we will look at the causes of the optimism, compare it to economic reality, and see where this "battle" will likely take our economy in 2017 and beyond.

The source of the optimism is pretty obvious, which is the hope Donald Trump will "make America great again." This slogan was borrowed from Ronald Reagan, and there is the general feeling we may see a dramatic rebound in our economic prospects now like we did beginning in 1982. Unfortunately, our economic picture today could hardly be more different than what we faced in President Reagan's first term.

Debt

When Reagan entered the White House in 1981 our government had 30% debt-to-GDP. This is quite low, with 60-70% considered a reasonable level. Today our government debt totals approximately 110% debt-to-GDP and will exceed $20 trillion by March 15. Even worse, it is presently scheduled to increase by another **$10 - $15 trillion** over the next 10 years **even if no new spending or tax cuts are enacted.** And this does not include the roughly $100 trillion in unfunded additional debts coming from Medicare and Social Security! In other words, we are in an untenable debt situation, while in 1981 our debts began quite low.

The chart below illustrates the stark difference between where President Reagan began versus where Trump begins in terms of government debt:



But this is only half, or one-third, of the story. In addition to government debt, individual debt remains right near the all-time high set in 2007, while the debt of our most fiscally sound corporations has tripled since 2009.

There is a very good reason we begin with this topic. Every objective study has proven economies cannot grow over 1% a year on average once government debt-to-GDP reaches 100%, or over 275% total debt-to-GDP including government, personal and business debt. We're at 110% and 360% respectively. In addition, these studies have shown that adding more debt once a nation is over-indebted not only does not stimulate the economy but slows it down further. This has been true for the last 700 years, and the only exceptions have involved countries who went into debt winning a major war and then promptly began to dramatically reduce the debt.

That's the reality. But the optimism we have seen since the election is based in large measure on the idea the Trump administration is going to dramatically increase our debts, which will help stimulate our economy to grow at around 4% a year? Perhaps the last 700 years of financial experience was all a mistake and debt truly is the key to eternal growth?

If you take everything President-elect Trump has said about his spending and tax-cutting plans and do some realistic, non-partisan analysis, you find his proposals would add another $5 trillion, and perhaps more, to the deficit. Added to the new deficits already scheduled to accumulate, this would put us over 200% debt-to-GDP in a decade, which is well above the level Greece has "achieved." Combined with the avalanche of Medicare and Social Security debt coming, this would truly be the end of our nation as a financially successful endeavor.

Fortunately there is some potentially good news on the debt situation. This good news involves the people Trump has selected to deal with our budget. First we have his Vice-President Mike Pence. Until recently I thought Mr. Pence might be the most anti-debt politician I have ever seen. For example, while in the House of Representatives he co-sponsored a constitutional amendment requiring balanced federal budgets. Mike Pence has been opposed to every increase in debt he has ever seen, and at times Donald Trump has clearly said Mike Pence will be in charge of interactions with Congress.

Then it got much more interesting when President-elect Trump nominated Mick Mulvaney, a Republican Congressman from South Carolina, to be his Budget Director. Mr. Mulvaney truly is the most anti-deficit politician I can ever recall seeing, and he was one of the co-signers of Mike Pence's balanced budget amendment. He got elected with Tea Party backing support in 2010, and his main issue from day one has been trying to reduce the deficit. He is a co-founder of the hard-right House Freedom Caucus that pushed former Speaker John Boehner from power.

In 2011 the House of Representatives needed to raise the debt ceiling in order for the government to be able to continue to cover all its expenses. Under intense pressure from the Freedom Caucus, led by Mulvaney, the House initially refused to authorize more debt. This led to the beginning of a panic, with all the financial headlines blaring the United States was going to default on our debt (i.e. not repay our bonds when they come due). Stocks went down 10% and there was widespread pandemonium in the markets for a few days. During those days the Republican leadership twisted enough arms of their House members to get the debt ceiling raised, **but Mick Mulvaney never voted to raise the debt ceiling. And on March 15 Mick Mulvaney is supposed to go to the House to try to talk them into raising the debt ceiling above $20 trillion. That should be "must-watch" tv!**

As director of the White House Office of Management and Budget, Mulvaney will be responsible for Trump's budget submissions to Congress. Those budgets will presumably address Trump's campaign promises to enact a major increase in military spending, a huge infrastructure program, more money for veterans, border control, a Mexican Wall, and homeland security while cutting taxes broadly.

So Donald Trump has picked someone whose primary responsibility is to prepare and submit the budget to Congress who is absolutely opposed to any new spending. Not only does he want to stop one more penny of deficit spending, he wants to pay back the $20 trillion we already owe asap. Yet the stock market has been euphoric in large part because Donald Trump is going to spend another $5 trillion in deficit spending?? Something's gotta give!

Instead of a smooth transition to massive new debt to spend in the (mistaken) attempt to stimulate the economy, President-elect Trump has selected the one man least likely to follow this path. You may want to mark March 15, 2017 as the day the excitement over the new Trump administration going on a multi-trillion spending spree comes to an abrupt half. There is simply no way Mick Mulvaney will encourage the House to raise the debt ceiling without massive spending cuts. Of course, we should never underestimate the ability of politicians to ignore principles, particularly when it comes to creating more and more debt. Perhaps the anti-debt wing of the Republican Party will fold and sign on to endless increases in new debt like they did when George W. Bush took office. We'll certainly find out here in the next few months.

This does not mean nothing is going to happen early in the Trump presidency. On the spending and budget side they will attempt to make changes which are "revenue neutral." For example, with tax policy you cut some rates but then simultaneously eliminate certain deductions.

Personally I have long believed our tax policies were pretty much a farce, particularly corporate taxes. Creating a revenue neutral program to fix our present system could be quite valuable. It's not easy to do, as the special interests who wrote the current tax laws will work tirelessly to scuttle any positive changes which would raise their bill. If we should get a comprehensive, revenue-neutral overhaul of our tax system, this could increase our economy's growth rate by perhaps one-quarter of one percent **in a few years**. Definitely valuable, but nowhere near the 4% growth rate people have somehow decided is right around the corner.

Interest Rates

In the late 1970s inflation began to ravage the U.S. economy, and by the time Reagan entered the White House in 1981 it was spiraling out of control. Ignoring the advice of the Republicans in Congress, the Reagan economic people encouraged Fed Chairman Paul Volcker to raise rates as much as needed as quickly as possible. By mid-1982 the interest rate the Fed controls, the Fed funds rate, topped out at 18.5%. You can imagine what this did to the housing market or to any business that needed to borrow money to operate. The ensuing recession and bear market for stocks was quite difficult, but by the end of 1982 we had "taken our medicine," and inflation proceeded to go down for the next 34 years – until the present.

This also means interest rates were then falling throughout the rest of President Reagan's two terms. Large cuts in interest rates are one of the strongest and most certain ways to get an economy to grow. If you also begin with low debt levels, this means consumers, businesses and the government have a lot of financial leeway to borrow more and more to expand. And this is precisely what happened beginning in 1982.

The *exact opposite* situation exists today. According to the Federal Reserve Board, the effective Fed funds rate is now .41%. Even more troubling, the Fed raised rates another .25% in December and thinks they are going to raise them 3-4 more times in 2017. While they should have "normalized," i.e. raised rates by 3-4% beginning in 2010, should they continue to raise rates in this very fragile economy we will be in recession quite quickly. Of course, we are certain they are only raising rates now so they will be able to lower them later when they see the initial signs we're in a recession. But no matter what occurs in the near-term, beginning with rates at an all-time high of 18.5% versus near an all-time low of .41% is the difference between sailing a boat with a strong wind behind it versus sailing straight into a gale or perhaps even a hurricane.

A "Business Friendly Environment"

Along with hopes for increasing stimulus spending, i.e. more debt, and tax cuts, many have become excited about a Trump presidency because they think he will be "good for business." President-elect Trump has promised to remove government regulations in many industries, freeing up companies to invest in and grow their businesses. I am fairly certain there are thousands of government regulations that do hamper business growth and productivity, and efforts to fix this problem definitely could improve our economy. That being said, this is hardly a new idea from a Republican president. In fact, every Republican president has promised to reduce and streamline regulations, with some succeeding more than others. However, we need to put this into perspective. Just like we clearly need to lower and simplify corporate taxes, we need to streamline government regulations. But similar to corporate taxes, if done reasonably well this *might* increase economic growth by one-quarter of one percent some years from now.

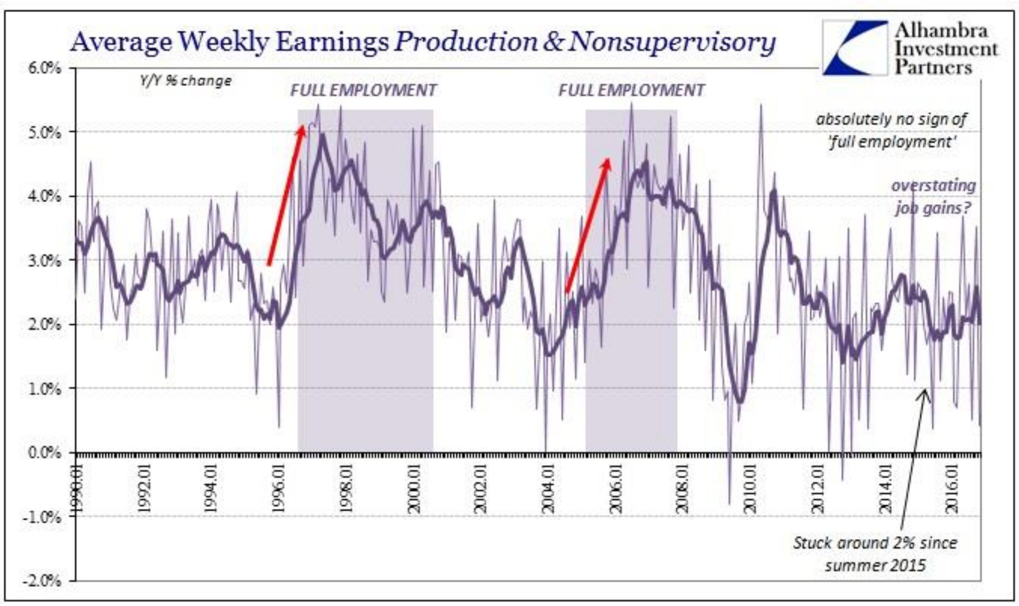
Of course, keep in mind regulations and taxes exist as they do today because large corporations benefit from the status quo. In many cases the actual reason we have so many regulations is that the most powerful corporations want them as a burden to their smaller competitors. As a result, while changing both our regulatory and tax systems is needed and would be a boost to the economy over time, it will not be easy to accomplish, and it definitely will not be the quick "jump-start" to the economy the market seems to be expecting.

Where is the Economy Today?

So the optimism we have seen in which people decided the economy was going to miraculously roar, doubling or tripling its growth right away as soon as our new president takes office, is based on ignoring essentially the entire reality we face today. Yes, it would be nice looking forward economically if it was 1982 today, but it isn't. Instead we are faced with extraordinarily difficult headwinds from every angle. We have already discussed the largest, which is our beginning level of extreme over-indebtedness. Perhaps the second largest hurdle we face involves the employment market.

I was shocked when I read a new report recently on the jobs market by Harvard and Princeton economists Lawrence Katz and Alan Krueger. The shock was due to the fact Alan Krueger was the Chairman of the Council of Economic Advisors under President Obama until 2013. Month after month I heard him talking about the wonderful new jobs people were getting. But analyzing all these new jobs objectively, the report concluded: **"We find that 94% of net job growth in the past decade was in the alternative work category."** By alternative work category they mean part-time jobs with no benefits. In other words, instead of having added nearly 15 million new jobs since the bottom in 2009, our economy actually added less than 750,000 good full-time jobs for middle-class workers. This glaring discrepancy between the government's pronouncements regarding our great labor market versus the reality workers are experiencing goes a long way towards understanding the results of the presidential election. You can tell people they are much better off all day long, but if they are working two or three part-time jobs and falling behind year after year they tend to not believe you.

The chart below highlights the problem from another perspective, as it shows weekly earnings growth since 1990. These are the earnings of only non-supervisors. If you add in the wage growth of the top 20% of earners it certainly looks much better, but when 80% of your population is seeing their income growth fall below inflation you have a very serious problem. Since 2011, 80% of our workers have been making only 2% more a year, while costs for many big expenses such as rent and health care have been rising much faster. Overall, middle class income and wealth has been dropping for over 30 years, a phenomenon which has been picking up steam since 2000.



Attempting to make up the shortfall, in the last year consumers once again began to dramatically increase their credit card debt. But even with adding on new debt, in November retail sales gained only one-tenth of one percent. Then in December retail sales did not grow at all if you subtract auto and gas sales – and yes, this includes online sales along with sales from "brick and mortar" retailers. With consumer spending being the largest contributor to economic growth, it's easy to see why the economy remains stalled.

Conclusion

The United States, and world, economy has now been deteriorating slowly but steadily for several years. At this point we are nearing the "last gasp" of struggling to maintain some growth by creating another mountain of debt. But with so many mountains of unresolved debt still littering our economies, it becomes harder and harder to eke out any real growth in the present. Ultimately the losses have to be admitted and the garbage of past bad decisions cleared away before we can move forward sustainably.

Here is one simple statement by one of the greatest investors of all time, Howard Marks, which sums up the unavoidable economic fact the world faces right now: "If a consumer buys a boat today with money made available through a low-interest loan, that's a boat he won't buy next year." The whole world has printed trillions of dollars and loaned it out at low rates so we could buy new boats, cars, houses, factories, cell phones, etc., etc., etc. The next phase of the global economy entails what happens when the money has to be repaid.

Here in the U.S., the public recognizes that things are actually not all right, and in response elected someone to tear down the status quo. While some of the business, tax and trade proposals coming from the new Trump administration would most likely be positive and are needed, in their entirety whatever new directions are taken have essentially no chance of magically transporting our economy beyond the many, many years of bad decisions based on the notion more debt solves all problems. Instead, each day it looks more and more as if the U.S. will quickly become ungovernable, a fact which may prove more than a little problematic the moment we enter the next recession.