Economic Update, October 2015

When Debt Comes Home to Roost

By Richard Morey

In this report I will first present two (and a half) competing views of the future trajectory of the economy, followed by the likely course the Federal Reserve Board will take if each scenario comes to pass.

The first view is that the economy is weakening. To make this case we'll quote from Albert Edwards, the economist from Societe Generale who has been the most accurate economic forecaster in the world every year since 2007. On August 12 he wrote a report we could title ***Recession Looming*** which was summarized by Rob Williams at Newsmax as follows:

> The danger for the U.S. is that China and other emerging-market countries will engage in a major currency war, trying to outdo each other with devaluations to make their products less expensive to U.S. customers. As the value of the U.S. dollar rises, American companies will suffer from declining overseas sales and unfavorable exchange rates.
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> "As investors realize yet another recession beckons, without any normalization of either interest rates or fiscal imbalances in this cycle, expect a financial market rout every bit as large as 2008," Edwards says.
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> "Investors should prepare for a tidal wave of deflation from Asia," Edwards said. "Prepare for sub–1 percent 10-year Treasury yields (meaning U.S. Treasury bonds will roar in price) and another financial crisis as policy impotence is soon revealed to all."

Our longer-term readers undoubtedly know we agree with this assessment. In January Mr. Edwards said we would see a "tsunami of deflation coming to us from China this year" which would push the U.S. into a severe recession. And indeed, last month import prices dropped by ***<u>over 11%</u>*** year-over-year. That is indeed looking like a tsunami of deflation. Deflation is pretty much synonymous with the worst economic outcomes – and soaring Treasury bond prices.

Support for this position comes from Daiwa Securities Group, one of Japan's largest financial institutions. Their top economist recently said they expect a China-driven global meltdown, one which **"would more than likely send the world economy into a tailspin. Its impact could be the worst the world has ever seen."** To hear a major mainstream financial institution say their baseline expectation is worse than the Great Depression was jaw-dropping.

Other than the news headlines these days discussing China's current economic problems, what evidence is there to suggest the U.S. is heading towards an imminent recession?

Last month I presented a number of charts showing all the key areas of the economy are indeed going in the wrong direction. In this report I'll just focus on the two largest issues:

1) Capital expenditures: These are large expenses used to expand a business, such as new buildings and equipment. We highlight this because some of the best economic minds say recessions are ultimately caused by a contraction in business investment. This makes perfect sense, as how can the economy grow if businesses aren't expanding?

   The most recent report (through August) on capital expenditures shows shipments down 2.5% year-over-year while orders have dropped 5.7%.

2) Retail sales: This is obviously a key area of the economy, as nearly 70% of our entire economy (as measured by Gross Domestic Product or GDP) consists of consumer spending. Given the size of this item, there are many ways to view this data, and the government (U.S. Department of Commerce data

from www.census.gov) presents 19 different variations and subsets of this data. Here are the most recent year-over-year results from the two most comprehensive tallies:

Total Retail Sales rose 1.62% over the last year.

Retail Sales minus auto sales rose .004% over the last year.

Capital expenditures and retail sales are the two largest factors one would consider when attempting to determine if our economy is heading towards recession (or is already in one). The first is clearly in the negative, but retail sales are still positive. In fact, after the most recent retail sales report came out I heard several so-called experts in the media proclaim retail sales are now "robust" and indicative of the long-awaited strong rebound in economic activity. I also heard one of the Fed governors recently describe retail sales as "strong."

We can definitively settle this debate in short order. Retail sales grow at 2% ***during typical recessions.*** In normal times they rise 4-5%, while in good times they exceed 5%. They are now growing somewhere between .004% - 1.62%. With a growing population this means the average person spent less money in August than they did in August a year ago. Other than the drop in capital expenditures, it would be hard to find a more convincing argument the U.S. economy is headed directly towards a recession or has already entered one.

Now let's look at the opposing plausible view. This would be the idea our economy will continue on the trajectory it has been on for the last several years. Over the last five years the U.S. economy has grown at an average rate of 2.2% a year (according to the U.S. Department of Commerce Bureau of Economic Analysis). And according to the Atlanta Federal Reserve Board (GDP Now), in the third quarter the economy expanded by only .9%.

Before getting too excited about a 2.2% annual growth rate one should keep in mind this has been the slowest economic recovery coming out of a recession in the last century. In almost all other cases, after a recession there is pent-up spending that comes out, driving up economic growth well above average for at least a few years. So in a normal, good economy we would have been growing at least 4% a year, and preferably 5-6%. We have therefore been growing at no more than one-half the rate we should have been experiencing. Each and every year the Fed and the financial media proclaims next year we'll finally take off, but it never comes.

Still, a 2.2% growth rate is not a recession. In fact, it truly is almost amazing we have not fallen back into recession before now. As we have explained in previous reports, nations that respond to debt crises by not restructuring their financial system but instead bailing out their banks and increasing government debt levels almost always end up growing at no more than 1% – for the next 20+ years! In addition, in our July economic update we shared the fact that economic growth can be calculated (objectively and accurately) by adding growth in the total number of hours worked in the country with the growth in productivity per worker. Both the number of hours worked and productivity have been growing at ½% per year, so our maximum economic growth potential has been and is today only 1%. And when your economy is growing at only 1%, it tends to easily fall back into recession, as even small bumps in the economic road are enough to drop you from +1% to -1%.

Yet we have been growing at 2.2%. How is this possible? I would have to respond by uttering something I have never expected to say, which is the credit for the difference probably goes to the Fed. While most of the $3+ trillion the Fed printed went into Wall Street speculation and corporate financial engineering, it appears as if just enough leaked into the real economy to inflate GDP above 1%.

So we have two possible scenarios, a return to recession or a continuation of subpar growth. Which path are we actually on? If the rest of the world did not exist one would be hard-pressed to bet against the status quo. However, even then the fact the Fed has stopped printing money would give us pause. Of course, the rest of the world does exist, and it is definitely in trouble. Several nations, including one of the largest, Japan, are already back in recession. And numerous nations are plunging headlong into what looks more like depression than just recession, such as the very large economy of Brazil.

Then we have China. Over the last year I have studied the analysis of China from the best economists in the world, and most believe they are now experiencing the dreaded "hard landing." Since until recently 60% of all world economic growth was attributed solely to China, if we remove their growth a recession in the U.S., and indeed the entire world, is flat-out inevitable. Looking at all the numbers and reports, it certainly appears as if they are indeed experiencing a hard landing.

However, last week I saw an in-depth presentation by a group of respected economists and investors contending that China is going to be not only fine but will continue to lead the world economy for many, many years. The last part of that sentence makes a lot of sense, but the idea China is doing fine today is belied by every reliable piece of economic data.

One of the Chinese economic experts we follow at Secure Retirement helped clarify the debate between those who believe China is going to have a financial crisis versus those who believe the concerns are overblown and the Chinese problems will soon blow over. Perhaps neither view is correct. The Chinese government has several trillion dollars worth of foreign reserves with which to buffer their downturn and prevent a financial crisis. Plus, financial crises are quite rare events. So instead of choosing between financial crisis and a continuation of good growth (after a relatively short pause), a more likely scenario is that they continue to struggle and slow down without having a financial crisis. This may be the most likely scenario, but it definitely should not lead to optimism, as it means China's massive contribution to global growth has ceased until further notice.

Even if China avoids a crisis, their slowdown is already triggering a crisis throughout the emerging market world. These are countries throughout Asia, Central and South America, and Africa (plus Russia and a few others in Eastern Europe) whose economies had become completely dependent on selling their natural resources and other products to an ever-expanding China. Unfortunately, the emerging market nations combined borrowed ***$9 trillion U.S. dollars*** in order to expand their capabilities to sell stuff to China. This is $9 trillion – borrowed from our financial system – that is now losing, and losing, and losing. This combination of a slowing China with massive emerging market indebtedness in money borrowed in U.S. dollars, may be the most likely trigger for the financial crisis Albert Edwards and many other excellent economists and investors are now predicting for the world and U.S. economy. But again, we do not have to see a financial crisis to have a recession.

Before concluding this section I would like to mention one other potential cause of the coming financial crisis, if indeed one is coming. This is a complicated topic, as it involves the most arcane and dangerous financial instruments ever created, which are credit default swaps. A Swiss company called Glencore is the second largest commodity trading broker in the world. If commodity prices should fall another 5% (they are already down 33% in the last year and 50% from their previous highs), this company will probably go bankrupt. Unfortunately, they have guaranteed ***trillions of dollars*** worth of credit default swaps. Now there is no way to know what this would mean, as these swaps, which basically insure financial institutions and companies against risks, are unregulated and hidden from public view. But there is a good chance one or more major banks (such as Morgan Stanley?) could lose trillions of dollars if the swaps Glencore sold them are no longer in effect. This would make our previous financial crisis seem like a lovely walk in the park.

Glencore has been in the news recently, but the third-largest commodities trader, Trafigura, may be in even more danger.

Summary

On balance, the evidence suggests we are probably either already in or nearing a recession. One of the best economists we study uses a 16 point analysis of the economy to predict recessions. This study currently says there is a 75% chance of recession. There is also a good chance this next downturn will be severe and quite possibly catastrophic.

Of course, a 75% chance means there is a 25% chance we will not have a recession in the near-term. Alternatively, it would not be completely shocking to see our economy continue to manage subpar growth. In the introduction I mentioned there are two and a half possible outcomes. The remaining one-half would be for our economy to break out of its doldrums and actually expand vigorously. This actually appears impossible in the status quo, though there is one chance it could occur, discussed below.

How Will the Fed Respond?

These are historic times in terms of Federal Reserve Board intervention, as they have been willing to employ experimental policies to massively distort the economy. There are now four possible paths the Fed may follow in response to the economic picture described above:

1) Raise interest rates. The Fed has been threatening to raise interest rates, saying the economy is on the verge of doing so well they will need to raise rates to prevent it from overheating! That is a joke, and even they cannot bring themselves to say it out loud the way I just described it. Last year former Fed Chairman Ben Bernanke said interest rates won't rise to "normal" during his lifetime. While we don't know how long he will live, I certainly do not expect the Fed to raise rates before 2020. They could raise rates once in the next few weeks or months just so they can say they tried. But if they do, they will drop them right back down to 0% shortly thereafter. The overnight bank lending rate the Fed controls, i.e. the Fed Funds Rate, has close to a 100% chance of being no higher than 0% at least through the end of next year.

2) Quantitative easing, i.e. printing more money. We are confident the Fed will be printing money again no later than the end of March of next year. However, even the Fed itself (in a paper published by the Kansas City Fed in July) knows printing money does not actually benefit the broader economy. To date it has primarily been used for Wall Street speculation, driving stock and junk bond prices higher. It has also led to massive speculation in emerging markets. Finally, corporations have borrowed massive amounts for "financial engineering," i.e. borrowing to buy back their own stocks or to purchase other companies (described as "eating your own seed corn" by one good economist). What it hasn't gone into is business creation or expansion.

   But times may have changed. Since the Fed stopped printing money, the Eurozone began and Japan escalated their printing. But European stocks have fallen – as much as 20% for some Eurozone countries – even as the European Central Bank has threatened to print more and more. And Japanese stocks have now lost their 2015 gains as they have re-entered recession. So the next time the Fed begins printing we could see stocks and other risk assets fall instead of rise. Since getting stocks to go up seems to be the Fed's primary mandate these days, clearly they will need another tool or two.

3) Negative interest rates. Not only will the Fed not be raising interest rates (or if they do only to drop them back down), we will probably end up with *negative interest rates*. Whenever the next recession

appears set to strike (at which time we will already have been in recession for many months due to the multi-quarter lag that always occurs between the actual onset of recession and the time the data begins to confirm it), with rates at 0% the Fed will be out of ammunition. Instead of letting the natural business cycle and markets clear out the dead weight consisting of companies that should have already gone bankrupt but were held up by access to borrowed money at rates manipulated far below market rates, the Fed is sure to act. That action will be to begin charging customers to keep their money at banks, i.e. negative interest rates. Lest you think this is impossible, keep in mind it is already occurring in parts of Europe. If you think this is crazy, you are 100% correct. In this report we will not detail the list of bizarre unintended consequences this has for an economy, but there are many of them. Negative interest rates are longer-term, economic suicide. But they sure would make the bond funds we own at Secure Retirement shoot through the roof!

4) Helicopter money. This will be the endgame for Fed policy. The term was coined by the economist Milton Friedman and used by then Professor Ben Bernanke to describe what a government can do to get out of a depression. The problem with money-printing or quantitative easing as the Fed has done to date is that the money tends to stay in the canyons of Wall Street. The Fed prints money to purchase bonds from the major banks. The original idea was that the banks would then have trillions of dollars worth of extra cash to lend out to spur economic growth. This did not occur, and instead the money was used for speculative purposes as described above.

   With helicopter money you bypass the banks. The purest form would be to mail every citizen a "gift card" that would have to be used in a fairly short time period such as three months. The Fed would print up several trillion dollars which would be mailed out to every citizen to spend right away. This would be nearly guaranteed to jumpstart the economy. In fact, using this method the Fed could make the economy grow by 5%, 10%, 20% - pick any number and it could be achieved in one quarter. However, unlike negative interest rates which would be economic suicide longer-term, this would be near certain economic death quite quickly. Inflation would soar, decimating stocks, bonds, retirement plans, government debt sustainability, the value of the U.S. dollar, etc.

   In practice I doubt the Fed would ever approve of this type of helicopter money – not because of the negative consequences but because Congress would have to approve any plan to print money without going through banks. Congress could indeed approve a version of helicopter money, but one based on their cherished ideals. If we had a split Congress and Administration like we do today, this could be a combination of tax cuts and infrastructure spending. But to do the job of actually stimulating the economy these would need to each be multi-trillion dollar programs. At the end of the day this approach would lead to the same outcome of rampant inflation. However, the economy and inflation would not rise as far or as fast if the money went this route versus dropping the money right into the pockets of consumers.

What *should* the Fed do? This is difficult to say, as they have made so many grievous errors since they adopted their failed policies over 15 years ago there is really no way out except a debt-clearing financial meltdown. Sooner or later (probably sooner) this will occur no matter what they do. The more they try to put it off, the larger the negative consequences will be. If I was in charge of the Fed I would resign immediately, apologizing for having followed mistaken theories and failed policies. If my resignation was not accepted, I suppose the best course of action would be to do nothing, as all the alternatives will only make the final outcome worse.

What *will* the Fed do? They will begin another round of quantitative easing, i.e. printing money to buy more bonds from the banks. They will then go to negative interest rates, as this is something they can do themselves quickly and easily. When neither of these works to keep us out of recession, they will look towards Congress to team up for some version of helicopter money. This might be one instance in which a deadlocked, ineffectual Congress/Administration will be a great boon to us all. By the time Congress could ever agree on how to proceed, hopefully there will be such a public outcry against failed Fed policies that we will never get to this final disastrous stage of monetary experimentation.

Summary

I hope this report did not gloss over the risks the world and U.S. economy face today. While that is said in jest, in reality this report barely scratches the surface of those risks. I hope we never see another time in which economic and market risk is so extensive and extreme. I just wish retired investors throughout our country could see this risk and protect themselves. Alas, that is not the way humans respond psychologically, instead preferring to always expect the status quo to continue forever.