portfolio construction forum

Turbulence in the world economy and markets

Dr Woody Brock | SED | 01 February 2016

Little of the turmoil taking place in the world economy and markets surprises us – and most is consistent with what we have warned of for a good while.

A year ago, we predicted that oil prices could easily fall to US$25 for three very different reasons: (i) the remarkable inelasticity of the supply and demand curve for oil (both are needed to explain the magnitude of price volatility we have observed in oil prices during the past 40 years); (ii) the three game theoretical reasons why OPEC would collapse – and did; and, (iii) significant excess capacity. As for the troubles in China and in many emerging markets, we have disagreed strongly for a decade about the longer-term prospects of the BRICS – a collection of nations that has morphed into a pile of Bricks – with the possible exception of India. We could, of course, (and probably should) augment the BRICS list by adding add Nigeria, Venezuela, and many other thugocracies now in a well-deserved state of distress.

James O'Neil of Goldman Sachs used braces-on-the-brain extrapolatory logic to predict that the success of China would continue unabated. The root concept of "adverse incentive structures" that would make it impossible for China to become a bottom-up, consumption–driven economy never occurred to him or his gullible followers. We stressed that rampant corruption would lead to a misallocation of capital and exploding bad debt, not only in China but in many other emerging market miracles. We predicted this would end in tears. It has, and the spectre of an emerging market debt crisis is now front-page news.

But until just now, hasn't the consensus viewed falling oil prices and the slowdown in China as the main drivers of slowing world growth?

To be sure, these developments matter, but they are only half the true story of what is happening to cause global growth to be 3% rather than the 6% it was and could and should be. Consider the sorry state of the largest economy in the world, Europe. Having suffered the slings and arrows of the Global Financial Crisis and the Chinese slowdown, what can it do? We all know the answer – still easier monetary policy, especially given the need to flight deflation. But wait... Is not "Eurosclerosis" well into its fourth decade, with the reasons for it having to do with sclerotic and inflexible labor and product markets, and having nothing to do with the 2010 crisis? But you don't hear much about this from Martin Wolf, Lawrence Summers, or others who should know better. Instead, you read over and over again about "natural" interest rates being too high, about the right policies of central banks, and about demography.

We also stressed why Main Street USA would be surprisingly resilient in the face of such problems. And, we discussed the prospect of financial market overshoot on the downside due to the impact of "endogenous risk", the correct way of analysing overshoot, in our view.

In this brief Memo, we update our views summarised above in the context of today's gloom, and attempt to put matters in better perspective.

1. PROSPECTS FOR MAIN STREET DUE TO CHINA AND COLLAPSING OIL PRICE

1.1. China's slowdown

We have long stressed the surprising independence of the US economy from that of the Chinese economy. First, recall that China accounts for only 13% of Global GDP, using the standard IMF metric. Second, US exports to China accounted for less than 1% of US GDP for the first three quarters of 2015 (the latest data available). This is very much lower than the percentage of US exports to Canada and Mexico. A sharp slowdown in China (causing reduced US exports to China) will reduce US GDP growth by slightly less than 0.1% in 2016, according to Professor Alan Blinder of Princeton. When the impact of slower Chinese growth on the GDPs of all other US trading partners is factored into the equation, this number doubles to a US GDP hit of -0.2%. All in all, a China-induced trade contraction should not be near the top of our US worry list, claims Blinder.

An overall slowdown of 2% in the rest of the non-US world economy (excluding China) would generate an additional export-based hit to the US economy of 0.75%. Thus, Main Street USA is facing an overall growth slowdown of 0.2 + 0.75 = 0.95%. This slowdown assumes that China will grow at 4.5% during 2016, 1.5% lower than the Chinese government expects. But, their forecasts have been and are transparently biased on the upside.

Will this world slowdown precipitate recession in the US? No, probably not, assuming that US growth in 2016 is 1.3% or higher before subtracting out overseas negatives. But this does not imply that other developments could not send the US into recession. Worsening consumer spirits, for whatever reasons, could further depress growth. But offsetting this risk is the positive that the notable fiscal drag of the past four years due to collapsing US fiscal deficits is now reversing. The US deficit will increase by about $45 billion this year (a boost to GDP) as opposed to its annual contractions during 2013-2015. In short, with some luck, the US could well avert a recession.

Finally, a collapse of global markets could trigger panic on Main Street USA, guaranteeing a recession. Indeed, it took asset market collapses in the US and overseas to cause four of the past six US recessions. But more on financial market risk below.

What is the underlying reason explaining the stability of the US economy?

It is the rate at which the composition of the US economy has been transformed from manufacturing and farming to services during the past three decades (and over a much longer time span, as well). What is particularly important here is that: (i) service employment and output are intrinsically more stable and more cycle-free than are the non-service sectors of GDP; (ii) some 84% of US employees now work in services, whereas manufacturing workers account for only 10% of GDP; and, (iii) the rise of the service sector has increased the share of consumption in the GDP accounts, and the consumptions sector is generally more stable than the Net Exports, Investment, and Government Spending sectors. This has been particularly true during recent years when residential and corporate investment spending have gyrated crazily, as has government spending with fiscal deficits rising from $360 billion a decade ago to $1.15 trillion during the Global Financial Crisis, and then falling back to $440 billon.

Could something happen to cause US consumption to plummet? According to a recent NBER study, a very good leading-indicator of recessions is a boom in household debt. Happily, for all our problems in the US, household debt growth is not booming. All this suggests that, while the US economy may be slowing, it's stability should continue to surprise on the upside.

1.2. Impact of collapsing oil prices

Another issue that divides observers of today's turbulence concerns the role of the oil price collapse on GDP.

The standard story has always been that paying 50% less for oil will benefit consumers, leaving them more to spend on investment and consumption. This is supposed to boost GDP, as it always has in the past. But this time around, the hoped-for boost to consumption has been less than expected. Why? A principal reason is that consumption growth has been trending downward at an accelerating rate in recent years for non-oil reasons. This probably reflects the growing conservativism of an aging population whose members failed to save enough to retire. But regardless of this observation, consumption growth will be much better than it would have been had oil prices doubled and not halved.

But prospects for consumption are only half the story of the impact of falling oil prices. The other half concerns the falling incomes of producers.

Could the GDP pain suffered by producers for the first time ever offset the GDP pains from consumer spending? What has changed in this equation is the increase in investment spending during the fracking explosion of the past seven years. It used to be that the people hurt by falling oil prices and investment primarily lived in the oil patch. But with fracking, many new small producers are in distress throughout the Dakotas, Pennsylvania, and elsewhere, as well as in the classic oil patch.

© PortfolioConstruction Forum 2016

Could the adverse impact of falling investment and employment in the energy sector fully offset any GDP boost from consumption? Perhaps, but what is not realised by pessimists is that employment in oil and gas extraction is only 0.13% of total nonfarm employment. So, the employment hit of a reduction in fracking is much less than we might imagine at first glance.

What about the impact of oil industry distress, not on employment, but on investment spending? Again, the impact is smaller than we might suppose given the fracking sector's notoriety in recent years. Capital expenditures by the energy-producing industry now account for about 5% of US total spending on equipment and structures. This is not far from its traditional average, although it is down from the peak of the fracking boom.

All in all, the benefits to consumers from falling prices should significantly outweigh the adverse impact on producers, trendy as it is to say otherwise. A greater problem could be the impact on bank balance sheets of energy industry bankruptcies.

> **Summary**
> All in all, the prospect that a US recession will result from falling oil prices and from the collapse of growth in China and elsewhere is not that large. This prospect may be magnified by other negative developments such as a collapse of financial markets (see below), but these other negatives are far more speculative than those we have discussed. First things first.

2. IMPACT ON WALL STREET

There are three important developments that will significantly affect the US and other financial markets.

2.1. Emerging market debt distress

Currently, the biggest threat to the stability of global markets is the possibility of cascading defaults on the part of emerging economies. We have warned repeatedly of the dangers posed by the reckless borrowing and the explosion of corruption in the emerging economies of recent years, developments that incidentally go hand-in-hand. Thus, a third global debt bust could indeed be in the offing. The first was the US housing bust, the second was the European banking bust, and the third may be today's nascent emerging market credit bust. Whatever the particulars, the outcome of such busts is never good, and our greatest fear for the US economy lies in this prospect.

What is particularly worrisome this time is that Western central banks are seemingly out of ammunition to deal with such a debt crisis, and central banks in the emerging economies

© PortfolioConstruction Forum 2016

range from healthy (China, to an extent) to sick. The inevitable creditor haircuts that will result can only bode ill for both the Main Streets and the Wall Streets of many economies.

2.2. Earnings growth

In two papers written in 2014 and 2015, we warned that the stunning 35 year growth rate of US wealth (National Net Worth, as computed by the Fed) will slow down over the next few decades very sharply, to one third of what it averaged during the previous regime. [Recall that during 1981-2015, national wealth exploded from $11.15 trillion to $85.18 trillion]. We detailed the major reasons why this happened and why wealth growth will mean revert downward during coming decades. [For a sobering wake-up call, recall that wealth growth was poor during 1966-1981 when the real mean return in stocks and bonds was -3% CAGR. These were the years of my father's retirement and by holding indexed stock and bond funds, his real net worth fell more than 60%.

While the largest drop in interest rates in history between 1981-2015 explains part of the stellar performances of stock and bond prices during this period, the most interesting story centered on earnings. We witnessed a never-supposed-to-have-happened rise in the share of corporate profits (after taxes) from about 6% to 10% of US GDP during the past three decades. [It was this rise in returns to capital that depressed the share of national income going to labor - the two shares must add to unity.] This rise in profitability generated years of earnings reports that surprised on the upside, thus boosting the psychology of stock markets already buoyant over an endless decline in interest rates.

> *We predicted nine months ago that this earnings story was over, and explained why this was so. Since then, S&P earnings per share (peaking in 2015 at about $110) dropped to $95 today. We are not surprised, and believe that former earnings growth rates will most likely not be seen again for a good while. Moreover, during this year of falling earnings, US growth did not decelerate so that the decline in earnings could not be blamed on a US recession. Yes, GDP growth rates bounced up and down, but they did not decline, and the Fed was confident enough in the future to finally raise the Funds rate.*
>
> *We wrote about why future developments would slowly reverse those special developments that caused earnings (and hence equity markets) to boom as they did. These included the rapid rise of China, the collapse of private sector union membership and, most importantly, the dramatic fall in the cost of capital goods as documented by Brent Neiman at the University of Chicago, whose work we wrote up in 2014.*

© PortfolioConstruction Forum 2016

We also warned that the rising popularity of indexing as the correct strategy for the future was the equivalent of fighting the last war, as indexed returns should be very lackluster going forward.

2.3. Market stability and endogenous risk

A proper analysis as to whether emerging nation credit market meltdowns and/or a recession will cause global equity markets to sink, or not, requires an analysis of the behavior of endogenous risk in the markets. We devoted 10 years of essays to this subject. In our view, the discovery of and mathematical characterisation of endogenous (as opposed to exogenous) risk represents by far the most important advance in financial theory of the past half century. This new theory from Stanford University explains when and why markets overshoot, and does so without relying upon banalities about irrationality. It is behavioral in a correct usage of that term.[1]

We are not at this stage in a position to carry out a full-scale analysis of endogenous risk today – but two observations can be made.

First, a principal reason for market overshoot (on the upside or downside) is due to the degree of correlation of market beliefs about the future. It is when most everyone agrees (high belief correlation) that "housing prices never go down" and then they do, that chaos results and markets overshoot downwards. Such overshoot is exponentially amplified by the degree of leverage (huge in the US subprime housing market). We do not see any such correlation of beliefs today.

Second, "concern" about a world where governments and central banks are increasingly seen as incompetent has led investors worldwide to accumulate a hoard of cash and liquid assets that should mitigate future downside overshoot. We thus confront an irony – market pessimism to date is creating a defensive moat around markets such that future volatility will be less than it otherwise would be.

To restate this – be grateful for the lousy performance of markets to date in 2016, for the reactions of investors to bad news may help prevent future downward movements from being as large as they otherwise might have been.

ENDNOTES

1. We cannot help but point out that classical pre-behavioral economics was itself behavioral. The law of supply and demand in microeconomics and the role of fiscal and monetary policy in macroeconomics are all about how consumers and investors behave in different circumstances, given their values and beliefs.

© PortfolioConstruction Forum 2016

Dr Horace "Woody" Brock is President of Strategic Economic Decisions, Inc., a renowned economic think tank. Dr Brock has spent more than 25 years counseling global corporations, governments and institutions who benefit from his in-depth analysis of ongoing structural changes in the global economy. He is author of American Gridlock - Why the Right and Left Are Both Wrong, Commonsense 101 Solutions to the Economic Crises. More than 50 leading chief executives, academics, journalists and investors endorsed the book, published in January 2012 by John Wiley & Sons, Inc.

Woody is a regular Faculty member at PortfolioConstruction Forum programs. This paper is abridged and reproduced with permission.

© PortfolioConstruction Forum 2016