Commentary
by Steve Henningsen
July 2015

How Much Further?

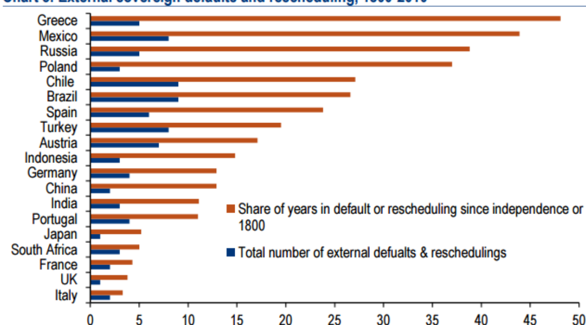
"If you shut up truth and bury it under the ground, it will but grow, and gather to itself such explosive power that the day it bursts through it will blow up everything in its way."
–Emile Zola, 19th - century French writer

"Globally, interest rates have been extraordinarily low for an exceptionally long time, in nominal and inflation-adjusted terms, against any benchmark. Such low rates are the remarkable symptom of a broader malaise in the global economy."
–Bank of International Settlements, 85th Annual Report, 6-28-15

"We are living through one of the most unusual economic and financial periods ever...The scary thing to me is how rarely anyone seems to acknowledge this fact."
David Folkerts-Landau, Deutsche Bank AG chief economist, 6-24-15

"Much of the Western world will require defaults, a savings tax and higher inflation to clear the way for recovery as debt levels reach a 200 year high."
Ambrose Evans-Pritchard, *The Telegraph,* 1-2-15

With Greece taking up so much of the world's attention these days, it seemed appropriate to use King Sisyphus' situation in this quarter's commentary. However, unlike King Sisyphus, who had to endlessly roll a huge boulder up a steep hill, it is countries like Greece that are being forced to pay for ever-increasing debt burdens, even though no one believes they can actually pay it back. The debt is just "rolled" forward in a different arrangement.



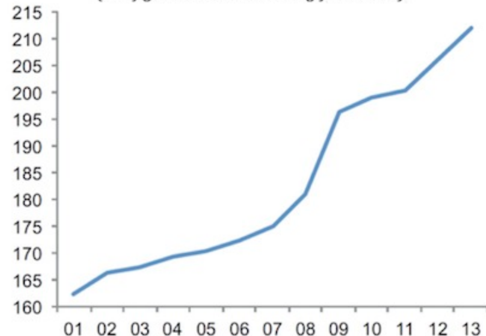
This chart shows Greece isn't the only stranger to debt problems. Since Greece's debts are relatively small, why not just let them off the hook and reduce their debts or allow them to leave the Euro and default. My guess is that Germany and France are afraid that a few of the other counties on this list (Portugal, Spain, and Italy) would have their hands out for debt relief in a nanosecond.

Although I believe in the long run it would be best for Greece to leave the Euro, my guess is that they won't be allowed because of the this neighbor-contagion risk and that a deal will be cut to postpone the inevitable default further into the future. Politicians aren't going to fall on any swords when the blades can be passed to the next guy.

"One day the day will come when every citizen must learn that he has to pay for the debt which the government is taking on and declares as being for the "welfare of the people."
–Ludwig Erhart, German politician

Greece is just a symptom of the overriding debt problem that I've written about for years. As you can see by this chart, global debt has been rising for over a decade with no slowdown in sight. And it's not just countries, but state and local governments as well, with Puerto Rico the latest to grab headlines away from others like Detroit and Chicago.

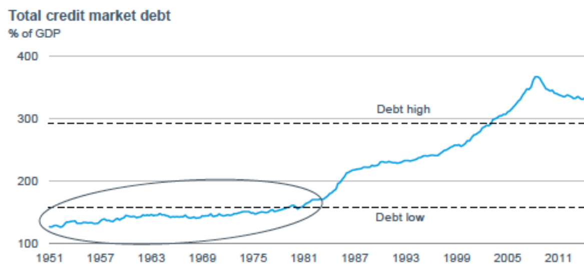
Global Debt-to-GDP is Exploding Once Again
(% of global GDP, excluding financials)



*Data based on OECD, IMF and national accounts data.
Source: Buttiglione, Lane, Reichlin, & Reinhart. *Deleveraging, What Deleveraging?* The 16th Geneva Report on the Global Economy. September 29, 2014.

In defense, many may proclaim our ability to grow our way out of these debts, as we have done in the past. However, we are at a point in history that will make this difficult because most of the developed world is approaching their demographically challenging years. In other words, old people tend to spend less. In addition, disintermediation in the services sector (think Uber and robotics) has been deflationary and will lead to further slowing of the jobs markets unless new industries emerge.

High debt = low US growth



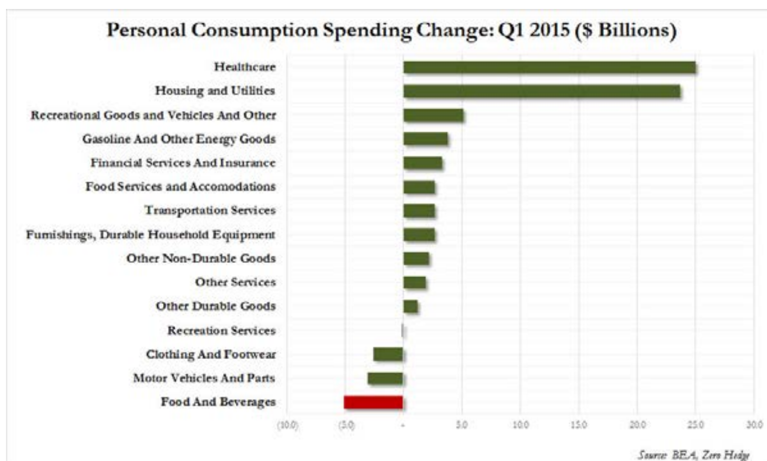
We are here →

	Annualized gain (12/31/1951-12/31/2014)			
Debt/GDP	Nominal GDP	Real GDP	Nonfarm payroll	CPI inflation
> 289%	3.7%	1.7%	0.6%	2.2%
156%-289%	6.3%	3.2%	1.5%	3.7%
< 156%	7.5%	3.6%	2.3%	3.9%

Another point made in the July 2015 issue of *Inside Information* was the debt itself. As this chart clearly shows, high levels of debt tend to slow economic growth. This makes perfect sense as "unproductive" debt acts as a governor on the economy's growth engine. If only the debt had been used for productive purposes, which it wasn't, then it might be a different story.

Furthermore, the global economy has been slowing down this year which doesn't help either. While the U.S.'s economy has been performing better than most, it has also struggled with most economic statistics coming in below expectations. We are continuously told it is just about to turn the corner with high expectations for a second quarter rebound in GDP after the first quarter's negative number. However, the focus shouldn't be on the overall number, but on its nature, as pointed out by Ms. Pomboy:

"Spending on healthcare (insurance and services) has increased $232 billion over the last twelve months. That increase accounts for a big 'two-thirds' of the $353 billion in consumer spending and one-third of the $666 billion growth in total GDP over the stretch…And wage gains are being wiped out by rising health costs. 'The increase in healthcare outlays over the last year is roughly equal to the $284 billion in wage gains for households during that time.'"
–Stephanie Pomboy, *What to Expect in the Q2 GDP Number*, 6-24-15



People spending money on healthcare and housing (rent) isn't the type of consumerism that builds a sound economic growth cycle. A recent Harvard University study, echoed this concern as quoted from the Executive Summary: *Over the span of just 10 years, the share of renters aged 25–34 with cost burdens (paying more than 30 percent of their incomes for housing) increased from 40 percent to 46 percent, while the share with severe burdens (paying more than 50 percent of income) rose from 19 percent to 23 percent. During roughly the same period, the share of renters aged 25–34 with student loan debt jumped from 30 percent in 2004 to 41 percent in 2013, with the average amount of debt up 50 percent, to $30,700.*

Obviously, with their high student debt loads and rent, the Millennial's aren't going to be much help in stimulating the economy.

Are Central Banks Losing Control?

"The question is are we now moving into the territory in trying to produce growth out of nowhere we are in fact shifting growth from each other, rather than creating growth. Of course, there is past history of this during the Great Depression when we got into competitive devaluation."
–Raghuram Rajan, Reserve Bank of India governor, 6-26-15

"The entire structure of monetary experimentation is falling apart; up to and including how the government collects and issues statistics on the most basic of assumed economic functions. The extreme and growing divergence between both expectations and asset prices and what is showing up as real recession elsewhere is playing out like cognitive dissonance, but it should be clear by now that monetary theory is being, in full, disqualified and disproven."
–Jeffrey Snyder, Alhambra Capital, 7-2-2015

Ever since the financial crisis of 2008, central banks have been intervening in the financial markets via cutting interest rates, Quantitative Easing or direct manipulation through stock and bond purchasing. This year alone world central banks have lowered interest rates over 50 times! As Mr. Rajan states above, this is the equivalent of competitive devaluation in which someone has to come out on the losing side. How long will Japan's neighbors tolerate the cheapening of their yen? In my opinion, it is likely that this global distortion of the financial markets will end poorly as recently predicted by investor Doug Kass: *The Federal Reserve's extended six-year policy of injecting massive amounts of system liquidity and stabilizing interest rates at near zero has been a powerful force on our capital markets and on stimulating rate-sensitive economic*

sectors (e.g., housing and autos). But, in maintaining monetary indulgence for such a lengthy period of time, our central bank has now distorted and screwed up our economy and our markets – perhaps for some time to come.

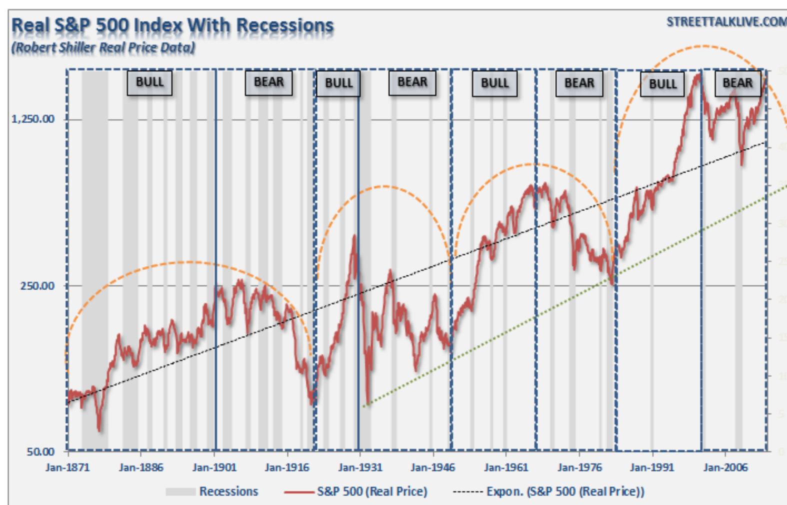
With the ECB and China's central bank beginning to lose some control over their financial markets, the last half of this year is shaping up to be interesting to say the least.

Portfolio Ponderings

"Right now macro doesn't matter. But that will change. When it does matter it will be all that matters."
–Bill Fleckenstein, Investor, 6-25-15

Although most stock sectors had slight gains (I reposted the S&P 500 Index graph to show the choppiness) this past quarter, with the bond market being the main loser, this is reversing itself as we enter July and uncertainty quickly makes its way into the investment world. While most are pointing their fingers at the instability in Greece and China, there are other potential pockets of worry, such as whether or not the Fed raises interest rates in September or whether the crash in commodity prices, such as oil and copper, are signs of an economic slowdown? Throw in an uneven U.S. labor-market recovery and continued increasing income inequality and the doubts persist.

These uncertainties are keeping stock markets embroiled in turmoil and volatility as many give up their gains for the year in the first couple of weeks of the new quarter. With some believing that the U.S. stock markets are currently overvalued, investor Lance Roberts made an interesting comment in his July 7, 2015 post, Is It Really Different This Time?:



"Historically, full market cycles have finished when prices complete a "mean reverting" process by falling well below the long-term mean. Since the beginning of the secular bull market in the 1980's that full "mean reverting" process has not yet been completed due to the artificial interventions by Central Banks to prop up asset prices…There is an argument to be made that this is could indeed be a "new market" given the continued interventions by global Central Banks in a direct effort to support asset prices. However, despite the coordinated efforts of Central Banks globally to keep asset prices inflated to support consumer confidence, there is plenty of historic evidence that suggest such attempts to manipulate markets are only temporary in nature."

Whether this is just a small blip down in a new “bull market” or an indication that central banks are finally losing their power to roll the debt boulders further into the future will, I believe, become clearer in the second half of this year.

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