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Fourth Quarter 2014 Economic Review

"*Anyone who believes that exponential economic growth can go on forever on a finite planet must either be a madman or an economist.*"- Kenneth E. Boulding

"*Mathematics brought rigor to economics. Unfortunately it also brought mortis.*"-Kenneth E. Boulding

There is so much to talk about! The accelerating growth in the US economy versus the deceleration elsewhere, the potential for deflation, the lack of synchrony in world economies, the Greek political situation and its impact on the Eurozone, etc, etc. But first, let's address the lousy job that most economists have done in recent forecasting.

This has been a very confusing time for most economists and strategists, including ourselves. Traditional rules of thumb seem not to apply in a complex geopolitical backdrop with ascendant currency wars and threats of deflation. In our search for direction, we have found the theory of evolutionary economics to be of some help; hence, the above quotes.

Kevin Boulding was a rarity, an economist that one could admire for his rather unique thinking. Born in Liverpool, England and Oxford educated, he came to the US at the age of 38 spending most of his subsequent career at the University of Michigan. Though trained in economics, he became very interdisciplinary at the highest levels of academe: Boulding was president of numerous scholarly societies including the American Economic Association, the Society for General Systems Research, and the American Association for the Advancement of Science. He was a proponent of evolutionary economics, seeing parallels between economic growth and the biological evolution. Biological evolution gives considerable emphasis to the ability of organisms to adapt to unpredictable change—their survival value. *Boulding believed that finding equilibrium, a concept that applies to simple systems in chemistry and physics had little place in the study of economics.*

Classical economic theories about aggregate concepts such as inflation, employment, and monetary policy were deduced from stable equilibrium simplifications of the economy. A system that is in equilibrium is stable over time with no energy or work required to maintain that condition, Boulding argued that economies could not be at equilibrium, but rather dynamic in order to achieve what is called a steady state. Adaptive change in an economy does not necessarily follow straight lines or a steady pace. There are periods of decline, regression and falling back. A valued product or service adapts using innovative knowledge and in doing so, increases its economic viability.

Classical economics also viewed capital as a type of good that can be consumed now, but if consumption is deferred, can be used for production of goods and services. Boulding took a broader view and described capital as consisting of human knowledge and know-how. Once the traditional factor of production (i.e. capital) is reinterpreted as know-how, one can easily conclude that know-how and the growth of knowledge are "the essential key to economic development". Investment, financial systems and economic organizations and institutions are in a sense only the machinery by which a knowledge process is created and expressed. Much like the catch phrase of biological evolution, "survival of the fittest", economies adapt and grow or decline depending on variation and differences so that some types and characteristics are more likely to survive than others.

The problem that Boulding saw and that most economists have missed is that economics, in trying to become more "scientific" has become less useful in forecasting. For too many years, promoters of most economic theory have created a "convention" that economics, to be regarded as a science, could advance only through mathematical deduction. According to this convention, great economic thinkers such as Adam Smith, Keynes, Schumpeter, or Hayek could not be regarded as true economists because their most important works used little or no mathematics. Though some of these classical economists were also distinguished mathematicians, they realized that math by its very nature, could not express the full complexities, contradictions, and ambiguities of economic life. Using classical beliefs, most economists have difficulty assessing the current situation in which behavior is inconsistent, motivations are ambiguous and outcomes are unpredictable. The economics profession is chock-full of high-IQ people who would be great engineers or physicists; the economics profession is sadly short on wise, insightful, and historically informed people who are good economists.

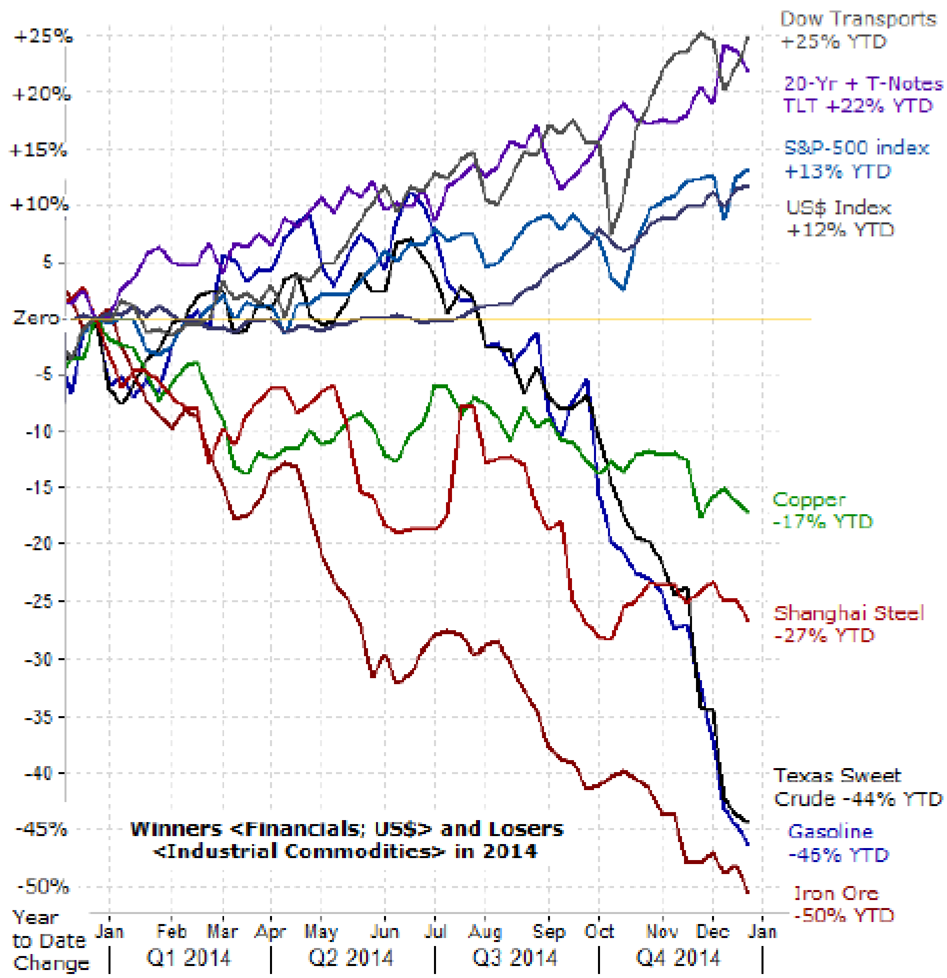
In our view, economics needs to explore the altered landscape of the last few years: the worrying growth of huge current-account surpluses and deficits, the seeming fragility of finance, and the frequency of financial crises that we seem to threaten. The period between the late 1980s and 2007, pre credit crisis, known as the "Great Moderation" coincided with large and potentially destabilizing rises in asset prices and debt. It seems that stability de-stabilizes and that naïve economics helps cause unstable economies. Though most classical economics worries about the "exogenous shock", an unpredictable change which may have an impact on the economy, it seems that most such shocks are emerging from within the system and are a persistent feature of capitalist economies. The threats to liberal democracy are not coming from the old threats of communism, socialism, labor union militancy, soaring inflation, or a collapse in business profitability but rather from financial and economic instability, persistent high unemployment and soaring inequality. The policy measures by which many Western countries moderated the impact of the credit crisis were heroic but have failed to return high-income countries to a state of good health. Governments continue to struggle with an aftermath of high unemployment, low productivity growth, de-leveraging, and rising concerns of fiscal solvency. The structural weaknesses of the Eurozone have become increasingly evident.

Think about the uniformity of opinion that most economists and strategist shared a year ago, an almost universal belief that interest rates had to move up in 2015. After badly forecasting the direction of the US Treasury bond market a year ago, the same group of seers is doubling down on their bets that 2015 will be a disastrous year for investors in Treasury bonds. Given the chance to speculate on declines (ie; short sell) in only one asset, 20% of investors, traders and analysts in a Bloomberg Global Poll conducted last month picked government bonds as their top choice, - the most of any category. One year ago, US-economists were virtually unanimous in predicting US Treasury bond yields would climb about half-percent higher by the end of 2014. With the Fed, the biggest buyer of T-bonds, poised to taper its $85-billion /month of T-bond and mortgage purchases, and eventually mothball its QE-3 operation, the 10-year Treasury yield was expected to climb +50-bps higher to 3.50% by Q'4 of 2014, according to the median estimate of 74 economists surveyed by Bloomberg. Instead, the 10-year T-note yield ended the year at 2.17%, tumbling -83-bps and has subsequently fallen as low as 1.64%. Similarly, the 30-year T-Bond yield has fallen to as low as 2.22%.

Why were the experts so wrong? Most bond prognosticators failed to recognize that US T-bonds do not act in an isolated vacuum. US Treasuries do not react solely to the developments in the US-economy. Instead, they are part of the global bond market, and also react to trends in the global economy.

Last year, economic stagnation in the Euro-zone, a recession in Japan, and a sharp slowdown in China's economy, conspired to weaken demand for crude oil, and in turn, helped to facilitate a "perfect storm," that contributed to the collapse of crude oil prices, and in turn, contributed to the sharp decline in British, German, and US-government bond yields. The yield on Germany's 30-year Bund plunged -142-bps last year to 1.36% and has recently hit 0.88%. As such, the higher yields on British Gilts and US-30-year T-bonds, look more attractive to yield hungry investors in Japan and Switzerland, where the 10-year yields are now 0.35% and an unbelievable -0.082% (yes, a negative yield for a Swiss ten year bond).

Yields have collapsed largely because the market is focused on the possibility of deflation. This has been particularly true in the commodity markets. Look at the huge dichotomy in performance of financial markets versus commodities:



Source: Global Money Trends Dec.26, 2014

Many of us remember the 1970's and the self-feeding cycle of increasing inflationary expectations. Both consumers and businesses bought ahead of need to beat expected price increases. That increase in demand strained supplies and pushed up prices…suspicions were confirmed, so buying ahead of need intensified. Deflation will be exactly the opposite, if widespread and chronic, people will anticipate it by deferring their buy decisions. Piled up inventories and excess capacity to make goods and services will result, so producers will cut prices to unload, Suspicions of deflation will be confirmed, and once again, buyers will wait even longer in a reinforcing cycle.

We expect that our deflationary experience will be more like the 1920's rather than the financial collapse of the 1930's. We do see some warning signs of deflationary forces at work:

- Declining interest rates are not stimulating demand
- Central banks are trying to meet inflation targets, this time trying to induce inflation rather curtail it

- G-7 retirements are leading to reduced benefits and slower growth in incomes and spending
- Restructuring which started in English-speaking countries is becoming more accepted globally
- Mass distribution to consumers is reducing costs and prices
- Technology cuts costs and promotes productivity
- Global sourcing of goods and services curtails costs
- The spreading of market economies increases global supply
- European and US consumers are switching from borrowing and spending to saving
- Beginning to see supply gluts e.g. China has produced as much cement in the last two years as the US has in the 20th Century!
- Information via the Internet increases price competition

US consumer prices fell in December by the largest amount in six years, dropping 0.4% reflecting another big monthly decline in gas prices and providing further evidence of falling inflation pressures. This was the largest one-month drop since December 2008. It was also the second straight monthly decline in prices with both months reflecting big decreases in gasoline prices.

Consumer prices also fell in the Eurozone in December by 0.2% for the first time in over five years, according to Eurostat, the statistical office of the European Union. A general decline in prices may sound good on paper but when deflation takes hold, it can wreak havoc on the economy. That's because consumers and businesses have an incentive to delay purchases and investment since prices are expected to fall further. Deflation strangles borrowers because their debts get harder to repay. Just ask Japan.

It is easy to label Japan as having suffered from its so-called two lost decades. In a broad sense that is true – modest but pernicious deflation, inadequate domestic demand, mediocre growth below potential, weak labor markets and a widespread sense of malaise. Over the period growth has been volatile – recessions, recoveries, growth, the sharp decline in 2009 as the global Great Recession hit all high income countries, Japan's partial recovery and then slide back to modest recession again in 2012, and now rapid recovery – at least this year.

The demographic realities of Japan's declining labor force since 1995, and now declining population, have choked off growth and will continue to hinder it; and the corresponding state of their aging populations should provide lessons for China as well as Europe. Chinese inflation at the consumer level moderated to a five-year low in January to +0.8%, the lowest level since the financial crisis.

But the greatest concern to governments is not deflation itself; the real concern is the impact of deflation on the already over-indebted governments of Europe. Seven euro zone countries are projected to have public debt to GDP ratios of over 100% next year!

The worry is quite legitimate from the perspective of indebted governments. With deflation, the burden of debt increases, making defaults more likely.

In a recent paper by the McKinsey Global Institute, the authors note:

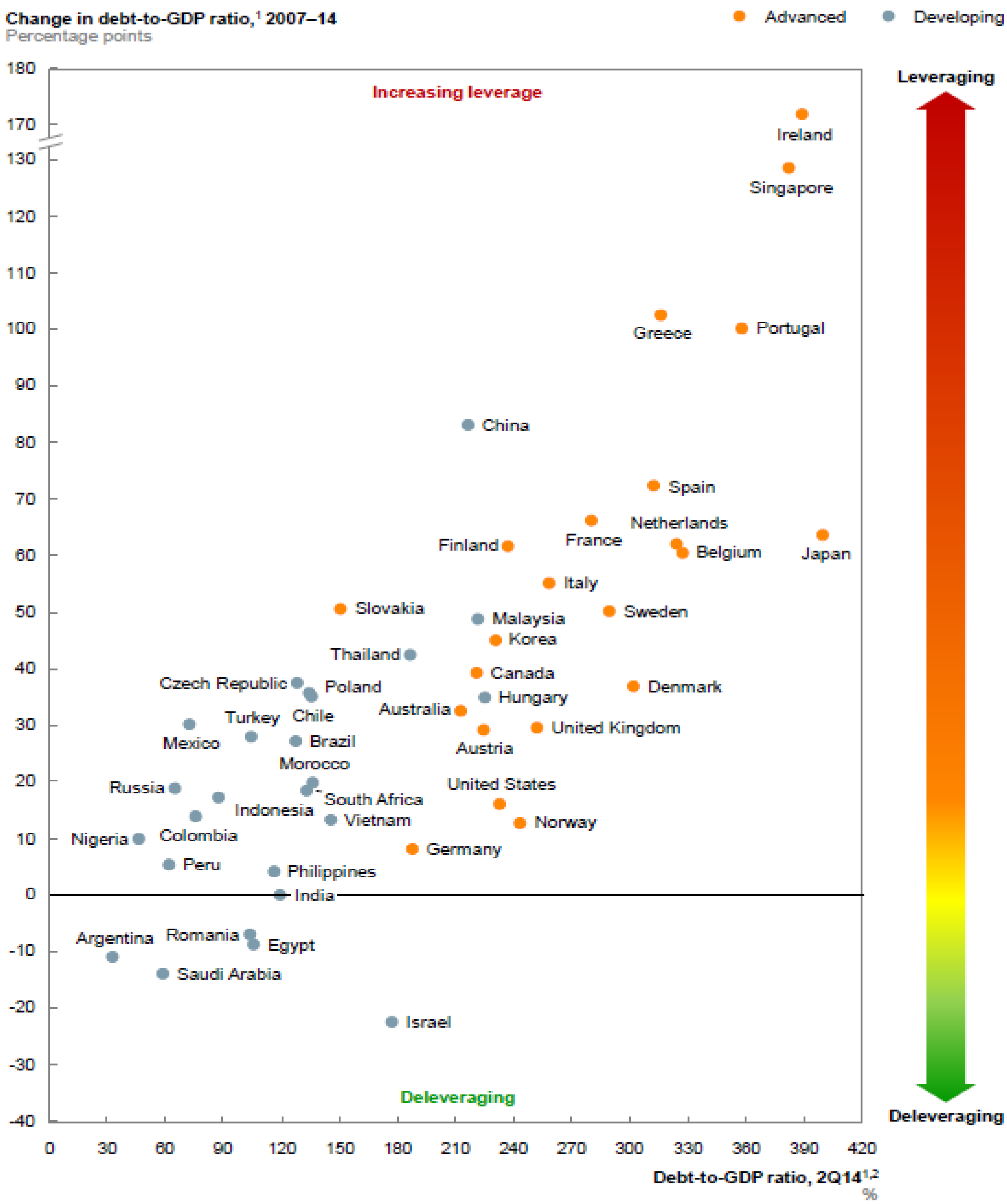
"We find that deleveraging since 2008 remains limited to a handful of sectors in some countries and that overall, debt relative to GDP is now higher in most nations than it was before the crisis. Not only has government debt continued to rise, but so have household and corporate debt in many countries. China's total debt, as a percentage of GDP, now exceeds that of the United States. Higher levels of debt pose questions about financial stability and whether some countries face the risk of a crisis. One bright spot is that the financial sector has deleveraged and that many of the riskiest forms of shadow banking are in retreat. But overall this research paints a picture of a world where debt has reached new levels despite the pain of the financial crisis. This reality calls for fresh approaches to reduce the risk of debt crises, repair the damage that debt crises incur, and build stable financial systems that can finance companies and fund economic growth without the devastating boom-bust cycles we have seen in the past."

China's debt is rising rapidly. Fueled by real estate and shadow banking, China's total debt has quadrupled, rising from $7 trillion in 2007 to $28 trillion by mid-2014. At 282 percent of GDP, China's debt as a share of GDP, while manageable, is larger than that of the United States or Germany. Several factors are worrisome: half of loans are linked directly or indirectly to China's real estate market, unregulated shadow banking accounts for nearly half of new lending, and the debt of many local governments is likely unsustainable.

The Bank of Japan (BOJ) is attempting to overcome the mild deflation that has lasted in Japan for nearly 15 years and to achieve its 2 % price stability target. In the face of the zero lower bound on short-term interest rates, the BOJ introduced nonstandard monetary easing policy called quantitative and qualitative monetary easing to achieve the target. So far, a number of positive outcomes have materialized. Compared with 2012, stock prices have been higher; private consumption is more resilient; more active real estate investment are taking place; and the yen's exchange rate has been at more depreciated levels. Most importantly, the growth momentum of the economy is gaining traction and the unemployment rate is approaching the pre-crisis lowest level. There are some signs of the economy moving out of deflation although the BOJ needs some time to reach the 2 % target.

Debt remains an essential tool for the global economy, funding needed investments in infrastructure, business expansion, etc. But high debt levels, regardless of whether they are in the public or the private sector, have historically placed a drag on growth and raised the risk of financial crises that have sparked past recessions. As you can see from the following chart, there is a continuing rise in global debt since the crisis. In fact, 14 countries have increased total debt to GDP by more than 50 percentage points since 2008:

The ratio of debt to GDP has increased in all advanced economies since 2007



1 Debt owed by households, non-financial corporates, and governments.
2 2Q14 data for advanced economies and China; 4Q13 data for other developing economies.

SOURCE: Haver Analytics; national sources; McKinsey Global Institute analysis

Using austerity to reduce debt is a very bitter pill as Greek voters recently demonstrated. Though the Greek economy is relatively small, the foundation of the European agreement, the Maastricht Treaty which led to the creation of the European Economic and Monetary Union under the new currency, the Euro could be rattled if not permanently damaged.

In order to preserve the stability of the currency, the treaty prevents national governments from doing what they need to do to stabilize their economies — namely engage in needed deficit spending, regardless of the magnitude, during times of recession for the purpose of stabilizing income and employment. Recent circumstances in the peripheral countries highlight the problems that could arise from a European supranational currency and a central bank which was not accountable to any national authority and which would push countries merely to become hostages to the whims of the financial markets. There is a deflationary bias in the structure of the Eurozone — that is, the tendency for policies to focus on lower inflation instead of more jobs and growth and to prevent greater public spending as a means to achieve growth. Major cracks in the Greek situation started when it was discovered that under the advice of Goldman Sachs, Greek authorities were finding ways of hiding their sovereign debt from the purview of the agreement.

From 2010 onwards, Greece achieved notoriety because financial markets recognized that the country might decide not to comply with the terms of loan agreements with banks. Eventually in 2012, European leaders held a summit at the French resort of Deauville and agreed that if the private holders of sovereign debt wanted bailouts, they would be held responsible for the losses. Because of these developments since 2010, deficit hawks everywhere vilified Greece for all the supposed terrible consequences of government over-indebtedness, even though the structure of the Eurozone made it impossible for Greece to manage its economy effectively.

Deficit hawks started preaching long-term austerity, and we've seen the awful consequences ever since. People have suffered terrible hardship and dislocation, with countries such as Greece and Spain reaching rates of unemployment worse that what happened in the United States in depth of the Great Depression. You'd be hard-pressed to find examples of such a severe collapse historically, with the possible exception of certain Latin American countries, such as Argentina in 2001. Those who predicted that that this austerity policy would eventually lead to an economic turnaround because of the belief in private sector rebound obviously got it wrong. After five years of negative economic growth, the Greek electorate — with incredible courage — told the so-called Troika that they had had enough, especially with these deep cuts in wages, employment, and pension transfers. Since the debacle of the 1930s, which is being repeated with such vengeance in the Eurozone since 2010, we see that pursuing austerity policies alone without some other outside stimulus, say, from increased net exports, can't lead to balanced budgets. Instead, it leads to disaster. These policies destabilize the private sector to such an extent that they actually jeopardize chances of any future recovery. Many Greek citizens felt that they had reached this threshold and wanted a reversal of policy.

Germany has warned the new Greek government that it must live up to commitments to its creditors, and with Greece's current bailout program ending in February it will have little breathing room. There may well be a willingness to give the Greek government more time to make its debt payments, but the present Troika seems rather uninterested in outright debt cancellation, even if there may be some desire to negotiate some smaller changes, like the creation of a distinct Eurozone-wide public investment fund which might do things like build and repair roads or support clean energy projects and generate sufficient overall growth, especially in the rest of Eurozone, to perhaps spill over into Greece and turn around its current account balance and also raise government revenues. These will be very difficult negotiations.

In the end, if the Greek government cannot renegotiate its crushing debt burden — without some form of debt forgiveness in however form it will be disguised — you could see a Greek default happen. If it reaches that point, we don't think there's anything in the Eurozone treaties that would prevent Greece from retaining the euro. The possibility was never contemplated in the Treaty. But Greece is not alone in its distress. Countries like Italy, Spain, and Portugal and even France have anti-austerity parties. That's going to put further pressure on Germany to accommodate. But it will also boost the support of the nationalist right-wing anti-euro parties, as in France. If all these parties manage to achieve power, it may well be either that the Eurozone countries establish ways for countries to have more latitude in taking action to stabilize their economies.

In the interim, Greeks could get some short-term relief with the depreciating euro in terms of increased net exports for all countries of the Eurozone. Also in the short term, there is the European Central Bank's commitment to do quantitative easing, or pumping new money into the economy. I have argued that quantitative easing doesn't work to stimulate private sector spending, but it might help backstop what would have been an eventual financial collapse of a number of Eurozone countries. A lot depends on how big the European Central Bank is willing to go with its plans. If the action was bold enough, Greek banks could benefit indirectly and it could give the Greek government some breathing room and prevent a default, assuming its current creditors demand payment. In the medium term, Greece could create some form of parallel currency set at par with the euro, like Argentina did in the early 2000s. The government in Argentina used "*patacones*" to buy things and pay employees and they became quite acceptable because ultimately regular people could pay taxes with this currency. The Greeks could have a parallel national currency without altogether abandoning the euro.

It's not that long ago that people spoke of the BRICs (Brazil, Russia, India, and China) as sources of marginal growth. The punditry couldn't stop praising them. However, in the past year, now that China's housing bubble has burst and its shadow banking system has imploded those who remember what BRIC actually stood for are about as rare as those who recall what it means for the Fed to hike rates. Eroding fiscal balances, high current account deficits, and very weak growth are presenting challenges to world growth rather than leading it, with the exception of India.

Our forecast takes into account what we think is ongoing slowdown globally. Though US growth will be superior compared to most developed economies, the impact of falling currencies will have some impact on our trade balances. Slowdowns in global spending seem unavoidable to us, and consequently higher priced US goods will not be in demand. Though most economists look for US 10 year Treasuries to return to yields near 3%, largely driven by the Fed's desire to boost short term rates, we fail to see the connection between a boost in short-term Fed Funds and the long term bond yield. The US remains a highly rated credit, and the strength of its currency, and the comparably better yield than most similar credits will continue to attract foreign capital into our bond market. We see subdued growth by year end that keeps us in the lower 2% growth level and yields which we think will stubbornly stay below 2.50% at the high end, and 1.75% at the low end.

Central banks are lowering rates at least in part to prevent their currencies from appreciating in value against the Euro and Japanese yen, as they jockey for position with trading partners doing the same. A lower currency improves price competitiveness of exports, and countries are looking for any edge to protect their share of the global trade market and keep their sluggish economies moving. Since the Bank of Japan started a new round of easing last October 31st, sixteen other central banks around the world including the People's Bank of China, the European Central Bank, the Reserve Bank of Australia, and the Bank of Canada have eased monetary policy in the face of sluggish economic growth and energy-fueled deflation. Widespread global easing will make it very difficult for the Fed to enlist its well-telegraphed intent to hike Fed funds rates this year.

As we said at the beginning, the economic backdrop is very complicated. The long-awaited transition to a post-QE US will be deflected and potentially diverted by the swerve of other global economies. The hoped for acceleration in US growth through consumption and lower energy prices remains modest. New political leadership in many countries is not supportive of the bitter medicine of austerity and may seek to subvert and undermine historical agreements and understandings. Our goal is to be pragmatic and adaptable in our approach to the capital markets.

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