Third Quarter 2015 Economic Commentary

Who are you going to believe, me or your own lying eyes? - Chico Marx

For China and other governments for whom economic growth is the main guarantee of political legitimacy, the temptation to fudge will always exist. –Financial Times

As we look back over our Economic Commentaries of the last four quarters, the overarching theme has been one of doubt and skepticism about the strength of the recovery from the Great Recession.

Perhaps it is early training in physics that is to blame. Scientific ideas are developed by particular ways of observing, thinking, experimenting and validating. Change in knowledge is inevitable because new observations may challenge prevailing theories. Simply put, science demands evidence. Janet Yellen, the Federal Reserve Chair seems to agree with a scientific search for evidence as she refers to a dashboard, an array of "gauges" that measure the health and vigor of the economy as the Fed tries to steer it towards its statutory goals of maximum sustainable employment and price stability.

Physics has its critics too. In his 2004 book *The Trouble with Physics*, author Lee Smolin reproached the physics profession for being seduced by beautiful and elegant theories (notably string theory) rather than those that can be tested by experimentation.

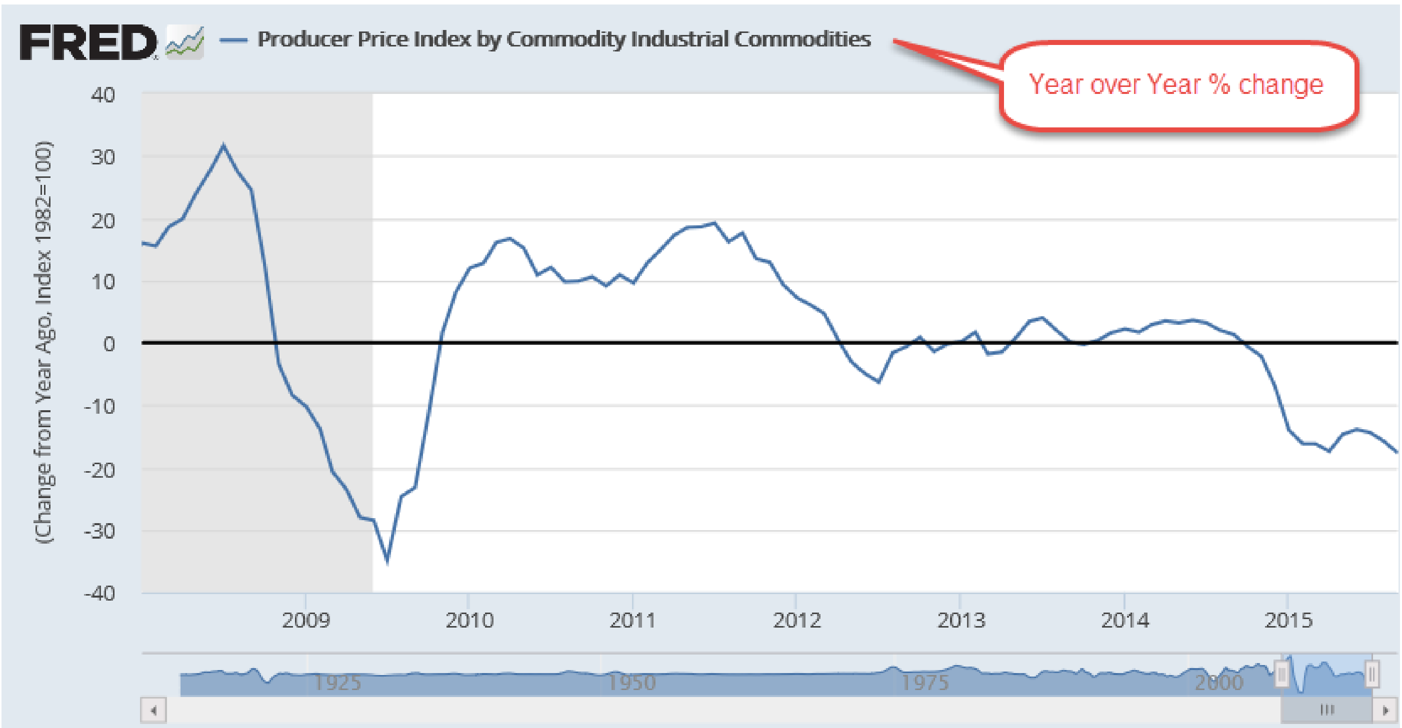
Economics is a social science, necessarily focused on policy rather than discovery of fundamentals. Nobody should really care much about economic data except as a guide to policy…we judge economics by what it can produce. As such, economics resembles engineering more than physics, more practical and applied rather than spiritual and fundamentally explanatory. However, as we focus on economic policy, much that is not science comes into play. Politics becomes involved, and political posturing is amply rewarded by public attention.

Ultimately, this cross-section of economics with politics makes it more vulnerable than the physical sciences to models whose validity will never be clear, because the necessity for approximation is much stronger than in the physical sciences, especially given that economic models describe people rather than fundamental particles, collisions or orbits.

Once again, after many months of speculation that the Fed was finally going to raise rates slightly, by one quarter of one percent, nothing happened…the Fed stood pat. Unfortunately, the long and seemingly unending central bank efforts at maintaining zero interest rates are adding to the confusion and the unpredictability of this economy.

Current prices of long bonds imply that market participants are confident that rates will not rise substantially over the next few years. Conventional wisdom, shared by policymakers at the Fed, says that they will. If the whole rate structure moves in line with the FOMC forecasts, the next few years will see the biggest losses in bond markets since the 1970s. Yet investors are still holding bonds at what are historically very low yields. Evidently either bond market participants do not believe that Fed will do what it says it will, or they don't believe that changes in policy rate will have any noticeable effect on longer rates. The Fed was considering a two point increase over the next year and half, while bond rates seem to imply that it will take twenty years.

This brings us to the Chico Marx quote from the Marx Brothers movie, "*Duck Soup*". The Fed would like to have us believe that domestic conditions are so strong that inflationary conditions will tighten sufficiently to warrant a rate rise. Yet, if we believe our own "lying eyes", the data does not corroborate the Fed's viewpoint:



Source: US Bureau of Labor Statistics, FRED-St. Louis FRB

Following a great deal of inflationary impetus prior to the Great Recession, industrial commodity prices have deflated since 2014, a trend which continues to point downwards. Social Security recipients need not be reminded of the inflation views. As the Social Security Administration notes tersely, "With consumer prices down over the past year, monthly Social Security and Supplemental Security Income (SSI) benefits for nearly 65 million Americans will not automatically increase in 2016."

As we have noted above, the bond market is a good gauge of inflationary expectations based on the difference in yields between various maturities. Bondholders implicitly make a bet on inflation, whether they know it or not. Traditional fixed-income investments may not provide the real return investors need during periods of high inflation. It's important to know whether your traditional fixed-income investment breaks-even with inflation. Break-even inflation is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality. If inflation averages more than the break-even, the inflation-linked investment will outperform the fixed-rate. Conversely, if inflation averages below the break-even, the fixed-rate will outperform the inflation-linked.

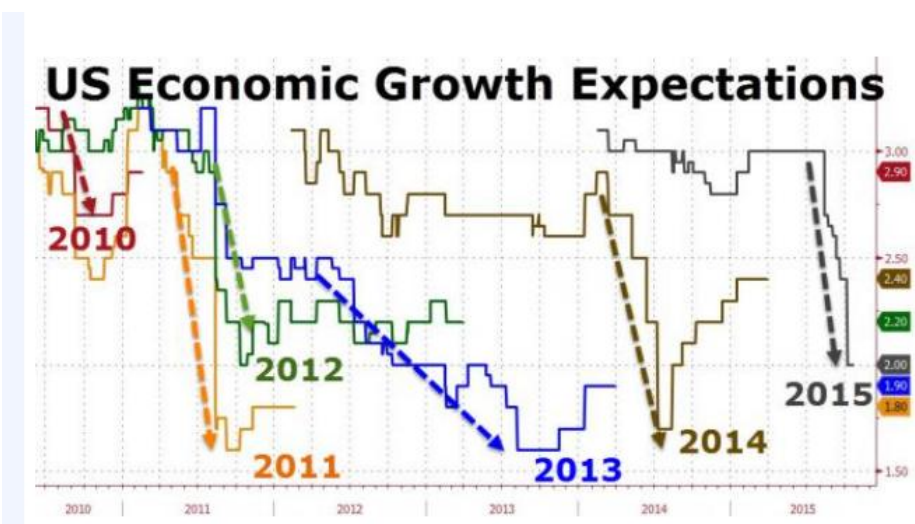
US Treasuries are available to offer inflation-protected yields (since 2003) or more typically, nominal, non-inflation protected yields. Here is a view of how the bond market has viewed inflation risk:

Source: FRED – St. Louis FRB

Long term inflationary expectations had a recent peak of 2.59% in September 2012 but have trended down to the current 1.47%.

So either the Fed won't do what it says it will, or it won't affect long rates, or bondholders will get a very unpleasant surprise. The only way everyone can be right is if transmission from policy rate to long rates is very slow — which would make the policy rate an unsuitable tool for countercyclical policy.

Let's look at how economic growth expectations have deteriorated over the last several years, dropping from the beginning of each year since 2010, always starting near 3% growth:



SOURCE: zerohedge.com The Fed's Inconvenient Truth 10/24/2015

John Cochran, a Senior Fellow of the Hoover Institution at Stanford observed in the Wall Street Journal (September 17, 2015):

The outcomes we desire from monetary policy are about as good as one could hope. Inflation is low and steady. Interest rates are lower than Americans have seen in generations. Unemployment, at 5.1%, has recovered to near normal. And banks and businesses sitting on huge piles of cash don't go bust, a boon to financial stability.

Yes, economic growth is too slow, too many Americans have dropped out of the workforce, earnings are stagnant, and the country faces other serious challenges. But monetary policy can't solve long-term structural problems.

So why the fuss? Well, many say, inflation will break out if the Fed does not raise rates and cut reserves. Or, say others, recession and deflation will break out if it does.

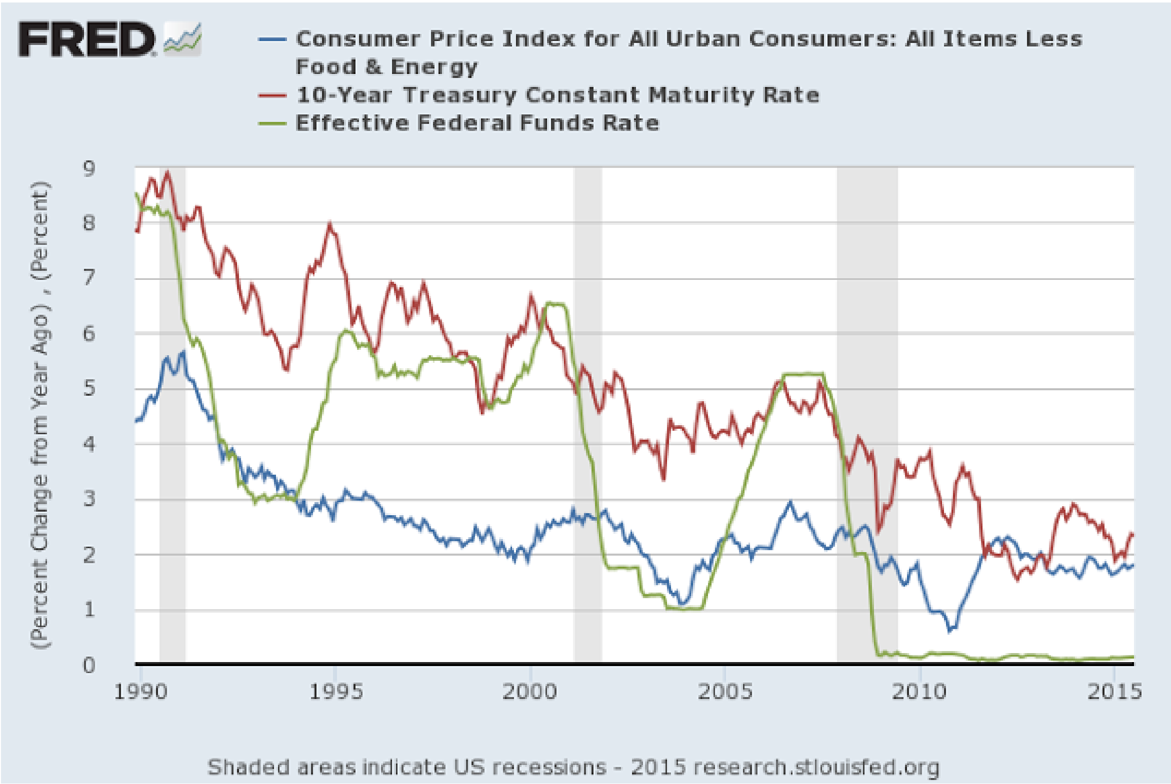
But the last seven years of calm have destroyed the long-standing theories behind these predictions. So why listen now?

Ever since the Fed implemented its near-zero interest rate policy in 2008, traditional Keynesians have been predicting a deflationary spiral. It hasn't happened.

The Fed went on to buy bonds and mortgage-backed securities through its "quantitative easing" programs, in return expanding bank reserves from less than $50 billion to nearly $3 trillion. Traditional monetarists predicted hyperinflation. It hasn't happened either.

The experiment was huge, and the lessons are clear. The economy is stable, not subject to Keynesian "spirals" requiring constant Fed intervention. And when reserves pay the same rate as bonds, banks do not care which one they hold. So even massive bond purchases do not cause inflation. Quantitative easing is like trading a $20 bill for a $10 and two $5 bills. How would that make anyone spend more money?

Cochran's observations of what happened to inflation represent a real economic dilemma that conflicts with traditional teaching of economic "science".



Source: FRED- Federal Reserve Economic Data-St. Louis Federal Reserve Bank

The graph shows the Federal Funds rate (green), the 10 year bond rate (red) and core CPI inflation (blue).

The conventional way of reading this graph is that inflation is unstable, and so needs the Fed to actively adjust rates. When inflation declines a bit, the Fed drives the funds rate down to push inflation back up. When inflation rises a bit, the Fed similarly quickly raises the funds rate.

That view represents the conventional doctrine that an interest rate peg is unstable, and will lead quickly to either hyperinflation (Milton Friedman's famous 1968 analysis) or to a deflationary "spiral" or "vortex."

And this instability view predicts what will happen should the Fed deliberately raise rates. Raising rates should result in an opposite effect on inflation, lowering it. When inflation is low enough, the Fed then quickly lowers rates to stop inflation from falling too much.

But in 2008, interest rates hit zero. Traditional Keynesians warned that a deflationary "spiral" or "vortex" would break out. Traditional monetarists looked at QE, and warned hyperinflation would break out.

(We included the 10 year rate as an indicator of expected inflation, and to emphasize how little effect QE had $3 trillion dollars of bond purchases later, good luck seeing anything but a steady downward trend in 10 year rates.)

The amazing thing about the last 7 years in the US and Europe -- and 20 in Japan -- is that *nothing happened!* After the recession ended, inflation continued its gently downward trend.

So, with no inflation in sight or predicted in the low yield of longer term bonds- an implicit forecast, and with both experience and academic theory stating little danger, why are so many at the Fed anxious to raise rates and trim the balance sheet?

As I read Fed statements, the mantras "normal" and "normalize" appear frequently. But "normal" policy is thought by many to have exacerbated boom-and-bust cycles, and a financial system based on massively leveraging a tiny amount of reserves fell apart. We could argue that the Fed should maintain current zero rate policy, incorporating the lessons of the past seven years, not "normal" policy as if we've learned nothing.

I suspect that the Fed, having sold near-zero rate policy and large balance sheet as exceptional monetary stimulus, finds it hard to concede that these are innocuous. Also, putting off the slight rate rise it has promised for so long might be embarrassing.

Furthermore, I sense that the Fed is spooked by recent efforts in Congress to revisit the central bank's fundamental authority. Perhaps the Fed wants to run up a flag saying "back to normal," with the implication "so leave us alone." But better relations with Congress are best pursued separately.

So, what should the Fed do? It should keep a large balance sheet. Liquidity is a great thing, and why forget the lesson that liquidity does not appear to cause inflation?

For interest rates, the Fed has set itself a nearly impossible task. Fed officials need to know what the correct, or "natural," real rate of interest is. But much like the boy who cried wolf, the cry has grown stale and unconvincing. Whether the Fed raises rates a quarter or even a half a percent will make little difference to anyone but bond traders. The Fed will go no further unless there is a surge of inflation or growth. And, no matter what the Fed does, pundits will berate it in both directions.

Like most US economists, global economists at the IMF (international Monetary Fund) have been consistently over-optimistic in predictions for the global economy. In its latest World Economic Outlook, the IMF cut its global growth forecasts saying that emerging markets slowdown may entrench low inflation and promote stagnation in the west.

Link : https://www.imf.org/external/pubs/ft/weo/2015/02/pdf/text.pdf

With some gloom, the IMF observes: *Six years after the world economy emerged from its broadest and deepest postwar recession, a return to robust and synchronized global expansion remains elusive. The revised forecasts in this latest World Economic Outlook report underscore the challenges all countries face. Despite considerable differences in country-specific outlooks, the new forecasts mark down expected near-term growth rates marginally, but nearly across the board. Moreover, downside risks to the world economy appear more pronounced than they did just a few months ago.*

While the talk has been of recovery and putting the economic crisis behind us, gross domestic product forecasts have been revised sharply downward almost everywhere. Relative to its 2012 forecasts, the International Monetary Fund has *reduced its forecasts* for U.S. GDP in 2020 by 6 percent, for Europe by 3 percent, for China by 14 percent, for emerging markets by 10 percent and for the world as a whole by 6 percent.

According to the latest growth projections of the IMF, the global economy is expected to grow 3.1% in 2015 and 3.6% in 2016. Like most economic forecasts, next year is always better than this year.

These dismal figures assume there will be no recessions in the industrial world and an absence of systemic crises in the developing world. *Neither can be taken for granted*. The IMF has over-estimated global growth by one percentage point a year on average for the past four years…a significant forecasting error in light of all the factors that ought to be boosting activity- interest rates near zero, worldwide money creation through quantitative easing, and recently, falling oil prices. The IMF also takes China's official growth numbers at face value, which brings me to the quotation about the "temptation to fudge" numbers.

The People's Bank of China (PBoC) cut its rates for the sixth time since November; and lowered the amount of cash that banks must hold as reserves in another attempt to jumpstart a rally on the Chinese stock markets. The easing of monetary policy is at its most aggressive since the 2008/09 global financial crisis, underscoring concerns within Beijing about the health of the world's second-largest economy. The PBoC lowered the 1-year lending rate by -25 basis points to 4.35%, - delivering another jolt of stimulus. Traders are betting on more reductions in lending rates and the reserve requirement ratio once more before the end of the year, with additional reductions in early 2016. "The PBoC will continue to monitor economic and price situations closely and use multiple tools to maintain liquidity at reasonable level," it said on it's website.

For most countries, delivering resilient growth when investors had expected an abrupt slowdown would be impressive. China is different. The announcement that its economy grew +6.9% in Q3, just below Q2's +7% pace, only leads to more doubts about the accuracy of Chinese figures. So it is sensible to look at the latest numbers in two parts: what the government reported and what ought to be believed. The official data appear to be doctored, not least because they cover a quarter during which China's stock market was in turmoil, falling some -40% from peak to trough, and tarnished Beijing's image. A mini-devaluation of the yuan in August added to the feeling that China's economy was in trouble. And a series of surveys pointed to contraction in the manufacturing sector.

Against that bleak backdrop, growth of 6.9% is a remarkably good performance. It might be China's slowest quarter since early 2009, the nadir after the global financial crisis, but the economy is twice as big now as it was then. A gradual, steady rebalancing of the growth model helps explain the solid figures. As commodity exporters can readily attest, China's factories are struggling. The industrial sector expanded +5.8% year on year in Q3, just about the weakest in more than two decades. But China is changing. The services sector expanded +8.6% year on year in Q3, matching its strongest growth since 2011.

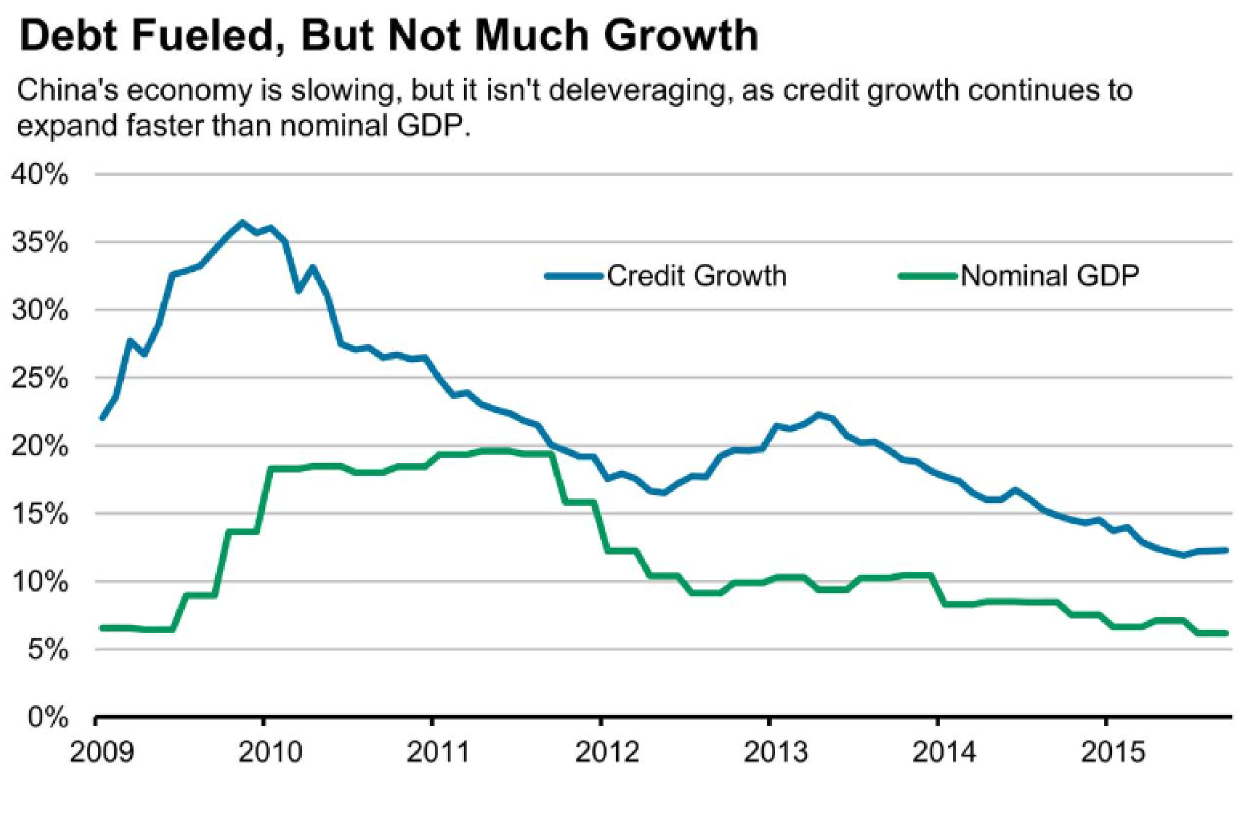
Signs of severe distress in China's factory sector can be deduced from the downward spiral in industrial commodity prices. Spot Iron ore at China's Tianjin port closed at $52.50 /ton this week, and has fallen -26% this year and is headed for a third annual drop amid a global glut and a slowdown in China's steel industry that have forced miners to slash costs to survive.

Just how believable are China's numbers? Analysts who question the data can generally be sorted into two camps: those who think that China's numbers are out-and-out fabrications, concealing the economy's true, grim state; and those who think that China's numbers are inflating growth but not altogether misrepresenting it. The most extreme skepticism about Chinese data focuses on a range of indicators that have served in the past as decent barometers for the broader economy. *Electricity output, for example, has risen just +0.1% so far this year, which would normally imply that real growth is far slower than the government's +6.9% figure.* Imports have also been very weak, falling nearly 18% year on year in September. But plunging commodity prices have depressed the value of Chinese imports. What is more, the shift towards more services-led growth shows up in current-account statistics, not monthly merchandise trade figures.

China does appear to be doctoring its growth data a little. The controversy centers on the way that the statistics bureau adjusts nominal growth figures to account for inflation. In Q'3, nominal growth was +6.2% but the government calculated that overall prices fell by about -0.7%, allowing real growth to hit +6.9%. That is odd, since consumer price inflation picked up a little in the third quarter, rising to +1.4%. Moreover, much of the apparent deflation stems from falling producer prices, but those, to a large extent, reflect falls in imported commodity prices, not domestic deflation. It is difficult to calculate deflators, since they rely on heroic assumptions about sectoral weights and price levels. But analysts who have developed rough substitutes put China's growth rate at closer to +5-to +6%.

One partial solution is to look at the government's nominal data alone, ignoring its deflator. Here, the picture that emerges is more closely aligned with the impression of a sustained slowdown in China. Nominal growth fell to +6.2% year on year in Q'3, markedly lower than the second quarter +7.1% pace. It was the slowest since 1999 and less than a third of the jaw-dropping +20% nominal rate chalked up in 2011. What's more, the collapse in commodity prices has flattered China's growth rate. The resulting fall in imports has translated directly into a big rise in the trade surplus, boosting overall growth. Stripping out net exports, China's nominal domestic-demand growth is probably closer to +4 or 5%, in our opinion. That is a sharper slowdown than the one portrayed by Beijing, and for China, that's considered to be a "hard landing."

Certainly, the rate cuts seem unusual in the face of GDP that is supposedly steamrolling ahead at this subdued 6.9% rate. But of greater concern is the following:



Source: People's Bank of China-National Bureau of Statistics, Wall Street Journal

According to the McKinsey data that we had provided last quarter, since 2007 Chinese nominal debt levels have quadrupled and China's 282% total debt to GDP puts it just above the 280% average for developed economies and more than double the 121% average for emerging economies. The Chinese "miracle" of avoiding a recession in 2009 wasn't anything special at all, it was just a centrally coordinated debt binge. As a result of this binge, China is now in the developed market league for total debt to GDP levels but playing with an emerging market roster of bush-league caliber institutions.

Meanwhile in Europe, ECB Chairman Mario Draghi has signaled more monetary stimulus, "The degree of monetary-policy accommodation will need to be reviewed at our December meeting when new macroeconomic projections will be available," Draghi said at a press conference in Malta. "We want to be vigilant, as people used to say in the old times." The actual statement and Draghi's press conference suggest that the decision to ease monetary policy further (from the current negative deposit rate combined with printing some 60 billion euro per month in addition to the ongoing expansion of fiduciary media by commercial banks) *has already been taken*. The time between yesterday's meeting and the early December meeting is merely going to be used to decide which "tools" to deploy and to what extent. Quite likely this will include further cuts to the already negative 20 basis points rate on the ECB's deposit facility, and a further expansion of QE.

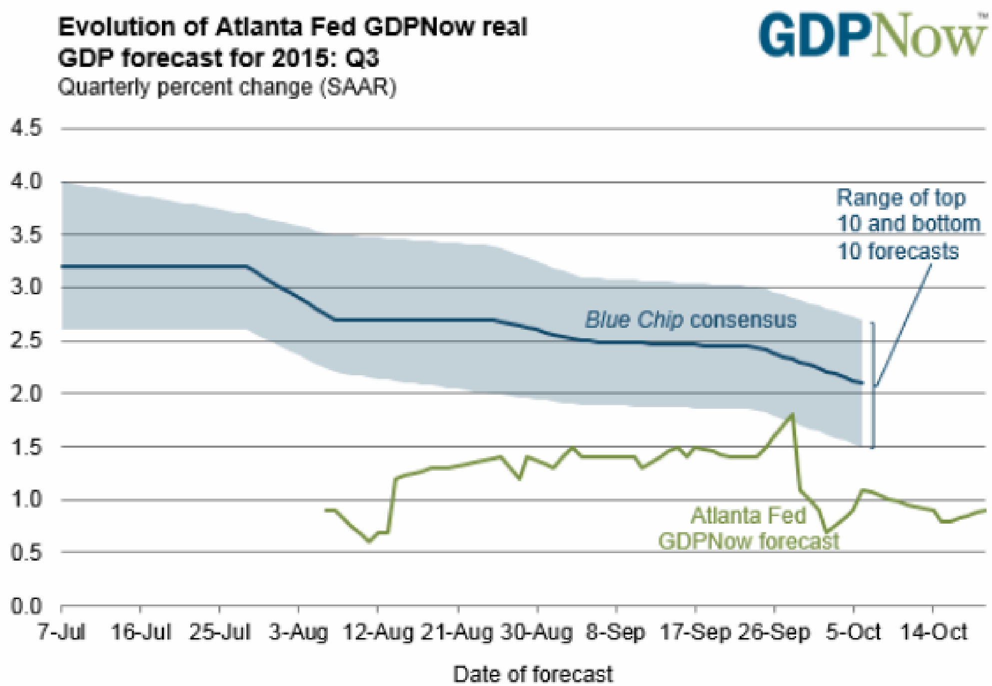
We are hard-pressed to justify this action, at least based on economic data. After all, the euro zone's aggregate economic data look better than they have in quite some time, with several peripheral countries specifically showing quite strong growth rates (their growth is stronger than that in the rest of Europe because they were actually forced to implement a handful of timid reforms). Even from a central planner's perspective, there seems little that is worth "fixing".

The Euro had found some recent stability, or at least had stopped falling, putting together a barely perceptible "bounce".

Source: Bloomberg- Making Europe Richer by Making it Poorer- Peter Tenebarum

Rather than hard facts or a dashboard, Draghi's actions seem to be predicated by "feelings". Bad things "might" happen, Draghi essentially averred. Sentiment may become worse. "Uncertainty" may increase. Similar to Ms. Yellen, he mentioned submerging emerging markets, especially China, as potential sources of trouble. And he couldn't keep from making an absurd argument that lower oil prices are somehow *bad* for one of the world's largest importers and consumers of oil, because they might "lower inflation expectations". The short end of the German yield curve out to five year maturities provides negative or penalty yields with the two-year yield falling to a record -0.33%. The euro has broken below $1.10 per dollar. We think the ECB is essentially using a policy of currency debasement to stimulate the economy.

As we had said earlier, we believe it is difficult to find much empirical evidence to suggest that economic growth expectations are improving, either here, or in most other parts of the world. Though the FOMC continues to express hope that a higher level of sustainable growth will justify interest rate moves, and most forecasters seem to have rosier views than we do, the Atlanta Fed's GDPNow forecast which uses current metrics as inputs, suggests a viewpoint that is much closer to our outlook:



This model suggests that real GDP growth for the US 3Q will be a very modest 0.9% versus a consensus 2.6%.

These model projections are not subject to judgmental adjustments or "feelings" much as the pronouncement of central bank officials. We prefer to deal with reality as we actually observe it rather than the Chico Marx, or politically tinged numbers that we are seeing far too often.

As always, we appreciate your confidence and your trust.

Richard Konrad, CFA, CFP®
Managing Member