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Wasted Days and Wasted Nights: Politics Snuffs Out the Global Expansion

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A Look Back

Every good economist (and tariff-damaged soybean farmer) knows that there will be a few **kernels** of wisdom from the past that can be useful for predicting the future. 2018 was a very complex year filled with political disruptions that ultimately sabotaged a powerful global economic expansion. At the end of 2017, the consensus economic forecast was that global economic growth would strengthen during 2018 led by the US economy that was in the process of accelerating, propelled by the then just passed income tax rate reduction.

Politics ruined this outlook:

- The advance of Populist parties throughout Europe undermined the EU in both its political fabric and its economic growth.
- The lingering effects from Brexit unsettled political and business confidence throughout Europe.
- US President Trump's trade war with NAFTA, the EU, Japan and most importantly, China, raised tariffs on international trade everywhere, disrupted supply chains with China, and calcified business investment and investors' confidence.
- The conflicts in the Middle East and Central Asia continued to escalate.
- A divided Congress resulting from the mid-term elections leaving the Democrats in charge of the house. In the present hostile political environment, this can only lead to political gridlock.

By mid-year the consensus economic prognostication was for the US economy to continue expanding through 2019. The positive effects from the 2017 tax cut would eventually diminish in 2019 and the economy would stumble into a mild recession in 2020.

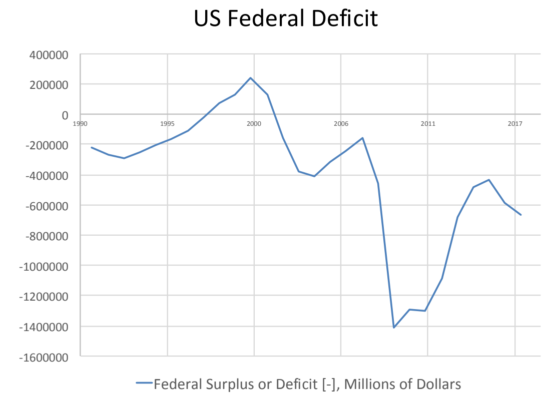
Looking Ahead

This consensus view seems too optimistic to me. It overlooks the negative signs already emanating from the financial markets, and the confidence-crippling effects coming from global political turmoil.

The Sugar Rush is over in the US

The US economy steamed ahead for most of 2018 fueled in part by the energy from the tax cut. According to most econometric estimates (CBO), the best part of the tax cut's influence on the US economy has been consumed. That implies that once the sugar is digested there will be an automatic setback unless some additional stimulant is forthcoming.

New fiscal support is highly unlikely to be forthcoming from Congress in the next two years. The Democrats now control the House of Representatives, the chamber where all new tax and spending bills must originate and pass. Given the present rancorous political environment in the US, the Democrats would probably ignore the prospective coming economic decline in order to weaken the President's chance at reelection in 2020.

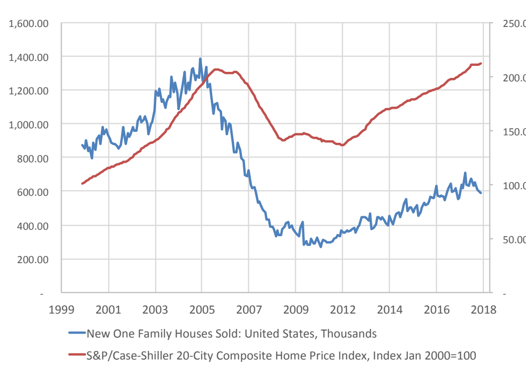


Mismanagement of Federal Deficit

The ballooning US Federal budget deficit will cripple the government's fiscal maneuverability. The tax cut enacted during a protracted economic expansion only contributed to a much larger deficit. In 2019 the fiscal year budget deficit is expected to reach US$1 trillion, the highest the federal deficit has been since the government's bailouts enacted during the "Great Recession" in 2009. Conservative Republicans will have to swallow hard before voting for a bigger deficit in 2019.

Ironically, the US debt ceiling will have to be raised by Congress in March of 2019. This perennial joust by Congress over authorizing its own obligations and its profligacy in creating the debt, can cause federal spending to cease while Congress puts on its hypocritical show of financial prudence. Debt held by the public totals $16.8 trillion, 80% of GDP, and far and away the largest pool of debt in the world. Capital markets will react very negatively to the congressional pantomime as they have in the past, and this may only temporarily steepen a prospective inverted yield curve, which is usually viewed as the black-robed figure with a scythe prophesying that an economic recession is knocking on your door!

New Home Sales fell in past year; prices will soon follow



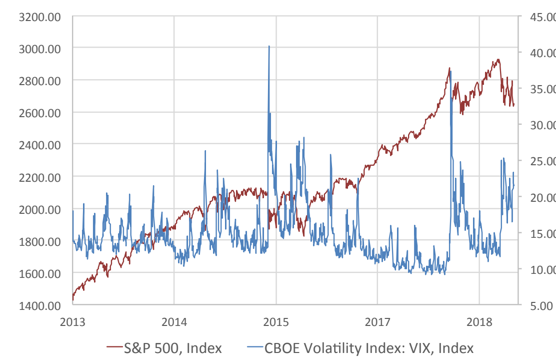
Housing has peaked

New home sales have been falling since December of 2017. Sale price increases in Case-Shiller's 20 city market basket have decelerated sharply over the past 8 months and are expected to turn down in the coming months. Housing woes this time are not expected to create the 2008 economic and credit debacle, but the housing sector is usually the first sector to stumble before a more widespread recession begins. Declines in construction activity transfer their slipping demand into many other sectors of the economy such as lumber and nonmetallic minerals. Moreover, falling home prices begin to challenge home owners' mobility and causes labor market rigidities.

Financial Markets are beginning to signal the end is near

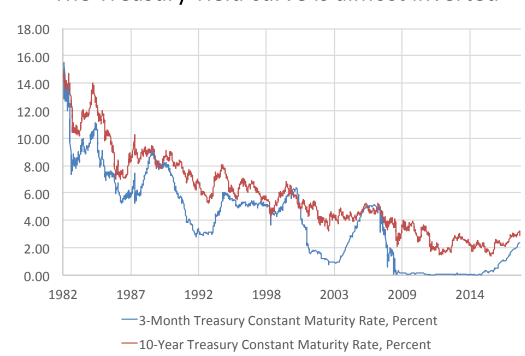
Volatility finally rose in the second half of 2018 as financial market participants began to sense that the economic expansion was going to lose its thrust and soon.

The S&P 500 started down as VIX increased



First, the stock market lost it upward momentum. It has fallen 8% since its peak in September. As a result, the equity markets have lost all of this year's gain. Strategists no longer view the decline as a correction. However, we must recall the wisdom from the former Nobel Prize-winning economist, the late Professor Paul Samuelson of MIT, who said 'the stock market has predicted 10 of the past 6 recessions'.

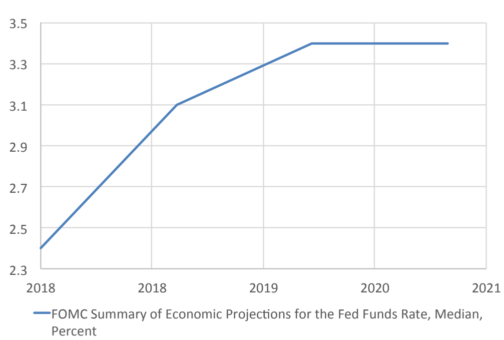
The Treasury Yield curve is almost inverted



Second, the yield curve (the spread between bond yield equivalent 3-month bill yields and 10-year Treasury note yields) has flattened, and when the Fed raises interest rates the next time, it will invert. And as was mentioned, it will become one of the most potent predictors of the next recession.

Third, The Federal Reserve has lifted its Federal funds rate 9 times in the past two years and is intent on raising it further. The current Chairman stoked markets recently by saying that the Fed funds rate is near to where they are targeting. However, another three, 25 basis point increases will raise it to 3% in early 2019. The FOMC has predicted that their estimated neutral Fed funds rate is 3.4%. While the Fed may believe this is a neutral rate, the markets may consider it much too tight for a slowing economy and additional tightening will propel the Treasury yield curve into inverted form early in 2019.

FOMC projected neutral Fed Funds Rate

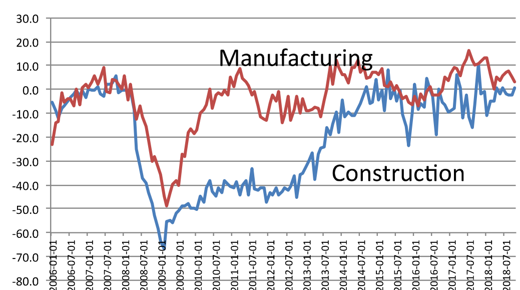


The EU faces Brexit

Brexit might have been the catalyst for more populist movements to begin in the rest of the EU, but it was also a symptom of some deeper issues percolating within the EU. For the UK a non-flattering deal reached between PM Theresa May and the EU negotiating team leaves Britons with the unwelcome choice of deciding on a poor deal or no deal. Either way the vote will weaken the present government in the UK and start them down a long and complicated journey to untangle their businesses from the EU and set up all those inefficient border bureaucracies that trade unions had eliminated.

The UK will slide into a no growth environment in 2019 as they attempt to grapple with the specifics of not having immediate access to the EU consumer market and to the tariff-free supply chain that EU membership provided.

UK: Confidence surveys are falling since mid 2017

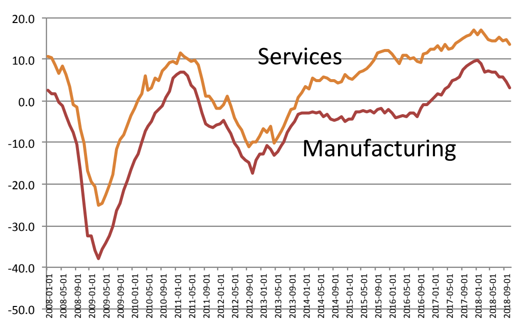


The EU is falling apart

The EU is now breaking down politically; member country by member country. At first, it was the populist movements in Poland and Hungary and the on again off again decision by the Spanish in Barcelona to cleave themselves from Spanish rule. Then came the fantasy union between the far left and far right parties in Italy to agree to form a government that is designed to deny the authority from EU rules and leadership. They are currently challenging the EU leadership with a budget well over the EU guidelines and are daring the EU to penalize them.

Then the longstanding Chancellor of Germany, Angela Merkle, and spiritual leader of the EU announces her retirement under duress from nearly all sides of the political spectrum in Germany. No clear successor has presently surfaced. Finally, the co-heir to the success of the EU, the French President Macron, is being throttled by violent riots in all large French cities where participants are demanding his departure.

EU: confidence turning down at start of 2018



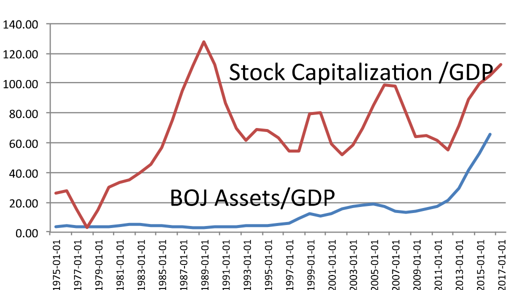
Economic growth in France is meager and, under the violent fabric of class warfare, businesses will be unwilling to invest, and ordinary citizens will hunker down rather than consume quantities of sugarplums during the holiday season.

Economic growth in the EU is predicted to gradually slow to a rate below their officially agreed miniscule long-term growth path of less than 1%. The German economy, the largest economy in the EU, has already begun to falter. Thus, EU growth next year is on the border of recession and, if political distress accelerates, then recession in the EU is inevitable.

Japan muddling along

Economic growth in Japan has begun to retreat from 1.9% in 2017 to 1.3% year/year growth in mid-2018. Trade tariff tensions have started to depress corporate confidence and investment. Moreover, the growth slowdown in China, Japan's second largest market, has directly impacted production in Japan. Natural disasters in Q3, 2018 caused economic growth to dive to an annualized pace of -2.5% and this pushed year on year growth below 1% in Q3. The biggest loss was in business investment, which plunged 10.6% on an annualized basis. Economic growth in Japan is forecast to slow significantly further in 2019 as US economic growth subsides.

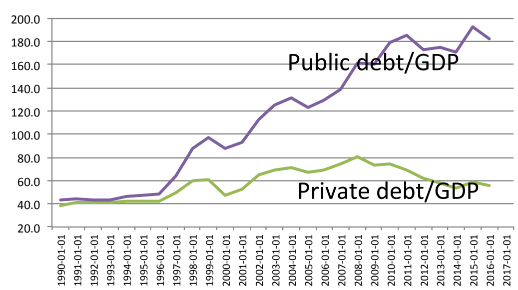
The BOJ is supporting more than the JGB market



The Japanese government has run out its

Abe economic stimulus and is hoping that continued aggressive monetary policy can buoy the economy. It appears that the BOJ's quantitative easing strategy has contributed to the appreciation of Japanese stock prices. The ratio of stock capitalization to GDP is nearly as high as it was at the end of the boom in the late 1980's when the Japanese economy was strong, unlike today.

Japan: Public Debt up Private Debt down



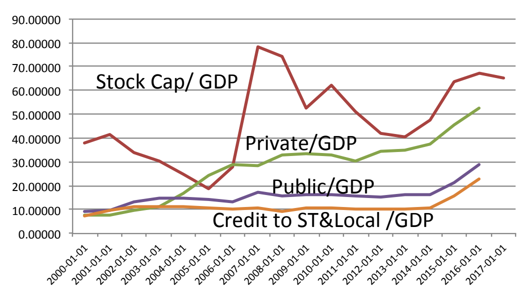
Another symptom of the government's usurpation of the economy is seen in the following chart, which reveals that public debt is soaring while private debt is declining. Corporations aren't financing growth despite the BOJ's ultra-low interest rate policy. This is evidence of the private sector's lack of confidence in the economy.

China: An opaque question mark

Real economic data from China is always hard to find – or held back – and unreliable when it is. Chinese data from 2016 evidences rising debt levels relative to GDP, particularly private debt. Reports (but no data) indicate that private debt, and State and local credit has increased significantly since then, especially in 2018 when the government began attempting to stimulate economic growth to make up for lost activity due to the tariff imbroglio.

Trade data with other countries, such as Japan, imply that domestic consumption in China is slipping amidst uncertainty over trade with US and imposition of tariffs. It is most apparent in automobile sales data that reveal consumers have tightened their wallets. Purchasing managers surveys also indicate a decline in business confidence. The headlines in the newspapers report that manufacturing and construction companies have begun extending holiday vacations without pay for thousands of workers.

China: All forms of Debt is rising



Conclusion: Politics rather than economics will halt this Global Expansion

Trade tensions exist and will exacerbate the decline in business and consumer optimism throughout the year. President Trump is trying to make gold out of clay, but the financial markets will look through the positive rhetoric and spin equity prices lower in 2019.

Congressional gridlock will freeze fiscal policy throughout 2019, when Democrats regain control of the House. Their intension will be to damage the President's chances for reelection in 2020 even if it means no economic growth.

The FOMC is on a path to raise interest rates higher. Every step they take — it could be four — the yield curve will invert further and herald recession in 2019. As US interest rates increase, they will support the dollar in foreign exchange markets. The US dollar is already relatively strong, making improvement in international trade very difficult.

At present there is no evidence of a private sector credit pileup in households, or businesses in the US, as there was in 2008. Therefore, credit woes will not precipitate, nor exacerbate the oncoming recession.

There is no help coming from abroad. The EU is suffering from its internal political turmoil and will not be an engine of growth in 2019. If political crisis erupts more robustly than it has in 2018, the EU economy will suffer and at best stagnate and more likely creep into recession. A recession in the EU will merely aggravate existing political tensions and could easily cause referendums in the EU on broader national extractions from common membership.

Leadership is lacking within the EU. First, Merkel and then Macron have distanced themselves from playing a lead role in solving EU problems and providing guidance for the future. Reform in the EU is needed to overcome the tribulations emanating from Brexit. In the absence of German/Franco leadership, the populist parties will run rampant throughout the EU, wreaking havoc on the present institutional fabric of the EU.

The EU is shattered. Divisive political agendas are voiced from the fringes and even the center. There is no leadership and no coherent policy prescription to counter the criticisms. Economic growth will probably decline well below it's less than 1% long run equilibrium rate of growth in 2019.

The UK economy will stagger through 2019 either coping with an unpopular exit agreement or surviving the economic calamity of no agreement and a new government leadership skirmish. Either way business investment will shrink until a new economic path through the political turmoil is discovered. The UK economy will be the victim of the political quagmire and will wilt into recession in 2019.

The Japanese economy, an externally driven economy, faces rapidly slowing economic growth from China and a projected recession in the US during 2019, its two biggest markets. Moreover, it's fiscal and monetary polices are limited by extent of their excessive use over the past few years. Consequently, economic activity in Japan is expected to be miniscule, or nonexistent.

China's economic dilemma is coping with an economic growth engine built upon cascading rounds of government infused debt, globally low wages and a relatively cheap currency. Now, when higher tariffs are increasing relative prices the Chinese government needs to provide more support. They can and will, but economic growth in China is unlikely to return to the rates experienced in the past, especially when external markets are in, or near recession.

The political breakdown of the liberal, democratic, international global order will leave economies needing more government support and financial markets will need a new regime to believe in.

For more information, please contact
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	KEY INDICATORS TABLE (AS OF 30 NOVEMBER 2018)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	2760.17	2.04%	2.04%	6.26%	6.26%	3MO LIBOR	2.74	83.96
FTSE	6980.24	-1.58%	-1.58%	-0.74%	-6.28%	10YR UST	2.99	24.00
NIKKEI	22351.06	1.96%	1.43%	0.26%	-0.73%	10YR BUND	0.31	-14.83
HANG SENG	26506.75	6.23%	6.46%	-5.93%	-6.10%	10YR SPG	1.50	3.92
STI	3117.61	3.34%	4.36%	-5.85%	-7.50%	10YR SGS	2.35	10.40
EUR	1.13	0.04%		-4.93%		US ISM	59.30	1.89
YEN	113.57	0.56%		0.92%		EU PMI	51.40	-13.81
CMCI	1180.38	-4.94%		-3.96%		JP TANKAN	16.00	0.00
Oil	50.93	-22.02%		-11.27%		CHINA IP	5.40	-11.48

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency