the advisor

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Kishikan

(Japanese for Déjà vu)

"Every day, in every way, I'm getting better and better". Émile Coué (1857 - 1926)

Cognitive dissonance rules!

The US stock market sits near an all-time high, credit spreads remain tight, inflation is benign, unemployment is at a fifty year low, and the ten-year old economic expansion will shortly set a record as the longest ever. In every way, could this economic cycle get any better?

This cycle has also led to higher structural budget deficits, higher household, private sector and government debt, declining interest rates, negative real yields, a growing number of 'zombie corporations' (kept alive by cheap financing), inflated financial asset valuations, and a financial system that is increasingly vulnerable to exogenous shocks.[1]

The American economy is sending mixed messages. Investors seem to be either buying the dream (stocks) or buying the reality (bonds).

As with optimistic auto-suggestions, there is a pervasive belief that the US Federal Reserve has everything under control, "the economy is strong", and there is "no recession in sight". It has become commonplace to dismiss the current investment climate with the premise of "this time is different."

It is different in the sense that, since 2009, Americans have been living in the false reality of a recovered economy. Debt has created that illusion. And it's not just America. Global debt is at an all-time high of roughly US$250 trillion and global debt-to-GDP is approaching 300%.

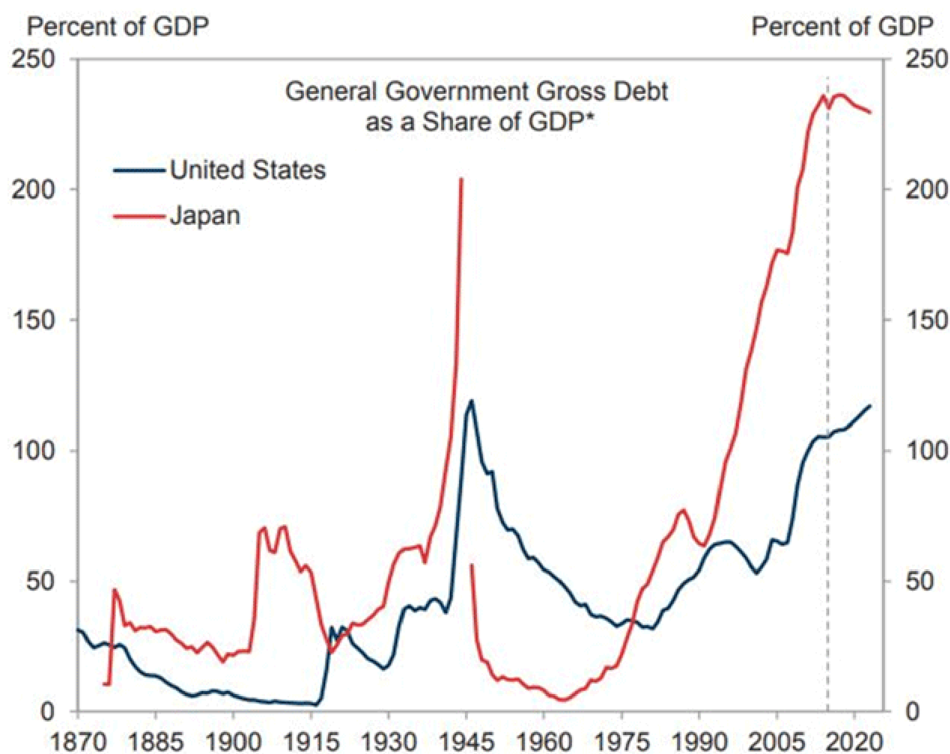
Because the world has too much debt, it is unable to grow at historical rates. In fact, the more debt there is, the lower interest rates have to be and the lower future economic growth will be.

With global economic data deteriorating and trade tensions increasing, some investors think the Fed will come the rescue by cutting rates again. Policymakers are claiming that any rate cuts would be nothing more than insurance for an otherwise strong economy to stay that way. The stock market's view of more rate cuts is one of near giddiness. But access to credit isn't the problem. Businesses that want to borrow can and do so on good terms. The problem is businesses don't need to borrow unless they are growing, which most are not. The Fed cannot rescue that.

We've seen this story before. It is eerily reminiscent of Japan's own monetary policy experiment to ward off deflation. Since the bursting of the bubble in the early 1990s, Japan's economy has been ailing.

The Bank of Japan (BOJ) has kept its monetary policy rate at or near zero for the past twenty years, without much to show for it. In that time, GDP growth has barely registered and inflation is nowhere to be found.

"Abenomics", an immense Keynesian programme financed by the BOJ, was then unveiled to much fanfare. It



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too has been a bitter disappointment.

Quantitative Easing (QE) programmes, such as asset purchases (the BOJ now owns over 45% of their government bond market and over 75% of their stock ETF market), plus various fiscal policies, such as infrastructure projects, tax relief and deregulation, have had little positive effect.

One thing the BOJ has engineered successfully is to drive down the yen's exchange rate, much to the ire of its trading partners. But the BOJ still seems to have lost the battle against anchored inflation expectations.

Japan's inflation problem has coincided with a demographics challenge: it has the world's oldest population and a population that has been shrinking since 2011. The global minimum worker-to-retiree ratio should be between 2.8 and 3.2 in order to afford to pay retirement benefits to a country's citizens; Japan's worker-to-retiree ratio is just 1.8. Japan already has a pension funding gap and will thus have to run budget deficits to support its retirees.

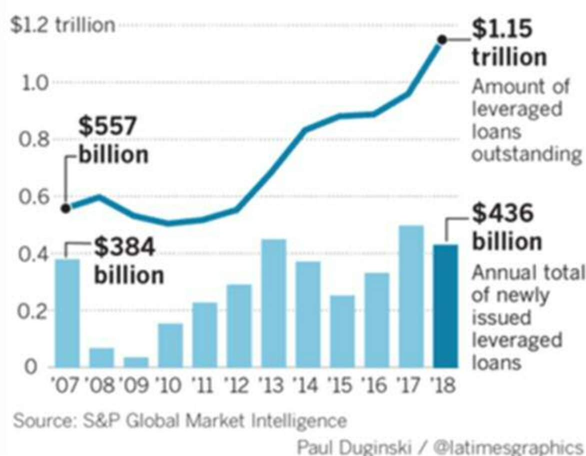
As the chart on the previous page shows, at least there is a lot more debt.

So the world's oldest society staggers on under an enormous debt burden without much prospect of economic growth or inflation to lessen the load.

If Japan's anti-deflation experiment has not worked, why model it elsewhere?

The Federal Reserve gave it a go anyways, with a zero rate policy from 2008 through 2016, which was largely ineffectual at generating growth. Then the Fed tried QE, and continued it despite the limited success and harmful side-effects (i.e. encouraging borrowing and higher asset prices). The European Central Bank followed suit, with even larger amounts, also to little effect. Now America is copying Japan's fiscal policy with deficit spending. The Japanese deficit as a percentage of GDP is projected to be below 4% while the US is closer to 5%. And given the ever-widening unfunded liabilities (i.e. Social Security, Medicare, etc.) gap, the US budget deficit will only grow in the future.[2]

Belatedly, the Federal Reserve is acknowledging the growing risks from their monetary experiment. In its latest financial stability report, they noted the high debt owed by American businesses as a top vulnerability facing the financial system. The report cited potential risks tied to non-financial corporate borrowing, particularly leveraged loans - a $1.1 trillion market - that grew by 20% last year amid declining credit standards. The report also warned of concerns from elevated asset prices.[4]



According to economist David Rosenberg: "There is no way you ever emerge from eight years of free money without a debt bubble. If it's not a Lat[in] Am[erican] cycle, then it's energy the next, commercial real estate after that, a tech mania years after, and then the mother of all of them, housing over a decade ago. This time there is a huge bubble on corporate balance sheets and a price will be paid. It's just a matter of when, not if."[5]

When it comes time to pay the price, a key risk will be market liquidity. When everybody heads for the exit, liquidity risk scales asymmetrically with the amount of debt in the financial system. Not everyone will be able to get out, let alone at the price they want.

Presently, the US economy is sending a confusing message, of rude health on the one hand and of signs of slowing on the other. Paradoxically, perhaps the dreamers and the realists are both right. Eventually one message will prevail, but probably not without the Fed's intervention.

This economic cycle may well continue but it will cost more debt, more QE and will jeopardize market stability. Despite the Fed's optimistic auto-suggestions, the experiment's marginal benefits are diminishing.

Lower interest rates will not prevent the next recession. However, they may drive America further down the same path that Japan is on.

Sources:

1. Jesse Colombo, "Trying To Prevent Recessions Leads To Even Worse Recessions", Clarity Financial, 21 June 2019
2. John Mauldin, "Japanified World Ahead", Thoughts from the Front Line, 2 April 2019
3. Chart page one, Ibid
4. Financial Stability Report, US Federal Reserve, May 2019
5. Lance Roberts, "What Could Go Wrong? The Fed Warns on Corporate Debt", Clarity Financial, 9 May 2019
6. Chart page two, Ibid

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