# Growth STRATEGIES

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## 1 – THE MOST RECENT GDP REPORT: TEPID

The US economy grew at a modest 1.5% seasonally adjusted annual rate from July through September, the Commerce Department just reported. That marked a deceleration from the second quarter, when US gross domestic product – the broadest measure of economic output – expanded at a 3.9% pace. Unspectacular overall growth last quarter remains a worrying sign that the economic expansion could be losing steam.

As reported in the *Wall Street Journal*, the slowdown came at the same time employers eased hiring after adding an average of more than 200,000 jobs a month for a year and a half. Measures of industrial output show the manufacturing sector bordering on a contraction, reflecting the influence of a stronger dollar and China's slowdown. And retail sales, outside of automotive purchases, declined in September and are up less than 1% from a year earlier.

Where does the economy go from here? The following are the views of two economists I track and respect.

## 2 – DEBT WILL CONTINUE TO RESTRAIN GROWTH

Looking at data from the last few weeks suggests that we need to be on "recession watch." Global GDP is clearly slowing down, and the data we are getting from the US suggests that we are going to see a serious falloff in GDP over the next few quarters. So writes John Mauldin.

The recent jobs report was just ugly, he continues. Private payrolls increased by just 118,000, which is about the minimum level needed for unemployment not to rise. Government payrolls added 24,000. There were serious downward revisions to the last two months as well.

While the unemployment rate remained at 5.1%, it did so largely because of a significant drop in the labor participation rate, which is not a good way to enhance employment. Further, the U-6 unemployment number is still a rather depressing 10%. Those are the people who are working part-time but would like full-time jobs, as well as discouraged and marginally attached workers. Very few part-time jobs pay enough to finance a middle-class lifestyle.

### EARNINGS RECESSION

Analysts have been steadily cutting 3Q earnings projections, writes Mauldin. Thomson Reuters data shows analysts expect a 3.9% year-over-year decline in S&P 500 earnings. Expectations are falling for future quarters as well.

These expectations have some strategists talking about an "earnings recession." Just as an economic recession is two consecutive quarters of falling GDP, an earnings recession is two consecutive quarters of falling corporate profits.

The headwinds are no mystery. China's weaker import demand is hurting all kinds of companies, especially raw materials and infrastructure suppliers. Accompanying the falloff in Chinese demand is an increase in the number of containers coming into

the US as the strong dollar allows us to buy more and sell less. Not a particularly useful combination.

## REVERSE DELEVERAGING

One of Mauldin's core beliefs is that massive debt levels have thrust us into a fundamentally imbalanced world. Given what happened in 2008, you might think we would have collectively learned our lessons about debt. We have not. Like an alcoholic who wants to cure his affliction with another shot of whiskey, we seemingly have concluded that the way out of a debt crisis is to create more debt.

Does that sound insane? It is insane, but it's also true. As the author points out, at the end of 2007 the global stock of outstanding debt stood at $142 trillion. Then in 2008 the financial world fell apart. Less than seven years later, in mid-2014, we had added *an additional* $57 trillion in global debt, and the data this year is going to show that we've hit another record high. All the talk about deleveraging was only talk. We didn't deleverage; we re-leveraged and then some.

Does economic growth justify higher worldwide debt levels? Not unless, writes Mauldin, you think the world's economy grew at a 5.3% annualized rate from 2007–2014. Debt levels grew at that rate. GDP did not grow at that rate anywhere except (possibly) China. Debt as a percentage of GDP is even higher now than it was in 2007: 286% vs. 269%. Using 2007 as a baseline is misleading, too. We now know that debt levels that year were excessive by any measure. If we had too much debt then, we have way too much now.

What has enabled such a debt-fueled boom? Low interest rates. US corporations have spent about $1 trillion over the last 12 months on share repurchases and dividends in order to sustain their stock prices. Much of this money was borrowed. Rather than working for an old-fashioned profit increase, businesses resorted to financial engineering.

## WHO ARE THESE RECKLESS BORROWERS?

According to McKinsey data cited by the author:

- Household debt grew 2.8% annually.
- Financial sector debt grew 2.9% annually.
- Corporate debt grew 5.9% annually.
- Government debt grew 9.3% annually.

Banks and households missed their chance to deleverage – which means they will have trouble again in due course – but they at least kept their debt growth in roughly the same neighborhood as nominal GDP growth. We are now in an even bigger debt bubble than we were in 2008. We are going to pay for it and eventually deleverage, but the process will look different this time. This is why everyone is so focused on when the Federal Reserve will finally raise rates.

## WORKING OUT OF DEBT

Mauldin concludes by citing Kenneth Rogoff and Carmen Reinhart, who wrote the seminal book *This Time Is Different*, cataloging more than 250 financial crises in 66 countries over 800 years, looking for differences and similarities.

Among Reinhart and Rogoff's findings is that it takes much longer to work off the excesses of a banking crisis than it does a typical business-cycle recession. The process can stretch out for years, with unemployment higher than normal and consumer demand sluggish the whole time.

The working-out process will not be easy. Reinhart and Rogoff say that after a banking and credit crisis it is typical to have 10 years of slow growth, and that economies in this situation often bump up against a kind of growth "ceiling." That matches what we see in the US right now.

Are we near the end of the process? Not likely. If recovery from a banking crisis can take ten years and we are only seven years in, then we have a few more years to go. A slow, muddle-through recovery may not be exciting – but it's better than the alternatives.

## 3 – WE ARE VERY LATE IN THIS CYCLE

The global economy is in an epochal deflationary swoon and the US economy has already hit stall speed. It is only a matter of months before this long-in-the-tooth 75-month-old business expansion will roll over into outright liquidation of excess inventories and hoarded labor. That is otherwise known as a recession. So writes David Stockman.

Writing of the recent GDP report, Stockman notes that the year-over-year gain of just 2.0% was the weakest result since the first quarter of 2014. And that's only if you believe that inflation during the last 12 months was just 0.9%, as per the GDP deflator used by the Commerce Department.

Moreover, the year-over-year gain in *nominal* GDP was only 2.9%, which represents a continuing deceleration. That's critically important, notes Stockman, because this has not happened since the 1930s. Our modern debt-dependent economy rests on the assumption that nominal GDP growth will be always sufficient to keep incomes – both private and government – growing faster than the carry cost of the debt. That assumption is coming under question.

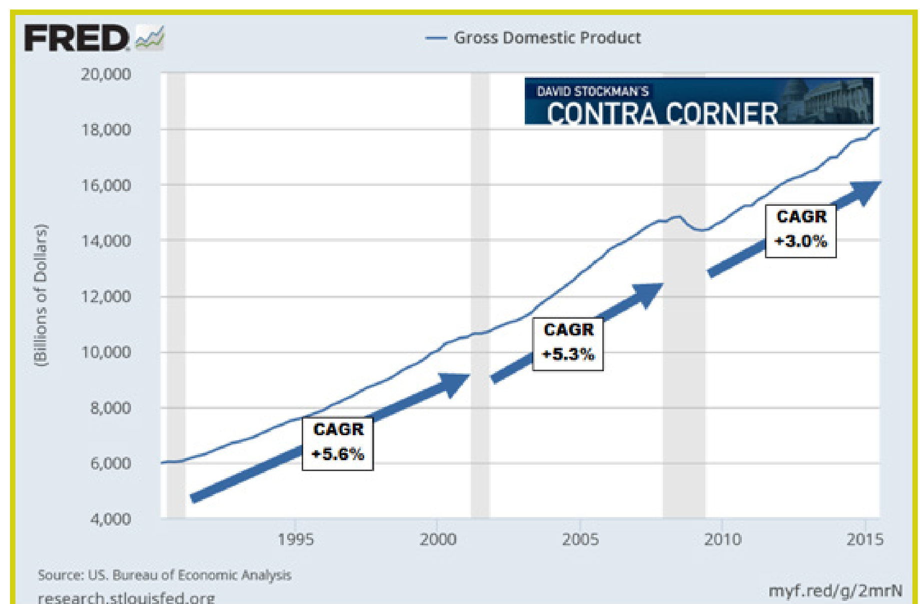
The ten-year forecasts for the Federal budget, writes the author, assume nominal GDP growth of 5.2% per year – that's the essential driver of long-run government revenue projections. Even then, CBO projects that after purportedly hitting "full-employment" around 2018 the Federal deficit will once again start rising, hitting $1.1 trillion per year early in the next decade.

But if nominal GDP growth continues to sink toward the flat-line, as it has clearly been doing for quite some time now, Federal tax collections will come in far below current projections, thereby causing the deficits and the national debt to soar.

And that risk is not appreciably different when it comes to the private household and business sectors, he notes. Each has credit market debt outstanding of about $13 trillion. How will nominal GDP ever be able to grow out from under these staggering financial burdens?

The graph below shows nominal GDP for the last three business cycles. During the 1990s recovery it expanded at a 5.6% annual rate, and during the Greenspan housing/credit boom after 2001 it grew at 5.3%.

But now we are 94 months from the pre-crisis peak and the growth rate of nominal GDP has plunged to 3.0%. What's more, that drastically lower trend rate includes the impact of the deep recession of



2008-2009. If we look at the trend since June 2009 the picture is just the opposite of the Wall Street "escape velocity" mantra.

To wit, during the first three years after the recession bottom, nominal GDP grew at a 4.0% rate. While that's still well bellow the historic trend, the more important point is that nominal GDP growth has been steadily decelerating since Q2 2012, not picking up speed as endlessly claimed by the Kool-Aid drinkers.

Therefore, when it comes to the single most important macro variable in a debt-driven economy – that is, nominal GDP – you can forget about the winter snow excuse or the inventory adjustment rationalization that have been offered to explain disappointing results in recent quarters.

The fact is, this quarter's tepid 2.9% GDP growth over prior year is unequivocal proof that the US economy is stalling – and notwithstanding the massive monetary "stimulus" that has been thrown at it by the Fed.

When you look inside this deflating GDP envelope, the warning signs become even more striking. Thus, it has always been the case that business plant and equipment spending accelerates as a business recovery ages and picks up steam, reflecting the need for expanded capacity.

***Yet Q3 2015 outlays of $1.579 trillion were just $9 billion higher than during Q3 last year. That's a rounding error gain of just 0.6%, but worse than that, it's a sign that real main street businesses see no evidence of impending escape velocity whatsoever.***

Even the old Keynesian standby of Federal spending on goods and services – which totals about $1.2 trillion annually – has not been doing much for GDP growth in recent quarters, and is virtually certain to weaken further owing to Washington's fiscal policy paralysis. That's all to the good from a fiscal sanity viewpoint, but it also means that another prop under the initial post recession recovery bounce has been removed.

To be sure, continues the author, the Wall Street stock peddlers will resort to the shop-until-they-drop American consumer card when all else fails. But the 3.5% gain in nominal PCE (personal consumption expenditures) during Q3 compared to prior year is nothing to write home about. ***That's especially the case because nearly one-third of that $415 billion gain was accounted for by health care and auto sales.***

It seems reasonably evident that car sales have already peaked owing to the exhaustion of sub-prime customers and that peak Obamacare is not far behind. In any event the release of personal income and spending for September left little to the imagination. Wage and salary income actually dropped in September and has been visibly weakening for the past year.

In a world in which consumers are already at peak debt and late cycle reversion to inventory and jobs liquidation lies just around the corner, it is not evident where US households will get the wherewithal to even maintain this quarter's 3.5% gain in PCE.

In short, concludes Stockman, there is absolutely nothing "decoupled" about the US economy and no way the Fed can prevent the domestic economy from sliding into the global slump.

After all, the Fed is pushing on a string when comes to the main street economy, and inflating the mother of all bubbles when it comes to the Wall Street casino.

Twice already this century it has been demonstrated that this combination eventually results in tears. Why should this time be any different?