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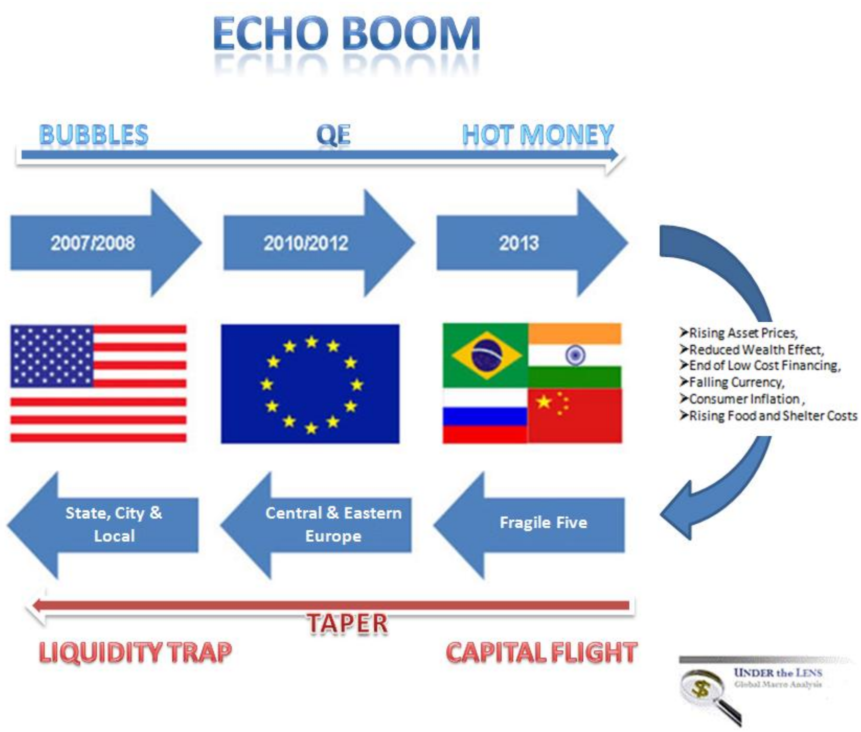
ECHO BOOM - Revisited

MACRO INSIGHTS



Gordon T Long
9/16/2015

ECHO BOOM - Revisited

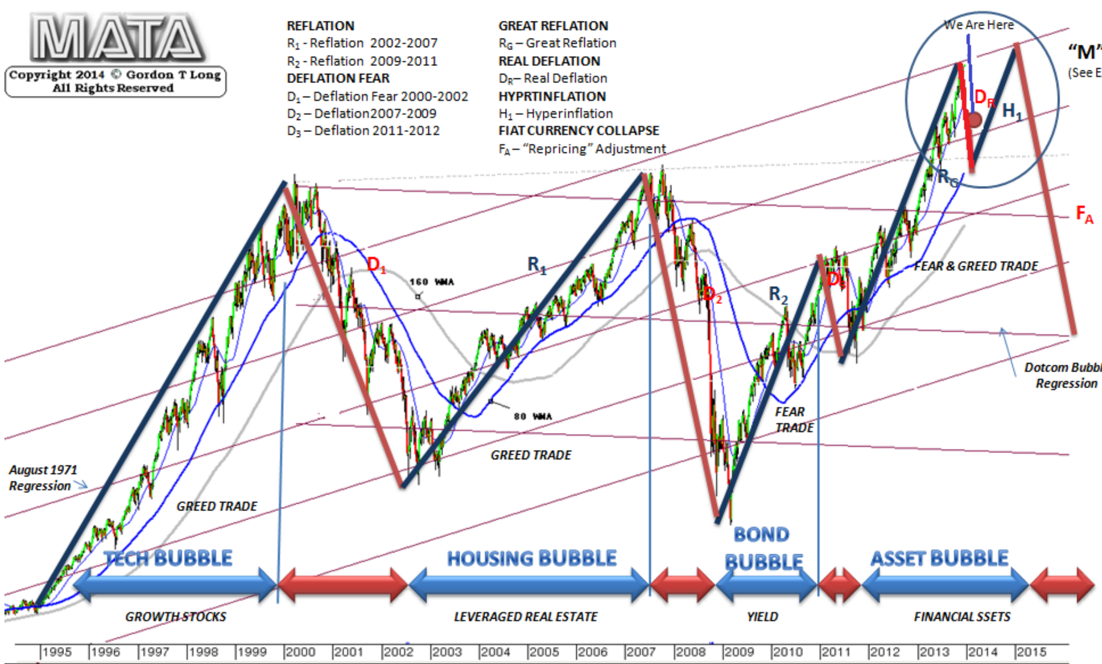
In the fall of 2013 I wrote the Thesis Paper – "The Globalization Trap".

I argued a number of ideas in the paper which are particularly important as we witnessed the August carnage in the Global markets. I felt some of those ideas needed to be revisited:

1- I said that credit acceleration and central bank liquidity growth would lead to a crackup boom. A boom that would come in phases as I will show in the next chart,
2- The resulting asset appreciation would eventually lead to real deflation and then collateral impairment,
3- That cheap money and credit would distort global markets and foster an "Echo Boom" in the Emerging Markets as a direct consequence of an overbuild out in capacity.,
4- The Emerging Markets would be the precursor to what I referred to as "Real Deflation",
5- This "Real Deflation" would force more central bank into further obscene experimental policies such as Collateral guarantees which in turn would ignite hyperinflation due to collapsing currency values.
6- In the final stages the US$ would be the last to be hit by a lack of confidence and the global economies would then see a global fiat currency collapse or more likely a massive global revaluation under distress conditions.

We have been in the "Real Deflation" period for some time now marked by D_r (see chart index below) until recently we haven't seen it in the US equities markets but it has been evident for in other markets for quite awhile now.

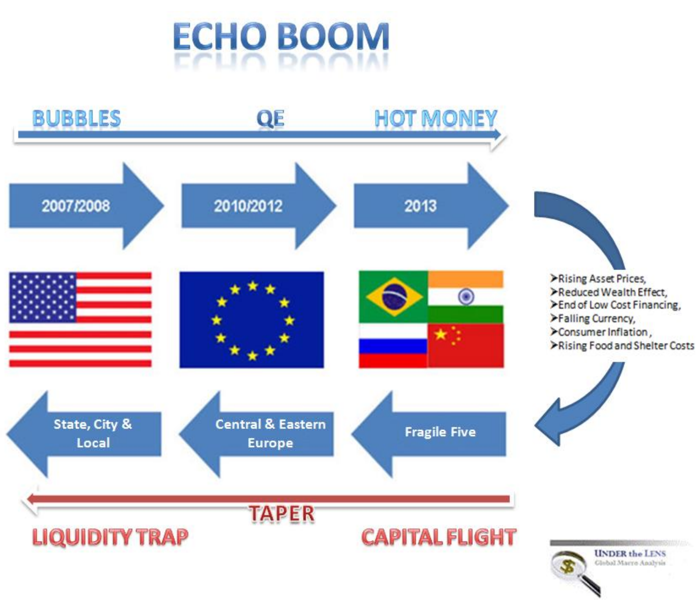
With the collapse in commodities, destruction of oil prices and falling trade volumes it has been devastating to the Emerging Economies. The trigger for the Echo Boom was actually the announcement by the US of "TAPER" or the ending of Quantitative Easing.



We are now on the bottom side of this Echo Boom chart from the Globalization Trap.

We can see below, from the original roadmap, that we expect problems in the Central and European countries to be next, as well increasing problems at the State, City and Local level within the US.

The resulting policy responses here will eventually lead to hyperinflation and that last leg up in US equity markets shown on the previous slide.



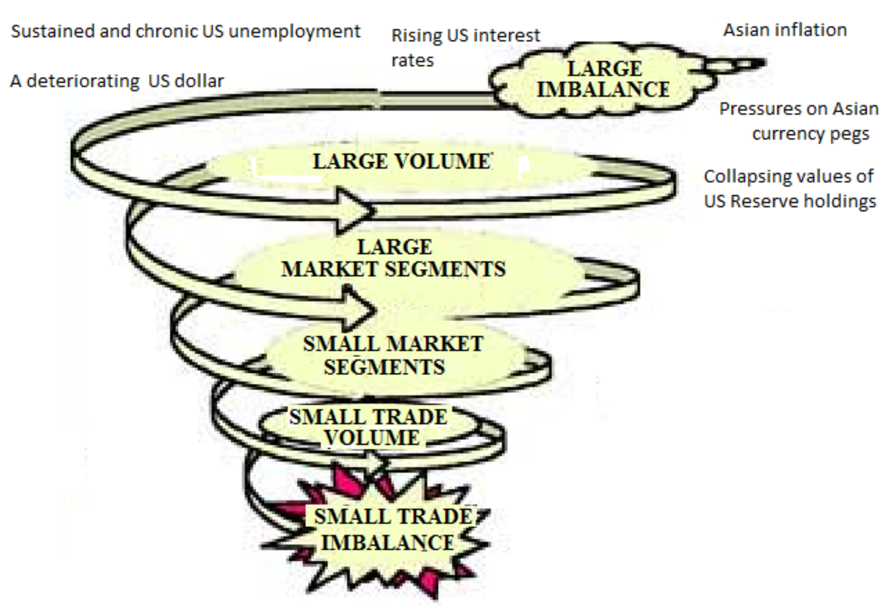
GLOBALIZATION TRAP – The Echo Boom

In May of 2008 during the Financial Crisis I wrote a number of articles arguing we had the initial stages of a breakdown in the Asian Mercantilism Model.

I argued and I quote from the abstracts on a series I wrote on the coming currency wars:

> **May 31st 2011**
>
> **CURRENCY WARS: The Economic Death Spiral Has Been Triggered**
>
> For nearly 30 years we have had two Global Strategies working in a symbiotic fashion that has created a virtuous economic growth spiral. Unfortunately, the economic underpinnings were flawed and as a consequence, the virtuous cycle has ended. It is now in the process of reversing and becoming a vicious downward economic spiral. One of the strategies is the Asian Mercantile Strategy. The other is the US Dollar Reserve Currency Strategy. These two strategies have worked in harmony because they fed off each other, each reinforcing the other. However, today the realities of debt saturation have brought the virtuous spiral to an end. **more>>>**
>
> **May 31st 2011**
>
> **CURRENCY WARS: EU: A FLAWED FOUNDATION, BUT A BRILLIANT STRATEGY**
>
> It was the perception of getting something of value without any meaningful sacrifice that initially fostered the EU Monetary Union. Though the countries of Europe were fiercely nationalistic they were willing to surrender minor sovereign powers only if it was going to prove advantageous to them. They were certainly unwilling to relinquish sufficient sovereignty to create the requisite political union required for its success. After a decade long trial period it is now time to pay the price for Monetary Union. I suspect that the EU membership is unwilling to do so. Though they likely will see the price as too high to do so, the price to not do so has become even greater. They have unwittingly been trapped by a well crafted strategy. **more>>>**

Virtuous Cycle versus Vicious Cycle

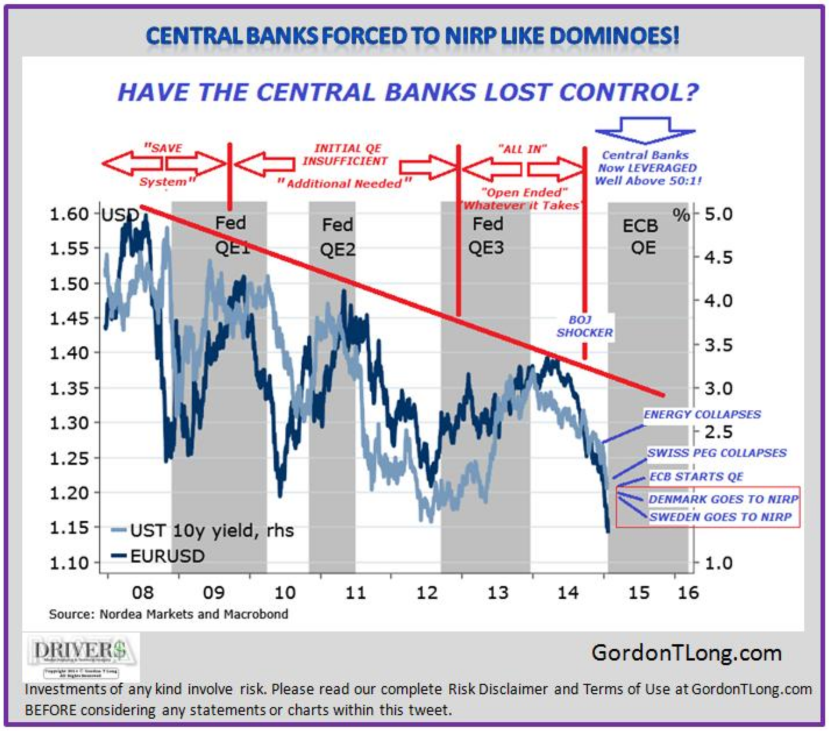


In a recent paper entitled "WTO's Stark Warning On Global Trade: "The Timing Belt On The Global Growth Engine Is Off"", Scott Miller, trade expert at the Center for Strategic and International Studies, a Washington, D.C., think tank states: "It is fairly obvious that we reached peak trade in 2007."

WSJ

> *For the third year in a row, the rate of growth in global trade is set to trail the already sluggish expansion of the world economy, according to data from the World Trade Organization and projections from leading economists. Before the recent slump, the last time trade growth underperformed the rate of an economic expansion was 1985.*
>
> *"We have seen this burst of globalization, and now we're at a point of consolidation, maybe retrenchment," said WTO chief economist Robert Koopman.* ***"It's almost like the timing belt on the global growth engine is a bit off or the cylinders are not firing as they should."***
>
> *Since rebounding sharply in 2010 after the financial crisis, trade growth has averaged only about 3% a year, compared with 6% a year from 1983 to 2008, the WTO says.*
>
> *Few see any signs that trade will soon regain its previous pace of growth, which was double the rate of economic expansion before 2008. In 2006, global trade volumes grew 8.5%, compared with a 4% expansion in global GDP.*
>
> *This year the WTO is expected to cut its 2015 trade forecast a second time after a sudden contraction in the first half of the year—the first such decline since 2009.*
>
> ***"It's fairly obvious that we reached peak trade in 2007,"*** *said Scott Miller, trade expert at the Center for Strategic and International Studies, a Washington, D.C., think tank.*

Since I wrote these papers we had the advent of ZIRP, multiple QE versions and Operation Twist.

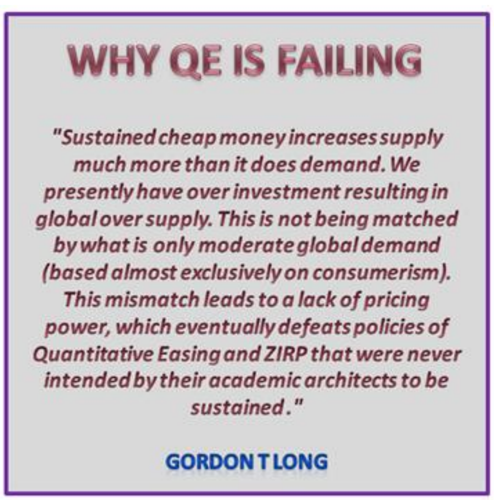


What they did was keep the global economy alive by fostering the growth of debt almost solely for consumption; consumption which was required to keep the US engine of global growth alive. A US economy which was already running at unsustainable levels of 70% consumption.

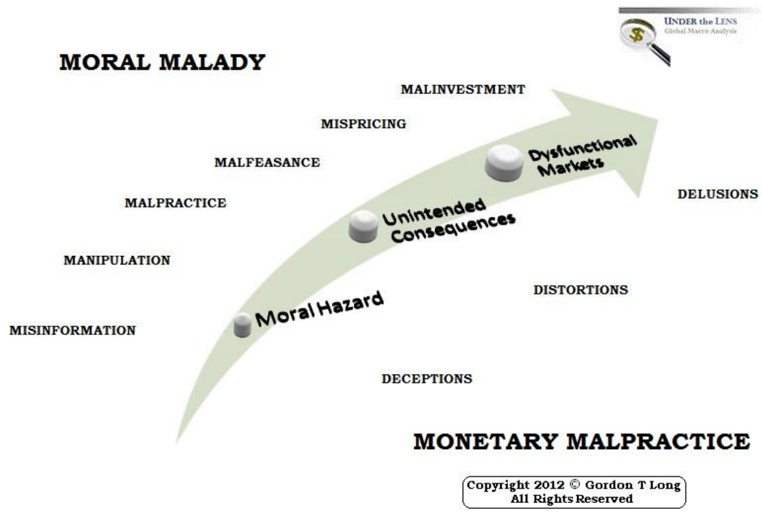
This cheap money marginally increased demand by bringing demand forward.

What is not often appreciated is that cheap money resulted in massive overbuilding of capacity. Evidence can be seen in China's sustained expansion but more importantly in the explosion in commodities and resources from the Emerging Markets.

At some point they come into balance and QE will no longer work. By continuing QE capacity only continues to increase as competition heats up and pricing power is lost.



All of this was perfectly predictable from the discussions we had during this period on the policies of Monetary Malpractice which were fostering Moral Hazard and Unintended Consequences leading to the mispricing of risk, lack of price discovery and malinvestment on monumental scale. Malinvestment which took the form of increased emerging market capacity based on expectation levels of artificial demand.



This is something right out of the Micro-Economics 101 courses taught to any freshman college student.

What actually brings this to ahead is that the falling prices in commodities places the export led Mercantilism business models of the most emerging markets in jeopardy. They potentially can't pay their debt because of now falling current accounts.

But there is something else even more dangerous going on.

Cheap money from the US's cheap money policy resulted in ~$9T being borrowed by Emerging Markets in US dollars. The idea of a "Carry Trade" is to borrow in a currency that will depreciate so you can pay the loan or "Carry" back in cheaper dollars.

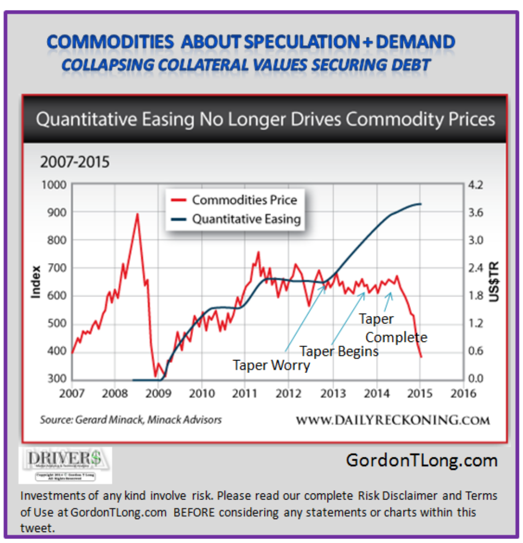
Unfortunately this is not what has happened as the US dollar has skyrocketed upward and Emerging Market borrowers have been caught!

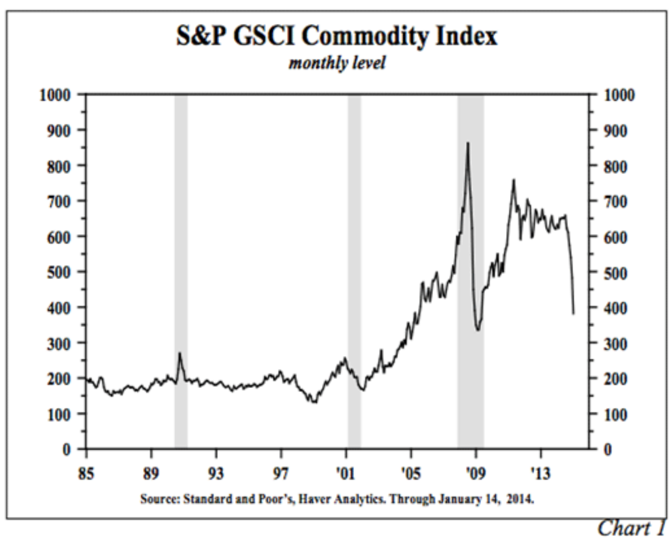
DEVELOPMENTS – Commodity Super Cycle Ends

The problems are getting worse as trade continues to fall as well as oil prices.

As I said earlier this was to be expected and has been evident since the US "TAPER 'program was announced by the US Federal Reserve.

It didn't just coincide with the beginning collapse in commodities but the rising value of the Us Dollar. They are inextricably ties as most commodities are priced and traded in US dollars.

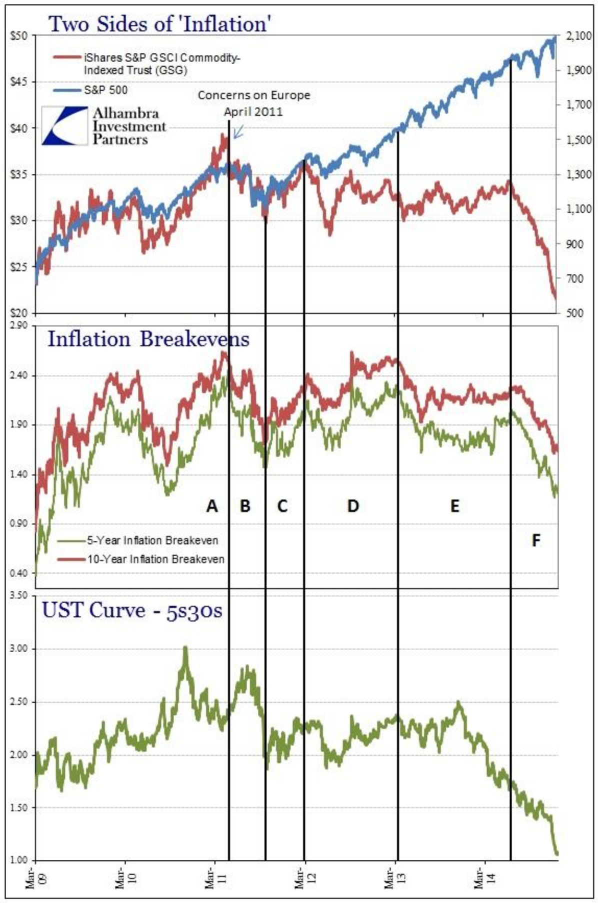




The commodities index is now trading at the lowest level since 1999 just prior to the imposition of the DotComm Bubble. Yet another bubble based on false expectations for real free cash flow growth that would generate real wealth.

BLOOMBERG COMMODITY INDEX SLIDES TO LOWEST LEVEL SINCE 1999

During this period there has been a complete inability of Monetary Policy to generate inflation. Inflation needed to keep Real Rates negative to maintain government debt payments.



A lack of inflation has added to the strength of the US Dollar on a relative basis as it effectively exported inflation and imported deflation.

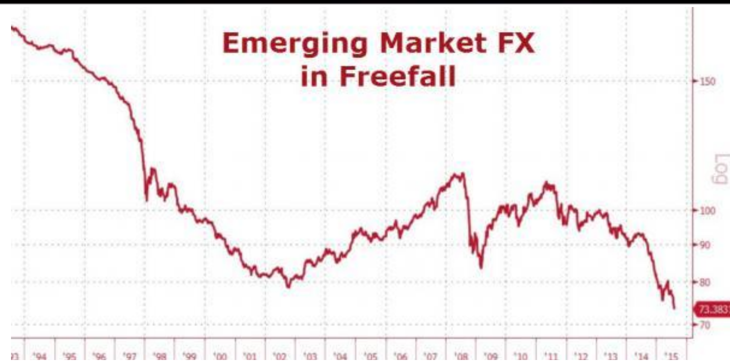
Over the past few weeks, the media has spent quite a bit of time documenting the veritable collapse of EM stocks, bonds, and FX in the wake of China's move to devalue the yuan.

The yuan devaluation effectively telegraphed Beijing's concerns about the economy, confirming fears that the situation was worse than the NBR is willing to admit and putting further pressure on commodity prices which are now sitting at their lowest levels of the 21st century.

Now, with EM in turmoil from Brazil to Malaysia, Bloomberg is out with the following map which sums up the carnage by showing just how many EM equity markets are in or closing in on bear market territory.

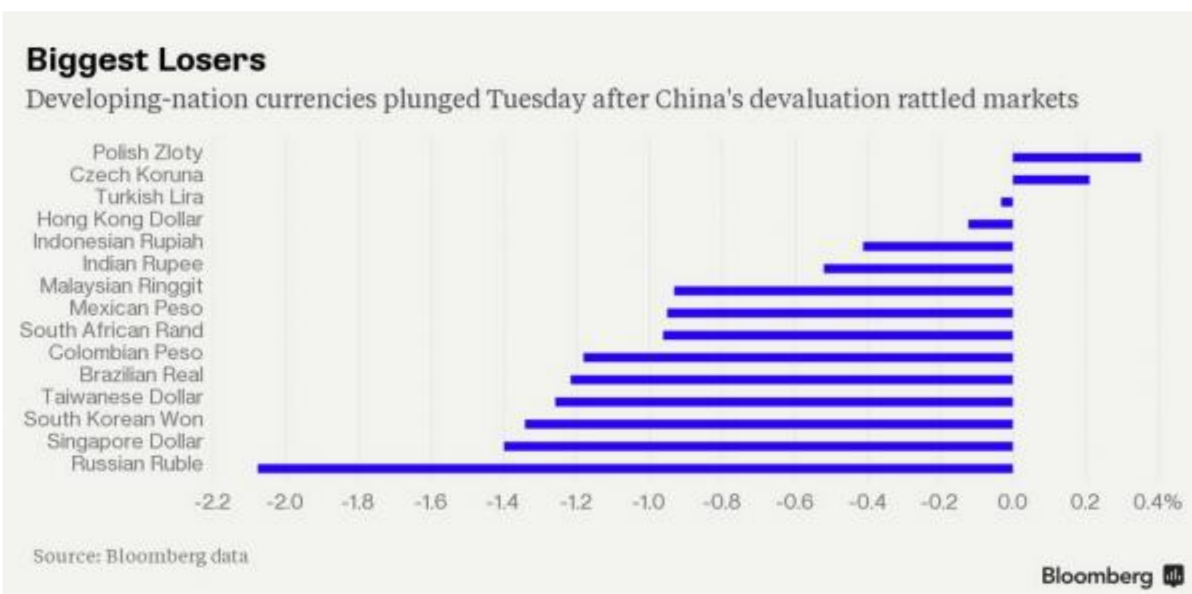
ECHO BOOM – Fx Problems Abound

The currencies of Emerging Markets continue to fall.



We have seen this before in the Mercantilist Export lead Asian Economies.

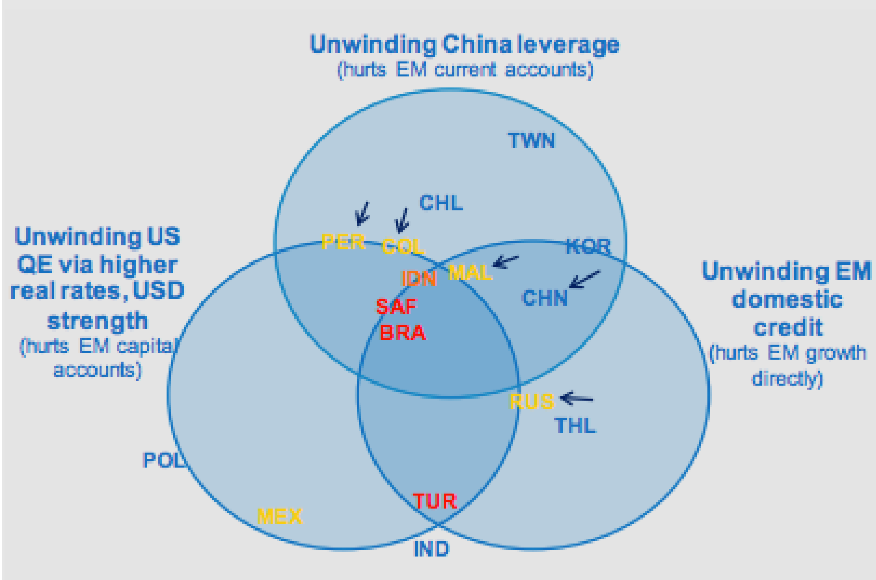
ZH: "[The] devaluation of the yuan risks a new round of competitive easing that may send currencies from Brazil's real to Indonesia's rupiah tumbling by an average 30 percent to 50 percent in the next nine months, according to investor and former International Monetary Fund economist Stephen Jen."



Given the carnage unfolding across EM currencies and the myriad headwinds the world's emerging economies face going forward, it should come as no surprise that sentiment has turned decisively negative. Is it time to be a contrarian? Both BofAML and Morgan Stanley now say so.

Exhibit 1

The Great EM Unwind – A Triple Unwind of EM Credit, China's Leverage and US Monetary Easing



Source: Morgan Stanley Research

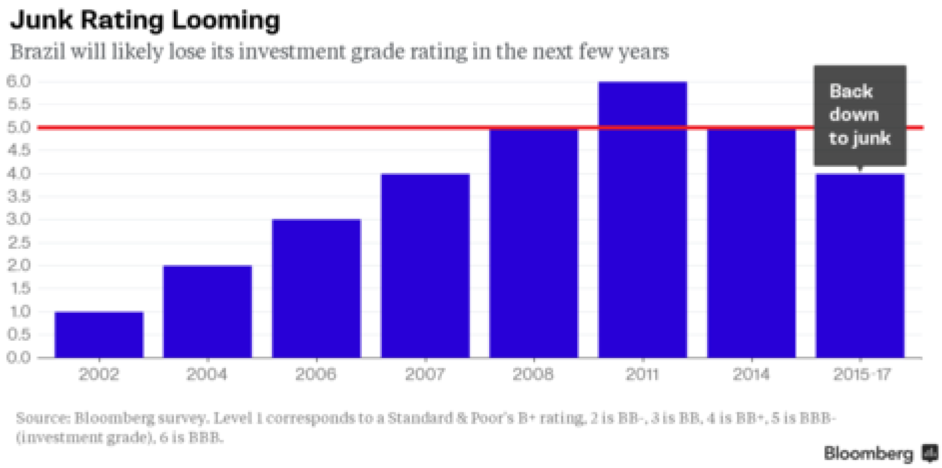
Exhibit 2

Our Heat-Map Heats Up – Particularly for the 3.5 Most Exposed Economies (Indonesia Is the 0.5)

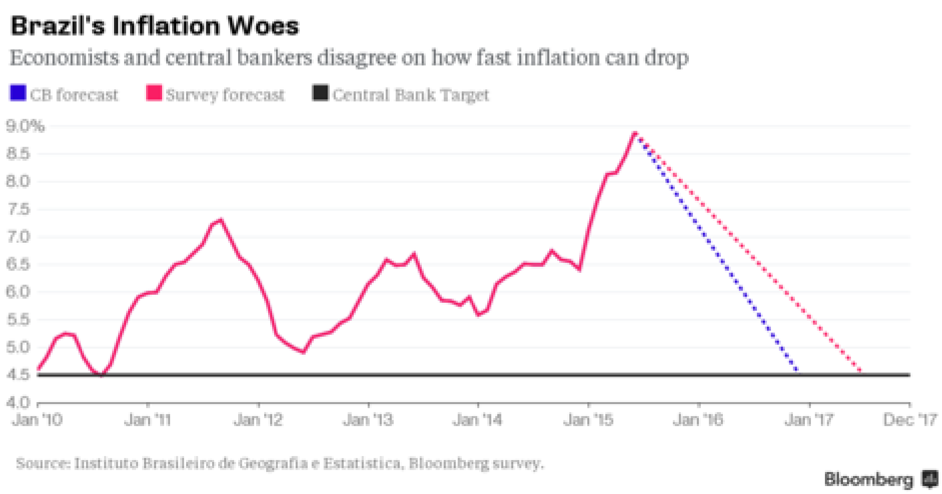
	Surge of Portfolio Flows (% GDP)	Fgn holdings of gov't bonds (% total)	CAB (% of GDP, 4Q rb)	Inflation (YoY)	Real rate (policy rate - current inflation)	Policy 'cushion' (rGDP - real policy rate, 2015e)	Budget Balance (% of GDP, 2015e)
TUR	10%	25%	-5.80%	7.20%	0.30%	3.10%	-1.40%
SAF	13%	35%	-5.40%	4.60%	1.40%	1.20%	-4.20%
IDN	5%	40%	-2.80%	7.30%	0.20%	4.50%	-2.30%
BRA	9%	21%	-4.30%	8.90%	5.40%	-7.50%	-5.30%

Source: National sources, IMF, Haver Analytics, Morgan Stanley Research

As an example Bloomberg reports that Brazil is now looking down the barrel of another likely event: a junk rating of its government bonds. "Latin America's largest economy has a 70% chance of losing its investment grade rating in the next few years, according to the median estimate in a Bloomberg News survey of economists.

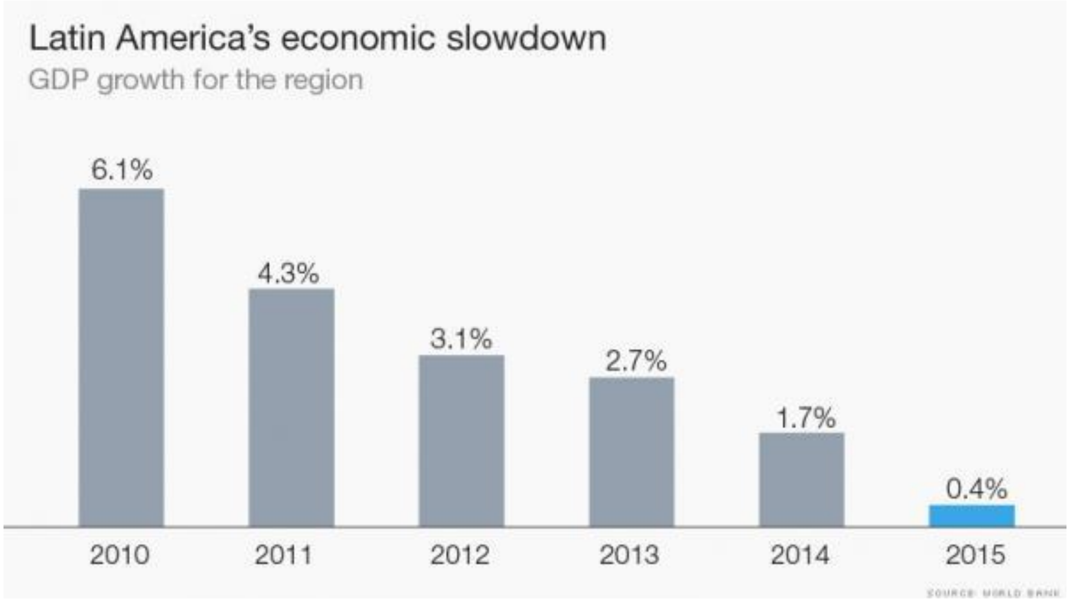


Standard & Poor's said last week it may downgrade the country's rating and revised its outlook to negative from stable. Brazil's bonds are currently rated BBB- which is one step away from junk." Obviously no one believes the official estimates.



Is it any wonder?

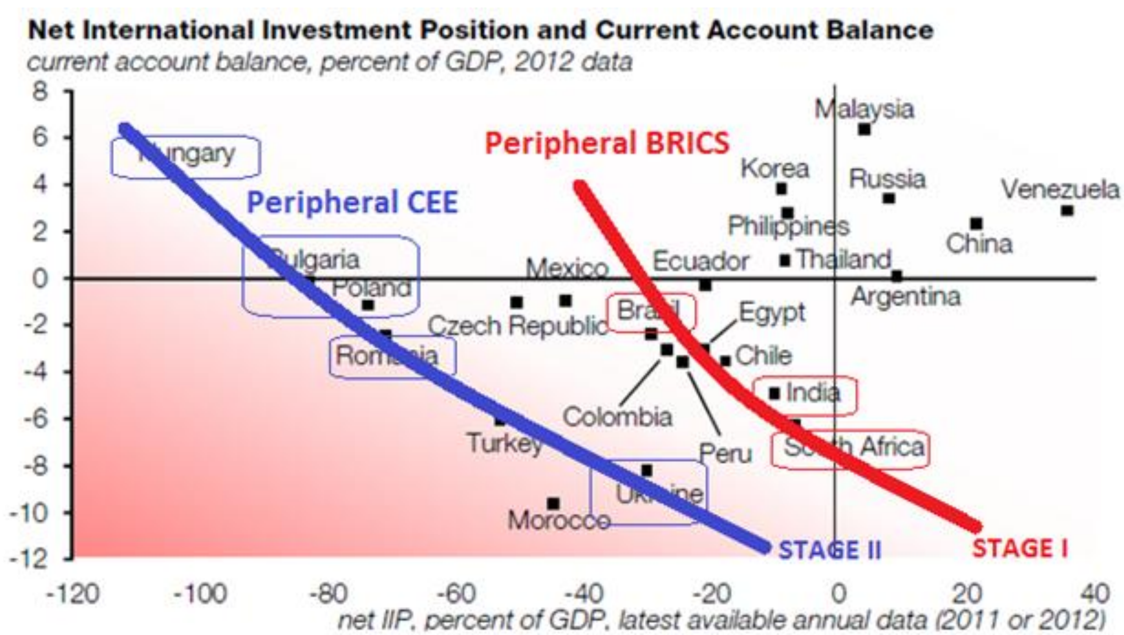
The pattern has been evident throughout areas such as Latin America since the Financial Crisis.



WHAT TO EXPECT

So what do we expect?

We believe that Central and Eastern Europe will soon be a major Emerging Market problem which will seriously impact the already unstable EU banking system.



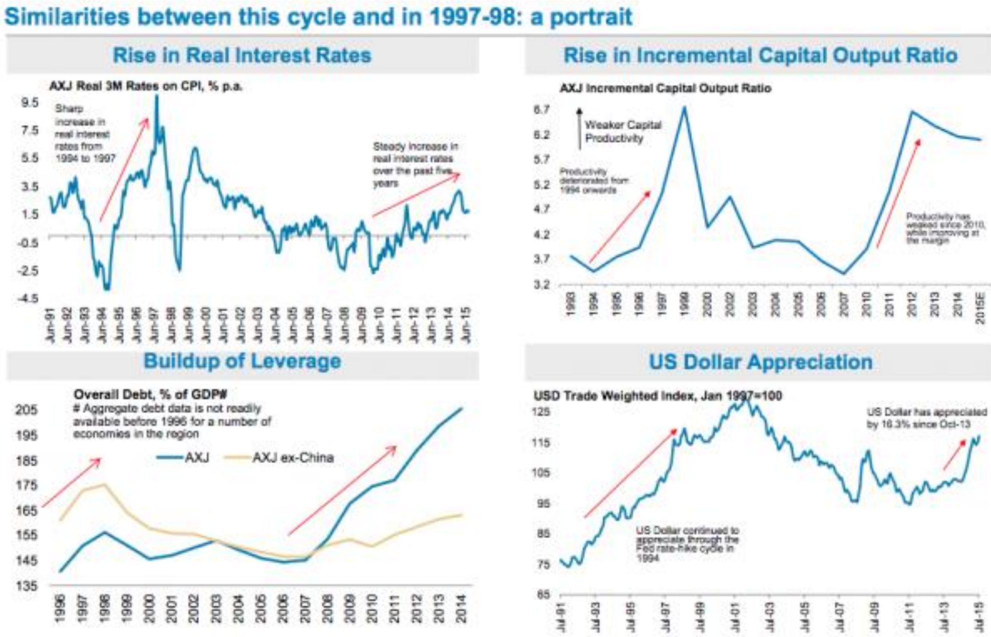
We also believe the February launch of the ASEAN common market will be a major problem for China and Japan.

The problems in the Emerging Markets can be expected to get worse. Potentially much worse!

According to J P Morgan, Asia today has a number of similarities with the 1990s cycle in terms of a misallocation led by a low real rate environment led and then an adjustment cycle triggered by reversal in US Fed monetary policy.

They specifically cite:

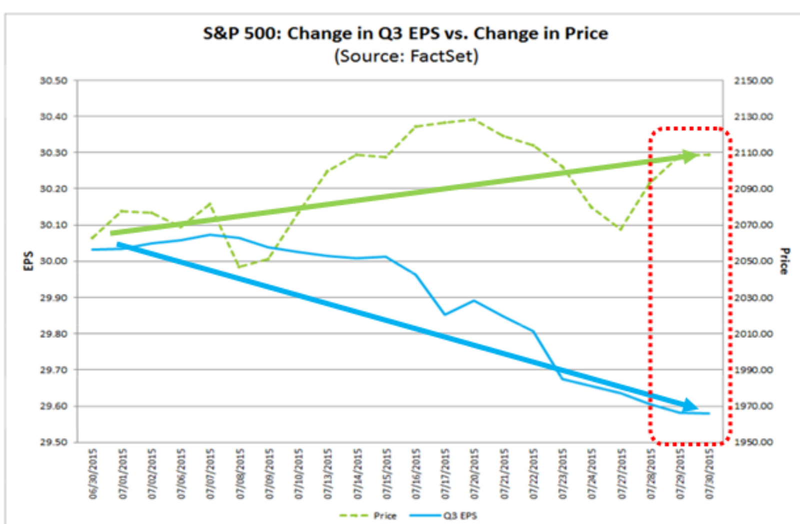
- A low real rates environment – aided by starting point of high excess saving and easy monetary policy in the US.
- Domestic misallocation – in both cycles, there has been trailing misallocation of resources into unproductive areas. This is best seen in the rise in the region's ICOR in both cycles.
- Debt build-up – Since 2008, the region's debt to GDP has risen by 52ppt, to 206% in 2014. Similarly in the 1990s, there had been a buildup of debt in the run-up to the Asian Financial Crisis.
- External trigger – the adjustment phase in both cycles had been triggered by the rise in US real rates and appreciation of the US dollar (though in this cycle, the slowdown in China has been an additional factor in driving the adjustment).

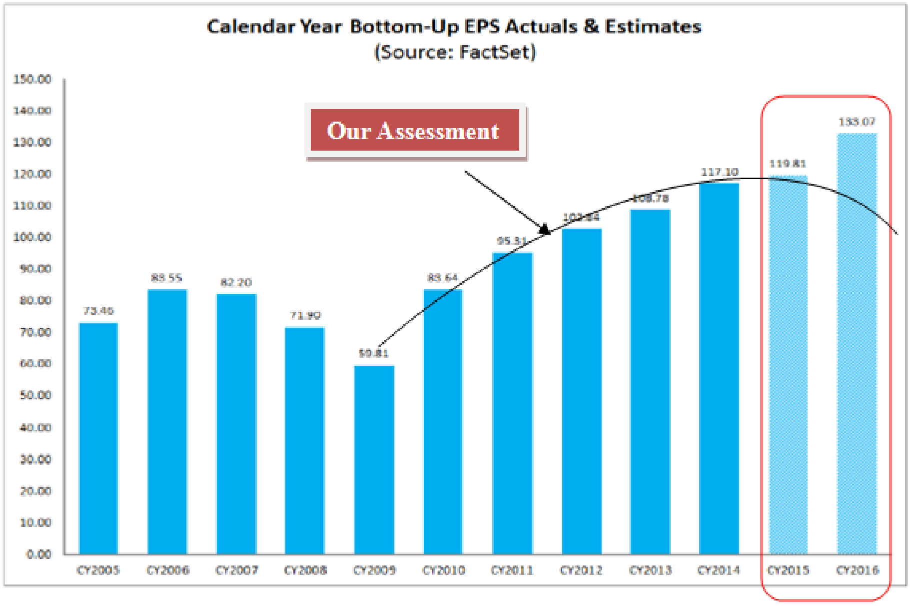


The final key commonality between the Asia crisis and now is the transmission through falling commodity prices and its aftershocks for EM commodity producers, especially those with pegged exchange rates and negative terms of trade shock. Kazakhstan's FX shift from peg to float and risk premium being built into GCC FX forwards for the Saudi Rial and Omani Rial illustrate this fragility now.

Where does the engine of global strength stand in all this?

We believe the US is on the verge of an Earnings Recession because so much of the S&P 500 earnings are now International. Slowing revenues and a rising US dollar are a bad elixir for earnings growth multiples!

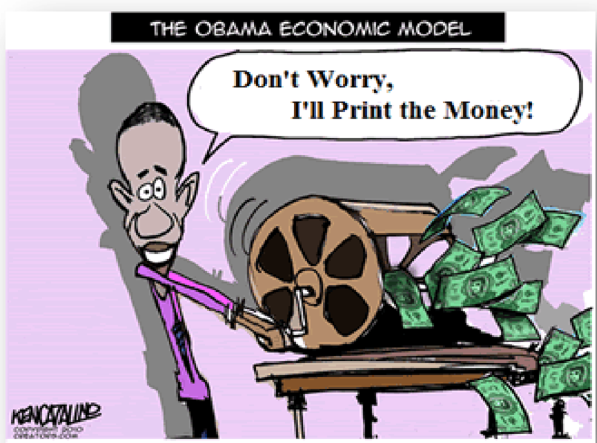




WE SEE AN EARNINGS RECESSION IN 2016

In summary let me remind you every month – don't worry because you know what the government will do.

"Never forget throughout this turmoil: "They will print the money!"



Until No one wants it or Trusts It!

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