GordonTLong.com

GLOBAL SLOWDOWN STEEPENING
Credit Cycle Is Reacting!

MACRO INSIGHTS

Gordon T Long
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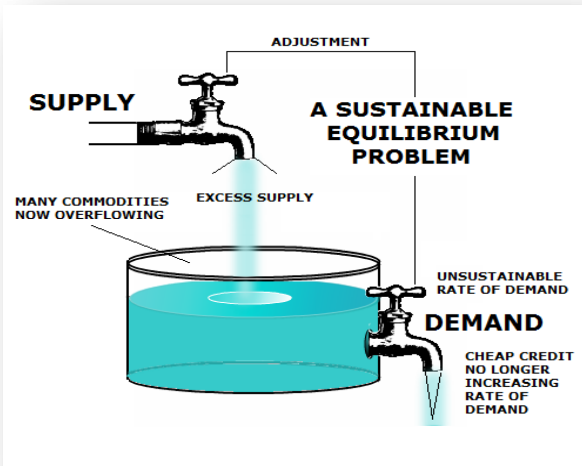
GLOBAL SLOW DOWN STEEPENING

Credit Cycle Is Reacting

QE: A FAILED EXPERIMENT

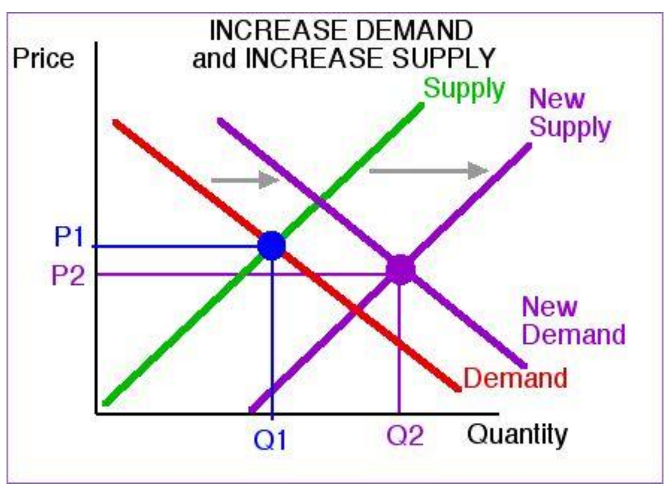
In March in "QE: A Failed Experiment" we started writing about how Quantitative Easing was becoming more about over supply than about its intended purpose of creating economic demand.

Cheap money may help consumers' ability to consume but it was having a much more profound impact on suppliers. It turns out that the expected wealth effect for consumers, paled in comparison to allowing producers to ramp up production and in turn for their suppliers to meet these rising abilities.



AN ARTIFICAL EQUILIBRIUM

At some point it can be expected that demand and supply will come into balance. That balance can be preceded by a massive overshoot of supply if money is made too cheap for too long a period of time.



Too many suppliers chasing slowing demand growth leads to lost pricing power. Margin and profit problems can be hidden with easy credit. Zombie companies can be kept alive and they in turn bring further pricing power pressures. This is the stage we are in now and I have also written about this.

What we are going to discuss here is we have entered another stage in this rebalancing. Specifically, we have a turn in the credit cycle as cash flows shrink and the requisite credit ratings for new loans are under pressure.

MORAL HAZARD CYCLE

In previous reports I additionally laid out that easy credit, quantitative easing and ZIRP brought demand forward. Quantitative Easing is no longer bringing demand forward and in fact is now working against this by reducing Pricing Power and unleashing powerful global deflationary pressures.

Whether you call it the Moral Hazard Cycle due to Monetary Malpractice, the policy responses of central banks and stimulus leads to over Financialization of the economy. This effectively becomes a bleed on productive capital and leads to slowing growth.

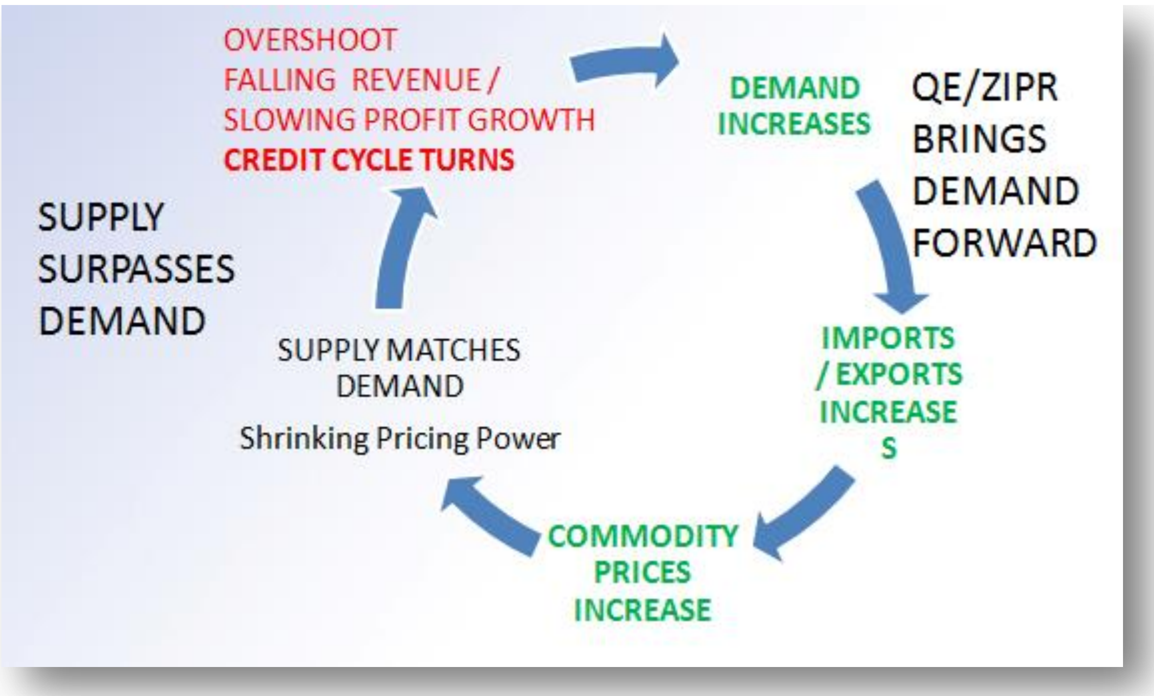
Instead of a healthy economic recovery we experience elevated asset levels, over valuations and growing income disparity.

BUSINESS CYCLE VERSUS CREDIT CYCLE

The cycle shown here begins and ends with demand.

Domestic Demand leads to increased domestic imports. This in turn leads to increased international trade and industrial production. This in turn increases commodity prices and the activity of commodity based economies.

This is what we have witnessed as I will show but we need to understand the signals we can expect when this demand / supply balance is met or overshoot.



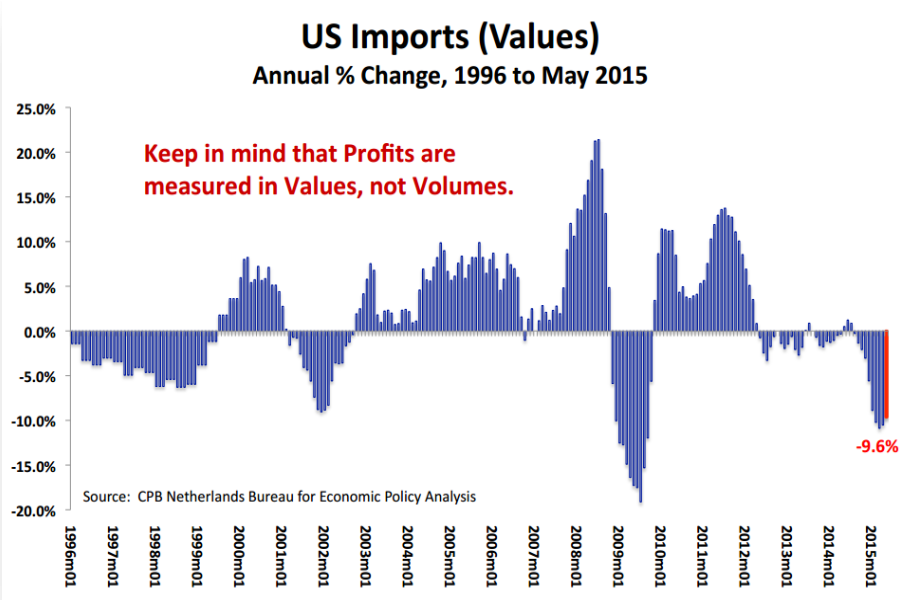
DEMAND & PRODUCTION – *A Global Supply Chain Shock!*

US Imports as a Measure of Real Economic Demand

Let's start where the demand has historically initiated from - the US consumer. The US is a 70% consumption economy and the spending habits of Americans have been the economic puzzle for decades. The question was only about how long it could possibly go on and what would stop it?

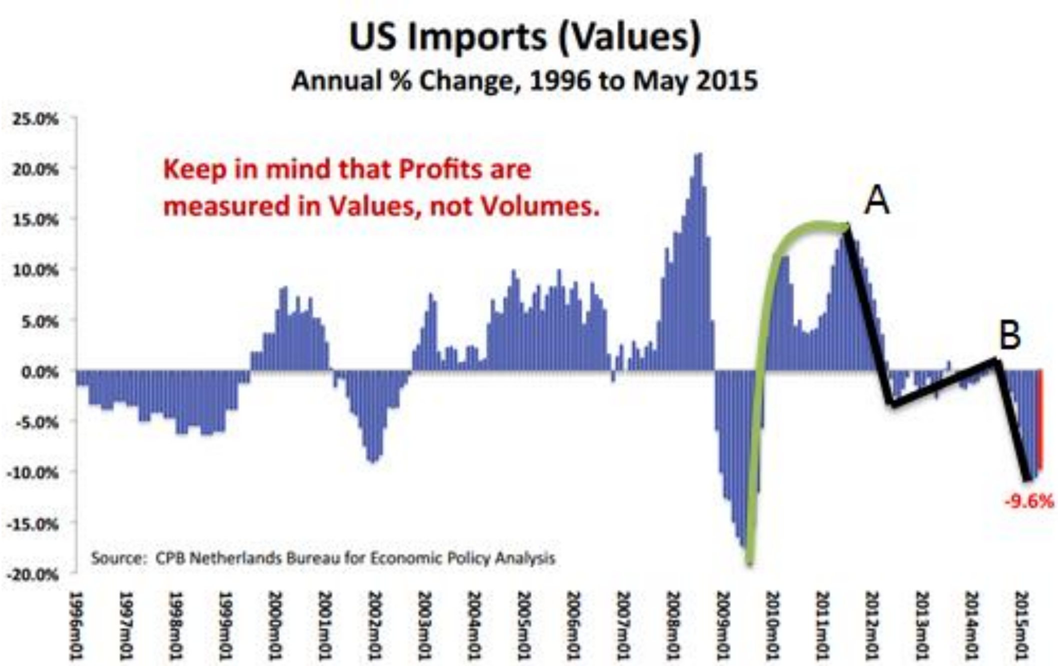
The 2007 Crisis stemming from residential housing gave us our first taste. But a steadily collapsing middle class and more than a decade of slow wage growth has finally impaired US consumption demand growth.

These factors, along with significantly falling energy import costs, has curtailed the flow of funds from the US into the global supply chain. The change can best visualized as a global supply chain shock!



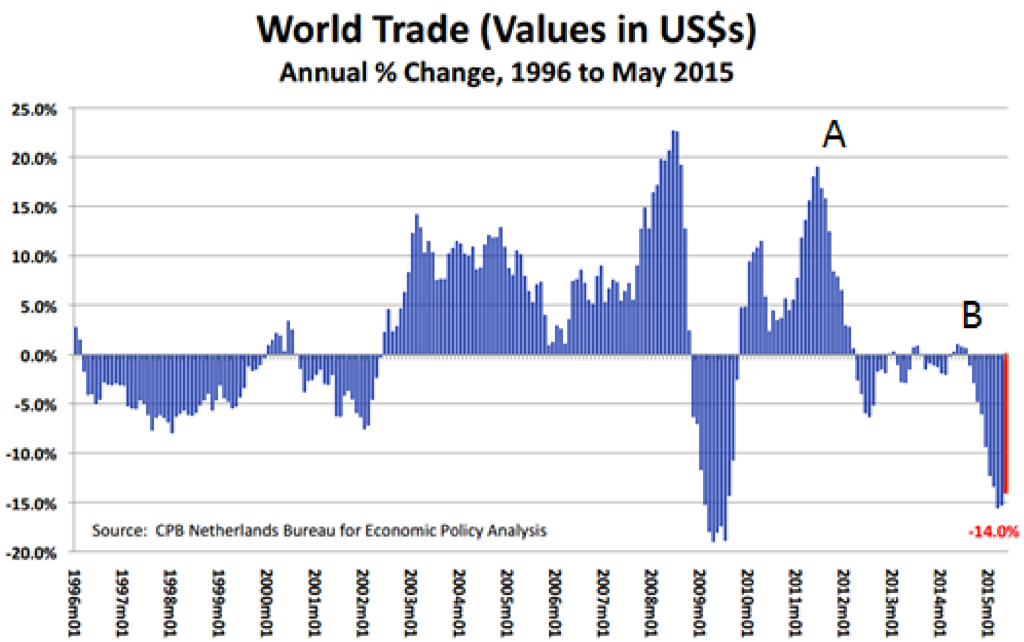
US Import Decline

Cheap money during the financial crisis initially had a major impact on stimulating demand by bringing future demand forward. This is shown in green. However in two waves this demand has plummeted shown at point A and B. We will see this wave and its turn dates as we progress through the supply chain shock.



World Trade Timing Pattern

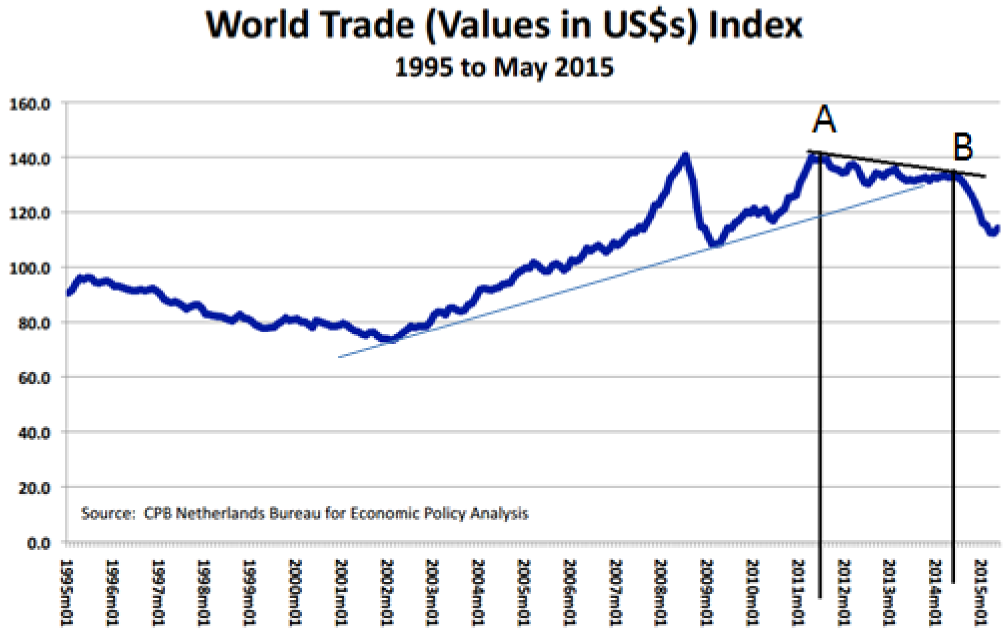
We see an exact correlation when we look at World Trade versus just US imports. There is an unmistakable correlation but to be fair, not necessarily causation.



Annual % Change Plummets

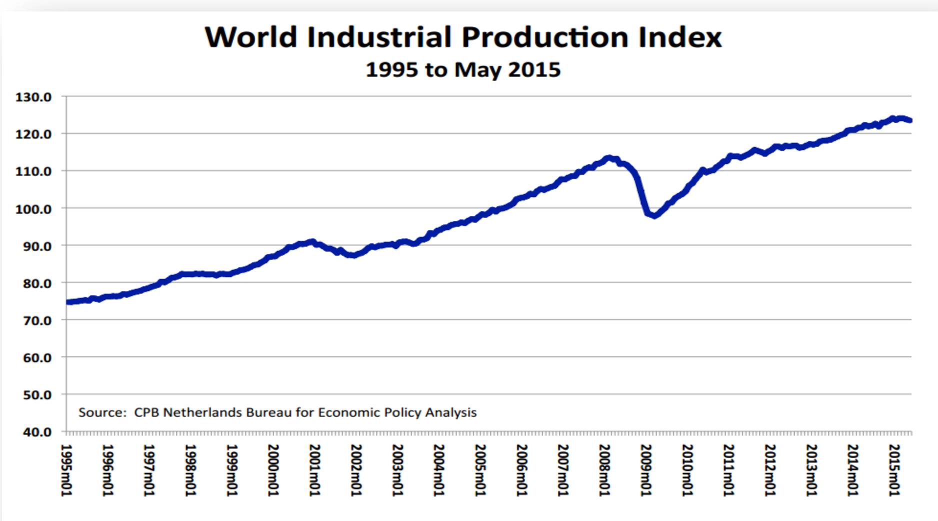
You can see a slightly different profile but with the same turn dates when we look at actual levels versus percentage change.

The profile reflects a steady decline from the initial demand increase with a clear acceleration after the last turn date. Clearly world trade is breaking down and it interesting to note that it is at exactly the point the long term support trend line shown here would indicate that a critical test was at hand. Technicians would tell us we have a new trend and it is down.



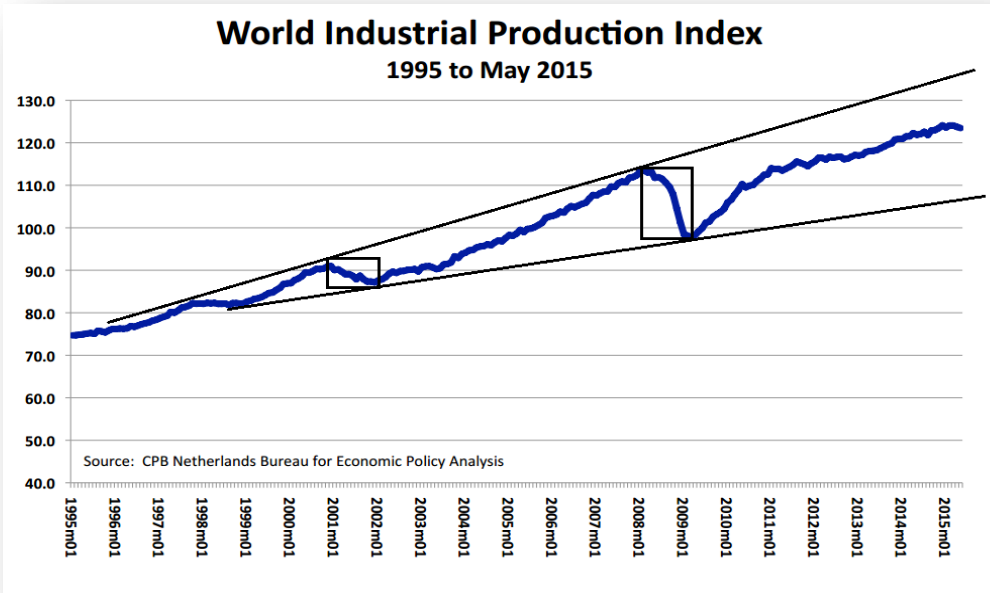
World Industrial Production

Let us shift our global supply chain examination to actual industrial production from which global trade is produced. It has clearly leveled off and appears to be turning down for only the third time in twenty years.



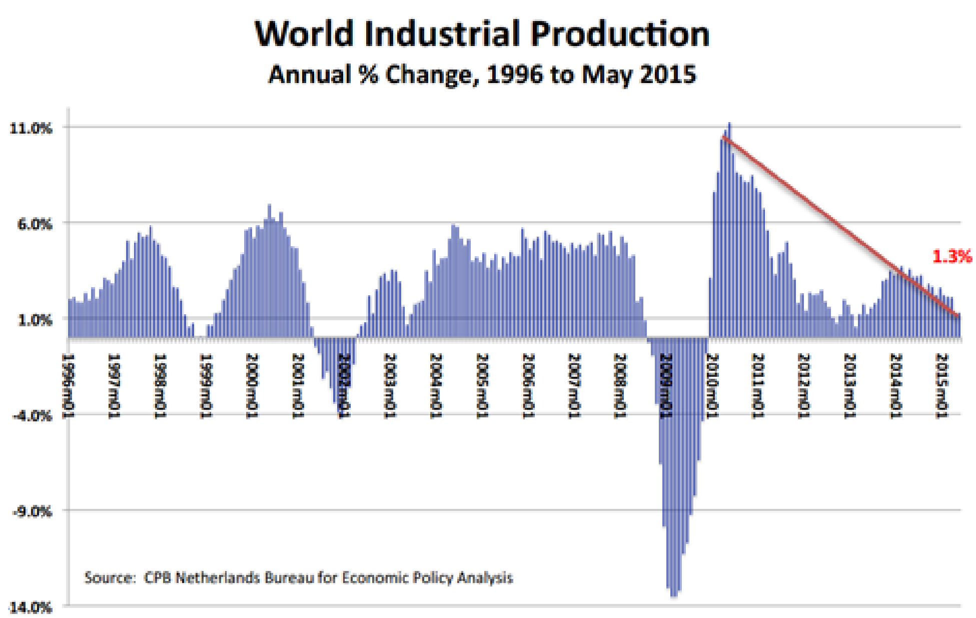
World Industrial Production – Boundaries

If we add some trend lines we see the the impact of the two financial market crisis we have experienced since the dotcom implosion. It also shows the degree of slowdown since the last financial crsis.



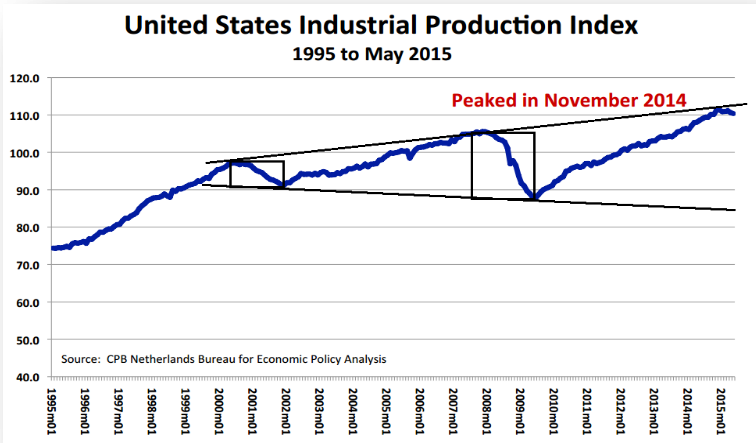
World Industrial Production – Annual Decline

Looking at World Industrial Production on an annualized change basis we see a steady and clear decline.



US Industrial Production - Boundaries

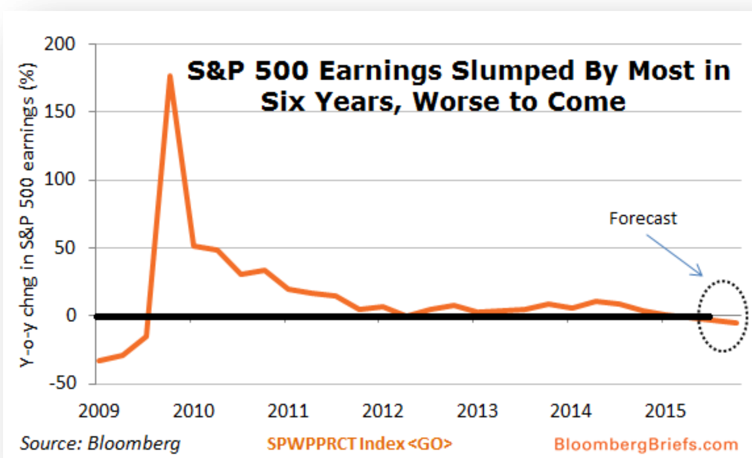
Going back to our trend lines but looking at US Industrial Production only, we see something quite interesting! Notice that the US reached its peak in 2014 and has clearly turned down since. The slope is much flatter reflecting the reduced rate of industrialization of America. This tells us something about job growth, high paying industrial jobs and middle class consumption.



CASH FLOWS – *Falling EBITDA and Free Cash Flow*

PROFIT HEADWINDS

We don't normally talk markets and earnings in our GMTP and defer those discussions to our MATA reports, but the preceding charts of slowing in global industrial production is showing in slowing top line revenue growth and more recently in earnings. S&P 500 earnings are now contracting.



Margins

S&P 500 profit margins have turned down. Historically this often precedes economic recessions.

The chart on the right shows how serious this is for small business operating margins. Of course none of this is laid out for you on CNBC which depends on advertiser revenues who in turn is held ransom by US consumption. This is simply a story that must be relegated to the back pages for fear of people seeing what is actually going on.

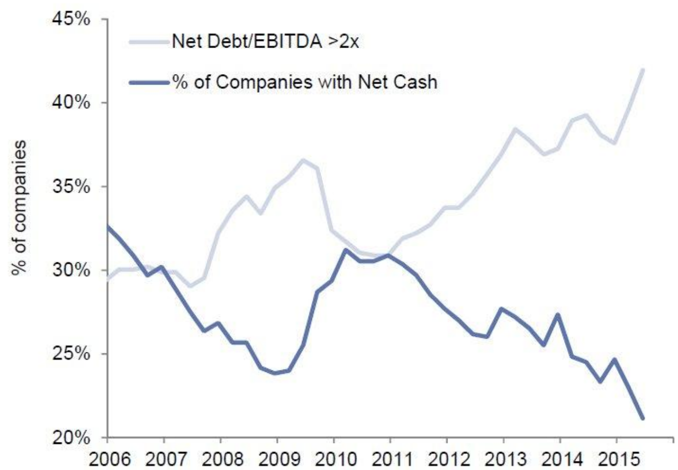
Corporate Cash Flows

It gets worse if we continue to follow the money.

So if top line revenue growth, margins and earnings are all falling, what about cash flow? There isn't much room to cut staff and freeze salaries and benefits. That has been relentless for over a decade!

Net Debt to EBITDA is 2 times higher than 2006 while the % of companies with net cash is the lowest since 2006.

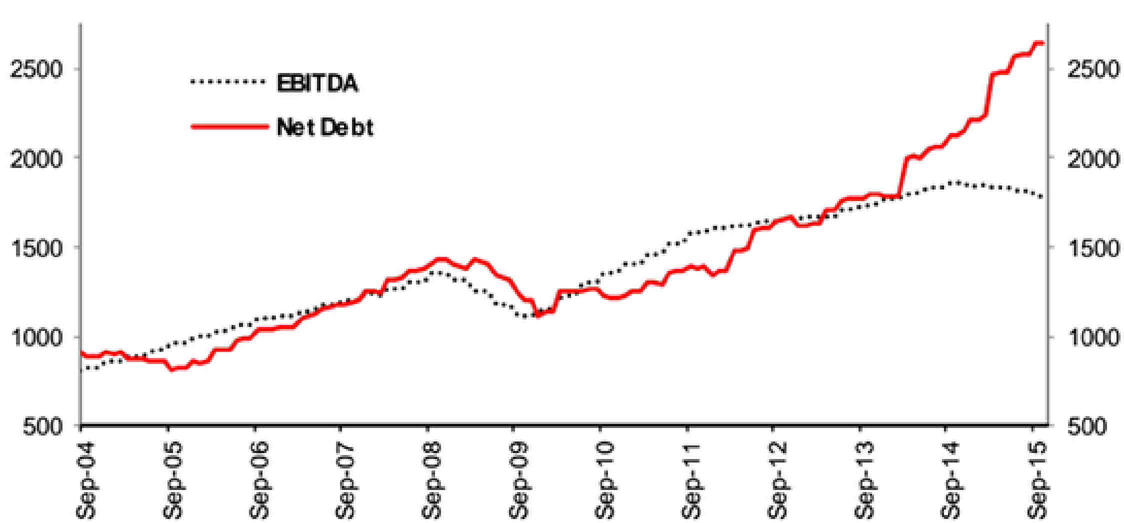
Exhibit 29: "Net Cash" companies are increasingly scarce
% companies with leverage (ND/EBITDA) above 2x vs. % net cash; GS coverage



Source: Goldman Sachs Global Investment Research.

US corporate debt has exploded and now massively exceeds EBITDA!

US corporate net debt has exploded and massively exceeds EBITDA ($bn, S&P 1500 ex fins)



Source: SG Cross Asset Research/Equity Quant

What does this mean? It means credit rating downgrades are ahead.

It means a reversal in the credit cycle!

Before we talk more about a credit cycle reversal, let's revisit the American consumer… the historic driver of demand.

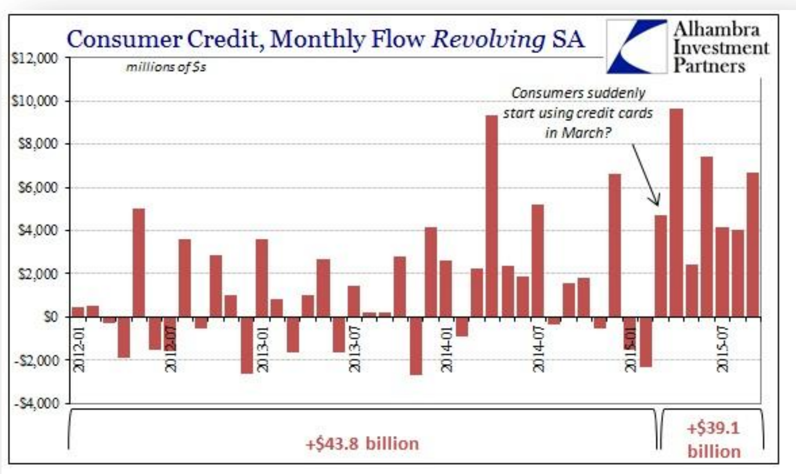
CONSUMER CREDIT

US Revolving Credit has significantly diverged from US exports. Divergences are often major warning signals.

What is this telling us?

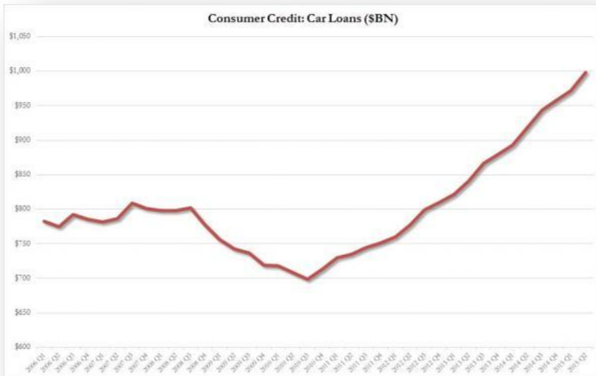
Tapped Out Consumer Spending Forced to Credit Cards

If you look at revolving consumer credit on a monthly flows basis it suggests the US consumer is tapped out and has started to resort to using their credit card to support their basic monthly needs. It definitely is not being spent at retail stores as everyone is reporting major concerns and worries about the holiday season.



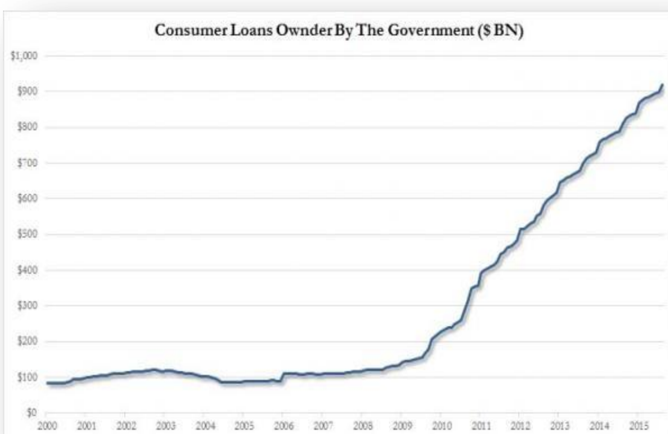
Car Loans

Credit is growing in only a few areas, but at some substantial rates since the financial crisis! Where is that and why? Well you can see it is in car loans.\
Americans are using credit to buy cars. Cars they need to get to work or to search for jobs.
But who is extending them this credit? Are you sitting down? You are!



Government Presence

The US government according to the latest reports is the owner of over $1 Trillion is auto loans! This nearly matches the entire growth in US auto loans! Between Auto Loans and Student Loans, the US government is the primary supplier of US credit. Not the banks!! They aren't lending and if they are they are selling the loans quickly.



Remember Government Motors or GM. Well GMAC was turned into Ally Financial which became the largest producer of ABS auto loans. The US government may no longer have a stake in Government Motors but guess who is still buying all that Ally ABS paper? Wonder why leases rates for cars are so low? Well the 3 years leases residuals allow that! Guess who owns the over inflated residuals? Right, as a tax payer you do!

Call this Fannie Mae II! Only this time you also have Sallie Mae for all that student loan debt being taken on by students living in their parents basements looking for jobs but taking non paying intern positions!

US Inventories

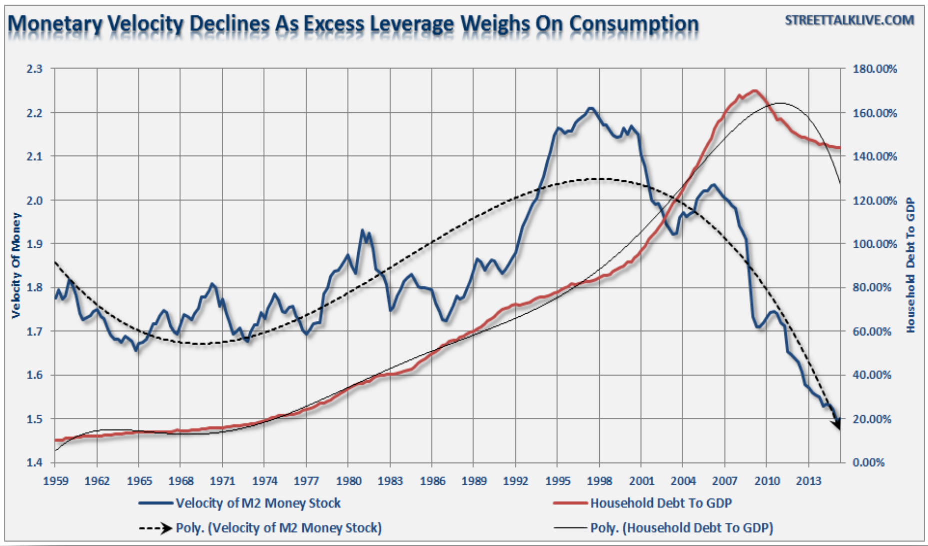
Retail sales are becoming such a problem that channel stuffing is now standard practice! This is not something we haven't seen many times before and is standard practice. Seldom has this situation not preceded a recession.

A recession the central banks would try and stop with rates already at near zero? This would be a first.

Excess Leverage & Velocity

The simple truth is excess debt and leverage is weighing on consumption. Money velocity continues to fall!

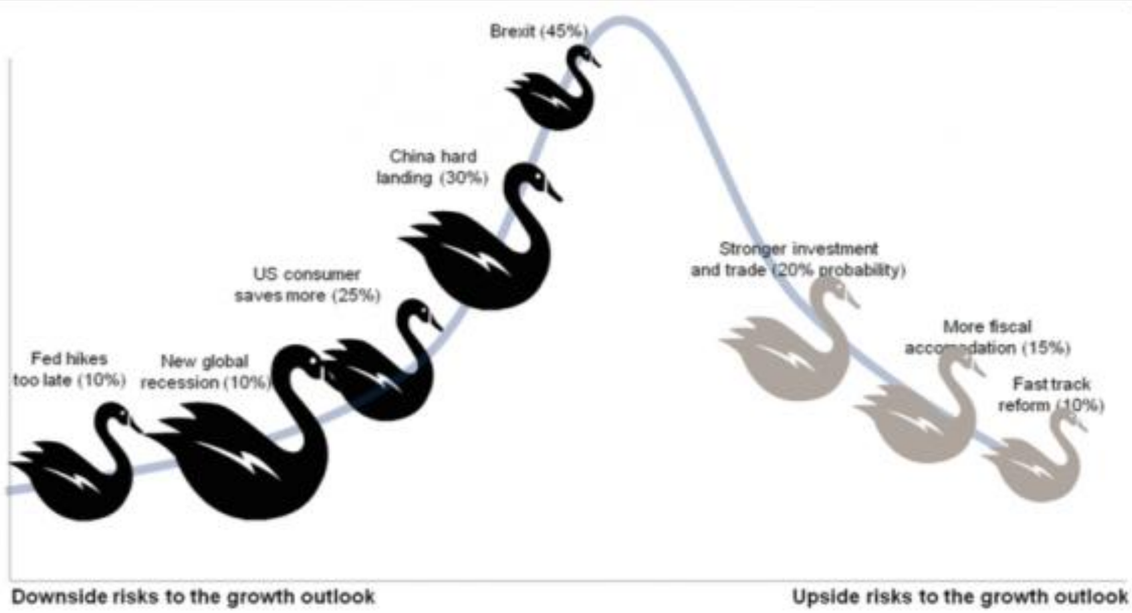
They wouldn't dare show this on CNBS!



World Trade versus Major Market Turmoil

When situations get this tenuous we can expect any disruption or black swan event to trigger a major problem. We have plenty of potential black swans to watch. I will leave these for another discussion.

Chart 1.25 SG Swan chart: Dominated by downside risks

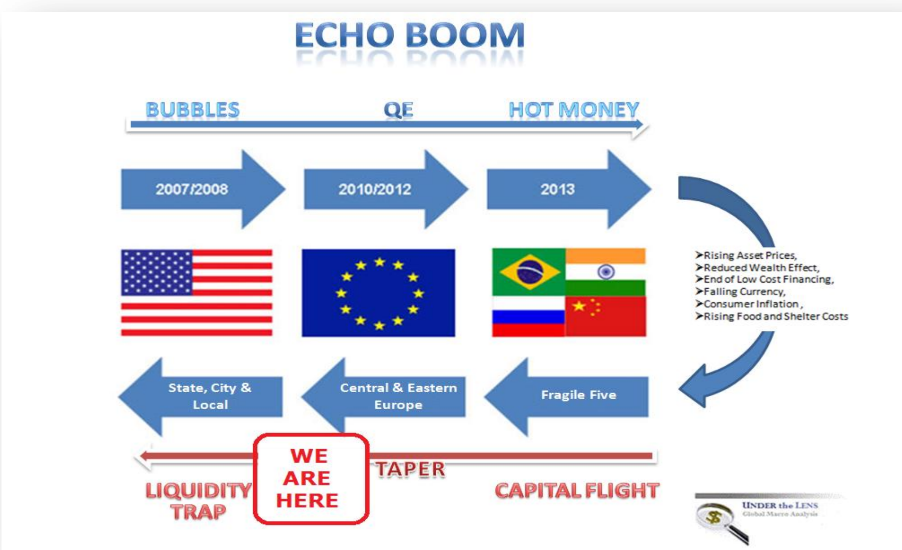


The x-axis gives an indication of how probable we consider a risk factor to be. The size of the swans gives an indication of how important the impact of that event materialising would be in terms of its upside or downside shock to the outlook.

Source: SG Cross Asset Research/Economics

COMMODITIES TIMING

I have shown this chart previously when we began talking TAPER. In the Globalization Trap thesis I argued the Emerging Markets who are the primary suppliers of commodity products would be hard pressed when the inevitable "Echo Boom" arrived. That is occurring now.



Baltic Dry

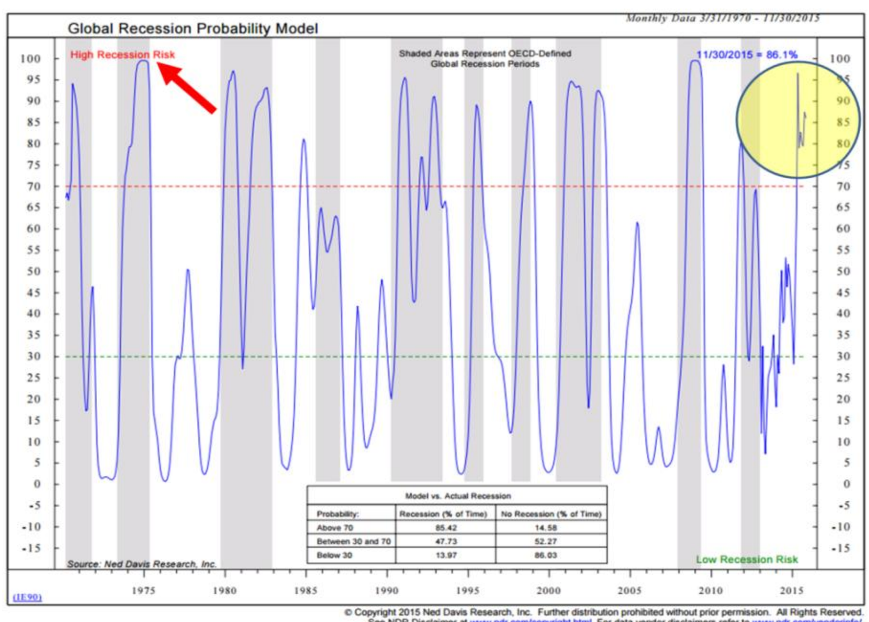
The Baltic Dry Shipping Index is now at levels we haven't seen before – not even during the 2008 financial crisis! Trade, Production and Commodities are not shipping.

Even the port of LA is seeing falling volumes as is US rail traffic. The story is consistent everywhere you look, if you have the heart to actually look.

Potential Recession

I am not saying we are going to have a global recession, but the data is strongly suggesting that this is a real possibility. Minimally, we can expect it to impact the data driven Fed in 2016.

The following model looks at a composite of leading indicators for 35 countries. Indicators such as money supply, yield curve, building permits, consumer and business sentiment, share prices and manufacturing production. It then uses a logistic regression method incorporating the composite of leading indicators and trend data for all 35 countries. The objective is to predict the likelihood of a global recession.



A score above 70 indicates a high recession risk and below 30 signals low recession risk. The box at the bottom center of the chart shows the "Model vs. Actual Recession." Note that global recession has occurred 85.42% of the time when the model reading has been above 70%. It is at 86.1% today.

CREDIT CYCLE – *Has Turned*

CREDIT CYCLE

Let's turn to what we need to focus on. All of this means the Credit Cycle can be expected to and in fact is turning! It is perfectly normal, even if we can't accept the reality of it!

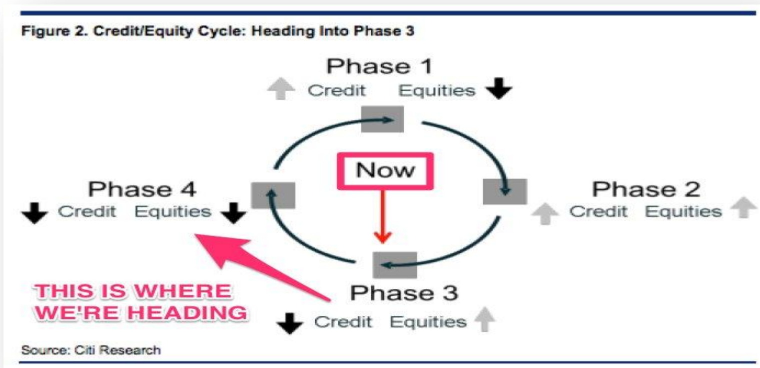


Figure 2. Credit/Equity Cycle: Heading Into Phase 3
Source: Citi Research

Credit Cycle versus Changing Cash Flows
My experience has been that shrinking free cash flows trigger this as Credit Ratings are reduced.

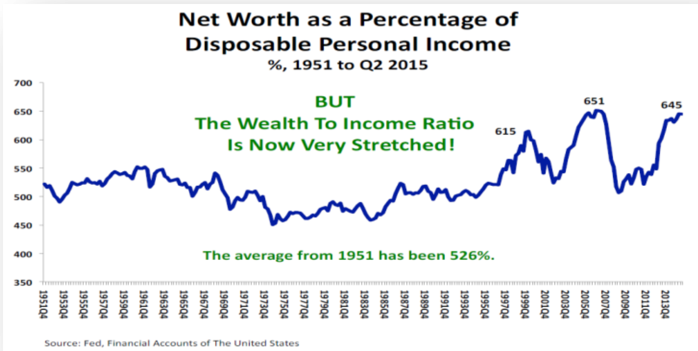
Whether officially or unofficially credit gets more expensive and more difficult to get!

Forced deleveraging as we discussed last month with Glencore is to be expected going forward.

Disposable Personal Income versus Net Worth

The consumer simply can't afford asset purchases or carrying costs when net worth as a percentage of disposable income reaches these levels. It isn't magic! It is simply mathematical!

Yes it can draw out longer. Yes the central banks can increase balance sheets and force more liquidity into the system but there is insufficient new unencumbered collateral to support new debt growth.



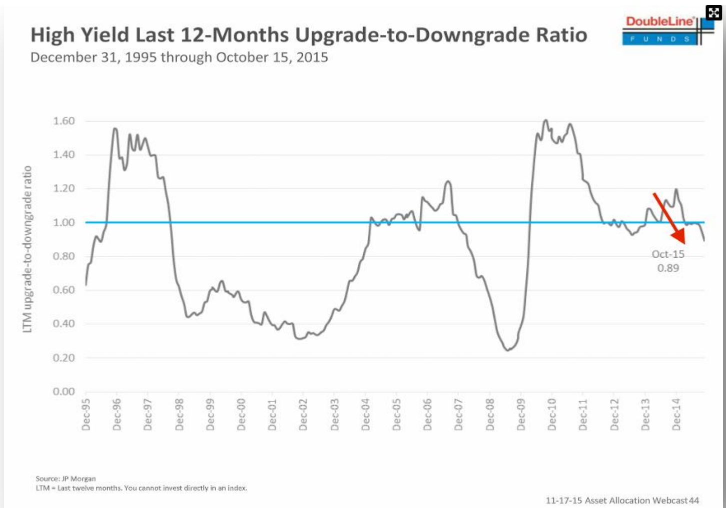
Chinese Non-Performing Loans

Additionally, we have existing loans going bad and their inability to be rolled over with cheap money.

This is not only a developed nation problem but is across the globe where excess supply has been built based on false demand.

HY Upgrade-to-Downgrade Ratio

There are many classic signs of a turning credit cycle which I lay out in November's MATA document which I don't have space to lay out here.



UNUSAL PATTERNS – *Just Six*

Something I would like to point out in closing is the number of disturbing anomalies we are witnessing in the financial markets. Not only is the credit cycle turning, but something is terribly broken somewhere in the credit markets. I would only be speculating at this point but Custodial and Counter Party Risk are something you should pay attention to.

EVEN BLOOMBERG CAN'T EXPLAIN UNUSAL PATTERNS

"Six Strange Things that have been happening in the Financial Markets!"

1. Negative SWAPS Spreads
2. Fractured Repo Rates
3. Corporate Bond Inventories Below Zero
4. Synthetic Credit is Trading Tighter than Cash Credit
5. Sigma Market Moves that aren't Supposed to Happen Keep Happening
6. Volatility Itself is more Volatile

GLOBALIZATION TRAP – *Revisited*

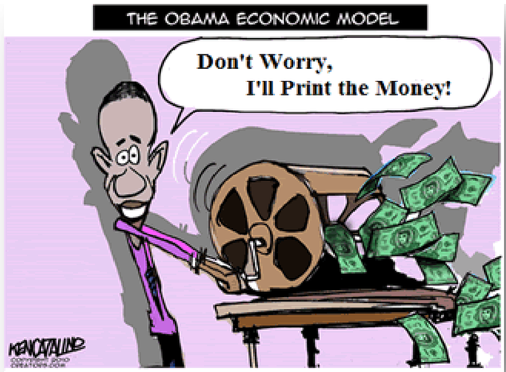
I believe we are entering the final sector in the roadmap we laid out in the Globalization Trap. Collateral, Impairment, Real Deflation, Real Wealth Destruction and a potential Crack-up Boom based on Central Bank reactions to the mounting and possibly insurmountable looming credit problems.

Unbalance – Everyone on the Same Side of the Boat

We have too many people on the wrong side of the boat, believing in Central Bank omnipotence. Nothing good ever comes from everyone believing the same thing in the financial markets.

Remember, the answer will be to print more money.

It is the only answer politicians can agree on.



Until No one wants it or Trusts It!

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