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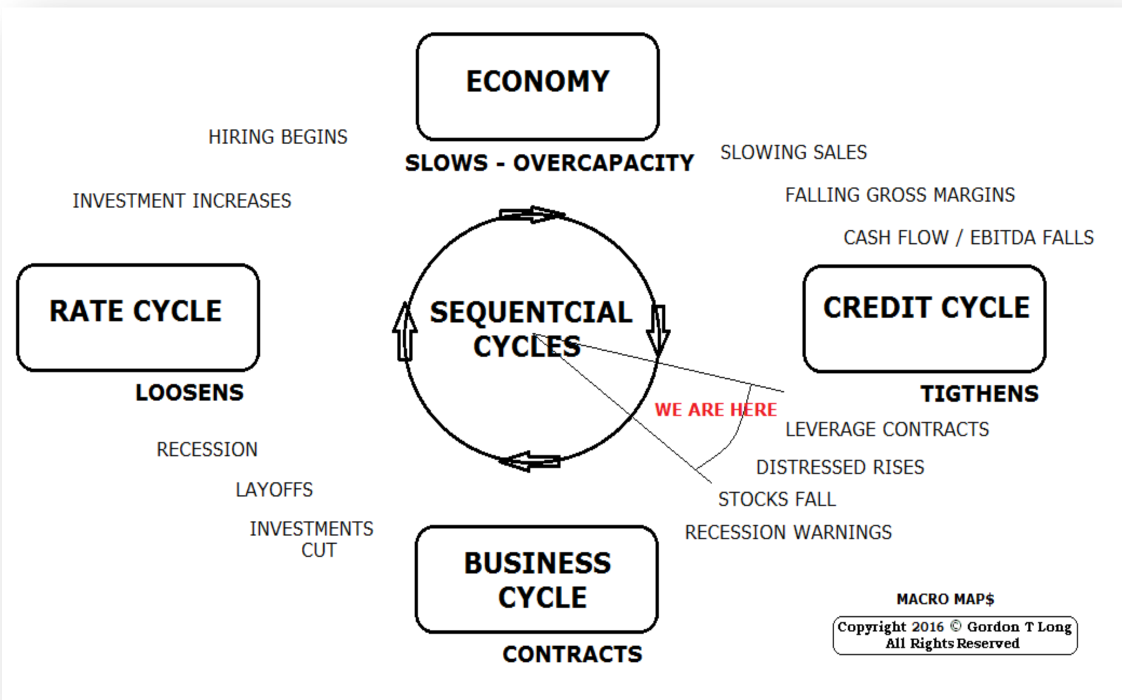
WHERE ARE WE IN THE ECONOMIC CYCLES?

The Credit Cycle Has Turned

MACRO INSIGHTS



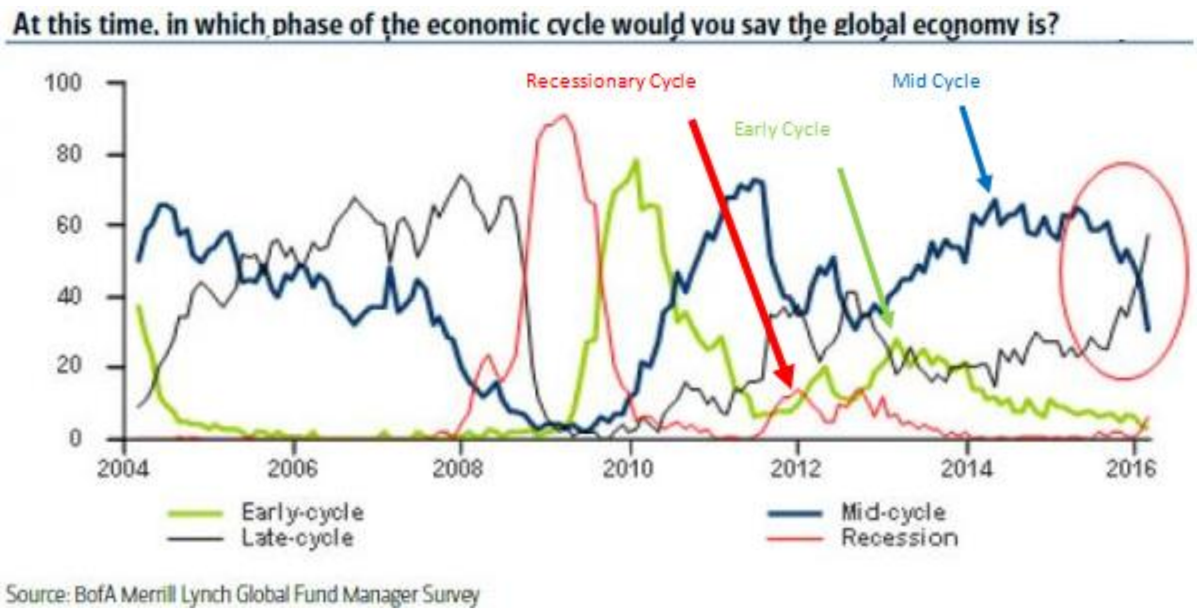
Gordon T Long
2/25/2016

WHERE ARE WE IN THE ECONOMC CYCLES
The Credit Cycle Has Turned

Which Phase of the Economic Cycle Are We In?

It is important not to lose perspective, from all the economic data coming at us, about where we likely are within the Economic Cycle. History has show that economies follow various cycles which have tremendous influence on asset valuations and market pricing.

The global economic cycle may be more important today than ever before as sovereign economies become increasingly inter-dependent.



We see in this chart by BoA Merril Lynch's Global Fund Manager Survey that the consensus is that the mid Cycle has turned down hard but that the Late Cycle hasn't turned yet. These surveys by their nature are delayed, as often the sentiment supporting them is lagging.

I suspect the Late Cycle has already turned down hard as illustrated by a turn in the Credit Cycle, which we have discussed in previous reports.

One look at Global Trade data and the Baltic Dry shipping index will confirm this even for the most skeptical. We have also shown these in previous reports.

Fed Sees Significant Financial Stress

Until recently the US has been the perceived beacon of economic growth when compared to other economies and regions. This is now being called into question by many mainstream analysts. I suppose better late than never, but it is more about the data becoming so overwhelming even the Fed's FOMC is raising it as an issue.

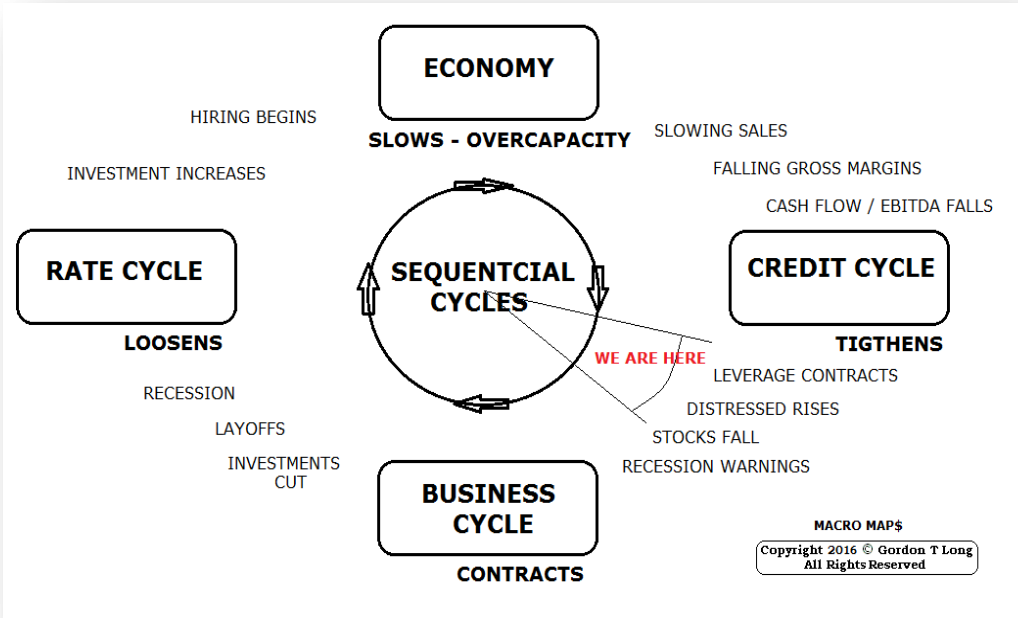
The Federal Reserve watch's closely the Cleveland Fed's Financial Stress Index. It shows stress to be significant and critically important, at levels that have previously forced the Federal Reserve to taken significant policy actions. These levels launched two highly controversial initiatives in Quantitative Easing 1 and Operation Twist.

Sequential Cycles

This Macro Map which I developed is an easy way to visualize the sequential nature of cycles. ***The Credit Cycle leads the Business Cycle which leads the Rate Cycle. The Federal Reserve always follows. It never leads.*** In fact the Federal Reserve can be counted on to follow the actions of the money center banks.

We already have evidence of Leveraged contracts like CLO's falling, Distressed debt rising, stocks weakening (down 20-25% globally) and recession warnings entering the lexicon. The Business Cycle has likely turned.

These are multi-year events, not quarterly events.



The Fed Worries about US Government Financing

Never forget that one of the most important responsibilities of the Federal Reserve (in concert with the US Treasury) is to ensure US Government operations are funded. As a consequence US Treasury yields and bond auctions are important.

This diagram showing the relative price performance of global financial assets to the US Treasury is also very important. As is clearly illustrated here, the Federal Reserve has a history of taking action when US Treasuries require assistance.

The fact the Federal Reserve was boxed into a corner and recently had to follow through on its directional statement to increase the Fed Funds Rate, must not be construed that the Federal Reserve will necessarily follow through on its stated gradual move upwards to

1.5% in the Fed Funds Rate.

As more and more central bank analysts start to see the recessionary signals we have been pointing out you can expect the Fed to reverse course.

Declining Believe in Federal Reserve's Directional Statements

I have long maintained that the US 10 Y UST will trade at 1% by the end of 2016. Time will tell, but the trend line is clear.

The US government is incapable of financing itself or rolling over outstanding debt if rates were to rise. 1.5% is the maximum possible but this will not be achieved because the credit and business cycles have already turned. A turn in the rate cycle (if we can even call it that) is ahead.

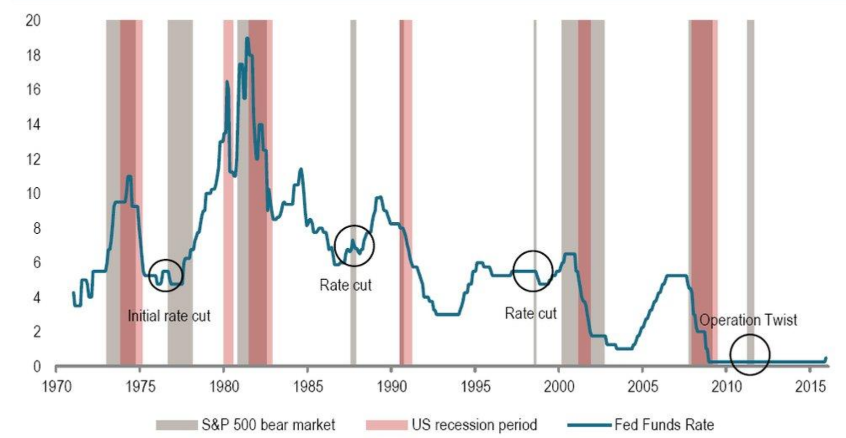
We are going to see new central bank initiatives in 2016 that will shock most. The central bankers are trapped.

Bear Markets Prompt Central Bank Actions

Even during equity Bear Markets that were not caused by a recession, The Fed has typically responded with policy easing.

So here we have strong indications of a US recession AND stocks looking at Bear Market threshold levels!

Figure 51: Bear markets without recessions have historically prompted Fed policy responses



Source: Thomson Reuters, Credit Suisse research

Bear Markets Prompt Central Bank Actions

Unfortunately it must also be noted that Fed tightening cycles have a history of unexpectantly causing “events”.

It is my opinion that history is not going to be kind to Fed Chairperson Yellen for raising rates (even as minor as they were) as events unfold in 2016-2017. It may go down as a monumental monetary blunder which triggered events when in fact she should have been dramatically increasing liquidity and credit.

Time of course will tell.

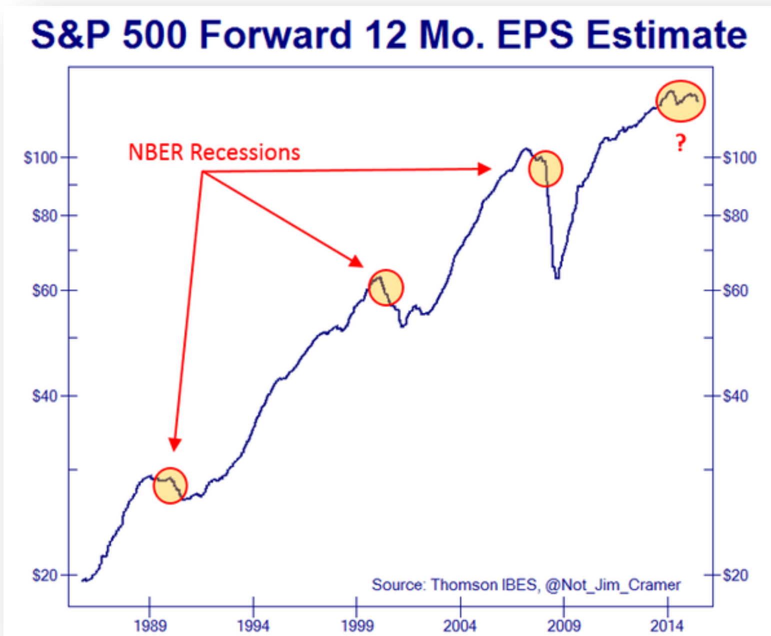
Chart 4: Fed tightening cycles frequently cause “events”

Note: Fed discount rate used pre-1971
Source: BofA Merrill Lynch Global Investment Strategy, Global Financial Data (GFD)

Falling Earnings Both Signal and Precipitate Recessions

We talk extensively in the last few TRIGGER reports about the pressures corporate earnings are under. You can expect this dated 12 month forward EPS estimates to soon fall significantly.

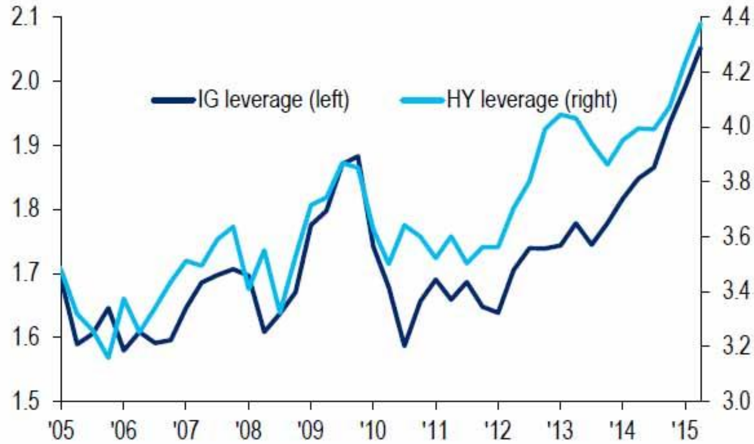
What is more important is that we are already at levels that later the NBER determines that we were already in a recession. Alarms must certainly be going off at 33 Liberty Street in New York and fire jackets being dawned.



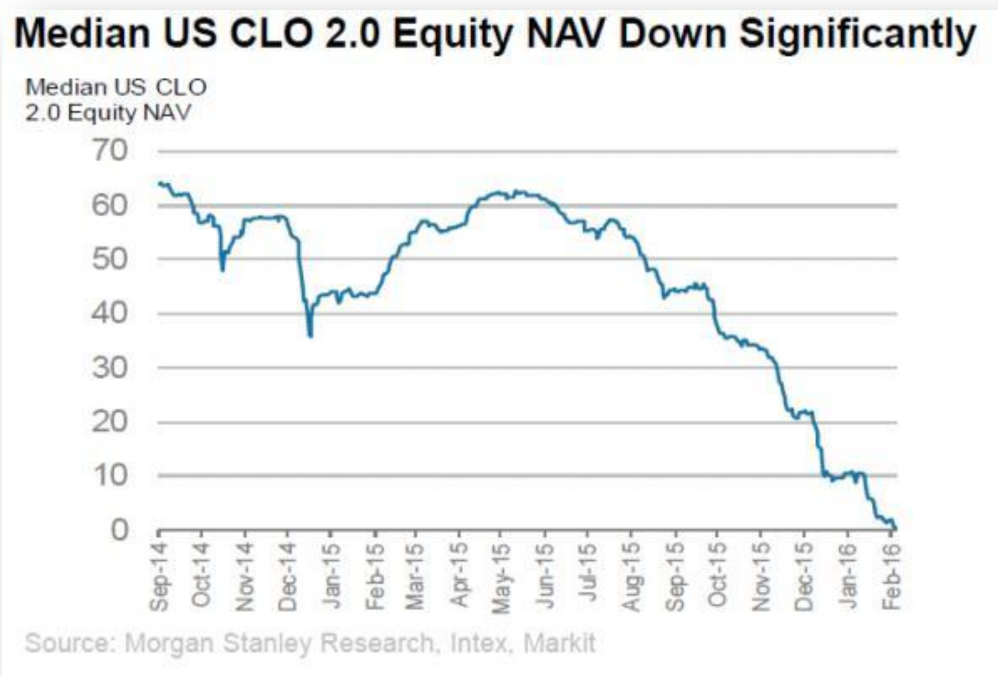
Fires Raging

If the Central Bankers don't act soon the fires may soon get totally out of control. For months we have been watching the carnage in the HY debt market but now we see the CLO (Collateralized Loan Obligations) down to levels signaling near panic.

Figure 3. Gross leverage for the typical IG/HY nonfinancial (ex-util), in debt-to-EBITDA*



Source: Citi Research, Factset
*median debt-to-EBITDA for BIG Corp and HYMI index eligible nonfins (ex utilities).



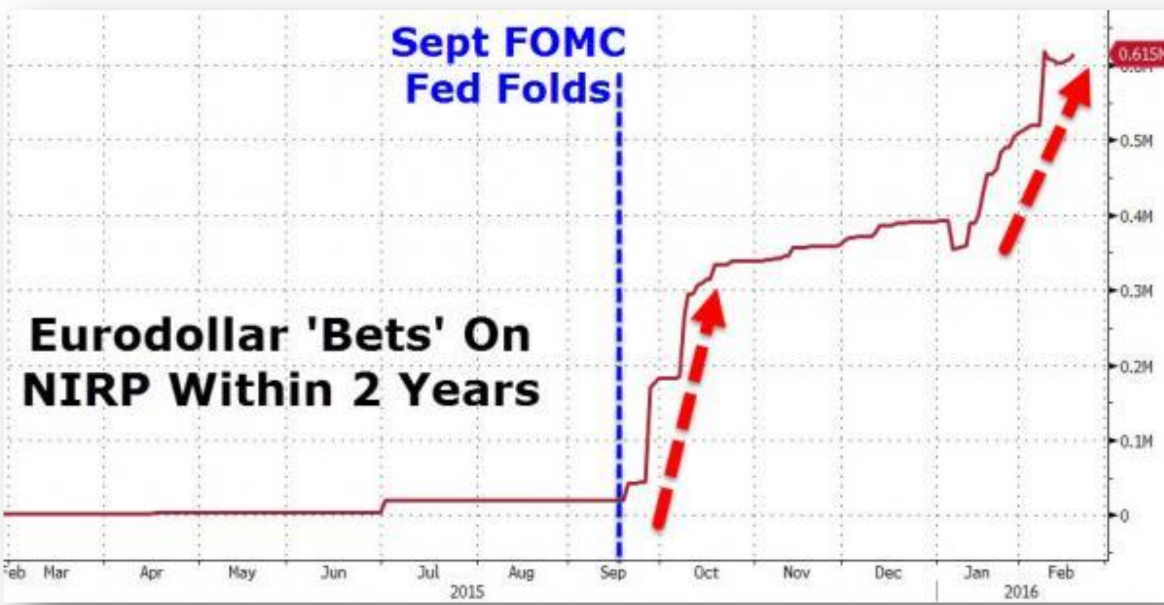
Remember CDOs (Collateralized Debt Obligations) at the center of the 2008 crisis and Shadow Banking problems?

Whatever It Takes

It is time for another ECB Chairman Draghi's "Whatever it takes" speech – if anyone listens this time?

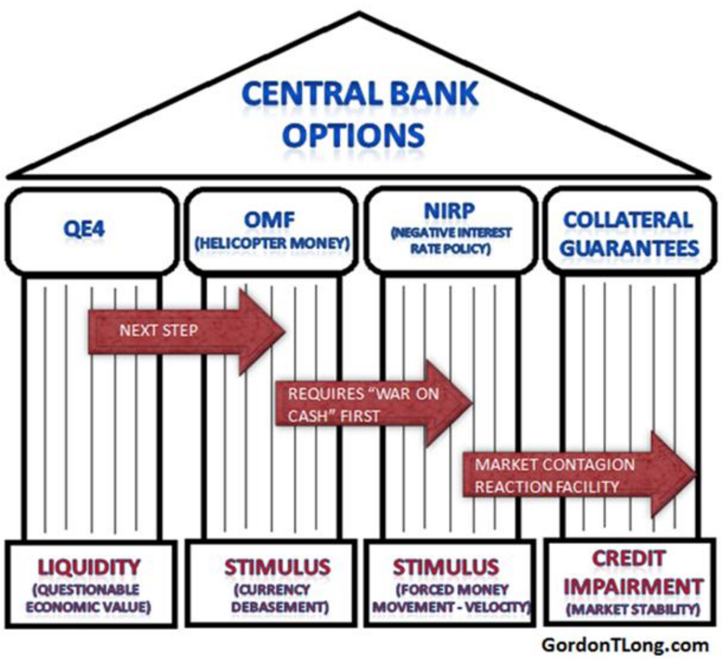
No Breadth and a Few Hiding the Reality

The big money is already betting NIRP (Negative Interest Rate Policy) is in the US's future. It is reality in the ECB, Switzerland, Sweden, Denmark and Japan.



Financial Repression Authority

I have done a lot of work at the Financial Repression Authority (which I am a co-Founder of) to determine where the central banks are headed. It has been my documented view we will see NIRP, OMF (Overt Monetary Financing – "Helicopter Money") and new rounds of QE in the not too distant future.



GET READY! Home safes are already selling out in Japan with the announcement of NIRP

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