

A BUBBLE TOO BIG TO FAIL.

In the film the "Big Short" a distraught investor asks how the bankers could act with such reckless (and profitable) indifference in the face of surging mortgage defaults. His answer was that they knew they would be bailed out when it all collapsed. The difference today is scale. In 2008 it was the New York Investment Banks scamming the markets prior to the Crash. Now it is the central banks themselves. They have created a financial monster that needs to be fed, for if it collapses, the fall out will be beyond imagination. We are no longer talking about banks too big to fail, but a global bubble too big to fail.

I predicted a Crash in 2019 even calling it the 2019 Crash. Did it occur? Yes and no. On the Yes side, there was a world industrial recession, a trade recession and most important of all, a profit recession. According to the most recent release by the CPB Netherlands Bureau for Economic Policy Analysis which covers the third quarter of 2019, world trade was down 1.1% compared to the third quarter in 2018 in volume terms. In terms of global production a mixed picture appears. Global production over the same period was up by 1% but down 0.3% in the advanced economies. Strip out China and the figures look even bleaker. (Source <https://www.cpb.nl/en/worldtrademonitor>)

Turning to profits, the same depressed picture appear. Profits in China are down 7.25% for the two months September and October 2019 compared to the two months a year earlier. In the USA quarterly pre-tax unadjusted non-financial profits third quarter are down 7.2% mimicking China. In Japan the fall in corporate profits was 10.9%. In Germany the fall was only 3% because profits fell steeply in the 3rd Quarter of 2018.

The fall in profits had a predictable effect on investment. According to the OECD, the latest forecast for investment in 2019 measured in dollars, is down to 1%, or stagnant. <https://data.oecd.org/gdp/investment-forecast.htm#indicator-chart> This compares to 3.9% in 2017 and 2.5% in 2018. Even in China which enjoyed double digit growth in fixed investment until very recently, the comparable figure is 3.7% for secondary industry, with the manufacturing sector at 2.5%. http://www.stats.gov.cn/enGliSH/PressRelease/201912/t20191217_1718051.html

Bubbles are good for personal consumption.

However the global economy was an economy of two halves, the halve-nots and the halves-everything. I have pointed out a number of times, that in many major economies, especially the biggest of them all, the USA, the top 10% spend as much as the bottom 80% on personal consumption. The top 10% rely heavily on capital gains, and their spending habits are shaped by the status of the share and bond markets.

The capital gains made in 2019 are staggering. These are the gains up to the 20 December, prior to the Xmas wind down. The Stoxx 600 which covers 90% of the European Stock Market capitalisation is up 32% this year despite Europe having been in or near recession for much of 2019. With a 8.8 trillion Euro market cap, the gains for 2019 amounted to 2.13 trillion, a sum bigger than the GDP of Italy. In Japan the gain was less at 18% and in Shanghai, despite a sharply decelerating Chinese economy and falling profits, it amounted to a gain of 22%.

The cake of course goes to the USA basking as it does in past glories. The Wiltshire 5000 index is up 33% just pipping the Stoxx 600. The total market cap of the Wiltshire 5000 as of the 20th is \$32.8 trillion roughly three times the size of all European and English shares. Thus the 33% increase in share prices represents a fictitious gain of \$8.2 trillion. To which can be added, the 14% return on the \$10 trillion of corporate bonds bringing the total to over \$10 trillion or 50% of GDP in 2018. Staggering. If just 5%

of those gains cashed in and spent in the real economy annually, that represents a boost of \$500 billion on the side of consumption or 2.5% of GDP.

Remove these capital gains enjoyed by a tiny minority in each country and the global economy implodes. The world economy is now addicted to these bubbles, though the fix needed keeps growing. Nothing could be healthier. A capitalist economy driven by low interest rates feeding speculation rather than a high rate of profit feeding investment has scrambled the DNA of capitalism.

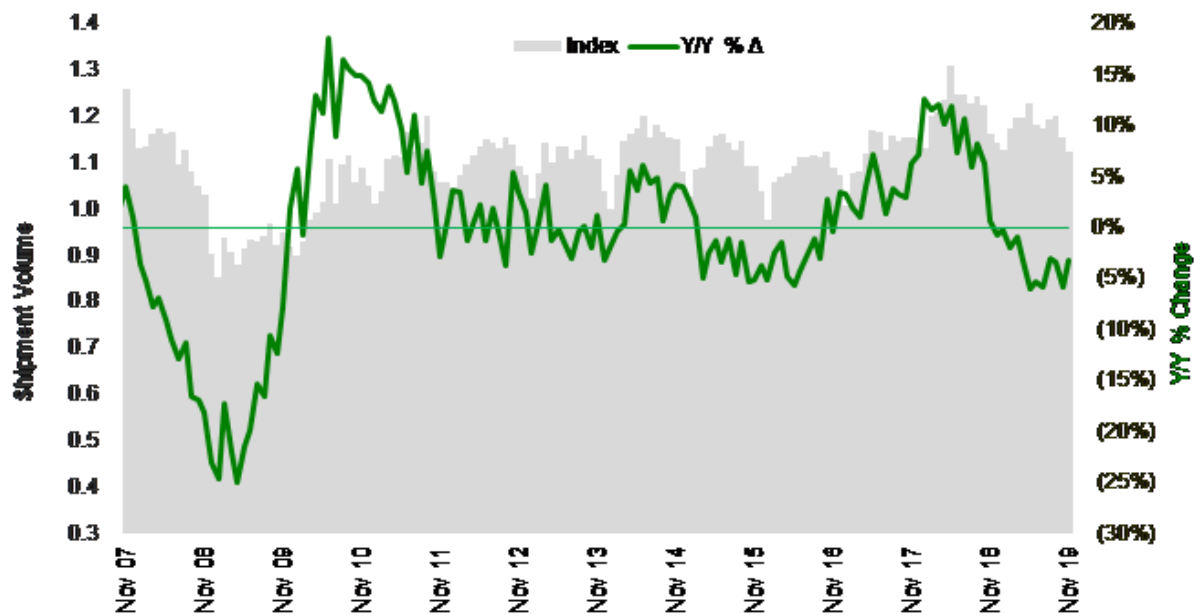
One graph really brings this out. FedEx together with UPS are the world's largest parcel delivery firms. These two parcel companies are bellwethers for business to business and business to consumer traffic. Any slowdown in the traffic of goods will register in their performance. So while both corporations are suffering significant slowdowns in their traffic, which is registered in their share price, the S&P continues to glide upwards.

Graph 1.



This divergence is replicated by the most recent Cass Freight Index below. It shows that the US is effectively in an industrial recession, despite the best efforts of the BEA to bulk up GDP data. Freight volumes are negative for the first time since the pseudo recession at the end of 2015. They have fallen for the last twelve months, a fall which has been steeper and deeper than in 2015 and 2016, yet interestingly current GDP now averages over 2%, whereas it averaged only 0.5% in both the final quarter of 2015 and the first quarter of 2016. A difference of 1.5% of which 0.5% is due to the expanding budget deficit courtesy of the Trump tax cuts.

Graph 2.

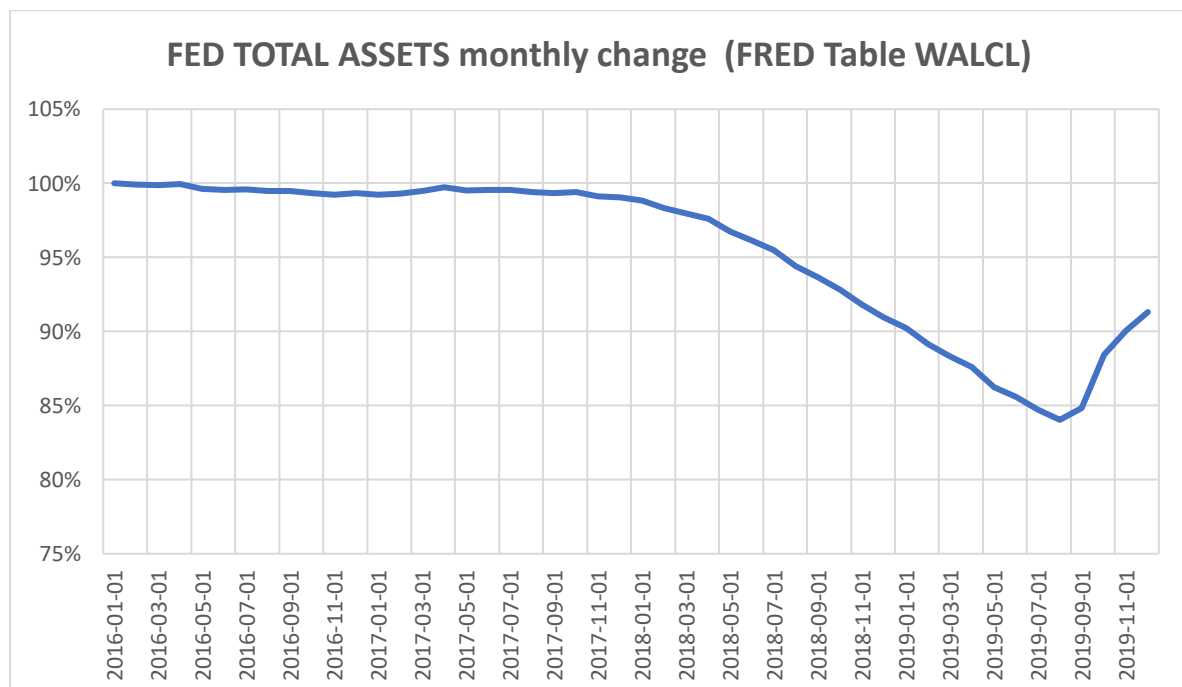


<https://www.cassinfo.com/freight-audit-payment/cass-transportation-indexes/cass-freight-index>

Central Banks become the dealers, not only money dealers.

Central banks are the key. Currently the FED is pumping \$100 billion each month into the REPO market while the Bank of Japan's and the European Central Bank open market operations are contributing \$15 trillion and \$22 billion respectively. The size of the FED's liquidity injection can be seen in Graph 3 below. It has been sizeable enough to significantly reverse the unwinding process (sale of bonds thereby mopping up liquidity) which began at the end of 2017. Within 3 months it will set a new record exceeding the total assets found held by the FED up to the end of 2017.

Graph 3.



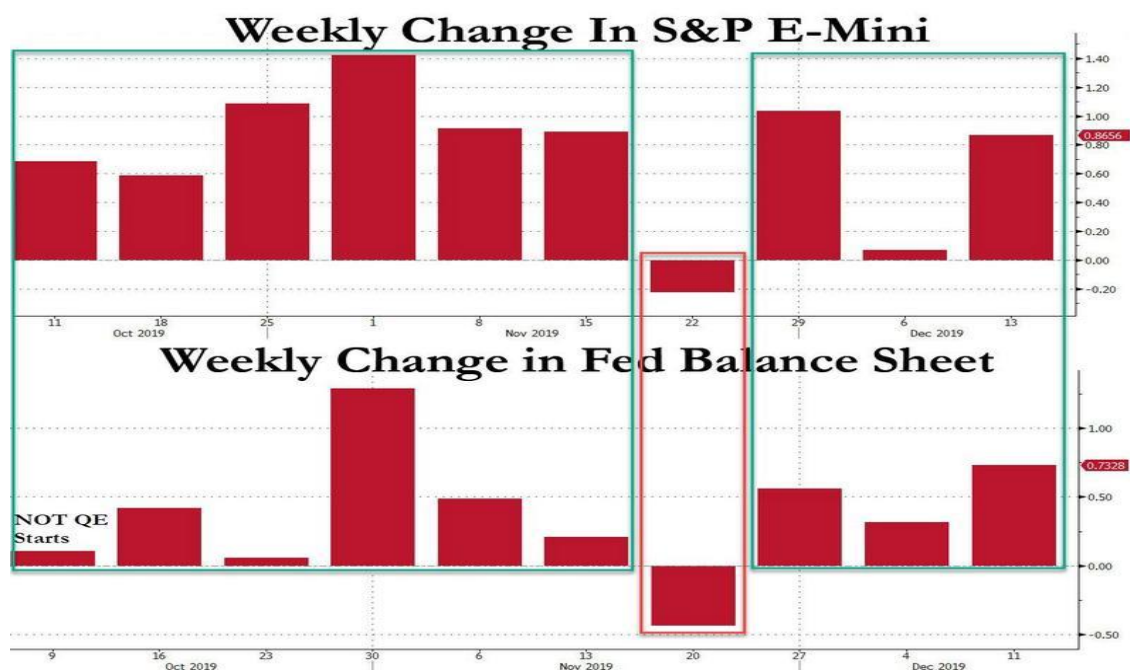
To show the movement more clearly I have indexed it. Since September the FED has injected \$326 billion into the financial pipework in New York representing a near 50% reversal in its unwinding of QE since the beginning of 2018. And we should never tire of pointing out that this time around, while the magnitude of the injection equals that found after the Crash of 2008, it is now occurring before the Crash. It seems the FED, based on what it learnt in 2008, is into preventative medicine.

However, it could be said that history will note that the Crash began in September 2019, because that was when the financial system seized up. What was first seen as a temporary FED facility has now morphed into a semi-permanent facility, in effect QE4 based on short term financial instruments.

The link between these injections and share prices was acknowledged by both CNBC and Morgan Stanley. Originally the FED said it was going to prevent this form of speculation via the REPO market. However, this what CNBC had to say on the 7th November 2019: *"As the central bank's balance sheet has expanded, the S&P 500 has grown at almost the exact pace."* The title to the article was even clearer. *The Fed's monetary juice has tied directly to the rise in stocks: 'Here we go again' 2019.*

Morgan Stanley even provided a graph connecting the injection of funds and the stock market response. As Morgan Stanley's Michael Wilson said in an article - ***How much longer can central banks continue to "juice" the markets?:*** *"how much of the powerful rally from September is due to the rate of change on growth bottoming and how much is due to this almost unprecedented rate of change in balance sheet."*

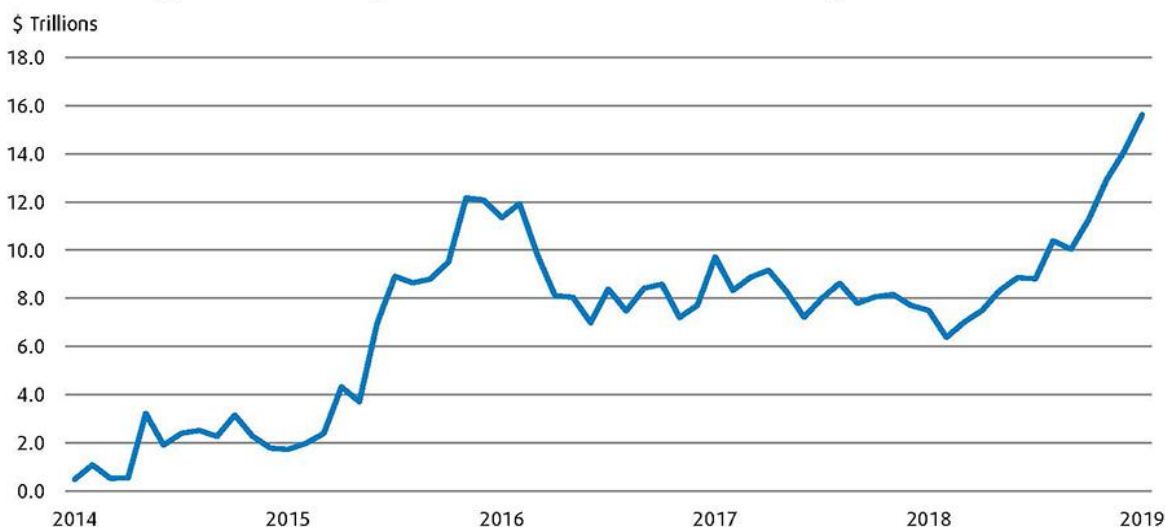
Graph 4.



And of course, all this money flowing into markets has also had the effect of juicing bonds, though there has been a recent hiatus. Still, 28% of global bonds experience negative interest. The \$9 trillion run up between 2018 and 2019 has only been matched by the run up between 2015 and 2016. These negative yielding bonds are a ticking time bomb, because when these bonds reach due date (maturity) they will only have their face value repaid, not their overpriced market value. The difference could lead to sizeable losses to the holder. This is the unavoidable limit unless governments buy them up shortly before due date and bear the loss.

Graph 5.

Global Negative Yielding Debt Has Reached Record Highs

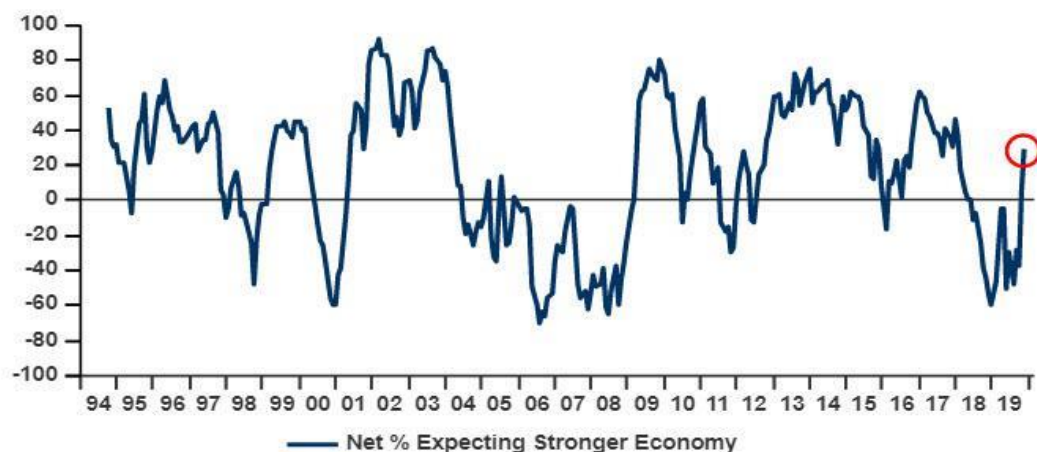


Source: BMO Global Asset Management and Bloomberg. Represents the Bloomberg Barclays Global Aggregate Negative Yielding Debt Index. Investments cannot be made in an index.

The final graph in this section shows the intoxicating effect on fund managers of the power of the FED. Since the injection of funds into the REPO market their “animal spirits” have been revived. This is the real aim of the FED, to get them to spend, spend that is on financial assets.

Graph 6.

Exhibit 21: How do you think the global real economy will develop over the next 12 months?



Source: BofA Global Fund Manager Survey

The world is on a financial precipice.

It is important to note that the profile of any Crash this time around will be very different to 2008. I believe that I am alone in seeing the Financial Crash of 2008 as a major but tangential event focusing on only one corner of the bond market, residential mortgages. Admittedly at \$14 trillion at the time

in the USA, it was the biggest segment of the bond market, bigger than government bonds and double the size of the corporate bond sector. An ideal playground for the banksters.

What is less known is that non-financial bond defaults (industrial defaults) with the exception of junk bonds was much lower than the default rate for housing loans. This is what Moody's one of the two leading rating agencies had to say in their 2010 review: *"As a result of rapidly increasing defaults in 2009, the trailing twelve-month issuer-weighted default rate for all Moody's-rated issuers jumped to 5.4% in 2009 from 2.0% in 2008. Among speculative-grade issuers, the default rate rose to 13.0% in 2009, almost triple its closing level of 4.4% at the end of 2008 and in close agreement with Moody's forecast of 15.1%. The 2009 year-end speculative-grade default rate exceeded the annual peaks of 10.3% and 10.0% set in 2001 and 1990, respectively, but failed to surpass the peak of 15.4% set during the Great Depression (see Exhibit 5). Measured on a dollar volume basis, Moody's speculative-grade corporate bond default rate jumped to 15.6% in 2009 from 5.9% in 2008. The volume-weighted default rate for all Moody's-rated issuers increased to 2.6% in 2009 from 2.2% in 2008."* https://www.ismymoneysafe.org/pdf/Moody's_corporate_default_and_recovery_rates_2009.pdf

The volume weighted default rate only rose from 2.2% to 2.6% despite the bulk of non-financial defaults taking place in 2009. Graph 7 shows that the default rate of 7% in value terms hardly registered when set against total outstanding loans during that period. In other words the write offs were not significant enough to substantially reduce outstanding loans.

Graph 7.



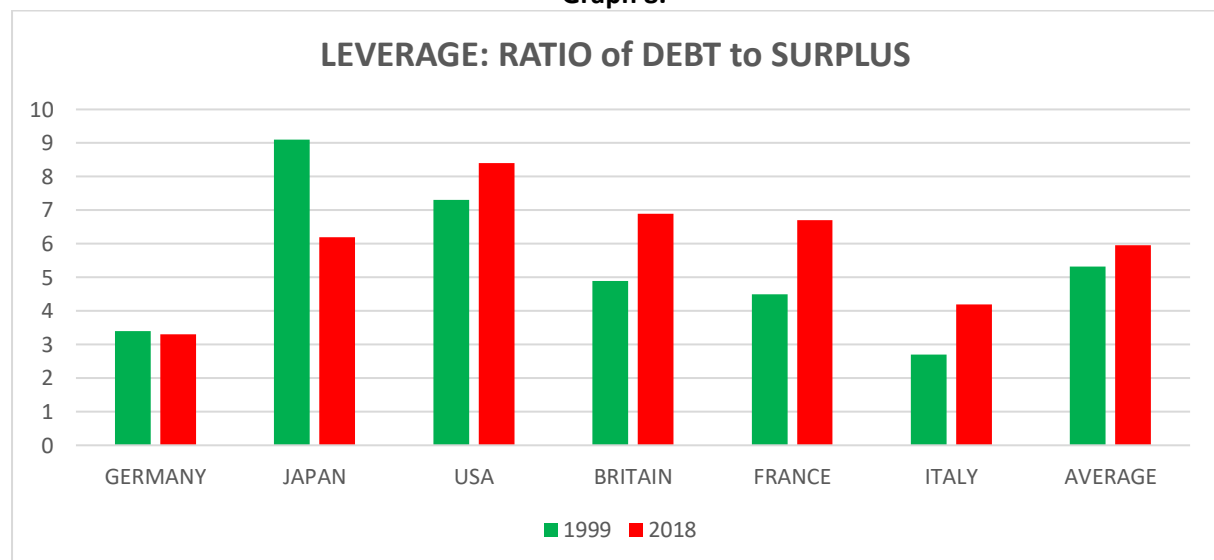
Now the focus for defaults will be in the corporate sector. This has been known for some time. What is different as we end the year, is that the fear is growing. In a recent article CNBC expressed concern about the growth and quality of corporate debt. *"Many Wall Street strategists share the concern about the ballooning corporate debt load but few sound as worried as Trahan."* The Trahan they are referring to is UBS strategist Francois Trahan. He is interesting because he relates debt issues to profitability. This is what he had to say: *"In a Tuesday note, Trahan said that U.S. corporate debt has surged by 50% since 2009 and now stands at nearly \$10 trillion. Such a jump in corporate debt would be more worrisome had it not been for the steady economic recovery and steep drop in yields, he said. Since*

2010, yields on Baa-rated corporate bonds have fallen to around 3.9% from more than 6.3%. This decade's surge in corporate debt could pressure stocks in 2020 as corporate earnings slow to a crawl, hurting the ability of companies to timely repay that debt..." "All of this takes place at a time when earnings expectations are just above flat and orders are falling according to the ISM. He is worried about downgrades for corporates like Amazon and Walmart." <https://www.cnbc.com/2019/12/18/a-10-trillion-debt-burden-coming-due-one-day-could-hit-the-stock-market-and-amazon-ubs-proposes.html>

The Financial Times was equally concerned on the 20th December when it quoted the Basel based Financial Stability Board which warned about the surge in leveraged loans. What was really interesting is that an exact figure for these bonds are elusive, their global size is anywhere between \$1.4 trillion to \$3.2 trillion. Clearly a difference of \$2 trillion is highly significant to the outcome of any Crash. Insurance and pension funds hunting income are heavily exposed to these bonds.

They have every reason to be. Leverage has continued to grow and given the weak outlook for profits appears to be unsustainable. Leverage may have fallen in Japan and Germany but elsewhere it has grown especially in the USA which leads the pack as Graph 8 shows.

Graph 8.



(Source: Federal Reserve of St Louis)

The most threatening feature is that this growing indebtedness is that it is not confined to the advanced capitalist countries, it is everywhere including India. The World Bank has just brought out a new report entitled *Global Waves of Debt*. It identifies the current wave of indebtedness as the fourth one. It defines this wave as "Similar to previous waves but larger, faster and broader." In greater detail: "In addition, whereas previous waves were largely regional in nature, the fourth wave has been widespread with total debt rising in almost 80 percent of EMDEs and rising by at least 20 percentage points of GDP in just over one-third of these economies." While EMDEs have gone through periods of volatility in the current wave of debt accumulation, they have not experienced widespread financial crises. However, the exceptional size, speed, and reach of debt accumulation in EMDEs during the fourth wave should give policymakers in EMDEs pause. Despite the sharp rise in debt, these economies have experienced a decade of repeated growth disappointments and are now facing weaker growth prospects in a fragile global economy." <https://www.worldbank.org/en/news/press-release/2019/12/19/debt-surge-in-emerging-and-developing-economies-is-largest-fastest-in-50-years>

India is a case in point. Today India is wracked by protest. Modi and the BJP are reeling. These protests may have been sparked by a threat to the secular state, but the same forces which are driving the protests are the same thing that drove the invasion of Kashmir, a growing economic recession. A recession fuelled by the lack of profitability causing debt to implode both in the informal banking sector and the state banking sector. It seems Modi is no longer the icon adored by foreign investors. *"After pouring \$45 billion into the stock market over the past six years on hopes that Prime Minister Narendra Modi would unleash the country's economic potential, international money managers are now unwinding those wagers at the fastest pace on record. They've sold \$4.5 billion of Indian shares since June, on course for the biggest quarterly exodus since at least 1999."* Bloomberg reported.

The difference between defaults in corporate bonds and residential bonds, is that production does not take place in homes, and, workers places of employment are not their homes. Even if they work from home this is work directed by corporations outside their homes. In the case of corporate bond defaults, this represents the insolvency of actual plants and factories not the insolvency of the head(s) of households. It goes to the heart of capitalism, the source of value production. And it is contagious. Firms are each other's customers and their defaults become contagious. A trillion dollars' worth of defaults in industry versus that of mortgages will have a much more devastating effect on production and on those who gain or live by that production.

The outlook for 2020.

Since the FED REPO facility and the tentative trade agreement between the USA and China, the speculators have been more confident, and, there has been some improvement in the outlook of CEO and CFOs around the world. However this is likely to be a temporary. The reason is that the conditions that emerged after the turning point in 2014-6 have not been reversed. If anything they have intensified. 2014 marked a turning point in the economic fortunes of the advanced capitalist countries and by 2016 that included the emerging capitalist countries as well. By 2016 it could be said that the period of globalisation, which began in the mid-1990s, had exhausted its potential.

Take the trade talks. Phase 1 does not return the global economy to where it was. It remains fractured and tariffs will continue to be in place until the USA imposes its' will on China. In short the world economy is in a worse place than it was in 2016. It is only when we see the tariff wars and central bank actions for what they are, symptoms of the deepening malaise rather than the causes of it, that we recognise how limited the effects of these actions will be. A question of postponing the inevitable.

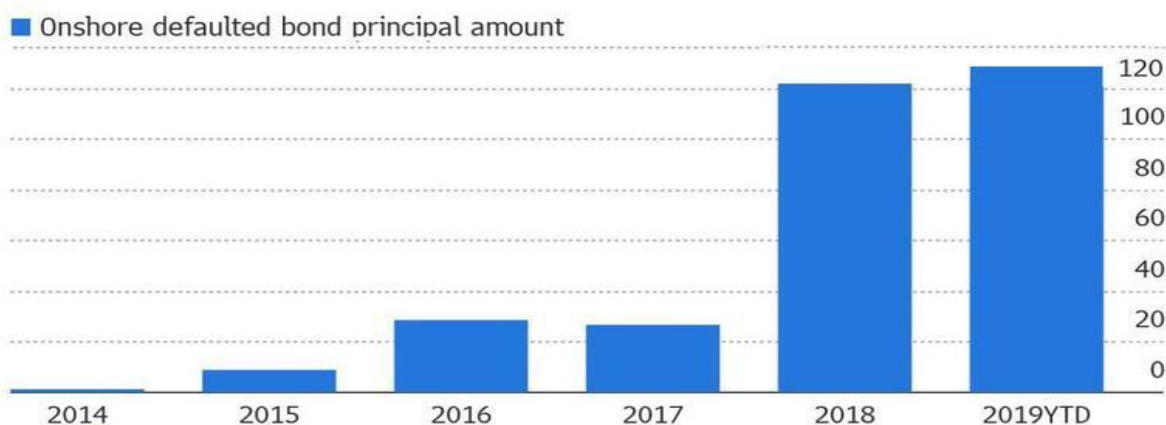
There has been a discussion as to whether or not the Crash will occur in China or the USA. The EU can be ruled out, for as big as it is, it is not at the centre of the economic storm resulting from the struggle over hegemony between the USA and China. Rather the EU will suffer collateral damage. Short of war, China will play for time, because time is on its side, while the USA will play for keeps as it did with Germany and Japan in the Second World War.

Whatever the case, the trade war has accelerated processes in China already under way and which would have occurred with or without the trade war. China's rate of profit began to fall in 2013, well before the trade war, limiting its scope for investment and placing definite limits on debt leverage. The result has been a sharp deceleration in its annual rate of investment which is the primary cause of the industrial slowdown worldwide. It has caught many countries in its wake, particularly Germany which was one of the countries benefiting from the industrialisation of China. Thus to answer the question, will the global depression emanate from China or the USA, the answer is already clear. The epicentre of the global industrial recession is China. It appears that when China sneezes ball bearings, the rest of the world bleeds.

With regard to the financial component, it could very well be both China and the USA, with the EU contributing. Certainly both countries have severe debt issues. In China as Graph 9 shows, bond defaults have been accelerating. The figures are in billions of Yuan. To put this figure into perspective, Fitch Rating Agency, calculates this is equal to a 4.5% default rate for all private company bonds, approaching levels last seen in the USA in 2008. Additionally, defaults are spreading from the poorer provinces like Tianjin to more prosperous provinces like Shandong which accounted for 11% of the defaults being discussed.

Graph 9.

CHINESE BOND DEFAULTS



Source: Bloomberg

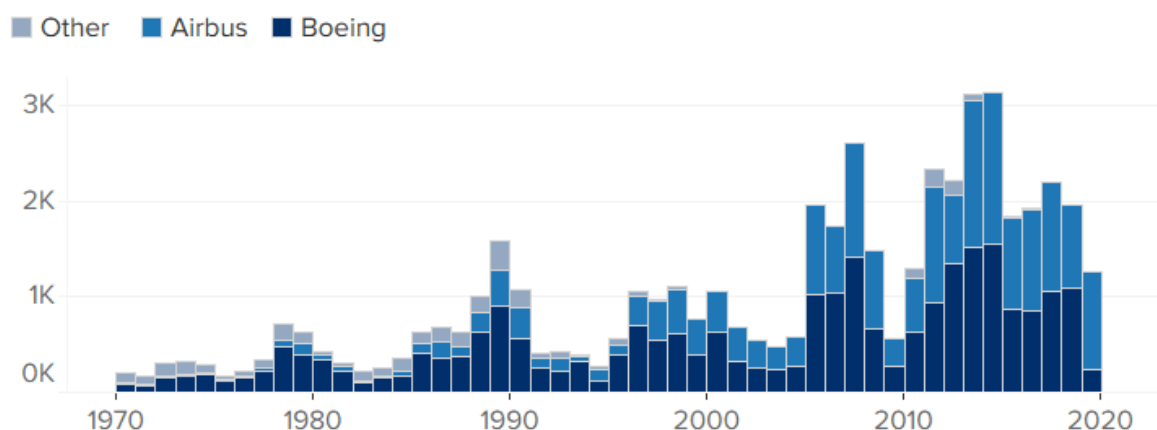
What has also changed is that a large state owned corporation, Tianjin's Tewoo, has defaulted for the first time. This corporation was big enough to make it into Fortune's Global 500. It appears that Peking's position on defaults has changed, either the government is allowing, or, it no longer has the capacity to prevent these defaults. If it is the latter case, then defaults could become endemic and they will include State Organised Enterprises.

Things are no better in the USA. The shale oil and gas industry, which accounts for nearly \$900 billion dollars of loans, or roughly 10% of the total of \$10 trillion in corporate debt is a busted flush. It appears that drillers are milking their existing wells for all they are worth rather than drilling fresh ones in order to keep the bailiffs from the door. This will provide only a temporary respite because these wells, unlike wells elsewhere, have a limited shelf life. It appears that the USA's modern Eldorado is effectively over, removing the most dynamic component for growth in the US economy. But it is one industry amongst many industries facing financial stress and solvency issues in the US.

If there is one industry that encapsulates the globalisation process, it has to be the aviation industry. Graph 10 below shows how the industry, in terms of orders, peaked in 2014/5. Now the industry is in decline. As aerospace analyst Sheila Kahyaoglu from Jeffries said in a recent CNBC report: *"The boom in orders is over,"* In the opinion of the author of the CNBC article: *"Both manufacturers will enter the next decade amid slowing air traffic growth and trade wars. Demand growth for their higher-priced wide-body jets that can fly longer distances has slowed the most, as carriers opt for nimbler, fuel-saving planes that can fly travellers on ever-longer nonstop flights..."* The two aircraft companies he refers to are Airbus and Boeing who will be hurt by the fall in overall orders and the shift to cheaper planes.

Graph 9.

Large commercial jet orders



SOURCE: Cirium. Data as of 12/13/19.



This is but one instance in a generalised picture. Painting a bleak future for capitalism is no longer a fringe activity. Even the “highly respected” Economist Intelligence Unit (EIU) predicts a sluggish future. If we consider what it is that Simon Baptist says, namely that future growth will be half as fast as the growth experienced since 2008, which itself was down by half compared to the pre-2008 period.. *“With the global economy already showing signs of a slowdown, Simon Baptist, chief economist at the Economist Intelligence Unit (EIU) suggested that patterns of growth are changing, and that growth itself can no longer be taken for granted.”* Simon Baptist Chief Economist The Economist Intelligence Unit <https://www.cnbc.com/2019/12/20/global-growth-will-be-half-as-fast-over-the-next-decade-eiu-predicts.html>

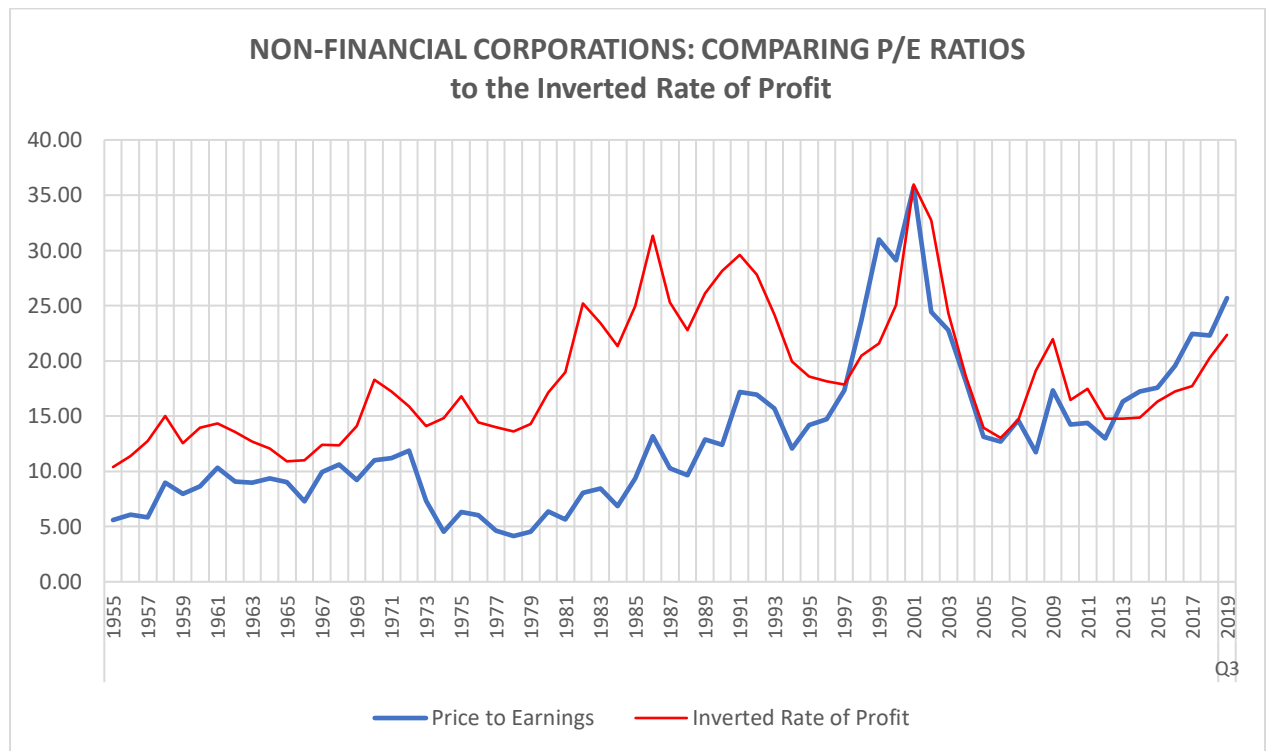
That projection puts global growth at less than 1.5% p.a. Truly a depression. For a comparison of prior GDP growth rates please follow this link to the World Bank website and graph: https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?cid=GPD_30&end=2018&start=1961&view=chart

Future prospects continues to hinge on the speculative bubble. It is worth reminding ourselves how precarious this bubble is. In a previous article linked below, I provided a graph describing the interrelation between the real multiple, the inverted rate of profit, and the fictitious multiple, the price to earnings ratio. In the first multiple the ratio is the value of fixed and circulating capital divided by unadjusted pre-tax non-financial corporate profits. The second multiple is the market cap of the Wiltshire 5000 which covers almost 100% of listed companies divided by the same mass of profits. <https://theplanningmotivatedotcom.files.wordpress.com/2019/12/the-fed-santa-pdf.pdf>

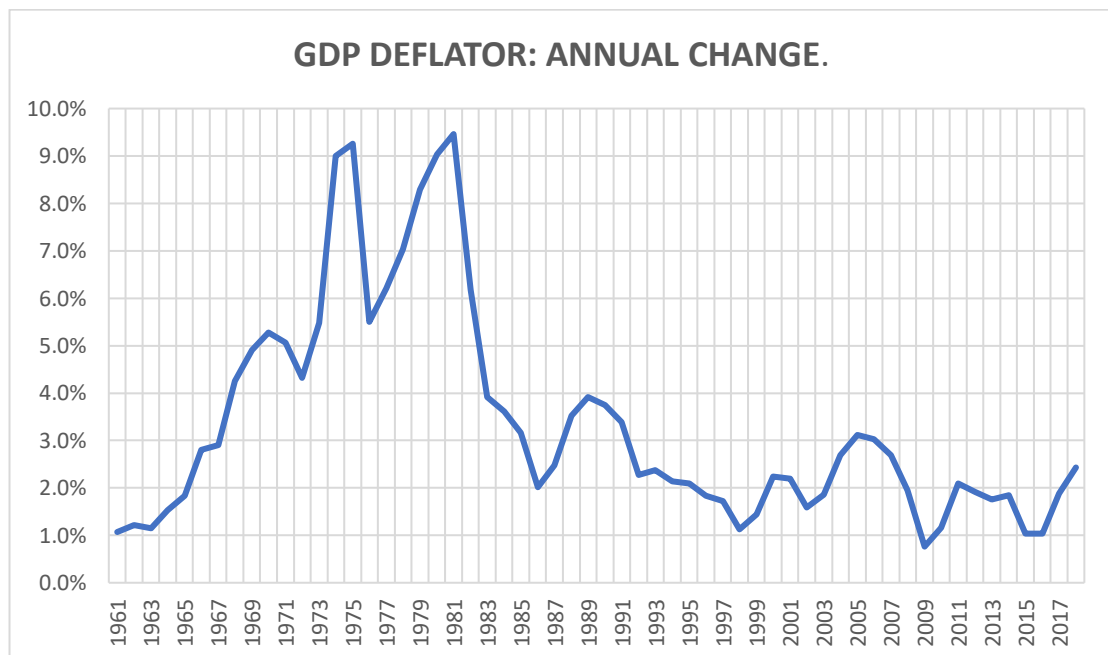
The following graph (Graph 11) plots the rate of inflation for the whole economy. It can be argued that the comparison between the two multiples are distorted during periods of high inflation. That is true, which is why the gap expands from the early 1970s to the late 1980s. But for the rest of the time, crucially the period from the late 1990s, inflation is not a factor, particularly compared to the 12 years from 1955 onwards. This is brought out in Graph 12, in which the reader can find my estimate for the end of 2019. For the final quarter of 2019, thus far, share

prices are up by 8%. On the other hand I expect the rate of profit to approximate that of the third quarter based on FactSet profit estimates and monthly NIPA investment estimates.

Graph 10.

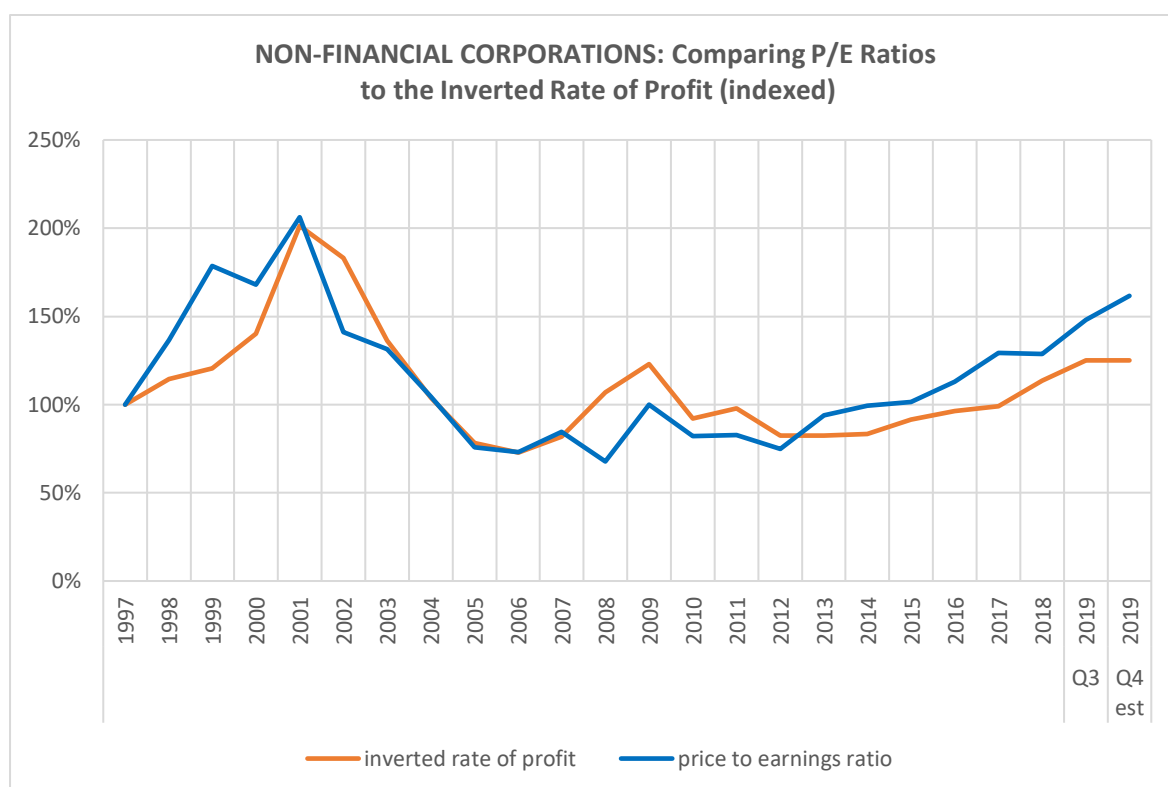


Graph 11.



(Source: FRED Table [USAGDPDEFAISMEI](#))

Graph 11.



In 1997 as Graph 10 shows, the two multiples met prior to crossing over. This provides a useful year in which to index both multiples at 100 to show their subsequent relative movements. Thus the current gap between the two multiples is 30 - 32%, compared to the maximum gap of 50% prior to the collapse of the dotcom bubble at the turn of the century. However, while that gap endured for three years up to 2001, this time it has endured for close to six years.

The longer and bigger the gap the more fragile the bubble. In contrast it could be argued that Japan has maintained the bubble for decades, albeit at the expense of zero interest rates and with the BOJ (Bank of Japan) becoming the world's biggest rentier, "coupon clipping" 40% of all bonds and over 10% of all shares. There are two problems with this scenario. Firstly, once the state embarks on becoming a rentier buying up bonds and shares, it deprives the capitalist class of an income source, forcing them to rely on the capital gains exercised by a diminishing pool of securities. Thus the state creates a process which it cannot end and which in the end does not serve its mistresses and masters.

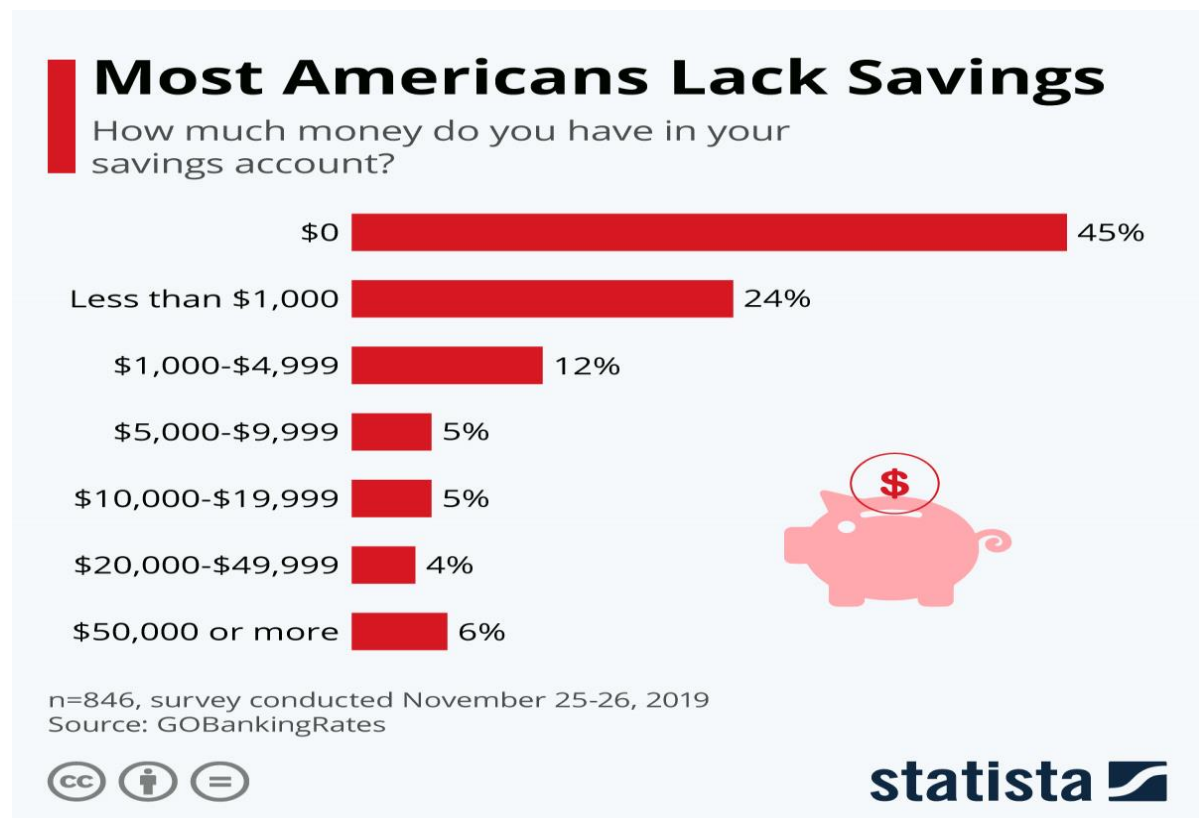
Secondly Japan's Quantitative Easing, at least until 2014, took place in a dynamic world economy powered by globalisation and the emergence of China as an industrial power. Looking beyond 2019, those favourable economic conditions no longer apply. As we have seen from Hussmann to The Economist Intelligence Unit, the outlook for capitalism is bleak. Thus the effect of Quantitative Easing will be diminished.

However, for the time being the imperative for central banks is to keep the bubble from bursting. In Graphs 12 and 13 two proofs are offered why this has to benefit the top 10% in general and the top 1% in particular. Firstly, there is the enduring capitalist fairy tale that once upon a time society split into the savers and spenders who became the capitalists and workers. Graph 12 shows that the bottom 80% of society is too poor to save. They simply do not have the capacity to save because they live from pay cheque to pay cheque. This has always been the case for the bottom 60% of society. The share of total savings of the bottom 80% currently is a mere 5.7% and this is an understatement

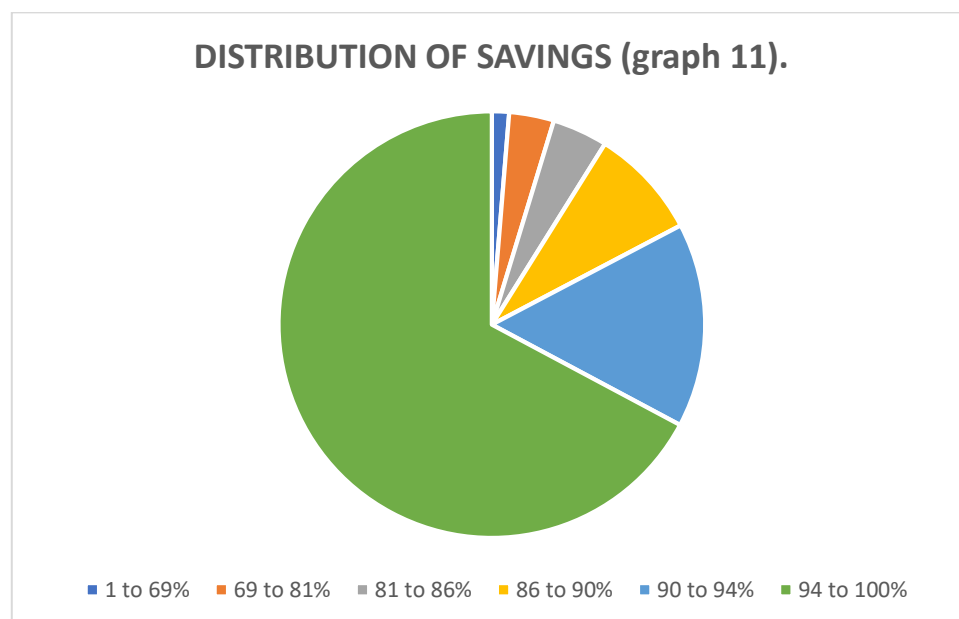
because I have assumed that the top 6% have average savings of \$100,000 which is on the low side. Despite this underestimate the top 6% holds two thirds of all savings.

Secondly, this being so, it is only the higher income groups that have the savings to invest in the first place. Thus only they can convert their savings into capital gains through speculation.

Graph 12.



Graph 13.



JP Morgan are of the opinion that the FED will provide financial support to the markets throughout the first quarter. This is in addition to the half a trillion injected between the second half of December and the first half of January. It took that amount of electricity to provide the necessary atrial fibrillation to keep the markets alive over year end. If this is the case a Crash will be averted during the vulnerable month of January.

In conclusion. A developing crash always emerges in the periphery before moving to the centre. Over the last month, on average, each week, over 500 cities world-wide have had significant protests, mainly led by the young. This has involved multiple countries simultaneously making it unique in history. The Financial Times uses the term “a vintage year for protests” to describe 2019. This is a strange term for a capitalist paper to use, only equalled by the author’s failure to recognise the root cause of these protests. True the immediate trigger may be tangential such as the extradition law in Hong Kong or the attack on secularism in India, but what they all have in common is a recognition by the youth that they have no future under the existing conditions and more importantly, that they are no longer willing to live under these conditions. Boris Johnson will learn to his cost, that the cities of England, populated by angry and disaffected youth, is not immune once Brexit goes pear shaped, which it will.

Yes, the scale and spread of these protests are unparalleled, but then so too is the global economic crash that is simmering.

Brian Green 24th December 2019