
Quarterly Economic Commentary

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Key Takeaways

- ▶ Risk of global recession is rising, and the main problem is EM debt.
- ▶ It's time to start thinking that long-term interest rates might not normalize this cycle.
- ▶ Corporate profits and sales are key to U.S. outlook.
- ▶ Eurozone is performing better--by eurozone standards.
- ▶ Japan's policies are failing to lift inflation, and missing the main point.
- ▶ We have too much uncertainty, not bad news, about China's economy and financial sector.
- ▶ Pessimism over EMs might be overdone. Be discerning.

Global economy: A world of gloom

A cloud of pessimism has wrapped the world economy. Activity reports signal a slowdown, especially in developing countries. Trade volumes are depressed. Inflation expectations have declined. The bells have rung in financial markets: jittery equities, sinking commodity prices, and rising credit spreads. The R-word gets tossed around a lot. If recession is the omen we fear, we should be parsing the corporate profit tea leaves.

Corporations can swiftly turn a soft patch into a hard recession. When earnings disappoint for several quarters managers put off capital spending. Financial markets echo the news, infecting sentiment beyond the corporate sector. Risk aversion takes hold, the business outlook darkens, and more managers scrap investment plans and freeze hiring. If earnings sag long enough, investment is pared down further and job openings cancelled. Unemployment starts rising. Consumer confidence buckles and households cut discretionary spending. Earnings projections then fall even further behind target, adding fuel to the fire. A recession is in motion.

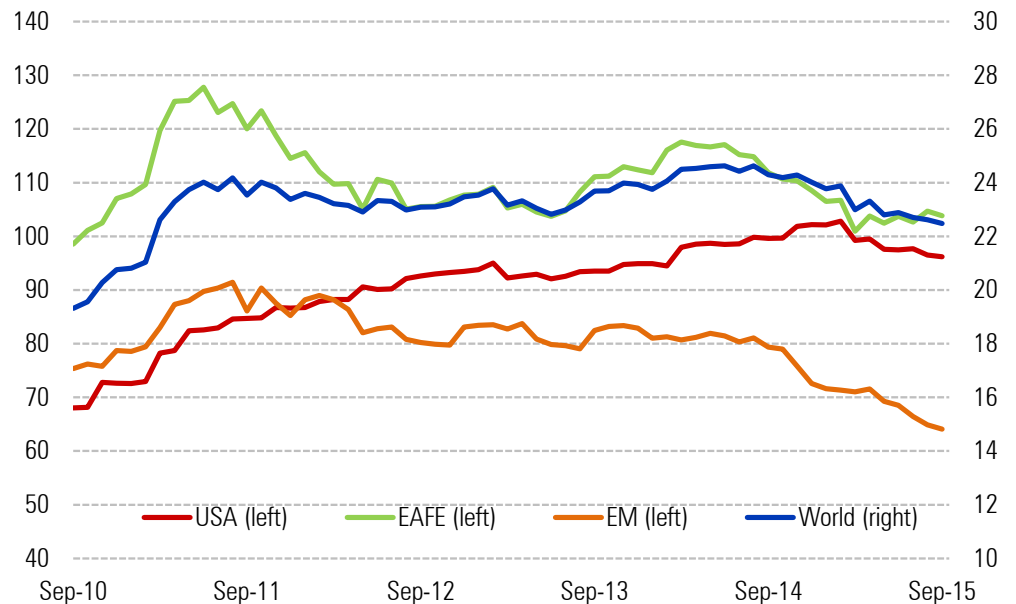
This dynamic is by no means inescapable. The economy goes through several lulls within a cycle, and we can't predict whether today's is The One. But the risk gets pretty high once, as today, the economy has been expanding for at least five years, profit margins are above average, and it gets harder and harder to squeeze profits out of sales.

Global earnings per share peaked in June 2014 (see [Exhibit 1](#)). As of September 2015, trailing profits had fallen 7.5% year-on-year, the largest decline since 2008. In the U.S. S&P500 operating earnings have shrunk on a yearly basis for three quarters. Outside the U.S., developed market profits crested in March 2014, and in emerging markets earnings have been on a slow decline since 2011. Granted, in neither region are profits in free fall—but by the time that happened a recession would be well under way.

Recession skeptics point to low oil prices. Every global recession since the 1960s has followed a spike of crude, but at present Brent trades 40% lower than a year ago. More broadly, lower commodity prices are a boon to the global economy: most countries and corporations are net consumers, not producers.

The pressing matter, I think, is not aggregate demand, but debt. If profits don't grow enough to pay back debt, the weakest borrowers go bankrupt. Besides the sentiment shock, a spike in defaults makes credit more expensive—for some, not available at all. As the cost of capital rises, fewer investment projects clear the required profit hurdle, and capital spending declines.

Emerging-market, commodity-exporting countries face the steepest road. Their corporate sectors have racked up some \$3 trillion worth of debt. Some of it is in dollars, which brings back memories of the 1998 Asian crisis. Much of the debt is to banks, not bondholders, which raises the odds of financial contagion.

Exhibit 1 Earnings per share, USD, 12-month trailing

Sources: MSCI Global, FactSet, Morningstar.

Crisis or no crisis in 2015, the debt pile is there, and it won't go anywhere in 2016 or 2017 or the year after. The known, immediate triggers are mainly two. First, the commodities on which many of those borrowers make a living have lost value. Second, their currencies have lost luster.

Brazil and Russia are already in recession. The International Monetary Fund just pegged Latin America as the region with the lowest projected growth in the medium term. But it's not only emerging markets. In Canada, also in recession, household debt-to-disposable income has risen to 164%, from 143% in 2008. Australia's debt growth looks similar. According to the McKinsey Global Institute, the global stock of debt grew 40% between 2007 and mid-2014. In advanced economies government has borrowed the most, but in emerging markets it's been corporates. The economy—and arguably wealth—also grew during that period, but not as much as debt. As a result the world is now more leveraged than before the Great Recession.

The hopeful scenario is that this is an intra-cycle slowdown. Stimulus measures introduced by Beijing might bear fruit in China soon. The European Central Bank's quantitative easing (QE) program has rekindled lending in the eurozone. Both Europe's and Japan's central banks appear willing to do more. In the U.S., low energy prices and interest rates support household spending growth.

Recession or hiatus, the silver lining is that policy interest rates haven't risen yet. In fact, four of the world's five main central banks are easing. But monetary policy—or anything else, for that matter—can't put off recessions forever.

Interest rates: Back to the future

Every year since 2011 market observers have been predicting that long-term interest rates would rise soon. Every time they've been wrong, for one reason or another. The eurozone crisis has scared investors, on several occasions, into "safe havens." U.S. monetary policy has stayed loose far longer than we thought (it's now been two years since the 2013 taper tantrum!). The once-hawkish European Central Bank has joined the QE camp. Growth in emerging markets has slowed down. Oil prices plummeted in 2014, putting off the recovery of inflation. And term premiums have remained strangely narrow.

As a result of this raft of one-off's, ten-year yields are back under 1% in Japan, France, and Germany, and under 2% in the U.S., Canada, U.K., and Italy. Real interest rates on prime sovereign bonds are around zero.

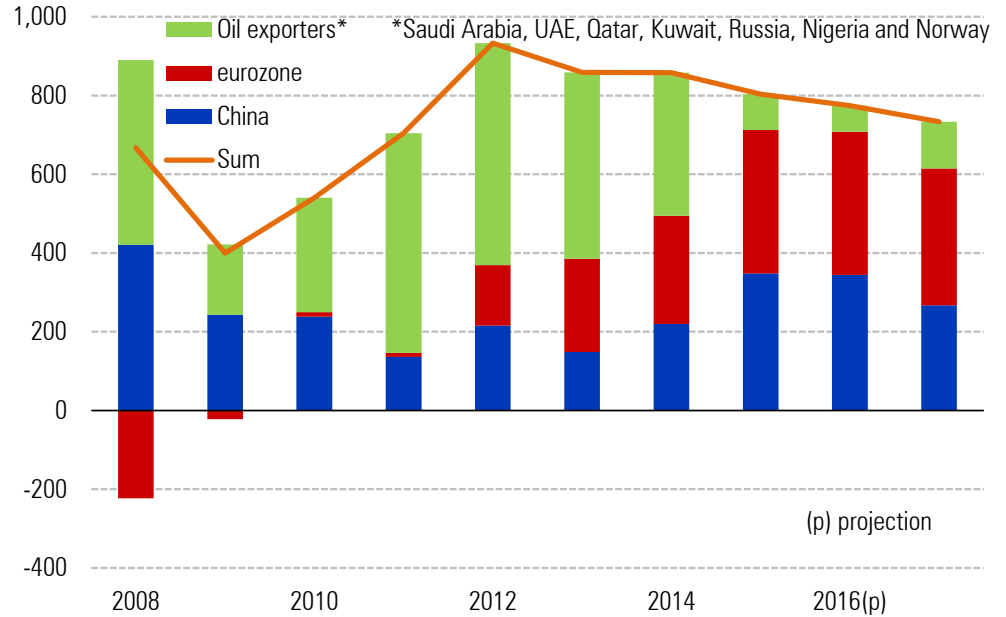
Undaunted by previous misses, economists polled this month by the Wall Street Journal think the U.S. Treasury note yield will climb to 2.9% in December 2016, and 3.4% in 2017. Likewise, consensus forecasts for Germany, Japan, U.K., and Switzerland show most forecasters projecting rises of at least 25 basis points in one year.

The scenario, however, where long-term rates don't normalize at all before the next recession, is gaining credibility. The first reason is aggregate saving. The global savings glut is not about to evaporate. China's national saving rate is almost 50%, but its investment rate will almost certainly continue falling. The IMF predicts only a modest narrowing of its current account surplus through 2017, which implies China will still be exporting sizable flows of capital seeking a home in developed markets. That means lower interest rates for the major world currencies. Offsetting China are oil producers, whose current account balances are quickly shrinking. But this is almost compensated by the widening surplus of the eurozone (see Exhibit 2).

The second reason is risk preferences. The tide is turning against riskier assets, such as high-yield corporate debt or emerging-market equities. Corporate credit spreads went up in August, amid the episode of volatility led by China. The markets have calmed down since then, but premiums have mostly stayed up, across the dollar, euro, and pound sterling, as well as in emerging markets, according to the Bank of America-Merrill Lynch indexes. EM sovereign debt spreads remain, likewise, elevated. The mirror image of less appetite for risk is more demand for prime sovereign bonds, ergo lower yields.

Third is monetary policy. Although central banks cannot distort long-term interest rates forever, they do have an influence in the medium run. Among the handful of central banks with the power to lean (for a time) against the market, none is in a hurry to tighten. The Fed keeps finding reasons to delay the liftoff. The European Central Bank is committed to asset purchases for at least another year. The Bank of Japan might have to enlarge its program soon, if it's really committed to its nominal growth target. And the

Exhibit 2 Current account balance of large surplus economies, USD billions



Source: IMF, FactSet, Morningstar.

central bank of China looks pretty busy offsetting the triple threat of slow growth, deflation, and financial panic.

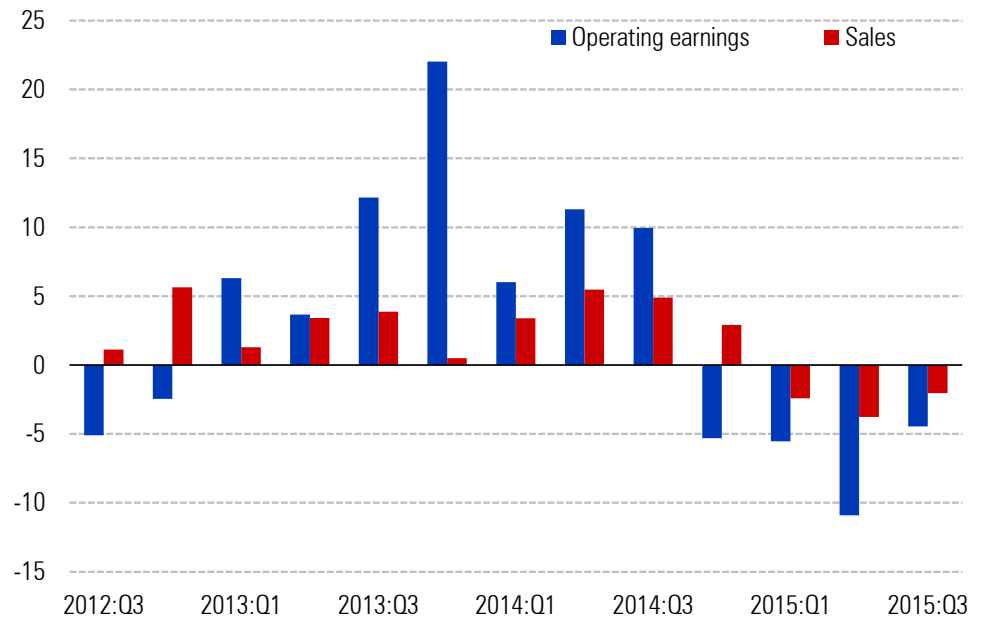
Fourth, and overlapping the other three, is investors' gut feeling that a global recession is coming in 2016 or 2017.

Beyond the next couple of years, too, there are reasons to think that long-term "risk-free" rates will stay low, relative to before 2008. Long-term productivity forecasts have been going down. Perhaps relatedly, the decline of physical investment appears permanent. The global rise of the middle-aged, high-saving population group is thought to push down interest rates—although links between demography and interest rates are complex and ambiguous. And the shortage of "risk-free" assets, in part due to the supremacy of the U.S. dollar, has no end in sight.

United States: Watch profits

The corporate earnings season is not bringing good news this quarter. For the S&P500, with some 200 reports already in, operating earnings per share have slid 4% from their peak in 2014:Q3. Adding to the concern, sales are falling too (see Exhibit 3). Annual revenue growth had not been negative since 2009, which is also the last time that top and bottom lines fell in the same quarter. Many point to the energy sector, which accounts for a big chunk of the overall decline. But sales growth has slowed from a year ago in every one of the other nine industries as well.

Exhibit 3 Sales and earnings growth, S&P 500, year-on-year % change



Source: S&P, Morningstar.

The S&P500 consists of public, large-capitalization corporations, which arguably are more sensitive to the rising dollar. But in the national accounts statistics, which include a more diverse swath of corporations, non-financial profits after tax fell 2.5%. For the Russell 2000, a small-cap index, earnings per share are growing now half as fast as a year ago.

Besides the impact on stock prices, I'm interested in profits because of their value as a leading cyclical indicator, as I explain above [Global economy]. Almost all the U.S. recessions since 1870 have been preceded by peaks in profits, most of them between two and six quarters ahead. The drop in profits is not proof that recession is imminent. But it's an indication that the risk of one is rising.

Some analysts bring up that the economy has grown 2.7% over the four quarters through June 2015. Most recently GDP posted a solid 3.9% quarter-to-quarter advance (annualized). But the all-consuming

GDP numbers don't tell us half the story. Real gross domestic income, which differs from GDP due to mere statistical error, rose just 0.7% in Q2. GDI growth has come below GDP growth for three quarters in a row. GDPplus, an optimal combination of the two series created by researchers at the Federal Reserve Bank of Philadelphia, shows our best guess is that the economy grew 1.2% (annualized) in Q2, down from around 4% the year before.

The feared profits-investment negative loop is not in motion. Business fixed investment strengthened through June, after slowing significantly towards the end of 2014. Non-residential construction and capital goods orders show decent growth. Residential investment doesn't show signs of letting up in the short term. Construction permits and home sales continue moving up, while inventory and vacancies are still low. Tighter credit conditions, if and when the Fed lifts interest rates, would slow down activity, but I think monetary tightening would have its main effect through sentiment. Investment weakness so far is confined to the energy sector. The prolonged period of depressed prices for oil and gas has discouraged new investment. Falling rig counts, for instance, already reflect this.

Two years have passed since the first hint of tighter monetary policy, by Bernanke in 2013. Several factors have been at play to delay the liftoff. The first one is uncertainty around the neutral real interest rate and the amount of slack in the job market. Regarding the neutral interest rate, several estimates point it's still depressed. The unemployment gap is less evident, but the Fed has focused a lot in under-employment this cycle. Plus, the last few years these variables have been unusually hard to pin down because market conditions have been odd: zero short-term interest rates, depressed labor participation rate, high rates of long-term unemployment and labor under-utilization, etc.

The second factor delaying the first hike is the stronger-than-normal link between central bank talk and financial prices. Fed-dependence is a real syndrome. To make it worse, the central bank seems much more averse to tightening too early than too late, whether it's out of fear of derailing the real economy or financial markets.

I don't know whether the liftoff will happen in December. For that, watch the Fed funds futures market. Investors' focus, in any case, should shift from "When will the first hike happen?" to "How much will the Fed tighten over the next two years?" On the second question, the market expects the shallowest rising path in decades, with a projected rise through December 2017 of less than 100 basis points. In what looks like a capitulation to the markets' view, the central bank's own projections have been coming down. In September 2014 the Fed put the policy rate at 3.7% for 2017. A year later the projection was just 2.75%. The "longer run" projections, which presumably remove cyclical considerations, fell from a median around 3.75% to 3.5%.

Eurozone: Up and crawling

Real-time gauges of growth, such as €-coin and the composite output purchasing managers index, suggest that activity held up during Q3 from Q2, when output rose an estimated 0.4% (1.6% annualized). The European Central Bank, however, is not at ease. At the October 22 policy meeting the central bank fretted about the slowdown of emerging markets, which presents “downside risks to the growth outlook.”

The ECB mentioned deflation too. Prices fell in September, year on year, for the first time since March. The central bank expects inflation will remain near zero before picking up sometime during 2016. But Draghi suggested that the risk is on the downside. The markets concur. The cost of ten-year deflation swaps has picked up, and the five-year, five-year-forward inflation swap rate (a measure of long-term expected inflation) has dipped since August.

Mario Draghi conceded that recent events warrant a “re-examination” of policies in December. Many observers think he has all but promised more monetary support. One of three announcements is expected. One option is to raise asset purchases immediately. Another one is to extend the program beyond September 2016. The third one is a cut to the current deposit rate of minus 0.2%.

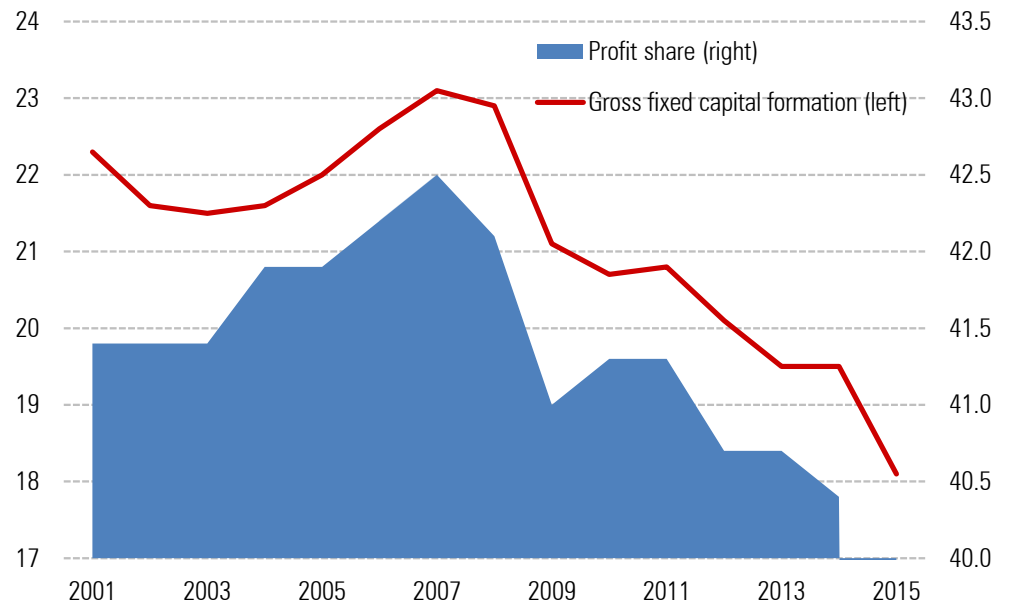
The inkling of further stimulus, along with the plunge of inflation expectations, will keep nominal yields near historical lows—the average rate on eurozone sovereign debt is under 1%. Shortly after the October 22 statement two-year yields for Italy and Spain turned negative. Germany’s registered a new record of -0.32%. Likewise, the euro slid under \$1.11, from \$1.15 a week before. A weaker euro is the easy way to prop inflation in the medium term, but it will stick only if the ECB keeps beating the drum—and then follows with action. For instance, in September, dovish comments triggered a similar fall, only to be reversed a week later.

A lower euro would support growth, too, through net exports. Trade figures will be important in the short term, as foreign sales have been a key driver of the recent economic rebound. Despite the contraction of world trade volume, in the first half of 2015 exports grew at an increasing rate, bulking the trade balance. In Q3, however, the surplus dwindled to €22 billion, from €65 billion in Q2. Exports to emerging markets, about 25% of the total, are bound to suffer as lower growth strangles capital expenditures and reduces demand for the eurozone’s wares. Germany’s exports (mostly of capital goods) fell sharply in August. Eurozone export orders have been declining through September, suggesting trade will contract through December and probably into 2016.

Domestic demand in Q2 made the smallest contribution to GDP growth since a year before. In that period household and government expenditures have strengthened, but that’s been more than offset by shrinking inventories and, last quarter, by slow capital expenditures.

Gross fixed capital formation of non-financial corporations has remained positive since early 2014, but growth is slow relative to the 2002-2008 cycle. The fall of the investment share of GDP has tracked the decline of the profit share since 2008 (see Exhibit 4).

Exhibit 4 Eurozone's profits (gross operating surplus + mixed income) and investment, as a % of GDP



Source: Eurostat, FactSet, Morningstar.

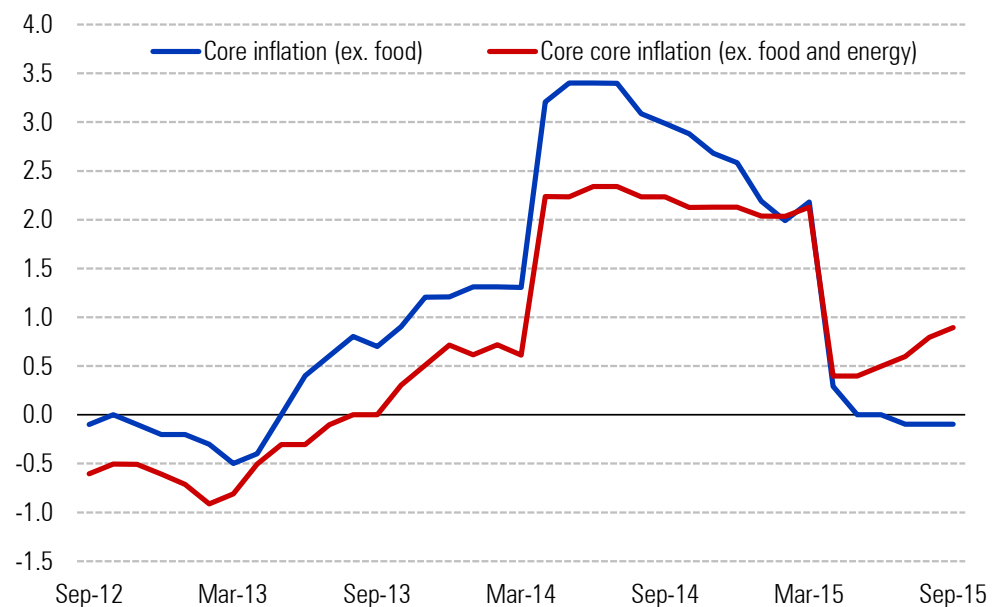
On other monetary and financial indicators, loans to the private sector continued rising year-on-year, particularly to households (1.4% change, versus 0.4% for non-financial corporations). The European Commission Bank Lending Survey shows a net easing of credit standards, also especially for households.

Labor productivity rose 0.4% in the first half of 2015, following a flat 2014. Real output per hour has increased a cumulative 1.3% since the cyclical trough of 2013:Q1, whereas total production has risen 3.2%. Unemployment has shrunk by about one percentage point, to 11%, over the same period.

Japan: Trying and erring

Japan is nowhere near its 2% inflation target, set for next autumn. Deflation, in fact, might be around the corner. The traditional measure of core inflation (CPI excluding fresh food) fell 0.1% in August. The new preferred measure of core prices (“core core” CPI, which excludes energy as well as food) is rising, but inflation expectations look lifeless (see Exhibit 5).

Exhibit 5 Year-on-year % change of core inflation indexes



Source: Ministry of Internal Affairs and Communications, FactSet, Morningstar.

The first arrow of Abenomics was succeeding at raising inflation—until it didn’t. The monetary base has more than doubled since end of 2012. The yen plunged and prices rose, but only through 2014. In 2015 inflation has been stagnant, as monetary policy fails to depress the yen further. The self-reinforcing cycle of higher inflation and higher inflation expectations just hasn’t kicked in. As of today, the main effect of quantitative easing has been to transfer a sizable portion of the government’s debt from the balance sheet of the private sector to the Bank of Japan’s.

The government just launched a new offensive. By 2020, they say, it will lift nominal GDP (NGDP) by 20%. That’s a moonshot. A 4% a year nominal growth rate almost doubles Japan’s recent performance. More importantly, they didn’t explain how they would do it.

The second arrow was fiscal stimulus, i.e. higher government spending and lower taxes. But Tokyo trimmed expenditures out of fear that debt and deficits would undermine solvency, in the eyes of the market. Out of the same fiscal concerns, the sales tax was infamously raised—although corporate taxes were cut. The combined effect of fiscal policy has not dented the financial surplus of the private sector.

Somewhat surprisingly, given the policies, the corporate surplus went down a little in 2014 and first half of 2015, whereas the household surplus has gone up.

Profits have stayed up. But the fatter cash flows don't trigger a virtuous cycle of higher investment and faster growth for Japan. The government's third arrow (structural reform) has felt, so far, like a pinprick. Recent progress in corporate governance and promises to liberalize the economy don't hurt, but overall Tokyo has done too little.

The elephant in the room is still the corporate sector. Two imbalances persist. First, the imbalance between the financial surpluses of corporate and household sectors; and second, the imbalance between corporate profits and corporate investment. A rising share of corporate earnings is either retained, or used to buy financial assets, or invested in capital abroad. Domestic capital expenditure has stayed weak, despite the economy's achieving the highest return on capital stock since 2007.

One problem might be that the return on capital is relatively low at home. Over the past decades—with a hiatus during the global financial crisis—Japanese corporations have increased offshore production and investment. Foreign profits, particularly for large firms, have become far more important for the size and location of physical investment than domestic earnings. That doesn't bode well for the domestic sector.

Raising the domestic return on capital should then be a priority. That's a tall order, even if politics doesn't get in the way, because it requires spurring that most elusive of growth factors: total factor productivity. But try Abe must.

China: Nerve-racking

Concerns over China's growth are warranted but not new. Official data imply the economy has been decelerating, smoothly, since 2010. Unofficial data suggest China's economy is slowing faster, but not crashing. The latest report from Beijing says the economy grew 6.9% in the third quarter, just a hair below the second quarter's 7%—and well above alternative estimations. Official estimates are widely discredited, and alternative guesses read as low as 4%.

China bears focus on proven indicators of China's performance. Electricity consumption, rail cargo volume, and commodity imports have tracked the economy fairly well in past. The "Li Keqiang index" and Capital Economics' "China activity proxy" are examples from this camp. China bulls, on the other hand, point that the service sector and consumption are driving China's "new economy." Beijing, they claim, is righting China's glaring imbalances. Over just 15 years the share of services in total product has shot up from about 40% to almost 60%, if you believe the government. And capital expenditures are rising at the lowest rate since 2010, but retail sales registered real growth of almost 11%, the highest in seven months.

The truth (one hopes) is somewhere in between. Traditional indicators might well be outdated. If, say, steel production gives way to health services, electricity consumption, imports, and rail transportation should plummet. The main problem, however, facing the high-growth defenders is that consumption and services growth data are difficult to second-guess.

The weight of the evidence suggests that China's numbers are plumped up and ironed out, but not utter fantasy. It appears the National Bureau of Statistics has been using the GDP deflator as shock absorber. At least twice recently, on quarters when nominal growth slowed, the government reported that the deflator had fallen, bumping up real growth. That was particularly odd because the consumer price index, which the overall deflator overlaps, didn't register a similar contraction. One alternative, then, is to look at nominal growth, which gives the impression that China is steadily grinding down, not crashing.

The bigger point, however, is that not knowing is nerve-racking. A three percentage-point range in China's headline growth ripples through the global economy into billions of dollars' worth of other countries' exports. From there they cascade into lower foreign exchange reserves, investment, growth, etc. From that perspective, it would be understandable that managers in China-sensitive companies over-reacted to hints of a hard landing.

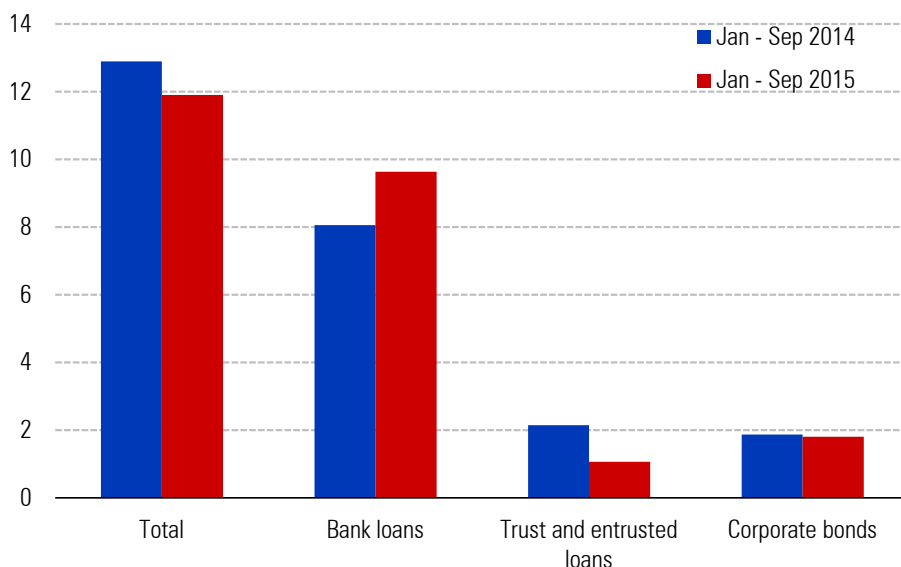
Uncertainty over China's true health has also been—and will be—the reason why markets react wildly to surprises. The August mini-devaluation of the renminbi was read abroad as a sign of weak growth. A massive risk-off wave ensued, with oil and EM-linked asset classes suffering the largest losses. In hindsight, the markets overreacted, but there's no reason they won't panic again.

The People's Bank of China has assumed an active role in 2015 on several fronts, with varying success. They tried to stop the stock market panic in August, and failed. The central bank has also delivered six cuts to either policy interest rates or the required reserve ratio (or both), in what amounts to a regular, steady easing path. It seems to help in the short run, as credit growth has picked up. The key point is that each new stimulus announcement is not necessarily evidence that Beijing is worried about the economy. The government appears to have a plan to smoothly provide fiscal and monetary support, until some target (unobservable by us) stabilizes around a certain level (unknown by us). That may be reassuring, or not, depending on how skilled you think Chinese policymakers are.

Fixed asset investment continued to soften in September, with growth down to 6.8% year-on-year—the slowest since December 2002. The manufacturing and real estate sectors (making up about 60% of total spending on fixed assets) have been the key drivers of the slowdown. In real estate, in particular, investment is now shrinking outright. Construction starts fell almost 14% through September, compared to the same nine months last year. Housing prices appear to be rising, but modestly and mostly in large cities. Total social financing—China's measure of total credit—between January and September fell 7.7% from a year earlier. Tighter regulation of shadow banking contributed to the decline, reflected in a 50% decline of the so-called "trust and entrusted loans." Traditional bank loans rose 8.3% (see Exhibit 6).

My five-year outlook and risk assessment for China hasn't changed. The country is on course for a growth deceleration toward 3.5%-5%, as well as a rebalancing of the consumption-investment mix, and probably further reductions of its current account surplus. The renminbi probably won't appreciate in the medium term. Beijing is doing its best to keep the transition smooth, but the risk is huge, because the private sector and the local government sector have amassed lots of debt.

Exhibit 6 Total social financing and selected components, trillions of RMB



Emerging markets: Mind the bathwater

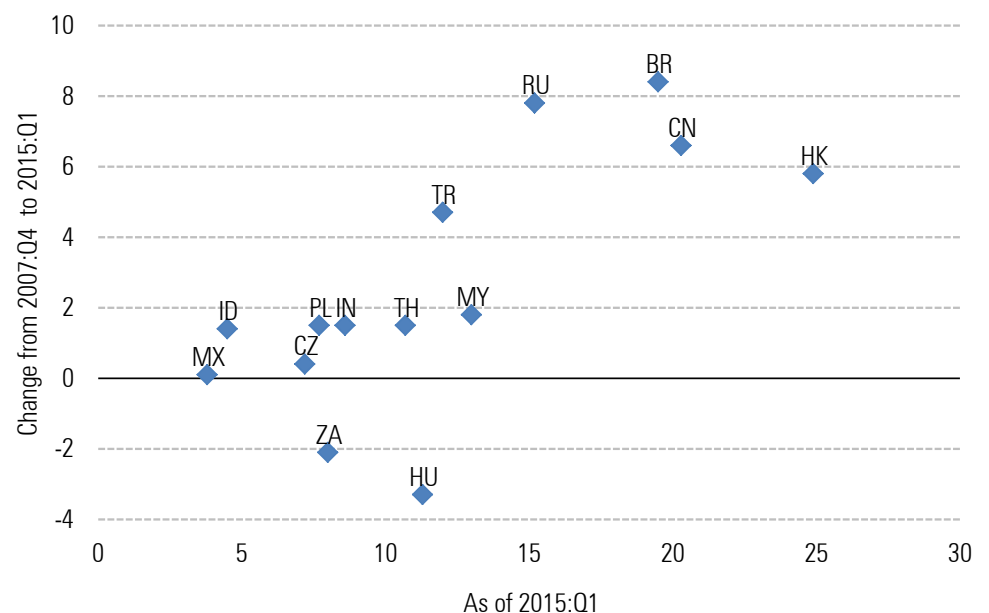
Sentiment has turned sharply against emerging markets. Economic growth has decelerated sharply, shrinking the gap between advanced- and emerging-market growth to its narrowest in recorded history (about three percentage points). The latest business surveys fail to register any acceleration among the BRICS group—India being a possible exception.

Some economists have warned that EMs could become a replica of the sequence of crises that began in 2007-08 in the U.S. and continued in 2010-12 in the eurozone. Observers have zeroed in on four possible triggers for an EM crisis: low commodity prices, uncertainty over China, U.S. monetary tightening, and the build-up in debt.

Of those four triggers, the latter presents the largest problem. If it weren't for heavy debt burdens, low commodity prices, higher interest rates, or doubts about China would produce, at worst, a garden-variety recession. High leverage, involving corporations and banks, raises the stakes.

Non-financial companies have a debt level equivalent to 90% of GDP; in Asia it's 125%. Slower profits and declining currencies makes the debt more difficult to pay back. Current debt service ratios, according to a database by the Bank for International Settlements, are above their long-term averages for every major emerging market save South Africa and Mexico. The cases of China, Brazil, and Hong Kong are particularly alarming (see Exhibit 7).

Exhibit 7 Debt service ratios, selected emerging markets, in percentage points



Pessimism over EMs, however, might be overdone. Fund managers have drastically cut their exposure to EM equities. One estimate puts third-quarter outflows around \$300 billion. In the selling frenzy, it's possible that investors are letting go of good investments along with the bad.

Take India, for example. Its economy benefits from lower commodity prices. The private sector's debt service ratio is a modest 8.6%. Economic growth, now higher than China's, has held up reasonably well through 2014 and 2015. Its current account deficit has shrunk drastically over the same period, and inflation—an historical ailment—has more than halved since 2013. But the MSCI index's dividend yield is above its long-term average, and the price-book ratio below. Over the past year the local-currency price index has risen just 2%; in U.S. dollar terms it's fallen 3.8%.

India might be one of few exceptions. More generally, a strong dollar makes EM assets look cheap. The only problem is that few participants are convinced that the dollar has peaked. In fact, if the Fed raises rates after all, the greenback might rise even higher. For better or worse, the consensus view is still that the U.S. will outperform other large economies, that the Fed will raise interest rates in 2016, and that China's growth and thirst for commodities are waning. All those hypotheses, by convention, are consistent with a stronger dollar.

Opportunistic investors with a long-term perspective should take advantage of once-in-a-decade cheap valuations in select EMs. From a macro-fundamentals perspective, India, Indonesia, South Africa, and Thailand strike me as relatively unlikely to have a financial crisis. From a valuation perspective, Russia, Brazil, and Colombia have taken the largest beatings in the currency and equity markets (but South America is not out of the woods, I think, yet). In the sovereign debt market, besides Brazil, Mexico, Indonesia, and South Africa are trading at unusually wide spreads. ■■■

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