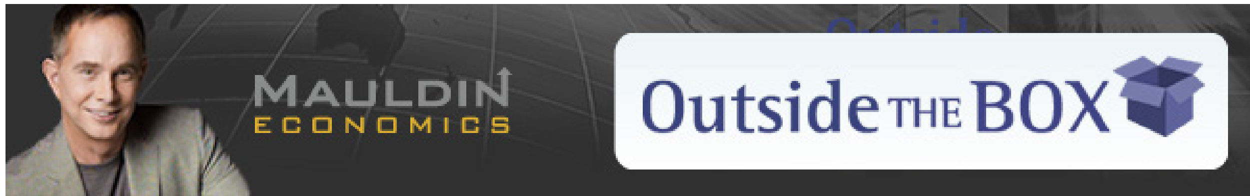


Risk On, Regardless

JOHN MAULDIN | April 9, 2014

When Gary Shilling was with us here last fall, he and I were feeling considerably more sanguine about the near-term propects for the US and global economies. In fact, I said about Gary that "that old confirmed bear is waxing positively bullish about the future prospects of the US. In doing so he mirrors my own views."

In today's excerpt from Gary's quarterly *INSIGHT* letter, he tackles head-on the shift in sentiment and economic performance that has ensued since then. He steps us through the ebullient headlines and forecasts that dominated at year-end, and then remarks,

> It's as if an iron curtain came down between the last trading day of 2013 and January 2014. A headline in the Feb. 5, 2014 *Wall Street Journal* screamed, "Turnabout on Global Outlook Darkens Mood."

Don't get me (and Gary) wrong: many of the positive factors that he and I identified last fall are still in play; but they are longer-term, secular factors such as technological transformation and a tectonic shift in the energy landscape rather than the cyclical factors that will dominate for most of the rest of this decade.

In today's OTB, Gary does an excellent job of summarizing and analyzing those cyclical factors. In this extended excerpt from *INSIGHT*, you'll be treated to sections on investor and consumer behavior, deleveraging, housing, income polarization, unemployment, Obamacare and medical costs, the prospects for inflation, the Fed, emerging markets, and much more.

Be sure to see the close of the letter for Gary's special offer to OTB readers.

I find myself in the lovely tropical city of [Durban](), South Africa. The hotel where I'm staying, The Oyster Box, is a lovely old throwback properly set on the Indian Ocean, where you can see the continual shipping traffic queuing up to get into the port, which is the largest in Africa. The hotel reminds me of the Raffles in Singapore, with a better view and somewhat more Old World charm. Or at least what I romanticize as Old World charm from movies I saw as a kid (though some of my younger readers are probably sure I lived in that era!).

I sleep now, then get up in less than five hours to catch a plane to Johannesburg, where I will spend the next three days doing more of the speeches and interviews that I've been doing for the last two, for my host Glacier by Sanlam. Anton Raath, the CEO, has that quintessential ability to make everyone feel welcome and keep them on goal. I am continually impressed with the quality of South African management, whether here or among the South African diaspora. If the government here could ever figure out how to get out of their way… I wrote a *Thoughts from the Frontline* almost exactly seven years ago that I called "Out Of Africa." It was a very bullish take on a country that I could see had wonderful prospects. And indeed investing in South Africa would have been a good move at the time – a solid double in seven years.

But this trip I've seen things and talked to people that don't give me the same feeling. We'll talk about it this weekend, after I have more meetings with both stakeholders and analysts of the local economy. South Africa seems to me to face many of the same problems that have beset Brazil, Turkey, and others in the Fragile Six. Why is this? Why should a country with this many resources, both physical and human, be falling behind? I think some of you can guess the answer, but I will wait to tell the rest of you in this week's letter.

Once again, for the fourth time in my life, my hot air balloon trip was canceled! Sigh. I am not sure what the travel gods are trying to tell me, but I will not give up, and one day I expect to soar above the earth on something other than my own hot air.

Have a great week.

Your wanting to come back to this hotel and pretend to be genteel for a few days analyst,

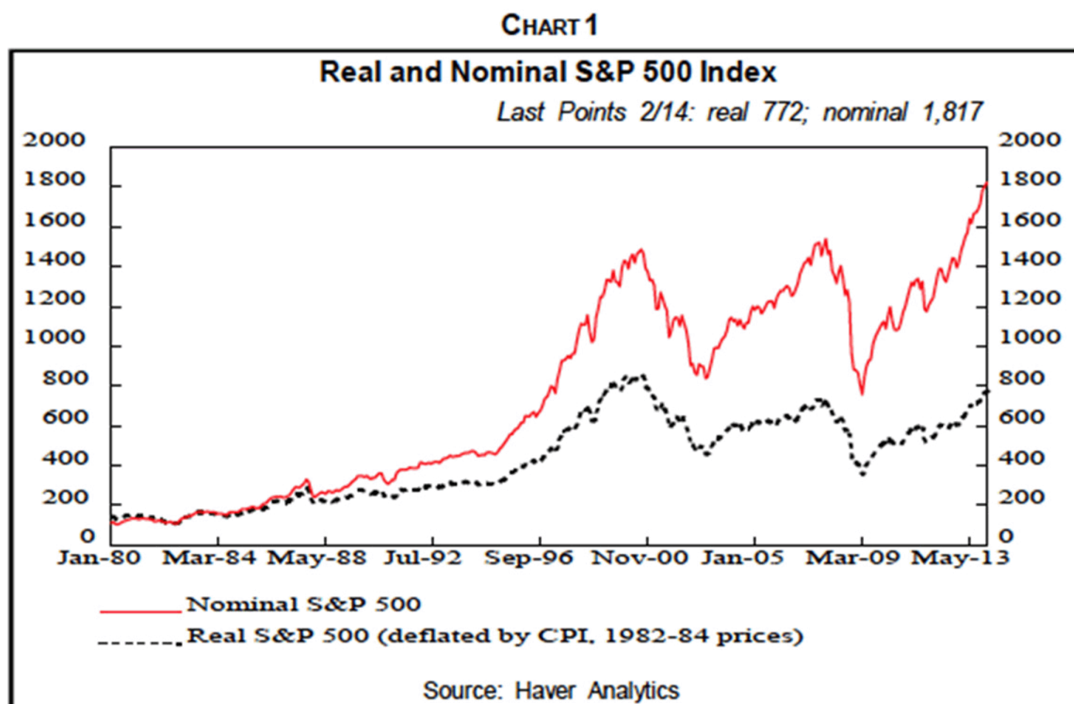
John Mauldin, Editor
Outside the Box

Risk On, Regardless

(Excerpted from the March 2014 edition of A. Gary Shilling's *INSIGHT*)

U.S. stocks leaped 30% last year, continuing the rally that commenced in March 2009 and elevated the S&P 500 index 173% from its recessionary low (*Chart 1*). By late 2013, many investors were in a state of euphoria, even irrationally exuberant about prospects for more of the same this year and seized on any data that suggested that robust economic growth here and abroad would underpin more of the same equity performance.

CHART 1



Optimistic Forecasts

Many forecasts from credible sources accommodated them. The Organization for Economic Cooperation and Development in January said the leading indicators for its 34 members rose to 109.9 in November from 100.7 in October, foretelling faster economic growth in the first half of 2014 for the U.S., U.K., Japan and the eurozone.

The International Monetary Fund in mid-January raised its global growth forecast for 2014 real GDP from its October estimate by 0.1 percentage points to 3.7%, with the U.S. (up 0.2 points to 2.2%), Japan (up 0.4 to 1.7%), the U.K. (up 0.6 to 2.4%), the eurozone (up 0.1 to 1.0%) and China (up 0.3 to 7.5%) leading the way.

Outgoing Fed Chairman Ben Bernanke on January 3 said that the fiscal drag from federal and state fiscal policies that restrained growth in recent years was likely to ease in 2014 and 2015. Other deterrents such as the European debt crisis, tighter bank lending standards and U.S. household debt reductions were easing, he said. "The combination of financial healing, greater balance in the housing market, less fiscal restraint and, of course, continued monetary policy accommodation bodes well for U.S. economic growth in coming quarters."

A *Wall Street Journal* poll of economists found an average forecast of 2.7% growth in 2014, up from 1.9% in 2013 and the official forecast of the perennially-optimistic Fed, made before Christmas, called for 2.8% to 3.2% real GDP growth this year. Also, chronically-optimistic *Barron's*, in its Feb. 17, 2014 edition, headlined its cover story, "Good News. The U.S. Economy Could Grow This Year At A Surprisingly Robust 4%. Forget The Snow. Consumers And Businesses Are Ready To Spend." Many investors also believed that the U.S. economy was about to break out of the 2% real GDP rises that have ruled since 2010.

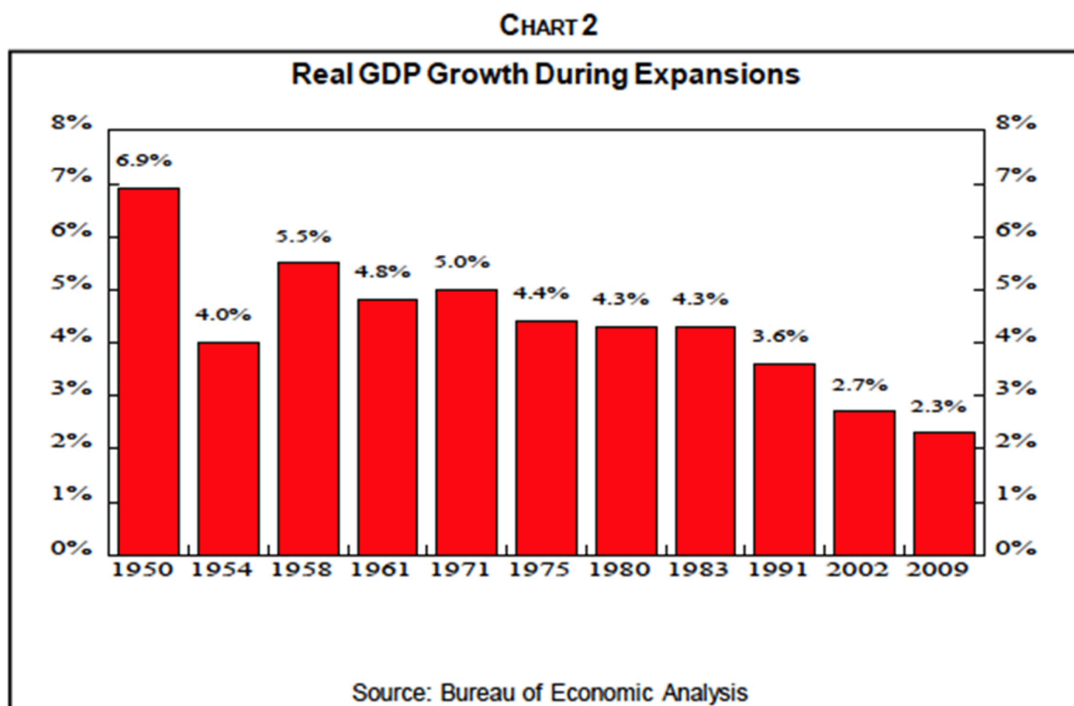
Sentiment Shift

It's interesting that *Barron's* ran this headline after investor sentiment shifted dramatically. It's as if an iron curtain came down between the last trading day of 2013 and January 2014. A headline in the Feb. 5, 2014 *Wall Street Journal* screamed, "Turnabout on Global Outlook Darkens Mood." As stocks flattened and then fell, people started to realize that economic growth last year was weak, rising only 1.9% from 2012 as measured by real GDP.

The fourth quarter annual rate was chopped from the 3.2% "advance estimate" by the Commerce Department to 2.4%, and one percentage point of the 2.4% was due to the jump in net exports as imports fell due to domestic shale oil and natural gas replacing imported energy. Nevertheless, exports remain vulnerable to ongoing weakness in American trading partners. Also in the third quarter of 2013, 1.7 percentage points of the 4.1% growth was due to inventories. Given the disappointing Christmas sales, these were probably undesired additions to stocks and will retard growth this year as they are liquidated.

Even the stated GDP numbers show this to be the slowest recovery in post-World War II history (*Chart 2*). And real median income has atypically dropped in this recovery, largely due to the slashing of labor costs by American business.

CHART 2



Pending home sales, which are contracts signed for future closings, peaked last May and had dropped considerably before cold weather set in this past winter while housing starts fell for a third straight month in February.

Wary Investors

While stocks soared in 2013, investors didn't dig too deeply into corporate earnings reports, but now they are. As we've discussed in many past *Insights*, with limited sales volume increases in this recovery and virtually no pricing power, businesses have promoted profits by cutting costs, resulting in all-time highs for profit margins. Many investors are now joining us in believing that the leap in profit margins, which has stalled for eight quarters, may be vulnerable.

They're also paying more attention to the outlook for future profits and cash-generation as foretold by acquisitions and spending on R&D. Shareholders favor those companies that invest while penalizing companies that fall short. Per-share profits gains due to share buybacks are no longer viewed favorably. Furthermore, investors are aware that two-thirds of the 30% rise in the S&P 500 index last year was due to the rising P/E, with only a third resulting from earnings improvement.

In mid-February, the S&P 500 stocks were trading at 14.6 times the next 12 months earnings, higher than the 10-year average of 13.9. As *Insight* readers may recall, we take a dim view of this measure since it amounts to a double discount of both future stock performance and analysts' perennially-optimistic estimates of earnings. In December, Wall Street seers, on average, forecast a 10% rise in stocks for 2014, the average of the last 10 years. But the average forecasting error over the past decade was 12% with a 50% overestimate in 2008. That 12% error was larger than the average gain of 10%.

Besides cost-cutting, the leap in profit margins has been supported by declining borrowing costs spawned by record-low interest rates. Low rates have also made equities attractive relative to plenty of liquidity supplied by the Fed and Chinese banks and shadow banks.

Last May and June, stocks, bonds and other securities were shaken by the Fed's talk of tapering its then-$85 billion per month worth of security purchases, in part because many assumed that also meant hikes in the central bank's federal funds rate. But then the Fed then went on an aggressive offensive to convince investors that raising rates would be much later than tapering, and investors have largely shrugged off the credit authorities' decision in December to cut its monthly purchases from $85 billion to $75 billion in January and by another $10 billion in February.

The Fed's decision in January came despite the recent signs of weak U.S. economic activity, weather-related or not, and indications of trouble abroad. Furthermore, although the Fed is still adding fuel to the fire under equities, it is adding less and less, and is on schedule to end its quantitative easing later this year.

The Age of Deleveraging

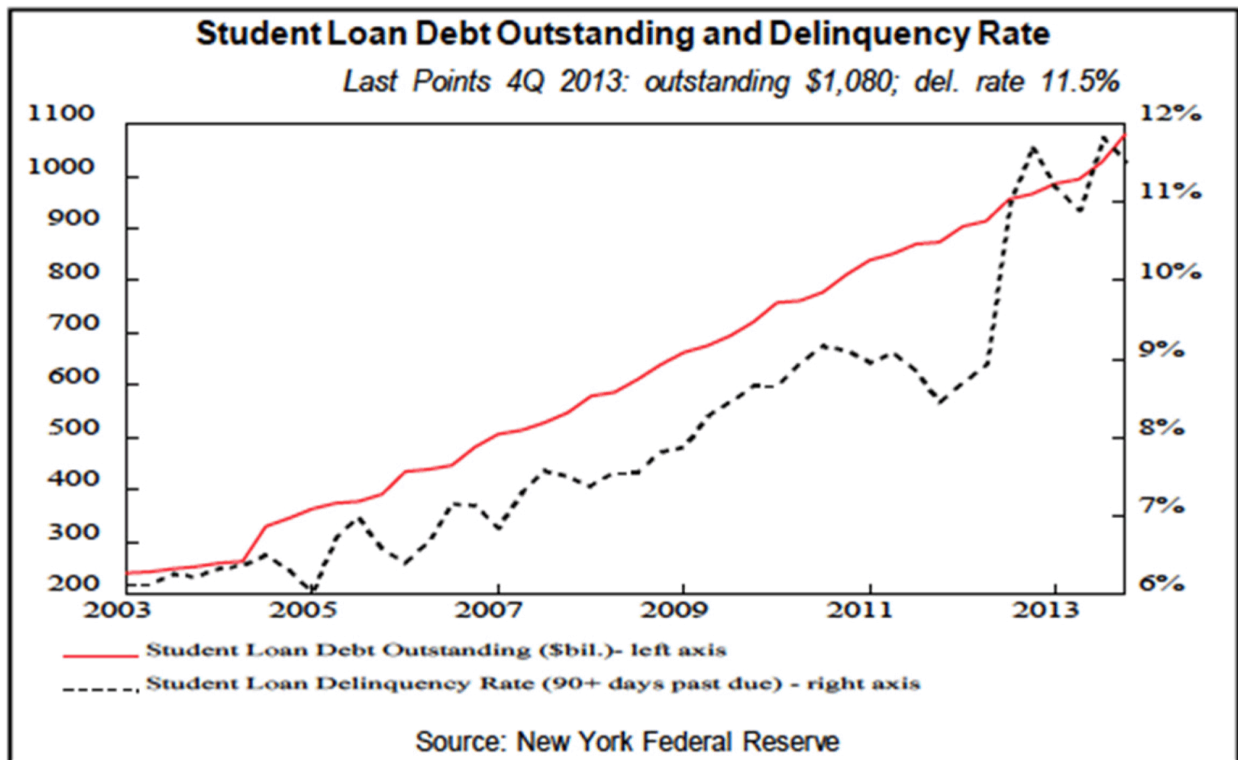
So the zeal for equities persists but we remain cautious about the spread between that enthusiasm and the sluggish growth of economies around the globe. As in every year of this recovery, the early-in-the-year hope for economic acceleration that would justify soaring equities may again be disappointed, and real GDP is likely to continue to rise at about a 2% annual rate.

Deleveraging after a major bout of borrowing and the inevitable crisis that follows normally takes a decade. The process of working down excess debt and retrenching, especially by U.S. consumers and financial institutions globally, is six years old, so history suggests another four years of deleveraging and slow growth. And, as we've noted many times in the past, the immense power of deleveraging is shown by the reality that slow growth persists despite the massive fiscal and monetary stimulus of recent years. Furthermore, although the Fed hasn't started to sell off its immense holdings of securities, as it will need to in order to eliminate excess bank reserves, it is reducing the additions to that pile by tapering its new purchases.

Consumers Retrench

In the U.S., some have made a big deal over the uptick in domestic borrowing in the fourth quarter of 2013. Auto loans have risen, the result of strong replacement sales of aged vehicles, but sales are now falling. Student debt and delinquencies continue to leap (*Chart 3*). The decline in credit borrowing may be leveling, but what's gotten the most attention was the rise in mortgage debt.

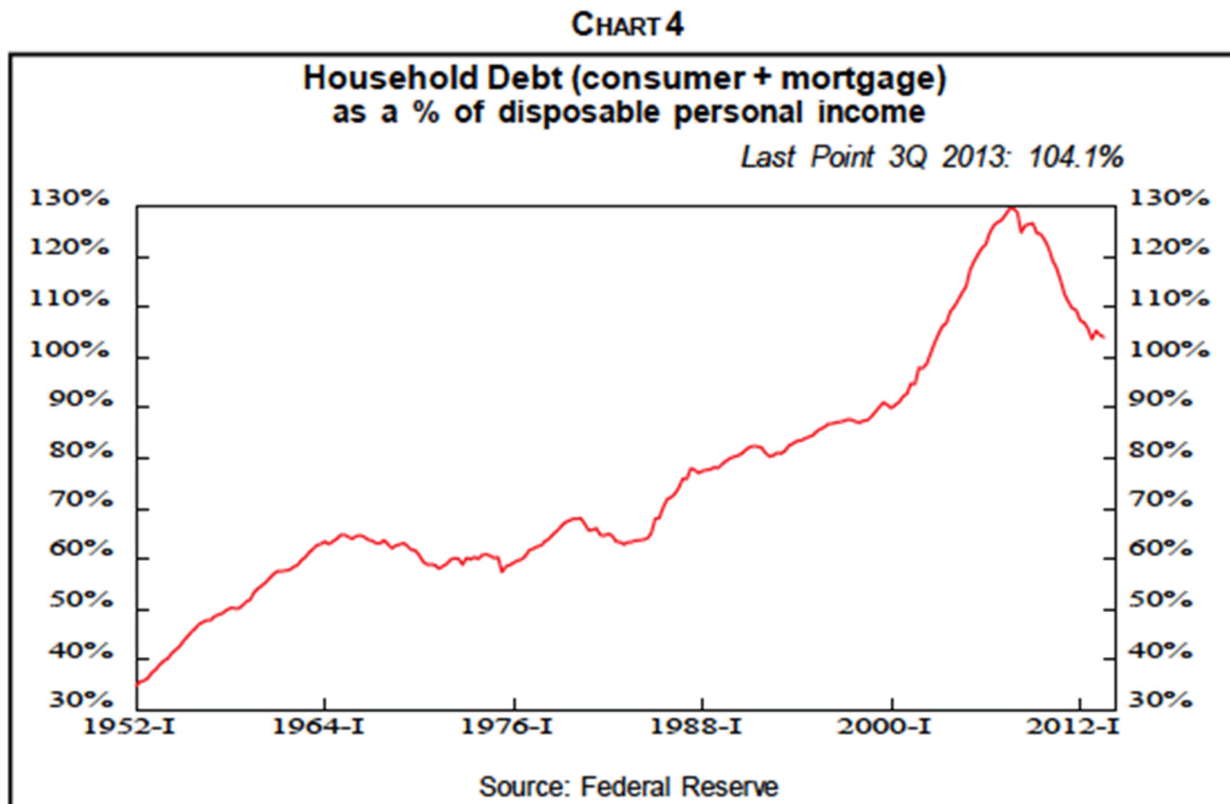
CHART 3



Since housing activity is falling, the mortgage borrowing uptick is due to fewer foreclosures and mortgage writeoffs as well as easier lending standards by some banks. They are under continuing regulatory pressure to increase their capital and slash their exposure to highly-profitable activities like derivatives origination and trading, off-balance sheet vehicles and proprietary trading, so banks are eager for other loans. Furthermore, the jump in mortgage rates touched off by the Fed's taper talk has slaughtered the profitable business of refinancing mortgages as applications collapsed.

Household debt remains elevated even though, as a percentage of disposable personal income, it has fallen from a peak of 130% in 2007 to 104% in the third quarter, the latest data (*Chart 4*). It still is well above the 65% earlier norm, and we're strong believers in reversion to well-established norms. Even more so considering the memories many households still have of the horrors of excess debt and the losses they suffered in recent years.

CHART 4



Furthermore, given the lack of real wage gains and real total income growth, the only way that consumers can increase the inflation-adjusted purchases of goods and services is to reduce their still-low saving rate or increase their still-high debts. Furthermore, consumer confidence has stabilized after its recessionary nosedive but remains well below the pre-recession peak.

So, in rational fashion, consumers are retrenching, with retail sales declines in December and January and slightly up in February. That's much to the dismay of retailers who appear to be stuck with excess merchandise, as reflected in their rising inventory-sales ratio. And recall that retailers slashed prices on Christmas goods right before the holidays to avoid being burdened with unwanted inventories. Of course, there's the usual argument that cold winter weather kept shoppers at home. But that's where they could order online, yet non-store retail sales—largely online purchases—actually fell 0.6% in January in contrast to the early double-digit year-over-year gains.

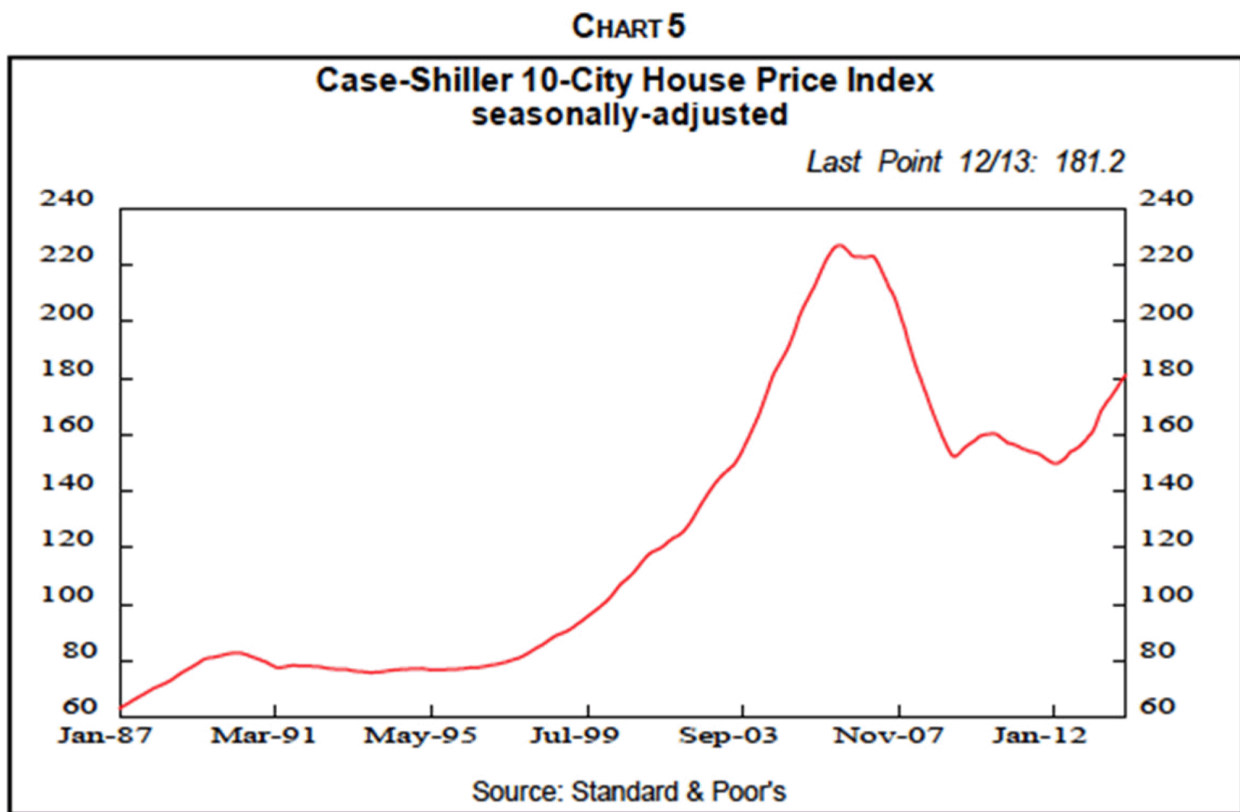
We're not forecasting a recession this year but rather a continuation of slow growth of about 2% at annual rates. But with slow growth, it doesn't take much of a hiccup to drive the economy into negative territory. And indicators of future activity are ominous. The index of leading indicators is still rising, but a more consistent forecaster—the ratio of coincident to lagging indicators—is falling after an initial post-recession revival.

Housing

Housing activity is retrenching, with pending sales, housing starts and mortgage applications for refinancing all declining. Also, as we've discussed repeatedly in past *Insights*, the housing recovery has never been the on the solid backs of new homeowners who buy the starter houses that allow their sellers to move up to the next rung on the housing ladder, etc. Mortgage applications for house purchases, principally by new homeowners, never recovered from their recessionary collapse. Multi-family housing starts, mostly rental apartments), recovered to the 300,000 annual rate of the last decade but single-family starts, now about 600,000, remain about half the pre-collapse 1.1 million average.

Many potential homeowners, especially young people, don't have the 20% required downpayments, are unemployed or worry about their job security, don't have high enough credit scores to qualify for mortgages, and realize that for the first time since the 1930s, house prices nationwide have fallen—and might again. Prices have recovered some of their earlier losses (*Chart 5*), but in part because lenders have cleaned up inventories of foreclosed and other distressed houses they sold at low prices. In any event, prices weakened slightly late last year.

Chart 5



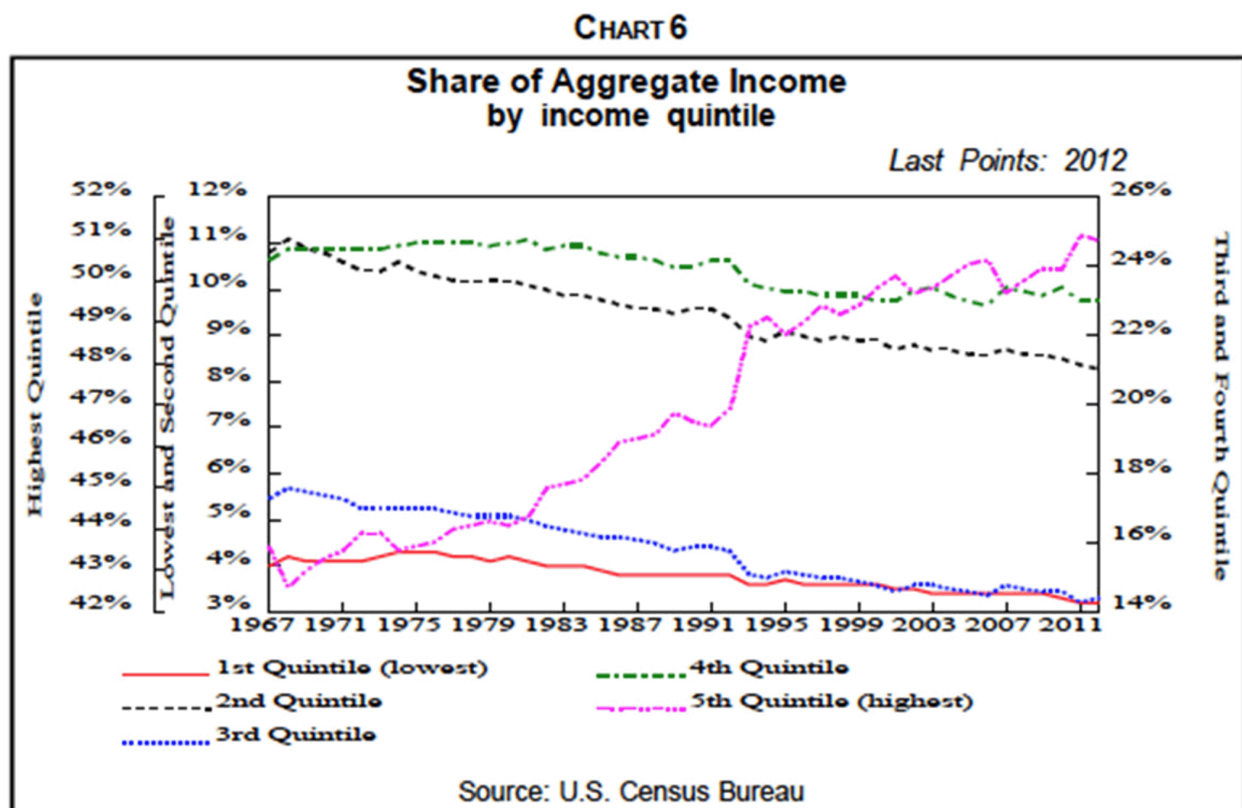
Some realtors complain that existing home sales are being depressed by the lack of for-sale inventory. Nevertheless, inventories of existing houses rose from December to January by 2.2%. Fannie Mae reported that its inventories of foreclosed properties rose for the second time in the last three months of 2013 as sales fell and prices dropped for the first time in three years. Also, with the percentage of underwater home mortgage loans dropping—to 11.4% in October from 19% at the start of 2013—potential sellers may emerge now that their houses are worth more than their mortgages.

Income Polarization

Rising equity prices persist not only in the face of a weak economic recovery, including a faltering housing sector, but also a recovery that has been benefiting relatively few. The winners are found in the financial sector and those with brains and skills to succeed in today's globalized economy that put the low-skilled in direct competition with lower-paid workers in developing lands. The ongoing polarization of incomes illustrates this reality eloquently.

Chart 6 shows that the only share of income that continues to increase is the top quintile. All of the four lower quintiles continue to lose shares. Income polarization is very real in the minds of many. It probably doesn't bother people too much as long as their real incomes are rising. Sure, their shares of the total may be falling but their purchasing power is going up. But now both the shares and real incomes of most people are falling.

Chart 6



Resentment is being augmented by huge pay packages of the CEOs of big banks that were bailed out by the federal government. The number of billionaires in the world, most of them in the U.S., rose from 1,426 in 2012 to 1,645 last year, far surpassing the 1,125 in 2008.

The leaders of financial institutions and other businesses appear to be setting themselves up as easy targets for President Obama, who is fanning the flames of income inequality with some rather pointed rhetoric. Last year, he said, "Ordinary folks can't write massive campaign checks or hire high-priced lobbyists and lawyers to secure policies that tilt the playing field in their favor at everyone else's expense. And so people get the bad taste that the system is rigged, and that increases cynicism and polarization, and it decreases the political participation that is a requisite part of our system of self-government."

Minimum Wages

Nevertheless, pressure to reduce income inequality remains strong and the Administration's attempts to raise minimum wages are an obvious manipulation of its efforts in this area. The President issued an executive order raising minimum wages on new federal contracts and in his State of the Union address called for an increase in the federal minimum wage from $7.25 per hour to $10.10 in 2016.

The effects of the minimum wage have been hotly debated for years, no doubt since it was first introduced in 1938, and during each of the nearly 30 times it's been raised since then, the latest in 2009. Liberals argue that it increases incomes and purchasing power and lifts people out of poverty. Conservatives believe that higher labor costs reduce labor demand, encourage automation, the hiring of fewer high-skilled people and result in more jobs being exported to cheaper areas abroad. A new study by the bipartisan Congressional Budget office found that both arguments are true.

The report predicts that 16.5 million workers would benefit from the President's proposal and lift 900,000 out of poverty from the 45 million projected to be in it in 2016. Earnings of low-paid workers would rise $31 billion. Since low-income people tend to spend most of their paychecks, higher consumer outlays would result.

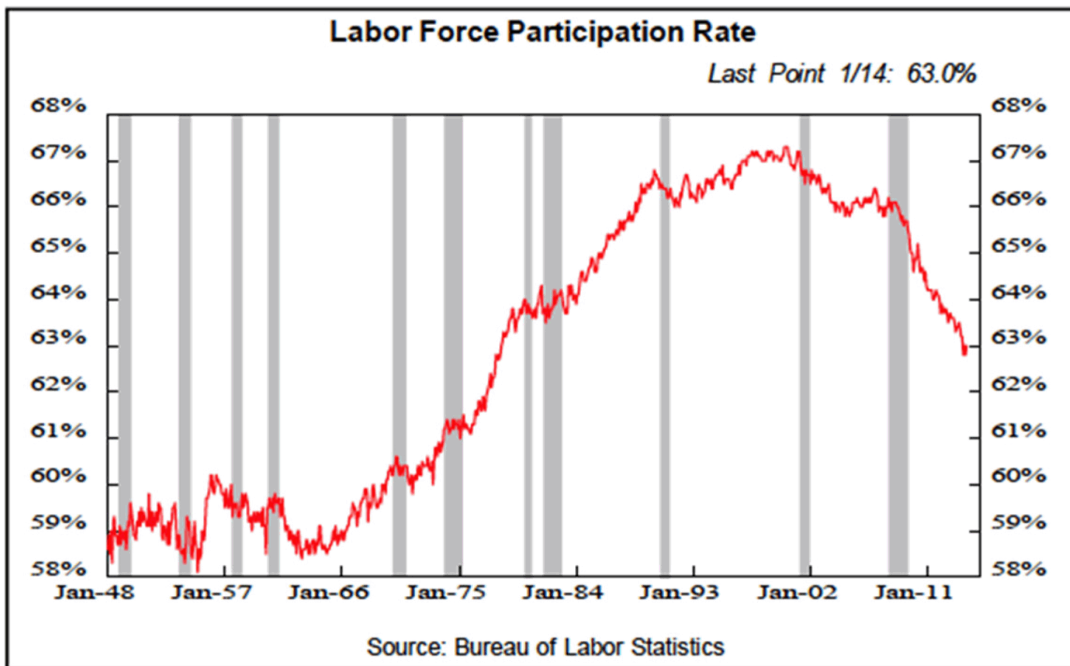
But the CBO also predicts that the proposed rise in minimum wages would eliminate 500,000 jobs and because of their income losses, the overall effect on wages would be an increase of only $2 billion, not $31 billion. Also, 30% of the higher pay would go to families that earn three times the poverty level since many minimum wage workers are second earners and teenagers in middle- and upper-income households. And higher labor costs would retard profits and result in price increases, muting the effects of more spending power by higher minimum wage recipients.

In any event, it appears that the proposed jump in the minimum wage from $7.25 to $10.10 would cause a lot of distortions and no doubt unintended consequences for a net gain in low-wage earnings of just $2 billion. That's less than a rounding error in the $17 trillion economy and would do almost nothing to narrow income inequality. Regardless of the merits, the evidence suggests that higher federal minimum wages are probably in the cards.

Unemployment

By his promotion of an increase in the minimum wage, the President reveals his preference for higher pay for those with jobs over the creation of additional employment. This seems strange politically in an era when unemployment remains very high, especially when corrected for the fall in the labor participation rate (*Chart 7*).

Chart 7



As also noted earlier, the cutting of costs, especially labor costs, has been the route to the leap in profit margins to record levels and the related strength in corporate earnings in an era when slow economic growth has curtailed sales volume gains, the absence of inflation has virtually eliminated pricing power and the strengthening dollar is creating currency translation losses for foreign and export revenues.

Obamacare

One reason for the Administration's emphasis on income inequality and raising the minimum wage may be to divert attention from the troubled rollout of Obamacare. True, big new government programs always have bugs but the Administration's overconfidence in initiating Obamacare and the lack of testing of its website is notable. Also, Obama promised that "if you like your plan, you can keep it," but many, in effect, are being forced into high-cost but more comprehensive policies. To reduce the flack it is receiving, the Administration plans for a second time to allow insurers to sell policies that don't comply with the new federal law for at least 12 more months.

Another problem for the Administration is that Obamacare will reduce working hours by the equivalent of 2.5 million jobs by 2024, according to the CBO. People will work less in order to have low enough incomes to qualify for Obamacare health insurance subsidies. Also, older workers who previously planned to keep their jobs until they could qualify for Medicare will cut back their hours or leave the workforce entirely in order to qualify for Medicare, the federal-state programs for low-income folks that are being expanded under Obamacare.

Hospitals may benefit from Obamacare. Under a 1970s-era law, they must shoulder the emergency room costs of the uninsured, but those risks are being shifted to insurers and taxpayers. Taxpayers will also pay more since 25 states have refused to expand Medicaid, leaving the federal government to set up and run the enhanced programs.

More Medical Costs

Not only is Obamacare proving unaffordable for many but also promises huge additional costs for the government. Healthcare outlays have been leaping and were already scheduled to continue skyrocketing under previous laws as the postwar babies retire and draw Medicare benefits while Medicare costs leap. The original projected jump in insured people under Obamacare was not projected by the Administration to increase the government's health care costs appreciably from what they otherwise would have been. You might recall, however, that when Obamacare was enacted, we noted in *Insight* that after Medicare was introduced in 1967, the House Ways and Means Committee forecast its cost at $12 billion in 1990. It turned out to be $110 billion—*nine times* as much. Obamacare is no doubt destined for the same cost overruns.

Acting in what they perceive to be their best economic interest, elderly people and those in poor health—but not healthy folks—have persevered through the government website labyrinth to sign up for healthcare exchanges. They're taking advantage of the law's ban on discrimination based on health conditions and age-related premiums. Many healthy people, on the other hand, don't want to pay higher premiums than on their existing policies, and many of those who are uninsured want to remain so.

So, to make insurance plans economically viable, in the absence of younger, healthy participants to pay for the ill ones, insurers will need to be subsidized by the government or premiums will need to be much higher and therefore much less attractive to all but the chronically ill. This self-reinforcing upward spiral in health care insurance premiums would no doubt also require substantial government subsidies. Aetna expects to lose money this year on its health care exchanges due to enrollment that is skewed more than expected to older people.

Many of the young, healthy people needed to make Obamacare function as a valid insurance fund would rather pay the penalty, which begins at $95 for this year, and continue to use the emergency room instead for medical treatment. Even the escalation of the penalty from $150 in 2014 for a single person earning $25,000 to $325 in 2015 and $695 in 2016 may not spur sign-ups. In total, there are 11.6 million people ages 18 to 34 who are uninsured, a big share of the 32 million Obamacare is intending to insure.

Some employers, especially smaller outfits, plan to encourage employees to sign up for exchanges and drop company plans. The government could push up the now-low penalties for not signing up to force participation, but we doubt that the Administration would risk the ire of an already-unhappy public in pursuing this approach. On balance, the taxpayer cost of Obamacare seems destined to exceed vastly the $2 billion originally projected gap.

The Fed

The Fed is on course to continue reducing its monthly purchases of securities and at the current rate, would cut them from $65 billion at present to zero late this year. The minutes of the Fed's January policy meeting indicate that it would take a distinct weakening of the economy to curtail another $10 billion cut in security purchases in March.

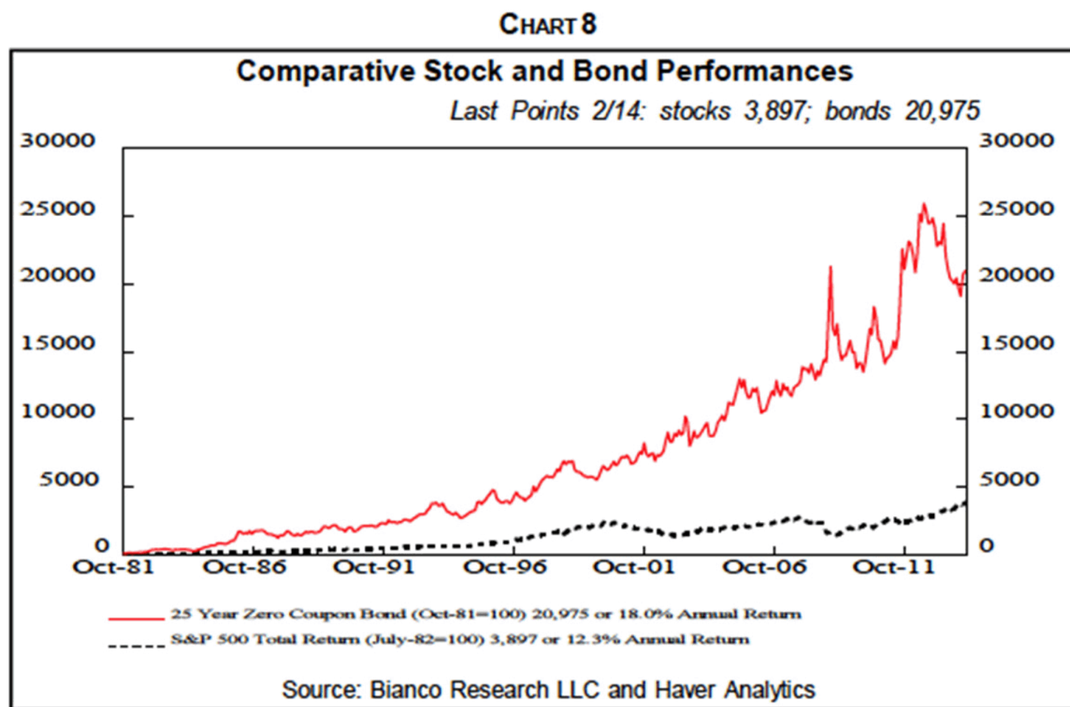
The tapering of the Fed's monthly security purchases only reduced the ongoing additions to the staggering pile of $2.5 trillion in excess reserves. That's the difference between the total reserves of member banks at the Fed, created when the central bank buys securities, and the reserves required by the bank's deposit base. Normally, banks lend and re-lend those reserves and each dollar of them turns into $70 of M2 money. But with banks reluctant to lend and regulators urging them to be cautious while creditworthy borrowers are swimming in cash, each dollar of reserves has only generated $1.4 in M2 since the Fed's big asset purchase commenced in August 2008.

At present, those excess reserves amount to no more than entries on the banks' and the Fed's balance sheets. But when the Age of Deleveraging ends in another four years or so and real GDP growth almost doubles from the current 2% annual rate, those excess reserves will be lent, the money supply will leap and the economy could be driven by excess credit through full employment and into serious inflation. So as the Fed is well aware, its challenge is, first, to end additions to those excess reserves through quantitative easing and then eliminate them by selling off its huge securities portfolio. This will be Yellen's major job, assuming she's still chairwoman in coming years.

Raise Rates?

Last spring, when the Fed began to talk of tapering its monthly security purchases, investors assumed that to mean simultaneous increases in interest rates, so Treasury notes and bonds sold off as interest rates jumped. In the course of 2013, however, the Fed's concerted jawboning campaign convinced markets that the two were separate policy decisions and that rate-raising was distant. Still, as in almost every year since the great rally in Treasury bonds began in 1981 (*Chart 8*), the chorus of forecasters at the end of 2013 predicted higher yields in 2014.

CHART 8



"Treasury Yields Set To Resume Climb," read a January 2 *Wall Street Journal* headline. It cited a number of bond dealers and investors who expected the yield on 10-year Treasury notes to rise from 3% at the end of 2013 to 3.5% a year later or even 3.75%. They cited a strengthening economy, Fed tapering and higher inflation. Many investors rushed into the Treasury's brand new floating rate 2-year notes when they were issued in January in anticipation of higher rates. About $300 billion in floating-rate securities already existed, issued by Fannie Mae and Freddie Mac as well as the U.K. and Italian governments.

Nevertheless, Treasurys have rallied so far this year as the 10-year note yield dropped to 2.6% on March 3 from 3.0% at the end of 2013. U.S. economic statistics so far this year are predominantly weak, as noted earlier. Emerging markets are in turmoil. China's growth is slowing.

Inflation

Besides concerns over the sluggish economic recovery and chronic employment problems, the Fed worries about too-low inflation, which remains well below its 2% target, and over the threat of deflation.

As discussed in our January 2014 *Insight*, there are many ongoing deflationary forces in the world, including falling commodity prices, aging and declining populations globally, economic output well below potential, globalization of production and the resulting excess supply, developing-country emphasis on exports and saving to the detriment of consumption, growing worldwide protectionism including competitive devaluation in Japan, declining real incomes, income polarization, declining union memberships, high unemployment and downward pressure on federal and state and local government spending.

Very low inflation is found throughout developed countries (*Chart 9*). It ran 0.8% in the eurozone in January year over year, well below the target of just under 2%. In Germany, where employment is high, inflation was 1.2% but lower in the southern weak countries with 0.6% in Italy, 0.3% in Spain and a deflationary minus-1.4% in Greece in January from a year earlier. In the U.K., inflation in January at 1.9% was just below the Bank of England's 2% target.

CHART 9

CPI
% change from year earlier

Canada	1.5%	Jan. 2014
France	0.8%	Jan. 2014
Germany	1.2%	Jan. 2014
Italy	0.6%	Jan. 2014
Japan	1.4%	Jan. 2014
U.S.	1.6%	Jan. 2014
U.K.	1.9%	Jan. 2014
Eurozone	0.8%	Jan. 2014
Spain	0.3%	Jan. 2014
Portugal	0.1%	Jan. 2014
Greece	-1.4%	Jan. 2014
Ireland	0.3%	Jan. 2014

Source: Census Bureau

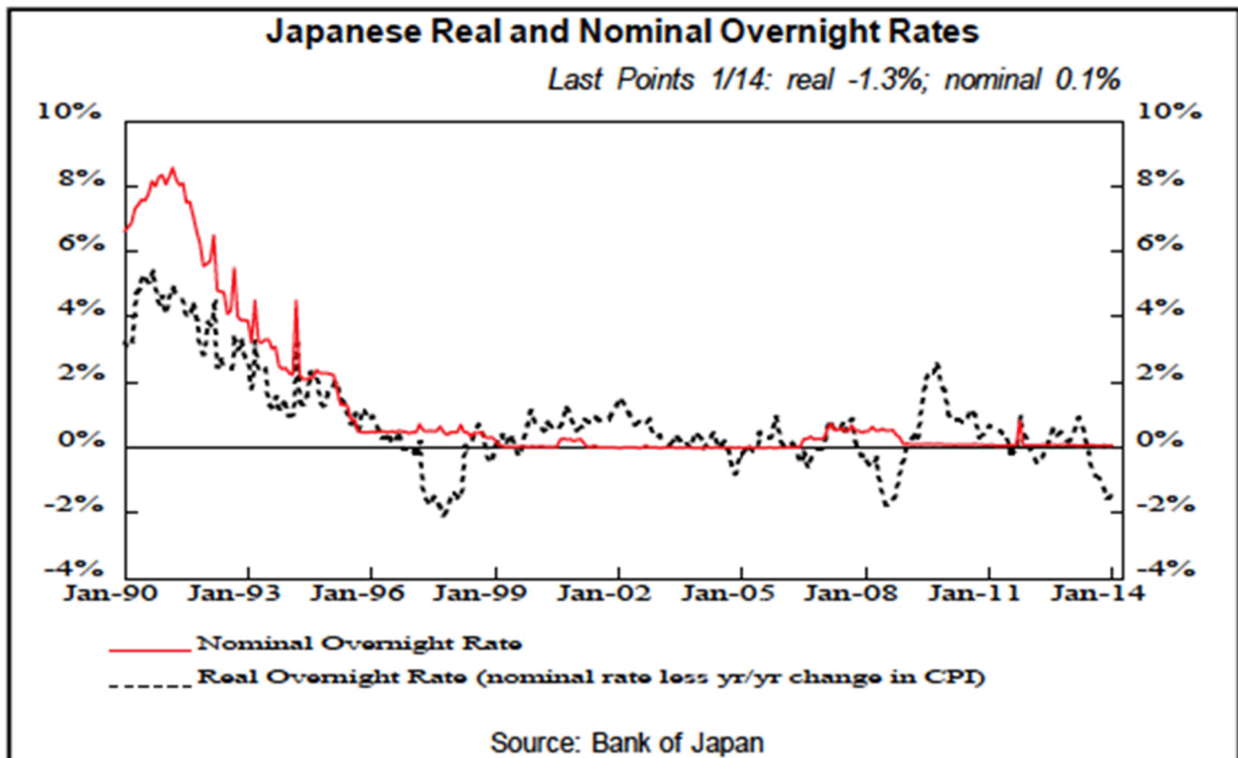
Chronic Deflation Delayed

We've noted in past *Insights* that aggressive monetary and fiscal stimuli probably have delayed but not prevented chronic deflation in producer and consumer prices (see "What's Preventing Deflation?," Feb. 2013 *Insight*). Still, this year may see the onset of chronic global deflation. And it will probably be a combination of the good deflation of new technology- and globalization-driven excess supply with the bad deflation of deficient demand.

Why do the Fed and other central banks clearly fear deflation and fight so hard to stave it off? There are a number of reasons. Steadily declining prices can induce buyers to wait for still-lower prices. So, excess capacity and inventories result and force prices lower. That confirms suspicions and encourages buyers to wait even further. Those deflationary expectations are partly responsible for the slow economic growth in Japan for two decades.

Central banks also worry that with deflation, it can't create negative interest rates that encourage borrowers to borrow since, then, in real terms, they're being paid to take the filthy lucre away. Since central bank target rates can't go below zero, real rates are always positive when price indices are falling. This has been a problem in Japan many times in the last two decades (*Chart 10*). Furthermore, credit authorities fret that if chronic deflation sets in, it can't very well raise interest rates. That means it would have no room to cut them as it would prefer when the next bout of economic weakness threatens.

CHART 10



Central banks also are concerned that deflation raises the real value of debts and could produce considerable financial strains in today's debt-laden economies. In deflation, debt remains unchanged nominally, but as prices fall, it rises in real terms. Since the incomes and cash flows of debtors no doubt fall in nominal terms, their ability to service their debts is questionable. This makes banks reluctant to lend. Governments also worry about the rising real cost of their debts in deflation, especially when slow growth makes it difficult to reduce even nominal debts in relation to GDP. This is the dilemma among the Club Med eurozone countries. Deflationary cuts in wages and prices make them more competitive but raises real debt burdens.

Emerging Markets: Sheep and Goats

As noted earlier, the agonizing reappraisal of emerging economies by investors commenced with the Fed's taper talk last May and June. Investors have been forced to separate well-managed emerging economies, the good guys, or the Sheep that, in the Bible, Christ separated from the bad guys, the Goats with poorly-run economies.

Our list of Sheep—South Korea, Malaysia, Taiwan and the Philippines—have current account surpluses, which measure the excess of domestic saving over domestic investment. So they are exporting that difference, which gives them the wherewithal to fund any outflows of hot money. The Sheep also have stable currencies against the U.S. dollar, moderate inflation and fairly flat stock markets over the last decade. Also, with their current account surpluses, the Sheep haven't been forced to raise interest rates in order to retain hot money.

In contrast, the Goats have negative and growing current account deficits. These countries include the "fragile five"—Brazil, India, Indonesia, South Africa and Turkey—with basket case Argentina thrown in for good measure. They also have weak currencies, serious inflation and falling stock markets on balance. These Goats rely on foreign money inflows to fill their current account deficits, so when it leaves, they're in deep trouble with no good choices. They've raised interest rates to try to retain and attract foreign funds. Higher rates may curb inflation and support their currencies but they depress already-weak economies while any strength in currencies is negative for exports.

The alternative is exchange controls, utilized by Argentina as well as Venezuela. That's why Argentina hasn't bothered to increase its central bank rate. But these policies devastate already-screwed up economies. In Argentina, artificially-low interest rates and soaring inflation encourage Argentinians to spend, not save. Inflation is probably rising at about a 40% annual rate this year, up from 28% in 2013 but officially 11%. Purchasers are frustrated because retailers don't want to sell their goods, knowing they'll have to replace inventories at higher prices—if they can obtain them.

Who Gives? Who Gets?

In some ways, even the Goats among emerging economies are better off than they were in the late 1990s. Back then, many had fixed exchange rates and borrowed in dollars and other hard foreign currencies. So they didn't want to devalue because that would increase the local currency cost of their foreign debts. Consequently, they all were vulnerable and fell like dominoes when Thailand ran out of foreign currency reserves in 1997. That touched off the 1997-1998 Asian crisis that ultimately spread to Russia, Brazil and Argentina.

Today, less foreign borrowing, more debts in local currencies and flexible exchange rates make adjustments easier. Still, as discussed earlier, the sharp currency drops that are seen promote inflation, but raising interest rates to protect currencies depresses economic growth. Either way, it's no-win in Goatland.

Furthermore, as our friends at GaveKal research point out, current account balances globally are a zero sum game, so if the Goats' current account deficits decline, other countries' balances must weaken. This is difficult in an era of slow growth in global trade. Which countries will volunteer to help out the Goats? Not likely the Sheep. Not the U.S. As noted earlier, the Fed has said clearly that the emerging countries are on their own. China isn't likely as overall growth slows and both import and export order indices in China's Purchasing Managers Index have dropped below 50, indicating contraction. Furthermore, China maintains her mercantilist bias and isn't overjoyed with her much diminished recent current account and trade balances.

A collapse in oil prices would transfer export earnings from OPEC to energy-importing Goats but oil shocks as a result of a Middle East crisis or an economic collapse and revolution in Venezuela seem more likely. Japan is going the other way, with the Abe government's trashing of the yen designed to spike exports, reverse the negative trade balance and the soon-to-go-negative current account. The eurozone is also unlikely to help the Goats due to its slow growth and attempts by the Club Med South, mentioned earlier, to become more competitive and improve their trade balances.

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