Macroeconomics Finally Gets Interesting

JOHN MAULDIN | December 7, 2014

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> "The future is already here – it's just not very evenly distributed."
>
> – William Gibson, Hall of Fame science fiction writer

Since I began writing this letter some 15 years ago, I've always done an annual forecast letter, generally in the first week of January. That letter is typically the most-read issue of the year, and I spend more time thinking about it than any other letter. I typically take the last week of the year off from writing just to concentrate on my research, and I often begin to compile my reading material the first week in December, which the calendar tells us is now. Helping me this year will be my associate Worth Wray and a few members of the Mauldin Economics team, and of course my many friends and readers.

This year I'm going to open up a little bit about the process of how I actually write a forecast issue. First off, I am not a model-driven guy. Over the years, I've come to have access to a rather amazing array of researchers and analysts who do deep dives on their particular topics, and their models are far more complex than anything I could create. I also make a point of reading conflicting viewpoints, especially those of people I know to be smart but whom I disagree with. If I can't figure out why they're wrong, then maybe I have to change my mind.

I take all of those models about different segments of the world and try to figure out how they fit together. Admittedly, that exercise involves a great deal more art than science. (And speaking of art, this letter will print a bit longer because there are lots of graphs at the end.)

One of the advantages I have is that when I encounter two or more conflicting opinions I can often pick up the phone and simply discuss the topic with the various authors to see if I can come to some clarity. Sometimes the most instructive things I can learn are the reasons why two very smart people disagree. I have learned over time that there is not as much black and white in economics as one would hope. There are lots of nuances and hidden connections within the global economy that are not obvious to the casual observer. The effort to understand requires me to absorb and distill the massive amounts of information I encounter – while constantly being aware of the biases, assumptions, and basic presuppositions of other writers.

Finally, it's never just about economics, because history, geopolitics, and psychology are always part of the mix. I simply try to read and view everything I can, a far wider variety of material than most economic commentators tackle, and then choose the path that makes the most sense to me as a forecast.

I tend to be more macro-oriented than market-oriented, but I do at least attempt some market forecasts (if only to demonstrate how futile they are, at least in the short term). In general, I find that macro events eventually lead markets. This approach makes timing rough if you're a short-term trader, but for those with a longer perspective the macro-driven view adds a great deal of value.

For the next two letters we're going to look at the issues I'm researching as we approach the end of the year. No deep dives but just a general discussion of the topics and questions we should be thinking about. Of course, we'll look at tail-risk events. What could go wrong? But we also have to ask ourselves the opposite question: what could go right? What might get even better? I can list several major countries where I think things will get structurally better in the short to medium term, and I'm optimistic about the future of numerous industries.

The research shows, and I've done letters about this, that being too negative is actually more harmful than being too positive. Cautious optimism is generally the most rewarding path. But you have to have a large dose of reality. If you live in Japan, the prospect for your currency is markedly different than if you live in Mexico or Norway (more on that later).

But before we begin the letter, let me briefly note that I will be doing a webinar with my friends Ian Bremmer and Jack Rivkin next Tuesday at 1:00 p.m. EST. We will be getting a sneak preview of Ian's 2015 geopolitical forecast and Jack's seasoned perspective (that's a polite way of saying he's been doing this for over 40 years) on implications for the markets. It'll be a fascinating 30 to 40 minutes. You can find out how to listen at the end of the letter. Now let's jump in.

Macroeconomics Finally Gets Interesting

2015 may be the year that macroeconomics really becomes interesting again, if it hasn't already. After a long period of relatively coordinated central bank policies and remarkably low volatility, the macro scene is becoming more dynamic. That's great for those who live and die by dramatic long-term shifts in global markets, but it should be terrifying for emerging-market policymakers, currency carry traders, Texas oil men, and, frankly, the average investor. King Volatility is back on his throne.

A LOT can go wrong in this kind of environment, and traditional portfolio design (sloppy combinations of active managers in a 60/40, 70/30, or 80/20 framework) will simply not let you weather a major economic storm. Think 2008. Think 1937. Think 1998 if LTCM hadn't been dealt with and banks and nations around the world had been a lot more levered – as they are today. The potentials for disruption are enormous, and not just for markets.

Let's start with a general list of topics.

1. The United States seems to be doing relatively well. Employment continues to improve at a 2% pace, more or less; GDP growth is more stable; and interest rates are likely to be low for some time. The equity markets are shrugging off anything negative. You can make a very reasonable case that this climate will continue for another year, so you have to start asking yourself, "What could go wrong?" On my short list is a potentially sharp reduction in capital expenditures in the

oil extraction industry. Then US exports are hit by the rising dollar, which also hurts corporate profits of large internationals, which impacts stock market valuations – developments that have historically signaled a major short-term top. And we really need to think through the deflation equation, as energy prices will lower the inflation indexes.

2. On the global level, there is the real possibility of a significant US dollar breakout and the unwinding of the US-dollar-funded carry trade. The policy divergence among the major central banks is on the verge of being very pronounced. That will have a far bigger impact on global markets than most of us understand. Such a divergence has traditionally not been good for emerging markets. Ironically, we also have to look at the possibility that the increased funding of global trade in Chinese renminbi may offset some of the impact. But will it be enough?

3. We have to pay significant attention to the number-one macroeconomic driving force in the world: Japan. The rapid fall of the yen in recent months has been the topic of numerous conversations I've had in the past few weeks. Longtime readers know I fully expect the yen to go to 120, on its way toward 200; but this recent move seems too far, too fast, when accompanied by no correction or even a modest pullback. We have to ask ourselves what is causing this. Have the Japanese lost control of their currency? It's way too early in the process for that to happen. That is a HUGE potential tail risk that must be analyzed.

4. Europe is working its way into an outright deflationary recession. Draghi keeps talking a good fight but never seems to deliver. Will he be able to garner enough support to override German objections to quantitative easing? And even if he can, is €1 trillion really enough to drive a stake through the heart of deflation? Will QE somehow increase monetary velocity and the money multiplier in a system that is basically still dysfunctional? And what happens when Greece defaults again this year? Europe is a big question mark. Can Europe continue to muddle through for another year, or will the structural crisis they have been holding at bay finally force them to deal with the real problems?

5. China is clearly slowing down, but by how much? How will slower growth impact its trade partners, especially those who have been providing basic commodities? China is also clearly overleveraged, with a monster shadow banking system that seemingly grew up overnight. Will they be able to manage the transition to a consumption-oriented economy rather than one dependent upon ever-increasing debt and foreign direct investment? How do they actually accomplish that? Does the Chinese desire to make the renminbi an international currency in conflict with the economic reforms that need to happen very soon?

6. Emerging markets are now 50% of world GDP. They too have become overleveraged and generally dependent upon carry-trade currencies. The average emerging-market currency is back down to a level (against the US dollar) last seen in 2002, with many of them showing signs of even greater weakness. We've seen this cycle before, and the end result won't be pretty.

7. Energy prices are down, and that's good for the energy consumers of the world; but low prices are going to create problems for various countries, including Russia and Iran. How will they react?

8. The widening policy divergence among major central banks, noted above, is going to have a major impact on currencies and create the real potential for a currency war. We have to get our heads around whether the Fed will actually raise rates as currently advertised, and if so, at what pace?

9. We need to pay attention to the significant and rising risk that a falling oil price poses for high-yield bonds. Depending on which side of the trade you're on, this can either generate real profits or big losses.

But all of the above are negative tail risks. Where are the bright spots for the future? If the proper stance really is cautious optimism, how does one consciously allocate capital today?

Those are nine bullet points off the top of my head, but I'm sure you could add a few. What questions are on your radar screen? I would love to hear what parts of the big picture may be missing, and please feel free to suggest reading and research. I actually do read all the replies in response to each week's letter. Now, all of the above is going to be more than we can cover in this letter, but let's get started.

The US: A Bubble in Complacency

While all the data shows that this is the weakest recovery in 75 years in terms of renewed GDP growth and employment, the fact is that the recovery keeps progressing. Yesterday's unemployment report was relatively strong, even if a significant number of the jobs were seasonal and of the lower-paying variety. The good news for me is that the number of people classified as working part-time for economic reasons fell by 177,000. Part of the true weakness in this recovery has been the marked rise in part-time employees. Clearly, some of that is due to Obamacare. Right now, the way I see the odds, it is likely that this soft recovery will continue.

For a recession to happen there would have to be some kind of shock. So what potential shocks are on the horizon? I can see several (and I'm sure if I go to Zero Hedge I will find a lot more).

1. Energy prices are likely to go even lower for a period of time. This week, one gas station in Oklahoma started selling gas for two dollars a gallon. Others will soon follow. What price your state will see depends a great deal upon how much gas tax your state collects. This significant a drop in the price of energy acts in much the same way as a tax cut. It can only be good for consumers. I know that all my kids (all seven now drive and pay for their gas) are very happy when the price of gas goes down.

   So where's the downside? I have written in previous letters that much of the current recovery, as subdued as it is, is due to the remarkable energy renaissance that is being experienced in several states around the nation. At least a third of GDP growth now comes from the energy industry. An outsized proportion of job growth (and they're good-paying jobs at that) is a direct or indirect result of increased energy production.

   Texas has been home to 40% of all new jobs created since June 2009. In 2013, the city of Houston had more housing starts than all of California. Much, though not all, of that growth is due directly to oil. Estimates are that 35–40% of total capital expenditure growth is related to energy. But it's no secret that not only will energy-related capital expenditures not grow next year, they are likely to drop significantly. The news is full of stories about companies slashing their production budgets. This means lower employment, with all of the knock-on effects.

Lacy Hunt and I were talking yesterday about Texas and the oil industry. We have both lived through five periods of boom and bust, although I can only really remember three. This is a movie we've seen before, and we know how it ends. Texas Gov. Rick Perry has remarkable timing, slipping out the door to let new governor Greg Abbott to take over just in time to oversee rising unemployment in Texas. The good news for the rest of the country is that in prior Texas recessions the rest of the country has not been dragged down. But energy is not just a Texas and Louisiana story anymore. I will be looking for research as to how much energy development has contributed to growth and employment in the US.

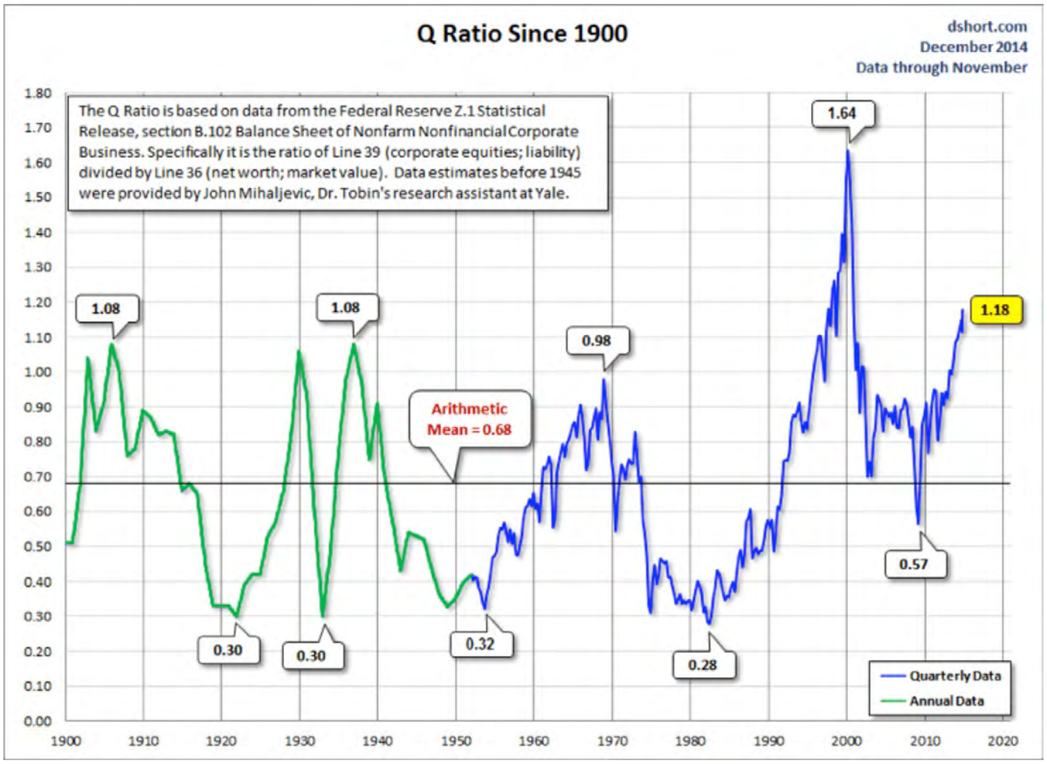
At the very least, low energy prices are going to be a headwind for growth. Has the rest of the economy picked up enough to offset a struggling oil industry? Attention must be paid.

2. Grant Williams (you may know him as the author of *Things That Make You Go Hmmm…*) showed up for a surprise visit Thursday night. I threw a few more peppers into the chili I was making, and we shared a few bowls, talking all things macroeconomics and investing (and watching a little Dallas Cowboys football, to boot). I posed the question to him, "What could derail the US recovery?" His answer sounded like it came from my own playbook. If any two of the global trouble spots – China, Europe, Japan, and the emerging markets – have a crisis at the same time, we could easily see a global recession. It would be very convenient for the US if they could all manage to stage their corrections consecutively rather than simultaneously. Is that too much to ask?

   The other thing we agreed on is that we are a little spooked by how fast the Japanese yen has fallen in the last few months. Both of us are serious Japanese bears and have been for years, but we would like to see a bit more control in the plunge of the yen, thank you very much. Or rather, *arigatō*.

3. People ask me all the time what the trigger for the next equities bear market will be. My "stock" answer is that it typically takes a recession to generate a serious bear market correction. But Charles Gave (in a piece highlighted in this letter) recently asked whether in the current environment a bear market might be the trigger for a recession – the exact opposite of what we've experienced in the past few decades. Prior to World War II, however, a bear market was a common trigger for a recession.

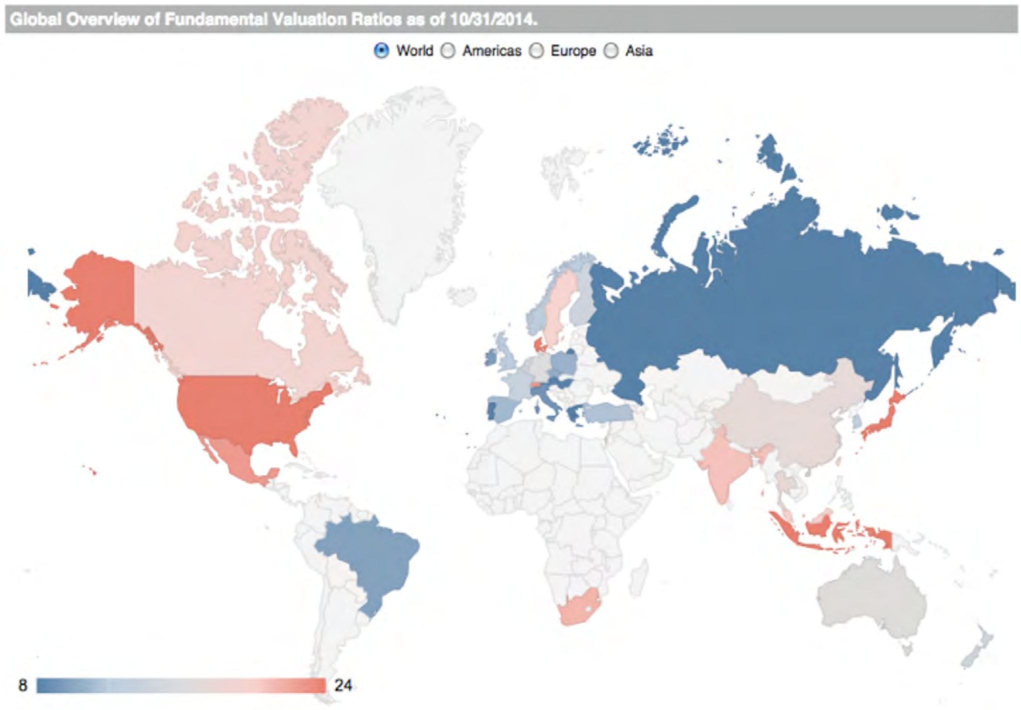
   And it's not like there aren't warning signs. Doug Short over at Advisor Perspectives did a fabulous and very thorough report this week on valuations and Tobin's Q ratio, looking into all aspects of it. Let's just use one of his great charts, which demonstrates that the Q ratio is clearly in bubble territory, outpaced only by the tech market bubble of 2000. (And as Doug shows, further appropriate refinements in the Q ratio result in an even greater current overvaluation.)



We could also look at Shiller's P/E ratio, which is clearly signaling overvaluation and (except during the tech bubble) has always seen significant corrections from its current valuation. Note that small-caps are already in a bear market; the somewhat (but not always) useful leading indicator of high-yield bonds is clearly falling; and the commodity sector is taking a beating. Quantitative easing has ended. If QE3 was indeed the driver of the bull market, we should find out soon.

With that noted, we have a very supportive monetary backdrop, with the Fed unlikely to ease significantly for quite some time. Turmoil outside of the United States will only increase a flight to safety, which is generally supportive of a rising equity market for the currency of choice.

Further, the following chart of global valuations (hat tip to my friend Barry Ritholtz over at The Big Picture) shows that they are generally well within reasonable historical levels, except in Japan and the odd country here and there. As we will discuss below, Japan has a macroeconomic environment that is extremely supportive of equities (as in the massive amounts of equities that are being bought by their central bank and by large pension funds that are selling bonds to buy Japanese equities).



The Land of the Falling Yen

I got an email from Hideyuki Sano with Reuters News in Tokyo, asking me to respond to the following query:

> Despite its snowballing public debts, Japan has so far managed to muddle through, avoiding a major punishment by "the bond vigilantes." Shorting JGBs has rarely been profitable, and no one seems willing to do so now with the BOJ soaking up a huge amount of them. Yet, many people think this is a disaster waiting to happen. I would like to know [your] thoughts on how the whole thing could unravel and how one should trade on this.

That's a very reasonable question. I've maintained for several years that I don't think it's practical to try to short Japanese bonds, but there are some very smart people who disagree with me. Let me see if I can lay it out for you.

Japan's opportunity to make a good decision was lost many years ago. Your debt-to-GDP is now in the 250% range, although more and more of that is being soaked up by the Bank of Japan. However, if interest rates were allowed to rise, it would not be too long until interest-rate expenses consumed an unmanageable portion of your tax revenues. Therefore, it is clear to me, at least, that the Bank of Japan and the Ministry of Finance will not allow interest rates to rise. The Bank of Japan will not only continue to monetize Japanese government current debt but at today's rate is monetizing in the range of 7 to 8% of GDP in addition. For all intents and purposes, the Bank of Japan is the bond market. Your pension funds (and I assume banks and other institutions) are slowly divesting themselves of Japanese debt.

A basic rule of markets is that you can control price or quantity but not both. Since the Bank of Japan is releasing massive quantities of yen into the market, the price of the yen is falling. It will continue to fall as long as the Bank of Japan is monetizing debt at such prodigious rates. I believe there is real potential for the yen to fall back to the rate of 200 to the dollar, which is only a retracement of about 50% from its all-time high (or at least its high in my lifetime). I have structured a 10-year options trade that would pay for half my mortgage if the yen does indeed get to 200. *Arigatō.*

By the way, since Japan is exploring brand-new territory (monetary policy-wise), it is not altogether clear how controlled the fall of the yen will be. There was a reason I bought 10-year options, as I think the odds are that this move will play out over a protracted period. But it is altogether possible that the currency market will simply throw up its hands at some point and yell "Enough!" And then the yen will fall too far too fast, and the Bank of Japan will feel it necessary to reduce its monetary easing. The question then becomes, what will happen to interest rates as a result? A drop of 10-20% from current accommodation? Probably not too much, and perhaps that would slow the fall of the yen. A 50% drop in accommodation? Shiruka – who knows?. One of the characteristics of unexplored territories is that there are always surprises as you come to the top of the next hill.

Although I do not believe it is their intention, the Bank of Japan has effectively launched what other countries will see as a currency war. Korea? China? The rest of Asia? Germany?! They will not easily give up their rights to be competitive.

You must understand this: currency wars are not logical. No one wins. The fact that the Japanese currency has strengthened against the dollar by something like 400% over the past 40+ years does not figure into the economic calculus of those countries whose businesses compete with Japan's. That was so yesterday. I expect the situation will have a rather messy ending, Sano-san.

My advice to anyone living in Japan? As much as possible, reduce your holdings of yen and move into gold or other hard assets if you want to keep your assets in Japan. Holding bonds and currency accounts will erode your buying power over time. I think the "trade of the rest of decade" will be to short the yen and to be long Japanese "intellectual property" stocks. By that I mean companies that sell technological products as opposed to products whose main costs are for materials and commodities (including energy) that must be imported into Japan. There is a reason your pension companies are rotating out of bonds and into stocks. Most individuals and businesses have much smaller accounts and can move so much more rapidly. Take advantage of the time you have.

The Dollar Rises Again

For the rest of the world, let me provide a few charts. As I write this letter, the yen is 121.5 to the dollar. Interestingly enough, the euro is at $1.23. Those numbers will cross in the not-too-distant future as the euro drops and the yen continues to rise. The chart below from Bloomberg shows the rise of the trade-weighted US dollar as measured by the US Dollar (DXY) Index.

With such divergence comes the major macro risk that the US Dollar Index is breaking out in a big way. To anyone who believes in technical analysis (and skeptics should keep in mind that a lot of macro and currency traders DO), it looks as though the USD is ready to break out of a 29-year downtrend that began with the Plaza Accord way back September 1985. ("To keep that in perspective, it was less than two weeks after I was born," says Worth Wray). Raoul Pal notes that this is the biggest downward-sloping wedge in the history of fiat money, and we may be very close to a BIG dislocation if it continues.

I wrote about this in a recent letter, "A Scary Story for Emerging Markets" (which Business Insider renamed "The Dollar Plays the Villain in the Emerging Markets Horror Story"), but this drastic strengthening of the dollar could not come at a worse time for our highly levered, highly interconnected global financial system. But this letter is already long enough, so we will start there next week.

Cincinnati, the Cayman Islands, and Florida

I am home for the rest of the month (with perhaps a quick trip to DC being the one outing), but the calendar for next year is beginning to fill up. I see Cincinnati, Grand Cayman, and Florida on my schedule. It has been a while since I've been in the Cayman Islands, and this time I will take a short hop over to Little Cayman to visit my friend Raoul Pal for a few days. A brilliant macroeconomist and trader, Raoul has now based himself in Little Cayman, although he frequently flies to visit clients. He is also a partner with Grant Williams in Real Vision Television, a fascinating new take on internet investment TV. I'll be writing more about it in the future.

As I noted above, Jack Rivkin (CIO of Altregris) and I are going to be interviewing Ian Bremmer next Tuesday. We'll be talking about the geopolitical situation all over the world and how it will affect our investments. I hope to steer the conversation to what is happening in Russia and the Middle East, with of course a nod to China; but we'll see what Jack and Ian want to talk about. My goal is for listeners to walk away with greater clarity about the changing geopolitical landscape and an actionable perspective on global markets and the potential for diversifying investment alternatives in 2015.

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Today is my granddaughter Lively's fifth birthday, so after brunch with some of the kids we will go to her party. Her mother, Tiffani, tells me it's a "jump party." I'm not sure what that means, but it sounds like fun. They grow up so fast.

Daughter Melissa (with a little help from her brother Chad) put up the Christmas tree and decorations today, so the house is just about ready for the holidays. Since we don't have a fireplace in the high-rise, we've had to get a little creative in hanging the stockings, and every kid's spouse and grandkid has their own stocking. I'm not quite sure how they remember whose is whose, but they do. This Christmas, it looks like all the kids will be here along with the grandkids (and maybe even a brand-new one, due right around that time). As the kids spread out and get married, it seems their inlaws want to snag them for some of the holidays, too. So my kids seem to have worked out that on either Thanksgiving or Christmas they will all be here.

My writing schedule has gotten quite crowded. In addition to Thoughts from the Frontline and Outside the Box, Tiffani and I are more than halfway through a book on millionaires; Worth and I are in the home stretch of a book on China; and Worth and I are continuing to forge our way through a book on the implications of a major dollar rally in the midst of sovereign debt corrections.

I am seriously considering only publishing the book on China in electronic form and for a much lower price than normal, mostly as an experiment. I literally have no idea what will happen if we do. I know that the explosive growth of e-books is beginning to look more normal, but they have already taken significant market share. I would like to know what you think. And if you have any experience publishing e-books on investing, I would like to talk to you.

Have a great week. My calendar seems to have filled up, just when I am trying to spend more time reading, thinking, and writing – and in the gym, of course. And we wonder where the time goes.

Your trying to figure out what to get the kids for Christmas analyst,

John Mauldin

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