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Anatomy of a Recession

The Chinese real estate cycle has peaked. These are decades-long cycles so the peak will hold for a while. Incredibly they have 60 bn square feet, i.e. twenty additional cities the size of New York, under construction. In the US, an incredible amount of printed money managed to create a serious dead cat bounce, but the record debt backed by residential real estate has hardly budged. So the bounce will not hold up with the disappearance of QE3 and the marginal Chinese bid at the same time. Our population owes $2.5 trillion on housing, with another $2.5 trillion held against commercial real estate, and given 50% of China's GDP since 2008 was fixed asset investment, with parallel demand for real estate in global financial centers, $40 trillion of hard assets worldwide are set for a healthy correction, to use an old school term. Combined with Europe's overhang and India's desire to lower structural inflation, we are looking at a global recession, unique in that it is emanating from emerging markets and in that the Fed's toolkit is completely exhausted. Yes, they can start QE4, but the political resistance will be immense.

Of course, the S&P is not priced for any of this. Our market-to-model ratio suggests 15% overvaluation:

http://rationalinvesting.com/ETFPortfolio.asp?etf=2&name=%20Spider

Cheap natural gas, however, will mean that the US is the last to go into recession, so ours is possibly 9+ months away. Eventually, the recession will be focused in the real economy on healthcare, and tech backed by ambitious valuations. There is a 6-12 month lag during which venture funded firms run out of cash after the IPO window closes. Also, in the real economy, US energy efficiency is improving, so oil prices might linger by its $75 average for the past 10 years, which would also mitigate our slowdown.

But the meat of it is in healthcare where we easily spend 2x, bordering on 2.5x, the rest of the G7, with far from commensurately better results. Obamacare proved to be just a subsidy system piled on top of the inefficiency. When the real bill comes due next fall, Congress will refuse to pay it, and that will create a crisis. Healthcare valuations suggest we keep spending close to 20% of GDP on it….

http://rationalinvesting.com/ETFPortfolio.asp?etf=198&name=%20Vanguard+Health+Care+ETF

Industrials might barely blink because they are benefiting from lower energy prices and already competitive US wages, though export driven large caps will suffer from a stronger dollar. But healthcare is facing budget cuts the likes of which it has never seen. The US spends $1 trillion on hospitalization per year, which rivals the entire per capita healthcare spending of other G7 countries. This is cutting edge end of life care – Dr. House applied to 100 year olds. It almost certainly has research benefits, but $2,000 an hour for specialist care defies the payoffs. It seems reimbursement is roughly 26 cents on the dollar, so US hospitals collectively bill $4 trillion a year, which is double the entire healthcare spend of the G7 ex US. Science fiction is easier to believe.

Finally, financials, which recovered incredibly on the back of the Fed's support, might face a wee bit margin crunch. And the dollar will get a lot stronger - the US currency's supply will dry up as the price of oil falls and domestic production rises, creating a negative feedback loop.

The Age of Politics

Why politics? Somewhere in the last fifteen years, finance wandered from guessing which dot com could stop burning capital in 2047, or hanging on to every word of Sir Alan the Handsome of Greenspan, and calling it 'research', to guessing which European country could go bankrupt despite ZIRP / QE etc. and where might Russia or Saudi be if the price of oil collapses or oil prices be if Iranians invade Israel, screw up their GPS readings (blame the CIA) and end up in Saudi Arabia. But make no mistake, this is about economics in its unvarnished cruelty; about what the consumer of the S&P500's products is willing to buy and what it takes to protect global US supply chains. The fact that we have let Libya go to the dogs and Aleppo go to hell and are doing the bare minimum necessary to keep Americans alive in Erbil, and are saying nothing about Hong Kong, impacts the resilience of those supply chains.

Rudi Dornbusch once suggested that business cycles did not die a natural death, they were murdered by the Fed. This time around, the recession is going to result from fiscal tightening instead. In every major economy, the pressure to reform government is immense. Rural citizens have not benefited from ever increasing funding of the worker's paradise, so that deficits will continue to contract to Maastricht criteria, if not primary surpluses. Additionally, spending will drift towards defense from social welfare. The result is to put southern Europe in a decade long recession, if you really wish to call a shrinkage of the government-union-mafia complex that. This will truly hit our shores starting next year as the Senate either goes Republican or the election forces Democrats in purple states to demonstrably brush up on bookkeeping skills. The proverbial wing flapping butterfly might be the fire sale of empty buildings in Chongquing, but the effects will be felt equally on Las Ramblas and on K Street. The Federal Reserve will have little to do with all this. I am calling the top in the bull markets of, for, and by central bankers.

The Russian Federation

Our most important conclusion, from a very sophisticated analysis, is that President Putin of Russia should do a US book tour. It isn't particularly important what the book is about or whether he writes it. If it were, Hillary would not have had a book tour. It takes a numerically challenged person to believe, given her calendar, that she actually spent the time to write her book. It took Fitzgerald nine months to write The Great Gatsby, and reportedly it doesn't hold a shade to her masterpiece, whatever it is called.

But why? The point would be to convince America of his liberal bona fides. I do not jest. Russia's survival as a country progressing from alcohol fueled chaos a la Yeltsin towards, say, a South Korean'ish one party democracy, to use the word liberally, is critical to US interests. Otherwise, it will eventually get un-federated into at least three pieces. A German colony, Chinese or Japanese colonies, and the Caucasus run by the Islamic State. To quote my four year old, "This could get complicated." Yes, yes, a few journalists have been roughed up and the occasional lawyer has died in jail but c'mon, Stalin killed 20k Polish nobles and officers out of hand at Katin and for him, it was a rounding error. More recently, Assad has destroyed Aleppo, and murdered half a million people outright while we were hallucinating red lines. Any comparison is embarrassing if not idiotic. As for Khodorkovsky, he applied for the job of Germany's Viceroy of Russia. From a geopolitical point of view, Putin showed remarkable restraint, perhaps to avoid the perception of Napoleon's execution of Louis Antoine, Duke of Enghien: "It was worse than a crime; it was a blunder."

In conjunction, a message to John Kerry: Stop worrying about Middle East peace. It hasn't happened in 3,000 years, and you ain't gonna get it done. The Israelis are big boys who grew up in a tough neighborhood. They can handle themselves. As for Hamas and the political class they represent, people who throw retarded teenagers strapped with bombs into crowds, or rockets into civilian areas, deserve very little sympathy. Salahuddin is turning over in his grave. Instead, focus on Russia. Why? That's where the money is. Or the oil anyway. And the Russian market is at 1x earnings: http://rationalinvesting.com/Region.asp?id=1&name=BRICS You could create a fortune to rival the one you married. The Russians will not mind if you help them out. And if additional production of oil holds down its price by 20 bucks over time, you might become, let's go out on a limb here, popular.

Energy and Materials

Easy money has created speculation in some obvious ways. But others are not as obvious. To put it differently, many awkward valuations become easier to understand if one treats convenience as an important element of price. Consider the difference between energy and materials sectors.

XLE
http://rationalinvesting.com/ETFPortfolio.asp?etf=10&name=%20Select+Sector+SPDR%2DEnergy

XLB   http://rationalinvesting.com/ETFPortfolio.asp?etf=12&name=%20Materials+Select+SPDR

(http://rationalinvesting.com/ETFModels.asp has the entire list.)

As of this writing, based on our Market to Model Ratio, the XLE is slightly overvalued, while the XLB is another 30% so. Why? Well, oil is a globally traded commodity, and as such its forward curve clears speculative demand vs. hedging of supply over many years. As a result the spot price reflects its natural level because storage has tremendous value - for strategic reasons many consumers choose to store for themselves at the corporate or national level. So the XLE trades par or cheaper to the S&P500.

Many materials on the other hand, are traded locally with no value to convenient storage. In that case, someone looking for an inflation hedge speculates through the ownership of the producing asset in the expectation of future price increases. So a mine for construction materials or a forest available for logging can trade at a yield below Treasury bonds to insure against potential inflation. This insurance premium is a pure function of the yield curve suppression estimated by the buyer, i.e. the extent to which, thanks to the central bank, forward rates no longer represent future inflation or spot rates.

The trouble is, the market treated easy money as a proxy for future growth. If growth remains AWOL, all that is left is stagflation. But that inflation expectation is derived from asset price driven consumption, NOT wage growth. This represents a narrow class of consumer, and if asset values merely slow down, the buyers of high multiple materials stocks are going to find out there is no pig in that poke.

The Rural Poor vs. the Central Banks

'Rural poor' conjures up different images: In Europe, workers in vineyards and dairies and tomato farms; in America the dust bowl, corn farmers and cowboys, and, as a political hack from Chicago indelicately described people who do not work at venture capital firms - 'people clinging to religion and guns'.

One definition of a democracy is a negotiation where the rich get the lowest taxes possible without facing the guillotine, and the poor get the most government spending without triggering inflation. This 'basket of goods' does not include prices at Saville Row. The trouble is, welfare infrastructure is majority urban, where recipients of services can have relatively high incomes. Yet rural working stiffs are being squeezed, whether through declines in farm support or higher tax rates, er, Medicare contributions. They believe demand from China and hence the price of hogs and corn and wine is highly cyclical; the older ones grew up without indoor plumbing and watched friends go bankrupt in times of stagflation.

So they are not particularly enthralled by current policies. Hence the Tea Party in the US. In France, they have Marine Le Pen, who has chosen her friends somewhat more carefully than her father. What is common is the desire to restructure the economic compact of west. The people who, for the sake of both God and country, provided sons to fight the Nazis, fascists, Bolsheviks etc. do not care to allow inflation and higher taxes to pay for disability and medical care fraud. That bargain works fine for the urban rich: it allows them to live highly specialized lives and have fewer children by outsourcing the defense of their cities, which makes the higher taxes affordable. If representatives of this professional class violate the bargain by squeezing rural voters, they will find defense to be a lot more expensive, and their global supply chains will get choked off by sundry caliphates and revolutionaries.

The current US academic-government complex is clueless about this, and moreover, it has demonstrated the worst knack for understanding US global strategic interests of any in history. To be fair, I am only aware US political history in the 20th century with sufficient confidence, so let's just state that this administration represents the worst geopolitical decision making in 115 years.

In conjunction, the Fed has sowed the worst possible confusion in people's heads by saying the price of land can be manipulated independently of the price of grain. What this says about either their own skill set or their cynicism is beyond the pale. The expected cash flow drives the value of the capital asset, it is not the other way around. There may be a wealth effect, but there is no Market Multiple effect. People spend a higher proportion of accelerating income. Clearly, they do not spend an inflated value of assets where the underlying income is stagnant and the multiple has gone up. Unless they sell, at which point they have to pay a higher capital gains rate and are left with very little income on the cash which again is taxed at a higher rate than before. Architects of our fiscal / monetary policy seem completely oblivious to this vicious irony. Worse, in Europe, Germans are nervous about default on their assets, and are not spending to buy southern European product at prices inflated by mafia taxes. Their own government's bonds have moved to negative yields instead, a stunning combination of prosperity and insecurity.

The Fourth Reich, A Spillover Effect

Heeeere'ssss Christyyyy…. Johnny Carson did not hold a candle to Christine Lagarde's TV hosting skills. Interviewing Janet Yellen at an IMF pow wow, she touched on all the right subjects, including, to placate the peanut gallery led by Raghuram Rajan, the spillover effects of US monetary policy. However, unlike the Carson show, nothing juicy was revealed. What matters not is the troubles of a billion Indian souls. Their banking system is a paragon of virtue, or incompetent in reaching the marginal borrower, pick your point of view. There is much too little money at stake to worry about. What matters is the couple of trillion in the European interbank system that is held in credit by German banks, not to mention their bond holdings. The politics of this debt is hardening, and one of these days, a country is going to default, followed by the rest of the PFIGs (the Irish I is gone, Spain has reformed some, but one needs to include France) and the German people might just decide that a trillion Euro loss was not part of the bargain. Chancellor Kohl may have thrown in a few billion here and a few billion there and, in 1984, held hands with President Mitterand in memory of Verdun (1916), but today's median voter was born long after the *Unternehmen Gericht,* and the million sons lost in battle by both sides are a piece of history.

http://en.wikipedia.org/wiki/Battle_of_Verdun

The German response to default might be what the Brits called gunboat diplomacy. At this point, Houston, the problem becomes too big to solve. Say the Germans take their defense budget from 1.4% of GDP, below contractual NATO minimums, to US equivalent 4%, nearly a triple. That, one might call a spillover effect.

The Imperative to Weaken the Euro

In response to the birth of America and the industrial revolution, Europe consolidated from hundreds of principalities to a handful of empires. Exhibit A was the Northern European Plain, mostly known as Germany, with parts in Russia and occasionally, Poland. The Czars swept everything to the east of them to create a vast hinterland of harvests and mines all the way to Alaska. Germans focused on industry, and quickly consumed their internal supply of raw materials. This led to reliance on, and tensions with, their neighbor-vendors, which eventually led to a war here and there. The solution to avoid contractual disputes getting out of hand was, first, for the US to guarantee the peace and fend off the Bolsheviks i.e. NATO in 1945, and second, for the Germans to pay with their savings on contractual frictions into subsidies for French and Greek farmers and miners i.e. European Coal and Steel Community in 1952.

1998: So far so good for the Europeans. The trouble started with the Euro on January 4, 1999. Certain countries have spent all of the temporary credit enhancement implicit from merging with the Deutschemark. Avoiding default now requires what economists politely call 'internal adjustments.' France's mafia, a.k.a. the General Confederation of Labor, call it a pay cut. Based on political will, a certain amount of reform was carried out and Germany softened the terms of endearment. But eventually, more of the welfare states need to be grown out of or hacked to size. Regulation is making growth difficult, and despite good advice from across the Channel, the Eurocrats are not backing down.

The alternative is to weaken the Euro. This requires QE which the ECB is willing to provide. But it also requires a buyer for goods and services. The global buyer of last resort are the Americans, who need to buy the Manchengo cheese and Chianti wine and show up at beach resorts to gape aghast at naked Europeans. This requires a strong dollar. Fortunately, we found shale oil. So the dollar should have strengthened naturally after the crisis. The Fed, in its redistributionist sympathies, held it back. The direct consequence is going to be the accelerated rise of the German military to make sure said 'internal adjustments' take place in debtor countries. Of course, this shift will be a complete surprise.

If US regulatory overreach and offsetting monetary policy both do not change soon, then southern European unemployment will remain at 25+%, default risk will re-emerge and a chain reaction will accelerate the re-armament of Germany by a quarter of a century. The idea that German economic power will never translate into a force that backs contracts is inconceivable. But this is an avoidable acceleration, because the world needs those 25 years to make geopolitical adjustments, for history to sufficiently fade. E.g. Russia, which would be panicked into response beyond what it can afford. The dollar will then strengthen anyway, but if the Fed were to stop, it might save the Eurasian peace for this generation, and the moves in markets and national boundaries might be less jarring.

In the meantime, John Kerry should focus on Russia. Yes, yes, they were incompetent with their inventory of Buks, but we will need them one day. Maybe they will lease us some of eastern Siberia or their Arctic coast rather than see it eventually fall to the Chinese. Or drop their client in Damascus. It might even earn Mr. Kerry a place in history a little different from where his boss is headed. Because, Tesla notwithstanding, we need the price of oil contained, to employ an infamous term of art. If Pax Americana is to last longer than the other reigns, as the Founding Fathers hoped, it will have to offer something in return for the trade deficits the world willingly finances. Like letting China know the US will not accept Tiananmen Square v 2.0 at the Admiralty in Hong Kong. Kerry's boss is going to be remembered, among other misdemeanors, for his default; for fiddling while Aleppo burned, and the flame of liberty was extinguished in HK.