Daniel Lacalle: Synchronized Global Growth was always a False Narrative

October 24th 2018

Erik: Joining me next on the program is Daniel Lecalle, a professor of global economics and chief economist for Tressis.

Daniel, thanks so much for joining us on the program. You and I are taping this interview a day before our listeners will hear it on Wednesday. Just as we began our phone call, we broke to new lows on the S&P 500, below the previous low – back on Oct. 11, I believe it was.

I think the big question on everybody's mind – I'll summarize this: Is this the big one? Are we really at the point where this longest bull market in history is over? And we're about to see either a crash or a new bear market? Or is this just a pullback that needs to play out and maybe we're headed to new all-time highs?

Daniel: Thank you so much for having me on the show. I think that what we're seeing right now is, basically, that markets are starting to get nervous about a number of catalysts that were not expected to happen.

The first one being that bond yields, the US Treasuries, the 10-year, would be rising above what was considered to be a warning zone level.

The second one is the yuan weakness and the decision by the Chinese government to try to tackle the alleged trade war through competitive devaluations.

Those two catalysts are doing two things. The first one is taking money out of riskier assets, out of emerging markets, out of the Eurozone equities, out of US equities, into safer assets.

The second one is sending deflationary signals to the rest of the world.

So it basically is sort of a reckoning of an environment in which there was a lot of complacency and a lot of wrong views about synchronized growth, future reflation, trade by cyclicals. Which ended up being almost one-sided trade, actually, that was being negative on the US Treasuries, negative on the US dollar, and bullish growth, bullish inflation.

And I think that that entire mirage is fading right now.

Are we entering a massive bear market? I don't think so. The reason why is because it is very

unlikely that we will see monetary policies globally become really hawkish. We're talking about normalization.

And, actually, what we are seeing is a very, very competitive and very, very loose monetary policy. If you go to the 30-year bond in the United States, it gives you a real yield of about 0.07. So that is probably going to continue to keep risky assets in the elevated-multiple type of environment.

Does that mean higher multiples? Does that mean continuing to inflate the levels further? Not likely. I think that what happens is the final phase of this extremely loose monetary policy, what is does is what we're seeing in Japan this year, or we're seeing in the Eurozone for the last couple of years, which is that monetary policy maintains multiples. It doesn't increase multiples of both equities and, obviously, valuations of bonds.

Erik: When Jay Powell took over the Fed, he effectively told markets, hey, there's a new sheriff in town and we're not in the business of supporting markets.

If this selloff goes much further, do you think that he's going to stick to that message and continue with the tightening program that the Fed is under? Or do you think that there is a potential for a reversal in monetary policy in reaction to action in the equity markets?

Daniel: There is a risk that the Fed gets nervous about a market correction and delays the tightening. But it would be a very big mistake. And the reason why it would be a very big mistake would be that the sort of placebo effect would last very little. Probably it might even not work from the perspective of making different asset classes go further up.

And, more importantly, would send a very negative signal to the market. If the Fed delays its rate hike plan, what the message that it gives to the market is that they know something that we don't. And that is not a good thing.

More importantly, it is a very negative message as well. Because if the Fed doesn't build tools into the next cycle now, after losing precious months in the Yellen tenure – in which it could have capitalized on a very bullish market to raise rates – if they don't do it now it is going to be much worse when the cycle really turns.

And that is the risk of stagflation that we, for example, who are living in the UK – or that is not something that we should ignore in, for example, the European Union as growth estimates come down.

Erik: Let's focus a little more on the bond market. You mentioned that as one of the catalysts. We've seen, as you mentioned, the 30-year US Treasury actually move above a 30-year trend line on the 100-month moving average on a monthly closing basis. That's a really long-dated trend line.

Is that just a false breakout? Or are we really seeing a major sea change in the direction of fixed income here?

Daniel: It is unlikely that the Federal Reserve will allow that to break further. Or, at least, they will try to contain it, in my opinion. And the way to contain it, actually, is to be more hawkish than probably what markets are expecting right now.

In the short term, I don't think that we're going to be seeing a massive change in duration.

I think that what we are very likely to see is that, as markets get used to seeing downgrades in global growth, while fiscal deficits or fiscal imbalances continue to rise in most economies and disinflationary pressures start to build in the economy via what I mentioned before – China on one side and, obviously, the evidence of overcapacity in some economies – it is probable that we see that 30-year bond, let's say, lose a little bit of steam.

Erik: The other thing you mentioned as catalysts for what's going on in the market was the situation in the Eurozone.

How would you characterize the overall picture there, in terms of both what's happening with ECB policy but also the challenges in Italy and so forth? What should we expect next, as investors, from Europe?

Daniel: The situation in Europe is one of missed opportunity. The Eurozone had a tremendous opportunity when the ECB launched its QE program for countries to really do their homework and improve their economies, get in shape, take the advantage of low interest rates and high liquidity to improve their debt and their fiscal imbalances.

Most of the countries didn't do that. Most of the countries basically took the savings in interest rate expenses – which amount to more than €1 trillion of saved interest expense – from the ECB program, spent it all, and now they got used to very low rates and high liquidity. And you're seeing the effects in countries like Italy.

But not just Italy. You've seen that the French budget, the Spanish budget, the Portuguese budget, the Slovenia one as well – all of them, the governments are looking at two very dangerous things.

One is to increase spending dramatically.

And the other one is to try to balance the budget with tax revenue estimates that are, I would call, close to science fiction.

So the problem of the Eurozone is that the ECB has injected €2 trillion into the economy. The balance sheet of the ECB is almost double, relative to GDP, to what the Federal Reserve's balance sheet is.

And what ends up happening is that, despite that massive stimulus and governments that have had very aggressive budgets – let's remember that countries like Spain, for example, have increased deficits almost every year, have been deficit spending almost every year since 2008. What ends up happening is that the level of growth is very poor, the slowdown is very evident in the economy, and countries have not prepared themselves for the winter, for an environment of rising rates and lower liquidity injections.

So what is the problem?

The problem is that any investor who is listening to us right now, any of us knows that there is no demand whatsoever for Eurozone sovereign bonds at these yields. And you would have to think twice at least in some of the countries to even start getting the attention of the secondary market. And that is a big problem.

That is a big problem because, even if the ECB continues pumping money into the economy, what ends up happening is that it only disguises the risk in sovereign bonds, as we are seeing right now (but moderately).

But risk appears – for example on the iTracks – now that you see the yields of corporate bonds and, obviously, in equities. Because cost of capital is going up.

So the situation in the Eurozone is missed opportunity from the stimulus, too high expectations of return to growth, we're back to 2009 bad habits from governments, and an evident slowdown in the growth of the major economies of the Eurozone.

Erik: You spoke about the sovereign debt in the Eurozone. Let's also talk about corporate debt, and particularly the high-yield. Something that's been striking to me is there are actually high-yield junk-rated bonds in Europe that are yielding less than the US 10-year. Something has got to be mispriced there.

What's going on? What drives this? How long can it continue? And is there a risk of a major meltdown in that market?

Daniel: What drives this is, I would say, three things.

The first, obviously, is the belief that the European Central Bank will keep its very aggressive monetary policy for much longer. Recently, we heard Mario Draghi saying that a policy has to remain competitive for as long as it takes. So markets get complacent.

The second one, which I think is even more worrying, is a very overly optimistic view of the solvency and liquidity of these issuers. If you look at, for example, the BIS (Bank of International Settlement) analysis, the number of zombie companies in the Eurozone has risen dramatically, has more than doubled in the last three years. This means companies that are unable to pay

their interest expenses with operating profits.

And this with very, very low rates.

So solvency ratios and liquidity ratios of issuers have actually not improved in the vast majority of this sector, the high-yields market. While, at the same time, the spread is about 300 basis points over the sovereign. Which is nothing. And as you very well said, in real-currency-adjusted terms it is slightly higher than the US 10-year.

Obviously, you have to make the exchange rate adjustment and inflation adjustment. But, still, you are basically paying these corporates to issue more debt while their ability to repay that debt is worsening.

So the risk of a meltdown is very high. Because if the European Central Bank, instead of normalizing policy, decides to continue perpetuating this imbalance, what will certainly happen is that sovereign bonds will not reflect the real risk of the economy.

But the market is going to react in the areas in which the ECB is not intervening. And this is, for example, high-yield as well as equities. So you will start to see that many of these high-yield issuers will have no possibility of, for example, refinancing. You will see much higher spreads.

That is, obviously, one of the symptoms that will appear if the ECB decides to ignore the real need to build tools for the next cycle and continues to maintain this perverse incentive type of policy.

Erik: If we move on to emerging markets, we've seen an outright meltdown in a lot of EM currencies. Particularly Argentina, as well as a lot of equity markets.

What is the macro driver behind this? What does it mean? And is it signaling something for developed markets that we need to pay attention to?

Daniel: Well, what happened with emerging markets is, unfortunately, what always happens with emerging markets. I always say to my students that emerging markets don't emerge. They are the same countries that were emerging markets when I was a kid.

What happens is what always happens – the belief that this time is different. So what happened – particularly and accelerating into 2016–2017 – was this idea that the dollar was going to be weak for longer. That liquidity was going to continue to be flooding emerging markets. That rising fiscal and trade imbalances were not a problem. You had an increasing number of countries that were deciding to take more aggressive budget risks.

So all these things were taking place as they did before.

But, on top of that, because of the impact of QE and the massive amount of money that fled

into emerging markets, what you had was a very large increase in the foreign-exchange-denominated debt of emerging markets.

On one side, you had tremendous demand from investors. Remember that Argentina issued a 100-year bond. Argentina, a country that in the previous 100 years defaulted at least eight times, was able to issue a 100-year bond at 8-something yield in dollars. But they had to issue it in dollars because investors were very aware of the fact that emerging markets do tend to allow their currencies to depreciate massively.

So what these emerging economies ended up doing was to take massive exposure, massive debt in foreign exchange currencies, while at the same time increasing their imbalances. And it exploded, or at least erupted, with the countries that had taken a more aggressive monetary policy.

Argentina, about 30% increase in money supply every year to finance government spending etc. Turkey about 16% rise in money supply for the past years, massive devaluation of the lira. Already in 2017 etc.

So it was this enormous wave that was building. And, suddenly, it burst.

Where we find ourselves now is a bear market in emerging markets. Bear markets in emerging markets don't end up in a few months. They take at least, usually, a couple of years. And the average loss in a bear market for emerging markets is about 55–65%. So we're very far away from what would be, on average, the bottom.

At the same time, we have in front of us a massive maturity wall of dollar-denominated debt while foreign exchange reserves are falling. They are not falling dramatically, which is why the markets are not aggressively negative in the last couple of months. But those reserves are falling. And we need to pay a lot of attention to that.

Erik: Let's continue around the world to China. Obviously, all American eyes are on President Trump's trade war with China. But I think there is a bigger picture behind the scenes in the sense that China's credit expansion has just been massive and a lot of people have been concerned about what happens if that bubble eventually bursts.

Where do you think the risks are with China? How should we be thinking about China in the current macro environment?

Daniel: Every time I speak with people about China, you have either the ones that say everything is fine because the country still grows at 6.5% (which is irrelevant because even the premier said that it was almost a made up number), and you have the ultra-bears who say that China is going to crash in a sort of 2011 Eurozone situation.

My opinion is different. I think what is more likely to happen in China is a process of gradual

move into stagnation. The entire economy is driven to maintain overcapacity, maintain the imbalances of the system, keep the banks pumping credit into non-economical return type of investments.

So the most likely scenario is not a crash. The most likely scenario is not that everything is fine. In my opinion, the most likely scenario is that what we see is actually the economy stagnating because it sort of feeds into this triple whammy of rising overcapacity, rising debt, and, at the same time, a government that has incentive to keep those imbalances as they are or rising.

Because the companies that are most at risk, they employ a lot of people. When the government has as its main incentive to keep people working no matter what, it is the idea that it is building white elephants and allowing mal-investment is irrelevant for the policy. And, therefore, as it moves – if you see industrial production, if you see consumption, if you see return on investment capital of the companies of the Shanghai Index etc. – you see that that is where it is heading to.

The idea of the Chinese government is that, because it is the only G20 country that has capital controls, it is also the only G20 country in which there are massive barriers to trade because there is no security of intellectual property. There is no legal security because there is no differentiation between government and the judicial system etc.

The government believes that it can export its way out of a problem. Hence, the trade war. Which is not a trade war. Either we've been in a trade war since 2001 or we've never been in a trade war.

The situation therefore is – what we have seen in the last, particularly, 10 years is that governments were accepting those conditions of the Chinese economy that you would not accept in any trading partner: capital controls, lack of legal security, lack of intellectual property security, etc.

Countries were accepting that because China grew a lot. But now that China is trying to reduce its problem of overcapacity, exporting its way out of the problem, you see that then – and mostly to the United States – then it's logical that the United States reacts from the perspective of, hey, I'm your biggest customer. As the biggest customer, I actually have something to say in this debate.

My opinion is that, now that the Chinese prime minister doesn't have any incentive to work to maintain his job – he's got a perennial job – he can have a much more aggressive stance to try to keep those things that they perceive as advantages. And they are not advantages.

Again, I come back to capital controls. And that is going to be the undoing and the reason why China stagnates. Because you cannot have a world reserve currency and an economy that becomes a global leader with capital controls and with lack of legal security.

Erik: The price of gold was trading almost in lockstep with the Chinese yuan. If you looked at the chart of gold priced in yuan, it was almost flat-lined. And then, all of a sudden, on October 11, with no apparent driver or catalyst that I've been able to identify, that correlation broke. Gold moved up dramatically against the dollar. And even on the Tuesday that we're speaking, gold is moving up again. Even on a day when the dollar index is holding its own.

So it's not the usual inverse relationship. It seems like, somehow, on October 11 all the correlations broke down and gold is on its own mission.

What's going on here? What's driving this?

Daniel: Before, what happened was that gold was suffering, also copper, because of the massive amount of gold-backed and copper-backed loans in China. As the situation in China was becoming more negative, and as you saw margin calls etc. coming up in equity markets and different other markets, what ended up happening was that those two commodities suffered in tandem as the yuan depreciated.

Now, what I find interesting, something happens end of September beginning of October. I always put in my Twitter account, for example, how consensus moves in terms of growth estimates of different economies. So consensus was, I would say, almost unanimously looking at China growing in-line or better than expected, and the US as well, while downgrading the rest of the economies. Or at least the rest of the major economies.

And at the end of September, this changes. At the end of September, you suddenly start to see significant downgrades to the growth of China while, at the same time, in these first weeks of October, the Chinese government starts to present a large stimulus tax cut.

So suddenly, I think, it's the realization – very similar to what we talked about (different catalysts) – the market realizes that the rhetoric of "China is fine" is broken. Because if China is "fine" and it's going to grow above estimates, and it's not affected by the trade war as the media says, and all these things, obviously, you don't make a massive tax cut program. And you don't inject 160 billion into the banks. And you don't launch a stimulus package.

I think that that is what changed. And, suddenly, gold, which was not working as a recession inflation hedge, suddenly starts working. And I think that what gold is starting to do is to reflect the tipping point of estimates from, hey, it's just a slight slowdown from the idea of synchronized growth to, hey, this can actually be a much more aggressive slowdown than we originally anticipated.

And I think it's been – those three to four weeks of different data points that led to change the perception of what China was going to do in the next few years.

Erik: Okay, Daniel, bringing this all together. Now that we've been around the world of macro, so to speak, let's talk about the US economy and where it stands.

Are we seeing signs, as the market is seeming to roll over, that maybe we're headed into a recession? Is the US economy about to fall off a cliff? Or is it a false alarm?

Daniel: I think the recession that the market is worried about is quite unlikely – a dramatic recession, a big 2008/2001 type of environment.

I think that the US economy is rightly perceived as having seen a very long cycle of growth. And that has to change at some point.

The problem of this cycle of growth is that – I always say to my students, there are 150 million Americans who haven't seen it. It's been very GDP-driven. It's been very official-unemployment-rate driven.

While the labor participation rate remained poor. While productivity growth remained very, very weak. While manufacturing jobs were continuing to disappear. All those things.

The reason I'm more bullish on the United States than maybe the majority of analysts is because that entire part of the economy that did not benefit from the demand-side policies of the 2008–2016 period is likely to be more than benefited by the strengthening of the US dollar.

Unfortunately, there are too many people out there defending a weak dollar in an economy that is so inward looking that it exports so little and in which consumption depends so much on strengthening of purchasing power.

So I think that the economy is going to slow down because the level of growth that we are seeing right now, and we have for the third quarter 3.3% growth – obviously it's not going to grow on 3.3%.

What I think is that it does have a lot of catch-up territory. Not just in terms of our productive capacity, utilization – we mentioned before the labor participation rate has to come higher to the levels of countries with similar demographics. The US cannot have almost 8–10 points of difference in terms of labor participation rate with countries with similar demographics. As I said, industrial utilization, purchasing power of consumers.

If the US government is wise enough to know that the voters and the citizens and the middle class – the people that actually matter for the next wave of growth – are benefited from a strong dollar, then you can have a stronger period of growth that is not going to be 3%. But it can continue to be in the region of 1.9–2% level of growth.

And these are important factors. Because, when you speak with many economists they say, well, maybe participation rate is never going to come back. Well, why? Just because you say so? No, it's because it's people that don't want to return to the work force. Well, that is a very simplistic and completely nonsensical answer.

So, as I said, I think that there is an entire part of the country, a massive part of the country, that did not benefit from the period of expansion – that can benefit from supply-side measures and drive growth further. Particularly if the rest of the world slows down and the dollar strengthens, which ends up benefiting the American consumer. Ends up benefiting, obviously, the American corporate sector, which is fundamentally selling to US citizens.

Erik: You said a moment ago *if* the rest of the world slows down. So let's broaden this discussion out to the global picture. The narrative that's gotten us here – I say narrative; I'm not sure it's right – is this idea of global synchronized growth.

Are we seeing a slowdown in that phenomenon? Or was that a false narrative to start with?

Daniel: It was a completely false narrative. It was the dream of central planners that you could have developed markets growing higher from monetary and fiscal stimulus and, at the same time, have emerging markets growing in tandem, slower but in a more sustainable way. It was a central planner's Excel spreadsheet dream. And it was fake. It was just synchronized debt.

What we've seen is massive increase in global debt. Global debt to GDP has gone up to plus-300%. And most countries have gone into large fiscal imbalances while not being the world reserve currency. Because, always, when we look at fiscal imbalances and we talk about the deficit of the United States, well, the US dollar remains the world reserve currency.

It's not the same for Argentina. And it's not the same for Brazil or for Spain or for France.

So what we have seen is not synchronized growth, but synchronized debt growth. And when it's synchronized debt growth – and the evidence of weakening productivity growth, weakening industrial production, weakening trade, weakening GDP growth as well becomes more evidence to the majority of consensus – that's when the mirage ends. Because the debt is there. The net financial requirements are rising, but the solvency and liquidity levels are not improving. And that's what we're seeing.

But, again, I think basically the reason why markets are so negative right now is because they were so excessively optimistic at the end of last year. If we had had this chat last year, the estimates for 2018 from consensus, from investors, from investment banks, from international bodies, were simply outrageously optimistic.

Erik: Let's touch on commodities next. You know, we've seen a really long trend of deflation in commodities. And then it looked for a little bit like there was a reflation expectation that maybe commodities were going to come back. And now we're seeing them starting to turn back down again. Particularly oil. Just as we're speaking, actually, it's gone down quite a bit.

What do you see in terms of what are the drivers behind this action in commodities? And where is it headed from here?

Daniel: I think that's pretty much the same. Commodities is a reflection of that reflation view. And the idea that stronger growth would drive inflationary pressures throughout the world as the slack in the economy was absorbed.

So we have to differentiate between metals and, obviously, energy commodities. Energy commodities, oil in particular, on top of all that was being bid up by massive supply manipulation. OPEC and the partners that joined the OPEC agreement kept a completely unnecessary lid on production growth when inventories were already coming down to the average of the five-year level when demand was already picking up. So it became, instead of a "deal with the glut" type of policy, it became a policy of greed.

And when you get greedy and oil goes to 80, in an environment in which global growth estimates are coming down, global demand growth estimates are also being revised gradually slowly but surely down, what ends up happening is that you, as OPEC, as the supply manipulators, are actually creating the negative scenario for themselves.

That is, in my view, what has ended up happening – by keeping too long the supply cuts, they created a short-term bounce on the oil price, a short-term and probably too large bounce – and generated the seeds of the undoing of that trade while growth estimates were coming down.

This is very similar with copper, by the way. Not because of supply manipulation in that case, but because of estimates of industrial growth demand. And it's been, again, added to the Chinese copper-backed debt problem that we mentioned before. Another of the issues.

So in these commodities, what you're seeing right now is the evidence of the combination of global growth slowdown with the destruction of the narrative of reflation as the driver of the next couple of years.

We will have to see, obviously, if what we see right now remains as simply a slowdown in growth estimates to a level that is more normal. Or we get into a succession or domino effect of significantly lower estimates of growth.

Erik: Well, Daniel, I can't thank you enough for a fantastic interview. Before we go, for our listeners in the retail audience who would like to follow your work, please tell them where your website is. And for the institutional audience, let them know how they can find out more about the fund you manage at Tressis.

Daniel: My website is dlacalle.com. For institutional investors, I have a small fund. It's called Adriza International Opportunities. It invests fundamentally in companies that buy back stock and that don't fall into the trap of low interest rates to increase debt and diversify internationally. Twitter: @dlacalle_IA. And Facebook, LinkedIn – we're everywhere.

Erik: Well thanks so much for a fantastic interview. Patrick Ceresna and I will be back as

MacroVoices continues right here at macrovoices.com.