Trolling The Bottom: Past The Point Of Maximum Compression?

What Happens After We Hit The Hard Deck?

Carl B. Weinberg
Chief Economist

www.hifreqecon.com/Jun2020

High Frequency Economics: Where We Stand

Before coronavirus and before oil prices crashed, world trade was falling and many economies were in or nearing industrial recession. Inflation was nil. Many bond yields were negative. That has not changed.

HFE's analysis: The lockdown of the global economy—a previously untested experiment— has caused **significant and irreparable damage**. Our view is that the economy hit its point of maximum compression in April. **The question is, how long do we linger here, how many firms will not survive the lockdown. Then, how many workers who now see themselves as temporarily furloughed will end up truly unemployed**

A "V-Shaped" recovery, returning to growth rates of 2018-19 will not bring the world back to prosperity.

A new **financial crisis, triggered by failed borrowers, is no longer a tail risk.** Banks may fail as borrowers default. Failures of insurers and pension funds are at risk as asset quality decays. Interest rates tumbling to and then lingering below zero pose solvency and cash flow risks to savers. **Another ABS meltdown is a real risk.**

If all governments in the world apply fiscal stimulus at once, in proportion, none can succeed.

Mutualized bonds issued by the EU will fund major fiscal support to stabilize the economy. They add glue to hold Project Europe together, it increases the potential scope of ECB QE... but how will the debts be repaid?

At the same time, **depressed oil prices** threaten **balance of payments/debt crises** in oil producing economies, especially emerging economies — particularly already-vulnerable ones like Venezuela, Nigeria and Iran — but also Canada and the United States.

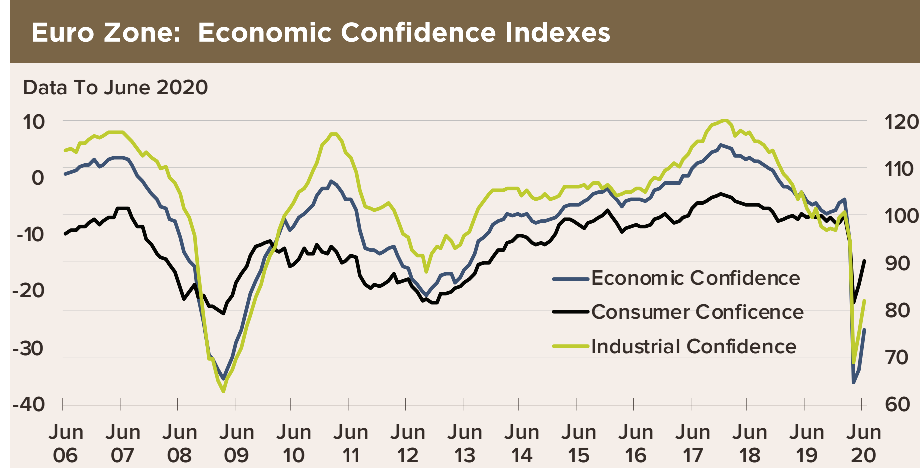
Negative yield curves are *still* toxic to financial stability. They kill bank lending and undermine the solvency and the cash flows of big pools of savings like insurance pools and pension funds.

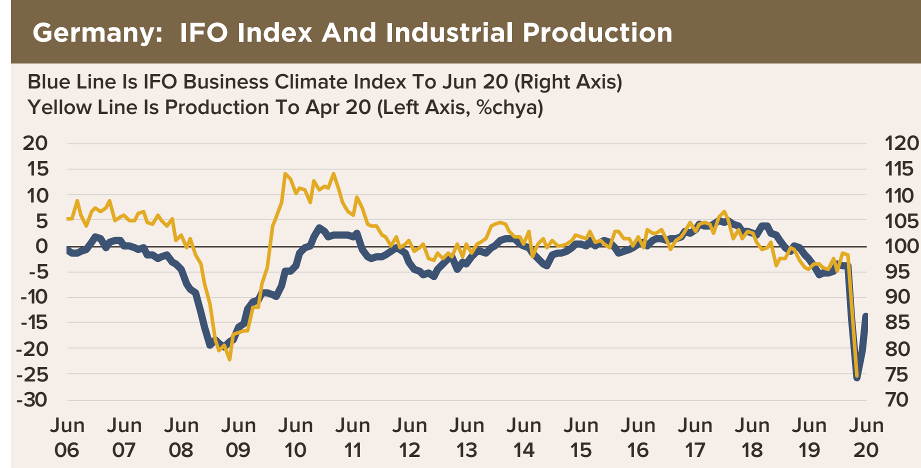
Euroland's industrial recession was in full swing before the virus hit. It cannot end until inventories fall back into line. Instead, inventories are exploding as demand has stopped more suddenly than output.

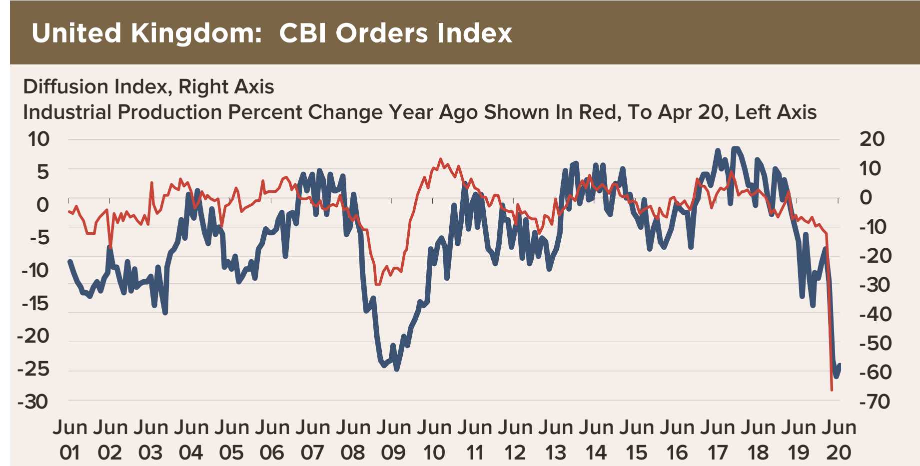
Headline CPI-based inflation metrics will fall all year in advanced economies, to or below zero. Core inflation metrics also will fall near-term, albeit slowly as wages fall. ***Deflation seems like a growing risk!***

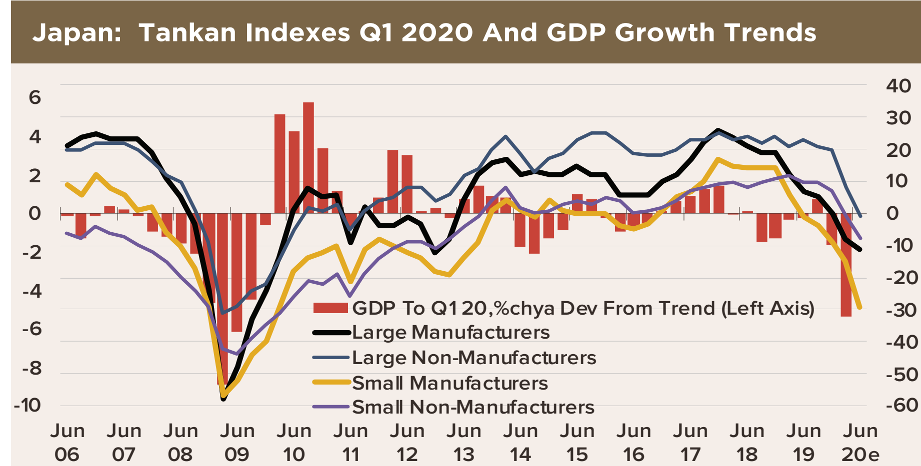
Informative Surveys That We Trust... Signs Of A Bottom Appear

Euro Zone to Japan, survey data point to decaying supply-side conditions prior to coronavirus containment policies. Indexes seem to have bottomed in April and now are stabilizing, consistent with the view that the economy got to full stop in April starting from full throttle in February.









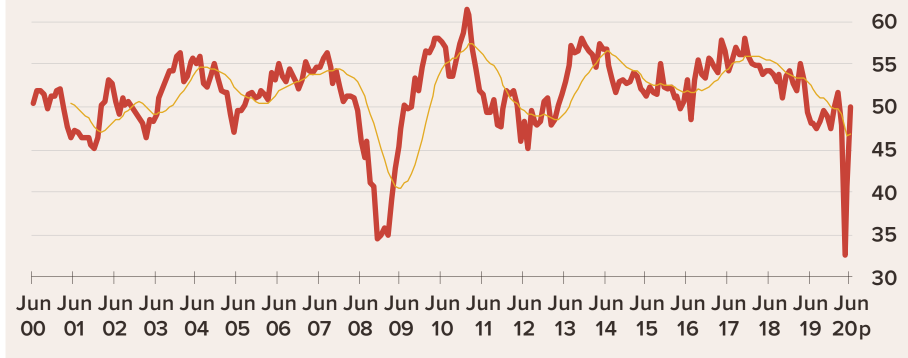
Surveys That We Have Yet To Come To Trust... Same Story

The world has not yet generated enough historical data to validate Markit's recently-invented PMIs. However, they do exhibit a bounce in May and June that is consistent with our theory that the economy bottomed out in April and subsequently stabilized at **depressed levels of activity**. A PMI is a diffusion index showing the percentage of respondents who see things better now that a year ago minus the percentage who see things as worse year-over-year. Levels below 50 are meant to signal contraction of the sector, **year-over-year.** Even if monthly economic growth resumes, year-over-year activity will be lower through next February.

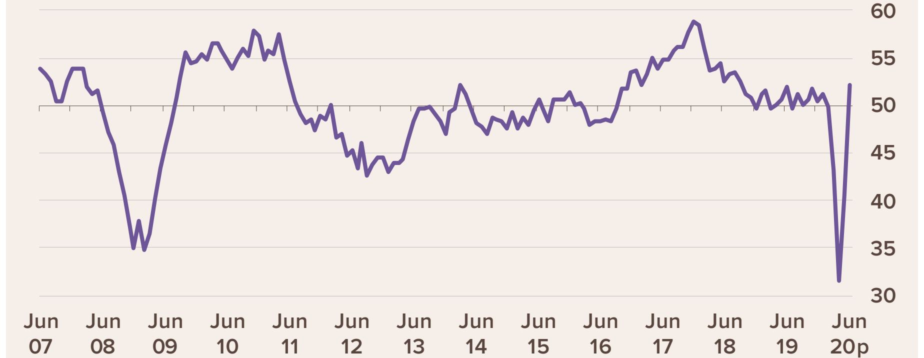
Euro Zone: Markit PMI For Manufacturing

Germany: Markit PMI For Manufacturing

United Kingdom: Markit/CIPS Manufacturing Sector PMI

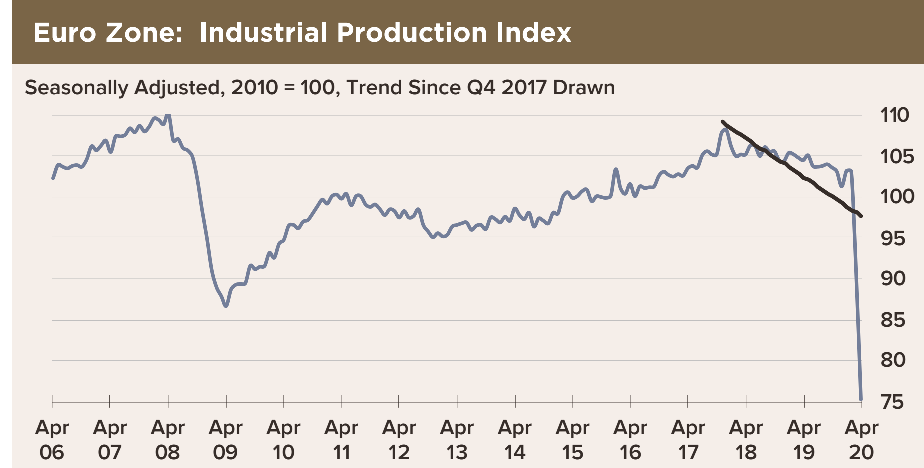


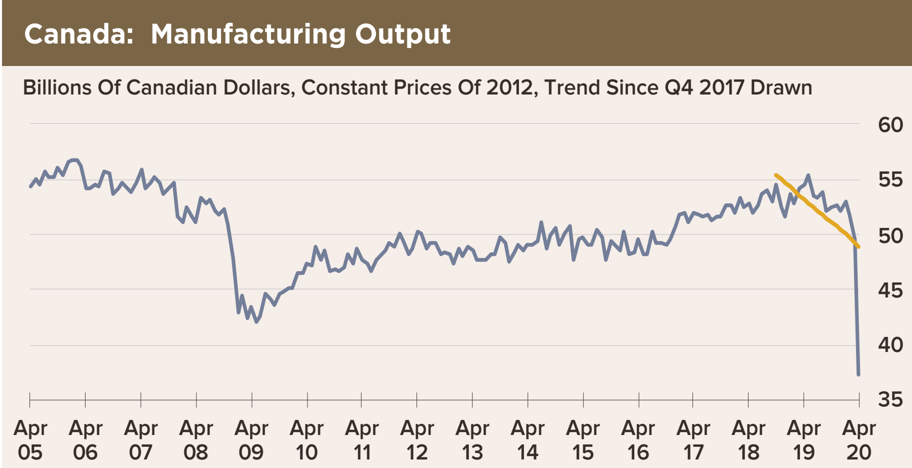
France: Markit PMI For Manufacturing

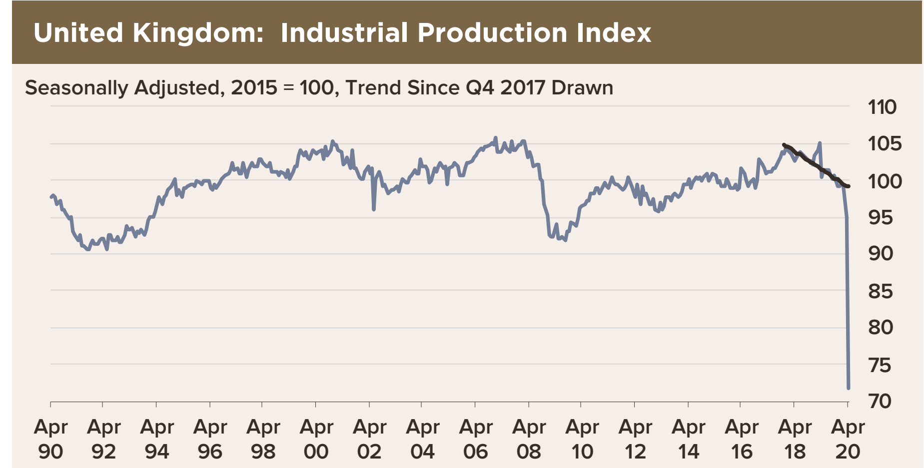


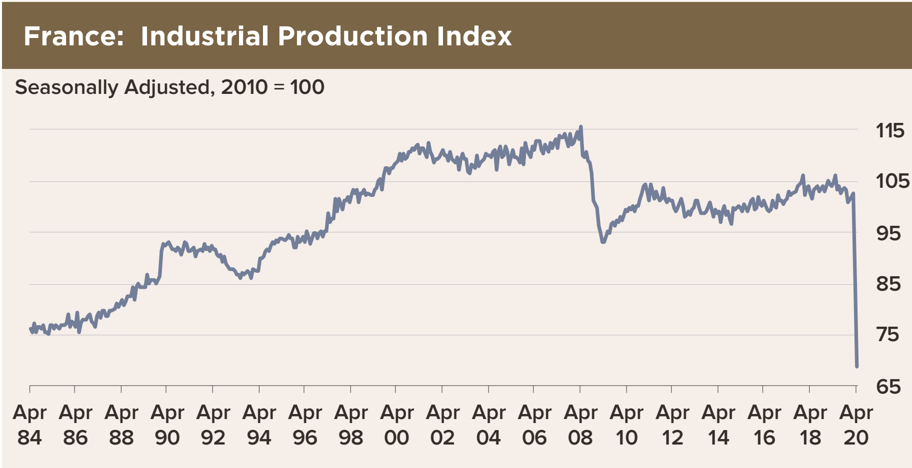
Industrial Output... The Bottom Is Pretty Darn Ugly

Euroland, Britain and Japan were in an industrial recession that started in the first quarter of 2018, before coronavirus containment policies. Upon lockdown, catastrophic declines in output were realized March, as factories were shuttered in the last two weeks of the month. Bigger declines were reported for April recording losses actually ocurring in both months. *On our theories of maximum compression, the levels of production should now stabilize after April lows and improve, slowly at first and then with vigor as economies unlock.* Once all the firms in an economy that can be shut down are shuttered, output will be depressed but cannot compress any more. In some places, output is down to levels not seen since the 1990s. *Only after economies have unlocked will we know how many firms and households failed in the downturn. That will be the starting point for recovery.*





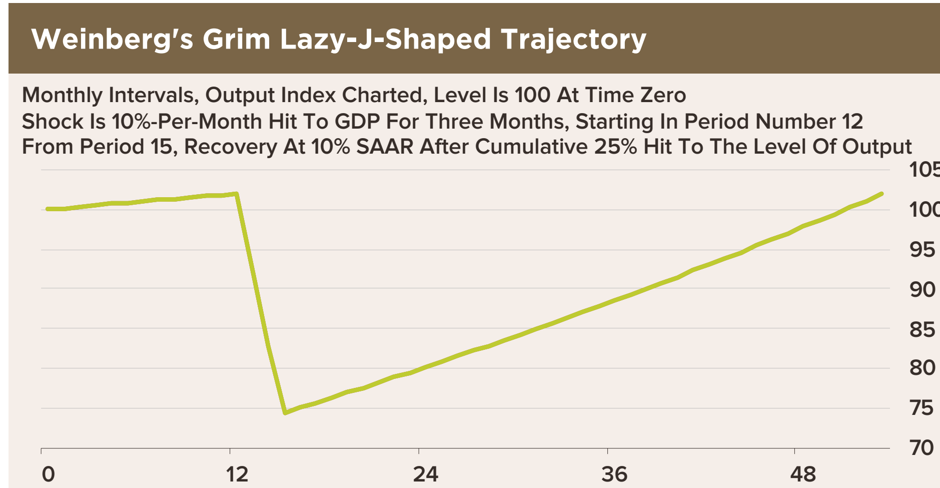


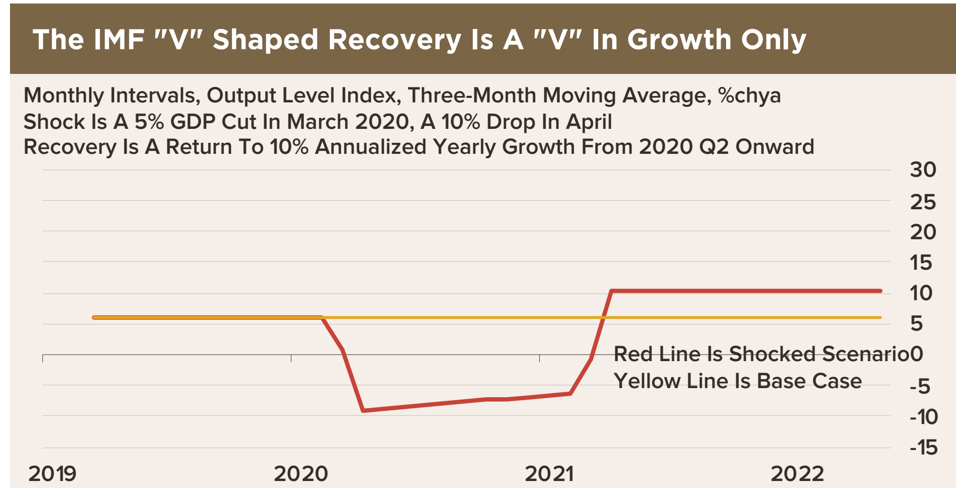


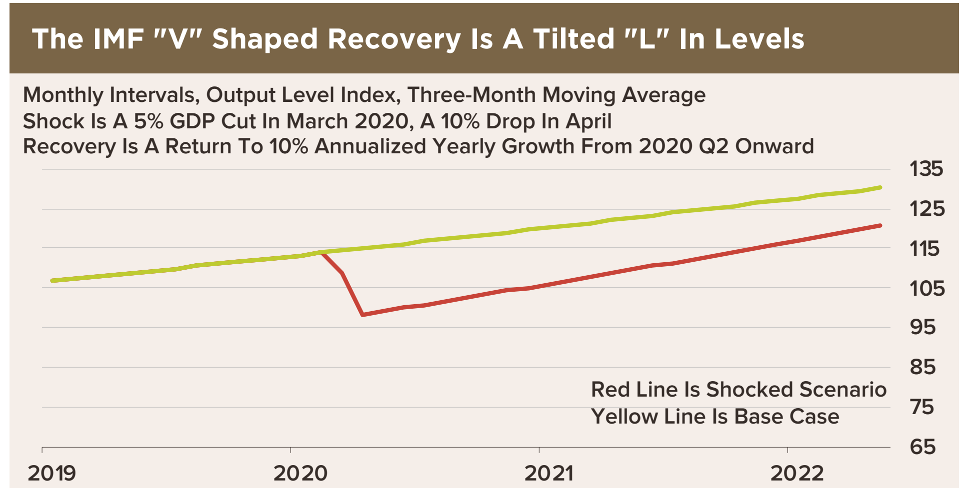
A "V-Shaped Recovery" Is No Return To Prosperity!

We drew these charts to illustrate hypothetical trajectories for the economy after a rapid massive economic contraction. Theorem: If a growing economy suddenly shrinks by one-quarter and then resumes growth at its pre-contraction rate of growth, the "recovery" begins at a reduced ***level*** and it will take years to get back to the ***level*** that prevailed before the contraction. Levels matter because the ***level*** of economic activity determines the ***level*** of employment and the degree of slack in capacity use. If an economy produces 25% less after a shock, then either it must employ 25% fewer people or everyone can work at incomes that are 25% lower. A return to full employment is years away!

Unemployment and wage losses will be determined by the *depth* of the downturn, the *duration* of its time at maximum compression, and the *toll* of the income disruptions How many firms fail and many households fail will set the baselne for the real recovery.

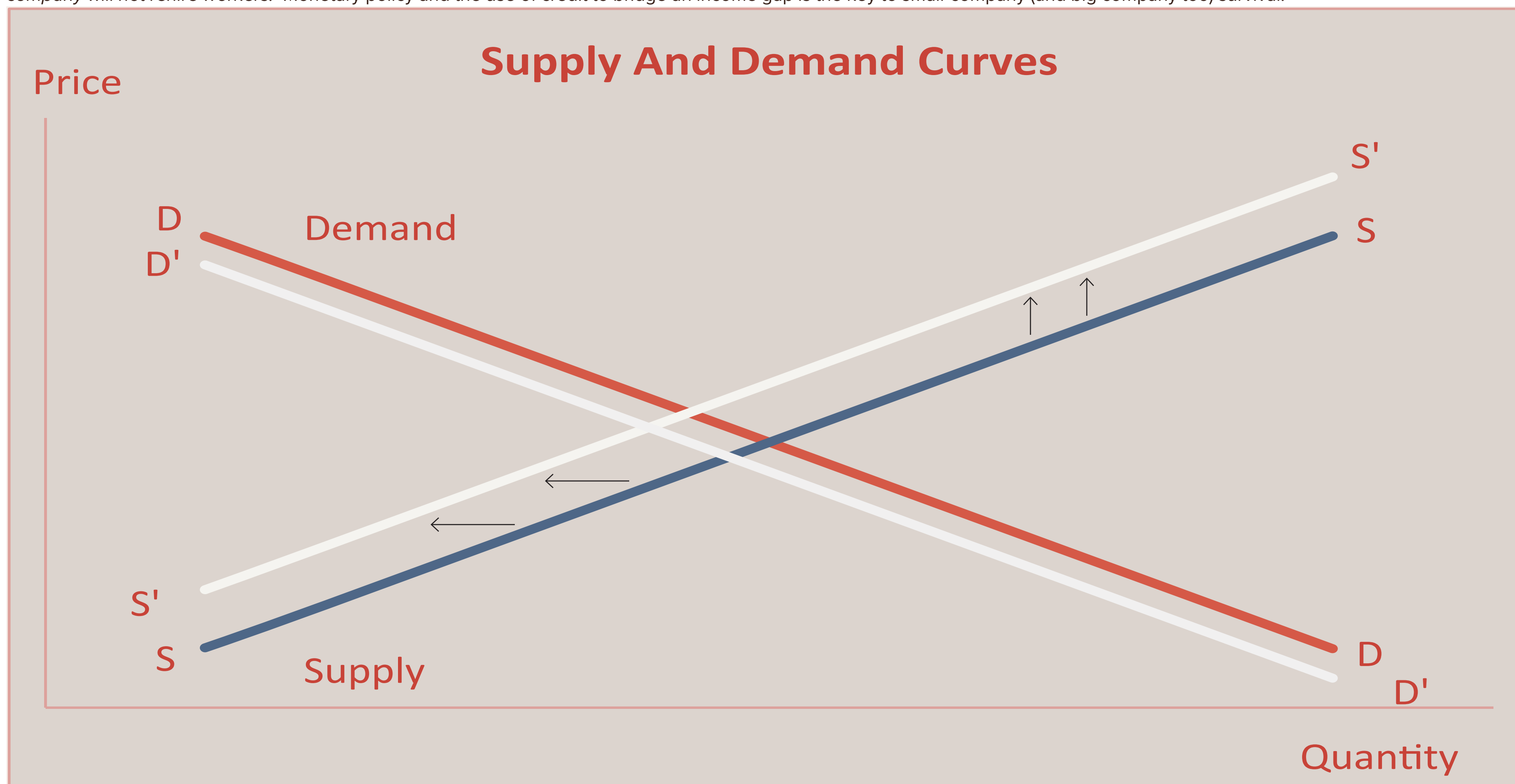






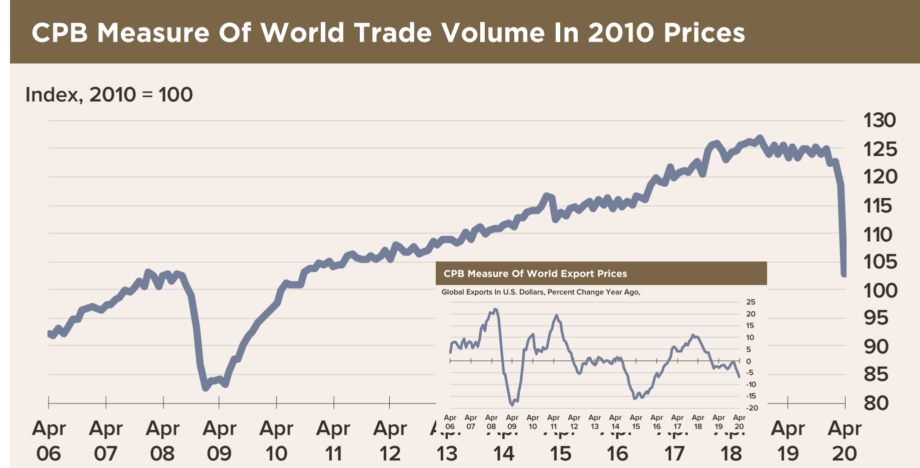
Supply Shock Vs Demand Shock In One Chart

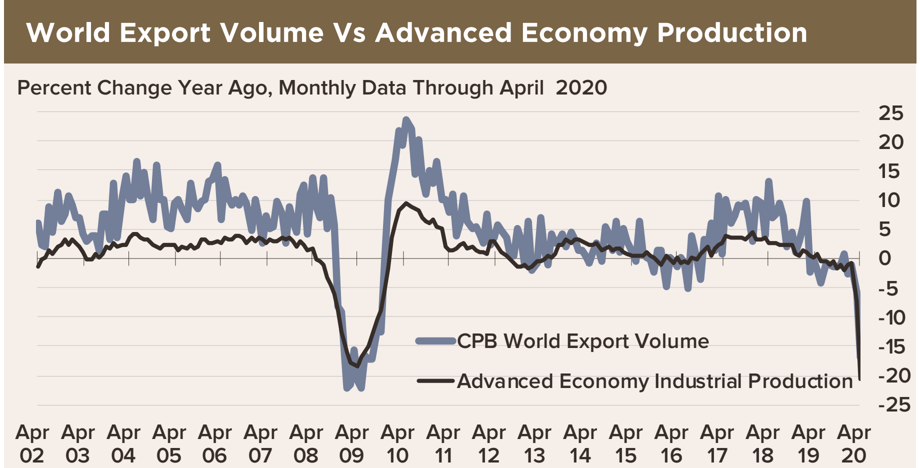
Supply and demand curves frame the issues clearly. Output is reduced by coronavirus containtment policies. So the aggregate supply curve shifts to the left. **This is why HFE is is worried about global stagflation after the demand shock is managed.** At the same time, loss of income with rising unemployment pushes the demand curve to the left, blunting the price increase but making the economic contraction more severe. **Even if fiscal stimulus returns the demand curve back to where it started, the supply curve will remain shifted to the left and prices will be higher at lower levels of output.** *The degree to which the supply curve can return to where it was depends upon how many firms survive this downturn. A bankrupt company will not rehire workers.* Monetary policy and the use of credit to bridge an income gap is the key to small-company (and big company too) survival.

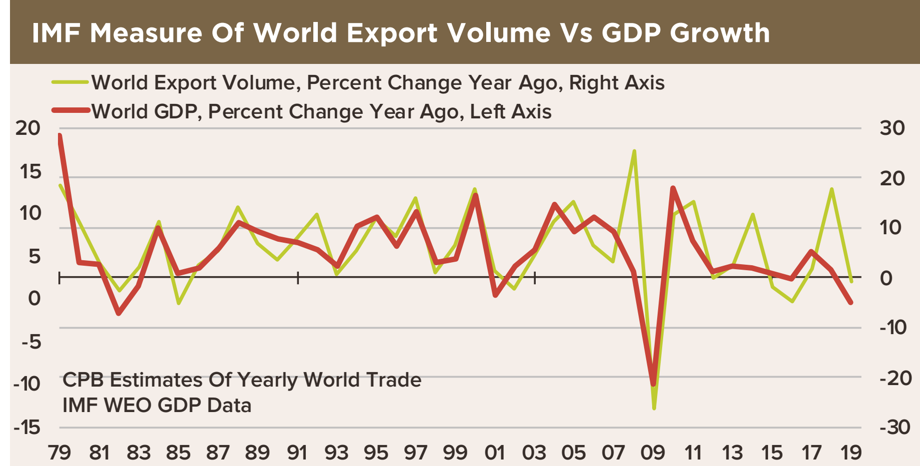


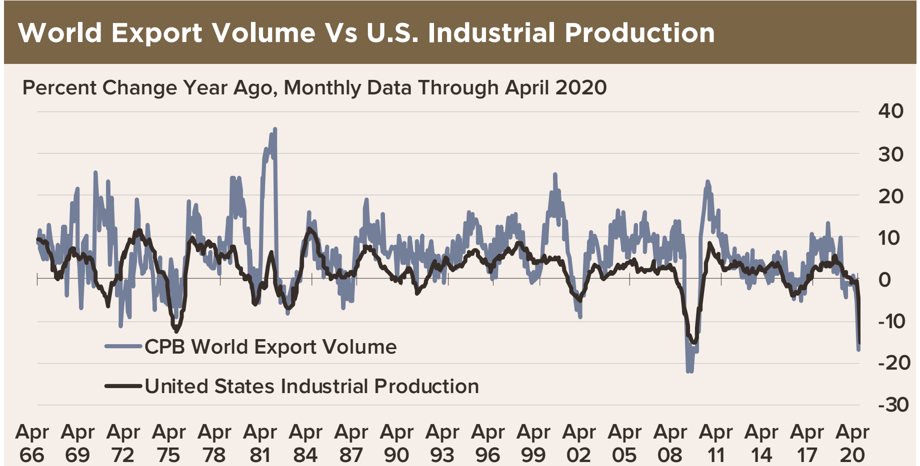
The Pulse Of The Beast: Trade

World exports are crashing. The volume of world exports was 16.8% lower than a year ago in April after a 5.6% year-over-year drop for March. Actually, world export volumes have-been lower than year-earlier levels in ten of the last eleven months, or all but three of the last 18 reports. Nothing good can be said about that. Coronavirus containment policies have caused the biggest and fastest contraction n world trade ever recorded. Whenever world trade falters or declines, world GDP falters or declines along with it.



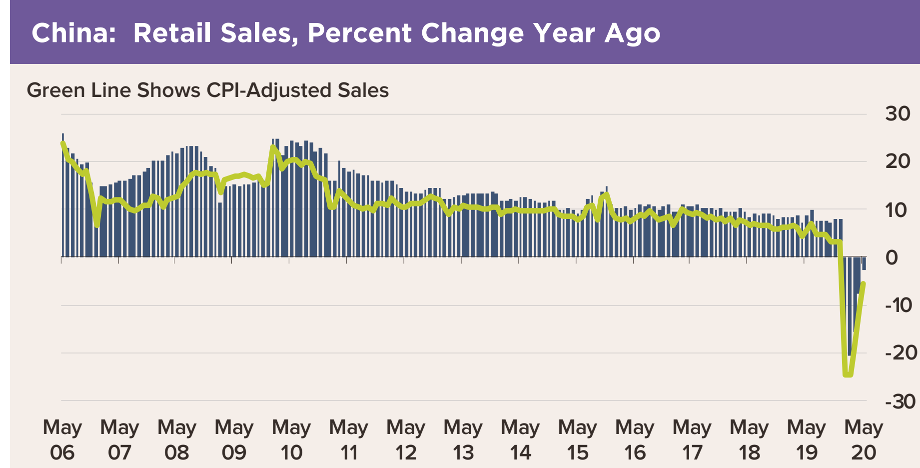


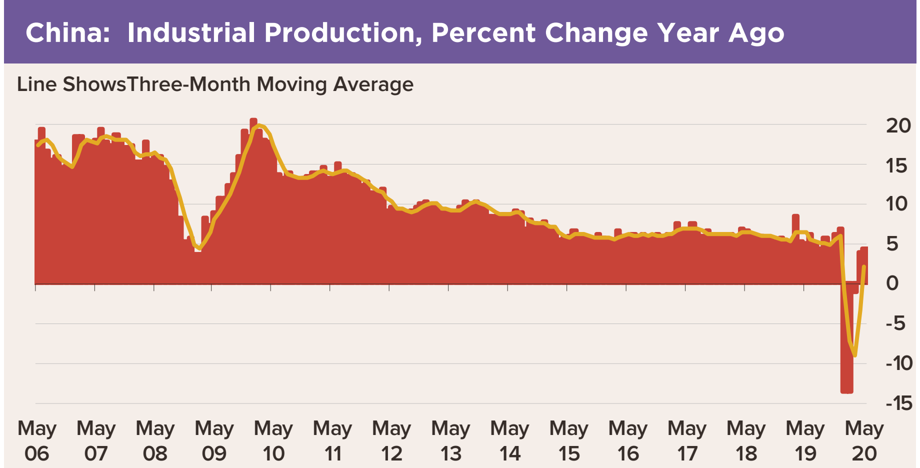


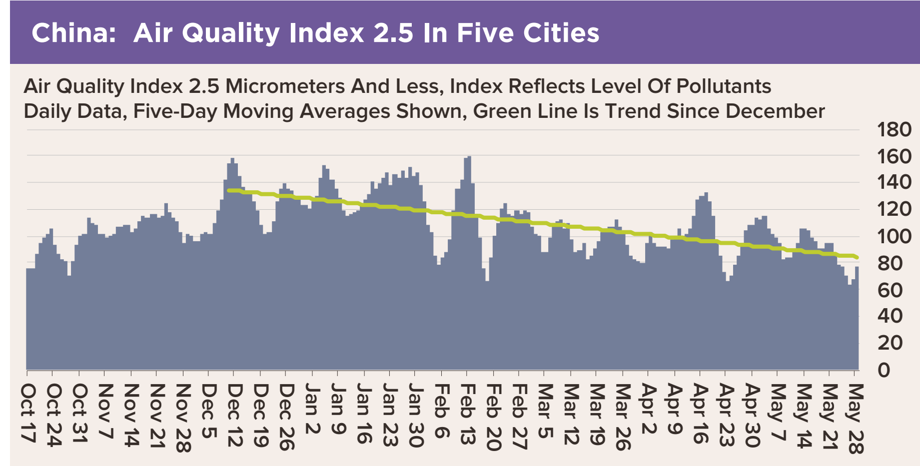


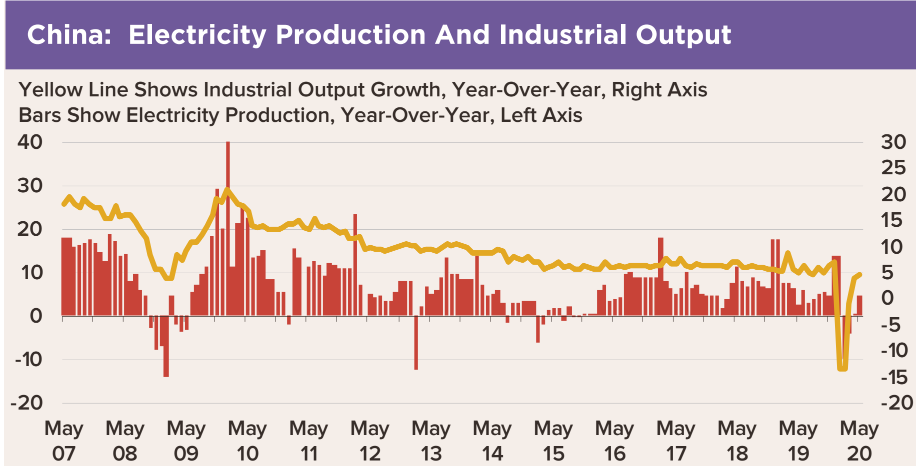
China's Remarkable Recovery May Not Be An Example For The World

Hard economic data put key indicators of China's economic output—industrial production, auto production, electricity generation, rail and air freight tonnage—above year-ago levels in April and May! Retail spending has yet to bounce back, but it is moving in the right direction. Air quality measures, an untested indicator, are the main signal remaining that recovery from CCP may not be complete. All of China's economy did not lock down, although the Hubei quarantine did affect broad swathes of the economy, especially auto output, by cutting supply chains. Prices ex-pork are nearly flat! Deflation risks will be haunting policy makers by year end as the year-ago spike in meat prices passes out of year-over-year arithmetic.





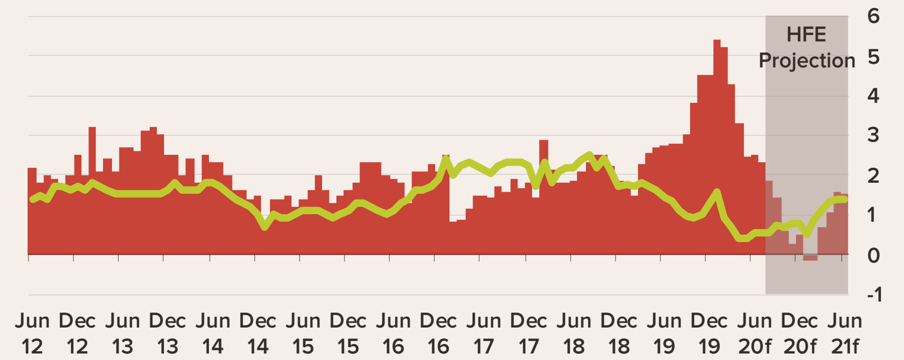




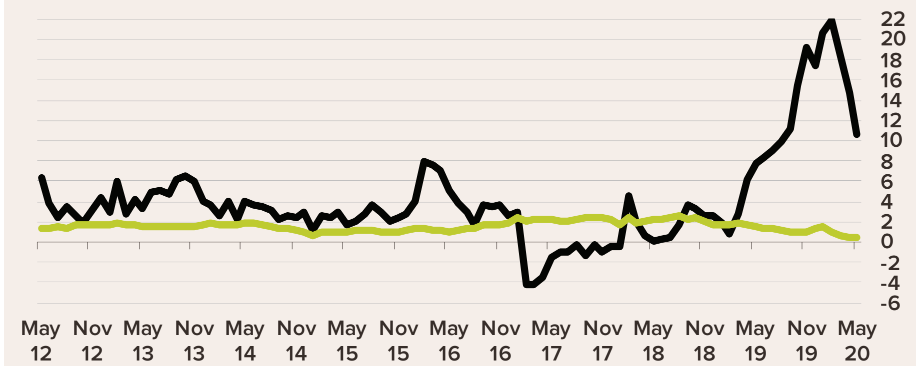
Deflation In China?

An explosion of pork prices that began in March 2019 has pushed up CPI. African swine flu decimated the pork herd, pushing prices up to 2-1/2 times year-earlier levels a their peak earlier this year. Non-food prices have been decelerating since mid-2018, and yearly increases are now headed toward zero. As year-ago pork prices rise, the basis for the year-over-year increases in food prices in the CPI rise too and inflation metrics drop. *HFE forecasts CPI will drop outright, year-over-year, by the end of this year.* The bottom line is that the slowdown in non-food prices will border on perceived deflation: The PBOC will not face any constraints on implementing policies to boost demand if prices are seen as falling.

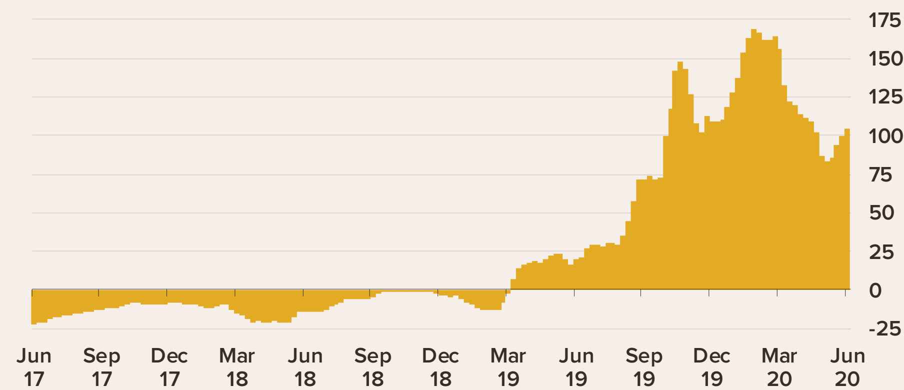
China: Consumer Price Index, Percent Change Year Ago



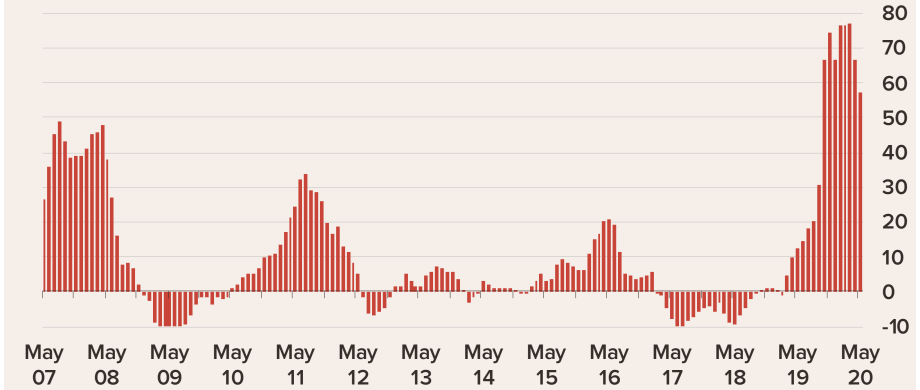
China: Consumer Price Index, Food Vs Non-Food Elements



China: Wholesale Pork Prices, Percent Change Year Ago



China: Price Of Meat In CPI, Percent Change Year Ago

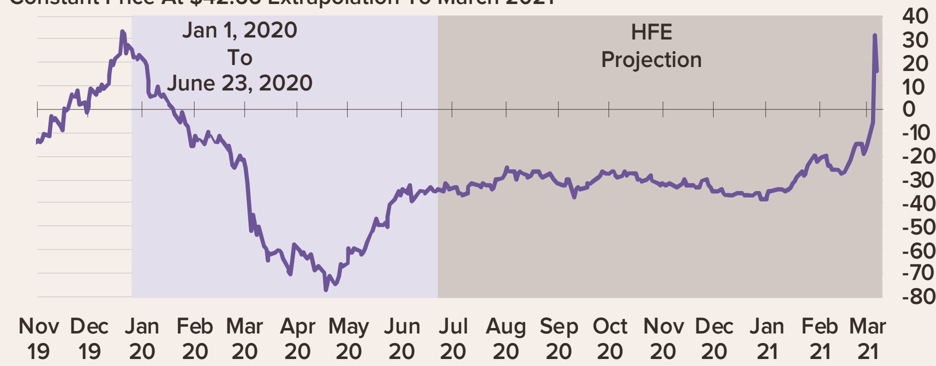


Tumbling Oil Prices Restrain The Global Inflation Outlook... For Now

On top of coronavirus jitters and China's response to the outbreak, a newly evolved trade war between Saudi Arabia and Russia have pushed down crude oil prices. So far, they have only recovered a fraction of their first quarter losseseven though OPEC+ has finally struck a deal: Inventories remain high. It will take years to work down excess stockpiles of crude. On our extrapolation, Brent crude prices will be lower than year-ago levels from now through early next year restraining headline CPI increases relative to core. Prices of auto fuels at the pump are down 15%-to-20% worldwide from a year ago. Current crude prices, if maintained, are slicing almost a full percentage point off today's headline-CPI inflation metrics relative to core. Most inflation metrics are below target already, opening the door for aggressive monetary easing into a global economic depression. **This drop in crude oil prices, along with the drop in industrial commodity prices, is a catastrophe for oil exporting emerging economies. There will be sovereign defaults in places like Venezueala, Nigeria and Iran.**

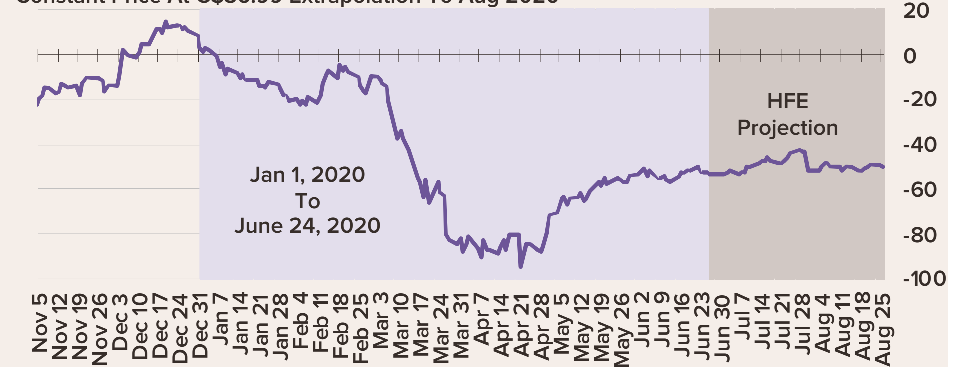
Brent Crude Oil Price Base Scenario, Percent Change Year Ago

Daily Data To June 23, 2020, U.S. Dollars/Barrel
Constant Price At $42.66 Extrapolation To March 2021



Canada Syncrude Price Scenario, Percent Change Year Ago

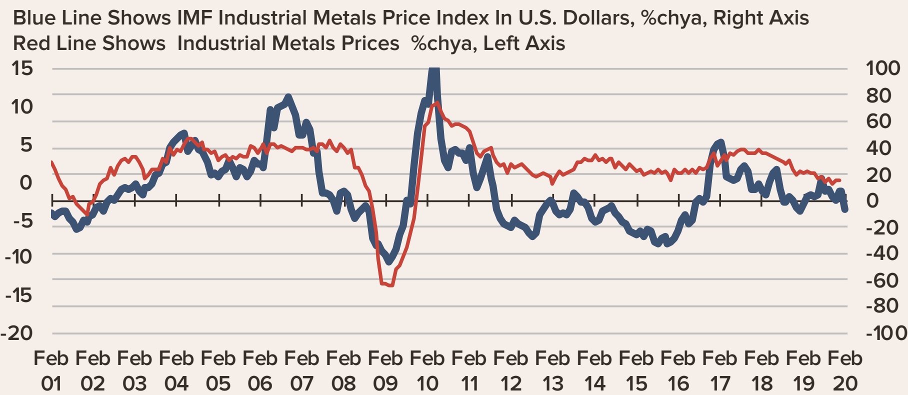
Daily Data To June 24, 2020, U.S. Dollars/Barrel
Constant Price At C$36.99 Extrapolation To Aug 2020



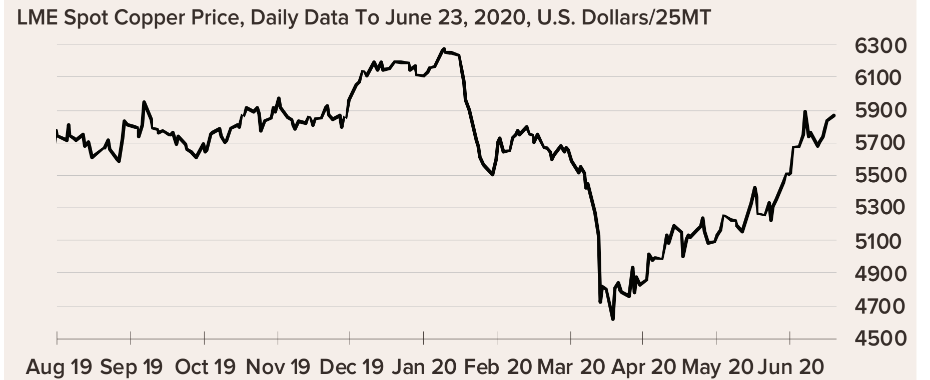
Industrial Commodity Prices Recovery As Lockdowns Ease

Raw materials costs crashed during the March/April global industrial lockdown. They have started to come back on recovery expectations, although although most are well below end-2019 highs. As we understand how the world works, it takes less stuff put into the world's industrial system to generate less output: So we think that once the scarring of the global economy is realized and assessed, commodity demand will falter again and prices will tumble again. This is bad news for commodity producers like Canada and Australia, as well as a large number of emerging economies that depend upon commodity export revenues to fuel growth and to fund the government.

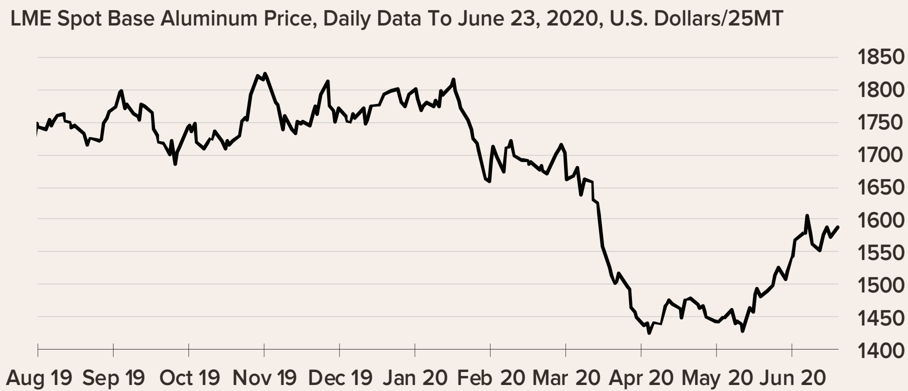
Industrial Metals Price Index Vs World Industrial Production



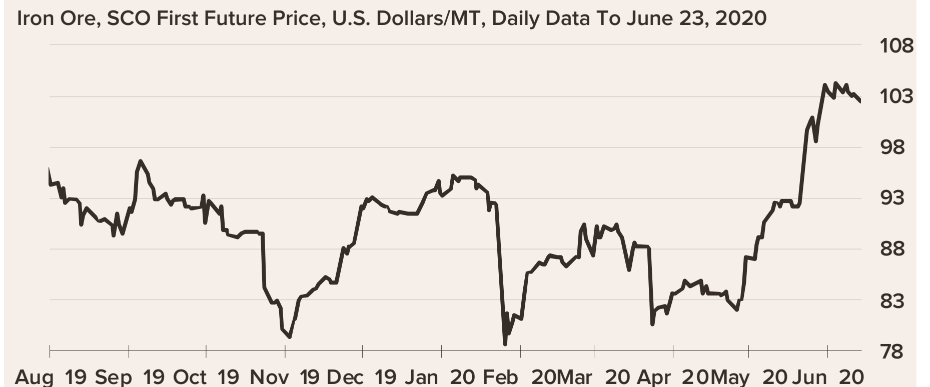
LME Cash Copper Price



LME Primary Aluminum Price



SCO Iron Ore Price



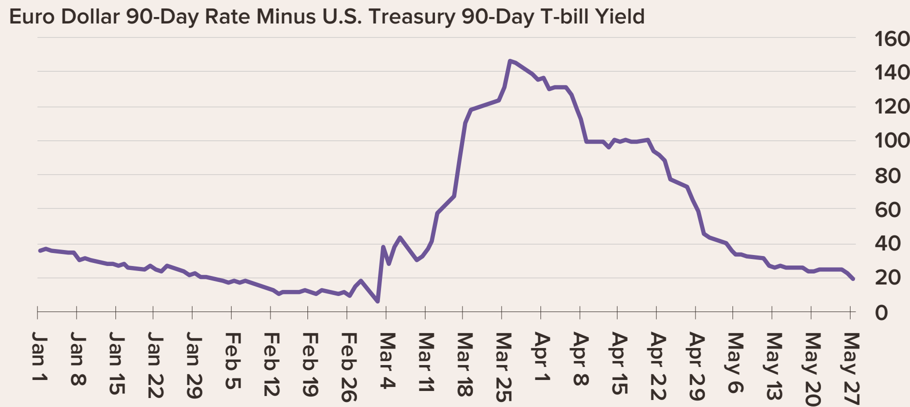
Key Takeaways... It's All About CCP

- **Coronavirus containment crashed the world's economies in March/April.** The baseline for recovery cannot be drawn until we see how much of the economy did not survive lockdowns.
- **Other important threats that pre-date CCP are world trade decline, negative interest rates and bond yields, oil prices too low to support existing industry, and excessively high inventories.** The world economy was vulnerable to external shock before CCP.
- **World trade** was contracting before CCP: The pulse of the global economy was failing.
- CCP has depressed industrial materials prices, that will fall again if recovery disappoints... as it might! Commodity producers—like Canada—will suffer, as will many emerging market economies.
- **Industry** was in recession in many economies at once before CCP. CCP turns what was a cyclical inventory downturn into a crash. Data show no sign a runup in stocks of unsold goods. *Uh, oh!*
- **Consumer spending** has contracted mightily in the face of rising unemployment caused by CCP. Inventory correction therefore will be slow.
- **Bond** yields, already below zero, still have room to fall with headline inflation and massive QE all at once... despite runaway fiscal deficits. Negative yields are unsustainable.
- **Bank lending** is the best antidote to CCP-induced recessions: Spreading losses over a manageable period is the only practical plan. Lending was too slow before CCP, in Europe and Japan especially. **Term lending facilities by central banks will boost lending substantially.**
- **Trade challenges** are off the agenda. **Windfalls from Phase One deal will not materialize.** Tariffs remain largely in place. Phase 2 talks are... not! Beijing will not support Trump re-election.
- **Inflation** is not a risk today. Energy prices will push down headline CPI this spring. Stagflation is HFE's forecast longer term as policy goes for monetization of aggressive fiscal stimulus.
- **All central banks are committed to historic stimulus for as long as it takes. Zero/negative interest rates, QE, term-lending schemes, lower capital requirements, will be in place for a year or more.** Monetizing sovereign debt is a trip down a slippery slope. **We do not believe in MMT!**

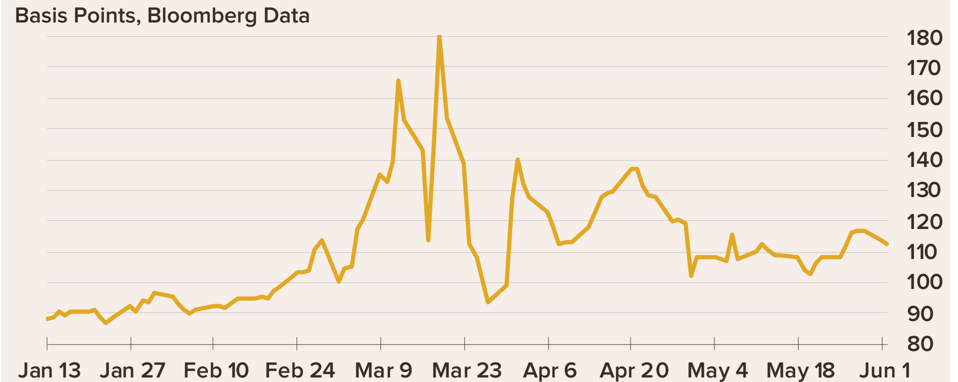
Financial Markets Are Only A Little Spooked About Financial Stability

Historically accurate measures of loss of confidence in the banking system strength are up, but not by a lot. The Treasury-eurodollar spread has widened substantially in the early days of the lockdowns, when financial markets were tumbling, as it has in past during sovereign debt crises and also in the global financial crisis. It is not nearly as wide now as in 2008-09, but it is slightly wider. Also, the premium on mortgage back securities over Treasuries has widened a bit, too. These metrics would warn that investors need greater compensation for taking on counterparty risk with banks… not a lot, but some.

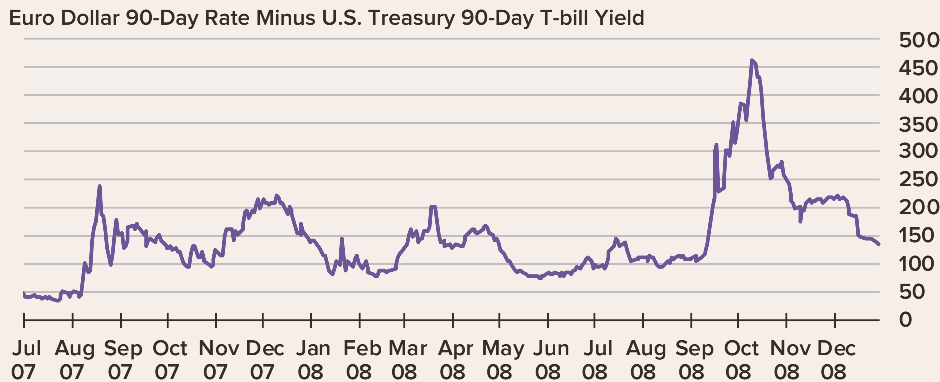
90-Day TED Spread Since January



MBS Vs 5-To-10 Year Blended Treasury Yields Since January

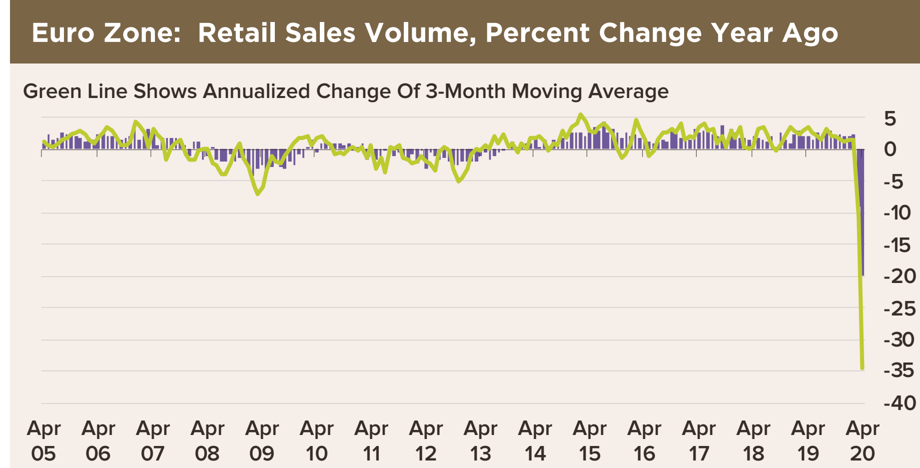


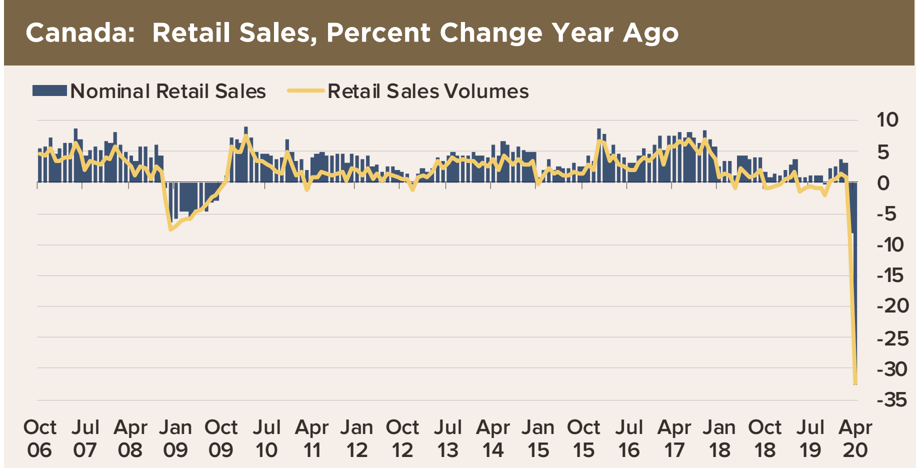
90-Day TED Spread During The Global Financial Crisis

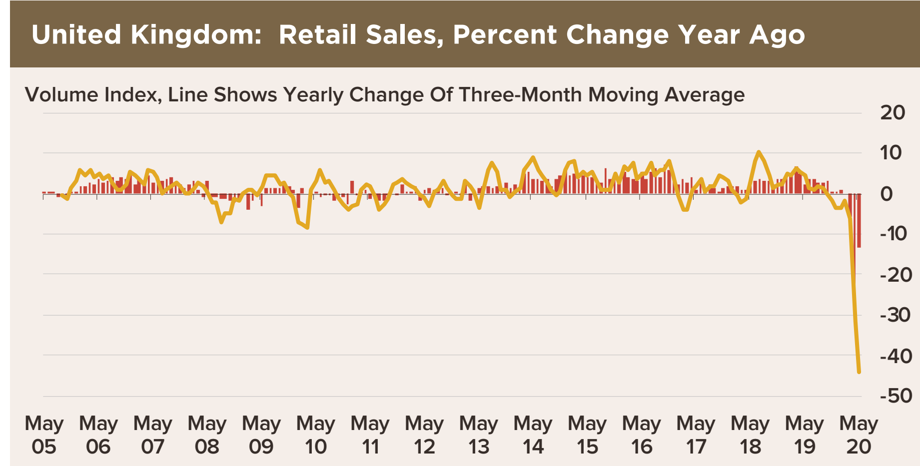


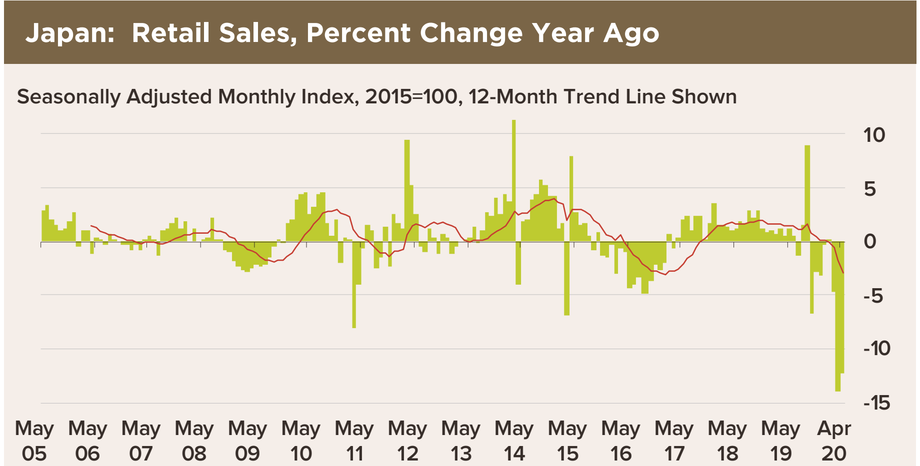
Consumer Spending... Not So Hot And Sure To Decay

Consumer spending was in the dumps before CCP. Now, the prospects for the next few months at least are awful. Payroll subsidies and short work schemes will soften the blow of CCP through Q3, but programs will expire in the fall and most governments do not have fiscal room to extend them. They are expensive! ***A fiscal cliff is looming into view! Uh, oh!***



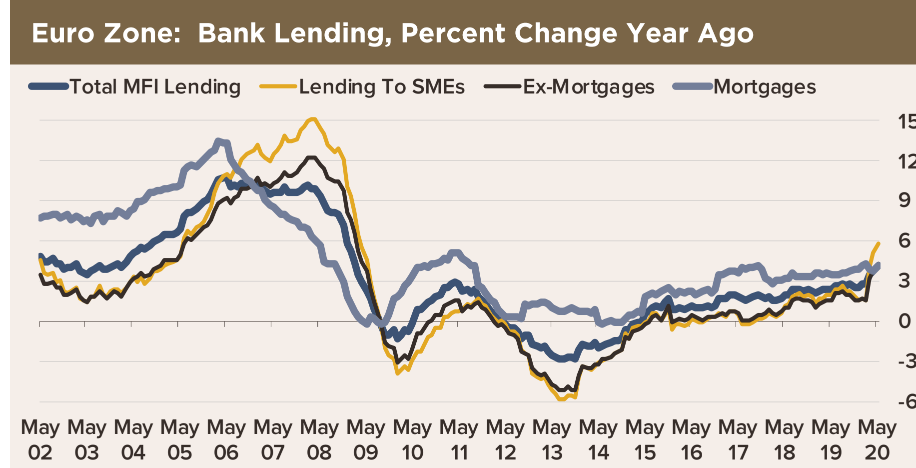


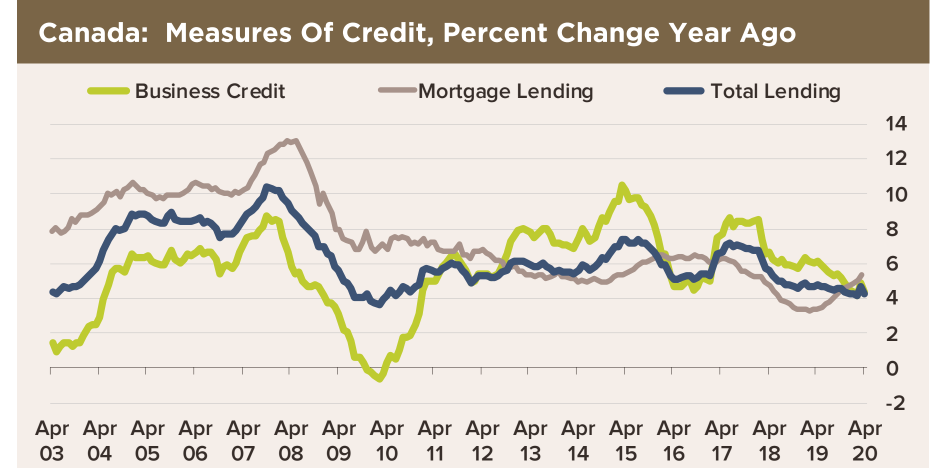


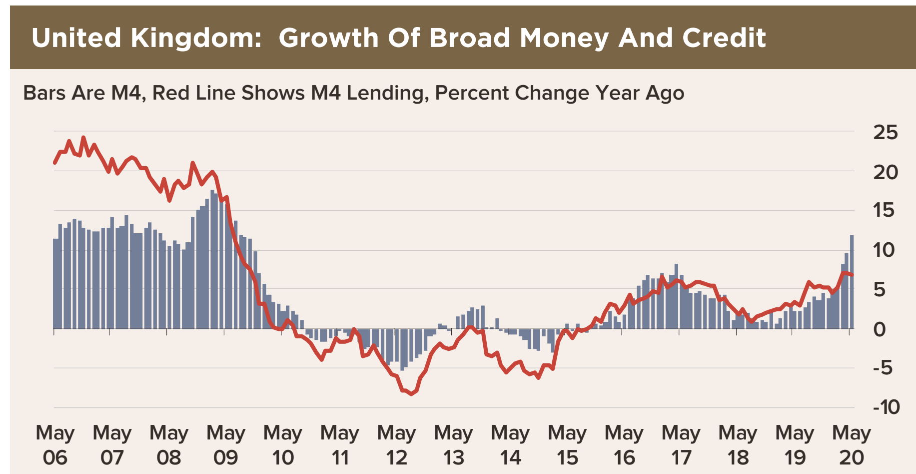


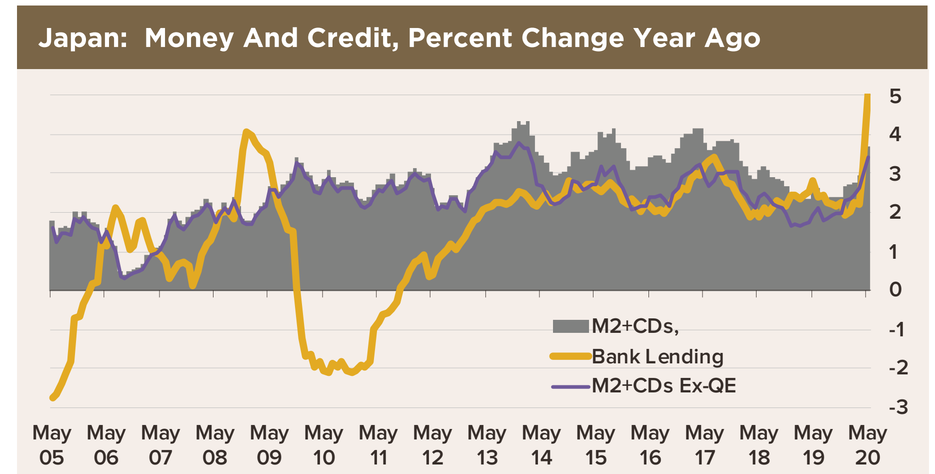
Bank Lending: Picking Up At Last As Central Banks Act

Growth of money and credit was too low to accommodate desired nominal GDP growth prior to Covid-19 stimulus measures, except in Canada. Credit had been slowing in most economies—even in Canada—at already unacceptably low rates of growth. That is all irrelevant now: Central bank measures to offset the impact of coronavirus containment will render all trends in monetary aggregates unrecognizeable for a considerable period. Hard core monetarists are wary of early evidence of explosive growth of bank deposits since CCP and economic stimulus was implemented. The outcome of that is TBD.



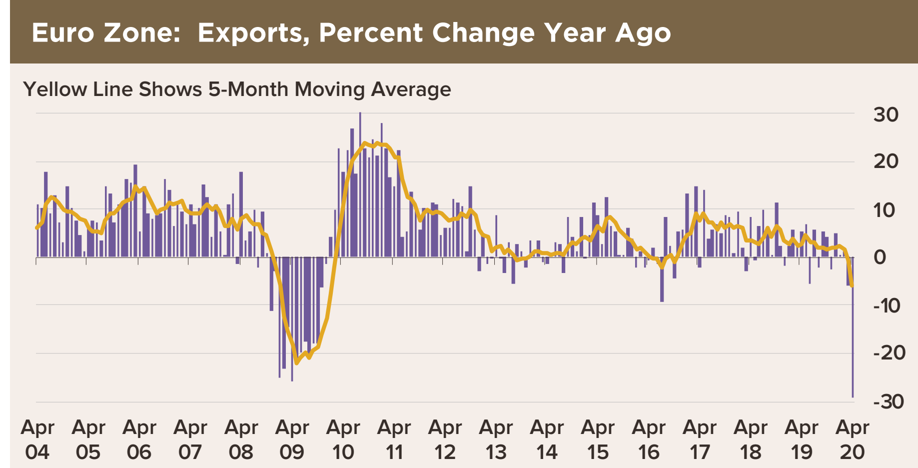


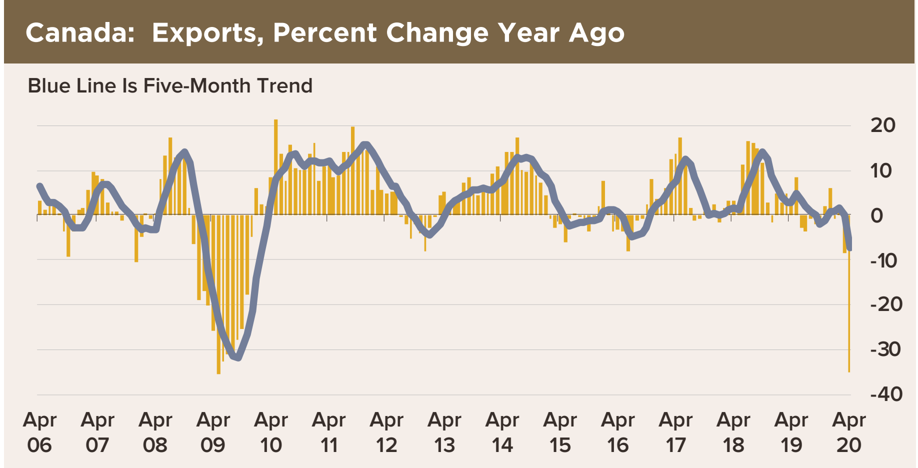


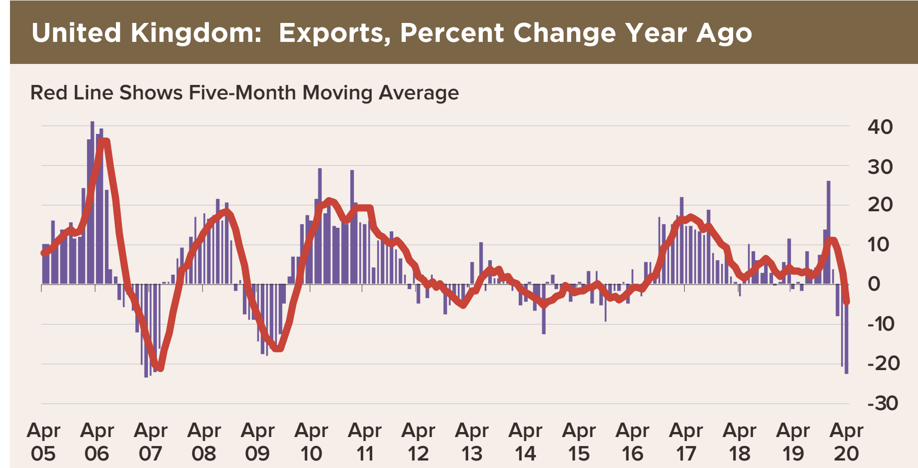


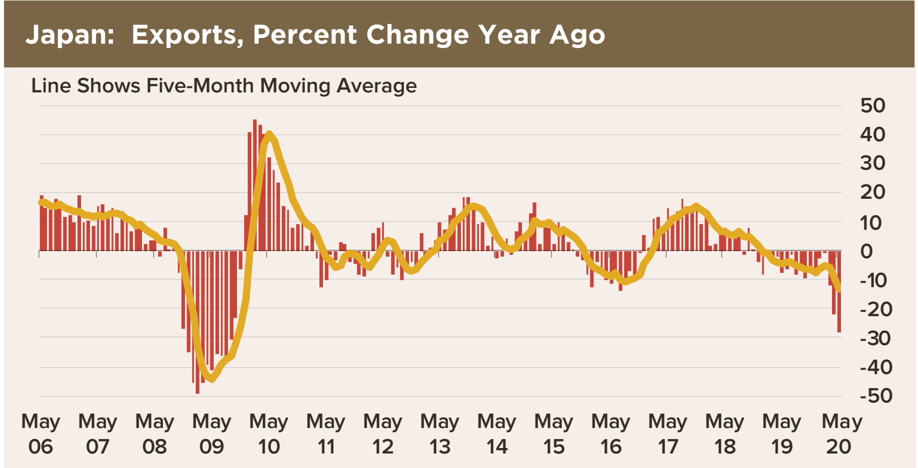
Exports Are Not Helping

The impact of the decline in global exports is evident in the national data. What we do know is that the global current account balance is zero. So when all countries try to stimulate demand with fiscal deficit spending, all efforts will fail: Higher government spending will simply **crowd out** either private consumption or investment.









For Every Country At All Times, Savings Equal Investment

$$(I_i - S_i) + (G_i - T_i) + (X_i - M_i) = 0$$

Always

Now Add Up The World

$$\sum(I_i - S_i) + \sum(G_i - T_i) + \sum(X_i - M_i) = 0$$

But, The World Current Account Balance Is Always Zero

$$\sum(X_i - M_i) = 0$$

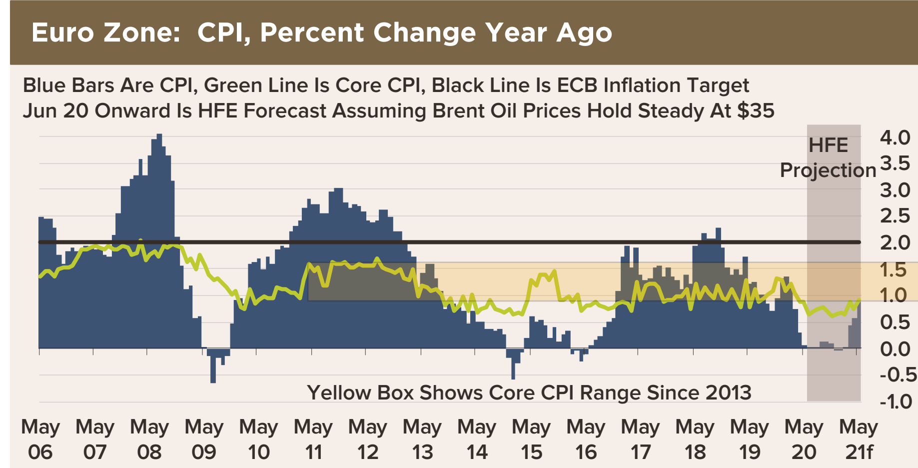
So Global Savings Investment Must Balance By Crowding Out I Unless S Rises

$$\sum(I_i - S_i) + \sum(G_i - T_i) = 0$$

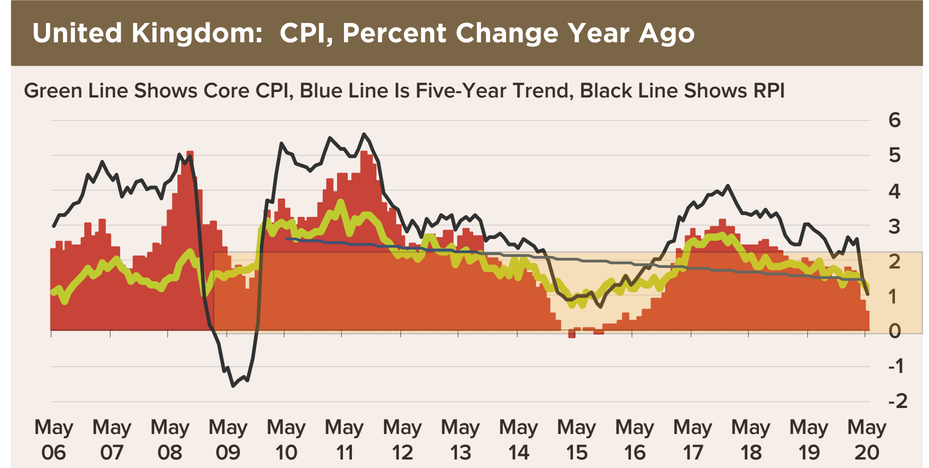
There Is No Inflation Risk... Yet

Oil price declines will deliver a drop in headline CPI metrics in the next few months. Specifically, headline inflation metrics will fall well below inflation metrics. Data point to a 15% drop in prices of gasoline at the pump in most countires: That will push headline CPI-based inflation metrics about 0.6% below core-CPI-based inflation metrics. **However, HFE forecasts supply shortages will start pushing prices up, and core CPI inflation metrics will rise with them.** Stagflation is the consequence of a leftward shift of the aggregate supply curve, especially if fiscal and monetary policies do succeed in supporting incomes.

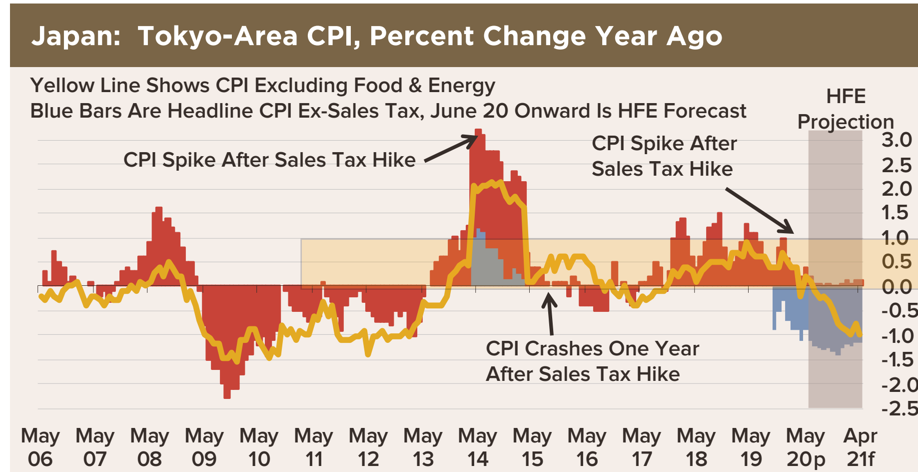
Euro Zone: CPI, Percent Change Year Ago



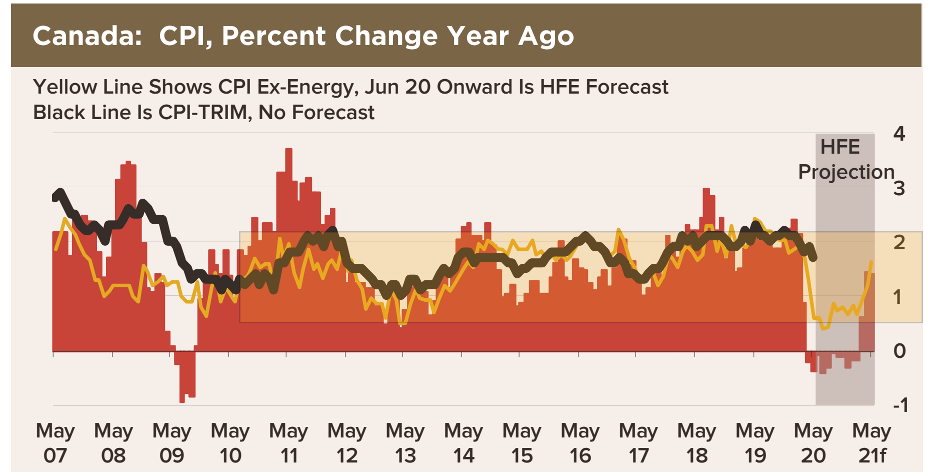
United Kingdom: CPI, Percent Change Year Ago



Japan: Tokyo-Area CPI, Percent Change Year Ago



Canada: CPI, Percent Change Year Ago



The Inventory Cycle Un-Masked

In many economies, excess inventories were building up before CCP. HFE believes an inventory cycle correction is at the root of the economic slowdowns and industrial recessions in most economies since early 2018. Demand is still growing but industrial output is down and employment growth has stalled. The pattern is clearest in Germany, Japan and Canada, but less so in Britain, where Brexit uncertainty is the key factor. Inventory cycles tend to be short and shallow, and they rarely lead to financial sector distress or crisis. However, the initial evidence is that the cut off of demand by CCP was more abrupt than the cuts in output. That means inventories may have exploded at the onset of CCP. Thus, recovery from CCP will be delayed and slow, because companies will not have to resume production to fill orders. They will satisfy demand initially from stockpiles of unsold goods.

Germany: IFO Inventory Index

Blue Line Is IFO Inventory Index To Jun 20 (Left Axis)
Green Line Is Production To Apr 20 (Inverted Scale, Right Axis, %chya)

Japan: Inventory To Sales Ratio

Seasonally Adjusted Monthly Index, 2010 = 100, Trend Line Since 2010 Shown

Canada: Manufacturing Inventories-To-Sales Ratio

12-Month Trend LIne shown

Euro Zone: Changes In Inventories

Billions Of Current Euros

Industrial Pollutants Levels Suggest Industry Is Still Depressed After Unlocking

China was the first country to lock down its economy to contain the coronavirus's spread. It is the first country to unlock its economy too. Reports are that China's recovery is progressing rapidly. However some indicators, like air pollution and air freight—are still low. Growth rates of industrial output have bounced back in official monthly data, and reports on auto output, electricity production and rail traffic are coming back to life. *Mainly free of the task of recovering from a coronavirus outbreak, China can continue its program of seeking to dominate the global economy unencumbered by competition from the G-7.*