August Economic Outlook, This Month a Focus on China

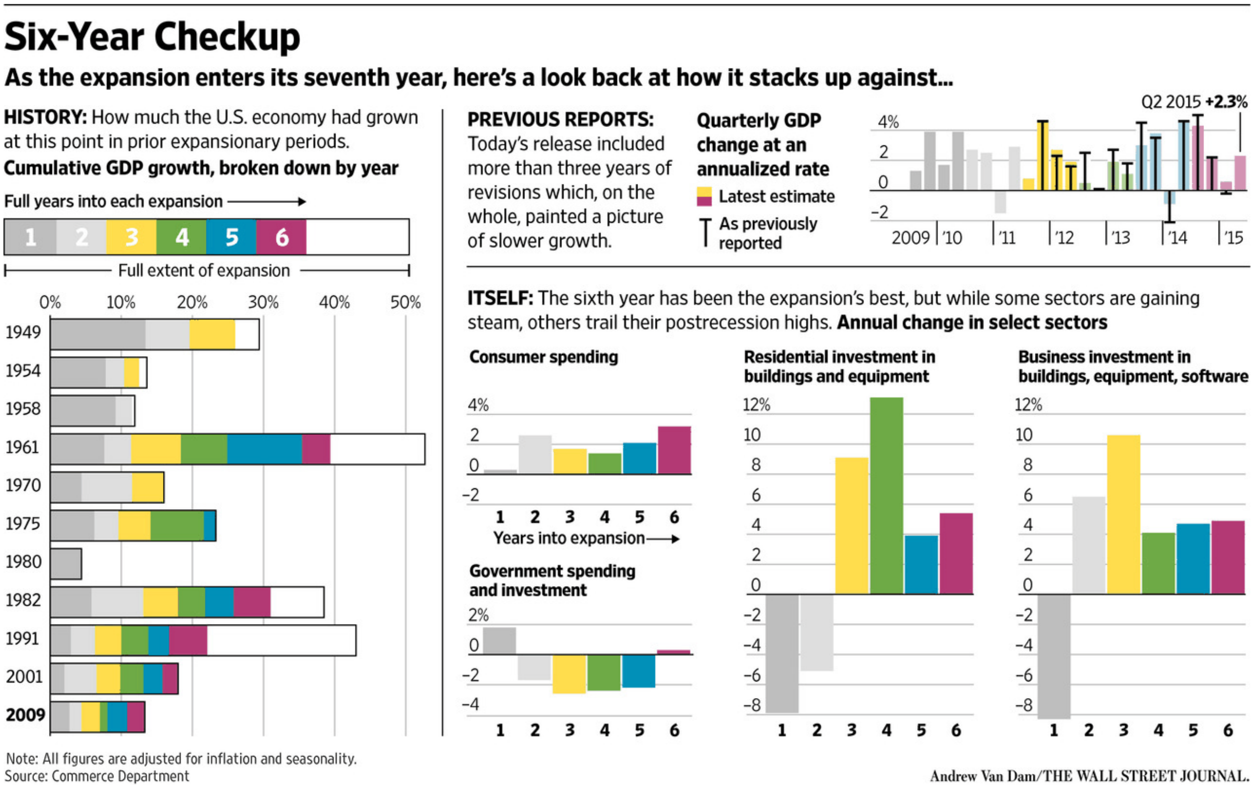
There are headwinds facing the U.S. economy: a strong dollar; the EU and Greece are still problems; China is slowing and their stock markets have turned bearish, and all the debt they issued the last few years will have to be addressed; the energy rich Middle East is dangerous and volatile; the Fed will probably raise rates soon, and this could cause dislocations in U.S. and global markets, especially in the bond markets (I will write about this in my August Market Outlook); an economy entering the seventh year of its recovery, longer than most.

This month I will do a brief update on the economy, and a review some of the risks from China.

Overall the economy is growing sub-par (as it has for much of this economic cycle), but is sustainable. Most of the risks to our economy and markets are external as listed above.

The Economy & GDP

Below is a very interesting chart that shows the trends for our economy, GDP compared to other economic cycles:



Here are some important points of the charts:

- There are 11 economic cycles post WWII, 5 cycles lasted about 6 years.
- The last 2 cycles' growth rates are smaller than most. The current cycle is one of the slowest.

The 1982 cycle benefitted from baby boomers starting families and the growth of consumer oriented stocks (Home Depot, Walmart, Nike…).

1991 cycle benefited from the digital and technology revolution (Intel, Microsoft, Cisco, Dell…)

The current cycle does not benefit from any major, domestic growth trends that can move the dial on a $18 trillion economy.

- The consumer has been the most consistent, and growth has not turned negative during this expansion.
- Government spending and investment was negative most of this expansion.
- Real estate and capital spending are typical of an expansion with strength at the beginning of a cycle, but cycles tend to lose momentum as they age. Both had substantial contractions the first years of the expansion; that is unusual.

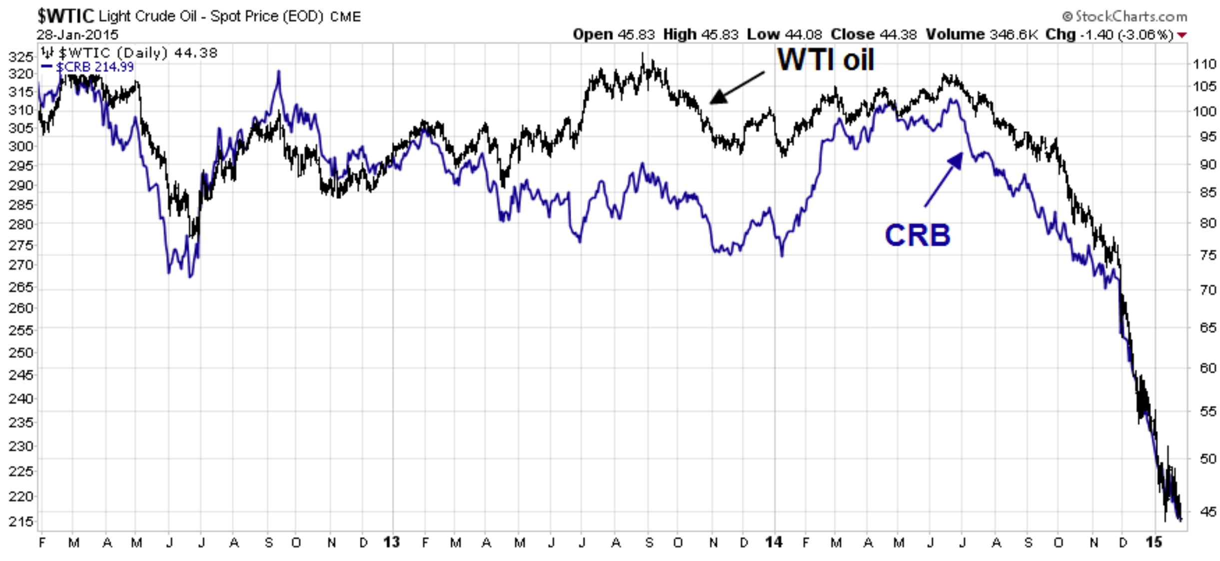
As listed in the first paragraph of this report, external factors are main risks to this economic and market cycle.

Most economists, analysts believe this low growth economy can continue to grow.

The Fed may raise rates in September or December and this may be disruptive to the global economy and markets.

CPI and the Fed

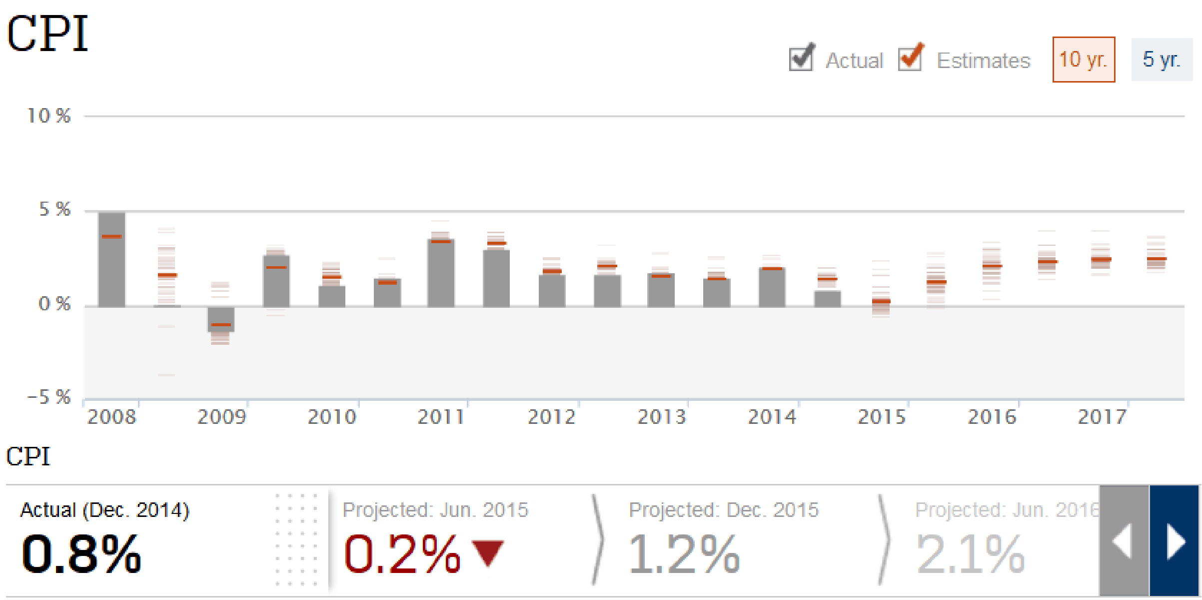
There is concerns among some investors, econmist about disinflation/deflation in the global economy. We are certainly seeing it in commodity prices, especially energy:



Source: StockCharts.com

The CRB, Commodity Research Bureau, is an index that tracks 19 commodities. Most commodity prices have been falling. This is helping keep inflation and interest rates low.

Here is the trend for inflation and inflation forecasts:



Low inflation is one reason why the Fed may be reluctant to raise rates.

The financial media, economists, and analysts are all providing their reasons why the Fed will raise or not raise interest rates this year.

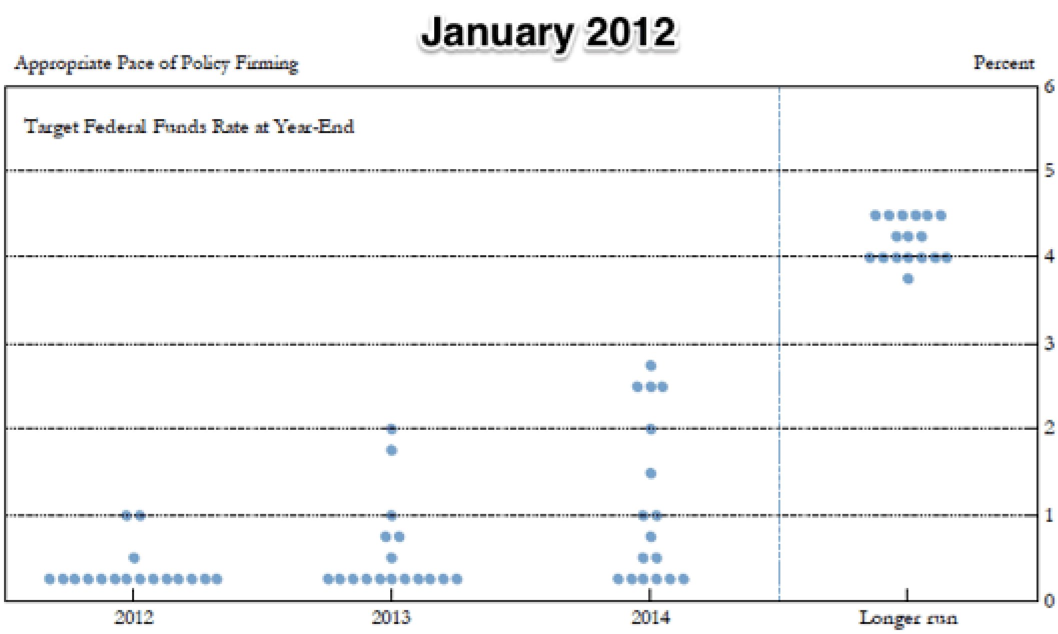
Below are the reasons given on why the Fed should raise rates next month, September:

- In past economic cycles, the Fed would raise rates to slow the economy and inflation, and inflation expectations. In this cycle the Fed would be raising rates to get rates back to normal levels. Normally rates would reflect at a minimum inflation. Right now the Fed funds rate is .25% and inflation has averaged about 1.8% in this cycle. Rates are artificially low, and are too low.
- Rates have been close to zero for too long, and the economy is probably strong enough to have a slight rise.
- The Fed needs to raise rates in September because December is too close to the holidays that has less liquidity.
- It would be more difficult to raise rates next year, an election year.
- Higher rates could help pension funds, and retirees. Savers that invest in fixed income investments, especially money market instruments including C.D.s. have suffered the most during this low interest rate environment.

Below are the reasons given on why the Fed should NOT raise rates this September or December:

- The rise in rates could be disruptive to markets, especially debt markets (I will write about this in my August Market Outlook).
- Inflation is too low.
- Job creation, and especially wage growth are not strong enough to raise rates.
- The U.S. economy is too fragile to raise rates.
- The dollar could rise more making U.S. goods and services globally less price competitive.

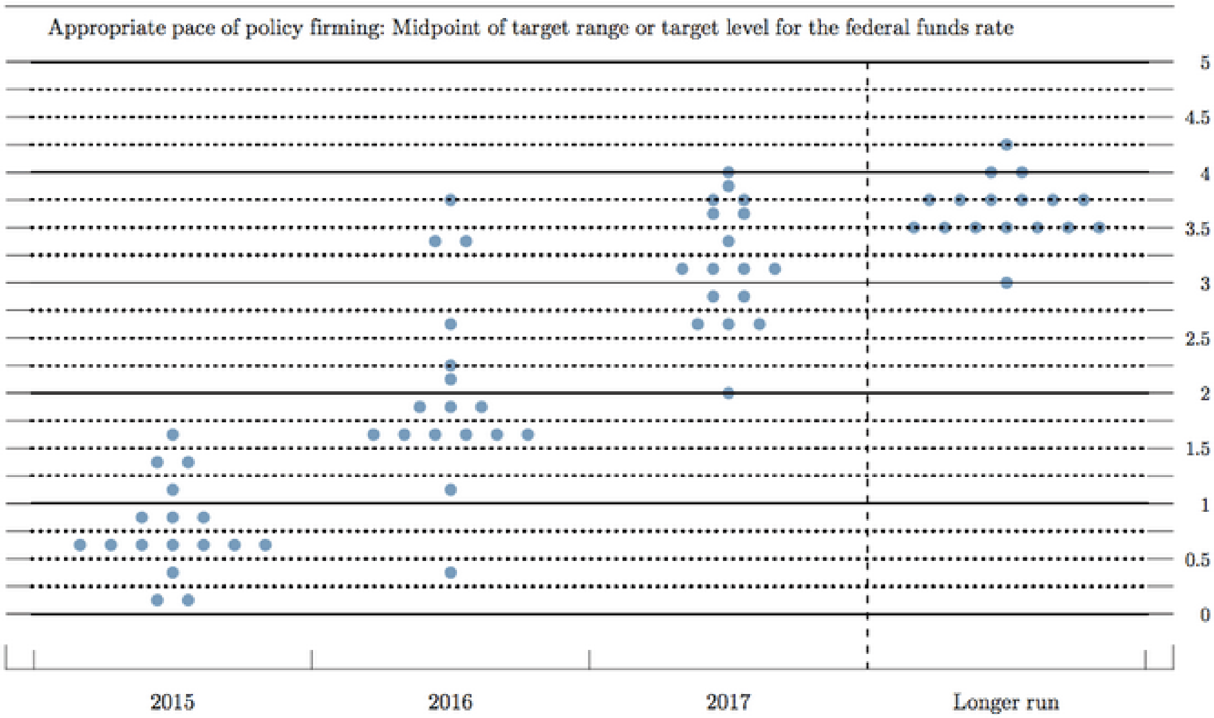
The Fed has been forecasting that they would raise rates for years and they keep pushing out its forecast. Below is a “dot plot” from a 2012 forecast:



Source: federalreserve.gov (Dan Hassey archives)

According to this 2012 “dot plot” rates were forecasted to start moving up in 2013, 2014. Of course, that has not happened.

Here is the latest “dot plot” from the Federal Reserve:



Source: federalreserve.gov

According to the latest “dot plot”, rates should start rising this year and will continue to rise the next few years. By 2017, Fed forecasts for the Fed funds rate would be between 2.5% to 4%, a normalization of rates.

China’s Economy & Stock Markets

China has many economic problems that could lead to problems for the global economy and markets.

Below is the trend for China’s growth:

China's growth has been slowing. Many analysts are forecasting China's growth to fall below 7% in 2015.

Notice that actual growth beat targets.

One of the reasons for the slower growth is the law of large numbers. It's difficult to grow a $10 trillion economy at 10% or even 7%.

China is now the 2nd largest economy in the world with the largest population. Below are a few economic metrics for China:

GDP

$10.3 Billion

GDP by sector

Agriculture: 9.2%   Industry: 42.6%   Services 48.2%

Per Capita Income

$8,211

Foreign Reserves

$3.73 Trillion

Population

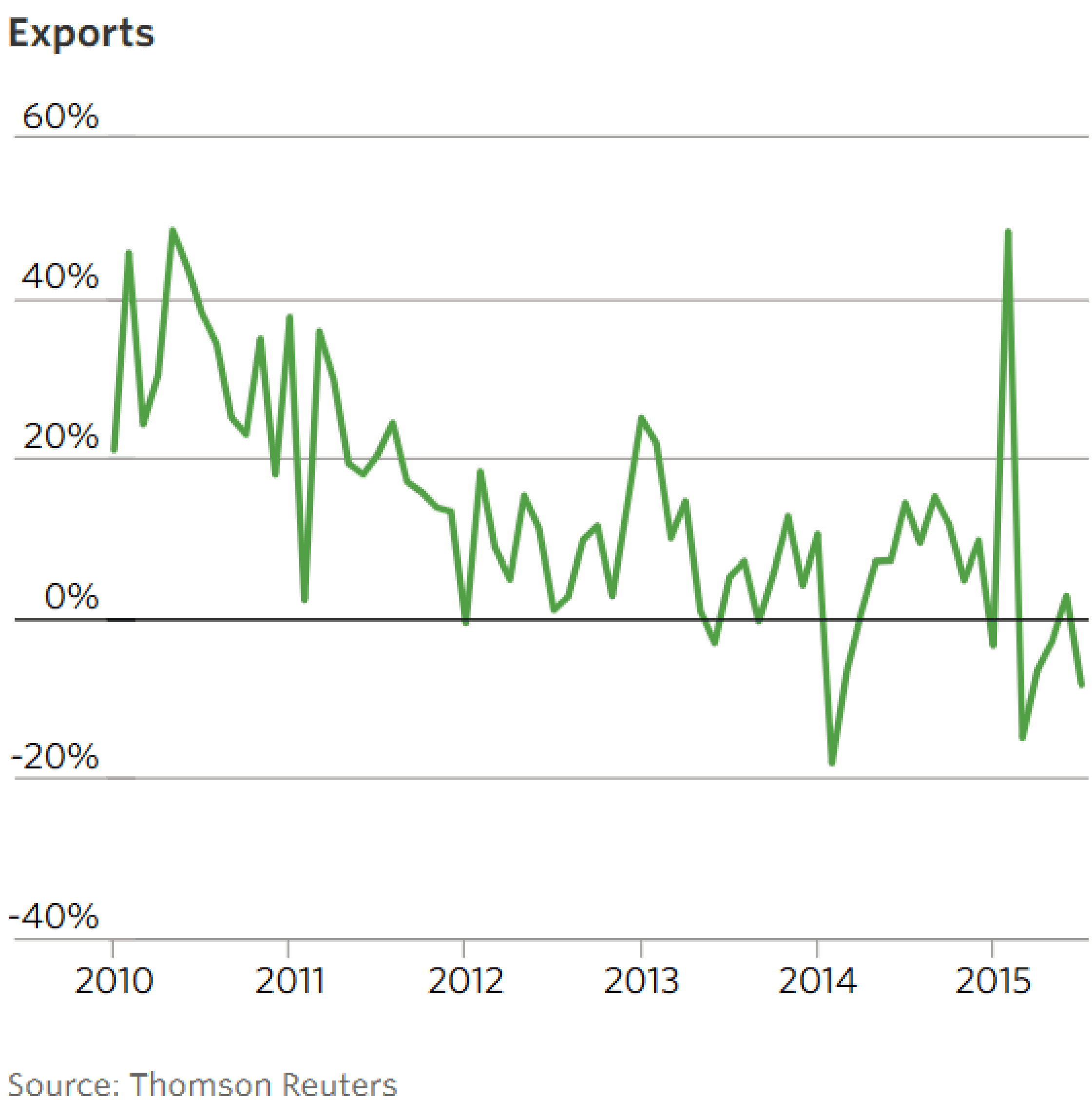
1.35 billion

Exports Falling

One of China's main concerns is growing its economy at a fast enough pace to provide jobs, food, energy and a higher standard of living for its 1.35 billion citizens. The Chinese government, leaders are always concerned about keeping social harmony, and avoiding social unrest.

Over the last few decades, China became a global manufacturing giant. China now wants to shift from being export, manufacturing driven to a consumer driven economy like the U.S. and Japan. Any transition does cause uncertainty, and we are certainly seeing that.

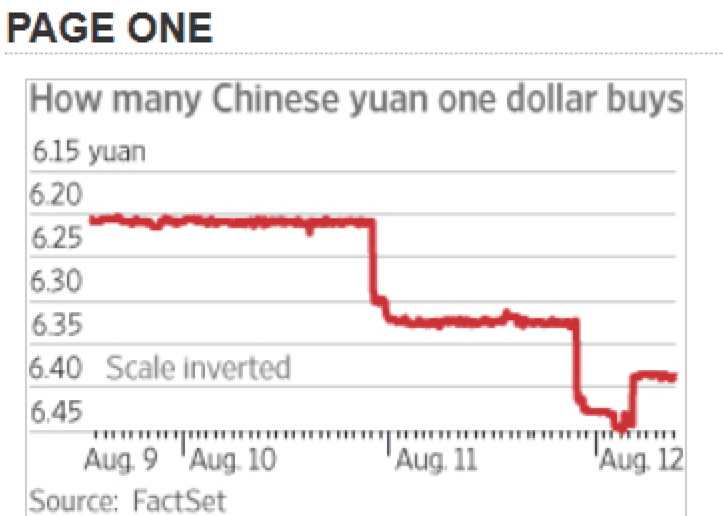
The chart below shows how exports have slowed substantially over the last few years:



Slowing exports is impacting overall Chinese growth. It will take time to shift to a more consumer oriented economy.

China's central bank allowed its currency to fall in the last few days. According to the Chinese central bank the reason was to allow its currency to be more market oriented. Most analysts believe it is to help their slowing economy, especially exports. We can see by the export chart above, their lower currency is more about helping their economy versus letting the market value its currency.

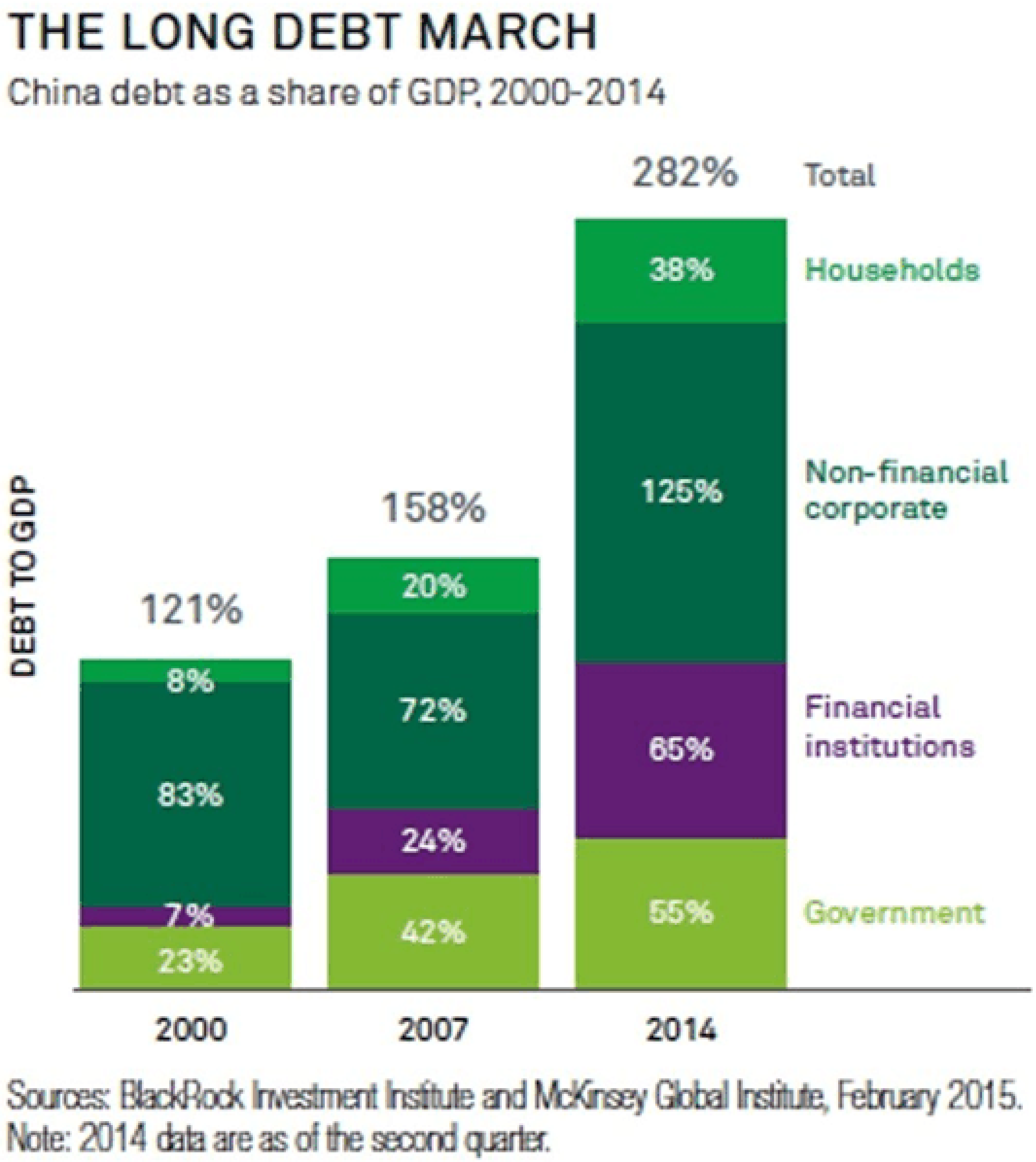
The change in China's currency versus the U.S. dollar, so far is small:



Even though the change in the currency has been small, the impact on global markets has been larger.

Debt

Another problem that the Chinese economy faces is their growing debt. China's debt has ballooned to about $21 trillion. The chart below shows the growth of the debt as a percentage of GDP:



China's debt to GDP has grown from around 121% to about 282%. Financial institutional debt grew the most, from about 7% of GDP to about 65%. The government's debt grew from around 23% to 55% of GDP.

Some of the debt was issued to help China through the global financial crisis of 2008. Because much of China's economy is centrally planned, capital allocation decisions are many times made for political reasons. Also, too much money went into real estate.

Many recessions are made worse, including for the U.S., by bad capital allocation decisions and too much debt. If China goes into a recession, it could be made worse because of their huge debts by all sectors of the economy, and the bad capital allocation decisions.

Another problem that China has is transparency and credibility. Many analysts and economists don't believe some of the economic data that comes out of China. If trust is an issue, it will be hard to attract capital.

There are economists, analysts, services that study the Chinese economy beyond official government data. One such service looks at data from Chinese manufacturers, retailers, construction firms to provide another view. According to this service, although the Chinese economy is slowing, it's in better shape than what most people believe. He sees, sales volume up, retail sales are doing better, and capital spending has stopped falling. Real estate continues to be a problem.

China's Stock Markets

China's Shanghai and Shenzhen exchanges have entered into bear markets. Originally the Chinese government had been encouraging its citizens to buy stocks and to use margin. The market became very speculative fueled by margin. As what normally happens in speculative markets just as fast as a market goes up, it will go down much more quickly as fear is much more powerful than greed.

China's stock market crash has lost about $3trillion in market value.

The Chinese government has been intervening into its markets to try and stabilize its markets. The intervention is shocking to free market advocates.

Last month Ray Dalio, founder of the largest hedge fund in the world, wrote to his investors that China's stock market volatility are "negative for growth" and if the stock market crash gets worse, it could tank China's growth for years.

We will keep an eye on the Chinese economy and markets.