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The Trump effect?

A special report on the US economy

- Recessionary signals from the US have strengthened during the fall, but Trump's victory has given a strong boost to markets.
- The US economy has room to grow, but the recent rise in the interest rates may not have been correctly interpreted.
- Increasing market failures are signaling possible worries ahead.
- The risk of a financial crisis remains high and political uncertainty in Europe has increased.
- We forecast that the US economy will grow around 1.9 percent, the economy of Eurozone will grow around 1.7 percent and the economy of Finland will grow around 1.8 percent next year.

As we noted in September (see Q-review 3/2016) several signals indicate that the peak of the global upturn that started in 2009 has been passed. Many indicators actually state that we should be heading to a recession. However, it seems that there is a monumental shift in the perceptions of consumers and businesses after the surprising victory of Donald Trump in the US presidential election. In this special report, we analyze the state of the US economy and shed light on the future prospects of the most globally important economy.

The downturn of the investments of the nonfinancial corporate sector (see Figure 1 in the appendix) are probably the most ominous sign of impending recession. Is there a change that this slowing trend would turn after Trumps victory? There is actually room for corporations to reverse the declining trend in capital formation. The indebtedness of corporations is still clearly below the peak of 169 % of GDP reached in summer of 2008 (see Figure 2 in the appendix). That said, total financial assets and thus leverage among the corporate sector are growing at a relentless pace (see Figure 3). Leverage among both investment grade and non-investment grade (junk) companies has grown beyond the levels reached just before the crash of 2008.

Looking somewhat deeper shows that the US economy is sending some very contradictory signals. Orders of core durable goods have contracted for 22 months and the US industrial production has contracted for 15 months – both longest streaks of decline in non-recessionary environment ever. Traffic at the US restaurants has fallen for the first time for five years. Delinquencies in the auto loan market, a market roughly similar size as the subprime mortgage market before 2008, has reached the highest level since 2009. Still, consumer confidence is at its highest level since July 2007.

One of the reasons for cheer has been a rather dramatic change in the bond markets, namely the increasing interest rates. Since the summer, but especially since the Trump's victory, the yields of bonds have been on continuous rise. There are practically two possible explanations for the large shift happening in the bond markets. It is either a sign

1. that higher inflation and growth are returning, or
2. that QE and other central bank policies are ending.

The outcome of the first option is clear. Although the rates are rising, inflation and growth will start to ease the debt burden of governments, consumers and businesses. This will restart the somewhat declerating US economy and the global economy.

But, what if the bond carnage is not because of impending faster growth and inflation? The fall in bond values started already in the summer and only accelerated after Trump's victory. The Bank of Japan practically announced in September that QE is not working anymore by setting a 'yield curve control mechanism' where QE will continue to operate only if rates are above a certain threshold. ECB also announced that it will start 'taper', that is to vein down the QE program early next year and the UK government has critised the policies of the Bank of England. We have been warning for the central bank induced distortions in the markets (see, e.g. Q-reviews June 2014 and March 2016). If this is a start to the normalization in the prices of bonds, there will be cataclysmic shifts ahead in the markets, which will be likely to lead to similar losses as from the securitized products (*credit default obligations*, etc.) during the crisis of 2007 – 2008. This time the biggest threat could lurk in the derivatives market. Derivatives were created to act like insurances against certain (foreseen or unforeseen) events. But they can also be used as bets against or for some market movements. Some reports indicate that a large chunk of the derivatives market was used to make bets on currencies and interest rates. If large upward movements in the interest rates prove to be permanent, some players will make big losses in the derivatives market.

Still, the real threat to the US economy may lie in the corporate bond market. The so called junk-bond market has seen some sharp decreases in issuance not seen since 2008. This could be the *canary in the gold mine* for the US economy. The fragility of the financial markets has also increased massively within the last year or so. There have been reports of sharp increase in failures in the repo (repurchase agreement) market. This is probably due to lack of high-grade collateral and drying up of liquidity due to QE programs, tightening the regulation of the financial markets and increasing risk-aversion among high frequency traders. If interest rates continue to rise in this environment, the non-investment grade market, worth over a trillion dollars, could freeze, which would be likely to start a fire sale of bonds also in investment grade bond markets. This would produce an almost immediate moratorium in business investment and a serious correction in the stock market. It should also be noted that if there would be a serious correction or fall in the stock market, it could easily collapse the consumer confidence, which has been the driver of GDP growth in the US for over a year. Rising interest rates are also likely to hit consumers although there is quite a lot of room for rates to rise the reach the historical norm of debt service payments (see Figure 4).

To summarize the situation in the US economy, the investing activity is not sufficient, but there is also no clear sign of recession which seems to be held back by large scale demand for financial assets, like stocks and corporate bonds. Increasing failures in the repo market do, however, give a reason to worry. Rising interest rates will affect the interest payments of the consumer, corporate and government loans. Its effects will become visible during the winter.

The situation in Eurozone has gone from hairy to surreal. The ECB effectively announced a tapering of the QE program and for a good reason. Central banks can own only a fraction of a capital market without a risk of a market failure. Owning stocks would also be problematic as it would make ECB *de facto* owner of private corporations.

After the Brexit vote, the response of the European political elite has been to continue as nothing major had happened. After Renzi's resignation, the response was even more muted. We think that there is a serious misconception of the dangers lurking behind these developments. The history of monetary and political unions clearly shows that their demise has tended to be abrupt, violent and often driven by public discontent on politics and on the economic demise. The European project has "dodged the bullet" several times during the past five years by bending or twisting the articles of EU treaties and through the capitulation of national leaders under the authority of the EU leaders. This policy has its limits. Building a federal state without the consent of majority of its citizens bears a risk of serious political backlash. Currently, it is practically impossible to forecast the future developments in Europe, but we will return to them in the first Q-review next year. Our estimate for the probability of a large political crisis in Europe has risen to 45 % for the next 12 months.

The global financial system is currently facing four threats. First of these is the one we have been warning about for several years, namely the European banking sector. Although the problems of the Deutsche Bank have eased somewhat, the European banking sector is still teetering on the edge of a crash as it has been since the European debt crisis erupted in the Spring of 2010. At the end of last year, nonperforming loans were at staggering levels in many countries of the Eurozone. In Italy, the percentage of nonperforming loans to gross loans was around 18 percent. The relationship was around 35 percent in Greece and 45.6 percent in Cyprus. Valuations of the European banking stocks have improved from their lows reached late last summer, but recent improvements reflect more the Trump rally than actual improvements in the business conditions. Rising interest rates will help the profitability of banks, but the falling value of government bonds is likely to diminish their capital buffers increasing the likelihood of insolvency.

The second threat is a combination of the rising value of the dollar, the increasing regulation and risk aversion among the big banks. In short, the threat arises from diminishing global dollar liquidity. It is estimated that the value of off-shore dollar debt is more than $10 trillion and tightening (dollar denominated) financial conditions can make it harder for banks to roll-over their dollar denominated debt. This could become a problem especially for banks that are already in bad shape, like banks in emerging economies. If roll-overs fail, it can lead to bank insolvencies in developing countries.

Third threat is China. After the crash of 2008, China has been fueling a massive credit bubble. It is estimated that the leverage ratio of Chinese economy, measured by debt held by the government, corporations and households, is closing 300 % of GDP. This is the highest figure in any emerging economy. China's credit-to-GDP gap, defined as the credit-to-GDP ratio and its long-run trend published by the BIS (Bank of International Settlement), stands at 29 %, which is one of the highest numbers ever recorded. So, there are reasons to worry. Chinese banks and officials are trying to abate the problem by transforming non-performing loans to "securitized assets" in a similar fashion as mortgages were transformed in the US before the crash of 2008. It may temporarily ease the problem, but only with the expense of even larger problems in the future if the loan portfolios keep deteriorating. Despite these obvious problems, it is hard to anticipate whether there will be a financial crash similar as in Japan in the 1980s or not, because China is a centrally controlled economic system and has large reserves. One thing is clear though. China cannot keep growing by increasing debt indefinitely. The Stein's law: *if something cannot go on forever, it will eventually stop*, applies also to China. There is a fair change of so called 'hard landing', where GDP growth will fall close to zero or even below, but there might also be just a prolonged period of sluggish growth. Still, if the risk of a hard landing realizes, it sends shock waves through the global financial fabric.

Fourth threat, although unlikely, is the most serious one: bursting of the 'central bankers' bubble'. This would pose a serious risk of a systemic crisis, where the basic functions of the society start to shut down, because it would mean that markets have lost their faith in the central banks. This would result in a chaotic rebalancing in the markets, which would occur through market-crippling falls in the value of several assets classes. Panic would take hold and the global financial system would freeze over. This would cripple modern societies.

We estimate that the likelihood of a new financial crash is 55 % for the next 12 months. We briefly increased it to 60 % in the wake of crisis of Deutsche Bank, but it has since subdued a bit. Still, risk remains high.

In Table 1, we present the *nowcasts* and the growth forecasts for the real GDP of the Eurozone, Finland, and the United States under a consensus scenario.

Table 1. *Nowcasts* (nc) and forecasts for the growth rate of real GDP in the US, Eurozone and Finland. Source: OECD, Bureau of Statistics and GnS Economics.

Quarter	Finland	Eurozone	USA
2016:1	0.82	0.50	0.21
2016:2	-0.15	0.31	0.35
2016:3	0.39	0.35	0.78
2016:4 (nc)	0.76	0.52	0.55
2016	1.8	1.7	1.9
2017	1.3	1.0	2.0
2018	1.9	1.4	2.3

Our forecasts tell a positive story. We forecast that the US economy will grow around 1.9 percent this yeas, 2 percent the next year and 2.3 percent in 2018. Eurozone will grow around 1.7 percent this year and 1 and 1.4 percents in the following years. Finnish economy would grow 1.8 percent this year and 1.3 percent in 2017 and 1.9 percent in 2018.

So, what are the prospect of the US and the global economy in the near future? In all honesty, we do not know. Forecasts are very positive, but the underlying market fundamentals are giving some mixed signals. There is some revived hope especially for the economies of Eurozone, but it all depends on the developments in the US and, in many practical matters, also in China. The 'Trump effect' has been very positive for the markets, but its effect on the real economy is not yet known. If real economic benefits fail to materialize, markets have been overvaluing the future. This runs a risk of serious correction.

It seems that the US consumers are they key. If their confidence remains high or even grows, there may be even a upturn in business investment. Policies of Trump may also contribute to this. If confidence wanes because of, e.g., increasing debt servicing costs, recession will not be short to follow. The problems in the financial markets are worrying and they are likely to get bigger if interest rates keep on rising. The stress and failures in the repo market are a symptom of some form dysfunctionality and distrust. Developments in the financial markets thus need to be followed closely. It has also been a turbulent political year. Next year can also hold some political shocks especially in Europe. But the outcomes of elections, as we have seen, are very hard to predict.

The biggest risk going forward is still the bursting of the 'central bankers' bubble'. There are some signs that it might be starting to unravel as we speak, but anticipating the bursting of asset bubbles is notoriously difficult. Central banks will also be likely to do anything to stop it from happening (helicopter drops of money, cash bans, etc.). However, if it were come to be, we would expect massive corrections in basically all assets classes and failures in several markets occurring within a period of few days/weeks. They would ignite a global financial crisis within a period of few months or even faster, which would run a high risk of a complete failure of the European and global financial system. The response of the authorities would probably be both panicky and excessive. The crisis would differ from the previous ones, because the solvency of the central banks would become under question. Some level of civil unrest would be almost certain. Although the risk of such a scenario is still relatively small, it is considerably higher than zero (we will consider the probability of a systemic event in the next Q-review). Thus, "hold and see" policy on investing and business is the best course of action for now.

Appendix

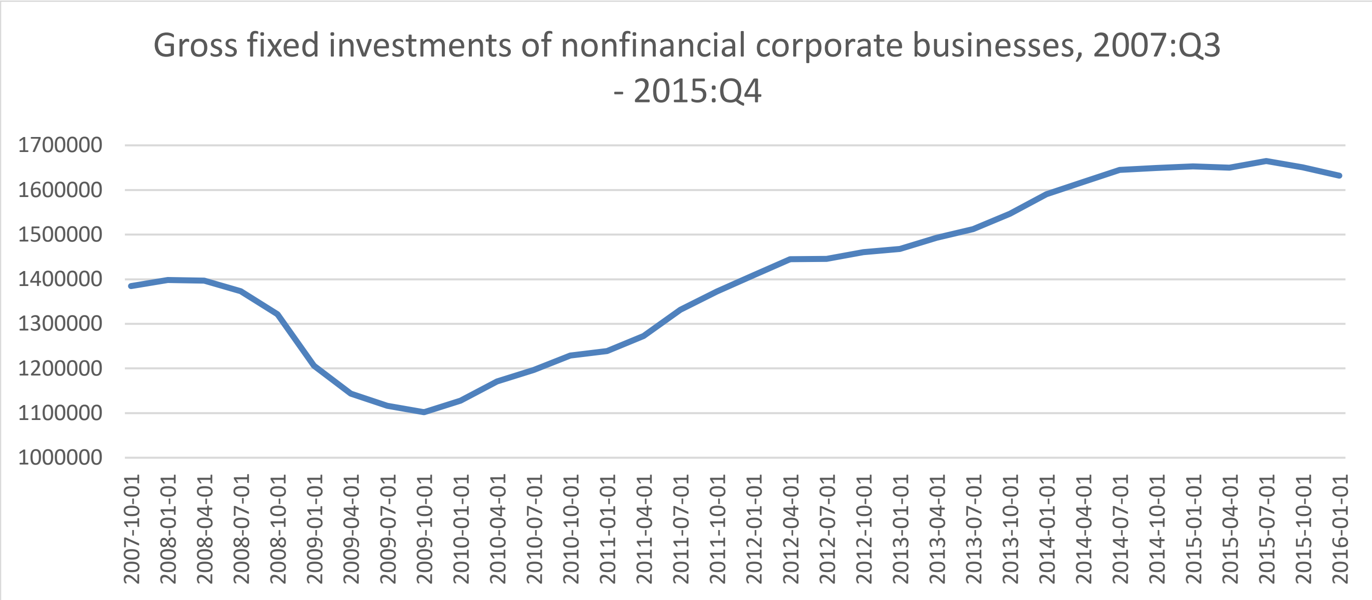

Figure 1. Quarterly nonfinancial corporate business; gross fixed capital formation in millions of dollars. Source: Federal Reserve Bank of St. Louis.

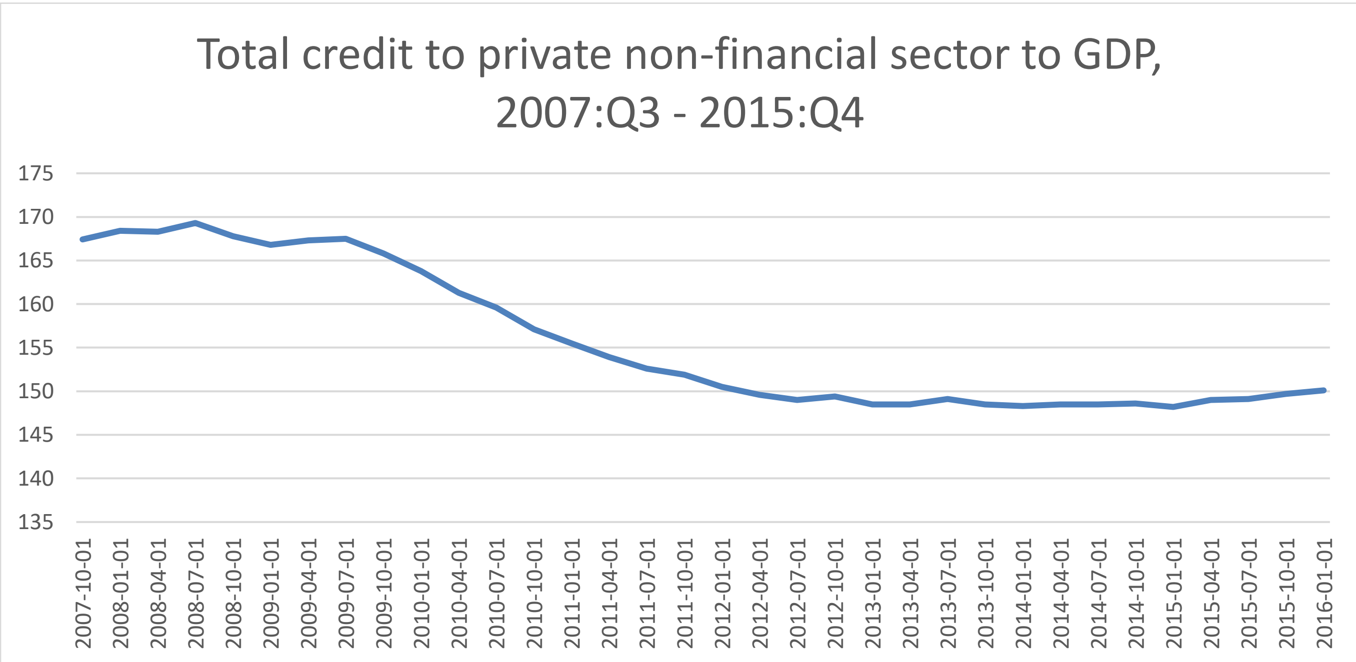

Figure 2. Total Credit to Private Non-Financial Sector for United States, Percentage of GDP, Quarterly. Source: Federal Reserve Bank of St. Louis

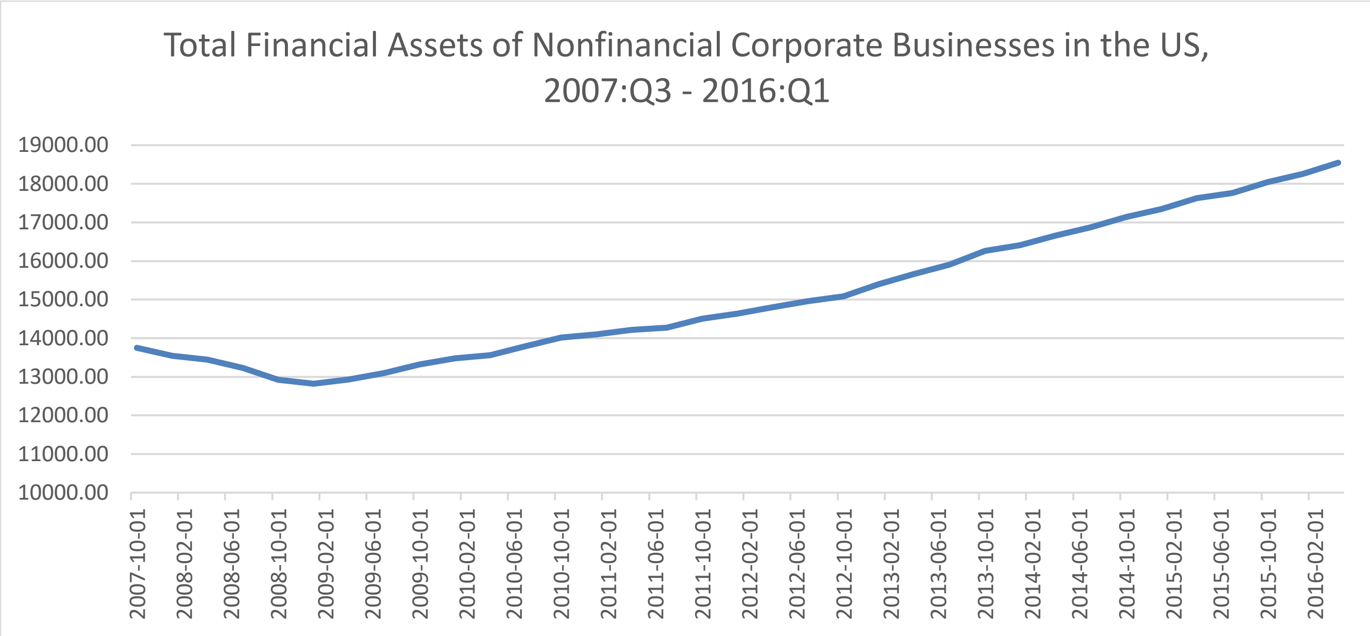

Figure 3. Nonfinancial corporate business; debt securities; liability, millions of dollars, quarterly. Source: Federal Reserve Bank of St. Louis

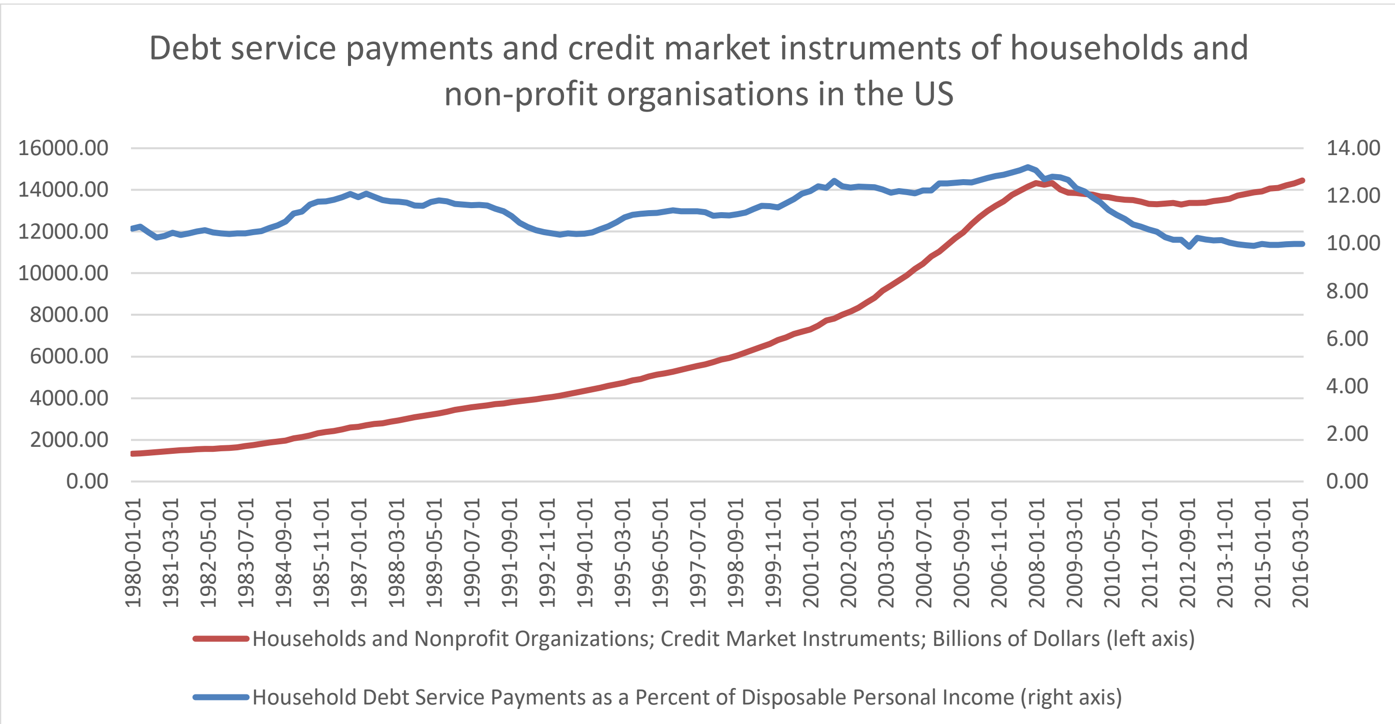

Figure 4. Household debt service payments as a percent of disposable personal income (right axis) and households and nonprofit organizations credit market instruments in billions of dollars (left axis). Source: Federal Reserve Bank of St. Louis

Process descriptions

The forecasts reported in this Q-review are based on the statistical modeling methods from the most recent academic research on predicting business cycle fluctuations. Nowcasts refer to the forecasts of the growth rates of the real Gross Domestic Product (GDP) for the current quarter. Nowcasts are needed because the standard measures for the GDP are published after a considerable lag and are typically subject to subsequent revisions, indicating that the coincident state of the economy is always uncertain. Our nowcasts for the current quarter are based on statistical models where all relevant information available at the time of nowcasting is utilized.

The GDP forecasts for longer horizons (over the current quarter) are based on the dynamic forecasting models where forecasts are constructed iteratively. This means, for example, that the three-quarter forecast is essentially based on the two-quarter forecasts and so on. Forecasts are constructed for all three economic areas (the Eurozone, Finland and the US) indicating that they depend on each other. Finally, note that the forecast scenarios considered in this Q-review are based on the expert view of GnS Economics.

The next Q-review will be published in March 2017.

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