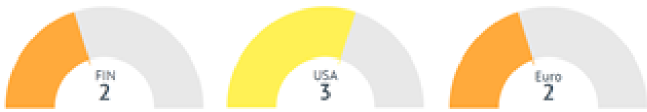
DEPRCON OUTLOOK 01/24/2020

Forecasts	USA	Eurozone	Finland
2019 Q1	0.77	0.43	0.29
2019 Q2	0.50	0.19	0.82
2019 Q3	0.48	0.22	0.50
2019 Q4 (nc)	0.67	0.22	0.14
2019	2.4	1.0	1.8
2020 Q1	0.6	0.2	0.4
2020 Q2	0.2	-0.2	-0.3
2020 Q3	-0.1	-0.5	-1.0
2020 Q4	-0.6	-1.4	-2.2

DEPRCON-INDEXES



OUTLOOK OF THE WORLD ECONOMY

Forecasts: Our growth forecasts have improved somewhat since our December outlook. The reason for this are the massive stimulus efforts launched by the Fed, the ECB, and China. They have delayed our estimate of the onset of a recession to Q3 in the US and Q2 in the Eurozone. It should be noted that if China maintains its massive stimulus program, the onset of recession could be postponed even further.

Global liquidity situation: (We are building a global liquidity database and a forecasting model, which predictions will be added to these reports during the spring.)

China stimulus: The growth of China's Aggregate Financing to the Real Economy (AFRE) broke its previous record in December (see Figure 1). Our event-analysis revealed that the price of copper has been a good proxy for the extent of Chinese stimulus. As it has remained high during first weeks of the year, we can assume that China has started the year by continuing its record-breaking stimulus. It has also been customary for China to open the year with a big stimulus in January. However, it can fade fast, and the price of copper has already fallen from its YTD highs.

United States

The US economy has continued to weaken as we have warned since the beginning of 2019. Industrial production fell for the fifth consecutive month in December. While the Empire State manufacturing index showed moderate gains in December and in January, activity fell in Richmond, Baltimore and Charlotte (the Fifth Fed District) in December. Many in the manufacturing industry fear that if new orders don't pick up in January and February, mass layoffs will start. That would sour the job market quickly.

While the ADP Institute's job market report showed a very large gain in December, the underlying trends are weakening. Manufacturers, energy producers and small companies have been shedding jobs. Auto sales were horrible in December with major auto producers reporting declines ranging from a relatively modest -2% (Fiat Chrysler) to a monstrous -29.5% (Nissan).

Moreover, Commercial and Industrial loans have been trending down since September. Late in an economic cycle, like now, falling C&I loans tend to signal that a recession is close. The majority of banks have also been steadily tightening lending standards on consumer and credit card loans since Q2 of last year. Although interest rates remain very low in the US, such extended tightening will eventually affect consumer spending, which has already been visible, for example, in the dismal Q4 performance of Target, a major retailer. The housing market has shown early signs of an of an upturn, but at this point in the cycle, combined with such aggressive easing by the Fed, this data should be taken with a 'grain of salt'.

The Philly Fed's leading indices also predict that nine US states are expected to fall into a recession within six months, the biggest number since the Financial Crisis. The Conference Board Leading Economic Index (LEI) has also declined in four of the last five months. Signs of an impending recession are getting more prominent.

China

China desperately pushed debt into the economy over the past year. It launched record-breaking additional stimulus campaigns in Q1, Q3 and Q4. The only time Beijing tried to deleverage was from around May through the end of June, and the economy immediately succumbed.

AFRE for 2019 broke the previous record set in 2017 rising to an astonishing 164 trillion Yuan, or 24 trillion US dollars. If we assume that the Chinese economy grew at the rate of six percent in 2019, the size of the economy would be around $14.4 trillion. As AFRE does not include all "shadow bank" financing, which reportedly grew at its fastest pace ever in early fall,[1] we can safely assume that debt growth exceeded the growth of the economy by at least by a factor of two in 2019. This, quite simply, is not sustainable.

It has been our working hypothesis through the fall that Beijing is desperately forcing debt into the economy to appear strong in the trade negotiations. However, as the sub-par growth figures show, the economy is not really responding to stimulus anymore. And, as we explained in Q-Review 4/2019, Beijing's ability to launch a massive infrastructure campaign, á la 2015/2016, is seriously limited by the massive budget deficits China and its regions currently run.

China has also changed its bailout policy to allow failures of State Owned Enterprises (SOEs). This has intimidated smaller banks, as it suggests that they may very well be forced to bear the losses associated with massive portfolios of non-performing loans in the eventual case of a serious economic slowdown or a recession. This has made them reluctant to obey the orders from Beijing to increase lending. For these reasons, China's stimulus may fade in the coming months leading to deepening deterioration in the global economy.

Eurozone

The export-dependent Eurozone has seen some 'green shoots' in the wake of significant stimulus by China. China's economic cycle leads Europe's by approximately 3 quarters (see Figure 1 below). For example, the service sector PMI of France rose to 52.4 and the service sector PMI of the Eurozone rose to 52.8 in December.

Yet, Europe's manufacturing sector remains deep in contraction. The Purchasing Managers Index of the manufacturing sector of the Eurozone was 46.3 in December. Germany's manufacturing PMI remained deeply depressed, at 43.7, in December.

Notes

Asset markets in the US have reached extreme levels, while the economy has continued to slow. This has greatly increased the likelihood of a serious correction.

In February, the Fed is planning to start to taper its term repo-operations from its current $35 billion level by $5 billion in each new term repo. If the Fed goes along with its plan, we can expect the stock market volatility to return, possibly with a 'vengeance', during next month.

It should be noted that any material correction in the stock market could lead to a fall in consumer sentiment, which is currently buoying the US economy. And an actual stock market crash would almost certainly guarantee a rapid onset of recession.

We are monitoring the situation closely.

[1] See the Beige Book.

Appendix: Figures

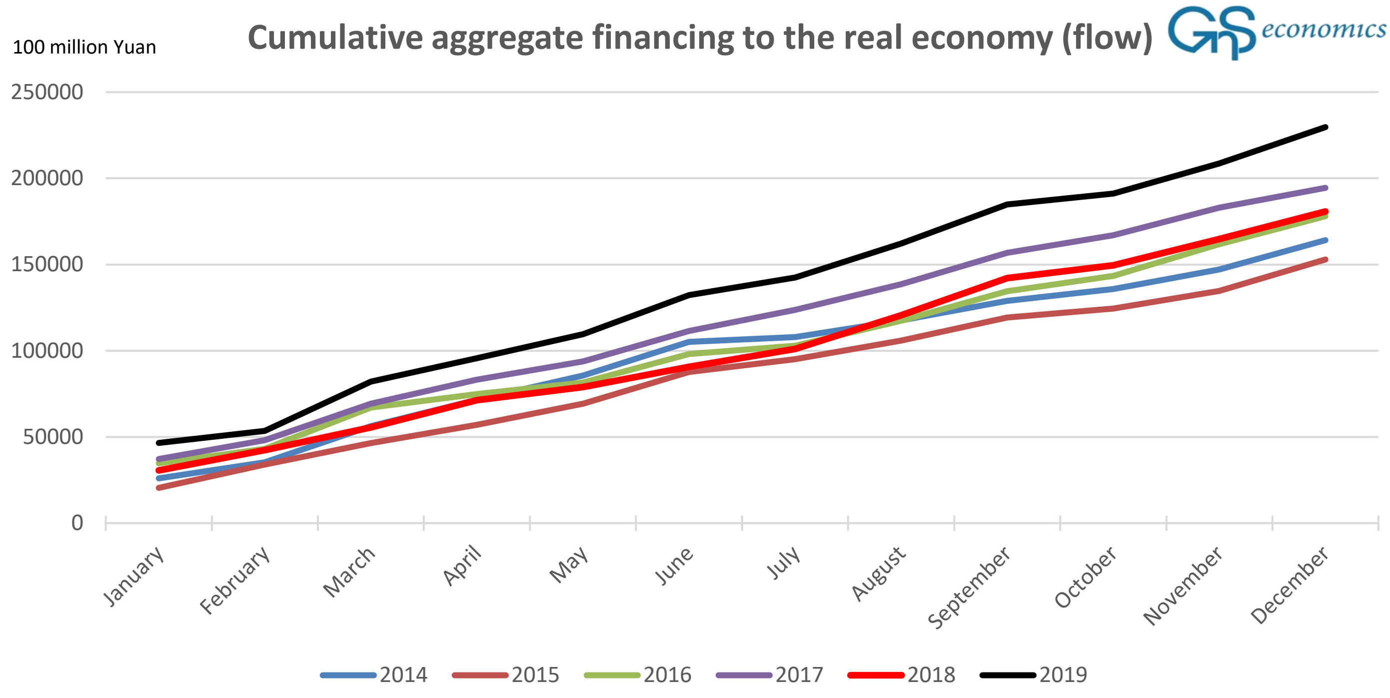


Figure 1. Yearly cumulative aggregate financing to the real economy (flow) in China. Source: GnS Economics, People's Bank of China

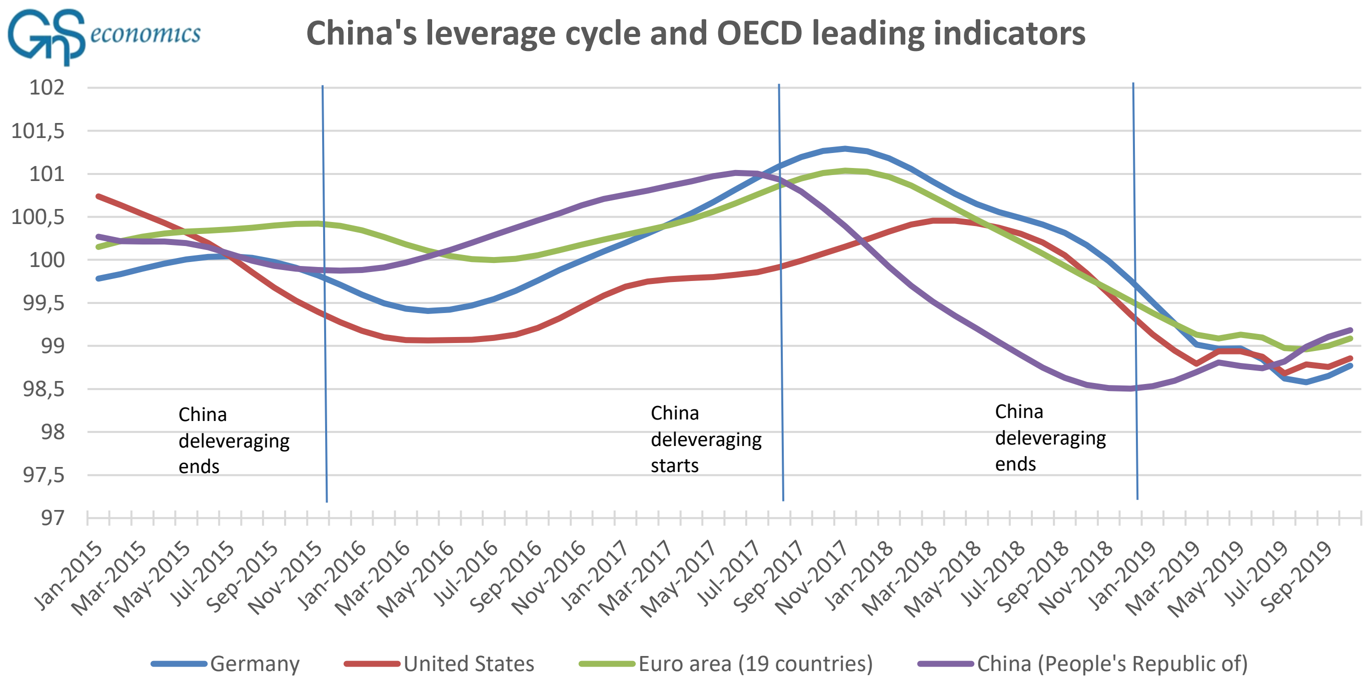


Figure 2. The leading indicators of the OECD and China's programs of leveraging and deleveraging. Source: GnS Economics, OECD, People's Bank of China

Appendix: The Deprcon -index

Deprcon is a **close proximity estimate** on the outlook of the **economy** and **financial markets**. In practice it is assumed to cover the next 1-2 quarters.

Values above three indicate an economic expansion and values below three indicate a downturn. If the indicator gives a value of 3, it signals that the economy is at a turning point. Value 2 gives a recession -warning, while value 4 signals a start of an expansion. Extreme values indicate either that an economy is in danger of overheating (5) or that is heading to a recession/depression (1).

We construct the estimate using information on the stock market, financial markets and our recession and crisis probability forecasts. This means that even if an economy is growing strongly, our outlook for it may be negative if recession and/or crisis probabilities are high.

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