Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Correction, Recession, or Crisis?

Monday, August 24, 2015

Donald Luskin

A long-overdue correction, and probably a mild recession. But a crisis? We doubt that.

Update to strategic view

EMERGING MARKETS MACRO, US MACRO, US STOCKS, OIL: The present global panic is worse than anything we expected, but we were right over the last month when we argued in probabilistic terms to take something off the table. The world is focused on China as the trigger-event, but we still think collapsing oil prices are at the root of it -- indeed, the two are intertwined. We see this as a long-deferred correction three years-plus of tranquility, and probably the harbinger of something like a mild recession…

[continued on next page]

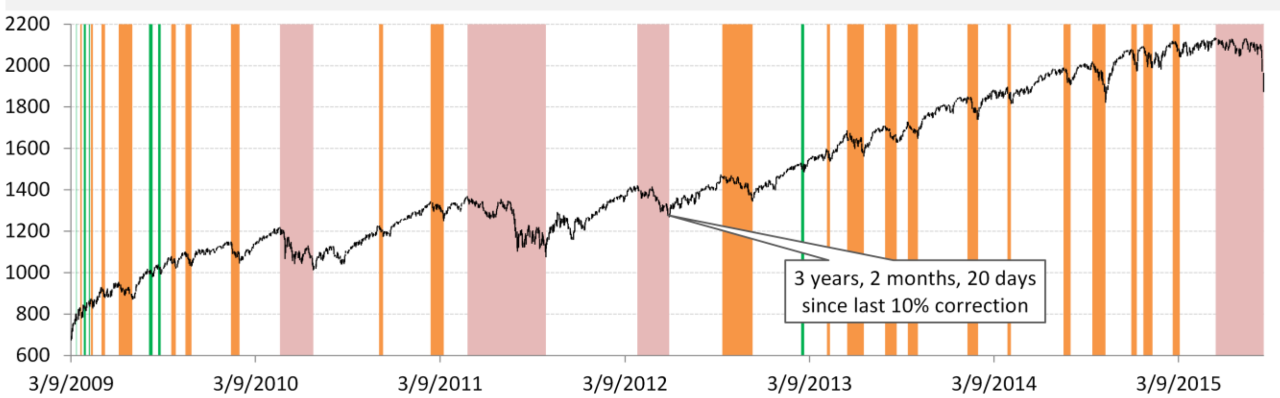
Paradox resolved. Very painfully.

- We'd been wondering (see "Another 'Reverse Oil Shock'?" Tuesday, July 28, 2015) how the US stock market was able to keep consolidating for months near all-time highs while forward earnings rolled over and credit spreads widened.
- Last week we said it might be "a gift" -- a chance "to take something off the table" (see "Is This the Oil Shock Tipping Point?" August 20, 2015).
- Obviously we weren't expecting the massive and rapid drop in equities that began Thursday, just after we wrote those words.
- *Be that as it may, as of this writing, the S&P 500 has fallen as much as 12.52% from its all-time high on May 20. Finally, in just a matter of days -- the long-overdue 10%-plus correction is here, after three years, two months and 20 days since the last one.*

As this has all unfolded we've been out-of-consensus in focusing on oil prices as the trigger-factor, while everyone else has been focusing on China. We've been concerned since early spring that we could be facing a credit and earnings crunch, and the first-ever recession caused by low oil prices (see "Houston, You're the Problem" March 9, 2015).

- We grant that the role of China in the present volatility is

S&P 500 corrections (intraday basis) 3-5% 5-10% 10%-plus



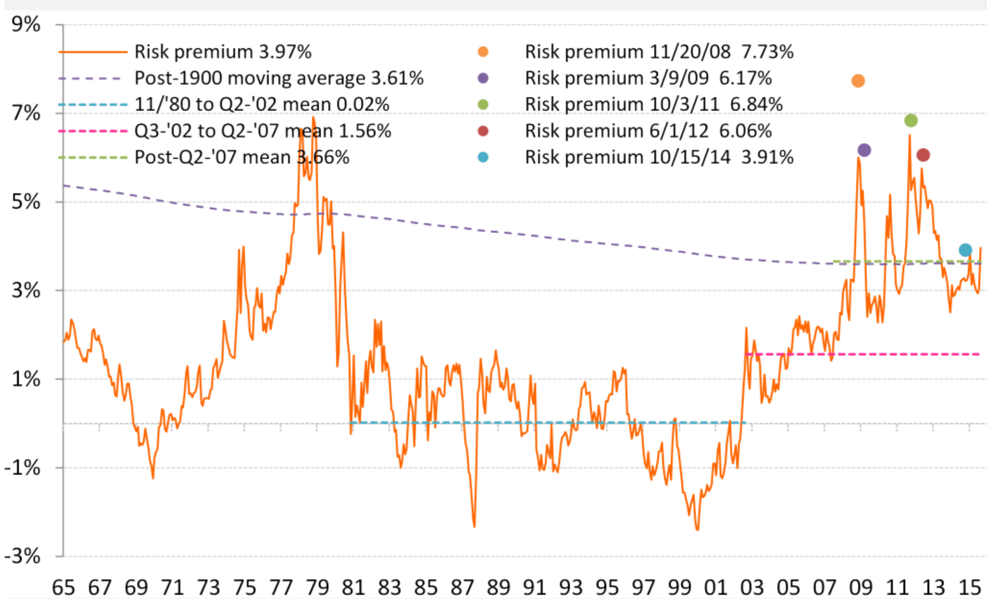
Source: Bloomberg, TrendMacro calculations indisputable (see ["On the RMB Devaluation"]() August 11, 2015). But we note that the wheels only really came off in markets after WTI crude prices fell to new lows on Wednesday.

- To be sure, because China is a major consumer of crude, a feared slow-down or hard-landing there might have been a factor in oil's decline from its recovery highs in May. But so far, at least, Chinese crude consumption remains virtually at all-time highs. And China will always need crude, even after its mad dash to modernity is complete and it no longer needs so much iron or copper.
- On the other hand, if what we've been calling a "reverse oil shock" causes a recession or even just a credit crunch in the US -- and imparts dangerous stresses to other important economies such as Russia and Brazil -- China would be a major victim. In the US, the effects of lower oil prices have already shown up markedly. The collapse in oilfield CAPEX took 40 bp off real Q1 GDP, and 82 bp off Q2.
- As the low-end factory for the world, China has taken unto itself the economic functions most strongly impacted by business cycle fluctuations. And with its growth already having been slowing for five years now, arguably it faces these imported cyclical risks from a position of some fragility.
- So for today's purposes, let's just say that the oil narrative and the China narrative are complexly intertwined, and that both are implicated in the global risk-off spasm we're experiencing.

The neck-snapping moves in global markets seem to imply a crisis, not just a correction.

- As of Friday's close, the S&P 500 equity risk premium (the forward earnings yield minus the 30-year Treasury yield) had moved back

S&P 500 equity risk premium (forward earnings yield minus 30-year Treasury)



Source: Various, TrendMacro calculations

Update to strategic view

[continued from first page]

…Despite the volatility, we don't see an outright crisis, even with a hard landing in China. The fat-tail risk there is massive social disruption that would pull China's link out of the global supply chain.

[Strategy Dashboard home]()

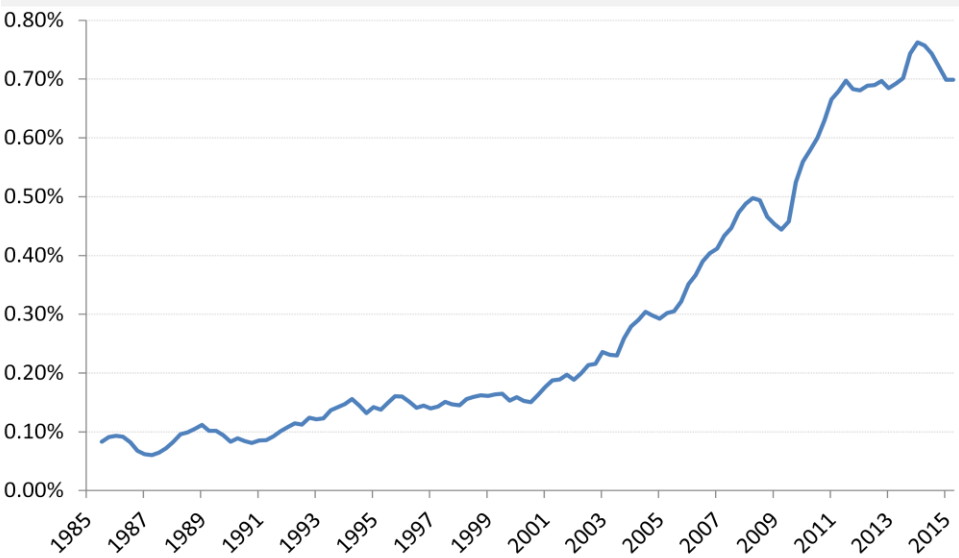
up to precisely its crisis-era mean of 3.61%. As of this writing, at the worst levels of day, it was above the mean at 3.97% (please see the chart on the previous page). This is typical of equity markets throughout the developed world.

- *Thus stocks are priced not so much for recession, but rather for the crisis world of Lehman and AIG.*
- What would a crisis now consist of?
- In some sense, the crisis could consist only of itself. That is, this large sudden correction after more than three years of tranquility could be so shocking to risk-propensity that it would become a self-fulfilling prophecy. We're not fond of such arguments, but it must be said.
- *More fundamentally, in the US, the "reverse oil shock" we're worried about would involve some defaults in high-yield bonds and some losses booked at large banks, implying a growth-damaging tightening of credit conditions and likely a recession. This could reach credit-crisis proportions at some extremely low crude price, but absent that it would only be recessionary.*
- We think the greatest potential non-linearity that might arise from extremely low oil prices would be a geopolitical shock, such as a highly aggressive Russian military initiative in eastern Europe.

But enough about oil. China is what everyone wants to talk about.

- We have to begin by remembering that China has already been slowing for five years. So what we're talking about now is only a continuation, even if perhaps a strong acceleration, of something the world has already had some time to get used to -- and has certainly talked about a great deal.
- *Obviously if China experiences a hard-landing it would certainly be an overall negative for global growth, and would have negative*

US exports to China as share of US GDP Nominal, rolling 12-month



Source: BEA, Bureau of Census, TrendMacro calculations

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.energy

[About us]

Recommended Reading

China does not contribute one cent to global GDP
Derek Scissors
FT BeyondBrics
August 21, 2015

[Reading home]

spillovers for most nations. But that's not to say it would be a crisis.

- For the US, the first-order effects a Chinese hard-landing might be surprisingly mild.
- For all the hand-wringing in earnings calls, US exports to China amount to only 70 bp of GDP -- and only 5.5% of total US exports. Those exports have managed to remain pretty stable even while China's growth has slowed over the last five years (please see the chart on the previous page). Because they are small to begin with, and because their growth seems to have been decoupled from China's growth, we think even strongly reduced demand from China would have little impact here.
- On the other hand, US imports from China amount to 2.7% of GDP -- which is 17.3% of total imports. Surely China in recession would struggle to become more competitive by slashing prices, so arguably we'd be a winner here.
- Similar arguments can be made to different extents among different trade counterparties for China. In some cases, such as Japan and Korea where trade volumes are larger, China in recession wouldn't necessarily have a lot more negative impact than in the US. That's because China is only a link in their global supply chains. Trade in high-value components made in, say, Japan, and merely assembled in China for ultimate consumption in, say, the US, would continue. Indeed, China's price for its intermediary role would likely be reduced to the benefit of everyone else in the supply chain.
- *We're not convinced that a hard-landing in China would likely lead to a debt collapse that would spill over into a global banking crisis.*
- For one thing, with its currency not freely convertible and its capital account closed, even though China is a global superpower, Chinese banking is not very globally interconnected.
- Within China, one frequently hears reports of massive indebtedness in relation to the size of the economy, suggesting a massive credit crisis in the offing. Okay, we don't doubt that there has been a great deal of financial intermediation of various forms to facilitate China's massive infrastructure growth. We don't have exact numbers by any means, but surely a great deal of that has been entirely internalized -- loans between state-owned banks and state-owned businesses and the state itself. In some sense this is how China conducts monetary policy, by directly controlling the credit channel. As in conventional QE in which a central bank buys its own sovereign's debt, in China it's simply one unit of government funding another -- quite literally IOU's to one's self. Such indebtedness would only collapse if the government wished it to -- and why would it?
- *In our view, the most salient potential crisis in China is massive social unrest that might arise from a recession. We're not forecasting it will -- but what if?*
- In the mildest case, it would make a recession deeper by interfering with economic activity. But in stronger cases involving massive military repression, or in the extreme case of an outright political revolution of some kind, it's possible that China would be taken substantially out of the global supply chain for a while.

- In such a scenario, the risk goes way beyond China no longer buying exports from the US. Now the issue is that critical work-flow elements required to deliver American-designed products to American consumers -- iPhones, for example -- suddenly become unavailable. Which is to say: iPhones would become unavailable. Which is to say: the largest American company by market capitalization would be brought to its knees. Along with thousands of others, all over the world, as their particular supply chains are rendered inoperative.

So we have three choices for how to understand this outright panic. Is it only a long-overdue correction, or the harbinger of a crisis? Or something in between -- the sign of a coming recession.

- The first part is easy. *A correction has indeed been long overdue. It's an historical fact: the longer you delay, the worse it is when it comes.*
- *We hate to say it, but the pieces are falling into place for some kind of recession -- triggered by an oil-driven credit and earnings crunch, only amplified by troubles emanating from China.* Without a true crisis, we don't see how it could be especially long or deep -- maybe it won't even be an "official" recession. By any reasonable measure, output gaps in the US and around the world are still quite high, having never recovered much from the Great Recession -- and you can't fall very far out of the basement window. Household balance sheets are far stronger than they were at the last cycle peak. And even if low oil prices are the trigger for a recession, at the same time they are an automatic stabilizer to some extent, imparting a great deal of consumer resiliency. Remember, we entered the last recession with oil still at $107 a week after Lehman Day.
- *Crisis? Sure feels like it at the moment. And we can tell ourselves stories about how it might happen. But we don't think it will.*
- With stocks priced for crisis, then the only question is exactly when to put risk back on -- in the belief that we're actually, at best, in a bad but inevitable correction, and at worst, entering a mild recession.

Bottom line

The present global panic is worse than anything we expected, but we were right over the last month when we argued in probabilistic terms to take something off the table. The world is focused on China as the trigger-event, but we still think collapsing oil prices are at the root of it -- indeed, the two are intertwined. We see this as a long-deferred correction three years-plus of tranquility, and probably the harbinger of something like a mild recession. Despite the volatility, we don't see an outright crisis, even with a hard landing in China. The fat-tail risk there is massive social disruption that would pull China's link out of the global supply chain.