Trump's
Recipe For Disaster

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MACRO WATCH

A video-newsletter analyzing trends in Credit Growth, Liquidity and Government Policy to anticipate their impact on economic growth and asset prices

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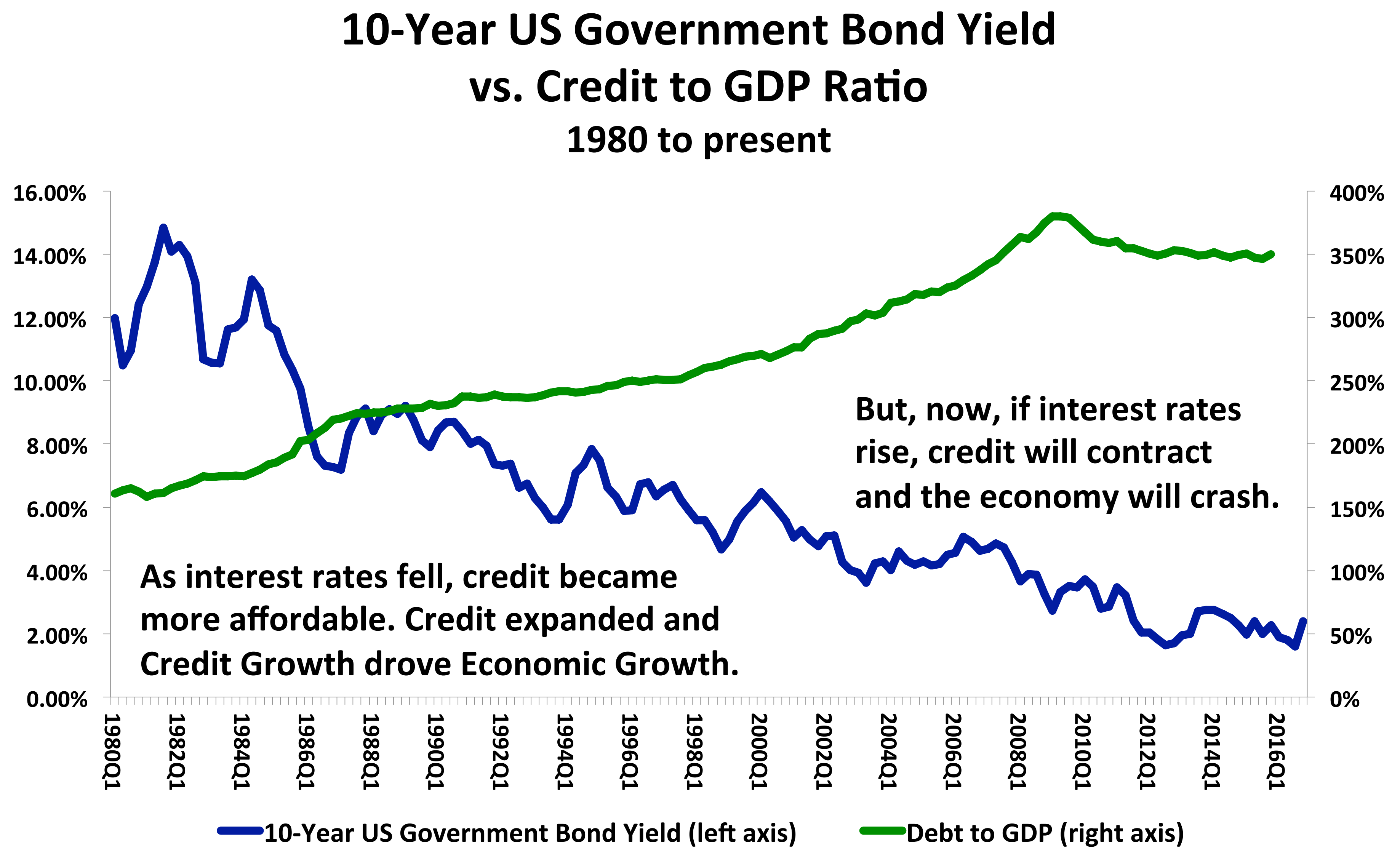
It’s Too Soon To Know, But…

- We simply don’t yet know what economic policies President Trump will put in place.
- However, based on his campaign promises and what we’ve learned since the election, there’s real cause for concern.
- A combination of tax cuts, increased government spending and policies that curtail trade would be a recipe for disaster because it would push up interest rates and crush the highly leveraged US economy.
- Five things will determine which way interest rates will move – and, therefore, the direction of all asset prices and the economy overall.

Here's Why Interest Rates Are So Important

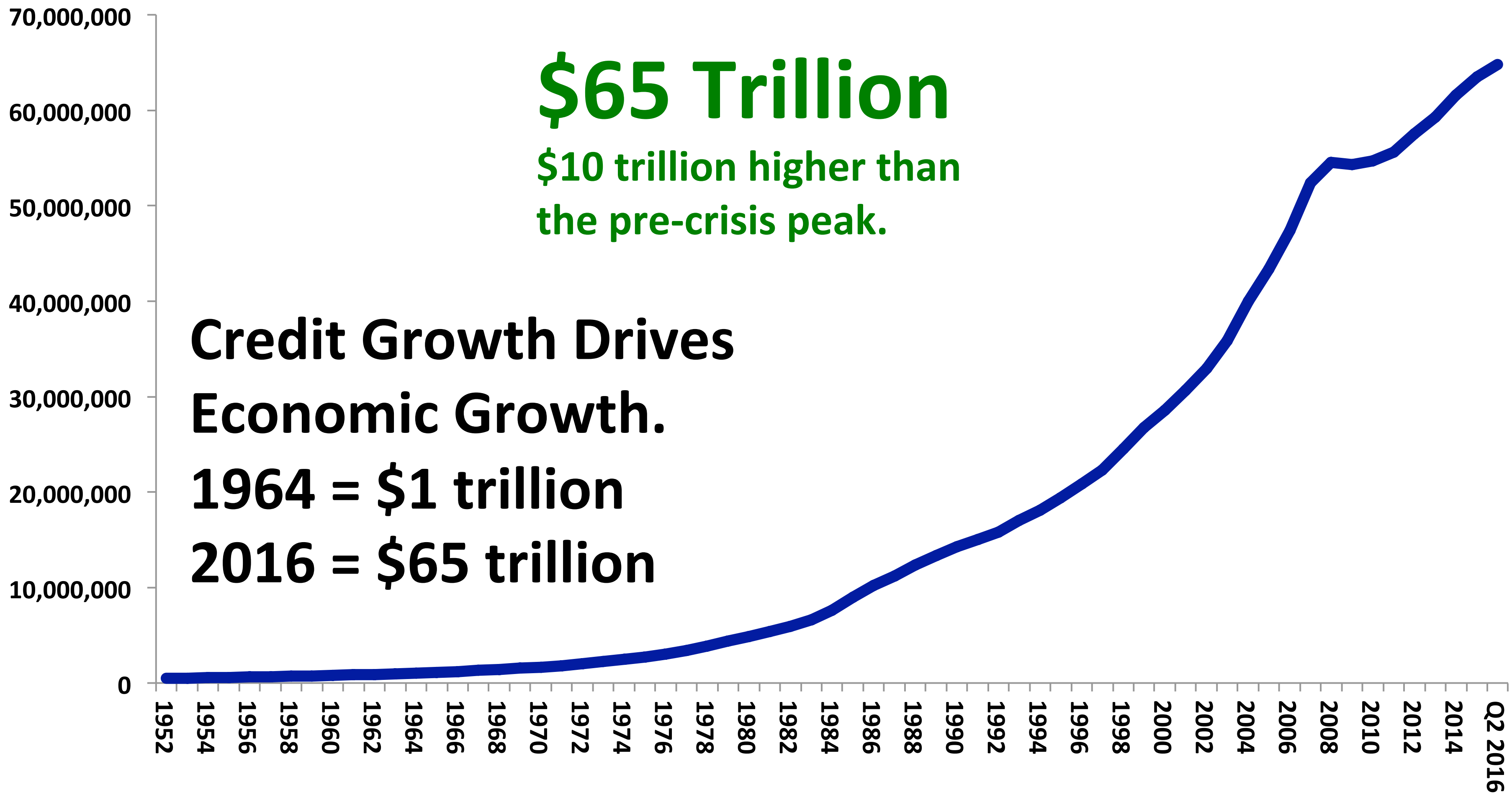
- The global economic bubble came very close to collapsing into a new Great Depression in 2008.
- That disaster was prevented by ultra loose Monetary Policy.
- Central banks slashed short term interest rates to 0% and then "printed" trillions of dollars worth of new money and used it to buy financial assets.
- That strategy allowed credit to expand and caused asset prices to soar, thereby reflating the global economic bubble and staving off economic collapse.
- What happens next will depend on interest rates.



Source: The Fed

US Total Debt = Total Credit

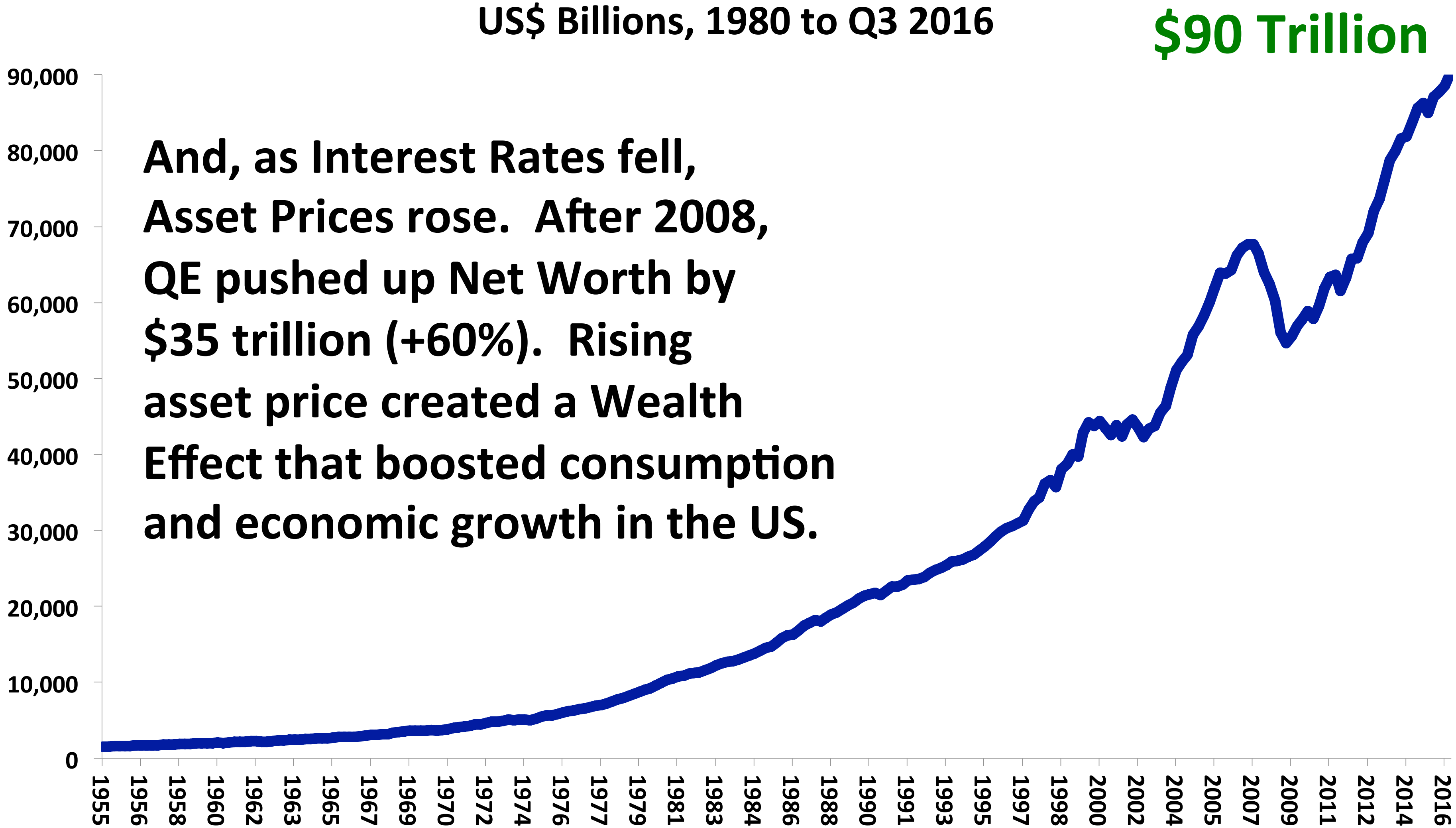
US$ millions, 1952 to 2016



Source: The Fed

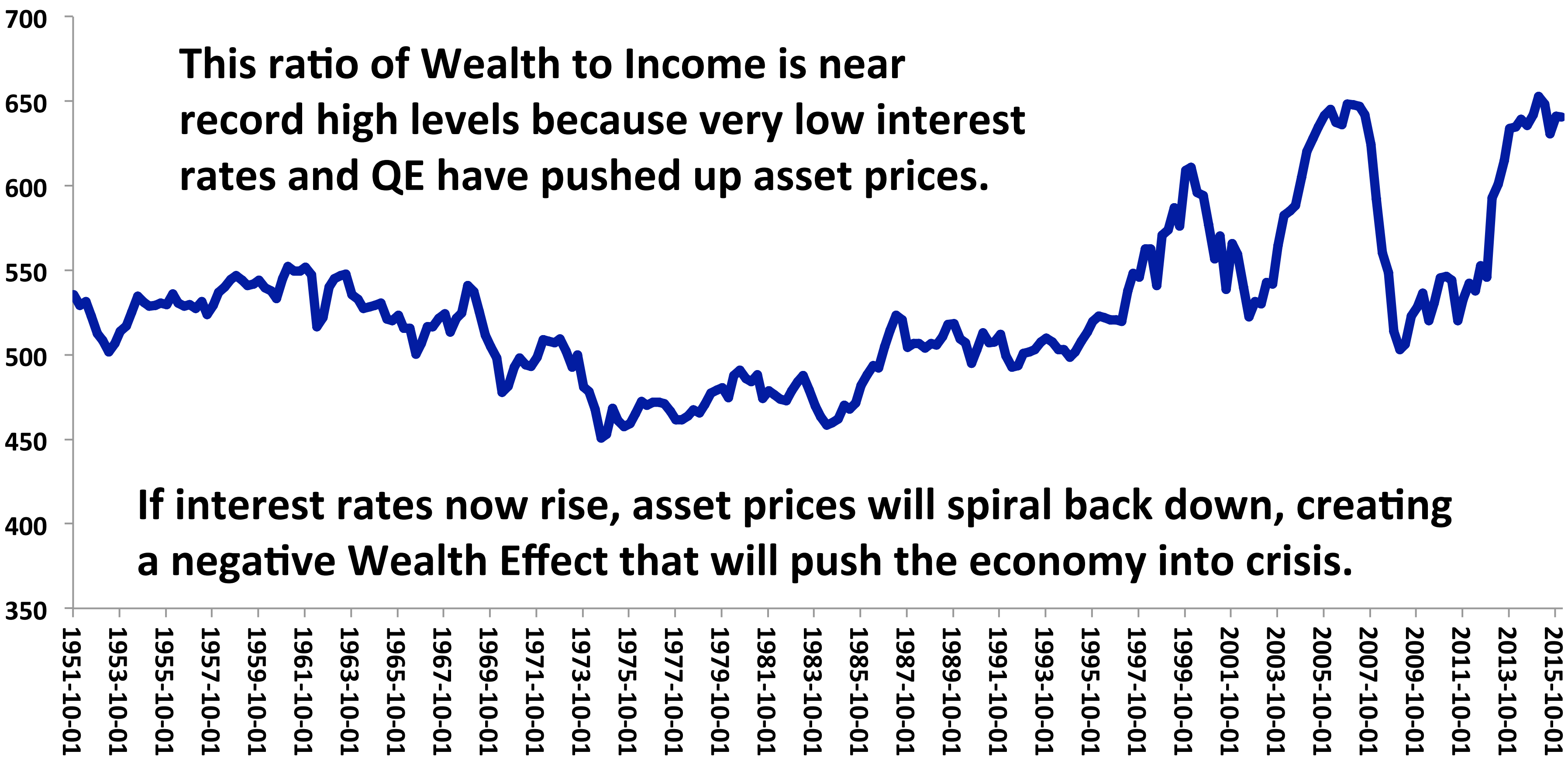
Household Net Worth

US$ Billions, 1980 to Q3 2016



Source: Fed

Household Net Worth
as a % of Disposable Personal Income
%, 1951 to 2016



Source: Fed

The Five Factors That Will Determine Interest Rates

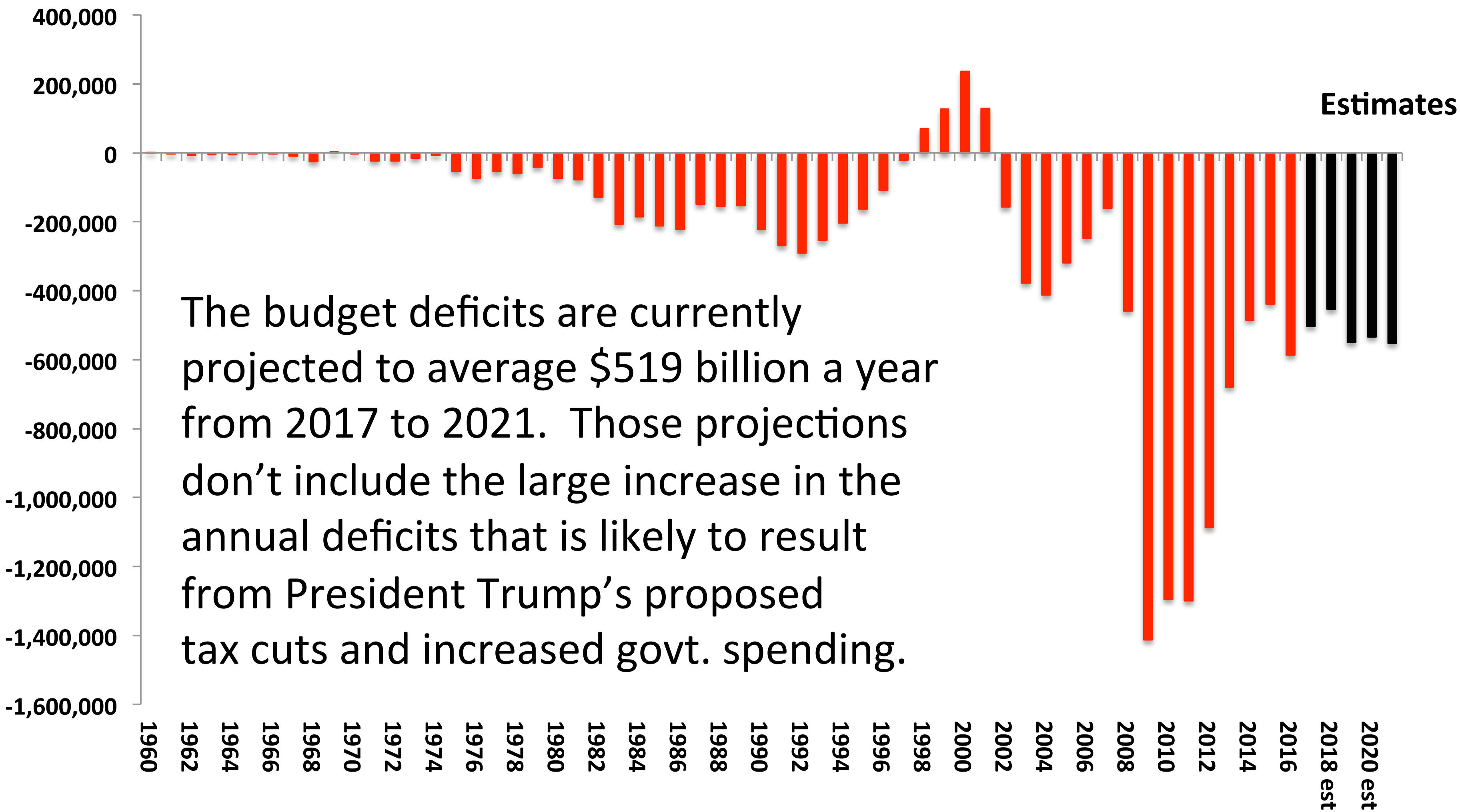
1. The Government's Budget Deficit.
2. The US Current Account Deficit
3. Quantitative Easing by central banks outside the US.
4. The Inflation Rate
5. The Chinese RMB Exchange Rate vs. the US Dollar.

1. The Budget Deficit

- President Trump’s plans to cut taxes and increase government spending on the military and infrastructure are quite likely to cause the government’s budget deficit to increase very significantly.

US Government Budget Surplus or Deficit (–)

US$ Millions, 1960 to 2021 estimates, (Fiscal Years ending Sept 30)



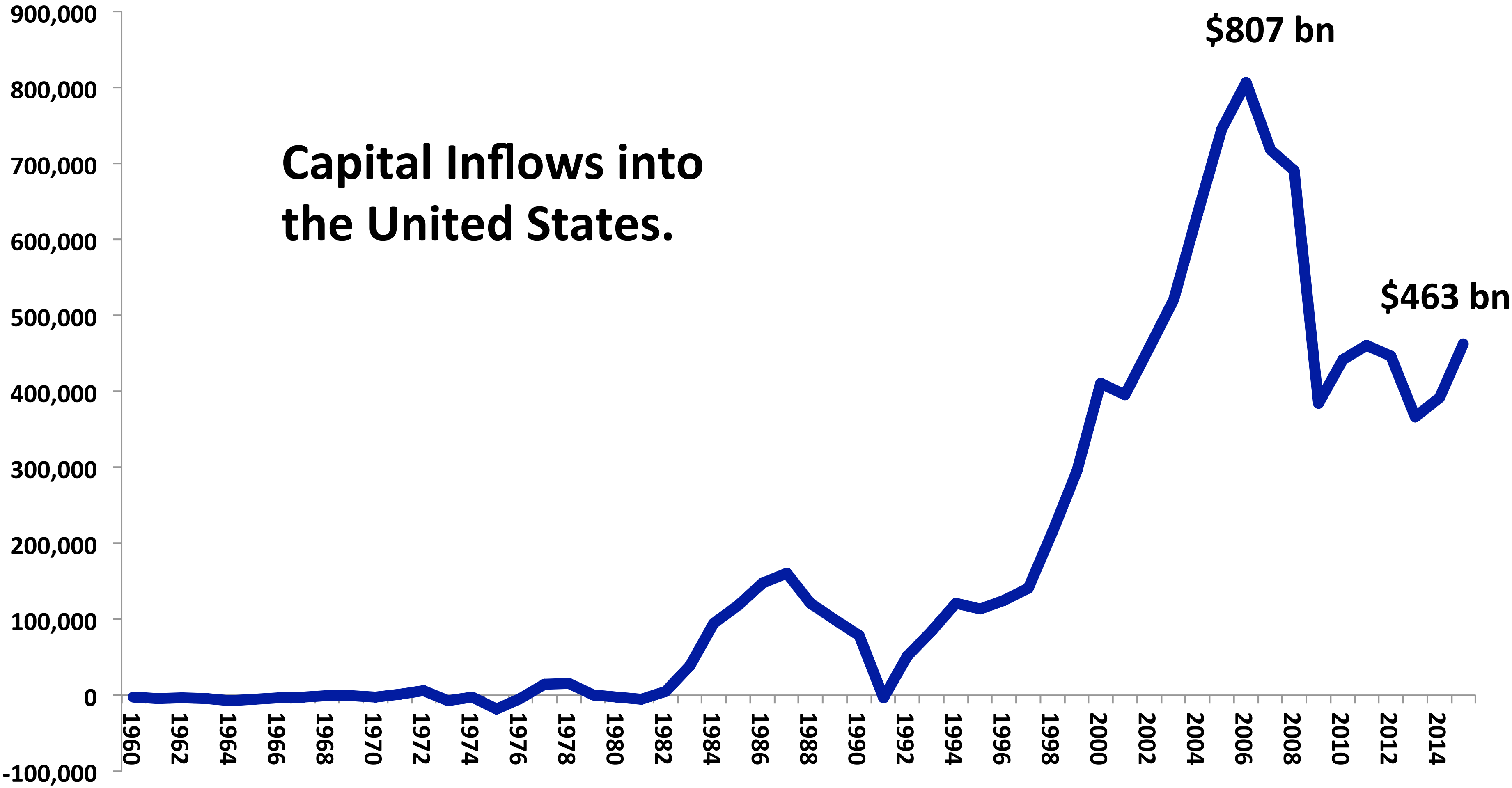
Source: Office Of Management & Budget

2. Capital Inflows

- Before Bretton Woods broke down, trade imbalances and capital flows between nations were very limited.
- But now they have become very large.
- Capital inflows into the United States have become an enormously important source of funding for the US Budget deficit.
- The larger the capital inflows are, the easier it is to finance the government's budget deficit at low interest rates.

The US Financial & Capital Account

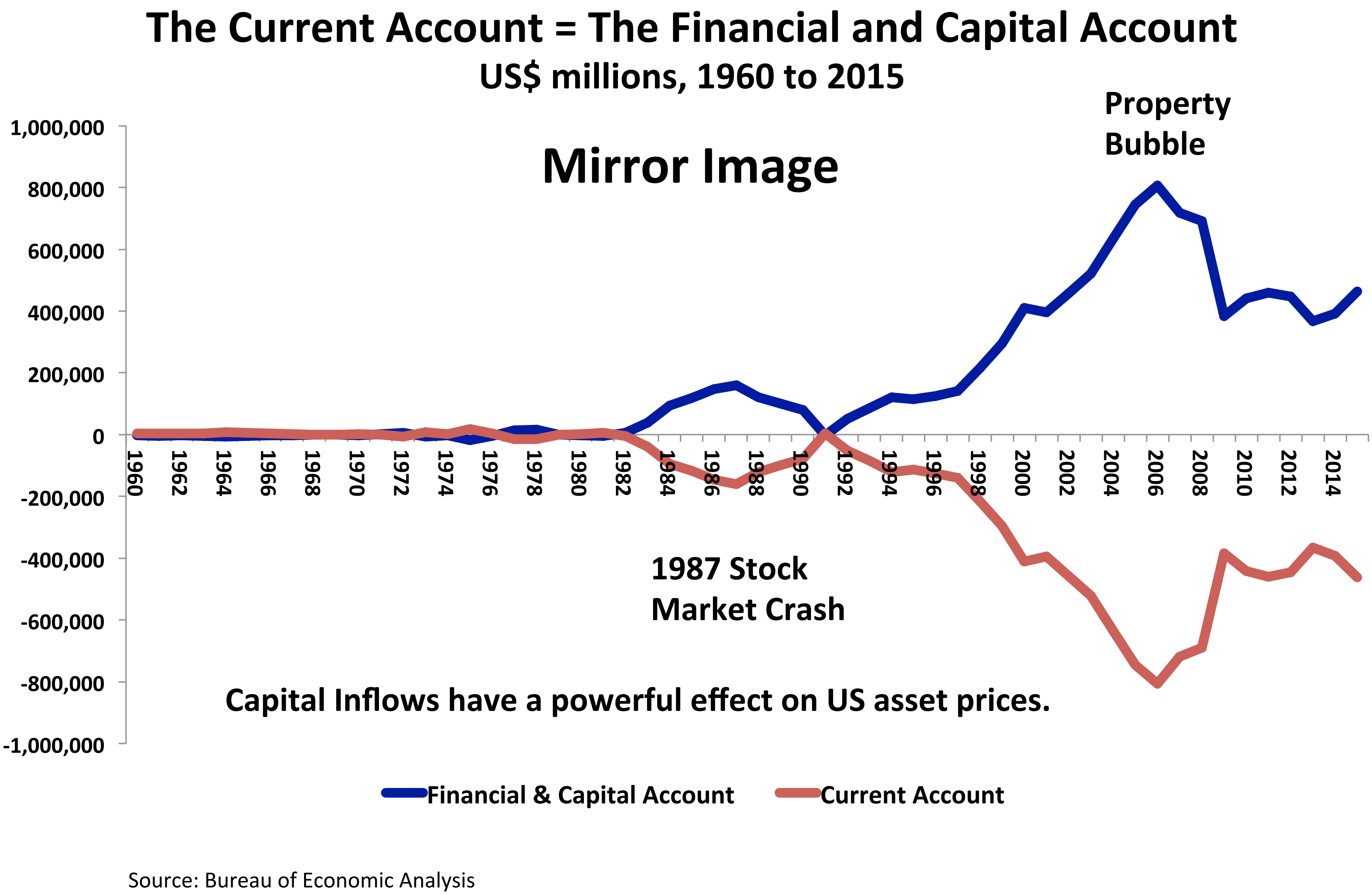
US$ millions, 1960 to 2015



Source: Bureau of Economic Analysis

Mirror Image

- The Capital Inflows are the mirror image of the Current Account deficit.
- When the Current Account Deficit grows larger, the Capital Inflows also grow larger, making it easier to finance the budget deficit.
- But, when the Current Account Deficit shrinks, Capital Inflows also shrink, making it more difficult to finance the budget deficit at low interest rates.


The Current Account = The Financial and Capital Account
US$ millions, 1960 to 2015
Mirror Image
Property Bubble
1987 Stock Market Crash
Capital Inflows have a powerful effect on US asset prices.
1,000,000
800,000
600,000
400,000
200,000
0
-200,000
-400,000
-600,000
-800,000
-1,000,000
1960
1962
1964
1966
1968
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1982
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1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
Financial & Capital Account
Current Account
Source: Bureau of Economic Analysis

Capital Inflows May Shrink

- Trump's plans to force US companies to bring their factories back to the US, to renegotiate trade deals and/or to impose trade tariffs on China and Mexico would all cause the US Current Account deficit to shrink.
- A smaller Current Account deficit would cause the capital inflows into the United States to shrink, too.
- Less capital inflows would mean less demand for US government bonds.
- That would push up interest rates and pop the asset price bubble.
- So, we must keep a close eye on the US Current Account Deficit because it will determine the size of the capital inflows.

3. Quantitative Easing

- Quantitative Easing is the third factor we must watch.
- Clearly, when the Fed prints money and buys government bonds, that pushes up the price of the bonds and pushes down their yields.
- Additional QE from the Fed now looks unlikely, at least in the near term. (We're going to have fiscal stimulus instead of monetary stimulus.)

Other Central Banks

- However, we must also monitor the Quantitative Easing being carried out by other central banks around the world because QE overseas impacts US interest rates, too.
- Currently, the ECB, BOJ and BOE (combined) are printing the equivalent of roughly $500 billion every three months.
- They use that new money to buy their governments' bonds. That pushes up the price of their bonds and pushes down their yields.
- Lower yields in Europe, Japan and the UK are now putting downward pressure on US government bond yields.
- However, if those central banks print less money in the future, US interest rates would probably rise.

Half A Trillion Dollars Per Quarter

The BOJ and the ECB are now carrying out Quantitative Easing on a very large scale. Here are the details:

Global QE

		Per Month	US$ Exchange Rate	US$ billion per Month	US$ billion per Quarter
BOE	£70 billion over 8 months	£8.75 billion	1.3	11.4	34.1
BOJ	Yen 80 trillion per year	Yen 6.67 trillion	100	66.7	200.1
ECB	Euro 80 billion per month	Euro 80 billion	1.13	90.4	271.2
Total				168.5	505.4

Source: Central Banks

US$8.15 trillion
Government Debt Cancelled Thus Far

Central Bank Holdings Of Government Debt
Converted into US Dollars, billions

		US$ Exchange Rate	US$ billions
BOE	£375 billion	1.3	488
BOJ	Yen 368 trillion	100	3,700
ECB	Euro 1,326 billion	1.13	1,500
Fed	$2,462 billion		2,462
Total			8,150

This total is scheduled to increase by US$1 trillion over the next 6 months.

Source: The BOE, BOJ, ECB, Fed

The Amount Of Government Debt Cancelled* So Far

Central Bank Holdings Of Government Debt As a % of Total Government Debt:

BOE	**25%**
BOJ	**35%**
ECB	**12%**
Fed	**13%**

Source: RD estimates
* Effectively Cancelled

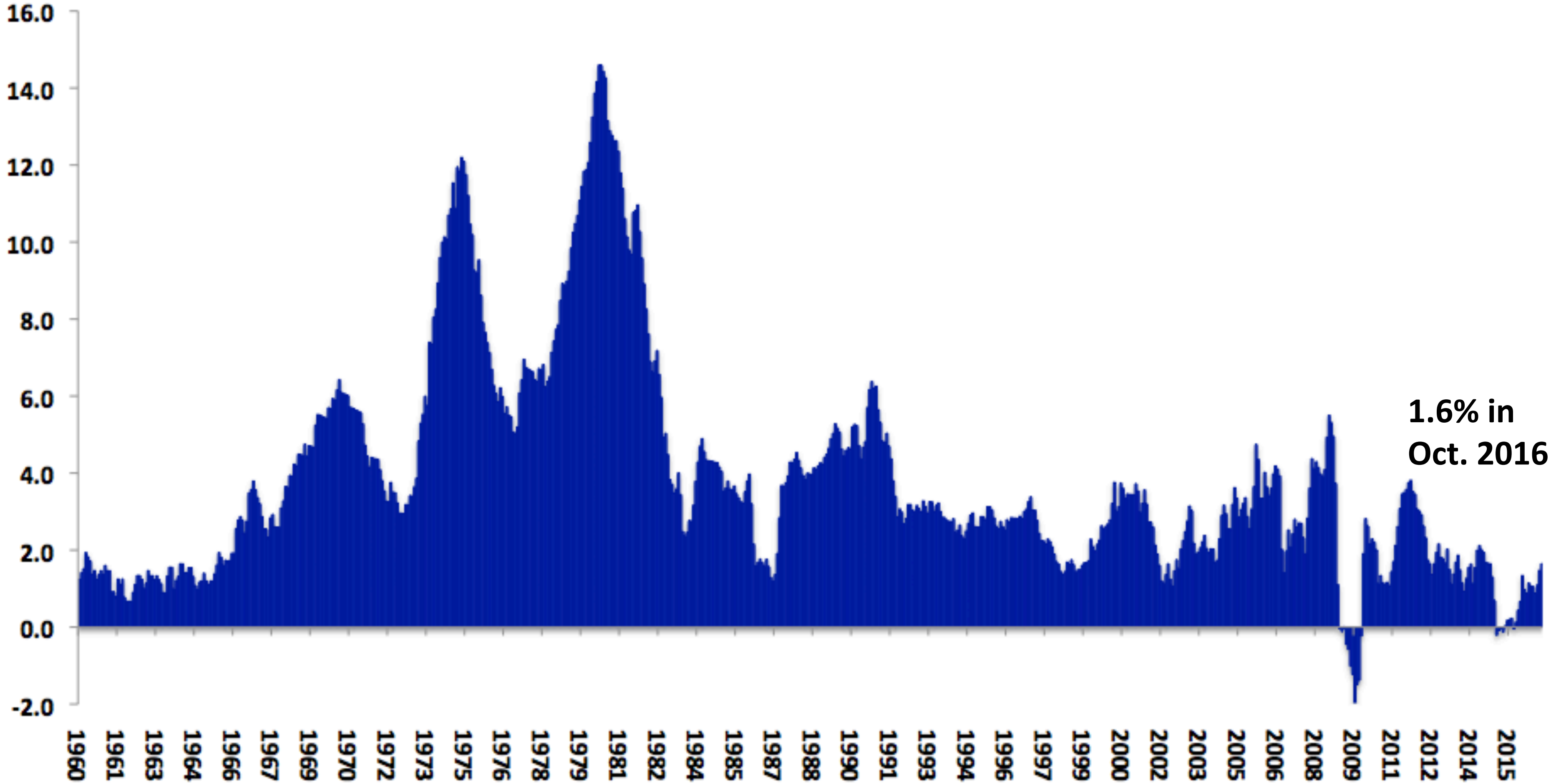
Note: The numbers for the BOJ and ECB are slightly overstated because some of the assets they have acquired are corporate bonds (but only a small part). The importance of the Fed's QE is understated because in addition to owning US$2.5 trillion of government bonds, the Fed also owns $1.7 trillion of asset-backed mortgage debt.

4. Inflation

- Inflation also affects interest rates.
- If the inflation rate goes up, the demand for bonds will go down – unless the yield offered on those bonds increases.
- No one will lend money for 3% if the inflation rate is 5%.
- In recent years the Inflation Rate has been exceptionally low – despite all the money that the central banks have been printing.

Consumer Price Inflation

Monthly, Annual % Change, 1960 to October 2016



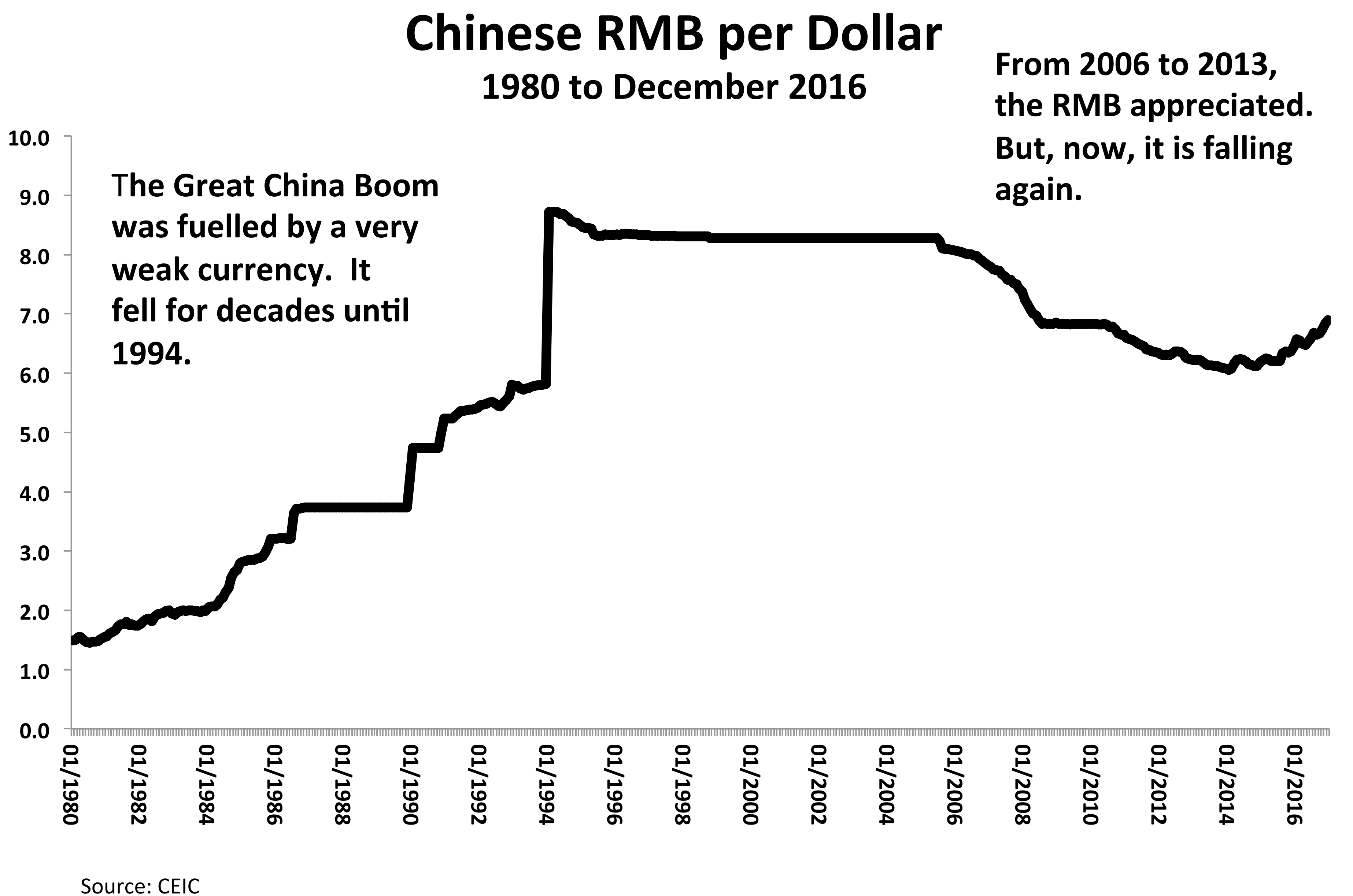
Source: St Louis Fed

What Could Cause Inflation To Rise?

- Inflation has fallen since the early 1980s because increasing trade with low wage countries has pushed down US wages and the price of consumer goods.
- Now, however, if the US imports less from low wage countries, the price of manufactured goods will rise, US wages will rise, and inflation will rise.
- Forcing companies to bring their factories back to the United States or imposing trade tariffs on imported goods would cause inflation to increase.
- Increased government spending could also cause inflation to pick up.

5. The Chinese RMB

- Finally, the value of the RMB could also impact US interest rates.
- The United States will import nearly Half A Trillion Dollars worth of goods from China this year.
- If the RMB continues to weaken against the Dollar, those imports will become cheaper and put downward pressure on US inflation rates.
- If the RMB were to strengthen (which is unlikely), then that would put upward pressure on US inflation.
- Of course, if the US puts trade tariffs on Chinese goods, that would cause a spike in the US inflation rate, which would push up US interest rates.
- By the way, in 2015 the US imported $483 billion of goods from China and exported $116 billion of goods to China, resulting in a US trade deficit with China of $367 billion - or roughly $1 billion a day.



Chinese RMB per Dollar
1980 to December 2016
From 2006 to 2013, the RMB appreciated. But, now, it is falling again.
The Great China Boom was fuelled by a very weak currency. It fell for decades until 1994.
10.0
9.0
8.0
7.0
6.0
5.0
4.0
3.0
2.0
1.0
0.0
01/1980
01/1982
01/1984
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01/1998
01/2000
01/2002
01/2004
01/2006
01/2008
01/2010
01/2012
01/2014
01/2016
Source: CEIC

The US Trade Deficit Is To Blame

- President Trump believes the US trade deficit has been responsible for the loss of manufacturing jobs in the United States and the downward pressure on US wages that has occurred over the last several decades.
- I agree.
- I've written about the harm the US trade deficit has done to the United States and about the destabilizing impact it's had on the global economy in all three of my books.

The Dollar Crisis

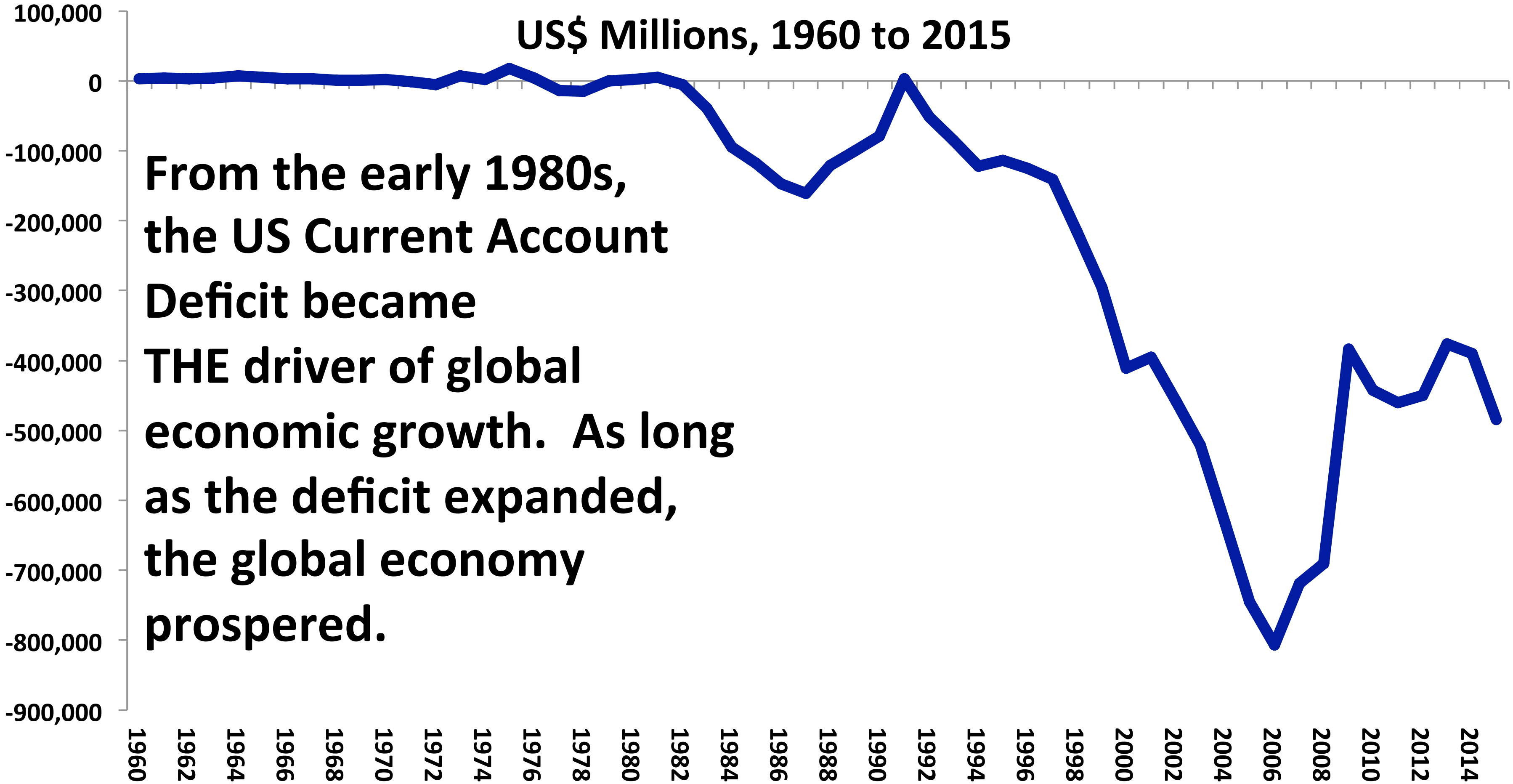
Here are the opening lines from my first book, The Dollar Crisis:

"The principle flaw in the post-Bretton Woods international monetary system is its inability to prevent large-scale trade imbalances. The theme of The Dollar Crisis is that those imbalances have destabilized the global economy by creating a world-wide credit bubble."

Not Easy

- However, unwinding the US trade deficit is going to be very difficult.
- Over the past 35 years, that deficit has become **THE** driver of global economic growth.
- In fact, the entire global economy has been constructed around unbalanced trade.
- At this point, the attempt to eliminate the US trade deficit could very easily cause the global economy to collapse into a new Great Depression.

US Current Account Balance



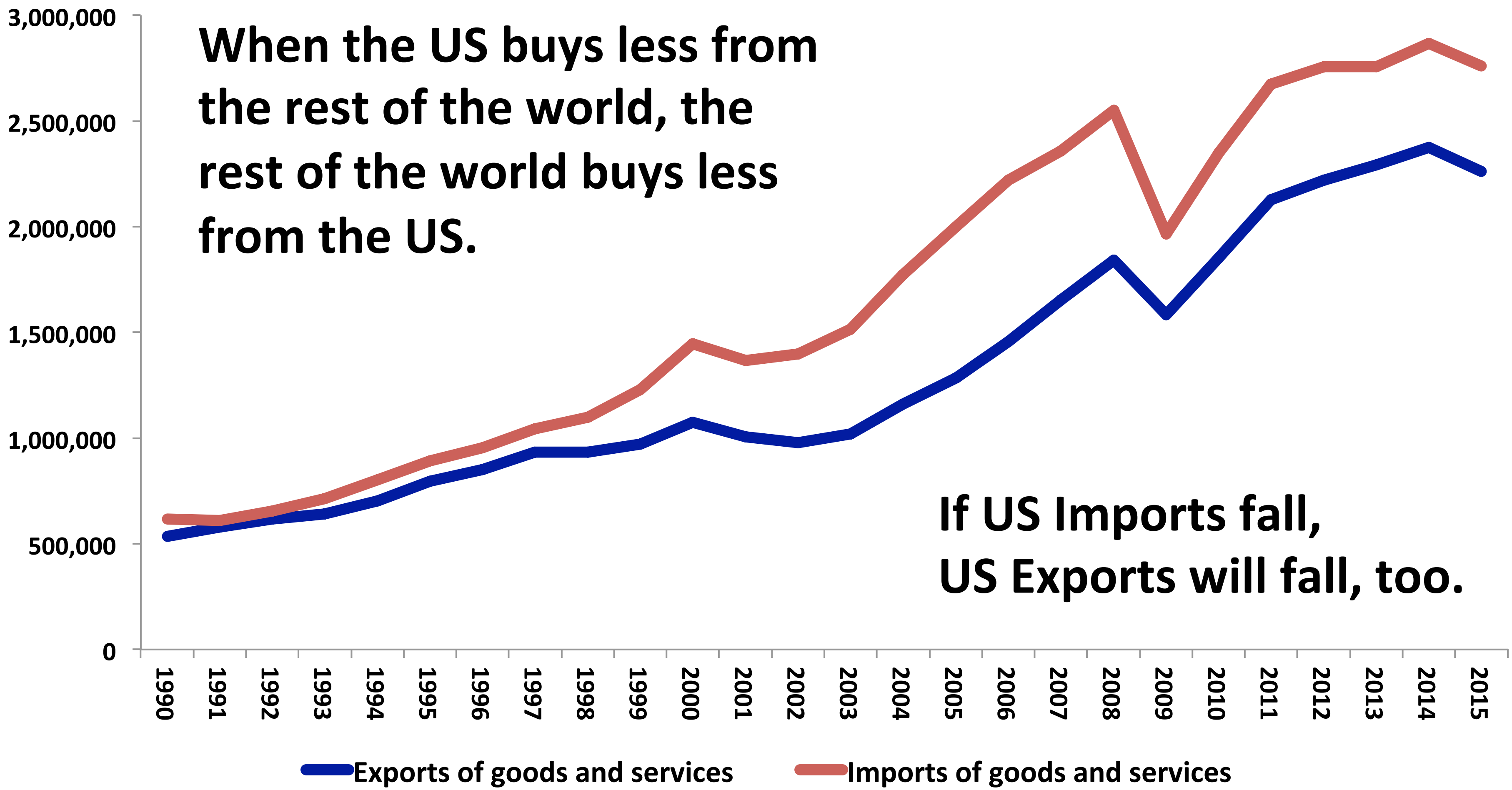
Source: Bureau of Economic Analysis

The Undesirable Consequences of Eliminating The Trade Deficit

1. If the US reduces its imports, the global economy will shrink.
2. If the US eliminates its $1 billion a day trade deficit with China, China's economy could collapse into a depression that would severely impact all of China's trading partners, and potentially lead to social instability within China and to military conflict between China, its neighbors and the US.
3. If the US Current Account deficit returns to balance, the global economy will suffer from insufficient Dollar liquidity, which could cause economic stagnation or worse.
4. A reduction of imports from low wage countries would cause US inflation to rise, which would push up US interest rates.

US Imports & Exports

US$ Millions, 1990 to 2015



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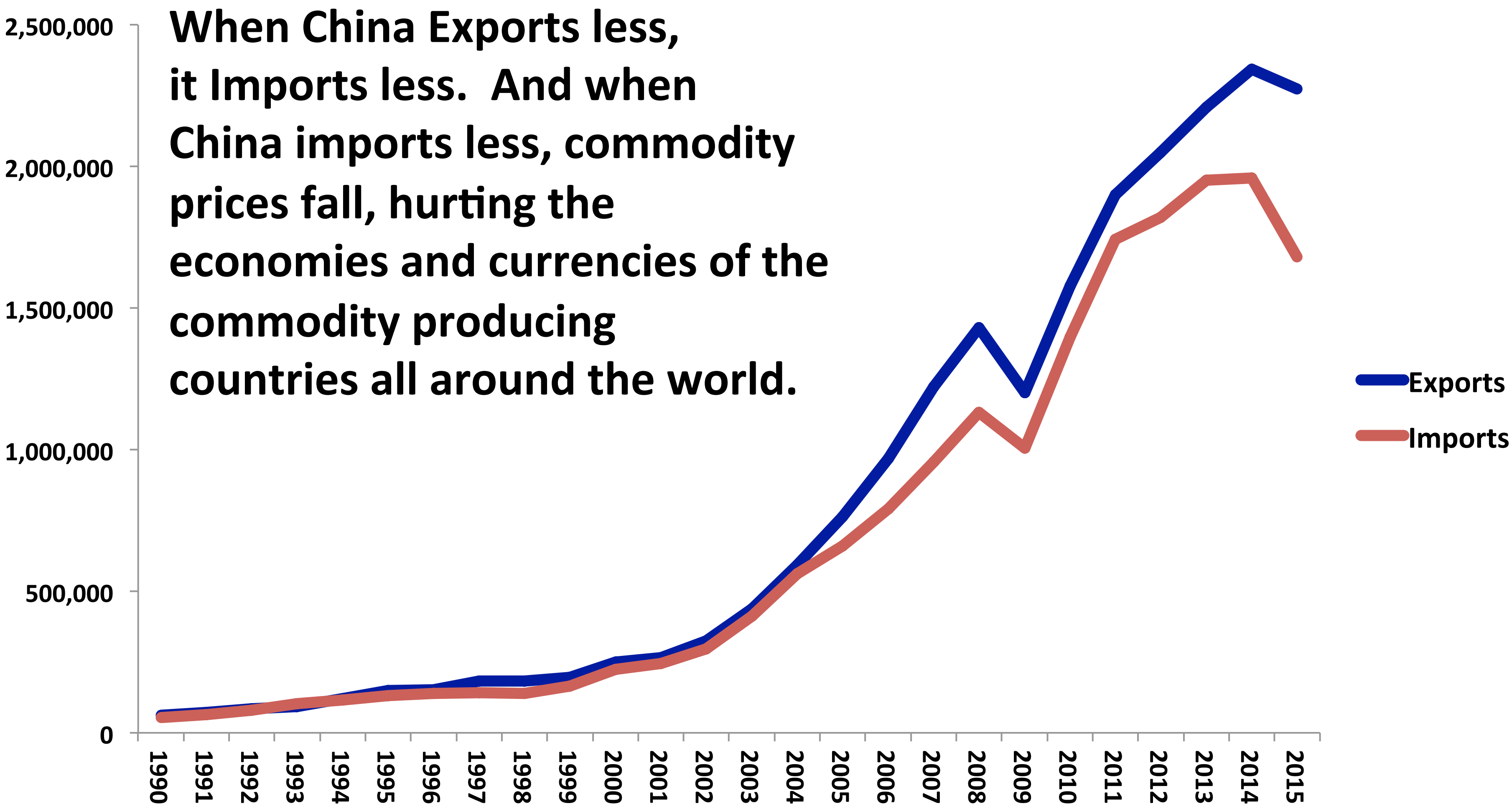
China's Exports & Imports

US$ Millions, 1990 to 2015



Source: CEIC

If China's Economy Implodes

- China's economy is already verging on crisis. It has massive excess capacity across practically every industry. So, product prices are falling, companies are loss-making and the banking system is stuffed with unrecoverable loans.
- If China's trade surplus were eliminated, the negative impact on China's economy would be devastating.
- In all likelihood, China would experience a severe depression, that could threaten the rule of the Communist Party.
- China might respond militarily – just as Japan did at Pearl Harbor after the US imposed an oil embargo on Japan in 1941.
- No one should underestimate the damage that could result from an economic crisis in China.

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Global Liquidity Would Dry Up

- When the world was on the gold standard, "global liquidity" depended on the discovery of new gold mines. Sometimes there was too much gold (16^{th} Century Europe, which caused inflation) and sometimes not enough (late 19^{th} Century America, which caused deflation).
- But under The Dollar Standard, global liquidity is determined by the quantity of Dollars in the global economy; and the principal way in which Dollars are injected into the global economy is through the US Current Account deficit.
- If the US Current Account Deficit were eliminated, the supply of Dollar liquidity would be too tight to support economic expansion.
- That would probably result in global economic stagnation or worse.

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The Undesirable Consequences of Eliminating The Trade Deficit

5. The elimination of the Current Account deficit would cause a sharp reduction in capital inflows into the US, which would also cause US interest rates to rise.
6. Higher interest rates would cause credit to contract and the US economy to go into recession.
7. Higher interest rates would also cause a sharp fall in US asset prices. That, too, would also cause the economy to go into recession.
8. Higher interest rates could cause a wave of credit defaults in the US and around the world, potentially leading to a new systemic financial sector crisis.

A Better Way

- For all of these reasons, I'm very concerned that it will not be possible to eliminate the US trade deficit without causing the global economic bubble to implode into a new great depression.
- Rather than attempting to eliminate the deficit, it would be wiser for the Trump Administration to allow the deficit to persist, but to pursue policies that would increase aggregate demand in the countries the US trades with and also in the United States itself.

A Better Way

- For instance, the US could enact policies that would force China to increase wages in its manufacturing sector. That would increase China's demand for US goods without causing a crisis in China.
- At home, the US government could sharply increase its investment in new industries and technologies. That would boost US purchasing power and growth – and, that investment could be financed at very low interest rates thanks to the deflationary pressures and the capital inflows resulting for the US trade deficits.

Conclusions

- The proposals outlined thus far by President Trump suggest that:

1. The budget deficit would grow larger (due to tax cuts and increase government spending);
2. The current account deficit would shrink (due to renegotiating trade deals, bringing US factory jobs back to the US and possibly trade tariffs);
3. And inflation would pick up (due to increased government spending, higher US wages, pressure on China to push up the RMB and, possibly, tariffs).

A Recipe For Disaster

- If those policies really are adopted, they would be a recipe for disaster because they would push US interest rates significantly higher – and that would pop the global economic bubble.
- If it pops, it may be possible to reflate it again with even larger amounts of Quantitative Easing.
- On the other hand, it might not be, in which case the world could be plunged into a new Great Depression.
- In that scenario, massive wealth destruction would only be the beginning of our problems. Our political institutions would probably not survive the strain.

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