Macro Wide Angle

Phase - A

JFK was always asking his Chief Economist the same question: "Where are we on the LM curve?" Let us assume, not ironically, that D. Trump asks a similar question today to L. Kudlow: « Where is the economy on the 50 years long Kondratieff cycle – Phase (A) or (B)?» Others have recently formulated the same question in a different way: "Would the world look the same in 5-10 years as it has over the past 50?[1]

J. Schumpeter explained long ago that each phase lasts 25 years, amounting to a complete cycle of 50 years. Innovations create a new demand during the unfolding phase (A) of expansion. Thereafter a 25-year phase (B) of so-called "creative destruction" unfolds to make room for the next cycle. In my view, J. Rifkin offers a far better explanation through his historical analysis, which points out that phase (A) could be the result of a combination of new energy and communication forces[2.] Since 1998, the world economy has expanded along phase (A), courtesy of the combination of nuclear energy and digital communications and this expansion should last until 2023.

[1] TIS Group – Report from the road – Part II — 03/18/2019
[2] J. Rifkin – Une nouvelle conscience pour un monde en crise – BABEL – p.52

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True, the financial crisis of 2007 momentarily interrupted the upward cycle for two years. But thereafter it resumed mainly because it was re-activated by a 10-year nested cycle, known as Juglar, as a result of which the S&P-500 rose uninterrupted for 10 years. But the significant correction at the end of last year seems to indicate that this Juglar cycle (2009-2019) is over and that the world economy shall henceforth limpi along the already 20 years old phase (A) of the Kondratieff cycle until 2023[3]. The S&P-500 could be limping along too.

2023

If all the economies will continue to grow until then, not all will reach 2023 unharmed. Some of them will reach that top level in a bad shape meaning loaded with debt. Why? In Physics, $E = M*V^2$, which indicates Energy is the work of two forces, namely, (1) Mass (M) accelerated at the squared (2) Speed (V) of light, as applied in nuclear fission. In Economics as well, GDP is a vector resulting from the combination of two forces: (1) Demographics and (2) Productivity. Hence, G = D*Pvity. Taking the first-order differential of this log expression provides you with the empirical equation economists use most to predict economic growth: $\Delta GDP = \Delta W + \Delta Pvity$, where (W) accounts for the people effectively at work.

Now debt accumulation does not come from nowhere and politicians should not be systematically accused for its occurrence. Indeed, when Workforce and Productivity unfolds at the same rate along a Razor Edge steady state[4] because the former grows at the same speed as the latter, courtesy of appropriate capital spending,

[3] TIS Group – Report from the road – Part II — 03/18/2019 “The Kondratieff winter ends with a monetary re-set, probably around 2020-2022. Major shifts in U.S. government spending, taxes regulation and political re-alignments are unfolding. Austerity is out, spending and growth-oriented policies are in.“

[4] R. Solow - "A contribution to the theory of economic growth" - Quarterly Journal of Economics - 1956

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debt is of no recourse. The economies that have been riding phase (A), especially the nested Juglar cycle of the last 10 years, by rigorously balancing the rate of growth of their Workforce with that of their Productivity will reach the top of 2023 with no debt to carry. These are the virtuous supply-driven.

Imbalance

But whenever the two sources of GDP growth do not grow hand-in-hand, debt necessarily comes into the picture to fill the gap, for one of the two reasons:

- Either because Labor growth falls short of Capital spending and Productivity outstrips Employment, as a result of which consumers need to feed their consumption needs through bank loans in order to boost their demand since income growth has failed on them. Such has been the situation in Japan and China over several decades. Corollary: Since income and consumption growth both fell short of production, trade surpluses accumulated and postponed domestic consumption translated into accumulation of Foreign-Exchange reserves, which contributed in part to diminishing the overall debt situation in some countries.

- Or because Capital spending falls short of Labor intake, in which case debt accumulation also becomes a necessity to boost investment via public or private spending, as has been the case in the United States, whose economy has been a structural net borrower of capital – domestic and foreign - by a lack of savings[5] (S). This is not surprising since capital efficiency in the U.S. is very poor. $3 of debt has only been producing $1 of GDP. The country has been so inefficient at utilizing borrowed capital that another measure of capital efficiency – the Wealth/GDP ratio[6], is now at 500% –, which

[5] Except from a brief period 2009-2019.
[6] P. Dominici – Absolute Return Letter – November 2018.

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is way above its long-term mean value of 380%, to which incidentally, it will mechanically return. Failing to boost its long-term productivity, the U.S. had to finance its consumption spending by asset growth and debt leverage rather than productivity gains and income growth. Corollary: The Fed policy has become totally geared at preventing assets to depreciate in order to sustain debt and consumption growth.

Phase - B

At the end of this debt super-cycle - $240 trillion, GDP $70 billion[7], i.e., Debt/GDP > 300% -, the world economies can therefore be split into three categories:

- (1) The virtuous supply-driven economies will be able to steer their way safely down the 25-year cycle of phase (B) beyond 2023. Among these, Germany (55%[8]), Ireland (64%), India (67%), Israel (61%), the Netherlands (50%), Switzerland (41%), Australia (41%), Chile (24%) and South Korea (38%) stand out because of their marginal indebtedness.

- (2) The demand-driven economies, which could miss a turn in the downhill phase (B) because of their excessive debt weight. In particular Greece (181%), Italy (127%), Portugal (117%), Belgium (99%), France (96%), Spain (95%), the U.K. (85%) and many of the Emerging Economies especially Venezuela (172%), Sudan (176%), Cape Verde (126%), Brazil (90%), and Egypt (87%). The exceptions in this category are Japan and China. The former because its excessive debt load (234%) is in part compensated by more than a trillion dollars of Treasury investments, which could be easily deleveraged during phase (B); the latter which is

[7] M. Santi - La dette, l'argent, le péché - 18/03/2019
[8] All figures in brackets are the respective debt/GDP ratios.

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the only heavy weight country will very marginal debt (54%) and with close to two trillions in Treasury investments.

- (3) But the big exception in this downfall scenario remains the United-States, courtesy of the Dollar. Endless printing will soothe the shrinkage of the U.S. economy during phase (B) but at an incredible cost, namely, a 40% devaluation in the Dollar that will be matched in the long run by a stiff resurgence in inflation, a necessary protocol to wipe out all kinds of U.S. debts (109%), of which $21,8 Trillion (National debt), $19,3 Trillion (Private debt), $13,45 Trillion (Mortgage debt), $1,6 Trillion (Student debt) and $1 Trillion. (Credit Card debt).

Investment Conclusions

Beyond 2023 country selection will therefore be the name of the game in the matter of investments. Germany, Ireland, India, Switzerland, the Netherlands, Australia, Israel and Chile should all be over-weighted as they will remain somewhat immune to the downhill phase (B), courtesy of their light indebtedness. In Asia, China should be preferred to Japan and even to South Korea while the Emerging Economies should be avoided by all means, especially Venezuela, Sudan, Cape Verde, Brazil and Egypt given the increasing difficulties they may encounter in servicing their debt in times of duress. Indebted Euro-countries will continue to suffer from a stable Euro, which will stand against spreading hyperinflation and wiping out their debts. But the whole world will experience a secular bear market typified by declining P/E multiples, as already heralded by the 2018 multiple contraction.

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