# GLOBAL ECONOMIC SITUATION

A Detailed, Objective (As Much as Possible) Investing Analysis


ABSTRACT

Western media is giving a biased view on the current economic situation. Not knowing what is going on in the world might cost you dearly over the next few decades. Plus, it is dynamic. Thus, it changes all the time, having a fixed perspective is risky.



Sven Carlin, Ph.D.

Stock Market Investing Course - FREE

The Current Economic Environment – A Detailed, Objective (As Much as Possible) Investing Analysis

Written: November 2019

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The Goal: To probabilistically explore economic developments over the next decade and their impact on various assets and investments. I am doing this research to see whether I am well positioned with my investments and portfolio to be ready for whatever might happen. The mantra is always the same: "Low Risk, High Reward".

## Contents

## Introduction

In a recent interview at the Greenwich Economic Forum, Ray Dalio and Paul Tudor Jones, both very respectable investors, completely trashed the current economic system. The interview built on Ray Dalio's article titled: **The world has gone mad and the system is broken**.

Dalio and Jones explained how the economic situation we are enjoying now is mostly thanks to high government deficits and 'free money' given the low, or even negative interest rates. The abundance of money fuelled stock market bulls for the last 10 years. Investors are awash with money that they are happy to invest in anything, even just promises, not earnings. This leads to high valuations that have historically led to negative real investing returns.

The 3 things they emphasized as big current and future issues for the economy are the following:

- The large and growing **wealth gap**. The printed money and low interest rates work only for those creditworthy. Thus, the money doesn't trickle down to all people and therefore, the wealth gap is increasing. According to them, this should lead to a rise is populism, higher future taxes, etc. like it was the case in the 1930s.
- Absence of **monetary policy** effectiveness. It is clear that all the fiscal deficits and practically free money is only enough to keep economies above water. Growth is slow and the big question is what will happen in the next downturn. And, downturns will come, they always do.
- The change in the world order due to the **rising power of China**. This leads to natural conflicts like the ones we are currently experiencing in the form of trade wars, technology wars, geopolitical wars (Honk Kong) and geocapital wars.

In short, we are at the end of the current monetary system and at the end of the long-term debt cycle.

Just shortly, my counterarguments:

- The wealth gap is there but how important is it? We live in a world of opportunity, that is globalized and allowed me to quickly move out of poverty, being born in the former republic of Yugoslavia. All you need is to speak English and be willing to work. Plus, if I look at the poor in the Netherlands, all have yearly vacations, subsidized rents and live a pretty good life. Yes, perhaps taxes will go up to cater and pay for higher requirements, but given the monetary policies out there, perhaps not a big deal. We are not in the 1930s. Unlikely there will be mass starvation.
- Monetary policy isn't working. Ok, so we will go to directly giving money to fiscal entities and people. The so called modern monetary policy. Policy makers say it all the time, they will do whatever it takes. Plus, it is all dynamic, information travels extremely fast and decisions are made based on current data while we all already know currencies will be sacrificed.
- China is rising, you can't fight 1.5 billion hard working people. There will be ups and downs, but the markets are already so integrated that you can't simply erase the 4,000 stores Starbucks has in China. Global capitalism could be stronger than local political egos.

The big question is what to do, how can we prepare or even take advantage of what is going on? And, what is actually going on and where in the world?

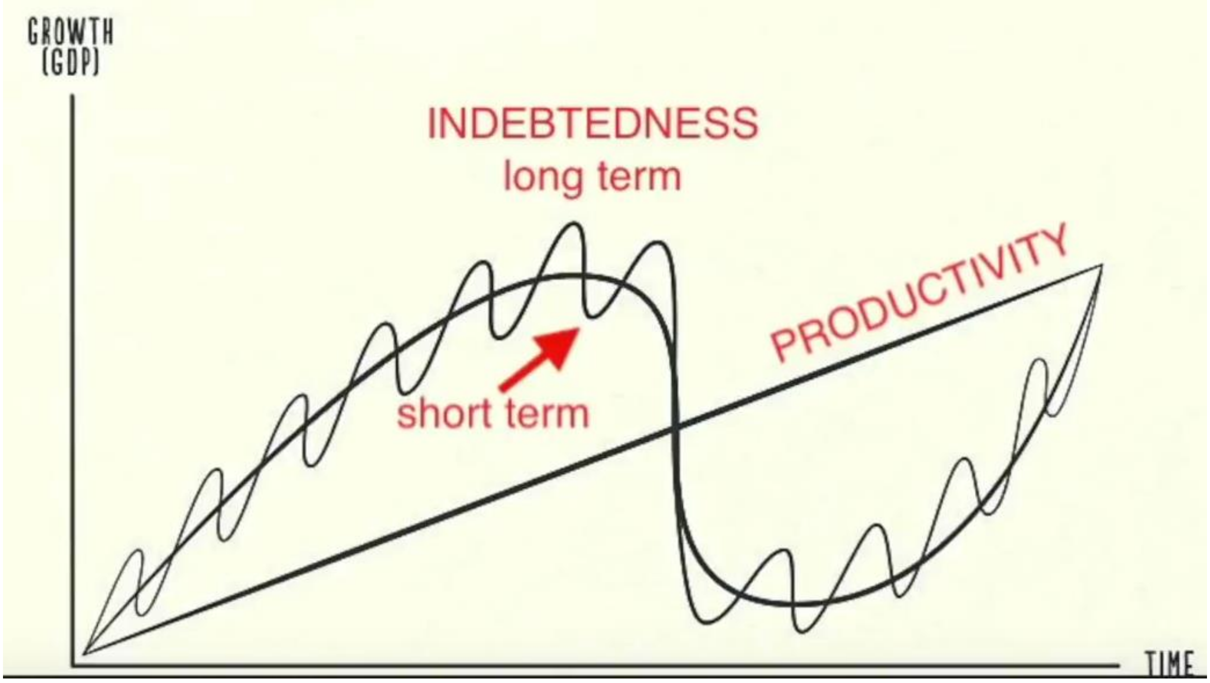
The world is more divergent than the info you might get in a western environment and therefore we must carefully assess risks and opportunities. There are always opportunities out there for those that are willing to look.

## The Global Economy

The environment is full with debt and according to Dalio, and common sense; we are at what should historically be explained as the end of the long-term debt cycle.

The main long-term driver of economic growth is productivity. If there is more knowledge, more technology, more people and more capital invested in development and education, productivity increases and the economy expands. However, productivity increases as education increases, in a broad sense. Unfortunately, education doesn't grow fast enough, plus developed countries' demographics aren't helping either due to aging. This leaves debt as the only option to keep up with global growth. As we all know, debt is a vehicle where we renounce future spending for current spending. Thus, something that unavoidably reverts in the long-term.

Figure 1 The long-term, short-term debt cycles and productivity over time



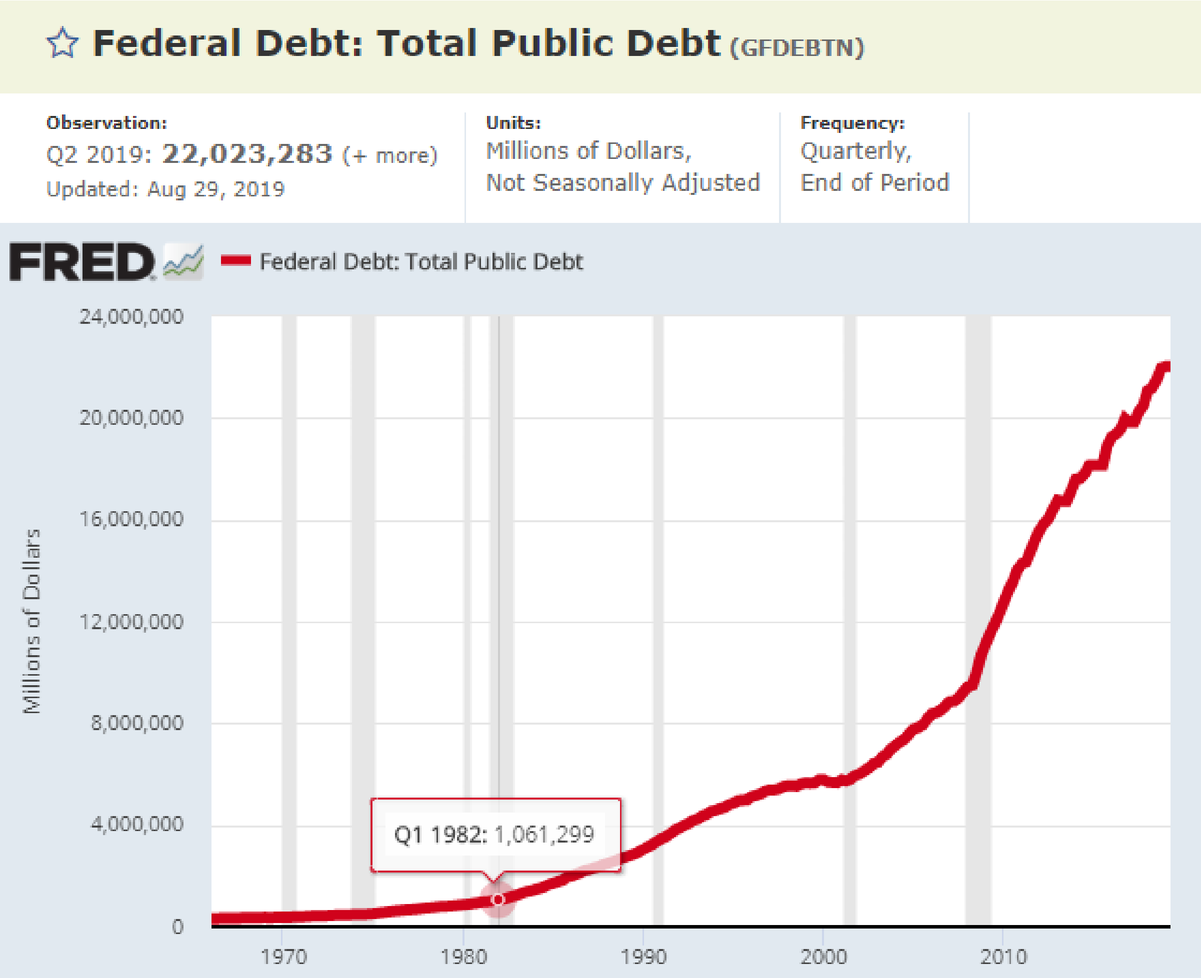

Source: [Ray Dalio – Linkedin]

At some point in time, it is inevitable for the debt to start hunting you back. It is actually what is already happening in the United states. The country has to borrow more just to pay interest on the previously consumed debt. Thus, the debt is not used to build schools, improve medical care or something that is adding value. No, the debt is used to finance interest. Let me give you a short overview of the global debt environment that will also show the unsustainability of large public debts and deficits.

## The Elephant in the Room - DEBT

Debt, both public and private has skyrocketed globally over the last decades. In the US, public debt, that does not include future, but certain and growing, liabilities for healthcare and social security (add $25 billion discounted to the present day), has increased 22 times since 1982. It might not be a coincidence that the S&P 500 has increased 30 times since then.

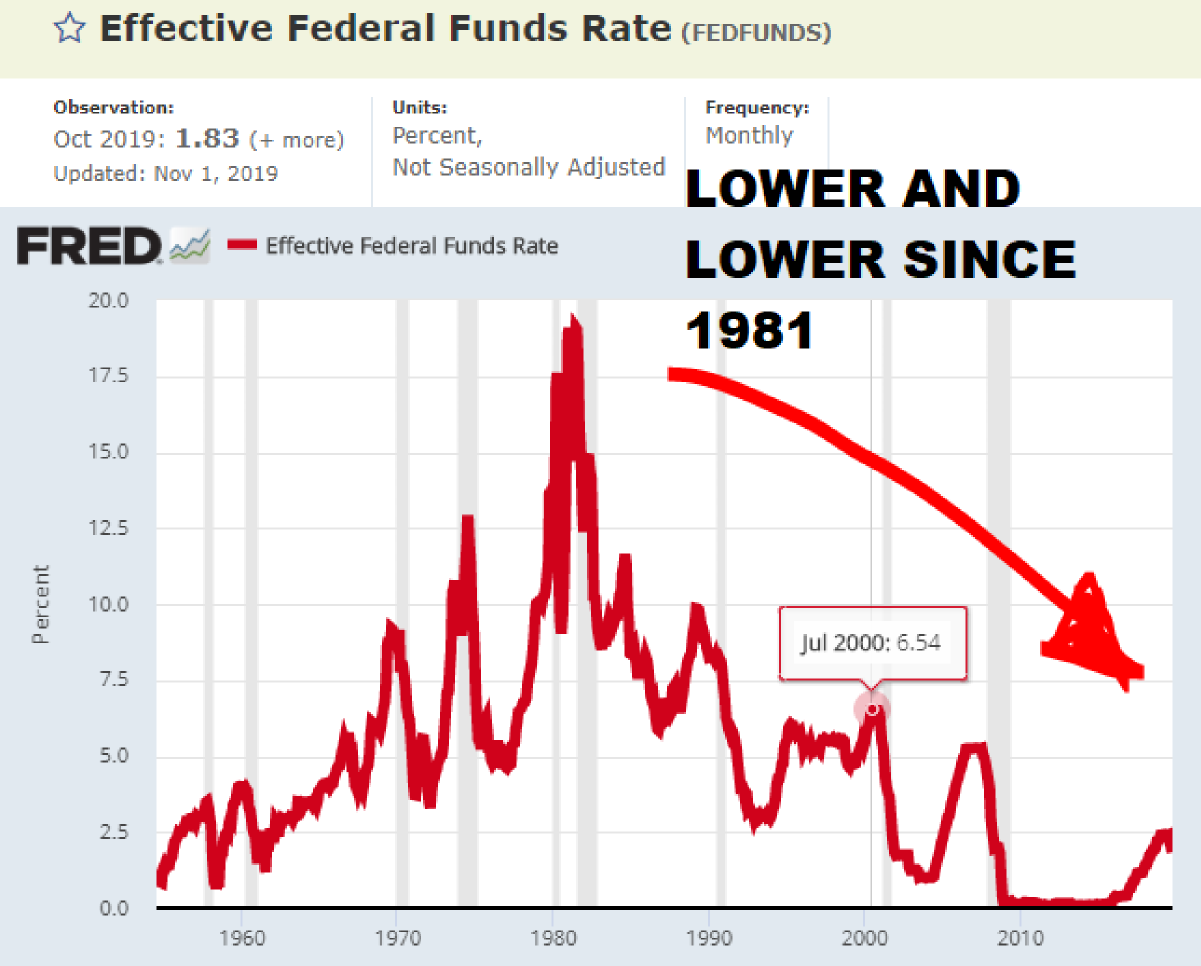
Figure 2 US total public debt has been exploding




Source: [FRED](FRED) – US Total Public Debt

The slow growth of productivity, population growth and increased global competition, leads to a situation where to enable growth, governments, corporations and people, have to reach into debt, more and more debt, to sustain economic growth. No government wants to be the bad government and put a stop to this, so they keep printing money and lowering interest rates to create a financially stimulating. This is called pushing on a string.

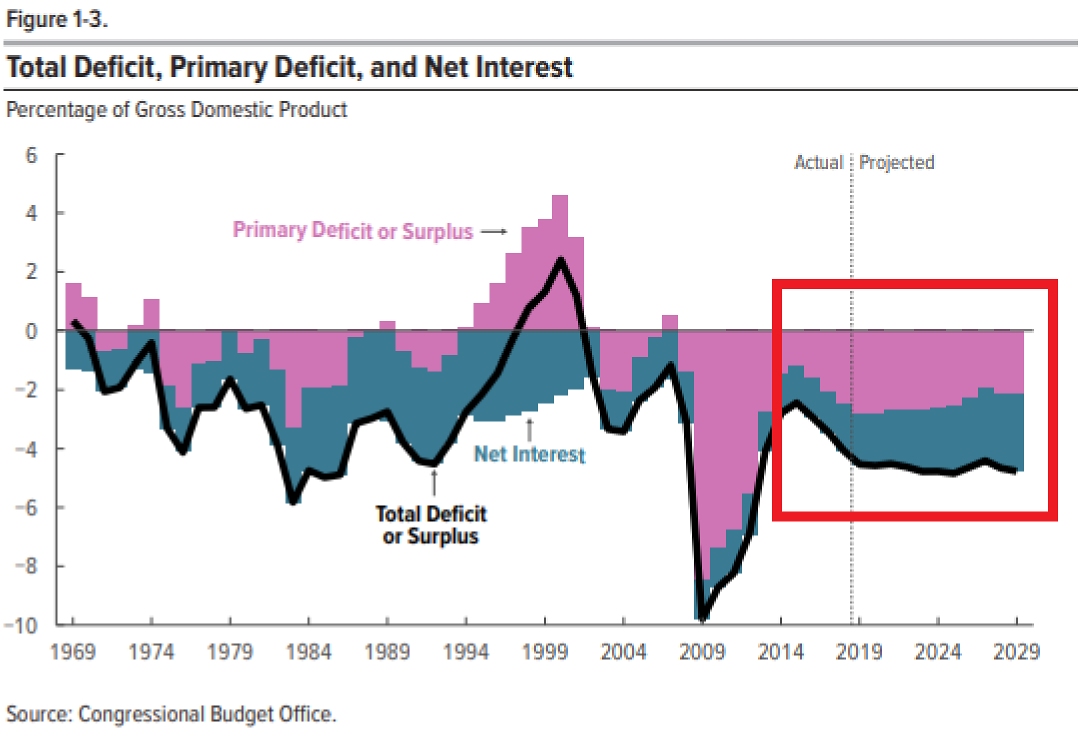
Figure 3 Interest rates are close to zero on a global level – US example – Effective Federal Funds Rate




Source: [FRED]

The pushing on a string can work for as long as there is trust in the currency. For now, given the abundance of money, there is also high demand for government debt, albeit often financed by central bank printing. The best example of how unsustainable this method is can be shown by looking at how 50% of the US budget deficits is used to pay interest on previously issued debt. A scheme where one has to borrow to pay interest on previously issued debt is often called a Ponzi scheme. But, for now, there is still trust in the environment.

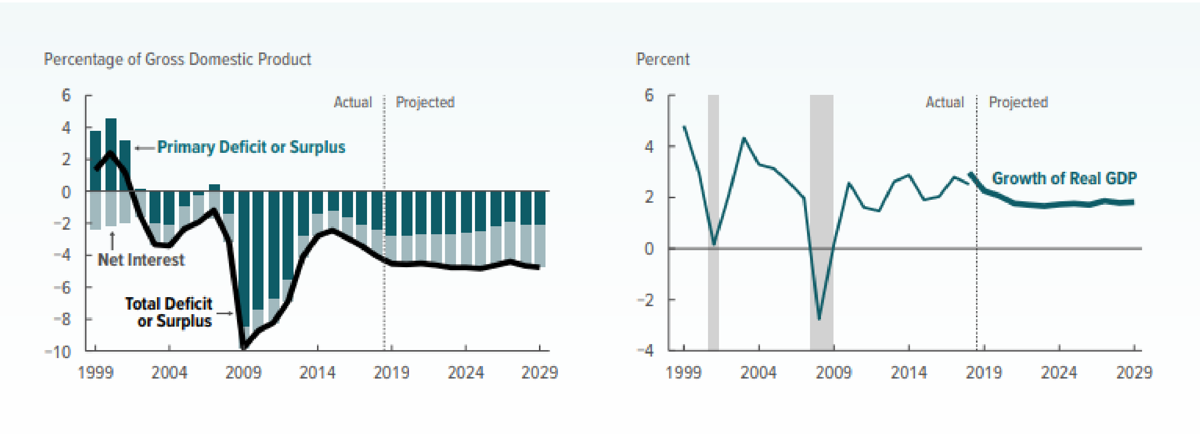
Figure 4 CBO projections up to 2029 – part of deficit used to pay interest (blue)




Source: [CBO – August 2019]()

When you have to borrow to pay interest, your debt burden can only go higher. The CBO projects US budget deficits to remain at 5% of GDP for longer (more than one trillion $ per year) alongside slow economic growth. Keep in mind economic growth projections never include unavoidable recessions.

Figure 5 Expected US budged deficits and economic growth




Source: [CBO – August 2019]()

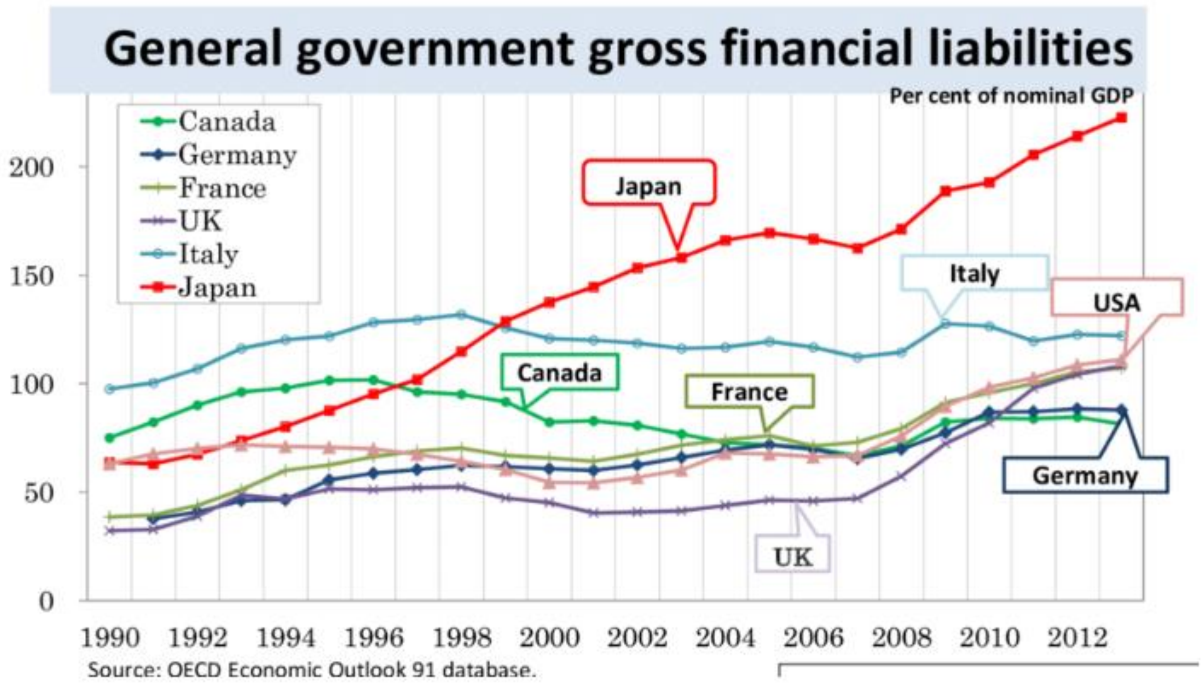
Now, the key investing thing here is that there is not much panic around the world related to the above, clearly unsustainable, debt issues. Why is that?

## Why is there no debt panic? The AHA moment!

The first reason why nobody is panicking, is that debt has been exploding all around the world. So, like with kids, the main mantra is: if they can do it, I should do it too.

Debt in Japan, the first country seriously affected by slow growth, has been exploding and the Bank of Japan is printing so much money that it has become the largest owner of ETFs in the country. The BOJ owns 77.5% of all the ETFs in the country and is on track to become the largest shareholder of publicly traded stocks in Japan. Owning 4.7% of the total market.

Figure 6 Government debt to GDP ratio




Source: Defying Gravity - Research Gate – Takatoshi Ito

Japan didn't see much economic growth lately but also trust in currency hasn't been really lost, there is little inflation, at least, there is no inflation in the way the governments measure it.

The second reason why nobody is worried about the debt, is that, for example, interest rates in the United States, are extremely attractive when compared to the rest of the world. If everybody has loose financial policies, all currencies trade within an equilibrium without sudden collapse. Further, cheap money allows for high competition that lower prices and subdues inflation. For example, shale oil production in the US has not made a positive return to shareholders on aggregate. Thus, all the businesses surviving are thanks to cheap money. This increases competition and pushes oil prices lower, no matter the profitability.

Figure 7 Most developed countries have interest rates below 1%.

Summary of current interest rates of a large number of central banks

| Name of interest rate | country/region | current rate | direction | previous rate | change |
|---|---|---|---|---|---|
| American interest rate FED | United States | 1.750 % | ↓ | 2.000 % | 10-30-2019 |
| Australian interest rate RBA | Australia | 0.750 % | ↓ | 1.000 % | 10-01-2019 |
| Banco Central interest rate | Chile | 1.750 % | ↓ | 2.000 % | 10-23-2019 |
| Bank of Korea interest rate | South Korea | 1.250 % | ↓ | 1.500 % | 10-16-2019 |
| Brazilian interest rate BACEN | Brazil | 5.000 % | ↓ | 5.500 % | 10-30-2019 |
| British interest rate BoE | Great Britain | 0.750 % | ↑ | 0.500 % | 08-02-2018 |
| Canadian interest rate BOC | Canada | 1.750 % | ↑ | 1.500 % | 10-24-2018 |
| Chinese interest rate PBC | China | 4.150 % | ↓ | 4.200 % | 11-20-2019 |
| Czech interest rate CNB | Czech Republic | 2.000 % | ↑ | 1.750 % | 05-02-2019 |
| Danish interest rate Nationalbanken | Denmark | 0.050 % | ↓ | 0.200 % | 01-19-2015 |
| European interest rate ECB | Europe | 0.000 % | ↓ | 0.050 % | 03-10-2016 |
| Hungarian interest rate | Hungary | 0.900 % | ↓ | 1.050 % | 05-24-2016 |
| Indian interest rate RBI | India | 5.150 % | ↓ | 5.400 % | 10-04-2019 |
| Indonesian interest rate BI | Indonesia | 6.500 % | ↓ | 6.750 % | 06-16-2016 |
| Israeli interest rate BOI | Israel | 0.250 % | ↑ | 0.100 % | 11-26-2018 |
| Japanese interest rate BoJ | Japan | -0.100 % | ↓ | 0.000 % | 02-01-2016 |
| Mexican interest rate Banxico | Mexico | 7.500 % | ↓ | 7.750 % | 11-14-2019 |
| New Zealand interest rate | New Zealand | 1.000 % | ↓ | 1.500 % | 08-07-2019 |
| Norwegian interest rate | Norway | 1.500 % | ↑ | 1.250 % | 09-19-2019 |
| Polish interest rate | Poland | 1.500 % | ↓ | 2.000 % | 03-04-2015 |
| Russian interest rate CBR | Russia | 6.500 % | ↓ | 7.000 % | 10-25-2019 |
| Saudi Ariabian interest rate | Saudi Arabia | 2.250 % | ↓ | 2.500 % | 10-30-2019 |
| South African interest rate SARB | South Africa | 6.500 % | ↓ | 6.750 % | 07-18-2019 |
| Swedish interest rate Riksbank | Sweden | -0.250 % | ↑ | -0.500 % | 12-20-2018 |
| Swiss interest rate SNB | Switzerland | -0.750 % | ↓ | -0.500 % | 01-15-2015 |
| Turkish interest rate CBRT | Turkey | 14.000 % | ↓ | 16.500 % | 10-24-2019 |

Source: Global Rates

Thirdly, low interest rates and high deficits offer a strong support for the economy. Thus, with unemployment going lower, increased competition and global technology development keeping prices low, we are not seeing the above described environment as dangerous.

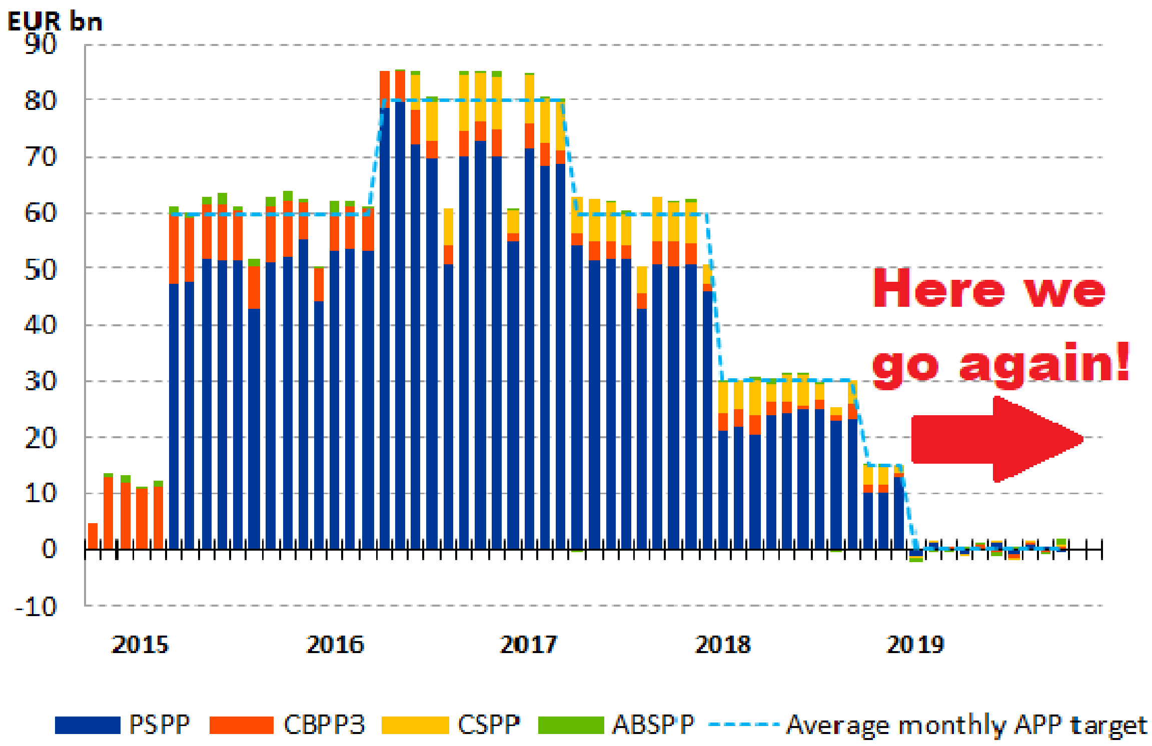
The fourth reason why nobody is panicking is of a psychological nature. Ray Dalio has been warning about the debt cycle and an imminent recession for half a decade now, but nothing has really happened. When something doesn't happen, people tend to disregard it as a possibility. It is like the fact that insurance sales spike just after a hurricane has struck. People need to see risk to embrace it. The last time the long-term debt cycle was risky was in the 1930s. The 1930s is something that probably nobody reading this remembers. For those that need reminding, the situation in the 1930s let to WWII.

Now, when will all the above mentioned issues matter? Well, when the next recession comes those should matter, or not?

## The Next Recession

Central banks and politicians have been doing whatever they can to postpone a recession. As soon as the situation in Europe started to slow down, the ECB launched a new bond purchasing plan where the bank intends to purchase €20 billion per month for as long as it takes for the euro zone's inflation and growth outlooks to return to satisfactory levels.

Figure 8 Historical ECB financial injections start again in November 2019

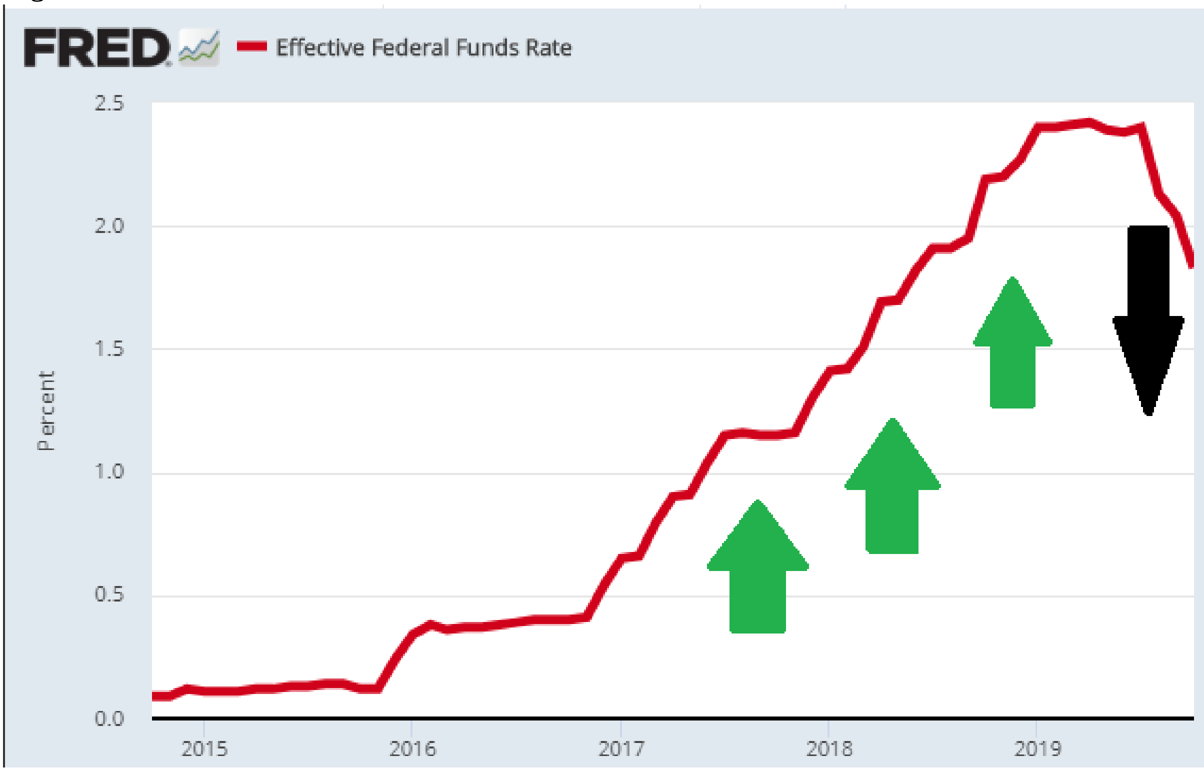



Source: ECB

This simply means that the ECB will print as much money as necessary for as long as necessary to sustain economic growth and stability. The ugly fact is that as soon as they stopped pumping free money into the system, the economy cooled off immediately.

Similarly, as soon as the FED increased interest rates, it was clear that due to the already high public, corporate and private debt levels, interest rates can't really go much higher.

Figure 9 Effective Federal Funds Rate 2014-2019




Source: FRED

## Monetary, fiscal policy and recessions

The thing is that recessions are a natural economic process and using whatever method to delay them, works for a while, but the future costs might not be worth it. We are already seeing how interest rates, that are usually the first method to use to regulate economies, can't be lowered much anymore. We are now seeing how the second method, purchasing financial assets is also reaching its limits, even in extremely positive times.

The third method, often called modern monetary policy, is a method where fiscal and monetary policy work together to stimulate the economy. Money is printed and given directly to the government. From the clues that we can get, where the new ECB president has been openly calling for more fiscal stimulus in Europe, have it financed by the ECB, we are just a step from a coordination of monetary and fiscal stimulus. The important thing for investors is, to quote: "governments who have the capacity to use the fiscal space available to them should spend on improving their infrastructure."

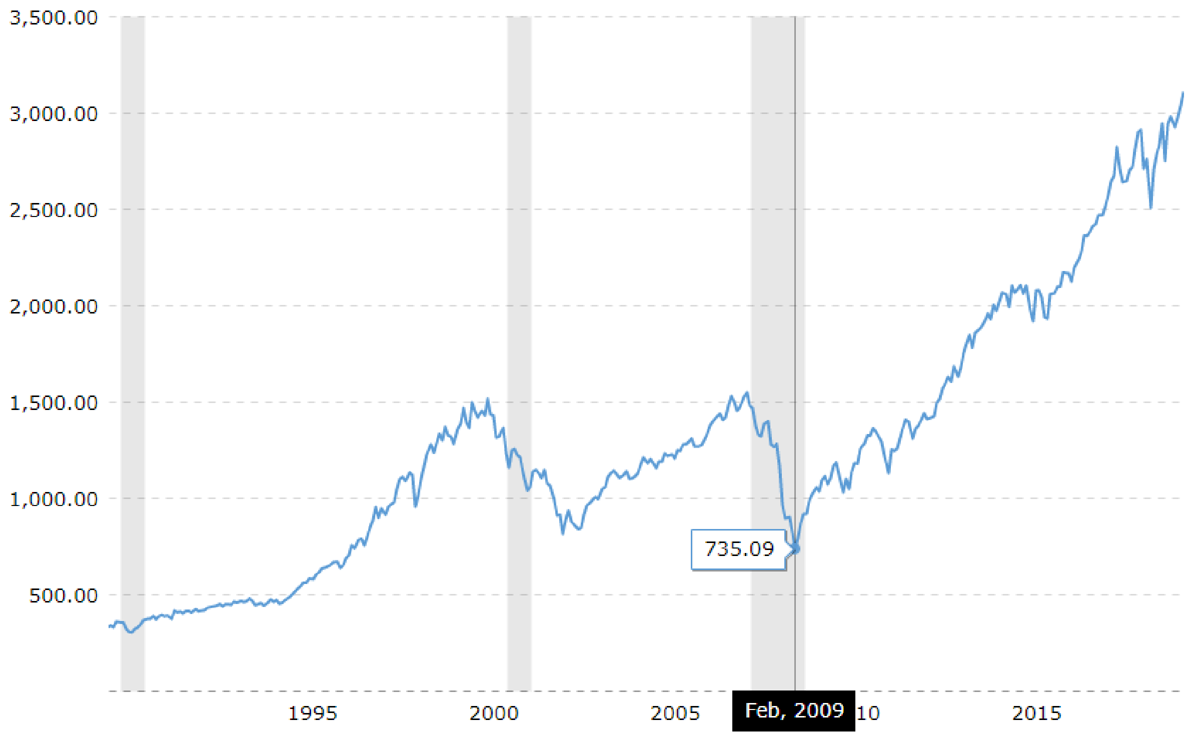
**Improvements in infrastructure mean more demand for the related industries. A thing to keep in mind when investing.**

In short, this simply means that companies in Europe will continue to be able to get free money, but I wonder whether it will help them remain competitive? As said in the beginning, it is not about debt, it is about productivity. Plus, at some point, somebody is going to yell that the king is naked and not accept the euro, or some other currency, as reserve currency. Imagine dealing with currencies where the counterparty has a printing press that can be used whenever necessary.

## The next recession and its impact

Nevertheless, economic slowdowns are natural and will happen again. We don't know when, but we can rest assured it will happen again. The question is: What will be the impact?

Well, the last two times there was a recession, the S&P 500 fell close to 50% from top tick to bottom tick.




So, many expect that the next recession will have a similar impact on stocks. However, history tells us that the average stock market decline during a recession is just 5.6%. Plus, all what we discussed above about financial stimulation, might really push stocks even higher despite a recession as central bankers and politicians will probably put money directly into your hands to help you buy whatever and push the economy higher.

So, when it comes to recessions, and especially in the current environment, it is really uncharted territory. It looked bad last two times, but there is absolutely no guarantee it will be the same a third time. We are in an environment where nobody knows what it will look like.

**The investing message is simple, invest in businesses that will do ok if there is a recession and do good if there isn't one. Buying businesses that will go bust in a recession is gambling.**

This was about the economy, but what about our currencies and the debt cycle?

## The long-term debt cycle solution (TELLS ME THINGS CAN GO ON FOR A LONG TIME)

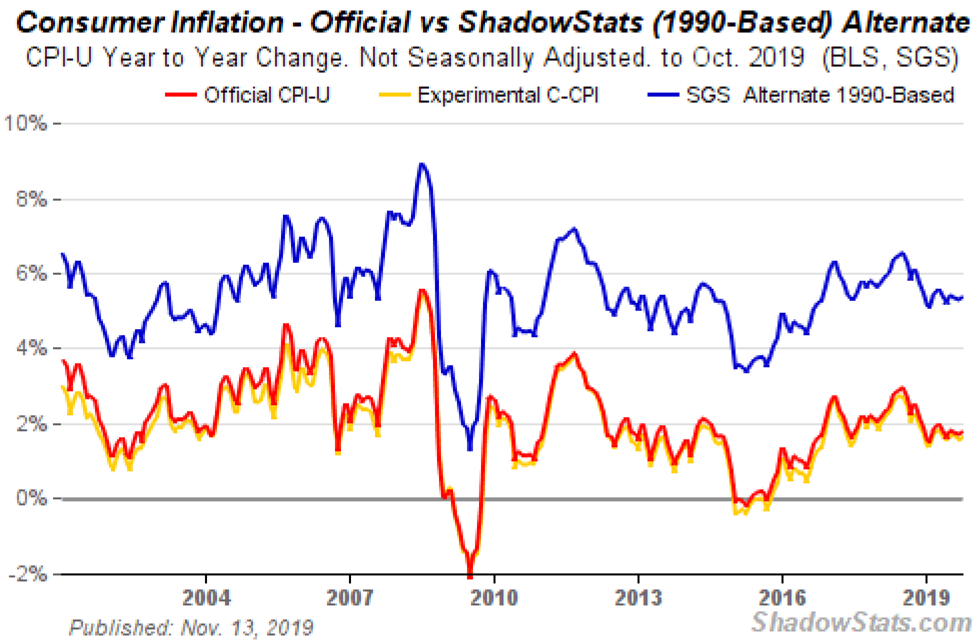
The conclusion is simple, the only way out from the huge debt burdens is to sacrifice currencies. Something that has been happening for a long time now, but it happens through small steps that you don't really notice. Also, it happens in a few areas where there is limited supply.

For example, Harvard tuition costs rose from $40,000 in 2005 to the current $67,580. If a home in Amsterdam cost €100 in 1990, today is costs €500. We don't even have to mention stocks, up 30 times over the last 35 years and many forget it, **but buying stocks and other financial instruments is the cost of your retirement**. The higher stocks go, the more expensive it will be to retire as you'll need to save more and more to build a nest egg and create an income yield. So, I would argue that we don't have to wait for inflation, inflation is already here.

## Inflation – measured and real

You have two inflations, one that is measured statistically by the government and adjusted for, improvements in the quality of the screen on your phone, for example. And you have real inflation that tells you how much does something cost. The difference is staggering and trust me, in life, it only matters how much something costs, not whether it has a 4k or 8k retina.

Figure 9 Real inflation is double what you might think




Source: Shadow Stats

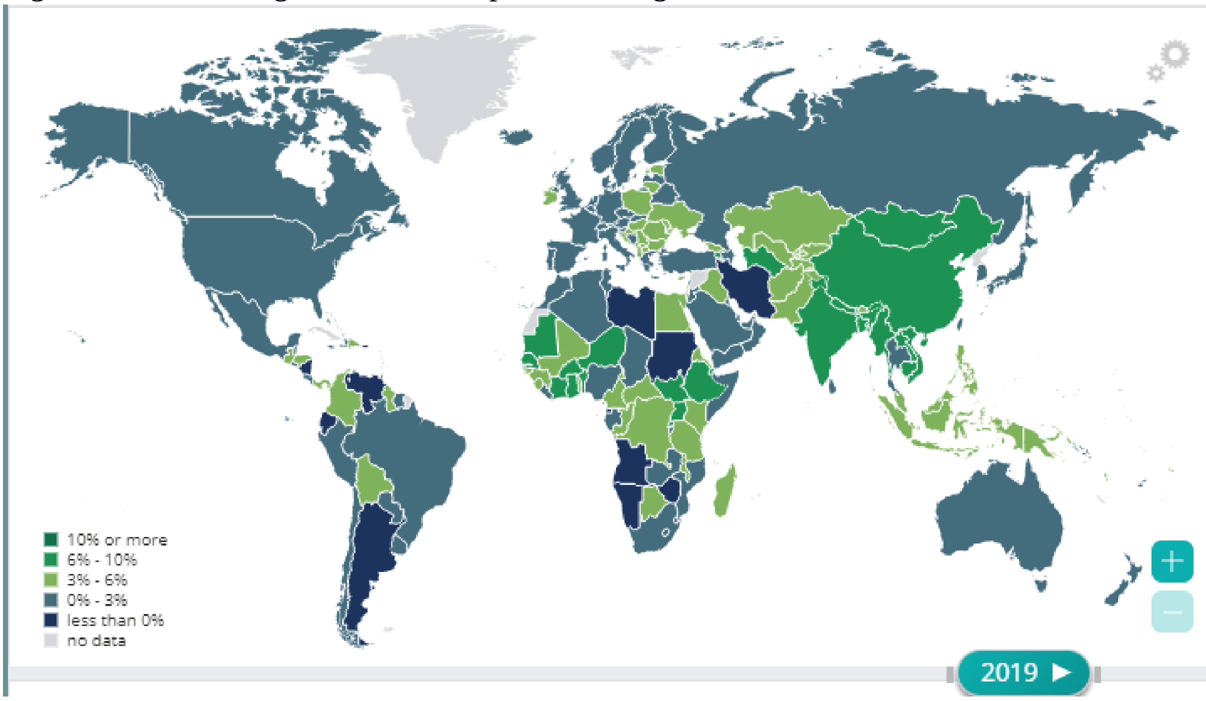
**The message here is pretty clear for bond investors; if you wish watch your money burn, hold long-term bonds.**

All the above sound a little bit like a doom and gloom forecast. If you look at the global GDP map, developed countries show slow growth alongside all their debt issues. A recession has been due for some time now and stock market valuations are high. However, this doesn't mean anything. A recession can come, but it can also be a mild one, like the ones in 2001 and 1990.

## What is going on in the world – growth and connectivity

When investing, or doing anything else in life, you have to always check whether you have a biased opinion or not. We are mostly listening to what western media outlets say and what western investors say. The picture they paint is in line with the situation in their environments. A look at the 2019 global GDP growth map shows how the growth is slow in developed economies, despite all the financial stimulus.

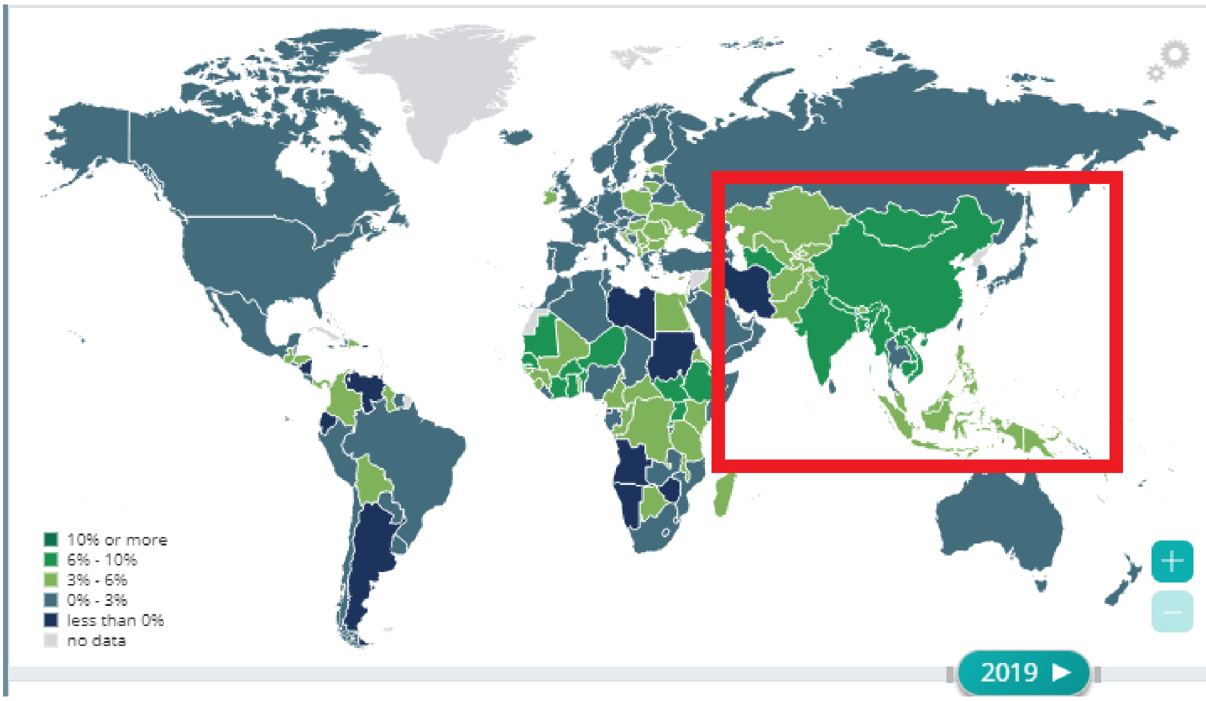
Figure 10 Real GDP growth – annual percent change




Source: [IMF]

However, if you don't focus on the grey on the above map, but on the bright green, you see a square with 4.5 billion people growing between 3% and 10%.

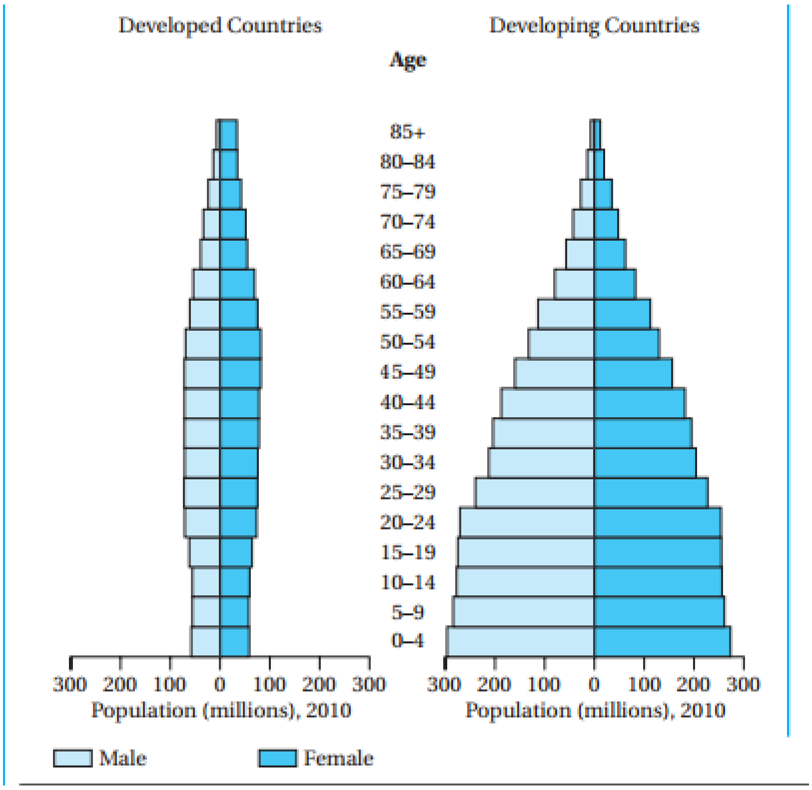
Figure 11 No matter what they say, Asia is growing fast while starting low and has billions of people




Source: [IMF]

I firmly believe, the Asian economic development should be the most important piece of news discussed on a daily basis. 4.5 billion people outweigh the 1.3 billion in developed countries. Plus, developing countries are much younger, more eager and thus, economic growth will continue, just perhaps not in your currency and not where you might wish it happens.

Figure 12 Population pyramid – developed and developing countries – 1.3 billion vs. 5 billion



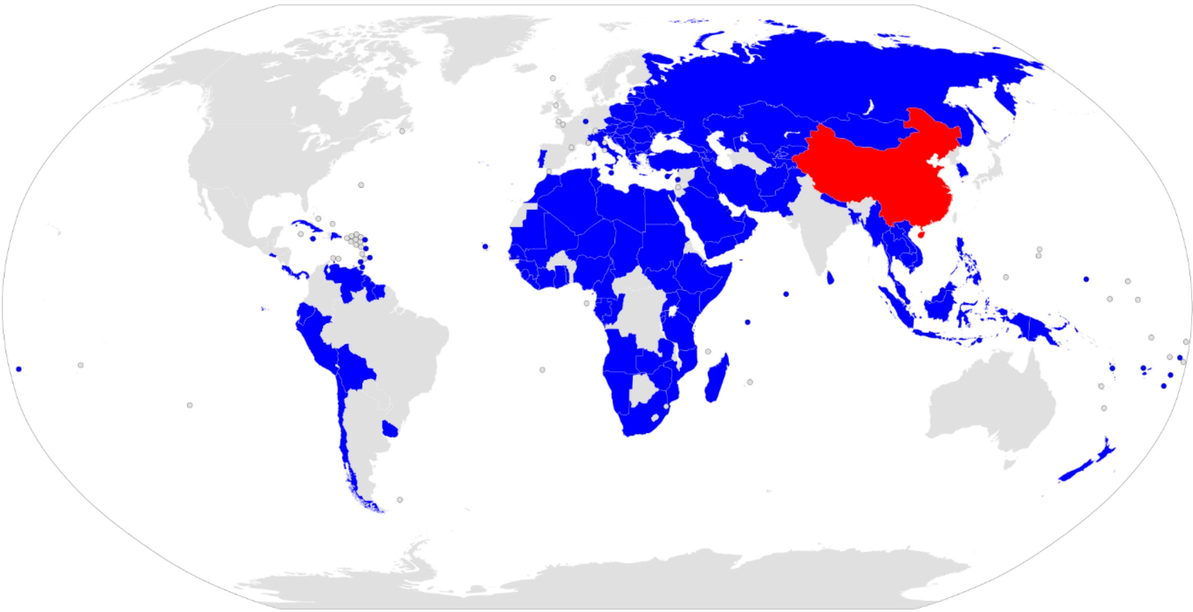

Source: Research gate

### Connectivity, synergy and development

Then, there is something that makes comparing things to the 1930s, like Dalio is doing, practically worthless. In the 1930s, the new deal saved America. Today, we have the Chinese One Belt, One Road initiative working and developing the word – trade wars or no trade wars, this thing is moving forward. The purpose of the one belt one road idea is to "construct a unified large market and make full use of both international and domestic markets, through cultural exchange and integration, to enhance mutual understanding and trust of member nations, ending up in an innovative pattern with capital inflows, talent pool, and technology database".

The number of countries that have signed documents related to the initiative is staggering.

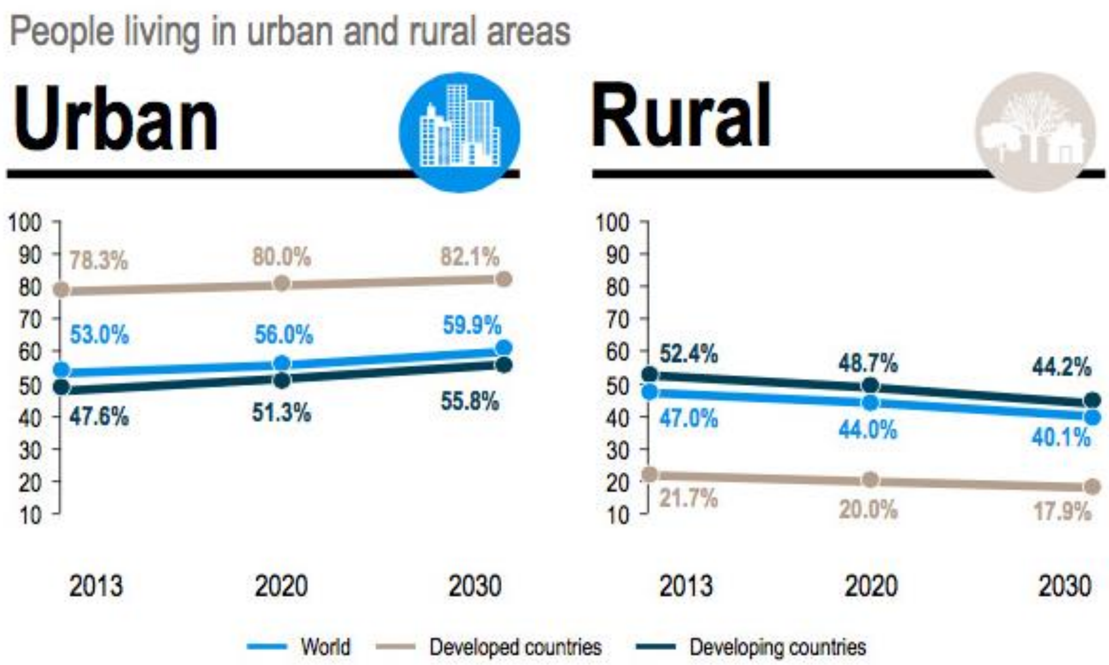
Figure 13 One belt one road footprint



Source: Wikipedia

Apart from the belt and road initiative, there is so much more that still has to happen, that can easily outweigh the 'bad' going on with developed countries. Just an example is urbanization.

Figure 14 250 million will move to cities over the next 10 years




Source: Consultancy

If the level of urbanization reaches the level in developed countries, there is a few billion homes that still have to be built over the coming decades. Not to mention infrastructure etc.

Then, perhaps the most important thing that wasn't there in the 1930s, is technology and the internet. If I wish, I can chat with somebody in India in the next 30 seconds, I can hire people all over the world and the world is getting more and more connected. This communication, information and human connectivity, alongside economic connectivity, will keep the world much more integrated than it was the case in the 1930s.

## Conclusion – what to take from this as an investor

Recessions can happen anytime and will happen sometime. There is nothing we can do about it but we can have some certainties:

- Currencies are and will continue to be sacrificed all around the world.
- The global economy will continue to grow with ups and downs. The power of developing Asia is incredible.
- There will be many issues in developing countries, but I'll park my money where whatever happens, I end up well off.

There are businesses selling in Asia and there are businesses selling in France and Italy. There are businesses selling globally and there are businesses focused on the local market depending on one company. Thanks to globalization, we can pick where to invest. That is what we as investors have to focus on. Dalio is playing a macro game, and he is really playing a game and he is a relative investor. Thus, the macro is what matters to him.

Individual investors have to play the micro game, invest is what you need, minimize your risks and accept volatility as your best friend. It allows you to buy cheaper and build your wealth faster. You can't time recessions nor predict economic developments.

It is pretty simple with the economy. In 15 years, the economy is going to be very different than whatever we can imagine now. It has been the case like that since ever.

15 years ago, nobody expected interest rates to be negative and stay so for almost a decade now. 30 years ago, China was a poor and weak country, now it is challenging the US for the globe's dominant country.

30 years ago, you could buy good businesses with dividend yields of 7%, today you can't. 30 years ago, we didn't even have email (author's note: I got my first email when I was 10 in 1993 – haha). So, worrying now about recessions or stock market crashes is a good story for the media to fill those headlines, but nobody knows what will happen. The solution remains always the same; invest in good businesses that will do well and deliver a good business returns no matter what happens and also, whatever happens, the businesses will be still in business. Focus on risk and leave the upside to the positive tailwind humanity creates.