

Opinion **Global Economy**

Braced for the global downturn

Well-meaning central bankers cannot offset the impact of an erratic US president on the real economy

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Rana Foroohar AUGUST 11, 2019

It's the calm before the storm. Last week's market volatility was ostensibly triggered by the US-China trade conflict turning into a full-blown currency war. But at heart, it's about the inability of the Federal Reserve to convince us that its July rate cut was merely "insurance" to protect against a future downturn. As any number of indicators now show — from weak purchasing managers' indices in the US, Spain, Italy, France and Germany, to rising corporate bankruptcies and a spike in US lay-offs — the global downturn has already begun.

Asset prices will undoubtedly begin to reflect this, and possibly quite soon. China may have temporarily calmed markets by stabilising the renminbi. But we are in for what Ulf Lindahl, chief executive of AG Bisset Associates currency research, calls "a summer of fear." He expects the mean-reversion in the Dow that started in January 2018 to turn into a bear market that lasts a decade.

It's an opinion based on data, not on emotion. There have been only 20 months since 1906 when the Dow's deviation from its trend line has been 130 per cent or more, as it is today. Those periods cluster rather frighteningly around the years 1929, 1999 and 2018. "US equities are at the second most expensive period in 150 years," says Mr Lindahl. "Prices must fall."

I don't think it's a question of whether we'll see a crash — the question is why we haven't seen one yet. After all, there are plenty of worried market participants, as best evidenced by the [\\$14tn](#) horde of negative-yielding bonds around the world. When this many are willing to pay for the "security" of losing only a little bit of money as a hedge against losing quite a lot, you know there's something deeply wrong in the world (full disclosure — most of my own net worth is now in cash, short term fixed-income assets and real estate).

My answer to the question of why we haven't yet seen a deeper and more lasting correction is that, until last week, the market had been wilfully blind to three things. First, the fact that there will be no trade deal between the US and China. Both sides are desperate for one but China will only do a deal between equals. Donald Trump is psychologically incapable of accepting this — his entire history demonstrates his need to feel that he has crushed the other side. It's a pathology that will only increase as the market goes down.

We've all known this for some time. But I think fear of what Mr Trump might do has been masked in part by algorithmic trading programs that buy on every dip that results from his erratic actions. This has diminished any lasting signal about the unsustainable current market paradigm.

Now, by allowing the renminbi to slide briefly after Mr Trump labelled Beijing a currency manipulator, China has shown that if the US president tries to play tough rather than play fair, it will take down the US markets and suffer whatever pain may ensue. It's a new reality hard for anyone to ignore.

In short, the [Thucydides Trap](#) is for real. In lieu of some big shift in US foreign policy post 2020 (one that none of the major Democratic candidates has yet articulated) the US and China are now in a multi-decade cold war that will reshape the global economy and politics.

Meanwhile, the Fed's decade-long Plan A — blanket the economy with money, and hope for normalisation — has failed. There is no Plan B. That's why gold is in demand, some hedge funds are putting up cash-out barriers, traders are shorting some investment grade bonds deep in negative yield territory, and we are poised to see the reversal of the last 10 years of capital inflows into US equities and the dollar. Mr Lindahl believes the US currency is now 25 per cent overvalued against the euro.

[The Fed](#) will undoubtedly try to paper over all this with more rate cuts. But as another savvy strategist, Dave Rosenberg of Gluskin Sheff, has pointed out, "the private sector in the US is choking on so much debt that lowering the cost of credit . . . won't cause much of a demand

reaction.” As he wrote recently, the term “pushing on a string” was first coined by Fed chairman Marriner Eccles in March 1935 to describe the bank’s inability to create demand via easier monetary policy.

It didn’t work then, and it won’t work now. You cannot solve the problems of debt with more debt. And central bankers, well-meaning and desperate as they might be to offset the damage caused by an [erratic US](#) president, can’t create real growth; they can only move money around. At some point, the markets and the real economy must converge.

I think that point is now. Capital expenditure plans are being shelved. Existing home sales are dropping, despite lower mortgage rates. And perhaps most tellingly, American consumers are cutting both credit card balances and their usage of motor fuel, as Gluskin Sheff points out — two things that are uncommon at any time, let alone in the middle of the vacation season. A summer of fear indeed.

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