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Weekly Buffet with Dave

9.13.2019
Economics & Strategy

David A. Rosenberg

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So What Changed Last Week?

From the September 9th edition of BWD

Quite a bit, actually.

Boris Johnson has dug himself a political grave by rolling the dice in suspending parliament and trying to call a snap election. The man who made Brexit his sole objective has now lost the initiative. What he did was blaze the trail for the House of Lords to approve a bill that blocks a no-deal Brexit, and the odds now of an extension of the October 31st deadline have risen dramatically. Not just that, but there is growing momentum for a second referendum. All this could be very bullish for sterling and U.K. assets.

The bounceback in risk assets has caused the markets to price out talk of a 50 basis point rate cut at the September 17-18 FOMC meeting — the odds are now 96% of a 25 basis point easing and the other 4% is for a 50 basis point cut. Just one reason why gold prices retreated last week (but are still up 18% for the year).

We had several central banks push back on easing policy — Canada, Sweden and Australia. These currencies responded in kind. The ECB also seems to be re-thinking its position on negative interest rates. So all of a sudden, we went last week to $15 trillion of global bonds trading with a negative yield from $17 trillion.

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We had two of the BRICs panic a bit with easing moves of their own. Russia cut rates for the third time this year — to 7.0% from 7.25%. And China's central bank, with its move to cut reserve requirement ratios, provided the equivalent of $126 billion of monetary stimulus. Much of this credit will be channeled, so it seems, towards transportation infrastructure — especially the rails.

Some things this week didn't change all that much, like the dire situation in Argentina with capital controls seemingly the only solution. And don't forget about the ongoing tensions in Hong Kong along with its first credit downgrade since 1995.

U.S. real GDP growth estimates remain rather uninspiring. Just 2% for Q3 from Macroeconomic Advisers and 1.5% from the Atlanta Fed. The NY Fed also trimmed back its Q3 growth view to 1.55% from 1.80% — seemingly unimpressed by the payroll data as much as we were. These don't sound recessionary but in fact are exactly the sort of sluggish numbers that immediately preceded the last three economic downturns.

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The global economy took a turn for the worse last week — the only reason the stock market rallied is because the USA and China said they are going to talk again about trade issues. Looking around the world, factory activity is contracting in the U.K., Germany, Japan and South Korea. As well as the USA — the ISM manufacturing PMI is down to three-year lows and the leading components are faltering. And as with the nonmanufacturing index, the export orders are sagging badly and an inventory overhang was evident in both surveys. Meanwhile, amidst last week's short squeeze in the stock market was the fact that the JPMorgan global manufacturing index contracted for a fourth consecutive month — the longest stretch in seven years (more than half the 30 countries in an industrial recession).

As for the US-China situation, all that is happening here is that there is the prospect of no more escalation in the trade war. But the damage has been done, and a Fed paper estimates that the lost global output growth in 2019 is just under 1% and just over 1% for 2020.

Monetary policy is no quick fix or antidote to these hurdles, which is why fiscal stimulus, even in Germany, is getting more and more press these days

Lost on the bulls is the reality that the move to boost the existing tariff rate on Chinese-made goods to 30% from 15%, and on a range of consumer items that American households love to buy, has not shown up in any of the data yet — except for the skew to retail sales and inventory numbers as people and businesses prepare in advance for the higher costs ahead. The average tariff rate now is 24%, up from 12% at the start of the year and just 3% before the initial volley in early 2018. You are dreaming in technicolor if you think this isn't going to have a dramatic dampening impact on consumer spending in the coming quarters and in addition to the pullback we are seeing in capex, the broad based decline in export orders and the unwind of the current inventory overhang. Monetary policy is no quick fix or antidote to these hurdles, which is why fiscal stimulus, even in Germany, is getting more and more press these days.

The Bull Market is in Canadian Cheerleaders

From the September 9th edition of BWD

I couldn't stop laughing over the weekend when I read the press headlines and Bay Street economists marveling over that surreal job headline in Canada for August. Think of what an 80k+ job gain means if you believe it — akin to an 800k surge in US employment. In fact, the StatsCan data were so not-to-be-believed that after all those Quebec jobs and part-time positions in Ontario are accounted for, there was no employment growth in other areas of the country.

The Canadian dollar has rallied hard on this report and on the overconfidence the BoC is now demonstrating.

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Overconfidence about what, exactly?

Over the Q2 print of -0.7% in real final domestic demand (not annualized)? The third decline in the past four quarters, in fact. Did you know, by the way, that real final sales in Canada would have contracted at over a 2% annual rate in the second quarter absent the dead-cat bounce in the depressed energy sector, all that activity at the local bar during the Raptors amazing road to victory and, well how can we forget this (maybe taking in too much of it) the 74% annualized surge in the cannabis sector. **No wonder productivity growth in Canada has slowed to a crawl...though pizza parlors and Pink Floyd albums have emerged into a full-blown bull market**.

There is so much backslapping going on, on Bay Street and dare I say, Wellington Street, that you would never know that business capex spending in Canada tanked at a 32% annual rate in Q2 (contracting in three of the past four quarters) which is a decline we have last seen in the 2001 and 2008 recessions.

Nonresidential construction dropped at a 1.8% annual rate in Q2 — contracting in each of the past six quarters.

Best to put the cork back in the champagne bottle for the time being

Consumer spending volumes on cyclically-sensitive durable goods fell at a 1.3% annual rate and has slipped in five of the past six quarters. Where exactly is this pro-growth hype coming from — including Mr. Morneau who should restrain himself from acting like an impulsive Donald Trump on his twitter account. Best to put the cork back in the champagne bottle for the time being.

Industrial production also shrunk 0.7% in June, which matches the decline in durable goods manufacturing — not to mention total manufacturing activity has slumped at a 2.9% annual rate over the three months to August. That's one heck of a swing from +3.3% at the turn of the year? Save for the most obtuse, who would dare to rejoice over data points like these.

Oh, did I fail to mention that Canadian real GDP has expanded 1.5% in the year to June? And strip out the public sector, and business sector activity is rising at the grand total of a 1.3% pace. But guess what — population growth, via an aggressive immigration policy, is running at a 1.5% annual rate. So depending on how you measure it, real per capita GDP is running flat to fractionally negative. What an economy!

While the employment report seemed constructive, it mostly spoke to the noise of the LFS data series. Looking at the situation on a three-month basis, employment in the retail/wholesale trade industry has fallen at a 2.9% annual rate, a testament to the shape of the Canadian consumer, which is none too good. The spillover from the global economic slowdown, and contraction in

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cross-border trade flows, are creating mega strains in domestic businesses reliant on the world economy, such as transports/warehousing where employment has declined at a 3.2% annualized pace over the three months to August. With the manufacturing sector in a recession of its own, jobs in the goods-producing sector has retreated at a 2.3% pace. I didn't hear many economists, strategists or pundits talk too much about the 7.2% collapse in Canada's factory workweek over the past three months, either.

The main story here is that while the Canadian job market looked bright and shiny in Friday's report, the engine is actually sputtering and it won't be long before the Bank of Canada is compelled to follow the Fed and the other 31 central banks who have cut rates so far this year. Expect the loonie's wings to get clipped once investors take a more in-depth look at an economy that is losing cyclical momentum at a time when there already is no growth at all in real per capita terms.

Risk and Uncertainty

From the September 10th edition of BWD

I get asked constantly about the extreme degree of risk there is in the world today. Of course, the answer is that the level of risk is at an extreme high, but the thing about risk is that the range of outcomes are still known — but it can be priced. **The problem with uncertainty is that the range of possible outcomes is not known and unlike risk, uncertainty cannot be priced.** And between global trade tensions, 2020 election unknowns and its crucial fiscal policy implications, Hong Kong strains, Argentina default risk, Iran and North Korea, rare is the day that uncertainty has been as high as it is today. And this includes other very tense periods like the financial crisis, tech wreck and 9/11 terrorist attacks. The way economists 'model' this out in their GDP equations is to introduce a 'dummy variable' to capture episodes of extreme uncertainty — and this shows through in rising liquidity preference and savings rates in the private sector. At last count, the drain to global GDP growth from all this uncertainty is fast approaching 1 percentage point for both this year and next.

We also have to weigh in the Fed's policy mis-step of having tightened too far this cycle, taking the funds rate at least 100 basis points above our estimate of where 'neutral' R-star is — which the central bank has been trimming of late after Jay Powell's mistake of taking it up to 3% not long after he took over the reins in early 2018. This is one area where I agree with President Trump — **between the 9 hikes and the quantitative tightening, the Fed de facto tightened policy by nearly 400 basis points this cycle**. Rare is the day, when the policy lags are taken into account, that such restraint — restraint that ultimately played a role in inverting the yield curve — has not caused a recession to follow suit. I was early on this call, too early as it turns out, but such was the case when I made the call in 2006 and

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2007. Next thing you know, nobody remembers that I was early — just that I was right. And I firmly believe that for the second time in just over a decade, I'm right again on this call.

The economic expansion ended up being so feeble that real GDP, fully more than a decade into this cycle, is some 15% below the trendline it would have been on

The 2002-07 expansion was built on an abundance of liquidity where nearly free money engineered a mortgage and housing bubble of epic proportions. The current cycle was fueled by an even more dramatic and prolonged effort by the central banks to borrow freely and generate asset inflation that in turn would propel a wealth effect on spending. Well, we got the asset inflation all right but with it came a massive widening in wealth inequality, which takes us to new extremes in terms of social instability, and the impact on spending was minimal. In fact, the economic expansion ended up being so feeble that real GDP, fully more than a decade into this cycle, is some 15% below the trendline it would have been on, had this recovery been anywhere close to normal. The reason we never experienced a normal wage cycle is because the labor market never tightened nearly as much as the U-3 unemployment rate suggested, because the employment-to-population ratio never came close to attaining its former highs.

The 'stimulus' that brought with it a dearth of safe bonds in the secondary market, and years of free money, did one thing — which was to entice corporate borrowers to flood the market with record amounts of global debt. This debt was used to finance a wave of share buybacks, which easily explains at least 20% of the bull market. **It's not that difficult to engineer a profits boom amidst the weakest economic expansion on a per share basis, when the share count plunges to its lowest level in two decades and renders the stock market more like a commodity than anything else**.

From my lens, the damage is done. The deepest negative effects from the trade war lie ahead, especially this latest round that hits a broad array of household goods. The recent macro data have been skewed by pre-tariff, precautionary spending by consumers and the same is the case on the inventory front by the business sector — the latter point highlighted in the latest ISM surveys.

That is the explanation that somehow gets muddled in the debate

The collapse in business investment globally (picked up on the front page of yesterday's WSJ), relative to where desired savings are, has been the critical factor behind the slide in market interest rates this year. That is the explanation that somehow gets muddled in the debate. Not to mention we are seeing deepening deflationary expectations, which is the only fundamental reason why an investor would buy a long-duration bond with a negative yield. **It should not be lost on anyone that what made this cycle unique was that for the first time ever, an economic expansion failed to close the output gap**.

And now with the OECD leading indicator slipping in each of the past eighteen months, to the lowest level since 2009, this output gap will widen

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and exert downward pressure on prices. That this happened with global inflation peaking this cycle at an unprecedented low level of 2%, half the 4% high of the last cycle, and looking at how far inflation rates fall in global economic downturns, one can surely be forgiven for maintaining a deflationary view and investment strategy. This is why the rally in high quality bonds, rate sensitive and noncyclical equities, volatility, gold, silver and Defense stocks will not end very soon and periodic pullbacks in any of these should be treated as buying opportunities.

While investors focus on how low Treasury yields are what they fail to see is how high they are relative to the rest of the world. These securities have an average rating of AAA that trade at a premium to many lesser-credits around the world. Plus you get paid in greenbacks, which tend to get in short supply in periods of high anxiety and uncertainty.

One other thing about Treasury notes and bonds — two in fact. What they have that nothing else possesses are safety and liquidity. Safety in that you know full well what you get paid upon maturity — that is true even with a negative-yielding bond, which is akin to putting your valuables in a safety deposit box for a fee for safe-keeping. That's the theme here — how to be safe, even for a fee, in uncertain times. And liquidity is key because it is your best friend when times are good, but quickly becomes a coward when things get rough. **Treasuries are like cash in that respect — a totally liquid instrument but with duration and a moderate yield pick-up (at least in the USA)**.

More on Uncertainty

From the September 11th edition of BWD

The stock market had its comeuppance in August and now it's the Treasury market's turn. Yields are backing up, but much of this is technical in nature as bonds became seriously overbought. We were fortunate enough to see those condition unfolding last week when we said it wasn't the same as the 'saying goodbye to an old friend' theme back in the spring of 2009 as much as a respite. There very likely will be an excellent re-entry point for the next leg of the rally. **I have no doubt that the economy will be pushing the Fed funds rate back to, or maybe even through, the zero bound before this cycle is over, and every step of the way I am sure Jay Powell will continue to tell the world that this is just some *"mid-cycle policy adjustment"*.** Right. He may well be saying this even as we get to zero!

This is not some little adjustment. This is an economy that never really fully recovered from the financial crisis, for if it had, the trend in real GDP would be 15% higher than it is today. Central banks and governments can try and paper this reality over by trying to generate massive asset reflation, but that

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is really no way to run an economy. In the end this has only exacerbated already-extreme wealth inequalities. **That the Fed got stopped out this cycle at 2.5% is unprecedented and speaks to the vulnerability of such a debt-burdened economy** — especially in the business sector. The fact that core inflation peaked at 2.4 per cent, the lowest peak in recorded history, despite all the monetary and fiscal stimulus aimed to create inflation, speaks volumes to the inherent deflationary forces at work.

Now I must say that the U.S. consumer has hung in remarkably well

Now I must say that the U.S. consumer has hung in remarkably well. But from my lens, there has been considerable precautionary spending ahead of these latest tariff hikes, which has borrowed growth from the future. Not to mention it has been financed largely by stepped-up credit growth and a drawdown in the personal savings rate. Look out for a fourth-quarter hangover. Housing, once the quintessential leading indicator of the overall economy, has been in contraction mode for six straight quarters and with no letting up. Commercial construction is stagnating and capital expenditures and business spending plans have rolled over. It goes without saying that the foreign trade side of the equation will be a negative — the sharp slide in export orders in both ISMs for August was rather telling. **And those same surveys alerted us to the current inventory overhang, which also was precautionary pre-tariff stockpiling, casting a cloud over Q4 growth**. This is at a time when, in the past month and change, both the Atlanta Fed and New York Fed have dragged their current-quarter GDP growth forecasts down from 2.2% to around 1.5%.

Employment growth has started to slow visibly, and leading cyclical indicators within the report flashed warning signals. Nobody should be feeling too comfy over the fact that job creation in the transportation industry has completely vanished over the past six months. Transportation services are critical in that this is the sector that ships all the “stuff” that make up a good chunk of GDP.

Now, there are a few issues that need to be resolved.

First, it’s not clear how the effects of this latest tariff hike earlier this month will affect the data. Will the retailers pass on the costs to the consumer? Many say they won’t, and that was a clear message in the pricing-plan measure of the small-business NFIB survey for August. Will the suppliers to the retailers bear the brunt? Or will it be the Chinese exporters? Well, as for that last question, we know that despite what the White House says on the matter, Chinese producers will not be facing the entire brunt of the impact. They may cut prices, as the latest PPI suggest, to maintain their market share. **Or, as we have seen, Beijing will just continue to resort to currency devaluation as it has to mitigate the tariff impact**.

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I see Rmb8 on the horizon, which of course, is also the luckiest of all digits in China

This is where the Administration could be wrong — in contrast to the USA, China is a command economy and it has far greater leeway to use the renminbi as a tool and an antidote to the tariff hikes. After passing Rmb7 on the dollar, I see Rmb8 on the horizon, which of course, is also the luckiest of all digits in China. For the consumers hurt by a weaker currency, I would say not to worry because Beijing is very likely to provide some targeted fiscal stimulus to ease the pain just as the PBOC did with its own recent limited policy move.

This recent risk-on move that prompted the rally in equities, especially the value and cyclical areas, and the sell-off in the safe haven assets like Treasuries and gold, coincided with the news that the U.S. and China trade officials are talking again. **It's a facade**. They've been talking for a year-and-a-half and along the way, President Trump has slapped in multiple tariff actions and President Xi has responded in kind. So we know that talk is very cheap and we know that China is not backing down. So maybe there will be de-escalation in this trade war, but there is little chance that the negative trade actions get rescinded — I really cannot see how Trump could ever sell that to his base.

Now, say that the White House does cobble together a "deal" with China to help buy votes ahead of the 2020 election. It will spur another risk-on rally that will be doomed as it becomes apparent that the emperor has no clothes. Any new deal has to go through Congress. And Congress is in no mood to do any deal with China that doesn't involve major concessions — and China isn't going to yield its current superior position in technology (5G) to anyone. For all the talk, there hasn't been a trade deal passed anywhere in this Congress — and if you haven't yet noticed, the USMCA was signed eons ago and yet is still sitting in the legislature so we are still operating under NAFTA rules here in North America. **If that deal hasn't gotten done, why on earth would anyone believe a deal is happening with China under the current environment of mistrust?** Not to mention the intensely contentious and far-reaching issues that are involved.

It may well be true that China is getting hit harder than the USA in this trade war, but suffice it to say that Beijing does have the tools to offset a good part of the damage. As I said above. The one thing we should all try to have a handle on is the extent to which China can withstand pain, suffering and shared sacrifice. It's part of its heritage, and its capacity to handle pain is something that the current round of baby boomers, Gen X'ers and Millennials have no clue about. I'm talking about civilians here, not military heroes.

It also was a big miscalculation to humiliate the Chinese leadership

This is one factor, I think, that Donald Trump has underestimated. It also was a big miscalculation to humiliate the Chinese leadership. There isn't a soul in

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China who isn't aware of the centuries of humiliation the country endured in the past. It is etched in their culture. The general lack of knowledge about all this has proven to be a big mistake — where is Henry Kissinger when you need him? — and could end up costing Trump his presidency.

That is still a close call and from where I sit, putting his age and gaffes aside, the Democrats best chance is with Joe Biden. Yet he is being impaled constantly by his own party, as the Democrats have shifted ever further to the left. **Four years ago, Bernie Sanders was a novelty. Now he's viewed as mainstream!** But I can tell you that the House is a forgone conclusion, the Senate all of a sudden is up for grabs and who knows what the turnout becomes and how the Independents end up voting when it comes to the Oval Office in 2020.

So in addition to the trade conflict, which is really more of a war for global economic supremacy between one existing giant and a beast that has emerged as a legitimate rival (and is not going to end for years), we also have home-grown political uncertainty. We have extreme levels of uncertainty on both levels, and what happens when uncertainty rises inexorably, as it has of late, is that businesses pull back. They withdraw. That means cutbacks in capex first, hirings second. This is what is happening right now though it is more evident with the capex data — but that is the point. Risk can be priced, monitored and assessed. Uncertainty means outcomes are unknown — the classic Donald Rumsfeldian "unknown unknowns". You can act on risk but you can't on uncertainty, where the only plan is to build a cushion of liquidity and shelve expansion plans — again, a major theme in the August NFIB report.

And this pullback in capex is being reinforced by the November 2020 election because so much is at stake here. Capitalism versus some form of socialism. **A Democratic sweep is no longer a remote possibility — and you should ask yourself as to what business is going to be committing capital to the economy in the next fourteen months not knowing what their ex-post after-tax return on investment is going to be?** Who in their right mind is going to be spending money on fracking in the face of what could be a green revolution that kyboshes the fossil fuel industry once and for all? Not to mention how all of the health care proposals will play out, especially for the pharmaceutical industry.

Uncertainty abounds — and layer on top what I just wrote about these other sources globally: the capital controls in Argentina, Brexit, the purge of the rain forests in Brazil, the South Korea-Japan trade conflict, Iran, and North Korea. When we celebrate Italy as the current poster child of political stability — you know we are into a whole new reality.

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And it has been this reality that has been behind — until this recent spasm — this year's big story, which is the huge downdraft in global market interest rates. The reason is obvious, except to the most obtuse who like to throw their hands in the air and say it makes no sense and how "expensive" bonds are. I cannot tell you how ridiculous that is. Think of interest rates as a price — a critical price — that equilibrates two very powerful curves: investment and desired global savings. **What this uncertainty has done is to drive investment far below savings and it has been nothing but the pure laws of economics at play that have pulled bond yields down to the ultra-low levels they have reached this year**.

And it has been this reality that has been behind — until this recent spasm — this **year's big story, which is** the huge downdraft in global market interest rates

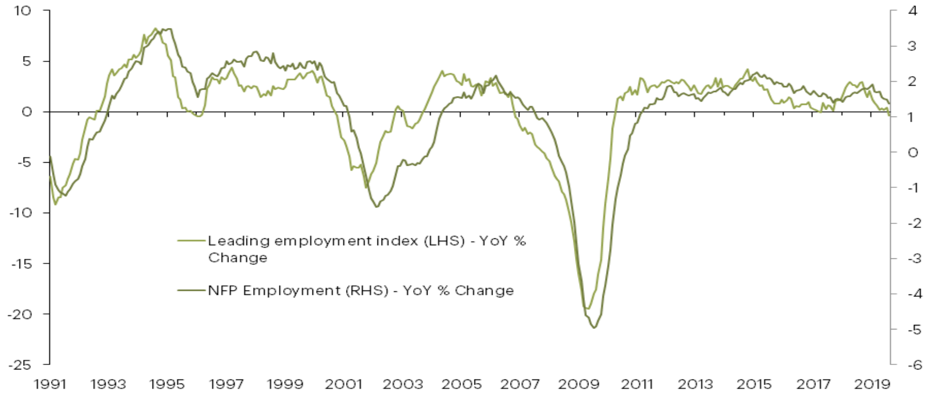
Employment Growth Will Continue to Slow

From the September 12th edition of BWD

Our leading employment index, which leads the trend in payrolls by about three months, is continuing to flag a much softer pace of job gains going forward. **In fact, at its current level (-0.37), it is at its most negative level since March 2010**.

CHART 1: Job Gains Poised to Slow
United States

(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

The primary reason for the slowdown is what is transpiring with manufacturing overtime hours, temporary help employment and the job loser's share of the unemployed. And as the charts below illustrate, each tend to be fantastic leading indicators of recession — pay close attention to these metrics in the months ahead.

Each tend to be fantastic leading indicators of recession — pay close attention to these metrics in the months ahead

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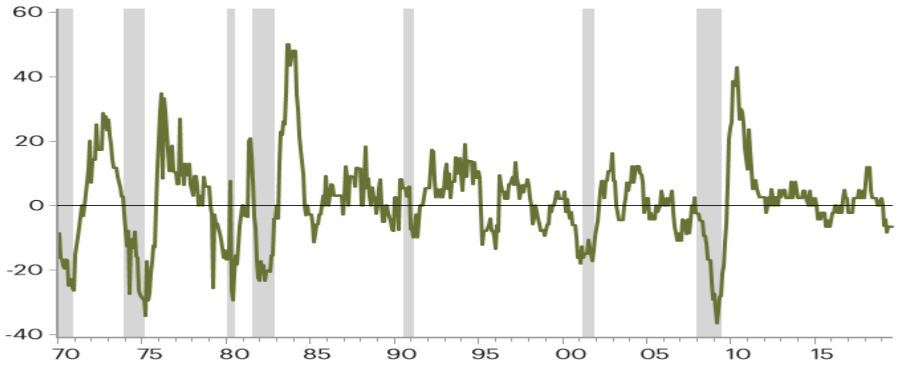
CHART 2: Manufacturing Overtime Hours
United States

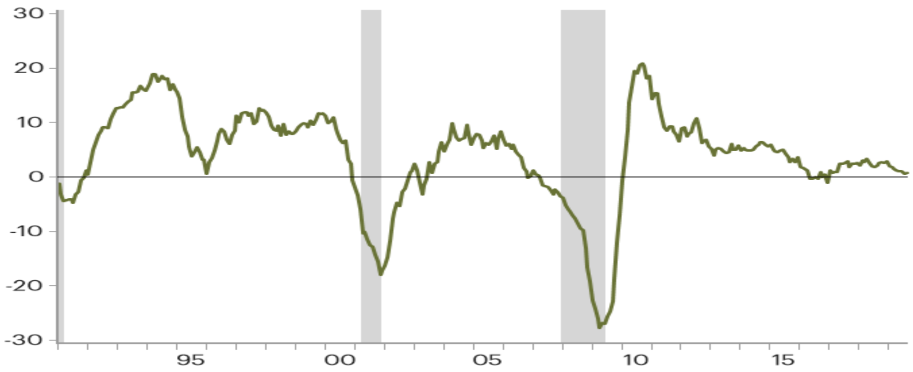
(year-over-year percent change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 3: Temporary Help Services
United States

(year-over-year percent change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

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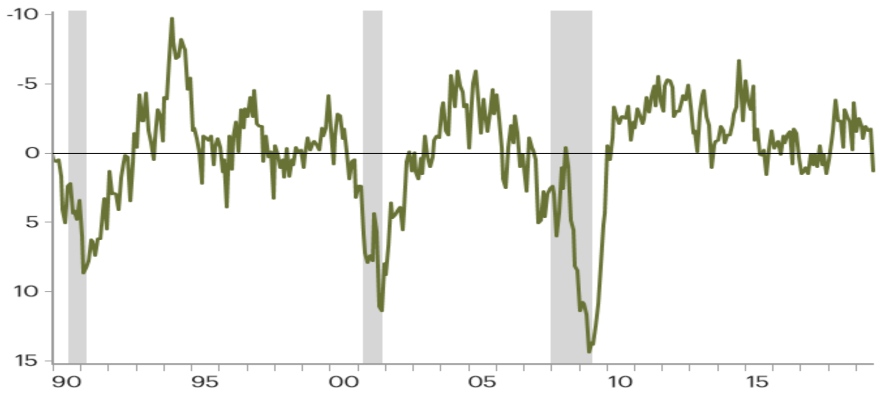
CHART 4: **Job Loser's Share of Unemployed**
United States

(year-over-year change; inverted)



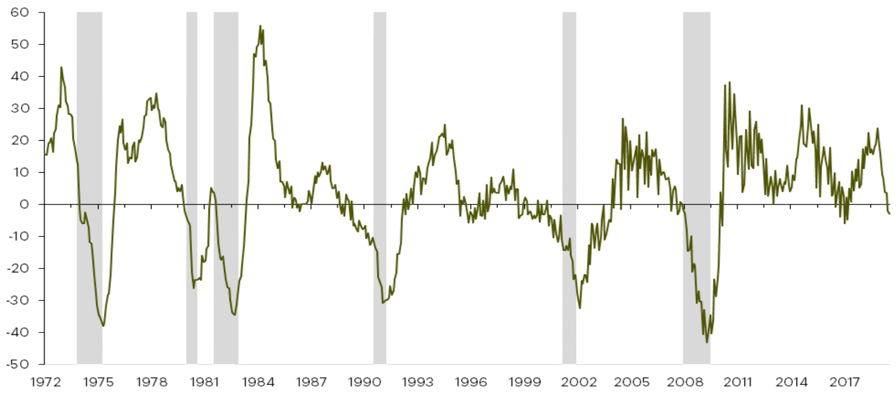
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Indeed, this is vividly evident in the fact job openings are now down about 5 ½% from their peak, or by 3% on a YoY basis

As we have been saying for some time, elevated uncertainty first led to a pullback in capex, but is now spilling over to the once rock-solid labour market. Indeed, this is vividly evident in the fact job openings are now down about 5 ½% from their peak, or by 3% on a YoY basis.

CHART 5: Job Openings
United States

(year-over-year percent change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Or how about the NFIB survey which showed plans to increase employment are down 6ppts YoY? **Ordinarily, declines of this magnitude tend to be associated with recessions.**

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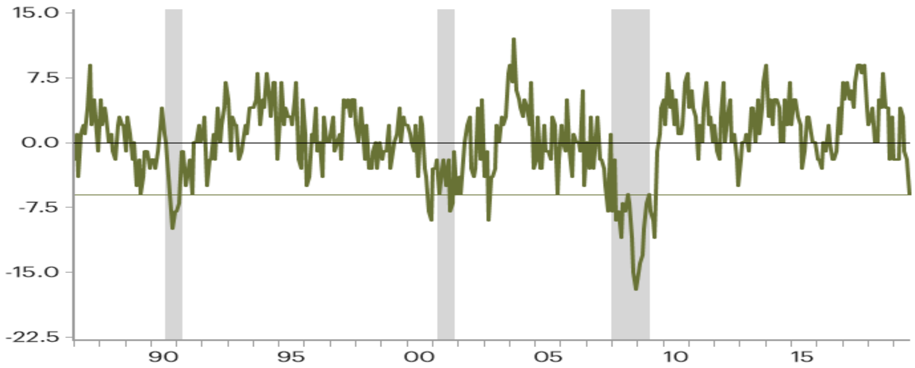
CHART 6: Planning to Increase Employment
United States: *NFIB Small Business Economic Trends*

(year-over-year change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

So, no matter where you turn, leading employment indicators are pretty consistent in their message — it is worth heeding their warning.

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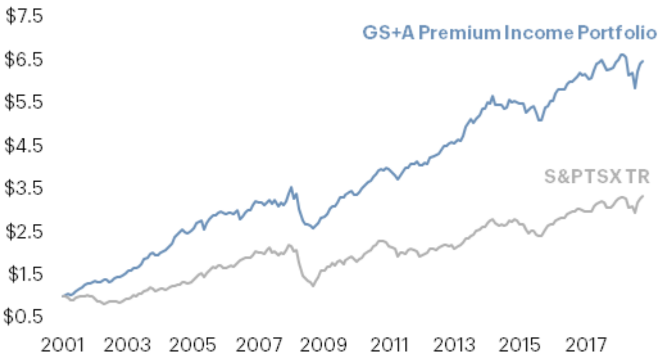

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