Global Strategy Weekly

Some dark deflationary thoughts in the face of market euphoria

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Some interesting developments in recent weeks have been buried beneath the avalanche of bullish chatter. In particular there is increasing evidence that nominal growth rates are sinking deeper into negative territory. Despite the bullish talk, this is the stuff of debt deflation.

■ Before my summer break, markets were wobbling nervously in reaction to distinctly mixed economic data. What a difference a few weeks make! We don't wish to be a wet blanket: we will probably get a positive GDP print in the second half of this year. But as David Rosenberg, Chief Economist at Gluskin Sheff points out in John Mauldin's latest *Outside The Box*, "while we are past the most pronounced part of the downturn, it may still be premature to call for the end of the recession merely because of the prospect of a positive third-quarter GDP result. After all, we saw GDP advance at a 1.5% annual rate in last year's second quarter, and if memory serves us correctly, the NBER did not subsequently declare the end of the recession!" What was also so shocking from my perspective is the massive downward revisions to personal income in the GDP release. Both nominal GDP and income growth have now fallen deep into negative territory (see chart below) – an integral component of Fischer's debt deflation dynamics (more on that later).

■ John Authers in the FT's *Long View* highlighted a *must read* piece of research from John Makin, writing for the American Enterprise Institute think-tank - link. Makin went so far as to allege a "bogus boom" in China. Explaining 'rapid' 15% retail sales growth, Makin points out that under Chinese accounting, goods count as sold when they are *shipped* to retailers, not when they are bought by consumers. Also, investment spending is inflated since bank loans count towards GDP from the moment the monies are disbursed to companies, rather than when they are spent - even if companies cannot find a use for them or put them into equities. I agree wholeheartedly with the bogus nature of Chinese 'recovery'. If the US in 2007 was a slow motion train wreck with carriage after carriage coming slowly off the rails in turn, China will at some point soon be pile-driving straight into the buffers.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	35
Bonds	20-50	35	50
Cash	0-30	5	15

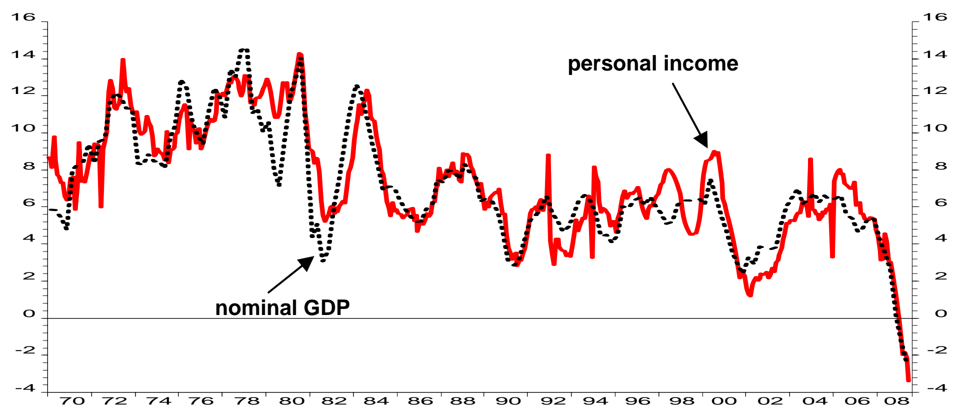
Source: SG Equity Research

Equity allocation

Very Overweight	
Overweight	US UK
Neutral	Cont Europe
Underweight	Japan Emerging mkts
Very Underweight	

Source: SG Equity Research

The Japanification of the west: US *NOMINAL* GDP and personal income now declining



Source Datastream

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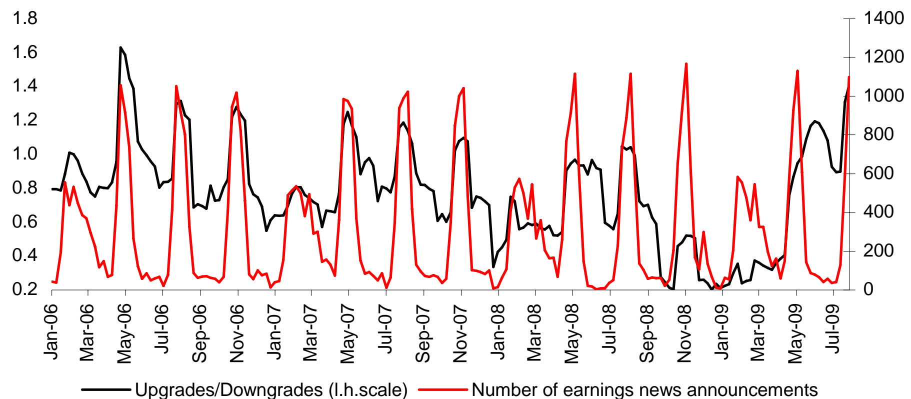
Andrew Lapthorne, our head of Quantitative equity strategy, has once again called the current rally spot on. Forget all the macro noise we all spend so long analysing. He keeps it simple, identifying that is always worth leaning towards the bull tack during the lying season – sorry I mean the reporting season (see *Time to buy? The impact of the US reporting season on equity performance* 9 October 2008– link). Companies still seem so fixated with their silly games of beating expectations on the day that a clear seasonal pattern emerges where the start of positive news can be predicted almost to the day (see chart below). For example, Andrew wrote in his 18 May *Global Market Arithmetic* (well worth getting for the weekly update of market data as much as for his offbeat predictions – link), that one should get out of equities until 13 July. Indeed that was TO THE VERY DAY the start of this current rally. If this seasonal nonsense continues, he says we should be lightening up once again on 24 August!

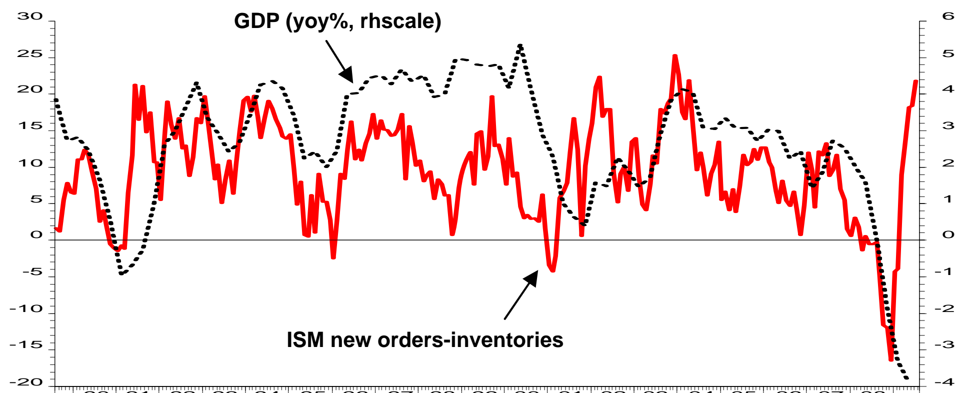
Close seasonal relationship between US company reporting season and eps upgrades



Source: SG Quantitative Research

Aside from this seasonal nonsense, it would be churlish indeed not to recognize that the macro situation has improved markedly. The bulls rightly point to data like the ISM new orders/inventory mismatch as evidence of a bounce in the GDP data in the second half of this year (see chart below). The unprecedented stimulus package has indeed had the desired short-term effect. The question, though, is not so much what happens over the next few months, but whether this can be sustained into 2010. On this the jury is still very much out.

US ISM manufacturing new orders minus inventories and GDP growth



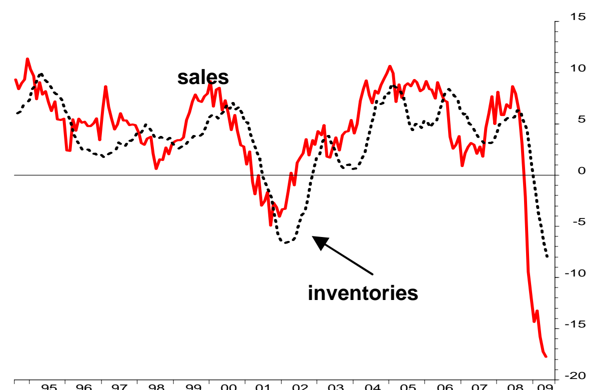
Source: Datastream

However, amid the supercharged stimulus the bulls continue to be surprised by weakness in both inventories and consumption. The latest Q2 GDP data showed another surprisingly deep $144bn drawdown (following $114bn in Q1) deducted 0.8% annualized from GDP QoQ (and incidentally the same yoy). We continually hear that the Lehman's debacle produced an excessive liquidation of inventory as companies over-reacted to events and that if production schedules are stepped up to prevent additional declines in stocks, this will make substantial additions to GDP growth (e.g. a 4½% addition if Q3 inventory change comes in at zero).

This is simply wrong. **The inventory liquidation, although large in $bn terms, has *NOT* been excessive** given the unprecedented 18% collapse in sales (see right-hand chart below). The rate of inventory decline, at 8% yoy, has barely exceeded that seen at the nadir of the last shallow recession in 2001/2 when sales fell only around 5% yoy. Manufacturing and wholesale inventory/sales ratios are still excessive (see left-hand chart below). This is exactly the explanation the American Trucking Association Chief Economist Bob Costello gave on the release of the 2½% decline in June's tonnage - link. That is why recent inventory data has been surprising on the downside and why H2 growth will be weaker than expected.

Manufacturers inventory/sales ratio

Business sales and inventory growth yoy %



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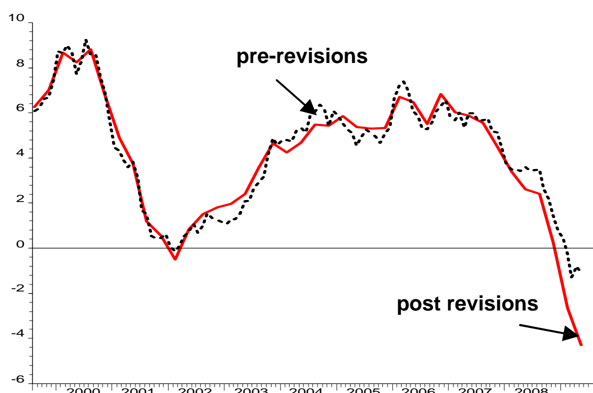
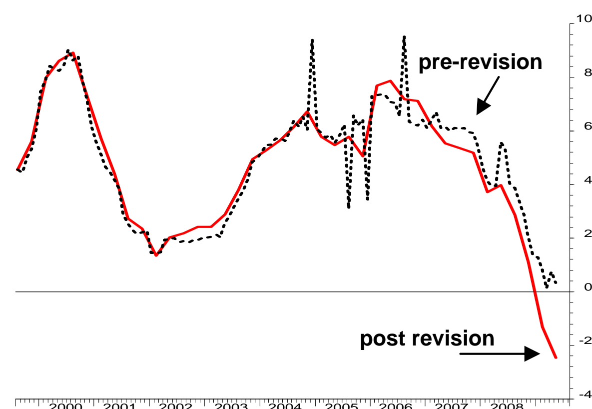
The excess inventory situation would not be such an issue if final demand revived. Yet as consumption continues to flat-line, recent data revisions in the latest GDP release show the true extent of shockingly bad consumer fundamentals (see charts below).

US wage and salary bill yoy % (pre and post revisions)



US pre-tax personal income yoy % (pre and post revision)



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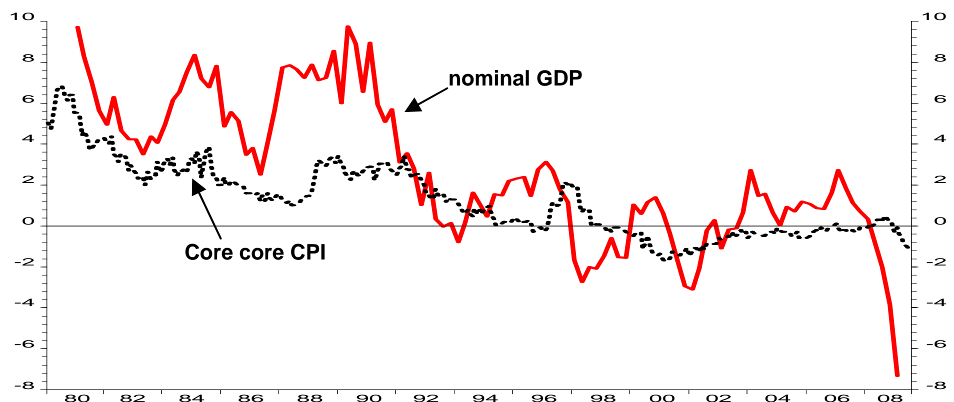
US nominal household incomes are now contracting at an unprecedented rate. The largest component of household income is wages and salaries which *had* been declining some 1% yoy. But after revisions the statisticians now admit to an unprecedented 4.8% decline! Total pre-tax household income is now recorded as falling 3.4% yoy in June.

"But aren't tax cuts holding up household incomes?" I hear you say. Even factoring in massive tax cuts, disposable income is still down 1.3% yoy. Total hours worked in the private sector are down a horrendous 7% yoy. This headlong plunge into negative NOMINAL income and GDP numbers is exactly what happened in Japan and is the stuff of classic Fischer debt deflation (see chart below). As debt/income ratios are excessive and need to be de-leveraged, a declining denominator will be the key driver to the coming 'Vortex of Debility'.

So while investors jolly themselves off on a cyclical recovery, tax-cuts have failed to hold the line. In the US and elsewhere, debt deflation is climbing the ramparts and putting the brave but under-armed defenders to the sword.

Japanese CPI (ex food and energy, Tokyo yoy%) and nominal GDP growth



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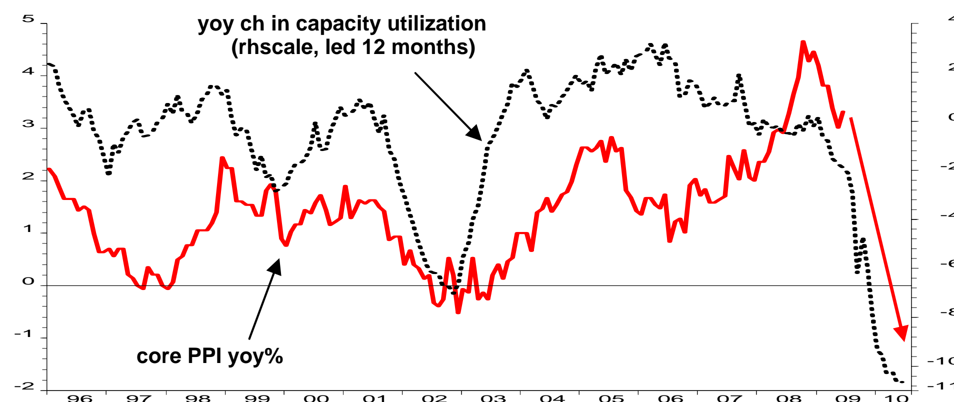
It would be fair to say that in the last six months core inflation has declined less than the market might have expected given extreme lows in capacity utilization. However, the downside surprises are only now just about to start (see chart below).

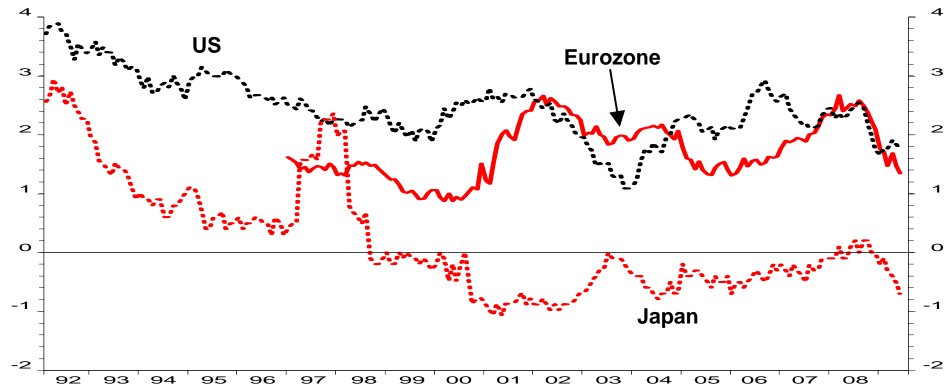
US capacity utilization leads core inflation by about a year



Source: Datastream

So if we are right and a weaker than expected recovery peters out towards the end of this year, then there will be little to hold back the unwelcome ravages of the deflationary hordes. Japan slipped into its negative nominal world almost a decade ago and the rhyming pattern of events a decade later is uncanny (see chart below).

Core CPIs (ex food and energy, yoy% ch)



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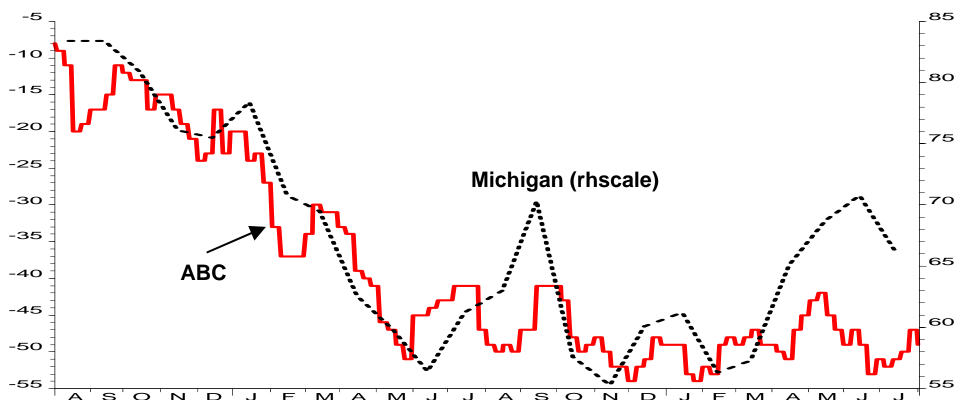
This does not matter if there is no excess debt to pay down (indeed that is the difference between now and the 19th century when consumer prices used to flip regularly from inflation to deflation and back again). But the world is still burdened with the excesses of the last decade's debt party. This would *also* not matter if the bear market in US equity valuations had fully played out in March of this year. But whereas on the Graham and Dodd PE measure the European equity markets became dirt cheap, the US did not. In this view of the world, as Jeremy Grantham mentioned in his latest newsletter: "we are in for several lean years in which the market will be looking for an excuse to be cheap" – link.

One final thought. Andrew Lapthorne tells me that, so far in the reporting round, 80% of non-financial companies are beating expectations. Yet 55% of these companies are missing their sales projections. The circle can only be squared by job losses. No wonder consumer confidence has barely recovered and no wonder nominal household incomes are now contracting at such a rapid rate. Roll on deflation.

US consumer confidence



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