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No Boom, No Bust: Part III

This is the final installment in my three-part series on the recessionary cycle, its leading indicators, and the implication on the global economy going forward.

The bottom line is that based on all traditional indicators (i.e. policy, economic, and markets), we are still some distance away from recession, at least in the traditional sense. Nevertheless, economic growth has been anemic almost everywhere, and global GDP has been expanding at a rate not far off from levels that were considered very close to global recession a decade ago. This is largely due to the fact we have probably settled into a new environment with greatly reduced growth potential.

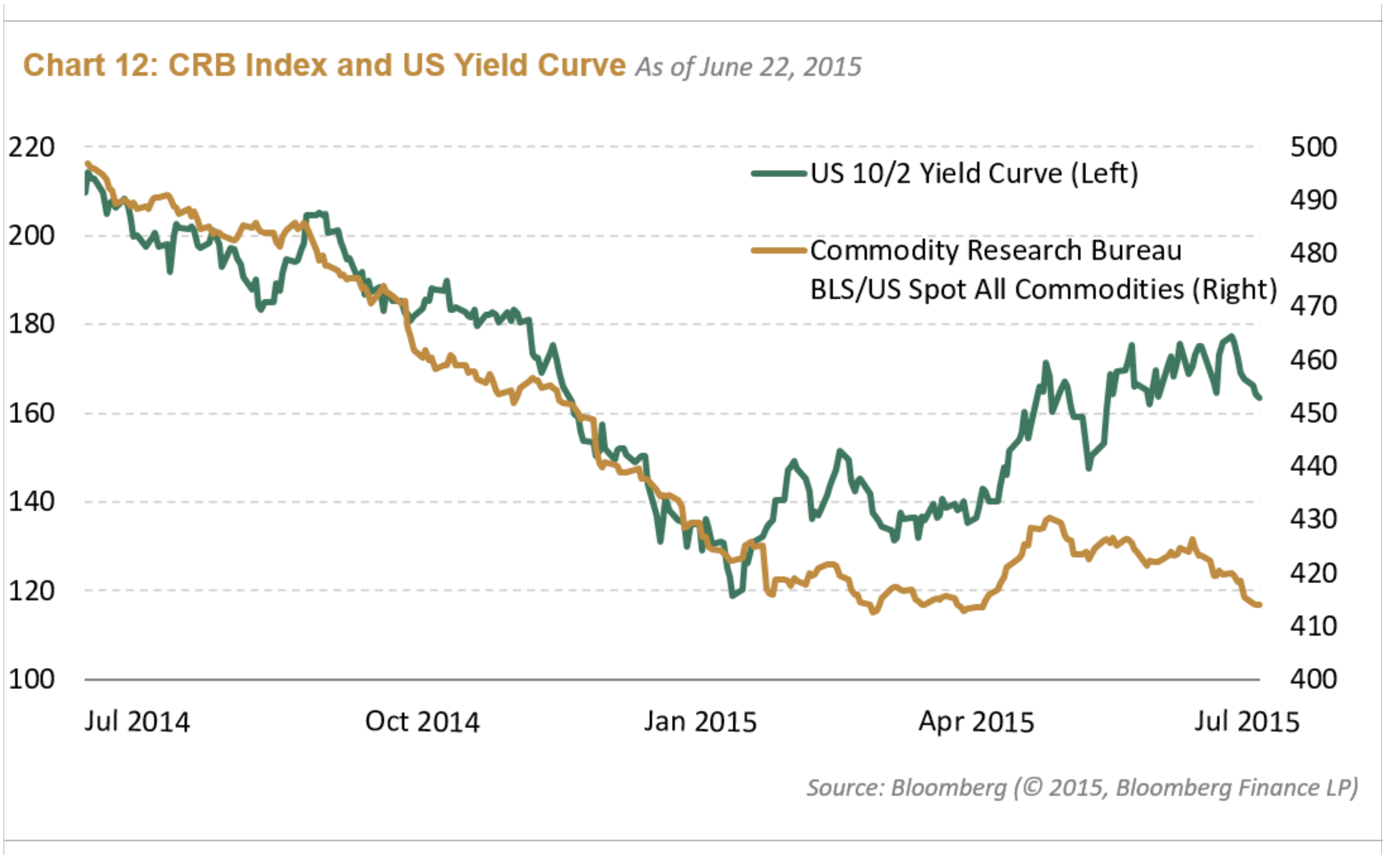
Looking Ahead

There are a few factors that may characterize today's environment. First of all, with G7 private sectors preoccupied with deleveraging, spending has been and will continue to be confined by the natural rate of income growth, which is about 2-2.5% in the U.S., 1-1.5% in Europe and 0-1% in Japan. This will be the new norm until or unless a new re-leveraging cycle starts in the developed world.

The much-reduced spending growth in the developed world means that the global final demand from the West will not allow suppliers—the manufacturing economies of the developing world—to use up their productive capacity. This effect is supported by the fact that post-2008 economic growth has been at best two-thirds of what was seen in the last decade for the developing world as a whole. For example, GDP growth for EMs as a whole averaged 7% last decade, and is expanding at 4% today. For global exports, the average real growth rate was more than 11% last decade and has dropped to 5% since 2010. As a result, export prices have been forced to make downward adjustments, while global trade is stagnant. This situation will not change drastically at any time soon.

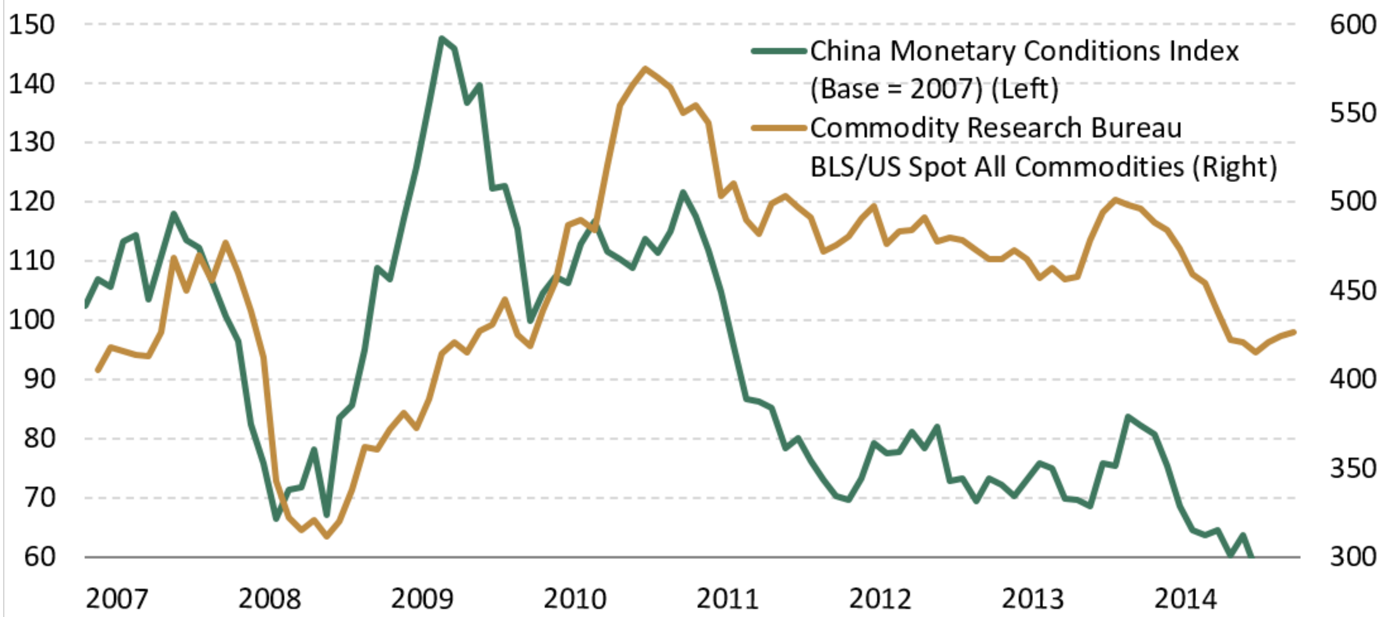
In practical terms, what are we looking for?

- Cyclical expansion will likely last must longer than most cycles in the postwar period, thanks largely to the anemic nature of economic recovery since 2009. In other words, the magnitude of the cyclical upswing has been and will continue to be modest, but the duration of economic expansion will prove to be long.
- We have just gone through a manufacturing downturn precipitated by a collapse in euro-zone demand. Nevertheless, this slump is very late as the European Central Bank is actively easing monetary policy. In fact, the recent behavior of global trade patterns, yield curves, and commodity prices all suggest that the manufacturing slump may be bottoming (see Chart 12 below). If so, global growth should slowly improve rather than slipping into another period of contraction.



With the developed world running at sub-trend growth as a whole, EM countries need to find endogenous growth to mop up excess capacity. Interest-rate cuts and expansionary policies are needed to generate such growth. The Chinese government is doing the right thing by cutting rates and the reserve requirement ratio while expanding public investment in infrastructure. I believe we have seen the tightest point in China's monetary conditions index (MCI). If true, this would be consistent with the view that the CRB index may have bottomed.

Chart 13: CRB and Chinese Monetary Condition Index *As of June 30, 2015*



Source: Bloomberg (© 2015, Bloomberg Finance LP)

The entire EM world needs to stimulate, either via monetary policy or through foreign-exchange rates. Asia's foreign-exchange rates are too expensive, restricting growth and causing price deflation. Interest rates in Latin America are genuinely too high, causing domestic activity to slacken. Asia needs to bring down its currencies, while Latin America needs to cut rates. Until then, EM assets may continue to underperform.

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