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Global Economy, 2014 – Looming Catastrophe Part 1

WRITTEN BY: ASHOK DHILLON



Ashok Dhillon has 40 years of front-line business experience in Canada and International markets. He has founded and led companies in construction and international power development.

Mr. Dhillon has worked and negotiated with highest levels of Governments in Canada and India. He has pursued and won mandates to develop power plants in Canada, and foreign jurisdictions such as Hungary, Iran, Pakistan and India with uncompromising ethical standards. His extensive experience in securing and negotiating multi-hundred million and billion dollar mandates in power project development, gives him in-depth knowledge and intuitive insights into macro and micro, national and international, geo-political and economic realities and trends.

Mr. Dhillon has been invited to speak on international business at various forums, including as an expert witness for the Standing Senate Committee, Government of Canada, on "The Rise of Russia, China and India".



About five years ago, the Global Economy - Humpty Dumpty - fell off the wall. The global economy now has more glue and tape on it than ever before, but it remains broken, and in 2014 this Humpty Dumpty is threatening to come apart at the seams, and this time there will be no arresting the fall, as in 2008.

The Global economy is broken and dysfunctional, and all the ministrations and policies enacted by the Governments and the Central Banks, since 2008, have only and steadily exacerbated and rebuilt the old problems up to a much larger scale.

The cures administered, excess liquidity, record monetary easing, and undue advantage of unprecedented easy and cheap money to the financial institutions, were the reasons why the world economies got into trouble in the first place. The current global leadership applied that same prescription of excess liquidity and monetary easing, only with greater vengeance. Of course, the other ingredients, excessive greed and unscrupulous behavior of those that pull the strings in the financial markets, and in the World Capitals, can always be counted on.

Never in recent memory has the exercise of piling on vastly more debt and leverage, to solve a problem that was created by excessive leverage in the first place, been carried to the current fearsome and fateful extreme. And, this 'experimental cure' is going to exact a heavy price, globally. So batten down the hatches because a perfect storm of excessive liquidity, force fed speculative investment into asset markets, inadequate global demand, serious overcapacity, high energy prices, moribund labour markets and excessive debt, is threatening global economic stability.

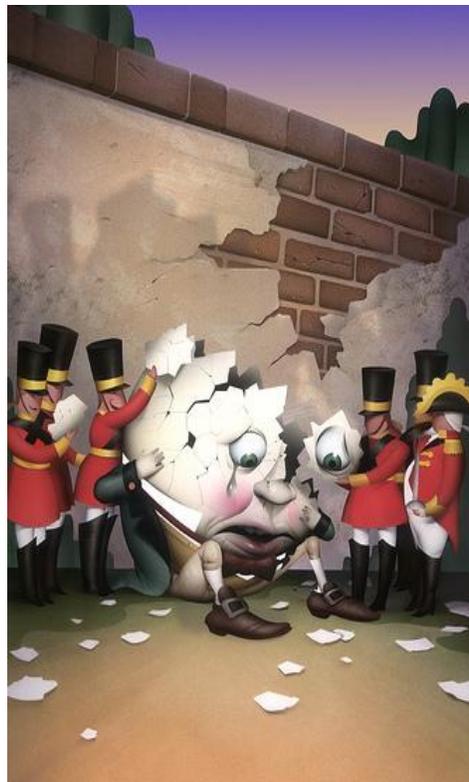
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During the past decades of mostly Republican led governance, America went on a financial deregulatory binge that cultivated destructive greed, fueled speculation in asset markets and culminated in the 'Crash of 2008'. Then President Obama got elected and he inherited an economic catastrophe from the Republicans.

But over the last five years Obama's Advisors and Administration have been a study in conformity, doing everything to please everybody, and ending up doing the wrong thing all with the best of intentions. To try and keep the totally broken economy afloat at all costs, rather than addressing the fundamental problems, his Administration through the Federal Reserve, has kept the World awash in liquidity, and other Governments followed suit (*who is willing to fight the American Administration and the Federal Reserve?*). So globally, none of the fundamental mistakes got corrected, instead the old ways prevailed, and now an even bigger catastrophe looms.

The American prescription of ongoing and massive stimulus has been followed by most other major governments and their Central Banks, through cash infusions and ultra-low interest rates, and the basic problematic fundamentals of the global economy have been ignored. The expected recovery has not taken place, and at the end of February, 2014, Europe, North America and the Emerging Markets are, and still remain broken. Therefore "all the King's horses (Liquidity) and all the King's men (Central Banks) could not put Humpty Dumpty back together again".



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The Global Governments and their Central Banks continue to rely on the prescription that particularly favours the financial market players, while the general populations struggle. This one fact has left most economies with lackluster consumer demand, over capacity, over indebtedness, regression in real wages and disposable income (*of the middle class, lower middle class and the poor*), and accelerating inequality in wealth distribution. These are fundamental structural problems that are not being aggressively addressed by most governments, and hence the continuing global economic malaise, and the looming disaster.

The day to day, month to month, constant ebb and flow of positive and negative economic data, economic uncertainty and the financial market volatility makes for great talking points, but the consistent uncertainty underscores what we have been predicting since the start of QE3 (about September 2012) that an unsustainable, uncertain and volatile economic environment cannot be fixed with just 'Quantitative Easing'.

As Governments and the Central Banks are forced to acknowledge the increasing impotence of their stimulative actions and policies, structural changes will need to be implemented to foster future stability. And since focused and co-operative effort in that direction, by Governments, was not undertaken in the past five years, we are reasonably certain that in the near term no real sustainable growth is possible, but in fact the opposite will likely take place, another global meltdown.

The sheer size of the cure (*global debt*) now poses a greater risk than the feared disease, a cyclical, albeit a deep recession. In trying to avoid a deep recession, the global governments and their Central Banks may be bringing on a global 'Depression'. This dire statement is not mere fear mongering, or an attention grabbing ploy, but is almost a statement of fact, because the current macroeconomic policies being followed by the Global Central Banks are breaking all immutable laws of basic finance, business and economics, and are therefore unsustainable and dangerous. The fact that they are deviating from the norm to the degree that they are, the resultant failure has to be that much more pronounced.

In early 2014, the elements of a perfect economic storm are: unsustainable levels of public and private debt; coupled with declining economic growth rates; muted international trade; steadily eroding values of most global currencies; and the biggest risk - new asset bubbles in most financial and real estate markets, re-inflated through ridiculous amounts of cheap and easy money through the Federal Reserve and other Central Banks, to the top percentile of the money market players. This extended experiment in over inflating economics was doomed for failure as governments shied away from correcting the basic fundamental imbalances first. The Chinese Government provided the latest example of the reluctance of Governments to let financial excesses fail, through last minute bailouts (*more on that later in the Report*).

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Most governments were loathe to enact the deep structural policy changes that have been required, to realign their economies to the new global realities post 2008. The reason being, such policies would have brought short to medium term pain, for long term gain. But, no government wants to face public or electoral wrath during their term, and would much rather push the problems further down the road.

It is so much easier to flood the financial system with printed money, boost assets markets, be they equities, bonds or real-estate, claim the rising asset prices as proof of recovery, and the forced improving statistical numbers as the appearance of recovery, even though it takes Trillions annually to keep up the façade, and ultimately hope like heck something takes hold, just so they do not have to deal with the real structural and painful issues.

In the past few years that is precisely what most governments have done; ignored the real problems, flooded the financial markets with easy and cheap money, and in the process declared various types of fleeting victories based on nebulous month to month statistical numbers of key economic indicators. Those numbers have constantly gyrated, occasionally to the positive but mostly to the negative, resulting in the current status: Trillions spent worldwide, and no sustainable global economic recovery.

We do not buy the ever changing 'stimulus' induced signs of life as recovery, because, these signs will vaporize upon total stimulus withdrawal (if *that ever happens*), as they have continued to regress regularly over the past five years. Thereby necessitating the constant reassurance, hand holding (*forward guidance*), and the ever present easy money flowing teat of overactive printing press stimulus of the Federal Reserve, and the other major Central Banks, to placate the 'tapering tantrums' of addicted financial and real estate market players-speculators.

In spite of all this molly-coddling attention and over feeding of the markets, the underlying global economies are still unable to stand on their own legs, and continue to sag alarmingly in spite of constant stimulus, necessitating additional verbal assurances from the Central Banks, coupled with injections of immediate cash support. In fact, it all resembles a vaudevillian act where a seriously compromised person is being held up and made desperately to seem alright by the companions, as they prop the person up and tell everyone that he or she is perfectly fine.



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The extraordinary printing press liquidity being pumped into the global financial system, and artificially held low interest rates, have been penalizing the general public, the cautious and the savers, by steadily eroding the value of their money and giving them negligible return on their deposits, while unwisely enabling and rewarding the large investors and speculators. And of course, the banks have proved to be bastions of misdeeds, greed and instability, and have once again received untold Billions with which they have overinflated asset prices and created the exact same environment from the effects of which we have been trying to escape for the past 5 years. Banks and investment banks have paid tens of billions in fines to investors and regulating agencies for their ongoing litany of misdeeds. It seems, it is a small price to pay for the multi-Billions in profits they make every year.

This time too, and once again, it will end badly as the various asset bubbles blow-up or deflate. There are far too many potential triggers in the struggling global economies and environment today that could provide the pin to prick the first bubble, and start the cascading phizzes and pops.

There are big asset bubbles and potential political trouble, brewing in China, Japan, India, the United States, Europe, Russia, Brazil, Argentina (*South America in general*), the Middle East, the United Kingdom, Australia, and some of the countries of South East Asia, like Thailand and Indonesia.

We have been consistent in our stand for the last year and a half that **'sustainable recovery'** was not possible regardless of size and duration of *'Quantitative Easing'* after QE2, regardless of claims to the contrary by governments and Central Banks. The frequently touted *'global recovery'* since then has been ethereal and nebulous at best, and as mentioned in our previous Economic Reports, we feel that global economic conditions are going to get much worse before they start getting better. We are in the calm before the real storm.

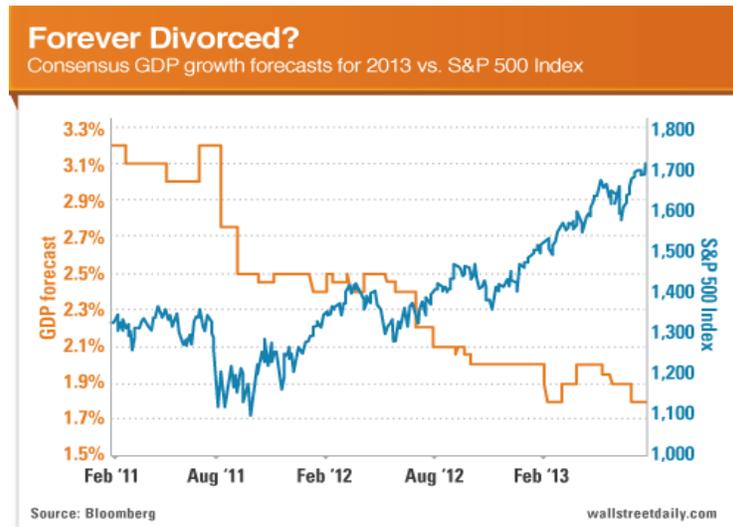
The largest Central Banks; the Federal Reserve, the European Central Bank, Central Bank of Japan, People's Bank of China, and others with their near irresponsible, ill-considered *'whatever it takes'* statements and stance, have unleashed a speculative boom (*as intended*) and a *'Debt Monster'* that demands to be fed insatiably, or it will wreak havoc in the financial and real-estate markets. So the Central Banks continue to feed the *'Monster'* with easy cash and low interest rates. Meanwhile, the conflicting pressure continues to mount on the over inflated debt-supported asset bubbles, and the trapped underutilized - low demand - underlying economies.

The only question is, where and when will the first collapse happen, which will bring the easy money debt supported house of cards down? The over-extended financial markets in the United States, dysfunctional Europe, overleveraged China or the long term insanity of *'Abenomics'* in Japan, could individually trigger the next global collapse, as could so many of the other festering problems around the World.

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UNITED STATES:

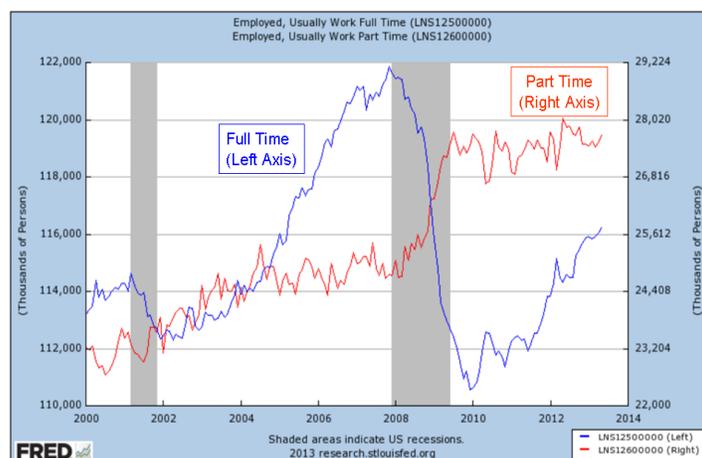


The U.S. is supposedly posting the strongest recovery out of most of the developed economies, although the chart above shows something quite different; a steady and substantial decline in the GDP growth rate, which isn't very encouraging, versus a prolonged and significant stock market rise that is obviously detached from the underlying economy, which is very worrying.

Still, there is broad consensus among most analysts and economists that there is a measurable economic recovery underway in the U.S. which has taken hold, and will only strengthen from here on out. We disagree with that analysis.

In our view, a closer look at the 'recovery numbers' whether they be jobs, housing, manufacturing, wages, consumer spending or capital investment, all show significant weakness and unsustainability. Additionally, the numbers as trotted out are misleading as they do not tell the real story of what is really happening in the economy. For example: Jobs...

U.S. Full Time and Part Time Workers



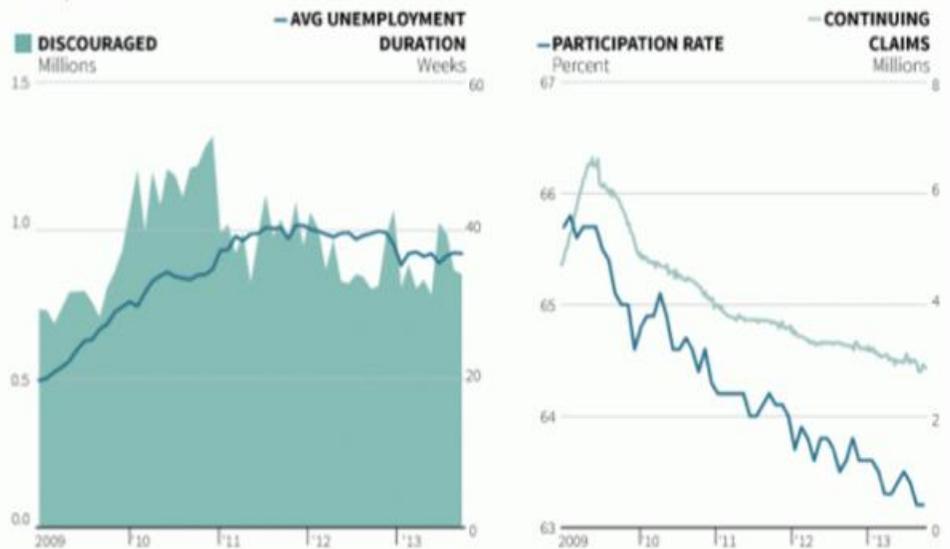
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The latest unemployment figures, which are steadily lower over the last year, and therefore presented as proof of recovery, are more so from people leaving the labour market than from permanent jobs being created and filled. In fact most of the jobs filled in the last year were part time jobs, and most of the jobs created were part time jobs, as the chart above shows. Additionally, a smaller percentage of the population was participating in the labour force as shown by the chart below. So the 'improving unemployment numbers' are without good permanent jobs and have more Americans choosing to leave the workforce resulting in 'improving' unemployment numbers. The U.S. economy is not producing good permanent jobs, and less rather than more Americans are participating in the job market (*chart below*).

U.S. unemployment and labor market participation

In September, the average length of unemployment edged down to 36.9 weeks as the number of discouraged workers fell to 852,000. And while the number of continuing jobless hovers below 3.0 million, the labor market participation held steady at 63.2 percent.



Source: U.S. Bureau of Labor Statistics
S.Cip. 22/09/2013

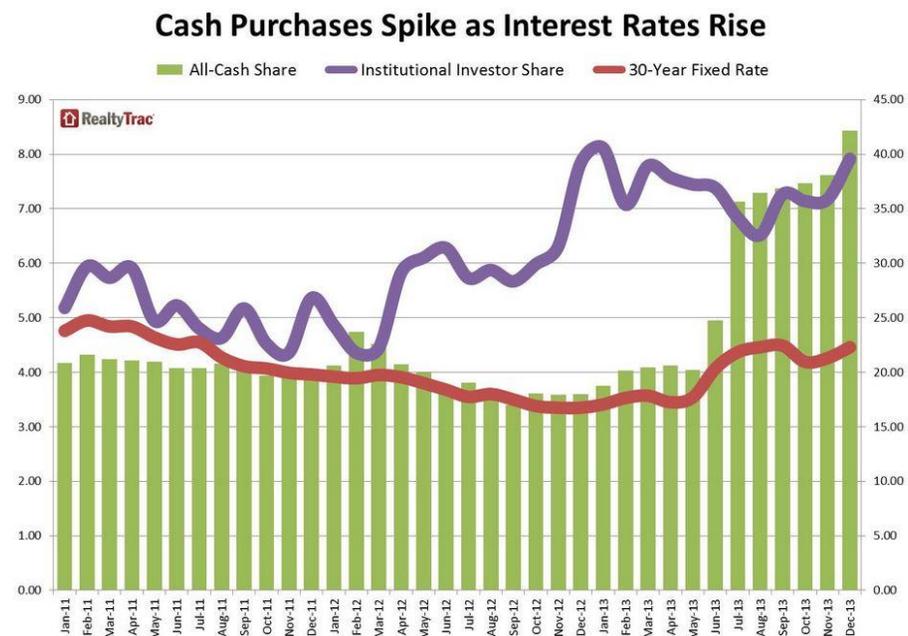
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Housing:

The improving housing sales numbers have been trotted out as proof of recovery, but these improved numbers are more due to financial players such as private equity investment funds, banks and speculators buying up large chunks of houses for sale as a speculative investment play, rather than American families or individuals buying based on recovery based financial strength of the average American. The cash coming into play here is due more to the cheap money available to large financial institutions from the Federal Reserve, than rising liquidity of the American family, as indicated by the Chart below.



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Corporations:

The ultra cheap money available to the large corporations and financial institutions have also allowed them to borrow at practically no cost and then turn around and either buyback their own shares in the stock markets to boost - the share price, market capitalization values, per share profits, and/or to pay higher dividends. Most corporations are not growing their top end revenues (*sales*) and some of the most iconic ones Wal-Mart, Coca Cola, and recently JPMorgan, have been issuing forward earnings warning for 2014. The Chart below shows the dramatic deterioration of earnings expectations by most of the companies comprising of the S&P 500. From a peak in the second quarter of 2010 there has been a dramatic rise in negative earnings pronouncements to the end of the fourth quarter 2013, which is likely to carry on into the first quarter of 2014. Just as dramatically the corporate earnings outlook has been deteriorating, the share prices have been rising (*blue line*) showing the extent of the 'disconnect' of the stock market (*in this case S&P 500*) from the underlying business reality.

S&P 500 Negative & Positive Preannouncements: 5-Year



And so it is with the other indicators. Apart from the odd *inexplicable* eyebrow raising jump to the positive side of some number, there is persistent weakness in manufacturing, consumer spending, wages to cost of living, and capital spending, indicating a less than robust recovery. Corporations continue to hoard cash and consumers continue to be reticent in spending, indicating across the board lack of confidence in the so called economic recovery.

The one area that has rebounded beyond expectations since 2009 has been the financial markets. Fueled almost solely by the actions of the Federal Reserve and dangerously disconnected from corporate and economic

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realities, the Dow and the S&P 500 have been consistently reaching new highs and setting records, pumped up by the torrents of liquidity still pouring in from the Federal Reserve.



The much anticipated “tapering” has been cautiously initiated by the Fed, BUT, with the caveat that interest rates will be held near zero indefinitely, and **the tapering can be rolled back and the spigots of cash reopened** if the economic numbers weaken significantly.

The ubiquitous phrase of the Central Banker committed to supporting the asset markets in the U.S., Europe, China and Japan has been “whatever it takes”. That phrase has taken the majority of the normal requirements and risks out of the asset markets (stocks-bonds-real estate), and understandably they have boomed, as speculation in assets has effectively been underwritten by the Central Banks.

So, the speculative party endures (*albeit a bit abated recently*) as the Federal Reserve continues **to underwrite the risk in the markets**. How long can this speculative binge last? The answer is, theoretically indefinitely, as the Federal Reserve has unlimited capacity to print money, as do the rest of the Central Banks. But we feel, as some others do, that the time of excess is once again coming to an inevitable end, the question still being, precisely when?

In reality, nothing goes up forever regardless how many reasons are trotted out to prove ‘it’s different this time’, and this time it won’t be any different. So, we are feeling the tremors of the tremendous strain of an over extended financial market, as it continues to fly in the face of economic and business realities.

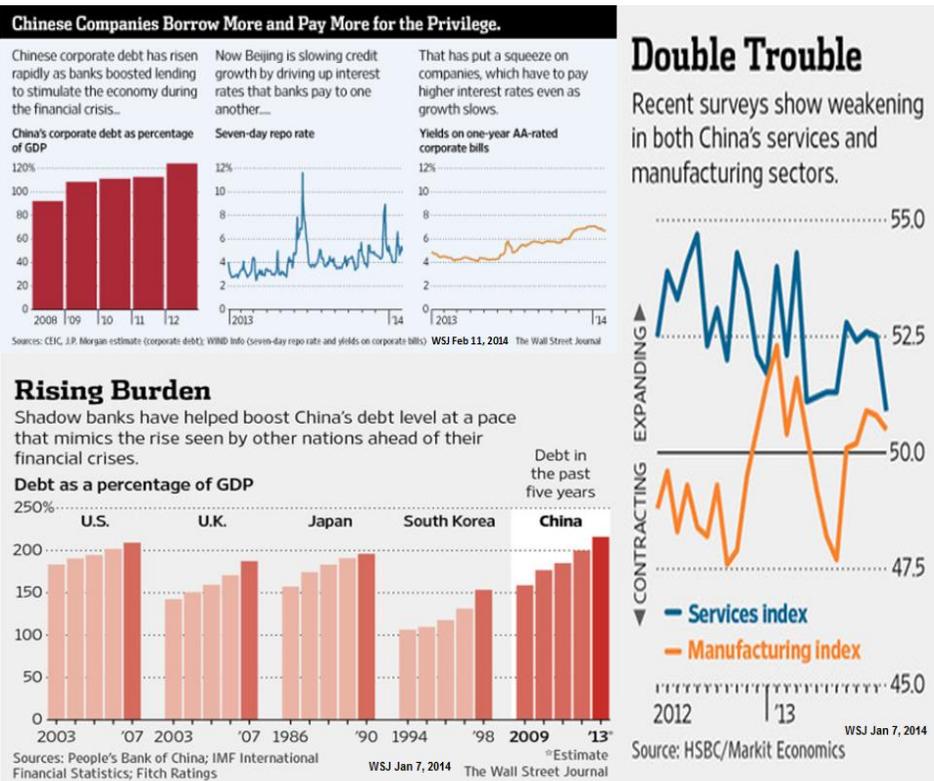
And then there is China

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CHINA:

China is now truly in a league of its own. Most numbers pertaining to China nowadays make everything else look rather insignificant in comparison, when compared to most other countries. And presently, China has a homegrown credit bubble that is now comparing ominously to the worst of U.S., U.K., Japan and South Korea's credit growth, in relation to their GDPs, prior to their near financial collapses in 2007, 1990 and 1998 respectively.



The Government of China had acknowledged the excessive credit growth problem in its last Plenum, and announced its determination to address it. But the reality has turned out to be different as the credit expansion has continued unabated over the past years (*chart above*) and since the November 15, 2013, 3rd Plenum.

The much publicized shadow banking activity has continued to climb, and some of the exotic 'Wealth Demand Products' (WDP) have started to implode. The Chinese Government *had* announced that it would allow market forces to function in its financial sector to bring some market discipline, but in the face of a major default it capitulated and stepped in (as *an anonymous investor*) to bail out the Trust Co., to prevent panic from spreading.

The first high profile bailout was of China Credit Trust Co. for its wealth demand product 'Credit Equals Gold #1', where the Government stepped in to the tune of US\$495 Million. But there is US\$427 **Billion** worth of such

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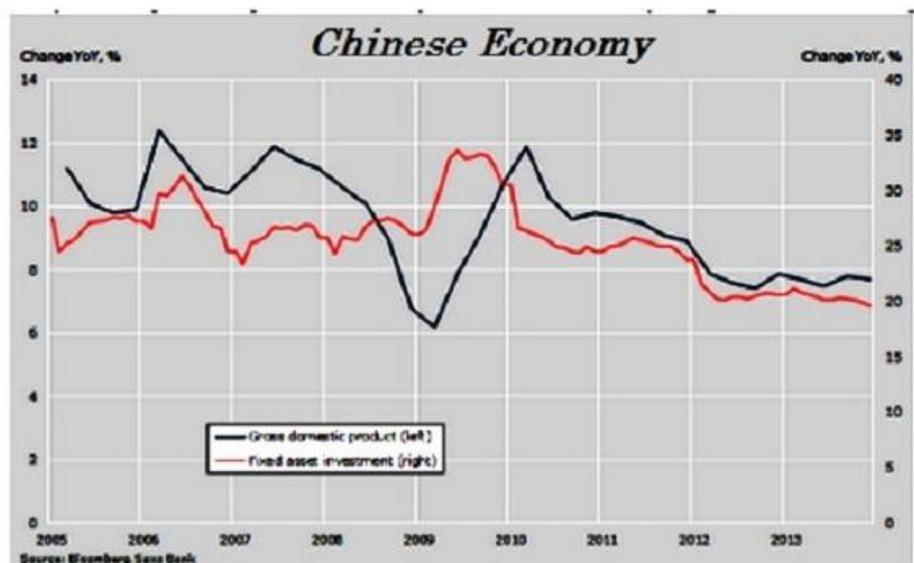
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liabilities due in 2014.

Most China watchers, including us, fear there is a lot more bad news to come out of China on its banking/shadow-banking side, as this is the tip of the massive credit boom iceberg that is slowly sinking under its extraordinary size and weight. (Note – China's debt is now closer to 250% of its GDP)



There is no question that the Chinese Government has tremendous capacity to bailout its sinking institutions, be they financial, industrial, military, political or social. The question is - can the singular might of the Chinese Government bailout all the financial and industrial problems they are experiencing today, most of which are inextricably intertwined. Both of those sinking icebergs, excessive financial leverage and industrial overcapacity, combined, may prove too much even for China's seemingly invincible Government. As the Chart below shows, growth is definitely on a downward trend.



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We have serious doubts that the Chinese Government possesses the kind of unlimited capacity that will be required to hold everything up indefinitely from here on out, in the face of shrinking World demand, and rising internal costs.

The other big problem China has is its limited control on Central, Regional and local governing bodies, that have their own agendas and vested interests. The stated policies of the national leadership, central planners, and national interest, are to a great degree secondary in importance to the regional and local governments and agencies, to their own interests. As everyone is aware, corruption is endemic to the Chinese system and greed is rampant, and the lower and higher levels of governments do that which benefits their interests first, before the national interest.

Those two nasty traits, corruption and greed unmitigated and unleashed together, bode ill for any country and its people, as it has been amply demonstrated in the financial industry in the West, of late. The sheer scale of these two ills in China may make the Western versions look tame by comparison.

We feel that eventually, sooner than later, the cost and fallout from the consequence of these entrenched problems, of endemic corruption and rampant greed, are going to be to scale to the disasters triggered in the West in 2008.

And, while most analysts and commentators have not given much voice to China's dependence on the rest of the World, we have always maintained that China, in the near to medium term, cannot regain or maintain its economic equilibrium without a revitalized global demand. And as we do not see that global demand reviving significantly enough any time soon, we feel that China is heading for much slower growth, barring a collapse of its credit bubble, at which time all bets will be off anyway.

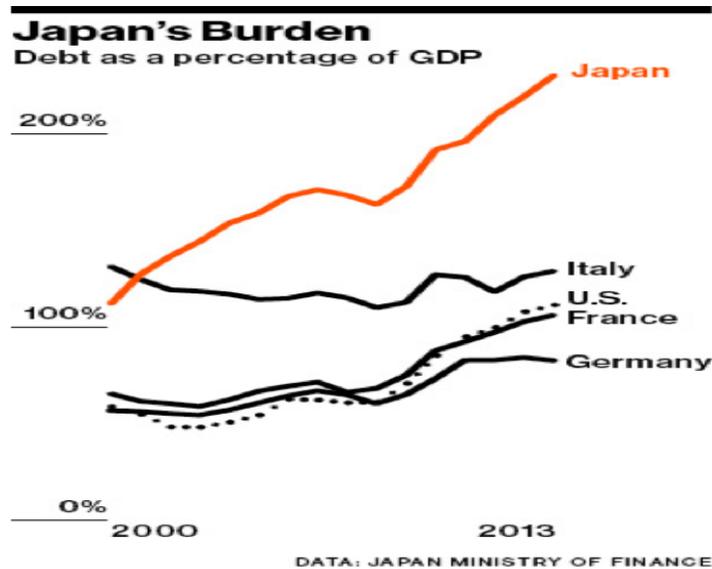
Regardless, we are expecting very challenging conditions in China's financial and industrial sectors in the near to mid-term, and we expect those challenges to multiply and threaten economic stability in China, and hence in the World.

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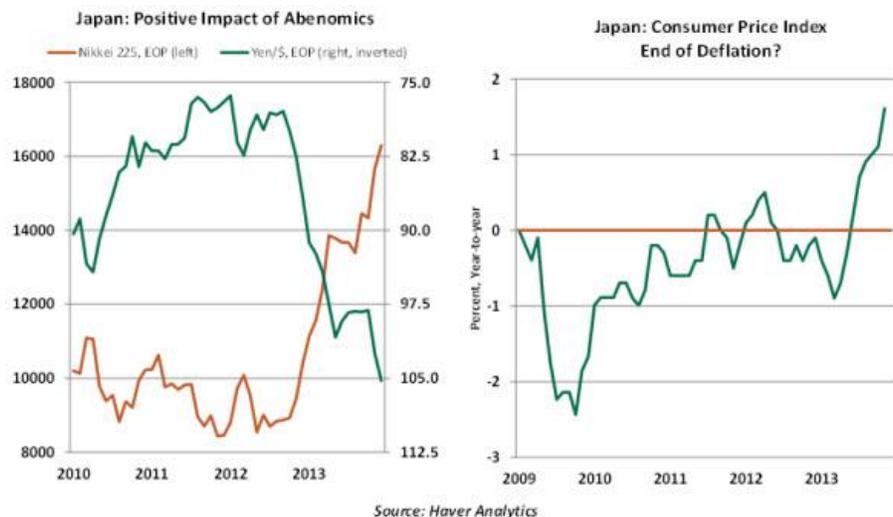
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JAPAN:

As debt induced growth goes, at this time Japan has to be considered the World champ. Japan leads all major economies where it comes to debt versus economic growth (GDP). When it comes to a developed country using financial stimulus and low interest rates to try to break-out of decade's long deflationary economic slump, and spur inflation and growth, there is no equal to Japan. Desperate times call for desperate measures and Shinzo Abe, Japan's Prime Minister has gone for broke.



The unprecedented liquidity unleashed by the Bank of Japan drove its currency the yen down, spurring exports, and its stock market the 'Nikkei' up, boosting long lost and desperately needed confidence among its despairing populace, and triggering foreign direct investment. This extremely aggressive, bold and almost foolhardy strategy has been so successful since its implementation that it's been named after its chief proponent, the current Prime Minister of Japan, Shinzo Abe, as "Abenomics".



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Abenomics succeeded quickly because the Japanese Government, once committed, took a 'no-backing-down' attitude towards the problem and startled everyone awake in the hereto long dormant economy, with the sheer scale and scope of its proposed fiscal and monetary stimulus. The Prime Minister projected a sense of total commitment to succeeding, which had been lacking previously, even in his past term as a Prime Minister, and a sense of determination took hold amongst the Government and the Bank of Japan, which rekindled hope in the population that till then had all but given up in the past years, of ever seeing a resurgent economy.

The Bank of Japan unleashed unprecedented liquidity into the financial system (*Yen 10.3 Trillion*); the yen was driven down dramatically, 25% in the first three months; the stock market soared 55% in the first six months, attracting greater domestic and foreign direct investment, and suddenly there was near euphoria, in up-to-then moribund economy, and a pleasantly shocked reaction from the rest of the World, which had also given up on Japan after two decades of stagnation. But, the bloom may be coming off the rose as the Chart below shows.



In 2014 the Nikkei has corrected sharply (see *Chart above*) and the negative aspects of the uber-stimulative package implemented through Abenomics maybe becoming more plainly and painfully apparent.

While the cheaper yen is boosting exports, the trade balance against Japan is soaring as the cheaper yen makes all imports that much more expensive, particularly energy. Japan is a huge net importer and consumer of energy (*oil and natural gas*). Expensive imports are also creating internal inflation, which is the target of the Government, but it is tough on the population which has not seen any material rise in their incomes. That is putting a squeeze on the average household resulting in dropping consumer demand, which is the opposite effect the Government had wanted. Additionally, Japan is a country

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of savers, and they are getting penalized by the prolonged ultra low interest rates. The low yen is also triggering currency wars with other countries, as other governments are forced to lower their currencies to compete in the international market place (*as China recently did*) putting downward pressure on Japan's exports and upward pressure on the yen, negating the effects of the massive stimulus.

Japan cannot have internal or external doubts about the success of its desperate gamble with a highly risky economic strategy. If doubt creeps in, support for the Prime Minister's radical and highly risky policy will start to vanish within Japan, and from external investors. That development will lead to an unmitigated disaster for Abenomics and the Country.

In addition to the headwinds of other sliding currencies resulting in slowing exports, and in soft internal consumer demand, Abenomics faces another approaching challenge - the proposed increase in the sales tax from 5% to 8% in April of this year. It is widely anticipated that prior to the implementation of the higher sales tax, consumption may spike in this quarter as everyone makes purchases to try and save on the additional 3% tax that is coming. But that anticipation maybe wrong, as hard pressed and cautious consumers and businesses may hunker down as the deteriorating impact of Abenomics becomes increasingly clear.

Japan has committed itself to a highly risky course of action to break out of its economic malaise. If the rest of the World was not suffering from similar afflictions at this time, it may have pulled of the gamble. But as every other country and economy is also trying to revive itself, the competitive pressures thus exerted on Japan, are going to make it difficult for Abenomics to succeed. Abenomic's failure will further bury Japan in unprecedented debt and indefinite economic stagnation, and at the same time it will just add another crushing load to the already fragile global economic structure, adding further impetus to the impending 'Global Crash II'.

Part II of this Economic Report (coming next week) will examine the current status of Europe, India, Australia, South East Asia and South America - their outlook - and how they will impact the global economic whole in 2014.