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The Global Recession of 2016

Forecaster David Levy sees a spreading global recession intensifying and ultimately engulfing the world's economies

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Although the U.S. economy is in pretty good shape, it doesn't have enough strength to fend off weakening fundamentals elsewhere, particularly in the emerging markets. That's the view of David Levy, the 60-year-old chairman of the Jerome Levy Forecasting Center in Mount Kisco, N.Y. Levy, who helps write the Levy Forecast, the firm's newsletter, argues that the more bullish consensus view underestimates the linkages between the U.S. and emerging markets, which account for roughly 40% of global gross domestic product. And he worries that China will have a very tough time making a soft landing as it tries to refocus its economy. To discuss his observations and their investing implications, *Barron's* sat down recently with Levy at our offices.

Barron's: *When we last spoke in August 2013, you were worried about the global economy. What's your latest assessment?*

Levy: At the time, we had a lot of concerns about China and the rest of the emerging markets. We were also worried about various political decisions. Europe, for example, was thinking about more austerity, the U.S. was thinking about very sharp budget cuts, and, as for China, who knew what they were going to do? But they were struggling. Essentially, our biggest worry was that if these more counter-stimulatory moves were made, that might put the world in a recession. More than two years later, we have started to see what I consider to be the housing bubble of this cycle. But this time around, it's the emerging market expansion bubble that's starting to break down. Even by the start of 2015, there were a few countries in recession. In other countries, such as Taiwan, there's clearly a general decline in the strength of the expansions. By the time we get third-quarter data, I expect to see that more of those countries are in—or very close to—recession. The problem is that, much like with the housing bubble, it's not something that shows up in economics textbooks.

Photo: David Yellen for Barron's

Where is it showing up?

In the financial dimension of the economy, where balance sheets live, and in profits. Looking at the entire global economy as one entity, the biggest source of profit growth in recent years was the net investment in emerging market export capacity. But now that net investment is slowing gradually in the emerging markets. It is evident not only from the data on exports from major capital goods exporters, but also from companies. One after another, when they talk about their outlook and performance, companies refer to weakness, weakening, or greater weakness in the emerging markets. It is much like the housing bubble in the U.S. nearly a decade ago when it started, because the deterioration of the emerging markets has the ability to topple the global economy.

How close are we to a global recession?

Parts of the global economy have already turned down, including Russia, which has some special problems related to energy and economic sanctions, and Brazil. Most of South America looks pretty close to recession, and we've seen slowdowns in other parts of the world. The one area that has picked up somewhat is Europe. But when we analyze what has been boosting their profits, it is entirely accounted for by the improvement in Europe's current-account balance. Obviously, the cheaper euro helped their exports. And they get an extra bonus from falling petroleum prices, but Europe's momentum is showing signs of starting to fade.

How strong is the U.S. economy?

The U.S. is doing fairly well. It does, however, have impediments to rapid growth, including a lot of debt, expensive housing, a crash in domestic energy investment, and, contrary to some views, a lack of incentives to expand fixed-capital investment much. But the one thing that has actually caused the economy to weaken a little is sagging profits. We've heard people use the term "profits recession," but there is no profits recession without a real recession. I see signs of things slowing as a result of that profits decline, which can be blamed pretty much directly on weakening exports and, to some extent, the dollar's strength. But most of it is because emerging markets have bogged down.

So the U.S. economy is weakening?

Yes, it is, but there is no way the U.S. by itself is about to keel over. The danger is not so much that we're going to start to slide sharply, but rather that conditions overseas will become much rockier.

Which could pull the U.S. into a recession?

Yes, and there are several reasons why. Such a scenario has never happened, certainly not in modern history. There is no postwar recession prior to which the U.S. economy was doing fine, only to get knocked down by the rest of the world. That's one reason people don't see the risk. But the emerging markets are not just going into a recession, they are going through a secular adjustment. Their strategy for the past 20 years—most evidently in China, but in other countries, as well—has been just massive investing and exporting. But they are too big to play that game anymore.

When investment drops, profitability falls. And there are the financial consequences of having created a lot of business facilities—in some cases, public facilities that are expected to earn income, toll roads, for example. When those assets aren't earning income, it not only causes problems with the debt used to finance them, but it also starts to undermine the collateral values, and it starts to cause equity values to drop.

How is the U.S. affected by all of this?

We expect not only a global recession, but also general asset deflation, aggravated by the fact that there is no room to cut interest rates at the major central banks. That's a huge difference, compared with other cycles. People are used to having the option of rate cuts that will do something.

What else is the consensus overlooking?
How serious the problems are. Let's take China; many people think that all it needs to do is rebalance its GDP. A little bit less investment, together with a little bit more consumption, and everything will be fine, the thinking goes. First of all, China cannot make a gradual adjustment to its investment, because they already have enormous excess capacity. Manufacturing capacity utilization is probably about 50%, possibly less, and 46% of their GDP comes from investment. That is insane, and it's way above even the worst of the Japanese bubble. At its peak, government and private investment in Japan totaled 33% of GDP in 1990.

In contrast, in the post–World War II boom in the U.S., with all of those interstate highways and schools being built, the highest we got to was about 25%. To invest 46%, as China is doing, you need the most ridiculous growth rate to make that work. Every year that they allow this to happen, they are undermining the finances of their entire economy. China must make some kind of rapid adjustment, not a gradual one, but it's not easy to do that.

One reason cited for the strength of the U.S. economy is that the housing market is on the mend. Is that thinking flawed?
Real incomes aren't where they used to be, and housing, when looked at historically, is very expensive. Housing, of course, had a tremendous rise during the bubble, and then came down a long way—but only back to normal valuations. Now, it is probably 30% of the way back up from the bottom. Buying a house when real incomes have not been growing can be pretty difficult. Certainly, the lower interest rates, and lower payments, are making mortgages more affordable. But the costs of down payments, real estate taxes, and insurance are all factors to consider, as well. People often get excited that all these kids in their 20s who have been living at home with mom and dad will finally move out. The problem, however, is that the jobs they are getting, in most cases, aren't making it very easy to move out. Another thing to consider is that apartment rentals are historically quite high. It is a tough time to get into new housing, which is really driven more by what people can afford.

What is wrong with the notion that the labor market is tightening, and that this typically doesn't occur when the economy is heading into a recession?
First of all, employment is a lagging indicator. It may be a leading indicator of forecasts, because when it is strong, people get excited and it makes them more optimistic. But, in fact, it usually doesn't peak until sometime close to the beginning of a recession. The real deceleration—and the real loss of jobs—comes as a reaction to weakening conditions, not as a cause of them.

How should investors be thinking about their portfolios?
Investors typically work with basic tenets, whether it's "don't put all your eggs in one basket" or you need to balance income and growth. Normally, that makes sense. The problem is that a lot of these tenets actually have to change, or at least be reinterpreted, when we're talking about an economy headed toward deflation in multiple parts of the world. There is barely any inflation in the U.S. and Europe, and another cyclical downturn would certainly push those economies towards deflation. We're already seeing it in commodities. All of that changes things, and then when you can't cut interest rates, it's setting up for all of the so-called baskets of eggs to be broken.

This is a time when shorting strategies—or at least underweighting emerging markets, if you are allocating assets—make sense. The one thing that keeps its value, with no risk attached, is Treasuries, and maybe a few other types of fixed income. We've remained long-term bulls on Treasuries, although we aren't expecting it all to happen at once. We have not yet seen the bottom, but we have seen negative yields on German Bunds lately. I am not sure that will happen here in the U.S. But in the next recession, we certainly will see a lot of downward pressure on foreign currencies—and on asset classes of all sorts—and a big rally in Treasuries, pushing yields to new lows.

Where will the 10-year U.S. Treasury, which was yielding about 2.21% recently, be trading a year from now?
We've been saying for a long time that, when we do get into a recession, the 10-year yield is going under 1%, which is a pretty conservative target. It would be very easy for a recession to push it below that level.

Do you expect to see that next year?
Bit by bit, the global economy is falling into recession, with the U.S. bringing up the rear. The Fed announced last week that it is raising the federal-funds rate by 25 basis points, or 0.25%, so it made at least one rate increase. Meanwhile, the global economy continues to deteriorate, and the U.S. expansion is showing broad signs of deceleration. We expect that the Fed will reverse course later next year. In all probability, the slowly spreading global recession will intensify and ultimately engulf the entire planet. It's at least 2 to 1 that we'll be in a recession at the end of 2016.

Thanks, David.
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