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The West to the Rescue

"An Officer of the Imperial Horse Guards Charging", Théodore Géricault - 1812

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The West to the Rescue

The emerging crisis in China has caused major convulsions in the global financial markets. The effects that an eventual Chinese crisis might have on global growth (China represents a third of world growth), and in particular, the contagion effect posed towards emerging economies through a collapse of commodity prices, have been of particular focus in evaluating the gravity of the Chinese crisis. However, this analysis leaves out a fundamental factor, which is possibly much more important than the Chinese crisis: the progressive acceleration of Western growth (which in this analysis we note as U.S and Europe), that continues to be very different to the global economic aggregate. This phenomenon in my opinion will mitigate, and even cancel out the Chinese crisis.

The relevance of the West in the global economy

China represents 15% of the world economy, but the West represents 46%. Here it follows than an increase of 1% in Western GDP is 3 times more relevant than a 1% drop in Chinese GDP. It is true that in the past China has represented a third of world growth, and if this growth is added to those experienced by other emerging economies, then China's global growth has depended on more than half of the emerging block. However it is not fair to analyze this statistic without understanding the enormous financial and economic crisis experienced by the West since 2008. Assessing contributions to world economic growth when the economy of the U.S has grown at a low potential and the European growth have remained nearly stagnant, a consequence of an economic and financial crisis which has caused the worst recession in 30 years, is not correct

On the other hand it is important to understand that the growth of many emerging economies depends on a considerable amount of exports made by Western nations, hence the Western consumer is a "last resort consumer". If the North Americans or Europeans go to the shops it is good news for world growth.

In this analysis we will expose several fundamental factors that explain how the crisis began back in 2007 and how the process mentioned above will accelerate, resulting in a higher economic growth that will ultimately be beneficial for global economy.

The period from 2008-2015 has been unusual

When analyzing historical series it is of great importance to understand if the same ones are relevant in order to make predictions. We have already explained how the crisis that erupted in the summer of 2007 has been the most serious in the West since the great depression. An alignment of a banking crisis and an economic crisis usually takes a longer time to get exit from, close to five years. The recent crisis has been so severe that its impact has probably had a harder effect (Table 1).

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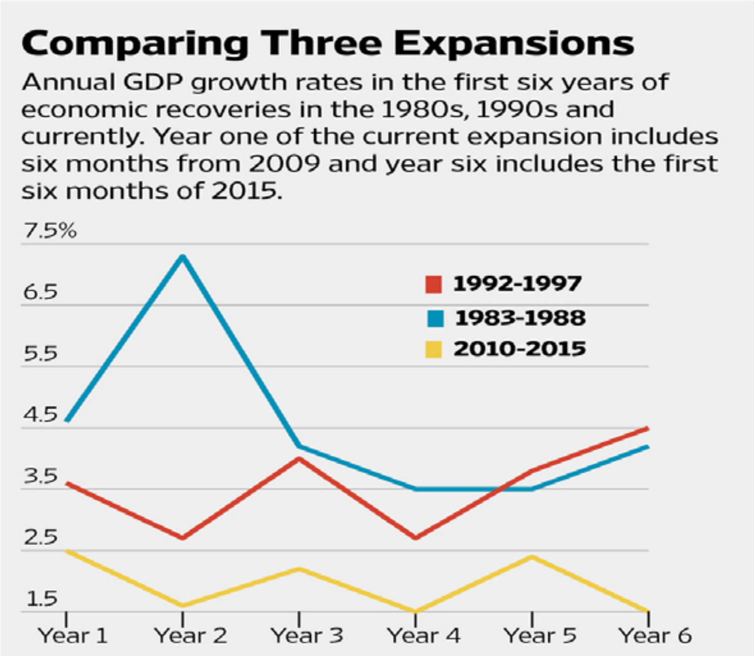
Table 1. The recent crisis has been worse than previous ones



Source: Bureau of Economic Analysis, WSJ

During this period, the West has had to cope with: i) a relevant fall of real estate prices, which has caused a banking crisis, a collapse in residential investments, and a fall in consumption (the movements of house prices explain the movement in consumption), ii) a period of financial crisis, which led to a stalemate of credit, and made disappear many companies solvent but illiquid, a process which in turn has resulted in higher levels of unemployment and which has seriously damaged consumption. Thirdly, an unprecedented financial crisis with a huge public deficit as a% of GDP, forced tax adjustments (tax hikes and public spending) which further damaged economic activity. Furthermore, an enormous invoice from the bullish commodity super-cycle, with the West being the net importer of them, as the GDP explains between the differences exports and imports, raising the cost of imports have damaged Western economies at a time of enormous vulnerability. Lastly, it had to face a collapse in investments, stimulated by the difficulty of access to credit and weak aggregate demand.

Finally, it is relevant to take into account the other more idiosyncratic events that have undermined the previous growth of the West. During the first quarter of 2014 and 2015, the U.S was hit by horrible weather that paralyzed investment and consumption; in addition, the strike of dockworkers on the West coast during the first four months of 2015 damaged trade, and in 2015 it has had to live with an appreciation of the dollar of approximately 20% which has adversely affected exports. For its part, Europe, and more specifically the Eurozone, which was in a period of construction in its monetary union, has had to live with a sovereign crisis that reached its greatest exponent in recent years with the bailouts of Portugal, Greece and Ireland and the rescue of Spanish banks as well as the Greek crisis of 2015. The sovereign European crisis has undoubtedly affected the financial sector, slowing down investments and consumption. On a positive note however, is that the political establishment and Eurozone architecture appear to have come out stronger from the crisis, which will have positive implications. It is important to put into context this succession of events, as without taking them into account it is not possible to explain why emerging economies have been the leaders in recent economic growth.

The good news is that all these factors are returning, and the effects can be very positive.

The reactivation of credit

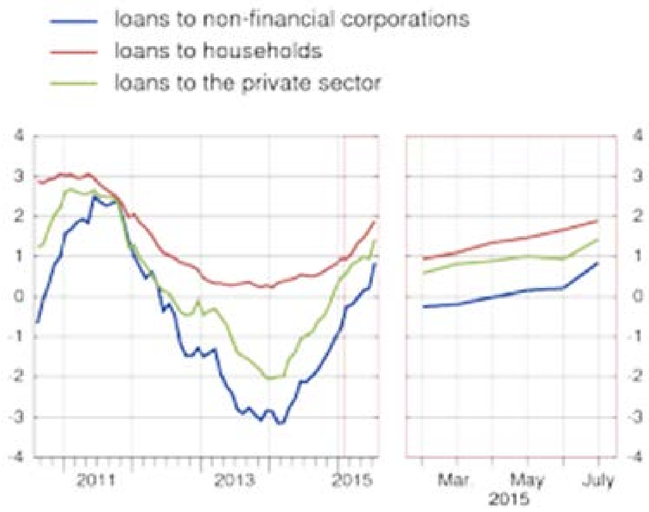
If a financial crisis can cause or accentuate an economic crisis to overwhelming proportions, as we have seen since 2008, the progressive consolidation of banks resulting in an expansion of credit can cause an opposite phenomenon, as credit begins to flows to households and businesses once again.

As the bank solvency and liquidity is restored, and supported by an expansive monetary policy that permits liquidity injections and brings the price of money to an all-time low, and reopens the capital markets, the economic impact is very beneficial. On one hand more mortgages are granted, which encourages real estate investment (that generates a lot of employment), and higher home prices, and in turn drives up the levels of consumption. Furthermore the access to credit can gradually increase investments, encouraging employment (on building a factory, workers are hired) and consequently raises consumption. In addition, when accessing consumer loans, households can afford cars or trips, stimulating demand. The export credits also facilitate the generation of demand via internal growth. In short, a reactivation of banking activity and capital markets acts as an extraordinary wakeup call for economic growth.

The U.S led the process of cleaning up the banks after the Lehman Brothers crisis, with a strong performance of clean balance sheets, which facilitated the economy of the United States to soon grow again and reach pre-crisis levels of GDP. Also, the strength of the U.S capital market as an alternative source of financing allowed many companies to access finance in the most difficult moments. The U.S financial system is in full throttle, as shown by the periodic surveys carried out by the FED (Senior Loan Officers Survey) that consistently show more appetite to lend, borrow and relax conditions for awarding credit. For example, banks are accelerating and increasing their consumer credit by 6.5%, which will further impact the acceleration of consumption. Additionally, the applications for mortgages in 2015 are rising by 16%, which explains the rebirth of real estate which we will look at later. As a whole, (including the corporate credit), the banks of the U.S are stimulating the total credit above 6% year-on-year. In the meantime capital markets, with the issuance of various bonds (investment grade, higher quality, high yield, more speculative) and securities (IPOs and capital increases) continue to develop very high levels of activity, which are the backbone of GDP and of the employment in the U.S. Furthermore, small companies' confidence indicator (NFIB) has increased with great force which has improved employment.

In its time, the European banking system, much larger than the U.S in % of its GDP, has been stunted since the crisis, in part by the very slow reaction of the regulators and governments to strengthen its ability to clean up the banking system. However, it seems that this culminated during the 2012-2013, and as the economic situation has been improving, two crucial phenomena are triggered: demand and the supply of credit have risen. The result is an acceleration of new credit flows into the economy, which rises with new credits in the economy (a more relevant indicator than the outstanding balance of credit that rises with new credits and reduces with historical credit repayments, being relevant to the new credit) and as a consequence drives investment and employment. In summer the credit grew at nearly 1.5% year-on-year, and accelerating a great achievement taking into account the years of drought). The quarterly ECB surveys note this improvement of credit, both in supply and demand (Table 2).

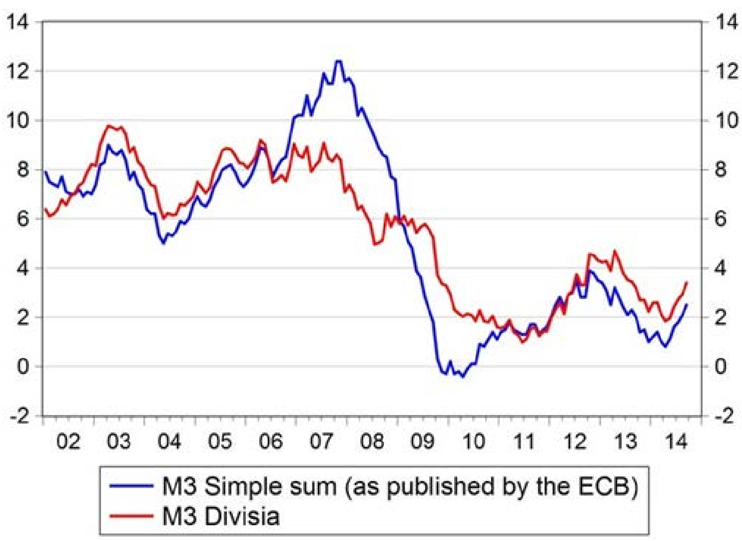
Table 2. Recovery of the European credit



Source: ECB

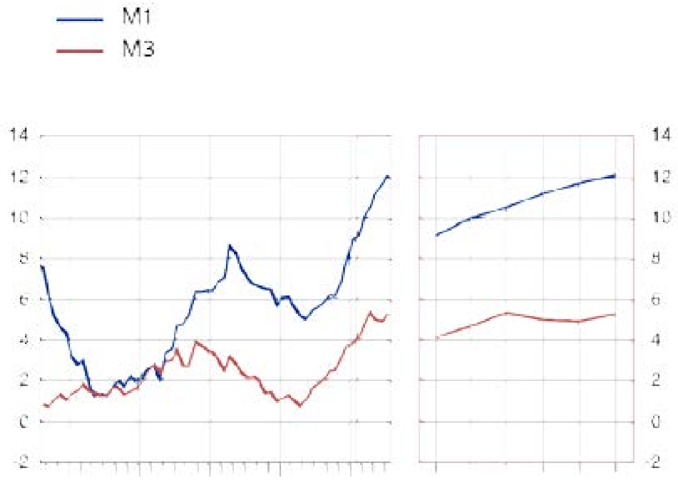
The better exponent of this situation than the progressive acceleration of the monetary supply in the Euro area (M3), is that it has been presenting nominal growths in the past to grow above 5% in the summer of 2015, which will undoubtedly explain an acceleration of GDP, especially if it is taken into account with a calculation of the monetary weight to the impact of each aggregate in the ability to carry out deals (i.e, contribute to demand). In this sense, EUR 1,000 of M1 that measures more cash and equivalents makes more transactions that EUR 1,000 in a bond of two years, even though both are calculated equally for the growth of M3. The concept of "divisia" weights for this concept showing that the acceleration is greater than 5% - Table 3- currency-, (in fact the M1 grows at 12%), which is positive for GDP -Table 4, acceleration of the money supply - which has led to an improvement in GDP (Table 5), the impact of the money supply in the economy).

Table 3. Eurozone monetary growth



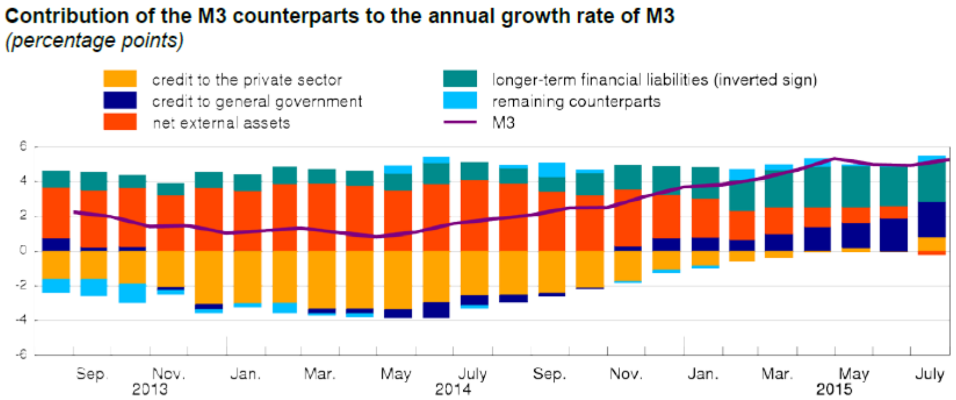
Source: ECB

Table 4. Acceleration of European money supply



Source: ECB

Table 5. Impact of money supply



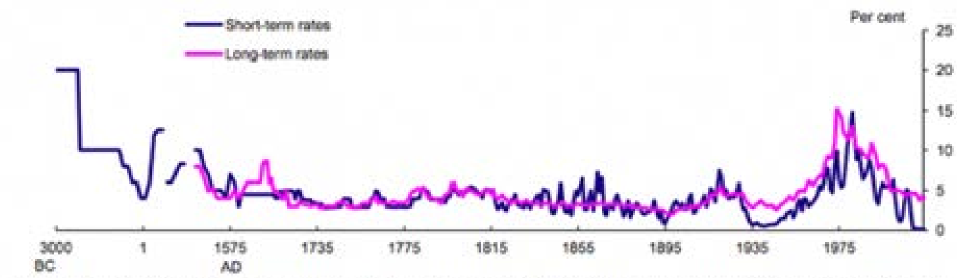
Source: FT

While Europe has been far behind the USA in terms of developing its capital markets, the crisis has taught a clear lesson of how harmful it is for an economy to have excessive dependency on bank credit. However, during the crisis, European capital markets have experienced strong growth, mainly driven by the bond market. For example, if the European High Yield markets represented 10% of the size of the U.S markets before the crisis, this percentage currently stands at 33% and growing. At the same time, the investment grade bond market is growing (its size already reaching EUR 1.4 trillion, 64% more than in 2007) and IPOs are also at very high levels. Finally, several European countries have created markets for mini-bonds for medium-sized businesses which are contributing to financing in the critical segment of SMEs. In the to do list stand, the reactivation of securization markets and project bonds (to finance infrastructure) and the announcement by the European Union of a bundle of measures ("green book") to accelerate all the dynamics and homogenize it in a context of a capital markets union.

As recently pointed out by the Governor of the Bank of England, the West today, is enjoying lower interest rates from Babylon…from 5,000 years ago. The effective awakening of liquidity and cheap money is evident (Table 6, interest rates through history). Hence it follows how the U.S economy begins its surprising rise from the second quarter of 2015, with annualized growth above 3% and that of the Euro area should go from the third quarter, when growth should accelerate to 0.4% quarter on quarter, and gradually reaching annualized growth of 2%.

Table 6. Interest rates throughout history

Chart 5: Short and long-term interest rates



Sources: Homer and Sylla (1991); Heim and Mirowski (1987); Weiller and Mirowski (1990); Hills, Thomas and Dimsdale (2015); Bank of England; Historical Statistics of the United States Millenial Edition, Volume 3; Federal Reserve Economic Database. Notes: the intervals on the x-axis change through time up to 1715. From 1715 onwards the intervals are every twenty years. Prior to the C18th the rates reflect the country with the lowest rate reported for each type of credit: 3000BC to 6th century BC - Babylonian empire; 6th century BC to 2nd century BC - Greece; 2nd century BC to 5th century AD - Roman Empire; 6th century BC to 10th century AD - Byzantium (legal limit); 12th century AD to 13th century AD - Netherlands ;13th century AD to 16th century AD - Italian states. From the C18th the interest rates are of an annual frequency and reflect those of the most dominant money market: 1694 to 1918 this is assumed to be the UK; from 1919-2015 this is assumed to be the US. Rates used are as follows: Short rates: 1694-1717- Bank of England Discount rate;1717-1823 rate on 6 month East India bonds; 1824-1919 rate on 3 month prime or first class bills; 1919-1996 rate on 4-6 month prime US commercial paper ; 1997-2014 rate on 3month AA US commercial paper to non-financials. Long rates: 1702-1919 - rate on long-term government UK annuities and consols; 1919-1953, yield on long-term US government bond yields; 1954-2014 yield on 10 year US treasuries.

Real estate recovery

Generally credit cycles go parallel to real estate cycles. A drop in mortgages usually causes a similar drop in real estate prices (via less demand) and vice versa. In turn, higher and lower loan volumes explain upward and downward movements in new housing construction, a very sensitive sector for employment. The crisis has caused a profound recession in the Western real estate sector, especially in countries where large bubbles existed (U.S, U.K, Ireland, and Spain). However, after the significant price adjustment for the situation stabilized, and as bank financing was encouraged, there was a revival of the real estate sector. It is important to stress the importance of this sector, since a) it represents a % of GDP, around 5%, b) it is closely linked to financing, as a rise in house prices improves bank balance sheets, causing greater propensity to lend, which drives GDP, c) it is a very intensive sector in employment, which affects consumption d) it presents important additional effects on consumption, which by increasing the price of homes, people "feel richer" and spend as a consequence of the increase, and e) the sector pulls along an auxiliary sector (construction materials, cement, household appliances) which represent another 3% of GDP.

Recently it has become explainable by the expansive monetary policy, which the data for points to an acceleration in this sector.

In the U.S the house prices are already up 5% (SP Case Schiller indicator), new mortgages have seen a rise of 16%, and the confidence of house builders of the U.S (NAHB) stands at 61, the highest level since 2005. Furthermore, the sales of second hand homes are at the highest level in seven years (Table 7), the visas for new home constructions are up 30%, the initiations of homes are at 1.2 million annualized, the highest level since 2007, and the sales of new homes in July climbed 23% year-on-year (although at a level two thirds lower than before the crisis, it could add an additional 2% to future GDP). The consequences of this real estate acceleration in the North American GDP (the residential investment growing at 8%) can be very positive and surprise consensus forecasts.

Table 7. Existing home sales in the U.S

Source: Bloomberg, Eric Platt and FT

In turn, Europe also observes how the real estate markets continue to improve. The U.K abandoned its crisis a while back, in 2010, and since then prices are now at their peak. In the Euro zone the real estate prices rose in the previous first trimester at 0.9% against the previous trimester, or nearly 4.5% in annualized terms. In Germany and France the real estate prices have shown a continued tendency to rise, and in Spain, after a very dramatic crisis, since the summer of 2014 there has been a clear turning point, with an annualized rise of 5% in the better quality indicator, the IPVR, of the College of Registrars, equivalent to a Case Schiller methodology. This tendency is revealed in the fact that the construction sector has returned to growth within the Eurozone (2.3% at the end of June), with its important connotations in employment.

It's the consumption, stupid!

Consumption represents the greater percentage of any developing nations GDP. At the same time, there is a direct relationship between consumption and employment. At higher employment, there are more people with a salary to use, and higher employment improves consumer confidence, and thus the percentage of salary spent vs. the savings increases. On top of this, continued employment triggers higher wage inflation, expanding the revenue available for spending. On the other hand, the level of consumption is related to the evolution of asset prices. Increases in the prices of stocks, bonds and real estate have an impact on higher levels of consumption. It is also very important to consider the positive effect of "disinflation", as prices gradually grow it releases an enormous level of purchasing power. The fall of commodity prices are also especially relevant, and in particular gasoline, as they release a large capacity of money that is consumed in other assets, accelerating its growth

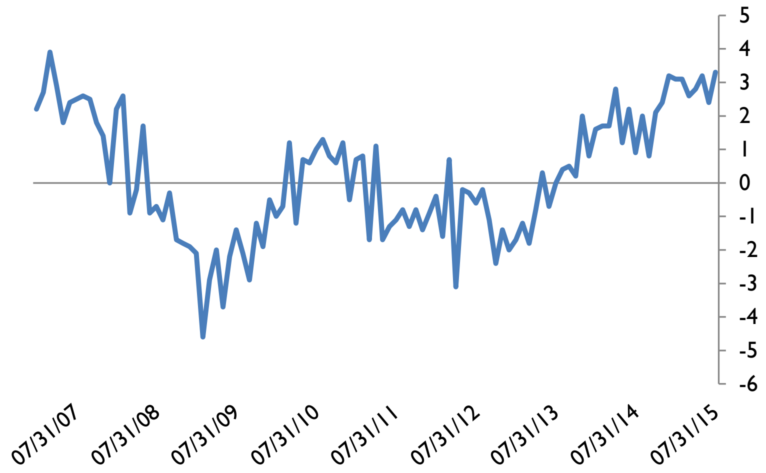
If we analyze the situation in the West, we can see how the stars are fully aligned to consumption, which has already been stimulated, accelerating more and more and that will have global repercussions (a greater Western consumption will emerging exports, undermining the damage, and increased consumption in turn, leading to further investment in the West, which will contribute to GDP).

The U.S labor market presents a very good evolution, with 2.5 million jobs created during the year, wages rose (2%), consumer credit has been growing strongly (6.5%), and layoffs are at their lowest levels (unemployment at 5.3% and weekly requests for unemployment benefits below 270,000, the lowest in a long time).

As a consequence, in the U.S, the main indicators of consumer confidence (Michigan and Conference Board) are at their highest levels since the crisis. Car sales are also at pre-crisis levels (approximately 18 million annually). In spite of the fact that consumption data for the first quarter were regular in regards to the weather, the reality is that since June the U.S consumption is accelerating, with the very positive data from July that has also been revised upwards in addition to data from May and June, rises of 5% consumption against the previous quarter, a phenomenon that could boost the annualized growth of GDP in excess over 3%.

In Europe these factors are moving slower than the U.S, but they are going in the right direction. In this sense, the progressive reduction of unemployment (11%) has allowed for important rises in consumer confidence in the Eurozone, Germany, France, Italy and Spain. The decline in energy prices, which weights quite heavily on the consumer has also been an important factor in understanding the improvement in consumption. Overall, retail sales rose above 3% with volatility amongst countries, but acceleration is the tendency (Table 8) as it denotes the evolution of employment and wages (growing 2.2%) confidence. These factors suggest that car sales should rise by about 10%.

Table 8. EU Retail Sales (% y-y)



Source: Bloomberg

An exporting giant in acceleration

The fundamentals of exports tend to be inversely related to the economic cycle. Therefore, during the "good" years, wages tend to grow above productivity, slowly undermining competitiveness. During the "bad" years, wages barely grew, and productivity usually grows strongly, generating itself as a major exporter. This is precisely the process that has favorably developed for the West (and unfavorably for emerging economies) after the crisis.

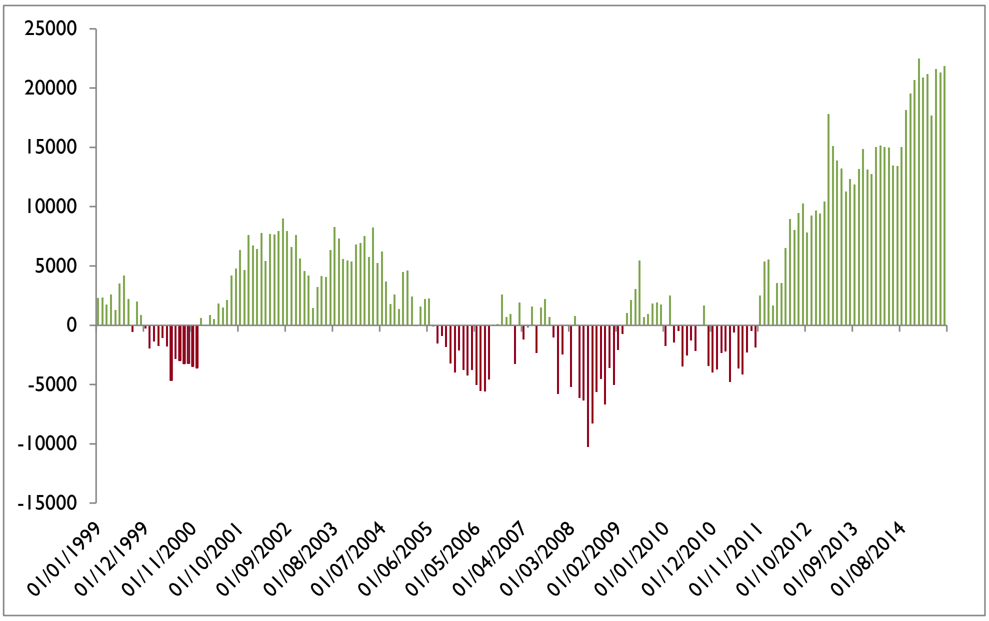
The US is not a major exporting nation (exports are less than 15% of GDP, compared to 26% for the Eurozone), and it has had to cope with a large appreciation of the dollar during 2015. However, its trade position has improved strides since the crisis. It presented an enormous deficit after the crisis in 2007, in part due to its energy dependency which has reduced its competitiveness. However, the energy revolution has allowed it to slash energy prices; improving competitiveness (U.S by law cannot export oil, except to Mexico, although it is likely that its position will be relaxed). On the other hand unit labor costs (net labor costs of increasing productivity) have improved substantially since the crisis by which the U.S has been able to replace imports through its own production (a phenomenon called insourcing, in contrast to outsourcing). The U.S presents one of the most productive labor forces in the world, and one which also works the most hours in the world. As businesses have not transferred labor costs, the improvement in productivity has won an enormous amount of competitiveness for businesses (Table 9). In this sense and despite the evolution of the dollar in exports in 2015 (falling 3.6%) the future exterior of the US is promising.

Table 9. Improvement of U.S business competitiveness

Source: Labor Department and WSJ

With regards to Europe, and more specifically the Eurozone, we are perhaps seeing the largest exporting power in human history, powered by four very large and successful economies on their exports: Germany, Spain, France and Italy. Europe exports general goods and services which are quite sensitive to the exchange rate; however in any case the weakness of the euro has helped them even more. The crisis has brought about a moderation in wages and a strong increase in productivity, which explains how Europe has progressively been taking a larger share of the global exports. As a whole, the Eurozone exports 26% of its GDP, with exports rising 6% year-on-year (vs. world trade increasing to 3%, hence the improvement of market share), Table 10. The trade surplus for the first half has now reached the EUR 115 bn. vs EUR 76 bn. over the previous year, a surplus unseen in centuries and the largest on the planet. This economic strength not only bodes well for a great economic power. In terms of current account, the Eurozone reaches a surplus of 2.6% of its GDP, close to EUR 265 bn. in twelve months, which increases liquidity and reserves of the economy. China represents 10% of European exports (approximately the same as exports to Switzerland), equivalent to 2% of their GDP, which is why the contagion effect is limited, especially in a context in which demand from the U.S recovers and the exchange rate helps (European exports to the U.S grew by more than 20%).

Table 10. Trade balance of the EU



Source: Bloomberg

Non-residential investments

The most evident consequence of the economic and financial crisis has been the strong reduction of investments as a % of GDP, a factor which has reduced demand, and generated overcapacity, hampering access to medium-term credit, a phenomenon which together explains the reduction of investments. However, a measure which gradually improved demand, the use of existing capacity will also rise, causing the need to stimulate new investments, especially as business confidence recovers (for example the confidence of American SMEs - NFIB - now stands at 95, a very good level from before the crisis) and investing, Europe is already at post crisis highs (Table 11). These are facilitated if the consumer behavior continues to gradually increase, and if one can access credit.

Table 11. Growth of investor confidence in the Eurozone

Fuente: Bloomberg, Naoimi Rovnick and FT Research

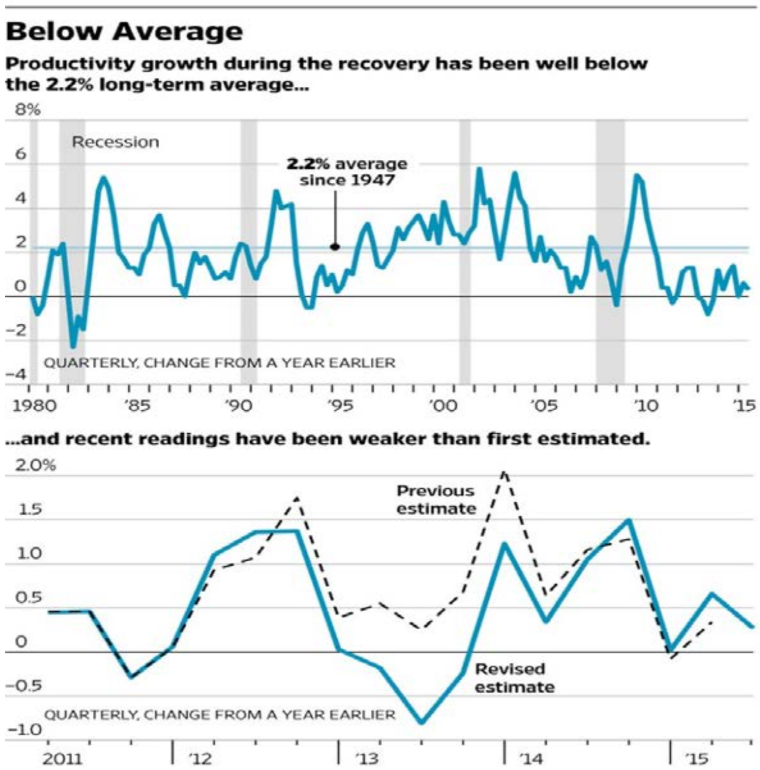
As we have seen, the factors that explain a change in the cycle of investments are being stimulated. Consumption maintains a positive track record, both in the U.S and Europe, access to credit is improving rapidly, there is an abundant amount of capital to long-term prices at historically low prices, and utilization capacity is rising (78% in the U.S, now exceeding the historical average). The factors are of significant relevance, since investor resurgence tends to carry an even stronger expansion of employment, which in turn generates consumption, encouraging greater investment and thus generating a virtuous circle. It is true that this process is still in its genesis but it has been growing and its acceleration will have profound consequences for Western economic growth.

Not everything is so promising…

Although this author is convinced that the future of the Western economy is clearly a future of sustained acceleration, it is also relevant to highlight the negative signals in order to have a complete picture.

Productivity is the "holy grail" of an economy, since it explains the wellbeing of competitiveness. The ultimate source of growth is not the total productivity of the factors. The West lived through a golden age of productivity from the 50s up to the 70s, with resurgence again in the 90s. However, the series indicate that despite technological advances, productivity has grown at half the pace since the 70s, for factors that are not completely clear (Table 12,). The consequence is that the growth trend of the West, if it does not change, would be less (although I believe that we will be waiting for a cycle of 2-3 years for more relevant factors), which can bring social spending into question, especially in Europe, with 7% of the world's population, with 50% of the world social spending, which is not sustainable with low growth levels.

Table 12. Growth of productivity in the U.S



Source: Labor Department (long term), St. Louis Federal Reserve and WSJ

Markets do not always agree with economies. A market can be drawn back by a country, since the businesses that make up an index have significant cash flows which are generated abroad. The emerging storm will damage the accounts of many Western multinationals, which can cause a drop in stock prices while the general macro environment continues to improve.

The China crisis and its contagion on emerging countries will affect European exports, however, the impact will be more limited than the noise of the media suggests. China represents less than 3% GDP for the West, a figure that might duplicate if the emerging economies are included. This position will not disappear, but simply stop growing, thus its negative impact on economic growth will be quite discreet. It is also relevant to understand that Western exports are generally low in elasticity, so the devaluation of emerging nations' currencies will not fully affect Western exports, which are not easily substitutable. Finally, the greater economic activity in the U.S and in Europe will fully compensate for the lower marginal demand coming from the emerging economies.

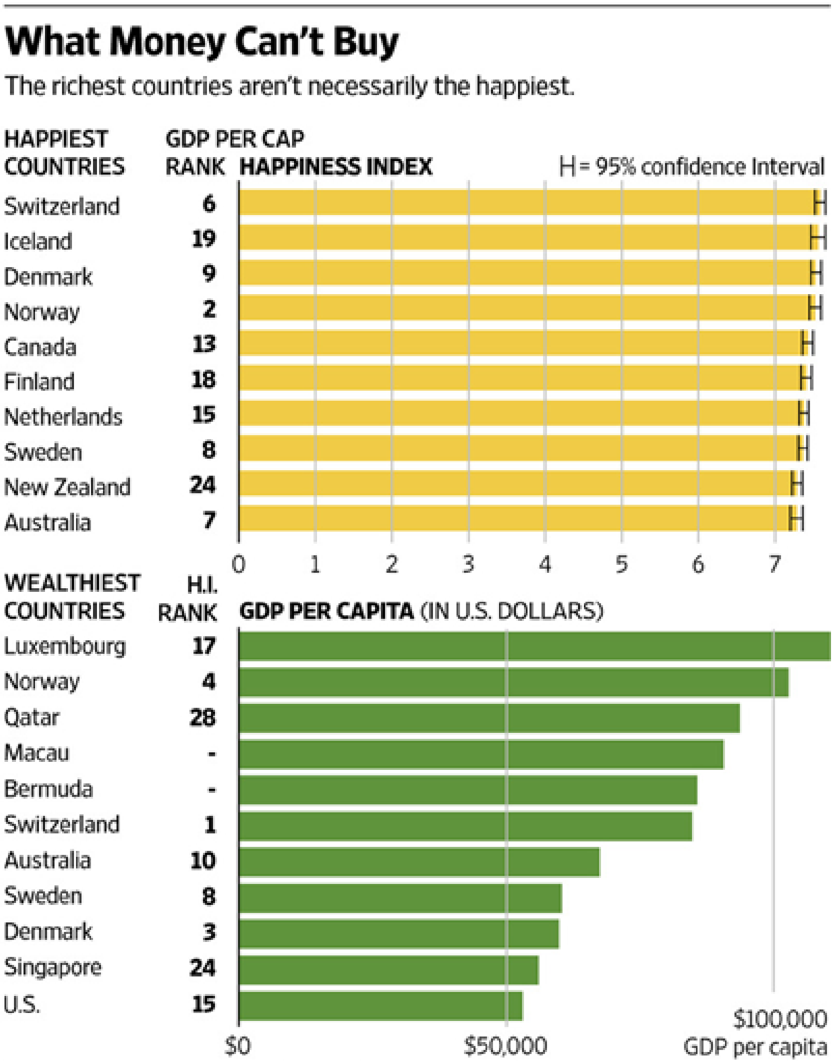
Lastly, and very importantly, the financial market and financing conditions have been greatly affected by ultra-expansive monetary policy carried out by the FED and the ECB. Correctly in our analysis, the acceleration of economic activity will ultimately bring a major risk of inflation (already standing at 1% in the U.S, and 1% in the Eurozone) which could cause a change in monetary policy and which could further damage the price of many assets…

Conclusion

Although the analysis of Professor Taleb on the black swans had his assertion and originality, in economics one runs the risk of not only not wanting to see the black swans, but when warned about them once, to then think that they are all black when in reality the vast majority are white. The terrible circumstances experienced by the West since 2007 are coming to an end…and the recovery that has already begun has started to have stimulating effects. The most important of these, in my opinion, is the acceleration of economic growth in the West which will compensate for the weaknesses of the emerging economies. It is not clear if the market is reflecting this thesis.

Oswald Spengler published his famous book "The decline of the West" back in 1917. Since then, the legions of prophets that have spread this thesis are in decline, but again and again they continue to contradict reality. It is logical that it is in relative decline if other less developed countries are growing at a faster rate. However, as pointed out long ago by an ex-President of the Spanish Government, a supposed decline with a level of level of income per capital around USD 40,000 would be a "sweet decline", as illustrated by the recently published annual report of the happiest countries in the world (Table 13), which the West continues to dominate.

Table 13. Happiness and GDP per capita



Source: World Happiness Report 2015; World Bank (2013 GDP), WSJ

APENDIX

Acronyms/ Definitions

ECB	European Central Bank
FT	Financial Times
FED	Federal Reserve System
IMF	International Monetary Fund
NAHB	National Association of Home Builders
NFIB	National Federation of Indepent Business
SME	Small Medium Enterprise
WSJ	Wall Street Journal

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About the author

Ignacio de la Torre is partner in Arcano since 2008, and is the author of the series of reports "The Case for Spain". He has 16 years of working experience in investment banking and capital markets, having worked before Arcano, in the equity research and equity sales teams of Deutsche Bank and UBS Investment Bank.

The author teaches Economy and Finance in IE Business School. He holds an MBA from INSEAD, a Ph. D. in Medieval History from UNED, a Bachelor in Economy from ICADE and a Bachelor in Law from UNED. He has published four books and obtained the Everis award as a co-author.

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