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Decelerating Growth And Accelerating Debt In Largest Economies

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Summary

- A fifteenth year of significantly slower trending U.S. and world production growth - structural underpinnings.
- Deceleration in global growth and high sovereign debt portend earnings headwinds.
- Low rates supportive, but dear market and sluggish fundamentals warrant investor caution.

Note: This article is an updated version of this Instablog post, published September 2, 2014.

Let us begin by saying quarterly GDP prints are lumpy and should always be considered in the context of trends and factor attribution. The weighted average trailing-four-quarter growth rate for the eleven largest global economies, accounting for over 67% of global output, crossed the 3% threshold in the fourth quarter of 2013, dipped slightly the next quarter, and fell to 2.5% in Q2, where it has hovered since. Other than a hopeful bounce in 2013, the trend has been on the decline since 2010 (see table below).

The fourth quarter showed modest sequential bounces from either contraction or anemic growth in six while the other five, including the US and China, were flat to down. World growth forecasts have recently been reduced by the World Bank (from 3.4% to 3.0% in January after a June cut - while raising US growth to 3.2% from 3.0%), the IMF (3.5% to 3.0% in January, also after a cut in July - also increasing US to 3.6% from 3.1%), the UN (from 3.2% to 3.1% in

November after also lowering estimates in May). All three, and most economists and Wall Street strategists have the US growing above 3% in real terms in 2015 for the first time since 2005. Virtually all of them had the same forecast entering 2014 (actual US growth in 2014 was 2.5%).

GDP Growth Trends for 11 Largest Global Economies - 67% of World Economy

(click to enlarge)

	2010	2011	2012	2013	2014	Q4 2014 Print	T4Qs Ending Q4 2014 (Annualized)	Debt/GDP 2012
US (22%)	2.4%	1.8%	2.2%	2.6%	2.2%	2.2%	2.2%	102%
China (11.5%)	10.4%	9.3%	7.8%	7.7%	7.3%	7.3%	7.3%	200%
Japan (8.3%)	4.7%	-0.1%	1.9%	2.5%	-0.5%	2.2%	-0.5%	212%
Germany (4.7%)	4.2%	3.0%	0.7%	1.3%	1.6%	0.7%	1.6%	81%
France (3.6%)	1.7%	2.0%	0.0%	0.8%	0.2%	0.1%	0.2%	90%
UK (3.4%)	1.8%	1.0%	0.3%	2.7%	2.7%	0.5%	2.7%	89%
Brazil (3.3%)	7.5%	2.7%	0.9%	2.2%	-0.2%	0.0%	-0.2%	65%
Russia (2.8%)	4.5%	4.3%	3.4%	2.0%	0.7%	0.0%	0.7%	8%
Italy (2.8%)	1.7%	0.4%	-2.4%	-0.9%	-0.3%	-0.1%	-0.3%	127%
India (2.5%)	10.5%	6.3%	3.2%	3.2%	3.2%	3.2%	3.2%	68%
Canada (2.5%)	3.2%	2.5%	1.7%	2.2%	2.2%	2.2%	2.6%	85%
Weighted Average	4.7%	3.2%	2.6%	3.1%	2.4%	2.5%	2.4%	122.8%

Note: Shadow banking system included in China Debt/GDP (estimated to be ~200%).

Source: World Bank and various primary, country-specific sources.

Sub-2% real growth compounded is into a fifteenth year in the US (1.8% from 2001 to 2014), without a 4% annual print in any year, versus a long-term average prior to 2001 closer to 3.5%. Gross world product growth has been 2.5% compounded since 2000 compared to 3.2% from 1960-2000,[1] and per capita GDP growth in the US has been in decline since the 1950s (less worrisome if income disparities were narrowing rather than widening). These trends are largely structural, relating to:

- An *actual* private sector capital allocation response to historically high sovereign debt levels and the attendant *threat* of austerity/suboptimal capital allocation in the economies needing to reduce those public debt levels (cyclical but bearing material implications - note in US, e.g., Budget Control Act/"sequestration" cuts of $12.5 billion in Federal R&D spending in 2013, and continued uncompetitive corporate tax regime).
- Contractionary demographic trends in advanced economies that account for the lion's share of global economic activity (secular).

- A more general lack of reinvestment optimism among capital allocators related not only to the factors cited, but other public policy trends and geopolitical dynamics (episodic but showing legs).
- Educational de-emphasis of mathematics and sciences in the US and other developed markets, with potential implications for innovation.
- Increasing wealth and income inequality with potential implications for aggregate consumption and social stability.

Advanced economies may also have simply reached the point at which the production base is so large that long-term trend growth from current levels simply cannot be sustained, absent innovations significantly more impactful than the transformational breakthroughs spurring the "three industrial revolutions … IR #1 (steam, railroads) from 1750 to 1830; IR #2 (electricity, internal combustion engine, running water, indoor toilets, communications, entertainment, chemicals, petroleum) from 1870 to 1900; and IR #3 (computers, the web, mobile phones) from 1960 to present." Growth prior to the industrial revolution was negligible for four centuries, and according to the work of Angus Maddison, there was less than 1/100th of 1% compounded growth in per capita GDP in England from years 1 to 1280, raising reasonable questions about axiomatic economic growth assumptions among economists and policy makers.
Slower structural GDP growth has implications for valuation of securities exposed to the relevant geographies, both equities and debt. Does it make sense for the cyclically-adjusted price-to-earnings ratio of the S&P 500 to be at its fourth highest level in history (trailing 1929, 2000 and 2007) if 1) corporate profit margins are almost 80% above long-term averages, and 2) future economic growth is going to be significantly slower than the pace supporting historical PE ratios? Of course not, and unless growth is going to return to a trajectory not seen since the 1990s, normalized equity earnings multiples will be ratcheted down to compensate investors for the lower long-term growth expectations via higher dividend yields. Moreover, slower-than-expected GDP growth will result in greater deficits, already projected to explode in the US and most developed countries.

Notes: [1] *World Bank World Development Indicators, International Financial Statistics of the IMF, IHS Global Insight, and Oxford Economic Forecasting, as well as estimated and projected values developed by the Economic Research Service all converted to a 2005 base year.*

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Great to see an economist taking his eyes off the economic dash board, and the spectrum of analogue ratio's and dials that exclude for most - a peek outside the window.
The social revolutions of the first and second economic revolutions had major impacts on those societies in which the revolutions arose.
Whereas...
The efficiency & interpersonal and corporate connectivity of the third revolution, the computer age, has resulted in a poor to perhaps negative economic impact on those countries who have had their benefits from the first two revolutions. [My opinion]
This third revolution ineffect has no gauge or economic dial to the economic dash board.

Another important point perhaps:- Your data schedule:-
The large national debt% of both China & Japan as scheduled above are skewed by the massive domestic propensity to save in those countries. This skew in part due to their society's reasonable deflationary expectation, and partly to a deeply rooted social conservatism.
China & Japan government's debt is more than funded by domestic savings, and the seeming debt plight of both China & Japan is nothing but a domestic issue.
The same cannot be said for all the other countries, whose populace's propensity to consume resoundingly trumps any domestic thrift. Their skew in the main due to the reasonable expectation of inflation, and a society rooted in the bling of a hedonistic (overstated?) visual consumption.
These latter countries debt is funded offshore and the seeming debt plight is everything to do with a dire foreign sovereign risk, and perhaps ultimately an inability to contain the profligate domestic expenditure.

5 Mar, 07:35 PMReply! Report AbuseLike0

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James Hickman
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Author’s reply » Thanks for the extremely thoughtful comment.

I think policy makers in DC look to Japan and draw conclusions they like - i.e., deficits don't matter - and ignore the very, culturally-specific Japanese elements that have facilitated such extraordinary debt levels without any increase in the cost of that debt. The US is on a spending trajectory that, barring painful entitlement reform OR more painful and massive tax increases, is worse than any developed country in the world (you sound like someone already familiar with the work of Laurence Kotlikoff).

Cheers