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BEATING THE COMING RECESSION

Now that the global economy has entered a Minsky moment, implying a powerful recession ahead, it becomes very important for all of us to understand what to do – that is if we want to live well. However, our difficulties pale in comparison to those facing the leaders of our governments. It is not fun to be the leader of the free world at a time like this. George Bush and his economic team are very likely to be painted with the same tarred brush as Herbert Hoover and Andrew Mellon. When Barack Obama becomes President, as looks likely, he will be inheriting his job at a cyclical spot that is historically disastrous, and he could see his popularity plummet as well. The last Minsky moment was the global Depression of the 1930's, and Obama's entry is at a time that could be placed after the collapse of the Bank of the United States at the end of 1930 (like Lehman Brothers) and before the failure of Creditanstalt, about four months later. Today's news is eerily reminiscent of those times, as the joint rescue of the Hungarian economy by the IMF, the World Bank, and the European Union, strongly implies a critical weakness in many Austrian and German banks, which are over-extended into Central Europe.

The new Democratic team can control the continuing debt liquidation and avoid a repeat of the worst of these Minsky events, but it will not be easy. As the US is the global bellwether, Obama and his advisors must keep the domestic damage down and get the economy growing. The GDP, by definition, equals consumption (C) plus Investment (I) plus government spending (G) plus Net Exports (X). Looking at 2009, we start the year with the engines of the economy in trouble. 'C' is going to be down several percent as unemployment is rising, personal net worth is dropping, and bank

credit is shrinking. Give it a -2%. Next, 'I' looks very weak as personal investment in houses is sure to be way down and corporate investment will be as well, as consumption is expected to be weak and credit is very tight: another -2%. Net exports, which have saved 2008, will be less powerful but I would give them a +1%, as US imports will drop more sharply than exports. All that is left is government spending. Obama and the world needs a 0.0% GDP or better, so 'G' must be a +3%. In a \$13 trillion economy that is an increase in the deficit of \$400 billion on top of a run rate we would guess at \$700 billion, not counting the 'investments' that the Bush team has made in our banks and is about to make in our automobile companies. Where should this money be spent? Infrastructure! Put people to work building for the common good; no more McMansions. At this time there is no risk of inflation as our banking system is broken and the normal multipliers of money have collapsed, so the worries of future inflation should be far, far away. If Obama does listen to his advisors and picks a strong team, to help Bernanke – truly the best man for his job – then the US will be growing again by the start of 2010.

The historically large asset position and the matching and offsetting liability position that is crushing our banks, corporations, and the vast majority of our citizens will melt away in the next few years. There will be bankruptcies galore. The bondholders, equity holders, and real estate owners will see the value of their assets drop, but if the current cash flow that the GDP represents holds up, the negative feedback loop will not develop. The collective net worth of the top 1% might drop sharply but the bottom 99% will be better off, and the US will lead the world out of this recession.✘

CYCLICAL PERSPECTIVE

The US dollar is a counter-cyclical currency in that it tends to strengthen when the US economy weakens and it tends to weaken when the US economy strengthens. The importance of this relationship has grown dramatically in the past few decades as global capital flows have increased in size relative to global trade flows. In the current decade the liquidity situation in the US has come to dominate the global market more than ever. In fact since 2000, the US dollar is strong when growth slows down around the world; and, when the dollar begins to weaken, it is a good signal that global growth is about to accelerate. The reason for this is that the world runs on dollars, just like a car runs on petrol. There needs to be a steady diet of liquidity to keep the global economy on the uptick and if for some reason the supply of dollars is crimped, the global economy begins to slow down.

On the chart below, we have also plotted the reciprocal of the Japanese Gross Domestic Product against the Dollar Index. The Japanese economy is pro-cyclical, meaning that the better the world does, the better it does, and the yen is usually pro-cyclical as well. Historically, the value of the yen correlated positively with the Nikkei and the global economy, which meant that when the dollar was weak, the yen was strong. When the US economy was weak, the yen was weak. In 1990, when the US economy was headed into a recession, the USD/JPY was at 160.00 and in 1995 while the US economy was very strong the USD/JPY touched 80.00. However, during the past few years, the yen has begun to move with dollar liquidity flows, and the yen has begun to move with the dollar – a lack of dollar liquidity means a strong yen. Yen strength should continue to next year. 

