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SIGNS FROM CHINA, US MACRO & FORWARD EARNINGS

MACRO INSIGHTS

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Signs from China, the US Macro & Forward Earnings

Excerpted from the latest MATA Report

During 2013, the Fed printed $1 trillion and the S&P 500 Index rose 30%. During 2014, the Fed printed $450 billion and the S&P rose 11%. Monetary tightening began with the end of QE 3. Since 31 October 2014, when QE 3 ended, the S&P is flat.

What all of this has done is left us in suspended animation! The market is now vulnerable to a sharp correction given stretched valuations, the weak economy and contracting corporate earnings.

2015 will actually be the first year *since 2007* without some form of quantitative easing! During this six year period the Fed's Balance Sheet has exploded by over $4 trillion and the US Government has spent another $11+ trillion. Between October and November of last year, the Federal Government issued $1 trillion in new debt in one month.

The bond bubble was $80 trillion going into 2008. Today it's over $100 trillion. The US had $5 trillion in public debt going into 2008. Today it has over $18 trillion.

Despite all of this the US has experienced the weakest recovery in 80+ years! That is assuming it's really a recovery? Every other recession going back to 1954 saw rates begin to rise a few years into the recovery.

It makes me pause and think that a year without monetizing bonds is going to be a big shock to the financial markets and stock traders.

As we have spelled out in previous reports, we are seeing global weakness around the world with very worrying signs coming from China and Emerging Markets. The US has been portrayed as the strongest economy with which to pin optimistic hopes.

I personally suspect the US economy in 2015 is going to keep moving towards recession and thereby force the Fed to launch QE4. Since the financial markets have now been carefully positioned for interest rate hikes, a QE 4 shift would likely cause violent swings in the price of stocks, bonds, currencies and commodities.

The thing to keep in mind however is the economy is is not starting from an equilibrium position. It's in a Central Bank Liquidity Driven bubble. It has been inflated to its current size by a five decade long, 59-fold expansion of credit. Recently, credit is no longer growing rapidly enough to drive economic growth at levels to halt financial deflation. This is terrifying global central bankers.

The fundamental reason for this is that credit can't expand fast enough because developed economy households are overly indebted and wages aren't rising fast enough due to Globalization. This means without additional stimulus the economy will fall back into recession.

I can't see how the Fed will risk such a recession (for fear that a recession would turn into a Depression), so I expect the Fed to launch QE 4 **later this year**. Let me stress that – **LATER THIS YEAR!**

Meanwhile, US Macro Surprises have suddenly become alarmingly negative and are clearly following forward earnings estimates lower (right).

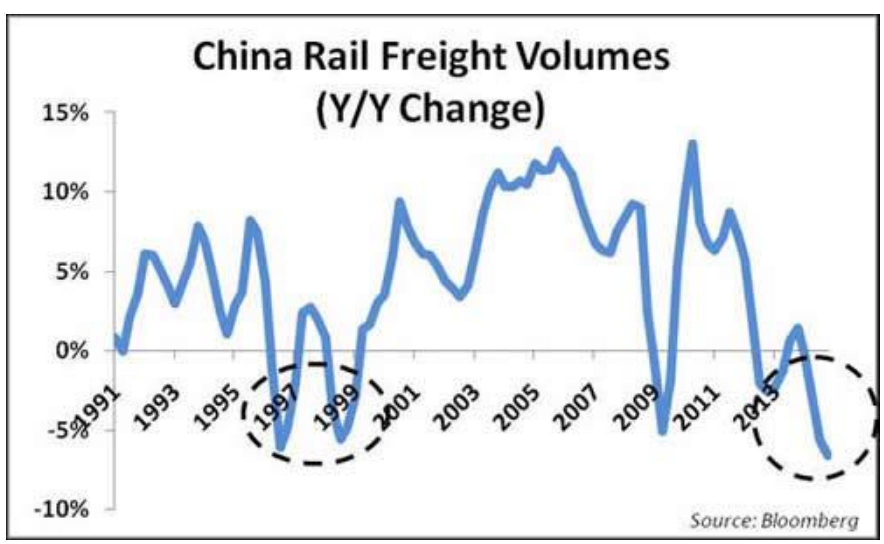
China Shows What is Happening With Demand

There is probably no better proxy for the global investment boom than the spot price of iron ore because it captures China's massive infrastructure construction spree and the waves of mining, shipbuilding, steel-making and construction materials spending that it set off all over the world. But this huge tidal wave has now crested, leaving behind the worst of both worlds——cooling demand and still expanding supply.

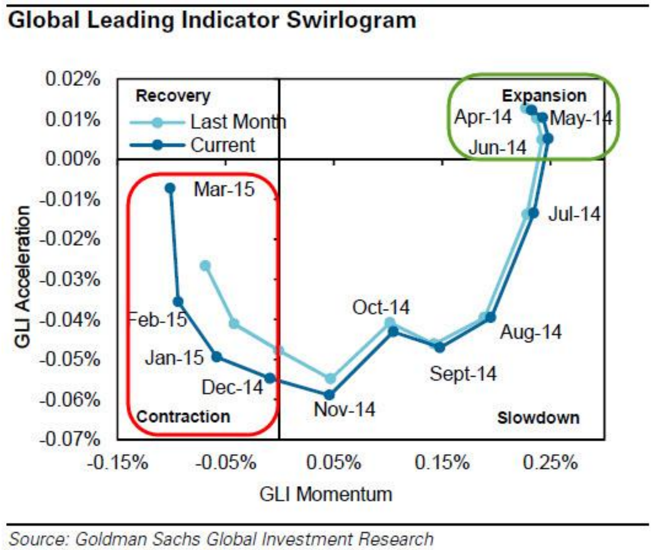
For the first time since around 1980, China's steel consumption is projected to fall in 2015——with demand slumping from 830 million tons last year toward 800 million tons, and that is just the beginning as China's credit-fueled construction frenzy finally comes to a halt. In fact, during the boom that took iron ore prices from a historic level of around $20-30 per ton to a peak of nearly $200 in 2011, China's iron and steel capacity grew like topsy. Production capacity expanded from about 200 million tons at the turn of the century to upwards of 1.1 billion tons at present.

The emerging global deflation has already brought the spot price of iron ore under $60 per ton—-or back to where the latest credit-fueled boom cycle commenced in March 2009. The consequences of that are visible, among many other places, in Australia's burgeoning depression and the slide of Brazil into its worst two-year economic slump since 1930-1931.

China Rail Freight Volumes



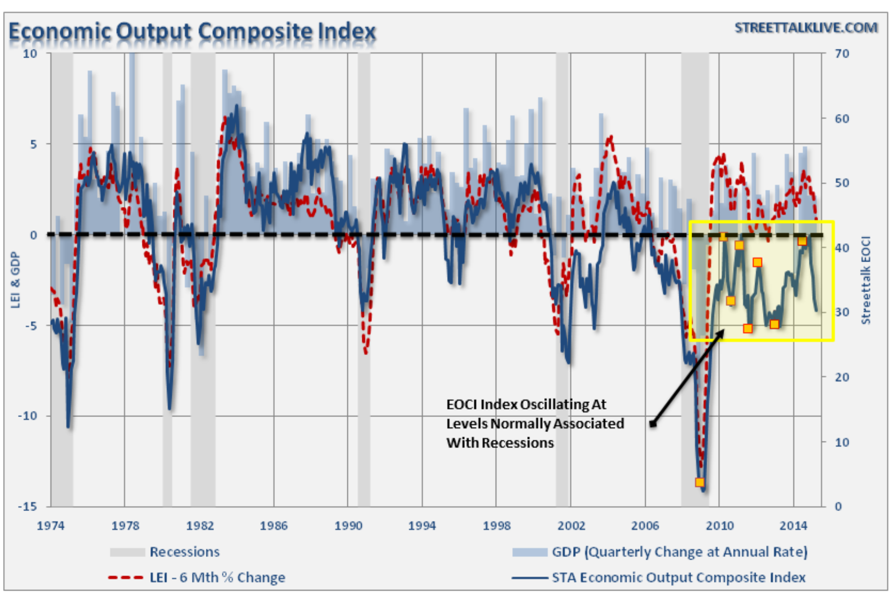
Goldman's Leading Global Indicator Swirlogram



ECRI Index Oscillating at Levels Normally Associated With Recessions

Lance Roberts writes:

> "However, with the economy currently growing at only slightly more than 2% annually, since the turn of the century, and inflation running well below the Fed's 2% target, what incentive is there in raising the overnight lending rate? In my opinion, none. Let me explain.
>
> Friday's employment report, which was not surprising in its decline, is a reflection of the deterioration in the economic data over the last two-quarters. That weakness can clearly be seen in the Economic Composite Index (click here for construction) which has fallen since the end of QE3.*(Gold squares show start and end of Fed's QE programs)"*



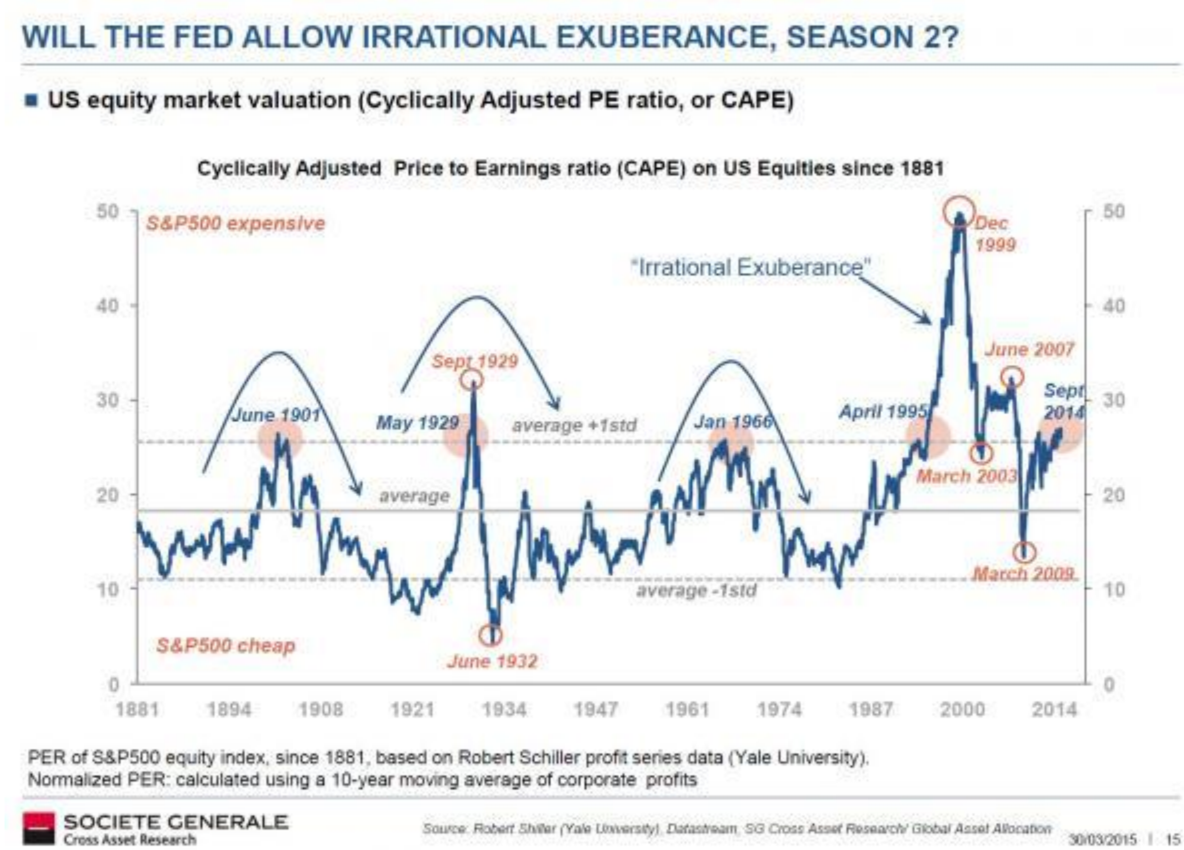
"While it is an accurate statement that the U-3 unemployment rate, as reported by the BLS, has dropped to 5.5% as of the latest report, there is much controversy surrounding the validity of that statement. (For more on this read: What Is The Real Unemployment Rate?")

While the majority of economists and analysts continue to be confused by the ongoing sluggishness in economic growth, the Fed is likely embarking on an interest rate increase cycle out of *"fear"*more than anything else. With the current economic cycle more than six-years into a recovery, the real risk for the Fed is getting caught in a recessionary slowdown with interest rates at zero.

Such an event would be extremely restrictive to the Fed's ability to limit the impacts of a recession and would jeopardize the fragile underpinnings of the current economy.

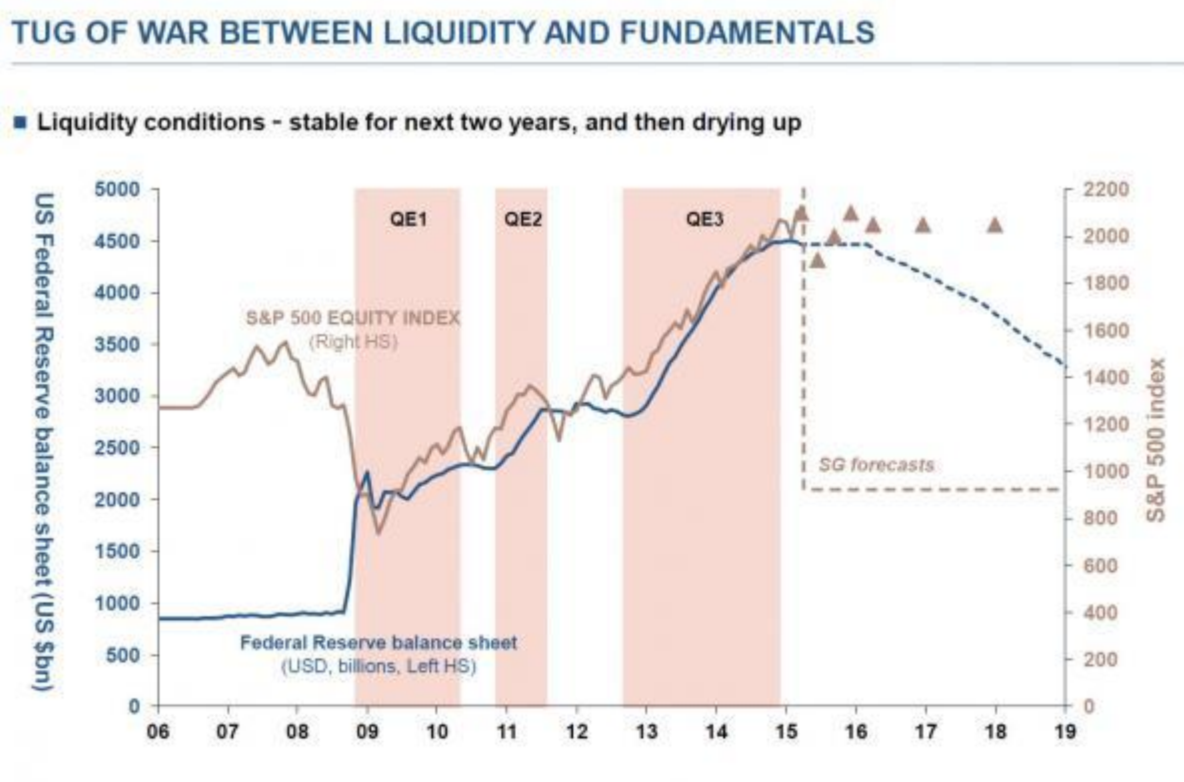
The economic data from March clearly suggests that the Federal Reserve should remain on hold, particularly since increasing interest rates is a policy used to *"slow"* an overheating economy. There is clearly no sign of that currently."

Call it the $4.5 trillion (the size of the Fed's balance sheet) question: in a report released overnight, titled "Reducing Risk in an Expensive World", SocGen strategists ask what is perhaps the most important question right now: **"Will the Fed allow Irrational Exuberance, Season 2?**" and point out that based on CAPE valuations, the US equity market now has two choices: it will either proceed to another round of irrational exuberance, or it will correct sharpy and dramatically.



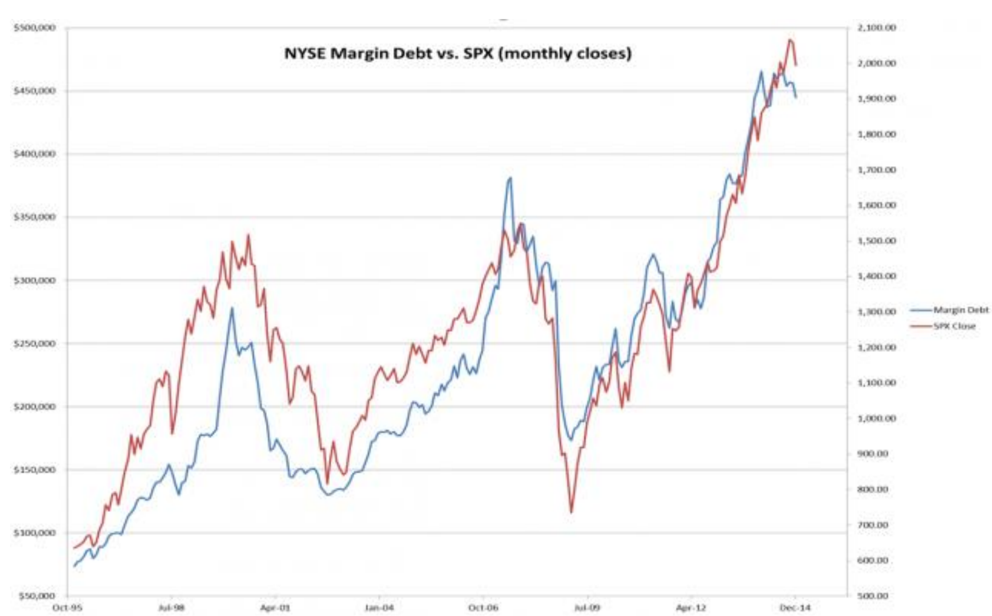
Then again, perhaps this question should have been asked back in March 2009 when instead of doing the right thing and letting bloated, overindebted companies fail, the Fed decided to fix a record debt problem with even more debt, in the hopes of ultimately spurring just enough inflation to wipe away this massive debt overhang, in the process making equity holders richer than they have ever been, and leading such "establishment" thinkers as Guggenheim's Scott Minerd to declare "**The long-term consequences of global QE are likely to permanently impair living standards for generations to come while creating a false illusion of reviving prosperity.**"

SocGen then tries to answer its own question by pointing out that the future of the market, driven entirely by trillions in excess liquidity, does not look very hot when extrapolating the S&P based on the size of the Fed's balance sheet.



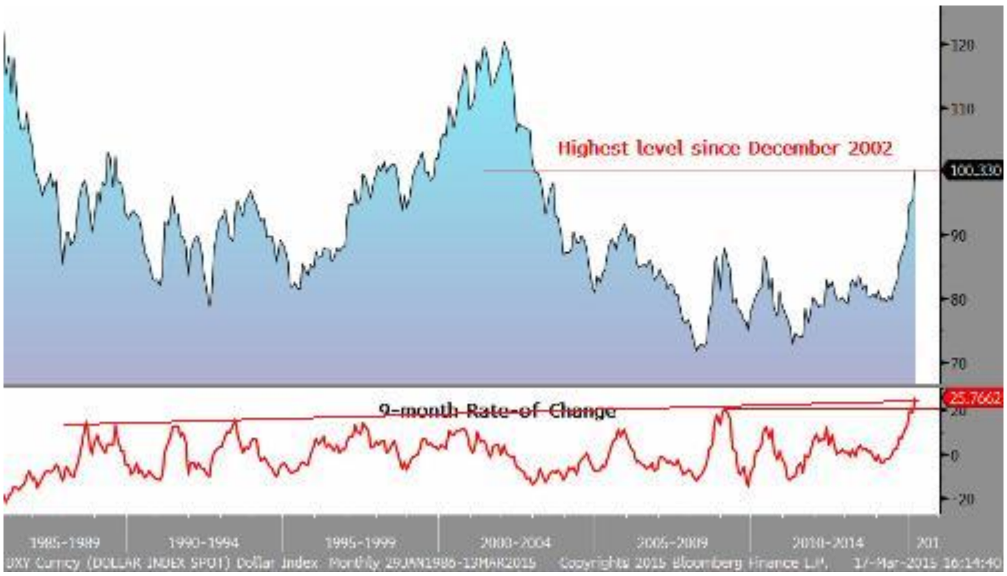
The key assumption above, of course, is that the Fed's balance sheet will contract, which may be a bold assumption: recall that the Climate Contingent Fed may simply opt to do QE during "harsh winters" and then hike rates to 4% in the summer.

Margin and Record Markets Highs



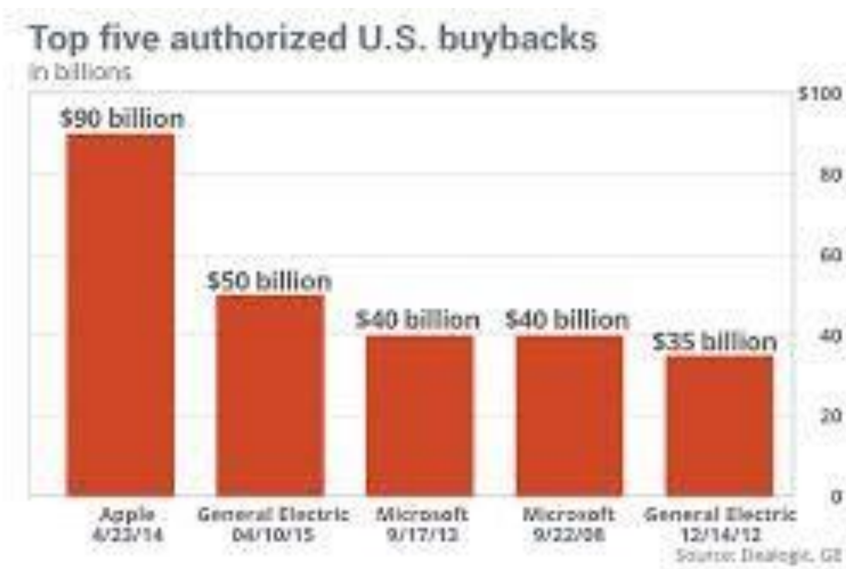
A Rapidly Rising Dollar Has Been De-Stabilizing

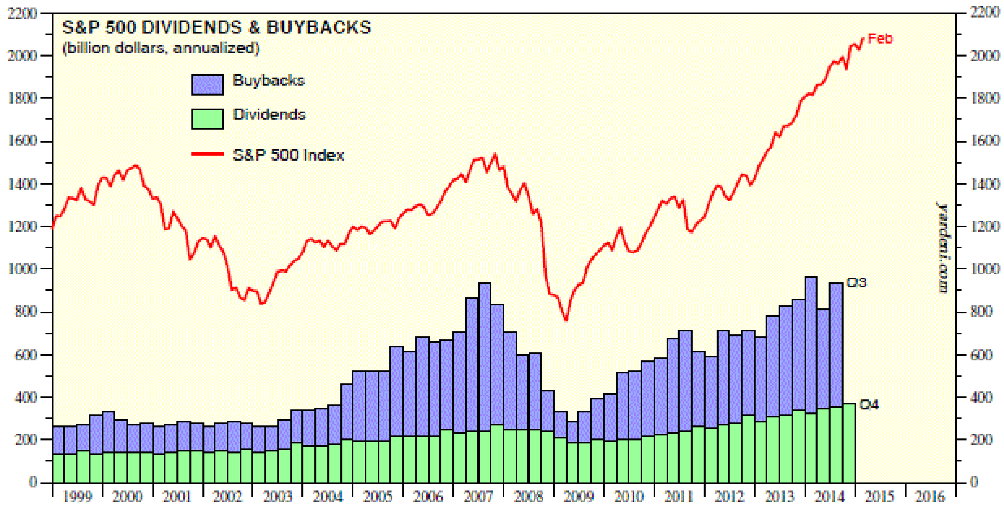
The rate of change of the US dollar has been de-stabilizing to the global economy. This 9 month ROC shown below illustrates how elevated it has become. Due to the amount of global debt denominated in US$ this makes the move dangerous within the context of a slowing global economy. Economies have less earnings to pay their rising debt balance.



BUYBACKS CAN'T BE SUSTAINED

When 90% of all profits are being returned to shareholders in the form of buybacks and dividends you know it is unsustainable and will soon come to an end. How can top line Sales growth be maintained without re-investment of profits?





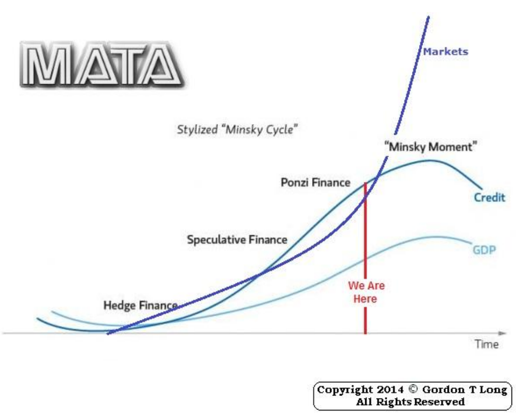
Source: Standard & Poor's Corporation.

CRACKS BEGINNING

Many are obviously becoming worried. When Margin Debt starts to fall markets traditionally soon follow suit!

HAVEN'T CHANGED OUR POSITION

After the near term expected correction we still expect markets to head higher towards a "Minsky Moment" in 2015. This is based on the assumption that Central Banks will react to any deterioration in the financial markets with more liquidity pumping!



Minsky's Debt Continuum

- Hedge finance
  - Debt that can fulfill all contractual obligations using cash flows
- Speculative finance
  - Can meet interest payments on cash flows, but require a "roll over" to meet principal payments
- Ponzi finance
  - Cash flows cannot meet interest or principle obligations. Requires additional borrowing or asset sales or rising asset prices.

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