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Up and Down Wall Street

A Scary New World Order

With China and other emerging markets gaining importance, the world could be in for a nasty shock when their economies sour. A discordant note in the jobs report.

By
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It used to be said that when the U.S. sneezed, the rest of the world caught a cold. That was because the American economy was by far the world's biggest, and relatively small ripples here could result in big waves when they washed up on shores abroad.

But, according to some new measures, America may be about to cede its position as the world's biggest economy to China, perhaps as early as this year. Not only would that be of enormous historical import, with the U.S. having been the No. 1 economy since surpassing Great Britain in the late 19th century; it also has profound economic implications.

In the new world order, what have been called "emerging economies" could soon account for half of global economic output by some gauges. Even by conventional measures, they already comprise 40% of global gross domestic product. All of which means that if the emerging markets catch cold, the contagion may then spread to the developed markets. Indeed, according to David Levy, chairman of the Jerome Levy Forecasting Center, the next U.S. recession could be the first in modern history to be caused by a downturn abroad. Moreover, he adds, the chances of the rest of the world avoiding a contraction—and being able to deal with it effectively—are slim.

If you're not already aware, *Barron's* and the Levy Forecasting Center go back across generations. Jay, David's father, was a trusted source of economic wisdom for Alan Abelson and Robert Bleiberg, the former writer of this column and the former editorial director of this publication, respectively. I have also followed the Levys' forecasts for nearly three decades and have learned much along the way.

David's key takeaway for investors is that the Federal Reserve is unlikely to be able to raise short-term interest rates for the rest of the decade. While the conventional wisdom is that the Fed will begin to hike its federal-funds rate target next year—from a 0%-to-0.25% floor, where it's been since late 2008—he sees the central bank stuck having to keep its key policy rate at the floor through 2019. (I will drop my annoying pedantry that the current decade runs through the end of 2020; it's incontrovertible, so that's enough.)

New data from the International Comparison Program of the World Bank show that, in real terms, China's economy may overtake the U.S.'s, not in 2019, as had been forecast, but possibly in 2014. This is in real terms, based on "purchasing power parity," which evens out differing costs across borders.

The most popular (albeit simplistic) way to gauge this has been the Economist's Big Mac Index, which measures the price of McDonald's signature burger in different countries. After all, a Big Mac is a Big Mac, whether in Toronto or Tokyo or Tuscaloosa. So, all else being equal, it should cost the same in local currency terms. Of course, it doesn't. In high-cost spots, a Big Mac is pricier, and vice versa. The difference helps give an idea of costs and actual purchasing power in different places.

Based on purchasing power parity, China's gross domestic product is poised to top U.S. GDP in 2014, because prices are so much lower in the former. Moreover, India's economy tops Japan's on a PPP basis, according to the World Bank report. (For more on India's ascendancy, see the cover story.)

According to the Financial Times, China tried to suppress these findings. Along with becoming the world's largest economy come certain responsibilities the nation would rather not shoulder, the report quoted sources familiar with Chinese official views as saying. Beijing would rather see China continue to be portrayed as a poor country, based on per capita income, the article added.

Whether the Chinese own up to their status in the world economy is beside the point. The emerging markets' influence continues to increase inexorably. And, says Levy, that poses the main vulnerability to the world economy.

The emerging markets' model of development—pump up capital investment to spur exports—has powered their remarkable progress, he explains. And the much-more-rapid growth has resulted in the EMs' overtaking the developed economies. Those policies have their limits, David contends. The EMs' growth depends on exports, in which they have invested heavily. That has led to significant overcapacity as the rest of the world has slowed.

For example, China's capacity-utilization rate went from 90%—equivalent to a U.S. boom—to around 60%, lower than a U.S. recession nadir. Given the state's resources and control over the economy, he is less worried than others about a hard landing in China. But, he fears, other export-dependent EMs will fare less well.

While the global economy can continue to hold up in 2014, he says in an interview, the global situation never has been as frightening. Given emerging markets' greater importance to the rest of the world and the U.S. economy, the Fed can't raise interest rates for years.

This call is as out of step with the consensus as the Levys' forecast in the mid-2000s of a recession that would force the Fed to slash rates to modern lows and keep them there for years. Their bet on a collapse in interest rates resulted in 500%-plus returns for investors in a hedge fund they formed back then, he points out.

Balance sheets, not earnings statements, are the key, according to David. Balance sheets were expanded to finance the growth in global capacity; now, that's reached a limit. Slowing exports mean shrinking income to service the debt.

Bond yields will fall, regardless of the decline of central-bank purchases, and the Fed will have no choice but to leave short-term rates near zero, he concludes. Even so, monetary policy can't fix the problem of bloated balance sheets, warns Levy. It is a sharp counterpoint to the bullish consensus.

COGNITIVE DISSONANCE IS the most human of frailties. And markets, being made of humans, also succumb to that condition of having to reconcile two contradictory ideas.

To wit, the Dow Jones Industrial Average attained a record level last week, albeit trailing the Standard & Poor's 500, the yardstick by which large U.S. stocks (and portfolio managers) are measured. Also last week, the 10-year U.S. Treasury note traded at its lowest yield of 2014.

To those who have been blissfully detached from the financial markets for the past four months or so, preferably in some salubrious clime and not sequestered from the world by some malady or other woe, it was stated with dead-set certitude at the turn of the year that stock prices were destined to continue their ascent and bonds were headed lower in price and higher in yield.

The bull market in equities has stalled, not surprising given the robust, 30% gains achieved in 2013. But with the benchmark 10-year Treasury yield, which ended last year at 3%, falling to 2.58% Friday, the unavoidable question is: Why?

The Treasury market is a Rorschach test for investors. To commit to such a parlous return implies two motivations.

First, that the yield will fall further, which will profit leveraged speculators with healthy capital gains.

Or, second, that institutional investors are seeking to hedge their portfolios of stocks and other risk investments with an asset that zigs while their other holdings zag. On that score, they may want an insurance policy against other risks, including the geopolitical variety, such as that posed by the situation in Ukraine. There could be other reasons, too.

Most illuminating was the respective markets' reaction to the April employment report released Friday morning. Nonfarm payrolls surged by 288,000, nearly half again the betting line on the number. Instead of the expected response—higher stock prices and Treasury yields—markets moved the other way.

Vladimir Putin is the obvious culprit. Yet the Treasury market has been confounding the experts, even ahead of the topless terror's expansion plans. And it's been more than the all-purpose excuse of rotten winter weather, which actually had a plus. In the anemic, first-quarter GDP report of a 0.1% annualized rate of expansion, consumption was bolstered by higher utility bills. As new data roll in, the revised number is likely to have a minus sign.

Still, the deep freeze is the villain, and the bigger the flop in the first quarter, the bigger the recovery in this quarter and the rest of the year. So say the bulls. But the big April payrolls gain also was accompanied by some discordant notes in the employment report.

Headlines will show that the unemployment rate plunged to 6.3% from 6.7%. But the household report, from which that number is derived, also had a stunning 800,000-plus drop in the labor force, which more than accounted for the lower jobless rate. That came as the labor-force participation rate reverted to a cycle low of 62.8% while the employment-to-population ratio remained at a depressed 58.9%. And don't blame us boomers retiring for the labor-force dropouts. The ratio of those over 55 in the workforce actually ticked up. Who else is going to pay for the kids in the basement?

The other key tell was that average hourly earnings were flat in the latest month. As discussed here last week, wages may be the best gauge of slack in the labor market while the percentage of adults actually in the market is at a low ebb. And pay isn't growing, which implies that job gains mainly are in low-wage sectors.

That would imply that the Dow's record is the dissonant note.