Highlights Leir Bubble Center 2015 Bubble Conference

Bubbles & Politics: China, 1857, 1929
September 18 -19, 2015

The Conference Participants met at the Leir Retreat in Ridgefield, CT that was formerly the estate of Henry J. Leir to discuss over two days various research presentations related to some issues and concerns that have arisen from an apparent increase since the 1970s of financial bubbles and their impact not only on the global financial system but also politics. The topics covered ranged from the consequences of a dramatically slowing Chinese economy to the historical political and social consequences of major financial crises.

While the discussion was wide-ranging five important policy issues stood out.

> **1) China -** During the 2014 Leir Conference it was correctly predicted that the Chinese economy would slow sharply during 2015. What was not fully considered was the impact this would have on energy [oil, gas, coal] and commodity prices the latter including agricultural products such as corn and soybeans and raw materials such as iron ore, copper and aluminum.
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> The 2015 Conference participants on the whole continued to believe that the slowdown in China's growth would continue. Indeed Professor Aliber expected China to suffer a major recession within the next three to five years due to unsustainable investments in real estate and the implicit leverage in the system including environmental degradation. Therefore the negative impacts on global energy and commodity prices were likely to get worse over the coming months or even years.
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> The conference participants offered two perspectives on China's slower growth. One was that China's export led growth model [sometimes called the Chenery growth model] was following the same

pattern as Japan, Taiwan, Korea and the Four Tigers. That is the growth in exports began in the early 1990s with lower skill labor-intensive products such as toys and apparel that were then subsequently upgraded to machinery, heavy industry and more technical products. However in successfully pursuing this process capital was acquired, the economic infrastructure was developed and wages rose along with the high rates of economic growth and factor productivity.

This process over time however inevitably opens the door to lesser-developed and still Emerging economies to move into the lower wage competitive space such as toys and apparel just as it did for China after Japan and Korea had gone through this same evolutionary development process. It was noted that Nike was often a bellwether in signaling this development.

From this perspective China is no longer competitive in many low wage products since companies such as Nike have begun to source shoes and apparel from Vietnam and Bangladesh. Further, China's infrastructure including heavy industry such as steel and autos is now quite developed. Indeed China now looks a lot like Japan in the 1970s with the same slower growth prospects.

The participants supporting this view thus see China's slowdown as systemic rather than cyclical. Thus money and fiscal stimulus coupled with a shift to consumer led growth cannot put China's growth back on the fast track. These participants also noted that Japan was a lot richer per capita when it began the shift to a more consumer oriented service based economy. Yet it still grew more slowly and took almost fifteen years to accomplish the shift away from export dependence. Also in China the wage-price gap between Chinese wages and its export products is much larger than it was for Japan and it has just begun shifting towards more reliance on domestic led consumption.

Those supporting the cyclical consumption view, though, believe that China can still achieve a growth rate above 6% for the next several years based on more domestic consumption supported by expansive government monetary, fiscal and regulatory policies and that in fact this process is well under way.

The continued collapse in global energy and commodity prices, though, along with the shifts in global production seem to support the view that China's export-led growth has tapered and that the Chinese economy is slowing systemically and much more than is currently recognized. Indeed this may be one reason Chinese companies are raising funds in the US market and wealthy Chinese are buying US, Canadian and EU assets as investment opportunities in China have dwindled.

A signal to this effect is the fact that the Chinese government is facing hard decisions regarding the state-owned companies and their declining competitiveness. One speaker explained that in fact the government was moving to a more socialistic approach to economic decisions and away from market driven decisions that could force inefficient state-run firms to cut employment. If in fact this is the case the argument for slower Chinese growth becomes even stronger since productivity improvements would be even more limited under an expanded socialistic regime.

2) High-yield Fixed Income Securities – At the 2014 Conference there was a consensus that a global Bubble had developed in high yield fixed income securities and it was recognized at the 2015 Conference that this had become a matter of regulatory concern because a high concentration of these securities were held by high-yield mutual funds and the market for these securities was relatively illiquid. Further many of these securities had been issued by firms in the energy and commodity sectors that were now under pressure due to slower global growth and especially in China. For similar reasons refinancing this debt would be difficult.

Thus the conference participants felt this was still an area of concern for the world financial markets. This was confirmed by a presentation that showed credit spreads had widened for such assets because a prior study had shown that such changes in credit spreads act as signals for bubble stages, narrowing during the expansion phase and then widening as investors become more wary.

Forecast – The economic forecast presented by the Leir Bubble Center Director at the Forecasting Conference sponsored by the Chicago Federal Reserve reflects these Conference considerations and thus projects relatively slow growth in 2016 similar to 2015 including very low growth in the first quarter with a pick-up in the second quarter and a dip in the 3d quarter before ending the year with relatively moderate growth. Overall he projects 2015-2016 real growth at 2.5% with unemployment falling to 4.6%.

3) Financial Bubbles And The Environment – Another question raised during the conference but not resolved was whether there was a bubble or a bubble developing in green investments. Apparently like many bubbles there are situations where properly structured green or environmentally sensitive investments can make sense, and lower energy costs from solar, tidal and wind power or smart buildings and factories have been demonstrated. However there is also a lot of hype and several firms in this space have gone bankrupt. Thus as in the dot.com boom and bust analyzing from an investment or credit perspective the likely big successes such as Amazon as compared to the many failures is a tricky process.

4) Social And Political Consequences Of Financial Crises – The conference also sought to look beyond the obvious economic consequences of a financial crisis such as negative economic growth and high unemployment and also beyond whether or not it involved a financial bubble. The focus here was on major social and political change. Interestingly if Presidential power is used as a political and social indicator, then only 1857 and 1929 standout historically as really important economic crises.

The crisis of 1857 helped to split the Democratic vote in 1860 over the issues of tariffs, slavery and regional economic development. This led to Lincoln's election based on a plurality similar to what happened in 1912 when Teddy Roosevelt opened the door for Woodrow Wilson or in 1992 when Ross Perot opened the door for Bill Clinton. Prior to 1860 the Democrats had controlled the White House for 60 years except for two Whig presidents each elected to only one term. After 1860 the Republicans generally controlled the White House until 1932 [72 years] with the exceptions being Wilson as noted above and Cleveland who was elected to two separate four-year terms. It should be noted though that during Wilson's tenure Republicans controlled the Senate and Congress. Finally truly major social and political legislation was passed as a result of the Civil War and Republican control [13th, 14th and 15TH Amendments].

1929 was another major turning point. From 1932 to 1980 a forty-eight year period the Democrats were back in control of the White House except for 16 years [Eisenhower and Nixon] where generally they still had to deal with a Democratic Senate and Congress. During this period there was again major social legislation pushed through by the dominant party including Social Security, the Civil Rights Act and Medicare.

Some common criteria that made these political and social shifts responsive to a major financial and economic crisis seem to have been at the time of the crisis large regionally based disparities in wealth and economic prosperity and powerful political forces opposing change represented by the dominant political party's intransigence over a hot economic and social issue such as slavery [1860] or economic parity [1929].

An interesting question raised during the discussion of these two important historical events is whether the Great Recession will also have a long-term social and political impact. The conditions as to regional differences and intransigent political positions over climate change and disparities in wealth and income seem similar. Also the passage of major social legislation by a dominant party [Obamacare] in reaction to the crisis appears analogous. However the participants agreed that only time would tell.

At the same time it was noted that governments now know a lot more than they did about Bubbles and systemic risk and are only likely to take direct action when the global financial system and especially banks seem at risk due to bank leverage or the exposure of a Systemically Important Financial Institution.

Thus with respect to many situations related to Bubbles, financial crises and the business cycle investors will be left on their own.

5) Simulating Bubbles – Finally the conference participants were broken into investment teams and were given a simulated investment environment that was based in part on the dot.com boom. The results confirmed the policy difficulties of managing such a bubble as groups taking defensive action did poorly while those aggressively investing in high growth stocks did very well. Thus in a real world situation the latter would attract investment assets as long as the bubble lasted while the former would probably be looking for jobs.

Actionable Results – The insights into the political and economic developments in China signal continued low growth and thus continued downward pressure on global energy and commodity prices and therefore stocks of companies directly or indirectly involved in these business activities.

It will also negatively impact the large existing amount of global high yield debt as well as the issuance of new high yield debt since a major portion of this has been to firms in the sectors now exposed to downward price pressures. The fact it is held by major mutual funds that are under increased regulatory scrutiny only adds to the market concerns. The S&P has been tracking the increased number of defaults by such issuers, which has now reached the highest levels since 2009.

Since governments will be more selective in their rescue missions and the use of taxpayer dollars, it would be wise for investors to be cautious in their exposure to China, energy and commodities just as it would have been prudent to have done so with respect to real estate related assets in 2007 and 2008.