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Fed risks repeating Lehman blunder as US recession storm gathers

AMBROSE EVANS-PRITCHARD

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The risk of a US recession next year is rising fast. The Federal Reserve has no margin for error.

Liquidity is suddenly drying up. Early warning indicators from US 'flow of funds' data point to an incipient squeeze, the long-feared capitulation after five successive quarters of declining corporate profits.

Yet the Fed is methodically draining money through 'reverse repos' regardless. It has set the course for a rise in interest rates in December and seems to be on automatic pilot.

"We are seeing a serious deterioration on a monthly basis," said Michael Howell from CrossBorder Capital, specialists in global liquidity. The signals lead the economic cycle by six to nine months.

"We think the US is heading for recession by the Spring of 2017. It is absolutely bonkers for the Fed to even think about raising rates right now," he said.

The growth rate of nominal GDP - a pure measure of the economy - has been in an unbroken fall since the start of the year, falling from 4.2pc to 2.5pc. It is close to stall speed, flirting with levels that have invariably led to recessions in the post-War era.

"It is a little scary. When nominal GDP slows like that, you can be sure that financial stress will follow. Monetary policy is too tight and the slightest shock will tip the US into recession," said Lars Christensen, from Markets and Money Advisory.

If allowed to happen, it will be a deeply frightening experience, rocking the global system to its foundations. The Bank for International Settlements estimates that 60pc of the world economy is locked into the US currency system, and that debts denominated in dollars outside US jurisdiction have ballooned to $9.8 trillion.

The world has never before been so leveraged to dollar borrowing costs. BIS data show that debt ratios in both rich countries and emerging markets are roughly 35 percentage points of GDP higher than they were at the onset of the Lehman crisis.

This time China cannot come to the rescue. Beijing has already pushed credit beyond safe limits to almost $30 trillion. Fitch Ratings suspects that bad loans in the Chinese banking system are ten times the official claim.

The current arguments over Brexit would seem irrelevant in such circumstances, both because the City would be drawn into the flames and because the eurozone would face its own a shattering ordeal. Even a hint of coming trauma would detonate a crisis in Italy.

To be clear, the eight-year old US cycle has not yet rolled over definitively. The picture remains fluid, hard to read in a world where key signals have been distorted by central bank repression. The third quarter will almost certainly look a little better.

"We are getting closer and closer to a recession, but we are not quite there yet, looking at our forward-indicators," said Lakshman Achuthan from the Economic Cycle Research Institute in New York.

"I can understand why people are getting worried. We have been seeing a 'growth-rate' cyclical downturn for the last two years. The longer this goes on, the less wiggle room there is," he said.

"We are sure there will be no recession this year or into the first two months of 2017, but beyond that there are worrying signs. The deterioration of our leading labour market index is very clear," he said.

Janet Yellen appears to have set the course for a rate hike in December CREDIT: BAO DANDAN/XINHUA / BARCROFT IMAGES

Mr Achuthan thinks it is still possible that US growth will pick up again for another short burst - lifted by a global industrial rebound of sorts - before the storm finally hits.

That was broadly my view earlier this year as the global money supply surged and a string of governments seized on Brexit to crank up stimulus, but what is striking is how little traction it has achieved.

The velocity of M1 money in the US has continued to slow, hitting 40-year low of 5.75 over the summer, and markets are only just awakening to the unsettling thought that China's latest boomlet has already topped out. Beijing is having to hit the brakes again.

Crossborder said new rules for money market funds that came into force this month have complicated the picture, causing the stock of US commercial paper to shrivel by $200bn. Yet there are ways to filter out some of these effects.

The plain fact is that 3-month lending rates in the off-shore 'eurodollar' markets in London have tripled since July to 0.93pc, sharply tightening conditions for global finance. Investors may have been too complacent in discounting these gyrations as part of a regulatory hiccup when something more sinister is emerging.

CrossBorder's liquidity measure for the US is now at levels comparable to the inflection point a few months before the US recessions of 1990 and 2001, and before the recession starting in November 2007 - and a whole year before Lehman Bank collapsed, nota bene.

Albert Edwards from Societe Generale says gross domestic income (GDI) was the most accurate gauge of the economy as the pre-Lehman crisis unfolded, and this measure has been flat for the last two quarters.

"The pronounced weakness of GDI relative to GDP might be an ominous omen, for it may well be indicating that a US recession is already underway - just as it was in 2007," he said.

It is certainly odd that the Fed should tighten into these conditions. The unemployment rate has risen to 5pc after bottoming at 4.7pc in May, and small business (NFIB) hiring plans have been flashing soft warnings for months.

"The Fed wants to get ahead of the recovery, and unless this is checked, it will lead to recession," said David Beckworth, a monetary economist at George Mason University.

Prof Beckwith said the US economy is still reeling from the shock of a 20pc rise in dollar's trade-weighted index since mid-2014. This in turn is squeezing the world's 'shadow-dollar' nexus.

The Fed faces horrible choices, of course. The longer it delays rate rises, the longer it perpetuates the deformed asset-bubble economy that so disfigures modern polities, and the louder the rebukes from Congress.

Critics are quick to note that price pressures are building, or at least appear to be. The Atlanta Fed's index of 12-month 'sticky price' inflation has reached 2.6pc, higher than nominal GDP growth itself. Call it 'stagflation' or the misery mix.

A President Hillary Clinton could flood the economy with fiscal stimulus if need be. Yet this takes time. CREDIT: GABRIELLE LURIE/AFP

Yet you can pick your inflation measure to tell any story. The Dallas Fed's trimmed-mean PCE - supposed to eliminate noise - actually peaked in June and has since been slowing on a six-month basis.

And it is - or should be - a cardinal rule of central banking that you never raise rates in response to rising energy costs. Oil spikes are not in themselves inflationary. They are neutral.

The truth is that nobody knows whether this is the start of a sustained reflation cycle, or just the last feeble flicker before America, Europe, and East Asia are swallowed into a deflationary vortex, the frozen circle from which there is no easy exit - 'lasciate ogni speranza, voi ch'entrate'.

What we do know is that the Fed cannot afford to get this wrong, as it did with such calamitous consequences from March to August 2008, when it talked tough on an inflationary danger that had already peaked and passed, tightening policy into the hurricane.

As we now know - and some warned at the time - the US economy had already buckled. The result of Fed sabre-rattling in those crucial months was the collapse of Fannie Mae, Freddie, Lehman, and the Western banking system.

Stanley Fischer, the Fed's vice-chairman, conceded in a grim speech this week that the Fed has now run out of ammunition and that this "could therefore lead to longer and deeper recessions when the economy is hit by negative shocks."

His prescription is to try sneak in a few rate hikes while it is still possible to create a buffer. Market monetarists say this is profoundly ill-advised, and may instead bring about exactly what he fears.

A President Hillary Clinton could and certainly would flood the economy with fiscal stimulus if need be. Yet this takes time. There are few 'shovel-ready' projects, and Washington is a fractious place. She may face a hostile House. The monetary crunch would have crystallized long before anything fiscal could be done.

The world will not end if premature tightening pushes the US into recession next year. But why court fate?