Central Banks May Lead Manufacturing Recession Straight to Wall Street Blowout

by Paul Gallagher

VOA

Steel pipes for export pile up at Lianyungang, China, Dec. 8, 2018.

July 12—There have been plenty of warnings since late 2018, from present and former central bank members and regulators in the trans-Atlantic countries, that the "next recession"—whenever in the future each one thought it might begin—will bring a wave of corporate defaults, which will blow up the huge debt bubble centered in the American corporate sector. Despite all the ominous talk about a "China debt collapse," recent surveys published on *Bloomberg News* have shown that far more of this bubble of overleveraged corporate debt is in the "advanced" countries, than the developing countries, including China.

With very little coverage in those advanced countries—even in the media's financial pages—the global recession was abruptly announced at the beginning of July, with a literally worldwide set of surveys of purchasing agents showing manufacturing and industry contracting in the major nations across the globe.

'Manufacturing Downshifted'

Purchasing Managers' Indices (PMIs) of manufacturing, published all over the world on July 1 for the second quarter of 2019, showed that a global recession is underway as measured by manufacturing and industry. The exceptions are some nations central to China's Belt and Road Initiative infrastructure projects, but the advanced-sector economies are all falling.

The manufacturing sector of China itself, like the American manufacturing sector, has stopped expanding this year. Behind the noise of all the indices and sub-indices based on surveys—two such for June were published in China July 1, one a government survey of state-owned enterprises and the other a private survey of SMEs, both appearing to show contraction by a small margin—the consistent picture is one of manufacturing stagnation since the beginning of 2019. This is also true of U.S. industrial production and manufacturing employment data. In China, it appears that what is contracting sharply is manufacturing for export; for example, that sub-index of China's official NBS Manufacturing Index was at 46.3 in June. This is well below zero growth, which is indicated in these PMIs by the level 50.

Many other Asian manufacturing indices for the second quarter show zero growth or below: Taiwan 45.5; South Korea 47.5; Japan 49.3; Australia 49.6; Malaysia 49.9. But Indonesia, Philippines, Thailand, Vietnam, and Sri Lanka continue to show manufacturing expansion.

This is "soft" data from surveying purchasing managers of large firms and CEOs of small and medium enterprises, but it shows the impact on manufacturing of the general situation of stagnation in world trade.

One purchasing managers' index for U.S. manufacturing released July 1 was that of the firm Markit, whose chief economist is Chris Williamson. His comment:

> U.S. manufacturers' reported business conditions have remained the toughest for nearly a decade in June. The past two months have seen the lowest readings since the height of the global financial crisis in 2009. The survey … paints a worrying picture of marked declines in both output and jobs. The June survey sub-index readings are consistent with manufacturing output contracting at a quarterly rate of 0.7% and factory payrolls falling by 18,000.


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These cranes in the Port of Oakland, California are overlooking a stagnation in world exports, as manufacturing also turns down.

The so-called "Global Purchasing Managers' Index," put out by JPMorgan, piggybacks on all the others. The economist compiling it, Olya Borichevska, Vice President of Global Economic Research at JPMorgan Securities, summed up in a July 3 report:

> The global manufacturing sector downshifted again at the end of the second quarter. The PMI surveys signaled that output stopped growing, as inflows of new business shrank at the fastest pace since September 2012.… Conditions will need to stage a marked recovery if manufacturing is to revive later in the year.

And Worse in Western Europe

The industrial conditions in much of Western Europe were indicated as even worse. German industrial production is dropping, being 2-4% below 2018 levels in the past two reported months. The German Federal Statistics Office found that production in April was 1.8% below a year earlier. In May, it was 3.7% down from 2018. Also in May, factory orders in the German economy fell by 2.2%. "The great order book deflation continues," an economist at ING, a Dutch multinational banking and financial services corporation, told Reuters July 7: "Devastating new orders data just undermined any hopes for an industrial rebound."

Led by the automobile sector, which is the dominant one in German industry, and the chemical sector, the manufacturing sectors reported drastic corrections to their forecasts for the coming three months. For the auto sector, this comes against the background that 12% fewer automobiles were produced in the first half of 2018 than a year earlier; 15% fewer were exported. In the chemical sector. BASF, the leading chemical producer and a leading one on the global scale, said it expected a huge drop of 30% in production in the third quarter of 2019. Layoffs were announced: Volkswagen 7,400; BASF 6,000; Ford 5,000—just to name some of the big cases. Short work for remaining workers was announced in significant sections of the auto, metals, rubber and plastics, machine building, and leather industries, according to the German Economic Institute, DIW.

And the American "manufacturing recovery," the "exceptionalism" constantly cited by Trump Administration officials, including prominently the President himself, has clearly ended in 2019. Manufacturing job growth, as reported by the Labor Department, stopped in January. And in June, the Commerce Department reported that U.S. factory orders were up just 1.0% in a year; industrial production was up only 0.8% in the same period.

This does not even consider the American farm economy, which every observer agrees is in a terrible

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Federal Reserve Board Chair Jerome Powell presents the Monetary Policy Report to the House Committee on Financial Services on July 10, 2019.

condition following four years of falling and even negative farm income, and then devastating floods in the most productive agricultural states this year.

Race Back To Zero Interest and QE

Federal Reserve chairman Jerome Powell's virtual promise on July 10-11 to Congressional committees to start cutting the discount rate at the end of this month, completes a rout of the most important global central banks, turning away from their short-lived "normalization" talk and back toward quantitative easing, zero rates and printing money. Only last December, the Fed was still *raising* rates.

Already on June 4, Powell, speaking at a Federal Reserve conference in Chicago, said that the Fed was ready "to help sustain the recovery with whatever is necessary." Powell said, clearly referring to a return to QE, "Perhaps it is time to retire the term 'unconventional' when referring to tools that were used in the crisis. We know that tools like these are likely to be needed in some form in the future."

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The Bank for International Settlements headquarters in Basel, Switzerland.

But the Federal Reserve's readiness to head back toward zero rates was extraordinary, considering that in May the Fed itself issued a report, and Powell a statement on it, about the growing danger of high-risk corporate debt which, it warned, is at levels relative to GDP, higher than immediately before the 2008 crash. An article in *Forbes* June 3, showed that the volume of leveraged loans in the U.S. economy has nearly tripled since 2007, while that of junk bonds (still the larger amount) has more than doubled. Between them, they are $3.5 trillion of the $14 trillion in U.S. non-financial corporate debt, with additional corporate debt steadily falling into these "junk debt" categories.

It is this bubble that the Federal Reserve is most concerned to "sustain" by now heading back toward QE.

But the so-called "central bank of central banks," the Basel, Switzerland-based Bank for International Settlements (BIS), warned again of a bank crash from corporate over-indebtedness in the advanced economies, in its Annual Economic Report released June 30. The *Guardian*'s headline about the report, "Corporate Debt Could Be the Next Sub-Prime Crisis, Warns Banking Body," was typical; it added a blurb: "Group for central banks says borrowing by firms with low credit scores is growing alarmingly, especially in U.S. and U.K."

Unlike the many other warnings by regulators about the bubble of "leveraged loans" and their financial derivatives—which claim the major banks are safe and only the "shadow banks" are threatened with this bubble imploding—the BIS June 30 report directly stated that the megabanks are in danger. It said the $3.5 trillion market in what are leveraged loans—loans to already over-indebted corporations, now dominating whole economic sectors such as oil/gas and retail in the United States—is greatly "overheated," and could lead to a "bank panic" as did the sub-prime mortgage bubble in the 2007-08 global financial crash.

The BIS report adds that, even though major banks insist they own only the safest tranches of the collateralized loan obligations (CLOs) made up of these over-leveraged corporate debts, those major banks will be hit hard if there are large numbers of defaults in these sectors.

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Deutsche Bank headquarters in Frankfurt, Germany.

That is exactly what is now coming on. The big London and Wall Street banks also thought they were playing it safe with the collateralized debt obligations (CDOs) made up of sub-prime mortgage securities in the 2004-07 period, when they kept only the AAA- or AA-rated tranches of those CDOs. When the mortgage securities bubble imploded, Morgan Stanley infamously led the way by suddenly losing $14 billion in this manner.

The BIS report concluded,

> Already, the [global] slowdown appears to be worsening and spreading. There are signs of weak consumption and investment.... Should the leveraged loans sector deteriorate [with defaults—ed.], the economic impact could be amplified through the banking system and other parts of the financial system that hold leveraged loans and CLOs. There could be sharp price adjustments and funding tensions. These risks should be seen in the broader context of the longer-term deterioration in credit quality and the generally high corporate leverage in many advanced economies.

What Will Central Bank Panic Do?

Hardly discussed at all, however, is that the biggest central banks' turn back to money-printing and quantitative easing—in fear of the return to global economic recession and defaults—will bring the big banks' blowout on. This is seen with Deutsche Bank, currently the blowout's potential "Lehman," or first domino. The world's biggest financial derivatives bank, trying to survive with its stock down 95%, has just laid off 20% of its banking employees worldwide and tried to form a "bad bank" to offload a large mass of its derivatives contracts onto some other institutions, or even governments. It claims it can hold its new losses in the process to "just" 7.4 billion euros, and has the liquidity easily to cover them. That estimate of losses in creating the "bad bank," is widely doubted.

As pointed out in an astute comment by Alhambra Investments on July 9, these financial derivatives contracts, made over the 11 years since the 2008 crash, were overwhelmingly bets that conditions created by the central banks would "normalize" and both economic growth and interest rates would rise. (Derivatives are largely bets based on interest rates.) Because of the failure of the central banks' super-easy money policies since the crash, "normalization" has never happened in more than a decade. Still, well over $10 trillion in debt assets worldwide have interest rates below zero; and this even includes some corporate *junk bonds* for which the *buyer* of the bonds pays interest instead of the *issuer!*

And now, *central bank discount rates are heading back towards, and/or below, zero again*. So the long-held derivatives contracts of the likes of Deutsche Bank—perhaps especially Deutsche Bank, which has more of them than any other bank in the world—will keep piling up margin calls and losses, becoming more and more "toxic." Its "bad bank" is unlikely to save it from becoming the Lehman of this crash.

The lesson suggested by Alhambra Investments' Jeffrey Snyder, Head of Global Research: "Don't bet on economists and central bankers. They really have no idea what they are doing."

The trigger of the coming severe problems of the Wall Street- and London-centered banks, however, while it may lie with toxic derivatives contracts as in 2007-08, will also involve the waves of defaults now coming in the industrial and related real estate sectors of the trans-Atlantic countries, as the global manufacturing recession has begun.