

Global Economy on the Brink as Davos Crowd Parties On

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Global Research, January 23, 2019

Region: [Europe](#)

Theme: [Global Economy](#), [History](#)

At Davos, Switzerland every year the global capitalist elite gather to party...and to prepare for the year ahead. This year more than 1500 private jets will reportedly fly in. Thousands more of their underling staff will travel via business class to handle their personal, and corporate, logistics. Shielded from the media and the public, the big capitalists share views in back rooms and listen to experts on finance, government policy, technology, and the economy. The experts are especially probed to identify and explain the next 'black swan' or 'gray rhino' event about to erupt. Wealthy celebrities are invited to entertain them as well after evening dinner and cocktails. But the real networking goes on privately afterwards, in small groups or one on one, among the big capitalists themselves or in private meetings with heads of state, finance ministers, and central bank chairmen.

Typically each annual meeting has a theme. This year there are several: the slowing global economy, the fracturing of the international trade system, the growing levels of unsustainable debt everywhere, volatile financial asset markets with asset bubbles beginning to deflate, rising political instability and autocratic drift in both the advanced and emerging economies, accelerating income inequality worldwide—to mention just a short list.

On the eve of this year's World Economic Forum gathering, some of the most powerful, wealthy, and more prescient capitalists have begun to speak out to their capitalist cousins, raising red flags about what they believe is an approaching crisis.

Ray Dalio, the billionaire who found and manages the world's biggest hedge fund, Bridgewater Associates, warned that he and other investors had squeezed financial markets to such "levels where it is difficult to see where you can squeeze" further. He publicly admitted in a Bloomberg News interview that, in the future profits will be low "for a very very long time". The era of central banks providing free money, low rates, and excess liquidity have run their course, according to Dalio. He added the global economy is mired in dangerously high levels of debt, comparing it to the 1930s.



Paul Tudor Jones, another big finance capitalist, similarly warned of unsustainable debt levels—created by companies binging on cheap credit since 2009—that “could be systemically threatening”. Not just government debt. But especially corporate debt, where levels in the US alone have doubled to more than \$9 trillion since 2009 (most of it high risk ‘junk bond’ and nearly as risky ‘BBB’ investment grade corporate bond debt).

Almost as worrisome, one might add, is the now more than \$1 trillion leverage loan market debt in the US (i.e. loan equivalent of junk bonds). US household debt is also now approaching \$15 trillion. And US national government debt, at \$21 trillion, is about to surge over the next decade to \$33 trillion due to the Trump 2018 tax cuts. And that’s not counting trillions more in US state and local government debt; or the tens of trillions of new dollarized debt undertaken by emerging market economies since 2010; or the \$5 trillion in non-performing bank loans in Europe and Japan; or the even more private sector debt escalation in China.

Corporate debt levels are not alone the problem, however. Debt can rise so long as financial asset prices and real profits do so—i.e. provide the cash flow available to service the debt. But when profits and asset prices (of stocks, bonds, derivatives, currency exchange rates, commodity futures, etc.) no longer rise, or start to turn down, then debt service (principal & interest) cannot be repaid. Defaults often follow, causing investor confidence to slide. Real investment, employment, and household incomes thereafter collapse, and the real economy is dragged down in turn. The real decline further exacerbates the collapse of financial asset prices, and precipitates a mutual feedback of financial and real economic collapse.

And financial markets began to deflate in 2018; and it is now becoming increasingly clear that the real side of the global economy is slowing rapidly as well.

In February 2018 the first early warning appeared for financial markets. Stocks plunged in the US, Europe and even China. They temporarily recovered—a ‘dead cat bounce’ as they say before an even deeper decline in the fall. Then oil and commodity futures prices collapsed by 40% or more in late summer-early fall 2018. Stock markets followed again in October-December 2018 by 30-40% in US, China, Europe, and key emerging markets. Key emerging market currencies—Argentina, Turkey, Indonesia, Brazil, South Africa—all fell precipitously as well. And housing prices from the UK to Australia to China to New York began to implode as the year ended. In January 2019 stock markets recovered—i.e. a classic, short term, bull market recovery in what is today’s fundamentally long term global bear market.

Dalio’s and Jones’ worries by unsustainable debt and pending crisis have started to become real, in other words.

Becoming real as well is evidence of emerging defaults, a critical phase that typically follows asset markets’ decline and slowing profits. In the US there’s the Sears default, with JCPenney in the wings. And the giant corporation, once the largest in the world, the General Electric Corp., slouching toward default. Its global profits slowing and stock price imploding, GE is now desperately selling off its best assets to raise cash to pay its excess debt. It’s not alone. Scores of energy companies involved in US shale oil and gas production are teetering on the brink. In Europe, there’s deepening troubles at Deutschebank, and just about all the Italian banks, and UBS in Switzerland, and the Greek banks. In Japan, there’s trillions of dollars in non-performing bank loans as well, which Japan’s central bank continues to cover

up. And then there's China, with more than \$5 trillion in bad loans held by local governments, by shadow bankers, and by its state owned enterprises that the China central bank and government keep bailing out by issuing 'trusted loans' (i.e. equivalent of junk bonds in US).

Default cracks have begun to appear everywhere in the global economy, in other words, major indicators that the excess debt accumulation and financial bubbles of the past decade cannot be 'serviced' (principal-interest paid) and have begun to negatively impact the global economy.

What's becoming clear is that the next crisis will not emerge from the housing sector with excess debt and price bubbles driven by subprime mortgage loans and related financial derivatives. What's more likely is that the next crisis will emerge from debt defaults and collapsing real investment by non-financial corporations. Moreover, the tipping point is nearer than most in business or media will admit.

Trump's 2018 tax cuts simply threw a veil over the real condition of corporate performance in the US this past year. The tax cuts provided a windfall, one time subsidy to corporations' bottom line. It is estimated that US S&P 500 corporations' profits were boosted 22% by the Trump windfall tax cuts alone. Since S&P 500 profits for 2018 were roughly 27%, it means actual profits were barely 5%. That's the real situation going into 2019—a condition that assures US stock markets, junk bond markets, and leveraged loan markets in particular will experience even greater contraction in 2019 than they did in 2018. The bubbles will continue to pop.

In the global economy, it is even more evident that by the end of 2019 it is likely there will be recession in wide sectors of the real global economy amidst further asset markets' price declines.

In Europe, the growth engine of Germany is showing sure signs of slowing. Manufacturing and industrial production in the closing months of 2018 fell by 1.9%. After a GDP decline in the third quarter 2018, another fourth quarter 2018 German contraction will mean a technical recession. Equal to at least a third of all the Eurozone economy, as goes Germany goes Europe. France and Italy manufacturing are also contracting. Nearly having stagnated at 0.2% in the third quarter, the Europe economy in general may have slipped into recession already. And all that before the negative effects of a UK Brexit or an Italian banks' implosion or deepening protests in France are further felt.

In emerging market economies, the steady rise of the US dollar in 2018 (driven by rising US central bank interest rates) devastated emerging market economies across the board. Rising dollar values translated into corresponding emerging market currency collapse. That triggered capital flight out of these economies, and their falling stock and bond markets in turn. To stem the outflow, their central banks raised interest rates, which precipitated deep recession in the real economy, while their collapsing currencies generated higher import prices and general inflation in their economies as well. That was the story from Argentina to Brazil to Turkey to South Africa and even to Asia in places.

The US halting of interest rate hikes in 2019 may relieve pressure on emerging market economies somewhat in 2019. But that easing will be more than offset by China's 2019 economic slowdown now underway. In the second half of 2018 investment, consumer

spending, and manufacturing all slowed markedly in China. Officially at 6.6% for 2018, according to China statistics, China's real economy is no doubt growing less than 6% due to the methods used to estimate growth in China. Its manufacturing began to contract in late 2018, and with it a significant slowdown in private investment and even consumer spending on autos and other durable goods. China's slowing will mean less demand for emerging market economies' products and commodities, including oil and industrial metals. A respite for emerging market economies from the US dollar rising will thus be offset by China slowing.

When both financial asset markets and the real economy are together slowing it is a particularly strong 'red flag' warning for the economic road ahead. And more contractions in stocks and other financial assets, together with slowing of manufacturing, housing, and GDP in Europe, US, and Japan in 2019, are likely which means trouble ahead in 2019.

Along with all the data increasingly pointing to financial asset deflation gaining a longer term foothold—and with real economy indicators like manufacturing, housing, GDP, exports as well now flashing red—there is also a growing list of political hotspots and potential 'tail risks' emerging in the global economy. Some of the 'black swans' are identifiable; some yet to be.

In the US, the government shutdown and the prospect of policy deadlock between the parties for two more years could qualify as a source of further economic disruption. In Europe, there are several 'tail risks': the Brexit situation coming to a head in April, the challenge to the Eurozone by the new Italian populist government, the chronic and deep street protests continuing in France, and the general rightward social and political drift throughout eastern Europe. In Latin America there's the extremely repressive policies of Bolsonaro in Brazil and Macri in Argentina, which could end in mass public uprisings at some point. In Asia, there's corruption and scandals in Malaysia and India. And then there's the US-trade war with China, which some factions in the US are trying to leverage to launch a new Cold War. Not least, there's the potential collapse of negotiations between the US and North Korea that could lead to renewed threats of military conflict. All these 'political instabilities', given their number and scope, if left unresolved, or allowed to worsen, will have a further negative effect on business and consumer confidence—now already slowing rapidly—and in turn investment and therefore economic growth.

Ray Dalio's and Tudor Jones' warnings on the eve of Davos have been echoed by a growing list of capitalist notables and their government servants and echoes. IMF chairperson, Christine Lagarde, has been repeatedly declaring publicly that global trade and the economy are slowing. Reflecting Europe in particular, where exports are even more critical to the economy, she has especially been warning about a potential severe US-China trade war disrupting the global trading system—and global economy in turn. The IMF has been issuing repeated downward adjustments of its global economic forecasts. So too has the World Bank. As have a growing number of big bank research departments, from Nomura Bank in Japan to UBS bank in Europe. Former US central bank chairs, Janet Yellen and Ben Bernanke, have also jumped in and have been raising red flags about the course of the US and global economies. Former Fed chair, Greenspan, has even declared the US is already on a recession path from which it can't now extricate itself.

Given all the emerging corroborating data, the red flags and warnings about the current state of the global economy, and the growing global political uncertainties, the Dalios, the Jones, and others among the Davos crowd are especially worried this year.

On the eve of the Forum's first day on January 23, 2019, a leading discussion topic among the cocktail parties is the buzz about the just leaked private newsletter from billionaire Seth Klarman, who heads one of the world's biggest funds, the Baupost Group. In his newsletter leaked to the New York Times, and widely circulated among early Davos crowd attendees, Klarman reportedly chides his readers-investors about not paying more attention to the social and political instabilities growing worldwide, about Trump's direction which is "quite dangerous", and the US in effect retreating from global leadership, leaving a dangerous vacuum behind. Investors have also become too complacent about global debt and risk levels now rising dangerously, he argues. It could all very well lead to a financial panic, he adds. The US in particular is at an 'inflection point'. He ominously concludes, "By the time such a crisis hits, it will likely be too late to get our house in order".

The recent statements by Dalio, Tudor Jones, Klarman, and the others reminds one of the last crisis and crash of 2008. When Charlie Prince, CEO of Citigroup, the biggest bank at the time, was asked after the crisis why he didn't see it coming and do something to avoid the toxic mortgage-derivatives bomb and protect his investors and customers, Prince replied he did see it coming but could do nothing to stop it. His investors and customers demanded his bank continue—like the other banks were—investing in subprime mortgages, lending to shadow banks, selling risky derivatives and thereby continuing to make money for them, just as the other banks were doing. Charlie's response why he did nothing to stop it or prepare was, 'when you come to the dance, you have to dance'.

No doubt the Davos crowd will be partying and dancing over the next several days in their securely gated, posh Switzerland retreat. After all, the last ten years has increased their capital incomes by literally tens of trillions of dollars. And capitalists are driven by a mindless herd mentality once they've made money. They believe they can continue doing so forever. They believe the money music will never stop. One can only wonder, if they'll be dancing later this year to the same song as Charlie's in 2008.

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