When Will We Face the Next Crisis?

Article in the Swiss Newspaper NZZ, May 14, 2018*

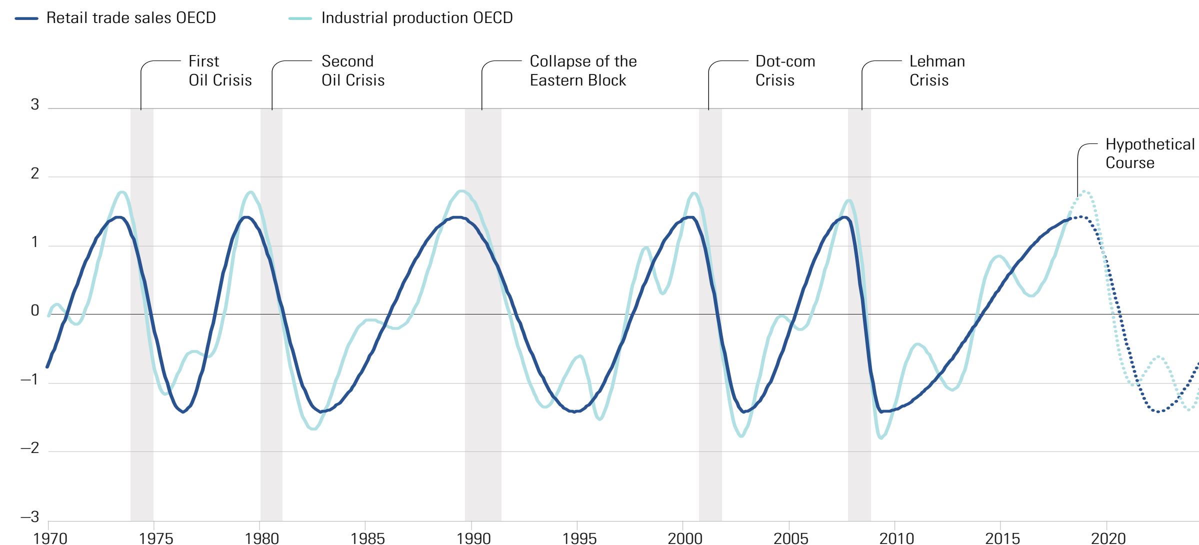
hpo forecasting
we predict your business

The global economy is in a comfortable state, albeit there are increasing signs of a slowdown in growth.

An intensifying trade conflict between the U.S., China, and Europe, U.S. sanctions against Russia, and increased volatility on the stock markets: The economic environment is far from comfortable right now. This contrasts with the stable global economic trend. The U.S. is currently undergoing one of the longest expansion phases in its history, the economy in most E.U. countries is booming, and there are impressive growth rates in the countries of East and Southeast Asia.

Overall, the world economy grew more strongly in 2017 than it had in six years.

However, the rapid pace of expansion is accompanied by increasing signs of an economic downturn. The growth rate in Europe weakened in the first quarter, with leading indicators pointing to a slowdown in industrial dynamics. Countries such as Germany are gradually reaching capacity limits, which are likely to slow the expansion pace over time. Simultaneously, the U.S. is in danger of overheating – fueled by the latest tax reform and the Trump administration's high-spending budget plan.



Consumption and industry cycle: deviation from trend, standardized 1990
Source: hpo forecasting (formerly USP Consulting; NZZ info graph/lea)

Interest rate curve in the danger zone

Most economists expect the economy to weaken in the coming year. Based on stable consumption, declining unemployment rates, a favorable investment environment, and mostly positive sentiment indicators, most economic forecasters only expect a slight slowdown. Nevertheless, several warning signals must be taken seriously. This includes the flattening interest rate curve in the U.S.

It has been a reliable leading indicator over the past decades. A new study confirms that inverted interest rate curves have preceded all nine recessions in the U.S. since January 1955. The only time a recession did not follow an inverted interest rate curve was in the mid-1960s – when it resulted in a mere economic slowdown. The interest rate curve currently still shows a slight incline. But it is slowly approaching the danger zone. This is because the increase in interest rates by the U.S. Federal Reserve has caused the short-term

* This article has been written by Nicole Rütti and has been translated by hpo forecasting. The original German article can be found here.

hpo forecasting ag, Gewerbestrasse 5, CH-6330 Cham, T +41 41 461 00 22, forecasting@hpo.ch, www.hpoforecasting.ch

hpo forecasting
we predict your business

rates to rise significantly, while the long-term rates have only risen slowly. However, the validity of the interest rate curve is currently being questioned. After the financial crisis, the central banks massively distorted the bond markets and thus the interest rate curve with their monetary policy.

However, it does not take an interest rate curve to show that things are out of balance. Risks include record levels of global debt – with China's rampant shadow banking system at the forefront. Added to this is the distinctive growth in the money supply due to the central banks' extremely loose monetary policy. A large part of the liquidity is likely to have flowed into equities and other assets rather than into the real economy.
Is there a way to forecast economic turning points? Economic researcher Peter Meier, who has specialized in economic forecasting for around twenty years and consults various companies and associations, is convinced of this. The ETH operating engineer and owner of the consulting firm USP Consulting has developed a mathematical model based on various global economic indicators that can predict demand for capital goods with a horizon of around one year. Many companies, particularly in the engineering sector, base their production planning on this model. For late 2018 or early 2019, the model – like most economic models – points to a flattening of the current boom.

Ominous domino effect

It remains uncertain whether this will be a dent or a crisis. To answer this question, Meier uses two economic indicators – demand for durables and industrial production. Deviations from the long-term growth trend are considered for both indicators, resulting in the image of an oscillation. These oscillations can be approximated by sinusoids, which correspond well with the economic indicators. The basis of this construct is the realization that the driving force of a business cycle is industrial production, which is supported by steadily growing consumption during the upturn. According to Meier, the demand for investment drops as soon as consumption reaches a peak in the economic cycle.

The average length of such a consumption cycle in the OECD area is seven to twelve years. If demand for investment, which accounts for around a quarter of economic output, suddenly collapses in the middle of a boom and demand for durables declines simultaneously, it results in great uncertainty with the potential for a domino effect. According to forecaster Meier, such a constellation was observed five times in the last fifty years, and each time was followed by an economic crisis: 1974 (First Oil Crisis), 1980 (Second Oil Crisis), 1990 (Collapse of the Eastern Bloc), 2001 (Dot-com Crisis), 2008 (Lehman crisis). The crises are named after their triggers, which may be relatively insignificant. However, they cause a downward spiral – because the economic situation is unstable at this point.

According to Meier, both the consumer and industrial cycles are currently heading for a new peak. His calculations indicate that this peak is likely to be reached during 2019. No reliable data can yet be provided on when the peak will be reached. Most economists have failed miserably in the past when predicting economic turning points. But it is equally evident that the current risks are considerable. The extremely loose monetary policy has helped to cover them up. A minor event might be all it takes to let the underlying issues rise to the surface.

Your contact at hpo forecasting

Josua Burkart
M. A. HSG
Managing Director
josua.burkart@hpo.ch
+41 44 787 60 15

Benjamin Boksberger
M. A. HSG
Forecasting Manager
benjamin.boksberger@hpo.ch
+41 41 461 00 22