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Are we over depending on capital gains?

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David Levy's April forecast, by way of Jerome Levy Forecasting Center, presents three notable viewpoints worth sharing this month.

The first is that capital gains are accounting for an increasing share of total investment returns, now making-up probably the majority of them. But, says Levy, it will be challenging to maintain those capital gains from now on.

The second is that whilst there is a popular view that foreign exchange can explain the extreme volatility so for in 2016, this is probably wrong. According to the prevailing view, Davy notes, the stability of the global economy leans heavily on currency stability and especially on a benign set of stable dollar exchange rates.

Specifically:

Purportedly, the additional strengthening of the dollar in late 2015 and early 2016 — on top of the strong rising trend of hte previous 15 months — was the primary cause of the January-February global sell-off. Moreover, it is claimed, a set of central bank policy changes following the February G20 meeting in Shanghai sent the dollar back down, revitalising financial markets around the world.

But, says Levy, this overlooks what is really wrong with the world economy. In Levy's eyes this has everything to do with over-expanded balance sheets relative to income, consequent financial strains, and incentives for ever more reckless financial behaviours and growing threats to the economy's ability to generate the profits needed to stave off a severe correction.

Which leads to the third point. Profits are falling around the world because of a gradually developing downturn in global next fixed investment, especially that share tied to the emerging market boom.

As Levy recounts:

Starting with the DMs, we note that net fixed investment, normally the dominant source of profits in a healthy economy, has been depressed ever since the housing bubbles burst throughout most of the DM sector. We have described the condition of most DMs as an expansionary phase of a contained depression. With the major DMs undergoing secular, sporadic, sometimes even backtracking corrections of balance sheet excesses, developed market net investment has been unusually weak in this business cycle. So, to achieve the profits needed to expand, they have depended on large government deficits or remained lackluster — or both.

Meanwhile, a great investment boom in EM economies, especially China, generated surging global net fixed investment — enough to pump trillions of dollars of profits into the global economy. However, that boom turns out to have been a bubble — a tremendous, speculative over expansion of balance sheets – and it has begun to deflate as the EMs increasingly suffer the consequences of this overexpansion: capital investment is turning down, global profits are getting squeezed, and the financial strains of excessive overhead and decelerating cash flow are undermining financial stability.

Put EMs and DMs together, and the result is a developing world retrenchment. As the EMs experience weakening investment, their profits decline, their economies slow, and their imports and international debt performance both weaken. That means lower exports and profits for already lethargic DMs, more stress on DM lenders, and a general loss of market confidence. These sentiments can reverse for a while on what is seen as favourable news (like a new Plaza Accord or weather-boosted US data). But, the undoing of the EM investment boom just keeps on playing out, becoming harder and harder to offset or contain.

And here are the charts to take note of.

First, this one indicating that manufacturing may be about to slip:

Then there’s this one showing capital goods orders are in a down trend in the US:

And last of all there’s this one showing global export volumes beginning to contract on a year on year percentage basis.

Over-depending on overly expanded balance-sheets and capital gains rather than earnings, needless to say, is kinda the same as over-depending on wealth creation through bubbles and beggar thy-neighbour zero-sum capital distribution. Ultimately not sustainable — even in a steady state system — because depreciation and maintenance are real things which have to be continuously re-invested in to maintain value.

Do the unicorn hunters preying on earnings and investment-light winner-takes-all business models understand this?

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