For nearly 25 years, the European Union (EU) has held together despite challenges from bankrupt institutions, separatist movements and members with widely divergent economic prospects. But that cohesion is being tested, according to Albert Edwards, by inside Eurozone countries that are losing their competitiveness. But his greater concern is the impact the Fed-induced credit bubble will have on the markets.

Edwards is the global strategist for Societe Generale and is based in London. He spoke at a private luncheon for clients earlier this month in Boston.

“The eurozone is a doomsday machine for some economies,” Edwards said, “particularly Italy.”

The problem, according to Edwards, lies in the fact that countries like Italy have become economically uncompetitive due to lower productivity. As a result, their real exchange rate is rising – the prices of goods produced in those countries have become too expensive to sell abroad.

“The only way to stand still is to deflate wages,” he said. Deflating wages is a euphemism for salary cuts in order to lower production costs.

Moreover, he said dissent – something the EU does not like to deal well with – will exacerbate Europe’s economic difficulties. “Unlike in the Brexit voting in the UK, young people in the weaker eurozone countries overwhelmingly want to leave the EU because of high unemployment,” Edwards said. Spain’s economy has grown 4%, yet youth unemployment is still close to over 40% as it is also is in slow-growing Italy.

In Italy and Spain, as time goes on dissatisfaction with the EU is likely to grow as the older population who remember the WW2 and favor the EU are replaced by a more dissatisfied younger cohort, he said.

“What will happen in the next recession?” Edwards asked rhetorically.

One answer to that question may come from China, he said, which will be a key indicator of whether
asset prices can sustain their current levels.

Volatility in all markets has been suppressed, he said, which is unsustainable, but there’s no indication of when it will end. This is the second longest bull market in history and the third longest economic recovery, now into its 100th month, according to Edwards.

“Clearly we are closer to the end than the beginning,” he said. “The question is how far we are from the end.”

I’ll come back to Edwards’ concerns about China, but first let’s look at his update to his “ice age” thesis.

An ice age update

In 1996, Edwards forecast an “ice age” during which bonds would outperform stocks. He based this on his experience observing the Japanese economy, and said that equity yields would rise and they would be “de-rated” while bond yields fell.

Indeed, he said, that happened from 2000 onward, just as it did in Japan.

In 2013, his equity call went wrong, as stocks rallied, he said. That, he said, was because of global quantitative easing (QE), which inflated equity prices.

Now equities and bonds have had equal total returns since 1996, following a recent catch up by equities.

But that may be temporary. He said that “the risk is that in the next recession – which is not imminent – equities will collapse.”

“Many of my extreme forecasts have been right,” he claimed, “and if this one is correct it will be pretty catastrophic.”

“It is not imminent,” he said, “but it is out there.”

Central bank policies

Will central bank policies abet or prevent a crisis? Edwards is not sure.

QE has produced inflation in the financial markets, he said, and is responsible for the extreme overvaluation of the “FANG” stocks. “Never in history have financial and physical assets been so overvalued,” he said, citing an analysis by Deutsche Bank.

He said it will be very difficult for the European Central Bank (ECB) to aggressively withdraw its QE because of the uncertainty surrounding the Catalonian secession movement and the upcoming Italian elections.
Despite those valuations, he said that the equity market “wants to rally.” Until recently, he said, equity price gains could be traced to higher profits. But now, he said, those gains are “perhaps because of Trump’s tax plan.”

“The Fed has found religion for some peculiar reason,” he said. “Despite rapidly falling inflation, it is determined to raise rates,” he said, but added it is too wedded to what the markets think.

But the bond market doesn’t believe this, he said, because two-year yields have barely moved up. The Fed has consistently “overpromised” and “under-delivered,” Edwards said, which is why the market doesn’t believe the Fed.

Also, he said the inflation data is “quite extraordinary.” He said the PCE and core CPI are surprisingly extremely weak, and both the U.S. and the eurozone are “one recession away from Japan-style outright deflation.” Moreover, the number of OECD countries with core CPI less than 2% is growing.

Kevin Warsh is Edwards’ preferred candidate – and among the most hawkish – to succeed Janet Yellen as Fed chairperson. The Fed will be far more reluctant to resume QE “in bulk” under Warsh than Yellen.

Warsh has one thing in his favor, Edwards said. “He is very rich – perhaps richer than Trump.”

“The real difference will be in the next crisis, and whether the next chairperson resumes QE and easing,” Edwards said. “Warsh will act slower than others.”

**The Chinese time bomb**

China has gone “off the radar,” Edwards said, because the dollar has declined this year, the Renminbi has been allowed to rise and its reserves stopped plummeting. This was likely because Chinese policymakers wanted stability in advance of the Communist party congress, he said.

But China is not stable, he said.

“It is a real boom and bust economy,” he said. Those swings are not seen in its GDP numbers, but elsewhere, according to Edwards. Housing prices a year ago were up 40% in major cities, but now they are falling, he said.

“China is an unstable credit bubble. It lurches from tightening to easing, like a ship that can’t keep an even keel,” Edwards said.

Now it will tighten to keep housing under control, according to Edwards.

**The fallout from a recession**

Edwards cautioned against the consequences of a recession in the U.S. or elsewhere.
According to David Rosenberg, an economist at the Canadian firm Gluskin Sheff, of 13 post-war Fed tightening cycles, 10 ended in recession.

“It may not take that much for this one to end in a recession,” Edwards said.

According to the IMF over 20% of US corporates will “go bust” at the end of the Fed next tightening cycle because of excess leverage, Edwards said. The U.K. is not be able to increase rates without triggering a recession. The Bank for International Settlements (BIS) has cited similar extremes in leverage among U.S. corporations, he said.

Edwards said that a recession would cause the equity market to drop, the VIX to go up and credit spreads to widen. “It would crush the corporate bond market,” he said. Covenants would be breached and it would set off a “death spiral” that would spread from the financial markets to the real economy, he added.

“It is impossible to predict when this would happen,” he said. “but with the volatility where it is these are very dangerous times.”

But present low-volatility conditions could persist for six to 12 months, he said. “The good news is that banks don’t hold risky stuff; it is held by households – specifically in investment-grade and high-yield ETFs,” Edwards said.

The surprise in the next recession could be like in 1991, which despite being a very shallow recession, saw many corporations go bankrupt or default on their debt because of leverage from Michael Milken and the junk-bond market, he said. “Corporations will slash expenses to service debt to stay alive, making the recession much deeper.”

"The Fed has created another massive debt bubble," said Edwards, "just as they did in 2007, but this time the excess is in corporate rather than household borrowing. And just like immediately prior to the crisis, investors are far too complacent. As in 2007, another credit bubble is likely to plunge the financial markets and economy into crisis. It is only a question of timing."