

## The Only Form of Permanence

Perhaps the first great lesson of economics, as emphasized by Henry Hazlitt, is that there is no free lunch. The second, courtesy of Frederic Bastiat, is that if it sometimes appears that there *is* one, it means that we simply have not looked deeply enough into the consequences of our attempt to enjoy it. The third, the joint insight of several generations of Austrians, is that the attempt to buy one for ourselves by resort to monetary manipulation is eventually doomed to fail. A cynic might say that the fourth and final lesson is that no-one ever wishes to abide by the strictures inherent in the first three rules.

Consequent to this, we deniers are fated to an eternal round of wishfulness, hope, euphoria, doubt, disquiet, and despair as we set about to cook just such a meal without ever being sure that we have sufficient ingredients with which to make it, enough time in which to prepare it, or even whether our appetite for it will remain equal to its complete enjoyment if we do.

In a similar vein, we see the credit theory of the business cycle vindicated over and over again, though each time in a guise just different enough in its superficial aspects to

trick us into believing we have truly managed to break the shackles of inevitability — *this time!*

Institutions vary, language evolves, circumstances change: but the twin boundaries of Time and Capital never fail to set the boundaries of the humanly possible.

So, today, we find ourselves at a pass where it is just possible that all the various threads, which we have so assiduously interwoven these past 15 years in the quest for our free lunch, are about to unravel in such a way that as each one shakes itself free, it helps unpick the knots binding those adjacent to it.

At the start of this century, China made its first, great, forceful strides towards modernity, dragging its crisis-cheapened neighbours in its train. A voracious demand for raw materials was unleashed, an overwhelming flood of goods was supplied in turn and solid accounting, go hang! Aided by the peculiarities of the international monetary system, we in the West did not strive overmuch to find ways to pay for this surprising bounty but, gulled by our superstitious central banking overlords who were determined to rob us of the extra real value this offered us by preventing its price from ever falling, we borrowed the means instead. As each new consignment of goods was sent out with a conveniently detachable IOU hung about its neck it seemed we were living the Yorkshire Tyke's dream, that we could truly 'Eat all, Sup all, Pay nowt'.

Well, we are now rapidly discovering that not only does the chef want us to settle up, but that those of us entranced by the sight of a perennially busy restaurant have spent our time building too many duplicates, forging too many sets of cutlery for their tables, and growing too much food for their kitchens. Some of us are left with bellies groaning from gluttony: some have grown lean from being overly fastidious with the menu. Many of us will go hungry — and the chef unpaid — in the months ahead.

**Sean Corrigan**

Wherever you look around the fringes of China—and, by extension, Greater Asia—it is hard to avoid evidence of the woes being suffered. Caterpillar sales in the region are as depressed as they have been since the GFC. Not just rail traffic, but both shipping rates and air cargo loads are flat or falling and output (of the tangible kind, at least) is decelerating in its turn.

This is causing ripples across the capital structure not just of China, but of the globe. For instance, in its latest quarterly report, IATA noted that, after enjoying a boost related to the disruption to sea cargo to America's strike-bound West Coast ports, air freight volumes had relapsed back to the levels of last year in a deceleration which was being aggravated by high inventory levels and sharply reduced semi-conductor shipments.

In a world where easy money has eroded capital discipline, this has not prevented net additions to wide-body freighter payload capacity every year since 2010, to which must be added record levels of storage. With the pre-Crisis highs being exceeded here in the dedicated sector, the inexorable expansion of civil aviation in general has also brought an accelerating increment in 'belly' or hold capacity, too, to the point that the hike seen so far this year stands at close to three times that delivered a short five years ago.

Needless to say, Asia leads the charge, being responsible for 40% of all new capacity added this last half-decade.

Out on the ocean wave, the travails of the industry there are well-known. Container rates out of China's main hubs, as recorded by shipbrokers Drewry, are off by nearly a half YTD. The SSE versions of these are likewise depressed: the Shanghai spot index is making new lows at barely a half of its autumn 2009 inaugural value while the broader CCFI index of spot and forward rates has recently inched back above lows not seen since it was first introduced back in the dark days of the Asian Contagion in 1998.

Dry freight rental rates are also plumbing unprecedented depths as a result, while as many as 10% of all sailings between Europe and Asia have been cancelled thus far. From the other side of the world, CASS attributes the greater part of the 23% slump in US export volumes suffered this year to weakness in China, especially—but not exclusively—in agricultural products

Globally, the Bremen-based RWI/ISL throughput index of TEU volumes at 72 leading ports has shown scant growth for the past year or more. When you contrast this with box-ships' long history of outpacing a growth in world trade which has itself tended to surpass GDP gains, the ramifications of this are immense. Indeed, it looks as if 2015 may well go down as the weakest year for container freight in at least the past 2 ½ decades, barring only the slump endured in 2009 itself.

We shall have more to say about trade below, but for now, let us just conclude by noting that this is hardly consistent with robust levels of internal growth in import-dependent China, much less for its export earners, *per se*.

None of this, naturally, was enough to prevent the NBS from cooking up a reassuring looking 7% growth number for the second quarter, nor did it discourage a regime supposedly no longer fixated on such blunt statistical milestones from sending out Vice Finance Minister Zhu Guangyao to ruminate on what the unbroken series of such expansions he all but promised will do for per capita income by the end of the decade.

But can this be believed? Here is not the place either to run through every field of enterprise in the country or to focus unduly on the plight of an extractive sector where profits have fallen by three-fifths, or the likes of the metal industry where the MySteel consultancy calculates that only 6 out of 163 major steel mills in the country is currently making a profit even as the CISA registered the first drop in output seen in the past two decades.

However, just to marshal a further anecdote or two with which to bolster the argument, let us note that passenger car sales, for example, are clearly past their erstwhile peak with June's 3.4% YOY *decline* sending shock waves through an industry pinning hopes for its members' global operations on the much-forecast rise of the new middle-class car driver in China. Output was also off 0.1% marking the first monthly double decline since the worldwide freeze of December 2008.

Taking the first half as a whole, the CAAM said that sales were up 4.8%, a decided turn for the worse when compared to the year ago jump of 11.2% while revenues for the period to May lagged, being 1% lower on 2014 and thus

implying a fall in unit selling prices. Remember, too, that Chinese car 'sales' include shipments to dealers and *these* good folk are separately reported to have at least 140,000 vehicles cluttering up their lots while awaiting the increasingly rare visit of an eager customer or two.

Perhaps even more indicative of the commercial and industrial status of the economy, first semester truck output and sales were each off by a sixth from the like period in 2014. Taken as a whole, vehicle production exceeded the previous year by a bare 2.6%, leading Ford, for one, to predict that this year would see an overall shrinkage in the market for the first time in at least 17 years. They'd better hope that sub-prime auto market back home holds up for a while!

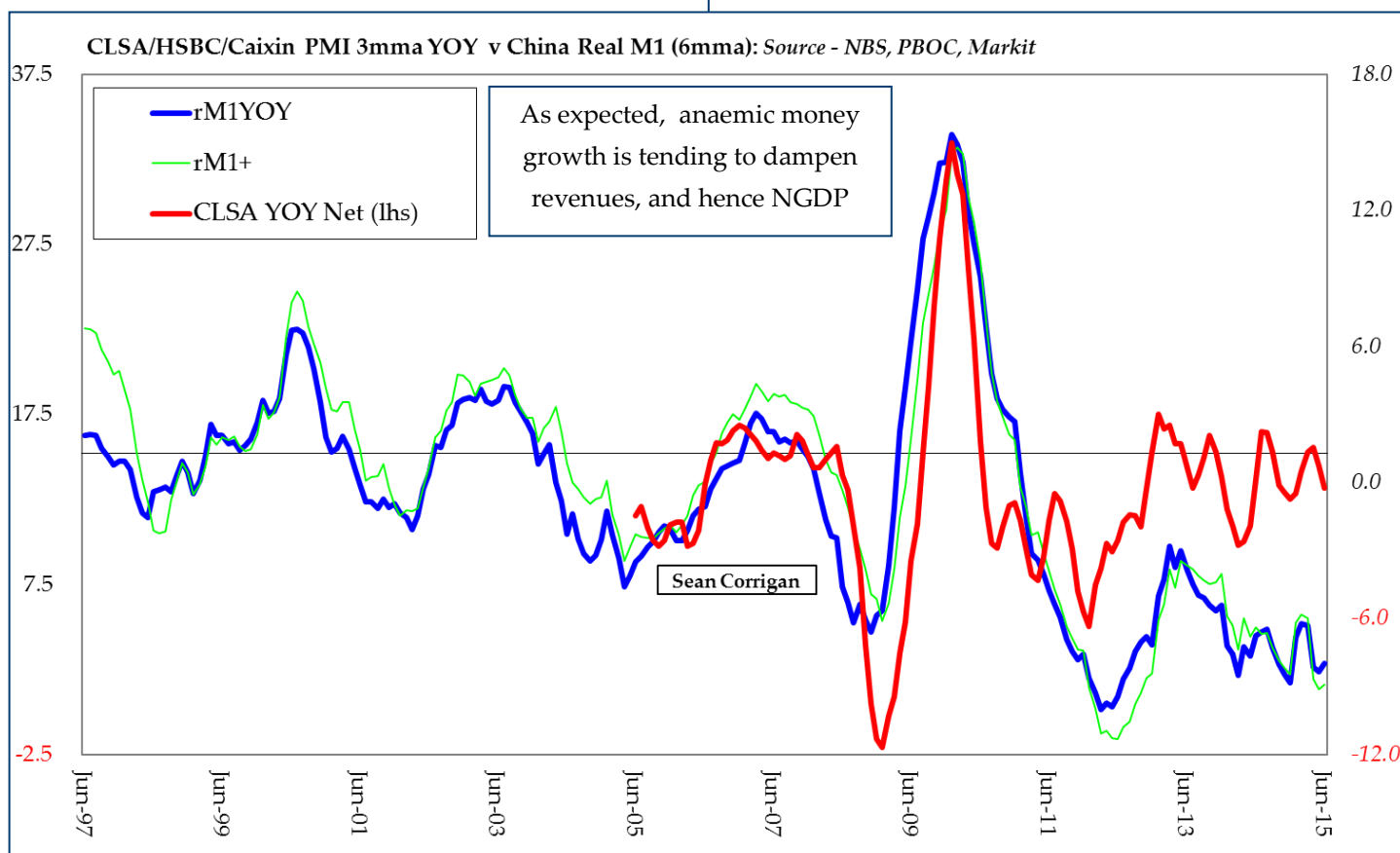
Given these sorts of specifics, it is easy to understand the scepticism with which the GDP numbers are routinely greeted. But even if we do take the numbers at face value, if only for the sake of argument, there remain serious questions about their composition. For example, the so-called 'secondary' sector—mining, manufacturing and utilities—came out of QII only 1.7% ahead of where it was in the same period in 2014 which at least was an outcome consonant with the revenue figures issued for the sector but which is nonetheless awfully anaemic for a supposedly vibrant economy.

Against that, those who have yielded to the command economy hype of the leadership might take some consolation from the fact that the sought-after 'New Normal' re-balancing was reflected in no uncertain terms in the 12.7% YOY growth in the comparably sized 'tertiary sector' (trade, logistics, and services, loosely). It is only when you peer further down into that disaggregation that the alarm bells start to ring, for here we find that finance (i.e., the stock bubble in all its lurid aspects) grew 27% while everything else in the field managed a less spectacular, if still passable 10% gain.

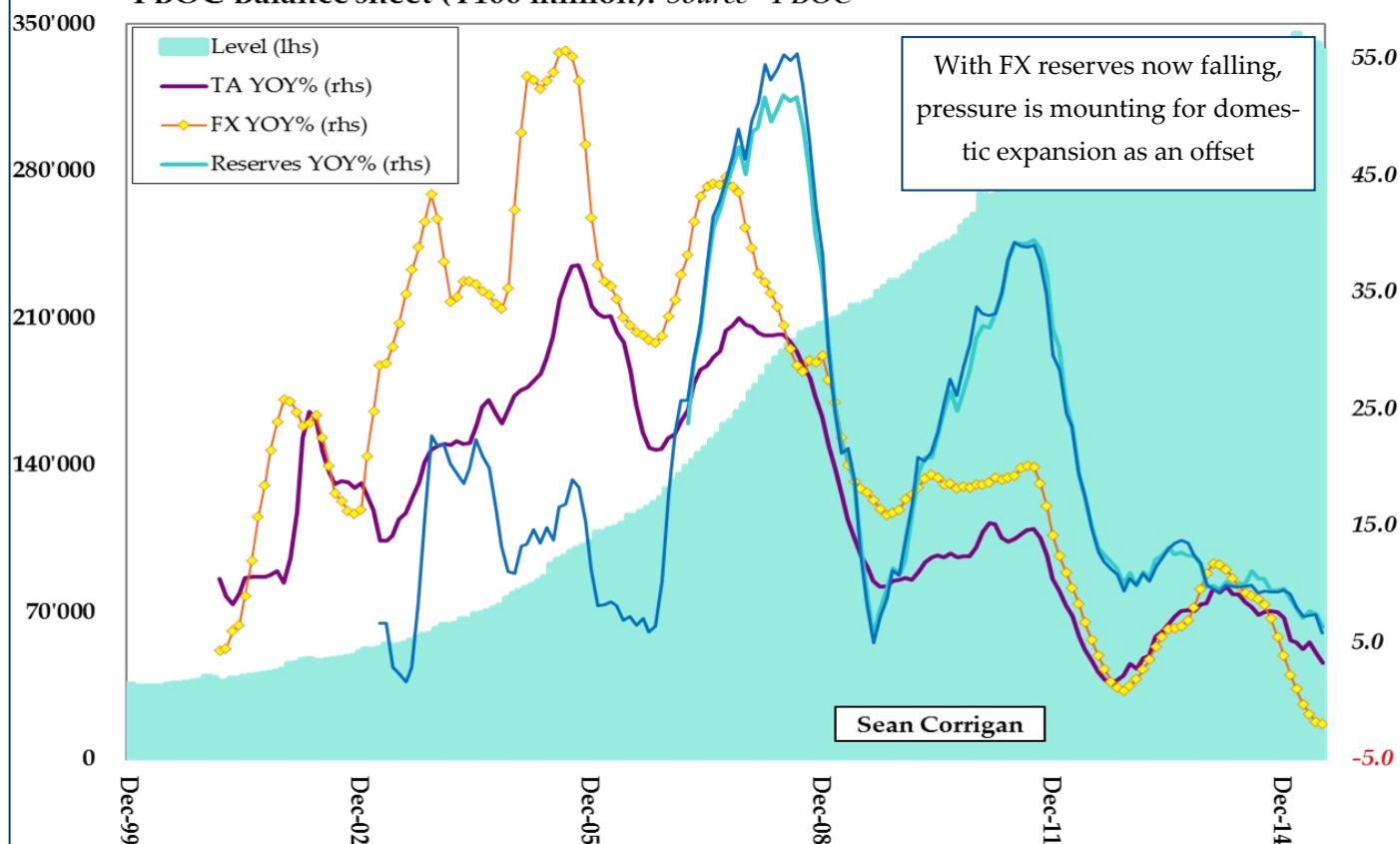
Finance, indeed, at just under a fifth the size of the tertiary sector, accounted for more than 35% of its total growth and hence was the source of almost three-tenths of the *entire* NGDP increment. Finally, though just more than a fifth of the smokestack sector in size, financial smoke-and-mirrors posted an increase more than 2 1/2 *times* as large!

Who needs dirty old commodities when you have an SAP accounting package or a credit line to the China Securities Financing Co.?

Here we arrive back at the issue of the aftermath of the Mississippi Scheme 2.0 – otherwise the stock bubble. Regulars will have seen us draw parallels between John Law's attempt to set an exhausted France back on the straight and



**PBOC Balance sheet (Y100 million): Source - PBOC**



narrow three centuries since and Beijing's latter day efforts to solve the conundrum of over-leveraged business and dysfunctional monetary transmission mechanisms by promoting what they hoped would be a mutually beneficial debt-for-equity swap.

Alack and alas! What they failed to foresee and neglected thereafter to control was the explosive nature of the citizens' speculative appetite. BofAML estimates the mountain of corporate debt to amount to \$12.5 trillion at an EV/EBITDA of 27.1 (vs \$7.8 trillion for US non-financials at a ratio of 12.2) and it was hoped to transmute some of that into share capital, with the corollary that some good part of householders' surplus bank deposits would be safely spirited away and the banks' balance sheets miraculously decluttered as a result.

Instead what we first got was a transfer of perhaps \$1 trillion of that debt from corporate balance sheets to individual ones through a range of intermediaries, both official, on-exchange ones and a via host of more 'informal' sources.

In the end, once the convective spiral of rising share prices and ever more gargantuan borrowing against them stalled out against the financial tropopause, the resulting deluge threatened to wash the entire hillside away, necessitating

the state's panicked, five-alarm rescue efforts.

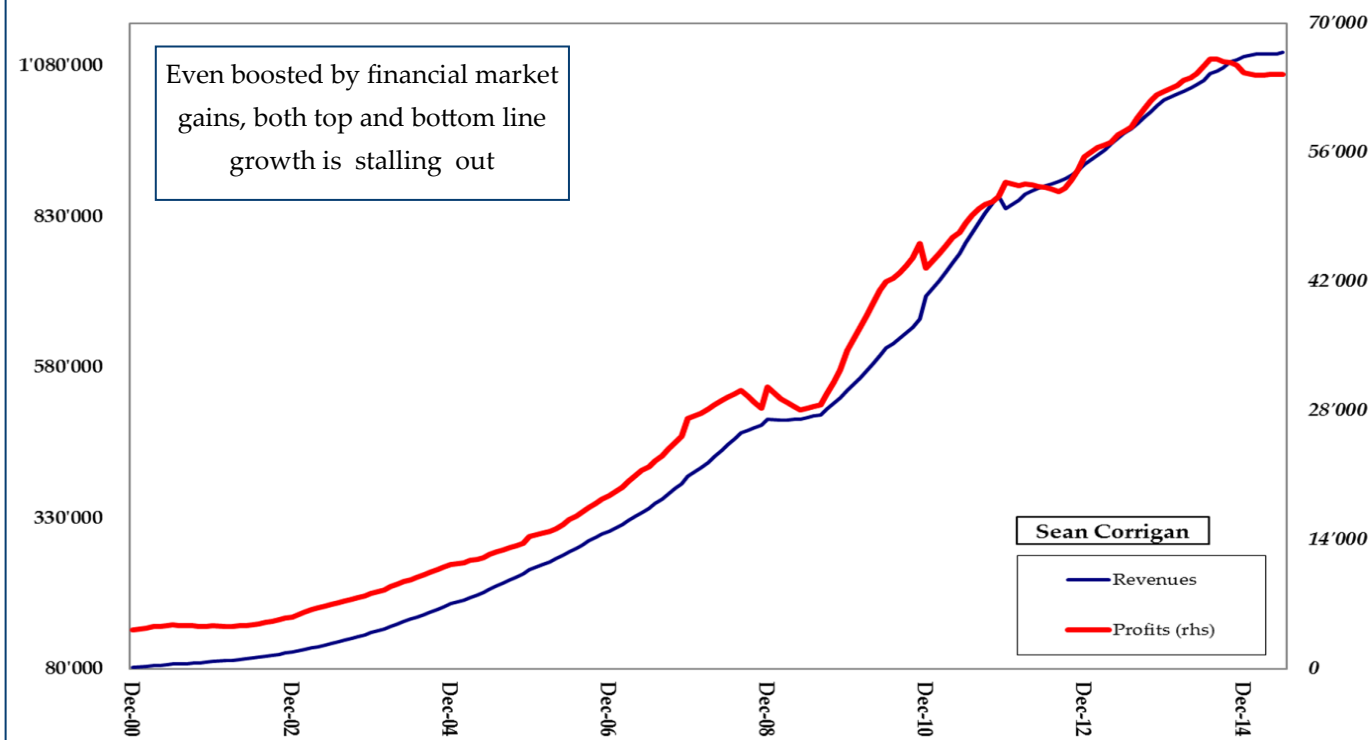
Added to this, as HSBC revealed, perhaps another \$400 billion of equity (equivalent to the peak margin balances at Shanghai and Shenzhen combined) simply became bound up as collateral for a further infusion of bank credit, thus necessitating, some say, the suspension of trading in many of the companies concerned lest covenants be breached, the firms fail, and the bank's woefully under-declared total of bad loans be publicly forced upwards.

Nor do the entanglements end there. Firms' own share-dealing had notably boosted profits while the bubble was in force, something which will clearly not be repeated in subsequent reporting periods and so something whose inevitable unwind will depress the mood as much in future as it raised spirits in the past. It is also entirely possible that, just as in late-1920s Wall St., some firms have been only too happy to issue highly-priced securities to avid buyers before parking the surplus funds with those agents who finance – often at eye-watering rates and at insanely high leverage multiples – those stocks' same purchasers.

In the attempt to avoid the market crash from wiping out a generation of 'Crazy Aunts', student plungers, and small business speculators, the third debt-for-equity swap is now



CHINA Industrial Enterprise Profit & Revenues, Rolling 12 mos, CNY100 mln: Source - NBS



underway, this time one which will bring all the debt back to the state—or at least to the state-owned banks upon whom the main burden of financing the rescue has seemingly fallen (much of it on a non-recourse basis, if rumours are proven to be correct). This comes just as they were being deluged with the odd trillion CNY in bonds of dubious worth from the enforced LGFV debt refinancing package.

At first it seemed that the mass intervention was going to do the trick. Enticed by the seemingly risk-free profits being offered by a stabilization drive which had pushed the A-shares up 25% and the small caps by 35%, burned fingers spent a week creeping back to the flames, adding another \$1 billion-a-day to the official margin total as they did. Then, WHAM! The biggest single day fall since the last market crash in 2007; a two-day move which scored no less than 4.2 sigmas in a 17-year sample; a three-day move which extended to 18% and which wiped out up to 40% of the intervening ascent – and margin to the tune of CNY85 billion, US\$13.5 billion evaporated once more.

There was some talk the trigger was the combination of an IMF call to rescind the more draconian controls and hints that the CSFC had repaid some of its borrowings early, but whatever the proximate cause, this is increasingly embarrassing for a regime which must at all times exude an air of Olympian control in order to compensate for its lack of representative legitimacy.

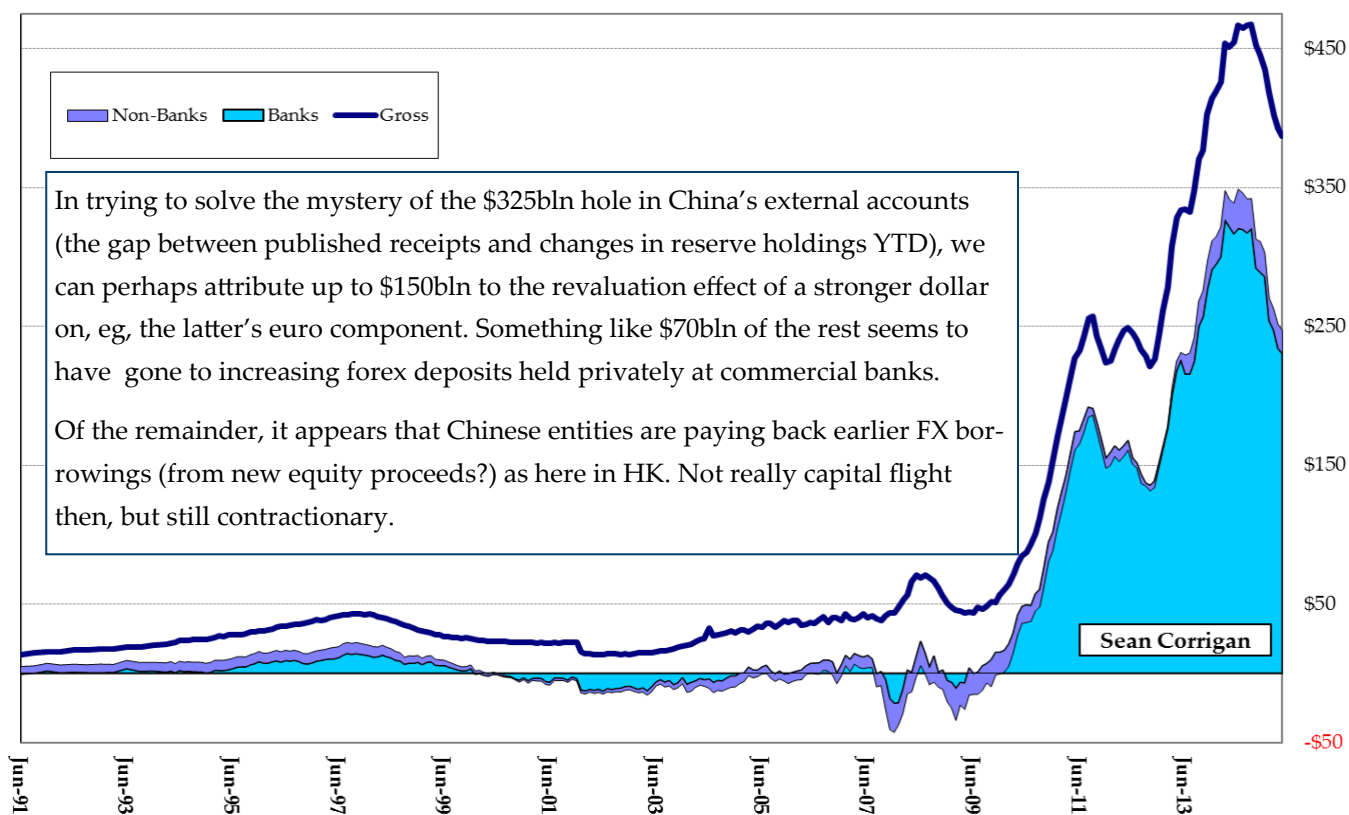
Though also unlikely to have provided the catalyst, it was perhaps fitting that the slump came on the morning when the monthly estimate of industrial corporate performance was released. While this did show some improvement from QI's 4.9%YOY profit growth to a more respectable-looking 7.1%, this was not without the caveat that it was the result not so much of better business but of lower financing costs (and, one supposes, some residual stock market-related gains) as well of the boost to utilities emanating from lower fuel input prices.

Underlining the pallid nature of the results, revenues were up a sickly 2.2%YOY. Alongside this, we have also seen that SOE revenues were off 5.6%YOY; that non-residential power use crept ahead by a meagre 1%; that nominal industrial output was up a scant 2-3%; and that M1 gained only 4.3% over the past year

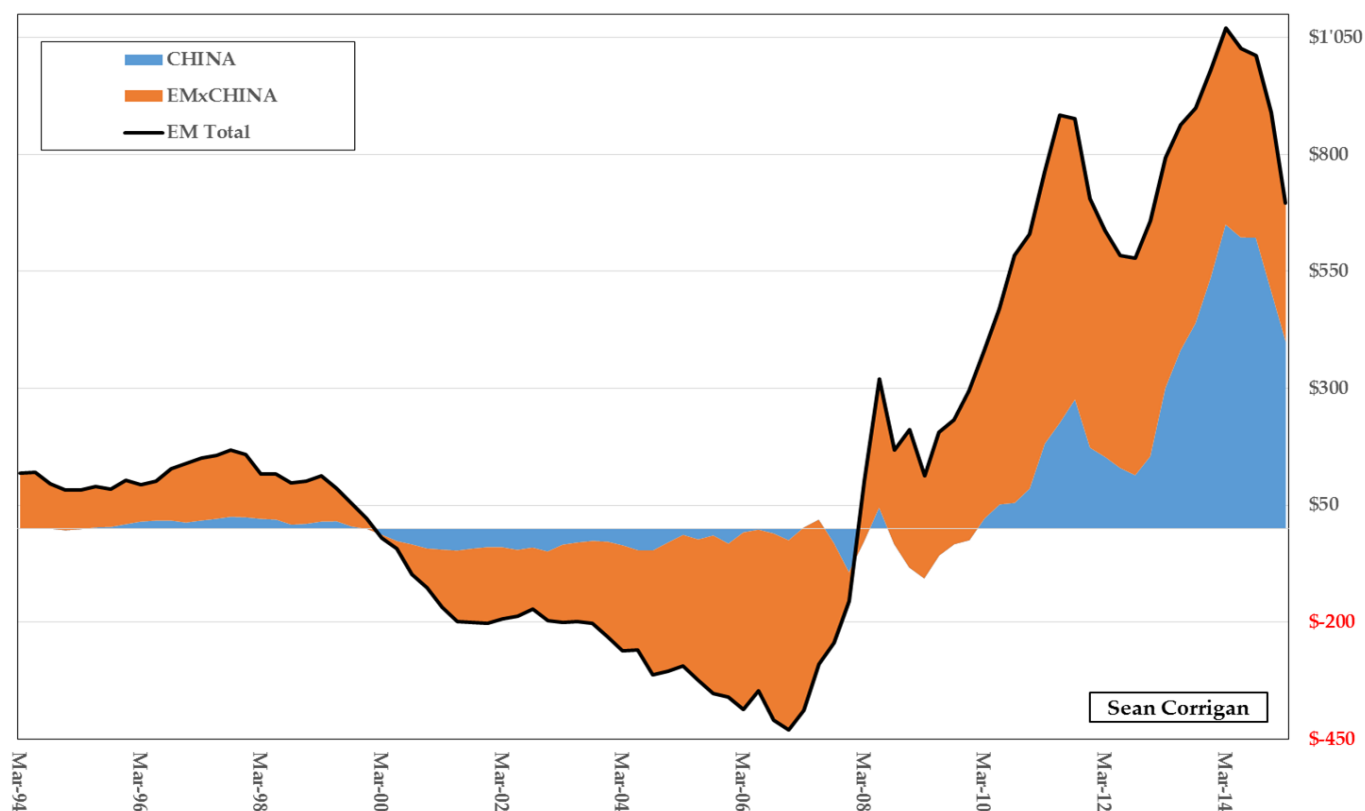
These are not the ingredients from which a quarterly-annualized 7.4% growth in industrial production or the fabled 7.1%-plus nominal GDP are long made – an inference confirmed in the initial denial made by an official spokeswoman who was wheeled out to insist that everything was above board, subject to best efforts, compliant with international standards—blah, blah, blah.

No matter what the last decimal point may be, the country is in the midst of a nasty slowdown. The ramifications go far wider than China, of course. The slowdown plus falls in resource prices are afflicting top-lines everywhere. All local CB chiefs can do is cut, devalue and pray.

HK Net Forex Claims on China: Source - HKMA, Bloomberg



Net Cross-Border Bank Lending to EMs & China, blns: Source - BIS



## WHERE THE MONEY GROWS: Wall St & West

That the US economy is not without its problems is hardly a matter for contention. That such problems could harbour the seeds of a broader retardation of growth in a country where government is becoming both more intrusive and more capricious and where no-one quite trusts the prices to be had in deliberately-distorted financial markets is also not to be neglected. So far, however, the plates are still just about spinning and the band is still pumping out a passable rendition of the Chuck Prince Charleston.

Let's take a point-to-point look at the last six years of recovery, doing everything in those same actual (undeflated) dollars in which the books are kept and which are therefore less subject to the statistician's hedonic whimsy.

Though we could always wish for better, in many ways we should be grateful to the breakdown of the numbers we do have. Overall, the economy has expanded by a quarter, at a 3.7% compound rate which may be slow by standards of the recent past but which also has been subject to relatively modest rates of price dilution by those same standards.

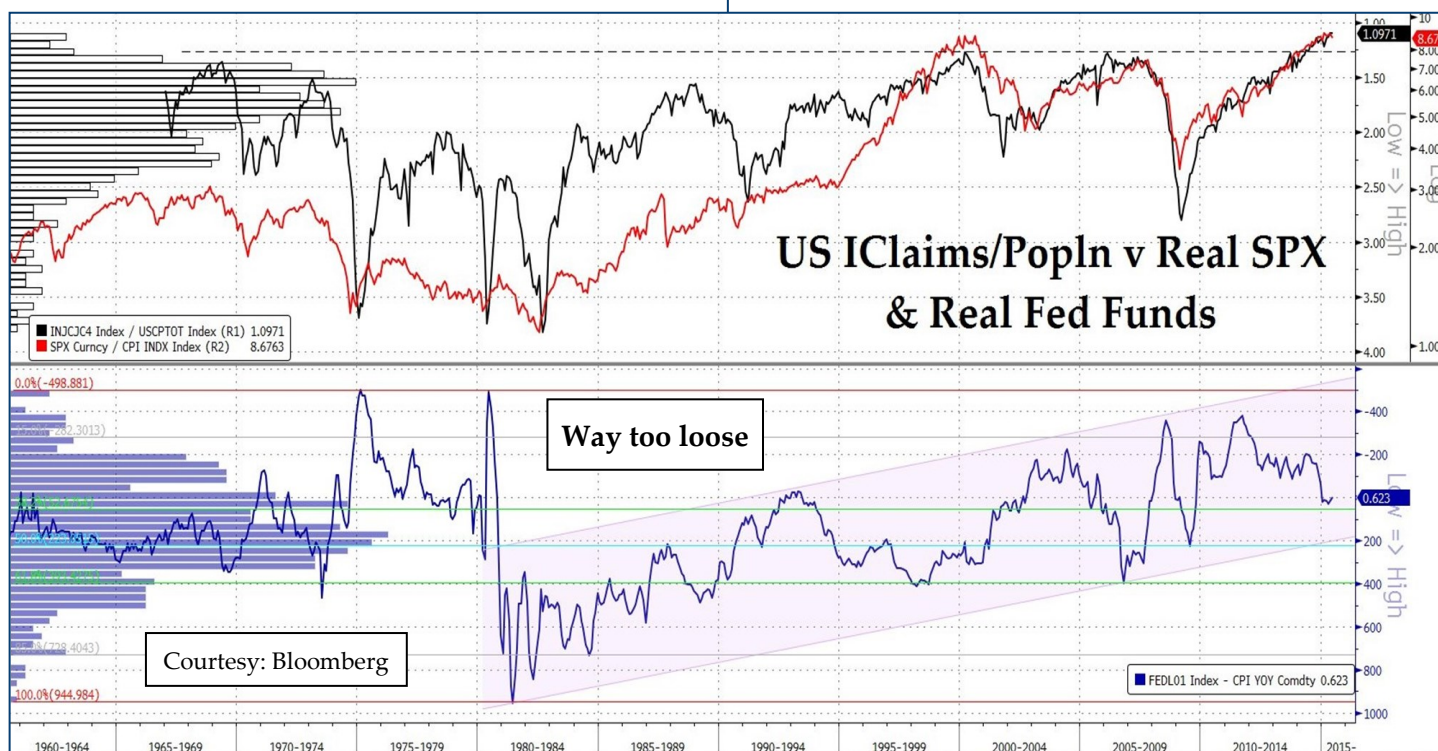
Better yet, Leviathan has been gratifyingly well-contained for all the Krugmanite urging with total expenditures growing at only a cumulative 5%, equal to a measly 0.8% CAR. Its so-called 'value-added' contribution to GDP has been running at half that (at 2.5% cumulative, 0.4% CAR).

Left with more room to manoeuvre, therefore, the private sector has grown faster than the whole economy, putting on 30% overall at a 4.5% compounded rate. Mirroring this, the sum of private wages have risen at a 3.6% p.a. clip as opposed to 1.2% for public sector ones and the ratio between these two outlays has improved markedly from 5.3:1 to 6.1:1 over the interval. Proprietors' income, meanwhile, has done even better, swelling by almost a half at a 6.5% annual rate.

Even that much-bemoaned capital expenditure tally has actually been none too shabby. Non-residential outlays are up 45% or by 6.4% a year. Within that, equipment spending has enjoyed an increment of two-thirds (8.8% CAR) and the rate ex-IT has almost doubled, rising at the gangbusters rate of 11.6% annually.

All in all, progress has been steady if unspectacular and, at least at this level of aggregation, unsullied by boomlet or mini-bust. Earned income—mostly privately-generated—is up, unemployment claims are way, way down (to multi-decade lows outright and to unprecedented levels as a proportion of the labour force). The twin gaps – budget and current account – if still wider than they might be, have both been substantially reduced along the way.

Some of those at the sharp end are actually finding things are going a little too well on the jobs front. As John Gra-





ham, finance professor at Duke University's Fuqua School of Business said of the findings of the joint survey his institution conducts every three months in collaboration with CFO Magazine: *'Wage growth expectations the past few quarters have been the highest in the survey since 2007. In fact, CFOs indicate that difficulty in hiring and retaining qualified employees is a top three concern, especially in industries like tech and health care.'*

Remind me again: *where* are Fed funds just at the moment?

Given all of this one might almost be tempted to conclude that 'austerity' works if what we had was not really a genuine tightening of the belt rather than – how shall we put it? – an abstention from further gross diseconomies on the part of the state. Still, it should be enough to give the NY Times' Keynesian attack dog palpitations at the outcome.

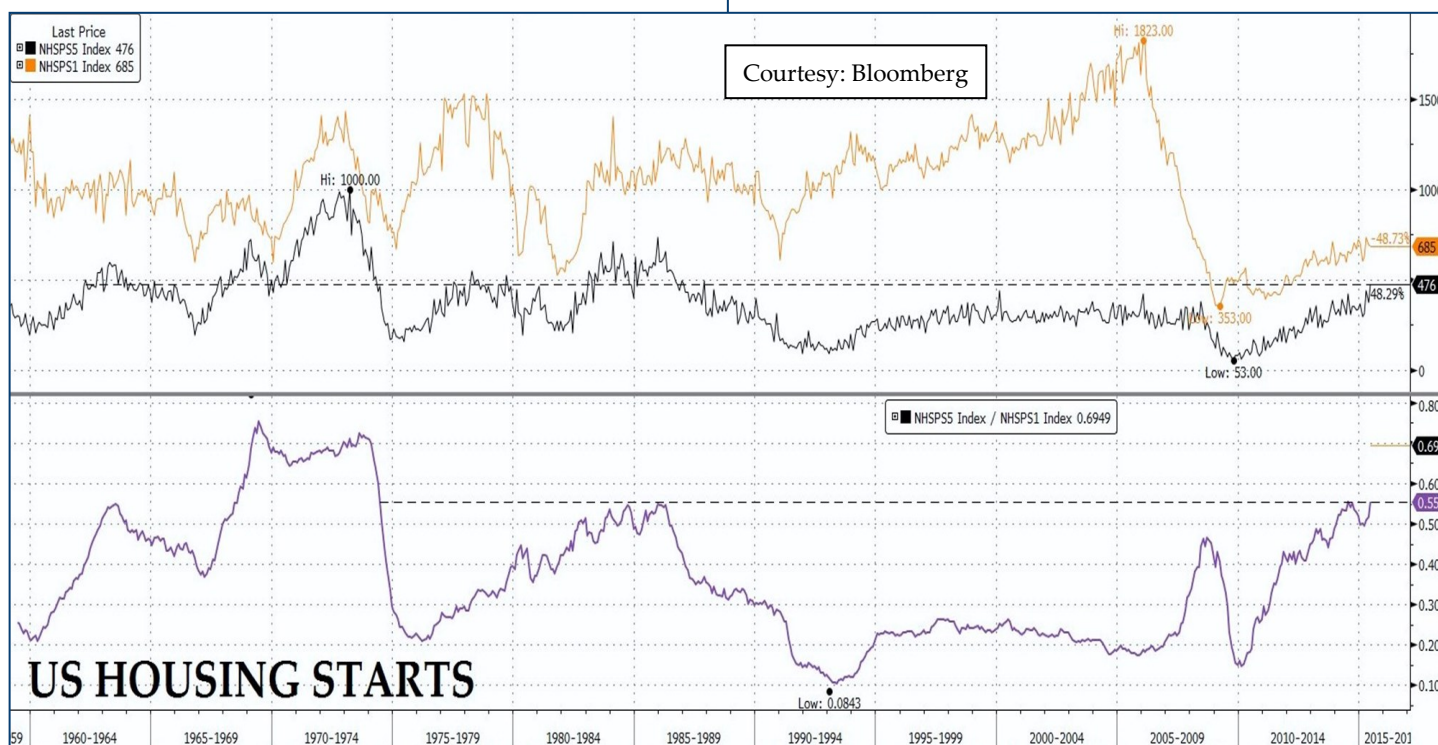
As for that nexus of the last bust, housing, despite a certain degree of discord among the various indicators, matters are almost starting to look a little heated again.

As the latest release showed, multi-unit housing starts were the best since 1985 after rising 13.5%YOY to stand 275% off their lows. Adding to the sense of latent excess, the ratio of starts for 5+ to single-unit buildings has not been topped since the inflationary peak of 1973. Permits were also robust, rising 30%YOY in total to hit an 8-year high with the multi-unit variety up +70% to a 25-year high. The ratio of this latter to single units was the best since 1986 and thus lay close to a 40-year peak.

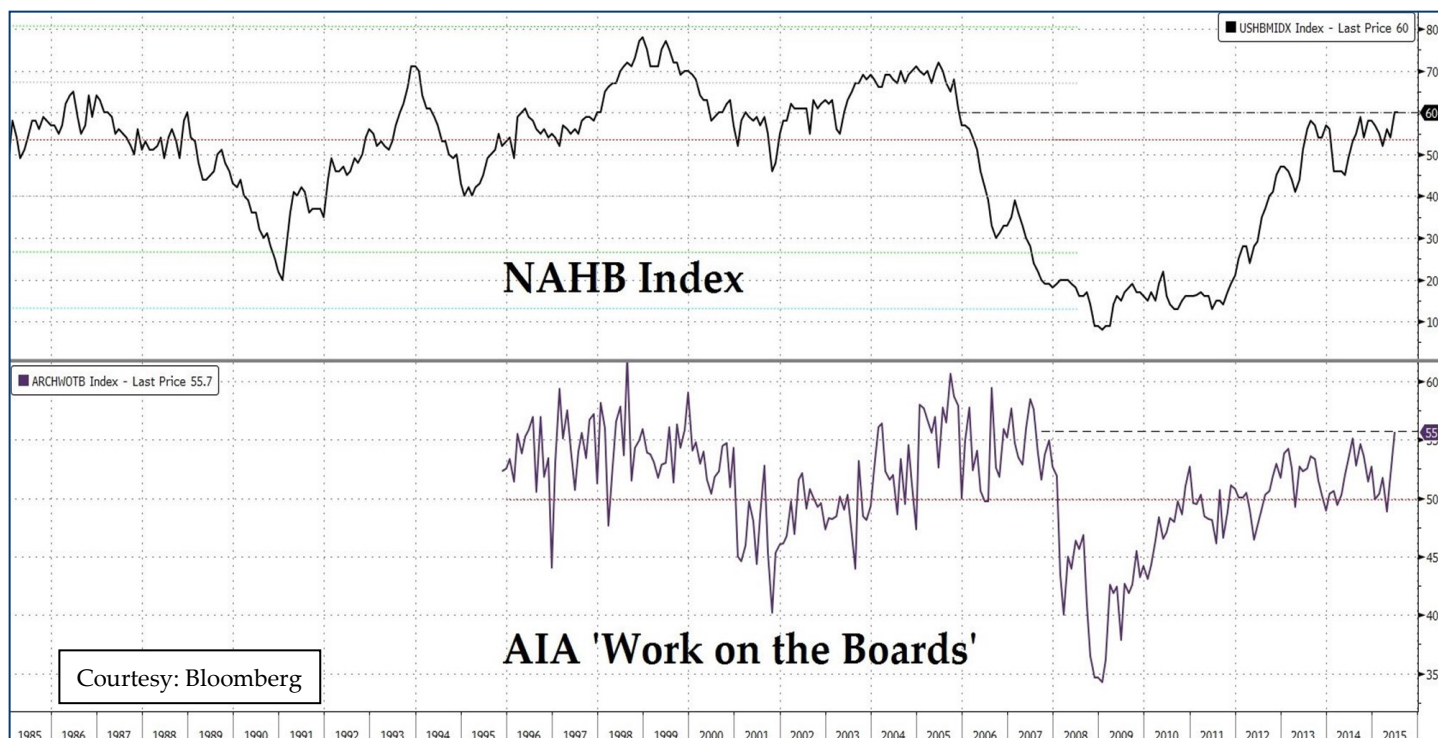
No surprise, perhaps, that real construction spending is up more than 10% a year to its best level since the GFC. In fact, this measure has only ever been higher during the period 1998-2008 which started with the loose policies of the 'Committee to Save the World' and ended with the even looser ones of the 'Committee to Save the World from the Committee to Save the World'!

Construction accounts for around \$1 in every \$30 that circulates in the economy and for one job in every eighteen in the private sector so this does undoubtedly help a cyclical upswing losing a good deal of the impetus from the shale revolution (if not, thankfully, the benefits attendant upon lower hydrocarbon prices). Employment in the construction sector has expanded at a CAR of 3.7% these past 4 1/2 years versus a CAR of 2.3% for all private jobs. The growth in the sum of earned wages attained a mark one-third higher (at a 6.6% CAR), appreciably better than the one-fifth uplift (4.4% CAR) achieved in employment in general.

Granted, there have been one or two hiccups in relation to new single-home sales. Here, the fact that the average sales price is falling faster from its record highs than is the median suggests that at least the top end of the market (the flight-capital, cash-on-the-nail end?) is currently faltering. But, to set against this, we would note that the NAR numbers are not exactly known for their unblemished accuracy and are always therefore in need of a little corroboration.







Such was *not* forthcoming from the latest Homebuilders survey which saw the NAHB membership as gung-ho as in pre-LEH 2008. Nor was there unequivocal back-up from the Architects Institute. Their gauge was also at Ante-Crisis highs, if also one delivered with the comment that while business was generally firm, top-end residential, in contrast to all other areas of activity, was becoming a wash. Homeowner vacancy rates, though, are at decadal lows of 1.9% nationwide while rental vacancies, at 6.8%, are at levels not seen in thirty years. As a result, median asking rents – which are making new highs – rose 6.2% over the past twelve months, the second best quarter since the collapse.

Given the irrefutable historical testimony of the disasters which ensue once a construction boom takes full root – and given the preponderance of housing costs in the CPI basket – one might again wonder just what is currently staying the Fed's hand.

## The Better Part of Valour

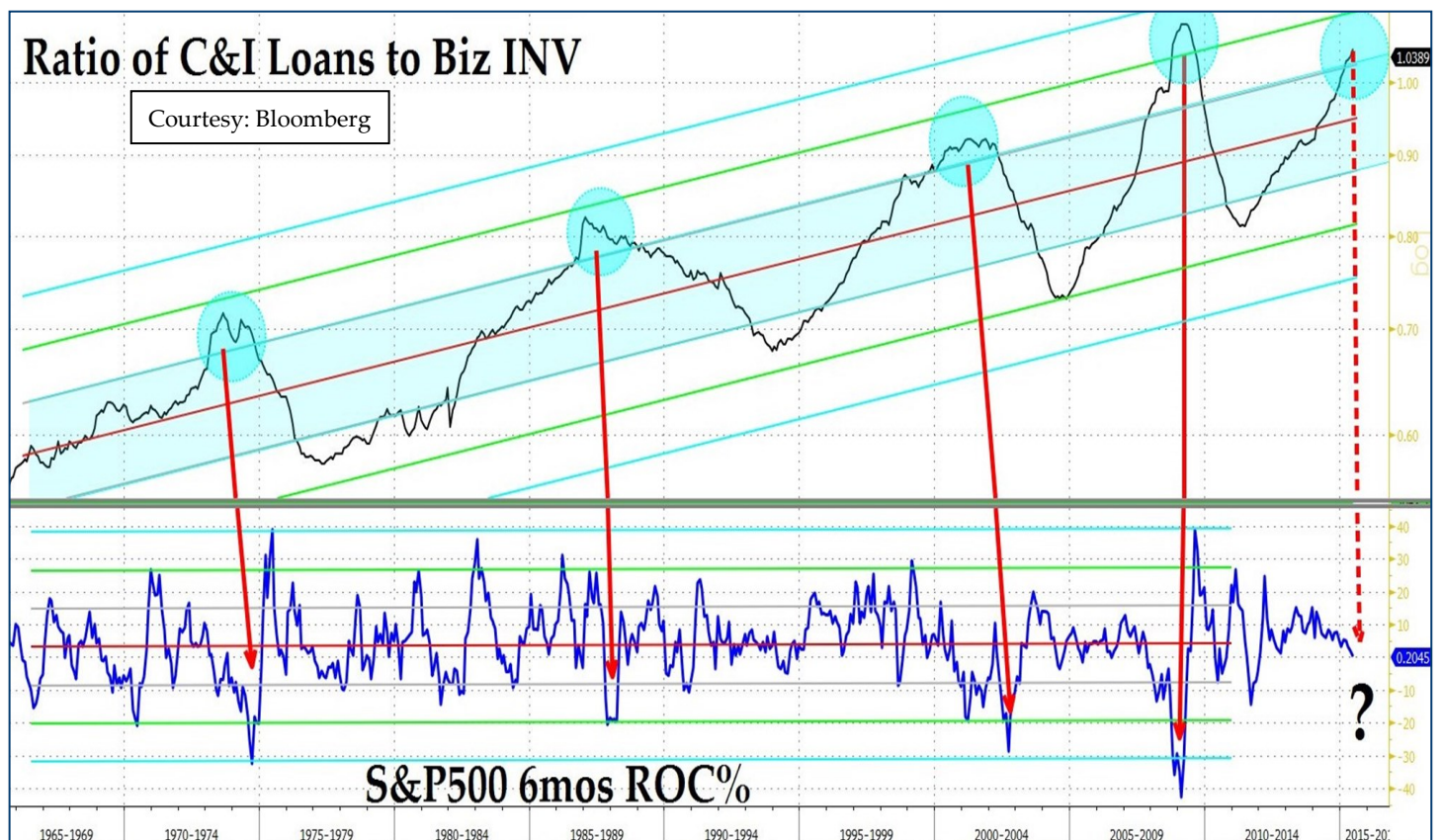
Of the two factors which would counsel the exercise of caution in attaching too rose-tinted a view to the US, the one is the frankly intangible concern that something, somewhere must be near a breaking point after nearly three years of steep, uninterrupted rises in asset prices, increases in leverage, and of the risks inevitably undertaken when plain vanilla instruments no longer deliver the yield necessary for savers to live upon or for institutions to make good their

contractual promises to clients, workers, and policy-holders.

Could it be the oil-patch? Student loans, Sub-prime auto lending? Could the shock-wave originate in one of the many candidates from abroad? Neither the source nor the likely timing can be honestly discerned at present – and it is exactly that lack of concreteness and conviction about the timing of the G-Men's next raid which keeps us at the speakeasy card-table until our discovery and arrest becomes inevitable when next they do kick in the doors.

As for the second, there are a few observations we would make about trends that just might be signalling an imminent top. Though we offer these more in the way of weather-lore than as part of a tightly-linked causal narrative, we could – if pushed – appeal to an Austrian narrative about the insouciant acceptance of exposures which becomes ever more widespread as the boom dulls critical faculties.

We could also sketch out once again the arguments about a possibly undue degree of productive 'lengthening' – that is the layering up of extra levels of highly-specific, lengthily-amortized, scenario-dependent combinations of goods and labour whose successful deployment depends intimately on many unknowable contingencies, all the way down that chain of transformations which loops and twists to its final consummation in the end-consumer's shopping cart. It is in precisely such environments of low interest rates and generally cheap capital means as we inhabit today that the



worst of such errors of mass malinvestment occur, as they did across the West a decade ago and as they arguably are doing today both in China and in its many dependents around the globe.

So, we first offer up a simple plot of that part of US bank lending which comes under the rubric 'commercial and industrial' loans. Though the trend of these is generally upward even in relative terms, it is surely not too controversial to suggest that a large part of these are contracted to finance inventories and/or goods otherwise delivered but not paid for – e.g. accounts receivables and other forms of vendor finance and inventories.

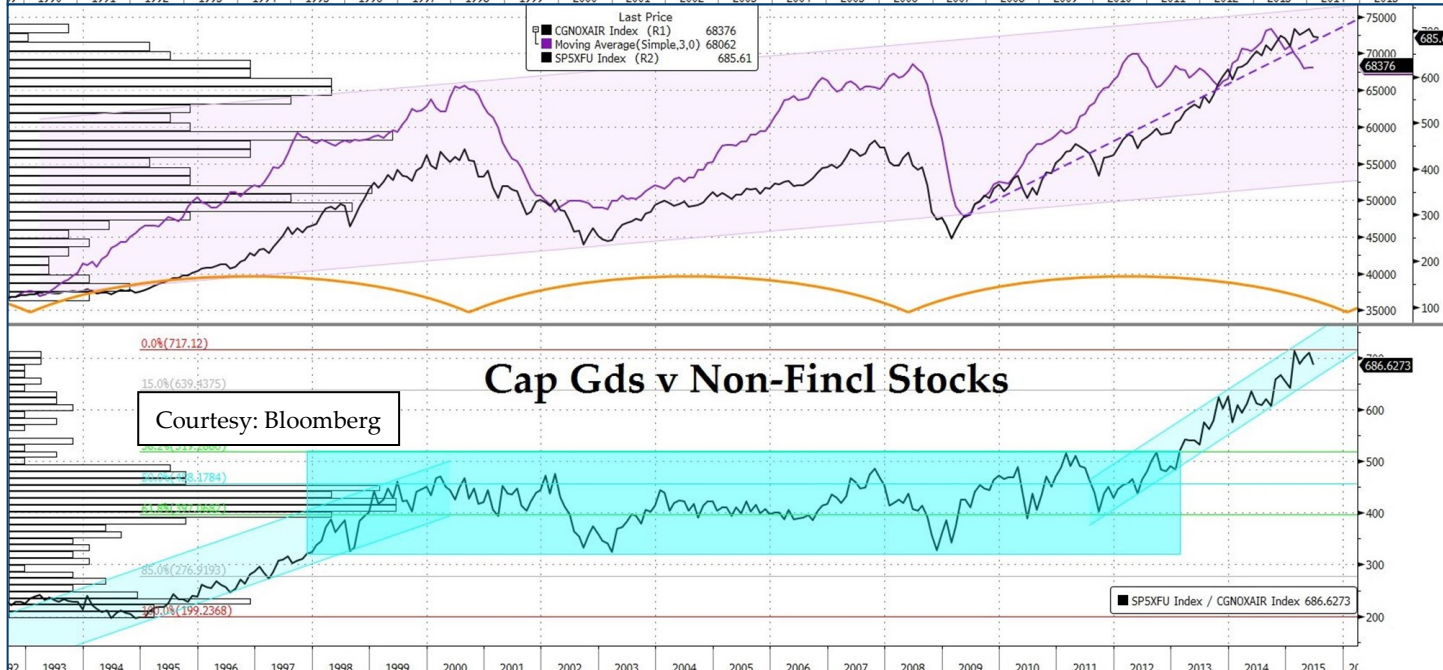
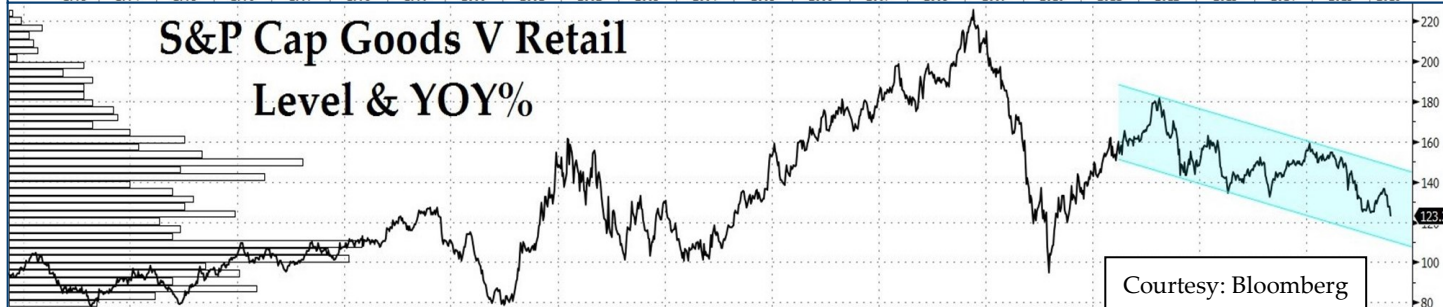
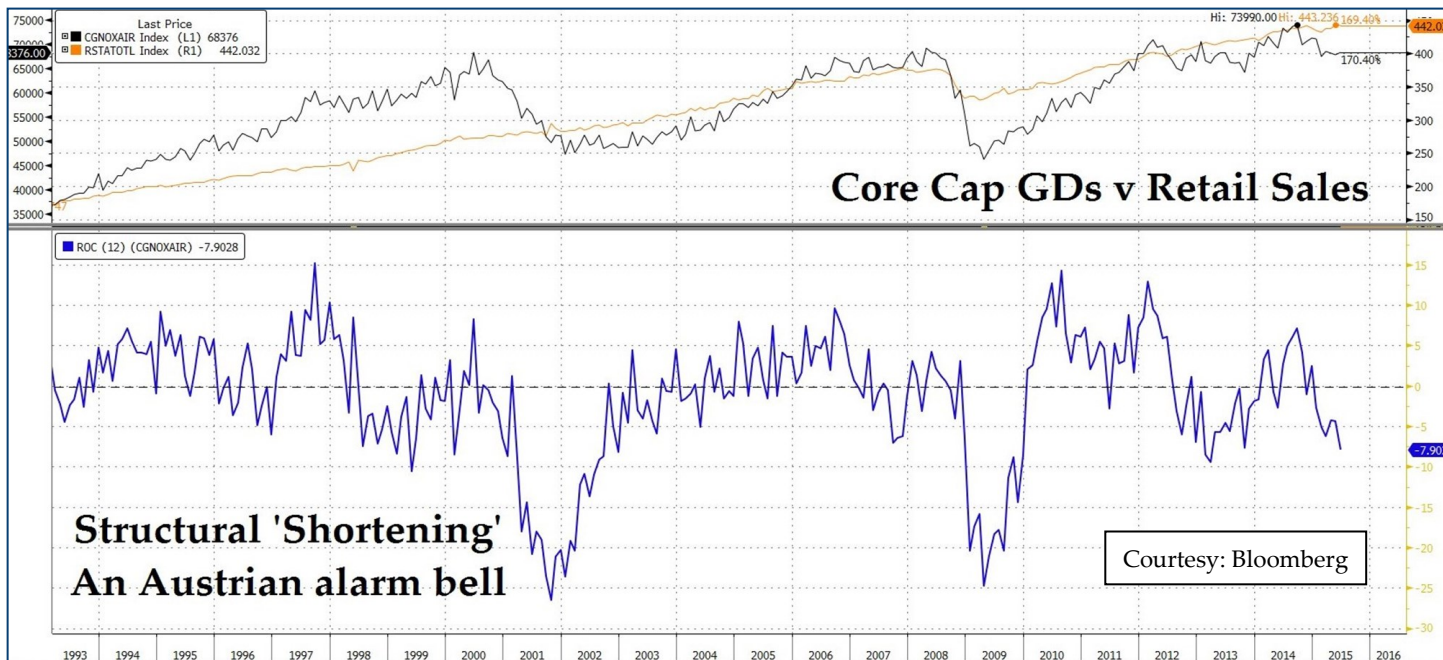
When, however, the count of loans shoots on up beyond normal bounds, we can start to wonder what it is firms are doing with the associated funds. Financing fixed- rather than working-capital, perhaps? Financing takeovers? Diverting funds to other, non-core uses – even speculating in stocks? Conversely, we may suppose that this can mark the distress phase characteristic of the latter stages of the cycle something in our Austrian description that Hayek termed '*investment that raises the demand for capital*' – i.e., that awful point when the first signs have emerged that the cash flows hoped for from one's undertakings are not going to arrive on schedule or in the necessary quantity and so one must scramble to try plug the gap by borrowing

Whatever the motivation, the chart shows that trouble lurks when this ratio gets too far above the trend and that such a departure has heralded each of the last four big stock market busts. What it also shows is that we are just now nosing into the danger zone.

This idea of an insupportably 'lengthened' productive chain can also be discerned in the relative size of the expenditures being made up near its origins – on capital goods – and at its culmination in the supermarket aisle. When capital goods shipments start to fall vis-à-vis retail sales – something which may well be reflected in the performance of the relevant stock sectors – there is usually trouble ahead. Again, we are now edging towards levels which accompany regional, if not yet global, recession.

Finally, backing this up is the observation that the capital goods cycle and the stock market cycle, have become broadly synchronous over the past twenty years, (Tobin's Q types will like this, too). Furthermore, we can readily see that the last few years' move has been similar in scale, if somewhat more rapid in development, to that which took place in the first great wave of the 'irrational exuberance' era after the Tequila Crisis, a period during which the US dollar strengthened to approximately the same extent it has of late. Moreover, we can also see that a slightly worrying divergence has opened up between the two series in recent





months as consumer equities have powered on to new highs even as capital goods sales have stumbled badly.

None of these signals are yet definitive, but they do bear watching even as we wait impatiently as the Yellen Fed inches painfully towards taking its first 'data-dependent' steps to raise rates (albeit with the promise that such a process will follow the disastrous, well signposted creep upward which enabled so much damage to be wrought after the Tech Bust).

Is this all part of an unfolding deflationary scenario? Not yet, not while money growth roars onward at almost 10% a year, half a decade at a time, and as median CPI rates threaten to set new, post-LEH maxima. The negative real yields out to 20 years which have resulted are not healthy for anyone, whether they are applying a nail gun to a 2x4 or appending their name to a lease agreement for a 4x4.

We utterly despair of the Fed. The economic model—to the extent there is one—is completely wrong-headed; the political accommodation is too spineless; and the moral cowardice in the face of the Ghost of '37 bogeyman is near absolute.

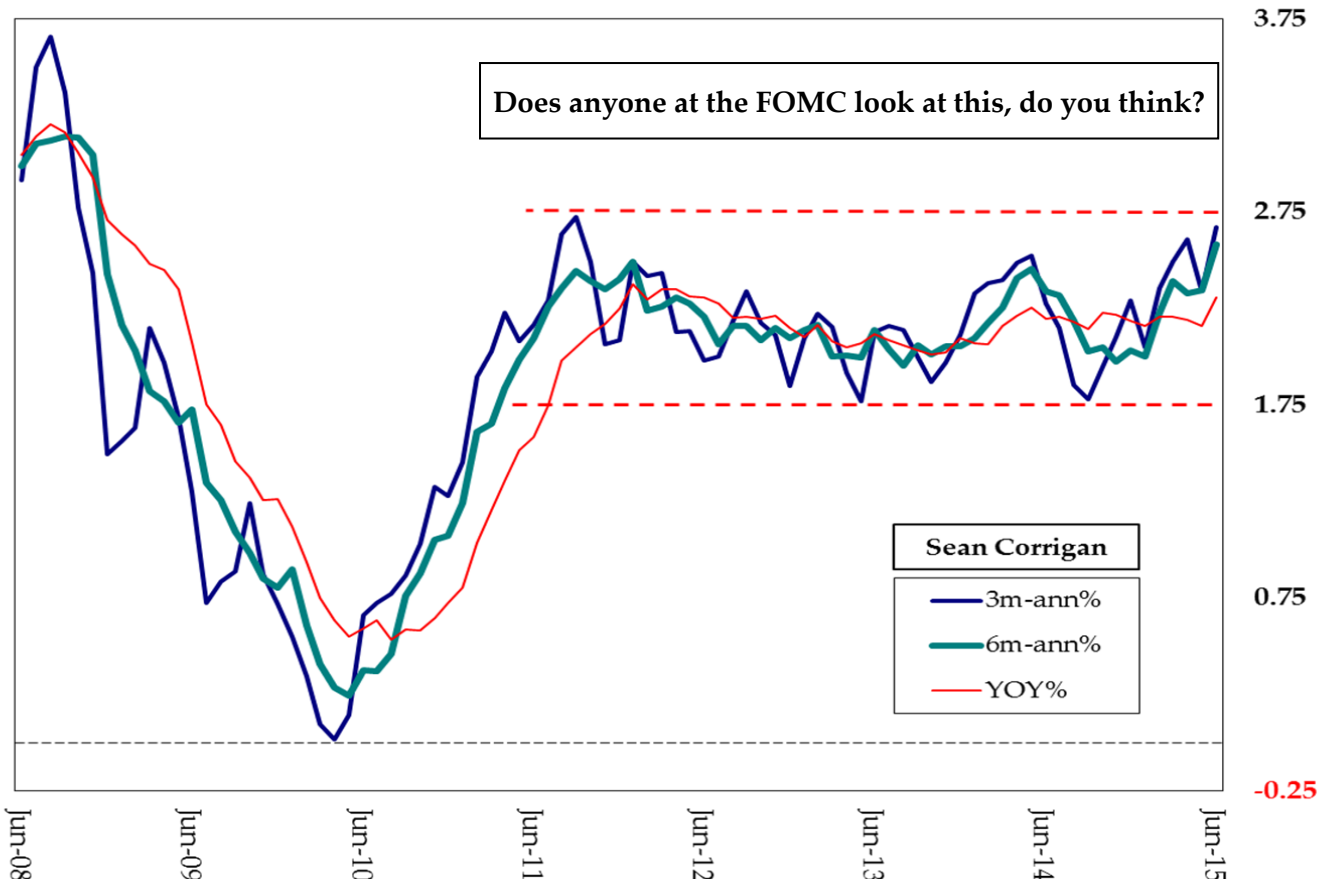
In fact, aside from all the other issues we have with its

members poltroonery, there is direct evidence that their dithering is itself becoming self-defeating in a classic example of what we, after the insights of our friend Robert Higgs, call 'regime uncertainty'. Witness the testimony of the Association for Financial Professionals in the press release which accompanied its proprietary 'Corporate Cash Indicators' release :-

*'Many companies in the United States built short-term corporate cash balances at a far quicker pace during the second quarter of 2015...' due to a 'significant softening in their business confidence', it noted. Pointing out that this defensive stance was likely to be maintained over the summer, the AFP posited that one of the contributory factors was that companies were '...hesitant to deploy and invest cash for the long term. The prevailing uncertainty can partly be attributed to the highly anticipated interest rate hike by the Federal Reserve Bank later this year...'*

Note that this is not an argument that a rate hike will itself snuff out all hope of future investment, only that the fear that its enactment might first spark some wider, risk-off conflagration in markets is itself acting as the stultifying factor. The only way to allay such concerns is to put the matter to the test.

US Median CPI: Source - Cleveland Fed







Screw your courage to the sticking place, Madame Chair!

The irony is then that the longer the FOMC leaves it before its pretence at renormalization commences, the more barely supra-marginal activity will have taken place in the meanwhile; therefore the greater the shake-out to be expected as and when rates do eventually rise and asset prices do at last stumble; and hence, the louder the howls of 'sado-monetarism' which will emanate from the more intellectually disreputable reaches of the econosphere when this occurs.

As *that* firestorm of denunciation reaches its peak, at best policy will become paralysed; at worst, it will be reversed lest a zombie corporation or a leveraged loan chancer threatens to fail. Cluttered up with such low-ROC resource hogs, the subsequent recovery will again be anaemic and the 'secular stagnationists' will have a field day in misinterpreting the cause of our torpor.

Wash. Spin. Repeat.





## HEAVY FOG IN CHANNEL: The View from Albion

Elsewhere, we turn our gaze to that other 'big hat, no cattle' champion of telling it as it will be, should he not change his mind again in the interim. For BOE Governor Carney has been gently hinting that UK rates, too, must rise one day – though never, perish the thought, to the extent they used to when Old Lady-endorsed, Tory Chancellor booms went horribly wrong in the past.

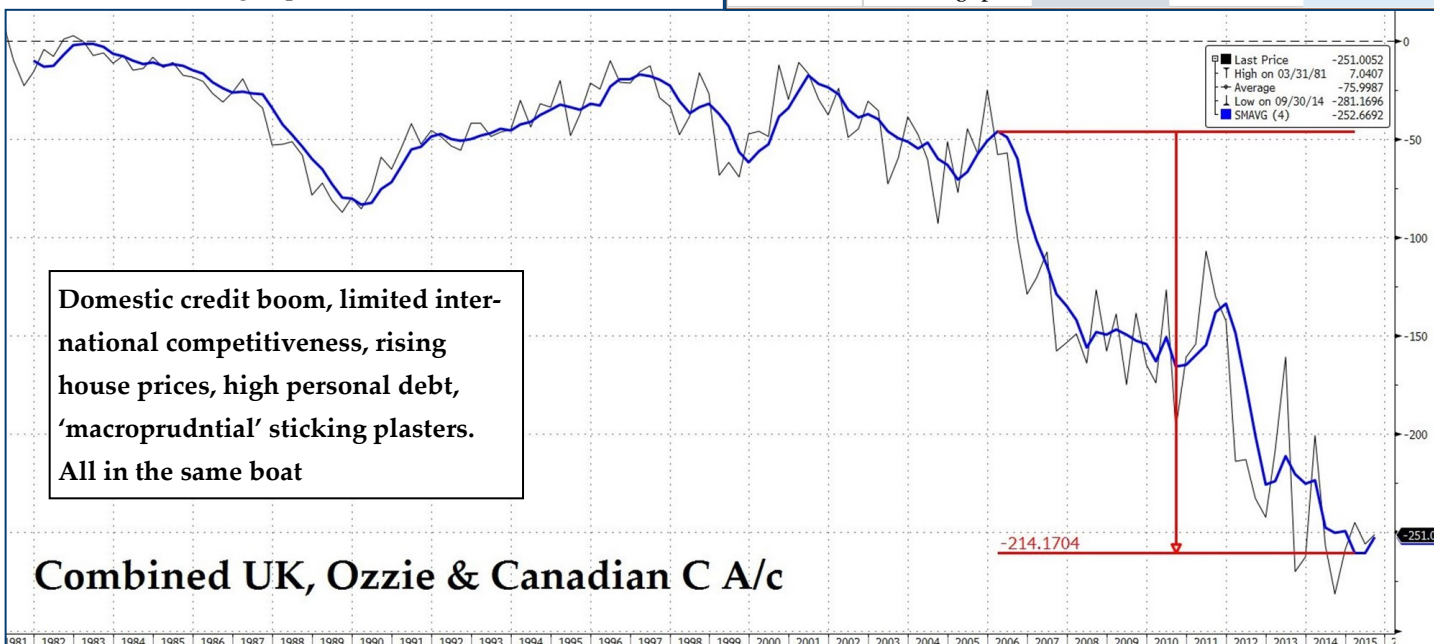
What is undeniable in the UK is that productive business is again beginning to doubt itself – even if it has the convenient excuse of a rise in sterling from the depths of the abyss behind which to shelter. Money supply, moreover, is beginning to grow a little less rapidly than of late, so leaving open the question of how dependent the system has become on the unusual generosity of its former provision.

It is chastening to realize that with private sector credit take-up so far off the Broon Boom's highs – albeit with all components now running at levels not seen since the ensuing debacle – the current account deficit still yawns so wide. It is also of little comfort to note that this titanic imbalance between domestic productive capacity and home-grown appetite is principally the fault of what the Left imagines is a criminally parsimonious government. Indeed, the UK's external shortfall is now second only to that of the much larger US in magnitude and is in fact a globally chart-topping twice as large on a per capita basis.

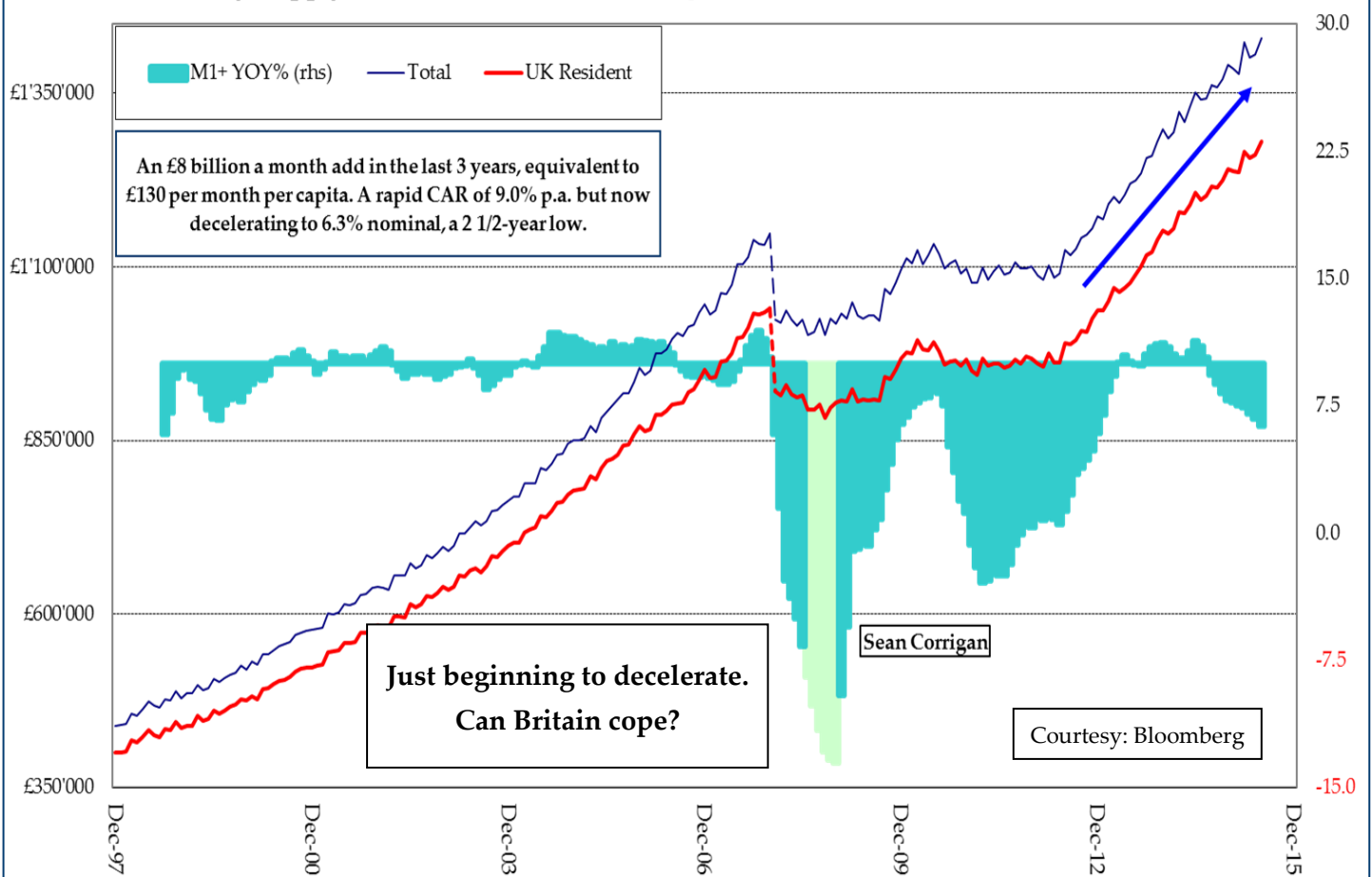
Not that the sin is solely a British one. Add in the other members of the Anglosphere - Canada, Australia NZ and

the USA itself, and you pretty much have the podium placings of the per person profligacy stakes accounted for, with a couple of willing substitutes to boot. There must be something about the central bank groupthink prevalent among those who imagine that a domestic housing bubble is the stock answer to an attack of lower trade prices.

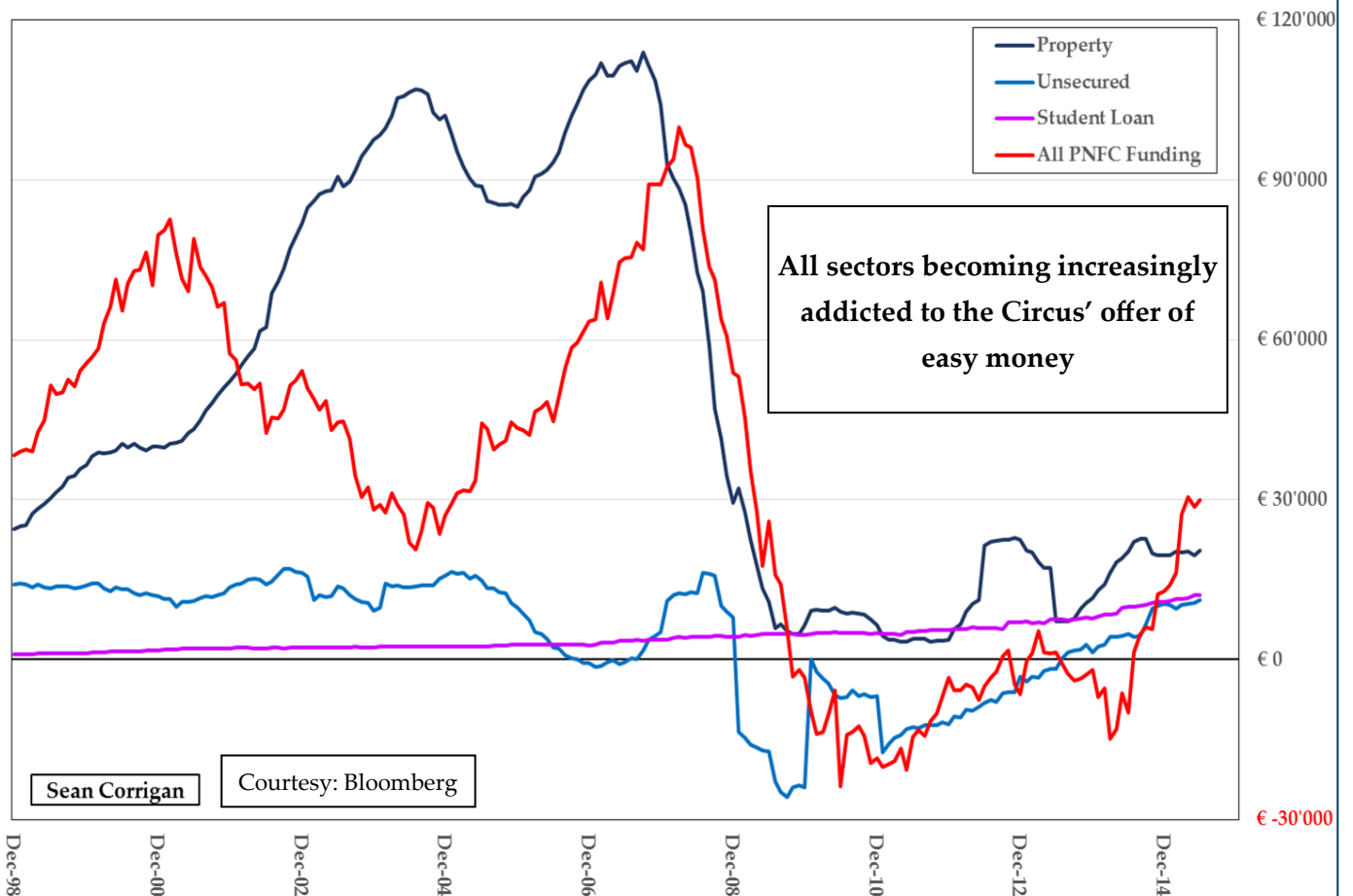
| Rank | Country     | 2014 C-A/c | POP   | per capita |
|------|-------------|------------|-------|------------|
|      |             | blns       | mlns  |            |
| 1    | UK          | -\$178.6   | 64.8  | -\$2'756.1 |
| 2    | New Zealand | -\$9.4     | 4.6   | -\$2'043.4 |
| 3    | Australia   | -\$42.0    | 23.8  | -\$1'764.6 |
| 4    | USA         | -\$435.7   | 321.5 | -\$1'355.1 |
| 5    | Canada      | -\$43.8    | 38.8  | -\$1'129.1 |
| 6    | Finland     | -\$3.8     | 5.5   | -\$695.9   |
| 7    | Turkey      | -\$45.8    | 77.7  | -\$589.7   |
| 8    | Brazil      | -\$104.0   | 204.6 | -\$508.2   |
| 9    | Mexico      | -\$26.5    | 121.7 | -\$217.4   |
| 10   | France      | -\$13.7    | 66.2  | -\$207.5   |
|      |             |            |       |            |
| 10   | China       | \$213.8    | 1371  | \$155.9    |
| 9    | Japan       | \$69.6     | 126.9 | \$548.5    |
| 8    | Italy       | \$41.7     | 60.8  | \$686.5    |
| 7    | Austria     | \$6.5      | 8.6   | \$754.7    |
| 6    | Korea       | \$97.5     | 51.4  | \$1'895.9  |
| 5    | Germany     | \$287.2    | 81.1  | \$3'541.5  |
| 4    | Sweden      | \$38.2     | 9.8   | \$3'893.7  |
| 3    | Netherlands | \$91.4     | 16.9  | \$5'405.4  |
| 2    | Switzerland | \$57.8     | 8.3   | \$6'965.3  |
| 1    | Singapore   | \$58.8     | 5.5   | \$10'685.8 |



UK Money Supply (mlns): Source - BOE, Bloomberg



UK 12-month cumulative lending, mlns: Source - BOE





With a mixture of delight and horror, the German press is making much of the divisions which appear to be sharpening between the Dutch-German-Finnish-Balkan bloc and the Latins to the point where Schaeuble now purportedly wants to take the largely *ultra vires* Euro Commission down a peg or two by setting up a legitimate, 'independent', co-ordinating body to subsume much of its official role. Simultaneously Renzi and Hollande are in full 'Flight Forward' mode, promoting the idea of yet more centralization of power so that they can act in an even more remote fashion, further insulated from national electorates who already feel such men as they no longer represent their aspirations in their own parliaments.

As with so many things European, some matters are almost beyond parody. While Hollande, with his 71% disapproval rating in the polls, is dreaming of a renewed Continental System and is so very eager to rattle his Rafales abroad, the proud nation which he heads stands helpless in the face of striking farmers, train, bus and tram drivers, tobacconists, teachers, doctors, firemen, midwives, and air traffic controllers and cowers from a mob of Channel-hopping benefit tourists at home. Lobbying for a Euro Super-State he himself stands accused by the President of the Assembly of French Departments, Dominique Bussereau, of putting up

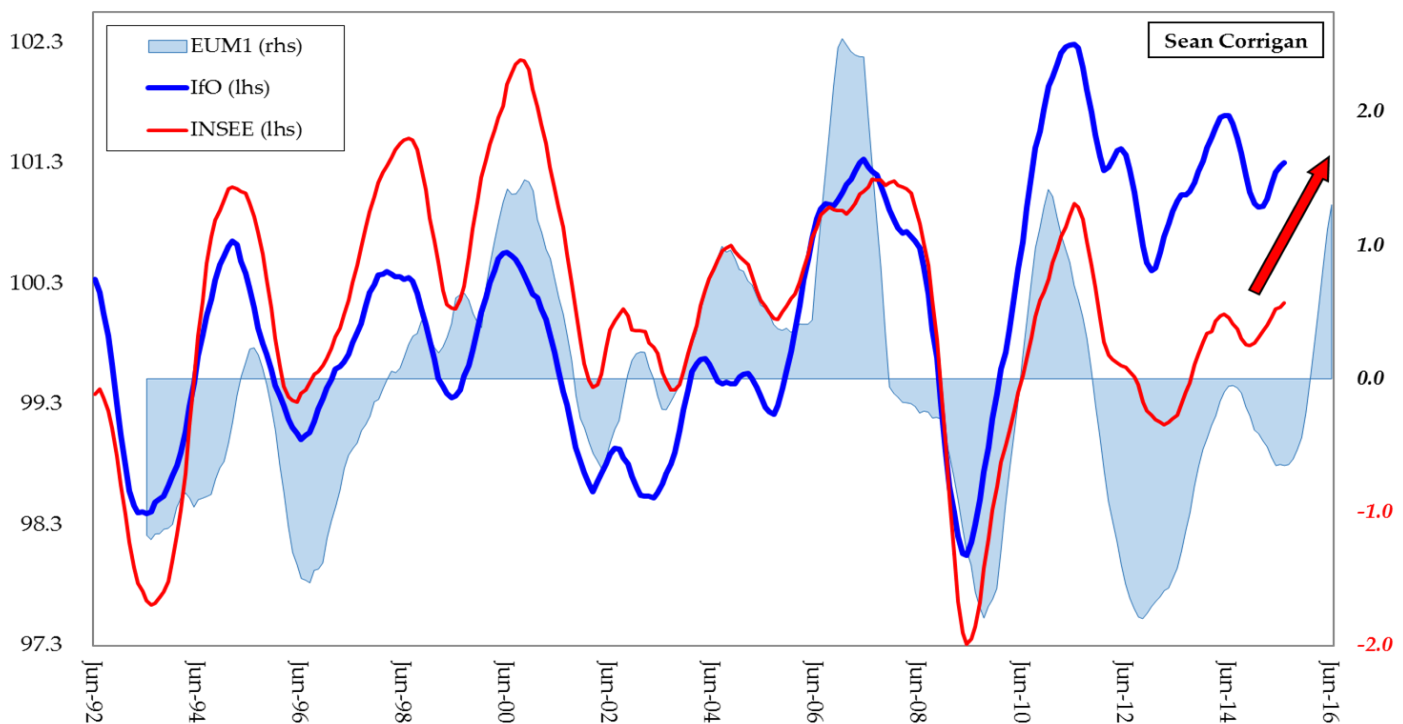
to five of them in jeopardy of bankruptcy this year, with another thirty said to be facing the same fate by the end of next.

But if we must tear ourselves briefly away from the fascination of watching the Euro-elite turn in on itself and while trying not to be too distracted either by Yanis' *'Mission Impossible—Rogue Nation'* aspirations or by the Metternich-like subtleties being ascribed to Schaeuble's manoeuvrings, we can do worse than to draw attention once more to the monetary explosion underway in Europe.

Indeed, June saw yet another new high in the rate of both real and nominal M1 growth, taking it up to two sigmas beyond the norms of the past 25-years—a rate of growth which, allow us once again to underline, is being enjoyed everywhere except in poor, benighted Greece itself.

With M1 still outstripping the growth of credit aggregates, the system becomes ever more liquid so more 'circulating capital' can be realized and redeployed in the form of cash. Both M1's own strength *and* its super-performance over its credit appendages augur well for business revenues in the coming quarters, as various confidence surveys are already beginning to presage. Shame the politics is such a dampener.

EUM1% sigmas from 7.8% trend v IfO/INSEE mean divergence, t+12 (6mma): Source - Bloomberg, ECB



## HERE BE DRAGONS: An Emerging Market round-up

EMs are an intriguing mix of bubble-finance overlay on easily-grasped fundamentals. When the credit cycle kicks up in the West and when the unclouded cerulean heavens encourage a spirit of adventure in bored Occidental asset managers, everyone wants to rush off to be a pioneer, donning a metaphorical pith helmet, stocking up on quinine, and hiring a party of bearers in the search for the financial equivalent of King Solomon's mines in exotic climes.

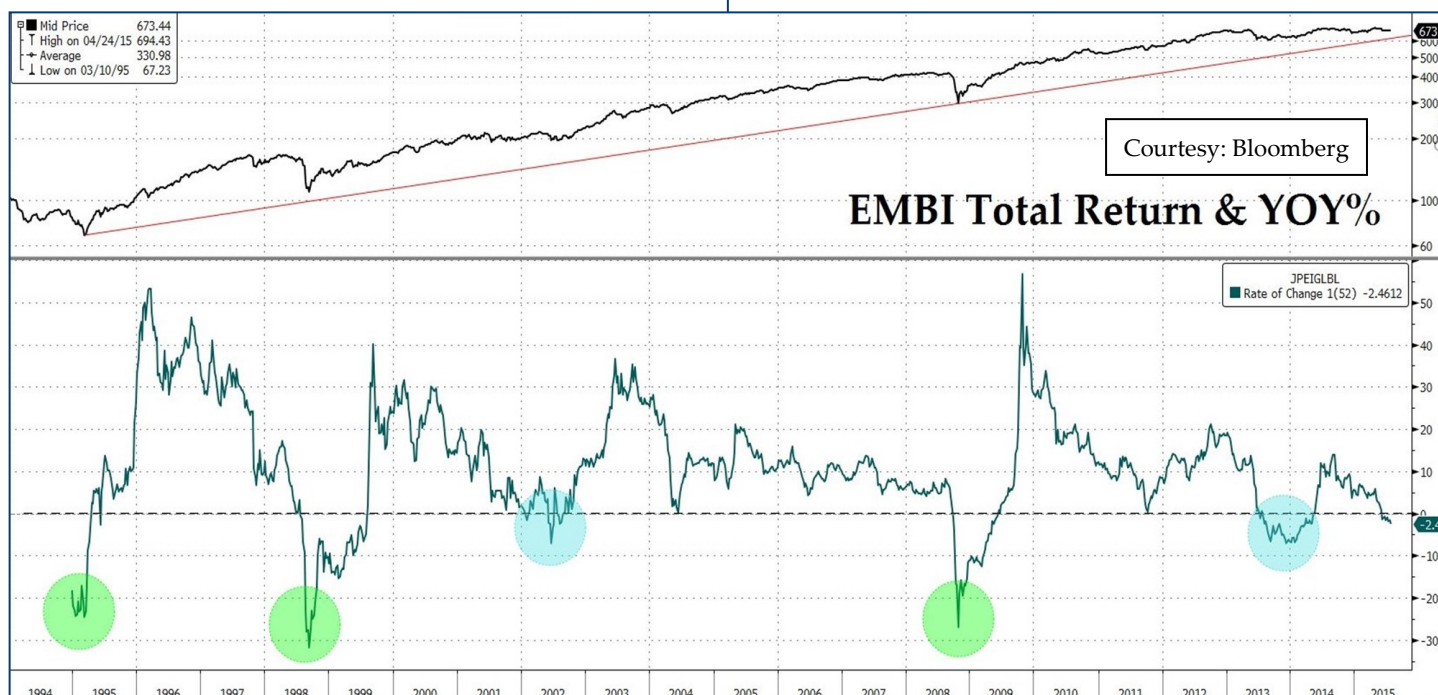
But presently the wheel of fortune is in a distinctly downward trajectory and El Dorado is harder to locate than ever. A strengthening USD, a slowing China, weaker commodities, a possible turn in the rate cycle—it is not always easy to separate cause and effect, but this is a classic recipe for a slump in Emerging Markets.

Prime among these must be those in Latam. Fears that Cristina Kirchner will see her and her husband's successors remain in office after October's elections (and, conversely, that opposition leader Macri is already tacking to adopt much of their platform) has seen the peso briefly trade above 15 to the \$ on the 'blue' market—a two-thirds discount to the official rate which is close to its worst ever. The black market bolivar, meanwhile, trades at no less than 100 times its official 6.3:1 parity as Maduro pursues the socialist dream to yet another triumphant conclusion. The sequestration of food supplies for state distribution is the latest stop-gap on the road to what seems an inevitable col-

lapse. Stagflationary Brazil—teetering on the brink of a downgrade to junk status—is not being helped by having ex-President Lula being implicated in the Petrobras scandal or by calls to impeach the tottering President Rousseff. The country is also one of the few to challenge the Anglos for membership of the unbridgeable current account group on an outright basis and if it does not come quite so close when scaled for population, it should neither need to be said that the per capita *incomes* which must support the external debt in the land of Bossa Nova are far lower than those enjoyed by the spendthrift Anglo-Celts.

Finally we have Mexico where they threw a party (an oil-lease round) and close to nobody came; a rebuff which helped the peso make its own all-time lows.

Thus, things are not exactly propitious in these most pro-cyclical of all markets. Add in that the residents of the constituent countries have become as slack in their budgetary habits as we have been lackadaisical in indulging their prodigality and we could soon reach a point where the pitiless erosion of prices becomes a landslide. Warning signs can be had from the sharp uptick in CDS spreads of such EM/commodity giants like Glencore and Vale, even if EM vols themselves are still dirt cheap. Bonds can go down in such places by 10% a pop even absent a catastrophe: you can easily triple that loss with one in attendance.







## BUY CHEAP, SELL DEAR: Market Observations

In concluding with our look at markets this month, we make no apology for devoting the lion's share of the attention to commodities as their slump is not only noteworthy in its own right but is giving rise to no little comment as to whether it portends greater difficulties ahead for us all.

The first thing we have to say is that it is not hard to find fundamental explanations for their weakness. Firstly, the track of world traded goods prices (of which commodities are an important component) shows a good fit with our decelerating measure of global money supply.

This latter is influenced in turn by both the vigour or other-

wise of individual countries' monetary creation and by the value of that contribution when translated into the dollars in which we sum them. Thus a rapid pace of internal expansion which is dissipated outside the borders in a precipitous currency depreciation may become less than a zero sum game in terms of affecting world price levels.

Secondly, it is the case that several important countries either peg to the US or otherwise try to manage the parity with it by way of accumulations of reserves in periods of dollar weakness. Such additional reserves are a prima facie cause of monetary increase unless actively sterilised and so

**World Foreign Exchange Reserves v USD TWI, yoy%: Source - IMF**



**World Foreign Exchange Reserves v EM8-M1+, yoy%: Source - IMF**



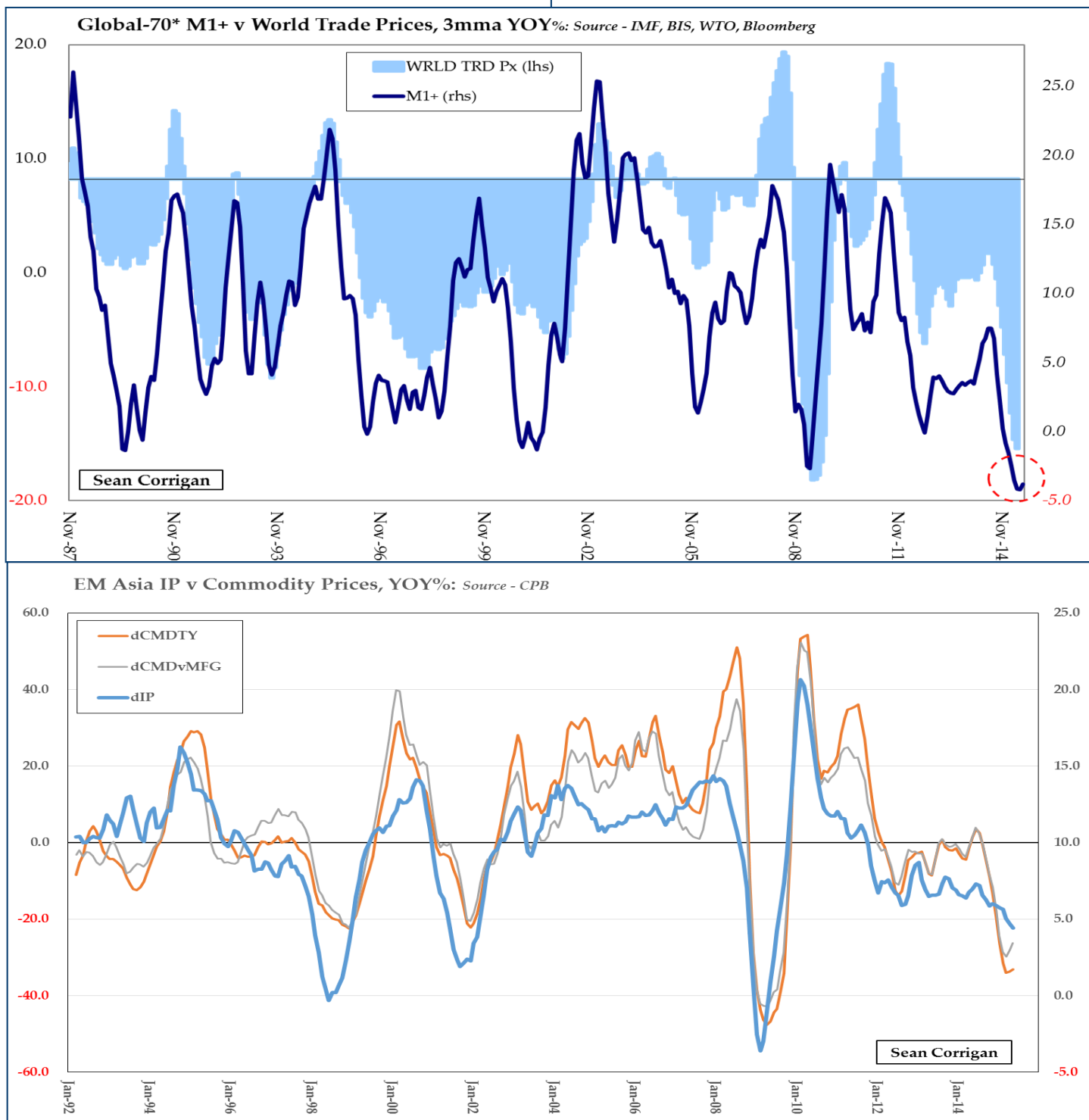


add monies which are either stable in relation to, or appreciating modestly against our *numeraire*, the greenback.

Conversely, in times of dollar strength—often those when some degree of capital flight from (or at least of capital *payback* by) the peripheral nations is taking place, reserve decumulation is the consequence. This brings with it the possible side effect of retarding, if not reversing, base money creation at the same time that everyone is busy trying to swap the local folding stuff for a handful of Benjamins. Again, procyclicality at work as terms of trade declines take place, external surpluses shrink or turn to deficit, and

tensions mount.

Turning to real side influences, it can further be shown that there is a decent correlation between the pace of world trade volume growth and the path of resource prices. We have already discussed above how poor the prospects are for such trade at present. An almost equally firm one exists with global industrial production in general and beyond that a very impressive one with what has become a globally dominant IP in the East Asian EMs (read greater China and its satellites) in particular. China, Ems, commodities, money, the dollar. QED.



Either way, we have a recipe for prolonged commodity weakness at present, even without factoring in such things as investor redemptions, hedge fund implosions, trading company bankruptcies, finance trade unwinds, or pulling-up-the-flowers, watering-the-weeds liquidations to meet margin calls elsewhere.

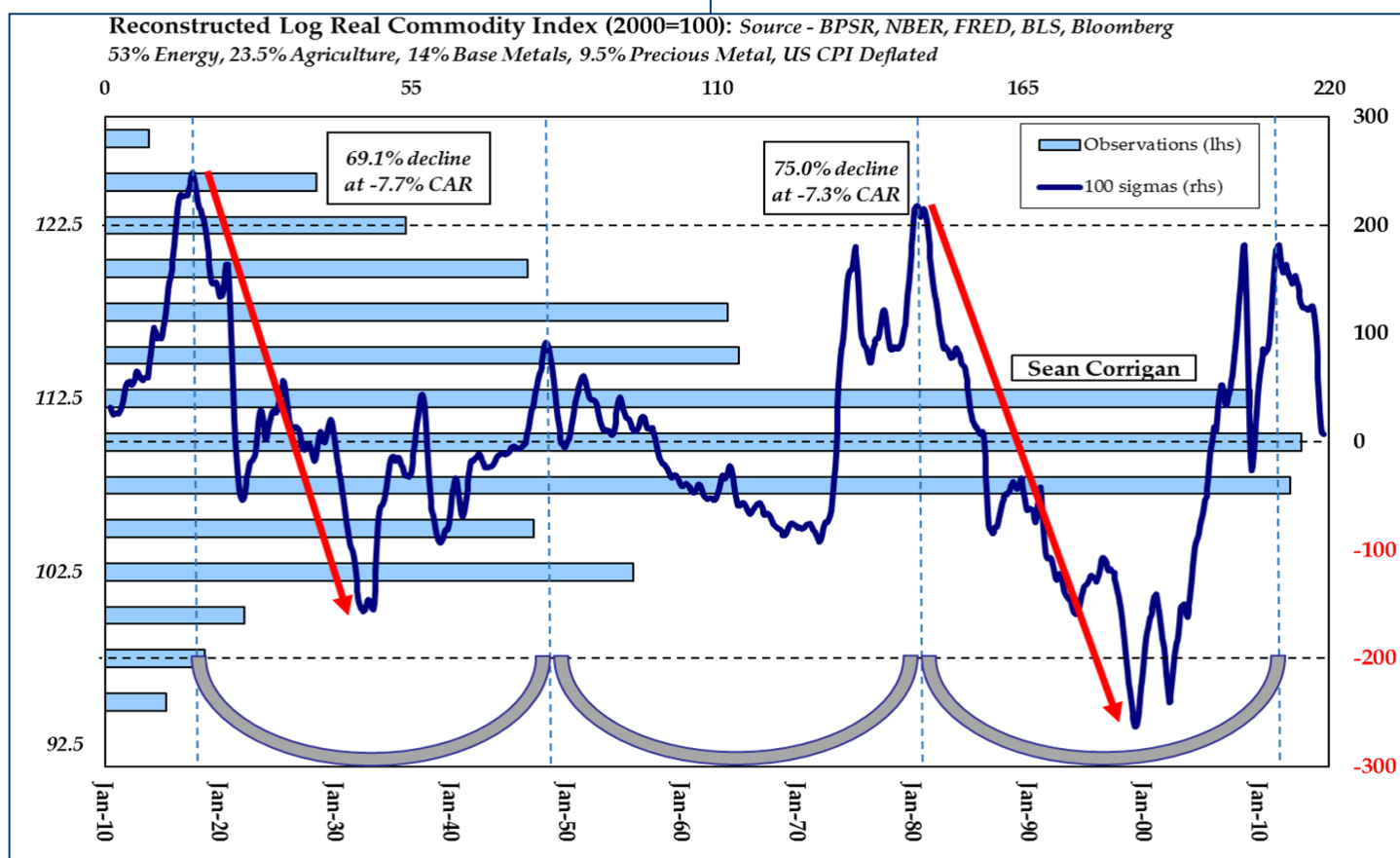
Worse, they are not exactly 'cheap' even now – not even by the standards of the last twenty years.

Though we have to exercise even more caution than is normally demanded of us when we try to reckon the 'constant dollar' value of things in the more distant rather than in the more recent past—and though one could fill out a PhD thesis in the attempt to weight the various components of a representative basket so that they better reflect their relative significance in differing technological and institutional circumstances—it will serve our purposes of illustrating the broad behaviour of commodities to take a mix typical of today's indexes and then deflate them with a standard measure, such as the US CPI.

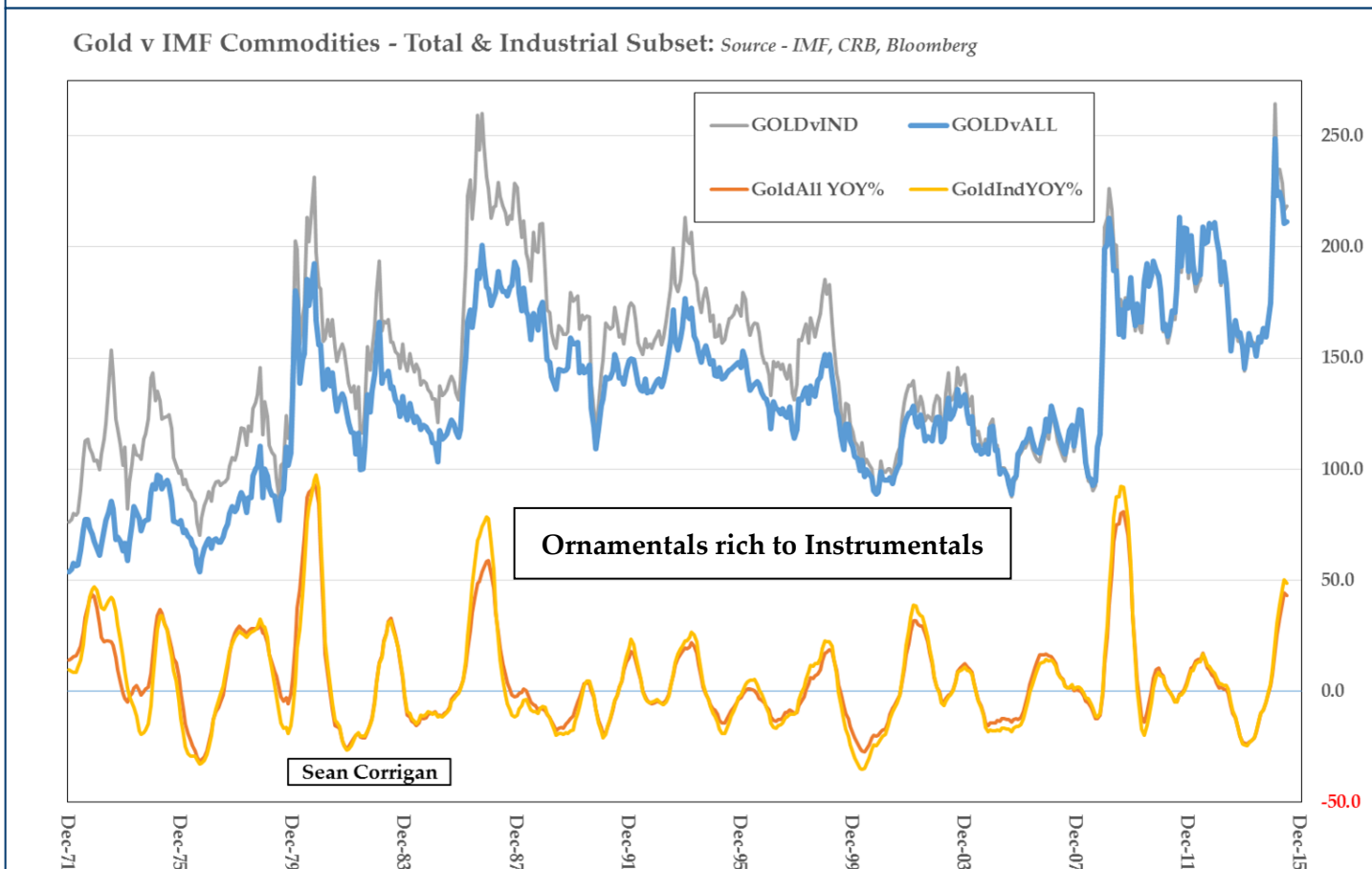
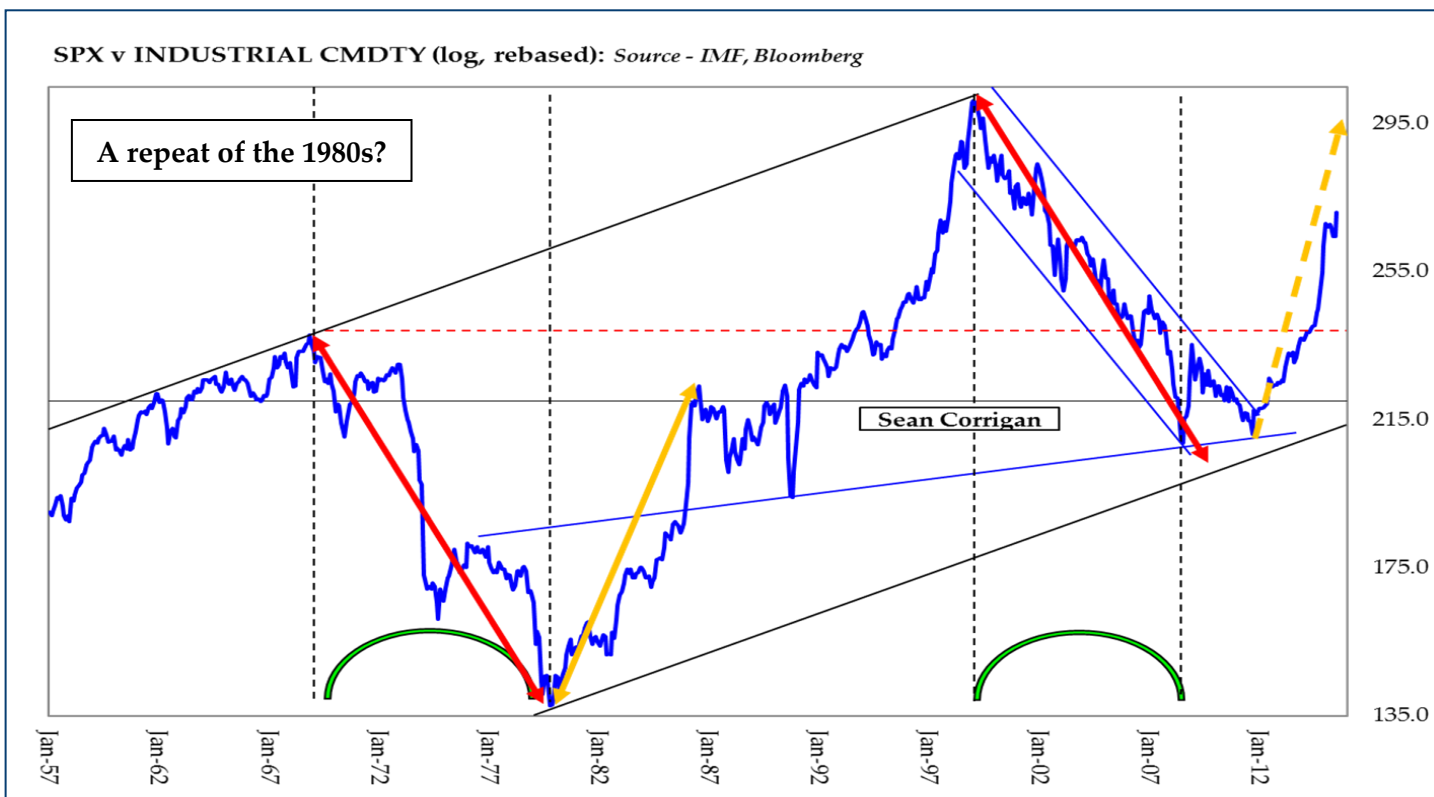
When we do this, we see that the admittedly somewhat energy- (and within that, oil-) heavy index which results has shown an impressive degree of mean reversion over the last century or so, mapping out what is a passing simulacrum of a classic normal profile.

Which is not to say, of course, that there have not been significant variations within that overall stationarity. Nor that there is not the tantalizing hint of a generational-scale, 31-32 year cycle at work within the pattern—one with three major and one lesser, but still easily identifiable, peaks occurring in 1917, 1948, 1980, and 2011. We can also note the rough correspondence in the declines from the first and third of those peaks—namely, those stretching respectively from the Great War to the Great Depression and again from the Great Inflation to the Asian Contagion and Russian collapse.

Calculating from monthly peak to monthly trough, the first decline took 15 1/2 years and sliced 70% off our basket; the latter lasted 19 years and extended to 78%. Malthusians and Peak Freaks, please take note that the extractive and agricultural industries weathered all of this and generally managed to increase production at lower cost along the way as they did. Today's ongoing slide has already matched the lesser, intermediate drop post-WWII of 46% in a fraction of the time that took, prompting the question whether we are in the early innings of a much more major reversal instead.

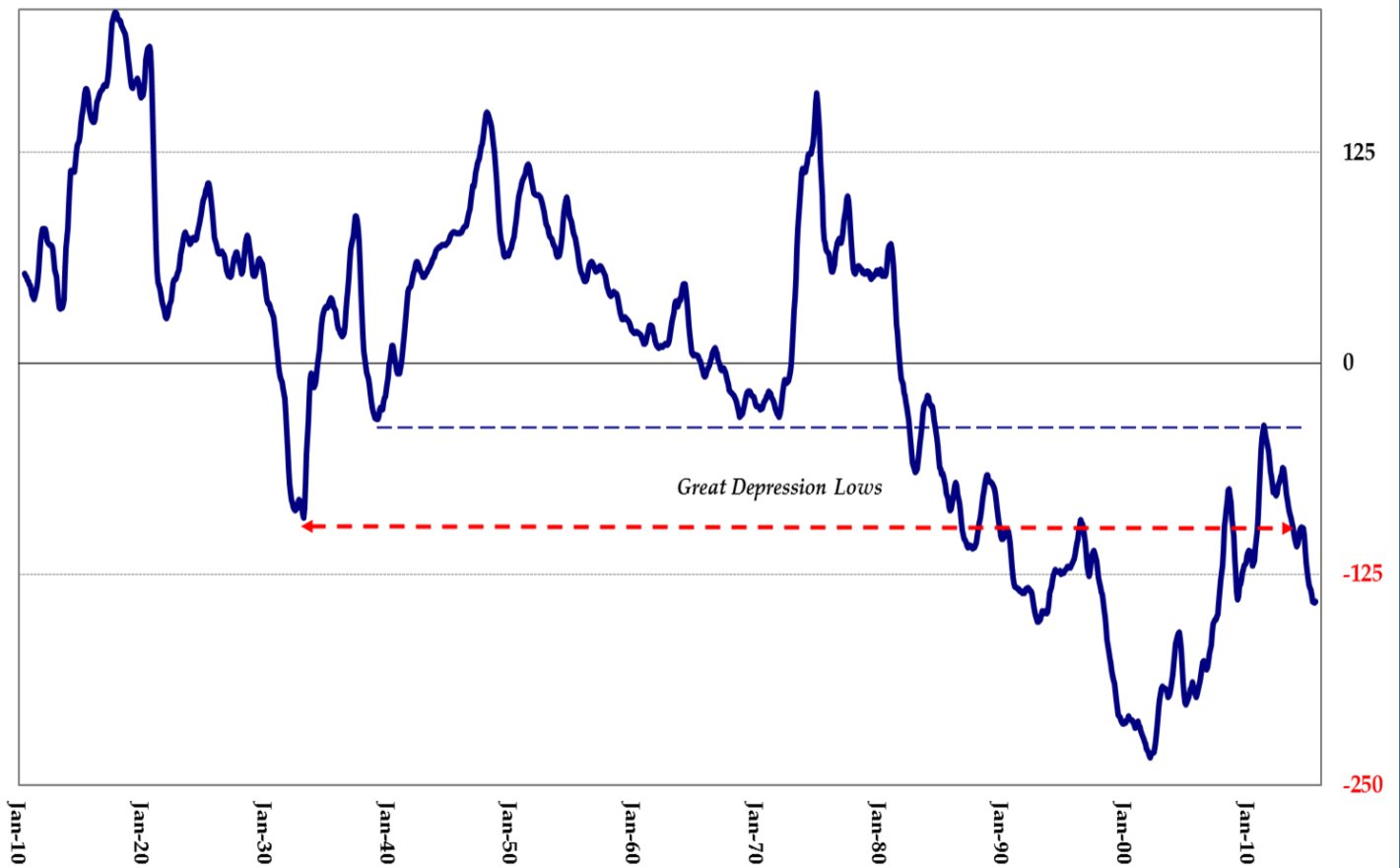


If so, note that, of the four principal sub-indices, Ags are already 1.4 sigmas below their long-term real mean; that base metals are now some 0.6 sigmas beneath theirs; but that energy (+1.3 sigmas) and precious (+1.8 sigmas) are still highly elevated. Since these last two are dominated by gold and crude, easily the most heavily 'financialized' of the group, we can perhaps understand why gold cannot find a bid and why 705MMBBL of remaining crude longs might well begin to tremble!

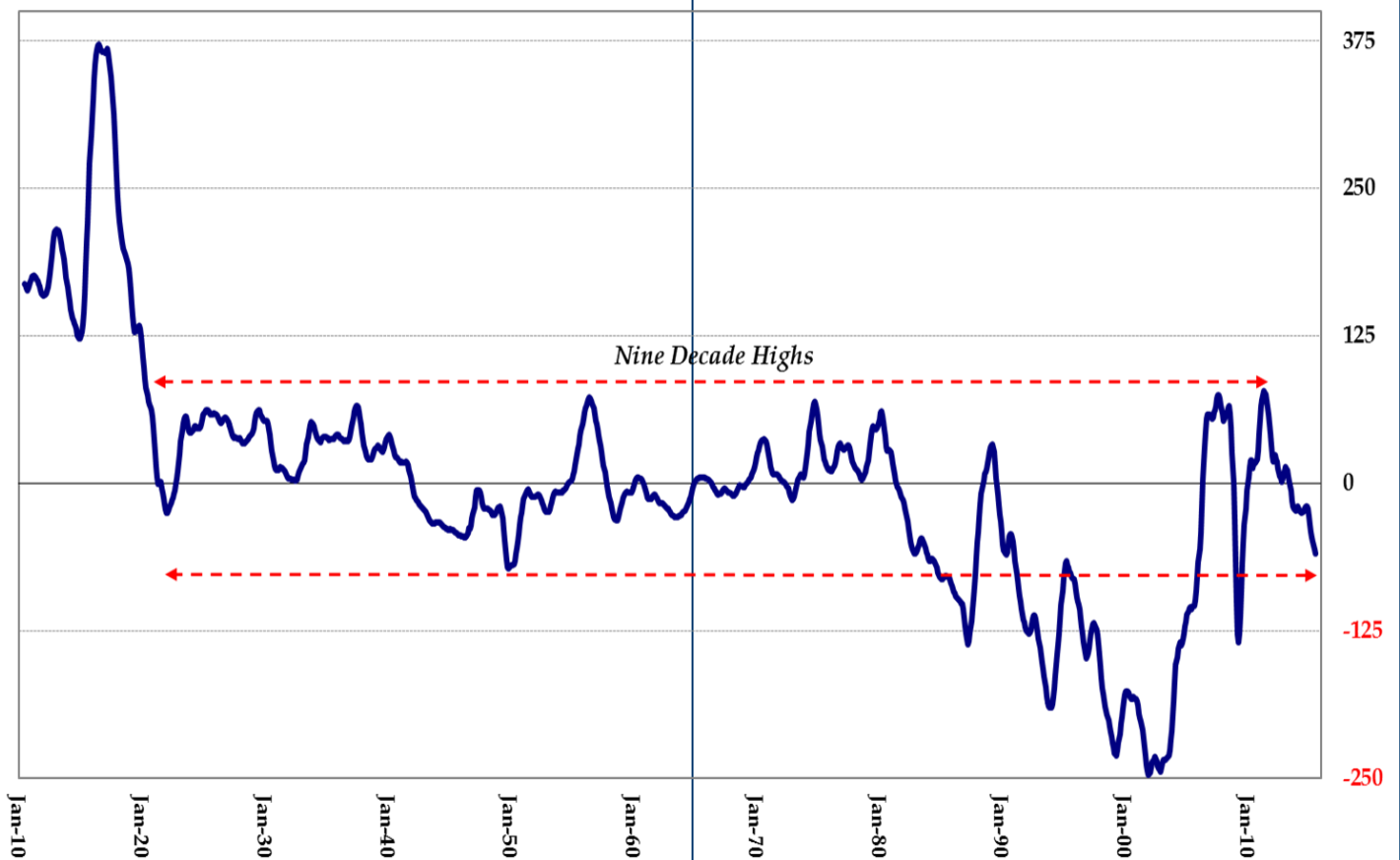




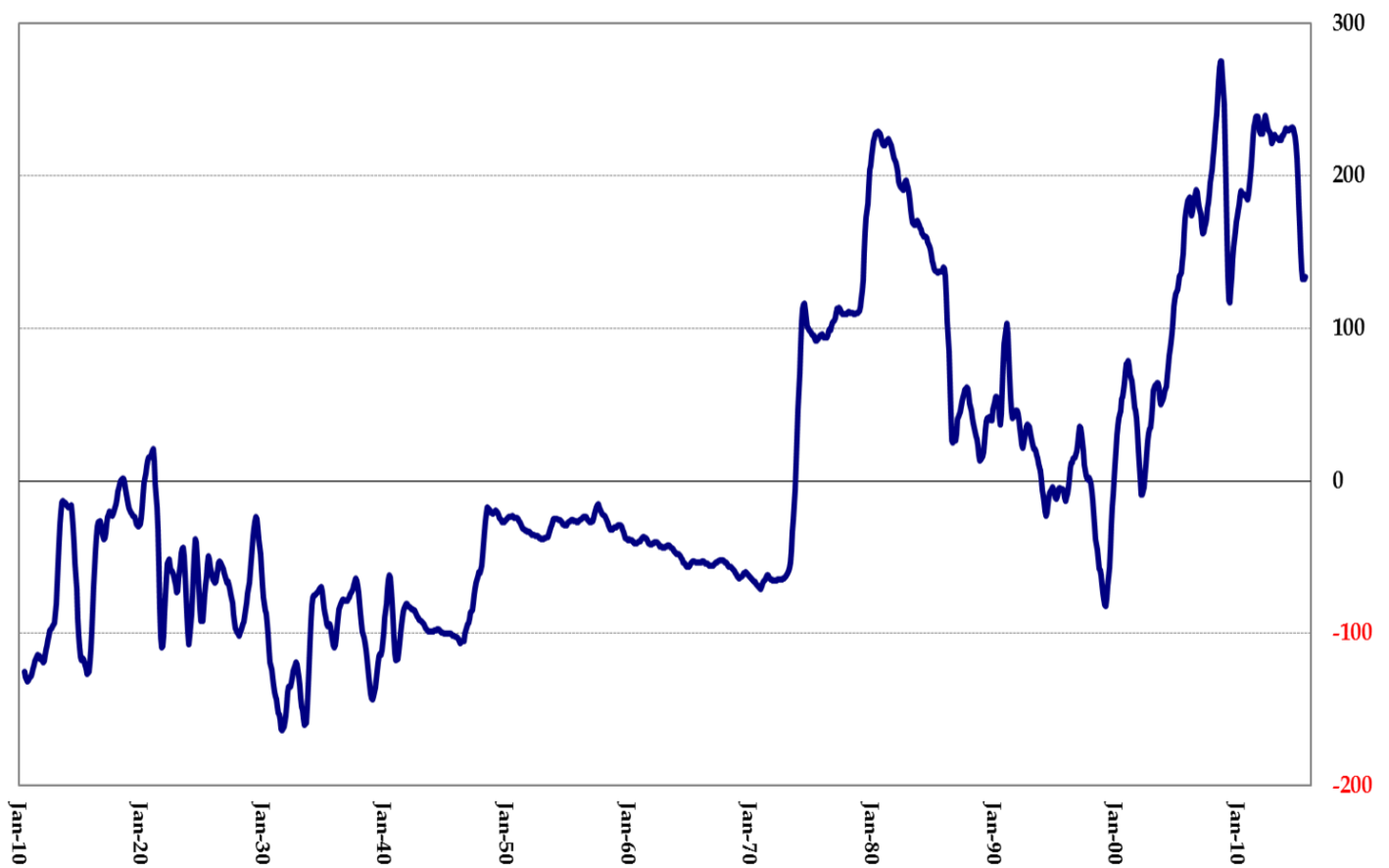
Reconstructed Log Real Agriculture Prices (2000=100): Source - BPSR, NBER, FRED, BLS, Bloomberg



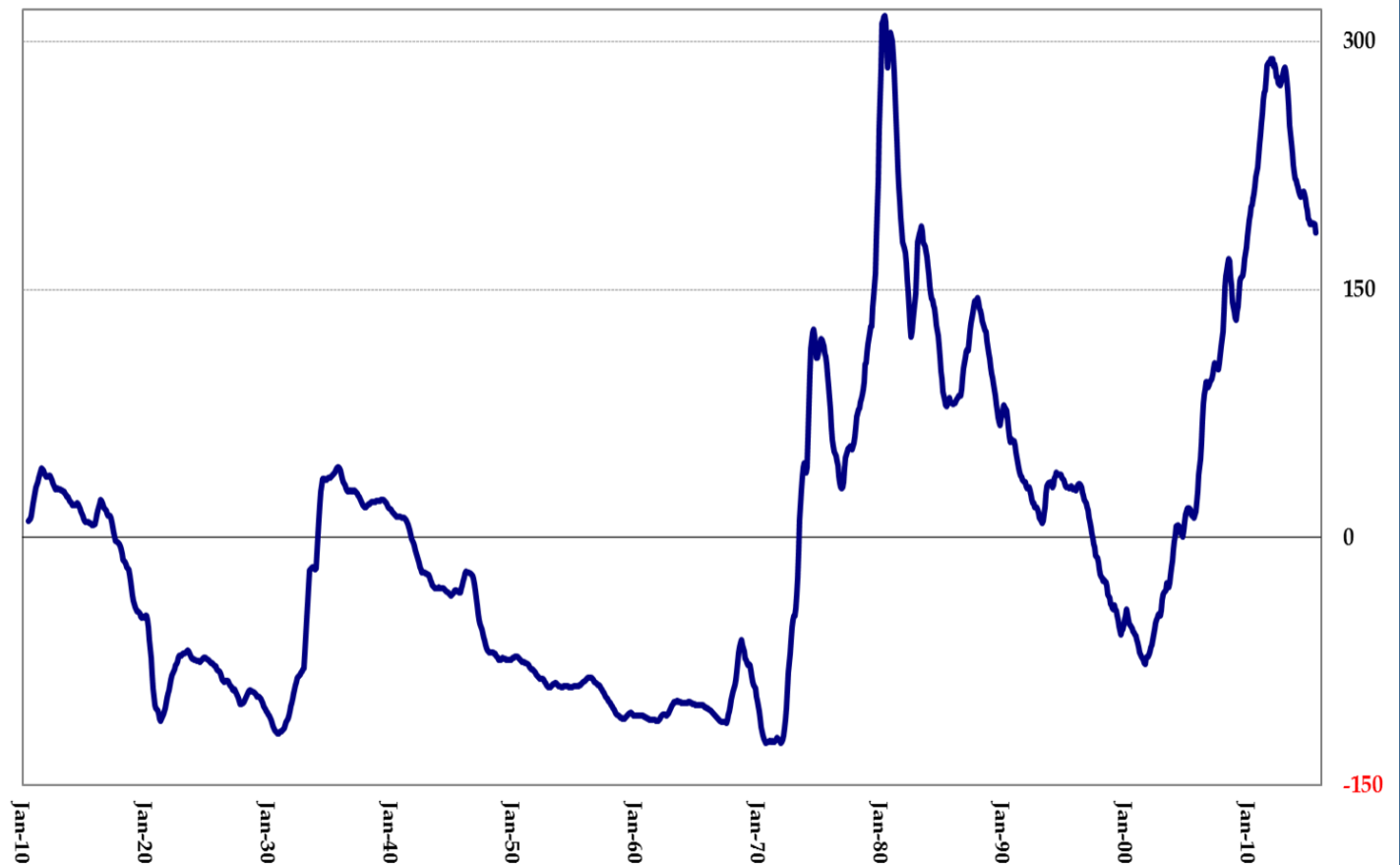
Reconstructed Log Real Base Metals Prices (2000=100): Source - BPSR, NBER, FRED, BLS, Bloomberg



Reconstructed Log Real Energy Prices (2000=100): Source - BPSR, NBER, FRED, BLS, Bloomberg



Reconstructed Log Real Precious Metals Prices (2000=100): Source - BPSR, NBER, FRED, BLS, Bloomberg



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