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When Every Problem is a Nail

Given the little local excitement taking place in China at present we make no apologies for taking another in-depth look at events there, in particular at the progress of what must surely be one of THE world's great stock manias.

In a country with a vast overhang of liquidity, anxiously in search of the promise of the sort of real return which can not be had through more traditional means, China has long been subject to waves of intense speculation.

The stock market last had its turn in 2007 before coming rapidly to grief when the financial crisis broke out the following year. Burned fingers bandaged, next it was property and the ghostly likes of Ordos were conjured up out of the wasteland only to lie largely unoccupied and unrewarding to an eager pack of real estate investors. Next the famous Chinese 'Aunties' contracted a nasty case of gold fever and helped propel the metal to its 2011 highs, only to suffer another calamity two years later as it plunged once more.

Now, with the full connivance of the authorities, they are once again glued to their TV screens and smart phone displays, watching every tick up (and latterly, *down!*) and pausing only to yell buy orders to their broker. Unfortunately, when launching what one supposes they thought would be a therapeutic debt-for-equity swap on a truly titanic scale, the mighty in Beijing seem to have overlooked the possibility that it would instead become a frantic debt-for-*debt* swap as Auntie borrowed all she could get her hands on to maximise her chance of gain.

Away from all that, we fulminate at the latter day lunacy of blind CPI targeting. It seems hard to imagine that, 25 years ago, the brave little RBNZ was breaking new ground by adopting the goal of keeping price rises to 0-2% p.a. in order both to provide an anchor for its own broader policy aims and, believe it or not, as a way for it and the government of the day to wean the wider public sector off the levels of increasingly obstructive interventionism which had long been its practice to undertake.

As the idea caught on that too many societal woes were being caused by free spending politicians and belligerent trades unions bullying a captive central bank into monetizing the effects of their poor housekeeping, inflation targeting by a newly independent Bank seemed the key to forcing governments to temper their ambitions and so to live more within their means. Never again were the traumas of the 70s and 80s to be visited on the people.

Now, however, we have all become victims of our earlier success. From being a handy standard around which to rally the liberalizing troops for an assault upon their wider objectives, CPI targeting has become an end in itself, if not THE end; the alpha and omega of policy. Especially malign is that it is wilfully blind to the broader consequences of a surge in money and credit. Worse, it is unabashedly asymmetrical in its application, with upward deviations from the target being quietly fudged and downward ones triggering ever more wild-eyed schemes of reflation. Should prices ever threaten to fall there is no limit to the size of hammer to be wielded to prevent this.

Sean Corrigan

IL MILIONE: Tales from Cathay

Given the extraordinary nature of the Chinese stock bubble, we find it impossible not to start with a commentary on—perhaps even an obituary for!—any other topic for truly, since we last wrote, the madness has only intensified.

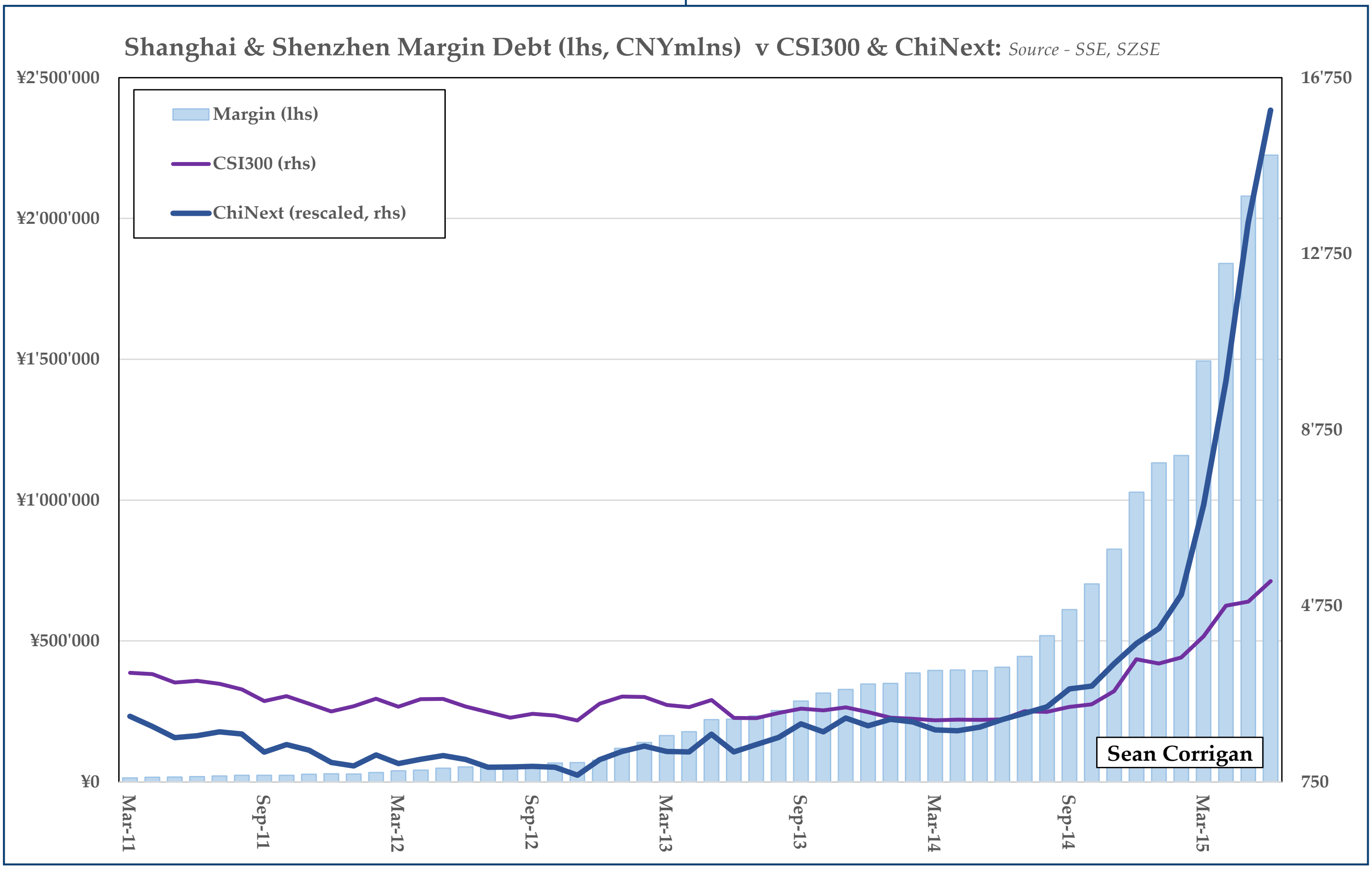
The attempt to convey in words alone a sense of what is afoot there quickly becomes an empty exercise in superlatives so, for the moment, let us simply try to let the numbers speak for themselves.

And what numbers they are! In terms of turnover, things were simply extraordinary. April and May combined saw $10 trillion's worth of shares traded (versus $4.5tln in New York), meaning that for every $7 which changed hands in the whole rest of the world combined, $8 were bought and sold in China. At that pace, China's turnover was 5 1/2 times its GDP while the multiple of national income realised Stateside was a mere 1 1/2. Just imagine what that means for broking house fees—or for stamp duty receipts, for that matter

Then we come to leverage. Official margin debt has doubled just since February and *quadrupled* since last August, adding over CNY1.1 trillion in that time, equivalent to $180bln or around $50bln a month. The total as of June 18th's peak was CNY2,273bln or $366bln, a sum equating to around 3.5% of market capitalization, more still of free float. For comparison, margin debt on the NYSE took a full 3 1/2 years of the bull market to double to today's $507bln where it still represents only 2% of market cap—even if that less lofty proportion is still a 98th percentile reading. Despite the ongoing rally in Japan, margin there is an unexceptionable 0.8% of market cap of the Topix, only some 0.2 sigmas over the post-Bubble mean.

What this means is that in the three months to end-May, Chinese margin debt accounted for 35% of all new loans taken out, equating to 35% of all the RE investment undertaken and to 13% of nationwide retail sales rung up. Since last August, the increase has exceeded the total contemporaneous addition to the stock of M1 money.

As a final attempt to have your jaws drop at the scale of the excess, consider that the addition to margin so far this year of CNY1.25 trillion amounts to the entire income of no less than 50 million Chinese at the average national wage of CNY50,000 a year. That's like saying almost the entire population of England, or of California plus Oregon and Washington State, took on a 100% debt:income obligation and ploughed it, alongside that same income itself, straight into equities as they soared ever upward. Witness the 2-month,



CNY1.5 trillion drop in household deposit balances reported by the PBoC as evidence of this. But that is not the worst of it. The official margin debt total in fact represents only a fraction of the overall credit which is helping erect this multi-storey house of cards.

For instance, the authorities have issued all manner of edicts to the brokers, some intended to limit the degree of leverage they offer, others to limit total credit to some multiple of their capital, yet others aimed at preventing the proliferation of 'umbrella' trusts—collective schemes which act to funnel bank and other finance into the market in a different guise. But what they have found it impossible to address is the growing tendency by which established companies are diverting funds away from the low margin daily grind of their core business and into the spectacular, high-return arena which is the stock market.

Nor have they yet gotten to grips with the many-headed hydra which is the nation's flourishing internet-based P2P network, a teeming ecosystem which counted over 1700 members at the last reckoning at the end of 2014 but which is probably even more populous now that the demand for funding has become so unstoppable. The interaction between firms, individuals and the banks and other financial intermediaries who come between them has become so profuse as to leave one dizzy. As Tencent laid out in a lengthy article on the topic, whether on the TV or internet, in the press or on stationary advertising hoardings, it is currently impossible to avoid the ubiquitous advertisements for sources of margin finance. *'We provide the funds—you keep all the profit'* as one of the more prominent temptingly declares. Needless to say, the contractual terms of such arrangements are carefully drafted so as to evade any regulatory restrictions, including the ostensible (but fundamentally non-existent) separation of the funds' providers from the intermediary offering the 'service'.

To take a different example, smartphone manufacturer Xiaomi has recently launched a consumer finance arm which is to be expanded into an asset management company. Meanwhile, companies in languishing sectors such as steel manufacture, electricity distribution, coal mining, and real estate are said to be particularly active in redeploying their capital—and, no doubt in making avail of their credit lines—to reap the rewards not just of stock speculation per se, but also to profit from the usurious fees and interest charges—often amounting to several percentage points per day—to be had by funding the punting classes.

No wonder that an in-depth examination of this phenomenon, carried by several newspapers two weeks ago, suggested that the scale of the involvement had grown to as much as an additional CNY1—if not to CNY1.5—trillion and that a good part of that was being extended on much more aggressive terms (some spoke of 4, 5, even 7 times leverage being available to those for whom the magnitude of the daily moves is otherwise proving a little too tame).

'A type of miracle Posterity will not believe'

As has been the case in every great financial mania since the days of John Law, each element of the madness is now fuelling the other. The NBS itself admitted that no less than 97% of the minor improvement in the April profit numbers for 'above-scale enterprises' was due to gains realised on firms' stock investments, not to any brightening of operational conditions. With UOB Kay Hian economist Zhu Chaoping calculating that such entities' notional holdings had doubled in a year to just shy of CNY1 trillion, there must seem plenty of scope for more of the same.

Much of the focus of the wider 'investing' public is, as ever, on 'concept stocks', whether internet-related, telecommunications, or so-called 'cleantech' in this incarnation. Partly, this is because these are the ones being talked up by the regime as offering the pathway to a brighter, more prosperous future now that the smokestack days are fast fading into oblivion. Partly, however, such New Era counters are prominent because a sizeable proportion of the new stock market gamblers are students—some, moaned one disgruntled professor to Xinhua, devoting up to six hours a day to 'researching' and trading their plays instead of studying to master their disciplines. How very non-Confucian!

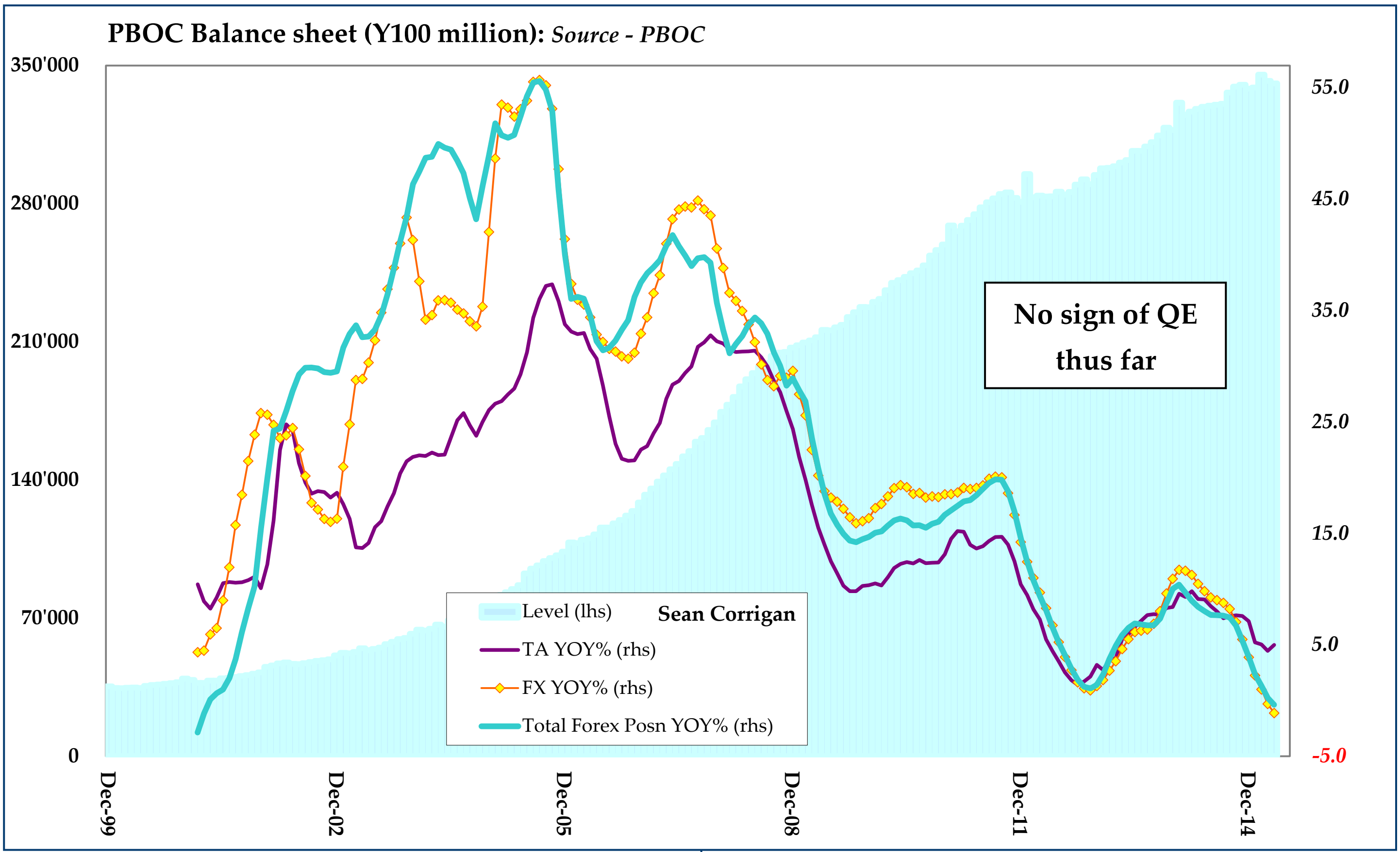
As we have also seen, many such companies are themselves benefitting from providing the financial and informational infrastructure the bubble. Thus, for so long as it lasts, they are able to produce a simulacrum of earnings growth and hence are seemingly able to validate some of their student sponsors' bullish prognostications.

In the reverse direction, the size of the gains being made in the market's near vertical ascent has reawakened the winners' appetite for more tangible forms of property, especially that to be found right in the eye of the hurricane in Shenzhen where overall prices jumped almost 7% in May alone with sales volumes which set new records.

Amazingly, in one particularly sought-after district, that of Nanshan, several articles claim that prices have risen 85% in a year! Whatever the representative nature of such an assertion, the Yi Ju research institute has reckoned that whereas 100 sq m of residential property cost 12.9 times the average income in 2012, by the end of last year that 'price/earnings' ratio had soared to 20.2 times. Is it any surprise that as many as one in five sellers is said to have been guilty of gazumping in recent months?

Shenzhen may be an outlier but, as the Centaline Property Agency revealed, trade has been exceptionally brisk in several other major cities. In Beijing, for example, pre-owned home sales so far this month are up 19.3% from the like period in May and are therefore no less than 250% ahead of where they were just a year ago before the stock market was making overnight millionaires out of mu tong merchants.

Xia Dan, an analyst with Bank of Communications Co summed it up nicely when he told a reporter that:- *'There*



is a renewed enthusiasm about buying real estate, which stimulated a rise in both sales and prices. The bullish stock market has generated massive wealth, strengthening a willingness to buy houses... Momentum in first-tier cities is particularly strong.'

Such has been the intensity of the demand, indeed, that banks such as Ping An and Bank of Hangzhou are said to have ceased lending altogether while others are reported to have substantially raised mortgage rates.

Just the right moment then, for property giant Wanda to start 'crowdfunding' its developments, tapping—yes, the burgeoning P2P networks—to offer retail investors of as little as a CNY1,000 apiece a putative 6% rental income as well as up to 6% from forecast capital gains.

Amid all this swirl of bootstrapped expectations and outright Ponzi activity, the whole gamut of M&A, venture capital, IPOs, and secondary offerings is naturally having its moment in the sun.

As Thomson Reuters recorded, the first of these has had a stellar run so far in 2015 with deal volume up three-fifths to a record $305bln. One fifth of that, in turn, has taken place in the high-tech sector—almost triple the amount undertaken in the like period last year and three-quarters of all deals have been domestic—a near 70% increase in dollar terms. Numerically speaking, no less than 2,542 instances have been registered, keeping lawyers, lenders, and advisors rubbing their hands in glee.

As for company formation, the optimistically named Zero2IPO group made it known that the CNY1.6 trillion in angel capital doled out in QI was three times that put to work the year before and—guess what—43% of the recipients were in telecoms and another 37% were internet start-ups. *'It is a golden era for both entrepreneurs and angel investors,'* said a breathless Chen Bin, executive VP of startup brokerage firm, AngelCrunch.

It certainly was golden over on the pump'n'dump paradise of Beijing's 'Third Board' for OTC stocks where, to the added incentive of Premier Li Keqiang's personal endorsement, the number of listed firms has skyrocketed from 2013's 343 (combined market cap of CNY137bln) to May 2015's 2,486 (market cap CNY850bln). So far, June has seen a further 114 new members, projecting a year end total in excess of 4,000 if a hard does of sanity does not continue to intrude between now and then.

Such an outbreak of cold-headed reason is not likely to emanate from the regime which, desperate to keep the plates spinning using any and all means, has already announced that not only is it looking at relaxing (!) rules for IPOs and at providing NEEQ (as is the Third Board's official designation) entities with an easier exit onto the slightly less Wild West uplands of the ChiNext NASDAQ analogue, but that it will set up a 'Strategic Emerging Industries Board' at the Shanghai Stock Exchange in order to *'attract private capital in emerging and creative businesses, and provide an exit channel for private equity and venture capital investors.'*

Tho' our Foreign Trade is lost, Our mighty Wealth a Vapour

Coming. as it does, amid a flurry of spending initiatives being issued by the State Council on what almost seems like a daily basis, why the unseemly haste, you might ask? Why run the risk of further encouraging what to any outside observer seems like a classic episode of collective financial insanity with all the potential which the eventual dissipation of the folly carries with it to discredit everyone associated with its propagation?

The simple answer has to be: it's the economy, stupid.

Let's look past all the faintly strained declarations which abound that the odd decimal point uptick in May's broader economic numbers marked any significant improvement in the situation. Clearly, all that policy activism itself should be proof enough that even the authorities do not really believe this has been the case.

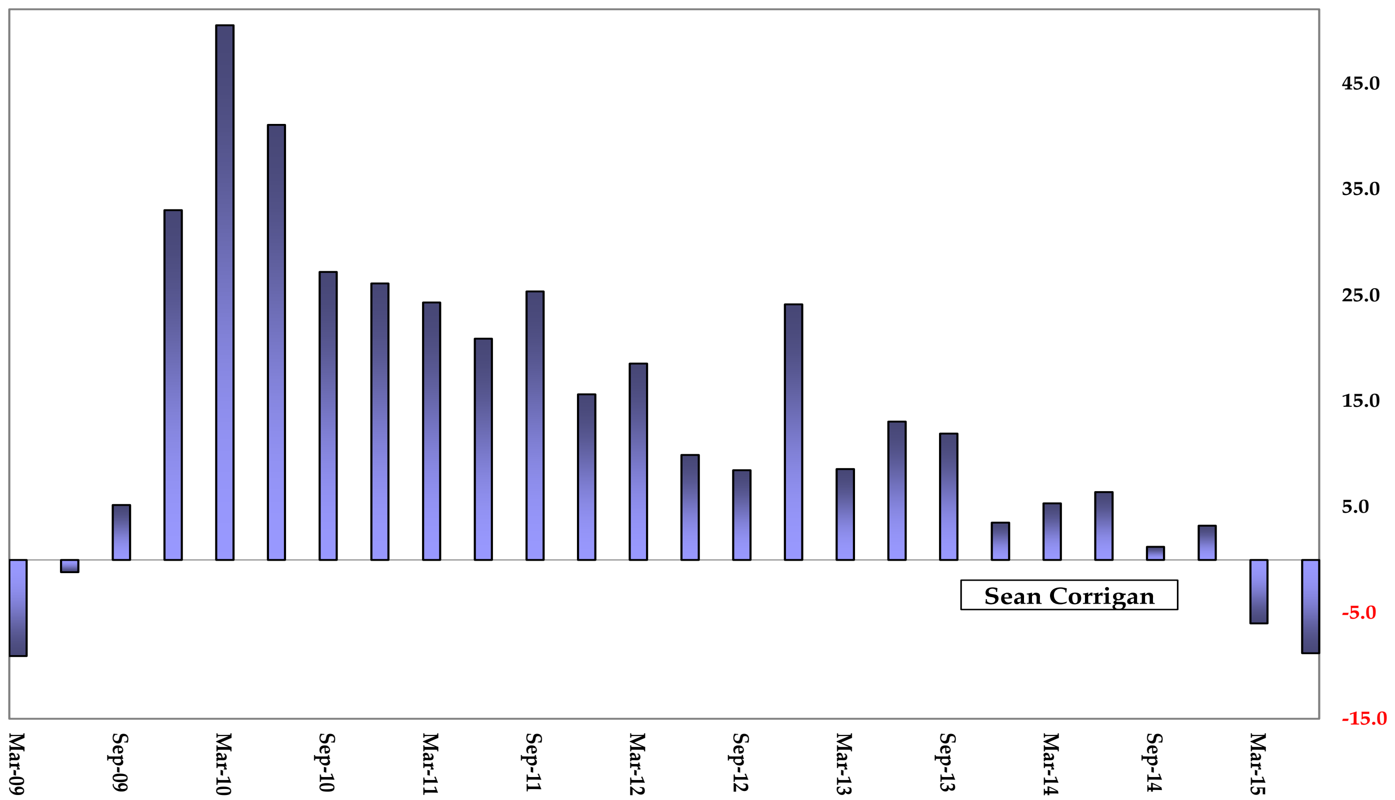
Even if we do take such things at face value, the vaunted 'recovery' in the growth of industrial production from April's lowly 5.9% to May's still hardly stellar 6.1% masks the fact that the rate prevailing over the last three months on an annualized basis was actually only 5.6%.

Of course, those of a sceptical bent would look askance at even this pace of increase, one hard to reconcile with the figures for national electricity consumption which show that when compared to the same period in 2014, non-residential consumption in the three months to May actually *fell* by 0.7%.

They might also recognise that, if June follows the course of the past two months, SOE revenues will be headed for a YOY decline of 8-9% in the second quarter, the sort of decrease last seen in the months immediately succeeding the Crash of '08.

Meanwhile, the China Federation of Logistics and Purchasing PMI came in at 48.3 for a MOM drop of 1.2% through the contractionary threshold. The fact that rail freight is running around 10% below year ago levels is widely appreciated, but it is perhaps not as well publicized that the Federation's road freight volume index is also off 7.6% YOY.

China SOE Revenue growth YOY%: ***Source - MOF***

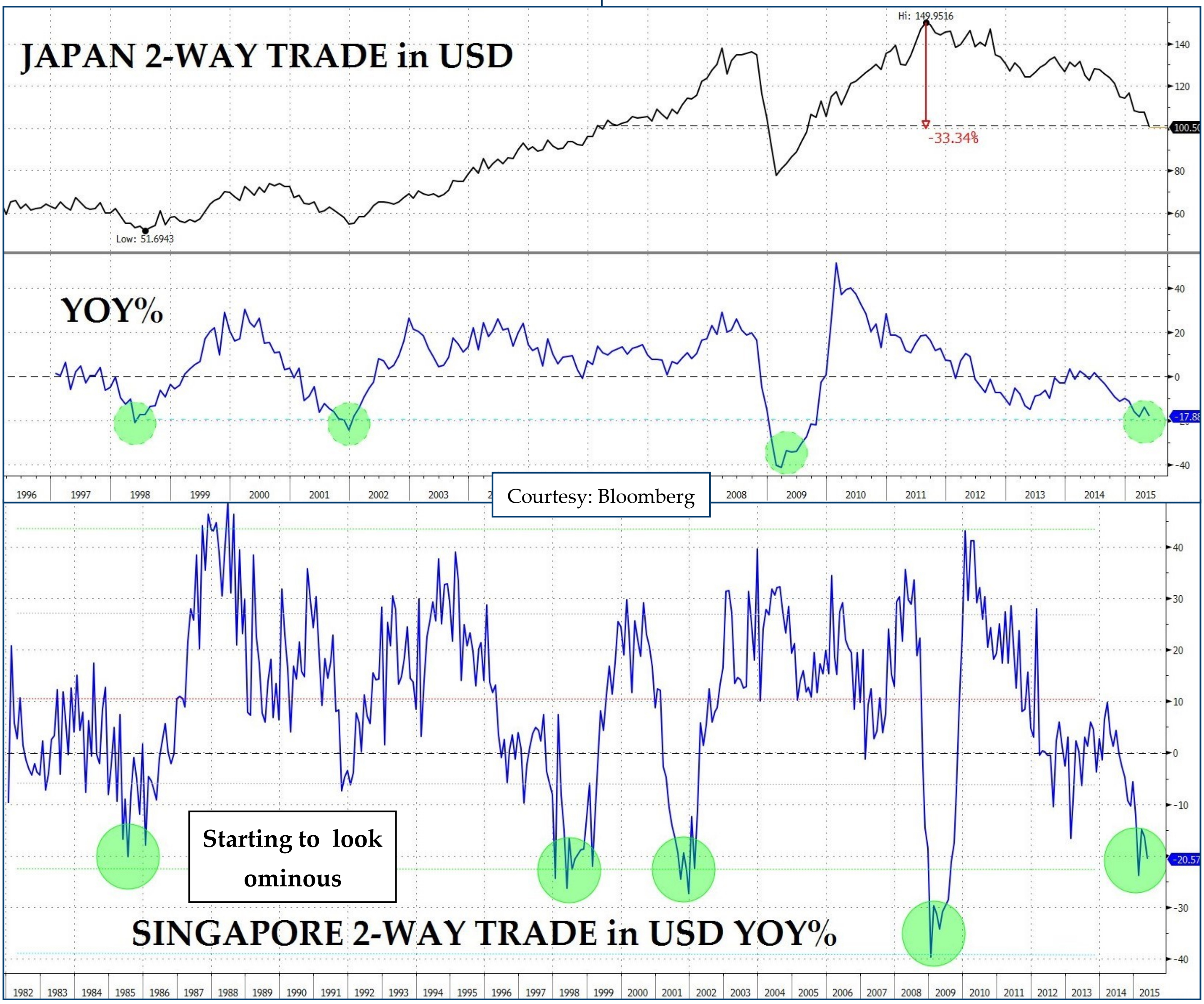


If things are bad on land, then shipping is nothing short of a disaster area. The same industry body's coastal bulk shipping index is down a whopping 21.1% while the Shanghai Exchange's measure of spot container rates, the SCFI, has halved since January and its broader CFCI is off 25% to touch a mark which is a full one-sixth lower than the inaugural value set way back in 1998.

Exports as a whole were off 2.5%YOY in May and imports by a substantial 17.8%, leaving the 3-month running total of 2-way trade 11.4% lower than in 2014. This is only the second seasonal loss for the measure in a quarter of a century, the other being, need we say it, in the GFC itself when it plunged 23%. Such weakness leaves the trend for the past four years, that is since the great reflation peaked out in the summer of 2011, at a mere 2.3% rate of increase—a very far cry from the double digit gains which characterised the previous, world-changing cycle mapped out after China's WTO accession.

Nor has the picture been much brighter anywhere else one looks. Korea and Taiwan show much the same pattern; Japan's 2-way trade in USD is fast approaching post-GFC lows; and, as can be seen below, trade flows in and out of Singapore are also suggestive of the pace of activity seen in crises past.

For the record, UNCTAD figures for 2013 had China responsible for what was far and away the biggest share of the world's container traffic. At 25% this was 4 times the size of the US tally and 9 times that of the next two biggest trading nations, Germany and Japan. Taken together the China sea network of China, HK, Taiwan, Korea and Japan made up two-fifths of global traffic. If they are struggling, it tends to suggest that so are we all.



DURCH DIESE HOHLE GASSE

An Alpine Outlook

Pity poor old Thomas Jordan at the head of the institution which oversees the world's safety deposit box of choice, the Swiss National Bank.

As Switzerland struggles to adjust to the franc's sudden, 12% revaluation against a region which takes almost half its exports (as well as from the ongoing collapse in the currencies of major trading partners such as Russia, Japan, & Latin America), our hero has continued to feel the sting of criticism at home for his late removal of the CHF1.20 ceiling against the euro.

Though one has a certain sympathy for those discommoded by this and by an enactment so necessarily unheralded that no-one's wife had foreknowledge (!), it is also true—as several Swiss luminaries have themselves pointed out—that the most vocal of Jordan's detractors are those who have benefited most handsomely—at the expense of every other member of society—from the implicit subsidy which they were granted when the SNB was controlling the parity against the euro even as it slid ever lower against the dollar and its fellow travellers.

Moreover, while its introduction was perhaps understandable in the extreme circumstances under which it was undertaken, the CHF1.20 barrier had long since fallen prey to that awful petrification which tends to overtake all such interventions – just ask the Fed or the Bank of England, much less the Lost Decade(s) ZIRP-junkies in Japan.

Undoubtedly, the cap was only intended to be a short-term palliative, for even if we cynics strongly suspected it would indeed be the case, who in the mainstream would have dared to suggest that, eight years on from the first cracks appearing in the façade of the Potemkin village which is the European Union, that gross, unwieldy polity would still be struggling to deal with the after-effects of its preceding decade of disastrous economic policy-making?

Who could have conceived of an ECB—an institution fully complicit in the debacle which ensued—that would become so power-drunk as to still be resorting to the failed nostrums of loose money and competitive devaluation at this remove from the crash? Who would really have envisaged the unabashed Latinisation of a body which has not only shed all pretence at being a Bundesbank writ large, but which is seemingly determined not to be outdone by the loose cannons at the Bernanke-Yellen Fed or at the politically-captive Kuroda BOJ?

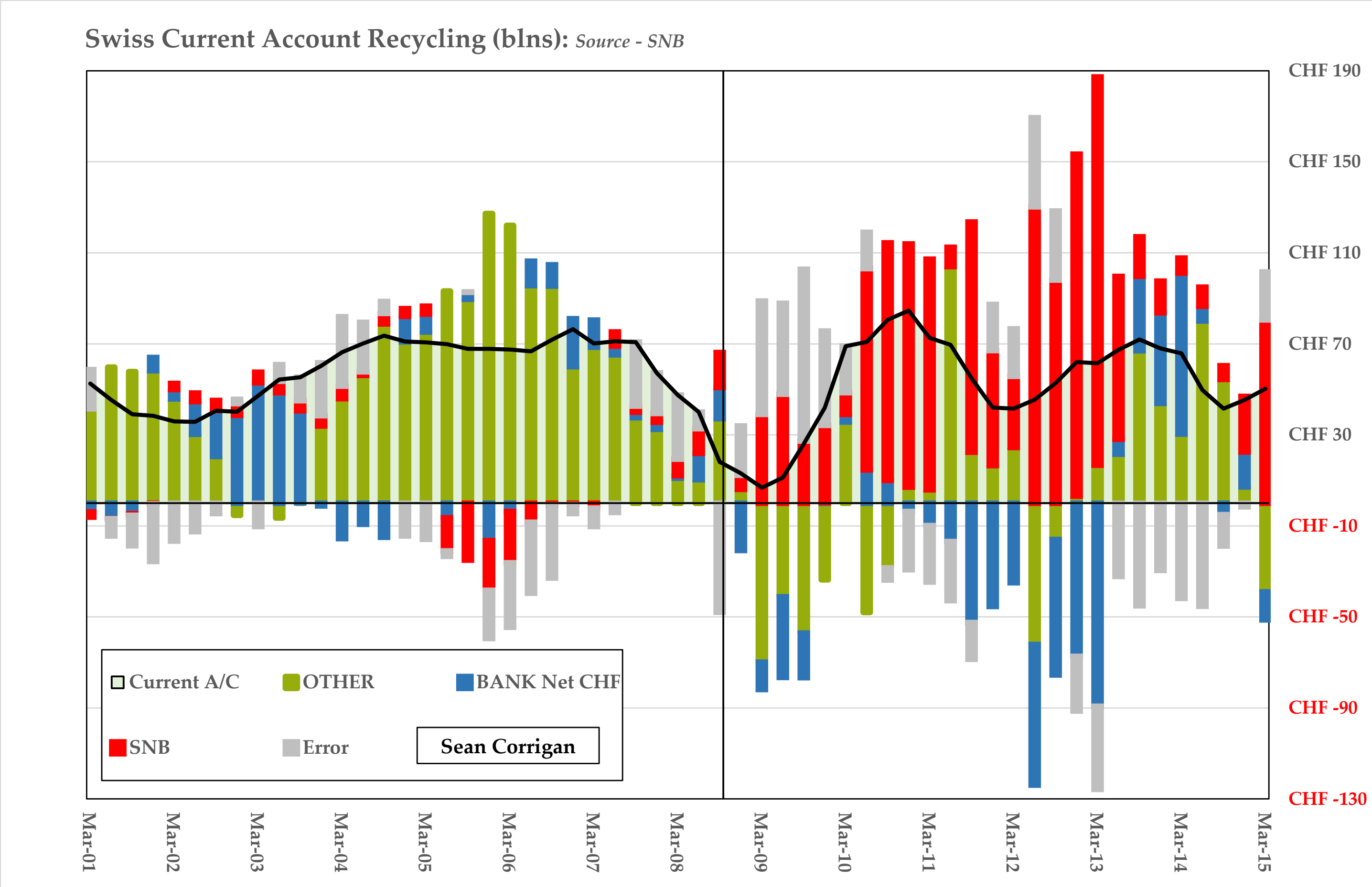
Kudos, Herr Jordan, for he seems to have had both the wit to realise and the moral courage to address the fact that the longer the cap stayed in place, the greater the risk that its side effects would become ever more noxious.

Not only did it tend to introduce distortions in the allocation of productive capital by unduly favouring exporters and import-competitors to the detriment of their peers, but it made those with surplus financial capital more tempted to keep their money at home (or to bring it in from abroad) by interrupting the traditional specie-flow mechanism of price adjustment. Had this not been the case and had successive buyers had to pay an increasing rate for their francs, it might have proven a deterrent, forcing them to explore other options instead. And, when they did so, imagine what bargains could have been had abroad, not just for those able to pop over the borders to buy their groceries, but for those seeking investments both financial and physical, if the currency had been left largely free to appreciate and had thus introduced an element of discount to those assets' acquisition.

Indeed, as the accompanying chart shows, with the cap in place, a certain unhelpful circularity had set in, one which meant that the Swiss had themselves to blame in part for their and their Chief's half-trillion franc predicament.

What a study of the numbers reveals is that while the impressive current account surplus has been broadly stable either side of the GFC (if undoubtedly reflective of the larger cycle) at a little over CHF5bln a month, its recipients have patently lost a great deal of their former hearty appetite for foreign assets since those dreadful days in late 2008.

In the seven years before that watershed, outward direct investment had 'recycled' just under half the necessary total (all figures unless otherwise specified are net) while portfolio investment added up to another four-fifths (55% as bonds, 25% as equities). In a somewhat overlapping category, banks were providers (i.e., lenders) of 15% of foreign finance in Swiss francs. With a fairly inactive SNB safely to be ignored and after the inevitable minor error term is included, *borrowing* in all other currencies and by all other sectors combined to make up the difference. Out went the trade invoices: in came the settlement notices.



Switch now to the experience of the past six years, after the earthquake of 2008. FDI has fallen by a quarter and so only covers a third of the current account surplus. Portfolio flows are even worse, dropping to less than a sixth of their former magnitude, led by a 95% (sic) fall in bond purchases. Together, then, these two items have gone from paying out 129% of the surplus to matching just 47% of it.

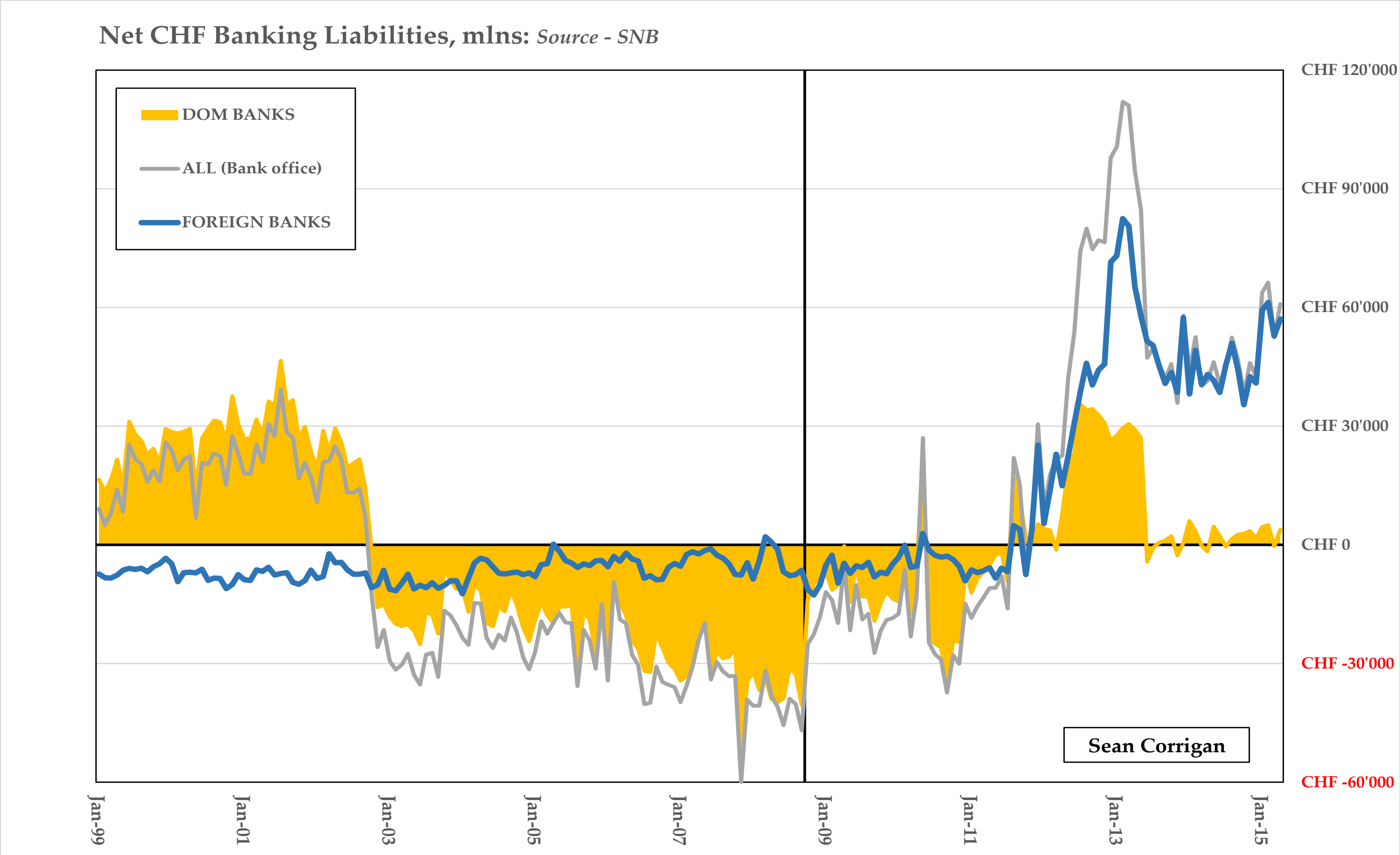
Banks, too, have undergone a change with respect to the CHF proportion of their dealings with foreigners. Net external *assets* of around CHF45bln have been transformed into net *liabilities* in excess of CHF60bln. Those abroad who saw the franc as a cheap alternative financing mechanism (notoriously, of course, for foreign currency mortgages in Eastern Europe) have unwound this particular example of a blown carry trade while a good deal of additional money has fled the turmoil of the EU to the point that almost that entire net sum of CHF60bln—a year's C A/c surplus—is now owed to their customers by Switzerland's cadre of foreign banks.

As noted before, the bank numbers *per se* overlap with other categories mentioned and, moreover, we have only considered the Swissy component of the former, but what this all boils down to is that the bilk of the burden these past six years has fallen on the SNB to the point where that august body has single-handedly taken on the duty of keeping the books in balance, acquiring CHF66.7bln a year in forex reserves as the principal counterpart to the country's CHF60.1bln average annual current account surplus.

Domestically, the impact is evident in a consideration of monetary developments. Sight deposits at the SNB (as banks pile their surplus cash up there) are up CHF340bln after adjusting for the Post Office's change of legal status two years ago. Add in a CHF25bln increase in notes and coin and the monetary base gain of CHF365 in the past seven years *exactly matches the cumulative external surplus recorded over the same period!*

Accordingly, Switzerland is yet another country where the central bank has come to dominate the financial landscape. In spring 2008, sight deposits equated to just 1.7% of M1 and the monetary base as a whole to 16.7% of it. On the other side of the SNB balance sheet, FX reserves then provided backing for a modest 16.5% of total M1.

Today the picture could not be more different. Base money accounts for nearly 80% of M1, the sight deposit component for two-thirds, and forex reserves for 95% of the total. As a result, we have another example of the QE era's per-



verse inversion of fractional reserve banking logic whereby a *doubled* supply of money (+CHF300bln) has seen the ‘inside’ increment—which banks are supposed autonomously to pyramid on top of the ‘outside’ sums they hold at the CB and as cash in their vaults—effectively *halve* from CHF225bln to CHF115bln, all in round numbers.

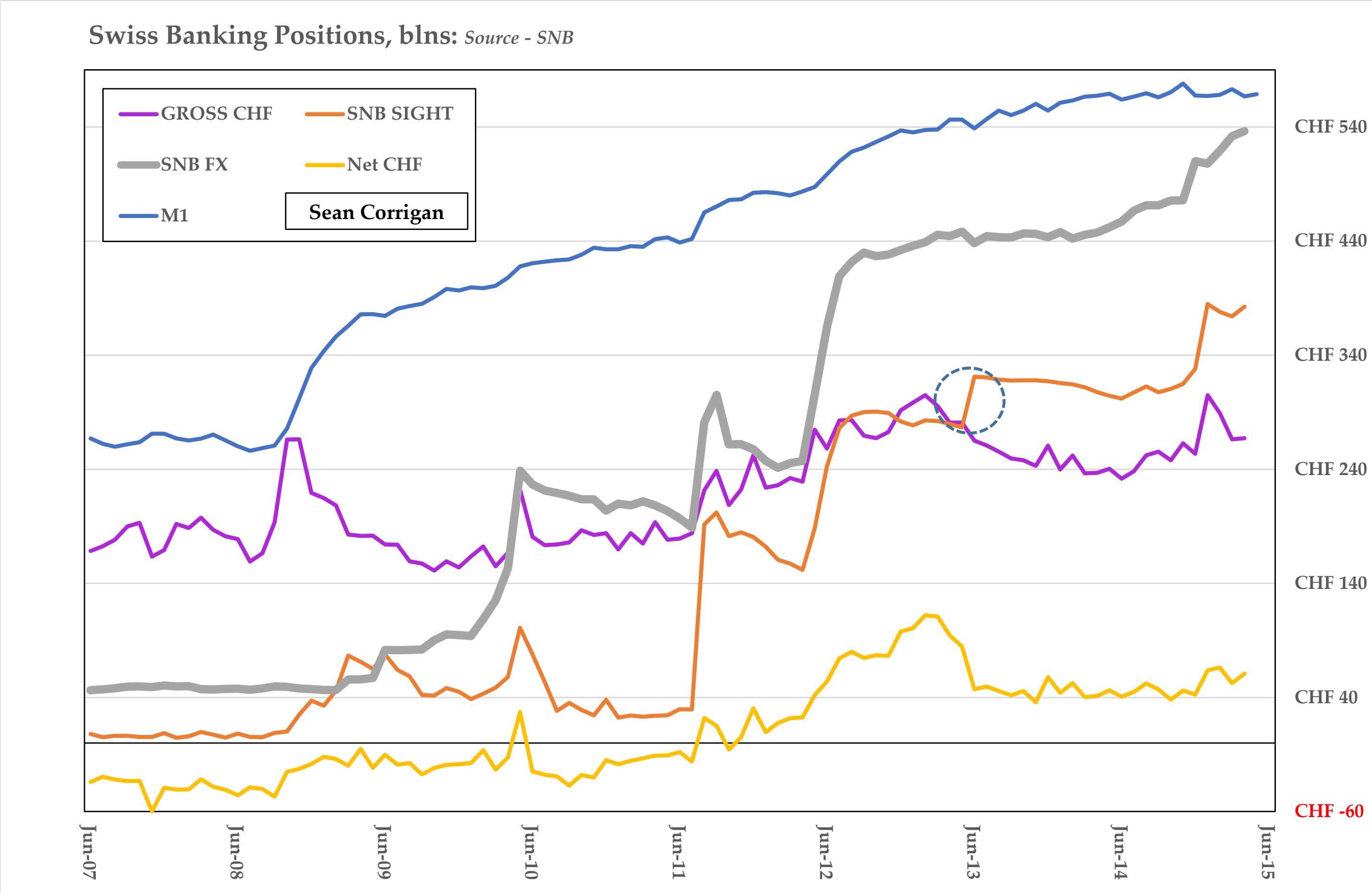
Similarly, instead of making their own choices about where to invest the income surplus earned from abroad, Swiss householders have been content to park an extra CHF250bln (and non-financial corporates an additional CHF25bln) in unremunerative deposit accounts while devolving the task of asset allocation upon the worthy bureaucrats at the SNB. Their own banks presently are the ones to stump up the management fee for this ‘advice’ in the form of the negative deposit rates being charged on the corresponding sight holdings against their overseer.

Given that the central bank is naturally a safety-first investor and that it is therefore partial to a little AA/AAA sovereign debt, this means at root that *all* the excess export earnings of the hard-working, highly-skilled Swiss *Mittelstand*, together with those of the world-beating pharmaceutical and engineering giants which are their compatriots, are no longer being devoted to the compounding process of wealth creation via entrepreneurial capital formation but are instead helping to lower the cost of financing for some goodly portion of the unfunded transfer payments, the market-distorting subsidies, and the bloated payrolls of the gargantuan, growth-suppressing public sectors of the Confederation’s near-abroad.

No wonder we are said to be suffering from ‘secular stagnation’ for, in truth, this imaginary plague is nothing if not an artefact of bad economics and misguided policy!

Worse yet, some of that embarrassment of riches on the books of the SNB is starting to burn holes in the pockets of local statists who not only itch continually to ‘do’ something with Other People’s Money but who typically confound that money with wealth and who also generally fail to distinguish between mere financial accounts and actual, utilisable real resources.

Thus it is that the Green-Liberal (yes, an oxymoron, I know) Party president Martin Bäumle has proposed that a fifth of this hoard be put at the disposal of a fund to pay for a whole eco-political wish list, including the decommissioning of the country’s nuclear reactors – formerly bastions of its strategic independence from the depredations of hostile neighbours as well as a safeguard against unreliable foreign suppliers but now a totem of an unenlightened past’s ignorance of today’s sacred cult of sustainability.



In a classic example of green Utopianism clashing with harsh economic reality, it seems not to have occurred to Herr Bäumle – a man who recently suffered the largest popular referendum defeat in 86 years (by 92% to 8% no less) over his highly ideological plan to impose a substantial tax increase on fuel – that the only way for the bank to turn the suggested CHF100 billion outlay into anything other than an inflationary disaster for the Swiss would be for the necessary goods and services to be *imported* and *not* to be sourced or contracted at home.

Furthermore, even if the SNB were foolhardy enough to agree to commute the foreign exchange holdings which it keeps against its sight liabilities (and, at one remove, against the mass of primarily domestic deposits), it would first have to persuade those in possession of francs to go decidedly against the trend and to use them to repurchase its own foreign currency assets. If not, it could only drive the prices of the first sharply up and those of the second giddily down—imagine the howls of outrage from both Swiss exporters and foreign government borrowers if that were the case! Next it would have to choose *not* to breathe a heartfelt sigh of relief as it simply extinguished the associated overhang of sight deposits, but would instead move to cover them with paper issued by the putative Bäumle Eco-Fund. Only thus could it allow the new monies to percolate back to the domestic banks as replacement deposits, albeit ones of an inherently more active, more *inflationary* kind than the predominantly passive, low-velocity ones they would be succeeding.

Given that CHF100 billion is around 15% of GDP, 28% of personal consumption and is roughly equal to a year's gross capital equipment purchases, can you imagine the consequences of actually doing this?

It will be hard enough for the SNB to extricate itself from its present dilemma without triggering either major financial instability or a nasty bout of inflation given that the exit 'strategy' seems to be limited to the vain hope that the perceived foreign need for a safe haven will one day evaporate even as the domestic hankering for ROW risk assets will gratifyingly revive. But with the likes of Mr Bäumle to covet disposition over the Bank's holdings, it would seem the peril for the admirably thrifty Swiss is even greater than one might first imagine.

WHERE THE MONEY GROWS:

Wall St & West

As the Fed dithers on, striving valiantly to find some excuse to justify its moral cowardice, the characteristic ill-effects of a period of over-easy interest rates are beginning to spread from the stock and credit markets to the usual outlets. Classic cars, fine wines, modern masters—it all sounds s-o-o familiar.

But the long benighted US housing market is also showing signs of stirring into life. Recent weeks have seen the MBAA purchase index score 25% above the autumn's lows, close to the top of the past 5-years' range (lumber has also put on a quarter in that time). Both new and existing home sales have also been robust, rising at around 8% yoy in transaction weighted terms—and at a real rate which is in the 96th percentile of the last 4 1/2 decades' range.

In terms of activity, too, total dollar spend (estimated as sales x median price) offers confirmation that things are heating up, being up a fifth in nominal terms from a year ago to the highest mark in the past eight. That same spending is also beginning to mount in relation to other broad measures of economic activity. For instance, in comparison to the wage fund it is up 17% in relative terms in the past year and versus business revenues the gain is 23%. This has taken the measure this past year near to the top of the range it has mapped out over the whole of the past 45, excluding that interlude in the middle during which the last great bubble was regrettably allowed to expand.

Whisper it also, but construction spending is also on something of a tear, rising 13.4% YOY to reach a six year high, where it is within 10% of the peak of the previous mania.

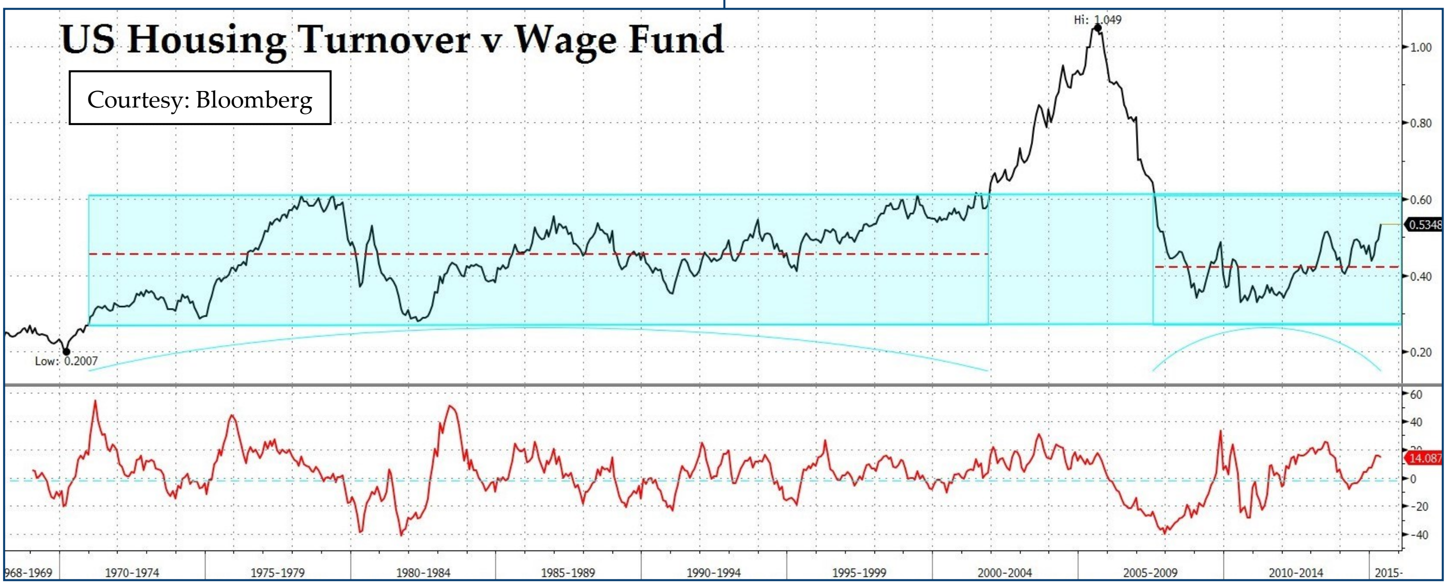
By way of visualizing just how far in such circumstances the current funds rate is from previous norms, we can readily match it against measures such as these. When we do, we can see the degree to which the Fed has transgressed all previous experience in leaving the rate so low for so long.

Were we ever to leave the narrow focus on CPI behind us, this might start to raise some doubts. But even with those mental shackles still firmly locked in place, a glance at the pattern of the funds rate versus the behaviour of the *Median* CPI offers room for more than a little doubt as to the wisdom of the current stasis.

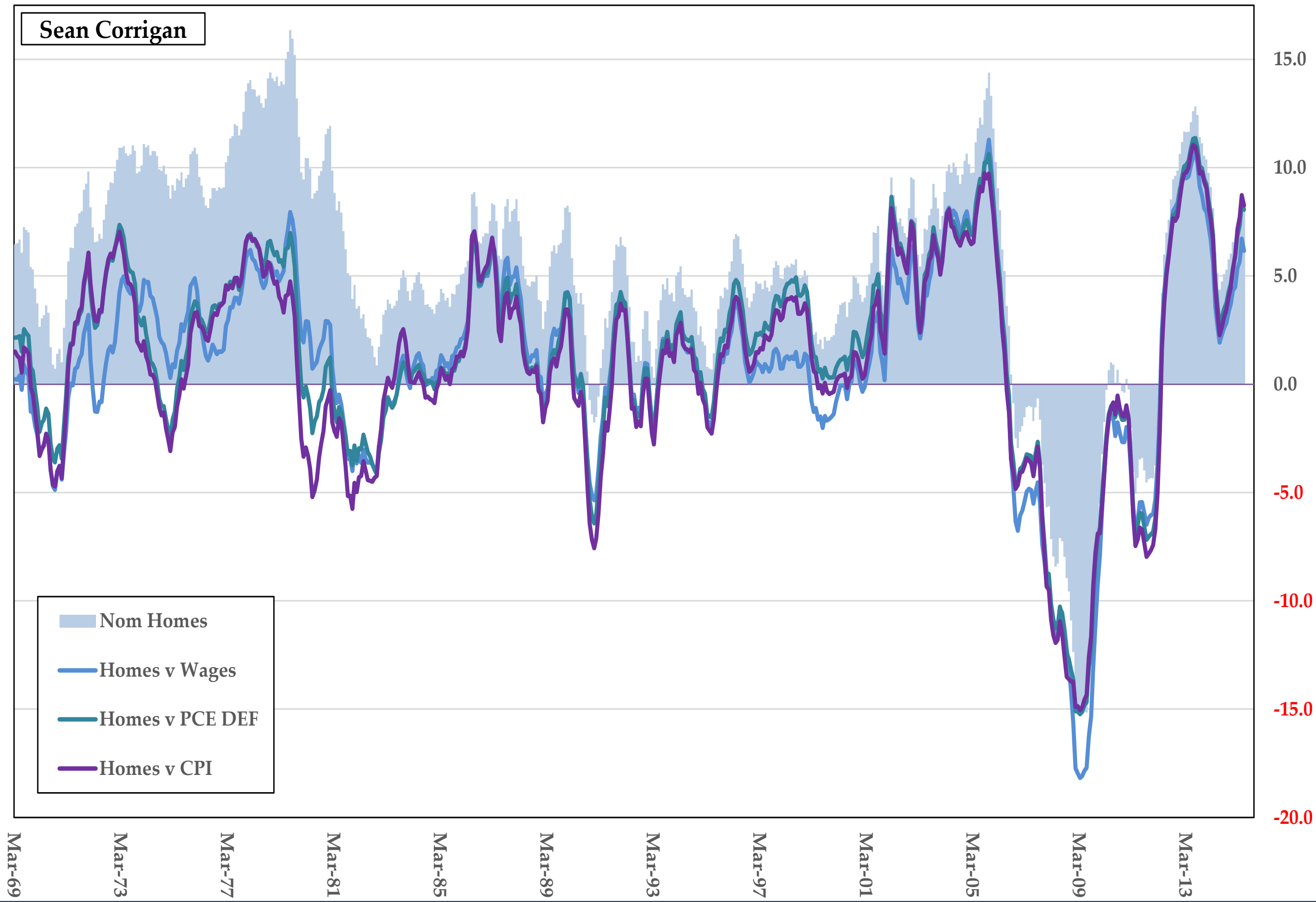
During the past 4 1/2 years, once the deflationary shock of the GFC had worked through the numbers, MCPI has averaged 2.1% with a high of around 2.8%. In other words, even accepting for a moment the modern inanity that consumer price rises alone constitute 'inflation' rather than being but one manifestation of the disease, and also supposing that the Fed's unspoken ideal of a steady rate of said 'inflation' is much the same 2% p.a. that has become a shibboleth for central banks around the world, we have been living in such a nirvana for almost half a decade.

During this time, the average funds rate has been no more than a few basis points, leaving the real rate at negative 2%.

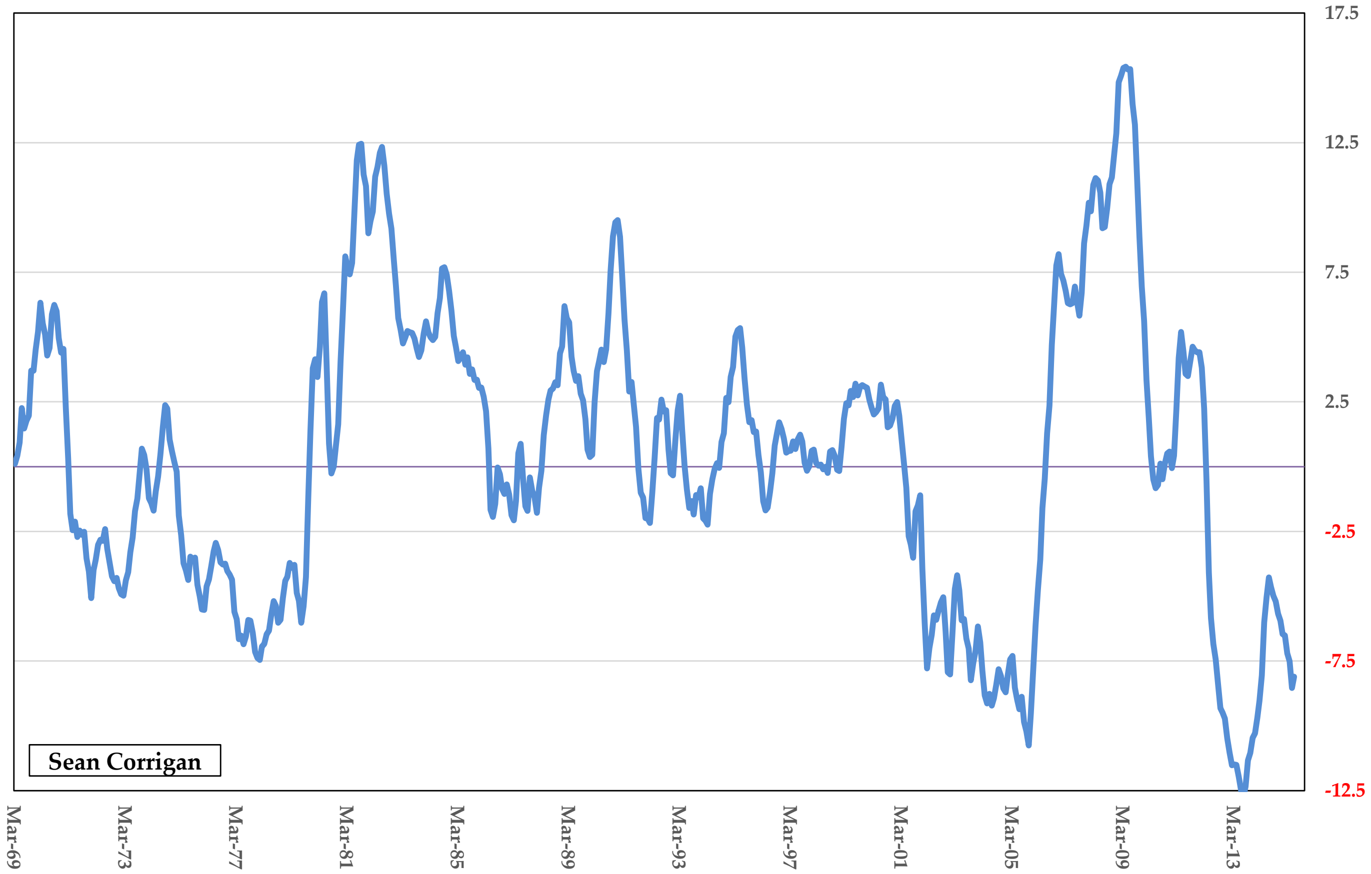
Now let us hark back to that Garden of Eden which supposedly prevailed during the 'Great Moderation', the fifteen years between, say 1992 and 2007 or so. CPI was typically 0.7% higher at 2.8%; the nominal funds rate—depending on whether you take the mean or the median—was either side of 4%, leaving the realized real rate at 1.2%.



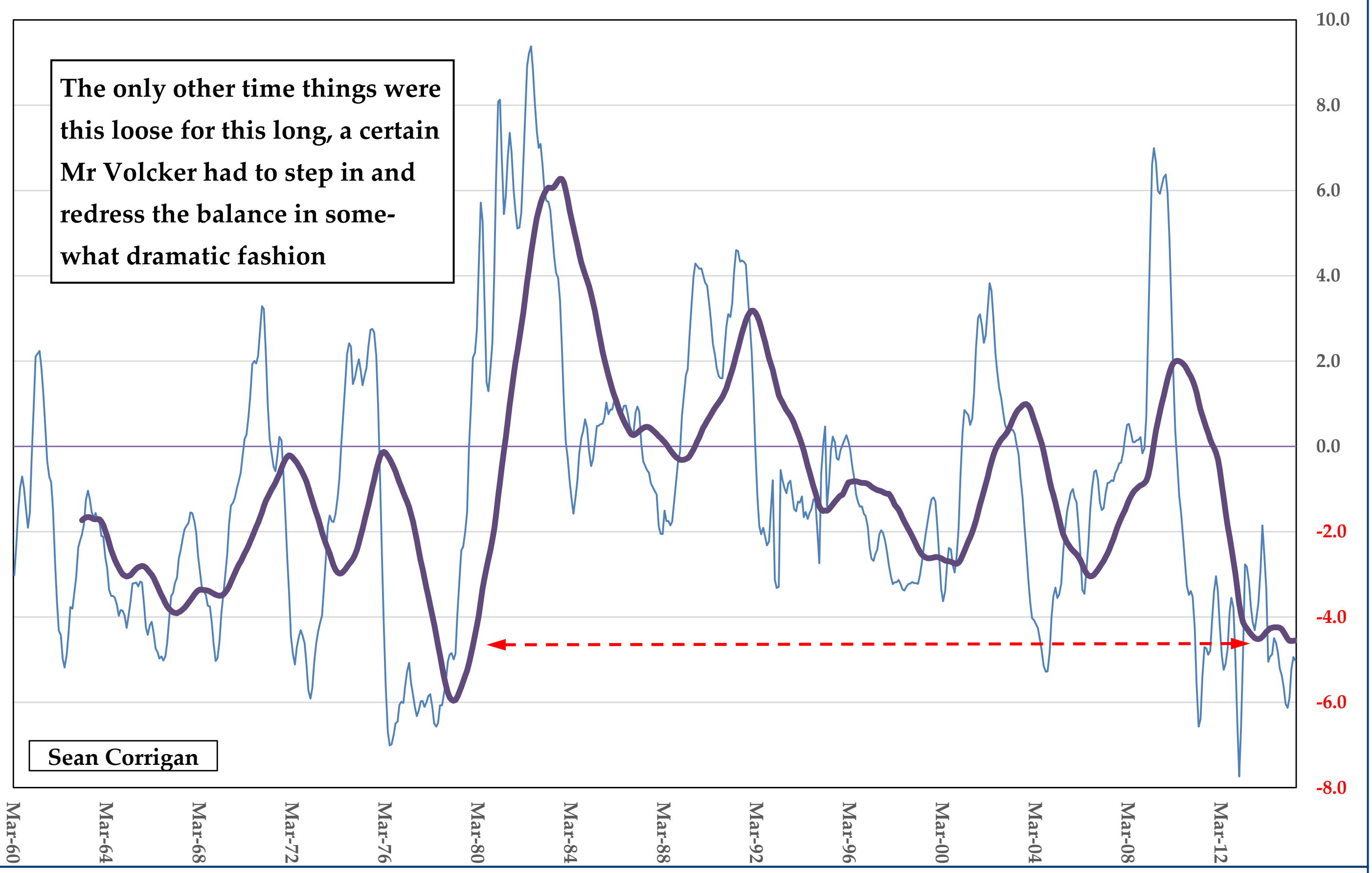
Real & Nominal House prices: *Source - FRB, Bloomberg*



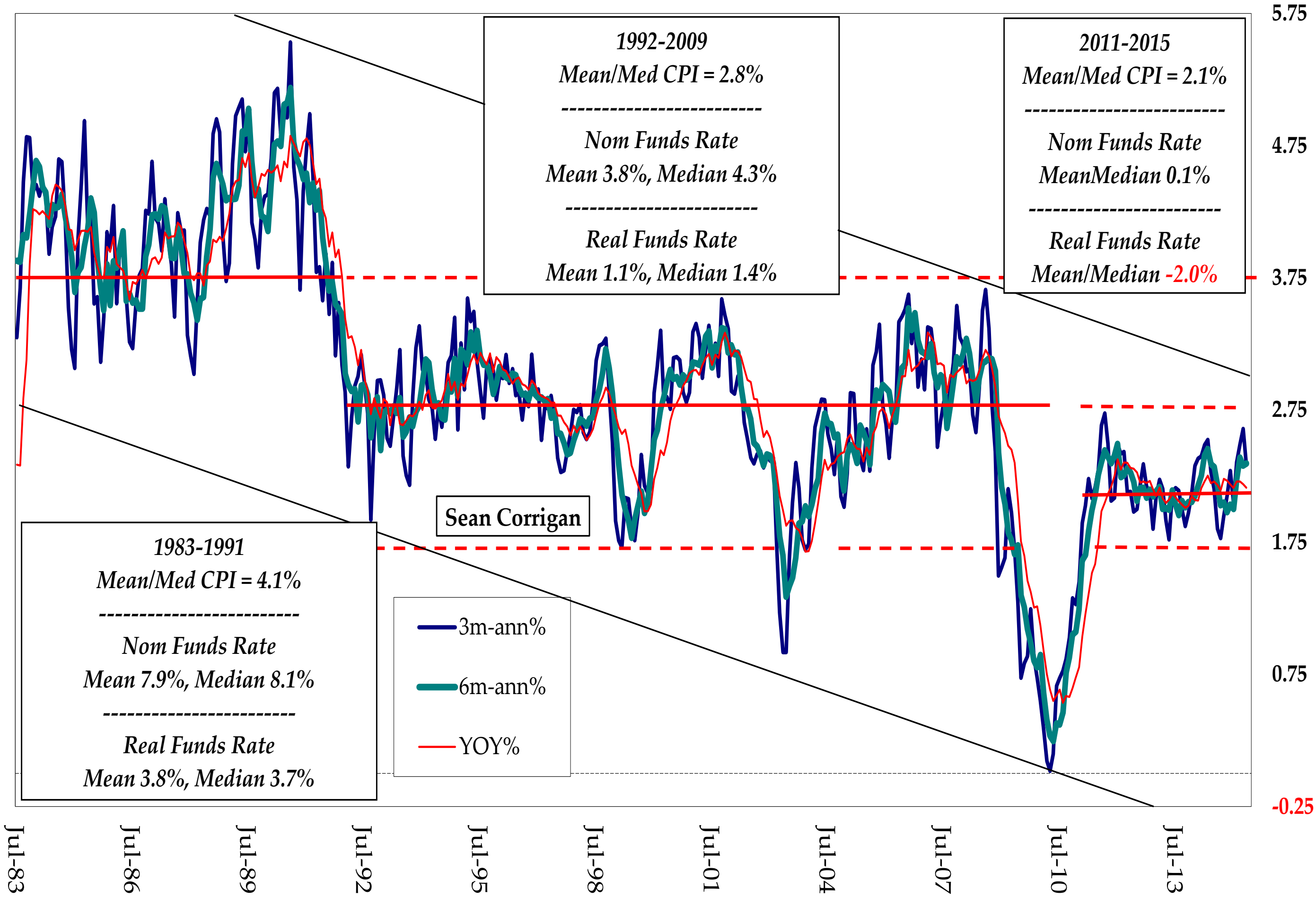
House prices YOY% v Fed Funds, 3mma: *Source - FRB, Bloomberg*



Fed Funds - Private Payroll Growth, current & 36mMA: *Source - FRB, BEA*



US Median CPI: *Source - Cleveland Fed*



Yes, that's right: during the period in which central bankers prided themselves on having delivered Heaven on Earth, the real funds rate was no less than 3-3 1/2% higher than it is today—and let's not forget that, for all our Overlords' hearty self-congratulation at their performance back then, those same, ostensibly halcyon days were punctuated and terminated respectively by the Tech Bubble and the global calamity of 2008!

MANY BE FALLEN OUT OF THEIR WIT

The Map is not the Territory

But if the Fed is using the currently reduced rate of climb of headline CPI as an excuse to do the unforgivable and focus on a real side variable which it can only influence in the short run—viz., unemployment—then it is not alone in its folly.

Japan is, as ever, the crazy aunt in the attic when it comes to this sort of behaviour. It is focused—to the exclusion of all else, it seems—on this whole surreal charade of trying to achieve an arbitrary, self-imposed target of faster price rises by trying to persuade people to take its determination to do just this much more seriously and so build it into their 'expectations'—the mystical forces which shape all reality.

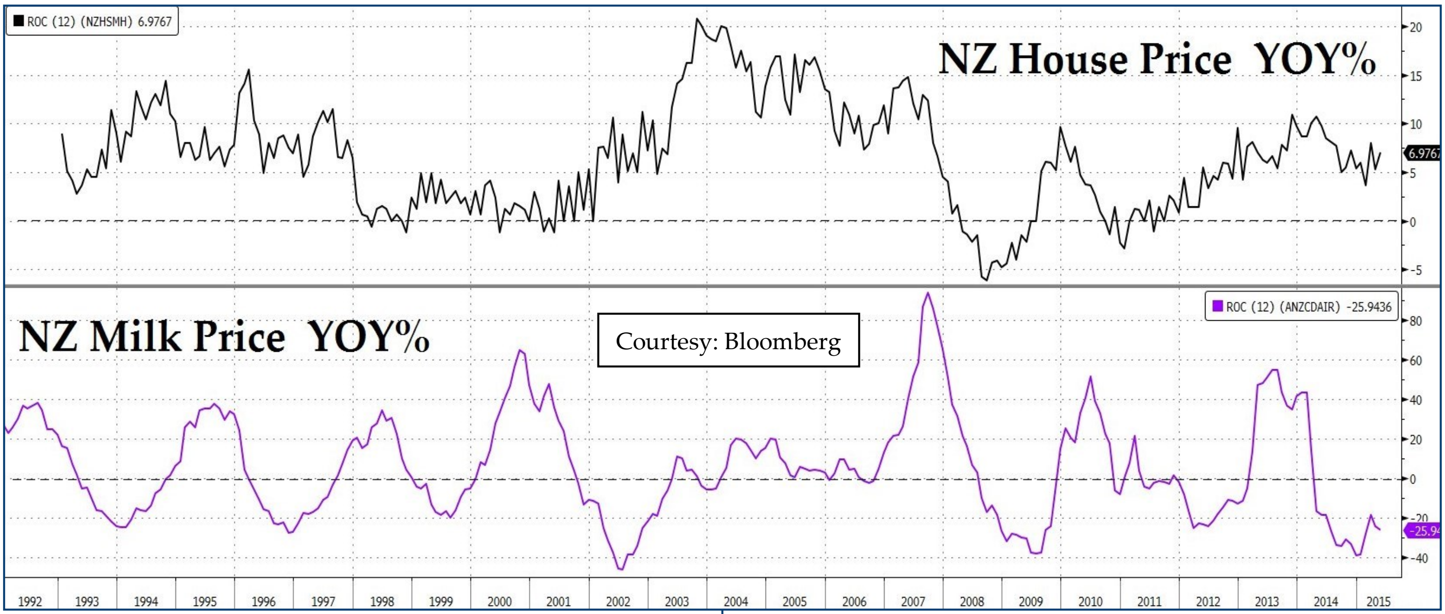
In a development surely beyond all hope of parody, BOJ chief Kuroda even explicitly invoked the spirit of Peter Pan to justify his approach, concluding his remarks to a conference audience with the injunction that if policy-makers only *believe* they can fly then—metaphorically speaking—they will.

Not for him the luxury of second thoughts in the face of either the reluctance of the economy to respond to his ministrations or the consistent finding of diverse surveys of opinion that he is in fact doing more harm than good.

Take the recent Reuters/Nikkei Research poll of business which resulted in one third of the 240 respondents declaring that present yen levels were hurting their prospects, a negative balance which would double to 60% if it were ever to mount to the 135 level. *'Excess* [forex] *volatility is a major negative for investment options,'* opined one of these tellingly.

Moreover, while a good 70% were ready to admit that sales were back to, if not above, levels which prevailed before last April's consumption tax rise, they also agreed that much of the boost originated overseas (and was therefore at least partly just a translation effect of a weaker currency). More ominously, but largely in line with what we have long been predicting would be the case, a good many of them also grumbled that, yes, sales might be higher but so, too, were costs and thus, in consequence, little of this increase was passing through to the bottom line.

But let us not unfairly single out the Japanese : examples of wilful idiocy abound.



While RBNZ head Graeme Wheeler indulged this month in a tirade against the 'crazy' house price rises currently underway in Auckland in particular, it did not prevent him dropping interest rates a week later and simultaneously offering the prospect of more where that came from.

A sudden change in Chinese desire for the nation's key milk exports, among other shifts in demand which are beginning to reveal a little too much boom-time malinvestment took place, has weakened the trade account and depressed GDP so, naturally, looser money is the required remedy. After all, this treatment has such a signal record of success in bringing prompt relief to all those other Austrian-style capital misallocation busts of recent times!

Across the Tasman Sea, things are not much improved. As the standing joke goes, much of Australians' recent income has been derived from digging great holes in their country and either shipping the spoil to China or building homes alongside them. The bifurcation between the two areas is now rather intense, to the utter perplexity of push-button policy-making, as one might well imagine.

Again, a structural change in demand—and an external one, at that—which was exacerbated by the over-investment encouraged by insufficiently tight policy in the upswing is now to be addressed with the blunt instrument of monetary policy. RBA board member John Edwards engaged in a little 'if wishes were horses, beggars would ride' wistfulness in a TV interview this week, sighing that the Bank's job would be easier if only Sydney property was not so overheated.

Well, yes, Mr. Edwards, if only. But how do you suppose it got that way in the first place?

And, seriously, Sport, do you really think a further depreciation of your currency will spark a new round of large scale capex from a mining industry which has just, says Citibank, written off 90% of the value of all M&A undertaken since 2007, recognising impaired assets to the tune of US$85 billion? Even that dreary toll does not take full account of the home-grown impairments with which they still have to deal and it may not include either the horrors facing an LNG industry rapidly turning from 'build it and they will come' optimism to everything-must-go pessimism as Asian spot prices slump from last year's peak just shy of $20.MMBtu to nearer $7 in recent deals.

Do you suppose 25bps off Ozzie borrowing costs, or a few big figs off the cross-rate, will turn that particular super-tanker about any time soon? No, but the former change *will* undoubtedly tempt the real estate flipper to take on another property, or the would-be owner-occupier to dial up the loan:income ration on his impending purchase.

Nor do we need to stop at the Antipodes. Similar concerns are being voiced in Canada where the household debt to disposable income ratio stands at 163%, up 50 points since the collapse of the Tech Bubble ushered in a New Era all of its own, that of unusually low interest rates. Up to 20 of those extra points have arisen since the property-market related demise of LEH gave the authorities the bright idea that we could rescue ourselves from the collapse of one overly-mortgaged house of cards by erecting another, even bigger one in its place.

Despite this—and despite uttering declamations of woe over the fact that its settings have led so many citizens astray (almost a quarter of oil slump-blighted Albertan borrowers have debt/gross income ratios higher than 250%)—the Bank cut rates once more in January, to a lowly 0.75%.

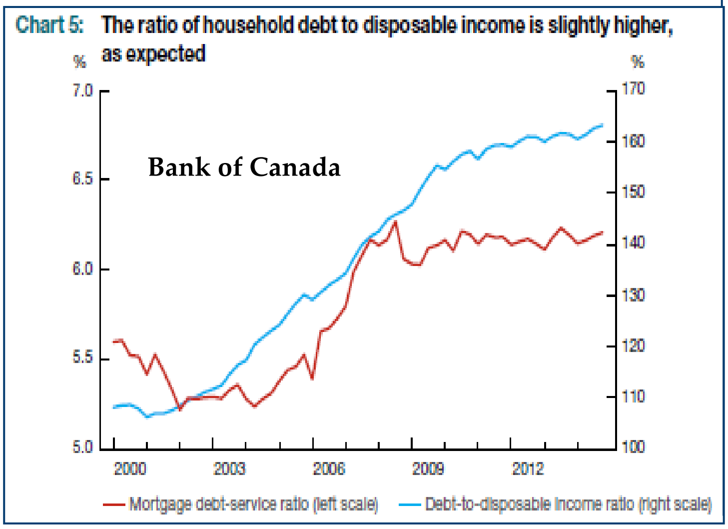
Showing that he, too, is prey to the CPI-fixation, BOC Governor Stephen Poloz justified the move by declaring, in a statement riddled with non sequiturs and question-begging, that: *'First, it reduced the downside risk to inflation by helping bring the economy back to full capacity over our projection horizon. Second, the cut helped mitigate the risk to the financial system by addressing the drop in incomes and employment caused by the oil price shock.'*

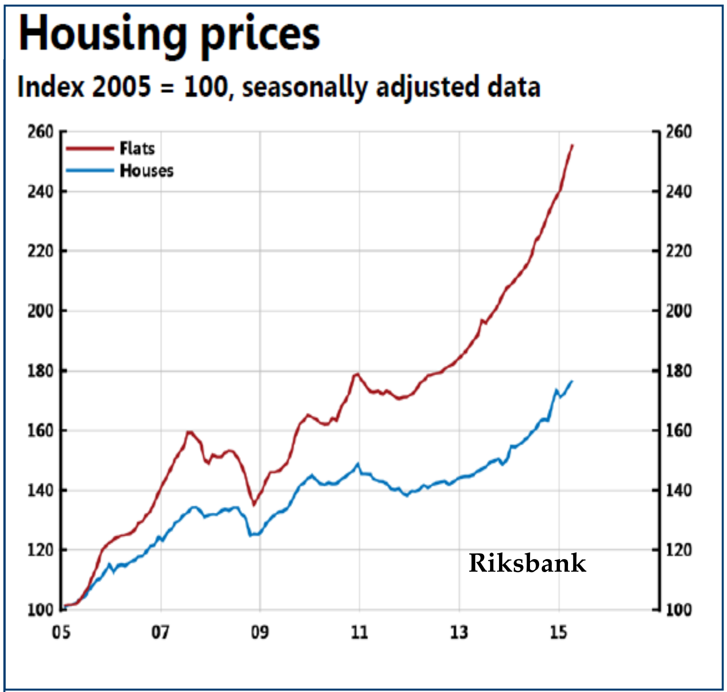
Sorry? Say again? You '*mitigated* the risk' to the banks by incentivizing yet more borrowing against assets you yourself say are some 30% overvalued? I'd hate to be around come the day you decide to *exacerbate* the risk instead!

But this is a disease which not only afflicts central bankers in resource-sector former outposts of the British Empire. There are those among the Scandinavians who seem to have caught a bad dose, too.

Denmark may appear to be among them but we can at least grant that its monetary guardians are hamstrung by the need to maintain the krone's peg to that bird of ill omen, the euro. It is not just because of a CPI fetish then that the central bank has introduced the now-orthodox unorthdoxies of negative interest rates and large-scale bond purchases but the SNB-style attempt to dissuade flight capital from paying any more than the most fleeting of visits to Wonderful, Wonderful Copenhagen.

Moreover, there seems to be some sense there that a drop in CPI is not, per se, evidence of 'deflation', as argued in a recent CB research piece. To the contrary, DNB governor Lars Rohde has just issued a clarion call for a tightening of the terms of mortgage finance—especially a limitation of the extension of interest-only loans to high LTV borrowers—and, realising he has no arrows in his particular quiver, he has also forcefully demanded that fiscal policy be tightened now before things start to really overheat.





As for the Riksbank, well, that is another matter entirely. As Deputy Governor Martin Flodén told an RBS gathering (a group which must contain several people who could tell us a thing or two about financial unsustainability): *'Monetary policy needs to be expansionary until we are confident that inflation has permanently been established at a much higher level.'*

Deputy Governor Cecilia Skingsley also spake thus on Monday last to underline her colleague's message: *'We are not yet home and dry and we certainly shouldn't underestimate the risks of setbacks. For this reason, we Executive Board members are prepared to make monetary policy even more expansionary if we assess there is a threat to the upturn in inflation.'*

Because, of course, given the plot of house prices above, nothing else could possibly be of concern than to succeed in pushing CPI *up*!

The irony here is that credit to both the property market and to non-financial companies seems to be flowing freely enough, as the Bank's May *Business Survey* reported:.

'In general,' it said, *'companies report that access to capital is good and that conditions for external funding are very favourable. One company representative expressed this by saying: "Money is free".'*

Even that pesky CPI is actually comfortably above zero when the possibly one-off and in any case ultimately enriching effects of the fall in energy prices is removed from the calculation. What sort of 'deflation' precisely is it then that exerts such a pall of fear over the good denizens of Brunkebergstorg 11?

Well, yes, 'demand' is weaker than many would like (when was it ever felt to be too much for the businessman one questions?) But there are other factors in evidence which are detracting from our entrepreneur's performance which could clearly be addressed without resort to the floodwaters of indiscriminate liquidity. Quoting again from the *Business Survey*, we find that:

'Costs will increase in that the employers' social security contribution for young people is being raised and this puts further pressure on companies to become more efficient. The companies in these sectors will review their schedules and optimise staffing in relation to demand, to hold down the number of hours worked. The effect is expected to be both that the number of employees declines and that the increased costs are passed on to the customers.'

Oh Dear! Another Social Welfare 'free lunch' turns out to have a Michelin star bill attached for those being driven to economic hell along the road of Collectivist good intentions.

Meanwhile, exporters have admitted that the deliberately weakened krona has not brought much in the way of extra 'organic' revenues, only money illusion translation effects. At the same time, those at home are suffering a bout of Japanese style profit compression and/or real income reduction.

Costs, we are told, *'have increased substantially in the consumer-related industries, which include the retail trade and the service companies mainly aimed at households. The latter mainly highlight the weak krona in relation to the dollar as a reason for cost increases. To some extent, consumer-related companies have already passed on the costs to their customers by raising their sales prices… '*

'There is still tough competition and in several industries customers' price comparisons are made easier by the increase in e-commerce...' - trained economists should welcome the efficiencies involved in the lowered 'shoe leather' costs of knowledge acquisition, not clamour for the Riksbank to print more reserves to offset the gains. As a result, the report continues, *'...companies are therefore allowing cost increases to affect their margins first and foremost, at the same time as working intensively on reducing other costs'* - among them the wages they pay, one presumes. And so the misery of ill-designed policy is spread far wider and defeats its own object along the way.

When the history of our times is written by our hopefully wiser descendants, they will surely scoff at us for succumbing, with hardly a protest, to this madness of hewing to a self-imposed CPI target to the exclusion of all other considerations. They will shake their heads in amused condescension that we do this regardless of how debilitating the side-effects, or of how despotic and unwieldy the 'macroprudential' sticking plasters applied to deal with these in turn become.

All is not completely lost, however for here and there, glimmers of an older wisdom can be seen peaking through the thickening overcast of intellectual gloom.

Our good friend Bill White has been at the forefront of those who question the folly for some good while now but recently ex-Buba head, Axel Weber, joined the lists with a hard-driving polemic carried on, of all places, the website of that hot-bed of Keynesian progressivism, Project Syndicate.

We recommend you read the whole article, but, for our purposes it will suffice to give you what our American friends would call the 'money quote':

'Central banks' exclusive focus on consumer prices may even be counterproductive. By undermining the efficient allocation of capital and fostering malinvestment, CPI-focused monetary policy is distorting economic structures, blocking growth-enhancing creative destruction, creating moral hazard, and sowing the seeds for future instability in the value of money.'

How could a card-carrying Austrian like your author quibble with that?

Market Observations

Dear US equities, How do I rate thee? Let me count the ways...

Way up here at record highs, there are still those who maintain that the US equity market is in no way overvalued. Given the ultimately indeterminate nature of such things, they may even be proven right. But what we can also say is that on several key valuation metrics equities are rapidly entering into the sort of territory only experienced once in the modern era, right at the very peak of the Tech mania of 15 years ago.

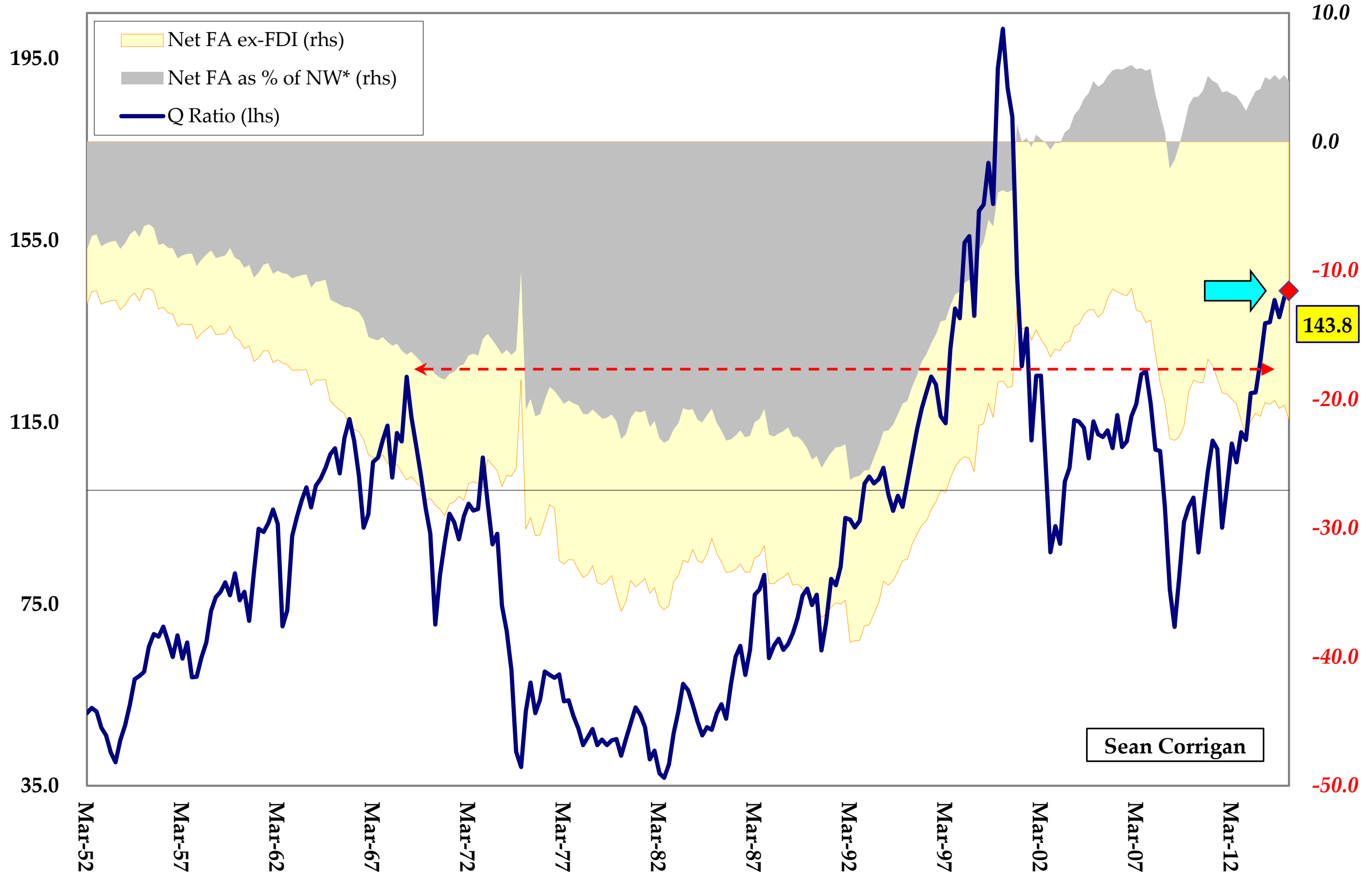
To show this we shall use the figures provided by the Fed in its comprehensive, quarterly Financial Accounts report—one which has the merit of amalgamating listed and non-listed corporates in an overarching combination but which therefore has the one demerit that the compilers have to estimate what the value of the unquoted portion might be when they give us numbers we require for total market cap.

What they also fail to provide are figures for revenues, though we can estimate these to a fair degree of accuracy from partial data provided by the Bureau of the Census, numbers which a cross check with the BEA's enhanced GDP by industry series, with S&P quarterly sales per share numbers, and with the annual IRS compilations of tax filings. Together these accord a fair degree of confidence in the representative nature of the ones we use.

We are also lacking timely numbers for interest payments, needed for calculating cash flow. Here, again, we use what balance sheet data we have, multiply it by existing market long and short rates and verify the reasonableness of our answer by reference to the annual numbers which the various statistical agencies report one or two years in arrears..

That done, we derive our version of Tobin's Q. Our first variation on the classic formulation arises from our distrust of the new protocol, adopted by both the Fed and the BEA, which treats IP as a fixed asset on the books. Yes, it undoubtedly has *some* value, but it can include that slippery fish 'goodwill' and can also consist of matters locked up in the heads of the firm's 'wetware', specimens of fickle hu-

True Q Ratio - adjusted for replacement cost of RE, IP & Net Financial Assets: ***Source - FRB***



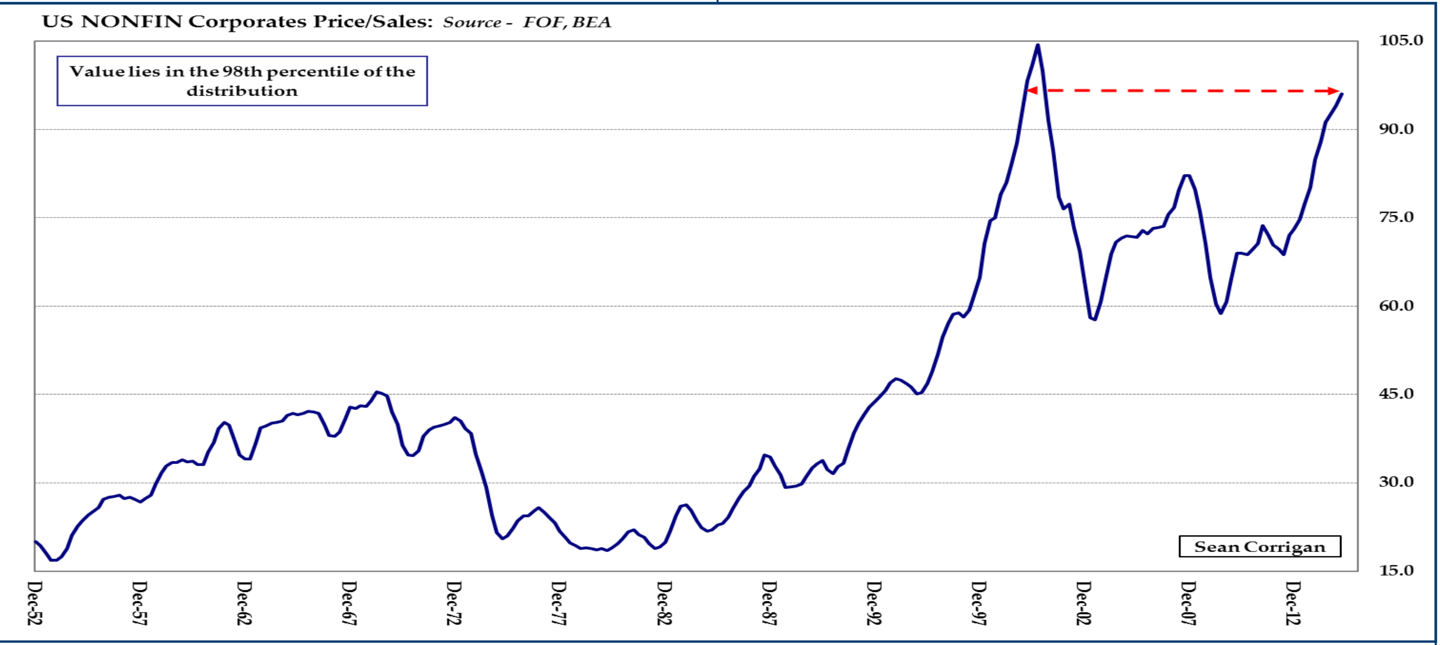
manity who may readily choose to ride up and down in someone else's elevator tomorrow and so , while never of course actually infringing patent law, can thereby rapidly transfer the recipe for their former paymasters' commercial advantage to the operations of their new ones. Rather than fret over how well the data deal with this, we strip them out.

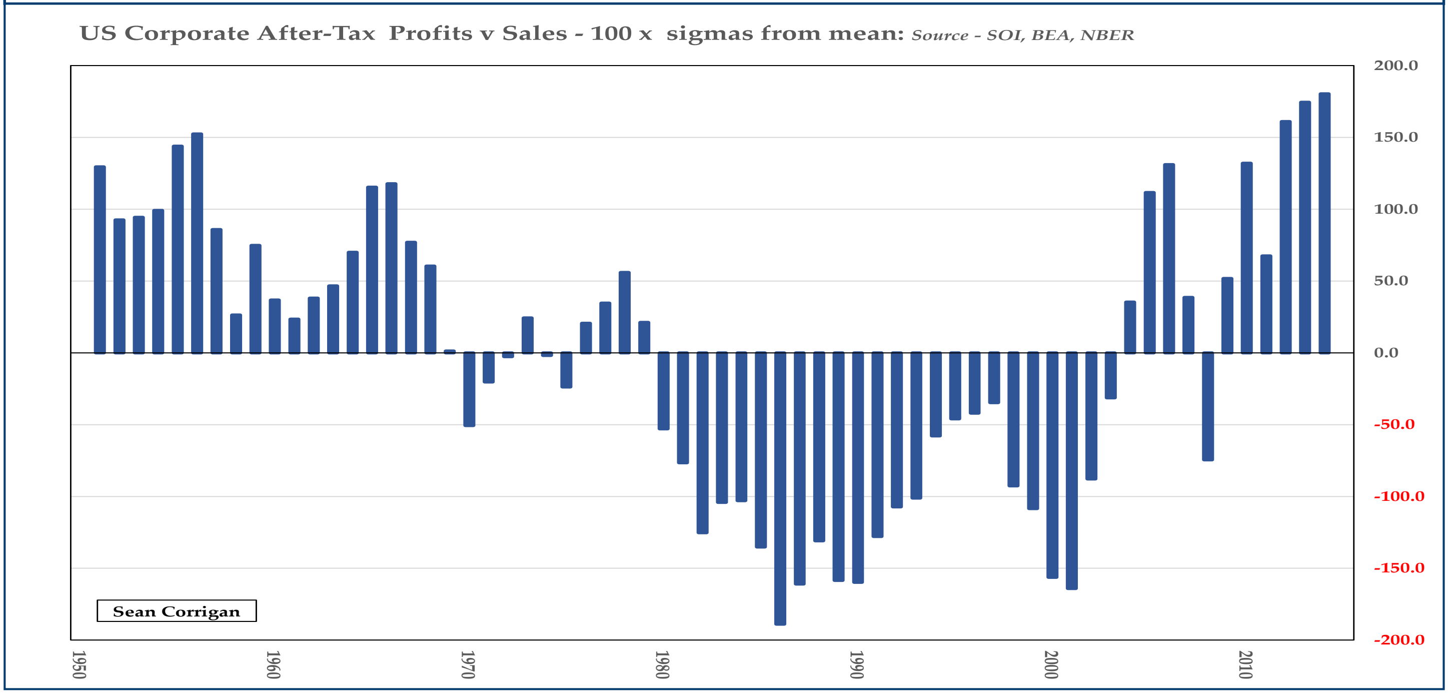
Next we reduce real estate assets to replacement cost on the basis that we do not want to include one set of notionally inflated assets in the calculation of another.

Finally, we take a jaundiced view of the fact that the average non-financial firm today is two parts machine shop, one part pension fund and one part asset manager-cum-bank. So, if there are positive net financial assets we deduct their total one for one from the posted market cap before we compare that with what is left on the firm's books. If there are instead net liabilities, since standard accounting deducts these one for one from tangible assets, we can simply revert to net worth.

Having done all that, what we find is presented here in graphic form: a non-financial universe only ever more expensive in the five years from the Committee to Save the World to the bursting of the TMT aneurysm.

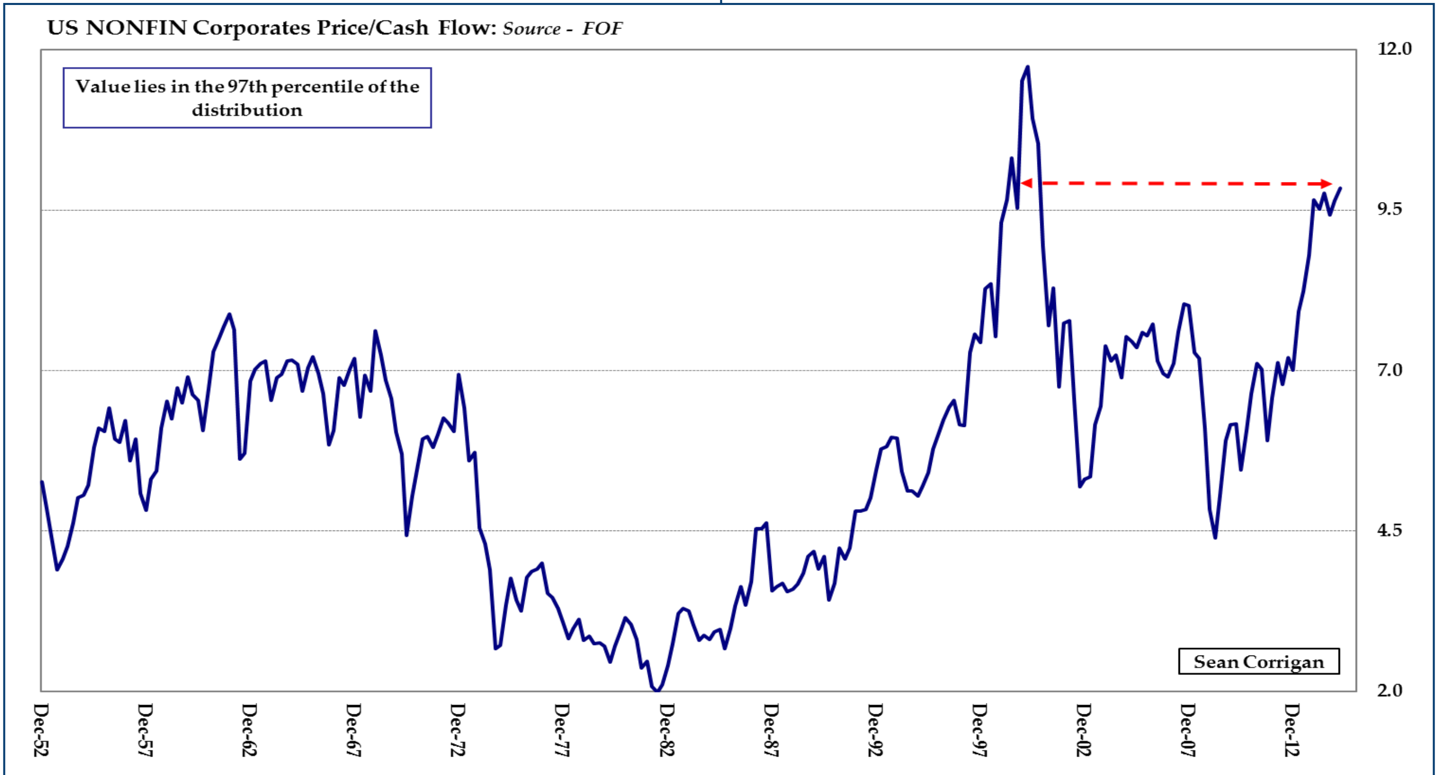
Price to sales, according to our best estimates are even more extended, sitting in the top two percentiles of the last 63 years' distribution, aided by the fact that the sales margin is one of the most elevated ever seen. If mean reversion hold any terrors, this last cannot be entirely good to know.

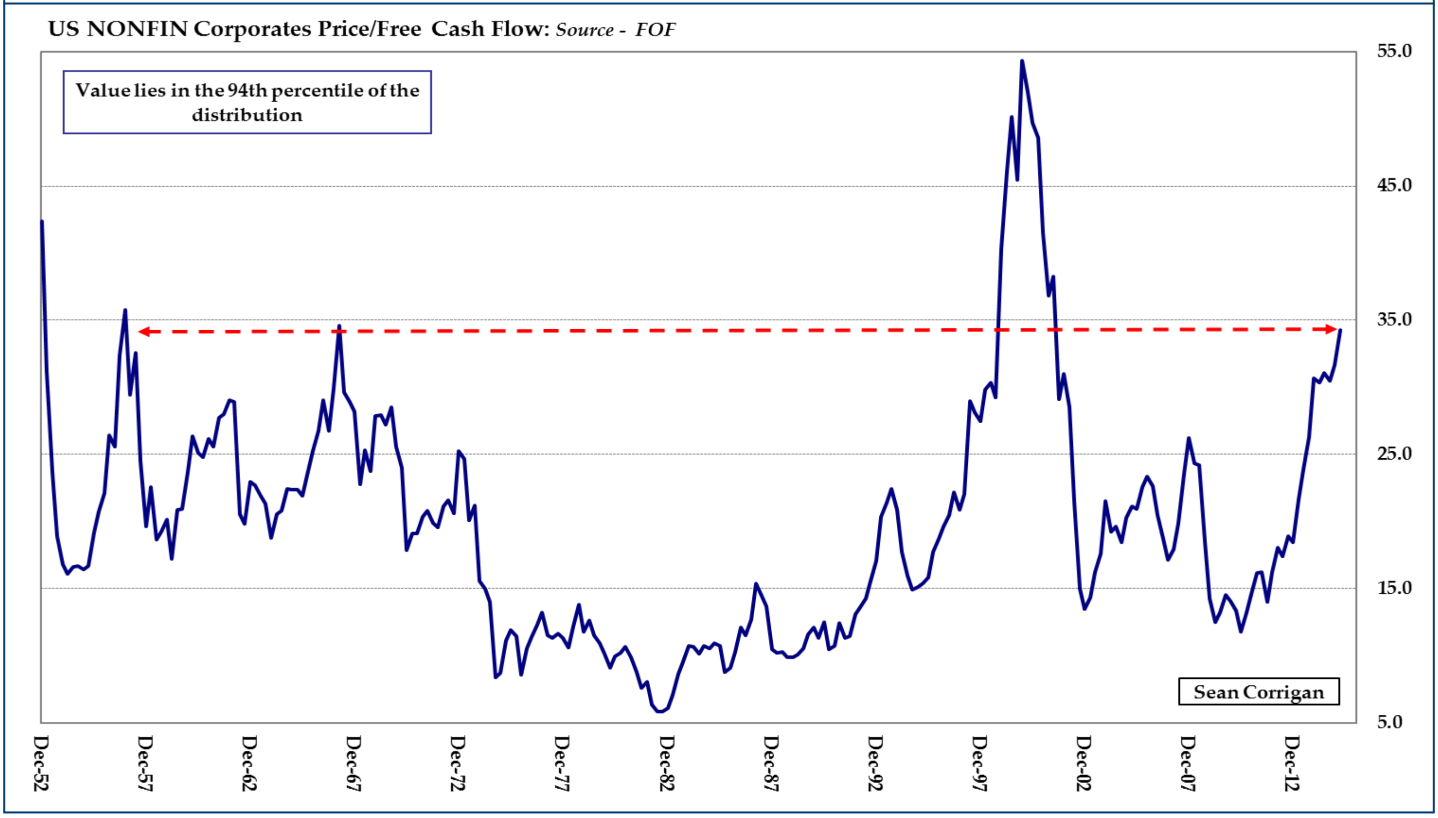


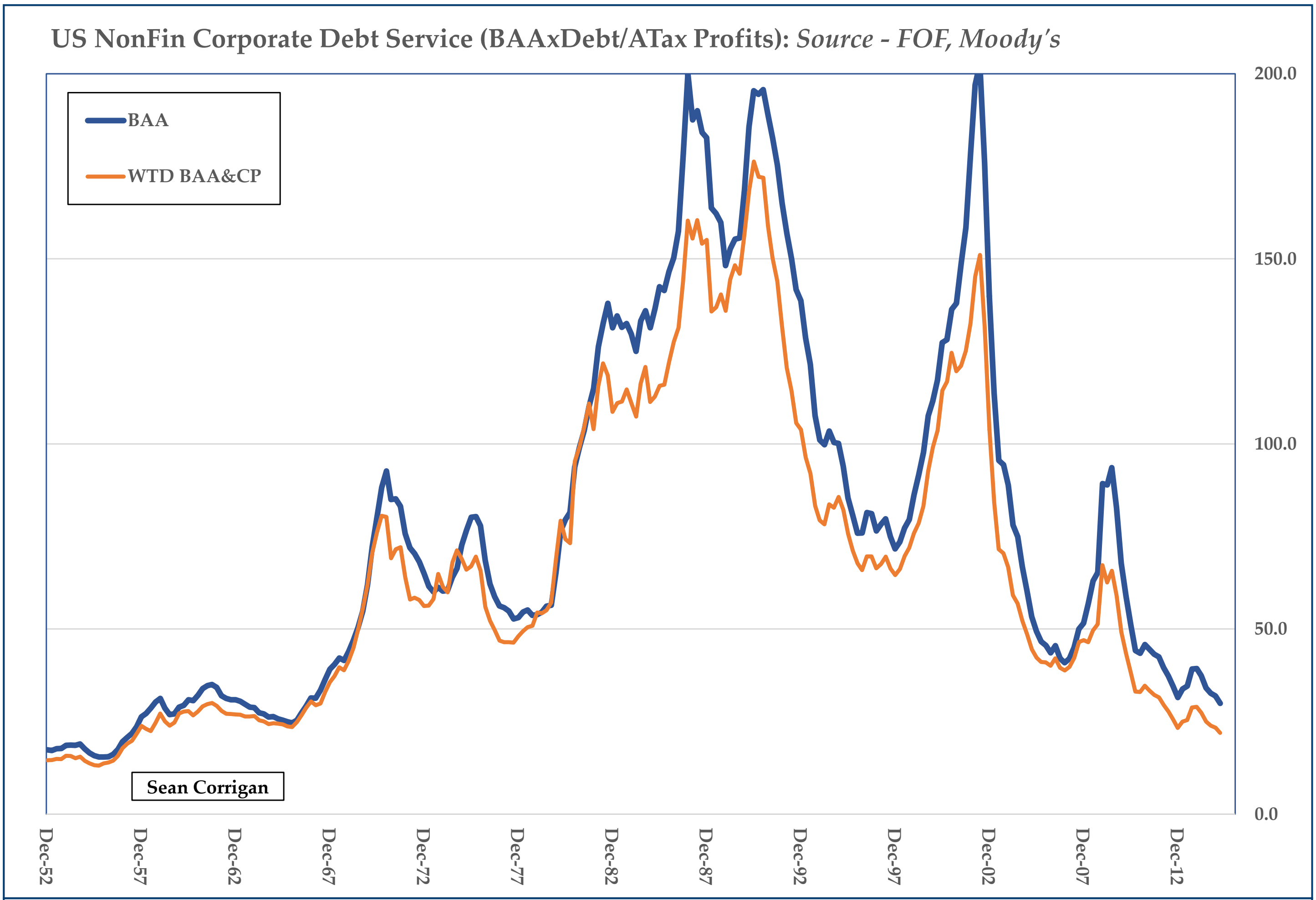


Price to cash flow paints a similar picture, up in the 97th percentile and only bested at the very peak of the last great suspension of critical faculties. The same sorts of price to free cash flow levels have been seen on four previous occasions, but the measure nevertheless again finds itself in the mid-nineties in percentile rank terms.

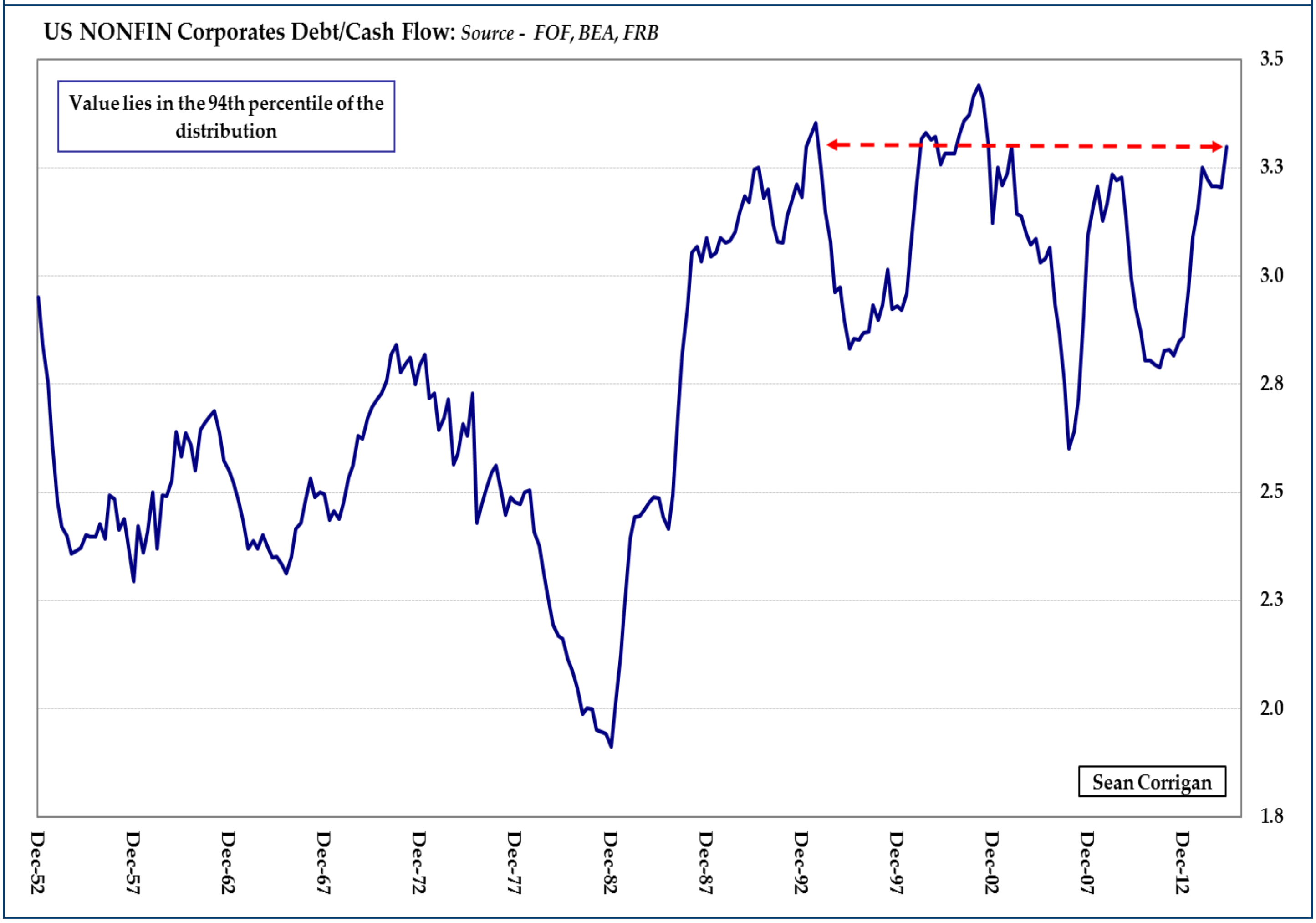
Then there is the cost of servicing debt and debt to income. Just like a Stockholm single-family home owner or an Albertan apartment flipper, Corporate America has taken an extraordinarily low debt cost for an excuse to load up on the gearing. Interest as a proportion of profits has not been this low since the late 1950s (one reason for historically high margins) and this has proven an irresistible temptation for the C-Suite to grow a debt to cash flow multiple to level which has only been seriously outstripped around the time of WorldCom's demise.







US NonFin Corporate Debt Service (BAAxDebt/ATax Profits): *Source - FOF, Moody's*
BAA
WTD BAA&CP
Sean Corrigan
200.0
150.0
100.0
50.0
0.0
Dec-52
Dec-57
Dec-62
Dec-67
Dec-72
Dec-77
Dec-82
Dec-87
Dec-92
Dec-97
Dec-02
Dec-07
Dec-12



US NONFIN Corporates Debt/Cash Flow: *Source - FOF, BEA, FRB*
Value lies in the 94th percentile of the distribution
Sean Corrigan
3.5
3.3
3.0
2.8
2.5
2.3
2.0
1.8
Dec-52
Dec-57
Dec-62
Dec-67
Dec-72
Dec-77
Dec-82
Dec-87
Dec-92
Dec-97
Dec-02
Dec-07
Dec-12

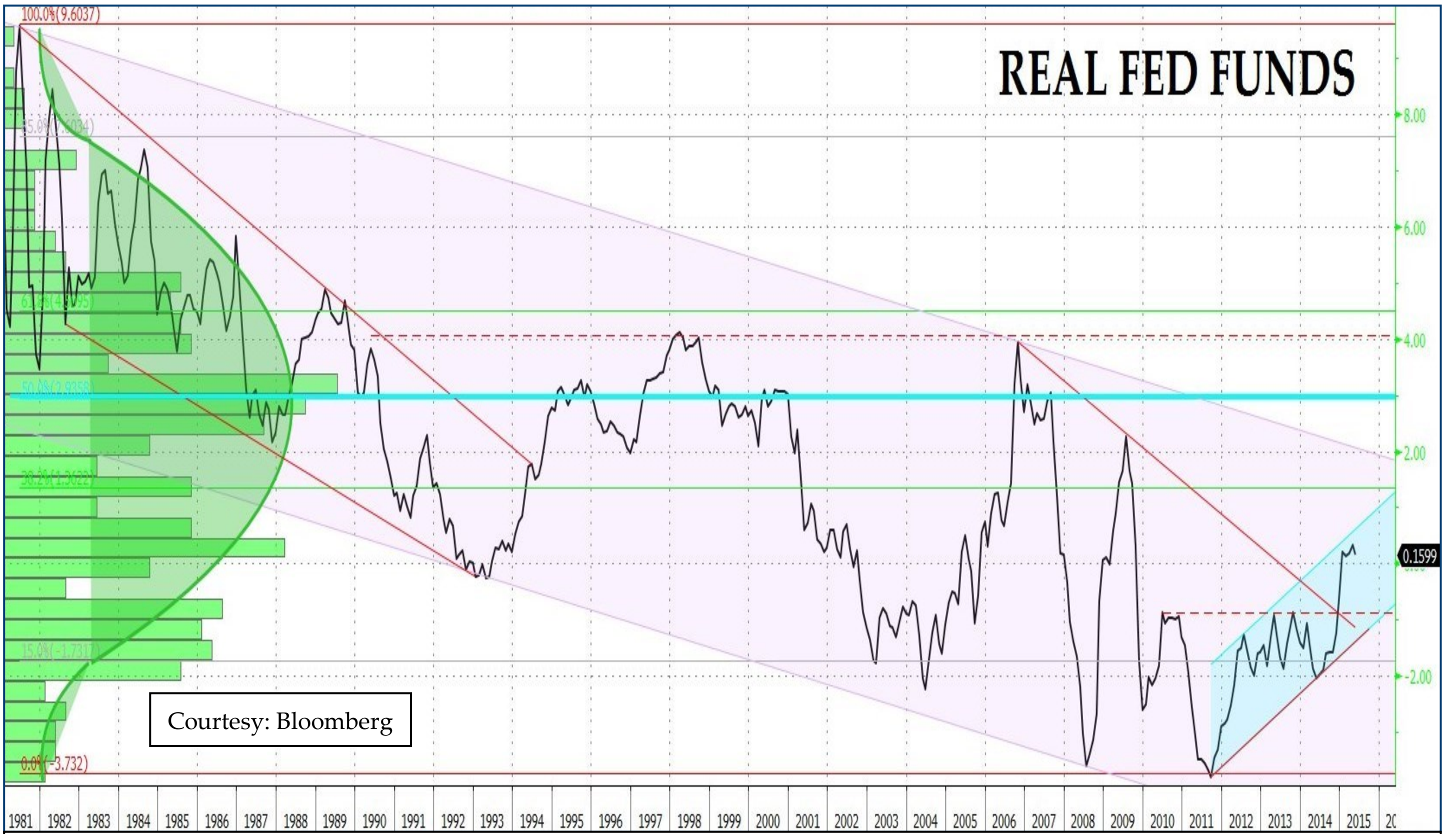
One other thing we know is that, though nowhere so aggravated as in China, US margin debt is nonetheless right up there with the best of them as a proportion of market cap. What we also should bear in mind is that the one-way bid for equities is in good part predicated upon the fact that the central banks have deliberately sought to make fixed income alternatives as unattractive as possible to its buyers.

That was fine and dandy while they were being aided in this endeavour by the self-accelerating, Ponzi-like rush to the peak of debt prices was keeping those in bondage to their benchmarks strapped to their seats at what was becoming not just a casino, but one loaded with flammable material and perched over an active fault line. However, the dramatic reversals suffered in the past few weeks may have served to focus the punters' minds once more on the desirability of actually enjoying an income stream. It certainly taught them a harsh lesson about the perils associated with reaching for an extra few basis points through leveraging up a normally staid asset class now come to display some of its highest volatility on record.

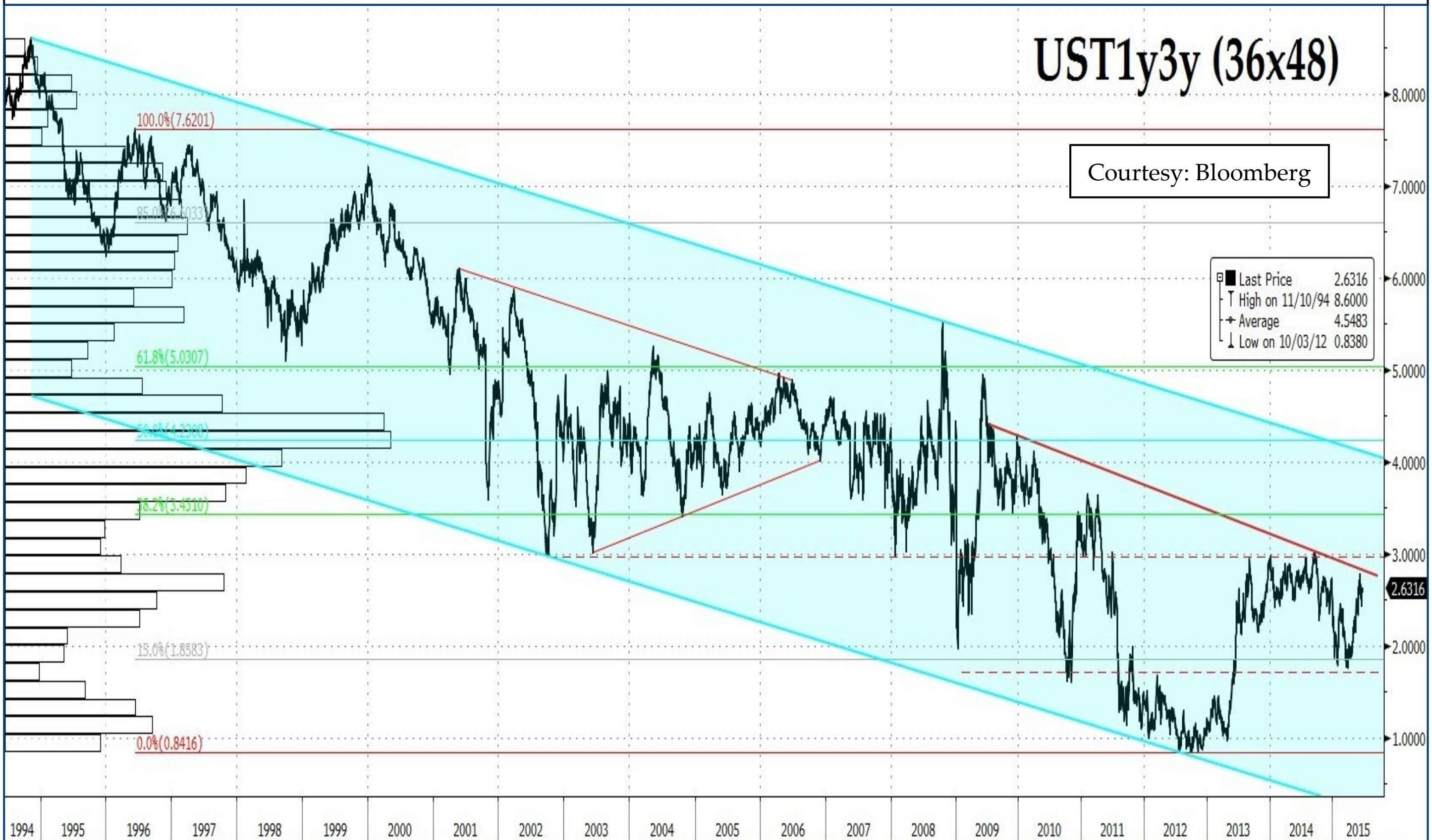
This is where things get interesting for equity investors, too. As the following graphs attempt to show, the blind chase for duration and credit exposure may finally be over after a long, long run which has lasted almost as long as even your grizzled author has been in the market. In part this has come about not just through the growing sense of frustration felt by long-term, buy-and-hold investors, such as pension funds and insurance companies, but also by dint of the scary lack of depth in a market where unceasing central bank offtake on one side and the heavier regulatory burdens imposed on dealers and their funding banks on the other have conspired to endow trading with an unprecedented degree of turbulence at the very moment when the BPV of the instruments involved has never been greater.

If—and the conditional is still a major one at present—this really has sounded the death knell for the Great Bond Bull Market and *if* they have therefore made their last widow, what we have next to focus on is the slow, punctuated, erratic business of gravitating back to higher-yield clusters of past value and eventually to mean/mid reversions *in toto*.

What that will all mean for stock prices is anyone's guess but it surely cannot fail to take the forced buyers away from the table even as it should eventually dampen some of the enthusiasm for buy-backs, buy-outs, debt-financed takeovers, and all the other Miller-Modigliani, tax-arb, jiggery-pokery of using cheap credit to generate pricey equity. Won't that be fun when it happens?



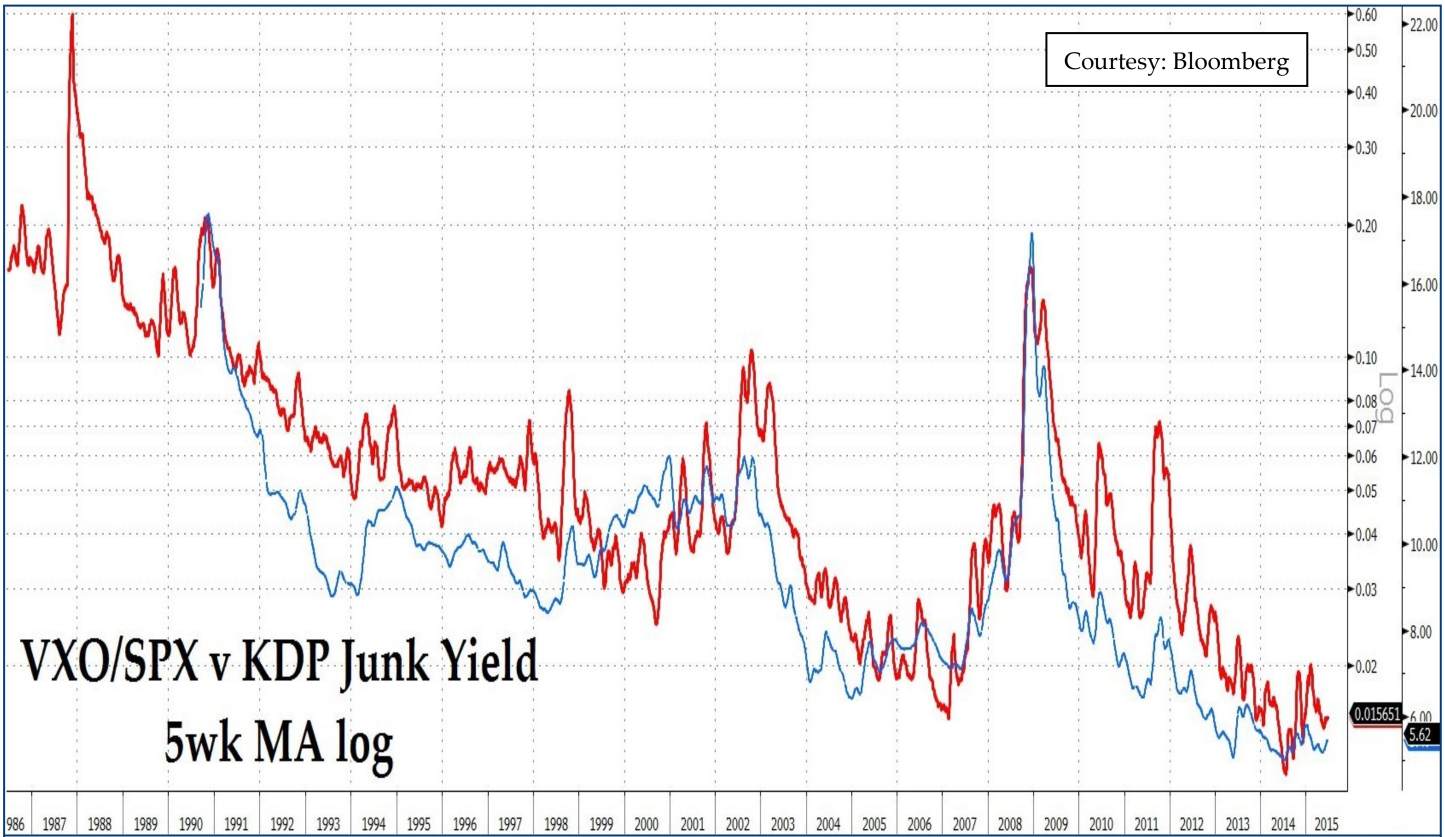
We have discussed how far below 'neutral' the Funds rate is. The above suggests we may be rejecting those extremes, even if this move is due to the impact of the oil price decline on the CPI side of the equation. As that drops out of the calculation, will the Fed be forced to prevent a destabilizing, pro-cyclical collapse in real yields by actually tightening?



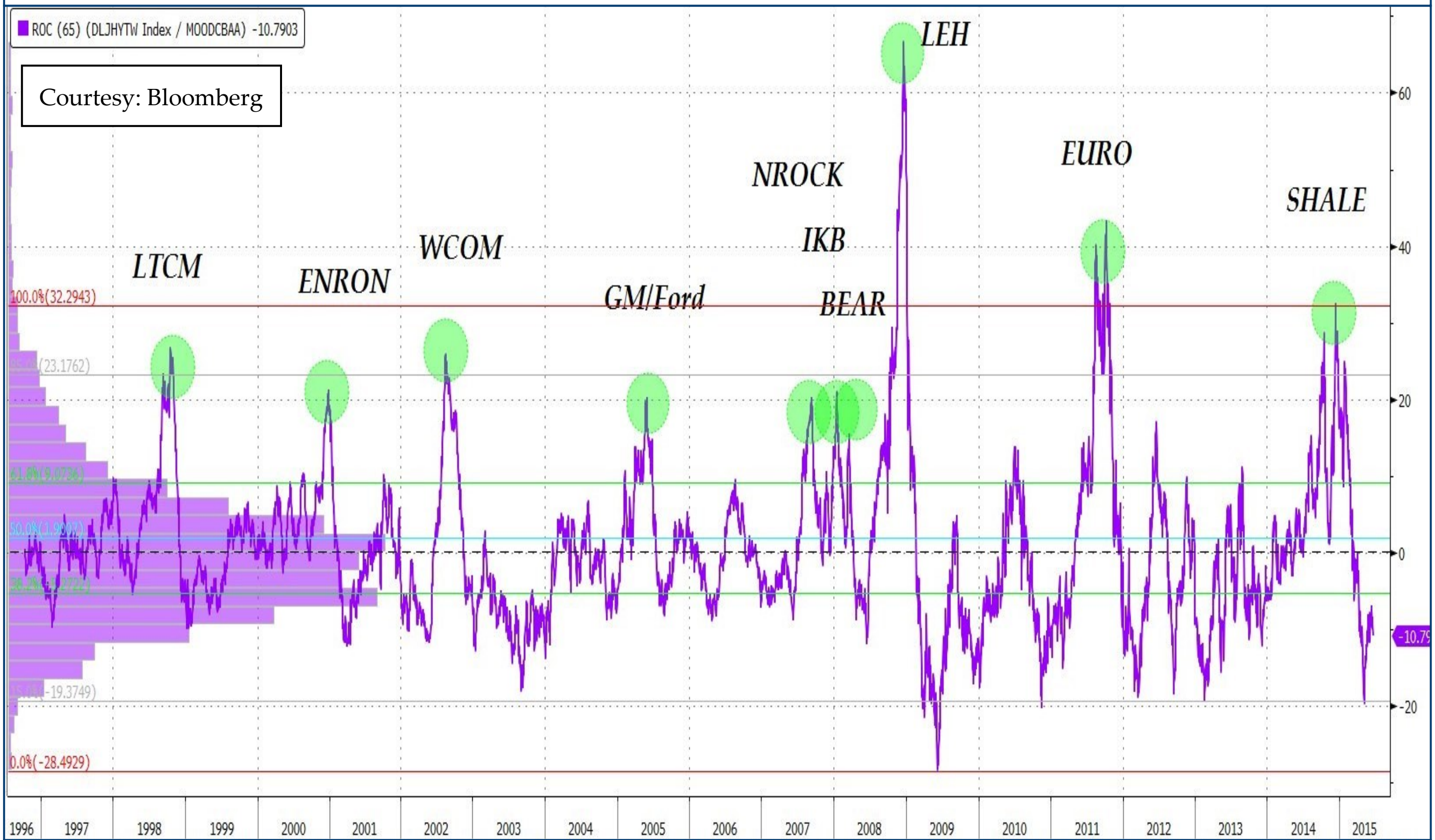
Already a nice 180bps move up from the Operation Twist and QEIII lows, but can it now push through the GFC trend line and the old Tech Bust bottom? Just remember that implied forward yields of up to 5%in this part of the curve back in 2006-7 were not, in themselves, enough to preclude the stock market from making what were then major new highs.

The same sort of impression can be had from BAA yields, this time in a distribution which stretches all the way back to the yield spike which took place during the Crash of '87, the starting point for almost three decades of bond bullishness to match the preceding three decades of sell-off. 5.50% looks key— scene of earlier lows & the Taper Tantrum high.

Here we superimpose BAA yields from the past 20 years on their own trace of 76 years earlier . Lehman Bros is seen to equate to CreditAnstalt, the 1931 bankruptcy which froze European credit, instantly rendered British banks illiquid and forced the UK off the gold standard. It also suggests that the Taper Tantrum was our 1937 moment. Pearl Harbor ahead?

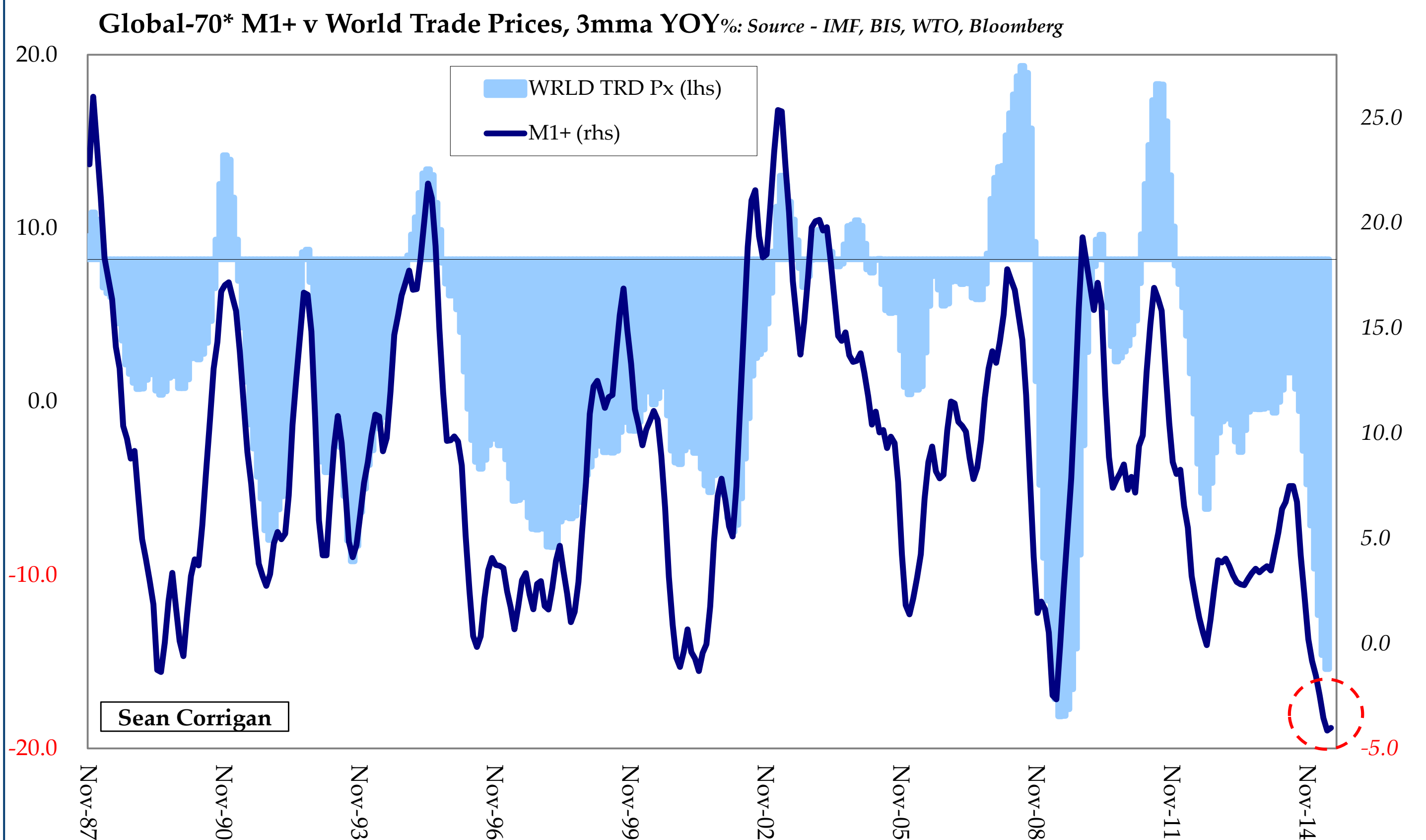


In red is the inverse of our usual 'Blue Sky' stock optimism gauges (roughly, the fraction of an index's value people are willing to pay for put protection) Being inverted, spikes are stress points and, as can be seen in blue, they neatly coincide with sharp increases in junk yields. What is also evident is that risk is not now exactly at the forefront of minds



A similar conclusion can be drawn from this plot, one which maps out the changing relation between mid-investment grade credit (in the form of BAA yields) and junk. The seismographic nature of credit episodes is clearly apparent as is the present belief that we will not be sitting through a screening of *San Andreas* any time soon in credit market terms.

The pause after its 23% run has meant dollar RSIs on a daily and weekly scale are comfortably neutral. Nor have we so far tested bullish resolve too much. The long-term chart would be completed symmetrically in time and space if it took until late in 2017 to rise back to the starting point of the last cyclical decline, neatly matching the 80s' Volcker move.



The chart does not show it, but global money supply has ticked up in the past two months, largely because the ECB's sizeable infusions were for once not being immediately dissipated in the form of a weaker currency. A stable yen helped the cause, too. Clearly, the most likely source of change rests with the near term fate of the dollar as discussed above.

Disclaimer

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