



Finally, we glance at the rout in the bond markets and wonder if it is just an example of sand-pile criticality – i.e., whether yields are rising, well, just because they are rising – or whether there might be a few nuggets of useful information lurking within the move. We conclude with some brief thoughts on an oil market which has managed to confound all those who typically only turned bearish right at the bottom.

Sean Corrigan

Which one shall I buy next?

For all the tea in china

There seems no question that the main topic of discussion this month has to be the goings on in China where a blizzard of top-down pronouncements and government directives is falling amid the seeming contradictions of a rapidly worsening real economy and an hysterically popular stock market. We add our twopenn'orth to the subject.

Meanwhile, the US – famously the 'least dirty shirt in the basket' in the lapidary phrase of ex-Dallas Fed boss Richard Fisher – has suffered something of a decline in its ratings in recent months on the back of a slew of weaker numbers; a drag only just being overcome by the assumption that this further delays that totemic first rate hike by the Fed. We try to assess whether the recent deceleration is anything more than temporary.

In the wake of an intriguing general election in the UK, we take a look at what it means for both policy and politics, stopping to offer our own rejection of Paul Krugman's barely rational diatribe against the country's 'austerity'. Europe, too, comes under the loupe when we parse just what it is that the esteemed head of the ECB presently thinks it 'takes' to get the economy rolling once more.

IL MILIONE: Tales from Cathay

Amazingly, there are those who still deny that the Chinese economy is struggling, despite all evidence to the contrary. More numerous still are those who assume that Xi Jinping has gathered to himself enough power to fine-tune a successful transition from a quantity-based system - where production was all too often seen as an end in itself - to a quality-based one where the satisfaction of consumer needs by genuinely profitable businesses takes its place.

Other than some push-me-pull-you hand-waving about the need to 'increase the share of consumption in GDP' very few of the latter class of optimists seems to have a clear idea either of what is needed, nor of the enormous scope of the difficulties carried over from the era of ghost-towns, local government capacity duplication, and the inefficiencies of the nation's incestuous state-bank-industry triangle.

To the first batch, that of the eternal optimists, we can do no better than to counterpose a weary litany of economic disappointments so bad that even the typically sunny official representation of the facts can no longer really disguise them.

For example (and citation does not imply endorsement) the given numbers for first quarter real GDP offered up a 5.3% annualized rate shockingly at odds with the Kabuki theatre being enacted over whether the economy will 'break' below the talismanic 7% barrier any time soon. At the same time, it appears that nominal GDP was a bare 5.9% ahead of that in the like period a year ago with the 'secondary' sector which consist of such stalwarts of the world of Five Year Plans as mining, manufacturing, construction, & utilities up only 1.9%.

Updating these somewhat, the just-released data for April show fixed asset investment decelerating further to a 15-year low of 12% YOY, a tardy enough clip which concealed the fact that outside of the areas where the regime is actively pouring concrete in time-honoured fashion, the non-infrastructure segments were actually increasing at a relatively lowly 10.4% pace. Incidentally, that 20% gain infrastructure spending was mirrored in a 26.4% increase in fiscal outlays. *Plus ça change.*

The echoes of the ongoing bubble and bust in real estate were also still reverberating, if at a reduced decibel score

after the recent easing measures allowed April to stage something of a rebound from the depths of March. Still, that left the total area on which real estate construction was taking place down a fifth, purchases off a third, and land prices down 30% over the past twelve months.

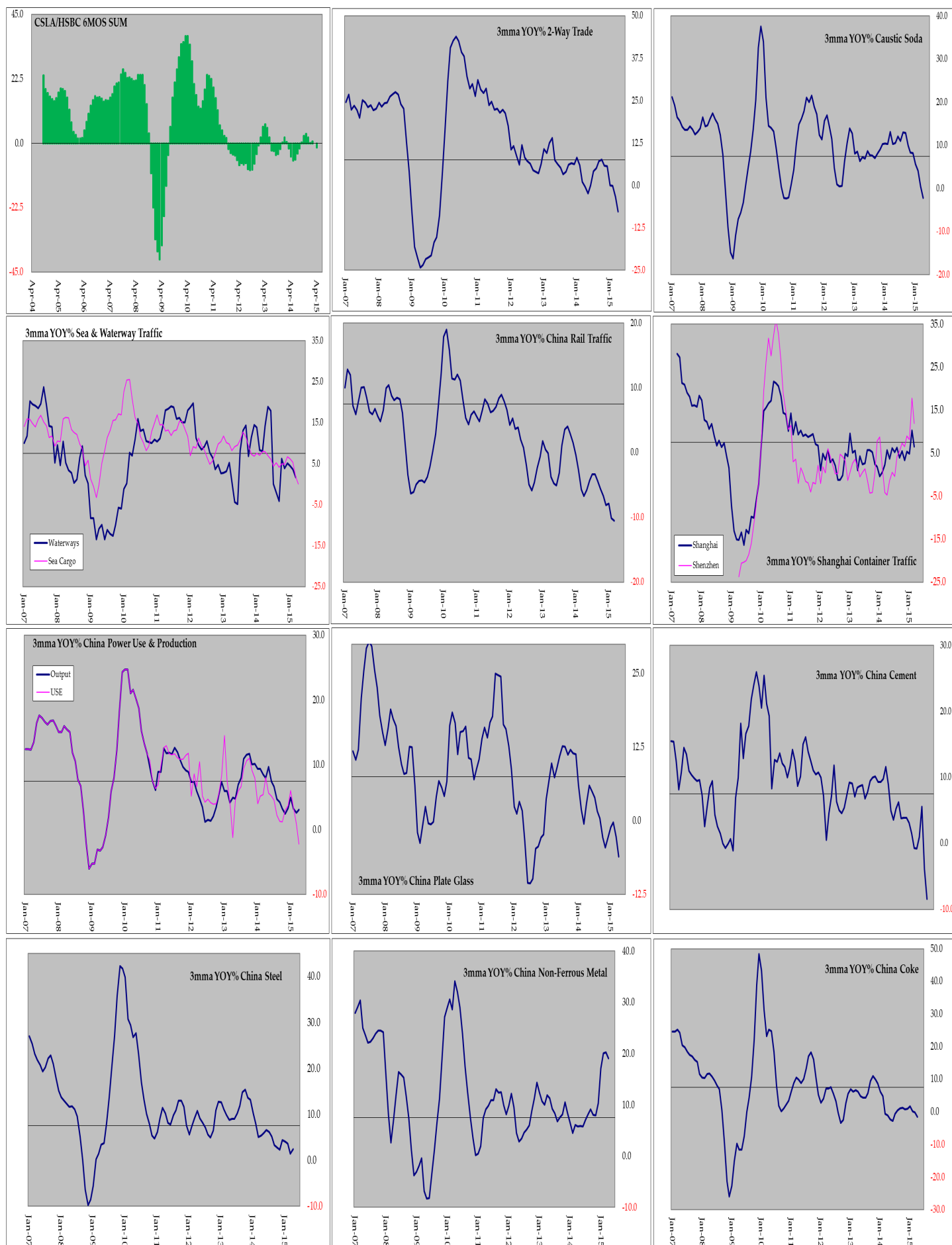
On the output side, industrial production has been running at a 5.2% annualized pace, which volume measure combines with the reported 6.5% drop in associated producer prices to suggest that revenues (even on the possibly heroic assumption that all these new goods will swiftly be sold at existing prices) are still shrinking.

Again, despite a minor uptick in April (possibly related to the vagaries of the Lunar New Year), non-residential power consumption is still a miserly 0.4% ahead of where it was in the first four months of 2014 and so at the weakest since the global collapse hit in early 2009. Though there is some evidence that tertiary or service sector use is holding up better than the now officially de-emphasized heavier industrial sectors, this still suggests that even the parlous numbers we have discussed above may not be giving us a full picture of what is afoot.

Auto sales – long the cliché of choice for those resource-use boosters who start every investment pitch with *'If the Chinese middle class uses as many of XYZ as do the Americans...'* – have slumped to a 2.8% YTD rate (and let us not forget that deliveries to dealers count in such 'sales'), with production just ahead at 4.1% so far in 2015. *'Customer traffic is not picking up despite big discounts, and inventory keeps piling up,'* said a Nissan dealership staffer quoted by Nikkei News, noting that many dealerships have two to three months of inventory, more than double what he deemed to be the appropriate level.

Little wonder then that the China Iron & Steel Association is predicting a 6% decline in overall consumption this year – no small matter in a country already plagued by perhaps 300 million tonnes of overcapacity, one which produces half the entire planet's steel and which outguns World Nos. 2 and 3, Japan and the USA, by factors of around 7.5 and 10, respectively.

Matters look little better when we consider the trade picture, for all that the re-emergence of hefty surpluses will flatter that all-important GDP number (that is if the likely continuation of the improvement in the terms of trade – the



Sub-Components of Chinese Industrial Output: Source—NBS

price of exports in terms of that of imports – does not have its paradoxical effect of overly lessening the calculation of the surplus' contribution to that most flawed of aggregates).

So far this year, China's exports have managed to eke out a 1.6% gain over the same period in 2014, but imports have undergone a fall of one-sixth. In dollar terms, the drop in imports from the last trimester of 2014 to Jan-April was actually worse than that suffered over the consecutive four month intervals which straddled Lehman's demise. This has left the value of two-way trade off by 7.7% to a three-year low – a percentage reduction which may have been beaten amid the calamities of the GFC itself, but one which was certainly not exceeded during the turmoil of the Asian Contagion, ten years earlier.

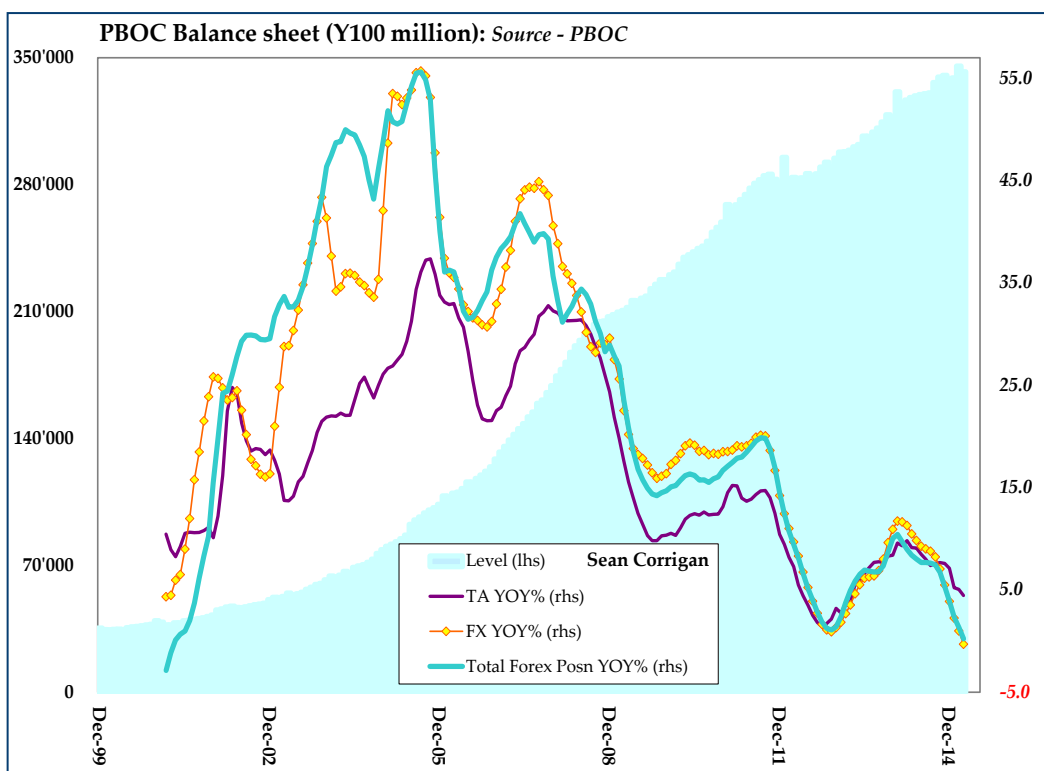
It might not be entirely a surprise to learn, therefore, that the Shanghai Shipping Exchange's composite measure of container freight rates is off by almost a quarter from its levels at the end of February. In its regular commentary on such developments, the Exchange notes that while the end of the protracted industrial dispute at America's West Coast terminals has allowed both rates and capacity utilization rates to recover smartly on that particular route (albeit at the cost of a certain softening of business on the substitute Eastern seaboard), as much as a quarter of capacity allotted to the route to Europe and almost a half of that

available to sail to Japan currently lies idle.

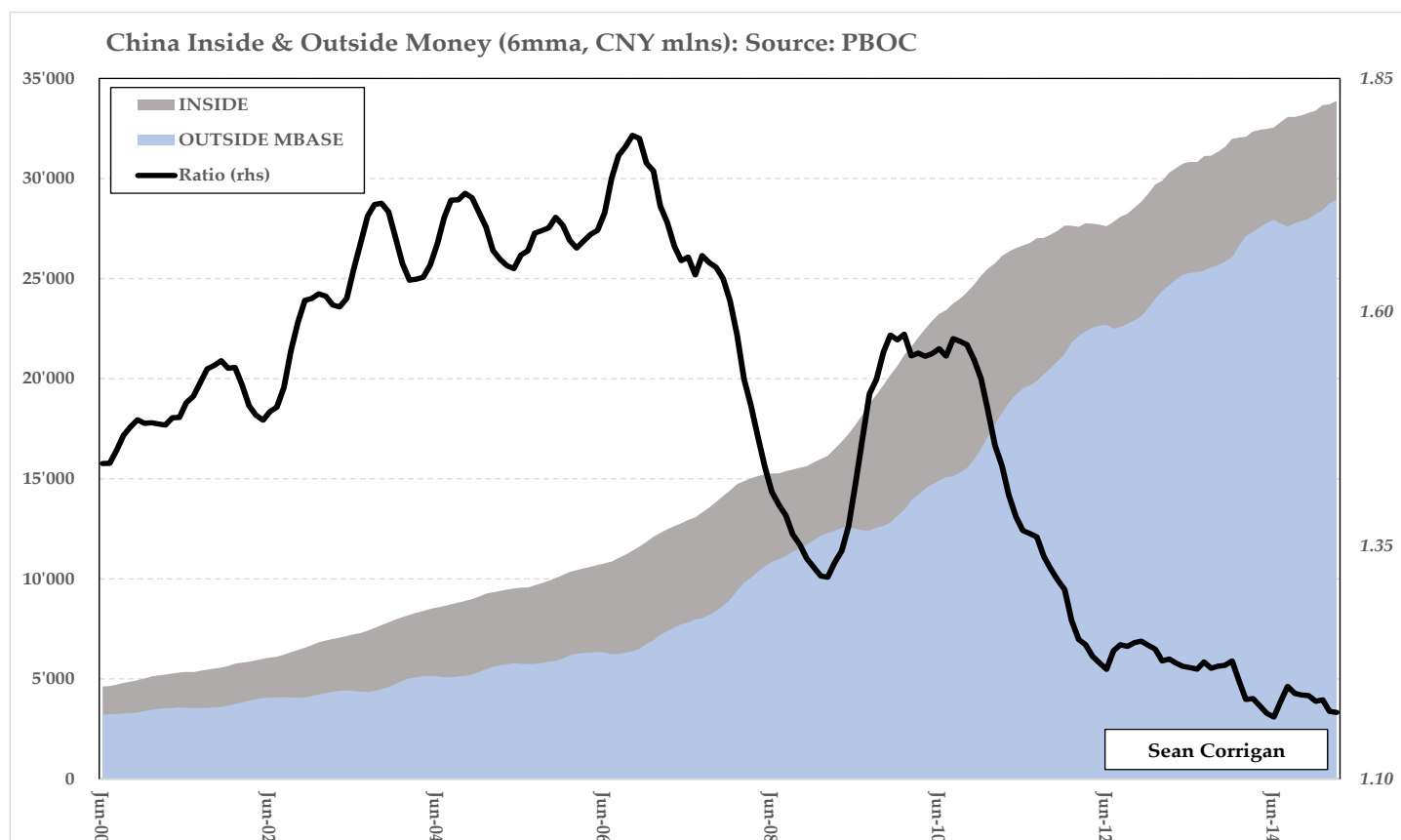
Nor, if the results of the semi-annual Canton Trade Fair are anything to go by, should we look for too vigorous a turn around. Total orders taken by the many hopeful businesses which gathered there to make their pitch were off by 9.6% from the previous year's event. It will perhaps raise no eyebrows to learn that orders from currency-devalued Japan were off 3% from their long-depressed levels, nor that the cash-strapped, rouble-wracked Russians tendered for 26% fewer imports, but it might occasion a little more astonishment that the US had contracted to buy 30% fewer goods, that reluctance no doubt being largely to blame for the 34% plunge in orders for consumer electronics.

All is Flux

All of the above is clearly reflected on the money side of the equation where the combination of clogged-up channels of finance, the ongoing drive to deter resort to the wilder reaches of 'shadow' financing, the misery of compound interest, and the cessation of – indeed, the reversal of – hot money inflows from abroad have served to cause a dramatic slowing of the growth rates of both money and of the higher orders of credit. Such a process cannot fail to have profound implications for revenue flows and hence for that subset of these last which figures in the reckoning of nominal GDP.



As revealed by SAFE, the generation of a QI current account surplus of \$78.9 billion together with a net FDI inflow of around \$50 billion was not enough to prevent the loss of a record total of \$80.2 billion in FX reserves. Somebody, somewhere was taking his chips off the table big time (a matter we shall revisit shortly) but, more to the point, such a loss of reserves has continued to pressure the central bank's balance sheet to the point that it only recorded annual growth of a meagre 4.4% in the year to March.



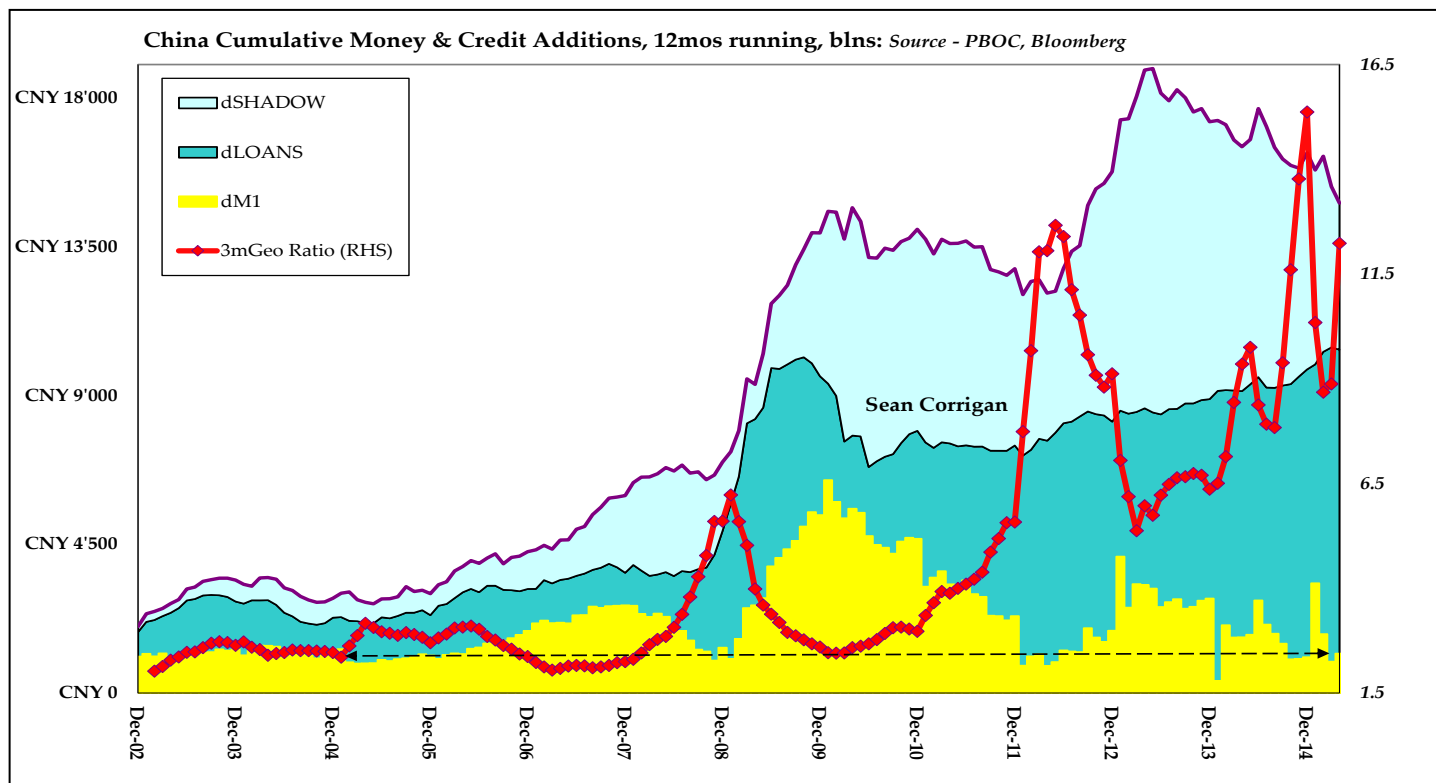
Given that China operates with one of the few effective required reserve regimes in the modern world, as well as a mandatory loan:deposit ratio, this is extremely important. With the ratio set so as to limit the expansionary effect of the accustomed influx of foreign exchange, the shrinkage in such holdings leaves the central bank with the choice of either expanding policy actively through open market operations or lowering the reserve requirements simply in order to maintain the status quo.

As the changes announced in recent months make clear, it has not been shy about so doing though an often overlooked point is the degree to which this has been actively 'stimulatory' rather than simply stabilizing. The fact is that the commercial banks' willingness (or ability) to add their own element of 'inside' money creation to that 'outside' money generation undertaken by the PBoC has fallen from the circa 60% addition typical of the period before the Great Crisis to one of under 20% today. This has served to put even more emphasis on Zhou Xiaochuan's decision making.

One major complication at work is one which is intrinsic to modern monetary systems, the fact that banks perform both credit intermediation and provide payment services

by issuing liabilities to the non-bank public. To this intrinsic and often vexatious duality, China adds the problems that it is at one and the same time trying to target infusions of what is the most fungible economic entity there is as a policy tool; that it is moving tentatively toward a liberalization of the current and capital accounts; and that it is doing this while trying to make banking much more a market-led, rather than a state-dominated, process.

That there are distinct limits to even this narrow field of discretion is well illustrated by the revelations of an unnamed banking official who informed Market News that even though banks were theoretically now allowed to pay customers a premium of up to 50% of the floor rate (up from the previous 30%) '*...we've been told that we are not allowed to float the deposit rate to the ceiling... the PBoC definitely wants to keep this under control and any deposit rate rises should come in a gradual manner.*' Moreover, it is hardly a testament to the new market-led resolve that banks were officially ordered not to 'blindly' cut off funding to any local project started last year, no matter how remote the possibility of receiving principal and interest payments from them seems to be.



Beyond the contortions associated with the attempt to nuance policy in this fashion, the Bank can add its conflicting goals of trying to recapture the transactions which the system's former failings had driven out into the Wild West of 'shadow finance' at the same time that it is trying to promote bond markets in general and the use of asset-backed in particular (the State Council, no less has just authorized a securitization programme of CNY500 billion to get that latter market kick-started). Finally, in a structure overly reliant upon the mismatch between short-term bank liabilities and long-term funding needs, it seems to be trying to promote a nationwide debt-for-equity swap, albeit one that has already taken on some of the fantastical proportions of the rue Quincampoix and the Law's ill-fated Mississippi scheme of three hundred years ago.

With so many moving parts to manage, one can almost sympathize with the poor old planners at the Bank. Almost.

If current press reports are to be believed, the confusion will become even more confounded in coming weeks. After partially relaxing the proscription on allowing interbank deposits to count towards quotas at the turn of the year, CBRC Vice Chairman Zhou Mu has lately hinted that the two-decade old rule that banks can only loan out 75% of their deposits may soon be suspended.

On the surface of it, this edict was one of those prime pieces of 'macro-prudential' policy about which our Western central bankers fuss when they simultaneously set and hold interest rates at ludicrously low and hence highly distortive levels. The problems, however, have been manifold for, as with all such arbitrary regulations, the stipulation has spawned a host of not always beneficial innovations as well as a great deal of unnecessary volatility in month-end interest rates as deposit-poor (usually urban) banks compete to attract funds from asset-deprived (usually rural) ones ahead of the date of their regular balance sheet snapshots. You may recall the struggle reached such a pitch in 2013 that SHIBOR soared into double-digits and the central bank had to step in covertly and provide emergency funds more than once, before taking a more pre-emptive approach in 2014 in order to try to avoid a recurrence of such stresses.

Lowered deposit ratios, coupled with reduced reserve ratios, and a widening of the permissible premium to be paid over the official deposit rate are all steps which would restore some operational flexibility to banks, even absent any big increase in the PBoC's balance sheet. Already there is much drooling in the press of a potential extra CNY7 trillion in the pot should the abolition transpire.

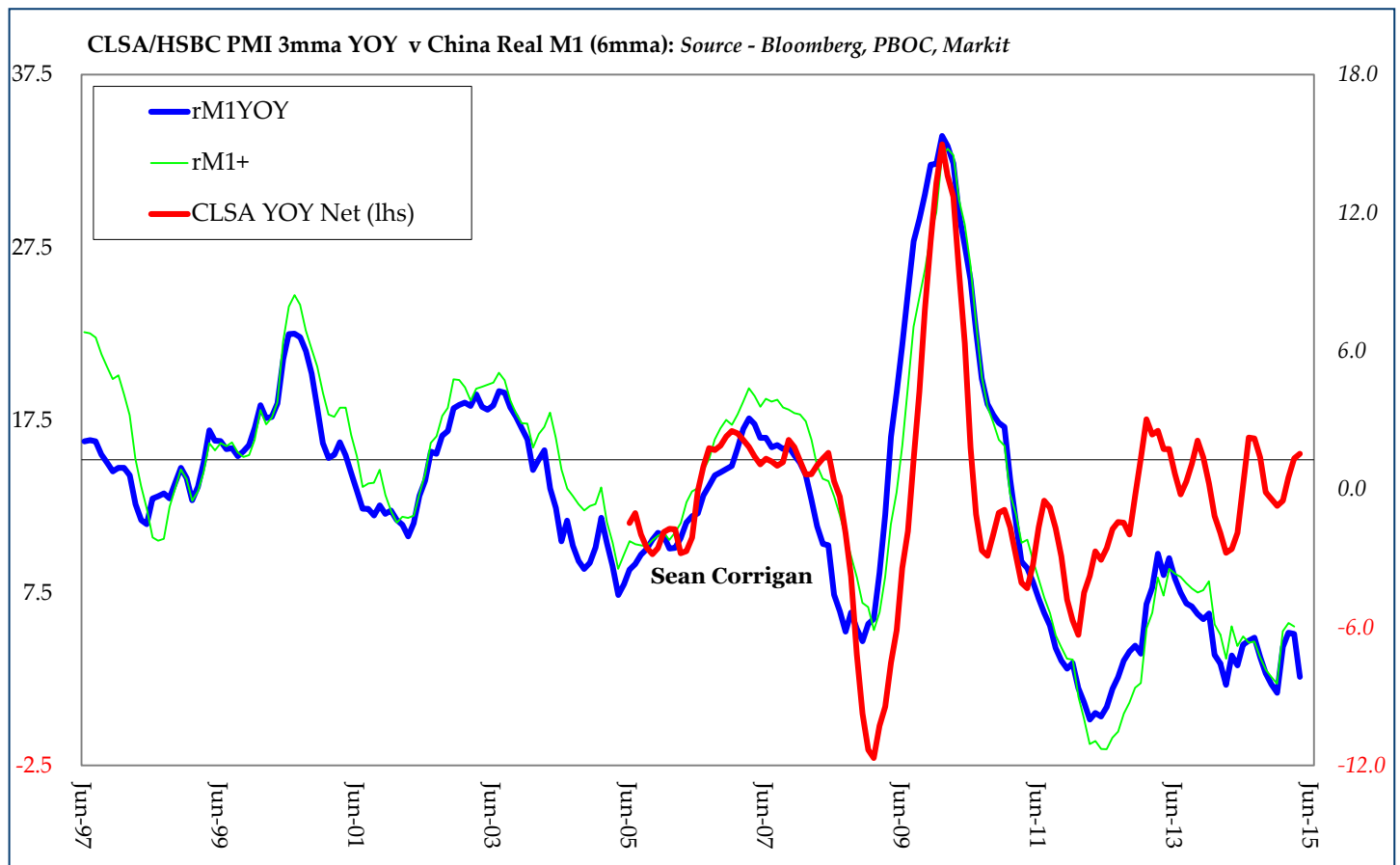
It has also been whispered that the CB's balance sheet may soon be expanded by at least Y900 billion and possibly by as much as Y1.77 trillion as a result of the imminent programme which aims to force banks to replace the expensive (if often unserviceable) local government debt – much of which is washed through opaque trust loans and so-called Wealth Management Products - with much lower-yielding, properly ratified municipal securities. In light of some initial lack of appetite for the pilot issue of these, the current scheme seems to insist that at least half of them will be forced upon the commercial banks with the sweetener that they will be able to pledge these otherwise untradeable securities as collateral for PBoC lending and in repo for the use of the state's surplus cache of fiscal deposits.

Though the swap itself offers benefits in that it frees up banking capital due to the drop in risk-weighting from the loans' 100% to the munis' 20% and though it will also replace loans with securities (and thus increase overall lending capacity should the loan/depo rule change not arrive in time), what this extra measure of support – one aimed presumably at helping preserve banks' net interest margins - will inevitably do is make something of a sham of the CB's insistence that it will not engage in monetary financing of

governments or, indeed, indulge in any other form of QE.

Indeed, in response to such rumours, PBoC Deputy Governor Pan Gongsheng was at pains to insist at a press conference this week that just because the CB *could* accept such collateral was not an indication that they *would* do so to anything like the full extent of the new bond holdings. Yet, to the extent that such alternative funding *is* extended, what it will patently do is force the banks to offer an alternative outlet for the funds of their existing depositors, i.e., to expand their own balance sheets in turn.

The idea, of course, is to get these newly-liberated monies into the hands of SMEs – or into one of the new PPPs which the government is also keen to get up and running - but, given current trends, they will probably end up either flooding back offshore to redeem some of China's sizeable offshore debt obligations (and so reduce the monetary base all over again) or they will act so as to pour more fuel on the already roaring conflagration which is the stock market.



The Great Wall of Money

We have written about this particular phenomenon before, but let us remind you that this present mania for stocks is nothing less than a tacitly encouraged means for deleveraging companies at the expense of the greater risks being run up by the legions of first-time buyers and amateur margin traders who snap up their counters.

Thus, even as the economy crumbles around them, Chinese equities are on a tear with the CSI300 up 35% YTD (and nearly 90% since last November) while the Nasdaq-like ChiNext has grown like a GM-powered bamboo shoot, adding 120% in 2015 alone. If P/Es for the main board's A-shares in Shanghai are still a globally comparable 21, the Shenzhen index has made it to 53 and the Chinext to a hefty 115.

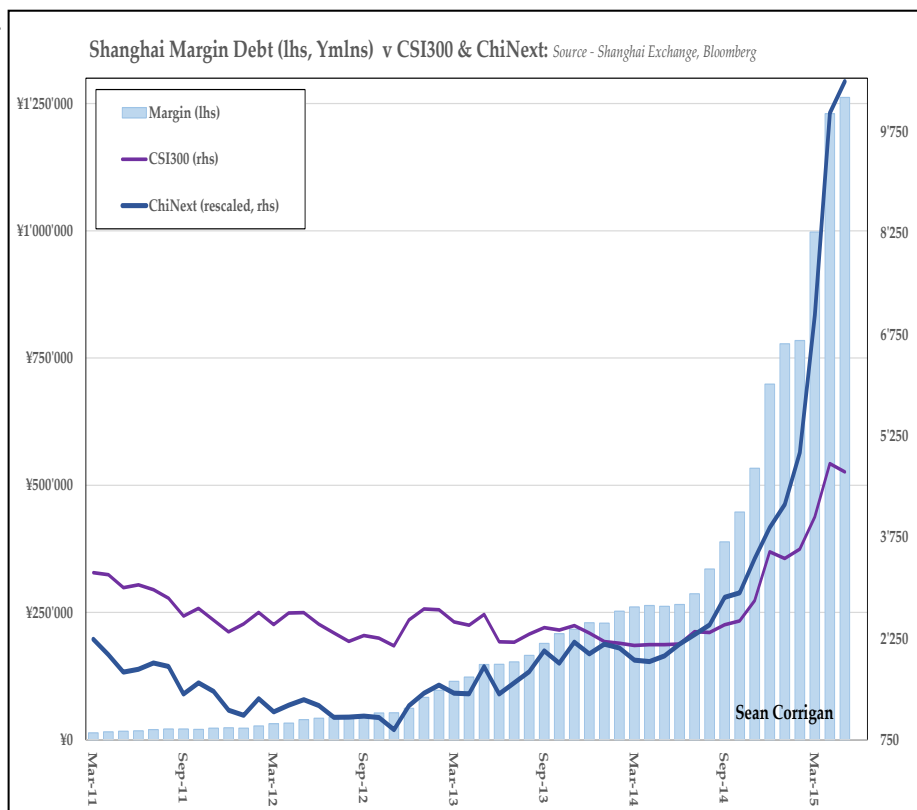
Turnover in April was CNY30 trillion – or around \$4.8 trillion dollars - with 90 billion shares a day changing hands, up 44% from March and 8.7 times the level of a year ago. To put such mind-boggling numbers in perspective, NYSE volume for the month was a lowly \$1.4 trillion at a rate of around 1.6 billion shares a day. Turnover in the US is therefore of the order of 100% of GDP per day – which should be enough frantic short-termism for anyone's taste. In China last month, it hit 560% of GDP. Dollar volume on Shanghai alone was greater than that in all of the Americas – North and South – combined and one in every two shares traded anywhere around the globe was traded in China, according to WFE data!

Making this all possible, on the Shanghai and Shenzhen exchanges combined, Y813bln in margin debt has been loaded up so far this year – a sum equivalent to almost one-fifth of all new bank loans extended in the country in that time and, indeed, equal to almost one *half* of April's entire increment. Note, too, that the SCMP ran an article suggesting that a disproportionate amount of this was being lent by just four banks, BOCOM, Minsheng, China Merchants, and Everbright with the last named - despite being considerably smaller in scale than the others - said to be the

most aggressive of them all. Fitch has not been alone in expressing its disquiet at the possibility for calamity which is entailed by all this.

Meanwhile banks which are constantly being hectored to lend to real businesses are instead blithely upping their exposure to leveraged trusts and asset managers as well as repoing that most intangible of back-stops, brokers' margin beneficiary rights. That last is something which smacks of the hair-raising practices pursued eight years ago, at the climax of our own last great folly, when hedge funds were merrily securitizing the phantom of their prospective future fee income and ploughing the proceeds straight back into the market and so generating more putative income to capitalize anew.

As the Chinese madness intensifies, the last seven weeks have seen 17.7 million new stock accounts and 7.4 million new fund accounts opened (some of these latter heavily leveraged), draining household accounts of Y1 trillion in deposits last month and piling that cash up instead on the books of the non-bank financial institutions with whom they deal. Try as it might, it is obvious that the PboC just cannot to force its ongoing infusions of monetary assistance into the wellsprings of real economic activity, rather than adding them to the ever expanding walls of this latest and arguably greatest speculative bubble.



Dealogic reckons that this frenzy has contributed a cool \$1.9 billion in investment banking fees YTD, while equity issuance stood at a record \$35 billion in Q1 and, reckoning from the partial data to hand, has probably climbed another \$10-15 billion in the weeks since then.

Putting all this together, what is effectively taking place is that debt is being transferred from corporates and their bankers to brokers and individual stock punters. It also seems that many firms are issuing equity willy-nilly, converting the proceeds to USD and using it to redeem some of their foreign debt. This may be what lies at the root of the US\$85 billion drop in monies owed to HK since last summer, in what has been a 25% reduction of the previous four years' dramatic increase in borrowings.

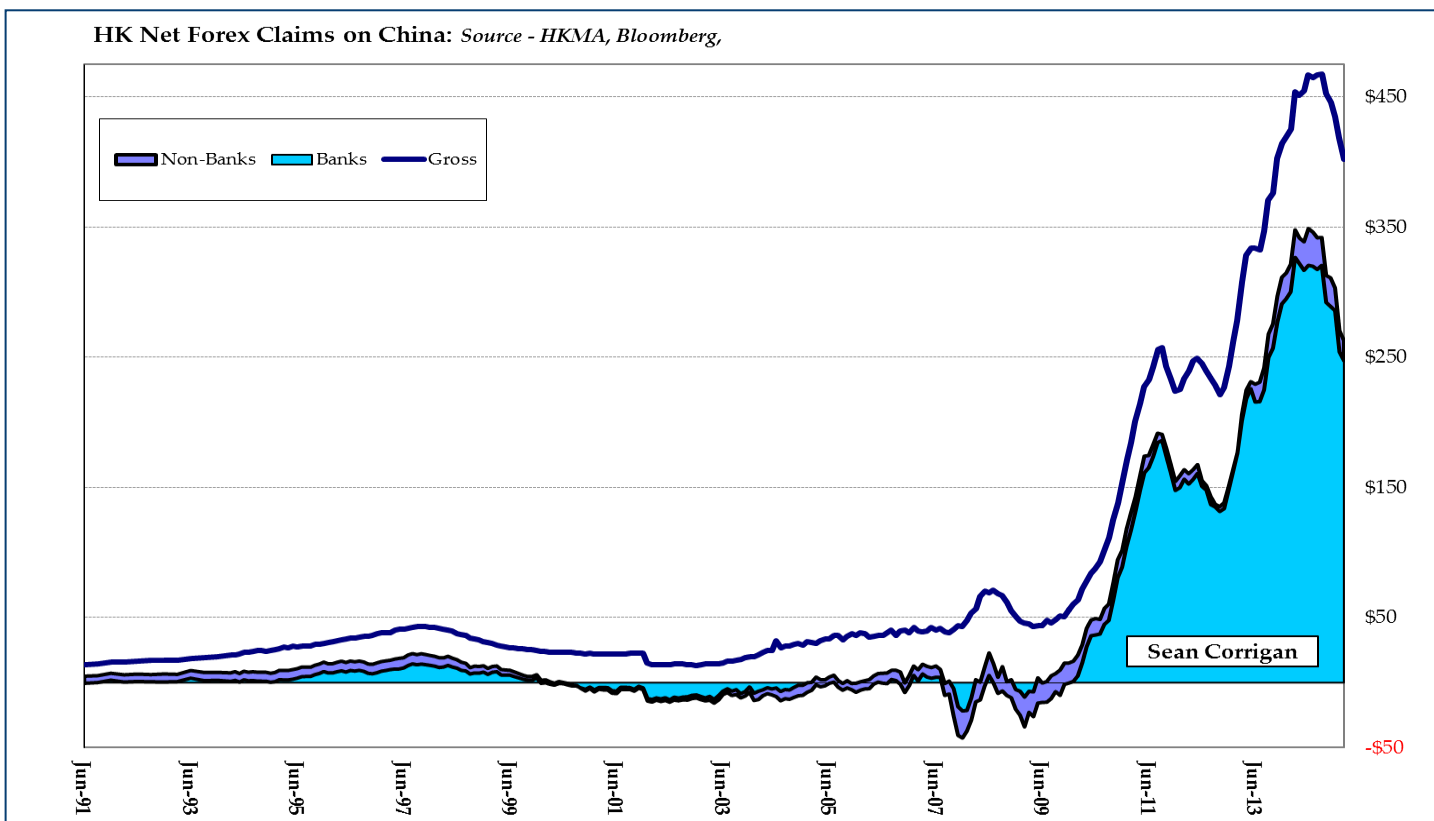
Remember the words of Li Xunlei, Chief Economist at Haitong Securities from last month's commentary? *'Each dollar coming into the market is a vote of confidence in the future of the economy,'* he was foolhardy enough to opine. That's as may be – but every dollar *lost* in that same market as and when the tide begins to turn will be a vote *against* the bosses who were so eager to foster the movement on the way up.

Faced with an economy stalling under the weight of its own contradictions; with unknowable quantities of capital either utterly wasted or helplessly locked into sub-

marginal uses; with the debt load crushing and the monetary system riven with fraud and inefficiency, like latter day equivalents of the Duc d'Orléans, regent of France, and his Scottish adventurer advisor, John Law of Lauriston, the CCP's top men have also opted to bamboozle the masses under their sway. By holding out the prospect of the fabulous gains to be had in developing a little-known wilderness far from the nation's heartland they have sought to exploit the enthusiasm thus kindled in order to transform some of that mass of unpayable debt into supposedly sure-fire equity holdings.

With the AIIB in place of the *Banque Générale* and the central Asian vastness of the 'Silk Road Economic Belt' taking the place of the pestilential Louisiana bayous, we can see all too many parallels.

Xi and Li really are riding the tiger with this one.



WHERE THE MONEY GROWS:

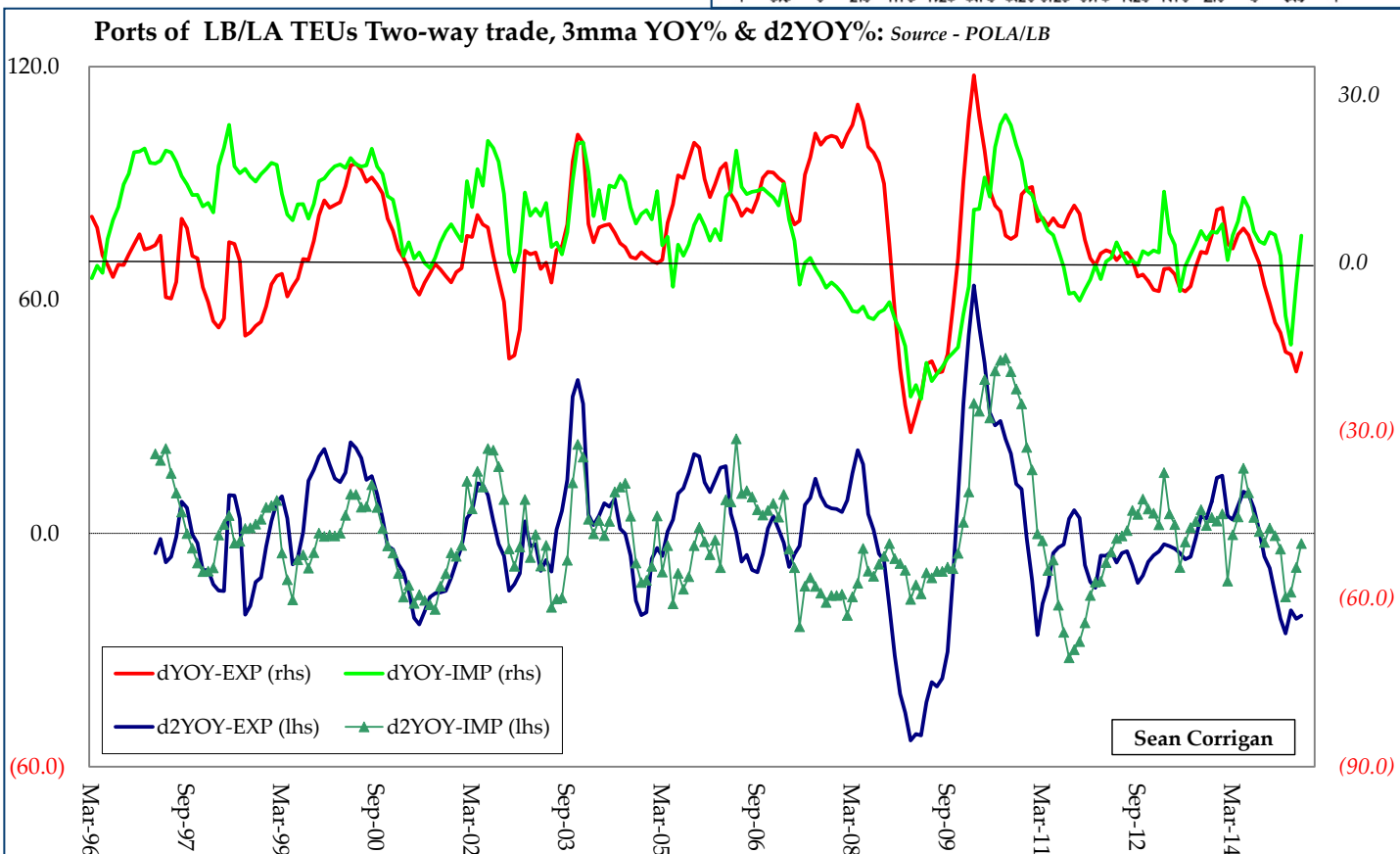
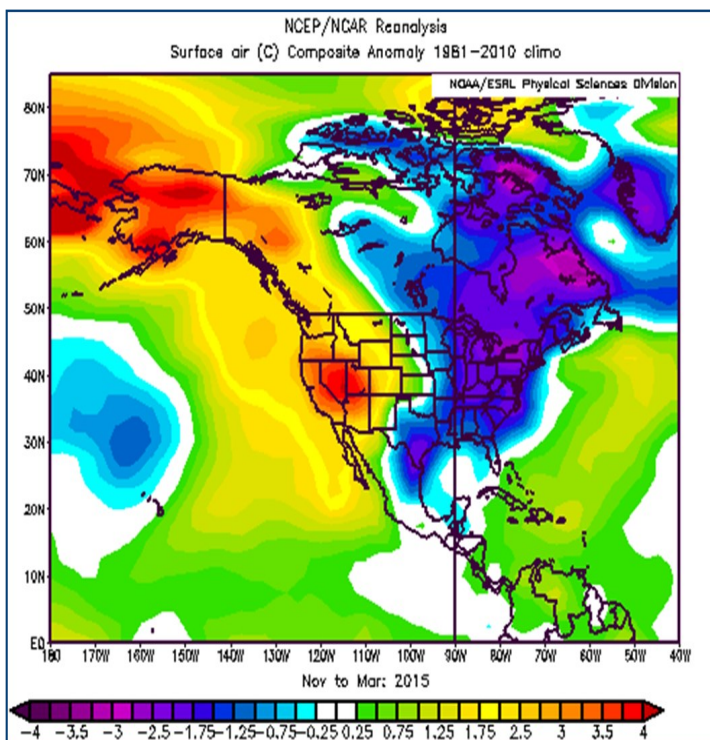
Wall St & West

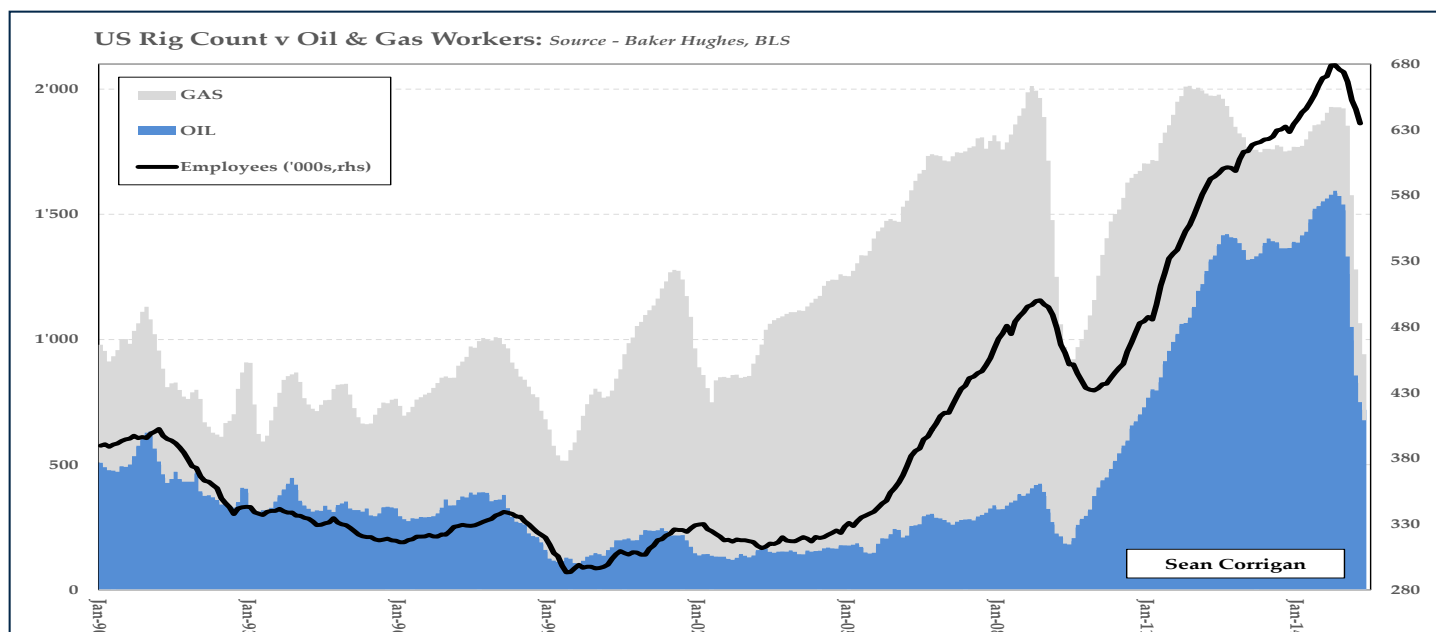
One is always reluctant to indulge in what might be construed as special pleading but it is surely hard to deny that, during the first three months of the year, the American economy suffered from a number of events of the kind a defensive CFO might write-off as 'extraordinary items' in his quarterly accounts.

First and foremost was the weather. Here we need to be clear that, despite the deliberate obfuscation of the Warmists over the matter, the major population and productive centres of the North East suffered an unusually harsh and disruptive winter, paralysing trade, making transport hazardous, and keeping consumers at home, cash flows pinched, and inventory building for several long, hard weeks.

Secondly, we had an unusual outbreak of industrial unrest, principally a six week-long dispute which affected a fifth of the country's refinery capacity and which was the largest in 35 years. Alongside this came the bitter culmination of a protracted, nine-month campaign of go-slows and walk-outs conducted by the West Coast branch of the Long

shoremen union, one which had a major impact on what the National retail Federation estimated was traffic amounting to one-eighth of GDP.





Thirdly, we had the crude crash and with it the disappearance of half the rigs working in the oil patch. This brought a loss of 45,000 relatively high-paying jobs among those directly employed in the business and had undeniably malign consequences for who knows how many more of those whose incomes had come to rest in part on providing free-spending roustabouts and cash-rich field engineers with all kinds of goods and services.

Given all of this, it is hardly remarkable – whatever that fatuous exercise in divinatory navel-gazing, the Citi ‘Surprise’ Index might have shown – that the first quarter was a disappointment to those whose main forecasting tool is an HB pencil and a six-inch rule. The larger question, however, is whether this setback has been enough to shake the US off its steady if unspectacular, private sector-led trajectory to recovery.

Until the past few months – and once the initial rebound from 2009’s deep, deep trough had settled into a more regular pattern – we had seen earned private wage income grow steadily by around 4.6% p.a. with private sector payrolls rising at an average of 210,000 a month, 2.2% a year.

Though the first number looks low when compared to the previous recovery’s 5.6%, once we allow for the fact that the trend rate of CPI change was 3% then, as opposed to 1.4% today, we can see that aggregate real income had actually been rising more rapidly. Moreover, job growth during 2003-7 was slower both in numerical (145,000 per month) and percentage (1.6% p.a.) terms.

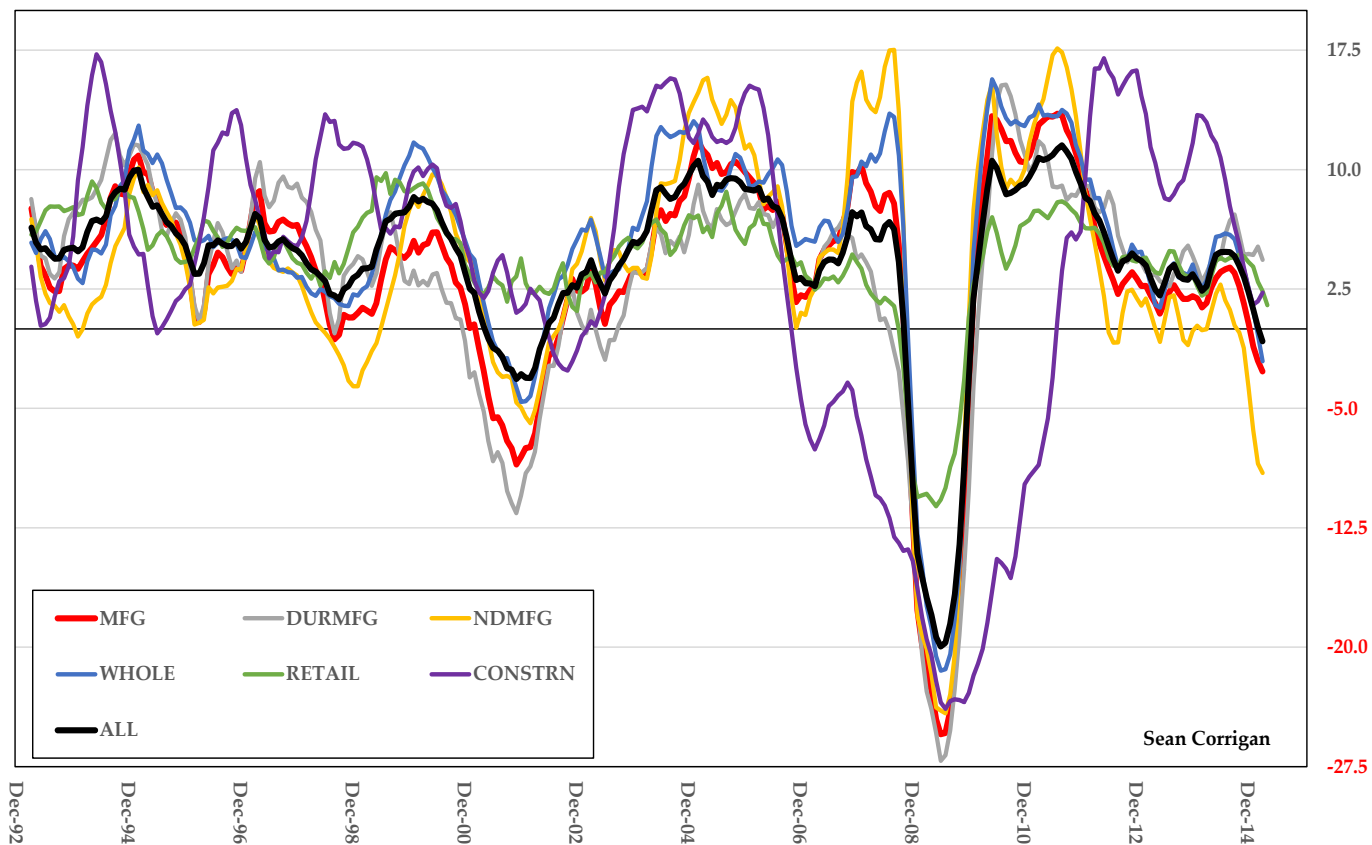
Similarly, real manufacturing production grew at a com-

pound annual rate of 3% in the five years to last December, exactly matching the quinquennium leading up to the Dec ‘07 peak. In the three years to the mid-summer peak, durable goods sales’ 5.4% CAR beat 2005-8’s 1.3%, retail sales of 4.4% were faster than the earlier period’s 3.2%, and construction spending was undergoing a massive 11.0% rebound versus a decline of 3.5%.

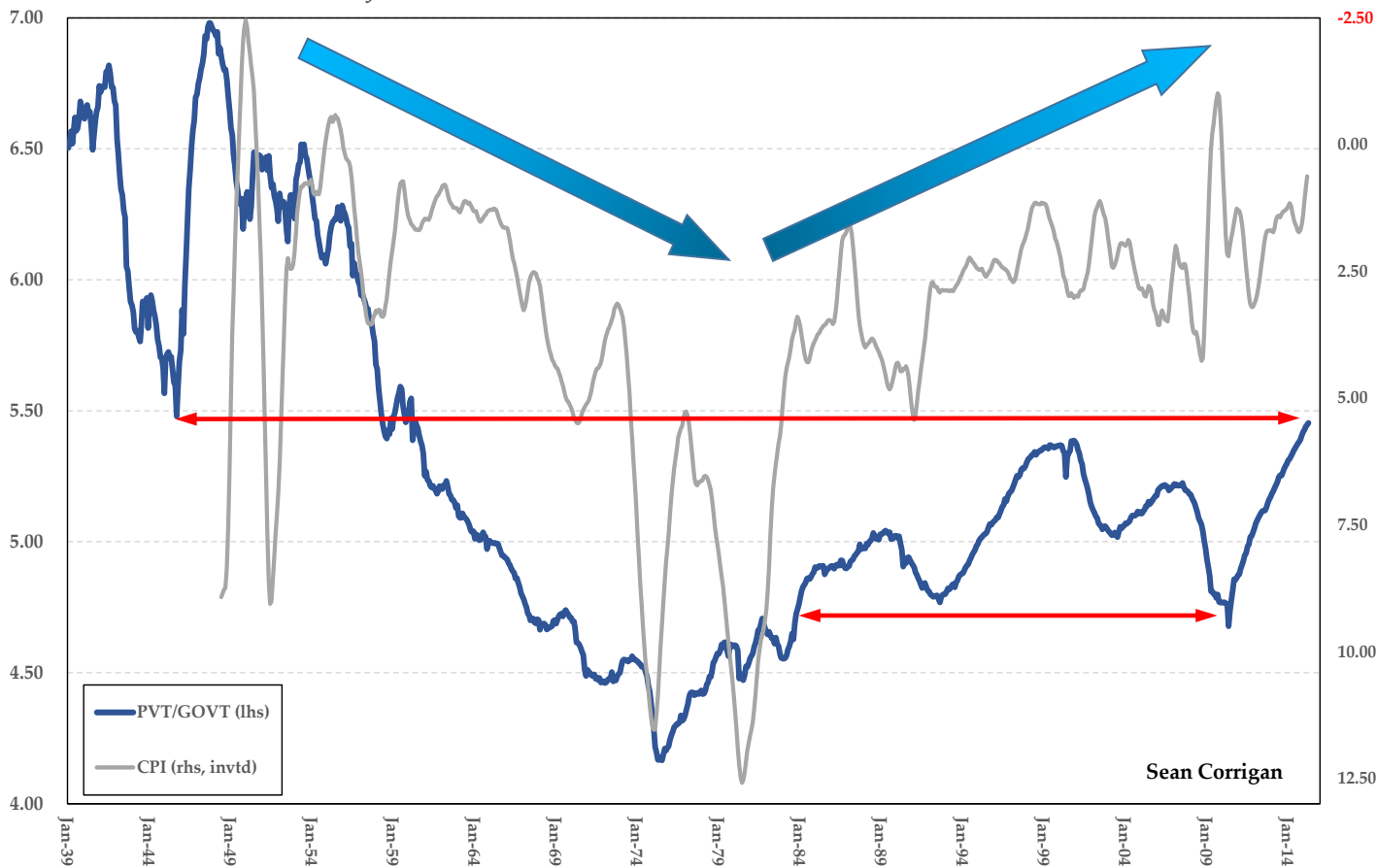
Finally, it should be noted that absolute numbers of initial unemployment claims have not been lower since late 1973 when the so-called civilian, non-institutional population was only three-fifths as large, and continuing claims not since late 2000 when there were 15% fewer of that subset of Americans. Backing this up, the Duke/CFO magazine quarterly survey had 70% of respondents anticipating wage increase due to retention and hiring pressures while, at the other end of the scale, the NFIB poll of small businesses revealed that: ‘...those that hired were more aggressive than those reducing employment, producing an average increase of 0.14 workers per firm, continuing a string of solid readings for 2015’. On top of this, a quarter of firms asked had already hiked compensation.

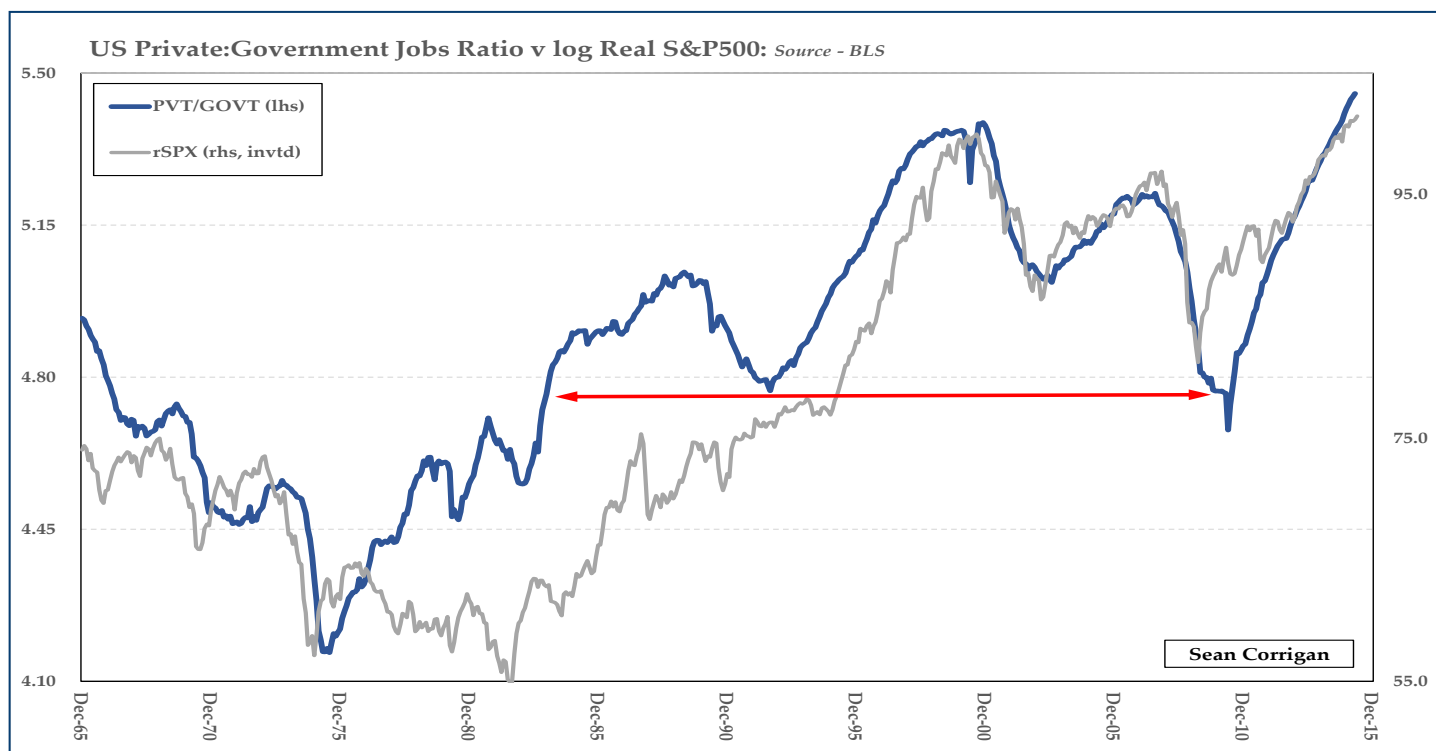
There may be all sorts of questions about the arcana of participation rates and partial idleness (some related to the provisions of extended benefits, the easier classification as ‘disabled’, Uber/AirBnB working patterns, etc.), but these are not the sort of numbers to attest to an overly slack labour market. The only place where such a lack of hiring does demonstrably exist is where its absence is likely to be the most beneficial, *viz.*, in the ranks of government.

US Biz Revenues, 3mmaYOY%: Source - Census



US Private:Government Jobs Ratio v 6mmaYOY% CPI-PCD: Source - BLS





The count of Federal workers, at just over 2.7 million, is today the lowest in almost four decades while state and local payrolls are no higher than they were in 2006. This has had the happy consequence that the ratio of private tax-payers to public tax-eaters has risen from the post-Crash lows of 4.7:1 (ignoring the spring 2010 dip associated with the hiring of temporary census workers) - which were the worst since 1983 - to last month's 5.4:1 which was the most favourable in 55 years.

The Ants & the Grasshoppers

Though there is no strict statistical correlation between the two (a not entirely unexpected absence given the many diverse factors involved), it should perhaps not go unremarked that the secular decline in this ratio from 6.5:1 in the aftermath of the Korean War to the bleak Carter recession of 1975 and its nadir of less than 4.2:1 were the years when consumer prices went from printing either side of zero (all without any panic about 'deflation' or any call for draconian monetary experimentation, you will note) to their peace-time, double-digit record worst.

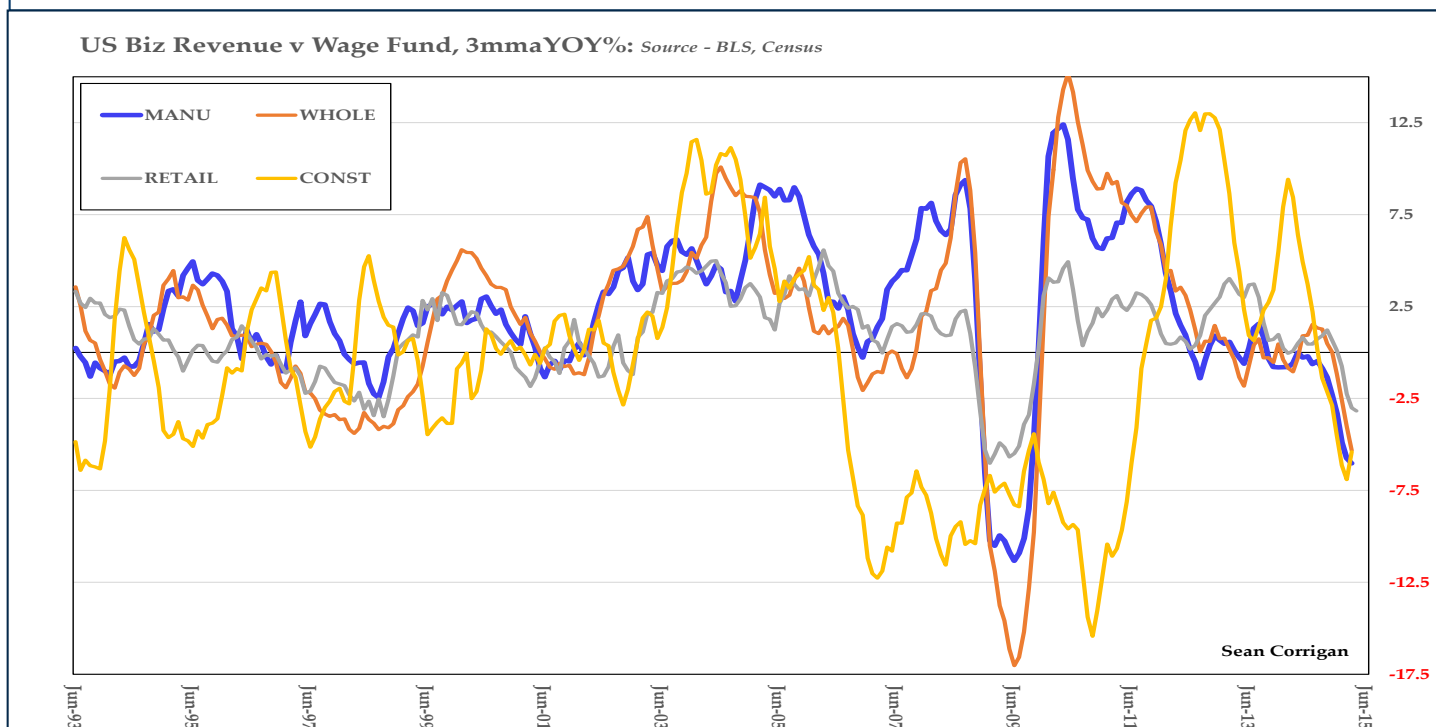
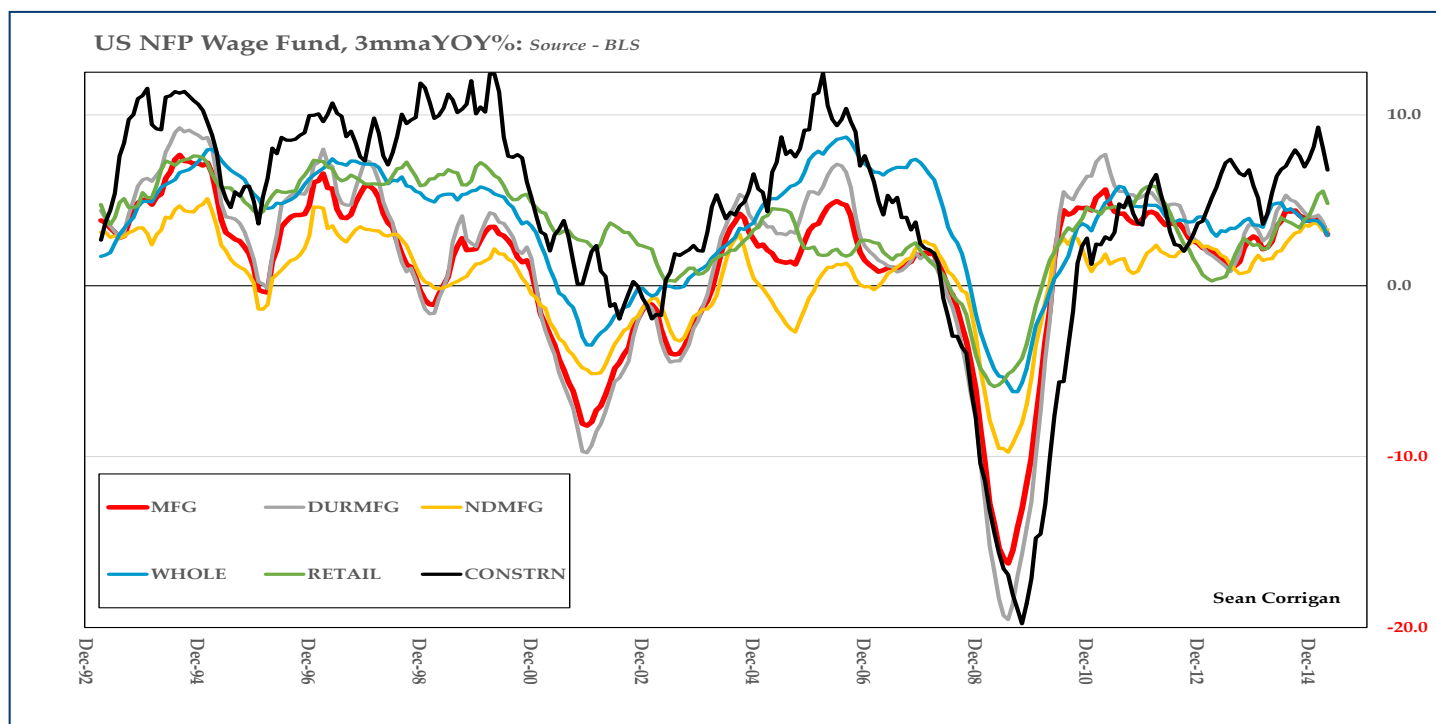
Since those dark days, the trend has been that of a gentle, upward undulation in the proportion of private to public jobs to the accompaniment of a broadly similar underlying decline in the CPI. So, Larry, over to you. Do we attribute your overblown fears of 'secular stagnation' in prices to

technological exhaustion and demographic decline, or is it more likely to be a consequence of some mild lessening of the dead weight of the State and a relative shift of resources away from the soft-budget, cost-plus, mandatory take-up 'goods' which issue from the dreary recesses of the town hall and the tax office and towards the cut-and-thrust, penny-conscious realm of competitive free enterprise?

That may be a debate for another time, but here it should also be noted that - with a couple of periods of slippage in 1977-80 and 1989-92 - this ratio has provided a fairly passable fit with the pattern of real stock prices as measured by the log of the deflated S&P500; a consonance which also makes a kind of intuitive sense.

So, if there was plenty of reason to be less pessimistic about the performance of the US economy of late, given that much of the overall tardiness was either a matter of money illusion or the revivifying starvation of the beast of Leviathan, and if at least some of the subsequent attenuation can be justifiably ascribed to a series of one-off factors, what if any might be the signs that something more serious is currently awry?

For us, the key thing to watch in the real economy is how two of the main indicators cited above develop in relation to one another: namely, business revenues and payroll outlays. The reasoning should not be difficult to comprehend:

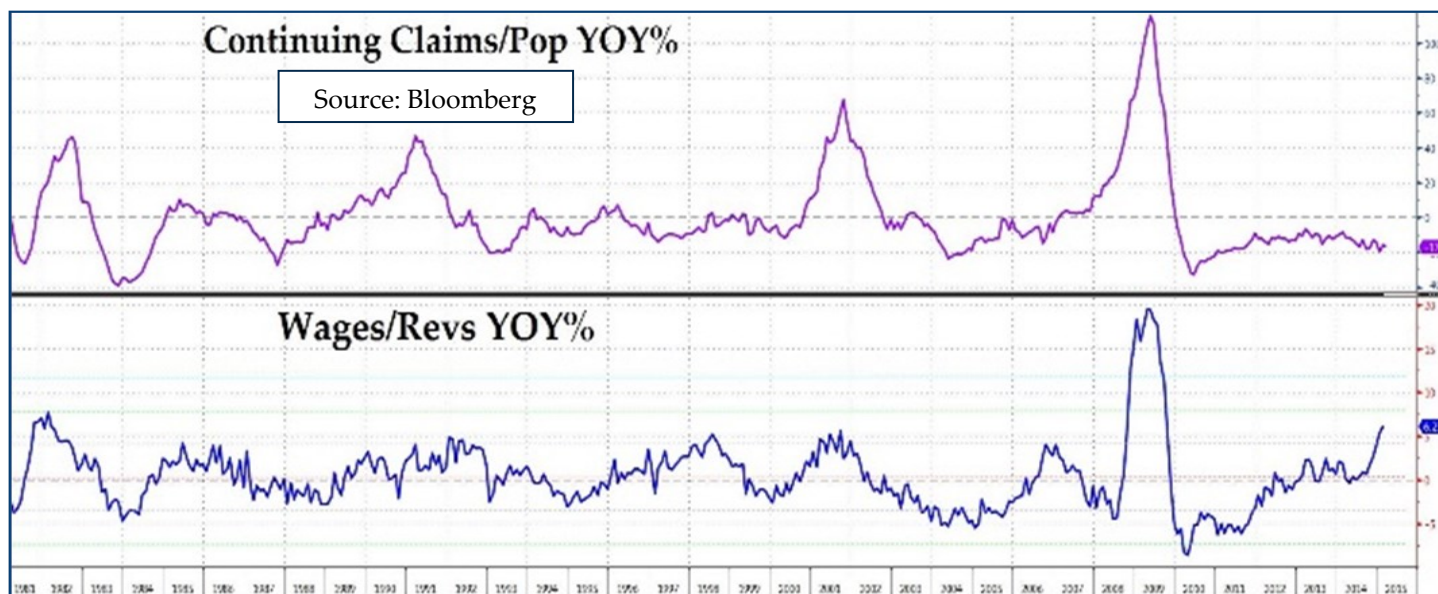


whatever tinkles into the cash register must cover the hire of labour (typically the largest item in the outgo column as a proportion of value added) and leave enough left over for both other expenses and for the provision of a return to the firm's owners and creditors.

Here is where things do look a little hairy. Revenue growth in manufacturing in QI slipped into the minus column, albeit with a disproportionate contribution from the non-durable sector which had its roots in the oil price collapse. A similar phenomenon can be observed in the wholesale

industry. Retail sales have also slowed dramatically from 4.7% yoy in October (on a 3mma basis) to just 1.5% in April, the tardiest pick-up in more than five years. Construction spending, too, has gone from double digits to low single ones in the space of a twelvemonth. [FIG14]

Correspondingly, payroll costs in manufacturing and wholesale are up 3% or so across the board; for retail, the figure is close to 5%, and for construction, slowing, but still a brisk 6.8% yoy.



Put these together and we find that the ratio of revenues to wage costs reads, from worst to best: -11.9% non-durable manufacturing; -10.4% non-durable wholesale; -5.4% private construction; -3.2% retail; and a thin positive cushion of +0.7% for durables in both manufacturing and wholesale.

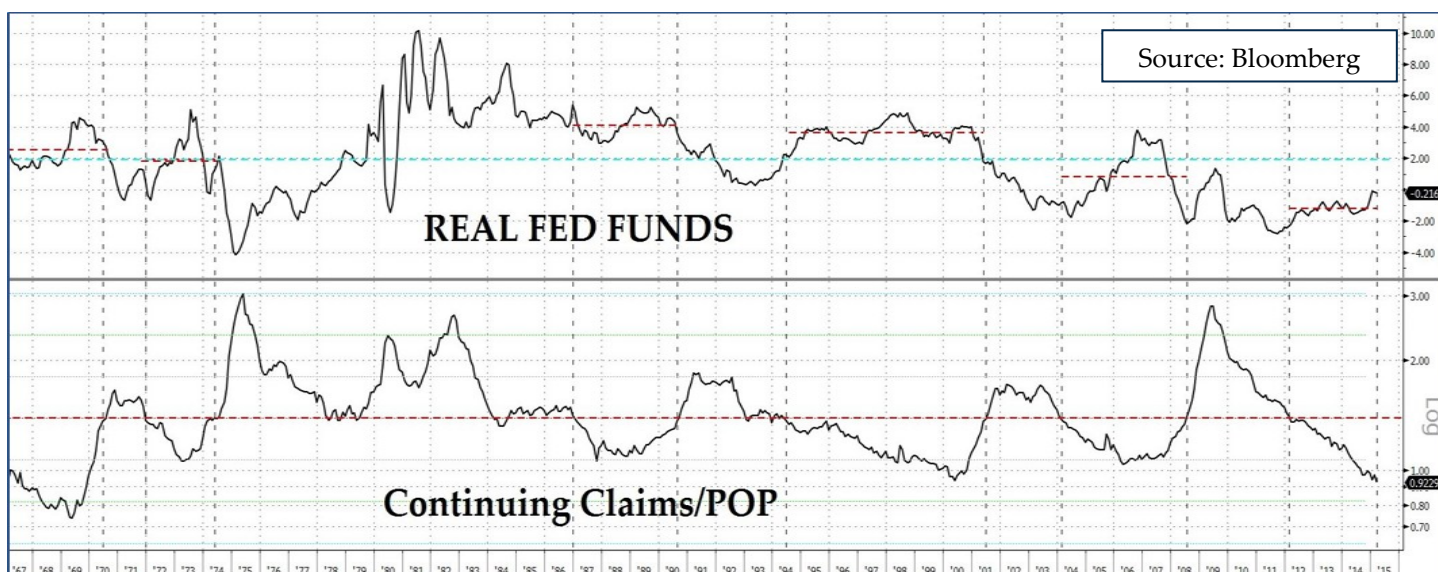
Now it may just be, of course, that much of that slowdown, being petrochemical related, has had its principal broad impact on input costs and so has allowed margins (which are ultimately the deciding factor) to be preserved outside the oil patch itself. This would mean that our rule of thumb was here overstating the import of the relative rise of labour costs.

However, that would still leave the worry that inventories, though now being written down in value, stand at a record with both the sales:inventory ratio at the highest in 12 years and its YOY change at the equal highest pace in thirty (the immediate aftermath of the GFC itself excepted).

The significance of this is that past episodes of such a rise have tended to signal a fall in the marginal utility of labour and hence a rapid rise in claims and unemployment. The caveat is that, as intimated above, it appears that when this occurred to the accompaniment of a rapid fall in energy prices – such as 1986 and 1998 – allowed for some decoupling of the two series.

The attempt to determine whether that is what we are experiencing today, as well as the degree to which any circumstantial deterioration in business conditions can now be unwound, will be key to the fate of the US economy.

One thing we do know, however, is that it is exceedingly unlikely that the Fed – prey as it is to that ghastly apparition, the Ghost of '37 – will have the temerity to begin renormalizing rates until all such doubts are fully dispelled.



HEAVY FOG: The View from Albion

It may not have escaped the reader's notice that Britain has just undergone one of the most unusual general election campaigns of recent times, one in which the sham duoliths of Labour and Conservative were at risk of being denuded of their formerly rock-solid support among the dispossessed of post-industrial Britain and the Europhobic middle respectively.

In the end, this meant that the opinion pollsters had little clue as to how the arithmetic would turn out in a kaleidoscope in which a confusing cluster of red, purple, green, and Welsh socialists tried valiantly to gang together to beat out the mainly English parties which stand slightly to what is known as the 'right' of them. In the end the anomalies of Britain's merciless first-past-the-post system saw the ever-refreshing (if equally contentious) Nigel Farage lead the UKIP upstarts to secure a remarkable one out every eight votes with a total harvest which just pipped that of the Scots Nats and the Lib Dems combined, yet which earned them one solitary seat to the others' joint 64.

Ancillary to this dispersion of electoral heft was the reverse Braveheart effect by which those English voters not already convinced that Cameron offered a better alternative to Miliband were instead persuaded that the only way to prevent the bare-kneed, woad-painted Caledonian hordes from redeeming their almost uninterrupted historical catalogue of military reverses south of the border would be to set aside any such doubts and resolutely vote Tory. '*Scots wha hae wi' Wallace bled*' and all that.

This, it turned out, was the one truly inspired tactic in an election campaign characterized by poor logic, sham debates, and the regular drumbeat of special interest bribes and headline-buying, publicly expensive, ad hoc initiatives. It was not the country's finest hour.

So what we have now is a Labour party in full melt-down where it seems each and every one of the relative political pygmies still with a seat in the new Parliament has staked a claim to the leadership. For its part, UKIP has dissolved into a messy and disappointingly amateur-looking schism while the rampant Scots cannot seem to decide how to play their over-proportioned and wholly extraordinary representation in an assembly of whose authority it is their exis-

tential aim to be rid.

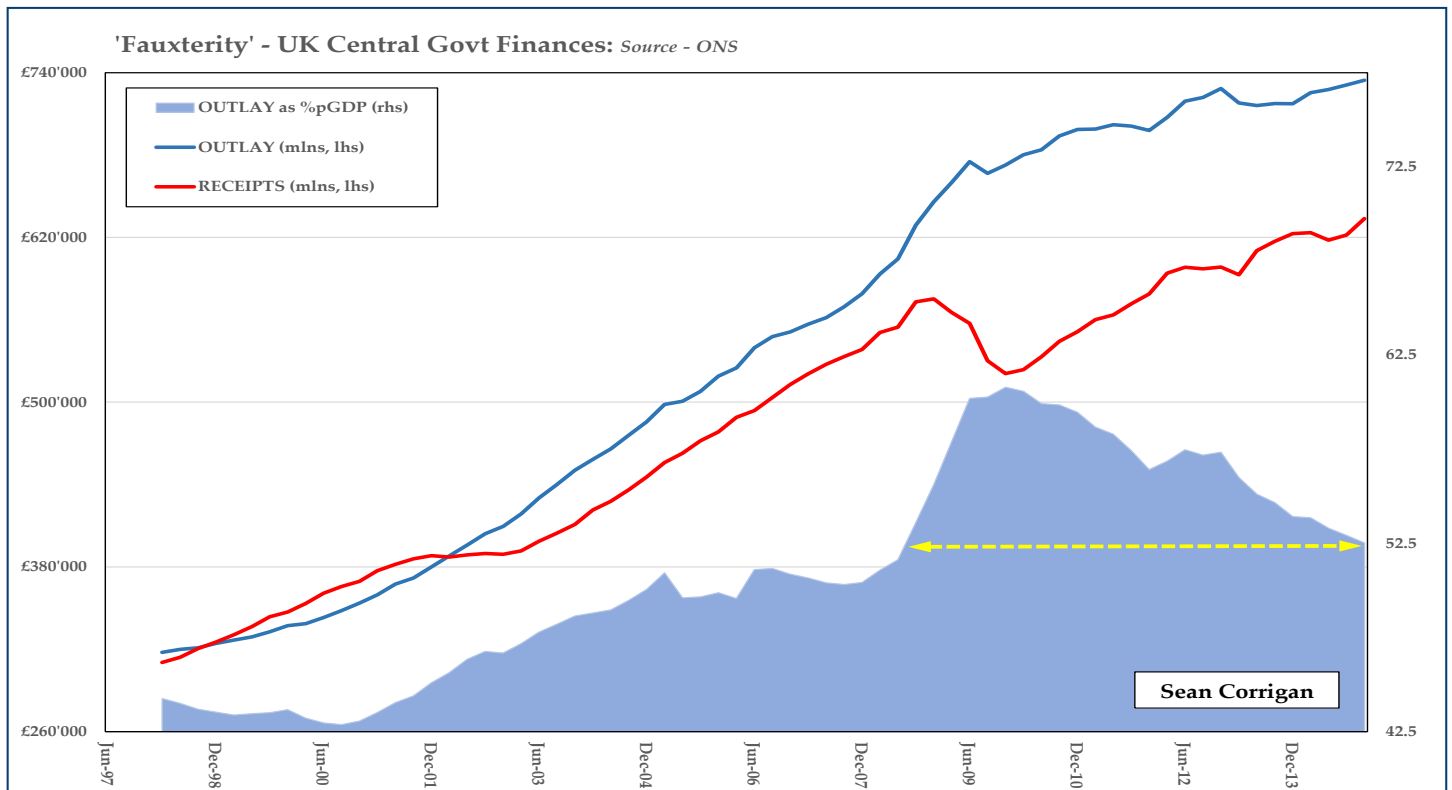
Above all, we now have a situation where Cameron and Osborne are temporarily triumphant but where the impatient Nemesis who attends upon their current Hubris will have her chance to take vengeance the minute the party's long-quiescent, coalition-inhibited Thatcherite faction starts to demand that Dave acts like a proper Conservative and no longer disports himself as a photo-shopped facsimile of a centrist trimmer such as a Heath or a Heseltine.

One wearily recurrent theme in the election was the shibboleth of the incumbents as the heartless Gradgrind champions of austerity. So well-established was this caricature – one which the Tories themselves were only too happy to adopt under the aegis of their tiresome mantra of the 'long-term economic plan' – that it served to mobilize a baying scrum of the great unwashed to march on Whitehall, the day after the democratic expression of the people's will was made known, in a pointless, if highly revealing, outpouring of manufactured fury, complete with diabolical jugglers, dog-on-a-rope welfare scroungers and a posse of Right-on, micro-celebrity poseurs.

But amid all this entertaining hullabaloo, here's a trick question to further divert the reader: define the swingeing 'austerity' which that unsurpassable stand-up comedy act, Paul Krugman, recently made the subject of the full blown rant he unleashed against its supposed practitioners in the op-ed pages of the British progressives' organ of choice, the *Grauniad* (sic)?

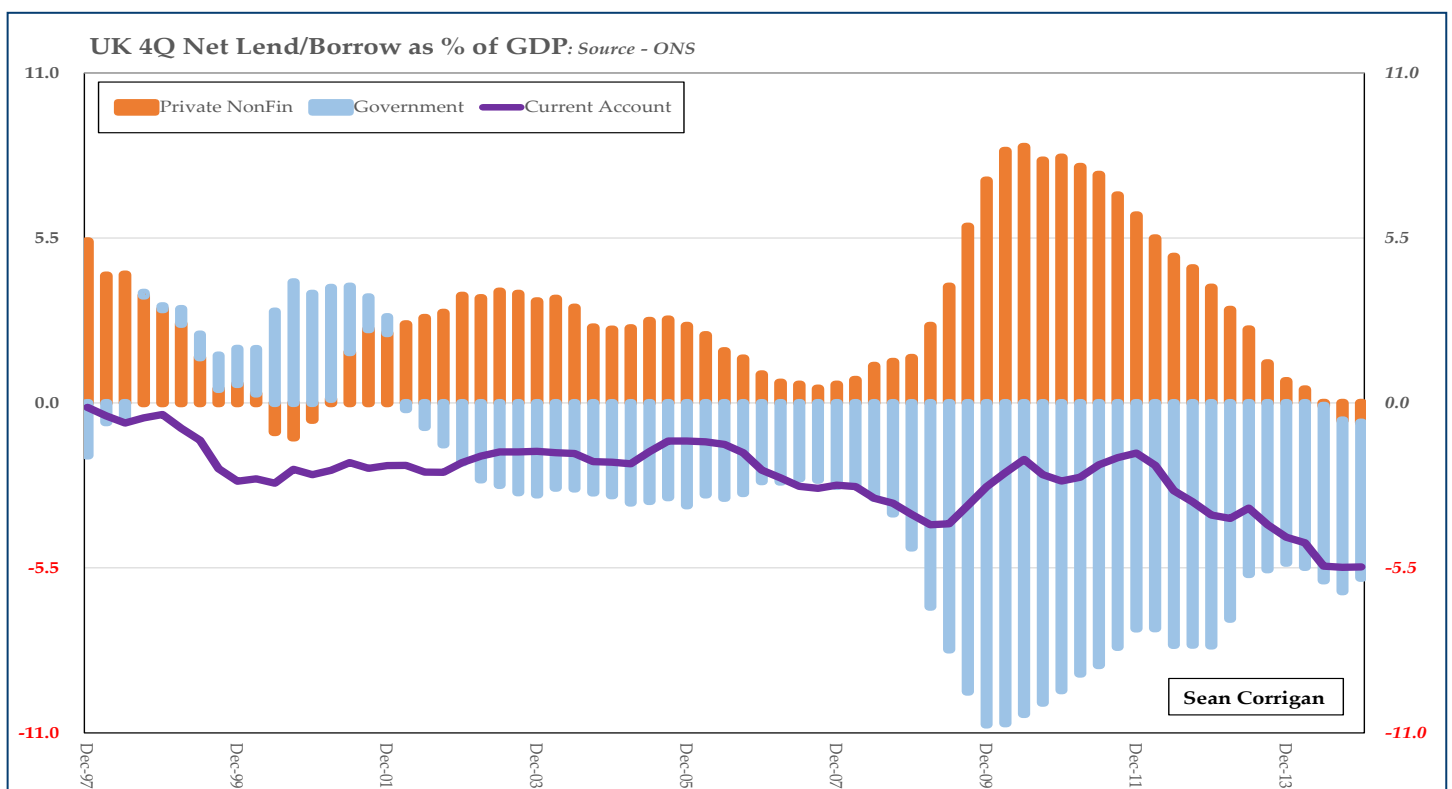
OK. So would it include an expenditure total still setting new records every month? One in which £1 in every \$7 spent was still having to be borrowed (largely from the ill-informed refugees fleeing Mario's policy of mass *rentiericide*)? One where spending as a proportion of non-government GDP was still above Culpability Broom's economy-wrecking heights of pre-Crash profligacy? Or one where that same proportion was fully 10 percentage points above that of the previous cyclical golden age, way back in 1997 when the first Blair government had not yet had time to realise its D-Nightmare programme of ensuring that '*Things Could Only Get Worse*'? [FIG18]

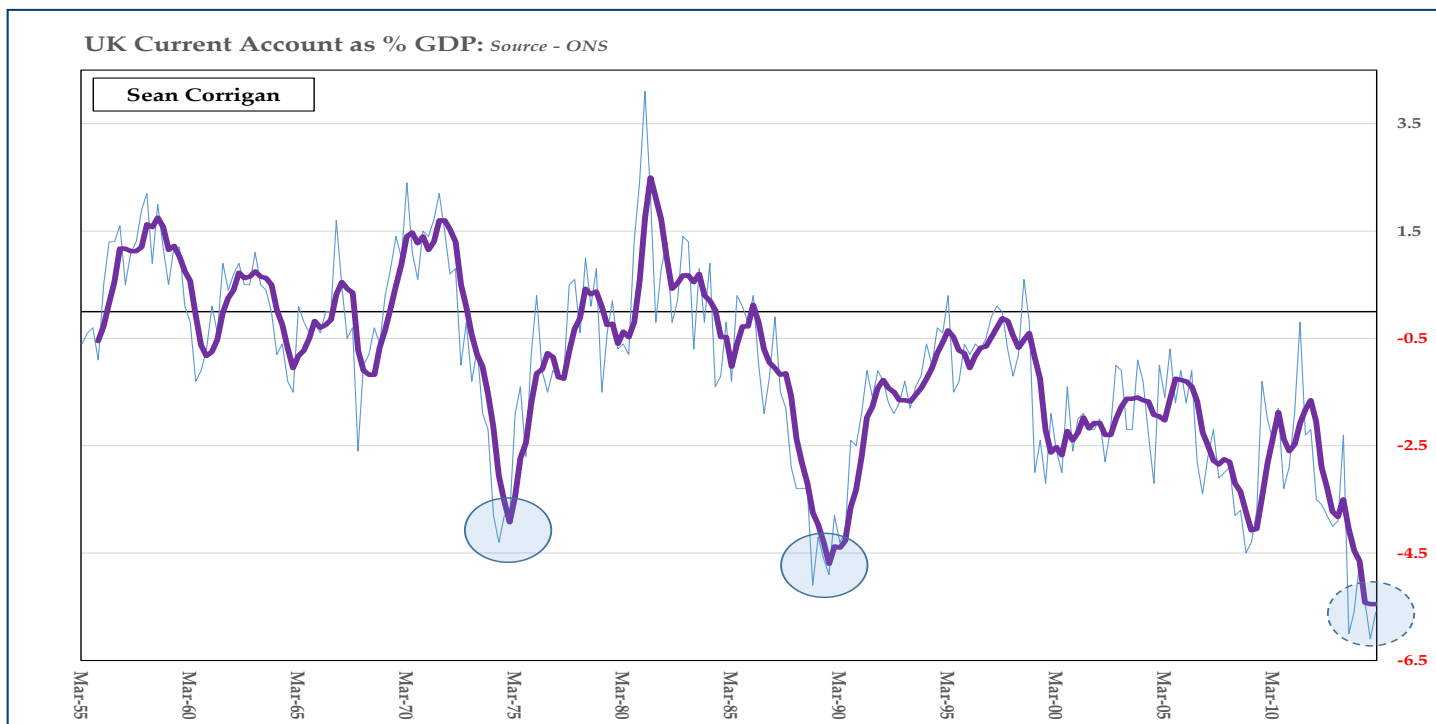
No? Well then, just take a glance at the appended chart and tell us if the 'austerity' debate is anything more than a sham.



Canard or not, it is a dangerous one, nonetheless, for the supporting monetary laxity entrained by Mark Karney's Circus is beginning to turn its potential evil into actual harm. Whereas, in the wake of the traumas of 2007-8, corporates and households alike were rebuilding their finances by setting aside around £70 billion annually out of their income and so were largely offsetting the state's gross in-

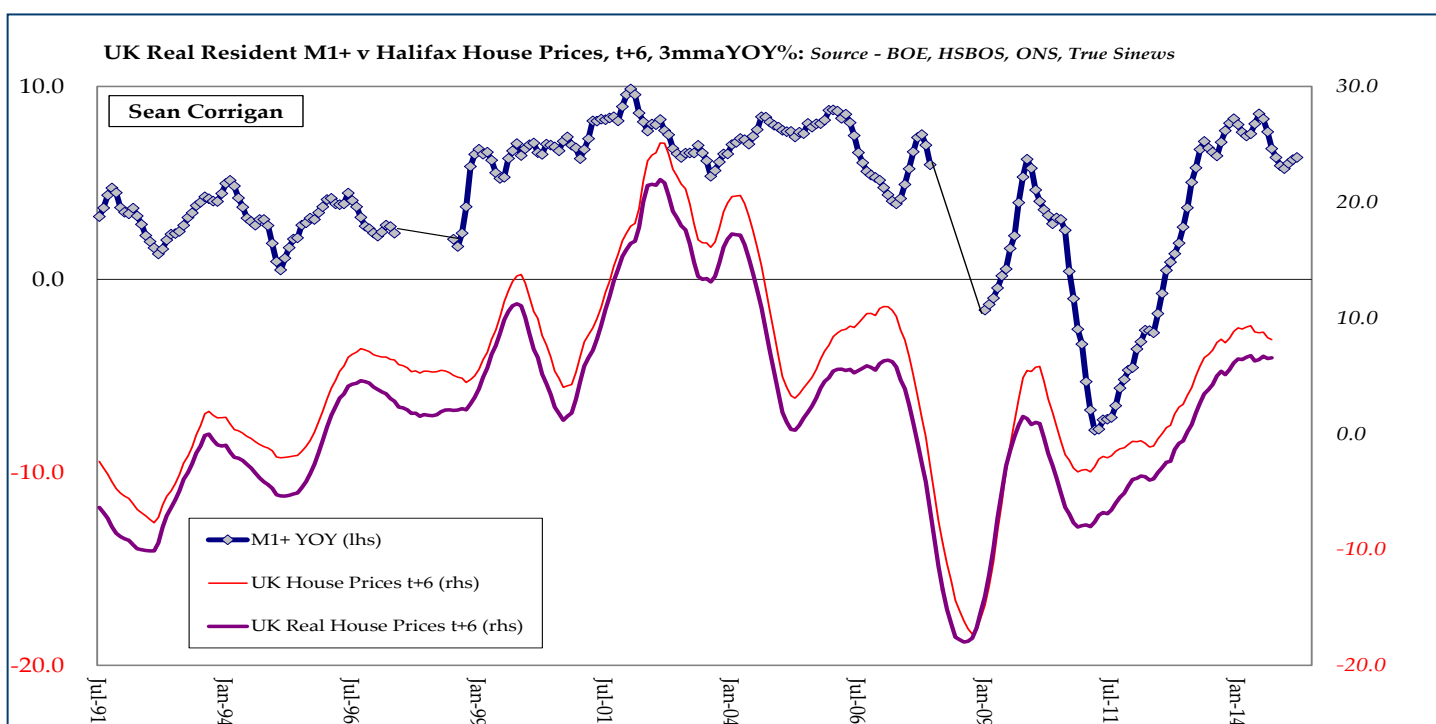
temperance, today the former are saving nothing while the latter ended 2014 running up the biggest borrowing tab since the heady days when Lehman's doors were still open and Chuck Prince was merrily dancing the Charleston over at Citibank.





This shift only leaves Johnny Foreigner to pick up the bill for British profligacy and luckily he is presently keen on the assets of a country where there appears to be some semblance of growth and where interest rates have critically not turned into warehouse dues across much of the yield curve. The terrifying scale of the UK's reliance on his enthusiasm can of course be seen from its flipside in the yawning, all-time record current account gap being posted these days.

Given this, who would really be a sterling bull, except to the extent that one wants a non-negative alternative to the Euro-Draghama, while the outlook remains clouded by the internal problems of the Zone's the will-they-won't-they farce with Greece, and by the potentially fractious issues to come when Cameron makes good next year on his pledge for a referendum on Britain's continued membership of the EU?



ACTA DIURNA: The European Perspective

In Europe itself, though there are glimmers there and there of recovery and though the utterly superfluous programme of QEuro has helped set financial assets roaring and increasingly threatens to add real estate to the mix, the way to meaningful restoration of prosperity seems fraught.

Ironies abound if only one chooses to look.

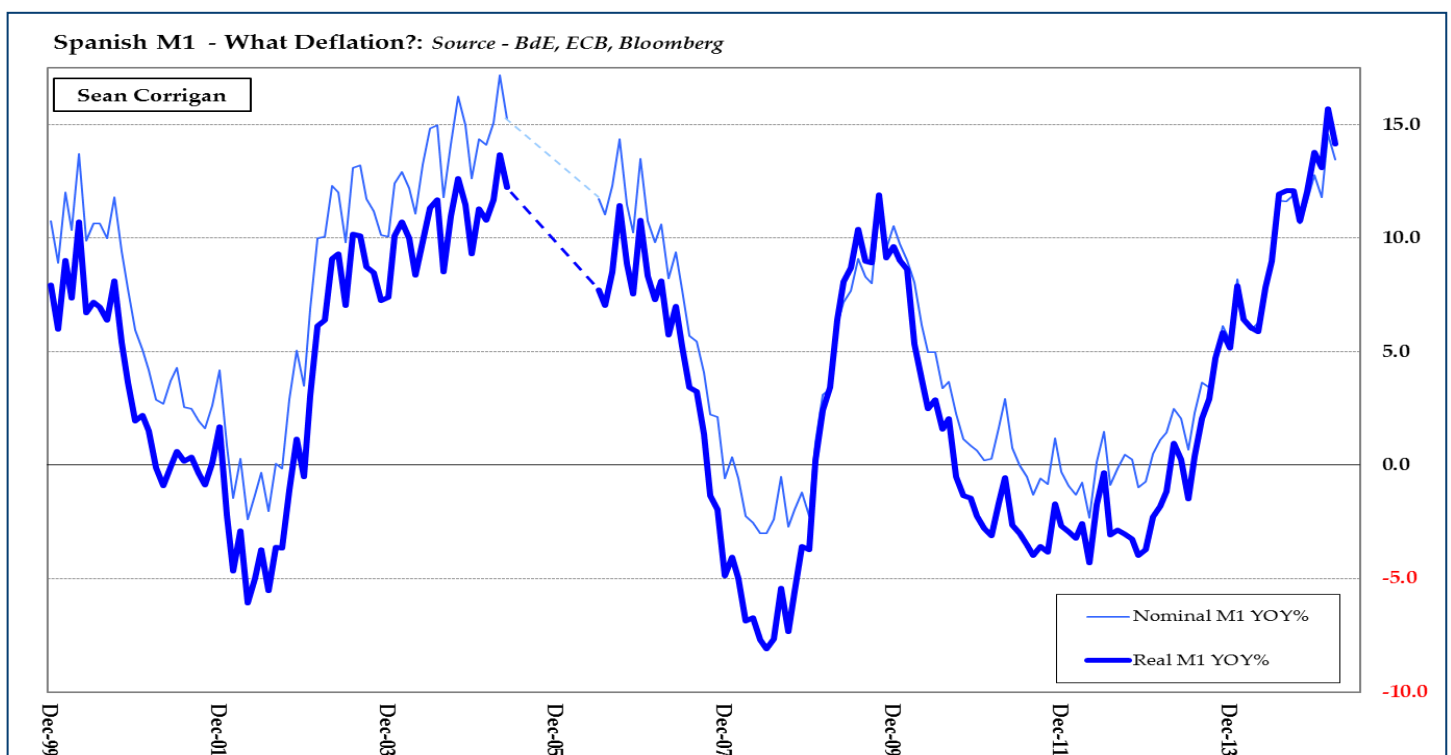
The secular stagnationists fret about the growth implications of the bloc's demographic slide yet it cannot presently find work for 23 million of its citizens across the EU as a whole. Worried about the lack of replacements for its greying populace, it has left 4.8 million under-25s without jobs, a Petri dish of discontent whose potential to become a breeding ground for a violent mass rejection of their patriotic ideals helps keep an increasingly ineffectual elite awake at night.

To the pampered Eurocracy, no cost seems too high to impose upon the ordinary citizen in the name of that baleful union of disparate nations formerly all too eager to free-ride on the mirage of uninterrupted convergence to German standards of global competitiveness before their rake's progress of unbridled public expenditure and unconstrained housing boom reduced them suddenly to impotent fury and mass penury.

The great symbolic 'Cross of Gold' upon which they have crucified themselves is the sacred single currency itself, even if it does carry with it the curse of the Nibelungs for many of its users. Yet, at the same time, we have lately heard a chorus of monetary cranks (Messrs Leaviss and Bofinger, you know who you are) telling us that the only way we can hope to preserve the euro is to ban people from ever having access to it in material form, all the better for the state to clip great chunks of value from its insubstantial edges at will, as well as all the easier for the state to monitor, control, and exact taxes from our every waking activity.

Finally, after long years of wheel-reinventing and breast-beating, mainstream macro-economists are slowly coming round to a half-articulated recognition of what the Austrians, for one, have long tried to tell them, to wit that it is the incurrence of too much debt which makes us prone to recession and that it is the persistence of too much of the wrong kind of debt *after* the Crash which helps stultify the recovery. Yet what is it that the central bank apothecaries are prescribing to us? A treatment which not only perpetuates existing debts but which makes the unwise contraction of further debts too painless to be long resisted.

For a breath-taking example of intellectual arrogance and of a wilful refusal to consider any criticism of one's adherence to a failed policy in this regard, one could do no better



than to consider Mario Draghi's latest speech at the IMF in Washington. A man of whom Talleyrand could have applied his famous dismissal of the Bourbons (*'They have forgotten nothing and have learned nothing'*), Draghi actually lauded that dire process of dangerous over-extension known generally as the 'search for yield', saying that:

'Lower rates have in turn created more net demand for borrowing. And banks have then begun to search for the "next tier" of borrowers, leading to a gradual easing of credit standards and - we expect - a further strengthening of competitive pressures.'

Airily, he denied he was creating the conditions for a future debacle with an appeal to the latest central banking fad of 'macro-prudential' policy.

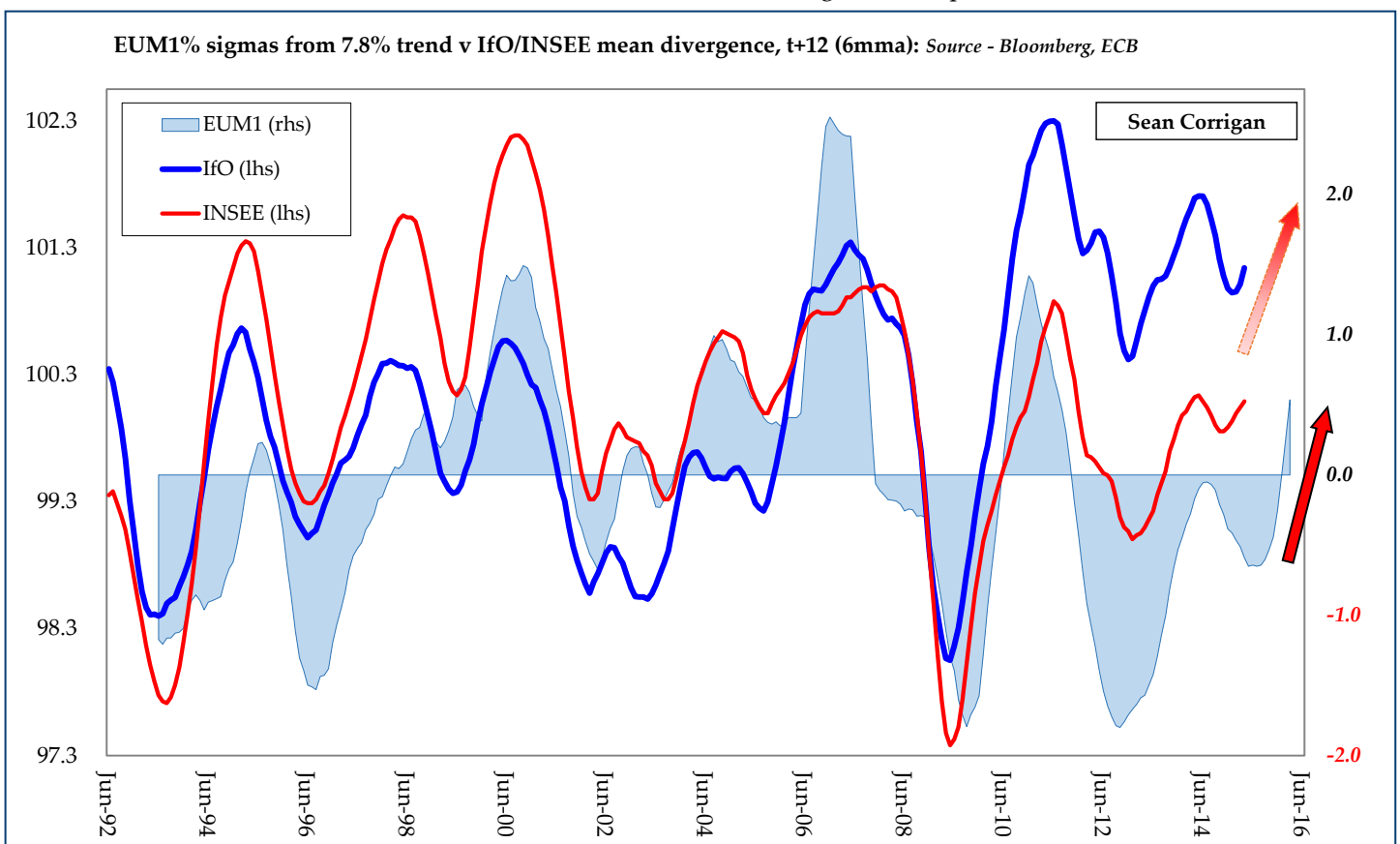
'While a period of low interest rates will inevitably result in some local misallocation of resources, it does not follow that it has to threaten overall financial stability. This hinges crucially on monetary policy being embedded in a complementary set of supervisory and regulatory policies that create incentives for balance sheet adjustment and responsible financial behaviour.'

The idea that entrepreneurial planning requires some sort of predictable, equitable, and reliable framework in which to take place never seems to occur to these Pretenders-in-

Chief at Knowledge. For what is the 'macro-prudential' approach but a self-issued licence to change the rules at whim whenever the malign and unforeseen consequences of one's previous tinkering appear, thus leading to a classic spiral of ill-judged intervention and arbitrary attempts at its later mitigation – in other words, a businessman's nightmare and an investor's bane?

Finally, Draghi tried glibly to deflect the charge that he was impoverishing the most vulnerable sections of society by 'redistributing' wealth away from poor savers and pensioners, actual and imminent, in favour of players in financial markets. He affected to be unmoved that they might suffer some short term hardship; they were after all those pariahs of modern macro – Savers! – sociopaths plagued with an obstinately *'lower propensity to consume'*, an unfortunate affliction which rendered them less *'helpful to the recovery.'*

No, he maintained, his version of tough love would be ultimately good even for those trying to eke out a living on their shrinking widow's mite. Their interest, he insisted, was that *'output growth remains on a robust path as this maximises the likelihood that their claims are honoured in full'* – i.e. better to be paid too little than nothing at all – and, besides, the greater the pain now, the shorter its duration.



Or as our sage put it: *'...the more monetary policy is able to encourage investment (let us glide over the non sequitur that interest rates are the sole impediment to investment), the faster interest rates will return into more normal territory.'*

With a degree of inconsistency that would be laughable if it were not so fraught with consequence for everyday folk, one of Draghi's executive board colleagues delivered himself of an almost exactly equal and opposite opinion on the very eve of his Chief's prognostications (while still maintaining that the current policy was the correct one, naturally).

Benoît Cœuré told a gathering of good and great in Zurich that suppressed rates and mass asset purchases could tempt people to lever themselves up into a *'rational bubble'* (the wonders of EconSpeak!) which would turn out to be *'very costly'*

Not only would this cause *'welfare-decreasing macroeconomic instability,'* he said, but *'it also brings about an arbitrary redistribution of wealth that may, in the worst case, undermine social cohesion and trust that the central bank is acting within its narrow price stability mandate. And moreover, it can create financial stability risks elsewhere, generating negative spillovers from what should otherwise be a normal international adjustment process.'*

Summing up, Cœuré concluded categorically that *'...it would be wrong to treat bubbles as a welcome replacement therapy to a sustainable growth model.'* Not exactly what Mario was arguing, was it?

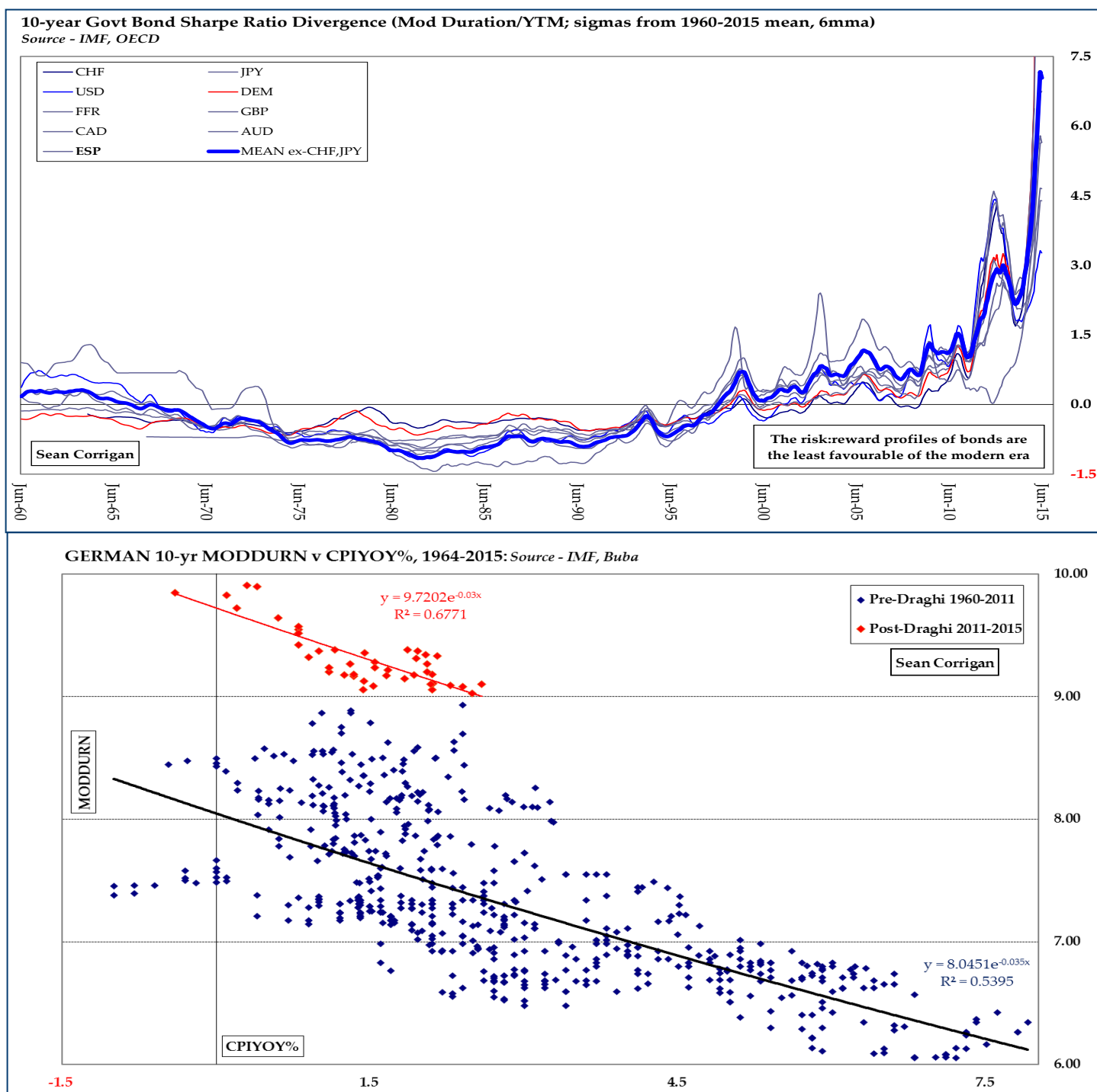
To think that all our livelihoods are at the mercy of men in office peddling such a thin gruel of warmed-over Keynesianism; two parts underconsumptionist pap and one part philosopher-king Fatal Conceit. Truly, future historians are going to have a field day in their expositions of the prevailing follies of our generation, assuming, that is, that we bequeath enough of a civilization to our descendants for there to be such creatures of calm contemplation and academic ease as historians.

BUY CHEAP, SELL DEAR: Market Observations

The salient feature of the past few weeks has without doubt been the gut-wrenching sell-off in the long end of the bond market – a collapse which, on the face of it, has no other explanation other than that the sheer volume of leveraged and duration-extended longs could no longer support its own weight, at least not when leant against by one or two of those big hitters most interested in launching a profitable bear raid.

If that really were the case, we could perhaps draw a certain comfort from the fact that the move sent a message to the Draghis of this world that they are not, as they seem to imagine, omnipotent as well as omniscient.

An unwind of that matrix of crowded trades which featured various combinations of being long the dollar and bonds, short commodities, could also have featured in the reversal. As such this could be construed as nothing more than a healthy clearing of the decks before the next leg of the trend resumes.





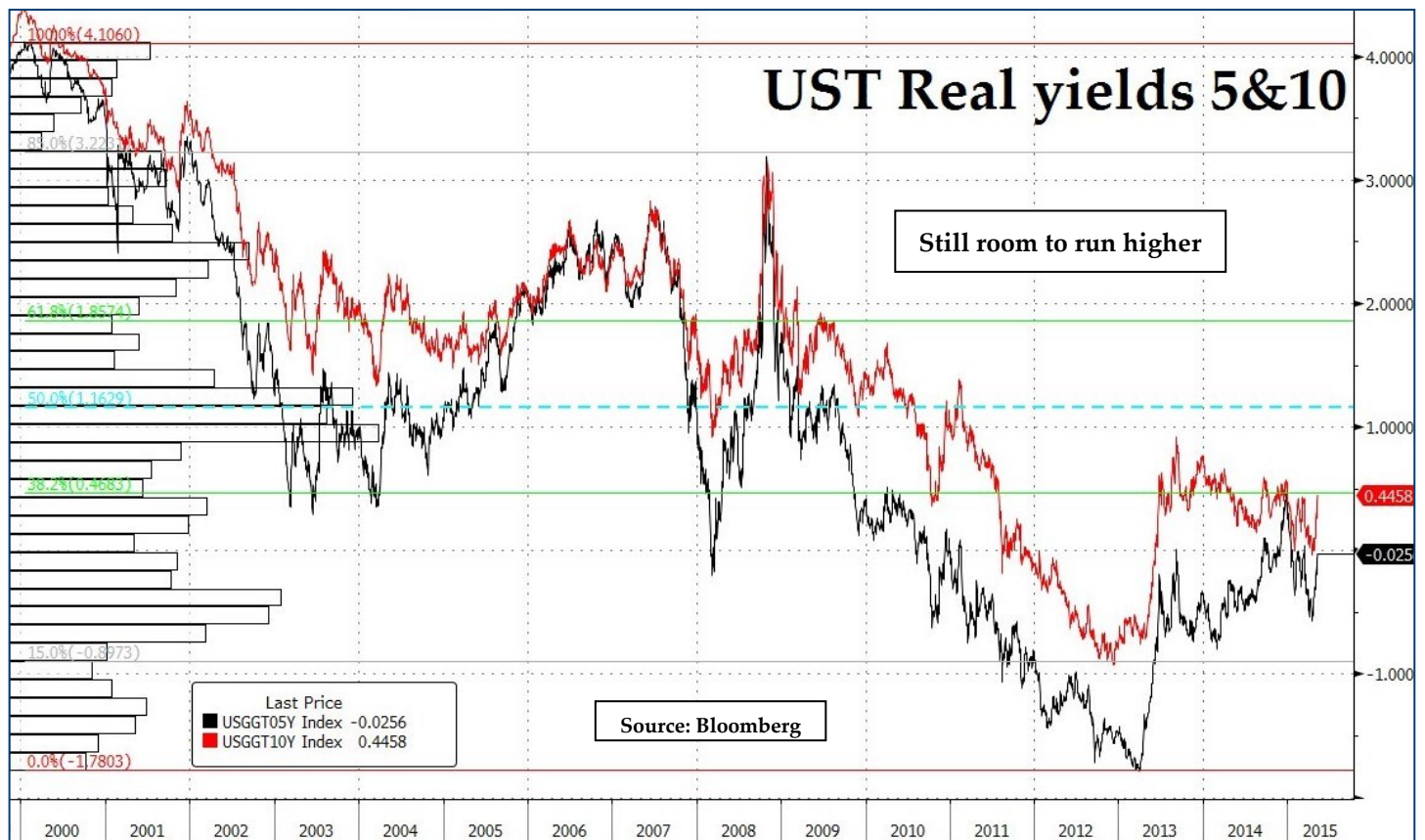
However, your author cannot quite shake off the nagging suspicion that what we have witnessed might have been the first run through of the constellation of moves we might expect as and when we next enjoy a run of more positive macro data, not least because the most dramatic declines occurred when a glimmer of hope had broken through the dismal clouds of economic despondency in Europe, to the point that people were beginning to wonder when the ECB would have to abandon its ill-judged programme of massive balance sheet expansion.

We have often pointed out how closely entwined the track of oil prices, bond implied break-even inflation rates (hence nominal yields, as well as curves), and dollar-euro had be-

come and here we saw a 180° swivel in all three – exactly as we might anticipate will happen when the Herd once more begins to believe in a degree of *reflation* which is just starting to foreshadow the eventual return of the *inflation* lurking beyond it.

Adding to the circumstantial evidence for such a shift, we not only had oil and copper bumping against the top of this year's ranges, but, seemingly out of the blue, a previously drifting gold price suddenly added \$50/oz and silver jumped \$1.60 - or nearly 10% - all in the space of a week.





It might seem premature even to broach the subject while the consensus is happy to use the same softening of the US numbers discussed above to defer once more its estimate of when the Fed will first hike, but it does bear watching, given the likely strength of the eventual reaction. Moreover, we should note that stock markets are now finding the upward thrust of low interest rates (which benefit them through the twin processes of *outsider* asset switching and speculative buying on margin and *insider* manipulation of the capital structure via buybacks and takeovers) is no longer enough to propel them readily higher against the downward pull of sated appetite and deteriorating expectations.

In such an environment, any further leakage of hot air from the bond market could well impair equities' buoyancy sufficiently to usher in the long-awaited correction. If we had a rout in over-owned bonds on grounds so ephemeral as not even to be easily agreed-upon, imagine the carnage in universally-possessed stock markets if some identifiable reason to sell them were to arise.

As for commodities, we would suggest that a cessation of the one-way trade lower has given encouragement to those aware of their extreme relative undervaluation to add their bid to that of the short-coverers. That such activity has

been under way seems to be born out in an examination of the Commitment of Traders reports. WTI net longs, for instance, are at their highest since the start of last summer's breakdown, with gross longs a whisker off an all-time high. In the case of copper, the record absolute net spec short seen in February (the third most extreme in history as a percentage of open interest) is now getting close to attaining a one-year high net long (albeit, as yet, a modest one of just 8,500 contracts).

Such a counter-rotation is logical enough to contemplate but it should not be taken as an imminent end to the present conditions of glut, much less as an excuse to indulge in fantasies about a return of the 'supercycle'. Save that up for later in the year if and when the current el Niño pattern develops sufficiently to spook the grain markets at a time when the drop in oil prices will presumably begin to wash out of the CPI indices.

At root, the move in oil which has been such a signal feature of the recent upheavals has been supported by the first signs that US production has reached its peak and that inventories – though still at all-time highs, especially if those for products are reckoned alongside the ones for crude – are also in the process of topping out. Against that, reductions in the rig count are definitely slowing and even, in



one or two regions, registering the smallest of increases once more. As another, possibly misunderstood indicator which has assumed an unheralded importance of late, the first week in which a positive number is posted is one which will provide a severe test of the new bulls' fortitude.

Elsewhere, the Atlantic basin is said to be awash with up to 80 million barrels seeking to find a home; cargoes of Azeri crude for May loading are said to languish unsold even as the day approaches when those for June are due to come to market; and while Iran has bemoaned the fact that Russia has been unable to swap the oil it has delivered under the terms of the pair's bilateral barter arrangements, it is now talking of the ability to dispose of some of the 10 million barrels it has in floating storage and of restoring exports to 2.5 mbpd from today's 1 mbpd within six months of sanctions finally being lifted, as is widely expected they will be, at the end of next month.

In its most recent report, the IEA described non-OPEC output as *'surprisingly strong'* with the low crude price being partially offset for the likes of Russia and Brazil by the marked decline in their currencies. As for OPEC itself, the comment was that its members were *'ramping up output'* and *'aggressively investing in future production capacity'*. Ahead of the June 5th meeting of the cartel, the Kuwaiti oil minister, Ali Al-Oman Omair said the recent rebound had *'ruled out'* the announcement of any cuts and Al-Naimi, his Saudi counterpart famously intoned. *'Insh'allah.'*

We should never underestimate the power of 'sentimentals' to dominate 'fundamentals' - and so we should not discount the possibility that crude prices could yet spike higher to, say, \$69, even \$73/bbl if we take out the high which lies at around \$64 on WTI - but the foregoing does not sound like the ideal backdrop to a sustained bull market, absent a further bout of deliberately-imposed monetary insanity from the likes of Signor Draghi.



Disclaimer

This newsletter is intended to give general advice only on the importance of Macro investments. The investments mentioned are not necessarily suitable for any individual, and you should use this information in conjunction with other advice and research to determine its suitability for your own circumstances and risk preferences. The value of all securities and investments, and the income from them, can fall as well as rise. Your investments may be subject to sudden and large falls in value and you may get back nothing at all. You should not buy any of the securities or other investments mentioned with money you cannot afford to lose. In some cases there may be significant charges which may reduce the value of your investment. You run an extra risk of losing money when you buy shares in certain securities where there is a big difference between the buying price and the selling price. If you have to sell them immediately, you may get back much less than you paid for them. The price may change quickly, particularly if the securities have an element of gearing. In the case of investment trusts and certain other funds, they may use or propose to use the borrowing of money to increase holdings of investments or invest in other securities with a similar strategy and as a result movements in the price of the securities may be more volatile than the movements in the price of underlying investments. Some investments may involve a high degree of 'gearing' or 'leverage'. This means that a small movement in the price of the underlying asset may have a disproportionately dramatic effect on your investment. A relatively small adverse movement in the price of the underlying asset can result in the loss of the whole of your original investment. Changes in rates of exchange may have an adverse effect on the value or price of the investment in sterling terms, and you should be aware they may be additional dealing, transaction and custody charges for certain instruments traded in a currency other than sterling. Some investments may not be quoted on a recognised investment exchange and as a result you may find them to be 'illiquid'. You may not be able to trade your illiquid investments, and in certain circumstances it may be difficult or impossible to sell or realise the investment. Investment in any of the assets mentioned may have tax consequences and on these you should consult your tax adviser. The opinions of the authors and/or interviewees of/in each article are their own, and are not necessarily those of the publisher. We have taken all reasonable care to ensure that all statements of fact and opinion contained in this publication are fair and accurate in all material respects. All data is from sources we consider reliable but its accuracy cannot be guaranteed. Investors should seek appropriate professional advice if any points are unclear. HindeSight Publishing Ltd is responsible for the research ideas contained within. They or any of the contributors or other associates of the publisher may have a beneficial interest in any of the investments mentioned in this newsletter.

Disclosures of holdings: None relevant to any content discussed within this issue of the newsletter

Copyright © HindeSight Publishing 2015. Any disclosure, copy, reproduction by any means, distribution or other action in reliance on the contents of this document without the prior written consent of HindeSight Publishing is strictly prohibited and could lead to legal action.