



The Gods Themselves Contend in Vain

If you pay heed to today's dominant Hydraulic School of economics, you would imagine that the world functions a little like Santa's grotto. Only submit your demand for goods to the eager elf on reception and it will be magically transmuted into the object of your desires, giving jobs and prosperity to all the eager little sprites beavering away up there at the North Pole.

Ergo, just hand out enough handy green shopping vouchers to passers-by and the nation's factories will soon be putting on extra shifts and the FedEx man will be putting the kids through college on his overtime pay alone. At least that's what everyone from Bernanke to Blanchflower and Carney to Kuroda would have us believe. In the short run, they might even seem to be right.

But over the medium to long haul, matters are a bit more complex than the '*consumption is 2/3 of the economy*' crowd can readily conceive. As a Bastiat or a Say would be quick to suggest, it is production which logically precedes consumption and just as we would not personally choose to undertake any task which did not seem likely to earn the expenditure of our time and effort, nor will any

sane, private businessman. Hence it is the mutually profitable exchange of what we have produced that allows us all to enjoy the fruits of each other's labours and it is the prospect of retaining a residual income for himself and his investors after he has disbursed the bulk of his receipts so as to give his junior collaborators their contractual share, which induces the entrepreneur to put his and his investors' resources at hazard.

Now it is true that what will be profitable – i.e., what will earn the one undertaking production enough of a surplus to put shoes on his and his funders' children's feet, as well as on those of his non-risk bearing co-workers – will be something someone else wants to buy with the means gained through his or her own prior act of production.

Thus the 'consumer' – i.e., we all when we step away from the workbench and towards the storefront – will help determine the composition, the quality, and even the quantity of the goods on offer through voting his or her spendable dollar, but since that same consumer's only sustainable method of fulfilling his wants honestly and without the exercise of compulsion is to market his own output, production is the act which enables consumption in general as well as that which satisfies it in particular.

Even if we stop there – and before ever daring to think about the complex, multi-layered tissue of interlinked production processes with whose treatment we Austrians are so obsessed; or forbearing to muse on the state of the physical and intangible capital endowment with which it is conducted – it should already be apparent that money *per se*, being no more than a medium which facilitates the exchange of production, is almost entirely incidental to this process.

Yes, a wider, smoother road is better to travel along than a narrow, rutted one, but once the former is capacious enough to carry the requisite amount of traffic, the addition of extra lanes is simply an avoidable waste of asphalt and Armco.

[continued over]

Sean Corrigan

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Worse still, if the builder includes too complicated an interchange, or insists on imposing too many lane changes and speed limitations, or bombards the poor motorist with an over-enthusiastic clutter of highly distracting signage, the journey along it may be less secure and more time consuming than before it was constructed.

The Price is Right

The price mechanism, the critical nature of which Hayek took so many pains to impart, is the one sure-fire way to help co-ordinate all the myriad of different undertakings being conducted in the market - some of them complementary, some competitive; some aimed at almost instantaneous consummation and others only ripening into a consumable good after the passage of much time; some rewarding their conductor in the first moment of exchange, others only doing so slowly, after many repetitions of the first incremental sale of its output.

Since all such prices, in anything other than the most rudimentary economy, are *money* prices, messing with money as a policy tool is a cross between dosing the patient with a powerful narcotic and injecting him with a neurotoxin. The all-important signals become confused or simply fail to trigger the correct response. Economic calculation, entrepreneurial calculation – even *consumer* calculation – are all thrown successively out of kilter. The matrix of economic activity – which is *not* a fancy piece of plumbing as much of the Mainstream seems to believe – is an evolutionary, multi-agent search process where best guesses must be applied in the face of an uncertainty which is all-pervasive and ineradicable (central bankers, please note). Price signals must pass along this network freely and must faithfully impart their information content to all who observe them.

The individual's aim must be to be robust enough to endure the constant friction of less than perfect choices and the buffeting of petty mistakes while constantly adapting and re-orienting himself toward the greater goal of whatever quantum of material fulfilment he has set for himself. As each such individual strives to do this, his actions naturally impinge upon those of all his fellows - as they do upon his - changing the topology of the matrix as they do. In such a world it is not the theorists' chimera of equilibrium we attain, but the energy of the ever-present disequilibrium that we exploit, seeking to arbitrage a little of it away and into our pockets. Order comes from Chaos, not from divine bureaucratic prescription.

Since the sum of these countless, shifting mutual influences – much less their development over time – is beyond all hope of computation or reduction to some useable analytic form, the process becomes one of a massively parallel trial-and-error search. In this, the primary unit of the information by which we seven billion people-processors feel our way to a modicum of greater want satisfaction is the price signals we perceive flashing through the motherboard.

If I pay X dollars for A units of goods or services offered by a You whom I will probably never meet nor even identify, will I reckon it worth the cost to me of acquiring said X by giving up my already-owned B units of different wares to some other, far-removed and most-likely anonymous third party? Will you simultaneously arrive at the same - if inverse - conclusion, and will they, and so on *ad infinitum*? The only way we can know is to frame the decision in terms of acceptance or refusal of bids and offers made using the common medium of exchange – the money - which, whether by emergent social convention or through arbitrary legalist compulsion, we have all come to adopt in our dealings.

Furthermore – and this is something decidedly alien to the bulk of that serial-selfie science of comparative statics on which most analysis relies – all these processes take place through *time* and just as it is important to operate within the fuzzy confines of the marketability and the value-accreting potential of the goods being swapped today, it is also important to adhere to at least broad standards of compatibility in assessing the merits of *postponing* the immediate realisation of our wants in favour of meeting them later; perhaps then on a larger scale, perhaps in a modified form, almost certainly in different circumstances and therefore in keeping with an altered scale of personal subjective preferences.

If the only way we can achieve a workable transfer of goods through space (even if only through that notional 'space' which marks your property off from mine) is by using money prices, how much moreso is it true when we try to move them through time as well? Furthermore, given that the foundation of our current mass prosperity is the compounding ability of successive generations of our forefathers first to win a surplus, then to spare it for future use as *capital*, a key parameter in the endeavour to advance our well-being by involves such temporal shifts. Thus, we should not be slow to realize that intrinsic to this is the

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money price of time itself – a quantity better known as the interest rate.

We are therefore doubly unfortunate that most central bank action – outside of that bolting-the-stable-door dirigisme which goes by that ugly neologism, ‘macroprudential’ – attempts to goad us into modes of action we might otherwise not have chosen by manipulating not just today’s money prices (via inflation, currency depreciation and the like) but also the relation between these and those of tomorrow. This they do by imposing not just what they – with all the fatal conceit of the philosopher-king, imagine to be suitable short-term interest-rates – but by seeking to influence the longest of long ones, too.

Since this is a little like randomly reprogramming the GPS system when we are half way across the ocean in the middle of a thunderstorm, can you think of a more certain recipe for repeated disaster?

Bailing out the Bail-outs!

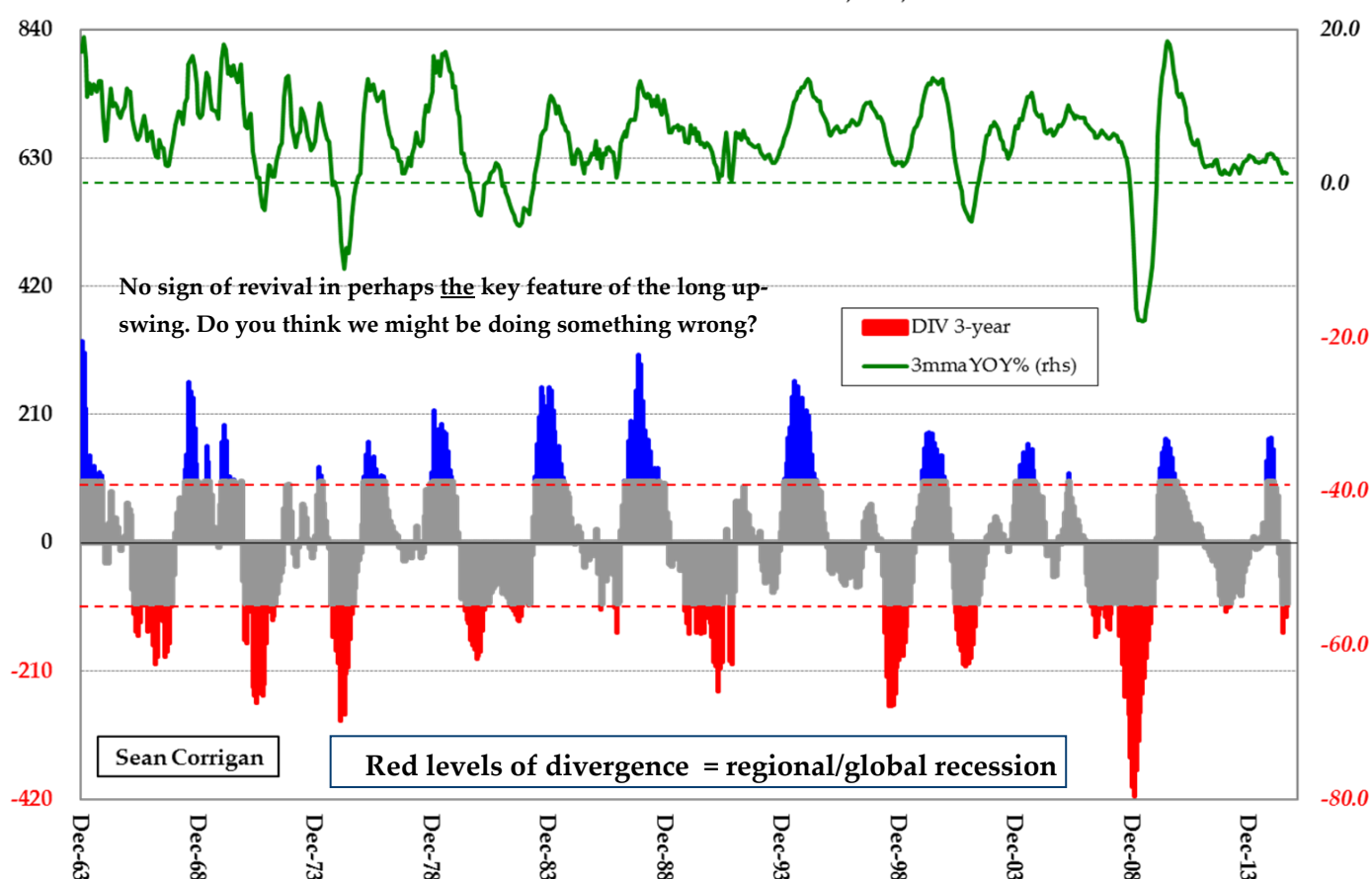
We have now been wrestling with the consequences of the policy failures of the early years of this millennium for seven (in truth, for eight) long years now; failures made in the

attempt to make good the failures of the preceding seven or eight years which ended in the Tech Bubble. This, too, was a manifestation of induced folly which, in turn, arose from the monetary apothecaries’ attempts to cure the bubble and bust in global property markets their ministrations had caused eight years or so prior to that – a crisis which had its root in the missteps taken between LDC crisis and Louvre Accord several years earlier again. Etcetera, etcetera, etcetera, to quote the King of Siam.

Yet, confronted with this repeated tragedy of misplaced interventionism, our current batch of tin gods is not just committed to the triumph of forlorn hope over bitter experience, it is arrogating to itself more and more power – if sometimes by default as the hapless political class cedes sovereignty to what it fondly imagines is the omniscient technocracy of the central bank.

A mark of the imbecility involved is to consider the BIS ‘Global Liquidity’ data. Here we find that, over the past six years – a period during which we are supposed to have been tackling our ‘debt crisis’ – global bank credit has risen by more than \$25 trillion to the point where it will probably surpass the \$100 trillion mark before 2015 ends.

WORLD TRADE VOLUME DIVERGENCE: Source - CPB, IMF, WTO



The Gods Themselves Contend in Vain (continued)

Large numbers tend to make the eyes glaze over but, to try to put this into context, that increase amounts to \$8 million a minute and the total comes to over \$14,000 for every man, woman, and child reckoned to be alive – well in excess of a per capita GDP total thought to be around \$11,000.

Thus it is that policies supposedly aimed at alleviating the burden of debt have only encouraged the incurrence of more of it. Hence the awful fear that should the cost of servicing that debt ever rise, it will swiftly prove to be insupportable and, ergo, the conclusion that we must continue to make more borrowing the easy option or risk an immediate global collapse!

It is an Austrian tenet that the mass disruption to steady progress generally known as the 'business cycle' starts out as a monetary problem but soon translates into a real one – i.e., it soon involves issues of misallocation of both the physical and human resources involved in all business activity. What those of us who share this diagnosis perhaps then fail to emphasize sufficiently is that real *solutions* – not the application of monetary cosmetics – are required to solve those same real *problems* once they have sprung up.

Once we acknowledge that the Planners' are every bit as clueless about the system as a whole as are we, it becomes apparent that the new, healthier order of things can only emerge from the bottom up as each person goes about applying their own specific abilities to their own equally specific ordering of wants so as to improve their lot. The role of policy, then, should not be to try to 'compensate' for the kinds of mass error which can only ever result from the imposition of prior, inappropriate policy choices. Nor should it seek to substitute for the individual's attempts at adaptation to his own particular niche the planners' overarching programme of engineering changes in broad, often meaningless economic aggregates.

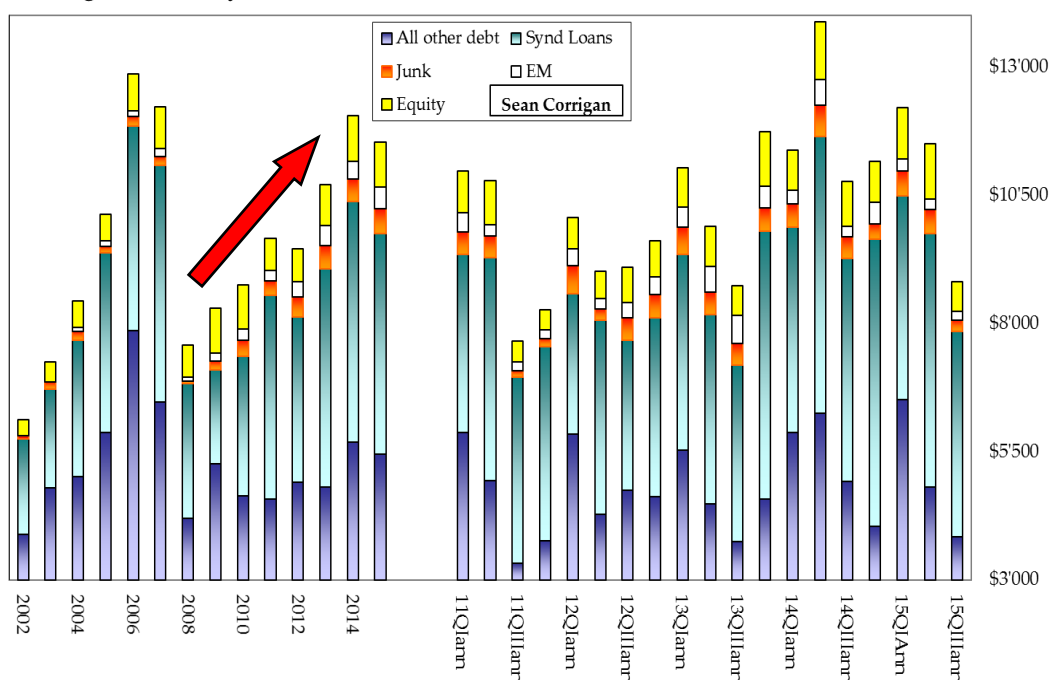
Perhaps now that the economics Nobel has gone to a man whose life work seems to have revolved around this very theme, it might give members of the Pecuniary Principate some much-needed pause for thought.

If it did, it might finally be recognised that the wisest policy is the one which seeks only to dampen the worst of the feedback storm at the height of the crisis – to set a firebreak and not to prop up all the trees, much less landscape the whole forest. That same wise counsel would then insist that we simply allow the organic, evolutionary healing process to proceed with the millions and millions of economic 'agents' effecting their own – and by their interaction, each other's – cure safe from the fear that their efforts will be brought to nothing by the continual introduction of new settings from on high or, conversely, without being bewitched by the Fairy Godmother into believing that they need not seek their own salvation since the details of their relief will soon be announced at a press conference to be held at Sonnemannstrasse 20, at the intersection of 20th Street and Constitution Avenue, or along the Nihonbashi-Hongokucho.

Microeconomic flexibility is what needs to be encouraged, not macroeconomic determinism. We need to replace heavy-handed *Befehlstaktik* with deft-fingered *Auftragstaktik*. We need the courage NOT to act.

Gross global security issuance (blns) - Source: Thomson Reuters

Deleveraging?



Totally Fed up!

A Fed which cannot convincingly steer between the Scylla and Charybdis of its existing dual mandate has now apparently taken responsibility for the entire globe - a presumption the cynic might say is already one shared by its country's militarists and legalists. Moreover, it has seemingly decided that it need no longer dissemble about the degree to which it has been captured by those it is supposed to regulate and so it has allowed itself to be publicly browbeaten by the titans of central bank-empowered high finance.

Not only must it therefore try to price every last poor soul currently without employment back into a job, regardless of the relative worth of his contribution to a potential employer; not only must it strive to steer the first derivative of the CPI index higher, no matter what the source of its current reluctance to move more rapidly up across the graph paper; not only must it pay heed to what its actions imply for people buying sun-cream in Seoul, ordering office stationery in Samarkand, upgrading to the latest cell-phone in Sumbawanga, or shipping soybeans from Sao Paolo, it must now take care that it does not upset the leveraged self-enrichment schemes of the one percent of the one percent who presume to tell it what to do and when.

If you despair at the naked political manoeuvrings of 'Whatever it Takes' in Europe, look with derision on the pandering to the Expectations Genie in Japan, or dismiss the folly (and grammatical garbling) of the soon-foresaken 'Forward Guidance' in Britain, what are you to make of the Fed members cowering before the Ghost of '37 and thus frozen in the headlights of the oncoming, spectral, eighteen-wheeler Semi of Uncertainty, barrelling down the highway at them, yet magically never quite reaching them either?

Being stuck with little in the way of conviction, much less the courage to stick by what puny ones they have, the Fed keeps offering itself the ongoing excuse that it needs just one more month's data - no, one more and one ore again - before it can resolve to act like a petulant child demanding more bedtime stories before it will suffer the lights to be put out. This semi-stochastic timidity is particularly ludicrous given the political emphasis which the Committee

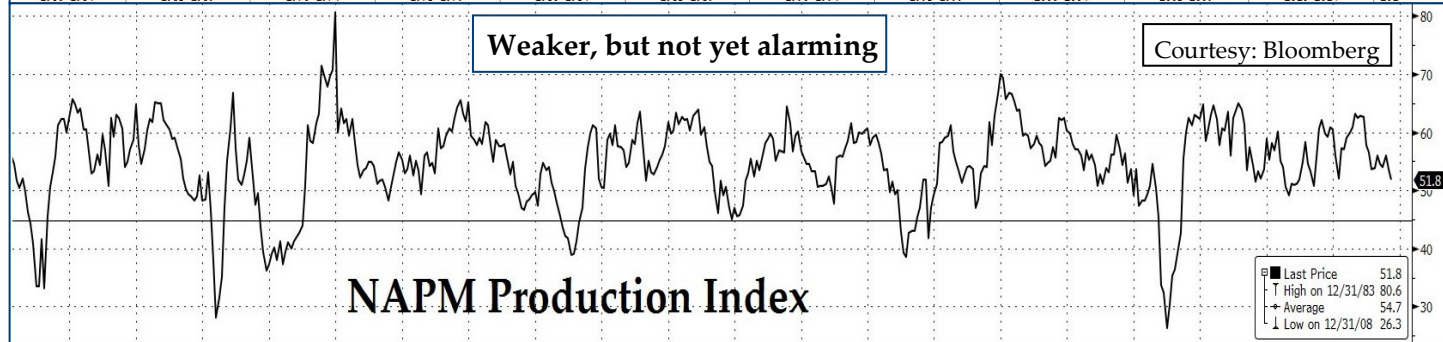
has come to place on the traditionally volatile and oft-revised employment estimate, especially since it is still wrestling half-heartedly with the vexed issue of whether the job market has undergone an as-yet unexplained structural shift in the course of the last cycle and so is not to be interpreted in the usual way by means of such numbers.

What it also cannot seem to grasp - though the market reaction, as well as the body of commentary, excited by September's failure of will should have made this all too evident - is that it is merely prolonging everyone else's lack of 'certainty' though its own eternal procrastination. Moreover, it has taken an approach - in confessing that it feels it cannot act when foreign markets are tumbling - entirely contrary to its frequently-repeated macroeconomic mantra of 'expectations'. How else to construe it overlooking the possibility that the sizeable moves in asset prices and currency parities which are giving it palpitations may already be pricing in the worst of the anticipated reaction? Given that everyone assumes the Fed will repeat the suspect and ultimately destabilizing procedures of 2004-6 and tighten oh-so gently and with plenty of forewarning along the way, can the FOMC not see that, the rumour having been heavily sold, the fact may end up being bought just as enthusiastically once it does eventually move?

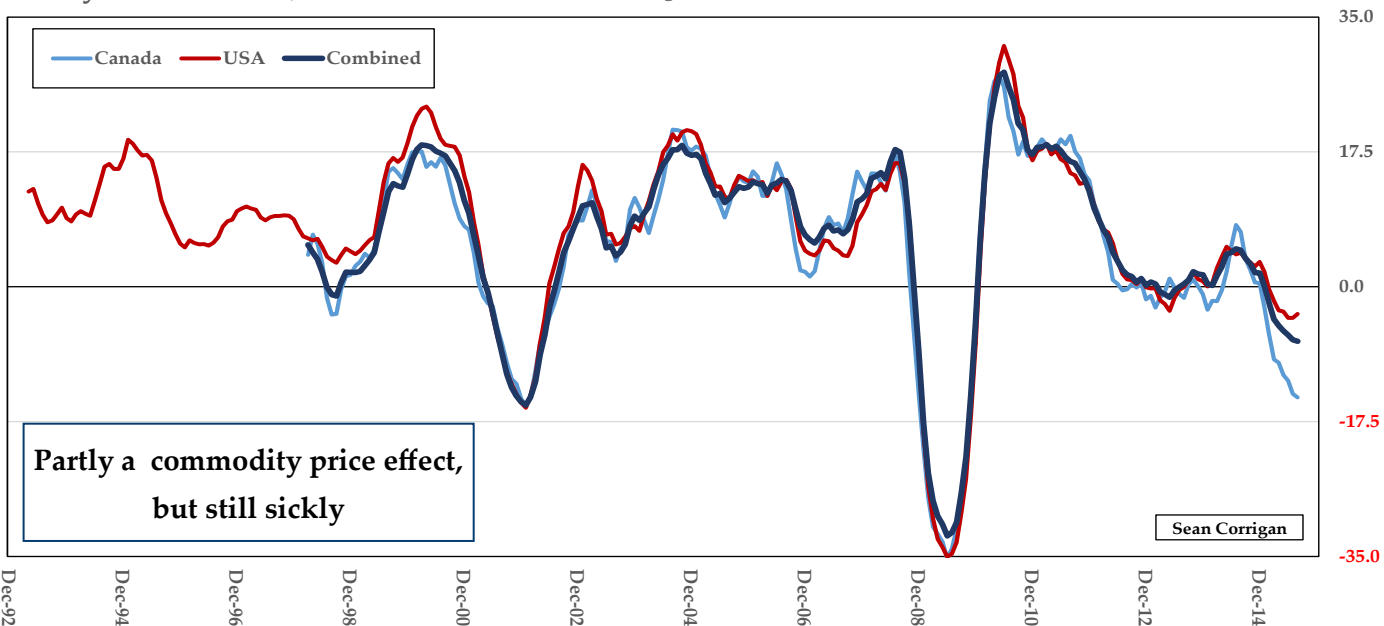
A final indictment is that the Fed's own irresolution is feeding back on everyone else's. In a bad case of I know you think I am aware of what you imagine I understand, the Fed is frightened of a financial market mood itself made more jittery by the dark suspicion that the central bank's inaction is rooted in some deeper foreknowledge of lurking economic frailties than that possessed by the market participants themselves, thus locking the two sides into a vicious spiral of doubt.

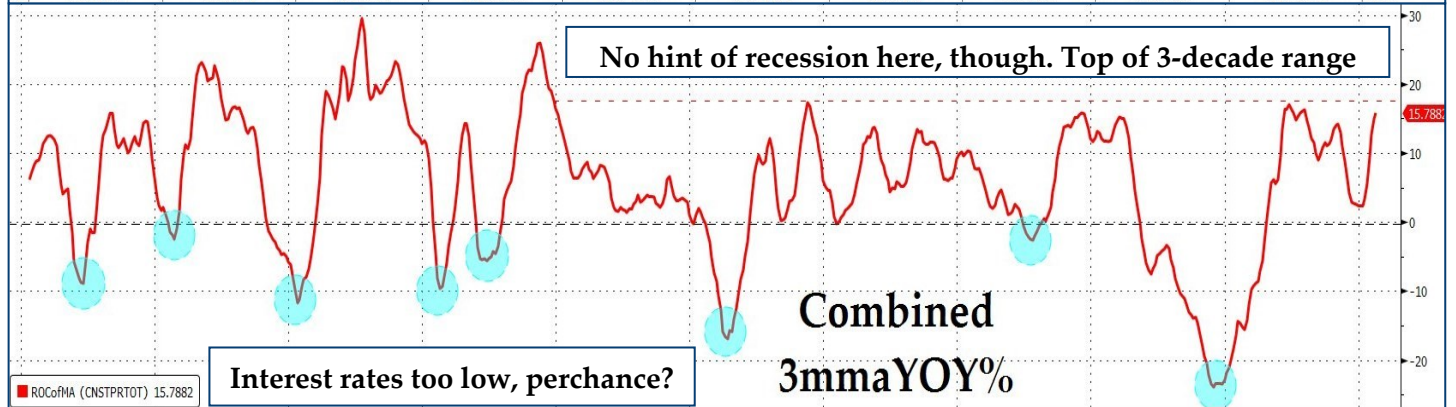
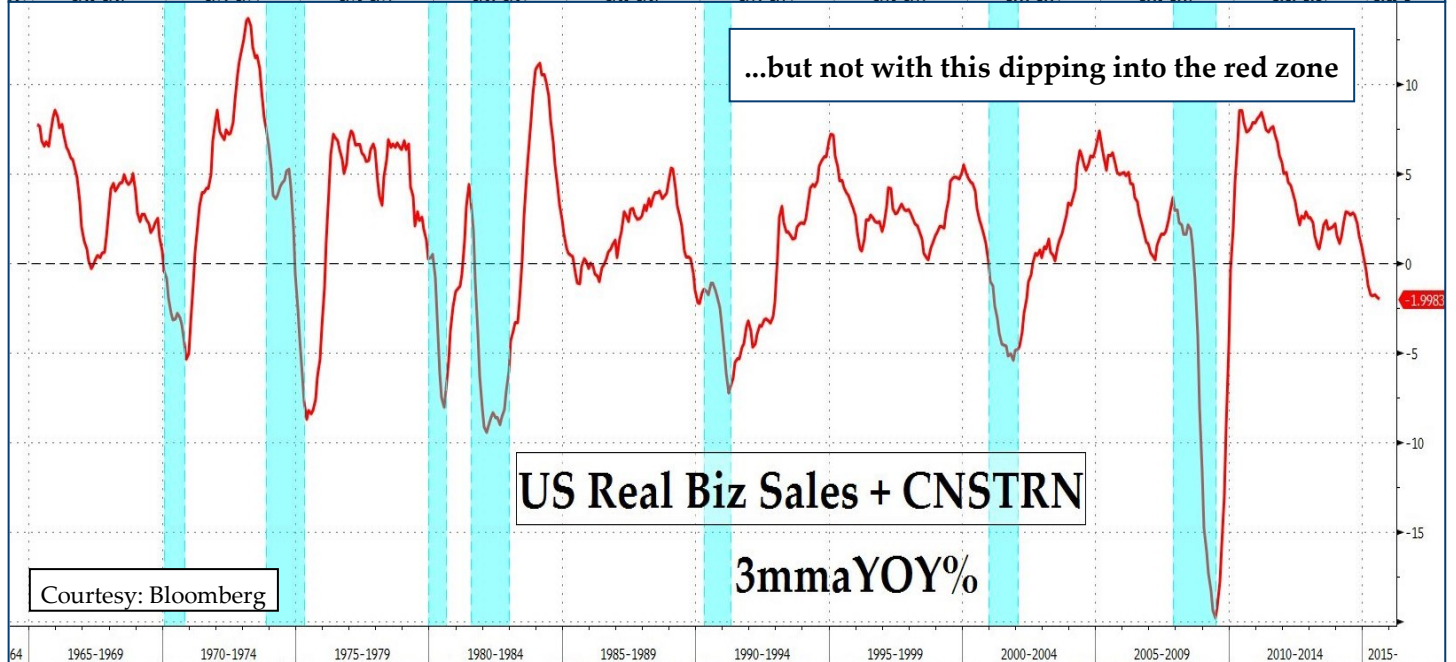
Circling the Void

So what of the economy itself? As we have argued above, the key to unpicking the puzzle is firstly to consider how cash is flowing through the world of business (something which can be cross-checked against, though not mechanically related to, the overall monetary backdrop) and then to try to see whether enough of the receipts are sticking to the hands of the firms in question to make it (a) possible and (b) desirable to remit the vast bulk of them to their



2-Way Goods Trade, 3mmaYOY%: Source - Bloomberg





workers and suppliers for another turn of the wheel. Additionally, we can try to determine whether conditions are propitious across the spectrum of activity, paying particular attention to the bellwether top end of 'higher-order' goods and not lose sight of any such differences in performance in the overarching aggregates or forsake them for a focus on the retail end of things alone.

Though we have already cautioned about relying too heavily on the employment data, in light of the Fed's fixation and the market's rapid. Post-release reversion to 'Goldilocks' mode we can hardly ignore it entirely.

So, yes, the headline numbers were poor: the past two months' average private payroll gain was a mere 109,000 – the weakest reading in three years and just half the average recorded in that interval. Goods jobs, too, are off 0.2% 3m-ma YOY, the poorest showing since recovery first took hold, but still short of the 1% or so shrinkage which has accompanied all recessions over last half-century or more.

It must be said, however that this does belie both the strength of the weekly claims data which are still setting record lows in both absolute and population-adjusted terms and the less timely JOLTS numbers which show a 4.2% overall rate of job offers which is better than those seen at the peak of the past two cycles in 2001 and 2008, with a million more openings being reported this year than last. Here the service sector – less subject to the vagaries of overseas markets or dollar translational effects – is doing especially well.

In terms of earned wages - the product of pay rates and hours worked, what we call the 'wage fund' – clear differences can be discerned between the sectors. Not surprisingly, the total in 'support services for oil & gas' have plummeted 18.8% alongside the rig count over the past year. Benefiting from cheap feedstock and a refining boom, 'petroleum & chemical products' are 10.5% ahead, more than doubling the overall non-durables' notable 4.5% advance; possibly struggling with a strong dollar, machinery makers are off 2.2%, badly trailing a weakening durable sector's 1.3% increase. Meanwhile, away from the business of making 'things', private services earnings are up 5.1%, and retail is 4.7% ahead of 2014.

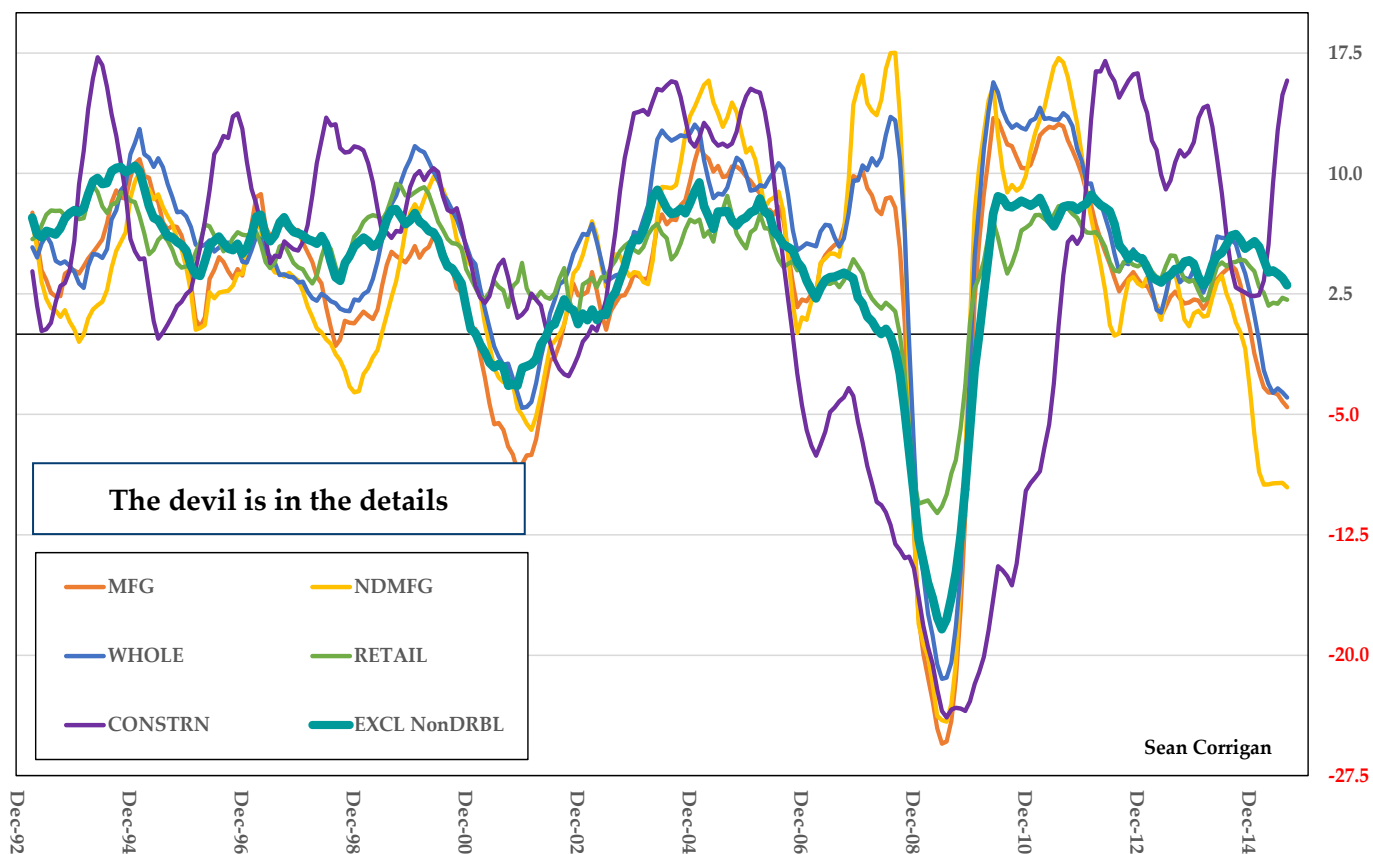
So much for the workers, what about the firms that employ them? Construction is the star performer, with private sector spending up 15.8% to the best levels in 2 ½ years. Retail looks modest with a 2.1% revenue gain, but strip out fuel dealers and gas stations and the remainder are enjoying 4.6% higher turnover. Where it gets more parlous is in wholesale – where non-durables' 7.1% drop is pacing a 3.6% overall decline which is the worst since the 2009 slump. Ditto for manufacturing where a durables sector just clinging to positive territory with a 1% gain is not enough to offset at 9.5% plunge in non-durables – again the worst since 2009.

Putting these together, we find revenues as a multiple of the wage fund – a good, though not definitive, gauge of whether labour is, at the margin paying its way - has manufacturing and wholesale enduring their worst spell in six years and retail its worst in 3 ½ with construction, conversely, doing its best since the start of 2013.

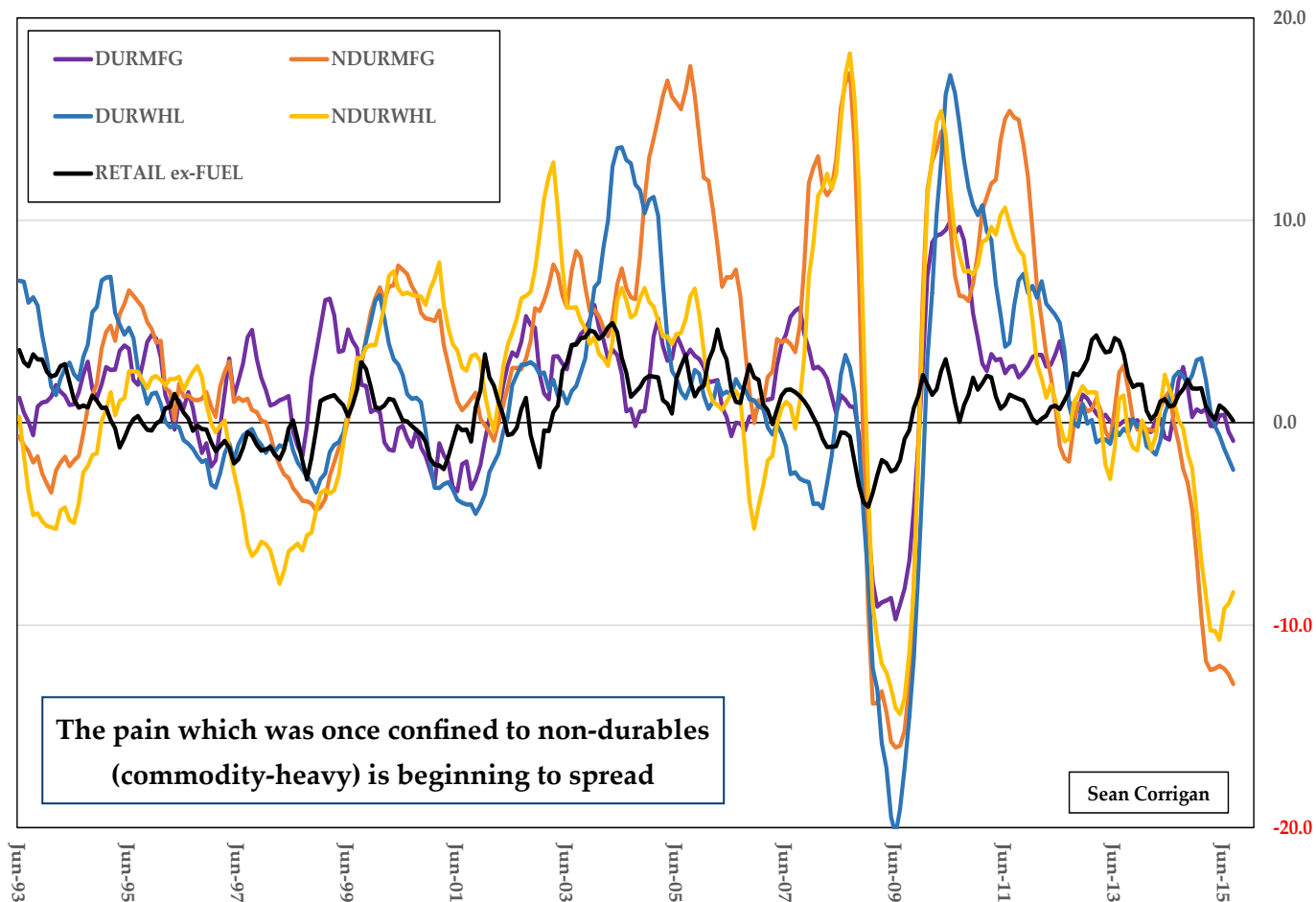
The one caveat here is that, just as lower hydrocarbons are dragging down retail sales, the same is probably affecting non-durables in general. Since profits do not necessarily move in lock-step with sales, it is conceivable that this measure is overstating the extent of the pressure. Not only would a wholesaler not care if he made the same 10¢ margin on a \$3 gallon of gasoline as on a \$5 one, he might even be happier since his need for working capital would be correspondingly reduced. Further investigation shows that headcount, the wage rate, and hours worked have all increased in non-durable manufacturing while profits outside of the blighted petroleum & coal grouping edged ahead by 2.1% in the first half on a 4.9% sales drop.

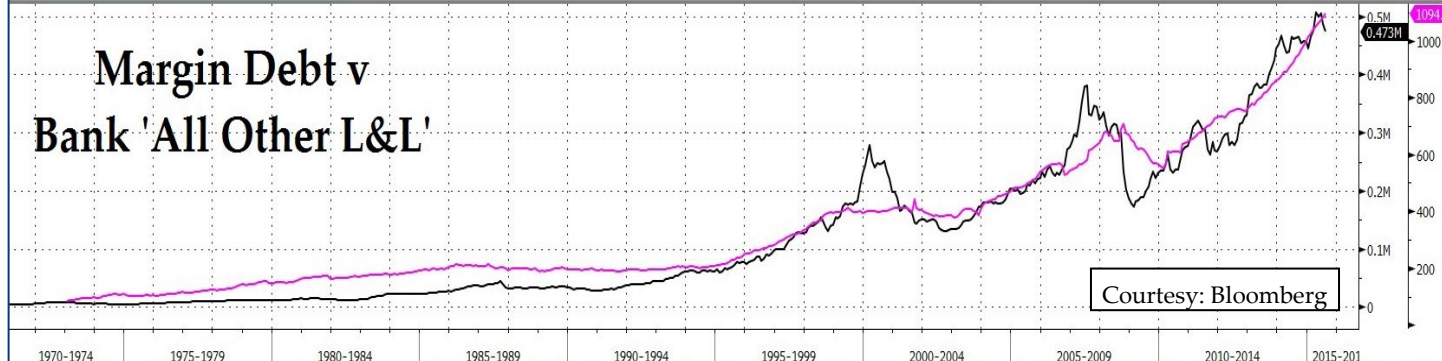
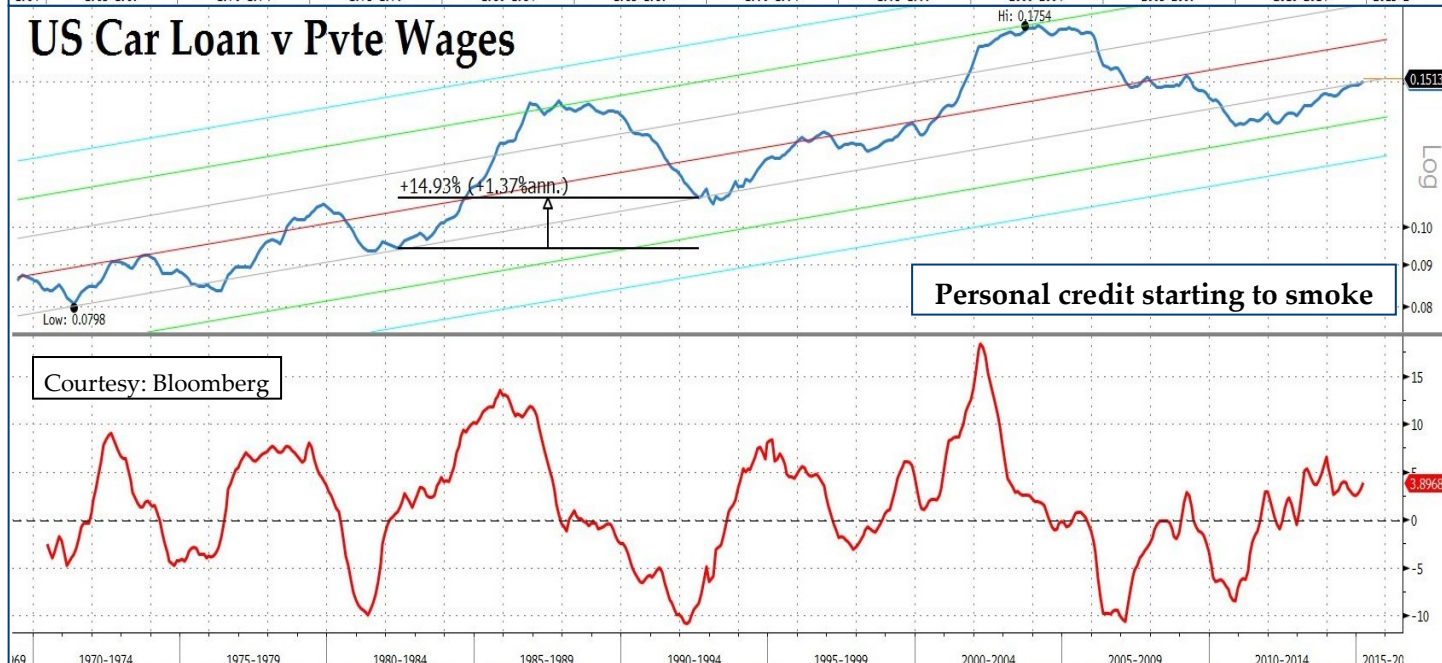
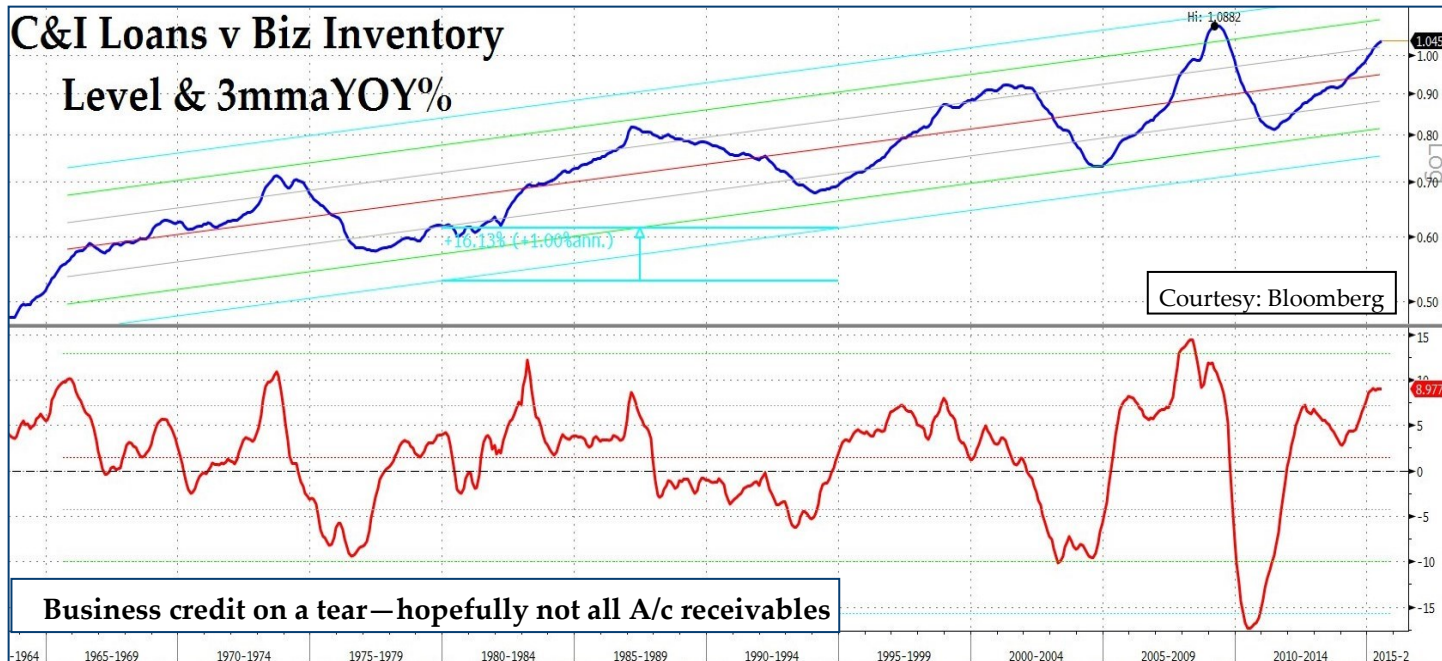
However we stack this, however, our Austrian spider sense has to be tingling: higher orders are struggling, lower orders are performing passably. Wages (and inventories) are up compared to revenues while C&I borrowing - rising at more than 10% p.a., or six times the long term trend rate, to swell 60% in the past five years and attain a level one-fifth higher than pre-LEH - is handily outstripping both.

US Biz Revenues, 3mmaYOY%: Source - Census



US Biz Revenue v Wage Fund, 3mmaYOY%: Source - BLS, Census





Negative Sum Game

But if this all argues for the Fed to maintain its wait-and-see stance (on the assumption that our suspicions that this has itself become counter-productive) when we look at what else easy money might be impacting and where, therefore, imbalances are beginning to appear.

Let's start with cars. Auto loans have risen 40% in 5 years to reach the \$1 trillion mark – loosely 2.1/20 years' worth of new car sales. They are therefore almost a fifth higher than at the time of Lehman and amount to getting on for 8 weeks' private wages. In addition to what was a record quarter for consumer credit additions – at nearly \$3bln a day - mortgage borrowing suddenly shot up to its fastest since the dying days of the sub-prime bubble, back in March 2008 (and if the most recent week's 27% jump in the MBA Purchase index should prove more than a momentary aberration, there could be more where that came from).

Together, the extra tally of IOUs has outstripped pre-tax private wages (and matched the sum of that income with that made by business proprietors) for the first time since the Crisis. Deleveraging R.I.P.

With all that borrowing going on, it should come as no surprise to learn that both car and house sales as a proportion of the population (the two enjoying an r-squared of 0.60 over almost half a century past) are both now firmly back to the middle of their long-term distributions. If you are looking for a sign of consumer 'normalcy' – one which might presuppose a spell of interest rate 'normalcy' to accompany it – you could not do better than that.

Taken as a whole then, there are signs that we may be entering one of those late cycle junctures where consumers are borrowing readily to add to the enjoyment of the extra income they have collectively earned just as the viability of their employment starts to rot from the capital goods head down.

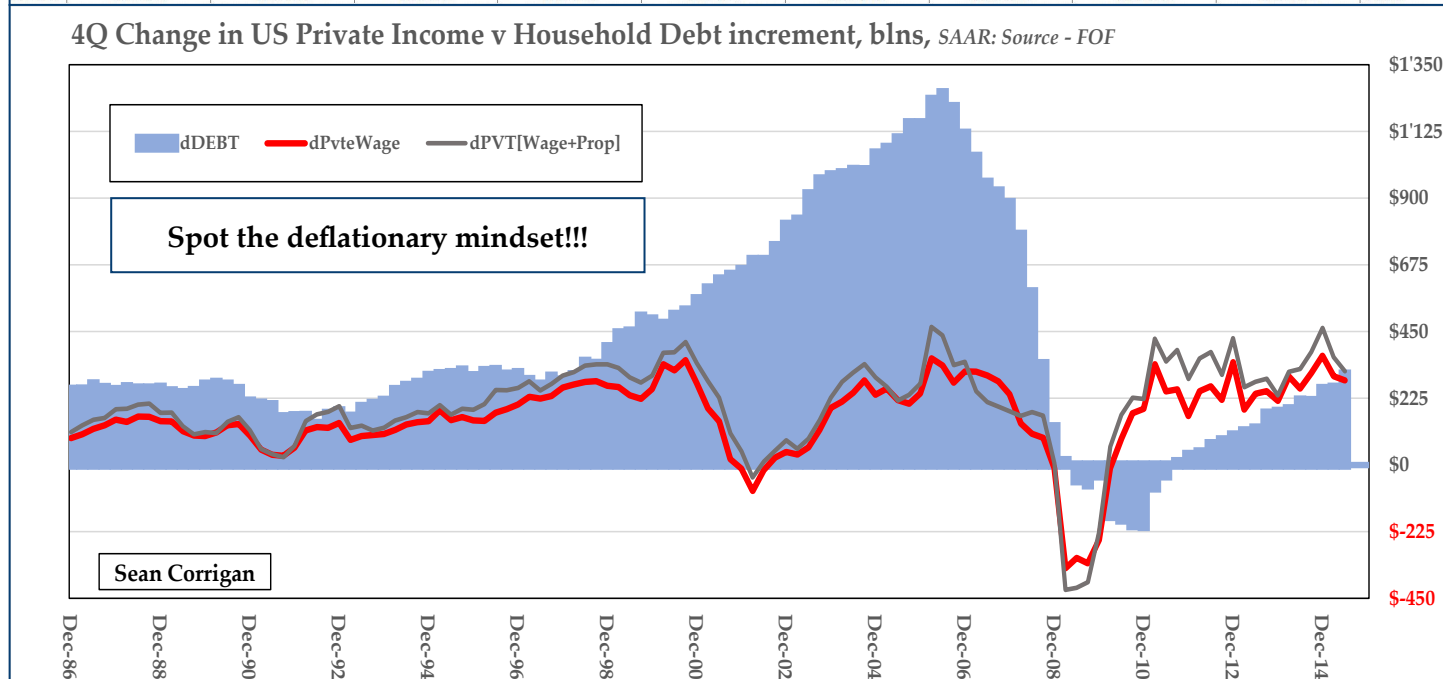
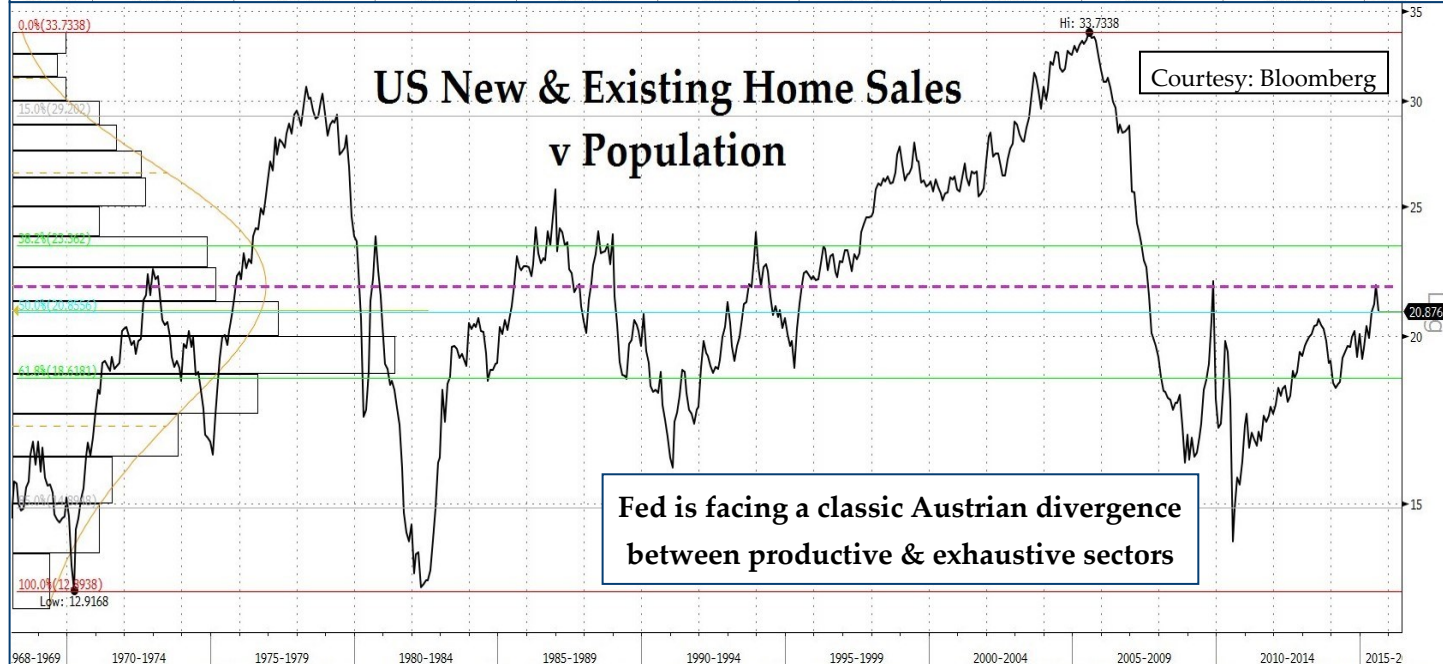
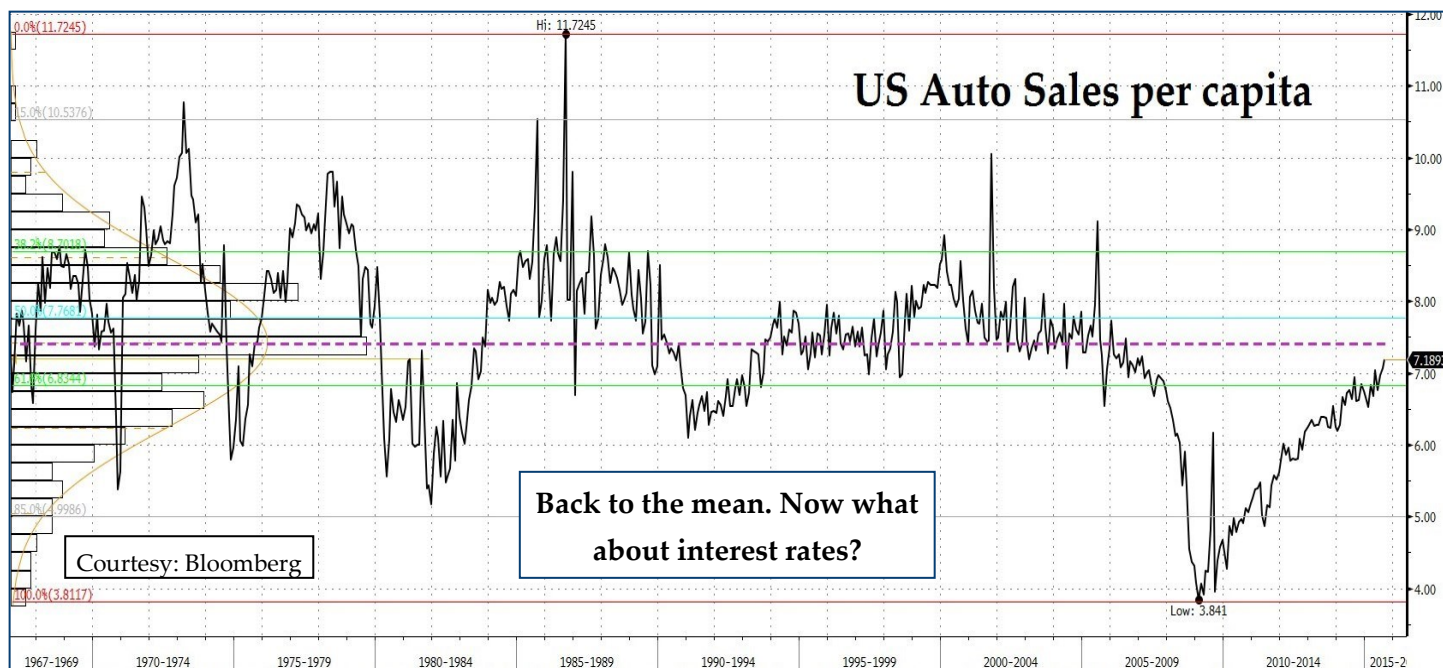
If these tentative symptoms of a loss of momentum do indeed take hold, it would seem to put us in a bind where, despite the awful incentives it gives to balance sheet overstretch by the household sector – as well as the empowerment of a governing elite not short of grandiose spending

proposals - the next move from the Fed could indeed be lower as some have already begun to speculate (and others have begun to salivate). This is not an assessment of your author's which should be taken to imply any endorsement of such an outcome, rather a reluctant admission of a likelihood which is based on the weary recognition of the dreadful asymmetry of Fed policy, an intrinsic failing which is reinforced by the intellectual, if not the outright moral, cowardice of that policy's enactors.

But if that dark day were to come to pass, can you just imagine the chaos it would unleash, both at home and all around the world? If half the planet bases its calculations on, parks some of its savings in, and backstops its local currency with a dollar which will henceforth bear not just a negative real interest rate (as for too many recent years past), but actually a negative nominal one, the ramifications would be incalculable. In addition, those commercial banks - domestic and foreign-owned - which hold \$2.6 trillion of inextinguishable reserve balances might be less than impressed when they go from offering a trifling return to costing them money to maintain. Those who hold up to two-thirds of the world's \$11 trillion in official forex reserves in the currency, together with their SWF brethren.

Closer to home, it would not be the least of the ensuing problems as it tried to head off the sort of property market madness which plagues many of today's NIRP Nordics in a country where special interest lobbies are so entrenched. By contrast, the diehard constitutionalists might not simply take the Fed's word as law if it tried to start imposing on-the-fly restrictions on them in the manner that its counterparts are wont to do in Europe. Be aware, too, that it is jokingly said in Texas that the archetype of a 'Bidness' man is that he is someone who works out how much credit the bank will extend him and then looks around for a scheme in which to put it to work. Can you imagine his response to negative short rates?

Signal:noise ratios? The balance between demand for loanable funds and the desire to save? Rational calculation of the availability of resources through time via the interest rate? *Fuggedaboudit!* When did any of that last bother a central banker eager to line up a lucrative post-retirement sinecure or sign a fat, kiss'n'tell book deal?



When Rams lock Horns

So far this summer, China has managed to cripple its stock market, snuff out once-vibrant futures trading thereon - each, at their all too brief climax, the most active on the planet - and call into being a now forcibly bottled-up genie of margin debt, firstly to exaggerate, then to try - with decidedly limited success - to stabilize, the quotations which comprise its object.

China has simultaneously been manoeuvred into lifting the lid on the Pandora's Box of the capital account. After introducing a less restrictive *legal* mechanism for moving funds in - and more importantly *out* - of the country to an accompanying flourish of rhetoric about the 'reform' process, it looked on, horrified, as \$140 billion dollars of carefully accumulated FX reserves were carried away in the first violent outrush of the howling demons of unintended consequences long incarcerated inside the recesses of that Box.

Now China strives, might and main, to weigh down again upon that lid - intervening here, tightening the rules there, threatening taxes, levying reserves, and exercising a heavy-handed brand of moral suasion everywhere. As a disgruntled - if understandably anonymous - local told the Reuters correspondent who solicited his opinion of all this at a private discussion: 'By "reform" they mean trying to correct an old error by making a new one'.

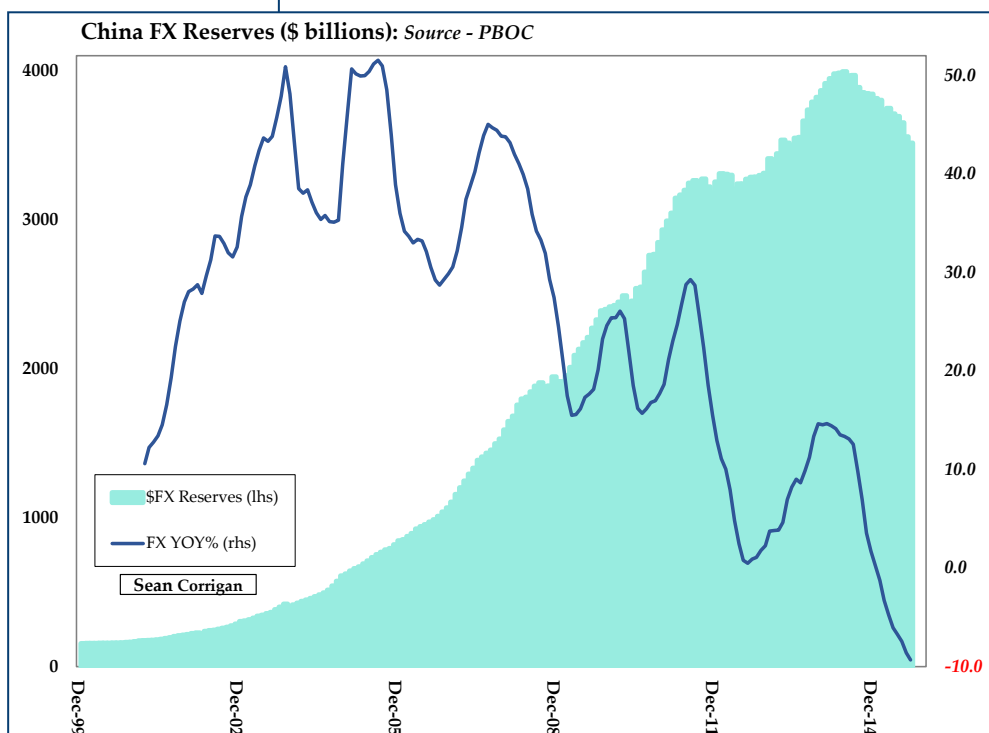
Meanwhile, partly as an offset, partly as a reversion to type, the central bank has not ceased from Mental Fight, nor the Sword slept in its hand. Interest rates have been reduced and large-scale OMOs resumed: domestic (as opposed to forex) reserve requirements have been slashed, variegated, and then been made calculable upon a full month's average rather than the stress-inducing final settlement day of old. A 'pilot' scheme for collateralizing bank loans has been extended to nine cities and provinces from the original two. The hoary, old loan-to-deposit ratio has been

abolished, that long-standing constraint having been softened at the start of the year by allowing - in what looks in retrospect like an act of unadulterated folly - non-bank financials' (shadow!) deposits to count towards the required total.

The many Occidental boosters of 'macro-prudential' policy - i.e., those eager proponents of relentless, intrusive tinkering - should not feel in any way at ease at such a spectacle

Over the course of its first few years in office, Beijing has been at pains to rein in the worst excesses of the free-spending, endemically venal local cadres upon whose shoulders the heaviest burden of the programme of economic development - but also the most glittering career chances and most tempting opportunities for self-enrichment - have traditionally fallen. To effect this, the central authorities firstly tried to staunch the flow of credit to its junior branches, then threatened the very persons who populate them by means of its high profile purge of the Party's most corrupt - tigers and flies alike.

But now the central authorities have swung about-face again in forcing the banks to restructure up to CNY3.5 trillion of those same local governments' largely unserviceable debts, by promoting the building of that Western-style Colossus of crony corporatism known as the Public-Private Partnership in order to funnel yet more capital means into



their low-return but highly concrete fantasies.

Nor do the inconsistencies end there. A Beijing at once Jovian in its fury and increasingly Chicken Little in its mounting panic has also 'confiscated' CNY200 billion or more of unspent budget allotments so that *it* may more rapidly expend them. Amid the tightening credit conditions and straitening fiscal situation, these monies have lain idle for two contrasting reasons. On the one hand there has been the fear of bringing a visit from some of Wang Qishan's finest if they were lavished, in time-honoured fashion, on the cadres' property developer buddies; on the other, because the confused local officials appear to have no clue as to how to use them to promote the sort of entrepreneurial activity and to seed the much vaunted start-up culture which Premier Li keeps haranguing them encourage.

Li himself tried to assure the recent Davos gathering that there was no need for bulk 'stimulus' - a statement so at odds with reality that all we are left to infer is that he has a rather idiosyncratic definition of the beast (not unlike the semantic confusion of those who rail against 'austerity' in other, fiscally incontinent, debt accumulating, QE, ZIRP/NIRP parts of the world). When delivering such remarks, the prime minister was obviously not privy to the memo which showed state outlays were up 25.9% yoy in August and by 14.8% year to date.

Then there is the non-financial corporate debt mountain, estimated at around 160% of GDP (depending upon whether SOEs are treated as 'corporates' or as branches of government) and which is threatening to buckle under falling EBITDA to interest and climbing outstandings to EBITDA ratios. The NPLs which are the obverse to many of these may already be into double digits, depending on which analyst you believe, while Moody's is feeling unsay about the disappearance of new 90-day overdue loans from the declared totals.

The solution? To heavily promote both the development of ABS markets and the practice of equipment leasing so as to open up the possibility of shuffling both assets and the associated debt off onto the lessor's balance sheet, there to be financed less obviously by the banks (who else?) and possibly soon to be accepted as part of that newly-liberalized

eligible collateral in its market operations by the PBoC itself.

That the nation's worryingly elevated levels of debt are to be dealt with by continuing to shuffle them from one balance sheet to another as part of the Keynesian parlour game of 'passing the bad, or depreciating, half-crown to the other fellow' should not overly surprise us: it is after all the one in which we Westerners have been indulging with the aid of our friendly, neighbourhood central banks for many successive turns of the cycle.

A Virtue out of a Necessity

While providing no ultimate solution (q.v., Greece), politically this seems far less dangerous than does making a return to Gladstonian probity - or to 'austerity' as the policy is derisively and misleadingly named today. Moreover, this became a case of *faute de mieux* once the past year's attempt to negotiate the other obvious escape route ended in debacle. This apparent lifeline was the one of transmuting much of the debt into equity and, at one stroke, rendering the claims safely irredeemable while indexing the cost of their service costs to the net income of the obligor. As we know only too well, this descended into the ignominious failure of the stock market boom and managed to leave more, not less, wholly unproductive debt in its wake.

Those overly sanguine about the state's ability to play this game *ad infinitum* might have their pretensions ruffled a little by the words of no less informed an observer than Zhou Xiaochuan himself.

Speaking six months ago at an internal government seminar, but only released to the public these past weeks, the Governor of the People's Bank said that the banking-system needed to go through a 'remedial' class. Though 'major difficulties' were only to be expected at times of economic transition, explained Zhou, without what he called 'strong measures' and a 'serious commitment' to cleaning up the financial problems and adopting a functioning market mechanism, China's banking system *might not survive*.

Meanwhile, we learn that one pillar of the much-vaunted reform of the nation's unwieldy SOEs will be to permit 110 of them (sic) to set up 'investment arms' in order, explained Zhao Changwen of the State Council DRC, to *buy and sell*

IL MILLIONE: Tales from Cathay (*continued*)

equities in such a manner that State capital can enter or exit specific industries'. This, by the way, is what passes for allowing the market a greater role in the allocation of resources in China!

We have already written of the broad similarities between today's China and the French Regency of 300 years ago, noting that the effort to sustain this second Mississippi Bubble is not only defaulting to an ever looser monetary policy - to the accompaniment of a similarly embarrassing drain of funds abroad - but that it involves a barrage of all too frequent, overlapping, and often conflicting policy initiatives. As everywhere in the world, the remedy for flawed regulation is sought in yet more regulation and the cure for over-indebtedness is yet more debt.

The lingering optimists make frequent reference to the regime's favourite slogan which talks of China's 'New Normal'. Under this rubric, we are to believe that heavy industry will be both restructured and de-emphasized while the newly liberated masses will make - and spend - their fortunes instead by starting up app-writing boutiques, by cutting one another's hair, and by remotely piloting drone delivery of online clothing purchases. (Higher order) production growth will slow while end-consumption will slowly accelerate to take its place, just like that!

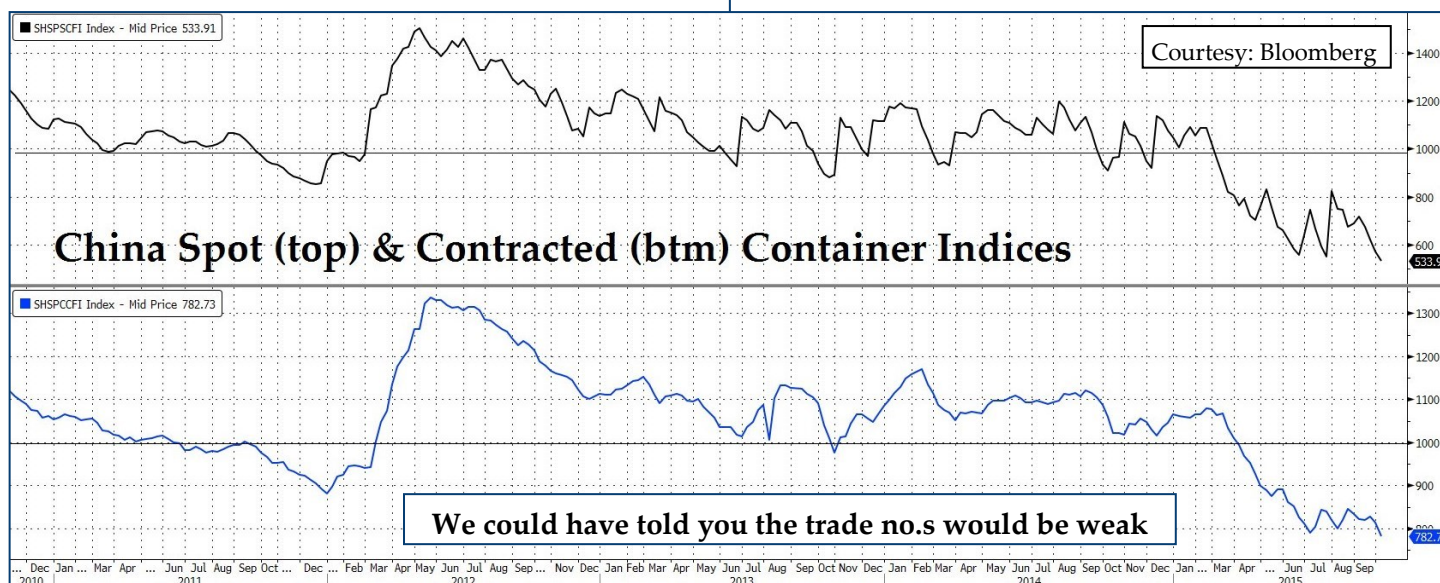
And, yes, some simulacrum of this shift may indeed be taking place. Fixed asset investment has slowed to a 15-yr low rate of gain, with land acquisition down by a third and new construction area off by a sixth. The past three months' tally of retail/wholesale sales was 11.2% ahead of

the like period in 2014 with a quarter of the increment coming from online activity and with the ex-petrol component rising by just over 12% yoy.

You could even take comfort from the fact that while overall industrial profits were a poorly 1.9% weaker over the first 8 months of this year as compared to last (with revenues a sorry-looking 1.3% ahead), this concealed a heartening divergence between the state's smokestack behemoths - whose revenues were off 0.8% and whose profits were down 6.3% - and the nimbler, privately-owned businesses which had the cash register ringing 5.5% more often and the income statement swelling by 7.3% over the period in question. On the slightly tenuous assumption that the overlapping category of foreign-owned corporates are also all private companies and noting that these did less well than the group as a whole, the performance of the private domestic residuum must therefore have been even more upbeat than the aggregate numbers suggest.

Any delight this arouses should be somewhat tempered, however, by the realization that the split means that those generating roughly two-thirds of the revenues (while being responsible for four-fifths of the assets and - more ominously - of the liabilities) are in dire straits, while those giving rise to a fifth are just coping, and a bare tenth are actually thriving.

As for the latter, it cannot be overlooked that the quarterly PBoC survey of entrepreneurs saw the steepest dive in the diffusion index in which the results are encapsulated in three years, taking it to the worst level recorded since the

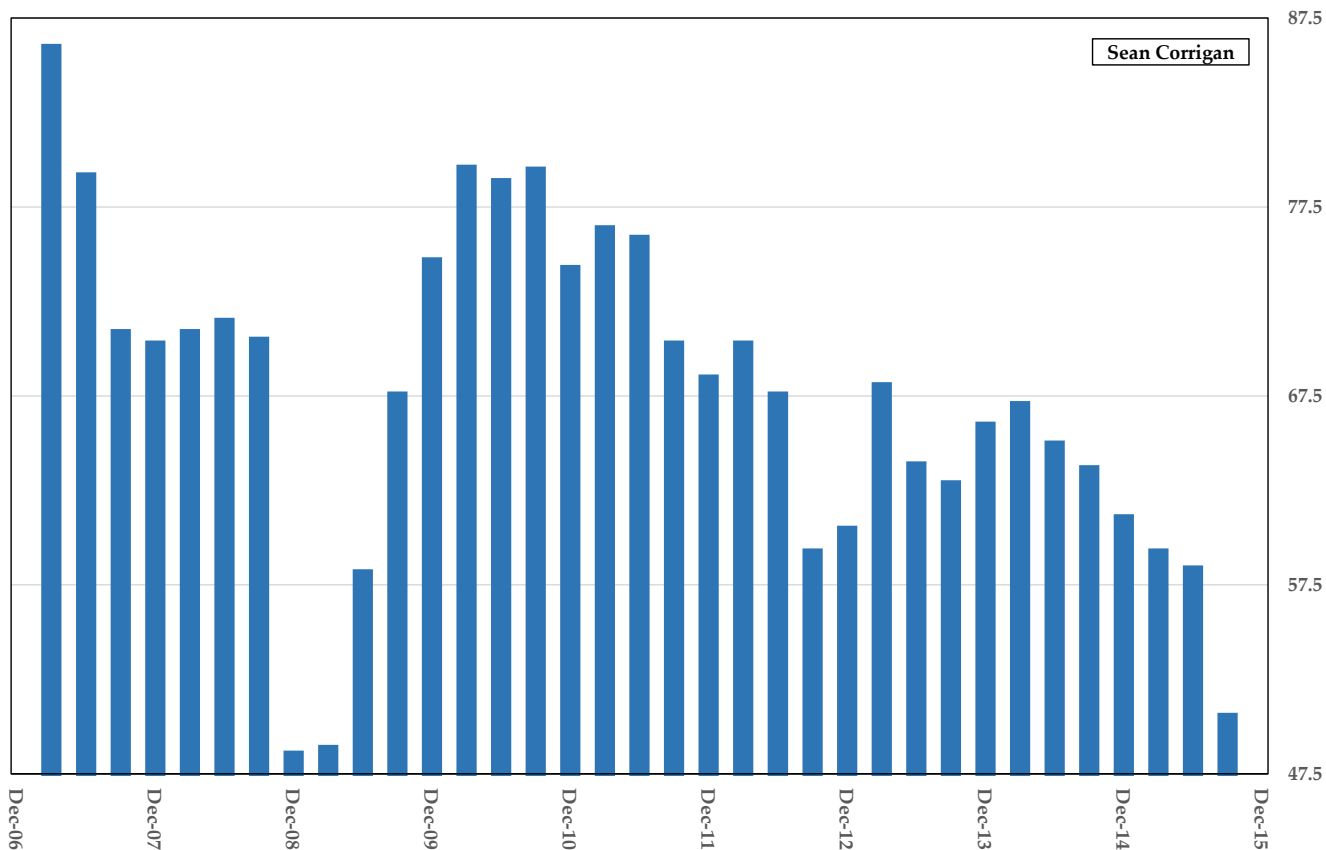


six month episode of 'Snowball Earth' which ensued in the immediate aftermath of the Lehman bankruptcy.

As a consequence, we really do have to ask ourselves at what point the idea of a 'New Normal' metamorphosis is imply the lipstick on the pig of a classic Austrian malinvestment bust.

The many, vociferous China doomsayers have undoubtedly squandered a good deal of their intellectual credibility over the years by forgetting, in their impatience, Adam Smith's knowing maxim that *'there is a great deal of ruin in a nation'*. Nonetheless, one cannot entirely suppress the feeling that, one day soon, when our over-eager boys again cry, 'Wolf!', the ravening beast will actually be coiling to spring and batten his gleaming fangs deep into our soft, ready flesh.

China Entrepreneurs Confidence Index: *Source - PBoC*



The Wood not the Trees

With all this backtracking and face-saving taking place, markets have been understandably whipsawed. Shorts had become so over extended that the inevitable reversal was so savage it handed the hapless momentum traders their worst month in the 35 years of Goldman's reckoning.

For now, peak pessimism seems to have been hit on China; oil prices have yet to make new lows which allows the combination of much bluster from the likes of OPEC about how strong demand is, the ongoing fall in the US rig count, and the sharpening of tensions in the Levant to offer the occasional brisk countermovement. Gold, too, has launched its third offensive in three months on the mid-\$1100s as part of a wider commodity bounce whose main impact has been a sudden alleviation of the pressure of EM currencies and stock indices everywhere.

Prompted by the new Goldilocks scenario that bad macro equals yet more central bank interference, the vibe has been to ignore the belated chorus of doom emanating from the large investment banks and the supranational bean counters alike. As one wag tweeted: *'Looking forward to telling my kids how the world was said to be too fragile to bear a 25bp rate hike, so we all rushed out and bought stocks!'*

Perhaps we would be best served, therefore by looking at things in a wider context for a change, rather than at the vicissitudes of the moment.

Where better to start than with the stock market and specifically the US one? Here, we find that the slowdown in sales discussed above has also begun to effect the delivery of profits. Indeed, multiplying the S&P500 EPS by the share count divisor for the index, we find that aggregate income in the past two quarters has dropped 19% from Jun-Sep 14's record high and as such is barely ahead of what was being booked in the latter part of 2006.

Several implications follow from this. Not only is turnover faltering but profit margins are at last receding from their near unprecedented highs. Taking manufacturing industry as a subset of this, 2015 has so far seen a reversion to almost the lowest levels in the past five years of recovery. This has also put returns on equity back into the danger zone. At a 14% 4Qma, these may be deemed respectable enough, but it should be noted that a retrogression to this

level from a prior cyclical high has ended in a swoon concurrent to each of the past three, four, even five recessions.

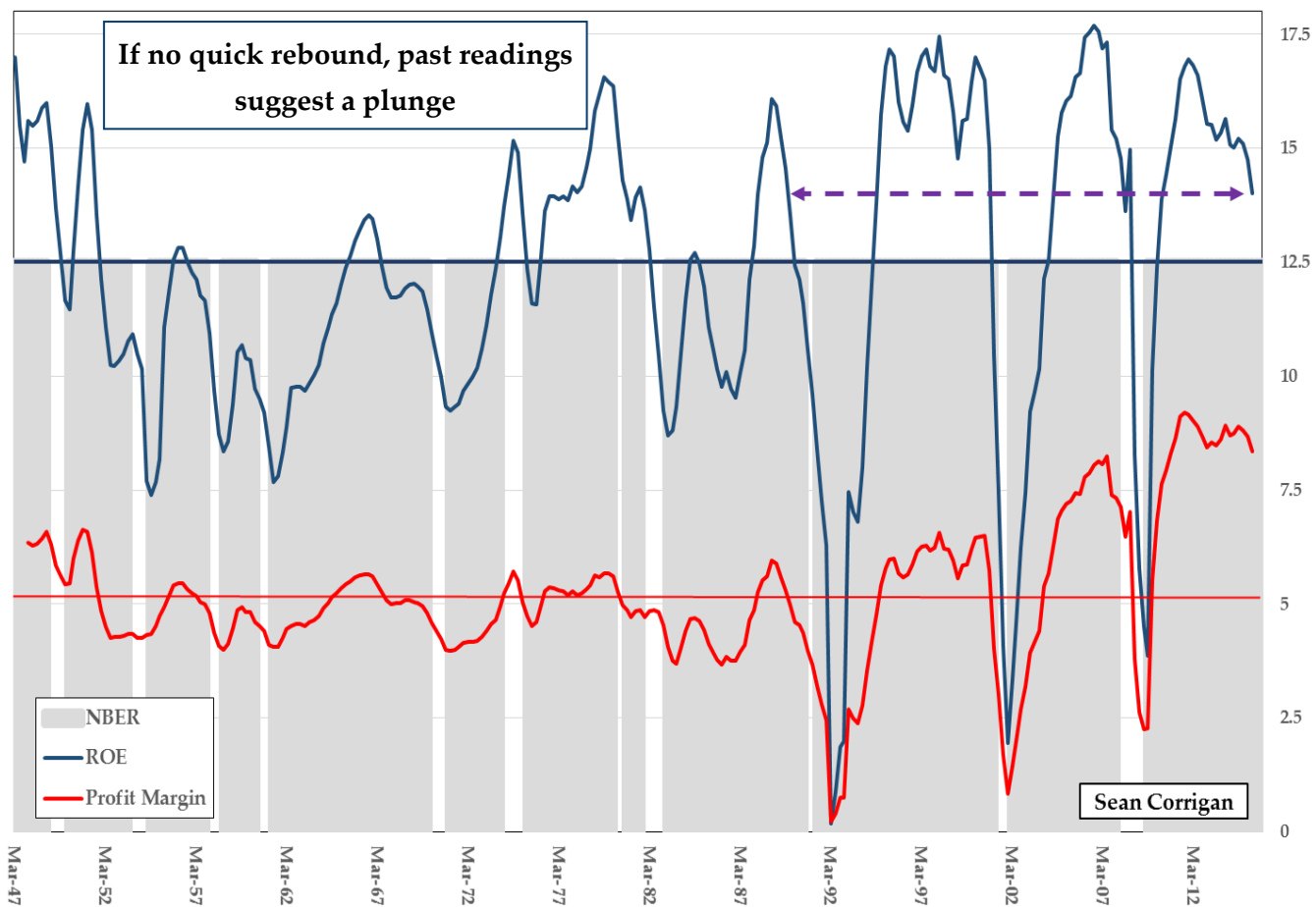
Furthermore, not only do profits constitute a higher than normal percentage of sales, recently they have opened up a marked positive divergence from their long term trend gain of between 6-6.5% per annum – a pattern which is, incidentally, one entirely consonant with the last sixty-odd years' growth in revenue, private GDP (as a wider measure of activity), and money supply (as the enabling factor of them all) Equities' likely reversion back to that trend – and hence to a greater harmony with such other measures - can at best come after a period of slower growth and possibly to the accompaniment of further outright retrogression.

Compounding this is that fact that stock prices have been rising faster than those same profits despite these having been showing a supranormal rise. If we compare the change in the index value with the earnings growth associated with it – in this case using 5-year rolling CARs from 1952-2015 – we see that the disparity is currently around 8%, a 13-year high and, at some 0.8 sigmas above the sub-1% norm, beginning to encroach upon the sort of territory from which the major reversals of the late-50s, the mid-80s, and the turn of the millennium were set in train.

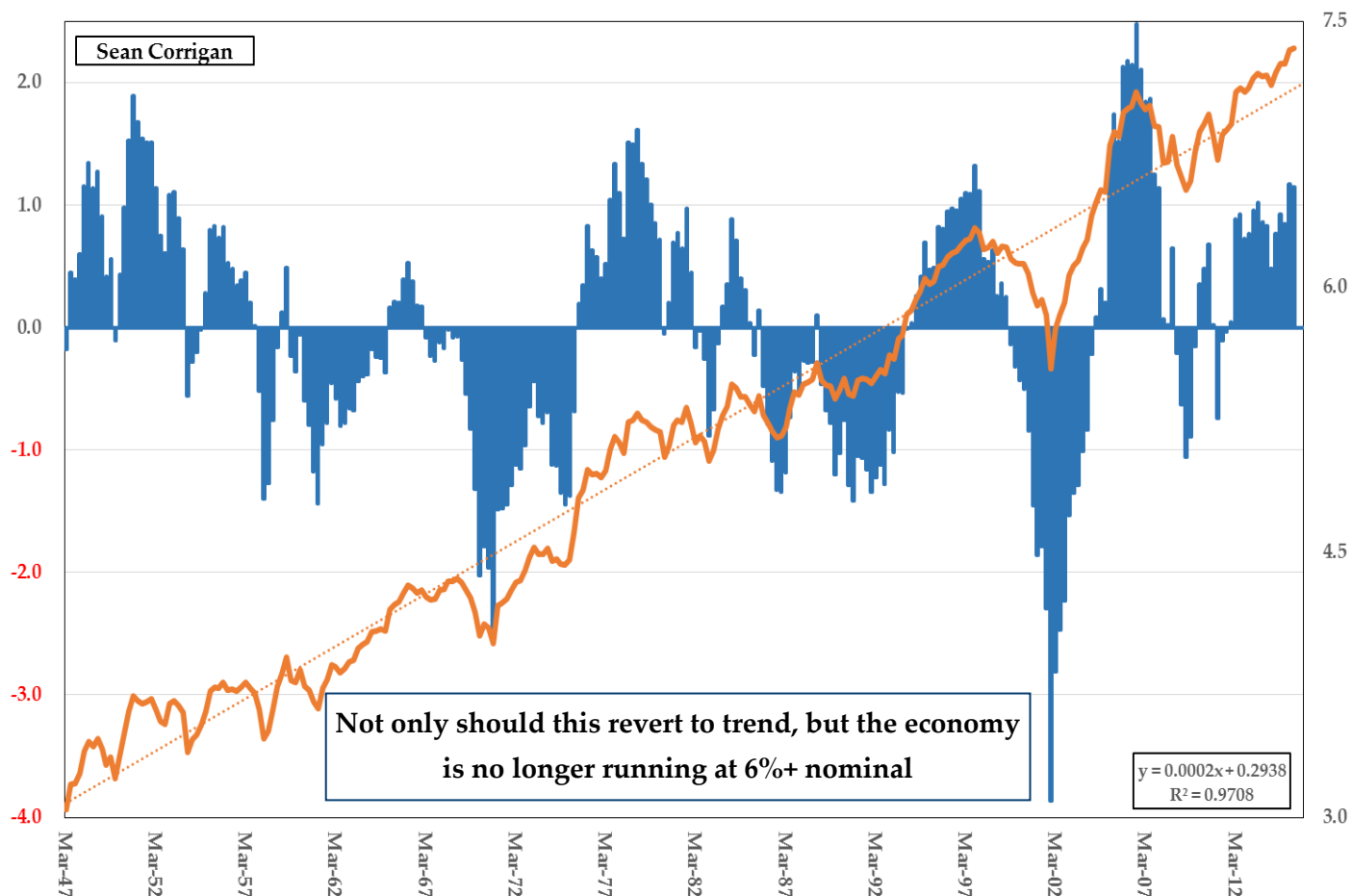
Nor is their overmuch comfort from other valuation measures. Price/earnings may not be causing alarm in itself – at least not in comparison with the Tech Bubble – but adjusted price/book is 1.3 sigmas over the norm, while free cash flow ratios are worse than those for reported earnings, and for ROIC worse than for ROE alone. Pay-out ratios are also inordinately high as a percentage of free cash flow leading one to assume that any further weakening must start to threaten dividend distributions even as debt-financed buy-backs may be susceptible to balance sheet constraints and so eventually stop flattering EPS numbers.

As John Hussman frequently points out, one of the best predictors of future returns on stocks is the valuation at which one buys them today. One of his favourites – our version of which we append here – compares gross value added for the corporate sector to market cap. Buy at a cyclical peak in this and you can almost be assured of scant reward over the course of the next decade. If this rule holds in the future as it has in the past, there could hardly be a

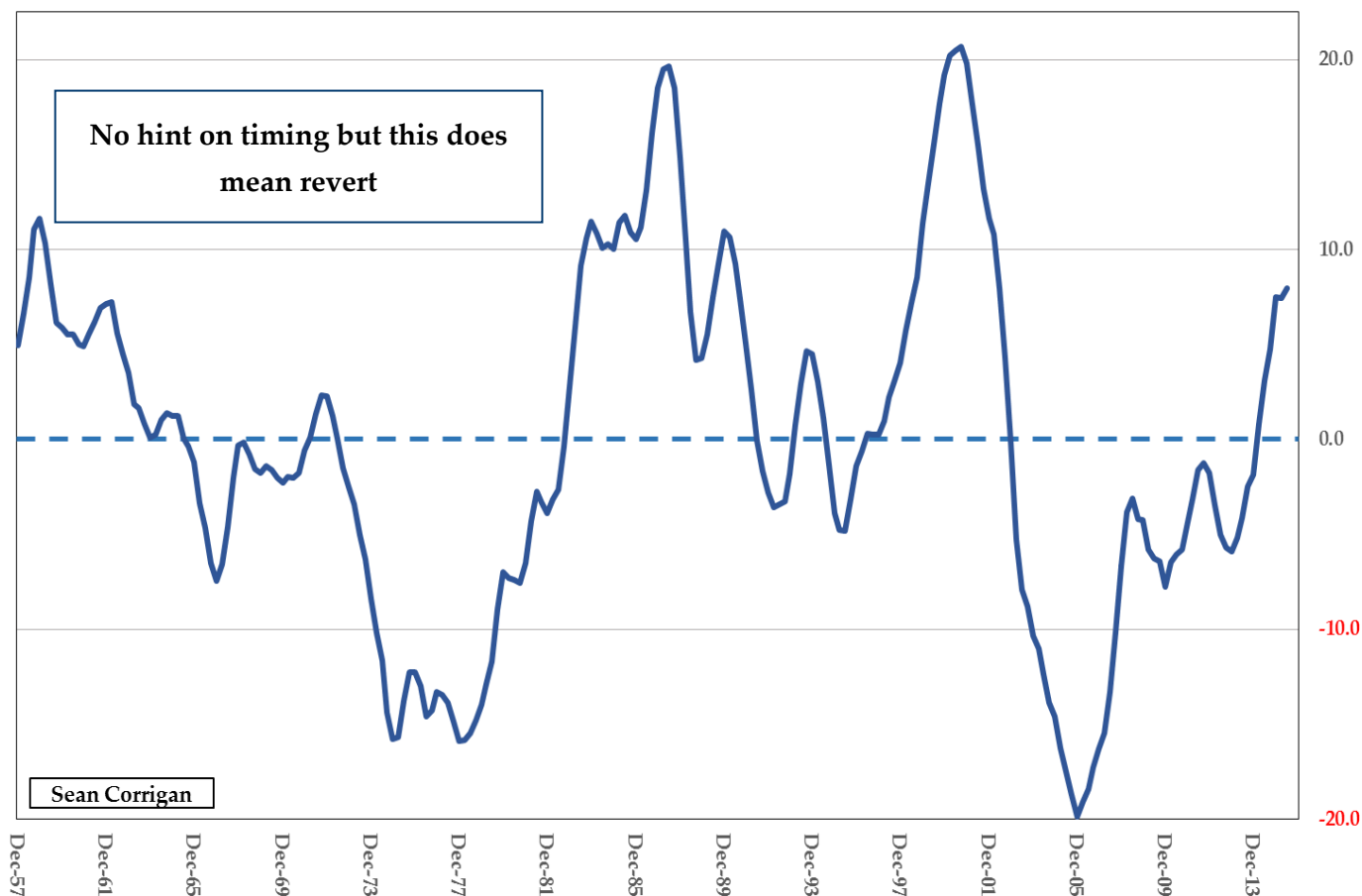
US Manufacturing Corporations ROE & Profit Margin: Source - QFR



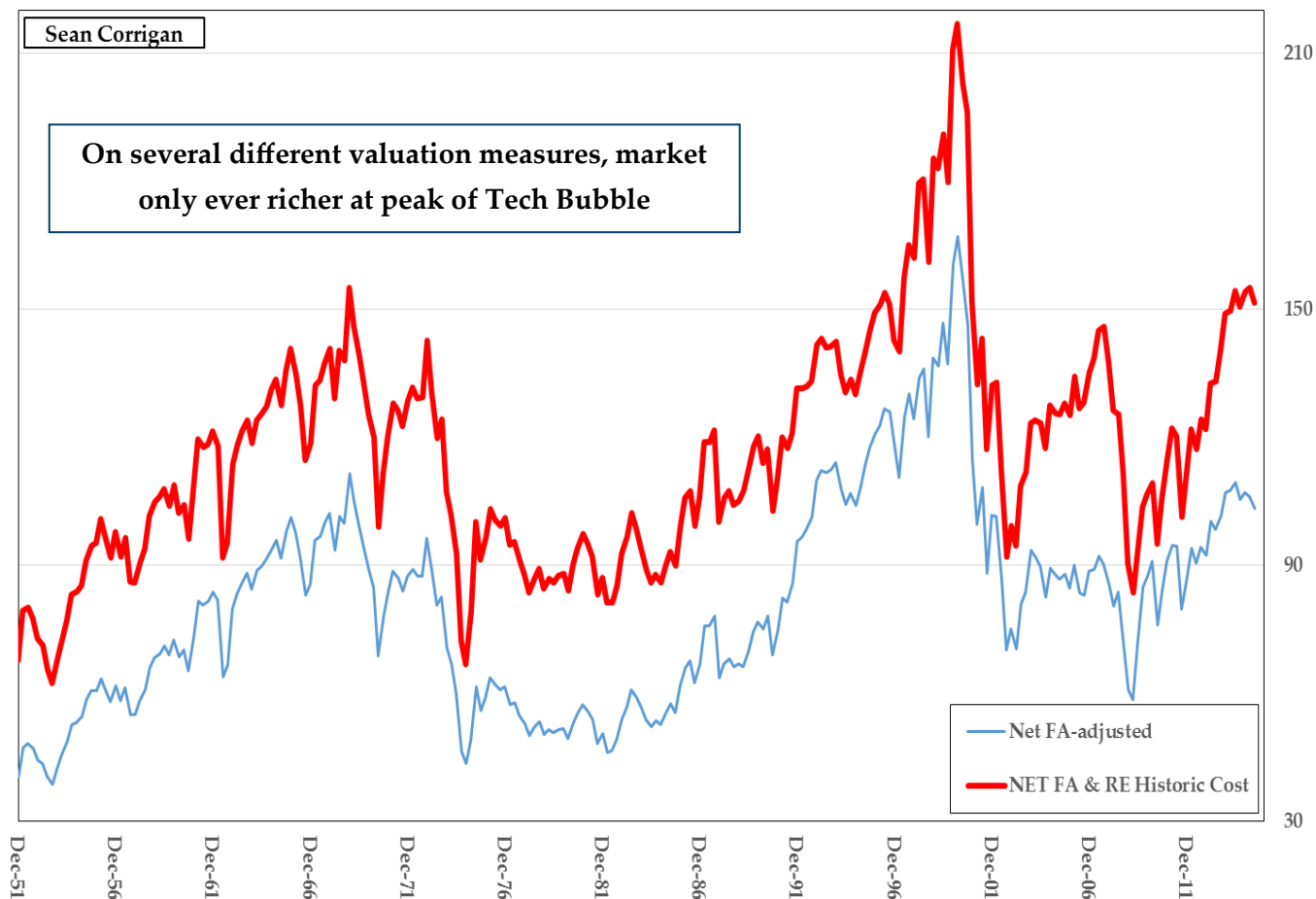
US Non-Financial Profit divergence from 6.1% annual trend: Source - Census, BEA



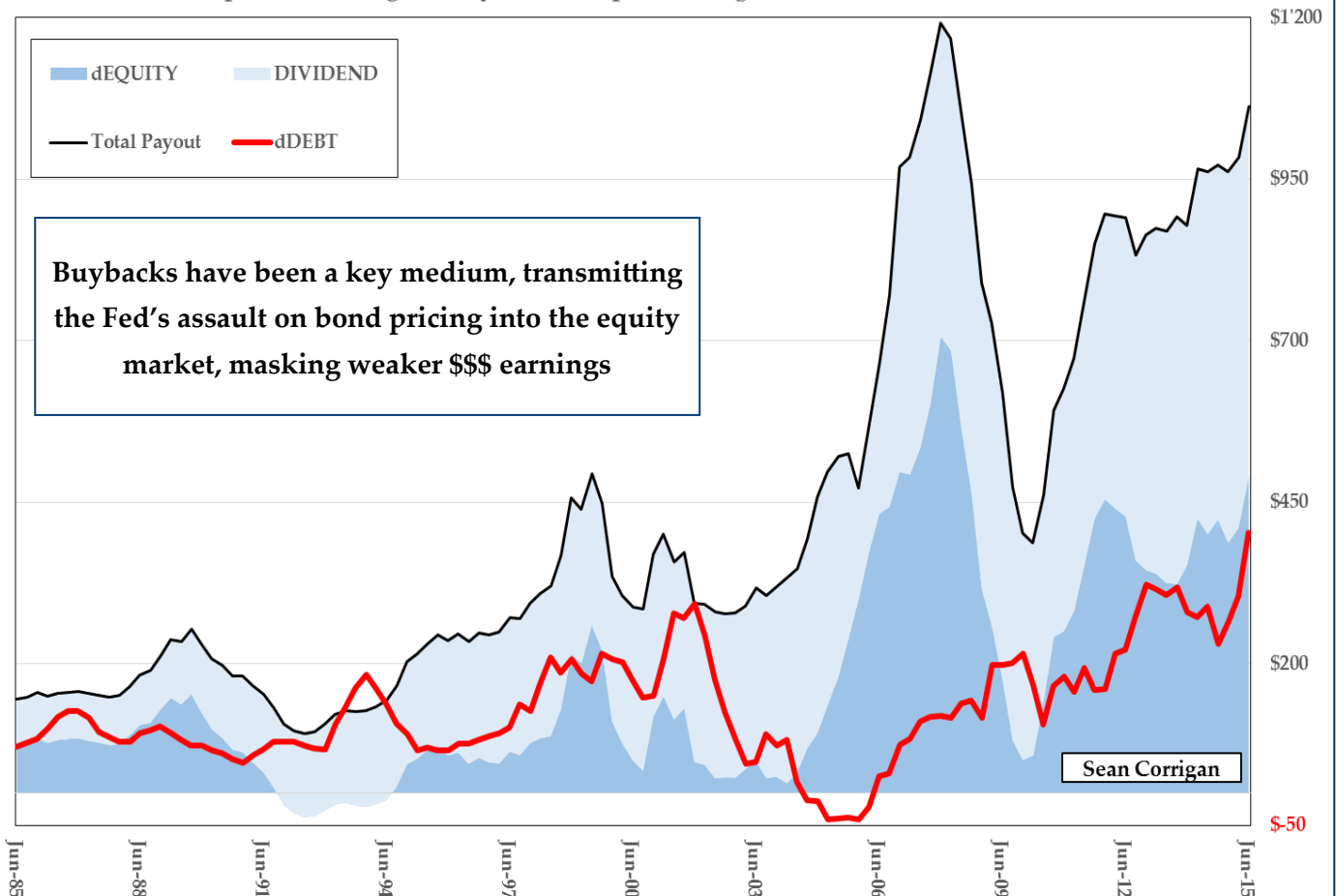
5-yr CAR d[SPX] - d[After-Tax Profit]: Source - FoF, S&P



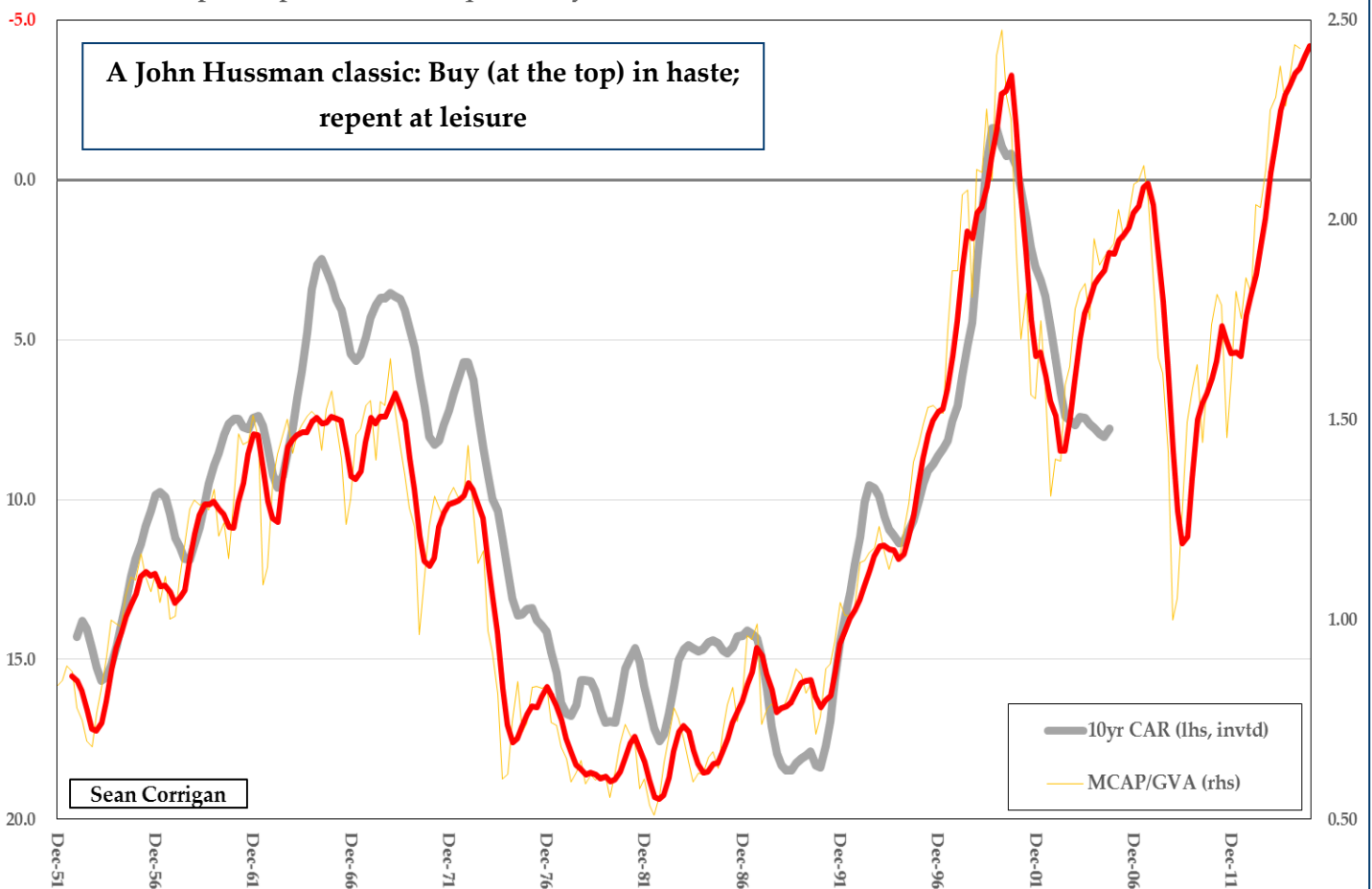
US Non-Financial Corporate Q-Ratio: Source - FoF



US Non-FIN Corporates rolling 4Q Pay-out & Capital change: Source - FoF



US All Corp MCap/GVA v subsequent 10-yr CAR: Source - FoF, S&P, BEA, Shiller



more unpropitious time to start buying stock market dips than the present.

It hardly needs saying that one of the reasons equities have reached these giddy heights is because of the exiguous level of interest rates – whether those on the short-term loans used to finance speculation or on the longer-term instruments which are their main competitors for space in the portfolio. Additionally, the effects on the CFO are all too apparent: a heavier schedule of buy-backs; more M&A and LBO activity, too. Ding-Dong Dell this Bud's for you!

It has to be granted that the central banks have made this all but irresistible in recent years, whether you compare earnings and dividend yields against those on corporates or junk credit, or whether you consider instead the relative returns between the two asset classes. The latter shows that, in the wake of the crash, stocks were no better off against bonds than they had been 30 long years before, at the beginning of the Volcker era. Today that has changed to the point that the ratio stands around one standard deviation above the norm for that period (after abstracting the bubble years of 1999/2000), as expensive in relative terms as they were at the beginning of the last downturn.

Pay to Play

Over the very long haul, it is somewhat sobering to note that – some fairly sizeable oscillations aside – the bulk of stocks' renowned outperformance of longer-dated bonds came in the quarter century after Pearl Harbor – a stretch for the first third of which the Fed was under the formal obligation to peg rates at the lowly mark determined by the US Treasury while, for its remainder, Fed 'independence' was more *de jure* than *de facto*, given its abdication of responsibility for managing the balance of payments to a fiscal authority the financing of whose increasingly heavy deficit spending the central bank also felt it was its duty to facilitate. [NB: To all those touting 'macroprudential' as a cure for loose money, please read the history of Regulation Q, the Interest Equalization Tax, Roosa bonds, and their grand climacteric, the New Economic Policy of those same years]

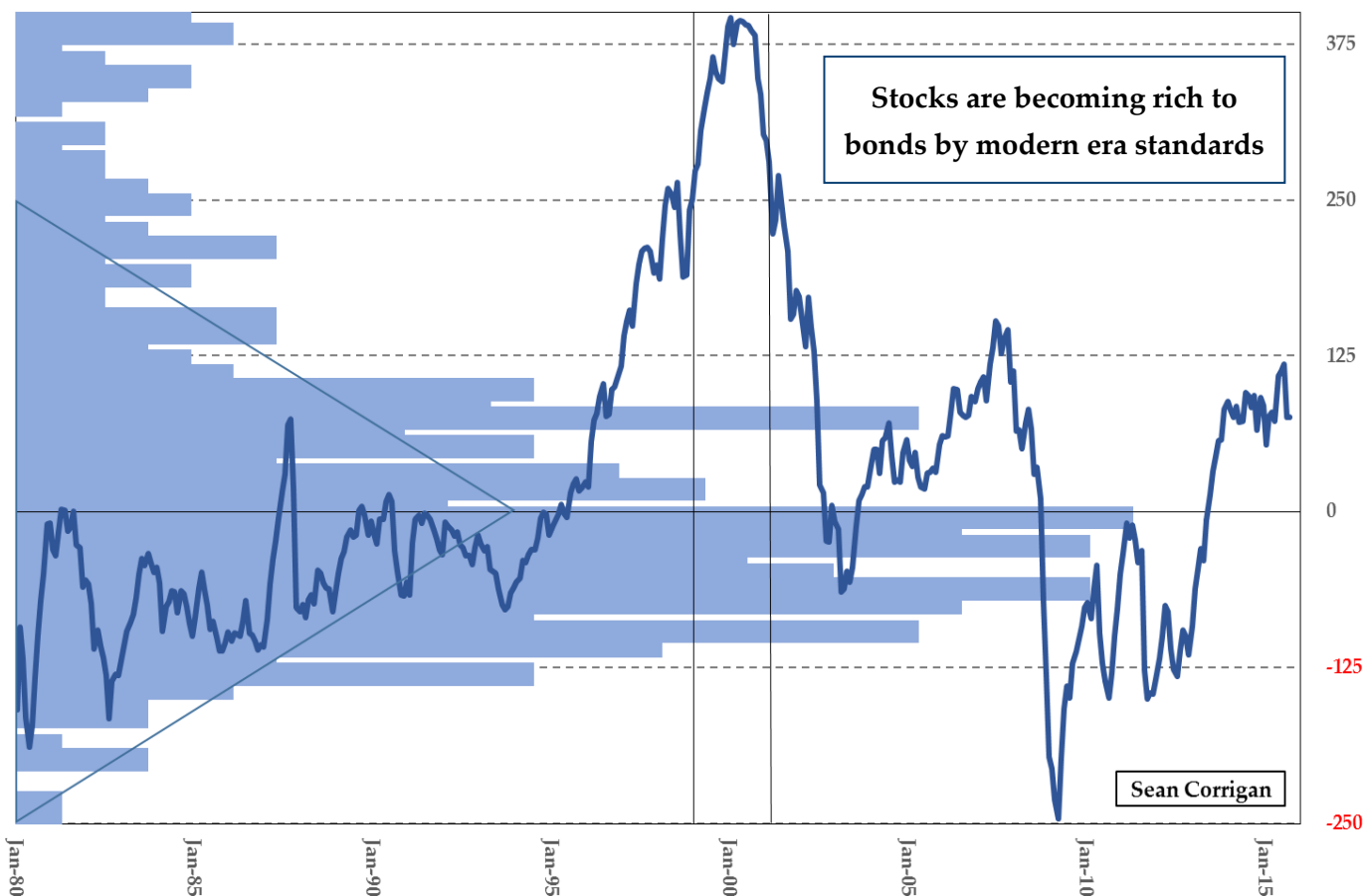
It is also the case that twice in the past hundred years, *real* stock returns have stagnated for lengthy intervals of time. From the 1929 peak to the end of the Post-WWII slump,

progress was negligible. Again, from the Go-Go Years highs, throughout the Great Inflation to the mid-80s, times were tough. Intriguingly, these two spells in the doldrums fell 35 years apart. Taking the mid year of 1939 and 1974 as the markers, a further 35-years centres us on the GFC. Note it has only been in the last few quarters that we have exceeded the 2000 highs. If we were now to sink back and languish below that peak until, say 2018, a third extended drought would have been endured after a similar generational gap. If so, be sure to buy the next big cyclical low, if you can identify it, for the next repeat would see a 16-year bull market ushered in once more.

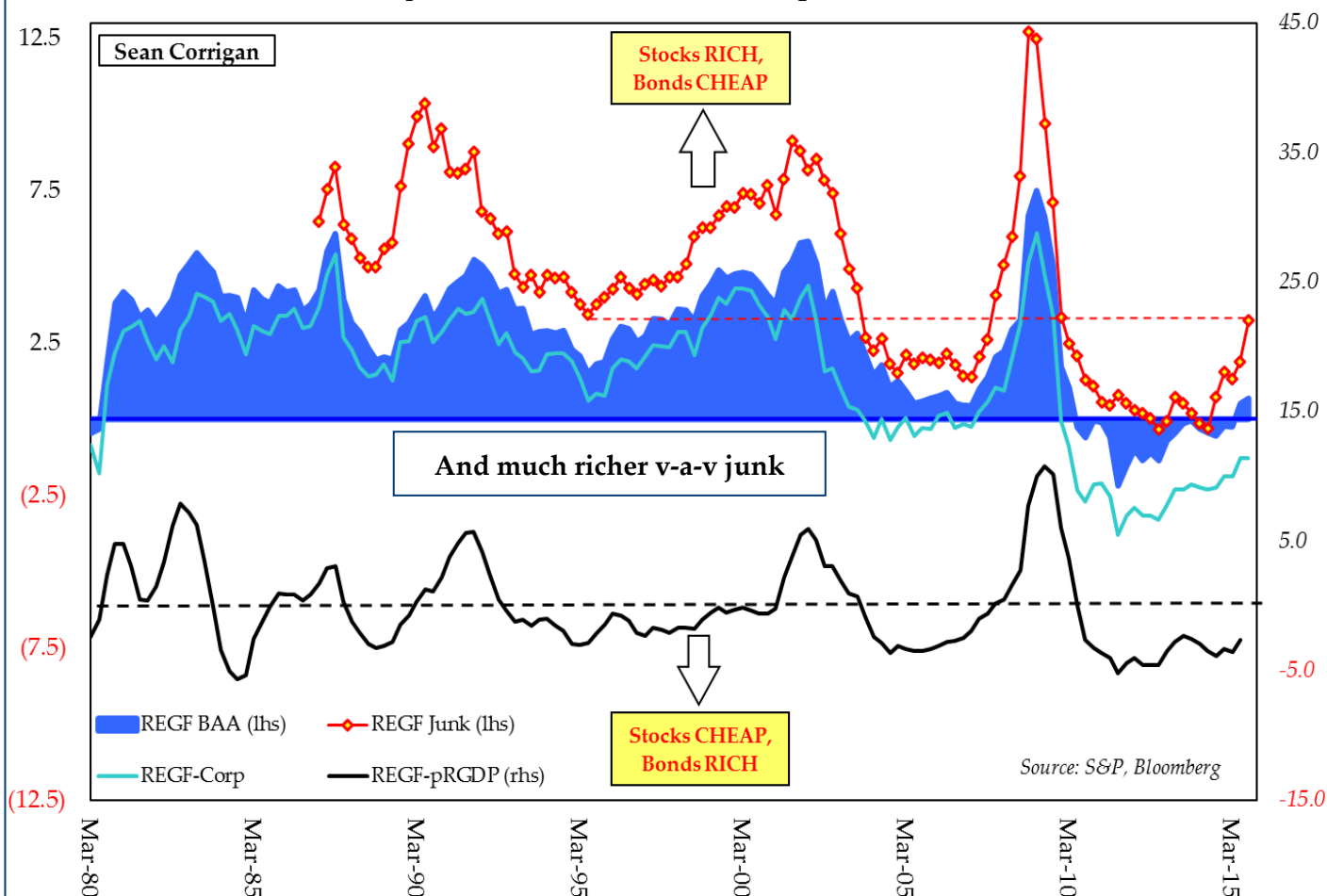
As for bonds themselves, the simplest valuation prediction equivalent we can find is the intuitive one: duration. Buy bonds at too high a duration and be prepared to suffer over the succeeding five years. You may be aware that there is a scruffy, though still discernible, relation between CPI changes and duration (strictly, its log) – one which has the unfortunate trait of making bonds almost as vulnerable to small changes in low CPIs as to big changes in higher ones. Thus, we stand in double jeopardy in the bond market. Any pick-up in 'inflation' – especially since this will be assumed to kick away the central bank support crutch – and hefty losses occur. Yet even a mere maintenance of the status quo would combine low coupons with stagnant prices and conspire to further diminish the rewards, though thankfully not negate them entirely.

Notably, the US T-note has gravitated back to its long-term, post hoc, real yield norm, largely thanks to the collapse in headline CPI to near zero – a spot where it has been driven to some considerable degree by last year's collapse in oil prices. This means that even a continuation of the present stasis – much less any significant rally – in oil will remove that suppressant in the coming months, as will the fading impact of a dollar which has also spent much of the past eight months range-trading in contrast to its impressive, 22% rally of the preceding eight. *Ceteris paribus*, this implies higher CPI growth, fewer Fed excuses, and upward pressure on nominal yields if we are to eschew lower real ones in future. Buyers of bonds here may be right to hide from overstretch in equity markets, but they are all intrinsically oil bears whose fingers are also crossed that things deteriorate hard in the likes of China before very long.

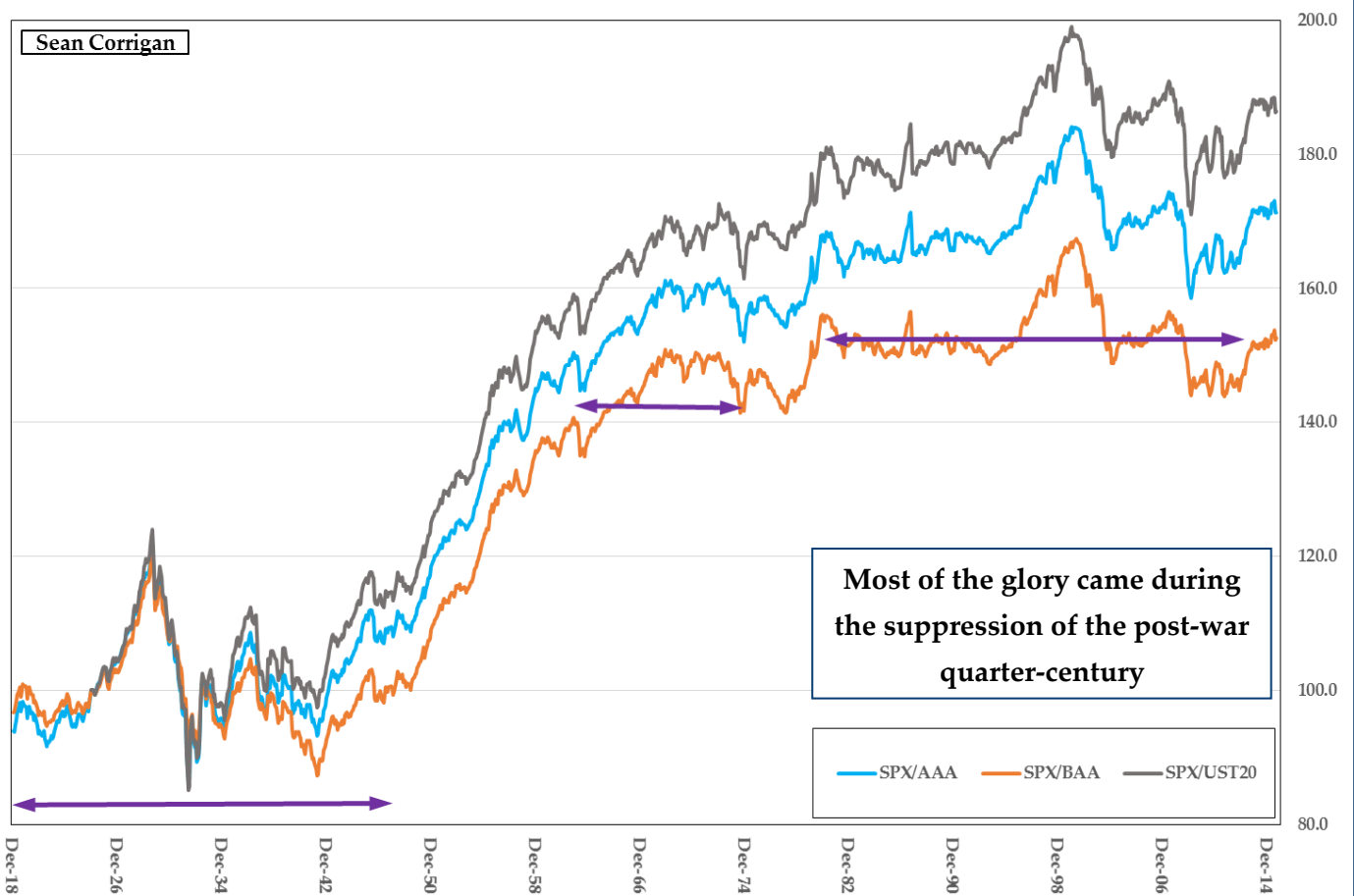
S&P500 v AAA TR, divergence from 1980-99, 2001-15 sample: *Source - S&P, Moody's*



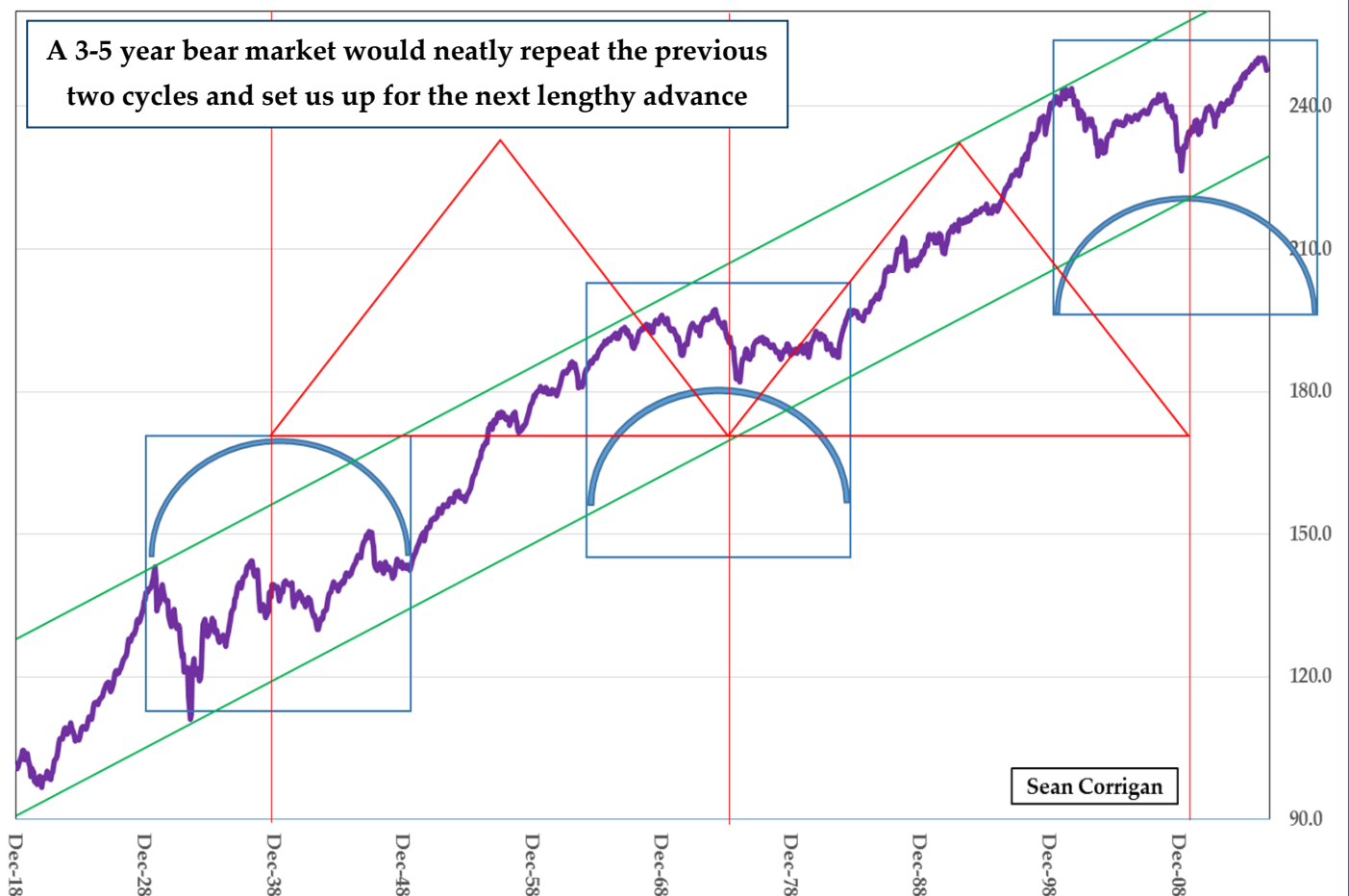
US S&P500 Real Earnings Growth Factor via BAA, Corporate & Junk Yields



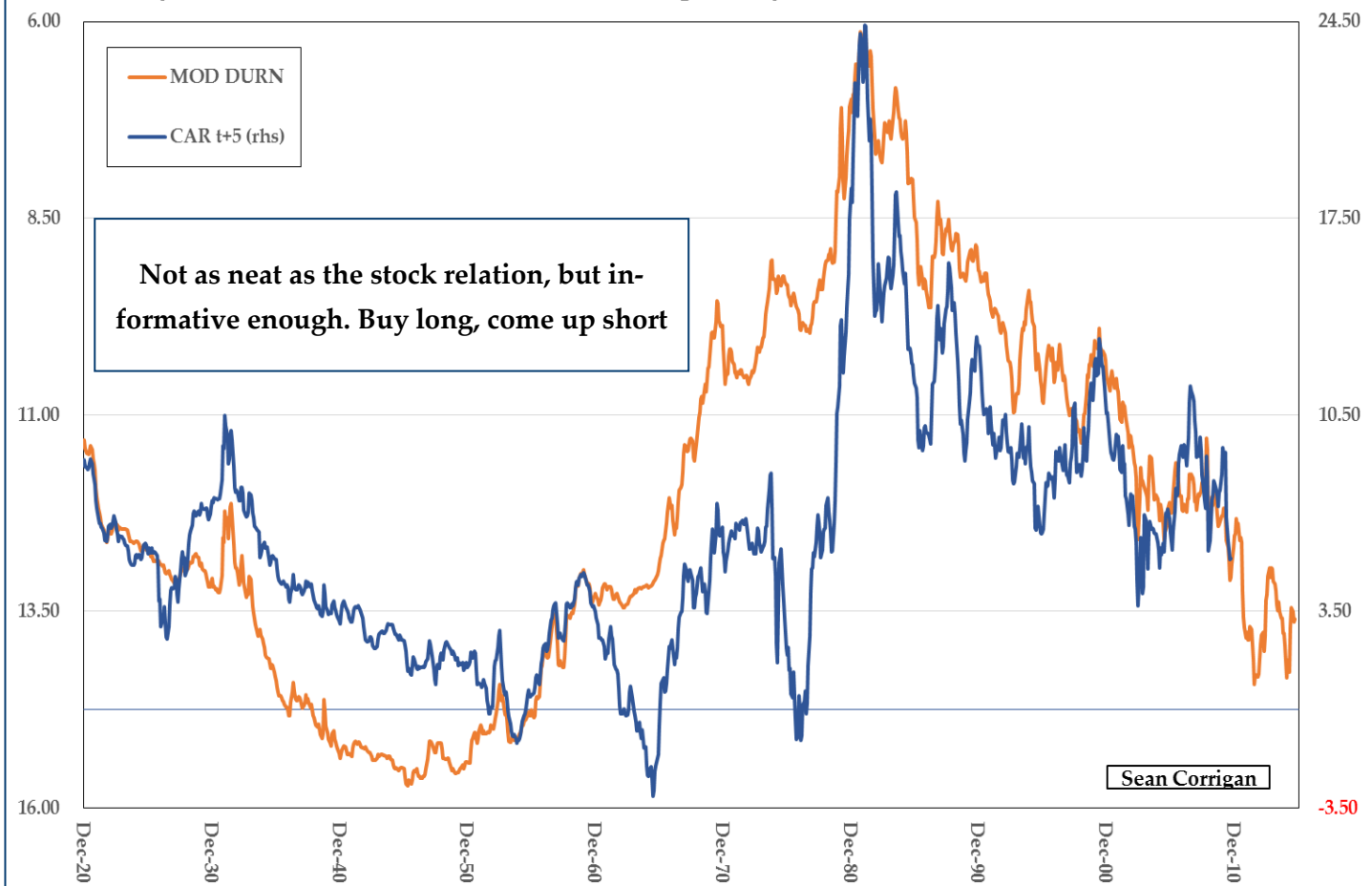
Relative Total Returns S&P500 v Long Bonds, In scale: Source - FRB, Moody's, S&P



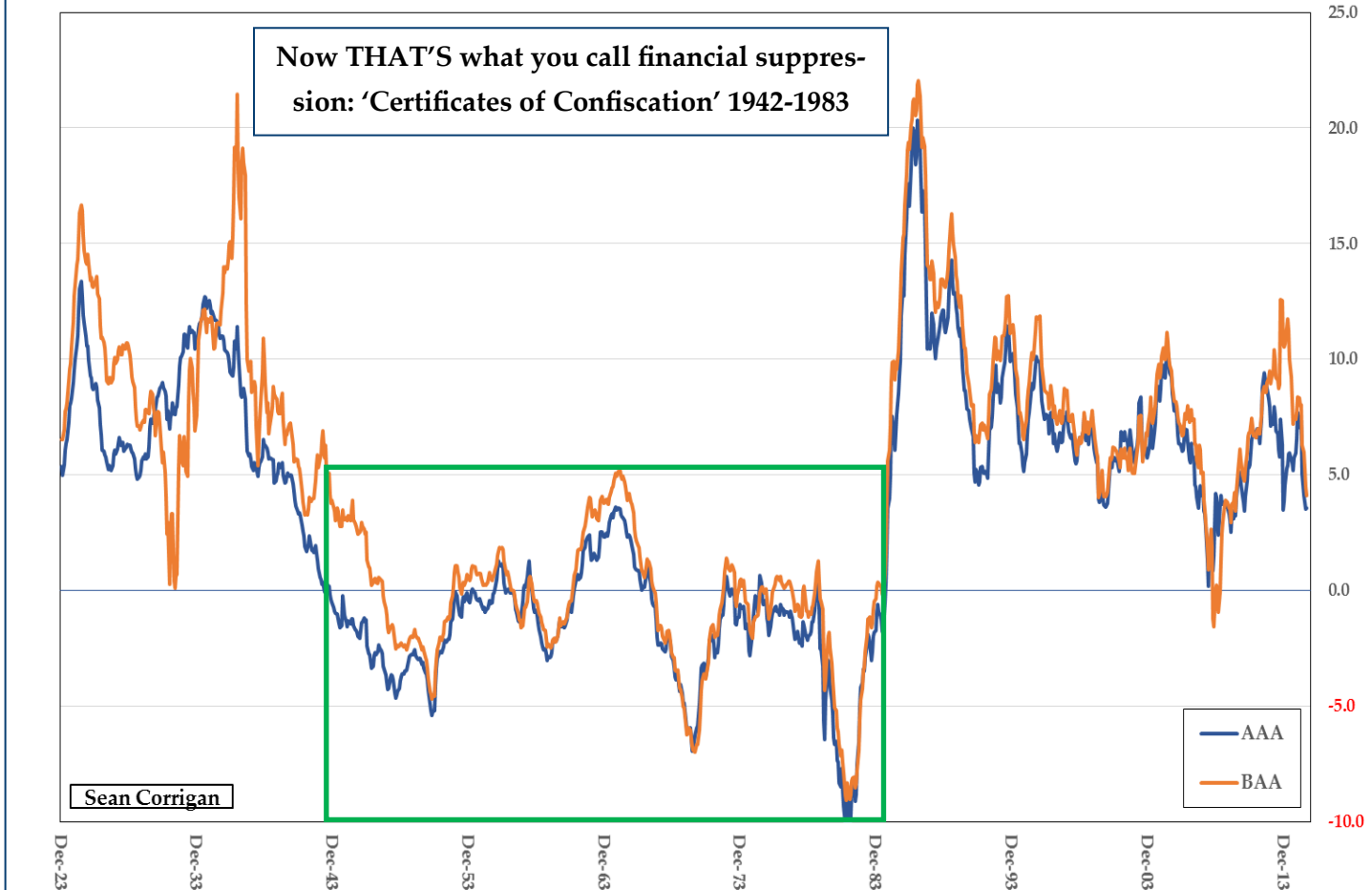
S&P500 Real Total Return: Source - S&P, Shiller, BLS



Moody's AAA Bond Duration (inverted) v Subsequent 5-year returns: Source - Moody's



Moody's Corporate Bond Real TR, 5-year CAR: Source - Moody's, BLS



Hard Assets, Tough Sledding

Finally, commodities. These, too, tend to display a long, cyclical pattern, both in real terms and vis-à-vis stock prices.

On their own, CPI-adjusted prices have tended to hit similar levels of upside excess every 30-33 years – in 1916, 1946, 1979, and at the late 2011 top. These outbreaks have been interspersed with grinding declines lasting between 16 and 24 years. Though the basket is currently back at its long-term mean, past *diminuendi* have gone at least as far as one standard below that mark, suggesting that while some of the excitement may be due to come out of the bear market, any relief rallies over as much as the next *decade* could prove a graveyard for premature or overly dogmatic beta bulls.

One might also note the quasi-rhythmic nature of stocks versus commodities in price terms. The latter's outperformance from Nasdaq 5100 to WTI\$147 was similar in extent to that enjoyed between the two oil shocks, in the aftermath of the Crash of '29, and through the inflationary years of the Great War. Equity rebounds from those lows have lasted around twenty years on the past two occasions and for ten years in the instance before that. You will not need reminding that we are barely five years into this one.

So much for prices, what about commodity returns (*what* returns, I hear you ask)? Here we use excess returns, not the total version, since the extra increment attaching to the latter hinges on those money market contributions to an entirely optional, fully-collateralized futures position which is strictly not attributable to whatever it is the commodities themselves are doing. Spot changes and roll yield it is, then.

Here the dirty secret of commodity investment comes to the fore, as the prevalence of contango markets (higher deferred contracts) and/or the adverse seasonality of constituents subject to annual cycles of harvest or temperature makes commodities something of an options trade at the best of times: great while they're swinging your way, but subject to a long term carry erosion which unhelpfully tends to get worse the more bearish the spot market becomes and hence the steeper the discount at the front to which time inexorably presses you.

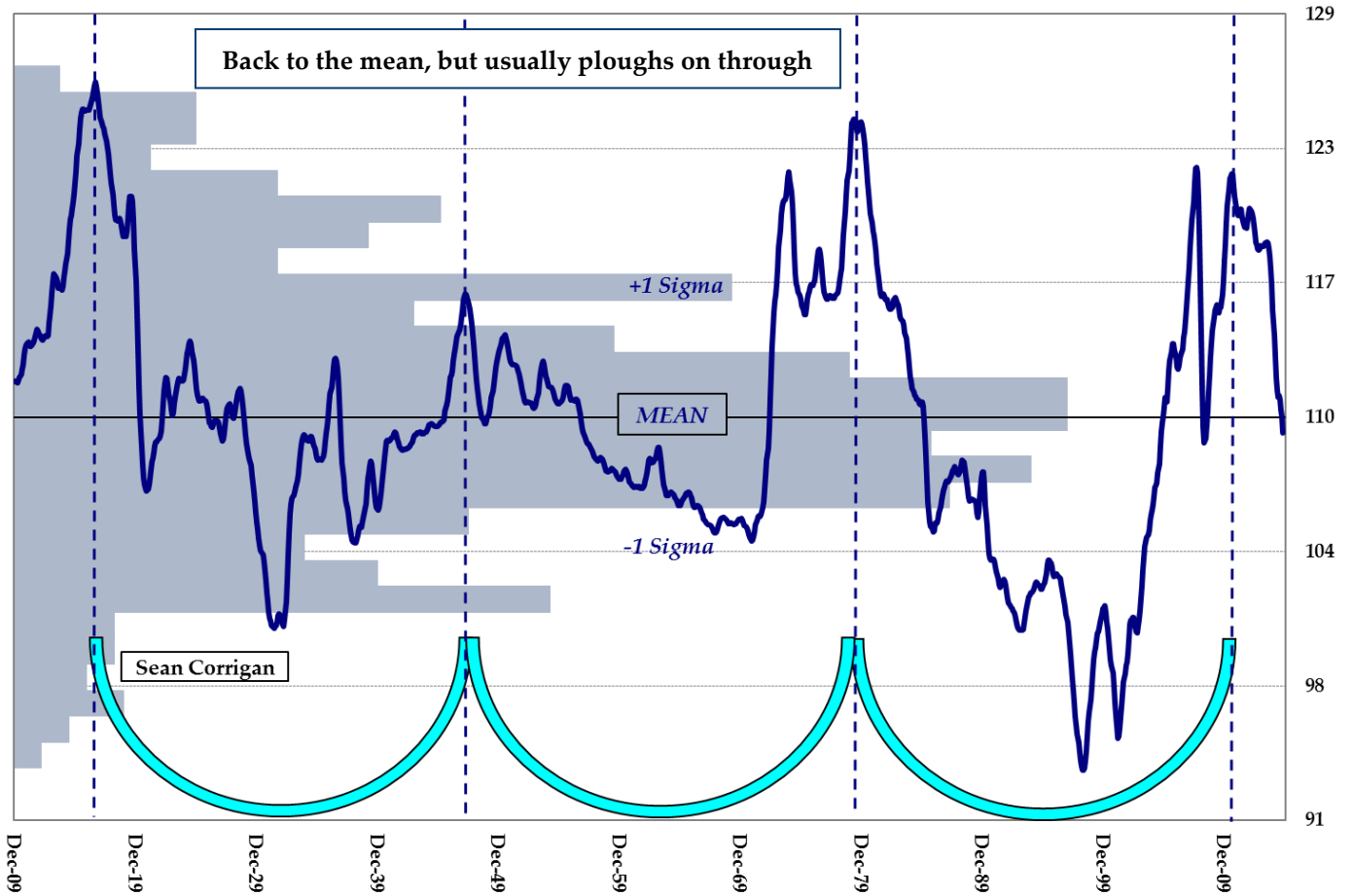
Taking it in the round, the charts show us two conflicting patterns for both outright and equity-relatives depending on whether spot prices or index returns are being examined. The former suggest more downside to come: the latter hint that we may already be at a point where some relief could be expected from what may be a temporary overstretch.

The only way to resolve that difference is to suggest that the curves – particular the dominant energy complex members which make up around a half of the typical basket – might flip into a permanent backwardation (deferreds are lower) of the sort that persisted throughout much of the 80s, 90s, and early 00s so that positive roll yields outweigh the effect of what may become a more gentle descent of prices.

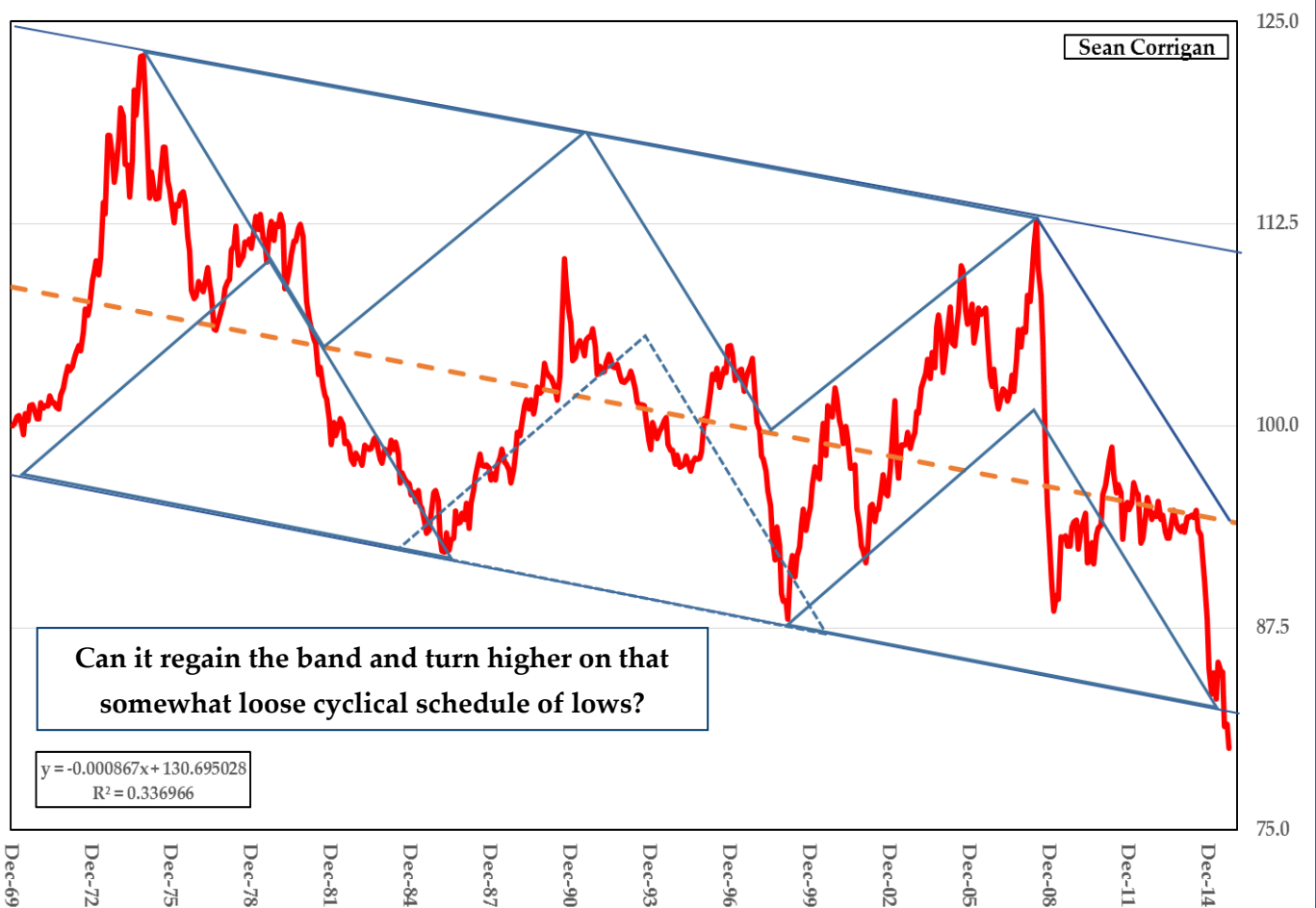
It may be that the increasingly crowded bandwagon of those calling crude back down to the mean-reverted \$20s and \$30s (in great part the same people who a year or so ago could only see it going higher) are simply wrong about which barrels could become so meagrely priced. Perhaps it will not be those for immediate delivery, but rather the shale oil-, Iraq/Iran-, and perhaps even the Libya-depressed forward ones which will come to rest there over the next few years.

However it plays out, the weight of history strongly suggests commodities are not for the buy-and-hold investor but are a Mo trader's vehicle in a game where even the ante can be high, much less the table stakes themselves.

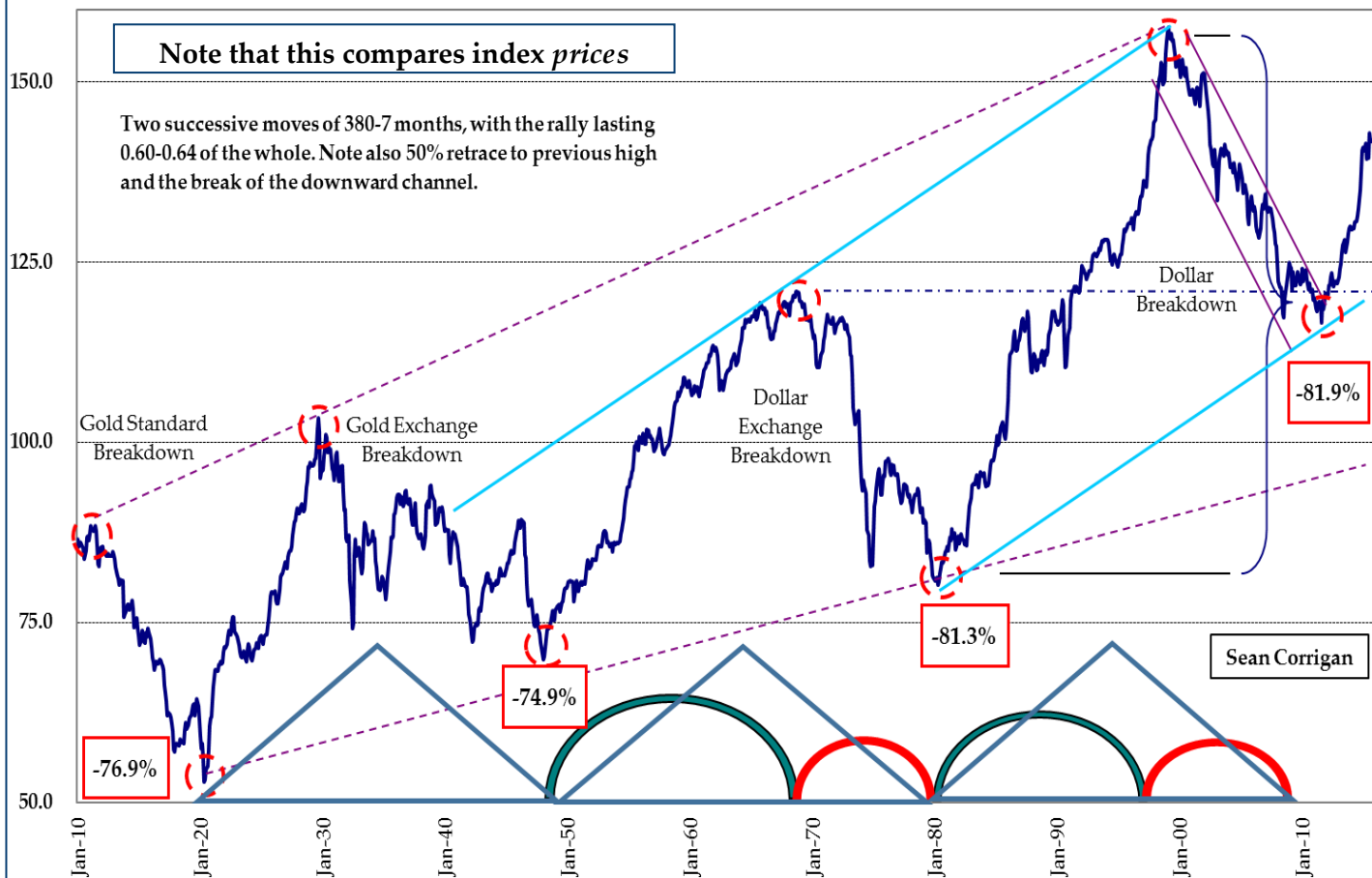
31 year cycle in ln price of Real Commodity Index (2000 = 100): Source - NBER, BLS, IMF, CRB



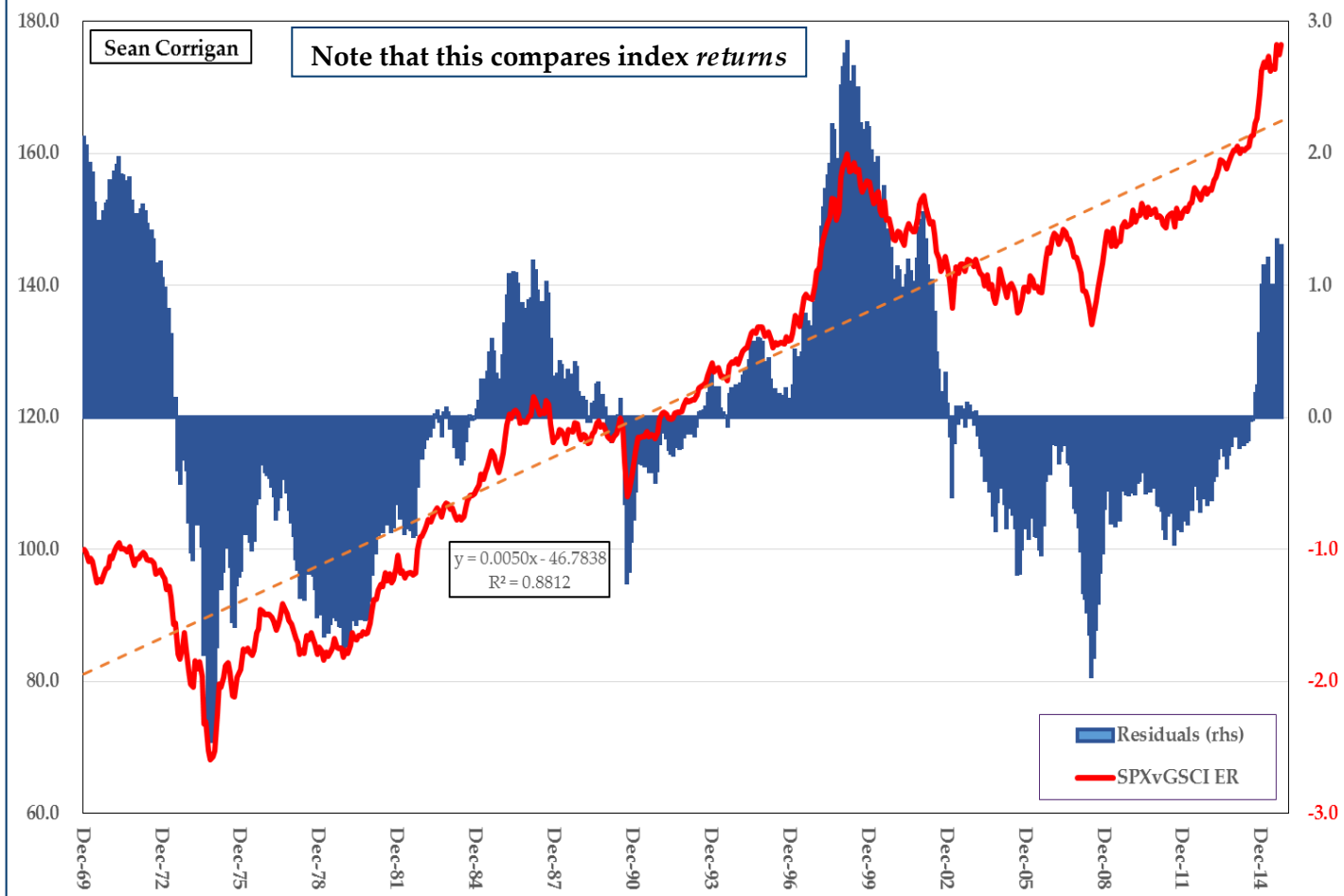
GSCI Real Returns, log scale: Source - Bloomberg, BLS



Rescaled log of S&P500/Commodity Index: Source - S&P, IMF, NBER



S&P500 TR v GSCI Returns 8.8% CAR, log scale: Source - S&P, Bloomberg



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