# MONEY MACRO AND MARKETS

*Unconventional Wisdom. Original Thinking.*

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*The ECB Council considers next year's inflation forecast*

## Hocus Pocus

We are in danger of being blinded by semiotics and so losing sight of substance. We are so convinced that the medium IS the message that we have forgotten to seek for the meaning it is supposed to convey. We have given in to the quack doctors and their unscientific theories of humours in the body economic. We are now so anxious to keep the patient's temperature minutely regulated that we have neglected to do anything about the malarial parasite which had earlier given him a fever and now has him shivering through a chill.

Daily we seek for auguries with which to inform our every action and if *our* High Priests do not dip their gory hands deep into the reeking livers of their sacrificial victims, they do scan the financial arcana entrained in the shifting arithmetical difference which exists between the accidental phantoms of the yield curves of two subsets of loosely-related securities, the ordinary and the index-linked Treasuries. In so doing, not only do they succumb to the false god of Expectations - a deity principally distinguished by never being right about anything important – they also forget that those same curves and differences are subject to a whole host of entangled influences, among them the actions of the historically violent interventions of the omen-seekers themselves.

But the 5-year, 5-year forward implied break-even inflation rate – for it is this of which we speak – is a *market* phenomenon and orthodox economics believes in the unimpeachable rationality of markets. At least until AFTER the event, of course, when our masters must do 'whatever it takes', regardless of law or custom, to mop up the toxic spillage from the irrationality they previously encouraged in those same markets' earlier. If, therefore, the market speaks, its message MUST be obeyed.

Just over a week ago, the ever ludicrous UK *Guardian* ran a headline which screamed *'Global economic fears prompt high street gloom'* which essentially asked us to believe that young mums in Bridlington were swapping to own-brand baked beans because the Brazil real was plunging and that the fall in Taiwanese export orders had teenagers in Teesside holding off from topping up their smart phones. But is it really any less risible when some ECB talking head starts agonising over the 'de-anchored inflation expectations' being heralded by a quasi-random dip in the 5y5y and starts militating to buy another half a trillion in securities as a response?

Similarly, it is all too easy to giggle at Li Keqiang's earnest declaration that his sprawling fiefdom would show a measure of 'growth' of a precise 6.53% per annum rate over the course of the next several years, but was he really opening himself up to any greater ridicule than that to which so many central bankers expose themselves when they scurry from one media appearance to another, vaunting they will use all 'weapons in the armoury' simply to ensure that a statistical echo of a synthetic basket of frequently purchased goods and services should rise at an arbitrarily small percentage each and every year and thus restore prosperity to all mankind?

*[continued over]*

**Sean Corrigan**

Seven billion of us each make multiple economic choices every day, each of them exerting a minuscule but nevertheless cumulatively important influence on the prices, not just of the goods explicitly involved in our exchanges, but also on those in the vast array of their competitors, substitutes, precursors, and complementary factors. Amid this unfathomable whirl, once every 30 days, a highly subjective, quasi-static sampling of a privileged subset of this uncountable profusion of transactions is taken by the temple guardians. When they have finished clicking their abacuses back and forth over their findings, we are then asked to believe that if the unit average has not increased by at least 0.165 of a percent – or, worse, if we suspect that people are starting to *believe*, despite all our protestations to the contrary, that it might not *continue* to do so in the coming months - the very pillars of our civilization start to teeter. This is truly madness!

As for the mystical 2% level to which that monthly increment compounds up over the course of a year, the estimable Bill White relates how it (or, more precisely, its predecessor) was effectively plucked out of thin air some thirty-odd years ago by a couple of his colleagues as they travelled to a parliamentary hearing at which they would make the then-radical, anti-inflationary case for the central bank at which they worked to be given a measure of functional independence.

Little could they have imagined the import of their actions for on such a slender thread of happenstance now dangles the fate of the world, albeit one since thickly embroidered with three decades of abstruse mathematical theorising, a goodly part of that under the aegis of the MIT crowd which has come to dominate the Fed and the ECB among others.

No matter that we protest that 'deflation' in the sense of falling prices, is a good thing, that it means we do less labour in the sweat of our brows for each hunk of bread we eat. No matter that we can point to many historical instances when falling prices were seen as a sign of, not a threat to, increased prosperity. No matter that the undeniable evidence of malign side-effects has built to the point that the ECB, for one, has recently resorted to special pleading; bleating on the one hand about how, when low rates allow yet more under-travelled roads and echoingly empty art galleries to be laid down, savers will finally have their due reward in the form of some sort of ill-defined social dividend and, on the other, about how it simply isn't true that the nasty politicians don't undertake the necessary reforms when the central bank sets the cost of their inaction at zero.

It may well be that the technological wonders wrought by members of the oil industry, together with the vanishing 'shoe leather' costs of searching out the best deals anywhere on the globe in the Age of the App and the re-orientation of much productive capacity away from the wastefulness of the late Boom, have given many hard-pressed families a little budgetary breathing space. But, be warned, if we plebs start to *expect* that the continuation of such a bounty is theirs by right, we must be monetarily disabused of the notion forthwith, no matter what extremes our due chastisement may involve.

Carved above the portals of the sancta sanctorum in Frankfurt and London and Washington and elsewhere, in letters of flaming brass, is the terrifying injunction: *'Thou shalt have no other gods before me nor shall thy prices rise less than 2% per annum for I, the Lord thy God, am a jealous God, visiting the excess liquidity of the fathers upon the thrifty unto the third and fourth generation of them that hate me.'*

Who has the temerity to argue with a divine commandment?

# HEAVY FOG: The View from Albion

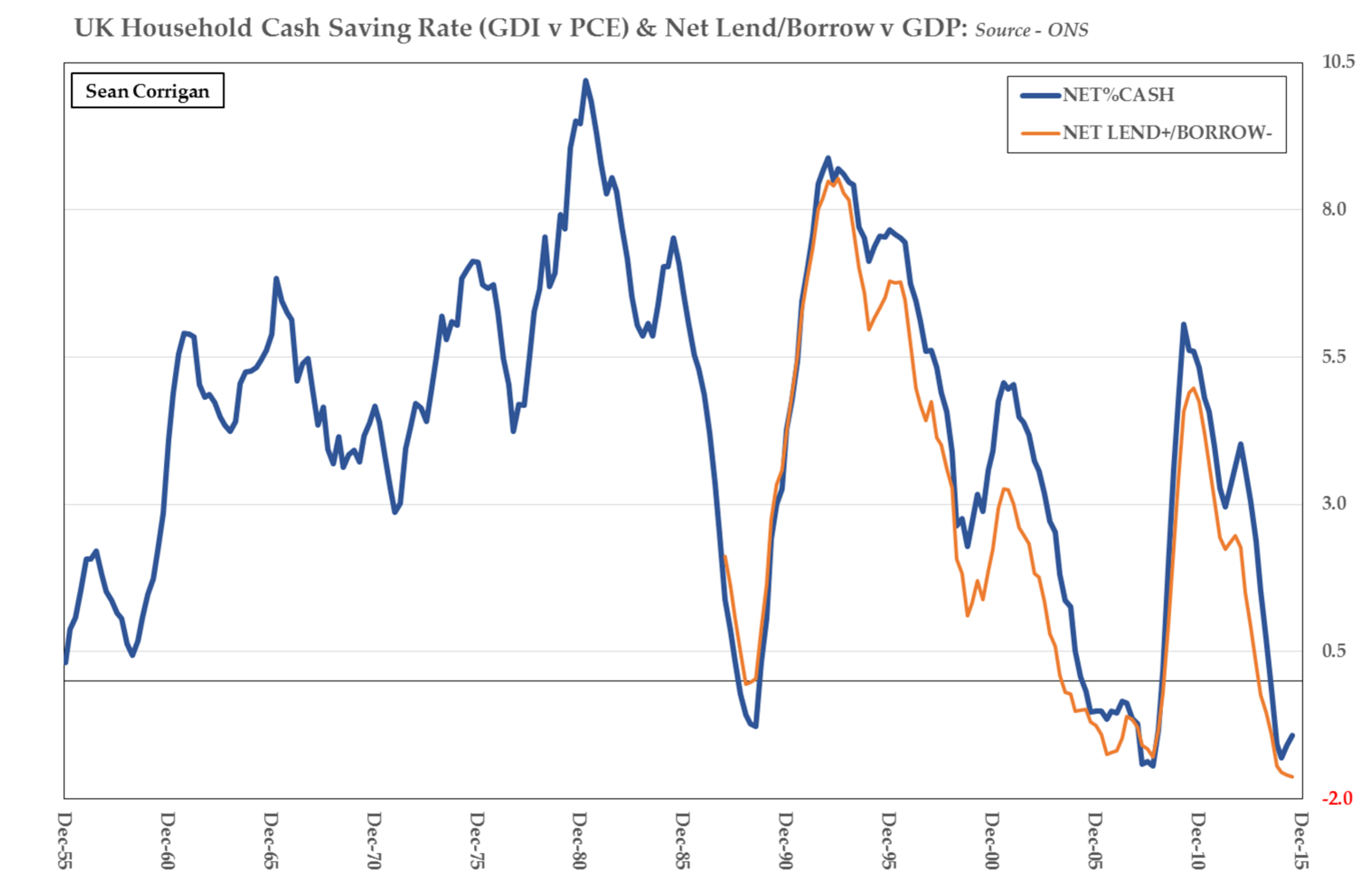
Having spared some time from his primary role of delivering big-sounding, career-enhancing lectures on issues such as climate change, the BOE governor, Mark Carney popped into the office to preside of yet another meeting where no change occurred and then braved the media circus effectively to scotch all thought of a rate hike until not just 2015, but 2016, too, has safely been interred.

For all those who have been taking central bankers at their word and thinking that they were plagued by 'uncertainty', such a confident lack of confidence should make it clear that what they are mostly lacking is not 'visibility' but vertebrae.

If only to be expected, this further acceptance of loose policy is nonetheless irresponsible in a country where the same old imbalances which have plagued it for so long are starting, once again, to peep out from under the rocks.

Borrowing is again on the rise with households taking on some £43 billion in new debt this past twelve months, the highest total since the crash. Half of that represents new mortgage debt – an uptake which has seen house prices soar 30% in the past three years to take them past the pre-Crash highs. In real terms, the numbers are perhaps even more striking with the present 7.7% rate of climb for the HBOS index hitting a 7.7% clip which is the fastest in a decade and which is starting to intrude in to territory previously reserved for bona fide housing bubbles. The other half is split 50:50 between good, old-fashioned consumer borrowing and the newly-built mountain of student debt, now fast approaching a total of £80 billion and which is doubling roughly every five years (see below).

As a result, household savings rates have turned negative in much the manner they did in the last few years of the Brown Boom – a fact to which even the ONS has recently confessed with its recent exploration of actual 'cash' savings (i.e., the ones which individuals can see in their bank balances after stripping out such intangible forms of 'income' as free chequing accounts and the more substantial, but nevertheless unavailable notional gains to their pension funds). This shows that, rather than running a healthy surplus of around 5% of disposable income, the actual figure is a good couple of percent into the minus column.



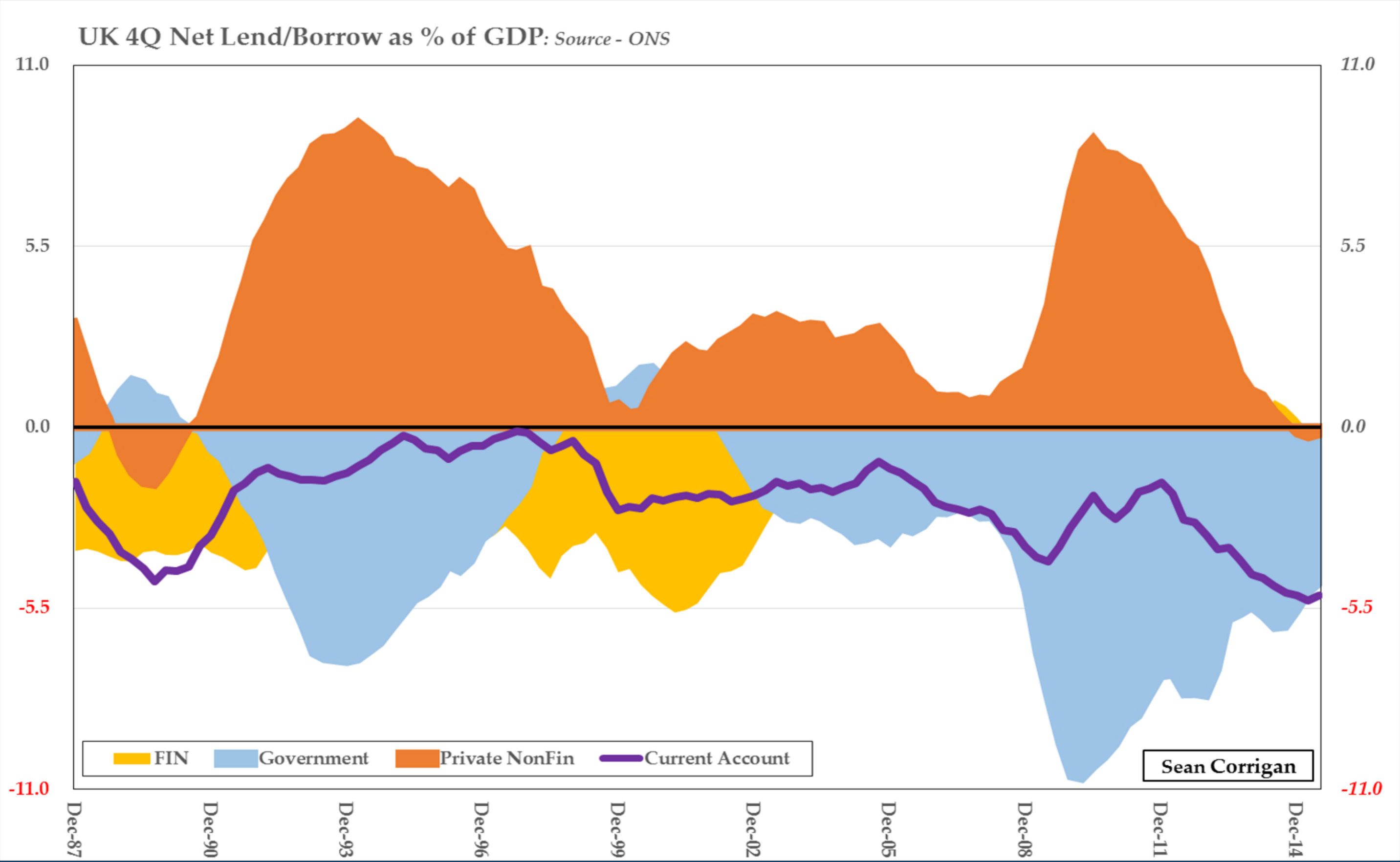
Householders' consumption of their capital is being offset in the accounts by a near equal-and-opposite surplus accruing to non-financial corporates in a reversal of their two sectors' classical roles. One might also note that the latter are managing to achieve this and to undertake a trend 5% real increase in investment spending only by having to finance it through security issuance, not self-fund it as they otherwise might largely have been able to do.

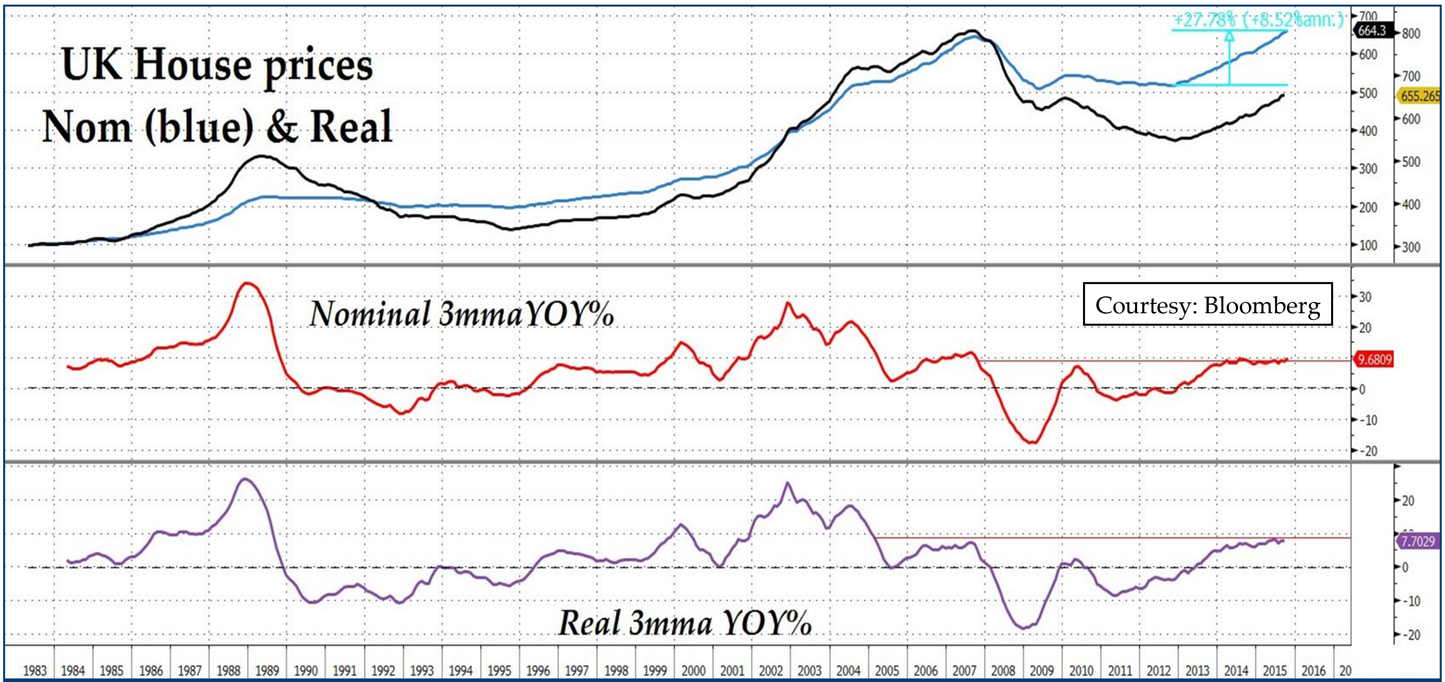
This conceptual extension of a generous helping of vendor finance highlights two further issues, each with ramifications for the argument about the appropriateness of the Bank of England's rate settings.

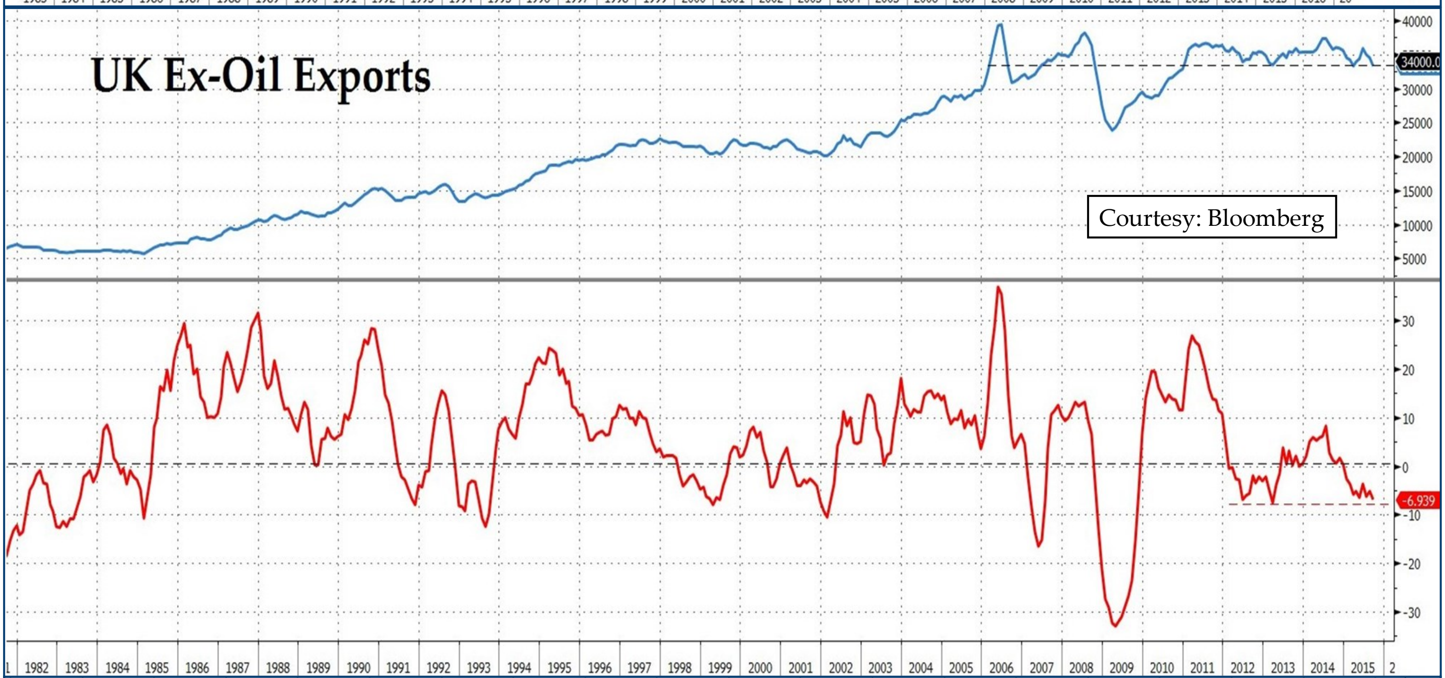
For the first, consider that this renewed burst of net borrowing had come about even though hours worked have hit an all-time record, after growing in the 3 ½ years to end-2014 at 2.2% CAR, almost double the pace of the previous two expansions. Although that increase has since largely fizzled out, the corollary has been that wages have begun to rise more steeply – with real incomes doing even better, given the concurrent drop in the change in consumer prices.

Indeed, in the spring, the combination of higher wages, slower price gains, and extra hours had seen the YOY rise in what we might call the 'real wage fund' hit its equal best level in the past 14 years. For the record, the Bank's base rate back then was a mere ten times its current mark - at a heady 5% versus today's piffling 0.5%. How did we ever cope?

Clearly, however handsome the rise in both aggregate – and lately individual – incomes, this has not been enough to satisfy UK residents' exhaustive end-demand, certainly not in the face of the historically low borrowing costs they face. It will be worth watching, then, how this re-leveraging progresses now that Fred Karney's Circus have all but ruled out the need for caution in the coming months. It will also be key to monitor whether the last few months' constellation of flat-to-declining hours, faster wage growth, and a slowing of the rise in their product signals that the labour market has become saturated – and hence that this less benign combination will deteriorate further – or, indeed, whether it signals a cyclical top in activity, *per se*. Either of those would imply that any extra incurrence of largely non-productive personal debt would be taking place on increasingly shaky grounds

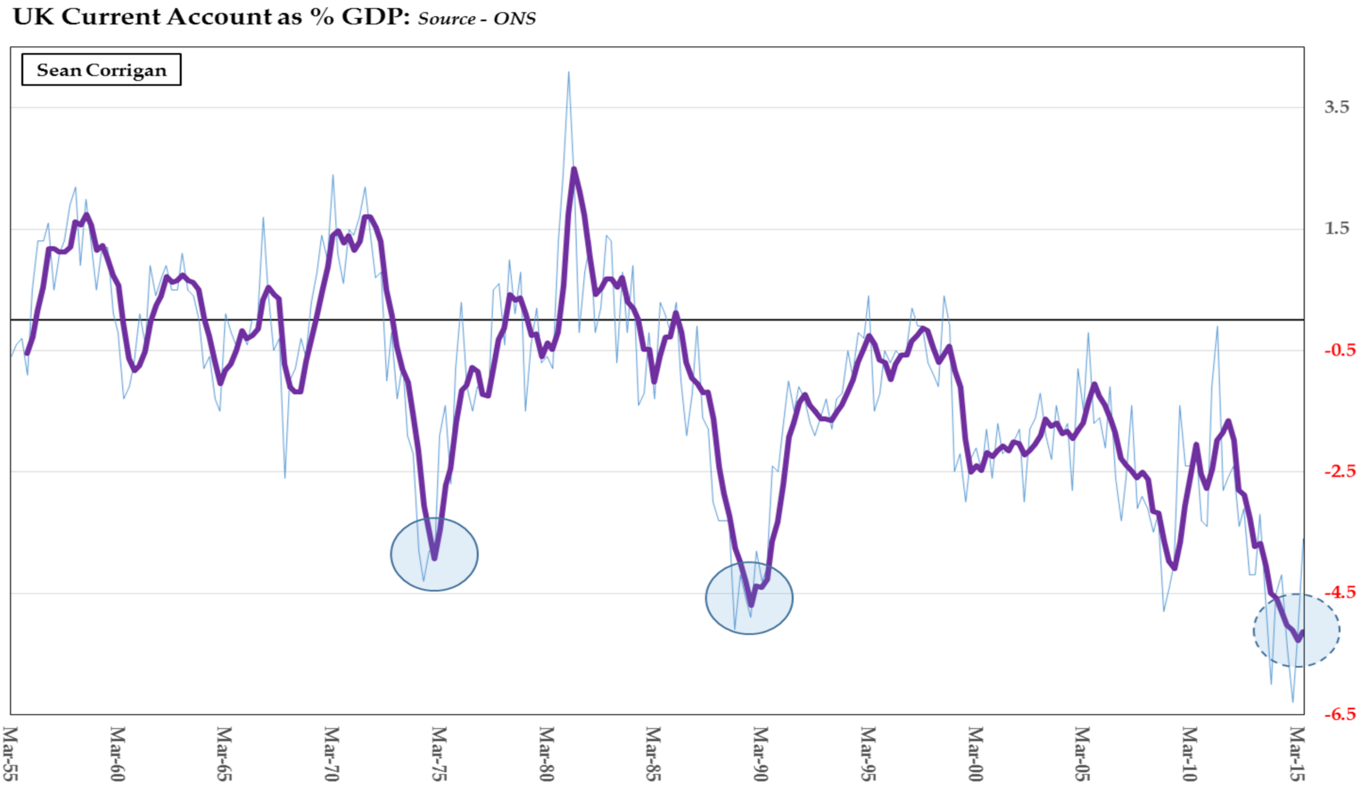



UK House prices
Nom (blue) & Real
+27.78% (+8.52%ann.)
664.3
655.265
Nominal 3mmaYOY%
Courtesy: Bloomberg
9.6809
Real 3mma YOY%
7.7029


UK Ex-Oil Exports
34000.0
Courtesy: Bloomberg
-6.939


MTEF1BC Index - Mid Price -28.00
CBI Export Orders
-28.0
MTEF1C Index - Mid Price -18
-18
CBI Total Orders
Courtesy: Bloomberg

## HEAVY FOG: The View from Albion *(continued)*




The other side to the mutual cancellation of non-financial private sector saving is that the burden of financing a government which is still routinely recording deficits in the neighbourhood of 5% of GDP (in fact, of around a quarter of its ostensible 'contribution' to that same measure) has to fall on Albion's friends abroad – hence its still-yawning current account gap, the largest in both monetary and percentage terms, as the ONS itself laconically noted, since records began in 1948.

A glance at the physical side of Britain's productive industries shows few signs of anything which might rectify this imbalance, with what few gleams of light there have been emanating mainly from the service sector – principally, of course, from the ever-problematical one of finance. Nor have recent examples of other kinds of suggested that anything of a renaissance might be on the cards. For instance, the latest CBI Trends survey showed an overall orders slump to a 2-year low, led by exports relapsing back to levels of January 2013. The British Chambers of Commerce backed this up in its own quarterly survey which there found that exports were in their most parlous state since just after the Crash itself.

Other portents of the struggle come in the shape of Ernst & Young's regular report which pointed out that the third quarter had seen 79 quoted company profit warnings, 5.6% of the total, which was the worst for the season since the Crash. Fall out from lower commodity prices and the unfolding Asian weakness were a feature, but domestic retailers were not immune, despite the consumer overstretch. It is also to be noted that the consultancy says it can see the first hint that an economically-ignorant but politically too clever-by-half Chancellor has given the Golden Goose a major thwack with his National Living Wage folly – as even the OECD has admitted might be the case. For its part, E&Y was warning that companies with a high labour-to-sales ratio could soon be in trouble as consequence of Osborne's manoeuvre: some might say that description just about sums up the UK as a whole.

As a result of all this, the UK now finds itself with gross external liabilities equal to 5 ½ times its GDP, with a net total which will end the year swollen to more than £370 billion, or more than a fifth of national income. For the first time ever, not only does the country have a deficit on portfolio of £250bln and one in the 'other' (largely banking) category of £205bln, it now has a shortfall of £90 billion in the FDI column, too. Worse, yet, the returns being earned on the country's holdings are below that payable on its liabilities.

Shuffling one entry against another, UK Plc is roughly square against the rest of the world with regard to equities, where a £47bln surplus of the portfolio kind lies against an FDI shortfall of £24bln. Conversely, the net external debt and loan total has ballooned to £615bln in what must largely be readily withdrawable commitments. Of some comfort, one eighth of that vast total finds a liquid offset in the shape of UK's forex reserves, while a little less than a quarter additionally has counterparts on the asset side by way of derivatives and stock option grants.

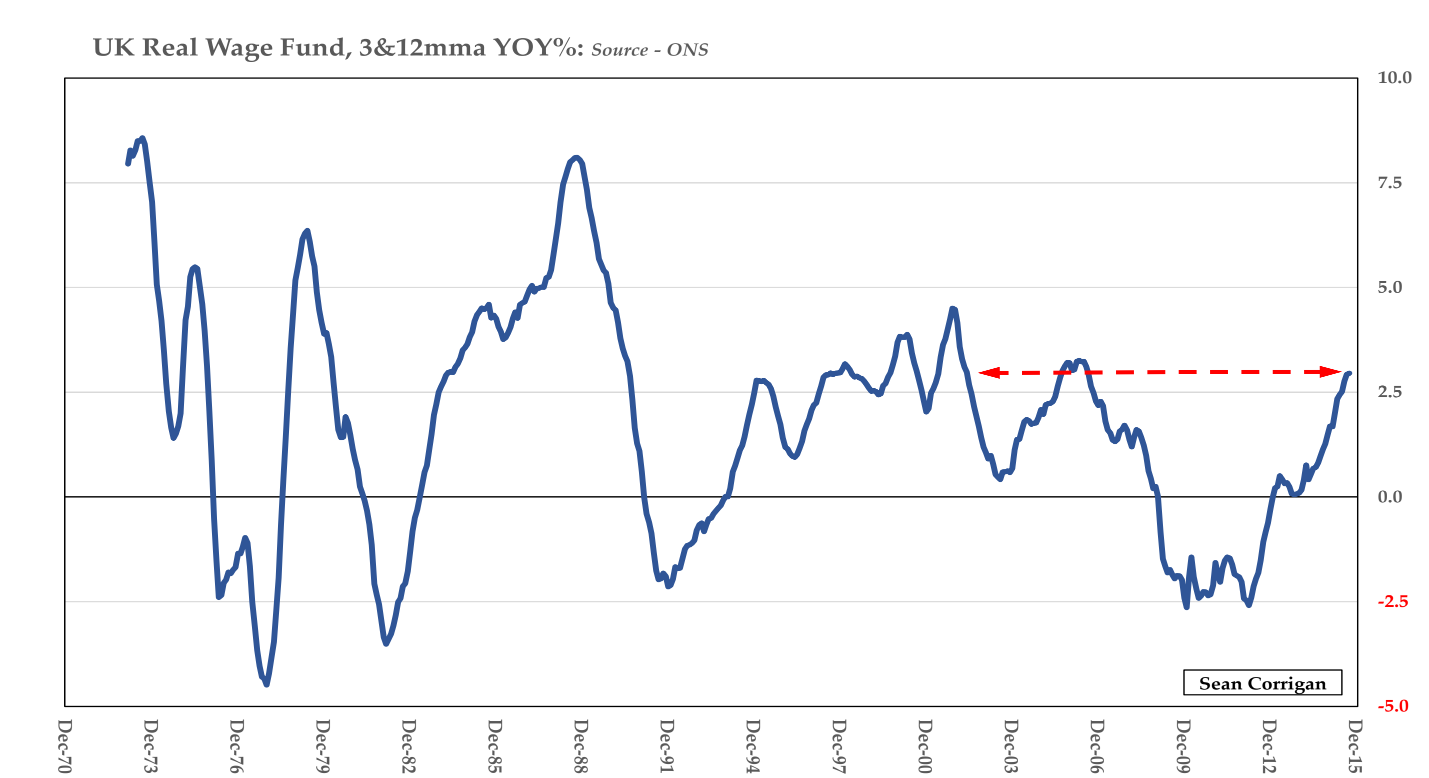
However, this still leaves an enormous mass of hot money with which to reckon even if we presume that we can rely on the constancy of the roughly one-third being held as others' forex reserves (with perhaps another one-sixth hidden beyond that if we treat the unallocated reserves in the IMF COFER report *pro rata* with the allocated).

Given all this, it would seem that Britain, much like in the 1930s – and as also in the '60s and '70s – cannot really afford to lose the confidence of its overseas creditors. Perhaps, a certain Mr. Carney might like to give some thought to that when next he deigns to devote some attention to the day-job.

One further thought. The entirety of the tab run up can be neatly construed to have been the result of the uninterrupted sequence of current account deficits Britain has run with the EMU nations – a monetary drain (if perhaps a material gain) of a near-matching £390 billion these past ten years. Brexit, anyone?

So how to sum this all up? Well, a good ten years ago now, your author was invited to give the main address at a private company function held in the Bank of England Museum precincts. Naturally, I was not able to resist poking a little fun at how The Old Lady was set up along lines suggested by William Patterson - a man who may have started as a buccaneer and who certainly ended up bankrupting his native Scotland and hence putting an end to its last vestiges of independence – so that a usurping monarch could use financial engineering to sweeten the pot for London's Whig oligarchs sufficiently that they would pay for his dynastic struggles with the Sun King.

More importantly, I described a state of affairs where a series of malign indicators such as deficits, unproductive spending, and house prices were zig-zagging upward, while more beneficial ones such as manufacturing output, exports, and net capital expenditure were doing the same along a barely horizontal trend. Quickly sketching in the



outline of a cartoon crocodile around these two traces of what would become the beast's wickedly gleaming teeth, I added a stick wedged between the two jaws to prevent them closing on the animal's hapless prey.

The stick, I told my listeners to conclude the talk, was comprised entirely of credit and when, one day, the stress became too much and it suddenly snapped, I warned that they would be advised to find themselves well clear of the hungry reptile's maw. The punchline received a modest smattering of chuckles and a little more polite applause but the Brown Boom was then in full swing and such ideas were all too distant from most of the attendees every day concerns to be seen as anything more than a mildly humorous, evening's diversion.

A decade on, under the emollient incitement of the latest adventurer to haunt Threadneedle Street, you might forgive me for experiencing a strong sense of déjà vu.

### *Those who can't do….*

As a PS to the above, the UK labour numbers do make fascinating reading. Of the nearly 1.4 million jobs by which the workforce now exceeds the pre-GFC peak, a glorious 5.2% of the increment has fallen to the lot of native Brits. Ten times that number have been taken up by other EU residents - of which over 450,000 from Eastern Europe and 140k more from Rumania and Bulgaria - while another 200k have come from the old imperial reaches of the Raj.

Though it would be ludicrous to suggest there had been a one-for-one swap between them, it should be noted that, over that same horizon, the sector showing the third biggest numerical job gain was Education (+340k), with each good soul entering into a career therein getting his or her very own extra student (+315k) to whom to cater. Student debt has trebled over that period, adding more than £50 billion to the outstanding total in the process, you will recall from above.

Education does, of course, contribute something to the balance of payments as well as to the human capital of the nation at large, but it is hard to resist the only slightly stretched observation that here we have a large group of hard-working immigrés – many of them ludicrously overqualified for the positions they take up in the UK since these pay more, or the associated residency offers better prospects, than they would otherwise enjoy at home – which is performing the economic functions vacated by the knowledge-hungry undergrads and devoted pedagogues respectively swotting up on and delivering lectures in Football Studies or Surf Science at one of the many newly-sprouted, Blair Bus-shelter Unis.

In case you were wondering, head-office admin, compliance form-filling, and general BS business took top spot in UK job creation – or 'Professional, Scientific & Technical Activities' as it is officially known – scoring an impressive 40% of all new jobs (+655k). Healthcare ran well to second spot with (+550k). At the same time, the former workshop of the world saw manufacturing almost literally decimated, losing 270k – or 9.2% - of its headcount despite the overall upswing underway.

And they wonder why the productivity figures have been so shocking!

## WHERE THE MONEY GROWS: Wall St. and West

With its score of 271k jobs added, November's US non-farm payroll came in strong at just the right time to put the December Fed meeting back into play as a possible venue for the long awaited, first baby-step rate hike.

The best number for 2015 so far, there was, in truth nothing that remarkable a number which was posted (at the first, revisable time of asking) at 0.9 sigmas over what has been a pretty stationary mean/median of 208k a month in the distribution laid out ever since the start of 2011 and the end of the great rebound from the Snowball Earth condition which followed Lehman's bankruptcy.

As ever – and on the premise that we take the numbers as they are presented to us - the devil is in the details of the release.

Regular readers will know that, where possible, we like to disaggregate the broader numbers, looking for the tell-tale signs of the kinds of relative shifts which might clue us in to a turn of the cycle in the form of mismatches between the flow of money into and out of the sectors as well as differences in their relative performance, especially between those at the 'higher' – heavy industry and capital goods – and the lower – retail, health, personal services – end of the spectrum.

To clarify by way of example, in the end-consumption biased GDP numbers, manufacturing products make up only around one in every six of goods directly bought by individuals to be counted in the measure, while slightly bigger dollar total is bought by one manufacturer from another only for the sum to disappear into the aether of the national accounting conventions.

Overall, of the $13.6 trillion of such vanishing goods which the BEA classifies as 'intermediate', manufactures account for fully 30%, making up a $4 trillion sum which doubles the $1,920 billion destined for the prominent PCE column. Add back in the $844 billion component of private fixed investment (another 30% slice) and you can rapidly see that the major influences in this key area are those emanating from other businessmen, not Mom and Pop cruising the aisles of some big box store.

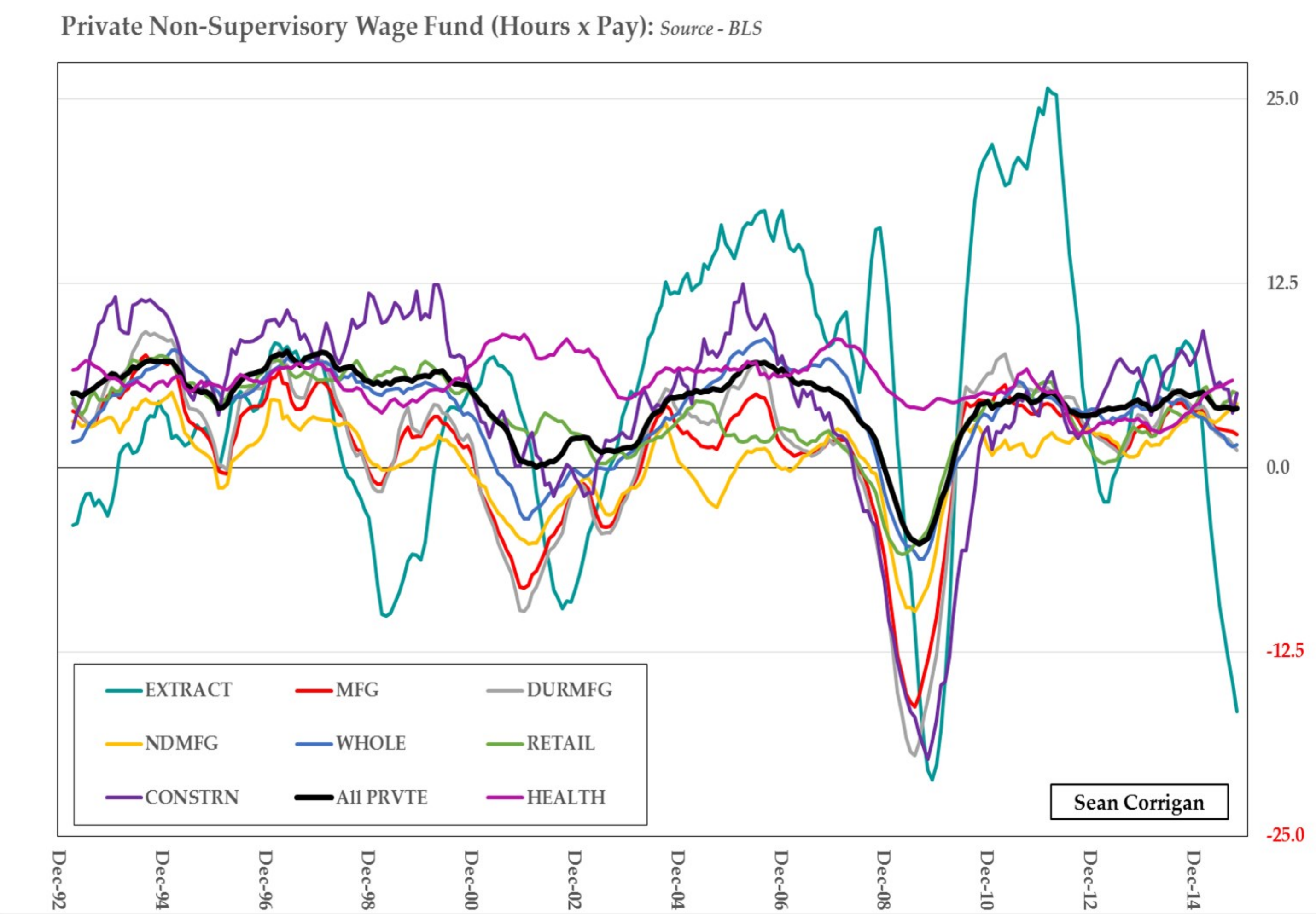
As such, the revenue and profit flows here tend to be much more variable and – many of them being both all too deferrable and hardly susceptible to being put to use in operations other than the ones they were first intended for – much more vulnerable to the vicissitudes of the cycle than are dog biscuits or dental services, for instance.

Similarly, if we are hoping to grow an economy and sustainably increase real wages, it is unlikely that this can be achieved without incorporating more capital stock in both thicker, horizontal layers and, more importantly, in more functionally distinct and probably more individually sophisticated layers interleaved between the first input of time, effort, and resources and the neatly packaged gewgaws sitting in the bottom of your shopping cart. We Austrians tend to call this latter the introduction of a more 'roundabout' method, though the term, with its overtones of delay and unnecessary complication is not entirely felicitous.

It is all too possible to keep the GDP aggregate bowling along without doing this and so we can have episodes of silent manufacturing recessions, hidden from the cognisance of the casual observer much like the archetype of the tree that falls unheard in the forest. But what takes its place under such circumstances tends to be a mixture of the kind exhaustive, one-shot consumption that makes no provision for replacing the goods being used up in the (or, more accurately, for maintaining the things and sustaining the who make the things which make the goods) moment and outright - often debt-fuelled – capital consumption.

As in so many things, the balance between the two matters, so departures from the norm – in either direction – can be highly informative. So if we consider things like sales, profits, output, payrolls, or outlays between the two ends of the productive structure – at either end of the national assembly line, as it were – we can hope to better gauge how healthy the patient is.

Exhibit A is the pattern of labour costs across the sectors (what we here call the 'wage fund'). Typically, this is both the largest expenditure for the firm and the most important source of income – and hence, in turn, the individual's primary means of conducting his own end-expenditure. Here we can see that in the extractive industry, this has unsurprisingly collapsed but also that the reading for manufacturing is heading inexorably toward zero, along with



Private Non-Supervisory Wage Fund (Hours x Pay): Source - BLS
25.0
12.5
0.0
-12.5
-25.0
EXTRACT
MFG
DURMFG
NDMFG
WHOLE
RETAIL
CONSTRN
All PRVTE
HEALTH
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Dec-92
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Dec-96
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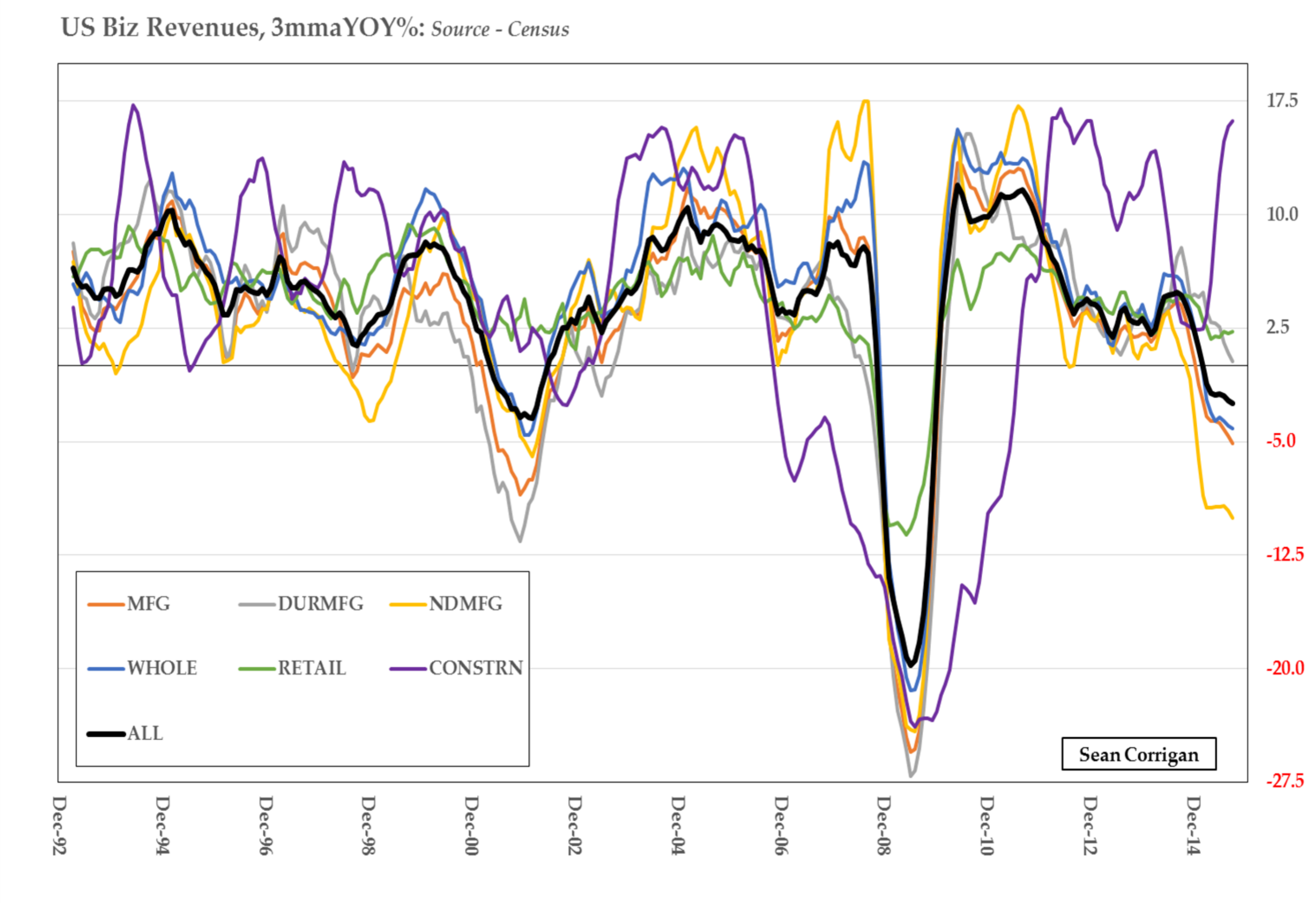

US Biz Revenues, 3mmaYOY%: Source - Census
17.5
10.0
2.5
-5.0
-12.5
-20.0
-27.5
MFG
DURMFG
NDMFG
WHOLE
RETAIL
CONSTRN
ALL
Sean Corrigan
Dec-92
Dec-94
Dec-96
Dec-98
Dec-00
Dec-02
Dec-04
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Dec-10
Dec-12
Dec-14

wholesaling. Retail and construction remains firm for now while health care (perhaps the consummate consumer good) is outstripping them all.

Exhibit B is sales themselves. Construction is booming, retail is doing OK, durable manufacturing is stalling out and – largely because of the price impact of lower commodity prices which is not therefore an unmitigated evil – wholesaling and non-durable manufacturing is in free fall.

Another barometer we tend to make much of is the relation between these last two, between labour costs and revenues and so between the source of cash and its single biggest drain. Now the plight of the higher end can be clearly observed but note, too, that retail costs are starting to play a role. Just as in the UK, the current vogue for grand political gestures in the form of minimum wage mandates is not likely to prove too helpful to the cause here, either, especially if Black Friday and the Christmas season dare to disappoint.

The next sophistication is to examine the ratio of manufacturing sales to the retail version, a construct which we can take back all the way to the start of the post-war era. A quick glance at the graph shows that when it falls as far as it has today, the sages at the NBER tend later to deliver a verdict of 'recession' but do not unfailingly do so. For an Austrian, however, any indication that the exhaustive consumption/reproductive consumption ratio is shifting in favour of the former generally bodes ill.

A neat illustration of this sort of thing – if one with not really enough history to be conclusive - is the difference between the readings in the ISM's two surveys. The more established one, of course, is that for manufacturing while the more recent addition samples non-manufacturers. This works conceptually even though the latter does garner the opinions of what are clearly enterprise-focused business alongside the retailers, restaurateurs, and movie theatre owners.

Here we show the spread for the employment sub-index and you will quickly notice that it has plummeted to the sort of mark only seen in the 2000-1 and 2008-9 busts. Suggestive as this is, we should nonetheless take note firstly that diffusion index responses do not reflect the magnitudes, only the prevalence, of perceived changes in the environment and secondly that, in this instance, the non-manufacturing sector is still headed clearly upwards, telling us that any weakness remains localized concentrated and not, as yet, endemic.

A similar impression can be had from a glance at the Q3 reporting data for the S&P500. Sales for Energy, Materials, and Capital Goods companies were off 34.3%, 15.1% and 7.8% YOY, respectively. Conversely, Discretionary Retail, Food & Staples, and Health Care had the till ringing 14.3%, 13.0% and 8.7% more frequently. With regard to earnings, the first trio (in order) dropped 56.7%, 13.5% and 3.5% while the latter threesome gained 30.1%, 11.6% and 14.5%. QED, would you say?

All in all, what we have here is evidence that while the economy may still be rolling, it is finally beginning to misfire with the higher productive orders struggling and the credit-driven lower end still booming.

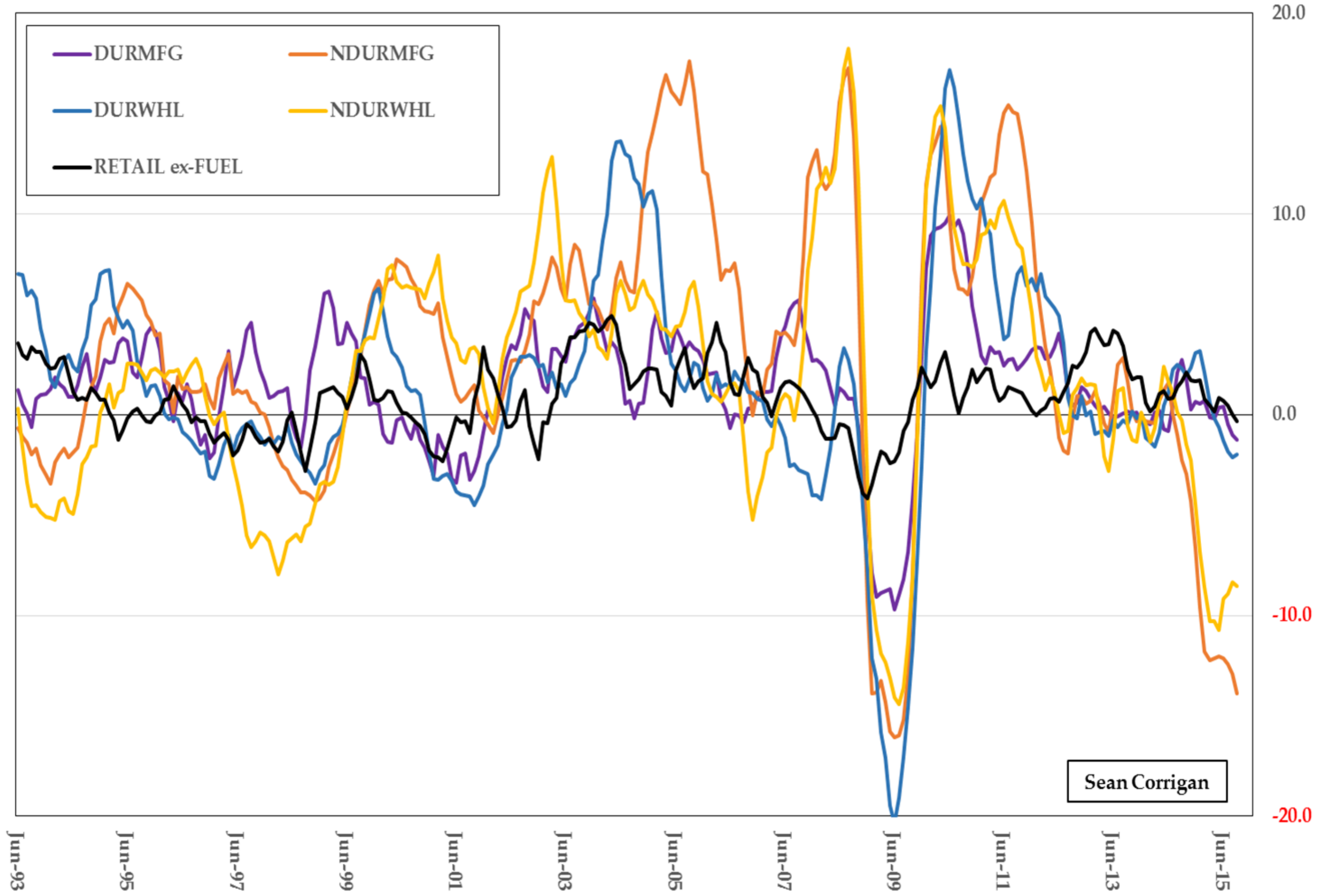
Auto sales, for example, have hit a 10-yr high, their 18.24mln SAAR having doubled the recession trough and only being beaten six times in a 40-year record. Auto loans, at around 11-months' current sales, now exceed $1 trillion having grown almost by half during the recovery. That's an awful lot of constantly depreciating metal which has to be funded, some of it by those also charged with servicing $1.3 trillion in student loans.

Nevertheless, while the extra money being spent at the mouth of the economy continues to out weigh any reduction being spend at the tail, few will be aware of the difference.

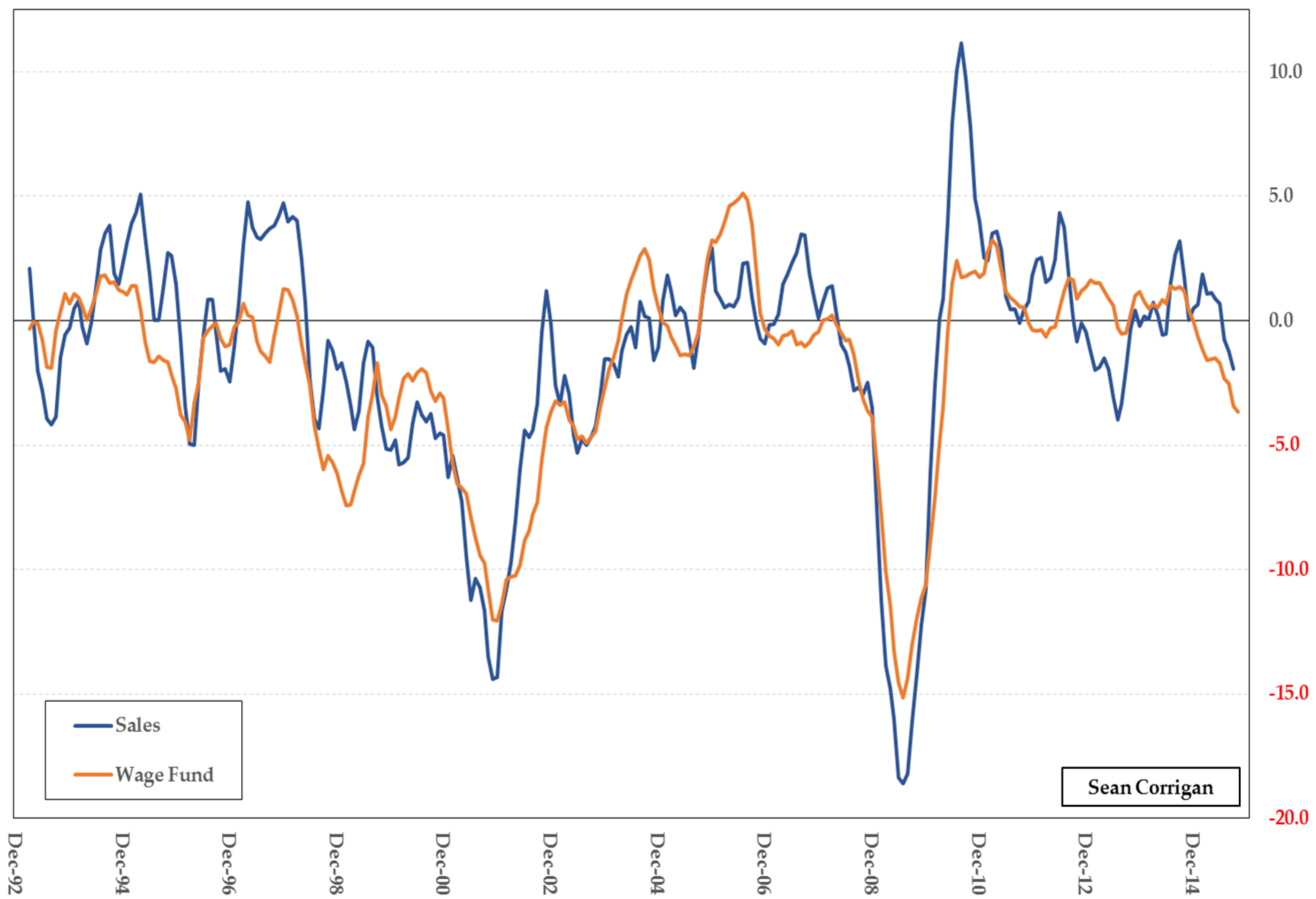
Yet beyond all of this, one further reason for caution exists: namely that - whether deliberately or not – the Fed has allowed some of the gas to leak out of the tank this past few months by presiding over a slowdown in money growth. If this persists, it could mean that, in Goose's immortal words, *'We're on vapour, Mav!'* On a three-month rolling basis, the deceleration has not yet been enough to condemn us to a nasty drop in activity, but the slowdown to sub-1% YOY on a straight month-for-month comparison nevertheless looks ugly.

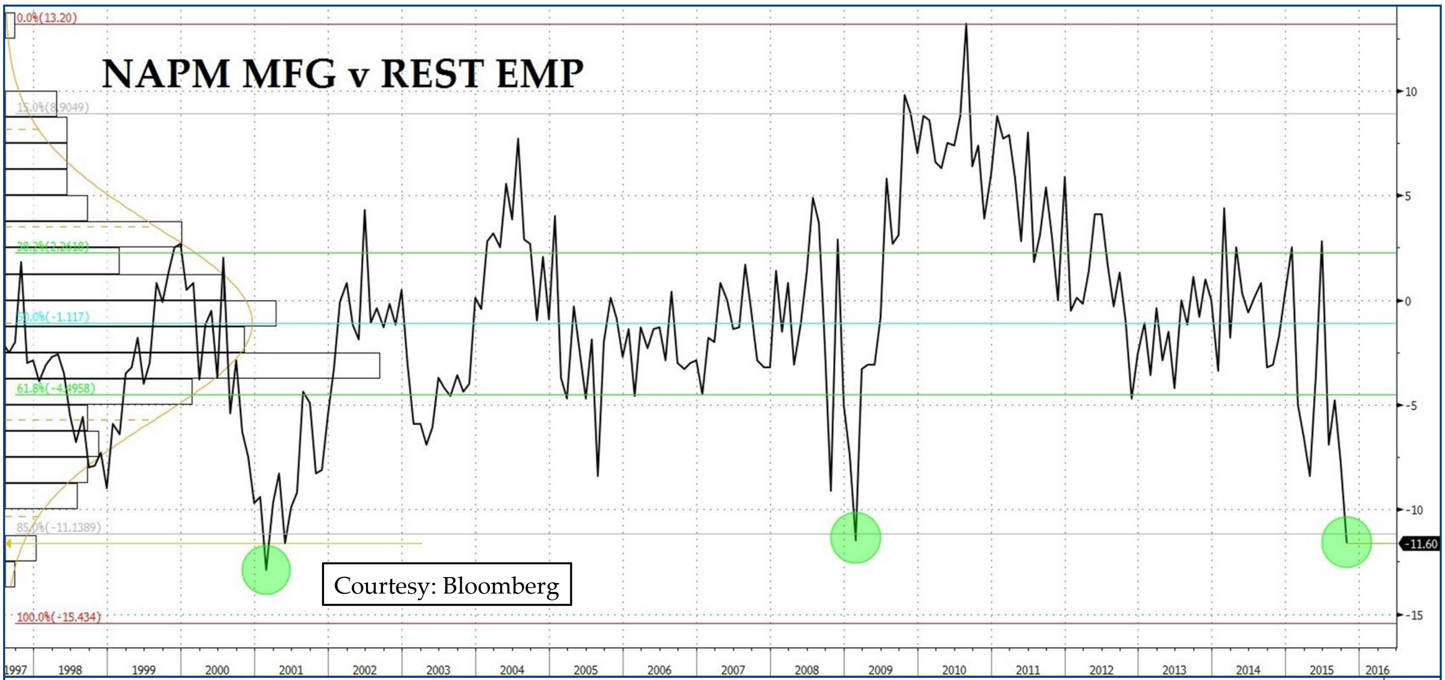
Be careful out there, people!

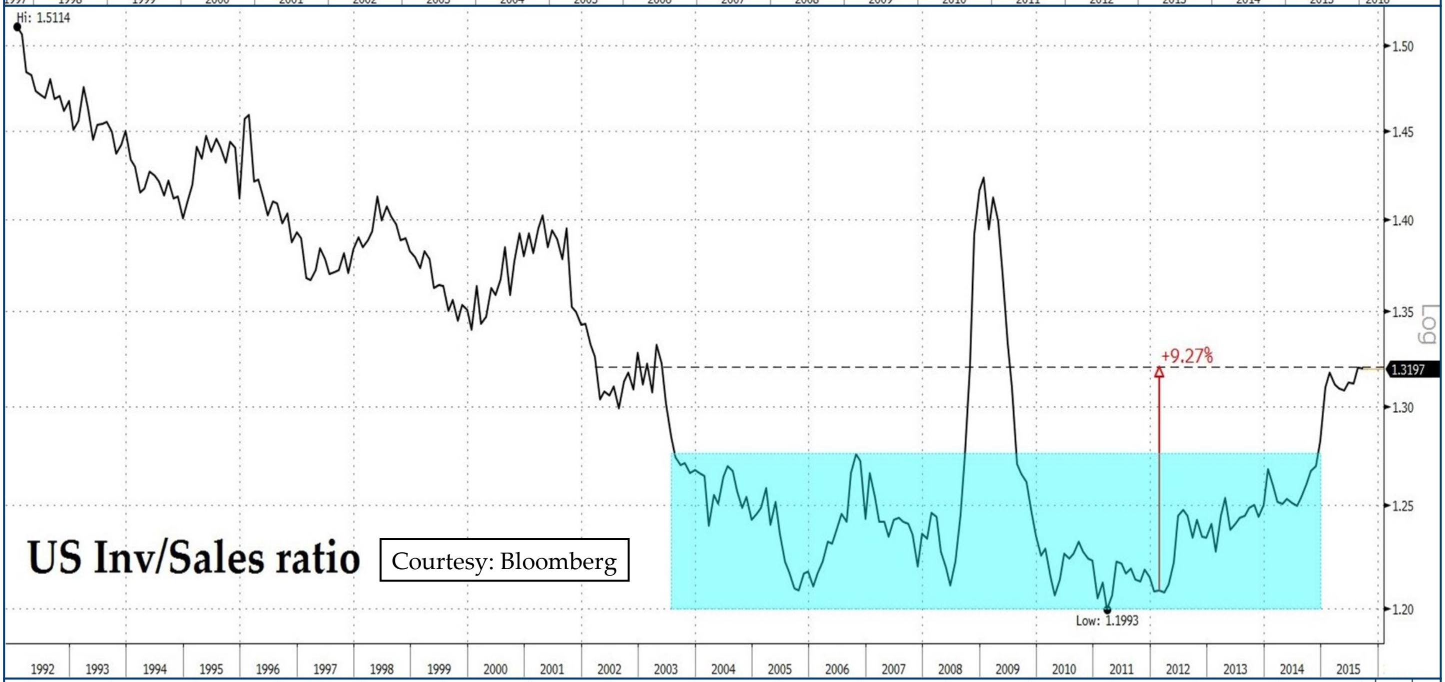
US Biz Revenue v Wage Fund, 3mmaYOY%: *Source - BLS, Census*

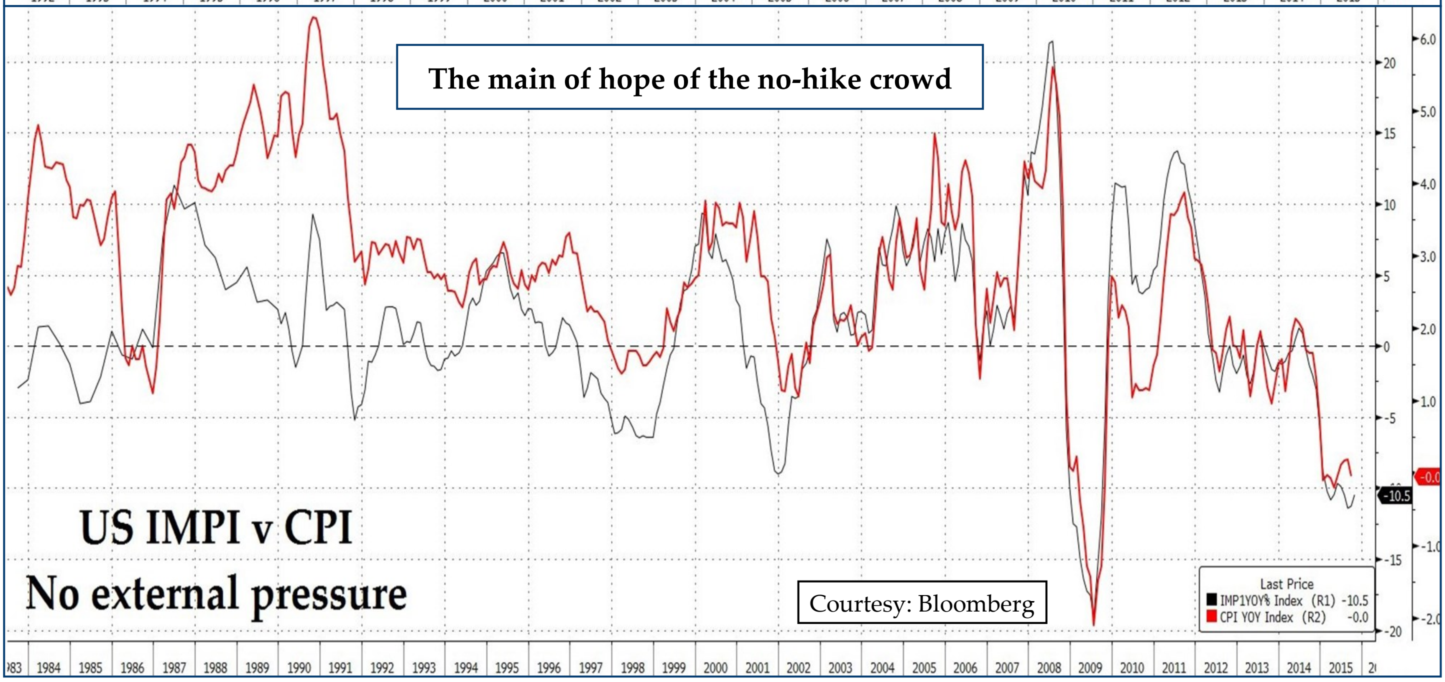


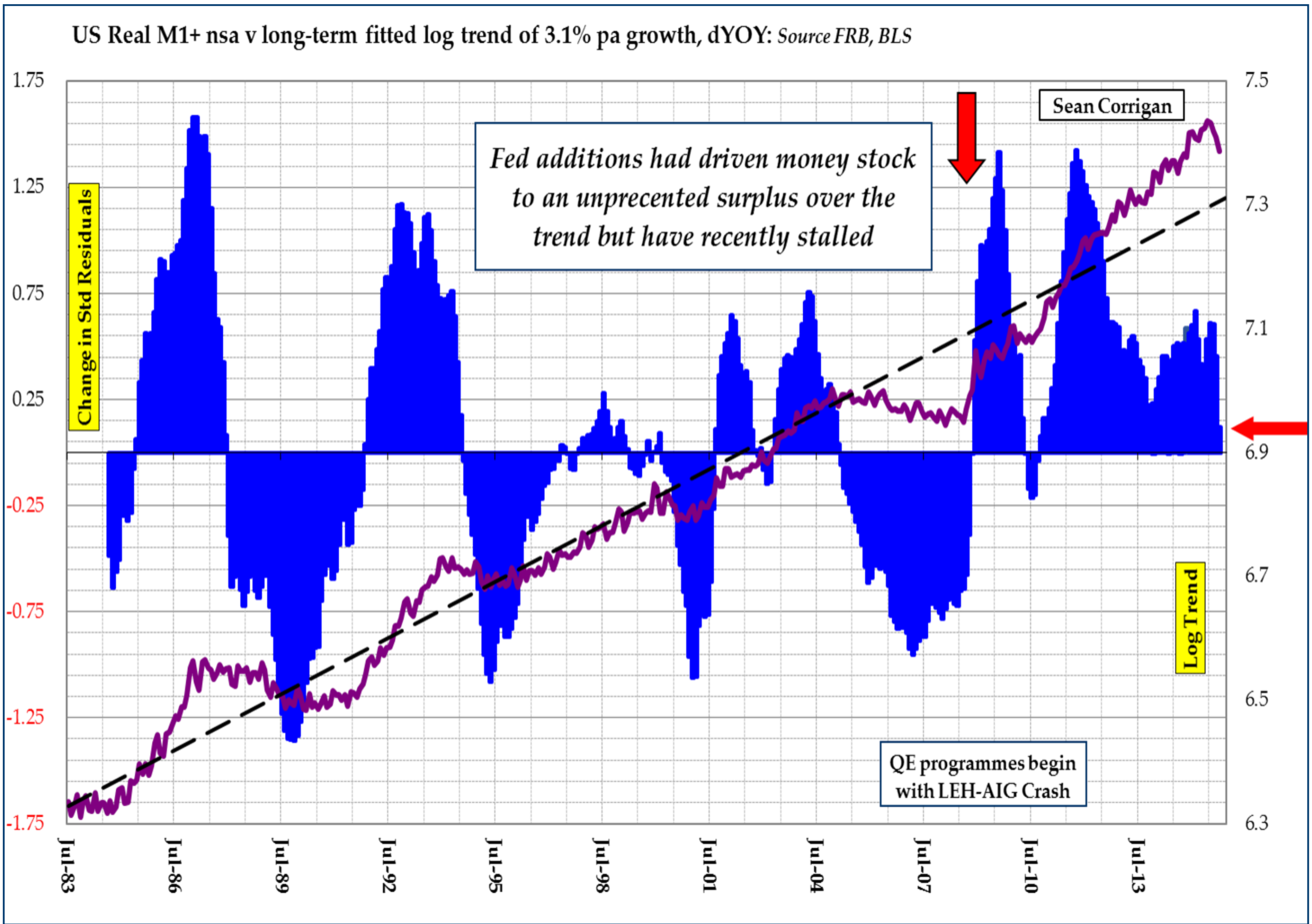

Durable Goods v Retail Sector 3mma YOY%: *Source - Census, BLS*

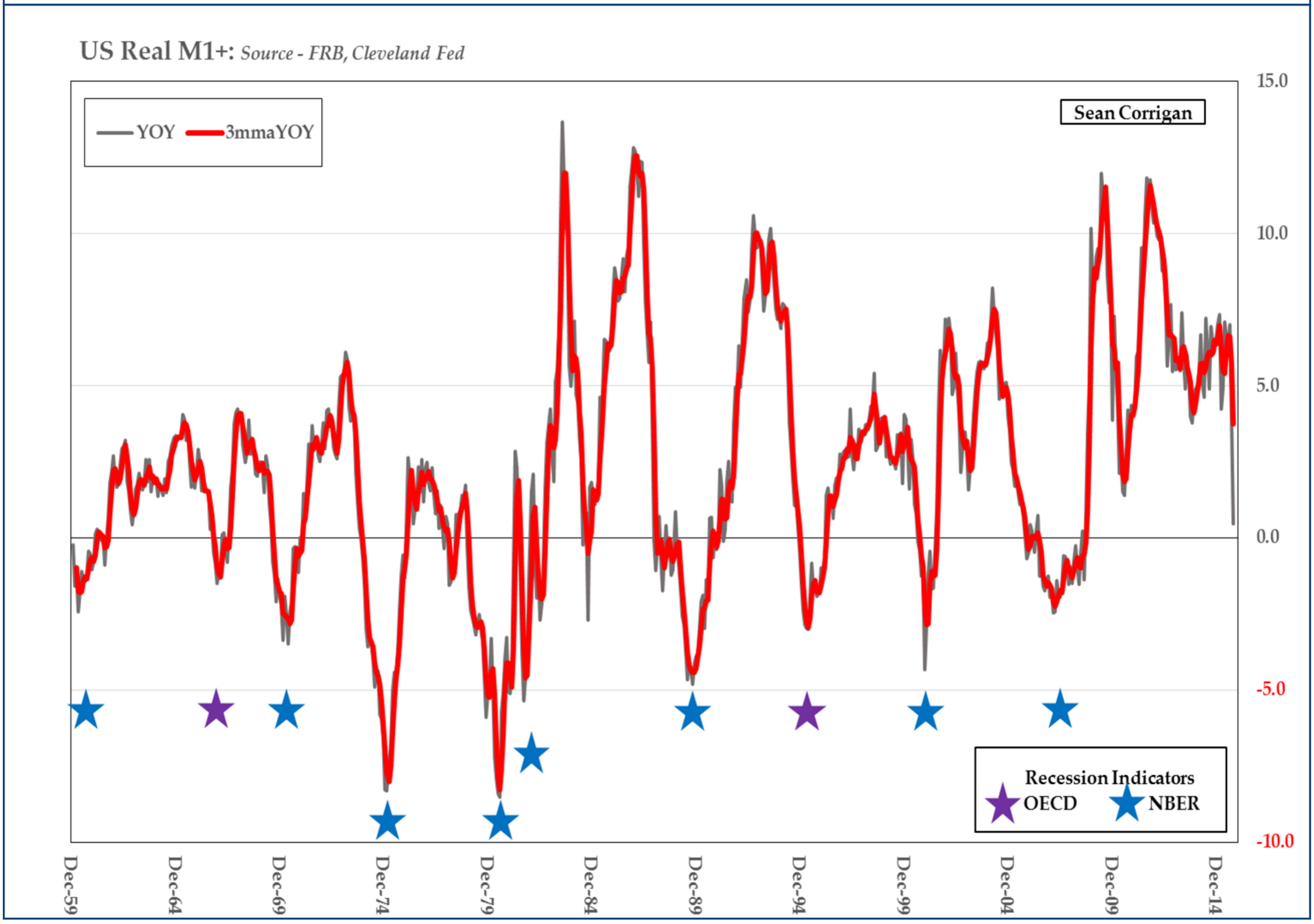



NAPM MFG v REST EMP
Courtesy: Bloomberg
0.0%(13.20)
23.6%(2.2618)
50.0%(-1.117)
61.8%(-4.4958)
85.0%(-11.1389)
100.0%(-15.434)
-11.60


US Inv/Sales ratio
Courtesy: Bloomberg
Hi: 1.5114
+9.27%
1.3197
Low: 1.1993
Log


The main of hope of the no-hike crowd
US IMPI v CPI
No external pressure
Courtesy: Bloomberg
Last Price
IMP1YOY% Index (R1) -10.5
CPI YOY Index (R2) -0.0


US Real M1+ nsa v long-term fitted log trend of 3.1% pa growth, dYOY: Source FRB, BLS
Sean Corrigan
Fed additions had driven money stock to an unprecented surplus over the trend but have recently stalled
Change in Std Residuals
Log Trend
QE programmes begin with LEH-AIG Crash
1.75
1.25
0.75
0.25
-0.25
-0.75
-1.25
-1.75
7.5
7.3
7.1
6.9
6.7
6.5
6.3
Jul-83
Jul-86
Jul-89
Jul-92
Jul-95
Jul-98
Jul-01
Jul-04
Jul-07
Jul-10
Jul-13


US Real M1+: Source - FRB, Cleveland Fed
YOY
3mmaYOY
Sean Corrigan
Recession Indicators
OECD
NBER
15.0
10.0
5.0
0.0
-5.0
-10.0
Dec-59
Dec-64
Dec-69
Dec-74
Dec-79
Dec-84
Dec-89
Dec-94
Dec-99
Dec-04
Dec-09
Dec-14

# IL MILIONE: Tales from Cathay

Since the good and great have returned from their 18th Plenum, the Chinese newswires have been filled with their bold pronouncements regarding the way forward in the 13th 5-year Plan. Naturally the aspirations centre around a clean, green, high-tech future which is as wondrous to behold in the mind's eye as it might be difficult to attain out in the grimy, lachrymatory smog-filled streets of the ailing, old industrial heartland.

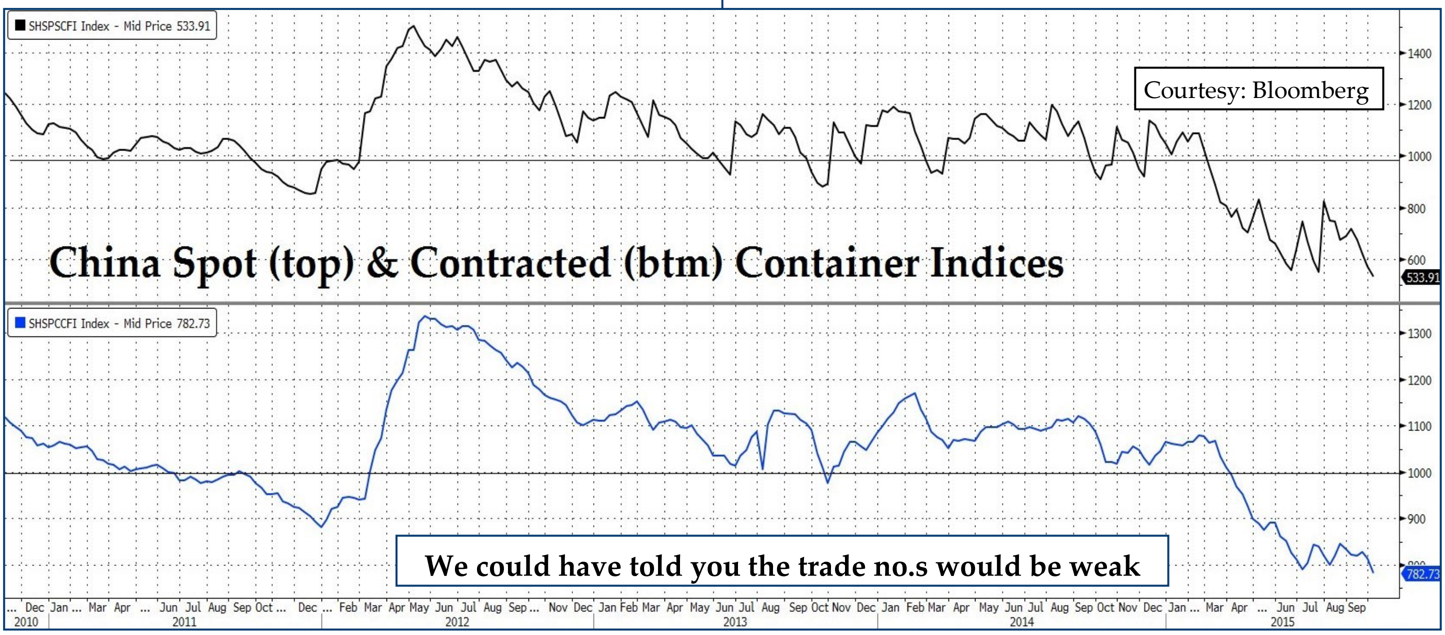
But amid all the heady rhetoric, it is also clear that the men at the top are becoming increasingly concerned at the degree to which the ebb tide of the Chinese slowdown has begun not only to leave many large vessels stranded on the mud banks, but to reveal just how parlous is the condition of much of the slipways, wharves and embankments which populate the shoreline.

Last week, this prompted the Finance Minister Zhu Guangyao to muse openly about further fiscal relaxation by pointing out that the so-called international norms of a 3% deficit and a 60% debt level were not exactly 'scientific' in nature. In truth being little more than the product for the crude arithmetic that if the EU could expect long-term nominal growth of 5%, a 3% deficit on a 60% debt stock would simply maintain that initial level of indebtedness. Theoretically therefore a China which everyone in authority tells us will grow at a real 6.5% indefinitely and where prices are presumably to rise by around the magic 1% a year, such a combined 7.5% per annum increase would seem to allow a little leeway on both accounts.

Sadly no-one in Europe ever bothered much about adhering to the numbers, even when that might have been possible. With the explosion in debt levels, the nagging persistence of wide deficits, and the NGDP level limping up at barely half that clip (and that from a point currently some 20% below the point to which the 1998-08 trend would have been extrapolated), we can see just how 'unscientific' this particular fiscal rule really was.

In China's case, however, one should not be too keen to abandon all pretence at restraint. The numbers which give Minister Zhu so much comfort after all do not allow for the obligations of the lower tiers of government, much less for all the TBTF industrial giants which line the nation's commanding heights. For all that, needs must when the devil drives, and Premier Li certainly gave hints that such a shift of emphasis might be expected when he emerged from a meeting of the Central Working Party Leading Group – prominently chaired by Xi himself – to promise (as *China Daily* put it) *'full use of the fiscal weapons'*.

Worryingly, the central bank also released a statement of intent in which the dreaded phrase *'aggregate demand'* intruded. As before, the Bank set itself the task of continuing *'to implement prudent monetary policy, maintaining consistency, and fine-tuning in a timely manner'* while going somewhat alarmingly on to assume responsibility *for 'preventing the… decline in aggregate demand during the process of restructuring'*



# IL MILIONE: Tales from Cathay *(continued)*

Before we could get too fired up about a return to the bad, old days of 2009/10 – or to the implementation of Draghinomics in China, too - it quickly became clear that the Bank's attitude was a little more nuanced. Such actions could only take place to the extent they did not add yet more 'water' to the system - local parlance for fostering more fruitless churning and asset-bubbling.

Furthermore, in a research note which discussed the impact on debt levels of real interest rates, not only were the authors wise enough to recognise that since relative prices are always in flux, different sectors experience different 'real' rates but they argued that not even more specific measures should be taken as the sole determinant of policy.

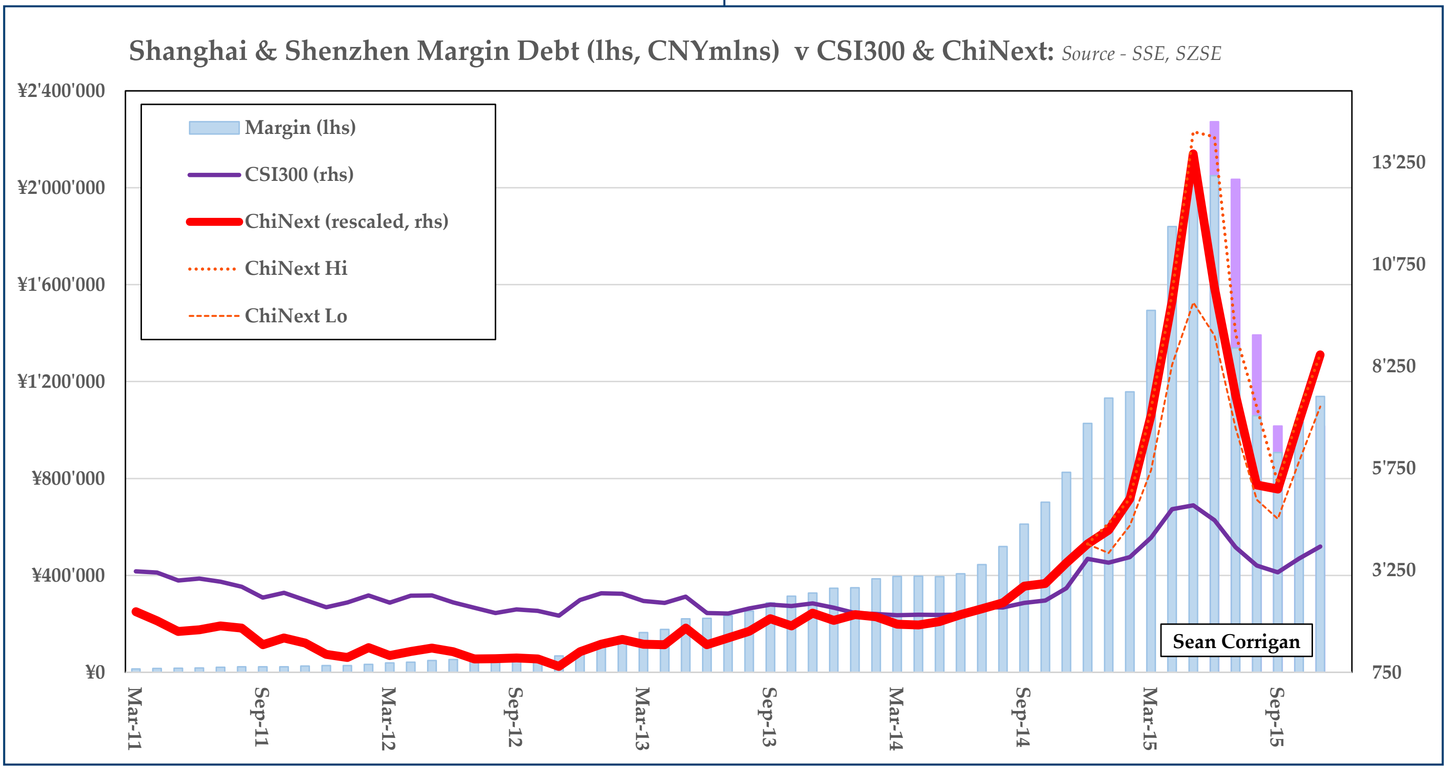
The first thing they pointed out was that a good deal of the fall in PPI – the worst offender in the deflationary police line-up – could be put down to the reversal of partly speculative rises in imported commodity prices and so had little import for domestic monetary policy (*er-hem*, Snr Constancio). More profoundly, it was explained that the whole issue of lowering the *nominal* rates directly under the Bank's control in order to prevent a rise in the *real* ones which are not was predicated upon the assumption that exactly such *'effective demand'* issues - as mentioned elsewhere - were at play rather than the more likely, post-Boom adjustments to overcapacity and what the writers called *'structural contradictions'*. A combination that we broadly-approving Austrians might term *'plan incoherence'* and *'malinvestment'* instead, the PBoC's finest implicitly denied that loose money had any role in the rectification of such dislocations in the productive structure.

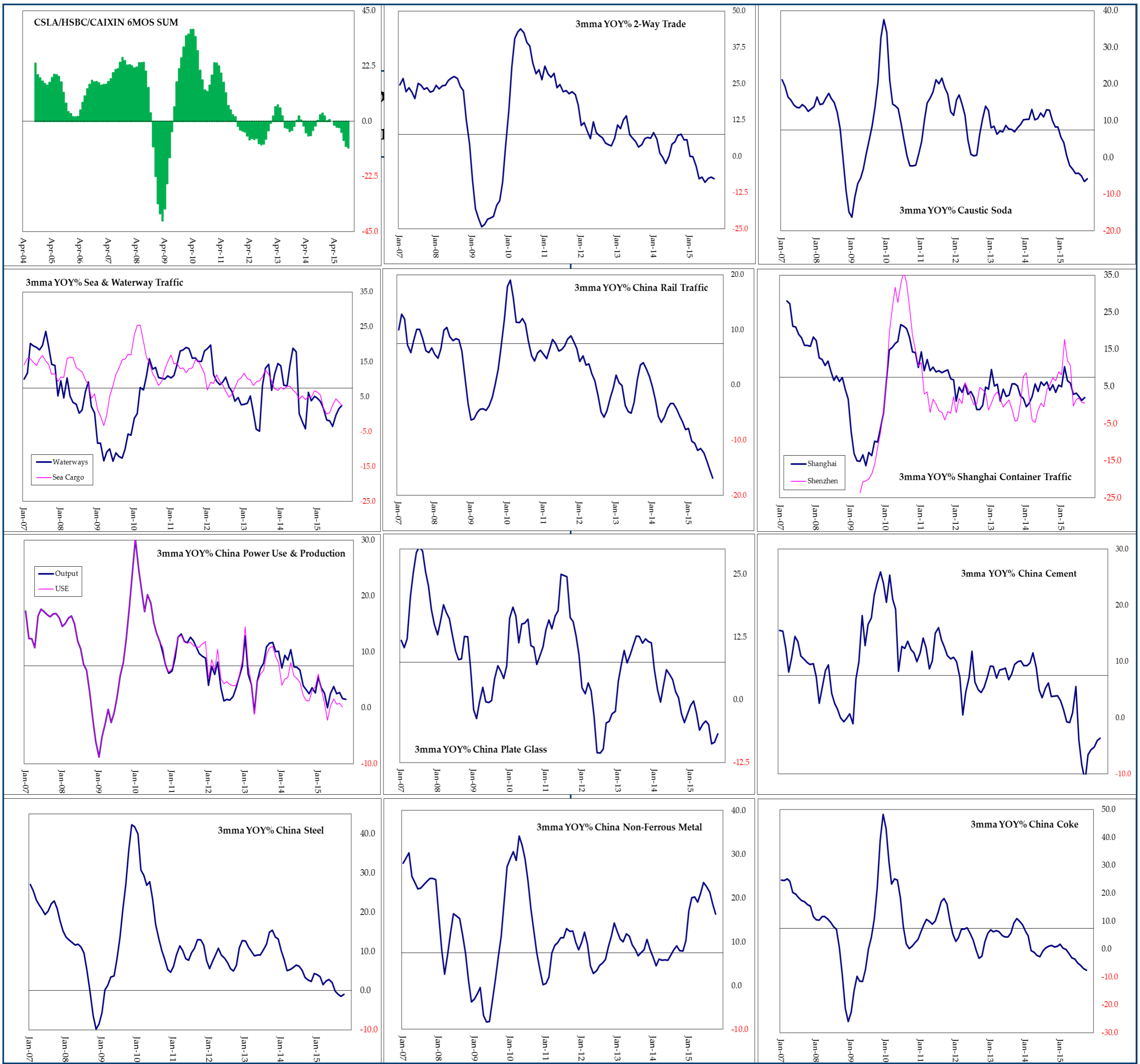
Having run through an outline of the vicious-spiral, debt deflation ideas of that failed Roaring Twenties stock plunger, Irving Fisher – ideas which lie at the heart of most of the misplaced policy plaguing the wider world today – the authors' verdict was frankly dismissive.

*'Although large-scale stimulus can give short term help in filling the demand gap and so keep the prices stable, the investments in question will soon expand their production and increase supply, so risking yet more serious overcapacity and debt accumulation, ultimately resulting in a greater downward pressure on prices.'*

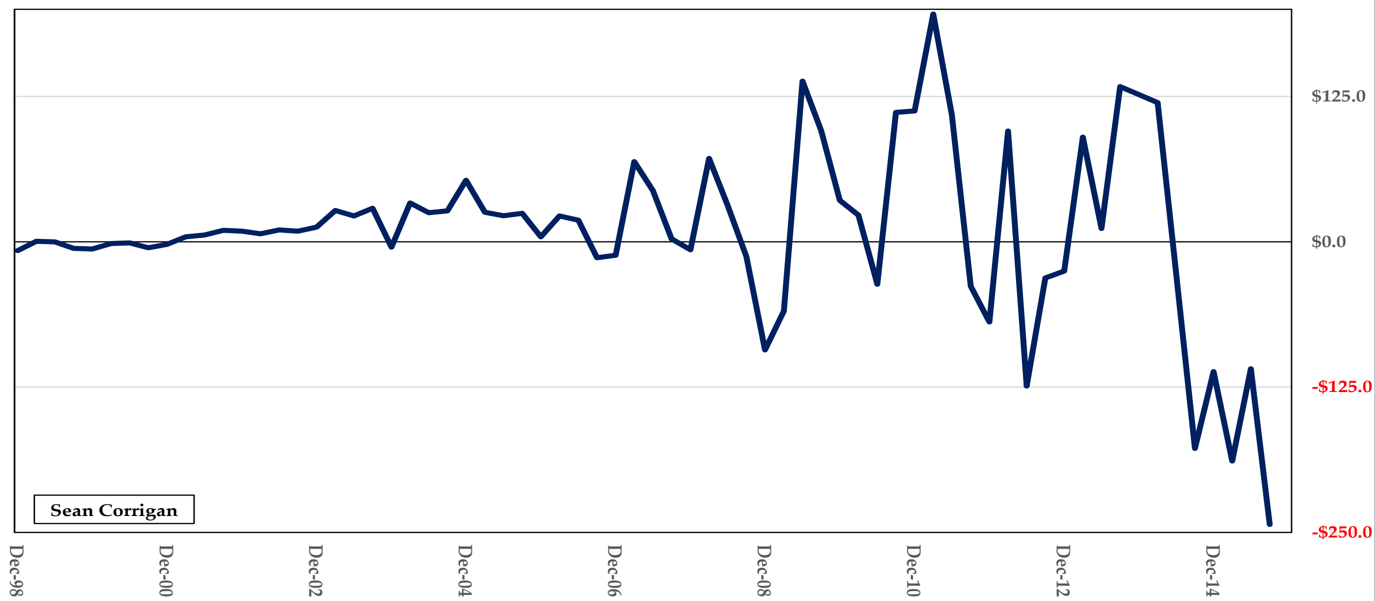
Whether this justifiable scepticism translates into practice is another matter, given political sensitivities which the current spate of high profile arrests and spreading 'inspections' might indicate are becoming all too elevated.

As a *Shanghai Securities News* investigation revealed, the people who have taken out $1.5 billion a day in new margin loans so far this quarter pushing the Shanghai Comp up 25% and the ChiNext 55% from their late summer lows do not seem to be paying much attention to the fundamentals.






Chinese Current Account less Accumulation of Forex reserves, blns: Source - Bloomberg



According to the reporters, barely a half of the 2,800 listed companies reporting QIII results had increased profits from a year ago, with a third suffering declines and a sixth outright losses. HI'15 combined profit growth of 8.7%YOY had slumped to a nine-monthly comp of just 1.5% on stagnant revenues. Worse, if financials and the two big oil majors were stripped out, the residuum posted a fall of 14.3% after first semester gains of 6.4% - a pretty sharp deterioration by any reckoning and one possibly related to the evaporation of the all-too ephemeral gains emanating from the stock bubble.

The October macro data round has brought little cheer either with 3-month annualized industrial production up a bare 5.6% by volume terms, something which was not enough to offset either the 6.2% annualized overall price fall or the 7.3% purchasing price drop which simultaneously took place. Similarly, the past three month's private fixed investment came in at no more than 8.2% ahead of the like total for 2014 – a pale echo of its former glories. Completing a gloomy 1-2-3, electricity generation for the past three months has been no more than 1.5% ahead of that for the same stretch last year, the weakest showing outside a Lunar New Year period in over three years.

One can only hope that a good portion of this was due to the hiatus associated with the WWII commemoration in early September and that subsequent months will see better levels of activity restored

Given all the above - as well as reports that the autumn Canton Export Fair suffered a 7.4% drop in orders and that the ongoing mutual guarantee credit crisis has now jumped from steel to coal companies – it is obvious that the birth pangs of the New Normal continue. What was more discouraging was to read comments by Professor Zeng Xiangquan, director of the China Institute for Employment Research, that the rot may already be prematurely affecting the sunrise sectors, too.

Quoting the latest employment index released by China International Intellectech Corporation (CIIC), a state-owned human resources group, the good professor noted that, in addition to the SOEs who were expected to bear the brunt of the restructuring, SMEs are also downsizing for the first time since early 2014. Noting that even 'hot' businesses such as high-tech industry, bio-medicine, education, and media have stopped recruiting and are, indeed, beginning to fire employees, Zeng complained that the *'official unemployment records from the National Bureau of Statistics have failed to sensitively interpret the reality, which the country should be fully aware of and prepare for'*.

Summing it up best of all, however, was surely the gallows-humour comment from what *21st Century News* would understandably only identify as *'an official from a prefecture level city in the East'*. This good soul responded to a journalist's enquiry into how his area was doing with the wry rejoinder that: *'the only smoke you can see now is that coming from the chimney of the local crematorium.'*

That 6.53% (sic) per annum seems a mighty long way off at present.

Normally, we would expect the final quarter to be one of a narrowing me-tooism—a period when those not already demonstrably committed to whatever happens to be identified as *the* winning trade of the year rush to get on board before book closing so they don't look too stupid in the eyes of their investors come annual report writing time.

With those already in the trade having little incentive to sell out of it—and with no-one having the appetite to take any other major risks—things typically start to peter out from the end of October onwards. Budgets made or damage being limited, thoughts take on a less urgent complexion as the nights draw in.

This year, however, a market increasingly in thrall to a population of central bankers becoming more hubristic and unrestrained (some might say megalomaniac) by the day, may have to keep the Bloomberg screen fired up and the lunch invitations unfulfilled a little while longer than its members might wish. For one, we have Draghi out doing everything he can either to pre-empt the decision to institute a further bout of easing in December, or else to drive both the euro and bond yields so low before it convenes that the policy will already effectively have been implemented before the gavel descends to call the Council to order.

On the other side of the Atlantic, despite having taken some pains in these pages to point out that there are growing signs of strain in a previously solid US recovery, we have to be ready for the Fed to move a hairsbreadth or two away from its emergency settings at long last

With a reasonably strong consumer sector to mask the upper order travails and only one more jobs report to negotiate, it is easy to envisage the meeting taking place in an atmosphere conducive to the dominance of a different set of considerations. By this we mean that December might bring a brief window during which conditions would allow the Fed to briefly set aside its 'uncertainty' paranoia and so enjoy a remission of that creeping paralysis which results from its profound horror of making a mistake, however honest, and being publicly mocked by the Krugmans of this world for its pains

At that point, the Fed might find that the next most pressing of what are frankly egotistical imperatives is not to suffer the scorn of those on the *other* side of the debate; those who feel its constant procrastination is costing the bank its 'credibility' - the most precious coin of those whose job admits of no more objective measure of their contribution to a project's success, but who nevertheless crave the psychological reward of being taken seriously by the world at large

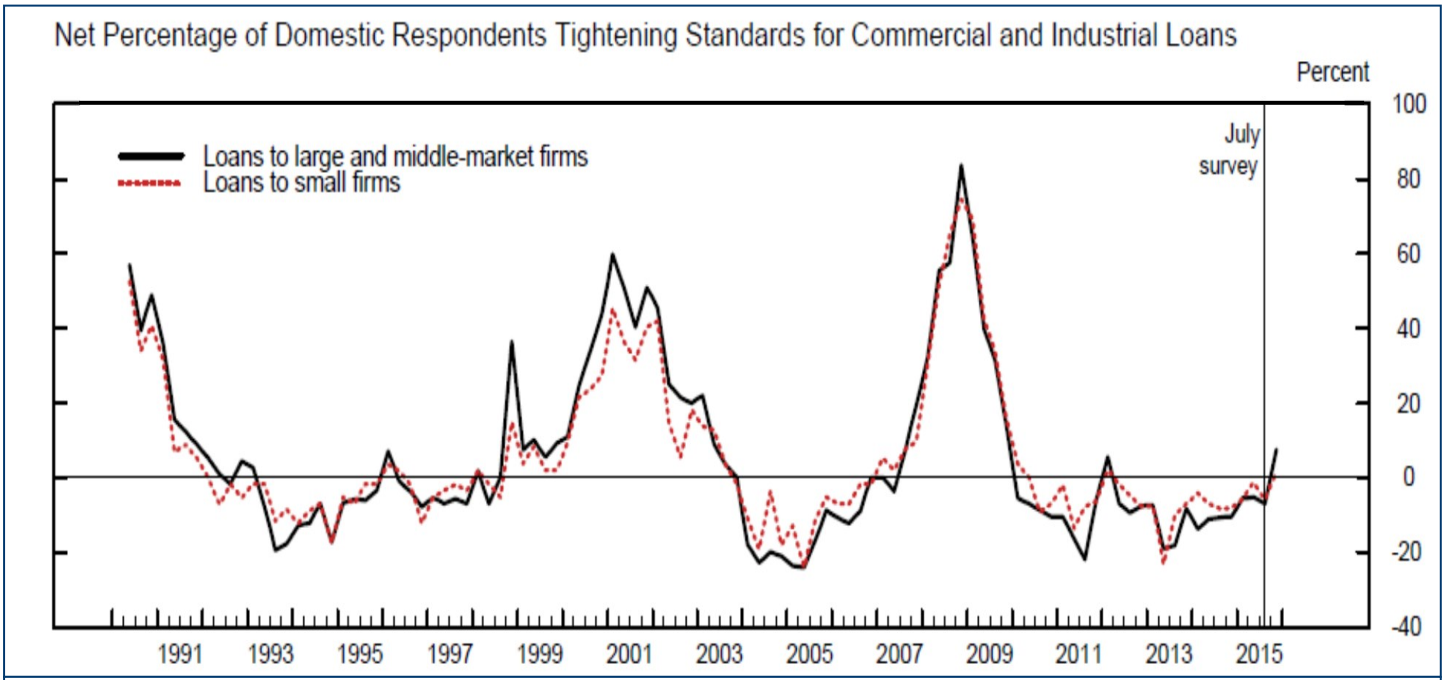
Further confounding market participants' hopes of spending the run-up to Christmas in a haze of light duties and heavy festivity, we are all also on guard for signs that a Chinese regime about which there hangs a faint miasma of desperation might also strike (no doubt over a weekend!) and unveil some sweeping set of new initiatives before the enforced quietude of the Lunar New Year exerts its characteristically deadening effect on all such novel departures a few months hence.

The one irony this year is that for several long months markets have been trapped in a range in a manner which few had really expected. Until recently, commodities had been mostly sideways to better since the summer; the euro was grinding upwards; the dollar itself had gone nowhere (at least against the majors) for eight long months. And if the Chinese devaluation triggered an attack of the vapours as the high, green days of summer turned, golden and russet, into autumn, even *that* excitement had largely dissipated, leaving several handy retracements of the falls suffered in equites, junk, and emerging markets to occur instead.

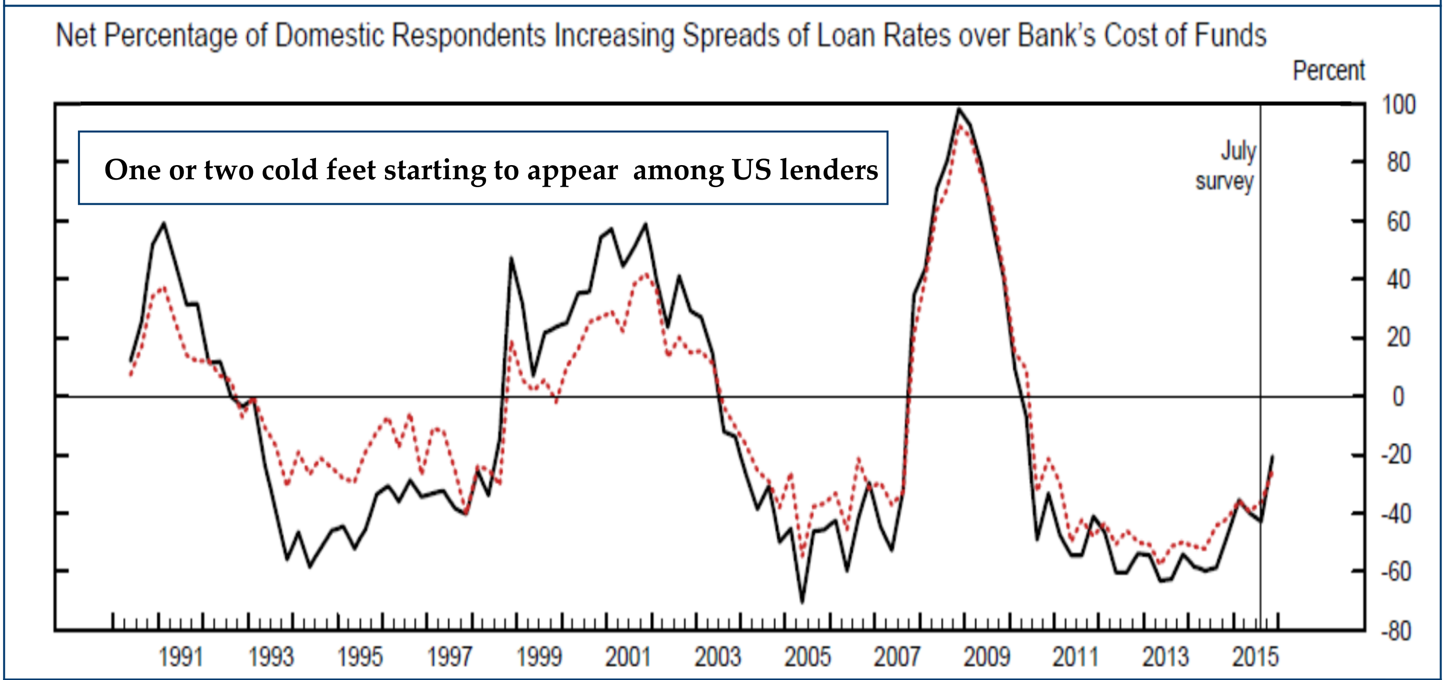
November has certainly not started in like fashion and it is not hard to see this bout of renewed turbulence from intensifying like a late-season hurricane.

If the dollar can build on its breakout up from its range; if commodities plough on through the lower end of theirs, it would be a racing certainty that peripheral markets everywhere would catch the bug and not such an outside bet that the rot spreads thence to the Big Boys, too.

All in all, it could just end up giving a whole new meaning to the phrase, 'Black Friday'.

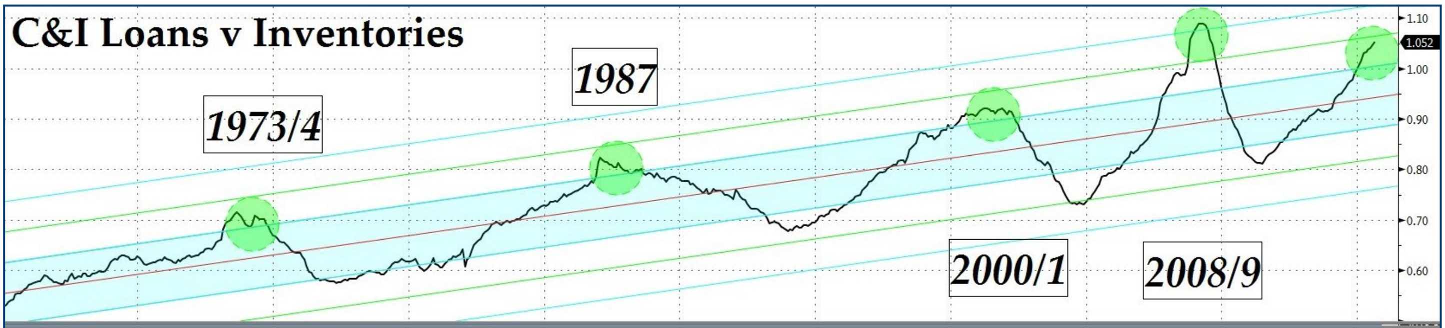


Net Percentage of Domestic Respondents Tightening Standards for Commercial and Industrial Loans
Percent
Loans to large and middle-market firms
Loans to small firms
July survey
100
80
60
40
20
0
-20
-40
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015

Net Percentage of Domestic Respondents Increasing Spreads of Loan Rates over Bank's Cost of Funds
Percent
One or two cold feet starting to appear among US lenders
July survey
100
80
60
40
20
0
-20
-40
-60
-80
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015

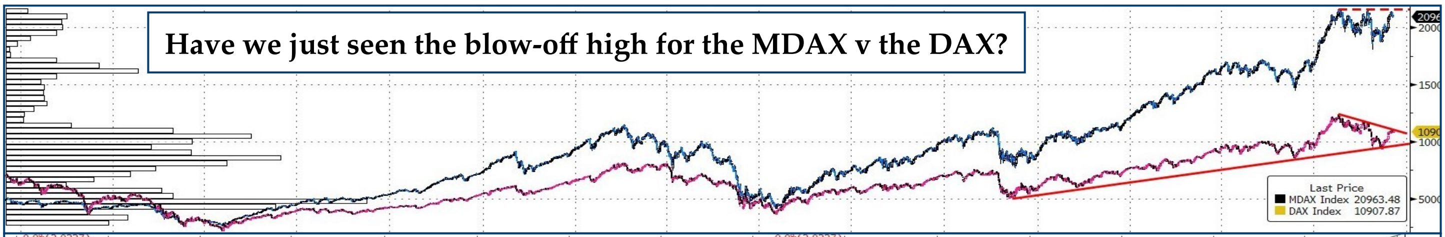

Moody's BAA-AAA
Not yet a crisis but maybe a recession?
Courtesy: Bloomberg
Hi: 3.468
Low: 0.31
1.378
3.50
3.00
2.50
2.00
1.50
1.00
0.50
1962-1964
1965-1969
1970-1974
1975-1979
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014


C&I Loans v Inventories
1973/4
1987
2000/1
2008/9
1.10
1.052
1.00
0.90
0.80
0.70
0.60


SPX 6mmaYOY%
When loans >> inventories, trouble looms
40
20
2.2166
-20
-40
1965-1969
1970-1974
1975-1979
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2

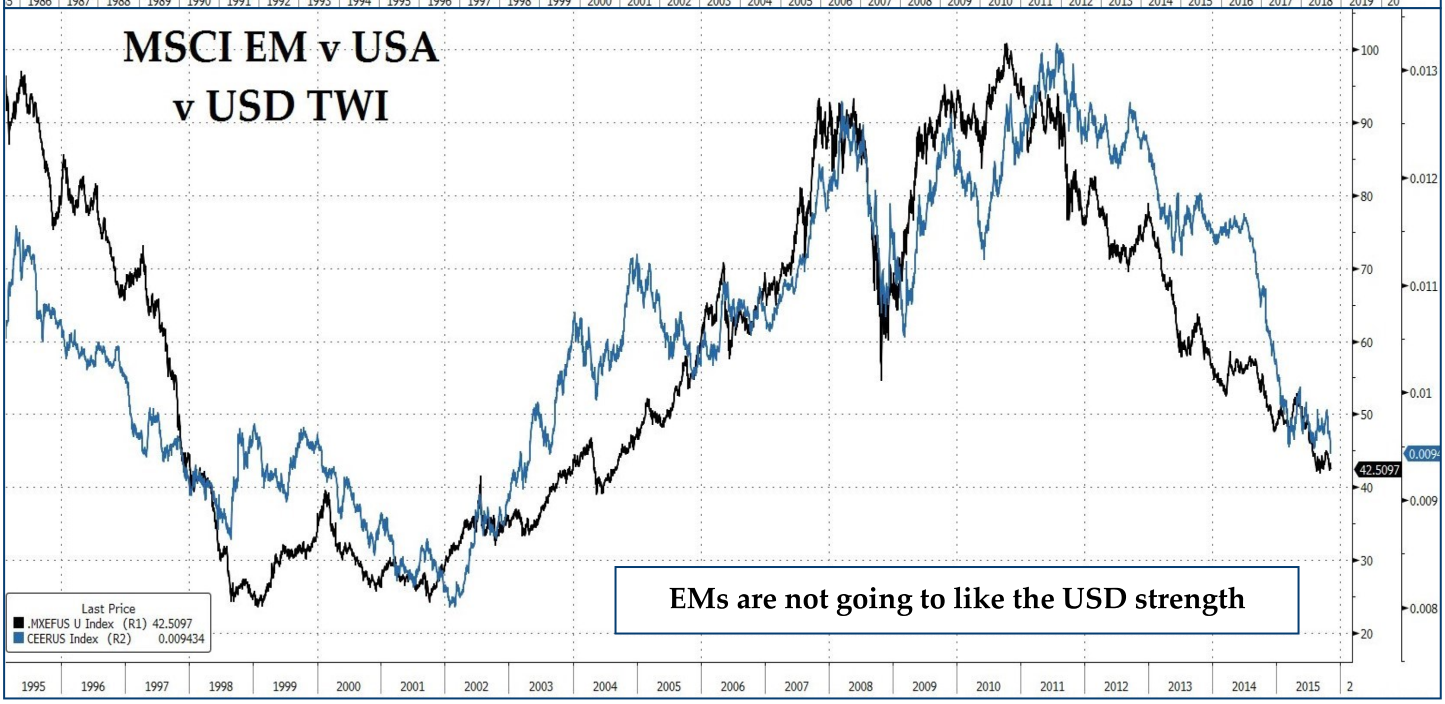

S&P500 Ex-FINL
v Biz Revs
With sales >> stock prices, reversion ahead?
0.0%(204.2971)
15.0%(182.949)
100.0%(61.9782)
200
180
160
140
120
100
80
60
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015

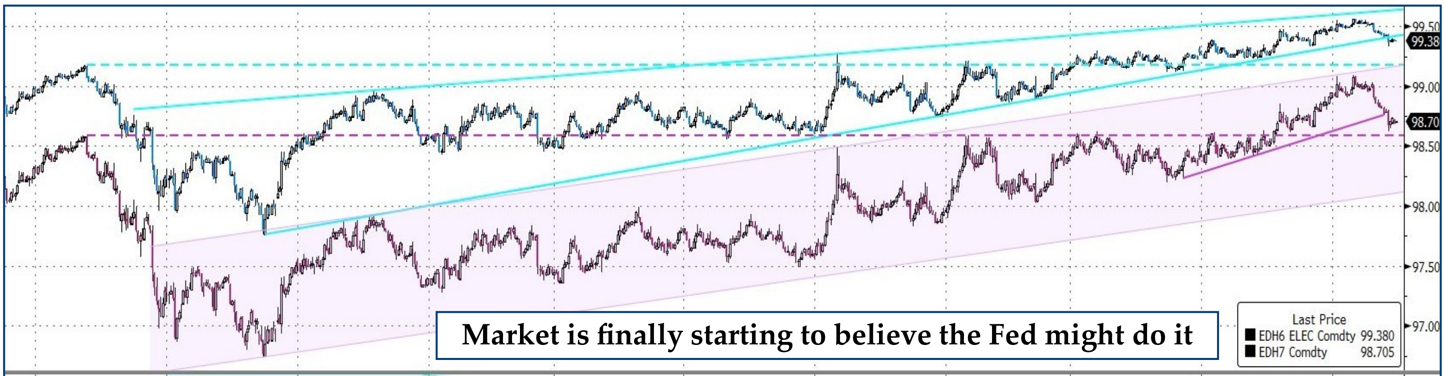

Value Line Index
All Graphs on this page courtesy of Bloomberg
Pretty clear where the fault-line for the QE rally lies
0.0%(4913.08)
15.0%(4324.99)
38.2%(3415.40)
50.0%(2952.77)
61.8%(2490.13)
100.0%(992.45)
-844.46
-844.46
4503.8
5000
4000
3500
3000
2500
2000
1500
1000
2008
2009
2010
2011
2012
2013
2014
2015
2016

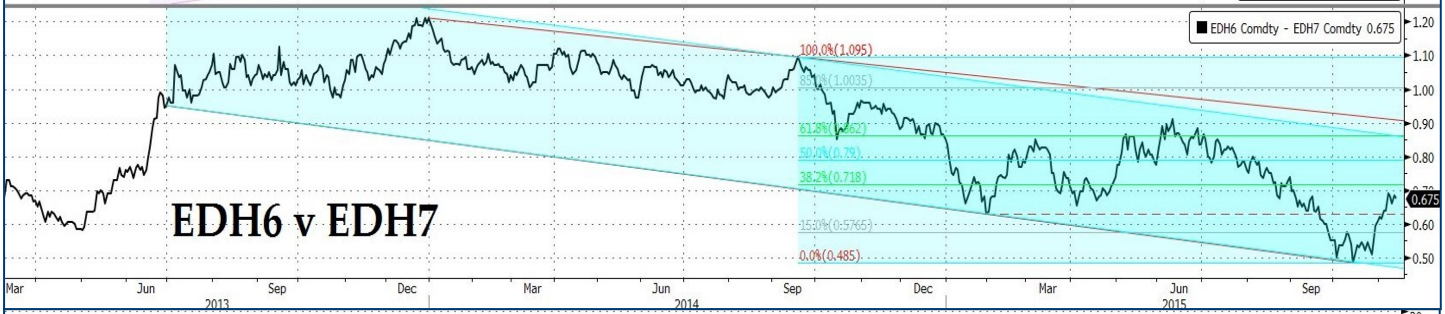

Have we just seen the blow-off high for the MDAX v the DAX?
Last Price
MDAX Index 20963.48
DAX Index 10907.87

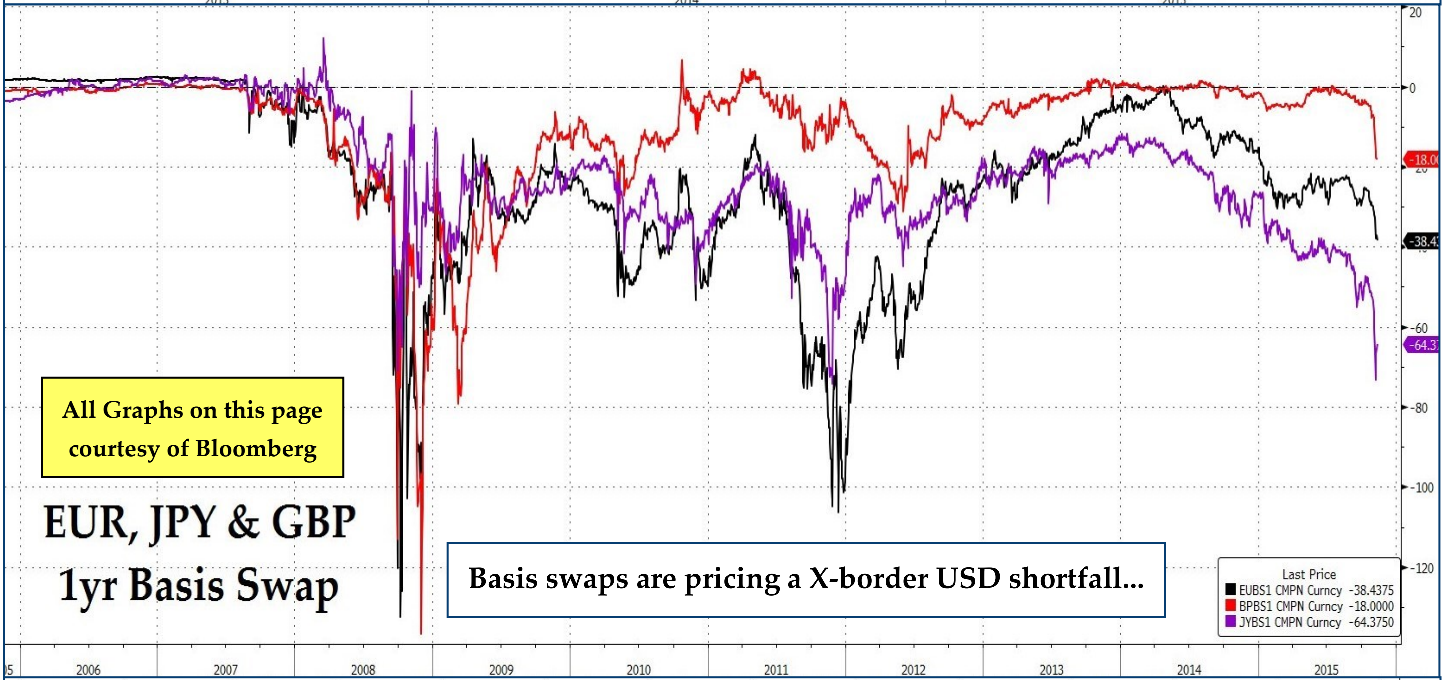

Resistances might mean an absolute peak, too
MDAX/DAX

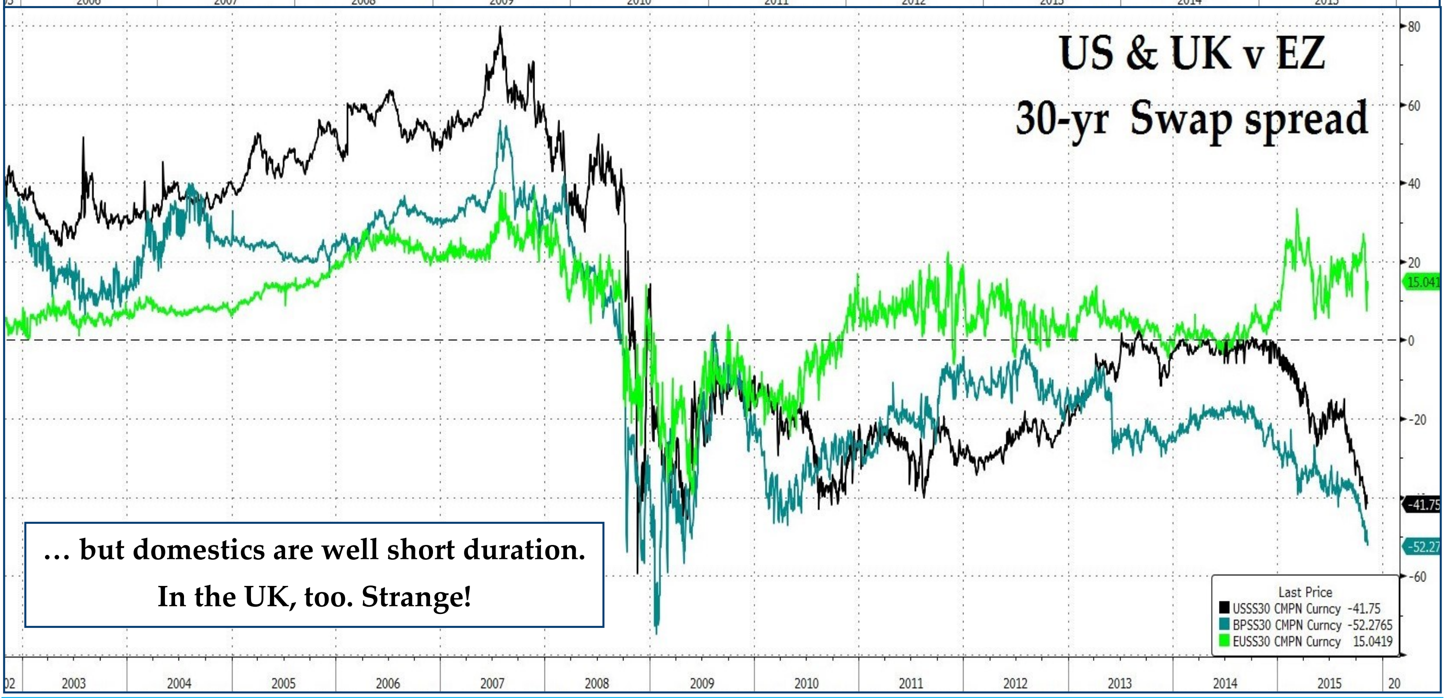

A new push away from the HVP. What a full breakout might signal
Nikkei in USD
All Graphs on this page courtesy of Bloomberg


MSCI EM v USA v USD TWI
Last Price
.MXEFUS U Index (R1) 42.5097
CEERUS Index (R2) 0.009434
EMs are not going to like the USD strength

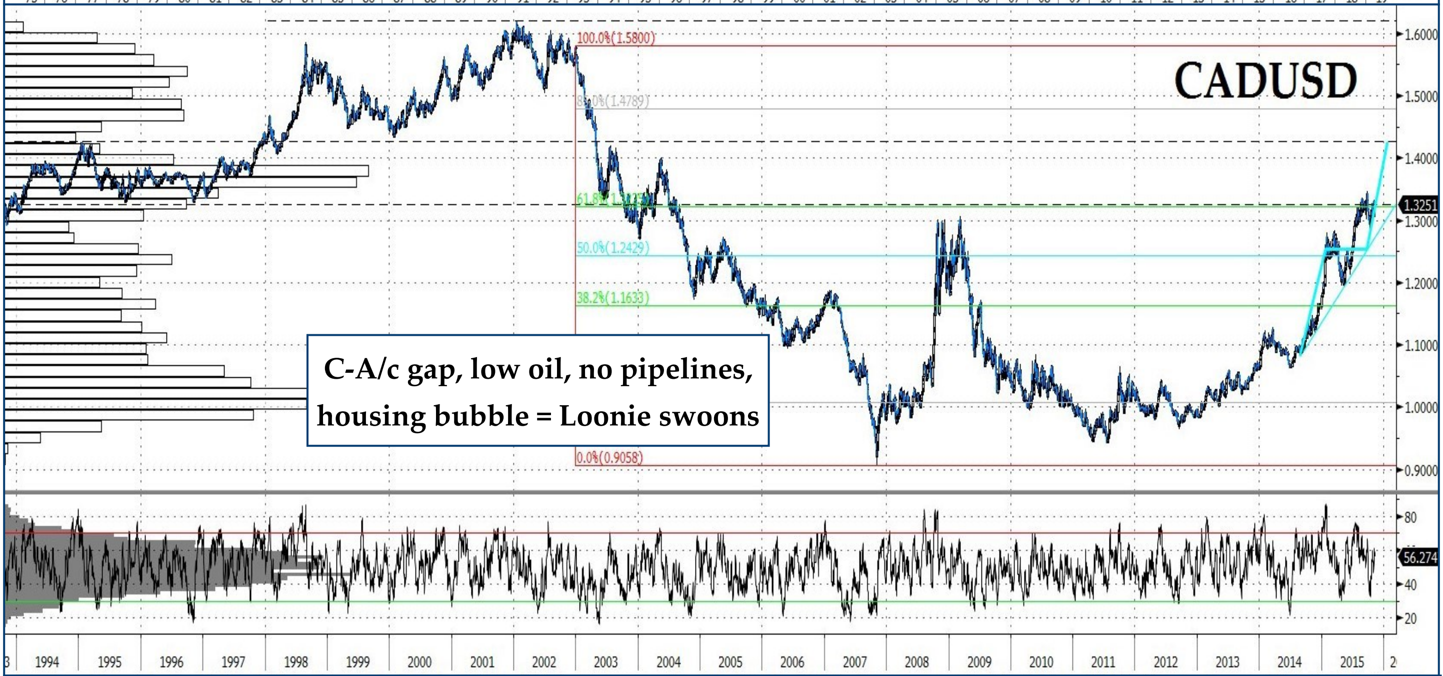

Market is finally starting to believe the Fed might do it
Last Price
EDH6 ELEC Comdty 99.380
EDH7 Comdty 98.705
99.50
99.38
99.00
98.70
98.50
98.00
97.50
97.00


EDH6 v EDH7
EDH6 Comdty - EDH7 Comdty 0.675
100.0%(1.095)
61.8%(0.862)
50.0%(0.79)
38.2%(0.718)
0.0%(0.485)
1.20
1.10
1.00
0.90
0.80
0.675
0.60
0.50
Mar
Jun
2013
Sep
Dec
Mar
Jun
2014
Sep
Dec
Mar
Jun
2015
Sep


All Graphs on this page courtesy of Bloomberg
EUR, JPY & GBP
1yr Basis Swap
Basis swaps are pricing a X-border USD shortfall…
Last Price
EUBS1 CMPN Curncy -38.4375
BPBS1 CMPN Curncy -18.0000
JYBS1 CMPN Curncy -64.3750
20
0
-60
-80
-100
-120
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015


US & UK v EZ
30-yr Swap spread
… but domestics are well short duration.
In the UK, too. Strange!
Last Price
USSS30 CMPN Curncy -41.75
BPSS30 CMPN Curncy -52.2765
EUSS30 CMPN Curncy 15.0419
80
60
40
20
15.041
0
-20
-41.75
-52.27
-60
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015


Sean Corrigan
for Hinde Capital
Finally, the USD has broken out.
Trouble in store if it gathers Mo
USD TWI
+18.24%
Log
106.0000
'75 '76 '77 '78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16 '17 '18 '19


CADUSD
100.0%(1.5800)
61.8%
50.0%(1.2429)
38.2%(1.1633)
0.0%(0.9058)
C-A/c gap, low oil, no pipelines,
housing bubble = Loonie swoons
1.3251
56.274
1994 1995 1996 1997 1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015


OZZIE
0.0%(1.1081)
All Graphs on this page
courtesy of Bloomberg
0.7140
Losing oversold status. 60c still possible
100.0%(0.4822)
2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016


CONT CMDTY INDEX
Nominal reversion and real price declines ahead? GFC lows & 2nd oil shock highs the key
0.0%(691.09)
15.0%(614.85)
38.2%(496.93)
50.0%(436.96)
61.8%(376.99)
100.0%(182.83)
-39.64%
Last Price 387.57
High on 04/29/11 691.09
Average 239.20
Low on 08/30/68 95.20
387.5
700
600
500
400
300
200
100
1956-1959
1960-1964
1965-1969
1970-1974
1975-1979
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019


CCI x USD TWI
0.0%(646.9706)
15.0%(594.9331)
38.2%(514.4484)
50.0%(473.5123)
100.0%(300.0539)
465.49
600
500
400
300
200
1965-1969
1970-1974
1975-1979
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014


CCI v MFG Wages
All Graphs on this page courtesy of Bloomberg
100.0%(61.0582)
61.8%(42.5002)
50.0%(36.7677)
38.2%(31.0351)
-45.02% (-1.52%ann.)
15.0%(19.7643)
0.0%(12.4772)
0.0%(36.3048)
15.0%(32.7188)
38.2%(27.1723)
50.0%(24.3513)
61.8%(21.5303)
100.0%(12.3978)
60
50
40
30
1956-1959
1960-1964
1965-1969
1970-1974
1975-1979
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014


Crude x USD TWI
The Fat Lady's still in the Green Room


Crude x USD TWI
All Graphs on this page courtesy of Bloomberg
A new low from here could be chaotic


GOLD x USDTWI
Neither NIRP nor Chinese buying giving much help


CMD x NRG ER
The carnage has been widespread


CMDxNRG ER
x USDTWI

## Disclaimer

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