



It's one louder, innit?

Not only is he a man who does not seem to understand how banks actually, not only is he dominated with the *idée fixe* of his blessed inflation mandate instead of paying more regard to what his institution should — and more importantly — should *not* do as a contribution to the material well-being of those under its sway, but dear old Mario is clearly no kind of a psychologist, into the bargain.

Thus it was that, having been careful to have prepared the markets for action (the better to present any doubters among his colleagues with an irreversible *fait accompli*), yet clever enough also not to excite them this time to a state of unassuageable frenzy, he brought out ALL the big guns — an intensification of NIRP; more, longer-term, zero-cost monies; a wider range and a greater amount of securities to be bought; a whiff of 'forward guidance'; a clone of the BOE's 'funding for lending' scheme with the added kicker that good little banks will actually be *paid* up to 40bps to lend — all this to an initially rapturous reception.

Twitter lit up with Oohs! and Aaahs!, the euro fell 170bps to a six-week low. Bunds jumped 2 1/2 handles, the DAX shot 250 points skyward to touch its best in 8 weeks. The sweet aroma of triumph pervaded the air!

But then our man snatched defeat from the jaws of the victory in spectacular fashion. Somewhere along the line he gave the impression that this package was so comprehensive it would be the last announced for some good while to come. The first signs of petulance were not long in coming after this relatively innocuous admission of the

fact that even on the ECB's amp, the dial doesn't go beyond eleven.

But that was only a foretaste, for next the ECB scored a spectacular own goal by downgrading its own growth and CPI forecasts for the coming year — implicitly telling markets, '*What we did last time didn't work, nor will what we do this time*'.

Given that no-one sane attaches any weight to their vaticinations (except in a tail-chasing dog sort of way with regard to what's on the policy menu), could they not have fudged the numbers — you know, undertaken a little econometrics with Chinese characteristics — in order to paint a brighter, more confident picture? After all, the entire multi-trillion economic *gavage* they are undertaking is supposedly aimed at making a very unbroody golden goose *expect* to lay more eggs in the near future, so why deter said tight-bottomed fowl by a declamation of their decidedly downbeat, DSGE divinations?

Nemesis' arrival was swift. The euro bounced and soared 4 big figures, the Bund lost 570 pips (!) *in einem Augenblick*, and the DAX slid no less than 500 points deep into the abyss from its brief, intraday zenith. Cue a barrage of equally inane comments from the Veruca Salt clones we marketeers have all become, the gist of which was that, based solely on the evidence of a four-hour, '*I want another pony*' tantrum of buying rumours and selling facts, all Mario's bold hopes for the next five years of his programme had failed!

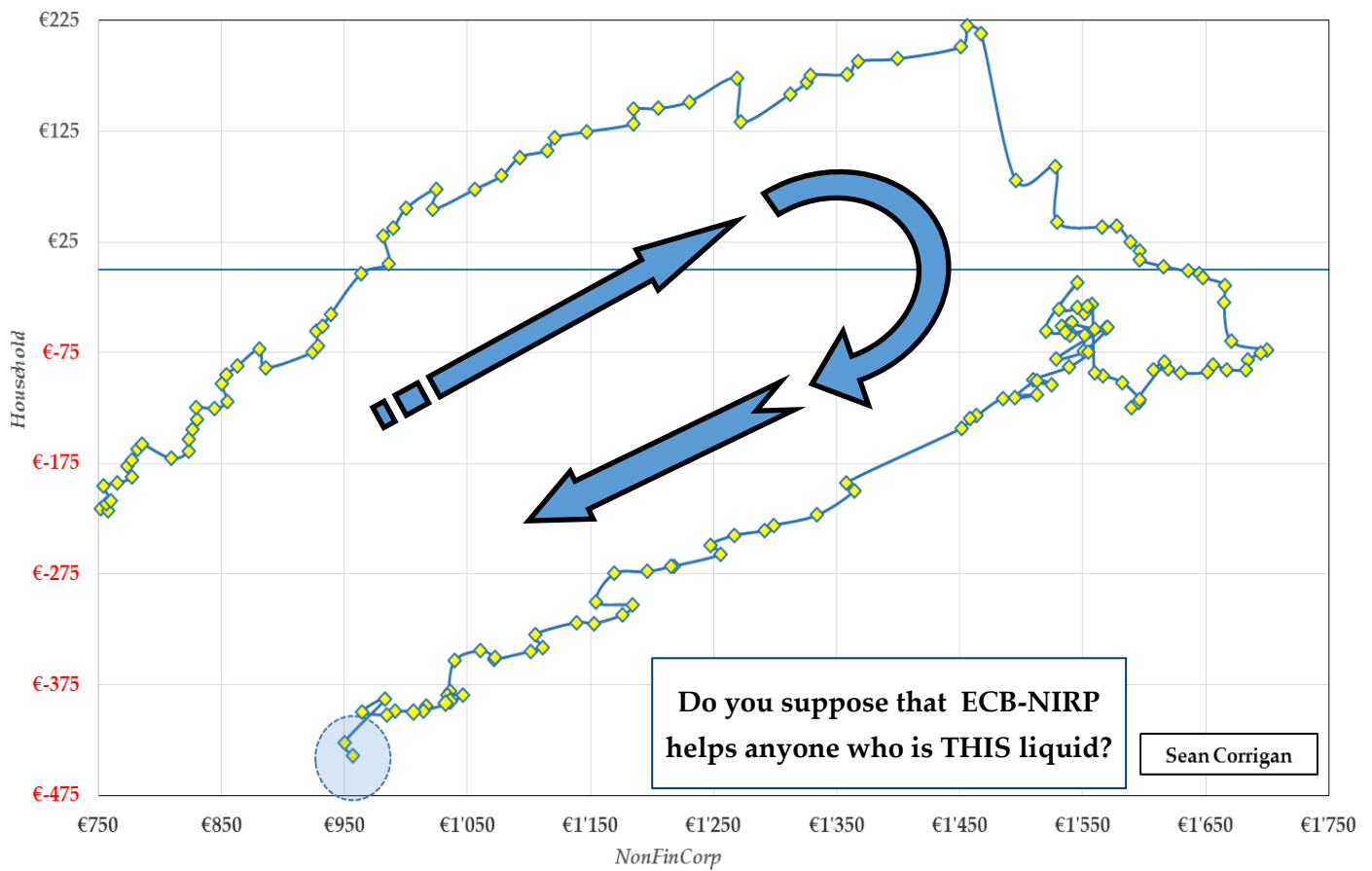
No greater testimony to the pernicious influence of our hyperactive central bankers can be had than this. Draghi takes his share of the blame for the opprobrium heaped upon him, too, for declaring bluntly that one reason for this latest, most radical intervention was that: '*financial conditions have changed considerably in this period of time, and there has been a widespread volatility of high intensity for a reasonably long period of time at that intensity. And that has caused, by itself, a tightening of financial conditions.*'

Since we all know that 'volatility' is a euphemism for 'sell-off', this says nothing other than '*we eased because markets sold off*' — and that, dear reader is the sort of casual moral hazard which makes spoiled, impatient children of us all.

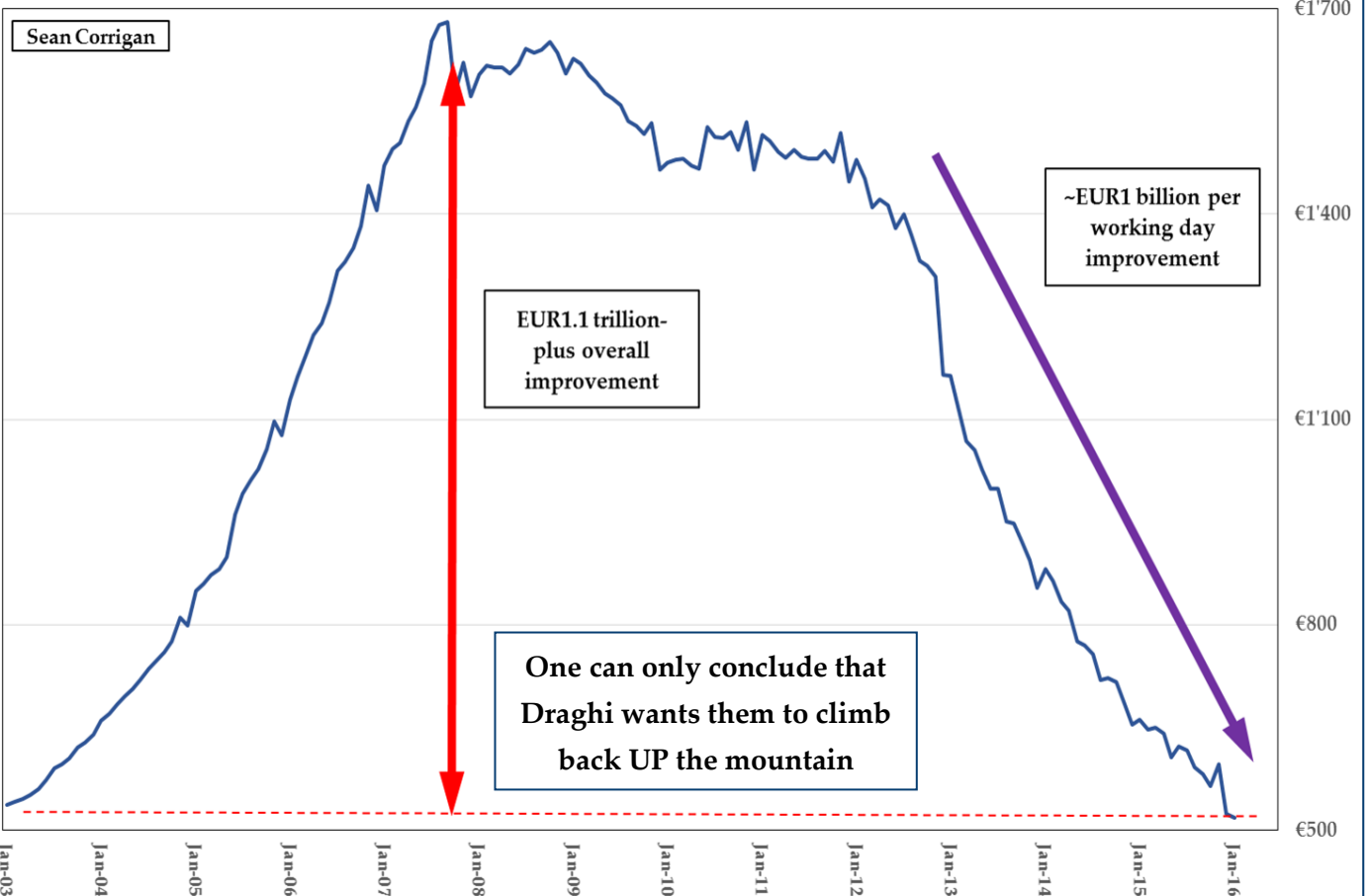
Sean Corrigan

2003-2015 PIIS Non-Fin Corporate & Household Net Debt [Bank Loans - Deposits], blns

Source - ECB



PIIS Private Non-Financial Net Debt [Bank loans - Deposits], blns: Source - ECB



One man who will not be impressed by what his successors have wrought—though he will be ever too much the gentleman to say so explicitly—is Otmar Issing.

To read the interview he recently gave to *Handelsblatt* is not only to drink a deep refreshing draught of from the wellspring of clear-headedness but to wrinkle one's nostrils at the faint hint of frustration which must be galling such a giant who sees his life's work being ruined by the pygmies who have followed him.

While arguing that the infernal 2% inflation target which has been transmuted from a signal of justifiable restraint into Draghi's licence to engage in almost unimaginable acts of monetary violence should not be wholly abandoned just yet, nor was it *'chiselled in stone'* and that *'more patience'* was needed in the attempt to reach it.

Issing allowed that a rapid, self-reinforcing, deflationary spiral such as experienced in the 1930s was the *'most dangerous'* development imaginable (perhaps his memory was selectively excluding the 20th century's two hyperinflations here), but he also emphasized that this was perhaps the ONLY such episode known to Man.

Taking up the argument that *'hard cases make bad law'*, he concluded his comments here with the ironical observation that a fear of death can itself be suicidal and went on to note that, even in Japan—that other poster-child of the helicopter money crowd—people have NOT desisted from spending, nor had their real, per capita income shrunk (a point your author often equally belabours).

So confident was he that we were not at risk of repeating the errors of the Brüning regime—he said he could see no such signs if one used a magnifying glass to overcome the *'blindness'* on this issue of which he was often accused—he insisted (rightly in my view) that an undershoot of the kind recently experienced was accompanied by fewer aggravating factors than was a similar degree of overshoot.

Contrast this with Draghi's somewhat hysterical response at this week's press conference when he protested:

'Suppose we had not acted at all. Suppose we had embraced what two years ago I used to call the "nein zu Allem" policy strategy, to do nothing. What would be the counterfactual? Of course we deem that the counterfactual would have been a disastrous deflation.'

In a display of further opposition to Issing's position the ECB head advanced another curious argument as he dealt

with a different questioner: one which in fact made a mockery of his fanatical devotion to the 2% 'mandate'.

This, he said *'...is defined as reaching an inflation rate which is close to 2% but below 2% in the medium term. Which means that we'll have to define the medium term in a way that, if the inflation rate were for a long time below 2%, it will [have to] be above 2% for some time. The key point is that the Governing Council is symmetric in the definition of the objective of price stability over the medium term.'* [our emphases]

What we hear see is the ever-arch Italian slyly trying to impress people that he sees every month of sub-target CPI—a period which already stretches out to three years—as a kind of 'reserve' with which to justify a similarly protracted spell of price rises in excess of the masonry-engraved 2%.

No doubt he will be smugly self-satisfied at such a construction being put on his words, since he will no doubt view this as a further aid to the raising of exactly those inflationary 'expectations' which he and the rest of the MIT-Keynesian cross-breeds hold to be entirely self-fulfilling.

The good Herr Doktor Issing will no doubt take a very different view of the matter.

Nor would he be alone in this: as one might imagine the German press was fairly universal in its condemnation of the new programme.

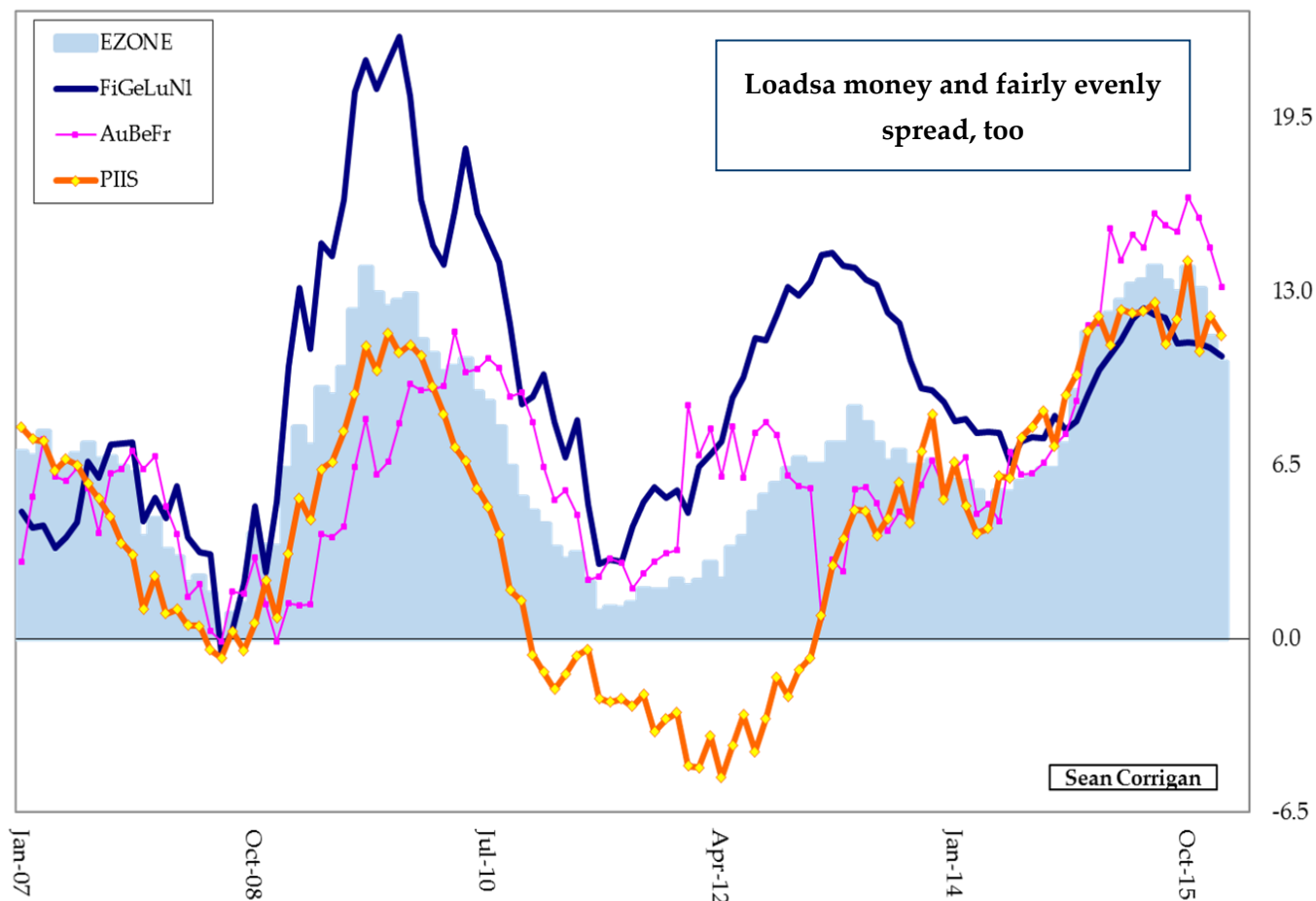
Citing unnamed central bankers, the newspaper relayed their dismay that Draghi's *'activism'* was the result of his being fixated on reaching the sacred 2% *'in the shortest possible time, using brute force to do it.'* Another snorted that he was not some unbridled miracle-worker but one who had become indifferent to the means he chose to achieve his goal.

As one might imagine, IfO Chief Hans-Werner Sinn also took a dim view of events, thundering in his best Old Testament manner that the changes represented *'the greatest transfer of wealth seen in Europe in the post-war era'*.

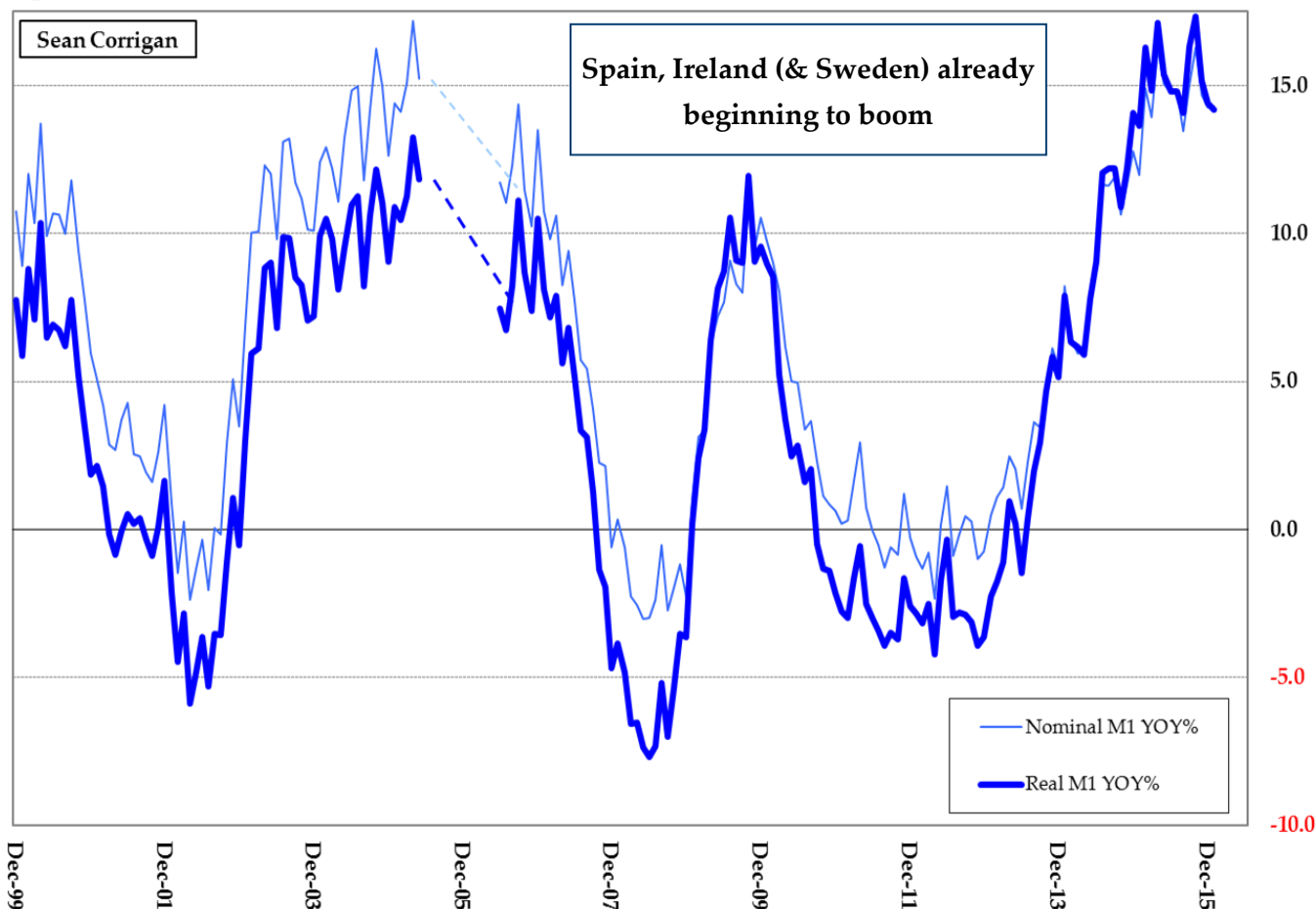
Former Bundesbank head, Axel Weber—the man whose principled retirement from the post, you will recall, left the way open for Draghi to assume his present ascendancy—had earlier accused the ECB of being *'part of the problem, not of the solution'* by turning 2010's *'crisis policy into a long-term programme'*.

By absolving governments of the necessity to face up to painful reforms and by *'acting as a department of the Fi-*

Eurozone YOY M1 ex-Currency%: Source - ECB



Spanish M1 - What Deflation?: Source - BdE, ECB, Bloomberg



ance Ministry' Weber charged the Council with not only endangering financial market stability but hindering the recovery process by relieving the pressure to write down bad and doubtful credits.

He further accused the Bank of engaging in a wholly undemocratic redistribution of wealth in favour of debtors and the rich at the expense of savers and the retired and reviled it for the assault on personal freedom which the mooted cash prohibition would entail.

Adding his *funf Pfennig-Wert* to the debate, former ECB Chief Economist, Jürgen Stark excoriated the Bank's 'shift to an American-style Keynesianism' and decried its practice of using the mandate in 'an unreliable and misleading fashion' in order to 'conceal its true objectives.'

'Negligently ignoring' the 'dwindling public confidence' in both the institution and the single currency, Stark complained it had 'become a political actor subject to fiscal dominance' and that it was heedless both of the risks it was running, their unsuitability for the task in hand, and the many malign side-effects being felt. It should stop trying to compensate for the broader failure of political will to enact the necessary reforms.

'Untrammelled policy can only be carried out by those who are entirely regardless of the consequences for others,' he concluded ominously.

You will not be surprised to learn that we endorse such opinions wholeheartedly. Money is a medium of exchange which works best when it approximates closest to that neutrality which in practice it can never obtain. What money should not be—and the long experience of history can be added to theoretical speculations in economics—is a blunt instrument of political activism. That way disaster lies.

The eminently justifiable suspicions being entertained north of the Alps are that Draghi has become more and more emboldened by the lack of constitutional limits on his power to treat the ECB as a latter-day *Istituto per la Ricostruzione Industriale*. As such, his increasingly brazen disregard for the wider sensibilities of those outside his narrow coterie of largely what the Germans refer to as *Welsch* confederates (one might almost say co-conspirators) is evolving into yet another source of dissent and division in an increasingly fractious polity not currently noted for their absence.

In addition to such purely economic disputation, one of the cardinal ones is the gnawing fear that Angela Merkel's

highly capricious (if not actually narcissistic) decision to open Europe's borders to all and sundry has planted the seeds of a wholesale social disaster, one whose bitter harvest could rapidly spiral into a near civil war of migrants against natives, of nation against nation, and of Left against Right. It only enhances this very real prospect of a Hobbesian descent to be aware that such an outbreak of strife would clearly be in the best interests of—as well as easily within the capabilities of—a small, determined cadre of IS fifth columnists, lying concealed among the many, more deserving arrivals, to first excite and then to aggravate. No need to reach for a firearm when you can force your attentions upon a Fraulein, after all.

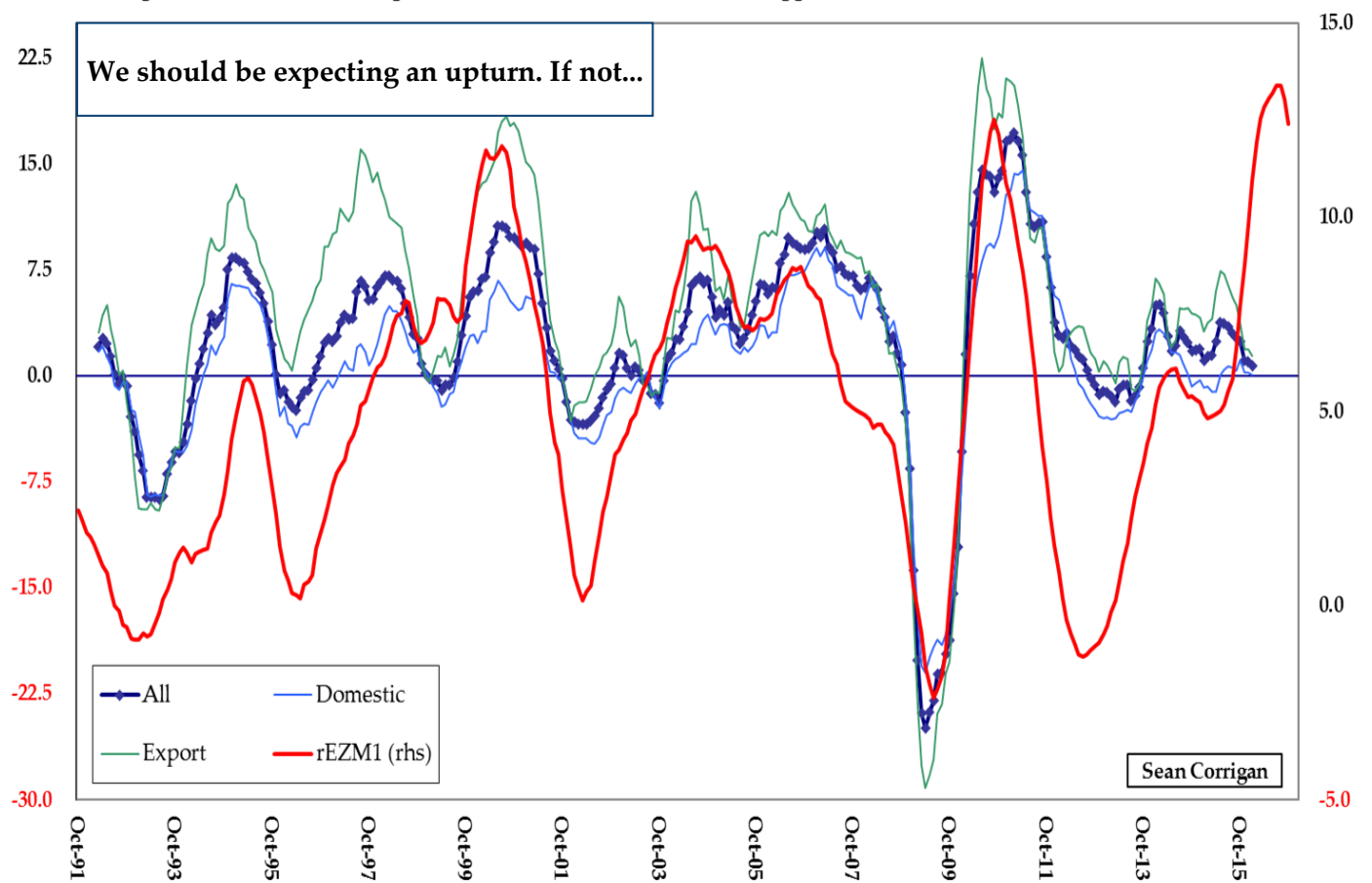
With the so-called 'social charter' which informs the relations between rulers and the ruled a very dog-eared document indeed across much of the Continent, the political landscape is also shifting as new groupings from and coalesce to the left and right of an intellectually exhausted mainstream. Regionalism is also on the march in many states—a phenomenon which stands in distinct contrast to the EU's eternal hunger to extend its sway to the east and south, no matter what the implications of such an overstretch may be.

Acting as a lightning rod for much of this discontent is the coming UK referendum on that country's continued membership of the Union—and the existential fear this arouses in the elite is that this might result in their Bastille once again being stormed by the mob and all their privileges and prerogatives therefore cast into doubt.

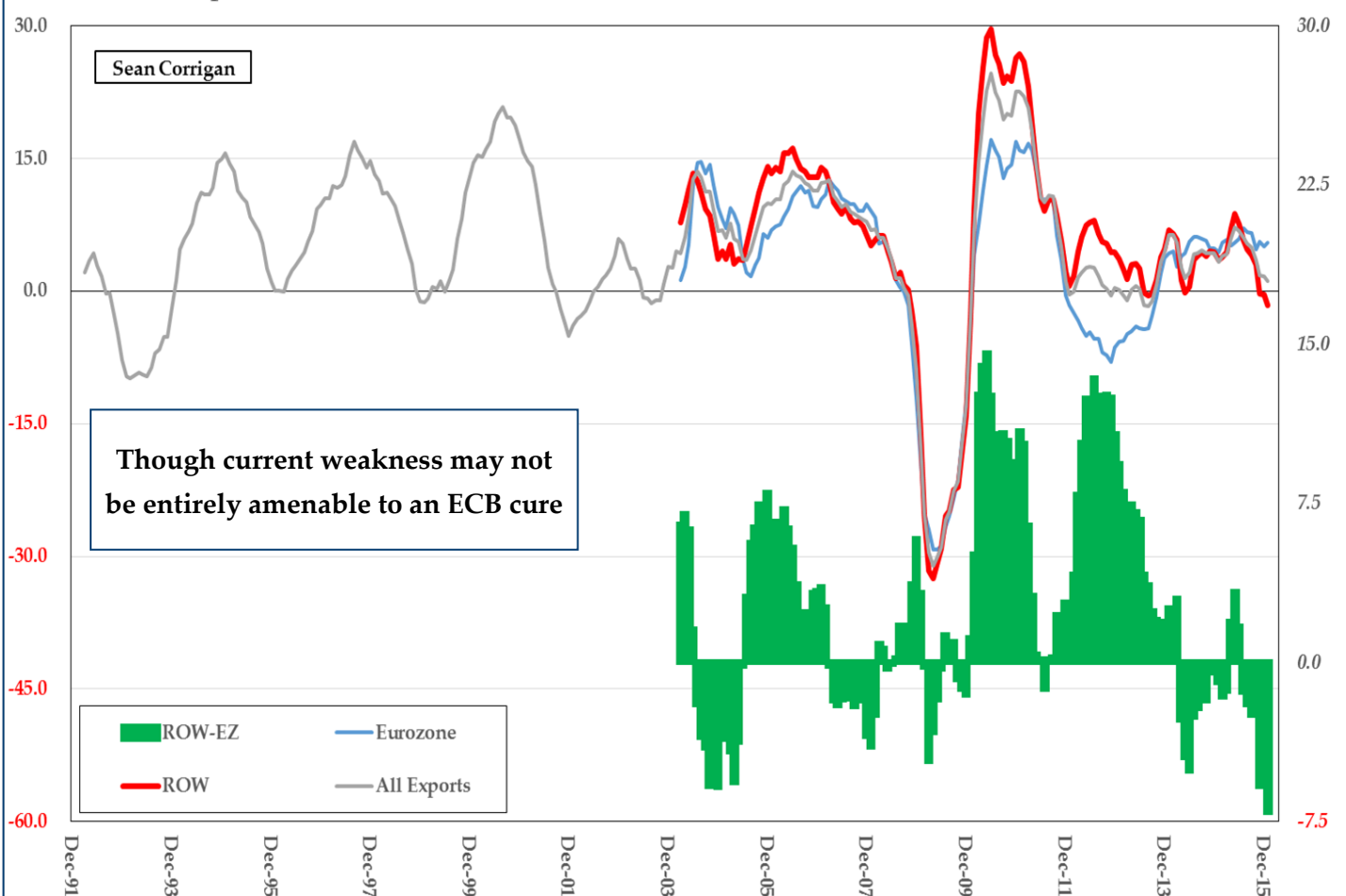
This angst largely explains the barrage of dirty tricks being practices as well as the drumbeat of dire prognostications daily issuing from what the 'Leave' campaign has disparagingly, if accurately, dubbed 'Project Fear'. As such, you can be assured that no stone will be left unturned—no stone whatsoever, including the engineering of either domestic outrage or heightened foreign tension—in order to cow the recalcitrant masses into delivering the 'correct' verdict at June's ballot box.

Whether you are a fervent believer in the fairy kingdom concept of 'animal spirits' or simply a realist who recognises that it is folly to make long-standing, possibly irrevocable commitments of time, capital and effort to new undertakings when one has no clear perception of what the political, economic, or legal landscape might be within which such plans must be carried out, you might wonder whether conditions are entirely conducive to Magic Mario's own ruinous schemes coming to an early fruition, either.

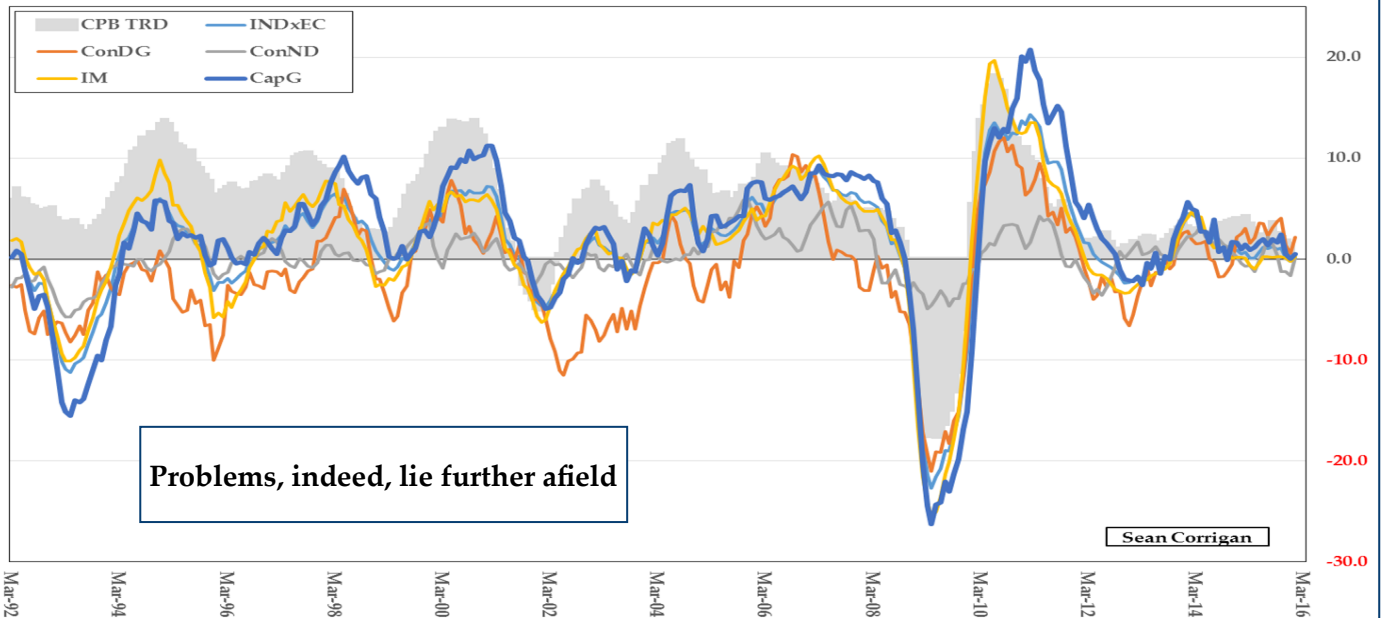
Change in Real EZM1 v change in German Industrial Revenues lagged 9 months: Source - BUBA



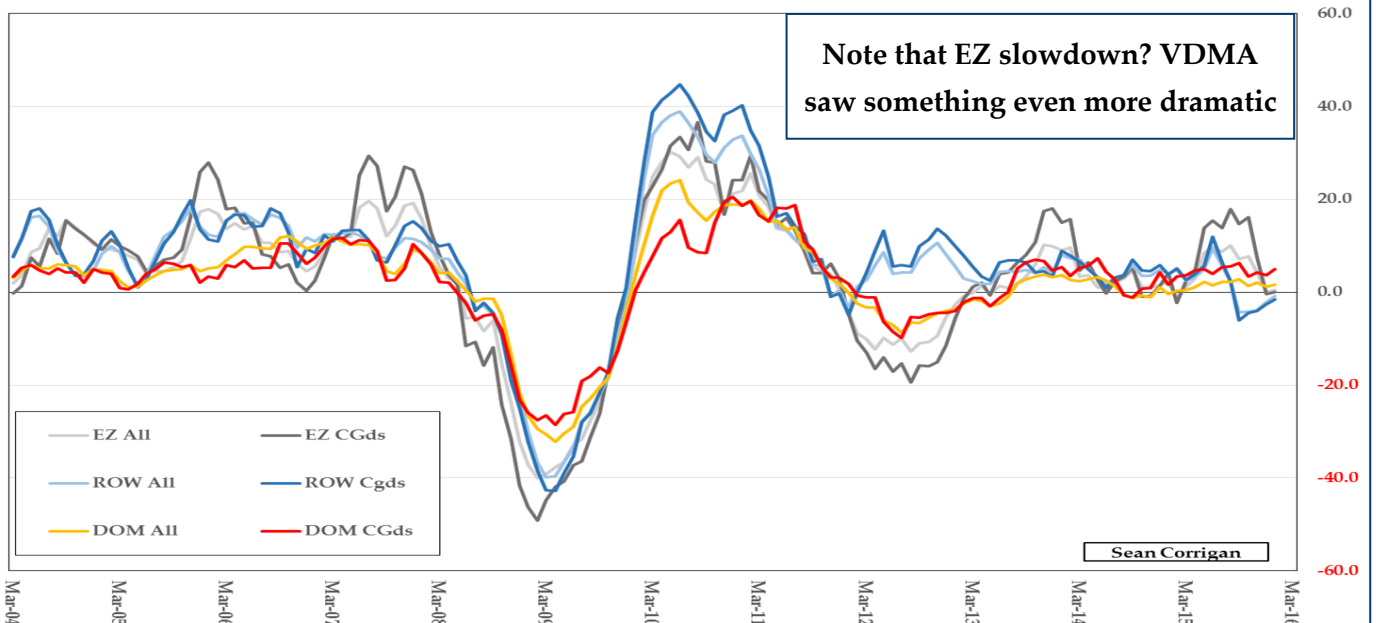
German Export Revenues, 3mmaYOY%: Source - BUBA



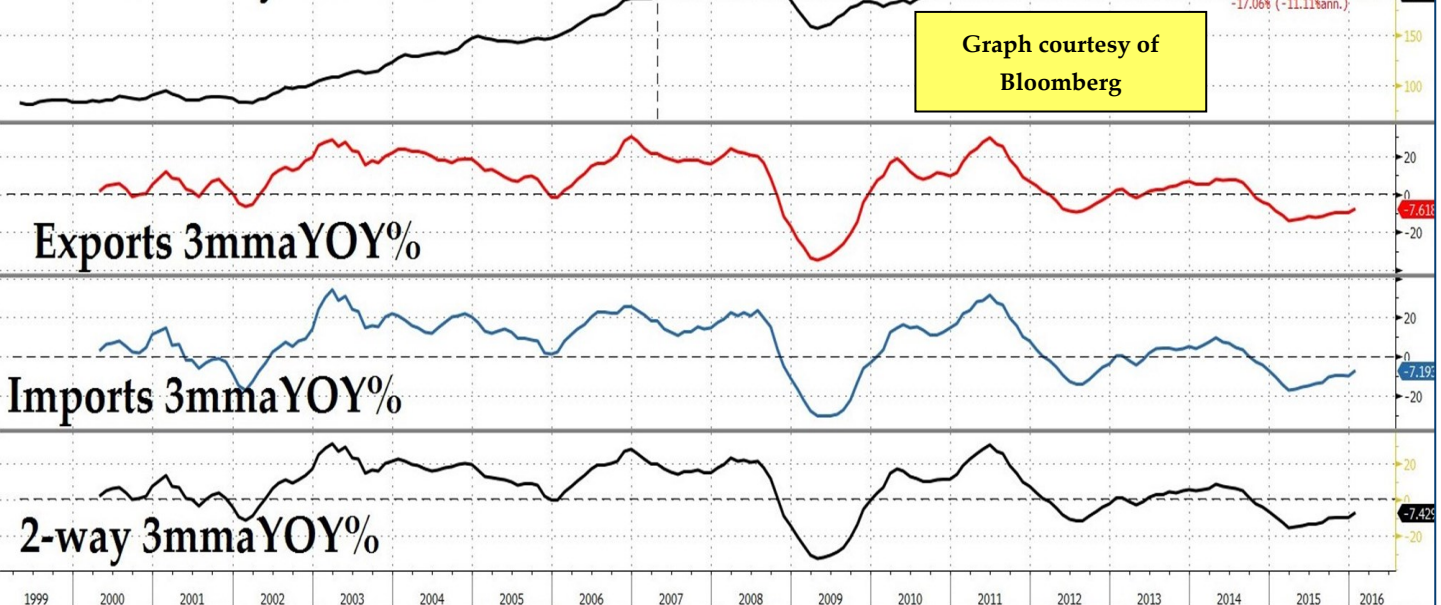
German Industrial Output v World Trade, 3mma YOY%: Source - BUBA, CPB



German factory orders, 3mmaYOY%: Source - Buba



German 2-way Trade USD



WHERE THE MONEY GROWS: Wall St. and West

It is surely indicative of the current, sorry state of affairs when the near-term financial markets hang breathless ahead of the monthly US non-farm payroll report. Not only is this vast, sprawling statistical artefact riddled with internal inconsistencies, not only is it subject to frequent, often significant revisions, but it is also very much a rear-view mirror indicator, telling us more about what has already happened than what we might expect to happen in the weeks and months ahead.

On the surface of it, the numbers were largely unexceptionable with a 230k net jobs gain, concentrated entirely in the service sector. Not willing to rest there, having built up the importance of the release for much of the preceding week, the Herd quickly seized upon a headline which declared that average private sector weekly earnings had fallen by 0.7% - their biggest drop on record!

In typically perverse fashion, the price action swung immediately as the perception spread that, rather than being strong enough to steel Federal Reserve resolve with regard to its putative programme of rate hikes, things now bore a sufficiently weak construction to put that schedule once more in jeopardy. Perhaps this was best evidence in a nervous, pre-Draghi currency market where the initial 80 pip loss suffered by the euro swiftly gave way to a creditable 140 pip gain.

With faint echoes of the breathless climate alarmist headlines which are constantly screaming that some factoid or other represents a worst, hottest, stormiest instance 'SINCE RECORDS BEGAN!' – when, at best, what is usually meant is 'since we first started taking measurements from space a couple of decades back' – that NFP pay 'record' only registered as such in the 10-year series for all grades of workers, not the much more long-lived one for 'production workers and non-supervisory staff'. The five times more numerous members of that latter cohort did indeed see a shrinkage in their wage packets, too, but this time of a barely noteworthy 0.3% - the weakest performance only since the end of 2014 – made up of a flat hourly wage and a slightly shorter work week.

Their bosses, however bore the brunt, we are to infer, with earnings off 1.2% as a result of a similarly shortened week and an 0.9% drop in average pay.

This last is not without its anomalies, however. Take the roughly one in five service workers active in health and education (comprising a veritable army, 22 million strong). Here 'production' staff (presumably those at the sharp end of a thermometer or blackboard pointer) saw wages rise 0.3%, hours slip an equal-and-opposite 0.3% and pay accordingly remain unchanged even as they made up round 25% of the total payroll gains. Their superiors, however, not only spent proportionately less time in harness, but also endured an 0.9% hourly wage fall to leave the pay-packet lighter by 1.2%.

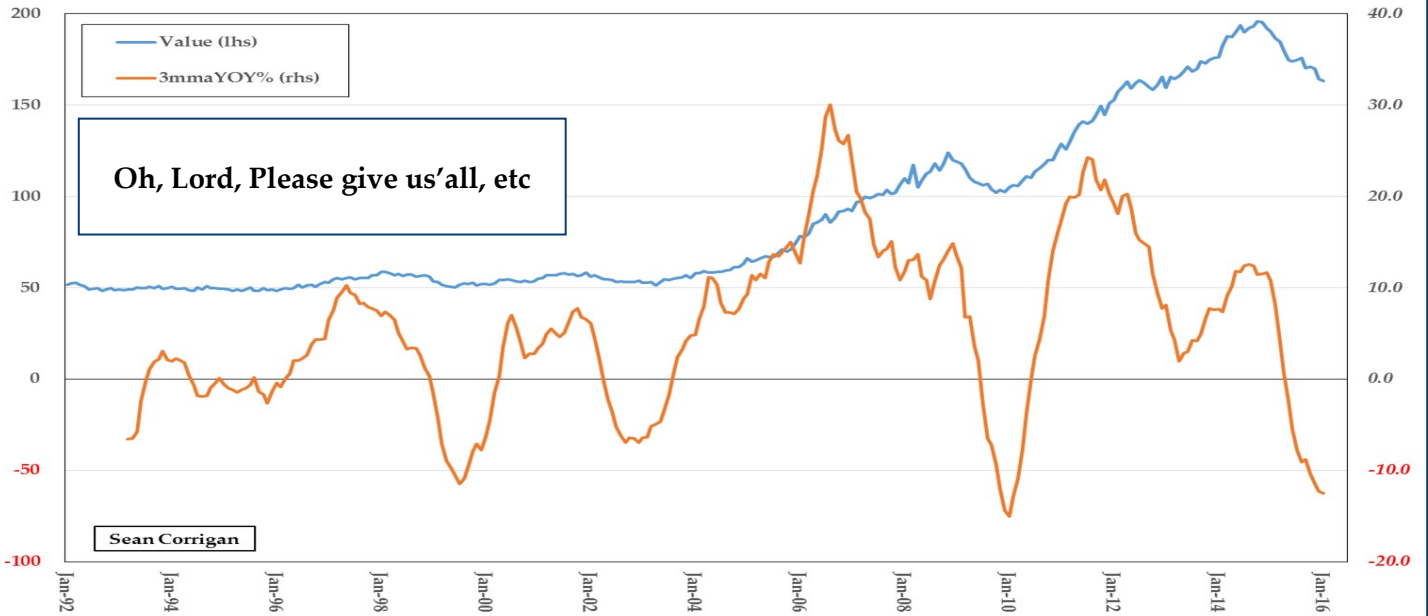
Five million frontline construction workers, meanwhile, received a 2¢ hourly pay rise and worked 12 mins longer for an 0.6% boost to their take-home, while their 1.6 million crew chiefs paradoxically felt a marked increase in the disutility of labour as a 21¢ wage rate rise led them to undertake a 108 minute shortening of time on the job. This left the overseers of one of the few boom industries a substantial 3.9% lighter on earnings – which was a shortfall larger even than that suffered amid the freefall which is the extractive sector.

Seriously, folks. Do we think the data stand up to detailed scrutiny of this type? Are we really to suppose that such single-month, decimal-point niceties – especially those presented in a series of relatively recent vintage which actually came with an admission that a three-year data error, stretching back to its very inception, had only just been caught and corrected by the BLS bean-counters - offer enough solid underpinning on which to base either one's investment decisions or - heaven forbid! – a central banker's policy vote?

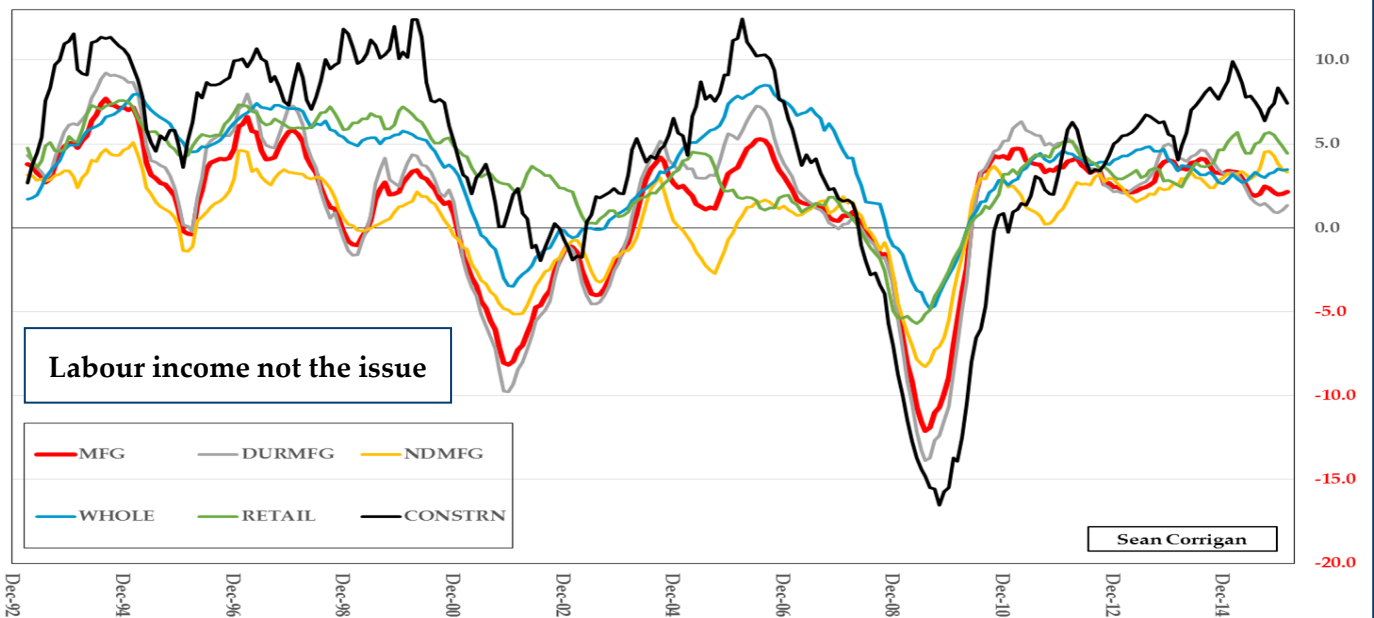
I rather doubt it.

Panning back a little, however, there is still some information we can derive from the jobs numbers – most notably we can get a sense of the collapse in the energy sector, where almost 120,000 jobs have vanished since the oil price began to slide in the second half of 2014. One in eight pipeline jobs, one in 10 drilling jobs, and a thumping one in four oil service jobs – one in six when taken all together - have been lost as ever more wells run dry, not so much of hydrocarbons as of revenues.

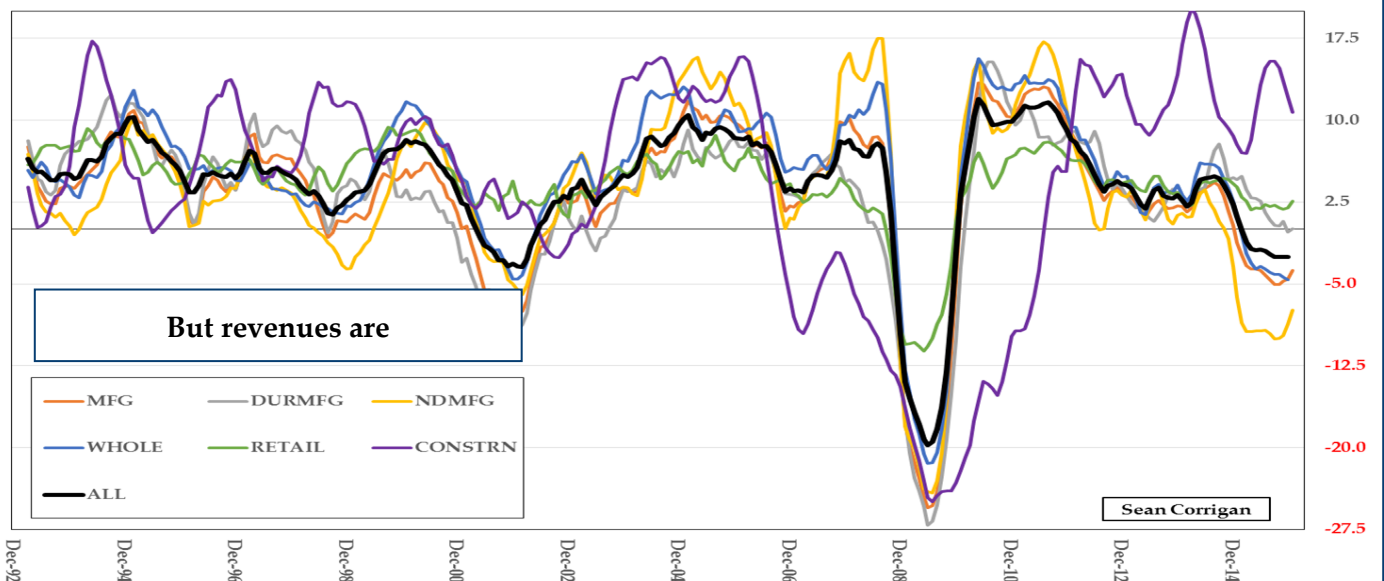
US Oil & Gas Wage Fund, 2007=100: Source - BLS

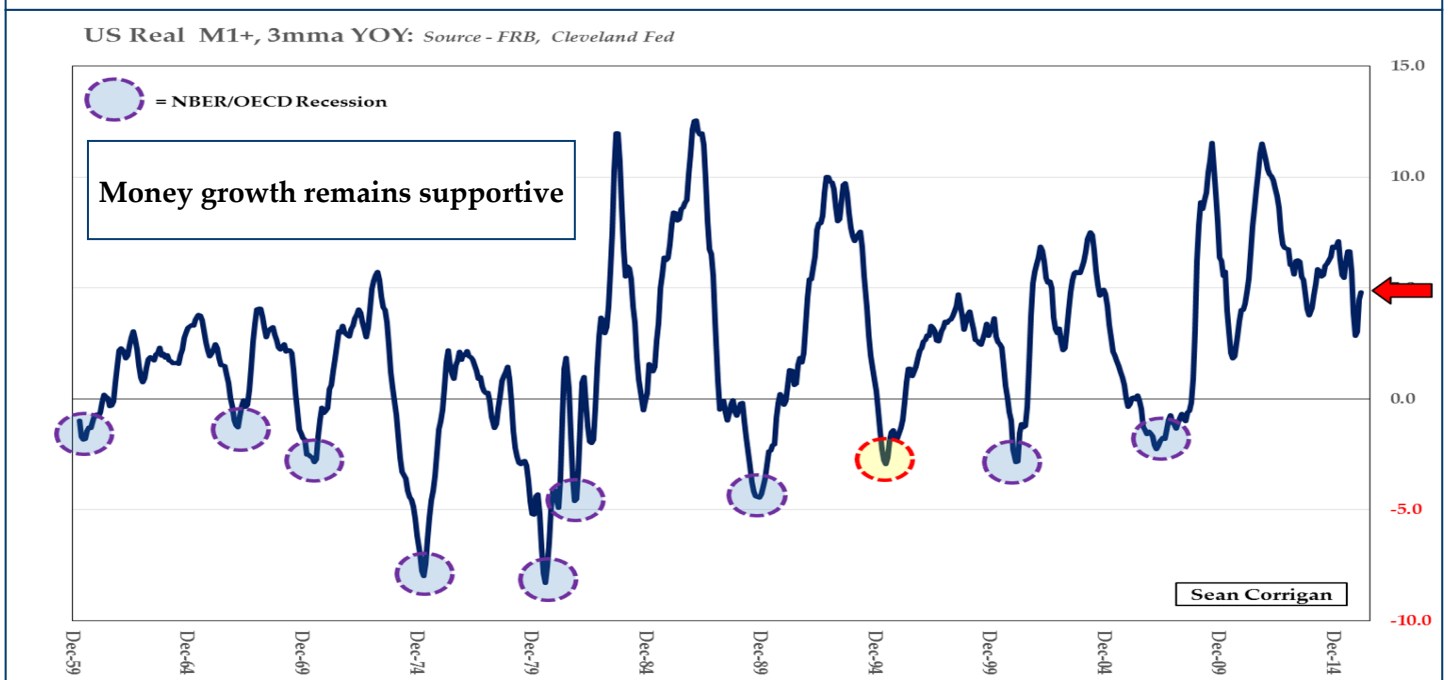
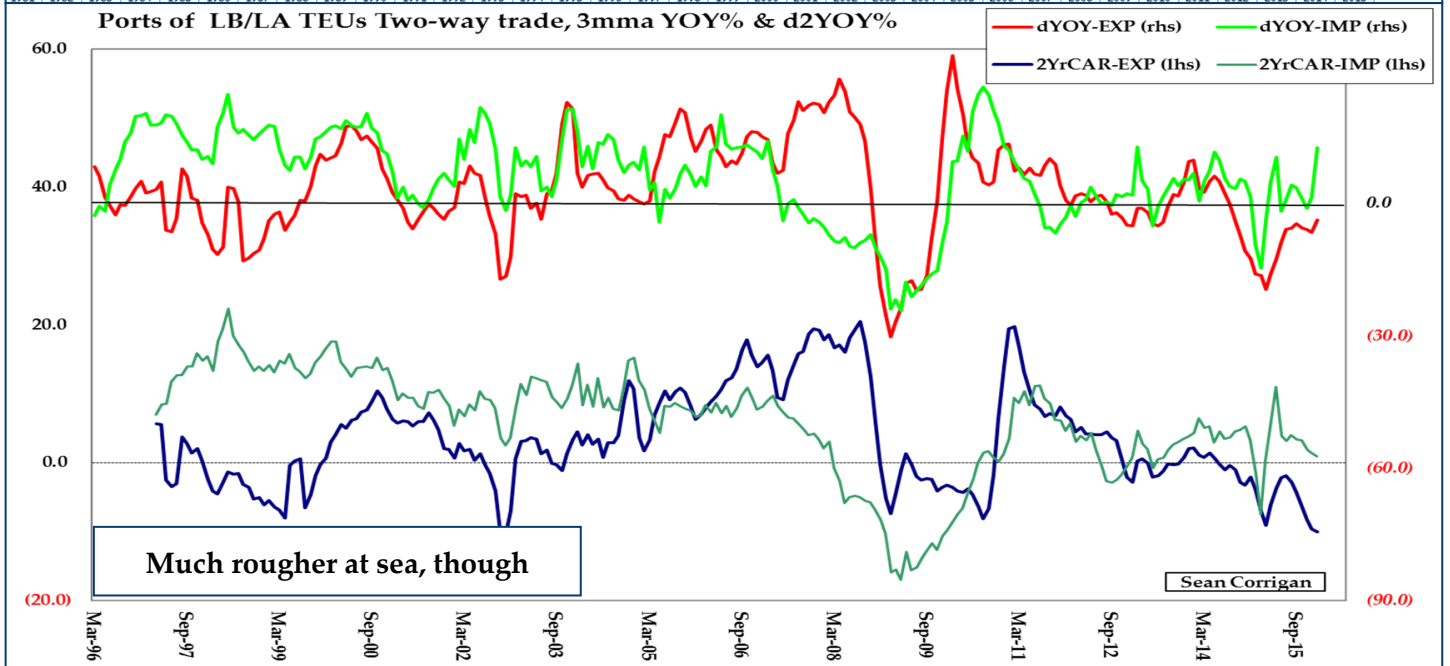
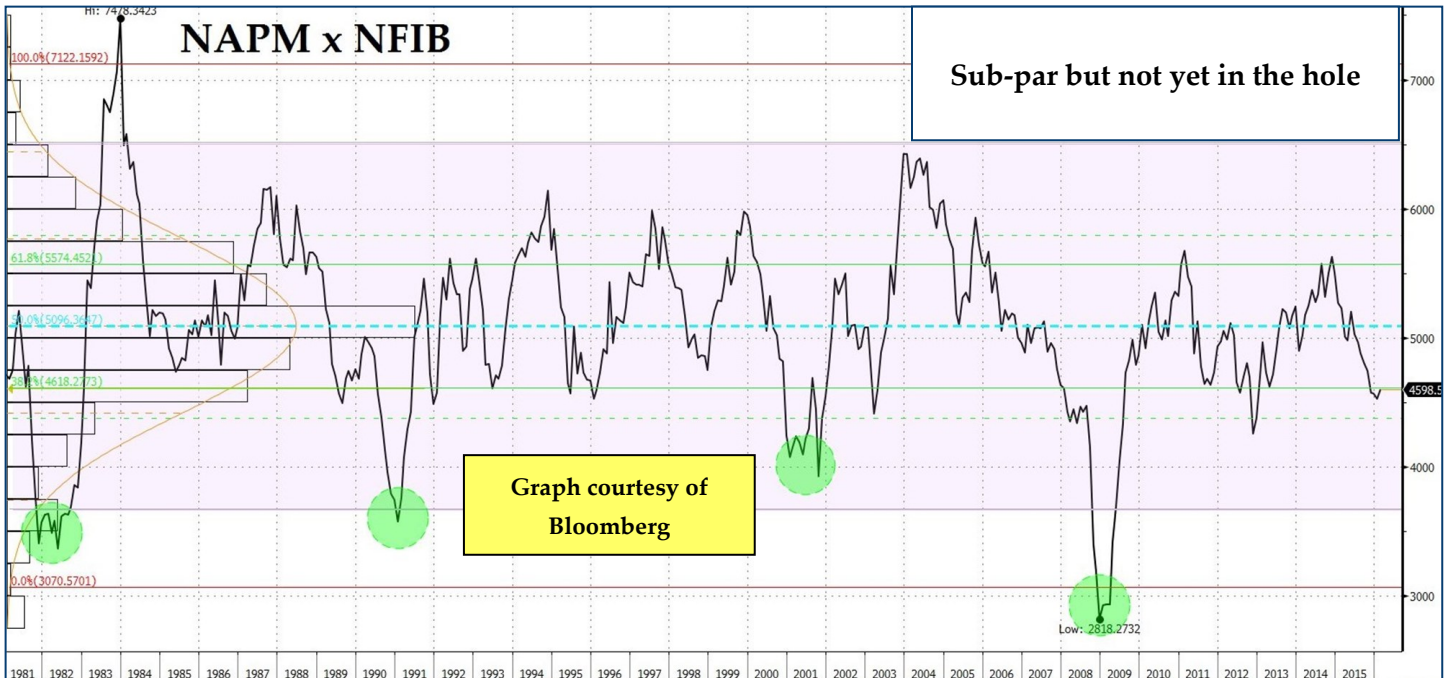


US NFP Wage Fund, 3mmaYOY%: Source - BLS



US Biz Revenues, 3mmaYOY%: Source - Census





In percentage terms, the reversal has been comparable to that undergone in the Snowball Earth episode, post-Lehman but, coming from a higher peak, the arithmetical loss of \$8.6 billion in salaries surpasses the \$5.7 billion drop from that earlier episode by a considerable margin.

Elsewhere, things might not be running as rapidly as some might wish, but at least the product of wages per hour times hours times workers is still growing - from a lowly 1.3% 3mma YOY% in durable manufacturing to 6% in health and 7.4% in construction. The only problem is that only in the construction industry are revenues running ahead of payrolls and accordingly, in a majority of stock market sectors, profits have been following a downward trajectory - a development which argues that any savings to be had on other input costs are failing to provide an offset to the wage-bill.

The lacklustre sales performance can be seen in other areas, too, whether in international trade figures or in the more qualitative surveys, such as those conducted by the ISM and the NFIB. Business is beginning to turn bad. For example, a comparison of container traffic at the major West Coast port of Long Beach and Los Angeles with volumes of two years ago (one made with the same period last year is rendered meaningless by the major labour dispute then underway), shows exports off at a 10% compounded rate - a slump comparable to that which took place in 2008-10 and a couple of percentage points worse than during 97-98's Asian Contagion.

As for those profits themselves - the things which entrepreneurs go to all the hassle of hiring people in order to make, let us not forget - well, they are off by a third to levels first reached over a decade ago. And the stock market sits two-thirds above the levels of those days, still trying hard to rally!

Ploughing a Lonely Furrow

Beyond the oil patch and away from the travails of the miners, another group of people who make a living getting things out of the ground is also feeling the ill-effects of a post-commodity boom hangover. Farmers.

Here we should remember that the horny-handed sons of the soil benefited greatly from a demand for their product for its own, traditional sake, but that was not all that was at

work. All the same, that backstop demand was greatly enhanced by the Kirschners' economic self-strangulation in Argentina, as well as from China's ill-considered farm welfare programme. The first of these served to keep a great deal of competition from the market by handicapping its soybean growers, cattle ranchers and others, not only with stiff export duties but the even bigger handicap of a ludicrously overvalued official exchange rate.

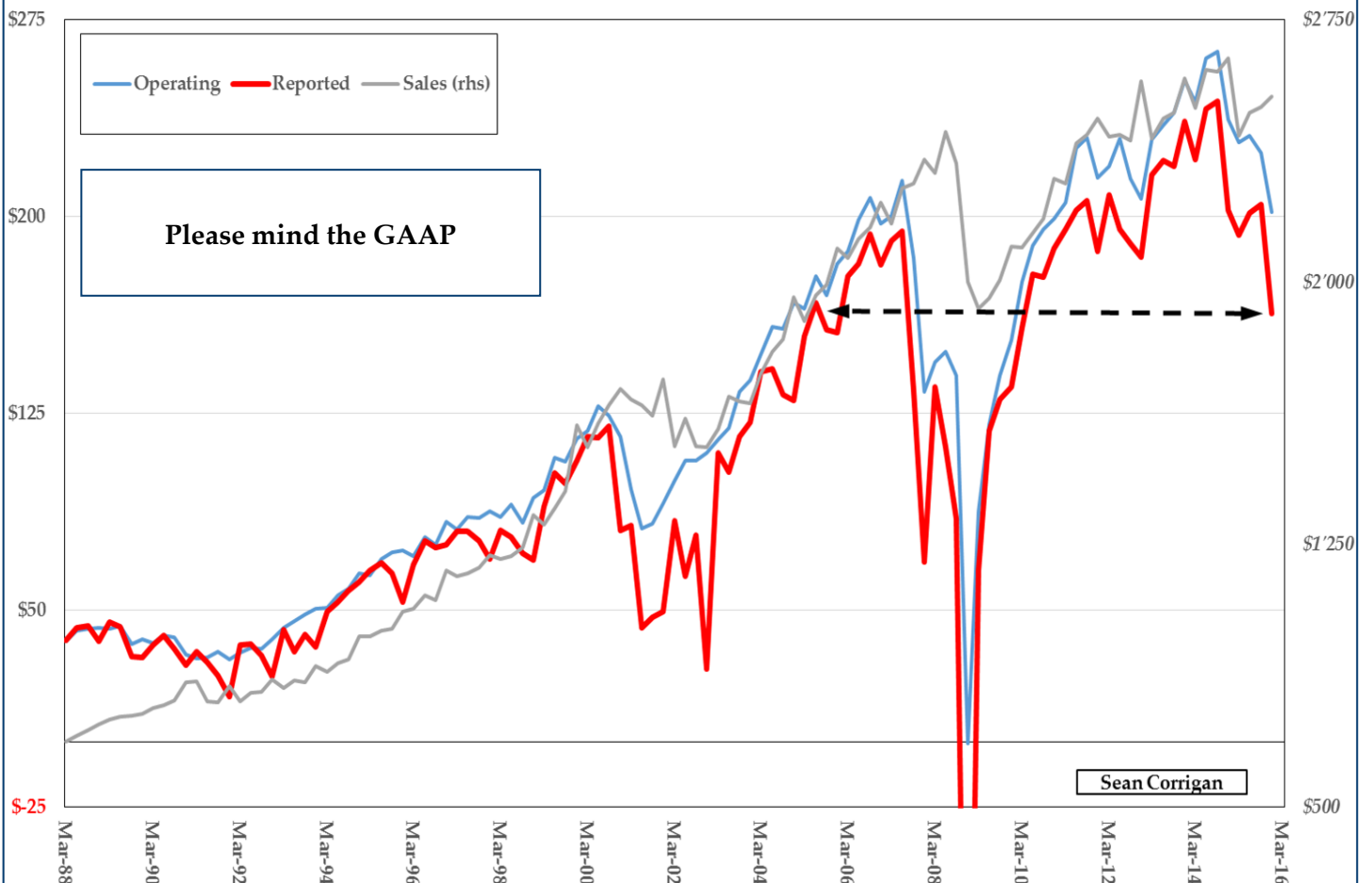
As the new government of Mauricio Macri has removed the majority of these impediments - with the repeal of most tariffs, the stepwise reduction of others and a handy 50%+ devaluation of the peso, strike one for the US farm-belt. Strike one-and-a-half on account of the real's simultaneous halving in value, too.

Another major source of demand has been from - where else? - China where soybean imports have risen 85% in the past five years and tripled in the past ten. High domestic support prices may have kept the rural masses contented, but they have also raised irresistible incentives for processors to source their grain on the world market instead (some of which ended up being used in the same sort of 'collateral' trade which kept the metals boys sweet, too). As a result, stockpiles have swollen to the extent that the nation is reputed to have a year's supply of corn rotting in the state elevators (a mountain it is now aiming to reduce by subsidizing ethanol manufacturers). Rapeseed oil is another source of embarrassment with the state currently selling six year old stocks off cheaply and no questions asked. Would you like dressing with your salad, sir?

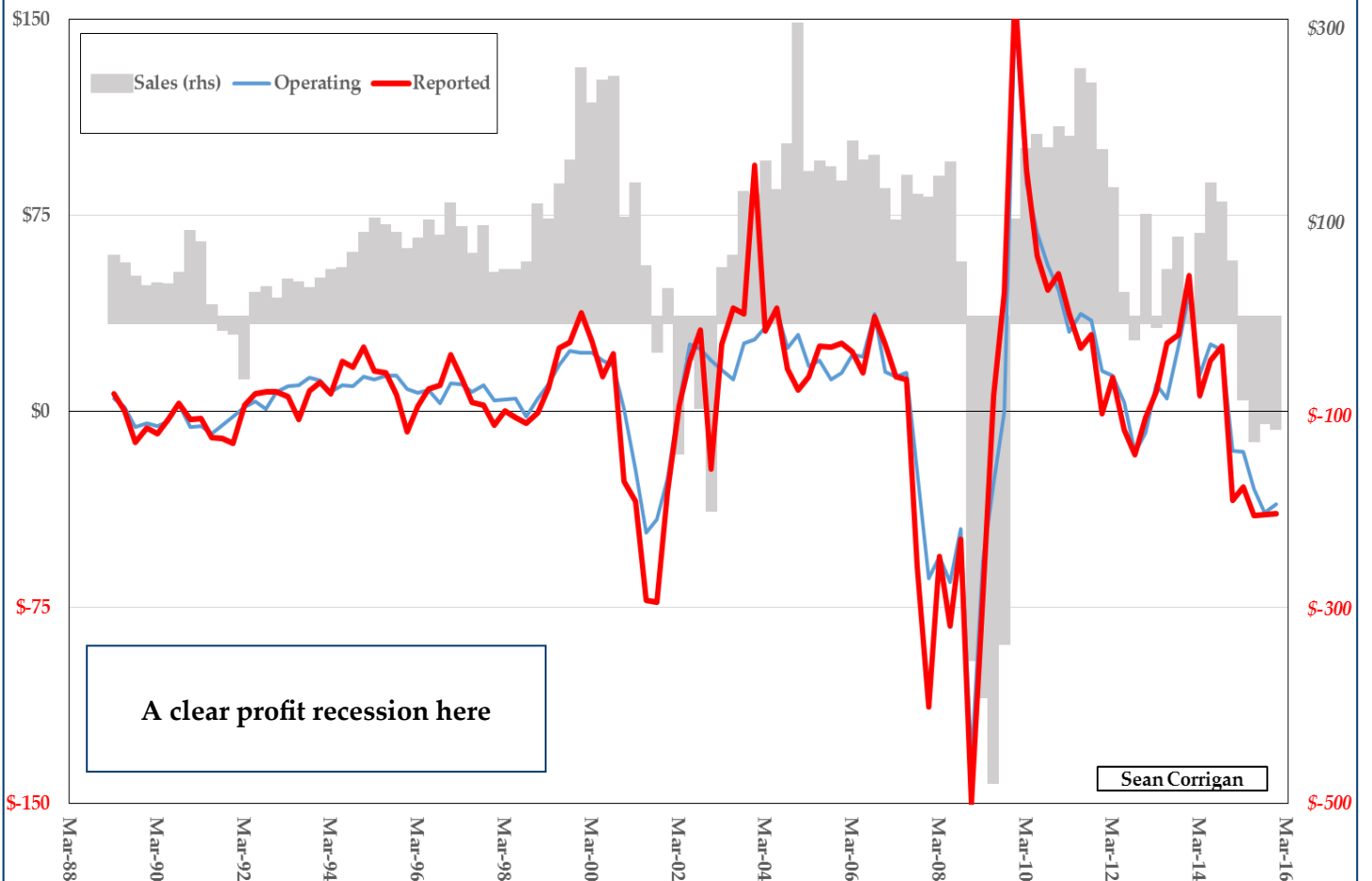
Similar distortions apply in the case of wheat, squeezed out of the feed market by cheap imported corn, alongside barley and sorghum, and faced with stagnant demand for flour milling. Meanwhile, sparked by a paranoia about 'food security', pressure was put on farmers to continue double-cropping rice as recently as 2014, with support prices for the earlier of the two harvests set as much as 15% above the grain available from neighbouring Vietnam. Inevitably, the surpluses exploded there, too, so today - surprise, surprise - official media outlets are exhorting farmers to concentrate their efforts on the second, usually better quality, crop and to abandon the first.

The standard trope is also that China has enough cotton to make two pairs of jeans for everyone on the planet in its

S&P500 Aggregate Sales, Earnings, \$blns: Source - S&P



S&P500 Aggregate Sales, Earnings, 4Q change, \$blns: Source - S&P



inventories. Not that this has prevented the payment of handsome subsidies to farmers in the key province of Xinjiang as well as (somewhat more rationally) or to local factory owners who set up spindles with which to turn it into fabric. In something of a pilot programme which may be extended to other sectors, the government has experimented with letting some farmers sell their produce on the market, then 'topping' up their incomes directly, instead of buying the grain itself only to see it pile up uselessly.

Though far from ideal, the principal is to allow the market to function better while still cushioning the grower from the worst of its vicissitudes. Since this approach was implemented local corn prices have fallen 35% vis-à-vis those on Chicago from 2014's relative record high. Despite trading in a much more volatile manner, relative cotton prices have also fallen 25%. Should China extend this new system, much less should it also seek to dispose of its inventories, the ramifications would be profound. [H/T Dim Sums blog]

Beyond such influences, US growers also face a double-whammy from the collapse in energy prices. Not only has this undercut the price support for biofuels – the ethanol/gasoline ratio, for example, rose 140% as the crude price fell, before subsiding somewhat in recent weeks – but cash-strapped shale drillers are nowhere near as avid in the hunt for leases, a further limitation to land-owner cash-flow to add to lower royalty payments.

Looking across the board, we see that cotton prices and rubber are off around 75% from their peak; milk is down 70% or so; corn has lost 60%; soy, wheat, sugar, and rapeseed have more or less halved; hogs are off 45%, rice 40%, palm oil 35% - even after an El Nino boost - and lumber by around 30%.

Where this is beginning have wider ramifications is the effect it is having on the price of farmland, thus potentially adding a collateral deterioration to what is already a reduced debt service capacity on the part of those who thought the good times would roll on a good while longer.

Indeed, farmland prices have largely mirrored those of agricultural commodities in this past decade, doubling in the eight years to the GFC, dipping briefly then doubling again in the four years to mid-2014. In each of those two doublings, farm mortgages outstanding rose 50%, taking them

from \$85 billion to close to \$210 billion today. As a result, returns on farmland investments (i.e., adding rental income to capital gain), according to the commercial property investors' industry body, the NCREIF, greatly outpaced those generated by urban investments over that same horizon.

Inevitably, this has begun to exert a malign influence on credit trends. As the Kansa City Fed pointed out in a recent report, with a diffusion index of farm income at its lowest in a 14-year sample, that for loan repayments is at its lowest and, conversely, that for credit extensions is at its highest since early 2003. Farm lenders are therefore not seeing much in the way of cash being freed up, meaning credit supply at the bottom end of the last fifteen years' range is bumping up against credit demand which is setting new highs in a series stretching all the way back to 1980.

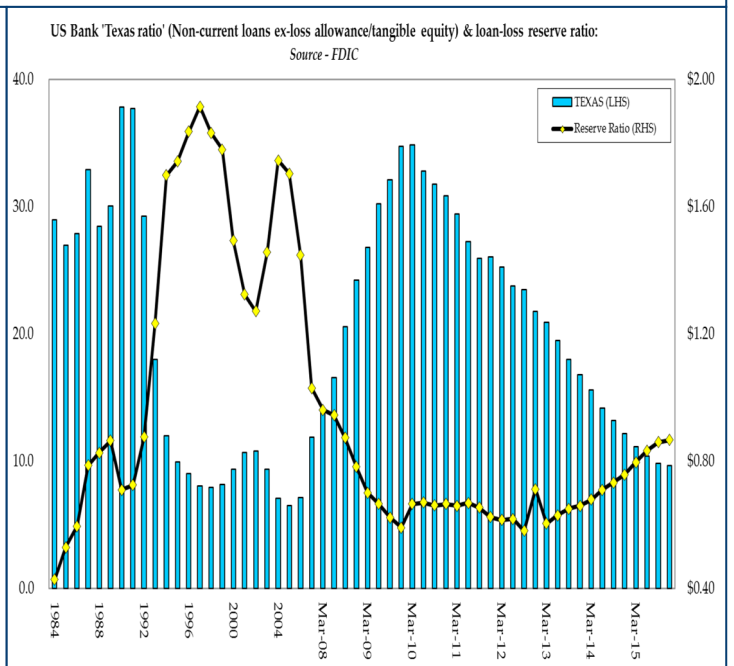
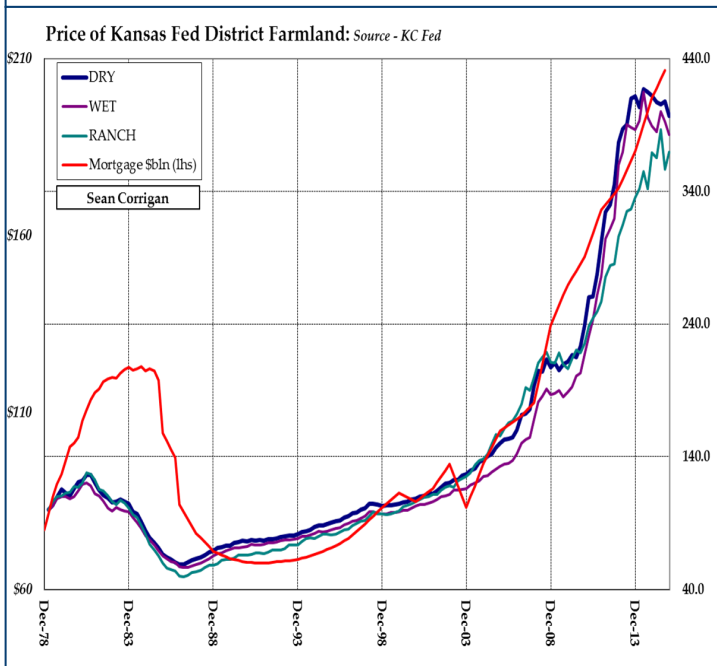
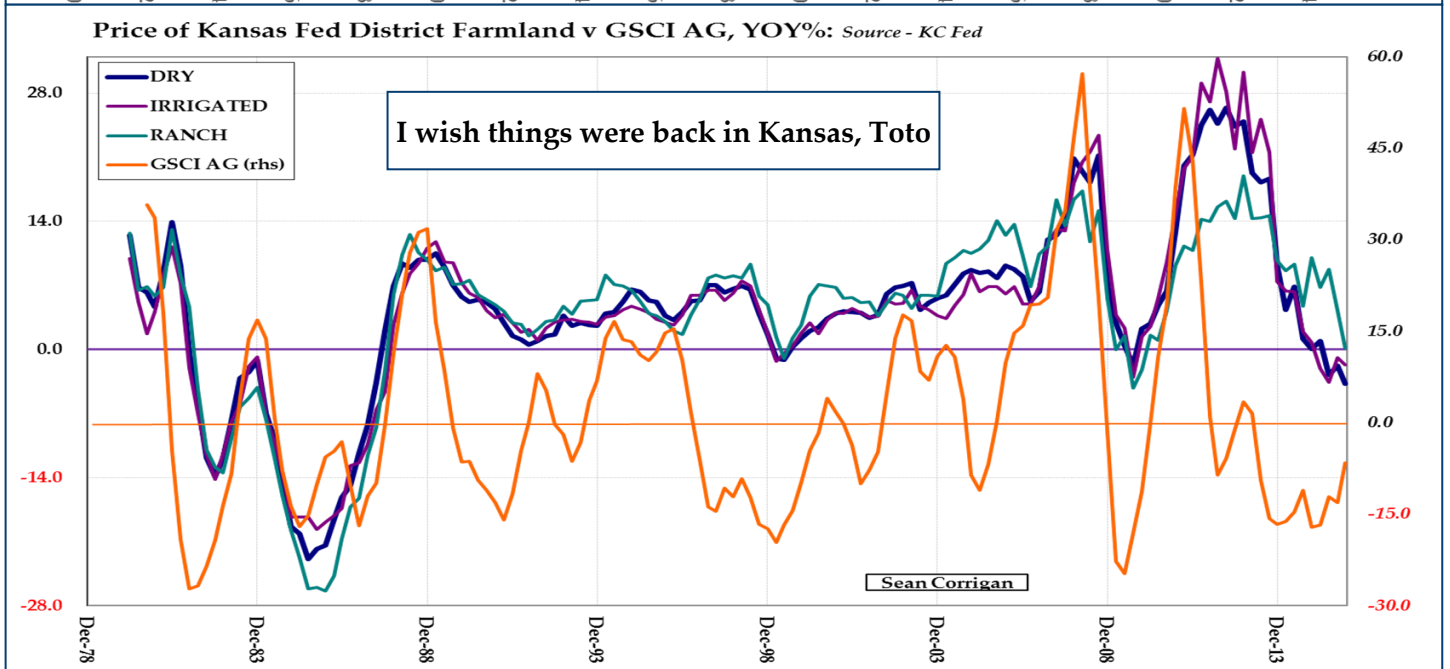
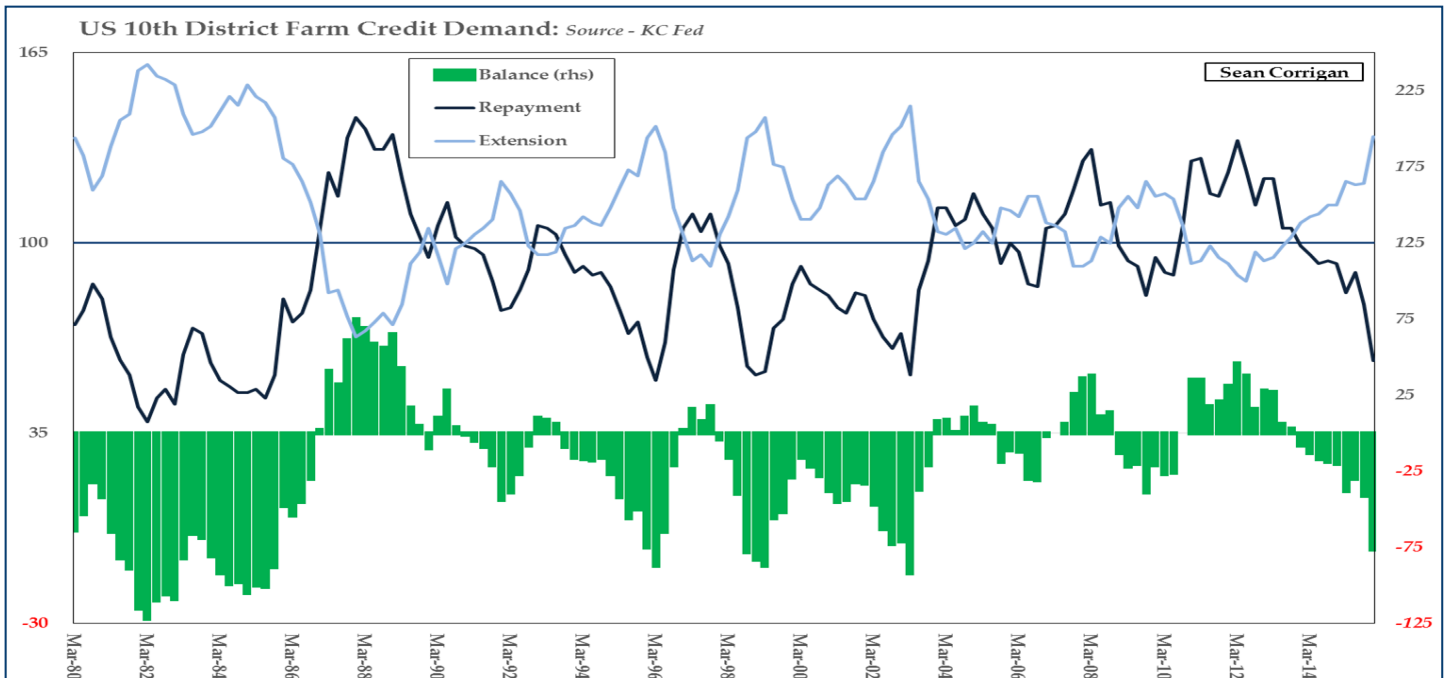
You can bank on that!

Something's got to give and when it does, it will surely redound to the detriment of the banks involved in this. Though bank leverage ratios are certainly healthier than they were the last time the wheels came off, we should need no reminding of how intrinsically non-linear is the business of banking.

The latest FDIC report, while generally upbeat, did note the first signs of doubt creeping in, remarking that: *'Net loan and lease charge-offs totalled \$10.6 billion in the fourth quarter, an increase of \$690 million (7%) compared to the fourth quarter of 2014. This is the first time since the second quarter of 2010 that charge-offs have increased year-over-year. Net charge-offs of loans to commercial and industrial borrowers were \$512 million (43.4%) higher than a year ago, while charge-offs of credit cards were \$292 million (5.6%) higher.'*

And while the overall decline in non-current loans allowed coverage ratios to edge higher to 85.2%, reserves *per se* fell *'...for the 21st consecutive quarter... [so that] the industry's ratio of reserves to total loans and leases declined to 1.37%. This is the lowest level for this ratio since the end of 2007...'*

Typically, the worst loans are made late in the cycle and often made in profusion, to boot. Thus, we find that, in the past two years, multi-family home loans have risen by 56%, construction & development loans and commercial & industrial loans each by 40%, farmland loans and other non-



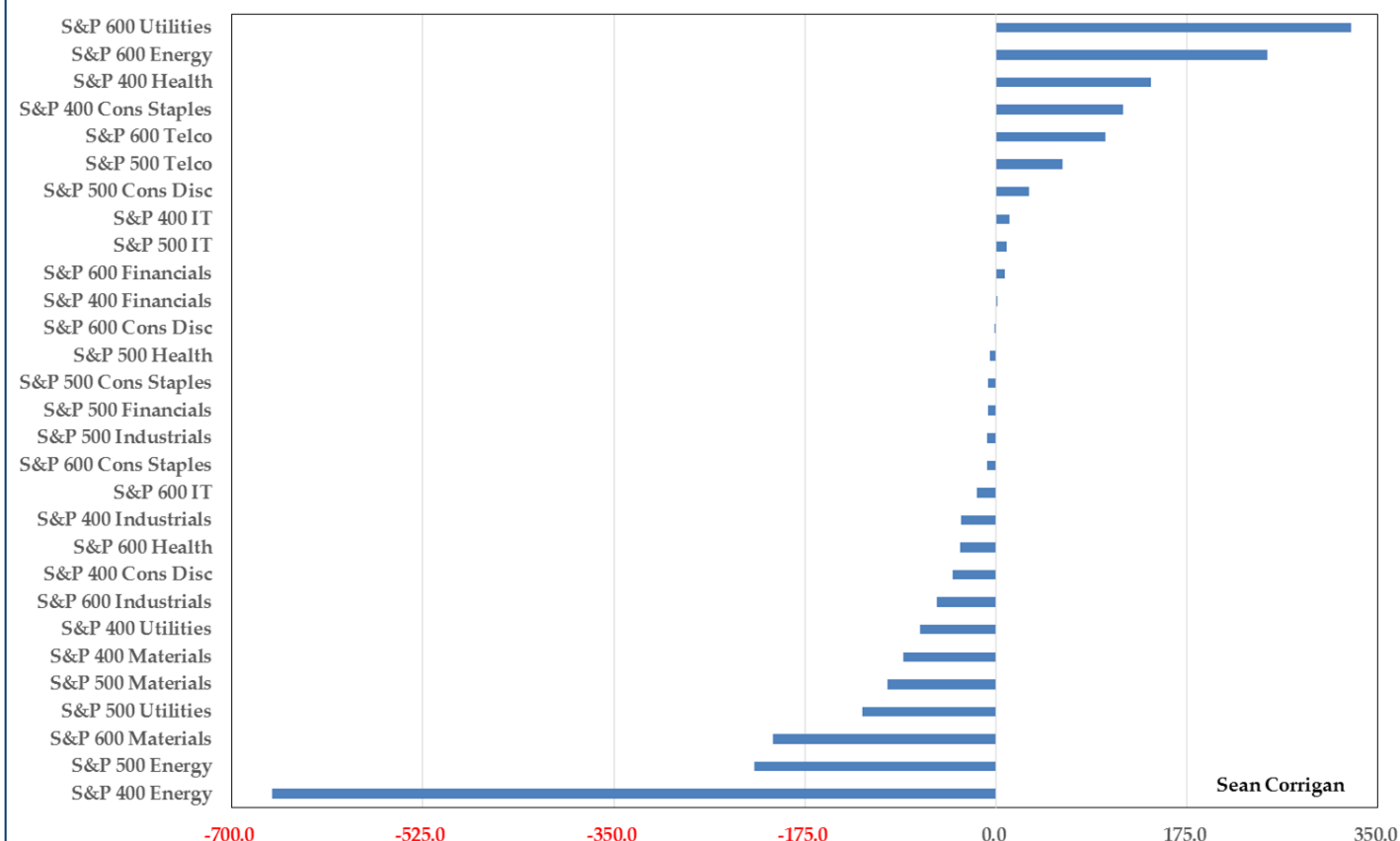
WHERE THE MONEY GROWS: Wall St. and West (continued)

residential real estate lending both by just under a quarter. System-wide, NYSE margin debt stands at \$450bln, student loans at £1.3 trillion, auto loans at over \$1 trillion.

Syndicated loan commitments to oil & gas corporations stood at \$275 billion in 2015 of which around one in eight were in some way 'criticized'. Other commodity industries accounted for \$60bln in impairments out of \$630 billion in potential exposures. Leveraged loans – many of them exceedingly 'cov-lite' - meanwhile, were up 35% last year to just over \$1 trillion, of which more than a quarter are in some way doubtful, a total which represents over 70% of all such dubious credit. For reference, US banks make around two-fifths of these loans, with foreign-owned banks responsible for another third.

On the surface, things seem very calm and unhurried at the moment – see for example the so-called 'Texas ratio' of NPLs less loan-loss reserves as a fraction of tangible equity – but any signs that the swan is starting to paddle faster should be taken as a warning that matters could deteriorate very rapidly thereafter.

Reported Earnings % Change from Q3'14: Source - S&P



For once, we will be (mercifully) brief on the subject of China, given that the coming days will not only see a batch of important data releases but also a welter of policy pronouncements and media exegeses relaying whatever it is Chairman Xi has decided—after duly considering all submissions and paying respectful attention to the voices of dissent, naturally—that he wants us to hear at the conclusion of the CPCC & NPC twin congresses.

Something of the spirit of the times can be seen from the heightened restriction on the public expression of contrary opinion of late, a process which stepped up a gear when Xi graced the offices of the three main state media outlets with his presence last month and exhorted staff their always to bear in mind that, *'all the work by the party's media must reflect the party's will, safeguard the party's authority, and safeguard the party's unity. They must love the party, protect the party, and closely align themselves with the party leadership in thought, politics and action.'*

Is everybody clear, now?

If, as a means of keeping control of the narrative this was a little more subtle than Pasha Erdogan's use of riot police and water cannon to silence the voice of the opposition, it is no less chillingly direct for all that

At the same time, we have not been spared reminders—both subtle and otherwise—that the 'anti-corruption' campaign is in full swing, providing as it does, a convenient screen for the ready elimination of all those not fully aligned with Xi's intentions in a land where practically no-one is immune from the taint of influence-peddling. How else, after all, to ration scarce resources in a world where market pricing still plays an ancillary role in that task?

Here we must pose the question of motives. Is Xi's tightening of the reins a paradoxical sign of *weakness*, embarked upon because he fears that, in the face of bureaucratic inertia and a sickening economy, he has lost his way and so needs to keep the lid very firmly clamped down upon any testimony to that effect? Or, conversely, is it that while he remains resolute about the changes he must bring about, he is hard-headed enough to know that any meaningful reform is bound to produce more short-term losers than winners and that these are anyway the more vocal of the two groupings as matter of simple human nature?

As we await further developments in order to try to decide the case, we do have to admit that it's not exactly looking promising for the second of these interpretations.

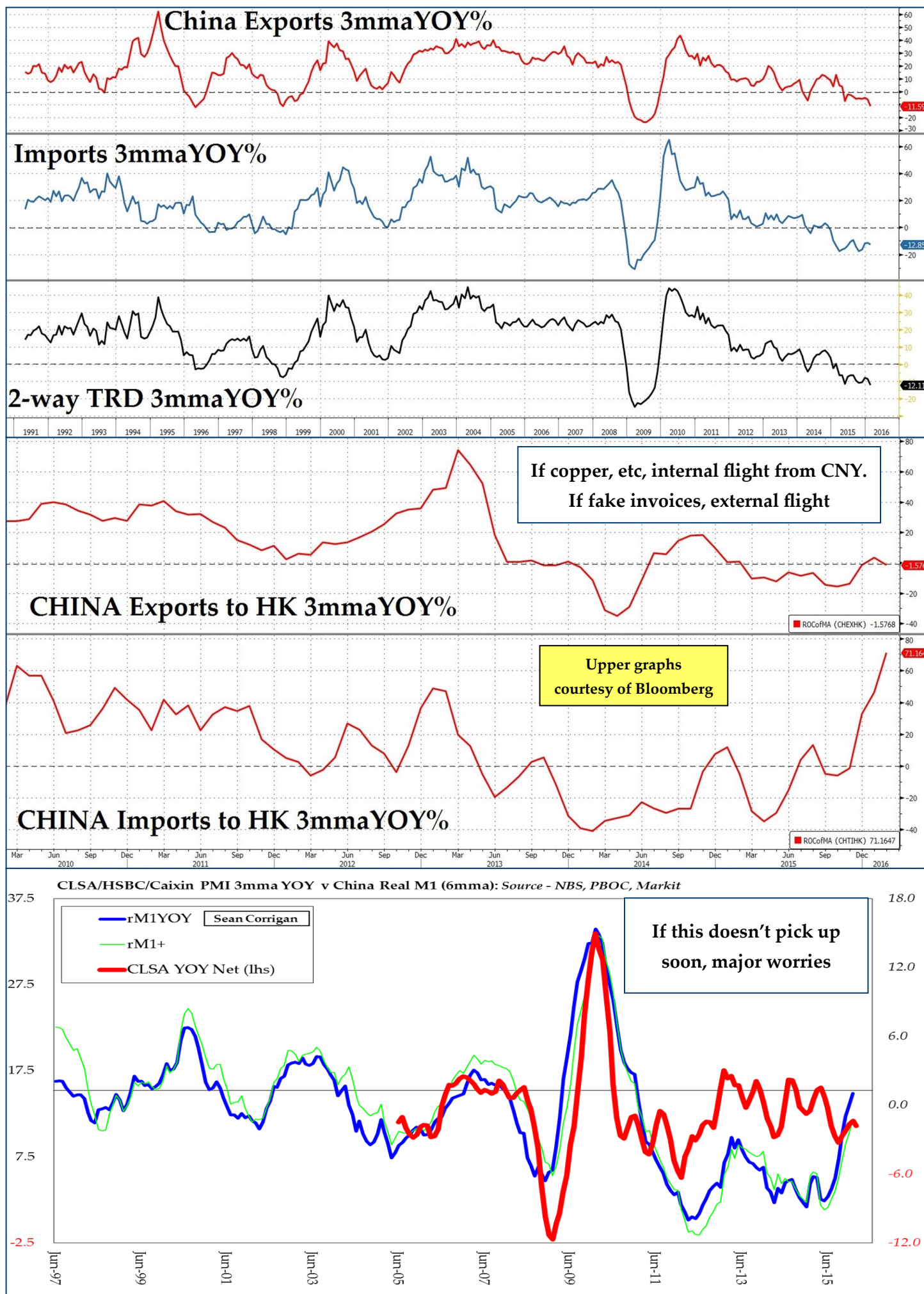
We say this out of regard for what seems so far to be a disappointing reversion to the bad old days of massive state intervention coupled with a frantic rear echelon firefighting exercise as the unintended consequences of much of this policy start to take on a life of their own.

If there is one thing the news from China repeatedly exemplifies more than anything, it is the irrepressible nature of human ingenuity in the face of both opportunity and restriction—whether this takes the form of outright criminality or simply of a rather more laudable ingenuity in finding ways to do what one wants to do regardless of whether one's overlords formally permit one to carry out the activities in question.

Thus we have see the sometimes explicit encouragement of a renewed fervour for real estate with campaigns to outlaw loans which are intended to meet the statutory minimum deposit stipulations. We have had much talk about how relaxed the authorities are over the drain of funds abroad and promises of further 'opening up' combined with superstar legal blogger, Dan Harris, insists is a radically new zeal to prevent money from being transferred out of the country.

Then we have Premier Li announcing untold \$billions in new investment plans while insisting that this is not 200910 all over again but a different KIND of state spending altogether. Monetary and fiscal loosening have been announced while the pretence at a maintenance of discipline has been practiced relentlessly.

For example, the present budget deficit, we are told, is a fairly modest affair and so can prudently be increased to the international 'norm' (do they mean the dead-letter Euro Stability Pact 'norm', one wonders?) of 3% of GDP this year. Except that 3% seems to have been calculated on an expanded total which might be hard to accomplish and, in any case, this brave show of fiscal modesty belies the fact of the titanic shortfalls which plague all those entities whose dealings are explicitly or implicitly underwritten by Beijing, such as the bankrupt lower government tiers and the ailing industrial behemoths among the SOEs.



Then there is the genius idea of bundling up and selling on bad debts as asset-backed so as to 'free up' bank balance sheets. In a narrow sense this might be sound enough—it being better to soak up money supply that way than have everyone pretend their bank deposits have some genuine backing, either from the corresponding assets themselves or from a scanty veneer of bank capital—but the truth is that the authorities will not resist the urge to allow these securities to become leveraged, just as they did when messed up their Mississippi Bubble 2.0 stock market debt:equity swap and as they are going to do this year gain vis-a-vis local government debt, on an even larger scale than last year.

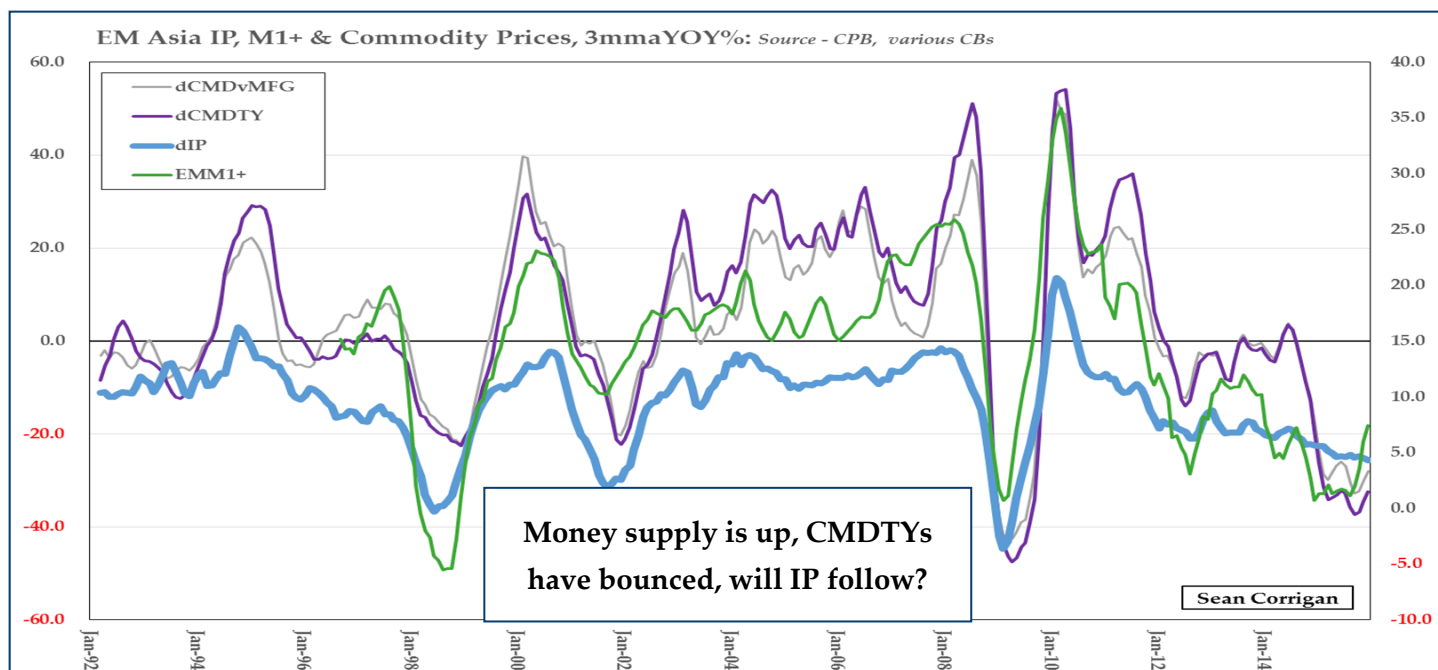
Add to this the wizard idea that banks will be permitted to take equity stakes in companies in return for their unserviceable debts. This is again something which often better recognises the reality of the situation and does indeed offer both lender and borrower a certain extra degree of flexibility, as well as better aligning their shared incentives, in working out the latter's problems, but the devil is very much in the detail.

The worrying sign is that Beelzebub is indeed to be found lurking in the small print. We say this because the press articles in which this plan has been foreshadowed have also been keen to underline that such swaps will mysteriously 'free up' lending capacity at said banks when all these are doing in truth is taking an unrecognised bad debt and shuffling it across the balance sheet to a much more junior position in the credit hierarchy where it would still serve to tie up bank capital absent a more indulgent treatment of said capital on the part of the bank's regulators or, heaven forbid, a move by the People's Bank to accept such shareholdings henceforward as collateral in its repo operations in a manner in which the original loans were not.

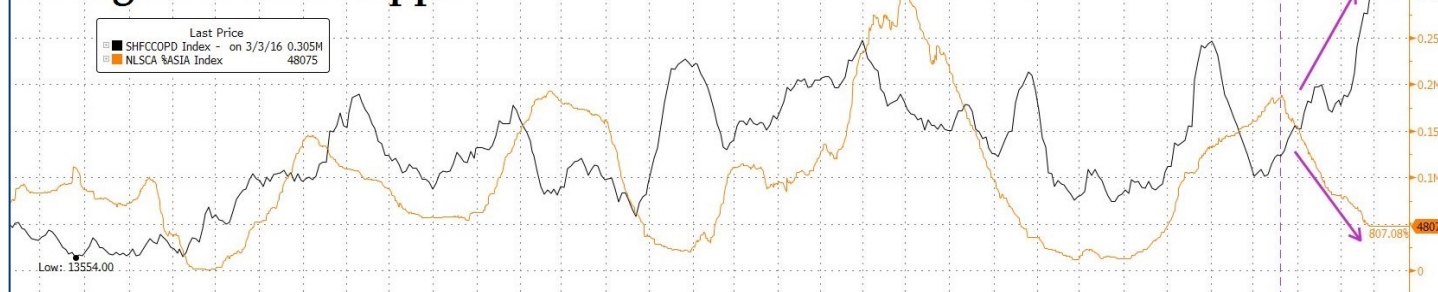
The layers of confusion and complexity grow ever thicker even if all the market has wanted has been simply to read 'STIMULUS!' into every headline sending its members either scrambling to cover shorts (steel and iron ore?) or even to start stockpiling physical material (copper, for example) anew.

Better not to get carried away just yet but to wait and see not only how bold policy pronouncements translate into action, but also what the full first quarter data run suggests

might be happening, away from the usual distortions associated with the moveable feast of the Lunar New Year. It will be a long couple of six weeks until they arrive.



Shanghai v LME Copper



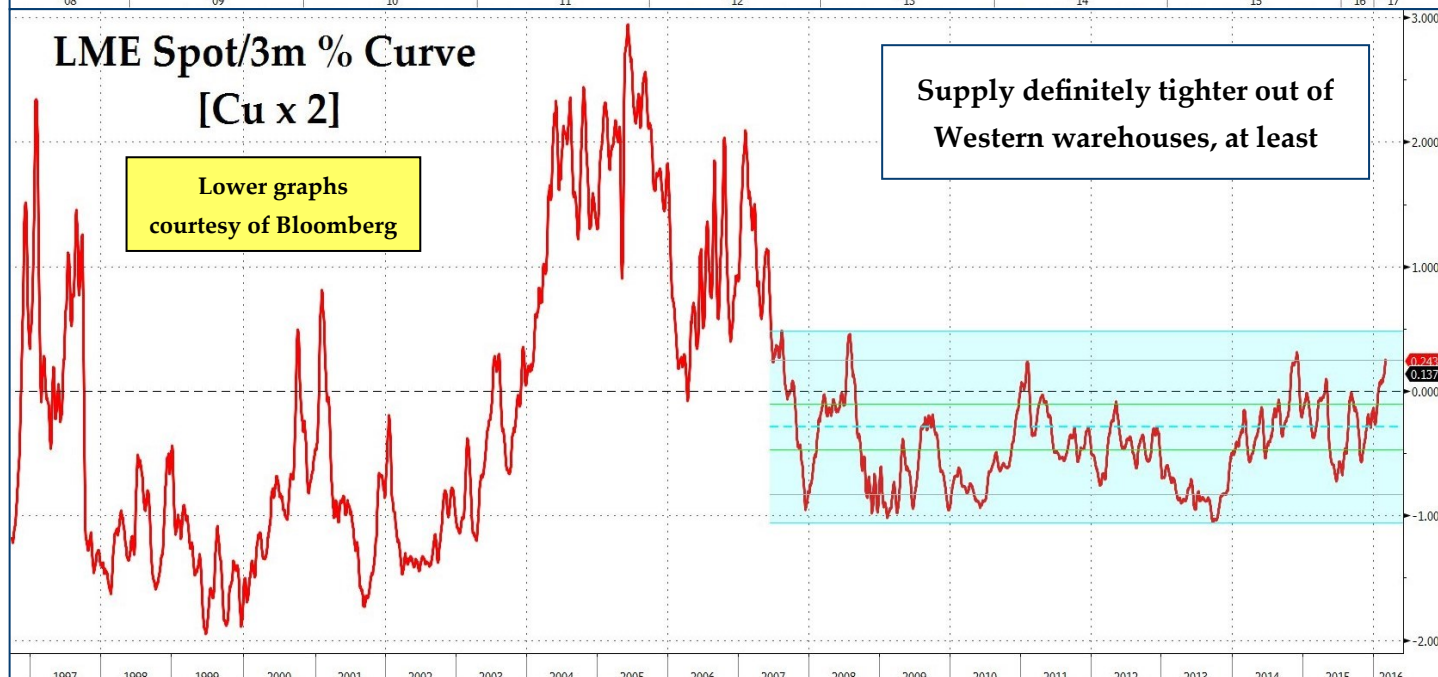
For use, or for Reg Arb?



LME Spot/3m % Curve [Cu x 2]

Lower graphs courtesy of Bloomberg

Supply definitely tighter out of Western warehouses, at least



DRILLING DOWN: Thoughts on the price of oil

A few weeks ago, the village fete palm-readers at the IEA warned us not to be seduced by ideas of a 'false dawn' in energy prices: today they have shifted clichés to talk of a possible 'light at the end of the tunnel'.

Once again, we seem to have encountered the curse of 'forecast by six-inch rule' — the pervasive tendencies for prognosticators to project the latest trend forward into the future and then to think up what are not so much post hoc as *pre hoc* rationalizations of what is underway in the world.

Oil (GOOG, JGBs, JPY, delete as applicable) has been moving higher, markets are rational, therefore there must be a reason (even if that reason is that hoary old logical impossibility, 'more buyers than sellers'); that reason is not entirely ephemeral, ergo oil will move higher still. You know the score.

In the IEA's case, the positive gloss has been more the result of reworking the numbers, it would seem and as such reinforces the other great rule of commodity investing — namely, that the 'fundamentals' are largely a fairy story concocted from paying inordinate attention to the tiny, residual difference between two much larger, numbers with error bars the size of a central reservation guardrail/

In this case, the IEA managed to up last year's increase to 1.8Mbpd from 1.6Mbpd meaning the embarrassingly large 'missing' barrels surplus has been somewhat reduced. Surprisingly, in light of the gloomy IMF macro outlook off which they base their own estimates, 2016 should still see another 1.2Mbpd demanded if the agency has it right.

Non-OPEC supply is said to drop 700kbpd this year, largely due to US shale cutbacks, while, on the OPEC side, a slower than projected Iran ramp up of 300kbpd YTD has been partly offset by an Iraqi fall of 130kbpd, leading to what its preliminary estimates suggest was an actual global inventory drawdown last month, for the first time since the like month last year.

All very bullish no doubt, but this poses the question of when and at what price those lost American barrels will return to the market.

Our good friends at Tudor, Pickering, Holt wrote recently that its conversations with producers suggested that hedging would kick in once the forward curve poked up above \$45/bbl, something already attained for the second half of next year. TPH argue that if prices were to nose into the \$50s where *'the vast majority of our firm's coverage can*

actually hold production flat with internally generated cash flow'.

For our part, we would not yet be prepared to say this was anything more than a counter-trend rally, aimed at finding the threshold at which long-term, more patient sellers alter the balance of supply and demand in decisive fashion and so set what will either be the upper end of a new trading range or the start of a renewed trend lower but, in either case, a milieu in which one must be looking for opportunities to sell alongside the Big Fish, not buy along with the minnows as has been the case these past few weeks.

As for hedging activity, we may glean a few clues from a volatility skew in the back months which has gone heavily negative on this latest run-up, principally because put vols have stayed elevated even as there has been a drop in the price of calls. With ATM vol being closely inversely correlated to the spot price ever since the sell-off first began in summer 2014 (i.e., the distribution of absolute movements has remained fairly stable, making the proportionate ones on which vols are calculated come out higher as underlying prices have declined), this suggests that hedgers are indeed beginning to sell calls in order to finance the necessary puts.

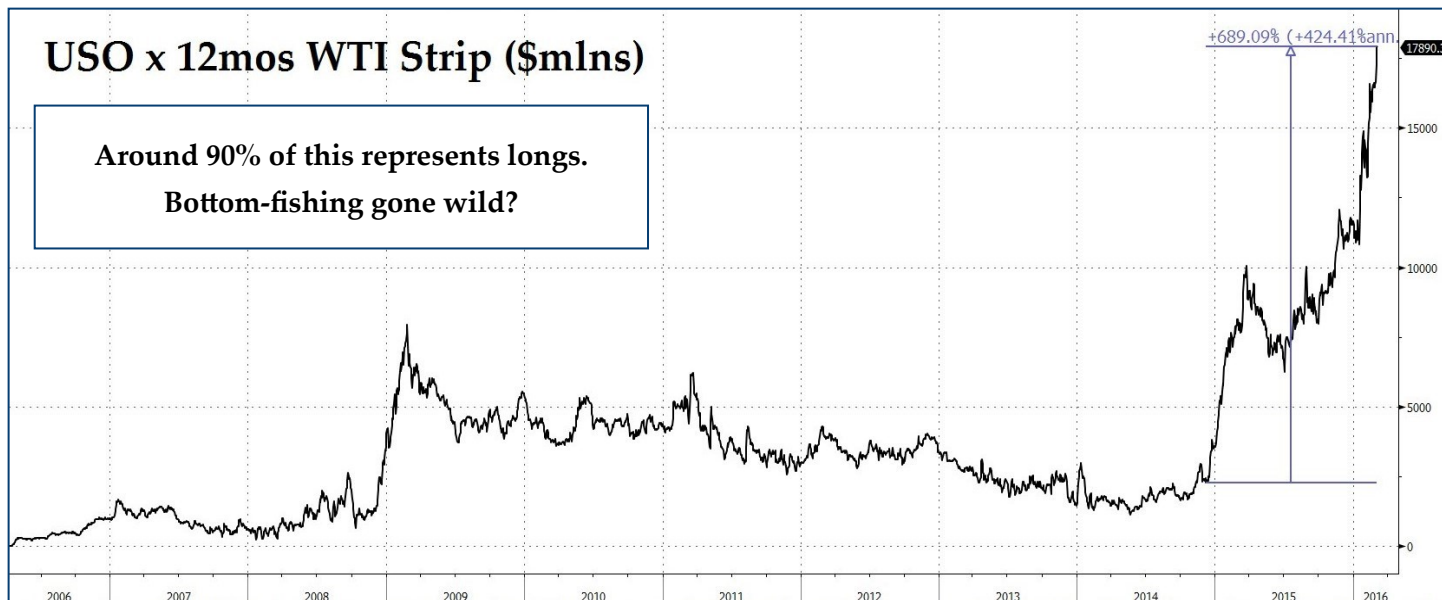
Whether this will be enough to cap the rally remains to be seen. Certainly ownership of the USO ETF is extremely elevated despite falls in the past three weeks while the delayed data to end-Feb suggest that short covering has been responsible for some reasonable part of this. COT data show a similarly mixed picture with spec shorts dipping as spec longs remain near record highs. Conversely, the Brent data from ICEX shows non-producers cutting shorts AND adding longs so that both the latter and the net stand at record highs in what is admittedly only a five-year run of data.

Ultimately, this still feels like the Mo traders are being forced out of what were easy money shorts taking the market into areas where those who actually get their hands dirty will be more than happy to hit the bid and so help keep the black stuff flowing.

One final thought to leave you with. The latest EIA data for natgas production shows a far less noticeable production decline than the agency had first reckoned upon, despite the plunge in rig counts to the lowest recorded by Baker Hughes in its 29-year sample. The reason can be no other than sharply better productivity. Could oil do the same?

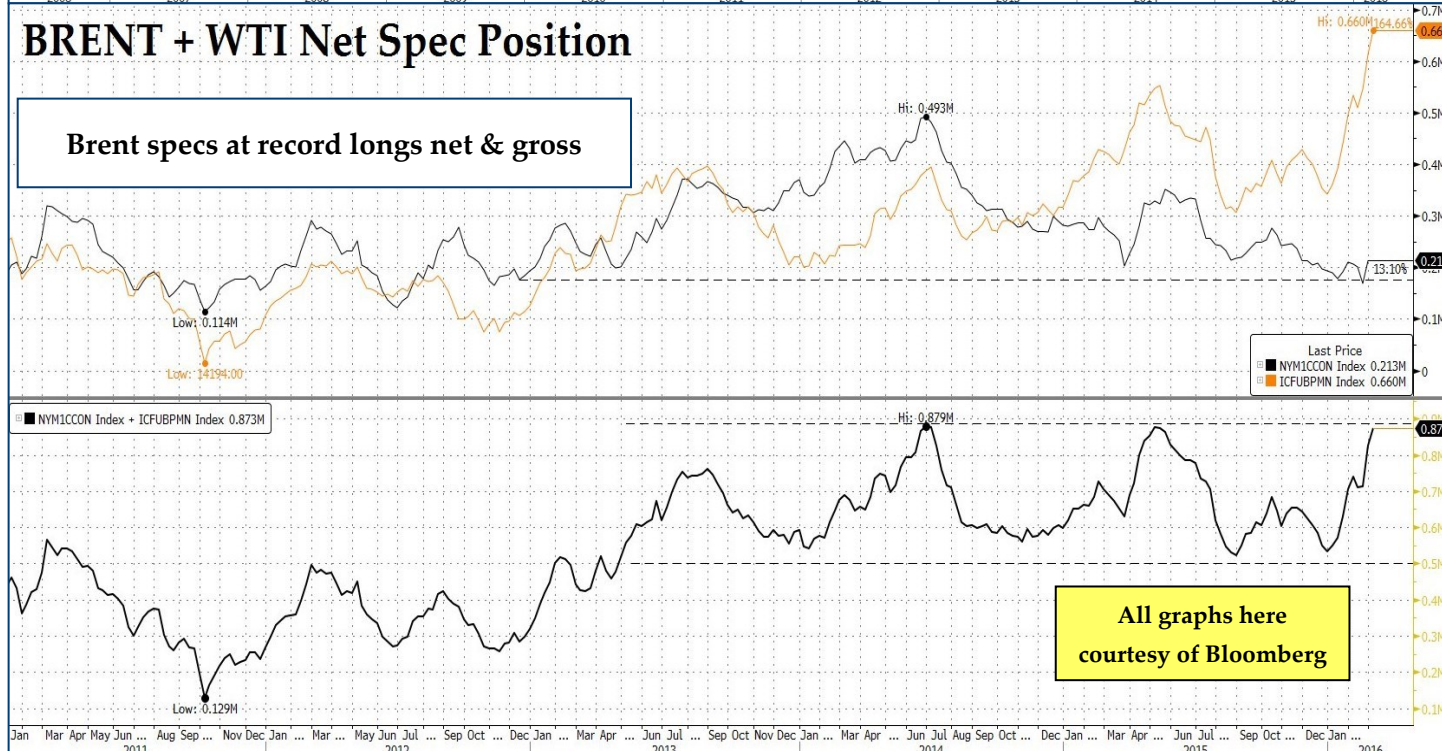
USO x 12mos WTI Strip (\$mlns)

Around 90% of this represents longs.
Bottom-fishing gone wild?

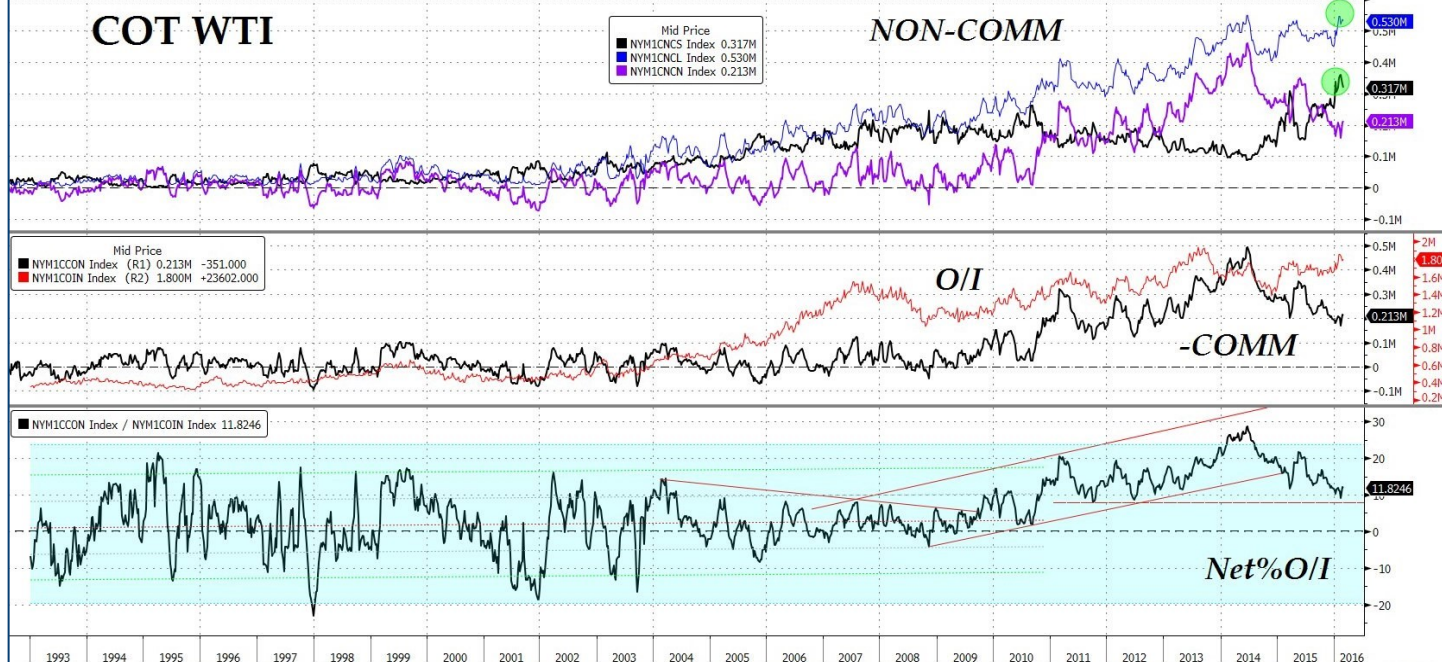


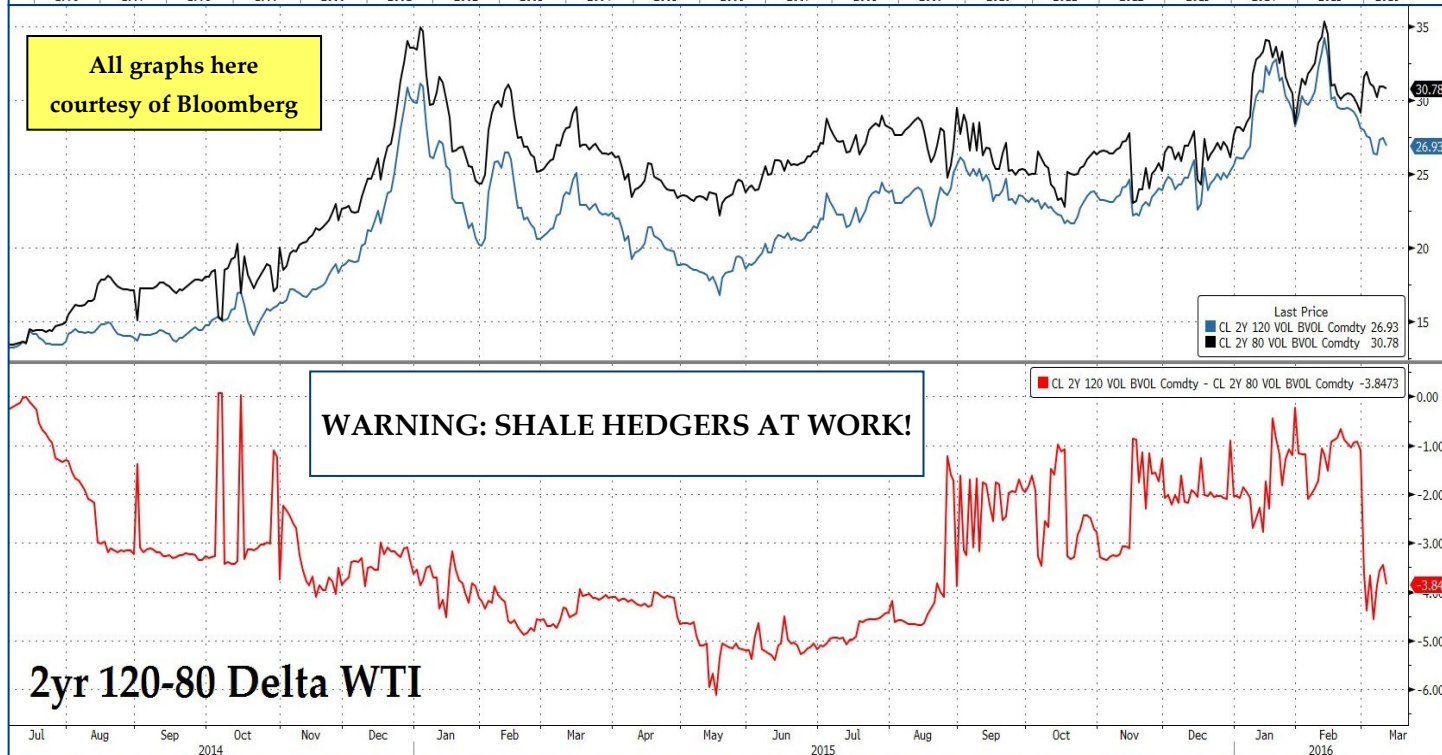
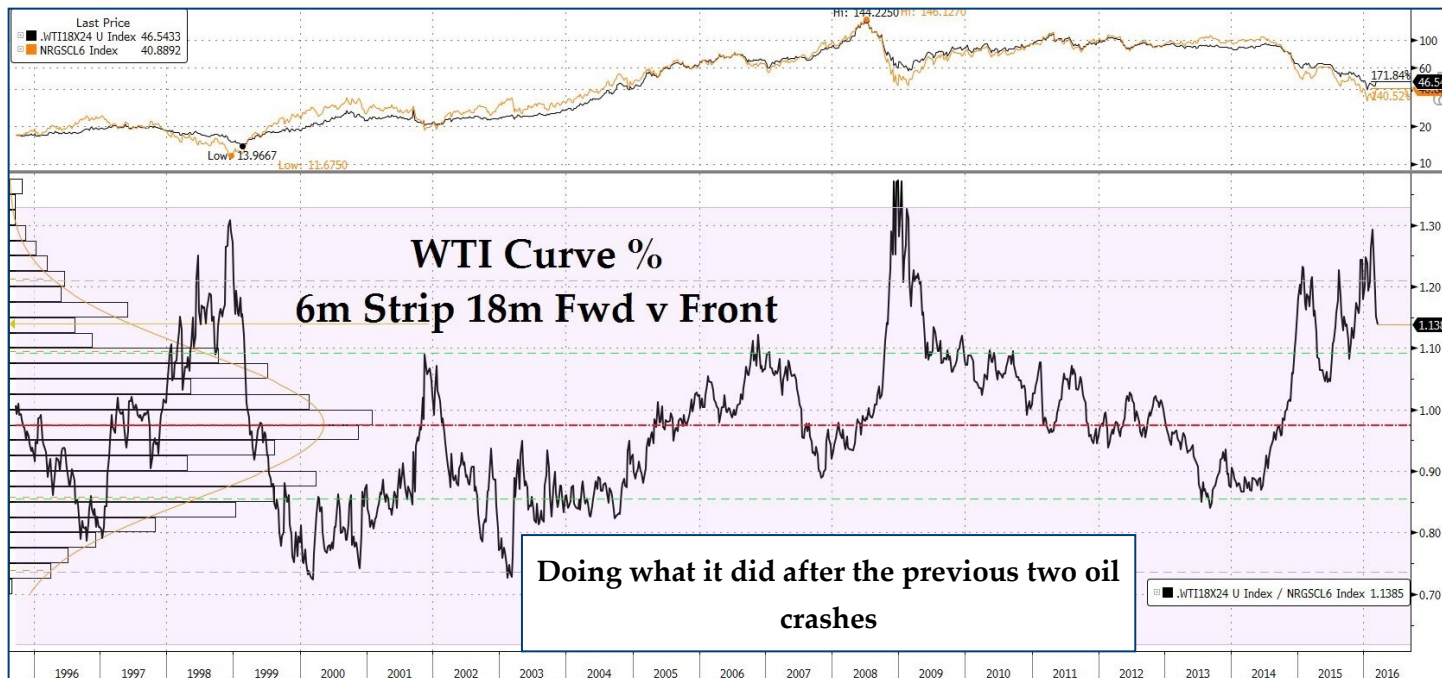
BRENT + WTI Net Spec Position

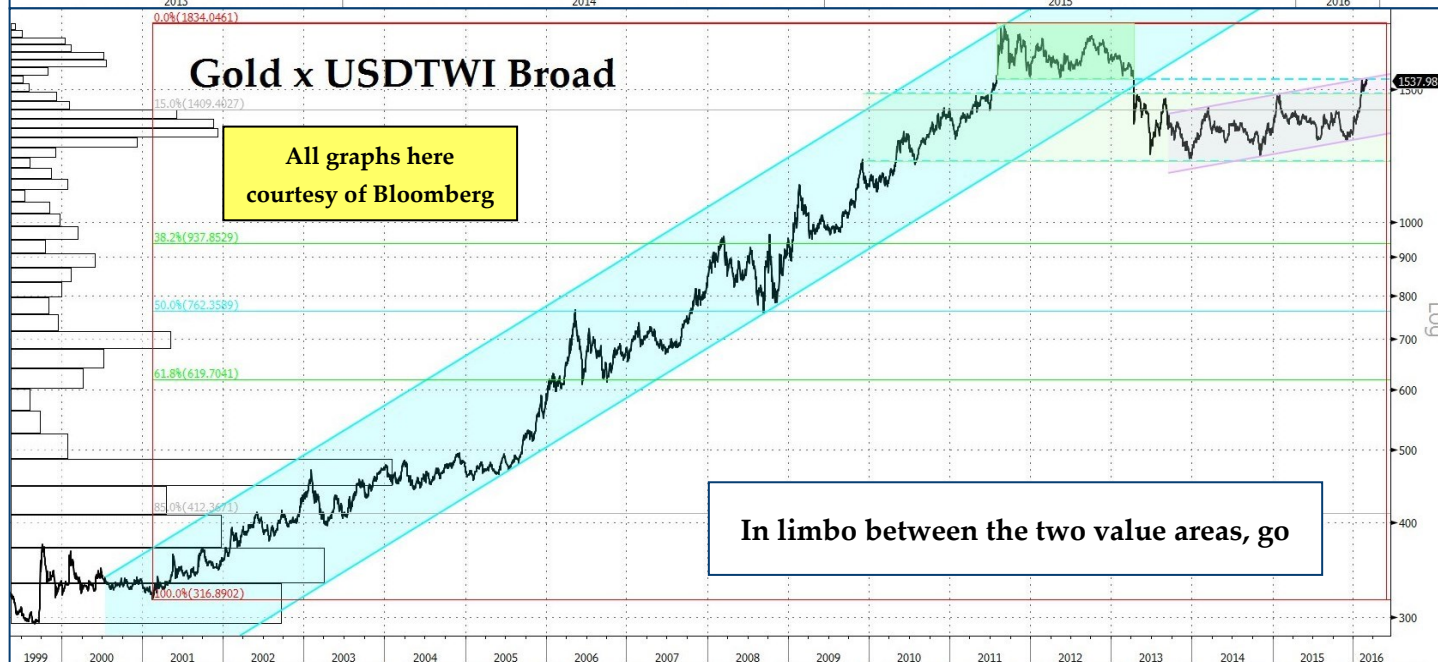
Brent specs at record longs net & gross

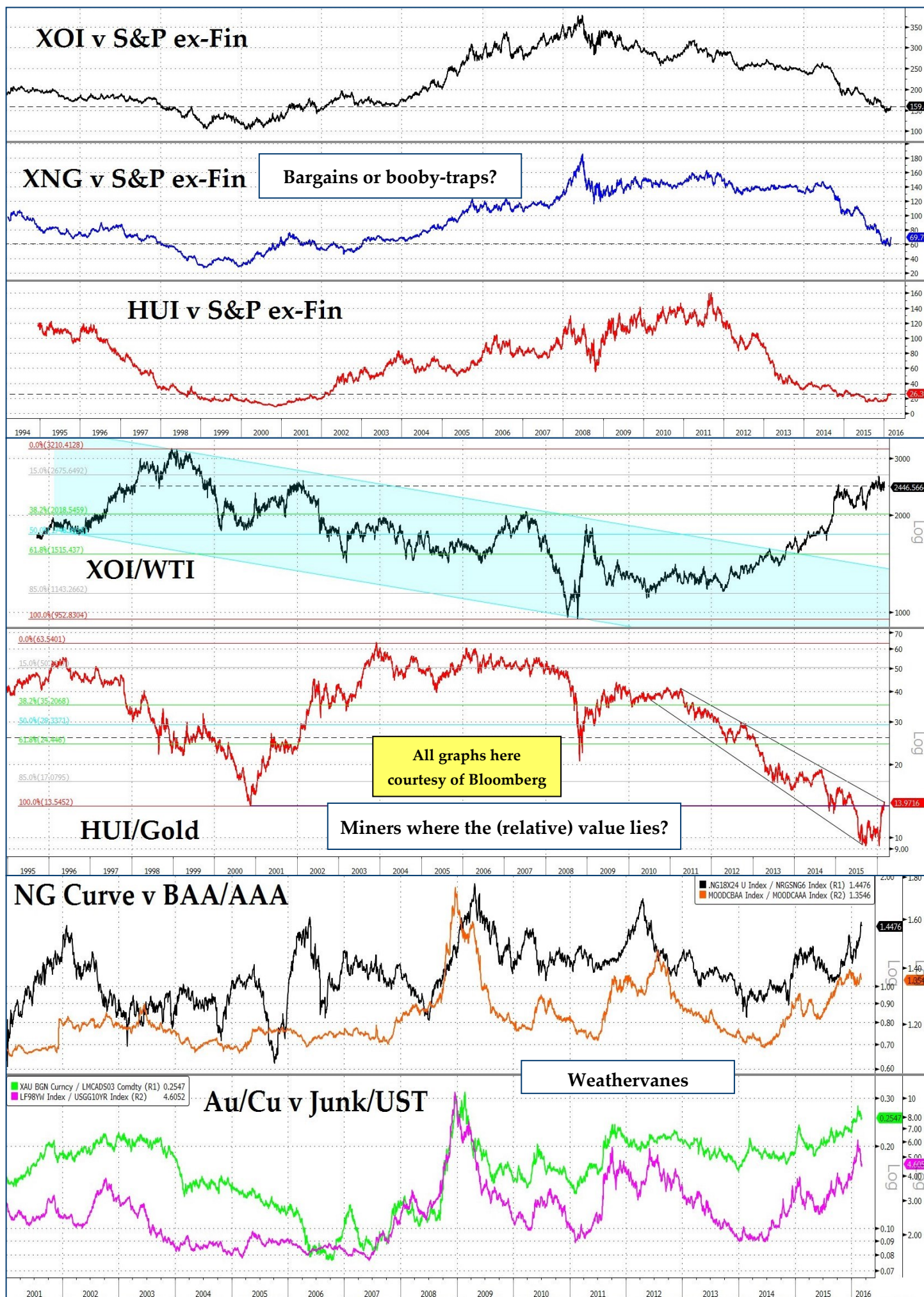


COT WTI







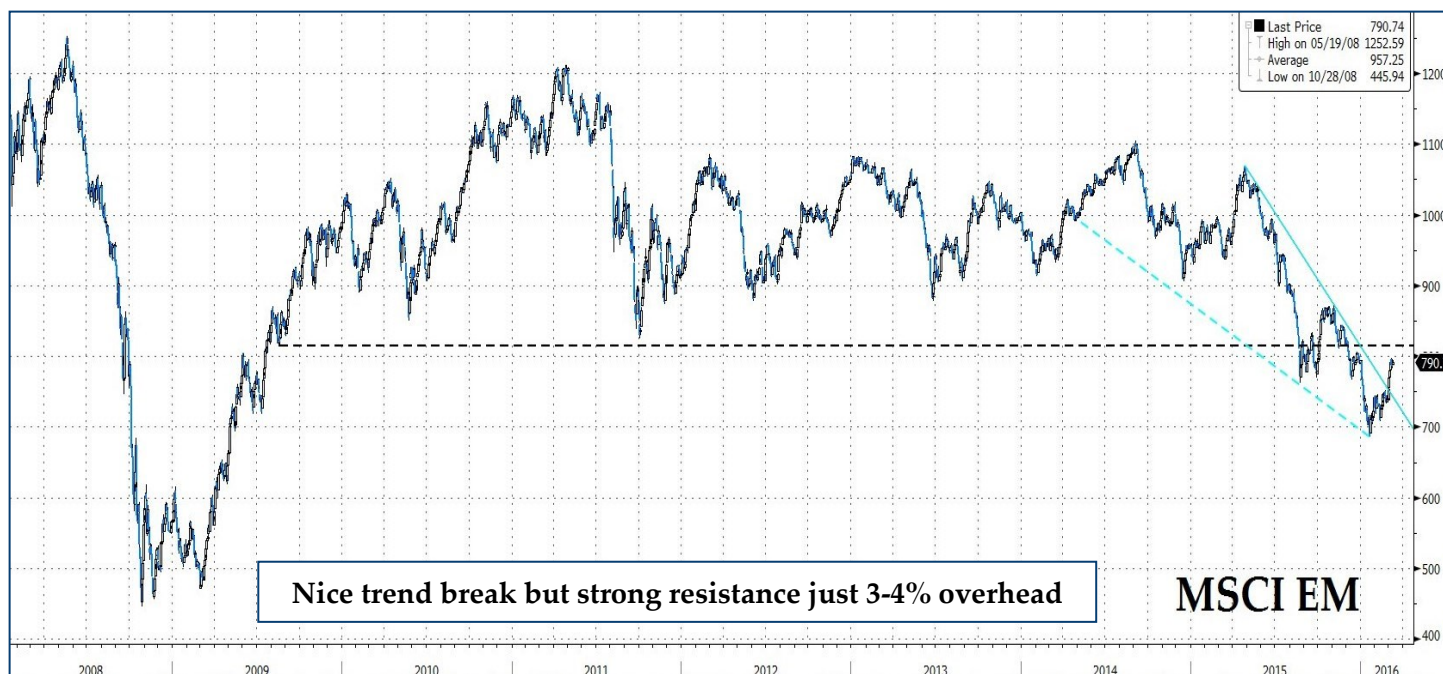


TOPIX v MFG Sales & M1, 2000 = 100: Source - Bloomberg, METI



DAX v Estimated Revenues: Source BUBA, IMF, Bloomberg







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