



Let My People Go!

Faced with a world which stubbornly refuses to conform itself to either their flawed computer models or to the mental prejudices encoded therein, the Good and Great are once more casting about for extreme, top-down, geo-engineering fixes to a mess they themselves have largely created. Central bank monetization of infrastructure spending is one such proposal – it has worked out *so* well in China, after all! Another is the already tiresome concept of ‘helicopter money’ – a kind of democratization of inflation for the App World which is somehow supposed to be free from all unfairly redistributive effects and thus to run no risk of being either self-defeating or self-exacerbating in its action. Finally, there is the dream held by the commissars and cranks alike of taking away our cash and so making us even more susceptible both to total surveillance and inescapable economic compulsion.

Sadly, it is still all too unfashionable to suggest as an alternative the approach of what Fritz Machlup, writing in the Thirties, called ‘*Auflockerung*’ - i.e., a broad-based loosening up of economic inflexibilities, followed by a determination to forego all further heavy-handed intervention. Clearly this is not a strategy likely to appeal to the Draghi’s and Kuroda’s of this world, men who want to reorder the Cosmos every month or so out of impatience that their serial acts of social violence have not yielded sufficiently dramatic returns in the few, short weeks since last they perpetrated one.

It is all too easy for such grand tinkerers to get hung up on the ‘if *A* then *B* but we want *C*’ shuffling of modern macro (which is far too mechanistic and zero sum a doctrine) and thereby to mire themselves in what looks like a maze of intractabilities, worst-case scenarios, and jarring dead-ends. The perverse beauty of such self-frustration is that then appears that the escape from it requires some bold, new, Gordian knot violation of the painfully accumulated and slowly refined wisdom of the centuries by the brash new *Novus Homo* in all his unconstitutional vigour. We truly all live in the Age of Blair, if not quite yet that of his infamous predecessor, Robespierre.

The irony is that we have come to appreciate how biology works on the basis of untold quintillions of small local problem solvers—genes, viruses, cells, and organisms—each spreading their every minor success more widely and, yes, altering their environment as they do by dint of their own actions and therefore having to adapt and innovate all over again (Red Queens, and all that). We also use brute force computer search routines, often massively parallel ones, for problem solving and accept that the better that they produce need not be the enemy of the best we might achieve if only we geniuses could take a pencil and solve the infernal Goldbach conjecture analytically.

But instead of allowing humans the freedom to act as analogues of such units of evolution, as economic genes or anthro-bytes engaged in an atomistic, if necessarily interactive, search for local maxima—and instead of giving them a relatively stable, predictable substrate on which to operate—the Planners want both to compel them to act according to the Plan and continually to change the environment in which that same Plan must be carried out.

They capriciously alter laws and regulations; take resources from *X* to give to *Y*; promote this, mandate that, and ban the other at whim—and still expect all the good little ants to carry on regardless. They mess around with the very communication between these ants—by meddling with the formation of interest rates, exchange rates, the availability of money and credit, for example—so that

every calculation quickly becomes unnecessarily speculative, an informational degradation which raises the lergley unobservable, but nevertheless all-important, social hurdle rate by spreading 'uncertainty', to use the overworked universal contemporary cop-out which is a paraphrase of Central Banker Corneal Dystrophy.

The solutions which the micro(economic)organisms produce are usually disdained both because they are 'bottom-up' and because they are most likely to be initially local, limited, and partial. Such scorn, however, overlooks the fact that they may well also then entrain positive network effects, excite emulation, encourage enhancement, and thus act as inspiration for incrementally better solutions to come.

But, none of this 'spontaneous order' rewards the venality, much less the vanity, of either the school-bullied Intellectuals now relishing a certain late-career payback, or of their erstwhile playground tormentors who have since quit the alpha-male cockpit of business or politics for the more august surroundings of the think tank and the expert panel. It will not appeal to either the self-made men or the ivory tower idealists, all of whom will tend to the pretensions of the Grand Chessmaster, of the Strategos, of the Modern Prometheus whom they each imagine themselves to be. For they and they alone presume to know how best to still the seething, fertile chaos of the world and set up in its place a Plato's Republic of well-ordered sterility.

As an astute if cynical commentator of foreign affairs observed the other day, *'Nato's principal mission is now to protect its members from risks which only Nato's very existence brings into being'*

So it is with the Philosopher Kings of the Fed, the IMF, the ECB *et al*, the tiresome meddlers of macro.

Sean Corrigan

Much airtime has been given of late to the phenomenon of the UK current account deficit, generally by those trying to insist that, despite its plunge to record outright and percentage lows, it is either just a trivial side-effect of the influence which a few misplaced overseas mining holdings have had on the investment income account, or that it is in fact a *good* sign because it is being *caused* by Johnny Foreigner's insatiable appetite for UK assets and hence his implicit vote of confidence in UK plc.

It is true that one must not be too mechanical—and hence too crassly mercantile—about how one treats such deficits. If I, as an individual, am at that advanced stage in my life where it seems better for me to maintain a certain material standard of living—perhaps in my retirement years—by progressively liquidating my capital endowment, that is my choice and mine alone, even if I must always bear in mind that such a process is necessarily finite and possibly irrevocable.

Similarly, if my company needs to make a large investment in new plant and equipment so that it can better maintain its place in the market or improve its chances of delivering profits, no-one will look askance if I turn to the bank or the capital markets for the necessary funds with which to effect this refurbishment.

In either case, it should be obvious that I—or my firm—are running the equivalent of a current account deficit and that this is being balanced, as it must be, by an equal and opposite capital account surplus. In the first instance, this takes the form of a reduction in my stock of assets, in the latter of an increase in my total of liabilities. Of its self, neither the first nor the second is inherently foolish or in any way reprehensible.

If, however, I am simply engaged on a Rake's Progress to libertine ruination—if I am spending well beyond my budget on non-productive ends and not only selling the family silver to meet the bills but issuing my IOUs to all and sundry in addition—then clearly matters bear a much less benign construction.

Scaling up from the particular to the general, the team at RBS (who seem to have been so pleased with their analysis that they have hardly ceased pushing it on social media these last few weeks) have made a great deal of noise about

the fact that much of the recent worsening has come about—as, in fact, the ONS itself explains at great length—because of a near halving of the rate of return on foreign direct investment assets from 8.1% in 2011 to just 4.3% last year. This meant that total earnings fell from £105bln to £60bln in that four-year stretch, with a disproportionately large amount of the decline (£21bln, or 45%) being attributable to Britain's multinational oil and mining companies.

FDI payments, meanwhile, rose from £51bln to £63bln as a 40bp fall in returns was offset by a one-third rise in liabilities. This was enough to swing the balance from a positive 3.2% of GDP to a rare, negative one of -0.2%.

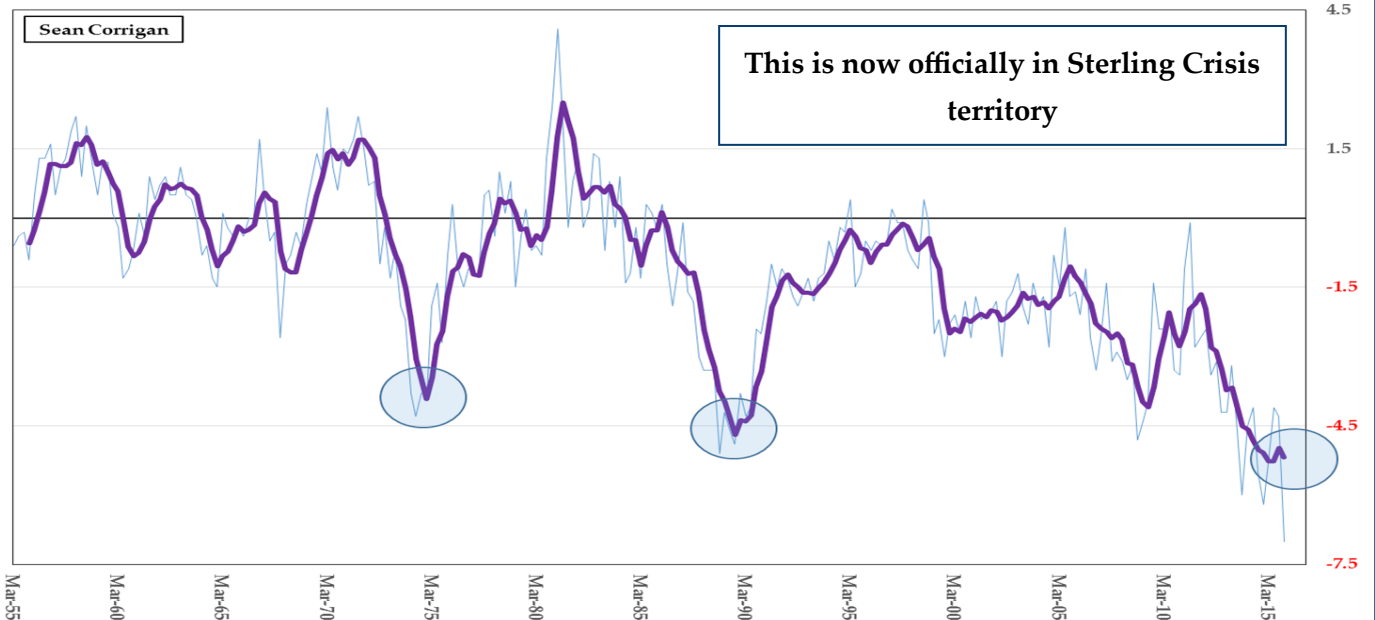
Now it may well be argued that this represents a one-off adjustment and therefore gives few grounds for further concern. That may well be the case, but it is also somewhat beside the point. For what you or I most often do when confronted by a large drop in our income is to seek to curtail our outlays. Britons—taken on the whole—have clearly done no such thing, hence why the current account shortfall has more than tripled from 1.7% to 5.2% of GDP over the period.

As for the other approach, the idea that the UK runs a current account deficit *because* the rest of the world hungers after its assets is to elevate a balance sheet tautology into a spur for tens of billions of pounds of transactions affecting billions of people. This is to argue that if a man with a strange accent knocks on your door one day and says, '*I want to own your house. Please accept the contents of my van as a payment,*' you have no option but to comply with his demands

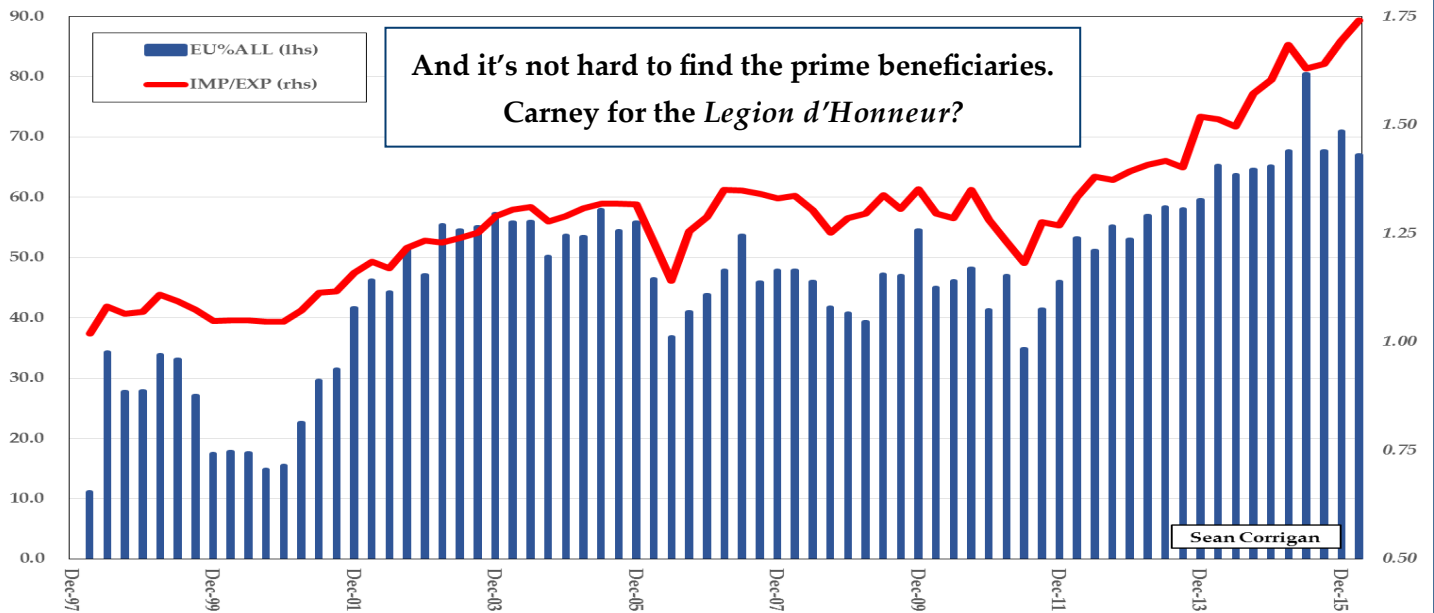
It is not to be denied that, since it is an inherent property of the balance sheet that it must balance, a shortfall in the flow of goods and services must be matched by a surplus of monetary receipts somewhere among the property entries, but if we want to see which is the driver and which the driven we need to take a backward pace or two.

A few salient facts need to be recognised first of all. Firstly, it is the case that these past four years have seen a rise in new vehicle sales of almost two-fifths (at an 8.1% CAR, if you will forgive the pun), a rise which—when extended into the first quarter of the current year—has so far culminated in the second highest ever monthly total, and the absolute pinnacle since registration numbers shifted, 18

UK Current Account as % GDP, spot & 4qMA: Source - ONS

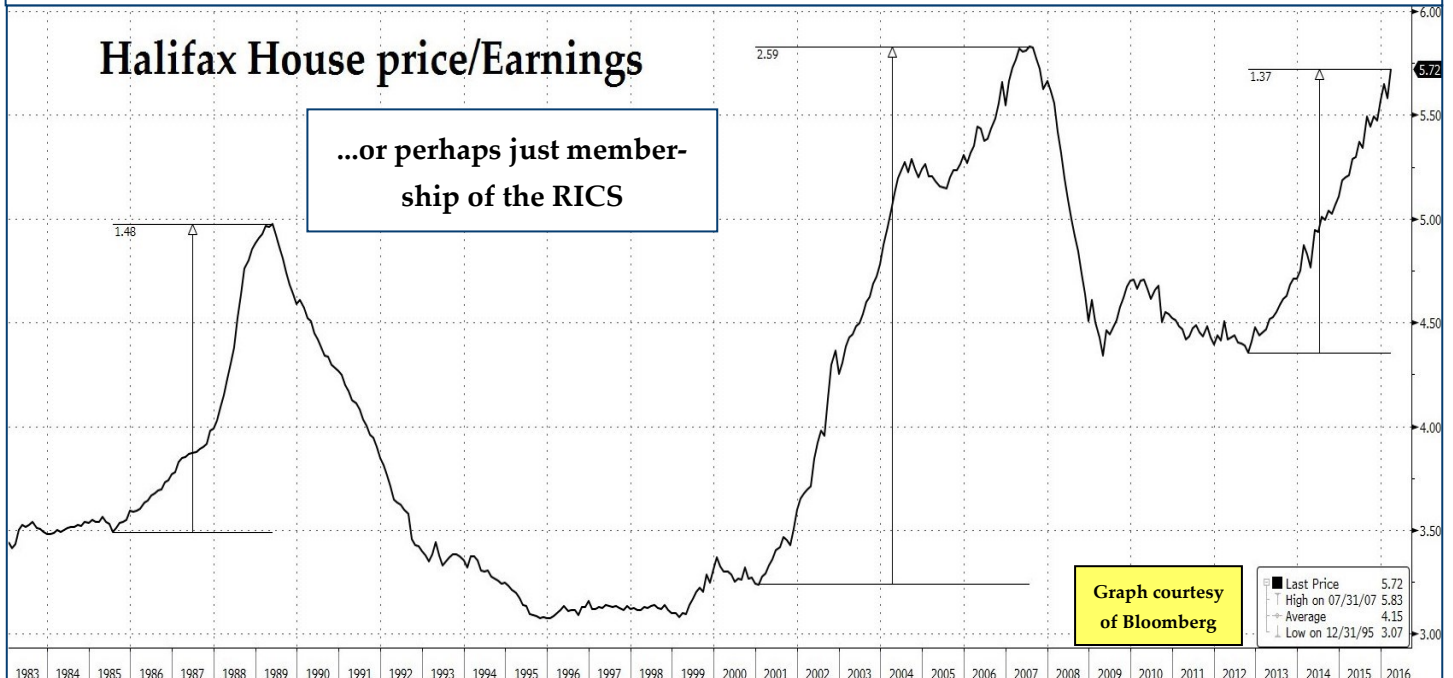


UK Goods Trade Deficit EU28 v All & IMP/EXP: Source - BOE



Halifax House price/Earnings

...or perhaps just membership of the RICS



years ago to a semi-annual from an annual changeover.

As Mike Hawes, chief executive of industry body, the SMMT, commented, '*continuing strong consumer confidence and low interest rates, meaning attractive financial packages,*' were a major factor in amplifying both the plate change effect and the broader boost arising because '*...the car replacement cycle is also kicking in with people replacing their cars after three or four years.*'

Keep that interest rate thing in mind for now.

Similarly, UK mortgage approvals—if still well below 2008's towering peak—have nonetheless risen 80% above their 2009-12 average, climbing over 30% in just the past year. House prices—as measured by HBOS—are moving up at a 10% annual clip. Whether in real or nominal terms, or when compared to the wholesale benchmarks off which the mortgage interest rate is set, prices have only climbed this rapidly in the finally ascent phase of the last two great booms. Since 2013, the price/earnings affordability ratio has expanded from 4.35 to 1 to 5.72:1, almost on a par with the 2007 high of 5.83 and far above the 1989 extreme of 5.0:1.

A House built upon the Sand

Of course, none of this could have come about without an increase in borrowing, exactly as that nice Mr. Carney intended. In all, householders charged £44bln—around 5% of their spendable incomes—to their tab, half of that consideration being devoted to the ancient British pursuit of ownership of a pile of bricks-and-mortar. While admittedly a sum only 40% of the record £120bln contracted in the twelve months leading up to the failure of Northern Rock, this nevertheless constitutes the fastest pace of debt accumulation since the wider calamity befell us all thereafter.

Echoing this creeping reversion, the great British house buyer may still be a good way from engaging in his or her former shiftless practice of extracting 'equity' from their home—i.e., of delaying ever longer the day when they could be said to actually own it, an act of releveraging which set a median rate of 3.1% and a peak one of 5.3% of PDI between 2001-7—but the 3% overall pay-down recorded in the latter half of last year was still the smallest exercise of such thrift since Lehman's demise.

But if *gross* borrowing is not yet running at an incontestably

fast lick—and if it seems therefore to justify the Bank of England's continued, lazy insouciance—the development of *net* borrowing is a much less ambiguous source of worry.

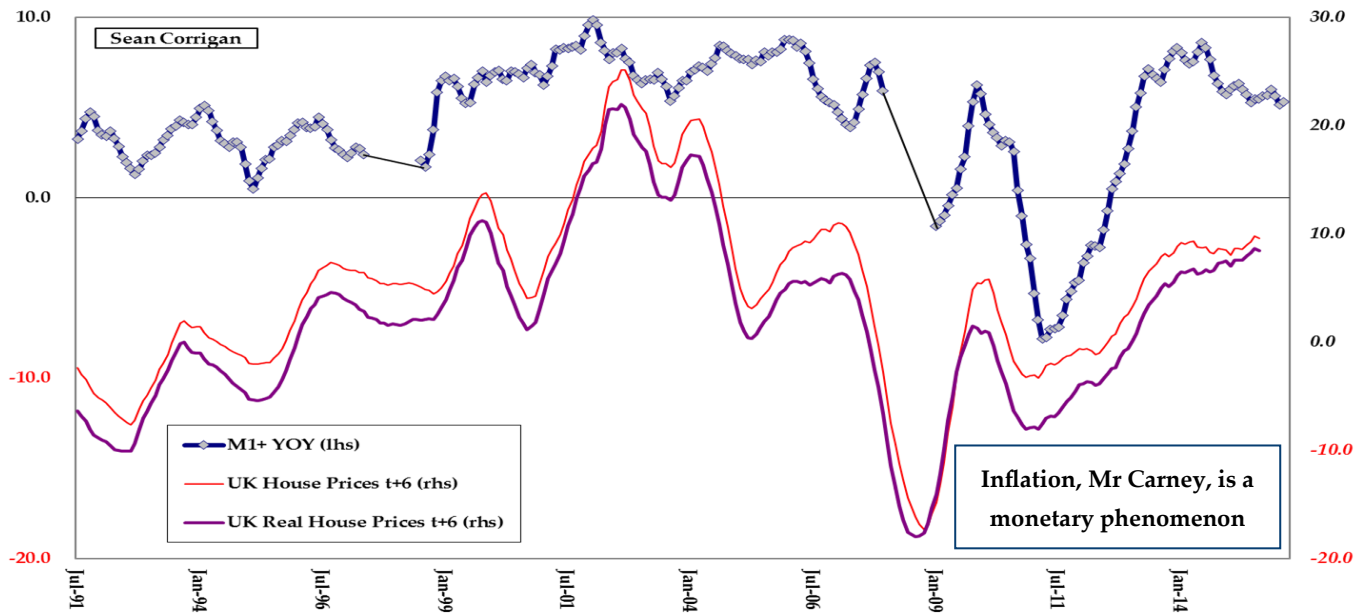
Firstly, note that the official household savings rate has just hit a paltry 3.8%, the absolute nadir of a five-decade quarterly series and a rapid deterioration indeed from 2010's post-Crash prudential highs of just under 12%. In fact, even this measure may not be telling the whole story since the particular calculation which it involves includes several non-spendable increments to income, most notably employer pension contributions.

So, if we look instead at the aggregate net borrowing or lending of the household sector, we find that the net *lending* maximum (i.e., the greatest accumulation of net savings) of £49bln attained in the first half of 2010 has since plummeted far into the red to the point where households were net *borrowers* instead of a hefty £31bln, twice 2007's pre-Crash worst in absolute terms and—at five pence for every one pound of disposable income—50% worse as a percentage, too. That 5% deficit, by the way has finally taken the palm from the Lawson Boom of the late 1980s whose collapse was to sow the seeds for the overturning of the Thatcherite revolution in the ensuing years.

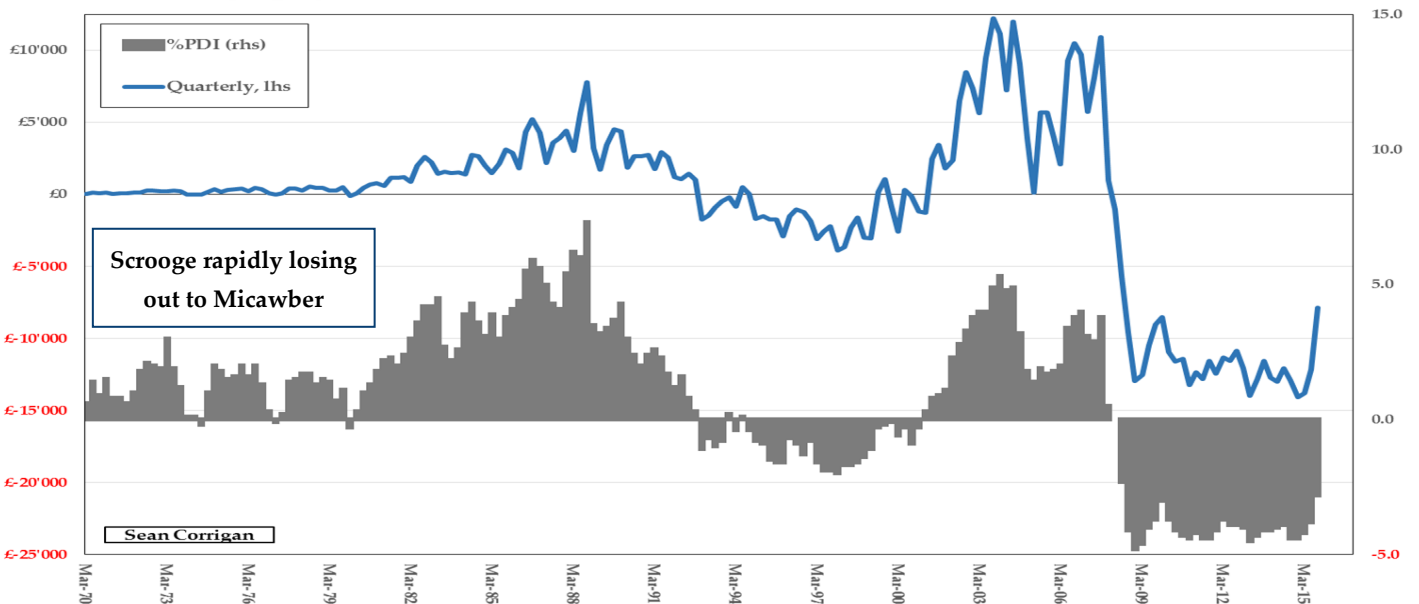
As a final attempt to put this into perspective, one might note that householders have borrowed more (£78bln) in the past 10 quarters than they did in the 10 quarters leading up to the last great crash. To fund the £235bln cumulative current account deficit to which this was a sizeable contributor, Britons sold £92bln of their FDI assets back to offshore counterparties, liquidated £105bln in derivative and ESOP claims, called in loans and withdrew deposits to the tune of £138bln—all of which the ROW settled by withdrawing an equal amount (£334bln) of loans and deposits it had placed in Britain.

As the ROW drew down a further £160 billion from its cash balances to buy FDI and equity stakes in UK companies, (together with a few sundry items such as a little sterling-dampening FX reserve accumulation) the domestic over-borrowing was finally met with a hefty £278bln in securities purchases, the bulk of them presumably prompted by the desire to escape the negative-rate hell of much of

UK Real Resident M1+ v Halifax House Prices, t+6, 3mmaYOY%: Source - BOE, HSBOS, ONS



UK Housing equity withdrawal, mlns & %PDI: Source - BOE



3mma YOY% UK Real Resident AMS v Retail Sales Volume, t+6: Source, BOE, ONS



Europe and Japan.

So Carney fosters a spirit of financial Hogarthianism with his loose rate policy and Kuroda and Draghi help their exporters finance the hunger for goods its excites with their own version. Marvellous! Money illusion, false prosperity, and fictitious capital all round!

What this essentially means is that the UK finds itself today in the paradoxical position whereby householders are not providers, but consumers, of savings and where non-financial industry is setting aside some of its hard-earned profits to helping them consume them even as it, too, raises the most gross funds in the market in nearly seven years. This is not a combination conducive to well-distributed capital accumulation or to the instigation of a virtuous circle of fruitful thrift and a growing material productivity which is not only its due reward but its further enabler.

How the Leopard got his Spots & the Lion his Debts

Back in the immediate aftermath of the crisis, the government was borrowing a near incredible £160 billion a year – equivalent to around £50 per capita *per week*. At that time, financial corporations were effectively square; their non-financial brethren were funding Big Brother to the tune of almost £60 billion; households were chipping in another £75 billion; and the Rest of the World was rounding things out with around £30bln (i.e., that was the size of the current account gap back then).

Today, Leviathan is much less ravenous—if still far too self-indulgent this far into a recovery—and so devours ‘only’ half what it did in the dark days of 2010. Householders—partly squeezed by the extra tax-take, the escalating green levies to which they are subject, and the mounting administrative costs required of them, but yet unwilling to forego the good things in life—are, as we have seen, borrowing about half of the amount that the state no longer takes up. Non-financial corporates, meanwhile, have seen their net addition to the pool fall by a half to £30bln—in part because of that same drop off in foreign receipts which we have dealt with above. This loss effectively negates a further 3/8 of the partial economies effected by the government. Finally, non-financial corporates are now net borrowers themselves, if only to the tune of around £10bln at

the last count, a sum just enough to cancel out the last sliver of George Osborne’s lop-sided ‘austerity’.

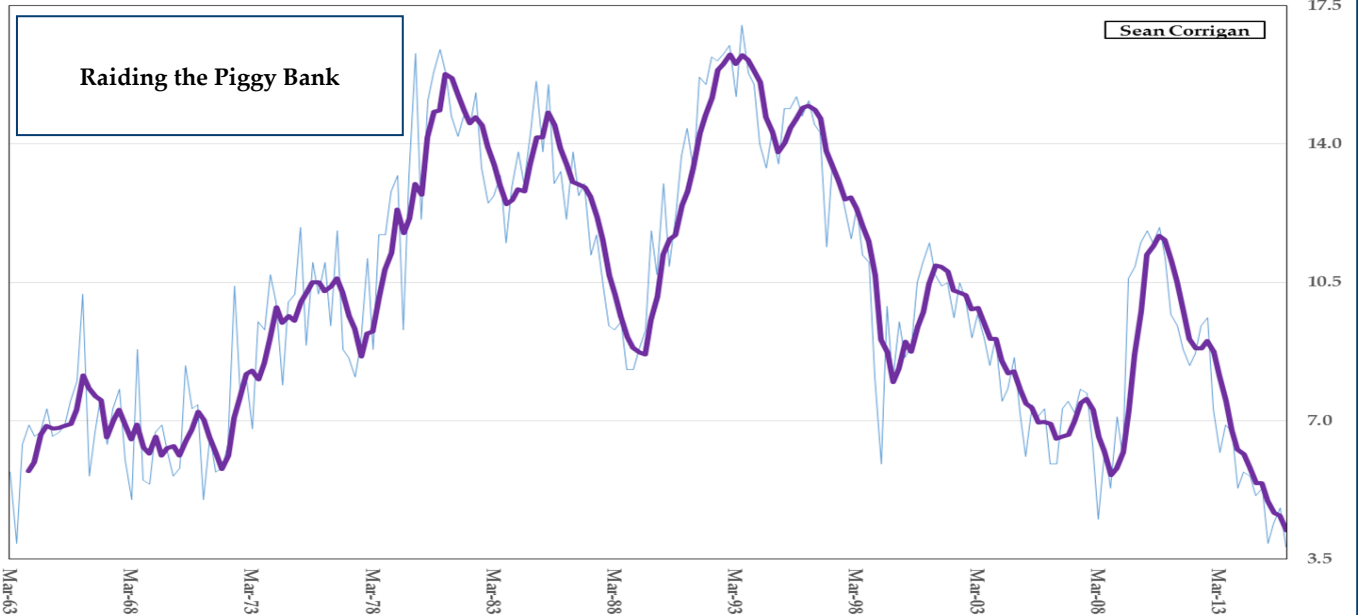
And so who makes up the difference, the 6% of GDP that the machinery of warfare, welfare, greenmail and red tape insists upon? Who plugs the 2.6% gap of a household sector facing, on the one hand, the huge disincentives to saving presented by negative real rates and a never-ending series of pensions raids and, on the other, the alluring, siren call of a shiny new motor to be bought on the easiest of terms before sitting pretty, parked in the driveway of that ever-appreciating Des. Res. one has just stumped up for ahead of yet another round of tax and regulatory shifts?

Who makes up for the fact that the corporate sector—which should, in an ideal world, be using others’ savings for productive ends, not offering its own up for consumptive sacrifice—can now barely scrape a third of what its own customers need to borrow? Yes, you guessed it, those kindly foreign gentlemen who are oh, so eager to acquire the title deeds to this Land of Cockaigne.

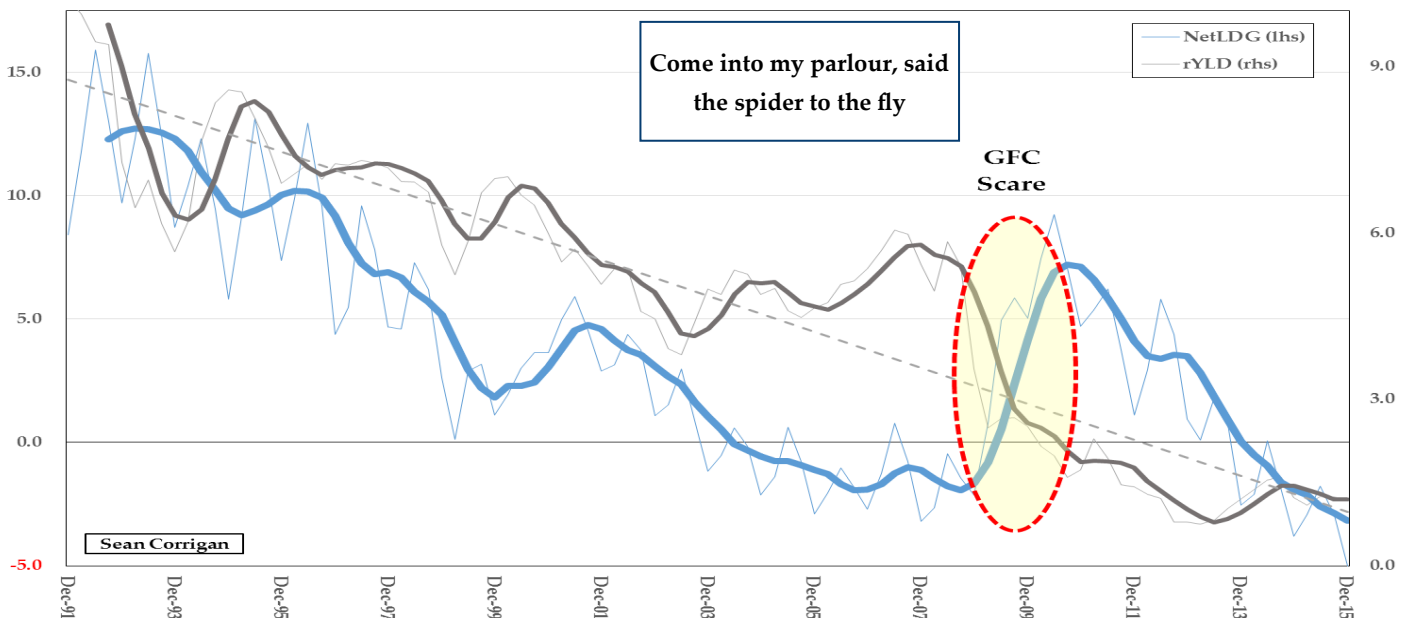
It has been a long journey from the first paragraphs of this piece but what we are now in a position to conclude is that:

- a) continued, historically-elevated levels of government incontinence are responsible for the bulk of the over-spending, as they have been for over a decade now;
- b) that Mark Karney’s Circus at the BOE have not only greatly assisted in birthing but nurturing well beyond its natural span this productivity-killing, politically-enervating, socially-demoralising fiscal beast (imagine how great the imperative to reduce debt costs the honest way if we had both unsuppressed real interest rates and no 25% round-robin, zero-cost monetization of the outstanding stock by the Bank to further attenuate them);
- c) that those same low real interest rates imposed by devotees of the wicked cult of Under-consumptionist ‘demand’ management have once again inveigled the plain, honest folk of Britain into living increasingly on the never-never while blindly relying on rising house prices to make good the hole in their finances;
- d) that, as a consequence, the country is more reliant on the kindness of strangers than it has been perhaps

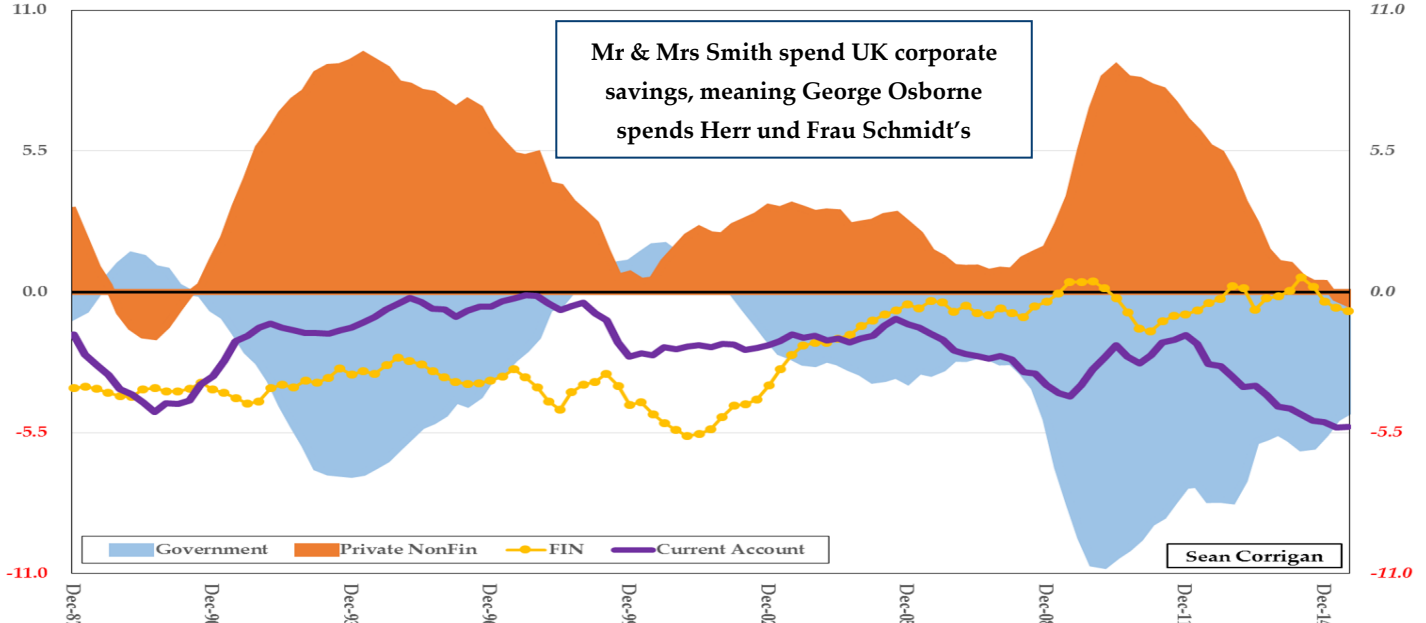
UK Household Savings Ratio, spot & 4Qma: Source - ONS



UK Household Net Lend/Borrow %PDI v 3-yr Libor: Source - BOE, Bloomberg



UK 4Q Net Lend/Borrow as % of GDP: Source - ONS



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

since the dreadful days of Lend Lease and Liberty ships—and certainly since the ignominy of its mid-70s IMF rescue—and this in a world where many of its least price-sensitive sponsors – *viz.*, foreign central banks, sovereign welfare funds, and various SOEs—are themselves not as flush as they once were as a direct result of the same collapse in commodity prices which has greatly impacted Britain’s own overseas earnings.

Make no mistake: the balance of payments was, is, and ever shall be a monetary phenomenon as Mises took enormous pains to explain in the aftermath of the Great War.

If the UK did not continually create new credit with which to buy more than it acquires in the course of its exchanges of goods and services, its books would perforce have to balance, just as would yours and mine. If foreign buyers of Britain’s assets and foreign purveyor of Britain’s credits were not themselves so flush with an embarrassment of liquid means or so readily supplied at home with cheapened credit, they, too, would be appreciably more choosy in their dealings.

Either way, the root of all evil, as the apostle (almost) said, is dishonest money. Over-easy credit. ZIRP + NIRP = usarp. QE screwy, phooey. Helicopter drops, sudden stops, CD swaps, and Abe flops. The whole bestiary of crankdom, Keynesian and otherwise.

And *that*, children, is why the UK runs such an eye-wateringly large current account deficit and that, too, is why the capital consumption which it involves, as well as the cementing in place of all the deadweight structures of state intervention and the skewing of ambition to non-productive ends which it both enables and induces, makes this an inherently dangerous constellation of factors and why the slide in sterling—signalling, as it does, our long-prophesied end of the UK’s ‘deficit without tears’—that willing suspension of disbelief by its now straitened creditors—may have some good way yet to run.

Unless, of course, the lunatics in charge of the foreign asylums do even more in the interim to destroy what little faith remains in their own currencies first, overtaking the pound in its race to the bottom along the way.



While on the subject of current accounts, perhaps few have been the subject of as much discussion of late—if perhaps to no very good effect—than the Chinese one, given all the angst over the diminution in that country's reserves these past two years.

To recapitulate the narrative, since June 2014, China appears to have 'lost' \$780 billion, or around a fifth, of its foreign exchange hoard. Given that the most visible two statistics for the country—its merchandise trade balance and its foreign direct investment receipts—run at around \$60-65 billion a month, the *loss* of \$37 billion in reserves takes some explaining. Needless to say, that is not a task in which the Chinese official numbers play a particularly comprehensive role.

What we do know (or perhaps that would be better put: what we are told) is as follows.

Since the drain first began, SAFE has identified cumulative outflows (as opposed to revaluation-fraught *stock* changes) of \$373bln, while the combined total of net trade (this time including services) and net FDI (subtracting those which are outward bound) came to around \$640bln, leaving us with just over \$1 trillion in movements to explain.

With net portfolio flow being a negligible \$21bln over this horizon, the bulk of the answer is to be found under that rubric of 'other' transactions which involves banking as well as more general sources of credit provision.

Of the total \$700 billion outflow which took place during the period under review, two-fifths (circa \$280bln) represented the Chinese acquisition of foreign holdings of deposits, loans, trade credits, and accounts receivable and so could partly consist of the effective holding of reserves at the individual or corporate, rather than at the state level, a feature to which the authorities have in fact often alluded.

On top of this, liabilities to foreigners fell by just over \$410bln, two-thirds in the form of loan repayments, much of the rest being accounted for by deposit withdrawals and the settlement of outstanding trade credits. Once again, to the extent that this represents a closing out of positions by those Chinese who had previously been engaged in a carry-trade arbitrage to raise cheaper funds in currencies which were expected to depreciate against the yuan, this would represent a healthy reduction of risk AND an effective use

of the very FX reserves to which this action had first given rise.

Which brings us to the final great component of the outflows, one which amounted to almost \$300bln, or \$1/2 billion a day, over the period in question: namely '*Errors & Omissions*' – aka '*We don't have a clue, either.*'

This one, rather defeatist line-entry amounted to almost 40% of the monies whose fate we must determine once we have dealt with movements across the current account and the FX reserve tally over this six-quarter horizon. Going further back, it still comprises 20% of the larger sum accumulated over the past six years, being more than three times the size of identifiable portfolio flows and half the size of contemporaneous FDI.

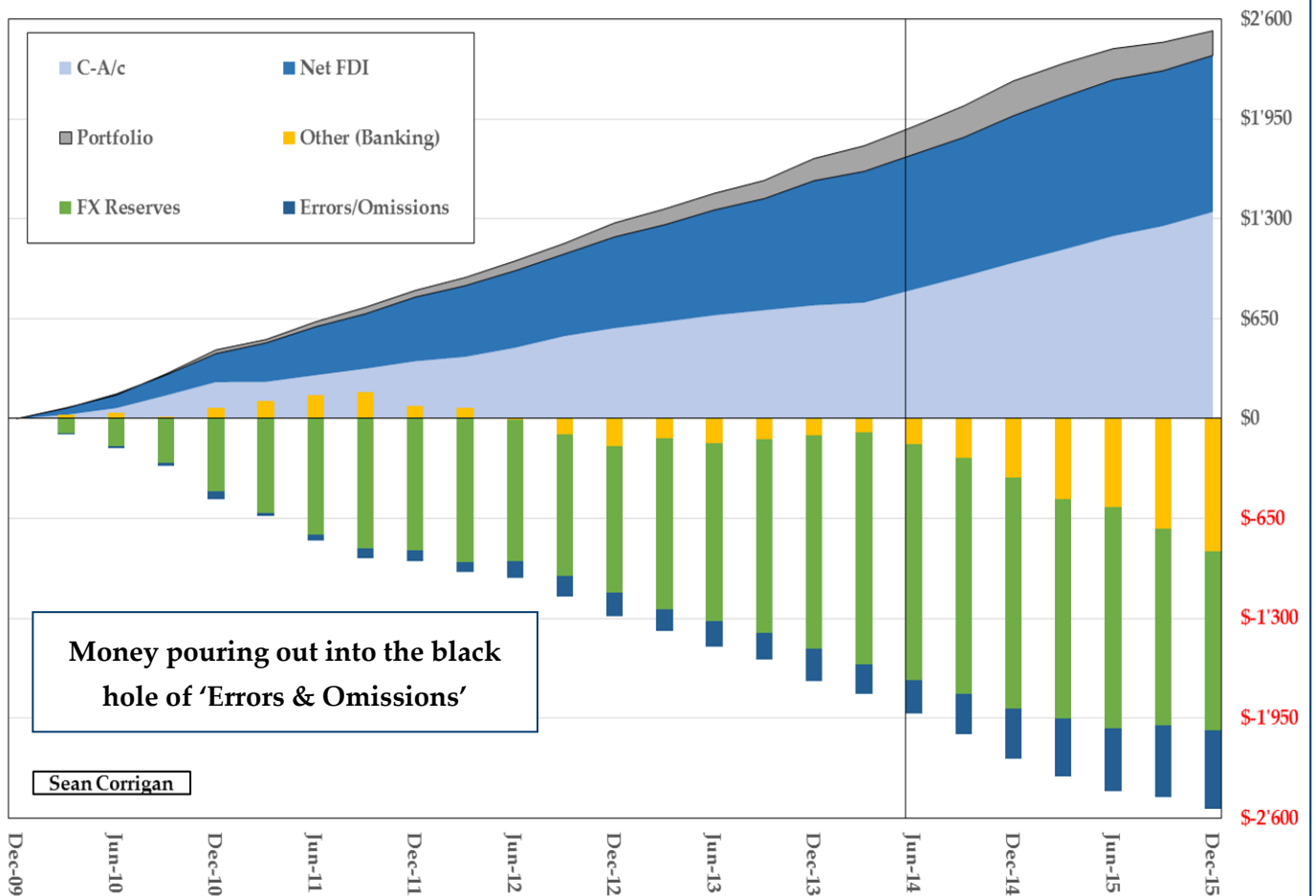
All in all, this means we have a black hole in excess of \$1/2 trillion in magnitude with which to contend when we start pretending we have insight into what exactly is going on across China's borders.

More immediately, a certain comfort was to be taken from the fact that the country posted an increase of some \$10.2 billion to its March total along with a 290,000oz addition to its gold stock (which was, however, the smallest since the new transparency regime regarding said holdings came into force last summer). Gold bulls will no doubt try to ignore the fact that the past two months have seen the rate of uptake halve from that which prevailed in the latter part of 2015, but the wider significance will attach to the forex reserves themselves.

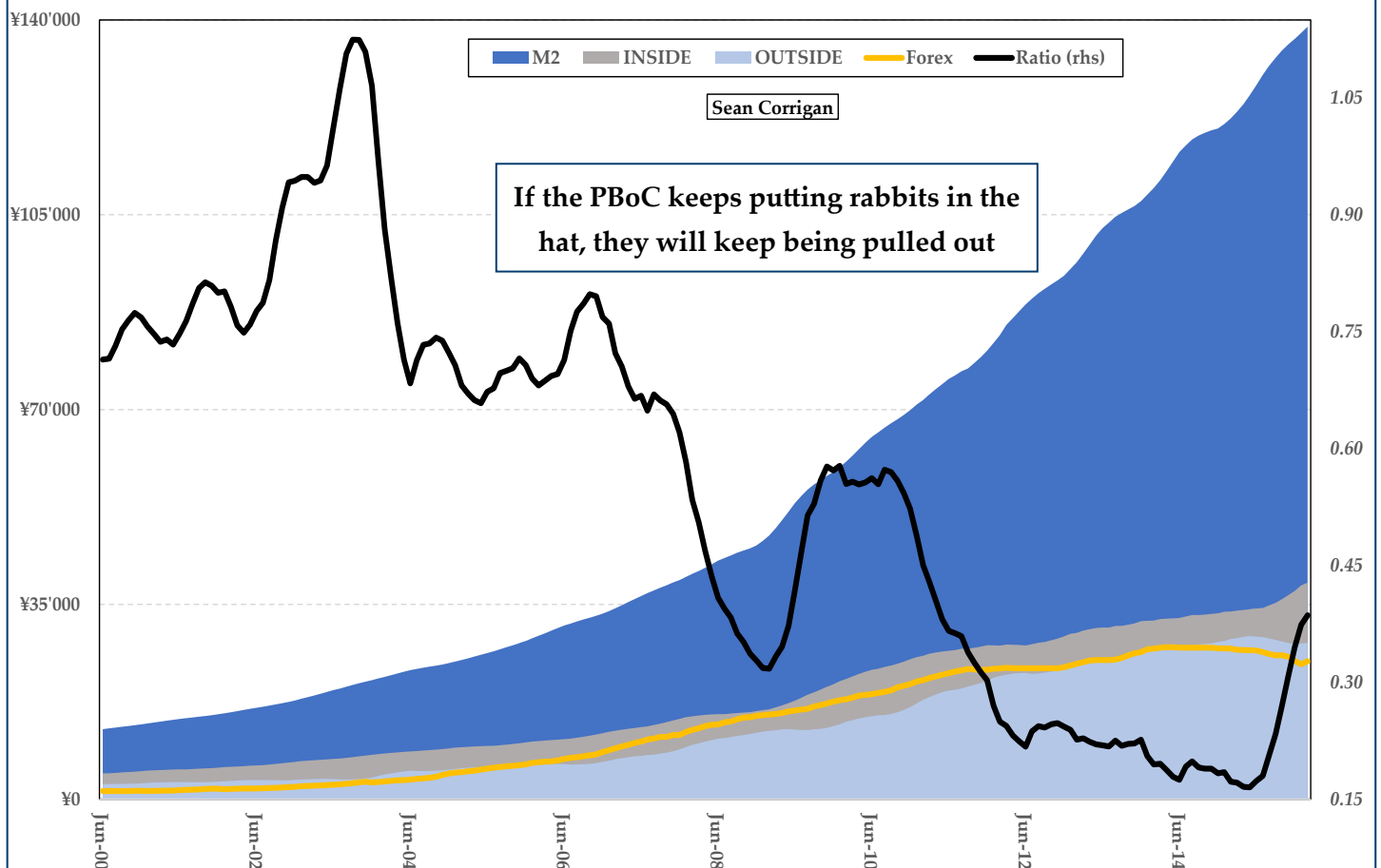
A plus of any kind is naturally not to sneezed at but, given that the US dollar continued to weaken in March, this was likely to have been flattered by the impact of a modest revaluation on the PBoC's other currency holdings. With trade and FDI inflows likely to be substantially positive, this means that the underlying leakage probably continued last month, albeit at a possibly lessened pace. Regardless of these mitigating factors, this is a market which for now is happy to assume that the worst is passed and that the central bank is firmly back in control.

There are even those who, in their wilder imaginings, have convinced themselves of the existence of a nefarious plot, hatched between the members of the G20, to co-operate in lowering the value of the greenback as a means to inject a

China external account cumulative, \$blns: Source - SAFE



China Inside & Outside Money (6mma, CNY mlns): Source: PBOC



little overdue buoyancy into commodity markets and hence into EM equity indices at large.

This all seems so at odds with both the overt desires of the BOJ and the more covert ones of the ECB - plus, the cynic of Realpolitik might say, it would appear almost guaranteed to lessen pressure on Washington's bogeyman in the Kremlin – that it seems highly unlikely to be true. But a market in search of a convenient *Just So* story with which to explain the reversal of the dollar's fortunes will not be easily denied, simply for lack of evidence.

Tactics without strategy is the noise before defeat

Beyond all of this, matters in China seem to be following their 'normal' course, if we derive that adjective from its interpretation in the military slang acronym SNAFU, that is.

Having agonised over how to reinvigorate a stock market still suffering the aftershocks of last year's seismic upheavals, the brightest idea they could come up with was to reinforce the Plunge Protection 'National Team' by adding an SAFE offshoot to the already operative pairing of the CRSC's China Securities Finance Corporation and the CIC's Central Huijin. That done, no less an eminence than Zhou Xiaochuan dropped a hint to the public at large to come revisit the delights of equity investing.

The regulator has also published a draft proposal aimed at boosting the security industry's net capital by around 20% and of doubling the reckoning of its members' risk reserves while simultaneously lowering the required ratios (i.e., increasing the permissible leverage) of these to liabilities and net assets both. One can only barely suppress a smile when one reads that the CSRC describes the intent as being one of making the risk coverage indicators '*more reasonable*.'

At the same time the insurance regulators are primed to push their charges into the lists as well with CIRC Chairman Xiang Junbo telling people that, given the high-quality of their assets and the fact that they are, by nature, long-term investors, '*their participation in the equity market can provide strong support to the market*.'

All the stronger, of course, when they also engage in margin lending or when they are themselves little more than captive subsidiaries of the very companies whose equity

they will buy or in whose property development schemes they will invest.

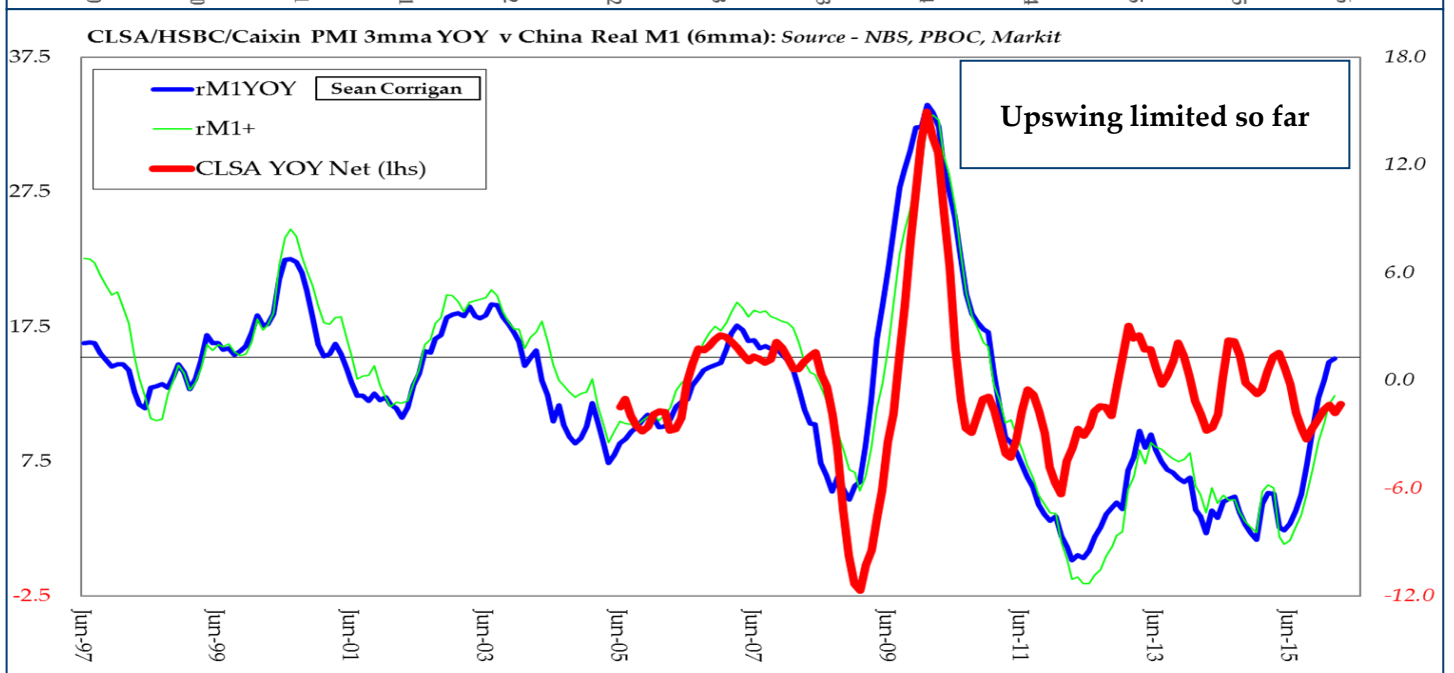
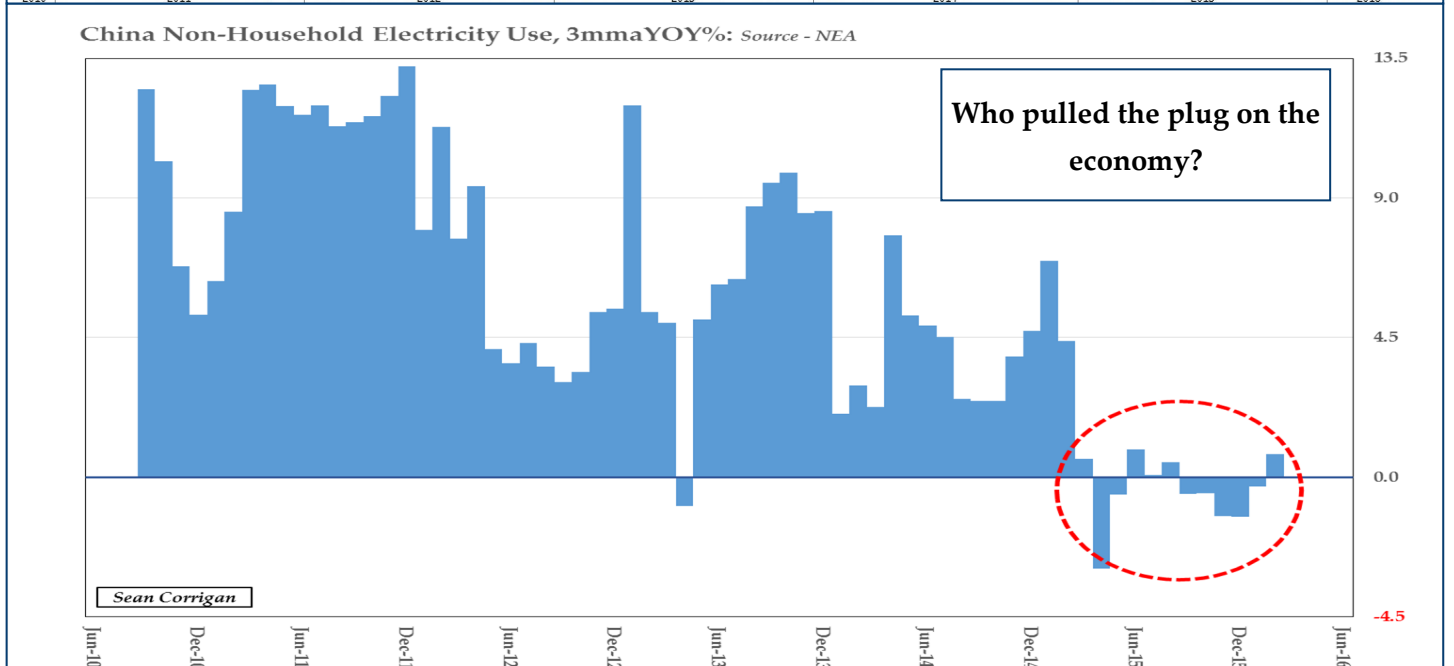
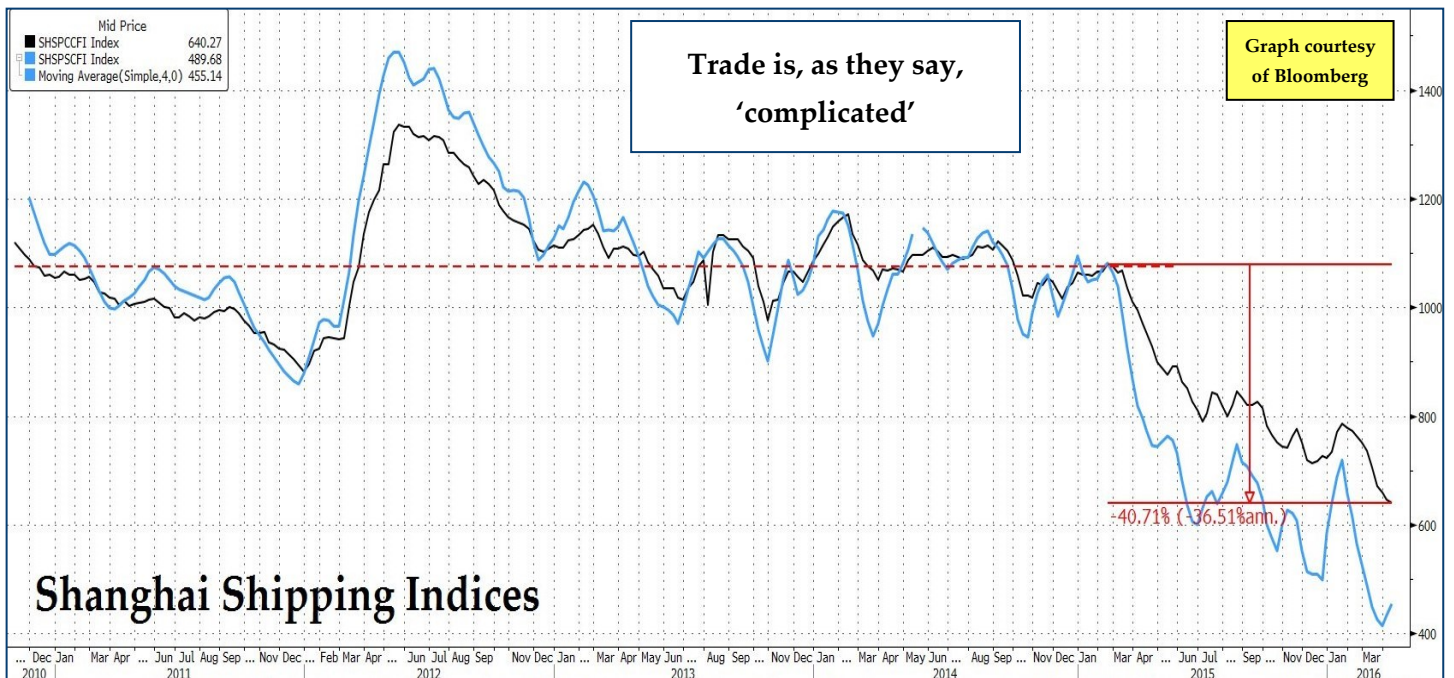
Carrying more than a hint of last year's Mississippi Bubble with Chinese characteristics, it appears moreover that Mr Xiang's hard-working minions are in the process of assessing whether no less than 130 new applicants for insurance licences should be given the nod.

The necessity for this revitalization push has since become very clear as the drive simultaneously intensifies to convert an initial tranche of up to Y1 trillion of bad banking debt into equity and thus to activate an NPL overflow mechanism in a timely enough manner to prevent the rising floodwaters of such soured credits from completely swamping the bank's balance sheets.

Naturally, such a scheme would have a greater chance of graduating from being an exercise in window dressing of decidedly dubious efficacy and painful transparency if it were to take place amid a renewed burst of margin-financed, speculative fever. That way it might be transformed into that game of pass-the-parcel which is the goal of much 'reform' and which is often just a means to stiff some far less influential patsy with the bill for cleaning up a VIP crime-scene. On top of this, the pilot stages of China's very own subprime securitization project are about to be launched as six chosen banks have seemingly been given the green light to wrap up a bundle of their problem loans and sell them on as asset-backed securities to a group of as-yet unspecified 'institutional investors'. You don't suppose that these latter, too, will be strongly supportive insurers—or that the banks will continue to finance the same, otherwise frozen loans at arms' length via, say, the repo market, do you?

If all that were not enough, rumours are also rife that the CBRC will soon bow to pressure from its pet banks and accede to a lowering of the provisioning ratio which they must apply in such instances from the current 150% to one of at most 120%. This would come just in time to prevent the banks from undergoing an embarrassing breach of the existing threshold as ever more of the Y2.9 trillion pile of special mention loans makes the ignominious transition to join the Y1.3 trillion in already-recognised bad ones.

One supposes that such a relaxation will not be too long in



coming. After all, the banks are 'owed' one for having swallowed the Y3.2 trillion loan-to-bond swap carried out largely at their expense last year in order to help the local government sector further delay its inevitable day of reckoning. On top of that, there is talk that a further Y15 trillion is being lined up for similar treatment over the next three years, with some private sector analysis suggesting that Y25 trillion over the course of the next five is a more likely total requirement. Much of that will have to be financed, one way or another, using the backstop of the banks, so measures to increase their firepower—such as handily reducing reserve quotients—are unlikely to meet with overly stiff resistance.

Astoundingly, the regulator is also currently setting up creditor committees so that any individual lender to an ailing firm will not be able to 'defect' so easily from the relevant consortium by demanding early repayment of its loans and so jeopardize the recovery chances of both its peers and, one presumes, of those with exposure to the struggler's own commercial customers and suppliers.

While being presented as means of 'harmonizing' behaviour and of preventing a reverse bank-run rush for the lifeboats once a given large borrower shows signs of foundering, one could hardly concoct a more certain recipe for blame-shifting, for the encouragement of Wise Monkey denial, and for the inducement of policy paralysis.

But, as even a cursory glance at the local press will demonstrate, bad debts and blighted industries are very much the topic of the hour, for all that the authorities' response seems to be that wearily familiar one of treating the symptoms of over-indebtedness by lending yet more money and of avoiding the immediate crystallization of loss by dispersing it, disguising it, and dissimulating about whose is the ultimate responsibility to bear it

By way of adducing a few, anecdotal pointers to the gloomy social mood, *Phoenix*, for example, was bemoaning the 'Four Mountains' of costs under which every business toiled. It listed these as expensive financing (especially for private companies); the heavy tax burden (68%?!?), high labour costs, and high rents in a bubbled-up property market. '*Economic Information Daily*' railed at the 265 'Zombies' which it said still populate the A-share index, all happily borrowing money, attracting government subsi-

dies, using ancillary shell companies, and exploiting—yes—insurance offshoots to play the markets and survive.

On a different note, *Caixin* ran a big piece asking, plaintively, '*How much DOES China owe?*' and found it could not exactly say.

Elsewhere there were numerous op-eds worrying about the deteriorating demographic mix or cooking up all manner of theories as to why easy money was draining between the cracks to provide Ponzi life support, fuel property speculation, etc., and was not therefore doing much to keep the wheels of industry spinning. A lengthy piece on *Sina* dealt with the horror story of wastefulness, Green rent-seeking and political grandstanding which is China's wind industry.

One of the more compelling pieces from this litany of despondency, highlighted on *Chinascopes*, moved beyond the purely economic and instead laid out the case for why the lack of a clear and reliable framework of law was preventing the forging of those fundamental bonds of commercial trust which would put all that money to greater beneficial use. Deidre McCloskey *would* be pleased.

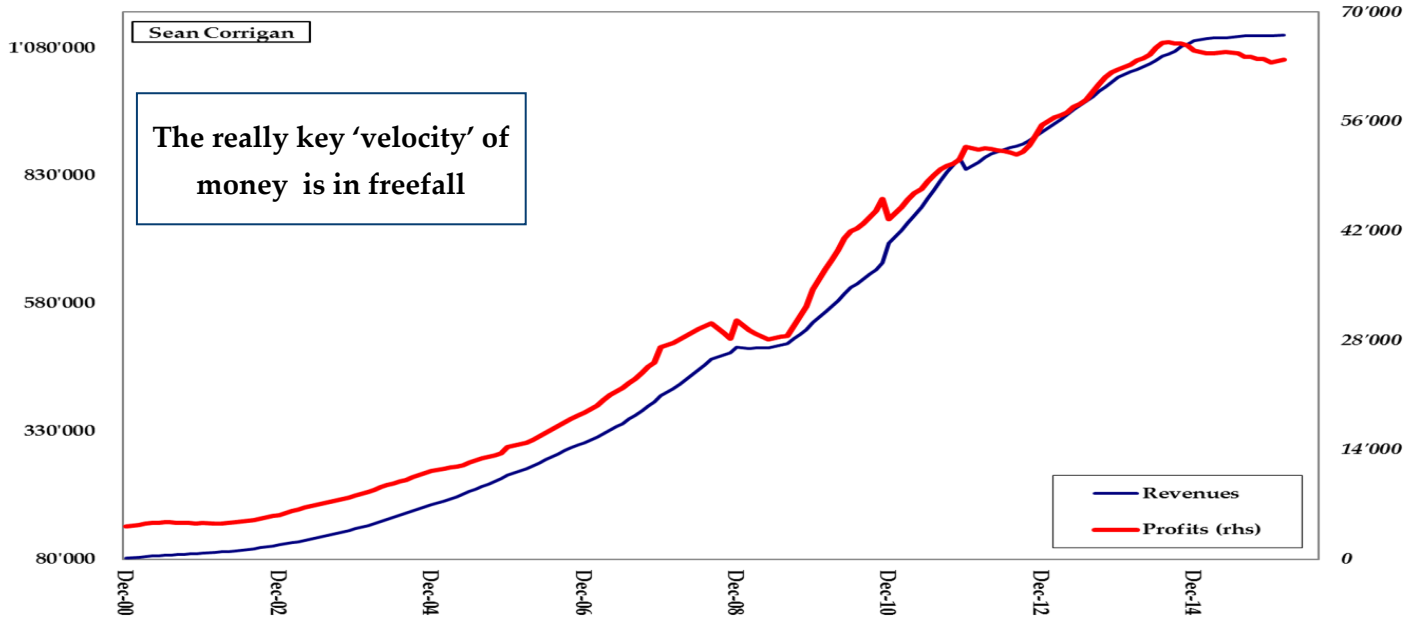
The mood, then, seems unrelievedly dark even before we tease away the official drapery to allow ourselves the tantalising glimpse of a situation in which Xi's arrogation to himself of all the levers of power is at risk of making him the sole focal point for all the simmering discontent and anxious incertitude which now seems to be plaguing this once brashly upbeat country.

A complete outsider—Leland Miller, compiler of the Chinese Beige Book survey—may have provided us with the best summation of the economic malaise which is a prime contributor to all this when he précised the results from his latest sounding: '*Collectively, our data show that firms first stopped borrowing, then cut spending, and now are becoming allergic to hiring.*'

Oh, and if there are signs that recent counter-measures may have stopped the gathering Tier 1 property bubble dead in its tracks, garlic prices are up 160% yoy—even by 318% in nine months, according to the Jinxiang index (sic)—and pork costs half as much again as it did last spring.

Hard times, indeed

CHINA Industrial Enterprise Profit & Revenues, Rolling 12 mos, CNY100 mln: Source - NBS

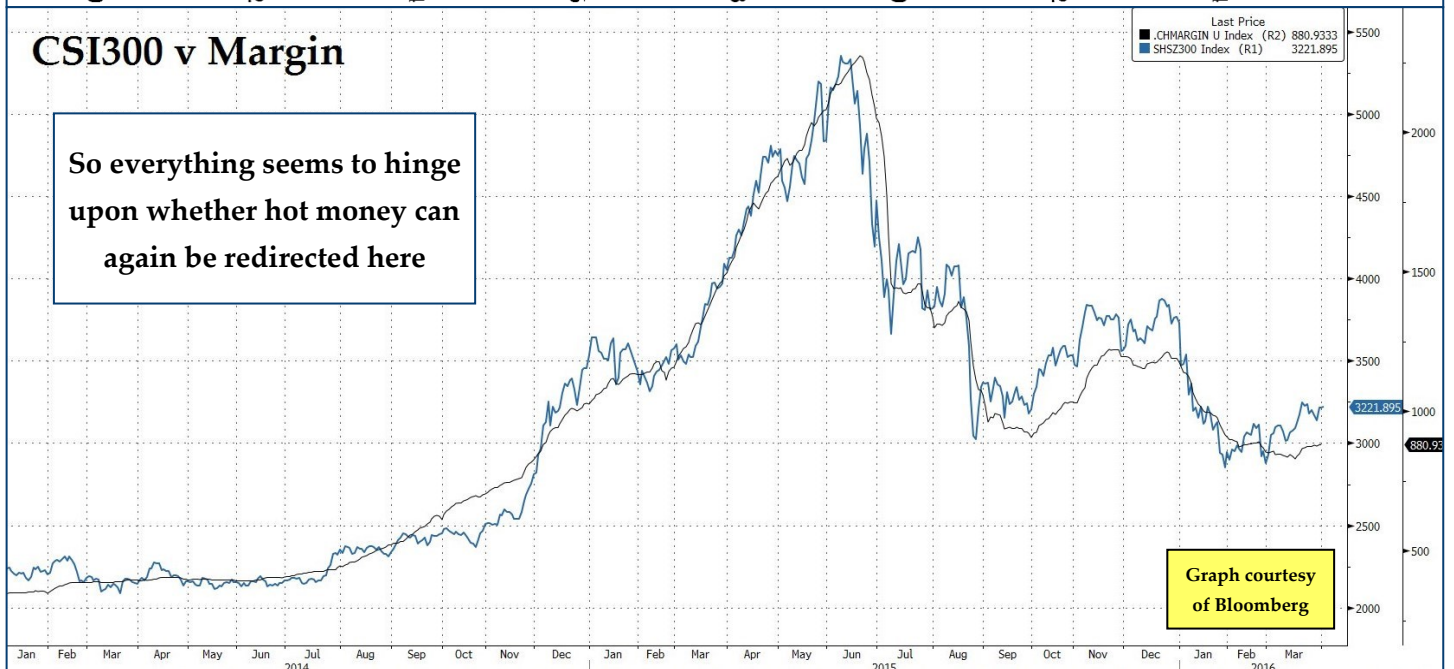


Chinese Industrial Profits & Revenues: Rolling 3-mos YOY%: Source NBS



CSI300 v Margin

So everything seems to hinge upon whether hot money can again be redirected here



WHERE THE MONEY GROWS: Wall St. and West

So, first the bad news, business revenues continue to fall for wholesalers in February taking them to where they were four years ago. Those for non-durable manufacturers did likewise and these are now at a mark they first attained way back at the end of 2007. Meanwhile, those for the colleagues bashing out goods of the durable kind have stagnated—albeit at close to their best ever levels—in marked contrast to the 7.8% yoy uplift they were enjoying 18 months ago.

On the face of it, inventory:sales ratios are similarly none too encouraging, touching ten year highs for retail, fifteen year ones for manufacturing, and climbing to what are at least a quarter-century's most elevated levels for wholesale (all three marks excluding those set during the GFC spike itself).

As a result, total private wages earned are growing as slowly as at any time in the past two years, if still at a positive, 4.3% pa nominal, 1.7% real, clip. Total wages earned in the extractive sector are now some 20% below their October'14 peak, dropping to the levels of four years ago and unwinding more than a quarter of the 180% rise enjoyed during the great commodity boom after 2003.

The combination of anaemic sales and increasing headcount and wage rates, means the ratio between the receipts and outgoings is under pressure in every one of these sectors, with the pain once again concentrated in non-durable goods manufacturing and wholesaling.

It should, however, be clear that all of this stems from the same root cause – viz., the precipitous drop in commodity and especially in energy prices which has taken place these past few years. Thus we have to be careful to allow for the possibility that two mitigating factors may be at work. Firstly, that the pain may be largely concentrated in the sectors most directly affected by the price change (together with those who rely, at ever greater removes, on the custom to which the formers' activities give rise, less the similarly decaying, *positive* influence exerted on those who buy their products in their turn). Secondly, we may wonder if the fall in sales receipts comes with broadly maintained margins and hence conceals a greater degree of stability in the ultimately decisive net income generated from them.

Evidence that the first of these factors is in play can be had

from a look at sectoral results for the S&P indices, specifically taking operating earnings per share—though now with the caveat operating in the opposite sense that high levels of corporate buybacks paint a flattering, not to say a highly photoshopped, picture of these. The upshot here is that, yes, energy is a disaster area and that materials and utilities, too, are less than robust, but that, conversely, things are reasonably healthy in both consumer staples and discretionary, in healthcare, financials, and industrials, as they have generally been for IT.

One additional source of comfort is the fact that while nominal new orders have suffered some of that same drag which is depressing the sales figures, the ratio between total order books and those same sales—the book-to-bill ratio, as it were—looks to be in good condition. This implies that, given the proviso that profits are indeed there to be had at the current level of sales, businesses in general can be as assured of a continuation of such an income into the near future as they have ever been.

Corroborating this was the March PMI release which saw both new and backlogs of orders cap off a three month climb to hit their best combined reading in well over a year with a jump in the former of a magnitude not seen since the great rebound of 2009, 6 ½ years ago. That leap was 1.7 sigmas above the five-decade mean and meant that the entire first quarter's rebound registered an improvement of a most welcome +1.5 sigmas.

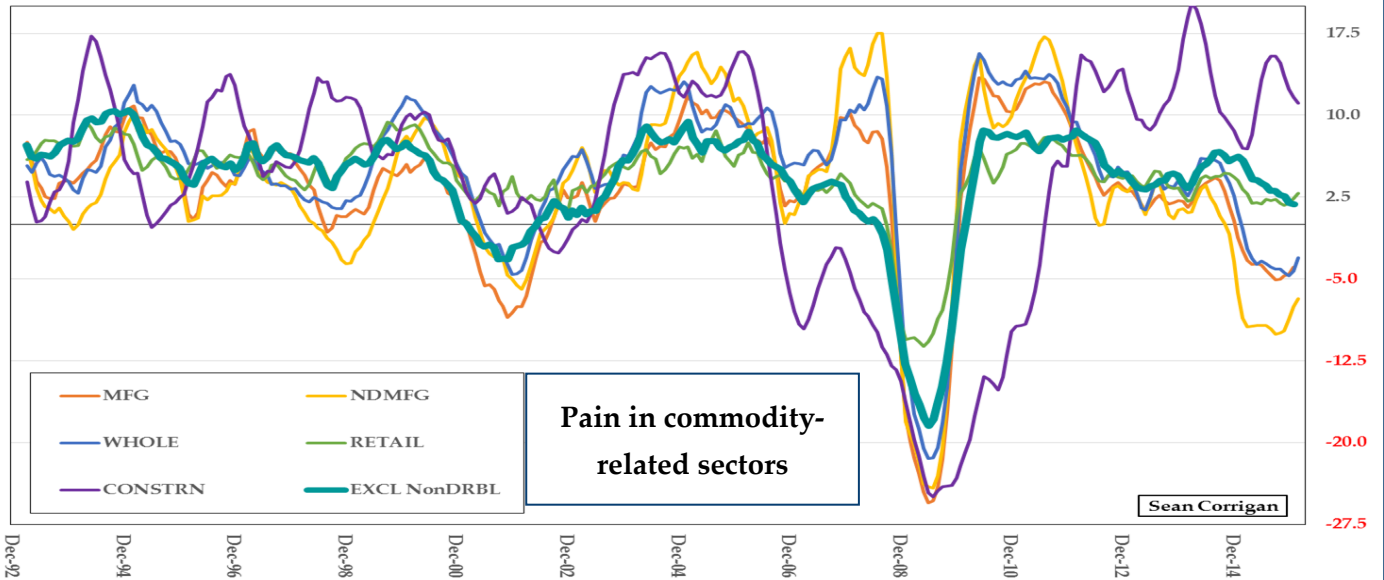
Adding to the sense that the outlook was improving, the comments chosen by the ISM to categorize each of its member industries included such sentiments as:

'We are understaffed and running lots of overtime,' 'Business... is booming...plant is at capacity,' 'Requests for proposals for new equipment [are] very strong,' 'Nationally, business seems stronger than a year ago. Internal volume is better than expected and vendors report stronger Q1 than expected.'

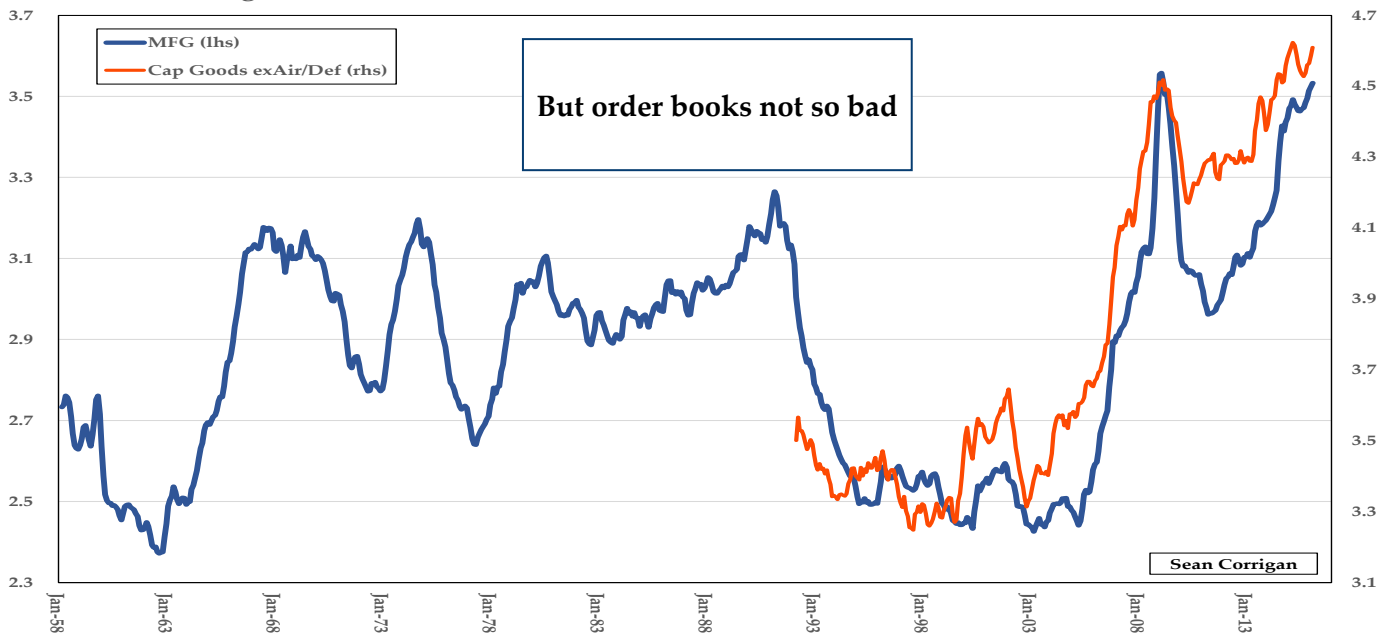
The further clincher for us is that monetary conditions are still highly favourable to growth with real M1+ accelerating slightly in recent weeks to hit 5.1% yoy. Bear in mind that, in every recession in the past sixty years, without fail, that measure has contracted.

Yes, there are scattered signs of weakness – some of which we have flagged in the foregoing, others in the accompany-

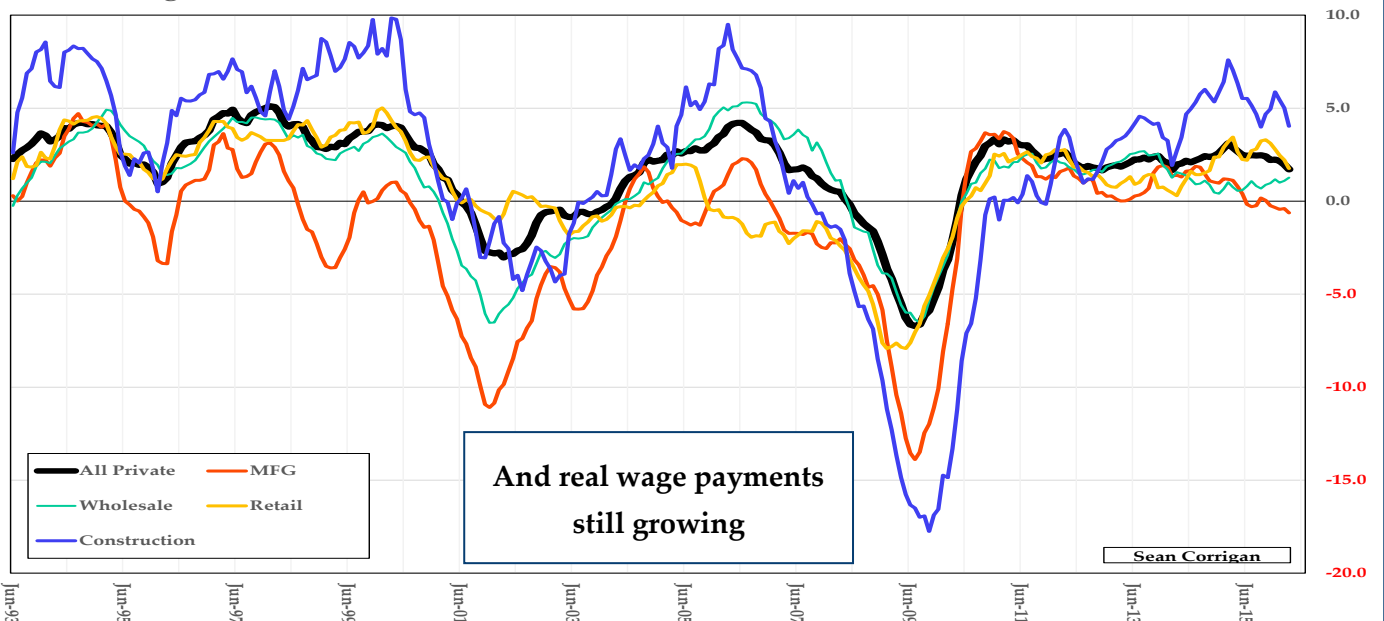
US Biz Revenues, 3mmaYOY%: Source - Census



Manufacturing Book:Bill: Source - Census



US Real Wage Fund, 3mma YOY%: Source - Census



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

ing charts. Yes, there are classic ABCT hints that the higher orders of production are not doing as well as the lower and, yes, the continuation of easy money is undoubtedly promoting harmful malinvestment as it ever does – look at the many Dot.com II unicorns for an obvious example.

Yes, it is possible to worry about rising levels of indebtedness, or about falling margins and returns on capital. Yes, one can make a somewhat lily-livered appeal to a kind of ‘precautionary principle’ of monetary policy to argue that, having first overdosed the economy on cheap money, the Fed is running grave risks by tightening, however pussy-footing the manner in which it is going about it. Yes, the world beyond the comfort of our mother’s apron strings is big, bad, scary and – UNCERTAIN!

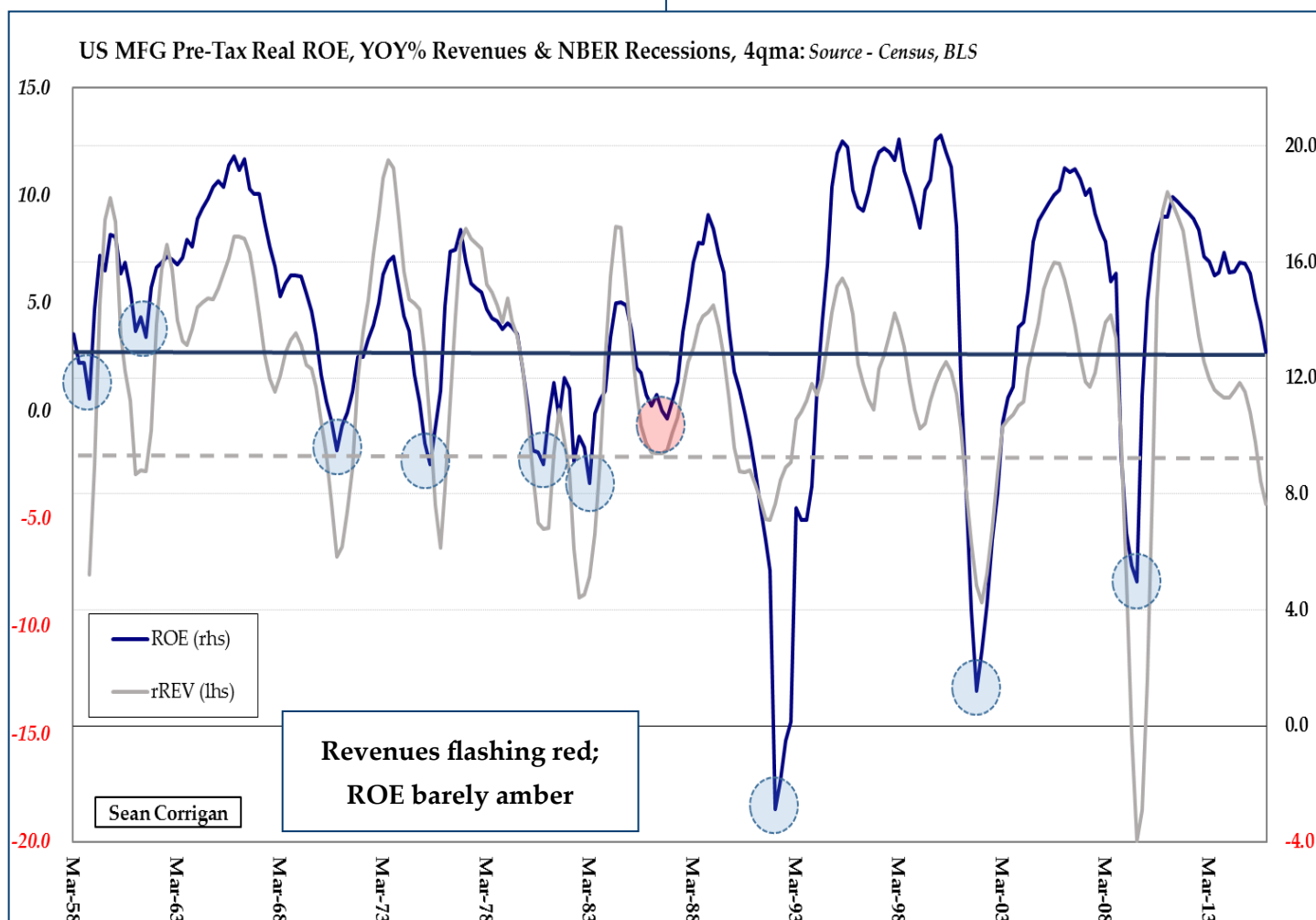
But, for now, clear, unequivocal warnings of an imminent collapse are not to be had so, while it always serves to keep a weather eye open, it is not now time to raise the storm beacon.

As Austrians, we are typically disposed to be micro-economic optimists and macro-economic pessimists. This

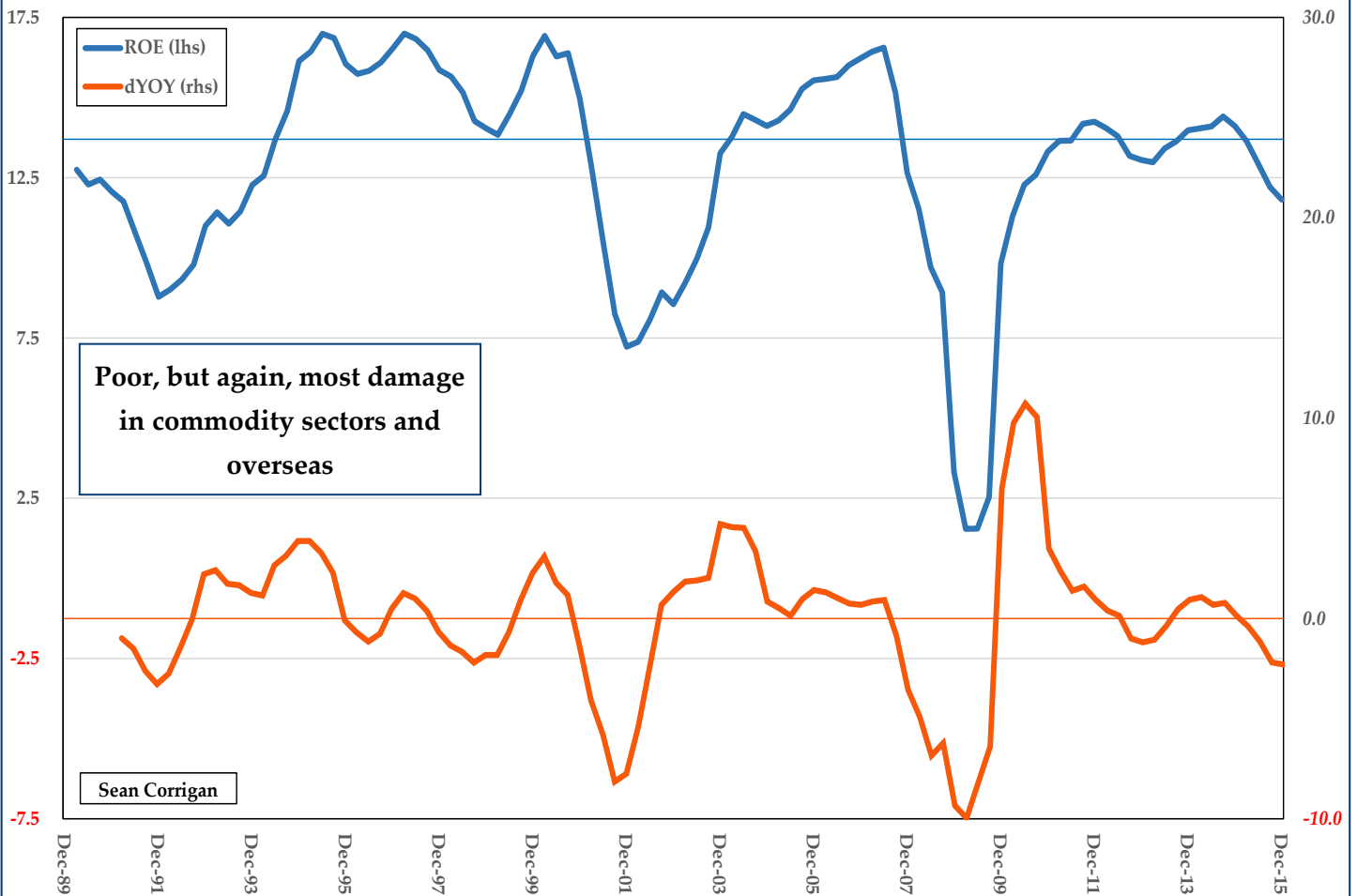
polarisation arises from our conviction that while the few Big Players—the states, the central planners and the corporatist cronies—almost inevitably do more harm than good (even on the occasions when they are honestly attempting to do the latter), the great, anonymous mass of Forgotten Men usually proves itself to be more resilient, adaptive, and more practically ingenious than anyone ever gives it credit for beforehand, meaning that, over the long haul, its members can usually overcome the many unnecessary obstructions put in their way by those who presume to be their shepherds.

At present then, though it might be a more closely run thing than it need be as a result of the Fed’s alarming vacillation, it looks as if the little people are still just ahead in the race.

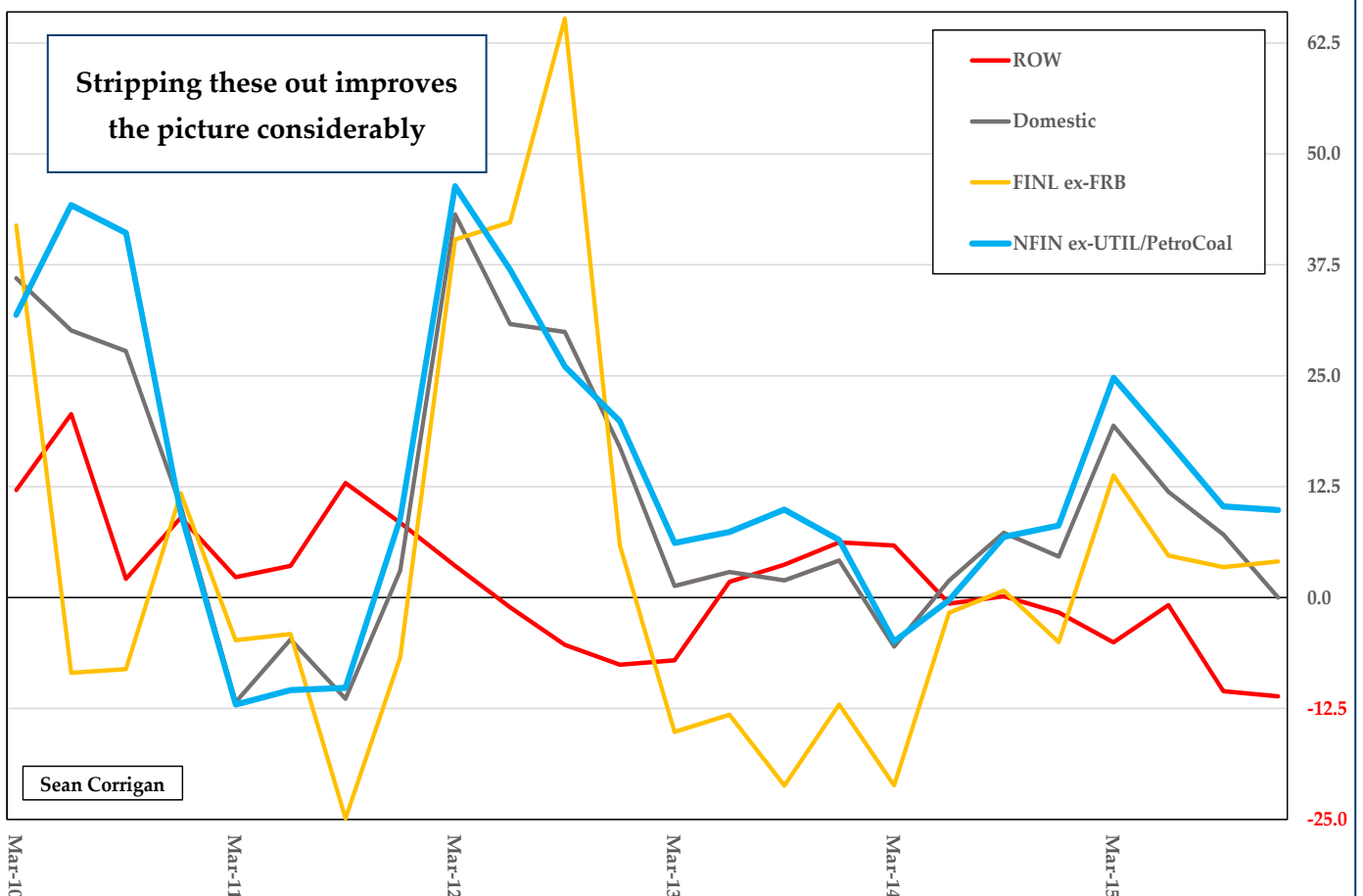
Long may it continue.



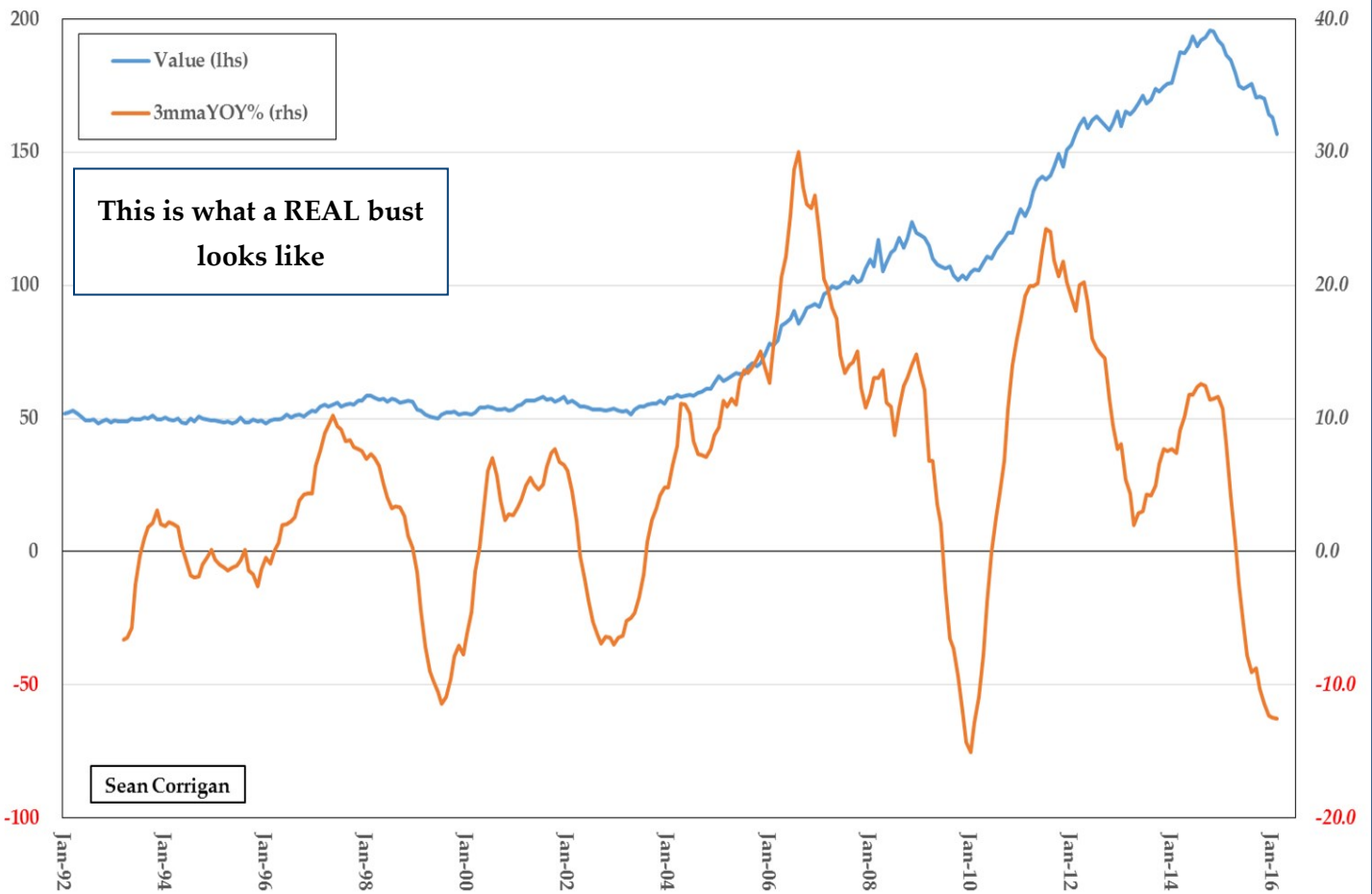
S&P500 ROE: Source - S&P



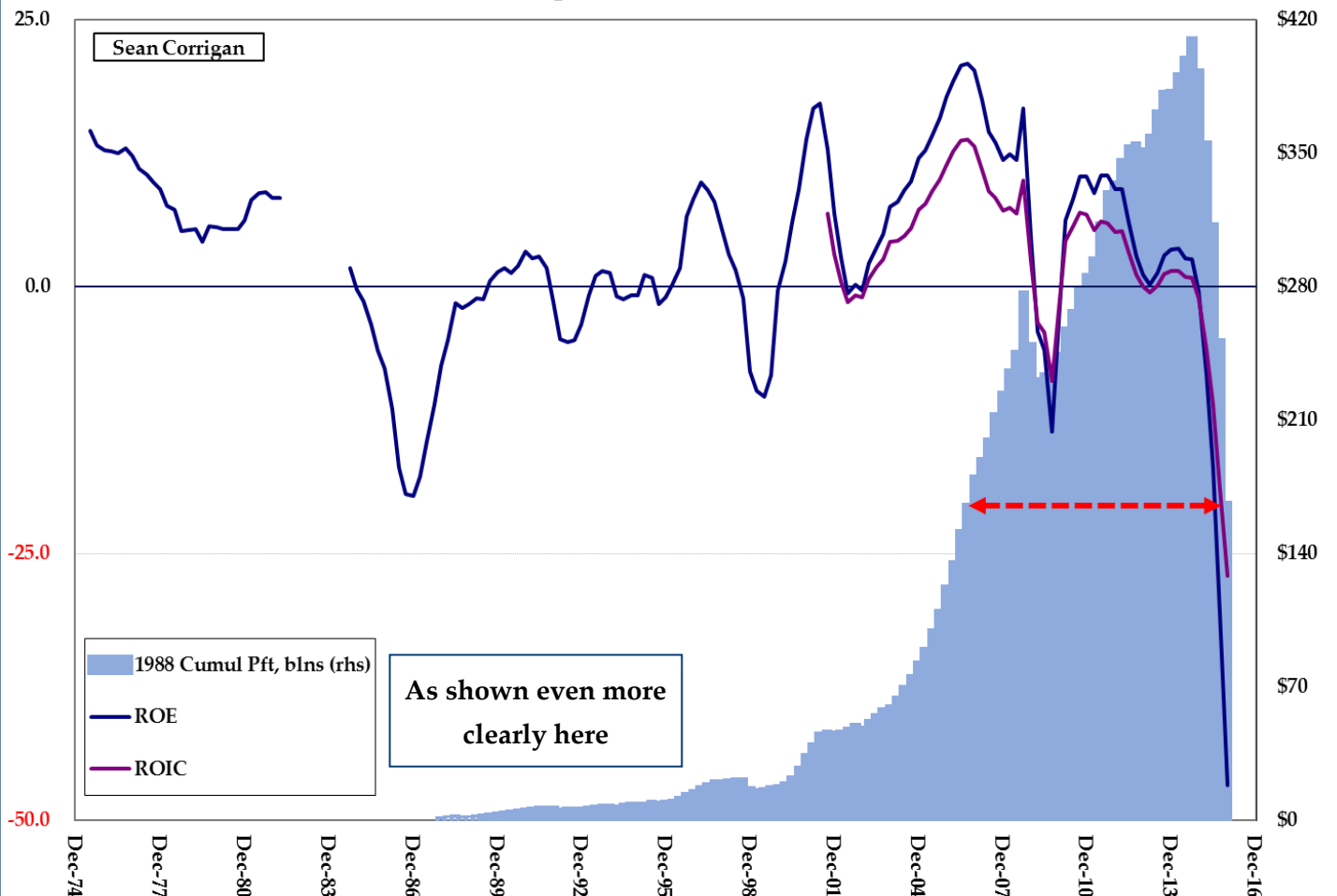
US Industry profits with IVA, YOY%: Source - BEA



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



US Extractive Profits, Real ROE/IC, 4qMA: Source - Census, BLS



BUY CHEAP, SELL DEAR: Market Observations

Hopes that a meaningful agreement will be miraculously reached to apportion oil output equitably between the commodity's jostling pack of increasingly fractious rival producers has been enough to push the black-stuff higher once more, triggering all manner of Risk On trades in the process and keeping huge spec longs at play in oil itself.

As oil has risen, put volatility has widened against the call variety and has simultaneously pushed to its most elevated levels since the upheavals of 2009—a combination which strongly suggests that those still operating in the US shale patch are buying a little much-needed protection, whether of their own accord or whether under the stern compulsion of their now far less accommodative bankers.

Meantime, the yuan continues to strengthen against the greenback while handily losing ground to a resurgent yen—a combination likely to see the Maotai being broken out in celebration in several of China's ministries.

Notable as the non-barking dog in this move is the fact that while foreigners are selling record amounts of Japanese equities, the Japanese themselves are pouring ever more money into ROW stocks and bonds. The upshot is that Y2.9 trillion has left the country in the past seven months, even as the yen has *strengthened* some 15% to hit a 2 1/2-year TWI high.

That foreign buyers were currency-hedged and that their exit would only have echoes in the forward points, seems uncontentious, but the locals escaping NIRP have surely not been selling their target markets' currencies forward have they, not when basis swaps are already so heavily tilted against them?

If not, the only conclusion to reach is that somebody, somewhere is having to bail out of a carry-trade gone wrong and buy back his yen in order to square up fast. If that is true, the ultimate extent of the move will be proportional to the degree of distress being felt times the size of the Herd's position.

Sterling remains pressured as the combination of the yawning current account gap we have dealt with above finally registers in the consciousness of the market. Though long willing to ignore this factor while the country offered some small yield pick up—one that moreover seemed only likely to increase, given that the UK at that time was showing faster growth than many of its Continental peers—sentiment, it seems, has since flipped 180 degrees and the pound is now being held in widespread contempt

The global shrinkage in foreign exchange reserve holdings may have put paid to one source of relatively uncritical sponsorship; positioning ahead of June's Brexit vote is being played up as another malign influence; while the Tories' current political embarrassment may be adding a little extra sauce to the trade. Taken together with recent softer numbers and the growing perception that Carney's BOE are another bunch of One-Trick ponies—ever eager to ease: totally terrified of tightening—and you have a near-perfect recipe for a mini sterling crisis to end the boom.

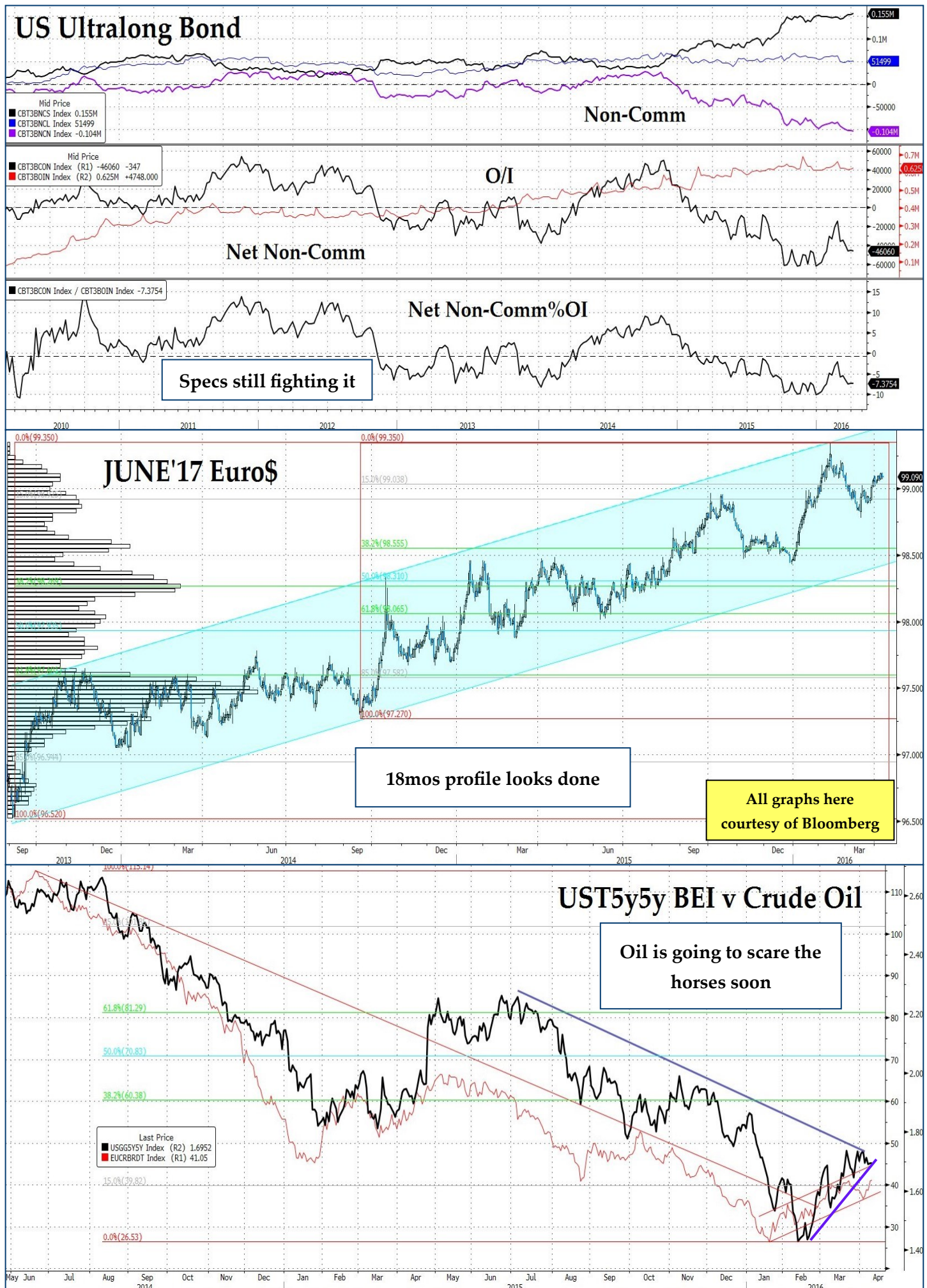
Despite stories in the German press that the government there is incensed at what is seen as Draghi's relentless drive to transfer vast sums of money surreptitiously from everyday German savers and pensioners to the ailing polities west and south of the Rhine, the euro remains bid and the markets generally calm, if we except the teetering banking sector.

Though few in the wider world have taken much note of Schaeuble's burst of *Sturm und Drang* on this issue, it might not do to dismiss his alleged fury *too* lightly. After all, the worthies at the German Constitutional Court do not operate in a vacuum. While it is almost improper to suggest that their lofty and disinterested exercise of jurisprudence would *ever* be polluted by petty, political issues, it is hardly to be denied that the burden of proof of a claim that the ECB was exceeding its due bounds could fall that much lighter in the scales of justice if the opposite pan was not felt to contain the full weight of either the government's or the nation's support for the Grand European Project.

Even if this reasoning were to remain mostly hypothetical—and, of course, heavily officially denied—one should not doubt the potential impact of even its intimation.

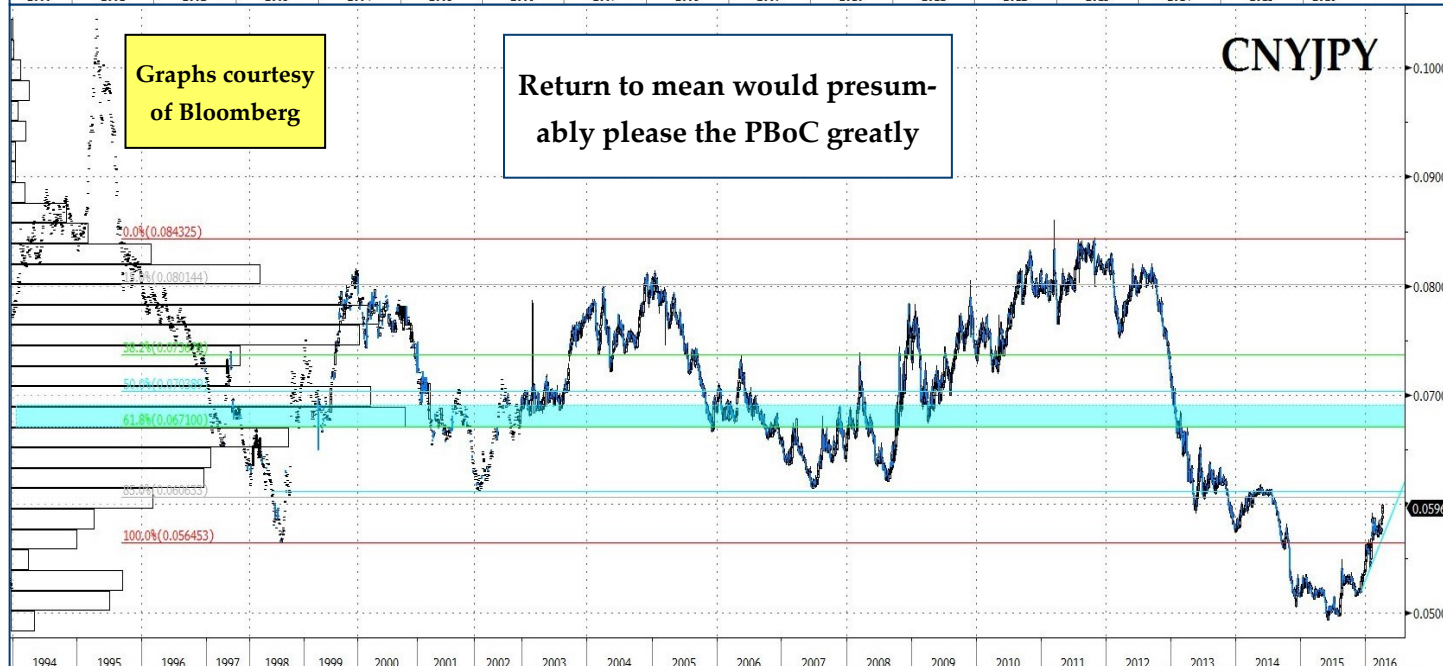
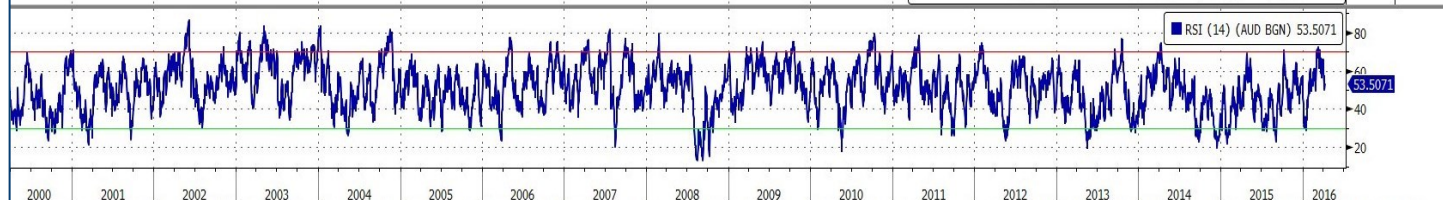
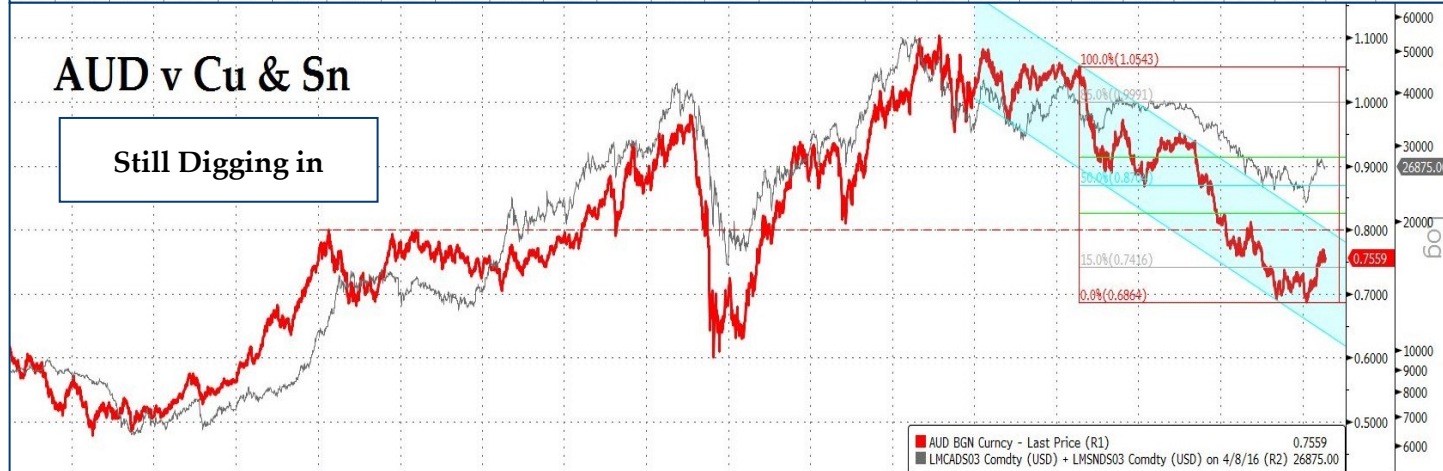
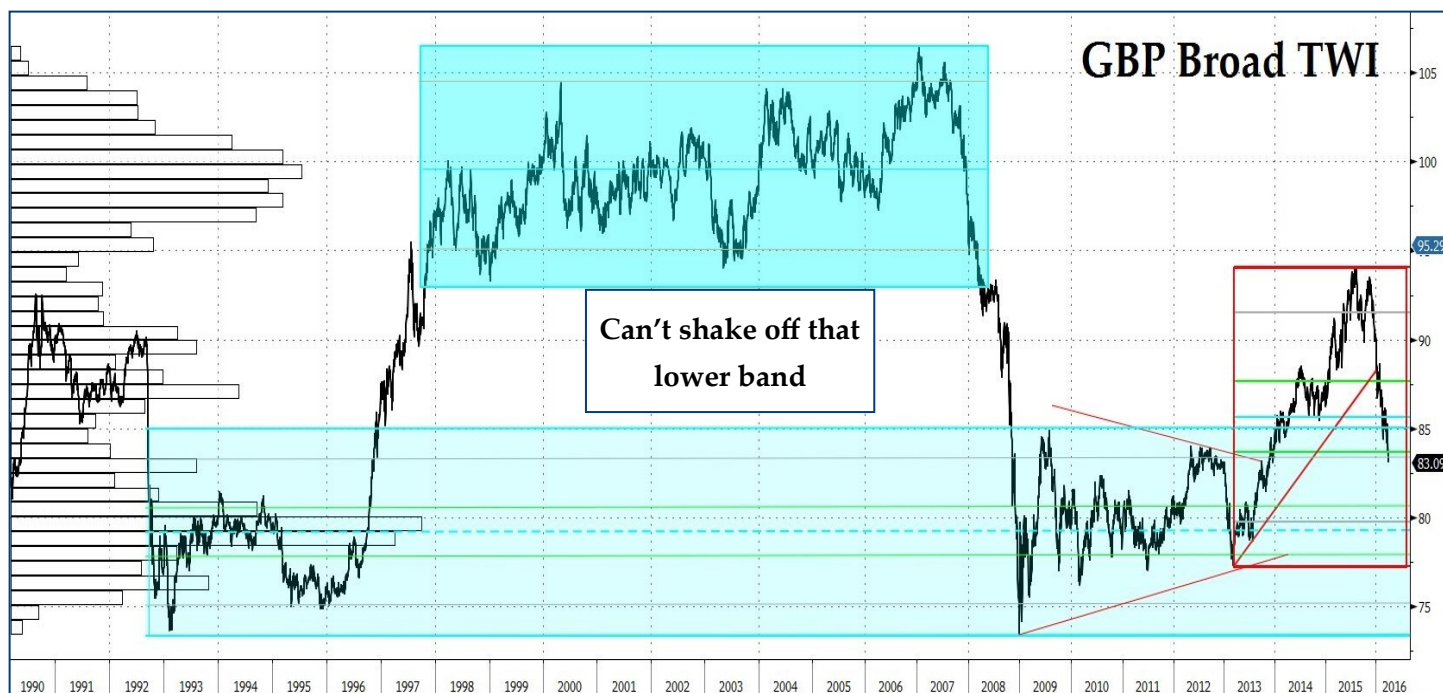
Draghi personally may be too overweening to tolerate any limitation of the powers he has so effortlessly arrogated to himself, but there must surely be others on the Council who might come to feel that the best defence of their oft-vaunted independence is to behave in such a manner that no-one openly challenges it.

Were that to be the case, we might finally reach a point where 'whatever it takes' is simply for Signor Draghi to sit on his hands and do nothing for a change. One can well imagine with what little relish the avid front-runners in the Eurozone credit markets would greet such a display of unwonted, if masterly, inactivity from the principal architect of the Wonderland they presently inhabit.





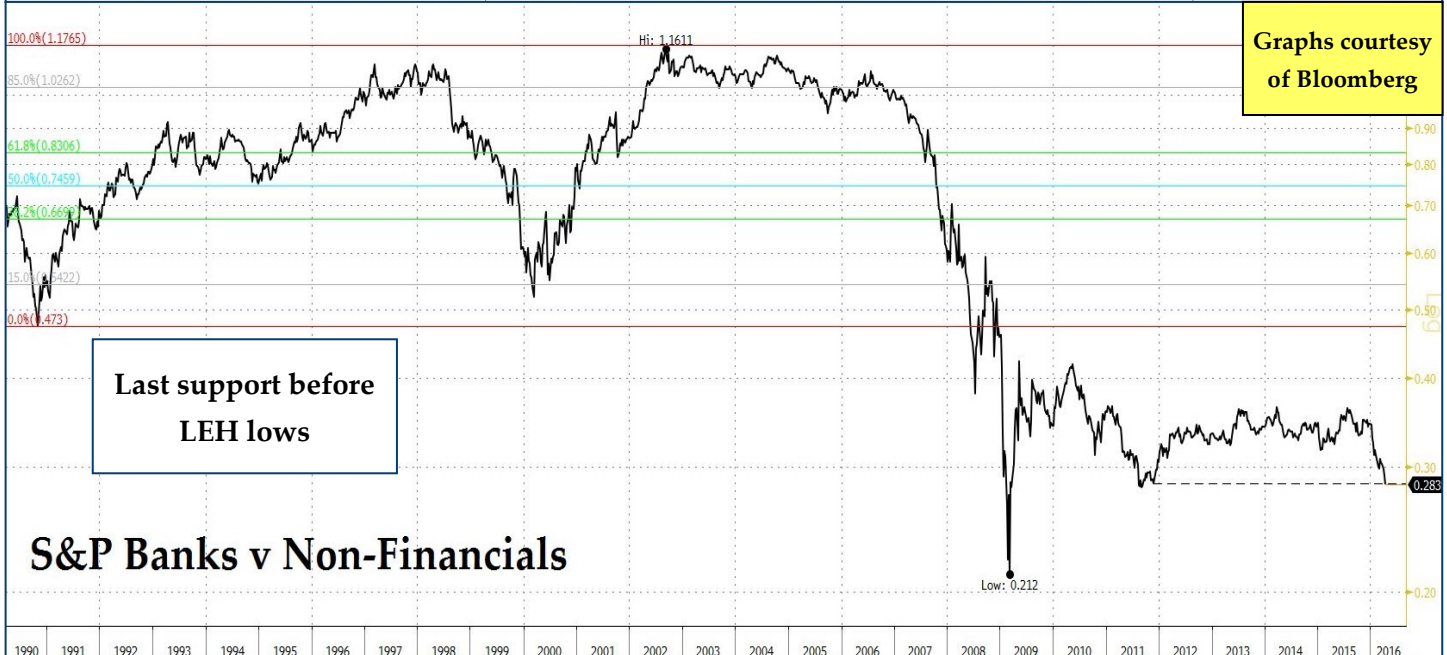




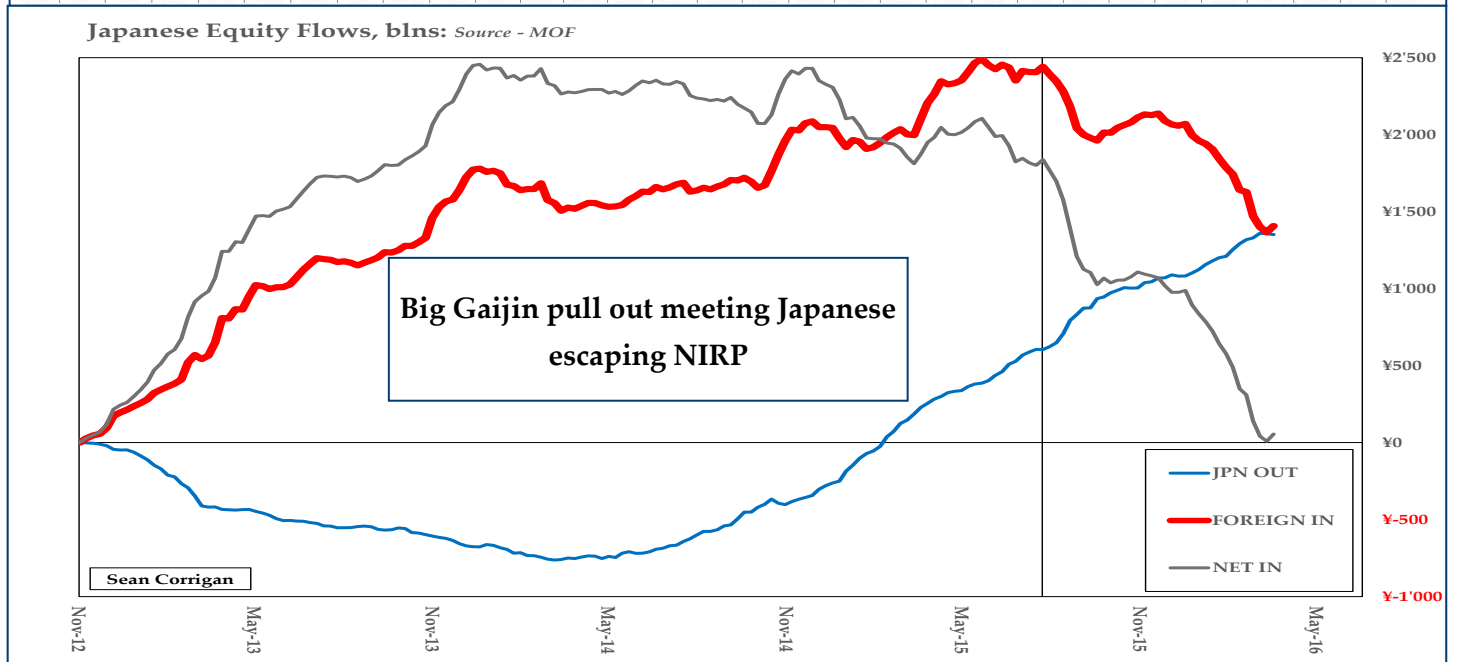


Graphs courtesy of Bloomberg





**Graphs courtesy
of Bloomberg**



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