MONEY MACRO AND MARKETS

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The Humours of Change Alley

As we lay out in some detail below, it is clear that Chinese banks have entirely lost their inhibitions about creating money these past twelve months.

It is equally clear that once such money is called into existence, *someone* must be caught in the act of holding it when a balance sheet snapshot is taken, however eager their desire to *'pass the bad or depreciating half-crown to the other fellow'* may be and thus regardless of what the fate of that money will be an instant after the shutter has closed on the statistical camera.

That the sum of demand deposits credited to the account of non-financial corporates has increased this past year, rising by around a third or Y4.7 trillion and hence constituting approximately 55% of the corresponding 28%, Y8.4tln increase in non-currency M1, therefore tells us nothing whatsoever about either the current motivation or future intention of those receiving it. As such, this is a compelling illustration of the cardinal rule that one should never to try to deduce dynamic effects from an exercise in accounting principles.

In disregard of this stricture—and even though demonstrating an anxiety laughably at odds with the modern-day inflationists' brook-no-hindrance efforts to place more money in the hands of those most likely to spend it—this accumulation has already prompted some of the more hackneyed members of the Commentariat to start banging on about China being caught in a 'liquidity trap'.

Heaven alone knows how such worries will develop if that stale, old wine in new, MIT-relabelled bottles concept of 'helicopter money' is one day put into practice, but it sounds as though the advocates of this '*scam*' of '*monetized fiscal stimulus*' (q.v., Weimar, Revolutionary France, Continental USA, etc.) will be as alarmed as the drunken magician who cannot recollect ever putting the rabbit into his hat in the first place.

In any case, this diagnosis is made in utter ignorance of the fact that Keynes supposed this somewhat mythical state of economic dyspepsia to arise through the witless response of those recipients of money whom he personified, in his usual supercilious fashion, as his fellow 'college bursars', men whose habitual incomprehension of what was afoot he, Maynard the Magnificent, affected to despise. As rates fell, these hidebound souls, so Keynes imagined, might so come to fear the capital loss which would be entailed by the inevitable reversion of bond yields to their pre-slump norms that they would hoard all the cash that came their way for want of any better idea of what to do with it, so holding up real rates, slowing the velocity of circulation, and thus worsening the slump.

All in all, a typically sophomoric, Keynesian 'paradox' from which, once he had stumbled into it, no lesser intellect could, of course, ever hope successfully to extricate himself. It is one which has been keeping the Bernankes, Buiters, Blanchflowers, and Blanchards rolling in honours (and honoraria) ever since

Ironically, it never seems to occur to today's 'college bursars' – those managers of pensions and other long-term investments who are happy enough to parrot this much-abused phrase – that, under the onslaught of today's central bank euthanasists, they, the rentiers, are not only *not* prey to such fears but they have become the most avid of momentum chasers, utterly heedless of the perils of mean reversion and instead actively seeking justification to buy for a further rise in prices (and, ergo, fall in yields). Though seemingly oblivious to the fact, in this way have they, themselves, become instrumental in forestalling all possibility of such a 'trap' from ever materializing.

Sean Corrigan

Every hand's a winner and every hand's a loser

In the heated atmosphere of the Brexit debate, much has been made of the state of the UK's external deficit on current account. Only interrupted by an all too brief reversal in the immediate aftermath of the Lehman Panic, this has, in truth, trended ever wider for a decade now – to little evident concern from either punditocracy or policy makers.

Indeed, were it not for the barrage of claim and counter-claim which has comprised the political upheaval underway in Britain, it is possible that it would have continued to receive little scrutiny even after suddenly yawning to a shockingly wide 7.1% of GDP these past six months – a gulf which is the greatest recorded since quarterly measurements were first instituted in 1955.

To put this into some sort of context, it leaves the UK with the world's second largest absolute BOP gap – being beaten only for the palm by the much larger US economy – and has it just pipping that other inveterate Anglo-Saxon over-spender, Australia, for the crown of greatest deficit per capita. On aggregate, the shortfall is roughly three times that of its nearest non-US rivals: on a headcount basis it is two-thirds greater than that registered by its Transatlantic cousins. Measured from the pre-crisis year of 2007, only Saudi Arabia – suffering an 85% peak-to-trough fall in the price of its predominant export – has suffered a greater deterioration in the arithmetic.

Faced with such evidence of imbalance, the renewed attention upon this particular measure has shown three main strands.

Firstly, there is the simple fear that the UK will no longer be the grateful recipient of what its central bank governor has referred to as the 'kindness of strangers' – i.e., the willingness of its foreign counterparts to continue to sell it so many goods on such easy credit terms. The unspoken anxiety is that any interruption of this willingness could lead to the dreaded 'sudden-stop' wherein foreigners demand their money back *en masse* and have to fight for the exit with anxious locals as they do.

Secondly, there is the question of whether the TWI's 18% plunge from its best level in over eight years – one set, after a 2 ½ year, 22% recovery, as recently as last August - to within 5% of all-time lows will be enough to bring some measure of relief to the patient. Thirdly, there is the more politically-charged question of what this all means for the UK's negotiations with its European 'partners', as well as those to be engaged in with nations in the wider world.

With regard to the possible salutary effects of a drop in sterling, several prominent economists have poo-poohed the idea that this could actually be the case, pointing out that much of the recent worsening of the accounts has its root in a marked decline in the income accruing to Britain's stock of overseas investments – an excuse for which there is partial – but certainly not a total - justification.

In order to examine the somewhat dubious merits of this claim, it is only necessary to make a closer inspection of the data.

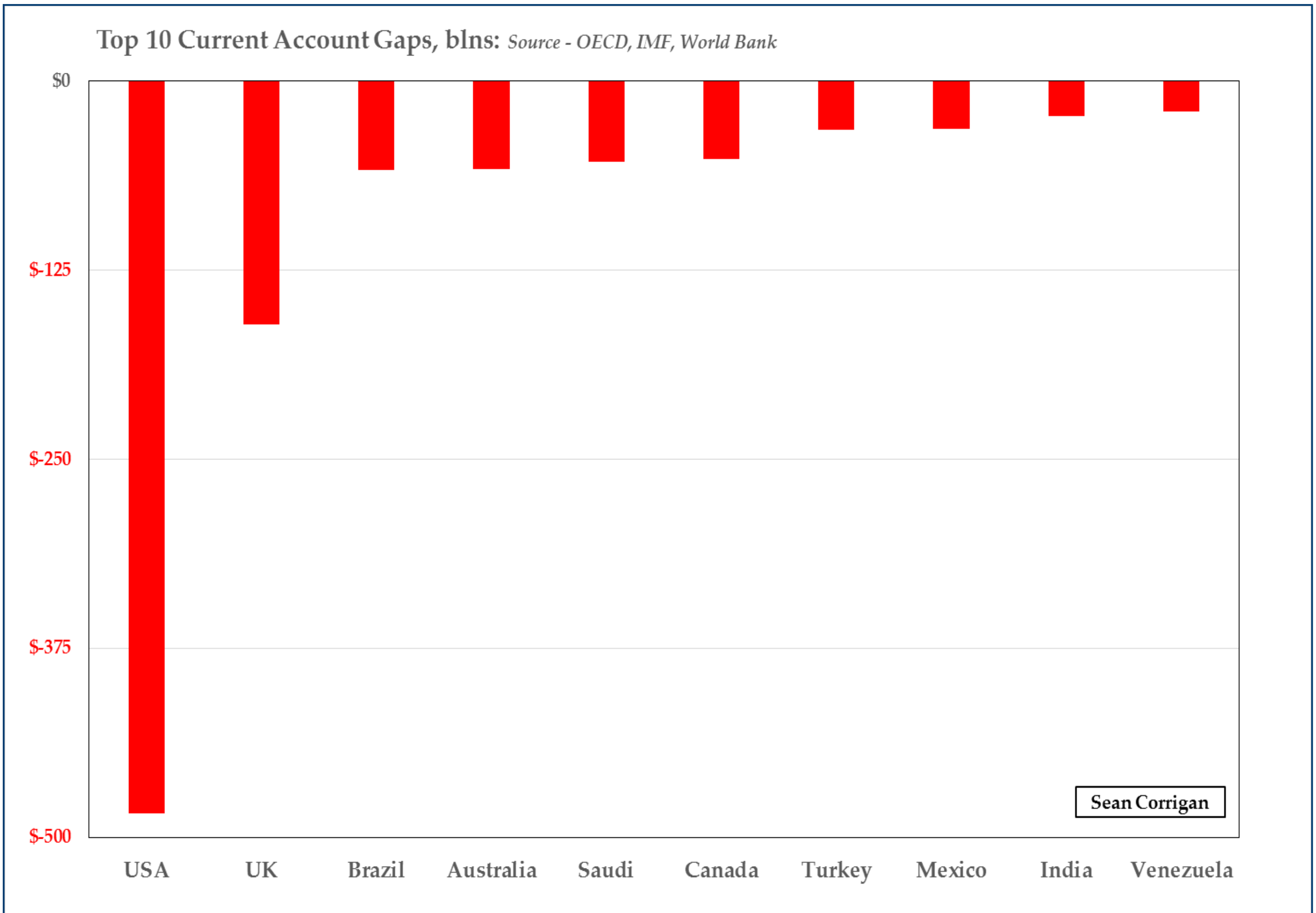
Treating the span from the start of 2014 to the third quarter of last year as our reference period and comparing it to the experience of the subsequent two quarters either side of year-end, we find – taking all such calculations on an annual equivalent basis – that the overall balance worsened appreciably from an already sizeable -£85.6 billion to a gargantuan -£133.1 billion.

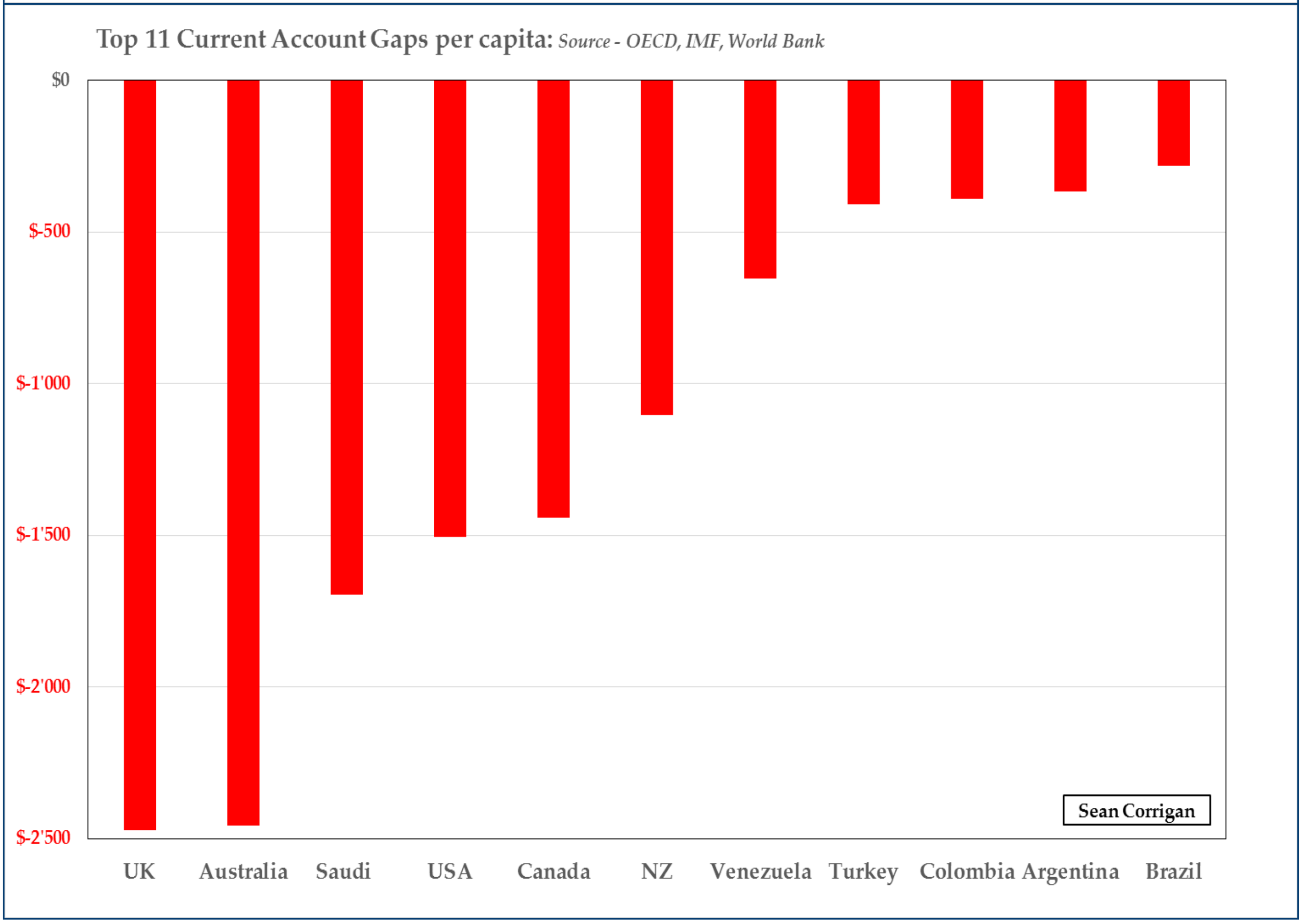
Of that £46.7 billion, 54% increase in red ink, just under three-quarters (£33.8bln) was indeed due to a slump in the 'primary income' category. The vast bulk of this was attributable to the sudden swing from small surplus to hefty deficit in that particular component recorded against non-EU nations – roughly half of that vis-à-vis the USA and a sixth against the BRIC bloc (a wider geographical breakdown is not currently available).

One can only surmise that much of this has been due to the ongoing commodity slump, as reflected in the FTSE Oil & Gas sector's 35% underperformance of the broader index, or the Mining sector's 65% relative slide. And so – yes – as such, there is little that a slide in the pound can do to ameliorate this, except for some minor translational effects in bringing home a shrinking pot of extracted dollar earnings.

Know when to hold'em. Know when to fold'em

However, it should not be overlooked that, notwithstanding such extraordinary factors, more than a quarter of the last six months' savage descent was due to a record deficit in the trade of goods being conducted with the EU. Would


Top 10 Current Account Gaps, blns: Source - OECD, IMF, World Bank
$0
$-125
$-250
$-375
$-500
Sean Corrigan
USA
UK
Brazil
Australia
Saudi
Canada
Turkey
Mexico
India
Venezuela


Top 11 Current Account Gaps per capita: Source - OECD, IMF, World Bank
$0
$-500
$-1'000
$-1'500
$-2'000
$-2'500
Sean Corrigan
UK
Australia
Saudi
USA
Canada
NZ
Venezuela
Turkey
Colombia
Argentina
Brazil

it therefore be entirely disingenuous to ask those who deny that the pound's recent setback can have any benign influence whatsoever if the 30% rise in the sterling-euro exchange rate, much less the 35% ascent of the ratio between the two regions' *real* effective rates, might have played some part when this more than doubled from stable, average levels of around £40bln a year which were typical of the period 2005-11 to a recent count well on the way to reaching £100bln p.a.?

As well as a question of relative pricing, admittedly, it might also have something to do with differences in both the availability and the appetite for credit, as well as with the purposes to which that credit is being put. This is something to which we shall treat in more detail below.

Taking the last two years as a whole, it should be noted that more than two-thirds of the UK's goods shortfall is attributable to dealings with the EU, even though they account for barely more than half of all two-way trade. Conversely, on the service account, where the UK actually manages a surplus, only slightly in excess of a quarter of such net income is earned on the more than two-fifths share of the global tally of activity attributable to Europe.

[As a brief digression, given that close to a quarter of Britain's service exports and nearly a half of its surplus is due to 'Finance', even this pocket of success is not an unalloyed positive, given that this is the sector most reliant on implicit, morally hazardous, state and central bank support. Such covert rent-seeking may help the country 'pay its way' in the world when the skies are blue but no-one should need reminding of how much of that ostensible bonus gets clawed back when the storm cones are hoisted, as happens with lamentable regularity.]

Being responsible additionally for seven-eighths of the primary income shortfall even in these straightened times when the ROW numbers have slumped and further chipping in half of the secondary income drain (thanks largely to the country's contentious net contribution to the EU budget), it is not entirely clear that the UK will have to play a weak hand in the forthcoming discussions with Continental trade ministers, especially since they are likely to be subject to narrow, mercantilist fantasies that (net) exports are all a good thing and (net) imports are all a bad one.

Put another way, for every £1.00's worth of goods imports shipped from the EU, the UK sends back only 60p in exports whereas the return in the rest of the world is 80p – a ratio a full third better. In services, even though Britain does manage to achieve a £1.31 inflow for every £1.00 laid out to its Continental neighbours that is still a full third less than the £1.91 it secures in the wider world. Taken together, what we see here is that a purchase of £1.00 made in Europe is offset by only 76p in sales whereas the ledger sees a welcome £1.11 receipt elsewhere.

That much-vaunted 'access to the single market of 500 million people' – with its concomitant denial of better terms of access to the multiple markets of the other 7 billion people who comprise them in their turn – hardly seems so compelling when viewed in this light. At the very least, this should fortify the Brexiteers in their resolve not to accept too large a manifest of non-economic baggage from the EU as the price for any extension of its current 'privileges'.

Knowin' what to throw away, knowin' what to keep

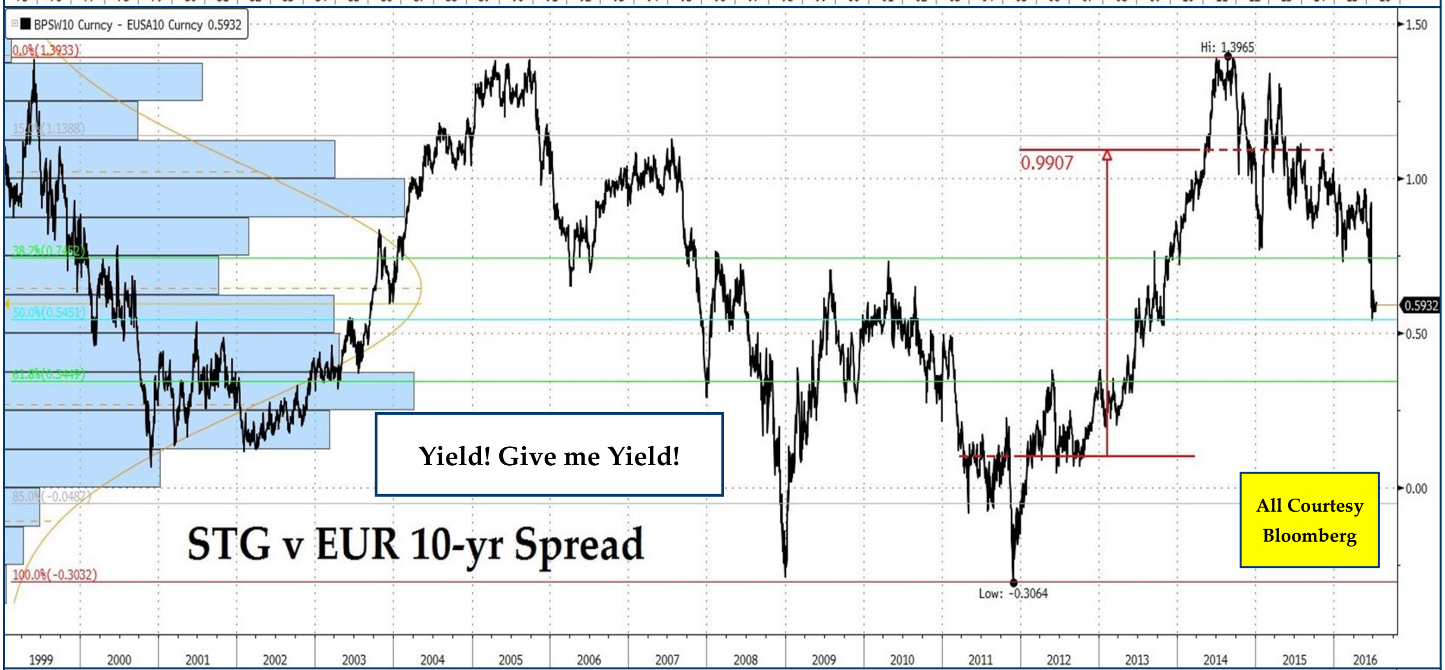
The flip side of any debit has to be a credit, of course, so the next question to consider is that of how the UK is paying for all this and then, by extension, just who is doing the paying.

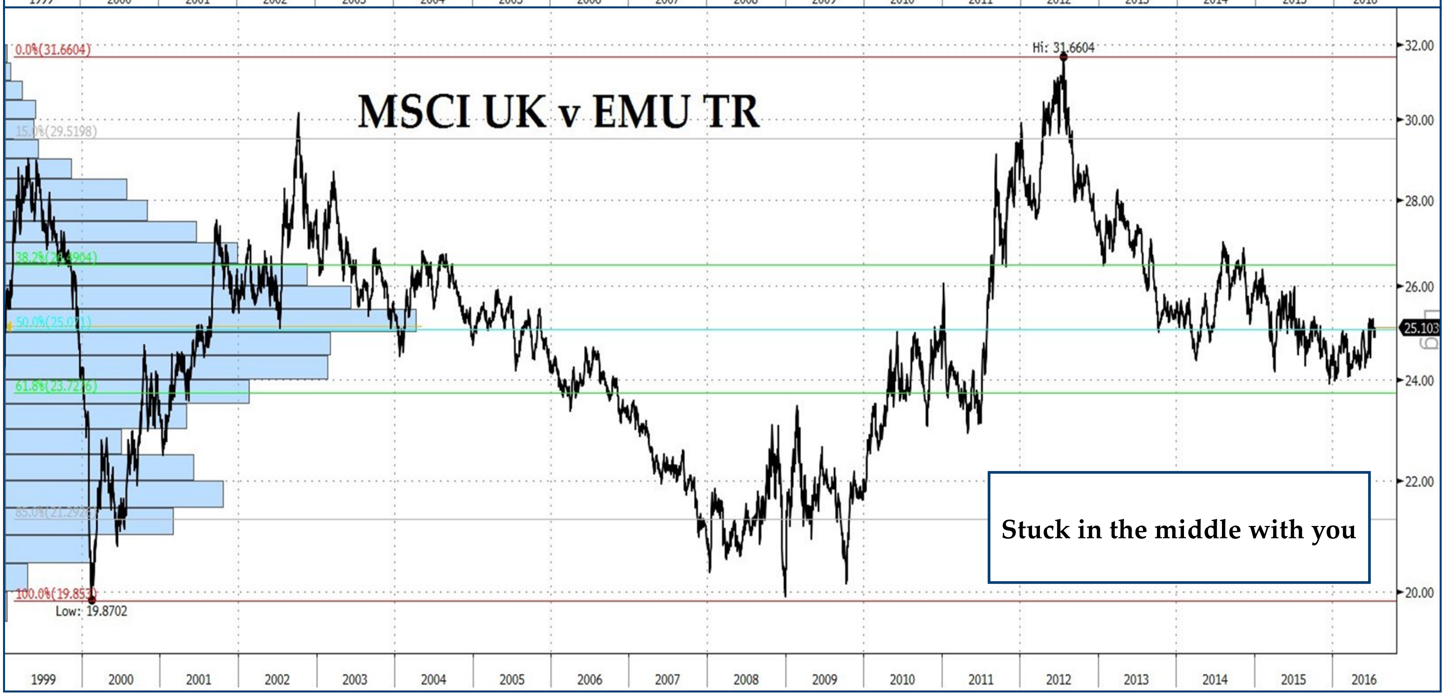
In the course of the past two years, the cumulative gap which those 'strangers' have been so kindly undertaking to finance has reached just short of £200 billion. This has taken place via two main channels; one of which offers some short-term comfort in that it has helped reduce the most immediate of vulnerabilities but which is also one which might signal greater problems ahead.

Thus, the largest single entry in the accounts shows that, in addition to running up that not inconsiderable trade and income tab, the UK has also had to accommodate a sizable, £429bln loss of desire on the part of the ROW to continue to place non-sterling deposits in the country (-£156bln) or to grant short terms loans (-£304bln) to its 'other' financial institutions.

In part this adjustment has been made through the hefty purchase of (non-zero yielding) UK debt to the tune of £278bln (£63bln in Gilts, £32bln in bank paper, and £153bln by other category of issuer). A further £62bln, by inference,


GBP TWI
If the rally helped widen the gap, why will the sell-off not help?
+20.82%
95.30
75.63
'75 '76 '77 '78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16


BPSW10 Curncy - EUSA10 Curncy 0.5932
0.0%(1.3933)
Hi: 1.3965
0.9907
Yield! Give me Yield!
STG v EUR 10-yr Spread
100.0%(-0.3032)
Low: -0.3064
All Courtesy Bloomberg
0.5932
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016


0.0%(31.6604)
Hi: 31.6604
MSCI UK v EMU TR
100.0%(19.853)
Low: 19.8702
Stuck in the middle with you
25.103
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016

has been redeemed as UK MFI's and other financials have liquidated a sizeable slice of their (currency-hedged?) off-shore equity holdings (the pension/insurance sector rid itself of a further £10bln or so), while the bulk of the remainder has been met by a corresponding reduction in the quantity of UK bank loans (-£78bln) extended to those abroad.

So far, so good since this reshuffling means that the UK is less reliant on wholesale bank finance; always a major aggravating element in any outbreak of economic turmoil.

A further British contribution to footing the bill took the form of a £16bln reduction in the equity held in and a £64bln recall of the credits (largely inter-company loans) booked against the country's stock of direct investment – both possibly a further consequence of the write-downs and disposals taking place in the sorely-afflicted commodity sector.

On the more active side, a handy consignment of family silver has been snapped up by the UK's foreign creditors in the form of a net £59 billion in FDI inflows (£85bln in largely unquoted equity purchases being partly offset by £16bln in simultaneous debt reduction) together with £89 billion in portfolio equity inflows.

This obviously represents a more stable form of finance in the present, but it also means that it will be less and less easy in the future for the UK to earn, as it for so long has managed to do, greater returns on its foreign assets than it pays out on its larger stock of foreign liabilities. Since its trade is likely to be in near-perpetual deficit, this can only imply a possible future snowballing of the overall balance of payments woes as net investment income adds to, rather than subtracts from, the sums to be settled.

Finally, by way of tidying up the reckoning, the past two years have also seen a paltry net £15bln in foreign debt being bought by Britons, alongside their £9bln receipts from derivative income and ESOP sales and the acquisition of £28bln in forex reserves – whether for reasons of precaution or to brake the earlier ascent of the exchange rate.

If you don't mind me sayin' I can see you're out of aces

On an even wider horizon, the seventeen years since the single-currency was introduced have left the UK with a cumulative £750 billion current account gap, as part of which a piffling £30 billion ROW surplus has modestly reduced the mountainous overall £780 billion EU deficit.

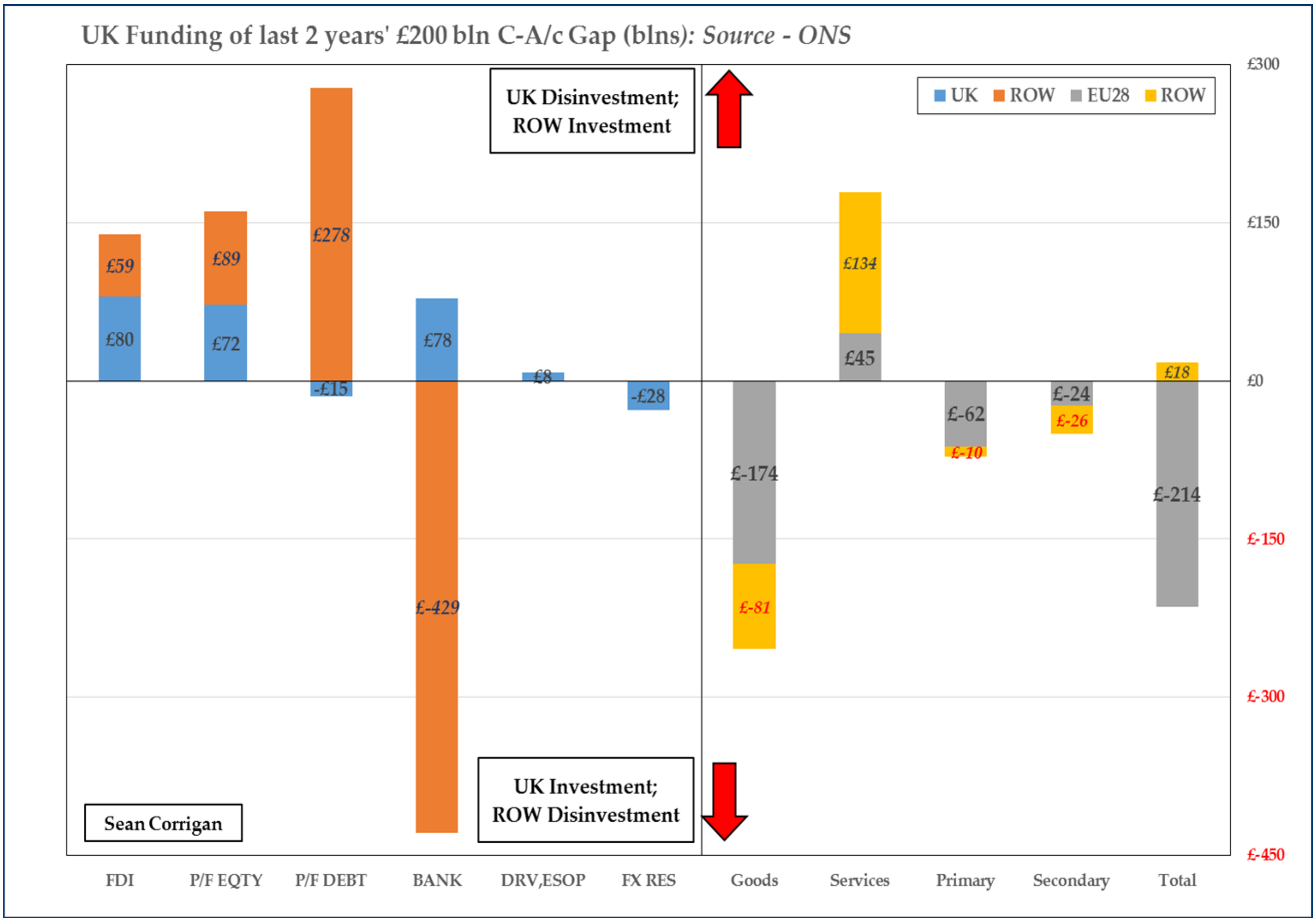
Global FDI flows over this whole stretch have almost exactly cancelled out, with a building outward excess in the early years reversing to the point of disappearance since the 2008 Crash. A steep net influx over the past two years has seen the portfolio equity balance move from accumulated net UK assets of £20bln to net liabilities of £140bln as a result of both domestic selling and foreign buying of each other's stocks.

What we might think of as build-up of carry-trade or repo'd debt holdings sees a net £270 billion of UK external bank assets now counterpoised by net debt liabilities, all of which leaves the $600 billion-plus residual from the current account to be bridged by an increase in outright portfolio debt holdings. This is a form of investment which has grown increasingly attractive as European yields have plunged to and through zero and as the spreads attainable on their UK equivalents having expanded from their 30bps median of 2011/12 to the 130bps attainable in the past couple of years.

But if Brits have run up a £3/4 trillion, 40% of (current) GDP external tab since the euro was launched, who precisely has been borrowing and spending so unrestrainedly in excess of income in order to do so?

If we now seek enlightenment among the UK's sectoral accounts, the answer is not long in emerging, for here it is all too evident just who has been responsible for making the new millennium a period of gross capital consumption in Albion.

Over the entire period, net private saving – the bedrock of genuine capital formation in any well-functioning society – almost exactly matched the external gap, coming in at £525 billion for non-financial corporations and £223 billion for households. But since such saving tends to the establishment of an external surplus, not a deficit, this arithmetical coincidence carries the wrong sign and so only doubles the


UK Funding of last 2 years' £200 bln C-A/c Gap (blns): Source - ONS
UK Disinvestment; ROW Investment
UK Investment; ROW Disinvestment
UK
ROW
EU28
ROW
£59
£80
£89
£72
£278
-£15
£78
£-429
£8
-£28
£-174
£-81
£134
£45
£-62
£-10
£-24
£-26
£18
£-214
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£300
£150
£0
£-150
£-300
£-450
FDI
P/F EQTY
P/F DEBT
BANK
DRV,ESOP
FX RES
Goods
Services
Primary
Secondary
Total


FTSE O&G v All-Share
F3OILG Index / ASX Index 210.784
Courtesy Bloomberg
FTSE MNG v All-Share
Two good reasons why income dried up?
F3MNG Index / ASX Index 322.5876
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
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2015
2016

size of the drain which must have elsewhere been in operation.

In part, this can be attributed to a financial sector which absorbed £370 billion in resources – itself perhaps suggestive of the skewed priorities at work in the land. But the main culprit is not hard to identify, for a cool £1.2 trillion in governmental deficits were accrued in this period, more than half of it during the so-called 'austerity' programme of George Osborne. Given that the bulk of what the state spends its (its people's) money on takes the form of outright consumption, often in pursuits which represent a detraction from, rather than an addition to, the productive capabilities of others, this is indeed a heavy burden to bear.

Nor is it one which should offer either future taxpayers at home or existing creditors abroad much comfort that the sums being borrowed are being put to use in a manner which will guarantee the generation of sufficient real value to enable both the service and, ultimately, the redemption of the associated debts.

By way of context, that £1/2 trillion-odd in corporate savings equates to around a quarter of all the gross fixed capital formation undertaken over this horizon and to roughly 100% of the net figure, a revelation which should prompt us to ponder whether that money might better have been spent in re-equipping factories, training workers, and developing new products and processes rather than paying the wages of Sustainable Footpath Outreach Officers and the expansive welfare benefits furnished to those for whom a life of Eastern European levels of hard graft for minimal pay in the potato field next door is too daunting a prospect in comparison.

When contemplating this vast diversion of effort and output, it is hard to resist the ironic observation that while so much heat was generated over the Leave campaign's slogan - contentiously emblazoned on the side of its battle-bus - that the nation should 'take back control' of the £350 million it claimed was being sent to Brussels each week when (after deducting internal transfers of £120bln a year) that self-same amount is routinely sent to centres of government in Westminster, Edinburgh, Cardiff, and so on down, once every 4 hours and 45 minutes!

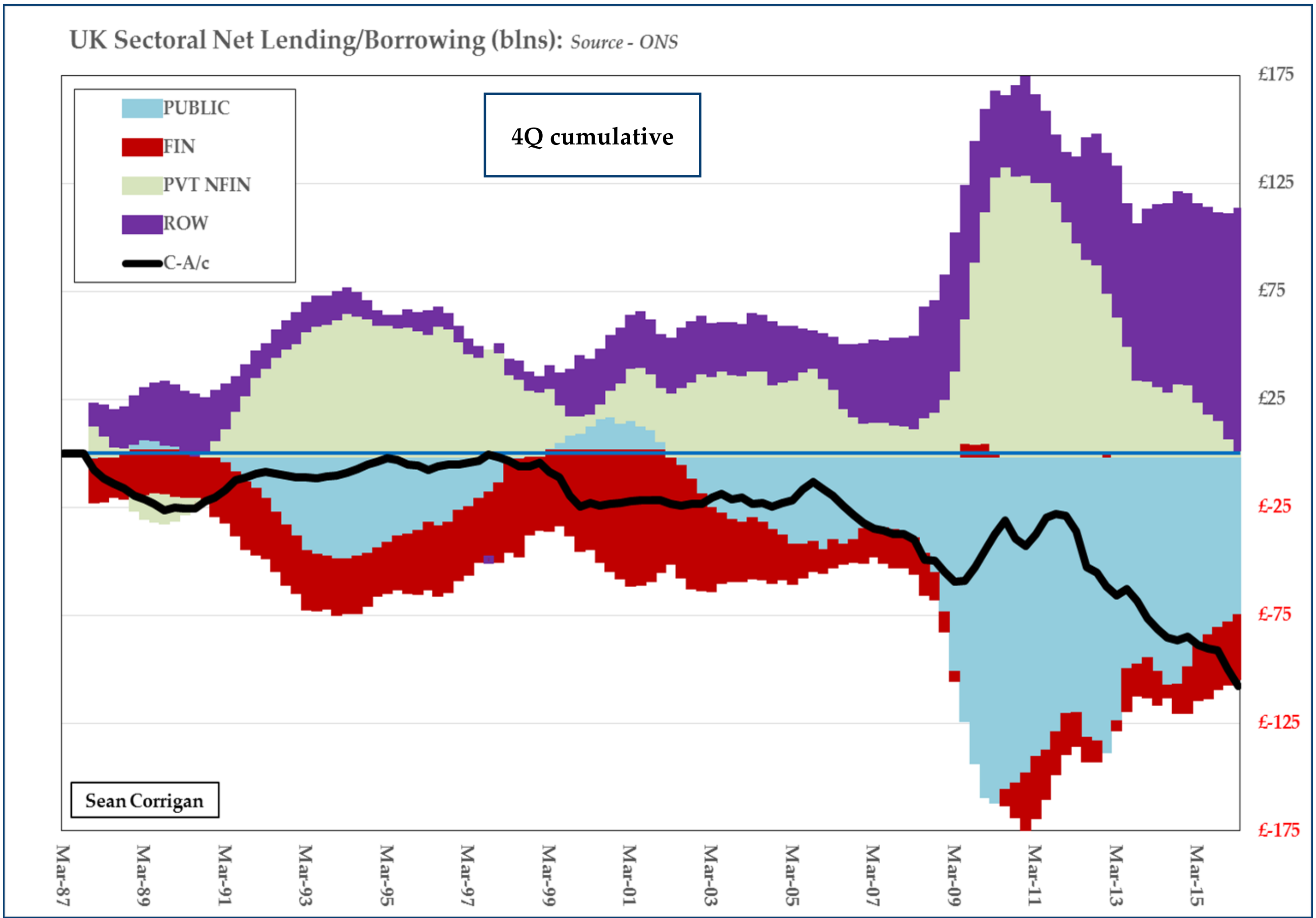
When the economic 'experts' regard the working of a nation which devotes so much of its people's energy to the Bastiat's Railway game of interposing a relay of powerful state intermediaries – with all their misaligned interests, imperfect knowledge, and lack of 'skin in the game' – between the buyers and purveyors of everyday services; and when they note just how much capital is blithely consumed to sustain this occupying army of 'soft budget' spendthrifts, they should not be entirely shocked to find that genuinely productive activity is being stifled as a result, worsening the land's unrequited reliance on foreign suppliers to meet needs it now has no hope of supplying itself.

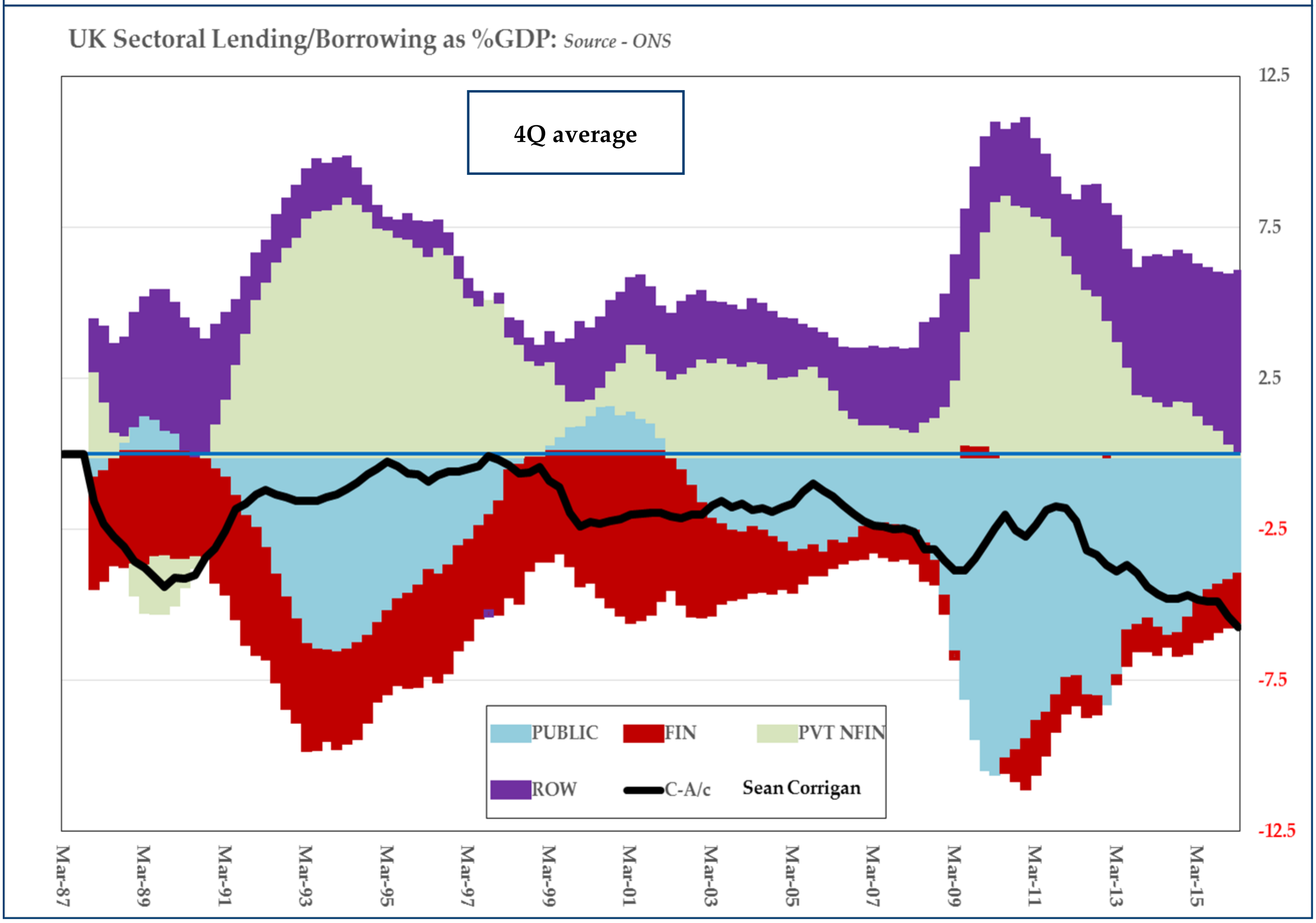
Far from seeing this as a 'paradox' whose resolution tempts them to heed the sickly sweet blandishments of the patent medicine men of macroeconomics and monetary manipulation, they should face up to the simple truth that industry languishes and commerce has grown unhealthy because Leviathan has waxed so large on the harvest of his subjects that they are not able to set aside sufficient seed-corn to increase the area under the plough.

Though it is hard to achieve a definitive view of how exactly one should incorporate it in a set of numbers which already require sizeable adjustments to reconcile estimates of flows to the contemporary record of changes in the stock of assets and liabilities, this already-debilitating lack of provision is being worsened by the other significant lacuna which exists in the intertemporal reckoning if not in the day-to-day account books.

This particular sinkhole concerns the fact that some good part of such 'savings' as are being made are plainly directed at securing an income in retirement. The sad fact, however, is that the funding position of defined benefit pension schemes in the UK has been adversely affected by the collapse in bond yields which has been engineered in such cavalier fashion by the BOE in the name of delivering 'stimulus' – i.e., of tipping the scales heavily in favour of borrowers and so promoting yet more capital consumption, regardless of the longer term consequences.

The extent of this, as the Pension Protection Fund lays out in some detail each month, is that the £1.7 trillion theoretical joint entitlement of such schemes' members is now underfunded to the tune of more than £380 billion – a near record shortfall of 22% which has grown 80% in a year and


UK Sectoral Net Lending/Borrowing (blns): Source - ONS
PUBLIC
FIN
PVT NFIN
ROW
C-A/c
4Q cumulative
Sean Corrigan
£175
£125
£75
£25
£-25
£-75
£-125
£-175
Mar-87
Mar-89
Mar-91
Mar-93
Mar-95
Mar-97
Mar-99
Mar-01
Mar-03
Mar-05
Mar-07
Mar-09
Mar-11
Mar-13
Mar-15


UK Sectoral Lending/Borrowing as %GDP: Source - ONS
4Q average
PUBLIC
FIN
PVT NFIN
ROW
C-A/c
Sean Corrigan
12.5
7.5
2.5
-2.5
-7.5
-12.5
Mar-87
Mar-89
Mar-91
Mar-93
Mar-95
Mar-97
Mar-99
Mar-01
Mar-03
Mar-05
Mar-07
Mar-09
Mar-11
Mar-13
Mar-15

one which afflicts more than four out of every five of the roughly 6,000 extant plans, if with varying degrees of severity.

Given that this not only represents a fifth of householders' calculated net financial worth, but is more than 70% larger than the sums supposedly put aside by savers in the period under discussion, and given, too, that it takes a 5% rise in equity prices to compensate for every 10bps lowering of Gilt yields, the inference should be obvious: the artificial suppression of interest rates is a means of unfairly redistributing an existing pie, not of baking a larger one.

On a warm summer's eve, on a train bound for nowhere

If we once more focus in on the present, another cause for concern looms; *viz.*, the ongoing collapse in private saving under the influence of Carney's destructively overeasy policy. Having become net debtors in the euphoria of the last boom, the rude awakening of the ensuing bust had initially prompted householders as a class to rebuild their balance sheets. Aggregate 4Q dissaving of £21.4bln (1.4% GDP) on the eve of the collapse thus reversed to net saving of £73.9bln (4.7%), two years later.

Over a slightly longer, but broadly overlapping timeframe, non-financial corporates similarly went from lending £24.6bln (1.6% GDP) to setting aside £64.9bln (4.3%) meaning that, as the grim reality of what the previous episode of malinvestment and the maintenance of too prodigal a lifestyle sank in, the private non-financial sector as a whole turned a scant £12.7bln (0.8%) in capital formation on the eve of the cataclysm into a healthy £133.8bln (8.7%) act of sanitization shortly thereafter.

However, as the pernicious collapse of yields, long and short, has persisted far beyond any possible emergency justification for them, neither side has been able to resist the tsunami of perverse disincentives put before them. Rather than playing their traditional role as the generators of productive capital, householders have again become net borrowers of £10+ billion while NFC's are now responsible for a surplus of only £12.9bln which is the smallest since mid-2009. As a combination, this means a bare £2.7bln is being set aside, hardly even an error term as a proportion of national income. Is it too surprising to remark that this is a situation not seen since the Lawson Boom was just rolling over from its peak, way back in 1990? Perhaps not once we realize that house prices are up 30% and commercial property ones 25% in the past three years.

With rather unfortunate timing, the ONS stats show us that the private financial sector is also a net taker of funds, the ~£27bln it presently requires being the largest call on the savings pool it has made these past twelve years. Foreigners – kindly or not – are therefore now funding housing speculation, student loans, online shopping, record levels of car sales, financial sector regulatory adjustments (among other items), and above all that biggest of Big Beasts, the ever importunate state.

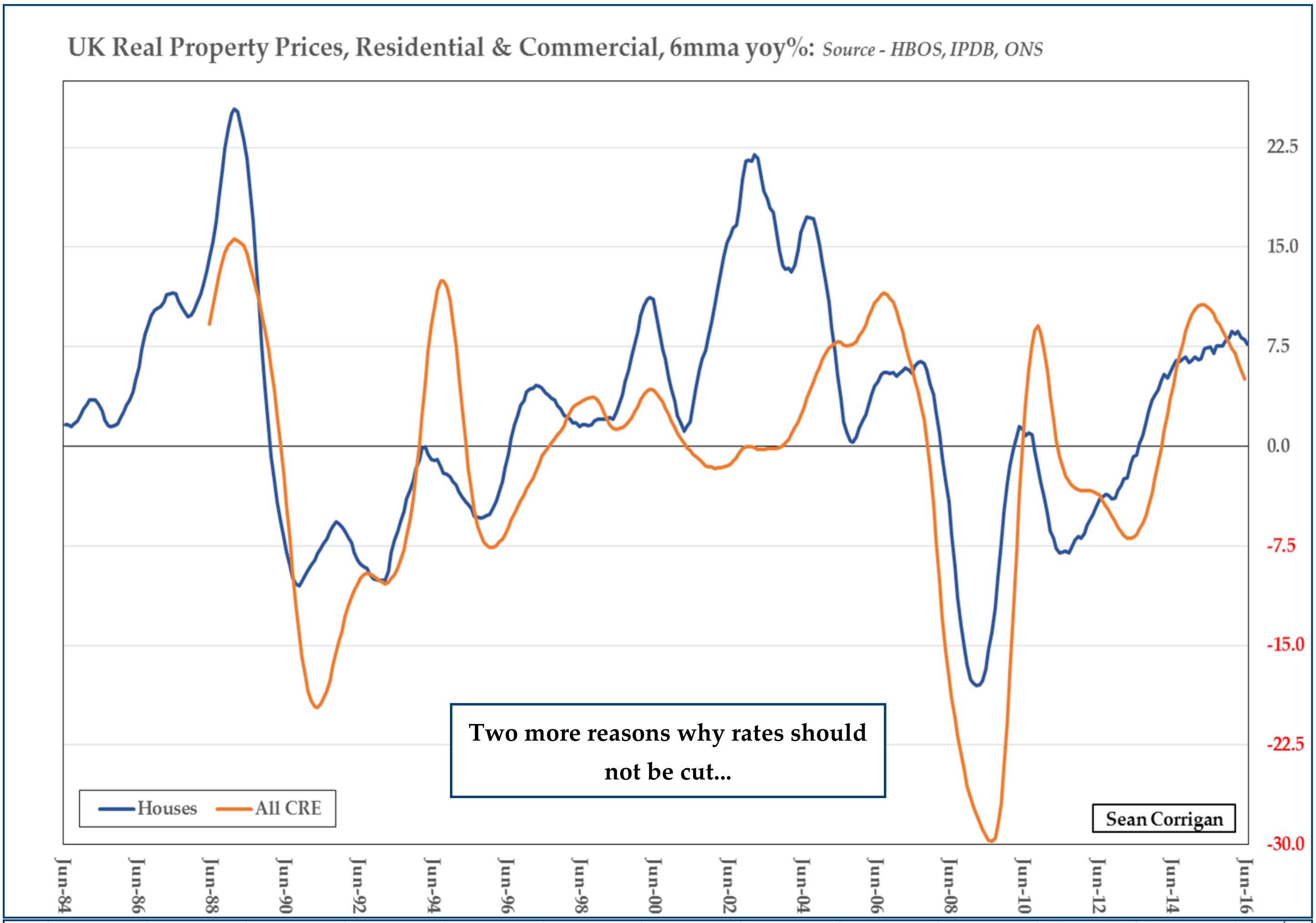
Does the reader think, then, that this is a country where any impending slowdown in what has become an increasingly unhealthily-founded mix of activity should be met with another round of 'muscular easing' to use the trenchant phrase of the BOE monetary extremist, Andy Haldane?

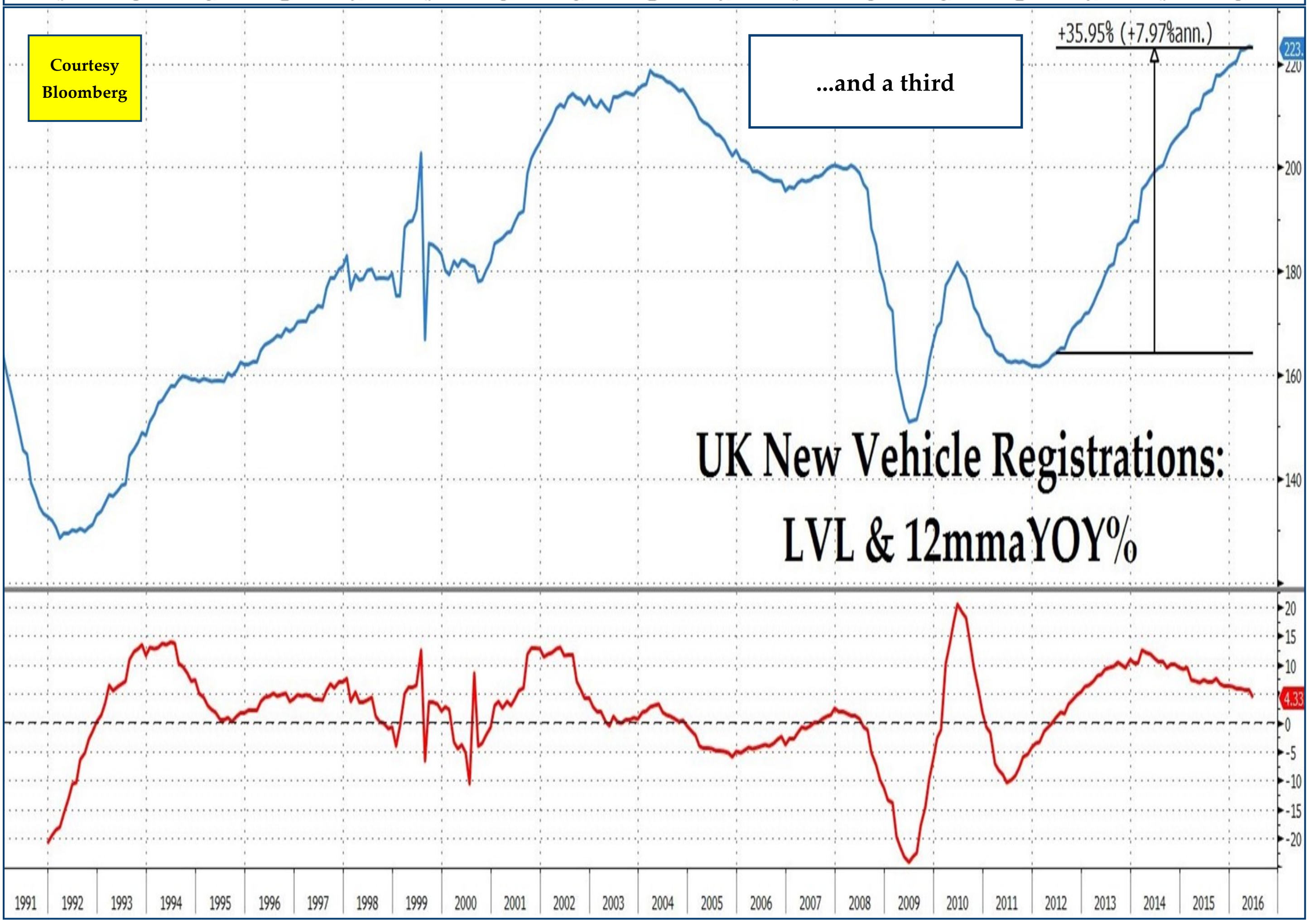
Does the reader also view with equanimity the idea that a government which has shown a typical inability to manage big projects - take, for example, the developing HS2 rail fiasco, or ponder upon the appalling confusion which characterises its entire energy policy (Hinckley Point, *q.v.*) - should now be borrowing – as the new Chancellor has hinted he intends to - to 'invest' in more grandiose infrastructure projects as part of some antiquated, Keynesian – not to say Schachtian – make-work-buy-votes plan?

If you're gonna play the game, boy, you gotta learn to play it right

Having posed those two rhetorical questions, we come full circle to the question of whether the fall in sterling could possibly redound to the UK's benefit. The answer as we see it is a fairly straight forward, Yes, but only if Carney and Hammond do not act to neutralize the depreciation's effects.

The country spends more than it earns abroad, spends it at an increasing rate, and tends to spend on non-tradeable or unproductive goods as well as on far too many actively counter-productive ends. The devaluation, by decisively moving the terms of trade, should redirect activity internal-


UK Real Property Prices, Residential & Commercial, 6mma yoy%: Source - HBOS, IPDB, ONS
Two more reasons why rates should not be cut...
Houses
All CRE
Sean Corrigan
22.5
15.0
7.5
0.0
-7.5
-15.0
-22.5
-30.0
Jun-84
Jun-86
Jun-88
Jun-90
Jun-92
Jun-94
Jun-96
Jun-98
Jun-00
Jun-02
Jun-04
Jun-06
Jun-08
Jun-10
Jun-12
Jun-14
Jun-16


Courtesy Bloomberg
...and a third
+35.95% (+7.97%ann.)
UK New Vehicle Registrations:
LVL & 12mmaYOY%
220
200
180
160
140
20
15
10
4.33
0
-5
-10
-15
-20
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016

ly while refocusing it away from exhaustive consumption. Exports and import-substitution should be favoured – helping to increase the opportunities for both labour and capital to find a new role (fraccing would be a big help here): imports should be discouraged – slowing the build-up of that most noxious form of indebtedness, the one which is contracted with no associated hope of redemption.

Yes, this will initially see a fall in real incomes, to the probable accompaniment of a rise in prices, until the system adapts to the new matrix of possibilities but the resultant hardship should be both temporary and later well-rewarded. But - and here is the biggest of big 'buts' – if the government and the Bank of England seek to supplement that shrunken purchasing power with yet another infusion of credit, this will not be a potentially therapeutic, if initially uncomfortable, reset but rather a re-run of the bitter experiences of the likes of serial devaluers such as Italy or Latam - or even of the reality-denying UK of the 1970s.

Britain has long been living beyond its means and has been afforded extraordinary licence to do so by the extreme policies implemented following the collapse in those other nations which had overstretched themselves prior to 2008's harsh awakening. If the lowered valuation of the currency better reflects the country's true circumstances and so sends higher fidelity signals to both consumers and producers regarding how best they should act and what they can afford most profitably to undertake henceforward, then all to the good, I say.

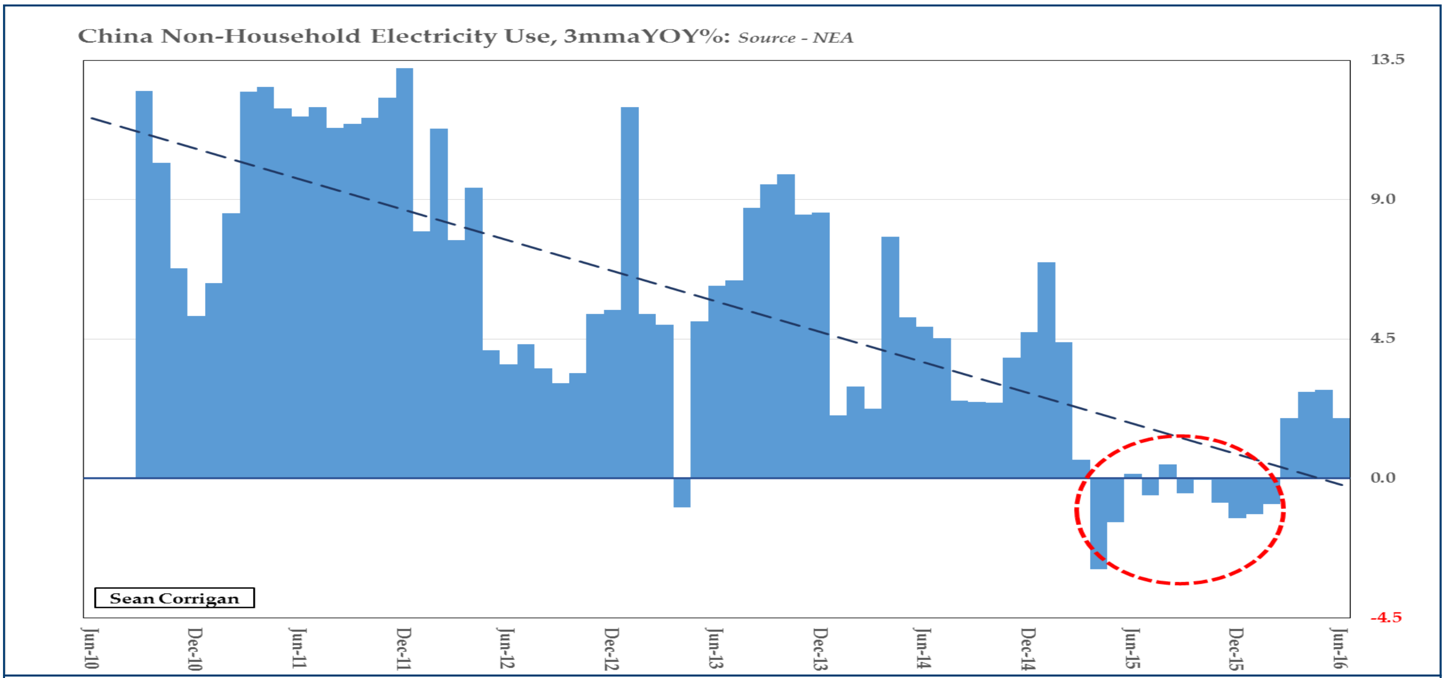
Then, just as happened after the 1992 devaluation, less, not more, recourse to credit and more responsible fiscal policy would encourage people to roll up their sleeves, work harder, rebuild both their finances and their industrial and commercial competitiveness and so offer themselves a much better set of potential outcomes, once the inescapable pain of the re-orientation process had been endured.

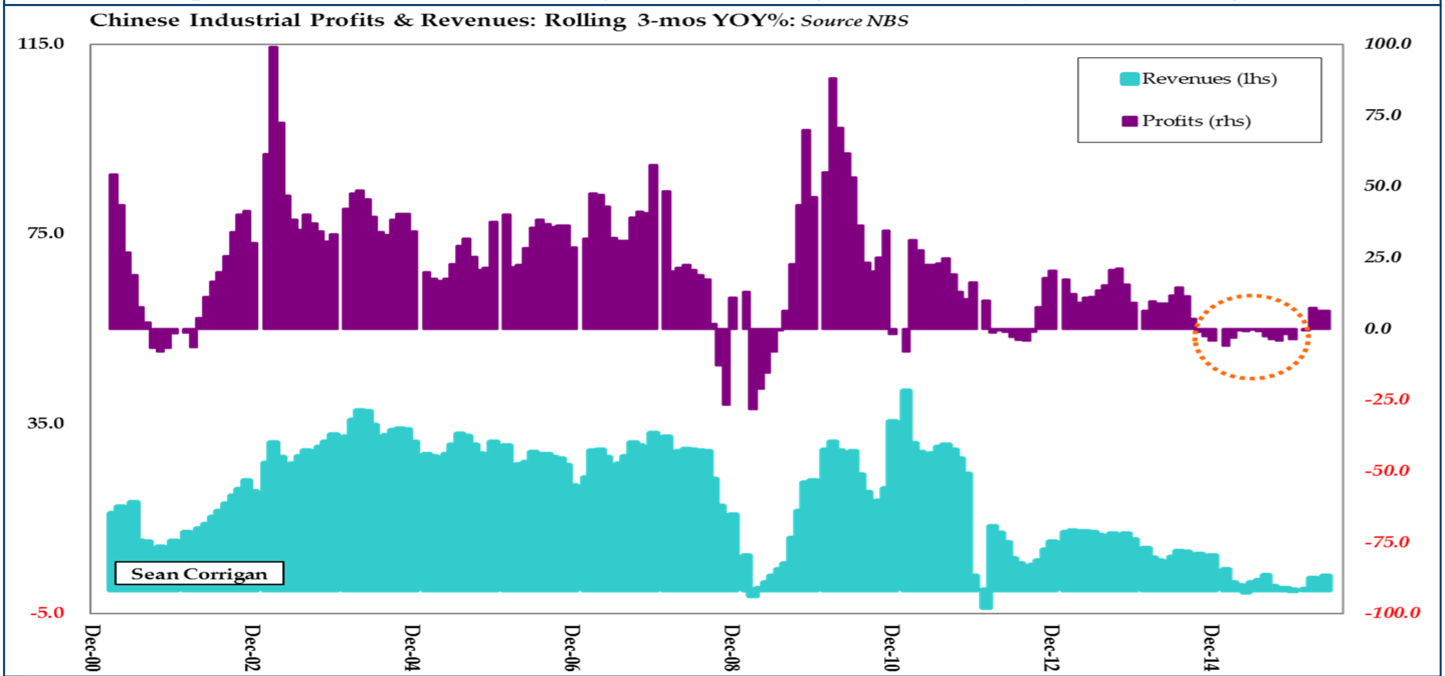
If the government wishes to lessen the degree – or at least shorten the duration – of this unpleasantness, the best it can do is remove barriers to entrepreneurship, lessen the costs and inflexibilities associated with employment, and firmly direct its rogue central bankers to act smartly to allow a restoration of genuine capital pricing.

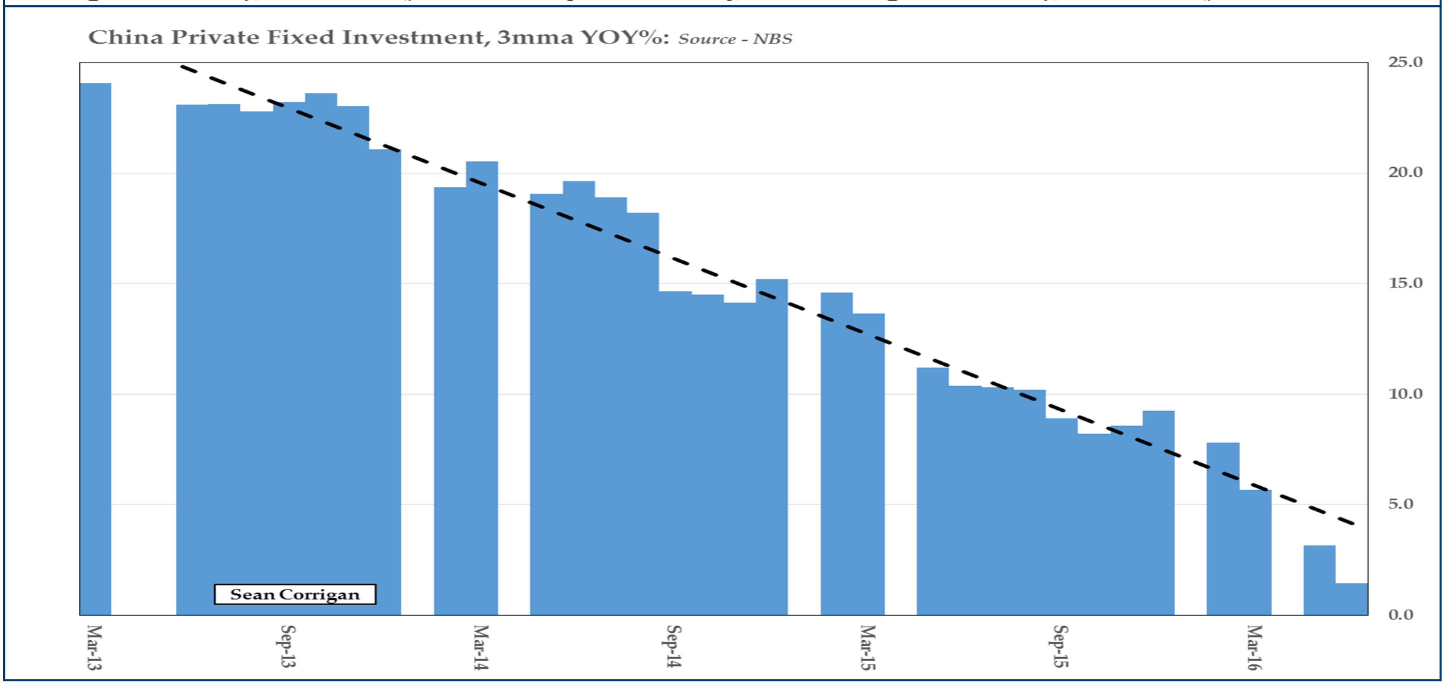
If, however, every increase in the bill for imported goods prices is accompanied by a zero-rate loan from the BOE; if every gain in income for a local exporter does not shift relative prices in his and his workers' favour - and so correctly place more resources at their disposal - but is instead greeted by a renewed competition with the revenue-reduced mass out wielding their cut-rate credit-cards; if the astute businessman spots new opportunities to expand only to be forced to vie with economically-illiterate ministers of state posing in their Hi-Viz and hard hats at sod-turning photo-ops, the drop in the pound will only be seen in retrospect only to have ushered in a new wave of woes, albeit a wearily familiar set of them.

Oh, and when it does all go horribly wrong, you'll be sure to see both the authors of such unnecessary evils and their unwillingly side-lined contenders for office blaming Brexit for the resulting calamity.

How better, after all, to deflect attention from the fact that both sides will have espoused almost exactly the same set of entirely inappropriate responses to both the challenges and the chances for betterment which that act of secession, that potentially Glorious Devolution, had fleetingly offered them and their fellow countrymen?


China Non-Household Electricity Use, 3mmaYOY%: Source - NEA
13.5
9.0
4.5
0.0
-4.5
Sean Corrigan
Jun-10
Dec-10
Jun-11
Dec-11
Jun-12
Dec-12
Jun-13
Dec-13
Jun-14
Dec-14
Jun-15
Dec-15
Jun-16


Chinese Industrial Profits & Revenues: Rolling 3-mos YOY%: Source NBS
115.0
75.0
35.0
-5.0
100.0
75.0
50.0
25.0
0.0
-25.0
-50.0
-75.0
-100.0
Revenues (lhs)
Profits (rhs)
Sean Corrigan
Dec-00
Dec-02
Dec-04
Dec-06
Dec-08
Dec-10
Dec-12
Dec-14


China Private Fixed Investment, 3mma YOY%: Source - NBS
25.0
20.0
15.0
10.0
5.0
0.0
Sean Corrigan
Mar-13
Sep-13
Mar-14
Sep-14
Mar-15
Sep-15
Mar-16

It has been some while since we devoted much space to the goings in in that land of eternally postponed reform, China – sticking plaster capital of the world. In part this has been because there has been little new to say, certainly not in comparison with the hoopla generated by its Mississippi Bubble 2.0 episode of last year and the flight of several $100 billion out of the country which began to gather in its immediate aftermath.

Gradually, however, the pot has been coming to the boil, leaving the poor little amphibian within croaking plaintively in discomfort.

The first thing to note is the truly remarkable turnaround in the monetary dynamic in the country, starting with the shift from forex-led growth to that of the internal kind.

The first phase of this started slowly enough as, for example, during the first five or six years after the great upheavals of the mid-90s, when forex reserves on the PBoC's balance sheet represented a fairly stable one-third of national M1 and were perhaps a twentieth of the global total.

Then, came the country's 2001 accession to the WTO – an event which might have been transformative enough on its own, but which came about amid the exceptionally easy policies introduced by its major trading partners, their aim being both to avoid any Franco-German embarrassment in the immediate aftermath of the launch of the European single currency and to offset the successive shocks of the bursting Tech Bubble and the epoch-defining attack on the Twin Towers a year later.

In the circumstances it was not too long before China had started to roar along with the upsurge of the commodity 'super-cycle' in which grand excitement it was both driver and driven.

Over the decade and more which was to follow, reserves multiplied remarkably as the authorities sought to prevent a runaway in the yuan, turning the equivalent of $180 billion in 2001 into a monster $4.4 *trillion* towards the end of 2014 and comprising three-eighths of the world's entire stockpile. Along the way, as the bank fought valiantly to sterilize some of the influx, FX holdings briefly reached a peak equivalent of 93% of domestic M1 in 2008 before dipping 10 percentage points or so during the horse-doctor adrenalin injection which took place in the wake of the Lehman crisis.

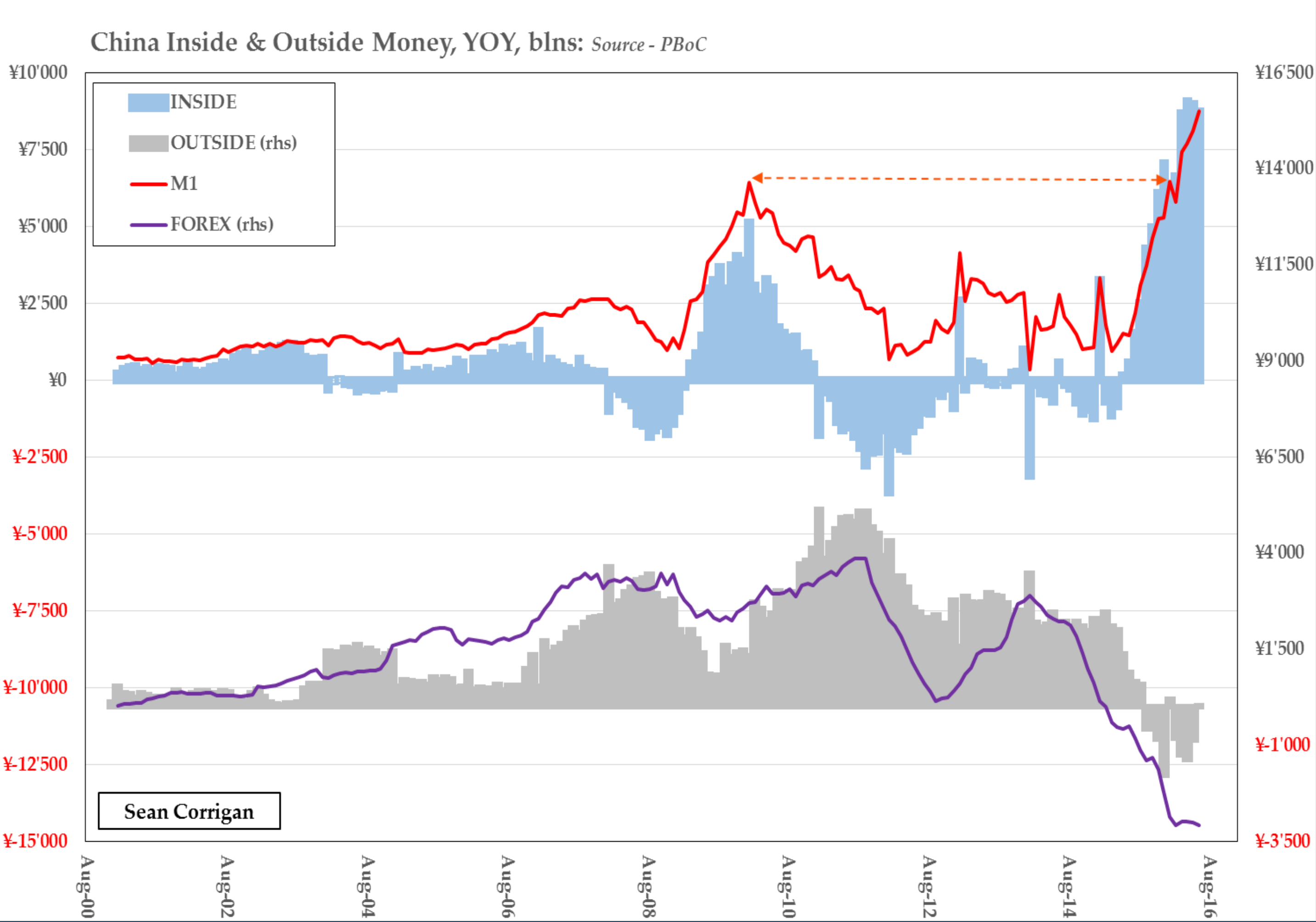
Having then remained fairly stable at 82% +/- 5% of M1 for the next five years or so, the onset of the forex drain which began two years ago saw the count of these fall by $8-900 billion (depending on the measure used to gauge this decline), depressing the fraction inexorably toward today's 11-year low of 53%.

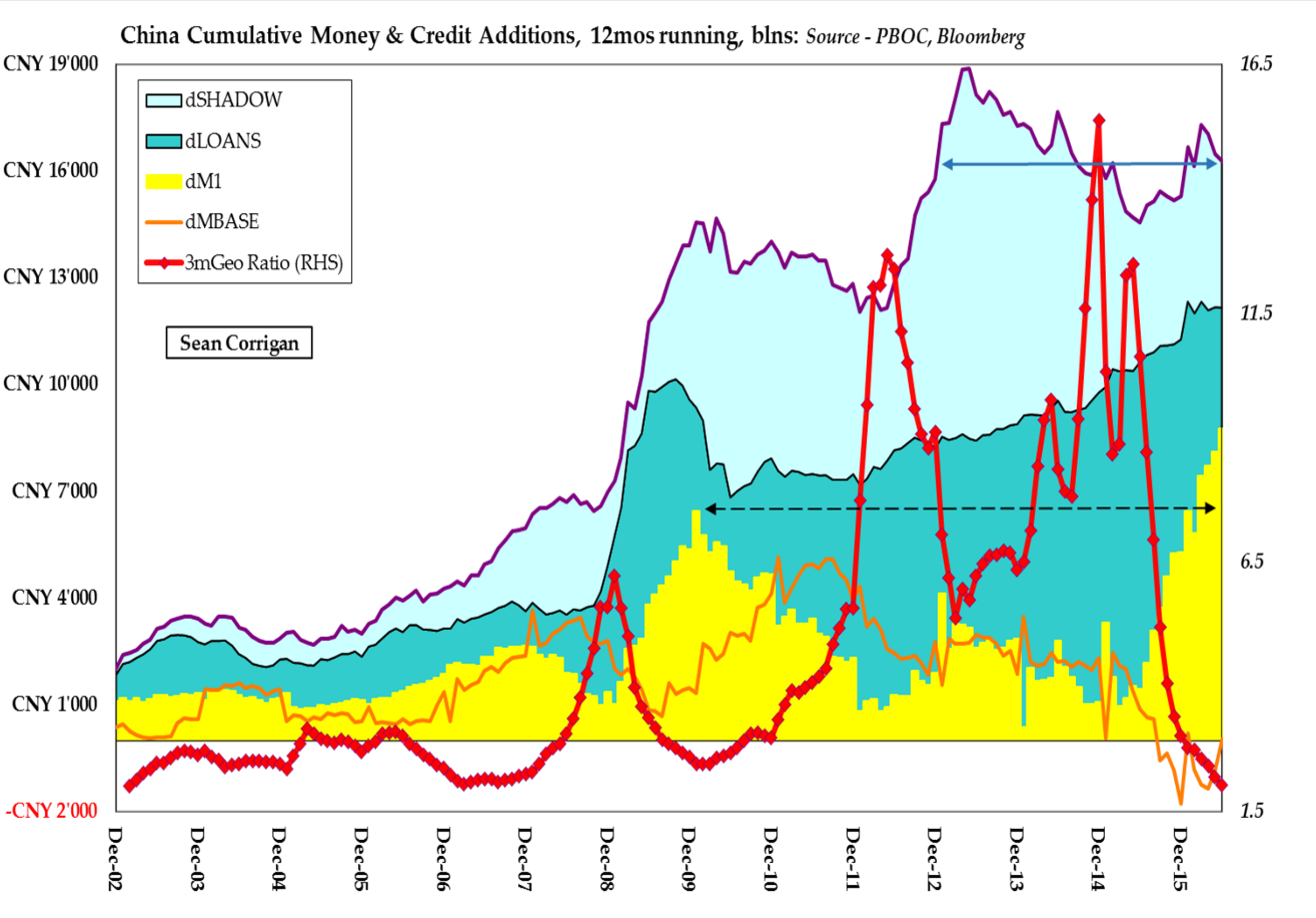
At the time, there were those who thought, by reverse extrapolation from the period of joint accumulation, that this would trigger a sudden, deflationary collapse in China, forgetting as they did that the central bank retained full discretion over the volume of reserves and, indeed, over most other aspects of the domestic money supply, subject only to the proviso that it would have to forego the exercise of such tight control over the currency if it were to prevent a major diminution from occurring.

Simultaneously, under the pressure of regulatory arbitrage on the one hand and the temptations of financial 'innovation' on the other, the domestic credit system was shifting away from a reliance on old-fashioned bank money in favour of 'shadow' finance. The annual increment of M1 on the liability side of bank balance sheets dropped to the bottom of the decade's range and growth in that same aggregate slumped to low single digits (that portion of it created voluntarily 'inside' the banks rather than by their Big Mother indeed went into decline for a period).

Meanwhile Total Social Finance (TSF) continued to add Y15 trillion or more to the pot each year, albeit with an increasing fraction of that (~75% at last count) again coming from orthodox bank loans as the authorities gradually clawed back a measure of control after the Spring 2013 apotheosis of alternative finance had left them to watch, fuming from the sidelines, when more than half the nation's new finance was generated and traded largely beyond their control, out in the dim reaches of the 'shadows'.

After reaching its post-collapse high-water mark in 2011, the economy then ground along ever more slowly, struggling as world trade stagnated, Europe languished, and commodities plunged. So, the imperatives began to shift once more, especially when last year's foolhardy attempt to accomplish a society-wide debt:equity swap by engineering a rapid rise in the stock market spiralled out of control


China Inside & Outside Money, YOY, blns: Source - PBoC
INSIDE
OUTSIDE (rhs)
M1
FOREX (rhs)
Sean Corrigan
¥10'000
¥7'500
¥5'000
¥2'500
¥0
¥-2'500
¥-5'000
¥-7'500
¥-10'000
¥-12'500
¥-15'000
¥16'500
¥14'000
¥11'500
¥9'000
¥6'500
¥4'000
¥1'500
¥-1'000
¥-3'500
Aug-00
Aug-02
Aug-04
Aug-06
Aug-08
Aug-10
Aug-12
Aug-14
Aug-16


China Cumulative Money & Credit Additions, 12mos running, blns: Source - PBOC, Bloomberg
dSHADOW
dLOANS
dM1
dMBASE
3mGeo Ratio (RHS)
Sean Corrigan
CNY 19'000
CNY 16'000
CNY 13'000
CNY 10'000
CNY 7'000
CNY 4'000
CNY 1'000
-CNY 2'000
16.5
11.5
6.5
1.5
Dec-02
Dec-03
Dec-04
Dec-05
Dec-06
Dec-07
Dec-08
Dec-09
Dec-10
Dec-11
Dec-12
Dec-13
Dec-14
Dec-15

and forced the authorities to call an urgent halt to the mania, leaving the country with more, rather than fewer, obligations to shoulder as a direct result of their failure.

With all this in mind, the decision was suddenly taken, one fine summer's day last August, to stop resisting the efflux of hot money – a choice perhaps not exactly hindered by a growing sense that the three-year, two-thirds appreciation versus Shinto Abe's yen to a 23-year high was becoming intolerable for its hard-pressed exporters.

Two major changes promptly ensued. Firstly, the PBoC was now free to compensate fully for the ongoing loss of FX reserves by conducting hefty repo's and by extending all manner of special loans to its banks: secondly, the need for a degree of currency-supporting restriction had at once been made largely redundant. As a clear sign this new leeway was actively being exploited, a Y3.4 trillion build-up in *'claims on other depository institutions'* proved more than enough to offset the Y3.1 trillion forex reduction in central bank balance-sheet assets relentlessly still underway.

More remarkable yet, this was the signal for previously unenthusiastic banks to throw their own sluices wide open. A year ago, the PBoC's base money contribution of 5.3% growth was being greeted, not by commercial bank multiplication, as in the standard textbook account, but by a 5.4% p.a. *reduction* in these latters' addenda (a phenomenon first mentioned above) so that overall M1 was left inching up by a mere 4.2% yoy. This was a magnitude of retardation which meant that the concurrently tenfold-larger increment to TSF was becoming dangerously illiquid by dint of having such an exiguous quantity of instantly transferrable money associated with its inception of much less-easily passed-on claims.

Now, one year, fifty big figures on the renminbi versus the dollar, and a 50% unwind against the yen later, the fact that growth in the monetary base has dipped into negative territory is actually of little consequence since the other banks' 'inside' money creation has soared 164% (*sic*) to a record Y9 trillion-a-year, Y25 billion-a-*day* outpouring. This in turn means that just over half the present augmentation to TSF - and more than twice its shadow component - is instantly being turned into readily spendable money and *not* being frozen into place in the form of ageing accounts receivable, long overdue bills, and reluctantly evergreened overdrafts.

In complete contrast to all this, what we seem to have in China is the relief from a far more tangible form of 'liquidity trap' – namely, the one which results from an inability to turn cloyingly illiquid credit into usefully liquid money.

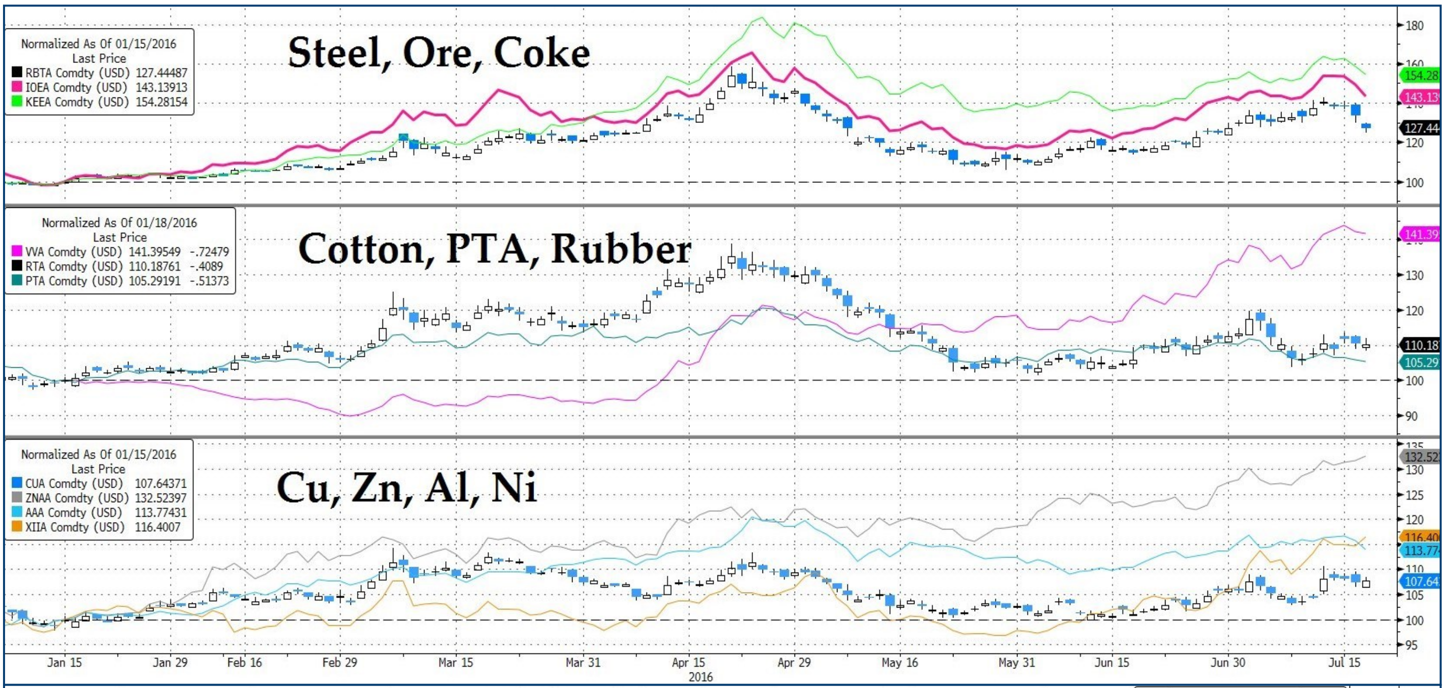
Now, it may well be that the substitution effects at work have so far prevented the money supply - rising in full G-suit fashion at nearly 25% and accelerating at an even more impressive 20% a year - from fully reinvigorating first revenues, then earnings, then output, and finally investment and employment, but that is not to say that things are not beginning to stir a little more rapidly than they have done of late under the Mandate of Heaven.

Heavy industry may still be in the doldrums and the private investment it once dominated might be on life support but this was, after all, the main locus of the past fifteen years' over-expansion and malinvestment. Nevertheless, non-household electricity use has inched up out of the red, mirroring the modest quickening of revenue growth (and its echoes in nominal GDP) to a 2-3% rate which may well be a snail's pace by comparison with the prodigies of yesteryear but which is nonetheless the first concrete sign of progress in some good while.

Next, we have only to look at the less benign aspects of this general relaxation in monetary rectitude. The stock market has again begun to rise and margin debt to edge up along with it in a move led by the more speculative indices such as the ChiNext (up 20% these past two months and now some 35% above the February lows). Though the frothiest of them have taken a tumble these past few sessions, commodities have also been roaring once more with prices up strongly and turnover on the Shanghai Exchange running at well over twice what it was last year.

Though this impulse has yet to manifest itself in the consumer price index, those for producer and purchaser prices do seem finally to have bottomed; the former ending a near two-year slide of circa 9% in February of this year with an annualized gain of 4.6% in the four months since, the latter following up a slightly larger drop with a faster, 5.2% annualized rebound.

Then we have the property market where residential turno-


Steel, Ore, Coke
Normalized As Of 01/15/2016
Last Price
RBTA Comdty (USD) 127.44487
IOEA Comdty (USD) 143.13913
KEEA Comdty (USD) 154.28154
Cotton, PTA, Rubber
Normalized As Of 01/18/2016
Last Price
WA Comdty (USD) 141.39549 -.72479
RTA Comdty (USD) 110.18761 -.4089
PTA Comdty (USD) 105.29191 -.51373
Cu, Zn, Al, Ni
Normalized As Of 01/15/2016
Last Price
CUA Comdty (USD) 107.64371
ZNAA Comdty (USD) 132.52397
AAA Comdty (USD) 113.77431
XIIA Comdty (USD) 116.4007
Jan 15
Jan 29
Feb 16
Feb 29
Mar 15
Mar 31
Apr 15
Apr 29
May 16
May 31
Jun 15
Jun 30
Jul 15
2016


CSI300 v Margin
Last Price
.CHMARGIN U Index (R2) 879.4399
SHSZ300 Index (R1) 3248.23
All Courtesy Bloomberg
2014
2015
2016


ChiNext v SHCOMP
0.0%(2.8329)
+242.91%
15.0%(2.5324)
38.2%(2.0677)
50.0%(1.8314)
61.8%(1.5951)
85.0%(1.1304)
100.0%(0.8299)
2.4928
2010
2011
2012
2013
2014
2015
2016

Il MILIONE: Tales from Cathay [*continued*]

ver during the first half was up by 44.4% over the like period in 2015 and where office sales were up 61.6%. Prices, by the way, were up a hardly trifling 12.3% for the former and 15% for the latter – though that is small potatoes compared to the almost 40% rise in existing home prices in Shenzhen and Hefei or the ~+30% ones prevailing in Beijing and Shanghai.

One thing we can be sure of is that if China ever gets the helicopters out flying, they'll probably be packing flame retardant chemicals, not monetary-fiscal kerosene. 'Liquidity trap' must share the same characters in Mandarin as 'table stakes'

Meanwhile, keep an eye on the renminbi. Loose money has so far coincided neatly with the sustained drift northwards of the parity we detailed above: there seems little reason to suspect this tendency will end any time soon.

BUY CHEAP, SELL DEAR: Market Observations

As a first reaction to the shock of the referendum result, sterling assets were hit hard. The previously outperforming members of the FTSE250 had a measure of comeuppance on the *ex post* logic that they were more heavily exposed to the domestic UK economy, but also simply because positions in this less liquid sector were (a) heavy and (b) represented a chance to take a profit. REITS were hit by the redemption freezes. Banks, insurers, retail, travel—all took a shellacking as a consequence.

Sterling's own slump was exacerbated by the violence of the rally it had undergone when unofficial polling, conducted just as the vote closed, suggested that Remain had achieved its expected triumph. It was subsequently kicked every time it was down by the strangely timed and exceedingly ill-judged interventions of its supposed guardian, the Governor of the Bank of England.

The Lord of Small Mercies be praised, had dear Mr Carney not taken the time to jet off to his native Canada in order to help Save the Planet or publicly hobnob with the gliteratti at Wimbledon while the market was straining to arrive at a consensus valuation for the currency, things might have been even worse than they were.

Banks in Europe also had much to endure—though whether that 20%+ drop was strictly due to the truculence of their near neighbours or to troubles closer to home was harder to say. Naturally, that financial five-bell alarm, gold, jumped $125/oz—or roughly 10%—in no time at all while crude resumed a slide which has seen it shed almost 12% in the weeks since.

Of course, the first (and only) response of those giant central banking turtles upon whose horny carapaces the destiny of the known Universe now rests was to promise more—even *unlimited*—'liquidity' should the slightest tremor be felt in financial markets. Reinforcing the bars which now so tightly cage price discovery and capital allocation, Blackhawk Ben Bernanke was said to have persuaded the ever biddable Abe-Kuroda comedy double-act to implement the dreaded 'helicopter money'. The yen gave back its ~8 big-fig post-Brexit rally and Mrs Watanabe immediately poured a chart-topping $25bln of her *hesokuri* reserves into *gaijin* bonds.

Thus did an initial 40bp rise in junk yields, for instance, flip straight into a 90bp decline. Thus did the US stock market make a new all-time high. Thus did government bond yields everywhere set new, new lows. Thus did VIX/VXO plunge to its least in ~2 years to come to rest in the 6th percentile of a three-decade series.

Why worry, then? Record valuations; atrocities in Europe; racial strife in America; military tension with Russia and China; the Middle East powder keg; Turkey's budding new Sultanate; Britain riven in two (or four, or six)? *Pah!*

Filter it all out: '*We stand by to print money*,' is the only message we need to heed before we lift the offer foolishly posted by those with less strong stomachs than we.

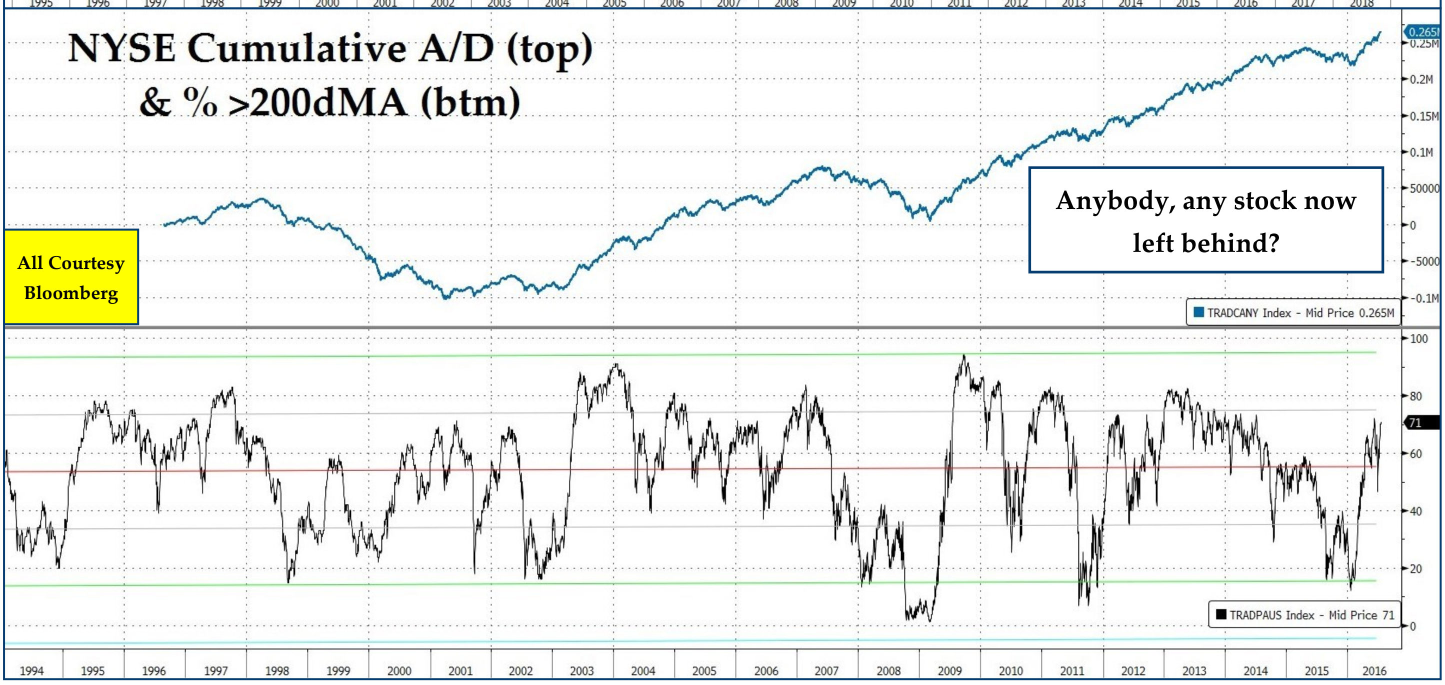

JPM Global Govt YTW
100.0%(9.292)
85.0%(6.989)
61.8%(4.499)
50.0%(3.596)
38.2%(2.874)
15.0%(1.850)
0.0%(1.391)
1.300
Log


It is JUST possible that we have seen a spike marking yield lows here
REX Vol-Based Risk:Reward
+826.92%
+497.66%
3.7467
Log

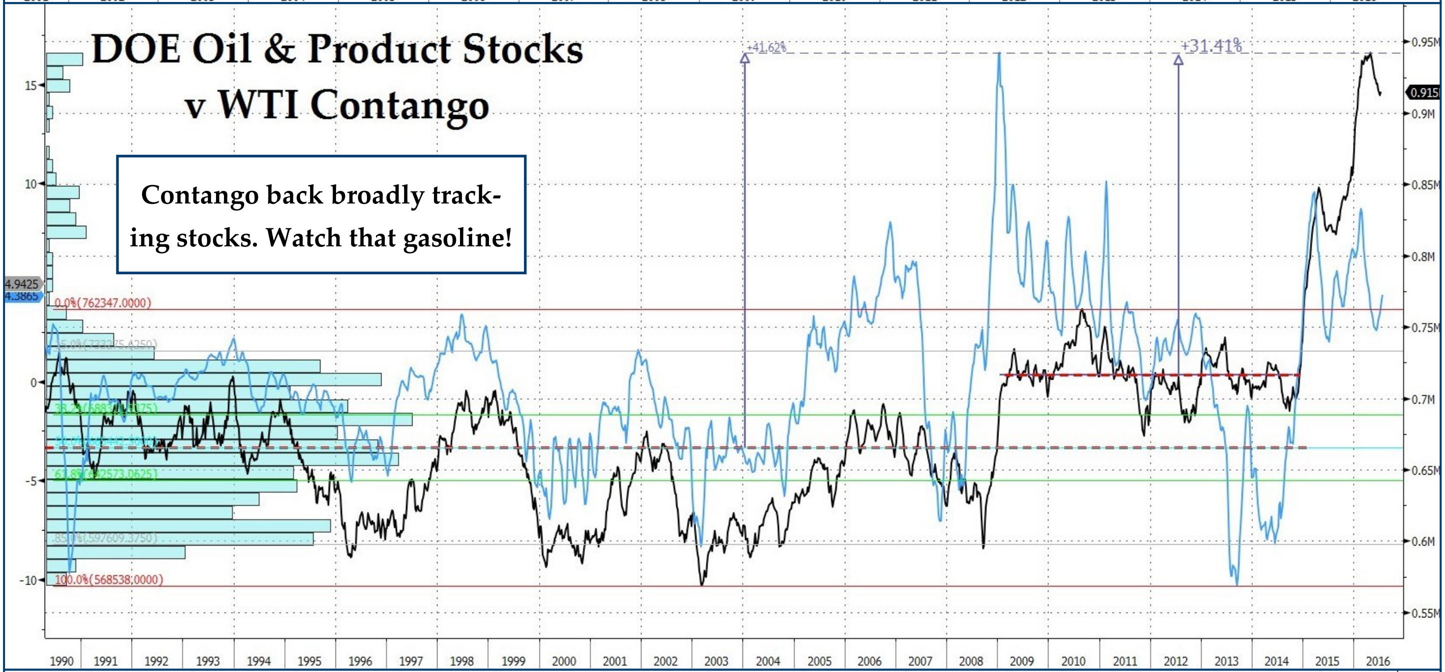

UST Vol-based Risk:Reward
+476.13%
+301.29%
+93.62%
0.0%(1.5235)
100.0%(0.4176)
1.2726
Log


MSCI US v Barclay's
AGG Bond TR
+155.48% (+20.25%ann.)
+146.45% (+15.07%ann.)
+245.62% (+3.25%ann.)
+188.37% (+3.24%ann.)
+107.18% (+4.51%ann.)
Still within the general
+3.2%pa channel
424.059
Log

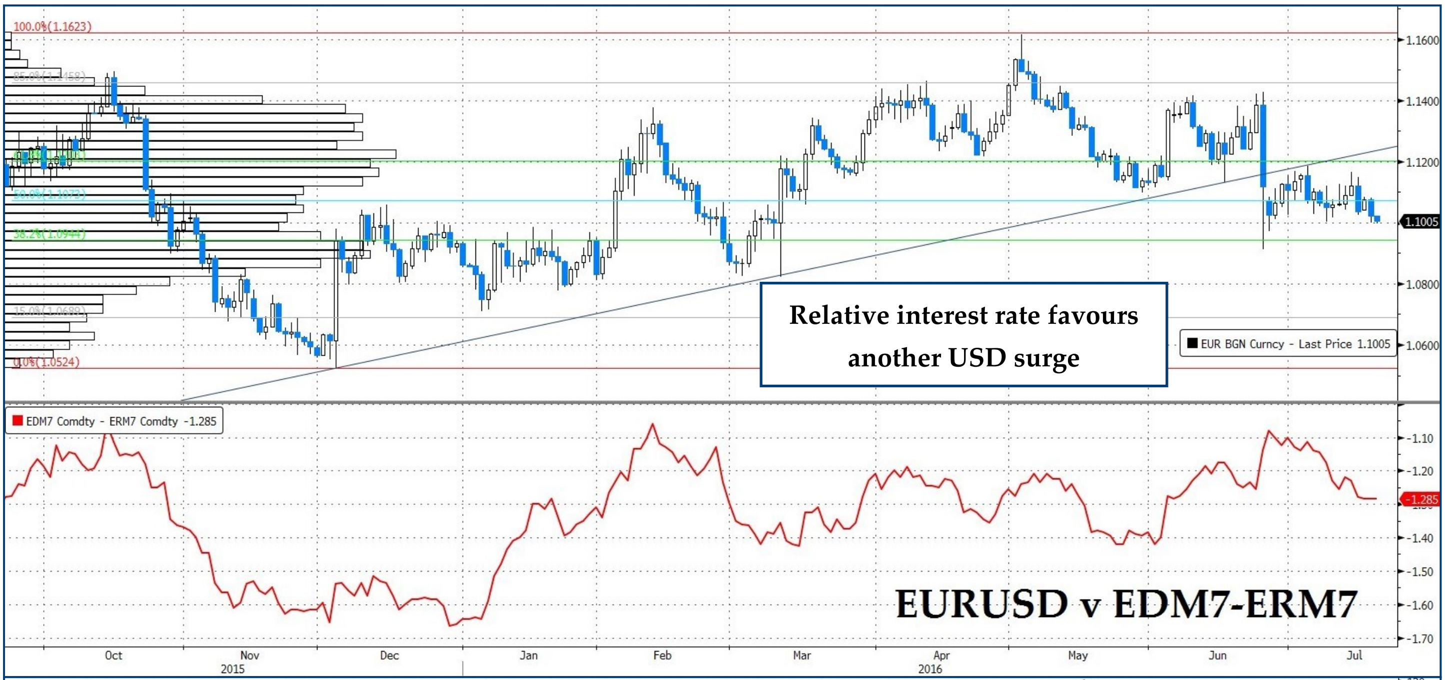

S&P1500
+232.50% (+17.70%ann.)
+239.49% (+25.98%ann.)
-48.42% (-22.86%ann.)
-53.82% (-62.57%ann.)
-48.76% (-27.28%ann.)
Now matched the Irrational
Exuberance/Tech Bubble rally
501.369
Log


NYSE Cumulative A/D (top)
& % >200dMA (btm)
All Courtesy
Bloomberg
Anybody, any stock now
left behind?
TRADCANY Index - Mid Price 0.265M
TRADPAUS Index - Mid Price 71


Copper in CNY
Test of the channel is key


DOE Oil & Product Stocks
v WTI Contango
Contango back broadly tracking stocks. Watch that gasoline!


GOLD
Tiring slightly but could still see $1400
All Courtesy Bloomberg


Relative interest rate favours another USD surge
EUR BGN Curncy - Last Price 1.1005
EDM7 Comdty - ERM7 Comdty -1.285
EURUSD v EDM7-ERM7
100.0%(1.1623)
38.2%(1.0944)
0.0%(1.0524)
Oct
Nov
2015
Dec
Jan
Feb
Mar
Apr
2016
May
Jun
Jul


JPY
Yen could see Y107.75 Fib, maybe Y110.30 mid on this bounce
0.0%(125.86)
15.0%(118.60)
38.2%(107.36)
50.0%(101.65)
61.8%(95.94)
85.0%(84.70)
100.0%(77.44)
100.0%(121.69)
0.0%(99.02)
105.99


All Courtesy Bloomberg
Struggling to build back in what would be swing's middle congestion
USD TWI
100.0%(125.0277)
61.8%(103.1159)
38.2%(91.5435)
0.0%(75.5000)
'75 '76 '77 '78 '79 '80 '81 '82 '83 '84 '85 '86 '87 '88 '89 '90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16

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