Money, Macro & Markets Monitor

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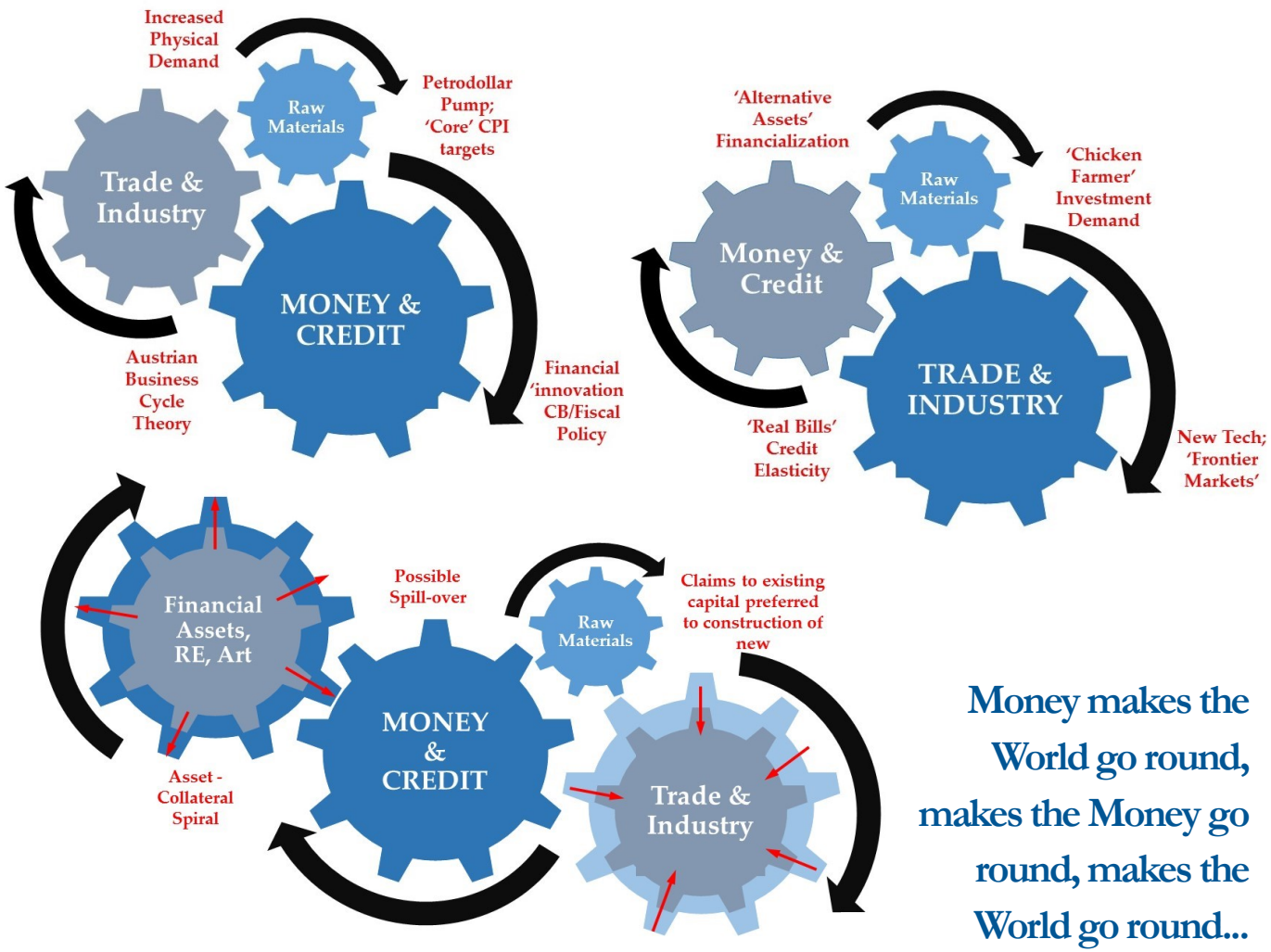

Money makes the World go round, makes the Money go round, makes the World go round...

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Volume I, Issue 8

Central Banks & Repetitive Stimulus Injury

Work undertaken by the Japanese economist Keiichiro Kobayashi over the years has had a common theme; namely, that persistent, post-bubble debt overhangs not only adversely affect the intangible elements of 'uncertainty' which plague people's planning for the future, but also have a real-world impact in preventing overburdened firms from raising much in the way of junior-tranche working capital, far less any new, long-term investment funding.

According to Kobayashi's logic, the simple fact that companies must pay money out (to workers and suppliers) in advance of receiving the proceeds deriving from their activities, means that any inability to bridge this temporal gap can only jeopardize their operations and with it their ability to give employment to people understandably not always willing to reduce their own call on the firm's dwindling resources – i.e., to accept pay and benefit cuts – in time to forestall the brutal commercial surgery of their outright dismissal.

Similarly, as the good professor has been at pains to point out, in an environment where interest rates are kept artificially low, the provision of so much surplus liquidity means that banks are given perverse incentives to forbear on loans – to 'evergreen' them, in the parlance – and so to enable the Undead firms to eat up resources and erode market returns to the wider detriment of the Living. With their balance sheets (often now the belated target of increased regulatory scrutiny) cluttered up in this fashion, the banks find themselves denying fledgling enterprises the support these latter need in order to flourish and so to reinvigorate the economy.

If instead of moving swiftly to excise the debt legacy through a combination of liquidation, debt-to-equity recapitalisation, and stern rationalisation, the nation operates a perverse form of triage whereby it is the most badly injured who receive first call upon the available medical treatment – or if it enacts a twisted policy of denying the geriatric ward nothing while denuding the neo-natal unit of both staff and equipment – is it any wonder the economy stagnates?

Yet this is precisely what the predominant MIT Macromancers have been doing, ever since the (first) Tech Bubble burst.

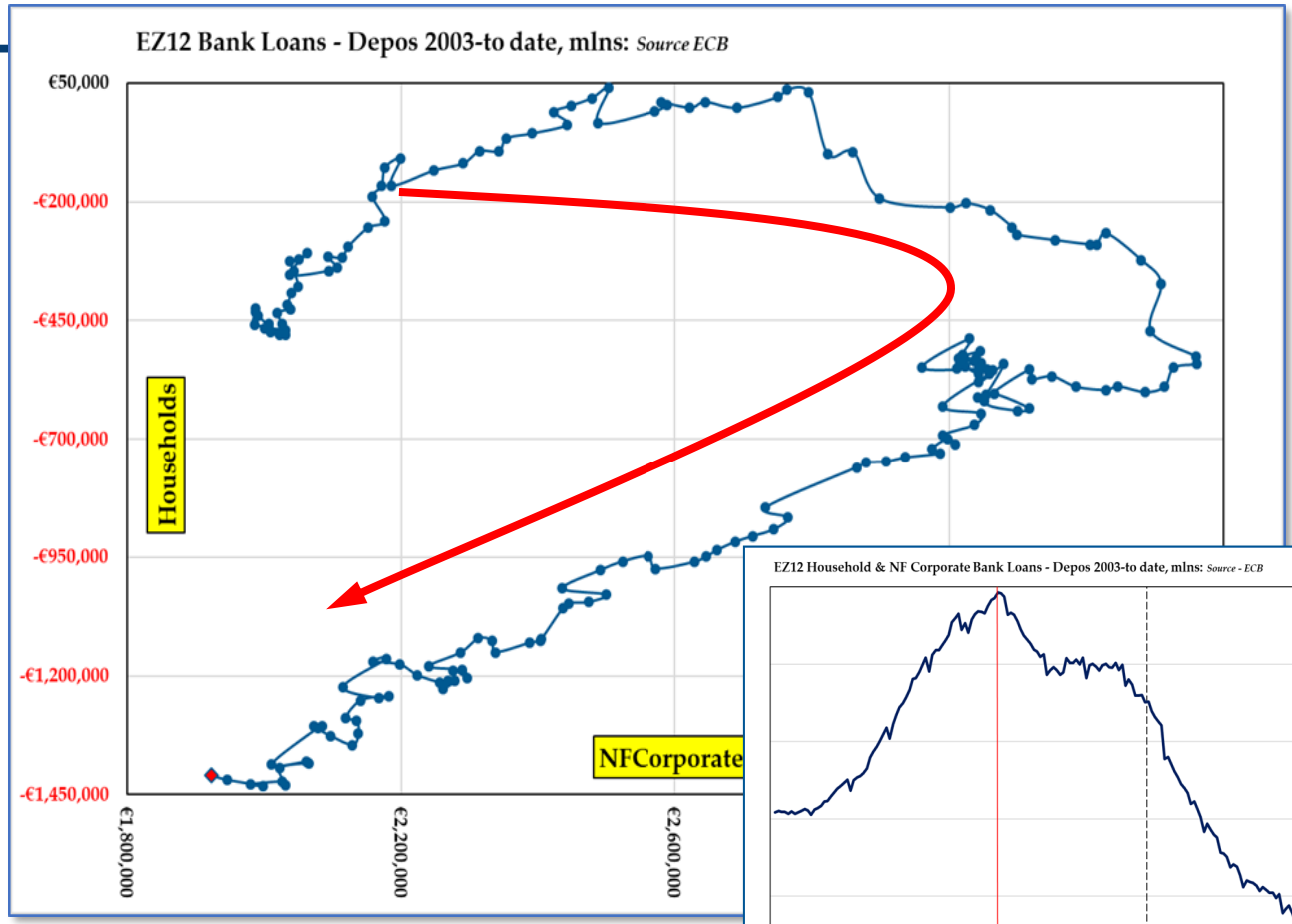
Da capo ma meno forte

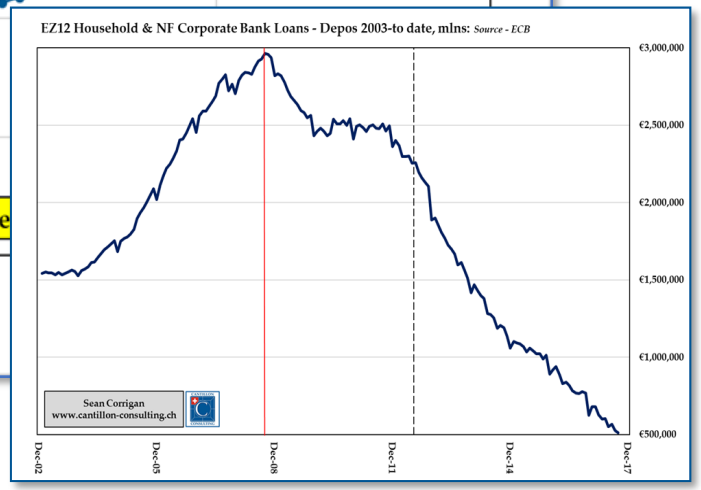
Let us take the case of Europe, where Mario has again Draghi-ed out the ending of his crude programme of intervention by promising a mere €390 billion more in transfers of mainly government debt to its books from those of the private sector and, principally, from the Doom Loop banks in his charge who have used him to shed almost €1/2 trillion in loan and security exposure in the past 2 ½ years.

Whether this continuation will be of any great societal benefit is entirely moot since households in the Eurozone have seen their asset-liability balance (proxied by the difference between bank deposits and borrowings) move rapidly towards surplus and hence to the point where the gross losses from negligible (if not negative) interest rates outweigh any putative gains. From being aggregate net borrowers of €40 billion at the peak of the (last) housing bubble, households now hold more than €1.4 *trillion* in net deposits. Not much 'stimulus' still to be had *there* from lower rates, one imagines. Non-financial business, in the meantime, has cut its net borrowing by more than two-fifths, or by a similar €1.4 trillion-plus, to levels not seen since the end of 2003. Similarly, therefore, we are well into a regime of significantly diminished returns.

Taken together, even the problem nations have undergone a marked improvement in the health of these two sectors, one which ranges in magnitude from €27 billion for Greece via €100 billion for Portugal, €217 billion for Ireland, and €480 billion for Italy to a whopping €800 billion for Spain.

Given this circumstance, it is surely incumbent upon us to ask just how much benefit Mario thinks can really be derived from his blind pursuit of his present course?





Nor has the influence been confined to the Eurozone alone. From the second quarter of 2015 to the latest month for which we have the numbers, EZ actors have bought almost €1 trillion in foreign debt securities while absorbing the re-sales of a further €350 billion of their own previously issued (almost exclusively government) debt. Spaced over just under 2 ½ years, that represents a €1.5 billion-a-day shift in the supply-demand balance abroad; a huge reduction in others' net duration, if you will, and hence a depressant on their yields, too.

Missing the TARGET

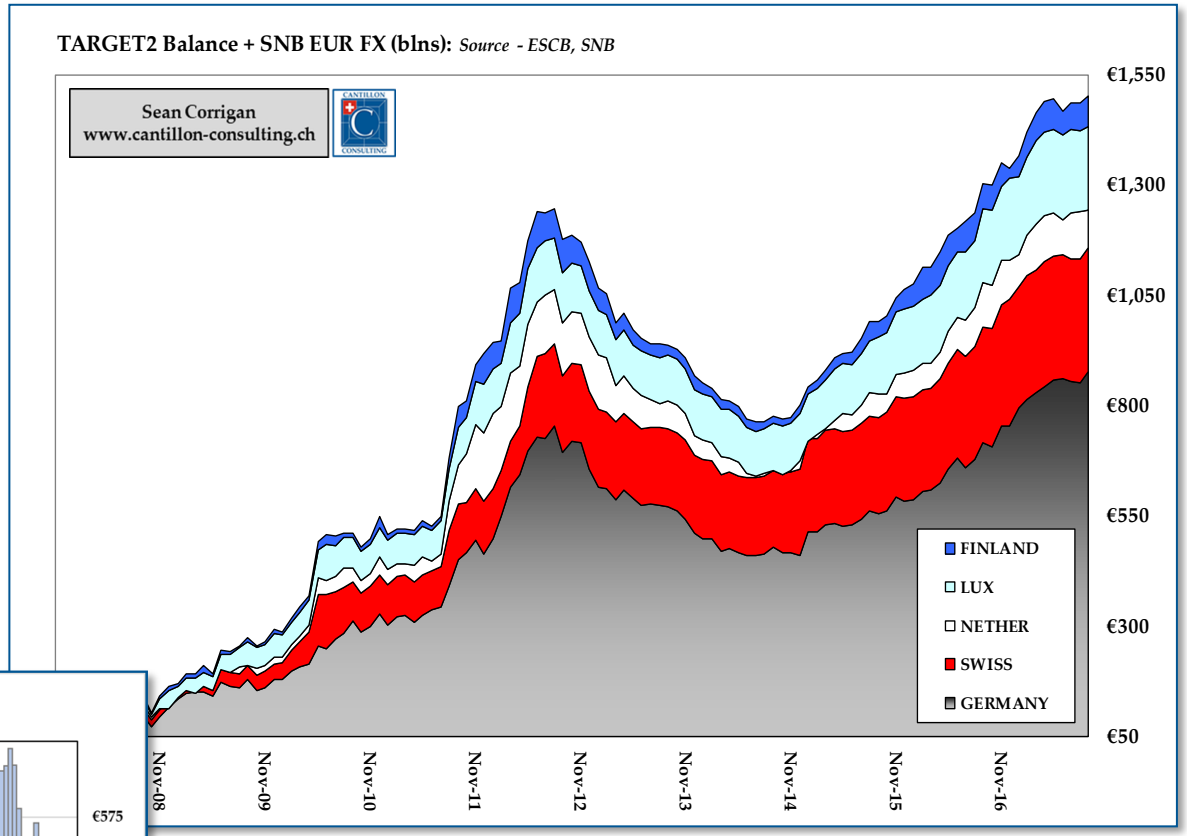
Meanwhile, the Eurosystem banks have accumulated no less than €1,300 billion in government debt at home. Of this impressive total, we could schematically say one third was comprised of the co-option of domestic commercial banks' funding of the state, one third was a way of giving the Rest of the World an easy route to the exit, and the remaining one third was an official monetization of Leviathan's past and present deficits (yes, for all the ECB's protests to the contrary, that is exactly what this entails). Has this, as the Bank insists 'bought time for reforms' or has it merely indulged both political incontinence and wilful procrastination in a Continental monolith screaming for a complete overhaul? I know which way I would cast my vote.

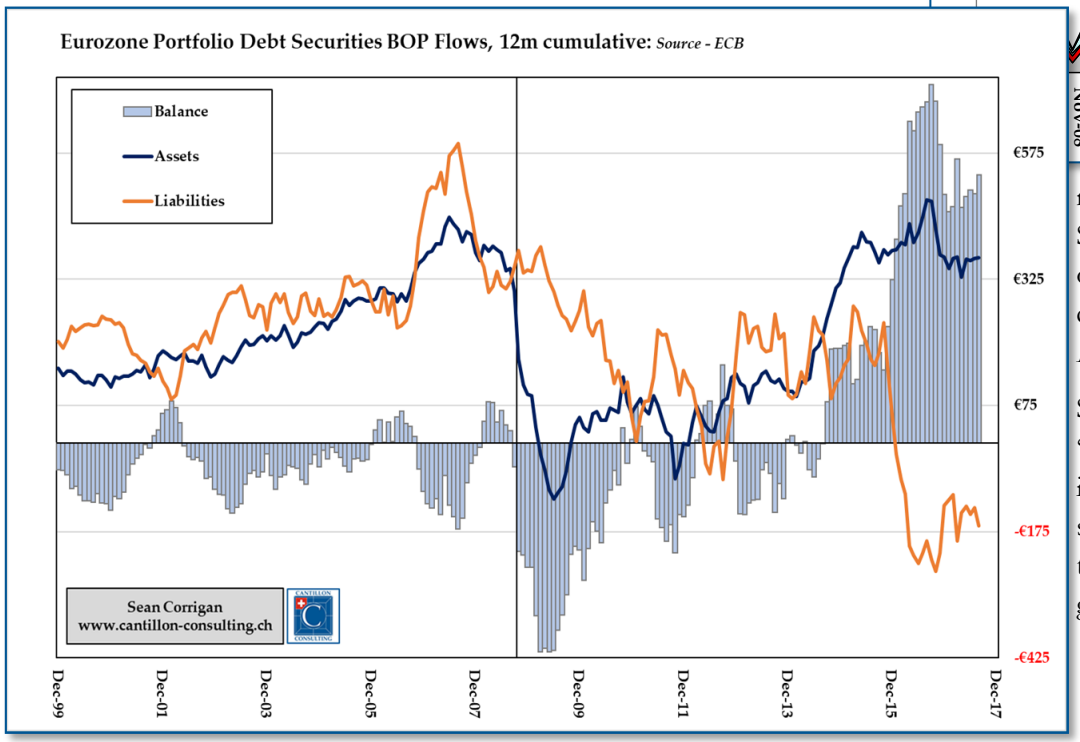
Furthermore, the scale of the dysfunction – the *discredit*, even – can be seen in the massive, €565 billion expansion of uncleared TARGET2 balances (on top of the further €67 billion acquisition of euro reserves by the SNB) which has taken place since that same spring of 2015. Germany has, as ever, dominated the creditors in this, with a €350 billion addition to its already mountainous tab, while the main three recidivists, in ascending order of shame, have been Spain with a €160 billion increment, the ECB itself (!) with €180 more, and finally Italy with a whopping €1/4 *trillion* extra outstanding (give or take the odd few billion). Thus, not only has discipline *within* borders been eroded, but also that *across* them has been further relaxed. What was once, say, a BTP sold to and hence properly *funded* by a US pension provider has since been transformed into that fund's hole-in-the-pocket-burning deposit at its German correspondent bank which in turn now holds a claim on the Bundesbank, having used the latter as its agent in passing the parcel immediately on to the ECB itself.

Looked at through a different lens, the effect of all this is striking.

Since Lehman failed, Eurozone M1 has all but doubled yet the supposedly broader M3 measure is up by only a quarter – a combination which is reconciled by noting that non-M1 deposits have simultaneously *shrunk* by a quarter, reducing their tally to where it was a decade ago in nominal terms and to turn-of-the-millennium levels in real. As S. C. Tsiang pointed out long ago, reducing and compressing rates to the point that transactional money holdings become indistinguishable from time and savings account balances in this way leads both to a confusion of purpose and to a potential loss of policy control, neither of them situations lightly to be countenanced.

The upshot is that commercial banks' total assets have remained effectively unchanged since April 2008 even as the deposits they hold at the ECB have risen by €3.6 trillion as a result of its ongoing printing programme. This increase has handily dominated the overall €3.3 trillion creation of new deposit money which has simultaneously taken place on the other side of MFI balance sheets. Such a disproportion of 'outside' over 'inside' money creation, as well as that of money-over credit-creation, means that the banks have become almost redundant, being reduced to little more than expensive pieces of real estate on which to site state-run ATMs.

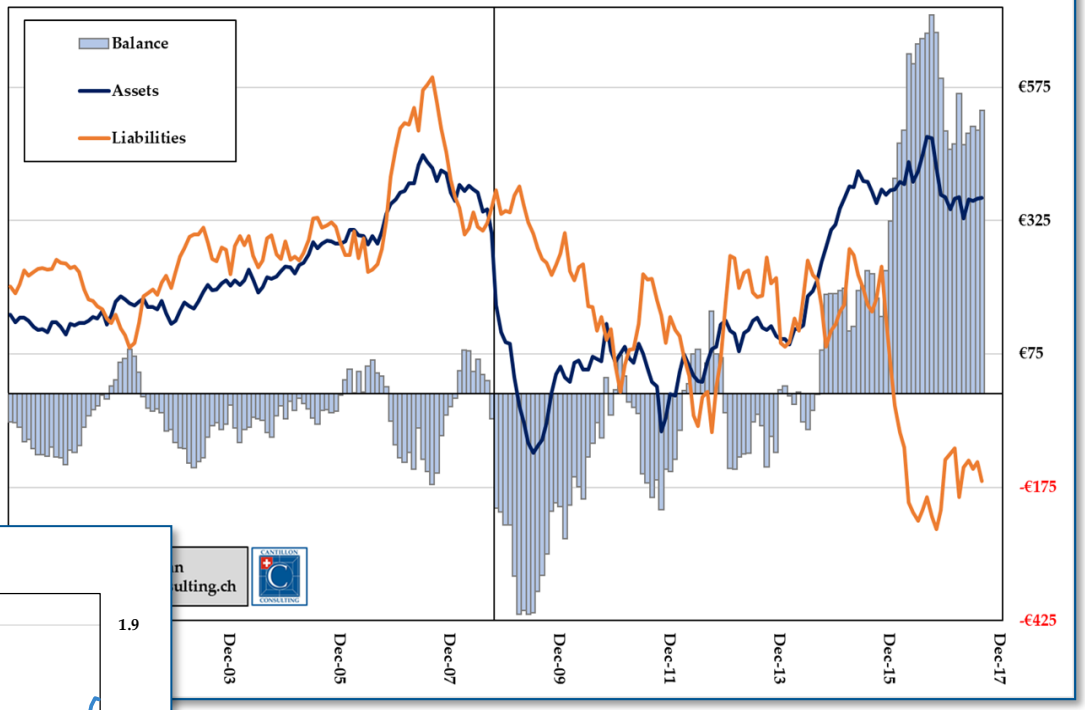




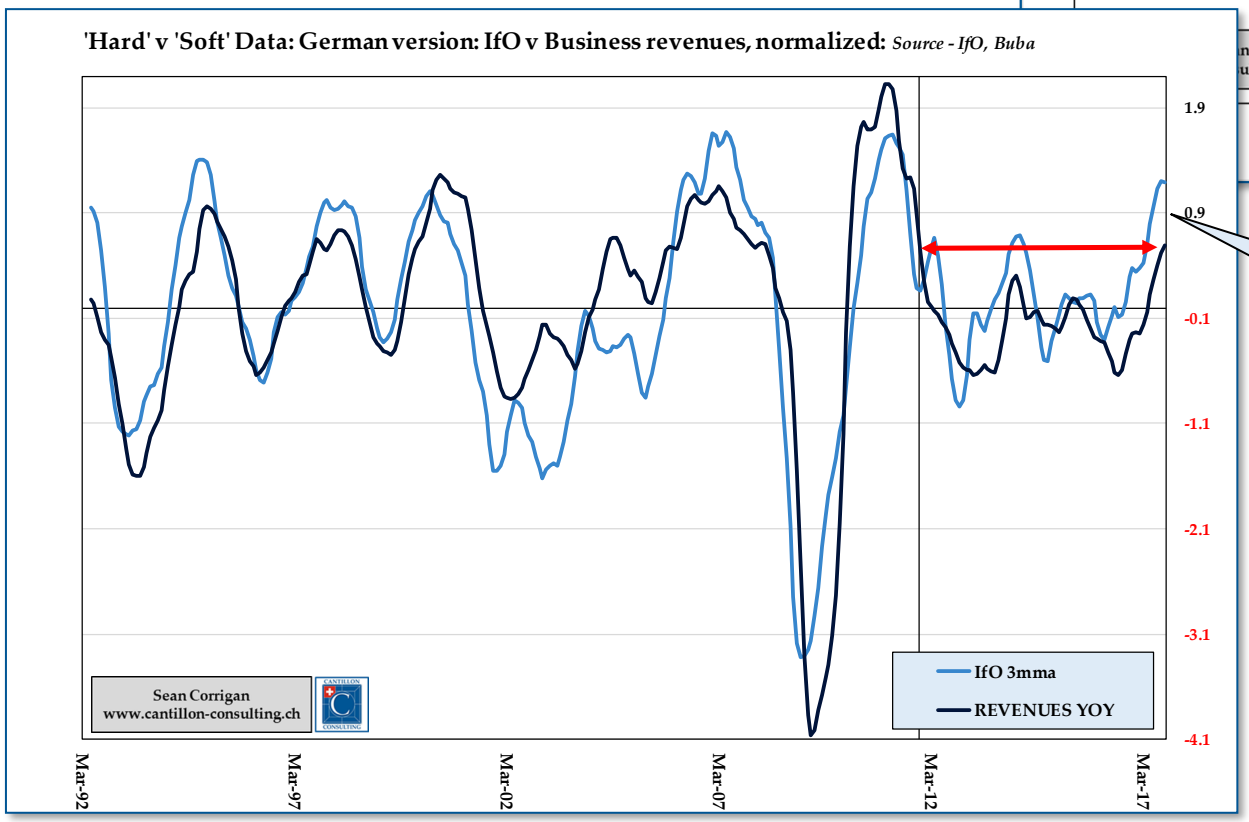
Such has been the result of that Pharisaic insistence upon hewing to the cabbalistic 'mandate' of ensuring 2% CPI growth in the face of much broader contention that this is an arbitrary and possibly obsolete benchmark at which to aim. Such, the cynic might suggest, is the toxic by-product of the ECB's *ultra vires* strategy to circumvent the constitutional barriers to Transfer Federalism and so usher the European Project to its final, glorious realisation—and democratic consent go hang!

Naturally, none of this criticism will be paid the slightest heed by Draghi, Praet, *et al.* And yet, with liquidity seeping out of every pore; with house prices and rents rising worryingly; with stock markets setting new records daily; with junk bond yields and spreads plumbing new lows; with PMI surveys hitting multi-year highs and - something to which these latter are closely attuned – with business revenues in Germany (for example) climbing at a 7% YOY clip which is the quickest since the early days of the rebound from the GFC, the ECB will blindly press on until next autumn at the least – and will, in the interim, search for any excuse to prolong Europe's agony even further and so to aggravate imbalances both within and without the single currency area.

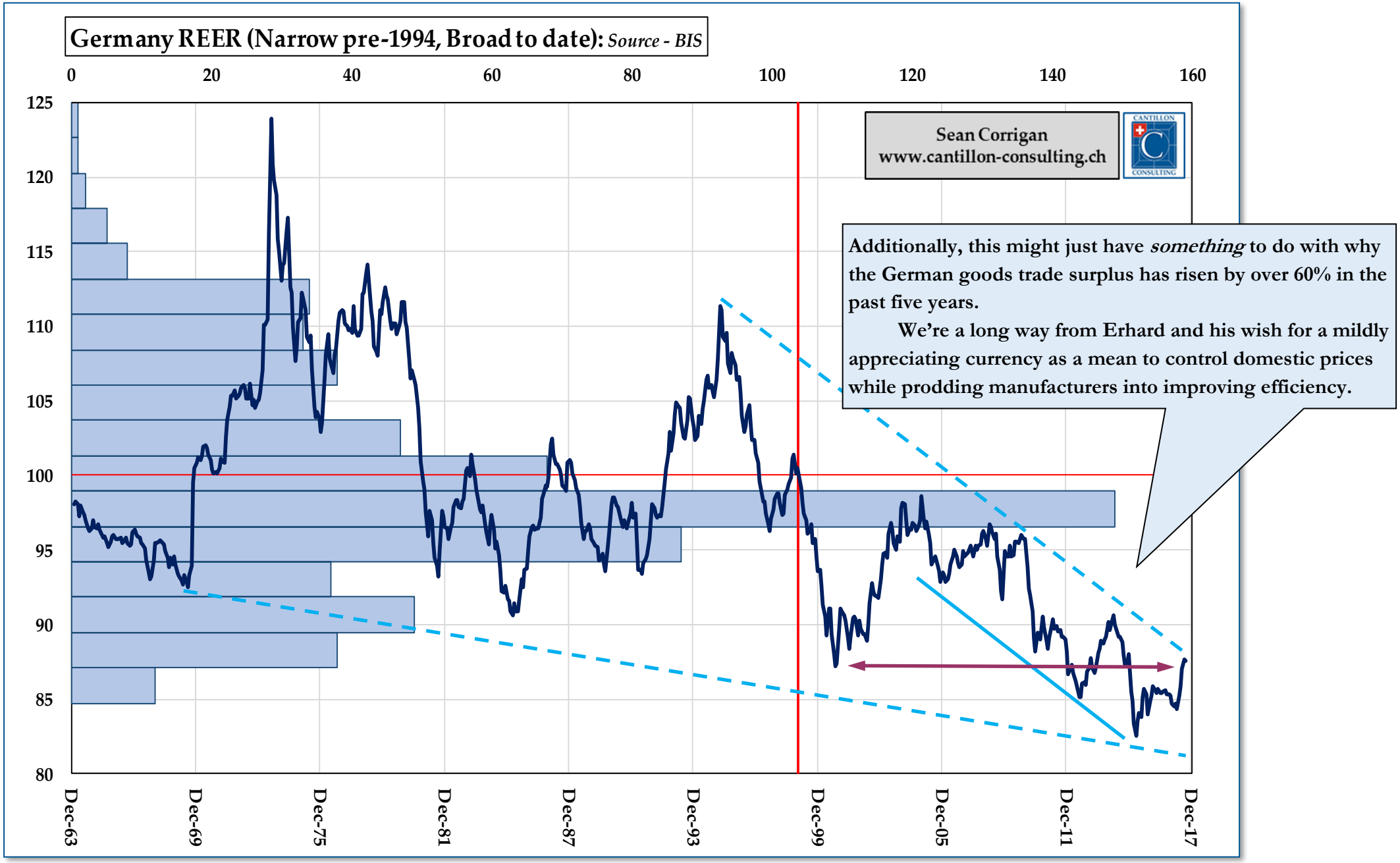
Eurozone Portfolio Debt Securities BOP Flows, 12m cumulative: *Source - ECB*



'Hard' v 'Soft' Data: German version: IfO v Business revenues, normalized: *Source - IfO, Buba*



The rip-roaring trends underway in Germany have the local press talking breathlessly of a movement to rival the golden years of the *Wirtschaftswunder* - the pundits not stopping to consider that the Easy-B Boom is based on decidedly more shaky foundations than was Erhard's genuine supply-side miracle.


Germany REER (Narrow pre-1994, Broad to date): Source - BIS
0
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95
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85
80
Dec-63
Dec-69
Dec-75
Dec-81
Dec-87
Dec-93
Dec-99
Dec-05
Dec-11
Dec-17
Sean Corrigan
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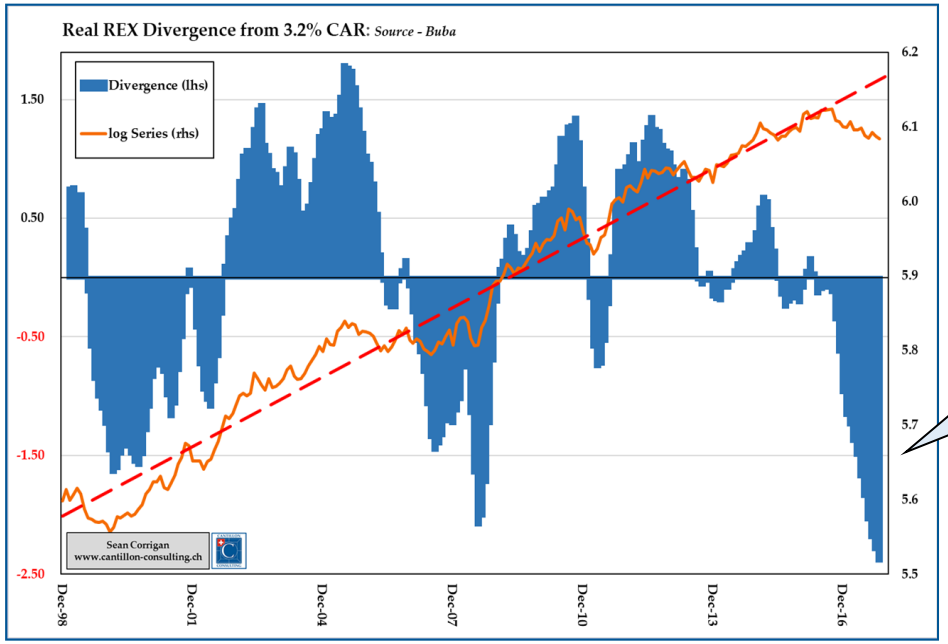
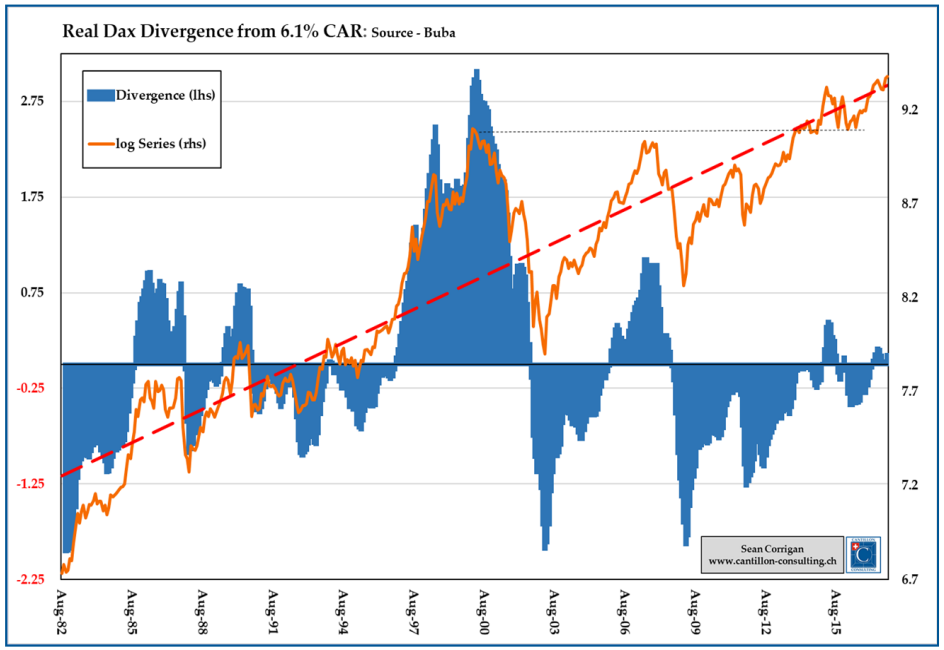
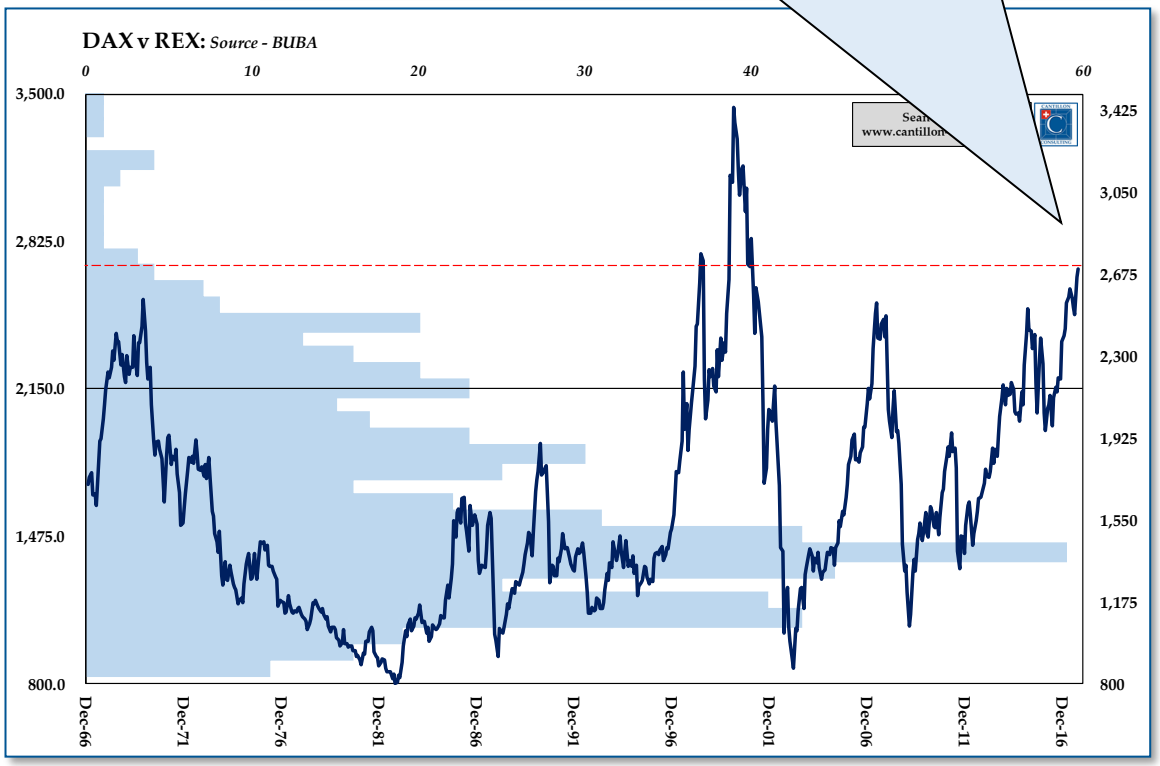
Additionally, this might just have *something* to do with why the German goods trade surplus has risen by over 60% in the past five years.
We're a long way from Erhard and his wish for a mildly appreciating currency as a mean to control domestic prices while prodding manufacturers into improving efficiency.

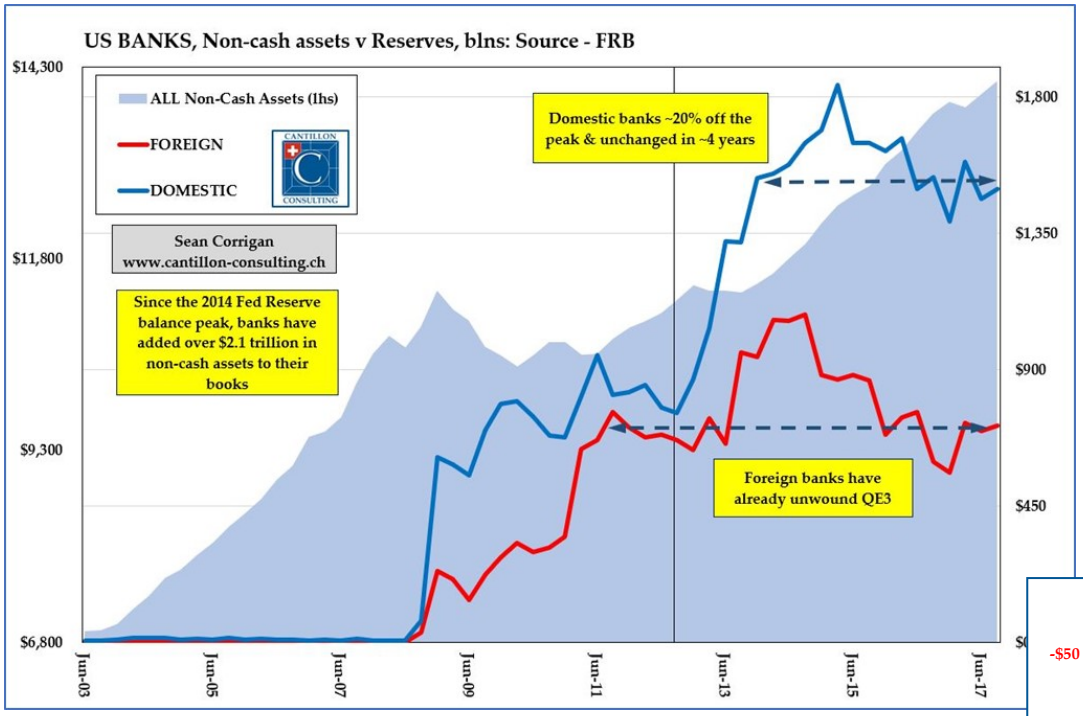


Even before the ECB has eased back in the slightest from its bond-buying, much less actually raised rates, returns from German bonds have slipped way, way below trend. The inescapable arithmetic of low/negative yields implies long-term disappointment for investors everywhere, even absent a price shock or quickening inflation.

Though the DAX itself has only just struggled back to its long-term trend (NB: a different thing from saying the move has been entirely justified by company fundamentals), this has seen the widest disparity to bonds since the Tech & Telecom, Neuer Markt madness. Will balanced mandates be condemned to buy more, hopelessly lagging bonds, or will they just chase offshore?







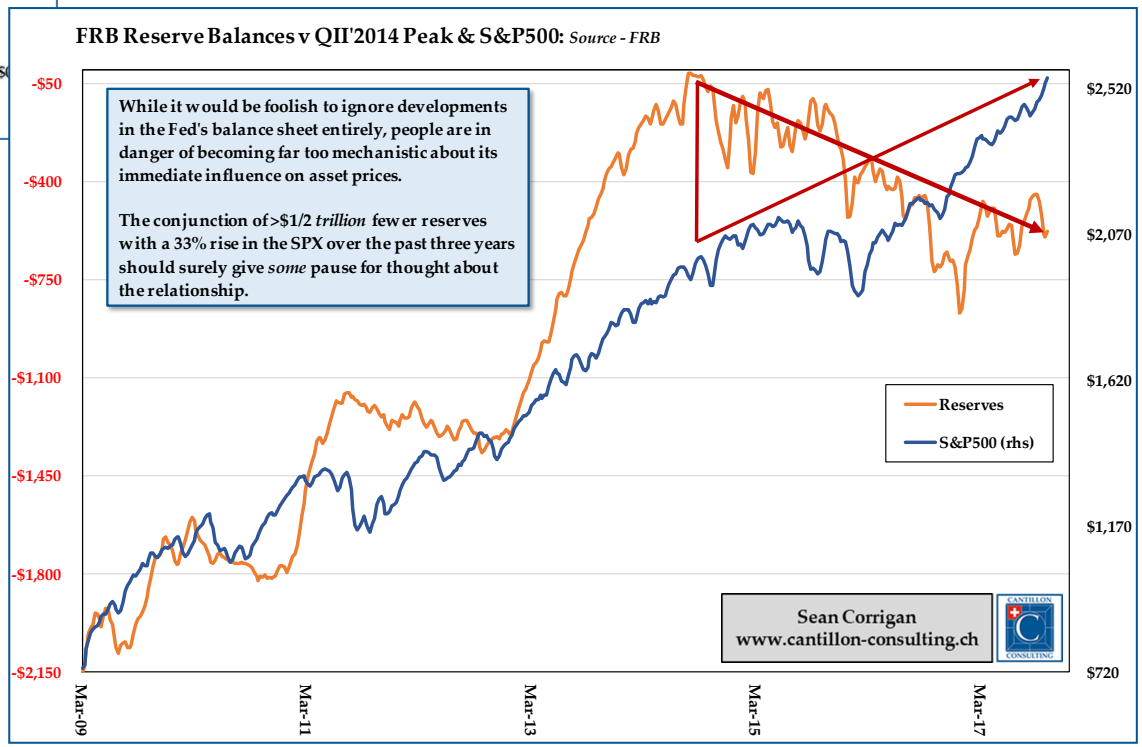
For all the fear and loathing in the US at the prospect of Fed balance sheet reductions, a point we continue to make is, that under the current institutional and regulatory framework, overall money creation—and that is the thing that matters, in the final analysis—does not move one-for-one (or indeed in much of any kind of proportion) with the provision of reserves.

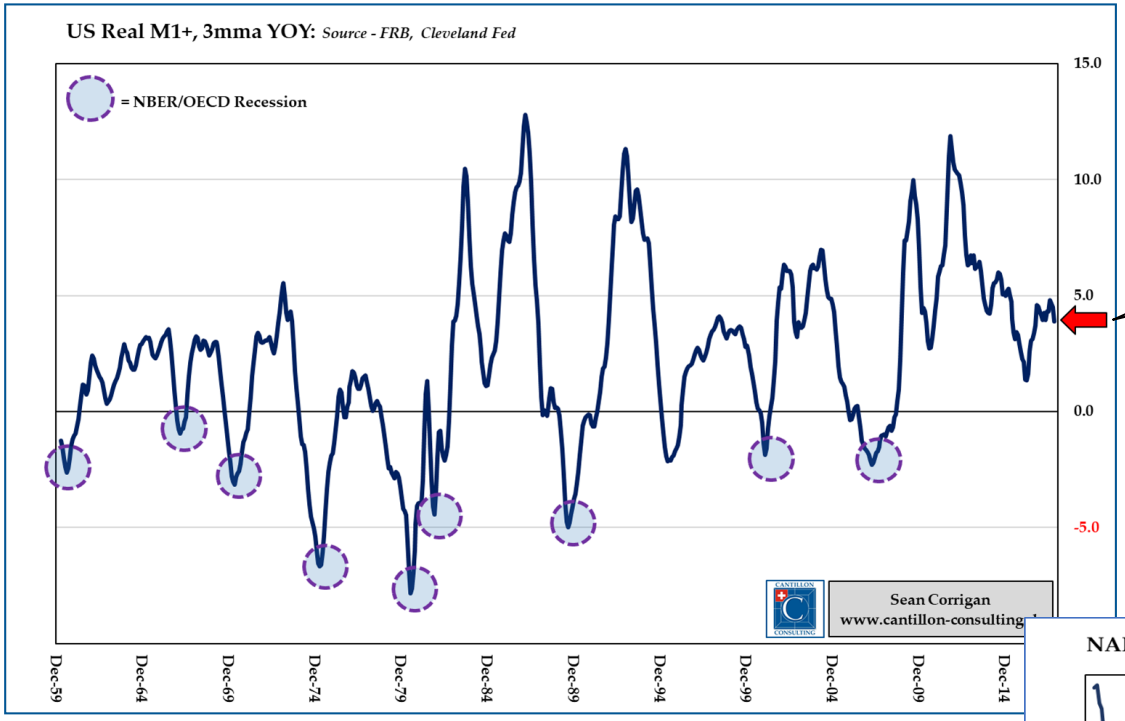
Abstracting from the effect on securities' yields for the moment, it is important to distinguish between the central bank's so-called 'outside' money creation (essentially its additions to the monetary base) and commercial banks' own 'inside' efforts. Contrary to the classic textbook treatment, it has been a long time since the latter 'pyramided' off the former as an easily calculable multiple.

The vast effusion of the former kind of money naturally dominated the process through the successive rounds of QE but the subsequent transition to a principal reliance on the latter type has been so seamless that divergences from the past four years' steady, 6.3% nominal, 3.9% real rate of increase—one largely in keeping with the overall trend rate of the past 3 1/2 *decades*— have been no more than minor.

As for reductions in holdings of bonds, while it would be too sanguine to dismiss the possible impact entirely, it is also not something over which to become overly alarmed. As the chart above shows, banks - and, by extension, their customers—currently hold far more in the way of cash assets than was their wont prior to the crisis. Even allowing for a higher degree of prudential demand in that cataclysm's aftermath, it may still well be the case that many would welcome the chance to swap back into higher yielding assets—a switch which, on aggregate, is impossible for the banks to effect, if not necessarily precluded to their depositors.

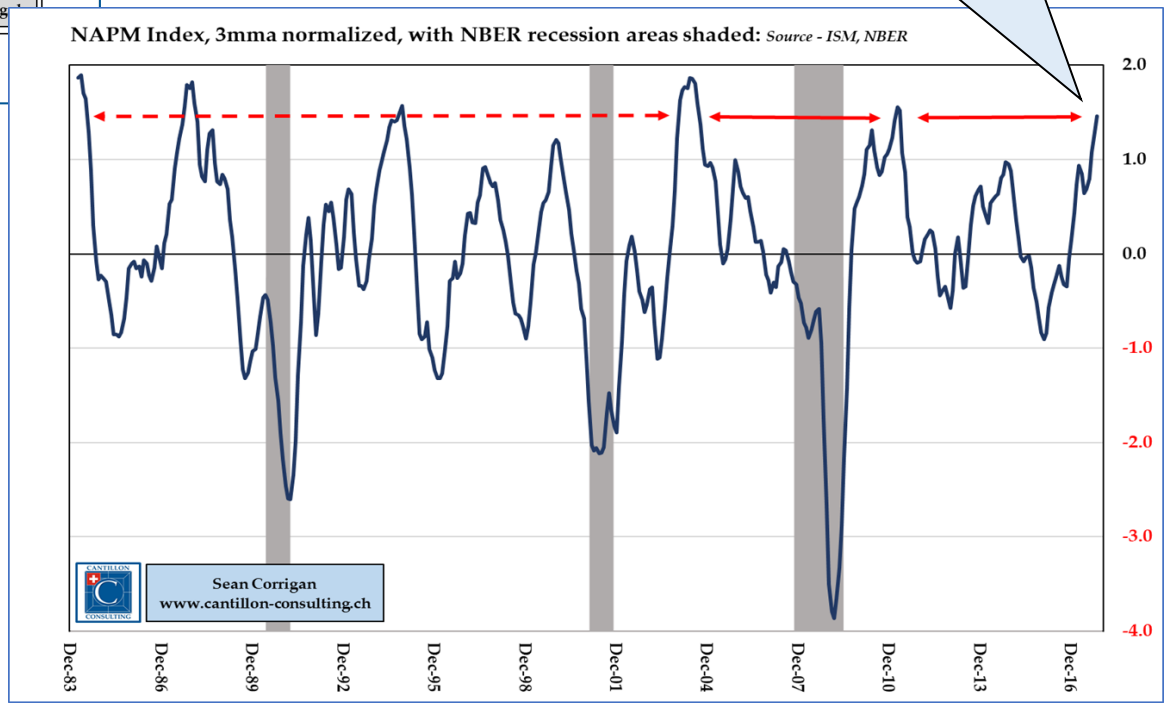
Yield hunger is still very much a fact of modern life. Thus, a tad more Treasury supply (the initial $10bln run-off pales into insignificance next to QIII's $570 bln in overall monthly domestic issuance) is unlikely to sate it just yet.

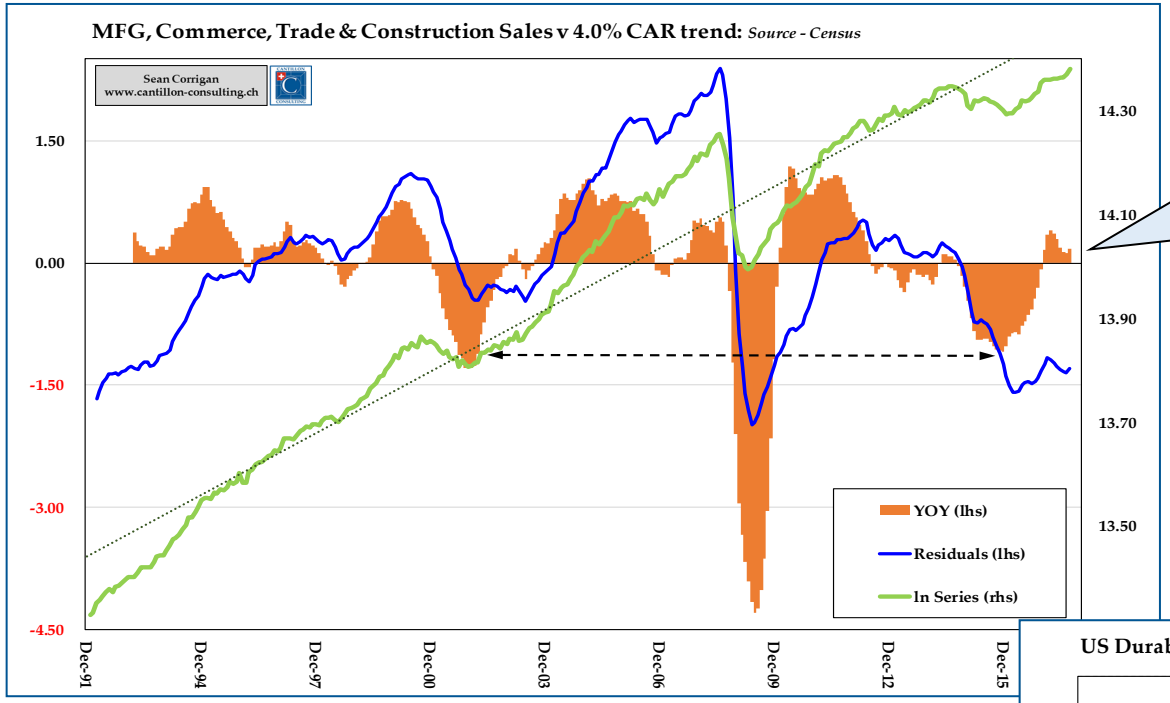




As we can see from the chart to the left, money provision in the US is far-removed from the sort of levels which have typically accompanied past recessions.

We repeat our usual mantra; when money circulates more quickly through the economy, cash registers ring more often, executives give more upbeat PMI responses, revenues swell and—usually—profits follow. The move of the ISM / NAPM version to near record highs tells its own tale of how well this is currently progressing.



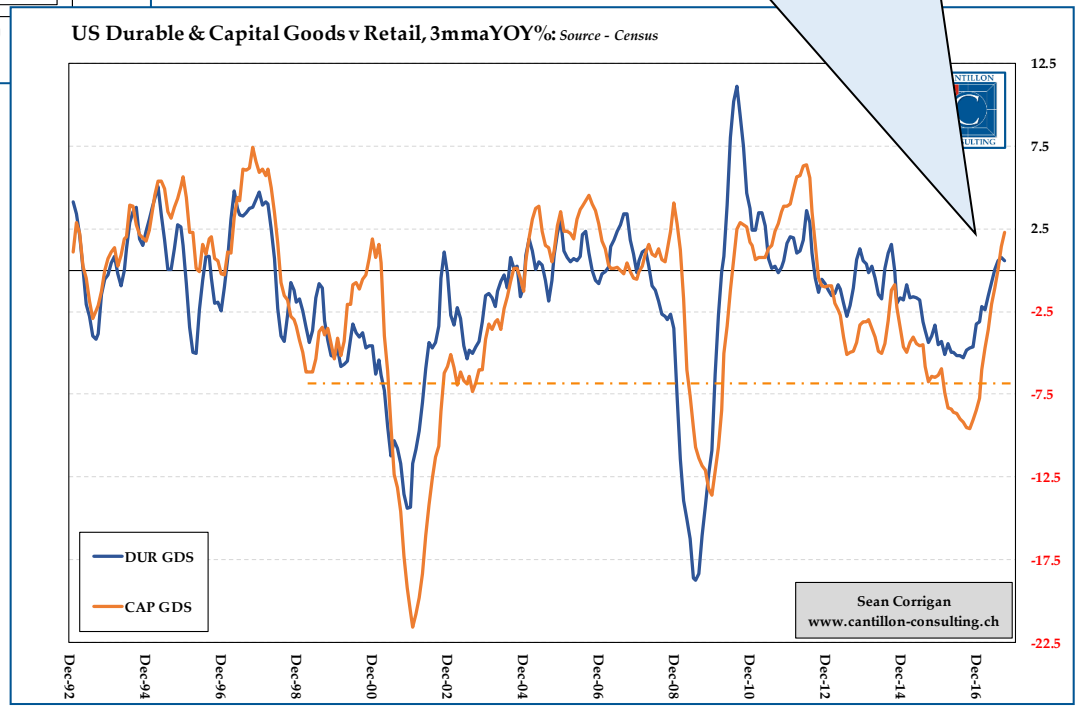


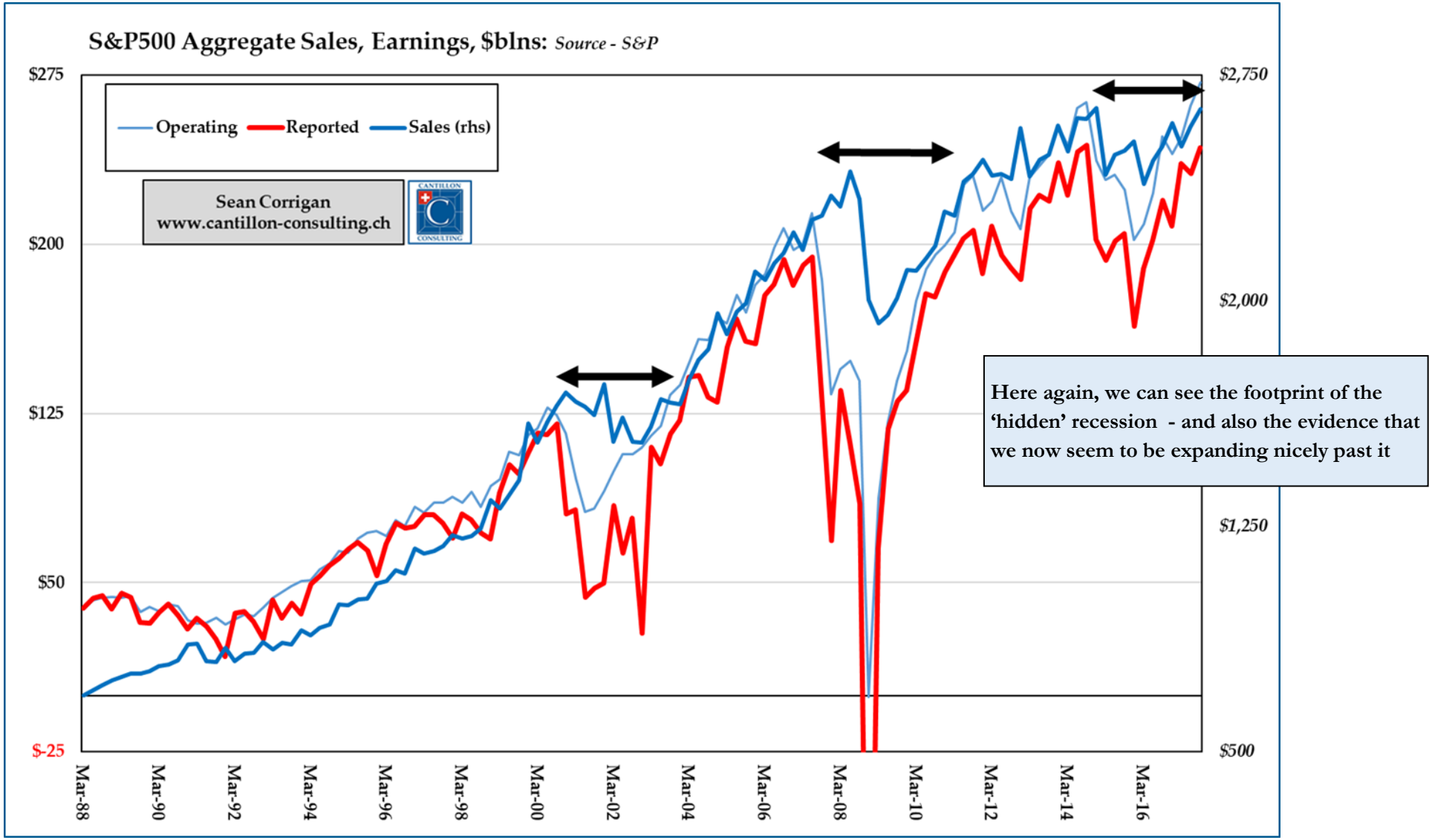
These two charts—the first representing activity in a sizeable sample of the total economy; the second a more 'Austrian' measure of the relative performance of 'higher'- and 'lower'-order goods—show both the depth of the shale-related 'hidden' recession of 2015/16 and the fact that it has now been firmly put behind us.

NB: for all the numerologists out there who insist that Pharaoh's seven-year cycle still applies to the modern economy, this episode would continue the loose succession 1992-2000-2008 into 2015, whether or not the official scribes at the NBER add their imprimatur. Accordingly, rather than finding ourselves in a post-GFC upswing now well past its biblically-allotted span, we might be only embarking upon the opening stages of the new one.

The main weak spot is in non-residential private construction, an area which has shown ZERO growth since January—its worst 9-month stretch since the spring of 2011. We shall be investigating this further to try to see if there are specific factors at work or whether it has implications for the wider economy.

As for that crap-shoot, the NFP report, overall private wage receipts were up by 2.8% 3mma YOY, their best showing in over six years. Otherwise all was very much in line with recent experience.




S&P500 Aggregate Sales, Earnings, $blns: Source - S&P
Operating
Reported
Sales (rhs)
Sean Corrigan
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$275
$200
$125
$50
$-25
$2,750
$2,000
$1,250
$500
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Mar-90
Mar-92
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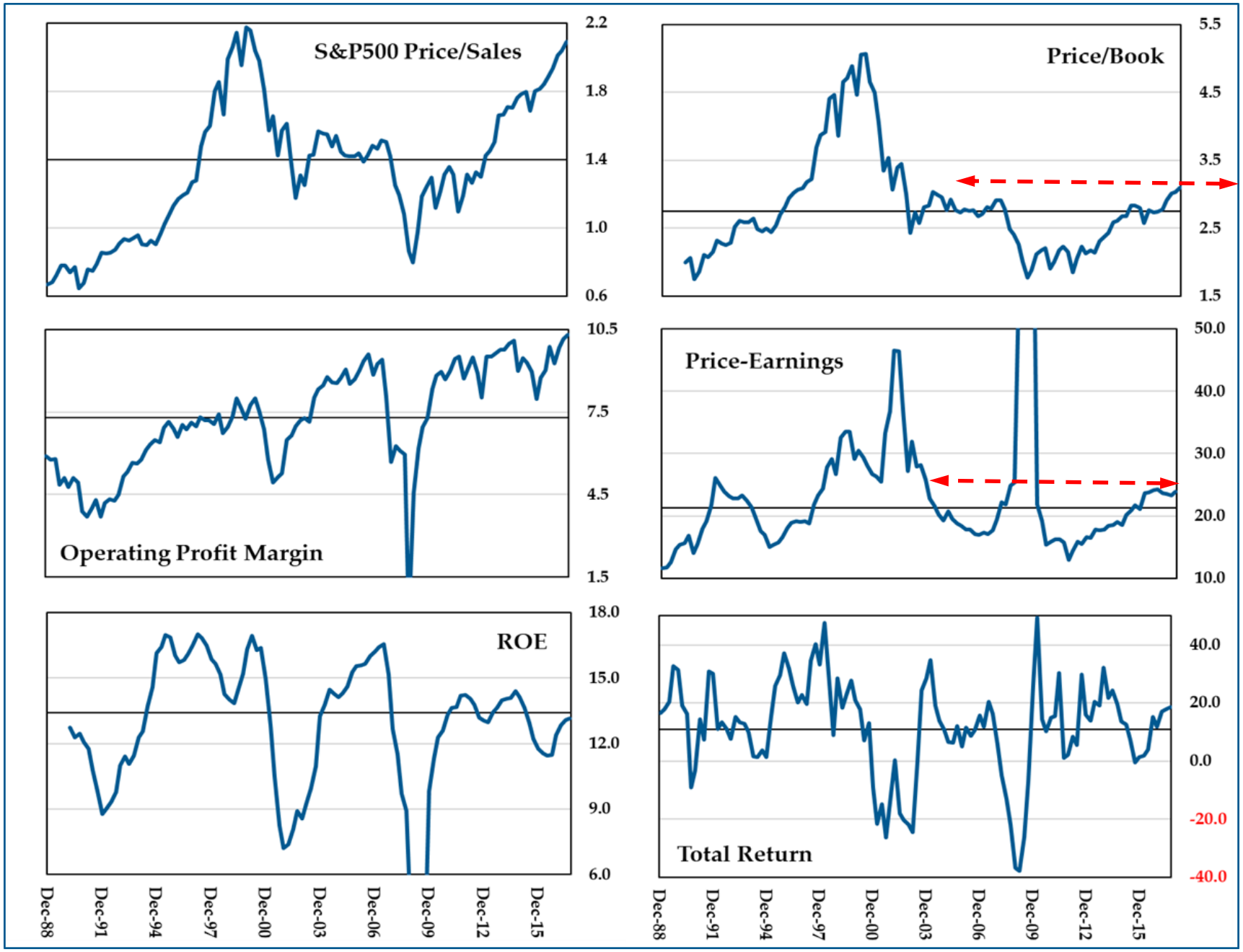
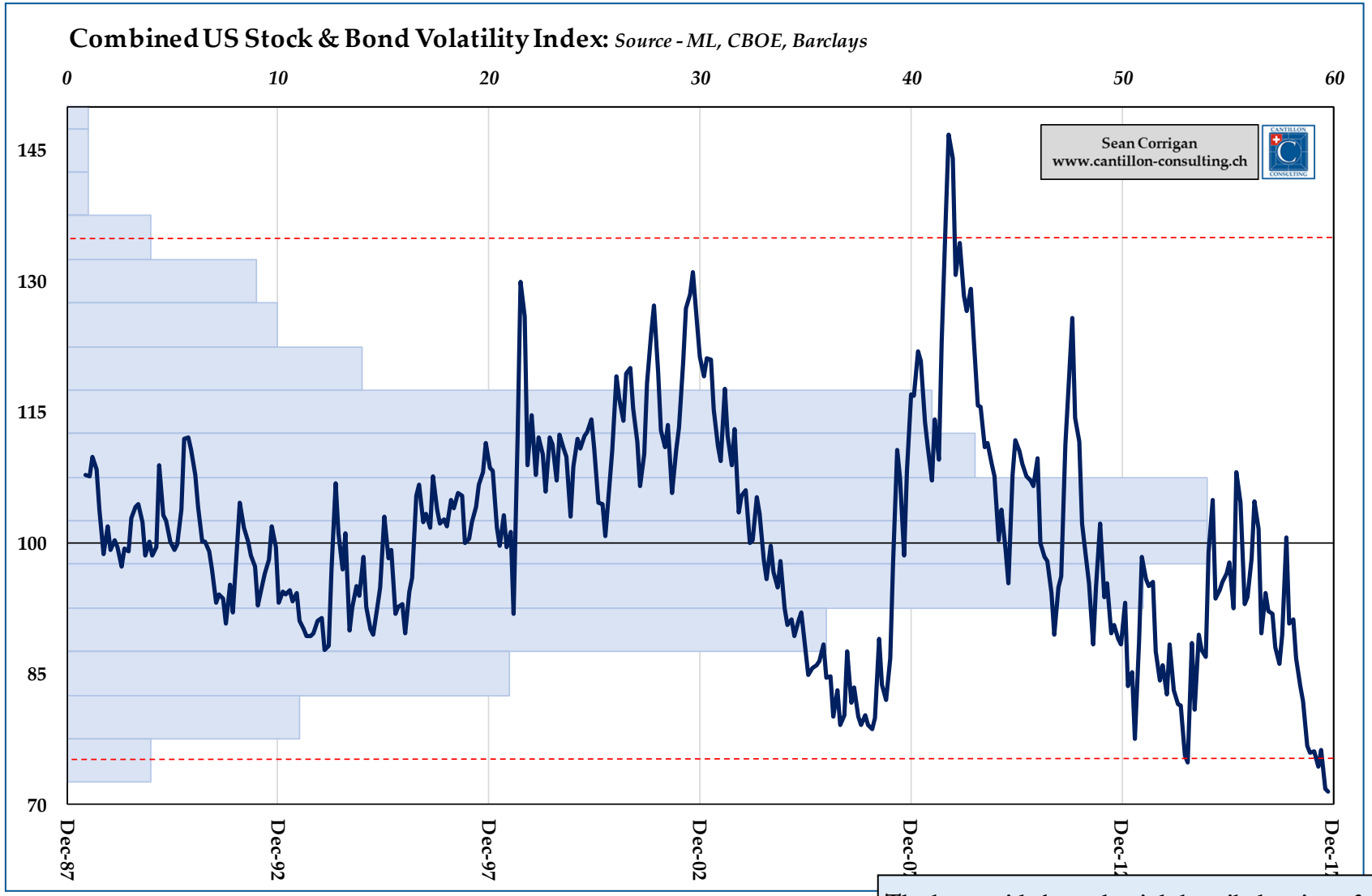
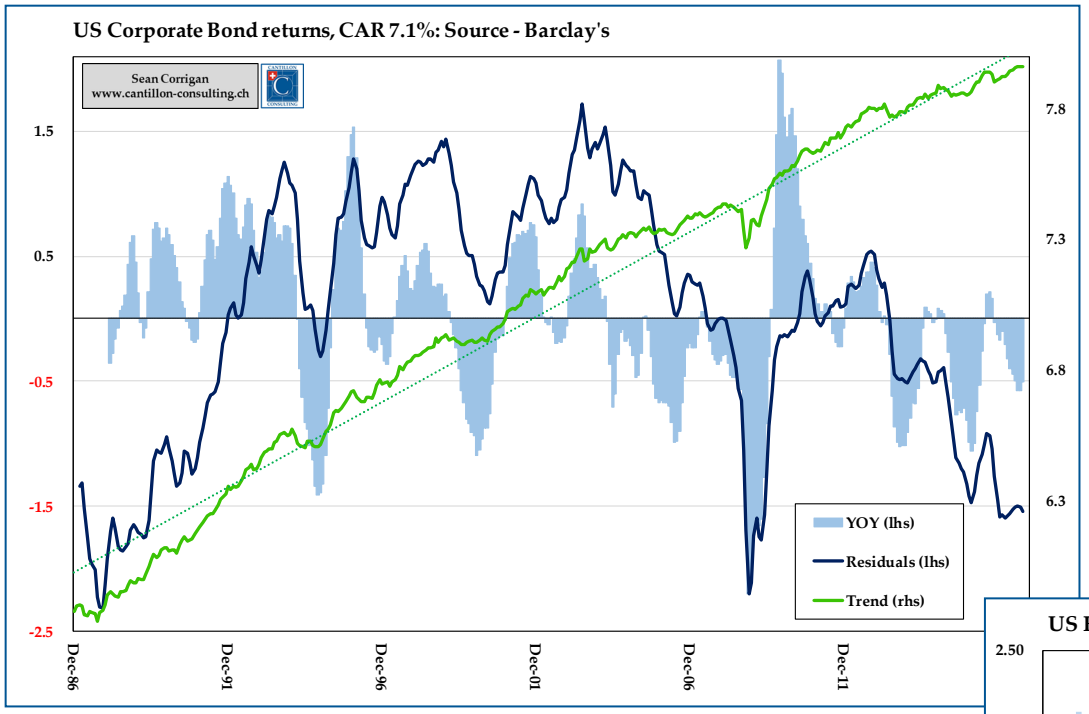
Here again, we can see the footprint of the 'hidden' recession - and also the evidence that we now seem to be expanding nicely past it



Needless to say, multiples are stretched even though ROE and investor returns are coming back from the shale bust. By contrast, ROC (not shown here) is being held down by the ongoing raft of debt-issuance

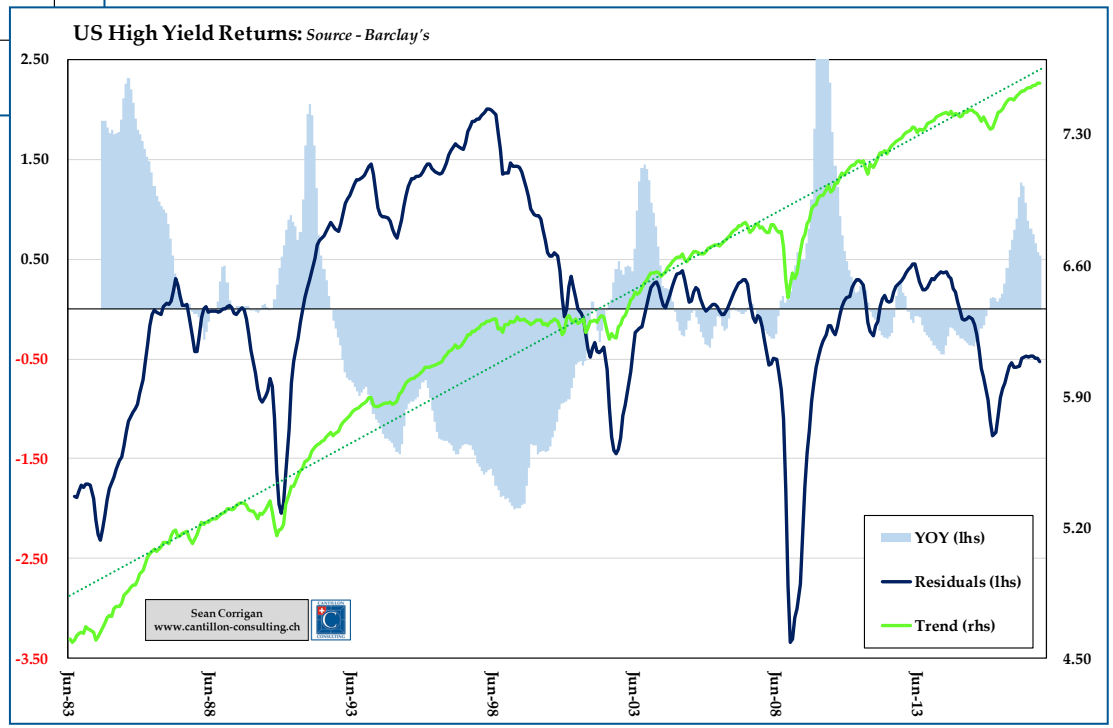


The least said about the tightly coiled spring of volatility compression, the better. Our working hypothesis is that all the Pavlov's dogs in this central bankers' market have been well-conditioned to expect dips not to trigger any deeper slippage, but merely to represent fleeting opportunities to make up any shortfall from their bogey. If so, this will probably drag on at least into year-end book-closing (SIGH)



Nowhere near as bad as is the case in Draghi's carpet-bombed ruins of capital pricing in the Eurozone, nevertheless fixed income returns in the States are also well below par, returning an average 3.4% over the past 5 years which is therefore less than half the trend 7.1%. Good luck, with that, pension-managers and insurance-premium float investors.

Junk, for its part, has returned an on-trend 8.7% over the past twelve months but has not yet made up the energy sector-led underperformance of the previous couple of years.



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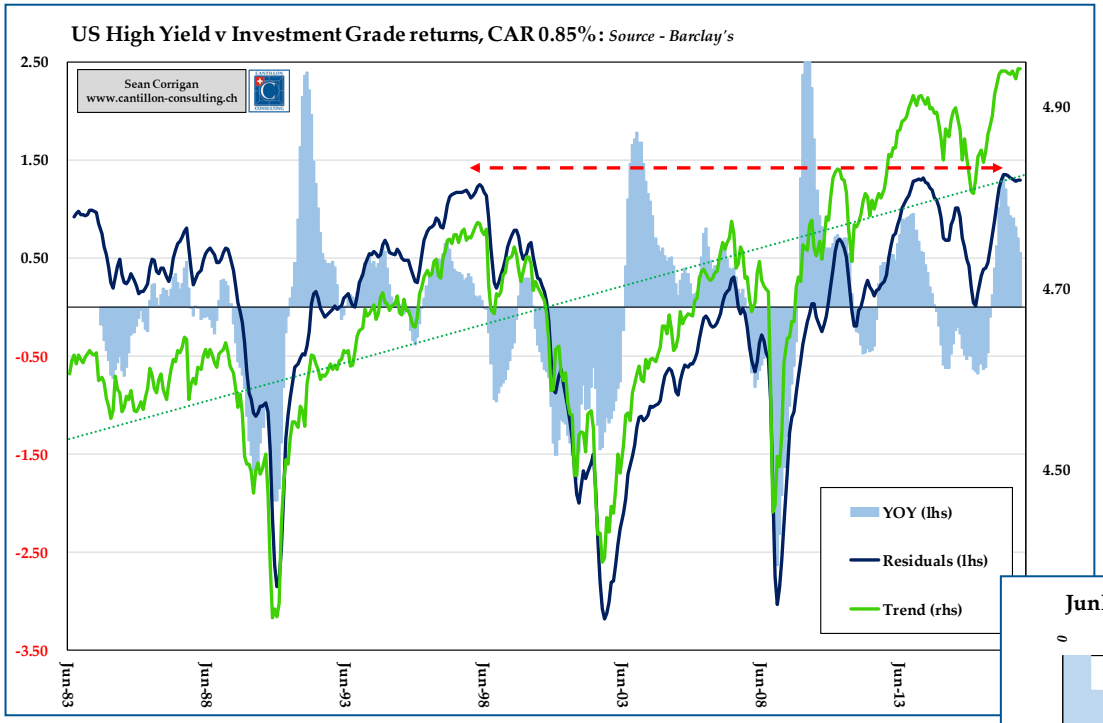
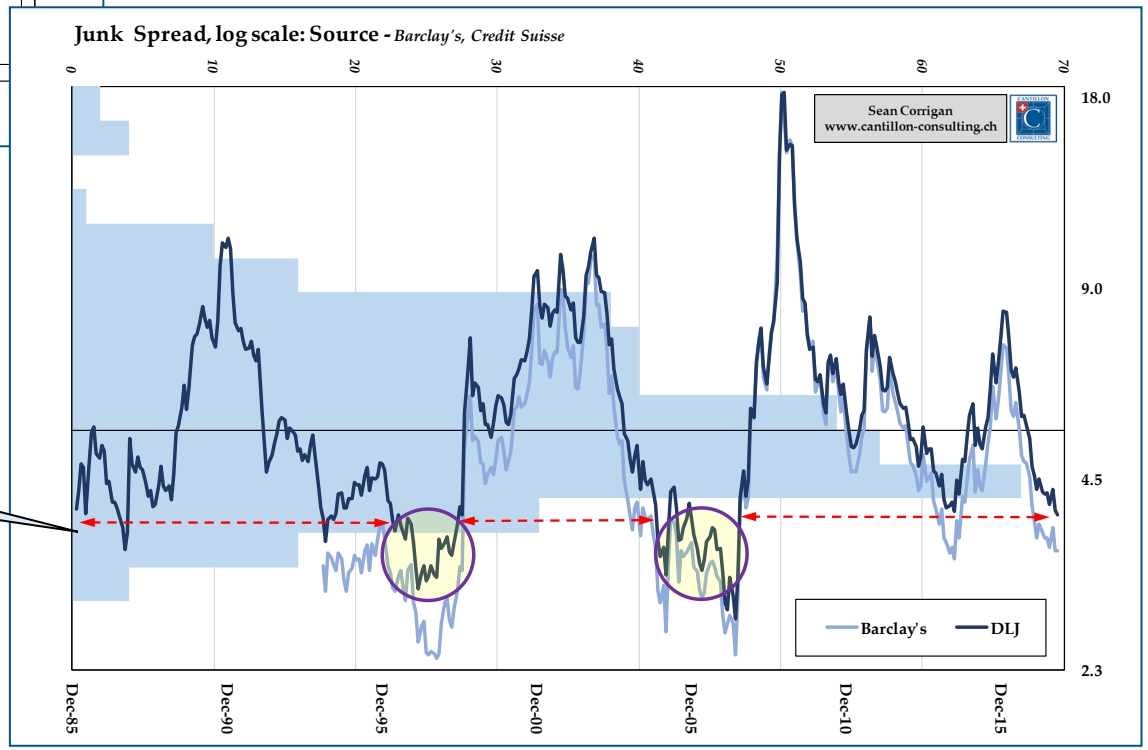


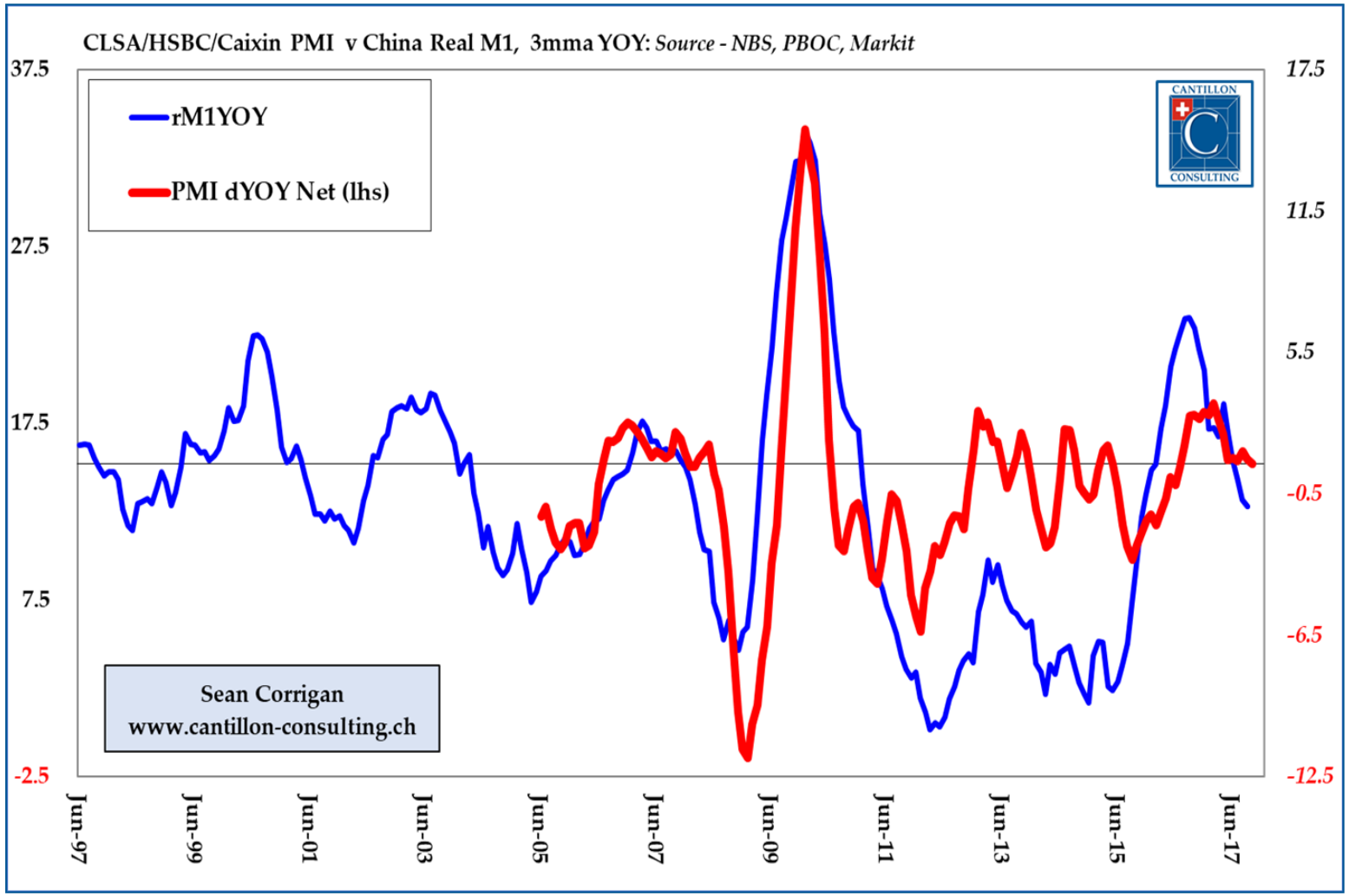
Plotted relative to investment grade returns, we can again see the clear impact of past recessions in the junk market—and also evidence that the next one has yet to generate any signs of its imminence. Over the 34 years of our sample, junk beats investment grade by less than 1% on trend. Its violent, swings & roundabout nature ill-suit it therefore to the role of buy-and-hold asset, but demands a macro-oriented approach

.

That said, the recent outperformance has been as extreme as it gets, matching the run which led to the implosion of those earlier, too-clever-by-half, great sellers of volatility and spread at LTCM.

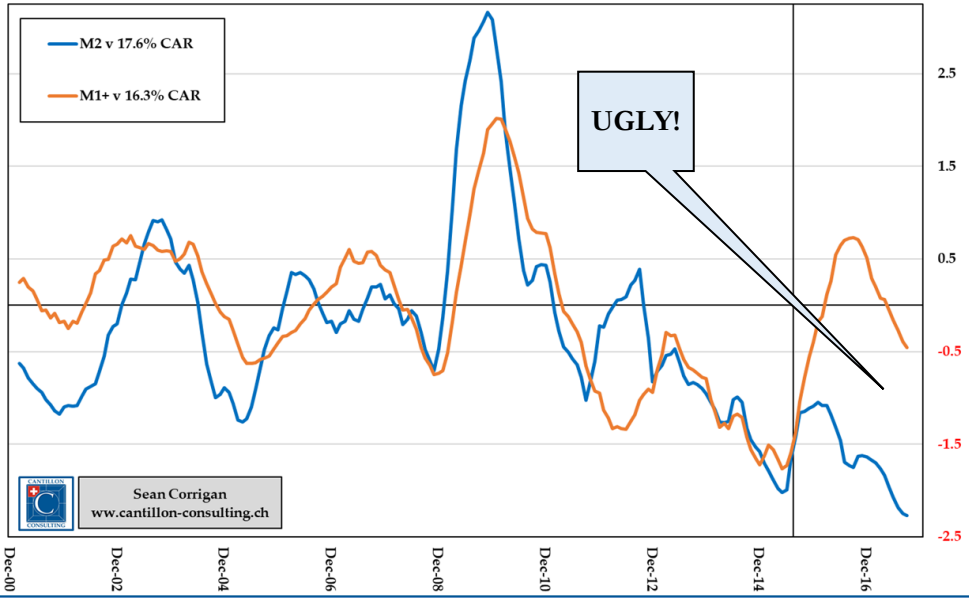
Spreads are also nudging into the sort of (pre-Oil Patch upheaval) territory where future hefty losses become well-nigh baked-in. Now at levels not far above those briefly enjoyed in the past two outbreaks of euphoria, note that, when it finally did arrive, the reaction in each of those episodes stretched to a swingeing 400bps or more.



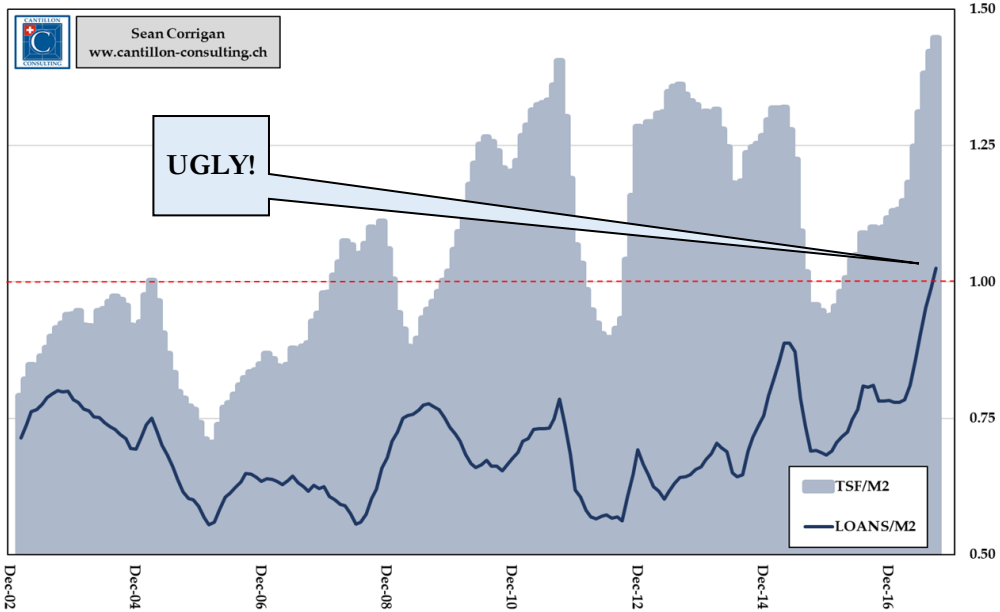


All we have argued above about the relationship between moving money, PMI responses, revenues, profits, and activity in general applies in spades to that pecuniary opium den which is China. Here there is a dirty secret: banks are creating more loans at the margin than they are securing proper, non-financial deposits against them. As a result, soaring credit is translating into less functional liquidity as well as an incipient balance sheet exhaustion. No wonder Zhou is sounding the alarm.

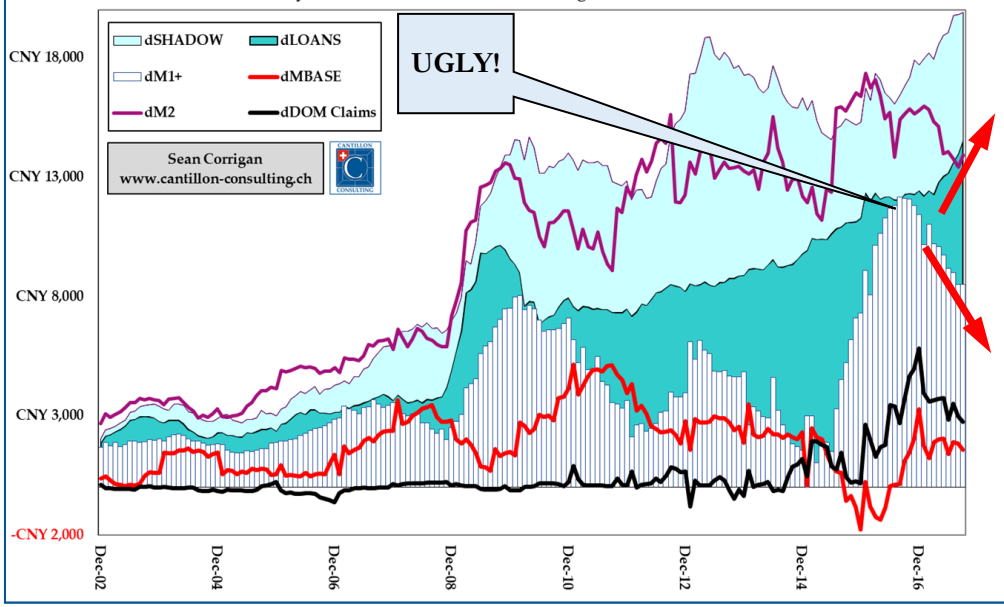
China M-Aggregates, YOY% Deviation from 2000-15 CAR: *Source - PBOC*



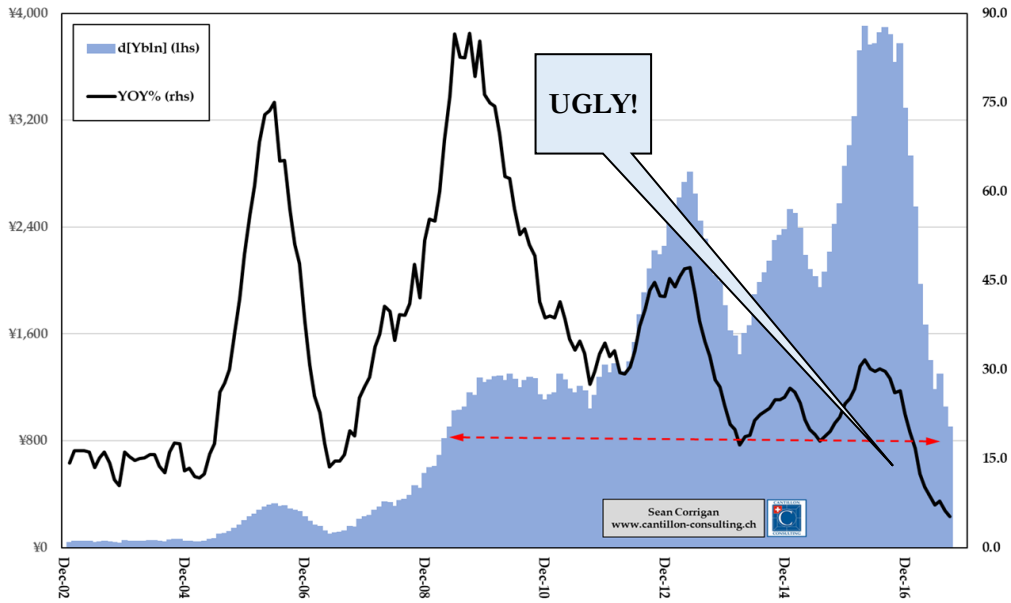
China TSF & Loans v M2 12-mos marginal ratio: *Source - PBOC*

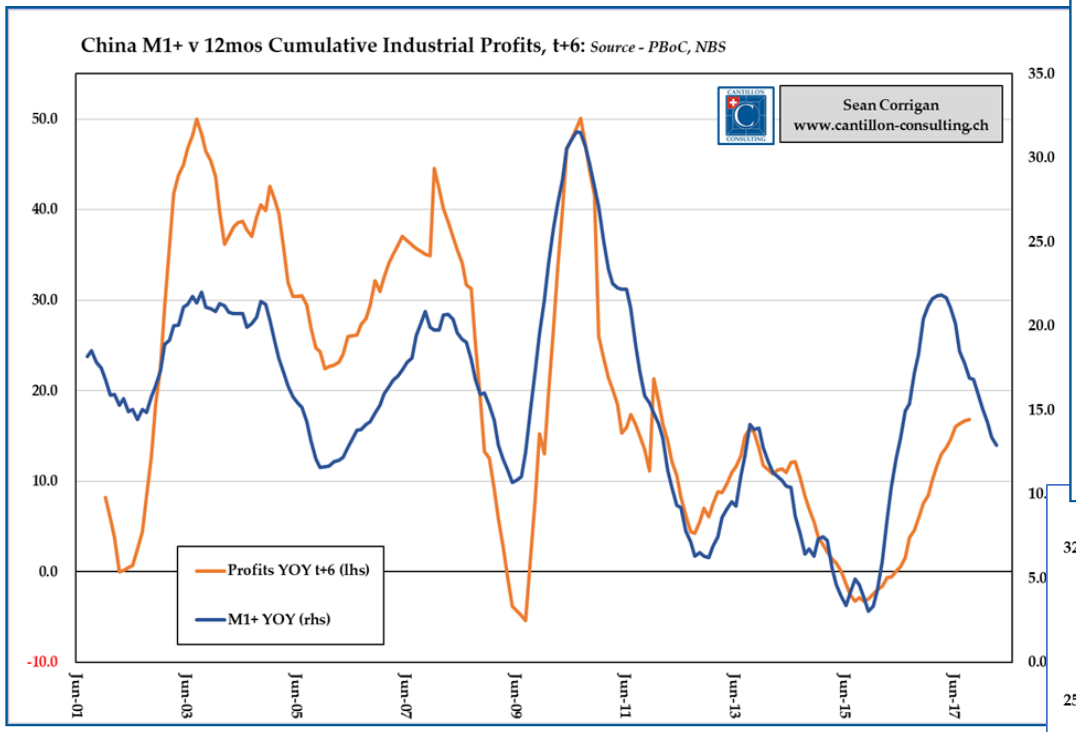


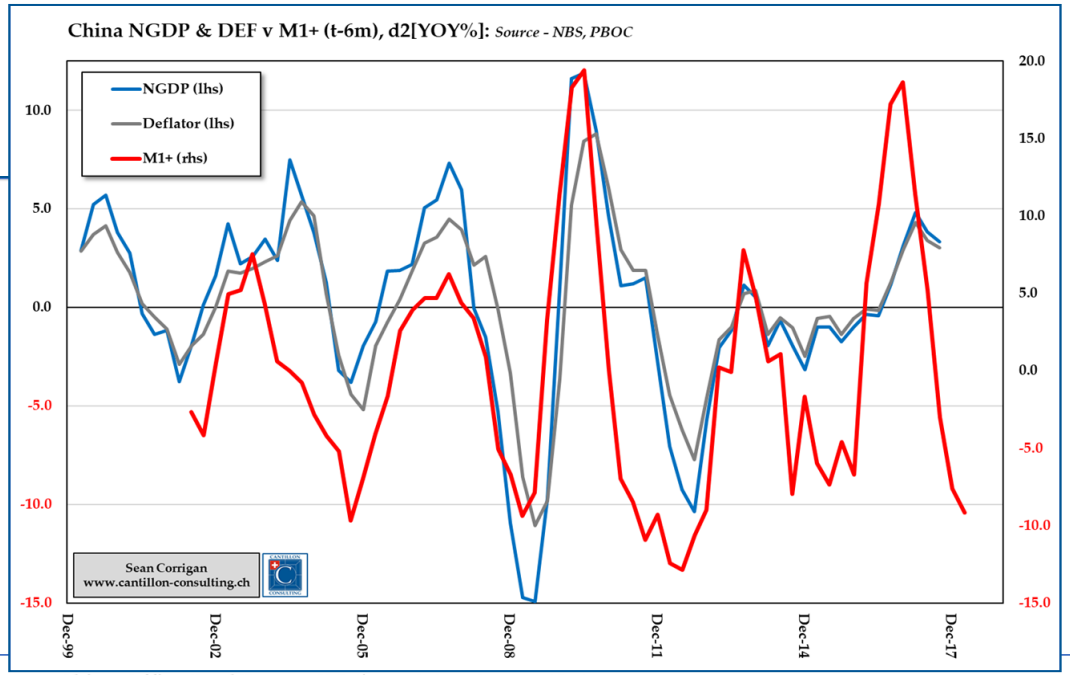
China Cumulative Money & Credit Additions, 12mos running, blns: *Source - PBOC*

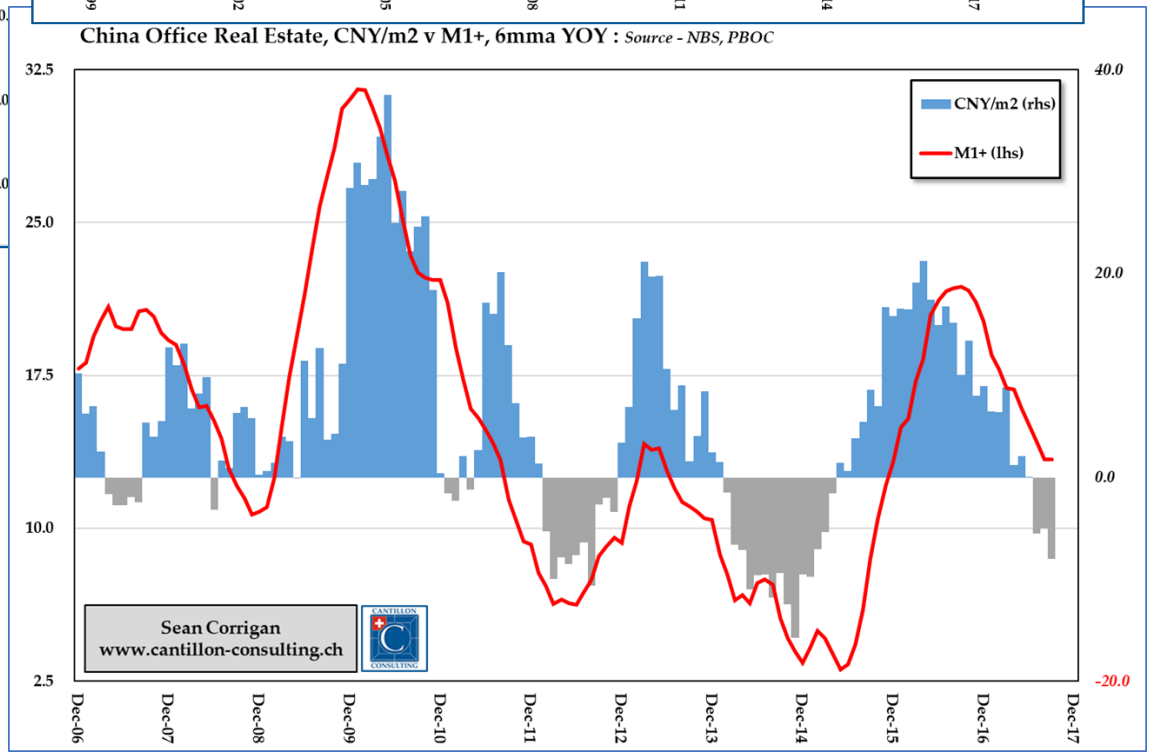


12m China NFC Bond Issuance: *Source - PBoC*

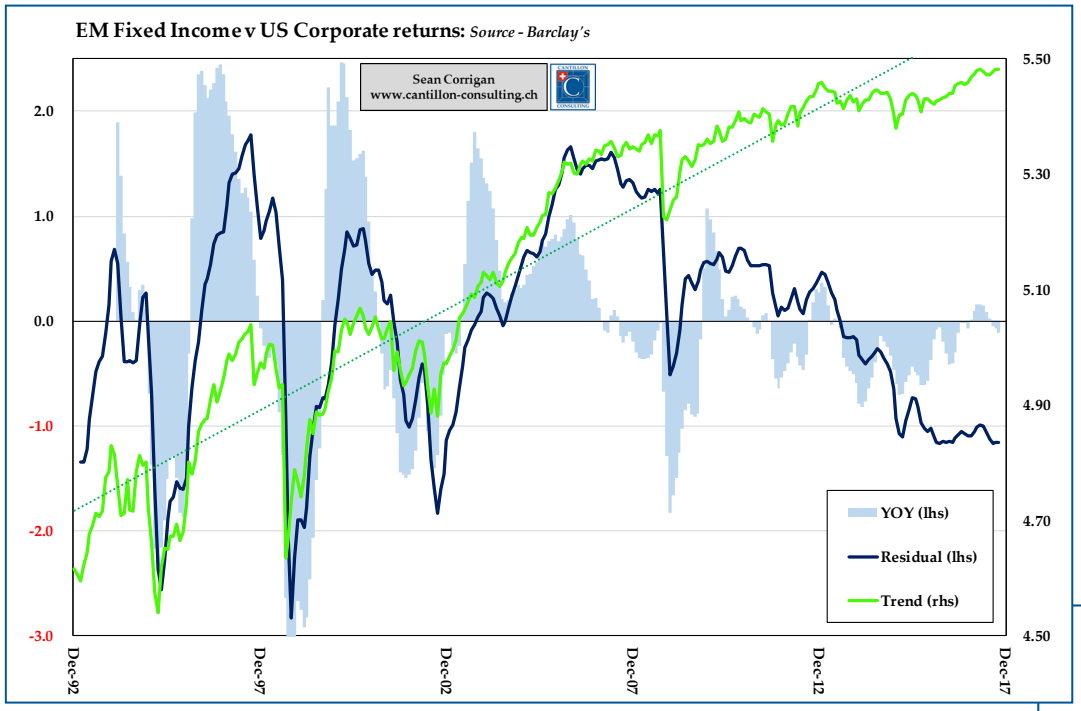






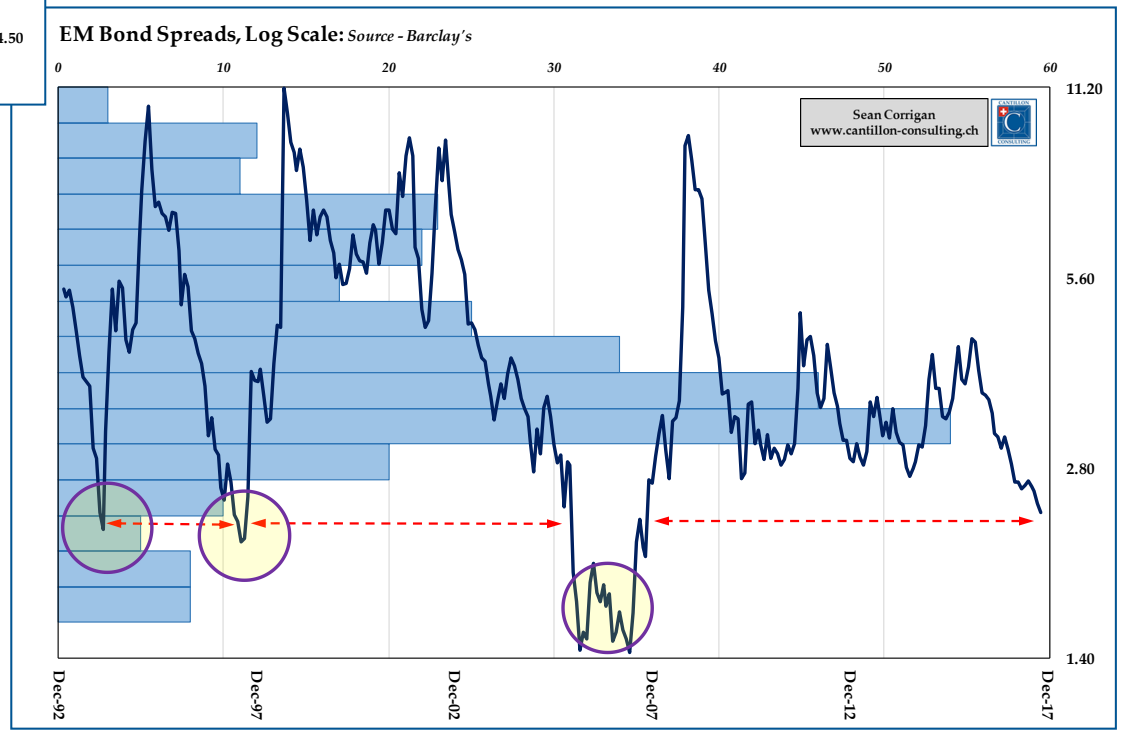


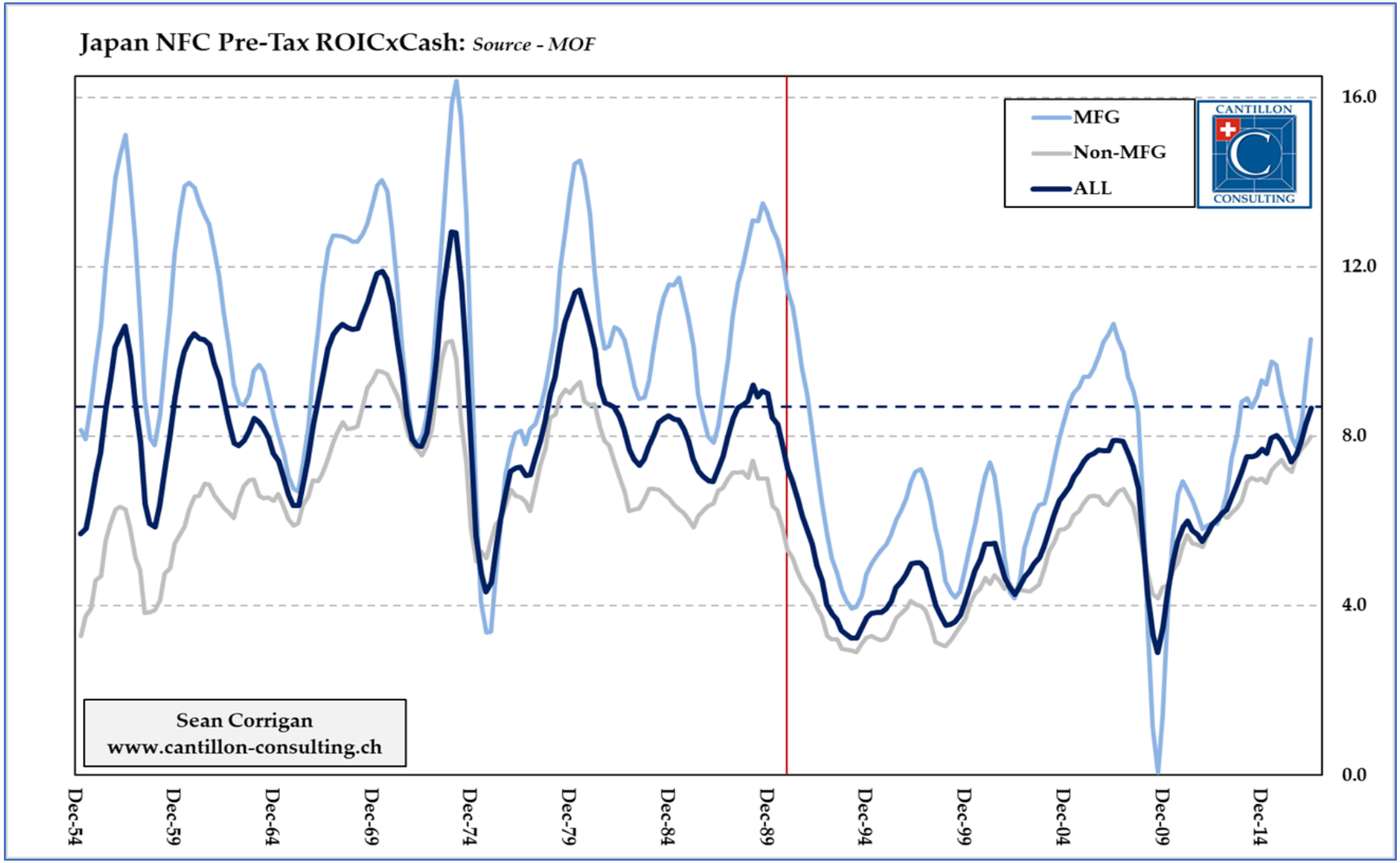
Whether industrial income and turnover, commercial real estate and commodity prices, or activity at large, China's soaring peaks and plunging troughs of sectoral boom and bust have one watchword: SHOW ME THE MONEY!



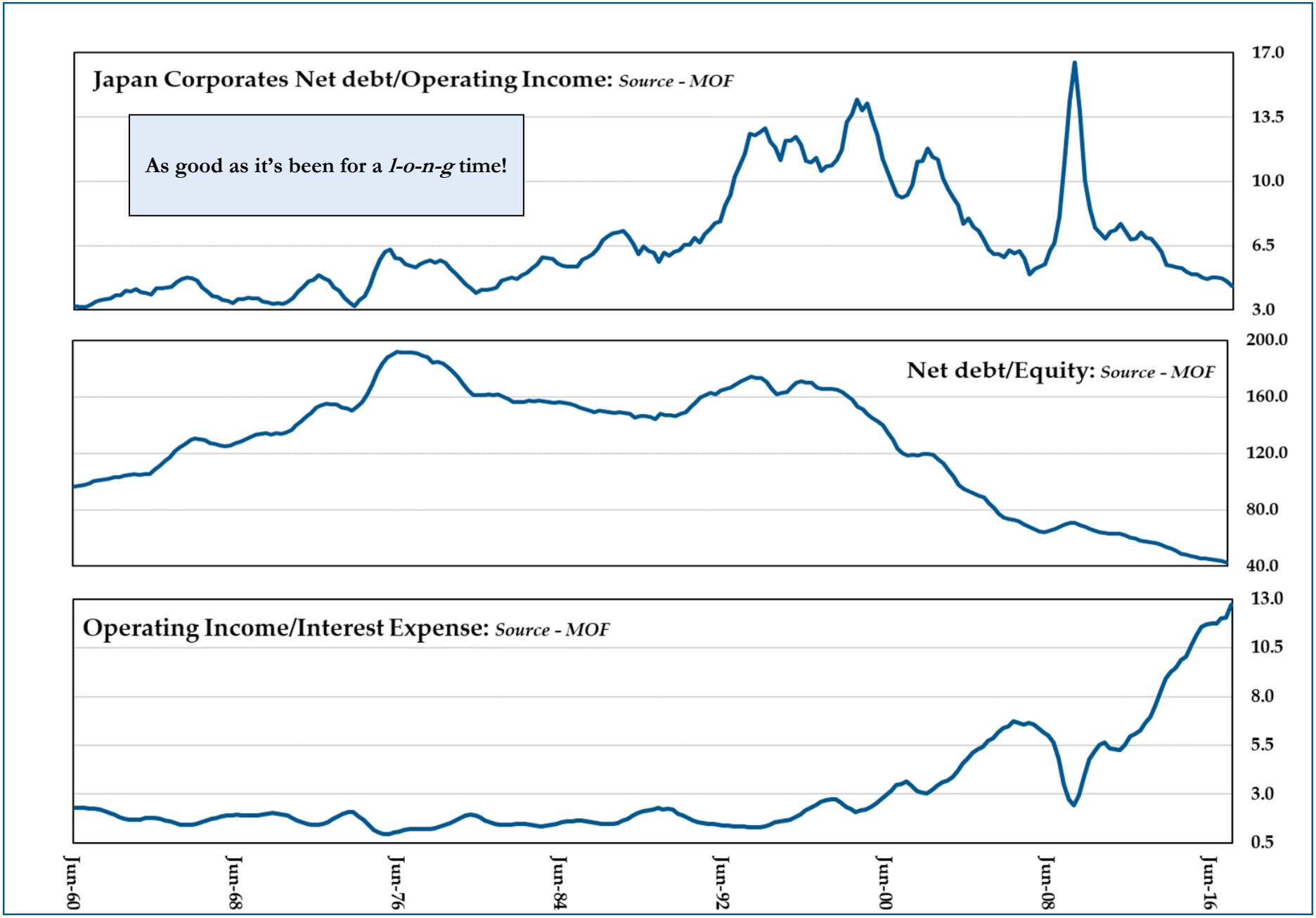
Beyond China, EM bonds comprise another class which has lost its lustre. Having returned ~10% per annum (and thus having outperformed EM *equities* by circa 2% pa) for a quarter of a century, returns since the start of 2013 have only been slightly in excess of 4%. Worse still, that period has seen performance relative to US corporates crumble from a 25-year premium CAR of 3.6% to a mere 50bps and that DESPITE spreads compressing into areas where—just as for US junk—trouble has ensued three times in living memory: viz, the Tequila Crisis—arguably the catalyst for all the hyperbubble-blowing, central bank 'firetruck-down-a-one-way-street', 'Committee to Save the World' overstretch experienced since—the Asian Contagion, and the GFC itself.

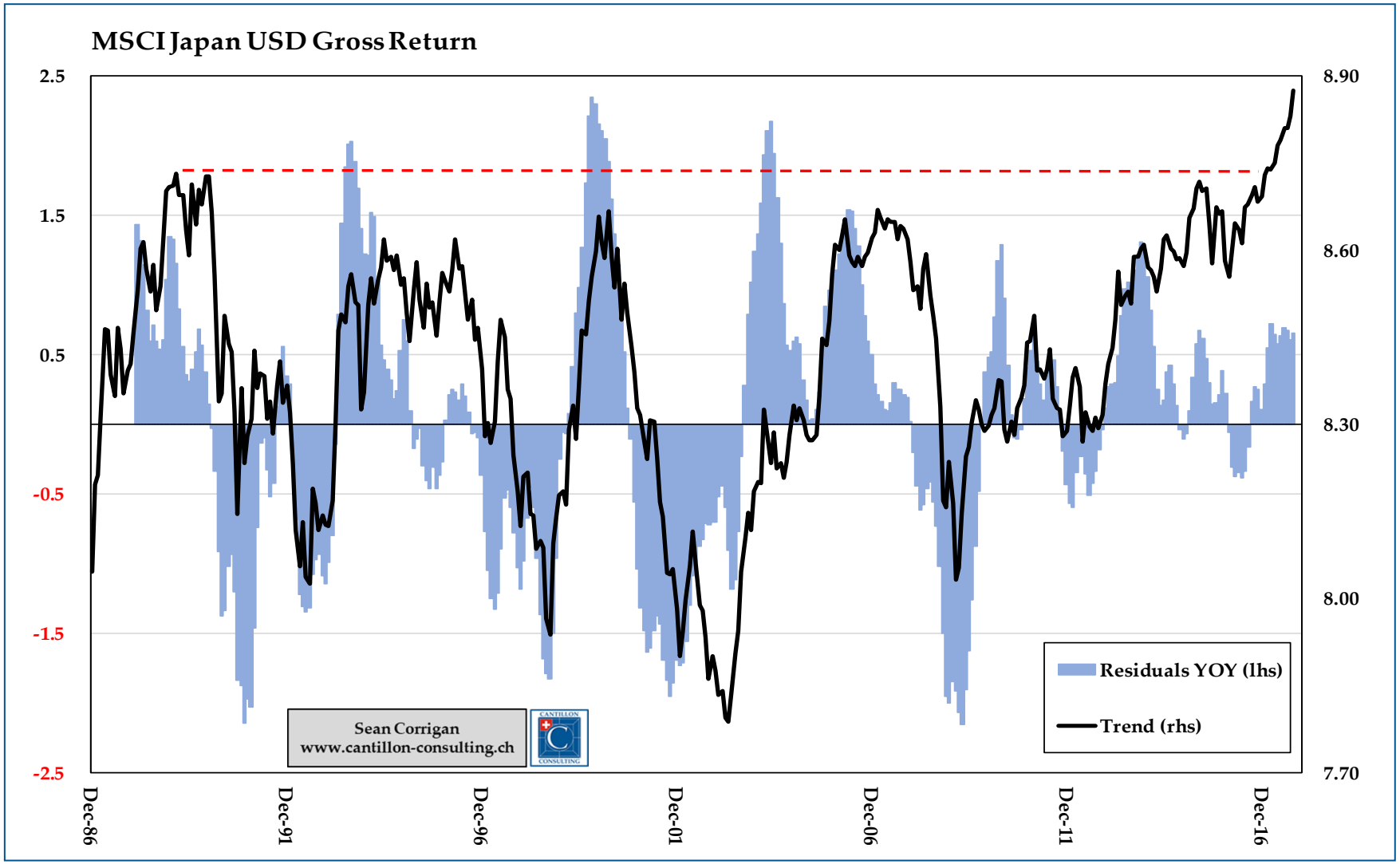
The roll-call of assets still really worth their salt is rapidly declining.





For all the slightly scornful tone with which Japanese equities' break-out to multi-year highs has been greeted, it is hard not to admit that at least some of this re-rating is not just a consequence of Abenomics and of Kuroda's Confidence Fairy, but of quantifiable improvements in returns and balance sheet metrics. Granted, some of *those* are artefacts of the prevailing loose money settings, but still, who are we to quibble?


Japan Corporates Net debt/Operating Income: Source - MOF
As good as it's been for a l-o-n-g time!
17.0
13.5
10.0
6.5
3.0
Net debt/Equity: Source - MOF
200.0
160.0
120.0
80.0
40.0
Operating Income/Interest Expense: Source - MOF
13.0
10.5
8.0
5.5
3.0
0.5
Jun-60
Jun-68
Jun-76
Jun-84
Jun-92
Jun-00
Jun-08
Jun-16



Finally, nigh on thirty years to the day, total returns in USD of the MSCI Japan have surpassed the hypoxic, 'Imperial Courtyard is worth more than Canada' peak of the Bubble! From a technician's standpoint, this all screams, 'BUY!', but though we have been calling for this for some months now, we are starting to feel a little queasy at the accelerating pace. The move since the cyclical low in February 2016 has been 21% annualized, almost matching that of the 1970-1989 trend itself. Moreover, the ascent has been steepening rapidly in the past few months and rocket-assisted in recent weeks by Abe's sweeping electoral victory. Not to be shorted, but maybe due a judicious pruning?

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All content is intended to give general advice only. The investments and instruments mentioned therein are not necessarily suitable for every individual and you should use this information in conjunction with other advice and research to determine its suitability for your own circumstances and risk preferences. The value of all securities and investments, as well as the income derived from them, can fall as well as rise. Your investments may be subject to sudden, often substantial, declines in value which may not be recoverable; others may expire worthless after a specified period. You should not buy any of the securities or other investments mentioned with money you cannot afford to lose. In some cases there may be significant charges which may reduce the value of your investment. You run an extra risk of losing money when you buy shares in certain securities where there is a large difference or 'spread' between the buying price and the selling price, a circumstance which means that, should you sell them immediately, you may get back much less than you paid for them. In the case of investment trusts and certain other funds, these may use or propose to use the borrowing of money in order to increase the size of their exposures and/or invest in other securities with a similar strategy. As a result, movements in the price of the securities may be more volatile than the movements in the prices of those underlying investments. Some investments may involve a high degree of such borrowing (often referred to as 'gearing' or 'leverage') This means that a small movement in the price of the underlying asset may have a disproportionately large effect on that of your investment. Accordingly, a relatively small adverse movement in the price of the underlying asset can result in the loss of the entirety of your original investment. Changes in rates of exchange may have an adverse effect on the value or price of the investment and you should be aware that additional dealing, transaction, and custody charges for certain instruments may result when these are not traded in your home currency. Some investments may not be quoted on a recognised investment exchange and, as a result, you may find them to be 'illiquid'. You may not easily be able to trade your illiquid investments and, in certain circumstances, it may become difficult, if not impossible to sell the investment in a timely manner and/or at its indicative price. Investment in any of the assets mentioned may have tax consequences regarding which you should consult your tax adviser. All reasonable care has been taken to ensure that all statements of fact and opinion contained in the either written or spoken form are fair and accurate in all material respects. All data is from sources considered to be reliable but its accuracy cannot be guaranteed. Investors should seek appropriate professional advice if any points are unclear.