Money, Macro & Markets Monitor

CANTILLON CONSULTING

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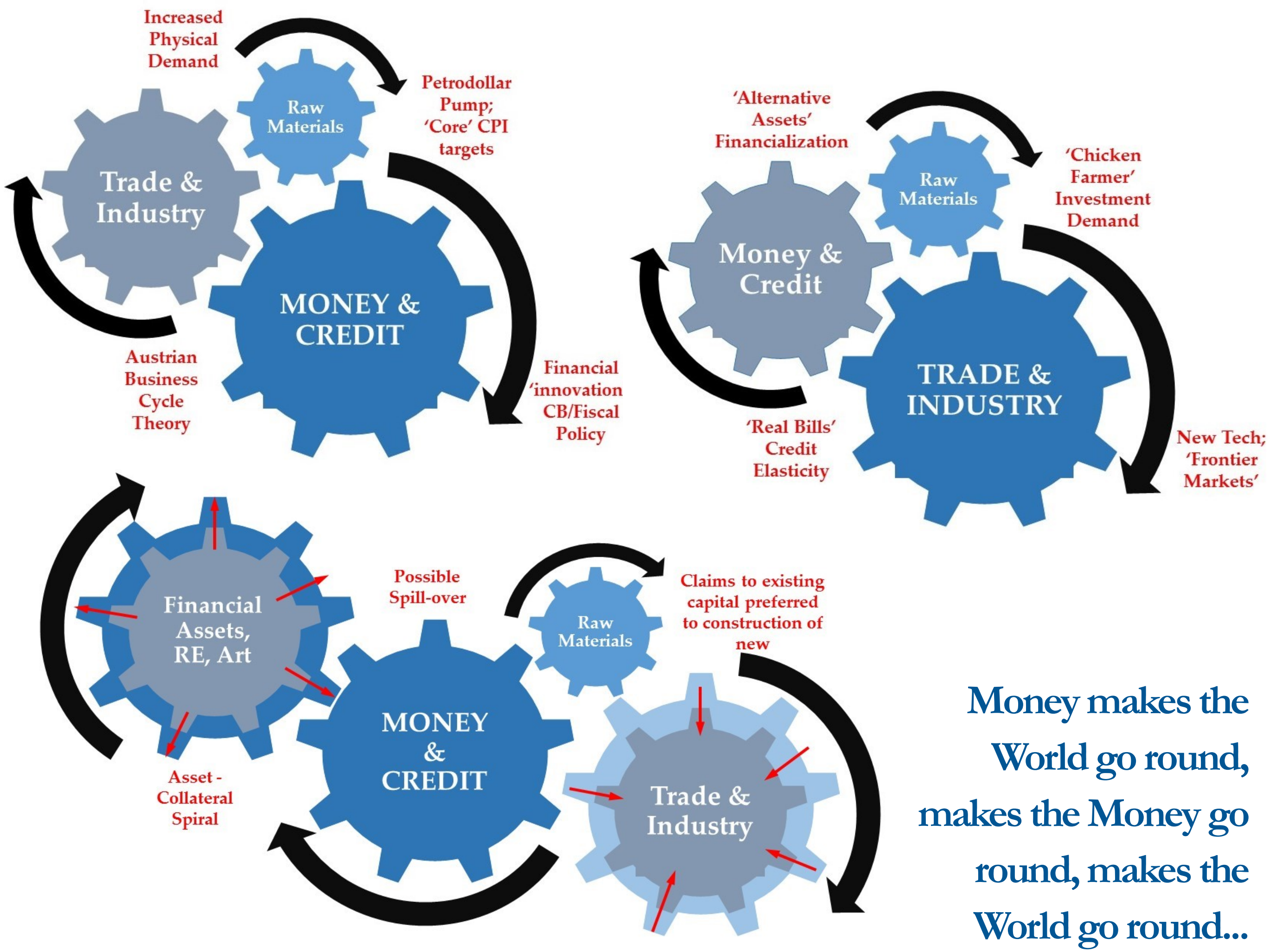
February 2018



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

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Volume II, Issue II

How the VIX Seller lost His Shirt

It has long been a prejudice of ours, O Best Beloved—in part the fruit of bitter personal experience—that February is a month prone to producing major upheavals and even to generating complete reversals of the prevailing *Weltanschauung* of the Investing Herd.

Schematically, we see the process as follows. Though the crowd returns from its sojourn on the beach after Labor Day suitably invigorated, the initial burst of creative energy engendered by the summer hiatus soon begins once more to wane. Then, once it becomes apparent to one and all that the mythically-ill-fated month of October is again going to pass without doing anything to live up to its malign reputation, thoughts inevitably turn to year-end book-closing instead.

With an eye to the preservation of reputations, as well as to a more venal anticipation of the yearly bonus allocations soon to be made, there then begins a good deal of juggling, a process generally conducted with two, mutually complimentary aims. The first imperative is to winnow out the worst of one's embarrassments before they have to appear in unmissably bold, red ink in the annual performance review while the second sees one trying to re-order one's positions—however belatedly— around whatever has turned out to be the year's winning trades. In that way, even the weariest hack might hope to spare himself too much aggrieved interrogation by an investor base demanding to know why THEY alone did not manage to benefit from what was *obviously* the exposure to take (albeit, of course, only obvious with the benefit of a dose of conveniently unacknowledged hindsight).

The pleasing net effect of this consensus clustering is naturally to reinforce the dominance of the assets and strategies which have made it to the late autumn with their noses in front of the field and to drive the stragglers even further to the rear. Gratifyingly, this should improve even the most-avowedly Mr. Mediocre's marks-to-markets, possibly even to the point where he forgets he's only in the trade for the most craven of reasons and starts to believe, once again, in his own undimmed genius.

With the reporting deadline then safely passed, our man's thoughts will turn—as will those of most of his peers—to wassailing away the waning weeks of the calendar, a prospect which will quickly drain him of any residual motivation to go about the gritty business of investment analysis until the New Year begins once more in earnest.

When that sobering point is reached, however, our man finds himself confronted with the renewed challenge of once more justifying his existence. Being by definition someone of decidedly average—or even sub-par—imagination, what is more likely to commend itself to him than to continue to back the same, trusty old horses which saw him across the finish line a few weeks previously when he was still making a pretence of putting in a proper shift? Given, too, that the awful pressure of yet another yearly bogey to make weighs most heavily when one's scorecard is a *tabula rasa* of non-achievement, not only will our man rebuild most of his earlier positions but, by now firmly convinced that to him belongs their intellectual paternity, he will likely put them on in greater size.

Initially, this will also prove a self-fulfilling prophecy. The sheer weight of Other People's Money being placed on the table by our Mr. Mediocre and the myriad mutual mimics in the Market's echo-chamber will at least commence by moving prices in his favour.

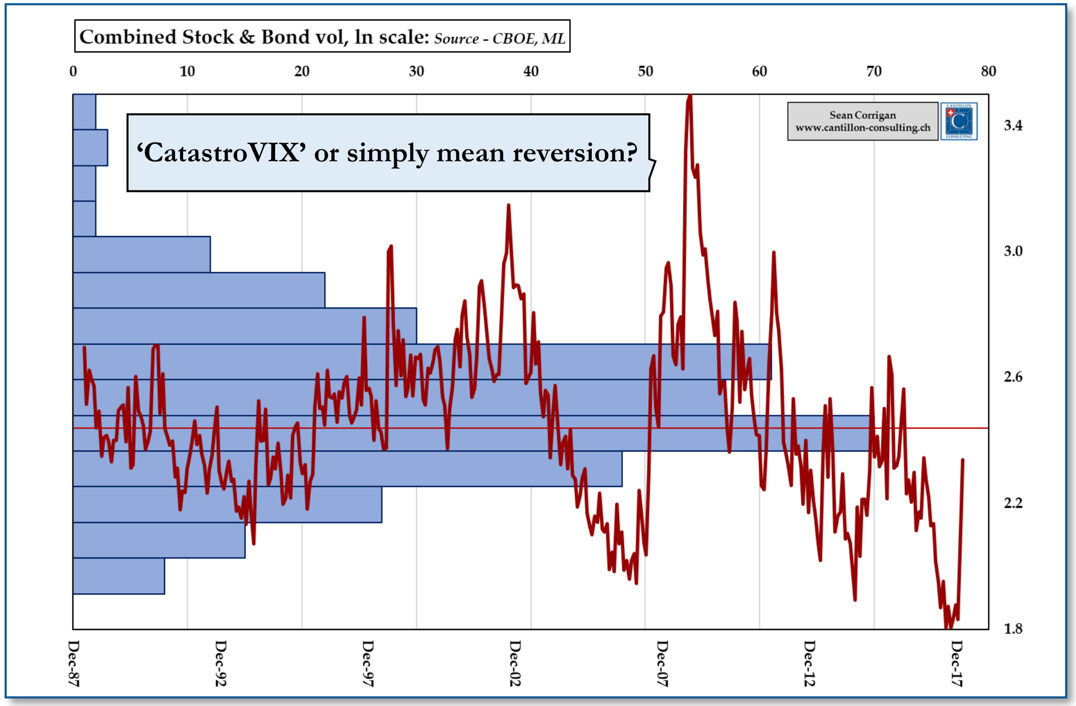
With little rationale behind these increasingly stale—and by now highly concentrated—trades beyond that of a rather shaky precedent, conditions now become ripe for a sudden bout of frustration, for a shaking of the overladen boughs, and for the first gut-churning pangs of self-doubt to dispel the lazy complacency which has prevailed over much of the prior semester.

Such, we would contend, was largely what lay at the root of the sharp reversal suffered last week.

Paradigms Lost

But, if this *is* the case, where does that leave the market now?

On the face of it, hardly affected. Stocks rapidly staged a major Fib retracement of their initial losses, reducing these to barely 4% of their all time highs. Implied volatility has increased, but only back to its long-term average after a period of extraordinary, trend-driven quiescence. True, the VVIX—that tail of the flea wagging the tail of the dog of market pricing—is perhaps 20% higher than it typically has been these past 5-years, but this still all smacks more of complacency than concern.



In credit, too, the ripples quickly dissipated with HYG similarly recouping 5/8 of its drop and spreads not yawning noticeably wider but rather—-well—just *yawning…*

Does this determined display of indifference mean that we can write off the late turbulence as just one of those things and carry on much as before? Can we continue to gorge on the good things the market has to offer us; our appetite whetted, rather than ruined, by the brief attack of dyspepsia which constituted the sell-off?

Well, perhaps. But crucial to such a prognosis will be the issue of what Papa next chooses to read to us children when he tucks us in to our beds at night. Will it be the familiar fable of '*The Boy who cried Wolf*' - a tale craftily selected to silence the many plastic Cassandras who have newly emerged to tell us that they knew all along that Humpty Dumpty was about to slip off his wall? Or will it be a re-imagining of an old classic, one in which Goldilocks at last tires of the search for the perfect porridge and instead seeks adoption by the very Bears whom she first broke in to despoil?

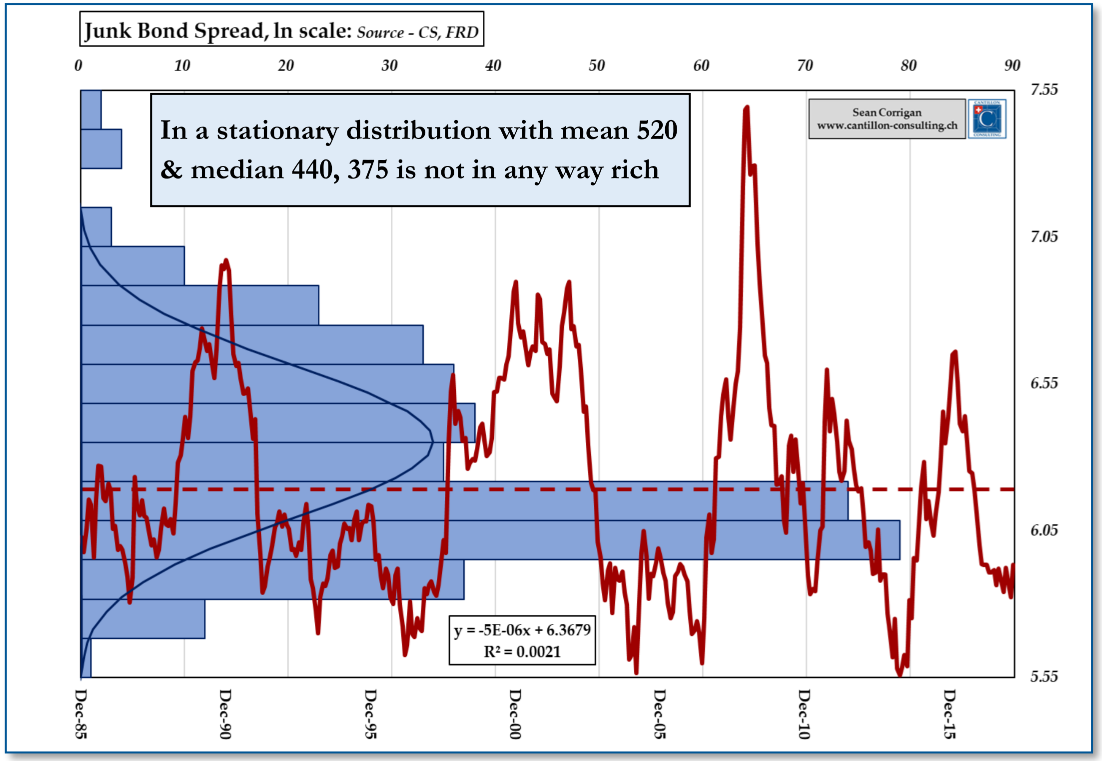
The reason this is so critical is that, for all our avowed focus on the supposed bed-rock of the 'fundamentals', these are themselves merely the creatures of interpretation. Much as any half decent epistemologist will tell you, data only become 'facts' when viewed through a prism of prior supposition and mental fabrication. We cannot search for even the most basic of natural scientific truths without holding a pre-framed theory in our heads to tell us what to look for and where else we seek in vain for meaningful signals amid the cosmic noise. Those giants upon whose shoulders we are supposed to stand may well afford us a better vantage, but they also tend to point us in a direction of their choosing, not ours.

How much moreso does this all hold true when it is economics—and its applied branch of finance—that we are considering? For this is pre-eminently a discipline in which the yardsticks we use in our estimations themselves possess no lasting rigidity or immutable length, but are shaped according to our shifting prejudices and so only measure what we choose to see and not to register anything of what we would rather ignore.

Given that ALL economic value is necessarily subjective; that markets are Herd phenomena; and that Homo Economicus is a *Rationalizing* Actor, not a *Rational* one, changes in the technical landscape such as we have just suffered can lead to what our student of the theory of knowledge might call a Kuhnian revolution but which we might prefer to think of as the spinning of new, post hoc *'Just So'* fable. By exerting a major influence on what comes to be seen as the consensus interpretation, this recasting of the narrative—or, indeed, any similar alteration of the 'sentimentals'—can all too easily act so as to change what we like to think of as the impitiably impersonal 'fundamentals'.

Heisenberg's Delayed Certainty Principle

This often leads to a build-up of cognitive dissonance, like the magma bubbling up under a dormant volcano or the stresses grinding on a fault line. We relegate all contradictory evidence or missing consequences to a series of entries in our very own, mental X-files only to move the now renamed folder— '*Monday Morning Quarterback*'—to a prominent spot on the desk-top the minute the gap between our current perception and reality becomes finally unbridgeable and the new one provides a better fit. The seductive charm of this is that no-one is ever made to feel they were wrong in their forecasts for more than the briefest instant. No, the minute the ground heaves under them and the markets take off in a



dramatically different direction, out come the May Day-Parade airbrushes; the scribes go quickly to work with corrective fluid and fresh typewriter ribbon, and—Hey, Presto!—soon we Initiates can all nod sagely in agreement once more when we relate our new, wet-inked Creation myth to one another in our circles of professional acquaintance. Jonathan Swift would truly have been proud of us!

Thus it is that the same people who spent half a decade parroting Kartoon Keynesian complaints that QE on its own would prove hopelessly ineffective and that aggressive fiscal 'stimulus' was therefore a necessary supplement to the 'treatment' of our economic ills now suddenly fear the onset of 'Quantitative Tightening' while simultaneously decrying the Trump administration for its pursuit of what they decry as its irresponsibly expansive spending plans.

In the same manner, the very pundits who all this while have glibly echoed the prevailing Central Bank, Woodford-Fischer gobbledegook about looking for 'improvements'—i.e., for purchasing power-sapping *increases*—in CPI inflation are now suddenly terrified of those so-called improvements' first, tentative appearance.

Bond yields, we were assured, could not rise too far because the world was too indebted to bear it (forgetting that the payment of interest is largely a transfer from the pocket of one passenger to another, not a puncture in the gas tank of the car they are riding in). Now, however, the talk is of some sort of Attic philosopher's meta-paradox whereby, as Reuters risibly put it: '*bond yields are rising on expectations that the Fed will tighten more than expected*'!

Lewis Carroll and Edmund Lear, please call your office!

I KNEW that would happen!

The upshot of all this may not be what the extreme rationalists would wish to hear. Only the market will tell us whether early February was a portent of much worse to come or simply a random judder which threw overboard a few of those foolhardily crowding the taffrail while most heavily weighed down with the baggage of too much leverage, in too esoteric an instrument, to nobody's cost but their own. Here, the main thing to bear in mind is that the more stretched those 'fundamentals' are by comparison with historical precedent, the more vulnerable the market will be whenever the Fates next maliciously decide to shake the branches.

If violent market moves have a tendency to give instant birth to their own supportive narrative, as we have argued here they do, it is always easier to construct one around a good, old, sour whiff of '*I told you so*'. Be assured that whenever the next reversal does arrive—whether it goes by the playbook of the somewhat analogous episodes of 1987 or 2000, or via some entirely new constellation of ills—there will be no shortage of folk claiming said prescience and adding considerable impetus to the correction as they do.

Sean Corrigan

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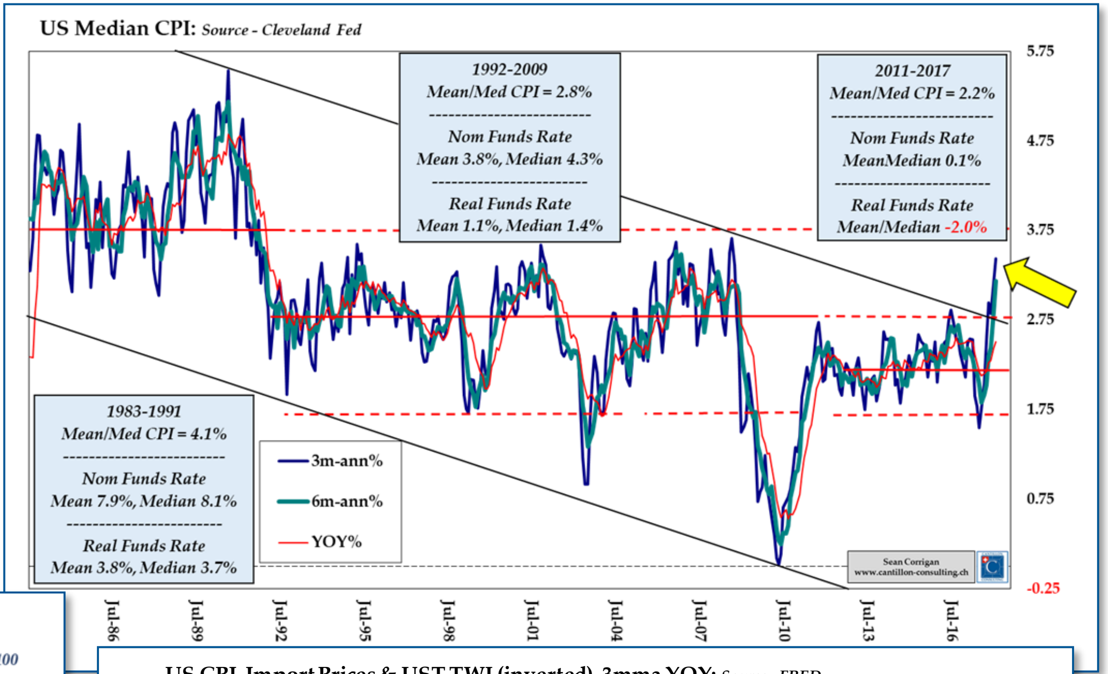
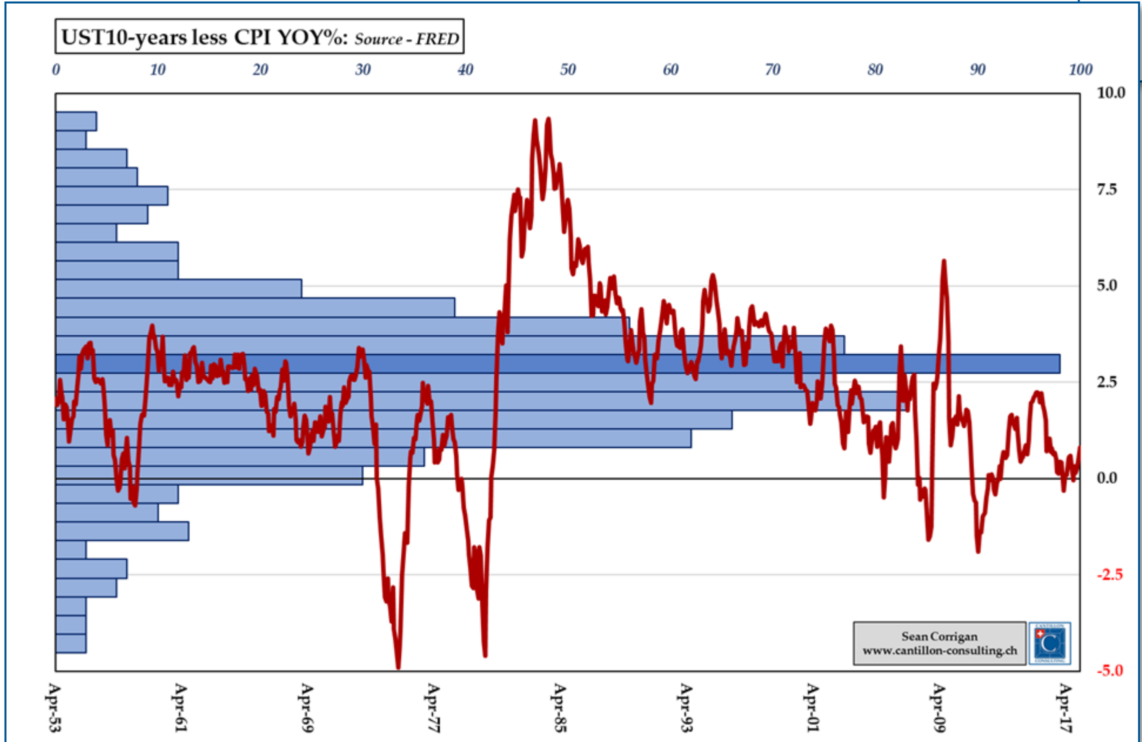
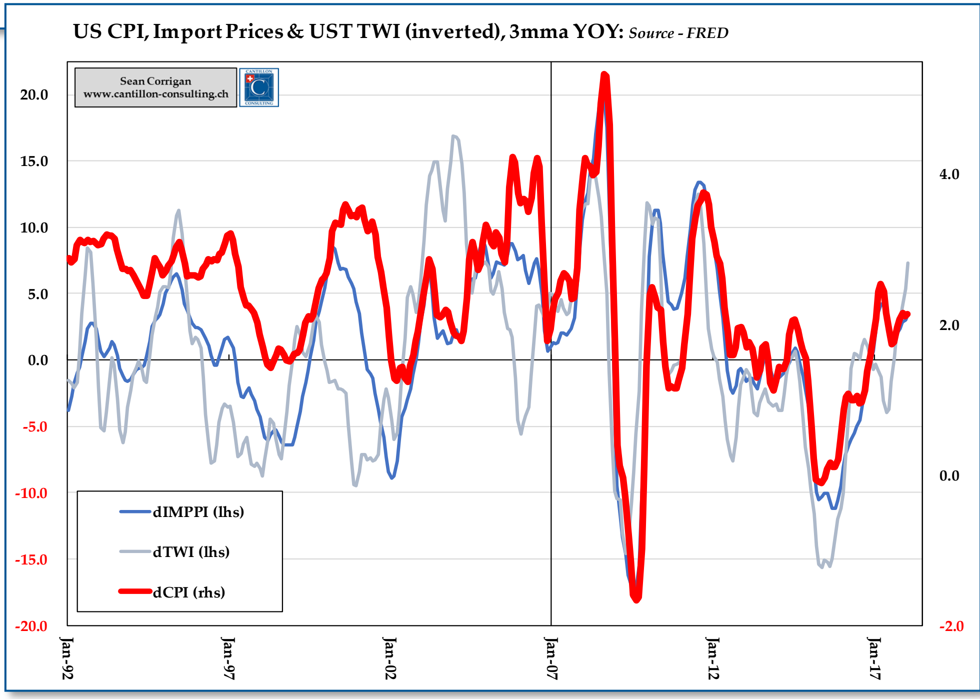
So let us briefly deal with these concerns. How much IS 'inflation' (i.e., a quickening pace of CPI increases) a problem? Certainly a touch troubling, as the updated chart to the right shows. While the YOY rate is still within the range of the post-LEH years, the 3– and 6-month annualized increments have shot to that period's highs and, indeed to 1.4 and 1.1 sigmas, respectively, over even the 1992-2008 norms (when Fed funds averaged a good deal more, yet still unleashed the modern era's most damaging debt bubble). As we see below, real bond yields (measured the simple way by subtracting contemporaneous CPI changes) are also still some good way below the norm, suggesting a deal more pain to come. NB: Changes in the dollar's TWI are 65% inversely correlated to those in import prices and these latter run to +82% v-a-v CPI itself, a relationship which has tightened further in recent years.

So watch the wider world for clues.



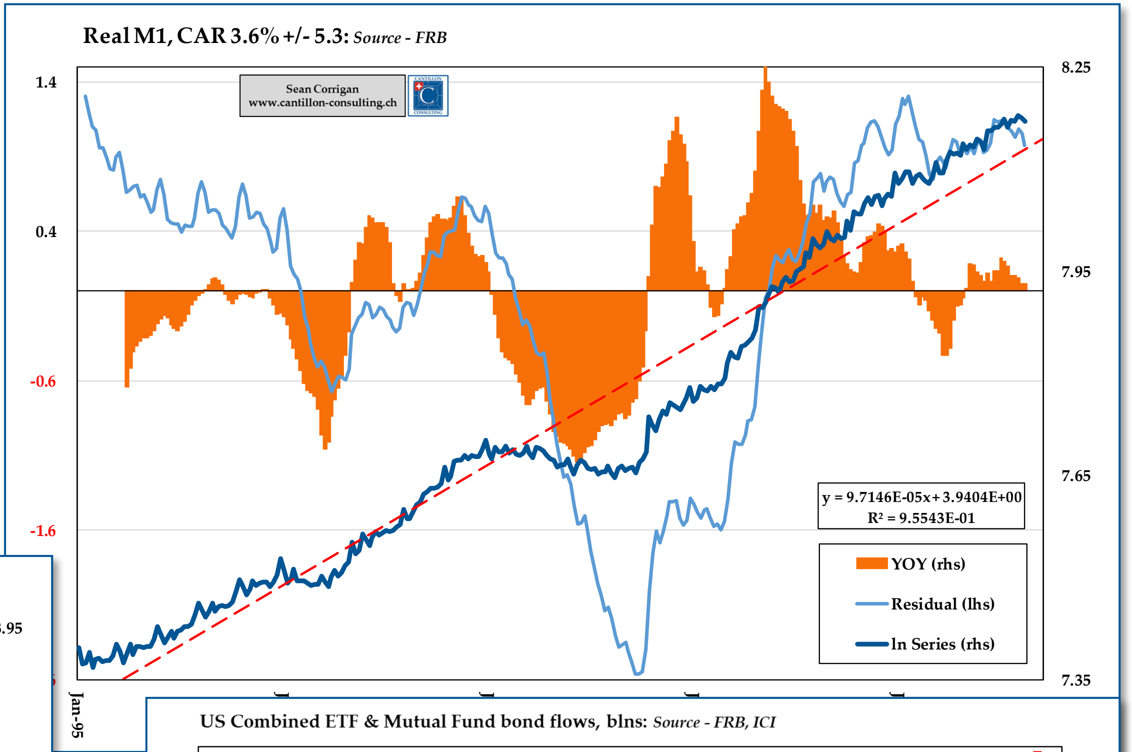


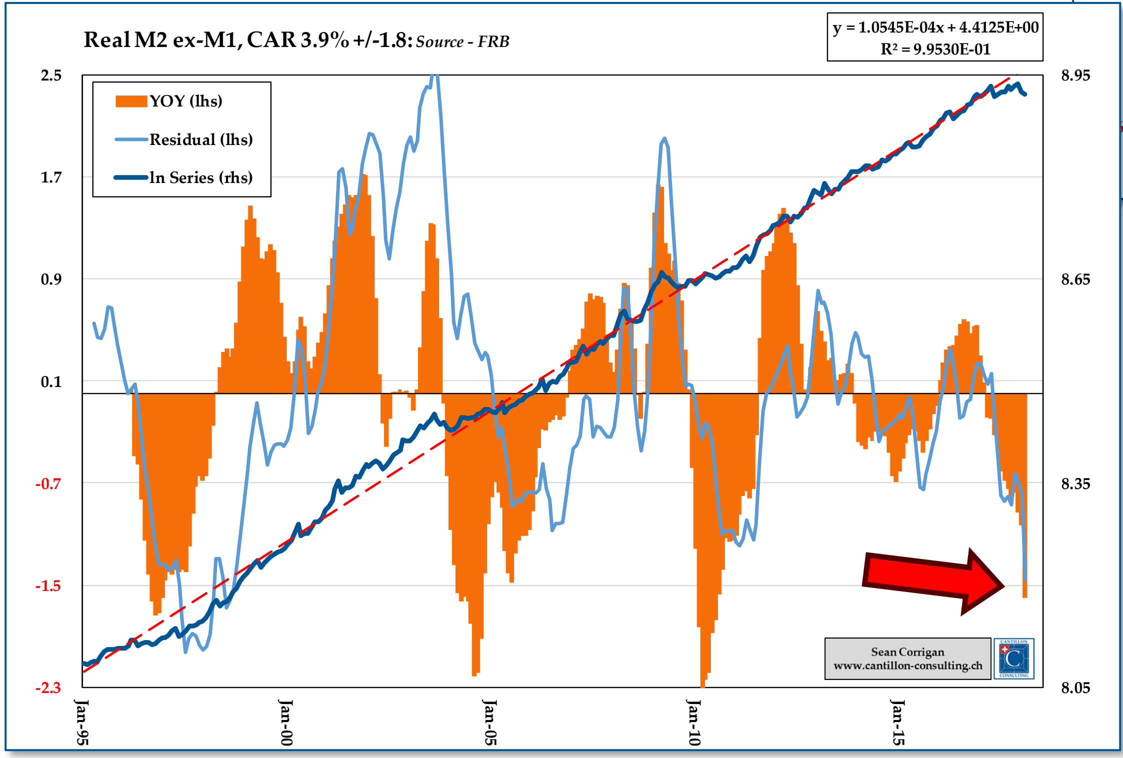


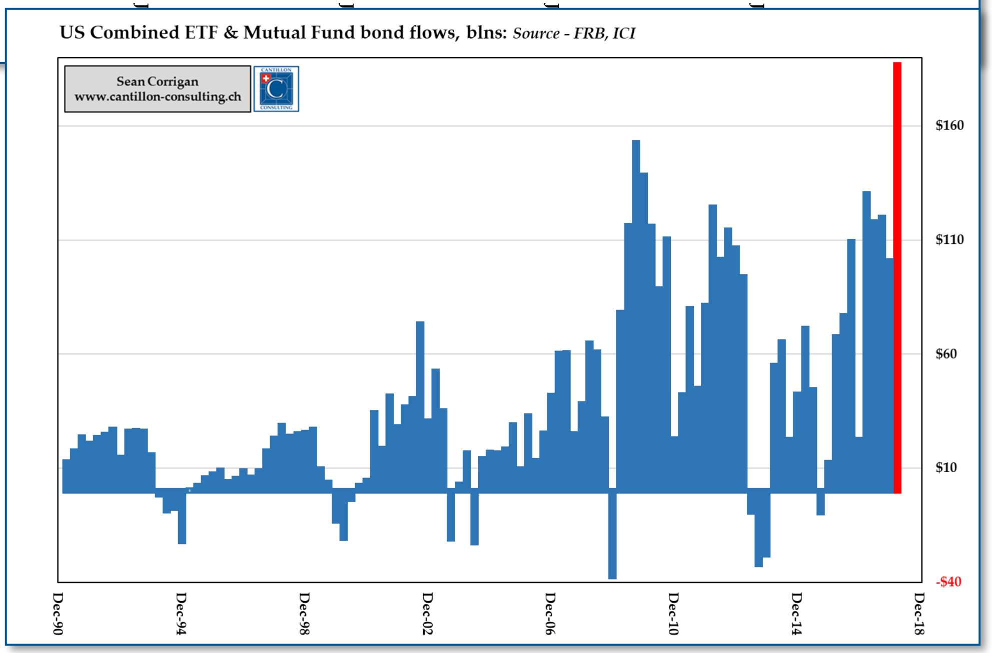
If there IS a silver lining of sorts, it is that some of the vast, QE-created, monetary overhang lying partly frozen place above our heads—which many now fear is finally beginning to melt and to slip off the ice-shelf into the warm, salty sea of inflation—may just be draining away instead in to a bond market which—heaven knows!—needs all the help it can get.

Note here that while real (as well as nominal) M1 is being fairly well-behaved by rising at its trend rate—one broadly consistent with 'normal', long-run rates of NGDP, real growth & dCPI—the components which make this up to M2 have not moved in a year and so are further below trend than at any time in twenty. So, what *is* happening to savings & time deposits? People seem to be cashing them in to buy bond funds, on course for a record quarterly gain.

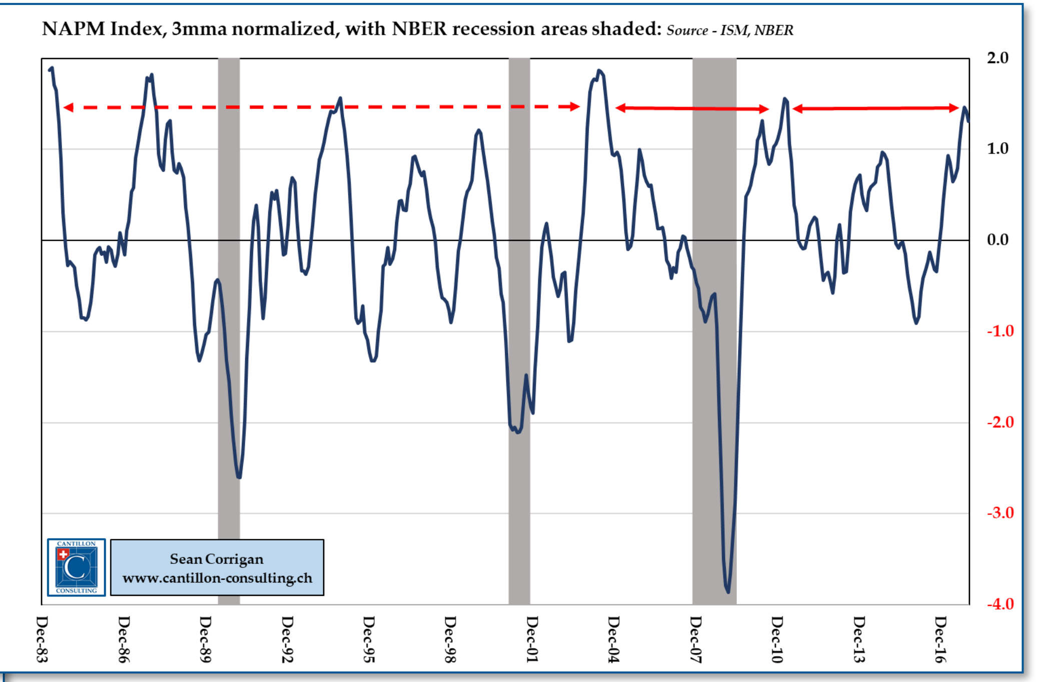
Higher rates may not be ALL bad news, it seems.

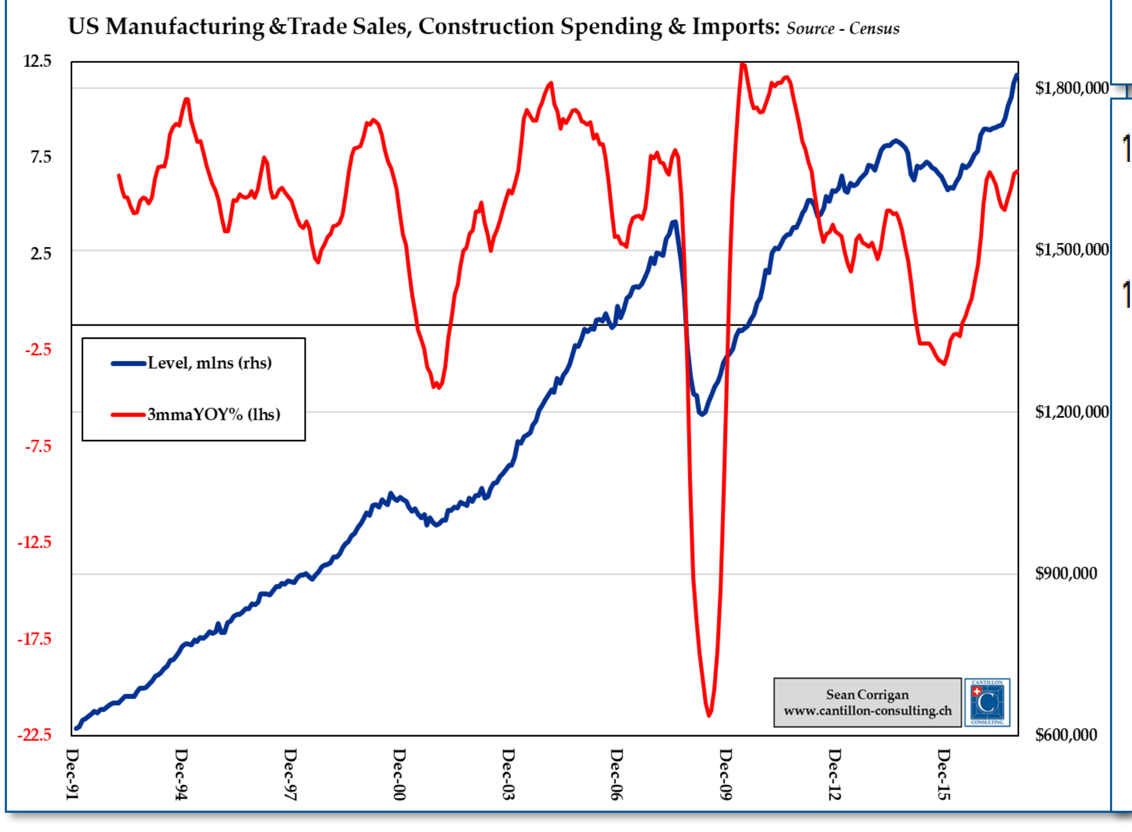


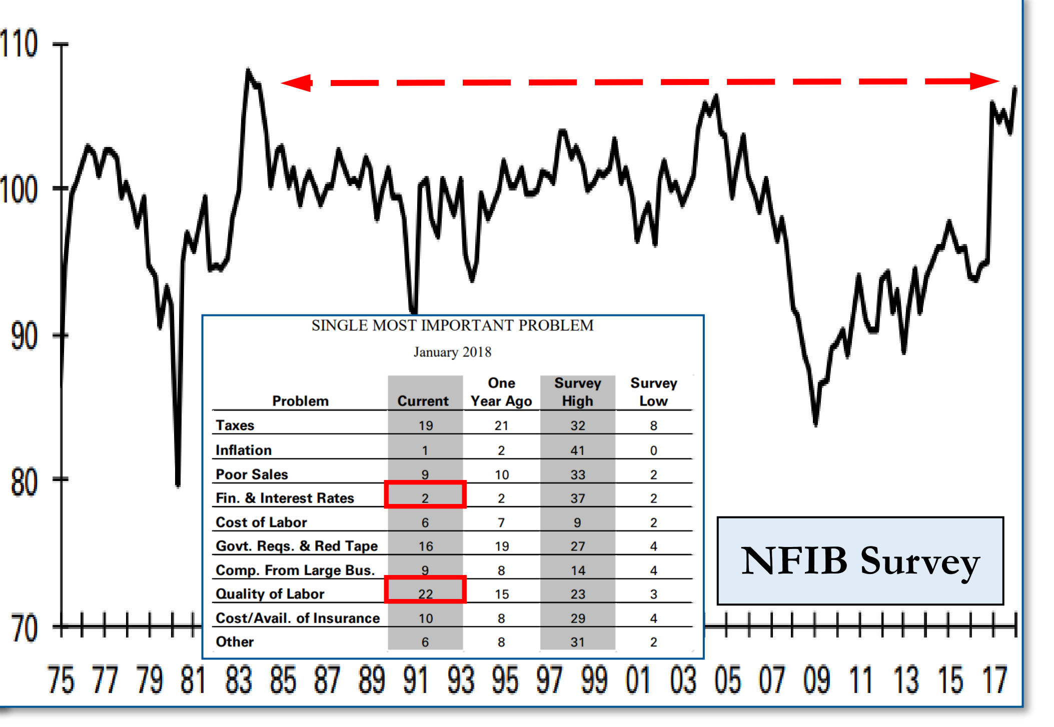




Meanwhile, both 'hard' and 'soft' data are pointing to continued vibrancy in the US & hence to Fed continuation. Business turnover is running at its best levels in 7 years, at rates not far off the median of the two expansions prior to the GFC. The NFIB survey is setting multi-year (and in the case of some sub-indices, all-time) highs. NAPM/ISM is holding to levels characteristic of the best conditions of the past four decades. To top it all, revenue projections for public US corporations run from 7.2% for small caps, through 8.7% for mid, to 8.0% for the S&P500, with between 2/3 and 4/5 of those having reported coming in ahead of these estimates. We all know such situations can suddenly degrade, given enough private sector over-enthusiasm & public sector stupidity, but there are no obvious pointers to this yet.





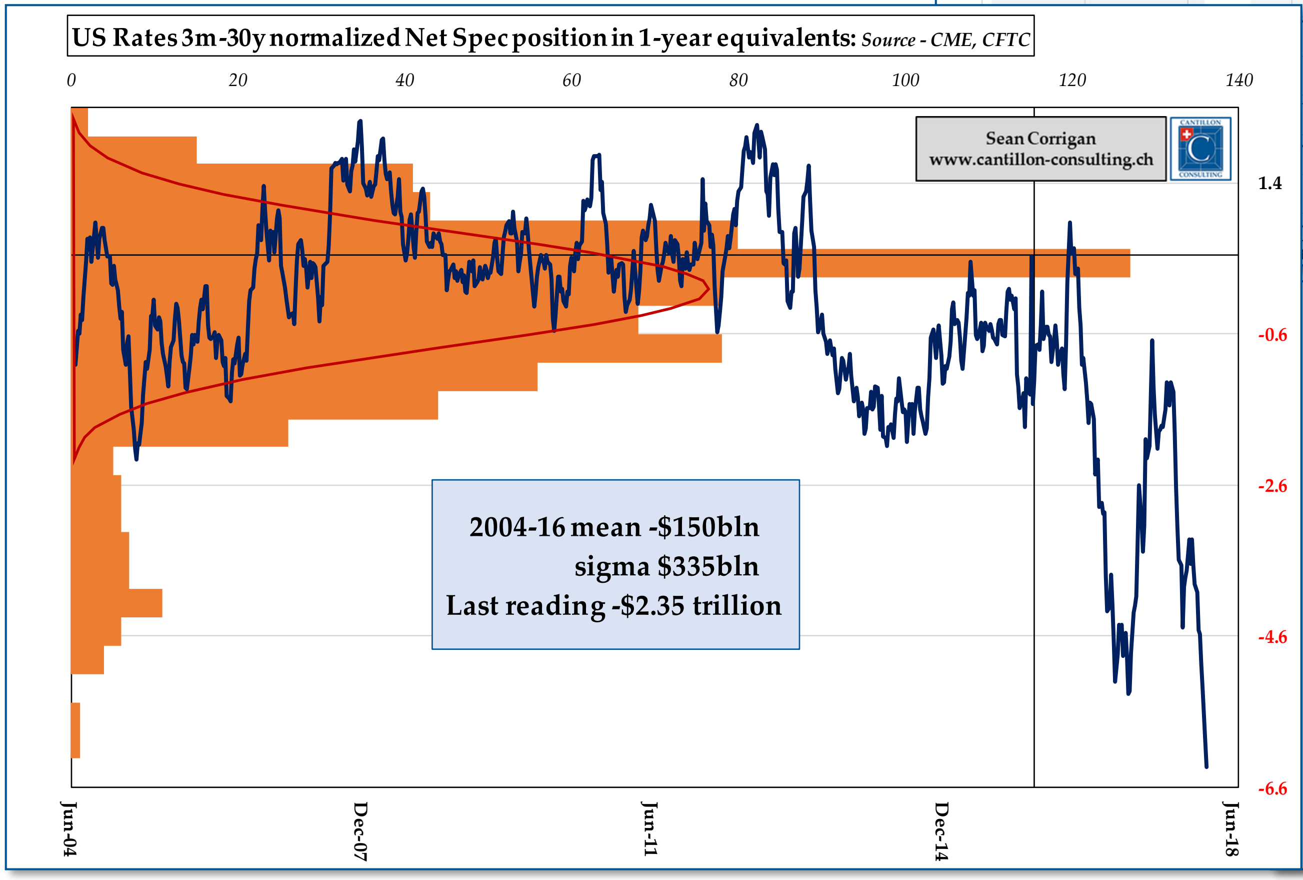


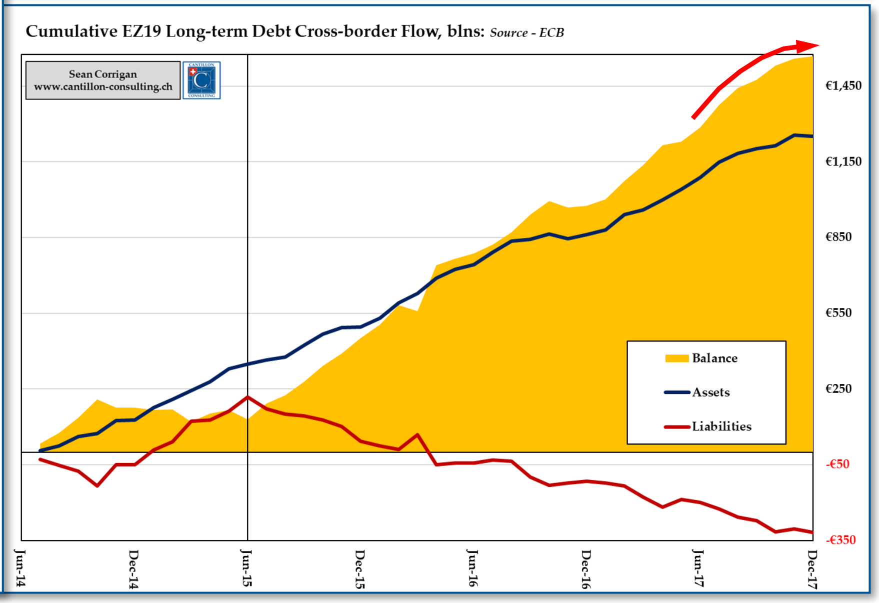
SINGLE MOST IMPORTANT PROBLEM

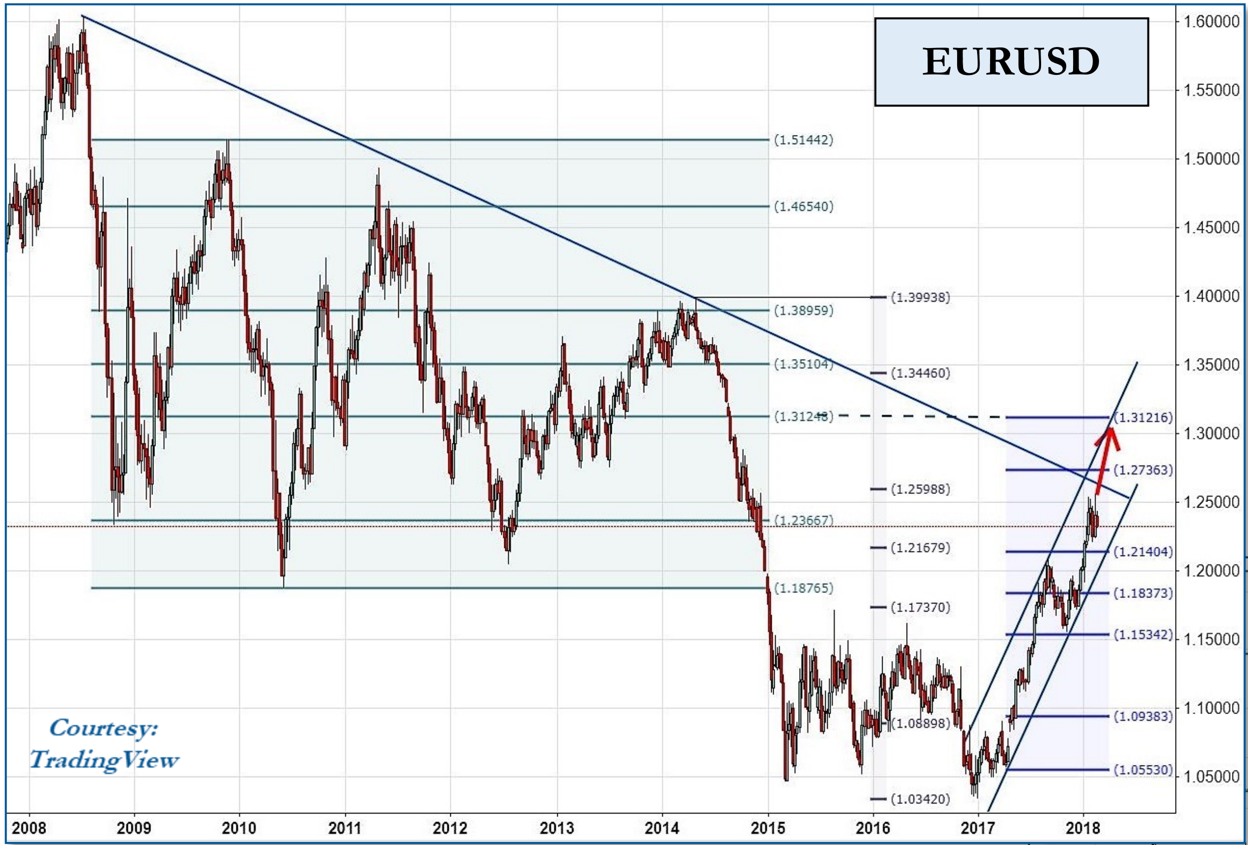
January 2018

Problem	Current	One Year Ago	Survey High	Survey Low
Taxes	19	21	32	8
Inflation	1	2	41	0
Poor Sales	9	10	33	2
Fin. & Interest Rates	2	2	37	2
Cost of Labor	6	7	9	2
Govt. Reqs. & Red Tape	16	19	27	4
Comp. From Large Bus.	9	8	14	4
Quality of Labor	22	15	23	3
Cost/Avail. of Insurance	10	8	29	4
Other	6	8	31	2

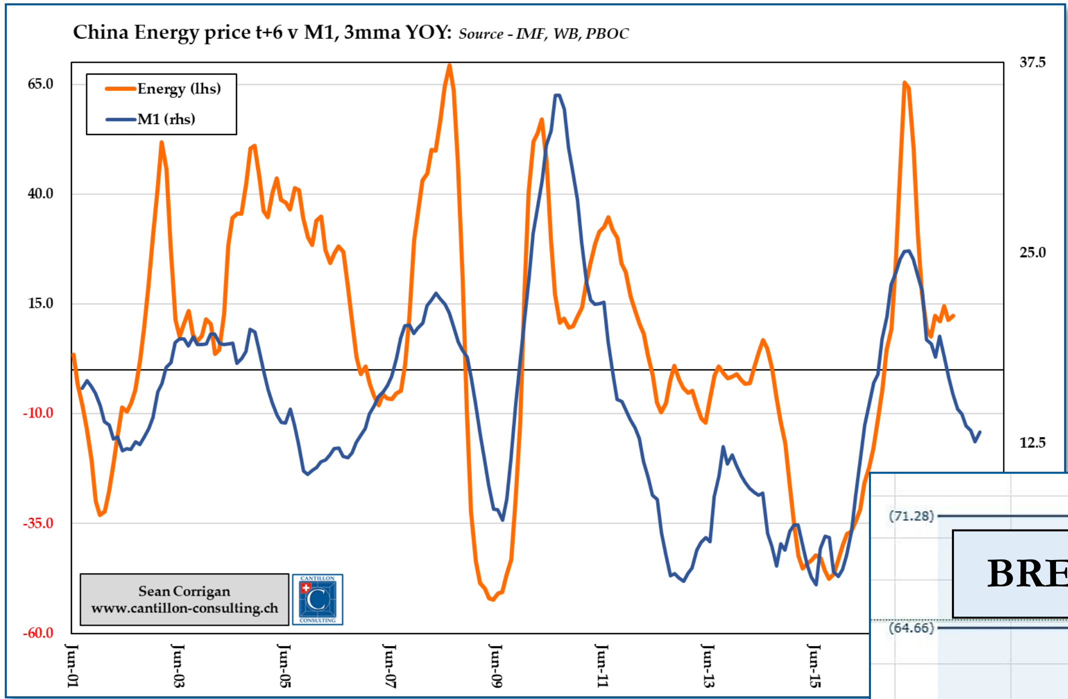
T-Note yields cannot yet summon the extra OOMPH! To break through the Taper Tantrum top, leaving them also just within the 1994 rate-shock, pre-LEH high channel. One reason they have been so far unable to overcome this resistance is the already breathtaking short position accumulated across the curve. Against this, one slightly more worrisome factor is the suggestion that Draghi-driven European sponsorship may just be starting to wane (bottom right). No more notable flattening, if so...







As for the Once Almighty Dollar, it has so far managed to stave off what still looks like a probable extension to $1.3100/50 v the euro and is barely clinging to the Y103.30 mark, below which lies the Abenomics/Kuroda mid-point of Y101.65.
Word that the local regulator is telling Japanese regional banks to improve their management of foreign bond holdings is hardly reassuring, since it means either no more buying, more FX hedging, or even outright selling may result.



Two immediate things snuffed out the crude rally: a sudden, renewed awareness of the scale of the US energy revolution and all-time high bullishness in futures. Beyond that is the caution that Chinese money growth has become progressively less supportive of surging commodity prices. There is a striking degree of symmetry in the crude chart off the shale bust lows of two years ago, combined with an as-yet uncompleted H&S at the top of the past 38 months' range. If confirmed a mean reversion to the vicinity of $50/bbl becomes conceivable.

To get a sense of what has happened in the US, consider that 2-way petroleum trade (i.e., both crude & its products) has remained roughly unchanged since 2006 at ~16Mbpd. However, in that time, imports are down 30%, and exports have more than quadrupled. Ergo, the adverse balance has collapsed from 12.9Mbpd to just 3.5 - or by 73%.

At today's WTI price, that represents a gain of c.$1/2 billion a day or fully $210bln pa, greatly easing pressure on the current account, as well as opening whole new possibilities for American foreign policy

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