Money, Macro & Markets Monitor

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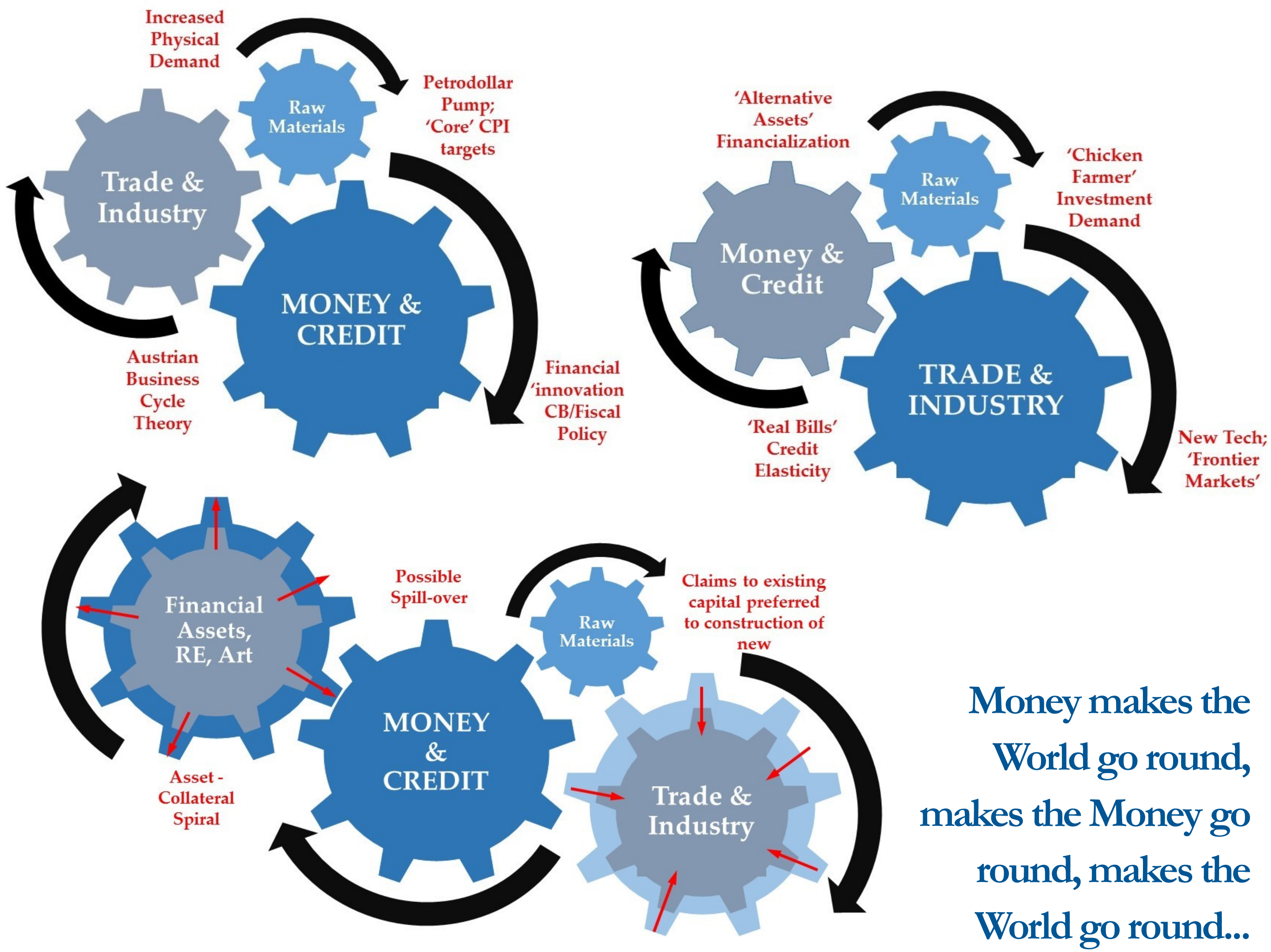


Money makes the World go round, makes the Money go round, makes the World go round...

IN THIS ISSUE:-

Volume II, Issue IV

Charge me more—or else!

In his much-anticipated opening address at the Boao Forum, Xi Jinping proclaimed his intent to continue his nation's 'opening up' process by lowering hurdles to capital access for foreigners in the financial industry and especially in insurance, while lowering tariff barriers on the automotive industry in particular.

Having seemingly adopted a much more accommodating line than perhaps had been suggested by the strident rhetoric dominating the official media, Xi's words were audibly accompanied by a mass release of breath in world financial markets, grown increasingly edgy in the wake of President Trump's loud attack on China's contentious trade practices.

The optimists will seek to interpret Xi's mollifying tone as a sign that the worst fears of a second Smoot-Hawley are now to be discounted, while the pessimists will be nervous that what seems like a swift triumph for the Art of the Deal will only encourage the 'Bidness Man' in the Oval Office to further acts of provocation.

The cynics will instead roll their eyes at the warmed-over nature of Xi's promises on automotive duties – this not being the first time that such intentions have been vouchsafed in recent years – while reminding themselves that the truly determined protectionist usually elevates all sorts of far more intractable and often ill-defined *non*-tariff barriers to limit his fellow citizens' freedom of choice when the mood takes him.

They will further note that the pending invitation to come help shore up China's hypertrophic and ramshackle financial superstructure is more of a poison chalice than a loving cup of international amity.

The final strand of opinion, not necessarily wrong, but definitely needing Atlas-like qualities of fortitude to bear the crushing burden of proof entailed by their interpretation is the one which surmises Trump does not in any way intend to disrupt global commerce, just to highlight the hypocrisy and double-dealing of so many of the of the participants in the global charade of 'managed trade' and so shame them into a series of mutually enriching concessions.

Well, yes, but....

Mine! Yours! Off the offer bid! Pull my bid!

Let us now return to the main front in this financial war of Blue-on-Blue. As so often happens when we Occidentals ingenues have to try to fathom out what the crafty, inscrutable Orientals (as we still subconsciously stereotype them) are up to, this whole trade spat has brought forth a new spate of instant China experts, few of whom can even lay claim to much logic, much less an inside track to the thinking of the heads of the CPC.

China will (is) selling - or has stopped buying - Treasuries, we are all anxiously assured. But have they, will they, and if so, why??

Yes, *stopped* buying at the moment, perhaps, since there has been no meaningful addition to FX reserves so far this year even though there should have been an accumulation of anything up to $60 billion if the trade and usual FDI surplus is added to the effects of a weaker dollar on the total.

But if not Treasuries then perforce something else and, whatever it is that China *is* buying, the inexorable logic of current account arithmetic tells us that it must be still rather substantial.

But, in any case, would China actively *sell* USTs? Hmmm, let me see. In order to preserve (or defiantly to extend) its trade surplus, people are proposing that it will act to tighten the domestic credit conditions facing its principal customer (by driving up interest rates there) while simultaneously weakening that customer's currency, thus shifting the terms of trade – i.e., the relative prices of America's imports and exports - against itself!

This is sufficiently fundamental to bear restating. China – if it is to continue to export to, more than it imports from the US - cannot help but accumulate claims upon the latter or, failing that, to find someone else to swap these for a consideration in goods or other claims. The first of these alternatives naturally only makes the dollars involved someone else's 'problem' – to recall the spirit of John Connally – and so alters little. The second ends up in the same place but does at least open the way for the Chinese to become a little more hurried in disposing of Uncle Sam's currency to the point they adversely affect its value and hence act to their exporters' detriment.

It is worth recalling here a further point we have frequently emphasized: namely, that the third-parties most avid to acquire such dollars in recent years – or, strictly, to disembarrass themselves of their own, central bank-driven surplus of the local money – have been found in the Eurozone, their efforts alone having been sufficient to finance three-quarter's of America's external shortfall since Draghi embarked upon his bulk-buying programme, back in early 2015, and despite the fact that the Zone has been responsible for less than a quarter of the global trade deficit over that horizon.

Bear in mind, too, that if China does rid itself of that part of the backing for the domestic monetary base which is held in the form of US claims, it will have to engage in a crash creation of arguably more potent domestic forms of reserves - much as it did when it was losing $700 billion of reserves in the 18 months after June 2015. For the record, this was a period which saw US long rates rise no more than 10-15bps (and actually *fall* for a range of lesser credits); the dollar strengthen by 7-10% (depending on one's index of choice); equities return 12% annualized, and another speculative wave unfold back in China, with new home turnover rising 35% and the price per square metre by 17%.

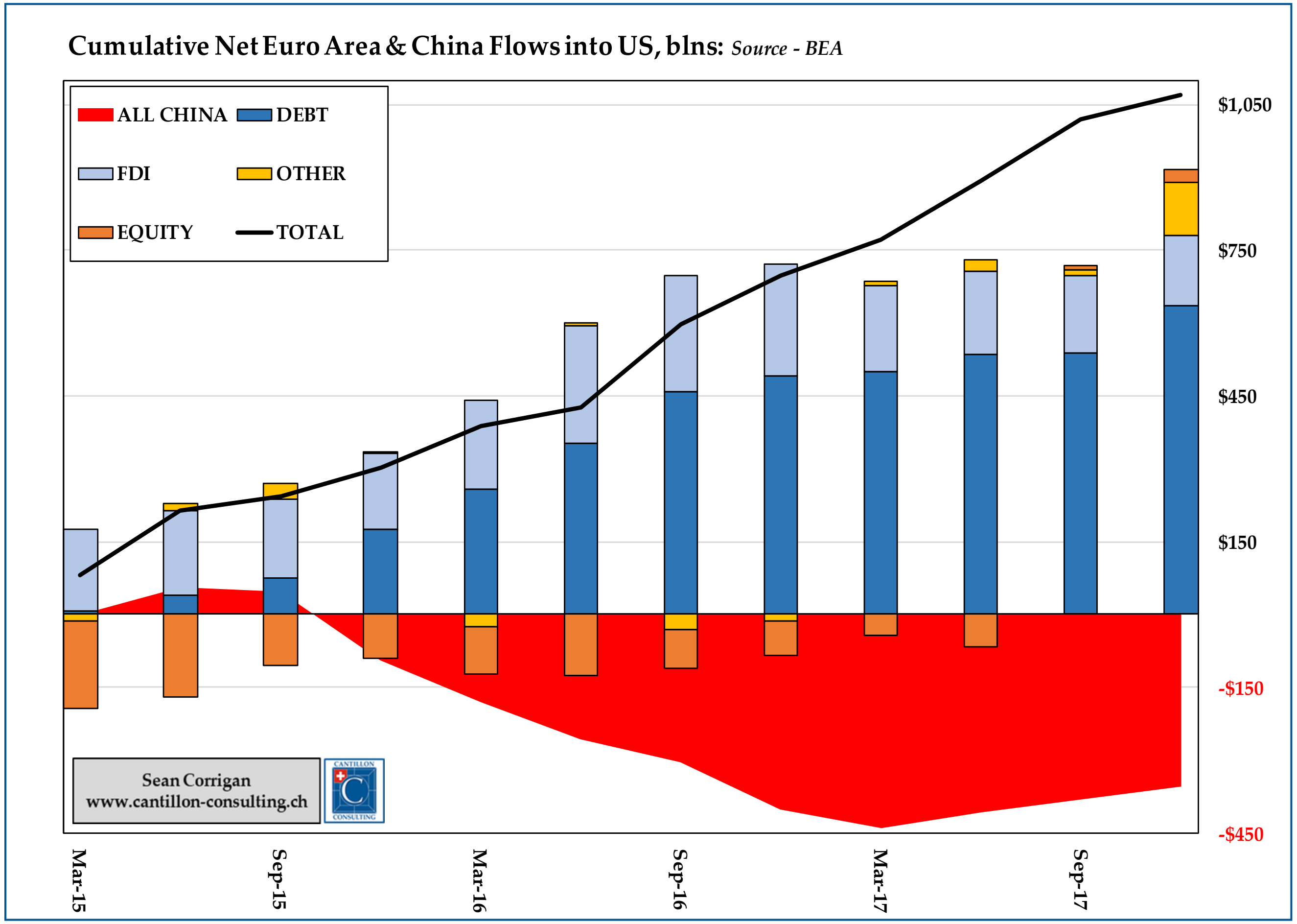
But, never fear, for all of the foregoing will be instantly neutralised, in any case, at least if we give credence to those who tell us that China will instead devalue the yuan (a caprice which will simultaneously hike input costs, destabilize OBOR project financing and further reinforce the hated greenback's reserve status at the expense of the renminbi). To do that, of course, implies selling yuan and - er- buying dollars, the latter then needing to be parked in - ooh, say- US Treasuries!

I don't know about you, but if China wants to 'pay bro; get whipped' on this gargantuan scale, I want to buy shares in whomever is their go-to guy on Wall St.

The Domino Effect

Before we leave the topic of the 'Trade Wars', let us draw attention to one other, often overlooked issue of some importance. This is that a great deal of what is notionally exported from China actually contains inputs sourced from other countries – or else greatly depends upon such third-party goods for the processes involved in their production.

For example, one can see that while in the 15 years after China's accession to the WTO, its trade surplus with the US did indeed increase by some $250 billion (a figure which represented around one-fifth of the contemporary increase in all imports), America's previ-



ously disputatious gap with Japan remained basically unchanged, as did those vis-à-vis South Korea and Taiwan, yet that latter trio simultaneously increased their excess of exports to China by around half that sum, or by circa $120 billion.

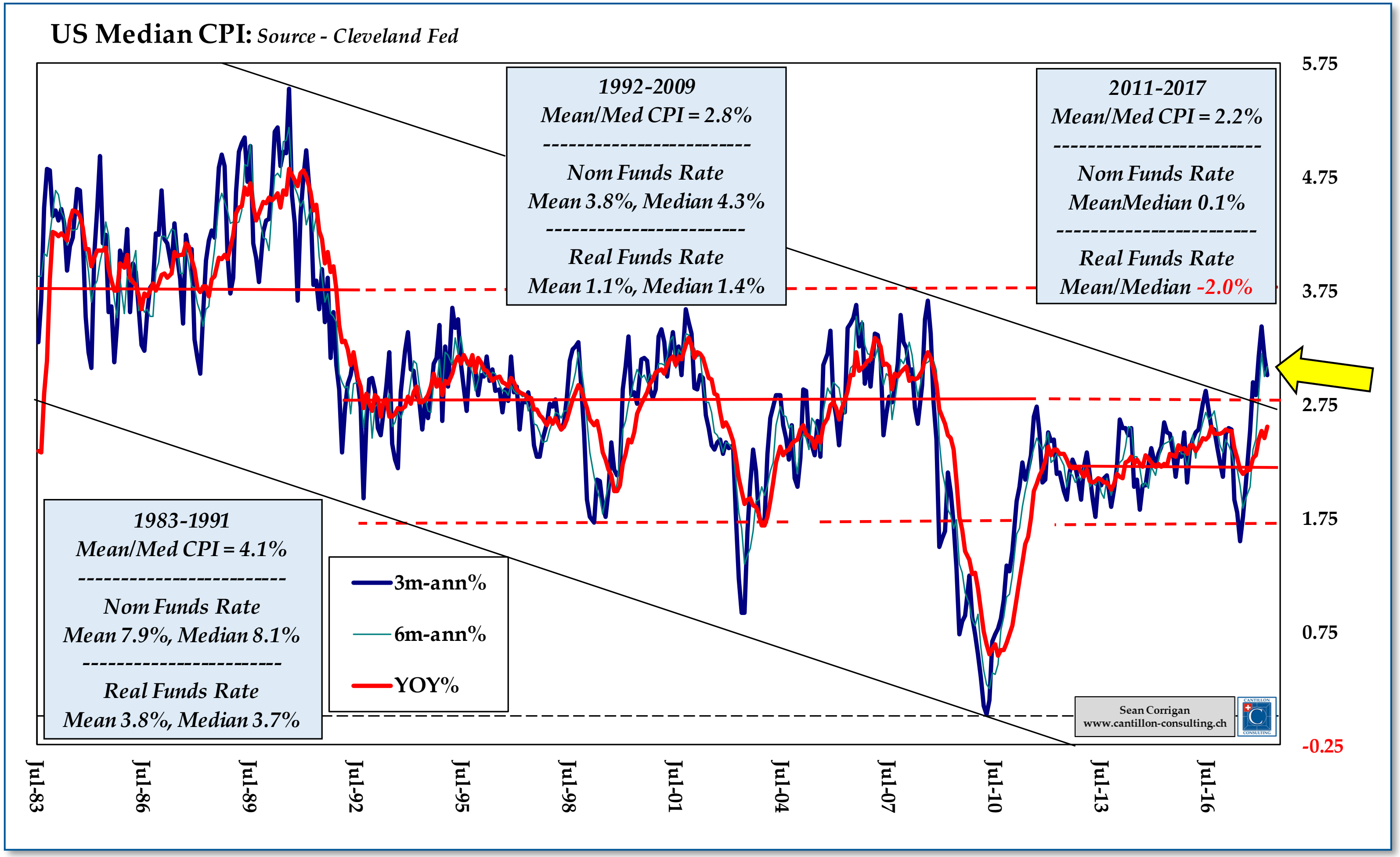
In recognition of such effects, the OECD is trying to put a figure to what it calls these 'global value chains'. By this reckoning, for the first eleven years of this century (2011 being the most recent data we have), China's own contribution to US imports rose from 4% to around 12.5%, almost exactly mirroring the Japan-Korea-Taiwan decline from 20% to 11%.

The stark lesson here is that efforts by the Trump administration to 'target' its imposition of tariffs and to exempt those whom it considers America's 'allies' will be much more problematical than it first appears, even without worrying about the wider, contractionary effects of such measures. Unintended consequences could be substantial, therefore, unless sanity quickly prevails.

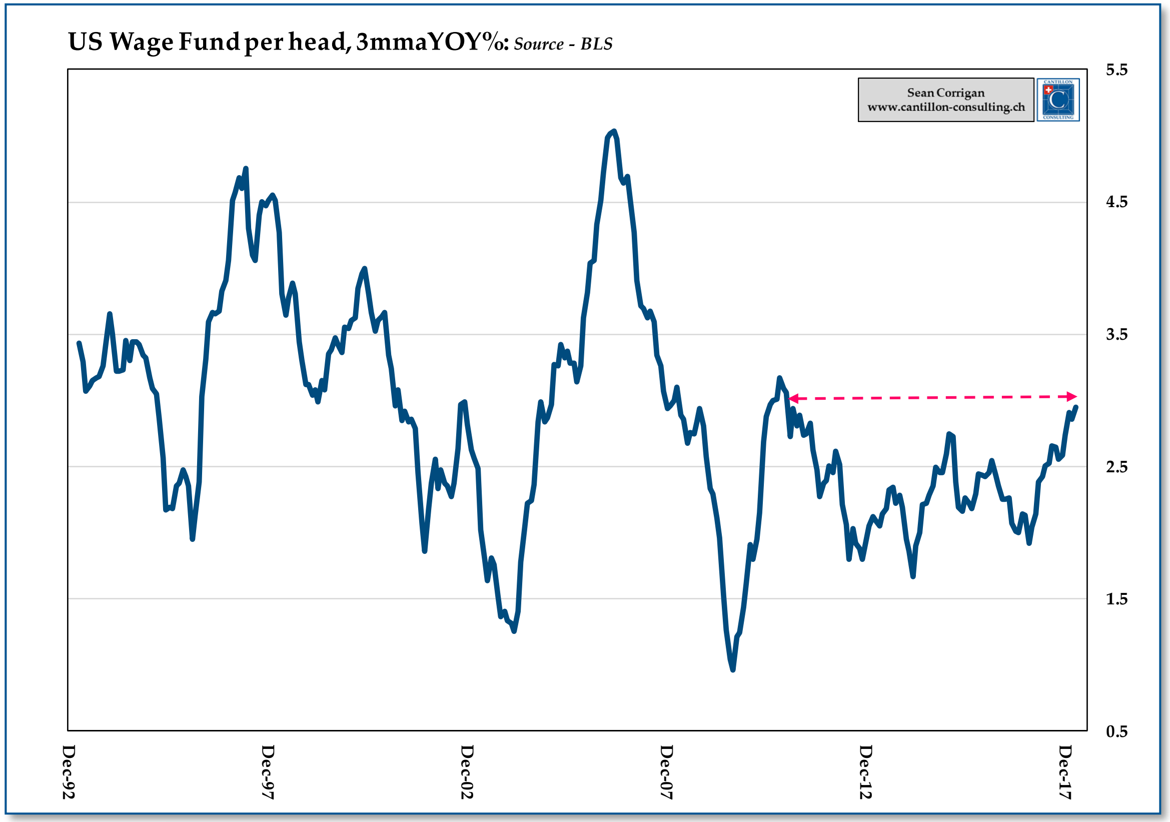
Waking the other Dragon

Other than pose a threat to growth – and potentially to some of the weaker nodes in the global nexus of credit – the one thing a trade war will undoubtedly do is needlessly raise the cost of goods. Add to this the boost being given to certain key commodity prices by the economic war being waged on the Russians – not to mention by the horrifyingly real prospect of a major shooting war breaking out with them – and the headline CPI index seems certain to continue its recent acceleration [see the accompanying chart].

Though such relative shifts should not be confused with the generalized process of inflation itself, they can easily feedback into broader behavioural changes as people seek to pass on the specific costs they incur and/or attempt to recoup their loss of purchasing power in other ways, e.g., through submitting increased wage demands.



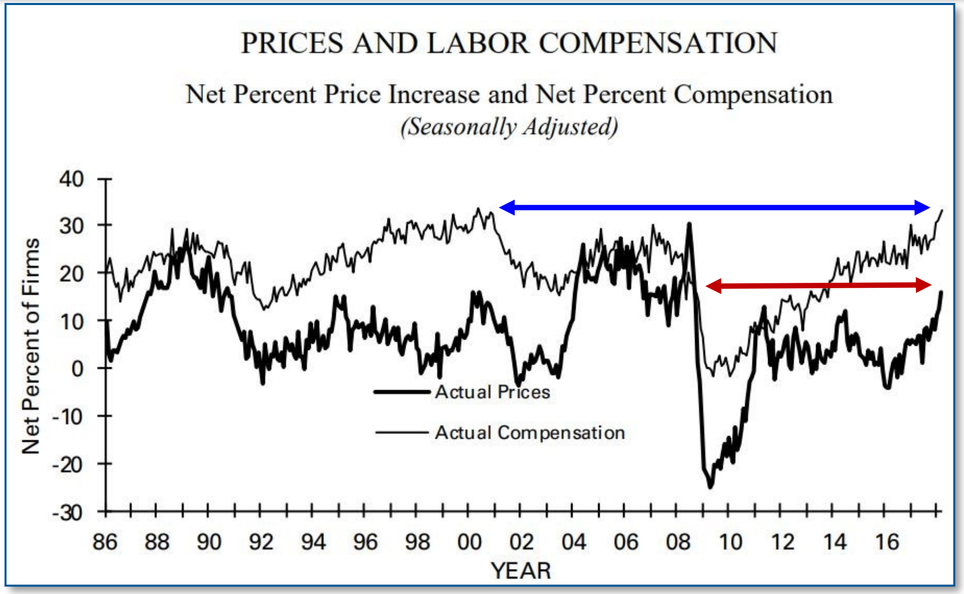
In a world where the deployable labour force is already in demonstrably tighter supply than in recent years [graphical evidence appended] and where real interest rates are still inordinately depressed [ditto], such an initial impetus could all too easily act to destabilize the present, fairly benign dynamic, phase-shifting it rapidly up into a much higher and hotter gear. Given that all of this would coincide with a pre-programmed loosening of fiscal policy (even before we start to think about the zero-constraint consequences of heightened military appropriations in a time of active conflict), few obvious means of restraint would be found to exist.



Picking up the Tab

To conclude what has admittedly been a very US-centric edition, we cannot resist a quick comment on the matter of the US Treasury's interest burden which, as several outlets have noted, is on track to become the single biggest item of outlay in the budget and hence can be construed as being the largest contributor to a deficit doomed to yawn ever wider after this year's epic display of fiscal incompetence.

While we stand second to none either in our distaste for the inefficient - and morally corrupting – tyranny of Big Government of any kind, or in our abhorrence of the essentially undemocratic nature of large and persistent imbalances in its budgets, three things are to be cited in mitigation of this particular aspect of the offence.



In the first instance, as we have frequently had to explain, interest is not paid out only to gurgle down some kind of economic plughole and thus drain all life from the system: it transfers resources from the payer (who has previously enjoyed goods in excess of his income) to the payee (who has forgone that pleasure in anticipation of that interest's receipt). Dickensian moralists might well cavil, but fair's fair if Mr. Micawber's creditors occasionally get their due.

Secondly, the interest rate figures, as typically presented in these tales of woe, are somewhat disingenuous in that they ignore the fact that such interest is taxable and thus that it automatically generates a partial offset, up to the level of whatever top marginal rate of tax the individual creditor must face. Thirdly there is the fact that approximately 35% of said interest payments originate in what are effectively state-guaranteed PIKs – i.e., that they arise from the accounting shuffle which sees the US Treasury issue debt to itself in respect of its obligations to the social security 'fund' and its own employees' pension pot.

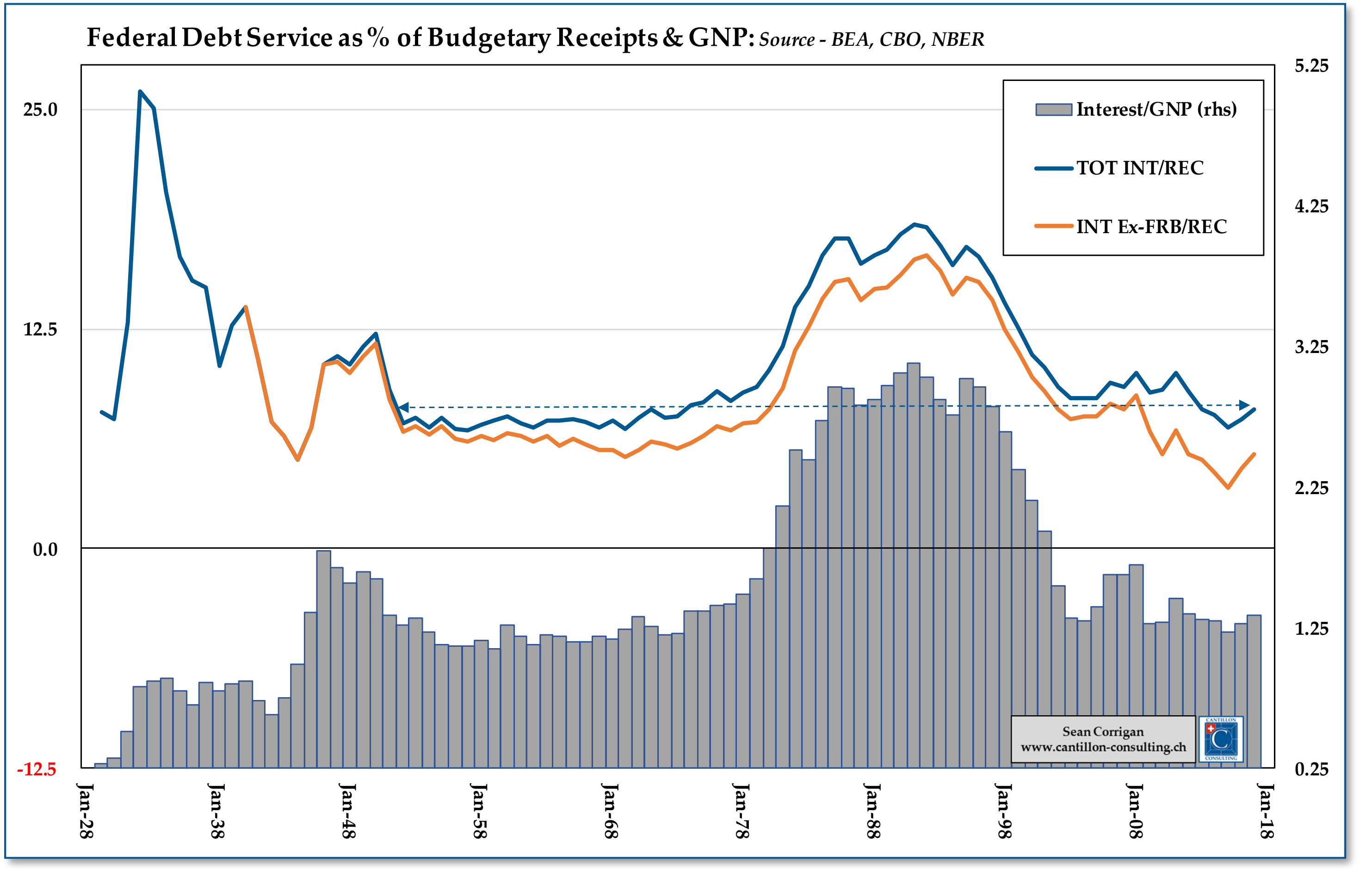
Fourthly, the Federal Reserve – whose portfolio may well be destined to decline, albeit slowly – accounts for a sixth of the balance, a holding from which it returns, as seigniorage, the predominant part to the Treasury, (viz, $83.5 billion last fiscal year, that being 30% of the total cash payments made on marketable debt).

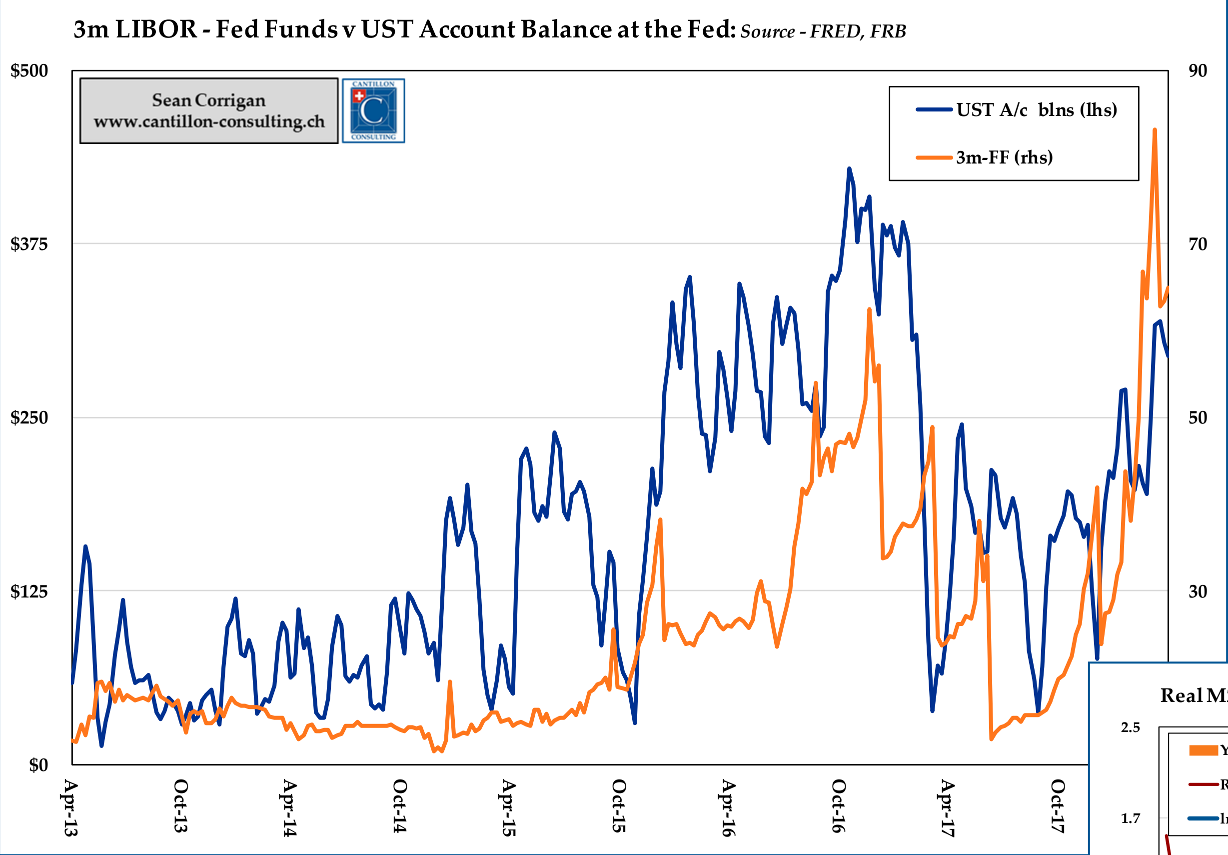
Where our argument about this not representing any 'leakage' from the US domestic system might be felt to fall down comes from a consideration of the 45% or so of the debt which is held abroad (of which roughly half by foreign official institutions). Yet, even here, we have to be careful, for those foreigners happy to hold part of their wealth in dollars and to earn dollar interest upon it are presumably also happy to spend some part of both from time to time. A large, if unquantifiable portion of that, will naturally be spent on buying goods and services from the people most likely to accept dollars - -i.e., from American citizens and American companies.

One final point: even if we ignore all the compensatory factors, the CBO reckons that nominal interest rate costs will triple over the next ten years – a period during which, on the rather anaemic trajectory of the post-Crisis decade, will see the overall economy grow by roughly a half. Thus debt service costs are on schedule to double in proportional terms.

That sounds terrifying until you realise that this would push them up to around 2.7% of GDP, a figure they last saw during the eve-of-boom year of 1998 and on which was routinely matched, and even exceeded, in the 15 years prior to that.

To repeat the point: giving Washington and its hordes of social engineers, vote-buyers, pork barrellers, lobby-fodder, militarists, welfarists, and general busybodies a larger participation in the nation's activities is an evil in itself which can only serve to reduce prosperity, liberty, and public morals, all - but to focus solely on the increase in the notional interest cost which this will entrain, is to almost entirely miss the crux of the issue.





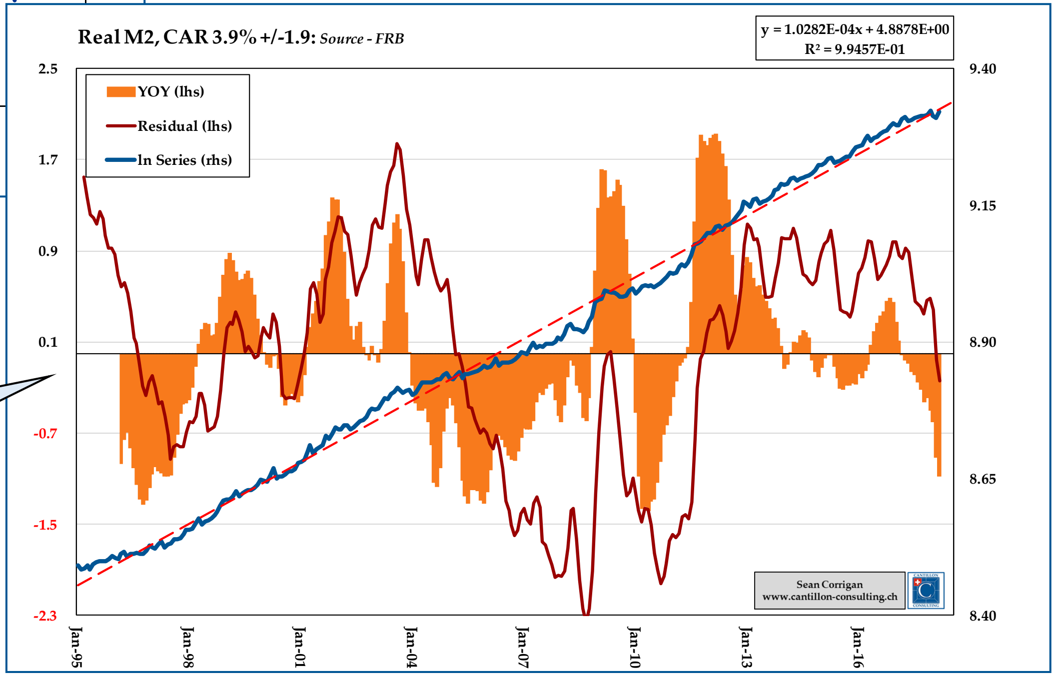
For all the talk of dollar shortages abroad driving up LIBOR-OIS spreads, basis swaps have stubbornly refused to corroborate that story.

Conversely, if we plot the 3-month spread over Fed Funds, we find a loose correspondence with the US Treasury's accumulation of a war-chest in its General Account at the Fed (left chart).

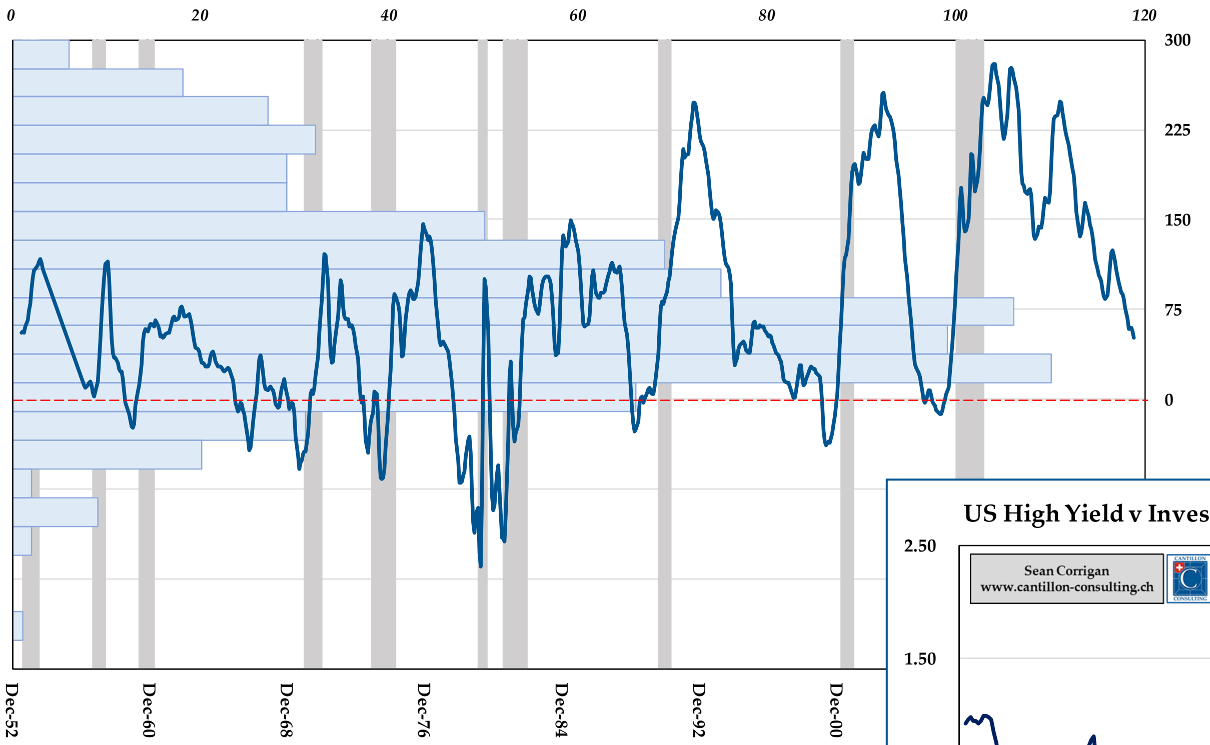
Looking for further clues, we can see that this balance has grown $138billion since just before Christmas, while the Fed has simultaneously let $31bln of its holdings roll off. Neatly coinciding with that $170bln drain, large US domestic banks have turned net creditors to their overseas branches by almost exactly that amount—their largest such position in the 13-years of data we have for the series.

This could imply either that these offshore branches have developed a sudden taste for Uncle Sam's debt, or that they are providing finance to those among their hosts who have done so instead.

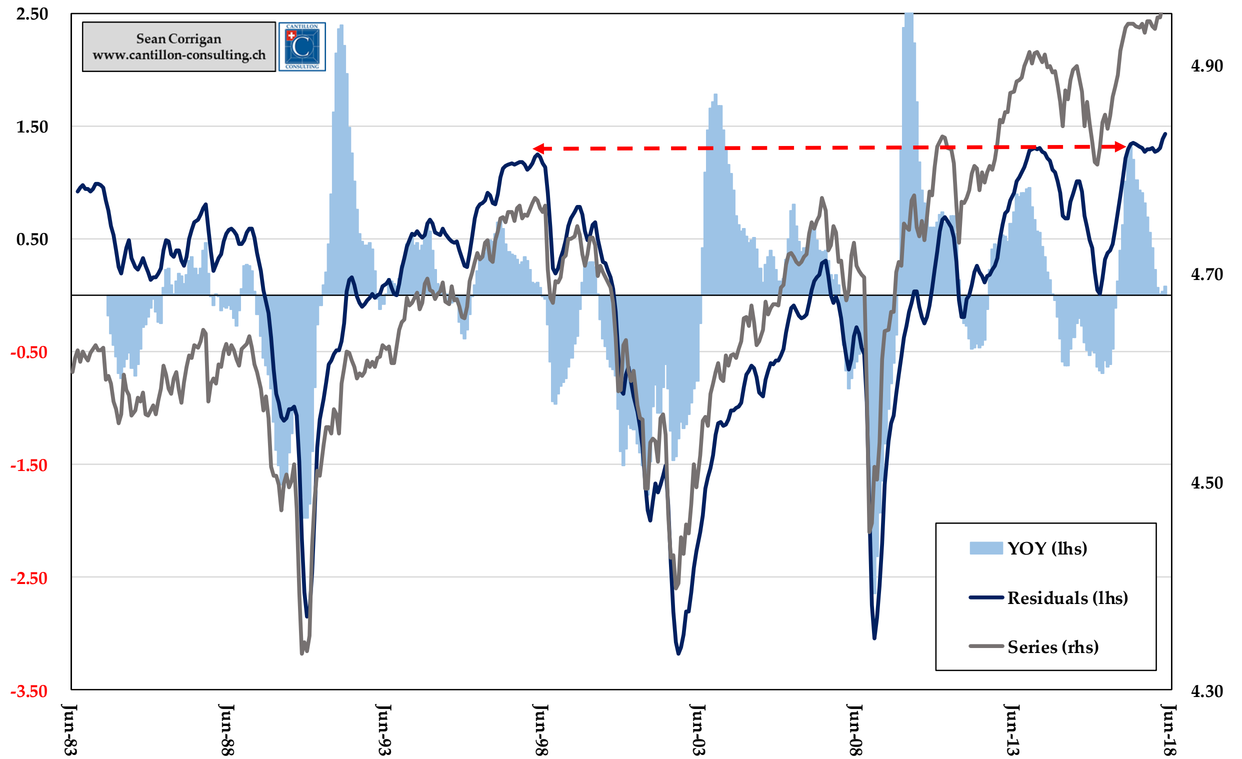
Whatever the true motive, this constellation of factors has definitely slowed both money and credit creation in relation to recent norms. Hence why markets have lost so much of their previous mojo?



UST 10y v 2y: *Source - FRED*



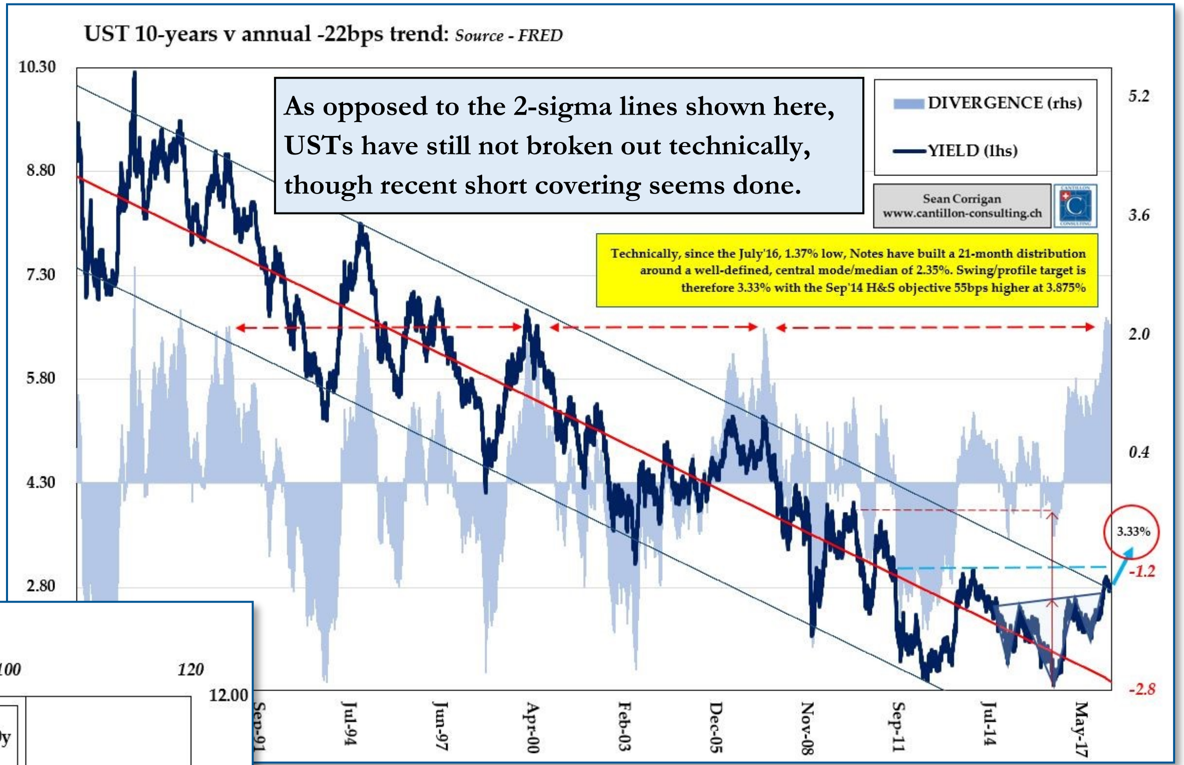
US High Yield v Investment Grade returns, CAR 0.85%: *Source - Barclay's*



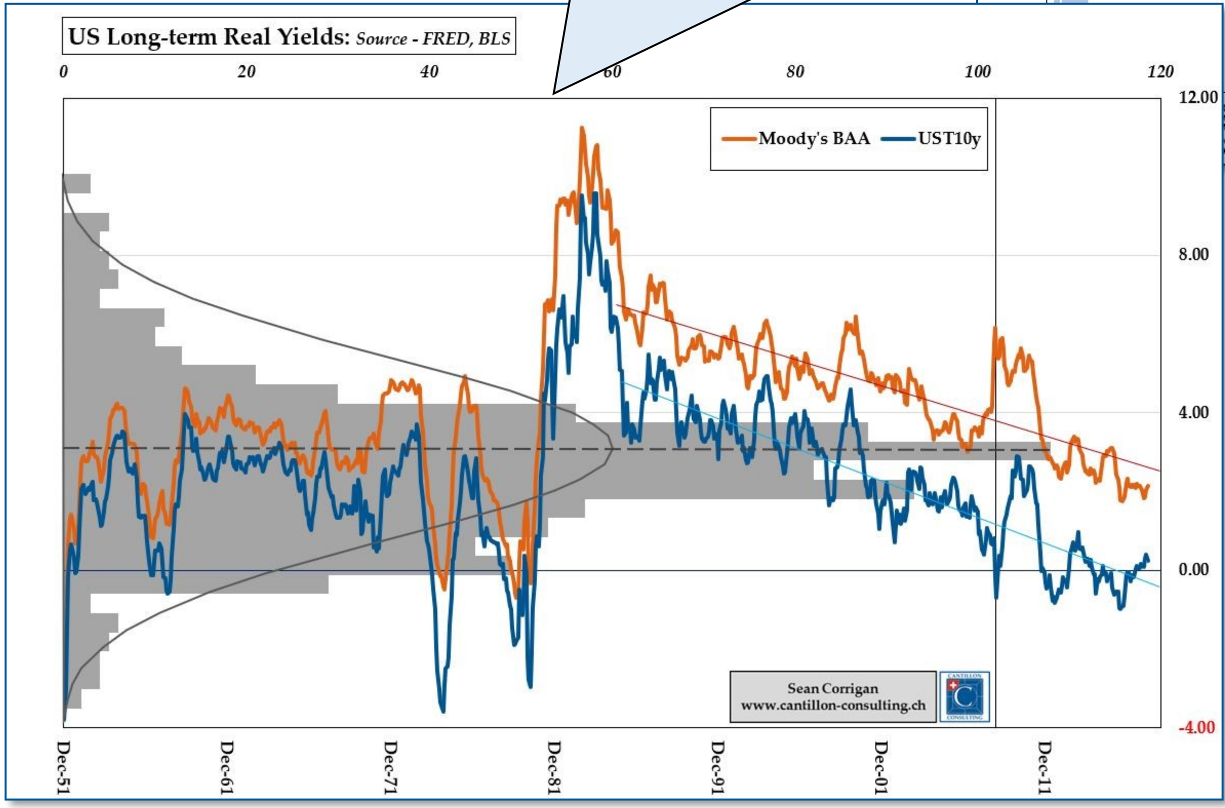
Which is not to say that this is yet signalling a recession. Nor—for all the fretfulness it generates—is the yield curve. Over the past 65 years, the median value for 2s-10s has been 66bps: today it is still 43bps. As a ratio, too, the last reading's 118% is actually a little in excess of the 110% median. As we can see, we should stay calm until full inversion is reached.

Similarly, that other storm beacon—the one which gets hoisted over in the high-yield market—is resting safely at the base of the mast. If anything, high-yield has begun cautiously to make ground against investment grade once again, as the broader stock market has regained some of its poise.

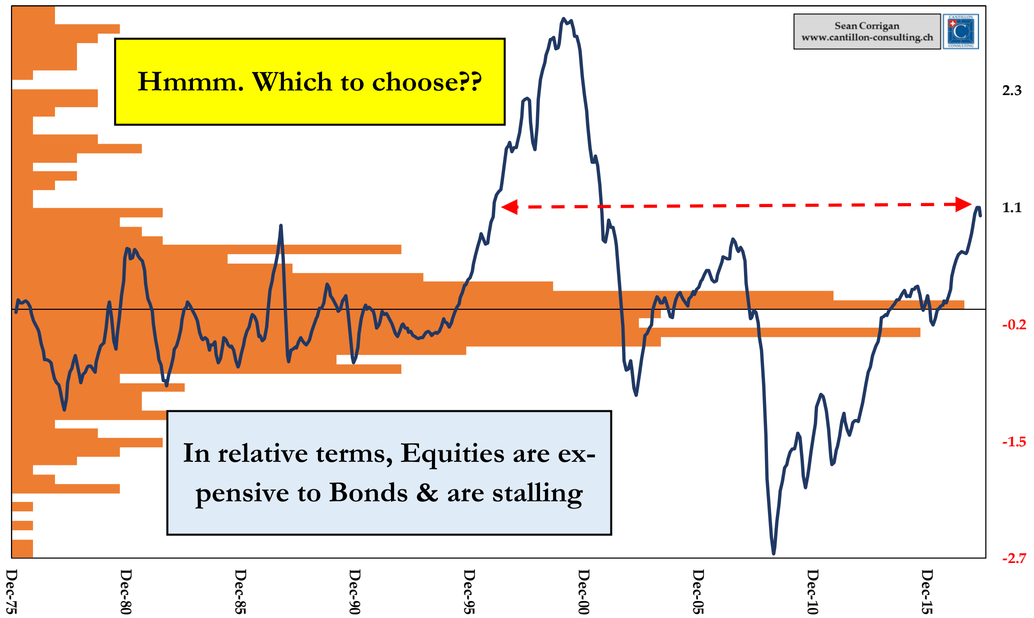
The party's not quite over yet.



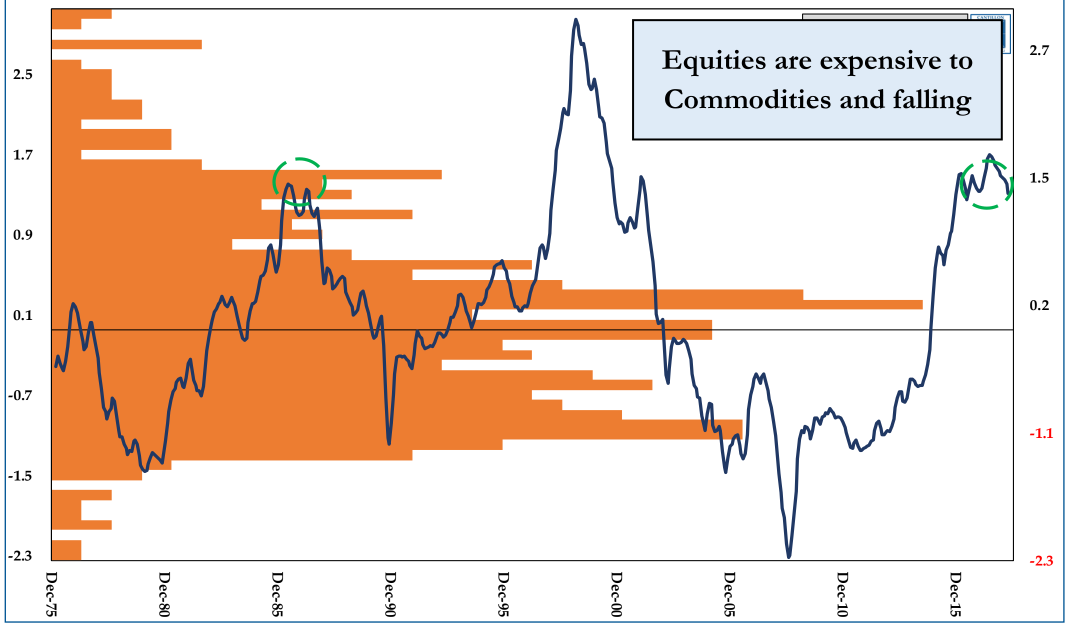
Taking the distribution from the Treasury Accord of 1951—when the Fed stopped actively suppressing long yields—to the first round of QE—when it and its peers started to do so, once again—the median real yield—in what is quite a well-formed distribution—comes in at 2.3%, with the mode some 20-30bps higher again. Either way, quite some considerable distance from today's still parlous 40-50bps



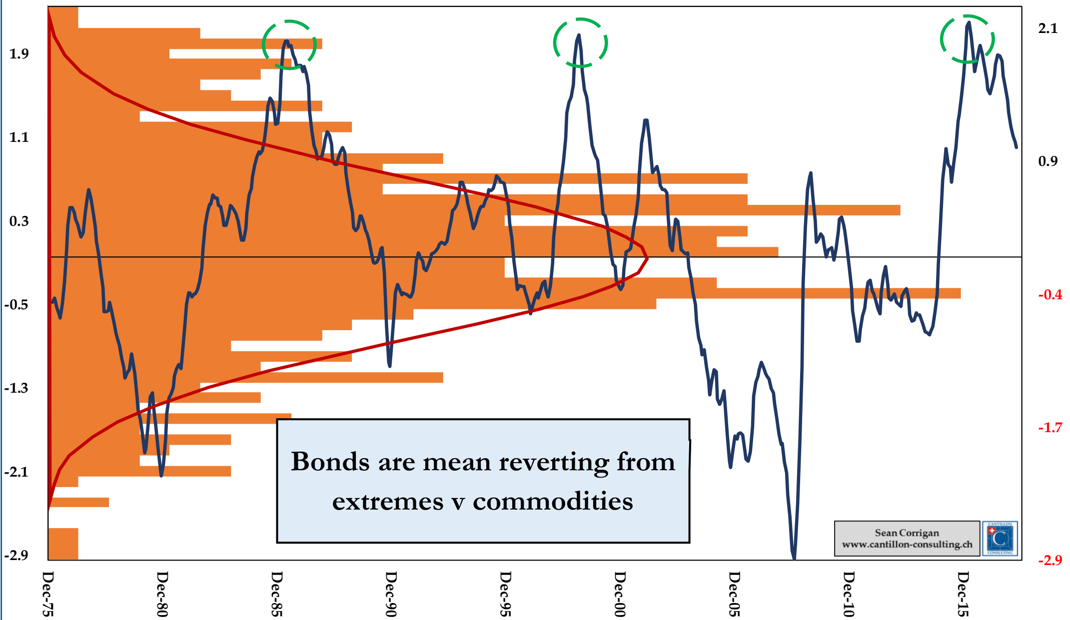
US Equity v Bond Returns; deviation from 3.0% log trend: *Source - MSCI, Barclay's*



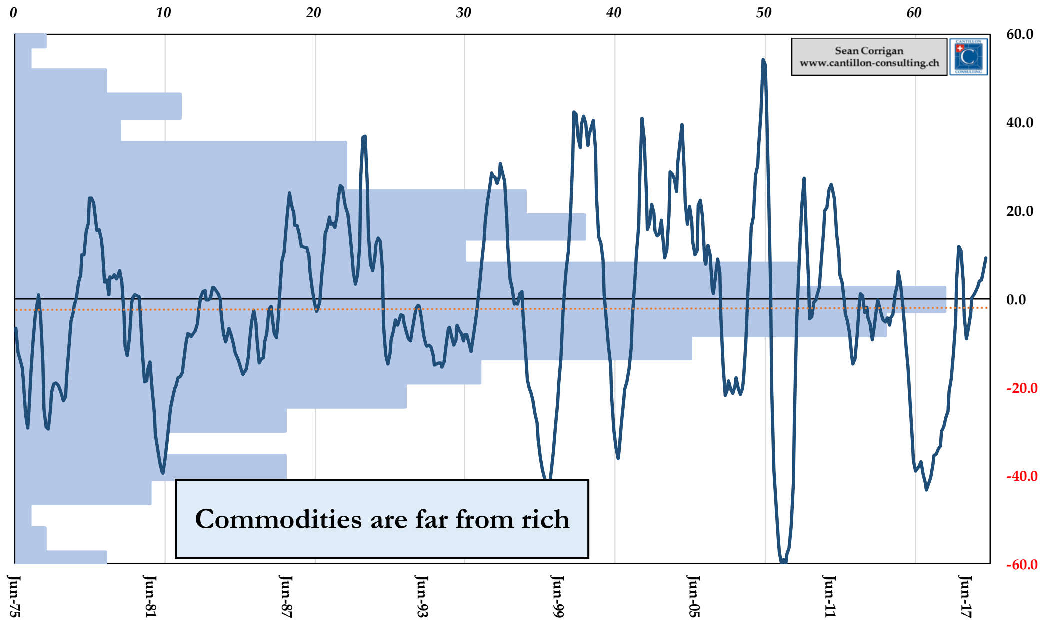
US Equity v Commodity Returns; deviation from 9.3% log trend: *Source - MSCI, GSCI*



US Bond v Commodity Returns; deviation from 6.5% log trend: *Source - GSCI, Barclay's*



GSCI Real Excess Return, 3mmaYOY: *Source - FRB, S&P*




WTI is building value above the old range & the mid-point of the 2014 slump. Absent a rapid change of mood, we look poised for a spike to the high/mid $70s—a move which would not be not good for bonds or Tech
(107.8)
95.5)
(76.5)
(66.9)
(57.2)
(38.2)
(26.0)
(67.1)
(61.0)
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(26.0)
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(72.1)
(64.9)
(61.2)
(57.6)
(50.3)
(45.6)
Courtesy:
TradingView
2008
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2012
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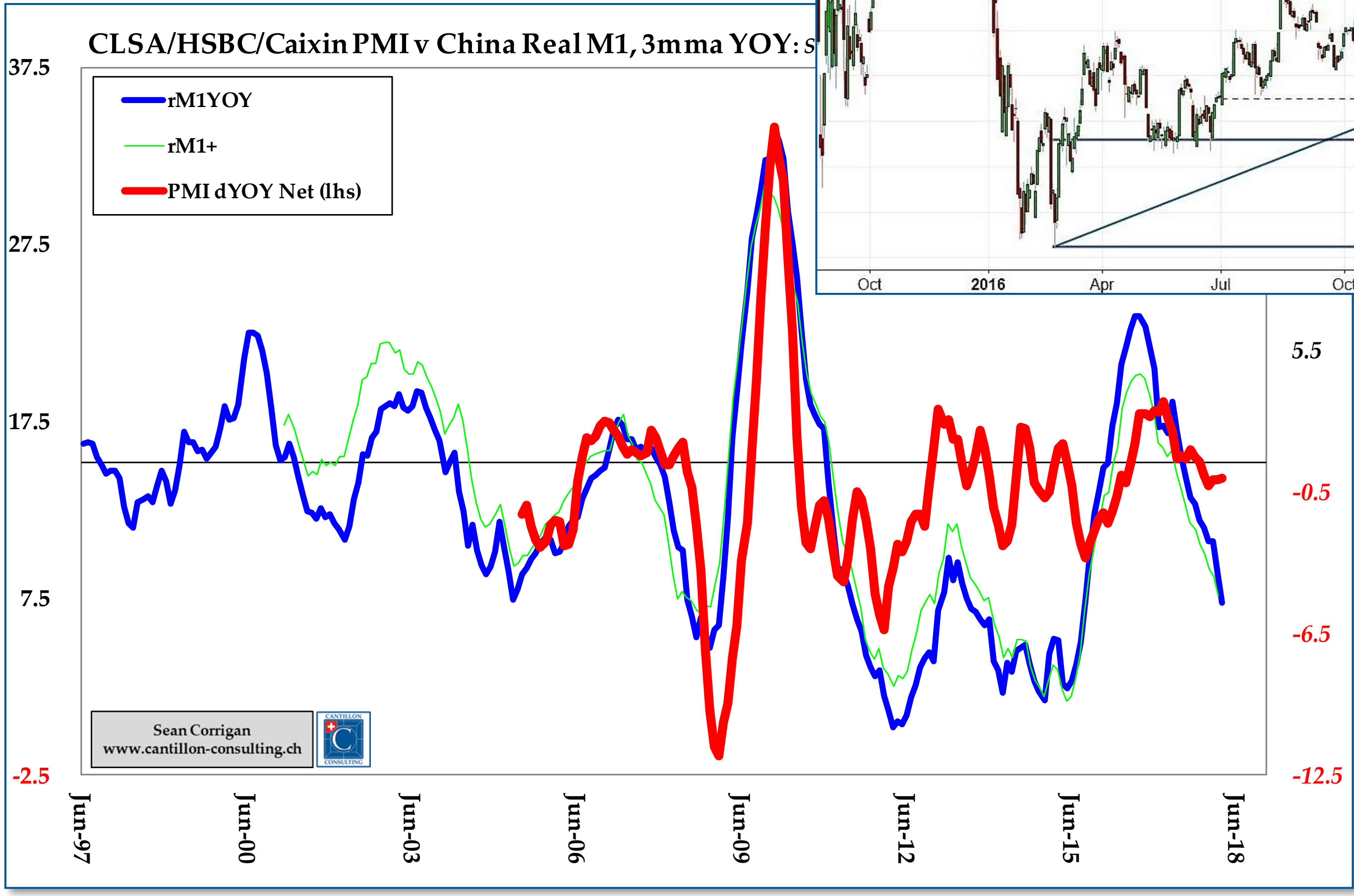
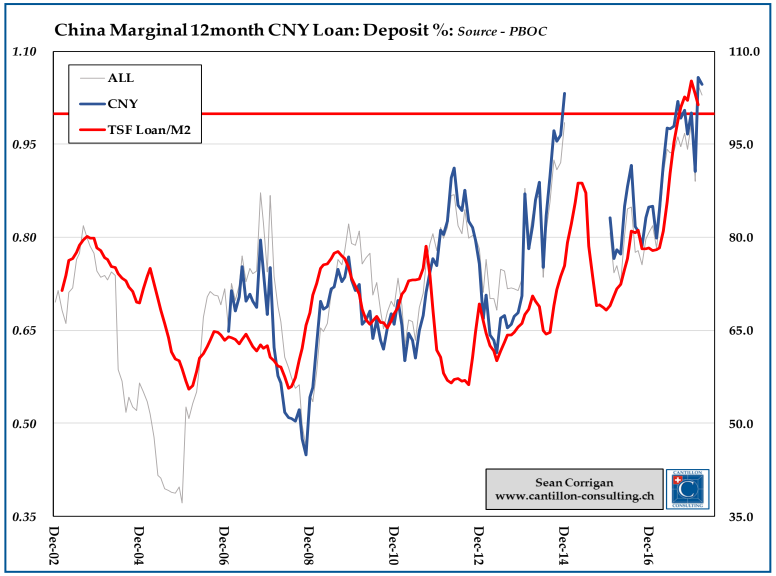
2017
2018

We are still awaiting the detailed breakdown of the PBOC numbers for March, but what we have shows the same pattern of deceleration and loans outgrowing deposits. The PBoC has announced RRR cuts—with the monies freed up to be used to pay back some of the Y10 trillion in special assistance built up since the 2015 reserve drain. That, however, will not alleviate the banks' growing loan-to-deposit ratio issues. Further real sector slowing seems likely (NB the March IP number was decidedly weak at just 4% annualized)





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'Silver alone is the True Sinews of the Circulation' - *Essai sur la Nature du Commerce en général*

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50% retracement of the 2014 slump, break of the Great Reflation trendline & probing upwards. $17,000/t not unthinkable
BUY WHAT RUSSIA SELLS; SELL WHAT CHINA BUYS
Nickel
Courtesy: TradingView


It had looked like this remarkable bull run was over, but politics have extinguished any desire to sell
Palladium


Zinc
Having traded strongly all through the last 2-years of recovery, zinc is now not far away from a test of major support


Much more equivocal after a 50% retracement. Support holding but hints of a messy H&S
Copper


Gold is still stuck in its $1300/70 trading range—much to the chagrin of the Armageddonists out there.
With risk assets better bid for choice, with volatilities again sagging, and with bond yields back on an upward path, the gold bugs are not having things all their own way
Courtesy: TradingView
(1496.4)
(1418.2)
(1305.2)
(1251.2)
(1199.5)
(1104.1)
(1046.5)
2012
2013
2014
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2016
2017
2018

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