Money, Macro & Markets Monitor

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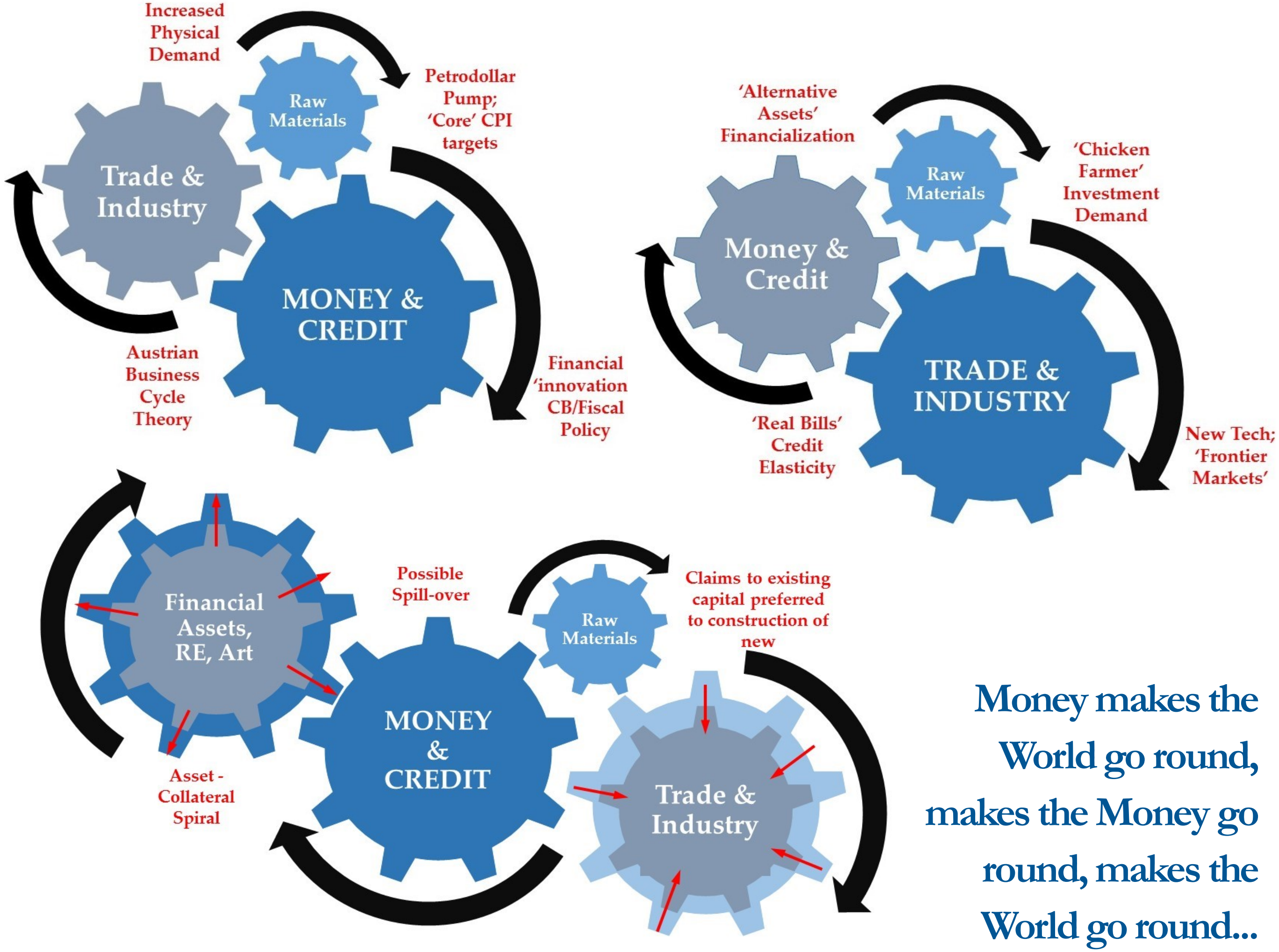


Money makes the World go round, makes the Money go round, makes the World go round...

IN THIS ISSUE:-

Volume II, Issue V

Five years to Midnight

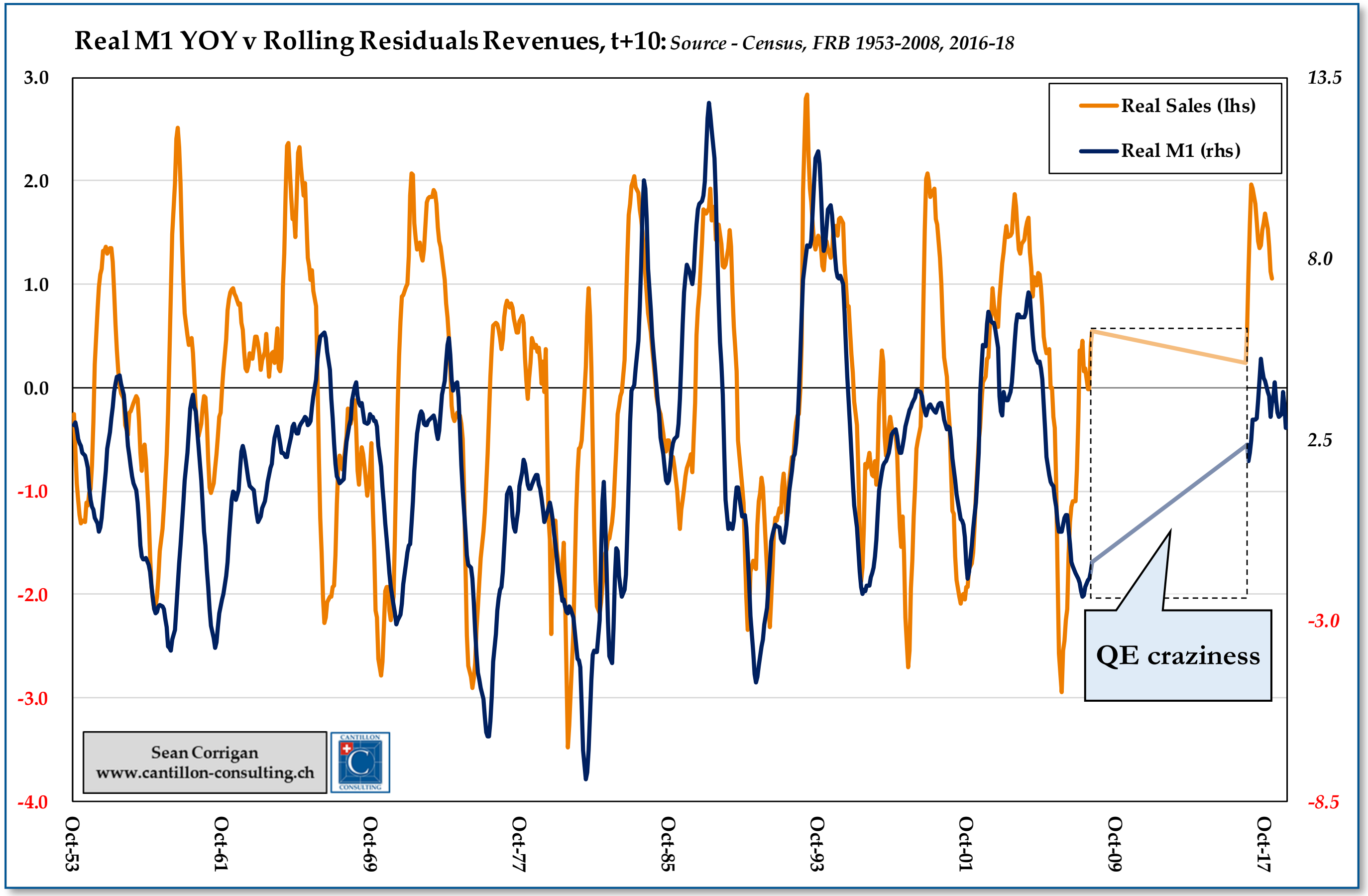
As the diagram on the front page of this publication tries to illustrate, our approach to macro is one which is sensitive to the interplay of the monetary side of the economy with the real one; which tries to relate the ebb and flow of credit to cycles of capital formation (and of ultimately wasteful misdirection); and which never forgets that the story which we Rational-*izing* Actors afterwards tell ourselves about what we see happening is as formative of asset prices - and hence of both returns and policy responses – as are those events themselves.

Money is of course, the 'loose joint' (Hayek) or the 'fluttering veil' (Leland Yeager) in the system, subject to a host of institutional changes, sentiment shifts, and policy intrusions. The past decade has seen one of the most remarkable experiments in monetary manipulation ever conducted, one which has, in some respects, confounded the mad professors who have been trying all this while to jolt the economic Creature back to life.

The fact that the opportunity costs to holding one's surplus in transactional form – especially when risk-adjusted for the effects of retail deposit insurance and seniority – have been shrunk to (and even, in some cases, through) zero has led to a grand confusion between transactional holdings – which the owner intends to spend in short order – and savings, which he does not.

Even more astounding is the fact that the so-called 'high-powered' (or 'outside') money which the central banks provide - and upon whose base the traditional exposition tells us the commercial banks should pyramid appreciable multiples of their own, 'inside' money - has, in several cases and for lengthy periods of time, been greater than the sum of all monies combined. The emergence of that negative multiplier has inarguably muted some of the impact of QE and has thus nonplussed both the 'Whatever it Takes' crowd, as well as its inveterate foes among the inflation-phobic and the ranks of gold bugs.

Be that as it may, money still matters and its ebbs and flows still exert their time-honoured influence upon our economic decision-making, even if these are demonstrably harder to distil out of the bulk data at present.

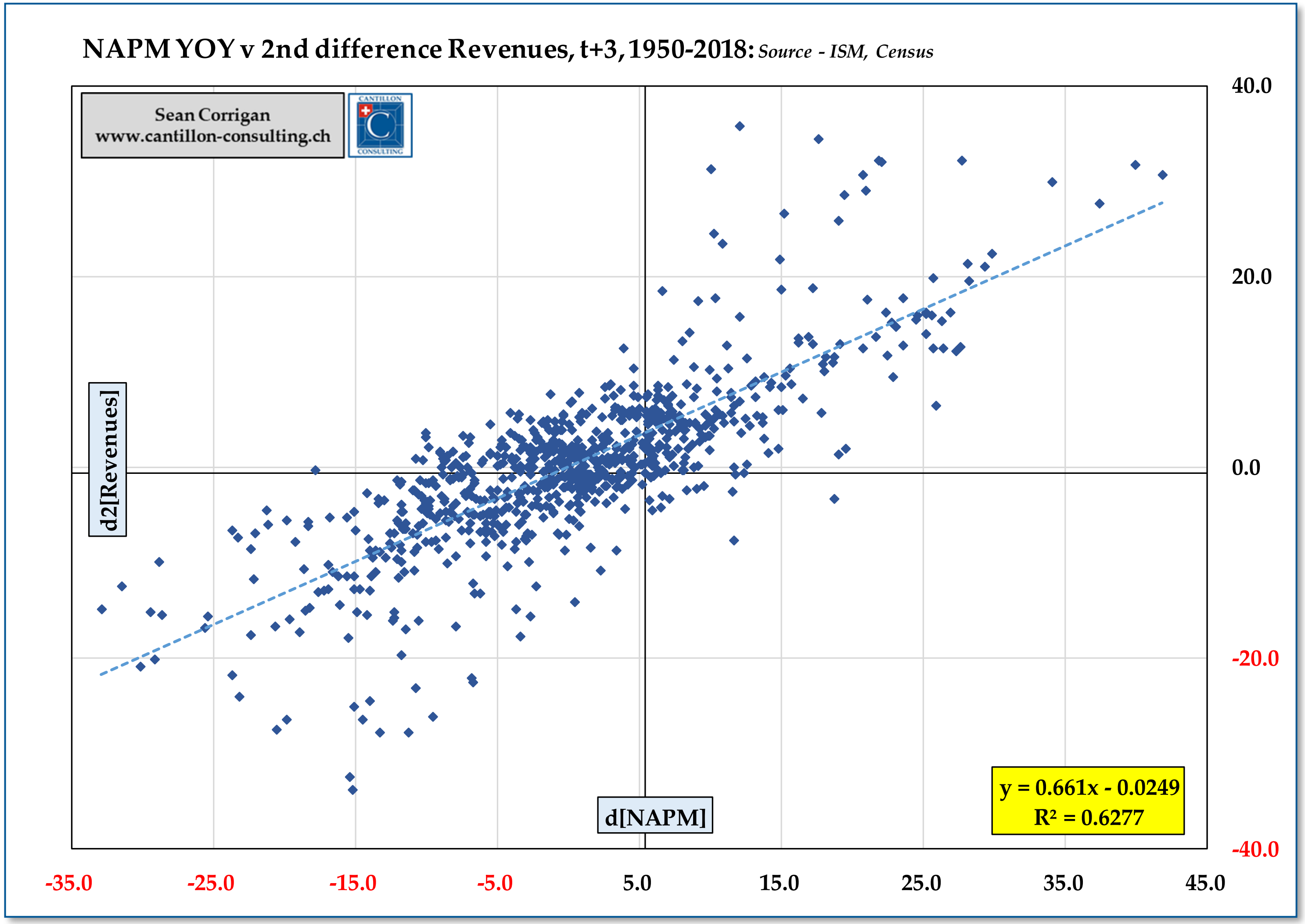


Given the intense current focus on interest rates – and given, too, the ominous, background susurration that our present recovery is now inevitably senescent – we thought this might be an opportune time to try to illustrate the implications of these ideas in a largely pictorial essay.

Where better to start than with the so-called 'soft' datum of the NAPM/ISM survey. Though only a diffusion index constructed from binary responses to the basic question, 'are things better or worse than they were last month?', its long-established reputation as a bellwether is, in our eyes, perfectly justified.

We have often argued that, when the questionnaire first pops up on the purchasing manager's screen, the clue to how he responds is largely to be found in his job title. Essentially, we believe that his impression of how well the business is doing is based primarily on how much he is buying; a decision largely based in turn on how much the firm is selling, or shortly expects to sell – i.e., on revenue flows both up and down the chain of production.

Though the survey is a qualitative one – and hence not strictly amenable to arithmetical tinkering – if we look at the simple increment from one period to the next, we can discern a pretty good fit with accelerations and decelerations in the actual dollars and cents flowing through the respondent's cash registers.



It gets better. As Austrians, we do not subscribe the crass, toilet-flush hydraulics of 'demand'-led macro, but insist that production necessarily precedes consumption, both temporally and causatively.

Not only does the mainstream approach put what we have called the 'Keynesian cart before the Hayekian horse', but it tends to submerge the greater part of economic activity, iceberg-like, below the water line of 'value-added' – in other words, that a narrow focus on typical gauges of end-consumption like retail sales and even, in greater part, GDP itself, misses out a great deal of much more variable and mutually contingent economic activity, to the detriment of our better understanding of what is really afoot in the marketplace.

Not to stretch the analogy too far, but the prevailing approach is akin to trying to assess a football team's chances only by looking at what the strikers are doing, meanwhile ignoring not only what happens in the build-up from the back, but all the work being done off the pitch, both in the boot-room and the board-room, as well.

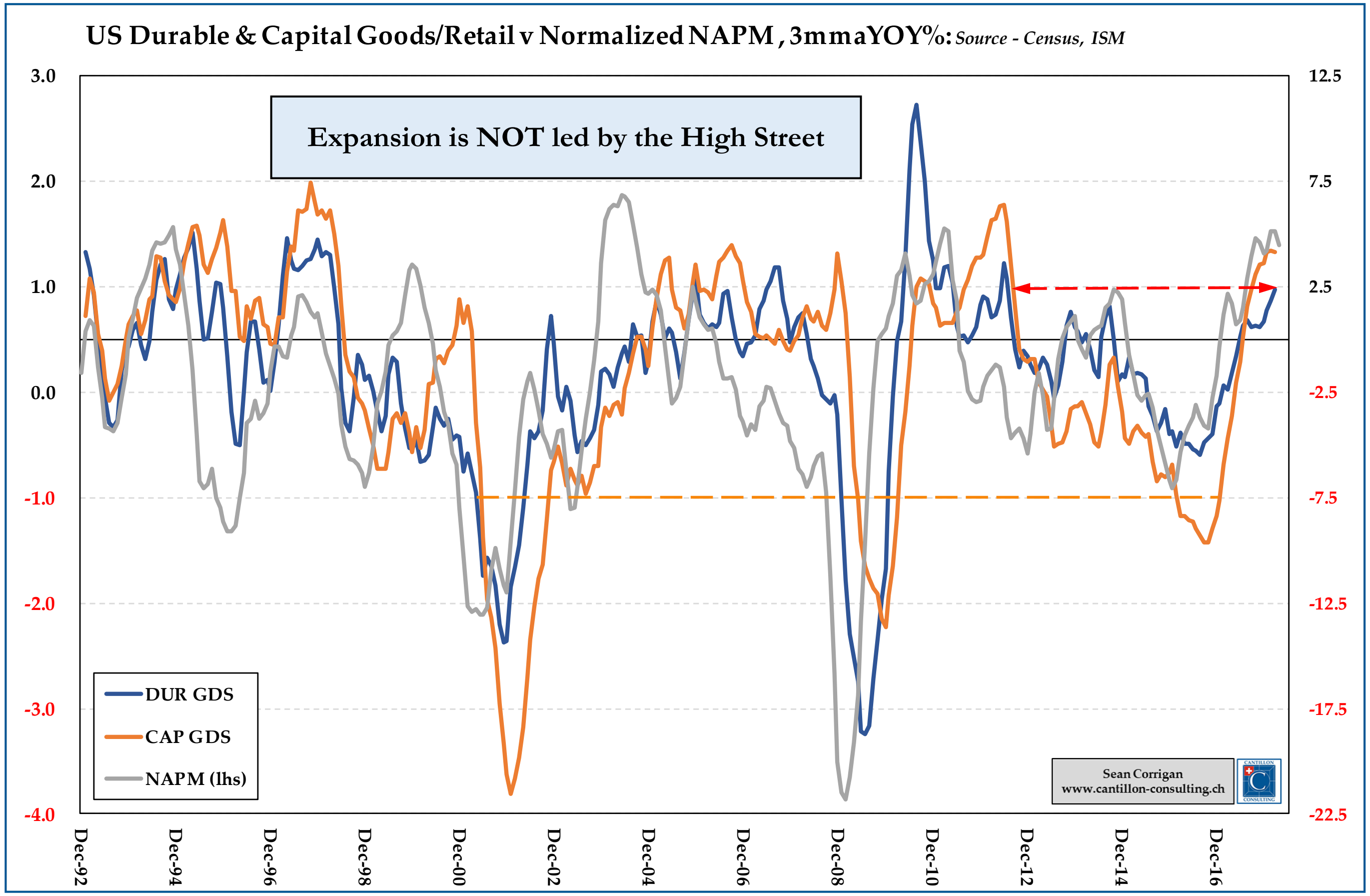
Ironically, some eight decades after Simon Kuznetz shaped the way most people think about such matters, by organising the statistical data largely according to these end-use precepts, the keepers of his flame at the BEA have belatedly been spurred by the signal failures of analysis which occurred either side of the GFC to devote some effort to tracking these wider flows, in the form of their (still incomplete) 'Gross Output' release.

In practice what we do is look at revenue data and then try to disaggregate it somewhat so as to give us insights into what is happening in the far more variable, more highly discretionary sectors, more slowly amortizing, more capital-intensive and hence more interest rate-sensitive sectors of the economy – what we Austrians tend to refer to as the 'higher orders'.

One method we routinely employ is to look at sales, income, payroll costs, and employment patterns in the durable goods sector – and, more specifically, in the 'core' capital goods subset – in comparison to those underway in retail, which we therefore use as both a scaling factor to allow for price, as well as volume, changes and as a way of checking the proportionality of the two ends of the chain.

When we do this, we get the gratifying result that the trace of the same, 'soft data' PMI numbers we considered above shows a good deal of similarity with the relative waxing and waning of higher-order versus lower-order goods sectors.

In fine, the classically understood Boom and Bust are, to us, phenomena of over–committing to capital projects, to excessively 'lengthening' the productive structure, in our parlance.



What we can also see is that when the NAPM is high and rising, the poorer end of the credit spectrum tends to out-perform that with a better pedigree – illustrated here by the total returns of junk divided by those attainable on investment-grade credit. Furthermore, we can look at the change in those relative returns and just make out a possible signal of trouble ahead for our 'lengthening' – and consequently for overall economic performance – when the converse applies and junk starts to struggle.

Though the co-movement may been plain enough to see, which is cause and which effect is a deal more difficult to determine since we have both to suggest a plausible, self-organising dynamic on the one hand, and to allow for official intervention (or the pre-emptive effect of market expectations thereof) on the other.

In the classic, producer boom exposition, a period of artificially lowered (or unnaturally maintained) interest rates encourages too much deferred-amortization, long pay-off capital to be laid down, both stretching the structure 'vertically' as well as bloating it horizontally by encouraging too many cheaply-leveraged copy-cats to spring into being.

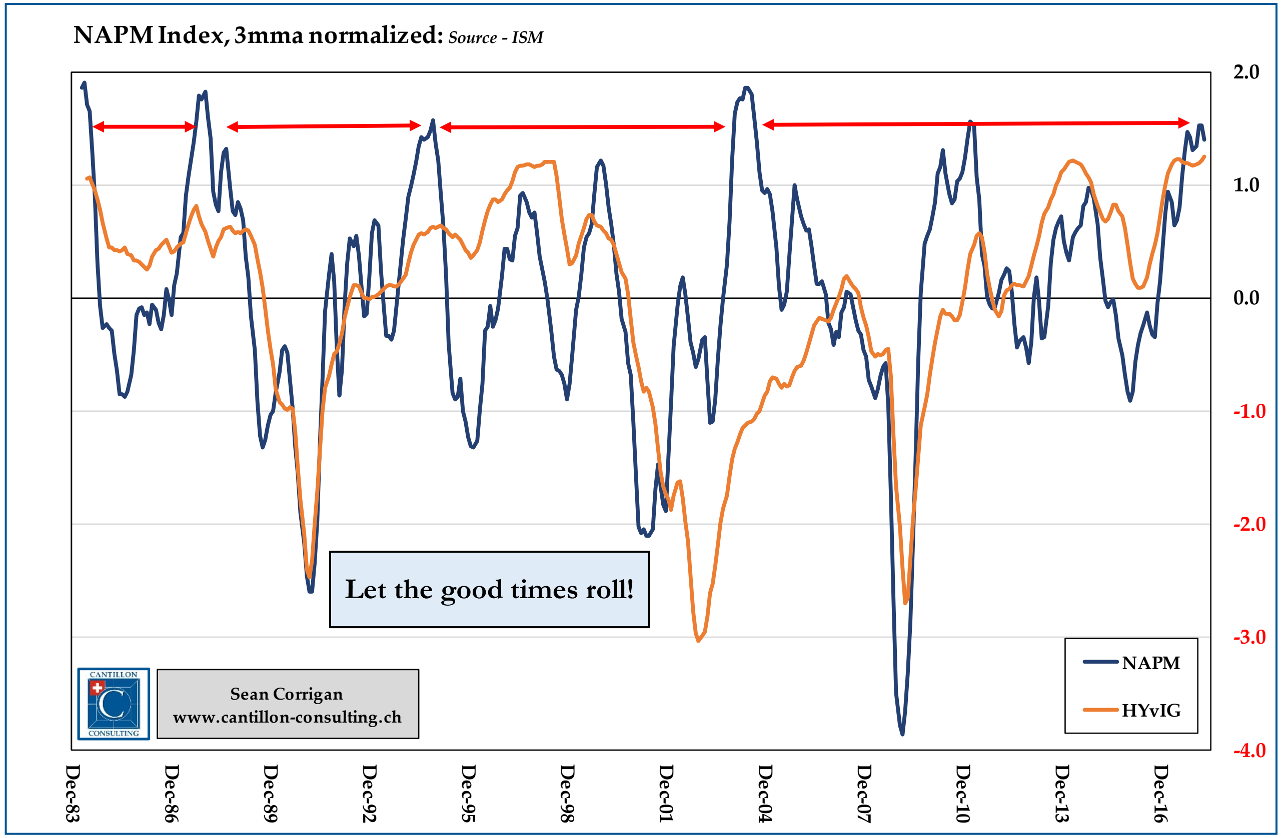
Given that such falsely lowered rates have been imposed from without, rather than arrived at from within, it implies, at best, that no underlying change to people's preference for making the savings has taken place – and at worst that such preferences have been shifted in a contrary direction.

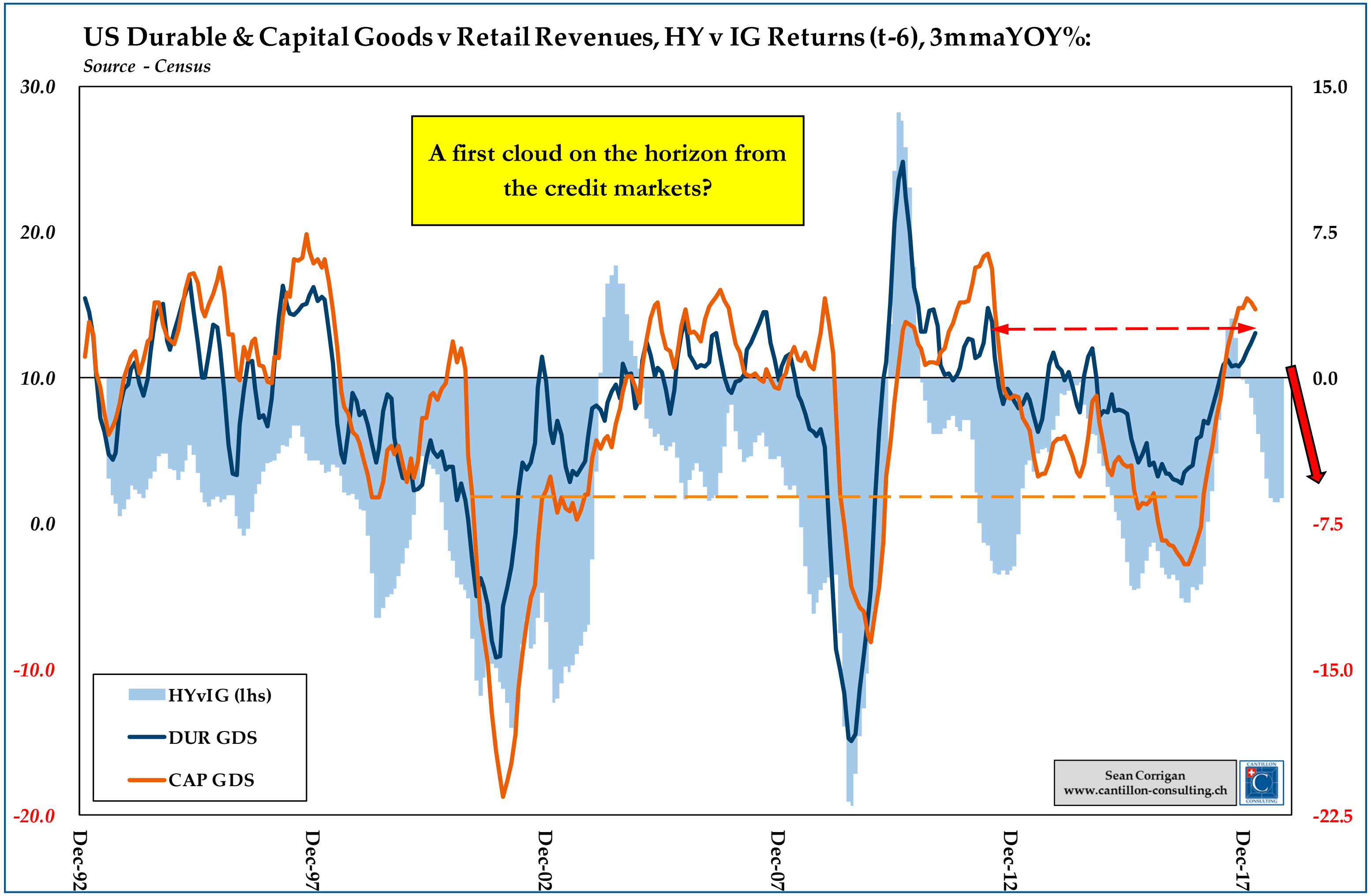
Though *finance* is, by definition, abundant, *funding* – in the sense of the availability of the real-world resources required not just for their own completion, but for the development of all the ancillary undertakings needed for the full realisation of their commercial value which are located further 'downstream' of them – is not, therefore. When our wise, Victorian forebears referred to the former as 'fictitious capital', they were indeed spot on.

As what we call 'plan incoherence' spreads, the extra money in the system fuels a tug-of-war between the eager spenders on today's goods and the would-be suppliers of tomorrow's. Free cash flow starts to dwindle and credit-market participants – always the glass-half-empty guys on the trading floor - begin to look at such strugglers' obligations in a much harsher light than do their who-needs-a-glass-anyway counterparts on the equity desk.

Credit spreads will now widen and – driven by our Malinvestors' desperation to plug holes in the income statement, any way they can – pressure will mount at the shorter end of the curve, whether overtly or through the attempt to bilk suppliers and squeeze customers in their accounts receivable and payable dealings.

Of course, at this juncture, the tightness in the resource market will lead either to higher prices and wages or to a ballooning of the current account deficit, either or both of which may incite the central bank to try to bolt the stable door which *it* had deliberately left unlocked. Either way, this is the point where the piper finally gets paid, and where that pesky yield curve really starts to flatten malignly and even to invert.





Taking a step back from the theoretical, an examination of past trends shows us that when revenues in the US start to grow faster than around 5-6% per annum the pace of price increases tends to quicken (the second difference of the CPI index rises) and, accordingly, the Fed starts to push up the Funds rate - at least, it used to do so in pre-Lehman days.

Since rising prices are the single biggest factor in setting bond yields (even if the residual 'real' yields themselves have been in secular decline, ever since Bill Gross was a boy), we can also see that a sustained burst of rising sales (and, recall, with them an increasing NAPM; durables' outstripping of retail consumables; salad days for junk bonds; a generally subdued VIX; and gold losing out relative to industrial commodities) - an upswing based on anything other than extra saving tends to sow the seeds of its own inevitable demise.

Since the bond durations which result from those yields are themselves intimately related to the multiples attached to equity earnings, asset values there also begin to face a headwind which may or may not be sufficient to temper the effect on equity prices of the initial intensification of revenue growth (whether before or after we attempt to adjust for our money's loss of value) which has brought all this about.

Moreover, since – as this newsletter's *Ursprungsgeist*, Richard Cantillon, famously pointed out three centuries ago – monetary inflation is a very uneven disease: once it takes hold, the widespread distortion and destabilization of *relative* prices by means of which it raises the *average* price levels of popular concern renders all entrepreneurial reckoning and accounting practice moot and so both magnifies the *post hoc* losses *and* deadens the *ex ante* appetite of the less wild-eyed commercial and industrial risk-takers, irrespective of whatever less favourable trends may now prevail in the capital markets.

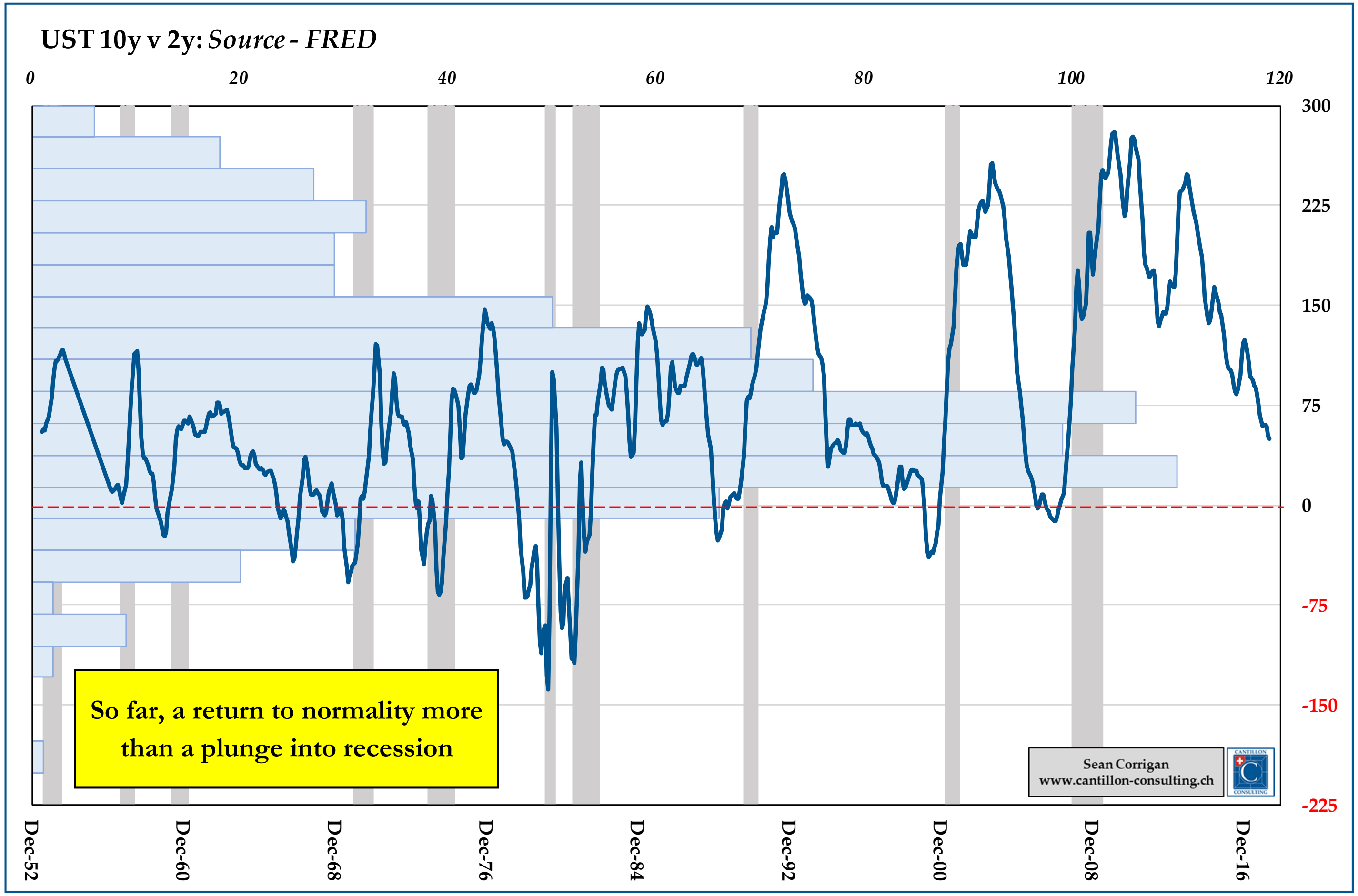
To sum up, what we can both argue and partly discern in the data (all we can ever realistically hope to do in a world where *ceteris* is NEVER *paribus*) is that once extra money is injected more rapidly into the system, it starts to move more actively through people's hands within a year of its arrival, boosting revenue growth beyond whatever have been the recent norms [Graph p2]. Such an acceleration finds its expression in the NAPM data [Graph p3] and is usually accompanied by a greater increase in 'higher-order' sectors in relation to what takes place in the nation's shopping malls [Graph p4].

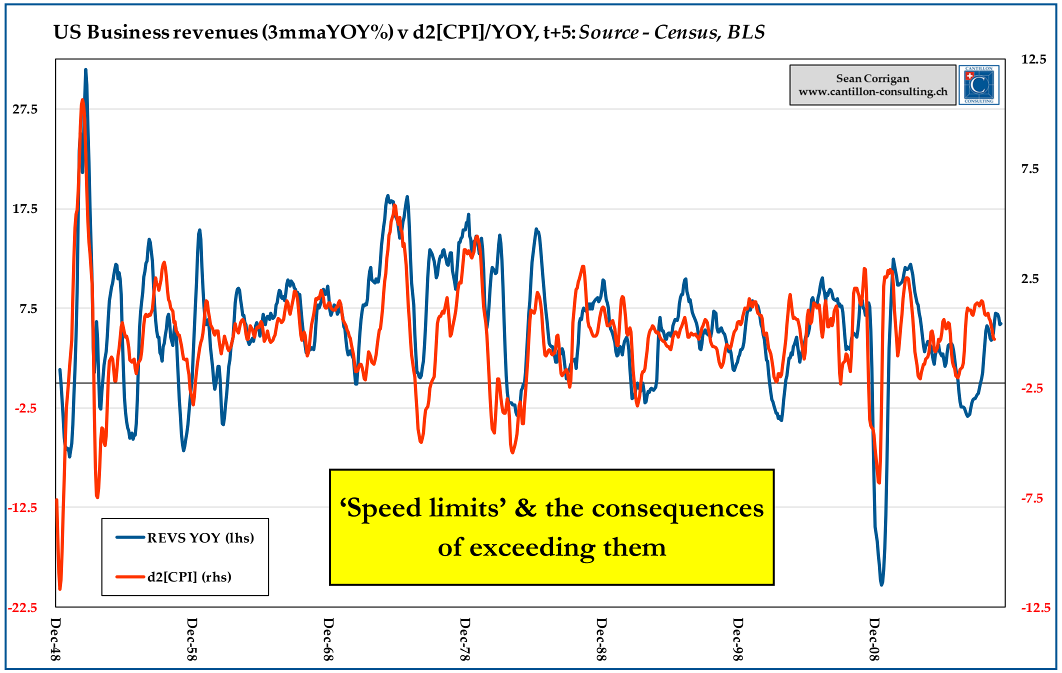
Under such benign conditions, credit spreads tend to compress, driving returns higher among the lower-ranked offerings [Graph p5]. Indeed, such is the coincidence that once that dynamic starts to weaken, much less reverse, it typically heralds an imminent end to the 'lengthening' – and, by implication, to the ongoing rise in the NAPM index [Graph p6]. If stresses mount sufficiently, the need to replace dwindling cash flow is wont to drive up short-term rates, irrespective of what the central bank may be doing, thus flattening and – in extremis – inverting the yield curve. Hayek called this 'investment that raises the demand for capital' [qv, Graph below].

Meanwhile, at least some of that surge in the movement of money will translate in to more quickly escalating prices such that, once sales start growing by something in excess of 5-6%, the Fed is usually stung into action before more than a few months are out [Graphs p8]. Higher short term rates, more demand for longer-term capital, and rising prices (especially of industrial commodities) all serve to bump bond yields up, pushing returns and durations down. Whether through the act of inducing investors to apply higher discount factors to potential future earnings, or because of the disruption to input and output costs to which all this might be giving rise, equity multiples will now tend to decline making the behaviour of stock prices themselves very much more moot [Graphs p9].

Historically, over the last three-decades of generally falling real and nominal yields, this back reaction has tended to become too large to bear once it drives 5-year Treasuries some 125bps above their trend and once that degree of elevation occurs inside a year [Graph p10] – the same sort of interval we can see (if somewhat weakly signalled in this case) in the retardative effect which the rise in bond yields eventually has on the very evolution that initially set it in train [Graph insert p10].

All in all, what we can now conclude is that even if we cannot know exactly *when* the alarm bell is set to ring, the clock is ticking inexorably down toward that hour of startled awakening, ladies and gentlemen.




US Business revenues (3mmaYOY%) v d2[CPI]/YOY, t+5: Source - Census, BLS
Sean Corrigan
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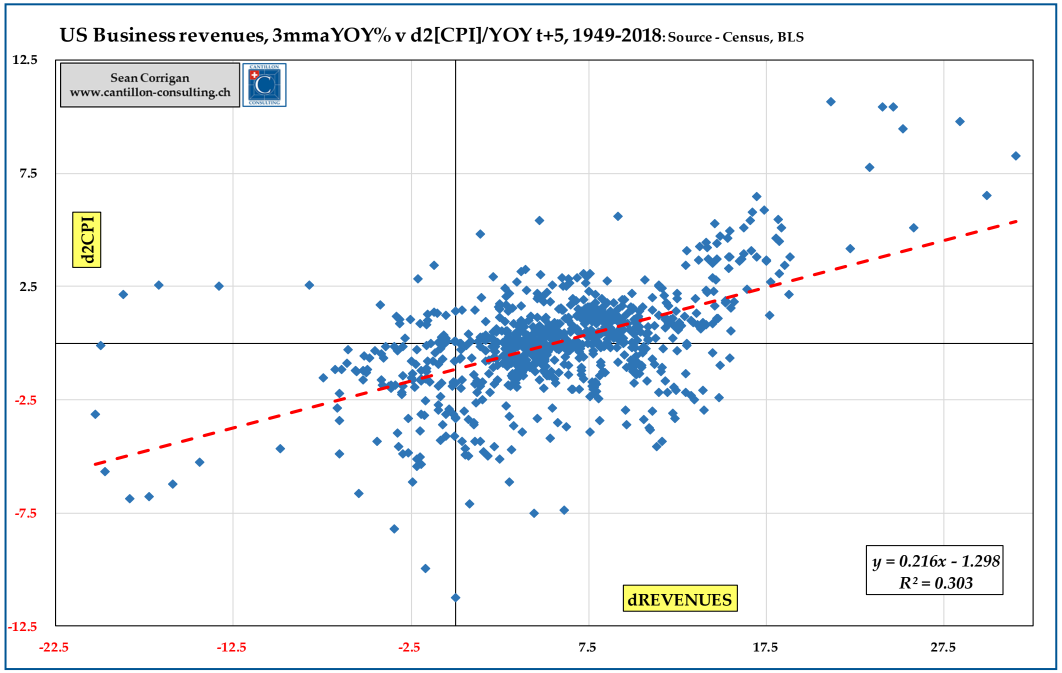
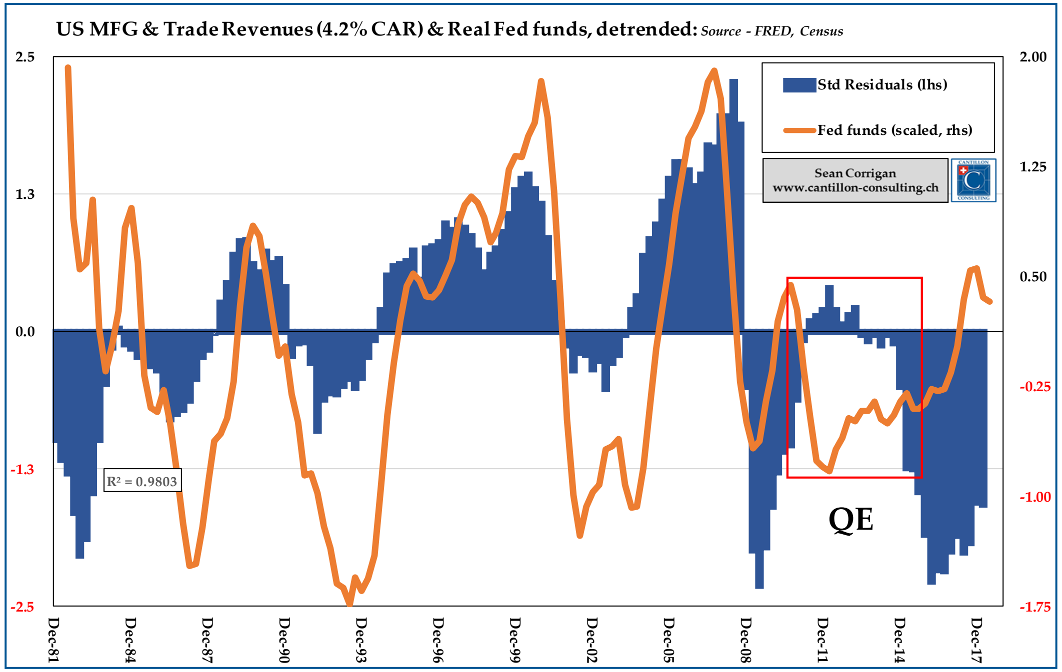
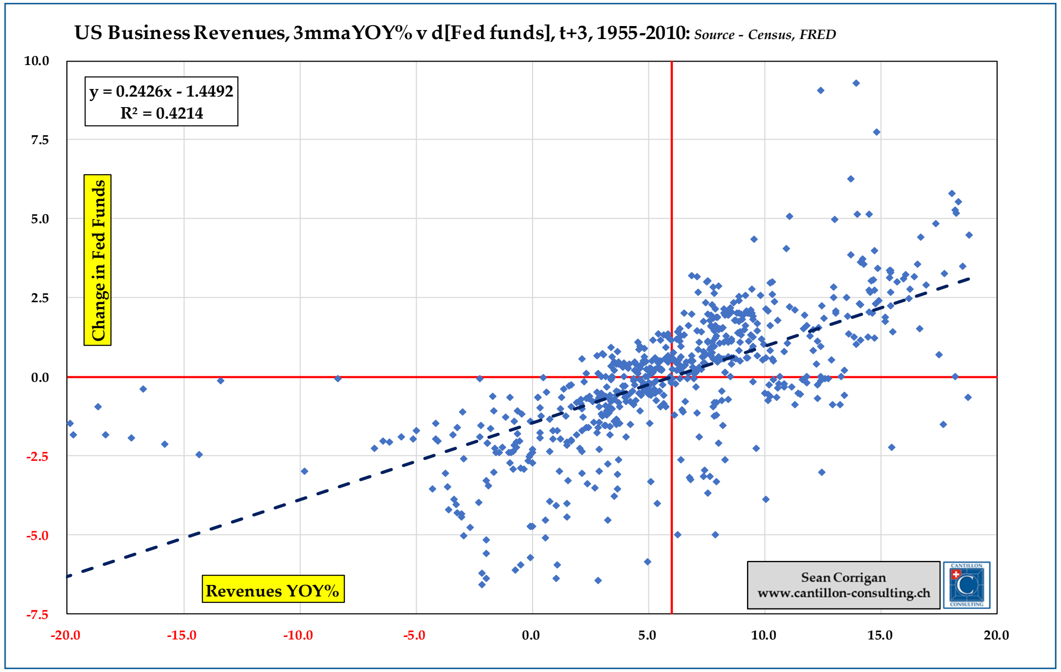
REVS YOY (lhs)
d2[CPI] (rhs)
'Speed limits' & the consequences of exceeding them


US Business revenues, 3mmaYOY% v d2[CPI]/YOY t+5, 1949-2018: Source - Census, BLS
Sean Corrigan
www.cantillon-consulting.ch
d2CPI
dREVENUES
y = 0.216x - 1.298
R² = 0.303


US MFG & Trade Revenues (4.2% CAR) & Real Fed funds, detrended: Source - FRED, Census
Std Residuals (lhs)
Fed funds (scaled, rhs)
Sean Corrigan
www.cantillon-consulting.ch
R² = 0.9803
QE


US Business Revenues, 3mmaYOY% v d[Fed funds], t+3, 1955-2010: Source - Census, FRED
y = 0.2426x - 1.4492
R² = 0.4214
Change in Fed Funds
Revenues YOY%
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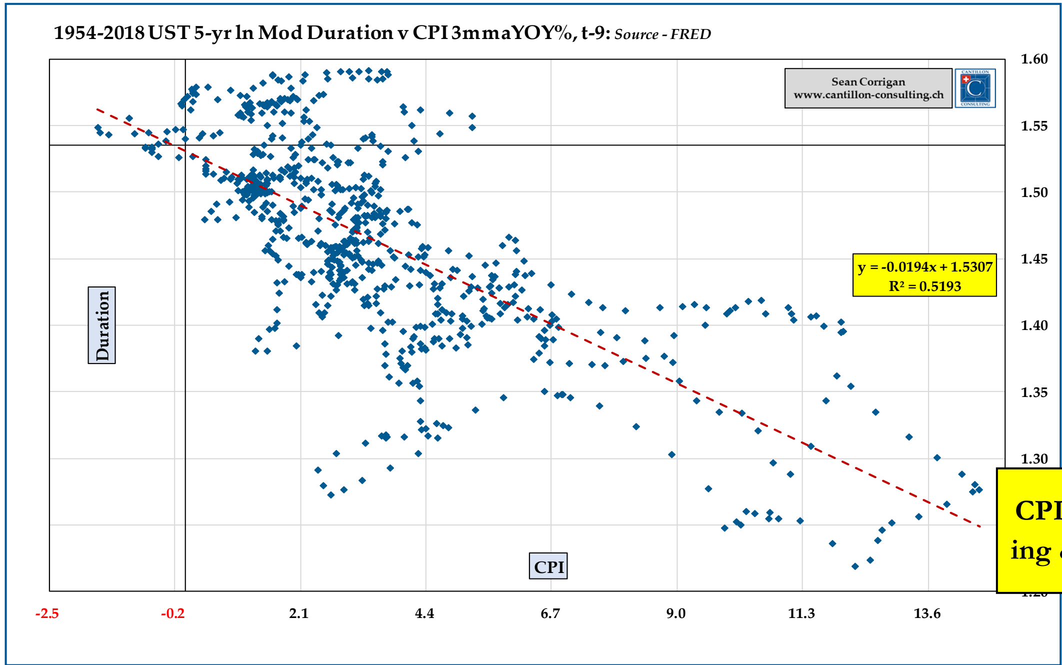
1954-2018 UST 5-yr ln Mod Duration v CPI 3mmaYOY%, t-9: Source - FRED
Sean Corrigan
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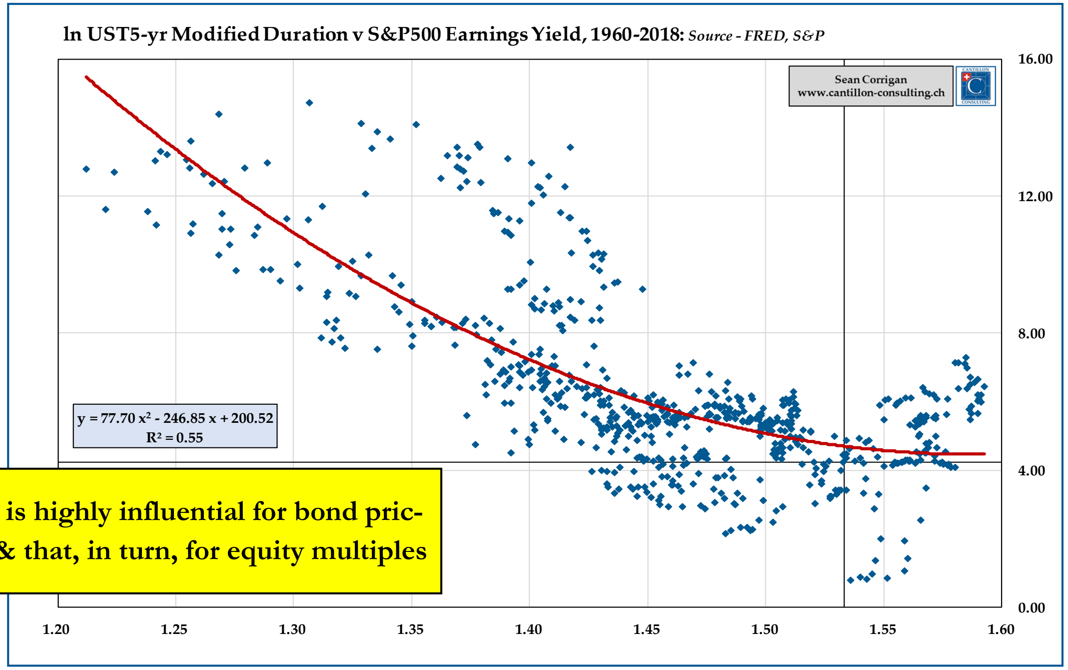
y = -0.0194x + 1.5307
R² = 0.5193
Duration
CPI
-2.5
-0.2
2.1
4.4
6.7
9.0
11.3
13.6
1.60
1.55
1.50
1.45
1.40
1.35
1.30


ln UST5-yr Modified Duration v S&P500 Earnings Yield, 1960-2018: Source - FRED, S&P
Sean Corrigan
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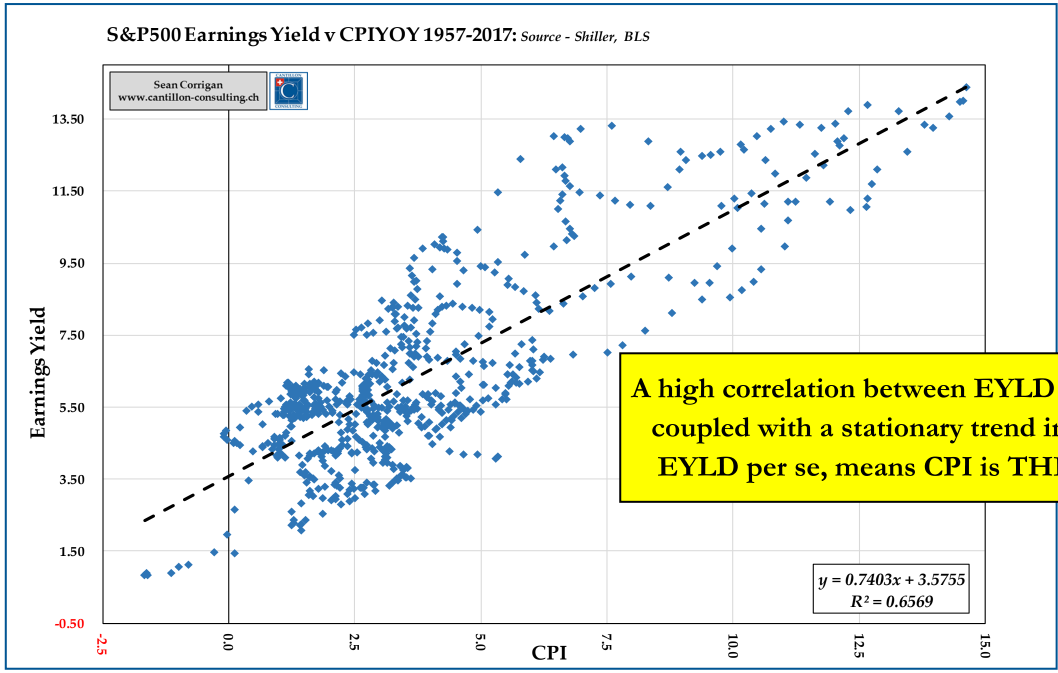
y = 77.70 x² - 246.85 x + 200.52
R² = 0.55
CPI is highly influential for bond pricing & that, in turn, for equity multiples
16.00
12.00
8.00
4.00
0.00
1.20
1.25
1.30
1.35
1.40
1.45
1.50
1.55
1.60


S&P500 Earnings Yield v CPIYOY 1957-2017: Source - Shiller, BLS
Sean Corrigan
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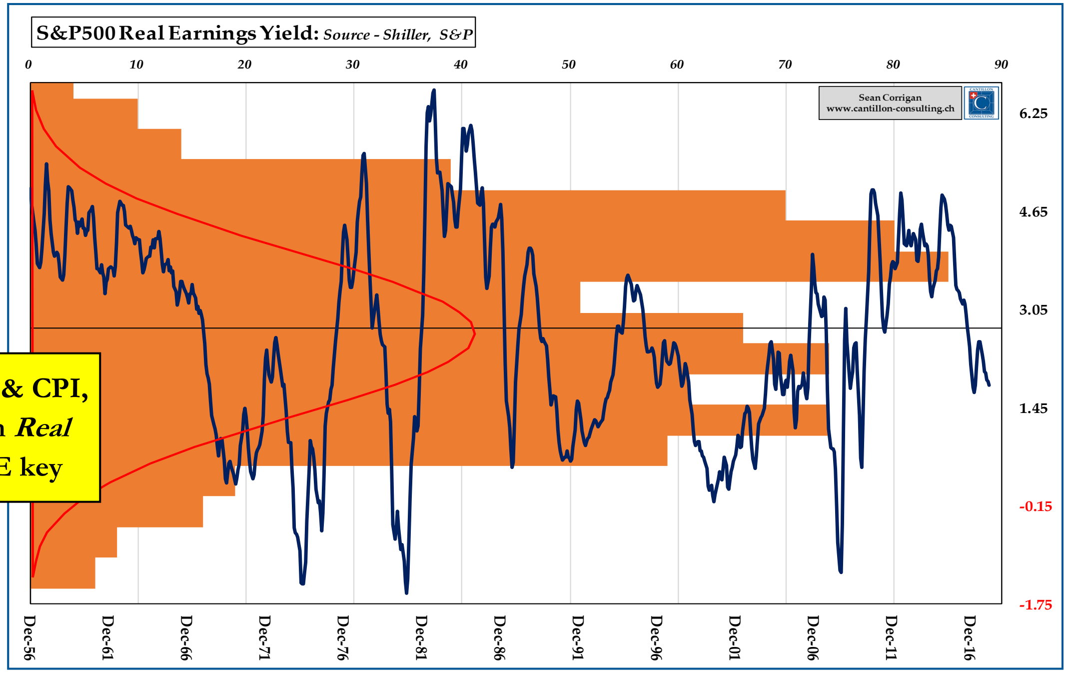
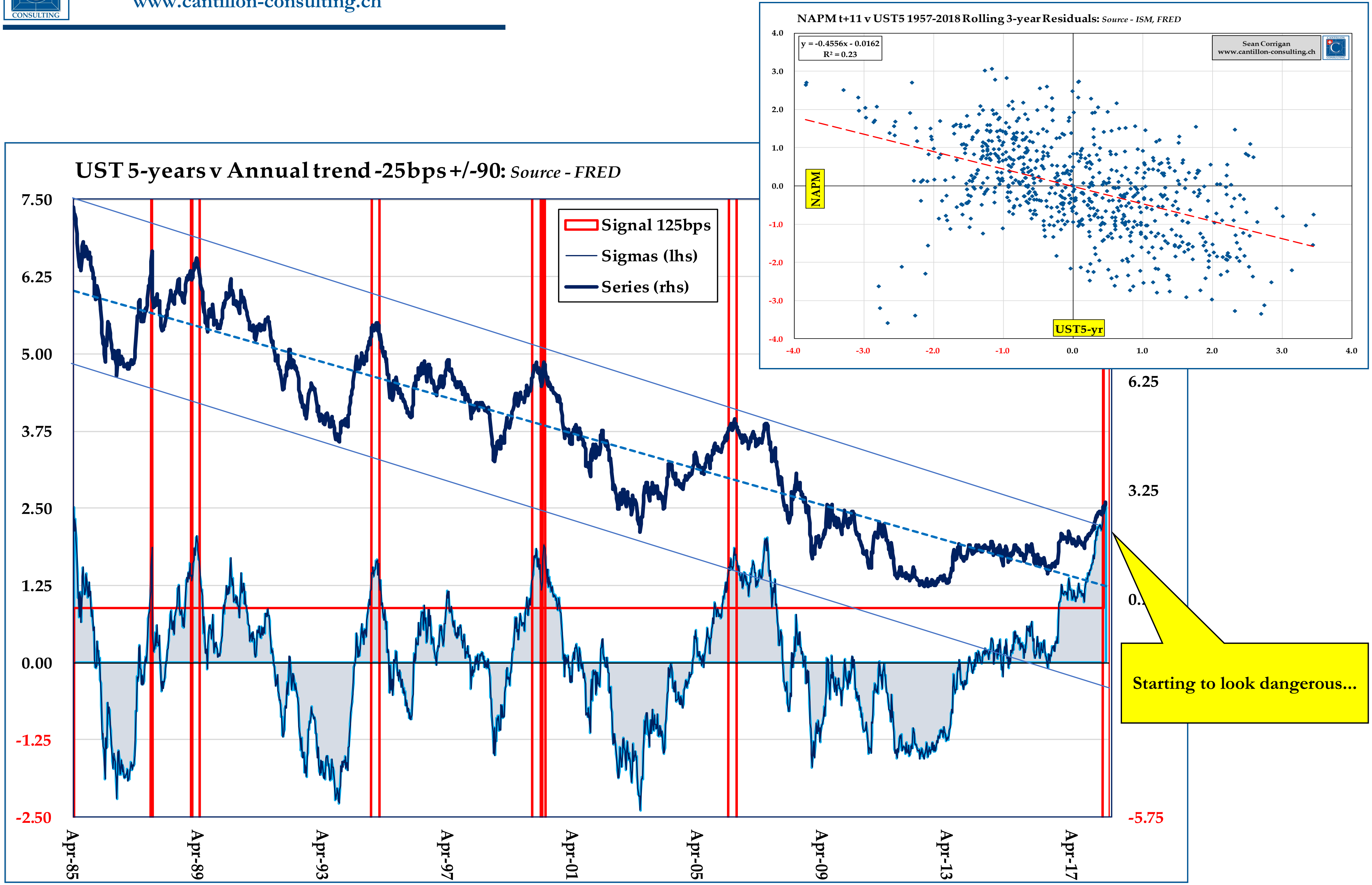
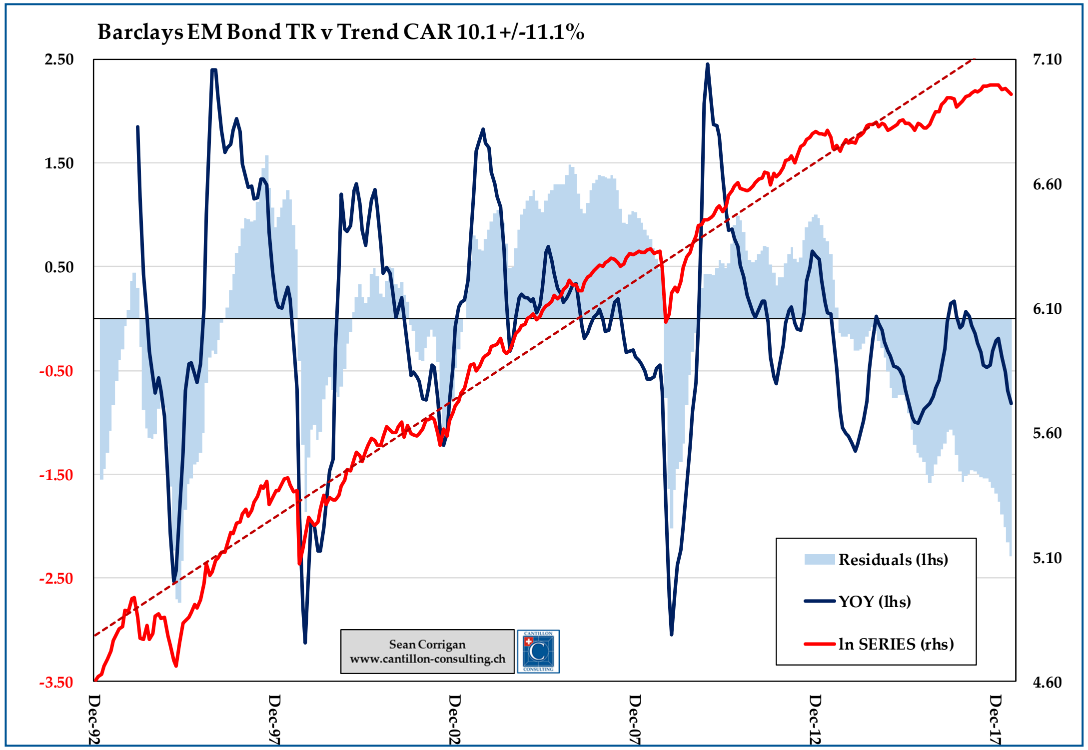
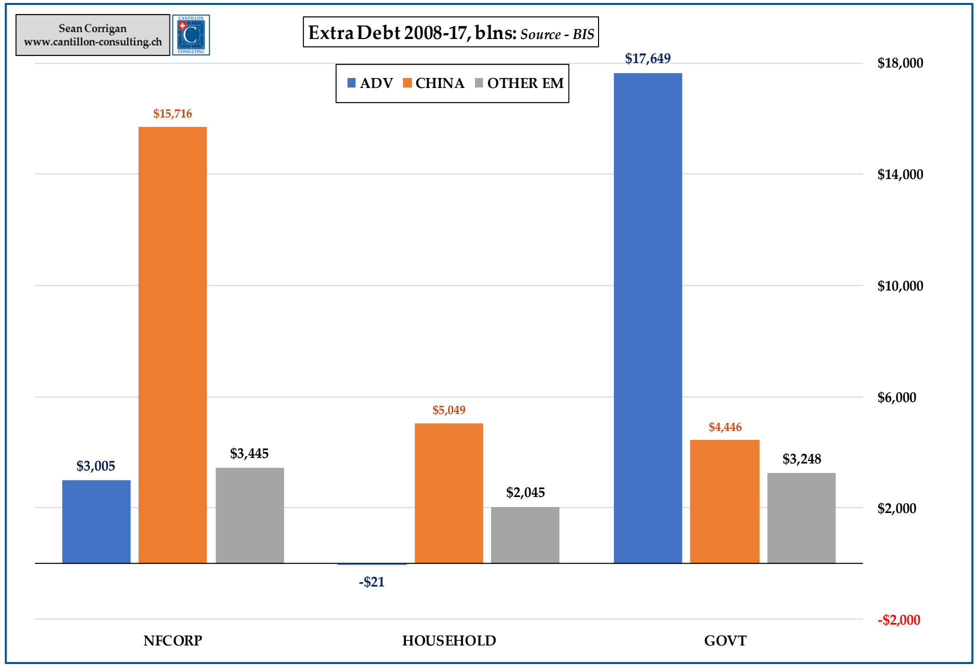
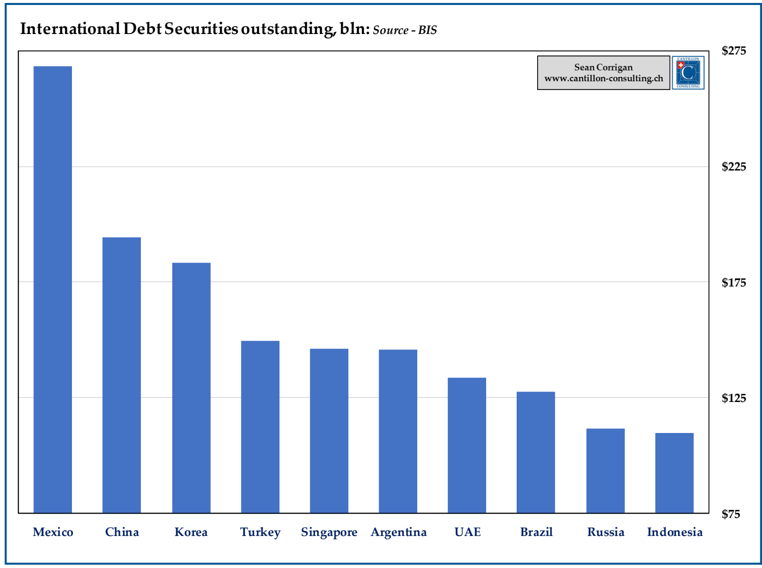
Earnings Yield
CPI
y = 0.7403x + 3.5755
R² = 0.6569
A high correlation between EYLD & CPI, coupled with a stationary trend in Real EYLD per se, means CPI is THE key
13.50
11.50
9.50
7.50
5.50
3.50
1.50
-0.50
-2.5
0.0
2.5
5.0
7.5
10.0
12.5
15.0

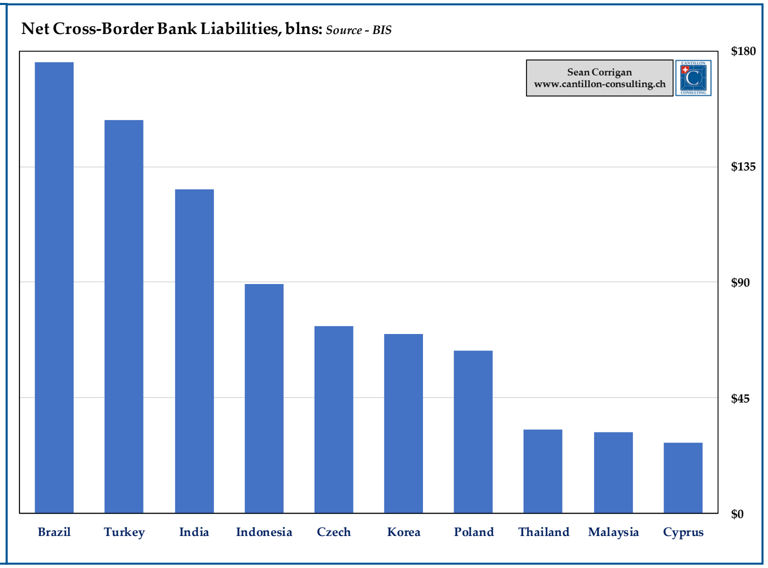

S&P500 Real Earnings Yield: Source - Shiller, S&P
Sean Corrigan
www.cantillon-consulting.ch
0
10
20
30
40
50
60
70
80
90
6.25
4.65
3.05
1.45
-0.15
-1.75
Dec-56
Dec-61
Dec-66
Dec-71
Dec-76
Dec-81
Dec-86
Dec-91
Dec-96
Dec-01
Dec-06
Dec-11
Dec-16


NAPM t+11 v UST5 1957-2018 Rolling 3-year Residuals: Source - ISM, FRED
y = -0.4556x - 0.0162
R² = 0.23
Sean Corrigan
www.cantillon-consulting.ch
NAPM
UST5-yr
4.0
3.0
2.0
1.0
0.0
-1.0
-2.0
-3.0
-4.0
-4.0
-3.0
-2.0
-1.0
0.0
1.0
2.0
3.0
4.0
UST 5-years v Annual trend -25bps +/-90: Source - FRED
Signal 125bps
Sigmas (lhs)
Series (rhs)
7.50
6.25
5.00
3.75
2.50
1.25
0.00
-1.25
-2.50
6.25
3.25
-5.75
Apr-85
Apr-89
Apr-93
Apr-97
Apr-01
Apr-05
Apr-09
Apr-13
Apr-17
Starting to look dangerous...









Though EM bonds now lie further below trend than at any time since the Tequila Crisis, to date this has been a wasting sickness (not least due to QE-lowered rates) rather than the classic 20-25% ‘sudden stop’ seizure of yore.

They have however returned a bare 1.5% cumulative more than US IG since the start of 2013, and are also lagging junk. ‘Risk & Reward’ springs to mind, especially v-a-v those Spanish banks who lend EMs *s-o-o-o* much!

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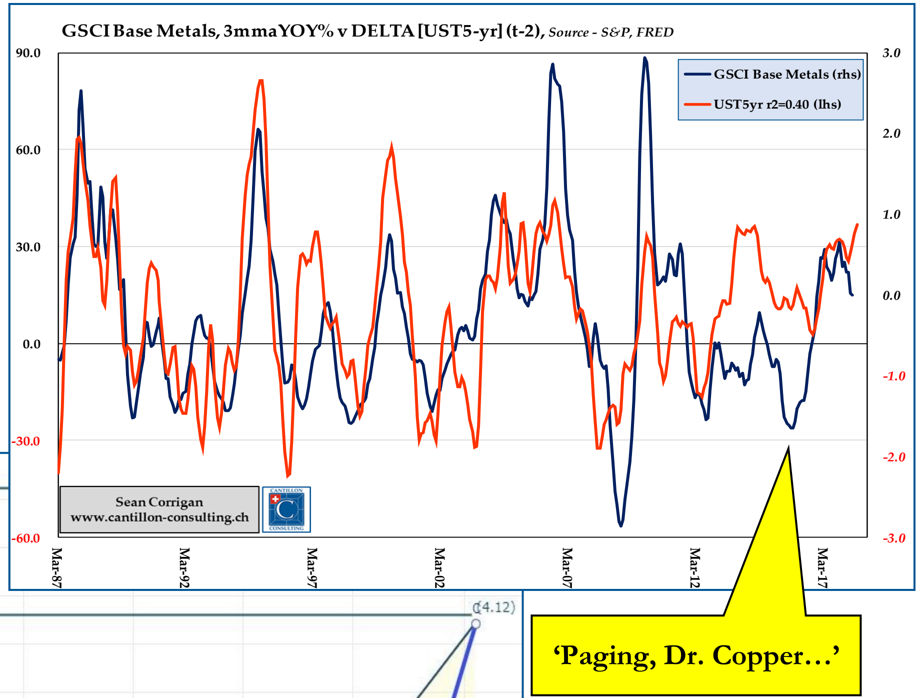
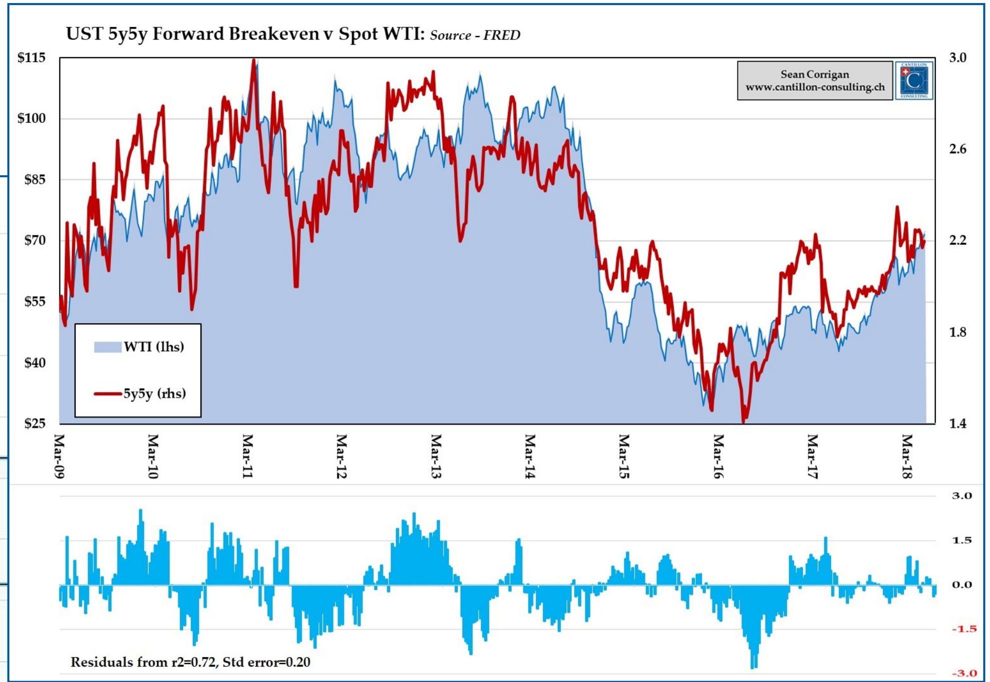
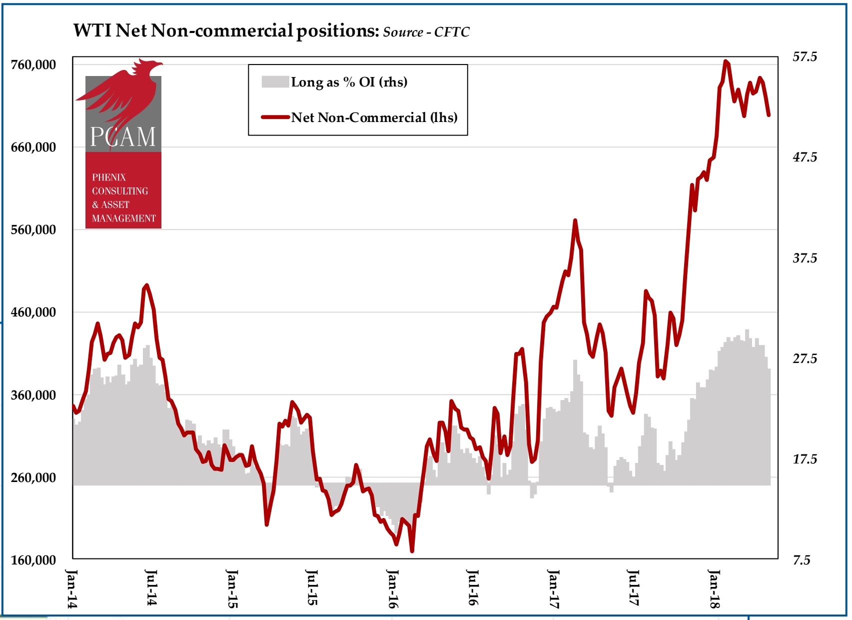


Copper's December high represented a 50% retracement of the 2011/16 slump—a natural point at which to consolidate. The Trump Era rally—not surprisingly one which has coincided with higher bond yields (upper left)—has left us building a pennant formation above the mid point of the whole 'Supercycle' distribution. If the trend/ channel line holds beneath, an upward break would project all the way to the overall profile's upper value bond at around $4.12/lb

If the break above 3.03% holds, look for a 3.34% target (mid of prior stock market-high, Fed Cycle range). Beyond that [shudder!], we raise our eyes to 3.80% & 3.95% Fib & post-crisis tops. Will the Fed take this as a cue to do more? Note, too, how oil drives the Fed's flawed 5y5y marker—ugly!



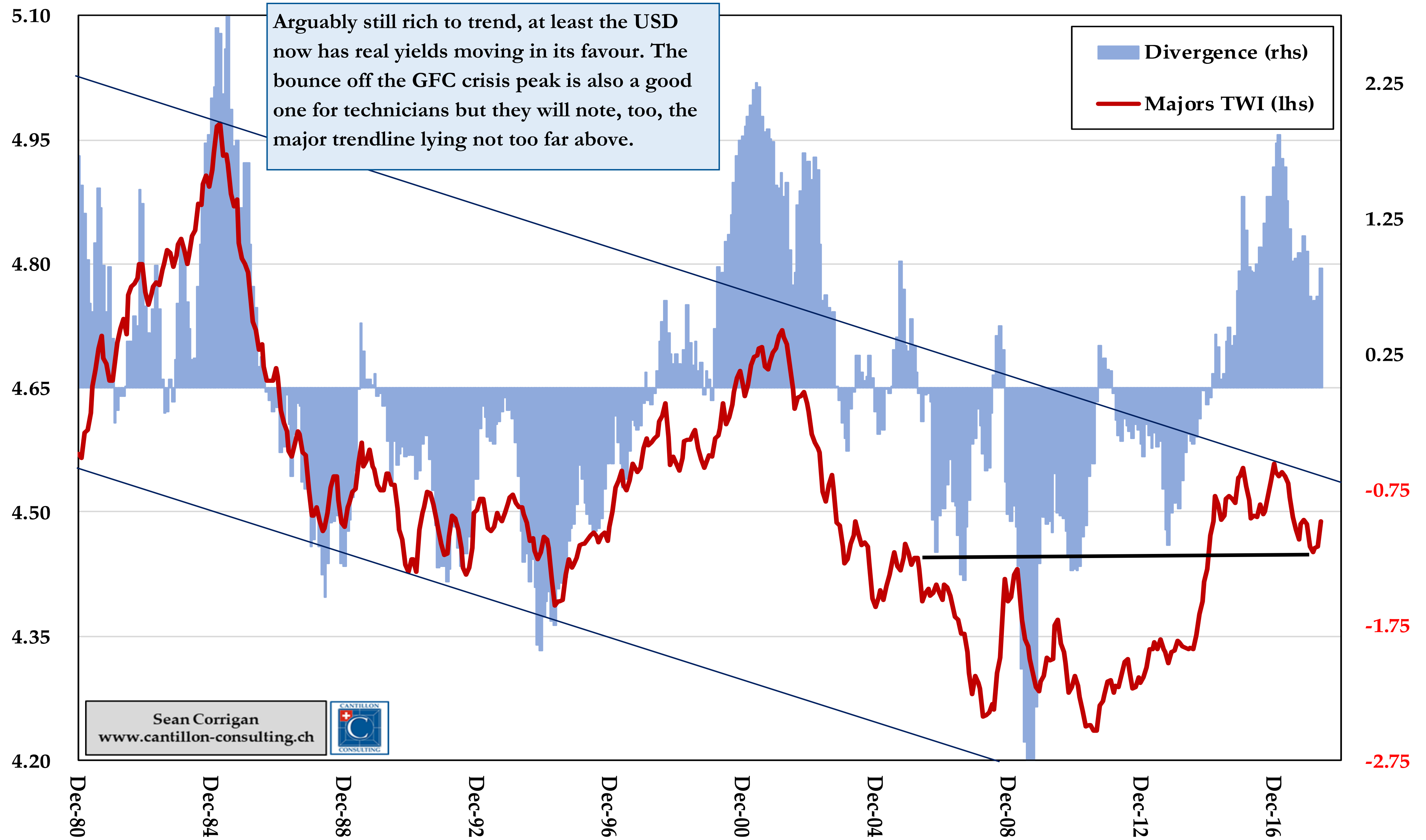
Last September's $45/bbl low, via QI's consolidation, argue for a WTI move to $79-80/bbl, the lower value bound of the pre-shale bust congestion area. At that level we find not only the fib of that slump, but also the trendline through the clear June '08 and June'14 highs. The market has actually reduced net longs almost to their lowest this year—ironically on *Commercial* buying, for once! Keep stops tight, but not time to bale, yet.



Note that the last time UST yields were this far above trend, gold was barely half of today's price relative to the other commodities. The metal needs another panic and fast!

Gold has finally broken support to rest on the Trump Rally trendline. Half of that move—as well as the mid-point of the last 5-years' range—lies between $1245/50, ergo the next target if weakness persists.

USD TWI v Majors vs Regression on Real UST10yrs [r2=0.58]: *Source - FRED*



Despite all the forgoing, those in the equity market have not yet entirely given up the ghost. Yes, if we fade here, it will mark a second successive, lower high, but the intervening lows are also rising. Caution would argue that the bond market must start to weigh at some point, but it would be equally foolish to fight the Herd if it instead manages to push us back up through that narrow 5% or so which separates us from the January highs and thus opens up the much higher profile targets one can then derive.

SENTIMENTALS OFTEN OUTWEIGH FUNDAMENTALS!

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