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Central banks, money flows & macro implications

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

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Europe

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If anyone was still under the illusion that the Italian issue is much ado about nothing, note that T2 flows into Germany hit the sort of level we have not seen since the 'Whatever it takes' days - and that despite not blowing up until the second half of the month.

Amazingly, there was talk – and even price actions – suggestive of a degree of 'surprise' that Draghi did not choose *just* this moment to set the markets to pre-emptively front-running a tightening. Instead, of course, he took pains to assure us that it will not only be long-delayed, but also exceedingly gentle when at last it arrives.

German TARGET2 Balance & MOM change, blns: *Source - BUBA*

June 18th 2018

TARGET2 Balance + SNB EUR FX (blns): *Source - ESCB, SNB*

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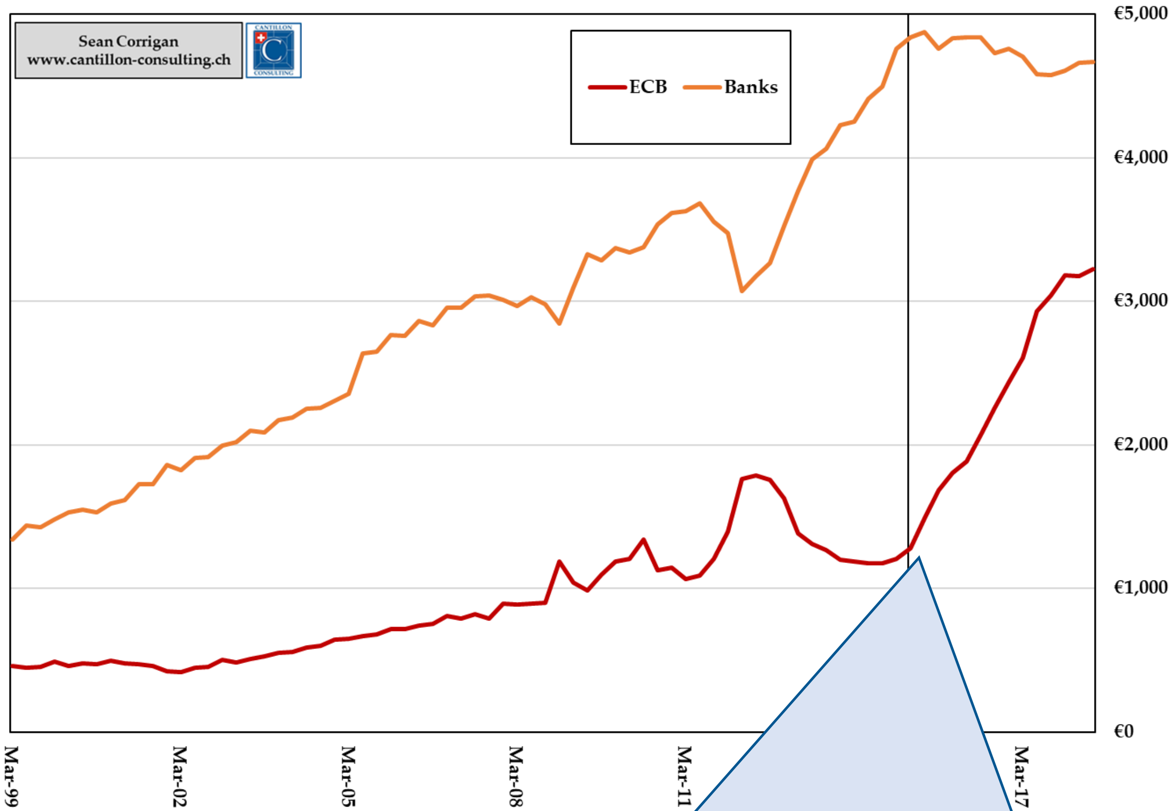
The scale of the issue. A 'clearing' system plus the SNB's unwanted credit-wrapper FX mountain which together are clogged with a balance the size of Canadian GDP

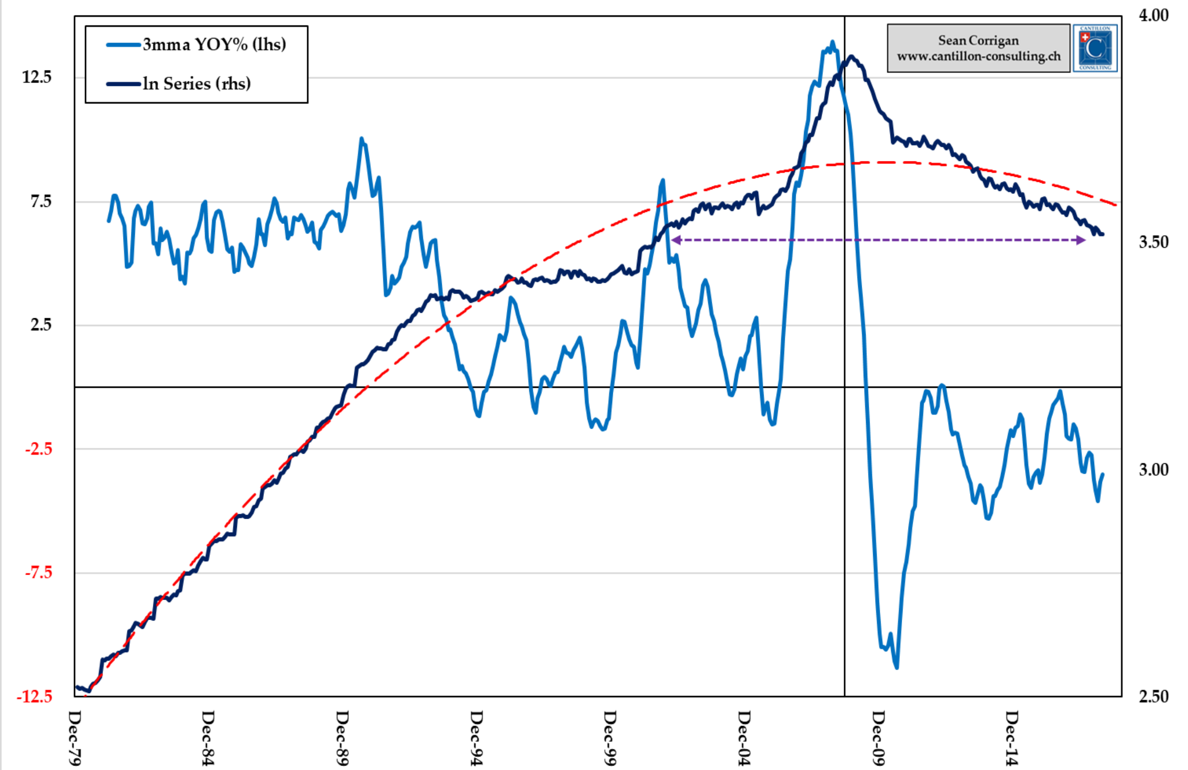
€1,550
€1,250
€950
€650
€350
€50

FINLAND
LUX
NETHER
SWISS
GERMANY

Nov-07 Nov-08 Nov-09 Nov-10 Nov-11 Nov-12 Nov-13 Nov-14 Nov-15 Nov-16 Nov-17



There are other ways to gauge the dysfunctionality of the ECB's approach, as these graphs attempt to do. Below we can see that higher orders of aggregates have fallen ever since the crisis, shrinking by a quarter to revisit levels of the first few years of the century (and that in nominal terms alone!)



Even worse, since the APP kicked in, even banks' own contribution to money proper (M1) has shrunk, leaving the score since Q1'15 at ECB +€1,945 bln; bank money -€185bln; bank credit -€230bln. Full withdrawal could therefore prove far more than the ECB can countenance, however salutary.

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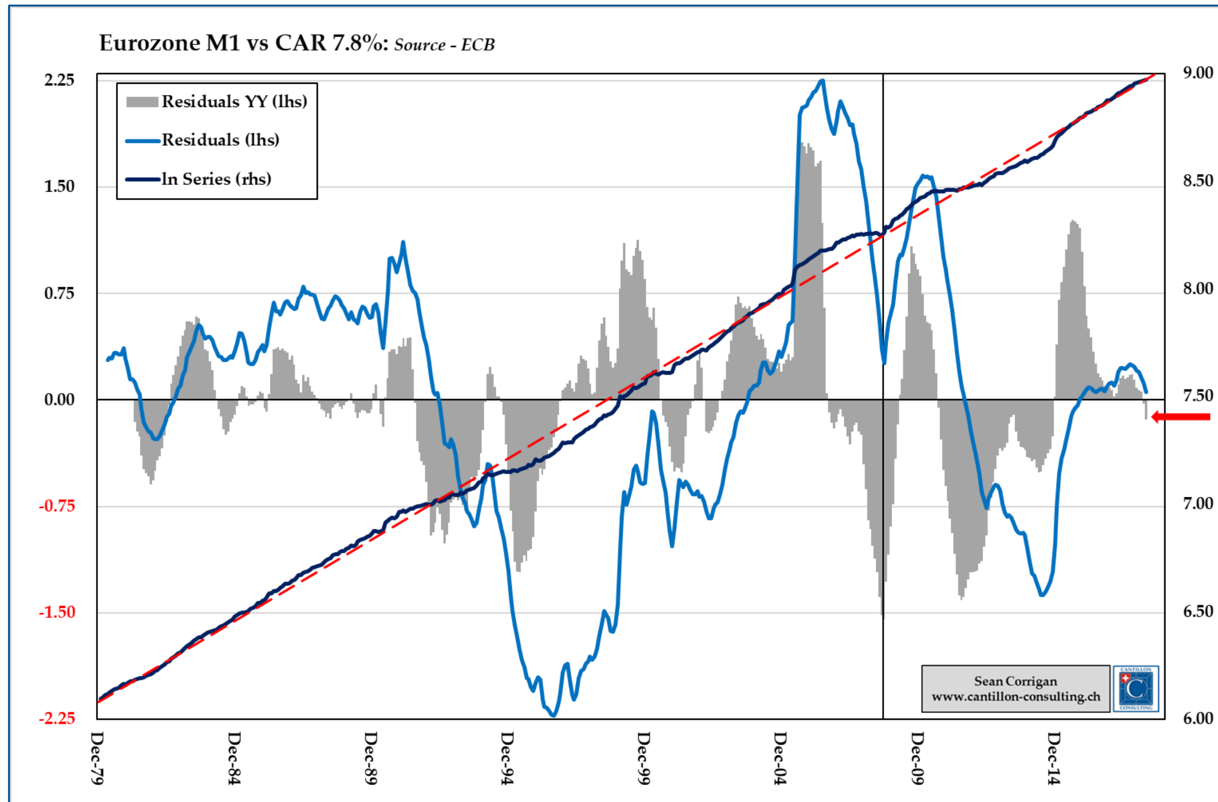
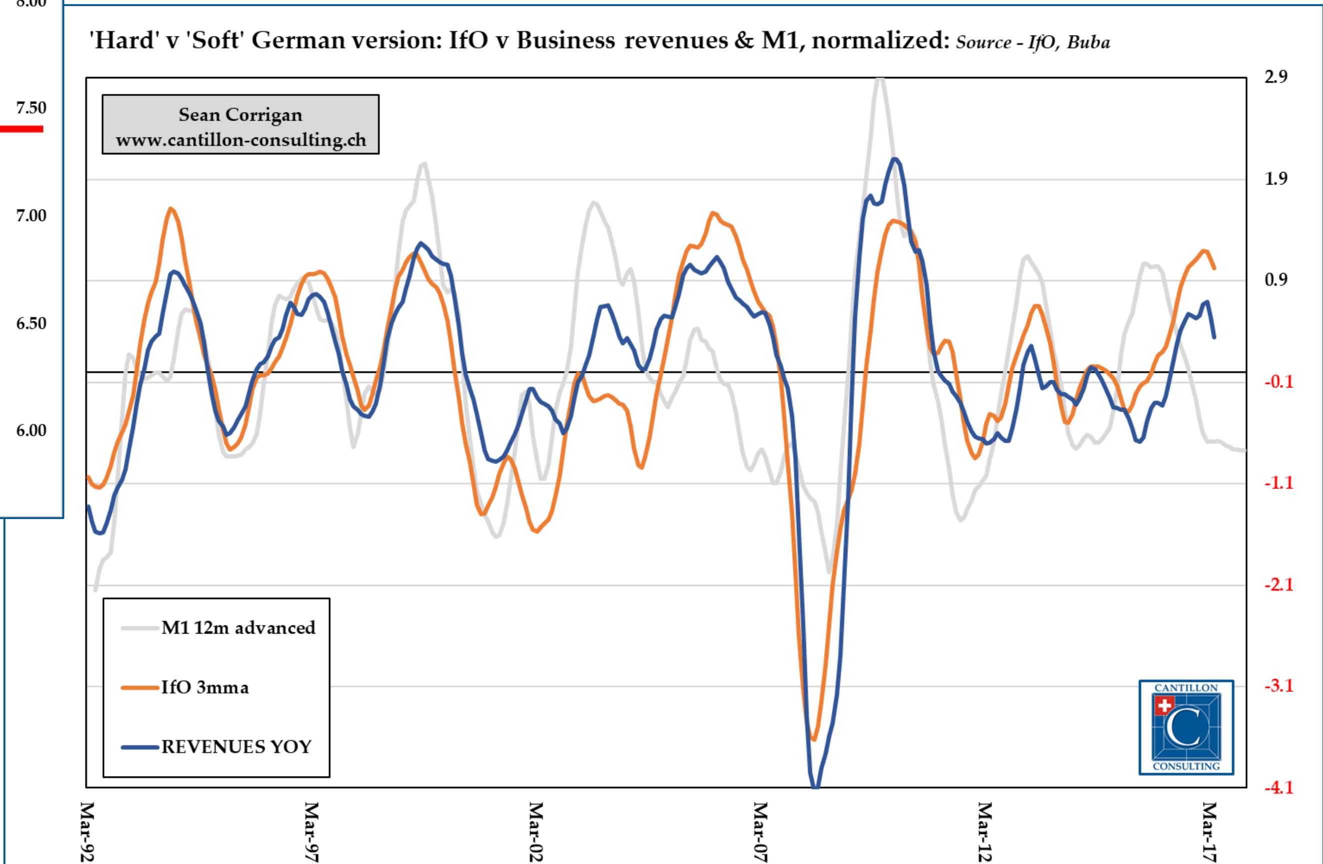


In recent months, the pace of additions - whatever their source – has noticeably slowed. Similarly, the IfO index has come off its record peaks and revenues have started to decline, as one might expect.



Notable deceleration has occurred in German exports both to the EZ (from 10.4% 3mmaYY in January to just 4.8% in April) and the wider world (where a second-difference drop of 6.2% has been suffered)
Though for that latter… perhaps we should look next to China – and perhaps also to the UK.

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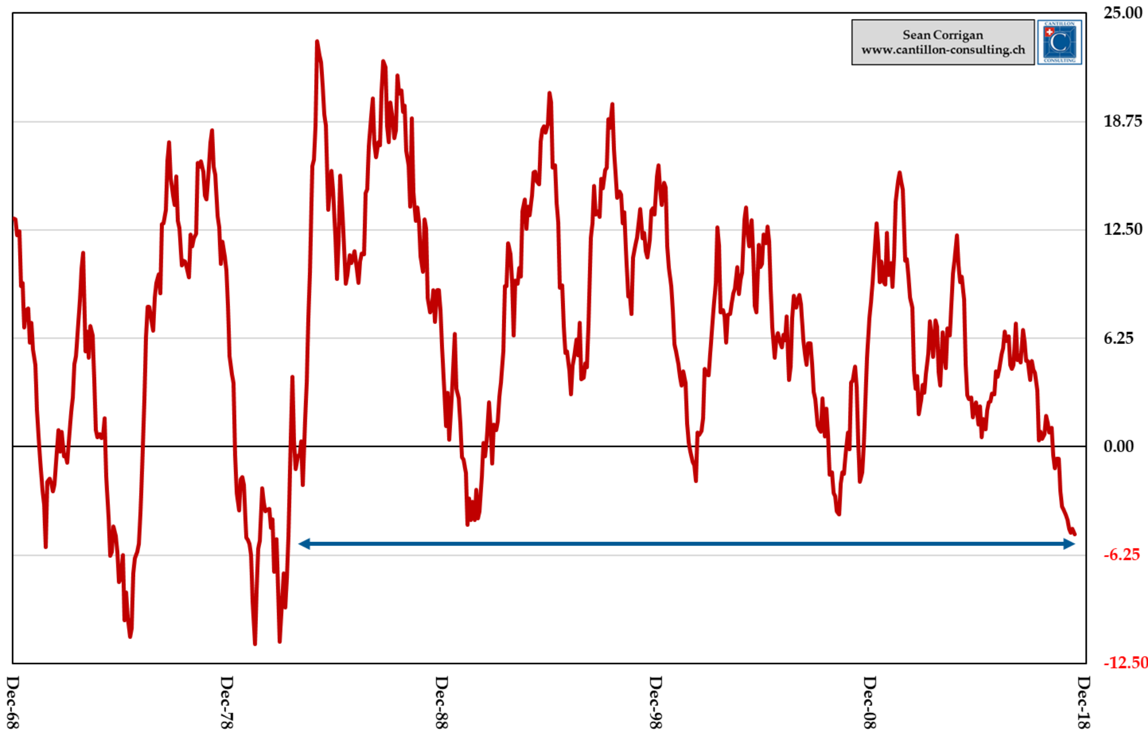
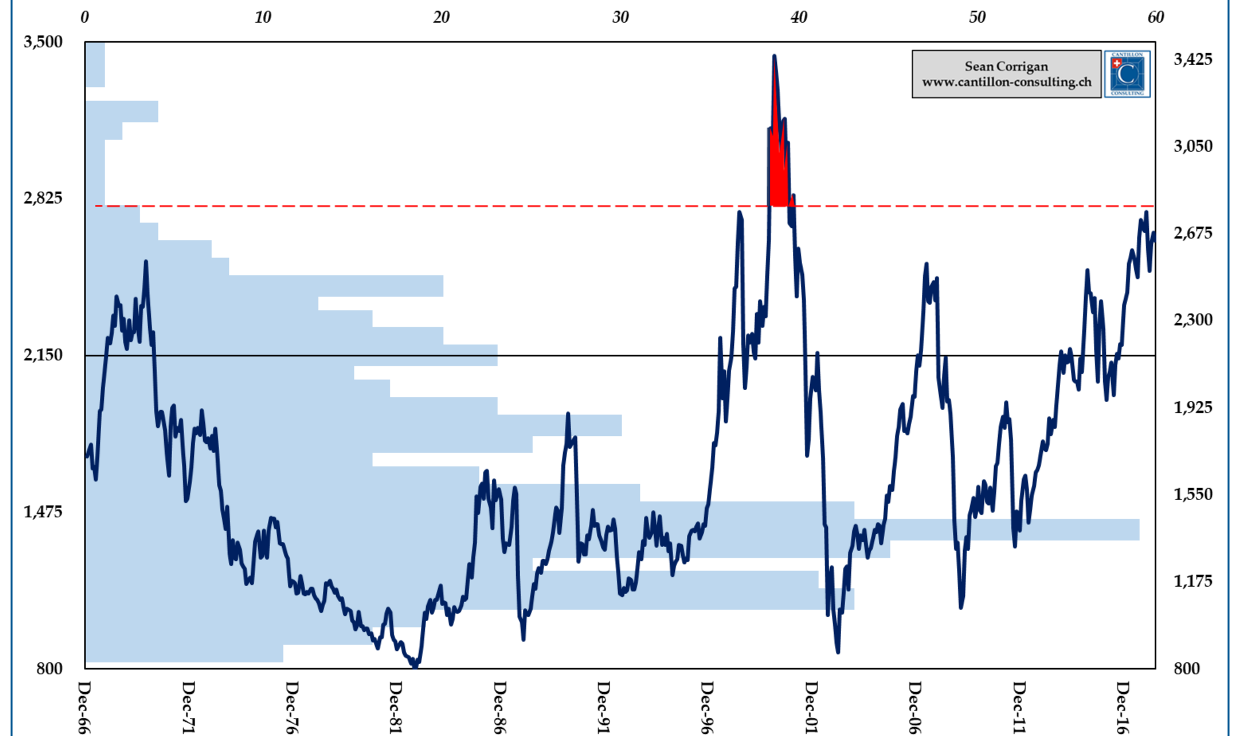


Driven to artificially low real and nominal levels by the ECB, German bonds have already experienced their worst 18 months since the inflationary catastrophes of 1981. A cessation of their mass monetization can only send yields higher even if it does eventually cap price rises. On top of which, spreads elsewhere in the Zone *must* widen. Ugly!



All of which is not overly comforting for a stock market which has only been more expensive to its fixed income counterpart at the height of the Neuer Markt madness at the turn of the century….

UK

UK Real Money Supply, 3mma YOY% and d2[YOY]: *Source - BOE*

If our dearly beloved Bank Governor were to spend a little less time trying to save the planet and generally posturing on the world stage, or making unfounded –not to say subversive- claims with regard to Brexit, he might note that he and his Merry Men have presided over a marked drop in the rate of growth of UK money supply, too; taking it down to levels not experienced since the post-devaluation austerity, back in the early-90s. As a hard money man, I should not wish to be taken as decrying this but I should like to suggest it runs counter to Carney's avowed mission and is something well within his competence to arrest, if only he were paying attention!

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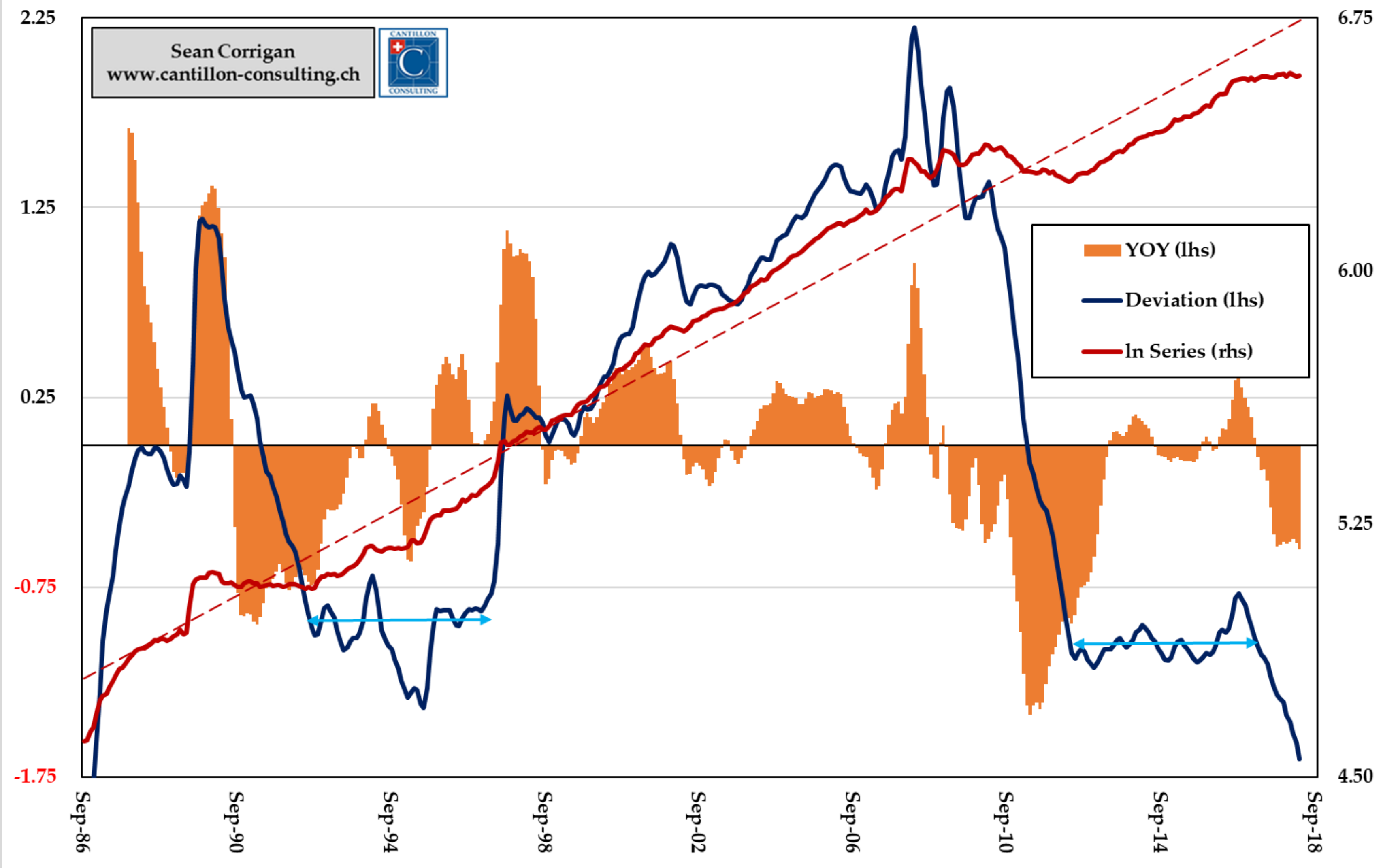

The Old Lady's money numbers are one of the least tractable sets of data with which to work this side of Shanghai, but the gist of this should need little explication. After 5-years or so of growth akin to that seen in the lead up to Northern Rock and all that followed on the global stage, money supply has effectively been frozen for some months now - something which cannot fail to have an impact on the 'real' side in an economy so addicted to an overabundance of the stuff

China

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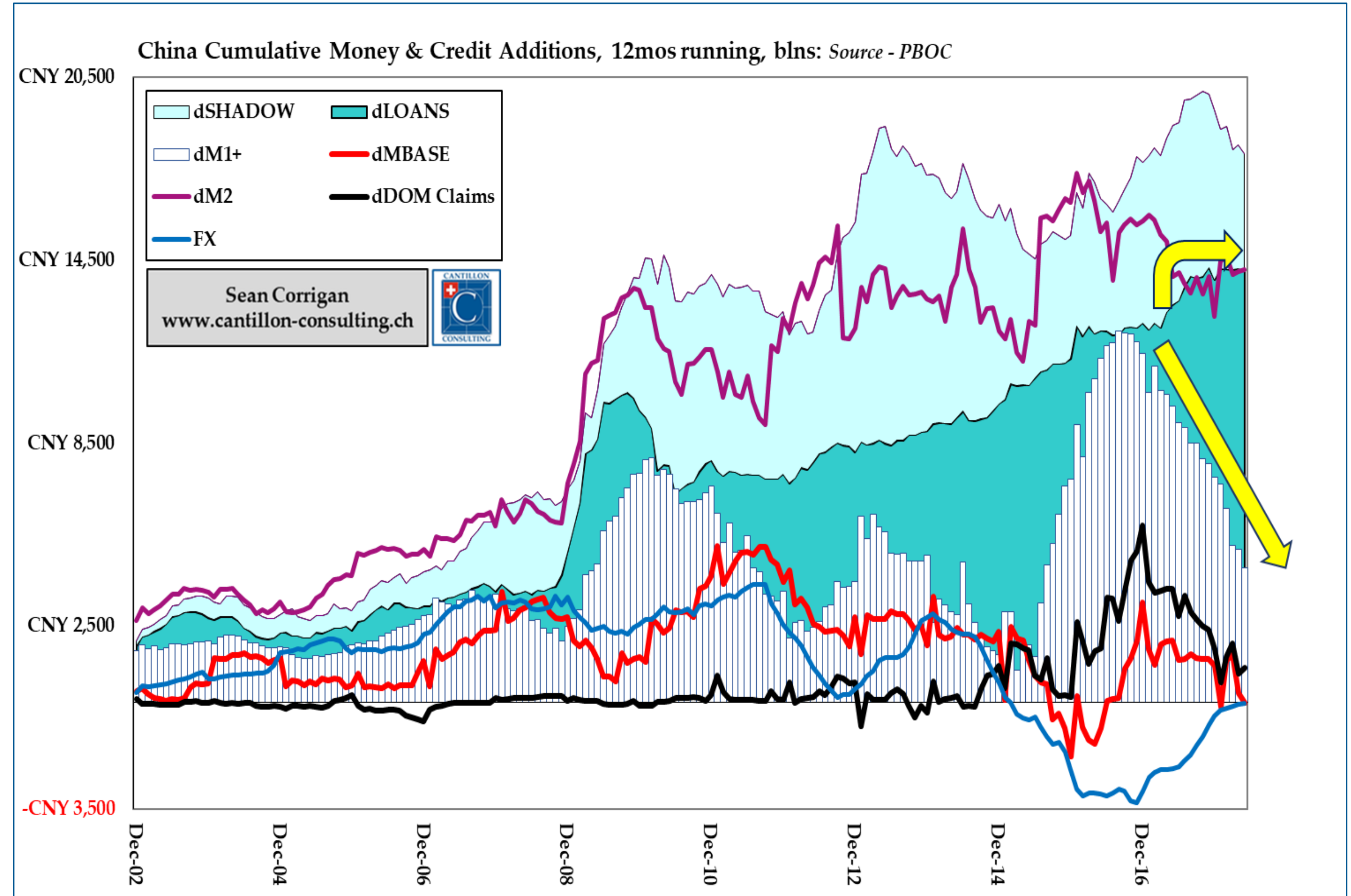
The real Chinese Puzzle. The PBOC wants to clamp down on shadow lending and move credit creation back to the banks it better controls.
However, this has run into the inconvenient fact that deposit growth (white bars) has slumped and loan growth (turquoise field), after a short lag, has therefore become static.
It is now playing with trading cuts in the RRR against a reduction in MLF offerings (which effectively lowered the first, in any case).
Its room for manoeuvre here can bee seen in the fall in domestic OMOs (black line) which has greeted the stabilization of FX reserves (blue) after the swingeing losses of 2015-16



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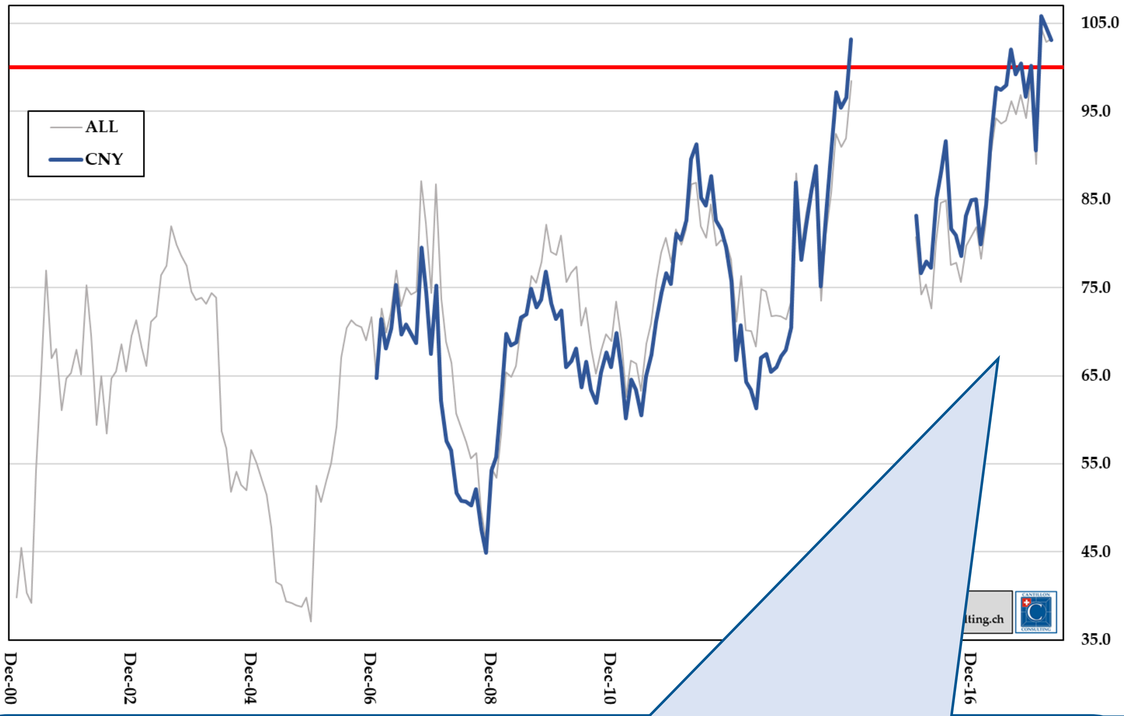
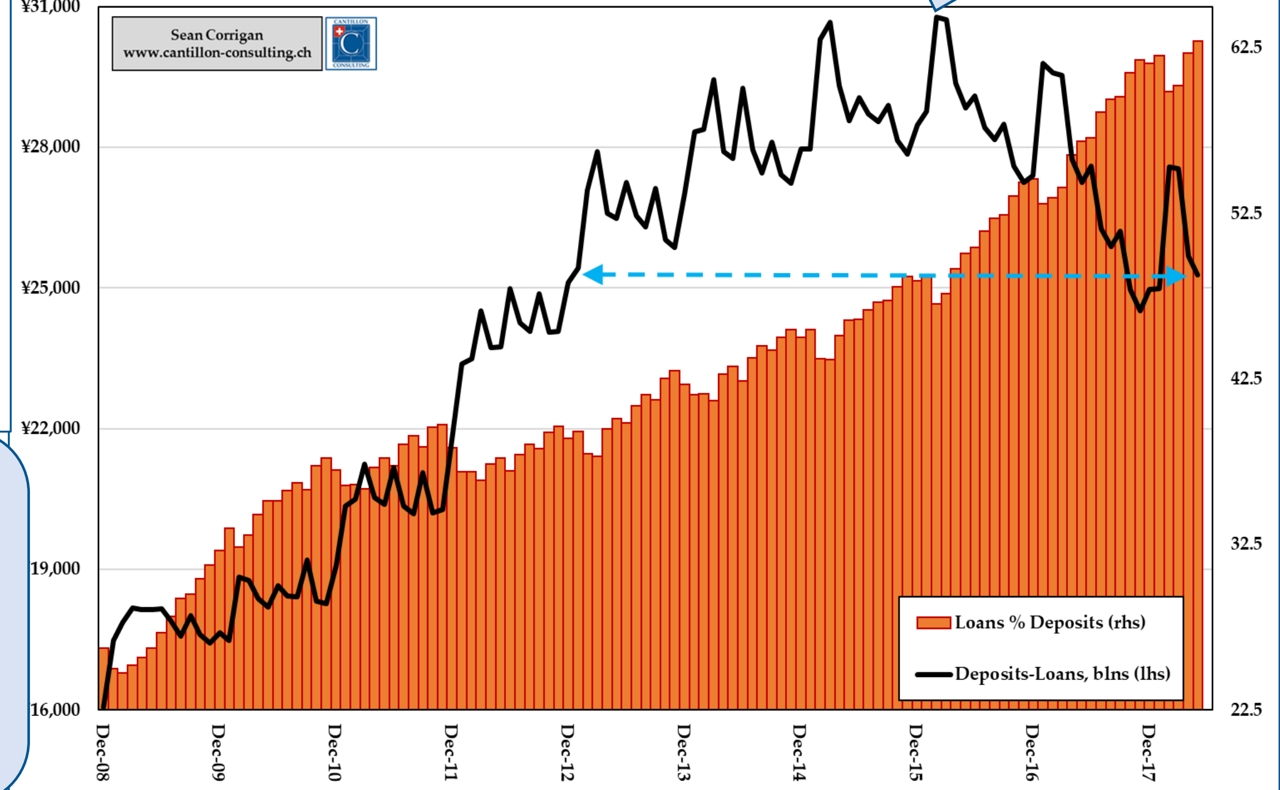
Note, too, that whether they were in the past or no, the Chinese people are no longer quite so keen on saving these days – or not saving at the bank, at least. A fifth of household's net deposit surplus has evaporated in just the past three years. Too many spenders at large!





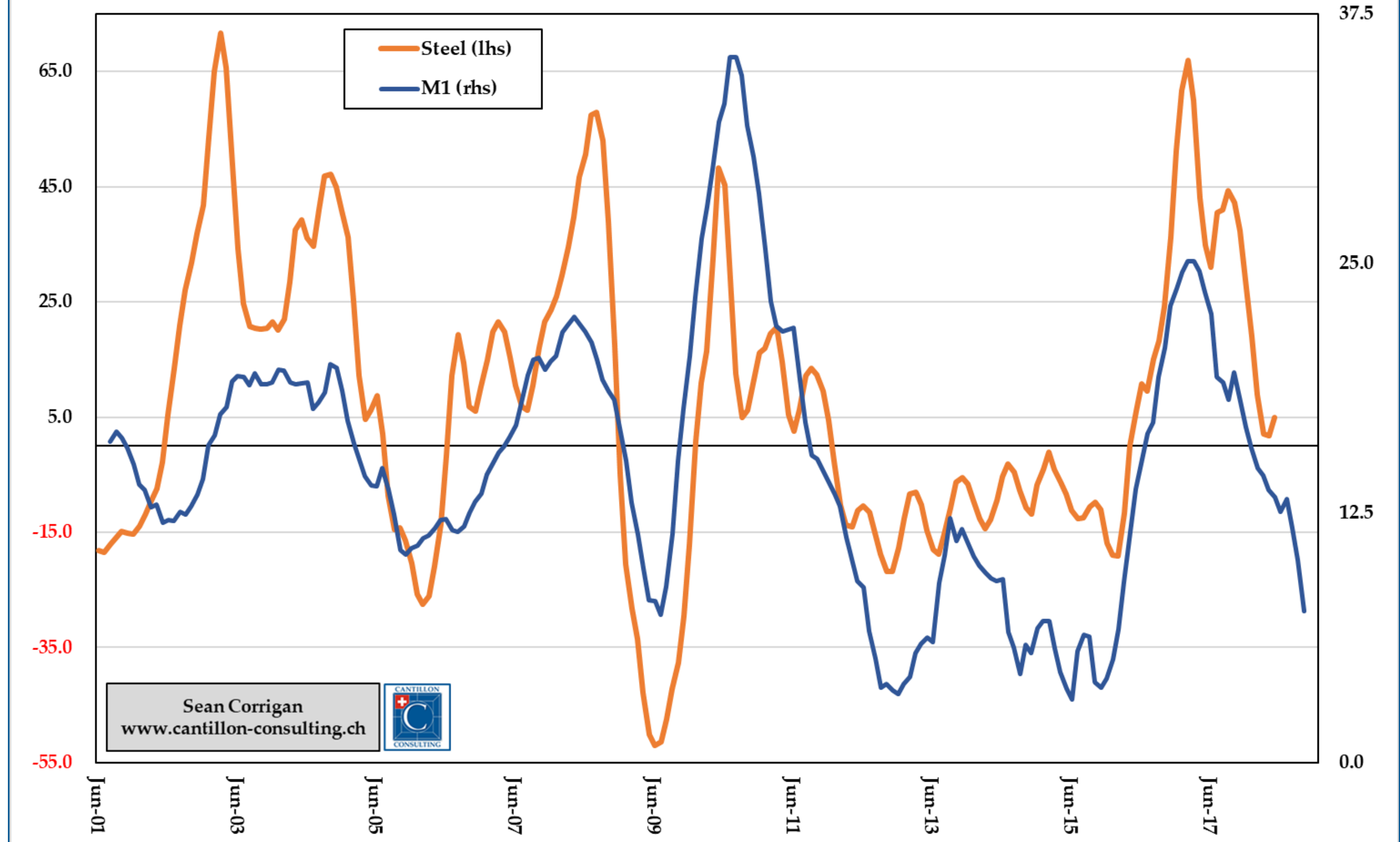
Though, in truth, there is nothing absolutely binding about the 10% ceiling for loan:deposit ratios there are actual target for this measure in China. Furthermore, if they are to be breached, banks need an alternative source of funds but this can only serve to impair their earnings, as well as make their funding base more volatile

As for what that implies for the rest of us?

Well, we can plot the PMIs, agricultural and industrial commodity prices (here, steel), as well as profits and revenues (or at least we could until the latters' numbers last month included some glaring and so far ineradicable inconsistencies v-a-v what we were presented with before) against trends in M1.

The fit never fails to impress.

Given that China is an Austrian Business Cycle laboratory overlaid with a partially-obscured command economy, it should perhaps come as little surprise that we're now slowing.



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Any surprises therefore that stocks have been so disappointing of late?

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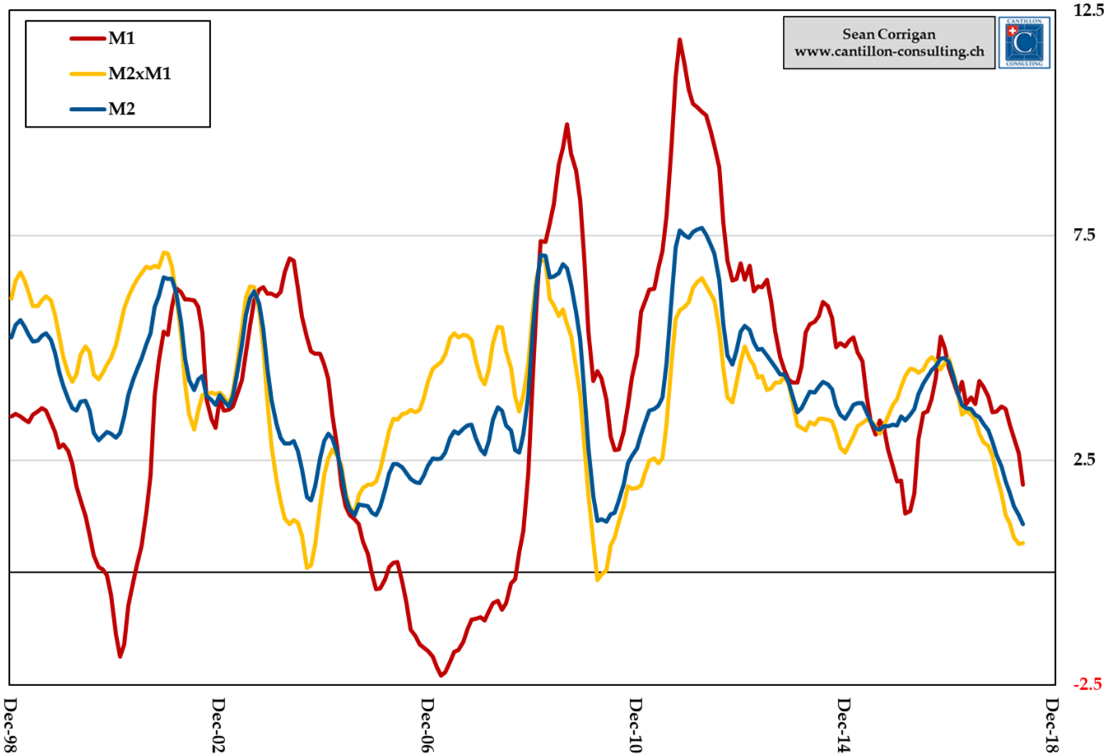
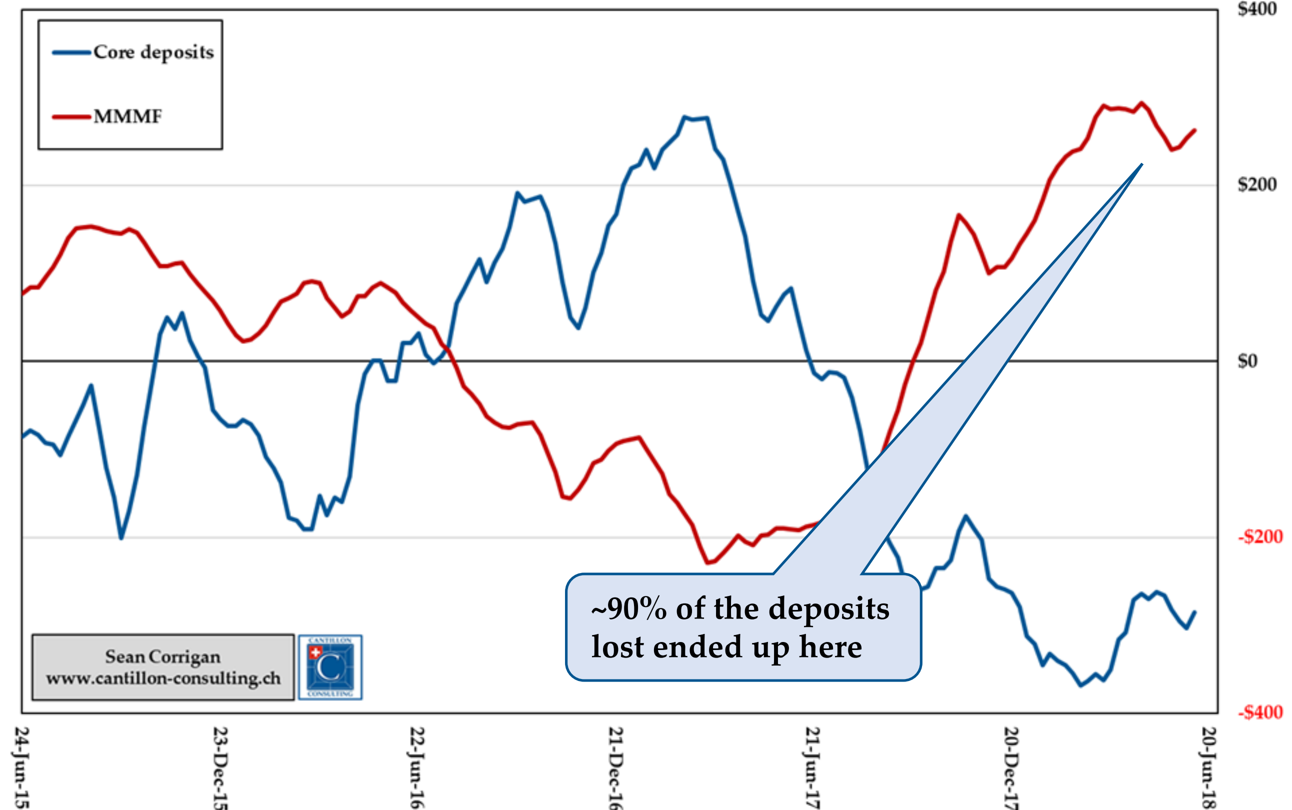
USA



Finally, the US. How much are the *Fed's* actions impacting the market? Certainly money and bank credit has slowed substantially this past 12-months. Ignoring the gyrations around the various incarnations of QE, real M2 has not in fact been this anaemic since 1995.



There *is* a mitigating factor. ZIRP removed much of the incentive to hold savings in their usual form, with little penalty to keeping everything in the transaction account & confusing the analysis. Rate hikes unwind that & money has found other outlets: $160 billion to money market & $325 billion into bonds in a year.

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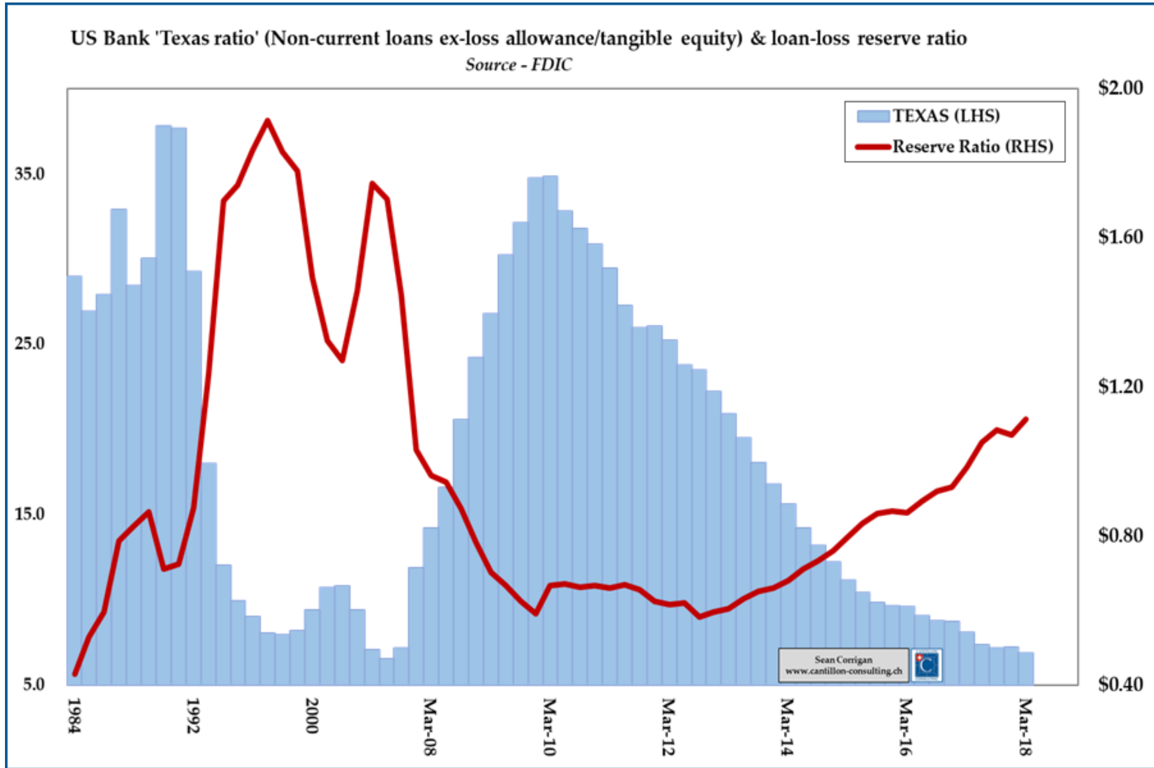
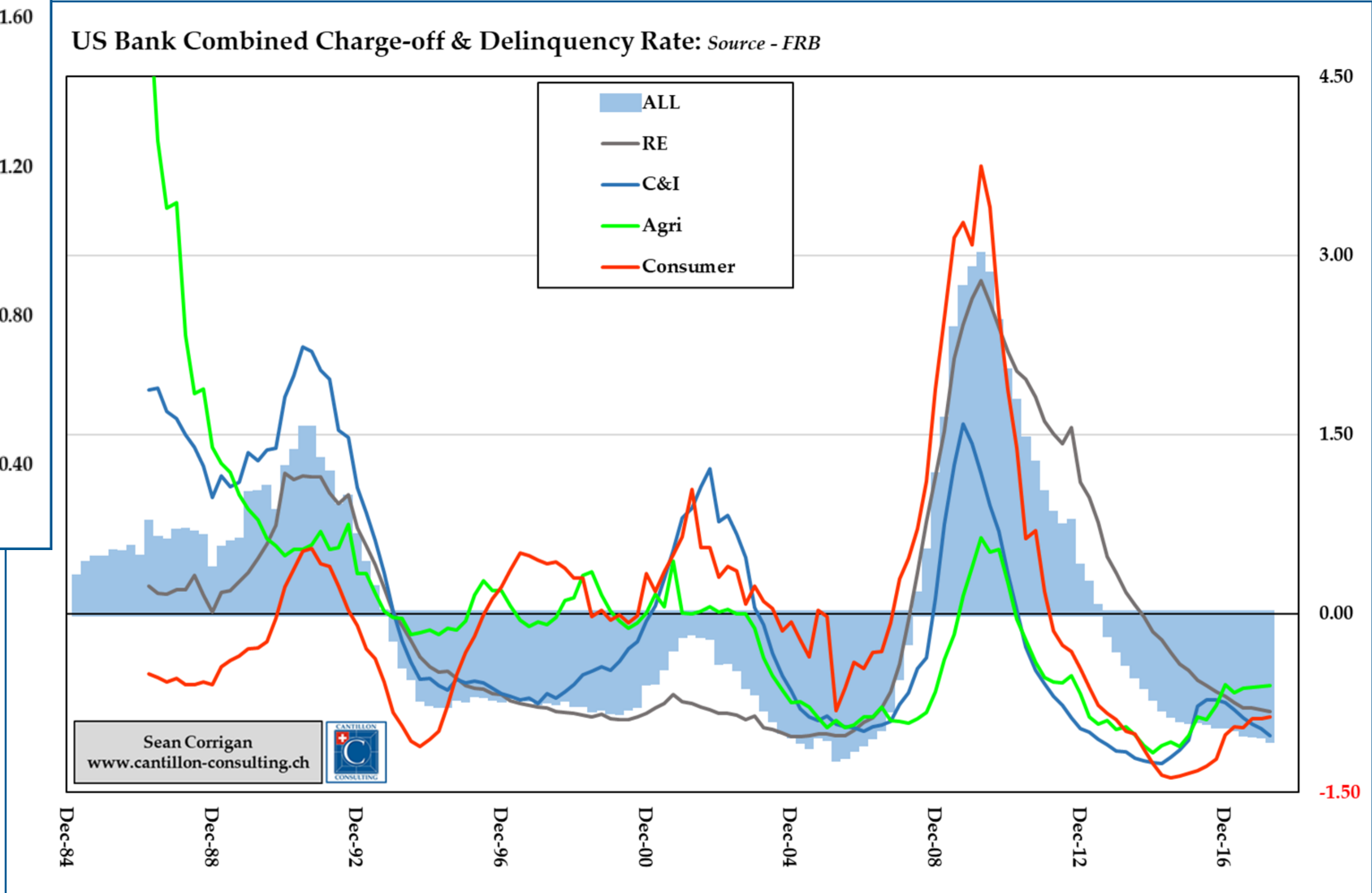


Meanwhile US banks are profitable, lightly leveraged (on aggregate), and reasonably well-provisioned. Getting rid of all those deadweight excess reserves is actually proving a boon



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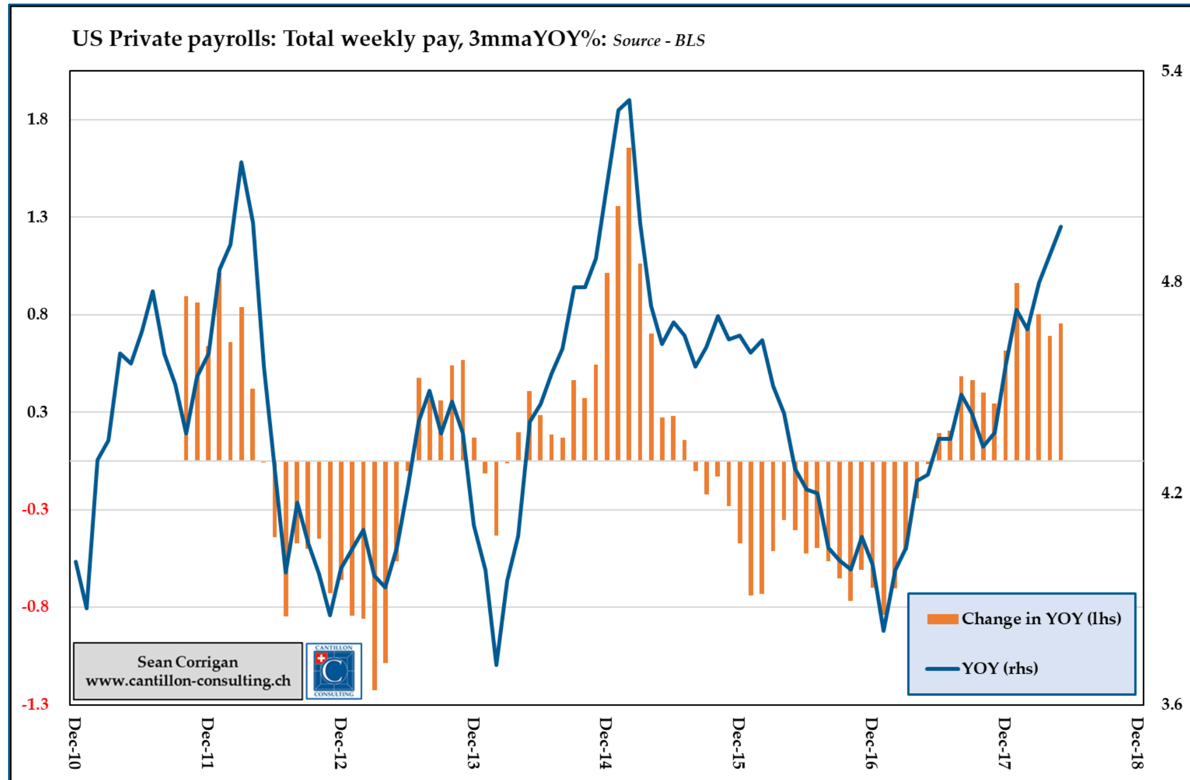
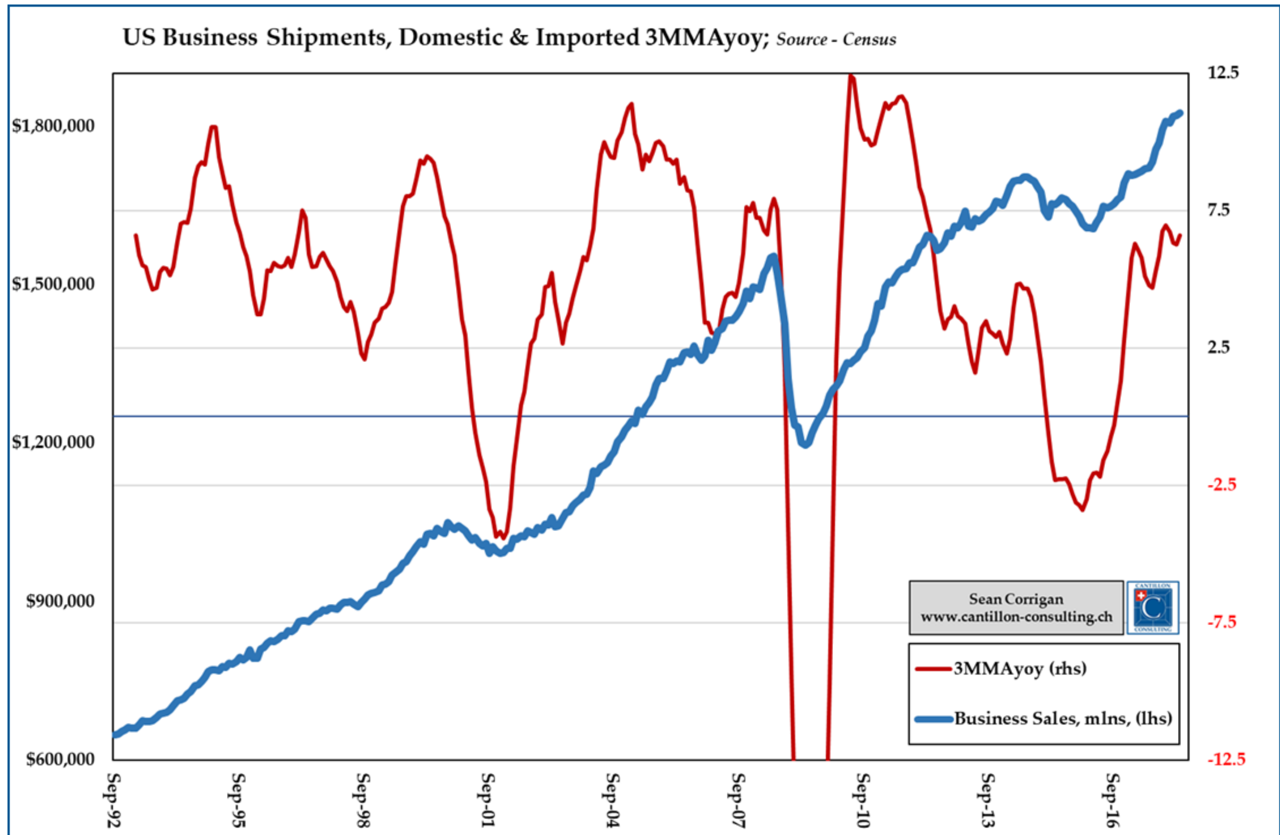
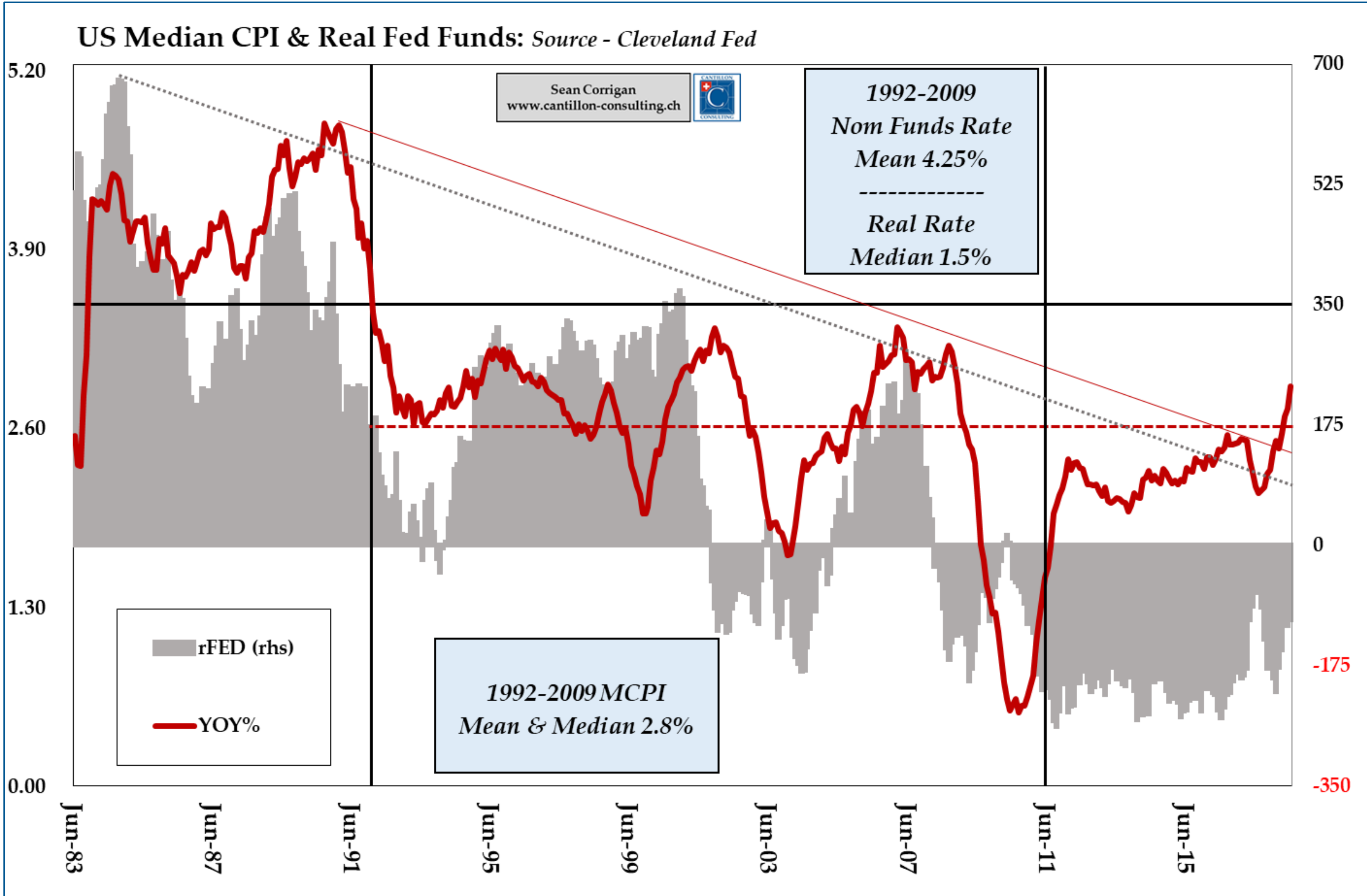


As a result, the job market is looking as strong as it has in years and business cash registers are ringing merrily. Changes in both the measures plotted here have a demonstrable correlation with those effected in the Fed funds rate. Real yields are also still very depressed, despite the moves so far enacted, providing further motivation for the FOMC.



Thus, unless he hits an hidden, underwater mine of financial non-linearity – or an all-too common EM catastrophe- Mr Powell is likely to continue tightening yet awhile.



CPI is now running at the 2.8% median rate of the pre-crisis era - aka the 'Great Moderation'!

In that period, the median real funds rate was PLUS 1.4%: today it still languishes at MINUS 1% - and that without allowing for the fact that the bar was set much higher during that earlier epoch's expansions.

Even allowing for the secular drift lower in real rate peaks (due to the greater debt burdens carried into downturns?), Mr Powell & his colleagues would seem to need a further 200bps REAL rate hike to get back to par

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Nor are conditions in the bond market exactly what you might call stringent

UST10-yr Real Yield via Median CPI: *Source - FRB*

Distribution (lhs)

Real Yield (rhs)

0 5 10 15 20 25 30 35 40 45

9.75 7.50 5.25 3.00 0.75 -1.50 -3.75

Dec-67 Dec-72 Dec-77 Dec-82 Dec-87 Dec-92 Dec-97 Dec-02 Dec-07 Dec-12 Dec-17

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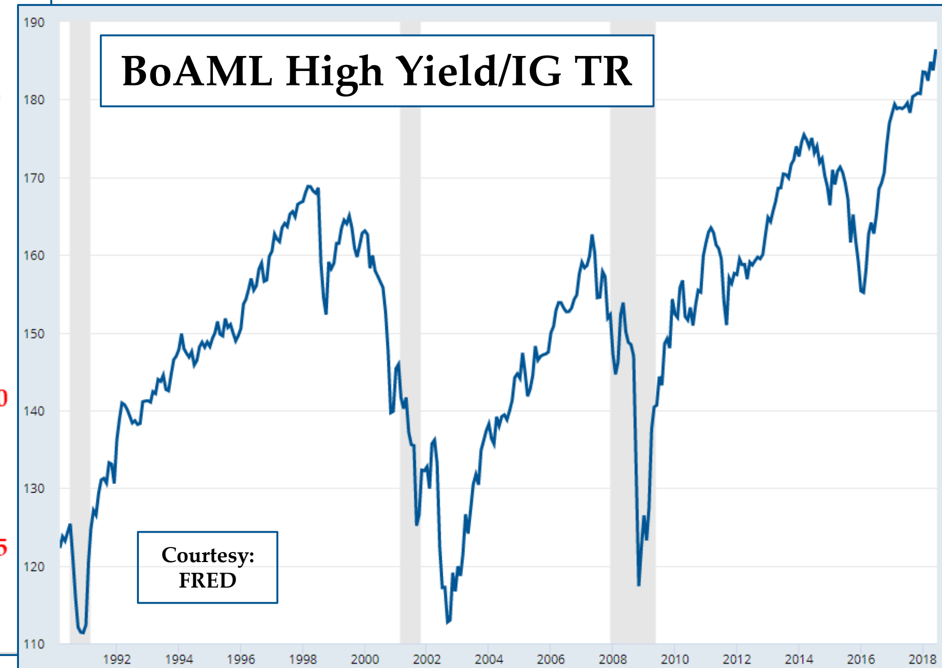
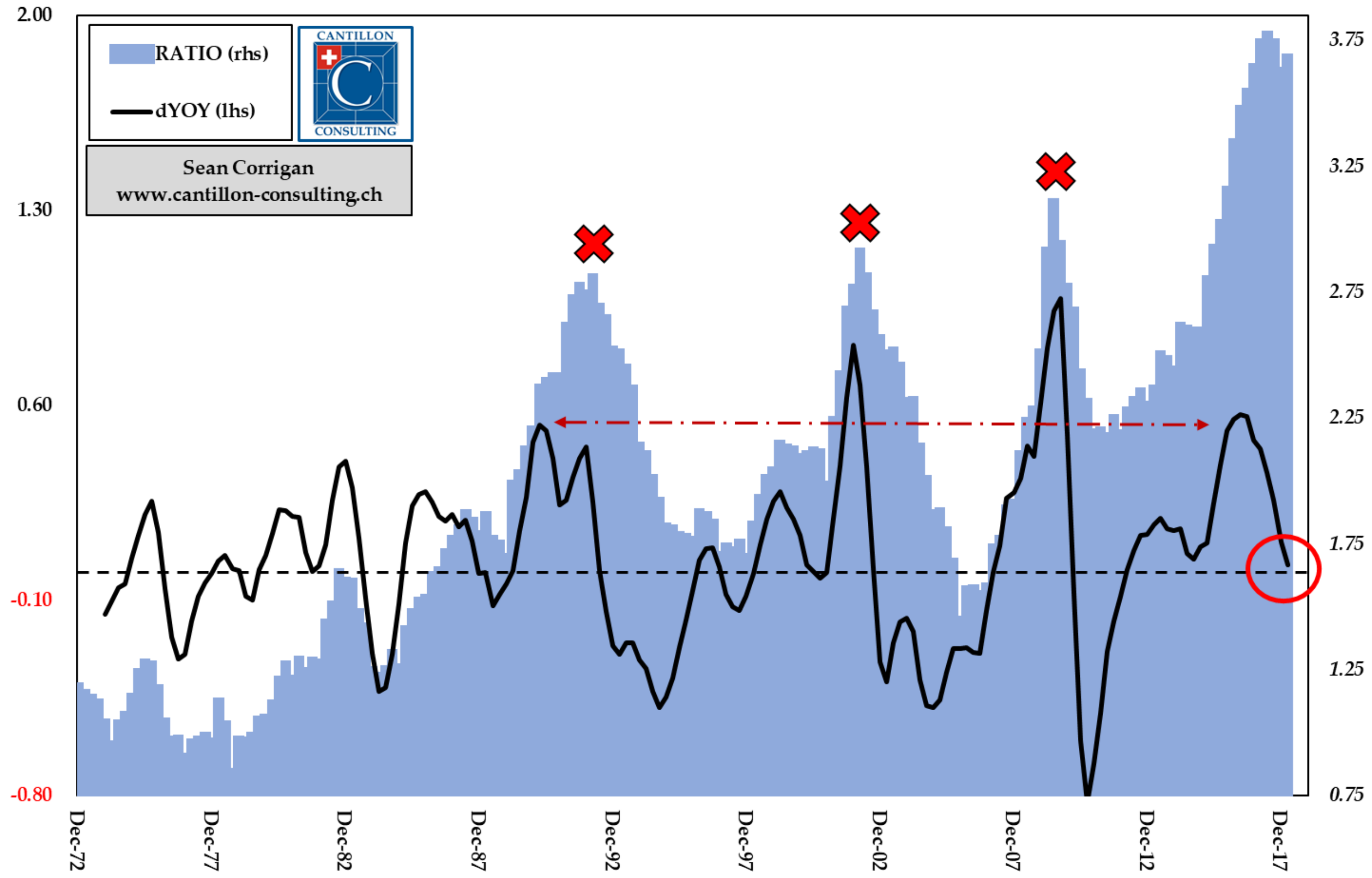




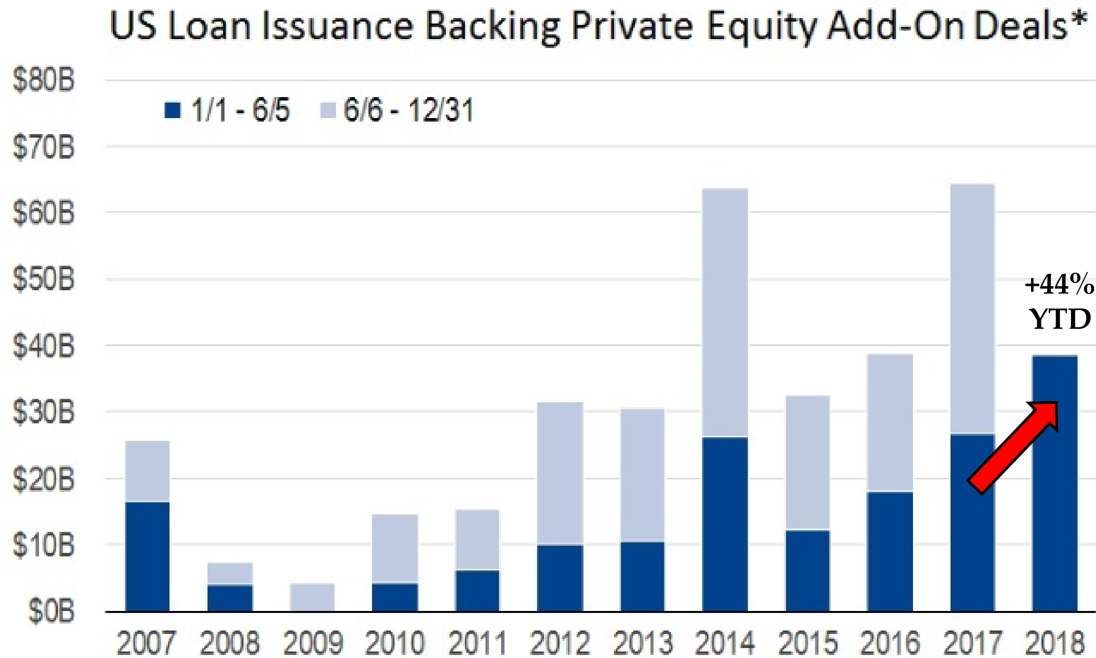
The most visible threat on the horizon is that the long years of loose money have encouraged a marked weakening of corporate balance sheets.

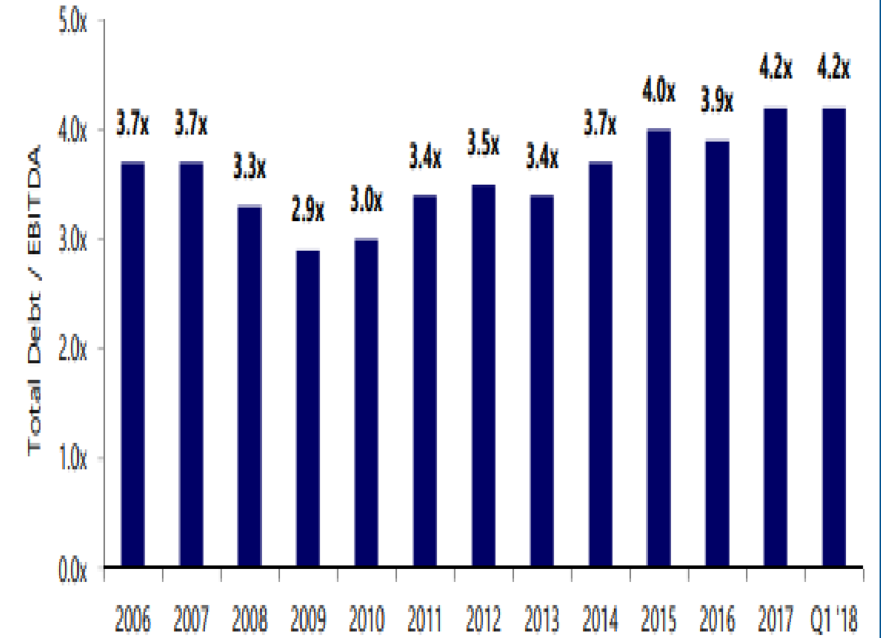
Though today's levels exceed the previous cycle peaks, there is one - possibly saving – distinction: Those prior excess were reached when earnings collapsed in the Bust, but this time it is the *growth* in those same earnings which has halted the rise in exposure.

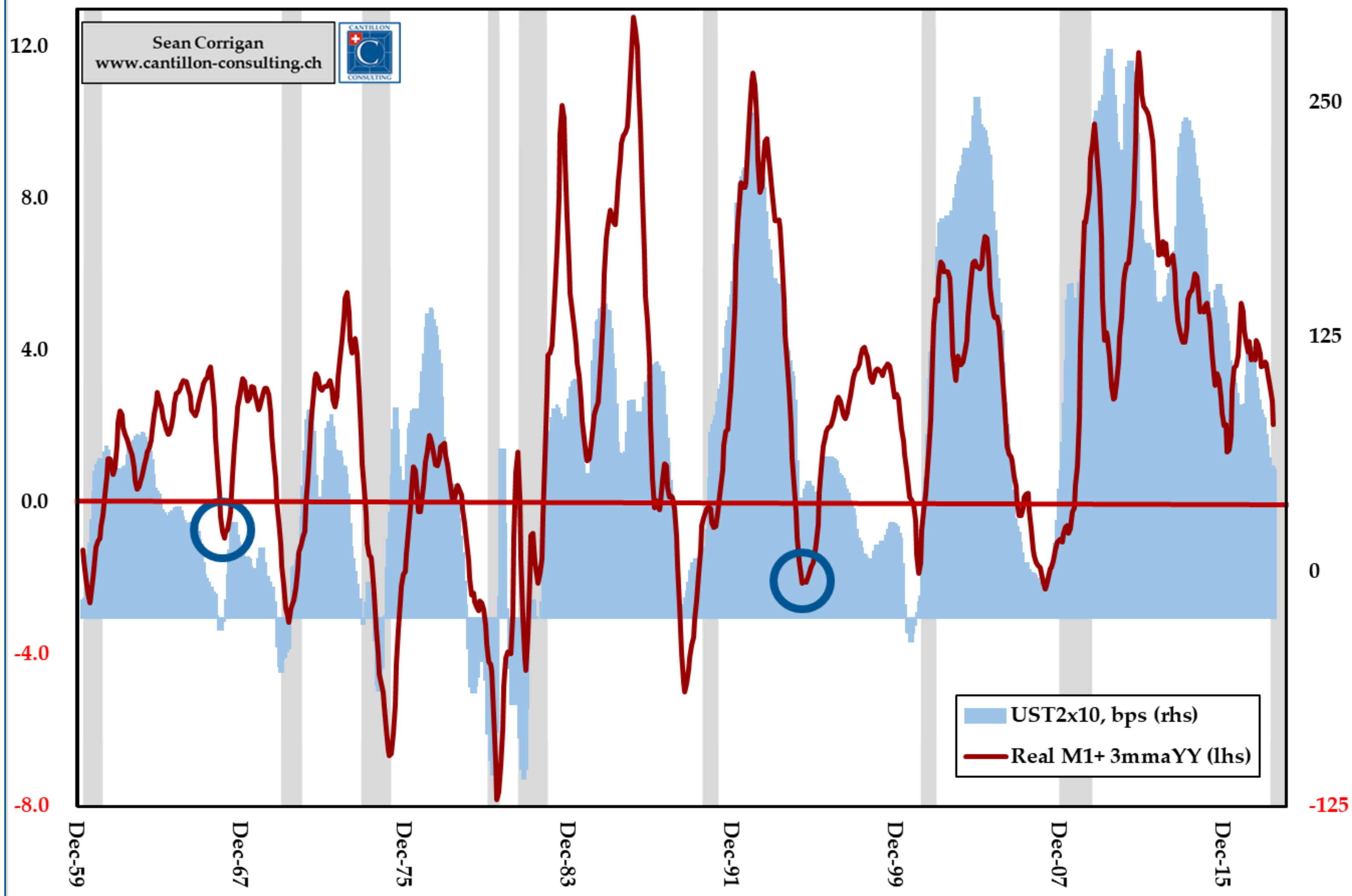
At 3.8%, net debt for manufacturers has grown at its slowest pace in 6 ½ years while operating income is showing its quickest rise in three at 6.7%.

There is hope, yet!

The usual suspects also hint at a certain innate fragility…







This, arguably, is the most important chart of all.

It shows how tighter liquidity tends to compress the yield curve and the distress of which those two phenomena are symptomatic tends to presage recessions in exactly the manner Hayek elaborated upon, 80 years ago.

Of the only two false alarms in half a century, the lattermost occurred when the Fed was making important changes to its reserve regime, thus possibly confusing the signal, though both the episodes circled are, in fact, OECD-designated 'recessions', if not NBER ones.

Today's readings, you will note, are not yet critical, though the margin for error *is* clearly dwindling.

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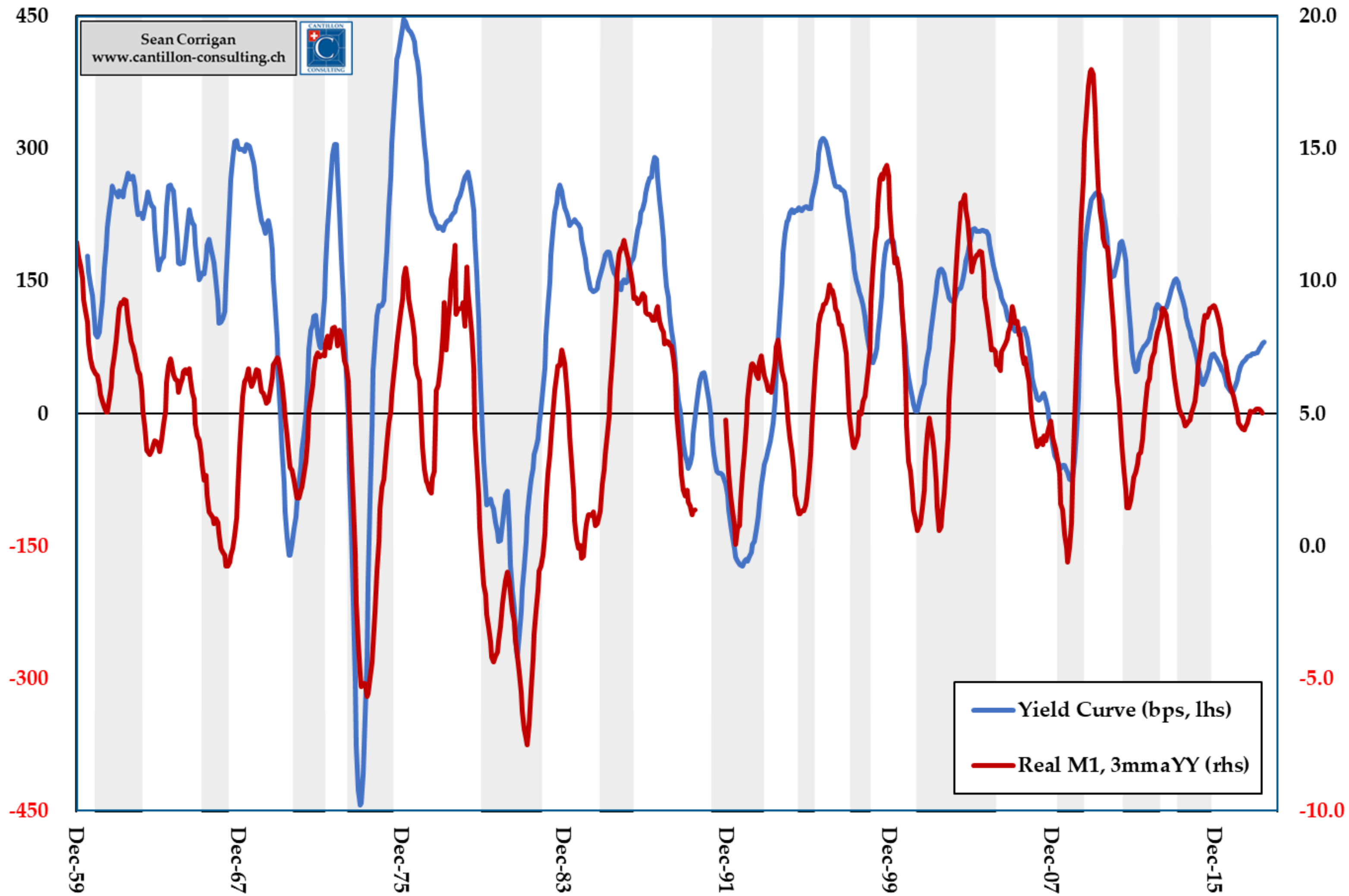

Germany shows a broadly similar pattern to the USA, as we might expect of the workings of this fundamental dynamic

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