Money, Macro & Markets Monitor

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October 2018

Increased Physical Demand
Raw Materials
Petrodollar Pump; 'Core' CPI targets
Trade & Industry
MONEY & CREDIT
Austrian Business Cycle Theory
Financial 'innovation CB/Fiscal Policy

'Alternative Assets' Financialization
Raw Materials
'Chicken Farmer' Investment Demand
Money & Credit
TRADE & INDUSTRY
'Real Bills' Credit Elasticity
New Tech; 'Frontier Markets'

Financial Assets, RE, Art
Possible Spill-over
Raw Materials
Claims to existing capital preferred to construction of new
MONEY & CREDIT
Trade & Industry
Asset - Collateral Spiral

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

IN THIS ISSUE:-

Don't chase the Base

Resisting the Impulse

Main St. rediscovers its love for Uncle Sam

Europe & Japan: direct & indirect lenders

Balance sheet blues v revenue repair

US equities still leading the way

Yields probing higher

Oil barrels north

Copper: will anyone bid me $3?

Rising rates bug gold

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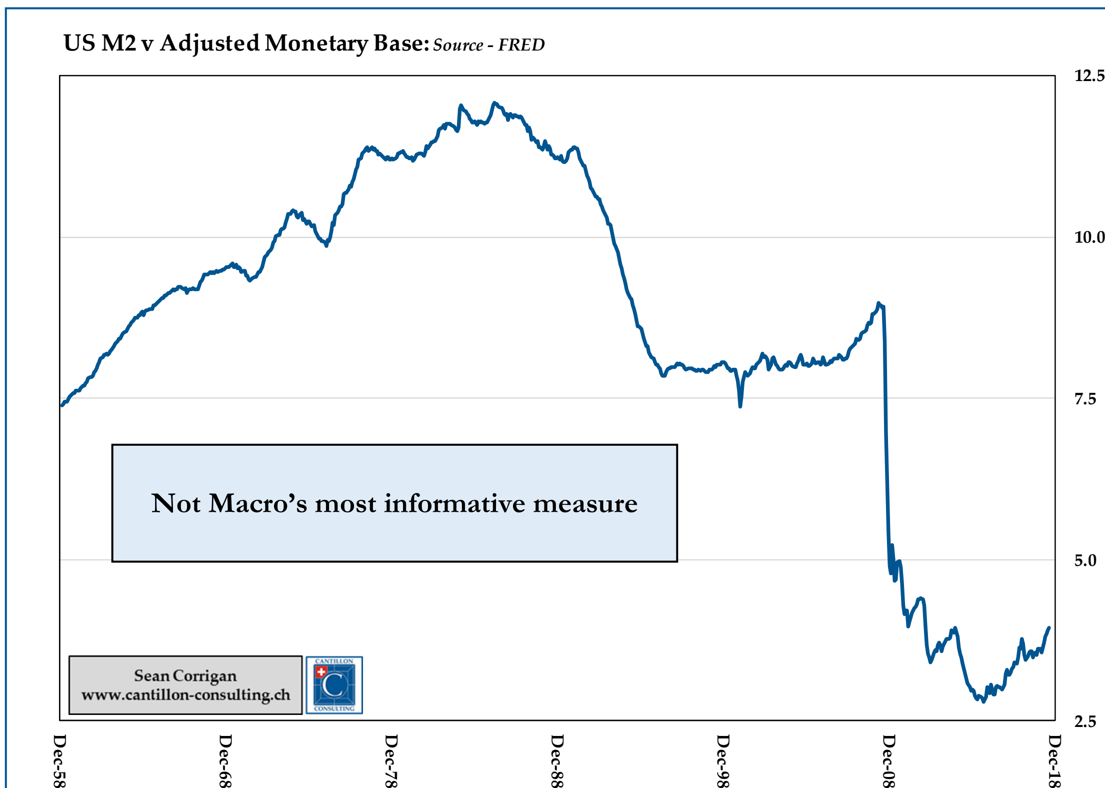
Damned if we do: damned if we don't

Leaf through any collection of economic commentary or (Heaven forfend!) scroll through Twitter and you will rapidly encounter any number of half-formed presentiments of doom, the main two strands of which take the mutually contradictory stance that debt of all sorts—and especially of the less 'respectable' kind—is mounting with dangerous rapidity and, conversely, that the Fed's actions to trim its overblown balance sheet, coupled with its steady delivery of drip-feed rate hikes, is far too much for the system to bear and so risks provoking an immediate crash.

Thus it is that policy is seemingly both too tight and not tight enough: that credit is too readily available and yet, at the same moment, in desperately short supply. So eager is everyone to set down a marker upon which later to base the claim that they were among the select few who this time 'Saw It Coming' that you do not even have to search particularly hard among the populous class of Carrollean Permabears to find those who believe at least two, if not the whole of Alice's six, impossible things before breakfast at one and the same time.

Thus, the financial echo-chamber resounds with admonitions to the effect that the global monetary base or else, right at the other end of the inverted pyramid, that strange beast, the 'credit impulse', is shrinking and with them all prospect of a continued rise in the price of speculative assets.



While we would be the last to argue that trends in money and credit are not crucial to the progression of the economic cycle (hint: look up the man from whom our firm takes its name), we would insist that the first is a highly suspect measure with far too many loose and elastic joints between it and the sharp end of the economy, especially in a world of non-binding reserve requirements, shrunken interest rates, severely compressed interest differentials, and significant institutional and regulatory changes.

Just look at the USA. From the ratio of around 8:1 which prevailed between M2 and the monetary base at the start of the 60s, the ratio had expanded to 12:1 by the mid-80s before dipping slightly into 1990; then slumped back to around 8:1 during the next few years' 'credit crunch'. An uptick to 2006's local maximum of around 9:1 all too briefly followed before the gauge plummeted in the GFC and then bled away in the ensuing QE to a paltry 2.8:1—from which nadir it has since struggled back to near 4:1.

Could anyone relying on this most inconstant of yardsticks have accurately forecast any of the ups and downs of the economy during that stretch? We would suggest not.

As for that other *concept du jour,* the 'impulse', we, too, have long paid attention to second differences and deviations from trend and not just rates of change, building upon the insights of our early-18th century inspiration, M. Cantillon, to consider not just the direction and magnitude of the flow of money and credit but how these vary from what one has recently become accustomed to in one's dealings and in forming one's entrepreneurial (as well as one's more narrowly speculative) estimations.

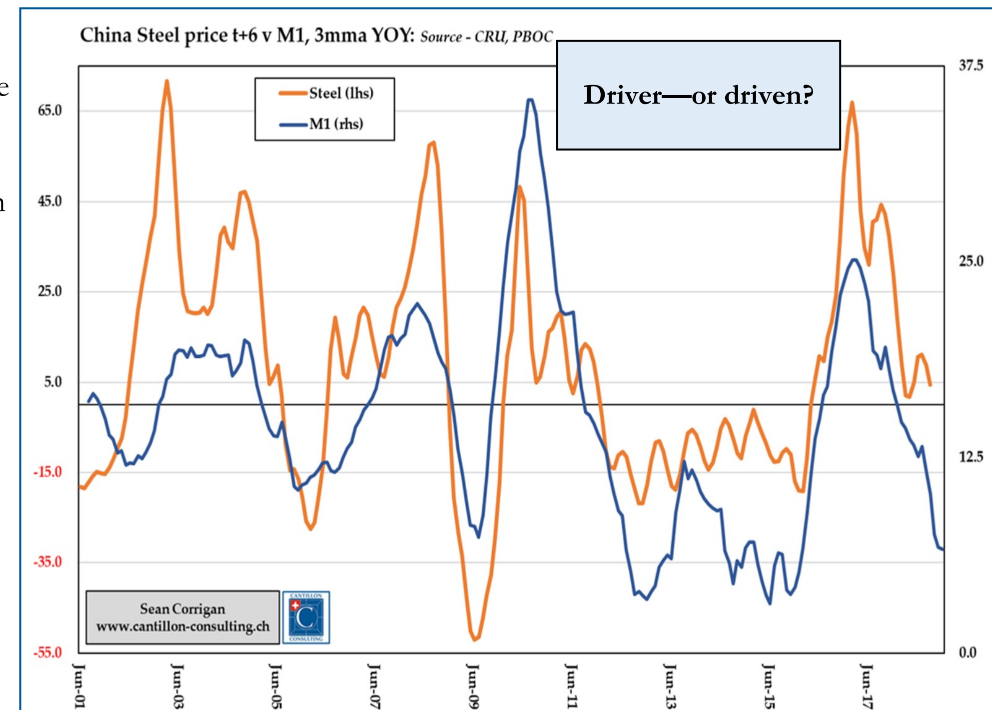
Our quibble with the vogue for this measure is that it has become well nigh ubiquitous as well as far too mechanically applied. 'Credit' itself is an overly nebulous term to be of genuine use—what forms of credit are we calculating and to whom is it being extended? The best one can say is that its definition is not quite so malleable as that other will-o'-the-wisp, 'liquidity'. Moreover, the critical distinction between credit willingly saved *ex ante* and those same means found to have been momentarily foisted upon some depositor or other claim holder *ex post* at the instant of compiling the data, is similarly too little discussed by those bandying the number about. Furthermore, scaling it by GDP raises problems of its own for those of us who like to look at the concertina movement of transactions taking place up and down the chain of production and not just at the final puff of air coming out of its sound-box.

Thus, we must counsel caution in the interpretation of such data. It is neither true that all extra debt is inherently evil, nor that if it accumulates more rapidly than GDP it is necessarily bad (though this happenstance should certainly elicit a certain wariness). This is because the ongoing specialisation of function and lengthening of the chains of production which is generally so enriching must inevitably require more recording of obligations between those newly involved in the greater number of stages as it implicitly registering their greater capital needs. Thus, this increase is not necessarily to be reflected one-for-one in the increase in final, saleable output one might expect to result from such a reorganisation of the processes involved.

A further objection to the current fashion of wheeling out some graphical 'impulse' at every opportunity is the rather basic question of causation. As the cog wheels displayed on our title page are supposed to illustrate, sometimes a new flood of money will percolate through the economy and entrain real-side effects as it does. Sometimes, however, new forms of activity are instituted and call forth the means of payment needed for their undertaking as they begin to burgeon into life. Credit chickens and engineering eggs can make for a dog's breakfast.

It is the curse of our existing system that either impetus can lead too readily to Boom and Bust if the money and credit flow consists of too much 'water' rather than representing the mobilisation of savings and hence the formation of genuine, as opposed to 'fictitious', capital. But, whatever the outcome—and no matter how close the correlation—it is rather presumptuous to say credit is the driver and not the driven in any particular instance.

Finally, it should be borne in mind that while the delineation between 'money' and 'credit' is at best fuzzy in the modern setting, as is also now the frontier between the key *transactional* holdings of the former and the QE-inspired intrusion of *savings* into the self-same banking accounts which contain them, this difference has still not lost all meaning. 'Silver (money) is the true sinews of the circulation', not credit.



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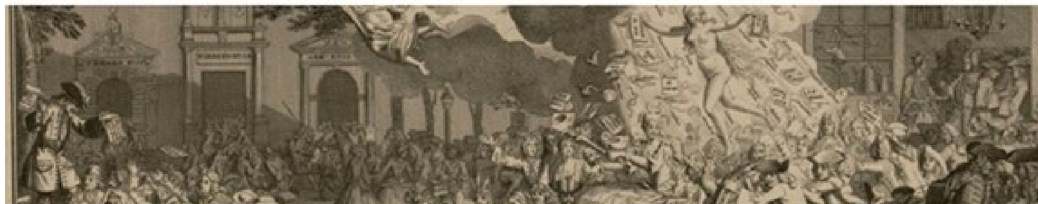
'Silver alone is the True Sinews of the Circulation' - *Essai sur la Nature du Commerce en général*



For much more, please visit the blog: www.truesinews.com

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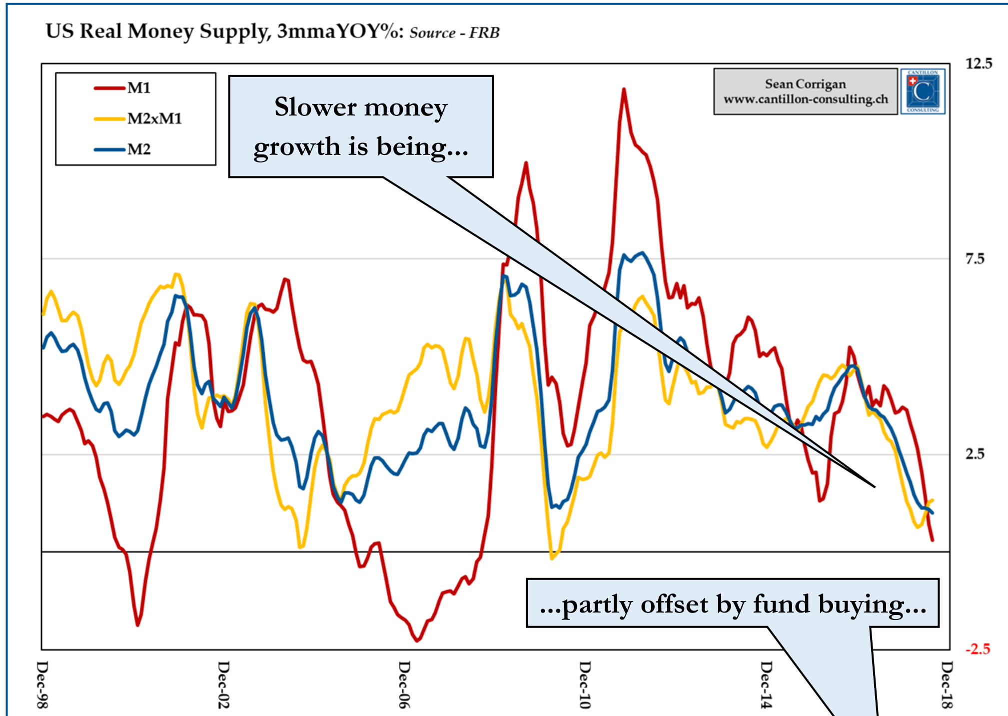
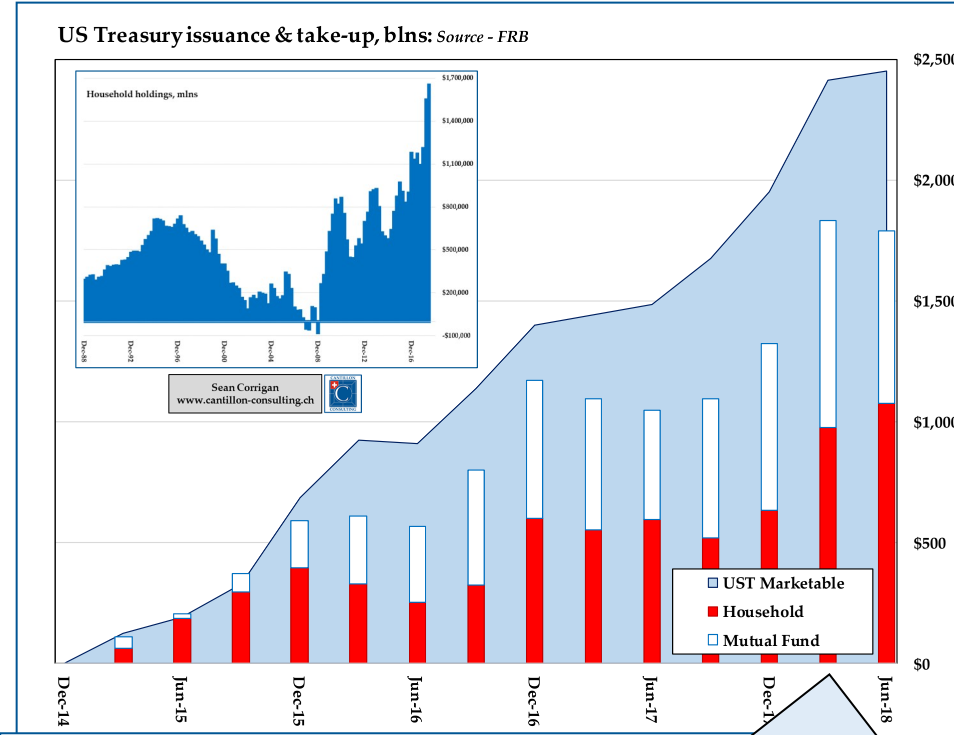
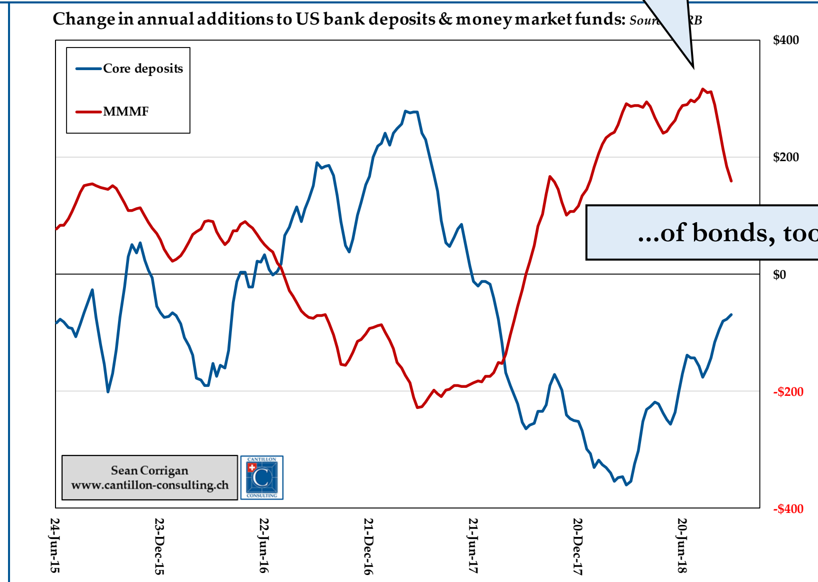
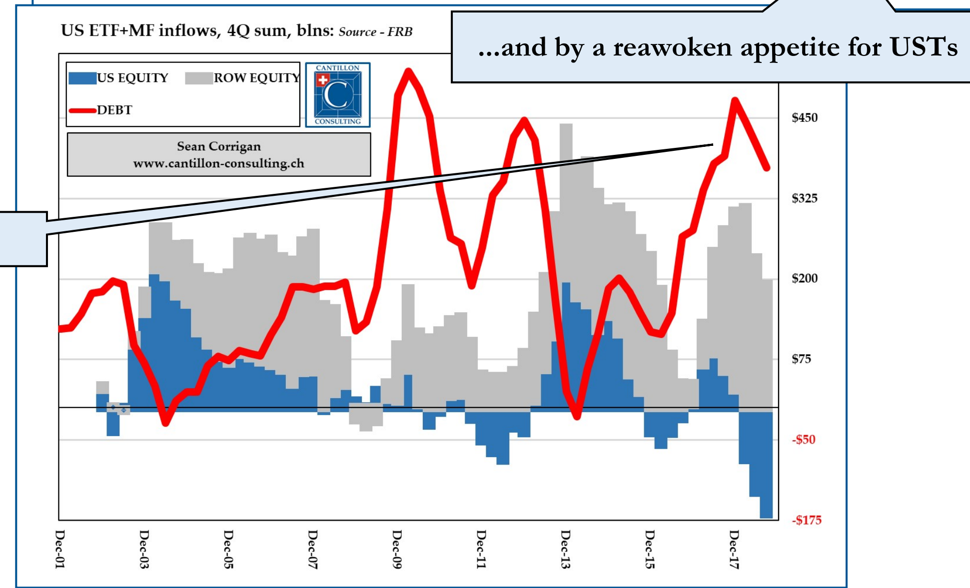
Since 2014, Households have bought 45% of new UST supply with mutual funds taking another 30% as funds formerly idled against IOER are again put to use

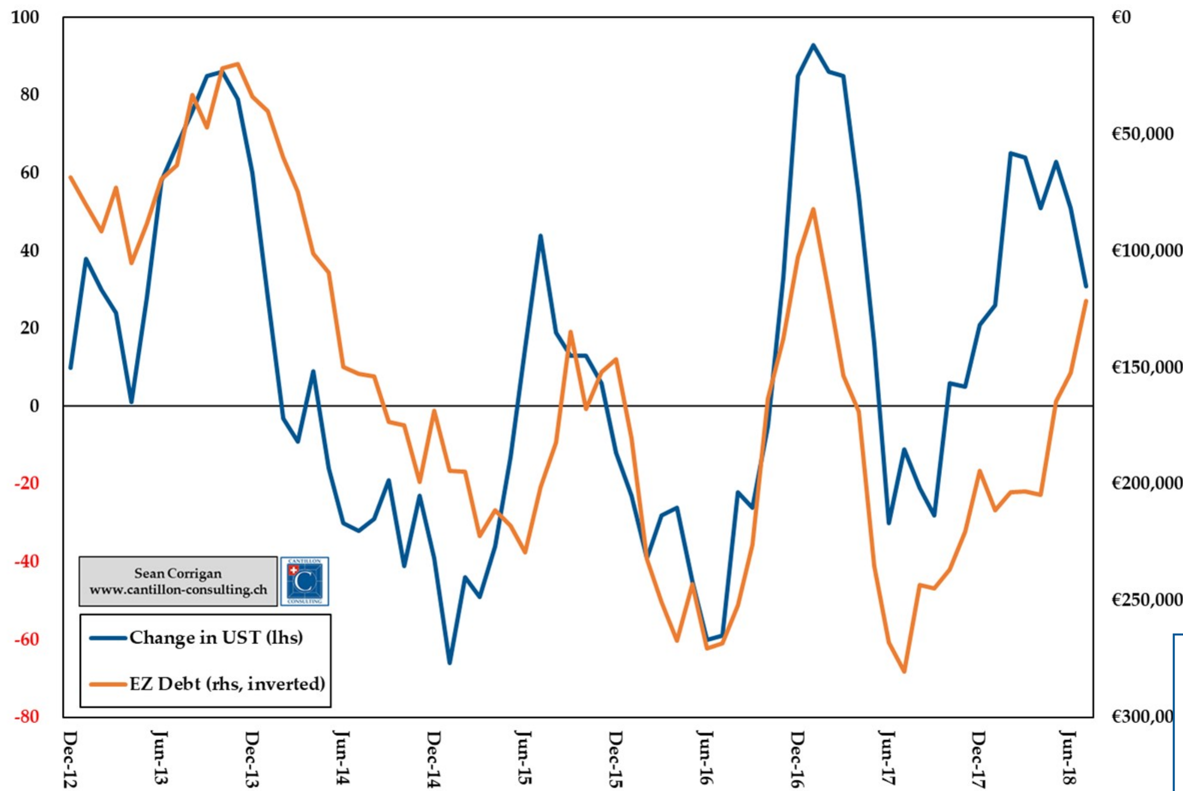








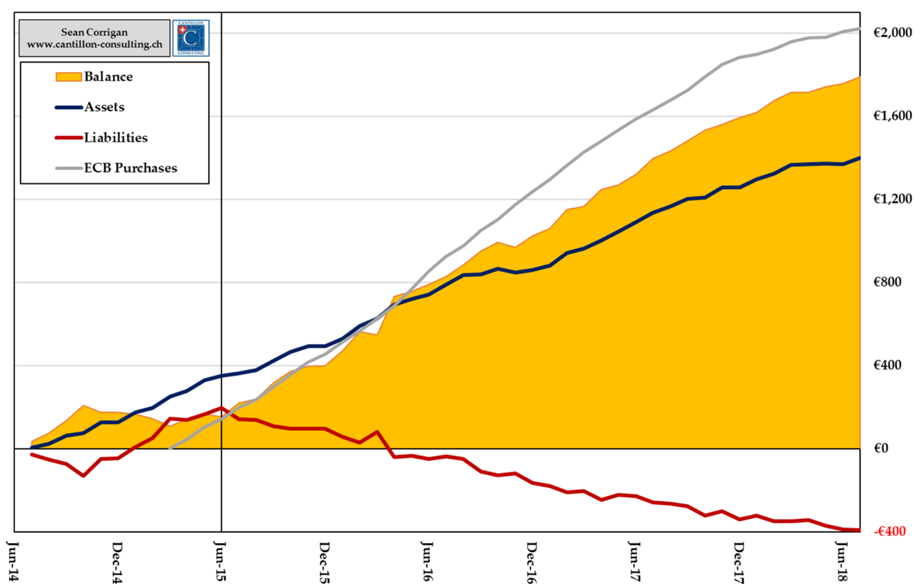
So far, this 'substitution' effect is dulling the impact of the Fed unwind, lessening QE's inflationary overhang, and damping the impact of greater Treasury issuance



We have shown the chart below on several occasions in order to highlight the fact that Fed policy is not the only game in town given that the ECB, in particular, continues to suck duration out of the global market and distort asset prices as it does so.

What we have NOT previously presented is the detail of that yield vacuum as it varies in intensity from month to month and its evident effect on US long yields (see left).

Since the end of 2014, the US version of its BOP figures shows that some 60% of the ROW's net portfolio debt purchases of just over $1 trillion came from the Eurozone, with a further 23% coming from the UK (some of that no doubt re-exported from original EZ investors). China, meanwhile was a heavy net seller (largely during the capital flight of 2015/16 which cost the nation a quarter of its FX reserves)



Therefore, as we continue to argue, US curve flattening is NOT principally due to the strictures of domestic monetary policy, reluctance on the part of lenders, or any obvious degradation of credit (more of that in a moment), but largely from abroad. However, with flows from the Eurozone at last appearing to slacken—even before Draghi scared the horses in his recent press conference— this dampening effect may now be abating.

The past six months have seen net 3-year low EZ outflows of ~€200 billion versus €350bln in the prior semester. Netting off 'other' banking movements (some of which will have been hedging– or repo-related), the contrast is even more stark: €150bln against €400bln.

Is the party finally ending??

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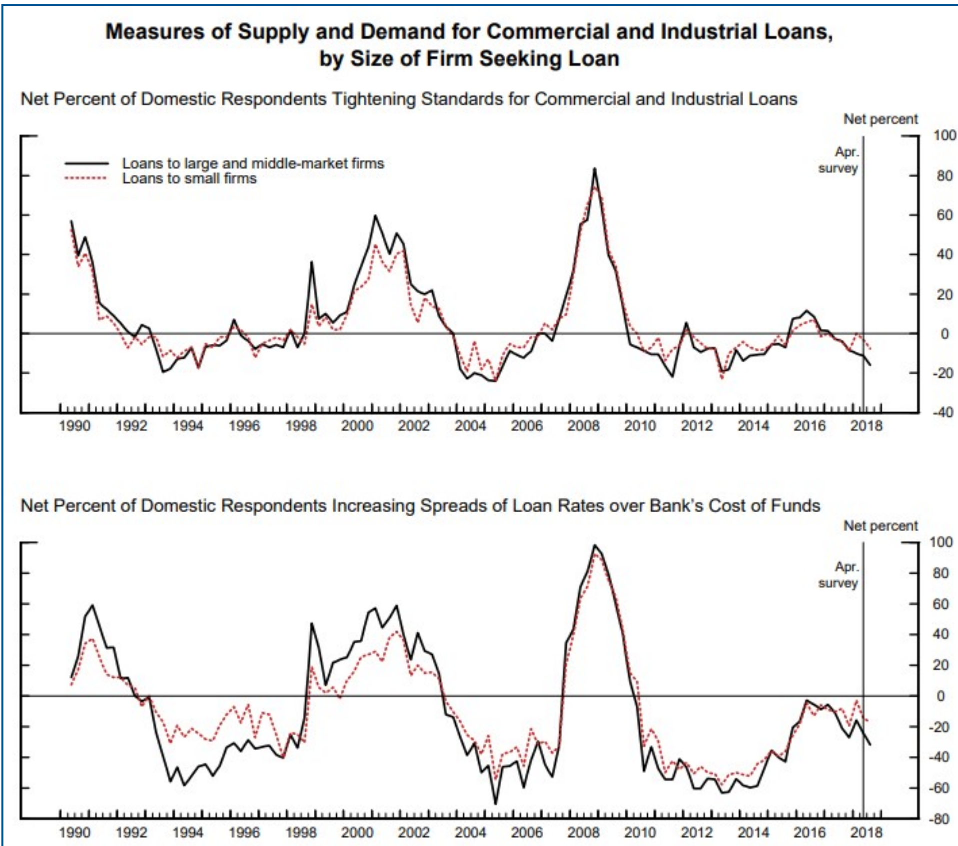

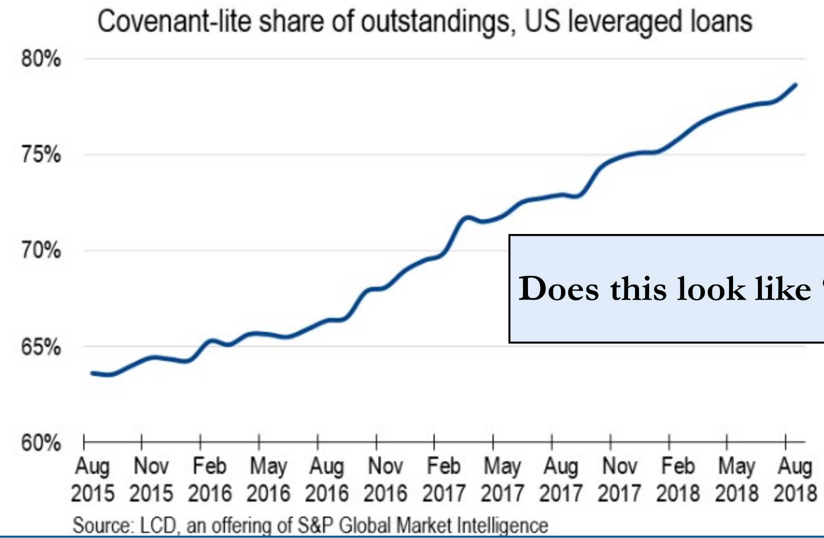

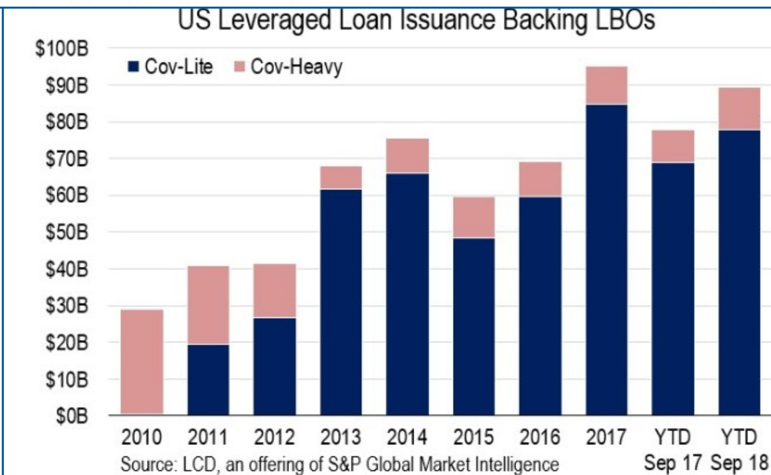

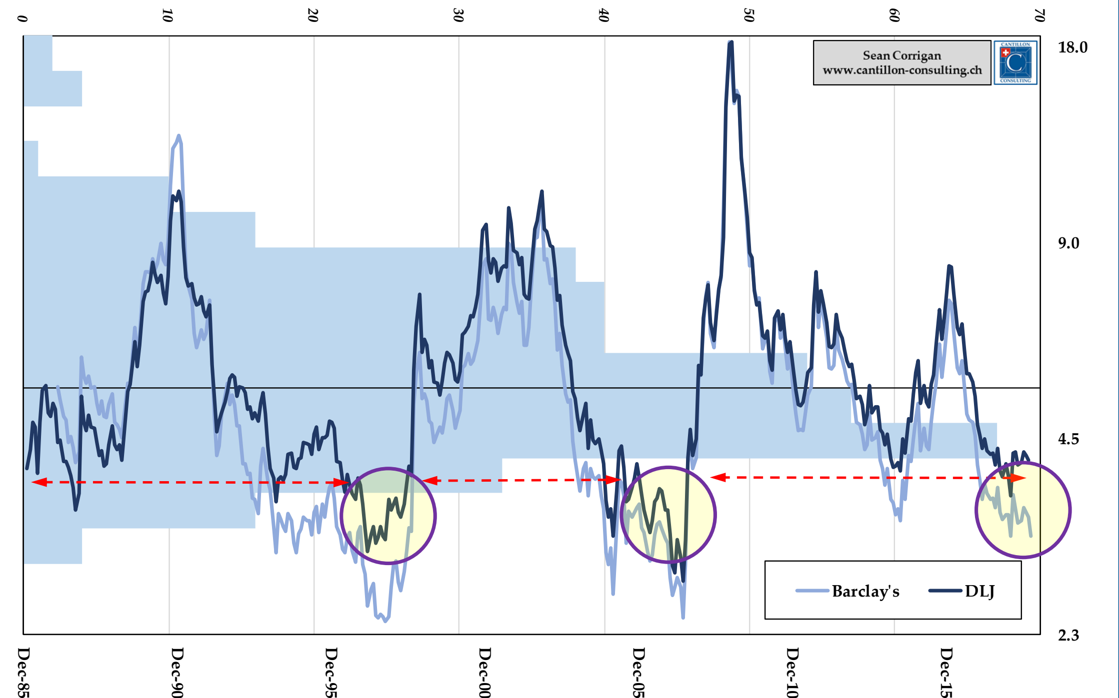

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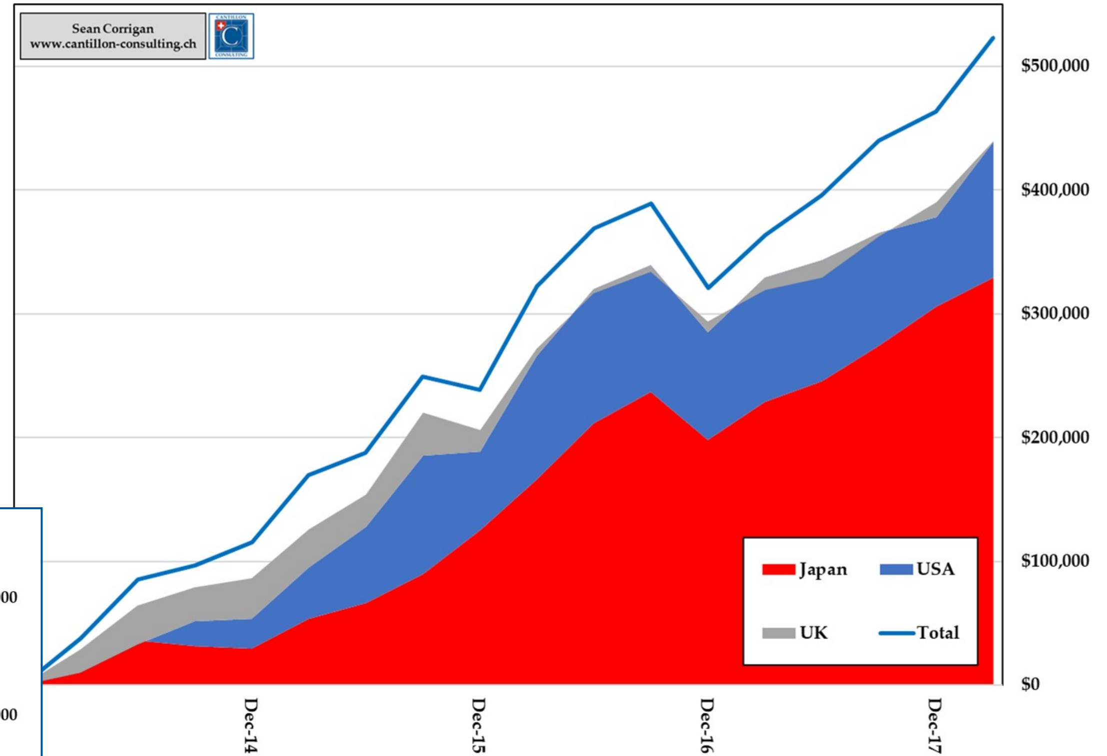
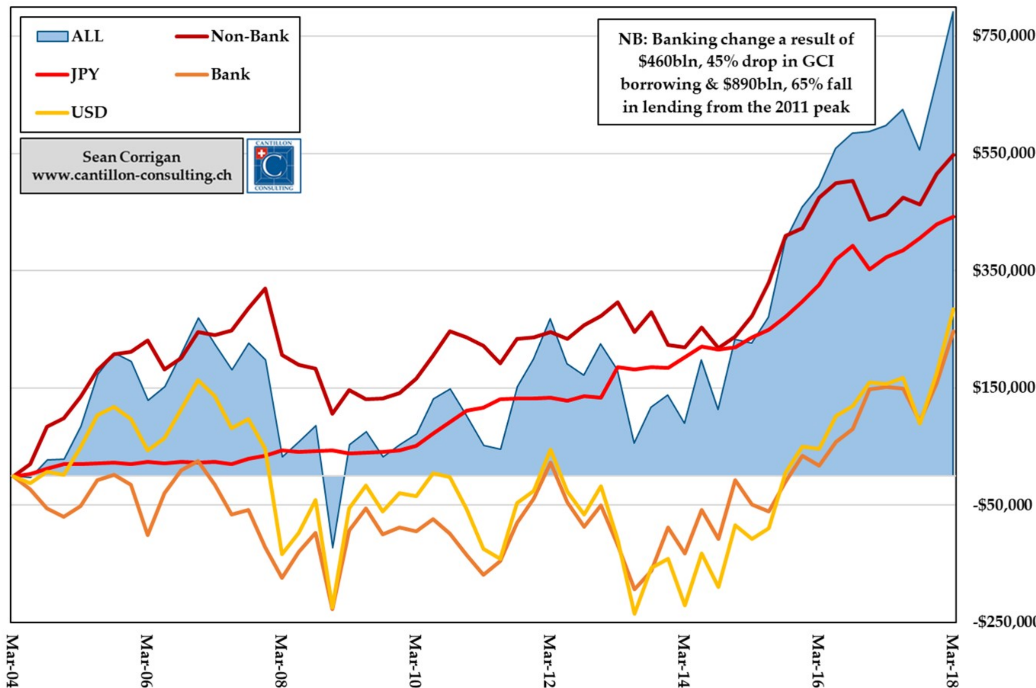
Given the excesses of Abenomics, it might be a surprise to learn that Japan's contribution to the US BOP deficit via the debt market has been minimal.

Japan's accumulation of US debt this past six years has been basically zero (sic), while the US has bought ~$160bln of its partner's paper (much of that hedged or leveraged, as we might infer from the matching increase in US 'other' liabilities to Japanese counterparties).

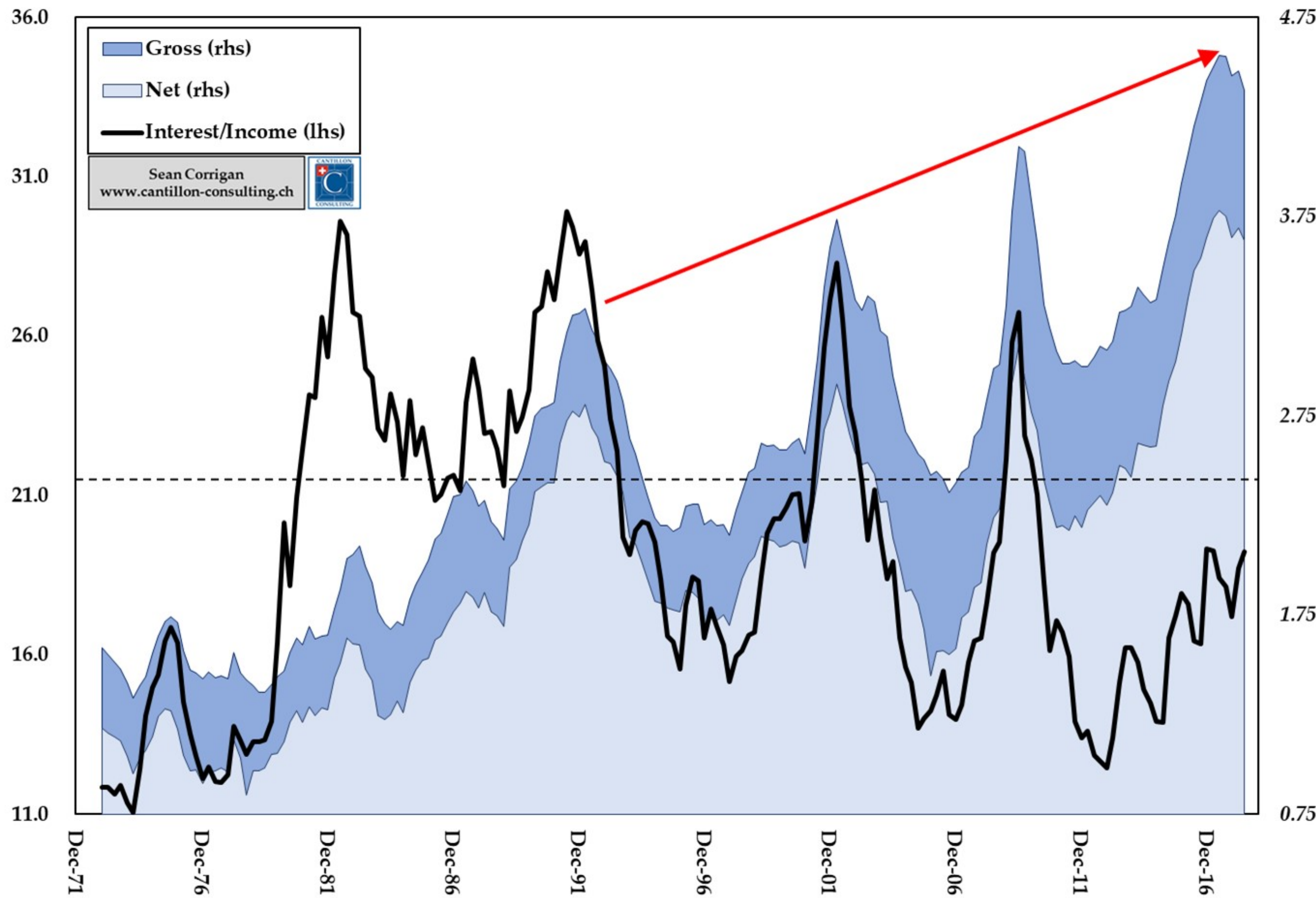


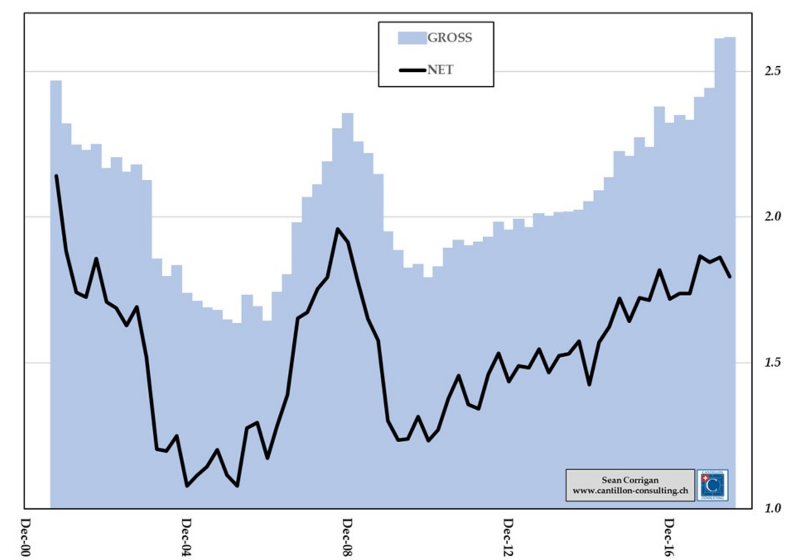


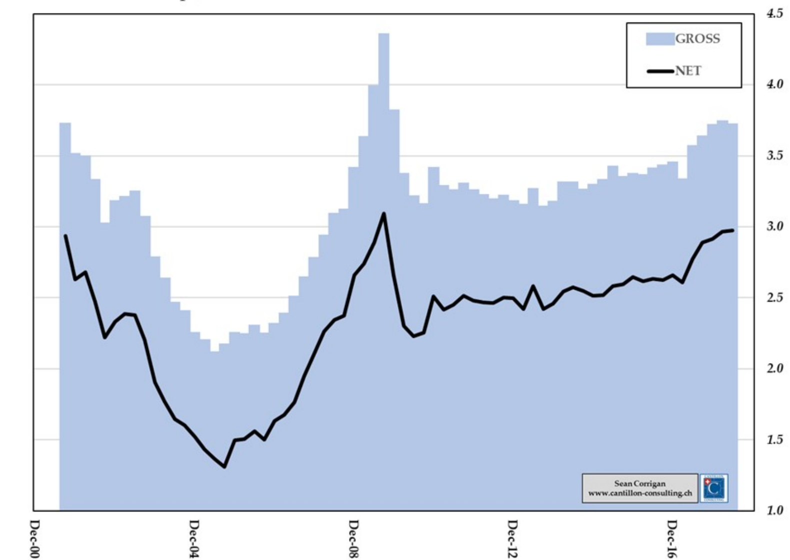
What Japan *has* done, however, is finance the expansion of hedge fund activity as seen here both from its banking exposures to GCI and that latter's currency exposures to the world at large.

GCI Non-banks have borrowed $525 bln offshore since the end of 2013—of which $260bln in JPY and $330 bln of that from Japan (two-thirds of the nation's global allocation). Though not specifically broken down, the $345bln gain in Non-bank FINANCIAL funding matches that figure far too nicely to be mere coincidence.

Meanwhile, the US BOP category which includes GCI saw bond buying of $260bln gross, $130bln net. Every little helps in alleviating pressure on the US long -end.







Perhaps the most talked-about worm in the bud of the current expansion is the state of corporate balance sheets. As the charts here attempt to show, the calculated temptation put in management's way by the same central bank-IMF hierarchy which now hypocritically pretends to be aghast at its actions has clearly added to vulnerabilities. The rise in equity valuations (itself partly caused by heightened use of leverage), general economic strength, and low interest costs have encouraged what might turn out to be a dangerous complacency. Moreover, loose debt terms may soften any future adversity for the borrower but will also inhibit the sort of speedy resolution, liquidation, and reallocation of resources needed for rapid recovery.

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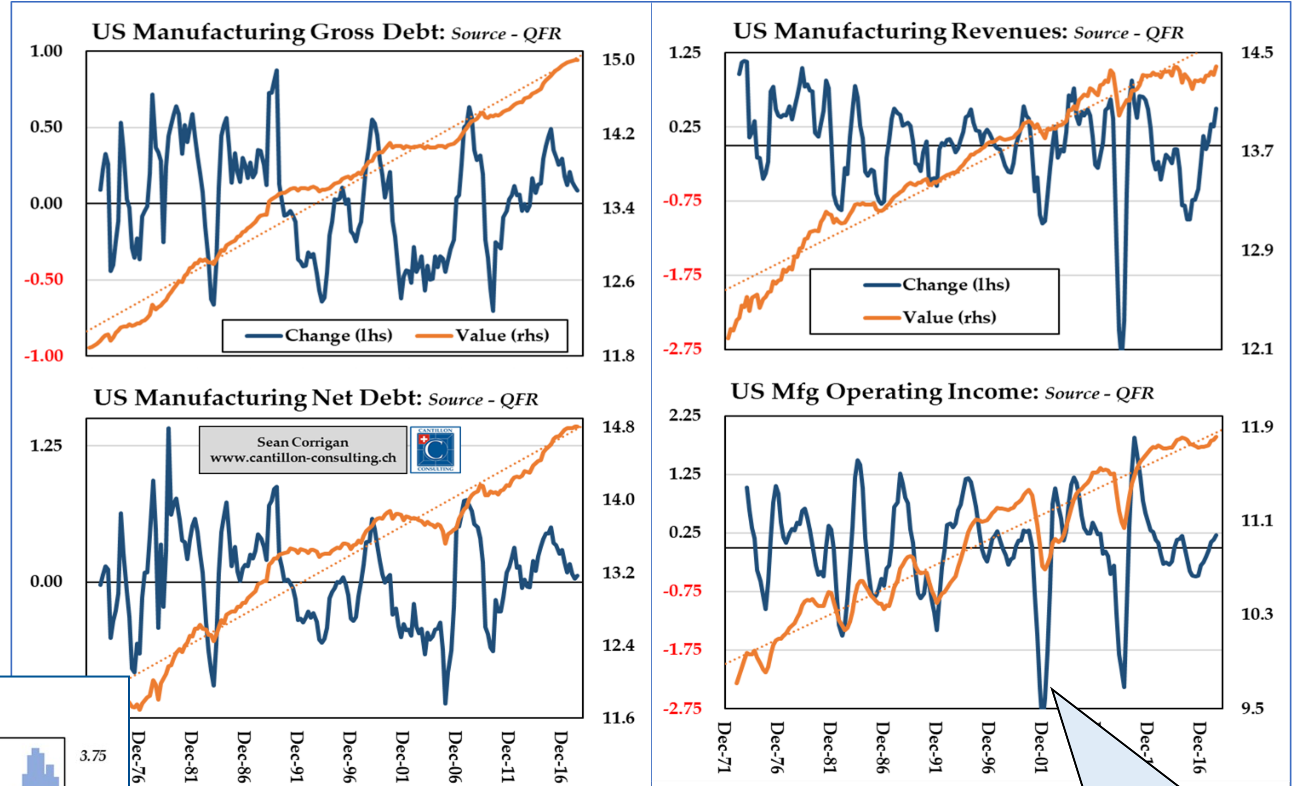
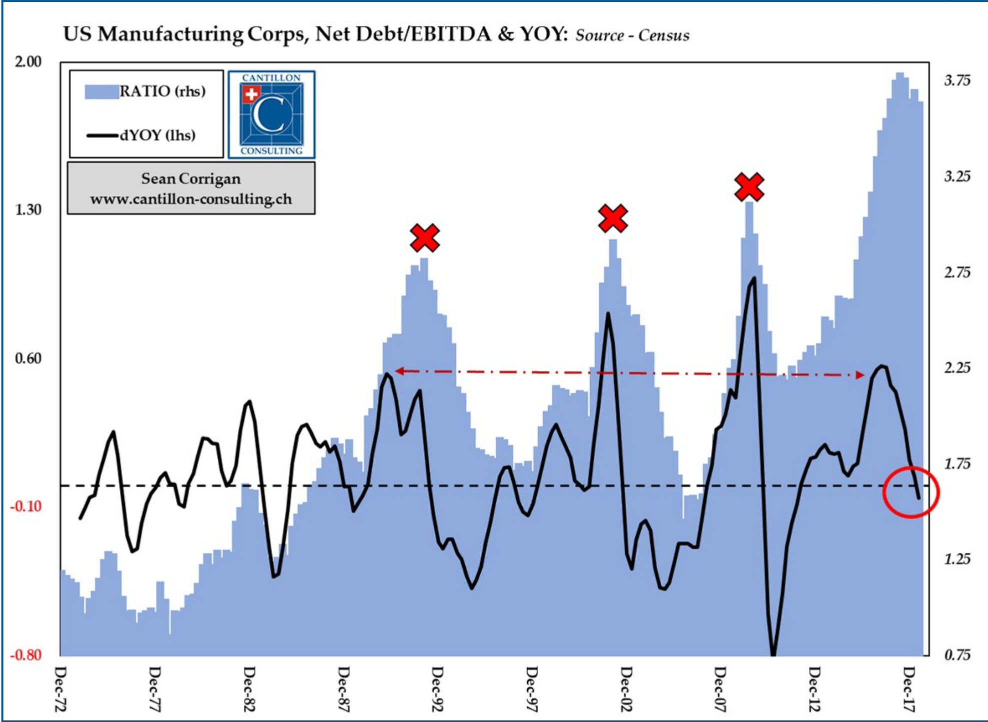
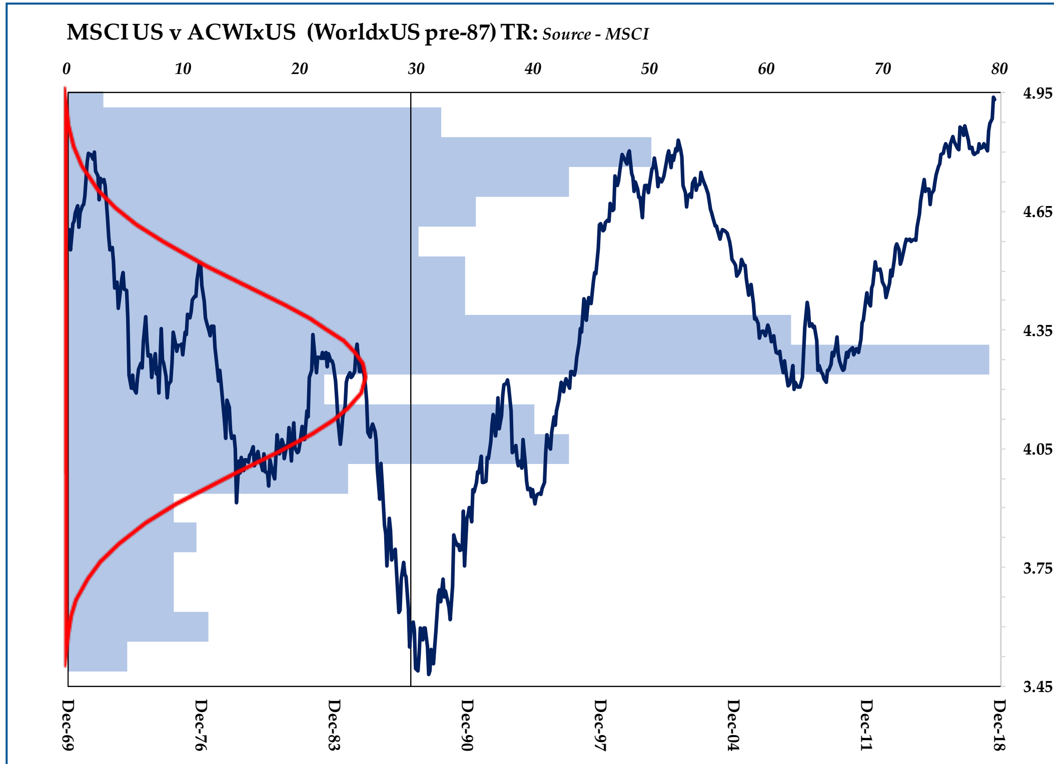
The primary comfort is that while both revenues and operating income are rising at a greater than 8% YOY lick (far above their trend 4.5% CAR and the best since 2011 and 2012, respectively), both gross and net debt have only crept up by just over 2% (again a seven-year record)

This has meant debt/EBITDA has actually both peaked and retraced outside of a recession-induced squeeze on cashflow and subsequent painful period of deleveraging—a truly rare occurrence. If this combination continues, we might not entirely grow our way out of trouble but we could at least mitigate the pain whenever the cycle does at last turn. Fingers crossed.



YOY change in deviations from trend





It is still not possible to call a top in US equity markets, however overpriced they may seem on 'fundamentals' and however unhelpful the bond market currently is. Be FANG-ful for small mercies. They have however never been so rich versus the Rest of the World (here on a log scale).

No wonder the President was boasting to the UN of his singular genius...

VALUE LINE INDEX

(7840.68)
(7843.01)
(7230.73)
(6813.38)
(6283.73)
(5802.07)
(5320.40)
(5224.48)
(4373.41)
(3761.12)
(3608.20)
(2019.30)
(992.00)
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020

Courtesy: TradingView

Assuming the FOMC does not perform a complete about-face, 5-years are still targeting the June 2008, pre-GFC high at 3.75%, while the risk for the 10-year comes in at the 2007-16 mid point, *viz.*, 3.35% When do we suppose that old chestnut—mortgage convexity—starts to become a factor, once more?

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Dr Copper has undergone a nice bounce now that (Chinese?) liquidation has run its course, but needs to trade above $2.95 for us to say anything other than that it has defined a new short-term range, smack bang in the middle of the past four years' distribution.
COPPER
(4.55)
(4.15)
(3.55)
(3.24)
(2.93)
(2.33)
(1.93)
(3.30)
(3.10)
(2.78)
(2.62)
(2.46)
(2.14)
(1.94)
Courtesy: TradingView
2010
2011
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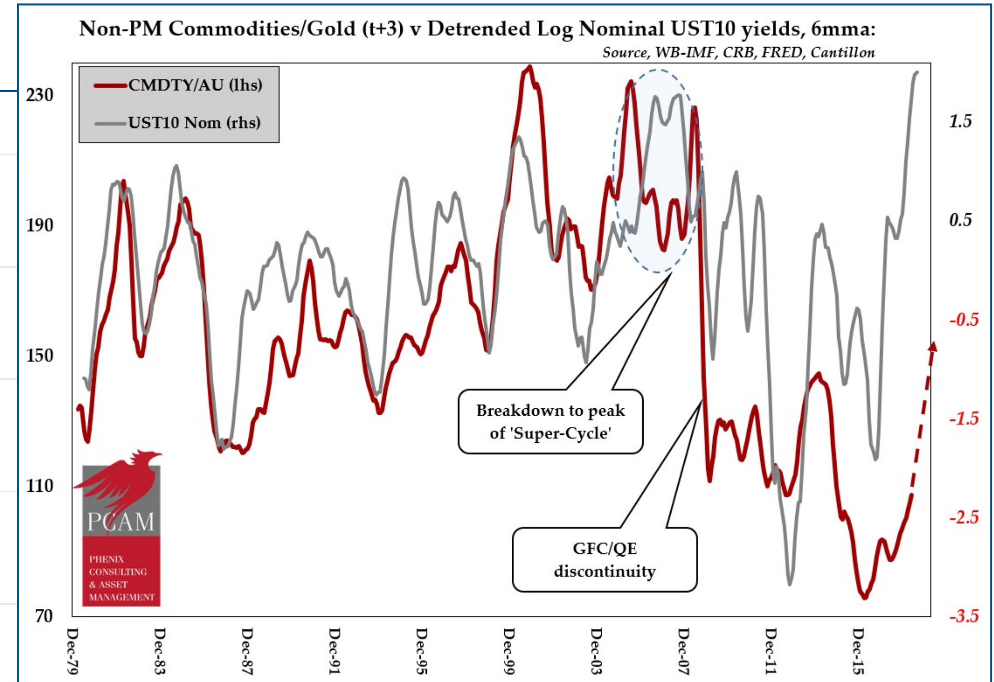


Gold's inability to push much beyond $1200/oz after such a steep fall bodes ill for any renewed rise.

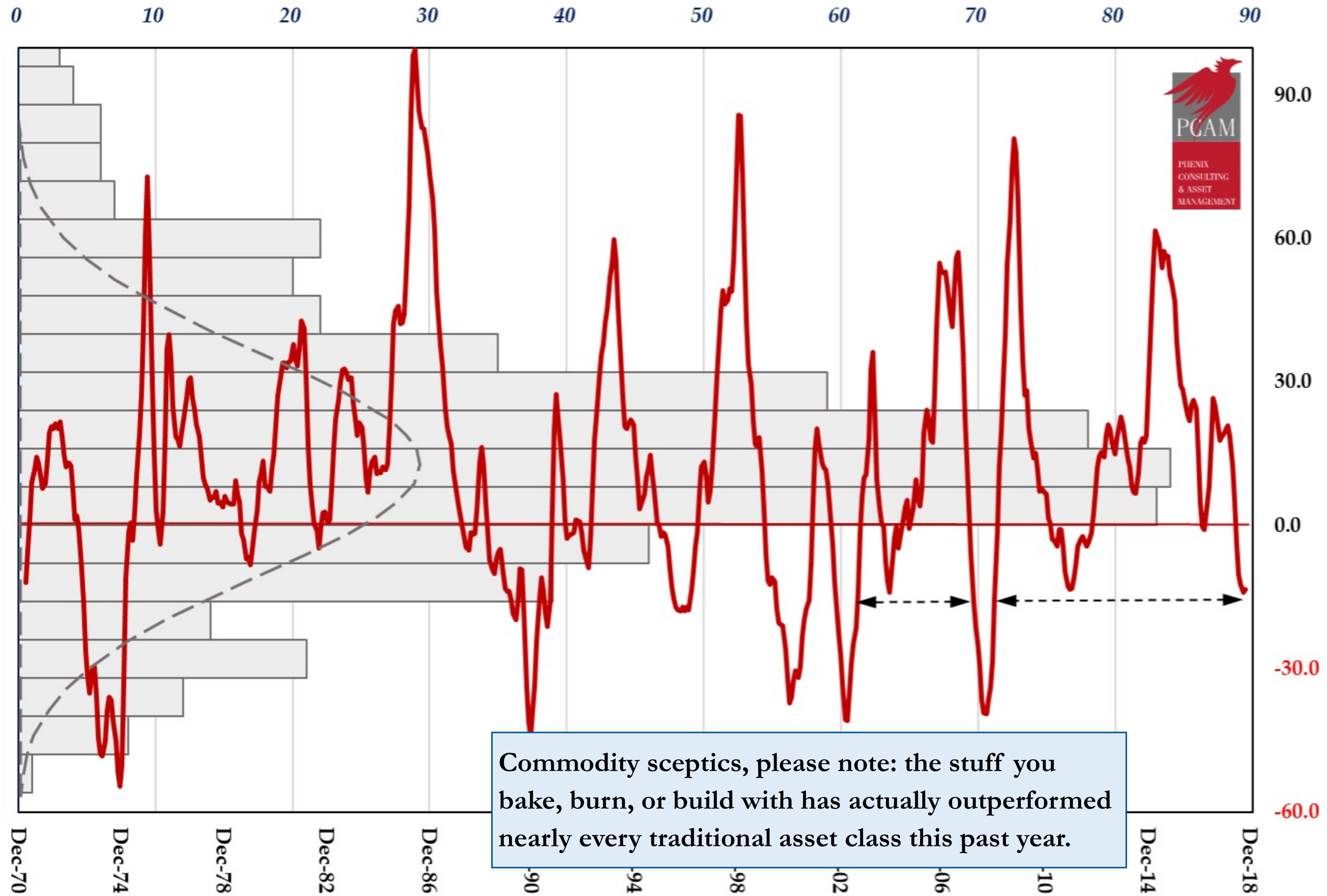
Interest rate trends are also firmly against any measure of outperformance taking place versus the useful (!) commodities.

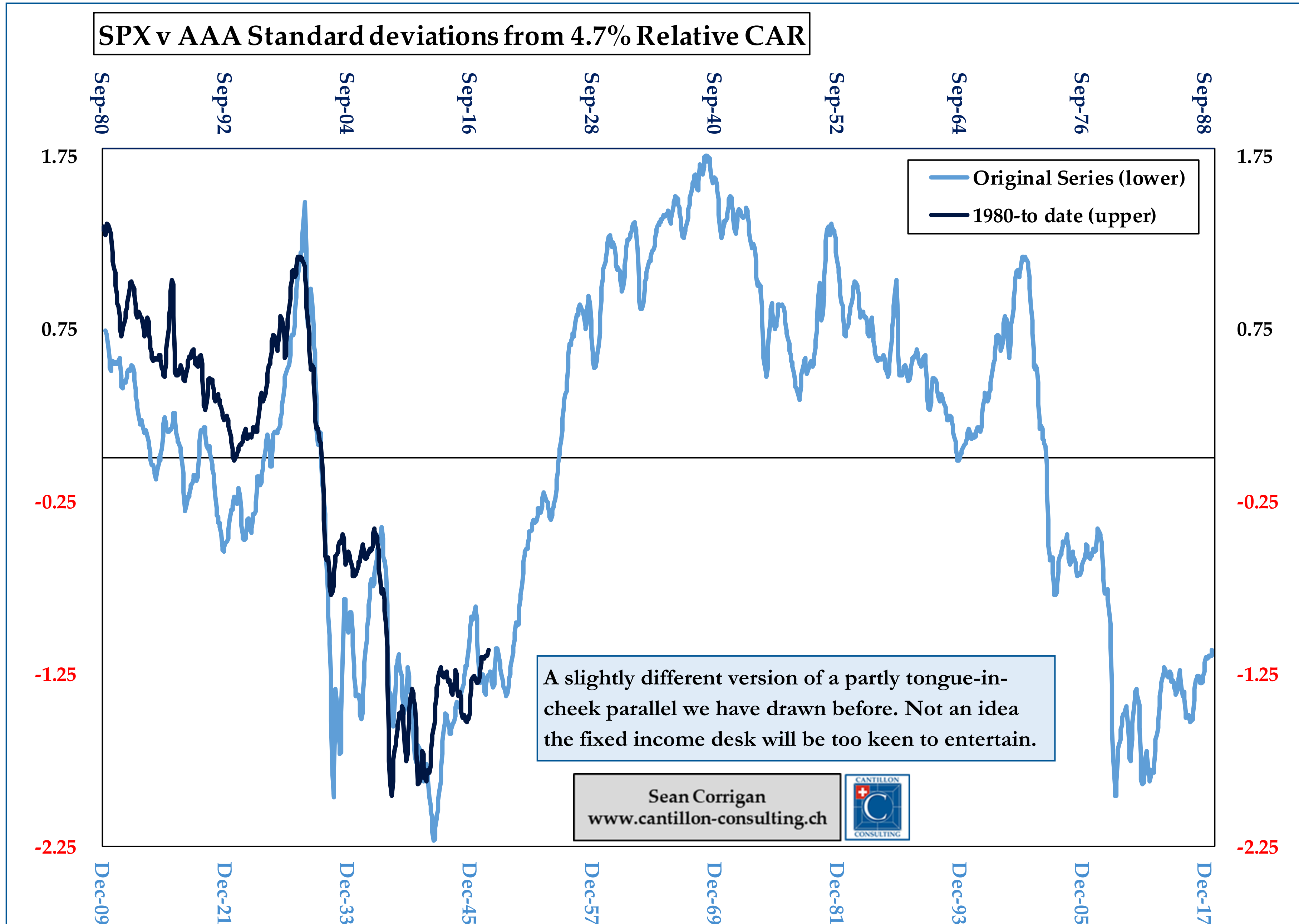
GOLD

(1487.16)
(1410.75)
(1373.77)
(1336.03)
(1300.53)
(1277.65)
(1247.84)
(1247.96)
(1218.27)
(1197.34)
(1159.89)
(1122.15)
(1104.24)
(1048.03)

2011 2012 2013 2014 2015 2016 2017 2018 2019

Courtesy: TradingView


ACWI Ex-US v GSCI, 3mmaYOY%: Source - S&P, MSCI
0
10
20
30
40
50
60
70
80
90
90.0
60.0
30.0
0.0
-30.0
-60.0
Dec-70
Dec-74
Dec-78
Dec-82
Dec-86
-90
-94
-98
-02
-06
-10
Dec-14
Dec-18
PCAM
PHENIX CONSULTING & ASSET MANAGEMENT
Commodity sceptics, please note: the stuff you bake, burn, or build with has actually outperformed nearly every traditional asset class this past year.



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