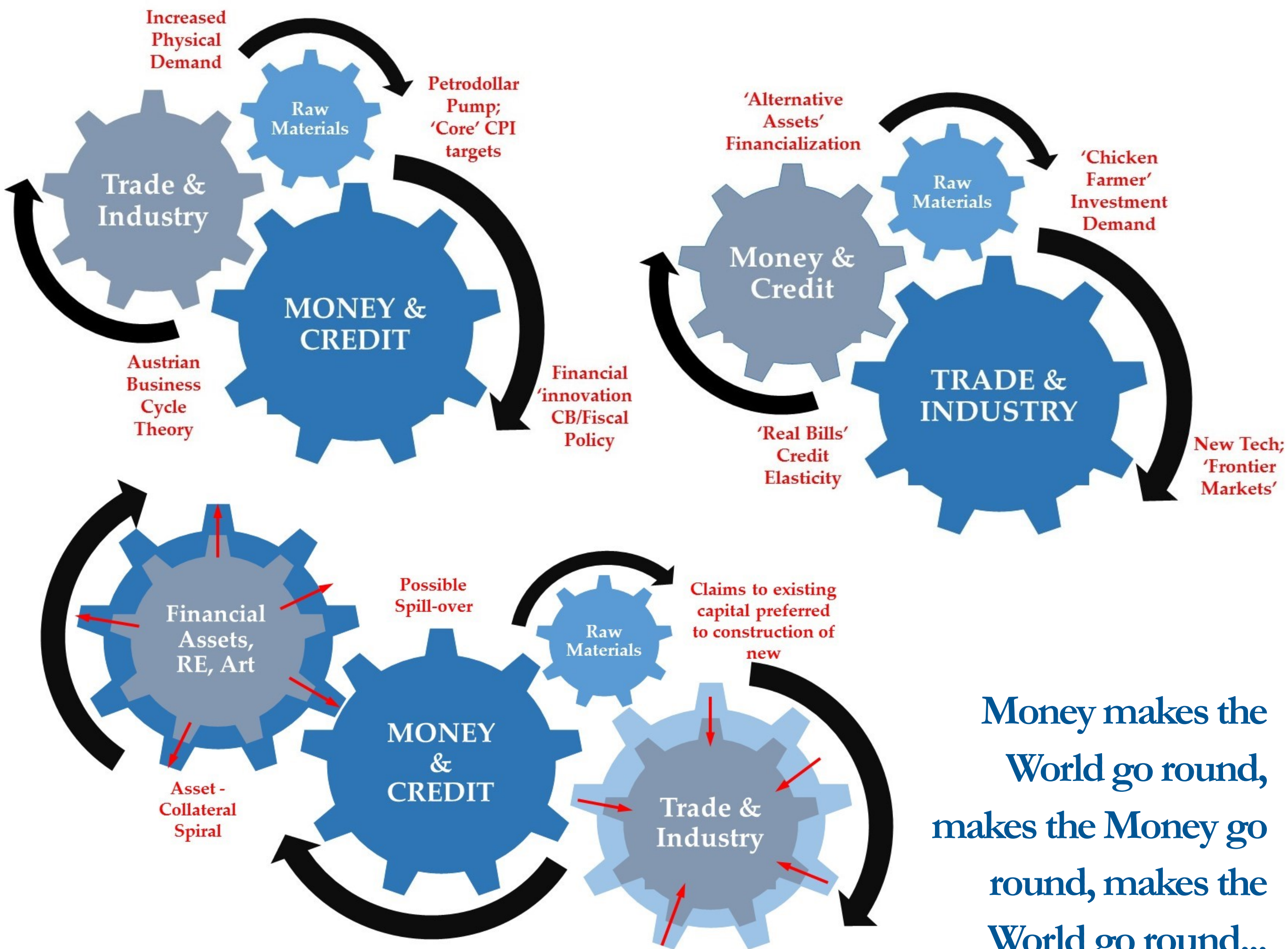
Money, Macro & Markets Monitor

www.cantillon-consulting.ch

December 2018

IN THIS ISSUE:-



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

Volume II, Issue X

Thus spake Zarathustra

"We therefore began to raise our policy rate gradually toward levels that are more normal in a healthy economy. Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy--that is, neither speeding up nor slowing down growth."

Since Fed Chairman Jerome Powell uttered these words in preamble to a speech which dealt far more with the vexed issue of 'financial stability' than with monetary policy, *per se*, that little adverbial qualifier, 'just', has received an inordinate amount of attention.

Those hoping to end the year without having to write too embarrassing a letter to their investors naturally seized upon it as offering them late hope for a previously discounted Santa Claus rally. Easy money types everywhere – whether or not they were people who hang on the President's every irascible and half-legible tweet – were left huffing that sanity had finally prevailed in the corridors of the Marriner S. Eccles building. Cynics and assorted goldbugs (the latter secretly pleased to do so) accused the Fed of cravenly kowtowing to the Mandate of Heaven.

Only here and there were more sober assessments to be found – interpretations which principally relied upon the fact that to be even '*just* below a broad range of estimates' for the Cheshire Cat smile that is the 'neutral rate' did not actually rule out the delivery of several further instalments of 25bp rate rises before the end of the series.

Though hardly lighting the blue touch-paper, Powell's words did add a certain immediate impetus to a market which had otherwise been trying on the verge of convincing itself that 'late cycle' had become the *late* cycle - as in passed on; is no more; has ceased to be; expired. In short: an ex-cycle.

We shall later examine whether there are sufficient grounds to share this diagnosis but, from a market perspective, the more immediate issue is how this latest evolution of its participants' primary narrative interacts with their positioning.

Here, it has to be admitted that the conditions for what we would still regard as a counter-trend rally in the *interest rate* markets are fairly propitious even if such a reaction, by loosening financing conditions overall might well set Mr Powell to moving more firmly from '*just below*' to nearer the mid-point of said '*broad range*' as part of his avowed '*exercise in balancing risks*'.

Ironically, had the President's stood behind his subsequent, typically equivocal climb-down in the confrontation with his Chinese counterpart it would, if anything, have strengthened the chances of this transpiring. Though his flip-flopping on the matter is straining nerves at present, if risk assets in general were to again whet the appetite; if commodity prices were to find even a temporary bottom on hopes of a supposed *quid pro quo* for any tariff hike postponement; and if OPEC and No-PEC could jointly summon up some resolve to act to stabilize energy prices, the Fed would presumably be given a much wider rein for future action.

As it stands, however, T-Bonds have already rallied almost seven handles, taking them back to levels of mid-September and hence unwinding the move which coincided with the equity swoon and the oil crash at the start of October. The spread between front month and 2021 maturity Eurodollars has collapsed from 63 tics (essentially two full hikes, plus a touch of term premium) to just 10 – meaning that the market is on the verge of pricing a complete end to the cycle once next week's seemingly set-in-stone increment has been duly delivered. Amazingly, instead of provoking sighs of relief, this relaxation itself has scared the horses by encouraging a bullish curve flattening whose very shadow the Herd—in full Bucephalus mode—now frets MUST signal a recession!

Breaking down the positions across the curve, via the CFTC data, we find a remarkable divergence has taken place since the Spring. Dealers have basically halved their extraordinary $1.8 trillion, 1-year equivalent Eurodollar long, with asset managers (unwinding yield curve or hedging plays?) covering one-third of the offer and the leveraged crowd taking down the other two-thirds.

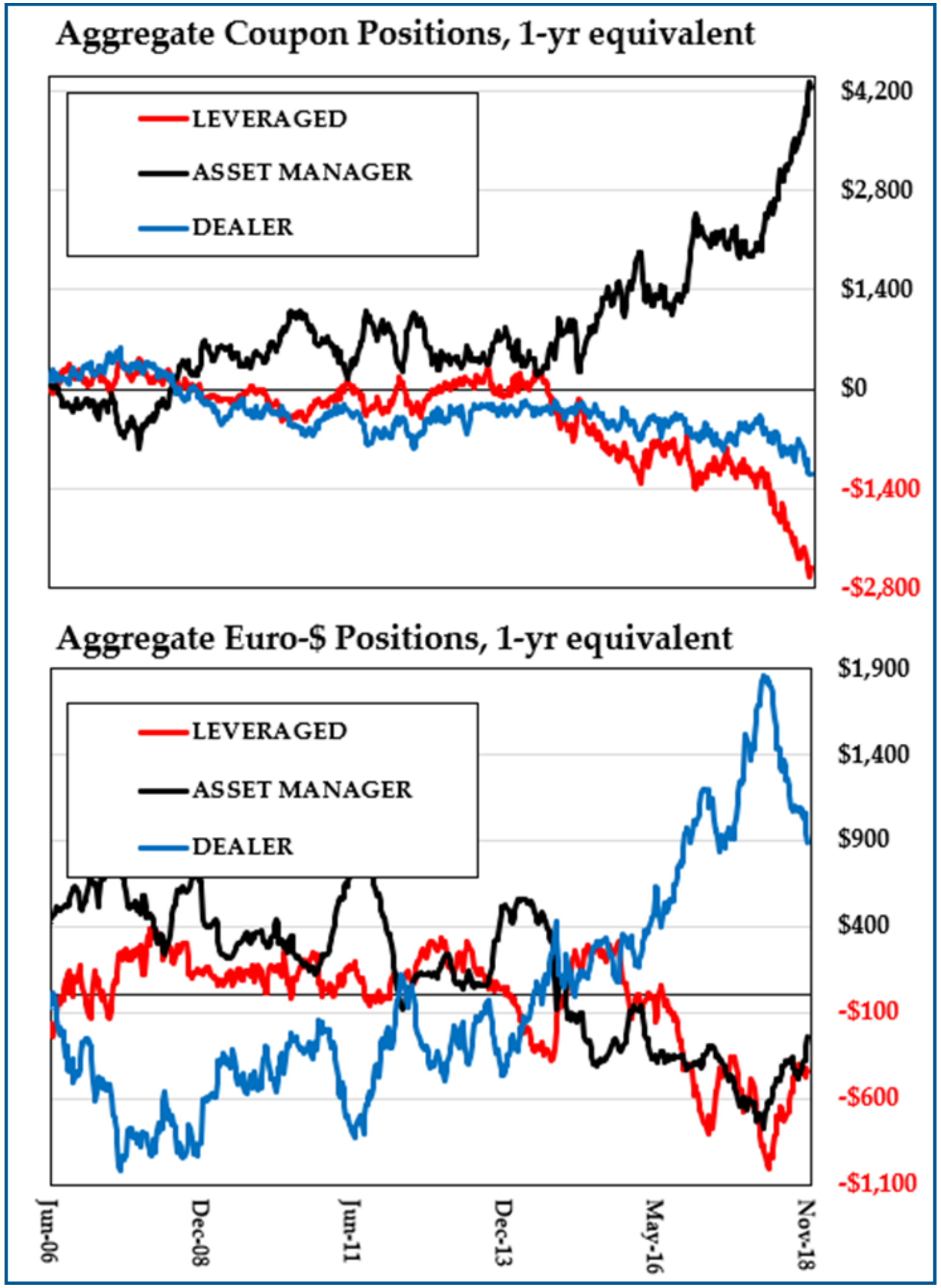
Across the coupon spectrum, however, things could not be more different as asset managers have doubled already elevated holdings these past nine months, to hit a monstrous $4.3 trillion net long with the leveraged crowd selling them $1.4 trillion of that (to leave them $2.7 trillion net short) and dealers (in part offsetting their record paper inventory, one supposes) being lifted for the other $700 billion or so.

Before Mr. Powell's Delphic utterance, it seems bets were being quietly being trimmed, down there at the sharp end of his sphere of influence, but, up at the QT-plus-Trump-tax-cut end of affairs, the game was still very much afoot.

Under such circumstances, the obvious drive to short-cover by the laughingly misnamed 'hedge' funds could have been predicted to mimic something of the panic unleashed in their recent $40 billion notional exodus from their crude positions – though one hoped that the far greater depth of the interest-rate markets would temper the worst excesses in this instance.

Accordingly, though some shorter-horizon support levels have proven too frail to resist this impulse—and while it is not hard to envisage, say, a further 10bps rally—nothing as yet has emerged to challenge the far less favourable medium- and long-term patterns which underline the drift to higher rates.

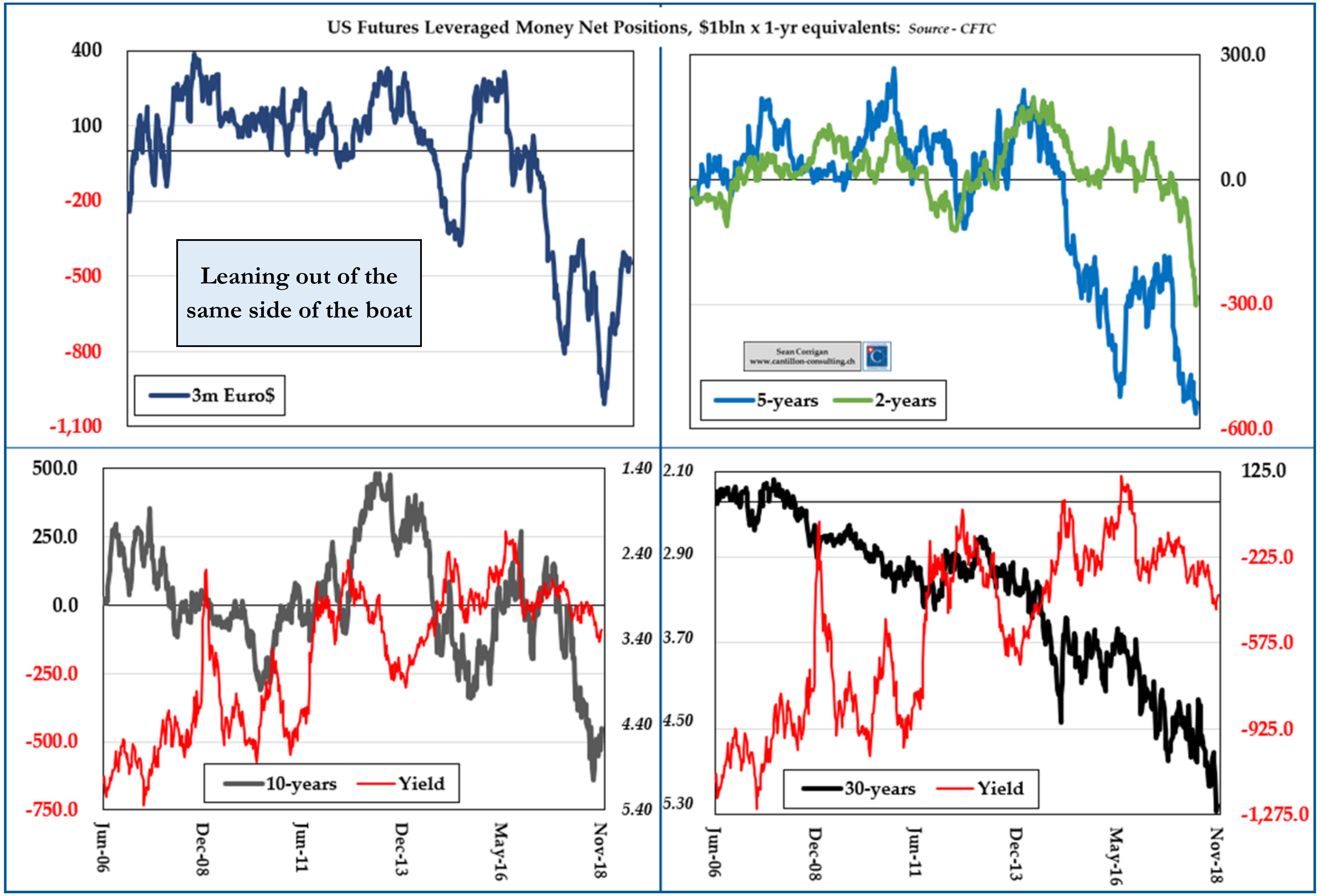
As for equities, the US ended the month still up there in relative terms, screaming in finest



James Cagney fashion, '*Look at me, Ma! Top of the world!*' Here, too, irony abounds for mutual fund and ETF data show that all this outperformance has come in the face of a persistent drain out of domestic stocks and into foreign; the former losing a cumulative $180 billion and the latter gaining $280 billion over the past 20 months.

As is only to be expected, we are currently seeing lots of dogs chasing tails as these less buoyant equity markets generate suitable *post hoc* 'explanations' for their loss of upward momentum and as those same explanations (principally related to lower earnings projections) seemingly justify the lack of enthusiasm after the event.

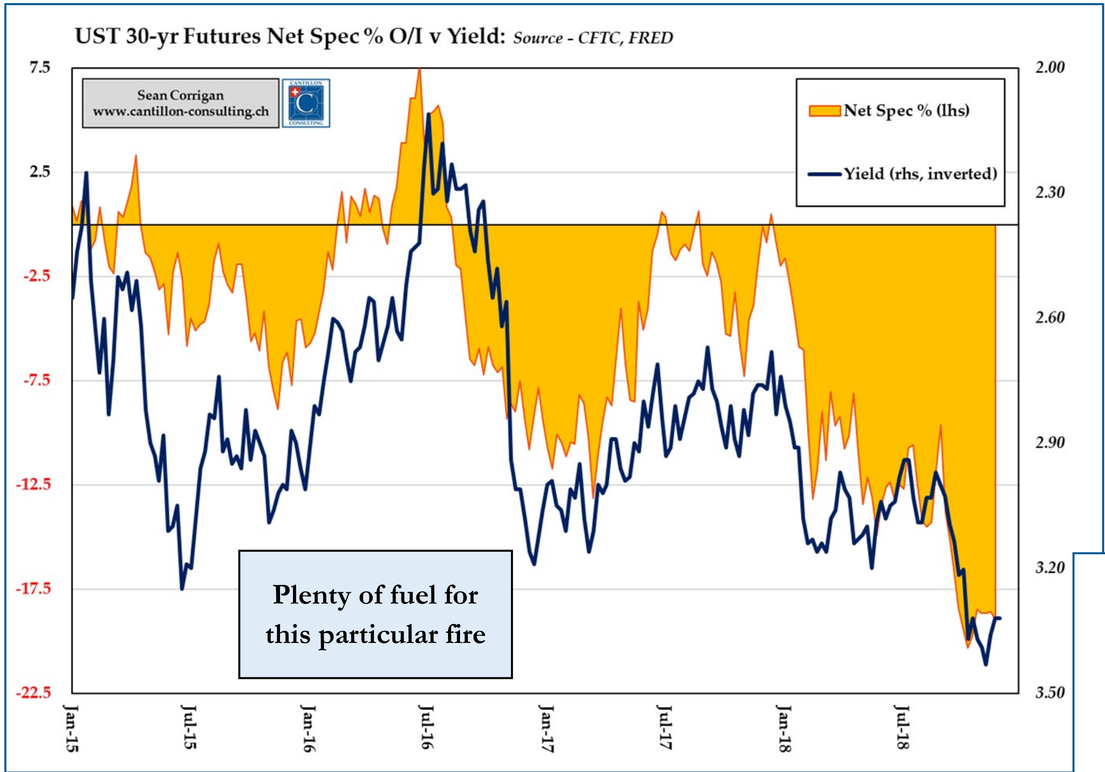
Whether any of this turns out to be at all accurate is a moot point but – as we often maintain – Man is not a *rational* investor, but a *rationalizing* one, so the only issue here is how deeply this mutual reinforcement of price action and confabulation can now become embedded in the market's *Weltanschauung* and so appear at least temporarily prophetic.

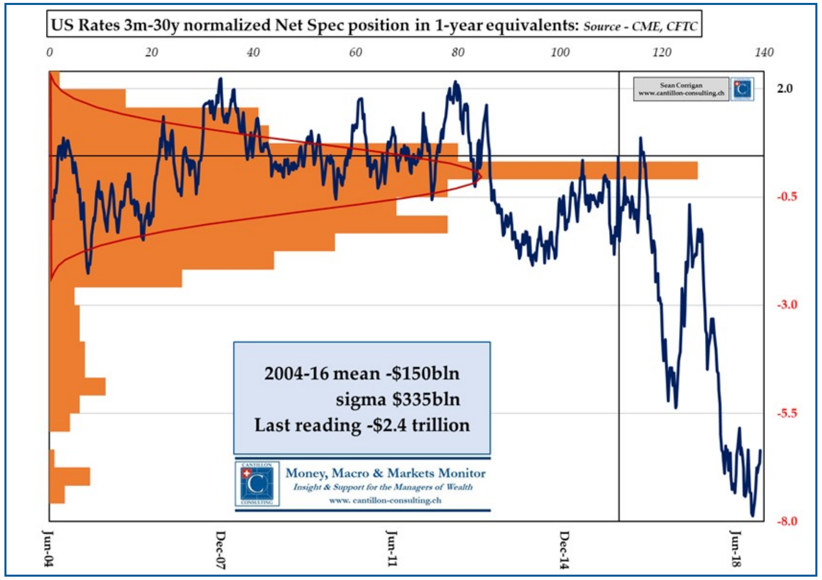


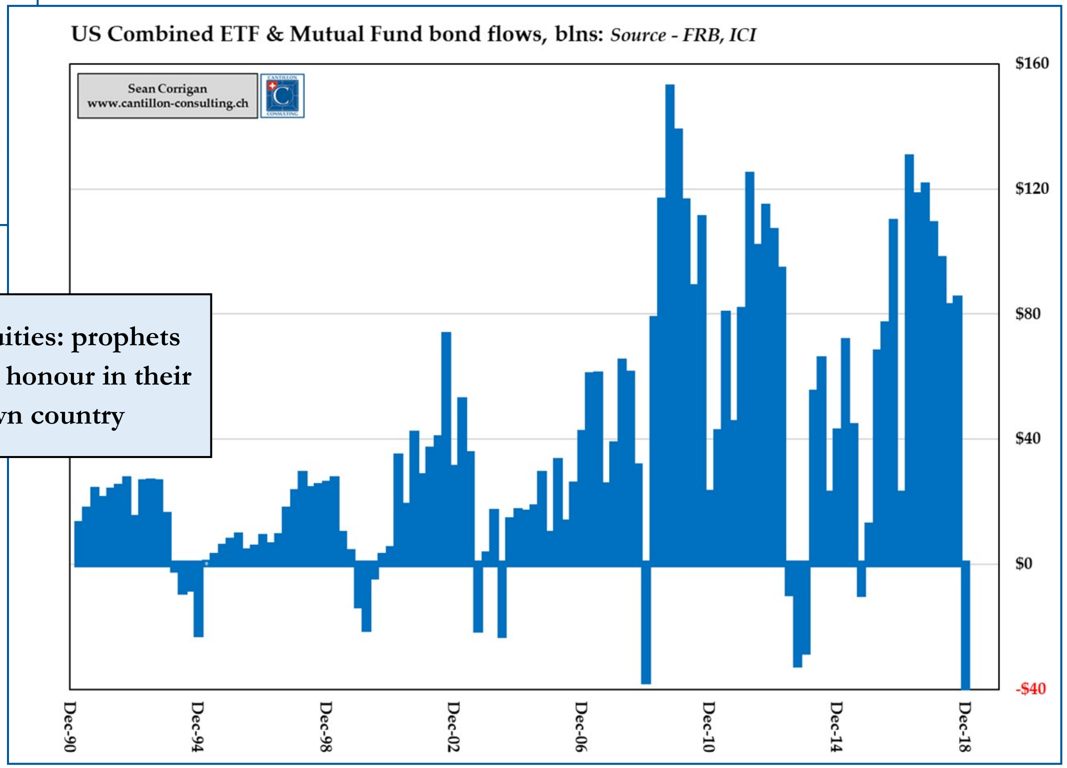
Thus, while the way forward from here may be more than usually unclear, the one signal feature of the times is just how unstable, how *nervous,* trading has become.

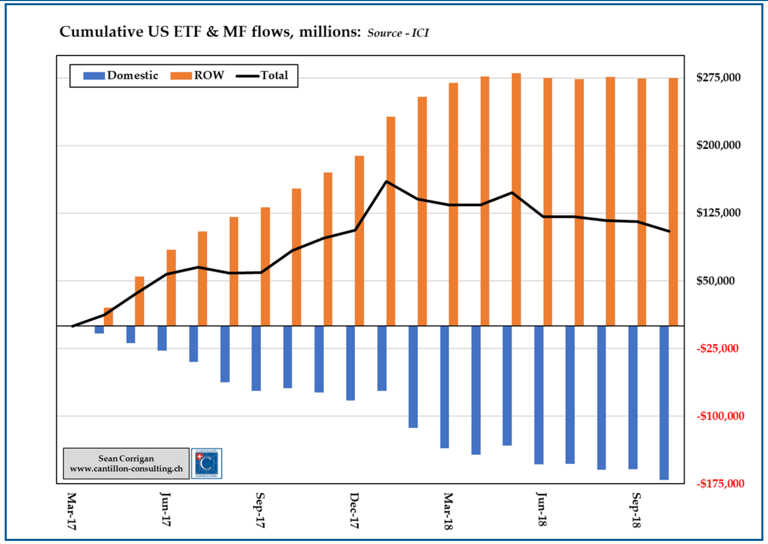
Trump the presidential Pinball. The unfolding Brexit debacle. *Les Gilets Jaunes* in France. Merkel's long drawn out—if well overdue—political demise. Salvini in Italy; Vox in Spain. Rampant Russophobia. The latter-day Gaius Caesar ruling the roost in Saudi Arabia. China's barely contained debt crisis. The UN hysteria on climate and its highly contentious and spectacularly ill-conceived migration 'pact'.

What a delightfully perverse Advent calendar of delights we have before us: behind each new little window a veritable Pandora's Box to open, every day from now 'til Christmas. *Yo, ho, ho!*

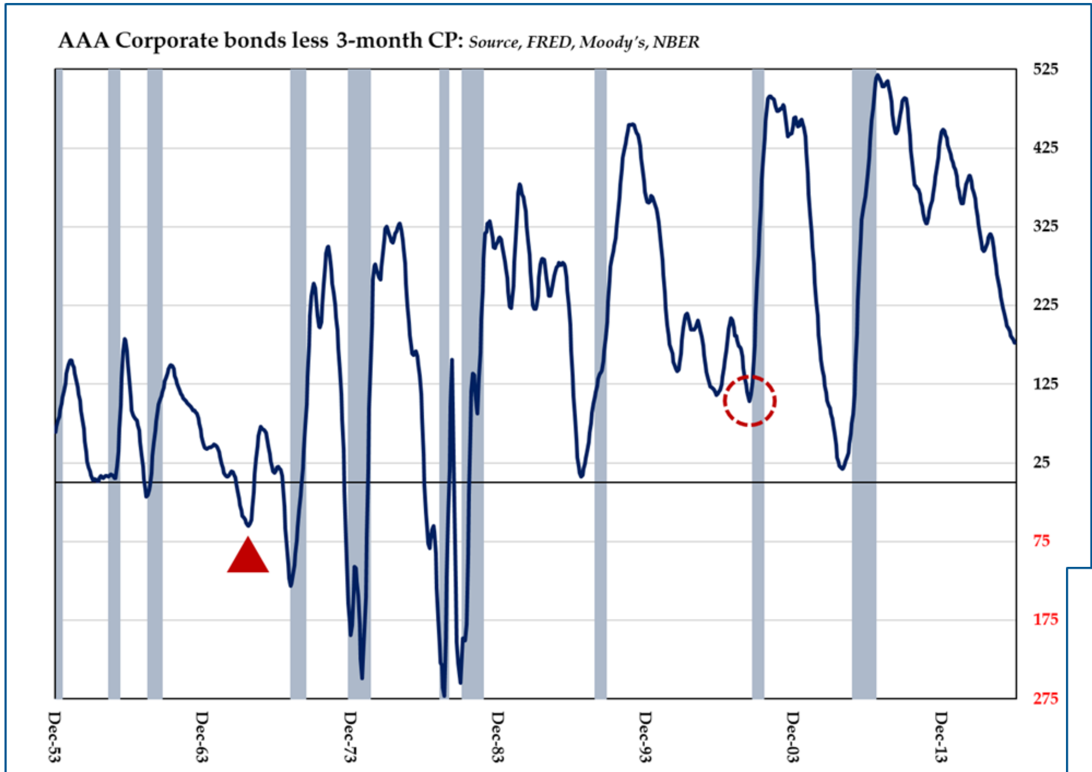






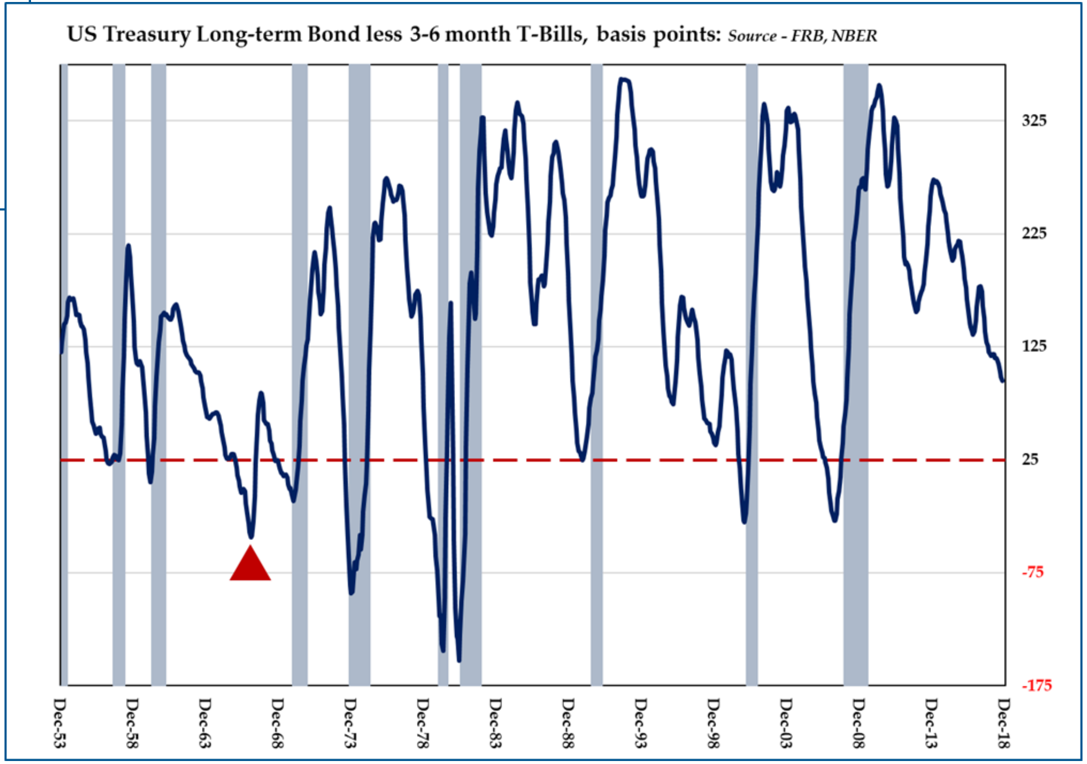


US equities: prophets without honour in their own country



Too much attention has been focused on the shape of the yield curve as if it has magical properties or as if long and short maturities are like the famous 'Ghostbusters' beams – never to be crossed lest 'total protonic inversion' occurs.

There are genuine boom-to-bust economic circumstances which also tend to drive an inversion (Hayek in 1937, q.v.) but these do not seem to be present today.



And what's so special about 2yrs v 10yrs, anyway? Look at 3-months v long-term paper.

Since the Korean War there has been only one false reading here (and that an OECD-designated 'recession') and only one partial miss in 2000.

NEITHER OF THESE IN IN THE DANGER ZONE TODAY

WHAT THE FIRM OFFERS

The fruits of a lengthy exercise of full intellectual independence, trading in, commenting upon, and analysing markets, placed fully at your disposal to help enhance your investment process.

Dedicated personal interaction, as well as written assessments, to enliven the debate and to mitigate risks by broadening the circle of opinion.

Detailed macro/market research with the possibility of undertaking special commissions upon request.

Ideas and arguments to incorporate into your existing framework of client communication either as 'white-labelled' material or, if you wish, to present as the stand-alone opinion of one of your firm's expert counsellors.

Assistance with content for reporting, proposals, marketing, etc.

Education and training.

Public speaking to entertain and inform you and your invited guests.

For more information and to discuss the specifics of what we can offer, please write to
info[at]cantillon-consulting.ch

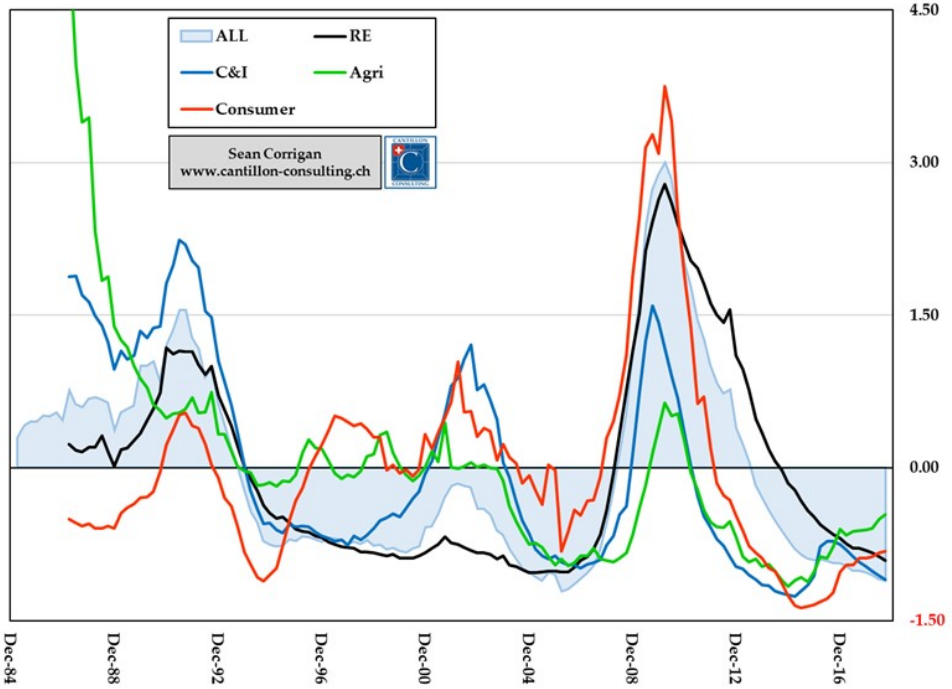
'Silver alone is the True Sinews of the Circulation' - *Essai sur la Nature du Commerce en général*

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

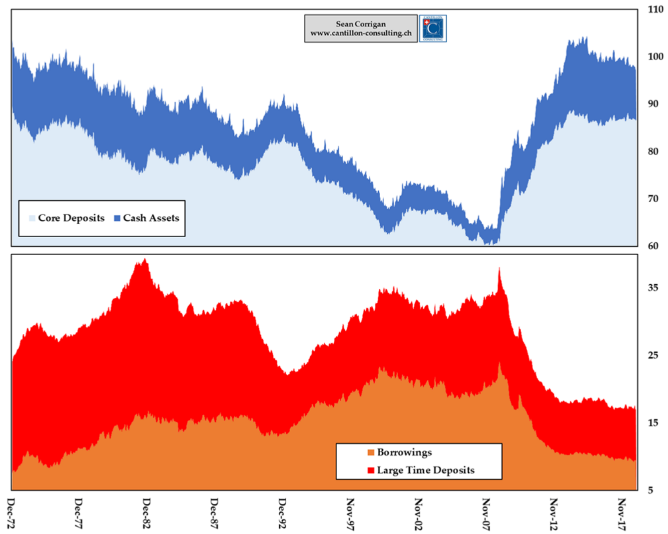
The extreme positioning only adds to the potential for violence here, but macro-oriented bears still have some grounds for hope, as far as these charts go

All external charts courtesy of TradingView .com & Investing,com

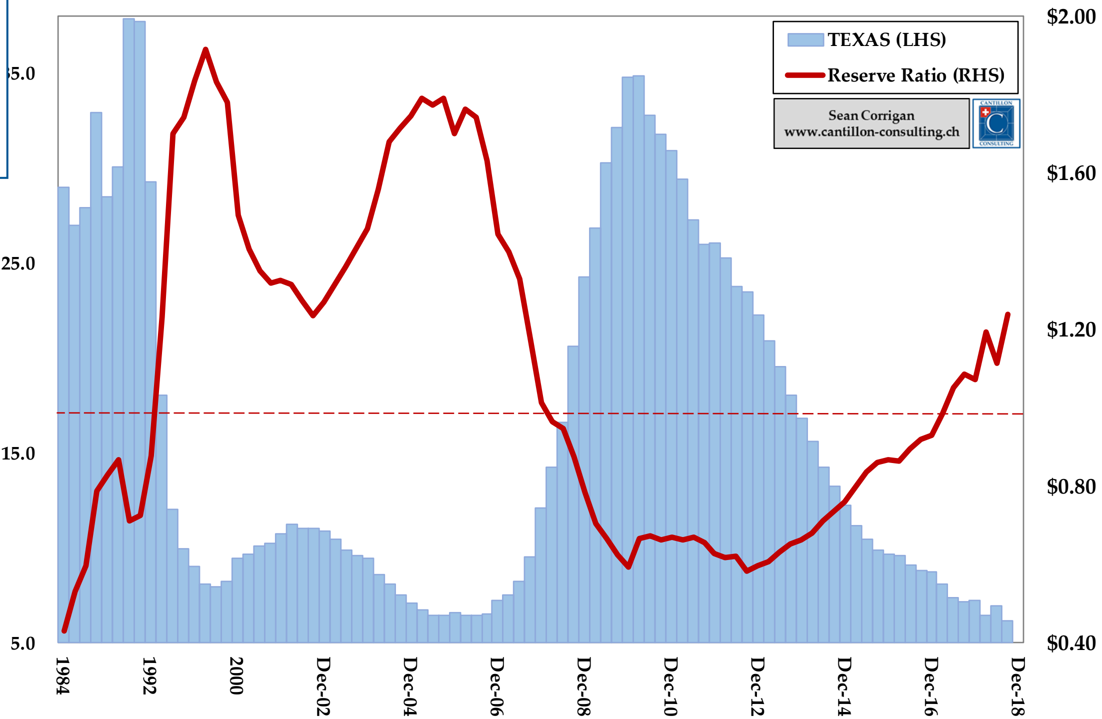
US Bank Combined Charge-off & Delinquency Rate, normalized: *Source - FRB*



US Domestic Bank Asset & Liabilities as % of Bank Credit: *Source - FRB*



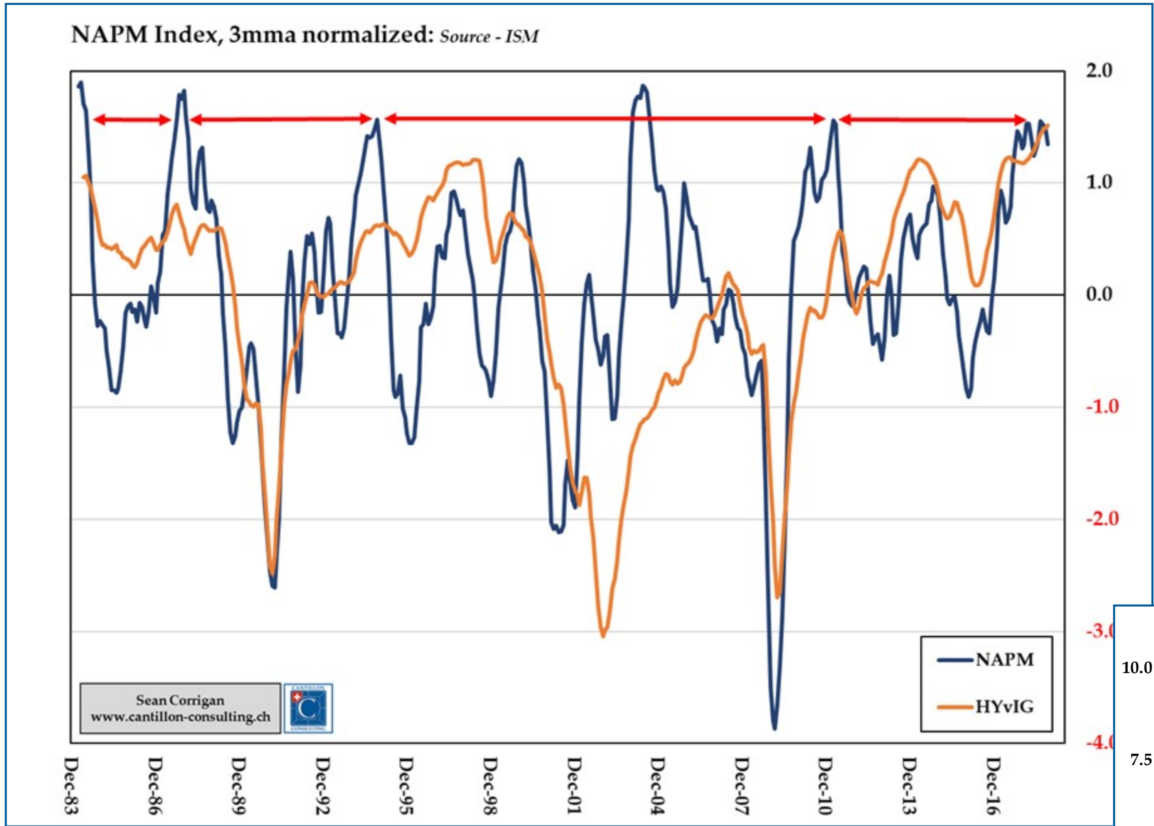
US Bank 'Texas ratio' (Non-current loans & ORE v tangible equity & loss reserve) & reserve ratio
Source - FDIC



OVERVIEW OF JEROME POWELL'S DECISION MATRIX

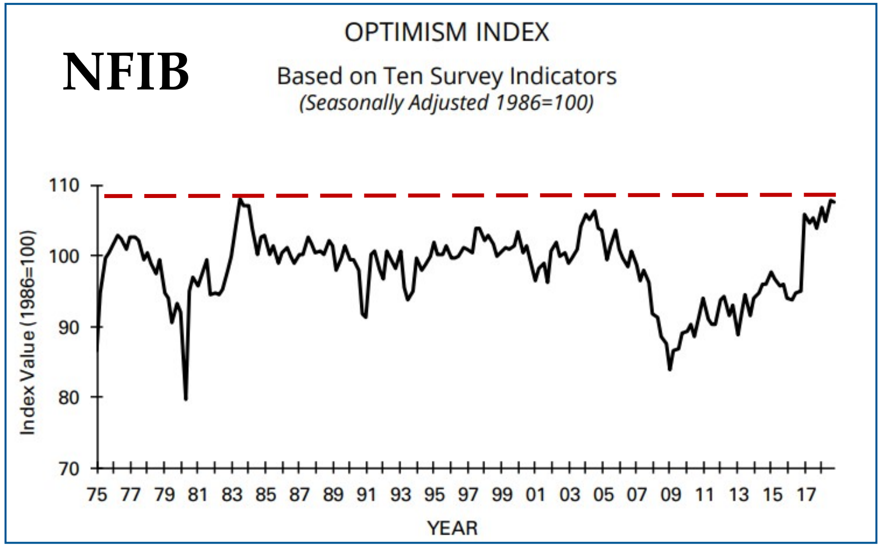
One clear positive is that the US banking system appears to be on a sound footing—though one should never become too complacent when dealing with such highly-leveraged, temporally-mismatched entities as banks.
As far as we are aware, however, while a slide into recession will inevitably cause pain, there is no obvious trigger for a non-linear cascade of failure, like we saw in the last crisis. Signs of a deterioration in credit quality are so far faint (if not entirely absent) and, on the current showing, banks will face that, whenever it occurs, with better sources of funding, a higher proportion of liquid assets, and a deeper cushion of both capital and reserves.

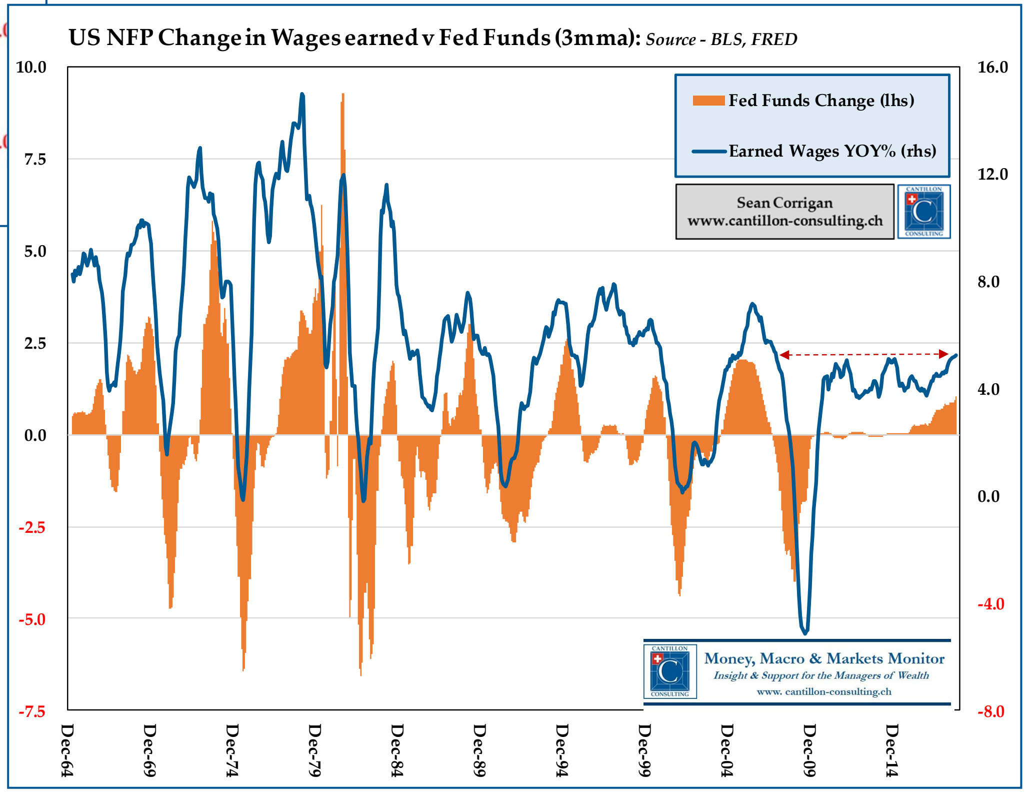
Chalk this one up to the 'GOOD' column.

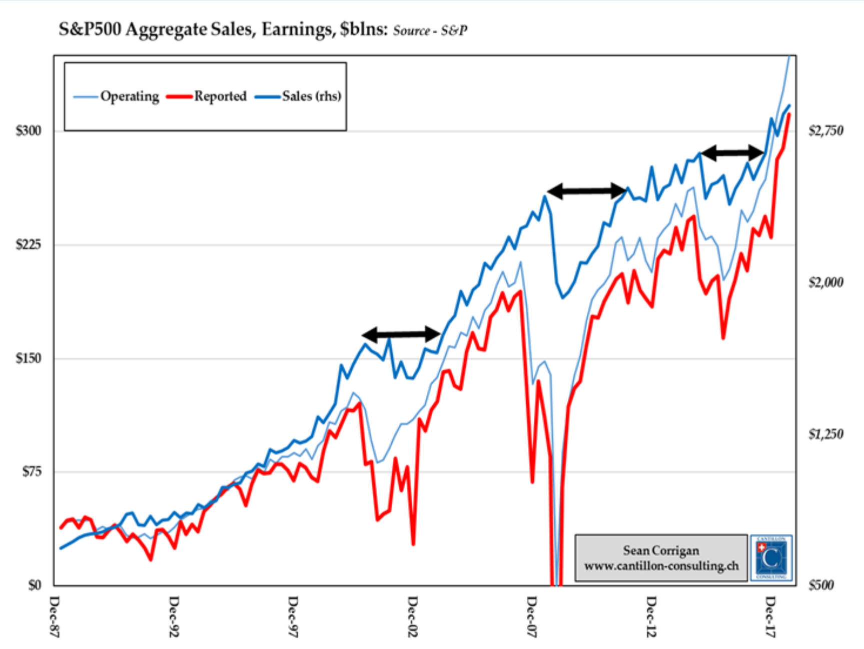


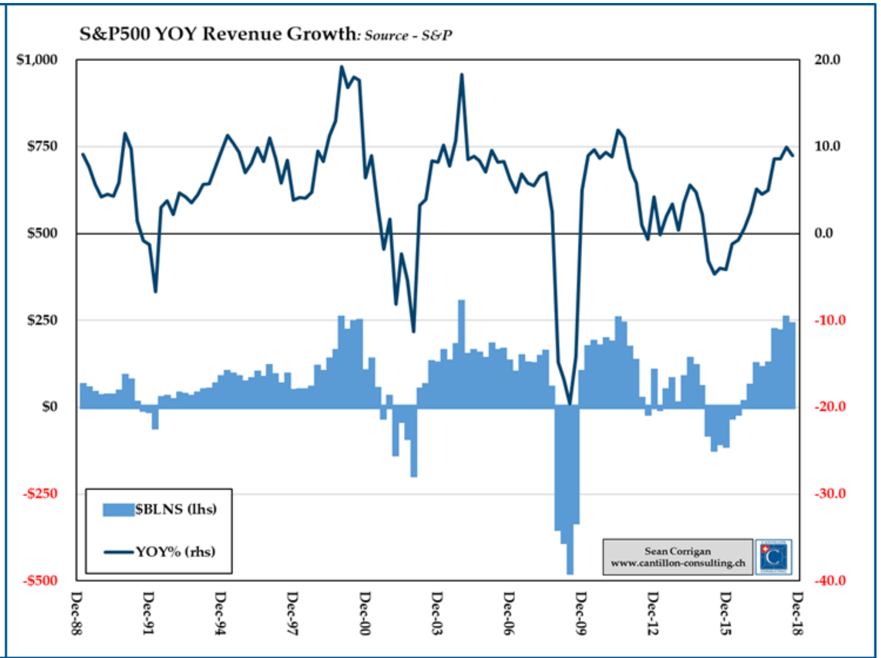
Similarly, business is still generally resilient at companies both large and small, with wages and payrolls expanding, revenues advancing at a commendable 7%-plus clip and profits still very much in evidence.

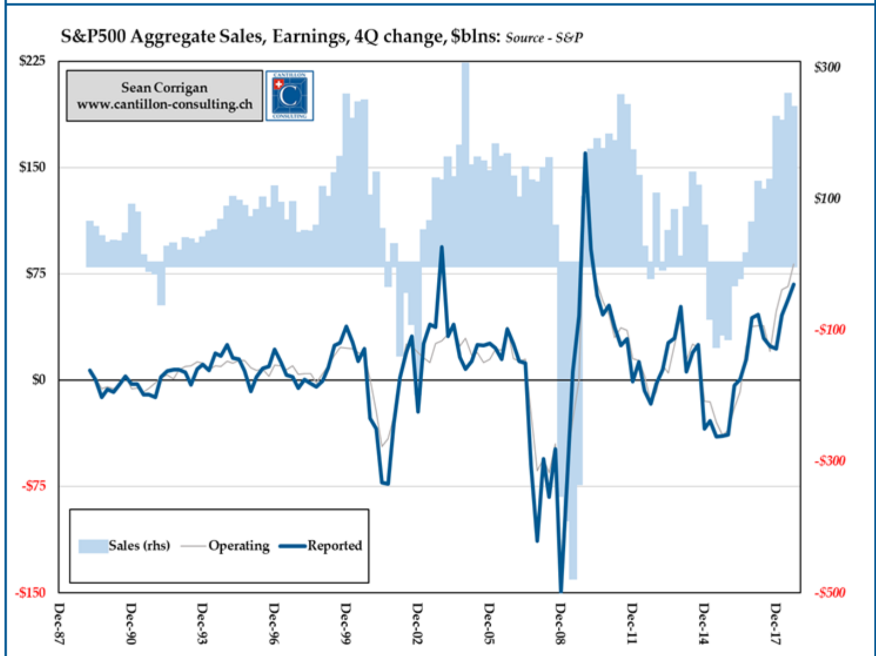
Another 'GOOD' rating.

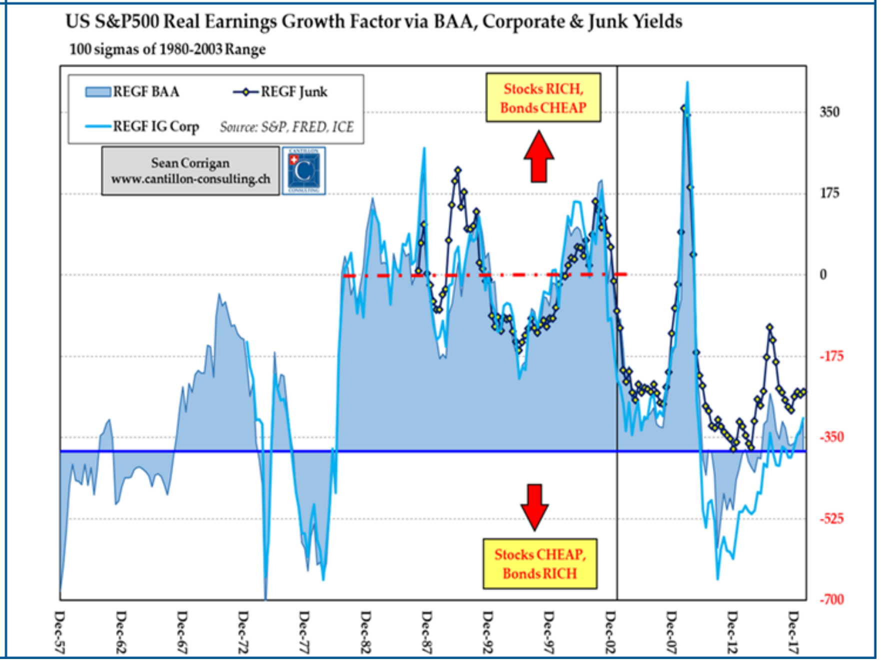










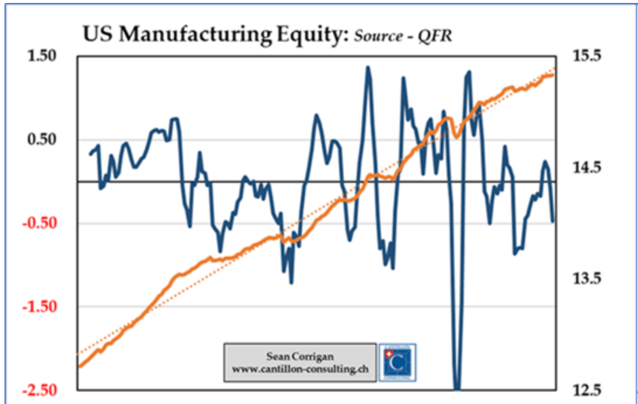


Analysts may be starting to compete over who can cut equity estimates the most, but the quarter just ended was certainly solid enough.

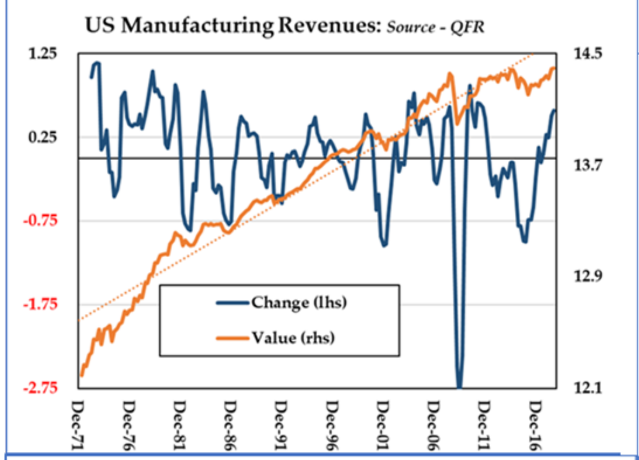
Adding a certain degree of comfort, the lower right panel shows that even today's higher bond yields are not yet offering too much of a challenge to equities' relative valuation.

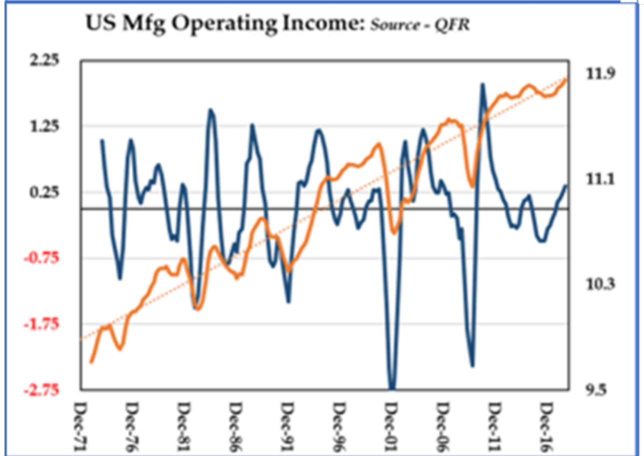
While hardly an impregnable defence against a sell-off, it does mean that, for one to be sustained, a good deal of additional confirmation will have to be delivered as stocks decline.

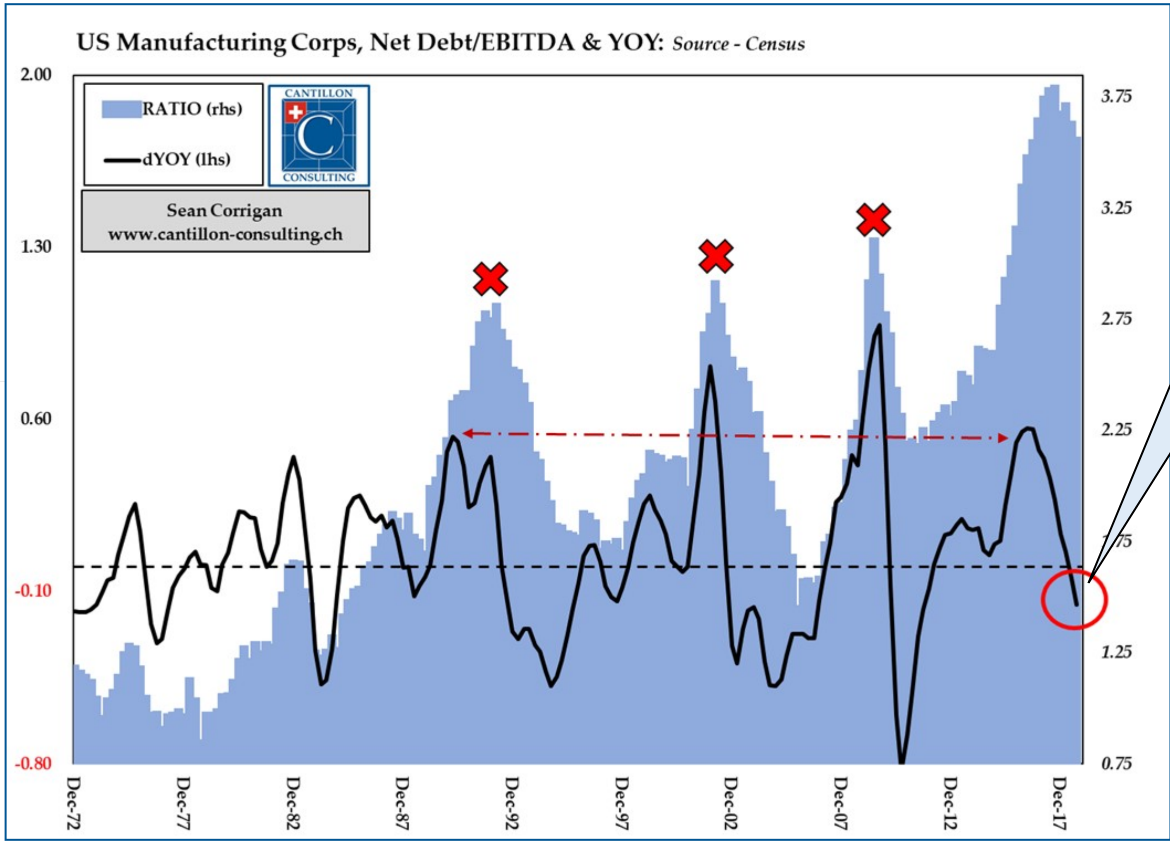
A tick for 'GOOD'



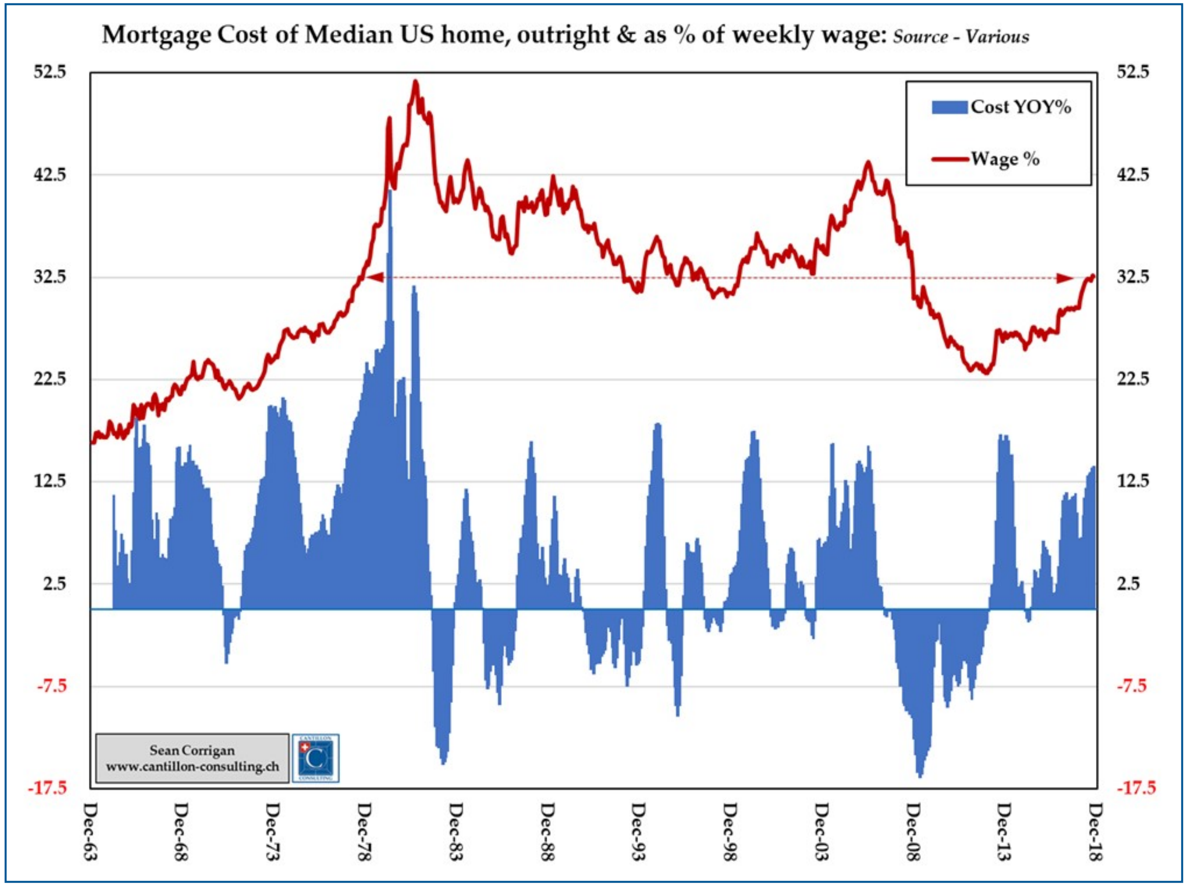
As we are all by now very aware, policy-makers—having spent a decade exhorting firms and individuals to borrow the historically cheap and abundant monies they have made available—are now trying to deflect blame by openly criticising them for responding to such blandishments. Driven by Miller-Modigliani earnings management, as well as a buoyant M&A activity, debt ratios have hit new heights but are also already falling. Manufacturing debt rose only 1.5% in the past year (the least in over 8 years) while revenues climbed 8.7% and operating income 10.6%. NB: Fed numbers show *Non*-corporate debt growing appreciable faster than the corporate kind.

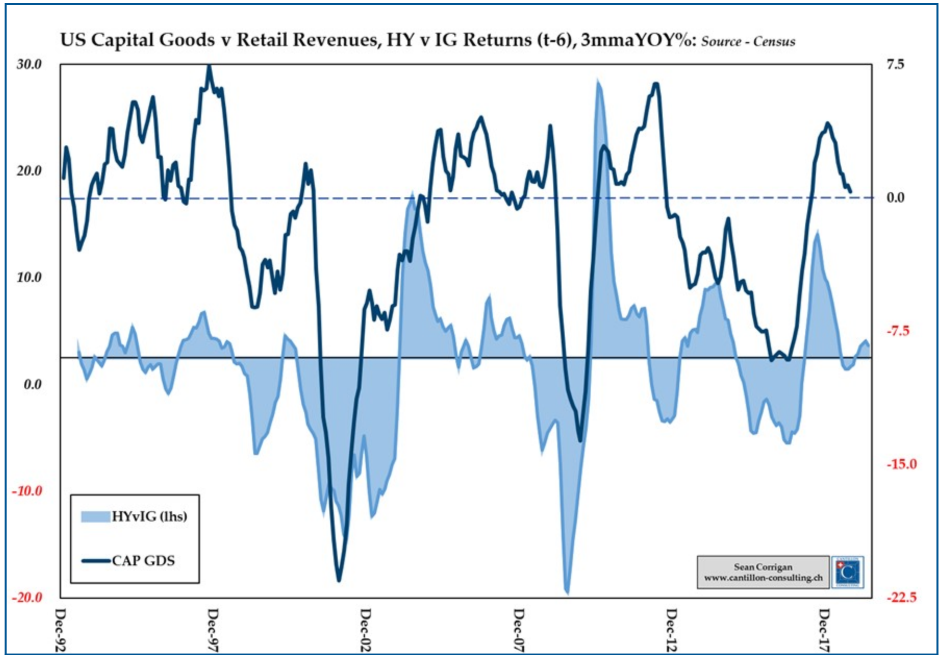


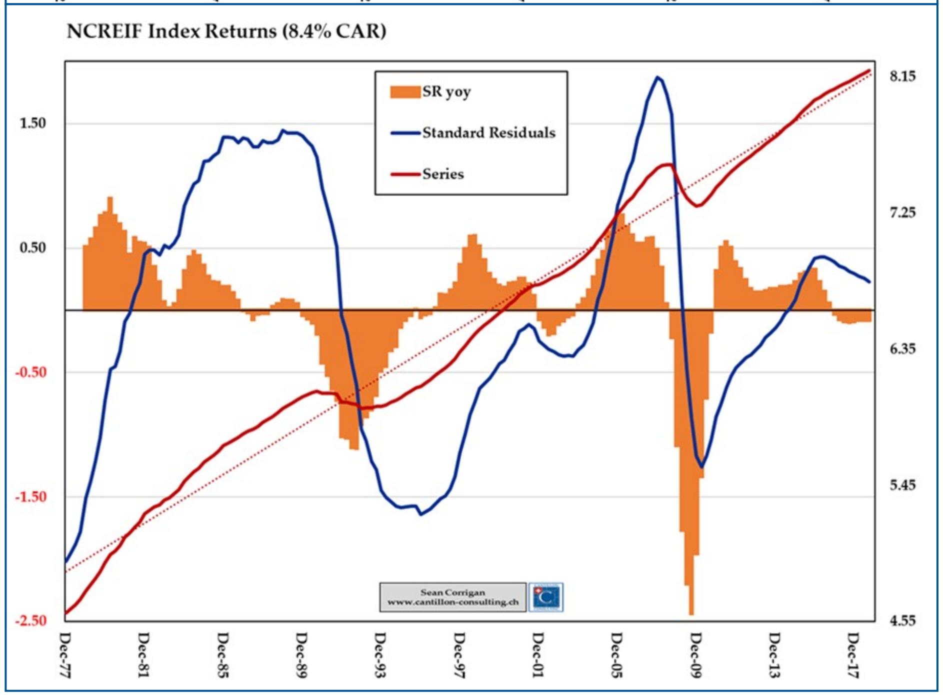




Score this 'BAD but cautiously improving'

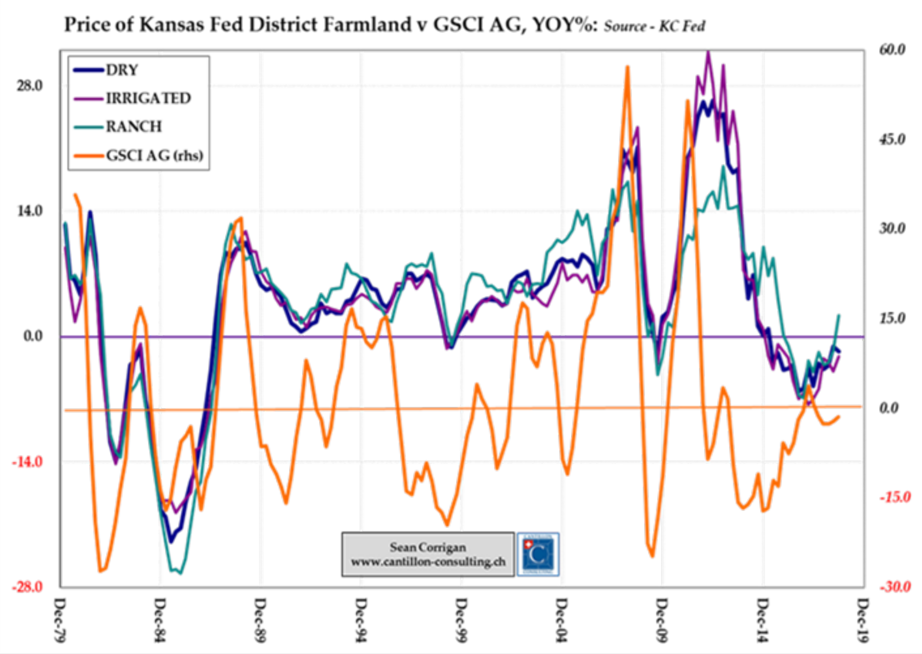


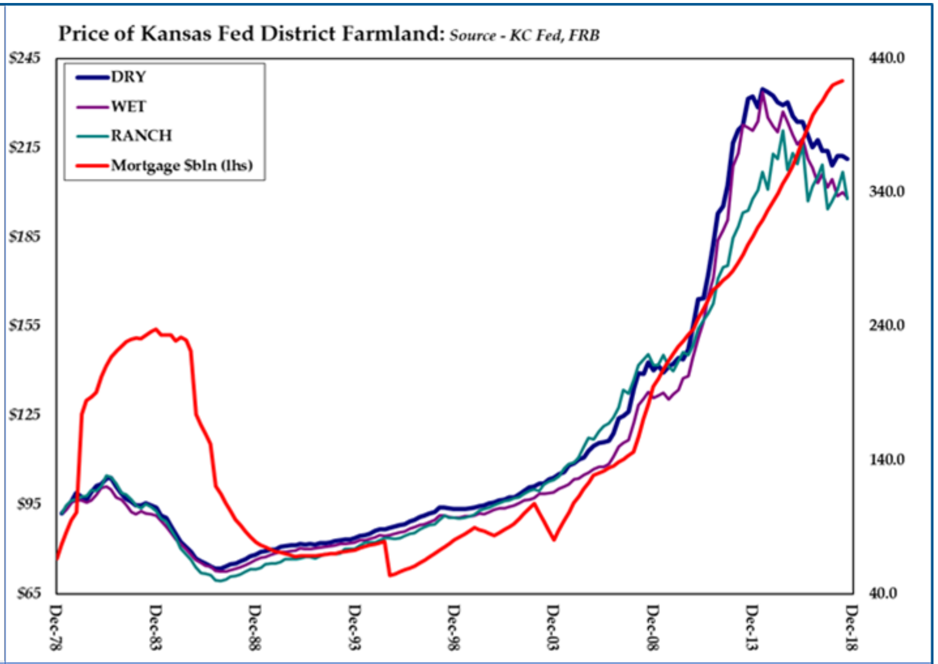


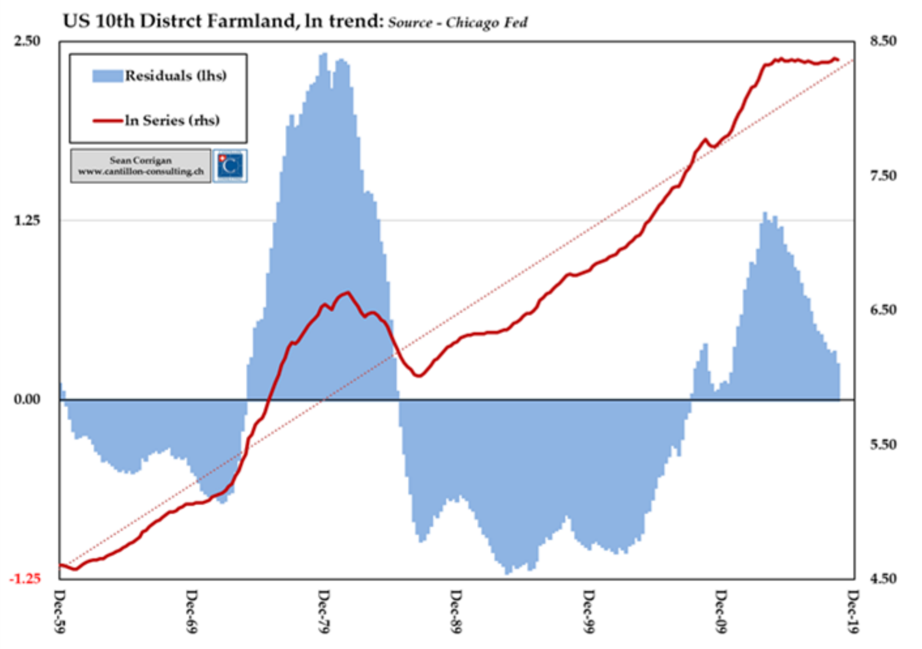


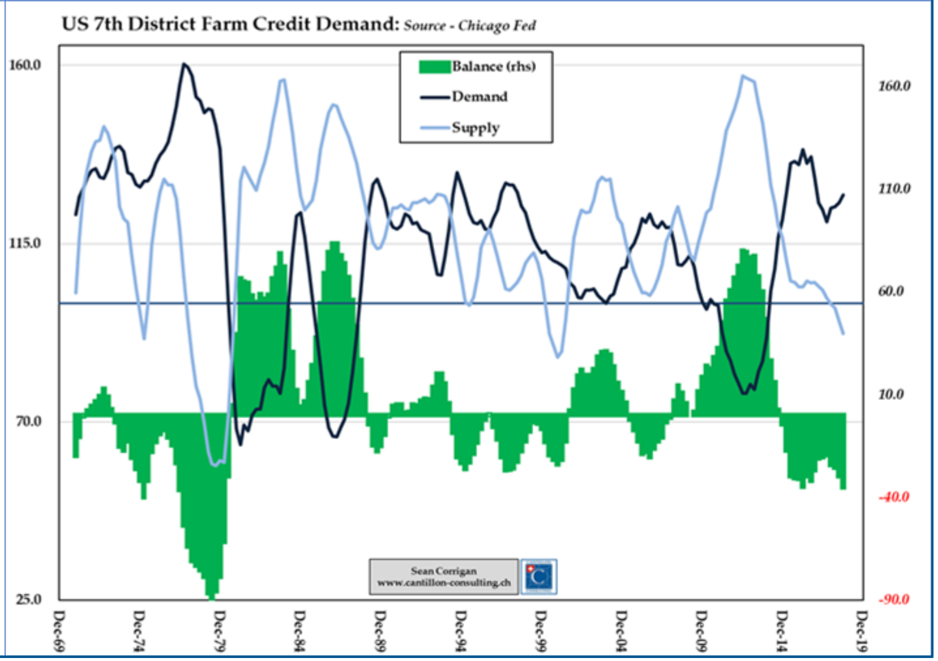
Higher home prices & rising rates can obviously mean budgetary stress. Taking the debt service burden of a 30-year standard mortgage on a median priced home as a fraction of the NFP average weekly wage, we can see a sharp rise from 2012's 40-year low. However, the current 32.5% is 5% below the mean of the three decades prior to Lehman & falls well short of the pre-crash peak of 43.4%. CRE (lower right) is climbing but doing so far less vigorously. What does make our Austrian antenna twitch is the absolute and relative deceleration of capital goods sales (top right)—something mirrored in the evident curtailment of junk's cyclical outperformance of IG credit.

'BAD', but not yet 'UGLY'.









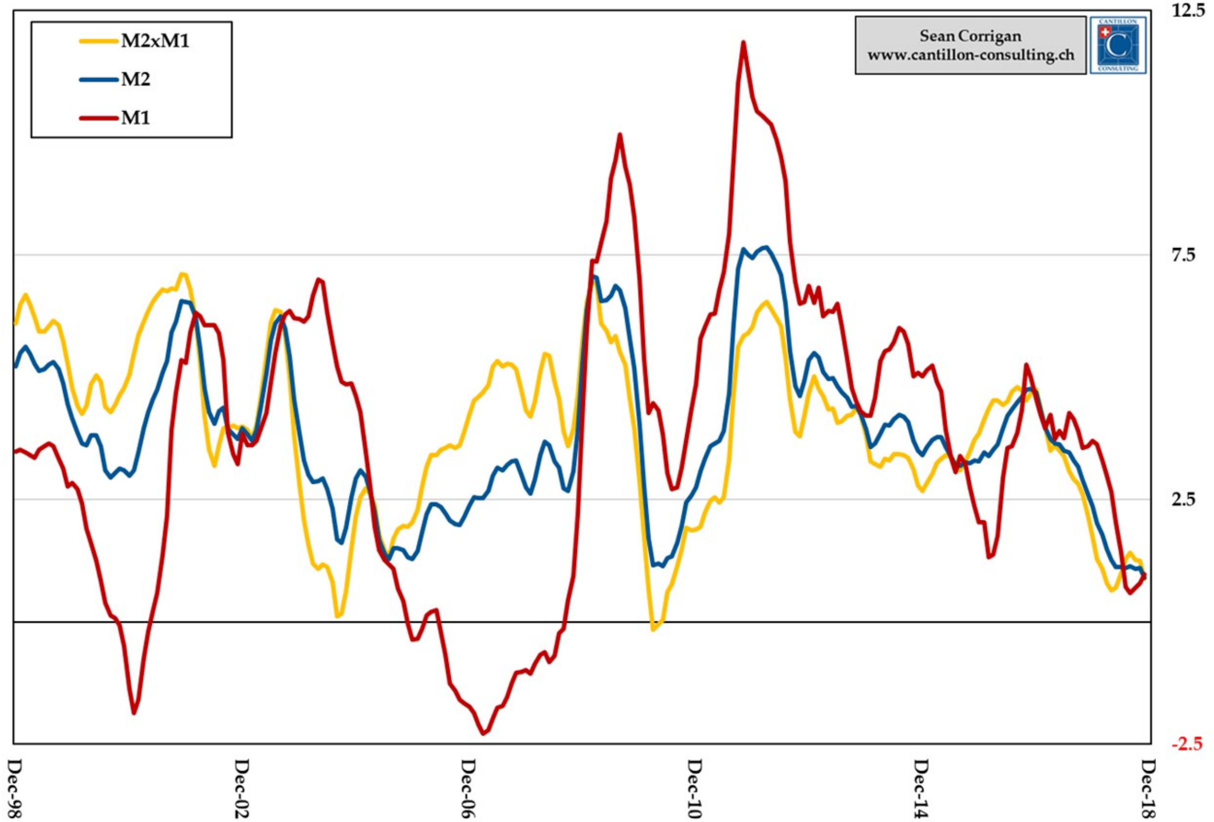
Fortunately, even at around $450 billion a year, a relatively small constituent of the economy, farming is undoubtedly having one of those Pharaonic reversals of biblical fame.

Land prices are flat or falling and debt conditions are worsening, prompting district banks to pull in their horns a little.

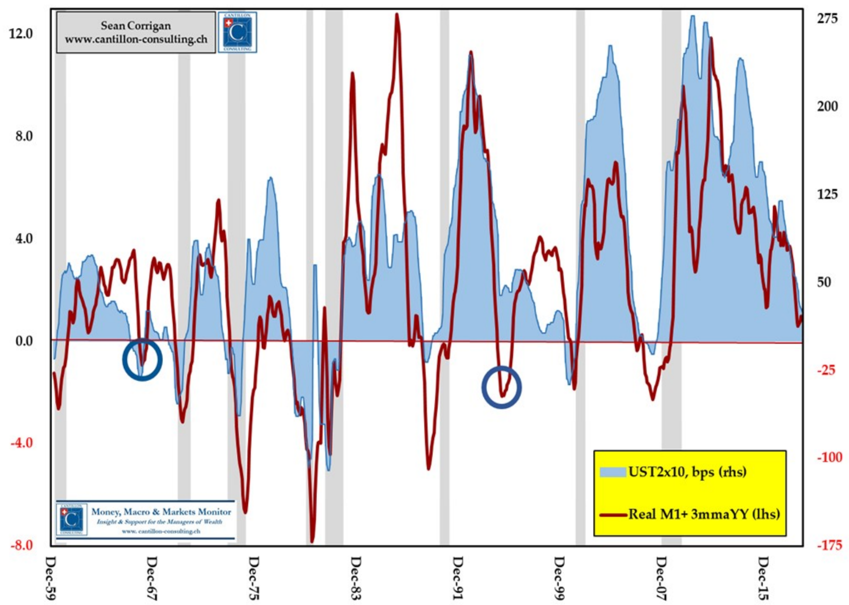
If only they could find someone in Asia to buy their beans, once more

Chalk one up to 'UGLY'

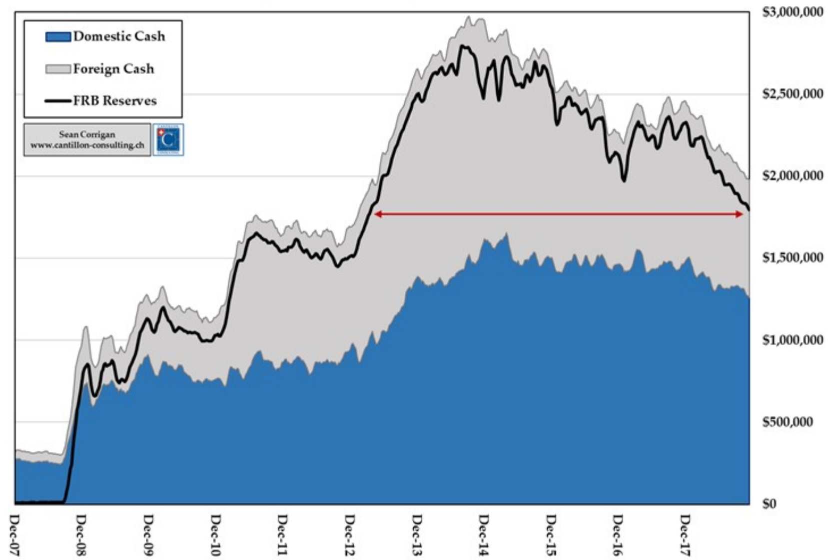
US Real Money Supply, 3mmaYOY%: *Source - FRB*



Real US M1+ v UST 2x10: *Source - FRB, FRED*

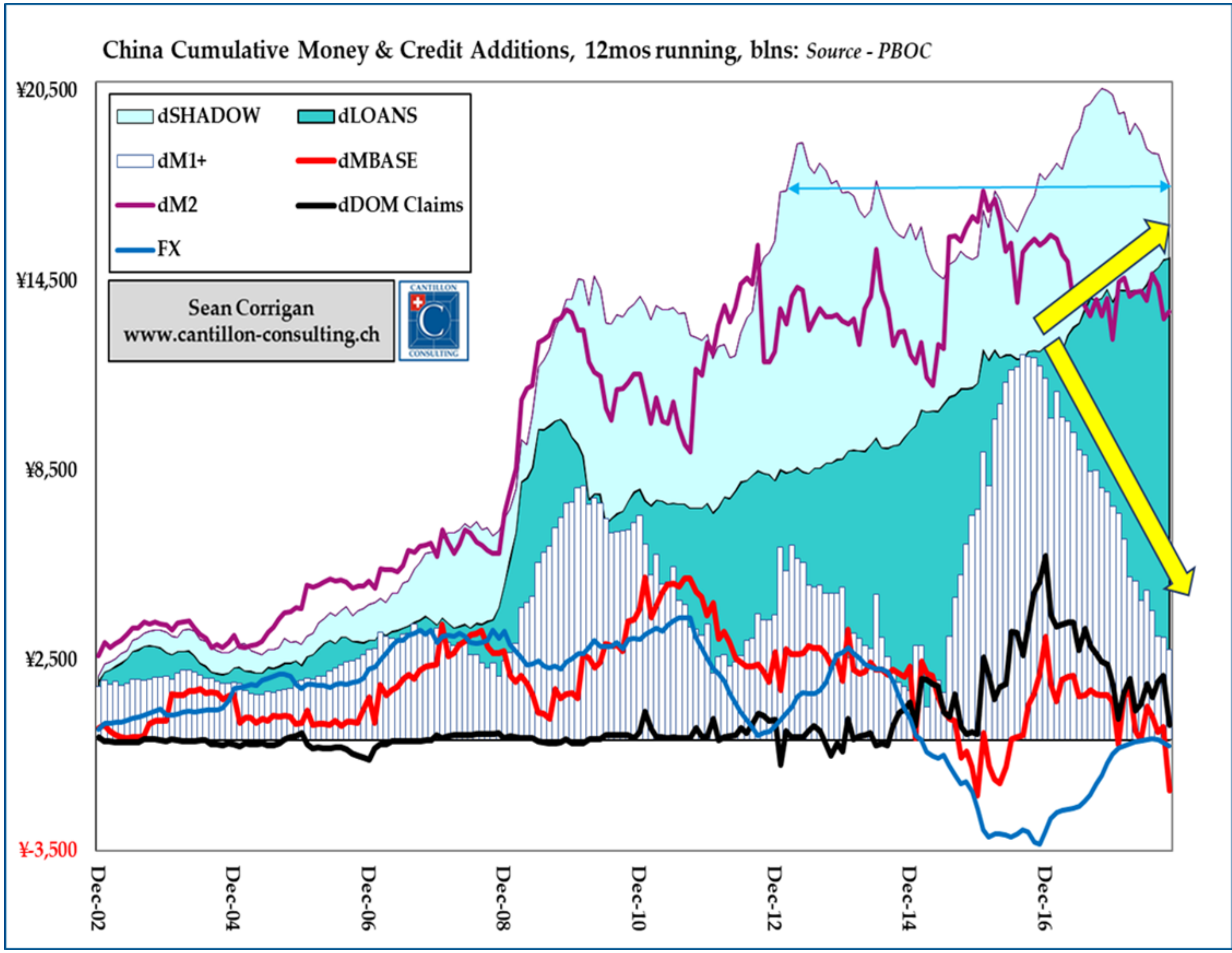


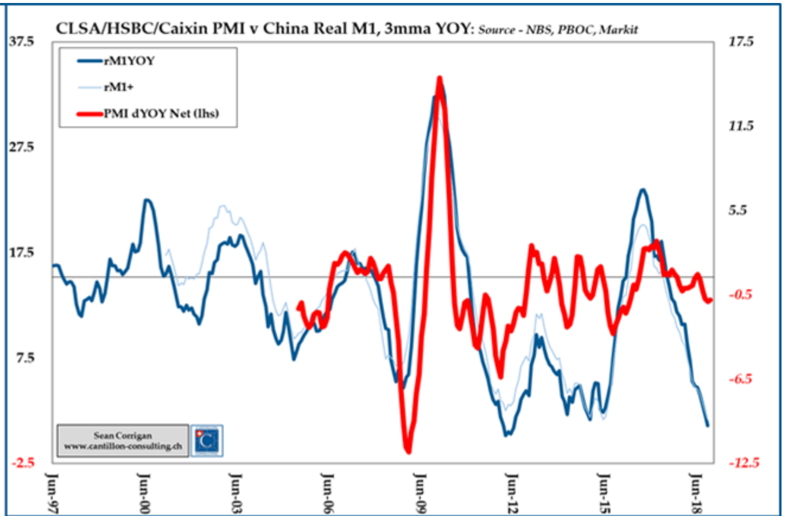
QT Reserve decline & Banking Incidence: Foreign v Domestic, mlns: *Source - FRB*



Just to recap on a theme to which we have already offered a good deal of commentary. The primary impact of Fed balance sheet reduction has so far fallen on foreign, not domestic banks (right) but money and credit growth is inarguably anaemic (top). The degree to which this simply reflects the 're-switching' of greatly abundant non-transaction funds back out from bank accounts in which they were previously inertly parked during ZIRP is as unquantifiable as it is undeniably at work. However, while in no way subscribers to the current fashion for viewing an inverted yield curve as a 'total protonic reversal', beam-crossing event, this, too, bears close attention

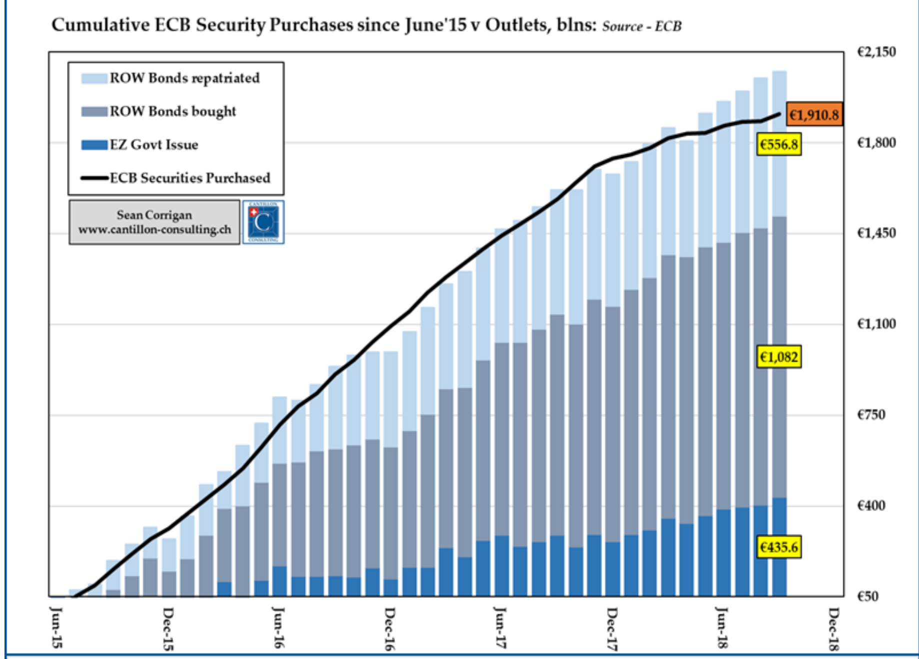
'BAD', not yet 'UGLY'.

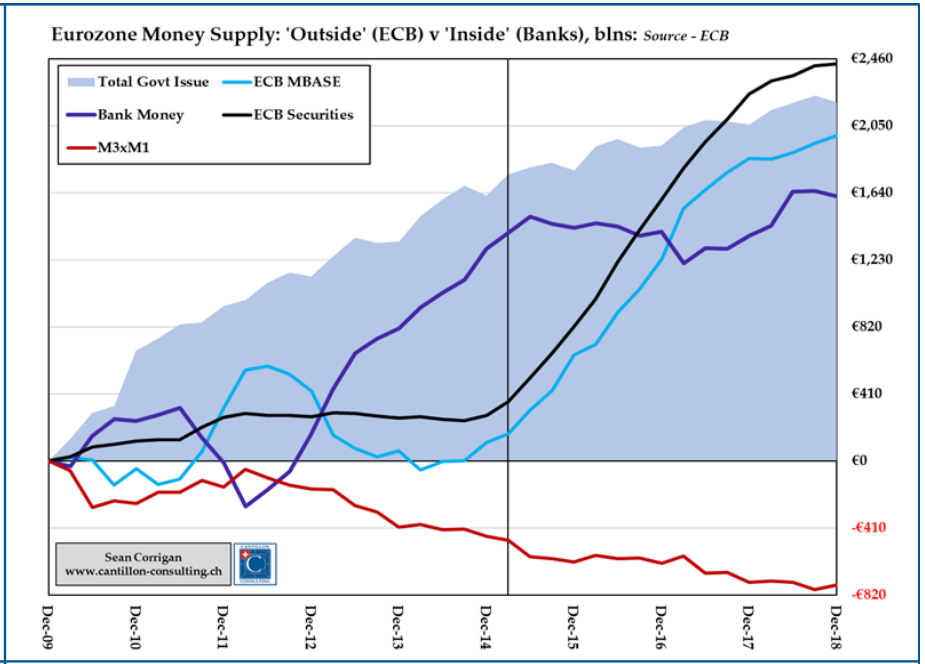


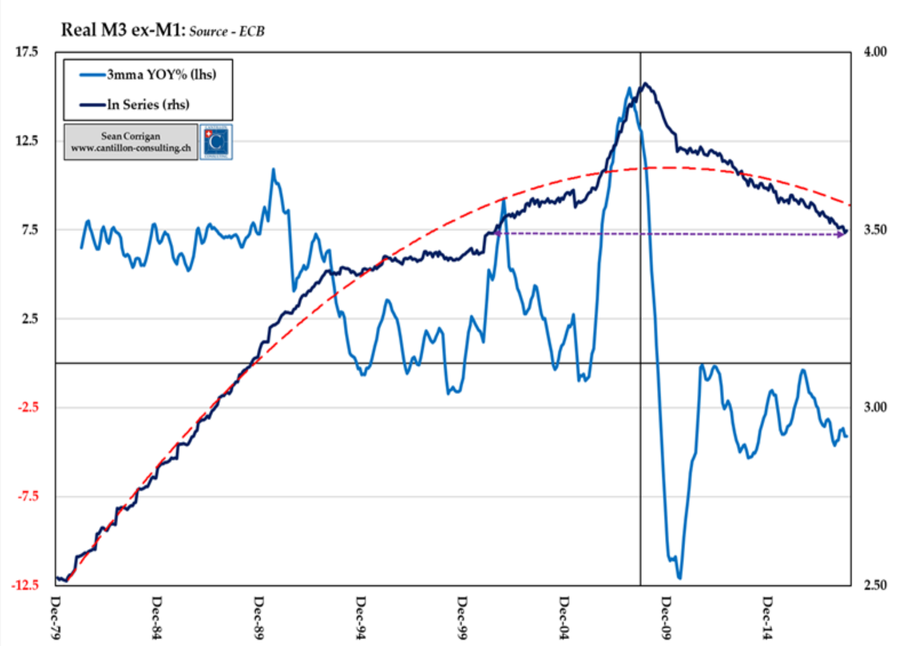


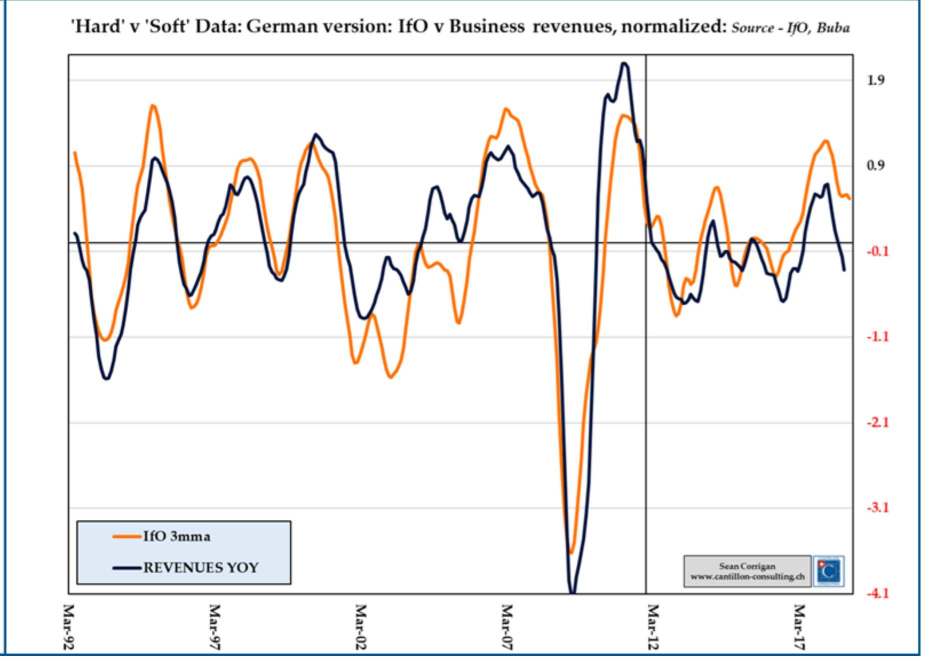
ELSEWHERE IN THE WORLD…

Covered at length of late. Suffice it to say there was nothing in the October numbers to suggest any remission in the squeeze underway in China. All the promises of billions in bail-out monies seem to be just that—promises—at this point.









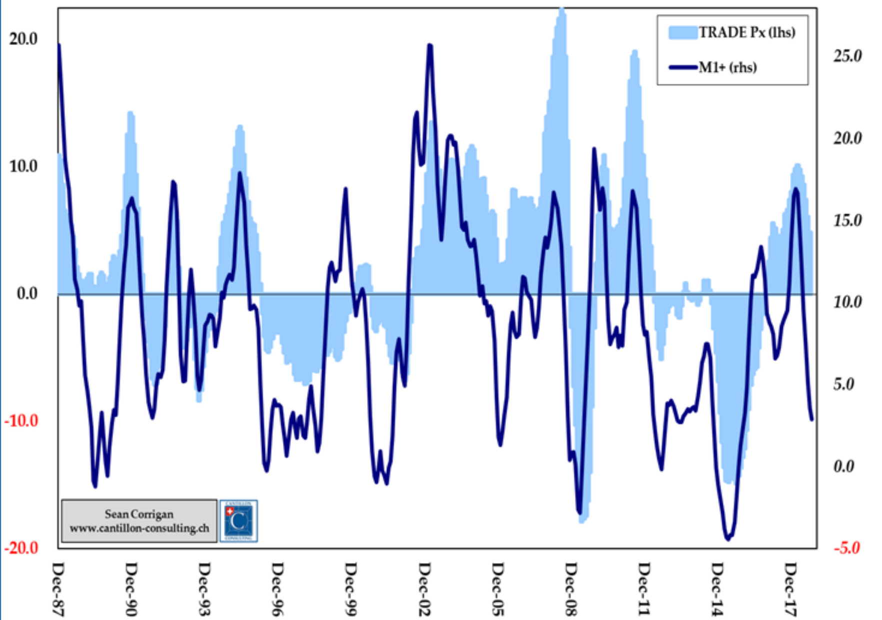
Something else we regularly highlight: the ECB is substituting for, not supplementing, credit creation and misdirecting it, at that.

This is hardly helpful to business turnover (though other elements of political stupidity are at play here, too).

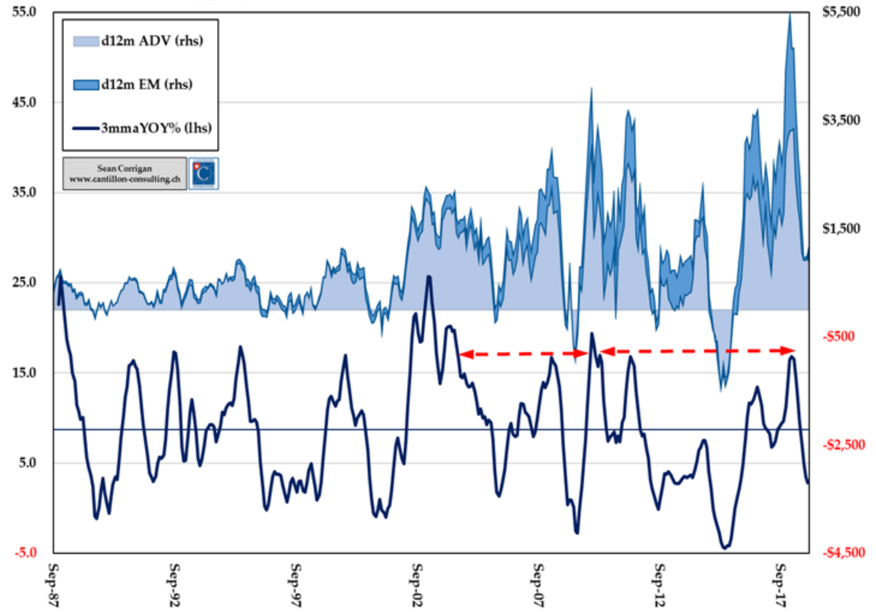
Dwindling revenue streams show up, as ever, in a weakening read from the IfO survey.

If the numbers continue to disappoint, expect Draghi to start wriggling out of his QE termination pledges.

Global-70* M1+ v World Trade Prices, 3mma YOY%: *Source - IMF, BIS, WTO, CPB*

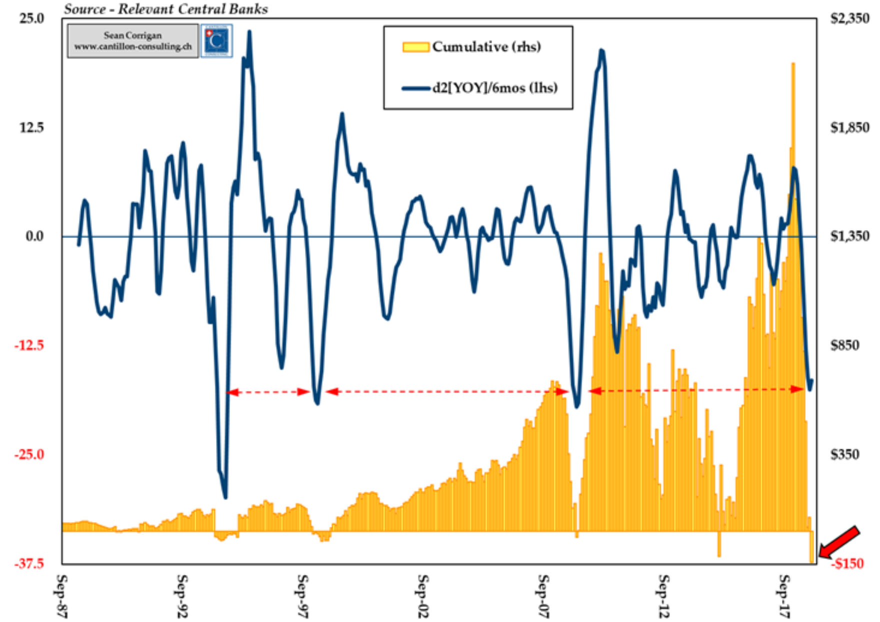


Global Money Supply proxy, 3mma YOY% & increment ($blns): *Source - Various CBs. OECD, IMF*

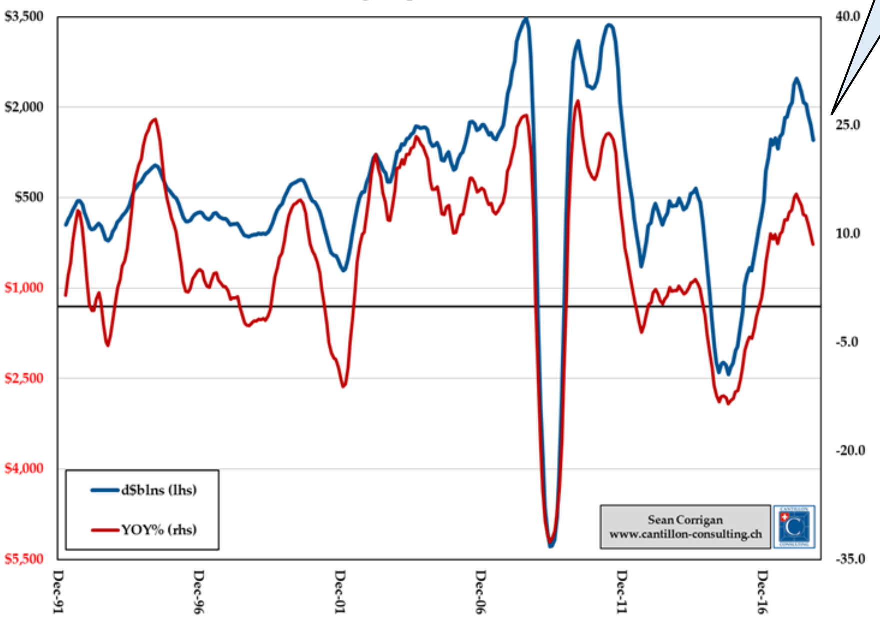


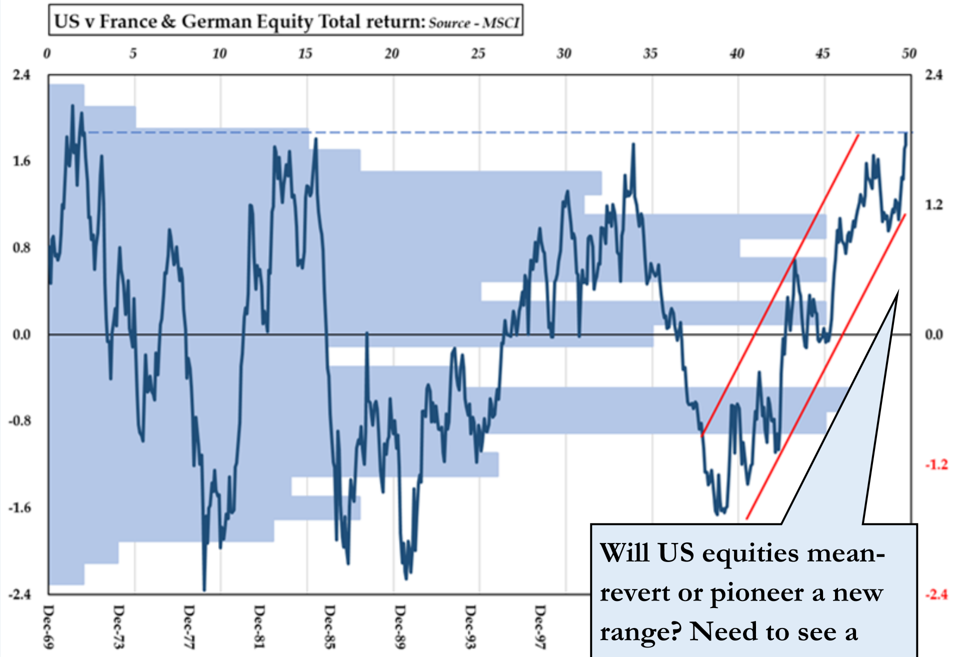
The translation effects of a stronger USD, coupled with slowing domestic-currency money growth in many places is all too evident in these charts, as is their primary impact, illustrated in the bottom right & top left panels

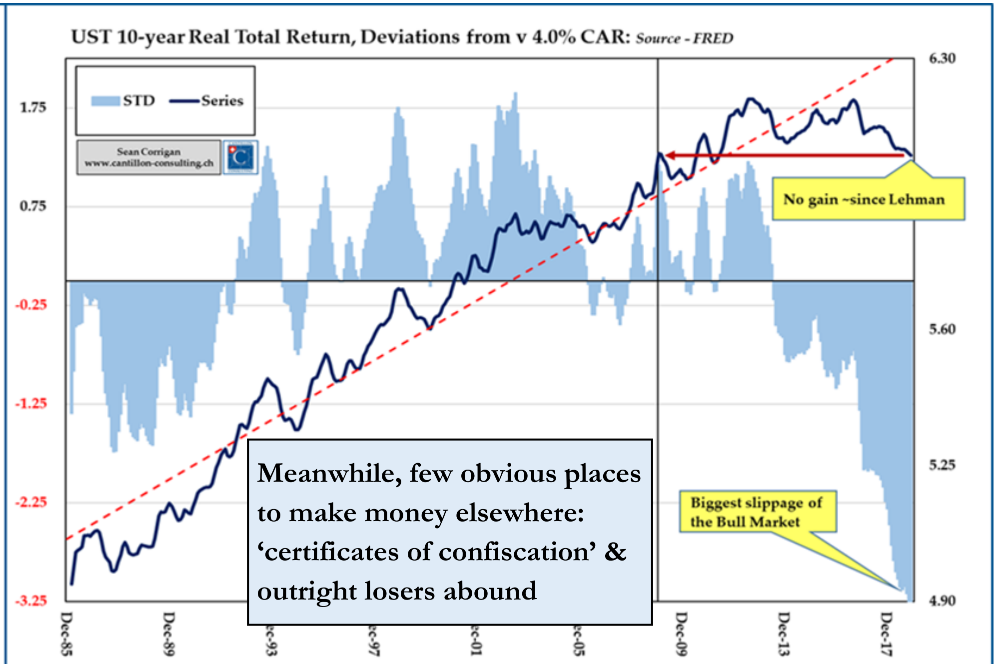
EM-8 Money Supply in USD, 12m cumulative (blns) & 6-month change in 3mmaYOY%:
Source - Relevant Central Banks



World Trade Value, 12-month change in pct & $blns: *Source - CPB*

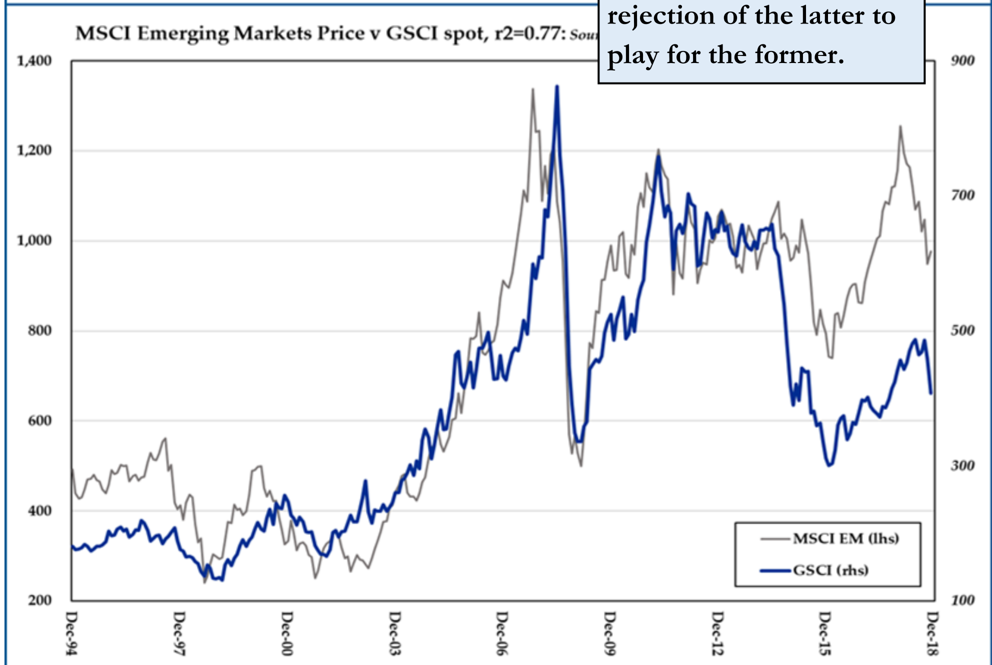


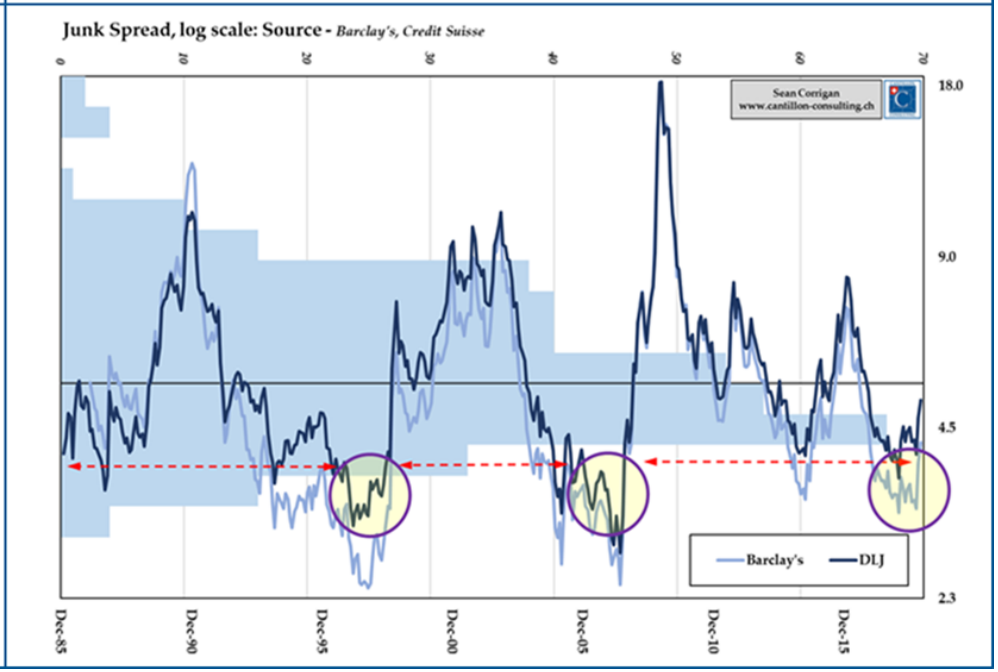




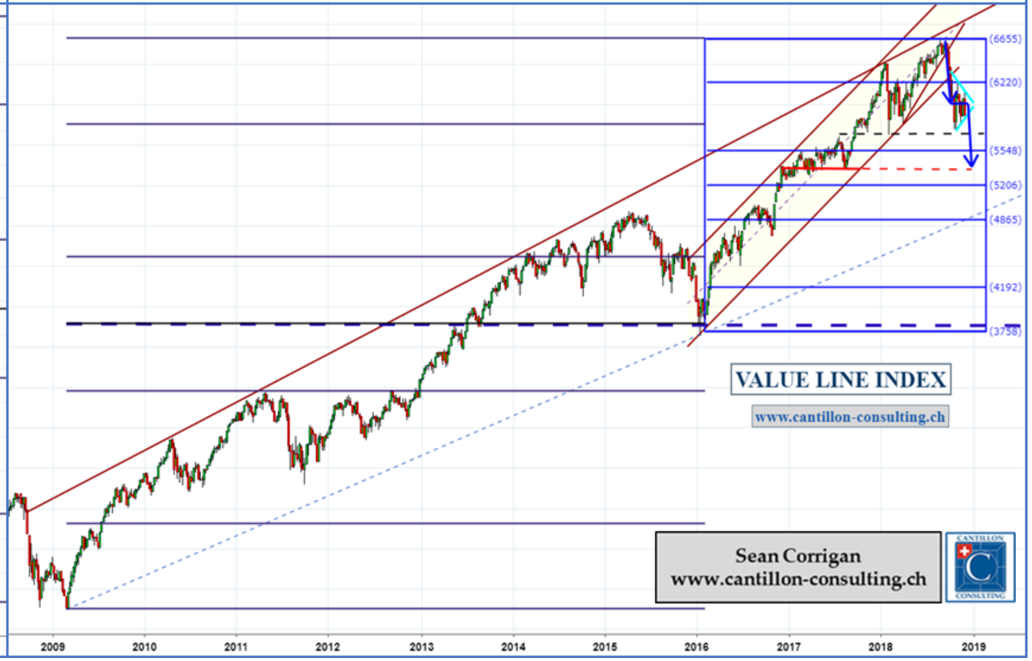
Meanwhile, few obvious places to make money elsewhere: 'certificates of confiscation' & outright losers abound

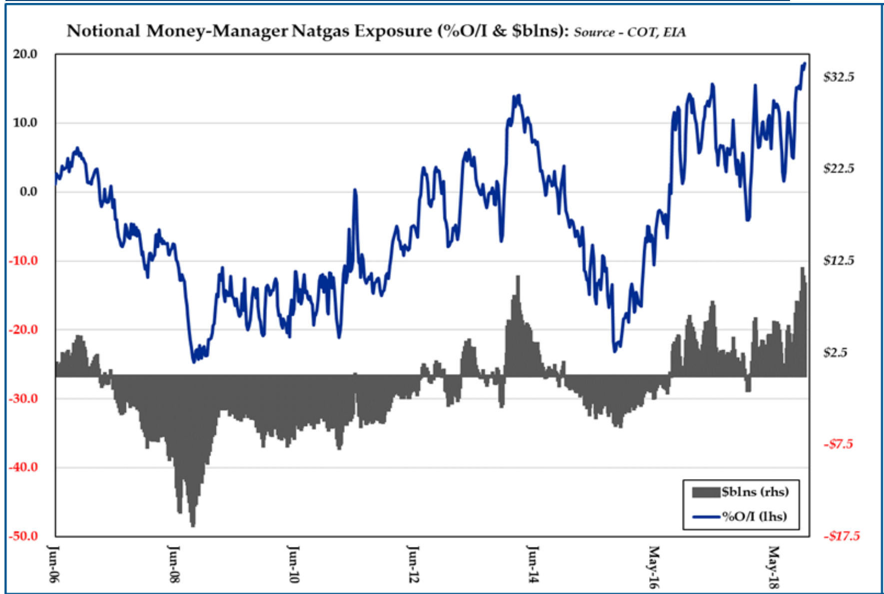
Will US equities mean-revert or pioneer a new range? Need to see a rejection of the latter to play for the former.

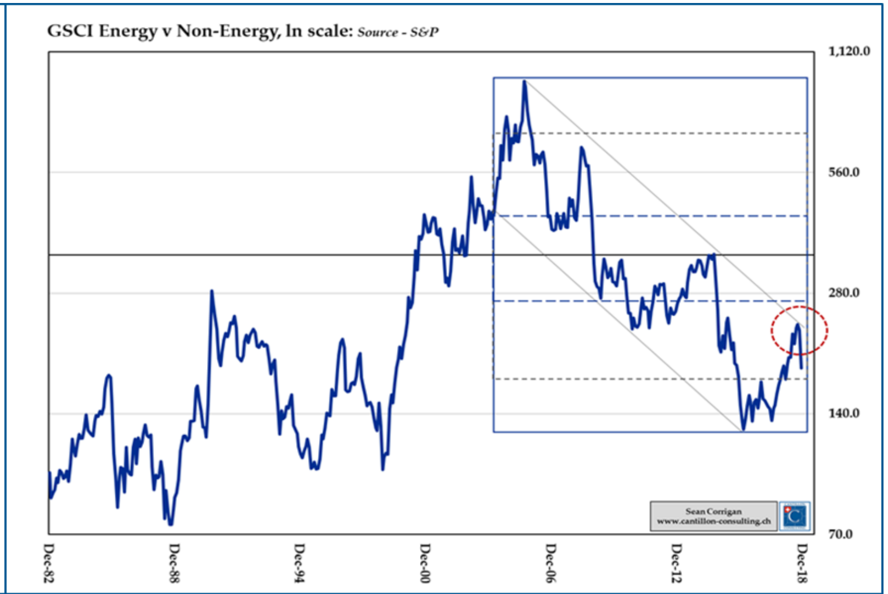


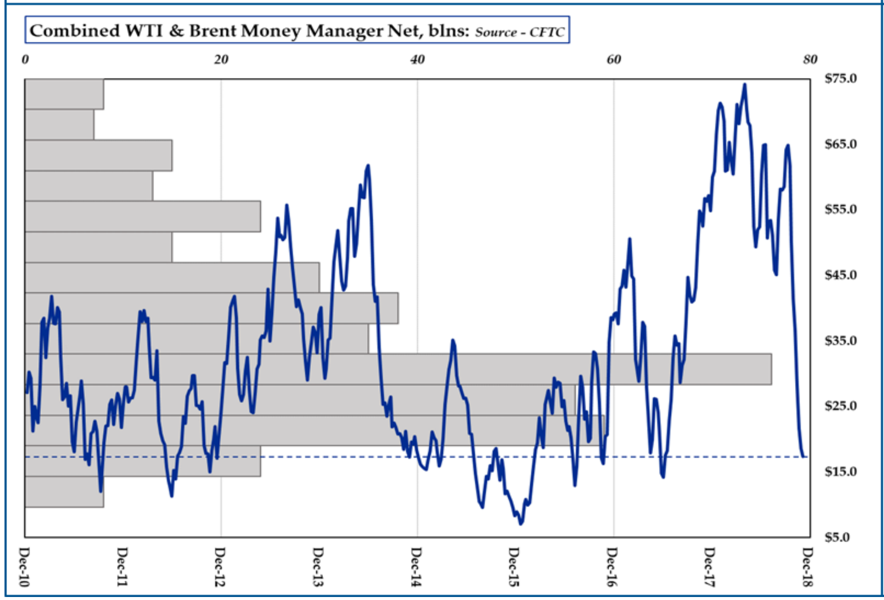


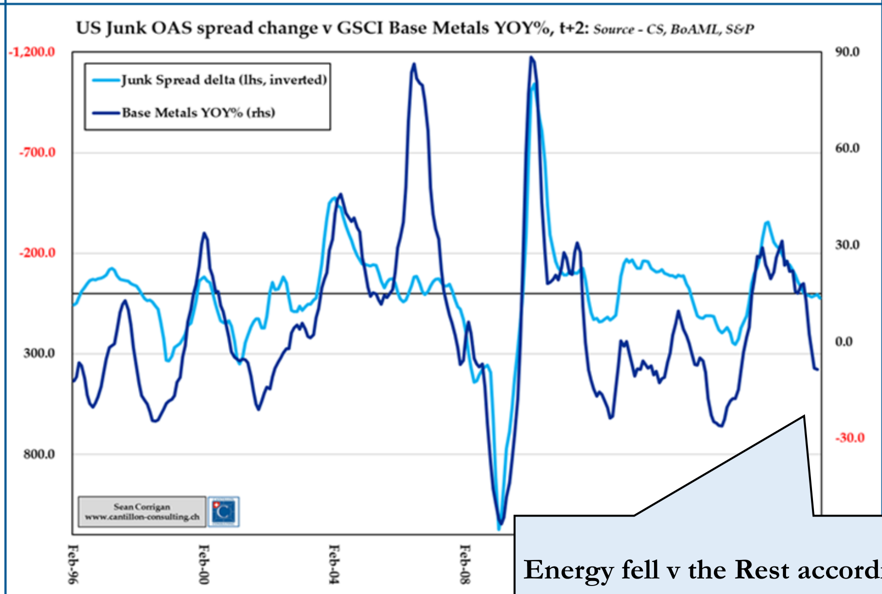
At best, these markets are now tracing out a big, messy range (above); at worst, they look scarily reminiscent of what happened 10-years ago (top right)



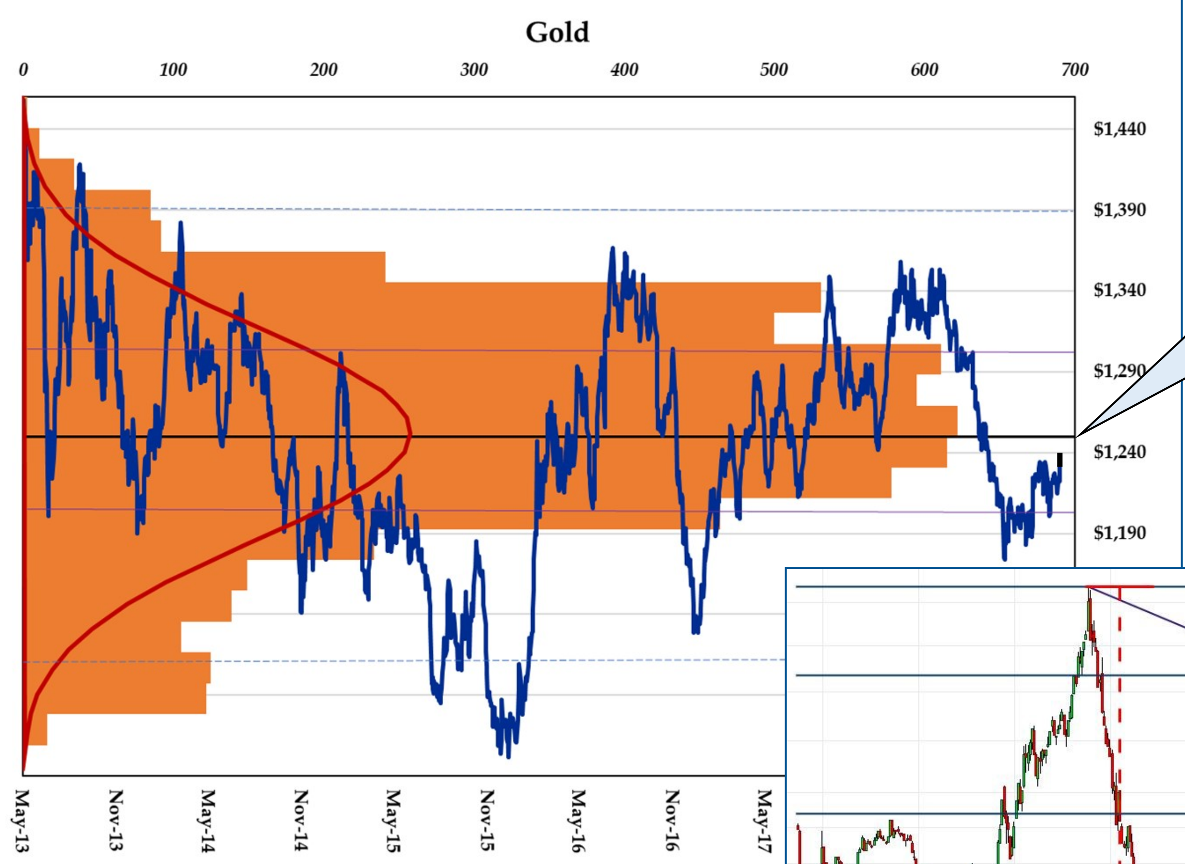








Energy fell v the Rest according to a textbook chart pattern. Oil now looks less worrisome than Natgas v-a-v hot money flows. Metals are being undermined by Chinese money trends and US credit moves, both.



As ever, gold gets a bid when nerves jangle, spreads widen, and vols go bid, But, for all that, it's still one big, long, 5 1/2-year, range trade, centred around $1250/oz

Despite the emerging view of the Fed as either politically pliable or economically anxious, nothing has yet taken the shine off the Greenback—as least as far as the majors are concerned. This long-term pattern looks neat enough but has yet to receive validation that a third bear market is in-deed imminent.

All external charts courtesy of TradingView .com & Investing,com

Disclaimer

All content is intended to give general advice only. The investments and instruments mentioned therein are not necessarily suitable for every individual and you should use this information in conjunction with other advice and research to determine its suitability for your own circumstances and risk preferences. The value of all securities and investments, as well as the income derived from them, can fall as well as rise. Your investments December be subject to sudden, often substantial, declines in value which December not be recoverable; others December expire worthless after a specified period. You should not buy any of the securities or other investments mentioned with money you cannot afford to lose. In some cases there December be significant charges which December reduce the value of your investment. You run an extra risk of losing money when you buy shares in certain securities where there is a large difference or 'spread' between the buying price and the selling price, a circumstance which means that, should you sell them immediately, you December get back much less than you paid for them. In the case of investment trusts and certain other funds, these December use or propose to use the borrowing of money in order to increase the size of their exposures and/or invest in other securities with a similar strategy. As a result, movements in the price of the securities December be more volatile than the movements in the prices of those underlying investments. Some investments December involve a high degree of such borrowing (often referred to as 'gearing' or 'leverage') This means that a small movement in the price of the underlying asset December have a disproportionately large effect on that of your investment. Accordingly, a relatively small adverse movement in the price of the underlying asset can result in the loss of the entirety of your original investment. Changes in rates of exchange December have an adverse effect on the value or price of the investment and you should be aware that additional dealing, transaction, and custody charges for certain instruments December result when these are not traded in your home currency. Some investments December not be quoted on a recognised investment exchange and, as a result, you December find them to be 'illiquid'. You December not easily be able to trade your illiquid investments and, in certain circumstances, it December become difficult, if not impossible to sell the investment in a timely manner and/or at its indicative price. Investment in any of the assets mentioned December have tax consequences regarding which you should consult your tax adviser. All reasonable care has been taken to ensure that all statements of fact and opinion contained in the either written or spoken form are fair and accurate in all material respects. All data is from sources considered to be reliable but its accuracy cannot be guaranteed. Investors should seek appropriate professional advice if any points are unclear.