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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

"Silver alone is the true sinews of the circulation"

Essai sur la Nature du Commerce

Volume III, Issue I

Ring out the Old

Jay Powell, the Fed 'Put', and those Beijing blues

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In place of one responsible Pharaoh, ...we have a multitude… and beyond these we have the Pharaoh passion, acting in governments big and little. When too much labour has been spent on (their) pyramids, or things that are dead and unproductive in the meaning of pyramids, there will be a crisis in daily well-being and free labour... will be as helpless as slave labour was. It cannot consume what it has produced; it is without all those human satisfactions that might have been produced in place of the pyramid, and it is without them forever. The labour that is lost cannot be recovered by unbuilding the pyramid.

Garet Garrett, "A Bubble that Broke the World", 1932

Ring out the old, ring in the new

At least that is what those who have suffered through what has been an unaccustomed period of tribulation will be hoping we can now do as the calendar turns and the sun begins its slow path through the heavens, back toward our Northern summer.

For, once the veneer of effortless enrichment had been scratched through to reveal the rotting timbers buttressing this most venerable of bull markets. As ever, once the parlour magician had shown just a little too much of his apparatus to allow for a further suspension of disbelief, the retreat was far more pell-mell than the advance.

Once the first, the topmost, the most precariously perched grains of sand had begun to tumble, inevitably they dislodged increasing numbers of their neighbours, accelerating and growing in power as they descended together until their accumulated mass turned the final quarter of the year into a veritable landslide of loss, if not outright panic.

Up by the stairwell and down via the lift-shaft in time-honoured fashion, proving, once again, that markets do not recoil on 'profit-taking' but on the increasingly urgent loss-realisation conducted by its erstwhile bull-market heroes, a hubristic breed now all too heedful of the salutary, Roman triumph admonition to the victor of the hour to '*Remember, thou art mortal*'.

Unavoidably, the move was not without its ironies. Faced with actual losses, many of the cod Cassandras who had been croaking (with some justification, it must be admitted) that the market had far outstripped the 'fundamentals', shamelessly segued into the dire prognostication that the fall had affected the instant transubstantiation of the thin wafer of pretended value which they had so vocally been decrying into a thick, tangible corpus of truth which could only be a harbinger of genuine economic distress.

For their part, Permabulls routinely affect to believe that every effortless rise in the notional value conferred by an unimpeachably 'rational' market upon their portfolio is testament both to their personal talent for investing and to the irresistible entrepreneurial genius encapsulated in the stocks they happen to own, while complaining that every decline is an error; an artefact of others' dilettantish fickleness or the fault of some shadowy, unthinking computer program.

In sum, members of this tribe, while no less prone to error, folly, or cupidity than their habitual detractors, are at least consistent in their approach. For them, the simple purpose of stock is to rise in price. Every such rise is a vindication of their righteous faith: every decline therefore an abomination utterly contrary to the natural order.

Permabears, by contrast, take a jaundiced pleasure in attributing every advance - however well merited - to some combination of the folly of crowds; to sell-side manipulation; or to the oily assistance of the punters' central bank procurers. Yet they are equally quick to shriek, '*Recession*!' should what they re-

US Durable & Capital Goods v Retail Revenues, HY v IG Returns (t-6), 3mmaYOY%:
Source - Census, BoAML, Cantillon

HYvIG (lhs)
DUR GDS
CAP GDS

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'Higher order' goods have been sending mixed signals of late. Unlike the broader durables category, capital goods are inarguably slowing, both outright and relatively, but *are* still positive. On the monetary front, we would seem to be on the cusp of something unpleasant, were it not for the fact that rate hikes have encouraged switches back to a more normal mix of holdings & few yet report credit constraints.

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

M2xM1
M2
M1

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gard as these malign forces once waiver in their application.

In essence, the most devoted Permabears are subject to that persistent strain of millenarian pessimism which has afflicted humanity in many guises throughout the ages (climate catastrophists, q.v.). Thus, while they can never see the least organic reason for the upswing, deeming all appreciation as an abrogation of rationality, they are not loth to turn a smart about-face and to insist on stocks' supreme virtue as a yardstick of real-world conditions the second they again head south.

Each of these mutually-opposed streaks of contrariness have been in evidence during the market's recent gyrations, as hope and fear, liquidation and bottom-fishing have clashed, sending the S&P swinging crazily from one moment to the next like a storm lantern in a raging Nor'easter.

As we frequently remark, the true struggle is usually one fought out over authorship of a narrative which is constructed *after* the fact as a means of 'explaining' the unfathomable powers which drive that largely unscripted, mass auction we call 'the market'. Perhaps no better illustration is currently to be had than the controversy which rages over Jay Powell's recent attempt at a clarification of his outlook.

Permabulls' transports of delight at what they see as him rolling over (in both senses of the term) the notorious Fed 'Put' are only slightly tempered by a nagging feeling that its extension might mean that Chairman Powell thinks he might soon have to exercise it, amid a bitter winterscape of economic contraction and financial upheaval.

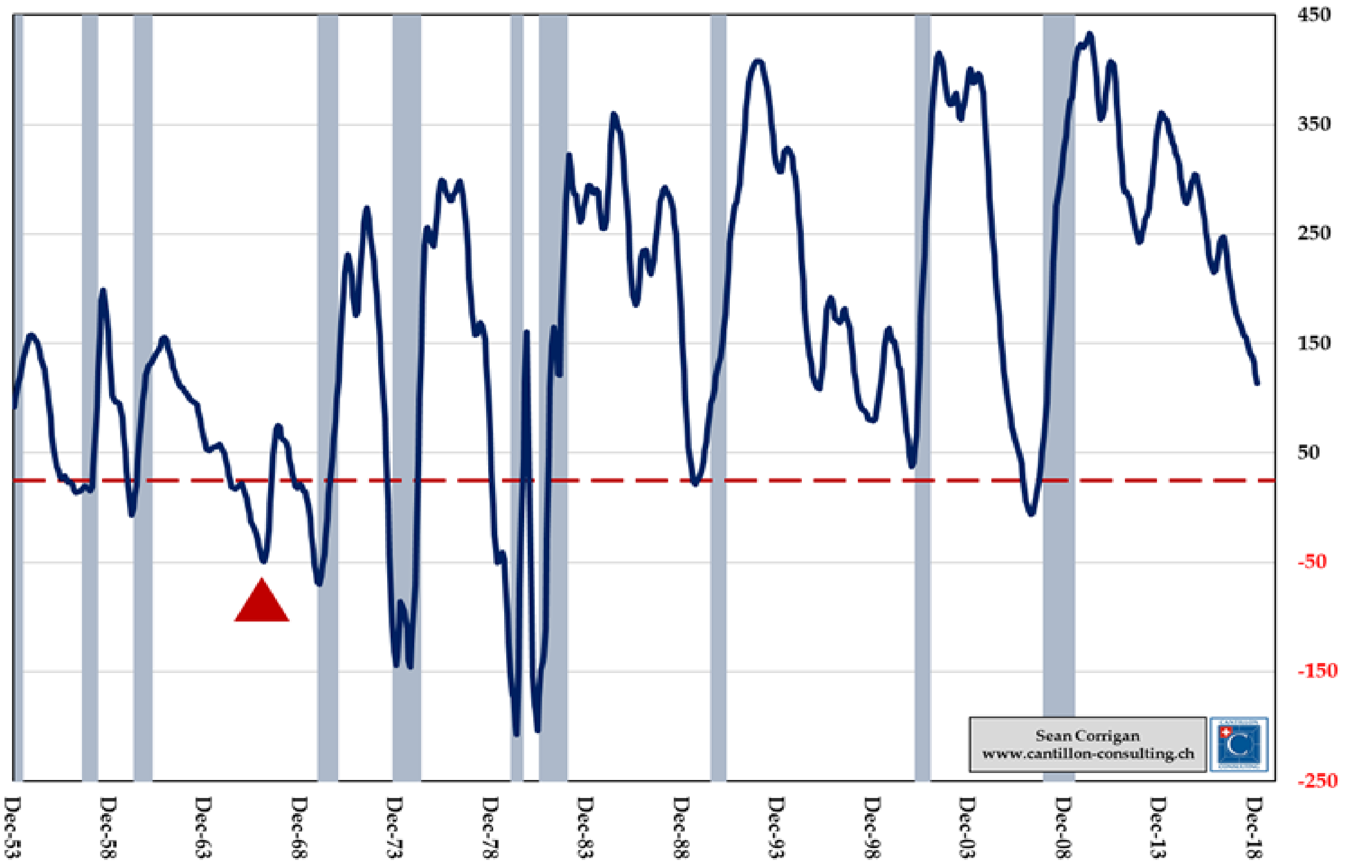
For once in partial agreement, many Permabears, meanwhile, have abandoned their tedious Jeremiads about how little resilience such a debt-strapped economy can muster in the face of even the most modest tightening of conditions in favour of uttering howls of anguished betrayal that Powell has dashed the sweet cup of *Schadenfreude* from their lips by arresting the market's slide.

For our part - though here we, too, may be making the wish the father of the argument - we are not entirely convinced that Mr. Powell was as unequivocally supportive (or predictably supine, depending upon your point of view) as is popularly supposed.

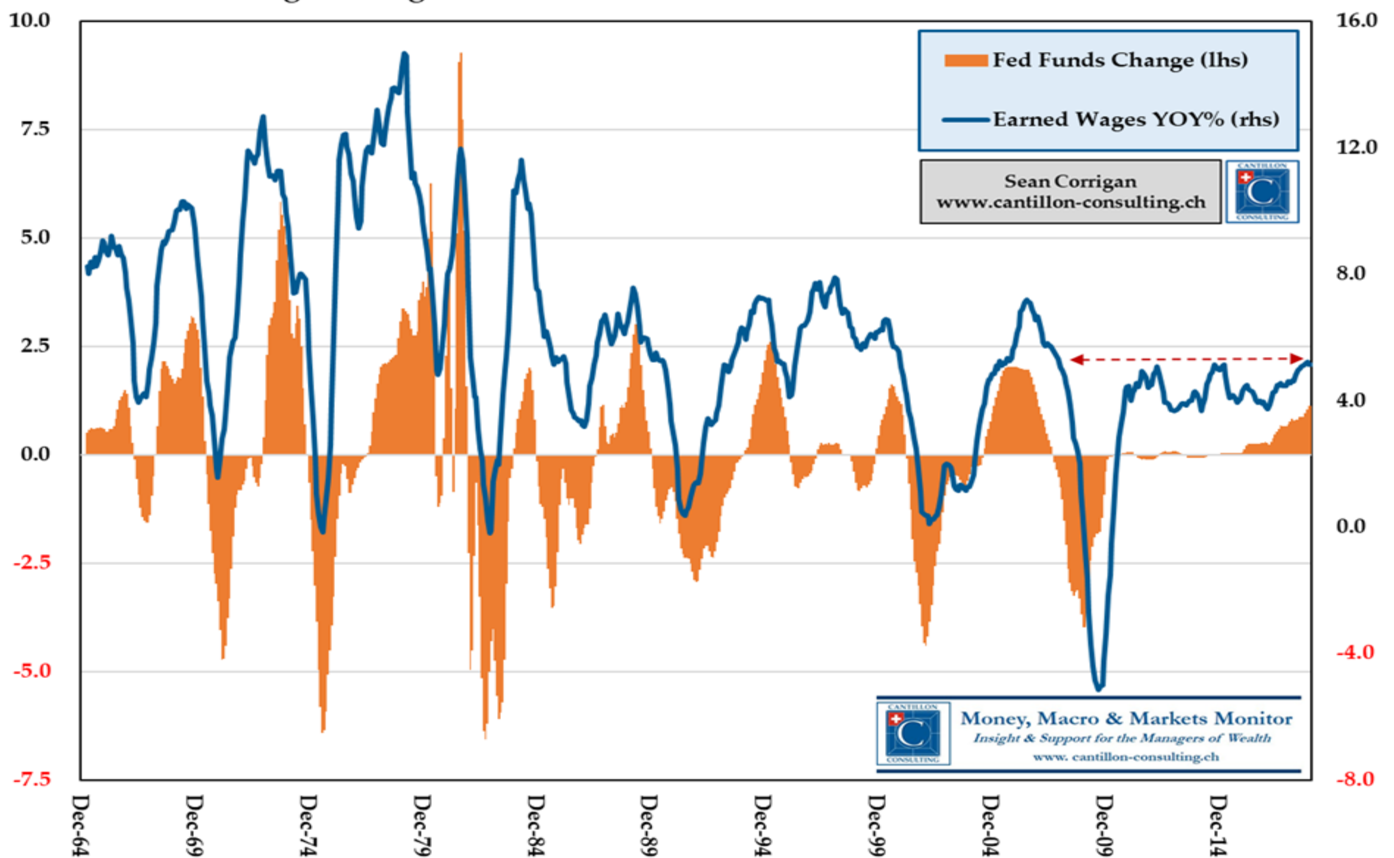
A practical man not given to either Greenspanite circumlocution or to Ivory Tower scholasticism *à la Bernanke,* what the Chairman effectively said was: 'My Fed is not so dogmatic that it will ignore new information when framing policy but could alter the pace and scope of rate hikes *if* it seems warranted'.

He did, however, set this rather Delphic promise deliberately in the context of a rehearsal of the evidence that the American economy has cooled only a little, if at all, and further accompanied it by a mild expression of surprise that none of this had yet led to a more vigorous round of price rises. Even his passing acknowledgement that recognition has belatedly spread that China poses a pressing threat to global well-being was followed by the remark that the PBoC was already doing what it could to mitigate the situation. And, just in case this was not clear the first time he said it, he repeated much the same points in much the same fashion at his appearance, a few days later, at the Economic Club of Washington.

One could therefore very easily put the construction on his comments that his avowed 'flexibility' of response might just as easily free him to hike farther and faster, rather than slower and less, as circumstances seem to demand. In light of the unease which he knew his less resolute colleagues on the FOMC would be soon seen to display in the subsequently released minutes, one might also infer that he was being politely collegial, rather than predictably craven.



Yes, the curve has flattened—even, in places, inverted. But we would argue this is as much to do with positional unwinds and cross-infection from overly-bullish trades in commodities and equities as anything more sinister. Our preferred rendition of this indicator is not yet at full alert. Meanwhile, the jobs market remains robust and—'lagging', or not, as an indicator—this will be key to Fed behaviour.



Likewise, with regard to the Fed's balance sheet reduction - the vexed issue of so-called 'QT' - he pragmatically stated that if he could be convinced that it was causing unwanted difficulty, it could easily be suspended. Far from being a full, *auto-da-fé* recantation of his earlier, repeated intent to continue the process of lightening the Fed's unprecedentedly heavy footprint in the market, this writer was left with the distinct impression that Powell had *not* yet been convinced, nor - seemed to be the clear intimation - was he likely easily to become so.

All of this enhanced degree of caution on Powell's part is understandable, as is the violence of market behaviour which led up to its expression. Not everything *is* quite as rosy as it was in the US economy at present - much less in the wider world - so the almost one-sidedly bearish positioning on rates which had prevailed until a few short weeks ago had long lost enough of its rationale to make it highly susceptible to a major reversal.

But the plain fact is that, when it came, the dissolution of the prior flavour certainties into a breed diametrically-opposed to them quickly degenerated into a genuine, Retreat-from-Moscow rout which then led to a classic piece of tail-chasing in which falling yields - by supposedly signalling an imminent recession - gave a miraculously 'independent' validation of said fall in yields and soon even implied, not just a cessation of further rate hikes, but an actual imminent retraction of them, leading on to curve inversions and, once *that* fabled bird of ill-omen was spotted, to a further fall in yields!

Thus, in just eight, short weeks, December 2019 eurodollar futures went from 3.3% implied - effectively incorporating four hikes over the funds rate correctly expected to be set at the upcoming December FOMC – to a mere 2.5% – i.e. to a no-hike scenario for that maturity which topples over into pricing an actual cut into more deferred contracts. Five-year T-Notes, meanwhile, started this grand reset by touching a 3.10% level not seen since the very week of Lehman's shuddering collapse and ended it after losing a quarter of their yield, or 75bps, in a single vertiginous swoop.

Given all this, one cannot help but think of Fritz Machlup's figuratively stupid magician who was just as surprised, in the Austrian's amusing analogy, as was his audience when he pulled out of his hat the very rabbit he himself had just concealed there!

Certainly, there are signals that the glory days of this expansion might be behind us. Nor are these just to be found in the collapse and irregular inversion of parts of the yield curve, but also in the alarm bell-ringing underperformance of junk versus investment grade credit; in the drying up of speculative issuance; in a real money supply edging towards contraction; in the relative weakness of capital goods sales, and in the deceleration of revenue growth in general (a phenomenon clearly reflected in the recent ISM dip to which Powell himself alluded).

It takes days of cold to freeze a river

Further afield, it is not just that China is in a full-blown panic, or that Australian and Canadian housing booms are fizzling; or that Japan is stuttering, but it is also that we must contend with a bout of renewed feebleness in a Continental Europe where the blue funk over Brexit, banks wreathed in red, strident green politicians, black-clad Antifa hoodlums, and rampaging Yellow Vests have together mixed a thoroughly unappealing palette of economic and political woe.

Whatever it takes, my dear Signore Draghi, it obviously doesn't take what *you* have been prescribing!

So yes, Jerome Powell may not now fell the need to force the pace quite as much as he did before, but nor yet is there enough to suggest he will cut – not on domestic grounds, at least.

Ay, there's the rub! For where such calculations lose

German Business Revenues 3mma YOY% v IfO: *Source - BUBA, IfO*

dREVS
IfO (rhs)

15.0
5.0
-5.0
-15.0
-25.0

105.0
97.5
90.0
82.5
75.0

Mar-92 Mar-97 Mar-02 Mar-07 Mar-12 Mar-17

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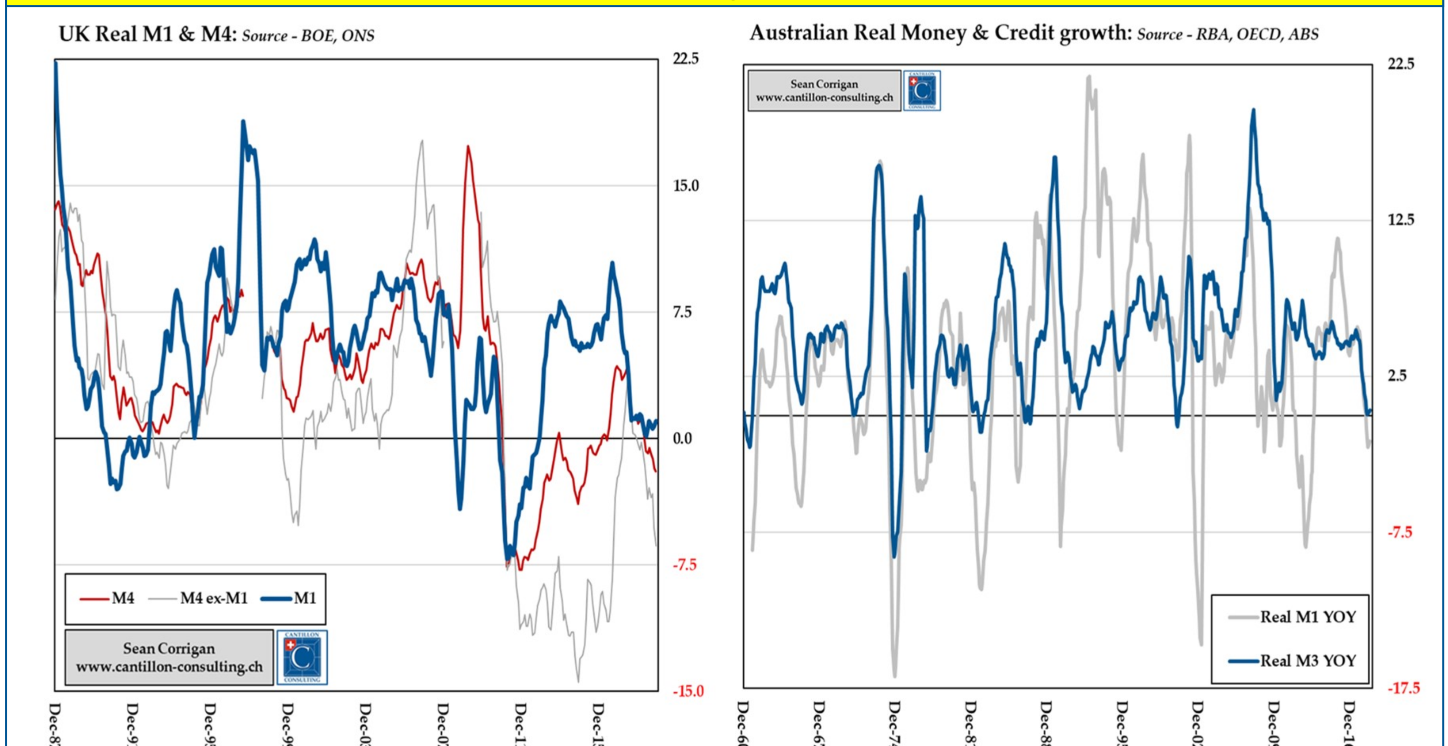
Not that all our focus should be on the Big Two. As we have been warning for some months, the latest batch of German figures was also simply too awful for the market to ignore. Presaging all this was—as ever—the slowdown long evident in revenues and that deceleration's reflection in the IfO survey numbers. Exports, of course, are a particular weakness, dropping 1.5% YOY for their worst showing since the start of 2010 and decelerating off a 6 1/2-year best clip by the most since the 2011 reflation boom rolled over the following year. Then there's the UK where Divus Marcus Carney has been seemingly unaware that real M1 is almost stagnant, M4 falling, and students the only eager borrowers. And as for Oz—well not the sort of numbers on which to sustain a housing boom, now are they?



their compulsion is when we consider that largest and greyest of all horned pachyderms – viz., the Chinese rhino.

Regular readers will be aware that we have long argued that the credit system in that dangerously overstretched economy was approaching the point of crisis [to jog memories, we append a few of our usual graphs here].

As Austrians, we firmly believe that the credit cycle *IS* the business cycle and that – to draw upon Hayek – crises start out as monetary ones and later morph into real ones. We frequently tell anyone who will listen that there are NO soft landings – sometimes adding Mises' pragmatical advice that to try to remedy any sizeable inflation through a deliberate act of contraction (rather than by simply desisting from making matters worse and allowing the system to repair itself) is to '*reverse the car back over the pedestrian one has just knocked down*'.

To those many intellectuals who express loud admiration for China's mixed-economy authoritarianism and who therefore claim that not only will the far-sighted, Oriental planners deliver greater prosperity in greater measure and with less delay than the unrestricted free market could ever hope to do, but that their 'Mandate of Heaven' enables them to stave off each and every threat to their grand designs, we admit – as Adam Smith taught us to do – that there is indeed a '*lot of ruin in a country*' (we wouldn't wish to be accused of being - er – *Permabears*, now would we?). But we do counter that while the effects of misguided intervention may be disguised, deflected, or diverted for much longer than your typical portfolio manager's attention span, economic law cannot be indefinitely suspended.

Hjalmar Schacht managed to deliver at least *some* butter alongside the many guns in the *National* Socialist setting in which he was one of the key technocrats and the threat of the Gulag kept people passively queueing for mouldy cabbage while each successive Five-Year Plan played out in the *International* Socialist milieu in which *they* were launched. Less draconian methods of misdirection and temporary over-compensation have allowed the build-up of enormities in many another polity in the historical record, from LBJ's 'War on Poverty' America to 'I'm Alright Jack' Labour Britain and to Craxi's and Andreotti's debt-laden souring of *la Dolce Vita* in Italy.

Thus, however long-deferred the reckoning, pipers do eventually have to be paid. Unfortunately for the fretting overlords in Beijing, theirs seems to be demanding his fee at just the same moment that the American hegemon seems to have decided to apply its Gaius Popillius Laenas doctrine of 'Full Spectrum Dominance' to them, as well as to the Russians and the Iranians.

By way of illustration, consider the recent brouhaha surrounding Air Force Brigadier General (Ret.) Robert Spalding's 'resignation' from his post at the National Security Council after the leak into the public sphere of a memo in which he made a forthright case that the US should prevent China from ever taking the lead in - and, explicitly, from weaponizing – the coming 5G networks and the 'Internet of Things' they will soon empower.

On the Chinese side of this divide, much has been made about the presentation of Wu Sikang, director of the Policy Research Office in the Shenzhen municipal government, in which he talked about the urgency of countering America's 'undeclared war' on his homeland. Hardly calculated to dispel such mutual distrust was Xi Jinping's almost contemporary exhortation for the military to become more battle ready and his insistence that Cross Strait reunification with Taiwan was inevitable, even if it had to be conducted at the point of one of those PLA bayonets he was demanding be newly polished.

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Closet Strangeloves, armchair generals, and other twisted denizens of the Military-Industrial Complex everywhere are, naturally in their element fomenting an animosity which not only greatly complicates either side's ability to resolve their differences over trade, but which could lead us to a place where having to pay a few dollars more for home-produced Christmas baubles might be the least of our worries.

While much comment in China has focused on the so-called 'Thucydides Trap' into which the nation's rise might lead, much more worrying would be a jump 250 years forward into the pages of Polybius. Far from the former author's readily-negotiable stumbling blocks of 'honour, fear, and self-interest' (*time, deos, ophelia*) being erected in the path of superpowers rapprochement, the terrifyingly cynical framework of the latter's – 'initiation, pretext, and cause' (*arch, prophasis, aitia*) – by which is implied that Rome-on-the-Potomac has already resolved that, much like Carthage before it, China must be destroyed (*delenda e*st). If so, all that remains is to find a plausible excuse for confrontation and then to provoke a suitably hostile reaction which can be used as a gratifyingly genuine-seeming *casus belli*.

The moon waxes only to wane

Setting aside such apocalyptic thoughts for the moment, what *has* finally begun to seep into the Western market consciousness is just how deep-seated are the problems in the economic and financial sphere in the Middle Kingdom, 'Trade War' or no.

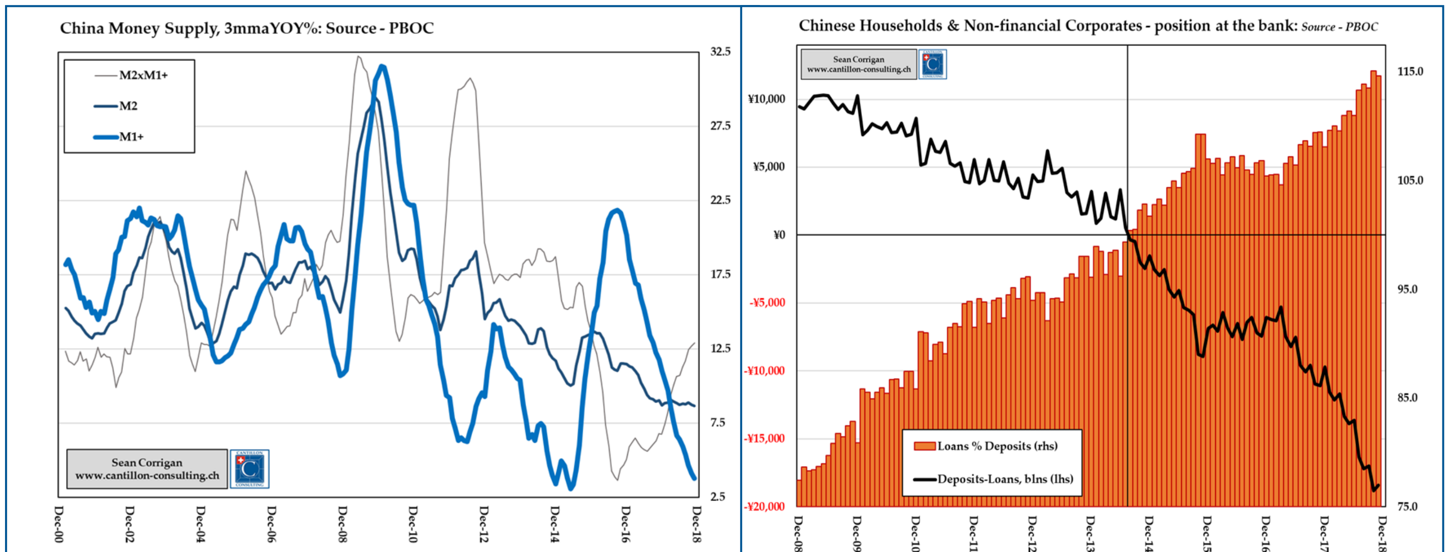
We will not again rehearse the tale of China's misfiring attempt to 'deleverage' in the first half of last year or of the predictable inability of the banks to fill the holes left by the near collapse of 'shadow' finance which this brought about. The stress of the subsequent, margin-fuelled collapse in the stock market then saw a remarkably open spat break out between the usually compliant central bank and its Finance Ministry elders, leading finally to a scheme whereby the authorities would allow anyone with just about anyone combing a semblance of competence and an identifiable balance sheet to lend money and to extend guarantees to the worst affected companies; to those offering to take them over; or to those willing to finance their conniving bosses' insupportable personal obligations.

Risibly, among the providers of these emergency backstops being marshalled into the front-line were none other than the very local government structures whose icebergs of outstanding obligation were supposedly a major target of the now-aborted 'deleveraging'.

The relief rally which ensued was, however, all too short lived, so the new year has brought with it another raft of support and stimulus measures such as the hoary old nostrum of announcing the laying of another earth-girdling 6,800 km of railtrack (almost half of it of the expensive, high-speed variety).

Infrastructure Keynesians should note that princeling Zhu Yunlai (son of fabled reformer Zhu Rongji) has since told a prestigious forum audience that China already devotes far too many resources to such ventures, perhaps drawing upon research conducted by his former underlings at the CICC who reckon that the projects' cash flows routinely cover less than half their interest cost – a shocking indicator of malinvested capital which reveals that what all the nation's famous armada of excavators are really digging are holes in the national balance sheet.

Yu Xuejun, the chairman of the supervisory board for SOEs at the China Banking and Insurance Regulatory Commission basically concurred with Zhu's assertions, telling his listeners yet another forum that NPLs were already due to surge, that the country was still trying to digest the last great slug of 'stimulus' and that the principal result of such policies was *'excess money supply growth, the worsening of*



China Marginal 12-month CNY Loan: Deposit %: *Source - PBOC*

ALL 12m (rhs)
CNY 12m (rhs)
OVERALL RATIO

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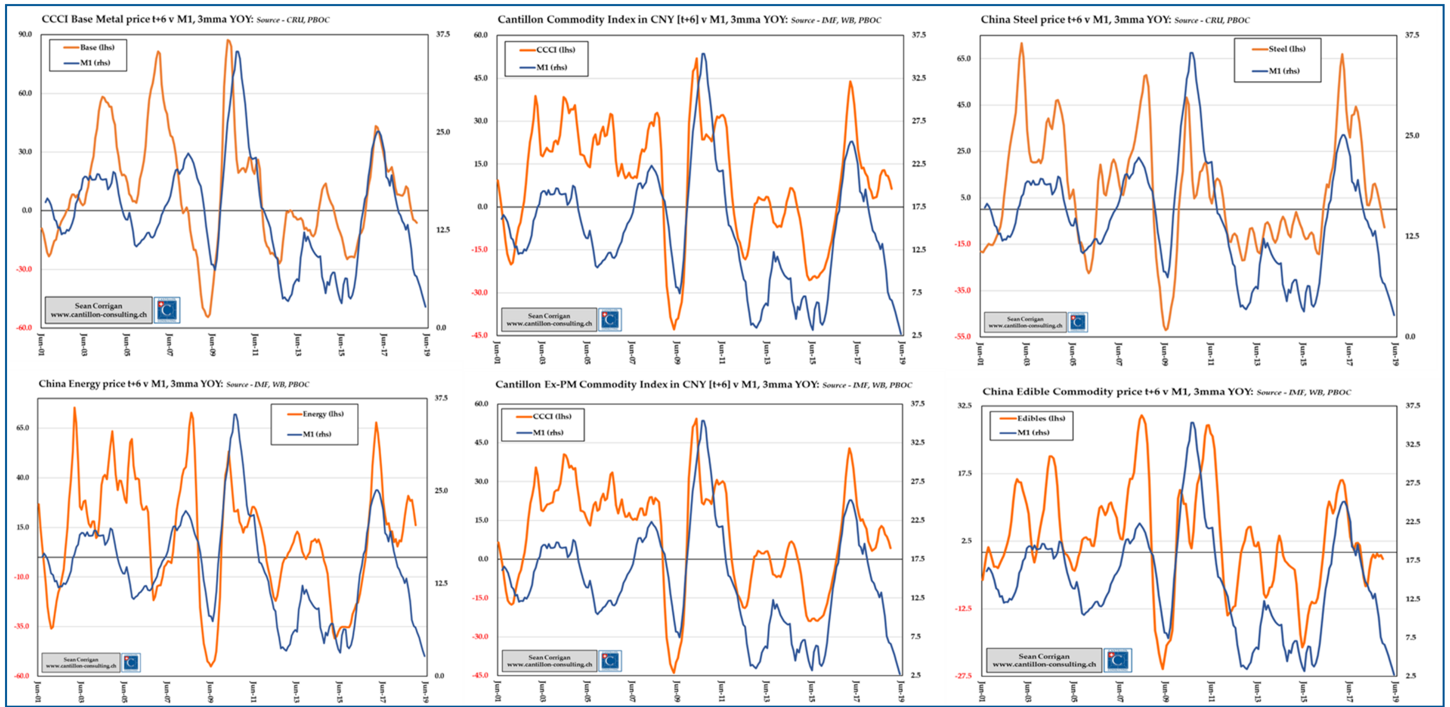
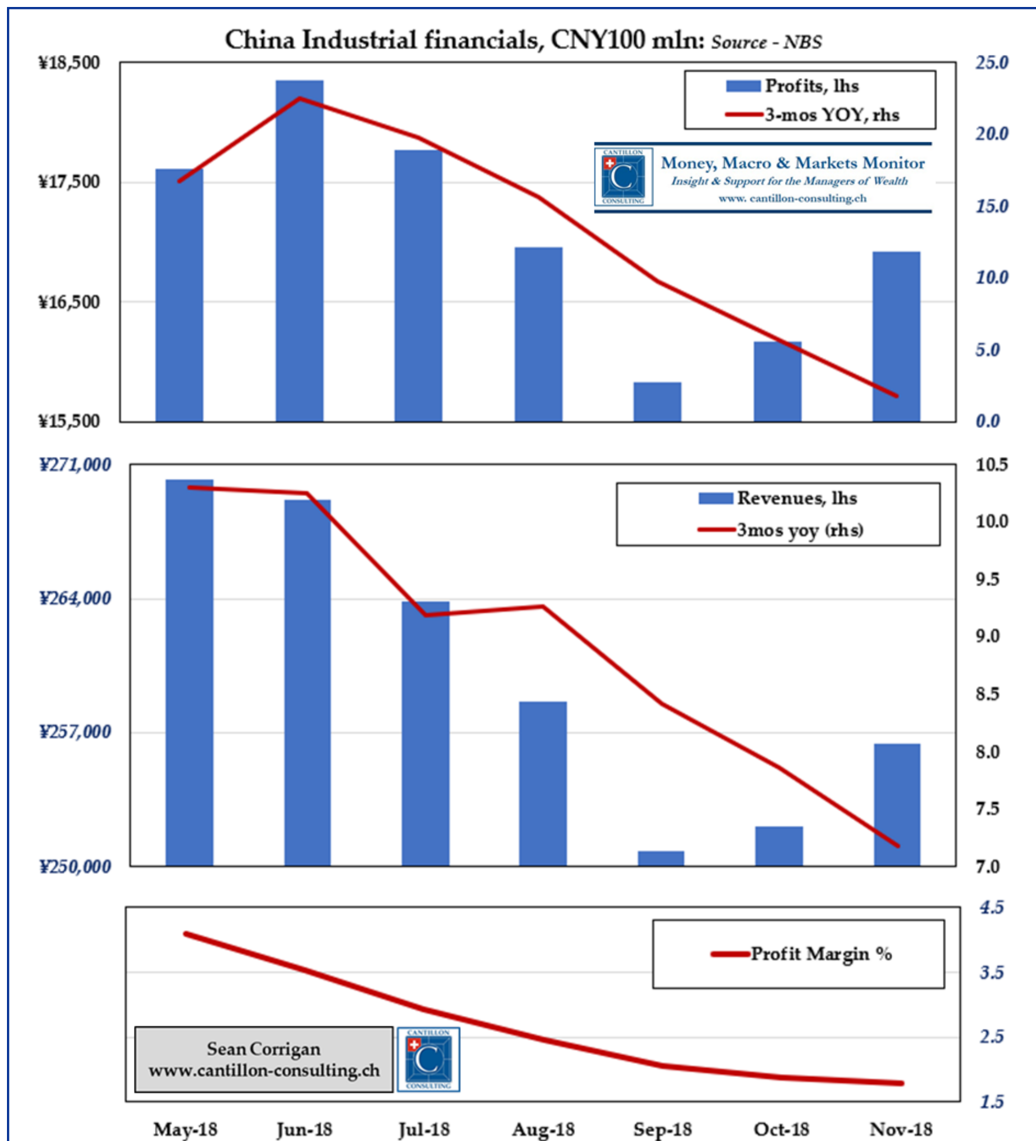
12mos Cumulative dM2-dLoans, blns

Dec-02 Dec-05 Dec-08 Dec-11 Dec-14 Dec-17

The Chinese banking system is running on fumes, hardly able to take advantage of the collapse of its 'shadow' sector competition. Those proverbial 'strings' are being pushed hard, at the moment.



Commodity bulls, look away now…



asset bubbles and a rapid increase in macroeconomic leverage'.

'*Hear! Hear!*' did you say? If so, yours was a voice crying in the wilderness for, in the space of only a few days, the PBOC has passed in swift succession from forcefully disavowing any prospect of resorting to another indiscriminate 'great watering' of monetary relaxation to announcing a widening of the scope of beneficiaries of one of its earlier, 'SME-targeted' reserve requirement cuts.

Then, having been browbeaten by a clearly rattled Premier Li Keqiang into a full-blown opening of the floodgates, it encouraged talk that it should next emulate the Bank of Japan and buy stock funds directly (instead of simply financing on ever easier terms everyone else who shows any inclination to do so). Drawing a curtain down on what was doubtless only the first act of a protracted drama, PBOC Governor Yi Gang next told an expressly summoned trio of journalists that a major plank of policy was henceforth to '*…prevent equity-related risks, to prevent various "black swan" incidents, and to maintain a stable and healthy development of the stock, bond, and foreign exchange markets.* '

Plunge Protection with Chinese characteristics, indeed!

But what good will this flurry of activity really do over anything other than the shortest of short terms?

Much insincere wringing of official hands (and a no less considerable amount of Permabear echo-chambering) has lately accompanied reports of the 38% recorded rise in outstanding, private non-financial debt during this past ten years of post-Crisis recovery. But what most of this nervy admonition fails to report is just how much of this has been due solely to our friends, the Chinese.

During the decade, BIS numbers tell us that China and Hong Kong alone were responsible for 68% of the $23.8 trillion of *all* new corporate debt contracted (the former of this pair of miscreants managing a whopping rise of 400% cumulative, or 17.5% CAR) with the tally for other EMs up 56.5% (making a modest enough 4.6% CAR), the US adding 41.3% (3.5% CAR), and the rest of the Developed nations who report being effectively unchanged (*sic*) on the period.

Now look at household debt. The global rise for this sector was $8.1 trillion, or 21.8%, but almost three-quarters was due to China (up 716%!) and HK (+121%) acting in concert. Other EMs chipped in an appreciable 73.6% cumulative, 5.7% CAR, America contributed a modest enough 7.1% total growth rate (at a bare 0.7% CAR), and the other DMs again saw a modest shrinkage of 4.1% overall.

Put together, the rounded scorecard reads:-

World +$32 trillion (+38%)

China-HK +$22.7 trillion (+431%)

USA +$5.4 trillion (+22%)

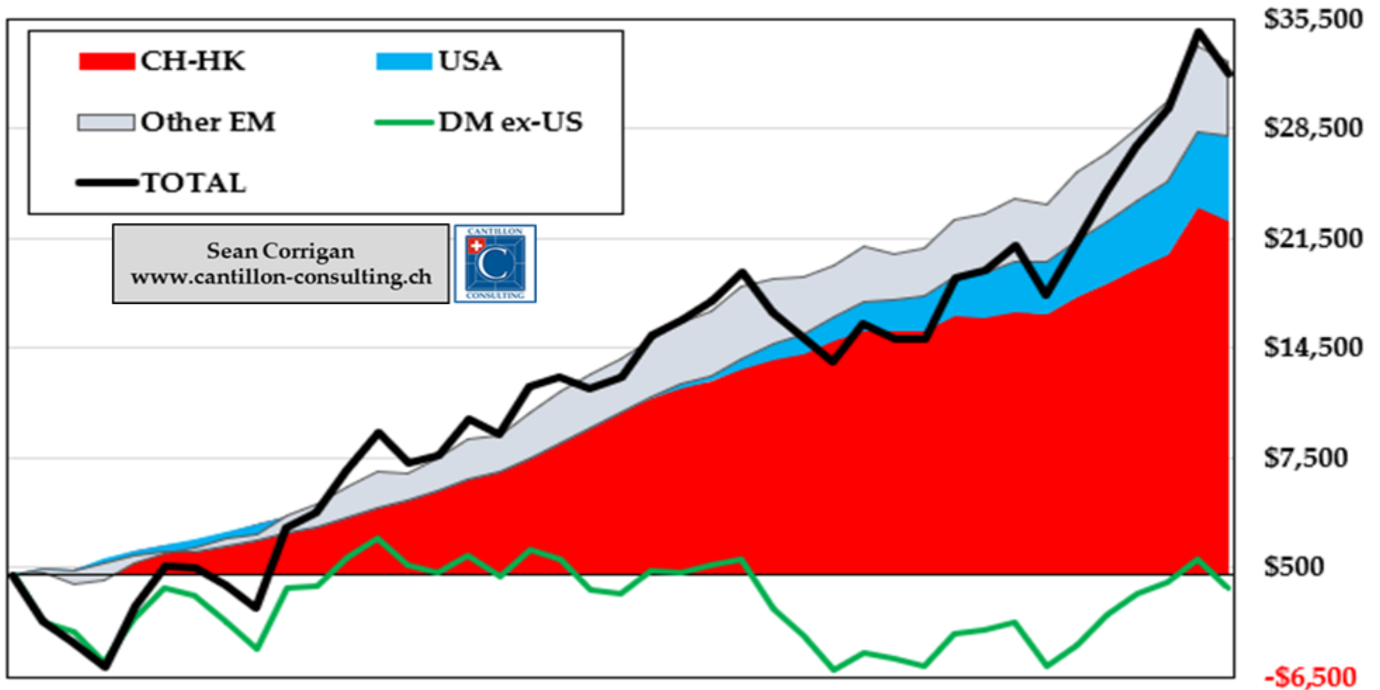
Other EM +$4.8 trillion (+63%)

Other DM -$0.8 trillion (-2%)

Not hard to see where the dangers lie, is it?

By now, most of those with an eye on markets will be familiar with at least the headlines that overall Chinese vehicle sales declined last year, something not seen since 1990, and passenger vehicles shrank for the first time since the Asian Contagion, 20 years ago – a drop which has already elicited vague promises of governmental 'support' for the market in the coming months. Another snippet gaining wide currency is that, after both Apple and Samsung issued profit warnings, news emerged that mobile device sales as a whole were off around 15% YOY, helping industry forecasters to the sorry conclusion that global DRAM prices could undergo falls on a similar scale this year.

But, if one wishes to get a real feel for just how dire the economic data is, one need look no further than



Private Non-financial Debt Growth, blns: Source - BIS
CH-HK
USA
Other EM
DM ex-US
TOTAL
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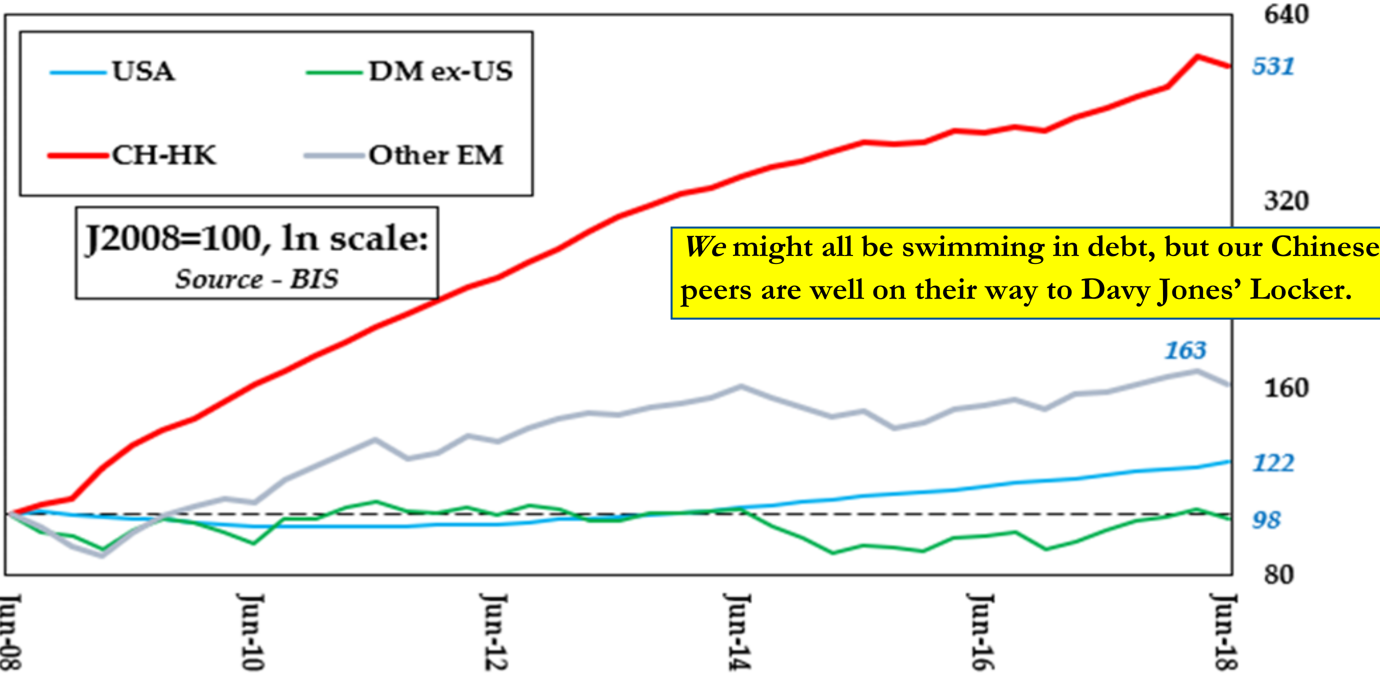
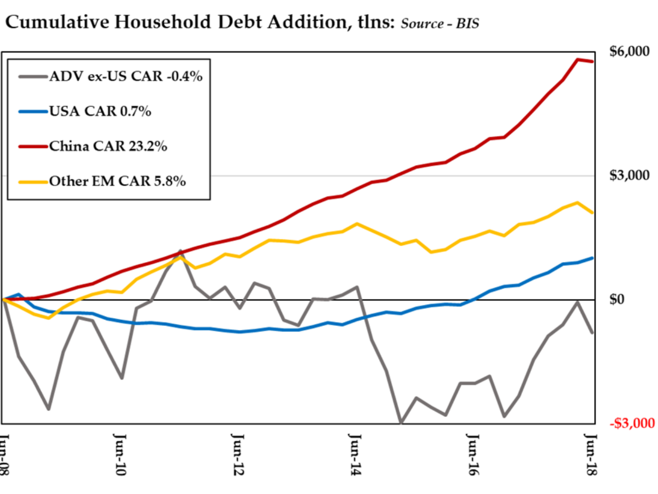
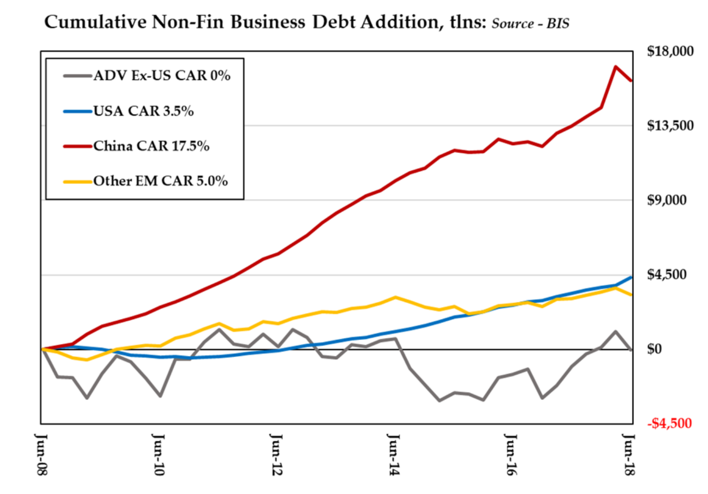
$35,500
$28,500
$21,500
$14,500
$7,500
$500
-$6,500



USA
DM ex-US
CH-HK
Other EM
J2008=100, ln scale:
Source - BIS
We might all be swimming in debt, but our Chinese peers are well on their way to Davy Jones' Locker.
640
531
320
163
160
122
98
80
Jun-08
Jun-10
Jun-12
Jun-14
Jun-16
Jun-18



Cumulative Household Debt Addition, tlns: Source - BIS
ADV ex-US CAR -0.4%
USA CAR 0.7%
China CAR 23.2%
Other EM CAR 5.8%
$6,000
$3,000
$0
-$3,000
Jun-08
Jun-10
Jun-12
Jun-14
Jun-16
Jun-18



Cumulative Non-Fin Business Debt Addition, tlns: Source - BIS
ADV Ex-US CAR 0%
USA CAR 3.5%
China CAR 17.5%
Other EM CAR 5.0%
$18,000
$13,500
$9,000
$4,500
$0
-$4,500
Jun-08
Jun-10
Jun-12
Jun-14
Jun-16
Jun-18

the reports put out by the Guangzhou Municipal Government. For a little context, this is a city with the population of Belgium and the gross product of Denmark which is the most important conurbation in a province with the largest GDP in China – at $1.3 trillion or so, roughly equal to that of Spain - and with 80 million inhabitants which puts it on a par with Germany.

Among obvious signs of distress there, retail sales – long used to displaying growth rates in the high teens and low 20s – slowed to 7% in 2017 before falling right through to *negative* 1.4% in the first 10 months of last year versus the like period in the previous one.

And it wasn't just domestic business which was lacklustre. In the same stretch, import growth of 10.4% had to be set against a 2.4% decline in exports, to leave the cumulative trade surplus 27% below the year-earlier period.

Highlighting the parlous state of government finances, tax collections through to November rose 6.5%, and overall city revenue climbed 7.1% (figures which tell us something less than cheery about nominal output in this former regional dynamo). Alas, expenditures shot up by no less than 16%, inflating the deficit by over 40% and reducing tax coverage from 59.4% of outlays to a miserly 54.6%.

But, most disquieting of all are the regional banking figures.

These revealed that while loans grew by a rip-roaring 18.2% YOY, deposits only inched up by 2.4% - a shortfall which not only pushed the overall loan:deposit ratio smartly up from 65% to 76% but also saw a marginal CNY4.9 in new loans granted for every CNY1 that found its way back onto the banks' books (for non-financial corporates in isolation, that marginal ratio was as wide as 5.6:1).

Thus, not only are banks short of capital – hence the new regulatory vogue for trying to promote perpetual bonds in order to plug the gap – but their funding and liquidity ratios are also coming under extreme stress, RRR adjustments notwithstanding. Thus, the only game in town as far as addressing that goes is the PBOC, so expect plenty more announcements from 'Big Mother' of assistance to banks and non-banks alike in the year ahead.

Governor Yi is therefore likely to be a very busy man, trying to live up to his 'mandate' and all the while pushing so exhaustingly hard on that string with which he and his economic charges have tied themselves up in knots. We shan't enquire too closely in how all this is to be managed in the context of the renminbi exchange rate, the need to limit capital flight, and the $1.2 trillion of officially-recognised foreign debt his countrymen have contracted (overwhelmingly in US dollars).

All in all, this tells us that if his counterpart across the wide Pacific, Mr. Powell, *is* to be forced to backtrack on his desired rate schedule this year, it will most likely be because Yi Gang proves unable to arrest the decline in China and not, in the first instance, due to developments originating at home in the US.

Set your dials, accordingly.

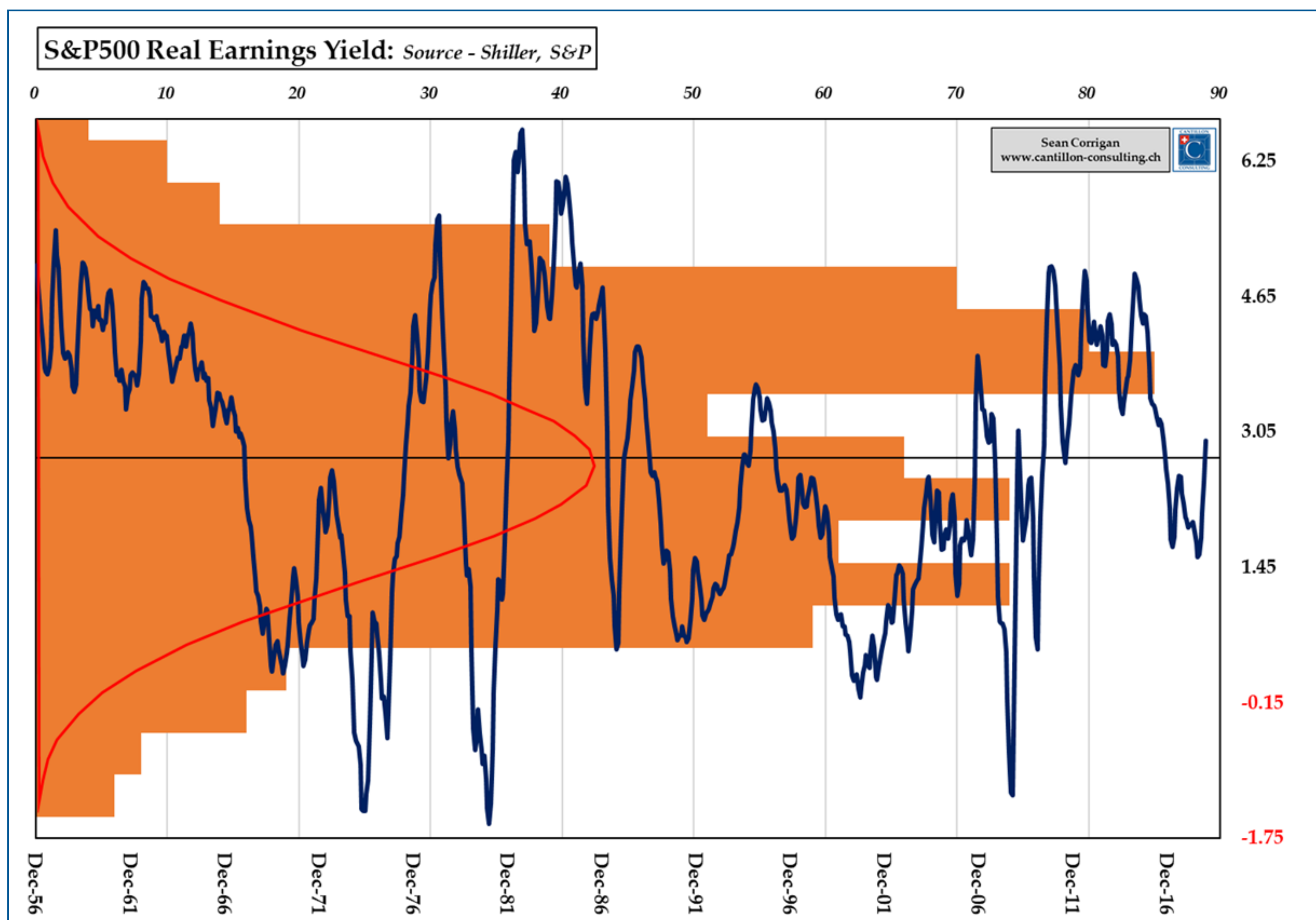
Sean Corrigan

Faced with all the foregoing, traders and investors must try to decide whether they believe the past few years' recovery trend is about to reverse, which regions will most feel the draught if it does, and – by extension – which asset classes are best positioned to withstand the chill as and when it arrives.

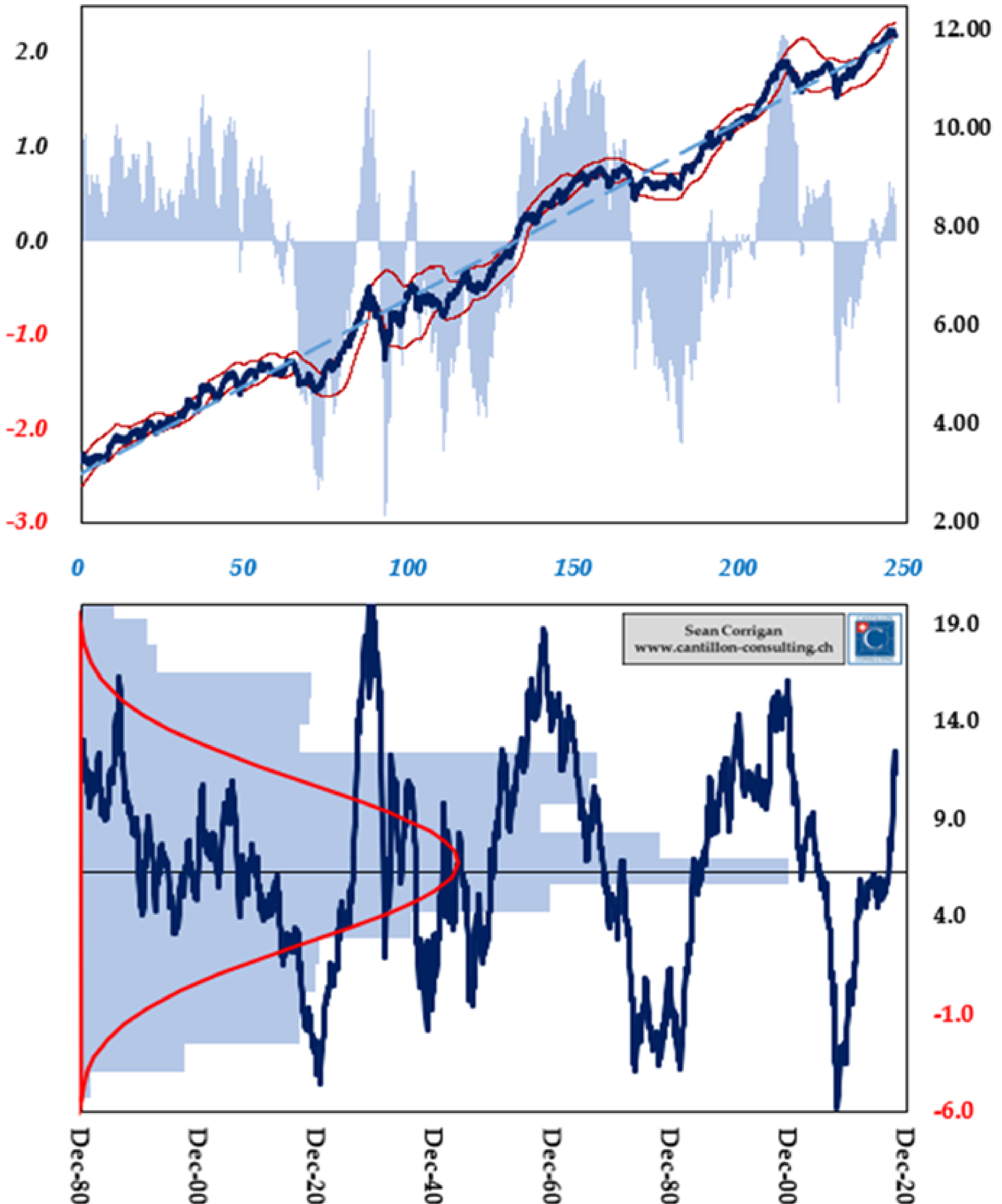
Though 'fundamental' forces are but one input into that decision matrix, it cannot hurt to have a sense of some of them, or of where relative valuations and cross-correlations stand, as the squall approaches.

At root, this boils down to the issue of whether belief in the Fed 'put' supposedly written under the stock market is a sufficient comfort to ward off a self-reinforcing slide into pessimism there; whether US equities can continue to outperform in the manner of the past few years; whether the recent easing of bond yields will persist (and whether one might hope for some actual real returns on one's holdings, for a change); and – intimately tied up in all these – what lies in store for the US dollar.

In order to help inform your decision, here are a few reminders of the state of play as 2019 gears up for action.



Earnings are, of course, not a given property of the system but at least the correction has left them in a more reasonable relation to prices, historically speaking, and hence stocks are somewhat less 'watered' than before the sell-off ran its course.



The S&P lying largely on its remarkably stable, long-term, real total-return trend is perhaps not as comforting as it might be, since divergences from a log trend do add up. What does seem more predictable is that the next decade might see a reversion to the mean ROC. The question is: how rapidly do we do so?

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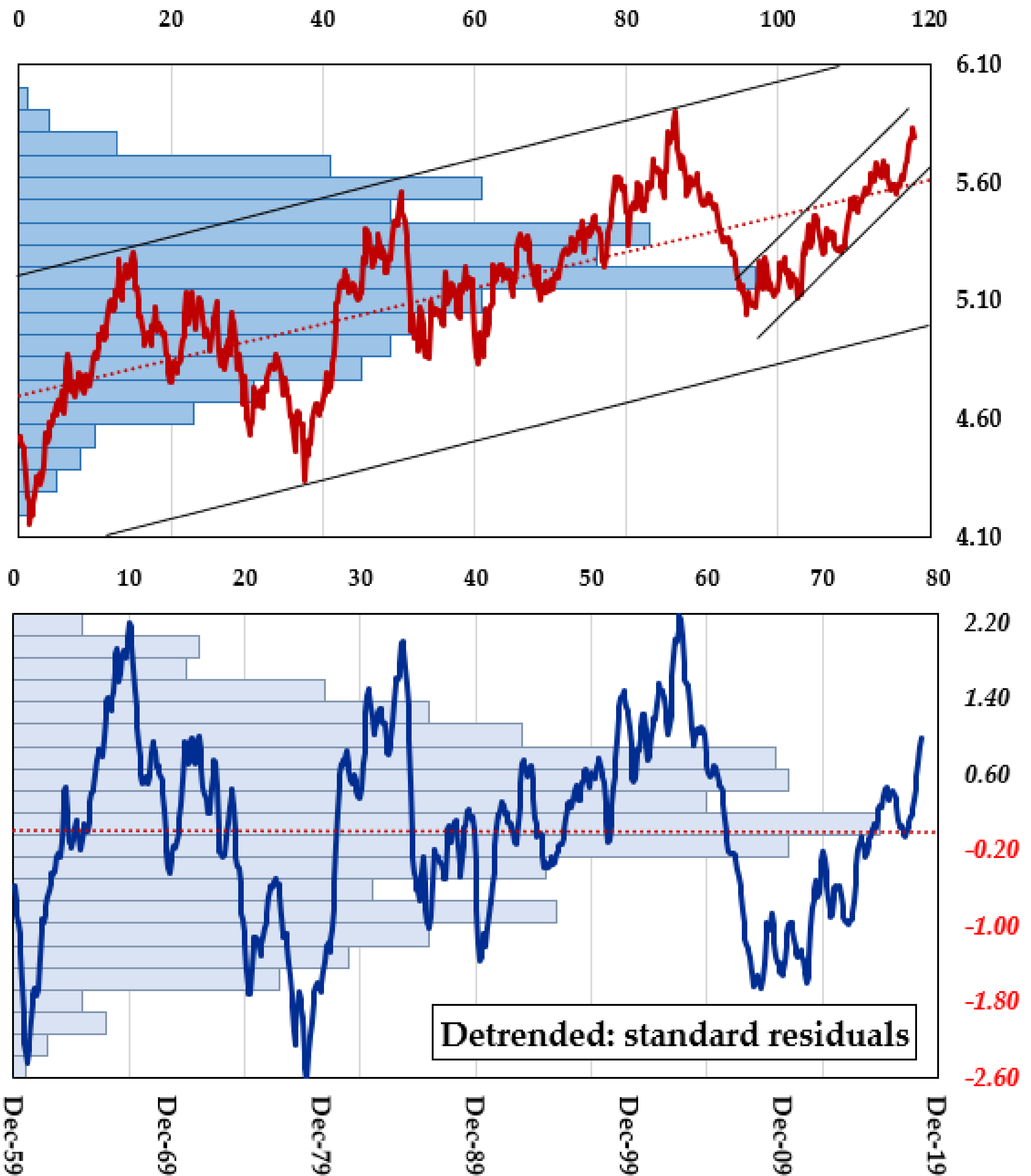

As per the ratio of gross total returns, the US is at its highest point in the nearly 50 years of MSCI data v the rest of the world's indices. Shown here against the DAX over ~6 decades, it is a few percent off its peak and around 1 sigma over trend. A chartist, however, would like the symmetry of prior maxima in both price (2.0/2.2 sigmas) and time (18 years). The 2021 repeat to which this points implies a continued outperformance of 30% in total over the next two years. Could it be the case? Bad news for the EU, if so.

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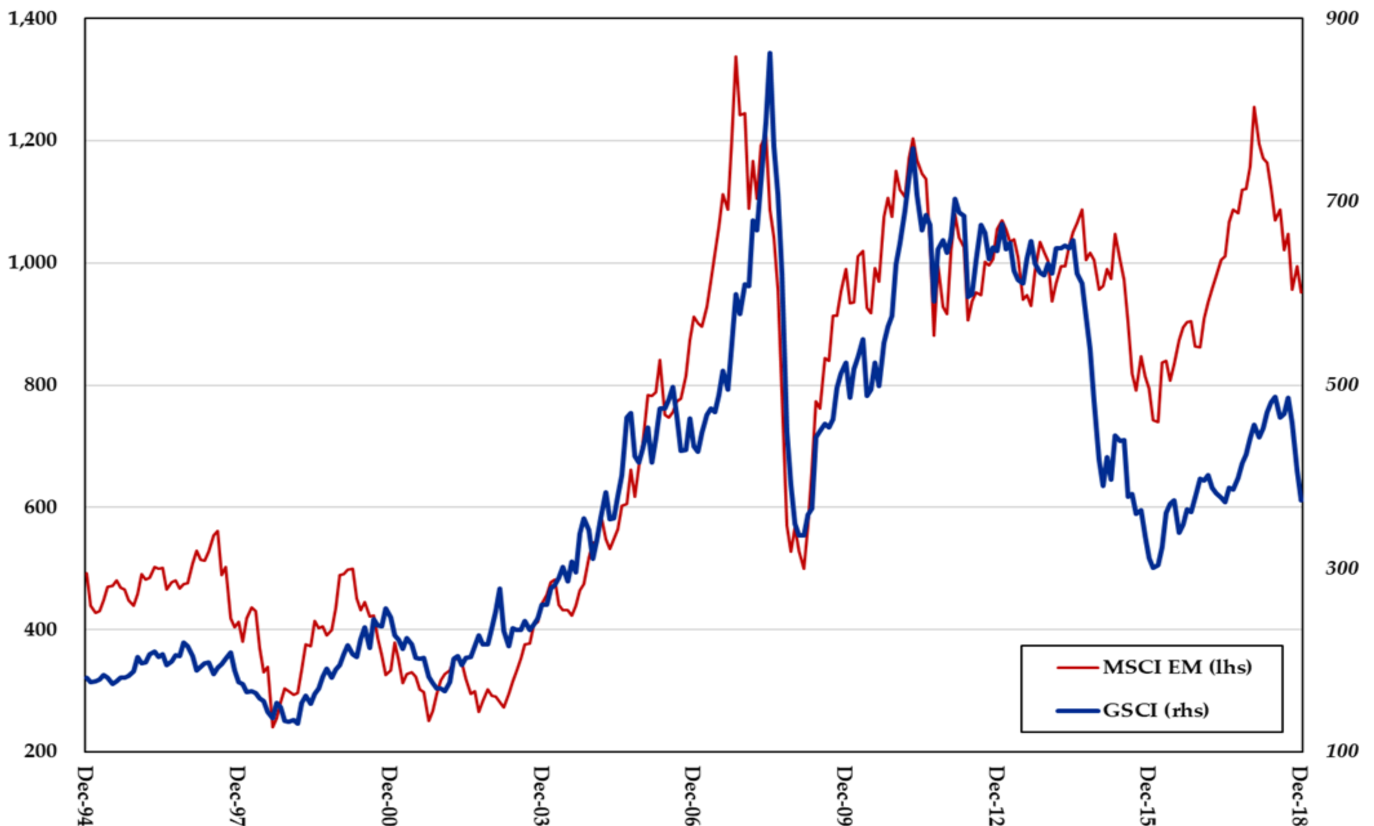
ACWI Ex-US v GSCI, 3mmaYOY%: *Source - S&P, MSCI*

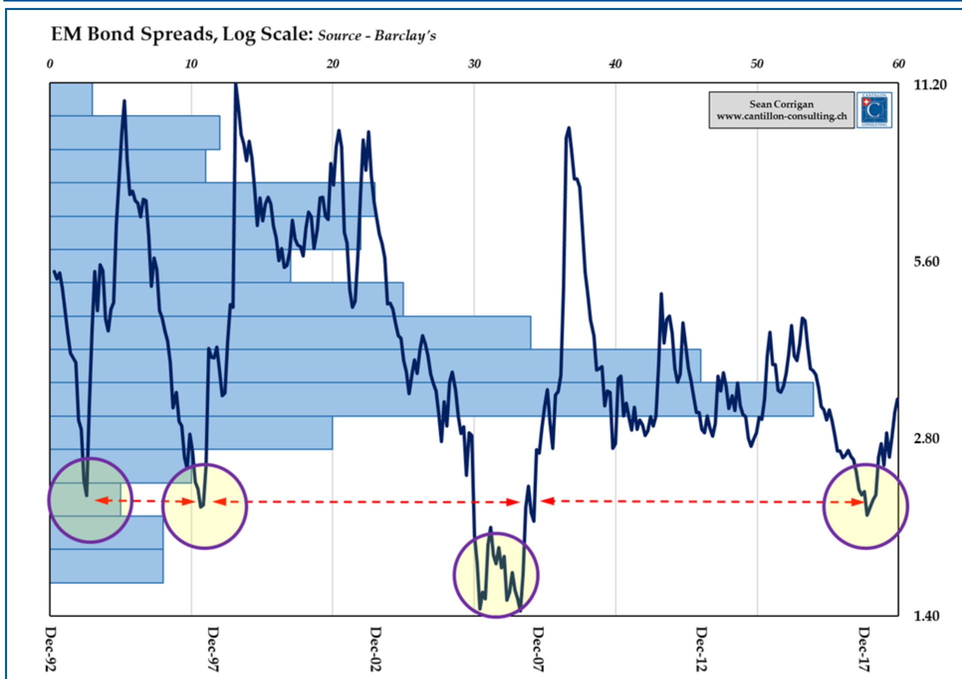
0 10 20 30 40 50 60 70 80 90

90.0 60.0 30.0 0.0 -30.0 -60.0

Dec-70 Dec-74 Dec-78 Dec-82 Dec-86 Dec-90 Dec-94 Dec-98 Dec-02 Dec-06 Dec-10 Dec-14 Dec-18

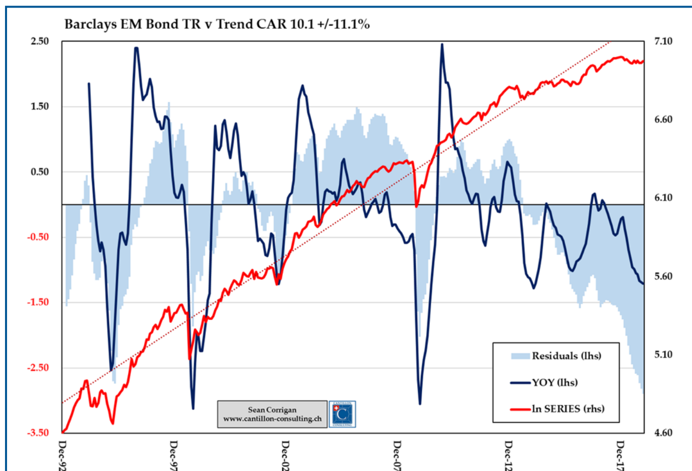


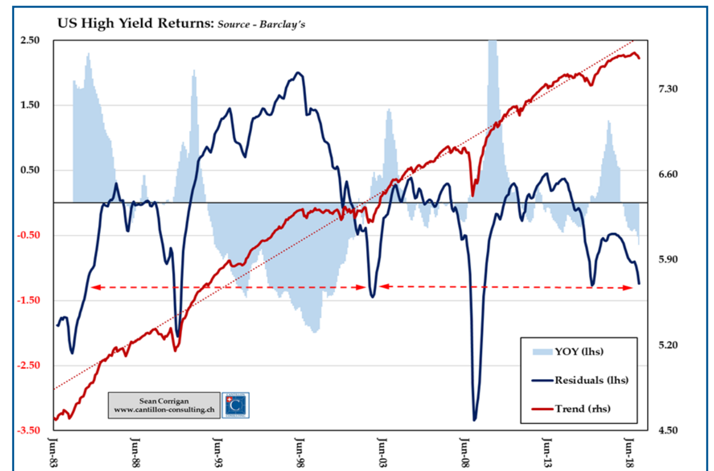
The upper graph suggests commodities' spell of outperformance should mean-revert to the converse case—a scenario which, in conjunction with the lower chart, hints at Emerging Markets lagging, too



From a position at the lower extremes of the distribution in both yield and spread, there is no hiding place for lesser credits when the euphoria fades. NB: ***Real*** returns will be even worse than those shown here, of course.

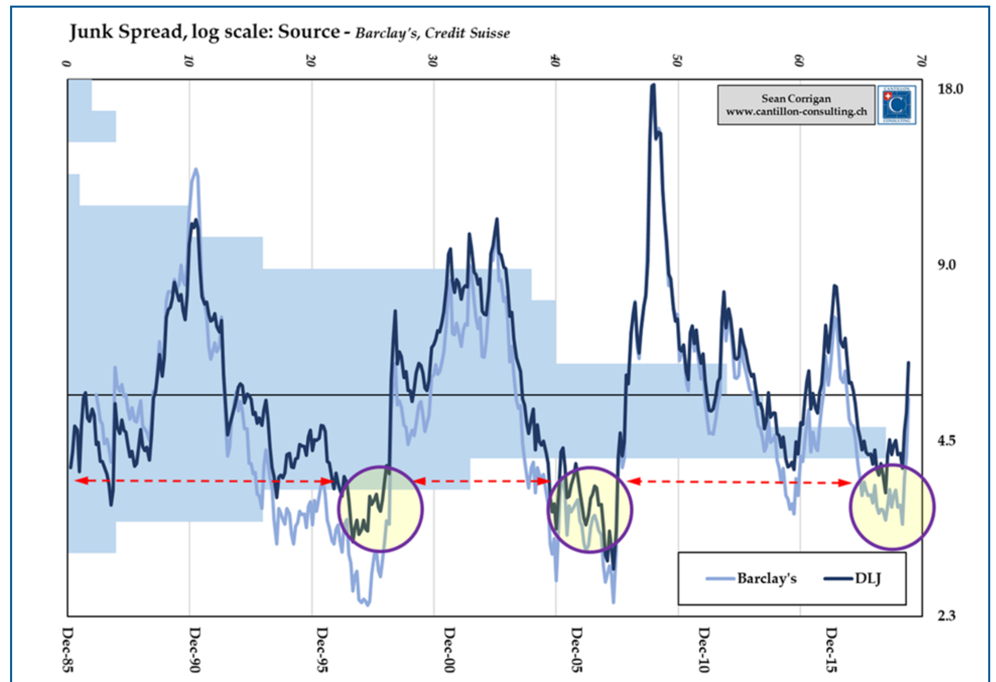
Emerging credits are already at their furthest below trend in the last quarter-century after undergoing their steepest fall, barring the sector's three principal crises. Back at the mode, can they now hold?





For its part, high-yield needs not just easy money, but buoyant equity markets (as well as rises in those for energy in the US case), but they have arguably already begun to price at least some degree of economic difficulty back in.

The question is now one of how much bond yields have been flattered by the relative scarcity of supply resulting from the erstwhile heavy reliance on making recourse to the loan market instead.



UST10-years less CPI YOY%: *Source - FRED*

0 10 20 30 40 50 60 70 80 90 100

10.0 7.5 5.0 2.5 0.0 -2.5 -5.0

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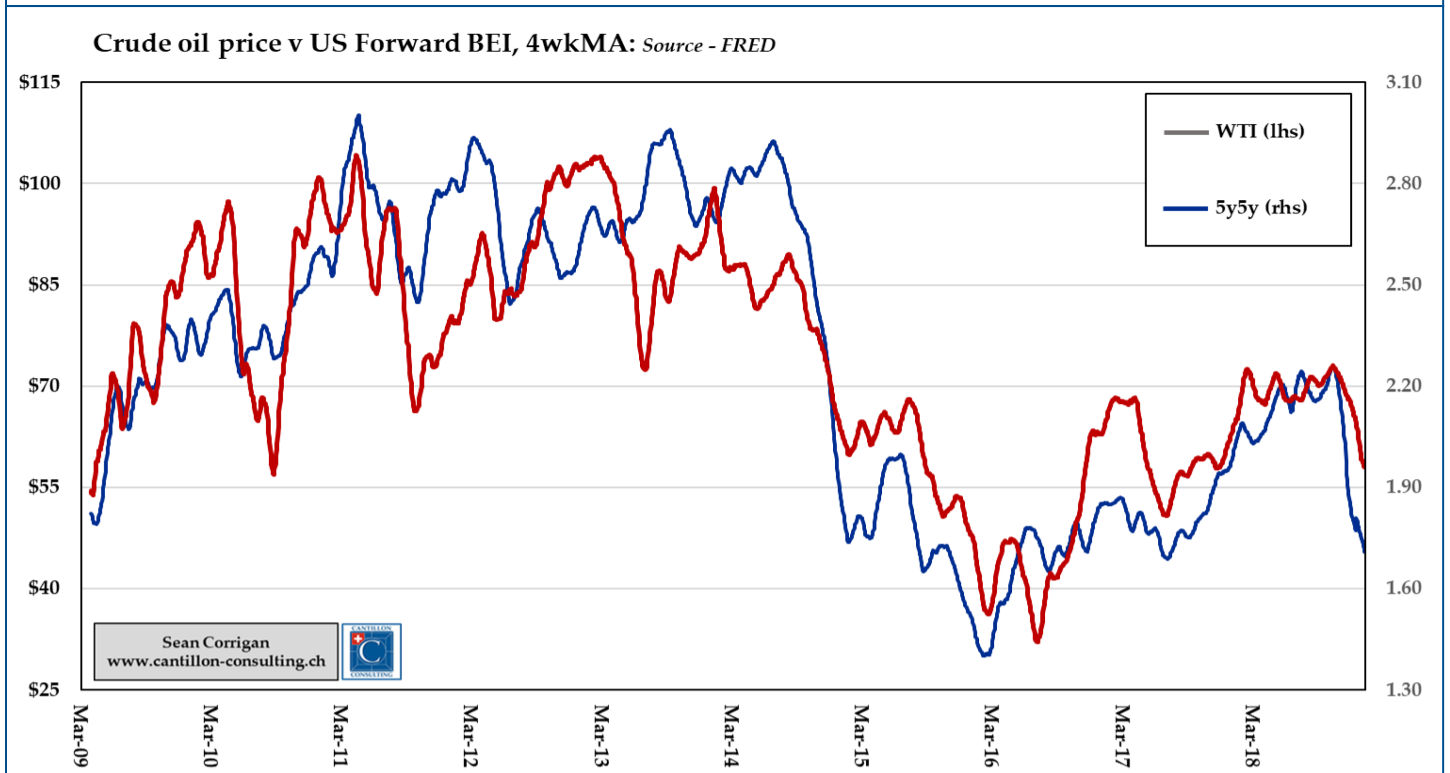
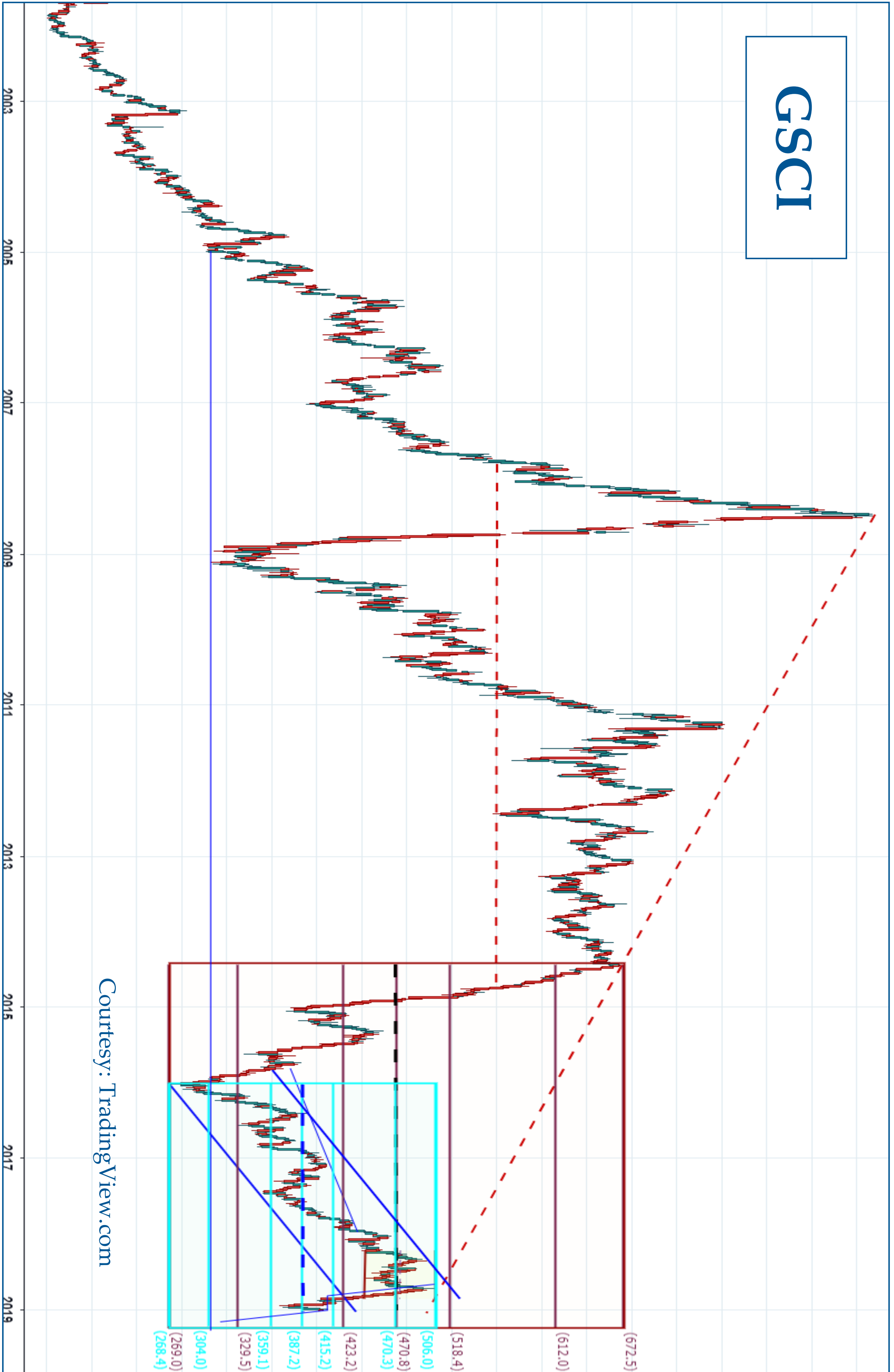
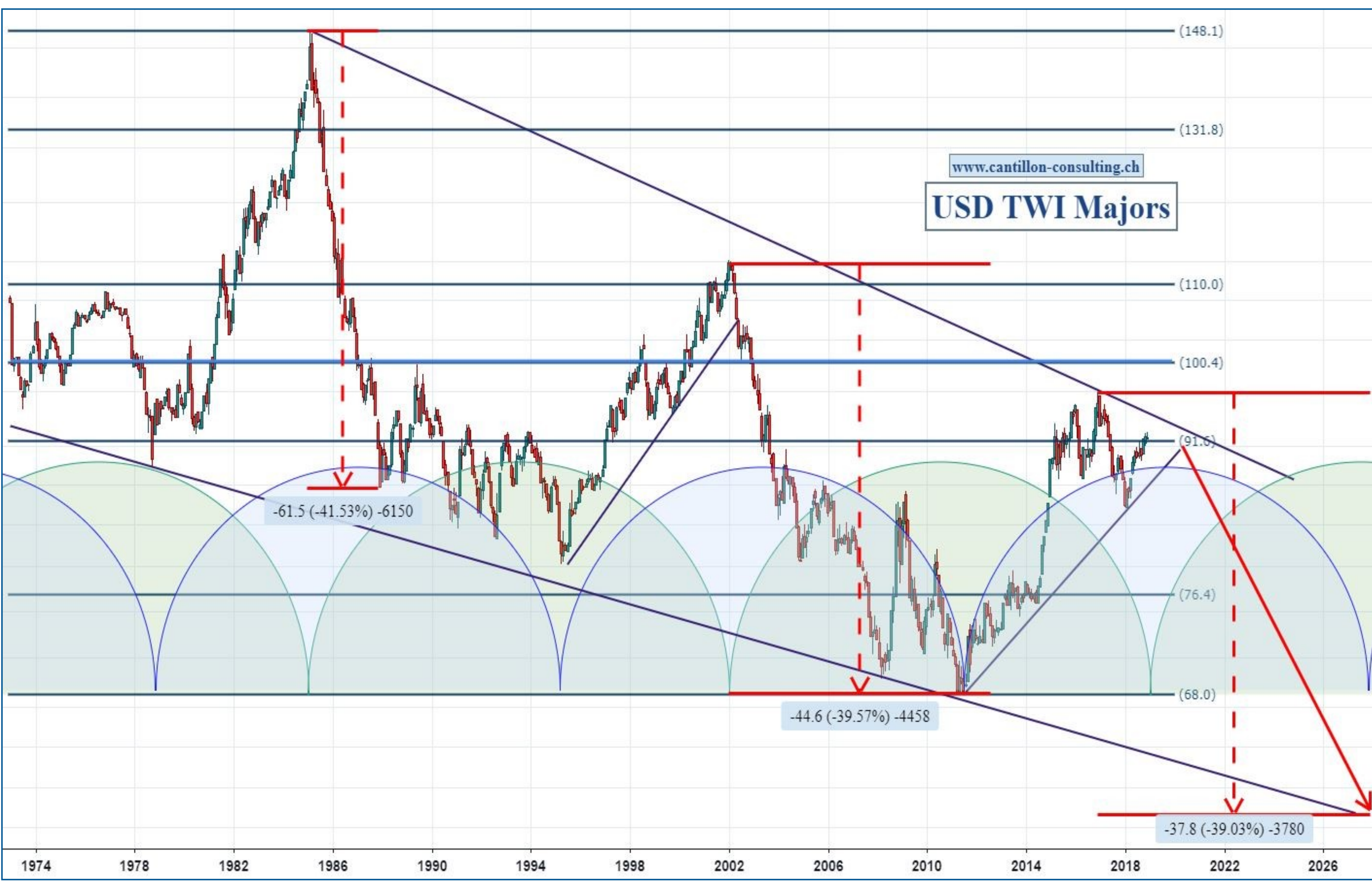
Apr-53 Apr-61 Apr-69 Apr-77 Apr-85 Apr-93 Apr-01 Apr-09 Apr-17



All the huffing and puffing about how swingeing the Fed has been in raising rates and real yields on the T-Note are barely positive and still a good couple of percentage points below the post-Treasury Accord mid and mode! As for 'falling inflation expectations', we repeat: 5y5y is a HIGHLY flawed measure, not least because the best the market can do to judge 2024-29 prices is look at where front WTI trades today!



So far, the recovery in commodities looks less than compelling—more a case of covering by opportunists who rode QIV's crude oil rout down to sell almost 200k contracts (ending at a 74-week gross short high) even as their panicking opposites were liquidating 400k of their heavy gross longs and reducing *their* exposures by $45 billion equivalent to a 4-year low. If the Chinese-led gloom starts eroding confidence again, we could be in for a test of 2016's lows—with all that implies for junk and BEIs, as well as for resource sector profits, jobs & capex.



The Almighty Dollar seems to be approaching a key juncture. Continued strength here (or, should we say, renewed weakness in, e.g., politically fractious, economically fragile Europe) and a break-out of a pattern forming ever since Bretton Woods' collapse could be the result—and would certainly help raise US asset returns vis-à-vis their competitors abroad. Conversely, the secular zig-zag lower could swiftly re -establish itself if such new highs instead fail to materialize. Keep a watchful eye on this!

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