Money, Macro & Markets

August 2017

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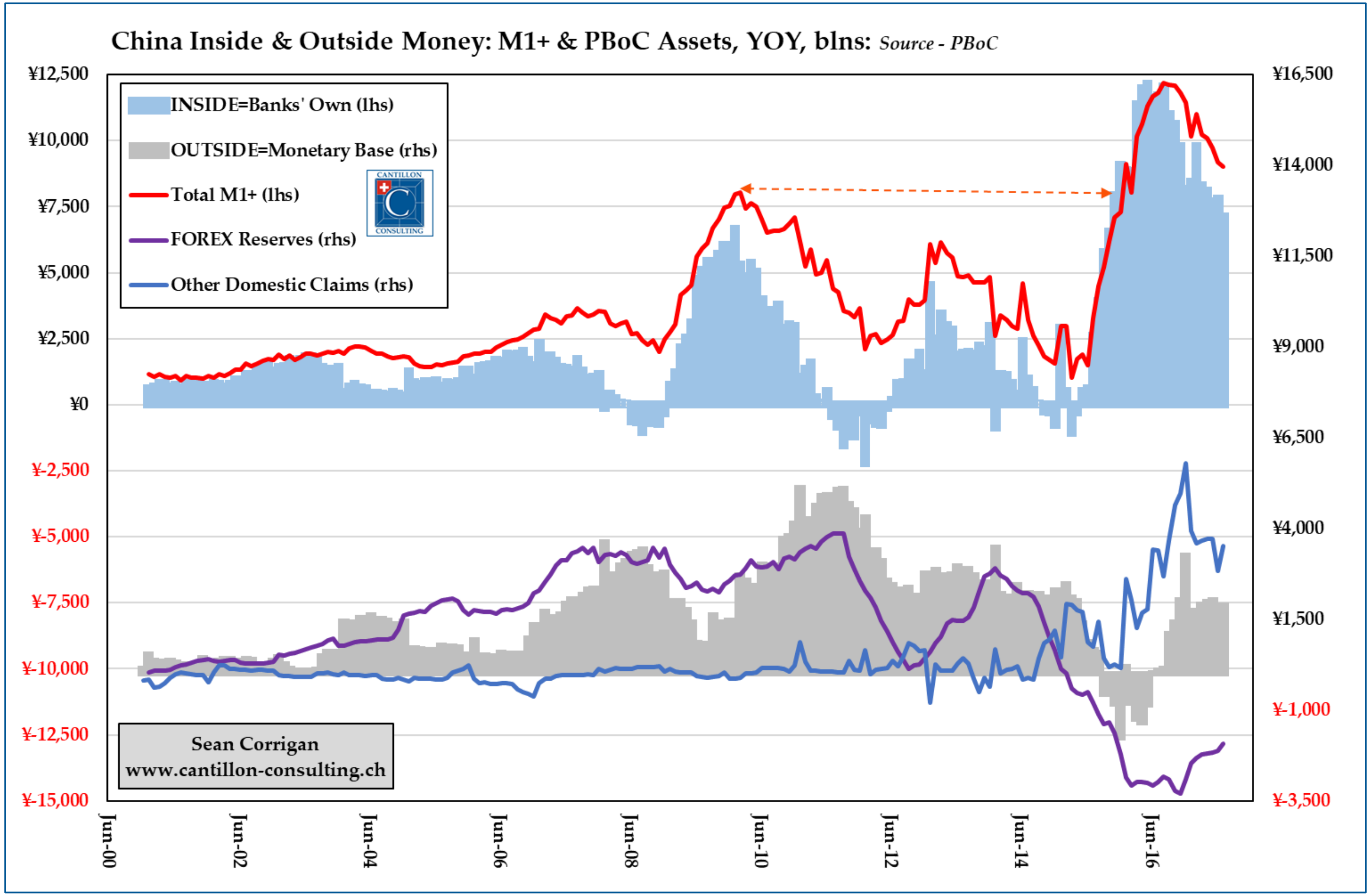
CANTILLON CONSULTING

Macro Overview

China: Is the tide turning?

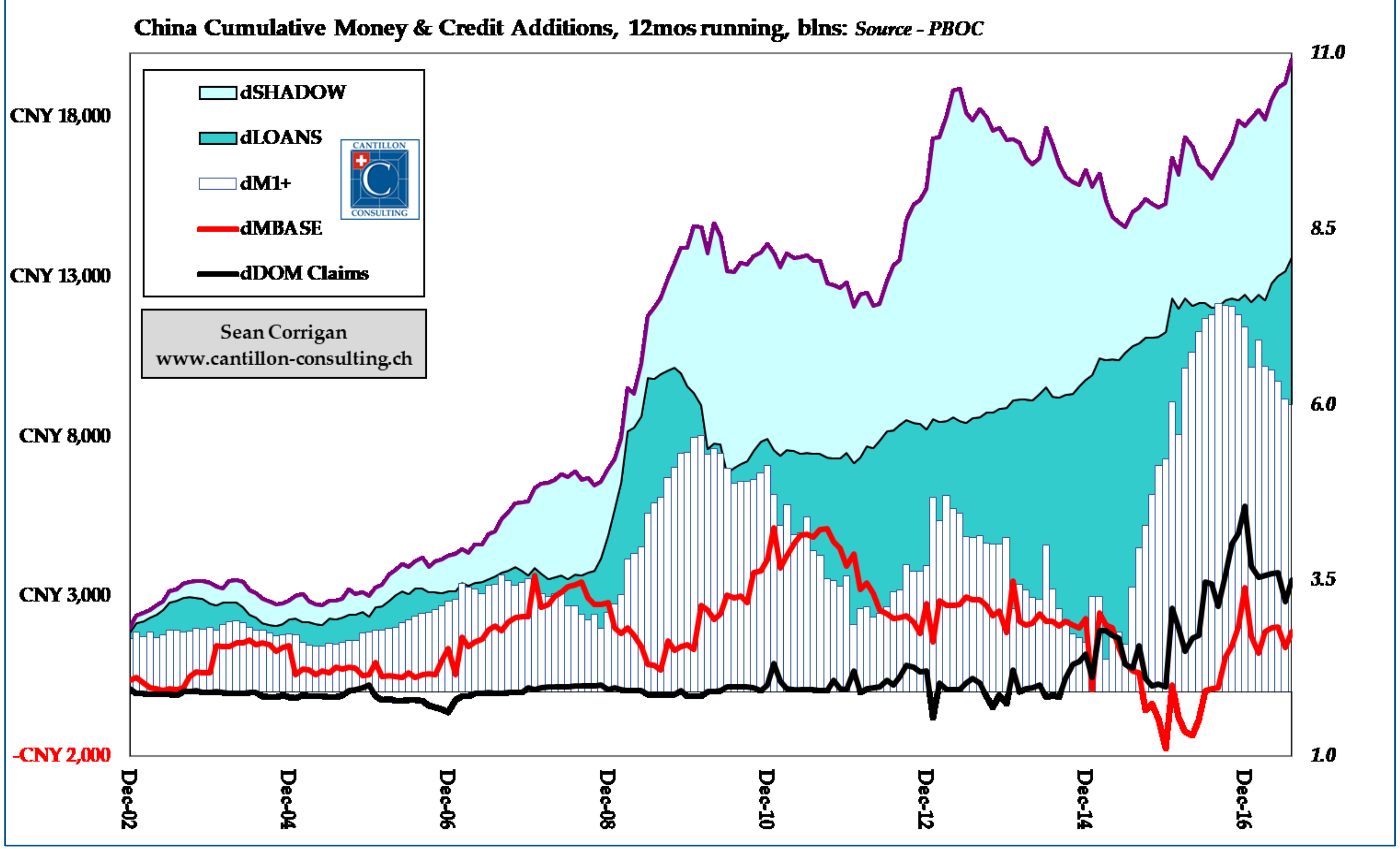


When China first started losing forex reserves in the latter half of 2014, the impact was initially to shrink the monetary base and so to tighten domestic conditions. Before long, however, the PBoC began countering the drain by adding copious amounts of liquidity (the steep rise in the 'other claims' category, q.v.) - particularly once the stock bubble collapsed 2 years ago.

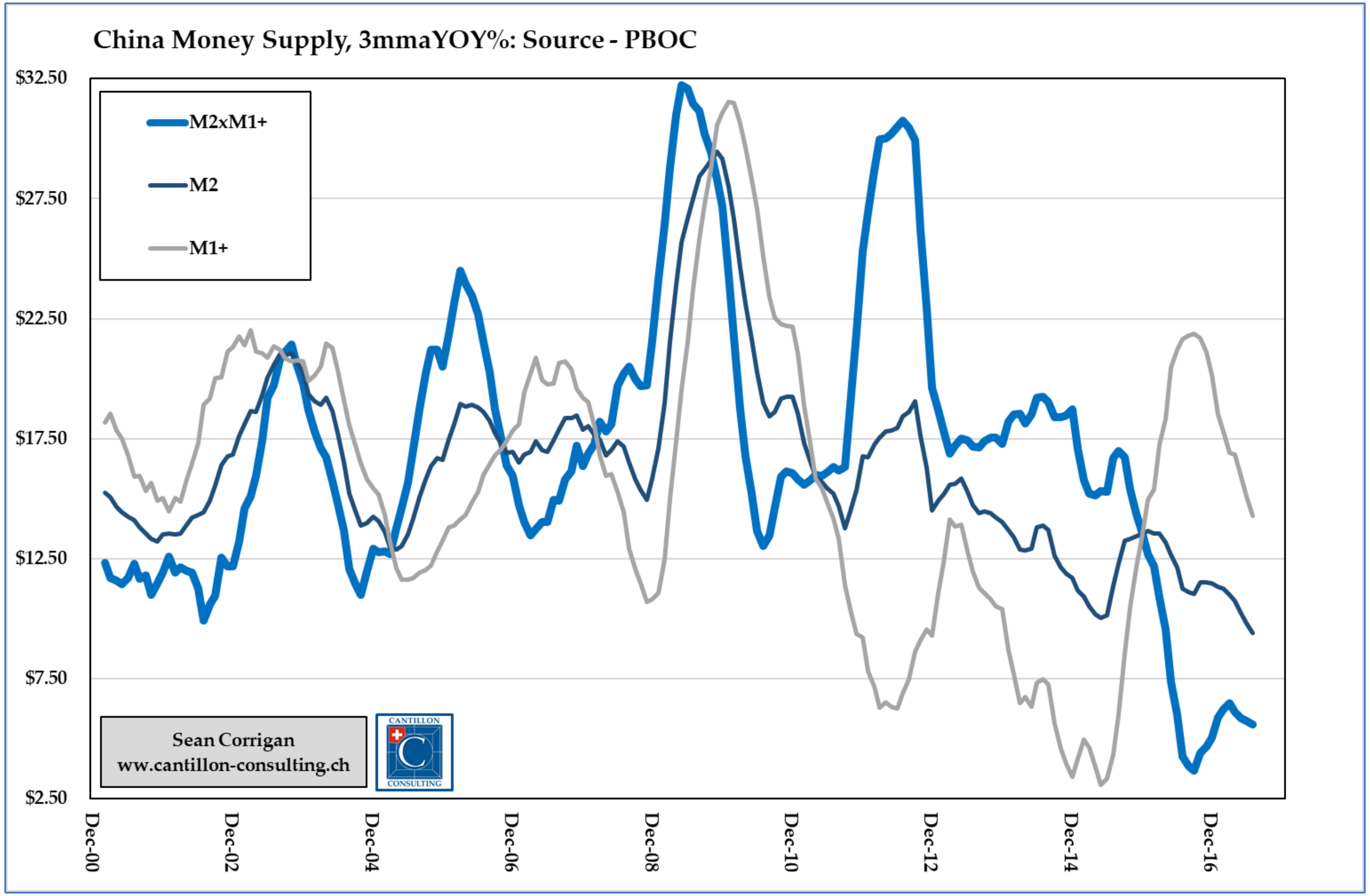
Spurred on by this, banks' own money creation efforts hit unheard-of heights, swelling M1+ by no less than CNY1 trillion-a-month in the run-up to last summer.

Commodity prices responded in due course; producer prices in general surged with them and – perhaps of greatest import – the real estate bubble expanded ever more rapidly.

Though still elevated, note that the magnitude of such additions is now dwindling (ergo the percentage change is falling even more dramatically).

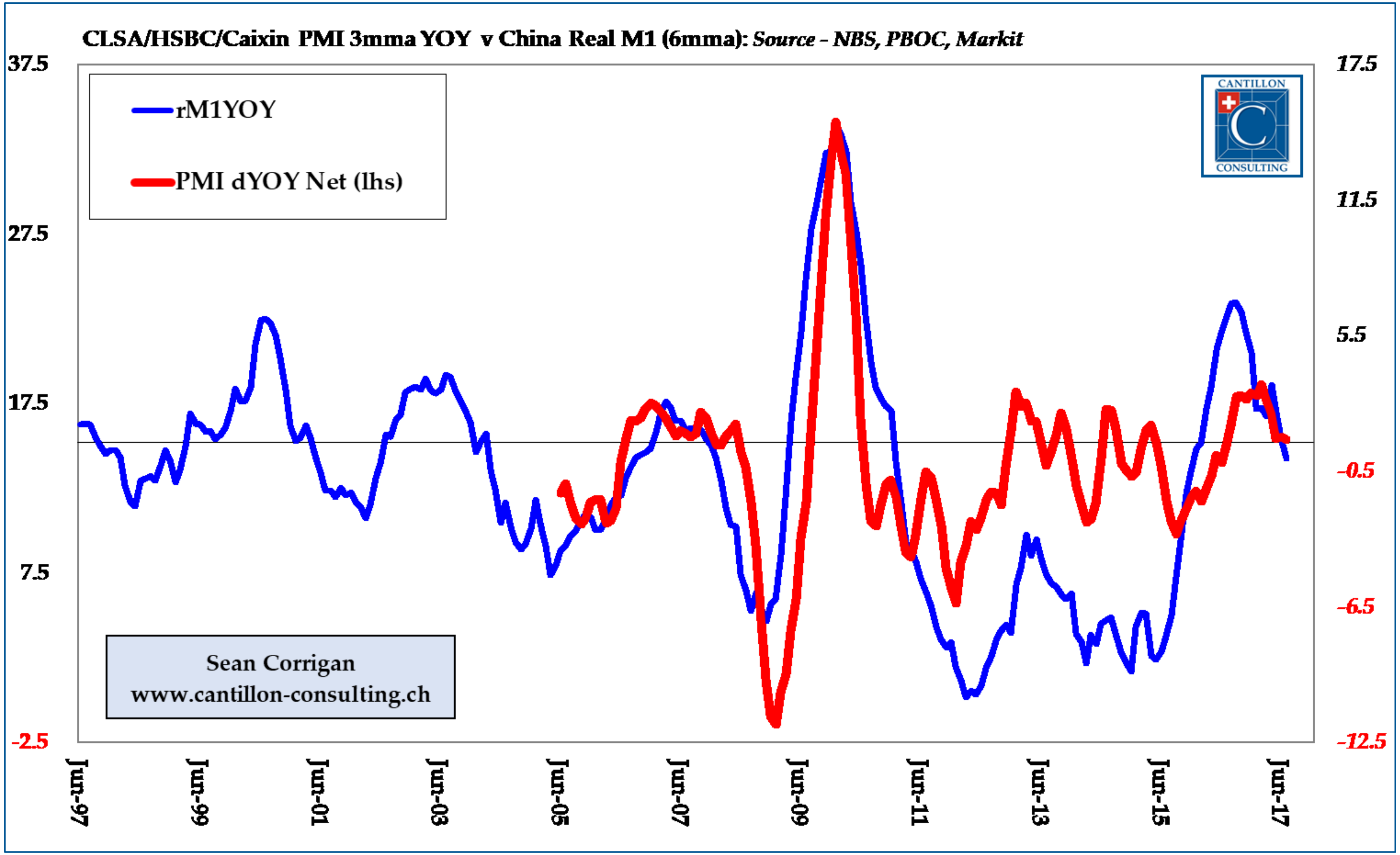


Here, we add to the previous chart a look at what has been happening on the asset side of bank balance sheets (as well as beyond that, out in the 'shadow' system). Note that, at last year's peak, ALL new loans were generating M1 holdings. i.e., NOTHING was being devoted to savings, only to what are implicitly transactional accounts. When credit expansion cannot generate even ex-post, 'forced' savings to mitigate its impact, the price inflationary impact is at its greatest. Recent months, however, have seen a partial cooling as M1 additions have lessened. The fact that the pace of both loan and shadow increments has simultaneously increased, means that other sources of funds are being utilized to a greater degree, notably those originating from foreigners, the bond market, and the PBOC itself.



Note here the intriguing collapse in non-M1 M2. No-one wants a savings or time deposit under current conditions, it would seem.

This means banks must rely either on wholesale funds and 'shadow' instruments or else run the greatest of liquidity/temporal mismatches in funding their loan books



As the M1 deceleration from last year's extraordinary peak has progressed, the PMI has shown its expected downward response. In due course, company revenues - and ultimately profits - will follow if this is long maintained.

Greater recourse to receivables financing (funded partly by recourse to shadow finance) can delay full recognition of this awhile, but it cannot fail to impair either the magnitude or the quality of earnings as it works through the economy.

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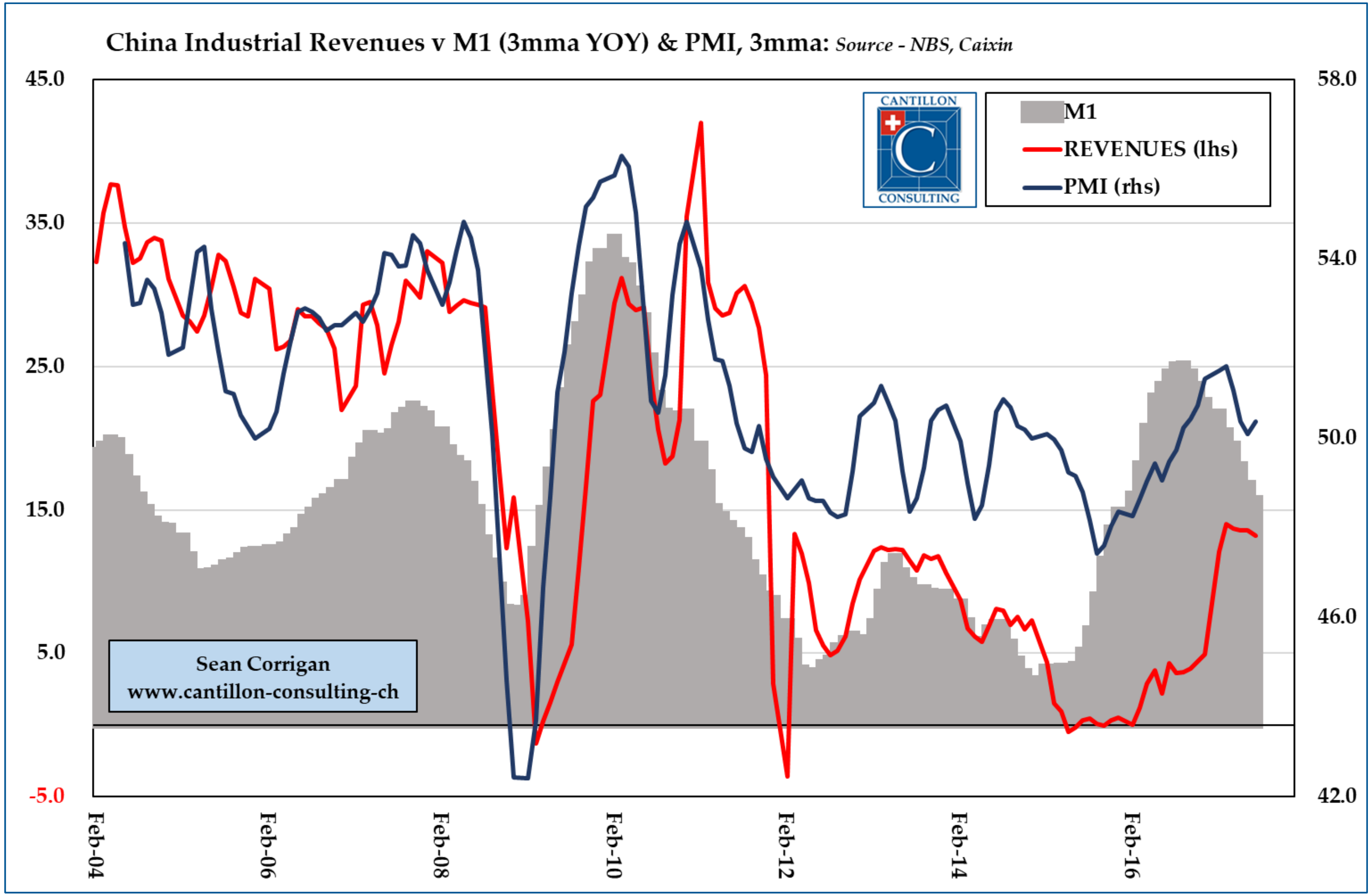
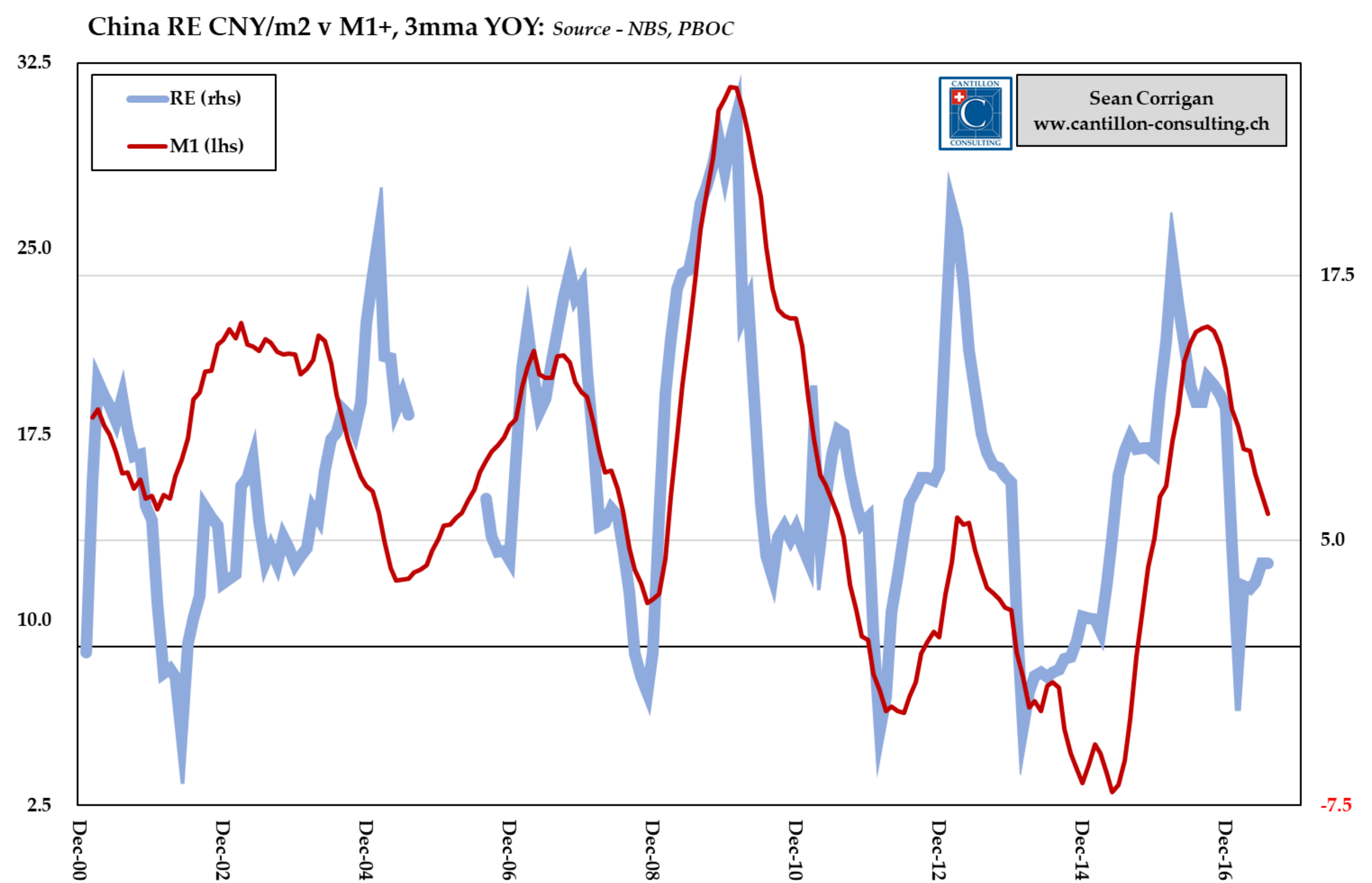


As we can demonstrate for other countries – eg, Germany and the US there is a reliable relation between business revenues and PMI survey responses.

Usually, Revenues are also linked to M1 growth, giving us a neat interlinkage of 'Hard' & 'Soft' and of 'Monetary' and 'Real' data

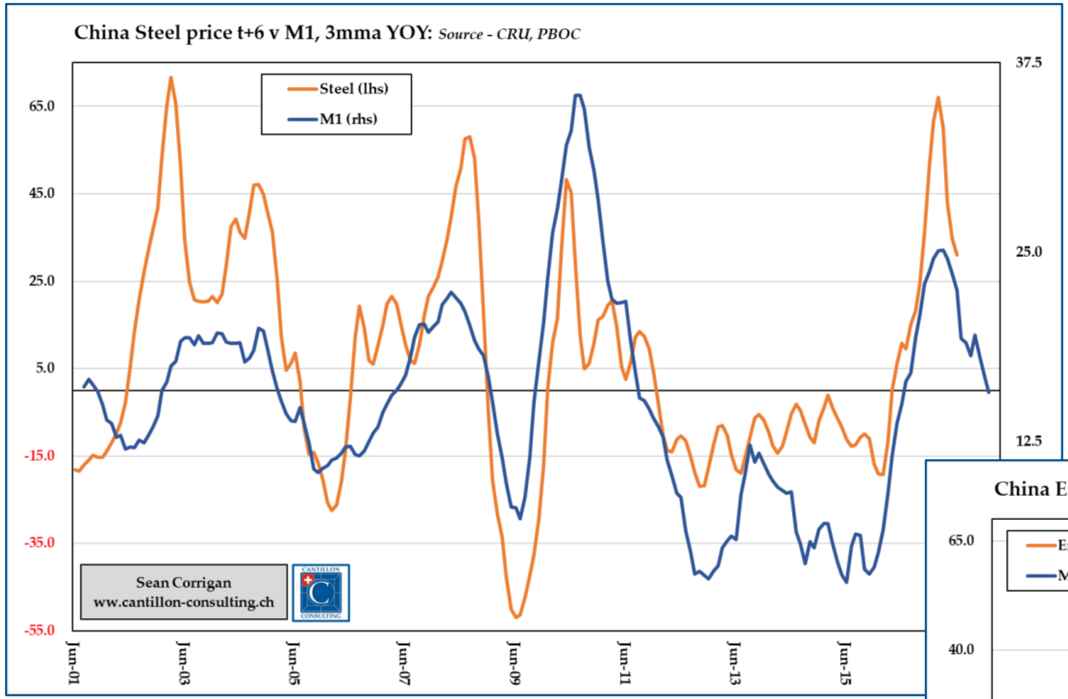


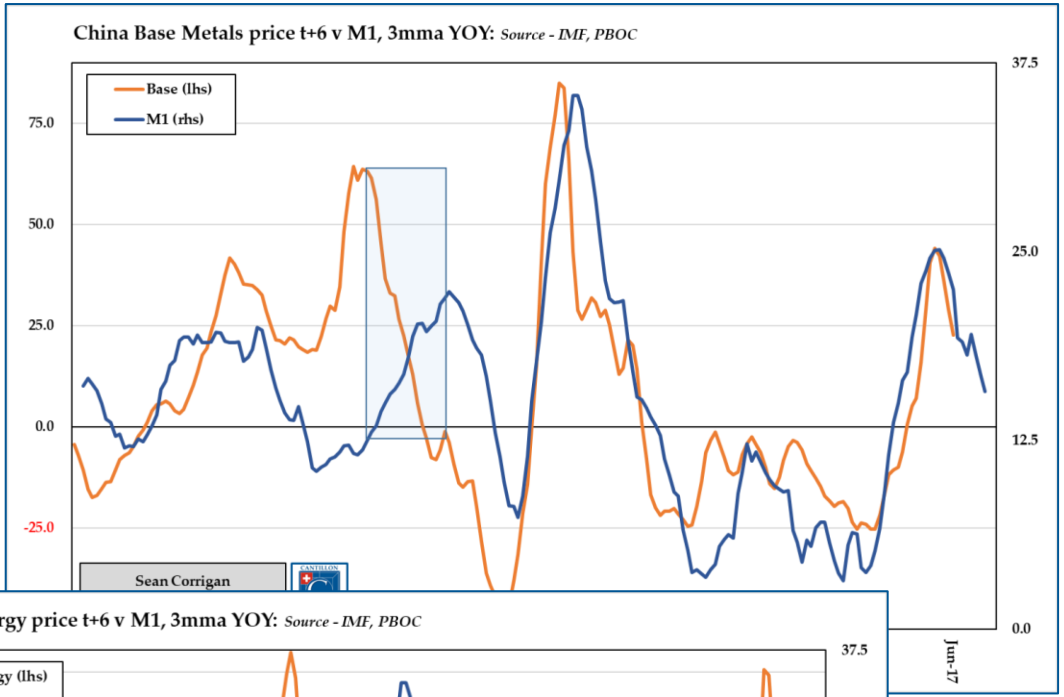
In constructing this series of residential real estate prices, we are well aware of the annoyingly variable impact of the Lunar New Year, as well as issues regarding the homogeneity of coverage in the official statistics. We are also fully cognizant of the noise created by the incessant 'macro-prudential' meddling which is applied to China's property markets.

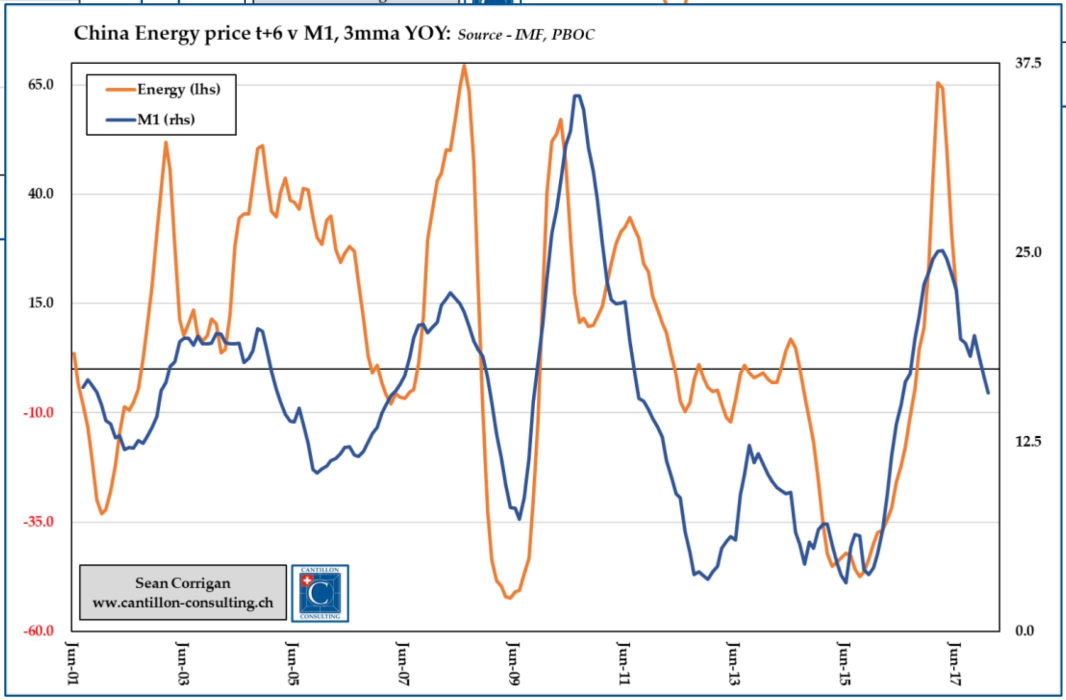
That said, we think this is reasonably representative of the broader trends, especially in more recent years when – once again – the link to the laxity or tightness of monetary conditions is only too evident.

One thing to note: the likely causality is that the urge to buy property encourages banks to lend and the new credit granted to that end *then* ends up swelling new, re-spendable money on the other side of the ledger as a result.

August 29th 2017





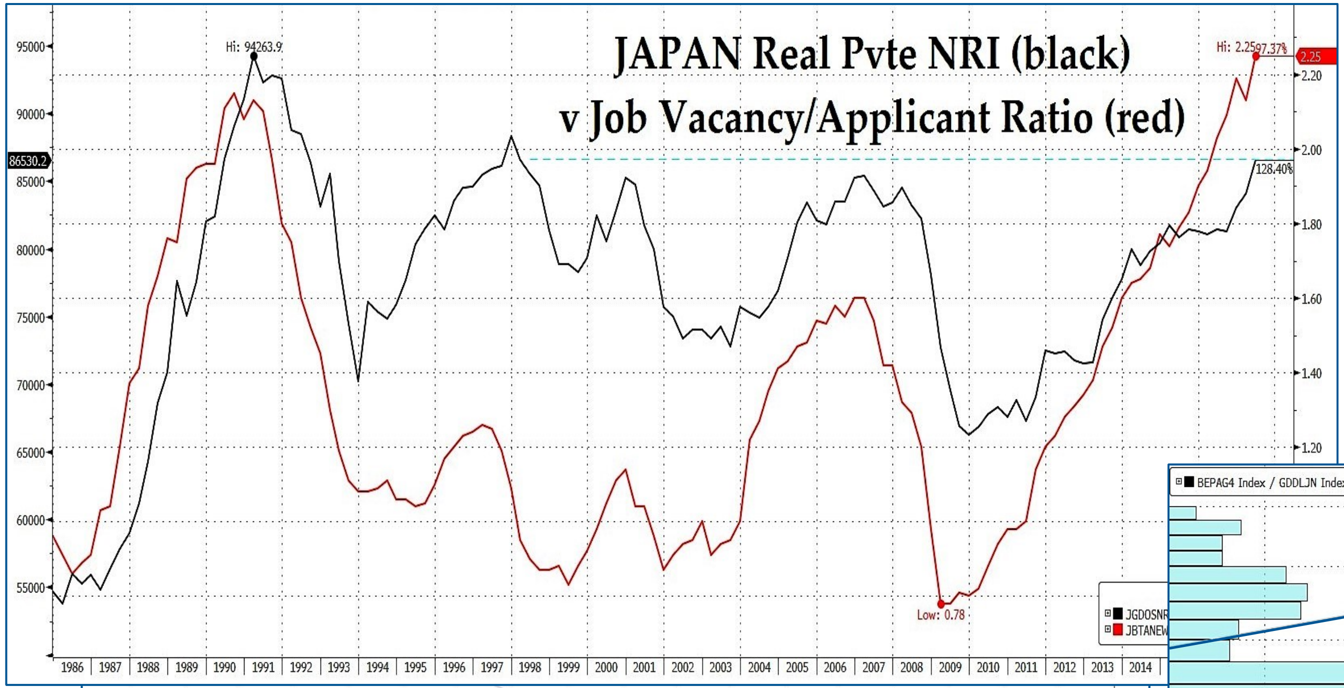


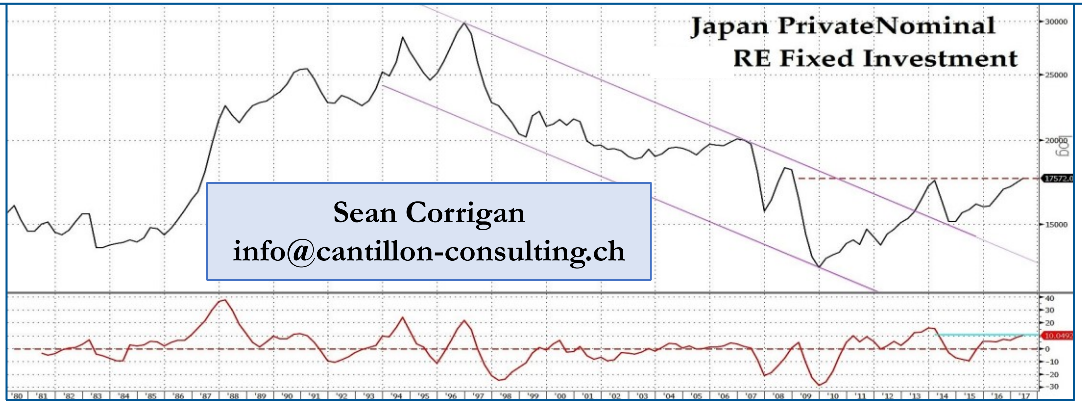
It is hard to argue that these trends do not continue to play a determining role in industrial commodity pricing, especially in that king of all speculative contracts, steel rebar.

Follow the money!

Japan: Scarce workers + abundant cash => Capex => Profits

Another solid read from Japan with GDP posting a 4% annualized gain which was the best in over 2 years. Better yet, the *private* component continued its sparkling run of the past 18 months, hitting new highs and registering a 2.5% CAR which is the best for a similar stretch since early 2014 and (GFC rebound aside) something you need to go back to 2006 to see previously equalled. Even Nominal GDP is now only a whisker off beating 2007's highwater mark, as a result. GDP *per capita* is, of course, stronger still.
As the main graph (left) shows, private non-residential investment played a big part in the rise; largely driven, one suspects, by the pressing desire to substitute capital for a shrinking supply of labour. Whisper it, but residential investment has also broken up out of its Lost Decades downswing (bottom, left).
Sorry, Secular Stagnationists, but this combination means that real interest rates would now be *rising*, were they free to do so. It also implies that aggregate profits should be enhanced, giving stocks a chance to push fixed income to the bottom of the post-Asian Contagion band in relative terms (below).





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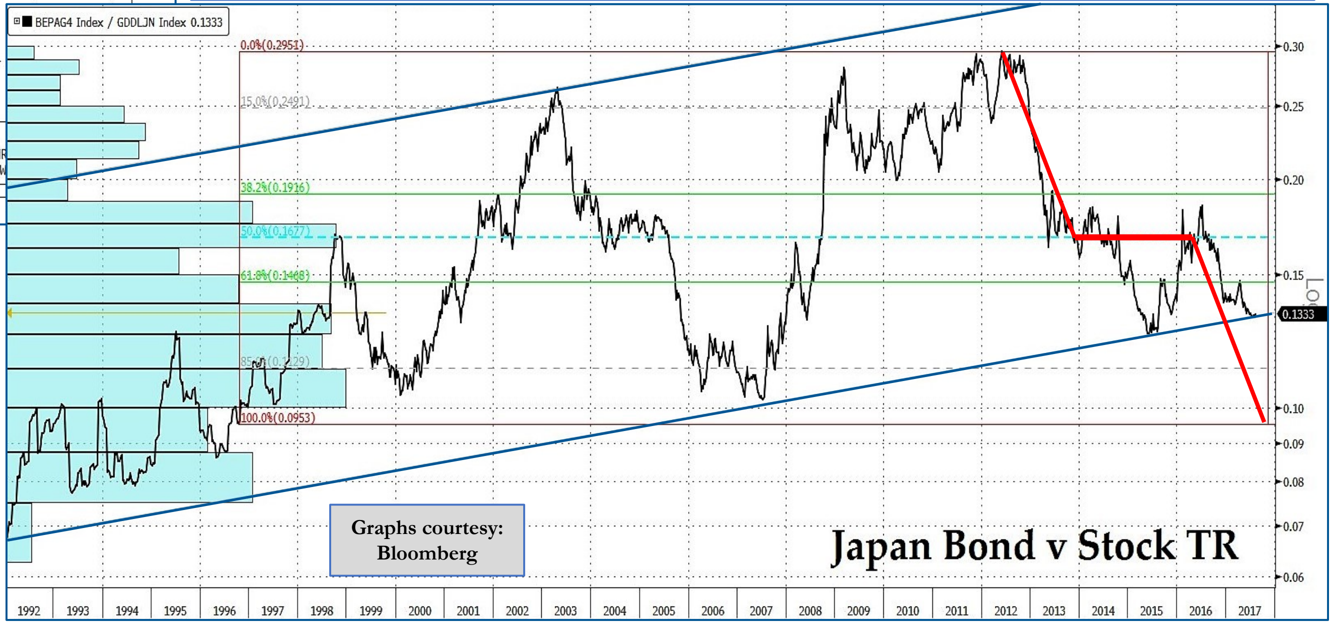
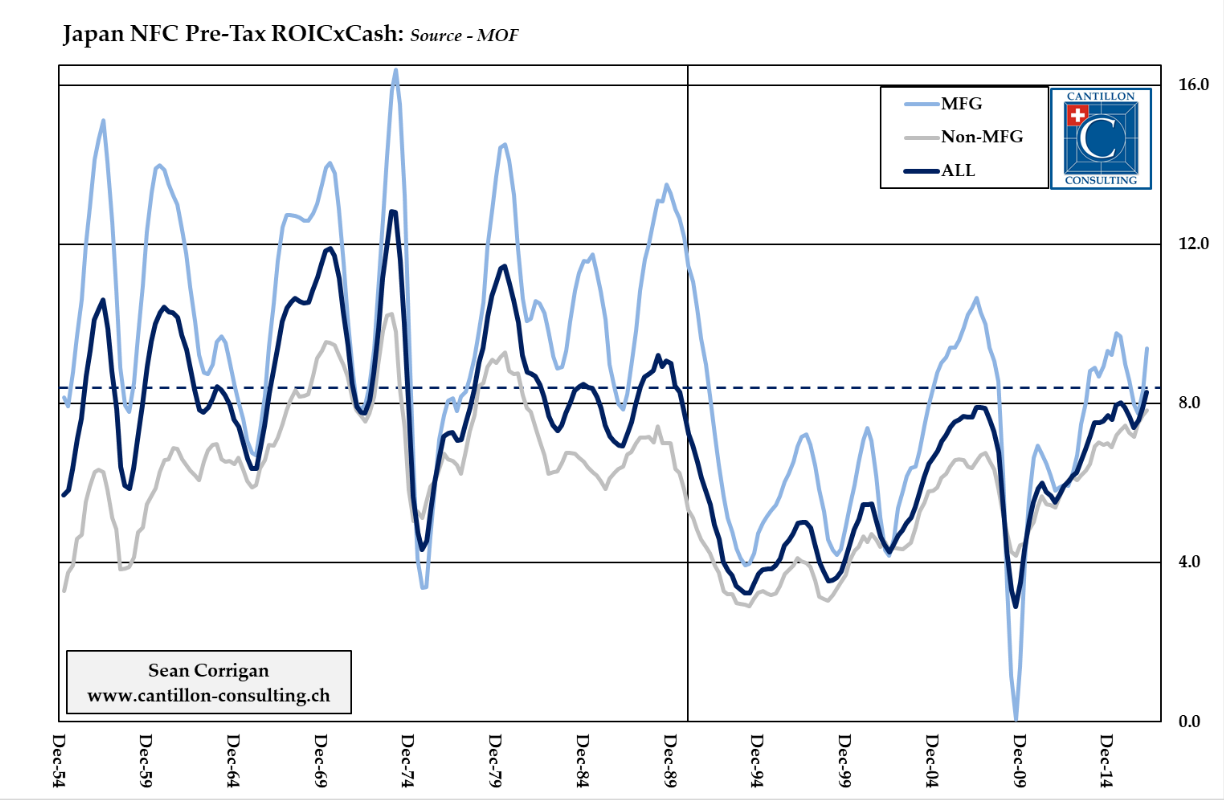
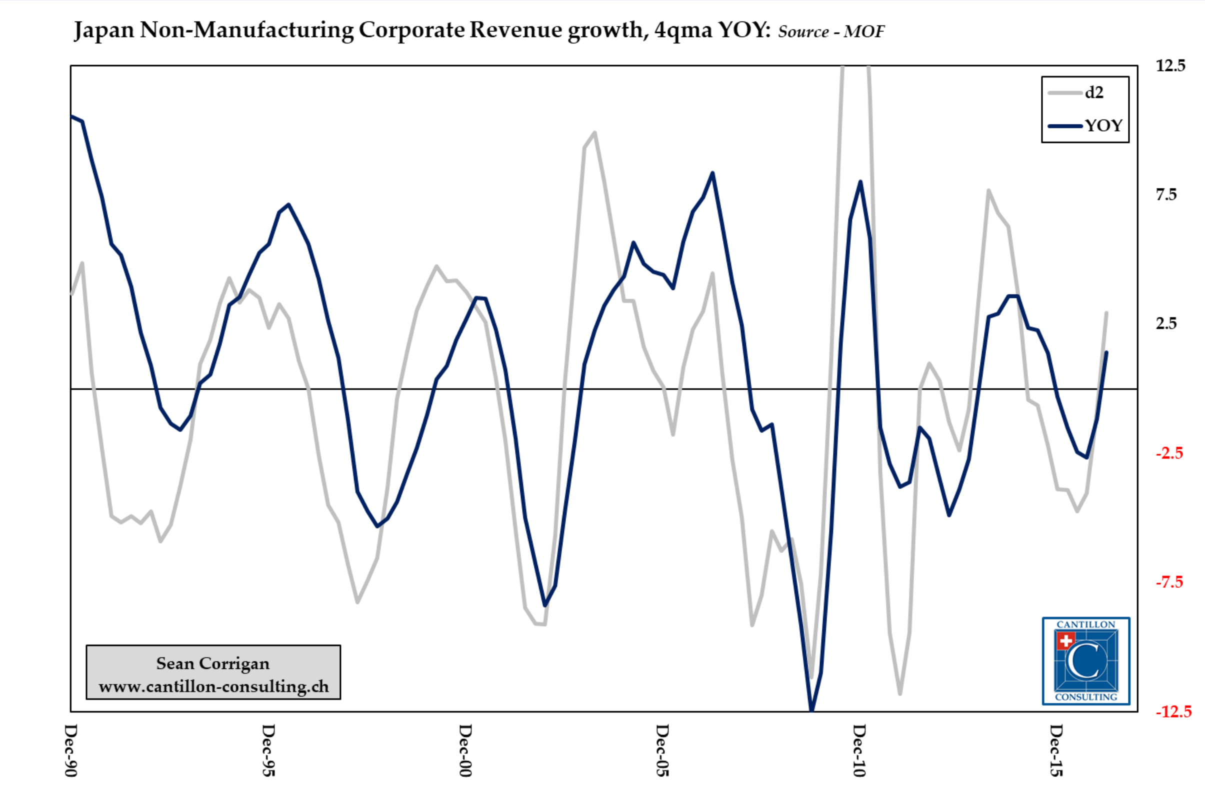


Graphs courtesy:
Bloomberg

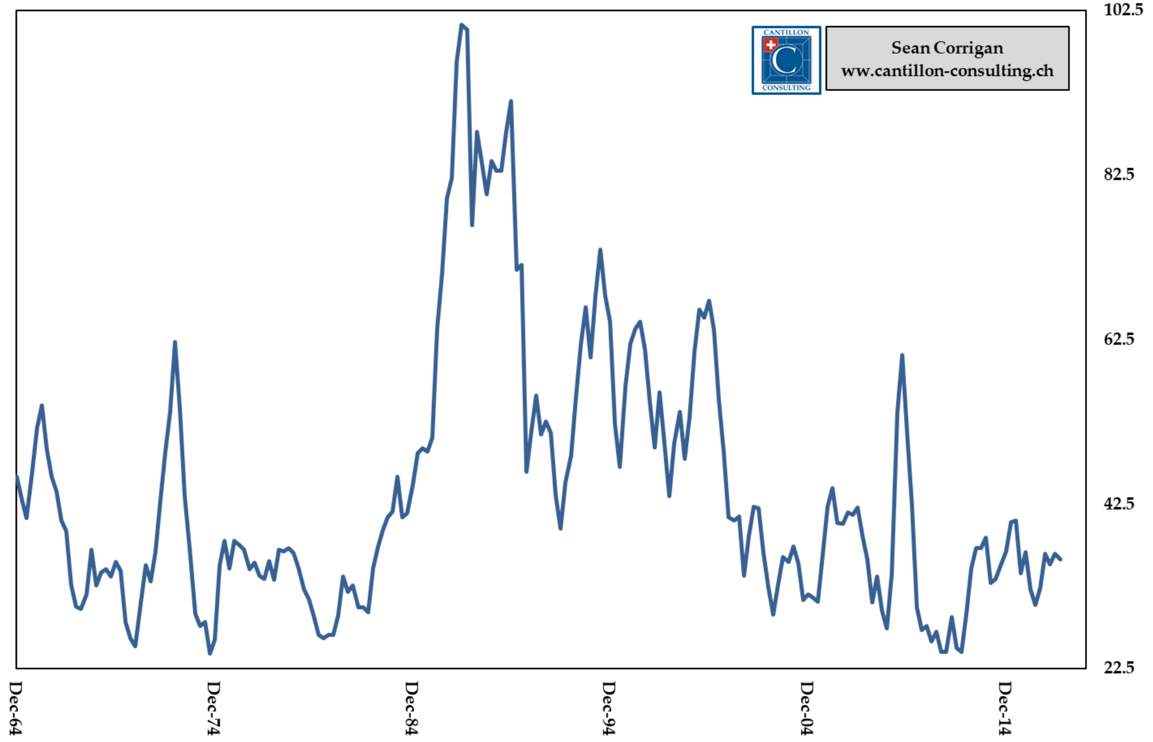


Still greatly under-owned and relatively 'cheap', Japanese companies are enjoying a pick-up in revenues together with better returns on equity and, especially, capital.

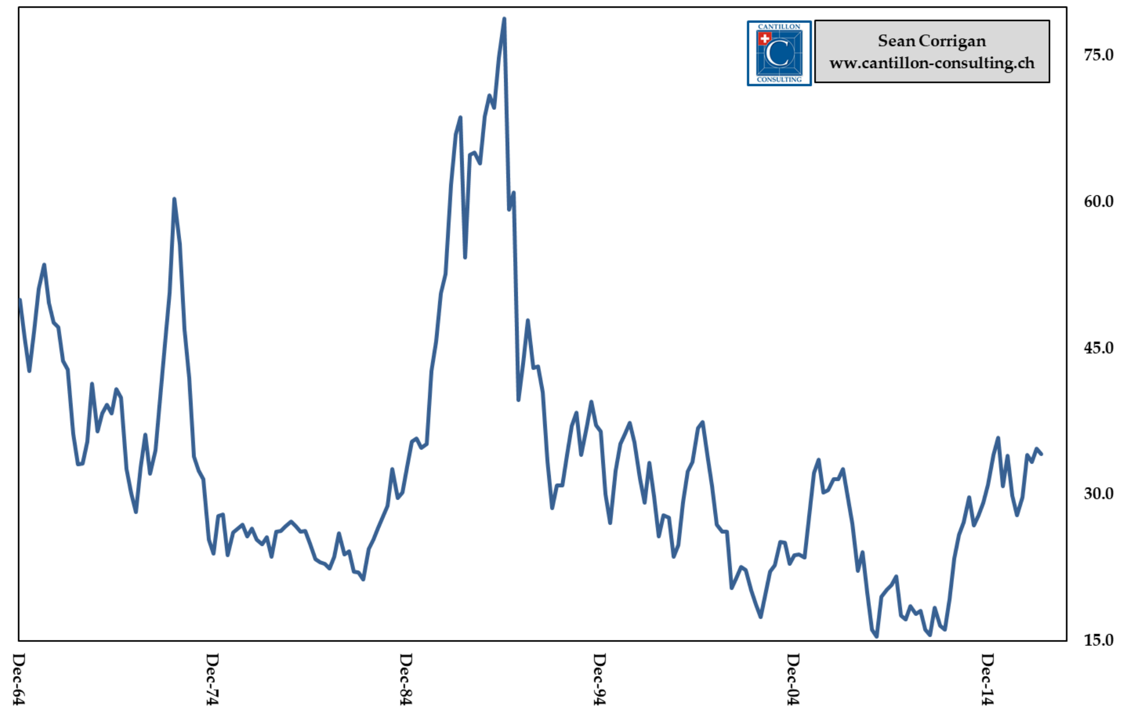


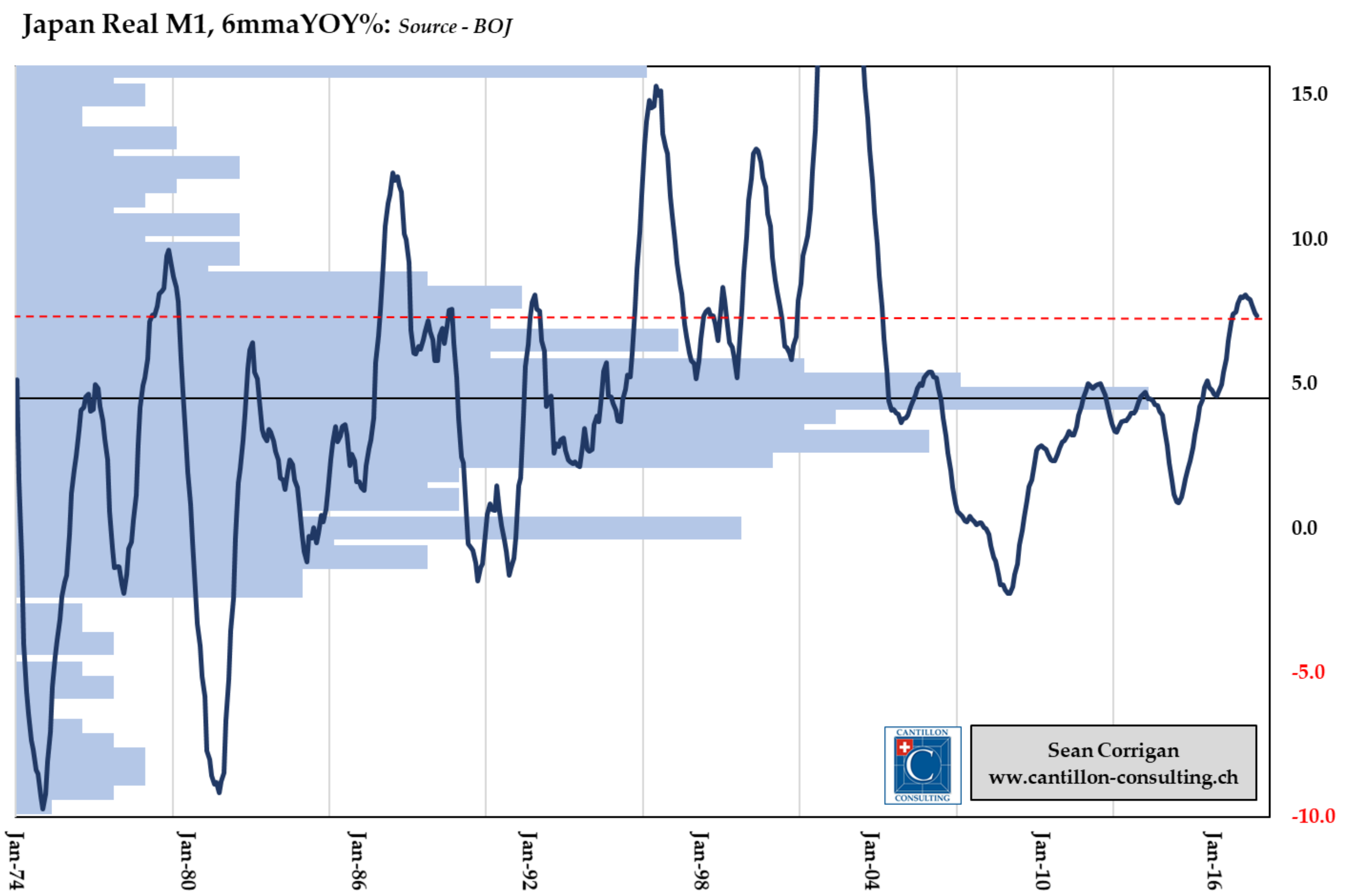
Multiples are hardly demanding while balance sheets are positively oozing with spendable cash and hence not at all burdened with debt, at least on a net basis.

Japan equities/Non-financial operating income: *Source- MOF, TSE, MSCI*



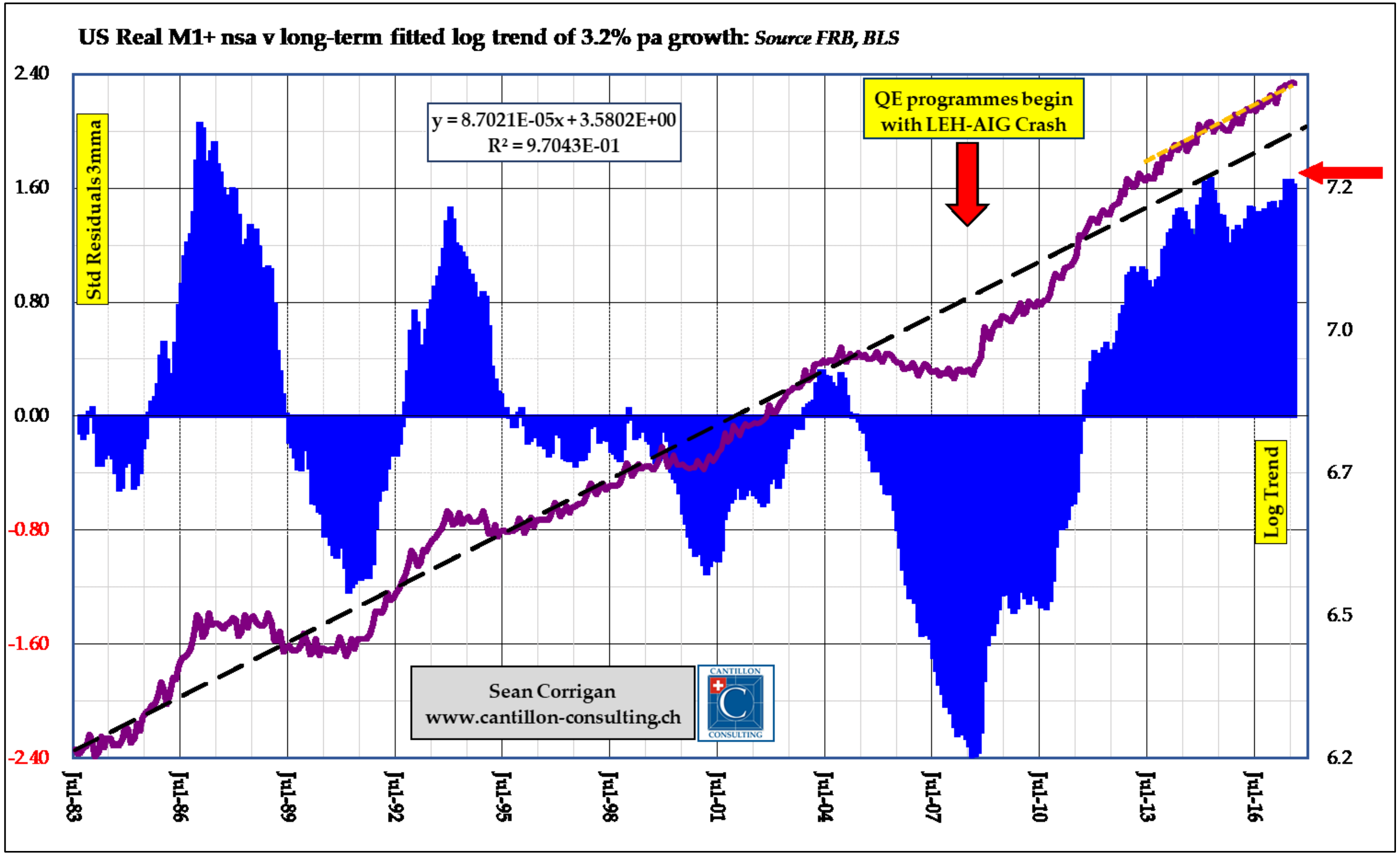
Japan equities/Non-financial sales: *Source- MOF, TSE, MSCI*





As elsewhere in the world, rapid real M1 growth is acting if not as a fuel, then at least as a lubricant for the wider improvements, even if one must always be wary of the malinvestment inducing nature of such sustained laxity

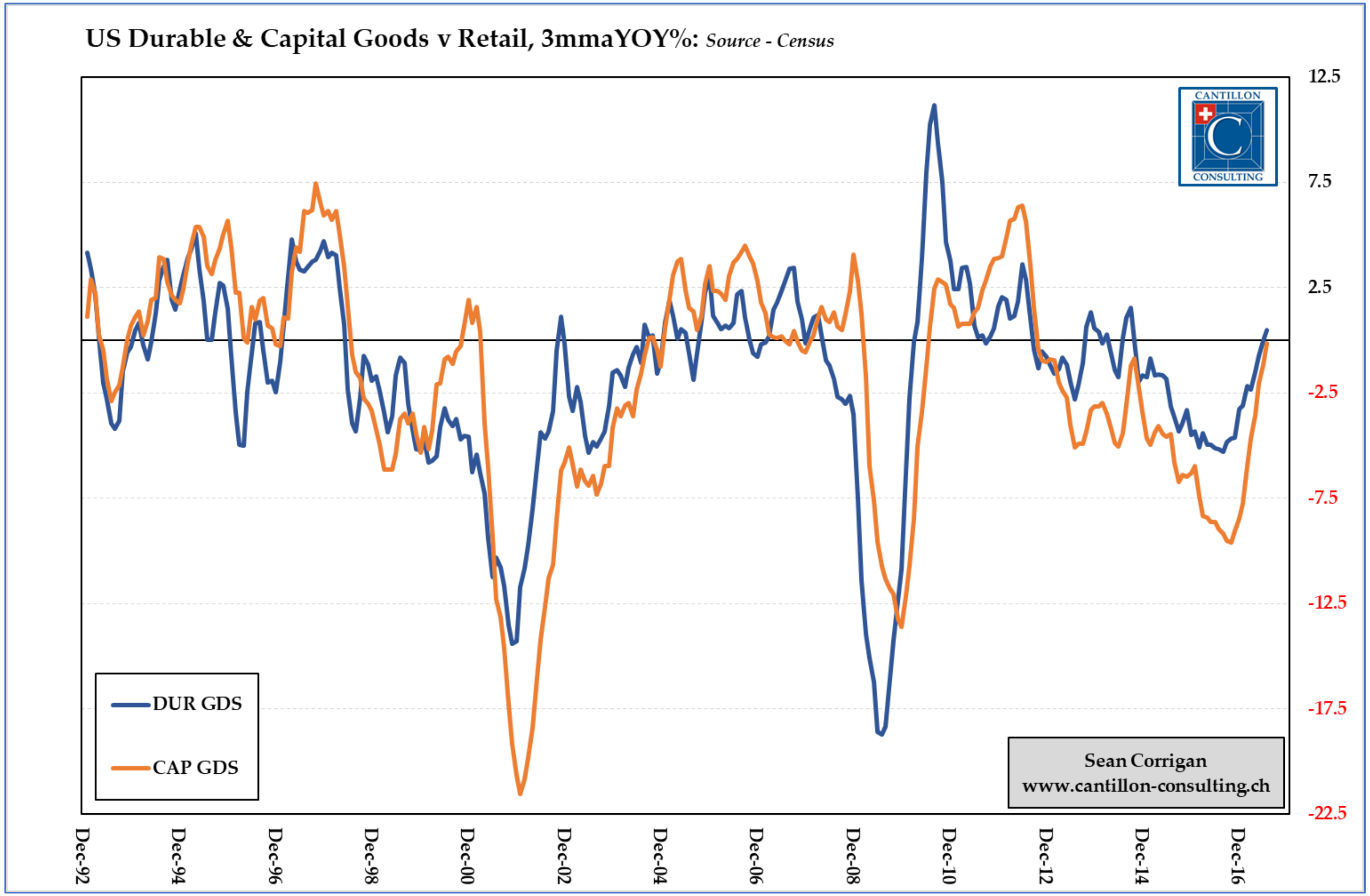
USA: Hanging tough – or just hanging on?



An absence of meaningful growth in the balance sheet (and an actual shrinkage in the monetary base) has not impaired over-reserved banks' ability to create endogenous, inside monies.

While the QE surge means the stock is well above previous norms, in fact the past 4 ½ years have seen M1 grow at a clear 6.4% nominal, 3.9% real trend which, in ordinary circumstances would be enough to ensure NGDP growth could run at a similar rate, in keeping with its pre-Crisis trends.

Granted, too low interest rates are, limiting the mobilisation of said monies by removing the opportunity cost distinction between the various vehicles in which to hold one's funds. Nevertheless current growth is rapid enough to keep the pot boiling.

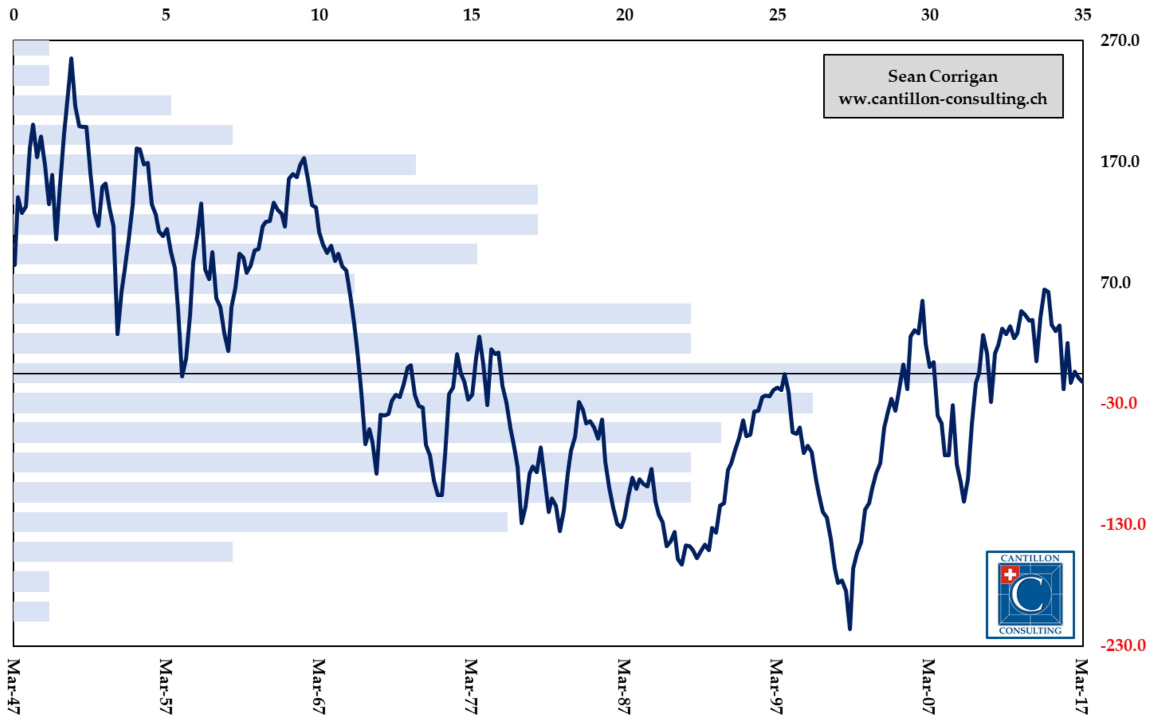


Last year, America finally emerged from the 'hidden' recession cause by the shale (and wider commodity) bust.

So far all indicators are still pointing upwards with the caveat that there has been a marked slowing in revenue growth in the past 4-5 months which does not show up here because of the lingering base effect of measuring off the lower reaches of 2016's mini-slump.

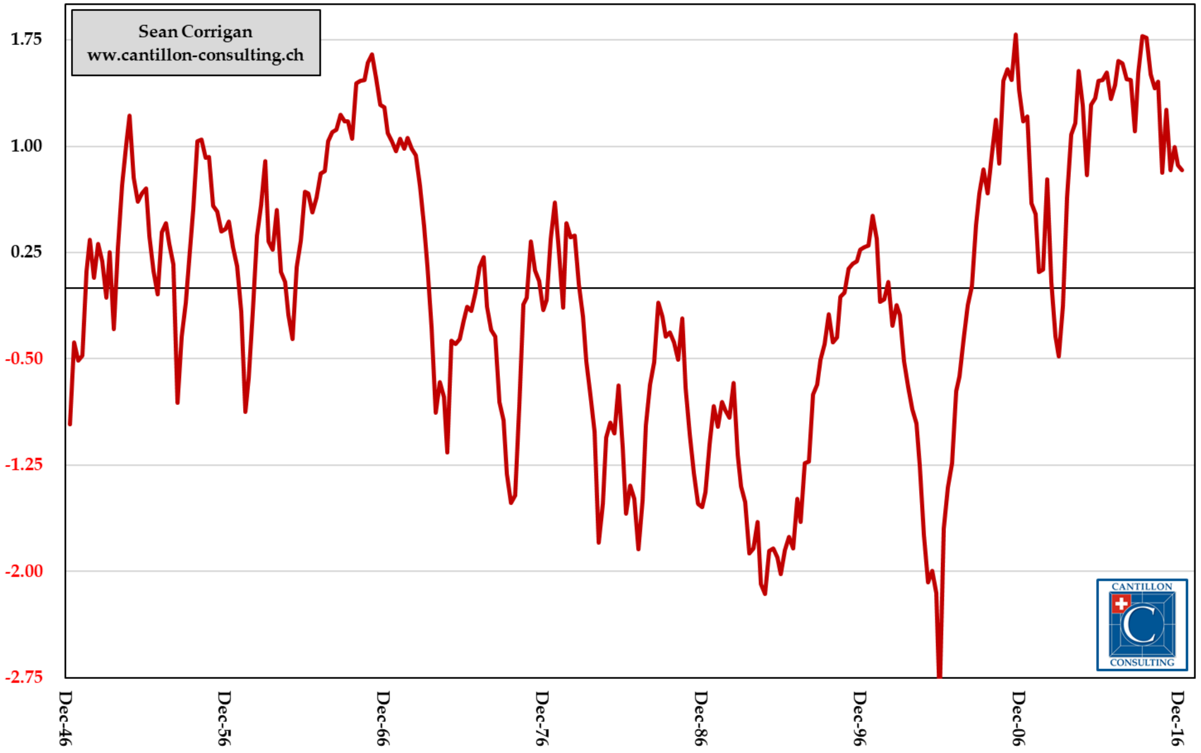
This bears attending to closely.

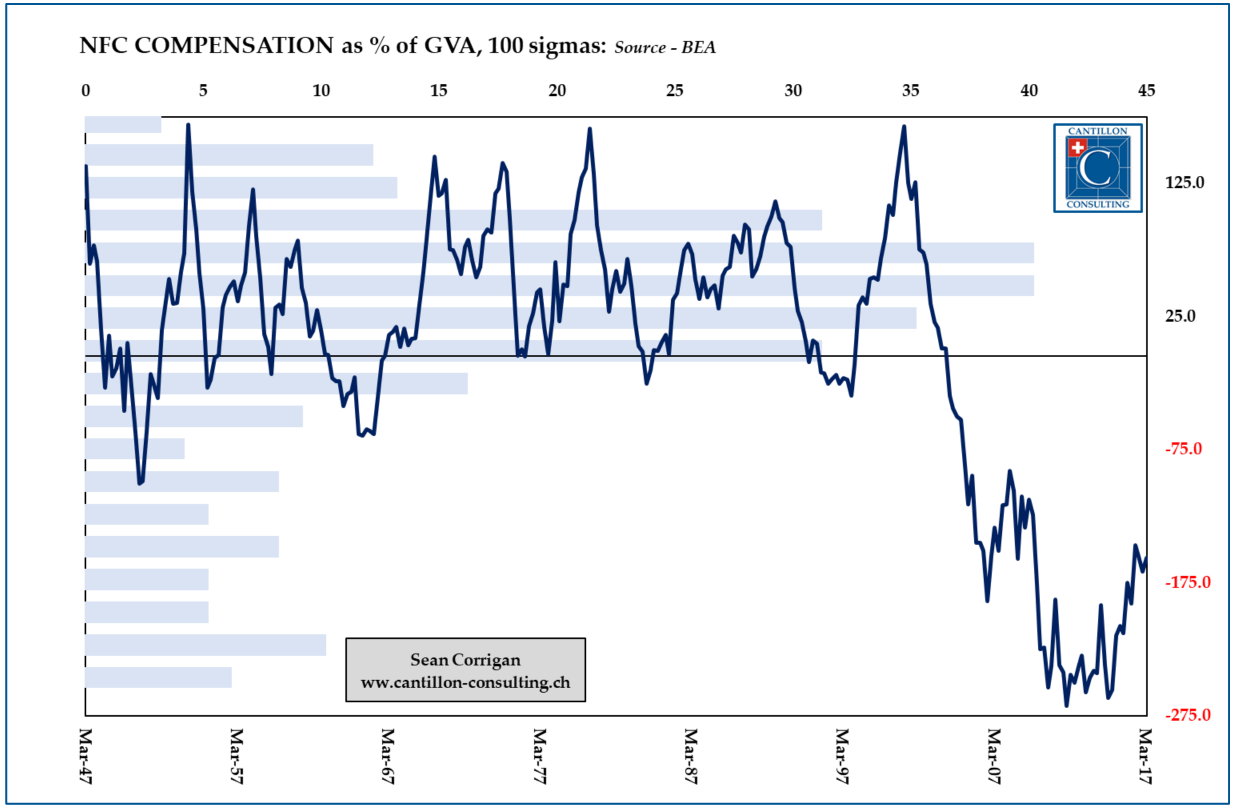
NFC Profit as % of GVA, 100 sigmas: *Source - BEA*



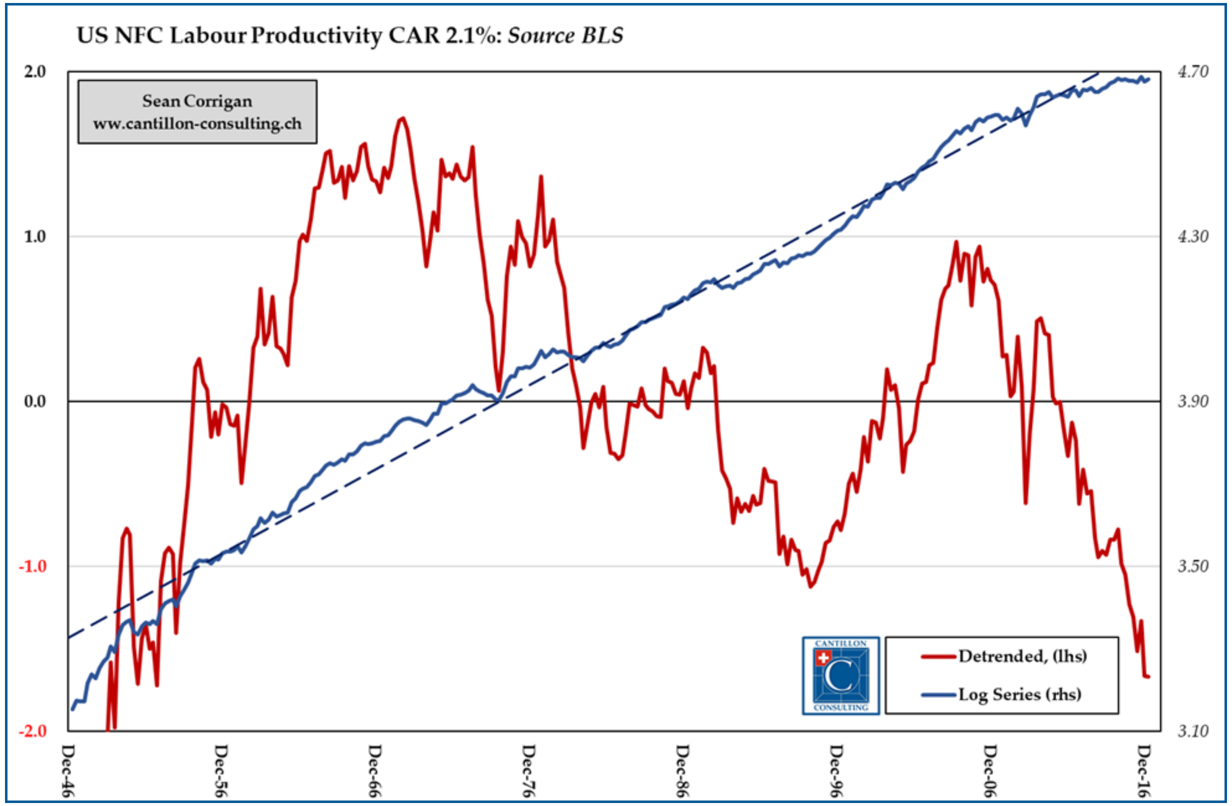
For all the talk of low 'productivity' in the US, the production of the one thing that matters – dollars and cents – is proceeding steadily enough

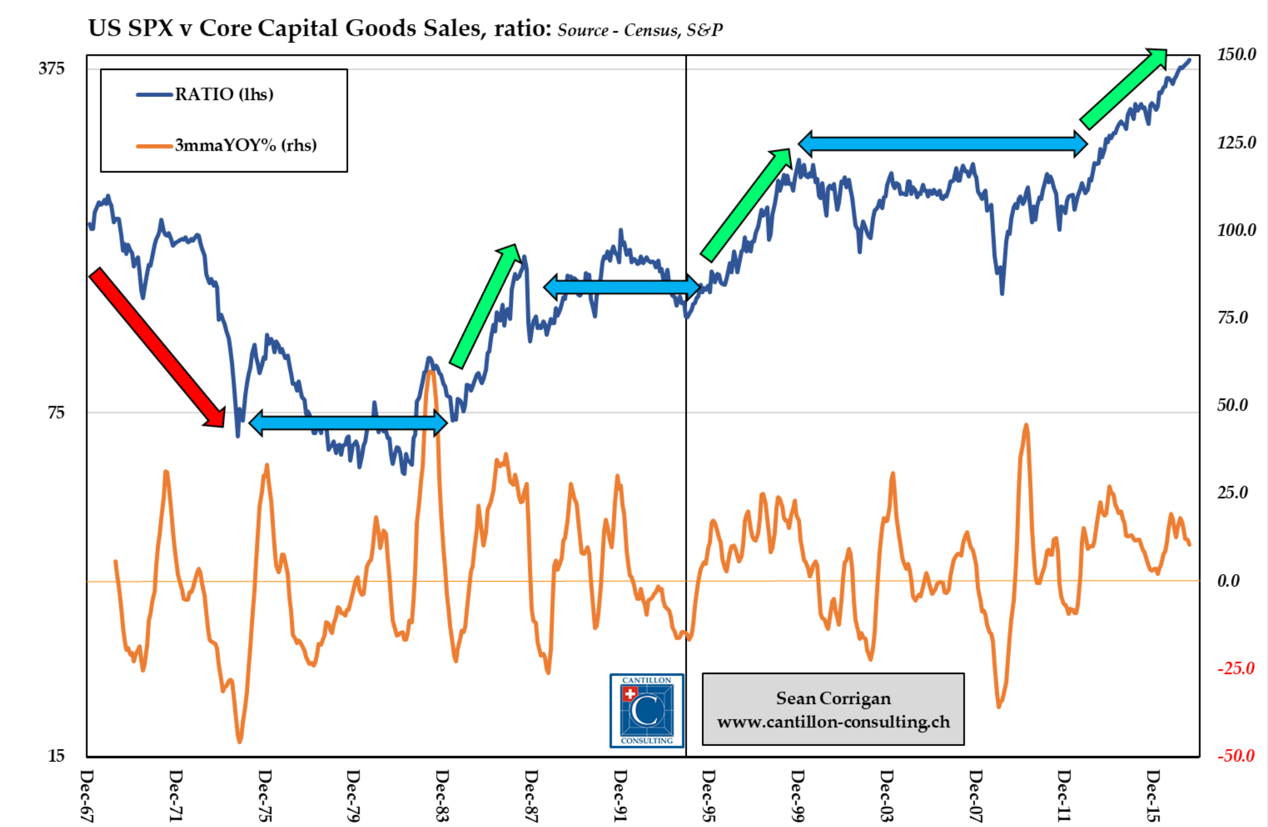
US NFC Real Profit/Hour CAR 1.3%: *Source - BLS, BEA*



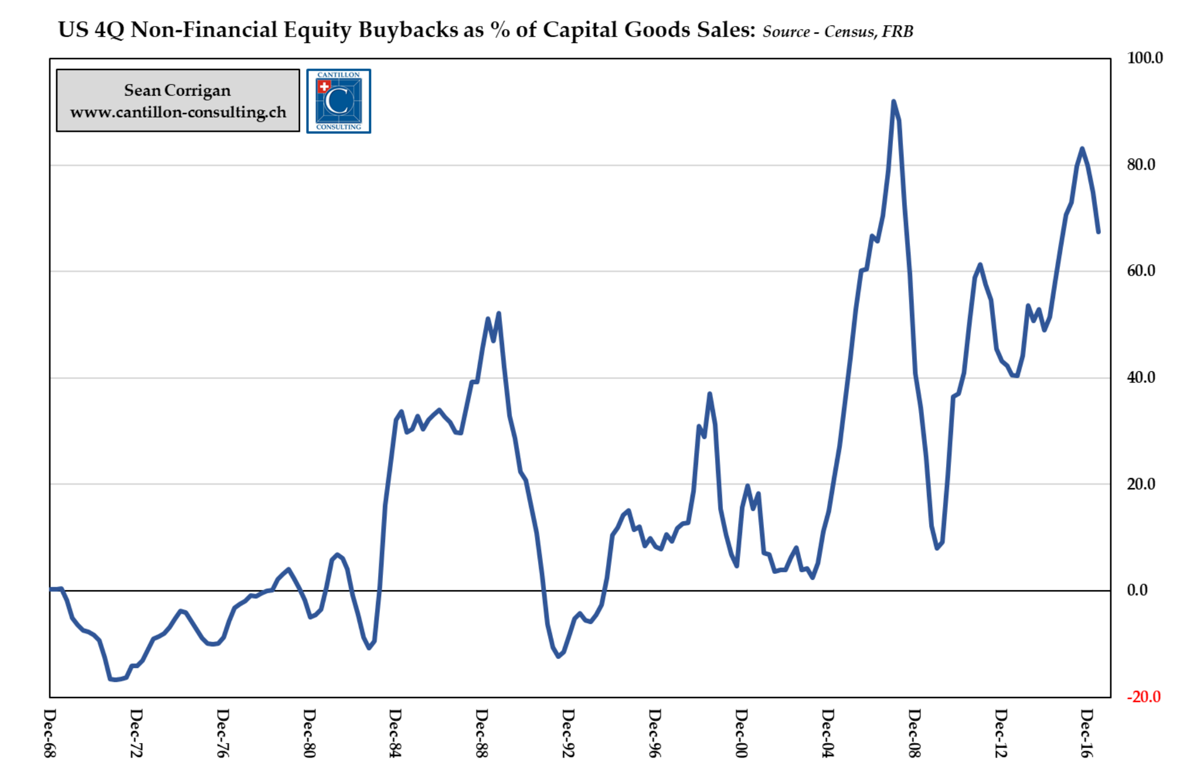


What is true us that returns - and therefore rewards - to labour are lagging. Many hands do not make light work when they are employed in low output activities (even negative output ones, if we reckon on the hidden toll of compliance, legal, etc)

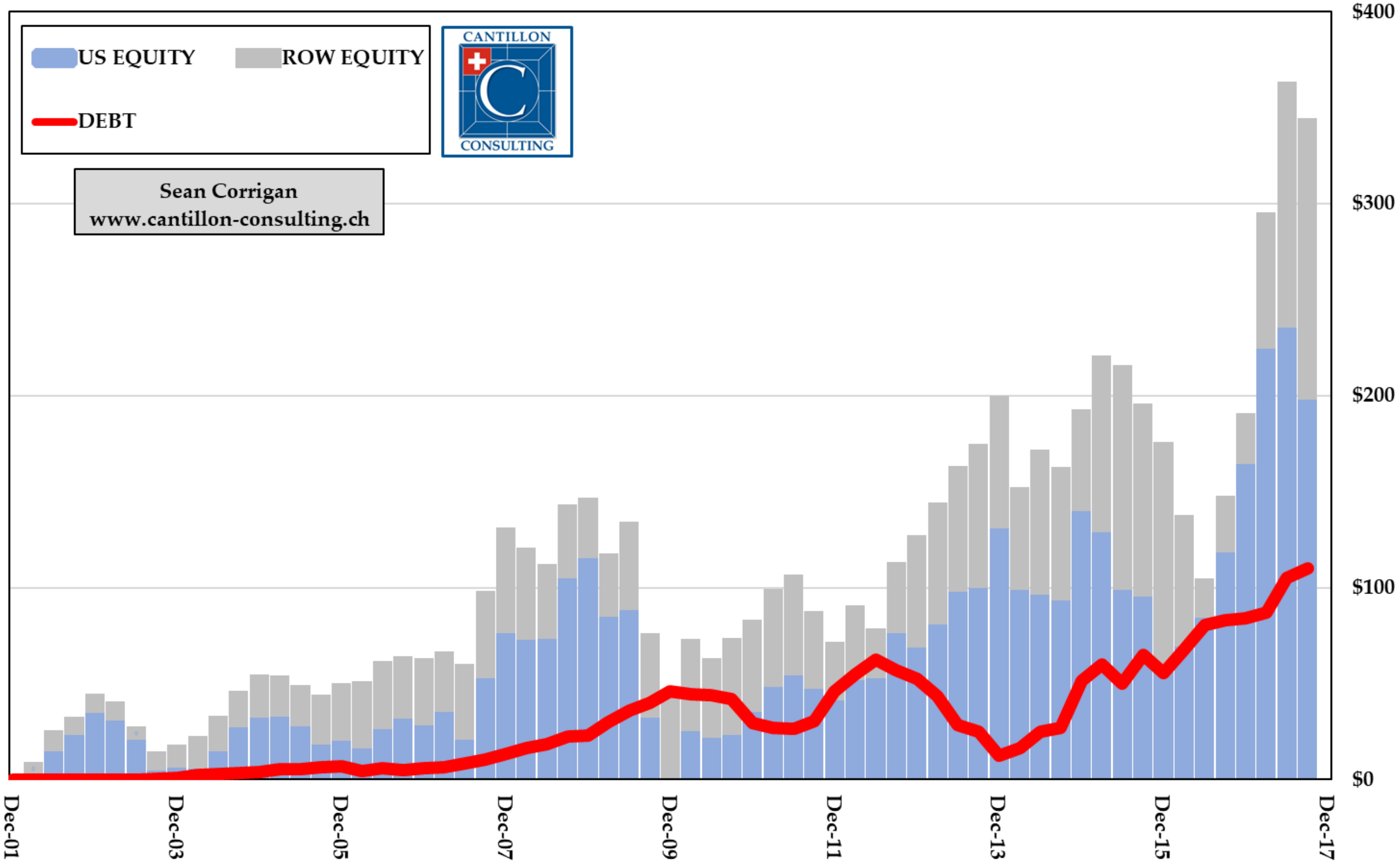




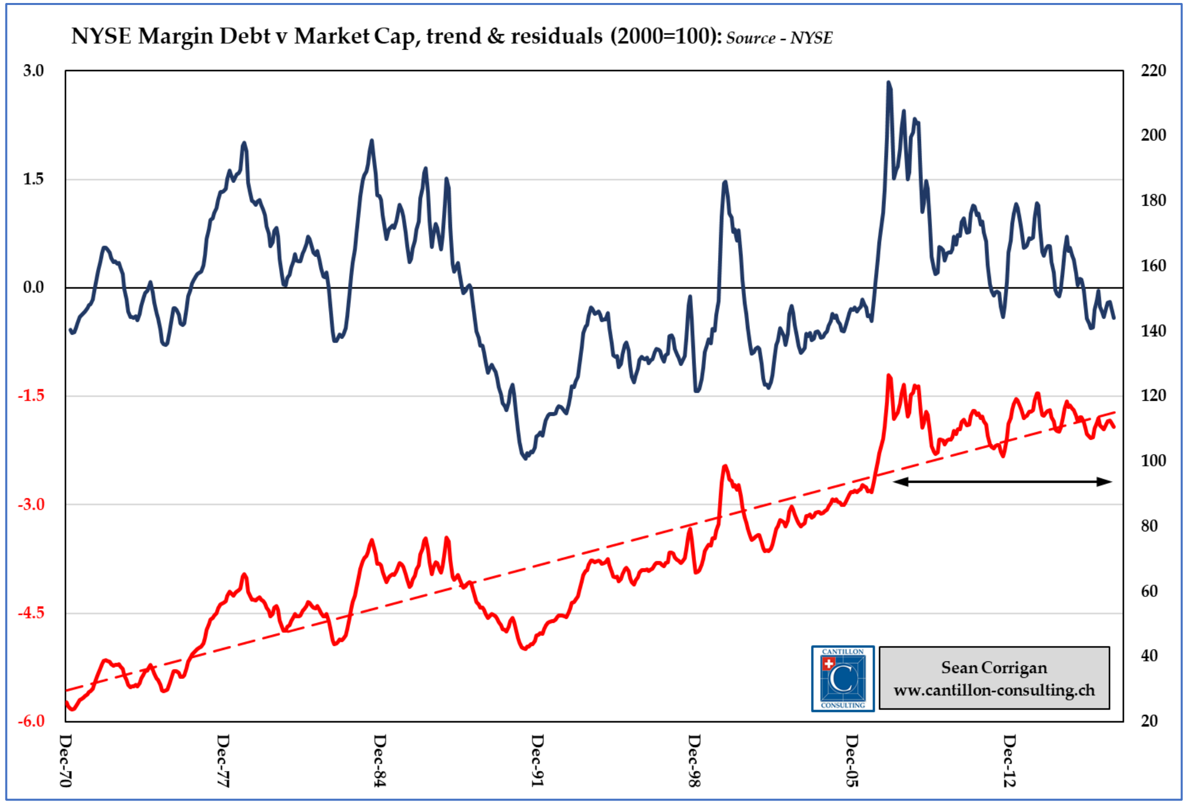
That is all enough to keep the focus on engineering share prices instead of the machine shop, a trend which cannot continue indefinitely without entraining ill effects



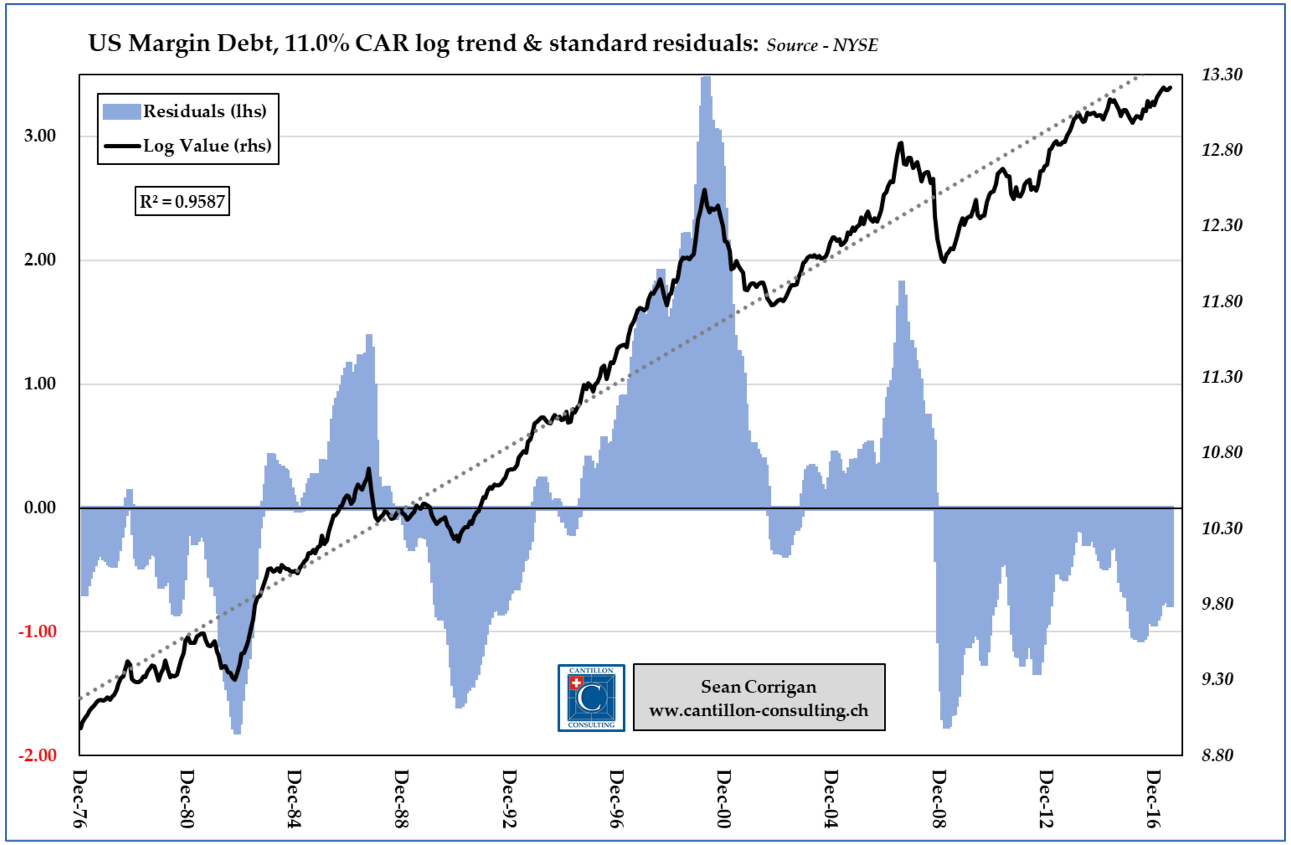
US ETF Fund inflows, 4Q sum, blns: *Source - FRB*



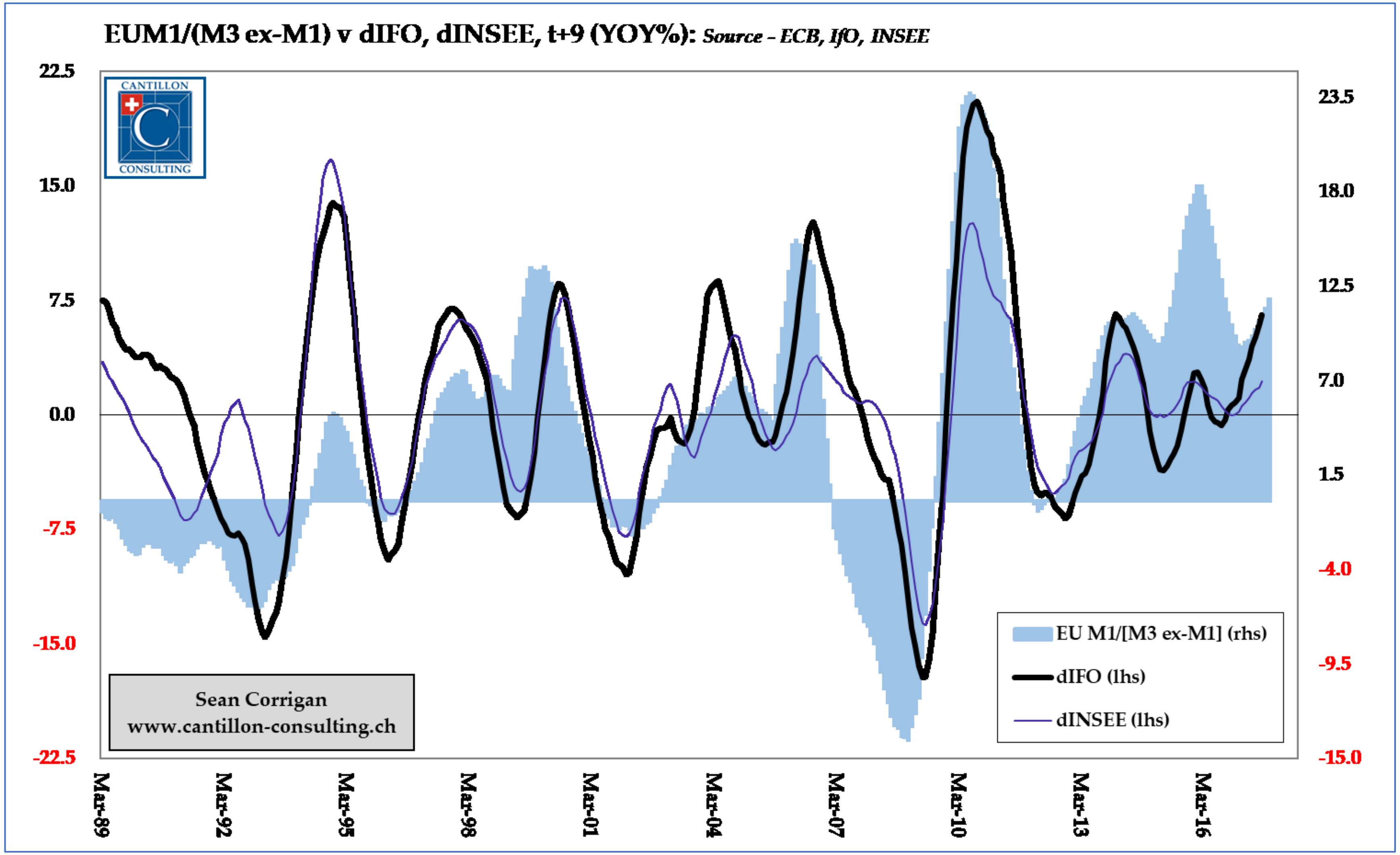
For all the lack of progress over the summer, fund flows have yet to show meaningful signs of drying up.



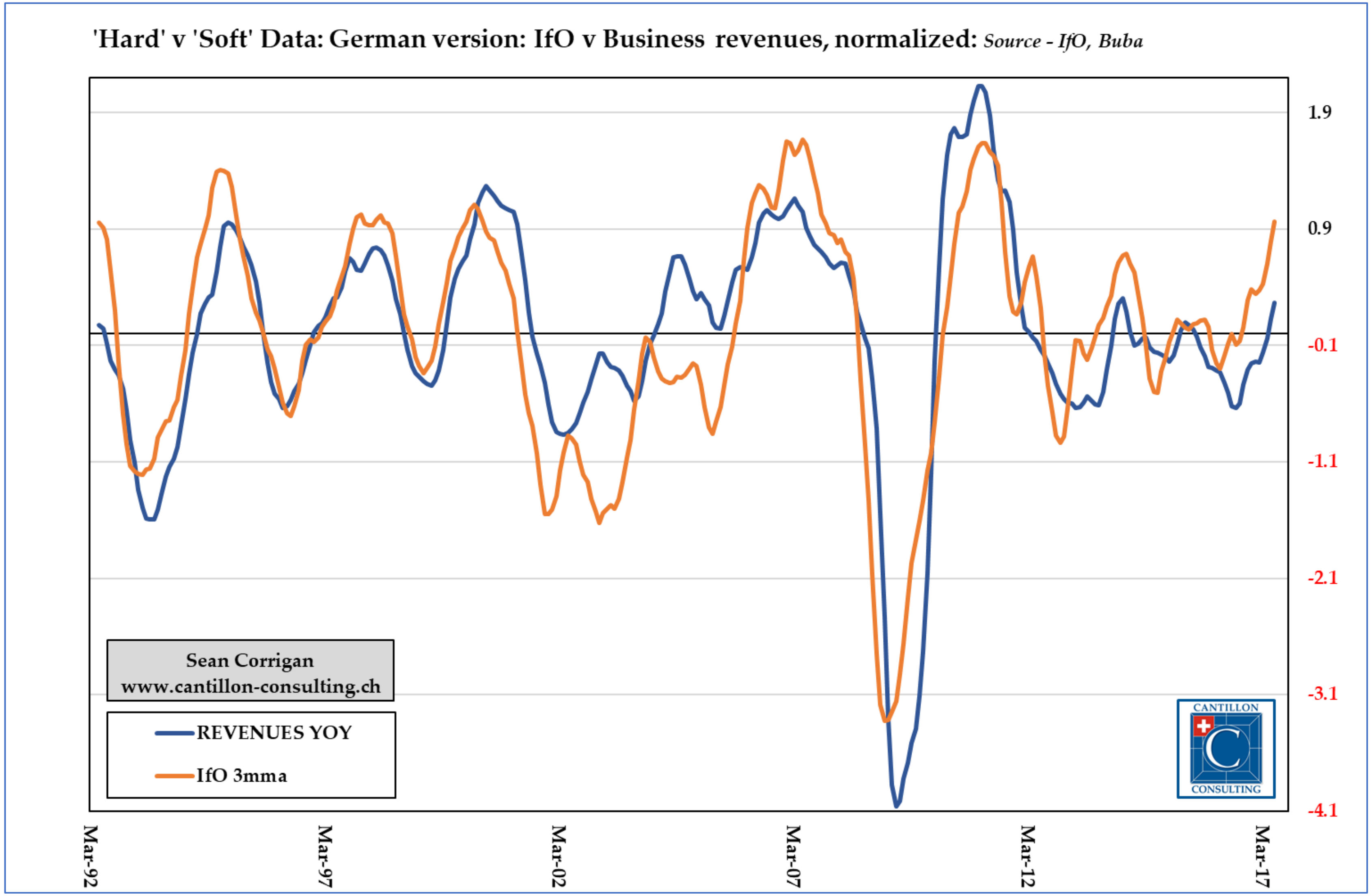
This has helped prompt much comment about the degree of leverage in the market. However, though at a record in absolute net and gross terms, both as a percentage of market cap and in relation to the long-term trend, margin debt has yet to hoist a major red flag.



Europe: Whatever it takes, please stop now.

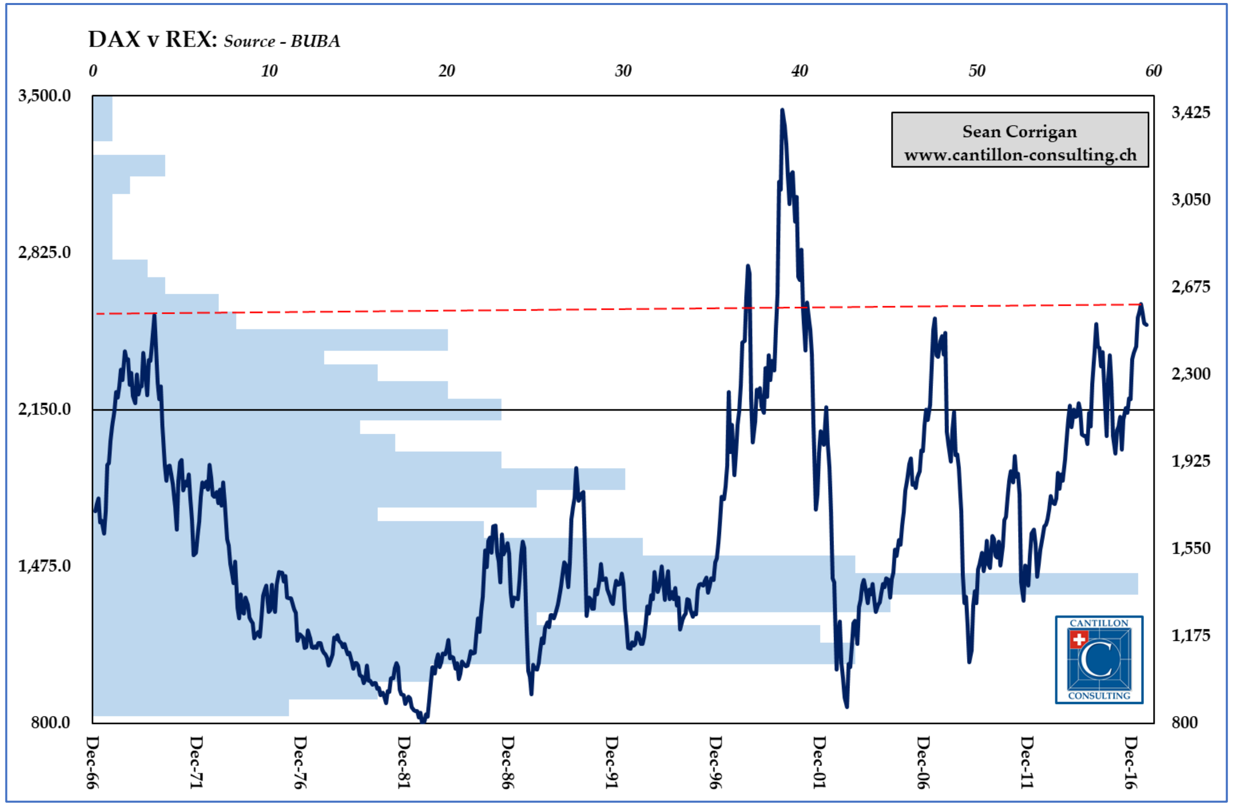


Overall money growth has moderated a touch, but the continued predominance of M1 over higher-order holdings points to greater usage of such transactional funds and hence a continued rise in IfO/INSEE/PMI readings to multi-year highs as well as in actual revenue growth

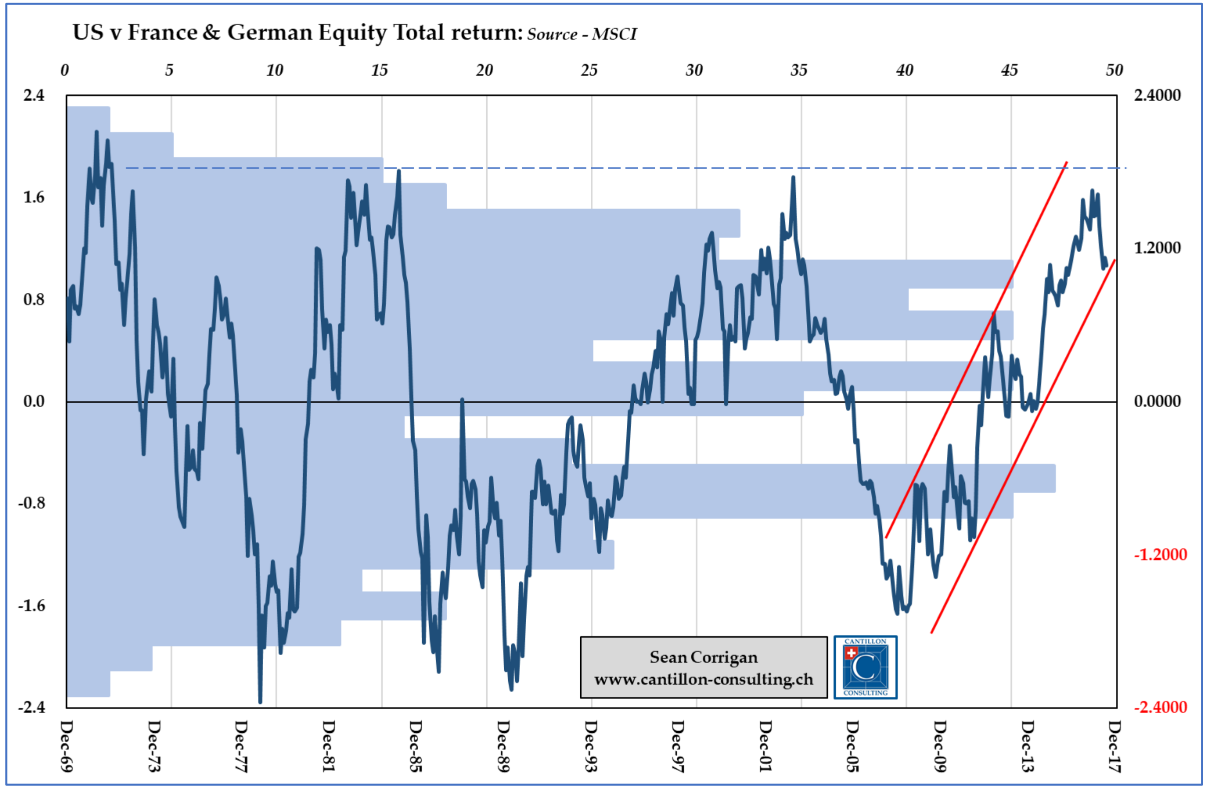


Again, the rise in IfO is being closely reflected in top-line growth for German companies

The ECB is in danger of overcooking this badly



The Dax is rich to domestic revenues and to a woefully underperforming bond market but, interestingly is actually just *below* its 35-year, 7.8% p.a. trend. Mean reversion v the US looks well underway, if not least because of the currency move in favour of the euro.



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