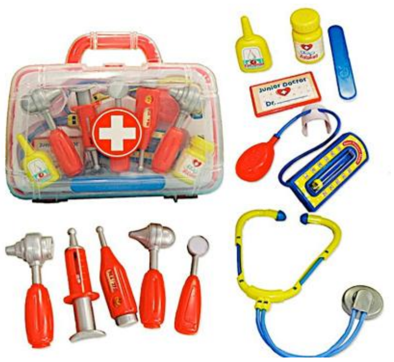
Macro Thoughts August 14, 2015 **Keith Grindlay**

Almost 2 years ago to the day (August 12th 2013), Macro Thoughts wrote: *'With promises of low long term rates remaining for years, is using guidance in the belief that words speak louder than actions a last resort, as there is little left in the monetary armoury?…. if rates are at emergency levels, what happens when there's an emergency? A few weeks ago, disinflation was discussed as being a greater problem than inflation for central banks.....companies have laid off workers and are now used to producing more with less and are not yet willing to invest in new machinery. Problems become more apparent when the world is on the mend but companies don't have the need or will power to create new jobs'.*



2008 was the year of the economic heart attack. The patient became comatose and after ten years of overindulgence on credit and the good life, there was inevitably going to be a pay back; 10 years of extravagance would take 10 years to recover from. Now it would appear the patient is well on the way to recovery – but, as after any such health scare, the patient will never be the same again and will need consistent monitoring. The original doctors (Bernanke & co.) may have changed and a new, more modern theory should have made a difference, yet there are still those who follow the old ways, prescribing old fashioned methods, such as the Philips Curve, to monitor the recovery when the condition warrants a different approach and a one medicine fits all approach is not good enough. *Many talk of higher inflation due to full employment, but few are considering deflation could create higher unemployment.*

Since 2008, demand (or lack of) has been the true driver of growth and inflation, and economists and central banks should be aware that, consistently, the level of supply has been far too high and this has caused deflation globally for the past 4 years. The fall in oil and commodity prices is not the *cause* of deflation, it is the *result* of deflation, and despite what the Federal Reserve and Bank of England are forecasting, rate normality may only be 1% to 2% over the next 2 to 5 years and not 4%, as some suggest. The central banks may raise rates higher but, as Japan has found, if you raise rates at the wrong time and by too much, you end up having to cut them again – although once hikes are established, it is unlikely rates would necessarily be cut below 1%, as QE is the new medicine.

In the past, the economic patient, led by the US consumer, had unquenchable demand that supply could only just keep up with. Hedge Funds only anticipated higher prices and front ran demand by buying early, pushing prices even higher. Central banks said one thing but did another. Governments talked of 'price stability', but happily allowed credit to grow and property prices to multiply. Households had salaries that could never justify the credit that was built up. Then, when it all went wrong, the lenders went bust, blaming others. Those who ran banks turned a blind eye to the products they were selling, which bundled up rubbish credit with strong credit, in the theory that no one would notice – but the poor credit was in the form of mortgages on houses for which the banks had no idea of even the location and eventually large areas were being affected by foreclosure….Denver, Illinois and Puerto Rico are still feeling the aftershocks of the markets and banks collapsing.

The patient in intensive care received all the attention, while other critical cases were in the waiting room. Surely China and Europe would recover when the US came out of its coma? The problem for others is that the US has needed to reform its old habits, so demand for commodities and fuel has fallen; in fact the US itself has turned from the centre of demand to the centre of supply, and the rest of the world is belatedly realising they have to solve their own problems. The US recovered while the rest of the world waited, doing nothing about their own governments' demands that again cannot be afforded; they now have to cut their spending, as the drip that helped the US recover is about to be turned off.

In a two horse race to raise rates, members of both the Bank of England and FOMC are falling over themselves to give rate warnings, rather than rate guidance of imminent rate hikes, while the rest of the world is being dragged under by weak demand and over supply that is again pulling commodity and oil prices lower. Are either the UK or US economies any stronger than they were 12 months ago? Probably not! Inflation is at zero, demand is still weak and though employment numbers are stronger this isn't reflected in demand and as Macro Thoughts has pointed out several times, wage growth appears to be coming from improved minimum wages (or the 'living wage', as Osborne calls it).

There is almost a whiff of desperation coming from both rate hike camps, as if fearing if they don't raise rates, they will miss the opportunity. This fear is justified, as they might well regret not having finished hiking by Q2 of 2016 as another opportunity missed.

Wage growth has been a quandary for the FOMC. Several times Macro Thoughts has argued that just taking a generalised, old-style economist view is no longer enough to determine central bank policy. Many took pay cuts to get back into the workforce after 2008 and the majority of those who did were from the middle age group of experienced/skilled workers. Demographics and technology are now taking things to a new level. Call centres that were a boost to economies such as India are already being replaced by computers and this is forcing India to retarget its manufacturing industries and trade, which will impact on other countries, not just in that region. Central bankers need to move with the times in recognising that classroom economics are no longer enough; there is a need to be hands-on in understanding the dynamics of change within economies.

The Atlanta Fed has revised its GDP expectation for Q3 to 0.7%, down from 0.9%, but Macro Thoughts recognises that US Business Inventories rose to their highest since early 2013. This should be enough to offset lower oil prices from Q2 in Q3's data, but needs to be looked through as it will act to drag down Q4 GDP, along with lower oil prices and potential rate hikes. With data deteriorating, and essentially worse than 2014, the window to hike is closing, questioning the curve in US rates. As Sovereign debt issuance increases globally and struggles to be taken down, long end rates being higher globally will be a drag on economies.

There are still those who want to compare 2015 rate hikes with 1994. As Macro Thoughts has highlighted already this year, the move by the Fed in 1994 was seen as a shock, though technical analysis should have warned traders not to be long and markets today are better aware of technical analysis. What *is* similar is the trend for flatter curves and the drive for carry trades (there was a painful reminder this week, when China threw their spanner in the carry trade works). This time rate hikes have been flagged so markets are aware; the shock of 1994 was re-enacted in 2013 when Bernanke announced tapering and bond yields spiked. CPI is at zero, with a significant chance of heading into further deflation, so the need for rates to move up 4% is highly unlikely.

US 30YEAR (Bloomberg)

The US 30yr generic chart is showing that yields have moved lower and through the up channel. The moving averages have crossed for higher yields, but a Head and Shoulders may be forming for lower. For this reason, Macro Thoughts has stood aside from recommending higher long end yields for the moment. It is difficult to trade for lower yields, especially when the Fed is hiking (though Macro Thoughts expects the initial move will be to 1% and to hold there until the rest of the world starts to pick up), and Macro Thoughts would wait for yields to be comfortably back in the uptrend before again looking for higher yields.

The net impact on the global stage of the Fed raising rates may be similar to that during the 1990s. Asia moved into a debt crisis within 3 to 4 years of the Fed hiking then, as higher US yields and a slowing US economy impacted on Japan and the rest of the region. This time, it is China's problem and, globally, any country with a high deficit that has been funded via cheap dollars will be forced to tighten spending, further slowing global demand, while pushing long end Sovereign debt yields higher. For this reason, curve flattening should not be compared to 1994; the Fed is already telling markets that rate hikes will be slow and gradual. In sympathy with weak demand and over supply, commodity and oil prices are significantly lower than a year ago and over optimism towards higher prices have done nothing to encourage a reduction in production.

Economists should be wary of using old school NAIRU economics, as Haldane of the Bank of England has highlighted this year stronger employment hasn't resulted in higher wage growth. It is also easy to get excited over better US Manufacturing and Industrial Production data this week. Production has been boosted by auto sales (which are strong), as well as oil and drilling, adding to the growing glut of oil supply.

This is also apparent in UK oil production, which will increase to 3mio bpd and is impacting on shipping, which is being described as an 'armada' of unsold oil cargoes. A number of industries that need to hedge oil costs had lost money from their hedges, shown in their annual results (airlines for example lost $100mio plus). These hedges need replacing, so some correction in the swift fall in prices after a fall from $107.50 to $46 (WTI – CL1 futures) should have been expected. This correction didn't help reduce supply, which has continued in full flow, so that once this short term pick up in demand dropped off, it should have been expected that prices would fall again.

Consistently the Bank of England's inflation expectations have been over optimistic, even ignoring their own economist, Haldane, and it is a worry that Broadbent appears to be blaming oil prices for inflation picking up within their forecasts. Current expectations are for CPI to reach 2.6% in 2 years and 2.79% in 3 year's time. *Whether CPI data this week is +0.1 or -0.1 or zero it makes little difference; the Bank of England has been adamant that inflation will turn higher in the second half of the year, yet lower petrol prices and cheaper utility bills on top of negative shop price inflation makes this very doubtful.* Perhaps instead of dealing in percentages the MPC should be asking what will make energy and food prices rise so quickly when China is exporting deflation, Iran is adding to global oil supply and Europe's policy changes on milk quotas at the beginning of the year was always going to increase global supply (forcing New Zealand to do a U turn on rate hikes), which is why Morrisons, the UK supermarket, have cows in their stores. UK dairy farmers need around 28p a litre to achieve any profit; many are being paid 23p to 18p. These farmers don't need an increase in interest rates. 80% of the UK's milk is produced domestically, but farmers cannot remain in business under such conditions, while the strength of sterling is making imports even cheaper from a global market that is vastly over supplied. Perhaps Carney should be shopping in discount supermarkets, rather than Waitrose in the Kings Road?

Meurig Raymond, president of the UK National Union of Farmers, said, 'It's simply not sustainable for any farmer to continue to produce milk if they're selling it at a loss. The plight of many farmers has become desperately serious and with no sign that things will improve, we really need urgent action from retailers, the food service sector and processors to show commitment to British dairy farmers'.

Farmers in the UK don't have the political clout of their French, New Zealand and US counterparts; nevertheless such a situation should be taken seriously, as shopping basket price wars, that the MPC appear to be ignoring, is the driver of low inflation and while BOE members fear what wage growth will do to inflation (which has yet to be seen), killing farm productivity, leading milk farmers to diversify into other products (Cheese and even wine), will lead to a decline in this domestic industry and encourage imports.

Over supply in the milk industry is indicative of the circumstances in a number of markets. The worst thing that could have happened in Q2 was the rise in oil prices, as this will have encouraged producers to maintain and increase production, so that when the airlines and transportation companies had finished replacing hedges, prices would fall. This fear was highlighted in April as prices began to rise.

The rebound in oil prices in Q2 will encourage over-optimism over UK growth for the year. Food price deflation in Q2 GDP data was -2.7%, manufacturing shrank 0.3% and construction was flat. The BRC Shop Price index (-1.4%, from previous -1.3%) has been negative (in deflation) for the past 2 years and falling for 4 years and to protect profits supermarkets are passing on lower prices to suppliers (farmers being paid 25% less for milk now that 12 months ago). This shows shop price deflation is hitting producers (note the general trend in producer prices globally) and will be persistent. In the end, *it will be employment in the farm industry that suffers and not inflation*.

If, therefore, the central bank is basing its policy on 'punting' that oil prices will rise over a short period (which is almost what Broadbent is saying) and blaming the lack of a rise for getting their sums wrong, then Osborne needs to worry. He was very willing to subsidise North Sea oil production, (helping to push GDP higher in Q2), but this is unlikely to be extended to farmers.

There is much made of UK housing and the lack of 'affordable' housing, yet if the demand for such housing was so strong, surely there would be builders that would step in to meet that demand. The fact is, it costs builders to provide such housing, which is almost a loss leader, rather than building more expensive houses which have a higher profit margin and this is pushing up rents and therefore the booming market is in the buy-to-let sector.

Buy-to-let now accounts for $1/5^{th}$ of UK mortgages and $2/3^{rds}$ of those mortgages are interest only (RBS appears to have buy-to-let central to its business plan). There are now over 2 million buy-to-let owners in the UK, all vulnerable to rate hikes that will potentially be passed on in rents (pushing up inflation!) It should also be made clear that moving into the buy-to-let market is not considered because of low returns from zero interest rates, as it is borrowing from banks that is driving the markets. Portfolios of multiple properties, all of which are potentially dependant on another, with no capital being drawn down, are all risking negative equity.

By raising rates, the Bank of England will itself help to boost inflation, but by reducing disposable incomes. The current activity in buy-to-let has been helped by the changes to pension rules, but recent law changes, lower tax relief, laws on immigration reporting and higher interest rates squeezing margins could swiftly slow this market.

Home owners have started to re-mortgage in preparation for higher interest rates, with re-mortgaging rising 30% in June compared to May (though the election will also have had an impact). Gross lending in June totalled £20.1bn, up 25% on May 2015 and 13% up on June 2014.

Carney has even asked for, though is ignoring, the work done by the Chicago Fed on the UK economy and there is the problem. Mervyn King started the ball rolling for Carney and despite all the criticism during his tenure, he knew the UK economy in detail. The marked difference between the UK and US central banks is that the Fed is represented regionally, whereas the Bank of England is not. With 9 members of the MPC and a reduced number of meetings, there is a definite need to differentiate between London, Northern and Southern England, Scotland, Northern Ireland and even Cornwall and Norfolk as much as there is in the US.

Bank of England leaver David Miles talks of weak near term inflation and the risk of steeper hikes, but if the remaining members don't see through the data they are in danger of bursting the current level of stability. David Miles is being replaced by Gertjan Vlieghe who will maintain his relationship as economist for Hedge Fund Brevan Howard. He will have enough time for both jobs as Mark Carney has amalgamated the release of reports and reduced the number of meetings, even amalgamating some meetings with the FPC. Plenty of time then for garden parties and hedge funds, especially as the rate hike decision won't be 'until the turn of the year'. Carney is adding another economist; interesting given the divide between Haldane and himself, yet Haldane who has been at the Bank of England since 1989 has so far been proven to be correct.

China should reflect on the lessons of Japan and the Asian crisis while considering the pace of changes being pushed through. Had Xi and Li started their changes 3 years earlier they may have been able to prevent much of the volatility over the past year. In many ways the example of Japan may be a template for China's future, a fear Macro Thoughts expressed even before the crisis. Every major economic powerhouse throughout the centuries has been derailed at some point, even going back to Rome. It's easy to be lazy when the ruling classes can take the gains, but at some point others want their piece of the pie.

The PBOC and several market commentators are suggesting this week's action to devalue the currency was part of a market reform – this is doubtful.

- They surprised markets by cutting the reference rate, effectively devaluing the Yuan by over 3.5%, immediately after very poor trade data (Exports were -8.3% and Imports -8.1% yoy).
- The timing, ahead of the Fed's September meeting, with an anticipated rate increase. They either couldn't wait for the Fed meeting in September or had doubts over the US raising rates
- In the same manner as the Swiss National Bank, the devaluation was despite, only days before, the deputy governor of the PBOC saying the currency, 'doesn't need to be devalued and it won't be devalued'. If this was a market move, then it should have been planned well in advance; so did anyone forget to tell Yi Gang? As Yi was speaking to a US newspaper, this would have been a good time to signal to the markets
- China has made several changes to encourage Foreign Direct Investment, including free trade zones. Although devaluing encourages export trade, another intervention by the

authorities after the criticism over stock market restrictions will create greater long term uncertainty and, if anything, drive investment away

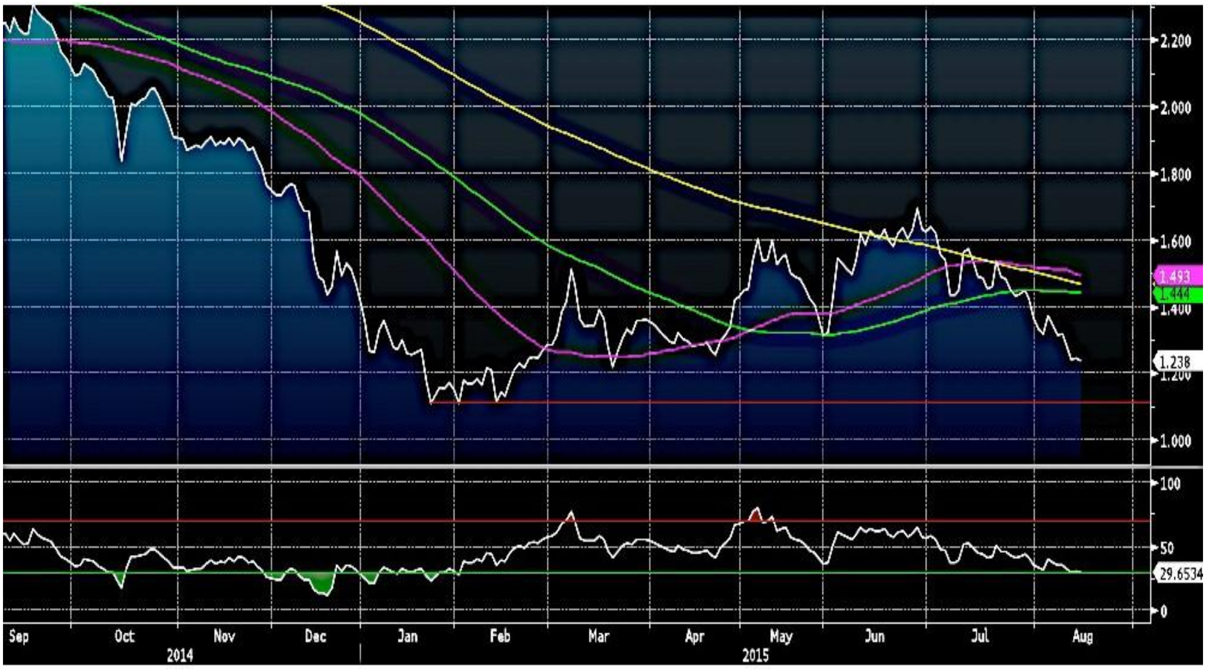
- China is running short of options and the devaluation came immediately after very poor trade data that continued the deteriorating trend of the past 5½ years. China's current account surplus prior to 2008 was 10% of GDP; it is now just 2%, suggesting the Yuan is at a fairer value and the appetite of domestic demand is changing while, internationally, other areas of the world are being used for production

Poor data is hitting home in China, once the global manufacturer. Complacent with the rise in the stock market, the authorities didn't do enough to control the leveraging; now they are threatening the work done to increase FDIC by further influencing markets and this is already being shown up in the currency outflows which will increase for the remainder of the year, from the $400bn to $800bn that has already left. Short term US Dollar liabilities are said to be $1.3tn --- levels that match that of the Asian crisis in 1998.

China and the region will also have to react to growing competition from India, as will shipping based countries such as Sri Lanka and especially Singapore. India has a policy to increase Productivity and to increase Manufacturing as a percentage of GDP (from 18% to 25% by 2022). Another increase in supply!

Carry trades such as with the Swiss Franc and now the Yuan always run a risk. Although Macro Thoughts had no strong view on the Yuan itself, it had been negative on the Singapore Dollar for some time. The economy has been in relative free fall since 2009; the government had acted to relieve house price pressure, pushing the market into negative equity. Though well capitalised, its banks have serious issues, with their loan books needing attention. While China's economy contracts and commodity prices continue to fall, Singapore's shipping industry has suffered ever since 2008/9 and is about to be given head-on competition from changes in India's laws, making it easier for foreign shippers to move from port to port.

NGB 2 05/23 (Bloomberg)



China has also signed an agreement with Russia to supply oil, so that while sanctions continue to be imposed, the flow between the two superpowers will continue, dragging demand from one supplier to another. To reflect the fall in oil, buying Norwegian bonds has been recommended. Though liquidity is better in swaps markets, Norwegian bonds should hold demand value. NGB 2 05/23 was favoured (circa 1.30%) and continues to trade lower in yield. Traditionally, Norway is an oil currency, but despite oil prices hitting lows and China potentially exporting deflation in an already flat inflation environment, NGB bond yields were not at their lows. Norway data has been weaker (rates were cut in June); Manufacturing PMIs were 45.8 in July, better than expected but have been below 50 since April. CPI was 1.8% from previous 2.6% yoy (underlying 2.6% down from 3.2% yoy). PPI including oil dropped from -4.9% to -6.6%.

All the while China has been the main news, Europe has had its own positive news via Greek bailout agreements. What may be positive for Europe may not be so positive for Greece. Macro Thoughts warned in June of the geopolitical risks of squeezing Greece too hard and with increased tensions from illegal immigration and events in Turkey, adding 2 years of hard austerity isn't going to help. Greece has its Eur86bn bailout agreement, but the cost is in the economy that will contract between 2.25% and 2.5% in 2015.

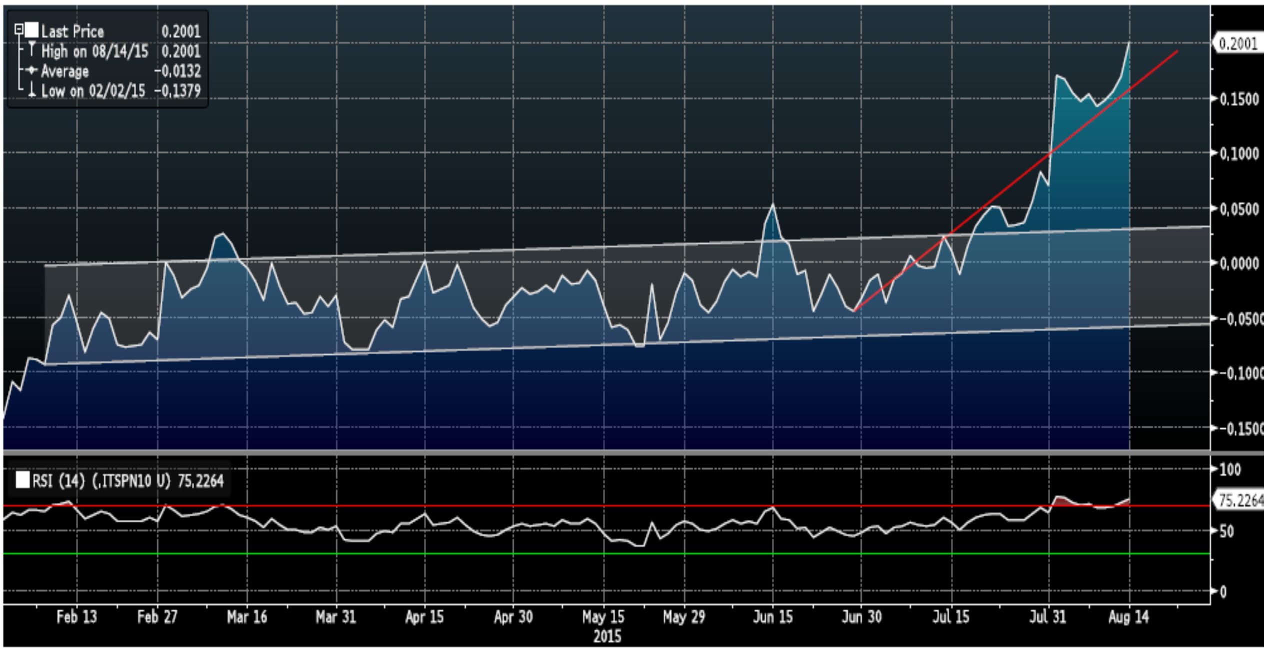
Data in Europe is set to depreciate given expected rate hikes in the US and UK, China exporting deflation and worsening global demand. Mid June, Macro Thoughts recommended buying German 2year bonds, against the trend at the time. This week 2year Schatz hit a record low, -0.29%

GERMAN 2YEAR (Bloomberg)

Macro Thoughts highlighted in Q2 that Spanish bonds would underperform in the second half of the year as the general election drew closer. Spanish 10 year bonds are trading 10bp to 15bp higher than Italy. Some spreads and the overall level of peripheral yield, helped by a lack of supply, appear to have gone too far and some correction should be anticipated over the coming weeks. Irish 5years, for example, have tightened to just 5bp into Belgium bonds. Though Irish growth is stronger than

Belgium, it will be difficult for Irish bonds to trade through Belgium without some correction (this is similar to 2014 when Irish traded through Gilts).

GENERIC SPREAD ITALY/SPAIN 10 YEARS (Bloomberg)



Despite markets definitely being in August holiday mode, geopolitical events and central bank action have continued to force changes and rebalancing across the globe. Macro Thoughts warned in July how price action can be more extreme than many anticipate.

The daily movement of the Dow on Wednesday this week was staggering. The previous day's close was 17,402 and, at the open, the market immediately dropped below 17,125, before rebounding to 17,423 and eventually closed at the same level as the previous day, 17,402. The moving averages for the Dow Jones Index for 50 and 200 days crossed for the first time since February 2012, suggesting a move lower might just be beginning. The move from low to high began in Q4 2011, from 10,404, and covered nearly 7,950 points from low to high. The overall trend that began in 2009 started from 6,470; rallying covered 11,880 points to the high at 18,351.

Should the Dow be close to 16,500 by the time of the FOMC meeting of September 17^{th}, then expectations of a Fed rate hike will be a lot different, especially after China devalued its currency, and again will force the Fed and members of the Bank of England to rethink their hawkishness.

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