Friday 21 December 2018

Quotable
"Every man takes the limits of his own field of vision for the limits of the world."

— Arthur Schopenhauer

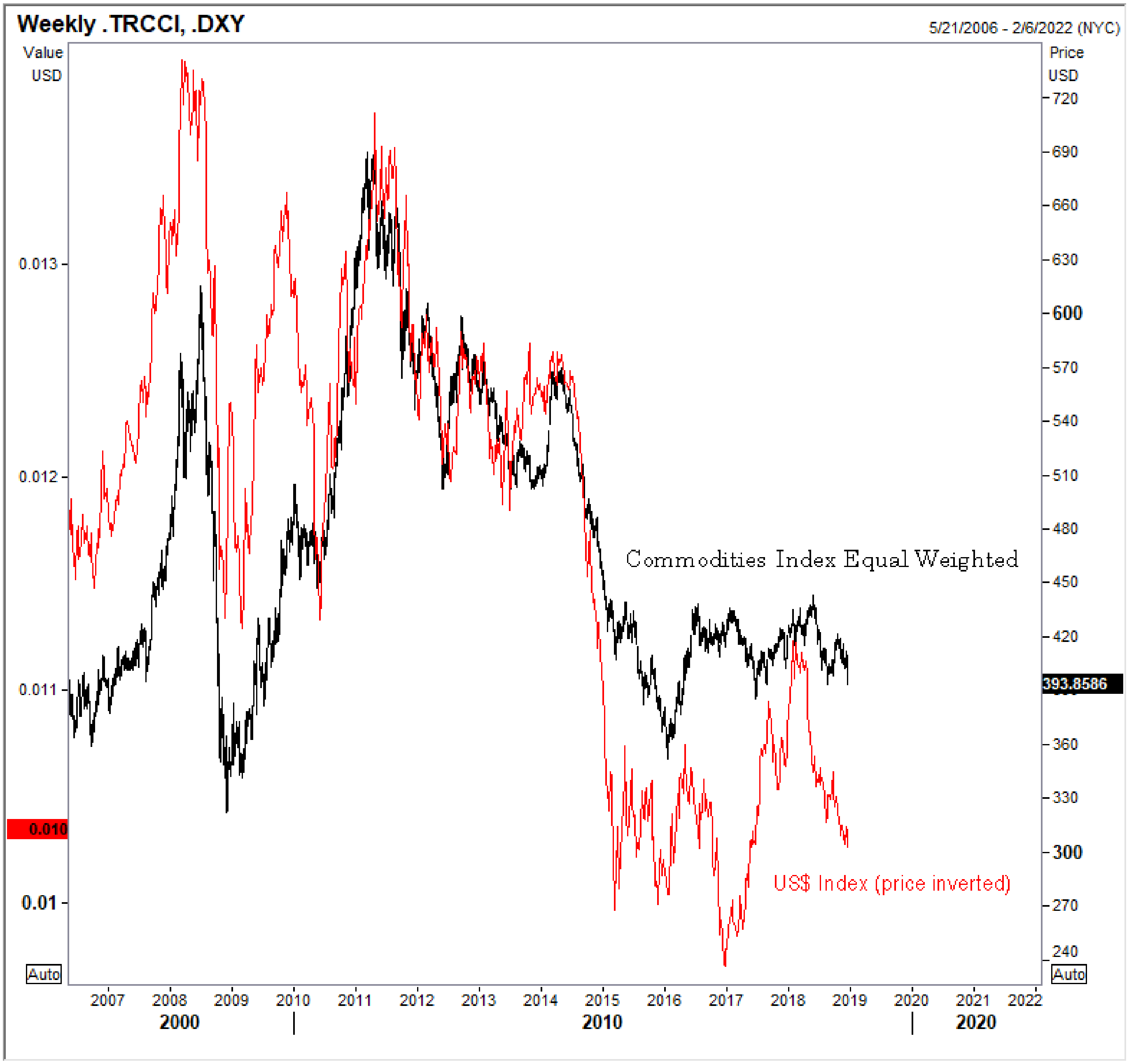
Commentary & Analysis

Deflationary bust in the making? A dollar risk bid likely follows…

There is a rising consensus which says: The Fed is engineering a deflationary bust. We agree. But we also believe the Fed is consistently behind the curve and a US recession is likely in the cards no matter. The investment implications: Lower long-term interest rates, lower commodity prices, and a stronger US dollar.

Take a look at the chart below, comparing **US 30-year benchmark yield, oil prices (WTI), and the US dollar index** (price inverted to see the correlation):

Commodities Index vs. US $ Index (price inverted)

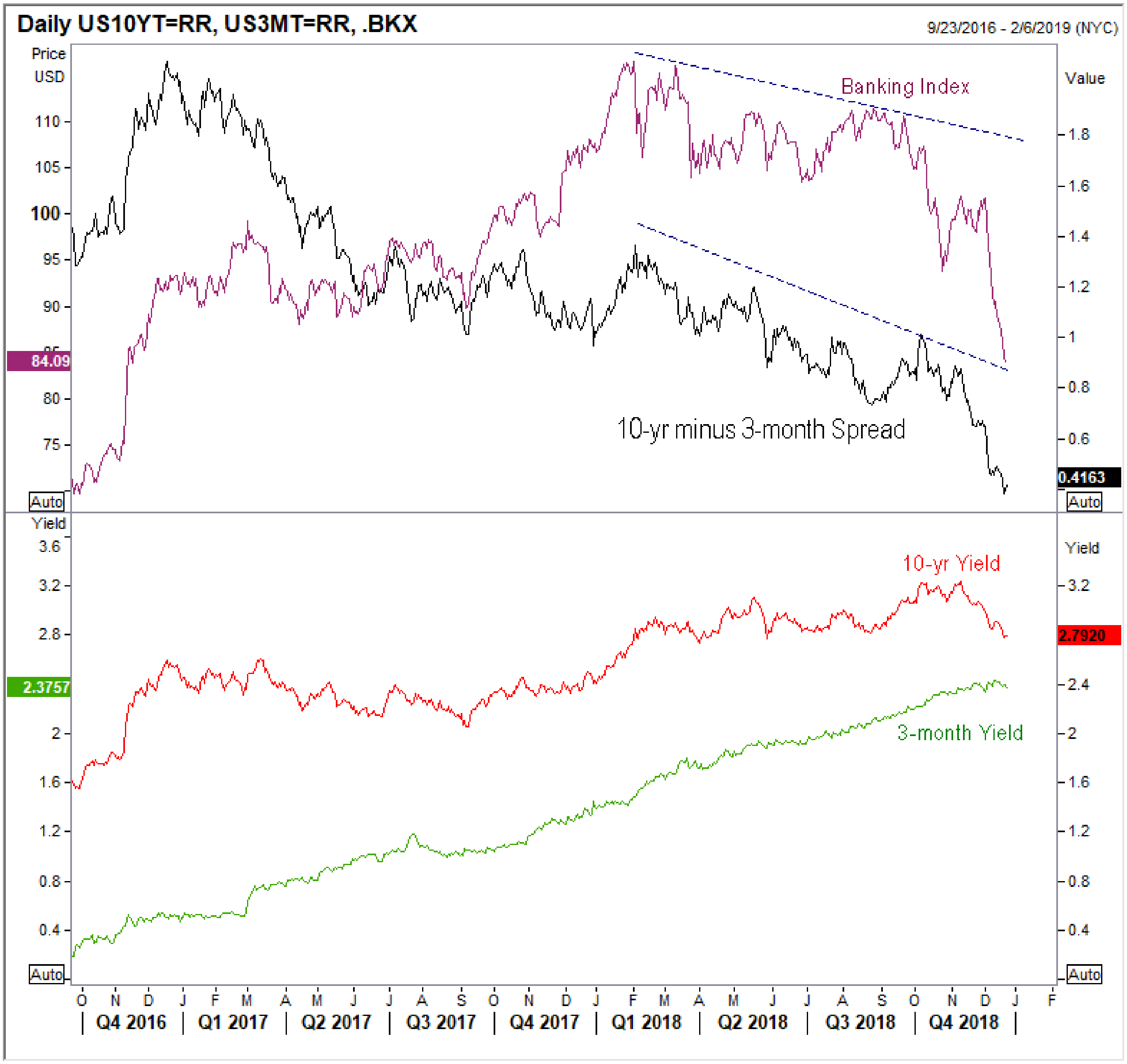


Global central bank liquidity, coupled with rising fiscal stimulus almost everywhere, was able to inflate risk assets after the credit crunch (but failed in mid-2011 measured by the commodities index (as you can see in the chart above). Though US economic growth has indeed rebounded, real stuff has remained relatively flat. The US economy looks strong. But consider how this came to be: A flood of liquidity dumped on to bank balance sheets, which is now reversing as the Fed reduces its own balance sheet. According to Hoisington Investment Management:

> Eight policy interest rate increases in short Quarterly Review and Outlook Third Quarter 2018 rates and a 30%, or nearly $1 trillion, reduction in excess reserves of the banking system appears to have had little impact on U.S. growth, as of yet.
>
> … With lags, the impact of Fed policy, however, has a broad reach. As noted in past quarterly letters, Fed policy determines world dollar liquidity. That **liquidity is palpably shrinking around the world where debt productivity is considerably lower than in the U.S**. As such, the erosion of dollar liquidity should weaken foreign economies before the monetary restraint is visible domestically.

Money supply growth is declining in the US, Europe, Japan, and China. And according to the Fed's own research staff, **the best single indicator of recession is the 10-year yield versus 3-month yield** *[don't let your own research staff get in the way of the dot plots]*. **And as you can see, the spread continues to accelerate lower.**

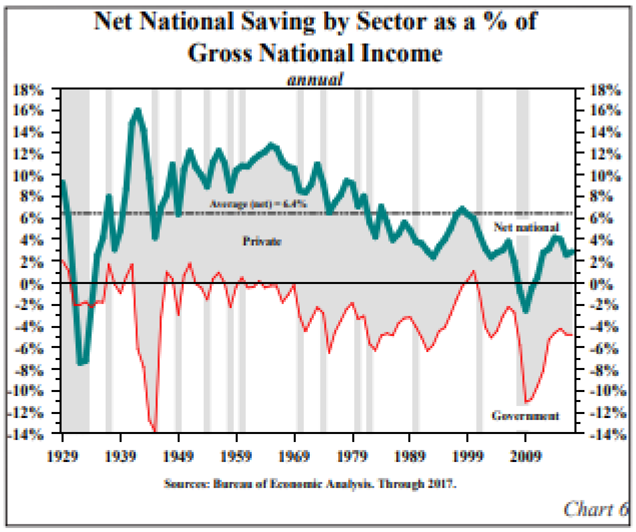
Given that banks lend long and borrow short, maybe it isn't such a surprise the bank stocks are getting hit hard. Below, the same chart, but with the **Banking Stock Index (BKX) overlaid on the spread.**



Despite attempts to rationalize away the recent decline in loans tied to banks and commercial paper, and more importantly, what the yield curve is telling us; our bet is the yield curve is more insightful than a group of economists viewing the world in the rear-view mirror.

There are two reasons we doubt US fiscal policy will help anytime soon: 1) with Democrats in control of the House, they will most likely stymie any policies that might help President Trump (and the economy); so any big infrastructure deal is likely off the table; and 2) the rising level of the deficit and overall US debt is beyond the danger zone and is already likely impacting US investment as it is—reducing productivity and future growth potential (the sugar high of tax and regulatory reform are likely history). Again, we turn to Houisington:

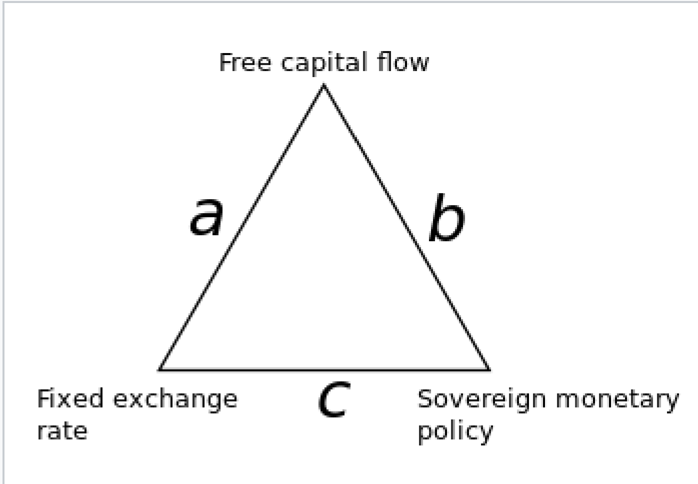
An analysis of the interconnectedness of the economy, or what is referred to as the circular flow of the macro economy, reveals another factor, over and above the government debt problem, that will enhance the impetus for economic activity to slow. For all economies, what is produced equals what is spent, which in turn equals what is earned (i.e., GDP equals Income). Based on this circular flow proposition, algebraically, national saving must equal physical investment (S = I). **Investment is critical to the growth of productivity**. Productivity plus labor force growth determines potential economic growth rates. Therefore, **to get an investment boom, greater national saving is required. Herein stands the problem. Government deficits are not saving, but dissaving, reducing the total saving available for investment** (Chart 6).



Since 1929, net national saving has averaged 6.4%, but with increasing government deficits (dissaving) over the past 17 years, the national saving rate has dropped by more than half to about 3%. **It is important to note that the projected increase in federal debt from $21.4 to $28.9 trillion will, all other things being equal, further reduce net national saving from approximately 3% to 2% or possibly even zero.** Thus, investment would be forced downward, continuing to erode productivity, unless, of course, consumer saving were to rise. But, **if consumer saving were to rise, this would reduce consumer spending and economic growth, undermining the incentive for more investment.** This is a recipe for semi-recessionary economic conditions, regardless of monetary mistakes. Indeed, both fiscal and monetary policy are guiding U.S. economic growth slower.

Now, if we layer into this US growth picture **the complete strategic shift in US-China relations, from global partner to global advisory**, how can this not be yet another major drag on global growth at minimum, and with potential to tip the world economy into a global depression? China is already in a precarious position as Chairman Xi continues to push the country into an Orwellian reality. Policymakers are well aware of the economy slowing. But also understand the dangers of letting the currency depreciate much further—a capital run out of the country would make matters worse.

Thus, China can run but cannot hide from the Mundellian Trilemma as we discussed in our October 2, 2018 Currency Currents (chart updated), excerpt below:



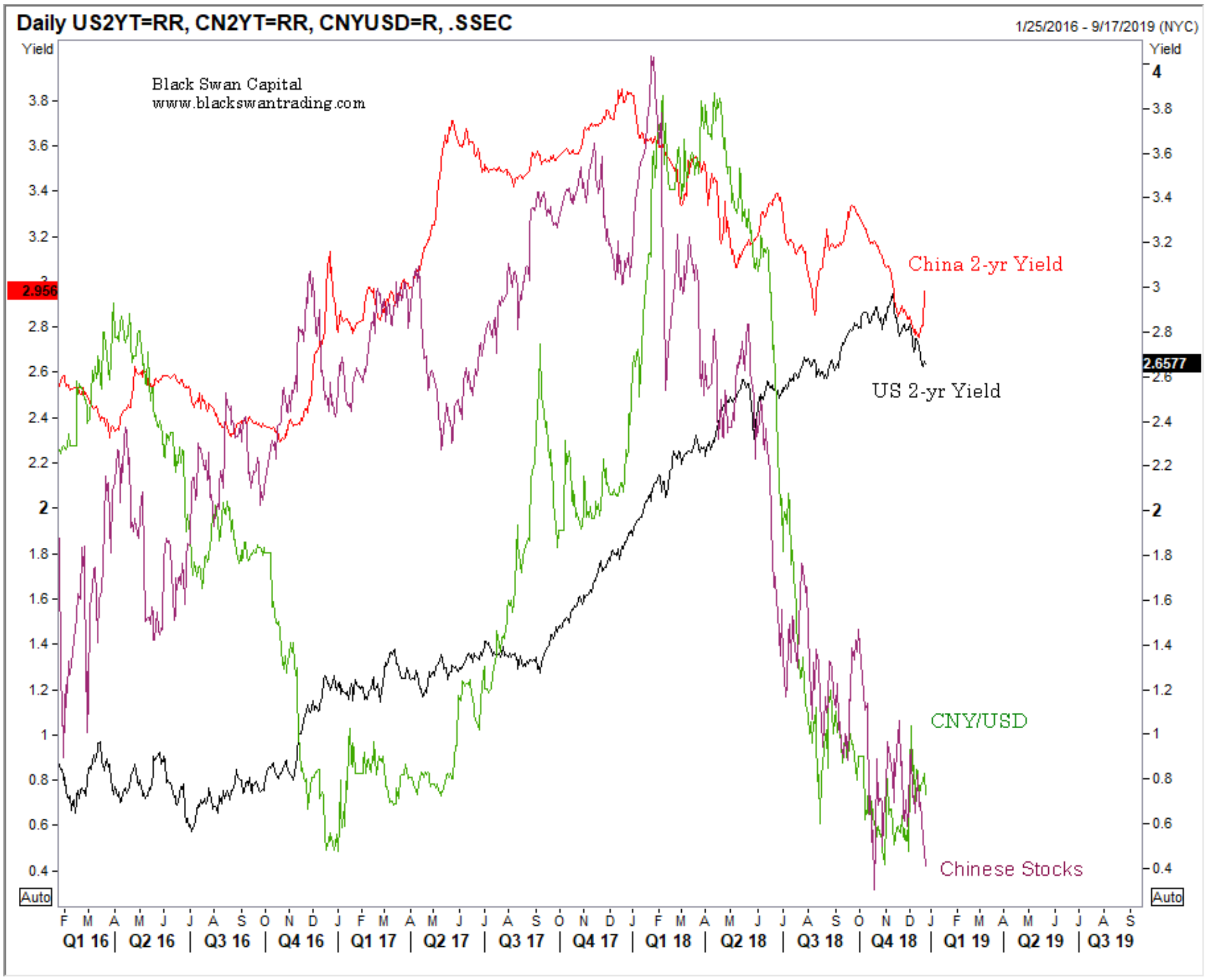
The Impossible Trinity or "The Trilemma", in which two policy positions are possible. If a nation were to adopt position *a*, for example, then it would maintain a fixed exchange rate and allow free capital flows, the consequence of which would be loss of monetary sovereignty.

The Mundellian trilemma says policy makers can control only two of the three main variables in global finance, but not all three at the same time.

"…it is not feasible to have at the same time a fixed exchange rate, full capital mobility and monetary policy independence. Only two of the three may co-exist (according to the Mundel-Fleming logic)," writes Helene Ray, of the London School of Business, International Channels of Transmission of Monetary Policy and the Mundellian Trilemma.

That's the theory. Now take a look at China's situation for application of the theory. Chinese policy makers seem to be stuck in a tight policy box—the alternatives available aren't very appealing.

The dynamics of the trilemma for China can be seen in the chart below...



The chart above compares the benchmark **2-year Chinese interest rate (red); to the 2-year United States interest rate (black); to the Chinese currency priced in US dollars (green).** Note:

1. The 2-year yield spread between China and the United States is narrowing [widening of late] as the Fed continues to hike the Fed Funds rate, while the Chinese 2-year yield is falling as China attempts to stimulate growth (so far it isn't working).
2. As the 2-year yield spread narrows between the China and the US, it pushes the value of the Chinese yuan lower; i.e. CNY/USD is moving lower as the spread (red line minus the black line) narrows. Hot money is moving out of China and into the US.

China is facing slowing growth, rising unemployment, and the possibility of a major acceleration in capital flight (as we saw back in 2016).

So, China's policy choices seem to be these:

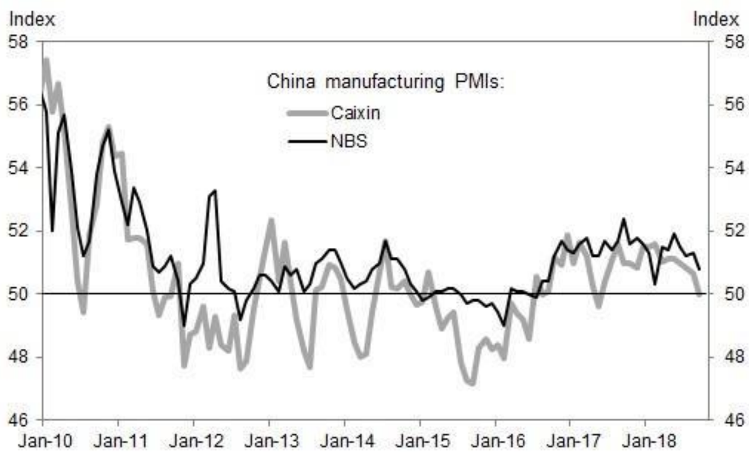
1. **Raise interest rates** and protect the currency (including capital controls) in an effort to avert a capital run. This means China loses control over sovereign monetary policy which calls for lower

rates to stimulate growth (add more debt). Unemployment rises under this policy choice and that means China's efforts to rebalance its economy and shift more resources to the household sector is stymied once again.

2. **Let the currency run** and lower interest rates in an effort to stimulate local demand. This leads to more household indebtedness. And with China's current account surplus now at just one percent of GDP, the measure of safety here if capital runs offshore is thin and a plunging currency would be seen by the United States a currency war on top of a pending trade war.

If China chooses #1, we can expect a continued deceleration of Chinese growth; the country's manufacturing index is approaching stall speed (see the chart below). But, rising rates would help slow the dangerously rising debt formation and be best for global stability, though internally rising unemployment is never popular.

China's manufacturing index grinding lower - China's NBS manufacturing PMI fell to 50.8 in September, from 51.3 in August and below the Bloomberg consensus of 51.2. While this was the first September drop since the NBS manufacturing PMI series was released, it was also the 26th consecutive month of prints above the 50-point mark that separates growth from contraction.



If China chooses #2 above and let's the currency run it risks trigger a major flow of capital not only out of China but emerging markets in general—a contagion trigger if there was one.

But there is a third choice I haven't shared, but there is a third alternative according to Andrew Polk at Trivium. From the *Financial Times:*

> "**China won't hike rates because they can't**," agreed Andrew Polk at Trivium, a Beijing-based consultancy. "The PBoC knows it's better to just let the currency go if it must." He adds that in the event of a worst-case panic scenario, China's central bank can revert to its "2016 playbook" — a highly effective combination of capital controls and intervention in the onshore and offshore renminbi markets.
>
> "But that playbook came at a high reputational and strategic cost, by signalling Beijing's willingness to suspend or even reverse critical reforms when markets are volatile. The Chinese government's painstaking efforts to internationalise the renminbi, and ultimately challenge the dollar's global dominance, have stalled ever since."

Makes sense, but the difference is this is 2018, not 2016. The spread has tightened a great deal since then' it is potentially a more powerful drain on China's capital given the rising risks of a trade war. ▲

…

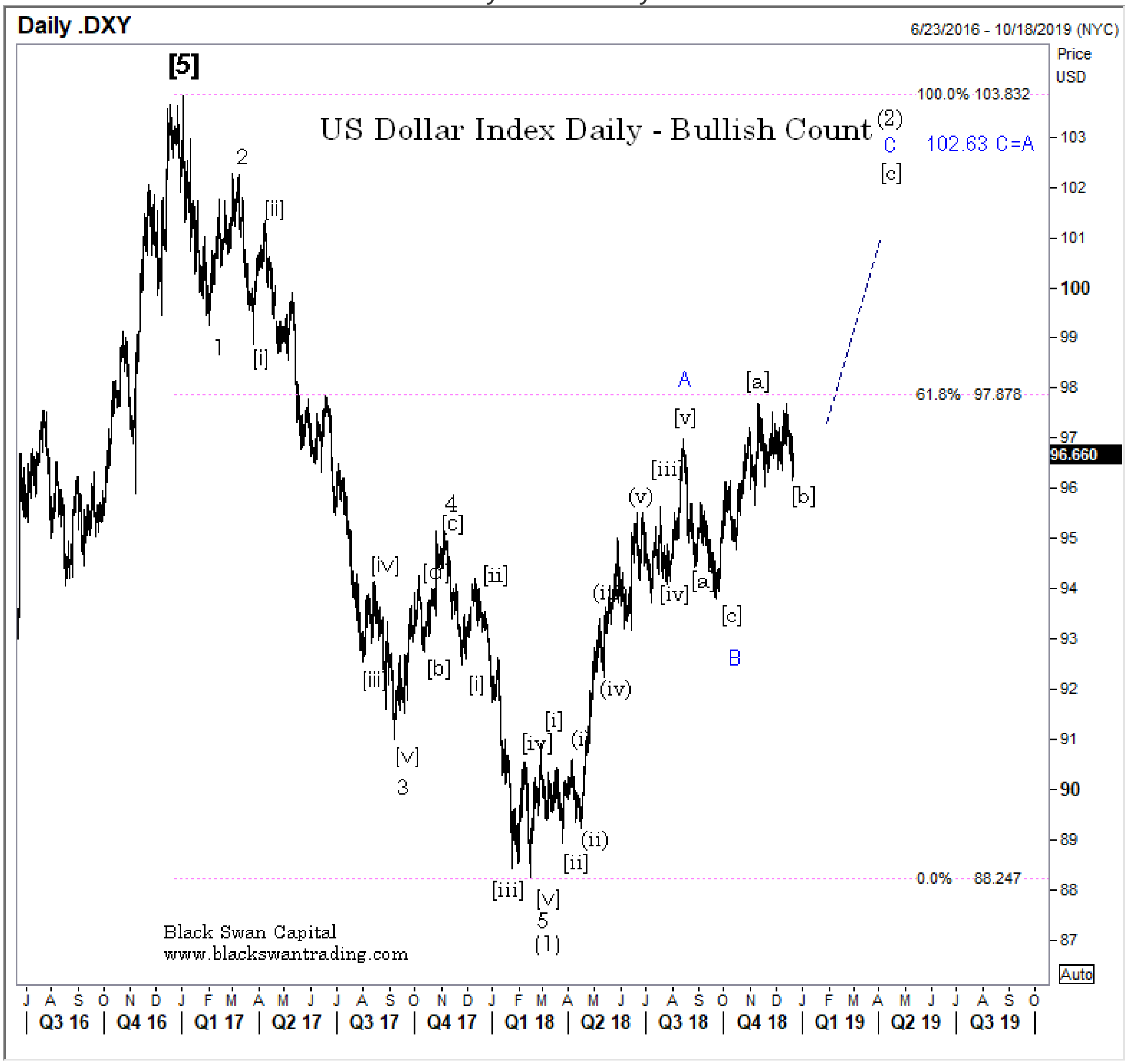
Well, the US-China trade real has grown more serious since early October—it has deepened and widened to other strategic areas. All the more depressing for China, and eventually US growth. If China lets its currency run, we believe it will trigger a global deflationary bust—a massive run into US paper and give the dollar a major risk bid.

Europe has its own hosts of problems. For example: Brexit, Italy, immigration issues, and social revolt across the continent. We sure can't count on the European consumer to be the engine of growth given that *milieu* of madness.

So, unless something happens quickly, such as the US and China coming to some type of major agreement, which is still possible but growing increasingly unlikely with time, it seems US long yields will continue to work lower along with oil prices (and other commodities) as the US dollar rallies on global risk.

As it relates to the dollar, technically we have been in a tight range the last couple of months.

And based on the longer term view we are bumping up against key 61.8% resistance, as you can see in our Dollar Bullish Count Daily Wave analysis—it comes in at 97.87:



So, we still lack clarity from the dollar index despite the hit to risk assets we are seeing. But, if the global macro environment as it stands now continues to play out, it seems increasingly likely the dollar is poised for yet another major leg higher—our target under that scenario is back above 100 on the US dollar index and test of the cycle high going back to 2008. Stay tuned and Merry Christmas.

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