Tigress Financial Partners

Macro Snapshot – Chief Economist Jean Ergas

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Europe taking baby steps – backwards or forwards? Oil coming under pressure, key weapon volatility not price cutting - Brexit, this is getting serious! US manufacturing to the rescue and does unemployment data mean anything?

European markets cautious – pullback in Asia – Italian banks under pressure

European markets are mixed with the stronger Euro restraining investor enthusiasm and the Italian banking crisis dragging down the local index. We are seeing a sharp pullback in Asia following a "wait and see" stance by the Japanese central bank. This has propelled the yen higher and reduced hopes of a rapid improvement in the Japanese economy.

Energy fundamentals in "pole position"

On the energy front fundamentals are once again in "pole position". This is driven by a strong increase in Iraqi production despite civil disorder and estimates that OPEC and Russia are still busily "pumping for cash". Iran continues to confound the scoffers with a 300000 barrels a day increase, adding further pressure to the export markets.

Big stick not price cutting but capacity to stoke volatility

What is clear is that the solution to oversupply shall not be from agreed production cuts. It shall be driven by the threat of relentless price cutting stoking market volatility, making incremental investment risky. Prices may have recovered but the market remains "unregulated".

The IEA warns that we may have too much of a good thing. Should capital investment not rebound by 2017, less capacity may result in a "squeeze" pushing prices sharply higher and blocking economic recovery. We continue to see a bumpy ride for energy prices with the US shale oil sector capable of surprises!

Euro Zone manufacturing continues its gradual advance

The Euro Zone manufacturing sector growth continues – albeit at less than the annual pace of the pre-crisis years. While Germany, Spain and Italy are picking up, French manufacturing is contracting. With exports under pressure and capital investment low, the key issue is whether Euro Zone domestic consumer driven growth has peaked.

The Longest Day in the currency markets – June 23rd 2016?

Brexit is "getting real". The Bank of England is getting ready to both provide the London banks with liquidity and FX for a "Brexit day" scenario. What needs to be borne in mind is that the result shall not be known on June 23rd but likely the next morning. Whatever the outcome - a sharp spike in volatility is on the cards.

Sterling could fall 15 -20 per cent – are we ready?

The "Day after" scenario continues to tax the best minds! One of the top City of London economists - now on the monetary policy committee of the Bank of England - sees the pound falling 15 – 20 per cent should the UK vote to go it alone.

Exit risk not yet priced in – will there be any dust left to settle?

According to this well regarded expert, the market has not yet appropriately priced in the exit risk. The UK central bank will however not act immediately on the interest rate front but wait for "the dust to settle". Will there be any dust left? One of the most recent polls shows the quitters in the lead!

While concerned as to the market disruption potential of a Leave victory, we see the UK economy as unbalanced with consumption reasonably resilient but capital investment and exports squeezed.

US unemployment shall rule the roost! Is it relevant?

The US week shall culminate in the release of the politically critical employment data on May 6th. We view analysis drawn from these data points using the metrics of the pre-technology and pre-China era as misleading. The relationship between employment and prosperity is now non-linear, with considerable downside but little upside.

A sharp rise in unemployment and the resulting "optics" can crush consumer sentiment. For many, though, gains from employment remain minimal.

Major US data today manufacturing – Weaker US Dollar shall not resolve all problems

Today the major US data shall focus on the manufacturing sector – punching well above its weight with regard to exports, pricing power and corporate profits. We are not holding our breath and d do not see a weaker US Dollar as a panacea for slow growth.

Not convinced by baby steps progress in China

We are seeing a modest expansion in China with regard to both manufacturing and services. This may attenuate fears as to a "sudden stop". However the improvement comes at the expense of a further build up in loans to insolvent companies and continued overcapacity.

We are already seeing this in the steel sector, where frenzied activity in iron ore speculation is pushing up steel prices. This is the tail wagging the dog!

Investors need to face the fact that the Chinese recovery is not self-sustaining. The longer the day of reckoning is postponed, the more blood there shall be in the streets.

Summary

Stock markets hesitate with technology, disappointing economic data and doubts as to central bank munificence dampening investor optimism.

Continue firming of oil prices and selected commodities reduces allays systemic risk concerns and lends a boost to producers.

Brexit concerns - notwithstanding forecasts of a NO vote – persist, with increasing fears as to a re-casting of Europe and international relations.

This week we shall be contending with the fall-out from the technology sell-off and markets evaluation of central bank strategies. Investors shall focus on key US economic data culminating in the politically critical employment data on May 6th. Will the Federal Reserve view a further fall in unemployment as sufficient justification to "bare its teeth"?

In depth review

A good week for destroyers of idols – cherished myths bite the dust!

We are leaving behind us a week which has seen the destruction of several cherished ideas. Technology is no longer seen as invincible, the Bank of Japan has paused in its easing and the US may suffer – if we keep going at this pace – the ultimate ignominy of growing slower than the Euro Zone.

In the midst of these paradigm shifts - oil has continued to firm providing support to stability hopes. We see this as a precarious situation - with market equilibrium at the whim of Saudi Arabia.

US central bank opts to play from backfield – focus once again veers towards cyclical considerations

In this context, the Federal Reserve has opted for caution while downplaying global risks – with the focus shifting to cyclical as opposed to systemic concerns. Some observers see the absence of further shocks from China and a rebound in emerging markets as allaying financial stability concerns and clearing the way for rate increases this year.

Apple impact macro- economic - does this reflect a slowing of the global economy?

The US market was dominated by disappointing results from several colossi of the technology sector, with the one-two punch from Apple. Results well below forecasts with regard to both profits and sales have re-kindled speculation as to whether this is a micro – product issue or a reflection of a generalized macro slowdown.

Carl Icahn adds to general joviality!

Apple's travails were in addition the focus of comments by Carl Icahn – who sees considerable "freedom to do business" risk in Apple's China based strategy. We see the issue not as freedom to do business but as a slowing of Chinese growth and of the pace of addition of new recruits to the middle class.

No time to be a hero!

The Federal Reserve has decided that this is no time to be a hero and placed both rate increases and aggressive talk on hold. In a rare moment of tangency with reality, the US central bank has admitted that economic growth has slowed, while making fewer references to the global context.

Are we waiting for Godot?

US economic data has confirmed this assessment. Notwithstanding income gains, consumers remain reluctant to spend - preferring to increase savings and / or reduce debts. With manufacturing and export powered growth in abeyance, an increase in consumer spending remains the bedrock for a sustained future expansion.

US exports disproportionately large part of pricing power

Much has been said as to the "closed" nature of the US economy – with only 12 per cent of GDP dependent on foreign trade. This is seen as a buffer to global volatility. This does not take into account that high value exports / manufacturing represent a disproportionately large part of pricing power and corporate profitability.

Inflationary pressures remain in absolute terms muted. This reflects both the continued "full court press" on consumer cash flow with massive overcapacity resulting in depressed import prices.

Wage growth remains meagre – structural shift in labor market and steady advance of technology

Wage growth remains scant, a function of both the migration to low paying service jobs and an apparently "unlimited supply of labor" reminiscent of an early stage developing economy. We also see an "undertow" of technological advance placing further pressure on both job creation and wage negotiation power.

ECB asks for an extension for the final!

With regard to the Euro Zone, while growth is slowly picking up – driven by "catch – up" consumer demand – prices are falling, leading to a re-leveraging of sovereign, corporate and personal debt. In a note of agreement with the Bank of Japan, the head of the ECB has asked for an "extension" to see the impact of the measures adopted.

What we see as not clearly defined is what shall constitute success. Whether an increase in inflation and nominal rates shall be synonymous with growth is not clear.

Choice between easing bank re-capitalization and short term boost to the economy

An increase in interest rates shall lift banking net interest margins – facilitating recapitalization via retained earnings. However, ensuing higher borrowing costs and risk spreads shall act as a constraint on growth.

Using a "rough and ready" time continuum – there are close parallels between today's ECB and the Federal Reserve in 2010 – 2011.

Restructuring of the banking system – with the aim of separating banking and sovereign risk – and an overall decrease in systemic risk remain the key objectives.

European Equities buffeted by rising Euro – will this prompt further short term action by the ECB?

As concerns the European equity markets, stock prices are being buffeted by the rising Euro – stemming from the Federal Reserve's docile stance – disappointing earnings and setbacks in the banking sector. Reflecting Europe's greater dependence on exports, inaction by the Bank of Japan and concerns as to greater independence of central banks from governments has cast a damper on prospects.

Italian banking sector – is this the shape of the future?

As regards the credit sector, the Italian bank rescue fund Atlas will need to step in as underwriter and likely buyer of the shares issued in the Banca Popolare di Vicenza IPO. Instead of reducing the linkages between banking risk and sovereign risk as envisaged by the ECB, it shall increase it.

European car emissions scandal shall increase uncertainty

We have also considerable pressure on exporters, with the EM focused car sector buffeted by slowing growth, the stronger Euro and the continuing car emissions scandal. We see the uncertainty as to the final cost of any settlement casting a pall on VW and other car makers.

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What future for the "New Europe"?

Brexit anxieties as the "Day of Reckoning" looms are having second round effects with regard to the "New Europe". These countries success has long been predicated on an expansion of and closer economic integration within the European Union.

Will their ambition to be "The China" of the EU developed economies be vinified? Is the point moot, with robots and technological progress eroding the competitive advantage from low wage labor?

Oil prices continue to rebound – risk assets benefit

With regard to oil, prices have continued to rebound notwithstanding the debacle in Qatar, reducing default risk attaching to energy linked assets and sovereign risk of the marginal producers. This has mitigated systemic risk concerns and shifted investor focus back to macro and earnings.

Still betting on a hasty retreat by US shale oil producers

The argument for oil price stabilization, seen as a first step to price increases, rests on expectations of a drastic curtailment of US shale oil production. The focus is now on "natural rebalancing" as opposed to production cuts by major producers.

Watch out for US cash break-even at US Dollars 40!

This rebalancing may take longer than expected. With many US shale producers achieving cash break even at US Dollars 40, current price levels may act as inducement to both "hang in there" and hedge future production.

Marginal producers still focused on maximizing short term cash flow

The oil market remains oversupplied with prices supported in part by production disruptions – which are temporary. In the absence of agreement to production cuts, producers remain free to pump as much as they deem necessary to maximize short term cash flow.

The price increases reflect expectations and not any concerted move to reduce production.

As concerns emerging markets, we are seeing a bounce in financial assets which is disproportionate to any change in basic economic fundamentals. A weakening of the US Dollar may reduce pressure with regard to the value of FX corporate debt liabilities. However, it has yet to limit economic exposure stemming from the uncertainties of the Chinese economy.

Political risk focused on UK EU vote on June 23rd

We see political risk as still centered on the Brexit vote – which is rapidly turning into an acceptable forum for intervention by foreign governments and supranational entities.
These pleas are centered on a dual axis.

Will trade carry the day?

Should the UK leave it would take 10- 15 years to renegotiate trade agreements. It might also jeopardize the negotiation and impact of the US – EU free trade agreement currently being negotiated.

Are we about to see the start of "The age of disintegration"?

Rather more worrying, a British “Farewell to the EU” is seen as ushering in “The Age of Disintegration” as concerns the European experiment. The impact is seen as ranging from a re-negotiation of existing ties within the EU to outright secession, with a lengthy prospective list of renegades.

Mounting populist rage fueled by the need to find a scapegoat for the shock economic adjustments wrought by globalization and security concerns may result in the “Great closing”.

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He is fluent in English, French, German, Italian, Spanish and Portuguese. He also has a certificate in Arabic – from NYU School of Professional Studies.

His career has spanned the complete range of macro risk analysis - energy / commodities with ENI - Global Fortune 500 17 - leading global natural resources group, capital markets with Swiss Bank Corporation (now UBS) and insurance / reinsurance with the A.M.Best Company. Jean contributes regularly to international media commenting on key macro-economic issues.

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