



May 16th 2016

US economy – all dressed up and nowhere to go? US and Europe is this the parting of the ways or “noise”? Chinese economy – straight out of central casting – as the famous Jazz song said “can’t get started”. UK exit concerns rising – hard core of exit fans resists! Central bank independence – is this a bad joke?

Markets gearing up for US data - better surprise on upside than stuck in a rut!

Markets shall be gearing up for a lot of US macro-data. We still see signs of growth as preferable to a collapse. While expansion may engender concerns of an earlier than expected rise in interest rates, a stumbling economy shall be viewed as the death knell for corporate profits.

With investors banking on an end to the earnings recession and deliverance from the second best solution of multiple expansion - there is a lot at stake!

Today’s action!

You go your way – I shall go mine!

Are we seeing a parting of the ways, with Europe slipping and the US hanging in there? Europe has confirmed its susceptibility to “Foreign affairs” by hesitating following the latest data from China. A rise in the oil price triggered by more disruptions has failed to lift spirits as investors look beyond the Nigerian delta and focus on the global macro picture.

China – pull up your socks!

With regard to the data from the world’s second economy, this is a case of not good enough, with lower than forecast data across a broad array of metrics. We see this as a classic case of decreasing returns on government stimulus measures. There is a limit to which you can prop up an economy whose clients are “working to rule”, like the UK trade unions in the 1970’s.

Where is the substance in the recent Chinese recovery?

The Chinese mini-recovery is being fueled by speculation on the back of loose monetary policy and continued overproduction. As we have often noted – deflation is less about oil than about competing with countries where the social break-even is considered more important than conventional accounting.

The Chinese economy while not kaput is generating low incremental returns on state largesse – with more lending simply adding to a mountain of bad debts!

Kindness of strangers – for some!

Notwithstanding commodity stocks are rising on hopes of yet further stimulus. This generosity shall be selective, with the commodity producers getting a slight lift, while those whose strategy is based on ever faster rising standards of living shall not get seconds!

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Japan – be careful on the downside!

This week we shall also be seeing Japanese GDP data, with many hoping that the world's third largest economy is not in recession. The key point is that while expectations for Japanese growth are low – a protracted recession is seen as a catalyst for more aggressive monetary policy and competitive devaluation.

With the EM story on hold, attention is shifting to the advanced economies as growth generators.

EU industrialists say no to Leave!

In the Euro Zone attention is now shifting to event risk as the UK – EU exit referendum looms larger. We are seeing polls which show 46 per cent wanting to stay, 43 per cent opting to leave and the rest undecided. We are now seeing the pressure build with grim opinions from leading EU industrialists.

We are getting to the heart of the matter – economic exposure

We see this as getting to the heart of the matter, future investment flows and economic exposure, as opposed to hedging transaction long sterling exposure. A loss on “cable” is a one off. A slowing of inward bound money into an economy with a massive current account deficit is somewhat more serious.

EU shot in the arm for UK economy – was tottering on verge of collapse

The UK economy which for years suffered from very low productivity and declining living standards has benefited enormously from massive EU capital inflows. This was driven by both the supply of equity capital from abroad reducing pressure on the capital markets and creating a wealth effect via absurd property prices.

Wait to buy that house in London!

One is in any case pleased to see that our view on the precarious state of the UK economy is shared by others. Parallels with the UK in the early 1990's are becoming increasingly common - an overheated housing market positioning the country for a housing crash and recession.

Euro Zone government bond yields mispriced – we agree! Some should be paying 10 per cent!

On the broader EU front, we are reading that the EU peripheral sovereign debt yields do not adequately reflect the UK exit risk. We agree, but would add that this is only a minor part of the picture. The key point is that the yields ex- Brexit do not reflect the parlous state of economies which despite low interest rates and a weaker Euro simply cannot get started.

We view the statements by the rating agencies as to the impact of a UK exit on the remaining EU economies as well placed but missing the essence. Abstracting from a possible UK exit, we are heading towards an EU de-caffeinated life.

Central bank independence – is this a joke in poor taste?

The UK economy – will there be a recession?

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The polemic continues to rage in the UK following statements by the head of the Bank of England that a UK exit from the EU would not only unleash the divine punishment but also a recession! This is raising questions as to the independence of the central banks.

Independence of central banks irrelevant when economic system is at stake

We consider this discussion to have been made utterly irrelevant by the financial crisis, when the focus shifted from cyclical management of the economy to saving capitalism for the capitalists. Independence ceases when the economic system risks tipping over – bringing in its wake democracy.

Right or wrong – it is hard to see any sentient being arguing that zero interest rates as anything but the primacy of politics over longer term sound policy.

Watch out for punches coming out of left field!

Japan – be careful on the downside!

This week we shall also be seeing Japanese GDP data, with many hoping that the world's third largest economy is clambering out of recession. The key point is that while expectations for Japanese growth are low – a protracted recession is seen as a catalyst for more aggressive monetary policy and competitive devaluation.

With the EM story on hold, attention is shifting to the advanced economies as growth generators.

Are we on the brink of the “Age of muscle flexing”?

Will VW usher in a new era of investor activism in Europe?

We read with interest that the Norwegian state pension fund, the world's largest intends to take part in a class action law suit against VW. This is due to the losses on its holding in VW stocks following the breaking of the emissions scandal.

Norway state pension fund owns almost 2 per cent of VW – shall we see the “weight of money” in action?

What is more interesting than the law suit is that the pension fund owns 1.64 per cent of VW's common stock. Is this the beginning of a new era in activist type investing in Europe? If so what shall be the consequences for corporate balance sheets and prudent reserving?

In a nutshell!

Stock markets have been struggling to maintain their footing. Stronger than expected US retail sales and a firming of oil prices have not been sufficient to offset further intimations of a slowing in global growth.

Major global groups are increasingly seen as leading indicators for the world economy. In this context, disappointing earnings have not helped to dispel a mood of caution.

Monetary policy remains accommodating – with the US the only central bank discussing further rate increases. The divergence trade is intact, with other major central banks still firmly set on stopping deflation in its tracks. We see the upcoming Brexit referendum as inducing prudence.



Oil prices have firmed. This is due to a combination of “Short end” of the curve disruptions and longer term expectations – or better put, hopes – of a substantial increase in demand from the emerging markets.

With regard to the China risk, we see the focus shifting from industrial data to the monitoring of the build-up in commodity and oil stocks. Is this hoarding prior to a repeat of “The Guns of August”?

This week further key US data – is there a “Fifth Column” within the Federal Reserve?

This week we shall be seeing further key US data, which shall include CPI, industrial production and key manufacturing data. The FOMC minutes shall be published – fueling another round of speculation as to the existence of a “Fifth Column” ready to raise rates. How close are we to the tipping point?

Expect more pressure on the pound and Euro

As the UK – EU referendum rolls closer, we are likely to see further volatility with regard to both the pound and the Euro. The single currency has shifted from being a safe haven from the cross-channel turmoil to being the “fellow traveler” of the UK’s fortunes.

Still about repaying debt!

What is the closing gap in US bond yields telling us?

We are silent witnesses to the closing of the gap between two year and ten year US government bonds to the lowest level since December 2007. Does this indicate low long term growth and / or a secular decrease in inflation expectations?

Absolute amount of debt the critical issue

Abstracting from the oft cited slowing of the emerging markets, we see as the key long term economic “deadweight” the still very high debt levels – across sovereigns, companies and consumers. Any excess cash shall be used to pay down this “burden of the ages”!

Two per cent inflation does not cut it!

With regard to inflation, a return to an inflation target of two per cent shall prove insufficient to restore pricing power across a wide breadth of business sectors. We are seeing negative demographics in the advanced economies and an intractable overcapacity in China.

Political risk building!

Earnings and macro data ceding way to political risk

Earnings and macro data shall however be superseded by the “Gathering Storm” of political events. The UK referendum, initially seen as a secondary, domestic matter has mutated into an international issue! Foreign governments and international organizations have not been remiss to threaten the apocalypse should the leave contingent win!

Will Spanish elections set the pace for European populism and shift to extremes?



With regard to the Euro Zone a general election in Spain on June 26th is seen as a bellwether for the growing populist discontent. The forging of an alliance between the euro and debt rejectionist Podemos party and the communist left is seen as threatening the traditional Socialist – PP binary option.

US campaign getting moving into goal zone – We see commonalities between the parties

Needless to say, the US presidential election – although the candidates have not officially been chosen- has spawned a wide range of forecasts as to future economic policy. We are starting to discern two commonalities.

Do not expect balanced budgets!

The first is that fiscal conservatism is unlikely, with the Democrats reluctant to cut entitlement programs and the Republicans ready to expand deficit spending.

A Farewell to Free Trade!

The second is a shared aversion to “business as usual” with regard to free trade agreements. We can expect a slowing in the pace of trade liberalization. The promise of “long run” equilibrium is not deemed a satisfactory offset to the loss of well-paid positions.

Turkey – EU relations rapidly souring

The honeymoon between Turkey and the EU are once again souring. Turkey is threatening to flood the EU with refugees if no progress is made on both visa free travel for Turkish citizens within the EU, as well as on the disbursement of funds for the migrant camps. This is what Gaddafi used to threaten Italy with!

General overview – The long run

Macro-economic data continues to disappoint – lagging realization that it counts!

Macro-economic data has continued to be disappointing, with already modest growth forecasts revised downwards. With a considerable lag time investors are starting to discern the limits of monetary policy and re-focusing on the “real economy”.

Are we seeing 1990's Japan writ large?

Deflationary pressures remain constant despite a firming of oil prices and massive monetary stimulus. The impression that we are on the threshold of a liquidity trap – Japan in the 1990's writ large – is rapidly gaining in credibility.

Debt repayment remains key objective

High debt levels are precluding further borrowing and forcing companies and consumers to employ cash flow to repay their liabilities. While gearing has been reduced worldwide sovereign, corporate and consumer debt remains very high.

Focus on emerging markets

Remain cautious on emerging markets – where is the structural change?



We remain cautious on the emerging markets space. The stabilization of the US Dollar lessening the balance sheet impact of currency debt mismatching shall not be sufficient to engineer a "Sea Change". Investors are starting to distinguish between "one off" political shifts – see in this regard the Brazilian "earthquake" and the fall in the real.

China – economic drivers have not changed

With regard to China, the economy continues to slow, with domestic demand apparently not sufficient to take up the slack from contracting export markets. While the service economy is growing, the major economic lever remains low value added export manufacturing. Some are seeing stockpiling of oil and commodities as a buffer for a prospective devaluation.

Brazil – are we at the turning point?

With the approval of the impeachment process and the passing of the presidency to Temer, the first scene of the first act of the Brazilian drama is over. Markets are now starting to grasp that the tough part has just begun, with a global cyclical upswing likely to have a limited impact. The "heart of the matter" is not commodity prices but the enemy within – public spending.

Whether any government shall be able to reverse rights enshrined during the transition from a military government to democracy remains the key challenge.

Euro Zone – we remain cautious!

Euro Zone – "Age of Re-Leveraging" looms closer

We are not surprised by a downward revision to Euro Zone growth in the first quarter. Adjustments within a very low band reflect "noise" and not signal. In our view inflation data is the key factor. With deflationary pressures resistant to negative interest rates, massive liquidity injections and firming oil prices, we see the "Age of re-leveraging" on the horizon.

European banking problem not over – cannot break umbilical cord between sovereign and banking risk

Together with the lack of inflation, we see the banking crisis as not over. Pressures on the Italian banking system are not abating. The government is now seen as the permanent back-up to the "coalition of the un-willing" of the private banks. One may well wonder whether the Euro Zone economy is strong enough for a severing of the link between banking risk and sovereign risk.

Focus on US

US economy – Federal Reserve sees lift off – are they right?

As regards the US economy – a better than expected result in retail sales and consumer sentiment have not been sufficient to mitigate investor concerns. The US economy is seen as stuck in first gear, with prospects based on hopes of a marked and diffuse rise in wages.

Cash shall be used to pay debts!



Whether this shall be sufficient for the US to look inward mitigating the impact of slowing global markets remains highly uncertain. Wages are lifting off selectively and from a low level. We continue to see the majority of spare cash flow as being used to pay down debt.

Focus on oil and commodities

Can oil prices rely on India? Is India to oil what China was to iron ore?

As concerns oil we have seen a firming of prices based on IEA projections of increased demand from the emerging markets – in particular, India – reducing the persistent excess in supply. This represents a long end of the curve factor as opposed to a short end squeeze driven by supply disruptions.

Saudi Arabia shall not wage battle on two fronts

We remain cautious on oil. With Iran coming on stream faster than expected and the Saudis not likely to change course. A government can only act in one sphere successfully at the same time – the Saudi priority now is generational change not a reversal of energy policy.

Commodities coming off the boil – is there life after the super-cycle?

Commodities have continued to come off the boil, with the China – largely speculative – driven spike, starting to ebb. The focus is now shifting from commodity prices to the extent to which the industry leaders can regain profitability in the absence of a new “super cycle”.

Need to look at commodity prices on a “normalized” long run basis

This is based on efficiency gains – lifting current margins – and a slashing of capital spending limiting future supply and equilibrium prices. We see a return to super-cycle conditions as difficult and argue for a “normalized” steady state pre-China boom metric for determining long run prices.

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