Tigress Financial Partners

Macro Snapshot – Chief Economist Jean Ergas

July 11, 2016

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In a nutshell!

We see continued safe haven and bond asset allocation flows – investors, despite a recovery in equity markets are reducing equity and increasing top rated sovereign debt – The UK pound is still far from having bottomed – We shall see further rounds of position "unwinding"!

Investor mood remains a movable feast, with investors continuing to attempt to understand the ramifications of the UK referendum.

Uncertainty continues to dominate on the political front and do not see this dissipating any time soon. What is clear is that as concerns the economic repercussions, we have barely started to see the consequences.

With regards to monetary policy, we see the central banks as still in an easing mood. We see hopes of stimulating growth and / or fighting deflation giving way to attempts to fend off systemic risk – with the two principal sources of same being constraints on interbank financing and "mass of money" shifts

Today's action!

One candidate race in the UK and prospect of more "kindness of strangers" from Japan!

Markets are up on what now looks like a one candidate race for the prime minister post in the UK and a resounding victory by the pro – monetary easing / QE party in Japan. We are also still seeing some carry over from the stronger than expected employment data last week. Many investors remain confident that the Federal Reserve shall not do anything to block job creation - regardless of pay levels- and – above all – shall not want to be the catalyst for turmoil.

Financial economy continues to rule the waves!

Where do we stand on this? The key is that the financial economy continues to rule the waves – with no discernible changes in the global growth picture. Investors continue to focus on the reaction and not on the causes- there is reason interest rates continue to plumb the Marianna's trench!

We are seeing strong flows into selected government debt triggered by massive build up in cash as a wide range of investors and companies are confronted with a dearth of attractive projects.

UK – Devil I know scenario – distressed asset sales a zero-sum game

With regard to the UK –this is starting to look like "A devil I know" scenario. The choices facing the UK are unappetizing. We shudder when we hear that the problems facing the commercial property sector are contained – shades of US sub-prime and expect that the bargain hunting of one shall prove to be the collapse of another. Distressed asset sales are a zero-sum game.

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We read with interest the UK's Chancellor of the Exchequer's article in the WSJ, extolling a reduction in corporate tax rates as showing the UK is open for business. Will this be enough to counter the "primacy of politics" and a "no holds barred" policy on labor mobility?

Investors continue to eye UK property sector

Investors continue to watch the UK property investment sector – with the risk of further blocking of redemptions triggering further panic. We see the property shakeout as still in its early stages and expect to see further downward "Step function" adjustments as leveraged owners of commercial and residential properties start to make for a very tight door.

Watch for second round effects!

Additional second round effects shall likely stem from multi-asset funds, which in a desperate dash for yield have plowed into illiquid cash generating investments. In the UK = this includes some of the fund management groups who have shuttered their dedicated property units. We expect some of the sovereign wealth funds - traditional investors in UK property to suffer losses.

Bargain hunters shall be very selective!

We read of a US real estate investment firm seeking bargains in the UK commercial property market following the recent turmoil. The fund shall invest UK sterling 1 billion of which 400 million equity and the rest borrowed. over the next 6 to 18 months. We see this as a classical distressed strategy presaging:
The scope for further declines in the medium term
Selectivity in the choice of assets – with likely second string prop

1-This week!

We are leaving behind us a week full of excitement- more to come!

We are leaving behind us a week replete with excitement as markets continue to attempt to assess the impact of the UK vote. This is taking place in a context of slowing global growth, continuing deflationary pressures and a European banking system which is floundering.

We are still at the "appetizer" stage of a long meal! UK shall play "hardball" – triumph of nation state over macro!

We reiterate our view that:
1 – We continue to see "The primacy of politics" drowning out macro data
2 – We are at the "appetizer" stage of the fallout from the UK referendum
3 – We expect any new UK administration to exit the EU and to take a hard line on immigration – limiting the scope of an accommodation on a "business as usual" basis with the EU.

US jobs data tells us little about direction of global economy

We have seen the US employment data and view it as proving little except for more low-wage hiring, which will do little to spur consumption. With regard to monetary policy, we see the US central bank "coming up for air" and unlikely to raise rates before the end of the year.

Monetary policy shall be subordinated to the risk of financial market volatility as multiple situations unfold.

We shall be seeing US retail sales and US beige book- see US becoming a safe haven for moveable capital

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With regard to data, we shall be seeing US retail sales hoping granting some insight into the robustness of the constitution of the US consumer. This shall be preceded by the beige book. We see the US economy as being a winner by default among the major advanced economies. It continues to combine growth – albeit modest – with political stability and an internally driven economic dynamic.

Bank of England meets – shall they cut rates? – Can monetary policy stop asset repricing?

Abroad, on the monetary front the Bank of England shall meet. This shall be critical to understanding the condition of the UK economy. The extent to which monetary policy can be effective against a political void and a still in its infancy repricing of grossly overvalued property assets.

UK property market – get ready for a loud, crashing sound!

The UK property market has historically been the leading indicator for a turn in the UK business cycle. We now see it as ushering in a structural shift, with lower safe haven demand from flight capital and doubts as to the shape of prospective economic relations dampening demand for London property.

Chinese GDP irrelevant – reflects government spending and dumping – divorced from market mechanisms

We shall also be seeing data on Chinese GDP. While important we view this data as bearing scarce relationship to any market based economics. The Chinese economy is being kept going by mini =-stimulus programs –with ever lower incremental effects – and by adroit currency "salami tactic" – slice by slice currency devaluation.

The dependence on the low value added export model remains the centerpiece of the economy. China's government still appears reluctant to write off the sunk cost of capital investment and is determined to privilege revenue and FX receipts over profits.

2- Global growth

Cautious on global growth – US likely the best in a disappointing lot

We continue to be cautious on global growth and view the uncertainty stemming from the UK situation further impacting modest prospects for the Euro Zone. China's efforts to lend impetus to its economy remain temporary and limited. In this context, the US – despite its manifold challenges- likely remains the only major economy with "stand alone" capacity.

A throwback to the "Cold War" – Europe remains "The crucible"

We continue to see Europe as "The crucible" - with political shifts likely to cause changes in economic policy. A protest against free markets and trade is underway and we expect social discontent to accelerate.

We see a structural shift in global trade

On the theme of global investment the G-20 trade ministers are sounding a cautious note- estimating that capital investment may fall 15 per cent next year. This is seen as driven by a slowing of trade. We might well add that overcapacity is still going strong, new manufacturing techniques are reducing production times and supply chains and that topping out of infrastructure investment in China will reduce exchanges. The slowing of trade growth is structural and not cyclical.

3 - Will we see a shift to micro and away from politics and macroeconomics?

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Will the start of the US earnings season signal a shift towards the more mundane business of business? Last week, we saw the US stock market on the verge of scaling new heights pushed by a shift towards US assets and expectations of prudence from the US central bank.

We view earnings as important. However, we continue to see markets in the thrall of politics, currency fluctuations and oil prices.

4- Focus on the UK

UK – situation - Bottom line is security!

Is this the end of the line for the Brexit "rejectionists"?

Is this the end of the line for the "rejectionists" who insist on a rerun of the UK – EU vote? The US president at the NATO conference has basically stated that – like it or not – the working assumption is that the EU and UK shall now start disengagement talks – and speedily too!

The concern is that uncertainty will further damage confidence in an already shaky global economy. With populist, anti – free trade and anti-immigrant on the rise a further economic weakening will spell further havoc.

For US bottom line remains security – this is the new "Cold War" – shades of Kennan and containment

We continue to see the US thrust in the direction of security policy – the bottom line remains NATO. This assumes a major importance in the light of the UK's large contribution to the European defense budget.

Which trade agreements are concluded between the EU and the UK is of secondary importance to the US. What counts – in a throwback to the Cold War – is the solidity of the European front against Russian expansionism.

We are watching sterling!

The UK remains the focal point, with sterling an accurate barometer of the UK's political and economic fate. Since the "leave" victory, the once world's reserve currency has collapsed close to 15 per cent. Doubts and caution are starting to prevail among the victors.

Exit difficulties for UK are becoming apparent!

The difficulty with regard to satisfactory post – exit trade and financial services agreements is becoming apparent. The establishment of bilateral agreements might take up to a decade.
In the meantime foreign direct investment shall be on hold constraining growth.

A tale of two economies – Is it the best of times and the worst of times?

We are continuing to see a marked divergence between the FTSE 100 – large global groups – and the FTSE 250 – small and mid-cap domestically focused economies. Companies with domestic sales shall be impacted by higher import prices and an economy likely to slip into recession.

5- Government debt markets signaling panic

Are we moving to global negative yields?

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Government debt markets continue to benefit from – despite a temporary stabilization in equity markets – from massive safe haven buying. We are seeing one bulwark of still positive yield after another capitulate! Negative yields are creating a dual pressure:

Negative yields creating a "full court" press

1 – Limiting the bonds available for purchase by the ECB

2 – Reducing bank lending margins – increasing longer term operating concerns at the same time as the UK crisis threatens to negatively impact the single currency area.

6- Banking crisis - source of systemic risk

Counter-piece to UK crisis – banking crisis – Italy at end of its tether with the EU

The counter-piece to the UK political crisis in Europe continues to be the banking crisis. The collapse of several Italian banks has put the Italian government on a collision course with the EU with regard to bank rescue guidelines and is rapidly leading to TARP solution. This is now – following the collapse of attempts to assemble a private sector "lifeboat" – considered the only way out.

The mighty – how they have fallen! – Deutsche Bank hitting new lows!

We are also seeing continued turmoil in Germany, where Deutsche Bank's restructuring efforts continue to flounder. The shares are hitting new lows as investors flee a sector deemed assailed on multiple fronts. Regulatory pressures shall remain a constant and the UK crisis is likely to negatively impact Euro Zone growth.

UK banks – shall we see another wave of state support?

As for the UK, the banking sectors shares have collapsed – without having fully recovered from the financial crisis. Bank stocks have fallen in excess of 20 per cent as political and longer term economic uncertainty refocus attention on exposure to the housing and overall – UK domestic economy.

UK "challenger" banks – is this a re-run of Countrywide?

We remain focused on the UK "challenger" banks which replicated the US Countrywide model – disproportionate exposure to housing and higher risk lending. One cannot exclude the UK government needing – should the collapse continue – facing the need to bail –out the once again improvident.

7- Emerging markets – are they an FX proxy?

As regard the emerging markets, we do not share the optimistic view that European asset allocations shall be partially shifted to the EM space. These economies continue to have a disproportionate correlation to global growth – which at the present juncture is in short supply.

We see the EM strategy as a bet on low interest rates and a limited strengthening of the US Dollar. The focus is on reducing debt servicing costs and not on an improvement in operating revenues.

8 – Oil and commodities – cautious outlook

US producers continue to confound all predictions

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While oil prices have staged a rebound from the US Dollar 25- 26 level, we continue to see the market as oversupplied. Short term, we see a move down to the US Dollar 40 WTI level as possible. US supplies remain robust and shale production continues to confound all predictions of its early demise.

Not wild about commodities

As for commodities, we continue to see the sector as having established a new and more constrained trading band. While one hears a great deal about a "bull market" prices are coming off a very low level. Longer term optimism is predicated on a reduction in supply and not on an increase in demand.

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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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