Tigress Financial Partners

Macro Snapshot – Chief Economist Jean Ergas

August 1, 2016

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In a nutshell!

Global growth expectations falling – markets still looking to central banks – will they deliver? – Political risk remains high and investors starting to focus on the US elections – We expect further volatility driven by the European banking crisis – Stress tests far from clearing the air!

This week we shall be seeing more US earnings and key macro-economic data culminating in the employment data. This shall be preceded by data on manufacturing, services and personal income with investors focusing on whether consumer spending and growth are diverging.

On the foreign front, the Bank of England meeting is expected to reduce interest rates and trigger a further fall in sterling. We see as more important comments as to the expected consequences of the UK's prospective "secession".

Global overview

There are no more "locomotives"! – US economy "swapping dollars" but not creating value

Global growth fundamentals remain weak with both the US and the Euro Zone posting lower growth and laying to rest any residual hopes of a "locomotive effect". We reiterate our view that in the US "optics" improvements in the labor market and economic expansion have been riven apart. Capital spending remains weak with companies hesitant to part with their cash buffers as uncertainty increases.

We expect little cheer from the EM space and put little faith in Chinese mini-stimulus programs. They are not a substitute for sound economic growth.

Euro Zone remains weak and risk of "re-leveraging" high

As concerns the single currency area growth rates have slowed sharply and achievement of inflation targets appears distant. This increases the risk of lower revenue growth, pressure on pricing power and the "re-leveraging" of corporate and sovereign finances.

Structural weaknesses which cannot be resolved via monetary policy shall be compounded by the repercussions of the UK vote.

Sterling is a "special situation" – we are now entering the second stage of the decline

We continue to view sterling as a "special situation" and see the currency as entering the second stage in its repricing. The first "step function – shock vote" adjustment having taken place the currency decline shall be driven by a steady drum beat of disappointing economic news. Central bank support shall not be forthcoming and the pound shall be a "clean float".

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Race to the bottom in European fixed income not yet over

As regards fixed income we see the “race to the bottom” in the European space as not yet over. This shall be driven by a continuing weak economic performance compounded by potential central bank efforts to “front run” potential nasty surprises out of the UK.

Investors are starting to grasp that domestic demand is driven by deflation “windfalls” and that this is not the way to sustainable growth.

Remain cautious on oil – “pumping for cash” remains dominant strategy

We remain cautious on oil and see continuing oversupply. Disruptions are not the same as policy changes. “Pumping for cash” remains the dominant strategy as Iran returns to the market and Iraq “floors” the accelerator. With the Middle East once again in the spotlight as Turkey re-enacts the 1970’s we see Saudi Arabia as reluctant to add to the tension.

We see political risk as high – extensive “second degree” risks – intersection of political and macro instability

We continue to see political risk as high with the UK situation far from resolved, the clampdown in Turkey gathering steam and the US election outlook looking possibly closer than many had expected.

“Second degree” political risks whereby macro-shifts are closely correlated to political decisions – such as the European banking crisis - continue to sow uncertainty.

Which is worse – the Democratic left or Trump?

The key issue appears to be the choice of the lesser evil. Which is worse – the adoption of a left oriented Democratic platform or the uncertainty stemming from a Trump victory with a concomitant redrawing of the global economic trade framework?

Focus on economic hot spots!

1 - European banking crisis

The banking crisis is being played out on several fronts

In Europe the banking crisis is being played out on several planes, both short term and long term. A solution remains contingent on waiving EU rules and /or governments succeeding in corralling private sector support for rescue plans.

Stress tests - do they reflect full range of risks?

In this respect we do not see the European banking stress tests as having cleared the air as to the extent of further action necessary. The stress tests did not take into account the UK’s future political and economic trajectory or the impact of negative interest rates on profitability.

We view the re-capitalization “package” for MPS as likely a “short term” gap measure for the bank and not materially impacting the outlook for the Italian or European banking segment.

2 – Oil prices shall continue to be under pressure

We see the continued fall in oil prices as exerting further pressure on sovereign risk, increasing the pressure on marginal producers and eroding reserves. The political driver behind Saudi oil strategy is once again dominant with Saudi Arabia:

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Not prone to want to risk de-stabilizing a brittle global equilibrium but seizing price weakness to exert persistent pressure on Iran.

3 – UK triumph of ideology over economic common sense!

Rift between reality and investor "wish list"

As regards the UK we continue to see a rift between the political reality and the "wish list" of many investors. Market participants appear to be underestimating the "ideological" component. This posits a return to economic pragmatism and concessions in exchange for unfettered access to the EU market.

Restricting EU immigration remains key constraint

We view these expectations as misplaced and see both UK assets and currency correcting as markets start to grasp the full import of the UK's economic and political "pivot". Freedom of movement – politically correct expression for immigration – remains the objective constraint to which trade agreements shall be subordinated.

Limited EFTA type agreements the likely outcome – where is the "knowledge economy"?

Comments regarding future trade agreements have been guarded and do not appear to prospect a EU lite solution but a shift towards limited EFTA type agreements. These shall be centered on merchandise limiting unfettered access for service exports – the backbone of the "knowledge economy".

See a "pincer" squeeze in the UK economy – foreign direct investors starting to balk

UK domestic data continues to point to further weakness on a broad range of fronts, leading to substantial downgrading of growth forecasts. With uncertainty still having the upper hand we see a "pincer squeeze" as the domestic economy slows and longer term investment flows from supply chain driven foreign direct investors start drying up.

4- Emerging markets

Remain cautious EM - like Brazil – myth of de-coupling exploded

Turning to the emerging markets we remain cautious seeing them – with the exception of Brazil – as put options on the US Dollar or hostage to Chinese growth and commodities. We view the "Myth of de-coupling" as having been exploded on multiple levels:
EM – developed markets
EM – China
The possibility of "EM in one country".

Longer term structural pressures shall weigh on EM

Abstracting from persistent slow growth in the developed economies longer term structural pressures loom. Advances in manufacturing shall shorten supply chains and continued overcapacity shall discourage capital investment. Domestic markets have proven incapable of generating sufficient demand to buffer contracting export markets.

Brazil is weathering the storm

We make an exception in the case of Brazil where looking past the political uncertainty and the many chronic structural problems continue to see attractive opportunities.

Our stance is dictated by two principal considerations:

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Brazilian institutions are holding

Political institutions are proving capable of effecting a transition of power within a democratic framework

There have been few examples of economic development where the institutional framework was "perfect"

We see a modest cyclical recovery taking hold

While structural problems abound – the principal challenge being fiscal policy, we see growth – albeit moderate – picking up next year as a – albeit moderate – cyclical recovery takes hold as excess capacity and inventories fall.

Impact of further rating downgrades shall be limited

As regards the rating "Damocles Sword" we see further downgrades as having a limited impact. The key shift from investment to non-investment grade has been absorbed by the financial markets and there has been strong demand for Brazilian debt. We do not see this as a further example of a "grasp for yield".

A strong economic team determined to fully exploit all margins of maneuver and strong FX reserves limiting sovereign default risk are providing a powerful underpinning. We see as apt the German proverb that "the start is the half of the whole"!

Argentina – is there a positive outlook after years of autarchy?

We see Argentina – while riskier than Brazil – as offering attractive long term opportunities for the more stout hearted. Our view rests on the dual axis of:

Longer term - after 12 years of a 1960's import substitution and hostility to foreign direct investment a transition to a more pro-business policy
Short term - an incipient Brazilian economic recovery providing a "pull" effect to the Argentine economy.

Could a possible structural shift be underway?

While considerable uncertainty remains and likely further pressures on the FX rate loom we see a possible structural shift underway. Argentina has disappointed before as regards abandoning populist strategies. However we see the chance of a greater than expected Brazilian upturn and increase in trade as providing a partial buffer.

5 – Central Banks

Shall abstain or ease monetary policy further

What of the central banks? We see central banks as still in an abstention or easing mode. The dismal US economic data which we see as persisting shall likely stay the Federal Reserve's hand until the end of the year.

We do not see any acceleration of US growth and view the economy as mired in a low wage growth – minimal capital spending mode.

ECB challenge shifting from deflation to preventing a Euro appreciation

As regards the ECB, we view as its principal challenge shifting from avoiding a 1930's deflationary collapse to preventing an appreciation of the single currency. A euro revaluation shall put paid to the Euro Zone's principal competitive advantage. Whether the continuation of a negative rates policy shall be sufficient is not clear.

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Continue to see Japan as a longer term issue

While investor attention has been focused on Japan we continue to assess the risk as longer term. We have not "written off" Japanese growth but with expectations minimal we view a potential shock effect for the global economy as limited.

The key issue in Japan shall not be growth but the need to "externalize" the funding of the foreign debt as negative demographics take their toll.

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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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