

August 4th 2016

Bank of England – Finally some realism – this is not junior varsity cheerleading – We see UK forecasts as too optimistic – Trotsky spoke of “The Permanent Revolution” – UK might find itself in “Permanent Transition”!

US gearing up for “The Number” – more low wages and income instability – Beware of false prophets and dawns in European banking - Stocks up on higher oil and central banks – show me the money!

Stocks in Europe up following Bank of England epic decision - First interest rate cut in 7 years!

Stocks in Europe are on the up following the Bank of England's decision to – taking a page from the ECB – “do what it takes to save the UK economy”! The UK central bank – which appears to be the one UK institution not in denial – has cut rates for the first time in 7 years, announced the resumption of targeted lending as well as a new round of sovereign and corporate QE.

Thank you Mr. Carney – reality not junior varsity cheerleading!

These decisions are driven by the first not Pollyanna – JV fan club assessment of the UK economy. Growth rates have been slashed and inflation – driven by a weaker pound – shall increase. As we mentioned recently, there is a reason that the “smart money” is piling into inflation indexed debt.

Brexit – Roberta Flack economics – “killing me softly”!

What do we make of this? We see the BOE breaking the news gently and expect the growth forecasts for 2016 and 2017 – at least- to be revised down sharply. These forecasts do not reflect the scale of the plunge in the recent economic data – and more important – expectations.

UK consumption model is coming under pressure

Services – which are largely consumed internally – have taken a punch, manufacturing is weak and capital spending is staying on the sidelines. We are starting to see the housing market – fulcrum of the UK consumption model – start to come under pressure.

This is not a competitive devaluation – This is the market voting on the UK's prospects

We reiterate our view that this is a situation not comparable to other periods of economic weakness. The exit from the EMS in 1992 did not imply a rebuttal of the UK's trade and investment framework. This is not a competitive devaluation engineered by a central bank but a market vote on the UK's economic prospects.

UK property crisis shall play out on two fronts- bank balance sheets and consumption – Get ready for a bloodbath in London property – do not pass go and do not collect 200!

Jean Ergas
(646) 780-8880
jergas@tigressfp.com
Twitter: @jean_ergas

Tigress Financial Partners
Member of FINRA / MSRB / SIPC
500 Fifth Avenue
New York, NY 10110
(212) 430-8700
www.tigressfinancialpartners.com

To subscribe to Jean's Global Macro Overview, order customized reports, or gain direct access to Jean, contact research@tigressfp.com.

We see the property crisis playing out on two fronts. The first is the “shock” effect on bank balance sheets. With regard to leveraged asset prices the estimate of a collapse of up to 50 per cent in some London prices looks about right. This shall have a considerable impact on bank balance sheets, as the “greater fool” strategy starts to look faded.

UK consumers shall get hit by one-two punch

The second impact shall abstract from leverage, be more broadly based and be a reduction in consumption as home equity falls.

Owning your home does not make it into an eternally self-financing piggy bank! UK consumers shall be hit with a one – two – punch of rising prices and falling asset values leading to a “pincer squeeze” on disposable income and consumption.

Monetary policy cannot re-write trade agreements

As to monetary policy we remain of the view that it cannot alter the climate of uncertainty or reluctance of companies to invest. Its impact shall be centered on the “financial economy” – boosting government debt but not having a significant pass-through effect.

The British people are being mocked – six pound reduction in mortgage payments shall be annihilated by import price increases!

We are perplexed to read that interest rate reductions shall lead to a six pound monthly reduction in mortgage payments. Not quite aware as to whether such comments are deemed to be humorous – however see these savings being rapidly gobbled up by rising import prices.

Consumption being financed by savings – is this sustainable?

Investors have also been digesting the US services data which points to expansion – albeit gradual. We refer back to personal consumption data showing that spending is being financed by savings. This raises questions as to the sustainability of the expansion.

We need to also bear in mind the link between services and capital investment, with the latter weak services shall be consumer driven.

Box tops sang about “The letter” – US getting ready for “The Number”!

We are gearing up for the employment data tomorrow with many “enthusiastic” following yesterday’s ADP data. We are neither amused nor impressed and see further declines in the unemployment rate – we are already at allegedly “full employment” as doing little to increase consumption.

US recovery “dog-miserable”!

While recognizing that the US and the globe succeeded in avoiding a complete meltdown in 2008-2009 this has been a dog-miserable recovery on several fronts. A large part of the working population has dropped by the way side, quality of job creation has collapsed and wages have stagnated. We are now not at “take-off” but likely at the start of the descent phase!

US economy makes “Night of Living Dead” look like “Breakfast at Tiffany’s!”

Notwithstanding we continue to hear from the powers that be that further rate increases are not to be excluded this year. The Federal Reserve is waiting to see confirmation of “favorable trends” from new data. A “first best outcome” scenario along these lines shall make “The Night of the Living Dead” look like “Breakfast at Tiffany’s”!

European banking sector – beware of false prophets!

Turning to the broader global spectrum the banking sector is enjoying a respite. However, we cannot speak of a meaningful “signal” rebound when banking shares – most of which are trading well below book - are trading like non-marginable stocks. Investors are focused on a binary solvency – insolvency paradigm as opposed to longer term performance analysis.

Is this the time to introduce a minimum leverage ratio in the EU?

The European bank regulator – EBA – has proposed the introduction of a 3 per cent minimum leverage ratio for all banks. This shall have a “moderate” impact on lending. The issue is not moderate or slight but that with the Euro Zone economy at tipping point, an even minimal contraction in lending can have a disproportionate impact.

Oil lending stocks support

Stocks are also being supported by data on the oil sector. Supplies are growing slower than expected and there is the prospect of the gasoline excess being slowly whittled down. While this may reduce the speed of descent we still see scope for forays below the US Dollar 40 WTI mark.

Pass through to sovereign risk shall not be immediate

With regard to the implications of oil price relative firmness, further stability shall be needed to quell apprehensions related to the US high yield energy segment and sovereign risk. While prices have risen from the depths of the winter they are still below the break-even levels for high cost producers.

Contacts

Jean Ergas**Chief Economist****(917) 551-6533 Direct**iergas@tigressfp.com**Ivan Feinseth****Chief Investment Officer****(646) 780-8901 Direct**ifeinseth@tigressfp.com**Philip Van Deusen****Director of Research****(646) 862-2909 Direct**pvandeusen@tigressfp.com**Ernest Williams****Institutional Sales & Trading****(646) 862-2912 Direct**ewilliams@tigressfp.com**Lily Li****Managing Director****Global Wealth Management****(646) 780-8903 Direct**lilyli@tigressfp.com**About Jean:**

Jean Ergas is the Chief Economist for Tigress Financial Partners LLC (Member FINRA, MSRB, SIPC) based in New York City.

He is an Adjunct Assistant Professor at New York University's School of Professional Studies and an Adjunct Faculty member at Manhattanville College. In 2014 he received the award for teaching excellence from NYU School of Professional Studies.

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.

Jean is a member of the American Institute of Certified Public Accountants and has an MBA and an Advanced Professional Certificate in Accounting from New York University's Stern School. He has also passed the FINRA Series 7 examination.

Tigress Financial Partners LLC - Member of FINRA / MSRB / SIPC**Research: (646) 780-8880 research@tigressfp.com**500 Fifth Avenue New York, NY 10110 (212) 430-8700 www.tigressfinancialpartners.com

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