Tigress Financial Partners

Macro Snapshot – Chief Economist Jean Ergas

September 6, 2016

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Are we entering uncharted territory? – See September as firmly in the thrall of politics and politically driven economic strategies – Advise against complacency as per US elections – Never say never!

1 – The stage is set and there has been no dress rehearsal!

Where to in September? Market focus shifts to levers of power

Mood is back to school and investors are starting to focus on a long list of events apt to have a significant influence on the markets. The key shift has been away from the micro – corporate sphere to macro- economic and political risk drivers. Oil continues to play a major role and central bank meetings dominate the calendar.

Social peace no longer a given

While not wishing to proclaim "The end of micro-economics" decision making has been delegated to sovereigns. The concern has shifted from longer term growth to ensuring a modicum of social stability. For the first time since 1945 we are seeing political risk in the ascendant in several of the advanced economies. This threatens social equilibrium – the essential bedrock for the success of macro policies.

Key global corporate driver shall be tax strategy

On the corporate front we see as the major event not earnings but the emerging aggressiveness of supranational entities with regard to taxation. The need to restructure tax driven structures can have a greater impact on both earnings and cash flow over the medium term than cyclical fluctuations. While we are not certain that other cases shall follow Apple - or be of the same entity – we see changes up ahead.

US elections–never say never!

As regards "The Elephant in the room" – the US elections, we advise against excessive complacency. Faced with drastic changes to their "life chances" many voters shall prioritize fears over what some see as economic rationality. We see voters in many countries championing a closing of the global economy and harking back to both social and economic protectionism. As the saying goes – "Never say never"!

2 - Today's action focus

US on holiday – ROW back to school – Russia and Saudi Arabia agree on a prenuptial – Will you still love me tomorrow?
Germany sends a powerful political signal – France shall follow!
We are seeing the limits of monetary policy - Is UK services data a false positive? – G-20 states: Trade is the solution!

US on holiday – rest of world back to school!
The US may have taken the day off but the rest of the world was keeping its nose to the grindstone as in the northern hemisphere schools re-open and the vacations are over! Investors are still seeking to interpret the US employment report and prepare for more monetary tussles at the ECB meeting.

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Lots of data – Two big producers strike an oil deal – or did they?

Meanwhile on the "real economy" front we have received confirmation of slowing of growth in the Euro Zone, stronger than expected services data in the UK and an understanding between Russia and Saudi Arabia to support the oil price.

Coming ahead of the sovereign producer summit later this month this looks like an energy "pre-nuptial". Will they still love each other tomorrow?

Europe under siege?

Merkel under pressure – do not underestimate impact of the regional vote

On the political front, the German chancellor's party has suffered an ignominious defeat in her home state. The CDU finished third. The catalyst was mounting opposition to the refugee policy, lending a massive push to the right wing AFD party.

Some may seek to minimize the significance of the defeat by stating that the AFD is strong locally but not nationally. So was UKIP in the UK! Do not underestimate the capacity of apparently local – fringe groups to trigger change at the political center.

Is this a vote of no-confidence in the Merkel government?

This has prompted questions as to whether this result is to be considered a "no-confidence" vote with regard to the current Merkel leadership. Will Merkel be the candidate next year? We are not surprised by the result, one more manifestation of rising discontent in Europe.

Monetary policy cannot resolve social fractures

Voters are now struggling simultaneously with the dual anxiety of economic stagnation and security concerns. Hitherto the political thrust has been geared to economic targets- seen as the critical support for stability. Monetary policy, as we saw in the case of the UK, is powerless with regard to broader issues of social cohesion.

Get ready for some heavy action in France next year!

We see the German regional election as offering encouragement to those advocating closing political and economic borders. The fact that sacred idols can be lambasted bodes well for the more extremist groups in France and Italy. We do not exclude the National Front candidate in France winning the first round of the presidential ballot next year.

Recently in France, the author of these lines saw the military – paratroops patrolling in Nice and Cannes. There is a widespread feeling that the line between a state of emergency and a state of war has been crossed. One terrorist attack has a far greater impact than a slight improvement in a macro metric.

Shall we see apostasy trials in the UK?

Is Theresa May an apostate? Backsliding on Brexit?

As concerns the vexing question of Brexit, the UK Prime Minister has started to apparently backtrack on two of the Leave campaign commitments. The first and most important is immigration – the driver of the struggle and the equivalent of states' rights in the run-up to the US civil war.

UK cannot have its cake and also eat it!

May has rejected the points based system and seems to be angling with some compromise agreement with the EU. We doubt heavily that the UK shall be allowed to have its cake and eat it. The second is that the monies which were previously paid to the EU shall not be used for the NHS - National Health Service.

The unacceptable face of Brexit – no incremental funding for state health!

We see the NHS issue as key – a reflection of the unacceptable face of Brexit. While May continues to talk about the need to reduce income inequality, not increasing funding on health looks rather stern.

UK services strong – is this a false positive?

UK services sector has come in well above expectations. Whether this means that the UK economy is in robust shape or bouncing back from the initial post vote collapse remains to be seen. Optimists point to this data as a sign of resilience.

More cautious voices focus on confidence levels, a still very weak commercial property sector and first signs of imported inflation.

Japanese government getting nervous about the UK

In this context, the Japanese government has voiced its concerns as to the future trade regime. The implication is that a substantial reduction in access to the EU single market and / or non-participation in multi-lateral trade agreements may cause Japanese companies to reduce their capital investment. This is not inconsequential.

Did the Bank of England panic?

The UK data is also raising questions as to whether the Bank of England was panicked into cutting rates. We do not think so. What we have hitherto been seeing is data coming off a very low immediate post vote level. The first reading was systemic.

Imported inflation lurking in the wings?

We are now seeing a bounce but the outlook is not rosy. Capital in the "gestalt" of the CBI sees uncertainty ahead and pressure on order books. At what point shall imported inflation start to erode the short term currency depreciation bump?

As we have often mentioned, we are seeing windfall profits reflecting the use of inputs bought pre-vote. This could change quickly.

Growth slowing in the Euro Zone – likely to also impact UK

The UK's prospects in the immediate shall also need to be weighed in the light of continued slow growth in the single currency area. While much maligned, the Euro Zone absorbs 40 per cent of the UK's exports. Despite much talk of one-on-one trade agreements, this shall be a hard act to beat.

Is the ECB reduced to shooting blanks?

Waiting for the ECB – will they move at first light?

Is the Euro Zone on a slow boat to nowhere? The Euro Zone composite index for August has been revised downwards. Will this push the ECB to act this week? We expect the head of the ECB to at the very least strike a cautious note and confirm readiness to act as necessary. Further action may be contingent on more data out of the UK.

G-20 – Trade is the solution!

The G-20 conference has trundled on and the spotlight remains firmly on maintaining an "open architecture" for global trade.
Austerity constraints on government budgets are forcing a re-appraisal of trade and absolute and comparative advantage as a catalyst for growth. Time to revise Adam Smith and David Ricardo!

Finally waking up to social aspects of free trade

While support for trade agreements being negotiated was reiterated, we are hearing more about the social component. The fallacy of averages with reference to overall growth rates, has hitherto obscured the impact of almost zero wage cost goods on specific communities.

We see the social focus as laudable but too little and too late.
The advanced economies saw social equilibrium as a constant. It is not.

3 – As we see it and not necessarily as we like it!

In a nutshell!

Central banks still in the ascendant – While pondering next move by the Federal Reserve, this week we shall hear from the ECB – Will they take further measures? Global growth revised downwards by the IMF

G-20 meet and focus is on trade – Are we seeing the end of free trade – Oil continues to weaken – Will there be a re-bound? - Increasing calls from within and outside of UK to invoke Article 50!

4 – In depth overview

This week markets shall continue to grapple with the US jobs report - Federal Reserve likely to take a simplistic view of the labor market

Next week markets shall be still coming to grips with the US jobs report and its likely impact on the US central bank's policy. While the jobs data was below expectation and that low wage positions are dominant should the Federal Reserve opt for a "brute" optic on employment, a rate increase this year cannot be ruled out.

We continue to see this as a likely scenario barring a major political surprise in the US and / or an increase in political and economic instability abroad.

Focus on the Federal Reserve

Shall Federal Reserve be data dependent or act pre-emptively

The Federal Reserve is now left to decide whether to respect its dictum of being "data dependent" or act on a pre-emptive basis. The signs of an upturn in either growth or inflation are not encouraging. Manufacturing – once seen as the workhorse of last resort – continues to be weak while productivity continues to fall.

Waiting for data on services

This week we shall be seeing data on services. These are mostly sold domestically relying on local inputs. This shall give us a more accurate picture of the strength of internal demand and domestic price pressures. The service sector is comparable to a de-facto snapshot of the domestic economy.

Federal Reserve focused on macro metrics in US – systemic risk abroad

With regard to the Federal Reserve's policy we continue to see the US central bank as moving towards its default "Monroe Doctrine" position. The cyclical conventional economic management focus is squarely on the US with external events seen in terms of their potential systemic impact.

In this context, we continue to hear hawkish voices from the Federal Reserve's plethora of messengers. While the arguments adduced for raising rates vary there is a consistency in the end game.

Focus on the US economy

See scant potential for boost to consumption from lower income brackets

We remain cautious on the US internal economy in the light of the minimal wage increases and miserable hours worked data. This data does not bode well for the economy gathering steam via consumer spending from the low income bracket. While previously those who already had spent more, it is now a question of recouping strength in numbers.

The US has hitherto reaped the benefit of an asset bubble wealth effect. Capital appreciation has had the upper hand in spurring purchases. This effect is now waning as the last drips and drabs from quantitative easing flow through the system.

Capital investment strike not simply a function of the elections

Some are pointing to the upcoming elections as a brake on capital investment. We tend to see this as a more engrained reluctance on the part of companies to invest long term in a low growth environment both domestically and abroad.

Irrelevant that Apple moves cash – will it spend it?

Globalization has led to a strong correlation in business cycles across borders making for caution and massive cash buffers. In this context, we see Apple's intent to start repatriating cash as moot. The issue is not moving cash but spending it. We expect to see increasing calls for fiscal stimulus programs.

Focus on government fiscal policy – are we at the turning point?

We shall see the state transition from entrepreneur to risk taker

Previously government intervention in the economy was seen in a context of development strategies – state as entrepreneur. The role has now shifted to government as risk taker. The key issue impacting the global economy is not immediate systemic risk but uncertainty.

State spending and expected demand boost is seen as reducing the risk premium and lowering the hurdle rate for investment. Monetary policy is useless if companies are intent on de-leveraging as opposed to reducing their cost of debt.
Focus on the UK – Are we near the break point?

UK point of tangency between political risk and economy

Turning to Europe, the UK situation continues to be the point of tangency between political - policy risk and the economy. We do not consider it possible to assess the UK's prospects ex-EU exit. The critical issue is therefore the invoking of Article 50 and the start of formal exit negotiations.

UK Prime Minister target of a pincer offensive!

We are seeing a "pincer offensive" targeting the UK Prime Minister. While the UK's erstwhile fellow travelers are urging an end to uncertainty – seen as constraining investment and strategic decisions – internally the ideologically driven "break-now" movement is gathering steam.

UK exit shall be a work in progress

The government has indicated that "The Schism" shall be consummated in the first half of 2017. The clear implication now seems to be subordinating the preparation of a detailed exit strategy to political imperatives. We continue to see the exit as a work in progress with substantial unfinished business at departure.

Priority shall go to the financial sector

With the EU members adamant on the issue of freedom of movement, the UK focus shall now be on setting priorities. We see the crucible as being the safeguard - to the extent possible – of the "commanding heights" of the UK economy, the banks and financial institutions.

Division of labor between government and Bank of England

This shall require a division of labor between the government and the central bank. The banks' position shall be shielded via government negotiations. A managed depreciation of the pound by the central bank is expected to act as a buffer against tariffs on goods.

We do not agree on UK foreign trade!

We are hearing arguments as to the irrelevance of the single market not seen as necessary to trade with the EU. This is missing the key point and assuming that all trade is fungible, which it is not.

EU – low political risk and non-lumpy cash flow

Trading in a low political and credit risk framework where demand and cash flow are constant is infinitely superior to scrambling for contracts in a plethora of economies with vastly differing legal frameworks.

Need to differentiate between finished and intermediate goods

This is also focusing largely on trade in finished goods and ignoring the UK's position as part of the EU supply chain. Specializing on one part of the production process and exploiting specific advantages is extremely profitable.

Focus on the ECB – has monetary policy reached end of the line?

We shall hear from the ECB - will they bite the bullet or wait?

Turning to the Euro Zone, sandwiched between the US jobs data and the Federal Reserve meeting, investors shall be focusing on the ECB meeting next week. The key priority remains preventing a slide into deflation, with price increases still elusive.

What is the impact of extending bond maturities?

Expectations are rife that the single currency central bank shall take action on a broad front. This shall include extending the duration of bond buying and the acceptable maturity of the bonds deemed eligible.

Monetary policy has reached its limit

We see these prospective measures as doing little to drive investment and job creation. Monetary policy and zero interest rates have not been sufficient to act as a catalyst for capital expenditure, leaving an attenuation of austerity policies and government fiscal stimulus as the only solution.

Focus on emerging markets

Chinese economy running out of breath!

With regard to the emerging markets we continue to see investor interest as stemming from the search for cash yield as opposed to macro-economic performance. As regards the Chinese locomotive, we see it as running out of breath.

Chinese overcapacity remains structural

With the transition to a consumer driven economy lagging the government is once again focusing on the traditional manufacturing–exports model. Overcapacity remains structural, increasing deflationary pressures, while the incremental *return on government stimulus is decreasing.*

Focus on oil – is a holding strategy sufficient?

Holding strategy on oil likely not sufficient to create a long term support

We see the oil price as continuing to come under pressure as it becomes increasingly evident that a "holding" strategy is unlikely to be sufficient to reduce oversupply. As an overlay - reductions in global growth forecasts shall temper enthusiasm for drastic measures.

Growth in oil demand in emerging markets not sufficient to offset economic stagnation in the advanced economies

Contrary to expectations, continued growth in several major emerging markets has not been sufficient to offset slow growth in the advanced economies. We see a longer term trend as increasing fuel utilization efficiency in the emerging markets may force a re-assessment of demand forecasts.

Is Saudi Arabia sending us a message?

Saudi Arabia's projected raising via the fixed income markets of US Dollars 15 billion reflects scant expectation of a sustained short term increase in prices. Saudi Arabia is skillfully arbitraging its position as an emerging market with massive FX reserves.

Focus on US election – could there be a surprise?

Gap between Trump and Clinton is closing – beware of the "silent majority".

With regard to the US presidential elections we are following the latest twist and turns in the Clinton e-mail saga. Whether this shall be sufficient to shift the balance towards the Republicans is not clear. What it shall likely do as the gap starts to close shall be to increase volatility.

In the UK silent majority roared – will it do the same in the US?

As in the UK exit vote, the "silent majority" did not speak - it roared. With Trump shrewdly "segmenting" his immigration strategy this may sway some of the doubters.

Free Trade – opposed by all?

Abstracting from the result of the vote – the focus is now on the anti-free trade policy espoused by both leading candidates.
The Trans Pacific Partnership shall have no backers in the White House and the EU-US free trade negotiations are now at breaking point.

Will we see a re-structuring of supply chains?

Decreasing interest in multi-lateral agreements and increasing protectionism do not bode well for supply chain economies. The fact that job losses are increasingly being driven by technology is subordinated to short term political considerations.

Focus on G-20 – Was this all about trade?

G-20 conference – are we seeing "The closing of the global economy"?

At the G- 20 conference the key topic has not unsurprisingly, been "the closing of the global economy'. We are once again hearing clarion calls against the threat of protectionism. We are also starting to hear a contrarian view on the fall in trade growth from the head of the OECD – who dares attack the sacred icon of technology.

Unemployment and shift to low wage service jobs not due to trade but to technology

While free trade is seen as having led to either a rise in unemployment or a shift from high paying to lower paying positions, this is seen as the result of technological advance. This has in turn led to higher productivity, requiring fewer workers. It is not a coincidence that the US produces more manufactured goods today than it did decades ago with three times the workers.

Issue of technology "job snatcher" now being tackled head on – monetary policy powerless against IT

We see this as tackling the issue head on and not letting governments off the hook. You cannot blithely continue to subsidize R+D and "incubators' without being aware of the consequences.

Technological change runs deep

What many have missed is that while the financial crisis was the storm on the surface, seen as controllable via monetary policy, there was a deeper current of innovation leading to changes in employment abstracting from short term shocks to the economy.

US still focusing on TPP and EU- US Free Trade agreement - trade agreement with UK not a priority

Tying together the twin themes of global trade and the UK, the US shows no sign of wishing to make a "separate peace" with the UK over trade agreements. The focus remains on regional agreements, such as the Transpacific Partnership and the US – EU free trade agreement.

Right to negotiate trade agreements does not guarantee improvement on current framework

While it is fine to argue that you are free to enter into trade agreements, this does not automatically imply that:

They shall automatically be better than what is currently available
That your trade partners might not want to also strike deals on a multi-lateral basis.
United we stand has never rung truer!

Will we ever see a concrete move in China to reduce overcapacity?

The G-20 has also decided to tackle the issue of steel overcapacity - one of the many points of contention between China and the other advanced economies. State subsidized overcapacity has both depressed steel prices globally and been a catalyst for deflationary pressures.

While China is pledging to reduce production by 13 per cent by 2020, this shall hardly make a dent in the problem.

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