Ten Seconds Into The Future. July 2014

Equity, bond, FX, swaption and commodity volatility have one thing in common. They have contracted steadily from 2008/9 levels to 2006 levels, almost in lockstep. To some, this is a sign of complacency, to others, calm.

The US economy remains the focal point of the global economy as it is one of the few areas of sustained growth, and its interest rate policy and treasury markets will influence credit conditions globally. In Q1, this growth faltered, ostensibly due to bad weather. Currently, the economy suffers from weak consumption, capex, and exports while at simultaneously facing a manufacturing renaissance and an improving labour market. I expect growth to pick up from Q2 well into the future, driven by a revitalized consumer and a recovery in investment as US capital stock has an average age of 23 years and is overdue for a wave of replacement. As stronger data emerges, it is likely to drive rates higher across the curve. Fed policy is likely to suppress the short end for a much longer time to come. Demand and supply considerations are likely to flatten the curve, so any short term steepening is catalyst driven, likely to be short lived, and should be seen as a buying opportunity, especially at longer maturities. US equities are currently expensive, having run ahead of themselves and risen through multiple expansion in the previous two years. Corporate profitability is also at cycle highs and further gains will require a further transfer of share of output from labour to businesses, a phenomenon the Fed has identified as unhealthy for the labour market and welfare. The relentless dominance of intellectual property in the so-called knowledge-economy may perpetuate this phenomenon. Individuals have limited capacity to accumulate intellectual property compared with institutions. Unfortunately, unchecked the decreasing share of profits due to labour will also lead to further disparity of wealth and income distribution. While corporate prospects are healthy, albeit patchy, corporate bonds remain reasonably priced especially in the investment grade sector. A surfeit of capital seeking high yield has reduced spreads relative to treasuries and high grade to the extent that they are relatively expensive. The outlook for the US remains optimistic, however, conviction around this call is quite

low.

In Europe, the picture is decidedly disinflationary with the exception of the UK and possibly Germany. Rates are likely to remain subdued for some time. In the Eurozone, the economy remains generally weak with pockets of fragile growth. France remains a significant risk as business conditions and sentiment remain weak. Peripheral Europe is picking up, particularly in Spain. Italy remains a problem area. What plagues Europe, generally, is that banks have not reorganized their balance sheets or raised sufficient capital and are therefore not lending, especially to SMEs which are the key to European growth and employment. The ECB has taken steps, notably with two TLTROs in the calendar, to boost bank lending to businesses. These measures are unlikely to work on their own, and more needs to be done, in particular, to improve bank balance sheets to enable lending. Policy is therefore expected to be accommodative for some time to come. New measures are unlikely in the second half as the measures announced in June are implemented and the ECB will want to see how effective they are. One area of particular interest is the vague statement by the ECB regarding its preparations for outright purchase of asset backed securities. Not only is this QE but it could signal the emergence of a liquid market for new securities, possibly with ECB credit support. This is of course speculation but would represent a step change in ECB policy and technology. Region wide, inflation is hardly a problem and fears of deflation are pervasive, with the exception perhaps of Germany. July witnessed the appointment of a new EU Commission President which presages the usual political horse-trading by member countries for key EU appointments to represent their special and particular interests, such as fiscal flexibility in the case of peripheral Eurozone. This occurs amid cynicism and disinterest amongst the people of Europe for the EU.

The UK is a slightly different picture. Growth is robust, albeit unbalanced, with big business taking the major share of the recovery. Concerns over an overheating housing market cast a pall over rates but this is unlikely to translate into immediate and significant policy action. While rates might be hiked, it won’t be by a lot and will probably be later than the market expects. Apart from luxury prime housing in the capital, fueled by foreign money backed by acutely low levels of leverage, the UK housing market is only in its early stages of recovery, and the government will not sacrifice the recovery on account of an anomalous segment of the housing market. Higher rates will choke of the recovery in SMEs which already trail

big business which mostly access the bond markets for funding. Inflation has begun to rise, although it remains below the 2% level at which policy action becomes a real prospect.

Japan’s recovery feels more and more real by the day. Abe’s Third Arrow appears to be material. The concern in Japan is to do with its funding model and its export sector. Globally, exports are facing a wave of mercantilism. Japan’s debt service and refinancing prospects are precarious. Japan is cash flow insolvent. Its trade balance has gone sharply negative for most of 2013 and reserves may come under pressure. The cost of shorting the 10 year JGB is low with the yield at some 60 basis points. Liquidity in the JGB market has also become fickle of late, remarkable for a large sovereign debt market. The question for Japan is if it can grow sufficiently quickly to maintain confidence. Between reality and confidence, always bet on confidence. So far, Japan has the confidence of the market and so the risk on trade continues.

China is an interesting market. It has one of the cheapest equity markets in the world and economic growth, while slowing, remains high by any standards. The risks of excessive credit are well documented and while they should not be ignored, the ability of the central government to bail out the credit system should also be taken into account. Don’t avoid the market for this reason alone, just make sure the fire escape is unlocked. Recent data points to a cyclical recovery, to a certain extent driven by macro prudential accommodation. With a closed capital account, monetary policy plays a big part in prices of assets, goods and services, particular in asset markets where international access is limited. It is likely that as the US Fed begins to slow the inflation of its balance sheet, the PBOC will eventually be under pressure to be more accommodative and this will likely trigger a risk on phase for Chinese domestic risk assets. This may not be too far away. While US rates are unlikely to rise, at least not significantly, for a couple of years, large scale asset purchases are being scaled back. We have seen some signs of monetary easing in China, which might trigger a sustained risk-on phase. Certainly, the sustained underperformance of China assets has led to them being under-owned and risks are to the upside.

A comment about LatAm and Brazil in particular. The World Cup is over, and the hangover has begun. Brazil’s economy has slowed significantly with no respite in sight. Industrial production has been soft and business sentiment is gloomy. As the economy has slowed, inflation has picked up again to over 6.50%. Brazil sovereign

spreads have begun to widen after 6 months of tightening. If Brazil is indicative of the region, the picture is not optimistic. Argentina's sovereign credit issues have added volatility to regional CDS spreads. LatAm is illustrative of export dependent emerging economies as de facto protectionism takes hold. Growth has to be internally generated through more domestic consumption. Without the crutch of exports to lean on, allocative efficiency cannot afford to be confounded by inflexible or policy distortion of relative prices.

Mercantilism is likely to proliferate as the world seeks a new model of growth. The past three decades were marked by accelerating globalization, offshoring, specialization and trade. The credit crisis of 2008 exposed the fragility of over-reliance on trading partners, and countries are seeking to find a better balance between domestic and export drivers. This new balance favors countries with a domestic demand base and disadvantages countries reliant on exports. The nature of domestic consumption is important. That domestic consumer base needs to demand goods and services produced domestically.

Inflation is an important indicator. The current global wave of money printing has not driven inflation, but it has driven asset prices. As long as central banks continue to print, asset prices will be supported. It is when central banks adopt a neutral or worse, a tightening position, that the trade off between goods and assets manifests. Europe will likely see further asset price inflation as the ECB continues to be accommodative and inflation remains subdued. The US is at an inflection where the Fed will slow its LSAP to only recycle run offs. There, assets will compete with goods and inflation will be a concern. In China, inflation is in a manageable range, but this hides considerable effort involving macro prudential policies.

Policymakers, central banks and regulators are always addressing the crises of the prior generation. The focus on inflation fighting led government to lose sight of more dangerous imbalances brewing in credit markets in the years leading up to 2008. Governments today are preoccupied with regulating the banking system and credit markets. It is safe to say the next crisis will not be precipitated by the banks. One risk is the re-emergence of inflation. Central banks have been in easing mode and will become conditioned to it. They may be late to turn off the taps when the barrel is full. This is a less probable risk given that inflation was a recent problem, the one prior to the credit crisis. Another risk is political risk. This can arise from a number of sources. The fracking boom has made the US more energy

independent which has led it to retract from the Middle East leaving it more time and resources to concentrate more on engaging China. This has destabilized the MENA region. This theme is unlikely to reverse soon and things are likely to deteriorate further as the US becomes less engaged in the region. The reversal of globalization is also likely to make the globe a more contentious place as countries become less interdependent. Another serious issue that an entire generation has tried to defer to the next will eventually rear its ugly head and that is of retirement funding. In most developed markets, available data shows impending funding shortfalls for entire generations as they come to retire. Households are generally unprepared and have not considered their financial plans for when they cease to be in gainful employment. For many, their savings will be insufficient, and this does not even take into account risk of illness which may either curtail the period of employment, or increase the cost of care in retirement. No doubt the financial services industry will be first to offer solutions, at a price.