Andrew Hunt Economics Ltd.

Consensus Confounded

Why Global Growth Is Slowing

July 2015

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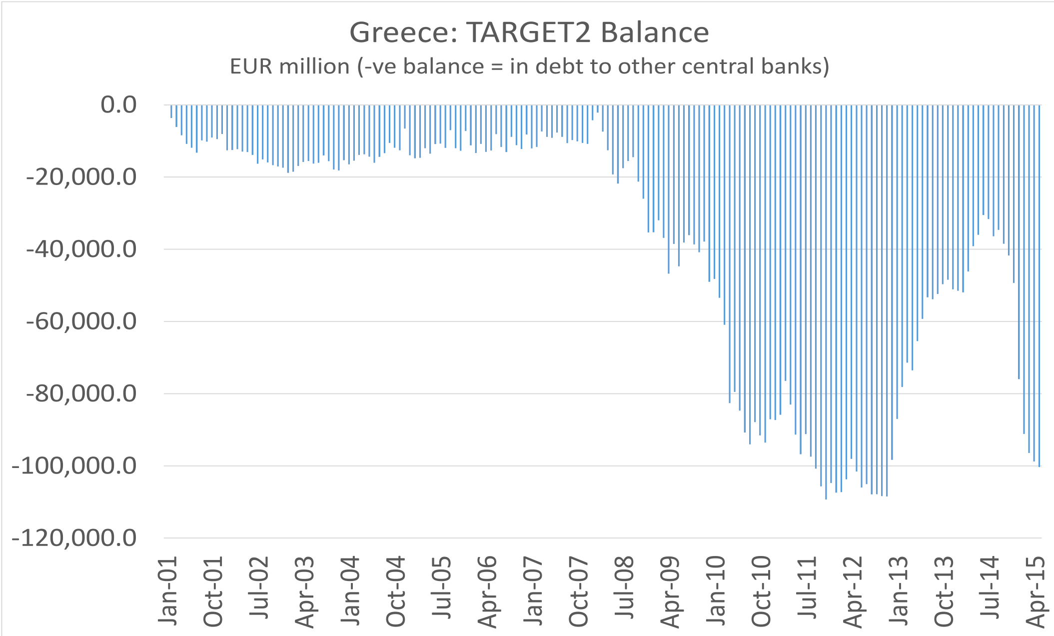
Data Cut-off 14th July 2015
All Data sourced from CEIC unless noted otherwise.

Euro: Problem Children and Trade Shocks

- It is an irrefutable fact that any currency union will involve regions that have been disadvantaged by terms of trade shocks (Wales post 1925); political events (DDR 1990); poor decision-making (Orange County); or simple (alleged) wrong-doing.
- However, a successful currency union must accommodate these areas via fiscal transfers.
- Wales currently receives proportionately 50 times the fiscal aid that Greece gains.
- The (English) policy of forcing deflation in Wales in the late 1920s was disastrous – and we are a little worried again.

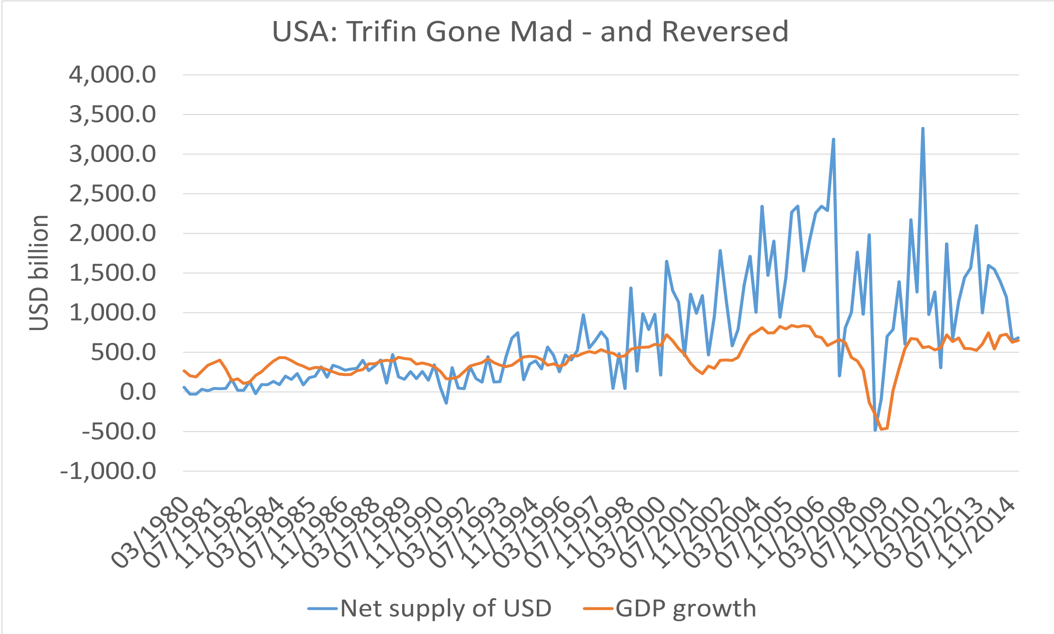
Greece: Kicking the Can Up the Hill

- The EU's and IMF's push for regime change in Greece is reminiscent of the Lehman / Fuld Affair.
- Ultimately, Greece must default. The maths does not add up for it to do otherwise.
- Germany's demands are kicking a can up the hill – it will roll down again!
- Greece will default, the question is on what? Defaulting on T bonds is 'ok'.
- If Greece defaults on TARGET2, it will likely force a deflationary reform of the way in which the ECB works.



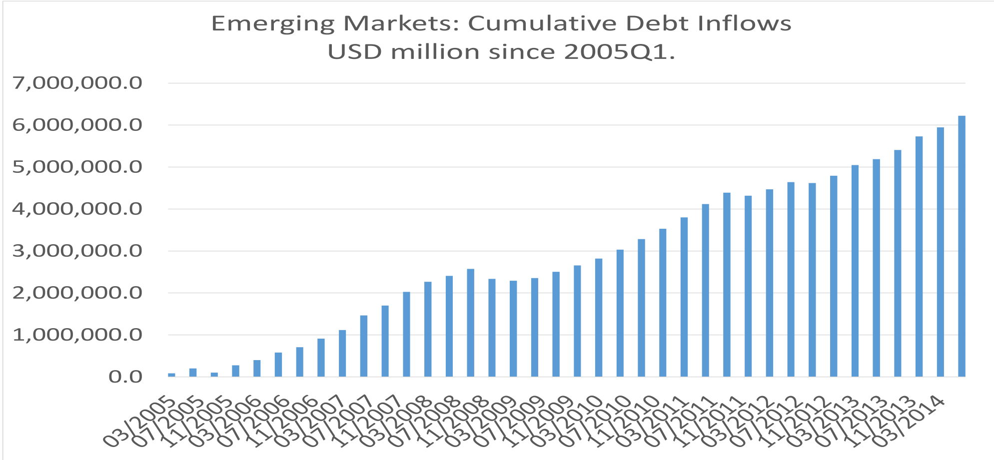
Primary Theme: Unwinding 20 Years

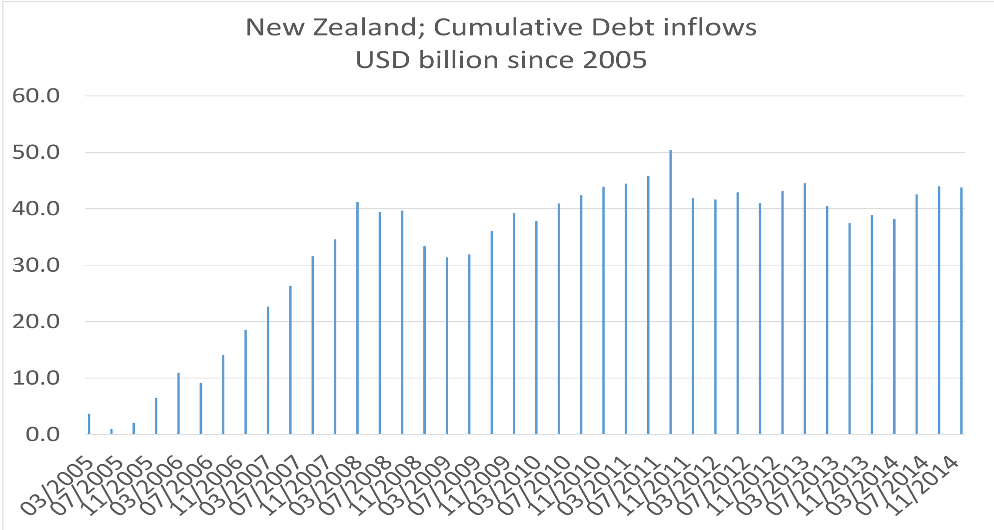
- The Federal Reserve's forbearance of a massive domestic credit boom post 9-11 and its response to the Global Financial Crisis created many more dollars in the world than could possibly have been needed.
- The glut of dollars led to a collapse in yields and to investors seeking capital gains & alternative stores of wealth around the world.
- *However, these (predominantly) credit flows may now be being repatriated.*



Over-owned Currencies, Out-sized Positions

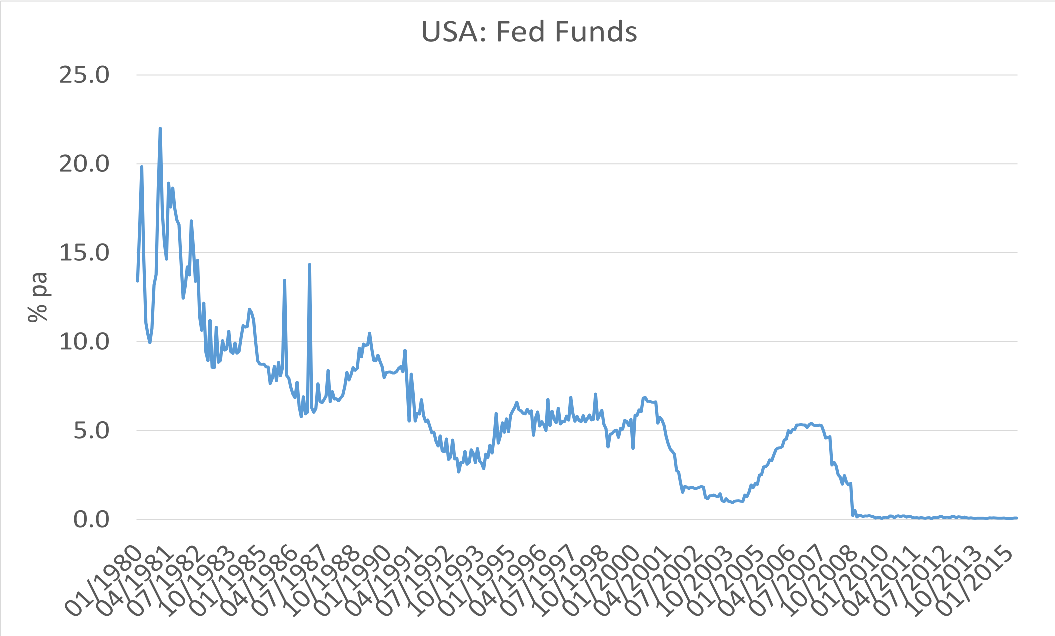
- The majority of the funds that were invested during the capital flows boom are currently held in (once) high-yielding currencies or EM 'concept' currencies..





Are Central Banks Still Predictable?

- The Greenspan Fed exceled in being predictable and this contributed to the explosion in global capital flows noted above (and the GFC).
- Now, central banks have become less predictable.
- Failed forward guidance regimes, "dots", vague data dependency, and unclear exit strategies each represent a move back to the 1980s' more unpredictable model of central banking.

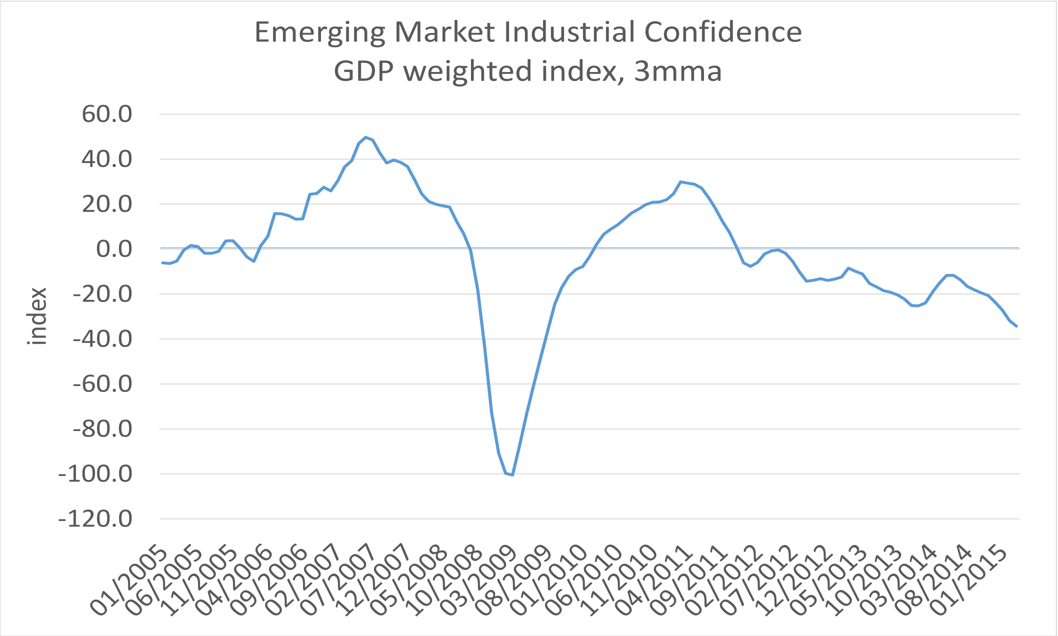


A Sea Change in the Emerging Markets

- The changes in 'G3' central banking behaviour has triggered a massive change in the direction of capital flows.
- Few of the former recipients have been immune.
- Even China has suffered record-breaking capital outflows.
- China's companies and even some public sector entities must raise cash to repay loans and fund outflows

EM Confidence Weakens

- Unsurprisingly given the situation, industrial confidence has slumped in the EM.
- We detect crisis-like conditions in some countries (Brazil, Puerto Rica, Turkey and of course Russia).

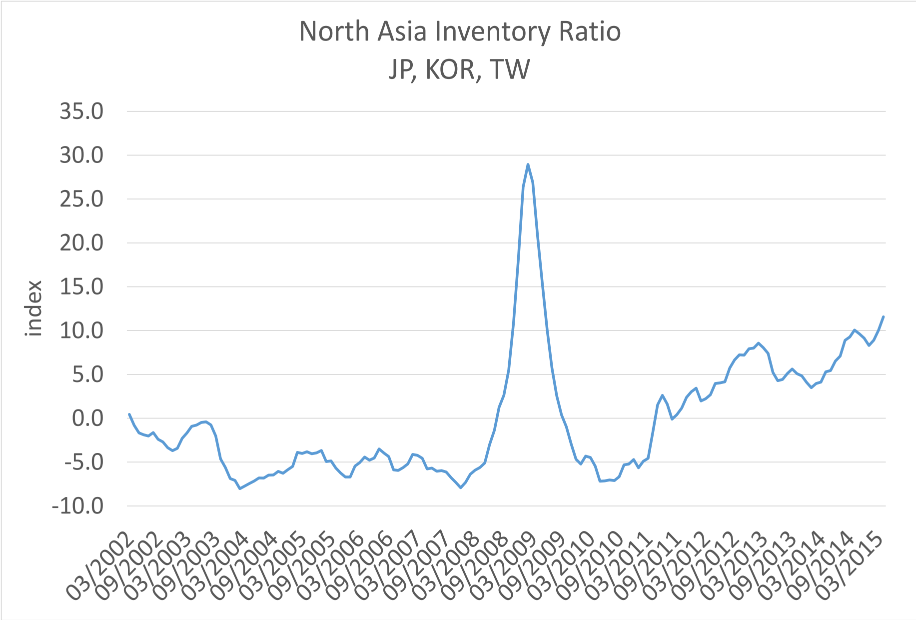


Impact on CAPEX Predictable

- Companies - or their bankers - need to raise cash in order to repay their debts.
- Hence, corporate austerity has become *de riguer* in the EM.
- Companies have cut back on CAPEX – we may be experiencing an EM CAPEX recession.

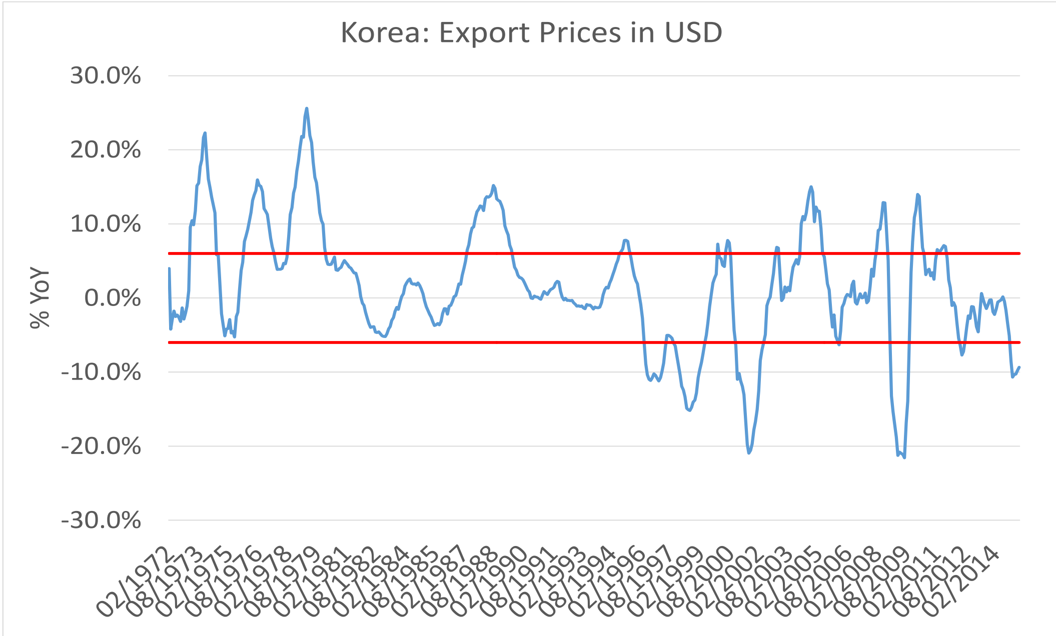
Inventory Liquidation

- Companies cannot afford to continue holding large inventories of unsold goods.
- However, faced with a weak world trade environment, clearing inventories is proving problematic.



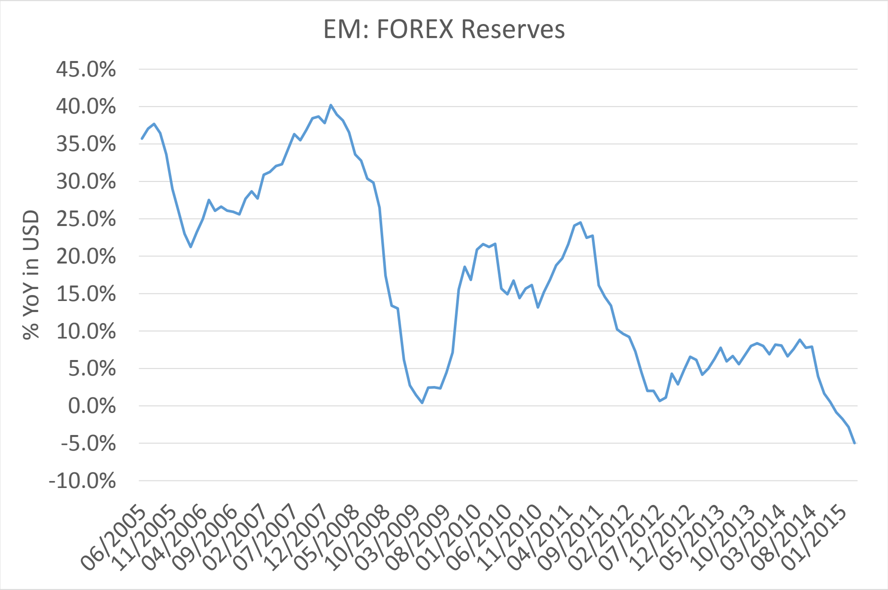
Deflation Part 1

- The need to reduce inventories has resulted in competitive currency movements and heavy price discounting by exporters.
- World trade price deflation remains firmly in the danger zone.



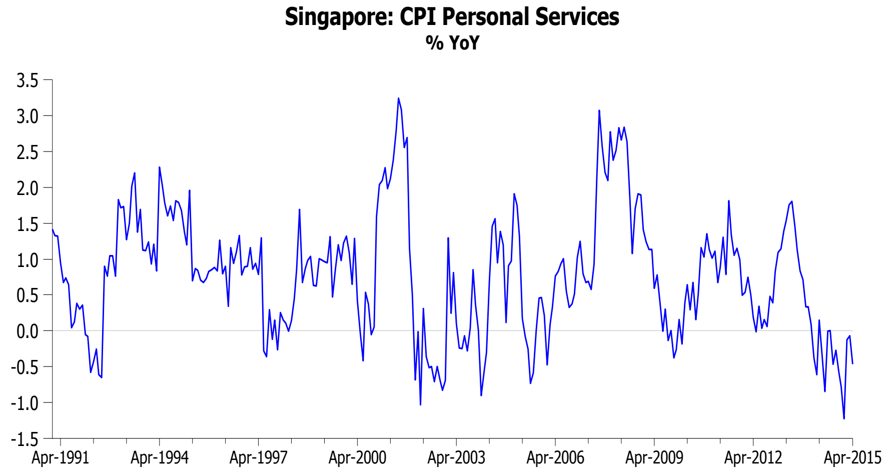
But Surpluses Not Large Enough

- However, even the high level of corporate austerity has not been large enough to fund all of the capital outflows.
- Hence, the countries are losing FOREX reserves.
- Lower reserves imply lower rates of reserve money growth and therefore a (deflationary) cooling in their domestic credit cycles.



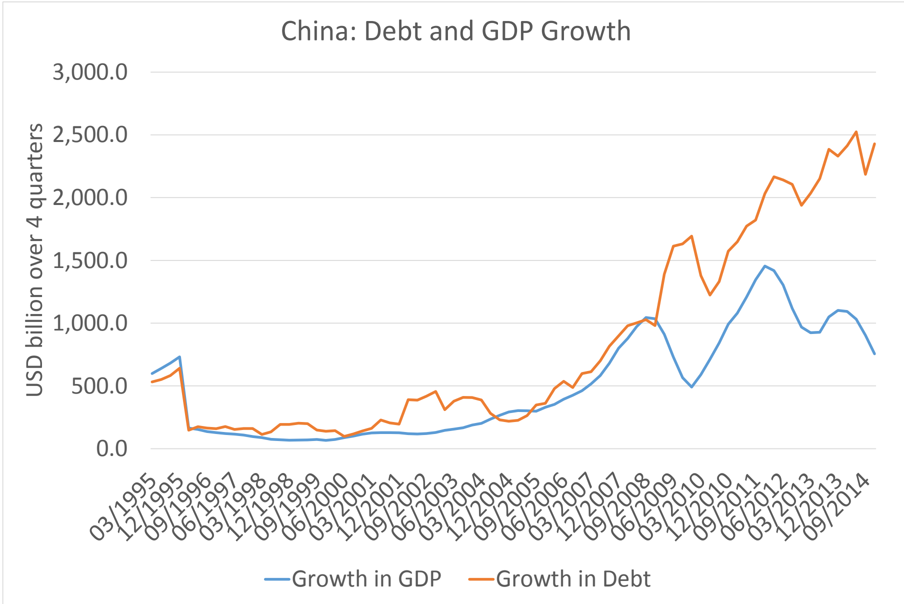
Deflation a Reality in Asia

- The slowdown in credit and consequent softer domestic economies has become yet another source of deflation within these economies.



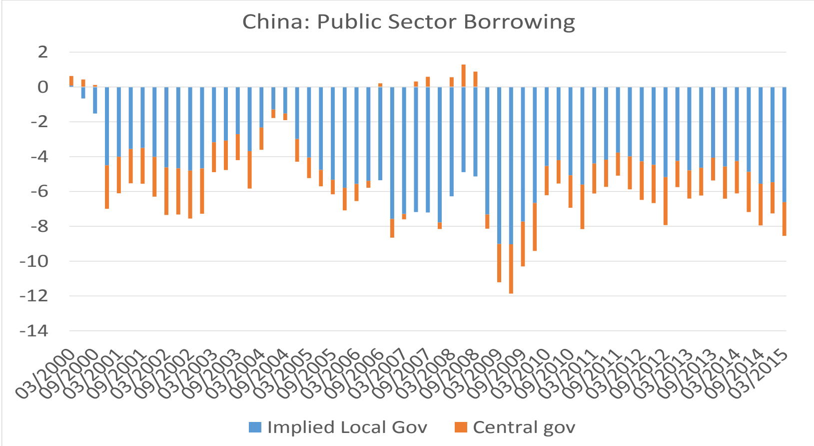
China: Simply a Huge Credit Boom

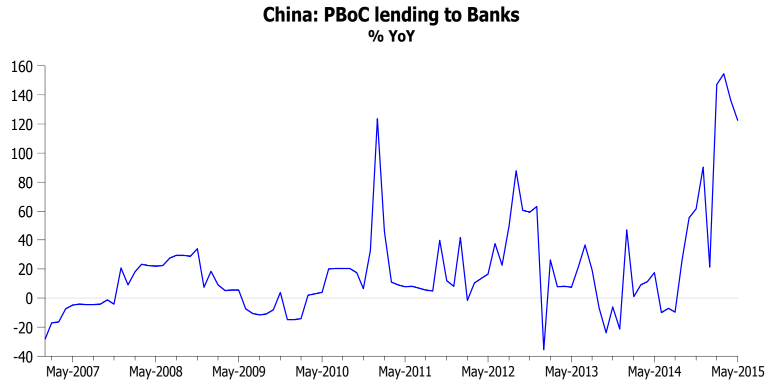
- Much of China's post 2007 growth was simply the result of a credit boom that funded an expansion in 'Local Government' spending.
- The increase in Local Govt spending may have accounted for a quarter of global GDP growth since the GFC.
- But now, 65 000 officials have been arrested and credit conditions have tightened.



China: Fiscal Policy Has Been Used

- Contrary to popular expectations, fiscal policy has already been eased.
- The central bank has also been active.
- Moreover, the attempted debt to equity swap via the stock market has ended.
- China is running out of policy levers.



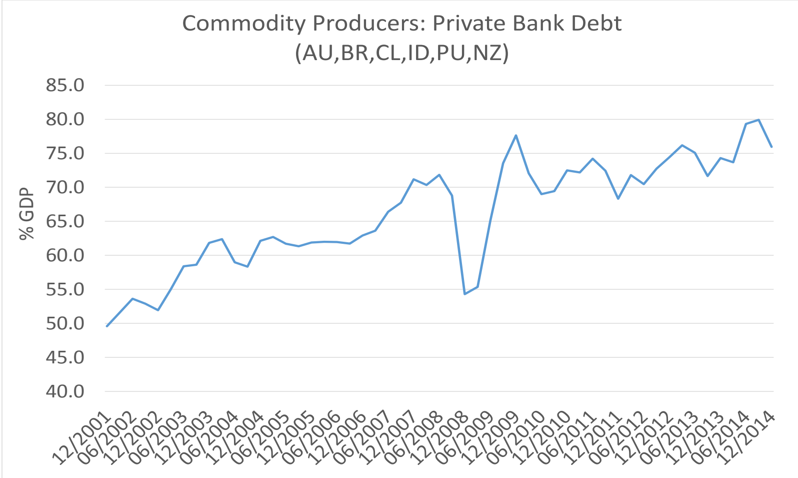


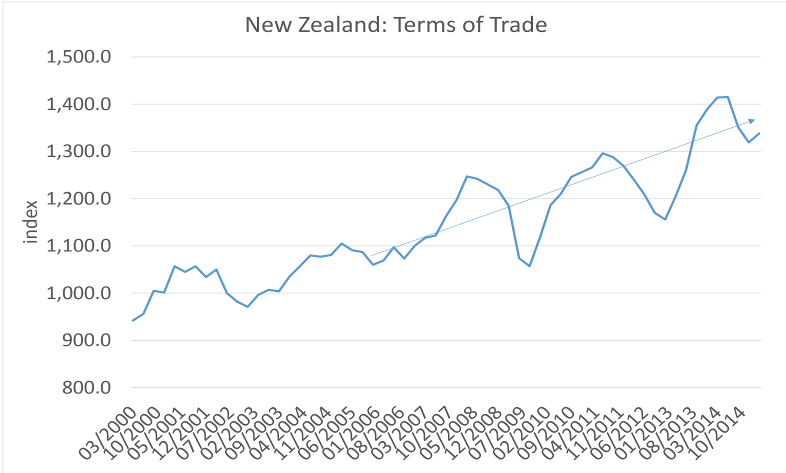
China: Running Short of Time

- China's economy is however weakening rapidly – hence the currency lever may be used before year end.

Commodity Currencies: Next in Chain

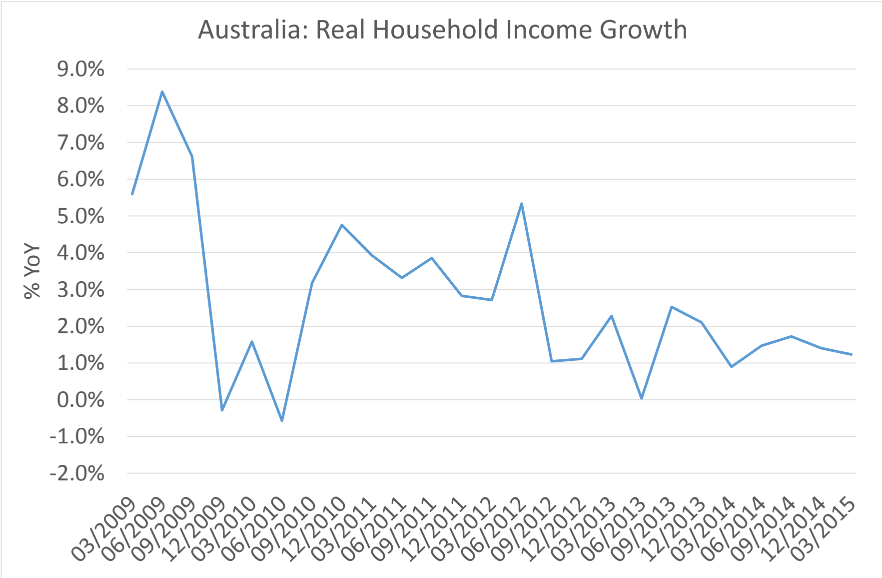
- The commodity producers have been badly impacted by the contraction in 'industrial EM' imports noted earlier.
- Unfortunately, many of these economies had incurred significant debts of their own during the commodity price bonanza.
- Now they must re-consider their previous income expectations given the changed outlook for EM growth and hence commodity prices.





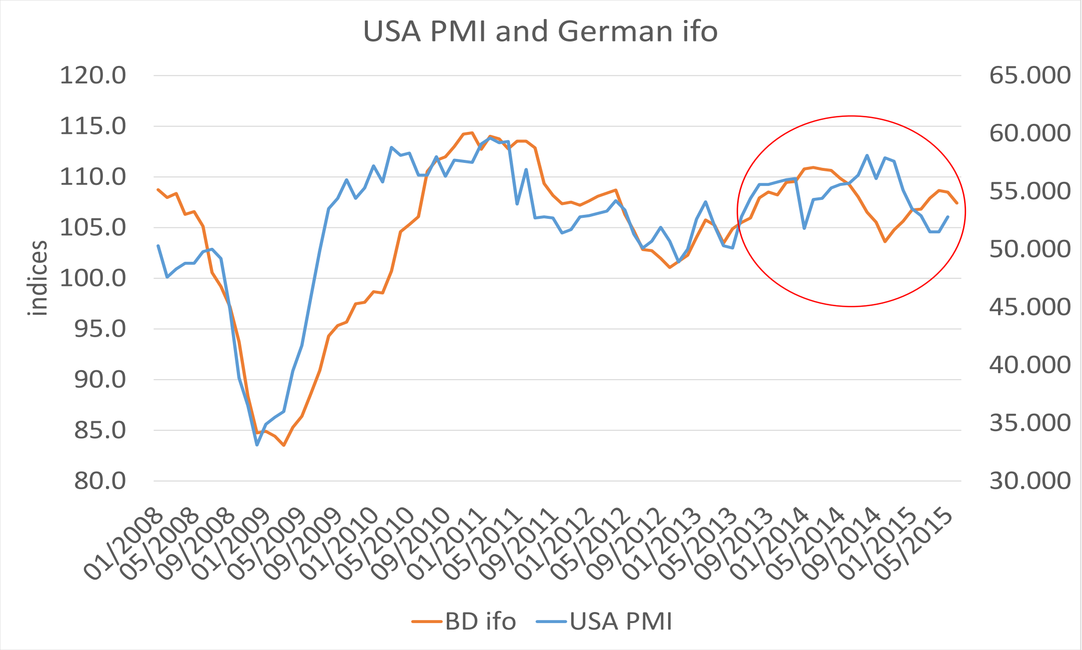
Policy Makers late, and Constrained

- Policymakers in many of the commodity producers are in a difficult position.
- They perhaps believed too much of the hyperbole re China *et al* and are now behind the curve.
- Now, they need to reduce rates but their currencies are home to huge 'carry trades'.
- Reducing rates may create outsized currency moves, adding to deflation and global currency "vol." that makes matters worse



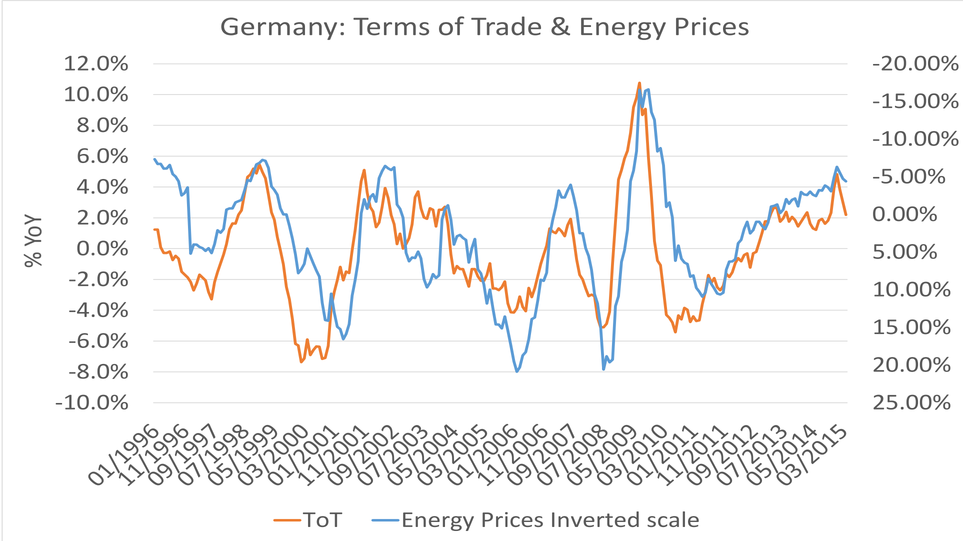
ECB: Beggar Thy Neighbour

- Europe also decided to join in the competitive devaluation game to save its exporters – albeit at the expense of others.
- This is not a spurious inverse correlation.



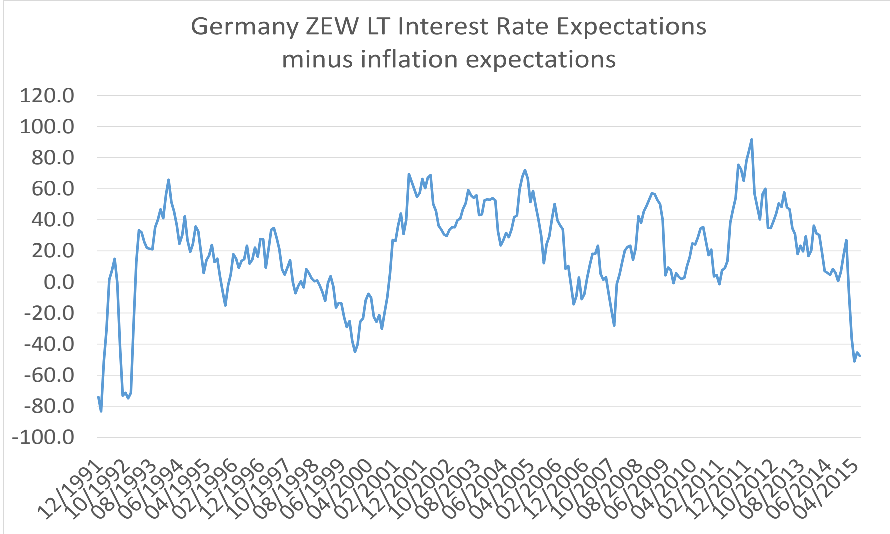
Europe: Households Saved By Terms of Trade

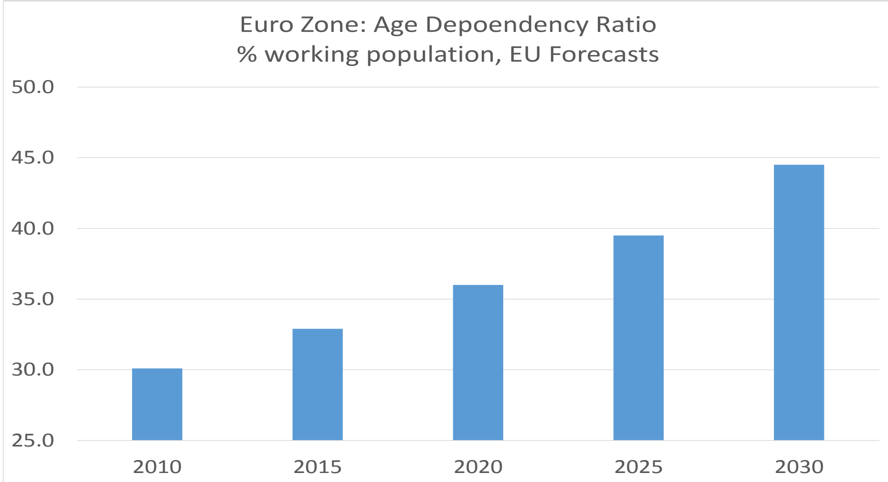
- In theory, the weaker Euro should have imparted a 'hit' to European domestic real incomes as import prices.
- However, this did not occur thanks to the weakness in commodity prices.
- Instead, Europe gained a 'temporary' terms of trade gain and a weaker currency. This was notably fortuitous for Europe, if not for the commodity producers.



Germany: Inflation Expectations

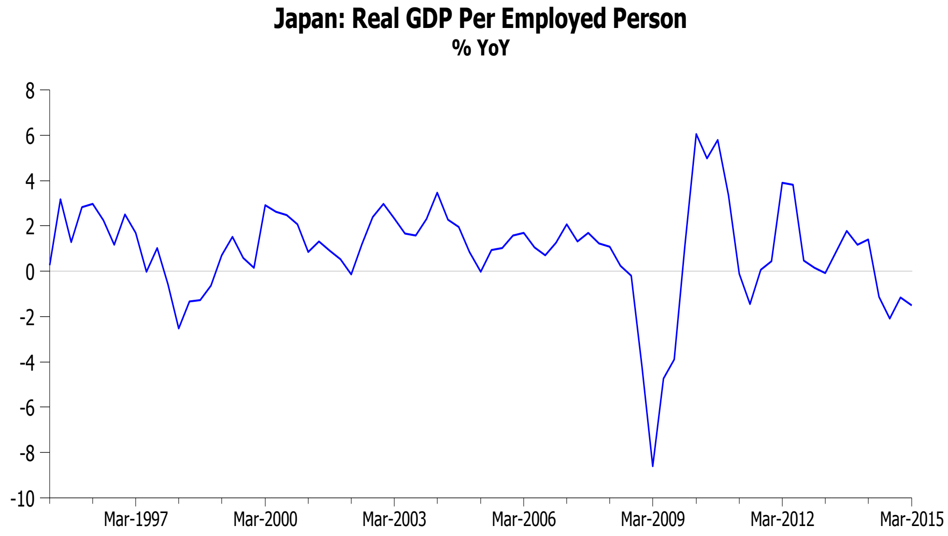
- However, as the ECB promised to do more and to weaken the Euro, Germany's ageing population sharply revised down their expectations for real yields and expected returns.
- The shock to German perceptions of their Long Term wealth seems to have been as severe as *GEMU*.





Japan: Disappointing Productivity

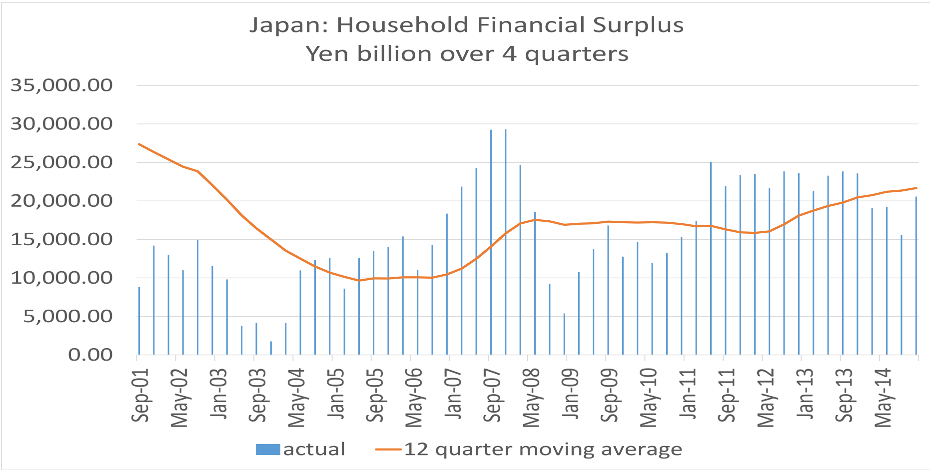
- Abe has promised much in Japan including faster GDP growth.
- *However, to achieve faster trend growth, Japan needs faster – not slower -productivity growth.*
- Has Abe stimulated the "wrong sectors"?



Japan: The Need to Rebuild Savings

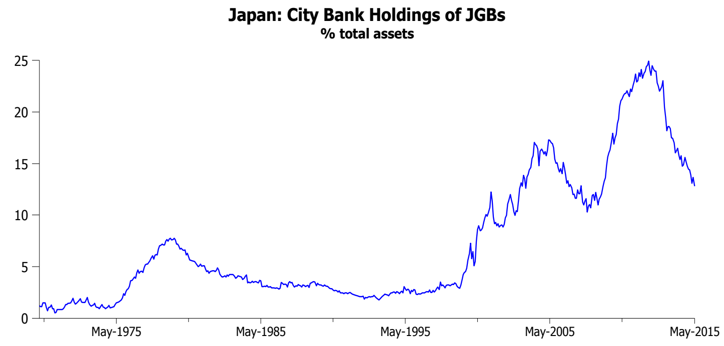
- Japanese households needed to rebuild the savings that they lost last year when taxes increased.
- The benefits of lower commodity prices have been lost to domestic savings.

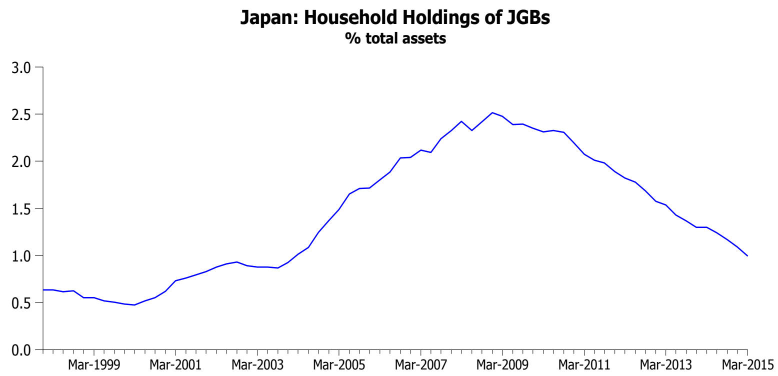
  Hence, growth remains anaemic.



Japan: Time to Exit

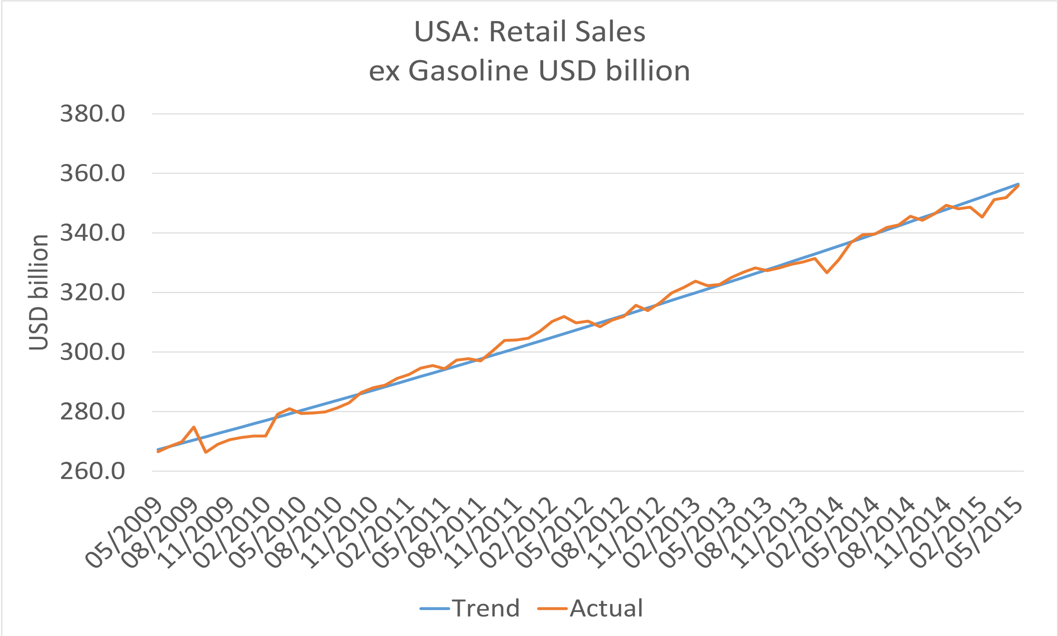
- Despite its lack of ‘success’, we understand that the BoJ is contemplating a tapering in the Spring.
- JGBs might well weaken, but would this matter now that so many are owned by the BoJ itself?
- We are no longer short JPY.





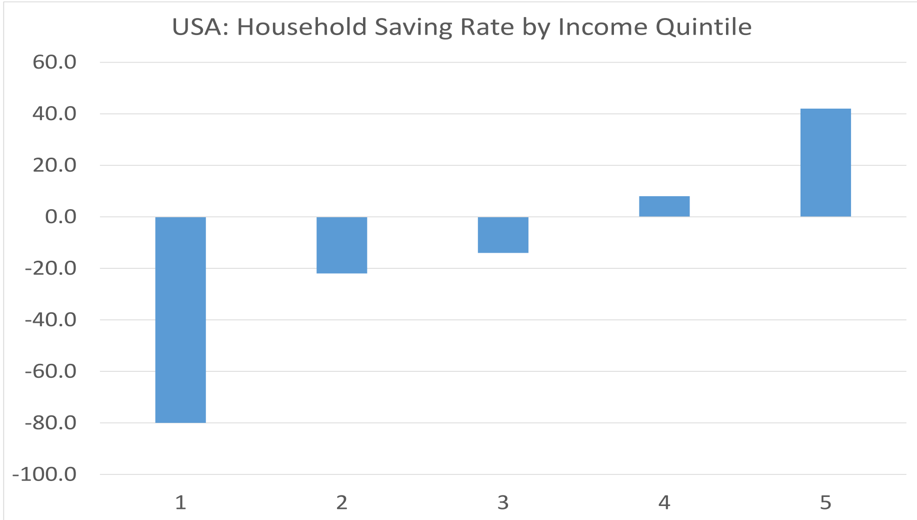
USA: Weak Consumption Persists

- US consumer trends remain modest, we see few signs of a meaningful acceleration



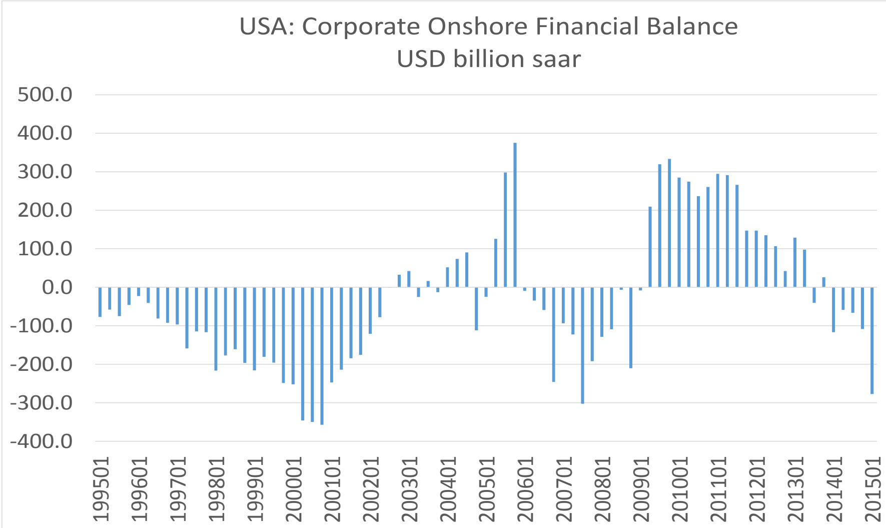
USA: Households Can Save!

- Post the GFC, the US became an expensive place for many residents.
- Hence, two thirds of people could not save.
- Since commodity prices declined and subsistence costs fell back, more people have been able to save.



Deflation and Corporate Profits

- As goods prices have declined and compliance costs have increased, corporate profits and corporate cash flow have come under pressure.
- This bodes ill for CAPEX and even employment in 2015H2.
- Those with jobs will be 'wealthier' – perhaps.



Conclusions

- Deflation has arrived in global goods markets following the beginning of the unwind of the Great Global Dollar Carry Trade.
- The carry trade was the result of "Triffin gone mad" but an unwind of the carry trade could provide an immense deflationary shock to the system if uncontrolled.
- So far, the unwind of the dollar carry trade in Asia has not proved destructive to global asset prices simply because the EM countries have been prepared to 'supply a significant proportion of the necessary dollars' from their FOREX reserves.
- However, now that their real economies are wilting, more of the EM may soon have to resort to the 'currency lever' in order to protect nominal GDP growth in their indebted economies. This would add to global deflation.
- The commodity producing countries are also now in a precarious position.
- Global growth seems likely to disappoint in H2, deflation remains a threat, and unless the US banking system can be made to reflate, global liquidity may already have peaked.
- We fear that the dichotomy between the state of the global real economy and the financial markets is becoming unsustainable. "Dance but Dance by the Fire-door and Listen for the Bell."

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