ECU

Interview

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Weekly Report
June 9
2015

Robust Employment Keeps Fed on Track

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1 What next for Europe?

Q Andrew Rozanov

So we seem to have lived through and survived the eventful macro day of last Friday, which threatened a potential 'triple-whammy' of a Greek debt default, a 'runaway' US jobs report, and the risk of an increase in oil production targets at the OPEC meeting… Where does that leave the markets now?

A Neil MacKinnon

Well, thankfully, the 'triple-whammy' you mention didn't translate into a 'Black Friday'!

The US non-farm payroll employment report for May helped validate the Fed's thesis that weakness in US activity in the first quarter of the year was 'transitory': a 280,000 increase in jobs, with positive data revisions to the two prior months, was better than expected. A marginal increase in the unemployment rate from 5.4% to 5.5% was simply a function of an increase in labour supply, which in itself might be a positive development reflecting improving confidence of people coming back into the workforce looking for a job. Average earnings growth ticked up

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to 2.3% from 2.2%. However, the decline in US labour productivity growth is a worry, and it is pushing up growth in unit labour costs to nearly 7%. And lest we forget, in most of the major economies, unit labour costs account for about two-thirds of total costs, so this is something the Fed will have to keep an eye on, in my view.

"... there will be no getting away from the fact that Greece has technically defaulted."

OPEC kept its 30 million barrels per day target unchanged, and the Brent oil price finished lower on the week. The supply/demand imbalance in the oil market has certainly shrunk, so precipitate declines in the oil price are unlikely. Which leaves the Greek problem still potentially hanging over the market. The government there missed the scheduled €300 million payment to the IMF, which is a first for any advanced economy in the history of the IMF. The repayment is reported to be 'bundled' into a larger amount to be wired on 30 June when Greece is scheduled to pay an additional €1.5 billion. The likelihood of that happening in full and on schedule is slim. If so, and allowing for 'periods of grace' from the IMF, there will be no getting away from the fact that Greece has technically defaulted. Deposit outflows from the Greek banking system are accelerating, with Greek bank stocks down some 10-15% last Friday. **The bottom line is: at 180% of GDP, the Greek government debt is unsustainable, and another restructuring is inevitable, thus imposing a haircut on Greece's official creditors, who currently hold 90% of the debt**. In addition, it is quite likely that Greece will have to introduce capital controls (though most of the money is probably abroad now), and potentially exit the monetary union.

A Kit Juckes

I agree that in Europe the Greek debt crisis continues to be a major focus. Towards the back end of last week, it looked as though a deal was near, but pessimism has returned. The Greek Prime Minister, Alexis Tsipras, is struggling to meet the demands of both Greece's creditors and of his party. A glance at the press and the blogosphere produces a number of essays on the perils Europe faces if it lets Greece leave the euro, as well as a number of articles making clear the frustration with the Greek leader's negotiating style. I think it is a safe bet that **whatever kind of deal is finally agreed, it won't be a long-term, stability-inducing solution**.

In the meantime, German bond yields continue to gyrate furiously. Last week, the ECB President Mario Draghi more or less told markets to get used to more volatility, just when most market participants were expecting a reprise of Benoît Coeuré's more calming words from the previous week. Most long-term investors are looking at the world and seeing very few reasons to own government bonds right now. If the bond-market sell-off goes too far, they won't find current equity market or indeed emerging market valuations terribly appealing either!

2 The US

Q Andrew Rozanov

Let us now turn to the developments in the US economy and what markets should expect from the Fed. Neil – you have been a staunch proponent of the view that the Fed will probably raise rates sooner rather than later, and until last week you were in a self-proclaimed 'minority of one' suggesting that a rate rise was still on the cards for the 17 June FOMC meeting… Now that the May non-farm payroll report is out, what are your thoughts?

A Neil MacKinnon

Well, I still believe the Fed ought to take action sooner rather than later, and I think that the US jobs report was strong enough to put the 29 July FOMC meeting in the frame for a possible hike in the target range for the Fed Funds rate. My previous – and, as you say, rather isolated – call for a rate hike at the 17 June meeting now seems too early on my part. Humble pie is now on the MacKinnon menu!

But what we have seen, as Kit correctly pointed out just now, is an increase in bond market volatility, with Mario Draghi's warning of precisely such a development at his press conference last Wednesday coming right on cue. However, this increase in volatility can be traced back to the earlier 'flash crash' in German bunds. **Periodic 'flash crashes' have become more frequent and reflect the liquidity paradox, whereby actual market liquidity has shrunk in spite of ample liquidity provision by central banks**. I agree with Kit that this volatility can easily spill over into the US equity market, which is now in its second longest stretch without a 10% correction since 1929!

Since the start of the year, the S&P 500 index has traded in a very narrow range, but it is widely documented that valuations are historically quite stretched. M&A volumes are at a record high, as is margin debt on the NYSE. The bulls will say "so what?" and point to a variety of commentators calling the top in the last 18 months or so, yet the market keeps grinding higher. My own view, which I have previously expressed in our discussions, is that **a 10% plus market correction is looming**. The Fed move, when it happens, is surely priced in, and the Fed is likely to wrap any hike in a large dovish wrapper. Recent speeches from senior Fed officials such as Stanley Fischer acknowledge the impact of tighter US monetary conditions on emerging market economies. The Fed also does not want a 'runaway' US dollar, given that the profits of 40% of S&P companies come from overseas.

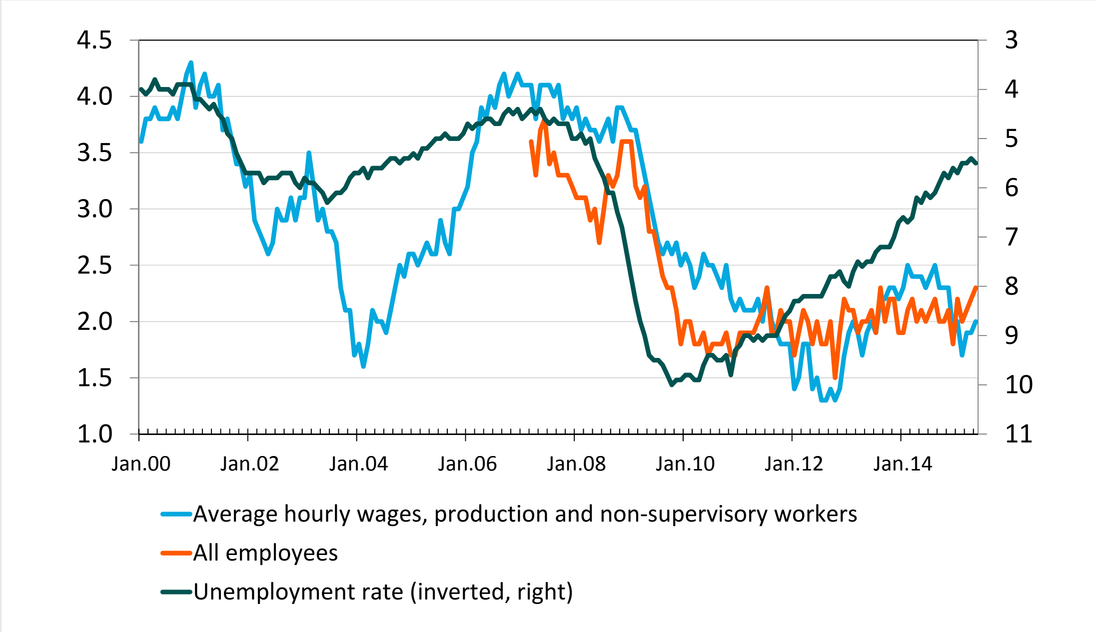
"... the Fed is likely to wrap any hike in a large dovish wrapper."

A Kit Juckes

The monthly US employment data often sets the tone for financial markets, and it's certainly useful for benchmarking where the world's biggest economy is. Of late, the pattern has been one of reasonably robust employment creation, while wage growth remains in a narrow range and the unemployment rate falls steadily. The absence of a pick-up in wage inflation (or indeed signs of any other kind of inflation) has allowed the Federal Reserve to maintain its super-easy monetary policy, supporting equity markets just about everywhere.

Since 2010, US real GDP has grown by 11%, which is an annual growth rate of about 2.25%. This has been achieved with the help of an 8.8% increase in non-farm employment and a 2% increase in the labour force. In the process, the unemployment rate has fallen to around 5.5%, and hourly wage growth has edged up from 1.9% (year-on-year) five years ago to 2.3% in May 2015, averaging 2% (compared to 2.9% in the three years before that).

US Wages and Unemployment



Source: The ECU Group plc, Bloomberg

The long-term challenge facing the US is the measly 0.5% difference between GDP and employment growth in this cycle, which is a problem the US shares with the UK. That's going to rear its head properly when 'full employment' is reached, wherever and whenever that happens. But consider that with an unemployment rate at 5.5% now, down from 9.8% in April 2010, a simple extrapolation would get to 5% – which is one possible guess of where full employment level might be – by the end of this year. So there might only be another seven months during which employment growth can safely remain at a faster pace that labour force growth. Then what?

As far as GDP is concerned, labour force growth has picked up to 1.1% in the last year. Demographics suggest this cannot continue indefinitely but, for now, it puts a best guess of trend GDP at between 1.5% and 2.0% per annum. Anything faster will have to be accompanied by even lower unemployment. Will that happen? Will it be accompanied by an acceleration in wage growth? And if so, will inflation follow as night follows day? Conventional wisdom is that once the US is at 'full employment', wage growth will start to pick up. In the last two cycles, the trough in unemployment was 3.8% in 2000 and 4.4% in 2006, but by then wages were rising at 4% per annum. The same conventional wisdom would also hope that productivity picks up at the same time. But there is a trade-off which happens at that point: how much faster can nominal GDP grow, and how much does the split between real growth and inflation change? At the moment, nominal GDP is growing in a 3.5-4.0% range, and real growth is in a 2.0-2.5% range. **If more productivity cannot be found, then real growth will be heading lower, while inflation will be heading higher**.

A Neil MacKinnon

To be fair, we shouldn't just be looking at the headline number in the jobs report, which was unambiguously solid. A more detailed breakdown of the mix and quality of job gains was actually quite variable. David Stockman, the ex-White House economic adviser, pointed out that the goods-producing sector of manufacturing, construction, energy and mining generated job gains in the month of only 6,000. Employment in this group is 11% below its pre-recession level. In contrast, jobs in health, education and social welfare sector increased by 84,000 and jobs in the hospitality and leisure sector, which are often part-time and low paid, increased by 57,000. It is this mix of low pay and variable hours that dominates the jobs picture and probably explains at least some of the sharp drop in labour productivity growth for the economy as a whole.

"Keep in mind that consumer spending accounts for 70% of the US GDP."

Keep in mind that consumer spending accounts for 70% of the US GDP. Perhaps US consumers are still cautious even several years after the financial crisis and do not want to get caught out again by being too highly leveraged. But if David Stockman is right, then the job gains that are mainly confined to low paid, low productivity workers in the service sector simply do not have the 'bang for the buck' to fuel a surge in consumer spending. If so, this would chime with the 'secular stagnation' thesis that envisages a long period of sub-par economic growth and declining productivity potential.

A Kit Juckes

My own bias goes roughly as follows. Competition from technology and from the rest of the world will continue to act as an anchor for labour costs, but won't prevent an acceleration in the coming months. The tight range of the last few years is likely to be broken by an acceleration towards 3.0%. That, in turn, may indeed boost the economy because stronger real wage growth in a consumer-led economy is a positive. It doesn't mean that the 'new normal' of weaker trend growth has gone away, nor does it mean that we are entering some new inflation age. But it does mean that we'll see stronger growth in the next couple of quarters, and it probably means that the 17 June FOMC meeting will see a statement that keeps the Fed on track to finally deliver a rate hike in September. That is probably all it takes for bond yields to continue trending higher, albeit erratically, and for the dollar to strengthen.

That's the general backdrop to global markets right now. In addition to which, of course, there are a number of cross-currents. Oil prices have stopped going up and commodity prices generally are drifting lower again. There's a chicken and egg relationship between a stronger dollar and weaker commodity prices that can easily spark an overshoot on the downside for the currencies of commodity exporters. A new multi-year low for, among others, the Australian dollar is possible before long, and if we see government bond yields in major markets head higher at the same time, beware frayed nerves across emerging markets!

A Neil MacKinnon

Actually, if we look at the 10-year US Treasury yield, it has been on a rising trend since the beginning of the year. Last week's warning by Mario Draghi about an increase in bond market volatility was well timed. My guess is that this upward trend will continue, with the trading range ratcheting up slowly. Inflation pressures are modest, and as I said before, when the Fed does move it will likely be presented dovishly.

US 10 Year Treasury Yield

Source: The ECU Group plc, DataStream

3 Forthcoming data releases

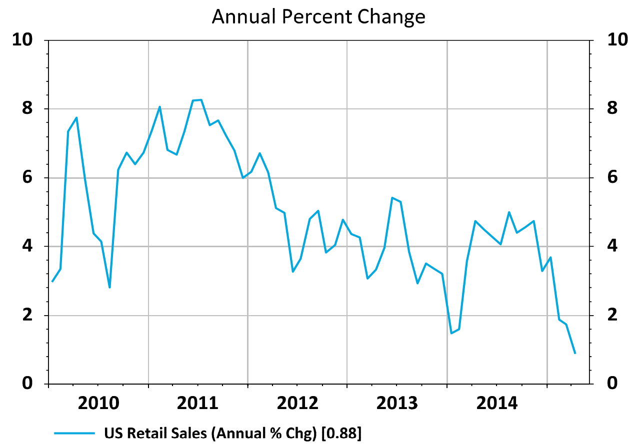
Q Andrew Rozanov

So what are you focusing on this week? What should investors be watching in terms of macro data releases and scheduled policy events?

A Neil MacKinnon

Well, after last week's potential 'triple-whammy', there is less macro data on the agenda. **The most important data releases are the US retail sales data on Thursday, and the next batch of monthly trade and activity data out of China**. In the prior US retail sales report, spending was unexpectedly flat. US consumers have been saving their 'dividend' from lower energy prices, which the OECD estimates is equivalent to a tax cut of US$500 billion.

US Retail Sales



Source: The ECU Group plc, DataStream

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However, there are some bright spots. Auto sales have had their best month since 2005, though I dare say a lot of the sales increase is down to an increase in auto credit. However, real incomes are rising as labour market conditions improve and my guess would be that we will see a rebound in spending. As households have been saving more, the latest report from the Congressional Budget Office (CBO) shows that the US budget deficit for fiscal year 2015 is set to be some 10% lower than last year, close to 2.5% of GDP compared to a peak of 10% in 2009.

Chinese economic data should confirm the recent trend of a growth slowdown. Meeting the official GDP growth target of 7% for this year now looks very demanding. 'Actual' growth is likely nearer 4-5%, with the probability of a 'hard landing' increasing. Interest rates have been cut three times in the last six months, and more cuts are in the pipeline. However, the extra liquidity is being funnelled into the Chinese equity market rather than into the real economy. The Shanghai Composite index rose by nearly 9% last week, making it the best equity market performer for the week. This certainly looks and feels like a 'bubble'.

China Shanghai Composite Daily

Source: The ECU Group plc, DataStream

Speculative activity by Chinese hedge funds in the Dalian and Shanghai commodity markets is also rife. An accident is waiting to happen here, and it would be no surprise if a hedge fund blows up triggering a classic crisis.

4 Japan

Q Andrew Rozanov

Just before we conclude, what about Japan? There seem to be some encouraging data revisions coming out of Tokyo earlier this week… Dare one hope that 'Abenomics' is perhaps beginning to bear fruit in the real economy?

A Neil MacKinnon

Indeed, the latest Japanese GDP data featured an upward revision in annualised growth to 3.6% from 2.4% in the initial estimate, mainly due to upward adjustments in capital spending and inventories. Consumer spending, however, was left unchanged, reporting growth of just 0.4% annualised. In my view, stronger headline GDP growth is unlikely to result in imminent monetary easing from the BOJ.

A Kit Juckes

"BOJ Governor Kuroda rather colourfully referred to Peter Pan as an inspiration for monetary policy..."

Is Abenomics working? In other words, is there any chance that it will do more than boost equity prices and undermine the yen, helping jump-start Japan's real economy? Last week, BOJ Governor Kuroda rather colourfully referred to Peter Pan as an inspiration for monetary policy, in the sense that you need to have conviction for it to work – in the same way that Peter Pan had to believe he could fly to be actually able to do so! In the same way, **the BOJ needs to believe (and it needs market participants and the general public to believe) that what it has already done will deliver real economic results. But in this effort, it may be tempted to bolster such conviction by a bit of policy overshoot** – maintaining extraordinary accommodation that takes the yen to even more ludicrously undervalued levels. But how cheap could the yen go? Based on my simple PPP-based valuation back-test, it is already at extremes of undervaluation, but it was equally overvalued in 2012 and in 1999. So we could go a little further in an overshoot, even if it yielded no immediately obvious gains in the real economy. Later this year, Mr Kuroda may still be tempted to implement another dose of QE – perhaps at exactly the same time as the Fed finally gets around to raising rates.

Andrew Rozanov

Gentlemen, thank you for sharing your thoughts and analysis.

Biographies

Biography
Neil MacKinnon
Global Macro Strategy Adviser

Neil MacKinnon is a long-standing and independent member of ECU's Global Macro Team and Global Macro Strategist at VTB Capital, having been ECU's Chief Currency Strategist for six years.

Previous roles include Chief Currency Strategist at both Citibank and Merrill Lynch. From 1982 to 1986, Neil was an economist with HM Treasury, where he worked for the Chancellor of the Exchequer and other UK Treasury ministers.

Neil sits on the Advisory Council of Business for Britain.

Biography
Kit Juckes
FX & Fixed Income Adviser

Kit Juckes is a long-standing and independent member of ECU's Global Macro Team and Head of FX Strategy at Société Générale.

Kit has over 25 years' experience having commenced his career in 1985 with Money Market Services International (which became part of Standard & Poor's).

His former roles include Chief Economist at ECU, Global Head of Research at RBS Global Banking & Markets and Head of Bond and FX Strategy at NatWest Markets.

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