Interview

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Weekly Report
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Markets Breathe a Sigh of Relief… But for How Long?

In this issue:

- **A solid 'Goldilocks' NFP data print reassures investors**
- **UK general election surprises markets on the upside**
- **Two big short-term risks remain: Greek exit *vs.* China Bubble**

1 Key Events

Q Andrew Rozanov

So it looks like last week brought good news with respect to both key events: the closely watched US non-farm payrolls report, which delivered a reassuring number of newly created jobs in April, and the UK general election, which – against all odds – delivered a majority Conservative win. Are these potential 'game-changers'? And where do we go from here?

A Neil MacKinnon

Indeed, markets were reassured on both accounts. In the aftermath of last Friday's 'Goldilocks' US non-farm payroll report, which came in at 233,000 new jobs, the S&P 500 index clawed back a small gain of 0.37% on the week. **The report was seen as 'market-friendly', and it keeps September firmly in play as the date for lift-off in the Fed Funds target range.**

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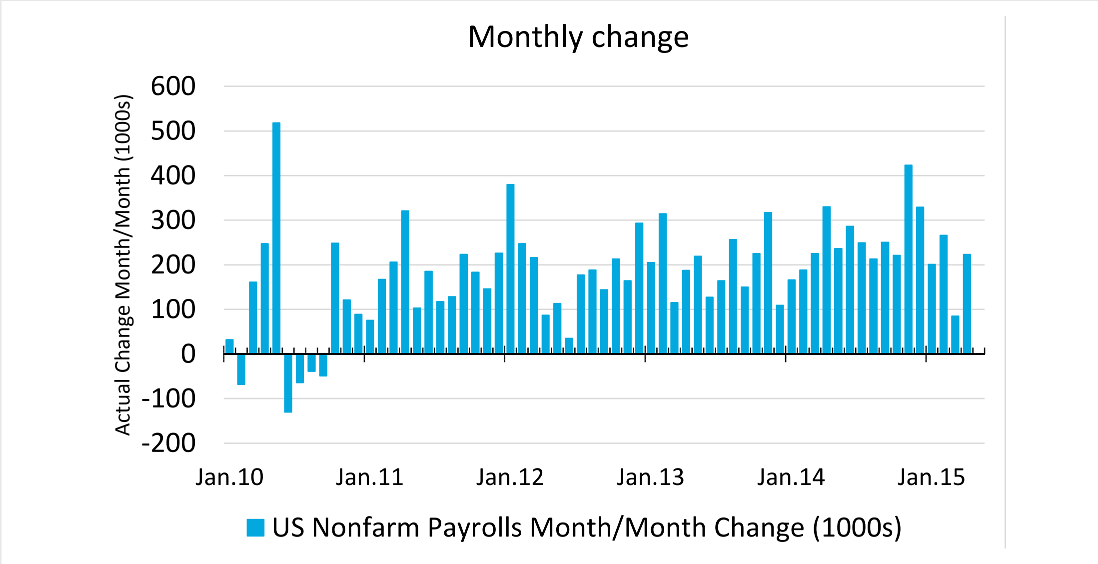
US Non-Farm Payrolls

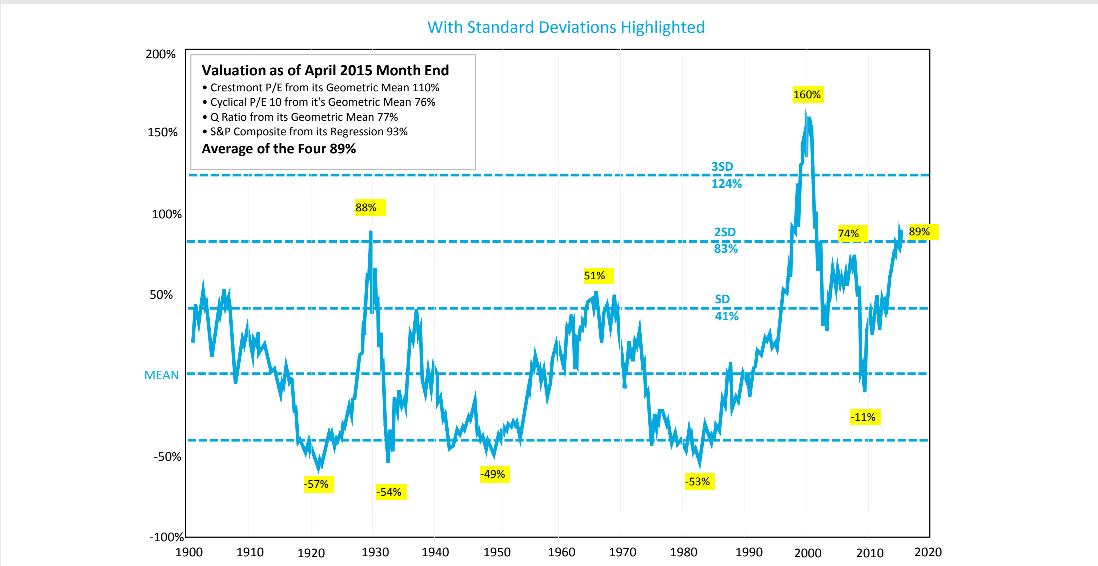


Source: The ECU Group, DataStream

"Further strength in equities, a higher oil price, and a softer US dollar might prompt the Fed to move in June ..."

However, I am still of the view – which is admittedly now a minority view – that the Fed's decision is not entirely "data dependent". Further strength in equities, a higher oil price, and a softer US dollar might prompt the Fed to move in June purely for reasons of securing financial stability. Just last week, Janet Yellen intimated that US equity valuations were "quite high" and that long-term interest rates were "too low", though she played down any worries about a financial crisis. But she is right to be concerned, as the chart below shows that **US valuations are exceptionally stretched**.

Average of the Four Valuation Indicators (Geometric)



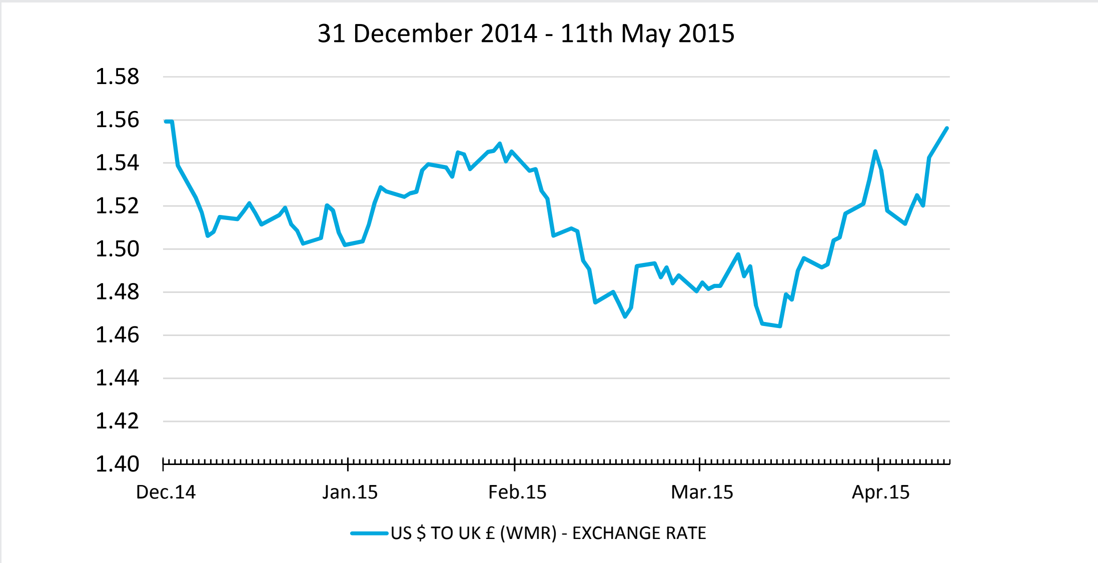
Source: Doug Short (dshort.com), The ECU Group plc

Fed policy has encouraged excessive risk-taking, and zero rate policies have contributed to record highs in equity markets and compressed bond yields. Leverage is back to the 2007 highs. Of course, in this monetary policy environment, valuations are ignored. **Fed policy has created 'one-way' trades and discouraged short positioning in equities**. In spite of ample central bank liquidity, market liquidity has actually shrunk, and we have seen 'flash crashes' in the Dow, in US Treasuries, in the Swiss franc, and perhaps more recently in the German bund market.

"Understandably, the financial markets heaved a huge sigh of relief ..."

As for the UK general election, in our conversation last week I ventured that the Conservative coalition government would win. The stars favoured Mr Cameron rather than Mr Miliband. However, even my expectation was trumped by the eventual outcome of a clear majority for the Conservatives. Understandably, the financial markets heaved a huge sigh of relief as UK voters – or was it primarily English voters? – rejected Labour's "tax and spend" policies which would have probably turned the UK into the economic equivalent of President Hollande's France. Nevertheless, I guess this 'knee-jerk' reaction in the markets might still prove short-lived: technically, somewhere between 1.56 and 1.5850 in GBP/USD is likely to be the top, with 7100 a barrier for the FTSE100.

US Dollar to UK Sterling Exchange Rate



Source: The ECU Group, DataStream

Now there are two key issues to worry about in the longer term: Scotland and the EU. The landslide victory for the SNP is no surprise, as I intimated after my recent visit to Scotland where the support for the SNP is widespread. The SNP want 'fiscal autonomy', but the Institute for Fiscal Studies (IFS) estimate that a Scottish budget deficit stands at 8% of GDP for fiscal year 2013-14. The SNP's position is typical of "tax and spend" policies, but with the added twist that someone else must pay for it. The fact is that North Sea oil revenues are drying up. The oil price is 50% down from last July. The English taxpayer is also likely to lose patience in funding 'free' Scottish health care and university tuition fees. The SNP have also argued that the Bank of England should do quantitative easing for Scottish infrastructure bonds. With the SNP now the 3rd biggest party at Westminster in terms of parliamentary seats, there is a real risk of fiscal chaos.

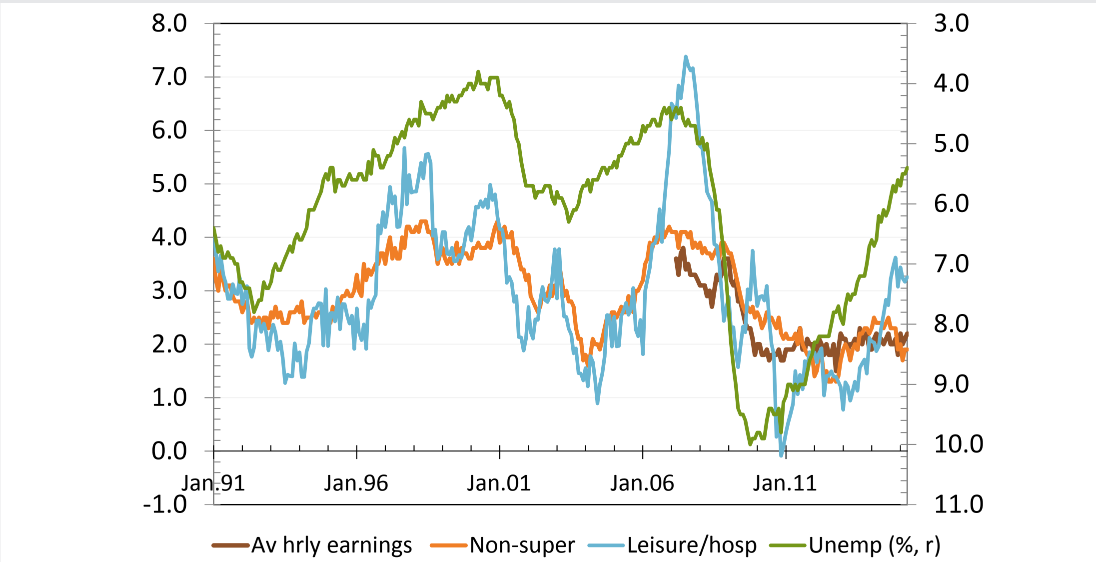
A Conservative government might be tempted to think that it can offer more fiscal bribes to keep the SNP sweet. This would be a mistake, in my view: international investors may become increasingly worried that **the SNP will become the proverbial "elephant in the room", threatening to destabilise the UK's fiscal position, and even potentially leading to a break-up of the country**. The notion, from the Conservative party's point of view, that allowing Scotland its independence ensures a permanent Tory majority in England is, in my opinion, dangerous short-termism. The other issue, of course, is the EU. **Remember that UKIP got 13% of the UK popular vote**. The notion that Mr Cameron can renegotiate anything of substance with EU policy-makers is misguided, in my view. Angela Merkel has already told him to forget it. Investors will not like the uncertainty that might arise from what looks like a second Scottish referendum (there are Scottish elections in 2016) as well as that arising from an EU referendum.

A Kit Juckes

"... there's every reasons to believe that the Q2 GDP data will indeed be a good bit stronger than the dismal data from Q1."

With respect to the US labour market, employment growth came in at 2.2% year-over-year, which is above long-term trends, a lot faster than the growth rate of the labour force, and enough to maintain a solid pace of GDP growth. Think about it: 2.2% growth in employment and 2.2% growth in wages are enough to sustain consumer spending growth of over 4% per annum in nominal terms, and there's every reasons to believe that the Q2 GDP data will indeed be a good bit stronger than the dismal data from Q1. While almost no-one, with Neil here being a notable exception, expects a June Fed rate hike now, there are growing expectations of a September hike. The better data may support the idea of an interest rate lift-off, but they don't reduce the likelihood of a very, very low rate peak by historic standards, and the continued lack of wage growth meant that risk appetite was recovering by the end of last week.

US Labour Market Indicators



Source: The ECU Group, DataStream

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On a broader note, every time I hear investors and market analysts fretting about the timing of the first rate hike, I cannot help thinking of family trips. Sitting in the car on a long journey, the children would grow increasingly restless and impatient, repeatedly asking their parents: “Are we there yet? Are we there yet?” The parents would invariably reply: “No, not yet, but we’ll be there soon. Be patient.” But, of course, before long the kids get even more restless, asking: “Are we ever going to get there? We’re bored!” Variants of this conversation happen in cars all over the world, between children and their parents. And at the moment, as the US unemployment rate falls month after month, you could forgive financial market participants for asking the same question. Are we there yet? Are we at that mythical place called the ‘non-accelerating inflation rate of unemployment’ or NAIRU, where the unemployment rate is low enough for wage growth to pick up? The answers we invariably get are ‘not yet’ and ‘we’re nearly there’. Well, what is clear is that **if there is a NAIRU, it must be getting closer!**

“Are we there yet?”

A more global labour force, increased competition between workers and technology, a shift in the makeup of the labour force, with more older workers staying in work or returning to work and being less aggressive in their pay demands, or a pick-up in part-time work and self-employment – these are all candidate hypotheses to explain why wage growth hasn’t picked up much yet. But **we still don’t know how low the unemployment rate must fall before wage growth accelerates – if it ever does!** There may be some small dose of comfort in the continued strength of wage growth in leisure and hospitality, which is just about the lowest-paid group of workers covered by the data. They currently earn about US$ 12.37 per hour, which represents a 3.3% year-on-year increase. The cheerful and badly-paid people who misspell my name on Starbucks cups are feeling the beneficial effects of economic recovery because coffee shops can’t afford to let the waiting-line get too long!

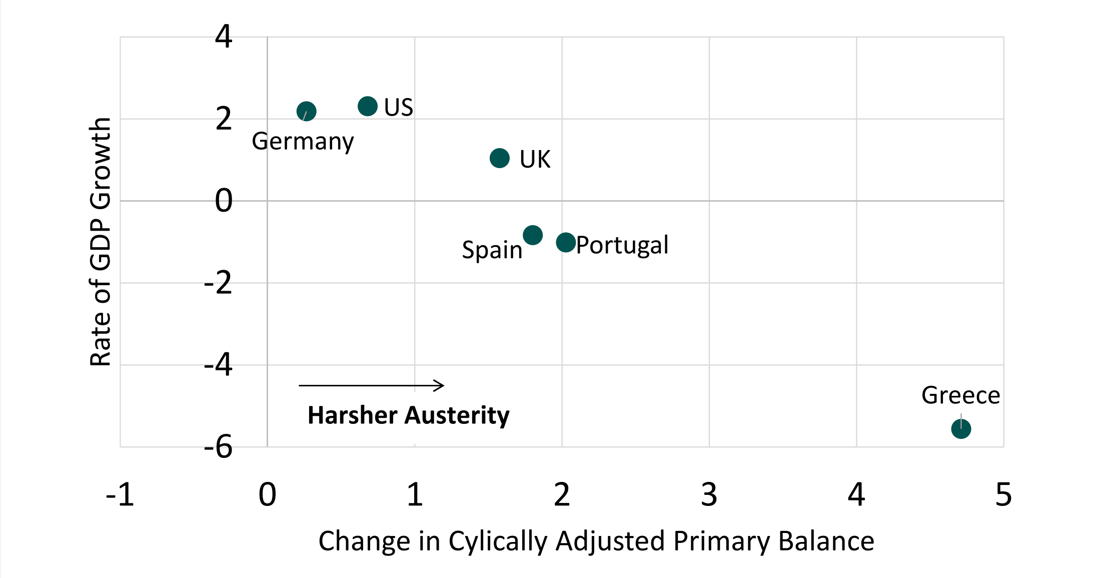
As for the UK election results, as you said at the outset, it was indeed the other big event of last week, at least in terms of springing a surprise. Fears of a long, drawn-out process to put together a minority and weak government have been swept aside, with the pound and the equity market duly bouncing the day after the vote. Any government is better than no government, and a clear majority win by the Conservatives, from the market’s perspective, is the best outcome of all. In the short-term, a relief rally in the sterling was supported by the reduction of short positions, in both the spot and options market, and a drop in volatility. However, here too euphoria may soon give way to reality. Maybe the economy, as well as the markets, will enjoy a brief ‘sugar rush’ from the result. Maybe the market’s pricing of the first rate hike by the Bank of England will come forward a bit from the first half of 2016. But **fiscal austerity is assured and will carry most of the burden of policy adjustment**. The economy is likely to grow, but not to accelerate. Rates will rise, but slowly. And the twin budget and current account deficits won’t come down very quickly. The pound is already very strong against the Euro, and is only likely to get much stronger on the back of Euro-weakness against the dollar, rather than due to anything that happens in the UK.

In the longer term, a Tory government committed to a degree of fiscal austerity, at the same time as being committed to a referendum on the UK’s membership of the EU, **is at the very least better for the gilt market than the pound**. Even if they fail in converting the budget deficit from the current 5% of GDP to a 0.2% surplus by 2018-19, the squeeze on welfare in particular and public sector spending in general, is going to be significant. Against that backdrop, there will be reason enough for the pace of monetary tightening to be very slow.

A Neil MacKinnon

Speaking of fiscal austerity, I just wanted to mention that Professor Paul Krugman had an interesting essay in *The Guardian* last week entitled *"The Austerity Delusion"*. I was struck by one particular chart from that essay, which illustrates quite clearly how **countries which implemented fiscal austerity got precisely what it said on the tin – lower economic growth**.

Fiscal Outlook



Source: The ECU Group plc, Paul Krugman

This is what traditional Keynesian analysis told us would happen, and it is still very much applicable in macroeconomic analysis despite the claims of the so-called 'austerian' school of thought and the Real Business Cycle theory. (By the way, our readers might be interested in the late Professor Robert Samuelson's interviews with The Atlantic Magazine, as well as in Professor Krugman's piece entitled "John and Maynard's Excellent Adventure".)

Often in political discussions of fiscal austerity, the theory and empirical evidence get clouded by people's political affiliations and persuasions. Things are not what they seem, and the reality is often different from the political rhetoric. For example, you would think that the UK Chancellor of the Exchequer, George Osborne, was some cruel and hard-hearted 'austerian' when in reality the UK government significantly eased back on the fiscal stance. That's why the UK economy ended up being the fastest growing economy in the G7.

2 The Rest of the World

Q Andrew Rozanov

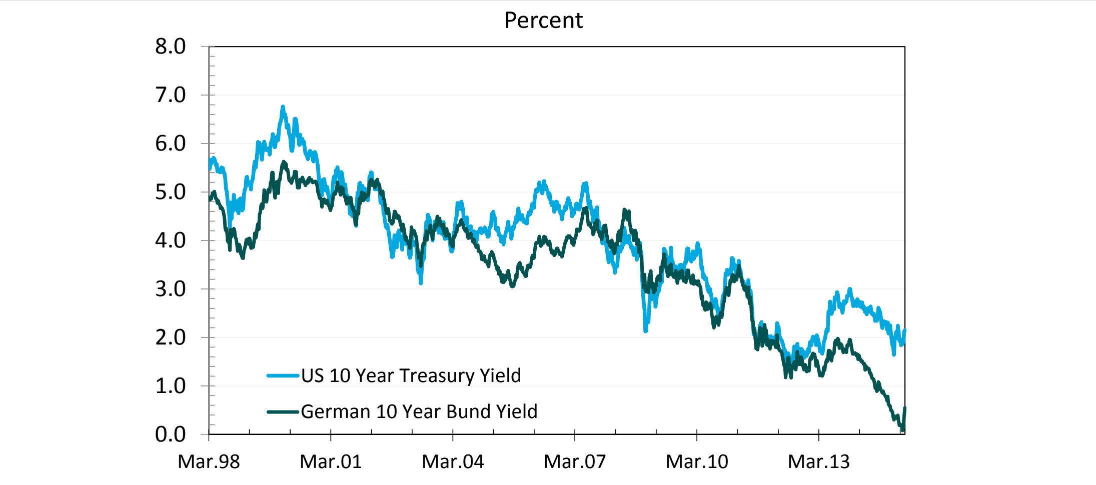
Now that the markets appear to have successfully cleared the hurdles in the US and the UK, at least for the time being, will they turn their attention to other parts of the world where investors still face major risks? I'm referring to the Eurozone, with its potential 'Grexit' problem, and China, where over the weekend the authorities implemented yet another round of monetary easing, cutting by 25 basis points the benchmark lending and deposit rates? Which is the bigger risk, in your view?

A Kit Juckes

"With Greek debt talks going ... down to the wire, jitters ... may return"

On Europe, the bigger question for me is what happens to bond yields – will the recent 'blood-letting' come to an end and will buyers return? The rise in German bund yields has been savage! Higher oil prices and an upward revision to growth expectations triggered the move, which continued far enough to spook investors in equities and in higher-yielding peripheral bonds. With Greek debt talks going, as usual, down to the wire, jitters in peripheral debt may return, and it's likely that we'll see Bund yields reach a peak soon.

US and German 10 Year Government Bond Yield



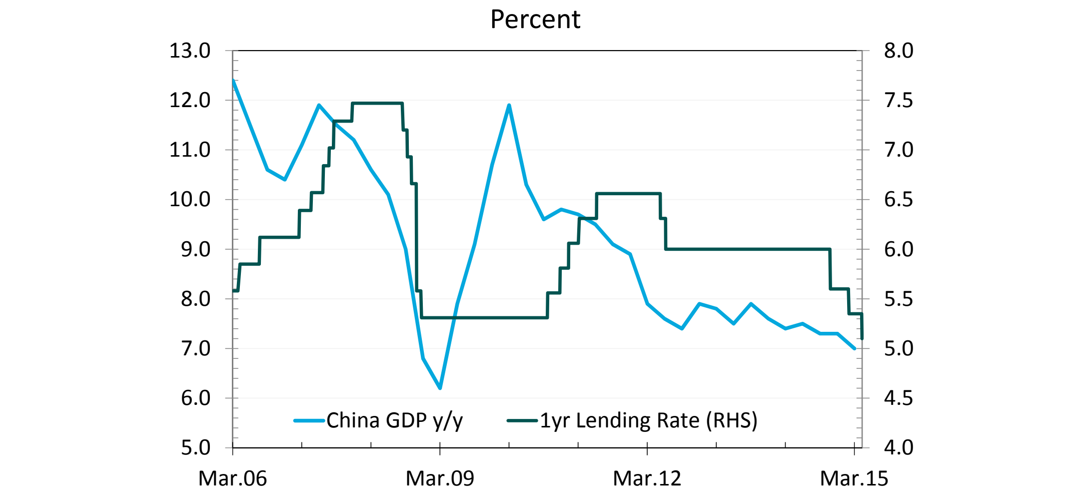
Source: The ECU Group, DataStream

That's probably a necessary condition for the Euro's short-covering bounce to end too. Last week's CFTC data show a continued fall in short Euro positions on the US futures market and while that's just a small sample of the currency market's positioning, it probably reflects where we are – still net short of Euros overall, but less so by the day.

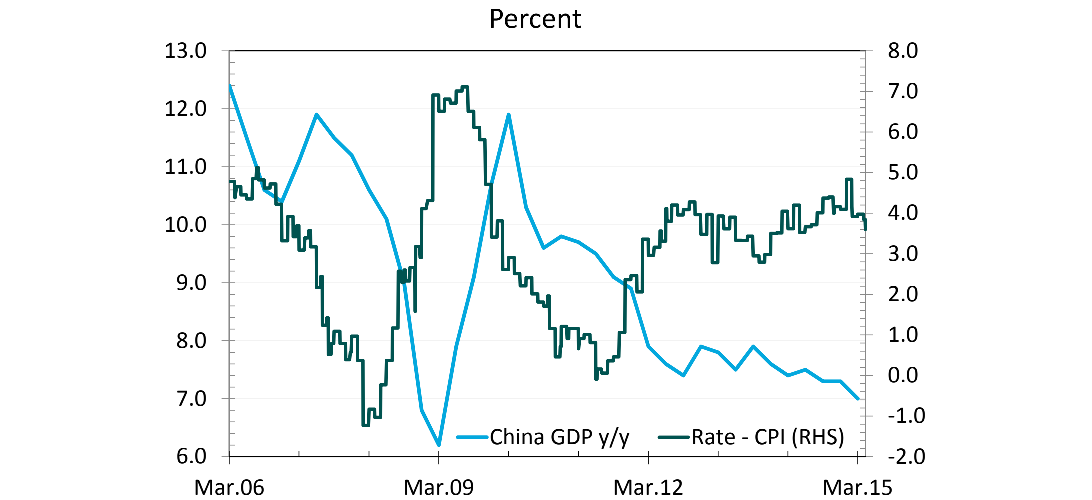
As for the Chinese data, it's a straightforward fight between euphoria in response to yet further monetary easing, and concern about the reasons for the move. **The Chinese economy is losing momentum and the authorities are losing hope of keeping GDP growth above**

7%. Furthermore, although the cut in 1-year domestic rates from 5.35% to 5.10% takes them to new lows, which is 1.5% below where they were at the start of 2012, in real terms rates are still quite high at close to 4%.

China Economic Growth and Lending Rate



China Economic Growth and Inflation



Source: The ECU Group plc

So any boost to global or even Asian risk sentiment could be short-lived, tempered by concern that the US economy is growing at a steady but unremarkable rate and China's economy is slowing. There's nothing here to make you too optimistic about Asian currencies, or too fearful of strong global demand adding to the very limited inflationary pressures in the world, even if inflation expectations are being nudged back up in response to the bounce in oil prices.

A Neil MacKinnon

"... this never-ending 'drama' has gone on for long enough ..."

The 'Greek drama' continues to unfold, with the government facing an impending cash-crunch as payments to its official creditors now start to escalate over the summer months. Press reports suggest that the Greek government is not prepared to give up its 'red lines' on certain aspects of welfare spending. Reports also suggest that the IMF is preparing contingency plans for a default. My guess is that **a debt default is a high probability. The wider impact on financial markets may turn out to be limited**, though. After all, this never-ending 'drama' has gone on for long enough, and investors could be forgiven for being bored by the ongoing spectacle. Of the two risks you mentioned, perhaps we should be looking more closely at what's going on in China.

The PBOC cut its benchmark interest rates for the second time this year. This was really no surprise as many 'China-watchers', including myself, were predicting further monetary stimulus as the country's economy slows down. Last week's trade figures were poor – even after allowing for the usual distortions that can arise from 'over-invoicing', holidays and other 'technical' factors – and chimes with the decline in world trade volumes reported in the first quarter of this year. Also published over the weekend, the latest CPI and PPI data continued to point to persistent deflationary pressures, which are largely a function of the previous excess capacity built up during China's investment boom. Disinflation and/or deflation implies higher real interest rates, which the PBOC recognise as further dampening lending and growth.

The latest batch of monthly activity data (industrial production, retail sales and fixed investment) will be published on Wednesday this week, and I expect the data to confirm the slowdown in economic growth. The dilemma facing the Chinese authorities is straight-forward but nevertheless challenging. On the one hand, they want to try and achieve their 7% GDP growth target. On the other hand, they also want to avoid pumping up bubbles in credit and in the equity markets. Last week, the Shanghai Composite lost just over 5%, but the latest interest rate cut is helping claw back those losses, thus maintaining the 'bubble-like' nature of the move in domestic stocks. The shadow banks had pumped up the property bubble, but ironically the equity bubble is being inadvertently funded by government money via the state-owned enterprises, which goes into equities rather than the real economy. Bubbles always burst when we least expect it, sometimes triggered by seemingly flimsy reasons. So watch this space, as I don't think the bubble is quite over just yet. **China is a key downside risk for the global economy**: without the momentum from China, we face a bleaker outlook going into 2016.

Andrew Rozanov

Thank you both for sharing with us your latest 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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Neil MacKinnon, Kit Juckes


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