GLOBAL MACRO VIEWPOINT
WEEKLY REPORT

Interview

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Weekly Report
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New Clouds on the Horizon

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1 US Recession Fears

Q Andrew Rozanov

Just when markets breathed a sigh of relief and thought the US economy was finally out of the woods given the strong employment reports, we are once again hearing warnings of a possible US recession… Many important economic indicators are suddenly pointing downwards again: retail sales, durable goods orders, industrial production, and economic surprise index – all surprised on the downside. What's going on?

A Neil MacKinnon

The news coming out of the US is indeed worrisome: there is no doubt that the recent economic data is soft. The so-called "control" element of retail sales, which the government statisticians feed into the official GDP data, is now at rates that augured the last two recessions. Durable goods orders (ex-transport) are now posting a negative growth rate. Industrial production has fallen for the fifth consecutive month. Thus hopes of an economic rebound are looking slightly shaky.

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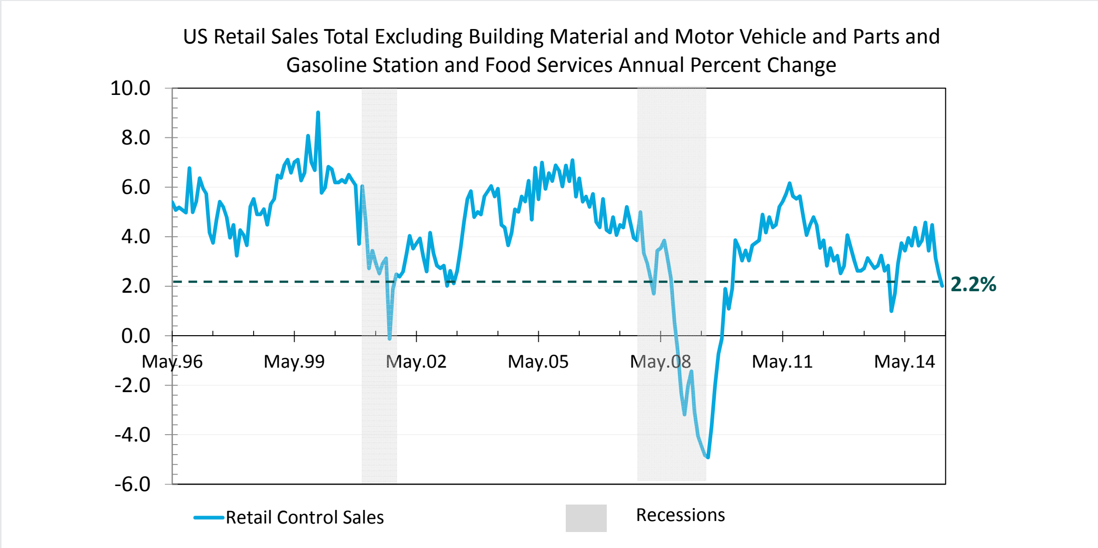
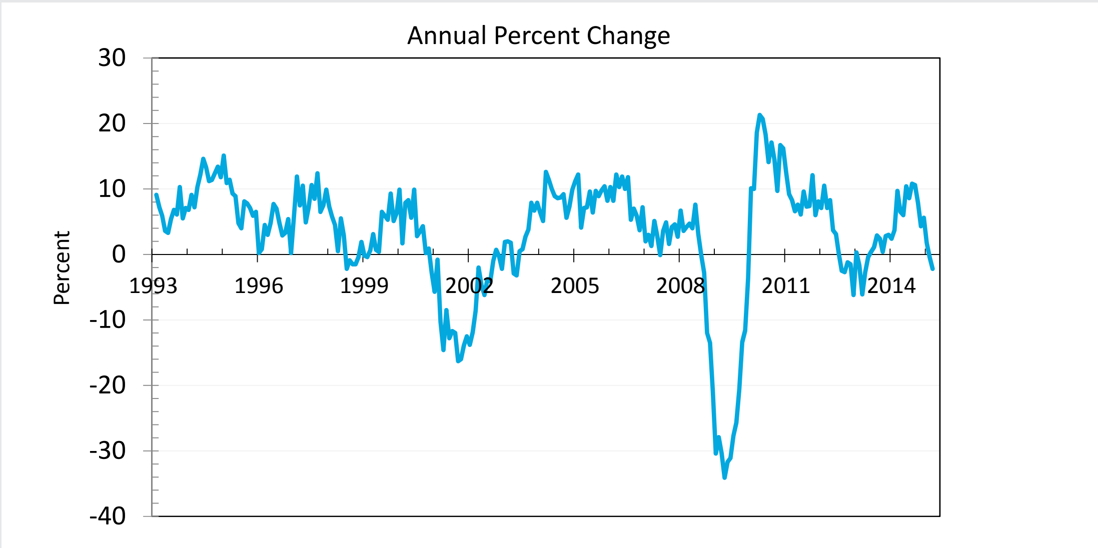
Retail Control Purchases



US New Orders Durable Goods excluding Transportation



Source: The ECU Group plc, DataStream

The Fed argues that the weakness in first quarter GDP growth is temporary and mainly attributable to bad weather effects, quirky seasonal adjustment factors or the impact of the West Coast port dispute. The Fed's John Williams in a speech last week ("Looking Forward, Forward Looking: The Path for Monetary Policy") argued that using a measure called "GDP Plus", which was developed by the Philadelphia Fed, real GDP growth was actually 1.7% in the first quarter and averaged 3% in the last 34 quarters. The San Francisco Fed has just published research which introduces a second round of seasonal adjustments and results in growth of 1.8%. Well, I guess the Fed's "data dependency" in terms of its policy decisions now entirely depends on which data they choose!

I have to say that **I am becoming more worried about the trajectory of the US economic recovery**. The Fed's arguments about recent softness in activity being temporary are starting to wear a bit thin. It is interesting that the supposed net benefits of a lower oil price, which were such a hot topic at the time when oil was on a downward path, have not yet materialised. We know that US shale oil producers have been hit, and that the lower oil price has already resulted in investment cutbacks and a loss of jobs in that sector. Meanwhile, consumers are increasing their savings even though labour market conditions seem robust.

"Presumably, the scars from the last recession and financial crisis are still affecting ... behaviour."

David Stockman, President Reagan's former economic adviser at the White House, recently observed that the very bottom of the jobs ladder accounted for the bulk of job creation in the United States, with employment in this sector typically being part-time and low paid. According to him, about 50 million low wage job-holders, who account for approximately one-third of the total US workforce, earned an average gross pay of just USD 6,000 in 2013. The New York Fed's latest report on Household Debt and Credit showed that **while deleveraging is over, US households are showing little appetite for building up debt again**. Presumably, the scars from the last recession and financial crisis are still affecting their behaviour. The fact that US equity markets are at record highs has no impact, as the average US household has little direct exposure to US stocks.

A Kit Juckes

It sure has been a good week for the 'secular stagnation' crowd – and by association, not a terribly good one for the global economy! You mentioned US retail sales, which indeed disappointed market participants: April saw sales a mere 0.6% higher than they were a year ago. But actually, if you smooth the data, adjusting for very low inflation and removing the volatile elements, the underlying trend isn't really quite so bad – more like a 2.5% annual rate. However, that still represents a disappointing pace of spending for an economy generating employment growth of 2.2% and a similar rate of real wage growth. I will echo Neil's comments by saying that **it's hard to avoid the suspicion that the US consumer is still focused more on reducing debt – which is admittedly still at a fairly high level – rather than on spending money**. Super-low rates and quantitative easing were supposed to encourage households and businesses to borrow, spend and invest, but the experience of the last few years argues for caution and for now, that caution seems to be winning the day, both in the US and the UK.

The disappointing data have triggered a response in the form of lower US yields, a softer dollar, and in recent days a recovery for equities and emerging markets. The context matters, however. The pace of employment growth is sufficient to maintain a downward trend in the unemployment rate that will eventually see wage growth pick up. The pace of income growth is sufficient to drive nominal consumption growth of over 4% per annum, even with falling debt/income levels, and the same is true for overall private sector debt. And most importantly, this is consistent with nominal GDP growth of at least 3.5-4.0% per annum, which in turn would be inconsistent with rates staying at zero.

2 The Federal Reserve

Q Andrew Rozanov

So where does this leave the Fed?

A Neil MacKinnon

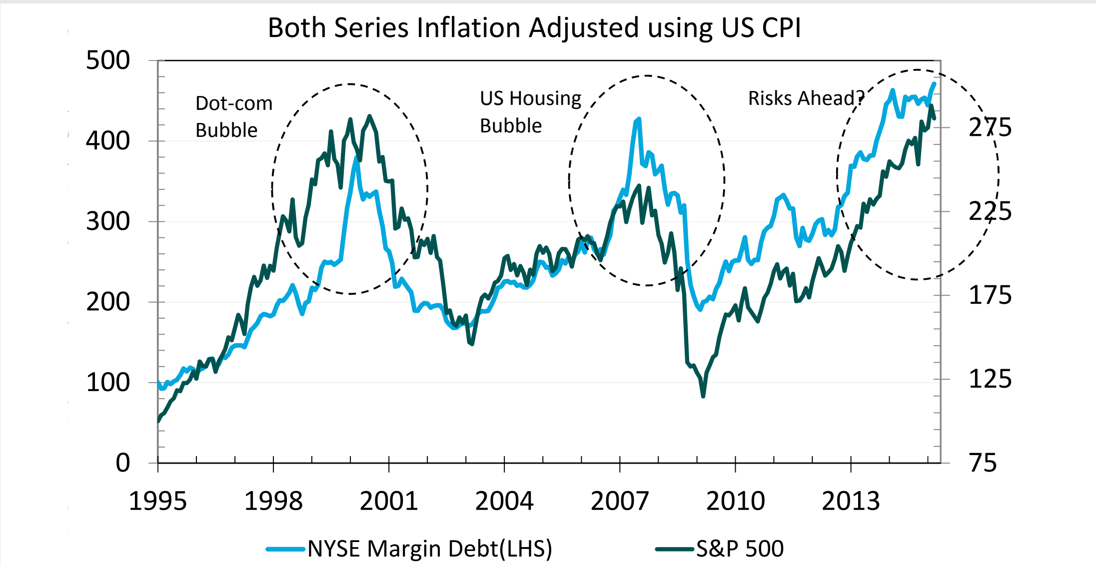
Well, in an uncomfortable place, that's for sure! I previously said that I hold a minority view that the Fed can raise the target range for the Fed Funds rate in June. Most market economists are now talking about September at the earliest. I am still of the view that June is in the frame, and my arguments relate not so much to what the data is showing, but rather a feeling – expressed by a number of Fed officials as well – that **the Fed is becoming increasingly worried about potential financial instability**. Remember Janet Yellen's recent comments about US equity market valuations being "quite high" and long-term rates being "too low"?

"... this does provide, in my view, a window of opportunity for the Fed to raise the target range for the Fed Funds rate."

The US 10-year Treasury yield moved to a high of 2.36% on 12 May, and at the time of writing it has eased back to 2.16%. There is interim technical support at the convergence of the 50- and 100-day moving averages at 2.00%. With the S&P 500 index hitting a record high at the end of last week and the US dollar easing back recently, this does provide, in my view, a window of opportunity for the Fed to raise the target range for the Fed Funds rate. Otherwise, **the Fed is going to find itself in the invidious position of 'normalising' policy into an economic downswing**, which would leave it with less ammunition to combat the next recession or the next financial crisis.

Janet Yellen will give an important speech on Friday on the US economic outlook which will contain important clues to the Fed's latest thinking. But when I see Fed officials coming up

NYSE Margin Debt and S&P 500



Source: The ECU Group, DataStream

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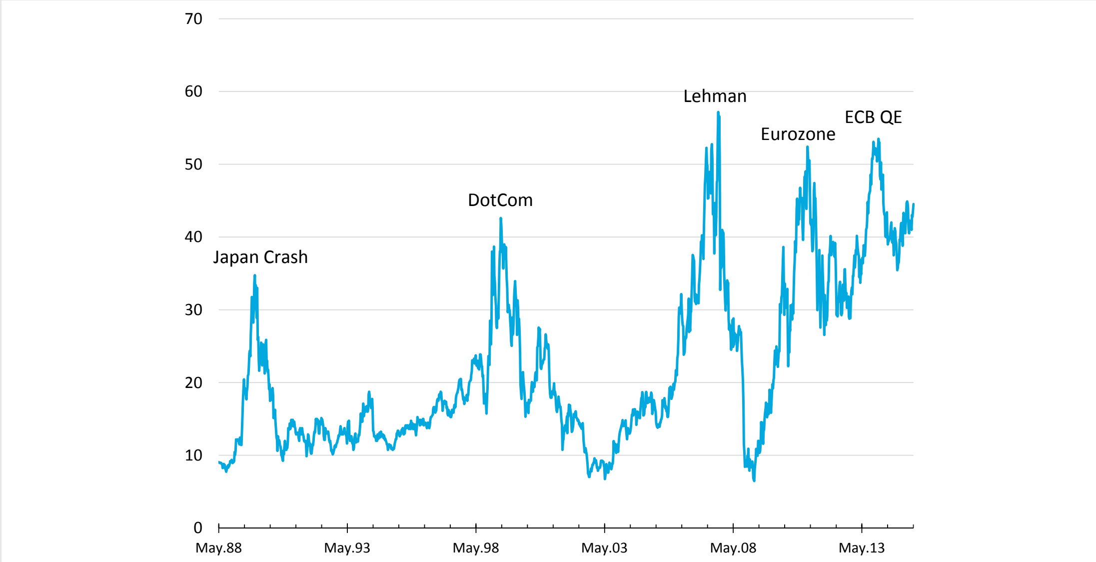
with alternative ways of recalculating GDP growth numbers to show that the traditional data underestimate the underlying strength of the economy, **it does seem to me that the Fed is looking for an alibi to start tightening**. My view has been that the Fed simply cannot ignore the outlook for financial stability. US equities are at record levels and credit markets exhibit all the signs of excess leverage. Other financial and real assets like art are also in a bubble: just look at the Sotheby's share price on the chart!

Sotheby share price: "bubble indicator"



Source: The ECU Group, DataStream

A Picasso painting recently sold for a record price at an auction. Sotheby's share price is something I use as a "bubble indicator," and as the chart above shows, peaks in the share price have coincided with all the infamous crashes since the late 1980s. It suggests that the next bubble is very much in progress, but we may not just be quite at the stage where the burst is imminent!

"...the Fed policy debate today isn't about whether rates should or will increase. They absolutely should, and they most probably will."

A Kit Juckes

Well, the Fed policy debate today isn't about whether rates should or will increase. They absolutely should, and they most probably will. Nor is it so much about the timing of the first hike: to me, September still looks likely, because the weak Q1 data suggest a better Q2, and wage growth is showing some signs of acceleration, even if temporary. **The issue is entirely about how fast and how far rates rise** after that. The front end of the US yield curve has too little priced in, as long as there is at least a single rate hike this year. By association, the dollar would benefit from any sell-off in short-dated bonds, even if the yield curve flattened and longer-dated Treasuries didn't do very much. But it's also worth observing that the US equity market is struggling to work out which is more important – the fading fears of faster rate hikes, or growing concerns that slower growth and higher wage growth would mean lower profits.

So while 'secular stagnation' becomes mainstream – and as we all realise that at this stage of the debt cycle attempts to induce people and firms to go on yet another debt-financed spending splurge are falling on deaf (or wiser?) ears – it doesn't alter the reality of economic and policy divergence. It just means that **the cruising speed of the US and global economy is going to be slower for a long time**.

3 China

Q Andrew Rozanov

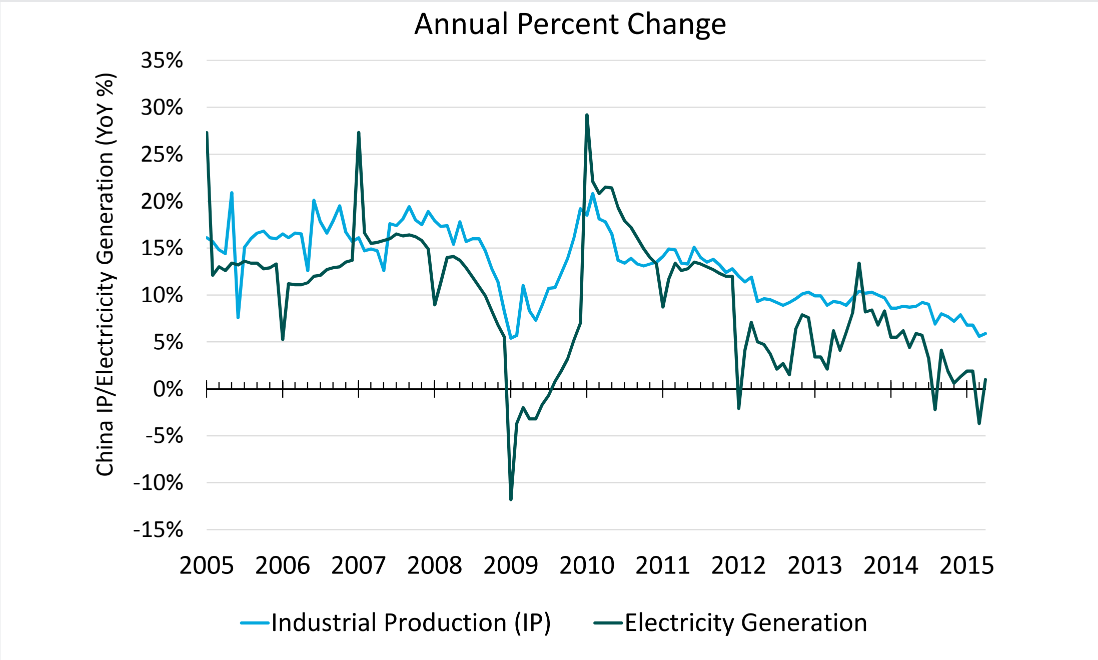
If the US is exhibiting a major disconnect between the downbeat economic fundamentals and the exuberant asset markets, what should we think of China? Neil, you suggested in our earlier conversations that a classic bubble formation was taking shape in Chinese stocks, even as the economy there was decelerating…

A Neil MacKinnon

"Last week's batch of monthly activity data were all in line with my expectation of slower growth."

Indeed, if the US economy is slowing, then it comes at an awkward time when the other economic superpower, China, is also in a clear economic downswing. Last week's batch of monthly activity data (industrial production, retail sales, and fixed investment) were all in line with my expectation of slower growth. Electricity output, which in my opinion is a more accurate guide to activity than the bogus GDP data, is running at an approximate zero rate so far this year.

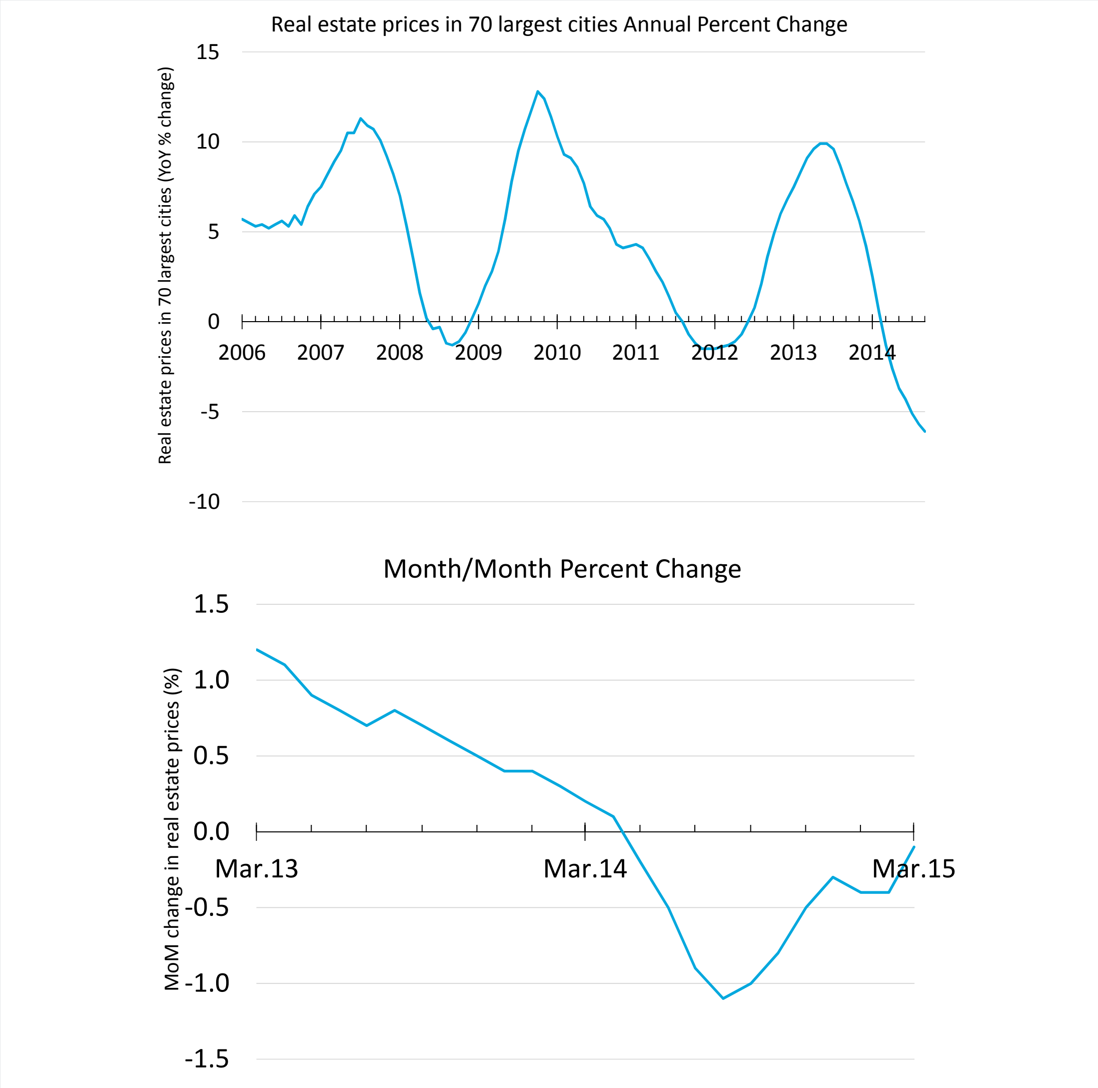
China Industrial Production and Electricity Generation



Source: The ECU Group plc, DataStream

The latest property price data released over the weekend shows Chinese house prices down 6.1% year-on-year in April, though on a monthly basis prices were flat – for the first time in 12 months. There are tentative signs of stabilisation, as residential house sales were up 7.7% year-on-year.

China Real Estate Prices



Source: The ECU Group plc, DataStream

Nevertheless, the Chinese authorities have made two interest rate cuts so far this year, and they also cut bank reserve requirements. Further stimulus is likely, and the PBOC is adopting an ECB-style LTRO program to help local government financing. But total social financing, the broadest measure of credit expansion, is down some 20% on a year ago. **Central bank liquidity is finding its way into the stock market rather than the real economy**, and as I have noted in our previous discussions, **the Shanghai Composite has all the hallmarks of a classic bubble, with IPO mania also notable**. Investors need to watch this space very closely indeed!

4 The UK and the Eurozone

Q Andrew Rozanov

OK, let us now turn to the UK and the Eurozone: what are your thoughts and projections?

A Kit Juckes

In the UK, we now know that we will most certainly get a Budget in July. And we also know that it won't be one full of government-spending largesse. The UK economy may still enjoy a 'sugar rush' as delayed construction projects are brought online and the London housing market picks up, but policy settings are going to be recalibrated to tackle the 5% GDP budget deficit through reductions in government spending. In the first instance, needless to say, this isn't bullish for medium-term growth prospects. It also shifts the balance of monetary and fiscal policy, with less need for rate hikes and, in the process, it takes further support away from the pound. So, **enjoy sterling strength while it lasts, because it may not last long**! The gilt market, meanwhile, may see talk of a slightly earlier rate hike than is currently anticipated (H1 2016), but the long end of the curve will benefit from the commitment to tighter fiscal policy.

As for the Eurozone, soft GDP data make 2% annual growth rate unlikely. Has the re-think on Europe's growth outlook gone as far as it can? Time will tell, but it feels a bit that way. Originally, the consensus was too gloomy on growth, and had priced in both the ECB's bond-buying programme as well as deflation. Now that those expectations have been tempered, maybe we will see range-trading in European bonds amid edginess about what might happen in Greece, where the government is quickly running out of cash. That, I believe, would see the Euro's short-squeeze run out of momentum. On a related note, I think we may have seen the worst, if not the back, of the bond market sell-off which has riled global asset markets in recent days.

A Neil MacKinnon

"The Eurozone is staging a cyclical economic recovery and slightly outpacing the US."

The consensus view at the start of the year was that the US economy would be the 'growth leader' for the world, with the Eurozone stuck in the deflationary doldrums. Against this backdrop, with oil prices declining and deflation risks apparently increasing, the consensus trade was to be long equities, long fixed income, and long US dollar. Both the fundamental and market views are now reversing. The Eurozone is staging a cyclical economic recovery and slightly outpacing the US. The recent 'global bond rout' which Kit just mentioned is, I believe, a function of the unwinding in extreme market positioning. Slower growth in the US and China should put renewed downward pressure on major government bond yields. As far as the Eurozone is concerned, last week's GDP data showed that countries like France – rather unexpectedly – and Spain were doing quite well, while Germany disappointed expectations with growth of just 0.3% in the first quarter. I think that Germany will face headwinds from the recent appreciation in the euro.

The rise in the euro is again a function of the turnaround in extreme short positioning – something I highlighted in our conversation a few weeks ago. At the time, I suggested that the EUR/USD had the opportunity to bounce back from the 1.05 level, thus squashing an early move to parity. I had observed that speculative short positioning in the euro was at an extreme level, which historically has proved to be a good contrarian indicator. My technical target for the EUR/USD retrenchment was around 1.13, although the exchange rate overshot to a high of just under 1.15 on May 15. (Likewise, I expected a GBP/USD rally to 1.55, although this too overshot to about 1.57). The rise in the euro, together with the increase in Eurozone bond yields, represents an inadvertent tightening of monetary conditions. This is all part of a more generalised position unwinding, but it now seems to be running out of steam. A speech by the ECB's Benoit Coeure on 18 May pointed to a pick-up in ECB bond buying in May and June, which was the trigger for a pullback in EUR/USD to about 1.1150. Later this week, Mario Draghi will speak at the ECB Forum on Friday, and it is a speech worth monitoring. Last week he reaffirmed that the ECB will complete their QE programme as planned.

"...negotiations between the Syriza government and its official creditors still seem to be no closer to an agreement."

With respect to Greece, negotiations between the Syriza government and its official creditors still seem to be no closer to an agreement. At the end of the day, we are talking about EUR 7.2 billion, which is the sum to be unlocked from the loan programme if the EU/IMF agree to the Greek government's reform package. EU leaders meet in Riga on Thursday, but this could turn out to be just another missed "deadline". There is no doubt that Greece is facing an impending cash-crunch. Last week, Greece had to empty its SDR fund at the IMF in order to make a scheduled loan repayment to the IMF. Robbing Peter to pay Paul! The next payment comes due on 5 June, and the Greeks will need to come up with EUR 1.5 billion in the first three weeks of the month. **I get the impression that the IMF is losing patience and I would not be surprised if they are making contingency plans for a technical default**.

Andrew Rozanov

Gentlemen, thank you as always for 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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Neil MacKinnon, Kit Juckes


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