GLOBAL MACRO VIEWPOINT
WEEKLY REPORT

Interview

Neil MacKinnon
Kit Juckes

Contributors:
Neil MacKinnon
Global Macro Strategy Adviser
Kit Juckes
FX & Fixed Income Adviser
Andrew Rozanov
Head of Institutions

Weekly Report
June 23 2015

Light at the End of the Tunnel: a Fast Approaching Train?

In this issue:

Page
1 Greek drama
3 Greek tragedy?
4 The US
6 The dollar
7 China and the emerging markets

- **Markets driven more by the Fed than Greece, but the end is (finally) nigh…**
- **'Lehman-style' crisis unlikely, but a broader EU political crisis probable**
- **Dovish Fed limits US dollar upside, but strong fundamentals bullish longer term**

1 Greek drama

Q Andrew Rozanov

So the world is, yet again, on the verge of a great Greek Drama finale… It almost feels like a bad case of Zeno's famous Paradox of the Tortoise and Achilles! We seem to be approaching ever closer to the inevitable resolution of the crisis – with the ultimate 'finishing line' getting nearer and nearer – and yet the never-ending marathon continues… Will we ever get there?!

A Neil MacKinnon

Well, so far, there has been little progress following the meeting of Eurozone finance ministers today (Monday 22 June), which was not helped by the fact that the Greek government apparently sent the wrong document to the EU late Sunday night and that Greek finance minister Yanis Varoufakis turned up 45 minutes late to the finance ministers meeting. Financial markets started the week hopeful of a 'last-minute' deal or an agreement to defer the whole process for 6 months. Reports suggested that the official creditors might make concessions on the primary budget surplus targets, as well as trimming back pension cuts and VAT increases.

There was even talk of accessing € 10 billion of bank recapitalization funds in the ESM or lifting the cap on Greece's T-bill issuance. 30 June is when the Greek government is required to pay the IMF € 1.5 billion, and it is also the date the current programme expires.

Trading the headlines during the Greek debt talks can be a dangerous game. Outside of the pressure on Greek financial markets, which saw the Athens equity index drop 11% last week, the impact elsewhere has been quite limited, though the DAX is off some 10% from its April high. In contrast, US equities are moving to new highs. The unwinding of hedges associated with the reduction of exposure to European equities might explain last week's resilience in the EUR/USD exchange rate, which held up remarkably well, but by definition this is a temporary phenomenon and I would expect the US dollar to recover its poise quite soon.

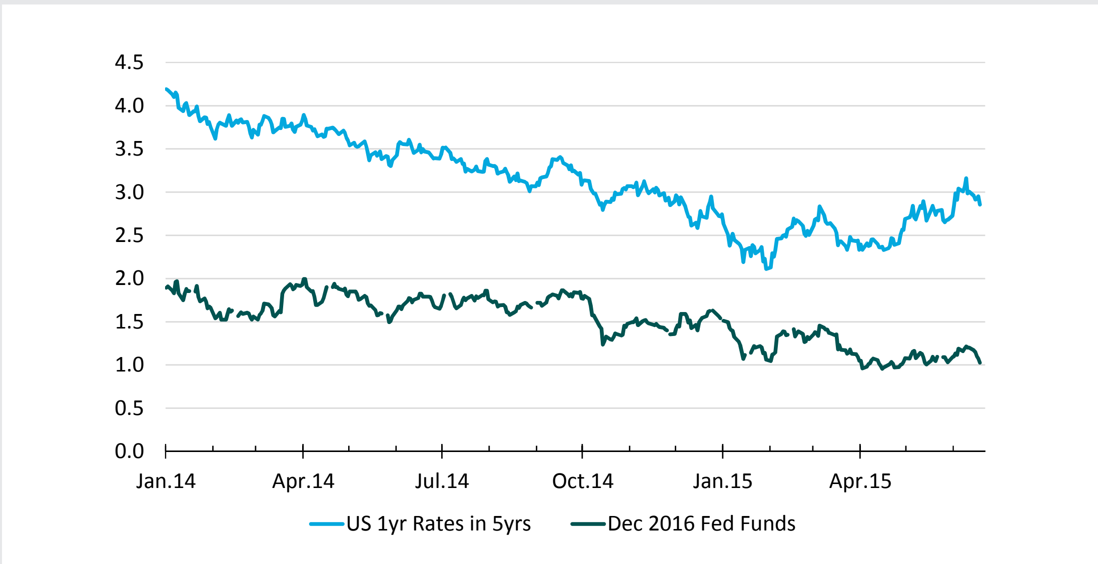
"... I would expect the US dollar to recover its poise quite soon."

A Kit Juckes

I would echo Neil's comment. It's the start of another week in which the Greek debt crisis dominates the political landscape and the front pages of the major newspapers, but maybe not so much current financial market pricing! **The FOMC meeting on June 17th was what really drove markets last week, and US economic data will continue to matter as much as, if not more than, the Greek crisis in the weeks ahead**.

Despite persisting concerns about a possible Greek default and/or exit from the Eurozone, the FX market has given a good impression of not caring recently. Last week's CFTC data show a further reduction in Euro shorts and a further reduction overall in USD longs. Meanwhile, **relative rates are still favouring the Euro**. For example, consider the EU/US short-term rate differentials: the pricing of where 1-year rates will be in 5 years' time is back to levels last seen in January, with US rates only 1.45% higher than those in Europe. This differential of where the market prices 1-year rates in the future has a decent correlation with the EUR/USD rate at the moment.

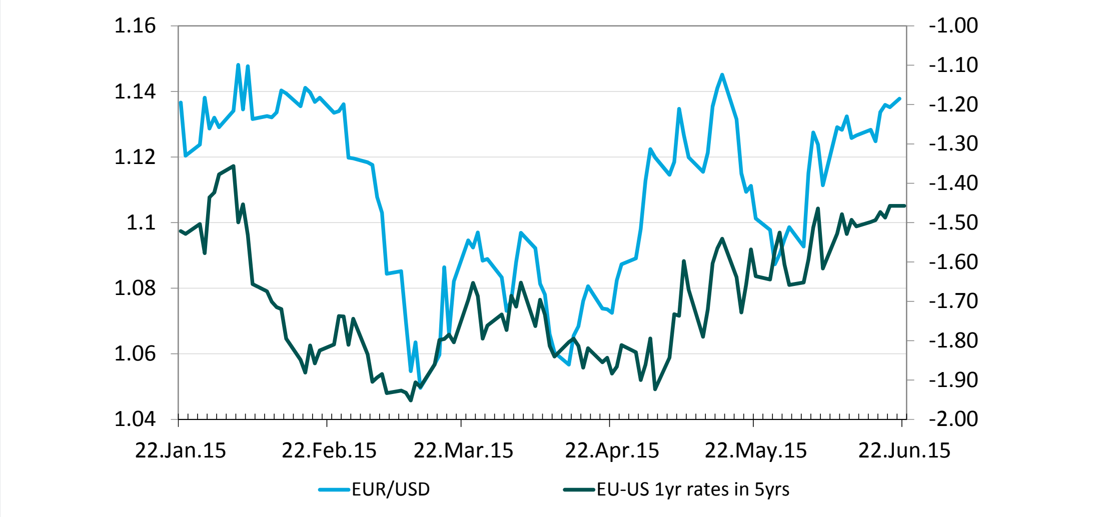
US 1yr Rates in Five Years and the Dec 2016 Fed Funds



Source: The ECU Group plc

e: research@ecugroup.com
w: research.ecugroup.com

EURUSD and EU-US 1yr Rates in Five Years



Source: The ECU Group plc

You could be forgiven for thinking that the biggest driver of the EUR/USD rate is not Greek debt talks, but the pricing of the December 2016 Fed Funds futures contract. In fact, anything other than a complete failure in this week's Greek negotiations will leave us watching the front end of the US curve as the driver of FX trends. All of which just goes to emphasise that **shifting expectations about the path of Fed and ECB policy rates still seem to matter more to markets than Greece's woes**. And with ECB policy changing little, that means that US economic data and expectations about the Fed matter more than what is going on in Europe. Whether the last-ditch attempts to avert disaster in Europe or the release of June 'flash' PMIs this week will change that, is not obvious, at least to me.

2 Greek tragedy?

Q Andrew Rozanov

But if this last round of negotiations fails, this time next week it will be official – Greece will have formally defaulted on its payments to the IMF. Could this lead to a 'Lehman-style' systemic event? And what are the broader implications for Europe?

A Neil MacKinnon

As it is, **financial markets and financial institutions have very limited exposures to Greece, so a 'Lehman-style' crisis is unlikely**, in my view. So far, the main pressure point has been on the Greek banks, which are estimated to have lost up to € 5 billion in deposits just last week. The ECB has increased the limit on its Emergency Liquidity Assistance (ELA) lending to € 86 billion. The ECB are unlikely to pull the plug on the Greek banks until EU Leaders have made a political decision. If we end up with a 'take-it-or-leave-it' ultimatum, then we are in a scenario of Cyprus-style capital controls and a Greek banking system that has gone bust. This will then become a solvency crisis rather than a liquidity crisis.

It can then develop into a political crisis for the EU project. In addition to the Greek banks melting down, the main financial exposure is actually with the official creditors as they own 90% of Greek government debt. A default would mean that it would be the EU, the ECB and the IMF that bear the losses. In the EU, this implies that the German taxpayer is ultimately on the hook. There is also a geo-political element. I spoke at the St Petersburg International Economic Forum last week and saw Greek PM Alexis Tsipras share the stage with President Putin. President Obama will be keen to make sure that America's 'geo-political' interests are not undermined by Greece falling out with the EU and turning towards Russia.

Ahead of Thursday's EU Summit in Brussels, where the 'Five Presidents' will deliver their report on further EU integration (or the 'quantum leap', as Mario Draghi described it), **the whole project could be jeopardised from the EU point of view if Greece becomes a template for other Eurozone economies – either in terms of concessions on their own debt or even an exit from monetary union**.

I read two very good accounts of the crisis this week: one was from Ambrose Evans-Pritchard ("Greek debt crisis is the Iraq War of finance") and the other from Wolfgang Munchau ("The real challenge this week is to save the eurozone"). Whatever your point of view on the EU and the pros and cons of monetary union, I think both articles are worth reading. My own view is that monetary union is structurally flawed, and better economists than I have long made the point that without a fiscal union and a banking union, it is 'half-baked'.

"... Germany is repeating the experience of the Gold Standard..."

In addition, **monetary union has hardly been an unqualified success, and recent years have seen it become a by-word for unemployment, austerity and rising debt**. Germany is repeating the experience of the Gold Standard, when the lead creditor/surplus economy failed to contribute towards the adjustment process which fell on the deficit nations. In the end, the political and economic costs of such a monetary arrangement became too high and the system broke down. The same fate awaits the European monetary union.

3 The US

Q Andrew Rozanov

Let us now move on to the US. For most market practitioners, the FOMC meeting last week seems to have confirmed expectations of a 'lift-off' in September, although there is now also a minority view of possible delay into December. What is your reading of the situation?

A Kit Juckes

Well, let's see. Last week the Fed didn't raise rates from the zero bound, but no-one – apart from Neil – really expected them to. Nor did the Fed do anything to shift the market consensus from its view that the first rate increase will come this year, probably in September. And the rate path implied by the 'dots', which show individual FOMC members' projections, remains well above what is priced into interest rate markets. However, Fed Chair Janet Yellen stressed that the pace of increases would be gradual, and the Fed also lowered its growth forecasts. With the May CPI showing a drop in core inflation and no signs of anything to scare the Fed, **the market got the**

clear impression that while the plan may be to raise rates unless the data disappoint, it really wouldn't take much weakness for the plan to change.

The result is that the rate that is priced in for end-2016 has fallen to 1.02%, the lowest level since mid-May. If the Fed does raise rates once this year, that means just three 25 basis point increases are priced in for the whole of 2016. To put this in context, the Fed raised rates by 2% in the first year of the last hiking cycle in 2004-2005, by 1.75% in the first year of the 1999-2000 cycle, and by 3% in the first year of the 1994-1995 cycle. There's 'gradual' – and then there's what we are pricing in now…

The combination of these soothing words from the Fed, the soft inflation data, and the mixed real economy data in the US has resulted in equity markets that are range-bound, a dollar that has lost its bid, and Treasury yields that have drifted back down. The US dollar has lost ground against a variety of currencies, and even if it hasn't really gone down, it hasn't made any gains either. Broadly speaking, in the short term, the idea that the US economy is moving in the right direction – strong enough to justify rate hikes, but only likely to see these happen at a snail's pace – is good for risk assets and investor sentiment, but not good for the dollar.

A Neil MacKinnon

"I can't help thinking that the Fed is messing this up, and ... history books on this period, [will criticise] the Fed ...for endangering financial stability..."

Last week's FOMC statement was indeed very dovish. I can't help thinking that the Fed is messing this up, and that when they come to write the economic history books on this period, the Fed will be criticised for endangering financial stability through an over-extended, ultra-easy monetary policy. Janet Yellen should remember that she is head of the central bank and not the Labour Secretary intent on creating jobs for all. The main reason why the labour participation rate is low is demographics. Unless I am missing something, zero interest rates do not create more babies!

As Kit mentioned, **the key message from the Fed last week was that the future path of interest rate increases will be gradual**. The FOMC's median Fed Funds projection was cut to 1.7% for end-2016 and 2.8% for end-2017. As far as the US 10-year Treasury yield is concerned, recent moves have been quite pronounced, though the 'big picture' is that the long-term downtrend in the 10-year yield is still in a downward trading channel, which will only be broken when the 10-year yield decisively breaks above the 3.50% level. The Fed's balance sheet, currently at US$ 4.5 trillion, has an important influence on Treasury yields. The duration of the Fed's bond portfolio is now gradually being reduced to about 6 years, which has the effect of pushing longer term rates up – which, of course, is just another form of monetary tightening.

While I was in St Petersburg last week, I spoke with Professor Kenneth Rogoff and Professor Jacob Frenkel on the outlook for the global economy. Professor Rogoff is famous for his research with Carmen Reinhart on the aftermath of financial crises. Their classic book "This Time Is Different" provided the template for my thinking on how the global economy would evolve in recent years. Their main message was that the financial crisis would bring about several years of below-par economic growth, rising unemployment and an explosion in public debt. Essentially, this is precisely what happened to the major economies despite zero interest rates, negative rates in Europe, and unconventional programs such as QE.

Now Professor Rogoff believes that the effects of a 'debt super-cycle' are constraining growth. Both him and Professor Frenkel dismissed the 'secular stagnation' thesis and would prefer the Fed to 'normalise' monetary policy now. Personally, I am less dismissive of the 'secular stagnation' thesis, and there are complex reasons as to why the advanced economies are experiencing low investment rates and declining labour productivity growth. For sure, there is always technological progress, though such progress might not manifest itself in higher levels of employment, even though we all benefit from progress in medical science or advances in IT communication.

"... Amazon does not employ the same number of people as Henry Ford did in his automobile plants..."

There is also an ongoing debate about whether the official GDP statistics might simply be failing to pick up the 'x-factor' which reflects technological progress, reduction in prices of IT equipment and other recent developments. For instance, Amazon does not employ the same number of people as Henry Ford did in his automobile plants, but that does not necessarily mean that the US or UK economies are in a depression. **If GDP data are not entirely accurate, then it begs the question of whether we really know what is going on in the world economy, in which case relying too much on GDP data as a guide for making monetary policy decisions might actually be worse than useless!** In light of this, the Fed's current 'data-dependent' approach may be a case of the 'blind leading the blind'...

4 The dollar

Q Andrew Rozanov

I can see how the Fed's well-telegraphed dovish approach and 'gradualism' with respect to raising rates may have cooled the enthusiasm of US dollar bulls in the short term, but the US economy still seems to be the only 'bright spot' in the global economy... Kit, what's your take on the dollar in the longer term?

A Kit Juckes

Here is how I think about it. The US dollar has gained over 10% in real terms over the last year. Incidentally, in recent history, we have only seen such rapid pace of appreciation twice: in 1998 and 2009. Going forward, further dollar strength isn't likely until the market re-prices upside Fed Funds risk. I may have mentioned in the past that I keep a close eye on the 5-year US TIPS yields, since historically they are reasonably highly correlated with the US dollar real effective exchange rate. I don't believe that we've seen the peak for 5-year TIPS yields in this cycle yet, and I don't believe the market can maintain the current Fed Funds futures pricing once the Fed finally acts. But macroeconomic data will have to show signs of faster growth and, more importantly, confirmation that inflation is going to move a bit higher before anything changes. In the meantime, we are back where we were for much of 2014, bullish on the dollar in anticipation of a pace of rate hikes which may simply not happen.

5 China and emerging markets

Q Andrew Rozanov

Neil, before we conclude, let me ask you to comment briefly on the situation currently unfolding in China, and on what's going on in emerging markets (EM) more broadly. You have been warning us for some time now about the spectacular bubble building up in China's stock markets, even as the country's economy continued to decelerate. Last week saw a dramatic drop in the Shanghai stock market. Has the bubble popped?

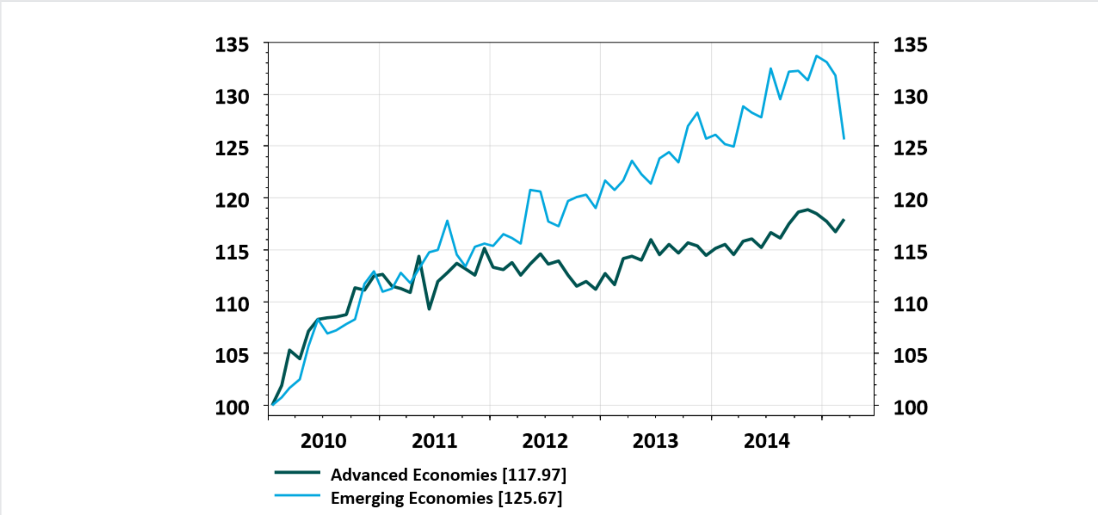
A Neil MacKinnon

"The credit bubble affecting China is considerable and is about 280% of GDP in total."

Indeed, it was a bad week for the Shanghai Composite, which had its worst weekly decline since 2008. I am not entirely sure that the bubble has burst and that we are seeing a definitive top. However, margin debt on the Shanghai and Shenzhen stock exchanges is not far short of a record US$ 400 billion. The credit bubble affecting China is considerable and is about 280% of GDP in total. As George Magnus points out in his research, the challenge facing the Chinese authorities is squaring the circle of trying to meet their 7% GDP growth target while avoiding a bursting of the credit bubble that could bring about a 'hard landing'. The GDP numbers do not reflect what is really going on, and GDP growth is certainly a lot lower at the moment. By the way, I would also note that short-selling in the Japanese equity market reached a record high last week, with foreigners being largely responsible – and foreigners own a record 32% of Japanese equities!

As for emerging markets more broadly, **there is increasing talk of an EM-induced recession**. It is noteworthy that export growth is down in China, but also in Japan and South Korea. World trade volumes are stagnating, and this could spill-over into the advanced economies. I just want to highlight a chart based on the CPB World Trade report, which provides the most recent export volume data globally.

Export Volumes



Source: CPB Netherlands Bureau for Economic Policy Analysis, The ECU Group plc

e: research@ecugroup.com
w: research.ecugroup.com

Of the BRIC economies, Brazil and Russia are in recession. China is slowing, and commodity prices are at multi-year lows, especially base metals and coal (which drives China's energy). The BRICs together account for 20% of the global economy. More generally, EM economies account for 52% of the global economy, compared with 38% at the time of the Asian crisis in 1997. So **my advice is to keep an eye on the trade data, especially out of Asia**.

Andrew Rozanov

Gentlemen, thank you very much for your views 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.

e: research@ecugroup.com
w: research.ecugroup.com

For more information on our other strategies, please contact Bansi.Jashapara@ECUgroup.com

Our Strategies

Global Macro Viewpoint — Neil MacKinnon, Kit Juckes


Weekly: Global Investment Q&A

Chaired by Andrew Rozanov, we provide a "Start the Week" client-driven Q & A discussion between Neil MacKinnon and Kit Juckes focussing on topical issues and driving forces influencing major asset classes.

Daily: Daily Bullets

A "Start the Day" roundup, providing opinion and strategy, and highlighting key events, data releases and global market news.

FX Strategy — Stephen L Jen

Fortnightly: Briefing Notes

Stephen Jen provides a detailed and rigorous study of a key topical investment theme or global market issue.

Weekly: My Thoughts on Currencies

Stephen delivers a strategic analysis of key global issues driving currency markets.

Asset Allocation Roadmap — Robin Griffiths

Quarterly: The Big Picture

Chief Technical Strategist Robin Griffiths takes a look at the longer term trends prevailing in global asset classes.

Monthly: Asset Allocation Roadmap

Robin uses ECU's proprietary models and qualitative analysis to give monthly strategic opinions and updates.

Thematic Pieces — Professor Charles Goodhart, George Magnus


Monthly: Think Piece

Professor Charles Goodhart and George Magnus write topical and thought provoking pieces that explore longer term themes in the market and issues that affect the global economy.

Why ECU?

Our People

Our leading and broad based macroeconomic research team comprise highly respected and internationally renowned strategists. As a collective, our principal team is actively engaged with and advise the world's foremost central banks, ministries of finance and leading global institutions.

Unbiased Research

Free from conflicts of interest, members of our macroeconomic team provide their independent, unedited and insightful viewpoints, reflecting their individual core competency and deep first-hand knowledge, experience and understanding of the chosen subject matter.

Market Timing

Our strategists are actively involved in global markets, in the context of managing money and/or risk. Their collective inputs, derived from their own knowledge and proficiency, provide money managers highly pertinent, concise, and timely event driven analysis and direction.

Advisory

A key element to our top tier research offering is in our ability to offer exclusive access to clients who appreciate the value of receiving unbiased, unscripted advice at the highest possible level, in a format that can be customised to address the specific needs and concerns of each.

e: research@ecugroup.com
w: research.ecugroup.com

Disclaimer