



Interview

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The Return of 'Irrational Exuberance'?

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1 The Global Economy

Q Andrew Rozanov

Before we go on this week's virtual 'tour around the world', let me put to you a very simple question. To anyone looking at the state of the global economy and the multitude of macroeconomic, financial and geo-political risks, the world appears to be a highly unstable place, where many things can go wrong. But to anyone looking at the recent performance in the world's equity markets – whether it's the S&P 500 or the FTSE 100 or the Nikkei 225 or the Hang Seng or the Shanghai Composite – every index seems to be pricing in perfection and an investor nirvana. Are we witnessing 'irrational exuberance'?

A Neil MacKinnon

I must admit that I am worried. We are seeing softer PMI data across the board: China HSBC manufacturing, Eurozone PMI manufacturing and US PMI manufacturing indicators were all

down last week. The Greek problem is getting worse, not better. There are legitimate concerns of a possible US earnings recession and potential further disappointment on economic growth. The outcome of the general election in the UK is a major source of uncertainty. And the risk of a bubble collapse and a hard landing in China is the biggest source of concern. And yet, last week we saw the S&P 500 index make a record high (as did NYSE margin debt), while the NASDAQ and the Nikkei both made 15-year highs. And the Shanghai Composite has doubled in the space of just 12 months! Quite frankly, **I am worried now about an imminent correction of up to 20%.**

NASDAQ



Source: Market Analyst

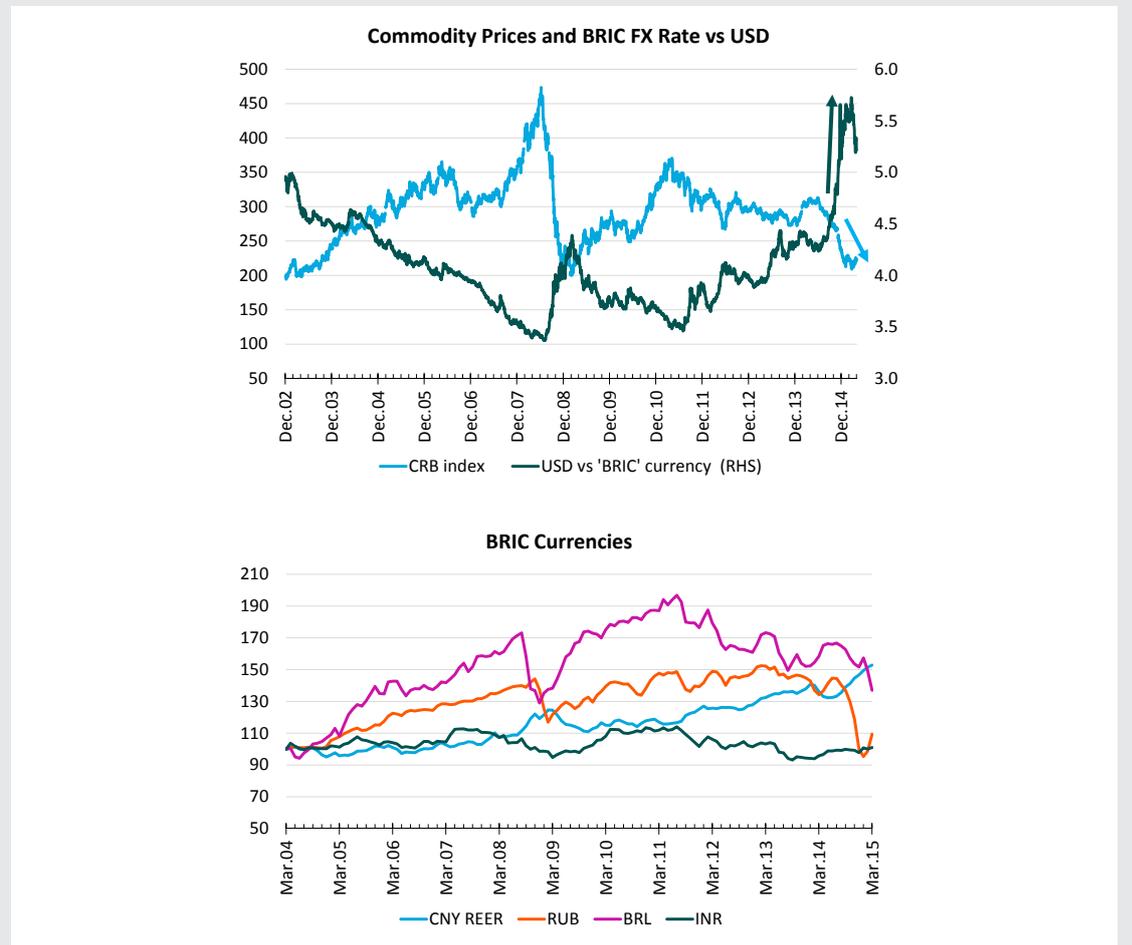
A Kit Juckes

“Between the fourth quarter of last year and the first quarter of 2015, oil prices, the euro, and bond yields collapsed.”

You could also look at it from a slightly different perspective: even as various equity markets are making record or multi-year highs, other assets have been moving in the opposite direction, making multi-year lows. Between the fourth quarter of last year and the first quarter of 2015, oil prices, the euro, and bond yields collapsed. However, oil prices stopped falling in January, the CRB commodity price index reached its low in March, and so did the euro and European credit spreads. Even European government bond yields managed a bounce of sorts last week. So from where I stand, the big market trends of the past few months have either ended or paused.

One other thing that reached a low last week was the level of US Federal Funds rate implied in the futures market for the end of this year. The December contract reached 99.67 on Friday, pricing in a rate of just 33 basis points, which is a full percentage point lower than was priced in at the height of the taper tantrum in 2013, and a quarter of a percentage point less than was priced in at the start of this year. If we have another week of mostly mediocre US economic data, we’ll see consensus forecasts of first quarter growth drop below 1%, thus setting the scene for an FOMC meeting which, surely, will leave the Fed continuing to watch data, doing nothing, and sounding dovish.

Commodity Prices and BRIC Currencies



Source: Datastream

2 The US

Q Andrew Rozanov

Since we're on the subject of the Federal Reserve and rate rise expectations, what are your current thoughts on this? The Fed keeps telling us that they will be data-dependent, and we know they are keeping close tabs on macroeconomic data, as well as inflation expectations and the US dollar. But what about the exuberance we see in the equity markets? Are they factoring this in?

A Neil MacKinnon

The consensus view in the market is that September this year is the earliest date for a 'lift-off' in the target range for the Fed Funds rate, but I am not yet ruling out June, as I think that the Fed is indeed mindful of the risks to financial stability from prolonging its current ultra-easy policy stance. But I believe the clincher will be the non-farm payroll report on 8 May: **if we see job gains in excess of 250,000 – then I think a June rate hike will be back on the agenda.**

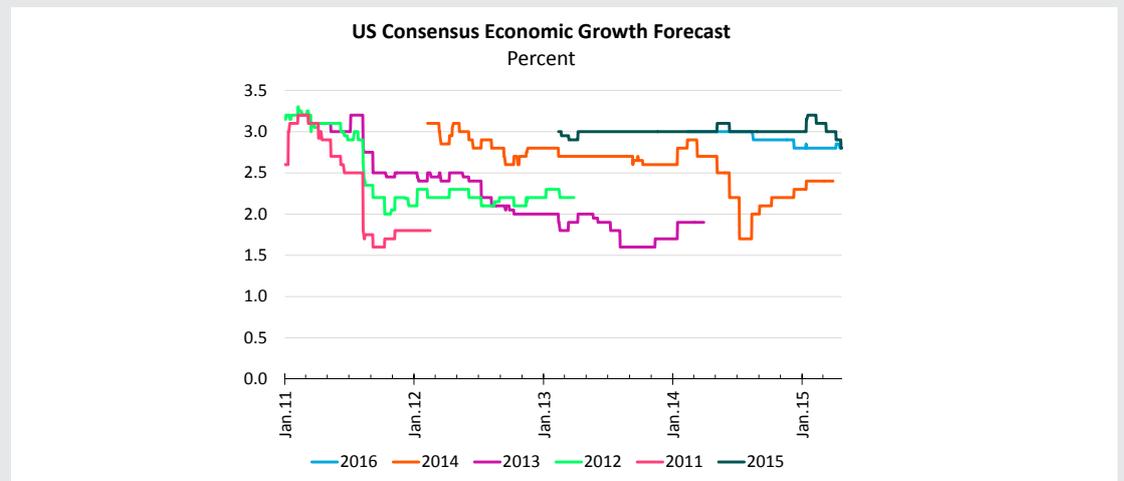
A Kit Jukes

It's interesting how at the spring IMF meetings there was all this talk about what markets might do when the Federal Reserve finally gets around to raising rates, and yet we don't seem to be getting much closer to that day. I mentioned earlier the pause we're seeing in the major market trends of the last few months – well, anticipation that the zero rate policy would finally end has played a massive part in those trends, namely, a stronger dollar, weaker commodity prices, and capital outflows from emerging markets. So we shouldn't really be surprised that pushing back the expected date of that first rate rise has seen some of these trends lose momentum.

"... anticipation that the zero rate policy would finally end has played a massive part in those trends..."

For the last few years, we were starting out in January full of excitement that, at last, we would see a 'normal' US economic recovery with growth accelerating on the back of an increase in capital spending, and with employment leading to a revival in the housing market and a splurge in the stores. Consensus forecast of GDP growth for every year during 2011-2014 was revised steadily lower in the first part of the year, recovering only some of that lost ground in the second half. So far, 2015 is seeing exactly the same pattern, with hopes of a 3%-plus growth fading away, and 2016 growth forecasts already coming down too.

US Economic Growth



Source: Datastream

A Neil MacKinnon

Actually, on this point, the Fed's Stanley Fischer suggests that **there might be a new seasonal pattern at work** and notes that in the first quarter of the last three years, US GDP growth has averaged 0.6%, with a rebound subsequently taking place. That indeed was the story last year, as GDP growth reached an annualised rate of 5.0% in 3Q 2014. As a result, I do expect the US economy to recover later this year, although I am mindful of the limitations coming from monetary tightening and the fading of the positive impact from lower oil prices.

“...favourite FX trades like long USD against AUD or CAD are looking stale and going nowhere.”

A Kit Juckes

Well, another year of solid employment growth and real GDP growth above 2% would surely strengthen the case for arguing that interest rates should be raised to a level meaningfully above zero, even in the absence of any serious signs of inflation! But I'm afraid the Fed is in no hurry to act: **despite the repeated negative experience from delaying interest rate rises in 1994, 1999, and 2004, it is still conventional wisdom that the risks from raising rates too early far outweigh those of delaying too long.** If we're left in limbo, watching the US economy fail to accelerate and waiting for the US jobs report data, which, as Neil mentioned, won't be out until 8 May, we can't expect too many market fireworks. In the meantime, as commodity prices have stopped falling and shifted to a range-trading regime, favourite FX trades like long USD against AUD or CAD are looking stale and going nowhere. We'll see what the Reserve Bank of Australia has to say about it this week, but at the very least, the US dollar rally and the fall in commodity currencies are looking a little tired right now.

3 Data Releases

Q Andrew Rozanov

This week is quite busy from a macro point of view in terms of data, earnings and central bank meetings. And yet, from what I'm hearing, you don't seem to expect much by way of potentially market-moving data or policy decisions...

A Neil MacKinnon

Indeed, from a macro analyst's perspective, this week has a busy calendar. The FOMC and the BOJ will hold policy meetings, though the general expectation is that both will be non-events. But let me go back to the US economy and the Fed. As we discussed, recent US economic data has fallen short of expectations, with Bloomberg's US Economic Surprise Index back at the lows we saw in 2012 (though not as low as 2008 and 2011). This week's US GDP data for the first quarter is also likely to disappoint if it prints in line with the Atlanta Fed's GDP 'nowcast' model, which points to zero growth. As I said earlier, I agree with the consensus view (and the Fed's view) that the US economy will bounce back. But **if we don't see a strong non-farm payroll report on 8 May, the market will inevitably start worrying that the Fed has got it wrong.**

Also, the US capex cycle may have peaked, if the latest durable goods orders is anything to go by. Core capex has been drifting lower from the peak seen in mid-2014, although this may reflect the investment cutbacks in the shale oil industry rather than anything more wide-spread. Nevertheless, a turning point in the capex cycle chimes with the notion that we may have seen the best of growth in the US GDP cycle when there was a 5% annualised growth rate in the third quarter of last year. **The worst-case scenario for the Fed is that they have "missed the boat" and face the prospect of tightening into the downswing phase of the US economic cycle.**

This suggests that the US 10-year Treasury yield will remain under downward pressure in the near term. Technically, I note that the 50- and 100-day moving averages, which converge around the 2.00% level, have restrained the upside for the 10-year yield over the past month or

so. With US equity markets at record highs and the US dollar a bit softer, there is a window of opportunity for the Fed to consider raising the target range for the fed funds rate. However, this is certainly not a “trigger-happy” Fed and only a very strong non-farm payroll report on 8 May will shift market expectations from a September move.

A Kit Jukes

I will just make one additional observation. With the world’s biggest source of economic demand operating at less than full speed, the rest of the world is fighting for a greater share of a global market which is not growing as fast as they would like. Hence the pressure for even more monetary easing and currency weakness. In other words, while the disappointment in the US data has undermined the dollar somewhat, it also reduces the chance of significant upside surprises elsewhere, particularly in emerging markets and in commodity exporting countries.

4 Europe

Q Andrew Rozanov

Let us now turn to the Eurozone and Greece. The eurogroup of finance ministers held its meeting in Riga last Friday, but it didn’t seem to get us any closer to a resolution. Have the risks increased since we last spoke?

A Kit Jukes

Well, there isn’t much new news in Europe. **A ‘Greek Drama’ is probably a more apt description at this point than a ‘Greek Tragedy’, but either way, Greece is running out of cash and time**, and progress to find a solution to the crisis is painfully slow. Markets appear to be, by and large, indifferent though. The euro is trading in a range, and the sell-off in bond markets is probably temporary. If we have learnt one thing from the slide in bond yields, it is that there are many investors in Europe whose mandates simply don’t allow radical asset allocation switches out of euros and Eurozone government bonds into unhedged foreign bonds and equities. In this regard, Japan can teach Europe a lesson or two: if you want to force investors out of domestic government bond markets, the regulators charged with oversight of insurance companies, pension plans and investment funds must play ball and allow this to happen. This lesson is even more relevant in the case of Switzerland than Germany, as the SNB tries to tighten up the rules determining who can avoid paying negative interest rates.

A Neil MacKinnon

I don’t think it was a surprise for anyone that Friday’s eurogroup meeting failed to reach a deal with the Greek government. As usual, “deadlines” are floating, not fixed. Nevertheless, as Kit was saying, Greece is moving closer to a “cash-crunch”. The next eurogroup meeting is on 11 May, and on 12 May the Greek government is scheduled to repay EUR 770 million to the IMF. Throughout the summer, repayments to the IMF and the ECB, as well as T-bill refinancing requirements, will escalate (the next T-bill refinancing is scheduled for 15 May, amounting to EUR 1.4 billion). Press reports over the weekend suggest that Greece’s official creditors are

“...if you want to force investors out of domestic government bond markets, the regulators ... must play ball...”

putting together a so-called “Plan B” which would countenance a Greek default without an exit from the monetary union. In the meantime, Greek banks’ reliance on ECB funding has increased sharply, and Greek bond yields continue to edge higher.

“Press reports over the weekend suggest that Greece’s official creditors are putting together a so-called ‘Plan B’...”

My view is that Greece will default quite soon. But I have to say that I have sympathy with the Greek position. The fiscal austerity imposed on them has been brutal and had a severe impact on the economy. They are in a “debt trap” set for them by Brussels and Berlin. The latest budget data showed that the Greek government debt-to-GDP ratio now stands at 177%. This is despite the 2012 debt restructuring that resulted in a sizeable “haircut” for private investors, who now own just 10% of Greek government debt. A further debt restructuring is inevitable. At some stage, Greece might well exit the monetary union and whatever the short-term impact, I believe that an exit will be beneficial for the Greek economy in the longer-term.

5 The Euro

Q Andrew Rozanov

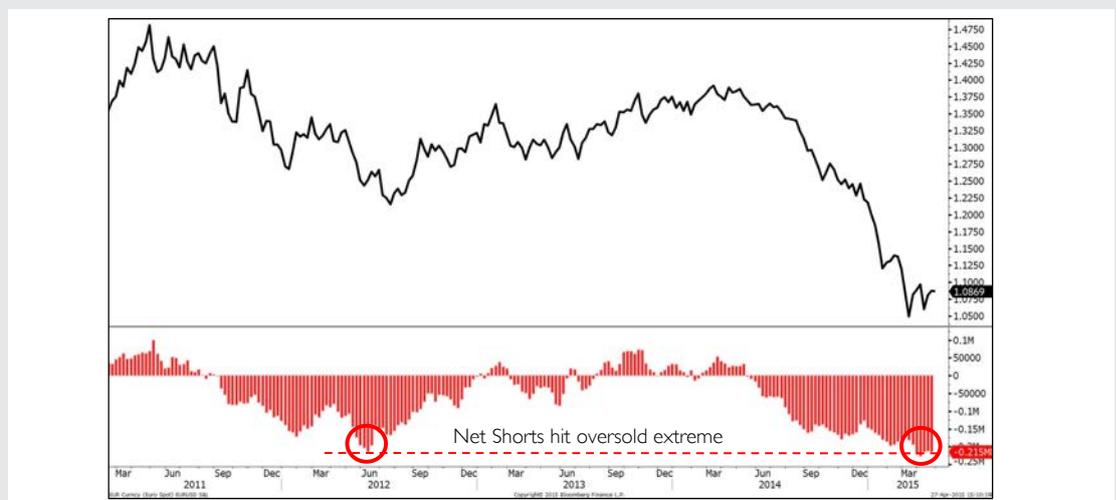
So what does this mean for the euro? More weakness ahead?

A Neil MacKinnon

Well, speculative positioning in the euro is extremely short, which probably explains why the downward move in the euro has now moderated and why EUR/USD has made a “double bottom” around the 1.0500 level.

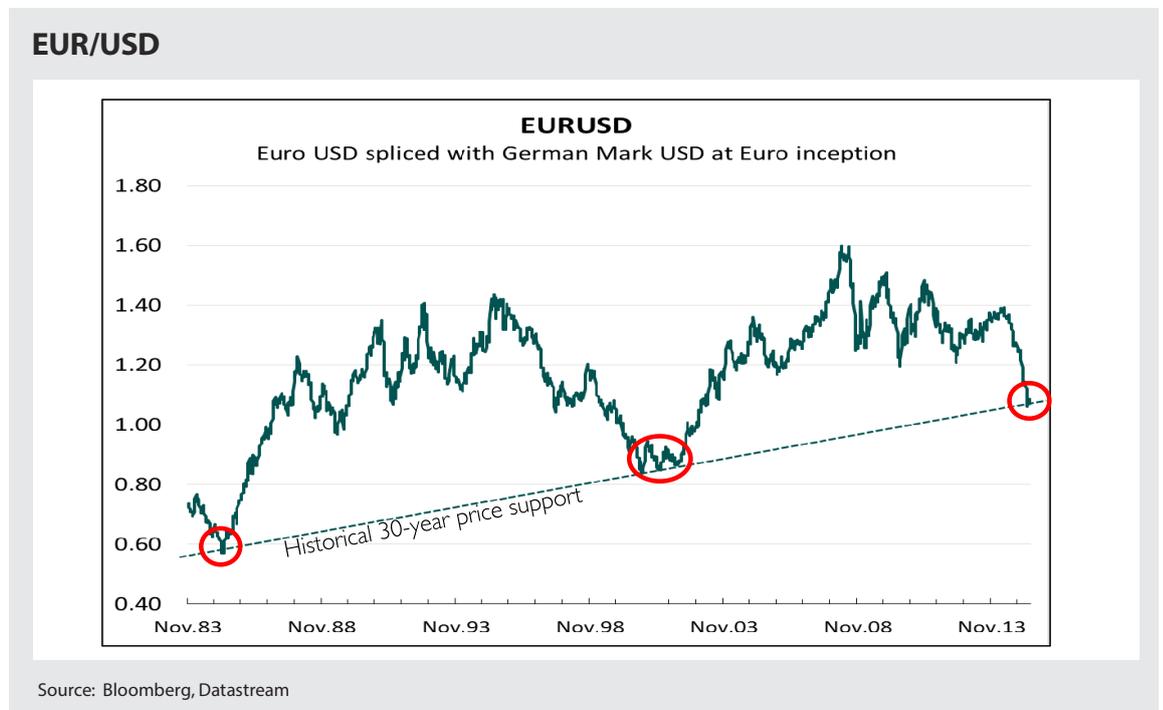
Fundamentally, the key drivers are still US dollar-positive, but in the short term, if the EUR/USD rate breaks above the 50-day moving average at 1.0892, then there might be a surprise move

EUR/USD



Source: Bloomberg

all the way towards 1.1350, which is the 100-day moving average. Also, the chart showing the historical 30-year price support level offers food for thought.



6 Asia

Q Andrew Rozanov

OK, let us now turn to Asia. This is the region where I fear the disconnect between exuberant stock markets and the underlying economic fundamentals may be the greatest. What do you think?

A Neil MacKinnon

The Shanghai Composite is certainly a “bubble”, but it may still be some way from bursting. **Inevitably, it will pop when we least expect it,** but all the classic characteristics of an “Eiffel Tower” bubble formation certainly apply here. The Chinese authorities are in a bit of a jam. They are loosening monetary policy and moving towards some form of QE/LTRO-type policies in order to achieve their 7% GDP growth target. Many economists believe that the official GDP figures are bogus and that other monthly indicators, such as the PMI data or power output, suggest that China might actually be close to a recession. The property price cycle shows no sign of bottoming: prices are down 5.7% year-on-year and total floor space under construction is at a 14-year low. This is highly significant, since **the property and construction sector accounts for 25% of Chinese GDP.**

But credit expansion remains resilient, with the “baton” shifting from shadow banks to traditional banks, according to the latest money supply data. It is also worth mentioning the activities

“At some stage, one or more of these Chinese hedge funds will blow up.”

of Chinese hedge funds, which are estimated to have at least USD 200 billion of funds under management. They have grown at an explosive rate and dominate commodity futures trading in Dalian and Shanghai especially. The recent bounce-back in the iron ore price, and commodity prices generally, reflects short covering by these funds. The connection between commodity price movements and fundamentals is pretty thin, and “fast money trading” appears to have altered the historic inter-play between supply and demand. At some stage, one or more of these Chinese hedge funds will blow up. Brent crude is also at a high for the year at USD 65, although CFTC data shows that long positioning on the part of speculative traders is at record highs. So if Chinese demand does not pick up, then the recent moves in commodity prices will fizzle out.

Brent Oil



Source: Market Analyst

Q Andrew Rozanov

What about Japan?

A Neil MacKinnon

Japan continues to struggle. Even with the BOJ’s QQE programme, a currency depreciation, a 15-year high in the Nikkei 225 index and some pick-up in real wages, the IMF does not expect real GDP growth in Japan to be much above 1% this year. Similarly, progress towards meeting the BOJ’s 2% CPI inflation target is proving difficult. Whether the BOJ increases the size of its QQE programme remains to be seen. Some commentators think it is possible in the summer, though comments from the BOJ about this are ambiguous. The BOJ meets on 30 April, but as I said, no change in policy is expected.

7 The UK

Q Andrew Rozanov

Finally, let us briefly turn to the UK – the general election campaign is in full swing, with less than two weeks to go before voting day. What’s your take on it?

A Kit Juckes

As the UK election draws closer, there is no change in the electoral math. The expected success of the Scottish National Party (polls now predict at least 50 SNP seats in Parliament) means that some form of SNP-backed Labour Government remains very likely. They will inherit a budget deficit of 5% of GDP, and a current account deficit that is somewhat larger. That makes the pound vulnerable to any bad news on the economy, but for now, strong employment growth and the lack of inflation are helping. No fireworks are likely and, if anything, with the UK interest rates priced for an even slower pace of increases (under 4 basis points per month) than the US, there is still some support for the pound if we get any positive surprises on the economy.

A Neil MacKinnon

The opinion polls continue to point to an uncertain outcome, with myriad possibilities that include, as Kit said, **a coalition arrangement between Labour and the SNP**. That **would probably be the worst-case scenario for the UK equity market**: not just because of the “tax and spend” policy that such a coalition would implement, but also because of the SNP’s intent on breaking up the United Kingdom. In that sense, they really are the “enemy within.” Let me also note on the side that the SNP’s ignorance about international economics is quite remarkable! The 50% drop in the oil price has now been conveniently forgotten, and the same is true of their original plan to peg the currency of an independent Scotland to sterling (Nicola Sturgeon should really read up on the recent travails surrounding the break in the EUR/CHF peg!) It really is astonishing to see how the SNP are quite happy to talk about shaking off 500 years of “English oppression,” only to happily hand over the keys of national economic sovereignty to technocrats in Brussels and Frankfurt, who by definition will dictate Scottish monetary and fiscal policy! For what it’s worth, I actually think that a Conservative/Liberal Democrat/UKIP coalition will be the outcome on 8 May.

“Nicola Sturgeon should really read up on the recent travails surrounding the break in the EUR/CHF peg!”

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 Jukes

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