ECU

Interview

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Weekly Report
May 27
2015

Fed Back in the Spotlight

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- **Europe in focus: Coeure's comments put an end to re-calibration**
- **Back to watching the Fed: markets may become 'super-sensitive'**
- **Keeping an eye on Japan: higher Nikkei and weaker yen ahead**

1 Europe

Q Andrew Rozanov

Last week, the Eurozone took centre stage in the minds of many macro analysts. First, Benoit Coeure delivered his market-moving speech in London on Monday. Then, we had yet another EU Leaders' summit in Riga, desperately trying to find a solution – even if a temporary one – to the whole Greek quagmire. Also last week, the ECB Forum on Central Banking was held in Portugal on 21-23 May with important speeches by top policymakers. And over the weekend, which happened to be a 'long weekend' in the US and the UK, the Greek interior minister made headlines by stating that his country won't make the EUR 1.5 billion payments to the IMF due next month. Therefore, I think it will be appropriate for us to start our conversation with Europe. What are your thoughts?

A Kit Juckes

There have been three distinct developments in Europe that are worth noting and bear watching going forwards. The first was, as you said, the speech by ECB board member Benoit Coeure

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during which he observed that after a rise in yields that was exacerbated by a lack of liquidity, the ECB will be front-loading some of their bond-buying, getting ahead of their monthly EUR 60 billion buying rate to compensate for a slower rate of buying during the summer. Another important development, in my view, was the second consecutive monthly fall in the Eurozone composite PMI. And the third was the reported warning by the Greek interior minister, which you also mentioned, that Greece will miss a payment to the IMF in June. The net result: **the rise in European bond yields now looks to be firmly behind us, and the same can be said of the euro's bounce**.

The notion that the ECB, planning to buy EUR 60 billion in bonds per month, may need to compensate for the difficulties of achieving that total during the height of summer surely comes as no great shock to anyone who has ever visited Paris in August. French, German and Italian bond investors are more likely to be buying ice cream than selling bonds to the ECB during the summer holiday season! However, Mr. Coeure chose to remind the market of the fact that the ECB can pick up the pace of its intervention precisely at a time when the euro rally and bond sell-off were both looking a bit tired. Also, this happened on a day when peripheral bond spreads were widening out, which the ECB probably dislikes even more than the correction in Bund yields or the euro. Central banker comments are all about timing, and **Mr. Coeure's timing was impeccable – if what he wanted to do was to halt the trends in spreads, yields and the euro**.

"The slight dip in the PMI wasn't a big surprise, but it may well bring to an end the upward revisions to 2015 growth forecasts in Europe."

The slight dip in the PMI wasn't a big surprise, but it may well bring to an end the upward revisions to 2015 growth forecasts in Europe. These will likely settle between 1.5% and 2.0%. So, with oil prices now looking range-bound, the big adjustments in growth and inflation expectations that triggered the euro rally and the bond sell-off, are largely done. From there, we move to the final act of the week, the warnings from the Greek Interior Minister which will make sure that the Greek debt crisis remains a topic of conversation in the coming days.

A Neil MacKinnon

Greece remains in the spotlight. As always, there are hopes of a last minute deal that unlocks the EUR 7.2 billion that keeps Greece afloat for a little while longer. However, it seems to me that discussions between the Greek government and its official creditors remain distant. More fundamentally, the key longer-term issue remains that of debt sustainability. At 180% of GDP, clearly it isn't. 5 June is the key date when Greece is scheduled to make a EUR 300 million payment to the IMF, which then escalates to a total of EUR 1.5 billion in the first three weeks of the month. Greece has spent the last few weeks going through all kinds of motions try and find some reserves of cash. **The fact is that they face an impending "cash-crunch" that can only end in a debt default**. To me, the IMF's position is unclear…do they just want their money back? And what happens then? Look out for capital controls for a start. But whether a default can be easily managed by the authorities is debatable. Investors will start to think that "Grexit" is next. Either way, a further restructuring of Greek debt is inevitable.

There may even be a view that this becomes "the beginning of the end for the common currency project" – as recently remarked by the Greek finance minister, Yanis Varoufakis. A run on the euro is easy to imagine, especially if the ECB pulls the plug on the Greek banks. From a market perspective, bond yields have already been edging up in Spain, Italy and Portugal. The recent regional and municipal elections in Spain are a foretaste of voter rejection of austerity policies. Portugal has elections in September. The opinion polls give the anti-austerity Socialists a small lead. Portugal has the largest debt level as a percentage of GDP in the EU, which stands at 350%, combining both public and private sector debt. Depositors will inevitably take their money out of "southern banks", so look out for pressure on bank stocks as capital takes flight. The ECB has exposure of about EUR 110 billion to Greece, while total official EU exposure to Greece amounts to EUR 331 billion.

2 The Eurozone

Q Andrew Rozanov

But if we were to look beyond the more immediate Greek problem – and even beyond the remaining problems in the periphery – are Eurozone policymakers demonstrating a reasonable grasp of what needs to be done more broadly? I am asking because the ECB Forum of last week is supposed to be Europe's answer to the Fed's renowned Jackson Hole Symposium, where policymakers and academics gather to discuss the economy and monetary policy from a longer-term perspective. What was your take on those proceedings?

A Neil MacKinnon

"... monetary policy can only do so much!"

Well, Mario Draghi's views on what needs to be done are pretty clear: monetary policy can only do so much! Now that the ECB has done its bit, they want to see governments do what's required in terms of structural reforms, and – where possible – deploy fiscal policy to support growth in domestic demand. The persistence of a double-digit unemployment rate in the Eurozone as a whole is a function of the extremely low economic growth rates in recent years. Productivity and investment are weak, and demographic factors point to a decline in longer-term productive potential.

The Fed's Stanley Fischer gave an interesting speech on the prospects for the Eurozone at the ECB Forum. He took his theme from Jean Monnet, one of the founders of the European Union, who wrote in 1976: "**Europe will be forged in crises, and will be the sum of the solutions adopted for those crises**." Fischer asked three questions: Has modern Europe developed primarily through crises? Will it be stronger when this crisis is over? And what challenges or crises is Europe likely to have to deal with in the future?

There is a clear 'democratic deficit' in the EU, and voters in the UK and throughout the EU now increasingly feel that the EU and EMU economic model has produced unacceptably high unemployment, a reduction in living standards and an increase in debt. Fischer correctly observed that **monetary union will not survive unless it brings prosperity to its members**. Can the euro survive and will the EU come out stronger and even more 'integrated' out of the current crisis, as Jean Monnet envisaged? Or will this be the "beginning of the end"? At the moment, the odds of survival are shaky, in my view.

3 The US

Q Andrew Rozanov

Now let us turn to the United States. Will it continue to be overshadowed by the developments in the Eurozone, or do you think the markets will refocus on the Fed's actions now?

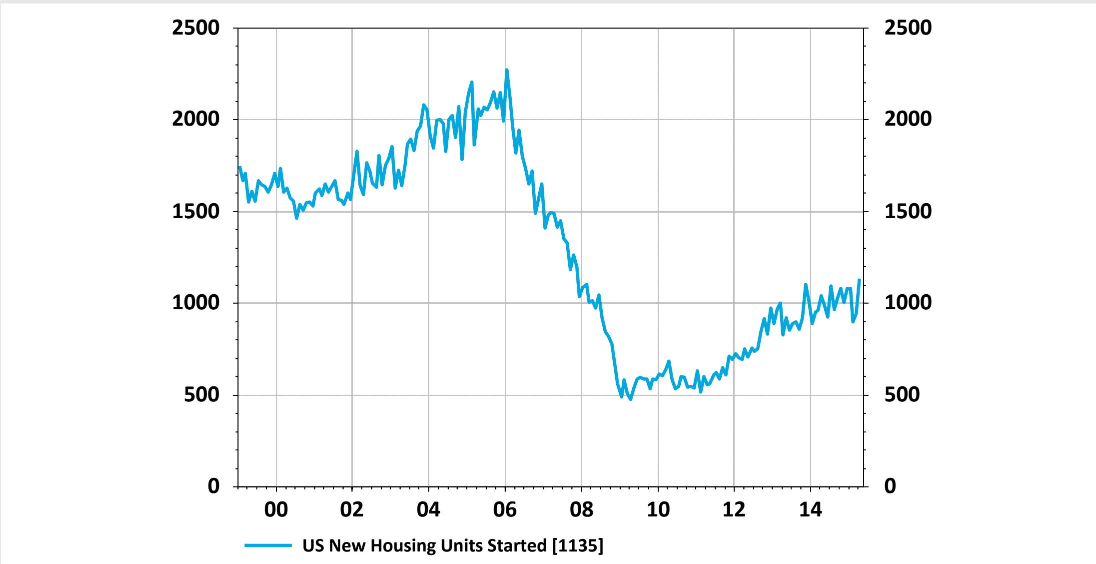
A Kit Juckes

"... speculating about when, how fast and how far they increase rates has been staple fare for markets over the last couple of years."

The Greek debt crisis may rumble on, but for the most part, the ECB will probably no longer be the immediate focus of the markets: they will go on buying bonds, and they will keep rates at these levels for a long time. I think the focus will now shift firmly back to the Fed, and to be honest, this prospect fills me with a bit of dread, because speculating about when, how fast and how far they increase rates has been staple fare for markets over the last couple of years. What it means is that **every nuance of the US economic data will now have a magnified impact on financial markets**.

Last week saw two key US economic releases: housing starts for April bounced sharply, and although headline annual CPI inflation dropped to -0.2%, the underlying core measure was less helpful and left markets going into the long weekend extremely edgy, as the dollar rallied and bond yields rose in the US.

US New Housing Starts



Source: The ECU Group plc, DataStream

In between, there were a range of slightly disappointing indicators, from the Markit PMI to existing home sales, while the FOMC Minutes show only that the Fed is uncertain how much of the weakness in the first quarter was temporary. So on we go towards revised Q1 GDP data, and then – in two weeks' time – the employment report for May.

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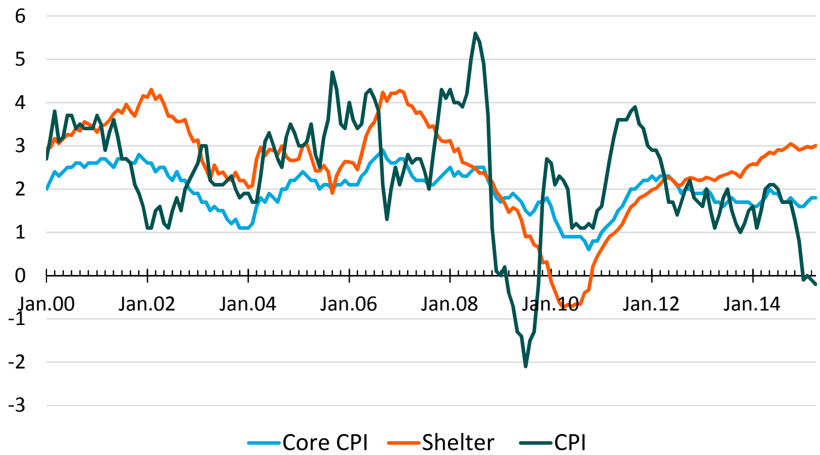
The biggest source of upward pressure in the US CPI data is housing, with 'shelter costs' – which represent a third of the overall index – rising at a 3% annual rate. Hence the wide gap between headline inflation and the underlying, ex-food and ex-energy, measure.

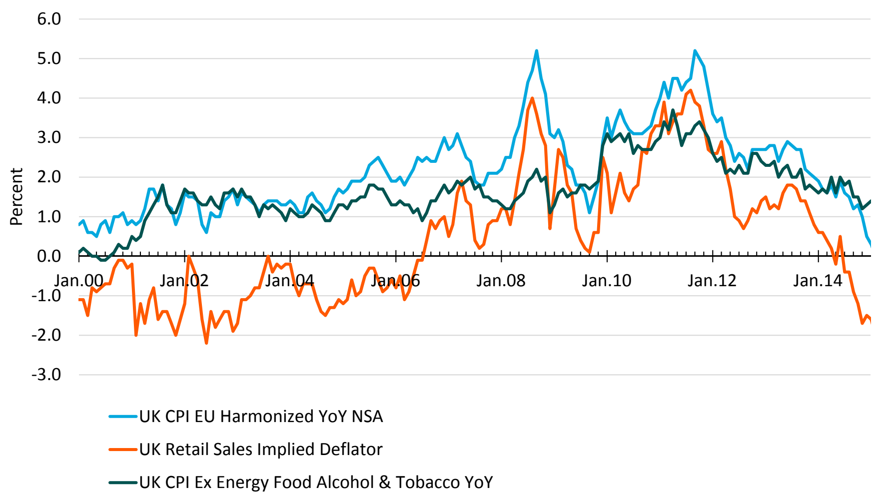
US CPI and Housing



Source: The ECU Group plc, DataStream

Measuring the annual inflation of housing costs is at best an inexact science, but on the measures used by the US and UK statisticians, US housing inflation is running considerably faster than is the case in the UK. By contrast, the UK retail sales data that were released last week showed high street prices, excluding auto fuel, falling at a 2.2% annual rate. So UK disinflation really isn't just about petrol prices. As a result, I believe that the stickiness of US housing cost inflation, at least as measured by the CPI data, is one of a number of reasons to look for the US Fed to hike rates much earlier than the Bank of England.

UK Disinflation



Source: The ECU Group plc, DataStream

A Neil MacKinnon

On Kit's point regarding sterling, there is of course the additional cloud now hanging over the British currency due to the impending EU in/out referendum in the UK. It inevitably creates uncertainty for investors, which is why some business leaders and the Bank of England want the referendum to be held 'early'. The Queens's Speech, which is delivered on Wednesday this week, is said to include details of the referendum. In the meantime, Prime Minister David Cameron hopes to renegotiate EU powers. Good luck with that!

As for the Fed, last Friday's speech by Janet Yellen highlighted that rate hike sometime this year is more or less inevitable. The Fed is hardly trigger-happy when it comes to raising interest rates. **I am still in a minority of one in thinking that June may still be on the cards**. The S&P500 index made a record high last week, and the US dollar is starting to firm up again with the USD/JPY at 123. I guess the US Treasury won't have a problem with 130…

"It's more a question of which data you are dependent on!"

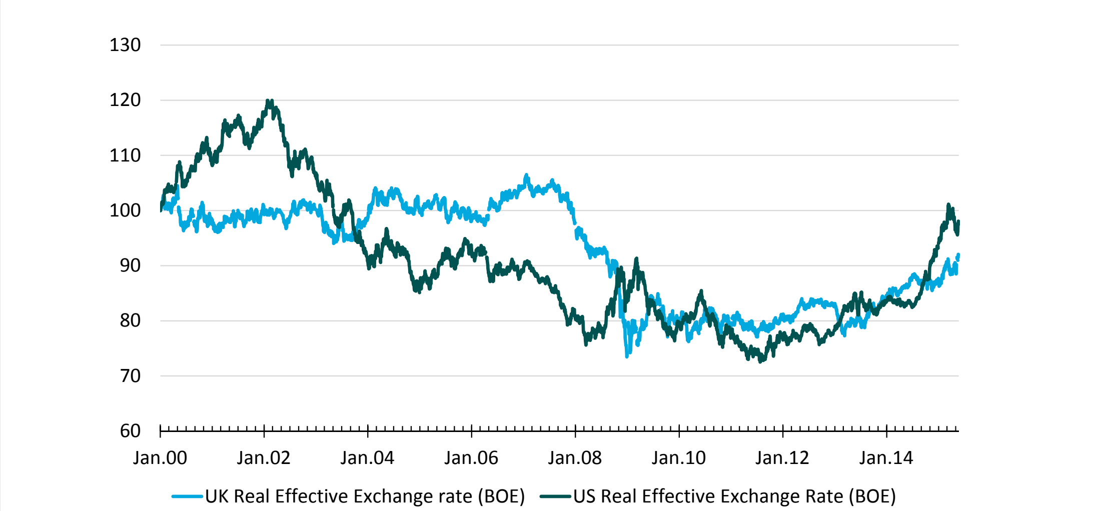
In our conversation last week, I mentioned the research from the Philly Fed and the San Francisco Fed that through a re-measurement of GDP, or by adjusting the seasonal factors, that GDP growth was actually closer to 1.7-1.8% rather than the 0.2% in the official statistics. I think that Janet Yellen buys into this. If the US economy is stronger than the official data suggest, this brings into question the famed "data-dependency" that the Fed has referred to in making its decision to raise the Fed Funds target range. It's more a question of which data you are dependent on! I note that the durable goods orders were revised up significantly in Tuesday's batch of US data releases. If the US economy is stronger, then this should be reflected in a stronger labour market. **The litmus test is the US nonfarm payroll report on 5 June**. In fact, mark 5 June in your diary, what with a Greek default possible on that day… I think OPEC are also meeting that day too! If the NFP data is weak for some reason, then I will have to eat humble pie and capitulate to the consensus view of a September hike.

A Kit Juckes

In my view, a September rate hike in the US is still a decent bet. However bad Q1 GDP growth looks, Q2 is likely to post a rebound. If that happens against a backdrop of inflation edging a bit higher thanks to the oil price correction, at the same time as the unemployment rate keeps falling, the Fed will likely feel that it is safer to hike in 2015 than 2016. And if that indeed is the case, then September will appeal much more than delaying until just before Christmas. Even a tiny acceleration in wage inflation in the meantime would prompt concern that they were delaying for too long. As I said, markets will probably react to every nuance of the US economic data in the coming weeks. And if it shows that spring has indeed brought not only better weather, but also correspondingly better data, we will see marginally higher US bond yields and a stronger dollar. The stronger dollar, however, has not fed through into US equity market weakness this year, which to me suggests that, finally, **the 'risk-on/risk-off' pattern of hyper-correlated financial market behaviour may be fading**. If a stronger dollar reflects a stronger economy but doesn't point to a dramatic monetary policy shift, it can be welcomed by the equity market and, by the same token, need not strike fear into the heart of emerging market assets.

In the UK, extraordinary high street price deflation actually feeds into stronger retail sales growth, in volume terms, as rising real incomes support consumer demand. The housing market is regaining momentum after the election, but the prospect of a tough Budget in July, with considerable public sector spending restraint, hangs over the economy a bit. A tighter fiscal policy will imply even less need for monetary tightening and an even lower peak in interest rates. That's good news for the long end of the gilt market, but less good news for the pound, which is looking quite stretched against the Euro and very vulnerable against the dollar.

UK & US Real Effective Exchange Rates



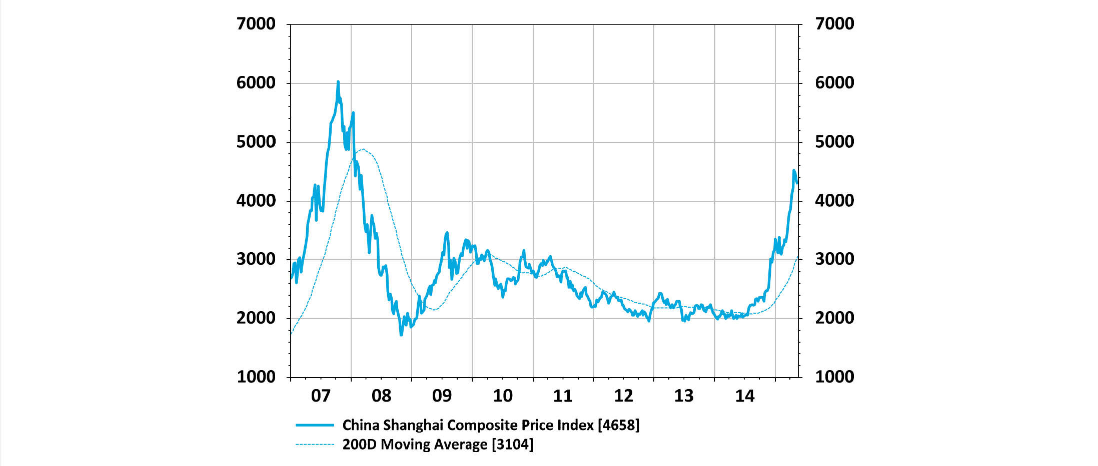
Source: The ECU Group plc, DataStream

A Neil MacKinnon

I agree with Kit that **the first hike will probably be well-received by the equity markets**. The Fed is likely to wrap it up with dovish language, and we have spent so much time cogitating about the Fed's intentions that when they actually do move, we will all breathe a sigh of relief! A problem further down the road is that the FOMC expect the Fed Funds rate to reach 3.5% by end-2017. That implies an aggressive pace of tightening, especially relative to what is being priced in the by the Fed Futures market, where expectations are lower compared to the Fed's. Historically, the US Fed Funds rate has fallen by an average of 500 basis points in all US recessions since 1970. In this cycle, the Fed won't have the same ammunition to combat the next recession or the next financial crisis.

All this comes at a time when the global economic picture is still shaky. China is definitely slowing: while it accounted for 85% of global growth in 2012, now it is likely to be about 25%. As I pointed out last week, China's monetary stimulus is finding its way into the Chinese equity market. The Shanghai Composite was the star performer last week with an 8% gain, and is up 52% year-to-date. A classic bubble is in play, which might still have some ways further to run before it pops.

China Equity Market: Shanghai Composite



Source: The ECU Group plc, DataStream

4 Japan

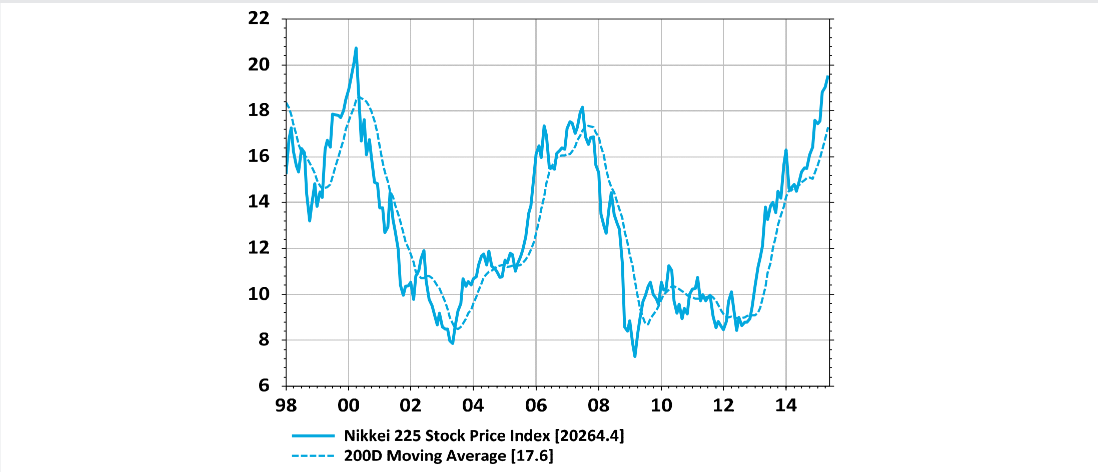
Q Andrew Rozanov

Before we conclude this week's update, let me ask you briefly about one country which we haven't spent much time discussing in the past, but which I hear is increasingly on the minds of institutional investors this year – Japan. What are your current thoughts?

A Neil MacKinnon

Well, Japan's PMI manufacturing index picked up last week, and the recent GDP data was also better than expected, though a lot of the increase was due to inventory accumulation. The Bank of Japan left its policy unchanged at the end of its two-day meeting, but "slightly revised up its assessment of the economy." The Nikkei index is now at its highest since 2000, and the USD/JPY is at the 123 level. Don't forget: loose money and soft currencies work wonders for equities!

Japan Equity Market: Nikkei 225



Source: The ECU Group plc, DataStream

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A Kit Juckes

At current levels, USD/JPY is now above its post-2008 crisis high. Interestingly, there hasn't been much of a catalyst beyond the continued strength of Asian equities. I mentioned earlier the breakdown in risk-on/risk-off correlations. I believe this might actually help USD/JPY longs: if the US dollar becomes stronger on higher US interest rates and if US equity markets continue to go up, this should work wonders for the long Nikkei / short JPY trade – even regardless of the lack of a Japanese economic driver to support this trade.

"...the Bank of Japan and the government are both committed to maintaining the current policies, which are asset market-friendly and yen bearish."

That being said, in terms of fundamentals, the Bank of Japan and the government are both committed to maintaining the current policies, which are asset market-friendly and yen bearish. From the technical point of view, the 124.15 high from 2007 is a reasonable target. Friday's CPI data will show core inflation in Tokyo for May almost back to zero, but I also expect strong data on employment and industrial production.

Andrew Rozanov

Gentlemen, thank you for your comments and views.

Biographies

Biography
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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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