Is Grexit Imminent?

US—Treasury market biggest source of risk?

Is ‘Grexit’ imminent amid signs of recovery in Europe?

China’s growth fades further

1 The Global Economy

Q Andrew Rozanov

Let me start with a ‘big picture’ question: how would you characterise the current state of the global economy and financial markets? What would you say are the main drivers at the moment, and what are the biggest sources of risk?

A Kit Juckes

Broadly speaking, three topics are driving global financial markets at the moment: (1) the never-ending story of when (and how fast) the US Federal Reserve will raise interest rates from their current exceptionally low levels; (2) the ECB’s asset purchase programme, and how long it will continue against the backdrop of the Greek debt crisis and the tentative signs of economic recovery in Europe; and (3) the economic slowdown in emerging markets, which is reflected most of all in the marked deceleration in China’s economic growth.
In addition to that, investors should keep an eye on the general election campaign in the United Kingdom, which is now in full flow and which is the source of considerable uncertainty; developments in Hong Kong, where until late last week investors seemed to be on an unstoppable buying spree in the local stock market; and oil prices, which have rebounded from their lows earlier in the year to trade in a range, thus producing somewhat of a recovery in the Russian rouble.

A Neil MacKinnon

I think Christine Lagarde put it succinctly when she characterised the current global economic recovery as “moderate and uneven.” According to the IMF’s latest assessment, they expect growth in the global economy to pick up from 3.5% this year to 3.8% in 2016, but in my view, this forecast might be open to disappointment, as tighter US monetary conditions and the fading effect from lower oil prices would likely result in lower growth. I believe that a global growth rate of 3.0% is more likely next year. For a while now, the IMF has been over-optimistic on the nature of the recovery, though over the last year or so they have become more circumspect given the hesitant, multi-speed, and sometimes fragile nature of the recovery.

Last week the IMF highlighted three downside risks to its forecast: (1) a further appreciation in the US dollar creating pressures for emerging market economies; (2) potentially disruptive asset price shifts; and (3) persistent geopolitical tensions. In its latest Global Financial Stability Report, the IMF also warned of a ‘super taper tantrum’ as the Fed moves closer to normalising monetary policy. But interestingly, the three downside risks I worry about the most have not been discussed anywhere near as prominently: namely, worsening deflationary pressures; rising protectionism; and use of beggar-thy-neighbour policies.

2 The US

Q Andrew Rozanov

Let us now zero in on the United States: not only is it still the largest economy in the world, it also seems to have been the only growth engine lately (with the possible exception of the UK), which has been leading this multi-speed global economic recovery. Will the Fed raise rates this year? And if so, what might be the broader implications of their decision – for example, in FX or emerging markets?

A Kit Juckes

The US interest rate market is now ‘priced’ for a single rate rise this year, bringing the Federal Funds rate (FFR) into a range between 25 and 50 basis points. FFR above 1% is not priced in until early 2017. Personally, I struggle to see how rate hike expectations can go any lower, or any further out, unless the market gives up hope on the interest rate cycle completely. The recent soggy economic data, whether weather-related or not, gives the Fed reason enough to delay the first move, and the dollar’s strength, along with the lack of any inflationary pressures, has convinced the Federal Open Market Committee (FOMC) that the risks associated with delaying are sufficiently small not to be too concerned. But the reaction in other markets to further adjustment of US rate
expectations is interesting. Many emerging market currencies, for example, are no longer rallying, as uncertainty about the Fed’s move and concerns about growth outweigh the usual reaction, which has been for investors to buy yield in the form of emerging market assets or equities. Fed rate hike expectations may be falling, but is it now a bit like pushing on a string as far as market optimism is concerned?

At the same time, while the US dollar has tracked the recent gyrations of short-dated Treasury yields, all that has done is to take the euro and the yen back up within recent ranges. Put differently, even as the market prices the FFR reaching 1% in 2017, EUR/USD can only bounce to 1.08 and USD/JPY remains well above the 2015 low of around 1.16. If US economic data prove to have only been weakened temporarily, then we are very close to the bottom for short-dated US yields, and the pause in the dollar’s rally is unlikely to go very much further.

“If US economic data prove to have only been weakened temporarily, then we are very close to the bottom for short-dated US yields, and the pause in the dollar’s rally is unlikely to go very much further”

At the same time, while the US dollar has tracked the recent gyrations of short-dated Treasury yields, all that has done is to take the euro and the yen back up within recent ranges. Put differently, even as the market prices the FFR reaching 1% in 2017, EUR/USD can only bounce to 1.08 and USD/JPY remains well above the 2015 low of around 1.16. If US economic data prove to have only been weakened temporarily, then we are very close to the bottom for short-dated US yields, and the pause in the dollar’s rally is unlikely to go very much further.

US Fed Funds (futures) Implied Probabilities for 2015 FOMC Meetings

At the same time, while the US dollar has tracked the recent gyrations of short-dated Treasury yields, all that has done is to take the euro and the yen back up within recent ranges. Put differently, even as the market prices the FFR reaching 1% in 2017, EUR/USD can only bounce to 1.08 and USD/JPY remains well above the 2015 low of around 1.16. If US economic data prove to have only been weakened temporarily, then we are very close to the bottom for short-dated US yields, and the pause in the dollar’s rally is unlikely to go very much further.

US Economic Surprise Index
We won’t hear much this week, however, as the economic calendar is light. But early May numbers from the ISM and from the Labor report will tell us more. And then we’ll have to see if equity and emerging markets, unable to get a lift from the hope of low rates being around for even longer, are setting themselves up for further weakness.

A Neil MacKinnon

I would like to take a step back and talk a little bit about one key theme in the market which I think may be somewhat under-appreciated, and which is directly linked to one of the downside risks I mentioned earlier: namely, the compression of market liquidity and the risk of deflation. Specifically, I am referring to the shortage of US Treasuries and other ‘safe assets’ in the global financial system, which, perversely, is taking place during a period when the major central banks have been pumping liquidity into the financial system! The problem is that the liquidity has not fully circulated in the real economy, as the money supply growth – particularly in the Eurozone and Japan – has been subdued. But the biggest source of risk might actually be the US Treasury market.

A quantitative easing (QE) programme can be thought of as an asset swap: the central bank buys bonds off the banks and the banks then deposit the cash from the sale of those bonds with the central bank. As long-term yields decline and bond yields fall to historical lows, the risk is that inflation expectations decline, raising deflation risks, which then sets in train further expansion of the QE programme by the central bank. In this sense, QE may actually be counter-productive. And as this continues, more and more high-quality government paper is taken out of the market by the central bank, while the private sector is increasingly reluctant to borrow in light of decreasing inflation expectations – thus resulting in the paradox of too much liquidity and an acute shortage of ‘safe assets’.

On top of that, due to regulatory constraints, traditional investment banks are cutting proprietary trading activities and lowering risk limits, thus causing a drop in dealer inventory levels (for US Treasuries, down to USD 1.7 trillion from a 2007 peak of USD 2.7 trillion). And this is all happening as the US government is issuing less debt due to the fall in the budget deficit from a peak of 10% of GDP in 2009 to 2.5% currently. Given this confluence of factors, should we be surprised by the ‘flash crash’ which happened last October, when the intra-day trading range in the Treasury market was nearly eight standard deviations, exceeding the price moves following the collapse of Lehman Brothers? I worry about the risks of the Fed tightening in this environment.

3 Europe

Q Andrew Rozanov

Let us now move on to Europe: what should investors focus on? Is it all about Greece at the moment? Or has the ECB, with its QE programme and a proactive Mr. Draghi standing ready to intervene, managed to create a ‘firewall’ around this problem?
“Already there is increasing talk of a ‘Grexit’ not necessarily causing contagion across bond markets and being manageable.”

A Kit Juckes

Indeed, while the European story is currently one of improved growth, there is increasing concern about the ability of the Greek government to make debt payments in the weeks ahead. The euro isn’t collapsing, and peripheral Eurozone bond yields have only moved slightly higher, but that doesn’t mean there is no fear of ‘Grexit’ or default. Rather, it means that the flood of money the ECB is pouring into the European bond markets simply trumps just about any other concern. Already there is increasing talk of a ‘Grexit’ not necessarily causing contagion across bond markets and being manageable. This, of course, raises the stakes. The less the euro area has to lose from a Greek exit and/or default, the less hard they will fight to make sure it doesn’t happen.
There really isn’t much point fighting a tidal wave of money. The euro’s bounce is tiny compared to the fall in recent months, but further weakness is likely. European bond yields will remain depressed, credit spreads will stay tight, and equity markets will probably go on performing well. And in the process, investors are increasingly being pushed into looking elsewhere for returns (which was, after all, the point of QE). So, European investors are shifting to US Treasuries, and that in turn means that even if the front end of the yield curve moves to price in a slightly faster pace of tightening, longer-dated yields will only move much higher when (or if) the inflation backdrop deteriorates. But I’m not holding my breath…

A Neil MacKinnon

Greece continues to be a problem. Even though the government overcame its first immediate hurdle when it repaid EUR 450 million to the IMF two weeks ago, the threat of an impending cash crunch has not gone away. Just look at the numbers: scheduled Greek payments to the IMF amount to almost EUR 1 billion in May, EUR 1.7 billion in June, EUR 4.7 billion in July and EUR 3.6 billion in August!

Eurogroup meet on 24 April, but the relationship between the Greek government and its official creditors remains poor, with much scepticism about Greek efforts at reform. The risk is, of course, that Greece technically defaults, with the probability of Grexit rising sharply. Watch out for bank holiday weekends in early May and Greek bank holiday on 1 June!

On the other hand, geo-political considerations from the US point of view suggest that there might be American pressure on Germany to come up with a last-minute deal. After all, the Americans do not want Greece to turn to Russia or find that the Russian Navy is berthed in the port of Piraeus. While some commentators might consider this scenario somewhat far-fetched, recent press
reports suggest that Syriza might sign a deal with Russia for Gazprom’s “Turkish Stream” pipeline project, which allegedly might unlock up to EUR 5 billion in advance funding. But in any case, the Greek situation needs to be monitored closely, as the risks of default are all too real: as Professors Reinhart and Rogoff pointed out in their classic book (“This Time is Different: Eight Centuries of Financial Folly”), Greece has been in default for 50% of its existence as an independent state since 1829.

A  Kit Juckes

From my perspective, what is happening in Europe at the moment is hugely significant, but I think it is much bigger than just the Greek problem. For most of the last thirty years, it has been US interest rates and bond yields which have been the drivers of global asset pricing. But this cycle is different. We can already see what the ECB’s policies have done to the Swiss franc and Swiss interest rates. Even in the US, I would argue that bond yields are kept down by what’s going on in the Eurozone. It is the weak Euro pushing up the dollar, not a strong dollar pushing down the common currency. The difference may be subtle, but it’s important.

Also, consider this: 10-year Swiss yields are already negative, and German 10-year yields will surely follow, unless there is a dramatic change in recent trends. And it won’t stop there! The Netherlands, France - who knows which countries could feasibly see their 10-year government bond yields drop below zero? The ECB’s QE programme, negative interest rates and the absence of inflation have conspired to create an increasingly bizarre landscape in the European bond market where investors pay for the privilege of lending governments money. Mind you, the alternative - putting cash in safety deposit boxes, demand for which has never been higher in Geneva - has obvious flaws, as the raid on the diamond vaults in Hatton Garden in London over Easter demonstrated only too clearly.
So what are investors to do? Again, in the short-term, they can’t fight the ECB: when the central bank buys bonds, yields fall. And the investors who sold the bonds to the ECB then have to look for other assets to buy. Since too few of those are denominated in euros, the common currency then also declines. Meanwhile, equities rally, helped by a falling currency, which boosts multinationals’ foreign earnings in euro terms, and because the yield on equities - the inverse of the price/earnings ratio - is increasingly attractive relative to bonds. If 10-year German government bond yields are negative, how high does a P/E have to be for its inverse, the equity yield, to be lower than bonds? The answer is infinity, which is, of course, absurd. But the more serious point is that low volatility or high dividend-paying equities are fast becoming the ‘safe’ asset of choice for European investors.

And in the short term, there are economic benefits: business confidence is boosted by rising equity prices, while corporate earnings, exports and even jobs are boosted by a weaker euro.
4 China and the Emerging Markets

Q Andrew Rozanov

Finally, what about China and emerging markets more broadly?

A Neil MacKinnon

There can be no doubt that we're witnessing a pronounced slowdown in the Chinese economy: according to the latest data releases, industrial production dropped to its slowest pace since 2009, while fixed asset investment has fallen to a 15-year low.

"...industrial production dropped to its slowest pace since 2009"

As we have been intimating for some time now, the Chinese authorities predictably responded by another round of monetary easing, as the central bank cut its reserve requirement ratio (RRR) by 1% to 18.5%.

Source: The ECU Group plc

China’s Reserve Requirement Ration (RRR)

Source: The ECU Group plc
This is the second reduction this year, and I expect a significant portion of this extra liquidity to find its way into China’s increasingly ‘bubbly’ equity markets. This liquidity wave will push the Chinese and Hong Kong equity markets even higher, just as foreign investor quotas are lifted. The dynamics do point to a bubble forming, but we may still be in the early stages… Enjoy the ride while it lasts!

As for the broader emerging markets, as I mentioned earlier, the IMF is worried about a ‘super taper tantrum’, and in this context it actually pinpointed four specific countries which it considers to be particularly vulnerable: Nigeria, India, Turkey and Brazil, which all have a large share of corporate “debt-at-risk.” The IMF expects real policy rates to remain high for many emerging market economies throughout 2015. But in the longer term, a bigger worry could be lower potential growth – not just in developed but also emerging economies – as pointed out by Olivier Blanchard, the IMF’s chief economist. Population ageing, lower investment and sluggish productivity growth are all pointing towards the so-called ‘secular stagnation’ thesis, so long-term investors would do well to look into this more closely as it relates to emerging markets going forward.

Kit Juckes

The emerging market slowdown is going to be a recurrent theme for the next few years. How much did the re-pricing of raw materials and commodities over the last decade boost emerging market growth? How much of that re-pricing was due to low US interest rates and a weak dollar? And how much was due to an unsustainable boom in Chinese infrastructure investment? These aren’t easy questions to answer, but what is certain is that all of the above factors played their part. The image of vast digging trucks dragging huge quantities of raw materials – some of which I had never even heard of before, extracted in places I never visited – sticks in my mind. Was it a boom or a bubble? What is for sure, is that Caterpillar’s share price has fallen by 20% over the last year, during which time the S&P 500 has increased in value by over 10%. What is also sure is that the commodity boom helped fuel the absurd growth of global currency reserves over the last...
decade, and as it is reversed, so those reserves will dwindle. The upshot of all this is likely to be two-fold. Firstly, much reduced capital flows to emerging markets and therefore more money staying in US dollars (and much less re-balancing of global currency portfolios out of US dollars). And secondly, continued disinflationary pressure from lower commodity prices and from weaker emerging market growth.

Emerging market assets have held up well into the slowdown, helped by easier monetary policy. Fed and ECB policies have helped them, and so have PBOC policies. But as inflation falls, real rates are not going down in China, and as the global economic re-balancing away from emerging markets continues, further Chinese weakness is inevitable.

This all adds to a clear sense of unease in emerging markets this week, and perhaps something worse in the weeks ahead. In turn, that continues to help the dollar and help the Federal Reserve justify raising rates later and more slowly. I just hope that the Phillips Curve is indeed dormant or dead, and that the Fed doesn’t find itself facing softer global growth and a sharp pick-up in wage growth any time soon.
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.
For more information on our other strategies, please contact Bansi.Jashapara@ECUgroup.com

### Global Macro Viewpoint

**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” round-up, providing opinion and strategy, and highlighting key events, data releases and global market news.

### FX Strategy

**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

**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

**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 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.

### 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.

### 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.

### 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.
Disclaimer

This Information Service is provided by The ECU Group plc ("ECU"), a Public Limited Company with Company Number: 2296619, registered in England with Registered Office Address 20-22 Bedford Row, London WC1R 4JS. The ECU Group plc is authorised and regulated by the Financial Conduct Authority (FRN 153704).

This research document is formulated by the Global Macro Team of The ECU Group plc, and is intended only for Professional Investors. The opinions, estimates and projections in this report constitute the current judgement of the author as of the date of this report. They do not necessarily reflect the opinions of The ECU Group plc and may be subject to change. The views in this report are based upon information from sources, which the author believes to be reliable at the time of publication and is not to be construed as a representation by The ECU Group plc. Prices and availability of financial instruments also are subject to change. This report is provided for informational purposes only. It is not to be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any investments or financial instruments or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation would violate applicable laws or regulations.

The markets or financial instruments discussed in this report may not be suitable for all investors and investors must make their own investment decisions using their own independent advisors as they believe necessary and based upon their own specific financial situations and investment objectives. If a financial instrument is denominated in a currency other than an investor’s currency, a change in exchange rates may adversely affect the price or value of, or the income derived from, the financial instrument, and such investor effectively assumes currency risk. Furthermore, income from an investment may fluctuate and the price or value of exchange rates and/or financial instruments described in this report, either directly or indirectly, may rise or fall.

The ECU Group plc discloses any interests, financial or otherwise, and any conflicts of interest or potential conflicts of interests, which could reasonably be seen to impair the objectivity of any research publications. This note is provided in accordance with s.54(1) of The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, which provides that the giving of advice in this way is neither that of:

(a) the regulated activity of giving advice; nor

(b) leading or enabling persons to buy, sell, subscribe for or underwrite securities or contractually based investments.

Past performance is not a reliable indicator of future results, and should not therefore form the basis of a decision whether or not to invest in any market or financial instrument mentioned herein. For reprints, additional copies, or for permission to use any of the content of this research material please contact your account manager at The ECU Group plc or email research@ecugroup.com.

This document may not be reproduced, redistributed or copied in whole or in part for any purpose. Neither this document, nor any copy or part thereof, may be distributed in any other jurisdictions where its distribution may be restricted by law and persons into whose possession the material comes should inform themselves about, and observe, any such restrictions ECU expressly reserves all rights in connection with its intellectual property, including without limitation the right to block the transfer of its products and services and/or to track usage thereof, through electronic tracking technology, and all other lawful means, now known or hereafter devised. ECU reserves the right, without further notice, to pursue to the fullest extent allowed by the law any and all criminal and civil remedies for the violation of its rights.

Copyright © 2015 The ECU Group plc