US Rate Hikes are Coming

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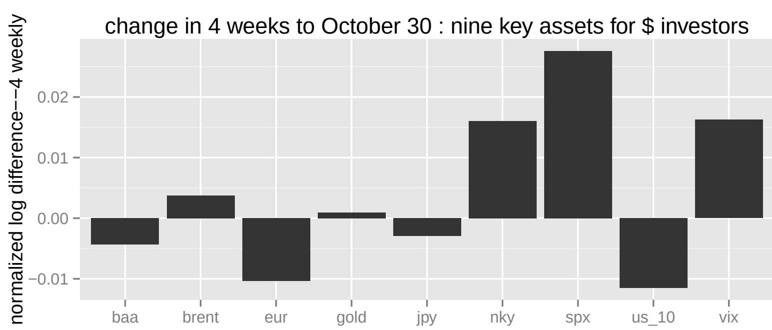
An equity rally that started with relief at Chinese action to buy stocks, and Fed inaction on interest rates, continued for most of the month. Adding fuel to the rally was the impression that the ECB would consider more deeply negative rates if necessary.

But, by month-end, stronger US data and a new determination out of the Fed to raise rates emerged. US ten-year and credit bond yields rose as did the dollar.

Emerging markets began to come under strain, just as they did when a Fed hike was last seen likely. Highly traded commodities were choppy, doing little over the month but up and down sharply week to week.



Draghi's hint of possible lower rates led investors to buy European government bonds, from which Italian bonds profited most. On the other side of the Atlantic, with the reopening of risks of a Fed rate hike, US and Mexican bonds sold off.

After a strong run, investors were exiting emerging equity by month-end. Asian equities, starting in Malaysia, Indonesia, Thailand and India fell sharply. Several emerging currencies, including those of Korea, India, and South Africa, dropped.

US is ready to hike: really this time. US spending surged to carry us through a long-awaited inventory correction in the third quarter. We knew global exports were pushed into US inventories as the trade deficit widened. Regaining control of inventories meant halting import growth for a time, which is what we have seen. This is not to say imports will not rise again, just that a massive excess of imports going straight into inventories should be avoidable.

Besides an inventory rebalancing, this US expansion has also had to overcome a shut down in shale oil drilling, which has dented equipment spending and construction. Regardless of these inventory and oil related setbacks, consumption has kept rising, probably due to the accumulated employment gains of the last few years. Car sales may have plateaued but home construction and investment outside of the oil sector should be growing. Lastly, on the positive side, the Federal government will be less constrained than it has been with a the new debt ceiling compromise just passed.

A sustained expansion through the inventory adjustment is not a surprise, but it is very comforting nonetheless. Whatever the true underlying situation, an impending inventory dip in US output was bound to color market discussion to the gloomy side. Coming through that dip with underlying demand mostly intact now puts the US and the global economy in a position for faster growth going forward. This, of course, is not final proof of a strong underlying trend, but it will suggest that a much more buoyant global outcome *is* possible. And that situation makes a Fed rate hike much more likely in December than seemed likely even a week ago.

United States

ACTIVITY	CREDIT	POLITICS
Underlying demand intact		US debt limit solved for two years
GDP shows inventory adjustment	Fed mentions a December rate hike	TPP is signed: legislative OK needed
Jobs growth on the low side	Weak bank earnings while rates stay low	Yellen's health problem unresolved
Statoil, Shell oil exploration cuts	Collapse and recovery of Glencore prices	OECD agreement on limiting tax avoidance
Moersk reports falling trade activity	Valeant pharma scams revealed, price drops	

Europe

ACTIVITY	CREDIT	POLITICS
	ECB's Draghi considers more negative rates	
Core inflation rises gently	Buoyant bank lending survey	Merkel asks Erdogan to hold back refugees
VW car assembly hit	VW struggles to correct diesel technology	Anti-Euro parties may govern in Portugal
Air France labor fiasco	EU banks restructure amid layoffs	

China

ACTIVITY	CREDIT	POLITICS
	Rate and RRR cuts	
	Sells CNY debt in London	
Car sales tax cut, sales up in Sept.	Beats out Japan for Indo rail contract	Xi visits the UK
Weak Canton Fair results	Steel company repayment difficulties	US complains about hacking and S. China Sea
Coal and iron ore prices dip		

Low for how long? The gloomy case. Debate about the apparently endless drift toward lower inflation and lower interest rates in the world economy continued at the Lima IMF meetings. The latest manifestation has been the ECB's suggestion that it may go for more negative interest rates. In this spirit, the Geneva Report[1], just published, considered the loanable funds market behind these low-rate trends.

One possibility is a global shortage of investment and demand for funds, perhaps because of a dearth of new investment ideas. Alternatively, fear of taking on long term investments in a disruption-prone financial world could be at fault, which to me is more likely. Both would be reasons for a shortfall in investment demand for funds compared with savings and suggests the need for low to negative interest rates to clear the credit markets.

In fact, in many places we now see a red-blooded readiness to wipe out the value of over-

[1] Bean, Charles R, Christian Broda, Takatoshi Ito, and Radall S Kroszner, *Low for Long? Causes and Consequences of Persistently Low Interest Rates* (Geneva: International Center for Monetary and Banking Studies, October 2015)

investment, in commodities and high-cost oil, for example, or in China's overinvested heavy industry. A system that absorbs losses and moves on to the next opportunity is one that should support a healthy process of creative destruction and *higher* investment over time. That should include moving on to replace all the varieties of commodity production for export to China that were directly and indirectly driving the world investment cycle since 2009. All this should become clear once the developed world drivers of the continued recovery become plain.

If investment is only briefly depressed, then maybe low demand is due to a failure on the other side of the credit market–in the over-supply of savings. Here the Geneva Report isolates global demographic reasons for middle-age populations to increase their savings against retirement. It also points out that these savings could be facing a shortage in risk-free assets, because of quantitative ease combined with the oversized accumulation of reserves by China, emerging markets more generally, and several sovereign wealth funds bloated by a period of sustained high oil prices. These factors could help explain extremely low long term interest rates without necessarily proving that markets need lower rates.

Overall, a quick survey of the likely causes of low interest rates seems to be due to temporary rather than permanent factors. Looking ahead, these are changing. We could easily find industrial country investment opportunities emerge after a ten year hiatus. We could also find middle-aged populations that are turning older will begin to spend their retirement funds. And, we could very easily find the crash in commodity producing emerging markets, and in China too, leads to a disgorging of US Treasuries held as reserves. All signs point to eventual higher US long-term interest rates.

Rate cut talk in Europe. In line with the gloomy discussions in Lima, the ECB revealed early in the month that it was considering more deeply negative interest rates. Activity, which had been picking up steadily, does seems to be slowing slightly. One reason is a question about the viability of growth based on Europe's big current account surplus at a time of trouble in China and emerging markets. Another is the twin impacts of refugees and the Volkswagen pollution cheating fiasco. Both surprises are troubling to the picture of a slow and steady recovery with in the context of stable social relations, solid unemployment support, and high technology. Some measures of consumer confidence have weakened in light of these concerns.

Draghi's ECB is eager to take new actions to insure recovery, including the more deeply negative interest rates. Examples elsewhere in Europe seem to show that up to -0.75% rates are possibly, so the ECB's -0.2% is not a necessary floor, after all. But why the rush? One reason among others may be the realization that bank lending is still contracting in Greece, Spain, Portugal, and Italy. A negative lending rate might make credit attractive even in a near-zero inflation environment, and it certainly should weaken the euro to cement the region's export gains.

Draghi's sense of urgency in getting to reflation may be propelled by fear of the debt overhang still awaiting resolution in big parts of Europe. This is what makes the much awaited Greek bank capitalization so important. Because it is not only Greek public debt held abroad that ails Greece: a mountain of unpaid domestic loans and mortgages has taken bank NPLs to nearly 50% of loans. In Greece, with its volatile politics of despair, a pressing need to obtain European credit before year-end to recapitalize banks *without* a depositor haircut will have to be balanced against European demands that banks be distanced from public sector influence and be given enforceable mortgage foreclosure rights. Another concern is Portugal, where an awkwardly anti-European government seems set to take office. Europe's recovery without debt write-offs remains to be tested.

China: rebalancing via consumers. Signs of economic stabilization seem to be sprouting up here and there. Car sales recovered slightly, and some signs of life in home sales in Beijing were reported. Even exports came back slightly. But the shut-down in coal, steel, cement and glass is clearly underway, draggng down total industrial activity, freight, and electricity usage. It is a fine point whether new services sectors, including finance, can be fairly said to offset the declines in heavy industry when the two are combined in China's GDP. What is certainly true is that heavy industry alone would have yielded a 2%-4% yearly GDP growth in 3Q, not the 6.9% reported.

Managing the process of rebalancing demand from heavy industry to consumer-oriented services, Chinese leaders have a few tools. One is lower reserve requirements for banks, and a new rediscounting plan to buy loans from banks. These measures should stabilize bank lending if foreign exchange reserves continue to drain from the system. And a big shift out of Chinese assets is certainly possible given their great growth in recent years and massive size today.

Other, harder, policies involve handing over state wealth to consumers to fuel consumer spending. One way is by allocating rural land to farmers, another is by giving migrant workers local services, and another by giving the public ownership rights in the state owned enterprises. State enterprises have, over time, become semi-private property of management, handed down by the establishment to its children. A recent sharp collapse in state enterprise earnings either reflects their concentration in failing heavy industries or a willful attempt to show there is little to share.

We are trapped in a cycle of market volatility driven by the prospect of sooner or later returning to normal interest rates. Early last month the thinking moved to include considering more negative interest rates in Europe as a possible counter to chronic deflation. That was until the news emerged that the US seems to have weathered the inventory correction that has long been a risk. The news makes the Feds dithering about rate hikes seem unnecessarily timid, perhaps related to Ms. Yellens possible disability. Whatever the reasons for earlier caution, rate hikes seem more likely now.

In case rate hikes do begin in December, risk free bonds will sell off. Until recently they reflected the possibility of no rate hikes until well into 2016, a view that will have to change when the reality of hikes arrives.

In equities, the key question now is what kind of an equity correction is appropriate during the beginning of a return to positive rates. Are equities indeed going to rise steadily on the basis that long-term growth is now assured? That is one possibility, the other is that equity valuations are high and have been heavily supported by cheap credit, particularly an oversized waved of bond-funded buybacks, that will no longer be so easy to execute. For us the equity risks in the system remain significant.