Stabilizing Britain outside of Europe

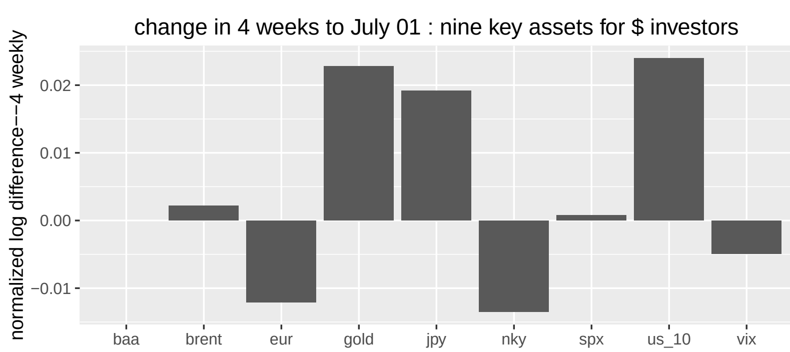
Lars J. Pedersen
lars23jacob@gmail.com

- **Brexit shocks**
- **Yellen's excessive caution paid off**
- **Europe of negative rates**
- **China drags itself into recovery**

Britain voted itself out of the European Union, to the surprise of many. Investors initially jumped for safety into US, Japanese and German government bonds and gold. Japanese investors repatriated funds from abroad to bonds and cash. Equities fell.

By month end, investors decided another dose of global monetary ease, including possibly more negative policy rates should be enough to compensate for the Brit-shock, which may be delayed or minor in any case. Bond yields fell sharply and stayed down.

By month-end, even big moves in Britain's floating exchange rate were seen as more a matter of degree for an already floating rate, not a revolution like leaving the Eurozone would have been for Greece. Core asset values bounced back, led by equities.



Sterling fell sharply, as did other non-euro currencies in the European Union, like the Polish zloty and Czech koruna. Countries within the eurozone and without the depreciation option, saw their equities fall hard–particularly Italy and Spain.

Bond yields went down broadly, and have stayed down, surprisingly. Negative government bond yields in Europe have become widespread, and yields also came down in the US and Japan. Corporate credits generally advanced.

Initially, investors sought protection for all risk but the very safest ones. Over the week after the Brexit vote they refined that aversion to concentrate increasingly on the UK and Italian negatives. Italy's banking strains led government bonds to sell off sharply against Germany.

More general risk measures, including the volatility of US equity prices, reversed and fell sharply by the last week of the month.

Yellen's excessive caution paid off. US activity rebounded into the second quarter. Consumer spending recovered strongly, after a dip in car and other sales. Sustained employment and wage gains still create the momentum in spending that should allow us to ride through an inventory adjustment, and a dip in output and imports. But that adjustment process can be derailed into a full recession, and if so we would know when we see faltering job growth. Unexpected weakness in May employment raises the risk here considerably and puts a heavy weight on this week's June employment report.

Any inventory adjustment will be a time of mixed signals and heightened risk as demand and production indicators point in opposite directions. As well, we have further complications in the collapse of shale oil drilling, and of orders for drilling equipment. Car sales seem to have plateaued in the first quarter, an adjustment that was inevitable after a long recovery. And home sales have been choppy, although surely helped now by a 25% drop in mortgage interest costs.

So, I must say Chair Yellen was right to hold off on a June hike, after all. I though she was too cautious at the time, but after Britain voted itself out of the European Union we all need to make sure that whatever speed-bump the UK economy hits does not derail the tentative European, US, and world recoveries.

Responding to the new risks, bond yields took another step toward zero in the US, and sank to negative in the big creditor markets of Japan and Germany. Such low rates imply a risk of policy failure. That is: low overnight rates and quantitative ease do not achieve global ignition in time, and the system lapses back into recession and falling prices. Still without a functioning fiscal policy, actual interest rates in that case might have to inch into deeply negative territory to finally get to negative real "natural rates", upon which policy stabilization today depends.

Low overnight and long-term rates are supposed to create incentives for borrowers, and to boost the value of assets with future income streams. Its a risky view, however, if asset price manipulation indeed seems to be failing as a tool, and we really are falling back into broad deflation. Those income streams valued by equity assets may have to be revalued *down* if earnings, too, are dragged down by deflation. Equity valuations will then be balanced uneasily between zero discount factors and *shrinking* earnings. The idea that equity risks are safe in this unlikely, but possible, deflationary case may be very misguided.

United States

ACTIVITY	CREDIT	POLITICS
Inventories begin to drop	All US banks pass stress test	
Strong retail sales	Only DB and Santander fail broader test	Hillary polls decisively ahead of Donald
Surprisingly low employment gain	Lending Club cuts mail loan commitments	
Slipping car sales	Puerto Rico control board passed	
Softer health care spending growth		

Europe

ACTIVITY	CREDIT	POLITICS
Solid IQ growth	M3 starts to grow outside of cash	
EuroCoin remains positive	New EU defense strategy: spend more	
Slightly weaker, but positive, EUR markit	Italy calls for e40b bank recap	
France PMI weaker during strikes	ECB corp bond buying starts	French strikes over labor law
		UK votes "Leave"

China

ACTIVITY	CREDIT	POLITICS
Restrictions on tier 1 real estate buying	Plan retraining and severance planned	
Renewed rail spending	New push for infrastructure spending	
Steel output slows after brief surge	MSCI does not include China equities	PBOC declares no devaluation plan
PMI surveys turn down	Acceptances, bonds slow after frauds	
	Collapse of private investment	

Europe of negative rates. Surprising many, including me, the British voted to leave the European Union. Now they must work out how to adjust to life outside the European Union. No country has ever tried to roll back the dense legal ties that Europe has spun across trade and regulatory regimes. Add to that the special position of the UK compared to Europe: it allowed itself substantial fiscal deficits and its early recovery has has led to a gaping current account deficit. In a way, the key to British exceptionalism already set by its highly non-conformist and independent macro policies.

Now the uncertainty of how a legal separation will work out will be tempered by this policy position. Uncertainty always leads to a reconsideration of long term investment plans, never to a rush to spend. Uncertainty for Britain comes from losing the advantages of guaranteed free trade, specialization, and economic efficiency of trading in the big European market. A freeze-up in investment will slow growth to further curtail any long-term risk taking. Spending in the UK's late cycle is likely to drop. Taxes will fall and the fiscal deficit will almost certainly rise sharply.

As Governor Carney pointed out, however, the key advantage to a freely floating position off the coast of Europe is that a weak sterling can take up some of the adjustment. He mentioned cutting rates, from a derisory 0.5%, presumably intending to explore negative rates as on the continent, or at least long delaying once expected hikes. A cheap currency is actually valuable at a time of incipient global deflation, because it assures the UK of the holy grail of enough inflation to keep real interest rates negative. But this policy of welcoming depreciation opens uncertainty about how much inflation will be too much. For the movement, that does not seem to be an issue.

So the rest of Europe now faces a weaker and devalued UK neighbor, which will import less, hurting Europe's export orders. Tools to manage shocks in Europe have been limited. Continental policy has long been dominated by the assertion that fiscal austerity in the separate nation states of the monetary union is necessary until a full federal budget is established. That transitional imperative of political economy has forced the ECB is increasingly aggressive monetary policy, often coming right up to the edge of effective fiscal policy.

It may be under-estimated by investors how extremely low sovereign bond yields can release the austerity imperative for Europe. Certainly the German theoreticians of union know that taking Greek interest rates toward zero and rolling principle will effectively eliminates the burden of its public debt. Similarly now for Europe as a whole. That is, as long as the ECB succeeds in achieving negative bond yields that removes the interest burden of *new borrowing* at these rates. The argument for austerity was always that spiraling public sector deficits with compounding interest would trigger an investor rejection of new funding. With low to zero compounding, low rates can now allow an nonthreatening fiscal policy of expanded spending in Europe, for defense and unified border control, first of all.

All this assumes the British example does not unleash a disruptive wave of other European exits. But that could be avoided if the UK exit and recession starts to look unattractive to others. And the administrators in charge of Europe will soon figure out the advantages from negative rates that allow them to finance decisive new spending initiatives. That can cement the case against any further defections and also take the pressure off the ECB to come up with increasingly inventive and divisive measures for growth. There could yet be many winners in Europe from this shock.

China drags itself into recovery. China is recovering more slowly each time you look. Purchasing manager indices have softened, industrial profits are slim, and steel production is dipping again after a brief burst, and private investment suddenly collapsed, triggering an immediate meeting of the State Council. Possible reasons for the investment collapse are overcapacity in industry and some real estate markets. Taken together, we still have a picture of a gentle recovery from deeply disappointing growth rates around the turn of the year, the full scope of which was almost certainly surpressed for fear of triggering unstable investor responses.

As we have been arguing, the key to Chinese developments is its oversized financial sector. After an unusual surge at the start of the year, a policy of fostering easy credit to ease the transition from heavy industry into other jobs may have been adjusted. So we find growth in total social credit slowed in June. Helping to slow down credit growth have been reported frauds in banker acceptances, and in one or two big bond issuers linked to local governments. As well, all lenders face increasingly common bankruptcies, using laws only recently put on the books, and until now rarely used. Lastly, PBOC governor Zhou also mentioned in his IMF talk that peer to peer credit, while favored by those who hope is will contribute to China's transition, will have to be brought into line with general banking rules.

After a few wild surges into commodity speculation, China's great quest for the next bubble seems to have settle for the moment on gold and bitcoins. China's serial speculative demand will not go away, because of its massive stock of low-returning assets of households held in financial assets. In response to this instability, and in an interesting stabilizing move, the authorities are hurredly seeking increased foreign investment in their key markets, including bonds and stocks. In the best case this will tend to stabilize those markets against possible radom but very large domestic speculative flows. Unfortunately, MSCI again rejected inclusion of Chinese equities into its global indices, so this initiative will have to wait a little longer, at least for equities.

Brexit plus a warning on US employment just took us one step closer to a renewed European and US recession, and investors must now reconsider growth and deflation risks.

I still assume for my main case that Brexit will be a small shock to a system otherwise slowly recovering, and that US employment gains will slow, but to faster pace than we saw for May. If so, a pause in US tightening and a longer spell of very expansionary policy in Europe and Japan should yield enough insurance against a general relapse.

But that is not the only case. Brexit and other shocks could tilt us over the edge to renewed recession. That alternative, far more dismal case, is more likely if you think that we are in an aging world with chronic demand shortfalls and deflation. In this world, asset prices are biased downward, as they have been in Japan. Even a hint of possible failure of massive quantitative ease for Japan, as raised by suddenly softer data there, points to a big risk to the whole risky project of global recovery through asset price inflation.

Possible outcomes for the system have become more extreme because of this emerging dismal case. An upcoming fork in the road for the system and for asset values is made even more volatile by years of quantitative ease. Financial assets and liabilities have been grown with the deliberate policy intent of pushing recovery through asset and wealth effects. I have assumed the greatest financial risks in a recovery involve a sequence of asset market corrections, starting in bonds, as growth and inflation finally catch up with asset prices that have moved so far ahead of normal. For the moment those corrections are on hold, but they can be back with redoubled force in my main case of an only slightly delayed global recovery.