

country Code ISO 3166-1 Alpha-3 Country Subunit Demonym Subject Notes Units Scale

123 124 125 126 127 128 129 130 131 132 133 134 135 136 137 138 139 140 141 142 143 144 145 146 147 148 149 150 151 152 153 154 155 156 157 158 159 160 161 162 163 164 165 166 167 168 169 170 171 172 173 174 175 176 177 178 179 180 181 182 183 184 185 186 187 188 189 190 191 192 193 194 195 196 197 198 199 200 201 202 203 204 205 206 207 208 209 210 211 212 213 214 215 216 217 218 219 220 221 222 223 224 225 226 227 228 229 230 231 232 233 234 235 236 237 238 239 240 241 242 243 244 245 246 247 248 249 250 251 252 253 254 255 256 257 258 259 260 261 262 263 264 265 266 267 268 269 270 271 272 273 274 275 276 277 278 279 280 281 282 283 284 285 286 287 288 289 290 291 292 293 294 295 296 297 298 299 300 301 302 303 304 305 306 307 308 309 310 311 312 313 314 315 316 317 318 319 320 321 322 323 324 325 326 327 328 329 330 331 332 333 334 335 336 337 338 339 340 341 342 343 344 345 346 347 348 349 350 351 352 353 354 355 356 357 358 359 360 361 362 363 364 365 366 367 368 369 370 371 372 373 374 375 376 377 378 379 380 381 382 383 384 385 386 387 388 389 390 391 392 393 394 395 396 397 398 399 400 401 402 403 404 405 406 407 408 409 410 411 412 413 414 415 416 417 418 419 420 421 422 423 424 425 426 427 428 429 430 431 432 433 434 435 436 437 438 439 440 441 442 443 444 445 446 447 448 449 450 451 452 453 454 455 456 457 458 459 460 461 462 463 464 465 466 467 468 469 470 471 472 473 474 475 476 477 478 479 480 481 482 483 484 485 486 487 488 489 490 491 492 493 494 495 496 497 498 499 500 501 502 503 504 505 506 507 508 509 510 511 512 513 514 515 516 517 518 519 520 521 522 523 524 525 526 527 528 529 530 531 532 533 534 535 536 537 538 539 540 541 542 543 544 545 546 547 548 549 550 551 552 553 554 555 556 557 558 559 560 561 562 563 564 565 566 567 568 569 570 571 572 573 574 575 576 577 578 579 580 581 582 583 584 585 586 587 588 589 590 591 592 593 594 595 596 597 598 599 600 601 602 603 604 605 606 607 608 609 610 611 612 613 614 615 616 617 618 619 620 621 622 623 624 625 626 627 628 629 630 631 632 633 634 635 636 637 638 639 640 641 642 643 644 645 646 647 648 649 650 651 652 653 654 655 656 657 658 659 660 661 662 663 664 665 666 667 668 669 670 671 672 673 674 675 676 677 678 679 680 681 682 683 684 685 686 687 688 689 690 691 692 693 694 695 696 697 698 699 700 701 702 703 704 705 706 707 708 709 710 711 712 713 714 715 716 717 718 719 720 721 722 723 724 725 726 727 728 729 730 731 732 733 734 735 736 737 738 739 740 741 742 743 744 745 746 747 748 749 750 751 752 753 754 755 756 757 758 759 760 761 762 763 764 765 766 767 768 769 770 771 772 773 774 775 776 777 778 779 780 781 782 783 784 785 786 787 788 789 790 791 792 793 794 795 796 797 798 799 800 801 802 803 804 805 806 807 808 809 810 811 812 813 814 815 816 817 818 819 820 821 822 823 824 825 826 827 828 829 830 831 832 833 834 835 836 837 838 839 840 841 842 843 844 845 846 847 848 849 850 851 852 853 854 855 856 857 858 859 860 861 862 863 864 865 866 867 868 869 870 871 872 873 874 875 876 877 878 879 880 881 882 883 884 885 886 887 888 889 890 891 892 893 894 895 896 897 898 899 900 901 902 903 904 905 906 907 908 909 910 911 912 913 914 915 916 917 918 919 920 921 922 923 924 925 926 927 928 929 930 931 932 933 934 935 936 937 938 939 940 941 942 943 944 945 946 947 948 949 950 951 952 953 954 955 956 957 958 959 960 961 962 963 964 965 966 967 968 969 970 971 972 973 974 975 976 977 978 979 980 981 982 983 984 985 986 987 988 989 990 991 992 993 994 995 996 997 998 999 1000

Stabilizing Britain outside of Europe

Lars J. Pedersen

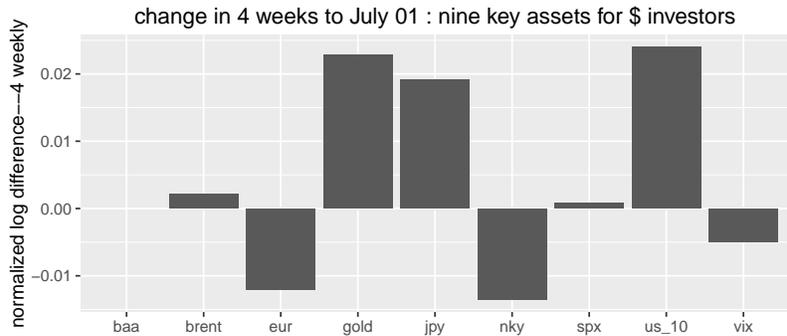
lars23jacob@gmail.com

- 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 Strong retail sales Surprisingly low employment gain Slipping car sales Softer health care spending growth	All US banks pass stress test Only DB and Santander fail broader test Lending Club cuts mail loan commitments Puerto Rico control board passed	Hillary polls decisively ahead of Donald
Europe		
Solid IQ growth EuroCoin remains positive Slightly weaker, but positive, EUR market France PMI weaker during strikes	M3 starts to grow outside of cash New EU defense strategy: spend more Italy calls for e40b bank recap ECB corp bond buying starts	French strikes over labor law UK votes "Leave"
China		
Restrictions on tier 1 real estate buying Renewed rail spending Steel output slows after brief surge PMI surveys turn down	Plan retraining and severance planned New push for infrastructure spending MSCI does not include China equities Acceptances, bonds slow after frauds Collapse of private investment	PBOC declares no devaluation plan

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 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

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

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 eliminate 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 a 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.

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 suppressed 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 it 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 settled 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 hurriedly 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 random 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 a 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.