Backup Policies for Growth

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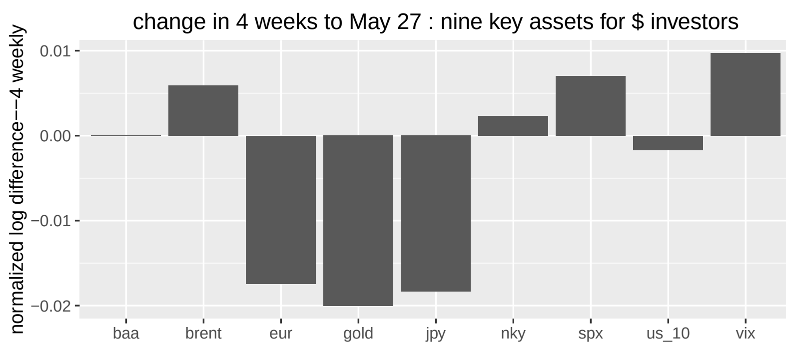
- **Iterating back to rate hikes**
- **How far can rates rise, using Fed logic?**
- **Europe's ever more radical debt proposals**
- **Bubbles in China are coming faster**

US growth expectations continued to firm up, pulling investors into dollar assets and out of the obvious alternatives: the euro, the yen, and gold.

As things looked up, investors shifted to longer duration bonds, and to equity markets. Oil prices rose to $50 per barrel, while some of the gyrations in Chinese commodity futures contracts added to the sense of a broader recovery.



The dollar rose against almost all other currencies. Mexico, Turkey, South Africa and Australia were down most sharply. Emerging equity markets followed local currencies down, although the pressure seemed to ease by month-end.

Credit was roughly unchanged, after a strong recovery. As I mentioned last month, investors have become stuck in an iteration between panic at the supposed damage from higher policy rates and ebullience at the hope of a reprieve. We are now moving from the reprieve to the rate hike stage, again, hopefully triggering less panic this time around.

By month-end, investors seemed to have settled for minor rate hikes that will not derail the recovery, as proven by higher oil prices. If so, the small hikes may not affect core asset values, which then leaves the coast clear to inch into riskier peripheral assets. Equities snapped upward to month-end, despite my doubts about valuation levels.

How far can rates rise, using Fed logic? Revisions of GDP brought out the drag on consumption and investment spending after January's equity drop. Further negative impacts from inventory and trade are quite possible, but these drags should be offset by a healthy snap-back in temporarily depressed consumption and investment. Retail sales, which we have already seen for April, already show this happening, investment data should begin to do the same as it comes in.

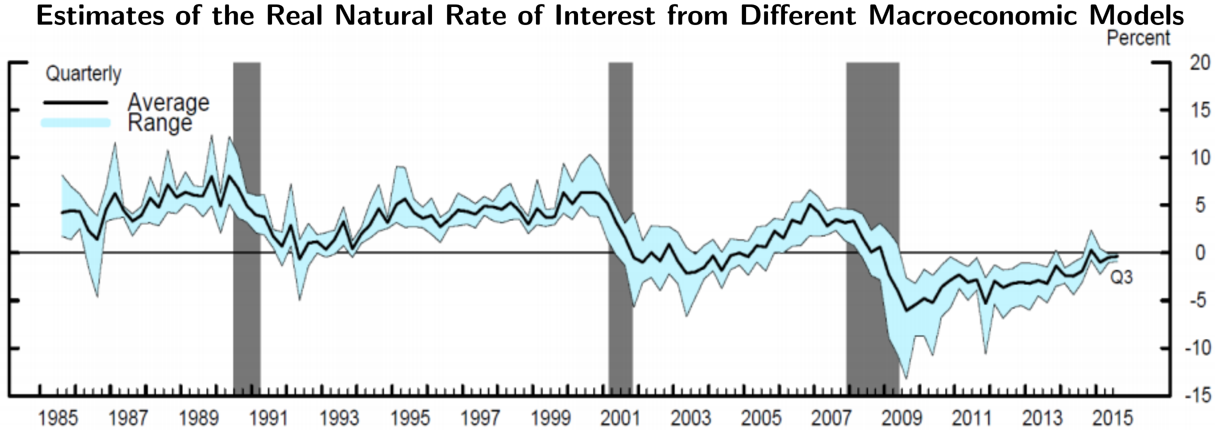
So, the current quarter is looking increasingly buoyant. Reacting to the stronger news, Fed talk has been trying to back away gracefully from what now looks like a panicky over-reaction to the equity dip in January, and excessive timidity in skipping a rate hike in March. Possibly in an effort to show the Fed's thinking was consistent, and not simply over-reacting to each cycle in equity prices, Vice-Chairman Fischer brought out the same chart of estimated "real natural rates" used earlier by Janet Yellen to show the logic of Fed thinking. See chart below.

Teased out of structural models, this rate is supposed to uncover the real interest rate that would push full employment and low inflation to optimum levels. A deeply negative rate of -5% was desirable in the US in 2009, the models show. The objective now is quite different, since a zero to 2% real rate could easily be desirable by 2017, and inflation is only a few prints away from 2-3%. The trouble now is how to engineer our way to normal natural rates with only a moderate asset price hiccup along the way. January's equity drop and drop in spending warned the Fed to proceed gingerly on this path.

Also arguing for caution, these "natural rates" are coming down cycle by cycle, to more and more negative values. That might mean something deeper ails the world economy. Or it could just reflect the once-in-80 year scale of the financial fiasco of 2008. I favor the latter view: it likely shows the scale of debt overhang in the US and abroad, and the understandably long adjustment by borrowers to repay, and by lenders to hold back lending.

This slow process of working out of the great debt overhang is increasingly unsatisfactory to voters. Alternatives keep coming up in political discourse, even in the US where the recovery has taken early root. One alternative is to replace slack private credit with public borrowing to rebuild crumbling roads and bridges. Or, more indirectly, we could forgive some portions of student debt to make room for young families to borrow. All these alternatives involve public borrowing, or debt reduction for some groups. They are the reserve tools of policy to hasten deleveraging, if needed, and they argue against the fear of forever-deleveraging and so the need for a timorous Fed policy.

Estimates of the Real Natural Rate of Interest from Different Macroeconomic Models



Source: Federal Reserve Board Presentation of Yellen on Dec 2,2015 and Fischer on May 19,2016

Europe's ever more radical proposals. Euroland activity has been buoyant, helped by consumption as inflation has fallen below wage gains. Resulting real income gains have bolstered spending, and then jobs, so a long-lived recovery may be developing that could have far to run. After the experience of 2011, however, investors and politicians remain understandably sensitive to ways in which Europe's unresolved union can derail progress. Most of the focus now is this month's upcoming vote on Britain's exit from Europe. For me, more striking is the bubbling up of fresh claims for easier fiscal policy by politicians under voter pressure in France, Italy, Spain, and Portugal. This may eventually threaten a coherent fiscal policy for Europe, but for now it should be a positive for demand and growth.

A European expansion that is gaining traction argues for a pause in hyper-active monetary policy. Some of the more radical variants of policy here have been dropped for now, including "helicopter money", that seem to some to have been made up mostly to solve Italian high-debt conditions. More deeply negative policy rates are also on hold, but the big ECB private and public bond buying program is still driving term interest rates below zero. These negative long term rates are a great anomaly of the global system because they imply Europe's unresolved debt hangover can only be cured with long term, deeply negative, policy rates. Negative government rates, kept below the rate of inflation for long enough, will indeed end up cutting down public debt burdens–but it is certainly a final, desperate, central bank approach to public debt reduction.

Greece's new debt deal with the EU, but not the IMF, brings out other ways to ease Europe's debt overhang problem. Effectively, the EU seeks to bury the Greek public debt into longer maturities, near zero rates, and forbearance of some payments. This assumes that over 20-40 years inflation will diminish the real value of the towering Greek debt, until it can be easily refinanced by private lenders.

But the IMF keeps bringing up debt write-offs, as do Greek politicians–at least for foreign-held claims. In its debt stability analysis, conducted as part of the Greek negotiations, the IMF teams bought out the interlocking character of this high-debt society. Taxpayers owe the government, the government owes suppliers and the EU, etc., etc. One might almost consider a general wiping out of claims to start all over and put the country back to work on sane principles. Here is where the IMF's proposal of public sector debt write-off is so disruptive; it opens the door a crack to discuss a more revolutionary, wider, debt wipe-out.

United States

ACTIVITY	CREDIT	POLITICS
Strong retail sales		
New overtime pay rules	European insurers seek US long bonds	
Atlanta Fed nowcasts 2.5% 2Q GDP	Spike in corp stock buy-backs in 1Q	November Pres elections loom
Investment spending stays soft	DoJ stops several mergers	Republicans unconvinced by Trump
	Equity fund withdrawals	
	Lending Club low-regulated difficulties	

Europe

	EU sanctions eased for Italy	
DE consumer sentiment up	Noway sues VW management over pay	
Strong DE growth in IQ	Draghi argues DE savings force down r	
EU fcst 0.2% CPI in 2016	Big bond issues ahead of Brexit vote	Greek deal likely before Brexit vote
Mersk profit collapse in IQ	Probably EU insurers seeking yield	IMF wants write offs not rescheduling
	BoE Carney sees recession with Brexit	Italy argues against bank bail-in rules
	ECB corp bond buying to start	Rajoy letter promises EU austerity

China

Home prices start to accelerate	Outflow regs supports home prices	
Steel production up after price jump	Seek int'l investment in local bonds	
Exports fall 2% in April	New regulations on shadow banking	
	Anti-spec regulations for commodities	

Financial bubbles in China are coming faster. China's snappy recovery in April turned out to have more to do with the lunar new year than a sustained trend. With May data, a slow recovery seem to be inching into place on the basis of solid income growth, bolstered public infrastructure spending, and remarkable rebound in home sales that must soon lead to construction. It might be slow, but it should be enough recovery for China to finally get to grips with the long-delayed closure of excessive, dirty, inefficient heavy industry. In case there was any doubt, the US and the EU are not going to tolerate dumping of these products into their markets.

To pivot in support private sector innovation and high-tech industries and away from heavy industry, the system needs a hyper-active financial system. Or so thinks Premier Li Keqiang. The trouble, as we have been saying, is that an exploding financial system can be hard to control. That is exactly what is happening now, as excess fund rushed from housing to equities (late 2015) to dollars (year-end) to commodities (last month), and now apparently *back* into housing and even bitcoins. An "authoritative figure" wrote that building a system on rising levels of leverage was illusory and he also said China might have to get used to a sustained period of lower growth, an "L shaped recovery."

The explosive path of total social credit supports the idea that a credit surge is underway, little of which is going to productive investment. You can tell that is true because the authorities just commissioned a report on the shortfall of private investment, and also because the explosion of credit is causing serial credit-fuelled asset price bubbles. What is going on in China in this regard is really quite remarkable, a hothouse version of the global excess credit cycle. If I were an authoritative figure in China, I would be worried, too.

If zombie companies are to be cut off from credit to release resources for more productive uses, how will China's rapidly evolving system achieve that aim? State directed credit rules are one way, another is to allow occasional defaults both on bank loans and bonds to teach creditors to track company data before extending credit. That is a lot to ask for suddenly from a system that comfortably lent state bank funds to favored state enterprises without apparent risk for decades. Yes, China has pre-positioned debt-for-equity swaps, and instruments to aggregate non-performing loans, all of which should ease the work-out of losses. But China still has a collosal mountain of debt subject to very arbitrary rules and suddenly changing risk. So there will be surprises. On balance, I am not sure those surprises will be big enough to derail a sluggish, but emerging, recovery. Critical to managing this process smoothly will be China's willingness to run up, when necessary, its very low central government debt.

Adding it all up, I see deleveraging obstacles to growth being eased by political action. In the US this comes with possible student loan write-offs, in Europe with easing fiscal policy, and in China with the upcoming heavy industry write-offs and easier fiscal policy. Europe leads in the exploration of deeper, more experimental, actions if really needed to guarantee global recovery.

So, I stick to my main view that we are due for market turbulence as exceptionally low interest rates will give way to hikes, because low rates have already made room for market-based deleveraging, and because these low rates can be supplemented by direct political actions, if needed. The only exception to this picture might possibly come via sustained, deeply negative, interest rates from the ECB.

If a broader recovery indeed becomes apparent toward year-end, Fed tightening will suddenly look to have a long way to go. Any sign of a break out of equity values on the upside would only accelerate that Fed tightening, which has been held back by the fear of equity disruption.