Welcome to the Donald Trump Show

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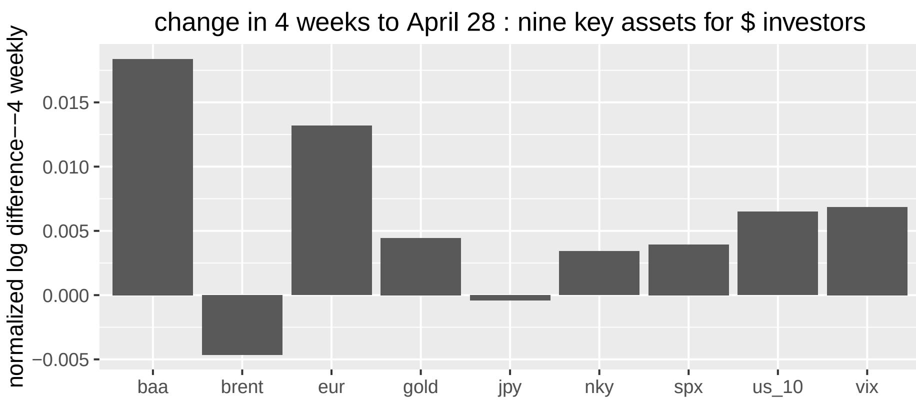
- **Counter-productive Trumpist policies...**
- **...vs a socially-inclusive European recovery**
- **Stabilizing Chinese finance**

Corporate credit risk was the big winner last month, reversing the losses of the month before as far-reaching US rate hikes look less likely.

The euro rebounded, as the European recovery keeps marching on and the worst-case French first round vote for populism was avoided.

In the latest week (not shown), a remarkable drop in expected S&P volatility rewarded sellers of options.



A go-it-alone US policy of supercharged growth with protectionism looked less likely, and so did a subsequent crash of that must be expected from that kind of banana republic policy making. The latest evidence of probable inaction was an ill-considered tax cut plan that is unlikely to go far.

Corporate bonds have been the big winners of a probably more toothless domestic policy. Higher rates are less likely, easing the pressure on highly leveraged borrowers, and the absence of high-stress policy lowers their risk from shocks, too. Government debt did a little better.

With lower risk of global policy accidents, global equities were broadly up, particularly in the emerging markets of Turkey, South Africa, and Malaysia. But in China, where specific IPO-lockups ended, and in Chile, where there were big strikes at the copper mines, shares fell.

Meanwhile, foreign exchange markets were sensitive to increasing external risks. The Korean won fell sharply as it became clear that a nuclear exchange in the area is conceivable. The Canadian dollar fell as Trump chose to make an issue of lumber exports to the US.

Counter-productive Trumpist policies... Growth appears to have slowed earlier than I thought in the US. As we discussed last month, a big inventory cycle has been propelling growth around the turn of the year, a process I thought that would continue to mid-year. In fact, inventory changes, which are almost impossible to pin down exactly by quarter, were a negative in 1Q. Because the bigger, multi-quarter, process is little changed, that means a less of a predictable slow-down ahead.

Under the surface, away from the inventory cycle, trend growth was held back by sharply slower consumption. Partly this was to be expected as consumption gains have propelled this recovery so far, and car sales are extended and ready to stagnate if not fall back. Consumer weakness is amplified by rising levels of income inequality in this recovery, which has favored upper-end households with a higher tendency to save than others.

Rising inequality has many costs. We also saw a new report by Angus Deaton on the accelerating mortality of white high school graduates, and a related thoughtful effort to find a way forward from Jamie Dimon in the JPMorgan annual report, doubtless reflecting his thoughts as he considered joining this troubled administration.[1]

To stop the mortality disaster, Dimon looks to viable jobs obtained after relevant training of high school graduates. Other solutions include lightening a regulatory burden on new businesses and the high tax rate that favors shifting activity abroad, Dimon says. Perhaps eight years of Democrat administration has tilted us toward excessive administration of details, but Dimon is also making a special plea for his financial industry..

What is clear is that productivity gains through new investment and research is the key to getting out of this deadly trap. And that an investment upswing, which seemingly began in 1Q, is long overdue. Radical deregulation might turn companies instead toward long overdue productive investment, and, of course, public deficit spending can finance needed infrastructure investment.

In this situation, Trump policies can be counterproductive. Discussion of how to cut health insurance for poor and elderly Americans seems to have caused a pause in health care demand. In fact, as much as half of the slowing consumption gains in 1Q may be due to this factor. Similarly, putting forward ill-formed ideas about corporate tax cuts, almost certain to be revised, do not make for a stable environment for long-term investment spending.

For me, all this means a major battle is emerging about claims that tax cuts can produce more than enough growth to pay for themselves. It is a problematic idea at this point of the cycle, when the low level of unemployment make it hard to see how much more effective labor can be put to work. In that case big tax cuts, if ever passed, risk going straight into Greek-style deficit spending.

United States

ACTIVITY	CREDIT	POLITICS
Investment recovery	Fed considers end to bond reinvestment Debate end to big bank unwind rules Trump proposes tax cuts	Negotiating with China-N. Korea Trump strikes in Syria, Afghanistan Protectionist talk dies down
Car sales drop CPI ticks down Payrolls low	US investors shift to EU Short Vol trade via ETFs grows GFSR sees corporate risks if rates rise WEO sees dollar risk if rates rise	IMF meetings: fear protectionism Ross counters: "rubbish" Trump gives up Chinese protection - goes for Canadian wood, world steel

Europe

Uptick in inflation Falling unemployment: rising incomes	Draghi fighting any end to QE	Macron-Le Pen next round
CPI dips UK retail sales drop after high inflation	EM central banks shift from euro Czexit from currency cap as inflation up UK firms start to lose EU contracts	May calls for UK general election June 8 EU toughens terms of Brexit

China

PMIs hold up but turning over	Credit growth barely slows Relax capital outflow controls Xiongan development area announced	19th National Congress
Steel prices fall	Corruption investigated in insurance	China in telling N Korea to stop tests

[1]Dimon, James *Letter to Shareholders*, JPMorgan Chase&Co. Annual Report, April 2017.

...vs a socially-inclusive European recovery. Political risk in Europe dropped off with Macron's strong showing in France's first round presidential vote. Now at least one voice, and the favored one in the second round, is in favor of European integration. Also, the surprising strength of the SPD's new presidential candidate, Schultz, means a considerably more forgiving fiscal policy is quite possible from Germany after its general election on 29 September. The worst of Europe's political divisions seem to be healing.

And European growth continues to trend higher. ISM-type indicators all show growth spreading from Germany and Northern Europe to Spain, France, and ever so grudgingly, to Italy. Even inflation ticked up. Looking ahead, the recovery should continue despite higher energy prices because a very constructive income and spending cycle has begun. Substantial unemployment support means long periods of high unemployment are manageable in Europe, often to the astonishment of outsiders. When productive jobs are again taken up, wage incomes rise some, but actual product rises by far more, to the benefit of company results and government support costs. That shows up in a surprisingly low and falling Europe-wide public deficit that will almost inevitably afford some targeted spending programs. And it shows up in an early investment cycle.

UK disadvantages of separating from recovering Europe are becoming more apparent. These costs must be energetically enforced by Europe, to dissuade others, of course. In particular, public agency specialization is one area that keeps coming up. Alone, the UK will have to have a separate agencies for atomic energy, space, medicine, and other research. Within Europa a far greater scale is possible by concentrating on a single European agency for each topic. Adam Smith applied to public policy shows a vast disadvantage for the UK, now seemingly determined to create many sub scale and ineffective institutions all its own.

ECB bond buying will continue to the end of the year. Tapering should then follow as the economic emergency fades further into the rear view mirror and bond buying continues to create increasingly obvious distortions. One distortion we discussed last month is the rise in Target2 balances. Another one is the gap of German bond yields below others, partly because outsider's foreign reserves are often held in highest quality available bonds and those German bonds are shrinking in supply as the ECB buys them up and Germany's public debt is actually reduced by public surpluses. A shortage of German government bonds has limited the choices of central banks in holding euros, leading to a shift into sterling or dollars, and weakening the euro.

A flurry of interest during the month emerged over a possible early end to negative interest rates, even before bond buying is fully tapered to zero. The idea is to stop the harm to bank earnings as soon as possible, because an important part of bank assets now earns less than bank deposits. Bond buying is at least as distorting, however, so this will certainly be an ongoing debate.

Stabilizing Chinese finance. Activity has been strong but seems now to be losing momentum. Car sales are down compared to last year, and apartment sales in Beijing have dropped sharply. Steel prices have fallen, possibly reflecting a drop in residential building that is almost all steel-intensive high rises. As steel prices ease off, iron ore and coal prices move down even more sharply. So we are back to the problem of cutting steel, iron and coal capacity for another year. Still, activity was strong in the first quarter, when state company earnings bounced. And a vast new sister city for the capital is proposed for Xiongan, focusing fresh investment spending.

Rising financial stresses that were so apparent last month have eased. Earlier, it had seemed that the need to intervene to hold the CNY was risking confidence in the system. Now reserves have recovered for several months, and the risk of much higher rates as a necessary alternative to interenention has eased. Overnight rates are far less volatile than in March although still creeping up. But the stock market has been soft, probably because of the expiry of large lock-ups on IPO equity sold in the last few years.

As we pointed out last month, the extraordinary license granted to Chinese finance in 2015-6 has led to enormous abuses while also helpfully funding some new businesses. Clearly a political decision has been made to tighten up now: Xi Jinping personally headed a party study group on financial stability. And a range of very tough controls have been applied by local authorities on home ownership and credit. None too soon, because some bank credit is now up to 80

The puzzle, which the authorities will have to solve, is how to stop a credit bubble without a credit crash. They have administrative tools, which effectively insulated most forms of credit from default risk before. Now they seek to create a measure of credit risk to cause something like a market credit crunch. But with the assignment of large losses still a political decision, these become unpredictable. Rational credit risk calculation becomes impossible. The idea that Chinese corporate bonds can be sold to foreign investors is particluarly problematic with so unstable a loss environment. But still the administrators try, demanding "risk management" methods be applied at financial institutions, presumably including a facsimile of market default risk under stable institutions and a solid historical record. I would love to see the details of this effort.

Meanwhile, as the 19th Communist Party of China National Congress nears, Trump and Xi have met to manage the North Korea problem. Local press give very much the impression that China would not oppose but rather might join in a surgical strike at North Korean nuclear facilities, which they say are fragile and vulnerable, if one more nuclear test is conducted. They also say that North Korean retaliation with a nuclear or conventional attack would lead to a US nuclear strike on the North. Their only red line is not to end up with US armed forces north of the DMZ, overturning the outcome of arms in the Korean War. So, it is hard to see how a North Korean nuclear test is now a rational act. But even a small possibility of irrational acts make for a remarkable level of regional risk.

My concern of a disruptive clash between tightening US policy and a mid-year US slowdown linked to inventories seems less likely. Instead the inventory slowdown came early, and the outlook for a broadening global recovery has become more important. A broad recovery is naturally stabilizing and markets have certainly responded accordingly.

Perhaps the biggest surprise now may come in how a broad recovery creates global inflation. Deeper global trade linkages have led to far more coordinated inflation rates than ever before. Around zero inflation, that means it takes a lot to get inflation going, but the change could creep up on you in a broad recovery. So far, global core inflation has advanced erratically, but when it turns up, it will be an easy step to rate normalization outside and inside the US.

Along this path, some of the cases pointed to by the IMF at in its latest World Economic Outlook are looking less likely. These included a fiscally super-charged but segmented US expansion that might flounder on sharply higher rates and a higher dollar. A more uniform global recovery, with toothless Trump policy initiatives, seem less likely to see that kind of crash.

Overall, I have to agree with investors that IMF-style market risks have gone down. I am just not sure that continued aggressive monetary ease on the scale we have seen will end without costs. In particular, asset prices seem set to keep climbing until the current red-blooded search for yield fails on meeting a meaningful return on cash. Or a picture of that encounter finally becomes visible somewhere across the system, say China. Beware the CPIs.