A Slow and Predictable Rollback

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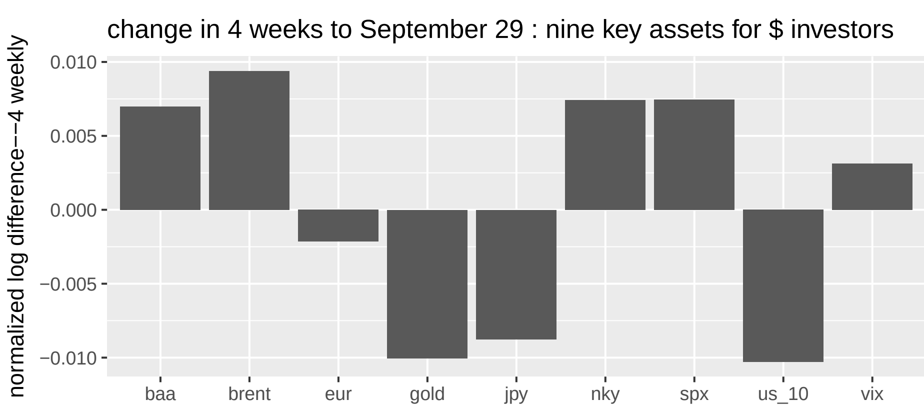
The dollar was broadly higher, and the yen fell, as investors considered higher rates, the rollback of QE, and the possibility of tax cuts in the US that could require more monetary tightening.

Core equity markets were mostly up as the global recovery seems to be gathering force and the headwinds of monetary policy normalization seem gradual, predictable, and possible to ignore.

Oil kept inching up, as a stronger recovery tilts the balance toward higher demand and output cuts may have drained excess inventories. But gold was down as the outlook for higher financial yields comes slowly into view.



Currency markets offered some glimmers of risk aversion, however. The dollar's broad rise included a sharp move up against several recently-favored high-yield carry currencies, including those of South Africa, Turkey, India, and Mexico.

And in Europe, the euro-alternative of sterling and swiss franc were up as the German election produced at best a weak coalition that will struggle to make progress toward a more federal Europe.

Meanwhile, Baa bond yields kept coming down, as the odds of a stronger recovery overcome fears of high risk-free yields. This is a particularly high risk area for investors right now if anything less than a Goldilocks scenario is coming.

Front Loaded Asset Prices. Higher asset values allow consumers to feel that their future needs are provided for, promoting consumption today. This is an inequality-inducing way to promote consumption, since it works upon already unequal asset holdings. But it has been the route broadly followed since 1990, and with redoubled effect after 2008. Below I show the development of household asset values compared to GDP. (These are cumulative, as "real estate" includes other assets **and** real estate, etc.) The great trend of the last few decades is that US asset values have gone up as the long term discount factor marches down.

Sadly, once asset values start to move up, speculative excess can follow, leading to the sudden variations in asset values to GDP we have seen. Subsequent crashes have led to increasingly severe recessions. Consider just the run-up in equity values to 1999, the run-up in housing prices to 2007, and the current run-up in equity prices through mid-2017.

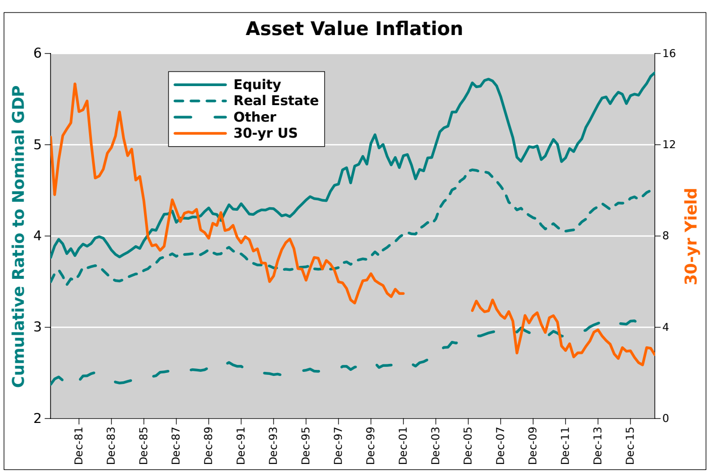
I have been fighting the last jolt up in equity values after Trump's election. In retrospect, I undervalued the idea that fiscal policy was no longer hostage to Republican fiscal austerity designed to cripple the Obama administration, so growth under a variety of scenarios now becomes more likely. At the same time, central bankers were perhaps excessively timorous in getting around to removing their massive quantitative ease, and bond yields stayed low.

So now we come to what comes next: consider some plausible paths. In one case, the Japan case, demand is crippled by aging populations and limited productivity gains. I think this is unlikely, because eventually aging populations demand more and produce less, which is *inflationary*. But if we are all becoming more like a deflationary Japan, just sustaining weak demand may require ever lower long-term rates, and ever higher asset values.

In a second, Goldilocks case, the central banks are finally successful in triggering enough asset value gains to start a recovery in demand and in inflation. Then policy can tighten gingerly into the recovery. Policy and long-term risk free rates rise but by less than inflation, holding asset values in a range as we transition to asset values supported increasingly by higher nominal GDP.

In my least favorite case, the central banks trigger a recovery just as forgotten low-income voters demand more direct fiscal spending. If that populist policy came into place inflation could come back and the US thirty-year rate could easily hit 5%, for example, crashing asset values. Here the pessimists have their day, again, because they assume an emergency return to super-easy interest rates to stabilize things after the next crash.

None of these cases will work out exactly, but the narrow path to a happy outcome may serve to show the risks created by central banks getting away from a policy that deliberately front-loaded our asset value cycle to get recovery.



Hurricane Complications. Underlying economic momentum will be hard to untangle for the next few quarters as an end to inventory rebuilding interacts with the effect of the hurricanes. I assume the hurricanes will reduce refining output in Texas and normal consumption in a wider area. That should be followed by a jolt upward to replacement home rebuilding and deferred consumption by the Fourth quarter. Through all this, consumption will be sluggish and sustained underlying demand still depends on the swing into investment spending and home construction. Lastly, inflation has been held back by the sharp price drop in cell-phone plans, but several measures of underlying inflation are rising more smoothly.

The upcoming attempt to reform our tax law is still surprisingly low on details. At best, the new law could exploit Republican control of Congress, together with a president who can sign contentious bills, to reward the Republican donor class, possibly at the expense of the populist right voters that got Trump into office. Even without that fundamental tension, conflicts within the Republican establishment itself find low-tax advocates facing deficit control dogmatists. Lastly, vested interest profiting from the current loophole structure will feel emboldened to fight for their welfare against an administration seemingly prone to failure. Accomplishing much under these conditions is doubtful.

Finally, bonds will start to roll off the Fed balance sheet this month. While approving the measure as expected, Chair Yellen and her dovish colleague Ms. Brainard made the case that low inflation was hard to explain at this point in the recovery. The exact linkage from low real interest rates and demand, which I think come mostly through asset prices, was glossed over. For Ms. Brainard to then say that it might be appropriate to overshoot on inflation in order to break low expectations, is also to say an ever-greater financial bubble is desirable. Dangerous thinking, because it ignores the long history of asset value bubbles and bursts that we have sustained over the last 20 years.

Merkel Slips. Business conditions seemed to be barely slowing in Europe. IFO and some other indices showed a pause developing in the great expansion of trade that has super-powered Europe's recent recovery. As aggressive global traders, European companies have felt the impact of a snapback in global trade around the turn of the year, but I expected slowing trade gains ahead. But so far, the diversified European manufacturing base is still booming, including oversized gains in the outsourcing centers of Eastern Europe. Inflation has been lower because of cheap oil, and is expected to stay low because of the sudden move up in the Euro.

Europe's German election was a setback for a stronger federal union. By garnering a larger than expected vote count, the populist AfD party took a big far-right chunk out of the right-wing CDU-CSU's natural place in the German political spectrum. Now, any move by Merkel toward a more federal Europe can be easily blocked by the Afd on the right and the SPD on the left. This deflates the impact of a strongly pro-European Macron presidency in France. Meanwhile, Ms. May seeks delay a full Brexit deal for two years past 2019. Her accommodating speech in Florence was a slight offset to the gloomy news in German as far as Europe's ever-so-slow progress toward a more stable federal union is concerned.

Meanwhile, the stabilization in European financial markets continues. Depositors are coming back to even the Greek banks, and that country was even able to sell a market security. As financial conditions heal, European banks are increasingly making private loans that should finance investment, and liquidating deposits in New York. Conveniently, funds are also flowing the other way as European investors are increasingly forced to buy US securities because of the intense QE-induced shortage of European securities the ECB has created. This has reverse flow has been an important factor holding down the rise in US yields.

The ECB is moving toward a reduced pace of bond buying, with an announcement now expected in late October. Like the US, the ECB plans to taper off its bond buying first, say during 2018, then to start raising rates ever so slowly in 2019, and finally to begin reducing its bond holdings in 2020. As President Draghi said, his board discussed scenarios. One complication, which the US also surmounted, was the autonomous rise in the value of the euro, as markets react to the coming long-foreshadowed tightening conditions before the central bank can get around to it, which actually causes the central bank to slow down its actions. But not forever.

After the 19th. Chinese activity may slow after the 19th National Party Congress concludes this month. Car sales had bottomed out after a disappointing first half, and housing construction should dip shortly. Local authorities have steadily tightened loan and approval limits for home buyers, provoking price declines in first tier cities. To offset these weakening factors, I am convinced that a bundle of new infrastructure orders were issued a few months ago to bolster the economy through the key 19th Congress. Certainly iron ore and rebar prices spiked at few months ago, only to fall off since.

Ongoing efforts to dampen financial leverage also may have taken a breather during the run-up to the 19th. State owned company debt is subject to limits, and inter-bank lending has been sharply curtailed. A crack-down on bitcoin-funded initial equity offerings is part of that dampening effort, which had a shock impact on global bitcoin prices. But even so, aggregate credit growth hardly slowed, as State banks may have been directed to free up credit briefly for state owned enterprises, and households have struggled to make rising home downpayments by taking out consumer credit.

Administrators still control a vast swathe of the economy, including the large state owned enterprises. An effort is underway to improve state management through mergers, presumably on the idea that innovative management is scarce, so consolidation can improve its average quality. In a related experiment, China Unicom made a public offering that was taken up by a range of local tech companies, in the apparent hope they will impart new vigor into the sleepy management of this state enterprise. Also, using its extensive administrative measures, the authorities have squelched capital outflows for foreign acquisitions. Then, when the CNY started rising too quickly, they reversed earlier measures requiring a 20% deposit on bank's dollar forward positions and customers' positions.

President Xi could be campaigning the 19th for a mixed approach, in which a smart and honest administration work with a large private enterprise sector. While he convinces the party elders and rival factions that this is the wisest course for China, no disruption, economic or political, is acceptable. North Korea's test of a hydrogen bomb this month will likely be met only after the 19th Congress concludes.

We are left with a growing world economy that buttresses asset values even as super-easy money is slowly and predictably withdrawn. Looking at the possible cases, I still think that at least a pause in this asset price recovery cycle is likely.

But this correction, coming later than I thought, depends on a substantial move up in risk-free interest rates. That in turn is not credible with first seeing glimmers of inflation around the system.

Clearly, the most disruptive case for markets now would be some slowing demand amid signs of returning inflation. And all risks go up after the 19th concludes.