Back From the Beach to Finad a Bundle of Risks

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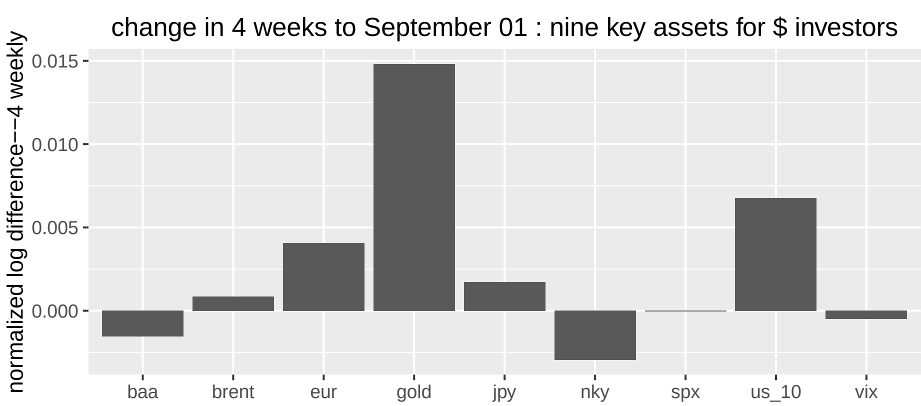
While many investors were on the beach, asset prices kept charging upward, with outlandish gains in gold and, more so, bitcoins. I was certainly wrong on that one.

In the closing week of the month, investors cycled into a wide range of assets, including US stocks and corporate bonds, The VIX index of equity options insurance also fell, again rewarding investors who sold options.

Oil prices were largely unchanged as Hurricane Harvey cut US refining capacity, but not crude oil production. While the refineries are down, gasoline shortages are possible and prices can rise.



Copper was up sharply, again, on the expectation of a broadening global recovery and a strong future for electric cars. Other metals needed in these cars were also bid up, as were the big mining nations, South Africa, Canada, and Chile.

As a global recovery, including commodity demand from China, looks more likely, several emerging market stock markets were up strongly. China, Brazil, Russia, and Thailand surged.

Meanwhile, Baa corporate bond yields are back near their absolute historical lows. These yields are at risk if either risk-free rates rise or ever lower default expectations are disrupted.

Jackson Hole Thinking. Money-alternatives have exploded in value because of our policy of continued massive quantitative ease. At Jackson Hole, Wyoming, central bankers evaded this key policy signal as none addressed how to unwind easy policies. This policy of ease is still ongoing on a great scale in Europe and Japan, effectively swapping (mostly) government debt for cash. That cash once accommodated the shift away from riskier assets. Eventually, as risk appetites return, we see a glaring shortage of desired risky assets and a surge in asset values, including for money-like ones such as bitcoins and gold.

I assume the key event of the next six months will be how central bankers navigate toward a path of less asset buying and the beginning of asset sales. As long term bonds become more available, interest rates should rise. But public discussion of this plan was held up, perhaps, by the uptick in political furor in Washington and the risk of nuclear exchange in Korea.

For me it was most telling when Yellen mentioned, in passing, that no central bankers were aware of the risks when they met at Jackson Hole in August of 2007. Exactly, but they could have seen the home price excess and foreseen some kind of trouble. Today, highly capitalized banks should be immune to another asset market crash. But, as Yellen says, we are not always aware of the key risks we face: so she implies the need for caution in the face of unusual markets. Quantitative ease will be reversed but in as gingerly and pre-programmed a way as possible.

Other points of central banking doctrine: trade protection as a device to boost national income got little support. British analysts of the impacts of Brexit have begun to concentrate on the regulatory uniformity in Europe that makes easy trade across the area possible, improving as Smith expected, the wealth of all. A fixed exchange rate union helps to make cross-country transactions transparent, but so too do identical regulations and laws. The UK did well enough without a currency fixing, but if it adds to that risk the new regulatory burdens it proposes, it may run into big losses in GDP.

If the freest trade is best, still societies adapting to trade will need to move workers away from impacted areas. If this movement fails to develop smoothly, evidence is accumulating that the result could be far more community devastation than we realized. Lower incomes lead to lower funding for education and less options for mobility. As entrenched firms slowly close, the damage can unfold over a long period with intensifying destructive results in these communities, as is visible in pockets in Brazil as well as the US. This, of course is an argument for social support and retraining, not trade protectionism.

US: A Budget Season is Coming. The US recovery is doing better than I thought. The tail end of an inventory adjustment may come this quarter, giving the still-buoyant manufacturing sentiment readings, and a probably stronger GDP, while underlying demand is holding up at around a 3% growth rate. A slow-down, if any, may not be visible until the fourth quarter, later than I thought.

Consumption was revised up sharply for the second quarter, largely to reflect the drop in consumer cell phone costs during a price war. These savings did not show up more phone services or in higher car sales, however. Cars sales are flat-lining a subdued pace after a long cycle of refitting the fleet. Meanwhile, job gains are slowing but still very solid for this stage of a recovery, but wages are only slowly creeping back up. CPI is rising slowly, too, after the pause created by those lower cell phone prices.

If consumption gains are to remain restrained, much depends on a recovery in investment. This does seem to be emerging, luckily, led by new aircraft orders. As well, the long pause in non-oil investment should have created many new opportunities by now. But construction activity has been surprisingly weak, partly because of lower shale oil drilling. As well, higher mortgage rates may have restrained speculative builders not sure of how well homes will sell. Since I think we need to get to higher interest rates eventually, we may have to work through an adjustment in housing prices to a higher interest rate structure. For now, equipment investment may now be our best hope for a robust investment cycle.

Meanwhile, a troubled US administration needs to get several must-do budget matters approved by year-end. One basic item is an increase in the debt limit, without which first, government workers are told to stay home and skip their pay-checks and then, second, the risk increases of a failure to make payment on debt coming due. Once we get over that hurdle, we still have to pass a budget that either continues current spending or reflects new Trump-Republican priorities. Then attention turns to a revised tax law, for which little detail has yet been revealed. A wounded administration cannot do much to persuade or shape a coalition to legislate effectively. And these wounds will not heal as the investigation of Trump's finances continues, including some very questionable deals in Georgia and Azerbaijan involving money laundering of funds from of Kazakhstan and Iran (of all places!)[1]

The Program for Europe. Europe's expansion continues to broaden. German job gains are quickening, and export orders remain strong. The stronger euro again caps inflation, which will reinforce real wage gains to keep up consumption. Some doubts about Germany's car industry after revelations of how it has avoided diesel regulation gave rise to a hiccup in sentiment surveys, but the damage may not be long-lasting. Mainly, the joint upturn in Europe is pulling up trade and exports for all nations. This is the moment where fiscal policy is easier and structural changes are easiest to adopt.

Macron's policies in France are aimed at taking advantage of the moment. He seeks smaller obstacles to firing workers in order to encourage employers to take the chance of new hiring. He also plans to make every effort to get France to the target 3% of GDP public deficit, all in the interest of pushing Germany one step toward a fiscal union with a reliable partner. His counterpart, Merkel, looks solidly ahead after a debate in Germany and heading into a 24 September election. Together, Macron and Merkel may make some progress toward a trans-european budget designed to dampen national recessions. Any such plan would be a huge positive for European confidence and investment.

Meanwhile, the details of the UK exit from Europe are turning out to be harder to negotiate than some imagined and the idea of being better off outside Europe is coming into question. Handling the border between Northern Ireland and the Republic in the South is particularly touchy. Even more damaging, of course, for Britain and the EU will be the loss of specialization in the great London financial market, probably replaced by smaller centers in Frankfurt, Paris, Luxembourg and Dublin. Brexit's self-harm is a reminder of the utility of economic union.

Lastly, the ECB's will need to cut loose from its very large asset buying program as promised "in the Fall". Timing may be affected by the way today's strong euro works to cap import prices, particularly for energy. To the extent cheaper import prices hold down headline inflation, the ECB may have scope to wait a little for more visible movement on underlying, domestically-driven, inflation before taking action. But it cannot wait for long. And changes in Europe's enormous bond buying program will have a global effect on bond yields.

[1] Davidson, A.(May and August 2017) *New Yorker Magazine*

Adjustments Ahead in China. Activity continues to surprise on the upside in China. Electricity use and freight movements are all up sharply, as is steel production, and rebar prices are surging. Industrial profits, particularly in metal working, jumped. A new round of public sector spending, and some relaxation of controls on local governments ahead of the National Party Congress was the likely source of this latest push. Indicators of non-public demand, including services PMIs, retail sales, and car sales are less bouyant. Separately, the resumption of a pork-price cyclical upturn means inflation rates will be higher in coming months.

The National Party Congress is meeting on 18-31 October. Presumably the main maneouvres are over to get the right people vote the right way as the Communist Party selects its leaders for the next five years and beyond. I still expect China will tolerate no disruptions of any kind until the process is completed. That means no war in Korea, no trade disruption with the US, no big wave of job losses in the rust belt, no risks taken with financial tightening, etc. Decisive actions that are pending in many areas will be postponed to November-December at the earliest.

But these actions are coming. Structural changes under consideration at the Congress include invigorating state enterprises, controlling the real estate price explosion, and controlling pollution. A bankruptcy process for "zombie" heavy industries is gingerly emerging in the application of deep haircuts on the public debt of several steel companies. Other, salvageable state companies will get debt-equity swaps. Meanwhile, a much-discussed effort to increase outside equity control, and tie management options to performance, was tried out at Unicom, a wireless communications company.

In other areas, no real solution for critically excessive pollution has been found for the Beijing area except a potential round of heavy industry closure orders. Lastly, the Congress has been considering how to improve the equity of housing in China, where early purchasers have property that new buyers can hardly afford. Possible solutions include land use limited to rental housing or a scheme to keep most of the value of land for the state while selling residents only a small share of its value in new construction.

Deleveraging efforts are on hold, like much else, until after the National Party Congress. Money rates will stay flat. As parallel banking has been limited by regulation, an increasing share of credit has been flowing through banks that in turn have have run through their annual lending quotas early this year: a credit shortage by year-end is possible. This will interact with tightening rules for internet-based banking, including bitcoin exchanges, and the tightening of macro-prudential rules on bank liquidity. I would expect credit to tighten abruptly at the end of 2018..

Political turbulence, including threats of nuclear war, came and went last month but are back again now as North Korea tests new bombs and missiles. Last month's flurry of concern was followed by relief, and that may be the result this time, too.

As political risk came down, investors focus on the view that policy rate hikes and the withdrawal of quantitative ease would be so gradual as to be imperceptible in asset prices. Silence on policy change at Jackson Hole added to that sense. The conclusion builds on the premise that goods prices are under continuous downward pressure and inflation will never rise again.

But that view clashes with the obvious financial excess that we have just seen in gold and bitcoin prices. Buyers of these alternative monies showed that there is too much cash in the system after 10 years of concentrated central bank swapping of bonds for cash. Regardless of what was not said at Jackson Hole, it is late to get on with ending quantitative ease.