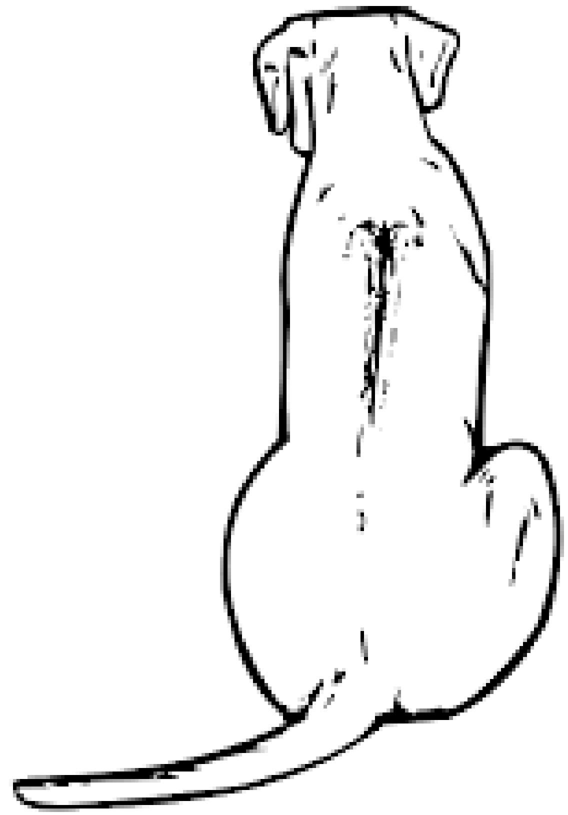
Money Times Confidence: Which will prevail?

Discontinuities in the system.

July 2020

Andrew Hunt
Consultant Economist
economist@hunteconomics.com

All Data sourced from CEIC unless noted otherwise. Data cut-off 13th July.



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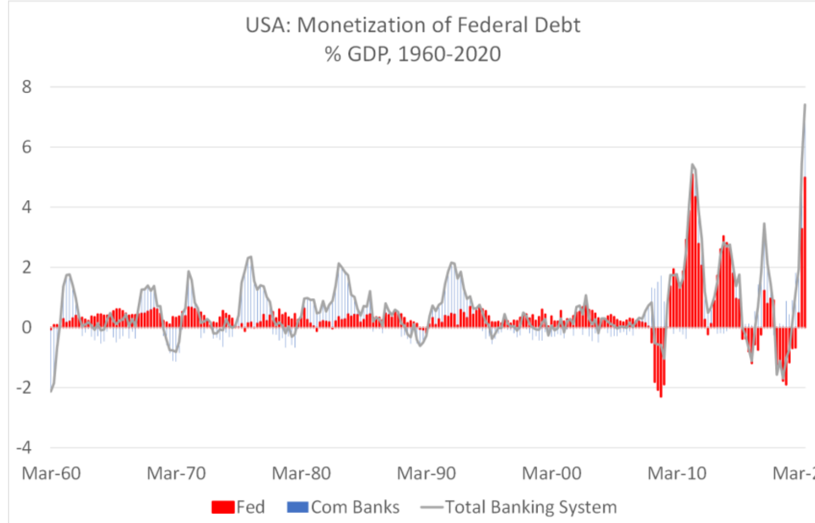
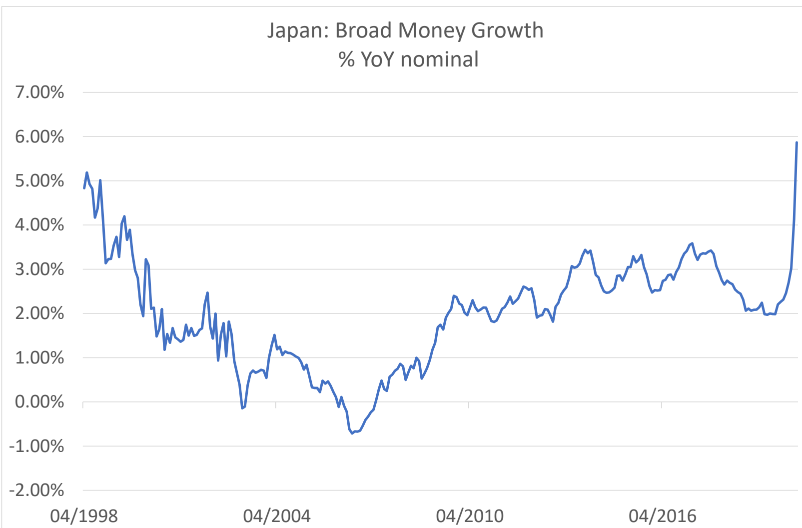
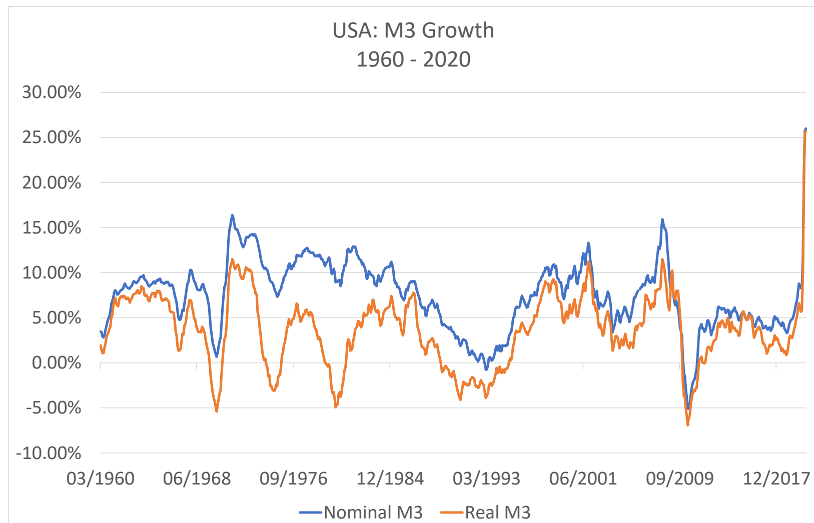
INFINITE QE – SUCCESSES AND FAILURES

The Fed has launched an unprecedented response to the Covid-19 Crisis, although the ECB / BoJ have been less “gung-ho”.

US Monetary Growth may currently be the fastest since the 1920s, or even the 19th Century.







NOT JUST PRINTING MONEY

The Federal Reserve is not omnipotent (who is?) and is potentially short-staffed.

In late March, when policy changed, it purchased an extreme number of bonds from the market – net issuance by the DoT was in fact surprisingly low at that time.

By absorbing these bonds, the Fed created a hole in the markets that certain corporates 'filled' via their own issuance.

In turn, these funded equity buybacks.
Hence, an equity market bubble has formed.

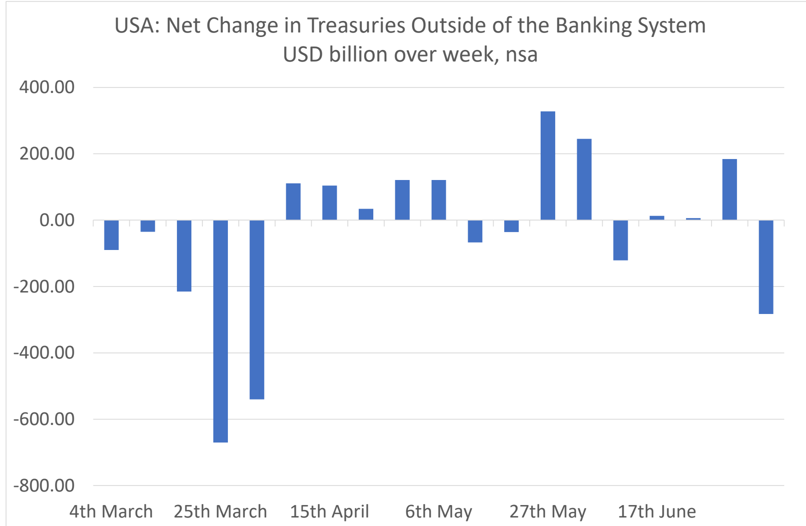
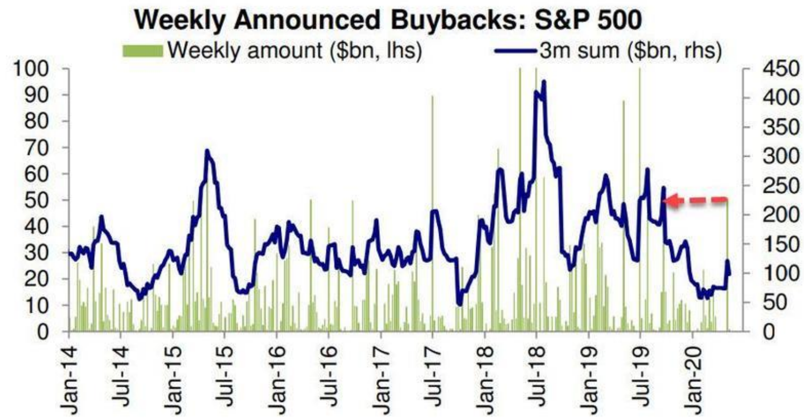


Figure 142: S&P 500 weekly announced buybacks



Source : Deutsche Bank Asset Allocation, Bloomberg Finance LP

BEWARE THE BAZOOKA

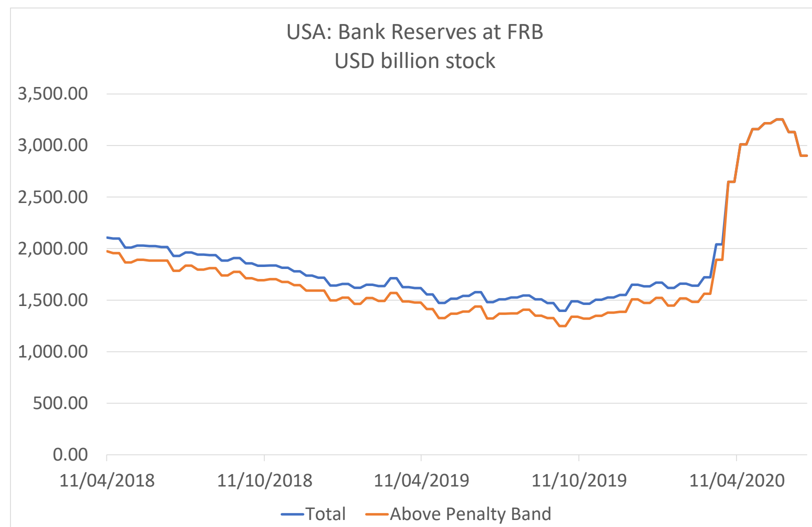
Bazookas fire forwards but ‘flame’ backwards. So can QE.

The extreme rate of growth in the major banks’ balance sheets in 2020Q2 left them ‘out of compliance’ with their various leverage and capital adequacy ratios.

Hence, they had to lower the average risk weighting of their assets.

Consequently, reserves at the Fed became the asset of choice.

QE has ‘gummed up’ the banking system.



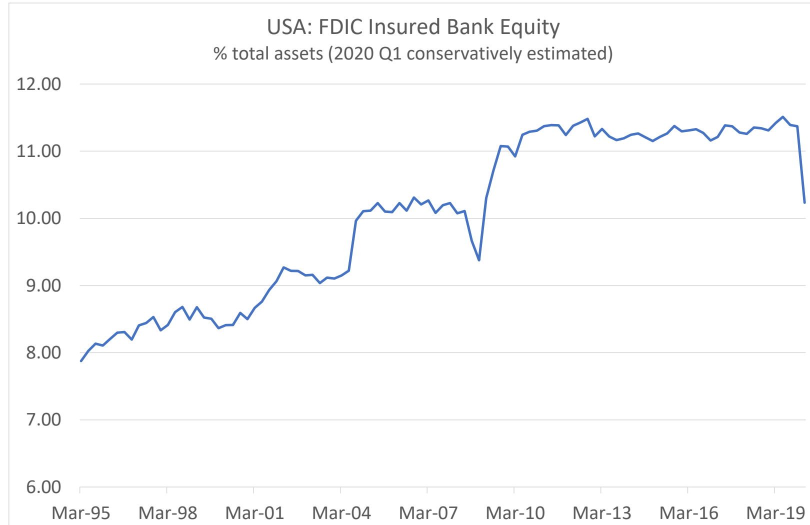
USA: CORPORATE CREDIT CROWDED OUT

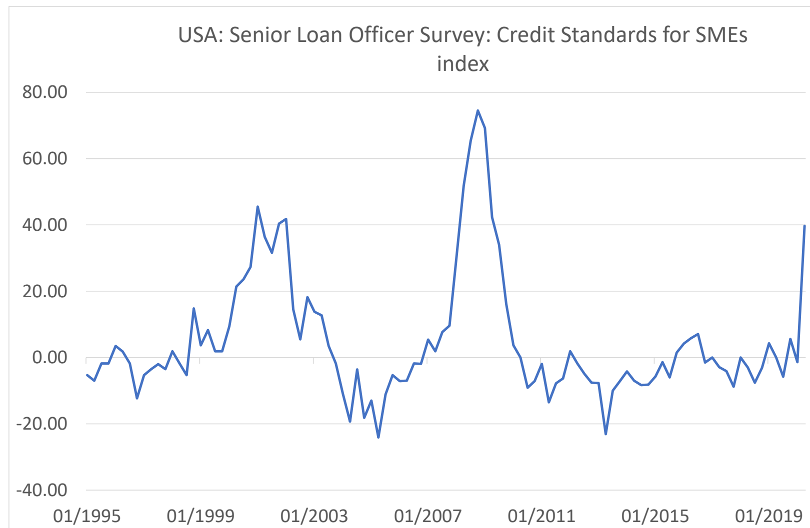
What banks could no longer afford to do was lend to high risk / new corporate clients, or households (which might not be profitable in any case)

QE caused a credit crunch.

Apple spent more on buybacks then was lent to SMEs in April.

The impact on employment and wage incomes was predictable.





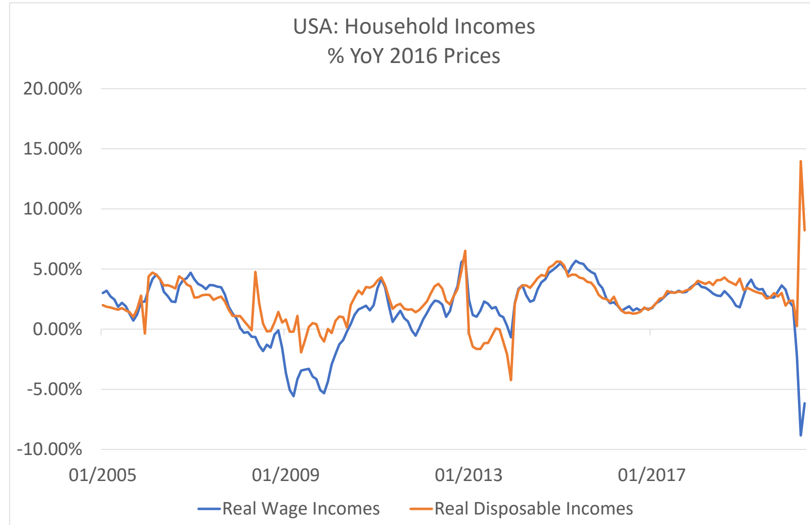
USA: FISCAL POLICY EASED

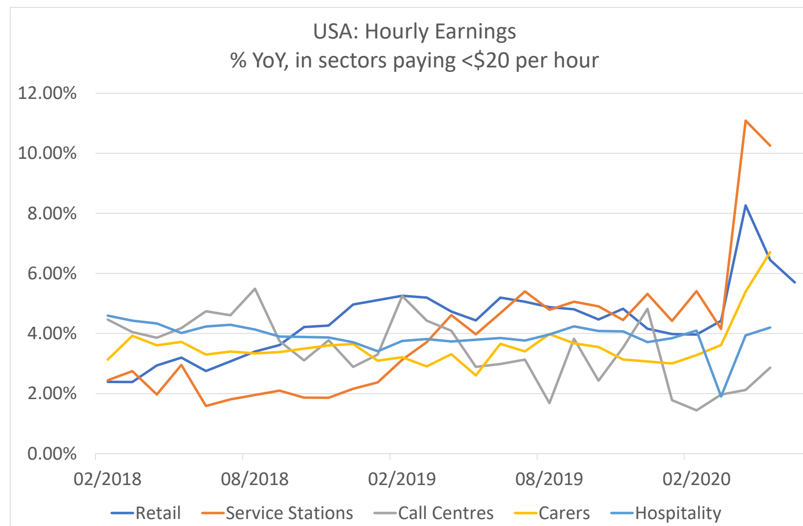
The Fed may have taken a few weeks to respond to the Crisis and then 'reacted with vigour', but the Administration reacted even later.

However, when it did react, it provided record income growth in the household sector!

It also changed the dynamics labour market by raisng the effective minimum wage.

We were all set for an inflationary "Post War Boom" when the Virus threat receded.





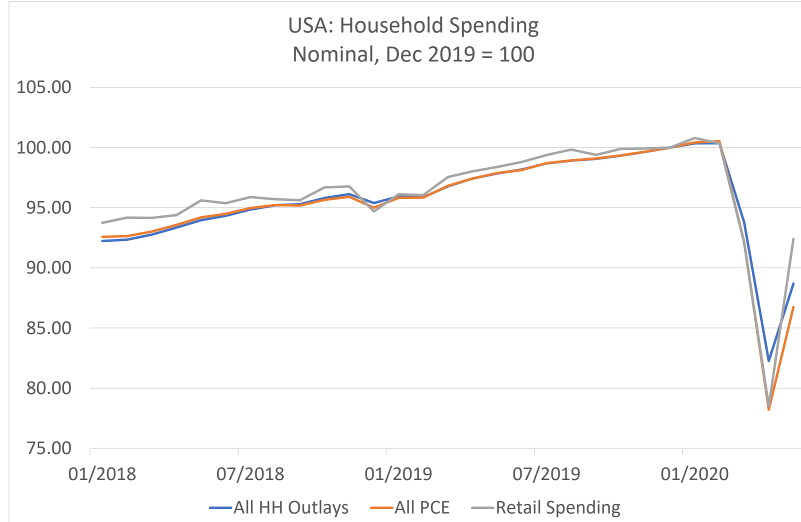
USA: LOCK DOWN EASED

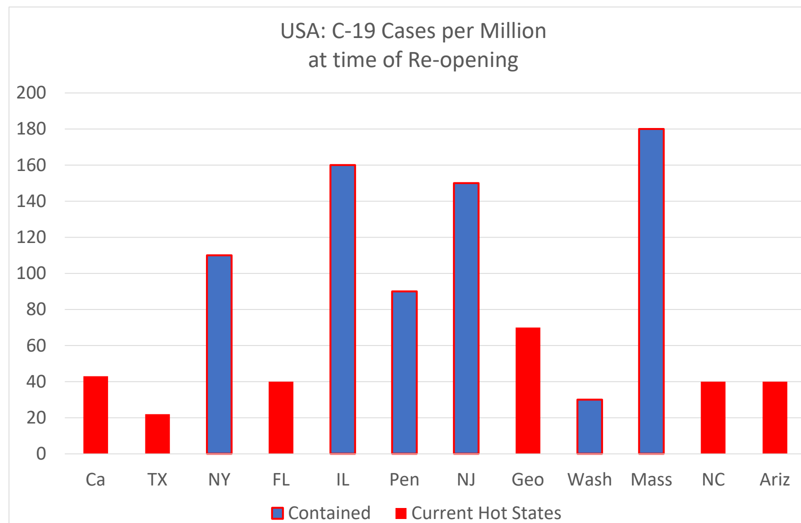
When the Lock Down was eased, spending bounced back.

However, the recovery in the NE was limited.

The South had no experience of C-19 (most of these States had YTD cases <40) and they led the economic revival.

The North East had Experience, the South did not.

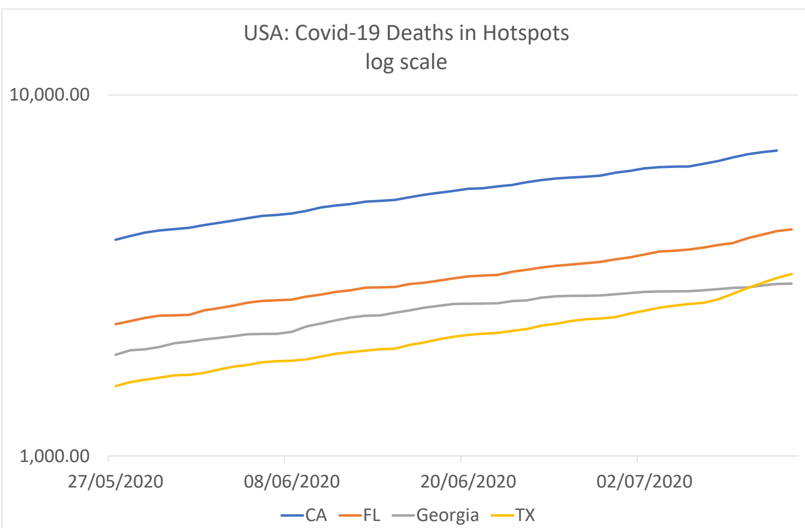


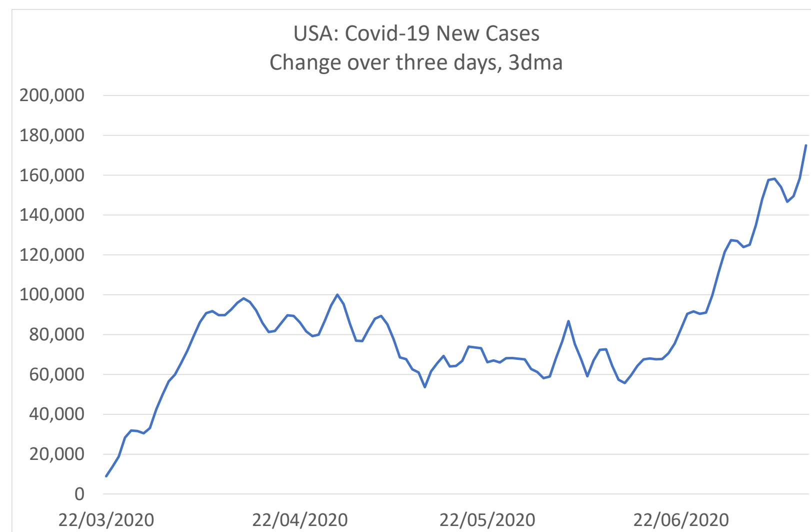


USA: THE TRAGEDY IN THE SOUTH

We can assume that either by law or choice, the spending boom in the South is now cooling, and the Post War Revival has been delayed.

Source: Google, JPMAM. Jun 23, 2020.

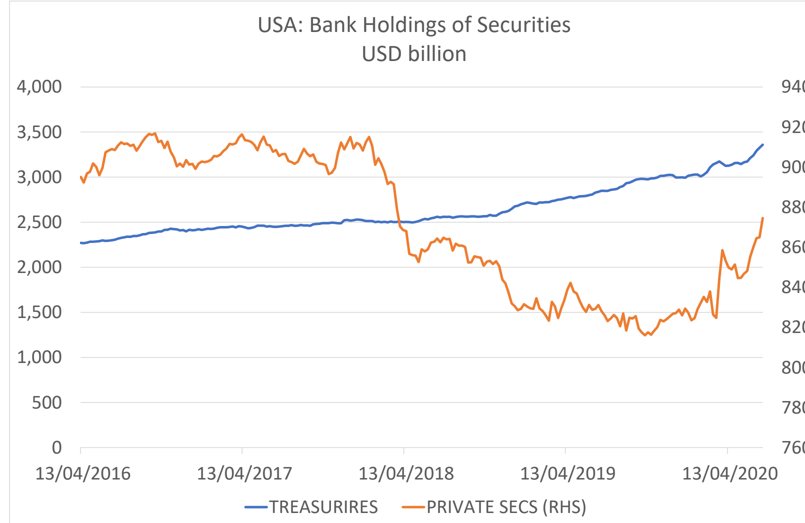


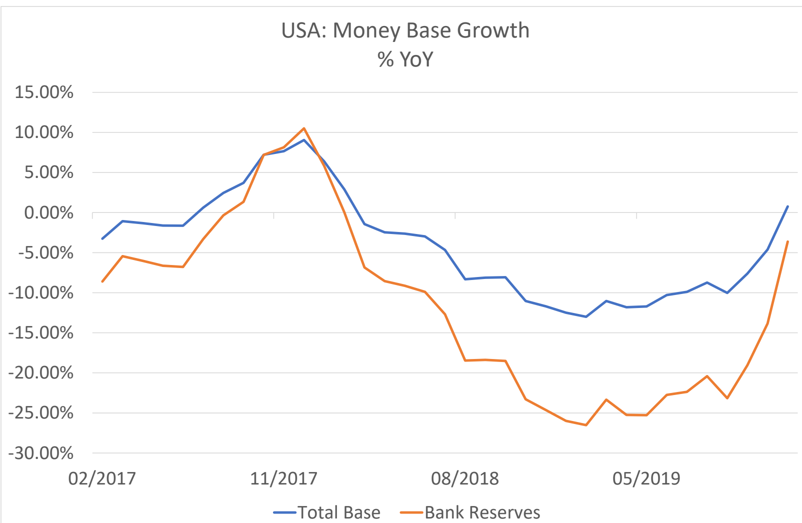


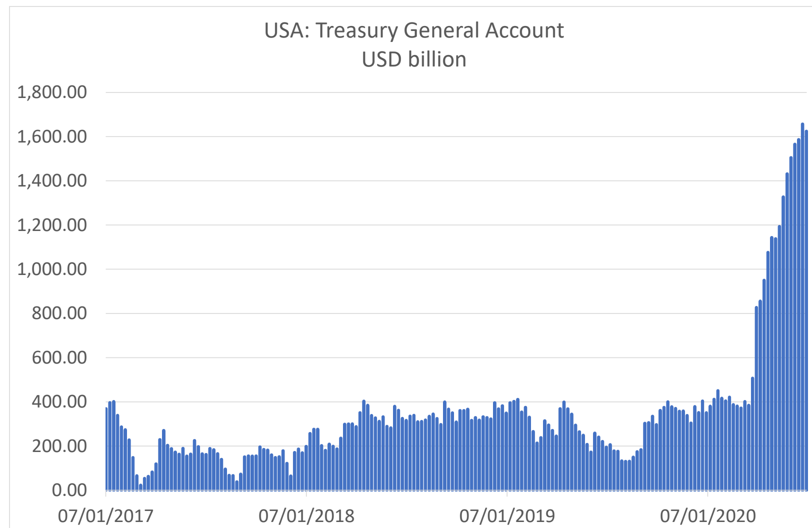
USA: POST WARE BOOM DELAYED, NEW LIQUIDITY WAVE

The system's insiders are returning to the bond markets as buyers – are the banks telling us that the economy is weakening again?

But, the Administration has money to spend. Could we see a repeat of the 2017 'Quiet QE' in markets?







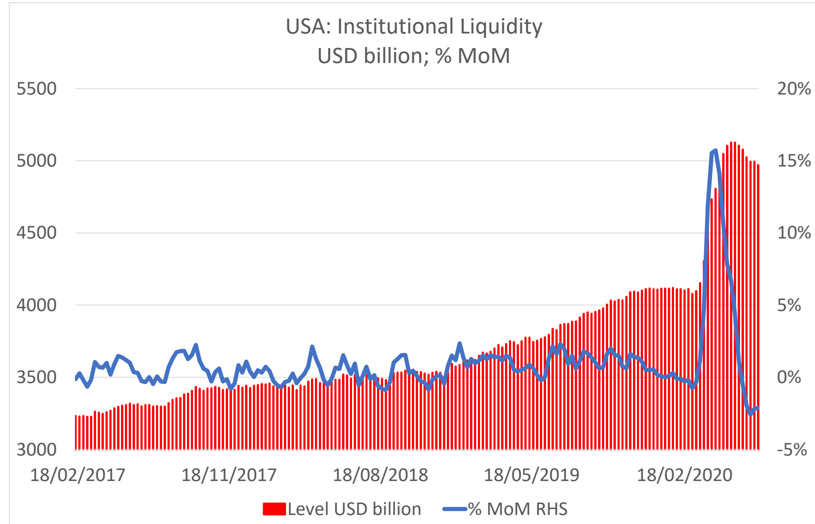
USA: THE STRANGE CASE OF THE MMF

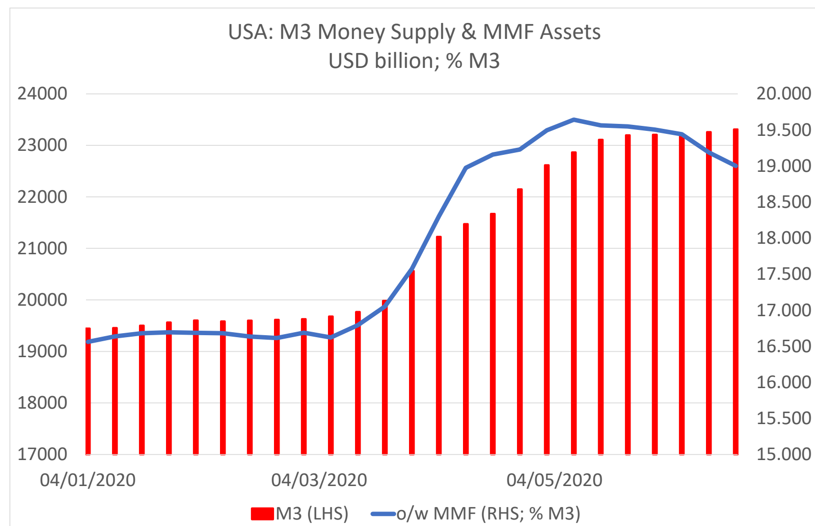
The Fed no longer publishes data for M3 but we can calculate the data from source.

This data reveals that half of the liquidity initially created found its way into Institutional MMF.

These funds are now potentially larger than the theoretical pool of assets that they can invest in!

So, the MMF had to turn to the (sponsored) repo credit markets.



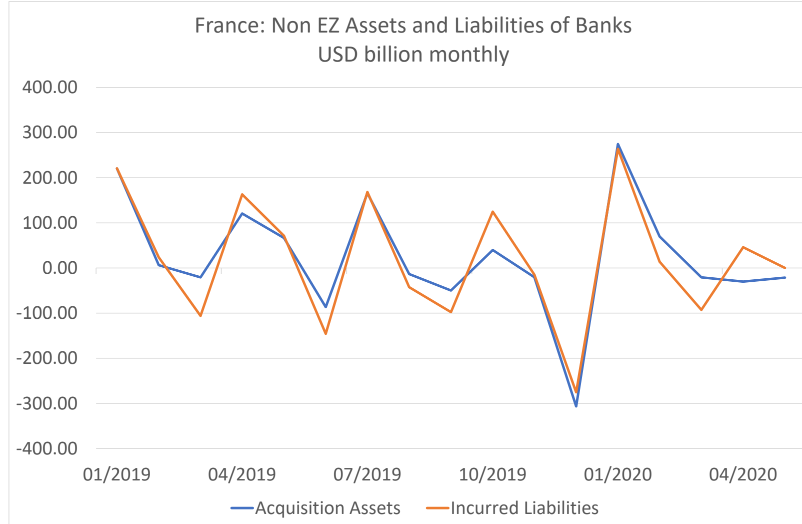


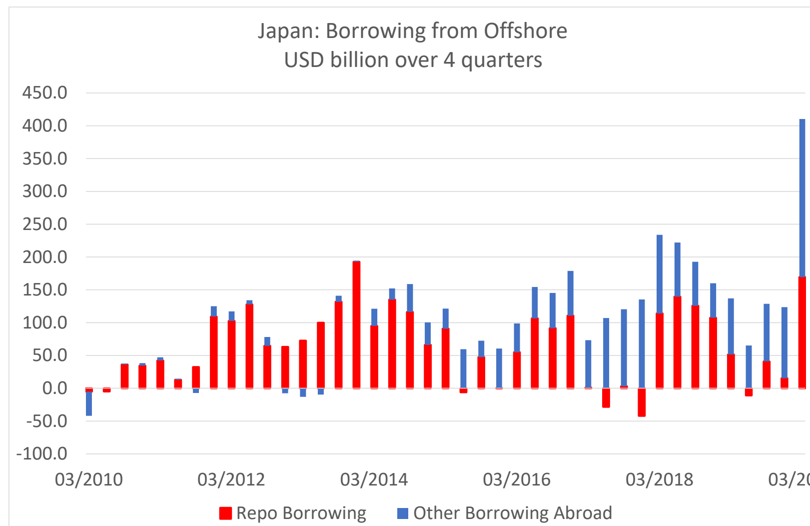
GLOBAL: JAPAN'S AND EUROPE'S REFUGEE BANKS

Japanese and EZ (=French) banks find it difficult to make money at home in the zero / negative rate environment.

So they have re-invented themselves as dollar lenders over recent years.

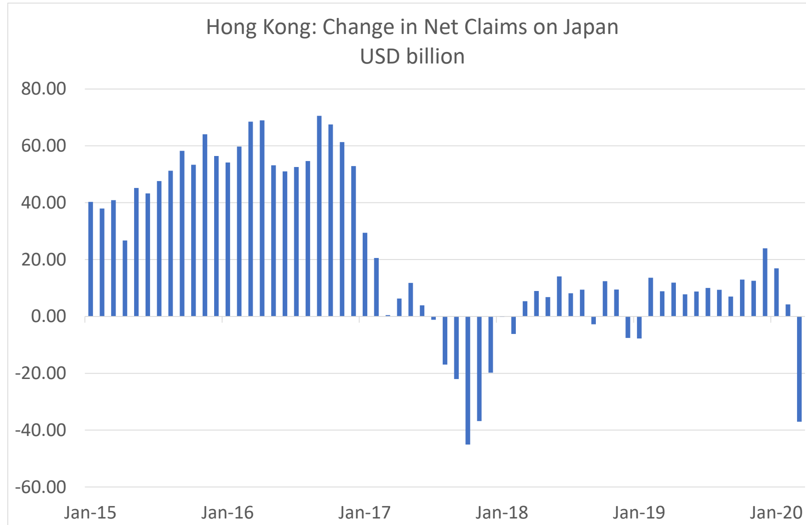
However, in 2020Q1, the EZ banks withdrew but Japan's banks became hyper active, borrowing funds from the MMF via the repo markets.

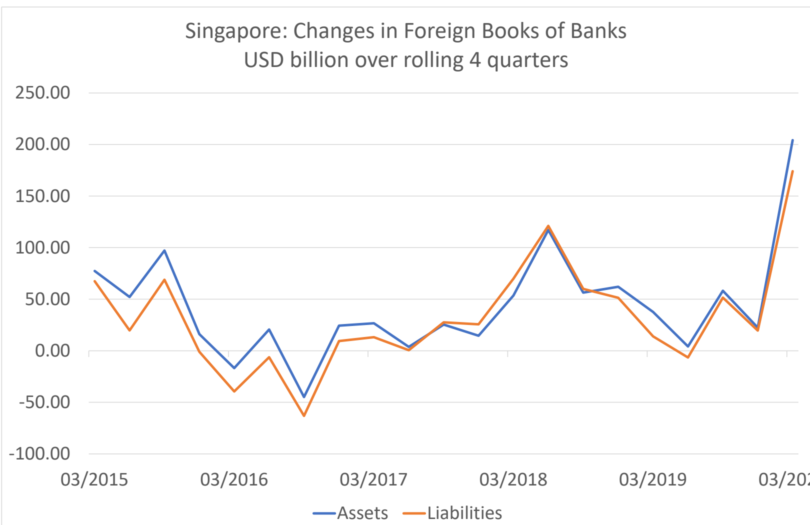


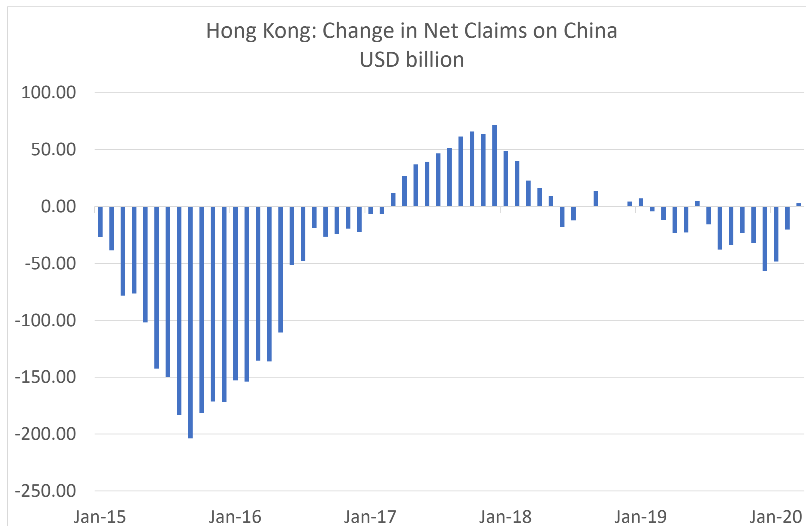


FOLLOW THE MONEY…

Japan’s banks then lent USD to thew Offshore Financial Centres such as HK / Sing / Sydney



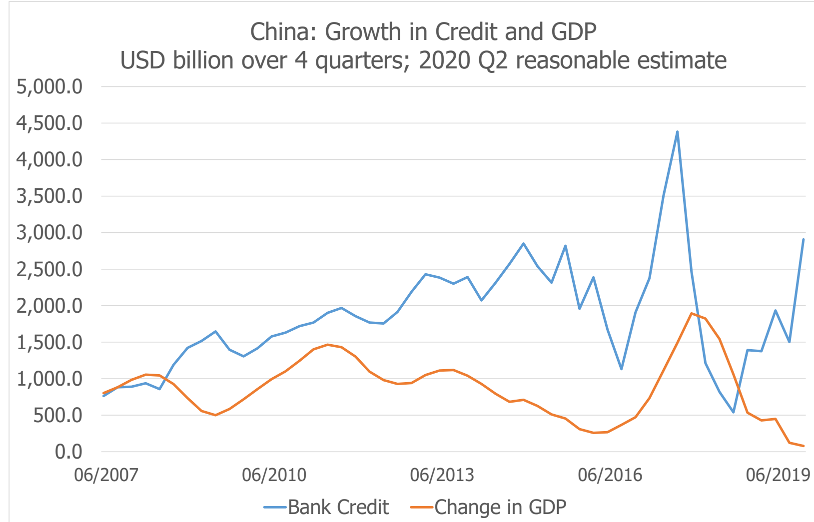




EMERGING MARKETS: CHINA REFLATES

During February, China's Policy Response to Covid-19 was very muted; the country was constrained by a weak Balance of Payments.

This all changed in late March when the dollar flows restarted, and China eased on an immense scale and the economy 'bounced'.



CHINA: THE 'PROBLEM' FOR THE RoW

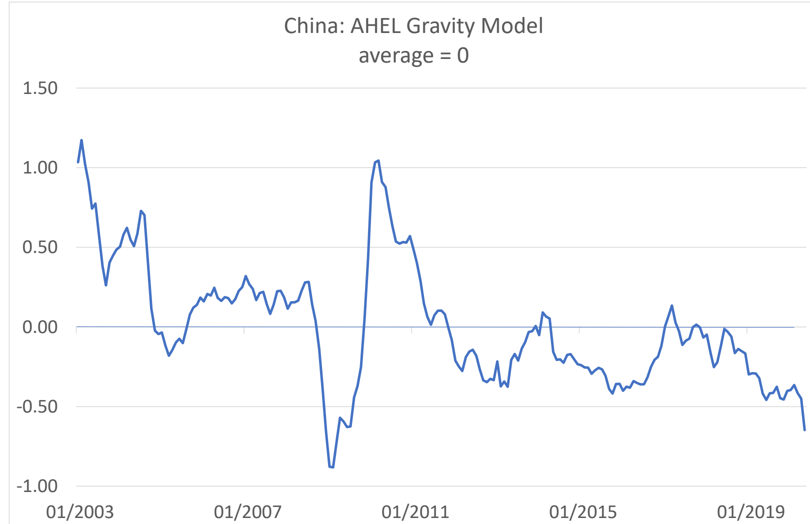
China's easing was directed at its supply side, consumers remained subdued.

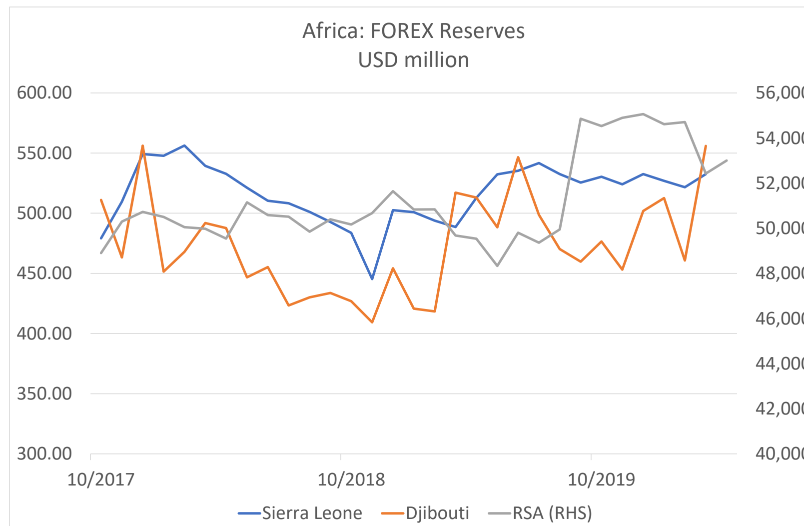
This implies that China was exporting deflation not reflation

The Development and ExIm Banks also reflated Belt & Road and hence the expansion of China's 'Soft Power' in Africa & Central Asia

China also employed some 'interesting accounting' to raise dollars.

The Hawks in Washington began to notice.

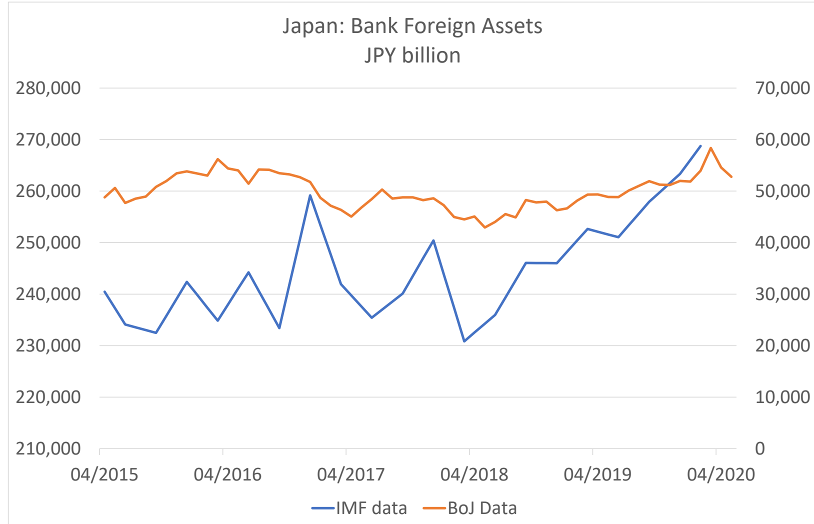




CHINA: THE BoP WEAKENS AGAIN

More recently, as the US MMF have lost funds, the Japanese banks have 'thought twice', and the OECD has raised risk weightings for Hong Kong, the flow of dollars to China has been interrupted and China's policy settings have tightened.

The US perceives an opportunity to thwart China's geopolitical aims via the capital account.



CHINA: FIGHTING DOLLAR HEGEMONY?

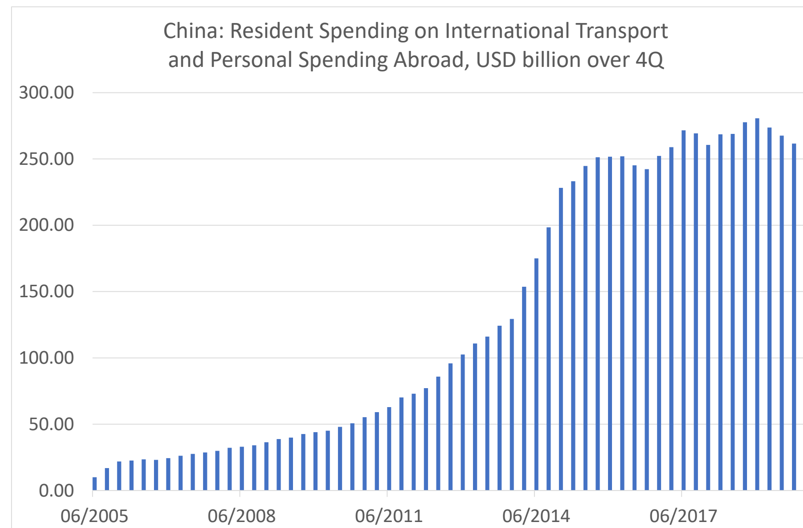
China has responded by threatening to 'de-link' from the dollar – Xi seems to be adopting a 'siege mentality'.

The RMB is not a reserve currency but Xi is looking to promote bilateral arrangements with key trading partners.

But, if China must repay some of its dollar liabilities (approximately 70% of GDP), then it will need a surplus in the Basic Balance.

China is already moving towards a hugely expanded current account surplus.

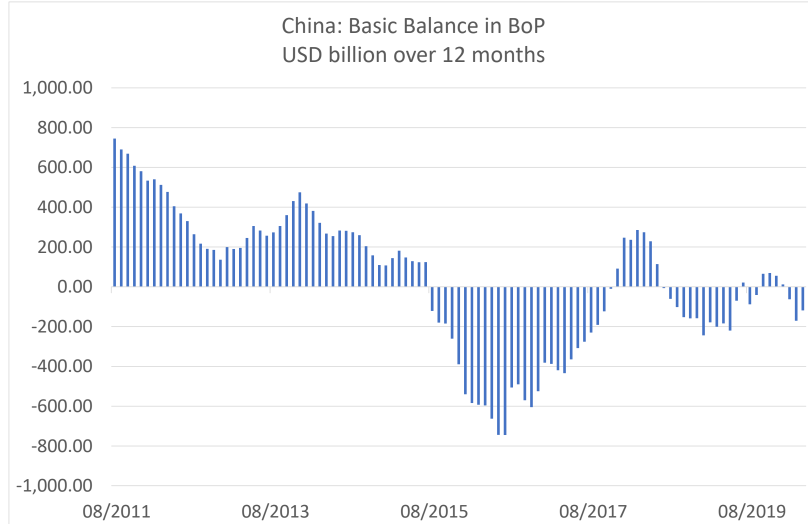
As we saw in 2017-18, China's imports are the arbiter of Global Trade Trends.



CHINA: TURNING FROM DEBT TO EQUITY?

Beijing seems also to have looked towards creating a domestic equity bull market to draw in foreign capital that would aid its basic balance, and at the same time allow its banks to raise new capital.

However, with the level of domestic excess money balances so high - but the banks reliant on wholesale funding, the authorities have found themselves beginning to fear a ‘run on the banks’.



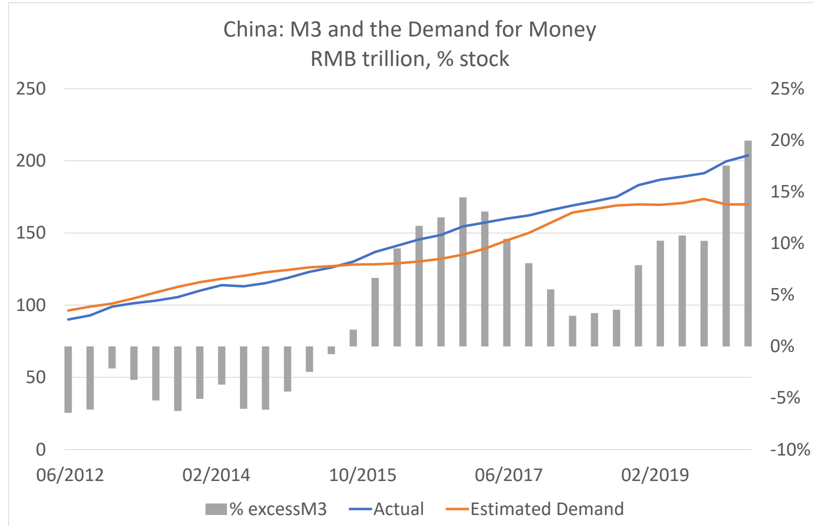
CHINA: MISTAKES & POLICY U-TURNS

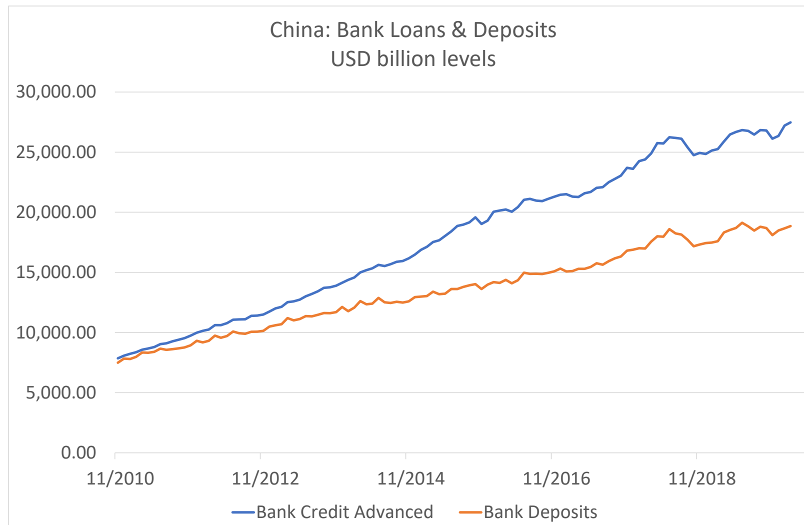
However, with the level of excess money balances so high - but the banks reliant on wholesale funding, the authorities have found themselves beginning to fear a 'run on the banks'.

The desire for a bull market has bene tempered and customers' ability to withdraw deposits is being controlled.

China's economic system relies on soft budget constraints and 'infinite credit'.

This model has created a vulnerability.



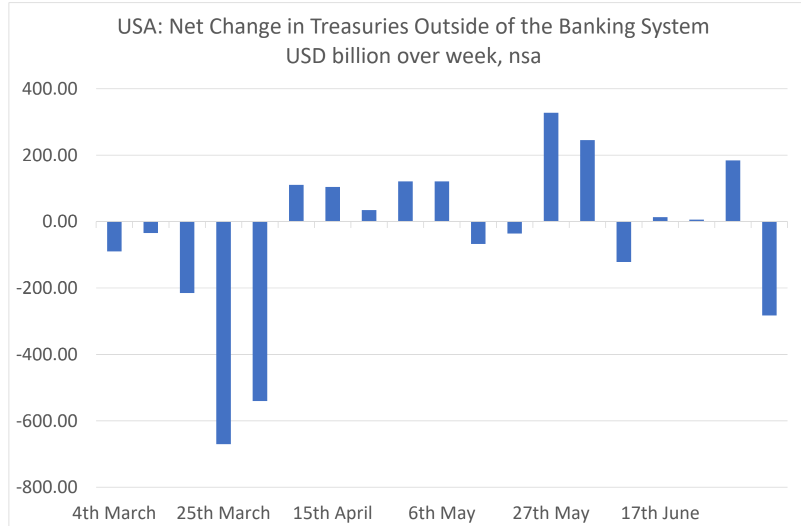


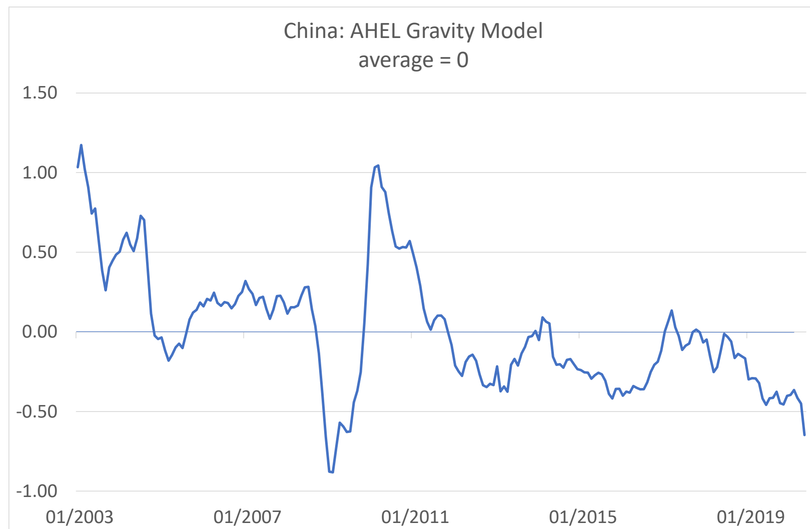
GLOBAL POLICY CALCULUS

With the President behind in the polls but holding large fiscal reserves and a compliant Fed, could Trump assume that he can exploit the PRC's problems and change the focus of the election away from Covid-19, while still supporting the equity markets?

Forcing China into austerity could be deflationary / stagflationary for the World.

In normal times we do not entertain conspiracy theories, but these are not normal times.

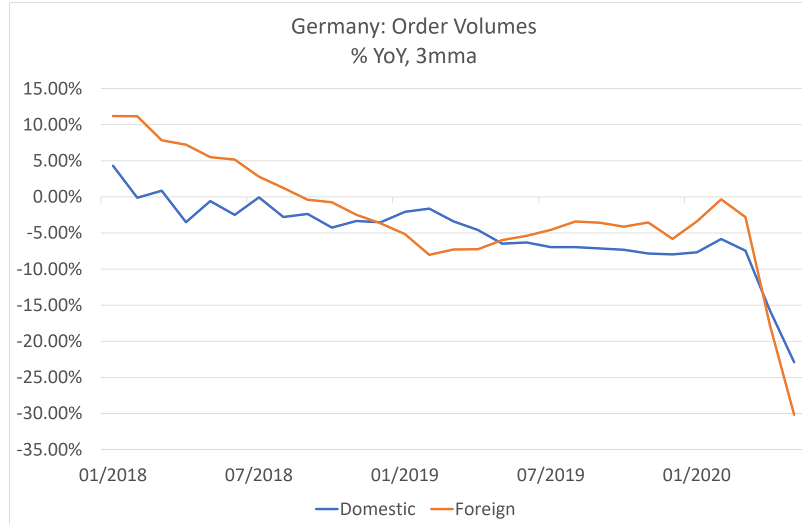


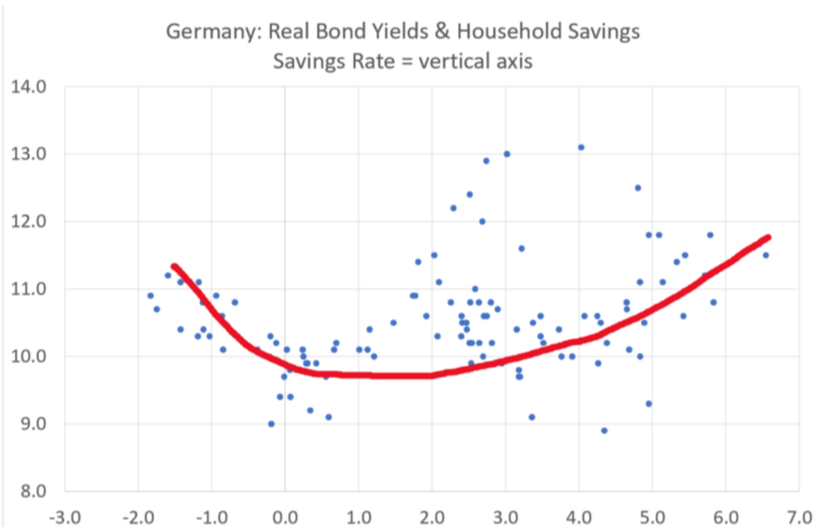


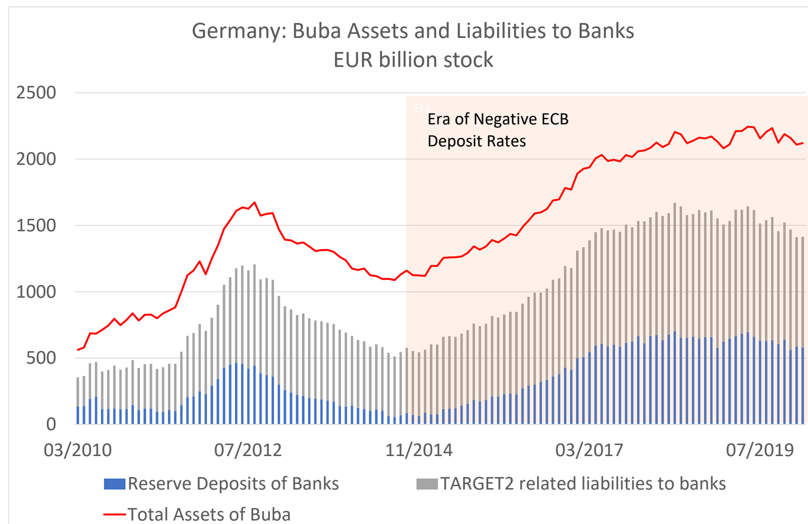
EUROPE: BETTER VIRUS DATA BUT EXTERNAL THREATS

The EU has so far made good progress vis-à-vis the virus, but a delayed recovery in US and China's surging current account surplus represent clear threats.

The ECB is now responding, but anything that expands its balance sheet impaires the BD/NL banks, while damaging consumption in the NW.

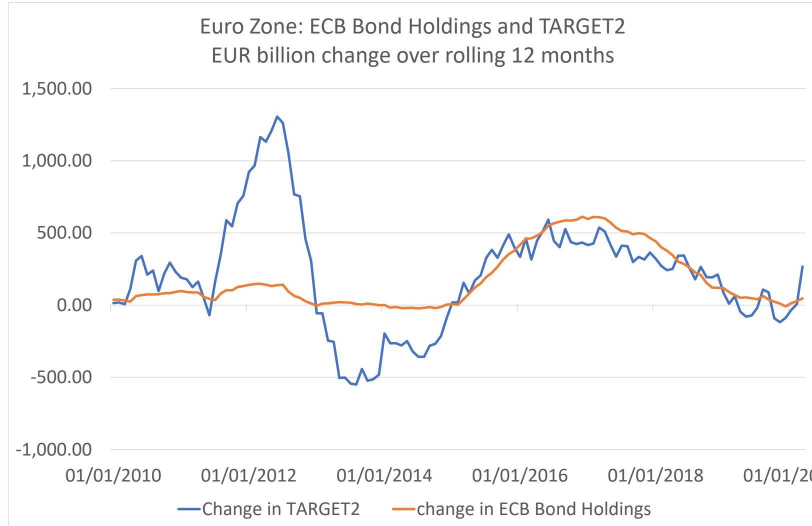


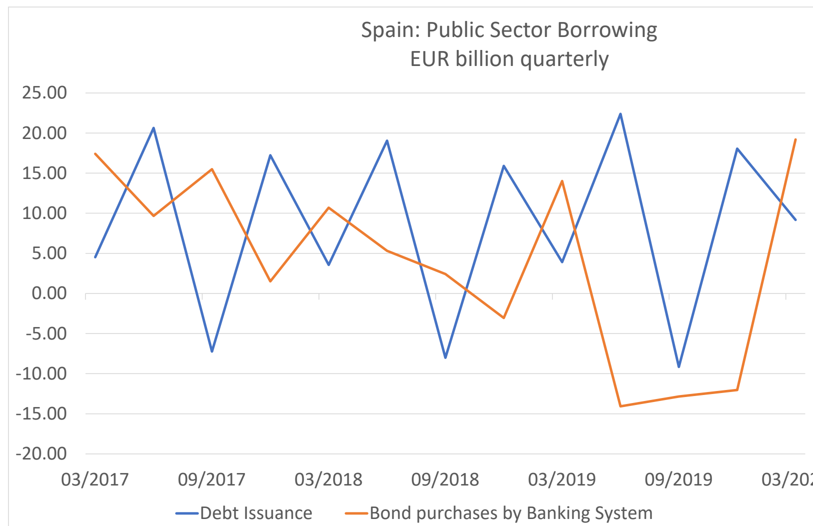




EUROPE: ECB AND FISCAL EASING REPRESENT THREATS

One Spain and Italy begin their fiscal responses, it will be interesting to see what occurs to their balance of payments positions and therefore their reliance on TARGET2

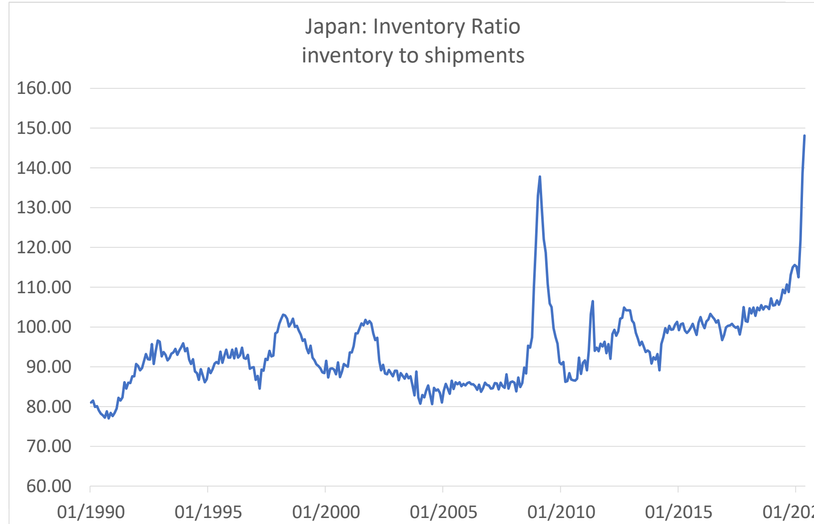




JAPAN: INVENTORIES – AND MONEY

Japan's CAPEX & chemical goods exporters are struggling and inventory levels are extreme. Consumers remain cautious.

However, the resulting demand for operating capital from companies has caused a monetary boom…..



CONCLUSION MONEY VERSUS COVID-19 VERSUS GEOPOLITICS

Our presentations normally evolve over time – some slides stay in, others drop out as we follow the cycle. We have not been able to recycle much of the predecessor to this report – we are on exponential time and events are moving quickly. This tells us much about the New Normal.

Households that have experienced Covid-19 shocks remain cautious – the spending revival in the USA was led by the States with no Coviod-19 experience but, once a country or area has suffered, people have remained cautious even when lock downs are eased.

Global growth will remain weak, and genuine new CAPEX will likely remain depressed.
We are on the cusp of a second wave of liquidity as the US reduces the 'TGA', the ECB ramps up its response, and Japanese credit trends improve. However, there will be costs involved for banks and other fincos as QE / Zero Rates gum up the financial system.

The recovery in the EM was based on fund flows that were ultimately sourced from the US MMF sector. These flows are now dwindling, in part because of Geopolitics. A Sino-US capital account war will matter more than any trade war might. It could cause a Global Depression.

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