MONETARY SCENARIOS

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Global Monetary Viewpoint

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EXECUTIVE SUMMARY:

Despite the persistence of extreme monetary radicalism in Japan and the euro-zone, central bank chiefs in both are dissatisfied with the respective economic outlooks.

This does not mean that radicalism is about to be abandoned. Political direction in both countries is favourable to its continuation and even strengthening under some conditions.

Japanese investors have built up massive portfolios of European financial assets in their search for yield and hence it is no surprise that financial markets are one important chapter in the EU-Japan free trade agreement which starts next week.

This rapprochement of Japan PM Abe to the EU hegemon carries some considerable risks, especially in the relationship to the US. These risks argue against the yen as safe haven.

Monetary Barbarians in Berlin and Tokyo: Shock Europhile conversion of Shinzo Abe

Gold, a barbaric relic according to Keynes, (he meant this in the sense of "primitive") rises in price when the forces of fiat money barbarism (in a wider sense of ferociousness, the antithesis of civilization), are strengthening.

We have seen that on a mini-scale in recent trading days and are likely to see it again on a grand scale if the neo-Keynesians prevail in monetary policy reactions to the present global economic slowdown.

(In modern idiom this school of economists subscribes to the view that "monetary engineering" can overcome and indeed navigate a way through "frictions" in the economy that improves real outcomes especially in the exit from recession).

ECB and BoJ chiefs explain disappointment

The chiefs of the ECB and Bank of Japan (BoJ) in their respective press conferences last week left no doubt that their radical monetary experiments are set to continue. Indeed, they hinted that the pendulum could swing towards radicalism (negative rates, long rate manipulation, novel types of QE) if the present global and regional economic landscape (in Europe and Japan respectively) continued to darken.

How do they explain present economic disappointment?

Number one explanation is the "Trump tariff war" of course.

The central bank chiefs would deny utterly (if any contrarian idealistic soul at one of those tedious press conferences posed the question) that their own monetary "barbarism" is to blame alongside the "ultimate enabler", the global monetary hegemon (US Federal Reserve).

President Trump in search of soft money candidates

As regards the Federal Reserve, the news last week was that President Trump is seeking to nominate two "easy money" candidates to the empty chairs on the Fed Board (according to chief economic advisor Kudlow).

Meanwhile informed reports circulated that the Federal Reserve is soon to abandon its programmed gradual contraction of the balance sheet.

(As highlighted in last week's Global Monetary Viewpoint the program is insignificant in terms of economic or monetary outcomes over the medium-term under the present regime where

reserves pay market interest. At most, program announcements can have a passing effect on market sentiment).

No doubt President Trump will find another neo-Keynesian economist (who would share the views of the present chair and vice-chair that the Fed by studying the position of the stars – the neutral interest rate and the natural unemployment rate – can navigate successfully a much better path for the economy than would occur under any "sound money" alternative). The President may fill the other chair with a private equity banker (with an innate bias towards soft monetary policy) to fill the empty chairs at the FOMC and get Senate approval.

There will be no resurrection of Senator Bunning who told Chief Bernanke in the course of his re-appointment testimony (2009) that he was "the definition of moral hazard".

Massive and prolonged monetary inflation around the globe (camouflaged in goods and services markets by a powerful downward rhythm of prices resulting from digitalization and globalization) has weakened and distorted the invisible hands of free market capitalism which generate prosperity.

Monetary radicalism produces low growth and low rates

We won't know until the end of this cycle, and possibly considerably later, where all the mal-investment is located which occurred under the present episode of monetary inflation. (Mal investment is a term which describes the misallocation of capital which occurs under market signals which have been distorted by monetary disorder).

Already the slow and disappointing pace of economic growth – and the new slowdown now apparent – is symptomatic of investment which has been sub-optimal.

Capital spending has been driven by the key motive of monopoly creation (for example, perpetual market power for the winner take all, whether actual as for Google or potential as for Amazon) or by other speculative narratives which in normal (monetary) times would have been rejected by sober-rationalists (investors who estimate carefully the probability of various scenarios from success to failure). In consequence, investment has been remarkably ineffective in generating economy-wide prosperity (as distinct from large transitory wealth gains).

Yes, there have been areas of strong business investment – big Tech, Silicon Valley unicorns, shale oil and gas, emerging market construction, big exporters in Germany and Japan, and so on – but in all of these cases the speculative narrative which drove the spending, sometimes highly leveraged, could yet prove to be very wrong. For example, there are yet many unpleasant surprises and reality checks plausible along the path of digitalization; and as regards the super-cheap yen and euro which lie behind the German and Japanese export booms, how sustainable is this?

Outside these speculative hot areas there has been a general malaise. Everybody and their dog realize that the speculative froth

in asset markets will dissipate at some point, most likely with a Crash, Hence the safest strategy for business decision-makers has been to eschew long gestation projects and concentrate on fuelling their equity performance by financial engineering (equity buy-backs and other forms of hidden leverage).

Consumer caution in Germany and Japan, but not US

In Germany and Japan there is some evidence in the macro-data that households realize the dangers ahead. The clues come from their response in aggregate to a mood of despair stemming from negative rates on traditional safe assets (government bonds and insured bank deposits).

Some households have boosted their savings accordingly. Some have decided out of desperation to assume highly speculative positions, or plough savings into illiquidity, hoping to find an exit from income famine.

In the US, overall response in the direction of saving more (in the personal sector as distinct from the corporate sector) is less obvious and has been over-ridden in the macro-data by a boom in private equity-driven consumer lending to non-prime rated households (including a large element of predatory activity - for example, the mailing out of cheques to individuals who can ill-afford the subsequent repayment terms - albeit less blatant than in the last cycle).

Press conferences in Frankfurt and Tokyo

In Tokyo the news was that PM Abe's BoJ Chief is not giving up at all in the long-run struggle to make Japan a land of 2 per cent inflation, even though current inflation measures have been sagging (core CPI inflation at a 17-month low in December 2018 of 0.7% year-on-year).

Yes, the BoJ has sharply reduced in recent months its buying of JGBs to a rate far below the 80bn yen annual target. That pull-back has come about as demand from the private sector including foreign investors for JGBs increased even at 10-year rates of virtually zero.

Notable has been the presence of dollar-based investors who swap JGB holdings into dollar paper and earn an attractive income stream thereby, sometimes significantly higher than on other dollar paper of similar credit risk. (This arbitrage opportunity is explained by the strength of irrational carry trade demand by Japanese investor for US credit paper, swapped back into yen so as to eliminate currency risk).

In Europe, by contrast to Japan, the central bank chief has called an official halt to further balance sheet expansion whilst indicating that this could be restarted if economic conditions deteriorated. That would be possible with Angela Merkel or her chosen successor in the Berlin Chancellery. But unlike Japan, a virtual one-party democracy, there are alternative political scenarios in Germany well within the realms of the mainstream.

Even so we should not underestimate the extent to which the German economy is now highly leveraged on policies of cheap currency and unmitigated chasing of export and re-export opportunity in China. Now Germany is in the front line of global economic slowdown with China at its centre.

Shock Europhile conversion of Shinzo Abe

Chancellor Merkel, like most other world leaders, was not present at the Davos pantomime last week. PM Abe was there in line with this present 6-month stint as chairman of the G-20. His speech was a wake-up call.

Listeners – and the cameras at this Swiss resort never capture the audience – heard much about the EU-Japan free trade agreement (formal name, economic partnership) coming into effect at the start of February. In waxing lyrical about this, PM Abe extolled his government's support for the free trade system now "under threat", thereby implicitly siding with Berlin's unease about the Trump Administration's "trade war" against Beijing.

The Japan PM made no mention of China's long-running offensive against the free world including global free markets to which the present US Administration's tariffs were a first and late response. Nor did he acknowledge that Washington had already granted a truce under huge pressure from Wall Street, Silicon Valley and the farmers to do so.

Earlier in the month, Shinzo Abe in his lightening European tour dropped in on Theresa May to warn publicly the British prime minister against defying EU power with a no-deal Brexit. And he let the Brexiteers know, if they had any illusion about this matter, that Tokyo would not reward their defiance by opening talks on a free trade deal between the two island economies, never mind the historical romantics.

Meanwhile, back in Tokyo, PM Abe's Bank of Japan Chief, Haruhiko Kuroda, pronounced that there is to be no turning back from monetary radicalism featuring euro-style negative interest rates and long-term interest rate manipulation. (In this cycle, Frankfurt, not Tokyo, was the pioneer of negative interest rates). Certainly, these policies have not pushed the inflation rate up to the 2 per cent target. But who doesn't know by now that the real purpose of monetary radicalism under present circumstances is currency manipulation and stealth taxation of fellow citizens?

(The stealth taxation is a form of inflation taxation – in which the interest rate on savings is held artificially low by monetary inflation which in this case does not show up in high reported goods inflation; the government gains from the abnormally low servicing cost of its debt).

Nothing new about Japan forming European alliances

There is nothing new about Japan periodically embracing European alliances and learning from Europe. The tradition goes all the way back to the Meiji Restoration. And the danger that European ties can stoke friction in US-Japan relations is also

familiar. But now Japan's geo-political situation is particularly fragile. The US, not the EU, is Japan's partner in security.

The essence of a Europhile policy for Tokyo is a close friendship with the EU hegemon, Berlin.

We know that the Trump Administration is watchful and alert to how Germany has been "gaming" global trade and security to the disadvantage of the US. The rapprochement of Tokyo and Berlin implicit in the concluding of the EU-Japan trade deal jars with the length of time during which the Abe government, worried about new demands to curb official or unofficial protection of its farmers and auto-makers, stalled the opening of talks with Washington an a free trade agreement (eventually agreeing to their start last Autumn).

Euro-yen financial integration amidst income famine terror

Increasing financial integration between Japan and the EU, one aim of the deal, makes sense to Tokyo not least given the massive accumulated stock of financial assets held in the euro-zone by Japanese investors made desperate for yield by the radical monetary experimentation of Abe-economics.

Yield hungry Japanese have flocked to French government bonds. There has also been a huge build-up of much higher yielding and riskier Italian government bonds. No wonder Shinzo Abe stands shoulder to shoulder with Angela Merkel in hostility and fear of any "populist" quake under the EU – whether a "no deal" Brexit or anything else- which could cause the pillars of the euro-zone to fall.

Shinzo Abe and his architects of economic policy would not admit to having spread the terror of income famine amongst their fellow citizens. After all he told the Davos crowd that Abe-economic had "defeated defeatism" and thereby the Japanese economy is prospering.

The business statistics have been at least superficially on his side, albeit that there is now a troubling slowdown. The chap yen for Japan, like the cheap euro For Germany, has stimulated a cumulative rapid growth of the export sector.

German and Japanese households (other than those earning bonuses in the big export corporations) are quietly suffering. Some may delude themselves that speculative froth will continue to compensate for negative returns on domestic bonds and money. But most realize that to attain their objective of accumulating capital for retirement they have to save even harder than otherwise. This is one reason whey negative rates have not produced the overall economic stimulus that their advocates predicted.

What if Merkel regime crashes?

In Japan all households are subject to tax by stealth on their savings. In Europe this tax is concentrated in Germany and other Northern European EMU members. German resentment in particular of the transfer to Italy most of all might eventually fan

sufficient support on the right to topple the centrist governments presided over by Chancellor Merkel or her successor.

If eventually the Merkel regime and the EU status quo over which it presides crashes, then historians will say that PM Abe made a big error in undertaking Europhile conversion. The sacrifice of total loyalty – economic and security – to an alliance with Washington would have been for nought.

Implications for market strategy

The shallowness of PM Abe's claims of success for his economic policy, the financial weakening of Japanese households, and the potential rift opening with the US, are all dangers for Japanese asset prices (in particular the stock market).

There are grounds for fearing that in the next global recession, Japan will be particularly hard hit. So-called safe-haven features of the Japanese currency could prove to be fleeting at best.

Third party carry trade positions in yen (non-Japanese borrowing this currency to finance assets around the world) are now on a much smaller scale than in the run-up to the 2008 crisis. And Japanese investors themselves may not unwind holdings of foreign assets in such a crisis given the fragile climate for the Japanese economy and its geo-political situations.

Chinese economic and political risks are daunting; in many scenarios these could drag down Japanese asset prices and the yen given the high degree of economic integration between the two countries and the geo-political exposures.

True, in principle, the Trump Administration could demand yen appreciation as part of the accompaniment to a Japan FTA and a China deal (which could also feature a yuan revaluation).

As of now, however, there is no evidence to suggest that the US Treasury under Trump loyalist Mnuchin is headed down this policy path.

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