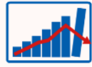
 MONETARY SCENARIOS

20 June 2019

Global Monetary Viewpoint

Author:
Dr Brendan Brown

EXECUTIVE SUMMARY:
The consensus economic forecasts point to global re-bound getting under way late this year, and gathering pace in 2020.

The summer forecasts of German research institutes fit into this picture. So does the strength of equity markets, as fuelled by the pre-announced "monetary stimulus" from the Federal Reserve.

Such optimism jars with actual and potential recession, evident in the emerging market world.

The optimism also ignores the extent of over-investment and mal-investment in hot sectors across the advanced economies.

The focus here is on two problematic areas: Brazil and German real estate.

German recession and the Brazilian canary: British pound signals EU turmoil ahead Alert: Powell's US pre-election money boost – same as Bernanke and Burns or different?

Fed Chief Powell losing his patience, yet trying to save face (against charge of submitting to White House) by announcing a pre-election (November 2020) monetary stimulus which will only take effect "on the ground" at the next FOMC meeting not yesterday (note Fed speak, if economic conditions require!) appears to many in the market-place as a reincarnation of the past. Think of Ben Bernanke and Alan Greenspan, preparing their pre-election bonanzas of Spring 2003 (ahead of November 2004) or Arthur Burns in Spring 1971 (ahead of November 1972).

The gold market is on the boil, and the dollar falling accordingly – exactly as one would expect when the monetary hegemon is about to deliver a dose of inflation (unknown how much to be reflected in goods inflation and how much in asset inflation).

Problem: history does not repeat, it echoes.

This time we are already at a record distance into a super long business cycle expansion. The next global and US recessions may already be on their way, with the forces (now generating that) more than resistant to Fed or ECB tinkering.

ECB Chief Draghi, in his comments this week, was more pessimistic than the latest consensus assessments from the leading German research institutes. He does not share the broad optimism in global equity markets, as fuelled by speculation on the pre-election monetary stimulus of Chief Powell and his colleagues around the FOMC table.

Draghi's pessimism might well prove right for the wrong reasons - not being due to "US trade war with China" but strong endogenous factors such as strong cyclical downturn in the emerging market world, a surprise and sudden cooling of the German real estate and construction boom, and yes a negative feedback loop from the aggressive currency war campaign in which the ECB is now engaged.

Mario Draghi – Italian nationalist and currency warrior to the end

Sig. Draghi's denial that the ECB is seeking to depreciate the euro (or at least resist effectively new devaluation pressure on the dollar as emanating from the Fed's pre-election stimulus) should not convince anyone, least of all Washington. The question of the

Also, some cautious optimism: Brexit is not the canary in the mine.

hour, and indeed the next few weeks, is whether Berlin (Chancellor Merkel) will seek to pull back from the dangers of a currency war campaign, by firmly blocking any Draghi "clone" or close fellow-traveller(as apparently favoured by President Macron) becoming anointed as his successor (see below).

Mario Draghi's prescription (for substantial downside economic risks), that the ECB might steer its official short-term interest rate by 10bp further into sub-zero territory, is surely absurd as a meaningful contra-cyclical tool.

That is, unless we include the "terror effect" on European and especially German savers of sub-zero rates, who thereby re-double their purchases of foreign assets. The result: a cheaper euro to start with.

Recovery from the next recession will not emanate from a tiny rate cut coupled with the transitory beggar-your-neighbour devaluation of the euro (until the US retaliates) prompted by this.

As always, the cynics amongst the ECB watchers might suggest that the motive here is to do all possible, to rescue Italy's membership of the EMU, and BTP yields notably fell in response to the Chief's remarks.

Ever greater negative yields on Bunds, drives desperation for income and fuels the irrationalities related to that ever-spiralling process.

Consensus optimism on German upturn unconvincing

Back to the consensus view from the research institutes: according to this, the German economy has been in a period of economic slowdown since mid-2018 with the blip of reported growth in the first quarter (as the drag of auto-emissions standards re-vamp and low-level Rhine in late 2018 were reversed). Into the second half of this year, a re-bound gets under way (according to the institutes).

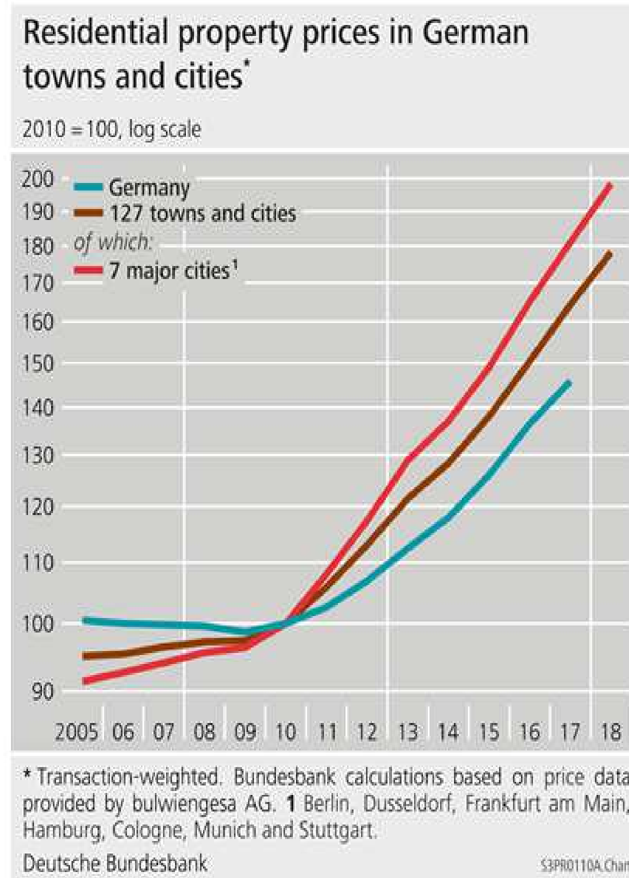
Throughout, the construction boom continues – and the construction sector relative to GDP is now around 1.5 percentage points above long-run norm.

The institutes forecast that the drivers of weakness through the first half (exports and business spending on machinery and equipment) start to reverse from the second half of this year onwards.

But what if exports do not recover, and in fact continue to weaken, and similarly if business investment declines in reflection of the soft conditions in the manufacturing sector (and of wider uncertainties – including the course of the currency war, trade retaliation by the US, and most important of all the course of asset inflation).

German real estate

House prices in top German metropolises have doubled during the present business cycle, rents are up by almost half that or less (excluded from CPI measurement), consistent with steep fall in yields



German construction and real estate boom/bubble

We should not regard construction boom (both commercial and residential) as a perpetual feature of the German economy, notwithstanding the relatively large size of this sector on average, relative to that in other advanced economies.

The growth of rents on both commercial property and residential property especially in top cities in the South of the country (whether East or West and including Berlin) has been impressive – several years at 5 per cent or more.

In turn, this rental growth has become extrapolated into expectations going forward, with speculative narratives to match. These have been a factor in the steadily falling rental yields which on prime class A real estate (residential and commercial) in metropolitan areas is now below 3% (residential); the other factor of course has been the collapse of bond yields and the related desperation for yield.

When will the real estate boom turn to bust?

We cannot get any clue on this from reading the marketing reports of the real estate brokers and the banks marketing clients

to join the party. They simply repeat the narratives as to why the boom will continue into the long-run future.

The research institutes (in their forecasts for the German economy) also assume that the long-run will not short-circuit into the present within their horizon. The trigger to a downturn is never obvious, in advance – other than general observations about global asset inflation and its path towards the final phase of asset deflation and recession.

Over-supply and downward revision of expectations regarding rental growth is plausibly the chief factor to monitor. Hyped up office rent forecasts in Frankfurt, based on Brexit, might be a specific vulnerability - Berlin is a class of speculative narratives to itself.

German institutes reject emerging market pessimism

Macro-economic forecasters, including those at the central banks, do not build the speculative momentum of asset inflation into their neo-Keynesian econometric models, and the German research institutes are no exception to this rule.

They project annual annualized growth rates for the German economy of 0.2% in 2019H1, 1% in 2019H2 (after 1% p.a. in 2018H2). Their optimism is reflected in the forecast of pick-up, in the second half of this year and beyond. The IFO institute projects 1.3% p.a. growth in 2020H1 and 2% p.a. in 2020H2. Its forecast is for a re-bound in exports and business investment into next year.

Implicitly, the institute is rejecting pessimistic scenarios (at least as candidates for the mainstream) for the emerging market economies in general. Furthermore, this is not just to do with China, albeit by far the largest member of this universe with strong knock-on effects to many of the others. AEI Scholar, Desmond Lachman, draws attention in his latest op-ed, "Bolsonaro's Brazil in Public Debt Peril", to one canary in the mine.

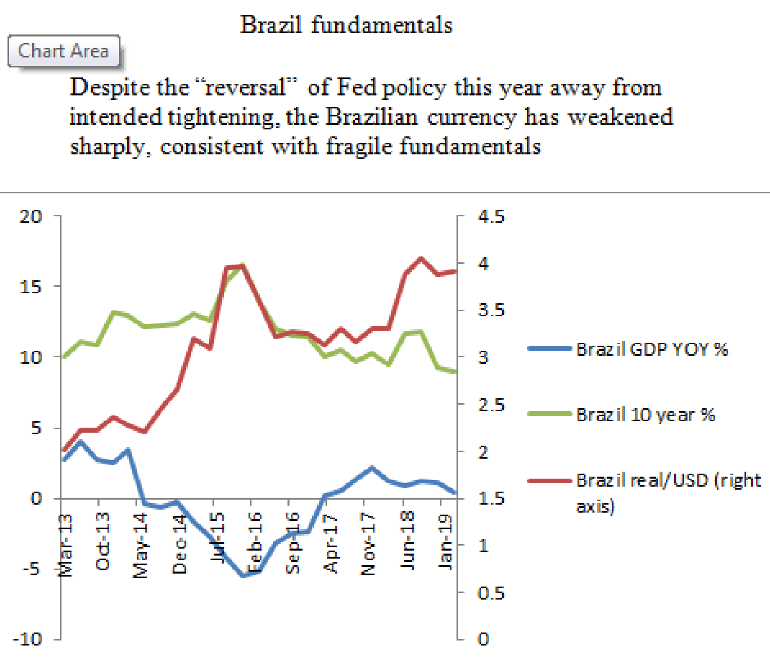
Brazilian canary

Brazil's economic growth is now put at around 1.5% this year, whilst its currency (the real), has fallen 10% back to the weakest level of the last few years. This 7th largest economy in the world (GDP just short of $2trillion) contracted in the first quarter. Despite widespread hopes to the contrary, the new President has not managed to make headway on tackling the severe issues of the public finances – with the deficit now put at 7.5% of GDP (and government debt to GDP at 85%).

Brazil already lost its investment grade status on bond issuance back in 2015 (before Turkey which lost its last investment grade rating in January 2017; and next in line could be Mexico with the accumulating debt problems of Pemex). The declining credit quality of Brazil has long been viewed widely as a potential catalyst to a brutal unwinding of the asset inflation rampant in global US dollar lending to the corporate sector in the

emerging market universe. Note, this lending includes elements of the carry (credit and currency) trades.

Germany's vulnerability to such an outcome does not just turn on its key trade links (concentration of exports to those countries); but there is also the financial contagion possible even back into the domestic real estate and construction bubble.



Data from Bloomberg

Forecasters of global economy over-focus on US

Forecasters of the global economy tend to focus on the US as the dominant force – and this focus is partly explained by the greater availability and timeliness of comprehensive data there than elsewhere.

Often, however, in the history of business cycles globally, the catalytic force forward into recession comes initially from outside the US.

We can think all the way back to the late 1920s, when the German recession starting in autumn 1928 led the descent into the Great Depression.

Germany was then the 2nd largest economy in the world, and Europe was of much higher global economic weight than of today, in terms of size.

We should remind ourselves of the current economic arithmetic.

At market exchange rates, the US accounts for 24% of world GDP, China 16% (likely a substantial overstatement of reality given widespread views that this is overstated), big emerging market economies outside China – India, Brazil, Russia, Indonesia, Mexico – 8.5%). UK, India and France are all about equal size at around $2.6tn or each just under 4% of GDP.

No British canary despite cheap pound

Despite the drama of stalled Brexit and the fall of the May government, the UK is not a plausible catalyst under present circumstances to global economic downturn.

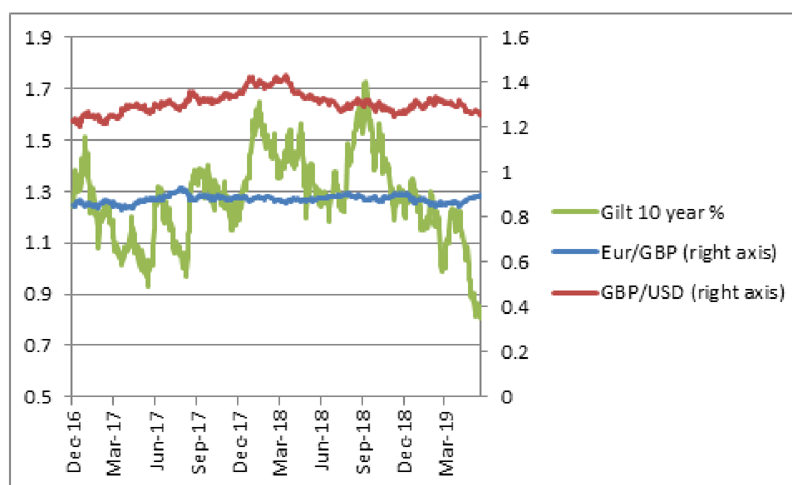
The consensus is for UK economic growth this year of around 1.5%, significantly stronger than Germany, though there is not a rebound seen for next year (unlike for Germany). The starting point for the UK economy is one of high employment and low unemployment (as for Germany). In the UK, the real estate and construction boom of earlier in the cycle have cooled somewhat (an understatement for some London real estate), unlike is the case for Germany.

Historically, the British pound has had some bad news characteristics – vulnerable, especially to weakness in the global financial sector, and related to that the emerging market economies (especially China). This vulnerability can be explained by the importance of the financial sector in the UK economy and more generally of the service sector (whose clients are weighted towards emerging markets in many cases).

The pound's softness of late could be attributable, at least in part, to emerging market slowdown and deteriorating credit ratings related to this. European banking concerns may also have played a role. Also, we have had a significant further fall in UK long-term interest rates in recent weeks, reducing any residual "carry trade" attraction for the UK currency.

British pound fundamentals

GBP weakness has been accompanied by significant falls in UK long-term interest rates – both explained in part by Brexit uncertainties



Data from Bloomberg

The more obvious factor in the pound's weakness has been the strong likelihood of Boris Johnson winning the Conservative party leadership contest and thereby succeeding Theresa May as Prime Minister.

Brexit under PM Johnson

The dominant assumption in the marketplace is that a "no deal Brexit" re-emerges as of a significant likelihood and the resulting economic dislocation would undermine the currency, not least if the Bank of England sees this as grounds for even more aggressive monetary radicalism.

That is the Pavlov conditioning built into present algorithms at least – no deal Brexit means sell Sterling. The reality may turn out to be quite different of course.

Re-inserting a no deal possibility with more vigour than previously into the UK's negotiating strategy may culminate in an outcome which is better for the UK and for the remaining EU than the so-called May Deal. Yes, there could be some transitional, raised uncertainty and even dislocation along the way to that destination, but surely long-run investors can look through such white noise!

How a Johnson Government would negotiate (or more fundamentally how it would devise strategy) is largely unknown at this point.

Sceptics worry about how Mr. Johnson re-buffed an invitation to meet President Trump (when in London) and whether he has really thought through the essential role and pre-eminence of a US deal in Brexit strategy. They also see no evidence that a Johnson Government would take a new turn in monetary policy, away from the aggressive radicalism sponsored first by the Cameron-Osborne team and then the May-Hammond team. At least, there are some positive possibilities here which certainly did not exist when arch-appeaser (some would say "cronyist" of Beijing and Teheran) and (soon ex) Finance Minister Hammond wielded power.

What is the central scenario for UK-EU negotiations into the autumn?

The UK will exit the EU on October 31, 2019, whatever happens.

There can be no deal by then and no new Withdrawal Agreement.

Instead, London may unilaterally offer a standstill on implementing border controls and tariffs for a one-year period, whilst negotiations on a trade deal proceed - undertaking that in the interim, budget contributions will continue to be made into the UK coffers.

That may become the new status quo, even rolled over within the year, with the UK gaining negotiating power from rapid moves forward to a US deal, and deals with India, Brazil, Korea, Australia, Canada, Mexico and Indonesia. A US deal precludes a China deal.

Chancellor Merkel's CDU party could well respond to all this, given the key importance of the German Mittelstand (German medium sized companies) who hold the balance in electoral contests especially vis a vis the pro-business FDP and who export intensively to the UK, by seeking to rein in Brussels and Paris

from their previous obdurate posture on such key issues as Ireland.

Ultimately, the Irish issue can be resolved in a way which allows a UK-EU free deal, only if Paris and Berlin jointly decide that there is no more blank cheque for Dublin.

It is possible that when Berlin eventually agrees to withdraw the candidacy of Bundesbanker Weidmann for the top post at the ECB (in favour of a Finish compromise), it will extract in exchange (from Paris) some commitments to move negotiations forward with the UK.

All of this is highly conjectural.

It is also possible that the CDU get into a coalition with the Euro-left/centrist Greens, making any immediate policy demarche in favour of a UK deal more difficult. Such a coalition may not have long life, but it could be long enough to mean that the transitory no-tariff status of the UK leads on to some type of tariff war (between the UK and remainder of the EU).

There could simultaneously be the emergence of a US-EU tariff war. The settlement of both might involve some joint UK/US diplomacy versus the EU.

The scenarios here are highly dependent on the outcome of the November 2020 US elections.