More money means more problems - at least outside the US (18/07/18)

The Solid Ground has long been concerned about the dramatic decline in broad money growth in the US following the election of President Trump. While most other indicators in the US have been pointing to the growing risk of inflation, the decline in broad money growth to very low levels has always raised the spectre of falling inflation or even deflation. With equity valuations and corporate debt levels so high, such an outcome would be a dangerous combination for US equities. However, in the past few months bank credit growth in the US has finally begun to accelerate and, nine months after the Federal Reserve began destroying high-powered money, the commercial banking system has accelerated the rate at which it is creating it. While good news for US growth and reducing the risk of domestically generated deflation, it poses even further problems for those struggling with the normalisation of US monetary policy.

The Fed has shown every indication that it wishes to tackle the US corporate credit bubble and if anything was holding them back, it would have been the continued lethargy of the domestic banking system and its inability to create money. Destroying high-powered money by shrinking the Fed’s balance sheet always risked worsening the problem as banks reacted to the decrease in their, albeit large, levels of excess liquidity. The Fed has been steaming ahead with its progressively larger balance sheet contraction, even given the collapse in bank credit growth and money supply growth. They took the risk anyway and, at least at this stage, the US banks, after a worrying initial few months, are now providing a very material expansion in their balance sheets. In the last two months the seasonally adjusted bank credit numbers have posted annualised growth of 5.2% - as recently as March this year the annual growth in bank credit was just 2.2%. In May and June the annualised rate of growth in M2 has been 7.0%. So something has changed and at a particularly strange time - as the yield curve flattens.

If banks borrow short and lend long, why would they be accelerating the increase in their loan books as long-term interest rates get increasingly close to short-term interest rates? Sometimes, of course, it is not their choice. Corporates have credit lines and, primarily when credit availability lessens elsewhere or short-term cash flow problems emerge, they call down those credit lines. Recent corporate results suggest healthy cash flows. Data for the commercial paper market, however, shows almost no growth in the size of the market in the first half of this year. So the pick up in bank credit growth, lead by growth in commercial and industrial loans, may reflect a keener pricing of short-term loans by banks relative to the pricing in the commercial paper market. The draw down in lines of credit by corporations, in reaction to a tightening of liquidity in the commercial paper market, is thus one possible explanation of the recent rise in bank credit growth.

It is always difficult to know when a turn in macro data represents a new trend. With the April bank credit data inflated by the acquisitions of credit assets by the banking system, we have the strong data for just May and June indicating that something has changed. Is this enough to indicate that the turn in bank credit and money supply is now compatible with the rising real growth, rising inflation and the rising asset prices that the consensus expects? Well, we are getting there and it will clearly be something that the Fed will be watching closely. Indeed, that close watch on the seeming turn in money and credit may ultimately be the key problem, particularly outside the US.

In recent quarterlies The Solid Ground has focused on the forthcoming credit crises in EMs (4Q 2018) and the breakdown in the global monetary system (2Q 2018). The rise in US interest rates and the contraction in the Fed’s balance sheet
is just one factor unveiling these structural problems but it is an important one. Anything that encourages the Fed to be somewhat more aggressive in its interest rate increases or stick with the programme for balance sheet shrinkage, announced in June last year, simply turns up the pressure on an over-gear global system struggling to create sufficient money to lighten ever rising debt burdens. To the extent that the US succeeds in this, where others fail, then the rise in US rates, through the USD management policies of key EMs, leads increasingly to the likelihood that the next crisis falls outside the USA.

So the rise in US bank lending and money supply growth in the past two months suggests that the risk of domestic deflation in the US is passing - though more data is necessary to establish whether this is clearly a new trend. In China in particular there is increasing evidence that the authorities do not wish to follow the Fed by raising interest rates as the operation of their managed exchange rate should dictate. Further interest rate rises by the Fed will further illustrate the different trajectories in monetary policy between the world’s largest and second largest economies. What must give in such a situation is the exchange rate. The stronger the US data, particularly if such stronger data is not accompanied by a larger US current account deficit with China, whether due to trade sanctions or other reasons, then the more pressure will come upon the RMB. As recent trading patterns in the foreign exchange markets show, this also has profound implications for the Yen.

*The Solid Ground* has long focused upon the difference between monetary policy in Japan and in the other developed nations. The exhaustion of local savings in funding the government has forced the BOJ to step in to monetise government debt while keeping interest rates at zero. This is not QE. It is not QE because it cannot stop. To stop would force interest rates much higher and snuff out any chance of generating the much higher nominal GDP growth essential to reduce the countries’ debt burden. So the BOJ balance sheet extension continues while the ECB’s plateaus and the Fed’s shrinks. The increasing evidence that the BOJ simply cannot stop its balance sheet expansion must ultimately be very negative for the exchange rate. The cautious will wait for this massive differential in narrow money growth to develop into a similar differential in broad money growth - there is no evidence of this yet. The more adventurous investor might like to focus on the way the Yen has started to trade on days when the RMB has been weak. The ability of the Yen to be a so-called safe haven asset, when the RMB is weakening, has clearly been called into question in recent weeks. This may not reflect the obvious divergence between US and Japanese monetary policy, but an increasing likelihood that the exchange rates of North Asia will move lower together. This growing realisation can lead to a ‘king has no clothes moment’ when the market realises that the combination of a continued BOJ balance sheet extension and a weak RMB means that the Yen is very much not a safe haven investment. The move lower in the Yen would thus precede the time when broad money growth accelerates to much higher levels.

So what of that increasingly flat yield curve - could it really be one of those rare false signals when a US recession does not follow? Well, it was in 1998, if the yield gap is measured using three month interest rates and the yield on the ten year Treasury. That was a year when the Asian economic crisis brought a deflationary down draft to the world economy that was imported to the US. It turned out that the US economy sailed through that downdraft, though the imported deflation produced subdued US inflation. The demand for US Treasuries was compounded by the liquidity crisis far from US shores. The result was low US long-term interest rates while US growth continued at a high level. The combination of low long-term US interest rates and robust economic growth sent equity valuations dramatically higher in the late nineties. Once again it is just too early to say whether just such a combination is once more upon us. However, the more the evidence of too much debt and not enough money is outside the US and not inside the US, then the greater the prospect that 2018 looks more like 1998 - and not just if you are a supporter of the French football team.

On balance your analyst continues to urge caution on equities - even in the US. The recent decline in commodity prices in general and copper in particular does not suggest that global growth is accelerating. Declines in both the RMB and the Yen should be the beginning of exchange rate declines that will put downward...
pressure on the price of manufactured goods, thus spreading deflationary pressures more widely. While its possible that the US economy sails on largely undisturbed, as it did in the late nineties, the risk of a major credit crisis spreading from EMs to Europe and then globally remains high. At this stage what is clearer, primarily due to stronger US bank credit and money data, is that the risk of a credit crisis and debt deflation are even more clearly extant outside rather than inside the US. While they may be partying in France like its 1998, it is still too early to extend the exuberance to US equities.
Important Legal and Regulatory Disclosures & Disclaimers

This research is for the use of named recipients only. If you are not the intended recipient, please notify us immediately; please do not copy or disclose its contents to any person or body as this will be unlawful.

Information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but Orlock Advisors Limited does not accept liability for any loss arising from the use hereof or make any representation as to its accuracy or completeness. Any information to which no source has been attributed should be taken as an estimate by Orlock Advisors Limited. This document is not to be relied upon as such or used in substitution for the exercise of independent judgement.

© 2018 Orlock Advisors Limited

Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220