All Lies and Jests – Quantitative Tightening with Chinese Characteristics (03/01/19)

‘When the Federal Reserve System tightened monetary policy in 1928 and U.S. foreign lending fell off, the international monetary and financial system came under stress. With the evaporation of capital flows from the United States to Europe and Latin America, foreign balance of payments deficits widened. Central banks suffering reserve losses were forced to re-trench. The most drastic measures were required of those countries whose balance-of-payments positions were already weak. This combination of events, and not merely the shift in monetary policy in the United States, set the stage for the 1929 downturn. Once this fact is acknowledged, inadequately understood aspects of the Great Depression fall into place.

The reason why, for example, economic activity began to decline in capital-importing nations even before the downturn became evident in the United States is the interplay of U.S. policy with imbalances in the pattern of international settlements compelled other countries to adopt significantly more restrictive monetary policies in 1928, and to alter their policies even more radically than that of the Federal Reserves.’


Welcome to 2019 - a year of tightening monetary policy, through the agency of smaller central bank balance sheets, in the world’s largest and second largest economies. In mid-December your analyst visited clients to discuss the new quarterly report (“What the Hell is Water? Why January 2018 Marks a Generational Peak for US Equity Valuations”) and found that most clients wanted to discuss Quantitative Tightening (QT). The reply of course is, ‘Which QT would you like to discuss?’

That reply was met with general bemusement as it seems that few people have noticed that the PBOC is also contracting the size of its balance sheet. In a period of low inflation and low broad money growth this combined central bank balance sheet contraction is at odds with what were, at least until very recently, expectations for higher real economic growth, higher inflation and higher asset prices. So why is the PBOC contracting its balance sheet? Why are Chinese interest rates rising? Why does the world prefer to believe that China is easing monetary policy when it is tightening? Could the decline in global growth, the slump in global equity prices and China’s QT 2018 share similarities with the QT Eichengreen notes, in the quotation above, as the precursor to the events of 1929?

In November 2018 the PBOC’s assets contracted by 0.94% year on year. They have contracted by 2.0% since August 2018. The key driver of such a contraction occurs as the PBOC enters the foreign exchange market to prevent the exchange rate deviating from its target rate. A contraction in assets means a contraction in liabilities and, if we look at the specific liability that is key in determining domestic liquidity - reserve money - it has contracted by 0.4% year on year and 4.9% from its peak in December 2017. That’s QT.

From the peak in Chinese bank reserves in December 2017, circa USD233bn of RMB liquidity has been removed from the Chinese banking system in the form of a reduction in bank reserves. That compares to a USD469bn decline in the total reserves of the US banking system over the same period. Of course, there is a major difference in the impact of the two QTs. The Fed’s QT is reducing the level of excess reserves in the banking system, whereas the PBOC’s QT is reducing the level of fully
utilised reserves in their banking system. The monetary impact of China’s QT should thus be much more powerful than US QT as it should directly impact the ability of Chinese commercial banks to expand their balance sheets. Recently the contraction in bank reserves has impacted interest rates and since August 2018 three-month SHIBOR rates have risen from 2.79% to a recent high of 3.39%. This apparently is monetary easing!

There is much debate as to the impact that reducing excess reserves in the US, through QT, has on the commercial banking system. The current required level of commercial bank reserves in the US is USD126 while actual total reserves are USD1,775bn! In the 4Q 2018 report The Solid Ground analysed the direct negative impact on equity valuations from QT. However, the monetary impact of the shrinkage in total bank reserves resulting from QT is open to considerable debate. Some would argue that reducing unutilised bank reserves will not act to impair the ability or willingness of banks to lend, or customers to borrow, and thus its monetary impact is limited.

It is not possible to have such a debate when QT acts to reduce fully utilised commercial bank reserves as it is doing in China. A shrinkage in such reserves, assuming the liquidity reserve ratio remains unchanged, would force a contraction in bank lending and thus a reduction in the total amount of bank deposits outstanding. In short, all other things being equal, it would be the type of monetary adjustment that Ben Bernanke often asserted was the key cause of the Great Depression. So why are we all focused on US QT and not on Chinese QT, given the likely much greater potency of Chinese QT? Based on a two-week trip to visit clients, the answer seems to be that nobody has noticed that the PBOC is pursuing QT because investors continue to focus on the words of the PBOC and not its actions. In markets words are not meaningless but on the whole the Sermon on the Mount is a better guide for practical men and women of finance: ‘Ye shall know them by their fruits.’

If monetary policy is about the price and quantity of money, China’s broad money growth is at the lowest level recorded, at least since World War II, and the price of money is rising. This, according to most commentators, represents the easing of Chinese monetary policy signalled by the PBOC since April 2018! There is a gap here between appearance and reality. The essential Shakespearean dichotomy between appearance and reality probably accounts for the enduring relevance for his work today. However, no matter how often we read the immortal bard, it is the lot of the human to struggle to differentiate between what is and what appears to be. ‘A man hears what he wants to hear and disregards the rest,’ are the words of Paul Simon not William Shakespeare but that modern bard understood why we all struggle with the distinction.

In 2018 the ‘China’s easing’ mantra soothed troubled brows - at least until August. Only in the second half of the year did we see the market action that showed the reality behind the alluring ‘China’s easing’ mantra. Chinese interest rates rose, China’s money supply growth slowed, commodity prices declined, Chinese manufacturing was contracting by year-end, global growth expectations declined, and the valuation of global growth assets shifted decidedly lower. That is a reality that does not change just because the PBOC says it is easing when the condition of its external accounts interacts with its exchange rate management policy to tighten monetary policy. That’s another key difference between US QT and Chinese QT - the US can choose to end their QT!

For those who hear what they want to hear then 2019 is about ‘China’s easing’, but for those seeking to comprehend the reality, the tightening of Chinese monetary policy will continue into 2019 unless the exchange rate targeting regime is
abandoned or there is a sudden large improvement in the capital account (see “Can China Reflate The World?” 3Q 2018). The job of the investor is to strain to avoid appearance and invest in reality, for as Hamlet remarked: ‘One may smile and smile and be a villain.’ Gerry Adams has just launched a cookbook and the PBOC continues to proclaim it is easing monetary policy. Apparently, ‘when you’re smiling the whole world smiles with you’.

For those looking for some guidance from history to gauge the impact of Chinese QT we do not have too far to look. The last contraction in PBOC assets was from February 2015 to December of that year and the MSCI World index declined by 19% from its 2015 high to its low in 1Q 2016. The impact on commodity prices was even greater, with the price of crude down 57% and fears that Glencore was insolvent. That, of course, was just Chinese QT. Today markets and economic growth are adjusting to Chinese QT combined with US QT. While the Fed can stop QT, the PBOC can only stop should it see a sudden and major improvement in its external accounts, or should it abandon its exchange rate policy. The former looks unlikely, making the latter very probable. Such a shift in Chinese monetary policy will, as subscribers well know, have as profound an impact on global asset prices as the end of the Bretton-Woods agreement or the end of the Gold Standard.

We began above with a quote from Barry Eichengreen and his interpretation of the cause of the initial market and economic adjustment in the US from October 1929. Eichengreen argues that the US trade surplus, plus the net inflow of capital in the late 1920s, acted to reduce liquidity outside the US and begin the deflation there, given the operation of the form of the gold standard then in place. While that deflation took hold, as early as 1927 in some commodity-producing countries, the US economy continued to expand, and its equity market continued to rise. Indeed, in 1929 US equity valuations reached levels never before recorded even as global growth slowed and deflation outside the US became increasingly evident.

As in 1929, so in 2018. In January the US CAPE reached 33.3X - just higher than the 32.6X reached in September 1929. That surge in US valuations occurred as the MSCI EAFE PE declined from 24.5X in 2016 to just 13.4X today. As in the late 1920s deflation outside the US, in asset prices and commodity prices, if not yet in the price of goods, has had no negative impacts on US asset prices, at least until recently. Does the peak for US ten-year Treasury yields in early November 2018 mark the moment when things changed?

Of course, today we do not have a gold standard. However, many countries, particularly but not exclusively in the emerging markets, continue to manage their exchange rates relative to the US dollar. Since 2012 The Solid Ground has argued that investors should avoid investing in such countries as the US would continue to run small current-account deficits and the ensuing liquidity squeeze in EMs would tip many into default, given their excessively large foreign currency debt burdens.

Today the MSCI EM USD index is below levels recorded in 2012 and, indeed, below its end 2009 level. Commodity prices, as measured by the CRB index, are now also below their end 2009 level. The MSCI EAFE USD index is just 8.8% higher than its end 2009 level. Following some mighty labour in the money mines by our central bankers, not much has been achieved in inflating non-US assets. From a peak in January 2018, the MSCI EAFE USD index has fallen by 21.4%.

Such adjustments to growth expectation and asset prices were evident outside the US in the late 1920s, but the impacts for US growth and US asset prices did not become evident until October 1929. Similarly, today the post-GFC so-called ‘equity bull market’ has actually been a US equity bull market - as it was for much of the 1920s. It was a product of the flawed construction of a monetary system, famously
exposed by JM Keynes even as it was being constructed. Today, with China’s external surplus dwindling, its money supply growth slowing and its economic activity slowing, we have similarly reached the end of another flawed global monetary system. In late 2018, as in late 1929, the consequences of this failure began to dawn for investors after one of the greatest and longest bull markets in US history.

Eichengreen’s compelling case for the trigger that initiated the decline in US equities and economic growth was published in 1992. It took that long for the mechanism that drove the initial crash in equities in 1929 to be understood! Similarly, today, while many arguments are given for the slump in non-US equities, which peaked in real terms in 2014, and the now-evident slump in US equities, few if any focus on the impact small US current account deficits and large government funding requirements are having upon other countries’ balance of payments, their monetary policy and their economic growth rates.

There has always been a possibility that this combination would produce the imported deflation, low domestic inflation and lower US bond yields that could, when combined with high domestic economic growth, lead to a melt-up in US equity prices. While still possible, it is becoming ever clearer that the melt-up has already probably occurred as ex US equity valuations have been declining since 2014. In particular, the difference between the appearance of Chinese monetary policy and its reality brings the timing of a move to a free float by the Chinese authorities ever closer, with initially major deflationary consequences in the US and across the world. Perhaps then the recent decline in global equities and commodity prices will be recognised for what it is: the initial deflation forced by a flawed monetary system that ends with devaluations, widespread deflation and then financial repression (see The Solid Ground 3Q 2016: “Capital Management in an Age of Repression: A Handbook”).

The professional investor, like the boxer, gets paid to fight. The professional, boxer and investor, stands up and sits down every time a bell rings. While every boxer knows that almost every fight is won by the man on the front foot, every boxer also knows that a time can also come when the best strategy is to remain defensive, soak up the punches and await your opportunities. For the investor that time has come again and it might be a long wait until we reach the equivalent of Round 8 of ‘the Rumble in the Jungle’. In the meantime, keep your chin down, and your guard up, and you will get cut but you probably won’t get laid down.

‘In the clearing stands a boxer
And a fighter by his trade
And he carries the reminders
Of ev’ry glove that laid him down
Or cut him till he cried out
In his anger and his shame,
"I am leaving, I am leaving"
But the fighter still remains...’

Paul Simon, The Boxer, 1970
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