Can Dumb and Dumber save the day? (09/04/19)

The US savings rate is rising and China’s foreign exchange reserves are not. For some these will seem to be irrelevant facts in a world where the focus is on the seemingly more urgent issue of growth. For this analyst the rise in the US savings rate and the only moderate growth in China’s foreign reserves are much more important. Their importance resides in the fact that they point to the growing impotency of monetary policy at a time of weak growth.

Investors have, like Pavlov’s dogs, begun salivating as they see the global growth slowdown as the ringing of the bell that signals monetary rewards for asset owners. This bell has been rung many times since 2009 and the monetary meat that followed has provided a sumptuous feast - at least for those who own assets. Such meat has been in ample supply now for over a decade. But now it is being delivered when the condition of China’s external accounts is dictating tighter, not easier monetary policy to the world’s second largest economy, and when the citizens of the US have decided to save more. These are profound changes which will mean, given that the world’s debt-to-GDP ratio has risen steadily in the past decade, that the next time the central bankers act, it may be merely the ringing of the bell and disappointment that follows.

As subscribers will know, The Solid Ground has been focusing on the profound impact of the supply and demand for US Treasuries since 1Q 2018. After a quarter of a century when the ‘crowding-out’ argument, predicated on the assumption that the need for government funding crowds out private sector funding, was wrong, the time has come to focus on why it is now right. This sudden change occurs primarily because foreign central banks have stopped buying US Treasuries, or at least that is what the monthly Treasury International Capital data tells us.

With the Fed no longer a buyer of Treasuries, the saver is finally the only key buyer for US government debt at a time when the Trump tax cuts have sent the annual US budget deficit to US$903bn in the 2019/20 fiscal year. To fund this degree of Treasury issuance the saver has to either sell another savings asset or save more. The recent jump in the US savings rate indicates that at even these low levels of nominal interest rates, the US saver is prepared to save more, thus mopping up this massive supply of Treasuries at higher prices and lower yields. As recently as November 2018 the US savings rate was 6.3% before jumping suddenly to 7.7% in December. One month’s data is probably best ignored, but in January the savings rate was 7.5% - this could get to be a habit!

A rising savings rate indicates that the rate of personal consumption expenditure will slow. Perhaps this is one reason why the Fed is engaged in the greatest turnaround in US monetary policy since Paul Volcker abandoned money supply targeting in the summer of 1982. Volcker had to abandon that monetary target because it had bankrupted Mexico, and then other emerging markets, and in the process created solvency issues for what were then called the US money centre banks. Has this Fed been forced into its volte face because of a sudden move by the US populace to save rather than spend? Perhaps it is too early to come to that conclusion but, if not that, then what is it that has so profoundly changed the Fed’s outlook?

Most market commentators have come to the conclusion that the Fed is capitulating to market and political pressure rather than any economic pressure. The Fed, it is argued, was frightened by the market reaction in 4Q 2018 and thus the Greenspan put, replaced by the Bernanke put, replaced by the Yellen put has now been replaced by the Powell put. After all Timothy Geithner made it clear in his memoir that the ‘role of the Federal Reserve is to spread foam on the runway.’ If that is correct, then this Fed can be easily stimulated into spreading such foam by market actions.

Others argue that the Fed is capitulating to political pressure. The words of the President, demanding easier US monetary policy, are one thing, but his plans to stack the Fed with malleable monetary doves is a more direct threat. As well as that political threat is another from a wing of the Democratic Party that would de facto end the independence of the Fed through implementing Modern Monetary Theory. Either way the markets don’t much care why the Fed has done its volte face as the ‘fix is in’; the monetary
meat can be expected and asset owners will once again be engorged. But what if the Fed has changed its mind for a very different reason? What if it is for the same reason that Volcker had to change tack in 1982?

The 1Q boom in global equity prices contemplates little if any negatives for corporate earnings from global economic developments. The Fed has been gamed by the markets or pressured by politicians, so what we get is a lower discount rate and a steady growth rate in corporate earnings/dividends. If, in fact, the Fed’s massive about-turn is driven by a fear of an impending economic development that imperils financial stability, as it did in 1982, then equity investors are wrong to believe that the Fed has once again fallen for the market-delivered sucker punch that has benefited asset owners for so many years.

The Solid Ground in this newsletter and in various quarterly reports has focused on the ticking liquidity time-bomb amongst Northern European financial institutions. That probable credit crisis has been ticking for many years as re-investment rates fell below guaranteed payout rates for life insurance companies and pension funds many years ago. The same problem, interest rates that are too low, has been destroying the commercial banking model and undermining the ability of commercial banks to expand their balance sheets and create money in the process.

Putting together two weak banks with limited ability to cut costs seems to be the German solution to that problem, but it is not clear that the unions and politicians will let them cut costs; nor does it change the flat yield curve which deprives banks of the opportunity to borrow short and lend long. With the regulator and Moody’s concerned that 2019 is the year when bankruptcy comes to German life insurance institutions, is it this that the Fed sees as the credit issue that requires a monetary volte face? Are the monthly discussions at Basel between central bankers more focused on the destructive forces within the Eurozone than the 4Q market shenanigans or the POTUS twitter account? Perhaps, but your analyst believes the real and present danger to global financial stability is evident in something which is itself very stable - Chinese foreign exchange reserves.

In the 3Q 2018 report for subscribers “Can China Reflate The World?”, The Solid Ground looked at how China might produce a growth acceleration while maintaining a stable exchange rate. The key to such a powerful combination, a combination leading towards higher global growth and inflation, was a major improvement in China’s external accounts. With the current account likely to deteriorate further in any boost to Chinese domestic growth, the key to both higher growth and a stable exchange rate would thus be a major improvement in the country’s capital account. Many are very hopeful that just such an improvement is underway. After all, both the MSCI equity indices and the Bloomberg Barclays Bond indices are about to see increased weightings and thus both Dumb and Dumber will be forcing capital into China.

Of course, that might prove to be correct, but a capital account is about much more than that dumb capital that ditches any fiduciary duty towards savers in response to changes in available market capitalisation-based indices. It is also about other forms of capital which are driven by entirely different factors. We have known for many years that Chinese citizens are desperate to get their money out of China, something at which they have proved quite adept despite Communist Party diktats to the contrary. We know that the pressure to get money out of China is growing as President Xi’s rule by man, replacing a nascent rule by law, continues to threaten property rights.

However, there is now a new threat to China’s capital account. Foreign direct investors, whose lack of underlying liquidity forces them to pay great heed to property rights, are now also changing their minds about investing in China. Ask such investors about their increasing reticence to invest and they will not just mention the decline in the rule of law and rise in rule of man, but an increasing difficulty in transferring funds from RMB into foreign currency. While such investors are used to the normal illiquidity associated with owning real assets, this new state-imposed illiquidity, even for cash, strikes them as a worrying sign for all future investment in China. So is there evidence that this reticence is impacting China’s capital account?
China’s foreign exchange reserves will always alter from month to month based entirely upon changing exchange rates. As the country holds a wide range of currencies in its reserve balances but reports its reserves in USD, exchange rate movements produce a change in USD balances whether or not the PBOC has been intervening in the foreign exchange market. China’s foreign exchange reserves for March show only a moderate rise. This indicates that China remains in a balance of payments that is, at best, ‘in balance’. It indicates that the accelerated portfolio in-flows are largely being offset by either a marked deterioration in the current account or a deterioration in other elements of the capital account.

China is desperate to attract and retain capital. It has opened up its equity and bond markets to portfolio investors and has been trying for some years to boost the RMB as a reserve asset. The country has also liberalised its rules on foreign ownership of domestic financial institutions. These policies are not working or, perhaps to be safe, we can say that they are not yet working as foreign reserves are below their highs of 2018 and well below their all time high of 2014.

The March sideways movement in China’s foreign exchange reserves, given the PBOC’s commitment to managing the RMB exchange rate relative to a basket of currencies, indicates that the capital account of the country continues to be in deficit, given that the current account continues to be in surplus. This results in no growth in the PBOC balance sheet and ultimately no easing in monetary policy. PBOC liabilities in February are back to levels first seen in early 2017 and less than 2% higher than they were in early 2015. This inability to expand the PBOC balance sheet reflects the lack of growth in foreign reserves and translates, through commercial bank balance sheet growth, to the lowest level of M2 growth ever recorded in China’s post war history, at just +8.0% in February. This is the much heralded reflation which the market is rushing to reward through higher equity prices.

Another month has now gone by without Dumb and Dumber turning China’s capital account materially positive and providing the monetary relief needed by a country with one of the fastest rises in debt-to-GDP ratios ever recorded. The capital account balance could deteriorate quickly. The Solid Ground has for many months drawn investors attention to the October 4th 2018 speech of Vice President Mike Pence which could well augur a Cold War with China in which the staunching of capital in-flow to China would be seen as a key Cold War weapon. Investors who expect China to reflate with a stable exchange rate had better hope that something changes and changes soon.

Perhaps Dumb and Dumber can come to China’s rescue but there is increasing evidence, with each month of stability in China’s foreign reserves, that the smart capital is going the other way. This is not a combination for higher global equity prices and suggests that lower global risk-free rates reflect lower growth and inflation expectations and not the nirvana for assets of lower risk-free rates and sustained profit growth.

The US savings rate is rising and China’s foreign exchange reserves are not. The US is saving more and, should this continue, will be spending less. Meanwhile, after a quarter of a century of large external surpluses, China’s external accounts are in balance. That period in history when the PBOC funded the US government, while creating excessive growth in the supply of RMB, is over. Now savers, predominantly US savers based upon monthly TIC data for foreign ownerships of Treasuries which shows limited foreign purchases of Treasuries, have to fund the US government and the early evidence, albeit over just the last two months, is that they will do so by saving more. This is not a combination for higher growth in either the US or China.

While travelling your analyst finally got a chance to read “Keeping At It” by Paul Volcker. This book is a must-read for all investors as Volcker’s role in the post-war global monetary architecture is dealt with in detail. In particular he deals with that period of the late 1960s, when he was at the US Treasury, when many began to speculate that the US could not continue with its commitment to redeem USD for gold. Of course, in public the commitment was consistently vouchedsafe by the administration. However, what Volcker’s book reveals is that privately those involved with the Breton Woods system, even US policymakers, knew that the unsustainable could not be sustained. Indeed, they probably knew this from as early as 1967, although the system itself was not to break until 1972.
So, what if Jay Powell looks at the cornerstone of the global monetary system since 1994, the link between the RMB and the USD, and similarly sees that this too cannot be sustained. The evidence that it cannot be sustained being the absence of a Chinese external surplus, the lack of PBOC buying of US Treasuries and the record low broad money growth in China. Of course, something might turn up as policy-makers hoped in the late 1960s. If so, they had better turn up soon and a lot rests on the necessity of the dumb and dumber capital flows more than offsetting China’s capital exodus and its worsening current account. Now if that is what the Fed is worried about, not the markets or POTUS or MMT, it is probably aware that that it needs to stand ready a lot of fire-trucks with a lot of foam for the runway.
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