MONETARY SCENARIOS

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Global Monetary Viewpoint

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EXECUTIVE SUMMARY:

Central banks, led by the Fed, have been "successful" this year, at generating fantastic new speculative froth especially in credit and equity markets.

It is not at all obvious that this grown froth will help smother present recessionary forces, in the global economy. If these win through, then asset markets for equity and credit will surely not sustain giddy heights.

Legarde at one end, and Powell at the other of the euro-dollar axis, means that powerful monetary inflation will continue, camouflaged still by digitalization. But both these central bank chiefs will face ultimately a hostile political environment.

In Europe, the German Right is likely to gain new effectiveness in tackling the ECB. In the US, Powell's past history as private equity baron will weigh against him, in the next crash where P/E bust will surely feature big.

Backlash alert as French politico and private equity baron share Europe-US money helm

Christine Legarde, as French politico ruling in Frankfurt, will inflame the German right, and should keep US defences against foreign currency manipulation on alert.

Jerome Powell, as ex-private equity baron at the head of the Fed, and more generally the prominent "P/E (private equity) folk" in top tiers of this Administration's economics and business team, may join to keep this alert dull for some time. Any attack on European negative rates could bring global asset price deflation shock. This fellow-travelling of top US economic officials with the ECB (not expressing opposition to negative rates in Europe as a tool of currency manipulation out of realization that these suit their purpose of keeping the asset inflation train on the rails) might not last for long especially in the context of US domestic political pressures (in the run-up to 2020 elections).

Those of us, with a keen sense of foreboding, might predict these political reactions in Germany and the US will be eventually so powerful as to suggest that this ex-French finance minister is doomed to be the last president of the ECB.

Pressure from the German right and eventually Washington could make impossible the continued pursuance of the negative rate cheap euro policy, on which the status quo of European monetary union depends.

US and EUR money chiefs are lawyers, but so what

Some critics of the Legarde nomination (by the EU heads of state at their recent summit) as ECB chair point to her lack of economic expertise.

Power-wise voices respond that she and the Fed chief are both lawyers, so what is the problem?

In fact, the common feature of both central bank chiefs having been lawyers earlier in their career is largely an irrelevance to the US-European monetary future. Much more important, in an overall appraisal of their future performance (including inter-action) at the helm of the US and European central banks, is their past distinctive careers, as French finance minister and private equity baron respectively.

The role of private equity in US (including Fed) policy

As regards the Fed side of the US-European monetary story, we should note that the influence of private equity (some would say its crony-capitalist connections) in Washington has grown in

this cycle with the fantastic boom ("bubble") in that industry. (The total of P/E funds globally put is now estimated in excess of US$3 trillion).

Evidence includes the fact that the present Treasury Secretary, Steven Mnuchin, Fed Chief, Jerome Powell, and the head business adviser to the Administration, Stephen Schwarzman, all are present or past private equity barons. This portends a political explosion, when the eventual bust occurs.

Biases and flaws in economic advice to new ECB chief

A non-economist, whether at the head of the Fed or the ECB or any other central bank, leans on economists in formulating their policy decisions.

At the Fed, the chief economist in this role is Professor Clarida, a staunch neo-Keynesian economist (some would say Bernanke-ite); Treasury Secretary Mnuchin is widely assumed to have played a key role in his nomination, just as for Jerome Powell.

At the ECB, the chief economist, Philip Lane, came into office as a result of another notorious EU appointment compromise; no one now remembers the details of the particular "horse-deal", but suffice it to say that this Irish economist (head of Dublin central bank) was the only candidate on the list. No one would fault Christine Legarde for forming a broader cabinet of economic advisers. Perhaps, she will bring in economic expertise from the French finance ministry (as did the last French head, Claude Trichet).

The set of policy recommendations which are formulated under Chief Legarde by her selected economics staff and Mr. Lane will not be different in concept from under Sig. Draghi; firmly held neo-Keynesian reviews, strong adherence to 2 per cent inflation targeting, and continuing monetary radicalism coupled with backdoor lending operations to weak banks and sovereigns, will remain the order of the day.

As IMF Chief, Legarde was an enthusiast and "believer" in all of this. Intriguing will be how far French nationalism replaces Italian nationalism in the ultimate policy making decisions, in so far as the Chief influences these.

Legarde does not share Draghi's academic camouflage

Mme. Legarde will be potentially an inflammatory figure for the German Right.

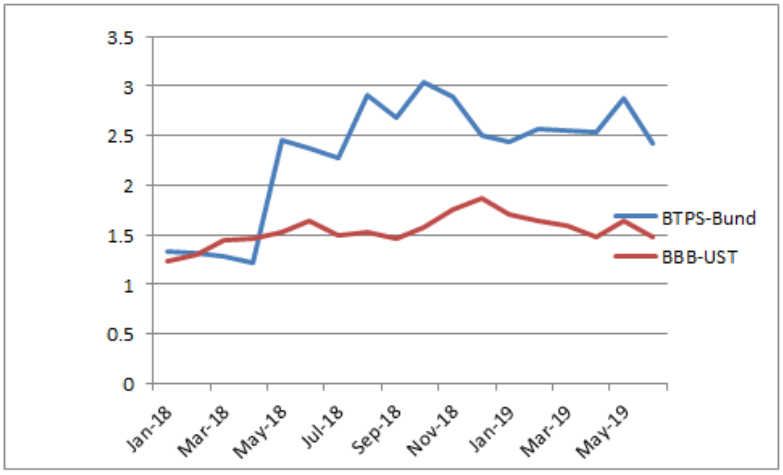
Yes, there have been those in the AfD and in the right wing of the CDU who raised popular anger against the ways in which ordinary Germany citizens are being taxed by ECB policies to pay for Italy (including imposition of negative rates on their savings).

Draghi himself, however, was never an easy figure against which to unite anger, given his academic pedigree – meaning he shared platforms with the great neo-Keynesian monetary thinkers including Stanley Fischer (his thesis supervisor) and Ben Bernanke.

In the US, within the corridors of the Fed and even Treasury, all this helped. Sig. Draghi enjoyed a special status of highly regarded academician and central banker, insulating the ECB in an important degree from charges of deliberate currency manipulation.

After all, in following the 2 per cent inflation target, Mario Draghi can claim to have been in the same academic and central banking tradition as the best and greatest of Fed officials during the present century.

Italy BTPs: the fall of 10-year Italian government bond yields below 2% has gone along with fairly steady spread vs Bund yields and BBB corporate bond yields in US



Data source: Bloomberg

All this now changes. An ex-French Finance Minister and after that IMF Chief who ostensibly strove for the best interests (according to the French elites) for France and Europe has none of Draghi's camouflage. She is an easy target for the anti-European elitists and others (on the German Right), who see their country as having been taken advantage of by France in particular.

Merkel's centrist strategy for CDU now backfires

At a time when Chancellor Merkel's strategy of shifting towards the Left to gain votes from the centre and even centre left is under review (and attack) from within her CDU (not least because it failed to delivered the promised rebound of support in the European elections), the nomination of Christin Legarde could be a game changer in German politics.

For a start, the Social Democrats (SPD), angry at Merkel's deal with Paris which puts her one-time protégé (and still defence minister) at the head of the EU Commission (rather than a Danish Social Democrat), might view this as the final straw. They have already suffered a haemorrhage of support in the European elections – a bad performance likely to be repeated in regional polls this autumn – and are widely expected to bolt from the Grand Coalition.

Meanwhile, the right of the CDU could gather forces to elect

their preferred Chancellor Candidate for general elections (as soon as the end of the year), in the expectation of winning back support from the AfD, which undoubtedly would be seeking to gain advantage from Merkel's acquiescence in Legarde as the next ECB Chief.

The Bavarian sister party (CSU) to the CDU is smarting due to Merkel's failure to get their candidate nominated as EU commission president, and they would certainly join with the right of the CDU in these strategic manoeuvres.

In summary, the Legarde appointment could be the catalyst to an important swing to the Right in Germany which ultimately would undermine European Monetary Union in its present form.

Legarde should put US anti-manipulation forces on high alert

In Washington, Mme Legarde helps politicize the currency manipulation charge, deflected in some degree under the reign of Sig. Draghi. When the Trump Administration seriously takes up this charge, (something the private equity barons are in no hurry to do as explained below) any pleading from Mme Legarde that the ECB is independent of government and does not seek to influence exchange rates, will be evidently empty of content.

In turning to Berlin, for cover against US attacks ostensibly about currency manipulation, Chief Legarde may not find as reliable an ally as did Sig. Draghi (who had formed a special relationship, some would say axis, with Chancellor Merkel). The next government in Berlin (if dominated by a Chancellor from the right of the CDU – by means no sure thing!) may be sympathetic to the view that continued negative interest rates are a form of currency manipulation, given their unpopularity with German savers.

Even big German exporters may come to see that a higher euro is essential to avoiding a trade war with the US.

Yes, Legarde could repeat the mantra of doing whatever it takes to save the euro, but when she repeats the lines, she may find that support from Berlin is less whole-hearted and effective than was the case for Draghi.

How long can Legarde count on US PE "allies" in Washington?

Mme. Legarde can hope for the continuation in office of Treasury Secretary Mnuchin, who has expressed no interest in getting Europe or Japan to abandon negative interest rates.

As highlighted here, like other key figures in the Trump Administration, he has roots in the private equity industry, which now holds political sway in some way even greater than the legendary bankers on Wall Street, who in early eras and episodes exerted power.

Whatever their protestations, the private equity "folks" like monetary inflation, especially under present circumstances where it does not show up in strongly rising consumer prices. Besides, private equity is global. One only has to look at the geographic span of the assets under management, at the big private equity

groups in the US, to realize that the shock of negative rate abandonment in Europe or Japan could inflict profound loss.

US private equity on the side of euro- and China-elites

There is nothing new about the power of private equity in this Administration, but its overall weight has surely increased. For example, the head of the business advisory group to the President, the chief of the biggest private equity firm, Blackstone, is also a great "friend of Beijing", some even describing him as the whisperer for China into the ear of the President.

The identification of this firm with the interests of the Chinese communist party bosses stems both from history (Beijing used to have almost 10 per cent of Blackstone share capital from when it made its public issue of equities just prior to the 2007/8 bust) and strong business connections (especially in the recent boom of Chinese enterprises close to the communist elites buying in the US).

Beijing has had evident issues with taking Trump Administration threats 100 per cent seriously, when the private equity barons in the Administration were indicating alternative messages.

How can we explain the influence of the private equity industry within the Trump Administration (an influence which extended of course to no action against this industry's tax privileges especially regarding so-called carried interest). There are some obvious points.

How did P/E reach its pinnacle of power in this Administration?

The growing immersion of the private equity industry in the real estate sector brought it into the personal business domain of the President.

Treasury Secretary Mnuchin in his key role of finding a successor to Chief Yellen at the Fed may have been drawn to a fellow private equity one-time insider (or baron).

Then there are the political donations which have featured in the post-election linkages between Blackstone and President Trump.

None of this comes out of a vacuum.

Private equity and its revolving door with Washington

The private equity industry's rise has been intimately connected with political influence. Think of the number of Cabinet officials including Obama's Treasury Secretary who found post-office jobs at the top of private equity firms.

What is the value of these folks to the industry?

First, there is the respectability gained (crucial perhaps to winning huge inflows from state pension schemes) and influence gained across hugely important privatized services for public sector operations (including, notoriously, prisons) where private equity features largely.

The plethora of regulations which were enacted, following the

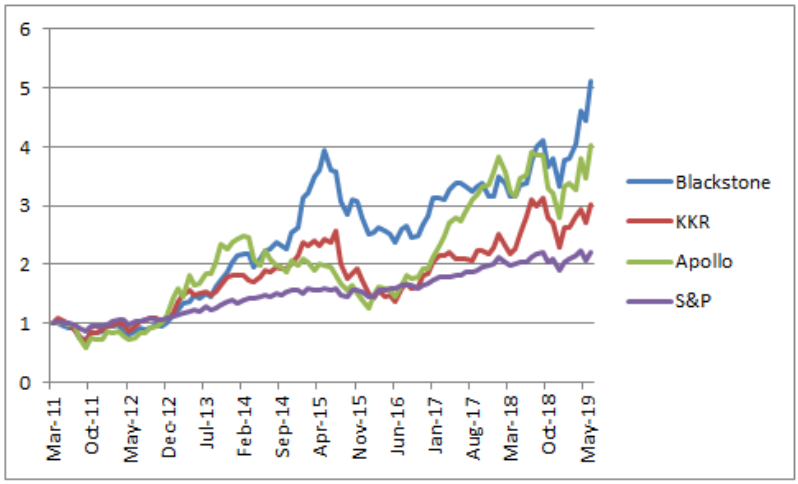
2008 crash and great recession, largely exempted private equity. The regulations provided new scope for this industry to gain large footholds in credit sectors which were previously the arena for banks – especially consumer credit (including borderline predatory lending) and direct lending to small and medium-size businesses.

Private equity loves monetary inflation

Transcending all of this has been the inflationary monetary policies conducted by the Federal Reserve (and its key followers around the globe). As investors have frantically searched for yield in the context of income famine, they have been drawn to high-yield and illiquid debt strategies – just the type of securities which private equity groups have issued by the companies which they buy and leverage up.

The combination of over-priced debt securities and extrapolative, expectations of continued rapid appreciation of equity prices (their core activity) has drawn in growing fans in line with the positive feedback loop - ideas of the behavioural finance theorists.

Private equity: phenomenal rise in shareprices in leading private equity groups is evidence of bubble conditions



Data source: Bloomberg

Alongside all this, the private equity barons have done a great job of spinning narratives about the superior efficiency of their organization-ability (to publicly managed companies), spared the quarterly reporting burdens of the latter.

There are willing takers of this narrative amidst the institutional investor community who are no fans of daily Mark-to-market accounting. The latter overlook evidence that private equity, in general, has done no better than the same funds invested in small caps and leveraged up to a similar extent, usually in fact worse.

Furthermore. these institutional investors in private equity have over-looked serious issues of accountability and even borderline irregularities – and how this has given to high fee practices. For example, in addition to weighty management costs

charged by the inside partners, there are payments to consultants who are in fact insiders; and the charging of management fees on huge amounts of cash waiting to be invested.

Private equity opens new channels of speculation

Private equity today is not just funds participating in the core activity of taking over companies and managing them for eventual re-sale (in the public market). It also spawns nearby activities – credit funds (including private equity) and real estate funds in particular where institutional and large private clients can participate directly often on a specially tailored basis (which particularly for real estate includes large amounts of leverage). These funds are entirely global in scale (Europe, Asia and America).

By opening up new channels of highly leveraged speculation in hot asset markets, we should regard private equity in this cycle as an important catalytic force in the asset inflation process, subservient of course, to the over-riding force of monetary inflation.

Private equity barons become media stars

In looking at the tremendous and ostentatious wealth generated for the private equity barons during the present cycle and the fantastic growth of the industry, the absolute focus should be on the inflationary monetary environment which empowered this. Evidently, the barons do not talk about the Fed enablers (and ultimately the buck stops at the Presidents who nominated these from Greenspan and Bernanke onwards) even if they most likely admit it to themselves in some cases.

Rather, the talk of the barons when they make their media appearances is of the innate strength of US capitalism, the strong economy, and the tremendous management and wider capitalist skills of the founders. For good reason we do not hear of the fiascos – including the role of private equity in leveraging up the retail sector in the last boom (2003-7) just when it was about to face an onslaught from online competition.

One of the biggest barons of all from the Carlyle Group has huge scope to promote narrative telling; in his gentle conversations with the great business leaders (some would say including the great monopoly capitalists) on the largest financial TV media – where his program has replaced the time taken by a tragically discredited (by scandal) host in interviewing personalities from the world of arts and science.

How is the wonder world of private equity, now in greater fantasy land than ever, likely to unwind?

In 2007/8 forecasts of private equity crash proved wide of the mark: next time likely not.

Private equity – the end of the boom

The story is likely to be led by a decline in collateral (asset values) which will lead to a jump in loan to asset values (at market prices). A powerful fact here almost certainly would be a down

turn in the business cycle, globally and including the US. Narratives will fade as extrapolative expectations dissipate.

As widespread credulity in the superior returns and ability of private equity diminishes, the bolt for the exit can start – exposing the inconvenient fact of illiquidity (ignored during the golden years). Wrongdoing exposed can add to the downward journey.

A big part of the bust story would likely include a rush for the exit from the real estate and credit funds built up alongside the core business – perhaps in response to a down draft in key real estate sectors which did not originate in the private equity industry itself. The magic of private equity is no more.

In fact, the private equity industry funds have been big followers in their real estate investments of popular narratives in speculation during this cycle – whether innovation cities, apartments to rent in city centres, logistic warehouses (for Amazon); the narratives have fed on each other. We should not forget, in this general story of boom, the knock-on boom for the industry of lawyers.

Political consequences of ultimate private equity bust

How would the bust of the private equity boom feed back to the wider monetary and political arena?

One can imagine the anger of the ultimate households whose pension expectations based on private equity are dashed and indeed reversed. It is harder to be precise about the political backlash. Yes, the Democrats would surely go for the private equity barons – even though previous Democrat administrations have done their own deals with these in various roles.

The present Fed Chair could suffer serious reputational damage and become a lame duck, even without a coup de grace from the President.

There are no grounds for anticipating that the blame will land loudly on the desk of monetary policy, in principle – especially the pursuing of radical monetary policy towards reaching a 2 per cent inflation target. Rather, we should expect a plethora of special stories of blame and new regulations.

Generally, in terms of the economic and market downturn, the dynamic forces unleashed by the bust of the private equity party would be a large part of the total story, with important international differences.

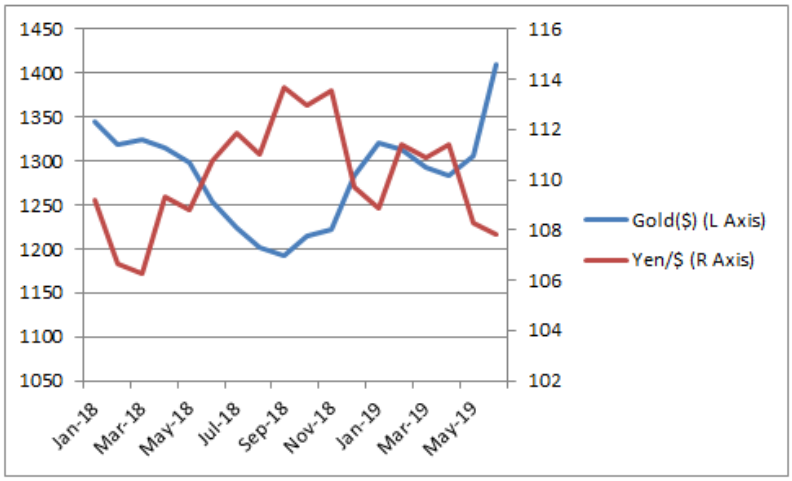
A postscript on Yen, gold, and private equity

For example, in Japan unlike other large advanced economies the banks have themselves become large holders of private equity originated credit paper, often of high underlying risks. Accordingly, the separation between credit loss in the shadow banking system and in the banks would be far less clear cut in Japan than elsewhere.

Continued strong positive correlation, between changes in the price of gold and the yen, suggests that Japanese potential financial fragility is not yet a significant market factor. But no one

should count on that continuing.

Gold yen Despite growing financial vunlneabilities in Japan, gold and yen continue to move together.
Meanwhile, rhetoric from BoJ about scope for further monetary easing is largely ignored in marketplace



Data source: Bloomberg