MONETARY SCENARIOS

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Global Monetary Viewpoint

Author:
Dr Brendan Brown

EXECUTIVE SUMMARY:
Investors have become accustomed to the periodic stampede of traders in markets where the narrative of "China-US trade war" has gone viral. The "truce" has ignited risk-on, and also fuelled speculation that the Fed will go easy on rate cuts.

This may well be the last such stampede – either in risk-on or risk-off direction – under the influence of China trade news, before Election Day. Investors concerned about US monetary inflation, for example, have less to fear now about their protective trades being upset by a stampede.

Analysis here suggests that gold should gain, and the euro lose from a combination of economic, political and geo-political factors, between now and Election Day.

Whoever wins, the White House disenchantment with the tech sector is set to deepen.

Euro crash, gold revaluation and tech hangover, whatever Election Day outcome

There is virtually no chance that on US Election Day a ray of sun will appear, in an otherwise bleak monetary landscape.

No serious presidential candidate will be campaigning for sound money, and in Congress this issue is virtually dead (except for Senators Toomey, Cruz, and perhaps Rubio).

The Republican incumbent in the White House favours a weak dollar. He hesitates, however, to bring this about.

The two means of effecting devaluation - demanding that Europe and Japan abandon negative rate policies or firing Chief Powell - would upset the stock market and the US Treasury market. Powell is no sound money advocate, but the tumult at the top of the US central bank would be negative for the US currency.

President Trump's would-be Democrat challengers also want a weak or soft dollar (Senator Warren is most emphatic about this, but with no plan).

For all of these, a reform of the US monetary system in a sound direction is neither desirable nor remotely a prospect.

US monetary risks stacked in inflationary direction

The US monetary risk scenarios for the long-run are all stacked in one direction – policy will become more inflationary than today, perhaps much more so.

The next Administration, whether Republican or Democrat, will seek to devalue the dollar when the next recession hits, if it is not already under way. They may well not achieve this aim vis-à-vis other fiat monies, where monetary experimentation could continue to be more radical, but only against gold.

Into the next economic expansion, any likely weakening of non-monetary disinflation (as the digitalization revolution ages) would translate into higher observed goods and services inflation for any underlying pace of monetary inflation.

Furthermore, massive fiscal deficits mean that US central bankers are well-disposed to generating higher taxation for the Federal government in the forms of monetary repression tax or actual inflation tax. Ultimately, they are answerable to Congress and nominated or re-nominated by the President. They try to hide this inclination by embracing arguments for any downward revision in estimates of r* (the natural or neutral interest rate).

Significant evidence of the inflation bias (in the present US monetary framework) comes from the recent Fed decision, effectively to resume QE (in the form of T-bill purchases rather than long-term bonds), in response to turbulence in the money market.

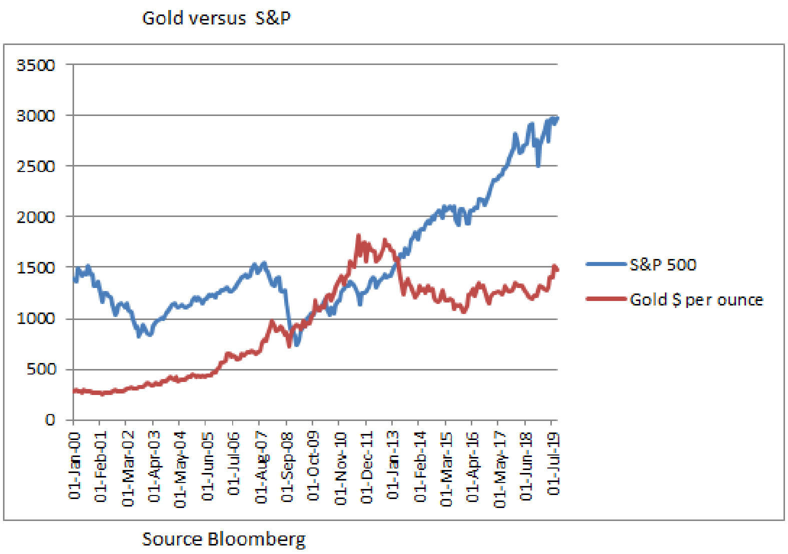
Those spikes in money interest rates, in recent weeks, were not symptomatic of money supply shortage in any orthodox sense. Rather, they were evidence of the dysfunctionality of the present bizarre and convoluted monetary control system devised originally by Chief Bernanke.

In this, the Fed seeks to peg short term market rates by varying the rate it pays on excess reserves – rather than as in the past by varying the supply of reserves, all of which were non-interest-bearing. Volatility in money rates is the norm under classical monetary regimes – whether gold-based or monetarist.

The obvious step for any central banker, not bent on continual experimentation, would have been to revert to the pre-2008 system of monetary control, where the monetary base pays no interest. There is indeed some cross-aisle support for this in Congress, where some Democrats object to the paying out of interest to the bankers, whilst a few Republicans are convinced that the Bernanke-ite control system is unsound.

Gold shines in corrupted monetary environment

No doubt, this vanishing of sound money from any significant place in the US political system (and of course in Europe and Japan) is a key factor in favour of gold as a weighty component of investment portfolios. Fiat money, of which the US dollar is hegemon, has entered a new stage of degradation. This is a long-run consideration, and does not mean that gold is on a one-way path upwards, week by week! In fact, this week risk is on, and gold is down, largely in response it seems to the China-US "truce".



Investors in gold realize that all carefully considered strategies (based on long-run perceptions) can suffer whipsaw, at least temporarily, as a stampede of traders who have been infected by the China-US trade war narrative bug, cross the path.

A presidential tweet, suggesting the trade war is on, creates a wave of risk-off, and the converse is true. Gold can be a heavy loser, at least within the short-run from any cooling of the so-called China-US trade war, even though this is not a fundamental driver of global economic activity or inflation.

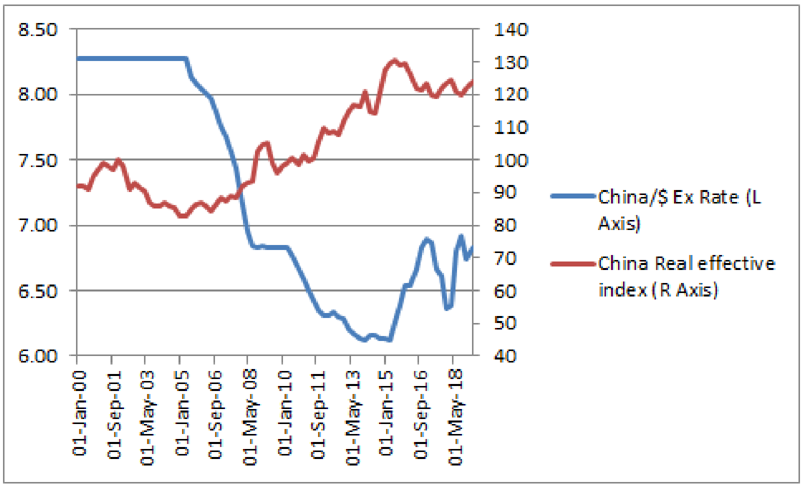
Viral China-US trade war scare now dying

The good news, for investors focussing on fundamental analysis, is that the China-US trade war stampede crowd should now disperse.

President Trump has signed on to a truce, it seems, albeit that the Chinese President still apparently needs some time and further concession. Many in the crowd might decide that the truce will last through Election Day, given the reluctance of the White House to upset the stock market boom.

Incidentally, the rumoured currency pact which forms part of the truce (China keeping the yuan round present level to the dollar, and limiting foreign exchange market interventions – limited anyhow in the recent past) is yet to be signed, and this might mean considerable disinflation pressure in China.

China exchange rate



Source: Federal Reserve Bank of St. Louis

An underlying slowdown of foreign investment into China (as global supply chains pivoted on that country are to some degree unscrambled) and related loss of competitive advantage should surely exert some driving force in real exchange rate depreciation, everything else the same.

Note, if economic freedom were to triumph, and in particular, currency convertibility achieved (meaning the end of financial repression), then we could imagine a rise in the equilibrium value of the Chinese currency, but none of this is on the horizon for now.

If depreciation is not to come via a currency devaluation, then it would come from domestic prices – especially those relevant to the export sector – falling.

The implicit tightening of monetary conditions to underpin the yuan against the dollar could add to the extent of speculative liquidation in Chinese credit and broader asset markets.

It has never made sense to say that the present global economic slowdown had its source in the US-China "tariff war" (especially when we take account of the many gainers as well as losers).

But if so many in the marketplace are trading on this belief and expect that a truce will suddenly bring an economic re-bound, who wants to find themselves crushed by a stampede?

Certainly not shorts on the S&P 500 or shorts on the US T-bond market.

On this latter point, remember that one of the biggest tellers of the China-US trade war narrative (as the key influence on global economic prospects) has been the central banks themselves.

How many times has Chief Powell told us that one reason for his mid-cycle rate cuts is the "extent of trade uncertainty". A truce presumably, means less uncertainty and less likelihood of a further rate cut.

Hence the chief's belief in the narrative adds tremendously to its live force. For now, however, a truce should mean the fall in market importance, if not death of this narrative.

President Trump's "peace in our time deals"

The truce, together with the fading meanwhile of the China-US trade war narrative, does have some fundamental bearing on market valuations.

As an illustration, we can see the truce as symptomatic of a desperation of the Trump Administration to deliver deals ahead of Election Day, if only partial, in areas where it has been negotiating toughly on the world stage.

Hence, we had signs of talk, early this autumn, with President Trump seeking a meeting with the Iranian President.

Renewed background noise is audible about a looming deal with the Taliban which would mean a plan by Election Day for US troops to pull out of Afghanistan.

There has been the deal (though no one has the details) between President Trump and Turkish President Erdogan, whereby US troops could be pulled out of Syria. Let's not forget that the President fired his hawkish national security advisor, John Bolton.

These actual and potential "peace in our time" deals are grounds for fear – most of all for allies of the US which until now have based strategies of national defence on implicit or explicit security guarantees from Washington, and in some cases, free-riding on these.

When these allies come to suspect that their US alliance is only weak at best, then some will attempt mitigating their risks, by reaching deals with natural enemies or with enemies of their enemies.

Hence, we have Saudi Arabia, additionally distrustful of US support (especially after the Iranian drone attack on their key oil installations), apparently opening some diplomacy with Teheran (ostensibly related to the Yemen conflict), and building an alliance with China (despite the issue of Uyghur Muslim treatment in that country).

Some close to the Trump Administration have claimed that China's pull back of economic cooperation with Teheran (stop to new oil investment, cutting oil imports) has been due to US diplomatic pressure; but more likely it is related to the promise and advantages of a deal with Saudi Arabia.

Some countries do not have any scope to make deals with their enemies. No scenario springs to mind where Japan could form an alliance with China. South Korea and Taiwan have limited possibility to compensate for any weakening of US implicit (Taiwan) or treaty-based (South Korea) protection.

By contrast in Europe, we can imagine a situation where growing doubts about US military guarantees and an unwillingness to step up their own military expenditures or host a new generation of nuclear missiles (to counter Russia's build-up), leads to a new form of rapprochement with Moscow.

Yes, the German Greens have become more hostile to Russia than in the past, but this can change swiftly. That is something to bear in mind when considering implications for the currency markets and the valuation of the euro.

Also, of relevance to assessing European dangers is the Turkish situation. US sanctions and European censoring of Turkey's military onslaught against the Kurds could lead President Erdogan to open the gates again to millions of Syrian refuges in his country to escape into Europe. This could fan a new rise in populist anti-immigration politics within the EU – raising the likelihood of huge political turbulence also in Germany, Italy and France.

Japan may seem less at risk of domestic political turbulence from Trump Administration pre-election peace in our time deals and military withdrawals. But, we should not be over confident about predictions for stability in one-party democracies such as Japan. Populist oppositions can spring up and assume considerable support with lightning speed.

We should note the failure of even the virtual one party Abe government, to make enough concessions to reach a meaningful free trade agreement with the US (which would have gone along with a deepening of the alliance between the two countries). It chose to settle for a mini-trade deal so slight in scope that it would not even require US Congressional approval.

This will give President Trump his pre-election boost with the farmers, but no serious opening up of the Japanese domestic markets (including crucially services) to US penetration (in addition to what has already been painfully agreed at a sluggish pace over the years).

Trade deals negotiated by this Administration, whether actual, mini, or phantom, have two standard features – first, wins for Big Tech, Big Finance and Farmers in the US; secondly, a no currency manipulation clause, which is drawn up with so much flawed input to be unfit for purpose (the Mnuchin Treasury has totally failed to overhaul the criteria used by Obama Treasury featuring bilateral trade balances, forex intervention and current account balances, but excluding monetary policies and financial repression).

In the present China-US truce deal, true to form, we have Chinese buying of US farm produce, permission to foreigners to buy 100 per cent interest in Chinese financial firms, and an exchange rate agreement.

Pressing China to end financial repression and make its currency fully convertible just did not figure on the Mnuchin Treasury agenda – and no one on Wall Street was pressing for this. Yet these reforms would be fundamental to China "playing by the rules" of a free global trade environment.

Anti-trust attack on Big Tech and beyond

In other recent trade deals negotiated by the Trump Administration (for example, Japan, Canada, South Korea), foreign governments have agreed not to take action against Big Tech's abusive practices (related to market power and privacy).

An intriguing question is how a Warren Administration would move forward from these agreements, given the high priority it gives to tackling these abuses within the US.

Indeed, the future of Big Tech, if not the dollar, could be crucially influenced by the US Election outcome.

A Warren victory might well bring anti-trust action in several dimensions, including the criminal pursuit of predatory behaviour by Big Tech monopolists and would-be monopolists.

(Yes, anti-trust cases are already being prepared within the Trump Administration, but there are grounds for doubting the seriousness or strength with which these will be pursued given the cosiness of its Big Business relationships).

Transcending the anti-trust aspects of Big Tech, and more generally of the digitalization revolution, is an even deeper economic concern, fanned eventually by monetary inflation.

Has digitalization spread and deepened far beyond what would have occurred without a massive speculative bubble around the world driven by unsound monetary conditions?

This may seem like a strange question to investors and commentators who view digitalization as the modern counterpart to electrification in the second industrial revolution or steam power in the first.

No one asked whether electrification or steam power would have been better curtailed in favour of horsepower or the spinning wheel, even though there were downsides. There were periods of excess "progress" – as evidenced for example by boom-busts in railroads or the over-investment of the 1920s.

That may, however, be a superficial take of technological history. IT and digitalization in particular are in the core area of information transmission, where there is a proneness to market failure given externalities. This vulnerability is exacerbated by an inflationary monetary system. Monopoly power and technical complexity in many ways impede the invisible hands; and monopoly power has been fanned by rampant speculation fed by inflationary money.

Over-digitalization has reduced prosperity

There are surely huge costs and imperfections associated with digitalization which were not foreseen when the economic world went headlong down this path: flaws in the internet, huge security risks, massive privacy issues, armies of technicians to solve the unforeseen problems as they arise, huge monopoly powers created and related abuse which no political system has yet addressed and may not do so.

Maybe, if much of this had been foreseen at the start, the pace of digitalization would have been slower, less extensive and less intensive.

There comes a point of no return.

Once the networks are in place and the big starting investments made, there is no going back to what might have been a much more efficient economic path, consistent with a faster overall growth of average prosperity.

A decade or more of remarkably slow overall growth may have less to do with hangover from financial crisis and more to do with a path of technological progress which has been far from optimal. The digital revolution has gone to extremes, not reined back by rational cynicism and insights into all the disadvantages subsequently revealed (beyond the point of no return).

The invisible hands of the market would have been more efficient in steering economies to the path of prosperity, if signals had not been so distorted by monetary inflation.

How much greater would be general prosperity today, if capital and entrepreneurial skill and non-distorted skills had gone into alternative paths through the forest of opportunity.

Dollar hegemony and the euro after Election Day

The US technological lead, especially in the digitalization revolution, has been a huge factor in the attractiveness of the US asset markets to global investors. Indirectly, this lead has been important to the real strength of both the US dollar and US dollar hegemony.

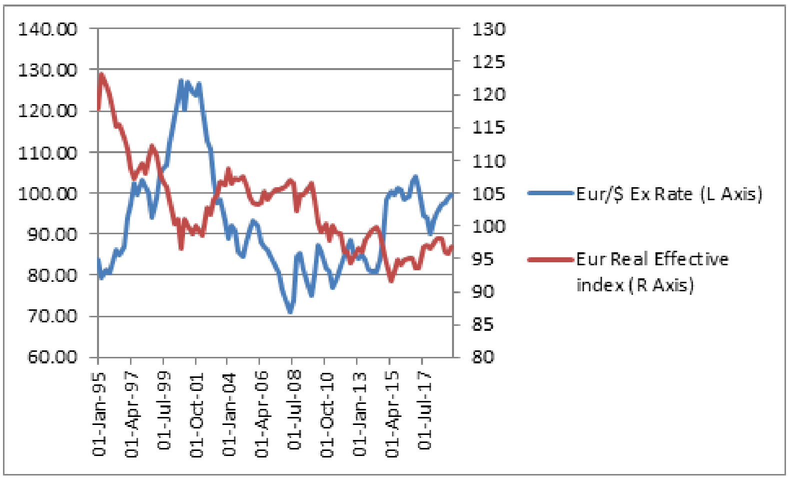
If indeed, the next bout of asset market deflation and recession goes along with a dawning recognition about the scale of malinvestment in the lead tech sectors, one might imagine that tarnishes both the dollar and US monetary hegemony.

Not so fast! Some pull back of the digital express train and a re-invigoration of anti-trust action might unleash a new era of creative destruction and economic growth in the US. The sick monetary environment, though, makes this more difficult.

Europe has its own accumulations of mal-investment – whether export sectors fanned by the cheap euro or the construction sector in Germany; and though not a producer, Europe is a top spender and a purveyor of digitalization.

By the bye, the euro has definitively lost all hope (in the eyes of investors) of ever becoming a European Deutsche mark.

Euro exchange rate



Source: Federal Reserve Bank of St. Louis

The euro in the years 2002-5 enjoyed an Indian summer (after the Winter of 1998-2002) helped by the Greenspan/Bernanke radical policy of "breathing back inflation" under President Bush in the run-up to the 2004 election. That summer has long gone, given the subsequent interruption of debt crisis and then Draghi's monetary radicalization.

Now the appointment of Lagarde to the ECB, the likely emergence of Green-led government in Germany (it is unknown whether the Greens will actually poll more than the CDU – they are both very close according to the surveys), the geo-political storm clouds (referred to above), all paint a weak euro picture.

An additional factor here (in euro weakness) is the ailing condition of European banks (likely to be exacerbated by the next episode of recession and asset deflation).

Widespread excess holdings of euros still exist, especially by international reserve holders, from a day when the euro had hard promise as a rival to the US dollar.

Bottom line:

This last stampede driven by news of "trade peace" is no time to re-assess fundamental perspectives of market value or economic direction.

Indeed, in some ways the passing of the stampede may embolden those with a more negative perspective than convey consensus about the durability of asset inflation (as supported by the longest ever US economic expansion), to implement corresponding active market strategies (whereas previously the thought of a risk-on stampede driven by a truce or a tweet would have been off-putting).

Gold is out of favour this week, on the back of the China-US trade truce and the linked probability that the Powell Fed will be more sparing with rate cuts through the rest of this year.

Darkening geo-political clouds, however, and the long-run monetary inflation outlook point in the direction of gold gains. One week of risk-on driven by a stampede driven by the China-US trade war viral narrative does not alter the perspective of a global economic slowdown which is gathering strength.