Macro Readings

29 Sept 2024

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Global Economy : Five Clusters

- We find Five clusters of countries with different Macro economic Dynamics :
  - Southern Europe and US (Steady Sate of Growth and Inflation)
  - China (decelerating growth - little inflationary pressures).
  - Emerging Europe, Chile and Colombia (boosting growth without overlooking inflationary pressures).
  - Most of Asia, the rest of Latin America, South Africa and Norway (weak exchange rates and financial stability concerns with slow the pace of easing).
  - Large African economies, Turkey and Argentina (restoring confidence in the exchange rate and bringing down inflation).

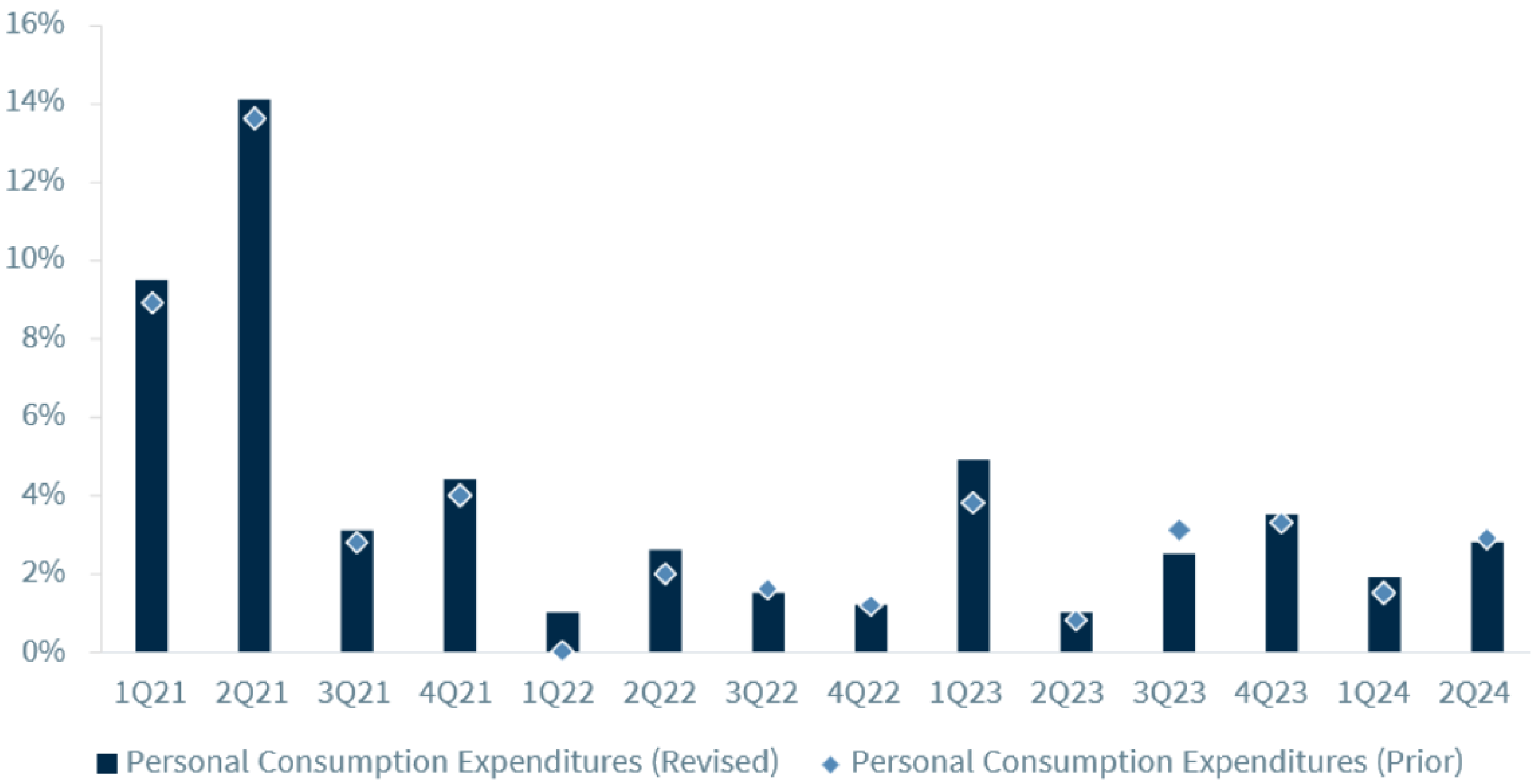
US : Fed and Markets : Sugar Rush

- After the first rate cut in two years went according to market expectations as the Fed obliged , the markets have continued to run with the Fed's ball and seem to have a 'sugar rush,' betting that Fed is going cut another 50 bps in November and another 25 bps in December for a total of 125 bps before the end of the year.
- Fed's argument for its rate cut was that the inflation and Employment situation was more in balance than before and that policy rates were too restrictive in this new environment. However, it is clear that markets are second guessing the Fed's economic forecast and are pushing for more rate cuts.
- The only way this could happen is if the US economy deteriorates considerably during the last quarter of the year. Recent data is still showing a very strong US economy as consumer demand remains resilient. Furthermore, lower interest rates will probably give some new life to the housing market, helping keep shelter costs high.
- Even in the unlikely case of weakening in economic activity over the next several quarters , it may be probably not enough to warrant the larger decrease in rates that markets are expecting, especially if shelter costs remain high.
- Thus, if Fed officials want to keep their rate cuts in line with last week's dot plot, they will have to hit the speaking trail soon to convince markets that what they are expecting is not consistent with what the Fed is seeing in economic activity.

US growth Dynamics:

- During the release of the third revision of the real GDP for Q2 2024, the BEA revised, mostly upward, the growth rates for GDP in previous three years -real GDP growth for 2021 was 6.1% versus an original increase of 5.8%; for 2022 it revised GDP growth from 1.9% originally to 2.5%; and for 2023, it revised GDP growth up from 2.5% to 2.9%.
- Perhaps the most important upward revision during this period was related to the first two quarters of 2022, which the BEA had originally declining by 2.0% and 0.6%, respectively.
- At the time of these releases, there was a big discussion arguing that those two consecutive quarters of GDP growth should have been declared a technical recession. Now, the controversy is over, as the BEA has revised both quarters up, to a decline of 1.0% during the first quarter of 2022 and an increase of 0.3% during the second quarter of 2022.
- Although many sectors of the economy were revised, the most consequential of the changes occurred to personal consumption expenditures (PCE) which, on average, was stronger than originally reported. Since PCE represents about 70% of the U.S. economy, the revisions to PCE pushed economic growth higher.

Revisions to Personal Consumption Expenditures



Source: FactSet, BEA

The bottom line is that consumer demand, and the economy, have continued to outpace even the most upbeat forecast as well as the official releases back to the start of the recovery from the pandemic recession.

Mistaking normal for weak

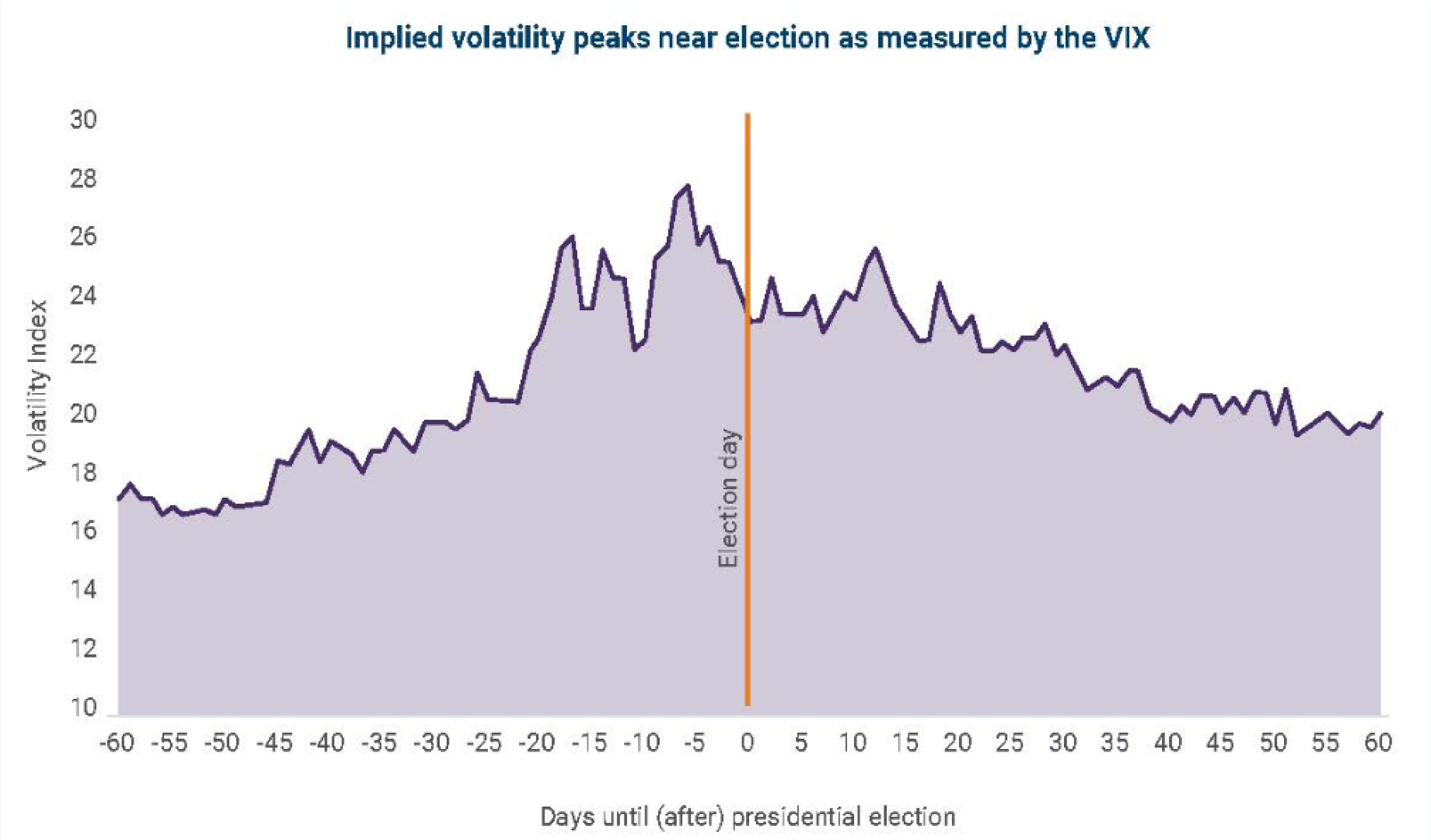
- Markets as well as Fed are believing in the theory of Labour market “weakness” .
- The current state appears to be a case of new entrants and returnees besides immigrants joining the labour force a smidge faster than businesses can absorb them . Immediately , the same is a seen as a signal of a teetering economy in need of more rate cuts,
- Even the Fed plays into this, saying they cut last week to prevent the jobs market from weakening further. This was an ‘insurance cut’ designed to stave off further labour market weakening and frontload some policy easing
- But when you remember that labour markets are a late-lagging indicator, then it becomes easier to see these wobbles as a trailing indicator of the bust, boom and volatile, uneven return to more normal trends that marked the past four and a half years.
- Recency bias being what it is, people look at monthly payroll gains in the 100,000s, compare them to the 200,000 and 300,000 figures that marked the initial lockdown recovery, and call hiring slow. But this year’s average monthly private payroll growth is 151,500 jobs.
- The average during the previous economic expansion? Not far off, at 163,800. Seems to us everyone is mistaking normal for weak.
- For stocks, this is all backward-looking. But it does suggest economic conditions aren’t actually weak. They are normal, while sentiment isn’t. And sentiment seems stuck to the downside, indicating some wall of worry persists on the economic front.

US Debt : Is it not a concern ?

- US National Debt has recently passed $35 trillion — over 120% of US GDP and is rising quickly. And of that total, almost $20 trillion was added in the last 15 years.
- It’s natural to be concerned about the growing size of the U.S. national deficit and how it may impact the economy and markets, but the financial picture is far from dire
- But big numbers don't necessarily pose a problem and the reasons are :
    - Large deficits typically result from recessions and crises.
    - Concern about national debt may depend on the metric used
    - U.S. debt has a captive audience
    - China’s U.S. debt exposure has declined without incident
    - Higher interest rates are only a problem if economic growth lags
    - The demographic concern — baby boomers turning 65 — ends soon
    - Social Security isn’t going bankrupt

Is Election risk underpriced ?

- As of now Markets have not yet seen any meaningful reactions from election uncertainties. We suspect they may emerge as November approaches and a focus on policy proposals (and differences) intensifies. Fed cutting in an election year tends to be an overall larger driver of returns versus the election itself.
- Volatility typically rises ahead of election day but often subsides quickly, as investors turn their attention back to the prevailing economic and market trends, which we'd posit won't shift dramatically based simply on the new Presidency.
- The larger takeaway is that markets have performed well under both parties, a condition that we don't think is under threat this time around.
- While a presidential election is a significant event, markets tend to focus more on the congressional makeup for insight into the future operating environment.
- In particular, we suspect a divided Congress will limit the potential for any extreme policy implementations, allowing the markets to take their cues from what we expect will be an extended economic expansion and ongoing cycle of rising corporate earnings – factors that throughout history have principally governed market performance.



Sources: Bloomberg, S&P Dow Jones Indices and Chicago Board of Options Exchange (CBOE) Volatility Index. Average S&P 500 total return 30-day volatility, 60 trading days prior to elections and 60 trading days after the election. Data begins with the 1992 election cycle and ends with 2020 election cycle.

US: Expansion Stays in tact

- The balance of data published this week provided additional evidence that the economic expansion remains intact.
- The main focus was on the state of the U.S. consumer. Personal spending rose 0.2% during August, below consensus expectations and a slight moderation compared to the 0.5% monthly gain registered in July.
- Although there have been shifts in the underlying dynamics recently, consumer spending has been remarkably resilient this cycle and overall spending was still up 5.2% over the year. That noted, a more moderate pace of spending appears to be taking hold against a backdrop of slowing income growth, which downshifted and grew 0.2% during August, amounting to a 5.6% year-to-year gain.
- Included in the personal income and spending report was the latest estimate for the Personal Consumer Expenditure deflator, the preferred inflation measure of the Federal Reserve. Encouragingly, inflation remained on a cooling trajectory during August. The headline PCE deflator rose just 0.1% during the month, continuing a string of mild increases.
- The core PCE deflator, which strips out the volatile food and energy components and provides a better snapshot of the underlying trend in inflation, came in slightly below market expectations and increased 0.1%. Over the past three months, the core PCE deflator has been running at a 2.1% annualized pace, which suggests further progress is being made in pushing inflation down to the Fed's 2% target.

East coast Port strike : Risk of Economic Disruption

- Thousands of dockworkers are set to strike at East and Gulf coast U.S. ports this upcoming week if the International Longshoremen's Association (ILA) and the United States Maritime Alliance (USMX) cannot come to an agreement regarding wage negotiations. Longshoremen are responsible for loading and unloading cargo at ports. The job includes working the cranes that haul containers on and off huge cargo ships as well as maintaining equipment.
- A strike would be the biggest disruption to the flow of goods in and out of the country since the height of the pandemic. While work stoppages at these ports cannot be ruled out, and a prolonged worker stoppage could disrupt supply chains, affect half of the US' containerised imports and every day of a strike to cause a backlog upto ten days.
- The strike could create a domino effect across the global supply chain, causing backlogs, equipment shortages, and increased shipping costs. Back of the envelope calculations how that Every day of a strike is expected to cause a backlog of five to ten days. And 10 days of backlog would take 70 days to return to normal.
- Beginning five weeks before the election, a strike could also inject new uncertainty into the presidential campaign. Fearful of the impacts, business groups and congressional Republicans have lined up to press the White House to invoke emergency powers and seek to block a strike, although so far Biden's administration has not shown a willingness to intervene. Port shutdowns would begin the same day as Tuesday night's televised vice-presidential debate.

PBOC’s Super Package

- The PBOC’s super package includes measures for policy rates and liquidity, the property sector and the stock market, as well as unexpected guidance on future policy moves.
- While the individual measures may seem limited, and resemble those tried before, there was a sense of urgency in their simultaneous announcements. This was a strong attempt to boost flagging investor sentiment.
- While the stimulus measures might help to relieve deflationary pressures, they will certainly not reverse them and at best can contain a further worsening of the balance sheet recession
- In a balance sheet recession, fiscal transfers from public to over-indebted private balance sheets are needed.
- For this, however, the US election matters
  - If China wants to neutralise the impact of any new punitive Trump tariffs, a meaningful one-off yuan devaluation could be necessary.
  - Conversely, if Kamala Harris wins, the dissipation of additional tariff fears could provide an improved backdrop for both Chinese policymakers and the market.
- Consequential decisions on fiscal or monetary policy therefore will likely wait for the US election, leaving more technical tweaks and monetary policy signals as the interim option.

Technical Tweaks …..

- There is a growing risk that deflation and weak economic activity might aggravate each other, creating a kind of 'doom loop': prices fall because demand is weak, and demand stays weak since Chinese households reckon it's better to delay spending in the hope that goods and services get even cheaper.
- Weakening the currency should be relatively straightforward –a weaker Yuan could raise the domestic price of imported goods by enough to help unroot China's deflationary psychology before it really establishes itself. Taking a leaf from Japan's play book , USDJPY moved from 100 to to JPY 150 over the past three years and pushed , Japanese inflation from minus 1 per cent to nearly 3 per cent.
- But the inexplicable drive for both a strong yuan when the policy is skewed towards reflation is an obvious Fundamental inconsistency that might not let this stimulus have a lasting effect
- A genuine reflationary package should normally involve a weaker Yuan and in the absence of that these measures are mere technical tweaks to mask this inconsistency.
- Simply put , unless Beijing is willing to countenance massive fiscal stimulus, it will likely have to accept a much weaker yuan to address the persistent weakness in prices.

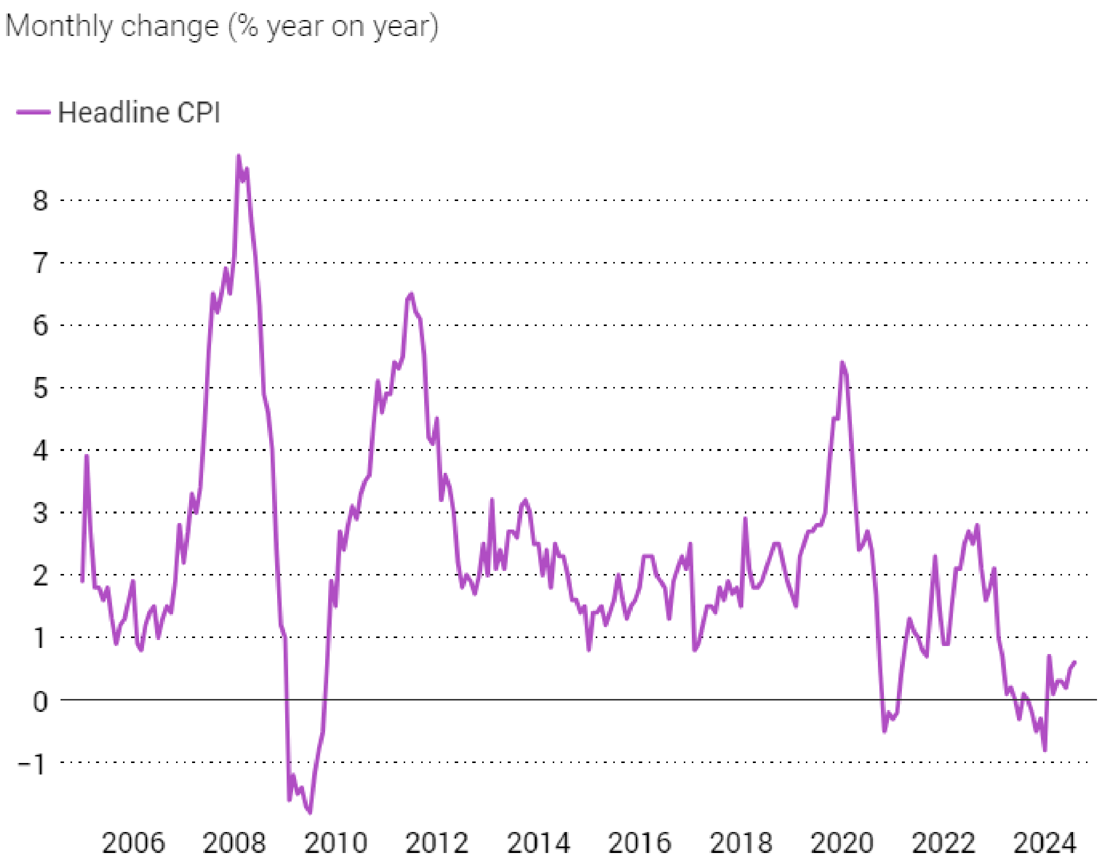
…less pragmatic and more dogmatic

- Super package once gain shows that the policy-making in China has become less pragmatic and more dogmatic and hence suboptimal decisions. In particular, these monetary policy measures might support asset prices in the initial euphoria.

- On the other hand, they will not trigger a new credit cycle in the private sector, for either companies or households.

- We know this from the lessons learned in Japan, where the private sector went into a combined savings surplus in the mid-1990s, and where zero or even negative interest rates never helped to rekindle demand for credit from the private sector, forcing the government to accept large, recurrent deficits that caused public debt to explode to over 250% of GDP.

China ‘s Headline CPI



‘Fiscal Space’

- Conventional wisdom holds that China has “fiscal space” to manage the distress. In reality, China’s fiscal capacity is highly constrained. The entire fiscal system is structured around revenues from investment-led growth, which is ending.

- Tax revenues continue dropping relative to the size of the economy, and the property market’s decline has hit land sales revenues as well. Actual fiscal deficits, including both central and local government budgets, are around 6-7% of GDP, and are likely to stay in this range, or rise. Persistent deficits of that size can be financed internally, of course. But they will limit not only Beijing’s ambitions for strategic spending, but also the use of fiscal stimulus to support growth in the years ahead.

- To put numbers ,In the first eight months of 2024, China's government spending was 22.21 trillion yuan, down from 22.86 trillion yuan in 2023. With a growth rate similar to the 5% GDP growth target, ideal spending should be around 24.00 trillion yuan, creating a gap of 1.79 trillion yuan, or an annualized 2.7 trillion yuan. At the same time, fiscal revenue reached 17.46 trillion yuan, down from 18.58 trillion yuan last year, leading to an estimated annualized gap of 1.47 trillion yuan. Combining these gaps indicates China may need to issue over 3 trillion yuan in special government bonds for stimulus.

- As such, despite the current surge in market optimism, the lasting effects will need additional policy supports and take time to manifest.

Rise of Southern Europe

- Germany, is struggling with a potent mix of short-term and deeper structural problems : Growth has stalled, its industrial model is challenged and political landscape fragile. On the other hand , Southern Europe has witnessed strong growth while Germany and France have struggled to recover following the pandemic. Southern countries benefit from larger service sector and lower energy price increases. A tourism surge since the pandemic, booming exports, and lower energy prices thanks to renewables and limited reliance on Russian gas, have given so-called periphery countries on the Mediterranean the edge in the euro area.
- Southern European economies that were long sneered at by their richer northern neighbors have turned the tables as they cement their role as growth drivers in the sputtering Euro area Just over a decade ago, these same countries — looked down upon as spendthrift and less productive — were at the core of a debt crisis that called into question the currency's very survival.
- We expect southern economies to continue outperforming as they benefit from strong services demand due to rising real incomes and strong labour market and this outperformance hs helped EURUSD hold its own even as the economies of France and Germany are struggling .
- In this context, it is relevant to note that unemployment has now stabilized in most euro area countries – Whereas it keeps declining in Greece due to high labour demand , unemployment has increased in Germany and France due to layoffs in the manufacturing sector.

Japanese Tactics : Talking hawkish and Staying Dovish

- After Friday's Liberal Democratic Party (LDP)'s election, former defense minister Shigeru Ishiba became the new President of the Party. Because the LDP has the absolute majority at the Lower House, he will become the new Prime Minister (PM) of Japan.
- The foreign exchange market immediately responded to the news with the Yen rapidly appreciating to USDJPY=143 from 146. In fact, he was competing at the second-round election against Sanae Takaichi who openly opposed to Bank of Japan (BoJ)'s rate hike as an avid supporter of Abenomics.
- On the other hand, Ishiba has already stated that he would carry on Kishida's framework on economic policies. In fact, he has been in favour of BoJ normalizing the monetary policy. While acknowledging some positive effects, he has been critical that the extraordinary monetary easing scheme lasted for ten years. Moreover, Ishiba kept Kishida's rhetoric to raise real wages by supporting companies to increase productivity.
- <u>Ishiba's nomination is unlikely to change the economic policies .</u>The BoJ is expected to keep retaining its tactics of Talking Hawkish and Staying Dovish . More importantly it can continue the corridor management in FX . The discussions on tax hike on financial income tax could end up with no definite conclusion as it has been the case with Kishida. The key remains policy measures to lift productivity, which is essential to raise real wages

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