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ECONOTE No. 54 The G3 economies: Yet another guide for the perplexed (and irritated!) **11/9/2016**

Summary

There is now predictability in the news headlines over the health of the G3 economies: Uncertainty over the fundamentals of the US, certainty over the abject failure of Abenomics in Japan and endless hand wringing over the failure of monetary policy in the EU. Why these economies just do not respond to the huge injections of cash, why is inflation so low and why zero to negative interest rates has no impact on consumers and producers ? What more can be done? There are a lot of simple and commonsensical explanations for all this, and, please note as we did in Econote no.53, "include out" (!) Asia where none of this kind of crisis is taking place. No negative interest rates, no long term subpar growth, no extremes of policies.

Investment Conclusions

The S&P performance bears no relation to consistent falls in earning growth and underlying threats of rate hikes (which we don't expect in 2016) while the Nikkei and the SPX reflect a mixture the poor outlook in both economies, strong JPY, Brexit, deflation and total absence of decisive and innovative policies. Stick to the consistently good performance of small Asians (Econote 53) and be weary of medium to long-term bonds where lengthening durations beg for an abrupt fall if and when the Fed acts. We like local currency Asian EMK bonds precisely because USD rates have now little impact on Asian economies and on their interest and forex rates.

Why this mess ? Answers do not need to be complex

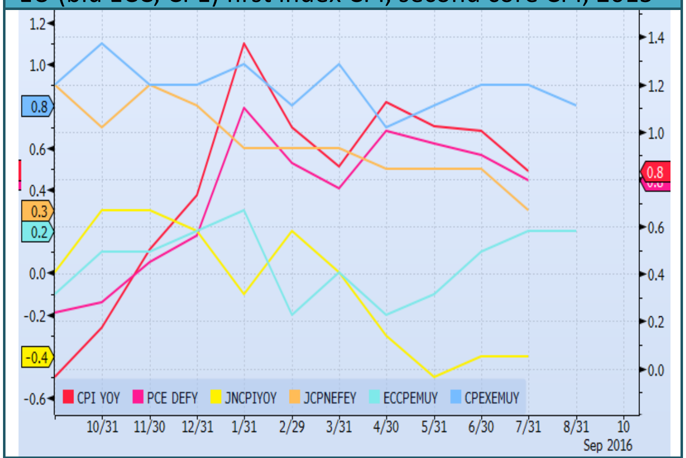
All G3 central banks are pursuing **inflation** of at least 2.0% and one of the factors which is stopping the US Fed from hiking is precisely that inflation is not accelerating. Japan is still grappling not just with low inflation but with deflation and similarly the EU is facing rates below 1.0% yoy. Why is this? Weak economies in the EU and Japan account for part of it, falling labor productivity in the US accounts for lower wages growth, and hence lower price rises, strong JPY in Japan makes imports cheap, and even cheaper oil and commodities, while in the EU the weak GDP growth keeps unemployment high and consumers unwilling to spend, helped and abated by low oil etc. prices.

The performance of **GDP growth** on a longer run basis (yoy) remains anemic through a mixture of low investment consumer spending despite the massively expansive monetary policy. All these economies could grow at minimum 2.0% rates. The relative shrinkage of world trade did not help, but then net exports were never of importance as growth drivers except at certain phases of the cycle in Japan.

	3Q.15	4Q.15	1Q.16	2.Q16
US	2.2	1.9	1.6	1,2
Japan	1.8	0.7	0.2	0.8
EU	2.0	2.0	1.7	1.6

The performance of the G3 stock markets has been poor with USD YTD by S&P 500 at 4.1%, Euro Stoxx 50 -3.3% and Nikkei 4.3%.The chart in the Factbox shows that the S&P 500 may have now reversed its outperformance of its 50D MA, while the EU and Japan markets on a RSI basis (2nd and 3rd box) are overbought and above their MA. Hardly conclusive proof, but these markets do not inspire confidence, especially when taken with the rest of their macro trends.

Fig.1: Inflation: US (red CPI, PCE), Japan (yel JNC, JCP), EU (blu ECC, CPE) first index CPI, second core CPI, 2015-



Source: Bloomberg

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Monetarism: Oh God, is it still ALIVE ?

All G3 banks embarked at different times and with different determination in a ,historically, massive expansion of money stock, defined as deposits with the central bank and with the banking system.They did this by buying financial assets from banks and from the public in general and, indireclty, by lending to the government. Note that the central banks did not buy bread and shoes, but paper assets from the financial sector. The result was exactly as expected, prices of those assets rose and their yields fell, as Fig.2 shows, although the pace was variable.So the result was higher inflation, but not in the prices of bread and of shoes but in those of financial assets. Ah, but that was not what the central banks wanted. The idea was that falling yields (in the case of Japan and EU, yields below zero, the famous negative rates, on which see Econote 52 for a thorough demystification) would cause consumers and producers to spend more and thus drive prices of breads and

FACT BOX: Equities as an investment asset for 2016-17 ?

Source: Bloomberg

of shoes up and thus also of wages and so starting a virtuous cycle of “good inflation”. As Fig 1 shows nothing of that happened because the “money” never arrived in the hands of the great unwashed masses, and also because high unemployment discourages spending, because banks found it easier and safer to lend to the government or simply to keep their assets in “cash” (recently, literally!) rather than lend . And in a vicious circle, deflation encourages postponement of consumer and investment spending and thus discourages the banks to lend and businesses and consumers to borrow. And guess what these G3 central banks did, except for the Fed which stopped in 2015, they did lots more of the same and promised to carry on doing so despite the obvious fact that it does not work.

Fig 2 : US (red), Japan (yel), EU (blu) ,2Y and 10Y yields

Source: Bloomberg

So if I am so smart, what do I suggest ?

Monetarism in the shape of more money in the economy driving goods inflation, never worked but has been succesful as a driver of assets inflation.But asset inflation does not drive investment in actual goods but rather in more paper assets.Financial asset ownership is highly concentrated in the hands of institutions and of the “rich” and, hence, does not translate easily to more spending. The idea of helicopter money, taken to its (correct) logical extreme is to hand wads of cash to the people, not to the banks, and stand back to see if they will spend it. Has it been done ? YES, most recently in Hong Kong and in Singapore,where unexpectedly large fiscal surpluses caused embarassed governments to send each and every ID holder a refund cheque , not the same as the central bank doing so, but close enough.

Expansionist fiscal policies on public works could also help as could, God forbid, selective increases in social security payments to ensure actual spending. Abenomics should unleash structural reforms, especially in the labour market, while EU should abandon tight fiscal policies, not minding Greece which is too small to matter. Not easy any of this, but more of the same after 7 years of failure, clearly is not the sign of intelligence but, as Boswell put it so well when talking on second marriages, "The triumph of hope over experience."

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