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Level 20,One IFC,1 Harbour View Street, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944
Email: afreris@ecognosisadvisory.com, Website: www.ecognosisadvisory.com, Facebook: @ecognosis

ECONOTE No. 71: Save your time, here is a "swot blog" on the US, EU and Japan — 30/4/2018

Summary

The proverbial man from Mars observing these G3 economies would be struck by the complete absence of synchronicity in all aspects of their cycles, and especially their policies. The much vaunted "global trends" do not exist any more. The safest way of examining these economies is on a one-to-one basis with sideways glances as to what is happening elsewhere. And this has nothing to do with Trump's "bull in the china shop" policy style, as the absence of global trends were already ensconced in the world stage before his election in 2016.This is not to say that, at least in terms of growth, things are bad. GDP growth rates have stabilized with the US leading the G3.

The **EU** is now clear of any existential issues, notwithstanding Brexit, and Japan is living with the absence of any different policies. **Abenomics** have failed, as did the BoJ's efforts to engineer higher inflation. The **US** is coping with a steady Fed determined not to be distracted by Trump, but the economy has to deal with incoherent, sudden and poorly executed policy steps. The best example is the shambles of tariffs and threats of trade wars

Investment Conclusions

The G3 economies are remaining in different phases of their cycles and, especially, on their monetary and fiscal policies cycles. This has given rise to some different performances in the stock and bond markets, with the **US** leading in equities performance. As the US monetary cycle is far more advanced than those of the EU and Japan, the higher USD interest rates will impose a celling on stock performance in 2018. The utter policy failure of the **BoJ** to stimulate inflation will not deter any further monetary expansion, but coupled with tighter fiscal policy this may also put a ceiling on equities performance. In the **EU** the slow recovery of the economy will, eventually, lead to higher rates, but not in 2018, thus giving a relative performance advantage to EU equities. All three bond markets will stay under the cloud of higher interest rates, either actual or expected. In a forthcoming Econote we will return to some further strategic portfolio suggestions, always within the limitations we operate (See the header of this note)

The basics first

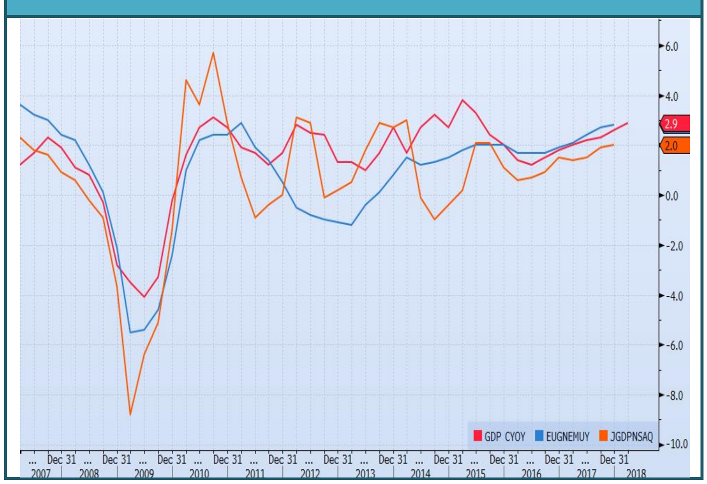
As Fig. 1 shows , in terms of pure trend the **US** is improving and also in quarterly numbers (see table below,annualised QoQ) it is doing now better than the EU and Japan.The sustainability of the US growth rate will depend on two potentially

	1Q. 16	2Q. 16	3Q. 16	4Q. 16	1Q. 17	2Q. 17	3.Q 17	4Q. 17	1Q. 18
US	0.6	2.2	2.8	1.8	1.2	3.1	3.2	2.9	2.3
Jap	2.7	1.3	0.9	1.1	1.9	2.4	2.4	1.6	--
EU	2.0	1.6	1.6	2.4	2.4	2.8	2.8	2.8	1.6

conflicting policy factors.The April 2018 meeting of the Fed kept the hikes to 5 so far since December 2016, but the Fed will not necessarily stop.The flattening UST yield curve remains a threat and a warning of a likely slowdown in growth, but the the near USD 1.2 trillion deficit funding requirement of Trump's tax and spending reforms will act as a boost. And herein lies the conflict, as the massive expansion of the borrowing requirement of the US governmen will push yields up at the time that the Fed is committed to hiking.There is, finally, the very ambivalent evidence as to whether the US corporate sector, now repatriating its trillion-sized cash pile parked overseas, will use it to invest in bricks and mortar or will simply spend it on dividends and share buy-backs.The evidence, so far, points to the latter option sitting very uncomfortabaly with the fact that part of the corporate tax cut was funded by spending cuts of the remnants of Obamacare.

And as US rates are rising, it is equally important to remind that zero interest rates are alive and well in the **EU and Japan.**In their most recent meetings, the **ECB** left the refinancing rate at 0.0% while a certain proportion of bank deposits with the ECB is still subject to a negative, -0.04 % ,deposit rate.The ECB also announced that its monthky bond etc purchases of EUR 30 bl will stay till September but, if necessary, may be extended past that date.So monetary policy stays loose for the foreseable future.**The BoJ** also had, finally, to eat humble pie over its 2.0% inflation target which has now been abandoned.Not so though the super loose monetary policy.The BoJ will continue its USD 730 bl a year bond purchasesas as well as with Its negative, -0.1%, key rate .As the graphs in Fig. 2 show, none of the economies examined here hit their 2.0% trend target inflation irrespective whether using the general or core CPI .For the US use is made of the PCE (personal consumer expenditure), which the Fed prefers. Japan registered sustained periods of deflation (2015-16) and now the current trend of persistent sub 1.0% inflation. The policy obsession with higher inflation is based on the assumption that accelerating inflation is supposedly good for business investment and for sustaining buoyant expectations. Low inflation, and worse, deflation causes consumers and investors to postpone their speeding decisions.

Fig.1: GDP growth: US (red), Japan (orange), EU (blue), YoYo %, 2007-18



Source: Bloomberg

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Once again: Why Monetarism does not work (and never did)

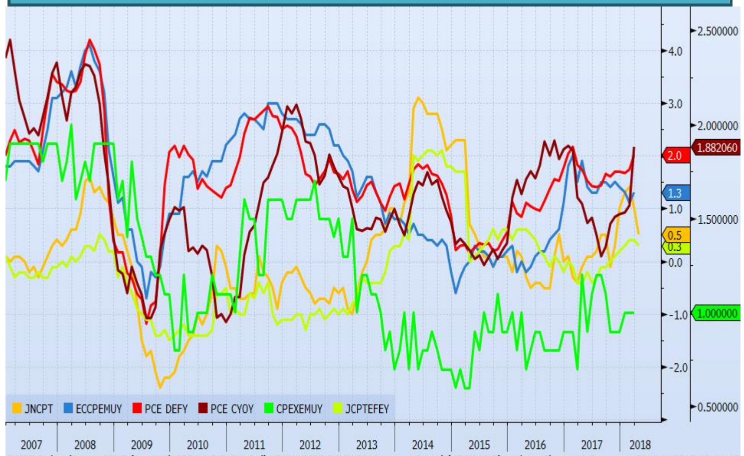
All the three main central banks have, or had, dedicated their post 2007 monetary policies on the principle that expanding money growth would cause more spending and thus, given the capacity constraints of the economies, would have pushed up the prices of goods and services.Higher inflation is deemed to be a "Good Thing "as it encourages consumption and investment as well as favouring borrowers who, pressumably, would invest.Although never explictly spelled out, the principle underlying these Quantitative Easing Policies was a crude version of the Quantity Theory of Money popularised by Milton Friedman and made almost into an article of faith in the 1960s-70s.Perhaps it is fortunate that Friedman did not live to see a major part of his life's work go down the drain, as the post 2008 experience was a resounding refutation that more money leads to faster inflation.It did not, and it will not.In all fairness, Friedman had made major contributions to other areas of Economics which more than justified his Nobel prize, but monetarism is definately not one that he should be remembered by.Briefly:

MV=PT, where M is the money stock, broadly defined, V is the velocity of circulation of money stock, the speed by which it changes hands, P is the price level of goods (and services ?) and T is the total of these goods and services available at any given time.Now the inverse of V , (1/V) ,can be redefined as the proportion of money held to the total value of goods and services at any given time.Or it can be even more intuitvely thought of as the proportion of money held by

Fact Box: Metrics of key stock indices (see text).Bloomberg

people to their total spemding.The assumptions now of the Qunatity Theory were that V, in general, would move very slowly, as would T, which would depend on the capacity of the economy to produce.Hence any change in M would be proportionately reflected on changes in P.Hey presto, changes in money stock are closely correlated to changes in prices.In the post 2008 period, what actually happened was that as M expanded fast, V fell quite significanlty as people accomodated more money in their portfolios, rather than spend it.In fact they did "spent " it but not on bread and shoes but on financial assets, and bonds in particular.The S&P 500 index had a strong and continuous rise since 2008 and the prices of bonds rose high enough as to give historically low yields.Indeed in the cases of the EU and Japan, several classes of longer term bonds registered sustained periods of negative yields ! So the Fed, the ECB and BoJ did get their inflation, but in financial assets and not in goods and services.Continuing faith in getting inflation up by pumping more money reminds of Samuel Johnson's quip that " a second marriage is the triumph of hope over experience".There are several more reasons why more money in the economy will not cause higher inflation, but the one shown here should suffice to illusrrate that the poor Quantity Theory has been more sinned against than sinned itself !

Fig.2 Inflation yoy %: US (PCE, basic and core). EU (EC, CPE, basic and core), Japan (JN, JCP, basic and core) 2000-2018



Source: Bloomberg

The impact of all this on investment

The charts in the Fact Box, show the S&P 500, (red), the Nikkei 225 (orange) and EU Stoxx 50 (blue) and, in the same order, their relative strength index at the bottom of the chart.The stock indices are above their 50MA ,and with the exception of the S&P 500, their relative strength indices show them to be overbought.The differentiation here might be between the two economies, the EU and Japan where interest rates are not going to rise in 2018, and even doubtful when they may do so in 2019, and the rates in the US where the Fed is on a hiking mode but fiscal policy has gone maxi loose both in terms of spending and in terms of corporate tax cuts.Given the fact that Japan had a reasonably neutral fiscal policy so far, but it is scheduled to hike consumption tax from 8.0% to 10.0% in October 2019, and continues to flirt with very low inflation, the EU may have the relative advantage in terms of expected equity performance for the rest of 2018.The case for the S&P500 can not be made just in terms of valuations or strong earnings in 1Q.18 as yields and short term rates will continue to rise, or perhaps worse, there will be persistent expectations of hikes. Japan is left at the botom of preferences by the absence of good news, let alone policy initiatives.Abe's administrations recent scandals will not help.

The overall environment in the EU is surprisingly steady given the absence of a government in Italy, the retrenchment of Germany from a "united EU" despite Macron's campaign, and the marginalisation of Greece where the extreme left imposed succesfully a severe squeeze, brought the budget deficit under control and followed the EU/ECB/IMF directives.The Brexit, is frankly a problem for the UK and not for the EU as the EU all it needs to do is to wait, and the UK, without a deal, will by 30 March 2019 have the same rights versus the EU as any other minor or major country without a special arragement or treaty.Its goods and services and its citizens will need to join the "All other passports" queue and have their visas and tarrif schedules checked. I continue to harbour a belief that the Brexit will not happen because of the whole shambolic UK political establishment as well as because the amateurish negotiation stance will simply collapse in March 2019.This will not be because of the absence of an agreement, but because there will be enough political desparation by then for the Parliament to say "stop" and lead the UK to a sorely needed rethink.

As for bonds, all three markets will have the overhang of higher rates, less so in the case of UST where it has already happened, but will also happen again.A neutral equities position towards the G3 may be warranted with a preference for the EU market.

Andrew Freris