# The Gavekal Monthly – March 2016

## Overview

**Anatole’s Take**  
Nothing To Fear But Fear Itself  
*Anatole Kaletsky*  
3

## Key Calls

**Europe**  
The Euro Recovers—For Now  
*Nick Andrews*  
12

**Japan**  
Negative Rates: Last Gasp For Abenomics  
*Joyce Poon*  
16

**China**  
The Renminbi And Capital Flows  
*Chen Long*  
20

## Dashboard

**Our Views in Brief**  
Economies, Markets, Themes  
24

**Indicators**  
Not Yet Time For Bargain Hunting  
27
Anatole’s Take

Nothing To Fear But Fear Itself

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Start of a bear market or end of the correction?

• Have we just witnessed the start of a terrible bear market? Or was the sell-off in January and early February simply a correction in a secular bull market that can be dated either from the post-crisis low of March 2009 or from March 2013, when the S&P 500 broke out of the 13-year trading range that had defined the bear market which began in March 2000?

• This question, which I debated with Charles last month (see Enter Ursus Magnus?), remains unanswered. The first half of February seemed to confirm Charles’s thesis about an Ursus Magnus. But markets turned abruptly on February 11, when I doubled-down on my bullish call (see Crisis? What Crisis?). Since then, trading and sentiment have broadly reverted to “Risk-On”.

• The net result was that markets in February ended the month pretty much where they started: The S&P 500 was up 0.5%, while the MSCI global and DXY dollar indexes each fell by about -1%. Bond prices gained slightly as unrealistic expectations of a hawkish Federal Reserve were priced out. But by the end of the month investors were again assuming one or two rate hikes in 2016, which seems a reasonable expectation.
Bears? What bears? Goldilocks still loves porridge

• The possible reasons for optimism are the same as they have been since mid-2009:
  ➢ Global economic growth continues at a modest but adequate rate of 3.0-3.5%. Trade imbalances have diminished. Currencies are stable and monetary policies are steady or highly predictable.
  ➢ Inflation is non-existent, guaranteeing near-zero interest rates in all advanced economies until 2018, and possibly for the rest of the decade.
  ➢ Profits outside energy and raw materials are steady or weakening only slightly. Near-record margins look sustainable, with no sign of cyclical pressures from wages, oil or higher financing costs.
  ➢ Debt levels may be high, but debt-service costs are historically pretty low.
  ➢ Equity valuations are reasonable and multiple-expansion is likely if profits remain steady, while 10-year bonds yield below 2-3%.
  ➢ Investor sentiment is negative. Most forecasters project another decade of abysmal equity returns—so there is plenty of room for upside surprises.
2015 was a “game of two halves”.

“Risk-On” February-July:
• US: employment growth confirmed self-sustaining expansion
• EU: ECB bond-buying contained euro crisis
• UK: election guaranteed 10 years of Conservative government

“Risk-Off” August-December:
• China: hopes of an orderly slowdown turned into fear of collapse
• Japan: Abe’s Three Arrows all flew in the same direction—but missed
• Oil: US$2trn consumer windfall turned into oil sector meltdown
“Explanations” of the risk-off sentiment have shifted almost daily:

- China will deliberately devalue the renminbi
- China won’t deliberately devalue, but will lose control of the currency
- Oil prices will fall to zero, signaling global depression
- Oil prices are stabilizing, but the US will slide into recession
- The US isn’t in recession, but central banks have run out of ammunition
- Central banks aren’t paralyzed but everything they do is counter-productive
- Negative rates seem to rekindle banking crises in Europe and Japan
- Dovish Fed/weak US dollar mean December rate hike was “policy mistake”
- Not-so-dovish Fed/stronger dollar mean China will devalue the renminbi…

What’s next?
The People’s Bank of China’s intervention has stabilized the renminbi and eliminated the arbitrage between CNY and CNH. This has required a US$100bn per month reserve outflow, but China could keep up this intervention for years unless it faced massive domestic capital flight. In theory that could happen, but in practice no country running a 3% of GDP current account surplus has ever experienced a currency collapse or capital outflow crisis.

Oil prices have stabilized in the range of US$25 to US$50/bbl as the oil market moves from a Saudi-dominated monopoly to a competitive pricing regime similar to 1985-2004. The bottom of the new range should be around US$25, which is about the production cost of marginal supplies from Russia, Iraq and Iran. Meanwhile, the marginal cost of US shale production should limit any price rebound to a long-term ceiling of US$50 or so.
US payrolls continue to grow by an average of 200,000 a month. With wages now also rising by 2% in real terms, this employment growth should mean decent consumer demand. A US recession is therefore extremely unlikely in the absence of massive external shocks or policy tightening. If February’s payroll report turns out to be near 200,000 instead of January’s 151,000, equity markets will probably rally worldwide.

Despite all the sound and fury about the possibility of a “policy mistake” in the December rate hike, the Fed is probably quite satisfied with the way that monetary policy is playing out. US inflation statistics are slowly but steadily moving up towards its 2% target. But with no serious price or wage pressures, the Fed will be happy to remain “behind the curve” of rising inflation, prioritizing economic growth and financial confidence.
Investors were mostly wrong-footed by the US dollar’s failure to strengthen after the Fed’s December rate hike. Some therefore concluded that the Fed had made a fatal “policy mistake”. In fact there was nothing surprising or sinister about the dollar’s weakness. A steady or slightly weaker dollar has been the normal outcome of major Fed rate hike cycles in the past.
A slightly weaker dollar is bullish for most assets

- This leaves one big worry outstanding from the January-February panic: The collapse of bank stocks around the world, especially in Europe and Japan. Nobody seems to be sure whether bank stocks “know something” about the global economy or financial system that is not yet visible in economic statistics or corporate results.
- And even if the banks have no skeletons in their closets, there’s always the danger of reflexivity: collapsing financial markets can sometimes create the crises in the real economy that they appear to anticipate.
- But extreme cases of self-fulfilling reflexivity such as the 2005-08 mortgage boom-bust are the exceptions in financial history, not the rule. Once prices fall far enough, momentum traders motivated by reflexivity are usually outweighed by value investors who follow Warren Buffett’s philosophy that when an asset get cheaper you should buy more of it, not less.
- **I therefore remain stubbornly bullish.**
Europe

The Euro Recovers—For Now

Nick Andrews
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Europe

The Euro Recovers—For Now

<table>
<thead>
<tr>
<th>What’s happening</th>
<th>What it means</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR/USD rallied in February to hit a high of almost 1.14, its strongest since October 2015</td>
<td>Despite negative short term interest rates, <strong>global market volatility is supporting the euro, which is being treated as a risk-off currency along with the yen and Swiss franc.</strong> As the sell-off in global risk assets continued through February, EUR/USD appreciated towards the top of its 12-month US$1.05-1.15 range.</td>
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<td>European equities fell -3% in February; German 10y bund yields fell -24bps to 0.11%</td>
<td>Risk averse investors in eurozone equities reduced their positions. But the negative effect on the euro was outweighed by eurozone debt investors, who curtailed allocations to foreign markets and sought safe havens at home, despite low (even negative) yields. The net effect of these portfolio flows was to support the euro.</td>
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<td>US-Europe two year interest rate swap spread tightened 25bps</td>
<td>The implied probability of a March Fed rate hike fell to 8% from 52% at the start of 2016, with the chance of a hike by year-end now just 53% from 93% at end 2015. In response, the US-Europe swap spread tightened, supporting the euro. <strong>But US$1.15 is probably a ceiling for the euro, and if the Fed does hike rates, fears of Brexit and bank problems could drive it to US$1.05 or below.</strong></td>
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</tbody>
</table>
Through 2014-15, low rates and quantitative easing drove eurozone debt investors to seek higher yields abroad, even as foreign investors turned net sellers of eurozone debt, and the euro emerged as a favored funding currency for non-eurozone issuers.

At the same time the eurozone’s economic recovery attracted foreign portfolio capital flows into eurozone equity markets.

In the “normal” market conditions that prevailed through 2014-15, net portfolio flows were dominated by debt outflows, especially as foreign issuers swapped out euro debt into their home currencies. The resulting capital outflows tended to weigh on the euro’s exchange rate.

As global risk aversion has risen in 2016, both eurozone investors and foreign issuers have turned cautious, and debt outflows have slowed, supporting the euro.
As heightened market volatility over the first two months of 2016 led to diminished expectations of US rate rises, the interest rate differential between US$ and EUR (measured by 2y swap rates) narrowed, supporting the euro.

However, with 2y US rates now close to 12m lows, further downside looks limited unless a significant deterioration in the US economic outlook leads the market to price in rate cuts. Barring any such deterioration, the euro is likely to remain capped at around US$1.15 from here.

If global market volatility now abates and expectations for US rate rises recover, eurozone debt outflows will re-assert their influence even as the interest rate differential with the US widens again.

Euro sentiment is likely to be further eroded by the chance of a new soft patch in growth, bank vulnerabilities, the refugee crisis and possible Brexit (see New European Crisis, Same Problem). So while US$1.15 is likely to cap EUR/USD, US$1.05 no longer looks a solid floor.
Japan

Negative Rates: Last Gasp For Abenomics

Joyce Poon

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## Japan

### Negative Rates: Last Gasp For Abenomics

<table>
<thead>
<tr>
<th>What’s happening</th>
<th>What it means</th>
</tr>
</thead>
</table>
| The BoJ surprised the market by charging 0.1% on new excess reserves that financial institutions have in its accounts | • Less than 4% of reserves will be charged 0.1% initially while the rest will earn no interest or 0.1%. **The purpose is to increase the cost of banks “hoarding” reserves.**
• Japanese bank shares collapsed, the yen touched ¥111 to the US$ and the broad market fell -16% peak-to-trough. This suggests investors think the Abenomics reflation plan is reaching its limits. |
| JGB interest rates fell across the yield curve; the 10-year rate is now negative | • Japan’s yield curve has collapsed, and with it bank profitability.
• More than 20% of global developed sovereign bond markets now offer yields below zero.
• Japan’s role as a “safe haven” complicates the analysis. **Part of the decline in JGB yields and yen strength may be due to increased concerns about Europe’s banking system.** |
| Japan's GDP contracted an annualized -1.4% in 4Q15, worse than expected -1.2% | • Private consumption, which makes up 60% of GDP, disappointed by falling -0.8%. But capital expenditure rose 1.4%, confounding market expectations of a -0.2% fall.
• The direct economic impact of yen appreciation should be modest. But a negative feedback loop could develop if corporate and consumer sentiments deteriorate. |
Contrary to the Bank of Japan’s plan, its January 29 rate cut caused tighter domestic financial conditions via the stronger yen and lower stock prices.

This unintended consequence means the BoJ will probably have to double down by cutting rates further and increasing its rate of asset purchases. The government will be under pressure to resort to direct foreign exchange market intervention if all other approaches fail.

Japan has little choice but to pursue a “whatever it takes” approach to monetary and currency policy as the downside from a failure of Shinzo Abe’s reflation plan could be devastating.

A persistently strong yen will hurt consumer confidence through wealth effects while companies will hold back from investing and resist pressure to boost workers’ wages.
If negative rates do support activity, they will primarily work through the exchange rate by encouraging investors to move from safe to more risky assets. The problem for Japan is that it has been pushing this strategy for three years and the marginal returns are diminishing. After all, the yen is already deeply undervalued, limiting the scope for policy action to induce further depreciation.

Another headache is that yen remains a “risk-off” currency that appreciates during market panics. Hence, any easing effect is easily subsumed in periods of global panic: recent examples include fears over Chinese policy “mistakes”, tighter financial conditions ignited by December’s US rate hike, and perceived default risk in Europe. As global tail-risks rise, it is becoming harder for the BoJ to deliver on its policy objectives.
China

The Renminbi And Capital Flows

Chen Long

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## China

### The Renminbi And Capital Flows

<table>
<thead>
<tr>
<th>What’s happening</th>
<th>What it means</th>
</tr>
</thead>
</table>
| The offshore CNH appreciated and the CNH-CNY spread narrowed | • After trading significantly weaker than the onshore CNY through 4Q15, the CNH rebounded in mid-January as offshore interest rates spiked. As a result, the offshore-onshore spread closed.  
• This suggests **the People’s Bank of China will sacrifice the development of renminbi internationalization in order to stabilize exchange rates.** |
| The renminbi was stable against the CFETS index through February, and rose against the US dollar | • The renminbi was stable against the CFETS basket index, trading in a 99-101 range. Meanwhile, since mid-January the renminbi has appreciated against the US dollar in both onshore and offshore markets, as the US dollar weakened against most major currencies. |
| China’s foreign exchange reserves fell by another US$100bn in January | • After falling by US$500bn in 2015, China’s foreign reserves fell by another US$100bn in January as the PBOC continued to intervene in the foreign exchange market.  
• Although China still has US$3.2trn of reserves, largely in liquid assets, investors are concerned by the rapid pace of the decline. **If reserves continue to fall, Beijing’s policy of maintaining currency stability against a basket index will not be sustainable.** |
After the spread between CNY and CNH widened to a record high in early January, the PBOC withdrew liquidity from the offshore market, causing a spike in Hong Kong’s renminbi interest rates. As borrowing costs for CNH shot to record highs, short-sellers covered their positions and the CNH strengthened against the US dollar. As a result the spread between CNH and CNY narrowed, and has now effectively vanished.

The renminbi has remained broadly stable against a basket of currencies, with the CFETS index trading in a narrow range of 99 to 101 over the last two months. The PBOC is now using the CFETS index as a reference rate in setting the daily CNY fixing. As the US dollar weakened against most other major currencies in the past weeks, the PBOC set the CNY fixing stronger, and the renminbi appreciated against the US dollar in the spot market.
Annual balance of payments data show that China’s capital outflow in 2015 was as great as US$700bn. Our analysis is that about 70% of this outflow was normal or healthy—consisting of the repayment of foreign debt and direct investment abroad—while 30% of the outflow was “abnormal”. There is no evidence of massive capital flight that could threaten the stability of China’s financial system.

The big concern remains the rapid depletion of China’s foreign reserves. After falling by US$100bn in January, China’s reserves now stand at US$3.2trn. They are still the world’s largest, and officials stress that most are in liquid assets. However, reserve depletion can only go so far before the basket peg becomes unsustainable. If the reserves continue to fall, the PBOC will either have to tighten capital controls or let the renminbi float freely.
# Our Views In Brief

## Economies

<table>
<thead>
<tr>
<th>Region</th>
<th>Analyst</th>
<th>View</th>
<th>Read more</th>
</tr>
</thead>
<tbody>
<tr>
<td>US inflation</td>
<td>Will Denyer/Tan Kai Xian</td>
<td>If the US$ falls further and oil prices stabilize, US inflation should gradually increase to the 2% target from here</td>
<td>Position For A Pick-Up In US Inflation; Deflation Deferred</td>
</tr>
<tr>
<td>China</td>
<td>Andrew Batson</td>
<td>Growth slows further in 2016 to 6-6.5% as industry stays weak and services soften</td>
<td>Breaking Down The Services Cycle</td>
</tr>
<tr>
<td>Emerging Asia</td>
<td>Joyce Poon</td>
<td>Growth is constrained by high leverage and limits on monetary easing due to weaker currencies</td>
<td>Emerging Asia’s Leverage Problem; China And North Asia’s Deflation Syndrome</td>
</tr>
<tr>
<td>US corporate profit margins</td>
<td>Will Denyer/Tan Kai Xian</td>
<td>Expect a contraction in US profit margins due to rising wage pressures and/or a strong dollar</td>
<td>On Profits: There Will Be No Revolution; High Profit Margins Are Here To Stay; Brace For Lower US Margins</td>
</tr>
</tbody>
</table>
## Our Views In Brief

<table>
<thead>
<tr>
<th>Market</th>
<th>Analyst</th>
<th>View</th>
<th>Read more</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan equities</td>
<td>Joyce Poon</td>
<td>Good earnings and improved corporate governance are still supportive, but the macro risk is rising</td>
<td>Japan’s ROE Revolution; Japan’s Point Of No Return</td>
</tr>
<tr>
<td>US equities</td>
<td>Will Denyer</td>
<td>As we are more than half way through the cycle, investors should hold a balanced portfolio of tomorrow’s winners and cash, treasuries or gold as a hedge.</td>
<td>Keep Calm And Rebalance Into Equities; Portfolio Construction Towards The End Of The Cycle</td>
</tr>
<tr>
<td>Renminbi</td>
<td>Chen Long</td>
<td>China doesn't want to devalue, but continued capital outflows could still force it off the peg</td>
<td>Capital Flows And The Currency Endgame</td>
</tr>
<tr>
<td>US dollar</td>
<td>Will Denyer/Tan Kai Xian</td>
<td>US dollar is unlikely to strengthen further as it is already at overvalued levels and the fall in oil reduces global demand</td>
<td>The Rising Supply Of ‘Earned’ US Dollars; Drop The Dollar Hedge</td>
</tr>
<tr>
<td>Equities</td>
<td>Louis-Vincent Gave</td>
<td>The top of the US$ and the end of the China panic signal a “pain trade” favoring cyclicals and EMs</td>
<td>Is The Bull Market Over? (II); The Birth Of A Pain Trade</td>
</tr>
</tbody>
</table>
## Our Views In Brief

<table>
<thead>
<tr>
<th>Topic</th>
<th>Analyst</th>
<th>View</th>
<th>Read more</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil: lower for longer</td>
<td>Anatole Kaletsky</td>
<td>Abundant supply means US$50/bbl is a ceiling not a floor</td>
<td><strong>Oil: Lower For Longer; Oil At Its Ceiling, Not Its Floor</strong></td>
</tr>
<tr>
<td>The low-rate fallacy</td>
<td>Charles Gave</td>
<td>Zero rates are destroying productivity and leading to a deflationary recession</td>
<td><strong>Poverty Still Matters For Capitalists; The Myth Of Secular Stagnation</strong></td>
</tr>
<tr>
<td>China policy uncertainty</td>
<td>Andrew Batson</td>
<td>Nationalist politics make policy choices less predictable</td>
<td><strong>Expect The Unexpected; The Nationalist Style Of Economic Reform</strong></td>
</tr>
<tr>
<td>US long-run growth</td>
<td>Will Denyer</td>
<td>US structural growth to slow to 2-2.5% as demographic factors that boosted growth in the last century have abated</td>
<td><strong>New Century, New Structural Growth Rates</strong></td>
</tr>
<tr>
<td>Renminbi internationalization</td>
<td>Louis-Vincent Gave</td>
<td>Beijing’s drive to globalize its currency to continue despite market turmoil</td>
<td><strong>The Crocodile Mouth About To Close; The New Way To Think About China</strong></td>
</tr>
</tbody>
</table>

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While a slight improvement from a disastrous January, the world MSCI still shed -1% in February.

The continued worries on China and the commodity complex have now be joined by a renewed concern on European banks (particularly in Italy).

On top of that, the US corporate spread keeps widening, highlighting a rising cost of capital for the US enterprise sector.

All in all, our indicators would warn against buying this weakness.
Indicators

Inflation still very much missing in action

**Diffusion index of 16 CPI components** — accelerating or decelerating

Vs. CPI (total, core & median), all smoothed with 3 month moving avg

**Break-even inflation rate for 5 year TIPS**

Gavekal Data/Macrobond

**The new GaveKal P indicator**

Various market-based and fundamental data aimed at gauging future price movements

**Momentum of the new GaveKal P indicator**

Various market-based and fundamental data aimed at gauging future price movements
US monetary base growth negative for the first time since 2001
Equity momentum broadly negative