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Weekly Economic Update

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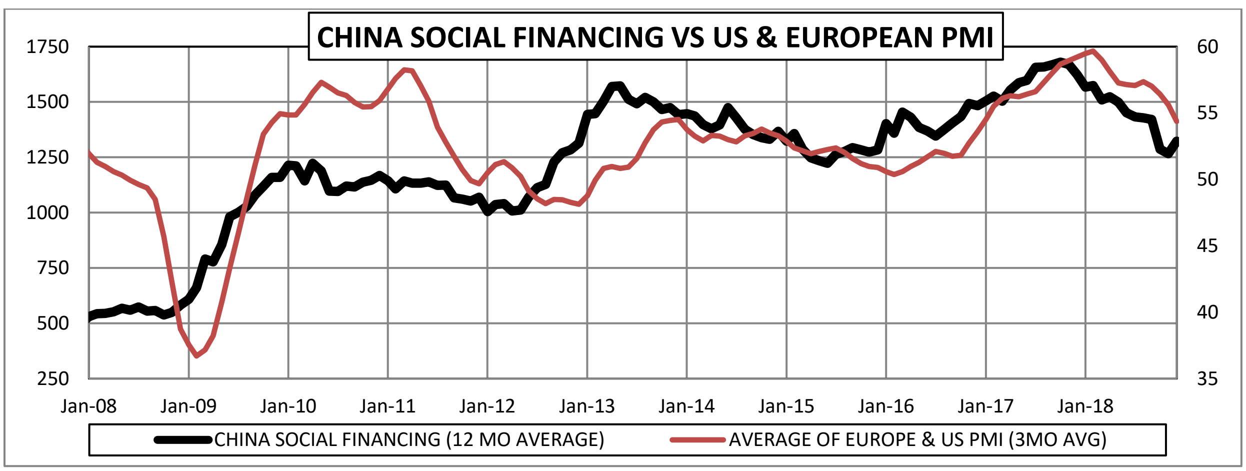
The global policy framework appears to be at a turning point. As we see it, there are five great uncertainties stalling investment and growth, in order of importance, they are; the Chinese credit crunch; the Sino-US trade war; US Federal reserve policy; Brexit, and the US government shutdown. The Chinese credit crunch heads the list, because in our view it is Chinese – not US – credit policy that drives the global industrial cycle. China's consumption of commodities and dominance of trade is the key to global economic volatility. That is also why the trade war is second. US monetary policy is a key input to dollar strength, and the ability of Emerging Markets to exploit Chinese stimulus. Clearly Brexit is the major issue facing Europe regardless of the global cycle. The US government shutdown, now temporarily ended, is a key signal as to whether the US remains in political gridlock.



Since Lehman, China's credit expansion has led the global economic cycle. It was their explosion of credit starting November 2008 that rebounded their economy after only one quarter of decline and saved the Emerging Markets commodities producers. Global PMI, using a three-month average, bottomed in February 2009, the S&P didn't bottom until March. The double bottom in Chinese credit in early 2012 generated a similar double bottom in world PMI six months later. The low point in China's credit issuance in June 2015 led to an upturn in global output nine months later.

Recently, Chinese social financing has begun to expand again after bottoming in November. We use a twelve-month measure because credit is so seasonal in China that it is the change from a year ago that drives psychology. Since mid-2018, China has been reducing reserve requirements and prompting banks to lend – but only recently has it caught traction. Note, that because a disproportionate share of Chinese credit is allocated in the first quarter, recoveries have been early in the year. The 2012 outlier required a massive injection of credit at midyear in response to the European credit crisis. Bottom line, conditions suggest further Chinese credit stimulus -- and a global upturn in the real economy near year end after a lackluster performance in the first half.

China has been scaling back the degree of credit stimulus each cycle to rein in inefficient allocation to real estate. Unfortunately, this is a byproduct of how their financial system works. Banks, most of which are government owned, lend largely to local governments and state-owned enterprises – at dictated rates lower than nominal GDP growth, so effectively government subsidized. It is the local government or SOE which allocates the credit to its suppliers, because it knows best who is in need and worthy, and earns a hefty spread. This worked well when the economy was largely investment led, but has faltered as China shifted to consumerism. Shadow banking was the Chinese market's answer to poorly allocated credit and huge credit spreads in a fast-growing small business economy. Many banks, SOEs and developers had significant side businesses in re-lending funds at higher rates to small and medium sized enterprises (SMEs). Note, non-market allocation (especially after Lehman) led to corruption and a crackdown in 2014 at the start of Xi Jinping's second year in charge. Shadow market allocation, which largely started after Lehman, was much more efficient, and boosted growth. However, its opaque nature eventually was seen as a threat to Party control of the financial markets, especially as many shadow banks were run by those forced out of government power since 2014.

Now, China is trying to build a better banking system targeted at SMEs rather than SOEs. This week brought another round of reserve requirement reduction, but targeted at banks that lend to SMEs. We wish them luck. It is our view that China simply does not yet have enough loan officers who can properly evaluate SME loan requests -- but because they are told to loan, they will. This is how the US got into the Lehman crisis, with increasingly lax surveillance of housing credit -- because the Government, not the market, said it was good idea for everyone to own a home. Also this week, China replaced the head of the China Securities Regulatory Commission, ostensibly for having been too conservative and failing to innovate. The equity market has not yet become the font of IPO financing expected to fund the transition of SOEs to public/private partnerships. Bottom line, as credit taps open, China, and ultimately the world economy, should be great for 12-18 months – which is what most folks want right now. However, after the 2020 Winter Olympics and the Party's 2021 centennial celebration, things could get exciting -- but for now that's beyond our 2-year crystal ball.

The outlook for a quick solution to the Sino-US trade war darkened this week as Trump was forced to climb down on his wall and the Government shutdown. Not one to lose two battles in quick succession, China now looks tougher – and Democrats are as willing as Trump to build a wall that keeps Chinese goods out. Moreover, there were no US government representatives in Davos to negotiate with Wang Qishan and his team – only the same elites Wang has been lobbying unsuccessfully to influence Trump for a year. We suspect it is now up to Liu He to shoulder the responsibility of a loss of face by agreeing to some kind of IP restrictions for a deal to be cut. We believe regardless of the short-term result this is a battle that will flare again as US elections approach.

Meanwhile, we expect the temporary end to the shutdown will be more enduring. Trump timed his announcement to make the market close and Sunday news shows. The market peaked for the day on the announcement of the speech, but slid after suggesting no support for a temporary fix. Conservatives are angry, but agree the shutdown was not generating leverage. Indeed, it was problems with TSA, IRS and even the FBI that ended this gambit after a second paycheck was missed. Also, anger from Republican Senators mattered – especially Ron Johnson of Wisconsin, a critical state. We doubt the government will shut down again on February 15th, but a national emergency may be called.

It remains unclear whether the President will speak at the State of the Union on January 29th (yawn), but Federal Reserve Chairman Jay Powell will speak at a news conference January 30th. He is expected to keep rates unchanged in January and explain why that is likely to be the case for some time. With a paucity of data available due to the government shutdown, private sector data, including markets, suggest a pause – if not end to tightening – is needed. With the end of the shutdown in January there should be little impact on Q1 GDP, but consensus is still for growth only in the low 2s -- barely above potential. Given that markets are already priced for an end to tightening, little reaction is expected.

With the Irish stating their opposition to any change from the EU on the backstop to avoid a hard border, Prime Minister May has little to offer the Parliament as a Plan B. Ireland may be playing brinksmanship, but it is just one of 23 possible vetoes of May's proposed renegotiations. The Irish despise a hard border and it association with the Troubles. Moreover, a longshot solution is the unification of the pro-leave North with the Republic putting them within the EU. The path toward Parliament taking control of the Brexit process and achieving an end to no-deal by delaying exercise of Article 50 is ever stronger. We continue to believe the EU will not accept a long delay, and the path of least resistance is to kick the can on the whole Brexit mess to the next election – much as President Trump suggested on DACA in his recent offer. As usual, kicking the can suggests a lack of political leadership and will – but that's pretty much the case everywhere today.

To recap, we believe economic uncertainty due to the Chinese credit crunch, the trade war, Fed policy, Brexit and the shutdown has stalled global growth. We see a weak first half to 2019 as a done deal. However, the rapid easing of Chinese credit, the end to the shutdown, and the widely expected pause by the Fed set the stage for a recovery in global growth later in the year. Kicking the can on the trade war and Brexit would add fuel to the fire. These two problems are the hardest to solve as they involve cross border policy coordination – an ever more important factor in a global economy with inherently synchronized cycles. Indeed, we think all nations are in the same global cycle, just at different phases (like housing and capital investment are in the one they still teach at school). In any case, this recovery will not be a barnburner, following the pattern of a long slow liftoff seen in the last two cycles.