GLOBAL
ECONOMY

2/18

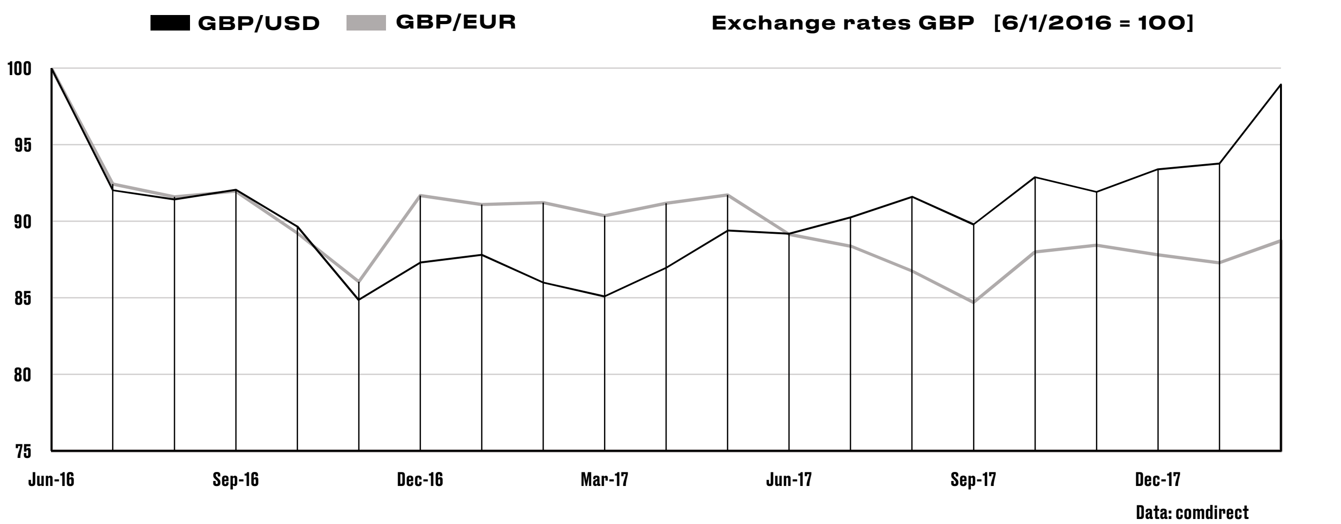
Oil futures herald elevated prices to stay

Drubbing of the Dollar about to reverse, creating volatility

J.S. Research

Theresa May sees her authority weakened yet further while EU27 starts to dig in over transition

She did it again. Not only, that the UK Prime Minister gambled on and lost an early general election back in June of last year; Theresa May also managed to weaken her position even further with one of the clumsiest reshuffles of a British government in living memory. Usually an instrument to assert the authority of the Prime Minister, with Cabinet members as well as ministers fearing the infamous phone call early in the day they have been sacked or at least demoted from their current position, this time around things went rather differently: Not a single senior Secretary of State had to leave or at least change departments, with Philip Hammond, Boris Johnson, Amber Rudd, David Davis and Liam Fox still all in their respective places. In a remarkable extension of this "re-appointment", as the BBC's political commentator Rick Robinson wryly put it, Health Secretary Jeremy Hunt, who was scheduled to switch to the Department of Business, Energy and Industrial Strategy instead persuaded (!) the Prime Minister to stay in his job. No way could have been devised to display Theresa May's lack of authority more ostensibly. More than ever, her government faces the continuous threat of collapse any time, which leads us to re-affirm our projection of yet another general election this year. It is all but impossible to imagine how this weakest of minority governments, propped up by an all too indeterminate arrangement with a wayward DUP, should hope to survive the oncoming, intricate Brexit negotiations on contentious issues such as Britain's status with regards to the European customs union, sovereignty over Gibraltar, or the Irish border. What's more, over in Brussels, the EU27 has stated that they intend the mooted transition phase to end in December 2020 – that is, three months short of the full 24 months envisaged by the British side. And even though this particular aspect of the negotiations might become the first point of rupture in the erstwhile unity of the EU27, the UK cannot hope to get the extra three months as long as Germany and France remain recalcitrant on the issue. The matter becomes even more complicated when taking the underlying reason for the EU's tough stance into account: Any prolongation of the UK being a member of the EU into 2021 would mean that it would automatically become part of the negotiations for the new

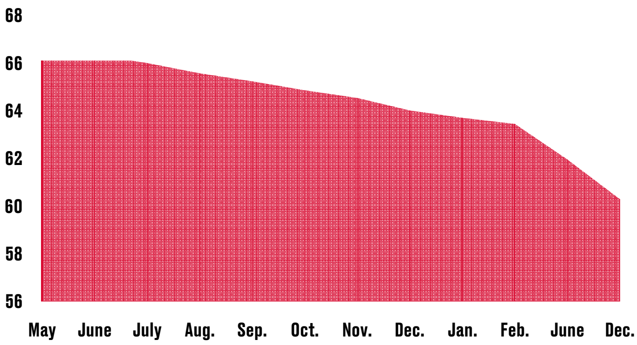


EU budget slated to be thrashed out then – a harrowing prospect for EU diplomats due to the potential bargaining lever it would present to the British. The front lines, thus, become ever more hardened after the brief honeymoon of the breakthrough in phase one of the negotiations, while the threat of the UK government imploding from its self-inflicted weakness becomes ever greater. The real mess of Brexit has only just begun.

Oil futures flipping into backwardation herald elevated price levels to stay

Oil futures markets have flipped back from contango into their traditional dance, known by the name of backwardation. Where contango takes dancers in the futures market from one step forward to the other (with prices rising every step along the timeline), backwardation prescribes the opposite – and that only seems to make sense in the upstream business of crude (see chart). Oil is a non-perishable, cheaply stored commodity not rising in value over time; why, then, should prices be the higher the more distant the fixed date of delivery is pushed? Yet just as dancers cannot easily switch step abruptly, futures markets in commodities tend to be auto-stabilising once a change of tune has occurred. In the case of oil markets, this simply means that millions of barrels stored even on anchored tankers offshore slowly but persistently start to wash onshore because it does not make sense any longer to keep them stored. This is part of the explanation of the recent, lasting draws on oil inventories, if a small one in comparison with heightened seasonal demand, geopolitical factors etc. Over time, of course, this draw on inventories countervails backwardation and eventually flips the market back into contango. Yet right now, we are at the very beginning of the former's cycle, certain to last unless there is a sudden collapse of demand (unlikely, regarding the rude health of the world economy) or an outright reversal of OPEC cuts (also unlikely, because many of the cartel's members have rarely been thus dependent on their oil revenues to finance their government budgets). It is this combination of high prices on the short end of the market and shrinking inventories which builds a wall of expectation driving oil prices higher in the next 6-9 months. Apart from the inevitable effect on inflation (see next article and section "Economic Ticker" on our website), this is going to entail two things:

Futures curve Brent (2/6/2018, 17:06hrs)



Data: Intercontinental Exchange

Net oil exporters will enjoy a prolonged period of improved terms of trade (ToT), buttressing their current accounts, while net importers will see their ToT de-teriorate, stoking inflation (cue Japan, where its central bank will be quite thankful for the effect). In what appears to be a strange twist, however, this trade-induced inflationary pressure will serve to appreciate the related currencies due to the increased room for central banks to normalise monetary policy (cue Nippon again, where the slightest re-trenchment of the Bank of Japan's excessive quantitative easing will result in the Yen displaying bouts of strength). Hence, crude plays an even more crucial role this year than usual: If we will be vindicated and the black gold keeps its elevated levels or even builds on them, a huge rebalancing in the global macro-economic system will be ensuing. 2018 stands to become a watershed in a multi-year (equities, commodities, world trade) or even multi-decade (bonds and other debt) setting.

Exaggerated drubbing of US dollar to be reversed once inflation kicks in, with volatile rebalancing to follow

The greenback has lost its stamina – and not even the passage of Donald Trump's eagerly awaited tax cut could lift it up. Indeed the object of one of our most radical volte-faces since the inception of our company, the dollar closed 2017 as one of the worst performing currencies in the world rather than rising in anticipation of the combined effects of the Fed starting to raise interest rates and a fiscal stimulus resulting from the tax cut – and is expected by most observers to stay weak this year, too. Well, not so fast. Even though we certainly do not intend to repeat our projection of a sturdy buck in early 2017, we again differ from the majority of analysts in expecting a decent dollar recovery from here. Here's why. First, markets in our view underestimate the Fed's determination to put the era of QE to an end. We expect US central bankers to raise rates at least four times this year, with a potential fifth raise in reserve depending on the actual development of inflation. Though rate expectations are baked into cross rates, they are prone to be surprised to the upside, lifting the dollar in the process. Yet even more important will be, second, the eventual effects of the tax cut bill stoking an already booming economy: If inflation has been staying a tame beast for now, don't expect it to lay low in the months ahead (see the related post in section "Economic Ticker" on our website). Energy prices might not continue their bullish run, but they will not collapse either, creating inflationary pressure if for purely statistical base effects (see above). That, in turn, will trigger second round effects, feeding into inflation expectations and, belatedly, wages. Now, on top of that, additional demand is created by Donald Trump's tax cut driving goods prices higher directly. Once, however, inflation will be kicking in, the Fed might be seen to be falling behind the curve, i.e. to have started raising rates to late. That in turn will result in the benchmark 10 year US Treasury yield reaching and surpassing the key three per cent level. Once this comes into effect, the dollar inevitably will recover, yet in a subdued fashion since the US will not be the only country to face inflationary pressure and, hence, normalisation of monetary policy. Yet there is one potent force against this mooted recovery of the greenback: The imminent trade wars the US President seems to be intent on launching will eventually trigger a stark retaliation by China. If Beijing's anger over trade barriers erected against its still vital export industry boils over, it might even threaten to stop buying US treasuries – with devastating effects. In an environment of rising rates anyway, the US are forced by their fiscal policy to sell more debt than planned originally. If one of the biggest buyers goes into strike, too, bond prices will collapse and yields skyrocket. Barring this outlier scenario (for China would harm its own currency reserves), there is hardly any other factor strong enough to keep the US dollar from regaining its foot. Anyway, if our base projection comes to fruition, two effects will follow: First, the erstwhile favourite destinations of investors' money in the past twelve months, emerging markets and their debt in particular will suffer, dragging real economies with them. Second, a sustained rise of the US treasuries' yields will finally have knock-on effects on equity markets, when bonds start to yield significantly more than the average dividend yield of the S&P 500. Even more pronounced will be the effects on high yield debt, mopped up by investors almost regardless of individual risk heretofore. In a first taste of what to expect, on 2 February both US equity and bond markets took a steep dive after new figures for annual wage growth had showed a marked acceleration, thus heightening inflationary pressure. European capital markets, too, had their worst couple of days around the event so far this year. Yet these first paroxysms ought to be short-lived, and the waters will probably remain relatively calm during the first quarter; thereafter, however, you should better prepare for turbulent times in the global economy.

Statistical Bulletin

Services PMI (Jan.)

Italy: 57.70 ↑ The PMI for services in Italy underlined its economy's recent catching up with the rest of the euro area's recovery. However, elections in March threaten to throw the country back into prolonged political uncertainty potentially nipping the recovery in the bud.

Japan: 51.90 → In Japan, the statistic continued to tend sideways, yet that counts as a success as services in particular still suffer from lacking inflation and, hence, retail prices inertia.

Business confidence (Jan.)

France: 113.0 ↑ Business confidence in France continued to virtually boil over in yet another proof of the country's exuberant mode following the implementation of the first reforms by its new President, Emmanuel Macron.

New Zealand: -37.80 ↓ New Zealand's businesses have been displaying the very opposite of last: Since the surprise formation of a Labour/populist right government last year, confidence has plumbed multi-year lows.

Terms of Trade (Dec., pts.)

Singapore: 103.22 ↑ Singapore's terms of trade continued to deteriorate, if mildly. The Southeast Asian city state faces increasing import prices of commodities in particular, mostly in excess of pricing developments for its electronic and other manufactured goods.

Taiwan: 109.90 ↓ Taiwan faces much the same challenge, for the very same reasons.

Exchange rate (Jan., vs. EUR, y/y)

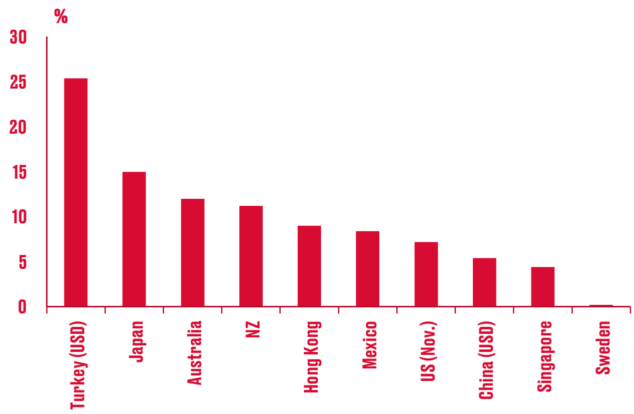
China: -7.5% ↑ China's Renminbi took a dive against the Euro in 2017, though in an orderly, single-digit fashion.

Turkey: -20.0% ↓ By contrast, Turkey's Lira all but collapsed against the common currency, and threatens to continue this trend except for a surprising raise of Turkish rates or a currency crisis resulting from the Italian elections.

Imports growth (Dec., loc. currency, y/y, nom.)

Turkey's imports are growing at a relentless pace, even measured in US-Dollars; by the same token, that is the Achilles heel of the country whose balance of payments becomes increasingly unhinged. In China, the dynamic has been subsiding of last, delivering further proof of a general economic slow-down.

Data: Trading Economics, bloomberg, comdirect, own calculations



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