GLOBAL
ECONOMY

9/18

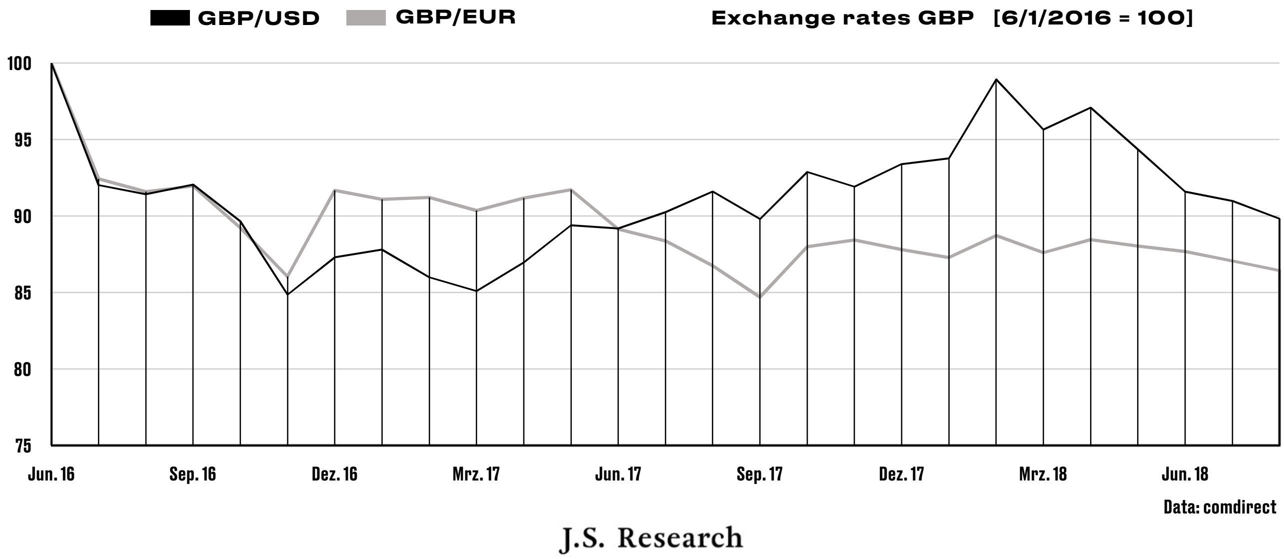
Japan's economy about to lift-off?

Dr Copper sounds the alarm on world economy

J.S. Research

Brexit process in Westminster thrown into complete chaos after Chequers plan declared dead

Only two months after its inception, the fate of the Cabinet's agreement on a Brexit plan at Chequers is what we've been projecting it to become from the start: obsolete. Not only that both ministers resigning over the adoption of the Chequers plan, David Davis and Boris Johnson, levelled scathing criticisms against it in the media just after the summer recess, but both Europhiles and Eurosceptics in the Conservative party, too, have come out in the open against the plan, and at least two alternatives stand to be put against a possible Brussels deal presented to Parliament. The first will be proposed by the European Research Group (ERG), the Brexiteers' faction among Conservative backbenchers and led by Jacob Rees-Mogg. The plan is believed to argue for nothing less but a 'clean' no-deal Brexit and possibly a later Canada-styled free trade agreement, thus augmenting the pressure for a solution to the Brexit process declared all but sunk by all too many observers and commentators. However, the Brexiteers appear to have agreed that the plan will not be presented on the Conservatives' party conference in Birmingham later this month already, which otherwise would have amounted to a direct challenge of Theresa May. Yet bizarrely, aggravating the risk of a no-deal outcome is the fact that many Remainers, too, seem to be following the stratagem that by rejecting a deal struck in Brussels, they can – after some further twists in the road – ultimately secure the reversal of Brexit altogether. That is nothing short of a high-wire act which is much more likely to result in an accident, i.e. a no-deal Brexit, than the rescinding of Article 50 stipulating Britain's exit from the European Union. A second plan is in the making by former Tory minister Nick Boles, who wants to cancel the already agreed transition period and favours the UK to stay in the European Single Market for a period of three years instead to win more time to strike a free trade deal later. Thus, the Brexit menu in Westminster is thrown wide open, with no plan or scenario currently seen able to muster the votes to pass. That is why, meanwhile, the rating agency Fitch has joined us in our bleak outlook, saying they were no longer working with a base scenario of a deal being struck and ratified before March 29 of next year. Anyway, senior EU officials have been quoted in the press expressing severe doubt that an agreement can be reached before December, which

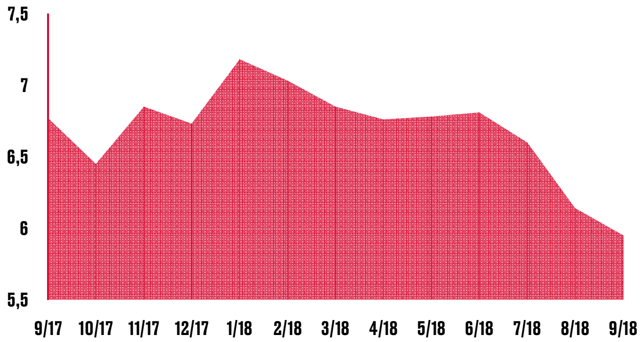


would leave the UK Parliament not being able to have its much debated “meaningful vote” before the year is out. One of the reasons – apart from the persisting quandary of the Irish border – why EU officials are sceptical about an agreement reached before December is that UK negotiators have been displaying their intention to use the future observation of the EU’s agricultural trademarks of origin, such as Cognac or Parma Ham, as a bargaining chip. That, in turn, is certain to ignite the anger of many European countries, but first and foremost of France, whose benevolence is crucial to reach any kind of a deal. Against this backdrop, the only scenario providing a way through the mess towards a deal agreed and ratified before time is running out has become somewhat more discernible: After leaving office, David Davis has seen to it that the alternative plan of his former department to that agreed at Chequers was made public, in effect amounting to a ‘Canada++’ free trade arrangement. Though this currently is way off what the Europhiles among Conservative MPs want, it might become the focal point where Parliament meets after every other plan has been thrown out and the only alternative, then, was a no-deal Brexit. That, however, presupposes that the Remainers and proponents of a soft Brexit among the Tory benches realise in time that their voting against anything but a “Brexit in name only” (see earlier issues of this report) will ultimately result in a no-deal Brexit.

Nippon’s economy might be about to ignite

Are they finally having an effect? When Shinzo Abe, the current Prime Minister of Japan, introduced his economic policies nicknamed after him several years ago, investors and businesses alike were hopeful that the potent mix of fiscal leniency and massive monetary easing would do the trick to push Nippon out of its latent deflationary limbo once and for all. Alas, to this day the programme has not delivered, at least not as much as was hoped for. Of course, GDP growth has been more or less stable since the financial crisis, yet still with the odd, pronounced slumps and rather underwhelming in general, too. Most economists agree that this is down to one element in particular: The intransigence of wages and, hence, the subdued consumption spirits of the proverbial Mrs Watanabe and her family. Even the largesse by the Bank of Japan pumping money into the system on an unprecedented scale while artificially subduing long-term interest rates has not changed that much. Rather, households as well as businesses have preferred to export their cash flows and savings overseas, leaving Japan the biggest international creditor even in front of Germany and well in advance of China. Hence, the economy has appeared to be relatively slumbering in the recent past just as in the years before: PMIs for both manufacturing and services have been staying clear of the neutral 50 points-level, yet not very dynamically. And although consumer spending has been growing, that growth has not been as strong as in the years before that enormous shock of a lift in VAT in 2014. That said, these days it appears that something is stirring in Nippon eventually. Inflation shows tentative signs of struggling free from deflationary territory, even though it has yet to prove its mettle: A comparable outbreak in 2014/15 collapsed as quickly as it emerged. But by contrast to then, labour supply is virtually exhausted, with the unemployment rate at 2.5 per cent and youth unemployment in particular at 3.8 per cent. Wage growth has duly and finally started to lift off, reaching its highest levels in over ten years and feeding expectations that Nippon might be facing an inflationary boost to consumption so long anticipated. That development is mirrored by a sustainable rise of consumer confidence in recent years, and skyrocketing consumer credit in particular, indicating households’ expectations of a persistent rise in their incomes. Further pressure on prices comes from trade, where the ratio between the country’s exports and imports prices, the so-called terms of trade, have been falling over the past months, since global demand for Nippon’s primary exports has become somewhat lacklustre of late while much of its imports – particularly energy – have become considerably dearer. Yet regrettably, there is one major snag which might yet counteract the incipient sunny weather: Should inflation overshoot, the Bank of Japan would have to retrench its massive monetary expansion one way or the other. Indeed, just its having increased its flexibility with regard to its bond buying programme back in July gave a jolt to the Yen, with international investors by now all too accustomed to easy Japanese money on an almost indiscriminate buying spree. And with consumer credit rising as fast as stated above, at some point Mrs Watanabe and especially her millennial offspring might want to repatriate some of their savings parked abroad to finance additional consumption. If those two effects combine to give the Yen a mighty lift, that could strangle vital export industries such as electronics and household appliances. Nippon's manufacturing sector, however, has been adapting to periods of a strong Yen, being able to weather such times far better than, say, ten years ago. And Mr Kuroda, the governor of the Bank of Japan, and his colleagues are unlikely to allow for too much of a rising currency when they are just in grasp of their long-term goal.

Copper spot price ($k per tonne, at first day of the month)



Data: London Metal Exchange

Dr Copper's travails indicate stuttering global economy

It is the only one among the group of industrial metals having earned a PhD: Used in almost every industrial application of our modern economy, "Dr Copper" is one of the leading indicators of the health of the global economy – and it doesn't look all too good these days. Its disconcerting development is aggravated by the fact that its falling price is not so much driven by supply but by demand. Having become the leading global consumer of industrial resources, the slowdown of the Chinese economy has left marks on Dr Copper, too. By contrast to all those often noisy statistics on Chinese credit markets and increasingly doubtful GDP numbers, copper with its international settlement is an unequivocal indicator that Chinese and indeed global economic activity have been hitting the brakes of late. Also, the current mode of the futures market in the metal makes us expect that the falling trend is here to stay: Apart from the very short end of the market disrupted by threats of industrial action at major copper producers, futures are in solid contango until the end of 2019, i.e., prices are rising in the date of settlement. That, of course, is just the normal modus operandi for metals not being subject to decay over time or other specific storage requirements driving spot prices higher than those for delivery in the distant future. Yet by the same token, it is only by way of flipping into backwardation copper futures prices were indicating that the recent fall in spot prices was nothing but short-term supply glut fears. Thus, futures are just corroborating the fact that, currently, the price of copper is very much driven by weakening demand. And it isn't just a blip. A look at the development of copper prices over the past twelve months (see chart) clearly shows a persistent deceleration of economic activity well in advance of trade war fears, say. The only soothing fact, then, might be that copper was increasingly replaced by other natural resources in Chinese manufacturing, for example by glass-fibre or other technologies in telecoms, or a changing mix of ingredients in battery production etc. Alas, the latter becomes nullified by the development of prices of those other natural resources used in battery production, first and foremost cobalt, nickel, and lithium, all of which have been falling over the past months, too (though that was equally driven by fears of a looming supply glut in the case of lithium). And other indicators such as fixed capital investment by Chinese state-owned enterprises (SOEs) falling by an annual rate of 14 per cent in May, according to Bloomberg, clearly show that copper is not so much replaced in its applications but is rather facing a falling base demand. Now is all this reason enough to worry? Surely, the global economy is not about to crash only because industrial metals in general and copper in particular are having a tough time? Well, the problem is not so much a sudden stop of the global economy in its tracks, but rather the implications for a more general slowdown in global economic activity for equity and, in particular, credit markets. Corporate bonds and stocks right now are not only priced to perfection; in the case of high-yield bonds (much sought after in times of meagre investment grade returns), they are well in dreamland territory. Any correction to this excessively sanguine pricing risks triggering one of those feared feedback loops where falling equity and hence asset valuations endanger the sustainability of debts, hence resulting in a bond sell-off – and all that in times of liquidity tightening by global central banks. So do observe Dr Copper's behaviour in the months ahead. If he stabilises, fine. But if his health continues to deteriorate, you better buckled up.

Statistical Bulletin

Services PMI (Aug., pts.)

UK: 54.3 → The services sector in the UK continues to hold up nicely in the face of ever increasing Brexit uncertainty. Crunch-time, however, is only now arriving, with the coming few months certain to become the most turbulent and inscrutable in modern British politics.

Brazil: 46.8 ↓ Brazil's economy still is in the troughs, aggravated by deep political uncertainty in the recent past, too. It is only after the oncoming elections that the country might regain some sort of a firm footing.

Consumer credit (July, y/y)

Austria: +2.7% ↑ Consumer borrowing in the Alps Republic is buoyant, if reasonable. For the time being, it simply serves to underline the country's ruddy economic health and general confidence.

Canada: +4.2% ↑ Canadian consumers, by contrast, have embarked on a credit binge too large for their own good, and that for quite some time now (see issue 6/18 of this report). Combined with a house-price bubble, this is the currently dominant macroeconomic risk.

Business confidence (Aug., pts.)

Spain: -4.3 ↓ Business confidence in Spain begins to turn sour, after first the Catalan secession crisis and then the defenestration of Mariano Rajoy as conservative Prime Minister by a parliamentary vote of mistrust.

Brazil: 53.30 ↑ In Brazil, at least the spirits of businesses have been improving of last, perhaps in anticipation of that very clearing effect – one way or the other – of the elections ahead, as mentioned above.

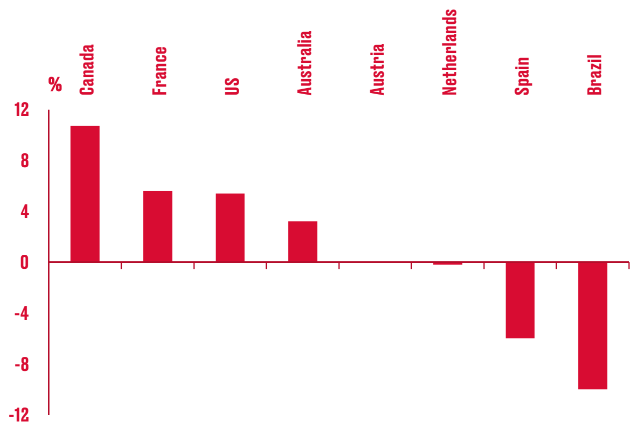
Current account (June)

India: -USD15.8bn ↓ India's current account is its Achilles heel, and has been for decades. Though the country's currency reserves are ample enough to pay for many months' worth of imports, relentlessly rising energy prices are augmenting the pressure on the trade deficit and, hence, the rupee, embattled anyway these days.

Mexico: -USD3.9bn ↑ Against all likelihood, embattled by a bellicose US President (well, in terms of trade, at least) intent on rewriting NAFTA to his country's advantage, Mexico's current account has been improving in the recent past, though the effects of the new accord struck between the US and Mexico remain to be seen.

Loan growth (July, y/y)

Loan growth in Canada is all but outranking all the other G20 countries, which definitely is too much to be wholesome. France, the US, and Australia just display what would be expected of decently growing economies, with Austria and the Netherlands indicating some pause for breath. Spain and Brazil, by contrast, are deleveraging too fast for comfort.



Data: Trading Economics, bloomberg, comdirect, own calculations

Design concept: Firm | www.f-i-r-m.de

Published by J.S. Research KG
represented by Jakob Steffen,
owner & managing director
Dohlenweg 10,
D-42115 Wuppertal, Germany