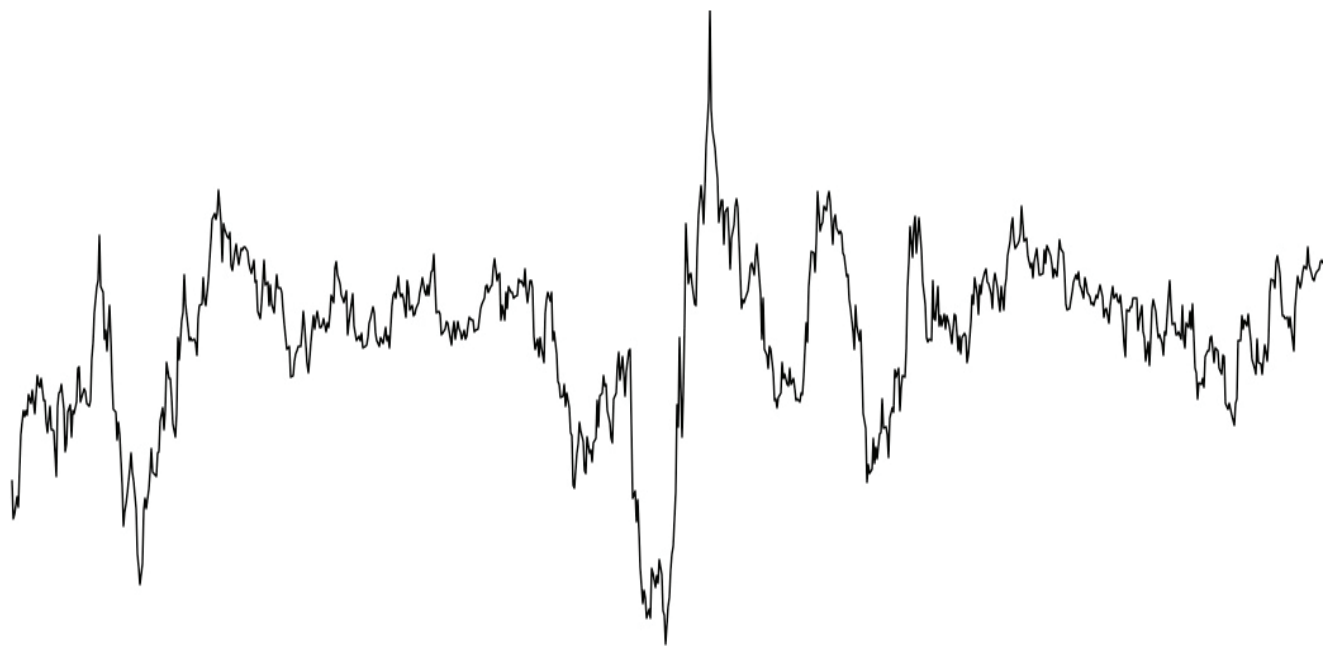


# ALPHA SOURCES

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## FOCUS ON THE OBVIOUS

The market always tries to distract investors from what the obvious themes, a bit like a good striker selling a dummy to a goalkeeper, before he tugs it away. I'll try my best to avoid that mistake here. Seen from my desk, the state of play in the global economy currently can be boiled down to two stories: **First**, the intensifying slowdown in real narrow growth in the major economies, and **second**, the fact that monetary policy divergence between the Fed and the rest of the world is being stretched to hitherto unseen extremes.

This doesn't mean that other stories—EM wobbles, Italian bond market woes, and trade wars—aren't important. They

are, especially for macro traders who have deservedly re-gained their mojo this year. But no matter how much joy investors have in the murky world on emerging market currencies, they will, sooner or later, have to take a view on the two themes highlighted above.

Using money supply as part of global business cycle analysis is a controversial topic. For some analysts, it is the holy grail, while others will walk out of the room if you even mention it. Many economists prefer the credit impulse—the second derivative of loan growth—but if you actually draw the charts, you will find that this indicator very often is closely aligned with M1 growth.



### SHOW ME THE MONEY

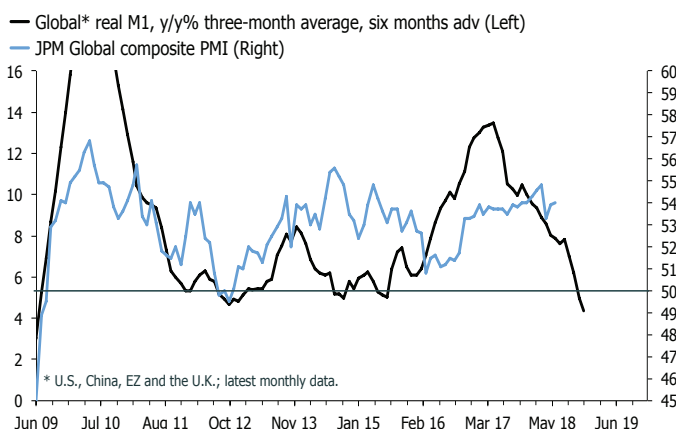
I am no fundamentalist, but I am a big fan of money supply as a business cycle indicator, mainly because it is, from an *empirical* perspective, one of best leading indicators. Its main deficiency is that it isn't equally reliable across the major economies. It is a good predictor for growth in the euro area and China, but not in the U.S.

As an *aggregate* global leading indicator, though, it is an indispensable tool in any serious macro analyst's toolkit, and it is currently sending a clear message. Momentum in global real M1 hit a new low in May, driven by broad-based weakness across the major economies. Nominal money growth is slowing sharply—in part as monetary policy is tightened at the margin—and headline inflation has shot higher. **This is usually a bad combination for headline global growth and risk assets.** The lead to real economic activity is anything from six-to-nine months, and the chart shows that the trend in M1 current signals a grim near-term future for the global economy.

The slowdown in China is particularly striking. Real M1 growth slid to a 36-month low of 4.2% in May, extending the slowdown, which began in earnest in the middle 2017. The last time growth was this weak was in the latter part of 2015, which preceded the swoon in global markets in the first quarter of 2016. The PBoC is aware of the situation; it recently cut its RRR ratio and my colleague Freya Beamish believes that it has effectively given up following the Fed higher. That doesn't mean, however, that the economy and markets won't have to pay a penalty for the slowdown in liquidity growth. In addition, China is not the only major economy, in which narrow money is slowing rapidly. In the U.S. real M1 growth ground to a near halt of 1.7% in May, and in the Eurozone it fell to a 43-month low of 5.7% in April.

**Equity investors will ignore the slowdown in M1 growth at their peril.** The final chart below shows that momentum in the MSCI World already has rolled over, and the trend in M1 signals further weakness.

fig. 01 / Waiting for the downturn? — fig. 02 / Slowly, but surely, equities are losing momentum





### THE FED IS GOING IT ALONE

The slowdown in global liquidity comes at a time when the tightening bias of many major central banks is in the process of being dialled back. In China, the PBoC appears to be in the first stages of reversing recent tightening. In Europe, the ECB is ending QE but also has all but committed *not* to raise rates at all next year, and in the U.K., the Q2 data have so far been horrible. Samuel Tombs, PM's Chief U.K. economist, recently pushed back his forecast for the next BOE rate hike to Q1 2019. Finally in Japan, Kuroda and the BOJ are still thinking, or perhaps dreaming, about a world in which they can actually *do* something, but for now, yield curve control remains in effect.

*The feet-dragging by central banks in Europe and Asia is in contrast to the gung-ho attitude at the Fed.* The Fed-raises raised rates again last week, and the fourth dot for 2018 was added. The first chart below shows that interest rate differentials—here between the Euro-zone and the Fed—have zoomed higher to new records, at least in this cycle.

**In my view, this trend is the single-most important issue for macro-traders and -analysts to take a position on at the moment.**

Interest differentials are not always a reliable indicator for the dollar, but the headline story as a result of widening monetary policy divergence *ought* to be easy: The dollar should rally against just about every other major currency out there. The idea here is relatively simple in the end; the U.S. economy has legs, while the rest of the world hasn't. If you **don't** believe that, you also believe the Fed can't fulfil its dots, in which case there is a big trade to be made.

Meanwhile, a world in which the Fed is hiking while the rest of the world is looking on from the sidelines is a world in which the U.S. curve continues to flatten. The 2s5s recently fell to a cyclical low, and I am on record for saying that that it's time to sell everything when it inverts. At this pace we can expect that to happen in latter part of 2019. That would be great setup for macro investors, except that it's probably also a little too obvious.

fig. 03 / The trend that won't stop — fig. 04 / Patiently waiting for the signal

