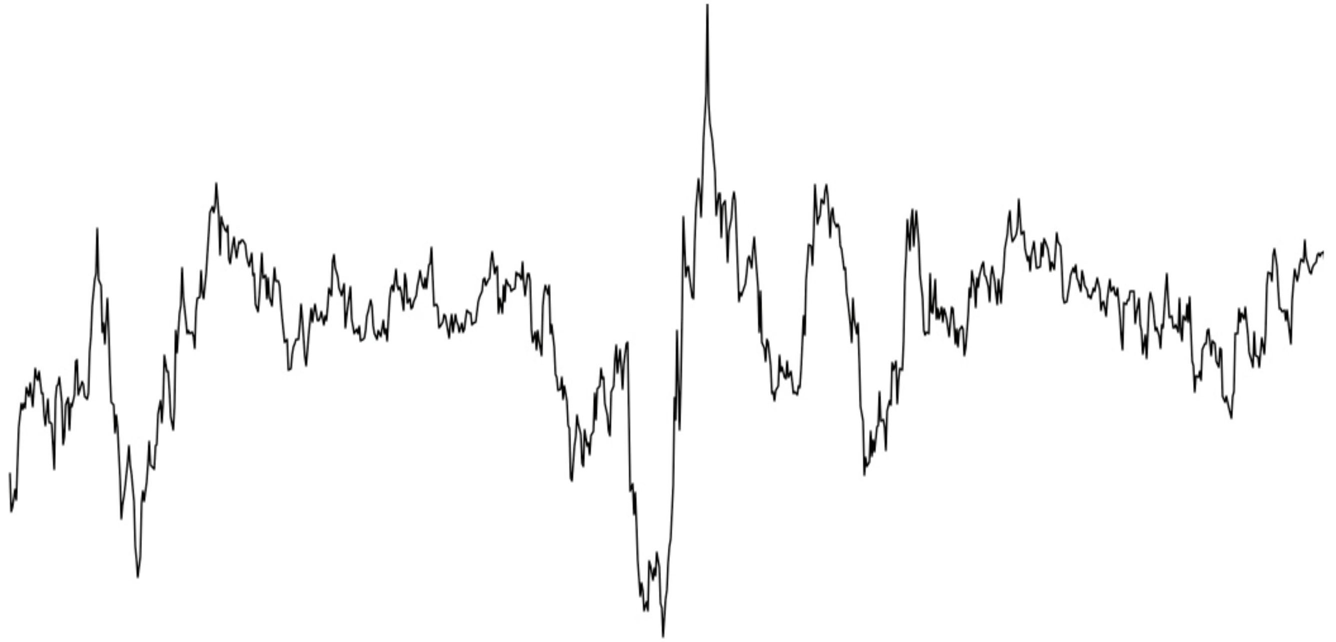
ALPHA SOURCES

AUGUST 13, 2019



CONTROL THIS

I am happy with the conclusion from my pre-holiday missive that FX volatility is making a comeback. Mr. Trump's threat to slam tariffs on Chinese consumer goods earlier this month prompted the PBoC to step back and "allow" USDCNY to breach 7.0. This, in turn, drove the U.S. to label China as a currency manipulator. Markets now have to consider that the trade wars are morphing into *currency wars*. This is significant for two reasons. First, it confirms what most punters already knew; the CNY is inclined to go lower if left alone by the PBoC. Secondly, it has brought us one step closer to the revelation of how far Mr. Trump is willing to go.

The problem for the U.S. president is simple. He can bully his main trading partners with tariffs, "winning" the trade wars, but he is losing the currency wars in so far as goes as his desire for a weaker dollar. The veiled threat to print dollars and buy RMB assets, as part of the move to identify China as a manipulator, is a loose threat. Just to make it clear; it would involve the Fed printing dollars and buying Chinese government debt and/or stakes in SOEs, which would probably be politically contentious. Moreover, the PBoC could respond in kind; in fact, it probably would. As such the next obvious step is outright capital controls, either

* / See additional charts on final page.

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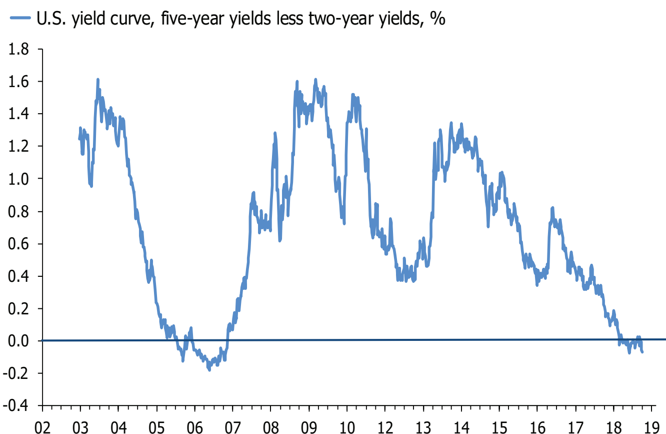
in the form of a tax on portfolio inflows, as proposed by Michael Pettis Matthew Klein here and here, or outright quotas on inflows, which would be the most draconian measure. War-gaming such a policy move is complicated, though allow me to spell out the main thrust of it. We are considering the idea of a tax or quota on buying assets denominated in the leading FX reserve currency of the world, which just happens to also be the currency of the world's strongest economy, with the deepest capital markets. **It's safe to say, I think, that markets' response to such a move would be cataclysmic.**

Unless this move is associated with a genuine desire in the U.S. to transition to an autarky, effectively leaving a big portion of its hard and soft power on the table, demand for USD will soar. This is because the only reasonable response by the rest of the world, especially the euro area and Japan, would be to print their own currency, in size.

I am happy, though, that this story is now out in the open. *The proponents of U.S. capital controls are, I suspect, also proponents of MMT, but it is only now that they're coming clean in terms of the actual consequences of taking their policy proposals to their logical end-conclusion.* In the main, they are grumpy that the U.S. is running a CA deficit, and wants the rest of the world to do "its part," but as Sri Thiruvadanthai, Director of Research at Jerome Levy Forecasting Center, explains here, it is a lot more complicated than that. My gripe with this argument is that it effectively proposes that the U.S. imposes its will on the rest of the world, and achieves a better 'competitive position' in the process. Those goals are irreconcilable, assuming free capital mobility that is.

In any case, this endgame is still theoretical. After all, if the White House cares about the stock market, and the short-term performance of the economy leading into next year's election, it ought to stop short of such dramatic measures. The move in USDCNY shows the futility of the strategy, but the euro and yen have *rallied* slightly in response to the dip in risk assets, nicely confirming their role as carry trade funders.

fig. 01 / Markets to the Fed ... fig. 02 / ...You're not done yet



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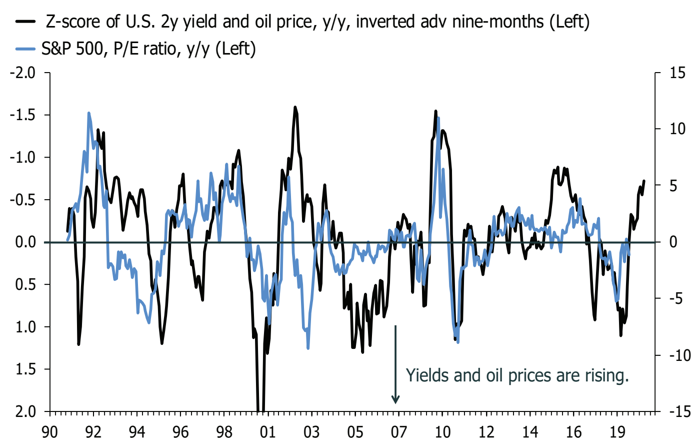
In addition, Mr. Trump probably will achieve part of his objective with his latest move; namely to drive the Fed funds rate lower. The FOMC duly cut rates in July, validating expectations, but markets aren't satisfied. The 2s5s remains inverted, and Eurodollars are still looking for significant easing next year.

With the recent shift in Fed, and indeed global central bank, discourse towards one based on downside risks, and the application of "insurance" rate cuts to ward of recessions that haven't yet occurred, it's difficult to pin an ironclad story on this. Either a recession is coming, no matter what monetary policymakers do, or the FOMC and its peers will do more, ultimately averting one.

Both of these scenarios point to lower short-term interest rates, especially in the U.S., which I reckon remains a fair bet. The alternative is that the Fed makes a spectacular u-turn towards old-school monetary policy, and re-starts its hiking cycle. This would be extremely painful, but it seems unlikely at this point with Mr. Trump still on the warpath, though the economic data will be watched closely by markets. ***Too much "good news" and we could be in trouble!*** With respect to the long-end, 10y yields *ought* to rise if the Fed does the market's bidding, which is to say, bear steepening the curve. Long rates remain locked for now, but if markets are even half-right about Fed policy, I'd rather not be limit-long 10ys; in fact I'd probably be short.

With respect to equities, I'll do a deep dive in the next few weeks, but the main story is unchanged. **Further upside requires that multiple expansion wins the tug-of-war with stalling earnings.** It has worked a treat so far this year, and falling yields and oil prices indicate that valuations can rise further. That said, the price action in August so far shows that there is a limit, especially if the U.S. and China are about to duke it out in a currency war. If I am right on the yield curve, financials and energy ought to be nice contrarian plays on a bit of outperformance. But for the index as a whole, base effects are challenging for strong returns in H2, especially after last year's Q4 plunge.

fig. 03 / Taking equity valuations higher into year end? — fig. 04 / Will this ever stop?



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