

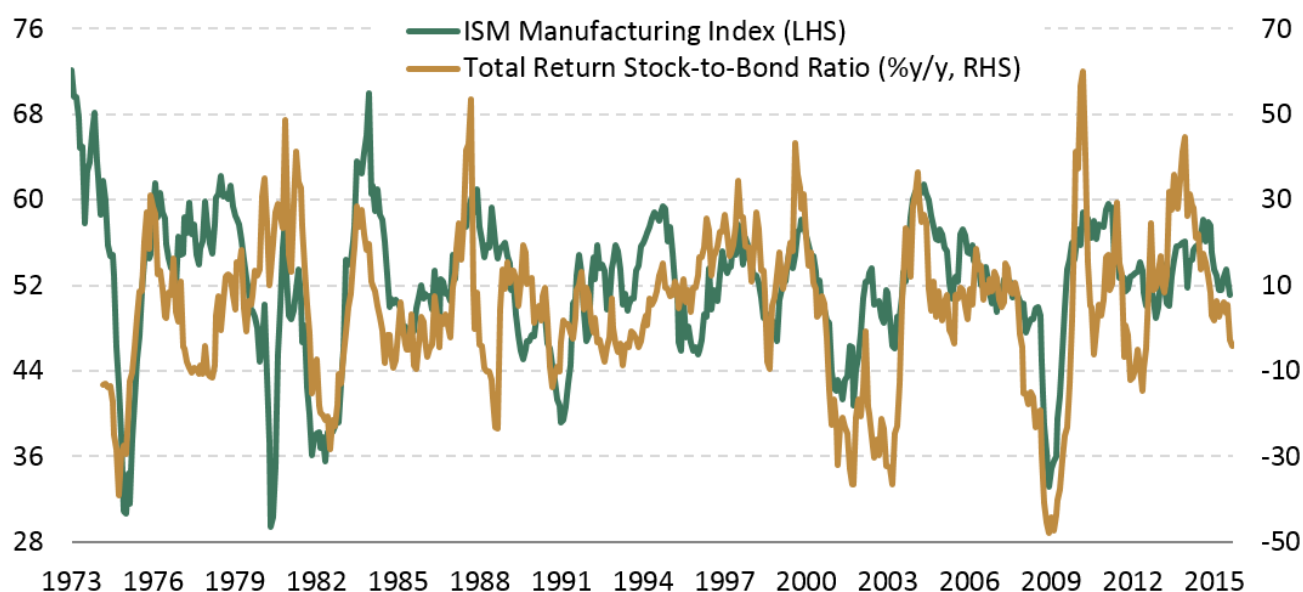
Navigating Through the Deflationary Crosscurrents

Two big market irritants—China and Federal Reserve (Fed) policy—have been the key reasons causing the global shakeout in risk assets since August. The question is whether these negative factors are fully absorbed by the recent market actions. The S&P 500 is down by about 9% from its recent highs, but 10-year Treasury yields have actually risen, standing at 2.2%. Market expectations of a rate hike have increased since Vice Chairman Stanley Fischer spoke at the Jackson Hole economic symposium on August 29.

Market signals suggest that downward pressures on global growth remain intense:

- The equity-bond ratio has dropped to levels consistent with a major growth slump in the world economy.

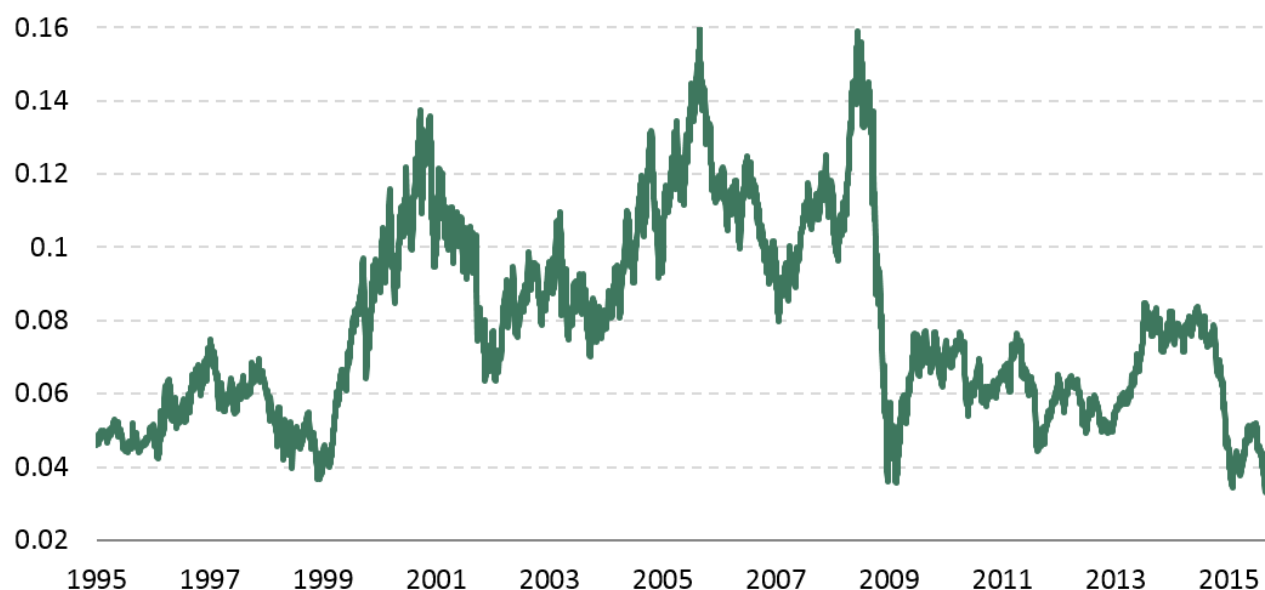
Chart 1: ISM Index & Stock-to-Bond Ratio *As of 8/31/2015*



Source: Thomson Datastream

- The oil-gold ratio has collapsed by 60%, which often happens during a bad recession.

Chart 2: Oil*-to-Gold Ratio As of 9/10/2015



**West Texas Intermediate Spot Price
Source: Thomson Datastream*

▣ Quality spreads have widened out from corporate credits to sovereign bonds.

Measured in the U.S. dollar terms, year-to-date returns for all asset classes are negative except corporate high yield bonds. During previous recessions, stocks and commodities always fell, but bonds usually performed well. This time around, bonds have failed to deliver positive gains so far this year, perhaps because yields have already fallen to levels consistent with a nominal recession. As such, bonds have ceased to function as safe-haven assets.

Table 1: Year-to-Date Index Performance

Index	YTD % Change	Index	YTD % Change
CRB	-9.8	DAX30 (\$)	-5.0
WTI	-13.4	S&P 500	-5.3
BRENT	-13.8	UST 10Y	-3.6
GOLD	-4.4	UST 30Y	-12.7
Junk	0.31		

Low nominal growth has been a key problem for global stocks. Chinese nominal gross domestic product (GDP) is at levels considered a “growth recession.” Brazil and Russia are already deep in recession. South Korea, Taiwan,

and Singapore have seen both price deflation and negative GDP growth for a few months and Japan's growth has been hovering around 0%. Euro-zone nominal GDP is 2%, lower than the levels during previous recessions, except for 2008. Canada has had six consecutive months of GDP contraction.

It seems as though only European Central Bank (ECB) President Draghi is concerned over the state of the global economy. Recently, he openly admitted the possibility of deflation in the euro zone and has warned of the negative impact of the emerging-market fallout. His remarks sent the euro sharply lower on market expectations that the ECB's quantitative easing program may be augmented. Nevertheless, neither the Fed nor the People's Bank of China seem too worried.

So far, China's policy response is very disappointing. There is no indication that Beijing will move aggressively and quickly to address the worsening problem of inadequate demand and a credit crunch. I believe Beijing's stimulus packages have been piecemeal, ill-conceived, and badly executed. Earlier in the month, China announced a \$10 billion enterprise fund aimed at providing funding for small businesses, but the scale of the program is too small to matter.

Despite five rate cuts, the real borrowing cost for the Chinese private sector is still punitively high, ranging from 12-15% in nominal terms. Frightened by more loan losses, Chinese banks are reluctant to lend. Risk premia in the private borrowing market remain extremely high, causing a serious credit crunch.

Fiscal policy is unduly tight, with all levels of government running either small budget deficits or even surpluses. Although fiscal stimulus is ramped up, the scale of public sector spending is too timid relative to the overall shortfall in aggregate demand. The yuan is way too expensive for Chinese manufacturers. Suffice it to say, the economy is fighting against the combination of very tight monetary, fiscal, and foreign-exchange rate policy.

Even though President Xi completely dominates both political and military establishments in China, he does not seem to be overly concerned about a slowing economy. Xi is probably ready to allow the country to endure some pain in order to transition the economy into a new model that is environmentally clean and primarily driven by consumer spending and services. These potential objectives explain why the Chinese government has done very little to salvage failing manufacturing businesses. Instead, authorities continue to force the shutdowns of factories that are considered to pollute the environment.

Is China's economy about to go through a downward spiral as many feared? So far little evidence exists that this is happening. In fact, broad money growth is picking up and credit creation is quickening somewhat. Most importantly, the Hong Kong China Enterprise Index (i.e. H Shares)—which is free from mainland government manipulation—suggests that although growth is subdued, the Chinese economy is steady.

Chart 3: H-Shares *As of 9/11/2015*



Source: Thomson Datastream

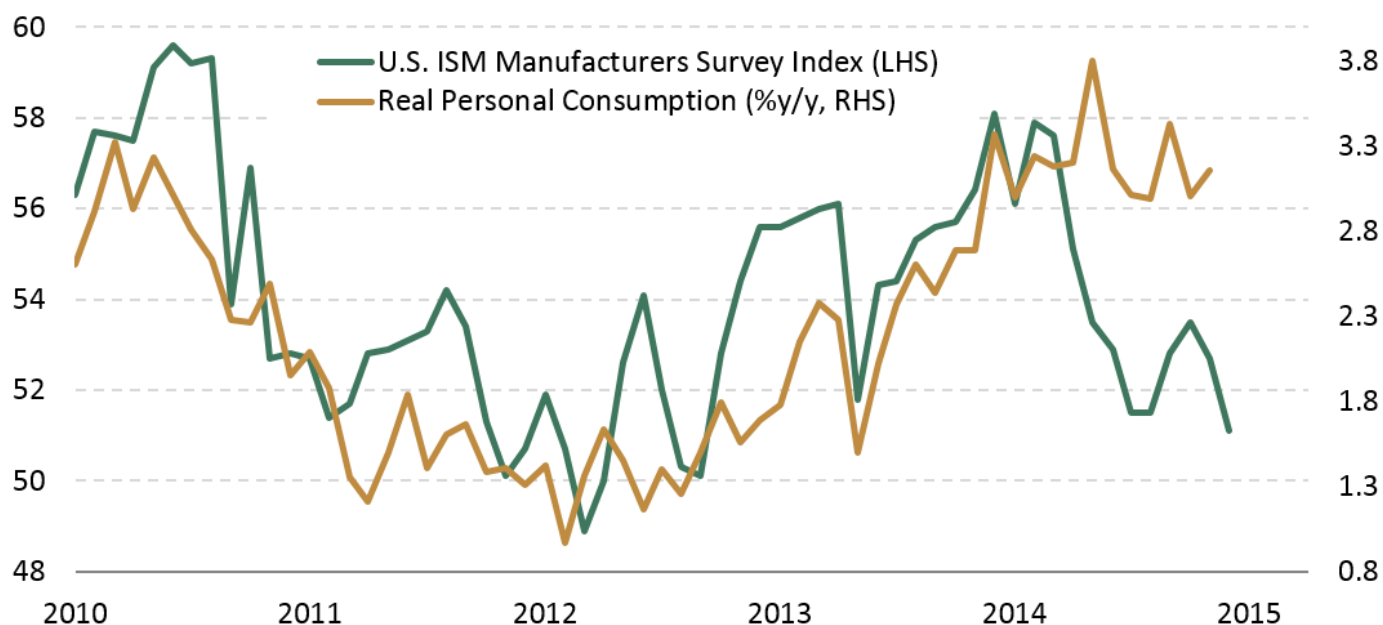
It is entirely possible the Chinese government will continue to follow its recent pattern of incremental easing. If so, there would be no “clean break” between a cyclical bottom and a recovery. Instead, growth could simply bump along the path of 6%-7% for a while longer. The economy doesn’t seem to be facing a big disaster, but it’s not in a major acceleration either. In other words, a big flat trajectory is the most likely outcome as far as growth is concerned.

With Chinese authorities not in panic mode, Fed policy is on a different trajectory. I think the Fed looks set to raise rates this year. Emerging market troubles and falling inflation have not changed the attitude of Fed policymakers. From Dennis Lockhart to Loretta Mester to Stanley Fischer—and most recently Jeffrey Lacker—the hawkish chorus at the Fed is growing louder by the day. Compared to Draghi’s cautious assessment of global growth and dovish tone on deflation, Fed policymakers sound increasingly hawkish.

The U.S. seems to have a two-tier economy: while a strong dollar and lower energy prices have crimped exports, dampened the oil sector, and caused tradeable goods prices to fall, domestic spending has been rather resilient. It seems that low interest rates, falling energy costs—and most importantly—an improving labor market, are insulating domestic spending from global shocks. In the meantime, money and credit creation is also fairly robust. Commercial and industrial loans are growing at a 7-8% annual rate. Together, these are the reasons why the Fed feels that it is ready to nudge rates higher.

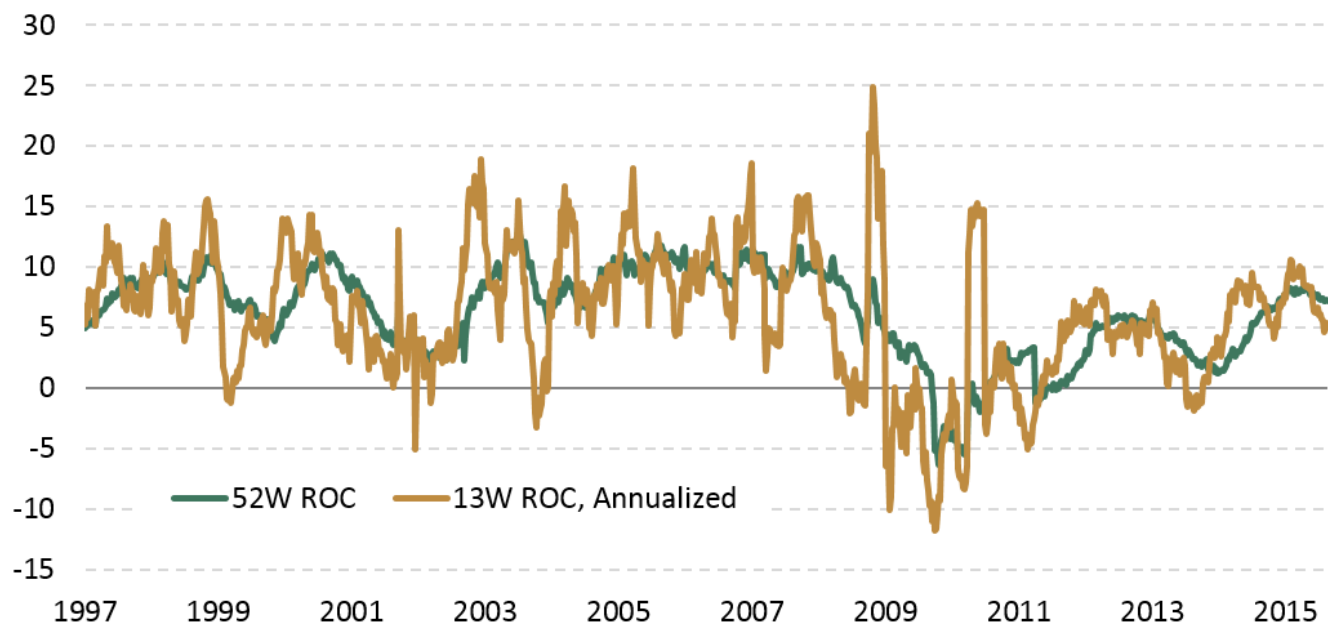
Chart 4: U.S. ISM Manufacturers Survey Index and Real Personal Consumption

As of 7/31/2015



Source: Thomson Datastream

Chart 5: U.S. Commercial Banks: Bank Credit Percent; As of 8/19/2015



Current prices, seasonally adjusted

Source: Thomson Datastream

In the end, the Fed cannot conduct its monetary policy in isolation. The intense deflationary pressures in the global economy and the much-muted inflation picture in the U.S. economy suggest that an expected rate hike—if

it is indeed delivered this year—would be largely symbolic in nature.

The global growth picture will not brighten up quickly with the Fed contemplating a rate hike and the Chinese government behind the deflationary curve. As such, risk assets may still face strong headwinds unless or until significant policy shifts take place. I believe the catalyst needed to revive reflation trades will either be the Fed starting to acknowledge global deflationary forces and refraining from signaling a rate hike, or the Chinese government starting to implement a powerful fiscal stimulus package.

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