Money, Macro & Markets

With a commendable – if belated - recognition of the unstable nature of the Chinese maxi-flation process (which is about as well-founded as a seaside hotel in a storm-surge), the market's heightened fears of even a partial abatement of the PBoC's largesse triggered the largest correction in the runaway Shanghai composite suffered in six months. At the same time, the market has yet to resolve its migraine—inducing cognitive dissonance over the state of those Western economies where monetary expansion is also proceeding apace and where it is similarly being channelled through state-owned, -controlled, or -supported entities, if not *quite*, so far, on the prodigious scale that Beijing has managed.

Thus, though it volubly bewails the prospect of 'deflation' – disregarding the rapid increase in the very same M-numbers which must, by definition, shrink if this is to occur - it also remains childishly happy to buy stocks on 'better' earnings (while ignoring the truly awful 20% fall in non-financial revenues which has accompanied them); and is pathetically eager to chase junk credits back to the middle of the band which pertained over the decade-and-a-half prior to the outbreak of the financial crisis, shaving almost a round one *thousand* basis points off their spreads to Treasuries.

So far in anticipation of a sustainable flow of earnings (Note to Mr Market: while everyone needs to adjust to the harsh new realities, it is impossible to grow nominal profits indefinitely out of ever lower sales) and so far ahead of even a peak in defaults and bankruptcies (sales as debt cover for the over-geared and commercial RE for many of the remainder), this can only be rationalized as a psychology of *in*flation, and *not* its converse.

Figure 1: KDP junk spread to UST

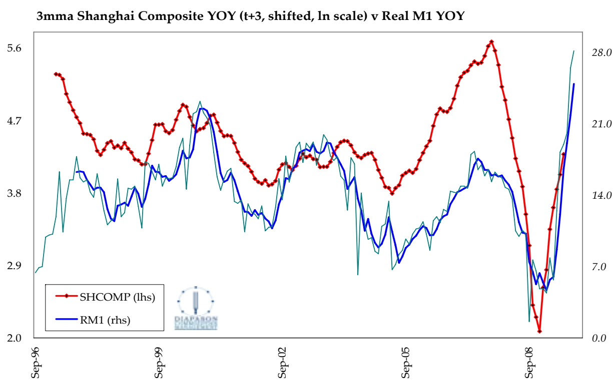

Figure 2: China Real M1 v Shanghai Composite

In its inimitable manner, the market also raised a ragged cheer in response to the news that 'only' an estimated quarter-million Americans lost their livelihoods last month, for the usual reason that this was neither as bad as has recently been the case, nor as elevated as had been divined from the steaming entrails of goats by the 'consensus' of professional haruspices who are second only to climate modellers in their combination of shrill persistence and fundamental incompetence in the science of prediction.

So, with fifty people being fired from the private sector every minute of every eight-hour working day this year (one a second if we discount the highly suspect birth/death adjustment); with the private work force slipping to a 22-year low 36% of the population; with seven *million* man-years the tally of lost production and earnings foregone by the current unemployed; with a record ~50% exhausting the normal 26-week benefit period (and so artificially depressing the weekly claims data), a whole barred-spiral of luminaries has rushed to proclaim the end of the recession.

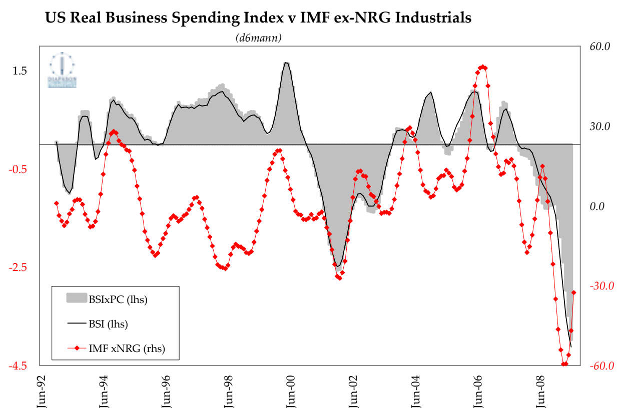

Figure 3: Business outlays and commodity prices

GDP may well pick up – after all, the trade gap is the smallest in nominal terms since QIV'99, cars are going to be sold (and presumably replaced) in sizeable quantities, and (*cf* below) federal outlays are running 22% above the same period in 2008. But, so far all the crucial elements of business spending seem to be militating against this meaning much. Pinched by falling sales (also off 17.5% YOY at the aggregate level) and collapsing 2-way trade flows (down 31.5%), there remains a marked disinclination to increase outlays on workers, inputs, or plant and machinery – a critical point since business-to-business spending is typically 2 ½ times the size of the personal consumption outlays on which so much blind emphasis is usually placed.

Obama and Bernanke may be close to moving the entire US inside a Schwarzschild horizon of heavily-monetized deficits – and hence helping Americans to burn their remaining sticks of furniture in the attempt to keep warm – but it cannot be over-emphasised that a high GDP count is not indissolubly linked to either wealth creation or corporate profitability.

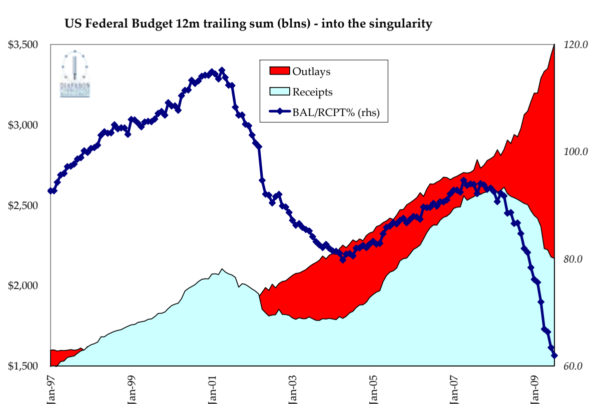

Figure 4: The US Deficit black hole

The potential implosion in US creditworthiness is being led by a fall in Federal Government receipts which was only once greater, in 1931, while the rate of increase in outlays in peacetime has only been exceeded in the New Deal years of 1931, '34 & '36 when, of course, they were starting from a much lower base. The difference between the two has only twice been wider – amid the global disaster of 1931 itself - and in 1942 – America's first full year of participation in WWII. In detail, 12-m trailing outlays are rising at 20% YOY - the fastest nominal pace since 1976 - while receipts have fallen 14.8% YOY - their fastest drop in at least 40 years. The percentage cover for outlays has been a pace-settingly poor 56% so far in calendar 2009, taking the deficit to no less than 78% of receipts and to a staggering 14% of private GDP where it is on track to reach between $1.6-$1.8 trillion for the full year - equivalent to the entire GDP of Spain, Russia, or Brazil.

Just as well, then, that the Fed and its confreres abroad have directly monetized almost 60% ($570 bln) of the net new debt issued this year, while the $665 bln of base Agency and MBS paper also magicked into cash has helped make Treasury paper seem a good deal less scarce to those whose offers it has so generously lifted. By its own admission, the Fed alone will snap up close to another $900 by year end while the other CBs – still engaged in an undeclared struggle to supply vendor finance to their countries' larger foreign customers – are unlikely to pull back just yet. Karl Helfferich and Rudolf Havenstein would be proud of them all: dollar bulls may not be quite so enamoured if the current trend holds.

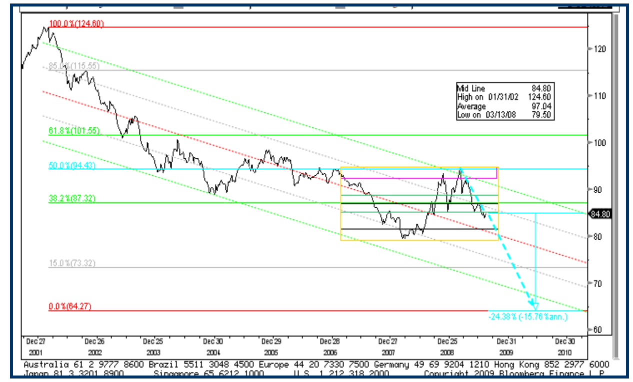

Figure 5: USD TWI index – feeling gravity's pull?

Commodity Corner

Record high seasonal inventories for all of oil, mogas, *and* heat; multi-year demand lows for each (3 years for Lo-S distillate, 6 for mogas, 9 for crude, off the chart for Hi-S); 16-year seasonal low refinery runs and 20+ year low capacity utilization rates; a market every bit as bulled up as before the June correction (having added 45% of the net spec crude long last week alone); Cushing overbrimming, WTI lagging, and contangoes rising; Natgas, coal, an uranium all languishing; chemical rail-car loadings at an 8-year seasonal low.

Given the above litany, it is very hard to love energy in general and relatively expensive mogas in particular… and yet we wouldn't like to be caught fading this mystical rally if some *Deus ex Machina* pops it through the early August highs, not with so much hot money making such large holes in trouser pockets everywhere.

Figure 6: September RBOB – just needs a spark

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