Material Evidence

Sean Corrigan

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Money, Macro & Markets

So not only has that economic sage *sans pareil*, Ben Bernanke pretty much declared the recession to have ended, but so have his master's, Obama's, teleprompter editors, too, and joy everywhere abounds!

Perhaps they should have consulted McKinsey whose latest global survey – while showing more guarded optimism than heretofore – have one third of all respondents (and 45% of manufacturers) declaring that their own companies are currently 'in crisis'. With almost half of the 1,549 firms around the world declaring that their No. 1 priority is to cut operational costs - and with the number restructuring to achieve that goal equalling those focused on renewing growth - the Generals' views, from the salubrious surroundings of their distant chateaux, do not exactly reflect the dispatches being received from the Donkeys up at the sharp end.

Reinforcing this contention, a George Mason study of some 3,500 non-financial corporates in the US, may admittedly point to some modest improvement in their generation of free cash flow, but it also emphasizes that this came only at the expense of lowered capex, tighter inventory cash management (i.e., a squeeze on both suppliers *and* customers), and a lower tax bill which was itself a consequence of reduced profitability.

We have said it before, though it bears constant repetition if only to drown out the Keynesian fetishization of the role of the 'Consumer', business spending in an advanced economy is usually more than twice as large as personal consumer spending and is *far* more discretionary (a business does not need 2,000 calories a day, for example). Moreover, private industry in, say, the US disburses – by means of wages, benefits, taxes, and net dividends – over four-fifths of the monies subsequently spent by its workers, pensioners, welfare contributees and their associated bureaucrats, and shareholders.

With their crude, child-in-a-sweetshop, demand-pull concept of the economy, the mainstream monotonously emphasizes the Egg of the latter's outlays, neglecting to consider that it is the Chicken (or, perhaps, the Golden Goose) which is not only antecedent – since the prospect of profit predicates wage payments and production must precede its own purchase - but which needs careful husbandry if it is to be persuaded to lay anything at all.

It should also be noted that these birds have their own distinct pecking order – and often a corresponding variation in their robustness – in what an Austrian would call the 'Structure of Production'. A near perfect illustration of this can be had by looking at the change in revenues suffered by the standard, broad S&P500 industry groupings between the successive first halves of 2008 and 2009. With the anomalous exception of Finance (no comment needed, here in - YAWN! - - Lehman Week), the 'higher order' the grouping (and hence, the less contribution it tends to make to that blessed GDP number whereat far too much analysis starts *and* stops), the bigger the loss suffered.

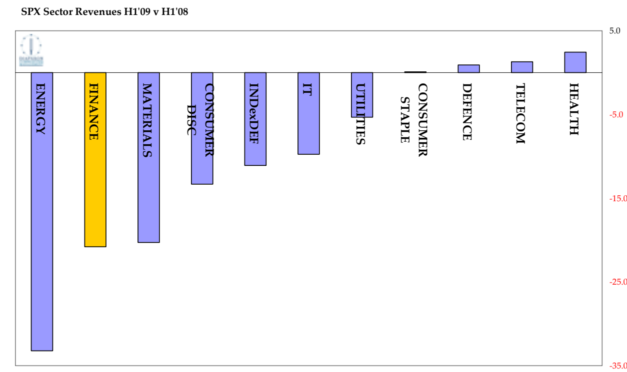

Figure 1: US Revenue % changes HI'09 v HI'08

Hence, why we can better gauge the underlying state of the economy by looking at exactly those features of capex, inventory spending, output and trade (not only 'globalization' in a boat, but a direct mirror of B2B spending everywhere) we tend to emphasize. Let us here introduce a few telling charts by way of a status report.

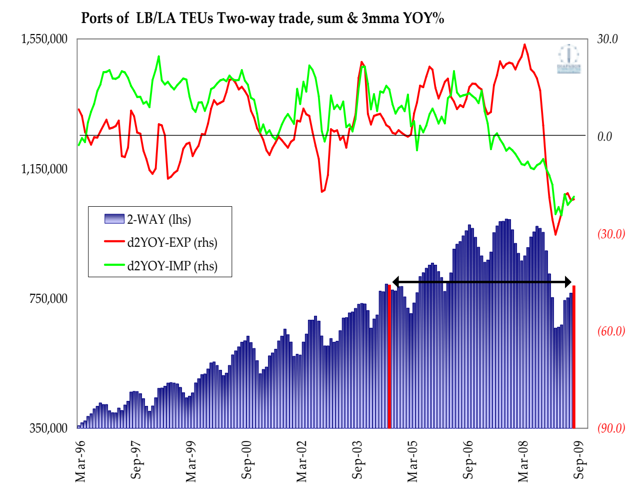

Figure 2: US West Coast TEU traffic: 3% down on 2004

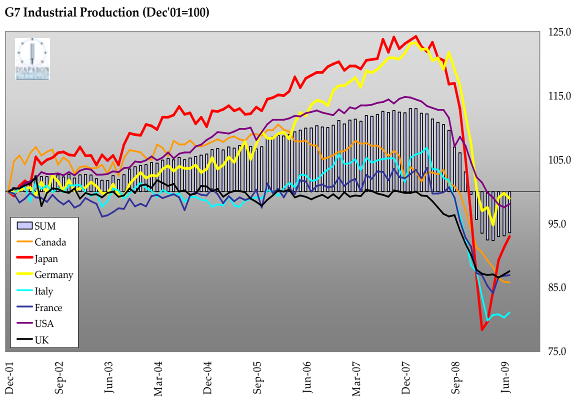

Figure 3: G7 IP: No gain since the '97Asian Pain

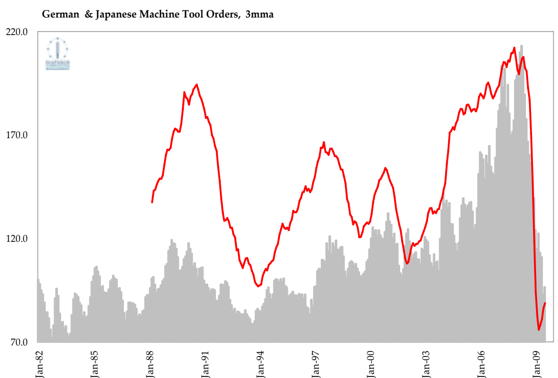

Figure 4: Machine Tool Orders

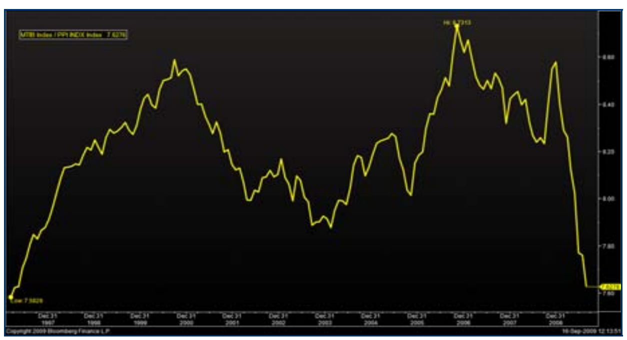

Figure 5: US Real Business Inventories - 12 year low

But, as we know, the stock response to this Grand Dislocation is to funnel money to those businesses most broken by it and to try to maintain the gross flow of new, (government-borrowed) dollars into a system shattered by its over-reliance on foolhardy increases of similarly unremunerative debt in the first place.

While that money percolates into the system, it will be hard for genuine entrepreneurs to deduce the right signals regarding both the long-term demand for their products and the likely cost they will incur to make it.

Figure 6: SPX x USD TWI – breaking resistance

Figure 7: MSCI EM x USD TWI – also close…

Not the least of the noise they will have to filter out is that mighty roar emanating from the money's effect on asset valuations, as well as currency and interest rates. For example, we can see that a stock market breaking all manner of chart points in its rebound is becoming increasingly divorced from the sorry state of real business – a conundrum whose solution is that earnings multiples (perhaps THE key driver of medium-term prices) tend to expand when money is easy and to contract when it is not, greatly magnifying the effect of that laxity and restriction on earnings themselves.

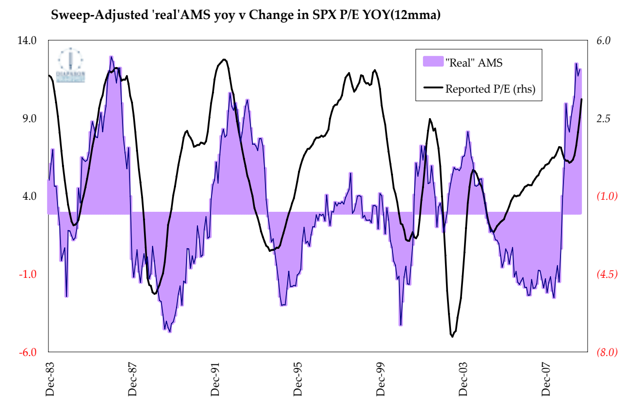

Figure 8: US stock multiples and money supply

As if this were not bad enough, there is the small matter of the fate of the $1.3 trillion overhang of excess reserves, currently being redeposited with the central banks of the UK, the Eurozone, and the US. There are some grounds for including this war-chest – however tightly locked up it may be at present – in the money supply proper on the grounds that it could all be spent or lent at whim by the increasingly avaricious bankers who have thus far clung to it out of a justifiable fear that their peers

– all too aware of the true state of their own parlous balance sheets – might refuse to finance them in their hour of need.

At a time when the Old Lady is publicly musing over whether to effect exactly such a shift by penalising those who hold them (possibly by the extraordinary Riksbank method of charging for the privilege), this might be of more than academic importance. To see the theoretical impact, consider that, if the ECB got its contribution fully mobilised, it would push real M1 from its already rapid 12.9% p.a. to almost 19%. If the BoE were to do likewise, we should be talking about a boost from 3.9% to over 18%, while if the Fed got into the game, we would see a veritable Saturn V launch from the current run-rate of 12.1% YOY ***to an escape velocity in excess of 50%!***

Figure 9: LEH, who? Total vol for oil, bonds, stocks, FX

Though matters are unlikely to be as dramatic as this suggests, the more asset markets climb and VARs fall, the more the dollar declines and everything else rises, the greater the temptation to put at least some of this pile to work 'earning' a return, regardless of whether the local CB actively promotes the deed.

Commodity Corner

If the Green Shooters would only admit it, there is little more timely testimony to the scale of their premature optimism than in the market for crude oil products. For example, low-sulphur distillate still shows greatly depressed demand and elevated supply – a key feature of our business v consumer argument with road freight traffic off twice as much as the passenger equivalent this year in the States (-13.5% v -6.8%)

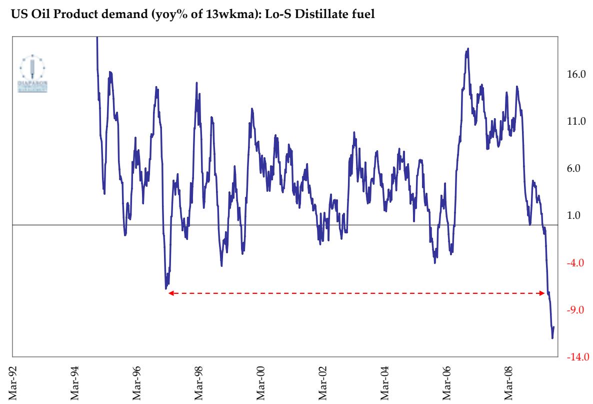

Figure 10: Lo-S Distillate YOY% of 13wkma

Partly as a result, the percentage profit to be made by refining a barrel of crude has plunged to a bare 3.8%, 1.4 sigmas below the 26-year mean of 15% and down there in the 98th percentile. No wonder refinery utilization is unusually low and global tanker rates are falling off the bottom of the chart.

Elsewhere, bond bulls should note that the upturn in dollar-based commodity prices has pushed up those of US imports and that this is at last beginning to feed through into the official CPI number – but then, silver – whose real price has a long history of preceding overall price level changes – seems to have been telling us that for the past two months.

Figure 11: Import prices v CPI YOY%

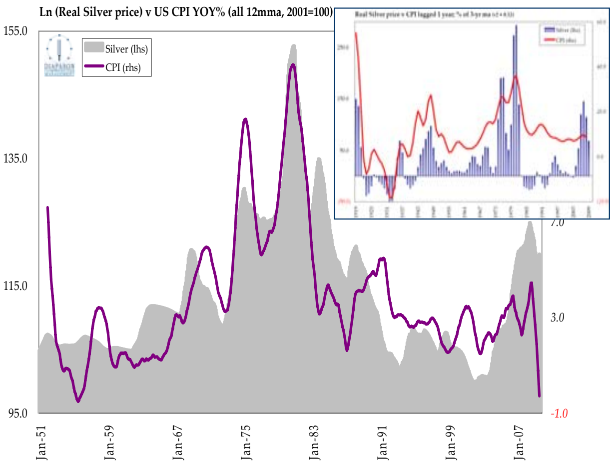

Figure 12: Real Silver price v CPI YOY%