Material Evidence

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Money, Macro & Markets

As the market holds its breath, pending the next tightening move from China, Caing magazine reveals a novel approach has already been instituted with the aim of curbing over eager loan officers at one major bank – head office arbitrarily locked all branches out of the company intranet!

So , there we have it: no need for Volcker reports and Dodd-Frank proposals; no necessity for Tobin taxes, bank break-ups, or Commissar Krugman mass nationalizations - just pull the plug a couple of times a month on the derivatives desk and send the structured products crew out for a mandatory stroll around the block three times a day. That should be enough to put a crimp in their capacity to make mischief on quite the same $trillion scale as has been their recent custom.

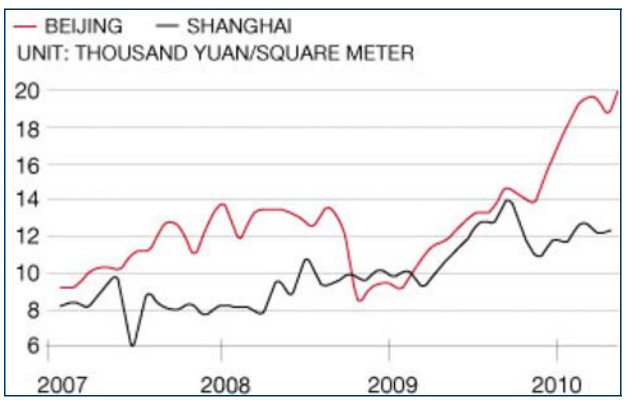

Fig 1: Chinese RE - The Witches' Brew

Back in China itself, the PBOC has already taken the more orthodox step of upping interest rates and mandatory deposit levels on mortgages in a further attempt to cool the speculative fever there: to what avail, only time will tell. One ominous development is that – as the same magazine article noted – off-balance sheet lending has been taking place on an "immense" scale and the sale of 'credit-based financial products' has also been accelerating after last year's partial crackdown. If such end runs around the regulators really are still an important part of the playbook, ultimately only a sharp rise in interest rates is likely to suffice to burst the bubble.

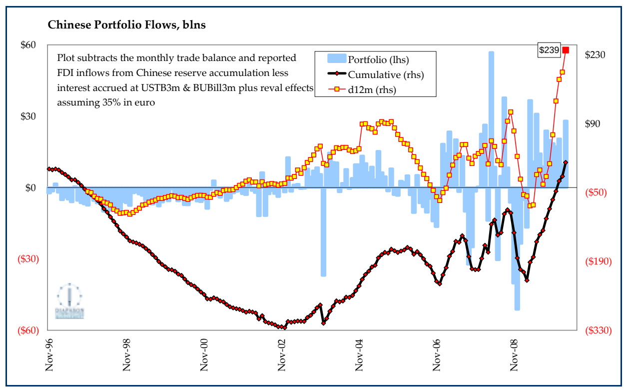

Fig 2: $1 billion a day in hot money

Some further perspective on the problem at hand can be had from looking at the scale of hot money flows being received (as calculated by the difference between FX reserve changes, trade balances and FDI inflows). Over the twelve months since markets bottomed and trade started to recover, it looks as if ~$240 billion – almost $1 billion per working day - has been leaking through the porous barrier of China's capital controls: some of it to finance commodity speculation; some to take party in the real estate frenzy; some to bet on an eventual revaluation of the Yuan; *all* of it contributing to the worldwide distortion in goods and asset prices which may yet come to haunt us.

Ostensibly, this has not yet caused a major 'inflation' problem- assuming, that is, you play the central bankers' Wise Monkey game of considering only changes in the CPI index to constitute 'inflation' (and if you thereafter trust it to be properly reported).

Even granted such a dubious proposition, we can come at this from three different directions, each of which strongly implies that either CPI will rise much more sharply in the near future, or that it already is higher than it is being declared.

Firstly, look again at our frontline indicator, real M1 and ask yourself if you see any reason why its explosion will *not* spill over into the recorded prices of consumer goods, as well as into those of property, petroleum, and palladium futures.

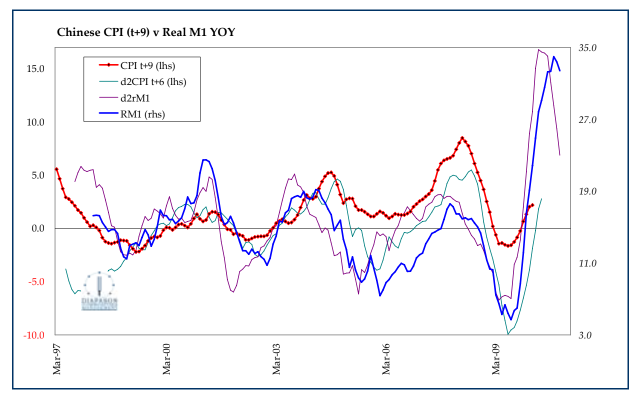

Fig 3: China real M1 v CPI

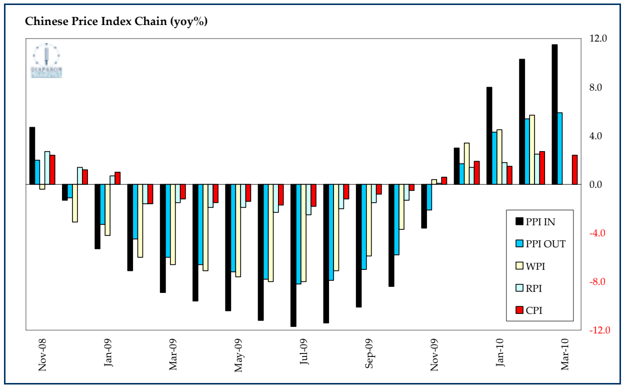

Fig 4: Pressures in the Pipeline

Next, consider the head of steam building *upstream* from Mrs. Li's shopping basket. Purchasing prices, producer prices, and wholesale prices are all rising at an accelerating pace, suggesting that it will take a veritable miracle of statistical legerdemain to prevent these showing up at the end of the pipeline, too.

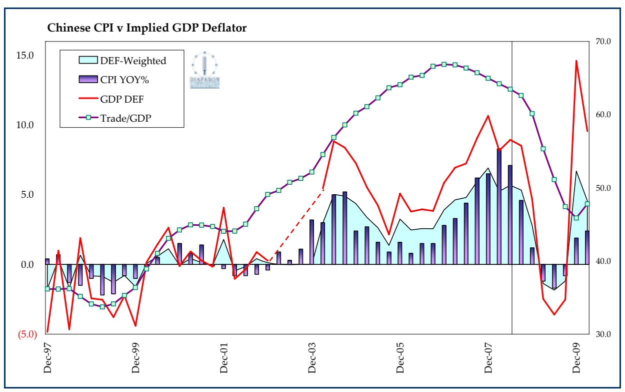

Fig 5: Pressures on the portside.

Finally, let us make an estimate of the GDP deflator – admittedly, a slightly suspect derivation from the partial numbers for real and nominal expenditures we are given. Then, let us weight it by the size of trade flows in the mix and set it alongside CPI, once again. In fact, this should be a flattering comparison since the somewhat counterintuitive arithmetical truth is that rapidly rising import prices (think crude oil, iron ore, and coking coal) help *suppress* the deflator because of the negative sign attached to imports in the GDP calculations. Despite this, the result is unequivocal: prices are rising faster than they seem to be in that one, politically key datum itself.

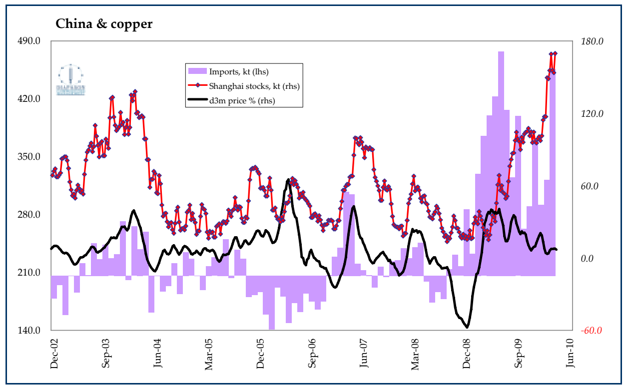

Fig 6: Dr. Copper's most demanding patient

Talking of trade, much has, of course, been made of China's rare dip into the red last month, a weight of commentary to which we would only add two brief remarks. Firstly, the scale of the swing from the previous month ($14.8 billion) is not unprecedented for this time of year, typically the low point in the annual cycle. Secondly, while the purchase of raw materials has been undeniably elevated this past year, no less than 60% of the change in the overall trade balance last month was attributable to increased net imports from the Big Three Asian industrialized nations – Taiwan, Japan, and South Korea – countries which are not renowned for their rich endowments of mineral or agricultural wealth.

Fig 7: Net imports of Iron ore, coal & oil products

Undoubtedly, then, much of China's intake was comprised of the machinery and components which are predestined to contribute to its *exports*, so let us not be *too* taken aback if the balance soon resumes its habitual upward progression into the Western gift-giving season.

Fig 8: Chinese trade balance v Asian-3 & ROW ex-A3

To conclude this section, let us offer further anecdotal evidence for the lopsided nature of this recovery by way of a quite from the Steel Business Bulletin:

"Europe's shipbuilding industry continues to struggle and may lose up to half its jobs before the summer… [said] a statement signed by EU regional representatives. Steelmakers confirm the very low levels of demand for plate. Sources in the steel industry say shipbuilding demand in Europe is now virtually non-existent. While demand from China and Korea for plate remains strong, almost no contracts have been signed this year for the supply of plates or other steel products to shipbuilders in Europe."

Price-limiting output *'gaps'* in the West, or just vast swathes of output obsolescence? You be the judge.

Commodity Corner

During the past few weeks, neither the increasing vulnerability of government bond markets, nor the ongoing imbroglio over the Greek rescue package has been able to dispel the halcyon idylls of the market's self-constructed 'Goldilocks' scenario of easy money and superficially better economic data. On and on we go, with the more risky outperforming the less: with US small caps beating large-cap counters; with junk bonds leaving investment grade trailing in their wake; and with Emerging Market equities beating their Developed World cousins hollow.

The 'Dash for Trash', then, is still very much in full swing and this despite the fact that Pluto has been anxious to pour his gifts of plenty into the laps of even the most hidebound of participants. Indeed, the S&P 500 ended the March quarter by completing a 55-week, 71% appreciation which marked its best run for a like period since way back in 1936.

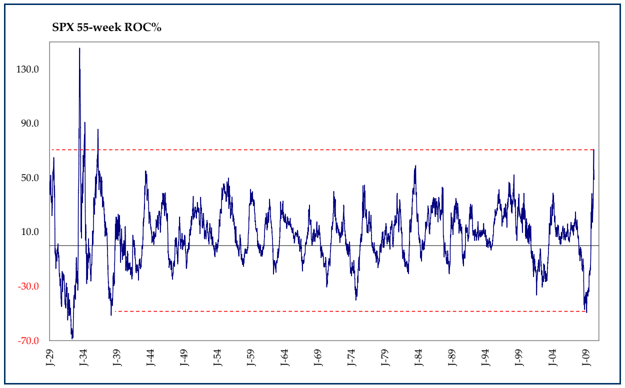

Fig 9: S&P500 55-week ROC%

What you might also note is that the preceding plunge to the March'09 lows was, in its turn, the worst suffered since 1938 and that swings of this magnitude are unknown outside of that dystopian, Dark Valley decade itself. Strange, then, that the VIX index has fallen back to its pre-Crisis lows to stand ½ sigma below its 20-year mean. Strange, that is, if you neglect the insidious corruption of values engendered by Global ZIRP.

We can further adduce two overlays which might give some technicians pause – just as the SPX itself approaches a full Fib retracement of its Crash. The first shows the broad similarity of pattern between the last great Bubble market - the Nasdaq - and the prior one – the Nikkei. This makes it look like NDX is approaching the analogue of the impact its own Crash had on the Nikkei in the spring of 2000.

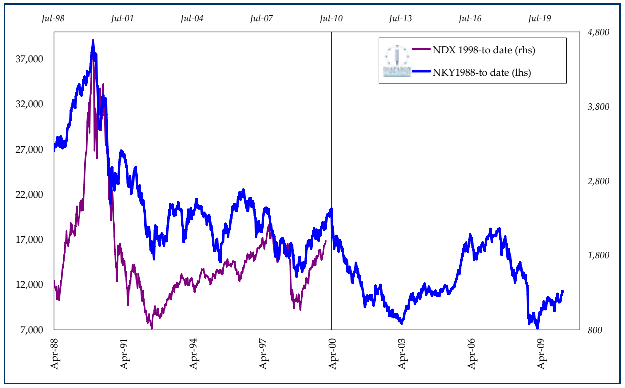

Fig 10: NDX '98-td v NKY'88-td

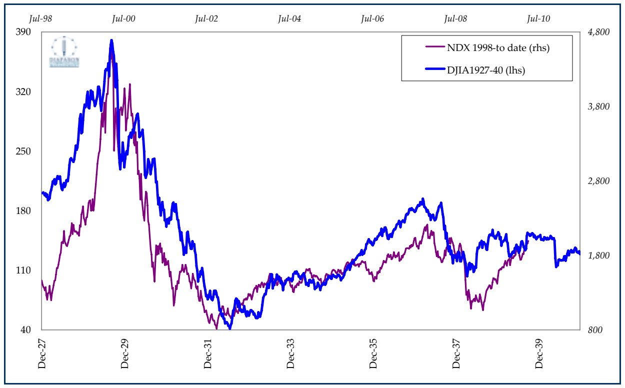

Fig 11: NDX '98-td v DJIA'27-40

The second shows the Nasdaq set against the 1920s mania – one for which, if anything, the correspondence is even closer. This suggests we are approaching – *ulp!* – a mirror of the pre-WWII peak and contains the deliciously ironical inference that whereas Bernanke & Co. are currently desperate to avoid a repeat of the policy 'mistakes' of 1937-8, the truth is that they have, in fact, *already* committed them when their belated, inching retreat from the loose money era subsequent to the Tech blowout steered us all into the shipwreck of 2008-9.

Two brief observations only on commodity markets, this week. Firstly, it behoves us to keep an eye on the ratio between platinum and palladium, which has shown signs of a possibly exhaustive acceleration, right at the lower end of a long-standing, range-spanning downward channel. With RSIs approaching extreme levels here, we are looking for a price action signal that it is time to play for a rebound (and hence where to put the necessary stop-loss in the event of being premature in this attempt).

Fig 12: Platinum/Palladium ratio

Lastly, be aware that all is not what it seems with WTI, at present. As the graph shows, for the five-years to the global nadir in early 2009, the WTI contango (here expressed as a percentage) tracked Cushing inventories (as a number of days' implied demand) with an r-squared of 0.72. Since then, however, the correlation has effectively evaporated (r2=0.10).

Does this provide proof conclusive that 'fundamentals' have utterly succumbed to mo-chasing 'sentimentals'; does it signal that WTI's benchmark status is once again in doubt; or does it simply reflect the fact that marginal oil demand for the world at large is not being determined in Oklahoma but 500 miles north-west of Okinawa?

Fig 13: WTO contango v Cushing inventories

Whichever is the truth, it means casting aside the old yardsticks and once again underscores the point that blind empiricism is a dangerous faith and that even the best model's *ceteris* is never *paribus* for long