



Update January 6th 2016

North Korea playing hard ball – China currency shock waves – oil falls – Transition, as in China transition to consumer society, new buzz word! Commodity earnings shall be of lower quality – Will the postman knock twice? Federal Reserve notes out today

Dr. Strangelove, I presume?

Is this Dr. Strangelove all over again rocking the financial markets? With North Korea's successful testing of a hydrogen bomb are we about to cross a dangerous threshold with regard to political risk? The key concern is that we are leaving the realm of economic rationality and skirting the borders of games theory played badly.

North Korea causes havoc – will this last?

North Korea's forays into a latter day Manhattan project together with a further fall in both oil prices and the Chinese currency are unsettling global investors – who are jettisoning stocks, crushing emerging markets and seeking out traditional safe havens.

We are hearing reports of further rating downgrades on the way for emerging market countries. We are not surprised and see several of these countries raising interest rates to prevent massive capital shifts. Better higher financing costs – than the risk of not being able to finance current account deficits.

Link between Chinese and developed economy stock markets remains strong

The question is not whether there is a link between the Chinese stock market and the Chinese economy. The issue is the strength of the link between financial turmoil in China and the performance of risk assets abroad.

A large part of the developed economy recovery has been predicated on asset prices as opposed to income – falls in financial markets have a disproportionate impact on consumption.

Oil falling – this shall continue!

We are seeing oil prices come under further pressure as markets have returned to focusing on the excess supply amid mediocre prospects for global growth. The political tensions in the Middle East shall act as a further inducement to Saudi Arabia and its followers in the Gulf – who share the same concerns as to a perceived Iranian threat – to redouble their economic warfare efforts.

Saudi Arabia can hang in there!

There is a very substantial cash buffer which combined with internal security tightening and expenditure cuts shall allow Saudi Arabia to “hang in there” for a good many years. Amid all the ambient pessimism, it is worth recalling that Saudi Arabian oil reserves are still in the US Dollar 600 billion range, liquid and that debt levels are risible.

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Saudi Arabia not playing Metternich!

The situation in the Middle East shows no signs of moving towards any form of moderation. We see the Saudi government calling the US bluff and acting in line with internal policy and not nebulous notions of diplomacy, as per 19th century Europe.

The Saudi government does not see it useful to engage in the pleasantries of the Congress of Vienna, which recast post – Napoleon Europe.

Better strict constraints on personal freedoms than disorder

The dominant strategy of the Saudi monarchy is to stay in power. This requires retaining the favor of the larger part of the population. While chafing under a fundamentalist regime they prefer massive constraints on public life to the disorder sown by the revolutions abroad.

The perceived power of the Saudi government to make short thrift of any opposition is highlighted by the lack of a spike in the oil price. Events have not succeeded in instilling a lasting fear of a major disruption in supplies or of civil war in Saudi Arabia.

US Shale – luck favors the brazen!

With regard to the US shale sector, we recall Mark Twain’s comments – following publication of his obituary – that reports of his death had been greatly exaggerated. This is confirmed by successful raising of finance for the US shale industry – heightening both the disparity in profit margins, counter-cyclical investing and expectations of further gains to be reaped from technological progress.

Commodities – profit driver moving from flow business to “risky business”

Commodities continue to be wobbly – with renewed pressure on the mining stocks. We are reading macho reports by some of the big companies being made by their trading arms, as they play volatility. This may well be but is scant consolation for their shareholders who have lost their shirts.

Lower earnings quality

The heart of the matter remains that trading profits – often linked to the taking of position risk and reliance on less reliable sources of supply – represent a markedly lower earnings quality than the massive large volume flow business.

They say don’t look back but on rare occasions we should!

My own humble adventures in the commodities trading and financing world in the early Mesozoic taught me that:

The key is supply – a client can usually be found

Banks do not like to see speculative “open” positions on balance sheets

We recognize the essential role of the market making “speculator” however need to be clear that this is “risky business”.

With respect to the sector we see some contrarian investors starting to move their armor into position. However - the decisive Eighth Army attack at El Alamein in 1942 - massive artillery barrage to smash enemy defenses - is still a ways off.

The new “buzz word” to sell stocks – Transition – a grim replay of de-coupling!

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Transition – as in the case of China – appears to be rapidly taking on the allures of that other unfortunate “buzz- word” de-coupling. How sentient beings could in the same breath chant the “Hymn to globalization” and simultaneously maintain that the other half were “doing their own thing” has always amazed me!

De- coupling – a fraud of historic proportions

The myth of de-coupling having revealed itself a fraud perpetrated on the innocent to sell them stocks, has now been replaced by the romantic notion that China is on the verge of a Ninja like mutation into a US style mass consumer society. This is not the case – as we can see by the Chinese authorities panic reactions to a manufacturing slump.

We see further squalls on the horizon and see investment in emerging markets as requiring – like football in US high schools – parental consent!

Turning to the Euro Zone, we are cheered by the news that the composite PMI index has risen more than forecast. We are seeing a continuation of the slow growth recovery – now spreading to the other major economies. We are concerned that France remains a laggard – which we see as reflecting a deep rooted resistance to reforms.

Euro Zone sovereign bond prices – The sun shall rise but prices shall not!

Sovereign bond prices are indicating investor perception that the major battle against deflation shall become more difficult. Falling commodity prices have thrown inflation forecasts to the winds and domestic demand is still being coaxed along by discounting. We are once again hearing reassurances from ECB officials that they “stand ready” - basically to punch at the waves.

Deflationary pressures shall remain entrenched as long as commodities do not stabilize, China does not stop dumping and wages remain moribund.

Expect a Stalinist Federal Reserve!

Today we shall be seeing the minutes from the last FOMC meeting. We expect to see a harder “Stalinist” line as opposed to the weak-kneed revisionism advocated by investors. The Federal Reserve has hitherto given no sign of backing down from its policy of measured increases.

Who shall be right on US monetary policy – Federal Reserve or investors?

With regard to the general economic humor, we are seeing an increasing divergence between the Federal Reserve which continues to see the US economy in great shape and economic analysts.

Different metrics to judge success

We see the key in the use of different metrics to judge success. The central bank sees the end of the “state of exception” as the all clear – no global panics October 2008 style. Economic analysts see success as rising earnings bolstering strong markets.

Analysts live from quarter to quarter, while central bankers think in terms of decades.

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