Daily Note – Europe's Liquidity Trap

Summary

Eurozone: The spectre of deflation stalks Europe

United States: Check out the yield curve action!

United Kingdom: Brits spending other people's money, again!

Good morning,

Deflation is a strange beast. When it gets entrenched it's almost impossible to eradicate because it is all to do with consumer psychology. When I was first learning economics, we were told that when the price goes down the demand goes up. But what is happening when the price goes down, and in fact the demand goes down?

In a deflationary environment when prices start falling, people get it into their minds that this will continue. Therefore, when prices are cut, people think to themselves that the bargain won't be today but might come next month when prices are cut even more. As a result, in a deflationary episode, the very act of cutting prices, repels demand causing prices to fall yet further.

Could this happen in Europe? Of course it could. And it happened in Japan in the past two decades.

How do you stop it? Well textbook economics will say that you should print money.

But what if there is a "liquidity trap" where people are saving/hoarding money and don't want to borrow and banks don't want to lend ? In this situation, cutting interest rates is, as the great Keynes observed, as effective "as pushing on a string".

Then we are in big trouble, because the only way out of this is government spending replacing private saving. But this involves expanding fiscal policy. Unfortunately for the EU, by signing the "fiscal compact" two years ago, the Europeans have outlawed government counter cyclical economic policy. So we are stuck.

Who says the Eurozone crisis is over?

With this in mind, let's examine what is happening in Spain at the moment.

Eurozone: Spain enters deflation

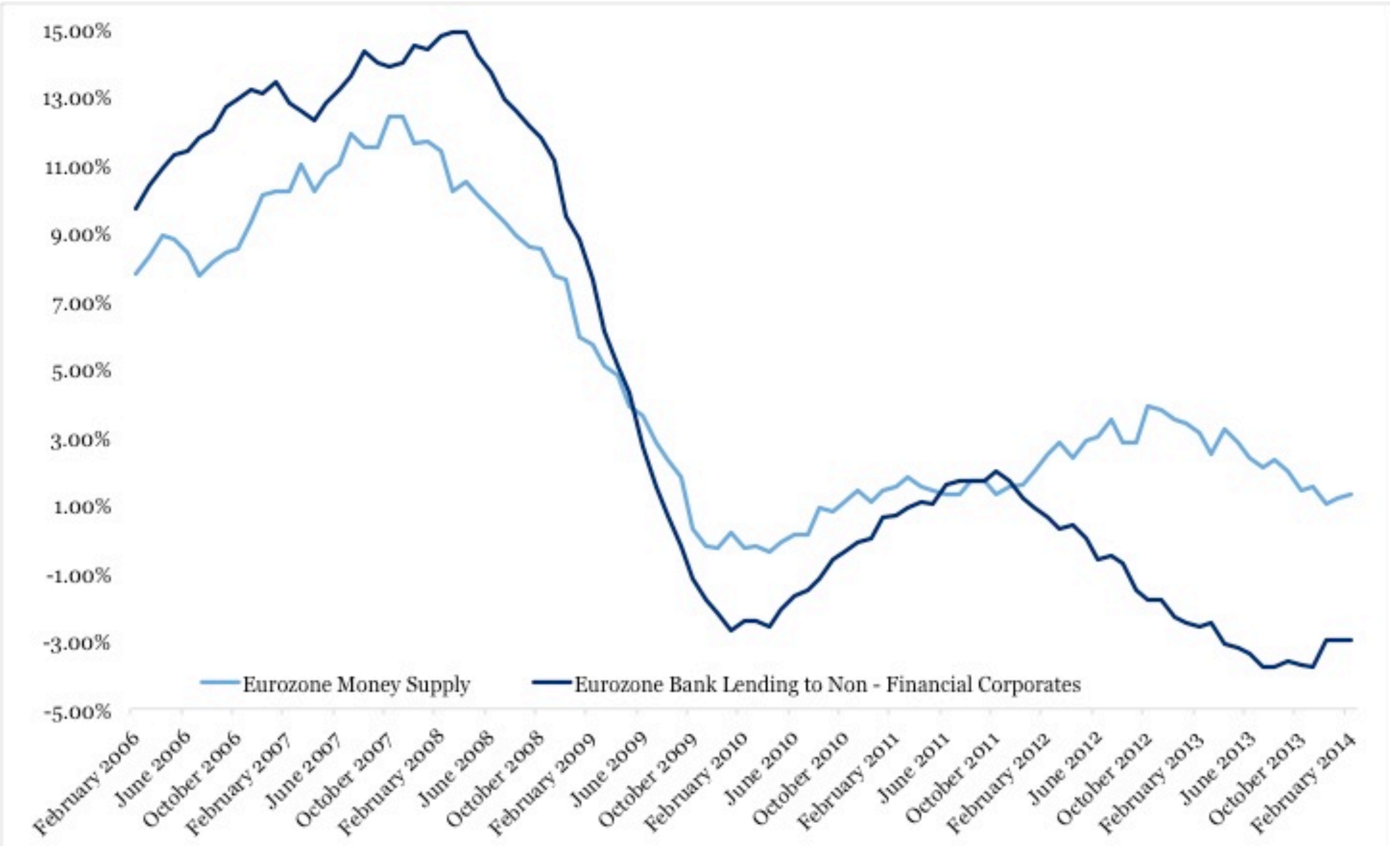
Table 1: Eurozone Economic Data

Event	Country	Period	Surv(M)	Actual	Prior
Import Price Index MoM	Germany	Feb	0.20%	-0.10%	-0.10%
Import Price Index YoY	Germany	Feb	-2.40%	-2.70%	-2.30%
Consumer Spending YoY	France	Feb	0.70%	-0.30%	-0.50%
Consumer Spending MoM	France	Feb	0.80%	0.10%	-2.10%
PPI YoY	France	Feb	-1.40%	-1.70%	-1.20%
PPI MoM	France	Feb	0.30%	-0.10%	-0.60%
Retail Sales YoY	Spain	Feb	--	-0.40%	-0.20%
Retail Sales SA YoY	Spain	Feb	-0.50%	-0.50%	0.50%
CPI EU Harmonised YoY	Spain	Mar P	0.10%	-0.20%	0.10%
CPI YoY	Spain	Mar P	0.00%	-0.20%	0.00%

As we wait for the key German inflation data later today, Spain this morning entered official "deflation" with prices now falling. This shouldn't surprise anyone looking at our chart of "peripheral" Eurozone CPI rates from yesterday here.

The "liquidity trap", mentioned above is evidenced in lending figures for the Eurozone. Euro area bank lending to non-financial corporations (NFCs) fell by €12.6bn in February, following a €9.3bn contraction in January. Credit flows rose in France and declined slightly in Germany but fell most conspicuously in the periphery (particularly in Italy).

Figure 1:The Eurozone Liquidity Trap



While activity in the Euro area might have stabilised, I expect bank lending to the corporate sector to remain weak. Without credit, you have no growth because credit is stealing from tomorrow to spend today and the only way spending can rise today is via this process of spending tomorrow's income today. We all do it. In fact, I am going to do it this weekend by putting dinner on plastic.

Is deflation in Spain enough to move the ECB next week? I am not sure but if EZ CPI data disappoints to the downside this morning then further easing next week becomes more likely.

The Eurozone is in a cul de sac and it won't get out of it with an overvalued currency. I am still happy to be short the Euro.

Let's examine what's happening across the pond.

United States: Initial Claims continue to improve

Table 2: US Economic Data

Event	Period	Surv(M)	Actual	Prior	Revised
GDP Annualized QoQ	4Q T	2.70%	2.60%	2.40%	--
Personal Consumption	4Q T	2.70%	3.30%	2.60%	--
GDP Price Index	4Q T	1.60%	1.60%	1.60%	--
Core PCE QoQ	4Q T	1.30%	1.30%	1.30%	--
Initial Jobless Claims	Mar-22	323K	311K	320K	321K
Continuing Claims	Mar-15	2882K	2823K	2889K	2876K
Pending Home Sales MoM	Feb	0.20%	-0.80%	0.10%	-0.20%
Pending Home Sales YoY	Feb	-9.00%	-10.20%	-9.10%	-9.30%

GDP growth in the fourth quarter was revised up to 2.6% in the third estimate (vs. consensus +2.7%), from 2.4% in the second estimate. This is very old news and not really that significant.

In terms of real time data, initial claims for jobless benefits fell 10,000 to 311,000 (vs. consensus 323,000) in the week ended March 22. The four-week average of initial claims ticked down to 318,000. So there is really nothing to report on the US jobs front.

United States: Check out the yield curve action!

Now let's gain a bit of altitude and see what is actually happening to the US bond market one week on from last week's FOMC meeting. Let's examine where we stand regarding the outlook for US monetary policy, along with US growth and inflation expectations.

The benchmark 10-year US rate has stabilised around 2.70% but the shape of the US yield curve has changed.

Long term interest rates are only short term interest rates with a risk premium. That risk premium is based on uncertainty surrounding growth and inflation expectations.

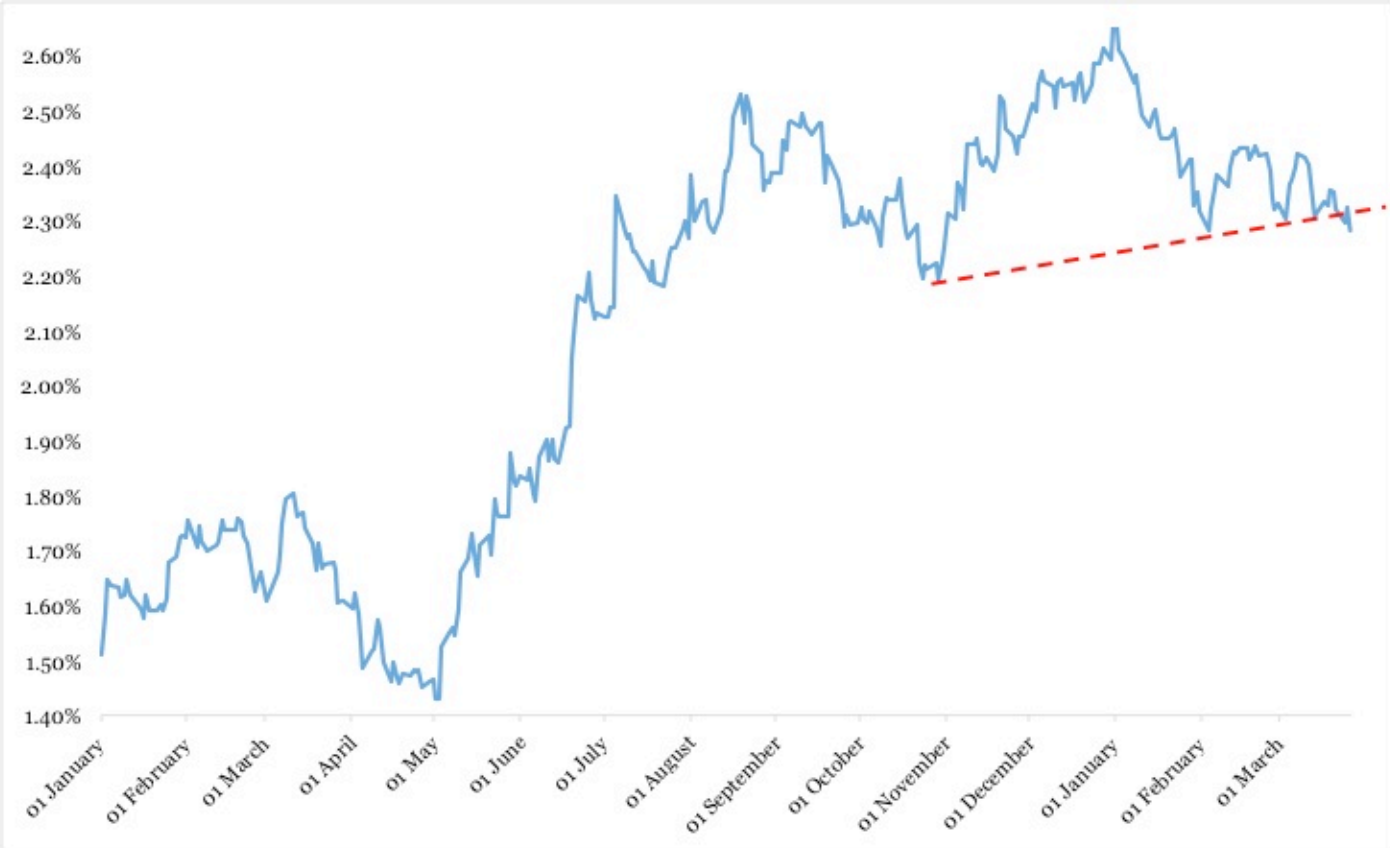
Traditionally a steep yield curve - where longer term rates are moving higher relative to shorter term rates - is a positive indication for growth. Longer term rates will anticipate growth and inflation before shorter term rates because short rates tend to be anchored by central bank policy and change when policy decisions are actually made. The long end of the curve is in the business of anticipating these changes.

The chart below shows the difference between US 2 Year and 10 Year yields. It has widened over the last year reflecting higher rates at the long end. Last year when the market thought that growth in the US would come in stronger than expected and of course, the Fed signaled its tapering process of weaning the market off QE, long term interest rates took off, dramatically increasing the spread between long and short rates.

We are now at a new plateau about 1% above where it was this time last year. This plateau was reached in late September and has been maintained more or less since then.

However ,this plateau might shift downwards again after Janet Yellen's comments last week.

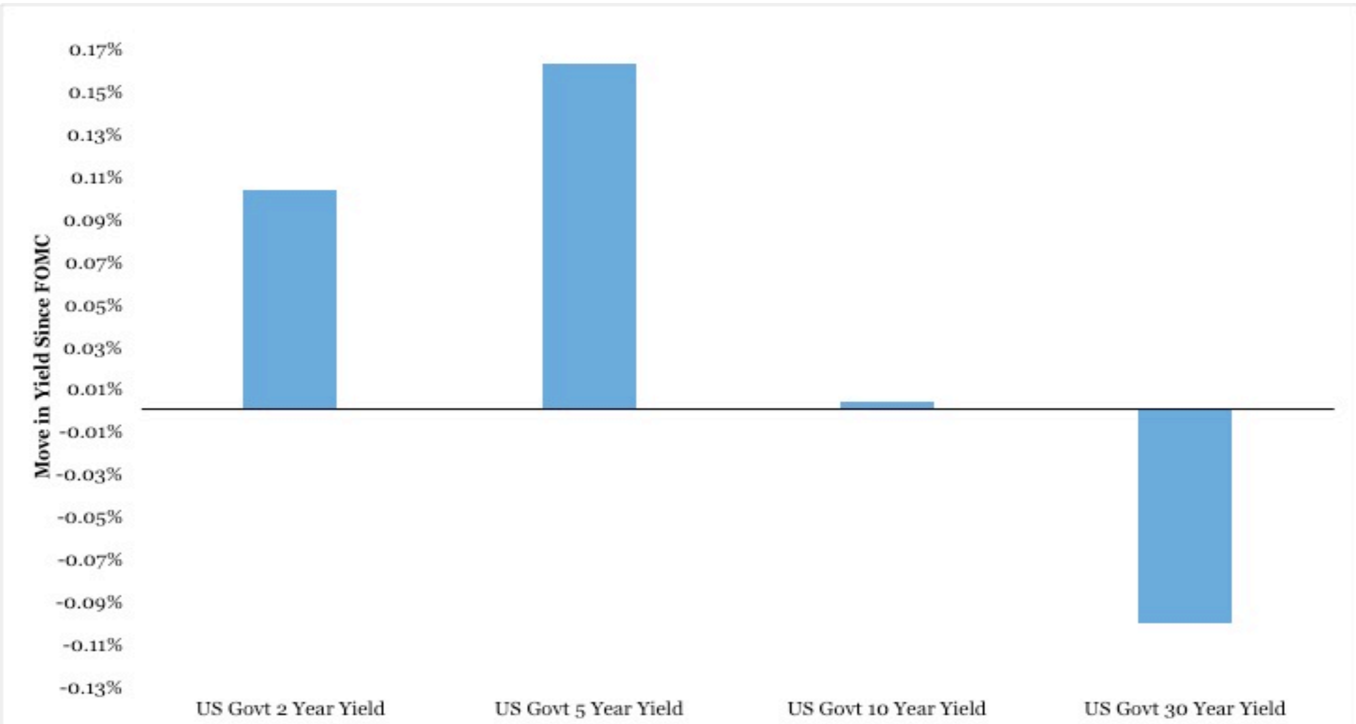
Figure 2: US Growth Expectations 10's vs 2's Yield Curve



Look at the next chart figure 3 below.

This shows the change in yield of the various durations on the US yield curve since Yellen spoke last week. While 2's and 5's have done very little, 30's are actually down in yield.

Figure 3: US Bond Yield move since last week's FOMC meeting



The yield curve has flattened. Short rates have moved higher and longer rates moved lower. These are some very unusual moves that are not seen very often in markets.

Traditionally, a flatter curve means the central bank is trying to wring inflation out of the system. But there is no inflation in the US economy. So what is driving this move?

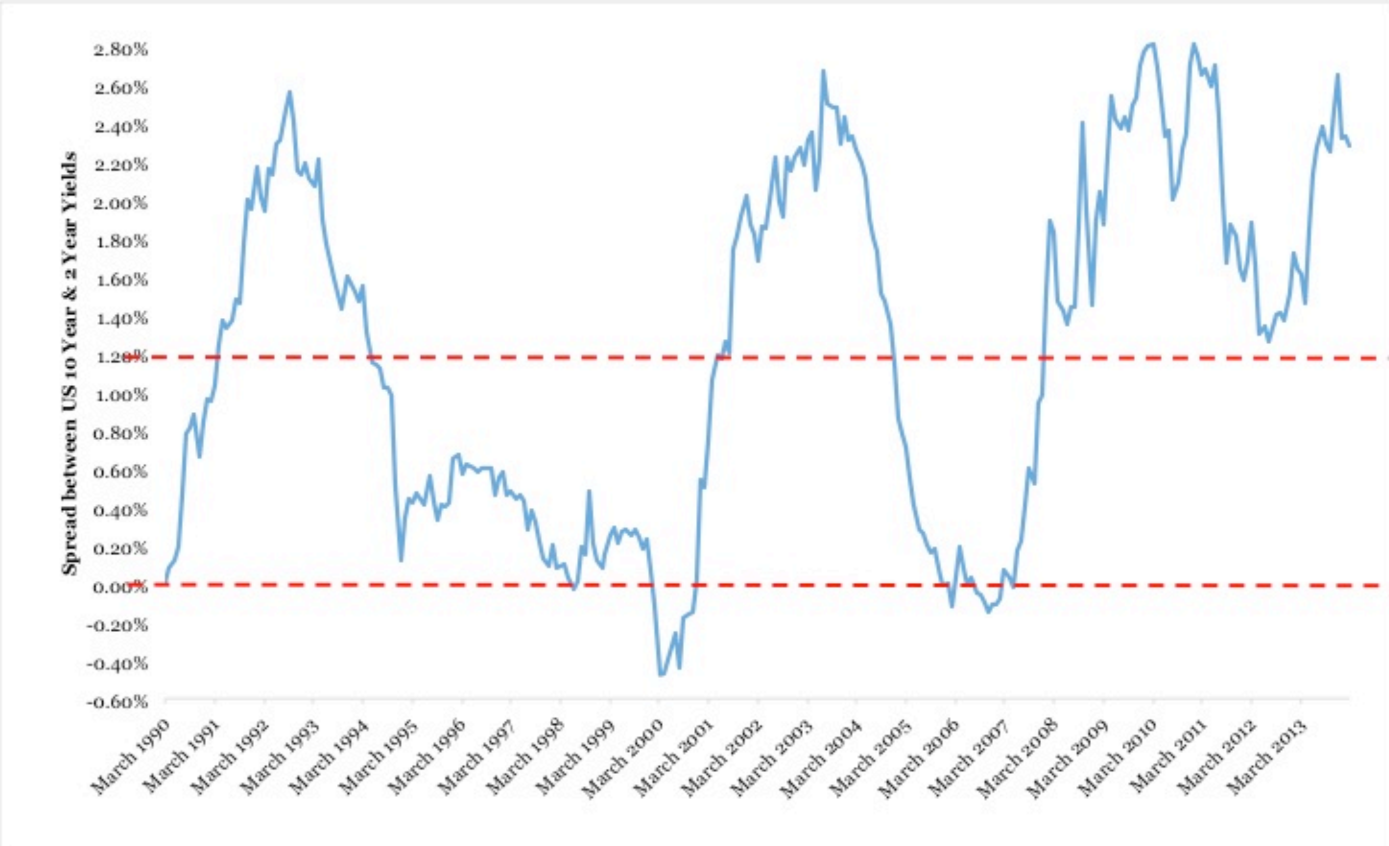
The main reason is that the Federal Reserve's trying to wean the market off QE and other unorthodox policy moves and return the money market to more normal conditions – the type of environment that existed before the 2008 crisis.

The market is beginning to price in a more normal interest rate environment in the US. At this point in the economic cycle, base rates would normally be circa 2/3% because the demand for money would be strong four years after the recession.

Higher short term rates without inflation should lower the yield at the long end of the curve (30 year) .This will be one of the key drivers of "macro" investing in the coming months.

Looking at the US curve today, we can see that it is still very steep versus historical levels (see chart below).

Figure 4 US Yield Curve Long Term



As a result, I'm pretty sure we will see some flattening of the US curve as growth accelerates and monetary policy progressively normalises. Looking at the chart above, we could easily see the curve now flatten back to 150bps from 230bps currently.

This would suggest 2 Year notes will go to 2% with 10's higher to 3.5%. This would put our 5 year note yield towards 2.5%. Not surprisingly, we remain very happy to be short this part of the curve.

United Kingdom: Brits are spending other people's money!

Table 3: UK Economic Data

Event	Period	Surv(M)	Actual	Prior	Revised
Retail Sales Ex Auto MoM	Feb	0.30%	1.80%	-1.50%	-2.00%
Retail Sales Ex Auto YoY	Feb	2.90%	4.20%	4.80%	4.40%
Retail Sales Incl. Auto MoM	Feb	0.50%	1.70%	-1.50%	-2.00%
Retail Sales Incl. Auto YoY	Feb	2.40%	3.70%	4.30%	3.90%

Retail sales volumes rose by +1.8%mom in February, a larger rise than was expected (Cons: +0.3%mom, GS: +0.5%mom). Retail sales data have been particularly volatile in recent months, but even discounting some of the strength of today's data, momentum in the retail sector is strongly positive.

The analyses done on the US economy above applies very much to the UK as well where 2 Year are currently at 65bps. We would see short rates moving up here as well in the coming months, maybe as much as 1.5%. Shorting the UK 2 year note is an interesting trade right now.

Portfolio: Further gains from our short Euro investment

Table 4: Our Portfolio

Trade Date	Pos	Market	Exposure	Trade Price	Current Price	P&L	Price Target
27/12/2013	S	Euro Spot	100%	1.386	1.3708	1.10%	1.32
13/01/2014	L	IPATH US TREASURY 5 YR BEAR	100%	39.965	40.7	1.84%	46
				1.54%	1.7036		
11/02/2014	L	ISHARES CHINA LARGE-CAP ETF	50%	34.97	35.1	0.19%	Spread
20/02/2014	L	LYXOR UCITS ETF DAILY SHORT	50%	37.28	36.52	-1.02%	Spread
		Open Position Return				2.10%	
		Closed Position Return				0.00%	
		Total Portfolio Return				**2.10%**	