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Daily Note – Fed fears?

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DAILY NOTE – FED FEARS?

Good morning,

Am writing from the very swanky Marker Hotel in Dublin's docklands on a glorious morning, making me feel like I am somewhere considerably more exotic. I am here to chair a corporate finance conference, which will involve small independent financial boutiques from all over the world. These are the sort of gatherings where you can really find out what is happening on the ground – miles away from financial markets - from people who are making investment decisions every hour or everyday.

I will keep you updated.

When I send out my daily note, I normally get between 10 and 30 responses from clients who agree, disagree or want to discuss the topic further. When I discuss what will happen if or when the Fed increase interest rates later this year, I will get 10 times the normal response.

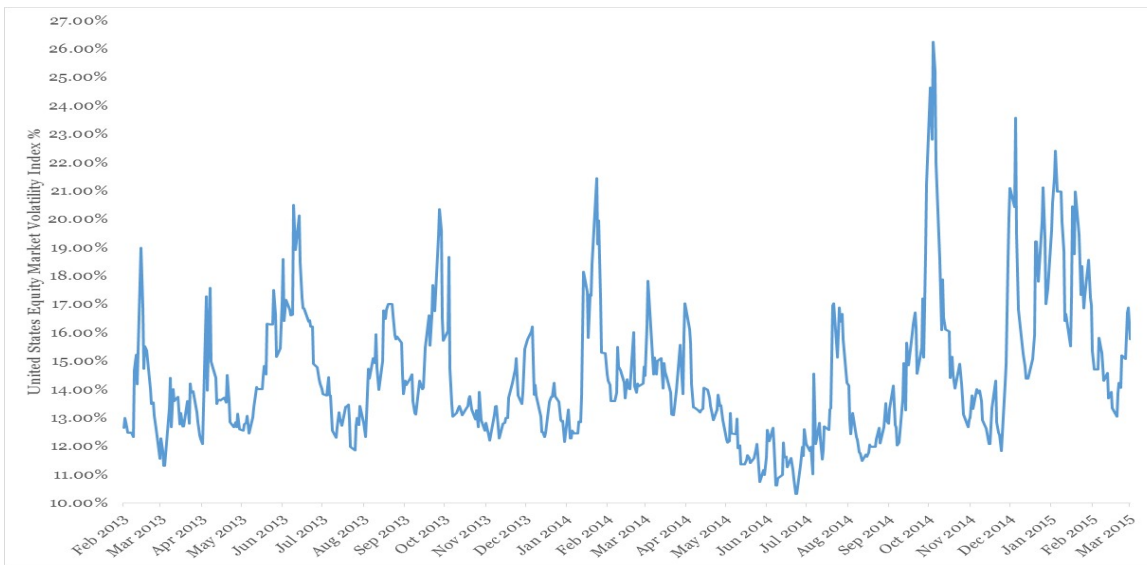
When the Fed hike rates some clients believe that equities will fall and credit spreads will widen. Other clients believe the opposite will happen. Other clients again believe the yield curve will steepen and because the euro area is now experiencing a solid recovery, the dollar will go down from here. Another group of clients think that long rates will go down as we get closer to lift-off because there are still no signs of inflation and hence, the Fed lift-off will be perceived as a deflationary policy mistake.

And many of the responses I receive come with strong opinions!

US rate rises – someone has to be wrong!

These different reactions tell me that there is simply no consensus in markets about what will happen when the Fed starts hiking rates. From a financial stability perspective this is worrying, because this tells us that a significant amount of investors hold high-conviction views that have to turn out to be wrong. In other words, many investors will get a wake-up call and will have to quickly turn their positioning around.

FIGURE 1 UNITED STATES EQUITY MARKET VOLATILITY %



The bottom line is with significant disagreement about what will happen when the Fed hikes rates we should expect volatility across all asset classes to be higher –so let’s trade volatility!

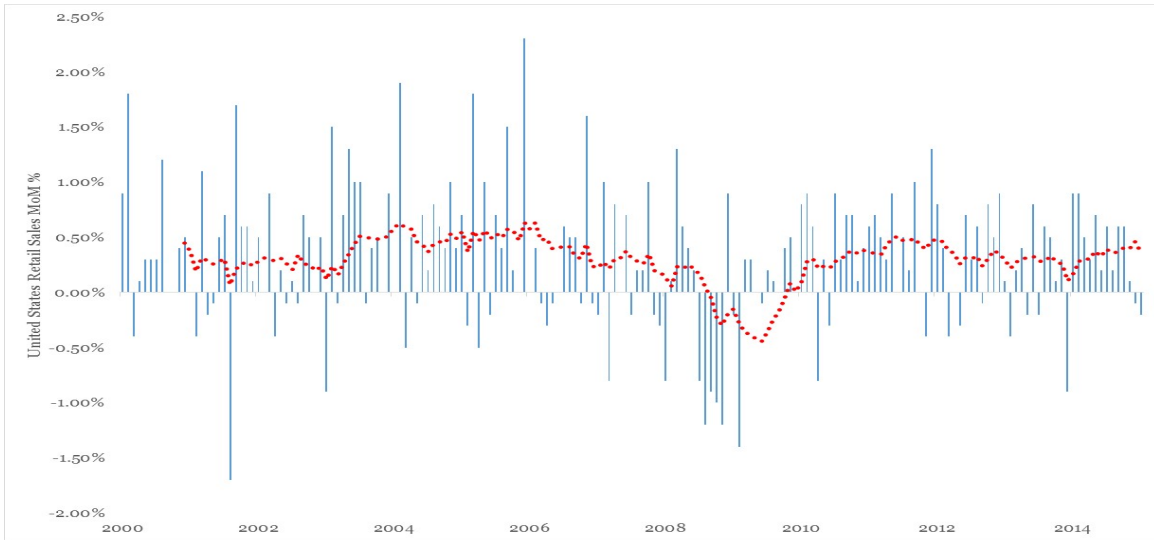
United States: Retail Sales hit by weather

TABLE 1 UNITED STATES ECONOMIC DATA

Event	Period	Survey	Actual	Prior	Revised
Retail Sales Advance MoM	Feb	0.30%	-0.60%	-0.80%	--
Retail Sales Ex Auto MoM	Feb	0.50%	-0.10%	-0.90%	-1.10%
Initial Jobless Claims	Mar-07	305K	289K	320K	325K
Continuing Claims	Feb-28	2400K	2418K	2421K	2423K
Import Price Index MoM	Feb	0.20%	0.40%	-2.80%	-3.10%
Import Price Index YoY	Feb	-8.90%	-9.40%	-8.00%	-8.70%
Business Inventories	Jan	0.10%	0.00%	0.10%	0.00%

Headline retail sales unexpectedly fell 0.6% in February (vs. consensus +0.3%). Core retail sales—used by the Commerce Department to estimate consumer spending in the GDP report—were flat in February (vs. consensus +0.4%), and were revised down a net one-tenth in December and January. A number of core spending categories reflected weakness, including general merchandise (-1.2%), electronics (-1.2%), miscellaneous (-1.2%), health and personal care (-0.7%), and furniture (-0.1%).

FIGURE 2 UNITED STATES RETAIL SALES MOM %

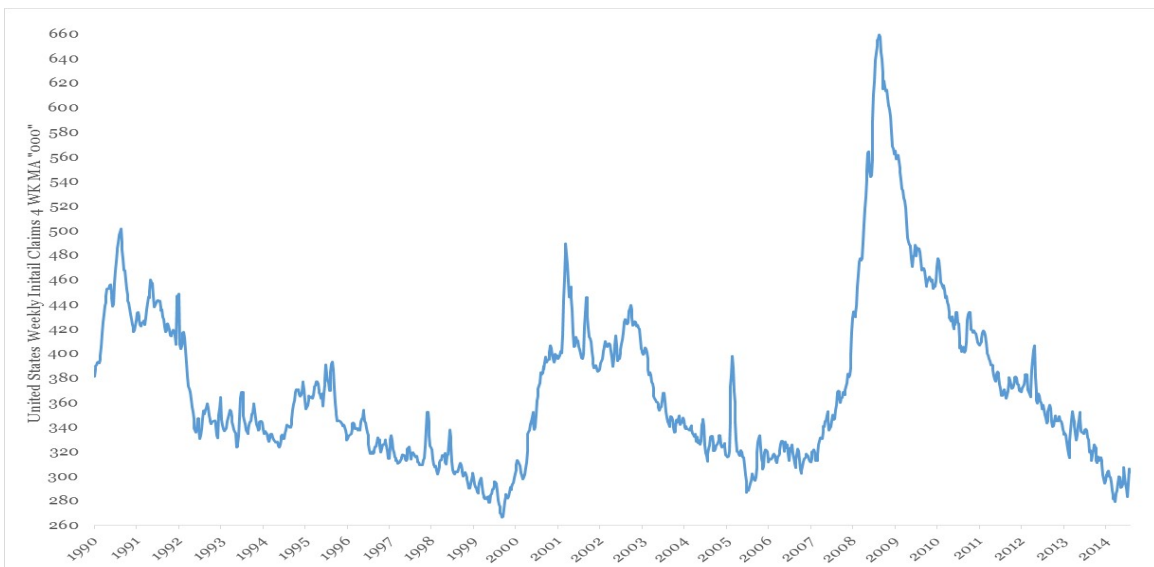


In contrast, non-store retail sales, which mainly reflect online sales, rose a strong 2.2%.

On balance, I think the pattern of sales growth by category strongly suggests a significant negative weather effect – after all if it is freezing, you don't go out!

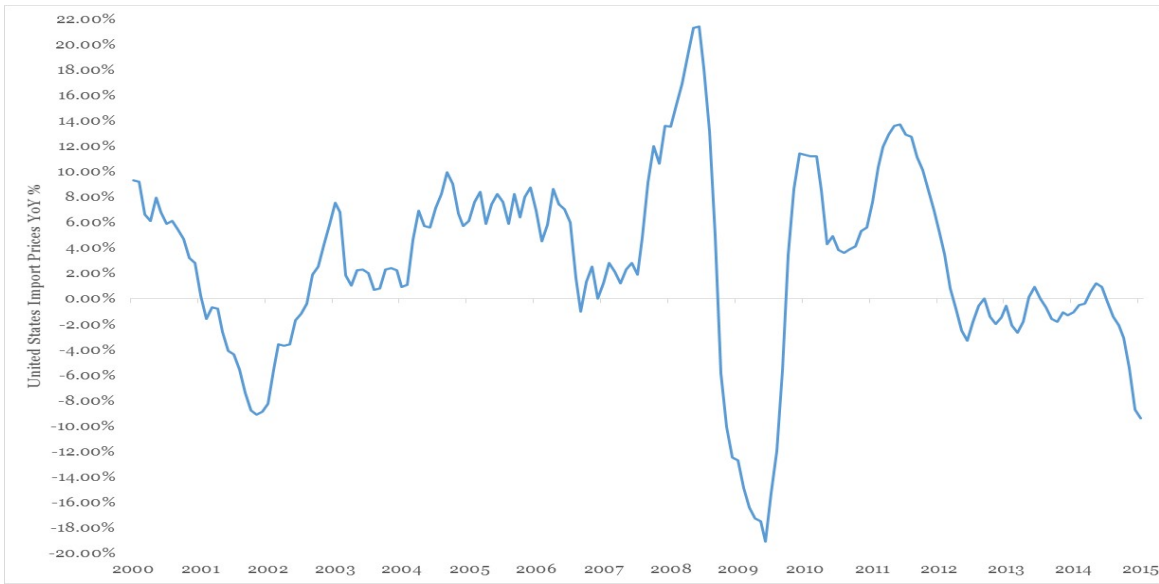
Elsewhere, weekly initial jobless claims fell more than expected to 289k for the week ended March 7 (vs. consensus 305k), down from 325k the previous week.

FIGURE 3 UNITED STATES WEEKLY INITIAL CLAIMS 4WK MA "000"



Finally in a busy day for US data, import prices rose 0.4% in February (vs. consensus +0.2%). Petroleum prices were the largest contributor to the increase, rising 8.1% after posting sharp declines in prior months.

FIGURE 4 UNITED STATES IMPORT PRICES YOY %



However, import prices excluding fuels fell 0.3% on the month as the dollar rises. No surprise there.

China: Economy being pumped with liquidity

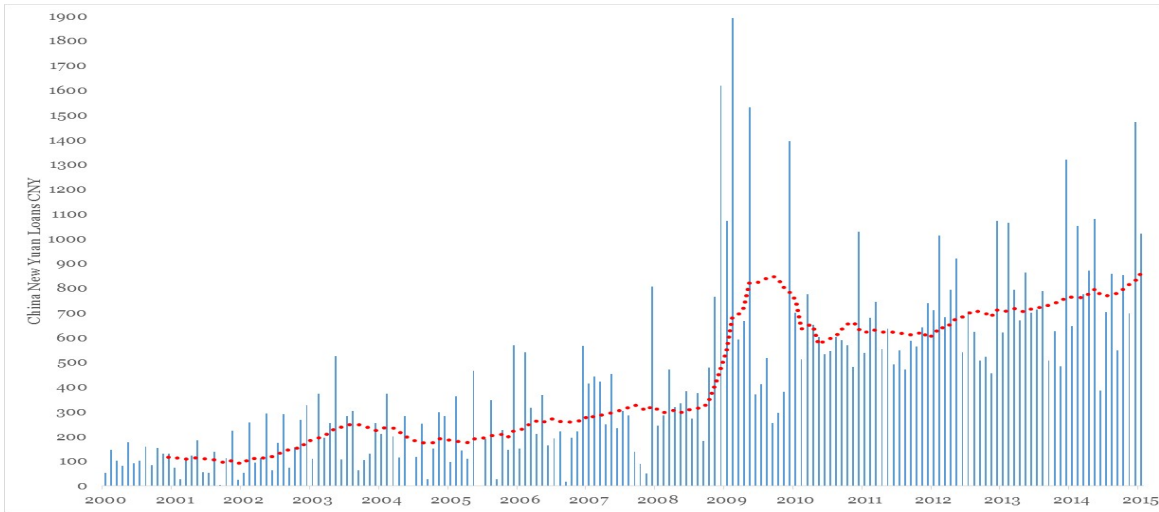
TABLE 2 CHINA ECONOMIC DATA

Event	Period	Survey	Actual	Prior
New Yuan Loans CNY	Feb	750.0B	1020.0B	1470.0B
Money Supply M2 YoY	Feb	11.00%	12.50%	10.80%
Money Supply M1 YoY	Feb	6.80%	5.60%	10.60%
Money Supply Mo YoY	Feb	-0.80%	17.00%	-17.60%
Aggregate Financing CNY	Feb	1000.0B	1350.0B	2050.0B

I talked in detail about China yesterday, here's some more views.

February monetary and fiscal data surprised significantly on the upside. This is evidence of the government stepping up the more aggressive ways of loosening policy over and beyond the modest adjustments to RRR, benchmark interest rates and exchange rates. These more aggressive measures are likely to include loosening of credit controls, as well as pressures on local authorities to speed up fiscal expenditure.

FIGURE 5 CHINA NEW YUAN LOANS CNY



When broad money and credit growth improves significantly, we typically see an improvement in activity.

It's also noteworthy that the two significant rebounds in broad money and activity growth since the leadership transition occurred in Q3 2013 and Q2 2014. The Party still has a high degree of direct control over the economy. It's still a one party State.

We remain very positive on large Cap China stocks, it remains one of our more contrarian views but we see the power of the PBOC to pump the economy with liquidity far outweighing the negative economic data.

Let the herd be negative.

Have a good weekend and fingers crossed for Cardiff!

Our Portfolio:

Trade Date	Pos	Market	Exposure	Trade Price	Current Price	P&L %
Open Positions						
27/12/13	S	Euro Spot	50%	1.210	1.061	6.15%
13/01/14	L	IPATH US TREASURY 5 YR BEAR	150%	35.630	34.8701	-3.20%
11/02/14	L	ISHARES CHINA LARGE-CAP ETF	50%	41.620	41.28	-0.41%
29/07/14	S	FED FUND 30DAY Apr15	100%	99.87	99.87	0.00%
08/08/14	L	IPATH US TSY 10Y BEAR	150%	22.880	21.3401	-10.10%
Open Position Return						-7.55%
Closed Position Return						0.00%
Total Portfolio Return						-7.55%
2014 Final Number						12.79%

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