DOWGATE CURIOUS INVESTOR

Friday 25th August 2023

15 Fetter Lane, London, EC4A 1BW
Phone: +44 (0)20 3416 9143
Email: hello@dowgate.co.uk

Can We Avoid Another Jackson Hole?

This week, the financial markets' primary focus will be the annual gathering of central bankers in Jackson Hole. Last year Fed Chair Powell used the event to deliver an uncompromising message that more work was needed. He was true to his word. Over the last year the Fed has hiked rates by 300bps in seven increments, with the Bank of England and the ECB following each step of the way.

In the weeks following last year's speech, financial markets went into meltdown. US 10 yr. Treasury yields soared from 3% to over 4%. The equivalent Gilt yield nearly doubled to 4.5% as the country lost its second Prime Minister in three months, the Pound crashed to $ parity, the World sought dollar safety, and the FTSE100 lost 10% of its value in six weeks. It all seems like a long time ago. Surely this year's event cannot be as consequential.

One reason history will not repeat itself is that bond yields are already broadly back to, and in some cases, above their peaks of mid-October last year. But this time, it has happened over six months rather than six weeks. Market participants have better adjusted. Or have they?

Index	Value	YTD (%)
FTSE 100	7333.63	-1.58
FTSE 250	15,512.64	-2.67
S&P 500	4,455.44	15.63
Gold $/lb	1941	5.8
Brent Oil $/bl	83.76	-2.55
Copper $/lb	3.79	-0.52
UK 10 yr yld	4.43%	21.37
US 10 yr yld	4.25%	14.18

With long and variable lags, the impact of the last 12 months of tightening has yet to be fully felt, particularly in areas like residential property. The warning this week from housebuilder Crest Nicholson being an example. In the US, the disincentive for homeowners with low fixed rate mortgages to move is so strong there are currently more registered realtors than there are properties for sale.

Rising long term bond yields deliver a bifurcated response. Indebted and unprofitable companies requiring refinancing, those who rely on the kindness of strangers, struggle. In contrast, profitable companies with cash-rich balance sheets and long-duration fixed-rate debt can thrive. The still hugely profitable Google parent Alphabet has net liquidity of over $100bn. As rates increase, it earns more interest on its portfolio of near-cash assets. The robust performance of NASDAQ, year to date is as much to do with a flight to balance sheet safety as an AI bubble.

This bifurcation is the same for households. Household wealth is concentrated among the baby boom generation. Older homeowners without mortgages who have money market investments, and bank deposits are the household equivalent of Alphabet. They have excess savings from lockdown and benefit from higher rates. Little wonder the travel sector is booming and restaurant bookings remain difficult.

While Powell has signalled that the US and Europe must keep their monetary tightening brakes firmly on, Western governments have their feet on the fiscal accelerator. The most significant component of increasing government deficit spending is the interest bill. These increased government interest payments represent a fiscal stimulus to that part of the economy that owns government debt. While monetary policy tightens conditions for the indebted, fiscal policy stimulates conditions for creditors. Although there are losers in this policy mix, overall household balance sheets remain, for now at least, in decent shape. But in China, things are different.

China's post-COVID recovery has misfired and has become a significant detractor to global growth, and its deteriorating household balance sheets are a major contributor to this. With falling residential property values and reduced savings due to lockdown, Chinese households do not have the excess savings enjoyed in the West.

According to Ambrose Evens-Pritchard, China's economy is in danger of a debt-laden deflationary spiral teetering on the edge of its $60tn residential real estate market, the World's single largest asset class. Zongyang Zoe Liu of the Council for Foreign Relations told Bloomberg's Odd Lots podcast that China faces the four Ds of, not enough Demand, too much Debt, poor Demographics and Decoupling from the West. Evans-Pritchard thinks China is heading for a Lehman moment with residential developer debt six times the level of the US subprime problem in 2008.

Is China entering a Japanese-style balance sheet recession, and if so, does it matter? Such a risk is possible, but its consequences would depend on the policy response. China remains one of the largest owners of US Treasuries, and a 2008/9 style banking bailout could force China to withdraw capital from the rest of the World just at the time Western governments, particularly the US, needs to borrow more. Although rising bond yields acknowledge this risk, there could be more to come.

DISCLAIMERS

This is for information purposes only and is not to be considered as advice in any form, including but not limited to investment, accounting, tax, legal or regulatory advice. The information does not take into account a persons specific investment objectives, financial situation or particular needs of any specific recipient. Opinions expressed are our current opinions as of the date appearing on the document only.

Any working examples, forecasts or data are for illustrative purposes only. Dowgate Wealth does not make representation that the information provided is appropriate for use in all jurisdictions or by all Investors or other potential Investors. Parties are therefore responsible for compliance with applicable local laws and regulations. Dowgate Wealth will not be held liable for any loss or damage resulting directly or indirectly from the use of any information on this site.

Last year Jay Powell and his central bank followers from the ECB and BoE, warned that inflationary expectations had taken hold and become imbedded in our core inflation measures. These pressures have dissipated partly from the West importing deflation via its Chinese supply chain. Germany's producer prices fell 6% last month, their sharpest fall since 2009.

Today China's policymakers are worrying that its households have entered a period of embedded deflationary expectations. Why buy an overpriced apartment today when it will be cheaper next year? The consequences of this mindset for a debt driven economy are potentially damaging. See the Japanese three lost decades for details.

This week Powell will no doubt refer to the Fed's determination to be driven by the data. No doubt, he will warn that rates must be higher for longer. Bond investors already know this. But this year, more than last, he must also be aware of what is happening across the Pacific if markets are to avoid a different type of Jackson Hole.

Jeremy McKeown
Editor & Market Strategist
Jeremy.McKeown@dowgate.co.uk
+44 (0) 7885 453 777

Jackson's Chart - US30 Monthly View (An Analysis by Jackson Wray)

The 30-Year US Treasury has been in an apparent descending channel since 1990, and in April 2022, it experienced an awaited breakout with weekly confirmation. Since then, it has been pushing towards the next key area of resistance at 4.2% - 4.5%, where it had a confirmed rejection in November last year and a continued slowdown in the following months. At the time of writing, it is back in this crucial range, with all eyes on Jackson Hole this week, where the bond market will be listening and watching closely. The tone will be crucial to how this market responds. Will the tone be more dovish than recent announcements, leading to a pullback, or will this move pick up further momentum with a continued firm stance?

Further Reading & Listening

- China's property crash is becoming more dangerous by the day
- The deep problems underlying China's economy
- MacroVoices #389 Justin Huhn: Update on all things nuclear
- IC Interviews: Fund manager Katie Potts
- Powell is using Jackson Hole as final push in inflation fight
- How inflation fuels government growth

DISCLAIMERS

This is for information purposes only and is not to be considered as advice in any form, including but not limited to investment, accounting, tax, legal or regulatory advice. The information does not take into account a persons specific investment objectives, financial situation or particular needs of any specific recipient. Opinions expressed are our current opinions as of the date appearing on the document only.

Any working examples, forecasts or data are for illustrative purposes only. Dowgate Wealth does not make representation that the information provided is appropriate for use in all jurisdictions or by all Investors or other potential Investors. Parties are therefore responsible for compliance with applicable local laws and regulations. Dowgate Wealth will not be held liable for any loss or damage resulting directly or indirectly from the use of any information on this site.