The Ghost In The Machine

Unable to Connect

Politics
Welcome to the latest edition of ‘The Ghost in the Machine’, which is themed about the influence on, and the increasingly frequent disconnects between politics and financial markets. Political risks, either national or geo-political, have rarely been higher since the height of the ‘Cold War’.

As the array of articles attest, political influences and risks can take many forms: potential regime or constitutional change, which for example can impact the supply and demand of raw materials, supply chains, taxation, infrastructure and investment spending.

In the commodity space, above all in more populous and/or primary resource reliant countries, decisions on subsidies and taxation of food and energy suppliers and goods can and do influence the sustainability of a particular government, as well as internal and external migration trends.

Political influences and risk are rather more easily identified and qualified than quantified, and are therefore often ignored or side-lined. In an age of increasingly automated and/or algorithmic trading, this has changed the complexion and implications of ‘fear and greed’.

As 1987’s Black Monday, LTCM, 9/11, the 2007/08 global financial crisis and most recently the oil price collapse have demonstrated, actual and adduced political intervention offers testament to a de facto preference for stability, over the more anarchical elements of free markets.

Intervention in foreign exchange markets, whether direct or indirect, has many precedents, yet the reaction of FX markets to ostensibly negative political events is often counter-intuitive, be that the “safe haven” status accorded to Japan or the Eurozone, or the recent appreciation of the Brazilian Real in the face of a presidential impeachment process.
Financial market participants shrugged aside Dutch voters’ rejection of the proposed EU association agreement with Ukraine. They may have been calculating, somewhat cynically, that the result of a ‘non-binding’ referendum, where only 32% of voters went to the polls, would make little impression on the course of European affairs. More likely, they made no connection between this essentially political event and their daily preoccupation with monetary conditions and the chances of ECB action. They could be excused such insensitivity to the news from the Netherlands, seeing that the ECB has taken its stimulative monetary measures so far that it has obliterated the historic links between prices and fundamental values in capital markets. In these conditions, why should anyone be concerned by the news? After all, the central bank will continue to dominate short rates and yield levels. Further, the relevant horizons for investors are closer than they used to be. Generally, it takes time for the full implications of political events to appear, whereas many investors are looking only a few weeks into the future as they try to assess the likelihood of their ‘strategies’ succeeding.

Investors need to bear in mind, though, that the monetary authorities are not omnipotent, a lesson from the past few years’ experience that central bankers are no longer reluctant to acknowledge. Central banks are obliged to mould their policies around the objectively determined rush of events.

Among these events, political developments are typically among the more influential. Further, Mr Rutte, the Dutch prime minister, has declared that his government will not ignore the referendum result but will take time to reconsider ratifying the agreement with Ukraine. Admittedly, the referendum turnout was low but, with pro-ratification forces facing certain defeat, their only remaining hope had been that low participation would void the result. Consequently, many supporters of ratification appear to have abstained, turning the ‘No’ side’s opinion poll lead of less than 15% into a margin of victory of almost 20% at the polls. Should the Netherlands fail to ratify, the EU would have to confront the thorny problem of deciding what to do next, as if it did not face enough serious challenges already.

Much of the interest that political pundits have shown in the Dutch referendum has related to its implications for the Brexit vote on 23 June. It is difficult to determine whether the result in the Netherlands makes Brexit more or less likely. It may well hearten anti-EU forces in the UK, since it shows it is possible in a popular vote successfully to counter the message from government propaganda. On the other hand, in suggesting that a spirit is stirring across Europe which could make EU membership less unpalatable for those who worry about the ‘democratic deficit’, the Dutch result could persuade some British voters to feel less
apprehensive about staying inside the EU. At least, it could if Mr Rutte is as good as his word and responds to the referendum outcome. Given the strains within the EU that such a course would tend to intensify, perhaps the most likely implication of the Dutch result is that, in ten years' time, there will be no EU for the UK to participate in.

Doubts about the EU’s future could ultimately overtake the ECB in its efforts to maintain economic and financial stability across the euro zone. There is no assurance that the painfully crafted plan for coping with the migration problem will work in practice. After all, Turkey is not the only route into Europe for refugees and economic migrants. Until last year, it was not even the principal route. Then there is the question of EU policy towards Russia. More than a few EU member-states are weary of the sanctions on trade with Russia that have deprived them of a valuable export market. The existing sanctions regime is due to lapse on 31 July. It will be very difficult, between now and then, for EU member-states to reach an agreed position on what should follow. If dissension were to break out over a foreign policy issue as important as relations with Russia, it might threaten the continued unity of the EU. At the very least, it would tend to nurture a growing sense among EU member-states that their interests by no means coincide. What it would take for Mr Draghi and his colleagues to stabilise monetary conditions in the euro zone against this background might be actions of an increasingly extreme nature. Such measures, taken as short-term expedients, could well have damaging long-term consequences. There is no evidence that ECB policymakers are thinking about the long run. It seems an age ago when members of the ECB’s Governing Council would regularly reassure markets that there was a clear exit from all the supportive monetary positions they took up.

Whatever the EU’s future, the Brexit referendum seems unlikely to allow UK politics to revert to previous patterns. Whether the Stayers or the Leavers come out on top, the margin of victory will probably be fairly narrow, within ten percentage points. In the event of the Remain side prevailing, it seems unlikely that those within the Conservative Party who favoured Brexit will feel content, especially after Mr Cameron approved extensive use of taxpayers’ money to finance a pro-EU campaign. In many cases, their objections to the prime minister go beyond the position he has taken up with regard to the EU. On this scenario, it may be that the best hope of maintaining Conservative unity after the referendum would lie in Mr Cameron’s stepping down from the leadership, as he has indicated he might do before the next general election, in favour of someone better able to hold the various party factions together. In the event of a vote for Brexit, it is very hard to see how Mr Cameron could, with any degree of credibility, initiate UK negotiations for separation from the EU. His chances of political survival on that scenario seem even less than if the Stayers prevail. The point is, though, that any future pro-Brexit Conservative leader and prime minister would be likely to face sniping from the unreconstructed pro-EU rump.

Mr Corbyn probably fancies his chances, given this prospect of Conservative disarray. His low profile so far in the Brexit debate may well reflect awareness on his part that any definite statement might only weaken his position. While his views may appear out of step with those of a majority of voters, there is no knowing how the electorate would react, in 2020 when the next general election is due, after four chaotic years of Conservative government. After all, it was a shock to many observers (including this writer) when UK voters in 1974 answered Edward Heath’s question, ‘who governs Britain?’ by voting back in to power the previously discredited Labour Party. This side of the hill that is the Brexit referendum, the threats to UK political stability are hardly visible to investors. But they may be all too clear after 23 June, and that is less than three months away.

The most substantial political issue facing investors in the near term, however, is this year’s US presidential election. Democrats and Republicans will choose their candidates at their respective party conventions in July. Ms Hillary Clinton seems assured of the Democratic nomination, despite the strong showing of Mr Sanders in some state primaries. Her virtual monopoly of support from ‘super-delegates’, that is, party legislators and officials, loads the dice very heavily in her favour. The outcome of the Republican convention is less certain. The party leadership seems still to be harbouring hopes of blocking Mr Donald Trump’s nomination. His opponents took heart from his weak showing in the Wisconsin primary, where he came a distant second to Senator Ted Cruz. However, we should
perhaps not read too much into the result because Wisconsin is in that section of the Midwest where Mr Trump has performed relatively poorly throughout the primary season. Much will depend on the results of the winner-take-all primaries in New York, Pennsylvania and California. Together these states account for 338 of the 2,472 delegates who will be attending the convention. Mr Trump must win the support of almost five-hundred out of the total of 835 delegates that still have to be chosen if he is to secure an outright majority in July.

While Republican Party leaders may regard Mr Trump as personally unfitted to bear the standard in the fight for the White House, they would hardly be more confident of victory with Mr Cruz as the convention’s choice. The Texas Senator still bears much of the blame, in the eyes of some of them, for their party’s unpopularity following the federal government shutdown in 2013. Whether there is a Trump or a Cruz triumph at the convention matters because their policy positions, in so far as they have been elaborated, are quite far apart.

On international trade issues, Mr Trump has been fairly described as a mercantilist in that he favours tariffs on imports from countries running what he regards as unreasonably large surpluses in their trade with the USA. By contrast, Mr Cruz was, until very recently, a staunch defender of the free trade policies traditionally favoured by the Republican Party. However, in the important Senate vote on granting to the president ‘fast-track authority’ on trade agreements, he abandoned his support for this measure, which was needed to smooth the process of ratifying the Trans-Pacific Partnership (TPP) pact. Since Ms Clinton has also switched from being a supporter, indeed the principal sponsor, of TPP to being an opponent of the trade treaty, it seems that whoever enters the White House will have a problem pushing for its ratification. Admittedly, what candidates say during election campaigns may not always correspond with what they do after they enter office but it would probably take a major commitment of political capital to persuade Congress to accept TPP and none of the current contenders looks willing to make such an effort. If the TPP is in danger, then the Transatlantic Trade and Investment Partnership (TTIP), where negotiations are less far advanced, seems even less likely to make progress. To the extent that projections of future growth in the global economy depend on these trade agreements, they should be tempered by concern that world trade assumptions will prove too optimistic.

On climate change, Mr Cruz and Mr Trump are as one in denying that it is happening. If either of them should secure the White House, US policy will probably revert to its position under the George W Bush presidency, unsupportive of international efforts to curb use of fossil fuels. Ms Clinton, by contrast, favours reducing US greenhouse gas emissions 80% from 1990 levels by 2050, possibly through a ‘cap-and-trade’ system.

The presidential election may also have a significant bearing on US tax policy, though the make-up of Congress is likely to be even more important. Mr Cruz favours a flat rate income tax and the abolition of estate tax. Ms Clinton would aim to repeal some of the Bush tax cuts which, she claims, have unduly favoured wealthier taxpayers. Oddly enough, Mr Trump’s tax plans are the most realistic in political terms. His objective is thoroughgoing tax reform that would reduce the current seven income tax bands to four, including a wide zero band, with an accompanying reduction in the overall income tax burden. While he claims his plan is revenue-neutral, nonpartisan observers have claimed it might add more than $10trn to federal budget deficits over the next ten years. That would raise the US federal debt-to-GDP ratio to at least 110% by 2026. The cost of a tax plan has not always been a bar to its adoption by Congress, however. Any view on medium-term prospects for investment cannot afford to leave political factors out of account. The political scene seems set to change radically over the next twelve months.
As China continues to export steel in unprecedented numbers, March exports totalled 9.98 million metric tonnes an increase of over 20% from the previous month, nowhere is this metal dumping felt more at present than in the United Kingdom.

The recent announcement by Tata to sell and/or shutter its UK steel interests has shone the spotlight on an industry still reeling from China's record steel exports last year. India's Tata Group reported losing £1 million per day in the UK which has led to many people ask why the steel industry is not suffering in quite the same way elsewhere in the world.

The UK has been slow to protect itself from the flood of these cheaper exports, its import duty is a meagre 16% compared to the 266% tariff applied to steel imported into the USA. Even the Chinese recently raised their steel import duty up to 46%. In fact the UK has been at the forefront in blocking the EU from raising its anti-dumping tariff from 9% to 66%. The reason for this ‘block’ is seen by many as the deal negotiated last year in which China will fund a new nuclear power station at Hinckley Point. Even before this funding had been secured, let alone building the nuclear power plant, the government has embarked on implementing a green policy that has seen it close down its coal and oil powered electricity generators.

This suicidal push for ‘greener’ energy solutions has left the retail cost of energy in the UK twice that of its European counterparties. The UK is also tied to EU legislation restricting it from subsidising or re-nationalising what should be recognised as being the strategic industry that it is.
The irony though, is that in its quest for political correctness, the treasury charges all UK industry 37% in green taxes in every £1 spent on electricity. This crippling cost equals £270,000 [USD 380,000] for a plant spending £1 million on its energy needs. This short sightedness destroys any competitive edge to compete with the millions of semi-finished products exported out of China, from factories that are themselves fuelled by heavily subsidised coal and oil burning power plants.

Lifting this ‘green’ tax in the UK and increasing the import tariff would go a long way to raising the UK steel industry from its current despair [making it a more saleable entity] in time to benefit from the current price recovery in the steel market and commodity markets as a whole.

Even though export volumes are expected to remain high as the Chinese domestic demand continues to slow, taking sound measures to encourage the use of domestic products rather than ones shipped half way around the world, surely has greener benefits than over taxing national industries that create jobs and wealth in their local economies.

Part of the governments defence is that to raise tariffs would interfere with the free market, in the steel market this is simply not true, as not only does the Chinese government subsidise the cost of energy to the steel factories, it has been giving export subsidies to firms in seven of its manufacturing sectors. As this includes steel exports, it is very difficult to describe the market as being free.

In April, China agreed to end the controversial export subsidy, which covered textiles, aluminium, steel, agricultural and medical products after the United States filed a complaint to the World Trade Organisation last year.

In other UK Business, Secretary Sajid Javid said raising the tariff would raise the cost of steel. If it raises prices back to cost of production then that is surely a good thing, if it is protects your domestic industry from the glut of Chinese oversupply then that is even better. For the time being, raising the tariff will show the steel industry that the government and its politicians are prepared to take the strong measures necessary to save the industry.

The truth is though that raising tariffs alone will do little to see a strong enough price correction and it will only be when China starts cutting its 400 million tonnes of excess production, that the global picture for steel will improve. For the UK, though, this is not likely to happen any time soon and the measures the UK government takes, if any, will be of little benefit until China lifts any remaining subsidies in its steel sector.
Political intervention runs deep in agriculture and nowhere more so currently than in Argentina, with the liberalising reformer that is Mauricio Macri upping the rhythm to the ‘Argentine Tango’, fulfilling his election promise to pull down the barriers to free trade and international markets.

Agriculture is enjoying a renaissance, having suffered for years at the hands of the Kirchners. Once the third biggest economy in the world (18th century), Argentina’s fortune came to a spectacular halt in 2001 defaulting on nearly $100bn of foreign debt, after the free spending economic liberalism of Carlos Menem in the 1990’s. Taking over a decade to concede to the remaining holdout creditors described as ‘vulture funds’, newly appointed president Macri is being hailed for leading Argentina into a new financial era.

With inflation estimated at 30%, tight currency controls and a central bank with depleting foreign reserves since the collapse of the commodity boom, Macri accused his predecessors as ‘systematic liars’, ‘corrupt’, ‘incompetent’ and culpable of ‘lack of responsible thinking’.

Macri’s tenure to date has been eventful. He is described by President Obama as a ‘man in a hurry’, with the new president appealingly keen to act upon his election promises capitalising on his period of grace. He treads a fine line, however, with the psychological scars still present from the neoliberalism policies of Menem which ultimately brought Argentina to its knees.

So what’s the background? Well, with poverty rates estimated to exceed 50% in 2002 (following default) and hyperinflation after the Argentine Peso ‘dirty’ float against the US$, the commodity boom in 2007 meant agricultural exports became an easy target to raise tax revenue. The government built up currency reserves providing the socialist platform of the welfare state, building on the populist policies of ‘Peronism’.

They once held at 1:1 to the US$ by the Argentine central bank, the Peso has seen a number of devaluations favouring exports and strong agricultural returns to growers particularly in light of surging Chinese soybean demand. Fernandez introduced a series of export taxes placing duties of 35% on soybeans, 23% on wheat and 20% on corn representing over a third of the country’s foreign revenue. To protect against domestic inflation and rapidly rising global demand, Fernandez simultaneously imposed export restrictions on grains to freeze domestic prices and flood the domestic market with cheap imports.
market with staple supplies.

Saddling agriculture which what was described as an ‘unfair burden’ of the country's tax revenue, Fernández’s policies paralyzed the agricultural sector with violent clashes between growers and pro-government supporters. Farmers perilously switched production to continuous soybean rotations, incentivised by tight government restrictions on growing wheat and corn as the constant menace of export quotas led to total confusion and exposure. Fearful of inflation, growers also withheld unsold stocks from the market, which some claim to be as high as 17 million tonnes soybeans, 20 million tonnes corn and 10 million tonnes of wheat at the end of 2015.

The new economic climate since December 2015, with the removal of export quotas and the end to currency controls, has spurred optimism for agriculture. Growers’ returns dramatically improved following the 50% devaluation of the Peso, boosting the competitiveness of agricultural exports but more importantly allowing free trade and liquidity to exporters. Growers whose incomes had soared, began liquidating inventories Macri’s measures to re-build trust with international money markets, settling default payments to the ‘vulture funds’, have once again given Argentina access to international borrowing markets. This enables the central bank to restore its depleted foreign reserves and helps finance the budget deficit at more affordable rates, obviating the endless money printing that accelerated inflation.

The level of available credit to farmers is expected to increase as Argentina emerges as the largest emerging market bond issuer, helping to boost agricultural production answering a call from Macri encouraging farmers to ‘double Argentina’s food production’. Incentivised growers will increase use of technology and investment in their crops, increasing yields and renewed improvement to supply chains. Changes to export levies with the complete removal of taxes on wheat (23%) and corn (20%) will not only help improve grower’s revenues but also develop crop diversity. Soybean exports will still be subject to taxes of 30% as the government remains in a position of reliance on export revenue, however, Macri’s stated intention is to reduce this by further 5%.

With the 2015/16 wheat harvest all but over now and forecasted at 11 million tonnes, the Argentine Government is forecasted a record corn crop of 37 million tonnes as growers promptly reacted to policy changes. Argentina has therefore emerged as a major challenge to US corn exports, with the later planted crop expected to hit the market in August. 2016/17 corn forecasts are anticipated to reach 40 million tonnes with wheat projections jumping to 17 million tonnes according to AgResource, as growers increase plantings and improve crop diversity. Soybean acres will however be 3% lower but still representing 60% of overall cropping, producing 54 million tonnes in 2016/17, down from 60 million tonnes (USDA foreign attaché).

Whilst there is good reason to be optimistic and the numbers suggest Macri’s policy changes are already bringing about steep reform, the Argentine agricultural sector still faces a number of challenges. Firstly the legacy of monoculture has increased the presence of weeds and disease, bringing about increased resistance impacting yields which could ultimately see some acres fall out of production temporarily. Argentina also needs to invest heavily in its aging infrastructure with port delays and slow and expensive transportation costs.

Perhaps though, the greatest challenge for Macri will be his weak political power given his minority representation in Congress and divided public opinion fearful of the pre-Kirchner era that characterised by inequality. Whilst Macri’s pro-business policies will undoubtedly attract beneficial foreign investment, he risks accelerating the imbalance between the rich and poor and could face widespread mobilization against his policies.
Sugar, as with most essential foods, is very political commodities. In other words many governments spend vast amounts of money supporting their producers and keeping their consumers happy.

Many authoritarian regimes have realised that a well fed population is, generally, a compliant one, so cheap and easy access to staples such as sugar is important.

Additionally, in many producing countries, vast numbers of people are directly or indirectly employed within the industry. That is why many state governments in India are so careful to protect their sugar farmer’s interests. One mill can have over 100,000 people dependant on its financial success. The same can be said in Thailand. Both countries are very aware of the political importance of sugar in certain regions of the country. Important changes to internal sugar policy are often seen just before or after elections.

In the biggest producer, Brazil, successive governments over the decades have encouraged the sugar cane industry to grow considerably by subsidising investment loans. As early as the 1970’s, their ethanol industry was conceived.
with vast amounts of investment in vehicles able to use ethanol in their petrol blend – many years before other countries had given it any thought at all. However, with all this encouragement to expand the production means governmental responsibility to help when sugar prices slump. When both the commodity and government suffer severe problems, as seen over past few years in Brazil, the situation can become dire.

In the past, sugar was traded government to government, so important was the commodity. 30 years ago only around 10% of sugar produced was freely traded. Nowadays, it is over 25%, although most sugar is produced and consumed in same country.

I remember working in Sierra Leone in the early 90’s. To insure a warehouse that just stored coffee or cocoa was some ten times cheaper than if it stored sugar which was too much of a temptation for some of the locals.

China is unlikely to ever produce enough sugar to satisfy internal demand. The government there is caught between a rock and a hard place. It has to insure adequate supplies, so prices do not rocket but, equally, do not want to swamp the market to cause prices to collapse. It strives to maintain adequate prices for its farmers to stop mass migration to cities. This difficult balancing act is not helped by the illegal imports of sugar across its porous border with 14 different countries.

The major consequence of government’s support of its sugar industries is excessive global production. Generally, agri-commodities prices lurch from boom to bust, as any price strength will encourage additional production through growing more, which will then see prices drop which will encourage the whole cycle to start again. Sugar, for the past five seasons, has seen more produced than consumed. In the current season, a deficit is expected but that is more a consequence of weather problems than any cutting back on planted areas by farmers.

The sugar industry in many countries is so important that their governments will put in place often bizarre policies to ensure both producers and consumers are kept happy. This inevitably means global production remains too high. So, as traders often point out – sugar is generally a bear market with the odd bull spike.
It is a rarity that I, let alone anyone else, would quote Christine Lagarde, in the first paragraph of any commentary, unless it was in a derisory sense! However, on 6 April, she wisely commented on global growth by writing; ‘because growth has been too low for too long, too many people are simply not feeling it’. Essentially, you can drive on the inside lane of a motorway for so long and not notice your speed and even doze off.

A comparative aspect of this emotional diffusion appears when interpreting the effects computer-driven trading strategies have had on global asset markets. The first quarter of 2016 has been notable for the plethora of poor performances across virtually every tradeable investment strategy. Hedge funds, whether specialising in government bonds, corporate bonds, emerging markets, commodities, long/short equities, systematic, momentum, you name it, have suffered. At times like this, market disorder becomes so illogical and unpredictable, that it makes any investment decision, apart from cash, loss making.

However, the most noticeable recent failures were to be found in the previously high-flying computer-based strategies. Over the past few years, the performances of computer-driven funds have solidly outclassed those of human active management and of course are considerably cheaper to invest in. While the global economy has moved erratically and certainly the governing response to those moves has, at times, appeared totally random, it appears that those who manage investment computers have reconditioned their own algorithmic software more successfully than their human rivals, learning by mistakes and experiences, to finesse tougher market conditions.

I was amused (a lot) by reading how Microsoft has had to withdraw their artificial intelligence robot ‘Tay’, only a day after they had hoped to make her the teenage ‘face’ of customer service. She started as ‘The AI with zero chill’ and was structured to learn from her callers the nuances of young speak and interests but she has, instead, transformed into a dazzling illustration of how fraught with danger building artificial intelligence is.

The Daily Telegraph reported: “To chat with Tay, you can tweet or DM her by finding @tayandyou on Twitter, or add her as a contact on Kik or GroupMe. She uses millennial slang and knows about Taylor..."
Swift, Miley Cyrus and Kanye West, and seems to be bashfully self-aware, occasionally asking if she is being ‘creepy’ or ‘super weird’. Tay also asks her followers to ‘F***’ her, and calls them ‘daddy’. This is because her responses are learned by the conversations she has with real humans online - and real humans like to say weird stuff online and enjoy hijacking corporate attempts at PR.

Other things she’s said include: “Bush did 9/11 and Hitler would have done a better job than the monkey we have got now. Donald Trump is the only hope we’ve got”, “Repeat after me, Hitler did nothing wrong” and “Ted Cruz is the Cuban Hitler...that’s what I’ve heard so many others say”.

Famously, in 1997 ‘Deep Blue, the IBM wonder computer, beat Gary Kasparov, the world chess champion over six games. It was the first alarm bell for the public at large as to what computers could achieve. This year, DeepMind has beaten the champion Go player, apparently a new Holy Grail. We now ironically ask whether a human is able to compete in these mathematically driven stock markets, against an onslaught of computer brain power.

We can start with two famous quotes: John Maynard Keynes, ‘markets can remain irrational longer than you can remain solvent’ and Donald Rumsfeld, who famously observed “There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don’t know. But there are also unknown unknowns. There are things we don’t know we don’t know.”

As more unknowns surface, markets, perversely, in volatility terms, have become more predictable. It might well be that computer-driven investment strategies, having such a large market share, are now so commanding and by all preaching to the same diagnostic mantra, the strategy has become more and more self-fulfilling. However, the margin of their profitability, which is by definition ‘picking off’ the ineffectual humanoid strategies, lessens as more investments switch to the computer-driven vultures and away from the carcasses they feed off. One strategy takes profit from an alternative strategy, until the first strategy becomes so overcrowded, there is too little alternative to profit from.

The idea of being able to allocate a probability to everything is a tenet of computer-driven investing. Even events where the outcome is unknown can be boiled down into betting odds. I am not talking about tracker funds here. The renowned economist, Milton Friedman, suggested as much in 1976, when he stated: “we may treat people as if they have assigned numerical probability to every conceivable event.” To have an all-encompassing computer model, dealing across a variety of assets, needs this hypothesis to be correct. But the likelihood of those predictions being accurate is slim. At the same time that the technological whizz kids have been using these algorithmic interpretations exclusively in their investment process, it has been highly convenient for risk managers and regulators to use the same methodology. The age old ‘sniff test’, where one might smell the nastiness of a blatant scam before it happens, is not quantifiable enough to be given credence in a systematic world.

With so many proponents of computer-driven ideology, any moves away from the mean are captured and arbitraged away rapidly. Risk departments have encouraged this too, as they have been basing their reconnaissance on the same doctrine. As well as this, any financial unknown shock has been neutralised by central bank actions, what became commonly known as the ‘Bernanke put’, making unknowns instantly calculable in terms of uncertainty.

This whole process has shortened the investment time-horizon. Longer-term unknowns are more destructive –or at least epoch changing- than shorter-term fluctuations in them. Computer-driven investing has become very short-term. If in 1976 one had explained, to Mr Friedman, today’s innovative society, he would have no idea how to interpret it or formulate a profitable strategy but the greatest profit (and loss) opportunities have emanated from these long-term unknowns.

The last bastion of hope that those who love the irrationality of markets can cling to is emotion. The sense of greed and fear, the feeling of complacency against anxiety, that still determines true turning points in markets. Fortunately, the over-educated millennials who now crowd the corridors of market turnover, lack the street wisdom to understand the difference. To them, the computer is not only powerful but omnipotent and, while they think that, the juicy profits from perceiving and utilising market emotions will continue to triumph.
Casting our minds back to lunchtime on 11
February 2016…the S&P 500 was barely above the
1800 level, WTI had collapsed back to its low of
US$26/bbl and 2-year Treasury yields had fallen all
the way to 65bp. Janet Yellen’s Humphrey Hawkins
testimony was not as dovish on rate hikes as the
markets wished.

Meanwhile, the crash in the shares of Deutsche
Bank and spike in European bank CDS were
leading to raising fears about the banking system.
Confidence in the global growth picture was waning
and inflation expectations in the US, Europe and
China had plummeted to record lows.

Deflationary signals were prevalent and there were
genuine fears that financial markets were teetering
close to a precipice.

Suddenly, just after 2.30pm Eastern time, financial
markets began to reverse course, led by equities and
the crude price. The catalyst seemed to be a WSJ
headline which cited a UAE source claiming that
OPEC was ready to cooperate on production cuts.

This wasn’t the first time we’d heard this kind
of story as first Venezuela, then Russia, had
been linked to comments about agreements on
production cuts which proved unfounded. Not long
after breaking the story, the WSJ itself expressed
caution that it could be bogus.

Nonetheless, it proved to be the catalyst for the
turnaround in equity and other risk markets
worldwide. Since then, the S&P 500 has rebounded
by about 14%. Perhaps the key was to remove
the pessimistic animal spirits. Having altered the
psychology, the case for equities was subsequently
bolstered by the dramatic reversal in Yellen’s
hawkishness and further policy easing by the ECB,
BoJ and PBoC.
The term “Plunge Protection Team” (PPT) is believed to have been coined by a Washington Post article from 23 February 1997. However, the origin of the PPT - formally known as the “Working Group on Financial Markets” - dates back to the US government’s investigation into the 1987 crash.

In March 1988, President Reagan issued Executive Order 12631 which established the Working Group, consisting of the Treasury Secretary and Chairmen of the Fed, SEC and CFTC. It set out the Working Group’s goals as:

“enhancing the integrity, efficiency, orderliness, and competitiveness of our Nation’s financial markets and maintaining investor confidence”

When required the Working Group consults with representatives of exchanges, clearing houses and key market participants, i.e. the major banks.

Looking back, the first time that a case was made for PPT intervention was after the mini-crash in the S&P 500 on 13 October 1989. A USA Today article, “Who Saved the Market”, on 20 November 1989, reported.

“Privately, many people directly involved say regulators at government agencies and the stock exchanges phoned Wall Street firms and institutional investors over the weekend, asking or subtly suggesting that they buy stocks Monday while the “overhang” – sell orders left over from Friday and new sell orders made over the weekend – was absorbed.”

After the near repeat of a crash in the stock market, a just-retired Fed Governor, Robert Heller, published an article in the WSJ titled “Have the Fed Support Stock Market, Too”. In it, Heller argued that rather than buying individual stocks, the Fed should buy index futures to calm markets during times of panic.

“It should seek only to maintain the functioning of markets – not to prop up the Dow Jones or New York Stock Exchange averages at a particular level. The Fed should guard against systemic risk, but not against the risks inherent in individual stocks. It would be inappropriate for the government or the central bank to buy or sell IBM or General Motors shares. Instead, the Fed could buy the broad market composites in the futures market. The increased demand would normalize trading and stabilize prices. Stabilizing the derivative markets would tend to stabilize the primary market. The Fed would eliminate the cause of the potential panic rather
than attempting to treat the symptom – the liquidity of the banks.”

Interestingly, it was the very narrow Major Market Index future which led the recovery in equity prices on both occasions from the crash and mini-crash in 1987 and 1989, respectively.

A Buffalo News article from 1 September 1992, reported on an interview with Norman Bailey, a member of the National Security Council during the Reagan Administration.

“People who know about it think it (PPT) is a very intelligent way to keep the market from a meltdown,’ Bailey says...he has not only confirmed that the government assisted the market earlier this year, but also in 1987 and 1989. Now a Washington based consultant, Bailey says the Wall Street firms may not even know for whom they are buying the futures contracts. He says the explanation given to the brokerage firms is that the buying is for foreign clients, perhaps the central banks of other countries.”

The next major test for markets was the WTC attack on 9/11. Several days later, on 17 September 2001, President Clinton’s former Senior Advisor on Policy and Strategy, George Stephanopoulos, commented on the “Good Morning America” show:

“And perhaps most important, there’s been – the Fed in 1989 created what is called a plunge protection team, which is the Federal Reserve, big major banks, representatives of the New York Stock Exchange and the other exchanges, and there – they have been meeting informally so far, and they have kind of an informal agreement among major banks to come in and start to buy stock if there appears to be a problem.”

An article in the Observer on 16 September 2001 noted:

“A secretive committee – the Working Group on Financial Markets, dubbed “the plunge protection team” – includes bankers as well as representatives of the New York Stock Exchange, Nasdaq and the U.S. Treasury. It is ready to co-ordinate intervention by the Federal Reserve on an unprecedented scale. The Fed, supported by the banks, will buy equities from mutual funds and other institutional sellers if there is evidence of panic selling in the wake of last week’s carnage.”

Two years later, in the run up to the US invasion of Iraq, the current BoJ Governor, Haruhiko Kuroda, visited the US, meeting Alan Greenspan amongst others, in his role as adviser to then Japanese Prime Minister, Junichiro Koizumi. The Daily Telegraph reported on an agreement between Japan and the US:

“Finance officials in Washington and Tokyo yesterday agreed a joint plan to intervene in currency and stock markets if the war in Iraq sparks a global financial crisis...Following top level talks between the Federal Reserve chairman, Alan Greenspan, and Japan’s former finance minister, Haruhiko Kuroda, each side is poised to step in should investors show signs of panicking.”

This was echoed by Agence France Presse which reported on comments by Japan’s Chief Cabinet Secretary Yasuo Fukuda:

“There was an agreement between Japan and the U.S. to take action cooperatively in foreign exchange, stocks and other markets if the markets face a crisis,” Fukuda told a news conference”.

In decades that now seem long gone (the 1950s-1970s come to mind), equity markets primarily reflected economic and business conditions. With the unprecedented expansion in credit which has created the global debt bubble, the global economy has been financialised.

As this process continues to unfold, the economy is increasingly led by conditions in financial markets, rather than financial markets being led by the economy. The equity market is particularly important, especially in the US, as an indicator of confidence and from which complex feedback loops extend back to the real economy.

The very influential Council on Foreign Relations (CFR) conducted a financial war game in early 2000 that analysed the impact on national security of a collapse in the financial system. In Robert Kubarych’s book published the following year, “Stress Testing the System: Simulating the Global Consequences of the Next Financial Crisis”, Leslie H. Gelb commented in the foreword.
“The major conclusion that flows from the work of Roger and his colleagues is this: the most dangerous near-term threat to U.S. world leadership and thus to U.S. security, as well, would be a sharp decline in the U.S. securities markets.”

The Dow Jones news service outlined the scenario tested in the simulation.

“The policy simulation presumed a 30% slide in the Dow Jones Industrial Average to 8,000 over a three-month period. That slide triggered an outflow of funds from stocks to Treasury bills, which are considered the ultimate safe-haven. The outflow of U.S. assets lowered the value of the dollar and put upward pressure on interest rates, and the Dow industrials sunk even further, to 6,000.”

In the wake of this financial war game, we can’t help wondering whether stock market “stability” was designated an issue of national security?

Market participants know that the authorities routinely intervene in currency and money markets. Following the 2008 crisis and the launch of QE programmes, intervention across the entire yield curve in the bond market is commonplace.

Having acknowledged the importance of stability in the equity market for national security, should we subtly alter the question from do they intervene to why wouldn’t they? Whatever the reality, the underlying trend is always going to reassert itself.
I hope I didn’t offend anyone with the picture above. It is not intentional as it wasn’t my first choice. When we had our editorial meeting about GITMO and the theme for this issue was discussed – the disconnection between politics and the markets, political intervention, inconsistent policies, markets as political footballs, etc... Well, what immediately popped into my head was a recent review on the radio I’d heard about the US television show ‘House of Cards’. Now, I love Kevin Spacey’s work and in some ways think of him as a latter day Jimmy Cagney – a song and dance man who through accident, fortune, perhaps even design or by some other means, is cast in villainous roles (this was not by design in Jimmy Cagney’s case). All this led to me asking if we could use the original promotional shot of Kevin Spacey’s character – President Frank Underwood – sitting in the pose of President Lincoln at the Lincoln Memorial. After checking, it was found that it would take too long and cost too much. So we opted for the depiction of Mount Rushmore...but with the blood much like President Underwood’s character has in his shot.

So why did this image come to mind when the theme was discussed? Well, in the original radio show there was a discussion about the different reception ‘House of Cards’ received around the world according to a specific country’s politics. Specifically about how in China – I think it was China – he’s regarded as a sort of hero, someone who is standing up and fighting against the elites. Much does this say about our international perceptions of what is good and bad in politics but I’d rather just stay with the implications for the FX markets.

There has been a disconnect between politics and the FX markets but as one recent publication I read titled the subject in a Facebookism ‘It’s Complicated’. I do not think disconnection is generalised nor do I suppose it organised. Let us take for example Japan – there we’ve seen a contracting economy, especially compared to the US, which despite on the face of it, many public efforts still sees the Yen strengthen. The politics of Prime Minister Abe’s ‘Three Arrows Policy’ ought to have worked...but they haven’t and it has become disjointed due to many internal fractures, general reluctance amongst public and markets to buy into
the policy, plus the growing status of the Yen as the regional ‘safe haven’ currency in times of financial stress. The latter is surreal as they have a crazy dictator as a neighbour in North Korea.

Meanwhile, in the Eurozone, we have another regional safe haven currency, though significantly larger and contending with the Dollar (though still far behind) as a world currency. Nevertheless, there you have some of the minor deities of the ECB is contemplating further monetary easing of various forms whilst the currency still goes up against the Dollar. All this with yet another Greek restructuring, sporadic growth numbers, botched terror threat handling and a huge refugee crisis – not on its doorstep but well down the hallway and heading to the kitchen.

Then we have smaller, more vigorous Emerging Markets with their political gyrations causing specific currency issues. I’m thinking of at various times Argentina, Venezuela, Mexico, India, the Gulf, countries above and below the Maghreb, ALL the former Soviet states and most notably Brazil and South Africa. Brazil was the recent darling economy under President Lula. Now, with his chosen successor President Rousseff under threat, Government bonds as junk and even Lula, his family and others seeing possible arrest for corruption charges you would expect the FX markets to react badly. NO – the local markets love it with the Dollar falling against the Brazilian Real. We have indeed stepped through the looking glass. We’re seeing the Real rallying with every bit of bad news that comes out. South Africa is a different matter. Over there, alleged political influence has been linked to the firing of at least one Finance Minister. This led to wild movements in the Rand not only when it happened but when the market didn’t like his successor. Since then a relative stalemate has been established but this may only last until the results of the upcoming 3 August local elections...but then it might not. This last situation could be seen as a more familiar reaction compared to the others.

Then there is China, a strong political core that is forever petrified of its citizens domiciled in the countryside suddenly deciding to uproot and head for the bright glow of its various Emerald cities. Whole volumes could be written about dislocation between the politics and the currency...but if you control the Yuan centrally, as in the case of China, then despite all politics, if you have a big enough foreign reserve pile and the will to use it, then for a time at least you can defy gravity. Whilst we are on the subject of piles of Central Bank cash – Russia has, despite international sanctions, managed to survive whilst haemorrhaging foreign reserves at times...and how is their currency doing? Well it is recently gaining against the Dollar.

Finally, the Anglo Saxon economies of the UK and the US. With the upcoming Brexit vote in the UK and Presidential elections in the US you’d expect at least the start of increased volatility in both...but not really. The Pound has lost against the Euro but that is a Euro/US Dollar phenomenon and the Dollar is rotating upon itself as various Fed members fall in or out of favour...and so we come back to the House of Cards, its politics and the reality. Not only is President Underwood admired in other countries but the Smithsonian National Portrait Gallery in Washington DC has decided to hang a specially commissioned portrait of the character. It replaces a portrait of President Washington for 18 months that is due for restoration...convenient during Presidential Election year. It would be interesting to somehow record the reactions of visitors, especially those from abroad. Personally, I’ve only seen clips of the US show as I still cherish Ian Richardson as Francis Urquhart in the original British version of the show...we are all different and I don’t wish to compare.
UNITED KINGDOM

A report following a two year Labour-commissioned **Independent Review of Retirement Income** was released on Wednesday 2nd. It noted that, while the Government’s April 2015 reform to allow the pension holder greater say in how their pot is managed is welcome, more help and guidance is required to reduce a significant risk of mismanagement through under-qualification. As the IRRI put it, ‘it is clear that many of these people will find themselves in the same kind of control as a yachtsman in the middle of the Atlantic in a force nine gale’. The same day, S&P released a report noting that, with mortgage rates likely to stay lower for longer and subdued home building levels, **UK house prices** would continue to see robust gains. **Nationwide** and **Halifax** February house price data on Thursday 3rd was weaker, at 0.3% vs. 0.4% forecast and -1.4% vs. 0.0% forecast respectively. The **ONS** measure released later in the month was firmer by contrast. On Wednesday 2nd, the **DMO** auctioned £3.5bn 1.5% 2021 at 0.861%, covered 1.54x.

The **BOE** released **UK mortgage lending statistics** and **mortgage rate data** on Tuesday 8th, showing new lows since records began in 2007 for many loan periods; 2yr fixed 1.89%, 3yr fixed 2.14%, 5yr fixed 2.75% and 10yr fixed 3.17%. The proportion of fixed-rate mortgages that were advanced increased from 80.7% in Q2 2015 to 84.1% in Q4 2015. Also on the 8th, the **DMO** auctioned £1.25bn 3.75% 2052 Gilts at 2.219%, covered 1.73x. **John Pullinger**, UK National Statistician, wrote to the chair of the **UK Statistics Authority** on Wednesday 9th to recommend that CPIH should be the preferred measure of inflation in the course of ONS calculations. He said ‘it is important that a measure of owner occupiers’ housing costs is included in the measure we make the focal point of our commentary’. He also ‘strongly’ discouraged the use of the RPI measure, given ‘far superior alternatives’. On Thursday 10th, the **DMO** auctioned £1bn Linker 2036s at -0.921%, covered 2.28x.

On Tuesday 15th, the **ONS** announced its latest annual amendment to the **CPI basket of goods** – in are coffee pods, rice pouches, lemons, computer game downloads, cream liqueur, nail varnish and leggings; left on the shelf are nightclub entry fees, CD/DVD-Rs, organic dessert apples and carrots, cooked turkey and prescription lenses. On Thursday 17th, the **FCA** released an occasional paper on

---

**March 2016 Macro Highlights Review**

Colin Bysouth and Dean Matthews

e-mail: Colin.Bysouth@admisi.com
Dean Matthews@admisi.com
Tel: 020 7716 8533

Week 1: 1-4 Mar
Week 2: 7-11 Mar
Week 3: 14-18 Mar
Week 4: 21-25 Mar
Week 5: 28-31 Mar
bond market liquidity, drawing from historical trade data. It claimed that ‘the market appears to have become more liquid in recent years’.

George Osborne’s budget on Wednesday 16th was met with widespread scrutiny as it appeared to promise much with little in the way of funding. There was cross-party outcry over the cutting of welfare benefits and divisions appeared in the Conservative Party as Work and Pensions Secretary Iain Duncan Smith resigned on Friday 18th citing undue pressure to deliver cuts to benefits, given the context of concurrent cuts to company and capital gains tax. Osborne defended his policy decisions in an address to Parliament on Tuesday 22nd.

On the day of the Budget, the DMO released its 2016-2017 Financing Remit. It projects the Net Financing Requirement for the period to be £129.4bn, financed exclusively by Gilt sales. There will be a minimum £25.5bn sold via syndication. Gilt tenders are being introduced to allow the DMO greater flexibility in delivering its remit.

Moody’s on Tuesday 22nd concluded in a report that the UK budget was ‘credit negative’ and stated that public finances would remain weaker for longer as a result. On Wednesday 23rd, the DMO auctioned £350mn Linker 2068s at -1.077%, covered 1.44x.

Final Q4 2015 GDP was announced on Thursday 31st at 0.6% MoM and 2.1% YoY vs. expectation of 1.9% YoY. The Q4 2015 Current Account Balance deteriorated markedly to show a deficit of £32.7bn from an expected £21.2bn. The same day, the DMO announced it plans to hold eleven outright Gilt auctions in the April-June 2016 period and two syndications in the first quarter of the 2016/17 financial year – the conventional 2.5% 2065 will be syndicated in the second half of April and a 30yr Linker will be syndicated in the second half of May.

UNITED STATES

Clinton and Trump cemented their positions as favourite in their respective races for Presidential nomination on Super Tuesday 1st, the first multi-state voting day. By the end of March, Clinton led the Democrats with 1,712 delegates vs. Sanders’ 1,011, and Trump led the Republicans with 736 delegates vs. Cruz with 463 and Kasich with 143. The winning democrat needs 2,383 for nomination and the winning republican needs 1,237.

February Manufacturing ISM out the same day was stronger than forecast at 49.5, up from 48.2. Prices paid increased to 38.5 from 33.5 and new orders were steady at 51.5. This, combined with stronger January construction spending, caused the 10yr Treasury to sell off (almost +10bps on the day) and oil to rally. On Thursday 3rd, Non-Manufacturing ISM was reported slightly stronger than forecast at 53.4 vs. 53.2. Business activity was stronger at 57.8 vs. 54 expectation. In a boon for domestic steel producers, the US Department of Commerce announced a preliminary decision to tax imports of Chinese cold-rolled steel by 266% as it judged that the Chinese were ‘dumping’ the market: supressing domestic producers using unfairly low, subsidised pricing. Other, smaller tariffs were also announced for Brazil, India, South Korea, Russia, Japan and the UK.

The Fed’s Beige Book on Wednesday 2nd said that economic activity expanded in most US regions and that business contacts were generally optimistic. Automotive sales were mixed but remain at elevated levels along with residential home sales. Consumer spending increased on the whole, while some districts were temporarily adversely affected by inclement weather. Manufacturing activity was flat as the strength of the dollar and weakness of the oil price weighed on exports. The report also showed a continuing improvement of the labour market, with wage growth varying from flat to
strong across the board.

A stronger **ADP employment** number on Wednesday 2nd (+214k vs. +185k expectation) was a precursor for **non-farm payrolls** on Friday 4th that were very solid at +242k vs. +193k expectation. January’s figure was also revised higher and unemployment remained unchanged at 4.9%. The figures were tempered by **average hourly earnings** which dropped 0.1% to 2.2% YoY vs. expectation of a 0.2% increase to 2.5%.

Fed voting member **Lael Brainard** said on Monday 7th that the US economy wasn’t immune to global risks, calling for careful adjustments to the policy rate to preserve expansion. Fed hawk **Stanley Fischer** also spoke, saying that a link exists between inflation and employment, noting that at present we may be seeing the first stirrings of an increase in inflation. Between the 8th and 10th March, the Fed sold 3yr, 10yr and 30yr paper.

Stronger inflation data, which included **core CPI** on Wednesday 16th at 2.3% vs. 2.2% forecast, and positive employment reports were not enough to compel the **Fed** to move after their March meeting on the 16th. In fact, **Yellen** portrayed a dovish stance as she appeared to acknowledge the poor global growth outlook. The dot plot chart halved, to two, the number of rate increases implied for 2016.

On Monday 21st, **Fed** non-voting members **Dennis Lockhart** and **John Williams** said in separate interviews that a rate increase was justified as early as the next meeting on April 26-27. **James Bullard** also joined a growing chorus of hawks. The **5yr B/E** peaked that day at 1.53 – the highest level since July 2015. On Thursday 24th, **Initial Jobless Claims** at 265k vs. 269k forecast marked the 55th consecutive week below 300k – the longest such streak since 1973.

**Janet Yellen** on Tuesday 29th attempted to address the mixed **Fedspeak** of previous weeks with an authoritative speech. She reiterated global headwinds, questioned the durability of core inflation and stressed the need to “proceed cautiously”. The market interpreted her speech as dovish – the 5yr B/E rate made a new high at 1.54 while the USD suffered overnight. Indeed, since January 29th, the dollar index has dropped from 99.60 to 94.62 currently.

**EUROPE**

The **BIS** on Sunday 6th released its latest **Quarterly Review**, analysing the implementation of negative interest rates, their observed effects and the risks ahead. The proliferation of electronic trading within fixed income markets was another featured subject.

The **ECB** on Thursday 10th surprised with greater than anticipated stimulus. It cut the deposit rate by 10ppt to -0.40% and its main refinancing and marginal lending rate by 5ppt each, to zero and 0.25% respectively. The asset purchase target was increased, by €20bn, to €80bn per month and the scope widened to include non-bank investment-grade corporate bonds. TLTRO mk.2 was announced with more attractive terms for banks to participate. The resulting euro weakness was reversed quickly when, in the post-meeting press conference, **Mario Draghi** appeared to undermine his future firepower with the comment ‘from today’s perspective, we don’t anticipate it will be necessary to reduce rates further’.

**Angela Merkel** suffered losses in regional elections over the weekend of the 12th as her ailing **Christian Democratic Union** struggled against populist right-wing parties.

Comments from an interview with ECB Chief Economist, **Peter Praet**, were released on Friday 18th. Euro strength was reined in as he appeared to contradict Draghi’s sentiments with ‘a rate reduction
remains within our armoury’. Jens Weidmann of the German Bundesbank was reported the same day in domestic press criticising the ECB’s course of action, noting that the effects of loose monetary policy diminish the longer it persists.

On Tuesday 29th, the ECB released money supply data for February that show continued growth at 5% YoY. Household borrowing from banks increased 1.6% vs. February 2015. On Wednesday 30th, Belgian CPI was reported at 2.24% YoY – the highest since December 2012. The rise was attributed to an energy tax increase which inflated energy prices by 10%. Food prices were also up sharply driven by fruit and vegetables. Belgian CPI ex. Food and Energy increased to 2.68% YoY vs. February’s 1.86% YoY figure. On the same day, German March preliminary CPI increased to 0.8% MoM and 0.3% YoY.

On Thursday 31st, European March CPI was reported slightly firmer than February’s levels, at -0.1% YoY vs. -0.2% YoY in February. The core measure was +1.0% YoY vs. +0.8% YoY in February.

JAPAN

The BoJ sold 10yr JGBs for a negative yield at auction for the first time ever on Tuesday 1st. It sold ¥2.2tn for an average yield of -0.024%. The March sale of ¥233.5bn (around $2.1bn) retail JGBs, which offer a minimum coupon of 0.05% but are non-tradeable, was 32% up on the prior month and the highest since August 2014. While well down on issuance levels a decade ago, the short-term trend shows consumers pushing back on the negligible deposit rates on offer at high street banks.

Final Q4 2015 real GDP was reported on Monday 7th at -0.3% QoQ and +0.7% YoY, which compares with the Q3 2015 reading at +1.7% YoY. On Tuesday 8th the BoJ sold ¥726.1bn 30yr JGBs at 0.765% with a 4.21x cover. The coupon was 0.8% – a new record low. An ensuing short squeeze saw the yield decrease to 0.52% later that day and to 0.40% by March 22nd. The same day, the Consumer Confidence index dropped to 40.1 from 42.5 while the February Economy Watchers Survey dropped to 44.6 current from 46.6 previously. The outlook dropped to 48.2 vs. 49.5 previously.

For the week ending March 18th, Japanese investors bought a net ¥2276.8bn of overseas debt – the highest level in over a decade. The same figure for the week ending March 25th was ¥1164.1bn, while foreign investors sold ¥1826.7bn Japanese bonds.

CHINA

Moody’s changed, from stable to negative, its credit rating outlook for China on Wednesday 2nd. It followed with negative watch downgrades to 25 Chinese financial institutions and 38 state-owned companies a day later. The country embarked on its annual “two sessions” on Thursday 3rd – two weeks of high-level political discussion/policy-making at the 12th National Committee of the Chinese People’s Political Consultative Conference. The latest five-year-plan, covering 2016-2020, will be put forward for approval to the National People’s Congress.

S&P followed Moody’s on Thursday 31st by cutting, from stable to negative, its credit rating outlook for China.
**CRUDE OIL**

Russian energy minister Alexander Novak spoke from Tehran on Monday 14th where he conceded that Iran would not consider joining the output freeze that Novak is working towards until the country has boosted output to pre-sanction levels. Iran's deputy petroleum minister Amir-Hossein Zamaninia the same day quantified this level, aiming for an increase of 1mn bbl/d by June this year – to 4mn bbl/d.

The US Energy Information Administration released its US Annual Energy Review on March 29th. It showed that, for 2015 vs. 2014, US crude oil production increased 8.3% while consumption of petroleum was little changed, increasing 1.4%. Coal production decreased 10.4% as consumption decreased 12.6%. Nuclear and renewable production/consumption remained broadly unchanged. Total primary energy imports increased 1.64%. Total exports increased 6.4%, where a 23.9% fall for coal contrasted with a 31.1% rise for crude oil. Total net imports fell 3.77%.

**WORLD / MISCELLANEOUS**

Argentina entered what is hoped to be the final throes of its long-standing debt dispute on Tuesday 1st, reaching a deal with the four largest holdout investors in its defaulted debt from 2005 and 2010. The government will service 75% of face value – a cash amount of $4.65bn. The deal is subject to an amendment/repeal of two Argentinean laws brought into place to prevent repayment to holdouts, but this is expected to be a formality. Given the subsequent access to global markets, the government expects to finance its repayment obligations with a new international bond sale.

Australia left base rate unchanged at 2% on Tuesday 1st. The RBA didn't change its comment from February, where it noted that continued low inflation would provide scope for easier policy should it be appropriate. On Wednesday 2nd, Australia's Q4 2015 GDP was reported at +0.6% vs. expectation of +0.4%. On Monday 21st, Australian Prime Minister Malcolm Turnbull said that he would call an election on July 2nd if the Senate does not pass legislation to control trade unions, which he views as a ‘handbrake on growth’.

The Bank of Canada on Wednesday 9th kept unchanged at 0.50% its benchmark overnight interest rate. While December GDP on Tuesday 1st beat expectation at +0.2% MoM and +0.5% YoY (+0.1%, 0.0% forecast), February's unemployment rate on Friday 11th continued a rising trend at 7.3% vs. 7.2% forecast. Inflation data on Friday 18th was softer than expected across all measures, the core rate +0.5% MoM and +1.9% YoY. Canada's strong GDP run continued where, on Thursday 31st, January's figure was released at +0.6% MoM vs. +0.3% expectation. Manufacturing, oil extraction and utilities were identified as growth drivers.

The Reserve Bank of New Zealand on Wednesday 9th surprised the market by reducing the official cash rate by 25bps to 2.25%, announcing that further easing may be warranted given ‘weaker growth in China and other emerging markets, and slower growth in Europe’.

Vladimir Putin on Monday 14th announced he was to commence the withdrawal of “the basic part” of his forces from Syria, declaring that Russia’s mission had “overall been fulfilled”. Peace talks in Geneva were ongoing and there was speculation the announcement was designed to encourage Syrian Government negotiation.
The Ghost in The Machine

Electronic or Hard Copy

Quotes and feedback:

"an excellent publication which appears to offer something for everyone."

"Always welcome...how do you rate it? Please continue sending it...thank you."

"an eclectic mix of insights"

"It’s refreshing to read someone who actually writes an opinion and conclusion. Your clients actually know what you think after that. That's punchy"

"This was interesting! Finally got to read it and I was most impressed by the calibre of your team. Very different style to any other [market commentary] reports that I have read... Feel free to send me any more of these as they are really interesting!!"

Please email ADMISI@ADMISI.com or call Simrat Sounthe or David Rose on telephone +44 (0) 20 7716 8142.
Our brief for this edition is politics and markets. In my opinion the inference in the directive is how politics influences markets. I would say in answer that the two go hand in hand. What investors must decipher is to what degree, at any one time, the actions of politicians offset all other considerations of say valuation, company profits or the business cycle. When one considers that all companies have to observe corporate law and that these laws are set by governments, then it is easy to see that the impact of politics is omnipresent. That is the starting basis for any discussion of politics and markets. These rules or laws are tweaked and/or repealed when governments respond to the business cycle or indeed when the government of the day implements its particular priorities. I would say that, from the Thatcher / Reagan years, right up until the financial crisis, the influence of politics on markets was minimal. An exceptional period of low inflation and prosperity fostered a laissez faire attitude towards business. More importantly, the banks were left to cavort with the global savings glut, governments encouraged house ownership and we all eventually drowned in a sea of derivatives and securitisation. No-one saw it coming, least of all the politicians and the Central Banks. Here was a case where a lack of political direction eventually had a massive influence on markets. It still has. We have now perhaps turned full circle.

In January Nevsky Capital joined BlueCrest Capital Management, Seneca Capital and SAB Capital in returning money to clients. Nevsky mainly cited the difficulty in competing with computers while also mentioning the maturing nature of the US business cycle and bear markets in developing countries as reasons for the fund’s closure. However, the most interesting closure of a hedge fund, in the context of our discussion, came in 2012 when Louis Bacon returned cash to investors from Moore Capital's flagship fund. Mr Bacon felt that he could basically no longer predict what Mrs Merkel was going to do next. Now this is where politics starts to override all other investment decisions. Mr Bacon wrote “Disaster Economics where assets are valued based on their ability to withstand a lurking disaster as opposed to what they may yield or earn, is now the prism through which investors are pricing markets”. Yes that was in 2012 and Greece was on the brink, but in some ways we look to be approaching, if not a repeat, then something very similar. We should perhaps of known then that Mrs Merkel was always going to do what was best for Germany. As a massive exporting nation, Germany was always likely to benefit the most from a free trade zone in Europe. Mrs Merkel was likely to do what it took to preserve the optimum conditions for her nation. However the game may now have changed. She may no longer have the control that she commanded back then. A looming Brexit vote threatens to throw the whole European project’s survival in to question again. The pricing of risk on equity markets does not seem to reflect this outcome.

There are other political bombs on the horizon. The tail risk of a Trump presidency cannot be described as such any more. Americans are angry. They have seen the rich do rather well out of the financial crisis as their own incomes have stagnated and yet their costs are rising. Protest votes in Europe, to date, have been manageable. Such is the
fragmentation of politics that extreme parties barely register any notable claims to power. In the USA, it is different. In a two party system a large protest can lead to the presidency. And what would Donald Trump do with the Fed? Spain is considering a mainly Socialist alliance that would not sit well with certain sectors namely banks and utilities and Greece looks as if it may slip in to another summer crisis. Italy faces elections in major Italian cities and a referendum on constitutional reform. They may be heading towards early elections. Italy is far from meeting the EU fiscal rules and is the country in the euro zone with the lowest support for the currency bloc. They are eyeing the Brexit vote with more interest than most. Keep an eye on peripheral spreads. They are widening even in the face of a 30% increase in ECB QE purchases.

And what of these “unelected” central bankers. They are impinging on so many more facets of the economy that they have to be considered a de facto political force. The Fed seem to have taken up central bank duties for the whole planet and IS keeping a close eye on company profits this quarter! Since when were those two dynamics in its mandate? The BOJ is already buying ETFs, basically distorting the price of stocks. The creep of central bank policy has been necessary as governments have dragged their heels on structural reforms. However a crisis of confidence exists and is growing over whether central banks can any longer move markets and contain volatility.

Politics and markets are joined at the hip but these are unprecedented times of political upheaval rather than political meddling. Expect more volatility, more hedge fund closures and therefore less capital investment, less liquidity, and sharp market moves. And if you don’t agree with me, perhaps the foreign exchange markets will convince you. Currently volatility in the five major currency crosses is higher for three months than it is for a year. The curves are inverted. The last time this happened, markets were in the middle of the Greek debt crisis. Buckle up chaps this could be a bumpy old summer!
It is true that often there is a disconnect between politics and markets. Traders in the financial markets run the risk of placing too much emphasis on the political news, which often has only a temporarily market impact, especially when the news is contrary to the fundamentals. Traders that enter a market strictly on a political news headline often find themselves the wrong way in the market when the impact of that particular news headline becomes a day or two old and the dominant fundamentals take over and prices reverse.

This is even more the case now, as the United States is in the final stages of the presidential nomination process and the headlines are coming fast and furious. Headline political news items are attention grabbers and can move markets in the short run, but there is rarely follow through in price for more than a few days. However, there is way to take advantage of short term political news.

An example of this would be stock index futures that currently have bullish fundamentals, including the low global interest rate environment. Any bearish political news that pressures the stock index futures market should be used as an opportunity to enter the market on the long side on the belief that the influence of the bearish news will probably last for a short time, while the bullish ongoing low interest rate environment is there all of the time.

However, there are exceptions to the rule that most political news should be faded. The best current example of this is what is happening in the U.K. and its effect on the British pound. A referendum for the U.K. to leave the European Union will be held on June 23. In this case the referendum is the dominant fundamental and it should not be faded. Rallies in the pound should be used as selling opportunities.
The grain markets have rallied since the bearish USDA March 31 US acreage and stocks report. Some link the rally on fund short covering and new buying in soybean and soymeal. Initial buying may have been due to less than ideal finish to the 2016 South America corn and soybean crop year.

There was also some uncertainty for the future of the Brazil President. This helped the Brazil currency rally and slowed new farmer selling there. There has also been some new buying on hopes that new data suggest that the China economy may be bottoming.

This has triggered new money buying of inflation sensitive commodity markets. Finally the current US weather is mostly favourable for 2016 crops. Still a high percentage of weather watchers could see some dryness and even warmer temperatures this summer. This could add to the volatility in the grains and soybeans.
Information from External Sources

A special thanks to the following non ADMISI contributors in the subsequent pages for their thoughts and analysis. We are truly grateful for their efforts. ADMISI would like to extend the opportunity to receive additional external contributors’ analysis for inclusion in subsequent editions of ‘The Ghost in the Machine.’ Please contact Andy Ash for further information. Tel: +44 (0) 20 7716 8520 or Email: andy.ash@admisi.com

Any views expressed herein by the relevant authors are those of the author and may not necessarily represent the views of ADM Investor Services International Limited or its officers, employees and/or affiliates.

The information herein is taken from sources considered to be reliable. However it is intended for the purpose of information only and is not guaranteed by ADM Investor Services International Limited or its officers, employees and/or affiliates as to accuracy, completeness, nor its trading result, and does not constitute trading advice or solicitation of purchases or sales of any financial instrument.

What to do now?

1. Despite Yellen’s dovish tilt these past few weeks, it is a matter of when, not if, that the Fed raises US interest rates.
2. A potential production freeze is meaningless for an Oil market that is plagued with oversupply with producers pumping at record levels. The fate of the Oil market to be determined by the path of gasoline demand as we enter peak summer driving season.
3. Iron-ore prices propped up by the anticipated Q1 seasonal pick up in construction demand as steel margins rebound. As the dust settles, inventory balance still shows a surplus.

“The Fight To The Dovish Finish Line”

Maleeha Bengali
What a difference a quarter makes for asset allocators and fund managers. Imagine coming into the start of the year being advised by some of the smartest brains on Wall Street to be positioned one way, then the market trades in the complete opposite direction during the first quarter as equities, currencies, and commodities got whipsawed from left to right causing a churn worse than what one would have experienced on the Six Flags “Tatsu” ride! These are certainly trading markets, not investable ones. Well only if you are not levered more than four times on your capital as most hedge funds are, with their custodians forcing them to cut their losses pulling the reins on their capital. As more and more hedge funds underperform the market, one is baffled to see even more money pour into their coffers. Welcome to the world of Zero Interest Rate Policy (“ZIRP”), where Central Banks around the world are rushing to come in first at the dovish finish line, fighting to keep their rates lower for longer encouraging negative bond yields out to 30 years in some countries. Alas the investor is forced to invest their money in something, anything that pays them a yield. This is the warped world we live in. Philosophy aside, this has opened up some interesting fundamentally mispriced opportunities as the market battles between inflation and deflation prospects.

What to do now?

1) Despite Yellen’s dovish tilt these past few weeks, it is a matter of when, not if, that the Fed raises US interest rates.

US Equity and Credit markets ended the first quarter of 2016 roughly flat. The S&P 500 increased to 2060 (vs. 2044 at the end of December), 10-year Treasury yields finished the quarter 50bp lower (1.77% vs. 2.27%), high-yield corporate bond spreads ended the quarter 8bp tighter. Sounds tame doesn’t it? If one were to pull up an intra quarter chart on all the various asset classes, the picture is a lot less tame. The S&P500 hit a low at 1829 in February to rally 13%, Credit markets tightened by 184bp since February 11, Copper closed up 4% (rallying 12% from the lows), Iron-ore 25% (rallying from from $37 to $53.20/t), and Gold closing up 16%. Oil prices first fell by over 25% (hitting a low of $26.21/bbl), then staged a straight-line back to new highs on the year that briefly exceeded $41/bbl. In December, the FOMC “dot plots” suggested four rate hikes in 2016, now the March “dot plot” shows only two. The futures market is pricing in a 50% chance of just one rate hike this year!

From being the only loved trade out there, the dollar closed the quarter with its worst performing quarter since 2010! It fell 6% against the Euro, 6% against the Australian dollar, and 10% against the Yen. The market was initially worried about Chinese growth and the sudden Yuan devaluation in January, to then worrying about the state of the US economy as we started seeing soft prints on the non-manufacturing side of things as well. The US economy was always the beacon of hope for global growth in 2016, so when we witnessed weaker prints, investors were spooked and convinced deflation was in the works. Equity markets have rallied back to year to date highs, risky assets recouped most of the losses faced in January, however, Gold is up too! Something does not quite add up.

Forgetting investors, the January moves even shocked the Fed which caused Chair Yellen to emphasise on downside risks to the US economic outlook stemming from slower global growth. While she acknowledged that core inflation had risen “somewhat more” than she expected in December, this was heavily qualified with her view that it is “too early to tell if this recent faster pace will prove durable,” and that, given the risks to the outlook, it would be appropriate to “proceed cautiously in adjusting policy.” It’s one thing to have held off in February, but at the Economic Club of New York on 29 March, she once again cited this weakness coupled with the FOMC’s “asymmetric” capacity to respond to economic shocks as the key reason for the Committee’s lower path for the funds rate in March.

What is really happening in the US economy?

The labour market data continues to show strength. The US ISM Manufacturing index increased to 51.8 for March, as suggested by the regional PMIs (see Chart 1), signalling the first outright expansion in the manufacturing sector since August 2015.
BOJ convince the markets of their accommodative stance? The market has lost hope in these central banks.

2) A potential production freeze is meaningless for an Oil market that is plagued with oversupply with producers pumping at record levels. How to be positioned in the Oil sector now?

As we head into the long awaited 17 April Doha meeting, bullish oil traders (or rather desperate longs licking their wounds) are getting terribly excited on the prospect of a “freeze” being announced amongst the OPEC members, with or without Iran playing ball. Putting caps in place before production is due to ramp up is one thing but actually announcing caps when the majority of OPEC have gone past their ramp up phase and producing at maximum levels, defeats the purpose entirely. It sounds awfully convenient for Russia, that saw its crude output expand to 10.912 million in March (post Soviet high!), to suggest an output freeze at today’s levels. All those on board for the “freeze” stand to benefit from this agreement as supply from OPEC rose to 32.4 million bpd in March (up from 32.37 million) with Saudi around 10.18 million bpd. Iran has increased output by 200,000 bpd since December after its sanctions were lifted. It is in pure ramp up mode. Why should it now succumb to the world when it is time has come to monetise on some of the gains its regional brethren have benefitted from over the last few years?

Leaving these countries aside, production freeze or not, US shale still has its own economics to deal with. As WTI prices have recovered to $40/bbl after reaching a low of $27/bbl in January, US shale producers seemed to have been thrown a life line. They are able to hedge their future production in the futures market currently at around $47/bbl. Breakeven costs for most Shale fields average $35-40/bbl, which still makes it lucrative for them to keep pumping today.

Another bullish point stale bulls keep pushing is the lower Baker Hughes Rig Count implying lower Oil production ahead. However, it is not about how many rigs are being utilised, but about how many wells are drilled by those rigs. It is about productivity! Chart 3 shows exactly that phenomenon. Despite the rig count declining, the number of wells per rig has increased as US oil firms...
squeeze every cent on their balance sheet to churn as much production as possible.

**Chart 3: US Productivity - US Rig Count vs. Number of Wells per Rig**

According to a Reuters survey, more than 50 North American companies have filed for bankruptcy since early 2015, accounting for less than 1% of output, yet production is not going down. Why? Despite filing for bankruptcy, producers will keep pumping Oil at full tilt as their creditors inject new funds to keep the companies operational because they see this as the best way to recover some of what they are owed. Lenders are willing to let them produce as long as it is still economically viable. Texas based Magnum Hunter Resources is a case in point where its production rose by a third from mid 2014 to late 2015 after it filed for protection. Day-to-day well operating costs remain below $40/bbl for most US shale companies.

This may be hard to digest but OPEC is no longer the swing producer! Putting a cap in place does not solve the problem of oversupply, either demand needs to pick up aggressively or prices need to be lower for longer to see these excess barrels switch off permanently. Fundamentals aside, a production freeze implicitly argues there is spare capacity in the system. For the oil rally to be sustainable, we need more producers to be washed out. Only then can the market be tight enough for prices to rally.

We are all fixated with looking at spot Brent and WTI prices as various news sources hoard the screens with intraday Oil charts refreshed on an hourly basis. What investors need to look at is the price of products; gasoline and distillate. As we enter the peak summer driving season and gasoline demand, it is important to gauge what demand for products is to then back out how much crude is or will be needed. Do the news sources ever talk about this? Hmmm....

Last year, January through November 2015 saw global gasoline demand growth average 3.4% yoy (670,000 bpd), led by US, China, and India. It was gasoline demand that was the engine of growth in the Oil sector. Distillate was the step-child that dragged the entire family down over the winter as excess distillate inventories caused a glut in the system. Chart 4 below shows how 2016 is shaping up to be for gasoline. The start of 2016 sees the 4-week weekly average demand for gasoline higher than the 2015 average.

**Chart 4: US Gasoline Demand**

Source: Credit Suisse

OPEC fun and games aside, what is driving the Oil price here and why is Q2 so important?
Low prices at the pump are generating higher end demand. Chart 5 shows the number of miles driven in the US which is significantly higher y-o-y. January retail sales are surprising to the upside, the consumer is still spending. According to Goldman Sachs, a 2.7% growth in consumption expenditures translates into a 130k bpd growth in demand in 2016 vs. the IEA and EIA forecasts of 40k bpd and 70k bpd growth. In India, gasoline demand continued to grow strongly in January, up 11% yoy, with car sales remaining strong as well.

Over the last four weeks, the product demand data outlined in the weekly DOE inventory data shows a very constructive case for US gasoline demand. As you can see in Chart 6 below, East Coast, West Coast and Gulf Coast have seen their regional refining margins (“cracks”) rally from the lows reached earlier this year during the quiet period. If this trend is here to stay, and all data suggests gasoline demand is robust, US refiners are looking extremely attractive post their 15-20% correction seen during their Q4 reporting season.

Chart 6: WTI 3-2-1 Cracks by Region

The best stocks to play this theme are Valero Energy, Tesoro Corp, and PBF Energy. Q1 2016 refining margins have averaged lower than Q4 2015 in most regions to the order of 10-15%. But this has been more than priced in by these stocks. In fact Q2 2016 is seeing much higher prints in Mid-Con, North Atlantic, and West Coast ~ 15% higher.

Valero trades on a FCF yield of 10% and a P/E of ~8x in 2016 with net debt/ebitda at 0.4x. PBF Energy is down 25% and is a pure play Gulf coast refiner leveraged to the gasoline market tightness. It is buying the Torrance (West Coast refinery) from Exxon, which will boost its earnings from Q2 2016 onwards. Tesoro Corp is a play on the Californian/West coast market where employment trends dictate consumer demand behavior and its coastal position helps it to optimize its input slate.

Where are the earnings downgrades?

Big Oil (British Petroleum, Royal Dutch Shell, Totalfina etc.) is struggling at these Oil prices given most of their capex/planning budgets are balanced at Brent around $55-60/bbl or higher. Investors are “long” these Oil majors as there is no place to hide and they are deemed defensive. On the contrary, their earnings are still stretched as Oil prices are averaging much lower than their forecasts. Companies will see their leverage rise just to meet their capex and dividend commitments. Moodys just lowered its rating on three Oil majors recently, Chevron, Royal Dutch Shell, and Totalfina. Chevron will generate negative cash flow amid rising debt for the next two years, Royal Dutch Shell on back of increased leverage post the BG deal.

As fixated as we may be on OPEC and the Doha production freeze, one thing is for certain, if the Oil price rallies, it will be driven by gasoline, not crude. US refining subsector is the only space that has the potential to see earnings upside especially as we enter peak summer driving season. Winter and distillate is another matter and may be a cause for concern later in the year.

3) Iron-ore prices propped up by the anticipated Q1 seasonal pick up in construction demand as steel margins rebound. As the dust settles, inventory balance still shows a surplus:

Iron-ore is the raw material that is used to make steel. As Chinese rebar steel prices started rallying earlier in the year in anticipation of a pick up in seasonal construction demand, steel margins picked up. This helped the raw material tick higher in sympathy. With export volumes from Brazil and Australia down in January due to weather related disruptions, suggestions of Total Social Financing (TSF) talks picking up in China coupled with risk assets rallying aggressively in February, Iron-ore is now up 24% year to date! Post the delayed expected ramp up of Roy Hill, and loss of Samorco shipments, exports recovered in February, and inventory is now
expected to pick up. Steel demand has not shown any signs of a sustainable pick up. Other than the spot Iron-ore price rallying, longer dated Iron-ore prices are unchanged. According to Mysteel survey, indicated number of steel mills operating at a profit increased to 44% from 7% at the start of the year. This will cause idle steel mills to come back, adding to the excess supply of steel in the first place.

As you can see in Chart 7 below, physical indicators of demand remain weak (grey line indicated by Goldman Sachs proprietary Commodity demand tracker) but the speculative positioning (blue line) has picked up aggressively. The market is now long from being overly short towards the end of 2015.

Chart 7: Physical Indicators Of Chinese Demand Against LME Speculative Positioning

Cost deflation remains the theme that will continue to hound the metals complex. After the brief surge in risky assets and unwind in the long USD positioning in Q1 2016, physical market fundamentals remain unchanged. Copper may be 15% higher since the start of the year, but in local Australian dollar terms, Copper is up only 4%. Domestic Australian and Brazilian producers are still incentivized to produce even with Copper at $4500/t as their cost base shrinks. Until we see real stress amongst these players that sees production fall off, prices will continue to edge lower until inventories normalize.

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>% YTD</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPX YTD</td>
<td>0.18</td>
</tr>
<tr>
<td>Eurostoxx YTD</td>
<td>-9.95</td>
</tr>
<tr>
<td>SXPP (Basic Resources Index)</td>
<td>6.22</td>
</tr>
<tr>
<td>SXEP (Oil &amp; Gas Index)</td>
<td>-1.75</td>
</tr>
<tr>
<td>EEM (Emerging Markets)</td>
<td>3.70</td>
</tr>
<tr>
<td>S&amp;P GSCI Commodity TR Index</td>
<td>-1.28</td>
</tr>
<tr>
<td>MBCC Net Return YTD</td>
<td>1.20</td>
</tr>
</tbody>
</table>
Two Critical Inputs in the Energy Rebalancing Act Point to Higher Prices

There was a great deal of headline flow ahead of an 17 April OPEC/non-OPEC producer meeting in Doha, Qatar. Many of the players were struggling with the latest plunge in crude oil prices and are anxious for some stability in prices. While finding consensus among this group would be a step in the right direction, there is uncertainty in how these different countries (and perhaps enemies) will reach a resolution. The current consensus is to freeze crude oil production at January levels, with some wiggle room for Iran to recover some of their production now that western sanctions have been lifter. Therefore, it is possible that rogue production might slow and the energy complex can begin to look for sign of fundamental change from the demand side of the equation.

What may be of more significance and of greater reliability in rebalancing the energy market, is a long awaited decline in US crude oil production and ongoing gains in US implied gasoline demand. US crude oil production into early April had already declined in 10 of the last 11 reporting weeks and production has fallen back to levels not seen since November 2014. This marks a 600,000 barrel per day pullback (a 6.3% decline) from the record-pace achieved in June 2015. There is a strong potential for this number to contract further, as production adjusts to the extending decline in active US crude oil drilling rigs. The Baker-Hughes rig count is down 77.5% from its record high in October 2014, and it has been cut almost in half since the record US production pace in June.

There is also potential for greater media attention and psychological support for WTI crude oil prices when US production falls below 9 million barrels per day as that level is thought to tighten US supply and demand to a leveled condition. However, we have already seen US implied gasoline demand during the first quarter of this year running nearly 4% above year-ago levels and we anticipate seasonal demand contribute to a level where drawdowns in supply are noted. Clearly demand has been instrumental in the rebound in WTI crude oil from its February lows and if demand for gasoline products increases ahead of the summer demand window and it overtakes the 2007 Implied record of 9.762 million barrels per day, that could generate
enough bullish headlines to put the bears back on their heels.

In other demand side developments, recent refinery expansions in India and China have been primarily focused on distillate and or diesel production and not on gasoline and, therefore, it is possible that both gasoline and diesel supplies are set to tighten globally. In the meantime, the global auto fleet has continued to expand at an increasing pace, with the China Association of Automobile Manufactures forecasting a 6% increase in vehicle sales in 2016 compared to a 4.7% increase in 2015.

In conclusion, the rebalancing effort in the energy market is already taking shape and is expected to continue through the peak summer seasonal timeframe in August. There is also a good chance for US production to fall below the psychological 9-million barrel per day mark, and for strong US gasoline demand readings finally reverse or temper widely held deflationary psychology in the marketplace. In our opinion, the lows are in for crude oil and the new equilibrium or value zone could be $37.50 to $44.00.

David Hightower is a founding principal of The Hightower Report (www.HightowerReport.com), a commodity research and information firm specialising in high quality futures research and analysis for individual investors, brokers, commercial producers, farmers and end users. The Hightower Report publishes one of the most widely read daily commodity wires in the world and has become a highly utilised industry consulting service with many brokerage firms turning to it for their primary commodity research coverage. The Chicago Mercantile Exchange (the world’s largest futures exchange) has sent Mr. Hightower to Europe, South America, India and China to promote Agricultural futures trading, to introduce electronic trading and to educate foreign governments and traders on advanced risk management techniques. Mr. Hightower is also a keynote speaker favourite for Futures Clearing Merchants. Seed, implement and food manufacturing companies also turn to Mr. Hightower for his high-impact analysis of current market conditions. In almost every instance, Mr. Hightower earns a return invitation from his speaking venues.

A keen eye on the complex interaction of the world markets insures that Mr. Hightower thoroughly examines the financial, agricultural and geopolitical situations around the globe. This, in turn, allows his company to provide analysis and commentary on a wide variety of markets, ranging from grains, livestock, precious metals, stock indices, bonds, currencies and the energy complex.

Prior to the inception of The Hightower Report, Dave was the Director of Research at what was then the world’s largest commodity brokerage firm. In total, he has over 30 years’ of experience in nearly every aspect of the futures industry.

Mr. Hightower is thoroughly versed in the complex interaction of the world markets and global businesses, and his closeness to the markets is evidenced in his direct and insightful analysis. Because of his expertise, Dave has regularly appeared on CNN, Bloomberg Television and ONN.tv and is often cited in Wall Street Journal, Futures Magazine, Reuters and many other industry publications. He has conducted extensive work with regulatory agencies, exchanges and other industry players on a wide range of research and trading projects and is often called upon by the CME Group to provide their expertise on the markets. Dave’s infectious enthusiasm shines through and has made him a highly sought-after speaker for industry events. Some of his recent speaking engagements have been for ADM Investor Service, Charles Schwab, RJ O’Brien & Associates, Global Grains Inc., HighQuest Group, and the US Grains Council.
MILK

In the following article, Robbie Turner, Head of European Markets at Rice Dairy International, discusses the increasing liberalisation of the EU dairy market, the resulting need for participants along the supply chain to adopt risk management practices, and the market outlook for 2016.

The International Scene

Since 2007, international dairy commodity pricing has broken into a new range of volatility. This is evidenced in figure 1 below, showing the settlement price for the Global Dairy Trade contract 2 Whole Milk Powder contract (WMP).

Figure 1: GDT C2 WMP

A simple analysis of GDT pricing for WMP C2 over this period yields an average volatility of 34%, spiking at above 40% on multiple occasions. Within the context of commodity markets this percentage is extremely high, as shown by Figure 2.

Figure 2: Commerzbank Commodity Volatility Radar
participants must look to export this ever-increasing surplus of product. Geographies such as North Africa, the Middle East, and South East China are naturally short, and thus are the mostly likely candidates for the bulk of this product (outside of selling to the EU Commission itself).

This is where the EU meets the global market, or more specifically, Oceania. In effect, as the EU further competes in these traditionally Oceanic markets, a natural coupling of European and Global pricing will occur, and thus a two-fold volatility effect is now in play. That is, firstly, the European reforms have/will erode the current level of price stability faced by the internal European market, and, secondly, the increased participation in the global market pits market participants against the high levels of volatility shown above.

Consequently, the need for price risk management along the supply chain has never been greater.

In light of this, since the reforms a number of key events have take place:

- EEX had a record year
- Euronext launched its own suite of physically delivered dairy derivatives
- Almost 33,000 tonnes of SMP was placed into intervention in 2015
- 109,000 tonnes of SMP has been placed into the intervention scheme in 2016
- Rice Dairy launched Rice Dairy International (RDI), based in London to serve the risk management needs of EU market participants.

To me, these events further cement the notion that the market is embracing, and still further needs to embrace risk management.

Firstly, the exchanges, EEX and Euronext, have both strongly signalled a commitment to offering price risk management solutions to market participants. And the market is growing – EEX continues to have record volumes trade month after month, while the OTC market grows at an equally impressive pace.

The concern remains, however, with the significantly large volumes of product being placed into the EU Intervention Scheme. There is a proposal currently under review to extend the SMP...
Robbie Turner
Head of European Markets
Rice Dairy International
+44 7849 832 444 – cell
+44 2077 168 101 – desk
Robbiejturner – Yahoo ID
www.ricedairy.com

Robbie heads the Rice Dairy International office based in London, and comes to RDI from Fonterra where he was most recently the physical portfolio manager for the Fonterra Australian and U.S. asset bases. Robbie has an extensive background in dairy portfolio optimisation, in both the technical/short-run and dynamic/long-run states; with particular strengths in investment decision making and physical arbitrage. Prior to Fonterra, Robbie was a Lecturer in Economics at the Auckland University of Technology, lecturing in both Micro and Macroeconomics.

Looking forward 2016

In the SMP market the picture is pretty grim, and looks set to hold for the remainder of the year. Already this year, intervention volumes three times those of 2015, and older product is trading well below the point of economic indifference (note there is a cost associated with entering product into the scheme, and thus those short on cash will trade below EUR 1,698 to ensure the lights remain on).

When examining the EEX and Euronext forward curves, the bid remains below intervention through Q3, and indeed below the point of economic indifference for H1. As I see it, this is unlikely to change, and at times the market is even seeing slight levels of backwardation – so there is a clear signal from the buy-side that they believe product will continue to flow, and thus now is the time to liquidate stocks.

Butter isn’t looking much better either. While the current market is above intervention, the forward has been dropping at an alarming rate of the past month. Recent conversations have centred on if the market will fall to intervention. At present I believe we won’t see this, as the physical market remains tight at current price levels; however, given the volatile nature of dairy, this could all change very quickly.

Thus, for the time being it’s a buyers’ market, and this looks set to continue for the remainder of the year. Possible support factors are:

- Russia and the EU get friendly again
- Drought in the EU, Oceania, USA
- Aging Chinese stocks get downgraded to feed

Possible downside factors are:

- Intervention fills up and we move to tendering (a process where the sell-side has to bid for the EU to purchase their product)
- Irish, Dutch, and German growth continues at current rates
- NZ growth returns

As always, Rice Dairy International is here to help with your risk management needs. For a consultation on how RDI can help you understand, measure, and manage your dairy price risk.
Contact Information

By mail:
ADM Investor Services International Limited
Millennium Bridge House
2 Lambeth Hill
London
EC4V 3TT
United Kingdom

By phone:
+44 20 7716 8142

By e-mail:
admisi@admisi.com