US Watch

FOLLOWING THE MONEY

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Economics: Asset prices matter

- Yields and curves shifting capital, pointing to slower growth
- Small-bank lending slows down -- a looming problem for Main St?
- Strong output data mean only that the economy is still growing for now

Markets: Pricing far from settled

- Soft data and market gyrations prompted the Fed to soften its stance
- Fed pause, QT taper should support equities, weigh on bonds
- But weak growth suggests earnings will slow more than consensus thinks

Politics: US-China trade settling on politics first

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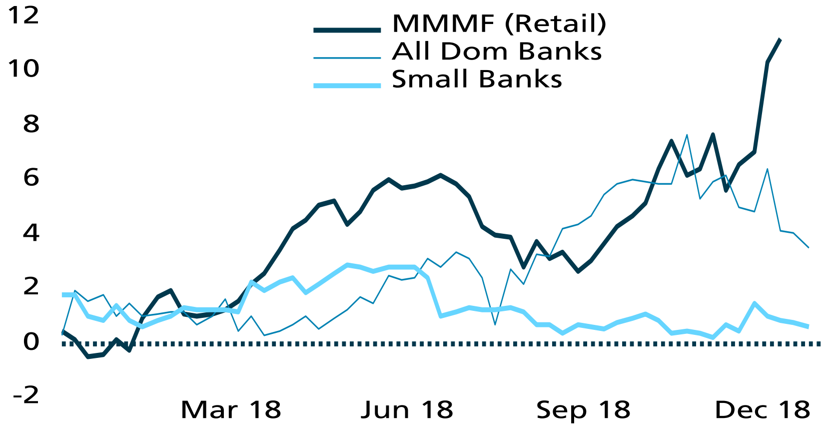
- Trump needs Xi to get N. Korea to cooperate

Retail Deposit Growth (3M %Ch)

Bank Deposits exclude Large Time Deposits



Source: Thomson Reuters Datastream, TS Lombard

Economics: Assets prices matter

- **Yields and curves shifting capital, pointing to slower growth**
- **Small-bank lending slows down -- a looming problem for Main St?**
- **Strong production data mean only that the economy is still growing for now**

The story is not about current growth, but about the impact of current market prices on future activity. Recent economic data, such as December industrial production, show continued growth. That the economy is still expanding is no surprise. The shift in market prices does, however, look to be moving capital flows away from supporting an acceleration in economic activity.

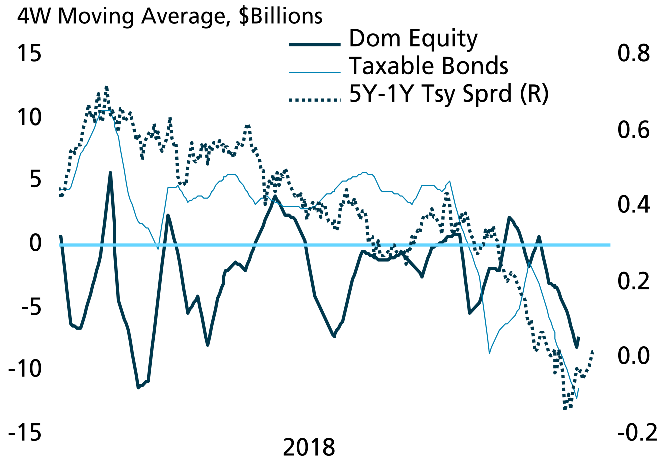
The data show a deceleration in retail deposit growth, an outflow of money from taxable bond and domestic equity funds (ETFs and mutual funds) and a slowdown in lending, notably for real estate (commercial and residential) and consumers. Commercial and industrial (C&I) loan growth has soared of late, but this is to finance the large inventory build-up that occurred in Q4 ahead of the increase in tariffs on Chinese imports that had been anticipated for January 1. As inventory levels wind down in Q1, we expect lending to slow accordingly. More critical to our story is what is happening at small banks (all but the top 25 as determined by the Federal Reserve). Small banks have been the main driver of lending during this cycle, and recent trend reversals imply that current Fed policies flattening the yield curve will be felt more on Main Street than on Wall Street.

The chart on page one shows that, for the first time in a very long time, money market mutual funds (MMMF) are challenging banks for retail deposit growth. The impact seems to be mostly felt at small banks. We cannot yet say there is disintermediation per se. What we can say (based on the chart below) is that MMMFs are the likely beneficiaries of outflows from domestic equity and taxable bond ETFs and mutual funds. Weaker deposit growth slows bank asset growth.

The outflow from these funds corresponds to the sharp flattening in the yield curve that began in early November. We can say the same about real estate and consumer lending as the spread between the two-year Treasury yield and the federal funds rate collapsed to zero (chart

Combined ETF and Mutual Fund Flows

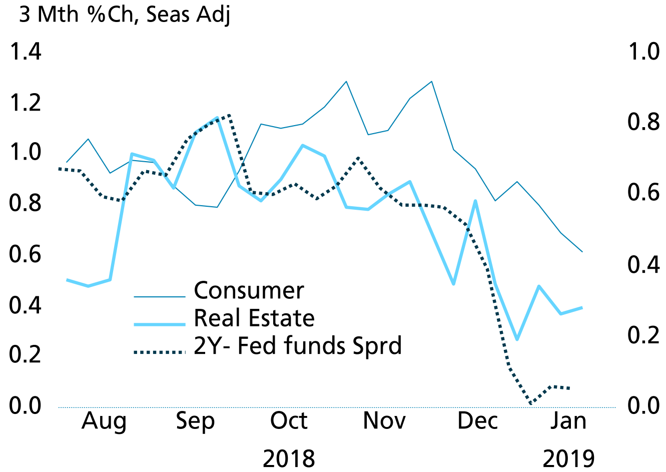
4W Moving Average, $Billions



Source: Thomson Reuters Datastream, TS Lombard, ICI

Select Bank Lending vs 2Y-Fed Funds Spread

3 Mth %Ch, Seas Adj



Source: Thomson Reuters Datastream, TS Lombard

above). C&I loans should join this downtrend soon enough. We have long made the point that a narrowing spread between 2s and fed funds causes banks to increase credit standards (we should get the January survey of bank lending officers sometime this week). When JP Morgan increased its loan loss reserves in Q4, a brave move in that it reduces profits (Wells Fargo went in the opposite direction to JP Morgan, reducing loan loss reserves to help boost profits in a quarter when overall revenue declined), it was another signal to us of a likely uptick in credit standards. No banker wants to be the first with the loan that goes bad once the economy turns softer.

Our focus will increasingly be on small banks. They have been the engine of business and consumer lending during this cycle and they have been net borrowers of liabilities (large CDs, fed funds, etc.) whereas the large banks have been net lenders. Small-bank loans have increased from 55% of large-bank loans when this cycle began to 75%. What this means in real terms is that local businesses have been drawing capital for expansion from local banks, so a reversal in this trend will hurt Main Street first. What we are seeing since the Fed pushed the funds rate over 2% in September is a slowdown in lending and a flattening in the ratio of small-bank lending relative to large banks.

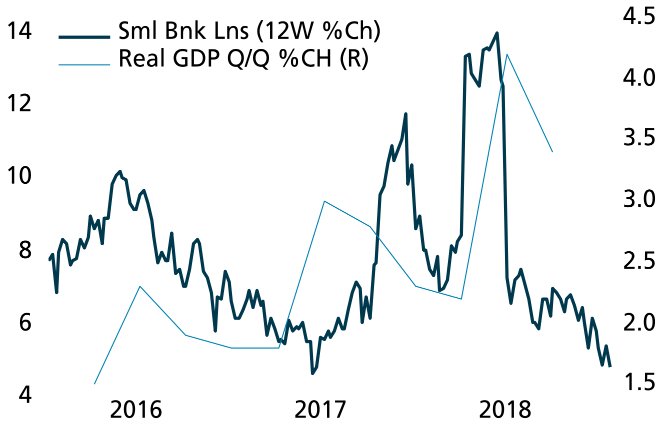
The importance of small-bank lending, particularly in this cycle, is tied closely to real GDP growth (see chart below). While the extension of small-bank loans is not the sole determinant of US growth, nor always the most important, the provision of credit is, more generally, key to economic expansion. The growth figures we see today always relate to earlier lending, and the slowdown evident in the banking data implies weaker growth in future.

Industrial production, for example, grows right into the end of the cycle. Its reversal, along with employment, signals the official start of recession, with little early warning of an imminent change of direction. We see in the chart below the industrial production diffusion index for a one month change, the current series and what the data looked like in the two years heading into the last recession. It is clear from the chart that the collapse in 2008 was not foreshadowed by the pattern in 2007. We do not expect 2019 to be a repeat of 2008, but this is based on what the patterns of lending imply about future activity, not current economic growth trends.

What ultimately lies behind lending patterns, the yield curve and corporate spending is profits. The chart below shows that pre-tax profits including inventory valuation adjustment (IVA) and capital depreciation (CCAdj) have finally surpassed the 2014 highs on a nominal basis,

Small Bank Lending* & Real GDP Growth

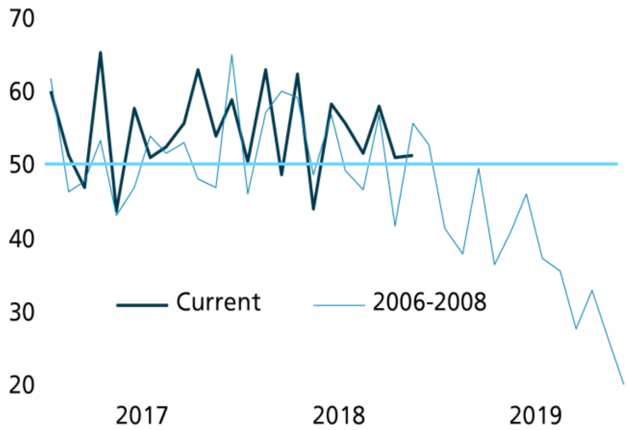
*C&I, Real Esate, Cons Loans; Annualized %Ch



Source: Thomson Reuters Datastream, TS Lombard

Industrial Production Diffusion Index* -- 1 Mth

*% Series Inc + 1/2 % Series Unch from 1 Mths Ago

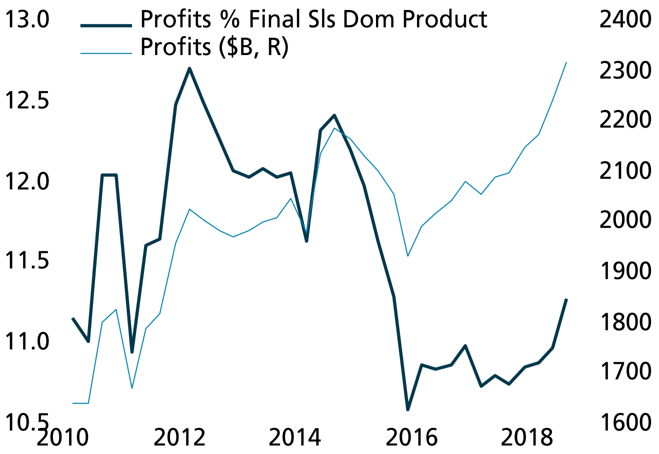


Source: Thomson Reuters Datastream, TS Lombard

but they remain well short when scaled to final sales of domestic product (a proxy for total revenue). One could also look at this lower ratio as evidence of narrower margins, which would not be surprising given how employment is increasing and wage growth is accelerating. It is equally of little surprise therefore that firms, at least those surveyed by the Philadelphia Federal Reserve, have more modest plans to add capex and workers in the next six months than they had a year ago. In fact, their plans shrank on a Y/Y change basis throughout 2018.

We will begin to get Q4 earnings in the coming weeks. Given the turn in bank activity and firms' investment expectations, profits are more likely to underwhelm than overwhelm. This all adds up to slower growth in the coming quarters. And it this prospect, as reflected in asset prices, that the Fed needs to respond to - not current data. Assets prices matter.

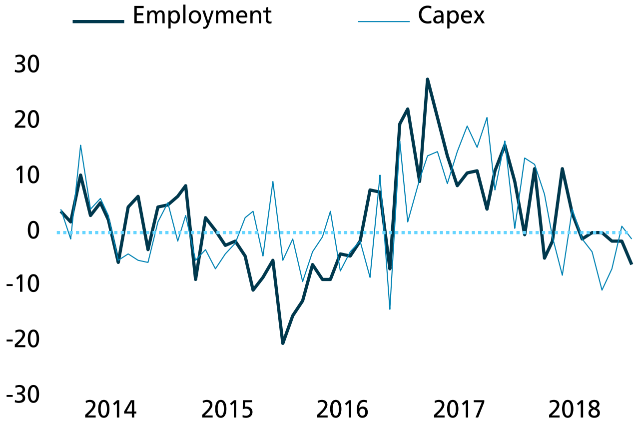
Corp Profits with IVA and CCAdj



Source: Thomson Reuters Datastream, TS Lombard

Capex and Employment in 6 Mths

Phill Fed Survey, Y/Y Change



Source: Thomson Reuters Datastream, TS Lombard

Markets: Pricing far from settled

- **Soft data and market gyrations prompted the Fed to soften its stance**
- **Fed pause, QT taper should support equities, weigh on bonds**
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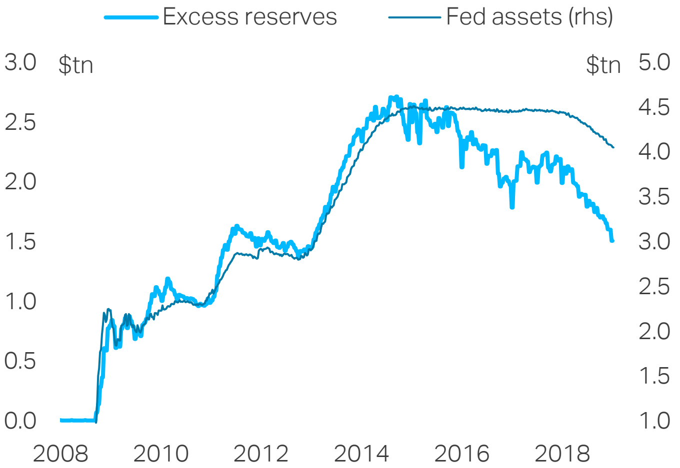
December's sell-off overstates risks. Over the past month markets experienced one of the wildest swings in recent history, dropping nearly 12% in the space of two weeks, only to stage a full recovery in little more that. One should always be careful not to overanalyse December market moves: this is a time when last-minute profit-taking, balance sheet window-dressing and characteristically low liquidity tend to amplify any downside swing.

But this degree of volatility cannot be ignored. That said, it would be a mistake to attribute all of the market's lurches in the past month to year-end effects. The hard reality is that macro data have been disappointing, especially in Europe but also in China and the US. Concerns about a possible recession – mostly because of a flat, even inverted, yield curve – have also become more serious. And, while equities have mostly recovered and the VIX has fallen to below 18 from its spike to 25 last month, Treasury yields are still lower than they were a month ago, suggesting that something with the "it's all fine" narrative is amiss.

Powell put. Fortunately, the market gyrations haven't gone unnoticed at the Fed, and a policy response has duly followed. We've long held the out-of-consensus view that the Powell Fed would avoid repeating the policy mistake several past Fed chairs have made – i.e. overtightening monetary policy when the economy is already slowing. We have forecast since at least last July the pause that the FOMC has now clearly signalled and that is priced in by the market. So, the Fed has listened to market concerns and has responded. But is it too little, too late?

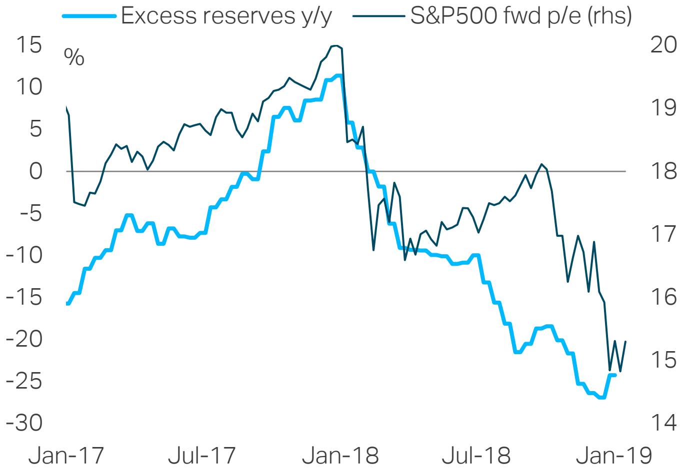
Yield curve still too flat for comfort. Powell's signal of a pause has taken future rate rises out of the market, with only a 10% chance of a 25bp hike now priced in for 2019. But the risk-off phase has caused longer-term yields to fall too, resulting in precious little steepening. In fact, certain sections of the short end of the curve (e.g. 2s3s) remain slightly inverted. An inverted curve at the front end risks creating a credit crunch that could tip an already slowing economy over the edge. Also, the Fed near-term forward spread (the difference between the 18-month

Excess reserves falling faster than Fed B/S



Source: Bloomberg, TS Lombard

Equity valuations affected by falling reserves



Source: Bloomberg, TS Lombard

forward three-month T-Bill rate and the three-month spot), while back in positive territory, remains too close to zero for comfort.

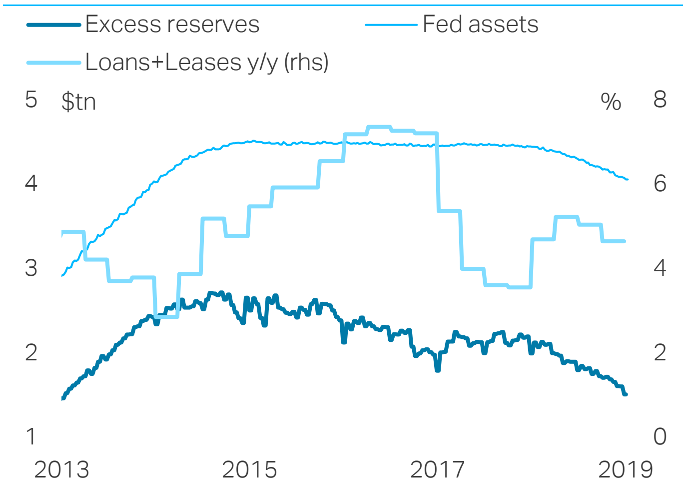
Quantitative squeezing. The market has also been concerned about the impact of QT. While the reduction in the size of the Fed's balance sheet has been minimal (about 10% from the peak), excess reserves have fallen nearly by half (left chart above). Banks still hold about $1.5trn of excess reserves, which may sound a lot. But this figure is probably overstated insofar as it doesn't take into account Basel III reserves, which US banks operating internationally require.

Credit growth accelerating reserve drawdown. Although the reduced level of excess reserves may not be a constraint just yet, the chart above right nonetheless suggests their drawdown matters. If the Fed persisted with QT at the current pace, credit creation could soon start to face headwinds. As the below-left chart illustrates, excess reserves have fallen faster than the Fed balance sheet when banks have used them to fund the extension of loans and leases. Whenever credit growth accelerated, the fall in excess reserves picked up pace too.

Will a QT taper help steepen the yield curve? The drop in excess reserves has not only had an impact on equity valuations, it has pushed up real yields too. A balance sheet reduction was meant to undo the effect of QE – i.e. it was meant to normalise the term premium and steepen the curve. Perversely, however, the rise in real yields and the decline in equity valuations have led to a steep fall in breakevens, such that the nominal yield curve hasn't steepened but has instead flattened. This means that slowing its pace may not be as effective at steepening the curve as straight rate cuts would be. Less QT should result in two opposing forces: more reinvestment of proceeds by the Fed, pushing yields down; and, perhaps, a greater risk appetite, which should push nominal yields up. The upshot may still be a steeper curve, but that's far from guaranteed.

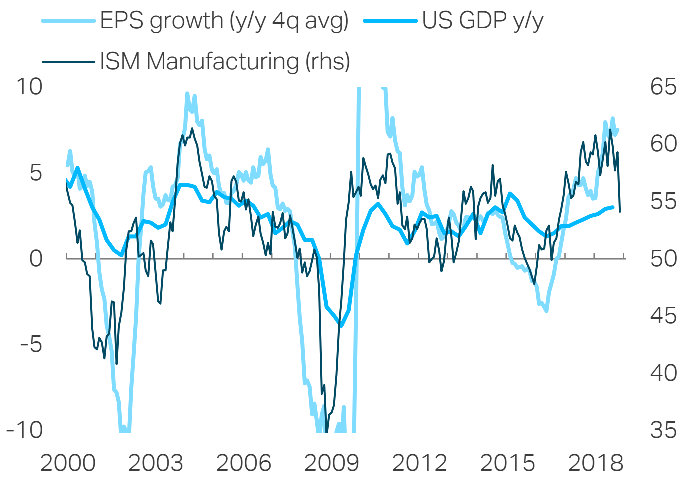
Drop in ISM manufacturing indicates slower earnings growth. Adding to concerns about the yield curve, corporate earnings are likely to grow more slowly than consensus currently anticipates, if the latest ISM Manufacturing release is anything to go by (right-hand chart below). Taking a more realistic assumption of 5% EPS growth this year (as opposed to 10-15% consensus estimates), US equities trade at 17x forward earnings – in line with the long-term average. This makes them hardly cheap and will likely result in disappointing returns in 2019, even if the Fed's more dovish stance were to result in less de-rating than further tightening would have caused.

Reserve fall compounded by credit growth



Source: Bloomberg, TS Lombard

Earnings winter is coming



Source: Bloomberg, TS Lombard

Politics: US-China trade talks, money or politics?

- **Immediate tariff escalation to be defused by sidestepping deeper issues**
- **Trump needs political win, Xi can't take a political loss**
- **Trump needs Xi to get N. Korea to cooperate**

The US-China trade talks due to take place in Washington at the end of this month look set to yield an agreement to defuse immediate tariff escalation, but only by sidestepping deeper issues. That would give Donald Trump, whose tweets on the subject have remained resolutely upbeat, the opportunity to declare a market-boosting victory for his policies while enabling the leadership in Beijing to focus on managing China's economic downturn and reviving confidence. But Robert Lighthizer and his allies would probably insist on maintaining longer-term pressure for structural changes in China while the technology war gathers pace. So the Buenos Aires ceasefire on tariffs is likely to continue but with growing exchanges of fire in other theatres of conflict.

Vice-Premier Liu He will arrive in the US with an array of gifts, including measures such as a reduction in excess car duties and increased purchases of farm products and energy as well as assurances that Beijing intends to make more moves on market opening, intellectual property and technology transfer. If Trump wants a deal for his own purposes, he can side with those in the administration who think a broader agreement can be constructed to enable the two countries to revert to a less confrontational relationship which will spare US companies from further trade war damage and cheer markets while setting Beijing on a more resolute path of reform.

In these circumstances, the Washington meetings on 30-31 January may end with a positive statement on trade, but with agreement that more talking needs to be done. That would mean suspending the March tariff escalation without removing duties already in force while China would be put on probation to implement its undertakings and the US could continue to press for more action on intellectual property and technology. Such an outcome – extending the 90-day truce agreed between Trump and Xi while kicking deeper issues down the road - would be the most palatable outcome for Xi and colleagues as they seek to park the trade war while they focus on the domestic economy. It would also be welcomed by those supply chain economies hit by the confrontation (See Daily Note "Is it all about China"? 17 January)

But the structural issues remain and present fundamental difficulties which Liu may outline at the talks. Xi and the Politburo are not going to accept changes that diminish the power of the Communist Party-led state in China's economic system. Indeed, the trend is towards bolstering political control (See "China Watch – The party's business play" 18 January). The monitoring mechanisms that the Trade Representative's team wants to ensure Chinese compliance and avoid becoming caught in an open-ended process would be unacceptable to Beijing - on grounds of national sovereignty and Party power. In addition, the battle over technology and cyber-theft will continue, with Beijing still intent on achieving its ambitions while the US canvasses allies to restrict companies like Huawei and Congress crafts more legislation to restrict China.

In the end, it will all depend on how Trump decides between a short-term outcome and longer-term aims, which will involve broader domestic political calculations. China will have in mind Liu He's last experience in Washington in May, when the president vetoed, as insufficient, the accord Liu reached with Stephen Mnuchin on increased imports of US farm and energy products. After last week's Wall Street Journal report that the Treasury Secretary had suggested – against Lighthizer's objections – removing all or some of the tariffs in the hope of a general trade agreement and a meaningful Chinese commitment to longer-term reform on lines approved by Washington, the reaction from the administration was that there was no current discussion of eliminating tariffs and that Trump "has no interest in making decisions now".

Another factor at play now is China's role in the run-up to Trump's second summit with Kim Jong-un, which has been set for next month following a flurry of diplomatic contacts. While sending a high-level emissary to Washington last week, the North Korean leader has paid another visit to Beijing to line up Chinese support ahead of the meeting with Trump. If the US wants more substantial results than it got from the Singapore summit last June, Xi looks like an essential partner - a contribution that Beijing will tip into the trade negotiation mix.

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