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Letter no: 925 **20th June 2024**

FINANCIAL STABILITY: HOW CLOSE TO THE EDGE?

Felix Martin opened our roundtable discussion with the observation that commercial banks are continuing to lose market share to capital markets, most recently to private markets. Banks' share of the UK lending market peaked in 1974 at 62 per cent and has been on a downward trend, rallying briefly in the early 2000s, before slumping below 40 per cent after 2019. He questioned the stability of a financial system intermediated primarily by capital markets, noting that the flexibility of banks' balance sheets – ultimately backstopped by the central bank – enables the banking sector to accommodate the unexpected shocks to credit demand that are an intrinsic part of a capitalist economy. (This argument is elaborated in a new post on the New York Fed website, titled "Nonbanks are growing but their growth is heavily supported by banks"). While the explosive rise of private credit could be viewed as just another iteration of the process whereby banks recycle excess credit risk from their balance sheets into capital markets, where it can be carried more efficiently, this supposes that there are deep pockets in the private sector ready to be deployed in a crisis. Unlike insurance companies, private credit funds do not tend to hold prudential reserves. The absence of a daily mark-to-market discipline in private credit – and a secondary market to stimulate price discovery – means the risk of nasty surprises from abruptly-recognised drawdowns is genuine. My financial stability concerns stem largely from the endogeneity of the financial system, where central banks have become embedded in the machinery of the system, where the structure of interest rates is conditional on the monetary policy regime and where financial system liquidity is inextricably connected to financial asset prices. We are living in a super-correlated system in which the value of bonds, equities and other financial assets rise and fall together. At times, this resembles a perpetual motion machine, as larger budget deficits manufacture more high-quality collateral, which encourages a greater risk appetite and higher equity values in a pro-cyclical loop (see

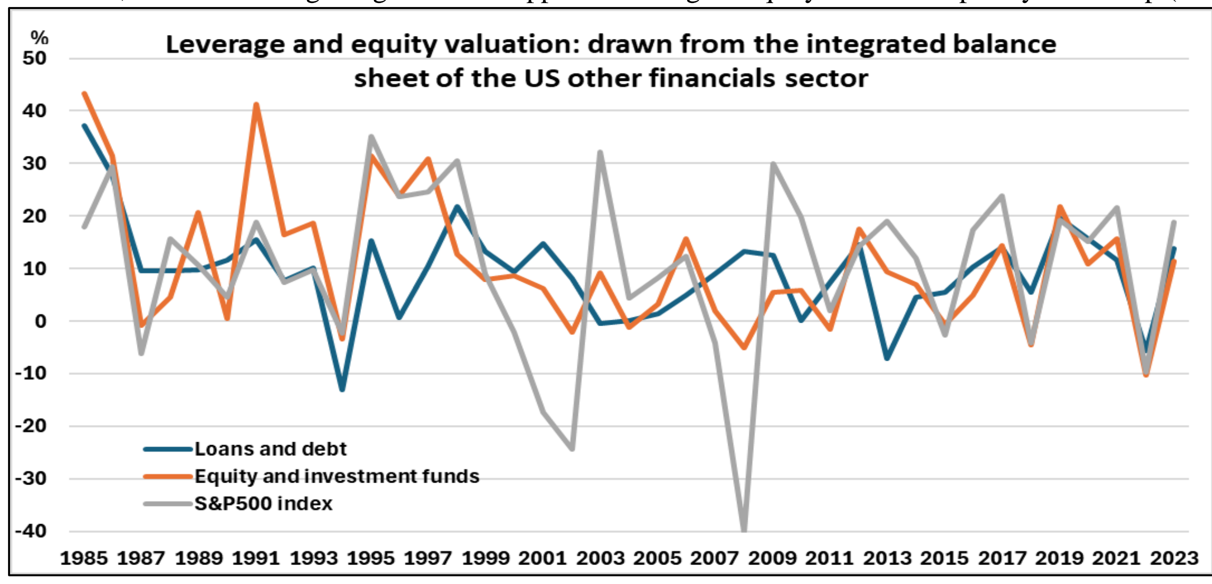
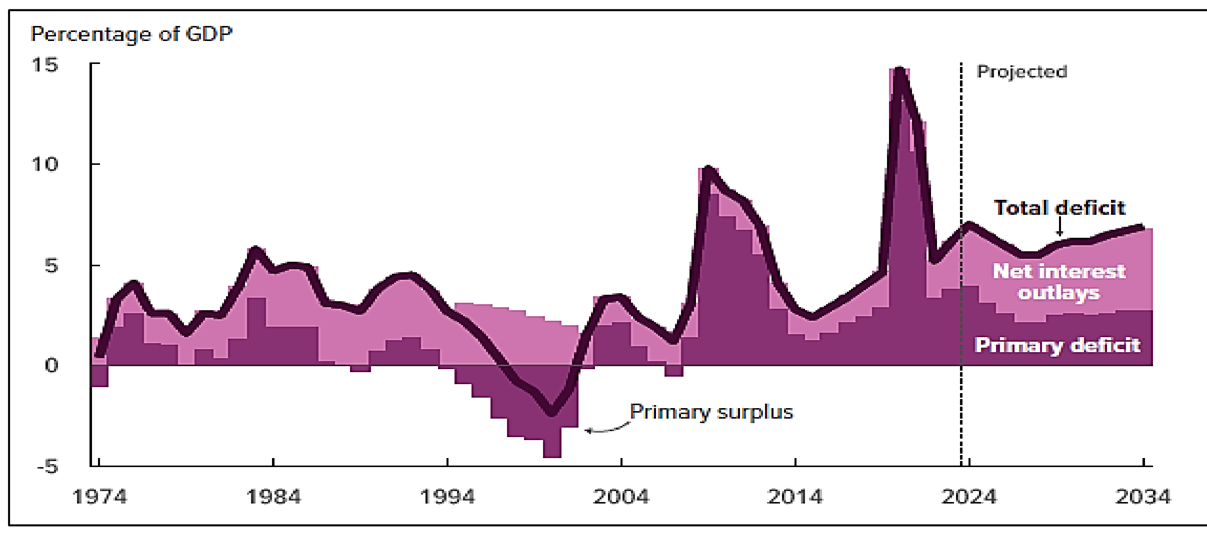


chart). The more difficult the political economy becomes, the greater the temptation to use public borrowing to address problems, whether distributional, demographic, relating to defence and security or the environment. The IMF's latest *Global Financial Stability Report* urged central banks to persevere with disinflationary policy settings for the "last mile", but political patience is running out and the pressure for interest rate cuts is intensifying. We have a financial system that is ill-equipped to deal with inflationary shocks and interest rate resets. While the focus of media attention is the central banks and their interest rate decisions, of greater significance could be the risk of fiscal reversal – either as a matter of policy preference or of necessity, if debt service costs spiral out of control. Burgeoning budget deficits can be financed – at least for now – but more draconian measures may be required before long. These may include a squeeze on the banks, such that they are forced to reduce their deposit interest rates, on the long-term investment funds, requiring them to hold more government debt, to force central banks back into quantitative easing or even to raise their inflation targets from 2 per cent to 3 or 4 per cent. The pain of the 2022 interest rate reset has not yet fully matured; the question is whether we should worry more about the impacts on banks via exposures to CRE and private credit or the impacts on financial markets of urgent constraints on public borrowing. Thanks to all who participated in the roundtable discussion.

US BUDGET: FOR WHOM THE BILL TOLLS

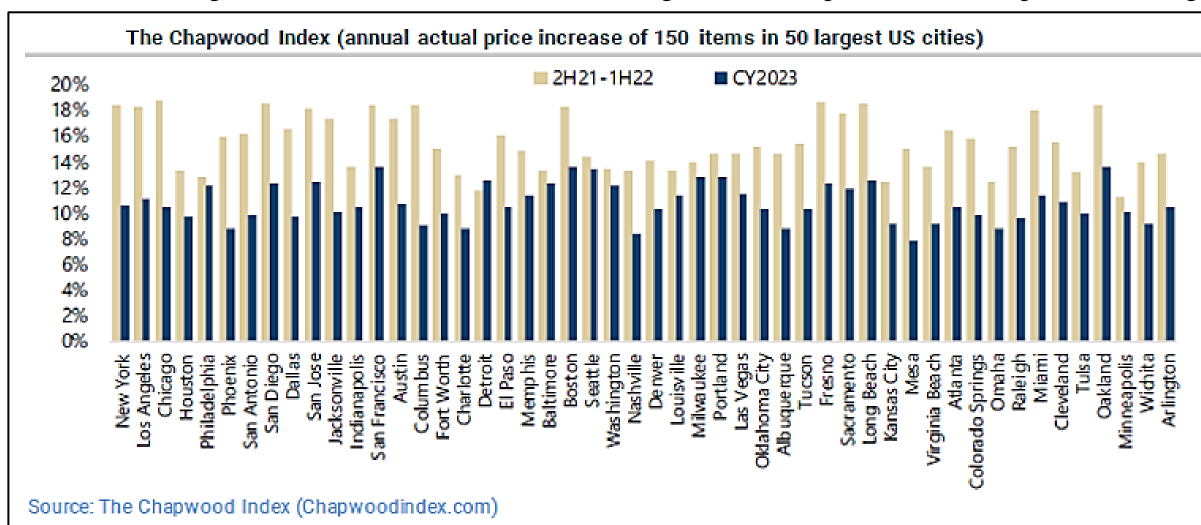
Bang on cue, the non-partisan US Congressional Budget Office has lifted its estimate for fiscal 2024 by more than US$400bn, compared to its February projection. The CBO envisages a deficit of US1.92trn in 2024, relative to US1.69trn in 2023. The new estimate reflects additional spending on aid for Ukraine ($60bn), Biden administration student-loan relief measures ($145bn), a $70bn cash injection to the Federal Deposit Insurance Corporation to cover shortfalls relating to bank failures and higher estimates for Medicaid spending. In its accompanying economic forecasts, the CBO projects stronger growth and higher inflation than in February. Note that this forecast includes an assumption that former president Donald Trump's tax cuts will expire, as scheduled, at the end of next year. The cost of extending those provisions could add more than $4.6trn (over a 10-year forecast horizon). The notable feature of the new CBO projections pictured below, is the burden of net interest rate outlays: "Beginning in 2025, interest costs are greater in relation to GDP than at any point since at least 1940 (the first year for which the Office of Management and Budget reports such data) and exceed outlays for defence and outlays for non-defence programmes and activities". The CBO observes that, for the years between 1974 and 2023, when the unemployment rate was at or below 4.5 per cent, on average the budget showed a primary deficit of 0.3 per cent of GDP. Despite its assumption of unemployment rates at or below 4.5 per cent in the forecast period, the primary deficit averages 2.5 per cent of GDP. The budget deficit to GDP ratio of 6.7 per cent in fiscal 2024, is expected to remain broadly constant for the following 9 years, implying that the ratio of debt held by the public to GDP rises from 99 per cent in 2024 to 122 per cent in 2034. Before we laugh too loudly at these forecasts, it should be remembered that the UK's Office for Budget (Ir)Responsibility arrived at similar conclusions last summer. What I find truly staggering about the CBO document is the happy co-existence of perennial 6 to 7 per cent deficits with 2 per cent inflation. No attempt is made to describe the monetary landscape



in which the public sector's unsustainable financial position is willingly financed at 4 per cent Treasury yields.

DOES THE US CPI UNDERSTATE INFLATION?

This is an old chestnut, but one that is worth revisiting in the wake of the 20 per cent uplift in the official consumer price index since 2019 in the US, UK and many other nations. Christopher Wood, of Jefferies, mentioned the Chapwood Index in last week's *Greed & Fear* and the chart below reveals its most recent findings across US states. The index seeks to measure accurate cost-of-living increases experienced by Americans by reporting the unadjusted actual cost and price fluctuations of the top 150 items on which people spend their after-tax income in the 50 largest cities. The index is updated and released twice a year. There is an intended criticism of the way the official index works: "while the CPI was originally a measure to evaluate a pre-defined, consistently weighted basket of goods, over time the basket of goods grew to an unreasonable 80,000+ items, muting dramatic price changes in common goods and services. By adding too many layers of complexity and algorithms you lose the organic, real results in a muddled mix of diluted data". The authors also suspect that changes in the way the CPI is calculated constitute deliberate state manipulation, designed "to keep government expenditures down and mislead the public with misinformation". Unsurprisingly, the authors point the finger at the Boskin Commission, 1995-96, as a blatant example of this manipulation. The index shows that the 'true' cost of living increase is far greater than the official CPI data indicates. For example, the latest data shows that the true cost of living increase in 2023 in the 50 cities ranged from 7.8 per cent to 13.6 per cent, though



Source: The Chapwood Index (Chapwoodindex.com)

down from a peak of 11.3 per cent to 18.8 per cent reached in 2H21-1H22. The huge gap between these readings and the recent prints of the CPI is partly accounted for by the Chapwood Index bias towards frequently purchased items, such as rent, food, gasoline and non-durable goods. The CPI also contains imputations of consumer prices, not least owners' equivalent rent. The Chapwood Index is not directly comparable to the CPI, but it provides a valuable insight into the perceptions of inflation that will inform voting behaviour in the November elections.

ZUT ALORS!

An unwelcome spotlight has been cast on France's fiscal affairs, in the light of the results of the European elections and the snap election called by President Macron. Andrew Hunt, Hunt Economics, was well ahead of the pack, noticing that France's underlying budget deficit was equivalent to 7 or 8 per cent of GDP back in April. Taking a leaf out of the US playbook, with respect to the administration's use of the Treasury General Account, the French government drew down its deposits at the Banque de France to avoid borrowing. Andrew reckons that this game is up and that, regardless of the outcome of the elections, primary debt issuance will surge over the coming year. Financing the deficit by borrowing from abroad (especially Japan) has just become much trickier. The degree of deficit monetisation is liable to increase, and with it, the inflationary risks.

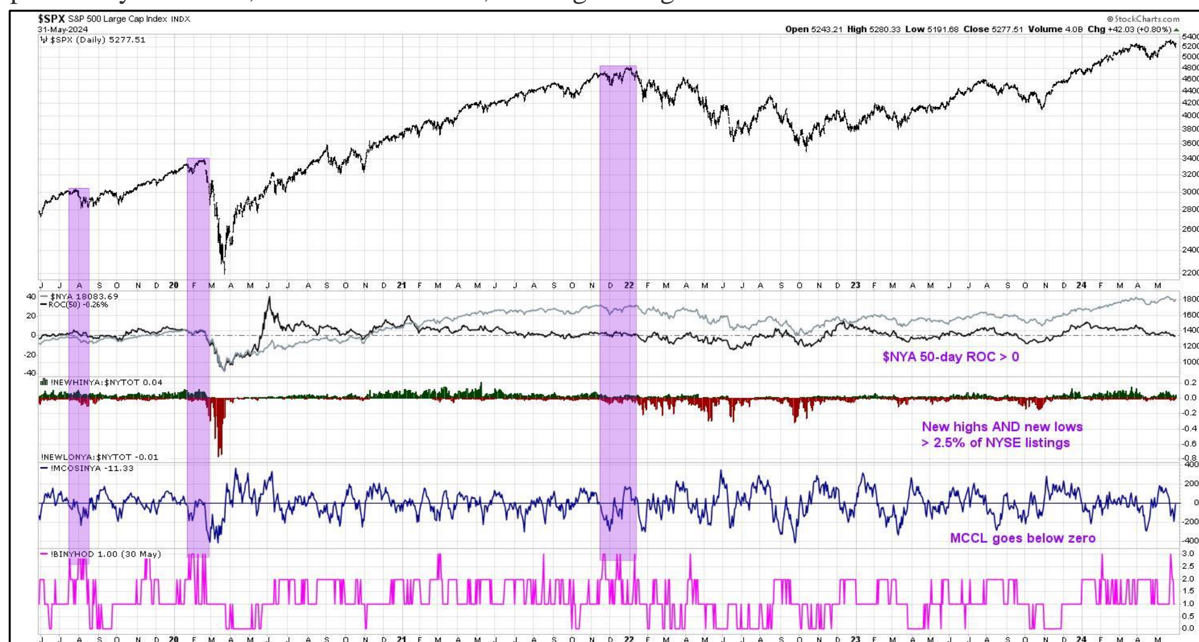
DIARY DATE

We plan to hold one more lunch event before the summer break, probably on Wednesday 10th July. Hoping to announce details during the coming week.

Peter Warburton

"HINDENBURG OMEN" STRIKES AGAIN!

This infamous technical indicator, based on a unique dispersion signature of market internals, recently coincided with the market's *'behavioural inflection pattern'* and **reopens the question of *"hot air, or crash risk"?*** The Hindenburg Omen (HO), named after the 1937 German airship that crashed in Lakehurst, N.J., serves as a *"warning sign of trouble ahead"* for financial markets, having already preceded every crash in almost 40 years: including 1987, Y2K TMT, 2008 GFC, 2018 *"Volmageddon"* and the 2020 Pandemic. However, it is by no means perfect. The *Wall Street Journal* published a study in 2010 that found the HO emerged during many periods of market calm, and only 25% of the time preceded what you could define as a crash. More recently, analysis by Sentiment Trader in 2020, concluded that clustering occurrences of the omen precede a market crash more often than not. This point was previously echoed by myself during a CNBC interview in 2013, alongside **the importance of overlaying a cycle framework,** to help increase probabilities of a reliable inflection point. The omen originates from the late market-timing expert Gerald Appel, renowned for crafting an assortment of mathematical models and indicators. Thereafter, Jim Miekka, a mathematician, fine-tuned it into a more comprehensive predictor. There are several parts to it, although there has been some debate as to the specific criteria. Details here. Mr. Miekka came up with the HO in 1995 as a way to predict big market downturns, developing a formula that parses data like 52-week stock levels and the moving averages of the New York Stock Exchange (NYSE). Other criteria include a rising 10-week moving average for NYSE and a negative McClellan Oscillator, a technical market breadth indicator. Mr. Miekka also originally said the appearance of one signal usually warns of a market top, but the **HO becomes more accurate when there are two or more close together.** Indeed, tracking the number of signals over certain time periods has a greater reliability in forecasting volatility. Meantime, **our *Roadmap signature model* continues to favour a market top in Q2 2024,** with heightened mean-reversion risk during H2 2024. An historic degree of HO cluster, albeit still awaiting a second confirmation signal, should alert investors to brace themselves. This is amplified by the ongoing triple whammy of headwinds: 1) Momentum exhaustion, 2) Rotation fragility, 3) Cycle asymmetric risk. **S&P500 confirms a bull-trap setup with a reversal under its trend-channel near 5300.** This unlocks a minimum price objective of -10% with overshoot risk. Recall that concentration risk still weighs at historic Y2K extremes, with now more than 50% of S&P500 YTD return derived from NVIDIA! This warns of the market's high-beta sensitivity to a minor tremor risk. Watch latest insights from industry peer Larry Williams, featured on CNBC, alerting to heightened risk into the summer months ahead.



Ron William

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