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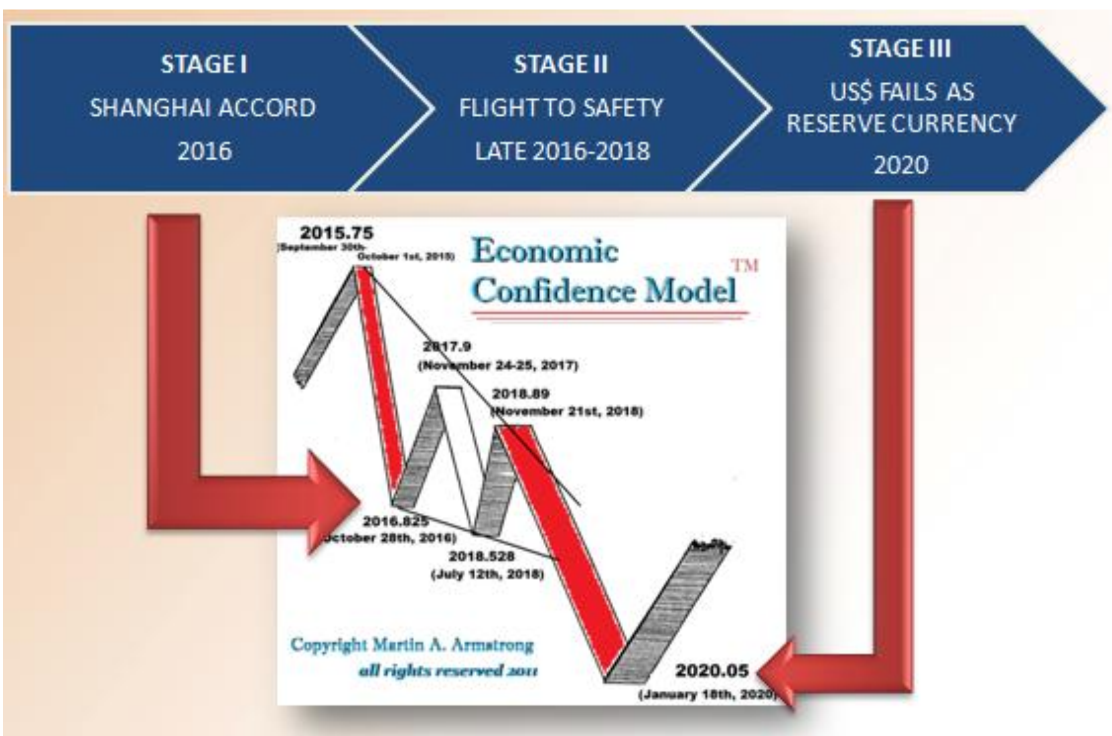
TRADING THE STEALTH SHANGHAI ACCORD

The Central Banks Coordinate Monetary "Expectation Setting" Policy

ANALYTIC INSIGHTS



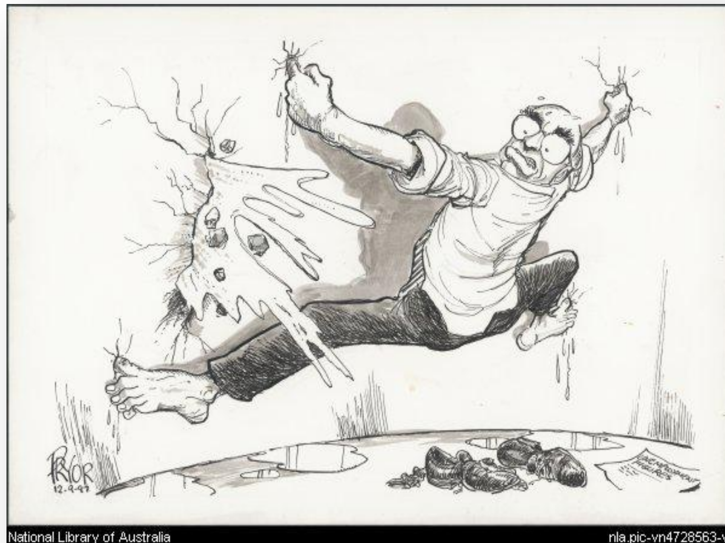
Gordon T Long
4/18/2016

TRADING THE STEALTH SHANGHAI ACCORD

The Central Banks Coordinate Monetary "Expectation Setting" Policy

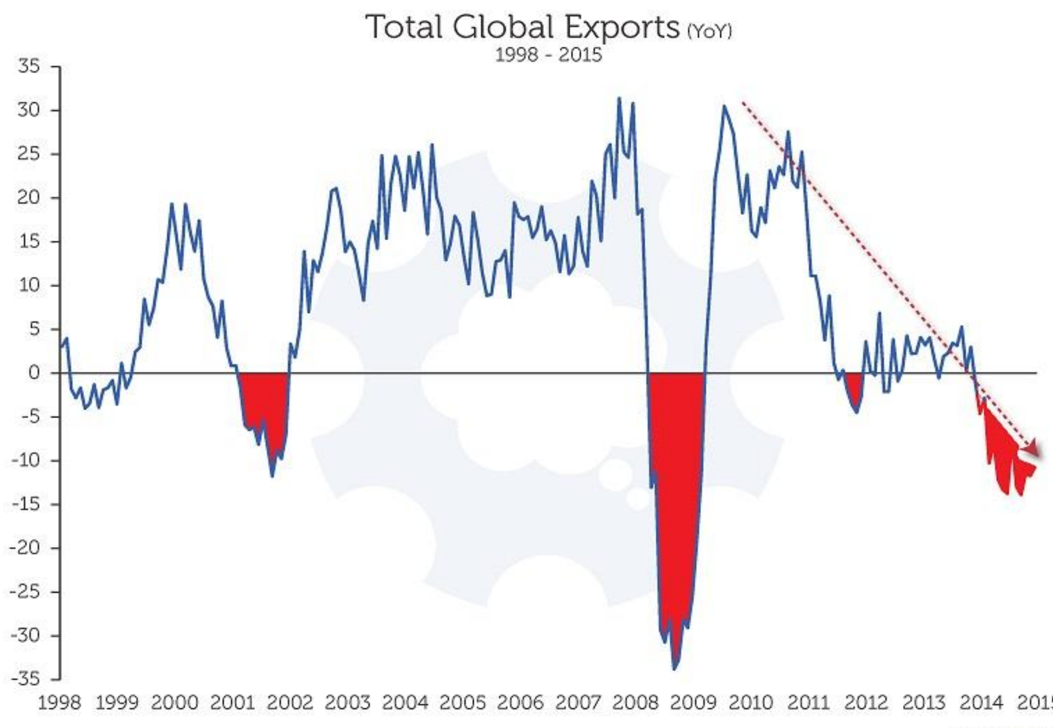
For the last year we have been reporting on the steadily deteriorating global macro environment. We previously illustrated:

- Falling Corporate Revenue, Margins, Earnings & Cash-flows,
- An Imploding Global Energy and Commodity Sectors,
- Tightening Liquidity and the Reversing Credit Cycle,
- The size and seriousness of unfunded and unpayable government entitlement programs,
- The level of unserviceable Household, Corporate and Government Debt,
- Failing Central Bank Monetary Policy Initiatives and increasing degree of desperation,
- Heightened Geo-Political Conflict Risks including Islamic Terrorism, an EU Refugee Crisis & and the emerging Brexit concern.

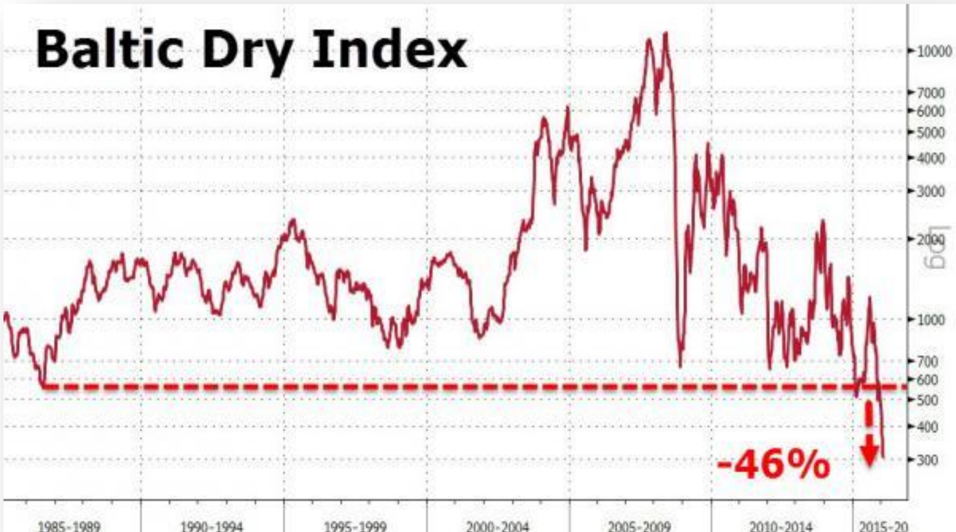


The list goes on, but what we need to focus on is the degree and continuation of collapsing global trade.

World Trade has collapsed in both Dollar terms and Units shipped.



Shipping Rates even unadjusted for inflation are at levels not seen since the mid 1980s. Worse than the lowest levels witnessed during the 2007-2008 Financial Crisis.

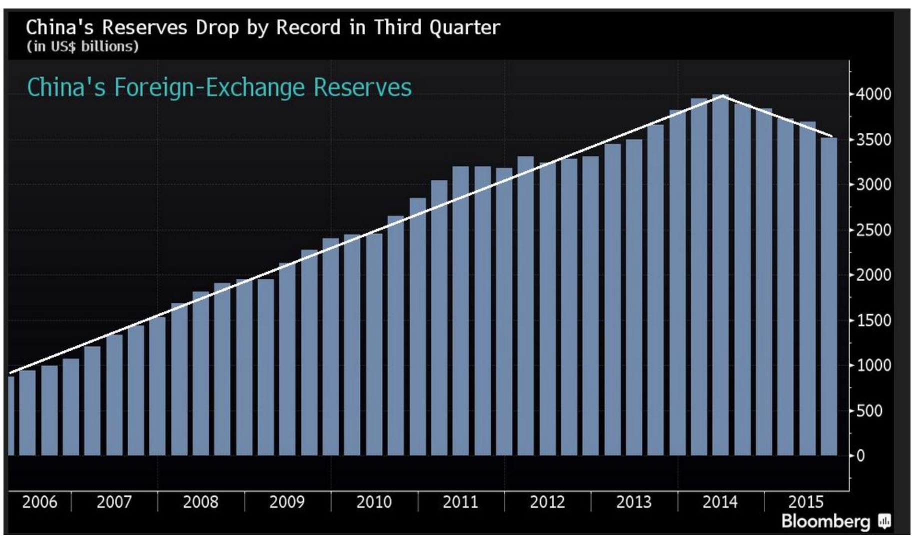


Clearly China is very close to a hard landing and has now been forced to implement almost "totalitarian" economic & regulatory measures to stop the fragile economic system from coming apart.

Capital is fleeing China, while its Investment & Export led policies are failing.

This is forcing China to sell US Treasuries which correspondingly causes amajor problem for US deficit financing!

Chinese FX Reserve Levels Have Reversed.



THE G-20 SHANGHAI FINANCE MINISTERS MEETING

At the recent G-20 meeting in Shanghai, China in February, German Finance Minister Wolfgang Schäuble was highly visible as he laid the blame at the feet of the the other members who continued with failed and dangerous policies. He spelled out publicly that:

1. Germany is against the world's top 20 economies launching a fiscal stimulus package in the face of slowing global growth,
2. Governments attempting to boost their economies with monetary loosening could be "counterproductive",

3. Reforms were more important and "thinking about further stimulus just distracted from the real task at hand",
4. Berlin does "not agree on a G20 fiscal stimulus package,"
5. " Monetary policy is extremely accommodating to the point that it may even be counterproductive in terms of negative side effects",

"Fiscal as well as monetary policies has reached their limits — if you want the real economy to grow there are no shortcuts without reforms."

THE BASIS FOR THE SHANGHAI ACCORD

BERNANKE'S "ENRICH THY NEIGHBOR" DOCTRINE

It is fairly well understood that currency manipulation is a negative-sum game. One country can get a small temporary boost from devaluation, but then trading partners are worse off, and the world is worse off. Ultimately, even the country that devalued first is worse off after others retaliate.

According to James Rickards:

> *A new theory of currency manipulation was created by Ben Bernanke. This theory says that if every country* eases *at the same time, everyone gets the benefit of easing, but exchange rates don't change much because of the coordinated timing. Bernanke called this "enrich thy neighbor," in contrast to the original "beggar thy neighbor" name given to currency wars in the 1930s.*
>
> *The concept of cooperation and coordination among the central banks can be carried several steps further. Several countries can ease or tighten at the same time in order to give one country some relative benefit by design. Central banks can give targeted relief to one country if they all cooperate in a secret plan.*

NEW POLICY TOOL OF "FORWARD GUIDANCE & EXPECTATIONS "

What has been discovered and tuned over the last decade is that Central bank policy changes work through expectations as much as actions. In traditional policy, a central bank eases by cutting rates or tightens by raising rates. But it can also ease by raising expectations about a rate increase and then doing nothing.

James Rickards additionally suggests:

> *If markets price in a rate increase and the central bank does nothing, markets can rally on the news. This is like an invisible rate cut, based solely on changed expectations.*
>
> *Having multiple central banks manipulate expectations and coordinate policy behind the scenes is complex. These efforts are doomed to fail because of unintended consequences and exogenous shocks. But that won't stop the big brains from trying.*
>
> *China's shock devaluation of the yuan last August was because China had not managed expectations. This shock destabilized the global financial system. The IMF and the Fed were quite upset that China was not playing by the rules of the game. On the other hand, China did not care much about the rules, because their economy was sinking under bad debts and capital outflows. China acted in its best interests regardless of the global impact.*
>
> *With this background and the recent yuan shock in mind, the global financial powers descended on Shanghai in late February.*

The G-20 central bankers and finance ministers agreed that China needed help. It's the world's second-largest economy and it was falling fast. There was some danger it could take the world down with it.

But further yuan devaluation was not possible (in the short run) because it was too destabilizing to markets.

THE CURRENCY CARTEL

Readers need to fully appreciate that over $5.5T of Currency is traded daily. Four currencies have dominated this trade for 2 decades. Those four currencies are the US dollar, the UK Sterling, The EU Euro and the Japanese Yen.

1985 PLAZA ACCORD

Going back in history, we need to also understand The Plaza Accord which was orchestrated by James Baker, who was Ronald Reagan's secretary of the Treasury at the time. The dollar had increased almost 50% from1980–1985, and reached an all-time high that year. The strong dollar was hurting U.S. exports and jobs. Sound familiar?

The Plaza Accord was a coordinated effort by the U.S., France, West Germany, Japan and the U.K. to weaken the dollar. These countries were the world's largest economic players at the time. The Plaza Accord worked.

The dollar fell 30% over the next three years. The U.S. economy got a second wind, and the long Reagan-Bush expansion continued.

Today the U.S., Europe, Japan and China together represent over 70% of global GDP. The IMF acts as a kind of facilitator for these secret meetings, and an "enforcer" for whatever agreements are reached behind closed doors.

WHAT WAS AGREED TO IN SHANGHAI

The solution agreed to behind closed doors was to weaken the yuan on a relative basis by strengthening the currencies of China's major trading partners, Japan and Europe.

They agreed to do it by strategically coordinating raising expectations. This has never been tried before on such a scale

Japan and Europe would be the losers in this round of currency manipulations.

- Japan was the winner in 2013 with Abenomics.
- Europe was the winner in 2014 with negative rates and Euro QE.

Now it was the turn of China and the U.S. to get a lift. The U.S. and China are the world's two largest economies. If they go down, the whole world goes down with them.

Both economies were showing signs of weakness. It was time for Europe and Japan to give it up to China and the U.S.

That's the legacy of the Shanghai Accord.

With Europe and Japan tightening and the U.S. easing at the same time, it was believed that nobody would focus on the fact that China effectively devalued, because the yuan/dollar cross-rate would be unchanged.

Europe is a larger trading partner to China than the U.S., so the yuan/euro cross-rate is actually more important to the Chinese economy.

What happened under the Shanghai Accord would be a coordinated devaluation that would be unnoticed because China took no official action and the yuan/dollar cross-rate was unchanged. It was an invisible devaluation of the yuan.

The Shanghai Accord will be a game changer depending on how hard the insiders push their new playbook.

POST ACCORD ACTIONS – IS IT WORKING?

Since this secret deal was worked out on Feb. 26, the first chance the central bankers had to put their plan into action was mid-March.

- The ECB met on March 10.

- The Bank of Japan met on March 15.
- The Fed met on March 16.

All three central banks would be able to implement the secret plan in just five business days. Now it was “game on” for the biggest currency manipulation since 1985.

Markets thought Draghi’s ECB “bazooka” would be long lasting. In fact, Draghi did the minimum necessary, and then said he was done doing more.

Markets expected Kuroda of the Bank of Japan to do more aggressive QE. Kuroda did nothing.

Both decisions acted like tightening relative to expectations. Then the Fed weakened the dollar with their dovish comments at the March 16 meeting.

By doing nothing and signaling slower tightening, the group changed expectations, which is a form of ease.

The euro and yen went up against the dollar immediately. Comparatively, the yuan went down with no explicit devaluation by China. This was the new Shanghai Accord in action.

The Shanghai Accord happened in stealth, but it may go down in history as a major turning point in the international monetary system.

TRADING THE SHANGHAI ACCORD

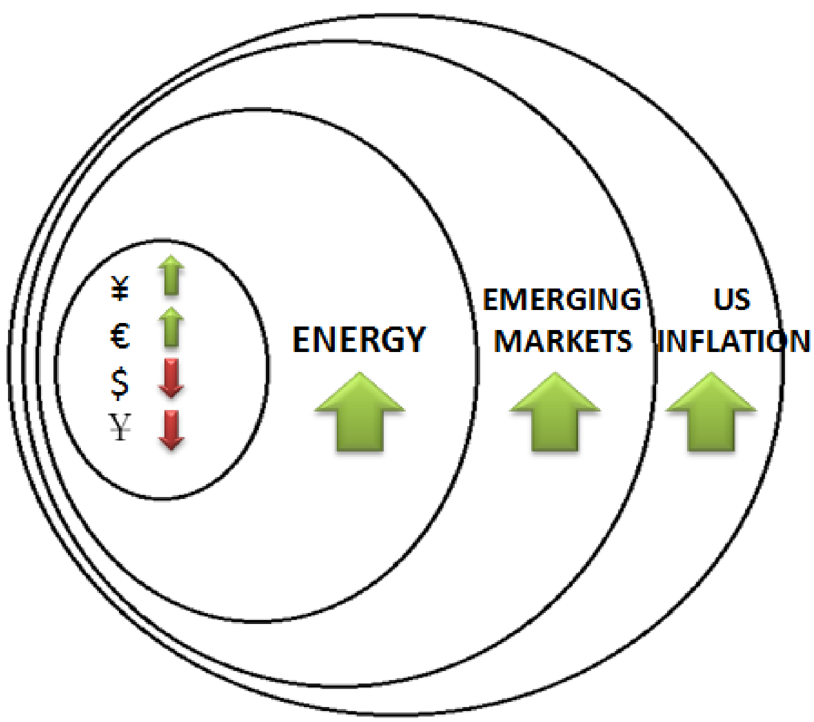
ACCORD - GOAL & IMPACT

The shock waves will be felt in every market in the world.

1. U.S. stocks will get a lift,
2. Japanese stocks will get crushed and
3. Gold will soar.

The consequences for Asia of a stronger yen and weaker yuan are not difficult to discern. Japanese corporate profits will be hurt two ways. Japanese exporters will be hurt because their products will be more expensive for foreign buyers. Japanese multinationals will be hurt when their overseas earnings are translated back into yen. It’s a double-whammy for the Japanese stock market.

Energy in the short term will likely fall because of oversupply and Iran refusing to go along with Saudi Arabia and Russia’s oil production cuts. Energy prices will however rise if the the US dollar begins to sustain downward pressures as a result of the Shanghai Accord.

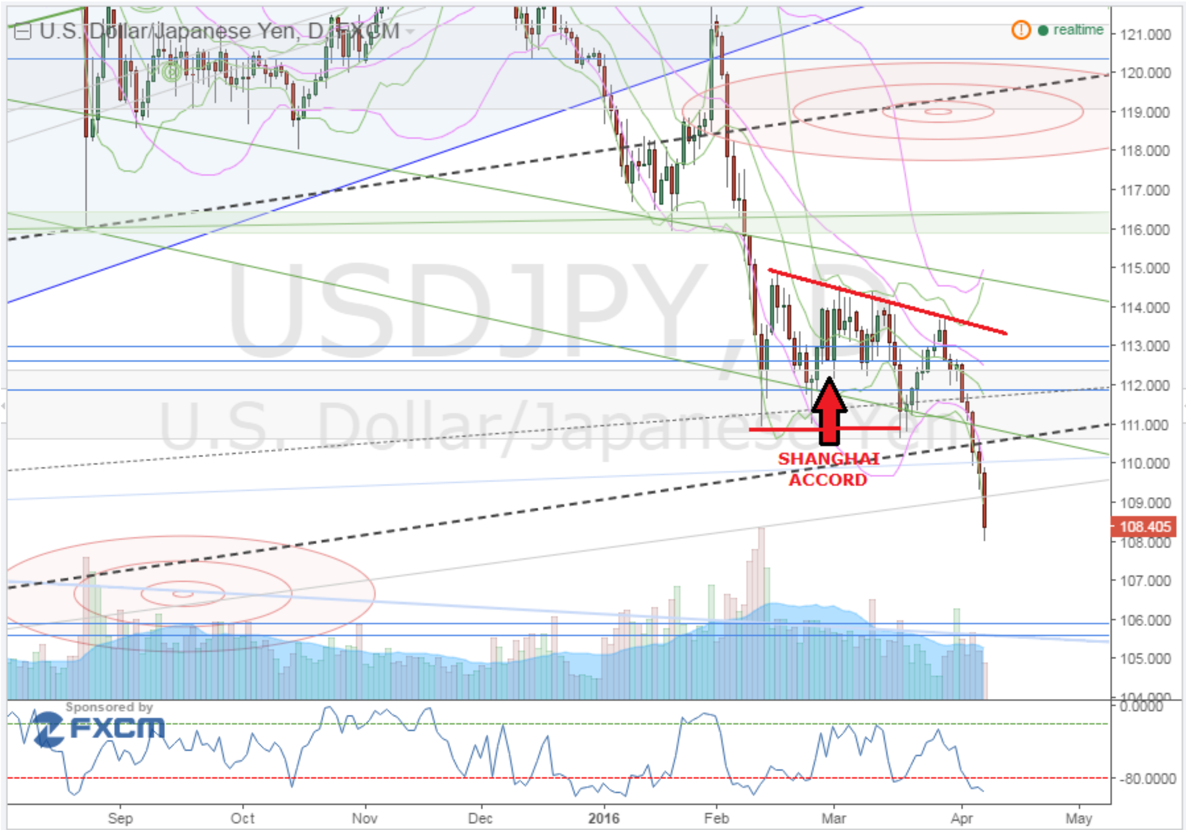


The YEN & EURO Will be Increased in Value Together => EURJPY Flat

The USD WILL WEAKEN Against the Euro => EURUSD Will Rise

Draghi has been forced to let the Euro rise to weaken the Yuan – Europe is China's largest trading partner.

The USD WILL WEAKEN Against the Yen => USDJPY Will Fall

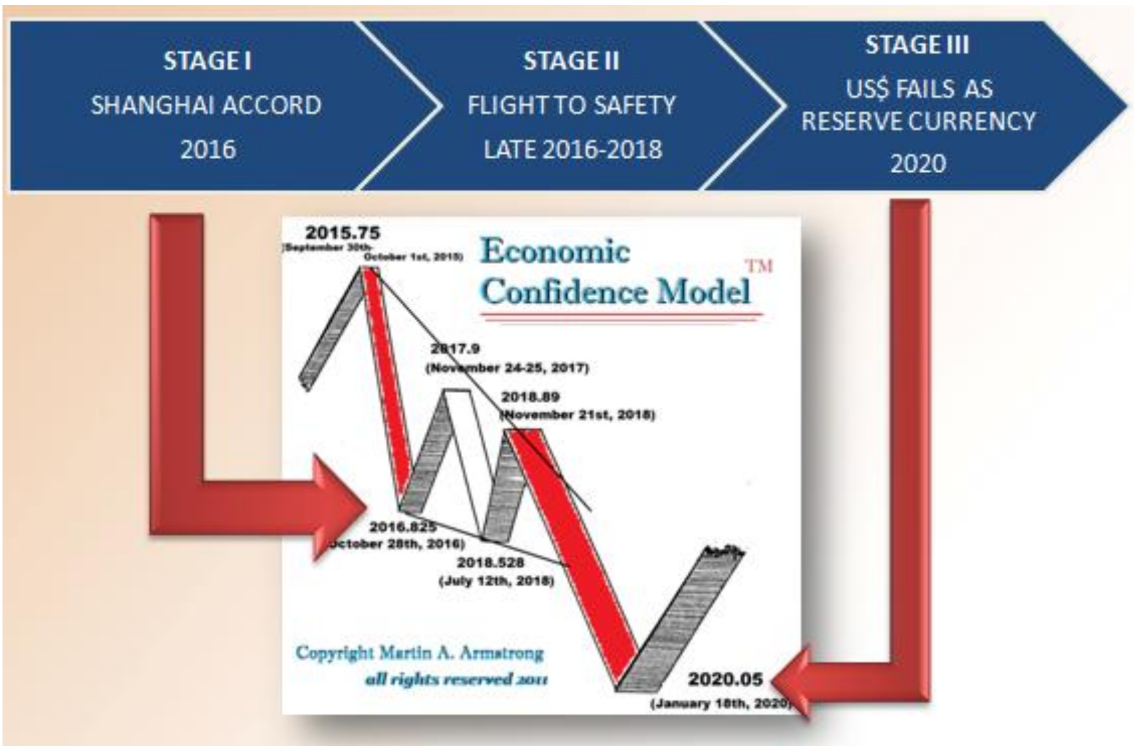


The YEN will Strengthen

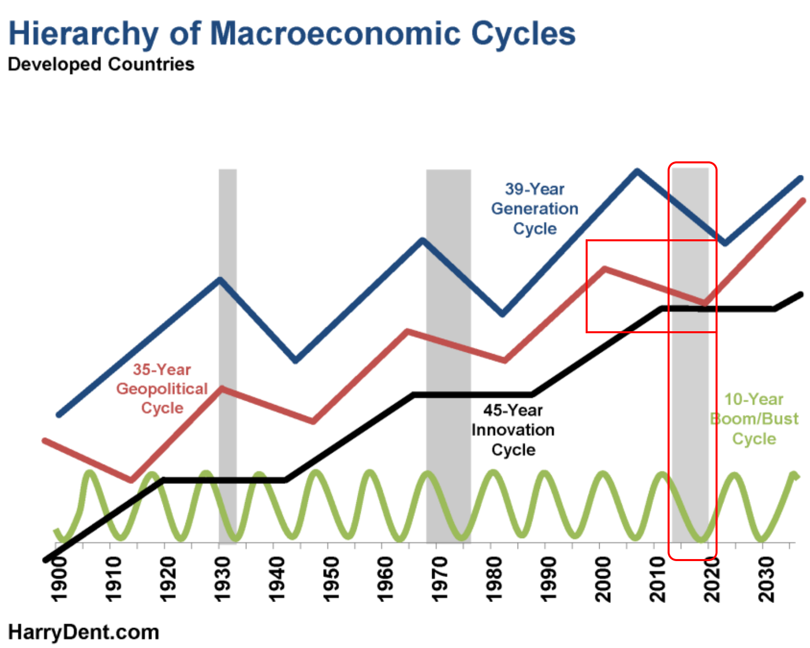
WHAT TO EXPECT

POTENTIAL ROADMAP – Armstrong's Economic Confidence Model

We have did a fair amount of analysis on various unfolding scenarios going forward regarding the Shanghai Accord, US$ strength and the US$'s longer term failing role as the world's Reserve Currency. We were surprised to see a very close fit with our findings and those of Martin Armstrong's and his Economic Confidence Model.



We were just as surprised when we overlaid it with Harry Dent's 35 Year Geo-Political Cycle



DRIVERS – Credit Leads Equities – Giving an Unambiguous Signal

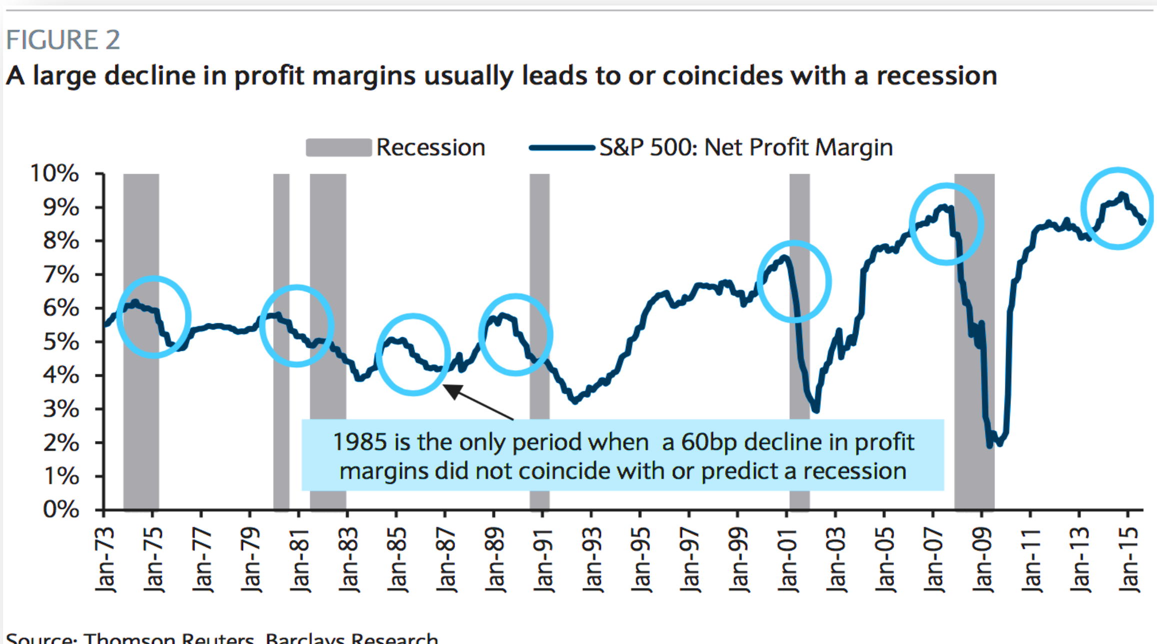
Credit Cycle turns in my experience always leads equities. It is presently giving a very clear unambiguous signal.

I have written a lot about the turn in the Credit Cycle since Q4 and I will leave you to revisit the details I have previously laid out.

The central issue is falling corporate free-cash flow and EBITDA levels.

Falling Margins Sending Recession Signal

We have shown in both the last MATA and GMTP reports extensive indicators that suggest the US is either already in or will soon be in a recession – even using government numbers which are [becoming almost totally unreliable](). At times I am starting to feel even [the government is losing track of all the "fixes"]() they are continuously putting into the statistics.



UST 2-10 Sending Recession Signal

A flat and Inverted Yield Curves are historically the most prevalent and consist indicator of coming recessions and process of realignment and adjustment. We have watched very closely since Q4 2015 the triple bottom in the 2-10 UST Yield Curve. We see that the triple bottom has now been decisively broken. We are moving to an inverted yield curve signaling the bond market sees economic issues ahead.

Weakening Markets

None of this bodes well for the equity markets in the near term. We fully expect market weakness after tax season is over and we enter the "Sell in May and Go Away" Wall Street meme.

Our 200 DMA and 400 DMA boundary conditions served us well during the 2007-2008 financial crises. They appear to be serving us well again

Bad things happen when the 200 DMA crosses the 400 DMA. It is rare and is almost always followed by a protracted period within the new directional trend direction it establishes. We aren't quite there yet but we are extremely close.

We had expected prices to minimally test the underside of the 400 DMA as overhead resistance before the Long Term top was finally in. This test which we pointed out in the last report has occurred.

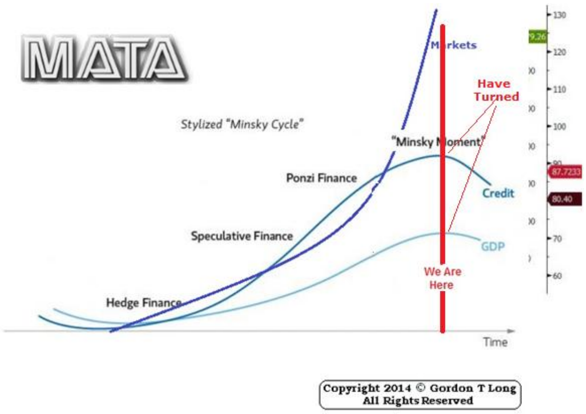
We also watch closely what the very Long Term Charts are telling us. This chart goes back nearly two decades. The message here is blatantly clear from a technical perspective. The question is only how long artificial government "pumping" can keep this bubble levitated?

CRACKS IN THE DIKE – A 1929 Type Trap

I continue to fully expect a Minsky Melt-up before all this ends very badly in 2016 - possibly 2017?

Eventually, it will be clear to all that central bank policies have been an abject failure.

The government's policy of Financial Repression are becoming too heavy handed as productivity falls, high paying jobs disappear and tapped out consumer demand steadily erodes.



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