|  |  |
| --- | --- |
| **In this issue** |  |
|  |  |
| **Overview 1**  **Arthur Kroeber**  ***East Asia’s Reforms—Thank the US***  **United States 2**  **Will Denyer *Thinking About The Unthinkable***  **Europe 3**  **Francois Chauchat *The Myth Of Youth Unemployment***  **Asia 4**  **Joyce Poon**  ***The Deﬂationary Specter***  **Resources 5**  **Nate Taplin**  ***Metals Take A Breather*** | |
|  |  |
| [**www.gavekal.com**](http://www.gavekal.com/) |  |

**East Asia’s Reforms—Thank The US**

East Asia’s two biggest economies are both under new management and this has promised a shake-up. In both cases the growth strategy hinges on the use of international trade and investment agreements to force the pace of service-sector liberalization that would otherwise be stymied by domestic politics. And in both cases many outsiders are skeptical. Should we believe the reformers’ promises, or heed the skeptics?

Skeptics argue that the forces of inertia are so great that they cannot possibly be overcome. In China the culprits are an addiction to credit- fuelled high growth rates and “vested interests” such as state owned enterprises. Credit growth is still strong, and explicit state-enterprise reform is off the table. So the government’s reform drive is not credible. In Japan, bad corporate habits entrenched by 20 years of deflation are impossible to correct, and Prime Minister Shinzo Abe’s solution is just the tired old formula of currency devaluation and infrastructure spending.

These arguments are lazy. They boil down to asserting that because reforms are difficult, therefore they are impossible. If that were true no economy would ever be reformed. Yet plenty have been, including both China and Japan in recent memory. (It is easy to forget that in the Koizumi years, 2001-06, Japan’s average GDP growth rate doubled.)

A clear sign of impending change is the greater warmth in both Tokyo and Beijing to the Trans-Pacific Partnership (TPP), an American-led effort to dismantle intangible barriers to trade and investment. Abe broke with his predecessors and signed up for the TPP, which is [central to his](http://research.gavekal.com/content.php/9081)  [hopes for doubling Japanese labor productivity growth](http://research.gavekal.com/content.php/9081) (mainly by reviving torpid agriculture and services). China has not joined TPP negotiations, but the previous government’s hostility has turned to cautious interest under new president Xi Jinping. And China has revived talks on a bilateral investment treaty with the US, and opened a potentially game-changing free investment zone in Shanghai.

Leaders in both China and Japan are clearly committed to greater openness as a lever for reform, and this sets them decisively apart from the leaders of countries—notably India and Brazil—where structural reform efforts are genuinely stalled. A wager against East Asian dynamism in the next few years will be a losing bet. Yet China and Japan’s embrace of openness also refutes the popular idea of “waning American power.” The centrality of TPP to East Asian reform discussions shows that America still sets the global economic agenda. China may be the world’s fastest- growing big economy, but America’s structural hegemony is alive and well.

### Arthur Kroeber

[akroeber@gavekal.com](mailto:akroeber@gavekal.com)

**© GaveKal Ltd. Redistribution prohibited without prior consent.**This report has been prepared by GaveKal mainly for distribution to market professionals and institutional investors. It should not be considered as investment advice or a recommendation to purchase any particular security, strategy or investment product. References to speciﬁc securities and issuers are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

# US: Thinking The Unthinkable

Hitting the debt ceiling is unlikely, but quite possible. This raises the unthinkable prospect that the US might default on its debt, thereby removing the pillar upon which rests the modern global credit system, the current reserve currency, and arguably the whole fiat money system—namely, the full faith and credit of the US government.

Given the stakes, markets are remarkably calm. One- month T-bill yields have risen a bit, from zero to 25bp, but the rest of the credit market has not panicked (see [**Waiting For The Last Minute**](http://research.gavekal.com/content.php/9100-Waiting-For-The-Last-Minute-by-Louis-Gave)). Moreover, gold prices are not going parabolic. Why?

**There is a risk that the political deadlock persists and we hit the debt limit.** When viewed as a battle between two parties, game theory suggests the Democrats have the upper hand and the Republicans should yield at the 11th hour (see [**Tragedy or Comedy**](http://research.gavekal.com/content.php/9094-Tragedy-Or-Comedy-by-Anatole-Kaletsky)**?**). But the Dems will likely have to offer some concessions, because **this is not just a battle *between* parties, but also *within* parties.** With relatively few “swing districts,” many House Republicans do not fear losing their seat to a Democrat; the real risk may be a tea-party challenge from the right. As such, many House Republicans may be less concerned about their party getting blamed for the paralysis, and more concerned about themselves

getting blamed for not being steadfast in opposition to government spending and debt. These Republicans are not bluffing.

**Still, we expect Uncle Sam to service his debt, and indeed add to it.** If the deadlock persists, President Obama will have to choose between legally binding, but inconsistent instructions from Congress. He can ignore tax-and-spend laws or disregard the debt ceiling? We bet it would take president five seconds to decide. **This could be how a longer term solution to the debt ceiling issue emerges: the executive branch ignores the limit and the Supreme Court backs the decision,** on the grounds that this upper bound is inconsistent with tax-and-spend laws and/or citing the 14th amendment (“the validity of the public debt of the US… shall not be questioned.”)

If Obama does reduce spending, the cuts will be carefully chosen to cause the least economic damage, but the most political fallout for the Republicans. Social Security checks come to mind. Debt servicing payments do not. A default would change the world as we know it; but it is not going to happen.

### Will Denyer

[wdenyer@gavekal.com](mailto:wdenyer@gavekal.com)

|  |  |
| --- | --- |
| **Connecting the dots**  What really matters in the latest US economic and market news | |
| **What happened What it means** | |
| **US government “shuts down” October 1st, as Congress fails to pass a budget or continuing resolution to authorize expenditures in FY14.** | In truth the government only “slimmed down,” as non-discretionary payments (e.g., welfare checks) are unaffected and some of the discretionary items were deemed “essential.” **With most payments excluded, the debt limit is still expected to be hit by end October.** |
| **US PMIs go in opposite directions. Manufacturing rose to 56.2** in Sep, from 55.7; **non-manufacturing fell to 54.4**, from 58.6. | **The simple average of the two PMIs fell to 55.3, from 57.2 (not too bad).** Disappointing month after three straight increases, but with the exception of last month this is still the highest average since 1Q11. Government “slim-down” likely to weigh on October, but not structurally. |
| **ADP estimates US private employment rose by 166K jobs** in Sep, up from a revised159K in Aug (but less than initial Aug estimate of 176K). | **This served as the primary jobs report, with oﬃcial payrolls not released due to the government shutting down non-essentials.** A lackluster report, which if anything increases the odds of further delays in tapering. |
| **NFIB small business conﬁdence held up, at**  **93.9** in Sep, only slightly lower than the prior month’s 94.1. | **Small business conﬁdence rebounded strongly around the turn of the year, and has held around 94 since May. Question is: how will it be aﬀected by the political debacle in October?** Investor conﬁdence (according to IDB/TIPP) fell to 38.4 in Oct, from 46.0. |

# Europe: The Myth Of Youth Unemployment

Extraordinarily high youth unemployment rates in some parts of the eurozone has caused deep concern, if not alarm. Even the most austerian EU policymakers argue that “something has to be done.” But a less emotional analysis of the unemployment situation shows that this is not where the real problem lies.

It is true that youth unemployment has reached record rates of more than 50% in some countries, like Spain or Greece. But contrary to what we read almost every day in the press, this does not mean that “one out of two” young people are out of work.

In reality, the majority in the 15-24 age class is studying in one form or another, and is thus counted neither in the numerator nor in the denominator of the unemployment rate. In Spain for example, 60% of the 15-24 cohort is studying, 17% are employed and 23% are unemployed. That is, a bit less than one out of four young Spaniards are out of work and looking for a job. This is substantial, but certainly not as great as 50%+.

As a result of lower fertility rates and rising education rates, the overall number of unemployed youth in the eurozone is today about the same as it was in 1996, at 3.5mn, and lower than the 3.8mn mark reached in 1993. By comparison, the number of unemployed adults who are older than 25 has climbed to almost 16mn, from 8.6mn in 2008.

**How then has a problem affecting 3.5mn people, i.e. youth unemployment, come to be seen as a bigger crisis than the one affecting the 16mn older persons desperately looking for a job**? Sure, “the youth” have always been a favored theme in politicians’ rhetoric. They are “the future of the nation”, so the sooner they get work experience the better; and when unhappy, they have a reputation for causing more social disorder than their elders. They also represent “our children”, and thus touch the heart of the parents who vote, etc.

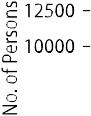
In practice, however, we have a hard time understanding why a jobless 22-year-old, who is comparatively better able to move to another country to find a job, would be a more serious problem than that of a mother or father of two suddenly losing her/ his job—especially in traditional areas where the head of the family subsidizes the rest.

Rather than focusing on temporary schemes for the youth, EU leaders would do better by stepping up both demand and supply-side policies, and carefully nurturing the nascent recovery in order to increase the odds of a lasting and broad-based reversal in unemployment.

### Francois-Xavier Chauchat [fchauchat@gavekal.com](mailto:fchauchat@gavekal.com)

**Save the parents from unemployment!**

Since 2008, the ranks of jobless youth in the euro area has swelled by a jarring 1mn. But in the meantime, the number of older unemployed persons increased by more than 7x this amount, to a new historical high of almost 16mn people!



As a result, youth unemployment in the euro area has shrunk to 18% of the total, from 22% in 2008 and 30% in 1993. In other words, unemployment of the young has become, statistically speaking, a smaller and smaller problem over time.

The real drama in Europe, for which there is no modern historical precedent, is not youth unemployment, but that of the workers of a more mature age.

# Asia: The Deﬂationary Specter

Asian markets face plenty of risks that range from weak developed world demand, a spluttering Chinese economy, heightened Japanese competition, and not least capital outflows due to the US Federal Reserve’s putative monetary tightening intentions. However, much of the Pacific Rim is stalked by another potentially malign influence that rarely gets a mention; namely disinflation. Indeed, Taiwan has already sunk into an outright deflationary situation, while Korea's CPI growth stands at a 14-year low.

A common refrain is that Asia’s deflationary impact is the result of weak commodity prices. But this is too simple. In aggregate, core CPI in Japan, Korea, Taiwan, Thailand and the Philippines is growing at a mere 0.8% YoY. The cause of this is inevitably moot. Taking a monetarist position of the type argued by Charles, the growing disinflationary pressure can be traced to the ongoing collapse in the velocity of money (see [**More**](http://research.gavekal.com/content.php/8539-More-On-The-Deflationary-Bust-Risk-by-Charles-Gave) [**On The Deflationary Bust Risk**](http://research.gavekal.com/content.php/8539-More-On-The-Deflationary-Bust-Risk-by-Charles-Gave)). Absent proper policy responses, the decline in monetary velocity can be a self-feeding process as the resulting rise in real yields increases the incentive to save rather than engage in commercial transactions.

In a disinflationary environment, debt can be lethal for highly leveraged economies. In parts of Asia this is the

situation with leverage once again an Achilles heel after years of easy money inflows. For Asia ex-Japan and China, private sector credit as a share of GDP is near levels recorded before the 1997-98 financial crisis. Against such a macro backdrop, falling prices would worsen the debtors’ balance sheet by increasing the real burden of their debts.

As a general observation the price-taker nature of Asia’s asset-intensive growth-driven model, means that regional corporates tend to do better in a moderately inflationary environment. Recent discussions with Asian companies across a range of industries clearly shows that few producers have pricing power even if there are signs of an incipient cyclical global recovery.

Having said that, we don't think a persistent long-term deflation is now a core scenario. The growth rebound in the US and Europe may just be feeding into Asian prices. Disinflation in the form of lower oil prices will also be good news at both the corporate and macro level. Still, the jury remains out. And given the geared nature of Asia, we would advise maintaining a hedge on regional portfolios using a 30 year zero coupon US treasury bond.

### Yuchan Li & Joyce Poon

[yli@gavekal.com / jpoon@gavekal.com](mailto:wdenyer@gavekal.com)

**Disinﬂationary pressure acute in Asia**

Taiwan recorded an outright deﬂation for the ﬁrst time in three years in August, as CPI fell -0.8% YoY. The September reading rebounded this was mainly due to higher food prices. Looking ahead to the rest of the year, Taiwan CPI is likely to stay much lower than the 2% cap set by the central bank.



Korea’s CPI rose 0.8% YoY in September which was down from the 1.3% increase observed in August, undershooting market expectations of 1.2%. This is the lowest level in 14 years and sits well below the Bank of Korea’s target range of 2.5%-3.5%.

# Resources: Metals Take A Breather

The mood in China—and among commodities traders, chasing the Chinese economy’s taillights—has improved markedly. Chinese industrial growth in August clocked in at 10.3% YoY, the highest since December 2012 and the second straight month of acceleration. Iron ore prices, meanwhile, were close to US$140/ton after falling to US$114 in June. On a YoY basis, iron ore was up 30% in mid-September, its best performance since 2011. Since then, however, prices have lost momentum. Is it time to pile back into China

-growth plays like metals, or best to sit on your hands?

Although the cyclical uptick in Chinese construction has clearly been a boon for metals, we would not get too excited. As we highlighted in our recent [**Housing**](http://research.gavekal.com/content.php/9090-DG-China-Housing-Construction-Review-2013-by-Rosealea-Yao-and-Thomas-Gatley)

[**& Construction Review**](http://research.gavekal.com/content.php/9090-DG-China-Housing-Construction-Review-2013-by-Rosealea-Yao-and-Thomas-Gatley), real estate construction activity apparently decelerated in August following several months of slipping sales growth and credit tightening. While full year figures should look better than the dismal second quarter, the pace of expansion will likely continue moderating in Q4, especially since housing inventories remain high outside of a few large cities. Credit growth has also moderated.

What this means is that the credit and construction driven recovery in metal prices since May is unlikely to extend further.

The empirical relationship between Chinese credit expansion, construction activity, and metal prices remains quite strong, as our chart below shows. Steel mill and developer inventory destocking in Q2 temporarily derailed this relationship but have not completely unhinged it. Construction activity and heavy industrial output tend to follow the credit cycle with a lag of several months.

Moreover, after suffering losses in the past 18 months, the financial conditions of China’s steel firms remain precarious. While steel inventories at Chinese mills have fallen somewhat in absolute terms since Q2, the ratio of firms’ product inventory value relative to sales (a measure of the impetus to destock) remains far above the long-run average of about 0.45. Third party surveys on sentiment of mill owners and new orders also showed a weakening trend in September, after hitting a five-month peak in August.

China’s construction uptick and an improving global outlook have already helped boost metals and other assets that prospered during China’s investment boom years. But no one should expect a return to the heady days of 2005-2011.

### Nate Taplin

[ntaplin@gavekal.com](mailto:ntaplin@gavekal.com)

**The more things change...**

The longstanding relationship between credit expansion, housing sales and materials demand (including steel) seemed to break down recently as both material producers and housing developers destocked.



Metals prices ﬁnally got a bump in late summer as the improving housing market ﬁnally fed into real activity. But the credit tightening which began in May, paired with weak proﬁtability at mills and inventories which—despite some destocking—remain elevated relative to historical levels, mean that metal prices probably do not have much more room to climb this year.