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GLOBAL BANKING AND MARKETS

Global Macro Commentary

Changing Course

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Part One, China

- An **economic slowdown** is underway in China. This is reflected in the steep drop in the commodity complex and in the currencies of emerging market countries. Large imbalances are being worked off as Beijing attempts to shift the composition of its growth. Policy decisions are not always economic.
- New sources of growth are being sought by Beijing as deleveraging occurs. Since officials care foremost about social stability, they try to preserve as many current jobs as possible during their attempt at economic transformation. During this period, banks might be averse to calling in loans. State owned enterprises (SOEs) are pressured to keep producing, so that workers can continue to receive a pay check. The result is over-production and downward pressure on prices.

Part Two, The Seven Year Fed Subsidy

- The Fed's zero interest rate policy has provided a subsidy to investors for the past 7 years. **The lure** of easy profits from cheap money was wildly attractive and readily accepted by investors. The Fed "put" gave investors great confidence that they could outperform their exceptionally low cost of capital. These implicit promises by central banks encouraged trillions of dollars into 'carry trades' and various forms of market speculation.
- Complacent investors maintain these trades, despite the Fed's warning of a looming reduction in the subsidy, and despite a balance sheet expected to shrink in 2016. It has been a risk-chasing **'game of chicken'** that is coming to an end. Changing conditions have skewed risk/reward to the downside. This is particularly true because financial assets prices are exceptionally expensive.
- Maybe investors **do not believe** 'lift-off' looms, because the Fed has changed its guidance so many times. Or maybe, investors are interpreting plummeting commodity prices and the steep fall in global trade as warning signs that global growth and inflation are under pressure. Is this why the US 30 year has rallied 40 basis points in the past 3 weeks? (see my July 17th note, "Bonds are Back")
- Either scenario creates a paradox for risk-seeking investors. If the US economy continues on its current slow progress pace, then the Fed will act on its warning and hike rates in September. However, if the Fed does not hike in September it is likely because problems from China, commodities, Greece, or emerging markets (etc) cause the global outlook to deteriorate further. Neither scenario should be good for risk assets.

Part Three, "Carry Trade"

- During the 2008 crisis, Special Investment Vehicles (SIVs) were primarily responsible for freezing the interbank lending market. SIVs were separate entities set up primarily to earn the **'carry'** differential between short-dated loans and longer-dated assets purchased with the proceeds of the loans. This legal structure allowed banks to own billions of dollars of securities (CDOs and such) off of their balance sheets. Since the entities were wholly-owned with liquidity guarantees, the vehicles received the same attractive funding rates as the parent banks.
- When the housing crisis (and Lehman collapse) spurred loan delinquencies, banks had to place all of these *hidden* securities onto their balance sheets. Since the magnitude of the SIV levered assets was unknown to others, bank solvency was questioned, and interbank lending froze. Many of these securities had to be sold at **fire sale prices**, i.e., prices well below their economic value.
- When the Fed begins to normalize rates, trillions in carry trades will likely begin to unwind. The similarity to 2008 is glaring, except that banks no longer own SIVs. Regulations have chased the 'carry trades' from the banking system into the **shadow banking system** where officials can't see or measure the risk. The banking system today is, no doubt, far less exposed, but too many sellers could overwhelm the depth of the market, leading to asset price contagion that filters into the real economy.

- The FOMC is probably fearful of such an outcome, and its unknown impact on the broader economy, which could explain why it has delayed 'lift-off'. It may also be the reason why the Fed emphasizes that the pace of rate normalization will be "gradual", and will remain "overly-accommodative". Unfortunately, the Fed recognizes that speculators do not wait to retreat in an **orderly manner**. They are also fully aware that regulations have impaired market liquidity; figuratively shrinking the exit doors. This is where 'macro-prudential' comes in.

Part Four, Counter-Productive Policies Back the Fed into a Corner

- Few lessons have been learned by market 'booms', and the 'busts' that always follow. 'Booms' occur when the Fed diverges the price of money too far below the 'natural rate of interest'. Easy money flows into ever less-productive assets. As prices are pushed ever-higher, the yield drop cascades down the capital curve. The process cannot be **sustained**. High prices directly infer lower future returns. Late-stage investors receive the lowest return with the highest level of risk (game of chicken).
- These cycles are tragic because 'busts' have negative consequences that are worse than the 'booms' are beneficial. During the 'bust', elevated asset prices go back down to their original or fundamental value. They may even **overshoot** on the downside due to the regulatory limitations that have been put in place during the 'boom' years.
- The 'wealth effect' is, at a minimum, reversed during the 'bust'. There is no 'free lunch'. More importantly, after the 'bust', the newly acquired higher **levels of debt remain.** The result is a lower natural economic growth rate, lower levels of future investment, and more regulation, which all lead to decreased profits.
- Zero interest rates undermine market incentive structures. Share buybacks have surpassed capital expenditures. **Cheap money** makes acquisitions attractive relative to new investment projects. Why not, cheap money implies high uncertainty. Furthermore, excess liquidity encourages malinvestment and over-capacity, and acts as a headwind for both of the Fed's dual mandates.
- Experimental monetary policy over the past seven years should reveal that attempts at artificial monetary inflation are ineffective. Yet, they give no hints of discarding this failed ideology. Unless this ideology changes**, ever-greater quantities** of printing just to repair the inevitable bust will be required as the chosen response. No wonder why Bitcoin is intriguing and confidence in fiat currencies has come into question.

- "Two roads diverged in the woods and I took the one less traveled by and that has made all the difference." – Robert Frost

Tomorrow, I will suggest a few recommendations for adjusting Portfolios

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Act on the Warnings

Wednesday, August 05, 2015

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This is an addendum to yesterday's note entitled, "Reversing Course"

Part Five, Notice the Warning Signs

- There are **warning signs** and visible market stresses beyond those mentioned yesterday. To list them all is beyond the scope of this note.
- Nonetheless, the impact of a **slowing China** is being under-estimated by markets. The steep drop in commodities is telling us something about demand. (It's not just oil: suppliers don't frack copper)
- Equity market 'internals' are deteriorating and momentum is **faltering**.
- Similar to 2008, the subprime corporate sector (CCC-rated credits) are showing **cracks** beyond the energy sector, e.g., into chemicals and technology. This is typically a late-stage phenomenon and a warning sign of growing risk aversion.
- FOMC members are threatening 'lift-off', but markets don't believe them, because they have 'moved the goal posts' of their guidance so many times. The Fed appears to want an ideal set of conditions which rarely ever materializes. Investors are inclined to stay fully invested until they **actually see** a hike with their own eyes. Complacency is high. Anyone who has entered the financial industry in the past 9 years has never witnessed a rate hike.
- Investing during ZIRP and QE has more to do with fully capitalizing on aggressive Fed policy, and less about finding value for the long run. The investment industry is so focused on short term investment results that decisions are motivated by the necessity of **beating peers and benchmarks** in order to keep one's job.
- Yet, "lift-off" will reduce the Fed's subsidy. Total rate normalization is the **removal of 'the gift'** provided to the private sector. The process in getting there will be the catalyst that begins the reduction of carry trades and market speculation.
- Positional **unwinds** may begin as a trickle, but morph into a cascade. Those who try to hold on will likely confront a shrinking Fed balance sheet in 2016. Investors should do their own homework to understand what this is likely to mean for risk assets (Hint: it's not a good result).

Part Six, Portfolio Adjustment Recommendations During Policy Pivot (with a few forecasts thrown in)

- Raise **cash** levels. Cash has great optionality enables it to be deployed at better levels. With rates so low, cash has never had such a low opportunity cost.
- Increase portfolio **liquidity**, while reducing portfolio volatility.
- Buy long-dated on-the-run **Treasury securities,** or the highest quality and most liquid corporate bonds. I expect an abrupt 'risk-off' trade as the Fed begins 'normalization' that will bring UST 10's and 30's well thru 2% and 2.75%, respectively. I can envision this happening prior to the September FOMC meeting.
  - If the Fed **hikes** it will likely help the long end.
  - If the global economy **sputters** due to China or due to other factors that force the Fed to remain on hold, then long Treasuries will again perform well.
  - If the Fed loses its window of opportunity to hike due to worsening financial and economic conditions then it has few **tools** left to provide further stimulus. Moreover, markets might begin to question the effectiveness of past actions and not believe future ones. In such, cries of "more Fed" which have benefited financial assets over the past few years would no longer help risk assets.
- Own US Treasuries **versus European debt**.
- Investors should **decrease trades** that try to play the Fed subsidy too aggressively even in a world of 'gradual'.
- Take down equity beta and hidden betas. **Hedge**, buy puts, sell calls, and buy tail risk on equity exposures.
- Set up for a long term structural bull market in the US Dollar.
  - As mentioned, slowing demand for industrial commodities from China is putting significant pressure on the budgets of emerging market countries and commodity exporters. Some of these countries may be incentivized to boost revenues by selling more at discounted prices. EM currencies have been leaking

lower all year and have **room to fall** to levels not seen since the early part of this century. (Own USD: EM = lower still, EUR<100, $/CAD>1.40, AUD<.6500)

- **Commodities** are over-sold, but have been struggling to have any bounce at all. This week the CRB commodity index fell below its 2009 low, sinking to a level last seen in 2003. In many areas, supply continues to surpass any increases in demand. Oil risks testing the $40 support level. Other industrial commodities risk falling to multi-decade lows. (Supply destruction takes time, and demand is slow to pick up).
- Investor outperformance in the next year will likely come from **defensive strategies** and reversing to risk under-weights with an emphasis on liquidity and reducing portfolio volatility.
- "Actions speak louder than words, but not nearly as often" – Mark Twain

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