Global Monetary Viewpoint

Tuesday, June 09, 2020
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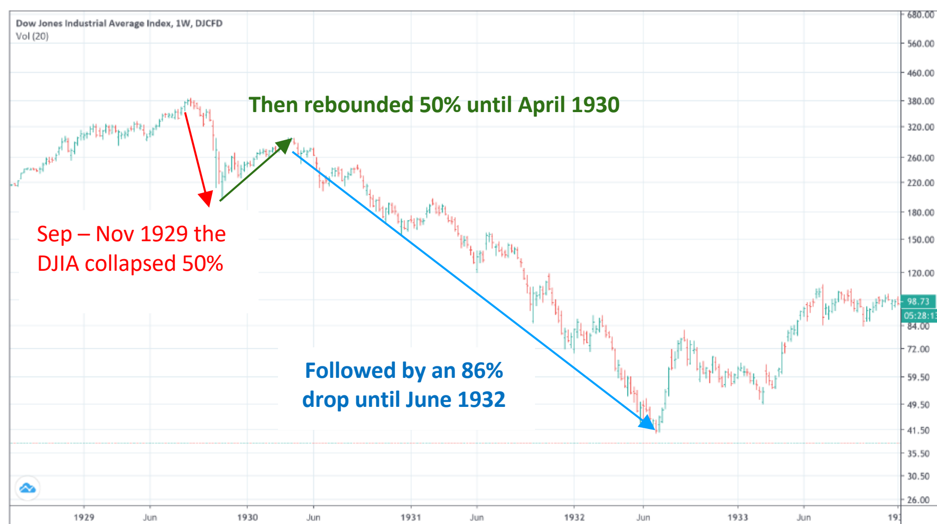
BEWARE OF MARKETS PRICING FED AND ECB LOANS AS GIFTS

The Fed’s power to control long-term rates and the price of credit exists only in the market’s state of mind. And the manna now falling on Italy in the form of the Macron-Merkel “Marshall Plan” and mega-purchases of Italian government debt by the ECB similarly are mostly a figment of market imagination.

Yet no one should doubt the role of narratives about gifts bestowed by central banks in bringing about a spectacular rebound in the US equity market from a crash during deep economic contraction. This rebound may yet go down in history as even greater than the bear market rally of November 1929 to April 1930.

Dow Jones Industrial Average: 1929 – 1933



Source: Trading View

History, of course, does not repeat itself. A key difference between now and early 1930 is the new powerful epicentre of asset inflation which has formed in “pandemic stocks”. These include companies whose immediate profit prospects are buoyed by the pandemic (for example cloud computing, online delivery, pharmaceuticals), and also companies whose post-pandemic prospects improve ostensibly due to enhanced monopoly power (as many competitors have become financially crippled). The nearest analogy to the present pandemic stock boom is the war stock boom during the period of US neutrality in World War One.

Even so, we should not dismiss the December 1929 to April 1930 ‘bear market rally’ as a cautionary tale suited to the present confluence of two strong currents. The supply shock of the COVID 19 pandemic did almost burst the asset inflation boom of 2016-19/20. It remains to be seen whether the massive fiscal

Executive Summary

A key element in the present “risk-on” boom in global financial markets – whether in credit, equity or currency markets - is the narrative that central banks, led by the Fed, are now manipulating down long-term interest rates and credit spreads, and that this manipulation can be effective into the long-run.

According to a prevailing view, vast loan programs joined with asset purchase programs are akin to gift programs, whether concerning US corporates, or the Italian State and banks.

In reality, central banks do not have the power to exercise sustained control over long-term rates. And their gift-giving and credit powers are also illusory. These illusions, however, can be powerful drivers of markets as at present.

The challenge for investors is how to navigate between the enjoyment of revived asset inflation with all its illusions, as extended by recent central bank actions, yet not become the victim of as large or even more significant bear market rally as from November 1929 to April 1930. Read on!

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and monetary interventions led by the Fed will prevent that burst from re-asserting itself and causing stalls in the economic pick-up from the collapse of Spring 2020. In the interim, asset inflation is flaring up again, and a robust pick-up of private consumption from hugely depressed levels is now occurring in the short run as a wave of infection has given way to a truce or lull. Full economic expansion would require a strong upturn in business investment – nowhere as yet evident.

Rational investors would be positioned so as not to suffer a huge loss in the event that Spring 1930 revisits us.

Arthur Miller wrote that "the market represents nothing but a state of mind; if it is Monday, but enough people in the marketplace say it is Tuesday, then it is Tuesday". Yes and No. Yes, in the sense that this "levitation from reality" can occur over substantial periods. But no, in the sense that reality ultimately makes itself felt.

Well, there is little doubt about the current market state of mind concerning long-term US interest rates and the price of high-yield credit. The Fed has it all under control. Long term rates will remain very low far into the future, even though there will be some anaemic responses to signals of cyclical expansion or inflation. The massive corporate debt purchases which the Fed is preparing to make will be rolled over, and rolled over forever, including interest income on these, meaning that they are gift-like rather than merely a temporary passive participation (of the Fed) in credit funds for liquidity generation.

If that is so, then the sky is the limit for US equities. After all, if credit risk has been extinguished, and long-term interest rates are in substantial negative territory in real terms forever, then where else is there to go? The equity salespeople (including their in-house analysts) tell us that by early 2021 the clock will have turned back to January 2020 – the pandemic will be over (vaccinations arrived or societal fear of disease largely subdued and well within rational bounds) and S&P 500 earnings back on track. Still, it will be even better because rates and credit costs will remain low.

It is never appropriate to dismiss the possibility of a miracle. But neither should we trivialise miracle and make it into our central scenario. These equity market analysts are not just telling tales of a miracle. They also expunge any mention of huge cumulated mal-investment through the prolonged monetary inflation of the last decade and beyond; think about shale oil and gas; international supply chains; commercial real estate; aircraft and auto sectors, export sectors in Europe, emerging market economies, and perhaps most of all, digitalisation.

The Fed's power to fix long-term rates: illusions and delusions

The fundamental determinants of long-term rates – or more specifically far forward interest rates in the term structure of rates – are inflation expectations and assessments of real interest rates in the long run.

Confidence in judgements about either factor far into the future should be low. As regards inflation, yes, we have the 2 per cent inflation target. But this is an emperor's new clothes story. Our contemporary dysfunctional monetary system is unanchored. A firm anchor depends on there being a monetary base consisting of highly distinct instruments for which there is no close substitute and for which there is a stable demand, not highly sensitive to small changes in interest rates or interest rate spreads. Moreover, the supply of this monetary

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base must be determined by a set of automatic rules which overall mean a low average growth rate over the long run.

US 5-year, 5-year forward rate (2008 – present)

Source: Trading View

Achieving the target relies on much inertia of expectations and luck with applying a powerful computer to churn through econometrics to guide the central bank in fixing interest rates. As to real interest rates – yes there are fashionable hypotheses out there, including secular stagnation (a thesis about permanently diminished investment opportunity) – which seem to back the idea of these being at zero or negative levels – but there is also much contrary opinion to those looking for it.

The investor who had strong views about possible high inflation and a stark rise in equilibrium real interest rates in the years which follow this pandemic would not be inclined to take on a huge speculative bet against the market's present state of mind (low or no inflation and low or negative real interest rates continuing). For he or she would not just be up against divergent views, but also up against a conviction in the marketplace that central bankers do indeed have some considerable power to determine long-term rates.

Some of this power may depend on an irrational mental process, which psychologists describe as anchoring.

In this context, investors latch on to the most prominent near number as a starting point to form their opinion. So, if the official short-term interest rate is at 0.5 per cent, then that is the starting point for developing a view as regards interest rates far out into the future, though its relevance may be small or non-existent. Central bankers in the post-gold standard world have always depended to an extent on this anchoring effect in increasing the power of their interest rate manipulation to affect the economy. This power was least under monetarism (where in principle short-term interest rates were highly variable) but has been much more significant under the 2 per cent inflation standard.

As a starting point, we should realise that Fed buying of say $4 trillion of US treasuries over a period of one year (a common estimate of QE program), when the total Federal debt next year could be 130 per cent of GDP (say $27 trillion) does not amount to price fixing power. The stock of debt outside the Fed, especially if we take account of the total universe of investment-grade corporate and non-US sovereign debt and swaps, is many times larger than that flow. The

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dominant factor determining the price of long-term bonds is investor 'state of expectations' (regarding inflation, real interest rates).

Robust US growth together with a dramatic post-pandemic shrinkage of savings surplus could fuel a discontinuous shift in the state of expectations.

The present situation of a substantial private sector savings surplus in the US (and abroad), with consumer spending reined back by physical constraints, capital spending very depressed by uncertainty about the future and present financial constraints, and huge transfer payments from the government to individuals, is abnormal. These huge savings are flowing into equally unusual and colossal public sector deficits.

It is possible though that in a strong growth environment, markets could at some point question the prevailing doctrines of secular stagnation and permanently low equilibrium real interest rates. Quite the opposite, the post-pandemic era could be one of capital shortage.

Households, with wealth holdings swollen by high savings during the pandemic and including now even more disproportionately high amounts of government debt, might step up their spending on consumption or indirectly on investment (via equities or direct construction). In the business sector, with so much of the accumulated investment now economically obsolescent – reflecting widespread mal-investment during the past decade and beyond – a shortage of capital could go along with abnormally high returns on new investment. In turn, a capital spending boom could get underway.

Yes, under these circumstances, the Federal Reserve could continue pegging short-term rates at zero. But investors considering the price of long-maturity bonds might start to question whether those short-term rates are indeed tenable or a yardstick for where rates will be in the future.

Is it too early for investors in long-maturity US bonds to start worrying about all of this?

The short answer is no.

Occasionally the feared longer-term future could short-circuit into the present.

If we are to believe the commentators, the strength of the US equity market today reflects in part confidence that earnings and profits will be back to pre-pandemic levels in aggregate two years from now. That may be an abnormally long perspective for a highly speculative market, but it sometimes becomes part of the narrative, and so it could also become the case with bonds.

Another critical element in US equity market strength is the view that the Fed and Treasury are bestowing tremendous gifts on the corporate sector via their "credit support" operations, greater even than the hand-outs of the Republican/Trump Administration business tax cuts of 2018.

Irrational Exuberance about Fed-Treasury Credit Support Program

Back to our central theme: in markets, if it is Monday, but enough people say it is Tuesday, then it is Tuesday.

Let's consider this within the context of the "dramatic" intervention of the Powell Fed and Mnuchin Treasury in the US credit market – setting up multiple programs to buy credit paper, including junk. Leaving to one side the whole topic of how this fits in with crony capitalism, the question here is whether in reality,

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the Fed has the power to fix the price of credit - and more than that, bestow massive gifts on selected areas of the corporate sector - and if not, when does that reality pierce through the present market myth?

The answer here is that the Fed does not fundamentally have the power to fix the price of credit. It may seem to possess that power for some periods, enabled by a market where the "state of mind" is that the Fed can indeed do so. But there is an inherent danger of reality piercing through at some point that the power does not exist. The grounds for this conclusion are:

First, note that the amount of credit guarantees extended by the Treasury for credit paper, which is eligible for purchase by the Fed, is at most $500bn (as in the CARES Act). This amount is a tiny fraction of the total credit universe in the US and even smaller of the global credit market space.

Second, the price of credit is not determined in isolation, but in general equilibrium alongside a whole range of other asset markets, some of which are closely arbitraged with credit. For example, high-yield US credit is arbitraged with the US equity market (via put and call strategies); if the Fed were successful in pushing up the price of US credit paper, this could set off diluting arbitrage flows with the equity market, which would tend to undermine it. These flows are stalled if (as now) the equity market also believes it is Tuesday even though it is Monday (meaning that the equity markets are pricing in a narrative that somehow the Fed has lowered the cost of credit for the long-run and made bankruptcy risk disappear in much of the US corporate landscape.)

Third, investors in appraising the price of US corporate credit paper consider a range of fundamental factors – primarily focused on the market value of the firm (aggregating all types of securities), the leverage ratio, the volatility of market value across a broad number of scenarios, and so forth. The fact that the Fed enters the market ostensibly as a price taker should not change this fundamental appraisal.

Fourth, the Fed is not in the position to roll-over credit to all borrowers under its various programs at low preferential terms irrespective of fluctuations in its solvency risk. These programs have limits, albeit the wind-down could be very gradual over time. In the interim, if there are bankruptcies, the Fed will be there alongside other creditors fully insisting on the best recovery terms. Other credits should not assume that the Fed will bow out gracefully and allow non-official creditors to ignore its legal claims.

ARE ECB LOANS TO ITALY GIFTS?

ECB loans to Italy, whether through its backdoor (loans to the Italian banking system) or its front door (asset purchase program) are different in nature from Fed loans to the US corporate sector. The ECB is in effect issuing deposits with itself in euro denomination and transferring the money to Italian sovereign and bank debtors; the Italian banks get the funds at zero or negative cost in line with the cost of funding to the ECB. Markets are likely assuming that the ECB will always be rolling over its investment together with interest in these debts (including Italian government bonds bought in the QE operations). There is no parallel in sovereign bankruptcy to the creditors obtaining a share of the underlying enterprise (in this case equity shares in Italy Inc.).

Even so, holders of Italian government debt outside the ECB (and the Italian banks) should consider the future debt servicing load including that amount of

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debt held within the ECB. In particular, if and when interest rates start to rise in the euro-zone, the ECB, along with other creditors, on roll-over would demand higher rates to be paid by Italy, but these could be beyond its means. Losses on non-performing loans to Italy in the ECB balance sheet would have to be made good by further transfers in from its stronger member countries.

There is a political constraint on this process. Moreover, in any eventual debt rescheduling plan for the Italian government and Italian banks, the ECB might not be prepared to share in the haircuts that other lenders accept, meaning that the latter have to take even more significant write-offs.

Vast and growing loans from the ECB to weak sovereigns and banks increase the ultimate inflation danger in the euro-zone. Debasement of the currency is a way in which that institution can reduce the relative amount of its liabilities in line with a cut in the real value of the weak loans on the credit side of its balance sheet.

Bottom Line

In today's market-place – whether for long-term US fixed-rate, US credit, equities, and indeed currencies – it is Tuesday, because enough people are saying it is Tuesday, even though it is Monday. That is a highly dangerous situation, as reality will pierce through at some point. Critical here, in the near-term, are likely to be sudden runs in the credit market-driven either by credit events or a reversal of huge speculative momentum trading, always a feature of asset inflation. Less plausible, notwithstanding the 10bp rise in 10-year T-bond yields in response to the most recent employment report, is any sudden large rise in long-term rates.

In reality, the Fed does not have the power to fix the long-term interest rate (though the market's illusion that it has the power means that it can indeed be successful in its manipulation for some time); Is it not dangerous though to 'fight the fed' and shouldn't one 'keep dancing whilst intending to exit the hall just before the music stops'?

Unfortunately, there is no alternative to fighting the Fed if investors wish to avoid being on the wrong side of history when extensive asset inflations and the sometimes strong bear rallies which follow them burst; but that does not mean abstaining from all participation in the asset inflation over long periods of time.

The Fed does not ultimately have the power to fix the price of US credit paper. But in the marketplace, the widespread delusion that the Fed has that power can contribute to it having the semblance of that power for considerable periods. Again, the challenge for investors is how to share in the pleasures of asset inflation without also sharing in the catastrophic losses which follow, when the delusions become reality. At present, the high speculative temperatures in the pandemic stock boom together with accompanying narratives about tremendous gifts bestowed by the central banks should make investors especially cautious about chasing "risk-on" trades.

In currency markets, the euro has been gaining from the market's illusion that the Macron-Merkel deal has produced a backstop for Italian government debt. On top, around 200bn of Italian government bonds might eventually be purchased by the ECB under the COVID emergency asset purchase program, as dramatically expanded last Thursday. First, a point of arithmetic. The Macron-Merkel fund will produce 100-150bn euros of aid for Italy, of which maybe half

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will directly contribute to Italy's budget (alongside there will be aid into Spain, Greece and Belgium, whilst France will gift itself out of its contributions to the new European fund).

Expectations that this is the start of the road to a federalisation of European sovereign debt is pie in the sky. The frugal four may go along with this, having made sure that they get some gifts from the funds themselves (as will France), but a second Marshall plan is surely highly improbable. Yes, Merkel's CDU party is now riding high in German political opinion polls. The Chancellor has apparently gained from public approval of her "handling of the pandemic"; but much can change in the year or more ahead to the next Federal Election – and the tremendous ultimate burdens from euro-sharing on the German taxpayer could again become a decisive theme.

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