Ten Seconds Into Darkness. 2015 02.

Equity and bond markets have been behaving well these past few years. Despite a slowdown in returns and a few wobbles towards the year end, 2014 was a fairly good year for investors. The MSCI World Index returned 4.8% while the Barclays Global Bond Index returned 3.8%. Clever positioning would have earned the average investor more, but even fairly obvious positioning would have earned an investor circa 6% without excessive risk or sophistication. With markets this sanguine one would expect the global economy to be good health. There are areas of concern.

Policy

The strength of the US economy relative to the rest of the world is resulting in a divergence in central bank policy. In a post 2008 world where central bank credit creation lacks extension to the private sector, countries are more sensitive to trade competitiveness. It would not go too far to say that the world has been engaged in a trade war since then. Today, the gloves have come off. Central banks no longer have the luxury of considering only the state of their own economies when they formulate policy, they have to take into account the policy decisions of other central banks, the state of other economies, and soon enough, the reaction of other central banks to their own policy decisions. This complicates an already difficult task, that of balancing growth, stable prices and the solvency and funding costs of their sovereigns. Central bank activity in the first 2 months of 2015 has been remarkable. The ECB announced QE, and a rate cut, before that the Swiss National Bank cancelled the cap on the CHF against the EUR and cut rates, the Reserve Bank of Australia, the Reserve Bank of India, the Bank of Canada, the Danmarks Nationalbank, and most recently Sveriges Riksbank, cut interest rates also. China’s PBOC cut bank wide reserve requirements having cut interest rates late last year and Singapore altered the trajectory of its currency policy in an effort to address low inflation. Russia has cut rates by 2% following a rate hike of 6.5%. in December 2014. A significant number of key interest rates and bond yields are now negative. The actions of these central banks are ostensibly to address the risk of deflation, however, currency devaluation is of limited use as currencies are all quoted one in terms of the other and the low inflation phenomenon is this widespread. The US will find itself having to balance the requirements of its domestic economy with the actions of all other central banks. The USD has been strong since mid 2014 and may be driven higher if as expected the Fed hikes rates in the middle of 2015. A strong USD will impair foreign earnings and terms of trade. One consideration the Fed will be making is how important the export sector is to the US. In the past the US ran a large negative trade balance but this has receded with re-shoring and growing energy independence. A more self sufficient US might be able and willing to pivot towards a more insular trade policy. A strong USD may have unexpected consequences. It can steepen emerging market term sovereign term structures and cause interest rates to rise. Non dollar debtors borrowing in dollars could be impacted as well. Some of these are well documented phenomena but there will be other less expected ones.

A more important but apparently less pressing question is how central banks normalize policy once their economy has reached a state of normalcy. Here the US Fed is an excellent case study being the only central bank with a robust economy, and having an acutely inflated balance sheet. Rate hikes may be determined by the strength in the economy, but the side effects have to be considered and tested for, something the Fed has been doing using term deposits and reverse repos since Oct 2014, seeking feedback on the desired level of reserves by the banking system. So far the results have been inconclusive. Then there is the question of when it will begin to actually shrink its balance sheet. This is the bigger question which will likely come to the front at some point.

Debt

Following the crisis of 2008, much debt was transformed and or transferred to more stable holding vehicles such as rescue funds, central bank or state balance sheets shielding them from price discovery. At the same time, massive bail outs and central bank money printing have depressed borrowing costs. While one sector deleverages, another leverages up. As one country deleverages, another leverages up. Generally, developed world economies have increased already high levels of leverage. Developing economies are catching up, albeit from much lower levels. The charts below illustrate debt levels, which are already high, but exclude unfunded liabilities such as pensions and health insurance. In developed economies, such unfunded liabilities can add a multiple or two of GDP to the already high levels of total debt. A population does not merely borrow from others, it primarily borrows from its own future; debt is an inter-temporal transfer. It is essential that the future productivity of the population is sufficiently high to repay its obligations. As it is, government debt looks like PIK debt, paid off either with new debt or with the proceeds of new debt. Only sufficient economic growth can, with time, reduce the debt burden.

Demographics

Economic growth is dependent on demographics, among other things. The rich world is generally an ageing one and the developing world, a young one. That the developed economies are the most leveraged is not encouraging. A high debt burden required economic growth, but economic growth is dependent on the steady growth of the labour force or its productivity. Japan is an example where an ageing population is resulting in slower growth and falling tax receipts. The government’s approach to spurring growth is to spend and borrow, a strategy that requires that the spending spurs more growth than it does accumulate debt. Otherwise, the stock of debt will only grow. With deflation as well, the real value of the stock of debt also grows.

Distribution Of Wealth

One of the surest and most topical trends has been the distribution of wealth. Inequality between countries has ebbed as poor countries caught up to advanced economies while inequality has risen within countries. This is in part a consequence of globalization where inter country wealth would be expected to converge while in-country inequality is boosted by capital and labour mobility. The efforts of central banks to boost economic growth by QE has created asset price inflation leading to the enrichment of asset owners, generally the more well to do. The fortunes of workers has lagged. Simultaneously, labor's share of output has fallen steadily and certainly accelerated downwards in the recent decade or so. This is not a universal phenomenon but certainly holds true for the major economies and globally in aggregate. Income inequality dulls fiscal and monetary policy, skews labour supply, and influences politics. Acute imbalances in the distribution of wealth and the share of profits can only trend so far before they threaten the social compact and the status quo. At that point, the capitalist and democratic ideology may be challenged and fundamental regime change could occur.

In closing:

These are selected long term fundamental issues that lay in front of us. Some of these issues lie further in the future but others are more immediate. It is rational to deal with the immediate issues first, just as it is human to deal with longer term issues later, when they become immediate and have accumulated scale and intractability.

For financial markets the response is, how can one make nominal financial profit in the short to medium term. For individuals, this is a rational response since they lack the ability to individually affect policy to address longer term, collective reform.

Relevant trading and investment strategies, and more importantly, loss avoidance strategies will be covered in the coming weeks.