Ten Seconds Into The Future: Musings From the Barstool. 2015 11

A number of themes frame the global economic and financial outlook.

The world has been operating monetary and fiscal policy towards sustaining growth at a higher level than the unobserved long term trend rate. It may be doing this for a number of reasons. For one, it can't observe the long term trend rate and could therefore simply be mis-targeting. A multi-decade period of credit driven growth may have biased estimates for trend growth to the upside. The dynamics leading to slower trend growth are slow moving and may have been overlooked. Demographics is an important factor in productivity and thus trend growth. Secondly, policy makers might recognize this mis-targeting but for other reasons, such as the servicing and paying down of an over accumulation of debt, ignore it and attempt to target growth above the long term trend rate. Whatever the reasons, this chronic mis-targeting of trend growth leads to markets mis-reading cyclical wavelengths, amplitudes and phases, and in a dynamic system such as economic and financial systems, a more pronounced cycle.

Demographics are a slow moving phenomenon. In the developed world we already have deteriorating demographics which possibly contribute to deflationary pressures on the one hand, and labour market mismatches on the other, which are inflationary. The implications for the net funding of social welfare and healthcare are also profound. In the emerging markets, once favourable demographics have now been eroded. China, for example, a heavyweight in the emerging markets, faces challenging demographic trends exacerbated by an unwise one child policy; this has now, too late, been relaxed. India appears to be the only large emerging market with favorable demographics, but even India will pass into an ageing demographic as its economy matures. Economists recommend immigration as a solution to ageing populations but such redistributions of human capital have limits in aggregate and costs to donor countries.

The shock from the 2008 financial crisis was larger than thought and ripple effects persist today. One of those effects is the initiation of a global trade war. Within this context the US has sought less reliance on external production capacity and energy supply. This new insularity has profound effects on global economics and politics. One of the primary reactions has been China seeking less reliance on US and other foreign consumer demand. This rebalancing away from exports and investment towards consumption has exposed a significant overshoot in capacity as well as resulted in slower aggregate growth as the large industrial and manufacturing sectors are de-emphasized and the economy turns towards services, retail and consumers. A consequence of the new dynamic between the US and China is that countries in the supply chain have had their business models invalidated. Many of these countries are in emerging markets.

The trade war has taken a toll on global growth. It is responsible for some of the loss in the long term potential growth rate. It is also responsible for the sharp slowdown in emerging markets which rely more heavily on trade for growth. The trade war model has some important implications for inflation expectations. Currently, markets are pricing for weak inflation to deflation. If, trend growth is lower than expected then output gaps are narrower than expected and inflation could be closer around the corner than the market predicts. If so, central bank policy could turn quite quickly when the first signs of inflation appear.

Since the financial crisis of 2008, banks have come under intense scrutiny and regulation. Once run entirely for profit, the public good supplied by banks as part of the credit and payments infrastructure was highlighted when some were deemed too big to fail. Banks are now regulated as essential utilities while remaining staffed by pathological capitalists. Governments and regulators on the other hand, have struggled to develop a coherent strategy for regulating banks, simultaneously requiring them to make more loans and take less risk. As the principal constituents of fractional reserve banking, banks thus heavily regulated have become less efficient in their function, albeit safer. The burden for funding economic growth must therefore fall upon the Shadow Banking system. Bond markets have grown in developed and emerging markets to serve the function of connecting savings to investment. One important aspect of facilitation, market making, has become impaired. New capital rules and principal agency separation legislation has led to much reduced market making activity by primary dealer banks and thus reduced liquidity, a development decried by the investing community. Inefficiencies in bank regulation have interfered with the credit transmission mechanism and blunted the effect of QE on the real economy. Rules relevant to structured finance have similarly throttled a once important credit transmission channel.

- Banks deleveraging. Capital securities are derisking.
- Bank disintermediation returns to rise. Direct lending, private debt, peer to peer lending, trade finance.

The past 7 years have been defined by extraordinary central bank intervention and influence in financial markets. Financial engineers are excellent at two things, innovation and over-extending. Low interest rates and QE have driven markets and to a lesser extent economic growth in this period. One, there exists diminishing marginal returns to QE in terms of impact on financial markets, and on real output. Two, the US Fed is about to move from easy to neutral and is headed for its first rate hike since the financial crisis. The ECB was late to implement QE and the impact on prices remains to be seen, thus far Europe has experienced a cyclical upturn in growth but inflation has lagged. The BoJ has maintained QE even as data has suggested they might have to expand further. China's debt overhang and large scale restructuring of its economy has a cost and the PBOC will need to maintain easy financial conditions. Thus far they have not been buying assets but they have been serially cutting rates and reserve requirements and been very active in open market liquidity operations which have been more targeted and highly expansionary. In all this, the Fed's divergence from the pack is interesting and will have profound impact on markets.

<u>Central bank policy will have as much influence at the inflexion point as it did in expansion</u>. The Fed's rate policy is therefore important. For one, other central banks will await the Fed before making their own moves. In the face of a rate hike, the ECB for example, might be encouraged to ease more aggressively as global liquidity shrinks and financial conditions tighten. The ECB meets Dec 3, two weeks before the FOMC on Dec 16. Draghi has been vocal and signaling further accommodation. There may be a full blown expansion of QE or there may be adjustments to the current program. One area which merits adjustment is the allocation between countries. Currently, the national central banks and the ECB purchase bonds pro rata to their capital key, that is the respective national capital contributions to the ECB. This results in more capital dedicated to the purchase of German and French bonds and less to the fragile periphery for which QE is more essential. The ECB could change the composition of the bond buying to increase the proportion of

Italian, Spanish and Portuguese bonds relative to the capital key.

- EUR duration to outperform USD duration.
- Peripheral EUR to outperform Bunds.

The BoJ has been unusually confident despite recent weaker inflation and growth data and may be waiting on the Fed to act. It too may accelerate or increase QE post a Fed rate hike. There are some who argue that core inflation has begun to recover in Europe and Japan and their central banks may stand on a Fed rate hike. However, a widening rate differential could encourage capital outflows and tighten financial conditions outside the US. It is difficult to be confident about the likely behavior of the BoJ and thus the JPY term structure.

- USD strength, EUR, JPY weakness.

While the Fed may raise rates, and the rate hike trajectory is signaled to be gentle, the Fed clearly wants the yield curve to not steepen significantly. The Fed has talked about reducing the size of its balance sheet, and has mentioned a time frame of 1 year after rate liftoff. Recent talk, however, has opened the possibility that this could be delayed for much longer. If current financial conditions coupled with a single rate hike slow the economy sufficiently, inflation expectations may even fall and suppress yields at the long end.

- USD 2-30 flattener or outright long 30 Y UST.

Investors have been concerned about the impact of higher rates and a stronger USD on emerging markets for some time now. The concerns are well known, capital outflows, higher costs of debt, and to some extent, a currency mismatch between assets and liabilities. The last point was a feature of emerging market sovereign balance sheets in the mid to late 1990s and was unwound when the Fed raised rates in 1994. The Asian Crisis of 1997/8 was one of the symptoms. Today, however, on the advice of the IMF and others, sovereign balance sheets feature a better currency match between assets and liabilities. Emerging market corporates, however, have increased USD borrowing significantly in the past few years although the last 12 months has seen market volatility and self-regulation unwind some of this currency mismatch. Chinese developers, for example, are calling USD bonds and refinancing in RMB. Emerging markets are likely to be better prepared for a strong USD and rising rates than before. Moreover, the Fed has signaled that the trajectory of rates is likely to be gentle, and the strong USD is already an 18 month old phenomenon.

- EM short trade fading. Consensus it likely too bearish EM equities.

The most sentiment driven markets are equities and the bulk of the returns in the last 5 years have come from a rerating, Corporate earnings have been less robust in quantity and quality as companies have boosted earnings from cost cutting, financial engineering in the form of recaps or debt funded share buybacks. 2016 earnings estimates have been scaled back in the last quarter with Europe leading the discounting with 6%, Asia ex Japan and China with some 4% and the US and Japan with 1.5%. With a neutral Fed and equity valuations at or above long term trend multiples, the scope for further gains is diminished. Look at 2015 returns, the best performing markets have been Europe, China and Japan, the more problematic economies where central banks have been in no hurry to tighten. Stronger economies such as the US and UK have performed poorly as stronger economic data have led to expectations that the Fed and the BoE would tighten. Liquidity still rules equity markets.

- Consensus is currently too optimistic about potential returns from European equities.
- European equities yet to fully price EM weakness, thus vulnerable.
- Consensus is currently cautious US equities and is likely to be proved right.

While liquidity rules equity markets, that influence will likely diminish in the US. In Europe, liquidity may limit the disappointment in equities and in China, expect the market to trade in a tight band for some time until the newly reopened IPO market has been cleared.

Credit markets have only recently found retail participation through mutual funds. While this newfound liquidity channel will add more sentiment driven volatility to the market, credit remains more fundamentally rooted than equity markets. This new found volatility has been a source of frustration as well as opportunity. Normally, credit is priced in an orderly fashion until institutional myopia accumulates a large imbalance and a liquidity crisis is triggered. Retail participation has made credit more volatile at higher frequencies but with smaller gap risk. The market has been concerned about gap risk from another source of reduced liquidity: primary dealer inventory. This is a side effect of bank regulation which discourages principal trading. This logic is flawed. Market makers make market not to provide liquidity, they do so because they believe they have asymmetric information. The current market for credit has institutional investors as the major participant followed by mutual funds and structured finance. Which is preferable, to have large, stable holders who own a significant portion of issues this reducing free float and liquidity, or to have many short term traders seeking to make high frequency profits? In either case, liquidity will be fickle. Credit can be approached from a trading perspective but to do so is to give up the advantages the asset class provides to investors.

Current credit spreads are sufficiently wide to represent value, given general conditions. Slow, positive growth is ideal for credit. In the US, credit from investment grade to high yield has underperformed recently as investors have fretted about a Fed rate hike and fears about fickle liquidity. In US credit, only the non-agency MBS market has generated steady and robust returns. While the robust housing market continues to support non-agency MBS, the opportunity is shrinking due to price discovery and a lack of new production as mortgages lean towards conforming loans which can be securitized by agencies. Agency risk transfer securities are a recent innovation and have not achieved critical market size. Corporate credit, however good value the spreads imply, have a market average duration which renders them sensitive to a rate hike, even if it is just one. Leveraged loans present a very low duration exposure to high yield corporate credit with structural seniority and security. Pricing has been stressed, however, as liquidity fears are more acute in loan markets. Spreads are wider for loans despite their seniority to unsecured bonds.

- If the thesis is that short rates will go up once in the short term and only gradually thereafter, and that the economy will face tighter financial conditions and lower inflation expectations, and thus term structure should flatten, the efficient trade is to be long leveraged loans and long 30Y USTs.

In Europe, the interest rate cycle remains benign and the ECB is likely to maintain if not accelerate QE. At the same time regulators continue to encourage the banks to deleverage. Euro leveraged loan issuers will be encouraged to deleverage by transmission. European corporates in general remain in deleveraging mode. A significant proportion of new issue is coming from non-European issuers. The efficient trade expression is to be long duration and credit.

- Long Euro high yield corporate bonds.

Relying on central bank largesse has been rewarding but when it is coupled with central bank regulation, the trade can be less risky as well. While European banks have been cleaning up their balance sheets since 2012, much remains to be done. The initial action of banks was to seek regulatory capital relief through creative balance sheet operations and accounting. Regulators were reluctant accomplices due to the seriousness of the problem. With greater stability and a cyclical recovery, regulators have become less pliant and are less likely to approve such transactions. The Oct 2014 AQR and subsequent capital raising has made European banks stronger. Also, recapitalized banks have now more latitude in disposing of NPLs as price discovery is less damaging. The consequence of this is the need for further capital raising. Add to this regulators’ tendency to overshoot and new TLAC guidelines and banks will be forced into more deleveraging.

- Continue to buy European bank capital securities.

Risks to the view:

While the Fed vs ECB policy divergence supports a strong USD, the position is perhaps the most crowded in the market today. USD strength was driven by both the Fed and the ECB. Soon, the trade will lose one leg of support, that is the Fed. Once a rate hike is done, the next is likely far off. The USD trade will have to stand on one leg, the accommodative policy of the other central banks, notably the ECB.

- Volatile USD.

Emerging markets. This is complicated reasoning. EM has done poorly because exports have stagnated. The strong USD was guilty by association and received wisdom is that a strong USD is bad for EM. One should question this. While true 20 years ago, sovereign liabilities are now better currency balanced. EM corporates have accumulated substantial USD debt and many will feel a balance sheet impact. However, many EM corporates earn USD and a strong USD has positive impact on cash flow and revenues. The market is currently very bearish on EM equities and bonds and neutral US and optimistic Europe. The EM exposure to European corporate revenues has not been priced. It is likely that 2016 will see EM assets trough and begin a forward looking recovery while Europe begins to price in EM near term or coincident weakness.

- Strong USD may support contrarian long EM
- Weak USD may endanger or delay EM recovery.

As we are reducing our expectations for European equity performance risks to the outlook are if European markets receive an unexpected boost. One possibility is fiscal policy. QE can improve the supply and cost of credit but it cannot improved the demand for credit. European growth has recovered somewhat but it remains tepid. More could be done if governments run fiscal deficits. Policies to deal with the refugee crisis and or defense could be approved as extra-budget items thus skirting austerity policies. While this is a possibility the constraints remain that Europe's current government budgets remain in poor shape with the exception of Germany. France, Italy, Spain, run primary deficits below -3% of GDP, in breach of Maastricht conditions making even extra-budget expenditures difficult to justify.

- Do not be too underweight and certainly do not be net short European equities.

<u>Deflation is very much the consensus view.</u> Headline inflation has clearly been depressed by falling commodity prices, particularly energy and base metals. Some of the impact of commodities leaks indirectly into core inflation. There has not otherwise been a good explanation for the weak core inflation except that final demand, consumer and business sentiment remains weak. If, however, trend growth,

which is not measurable, is indeed slower, then the output gap could be narrower and inflation could rise unexpectedly.

- TIPS may provide a tail hedge to inflation.
- Floating rate debt instruments can provide an inflation hedge.
- Gold’s usefulness as an inflation hedge is questionable but at for those pathologically inclined to gold there may be some rational justification for holding some of it.