

Being Too Bearish? The Next Bubble.

I've not taken my own advice lately and have been too bearish on risk assets. Entirely my fault for ascribing more weight to fundamentals than I normally do. Slow growth doesn't mean no growth and while I did expect a US manufacturing and export led recovery in mid 2011 and a slowdown in early 2012 I did not expect US housing to be as resilient as it has been. That's misreading the shorter term cycle and dynamics and the power of the Fed and QE3 whose focus has brought down mortgage rates and financing costs. The timing of QE3 to coincide in an upturn in housing was also unexpectedly adroit of the Fed.

China as well, where I was extremely bearish in the past two years has seen some incipient signs of bottoming. My view here is still tempered by the substantial risk China runs in its shadow banking industry which is as yet unresolved. The SIV like nature of a large swathe of the Chinese financial system makes it just as fragile as an SIV (basically an off balance sheet, unregulated bank.) Otherwise China's economy is indeed becoming a more consumption led one, if nothing else because infrastructure led growth has hit its funding limitations as well as point of diminishing marginal returns, and exporting is of limited purchase when your trading partners are all slightly broke. Consumption now accounts for just over half of China's GDP, surely a positive sign.

The ECB's unlimited bond purchase pledge, the various bailout packages tabled between the Club Med and the Western Club Fiscal Rectitude have reduced the risk of Euro disintegration, at least for now. No one expects the Democrats and Republicans to engage in mutual annihilation and thus expect some sort of rational resolution to the so-called Fiscal Cliff. In fact the markets seem to be unwinding from some of the pessimism accumulated in the earlier part of the year.

China's leadership transition appears to have taken place smoothly although we will only understand the dynamics of the new government better as they begin to govern over the next year or so. Nothing alarming or controversial has emerged. That the local A share market has shrugged off this development and continued to fall is an artifact of the investors more than the fundamentals of the underlying companies.

Has the world recovered? From what exactly has it recovered? What can we expect for next year?
Is the world still Broken?

If equity markets were a barometer for whether the world was broken or not, the answer might be a resounding 'no'. But equity markets are a barometer for popular opinion and the psychology, and debt markets or indeed any market for securities bearing income must be a barometer for abnormal psychology, so acute has become the thirst for yield from any source from bonds to equities to sale of options.

If to governments have done one thing well it has been to manage so poorly that expectations became sufficiently low that any sort of reprieve or improvement, however infinitesimal, would be greeted with a cheer. While government balance sheets are still stretched and cash flows still unsustainable, sufficient rhetoric if not progress has been made to placate the markets. A perverse reaction to any sort of bad news keeps the treasury market sufficiently supported that the Fed no longer has to buy US treasuries since private investors are buying them anyway. The same can be said of Bunds and Gilts.

The pursuit of yield particularly in the sub investment grade sector is interesting since by underwriting most refinancings, investors are helping to delay defaults.

Equities are being supported particularly in that class of companies who continue to pay a good clip of dividends. Equity income funds sprang to life to capture this new theme. D

So no more broken world?

Interest rates will be forever low since any significant rise in interest rates might impoverish whole layers of society, whole groups of countries, a substantial swathe of companies and buy to let real estate investors (institutions included.) There is no way any central bank could tolerate higher interest rates from a systemic risk perspective. Even Emerging Market central banks realize that their housing markets might do a Spain or an Ireland.

Inflation is already high but its not been sufficiently acute to merit real concern. Poorer nations suffer more from inflation but no country in he world really has the power to address it. In a sufficiently open economy it matters less who operates QE, the liquidity flows along

the path of least resistance.

High levels of public debt. The pledge to print unlimited amounts of money is an equivalent pledge to monetize and refinance unlimited amounts of maturing debt thus ensuring the liquidity (though not the solvency) of public balance sheets. This can theoretically carry on as long as inflation does not accelerate.

Equities are cheap relative to cash, government bonds, corporate bonds and even high yield. One might be surprised why equities haven't done even better this year. Yet so much of equity valuations hinge on interest rates to support both multiples as well as yield gaps. One consequence of the concerted efforts of government to compress yields is cheap equity valuations. But it also creates correlation and even more; dependence between asset classes.

Investors it would appear would be well advised to be well invested in risk assets. But what about the unresolved problems? The concerns which many market observers have are focused on the excessive debt levels that remain in the financial system, the solvency of sovereigns, unconventional monetary and fiscal policy which some might argue was borderline fraudulent or disingenuous at best, the risk of runaway inflation. The current strategy of governments and regulators has been to delay resolution in the hope that time, economic growth and inflation will gradually bring relief. The risks to the current status quo therefore are a pick up in inflation or a crisis of sovereign debt which in either case leads to a bond selloff and a rise in interest rates, the one unifying force supporting asset markets and economies, which would cause a selloff in most risk assets from equities to real estate, commodities, high yield and just about anything reliant on cheap funding or low discount rates.

Of course this point might never come but I should point out that crises hit not because people don't see them coming but because people are unprepared when they happen. I've seen first hand the years preceding the Asian crisis of 1997 when professional investors fretted about the funding imbalances of Asian corporates and governments. Most of these professional investors stayed invested until the crisis hit, then sought to exit, some with success, some not. Likewise the Dotcom bust was not unforeseen by professional investors. Some decided to exit early, some late. The crisis of 2008 was telegraphed to the fixed income markets as early as 2006, and yet again intelligent investors were split evenly between those who got out early and those who got out late. If you are the sort who likes to get out late you need to trade highly liquid instruments, not use excessive leverage and be able to manage your own emotions. Those who exit early usually gripe about their own poor timing but should resist the temptation to capitulate and re-enter the fray.

There is a bubble in fixed income as clear as day. Here is how all these stories begin. One: someone gets the ball rolling. The crisis of 2008 prompted a flight to safety and the risk free asset at the time was sovereign bonds, in particular US treasuries. Two: a non-economic buyer emerges whose purchasing power is overwhelming. This would be the US Federal Reserve expanding its balance sheet as part of QE or quantitative easing. Three: regulation encourages and reinforces the trend. Increased banking regulation, capital requirements and the risk weighting treatment of assets under the Basel 3 framework encourage private commercial banks to buy sovereign bonds. (They consume little to no capital under Basel 3 unless they happen to be Greek, Spanish or Italian.) All this sovereign bond buying leads to a shift of the entire yield curve to lower rates at all maturities. What does this do to all fixed income securities? It reprices them upwards. Corporate bonds rally across investment grade to high yield, so do asset backed securities, perps, real estate REITS and physical, anything that pays a fixed coupon. Floating rate securities do not benefit from this dynamic. Four: investors see a rising trend developing in these fixed income securities and dive in driving prices even higher and yields even lower. Five: yield addiction drives investors to be less judicious in obtaining yield and product providers to be more inventive in providing yield. One alarming sign is that the return on assets in fixed income has shrunk so much that to maintain a decent return on equity investors need to apply increasing levels of leverage.

Bubbles can take a long time to burst. There is a bubble in fixed income. The question is, do you have the flexibility and nimbleness to sidestep the bursting of this bubble or not? If you do, then by all means, lever up your bond portfolio. If not, look for alternatives that are not too linked to interest rates. They are not so easy to find.