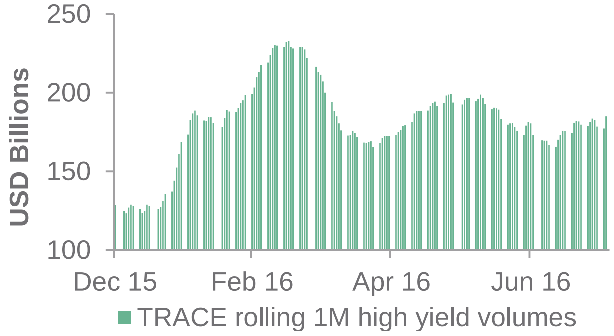
Income & Fixed Interest Newsletter

Vimal Gor

Nothing to see here, move along; the risk-on move since the Brexit vote has been nothing short of outstanding. The VIX fell from 25.8 on Brexit day to 11.9 at the end of July, a 54% drop and the largest 1m change since 2003, similar moves were seen in FX and rates vols. Anyone buying volatility into event risk has been well and truly served as vols drop much faster than they go up, and realised vols are tiny relative to implied. The goldilocks scenario has been fully embraced and it's difficult to try to fade it, in any size or with any conviction.

Emerging markets are the flavour of the month and inflows into high yield and low-grade bonds are at record highs. Bonds yields are low which supports infinite equity valuations and earnings are beating as the economic surprise index pushes to new highs. What's not to like? Nothing at all. The music is playing loud and you'd be a fool not to dance. As most of you will know these aren't my kind of markets, I leave the carry trade for other people to run, we are running core longs in the front-ends on the assumption of ever easier central banks and have increased our long vol tail insurance, apart from that I've got a pretty relative-value and tactical book. It was a quiet month on the portfolios with most returns close to benchmark, apart from the BT Wholesale Monthly Income Plus Fund which had a very strong month.

Chart 1: Selling like hotcakes



Source: Bloomberg

You take the blue pill—the story ends, you take the red pill—you stay in Wonderland

In this newsletter I wanted to go out on a tangent and address something that has been bothering us on the BTIM I&FI desk for a while now, it links to a comment that the famous/infamous Elon Musk made recently that it's likely that we are all living in a computer simulation. Love him (as a serial big thinker and planet changing demigod) or hate him (as a subsidy grabbing fraud) you have to admit the idea holds appeal. I often think the same about our financial system as it feels like we are living in the matrix; everyone tells me the world I live in and the markets I position in are capitalist and democratic, but then why does it feel so much like a dictatorship where unelected people control everything? For fear of being labelled, a 'zerohedge' nutter or freak, in this newsletter I want to look at the role central banks play and ask are they really democratic?

The setting of short-term interest rates has traditionally been the job of the central bank. Once an overnight rate or refinancing rate is set by the bank, its ability to print money to defend that rate gives it the ultimate power. This power is given to unelected officials who are usually academics and try to fulfil the mandate of the central bank through setting these all-important short-term rates. The mandate is usually a mix of inflation, growth or employment and it is left to the expertise of the governor or board to decide what rates need to be to meet their objectives.

For some reason, however, the central bank is also seen as the beacon of capitalism. We struggle to see what is capitalist about having a bunch of unelected people sit around a table every 4 to 6 weeks and decide what's best for everyone else, either in their country or increasingly the world. While monetary policy was important pre GFC, it was only one of a number of factors which impacted growth and arguably it was only of marginal influence in driving structural growth as this was largely driven by fiscal policy and government regulation. But as politics globally becomes more partisan, less and less get done and therefore fiscal policy sits on the backburner, which has meant the central banker's role has morphed into something grotesque.

Nature abhors a vacuum

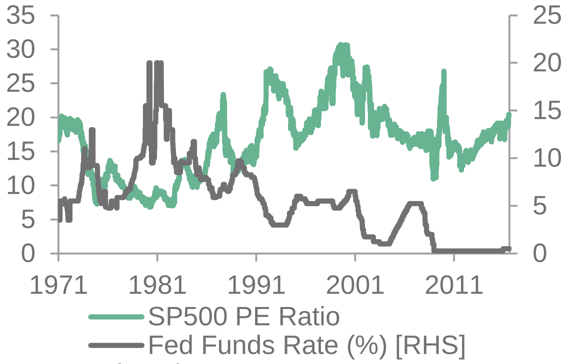
Central bankers now attempt to control the price of everything, they set the short-term interest rate (via monetary policy), they set the shape of the yield curve (via operation twist), they control the price of equities (via the capm and direct buying), they control the level of currencies (via jawboning and QE programmes), they direct credit (via macro-prudential tools), they control who can intermediate in the system (via regulation), they control the leverage in the system (via capital ratios), they determine banks business models (via too-big-to fail rules) the list goes on and on, and remember these institutions are all unelected and largely unregulated.

But unfortunately the envelope is being pushed even further, and we are now stepping into the realm of highly experimental easing techniques that could cause some serious harm. Plus there is no longer any market mechanism to warn or discourage some of these practices because the bond vigilantes have been tamed. A central banker effectively has total control everything. As Uncle Ben said in Spiderman "with great power comes great responsibility" but who are the central banks responsible to? Are decisions based on the greater good or tailored for the benefit of a specific group of people? And what of the social costs of supposedly rational economic decisions, where are they accounted for? While the policies of central banks are supposed to be for the greater good there can be no argument that the monetary policy decisions taken over the last few years have benefited the rich much more than the poor and created social issues not seen for decades.

One ring to rule them all

When you have control over all interest rates you implicitly control the valuation of most other, more risky, assets, e.g. equities, commodities, property, infrastructure. Valuations for all of these asset classes are dependent on the risk-free rate as a way of equalising the trade-off between risk and return between all different asset classes. If the risk return trade-off is skewed or altered for government bonds, then it follows that the risk-return trade-off is skewed for all riskier assets above it.

Chart 2: Linked at the hip



Source: Bloomberg

Controlling the valuation of asset classes also means controlling the flow of capital between these asset classes and as such between regions as different regions have different pools of capital and investable assets. The flow of capital between developed and developing markets is a huge part of this, and is a key reason for why emerging markets have huge inflows, or conversely come under a huge amount of stress. As we've written about before, this flow of capital back out of EM has been a key theme for us, and we've successfully played this by being short EM and commodity currencies.

The difficulty right now is that capitalism isn't about a person or a group of people controlling the flow of capital and definitely isn't about anything but the fabled 'invisible hand' controlling the valuation of risk assets. The purest form of capitalism has the market deciding everything, with the key tenet being that any allocation of capital or evaluation of risk has a price attached to it; with that price itself being altered by the flow of capital into and out of that asset. With that in mind then how does having a group of unelected people decide on short-term interest rates and more recently determining massive buying of government bonds (or in the case of the BoE and the ECB corporate credit as well) fall into this capitalist mindset?

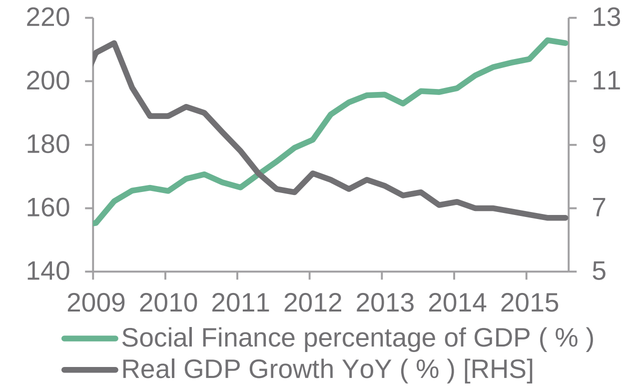
Democracy, communism or dictatorship?

Doesn't this mean that the way global economies and markets are now run is either the communist model or a dictatorship masked as a capitalist democracy? The slow transition from a capitalist society to a communist-lite one isn't in our view just a thought experiment, it is there in fact, what else are the much-lauded Macro-Prudential Tools that central bankers love so much if not a direct way to control the price of credit. Was I the only one that found it worrying that post Brexit the most powerful person in the UK was an unelected Canadian (no offence meant) sitting in Threadneedle St?

While I am certainly not suggesting a conspiracy or any sort of subversion, I am considering what happens if the institution of the central bank and the academic theory that it is built upon is flawed and is hurting far more than its helping. How do we know that, if the market never actually had a chance to decide, that short rates should be at 10% rather than deeply negative? If interest rates are low and growth is weak the typical central banker's response is to cut rates further, but what if the low rates are causing the slow growth, that's a pretty bad mistake to make isn't it?

So let's continue down the rabbit hole and ask the ultimate question, which is- if central bankers are acting like communists, then will our system fail spectacularly like, for example, the Soviet Union? In my view communism isn't all bad, and in certain circumstances it is the preferred economic model, as communist or control economies can benefit massively from a controlled flow of capital into targeted industries or social projects. The most recent example of this is how the Chinese have managed to drive infrastructure investment and expand supply in industries that have serviced this such as steel and cement production. Most of this expansion was pushed through state owned banks to lend to state owned enterprises (SOEs), under the command of the government. Ideally there wouldn't be anything wrong with this if the projects that were being funded and built were providing an economic rate of return over a hurdle that suggested the project was profitable - but evidence suggests this isn't the case. A glance at the trend of marginal addition to economic activity of every extra Yuan of credit pumped into the Chinese economy suggests that projects started in the last five years have had very little effect on supporting GDP growth at all, and look more like existing projects are just having debt rolled over to allow their existence without having to take a loss.

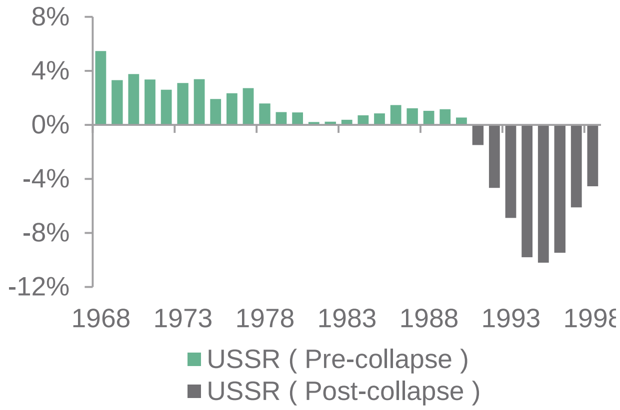
Chart 3: China – pushing on a string



Source: Bloomberg

The Soviets suffered from the same problems. Controlled capital allocation into industries that were never viable, let alone the huge investment in cold war technology that ended up never being used at all. This led to a situation where, in the end, supply in the most basic goods such as bread was so sorely lacking that it led to collapse of the system driven by revolt. This inability to supply the most basic of human needs was only a situation the Soviet Union arrived at because of the severity of misallocation of capital in the decades that preceded it. The fall was long and painful, with disasters such as Chernobyl more proof that too much was built too fast and well beyond the means of the populace.

Chart 4: A slow moving car crash



Source: Maddison Project

In this case the revolt (which is just another form of populist movement) facilitated change that allowed the system to repair itself. If we extend this line of thinking then do the current key issues (inequality, low wages, geopolitical tensions etc.) exist because of the failures of monetary policy in the western world, and importantly are they bringing about the populist movement that we are seeing in politics right now. We are seeing a clear shift towards an anti-establishment, pro-protectionist movement that may well result in further shift towards systems where borders are more protected, further restricting the flow of capital and making it harder for markets to set a fair price for risk and capital. Central bankers would surely be against the sort of policies that these players are putting forward, but has their meddling in the system over the last 50 years essentially created this?

They thought they had tamed the cycle, unfortunately not

While it may seem that this form of easing of monetary policy action has only really been in effect since the GFC, in reality interest rates have been falling to accommodate for sagging growth and inflation since the end of the oil crisis in the 70s. Fed Chairman Paul Volcker was seen to be so effective at crushing the stagflation spiral during the oil crisis by aggressively hiking rates that the opposite view, e.g. cutting interest rates to support growth and inflation, was pushed to its max. The world never need suffer the injustice of a recession again as lower interest rates were the cure-all, as that economic titan Gordon Brown (ex-British Chancellor and PM) so eloquently said “we have abolished boom and bust”, a mantra that was followed across the world. For the most part, it probably worked. The only reason it worked, however, is that it encouraged an unprecedented growth in credit and debt not only at the government level, but at the household level too. This culminated in the GFC, which was inevitable given the lack of control of this credit growth.

Chart 5: Debt continues to grow

Source: Bloomberg

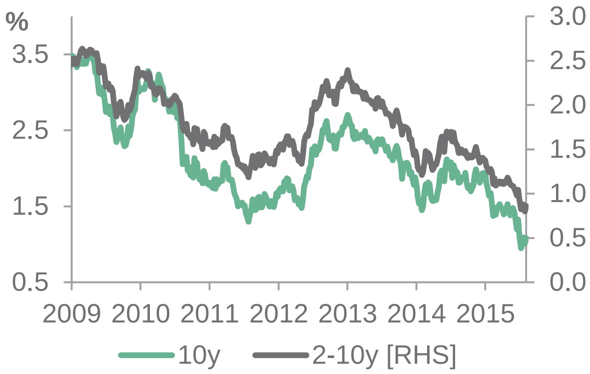
Evaluating the effectiveness of monetary policy is one aspect, but proposing an alternate system to monetary policy setting is another. The market could technically set the rate for overnight money itself, but this setting would be dominated by the banks. Given the FX, LIBOR and BBSW scandals of the past few years it would be difficult to build support to allow the banks to set such an important rate either, and banks themselves are not infallible, as we saw during the GFC. If a financial crisis does hit again, the short rates for lending would spike to levels that might cause even more damage than the actual crisis itself. In these situations the central bank is meant to be there to provide liquidity to the banking system to avoid such situations, but this represents intervention in its own right.

Of course it all comes back to the fact that the entire financial system is built upon the inherent liquidity problem of lending for a long time but borrowing only for a short time. Recent changes to banking regulation have made the gap between these two things far closer than what it was previously, but this key 'maturity transformation' that the financial system facilitates is not going away, and even suggesting it should go away would see our current way of life disappear into the ether.

Tailwinds have turned into headwinds

It may seem contradictory for me to put this view forward, as over the last number of years writing this newsletter there has been one constant theme, and that is that we expect economic growth to continue to slow, inflation continue to soften and as a result interest rates across the whole yield curve in every region to be lower. This has been mirrored in the fact that it has also been our only investment theme to have been 'live' this whole post-GFC period, and has resulted in portfolios that have predominantly been long duration also with a bias towards yield curve flattening. It should come as no surprise that it has been our most successful trade, with the biggest profits coming out of Australia, New Zealand, the US, Europe and Sweden. While there have been very shallow cyclical upswings over the last few years, none of these has been remotely close to being considered a recovery. This is no surprise because both of the drivers of growth - demographics and productivity growth - are both headwinds where they used to be tailwinds. Nothing anyone does is unfortunately going to change these facts, and all we can really do is change our focus to adjust for our new reality.

Chart 6: It's all about the short end



Source: Bloomberg

The death of the demographic dividend has been staring economists in the face for about twenty years now, but policymakers have done nothing to accept it. Cutting interest rates and amassing more and more debt has been the only response, and even after the debt fuelled disaster of the GFC, governments and central bankers urged us to keep on adding more and more debt. This cycle continues spinning ever and ever faster, as interest rates ratchet lower and debt levels higher in a devil's pact.

We are now well and truly past the point where the impact of low rates widens the gap between the haves and the have nots. The low rates have benefitted those who already have capital (prices of assets have skyrocketed in the last few years even though regular consumer inflation has gone the other way), or those who have been able to borrow to take advantage of those low rates. The shrinking middle class, hurting from globalisation, largely hasn't been able to take advantage of the 'expansionary' monetary policy. While this segment are indebted so low rates does help, the greater impact has been from the disappearance of good paying jobs with the replacement being low paid service jobs which doesn't leave the next generation in a particularly good position.

Chart 7: Plumbing new depths

Source: Bloomberg

More jam today and tomorrow

Despite this, what we are starting to get worried about is that central bankers look like they are getting geared up for the next assault. Their mindset seems to be 'if it doesn't work we need to do more and faster' the opposite of what a normal laboratory experiment would suggest. Until we start thinking seriously about fiscal response, which is definitely coming but very slowly, the central banks will continue to experiment even though our economies are hardly any healthier than they were before we embarked on these extraordinary easings. We can say with almost 100% certainty that the Bank of Japan will start funding Japanese government fiscal spending (aka helicopter money) within the next year. The pattern has already been set - get markets comfortable by continually leaking information about future plans in the press - and we expect the same plan to play out again in the next six months. The ECB will surely adjust its buying programme to address the issue of bund scarcity, increasing purchases of peripheral debt with Italy being by far the most important target.

Also at 100% certainty is that the Federal Reserve will continue to disappoint on their hiking plans versus what the market expects and even their own guidance through the ridiculous and misleading dots system. This doesn't mean they won't hike again, but they are continuing to 'ease' from previous expectations. They really have no choice in the matter either as it is almost impossible to be able to normalise monetary policy when so many other central banks are going so aggressively in the other direction. The downshift in US growth over the last year can be explained by two things - the strong US Dollar and weak oil prices. The tumbling oil prices is in itself a symptom of interest rates that had been held low too long causing the misallocation of capital to investment that was far beyond requirements. This could have further effects in a butterfly effect type situation.

More immediately however the Bank of England cut rates aggressively and restarted its QE bond buying programme on the back of the Brexit vote. While the threat of a recession is real due to a slowdown in business investment (the consumer is holding up better than expected), inflation is actually picking up, equities are higher than they were pre-Brexit and unemployment is below 5%. Despite this, the Bank of England indicated they will cut rates to (just above) zero and will buy billions of pounds of corporate credit even though credit spreads are far tighter than they were pre-GFC. There is an element of politics to this decision in that if things go far worse for the UK economy than expected, then Mark Carney can claim that they stopped it from getting worse. If things are better than expected then the Bank of England is the hero because "everyone was expecting a recession". The act of further easing policy is almost a knee jerk reaction, accepted and never questioned.

Helicopter money is coming

The endgame for these moves is, as I have stated before, a relinking of the governments and central banks. This gets around the central bank's independence, making it purely just a tool for the government to have unlimited capability to provide capital for the greater good. We have no issue with governments taking advantage of super low interest rates to provide fiscal stimulus, but printing money to do that is a step that should be taken with incredible caution. History hasn't been kind to those countries that have stepped down this route, examples of what occurred in Japan, the Weimar republic and the step to World War II are very hard to ignore.

As central banks continue to control the risk-return trade-off for interest rates across the spectrum of maturities it is important to remember that while they have been successful in controlling the 'return' part of the equation (by driving down yields future returns have been booked already), the 'risk' part is still a lot higher than the low yields would imply. The analogy would be the credit market pre-GFC. While credit spreads were extremely low during this period of time, these low returns hid the risk inherent in these securities. We always have to be aware of the same situation occurring in government bonds.

Something in the future may cause central banks to lose control of the yield curve or perhaps an external event will cause a re-assessment of the link between low growth and further monetary easing. For now we will continue to make money based on our view on growth and inflation globally, but the threat of higher yields because of an unexpected event will always be a key concern for us, and our stop-loss driven investment process will help to protect the portfolios when and if that change occurs.

Vimal Gor
Head of Income & Fixed Interest
BT Investment Management

About BTIM's Income & Fixed Interest Boutique

BT Investment Management's Income & Fixed Interest team of nine dedicated professionals, led by Vimal Gor, manage the #1 performing Australian composite bond fund of 2014 and 2011.

For the latest Market Insights from Vimal Gor and his team visit btim.com.au/education-and-resources/

For more information
Please call 1800 813 886, contact your business development representative or visit www.btim.com.au