Income & Fixed Interest Newsletter

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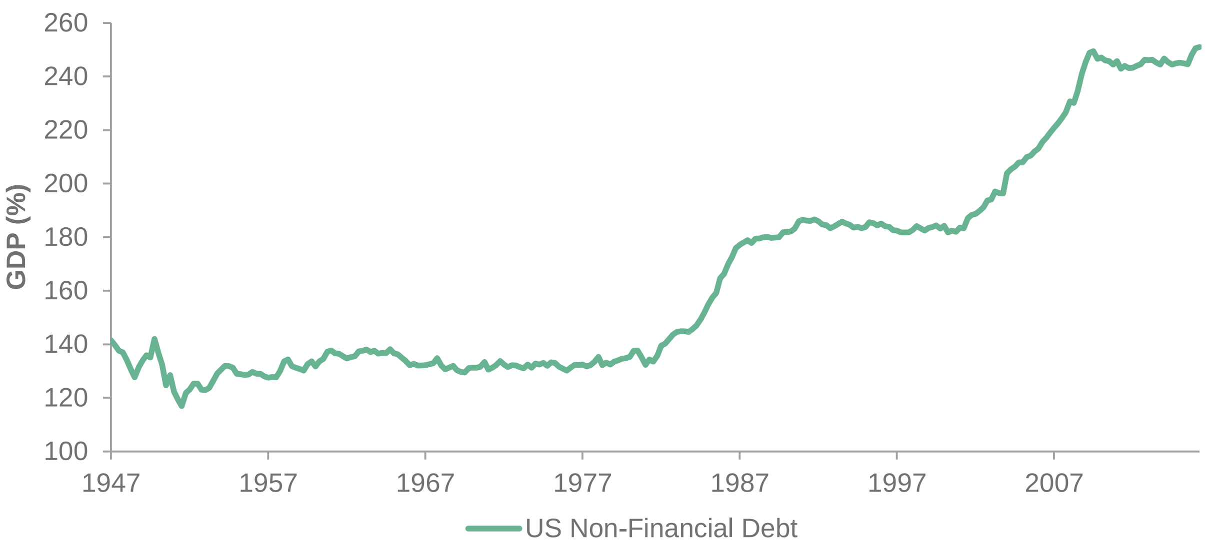
September was a reasonably volatile month as the markets had to digest key meetings from the ECB, BOJ & Fed and deal with a renewed focus on the viability of Deutsche Bank, after the US Department of Justice (DOJ) put forward their opening bid on the mortgage-securities cases fines. In this newsletter I look at the BOJ plans in depth but the other two central banks meetings were also highly relevant. The ECB was the first key central bank meeting and they disappointed markets as they chose not to extend the QE program another six months. This doesn't mean that they won't, but it keeps the markets guessing and raises the spectre of a possible tapering. The last cab off the rank was the Fed who managed to out-dove the markets yet again and now view interest rates as only 'moderately accommodating'. Given how quickly their estimates of the neutral rate are falling they may well have completed the tightening cycle after only 1 hike. The clear message from all three central banks was the limit to which monetary policy could be relied upon to drive growth going forward. While the markets are now keenly awaiting a fiscal response we fear this may only be forthcoming materially in the next recession, which increasingly looks not that far away. We had a pretty quiet month of returns for our funds, with our flagship portfolios generally in line with their respective indices.

Pushing on a string

Two newsletters ago we introduced the idea of how central banks, the supposed bastions of capitalism, are increasingly turning towards actions that define the controlled economies of communist countries. It is clear they are acting with good motives as they desperately want to arrest the decline in global GDP growth and inflation, but fail to acknowledge these downward trends are a result of long-term macro influences largely immune to monetary policy. These long-term trends include degrading demographics, falling productivity and falling world trade. They have a chance of being addressed with smart government reform policy, but with the strong shift towards populism and with it the threat of isolationism it is unlikely these tough remedial polices will be forthcoming. There is no doubt that we have are now firmly in the Kondratieff wave's winter phase that sees significant declines in prosperity and growth. A number of hard lessons will be learnt on the ride down but as central banks continue to fight the inevitable with their monetary policy experiments they make the end-game more certain but the timing more difficult.

It seems everyone in power is doing their best to perpetuate this state of denial. World debt-to-GDP has reached new highs again, with governments driving the borrowing via directly running fiscal deficits or by promoting growth in debt elsewhere through policy. Global central banks are also doing their bit to avoid the admission of a lower level of trend growth and inflation by essentially 'fixing' prices in bond, credit and equity markets. Previously we had a set amount of buying conducted by central banks under the banner of "quantitative easing", which started with the buying of government bonds. This could arguably be seen as a more 'normal' type of monetary easing as it attempted to get yields down without actually intentionally controlling them. This is only true of course if it doesn't impede market liquidity, but this is pretty hard to avoid when you've been forced into a situation where you are essentially indefinitely tied to the program. The argument gets far weaker as they began buying credit and equities, as these markets far exceed their remit except in cases of extreme market stress. Maybe they know more than we do and the market is in a state of extreme stress? Either way, the Bank of Japan meeting at the end of September was a key turning point and a monumental shift in actions of central banks, which now explicitly have no interest in allowing markets to clear.

Chart 1: Debt loads reaching new highs



Source: Bloomberg

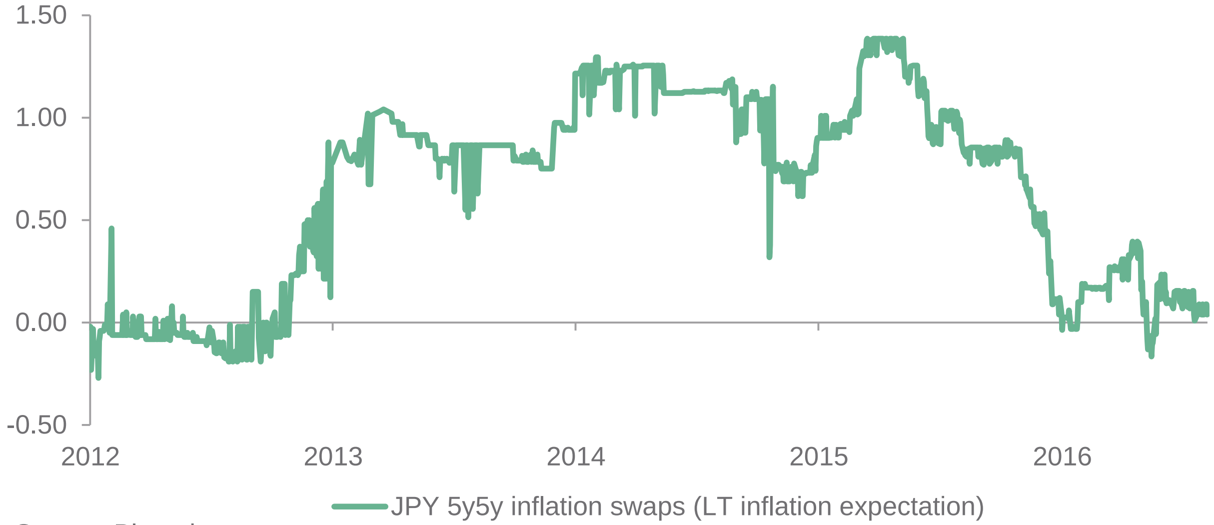
The BOJ's latest volley: QQEWYCC

The Bank of Japan (BOJ) meeting was eagerly awaited as it had already announced a comprehensive review of monetary policy, so a radical change was the only option for the bank given the build in expectations (see this newsletter on the problem that central banks face with climbing expectations of further easing). The need for the Bank of Japan to deliver something more radical was acute, as it is getting destroyed on nearly all of its metrics even though they have already tripled down on extraordinary easing measures. The Yen has appreciated roughly 25% since they announced negative interest rates, resulting in material disappointments in both growth and inflation. Action was needed, any action, it didn't matter what, and that's why we got actions and an announcement which were confusing and contradictory, when viewed in isolation.

Firstly, as part of the BOJ's comprehensive review, they have signalled that they are still committed to get inflation back above 2%, but have admitted that it is not likely to happen in the near term. Since they have failed so alarmingly, the review also identified a change to policy which will see the monetary base expand until this target is reached. How it will be done however brings about a momentous shift in central bank policy even more meaningful than when the ECB ushered in a new era of negative deposit rates. The new policy is called "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control" and it is as confusing as it is difficult to say. Allegedly it aims to do two things, the BOJ say it best:

The new policy framework consists of two major components: the first is "yield curve control" in which the Bank will control short-term and long-term interest rates; and the second is an "inflation-overshooting commitment" in which the Bank commits itself to expanding the monetary base until the year-on-year rate of increase in the observed consumer price index (CPI) exceeds the price stability target of 2 percent and stays above the target in a stable manner.

Chart 2: Previous BOJ easing worked for a while



Source: Bloomberg

When viewed rationally the "inflation-overshooting commitment" is just more ridiculous rhetoric that essentially says that because we failed so spectacularly to lift inflation in the past, we will now keep pushing on a string until it exceeds the level we have not been able to achieve historically. How is that comment even vaguely relevant? Hasn't the market response to their recent actions shown they have zero market credibility left and therefore this type of forward guidance is completely useless?

Who's in control? And of what?

It is however the first part of this paragraph that has the key word in it which is a substantial shift away from current extraordinary monetary policy, that word is 'control'. "The Bank will **control** short-term and long-term interest rates" is a far step from what any other central bank is currently doing right now. That they are looking to control the shape and level of the yield curve highlights the arguments we have made in previous newsletters; that market manipulation is accepted and that 'the man' really doesn't care what the market thinks and has decided to fix levels without considering supply and demand dynamics. How will this be done? From the mouth of the BOJ:

The Bank will purchase Japanese government bonds (JGBs) so that 10-year JGB yields will remain more or less at the current level (around zero percent).

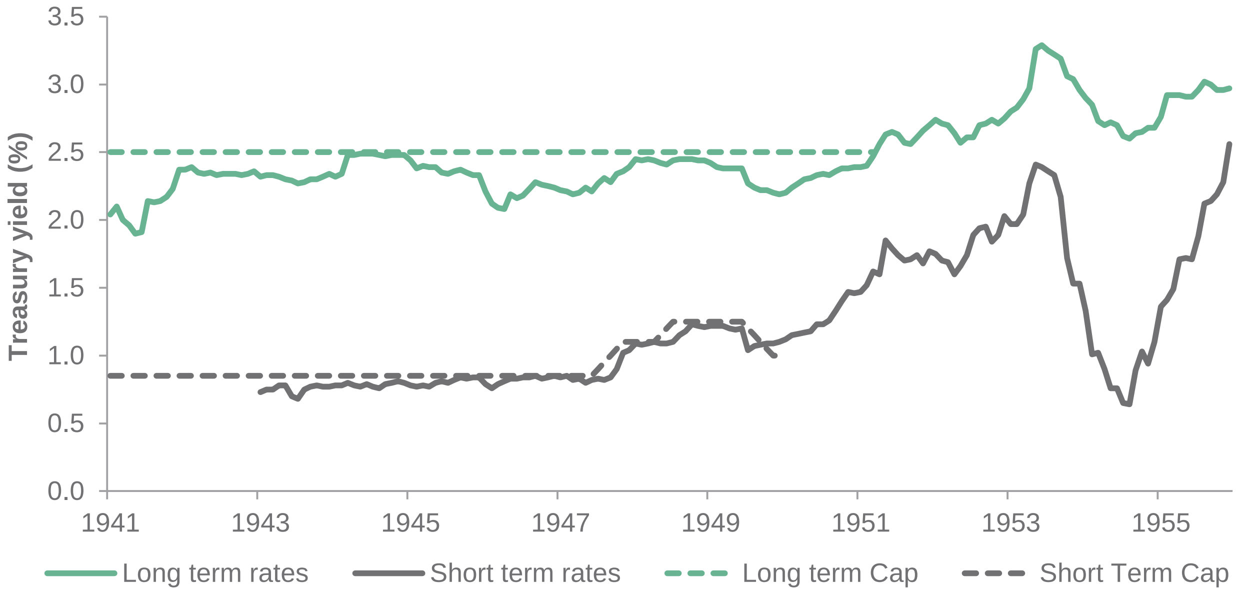
The BOJ have specified short-term interest rates to remain at -0.10%, but have now committed to doing what they need to do to keep the 10 year JGB at around the 0% level. This bond yield has been as low as -0.30% in the middle of this year and has been below 0% since the January BOJ meeting where they initially moved rates into negative territory. This would suggest that they won't need to buy any more bonds than they did before (where the current pace was set at 80 trillion yen of bond buying a year), and in fact maybe buy even less. It wouldn't be a particularly prudent move for the BOJ to admit they would be buying any less, so the disclaimer (which is about as credible as the promise to "overshoot" the inflation target) is that:

With regard to the amount of JGBs to be purchased, the Bank will conduct purchases more or less in line with the current pace -- an annual pace of increase in the amount outstanding of its JGB holdings at about 80 trillion yen -- aiming to achieve the target level of a long-term interest rate specified by the guideline.

But this is completely contradictory, either you are targeting the level of yields or the amount of buying, there is nothing to say that the current level of buying will keep rates stable, in fact it's guaranteed to not. But of course they would say that, as they have seen what has happened when central banks have implied they might be tapering purchases and the market chaos that has resulted from it. The communication here is positive enough so that the market won't take it as a 'taper' event, but the proof will be in how the market actually trades. If the BOJ continues to actually buy this amount of bonds and bond yields fall back to prior lows, does this make "yield curve control" a failure? Who knows, they could actually be forced into a situation where they are selling bonds instead of buying them, i.e. removing liquidity from the system.

If the yield level is credible then the BOJ won't have to increase its balance sheet much to enforce the level. This was the experience of the Federal Reserve during wartime in the 1940s which was the last time anything like this was attempted by a central bank. While this new policy from the BOJ isn't a "yield cap" like the Federal Reserve's, the lesson is still one to consider. They were successful at setting a yield cap so that the government could fund itself for the war effort in the cheapest manner possible and this resulted in the balance sheet of the Fed growing, although not as much as you would have expected.

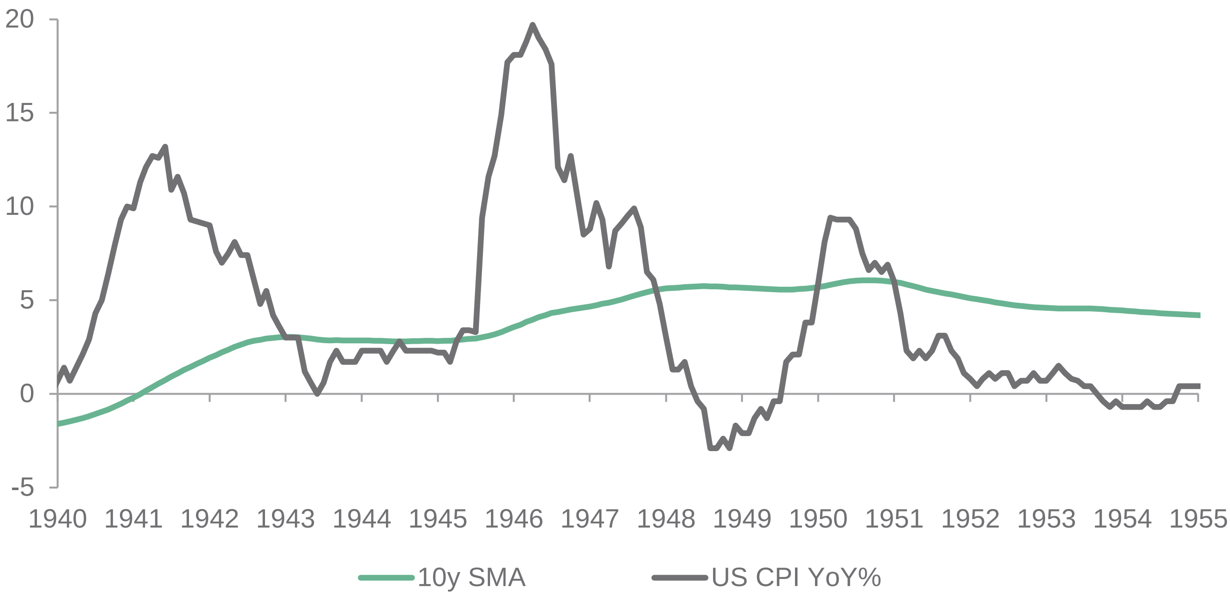
Chart 3: War time yield cap worked…



Source: Banking and Monetary Statistics, 1941 - 1970, Federal Reserve

However these two periods aren't comparable because the entry into wartime was highly inflationary as there were obvious constraints on supply and great demand for products due to the war effort. Headline CPI inflation ran at rates greater than 10% during the war, and then peaked at nearly 20% in the immediate period post-WWII. The 10 year moving average of inflation recovered from the deep deflation evidenced in the Great Depression to rise above 5% by the early 1950s.

Chart 4: …even when inflation was high



Source: Bloomberg

With a cap of 2.5% on long-term Treasuries, this meant that 'real' rates of interest were deeply negative, enabling the government to borrow very cheaply for reconstruction efforts. Even during the worst of the post-GFC period, real rates of interest as traded in the inflation linked bond market (referred to as 'TIPS' in the US) didn't get as low as -1%, let alone -10%. If the BOJ simultaneously achieves its goal of 2%+ inflation while keeping Japanese bonds at around 0%, then real rates would be at -2% or less, which would create a situation where the BOJ would likely have to buy more bonds and increase their balance sheet like the Fed did in the 1940s, easing monetary policy even more.

The problem that Japan now finds itself in is perpendicular to the US in the 1940s. Inflation is falling, and if it falls further resulting in real rates climbing the BOJ will be forced into selling bonds, unless it cuts short-term interest rates (even more negative) to keep up with lower inflation. Cutting rates more negative or selling bonds are bad choice considering the effect that negative rates have had on the banking system as we have spoken about before. So the yield target will actually work in reverse to what they want. If inflation falls further then real rates rise which has a tightening effect on financial conditions. This should cause yields to fall, resulting in the BOJ moving towards selling bonds which is also the same as tightening monetary policy, an event usually associated with even faster falling inflation. Therefore this policy may be procyclical, an undesirable trait.

It's not a botch at all, it's a great masterplan

So stepping back, when viewed in isolation the BOJ plans are confusing and contradictory. But if we think about the plan as a way of stopping yields rising rather than as a way of easing monetary policy further, the picture comes into sharp relief. When we look at it from a holistic viewpoints (monetary and fiscal together) the BOJ package was elegant in the extreme and masterfully constructed. We have been writing about the possibility of helicopter money in Japan for the last year and believe this package by the BOJ make it highly likely now. We think that this would be a game-changer in regards to rescuing the global economy, because other countries will follow if it proves to be successful in Japan.

The key point to understand is that the BOJ is controlling the level of yields, which are normally set by the interaction of supply and demand. From the demand side this plan makes no sense, but if the desire is to stop yields rising as supply increases it works excellently. The BOJ's new “yield curve control” policy means that even a huge increase in bond issuance wouldn’t result in yields rising. In effect this new policy has effectively been a realisation that;

1. Monetary policy (through QE) alone is not effective at lifting inflation; and
2. Very loose fiscal policy through helicopter money may be the way to lift inflation
3. So let’s do lots of 2
4. Repeat 3 until we get inflation

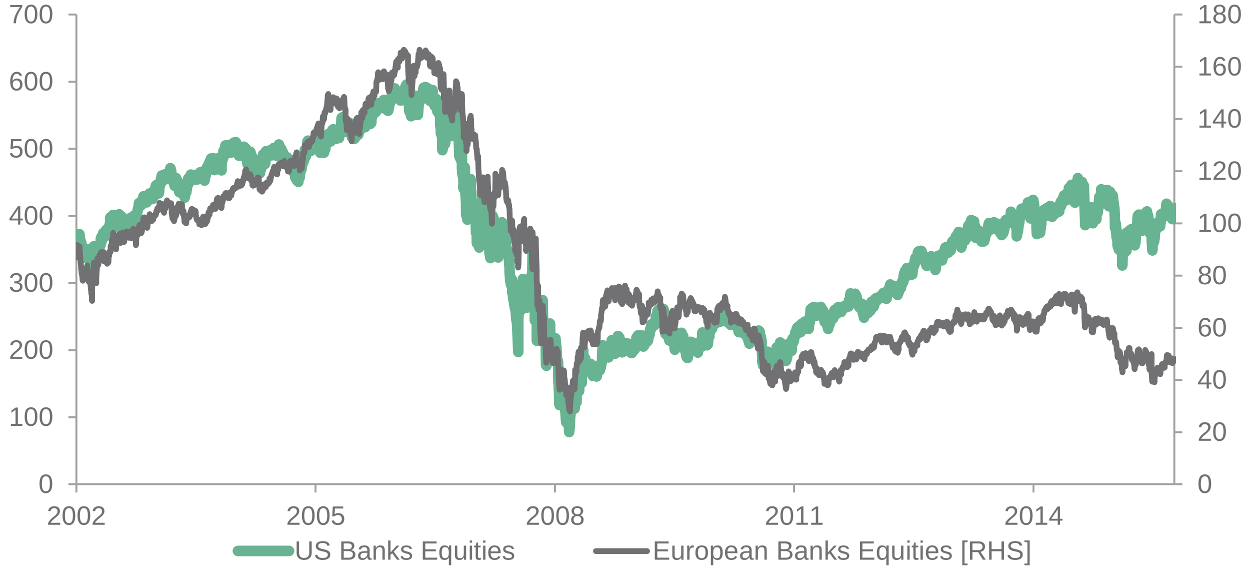
Our expectation now is that Prime Minister Abe pushes through substantial fiscal policy easing, probably targeted on wages, labour market reform and infrastructure. With its recent actions the BOJ has clearly set it up and the MOF just needs to knock it into the back of the net. This situation is a one in a generational (or 42 year k-wave) opportunity and we expect the Japanese government to step up very soon.

Tit for tat

While this BOJ meeting was arguably one of the most important things to happen in global macro markets for years, there is no denying the importance of headlines that have been bounced around regarding the supposed implosion of Deutsche Bank. Under stress all year as a result of changing regulation which has put its entire business model under threat, the latest bout of volatility has however been caused by the declaration of a fine imposed by the DOJ. The $14bn fine slapped on the bank in the most public of ways reflected less about the seriousness of the crime (it's arguable if in this case there really is a crime anyhow) and more about the ability of the bank to be able to pay after the requisite amount of ‘haggling’ occurred. The transatlantic fine here looks like a direct tit-for-tat after the EU’s fine on Apple, even down to replicating the dollar amount of the fine.

European banks are already struggling greatly over the imposition of significant regulation, which is in a lot of circumstances misguided and is affecting the profitability of these institutions directly. Little sympathy will be found for them in governments that are quickly moving towards populist policies, enabling some to build a whole career out of berating the banks. The very public trial (and execution) of the CEO of Wells Fargo by Elizabeth Warren is evidence of this and while the crimes committed at Wells Fargo are real (and to be sure there are many other examples at other banks which need to be punished), killing the system that provides the grease to keep the financial system working might not be the best outcome for everyone. The problem is that while a bank like Deutsche who pays out 50% of revenues to staff while they aren't making any profit is likely to get little sympathy from the part of the voting base that is becoming more and more vocal.

Chart 5: European Banks continue to have legacy issues



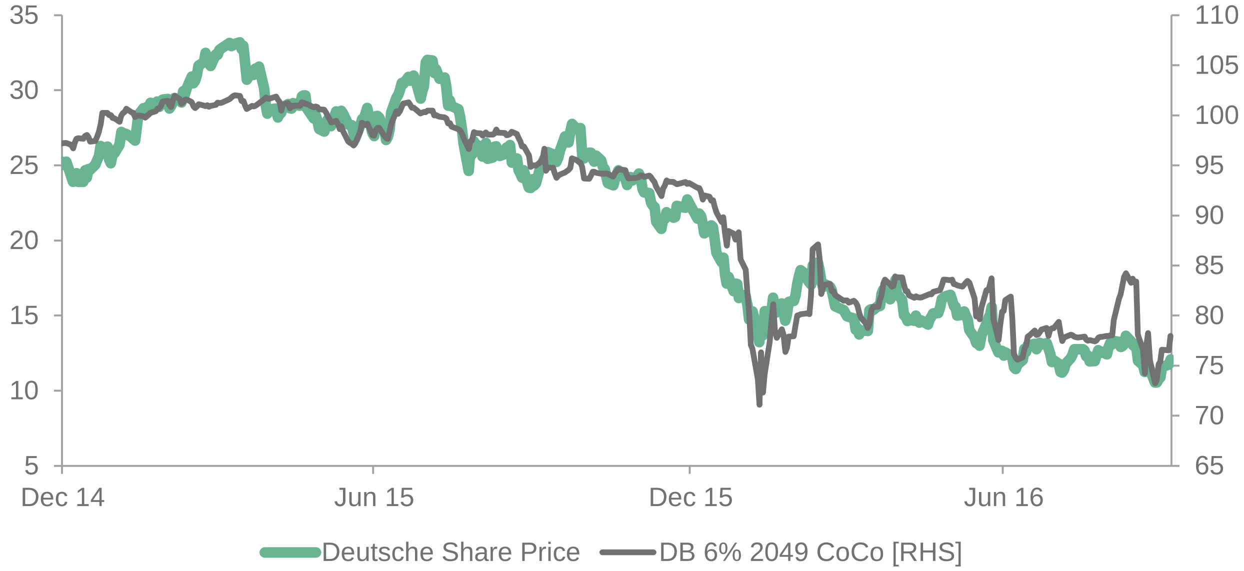
Source: Bloomberg

The actions of the DOJ by issuing such a large fine put the bank under real pressure as it was far larger than DB had provisioned, which was around the $7bn mark. As expected the fine was enough to put the bank under significant pressure due to a loss of confidence in its viability. This was compounded by the announcement by the German government that Deutsche wouldn't be bailed out, which while commendable is highly dangerous as it allows the bank-run to continue. The rumour mill sent the stock close to single digits, which has fallen just about 50% in 2016 alone.

CoCo (and hybrids) can trade like equities

The DB CoCo (contingent convertible) bonds as would be expected copped an absolute beating as well. While a 'new' type of security for the Europeans, the CoCo is very similar in structure to the popular exchange traded bank hybrid in Australia as it is convertible into equity when the bank is under the most stress, and sits just above equity in the capital structure. These DB CoCos have lost around 20% of their value in 2016, however this has been offset by a fairly substantial coupon of 6%, far higher than what bank hybrids pay in Australia. We have been highlighting these risks for a while, but the market is now starting to come around to the inherent default and liquidity risks contained within these instruments. While DB has been under significant idiosyncratic stresses, investors should be aware that hybrids do not constitute a low risk fixed income exposure, but contain risks that are far closer to equities than what people desire of their fixed income exposure.

Chart 6: Hybrids can trade like equities



Source: Bloomberg

This month's examples of growing government intervention in markets has been through the heavy handed regulation of the banking sector and the shift to the direct control of market prices by the BOJ. Next month we will surely have a few more to add to the list. It is important to remember that while communist states chose to directly allocate capital to those investments and set prices in those markets that they felt would be beneficial for the greater good, the imbalances caused by these decisions resulted in their eventual undoing. Setting the level of 10 year government bonds may seem more innocent than meddling directly in the economy, but in reality it is only a few dangerous steps away from breeding the same imbalances.

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

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