Strategy Thoughts

August 2019

When the clearly absurd is rationalised,

things rarely end well!

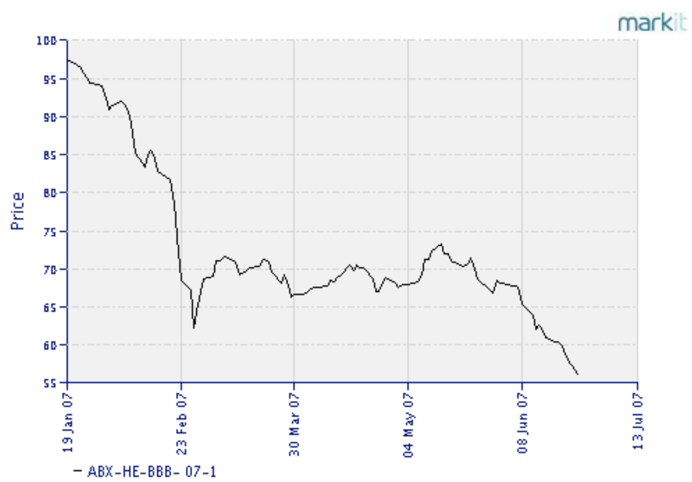
Introduction

Over the last two months equity markets as a whole have been range bound. This can best be seen in the MSCI all country world index which is currently at the same level it was at in early June. It was also at the same level in March of this year, October of last year, March of last year and December of 2017. The same cannot be said for fixed income markets where yields have continued to slide.

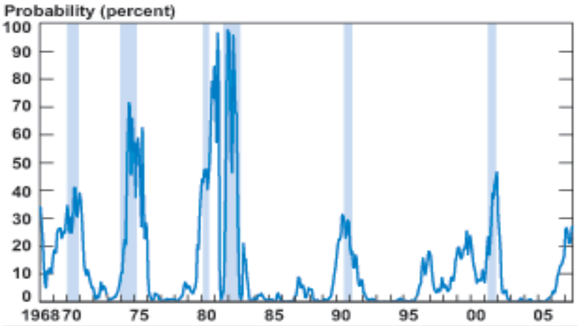
Having spent most of the last two months in the UK and Europe this month's Strategy Thoughts will probably have more of a European flavour. This is probably timely, and undoubtedly appropriate, given some of the absurdities that are now being seen in that region. One of these absurdities, the explosion in negative yielding debt, and the possibility that Europe as a whole may be the 'canary in the coal mine' for the next major market and economic setback, are explored in this month's Strategy Thoughts. In addition, this edition also reviews where a major surprise may soon be approaching and the disappointment that the recent interest rate cut in the US has so far delivered.

Europe, the canary in the coal mine?

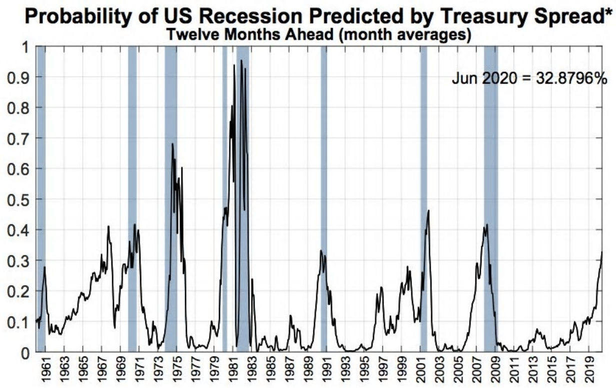
Long before what would become known as the GFC or Great Recession began, and equity markets started to collapse, there were many warning signs, or canaries in the coal mine. The chart below appeared in Strategy Thoughts in June of 2007; it showed the value of bonds related to a basket of subprime mortgages that were only one year old. In the first six months of 2007 these bonds lost almost half their value. Despite this 'canary' no one was too concerned at the time and the problems of a falling US real estate market were seen as isolated and limited. The idea that this could be the source of any kind of financial contagion could not have been further from the then prevalent consensus expectation.



Six months earlier I included the following chart outlining the risk of a US recession according to one of the New York Federal Reserve's models;



The model had risen to levels indicative of previous recessions but again, few saw any reason for concern. Remarkably, the same model (updated and shown below) has risen to levels that have preceded all recent recessions.



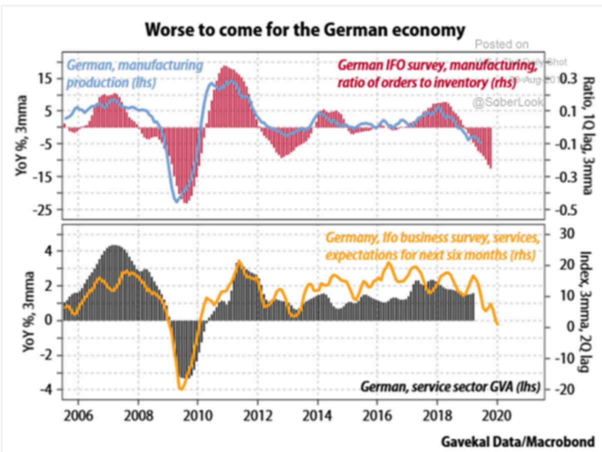
*Parameters estimated using data from January 1959 to December 2009, recession probabilities predicted using data through Jun 2019.
The parameter estimates are α=-0.5333, β=-0.6330.

This time the 'canary in the coal mine' warning of an imminent downturn is not to be found in a falling US real estate market, or even a US recession, it is likely being seen now in Europe.

The UK's Express reported;

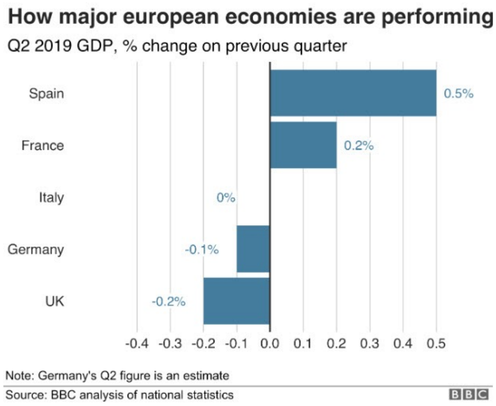
Germany collapsing to recession - but Merkel quitting will plunge country into HUGE crisis

GERMANY is surging towards recession as its economy continues to collapse, but Angela Merkel quitting now would plunge the country into a political crisis for years to come, experts have warned.



Business Insider and the BBC have both been highlighting the fragility of the European economy;

Three of Europe's biggest economies are probably in recession — and the ECB is totally out of bullets Business Insider



And Eurozone equity markets are beginning to show signs of rolling over;

The chart above shows the Eurostoxx 50 index over the last five years. The post GFC high for this index was in early 2015, it struggled to a lower high in 2017 and has now fallen from an even lower high to sit more than 10% down from early 2015.

The chart at the top of this page from the BBC shows that Italy's economy narrowly avoided contracting in the second quarter, unlike Germany and the UK. However, Italians, and investors in Italy may have longer term issues to worry about than quarterly GDP numbers. Italy's debt burden, as a percentage of GDP, has risen to levels not seen since WWII, when it last defaulted on its debt.

With an economy on the brink of contraction this relationship is only going to get worse and as Capital Economics point out, it is hard to see a positive way out of this dilemma for Italy;

> "**There is little that Italy's government can do to prevent its debt ratio from rising.** For a number of reasons, not least of which is its membership of the eurozone, the three paths to debt reduction – **faster GDP growth, fiscal austerity, and higher inflation – are either closed off or likely to be ineffective**. Accordingly, we think that Italy will eventually be forced into a debt restructuring or **outright defaul**t."

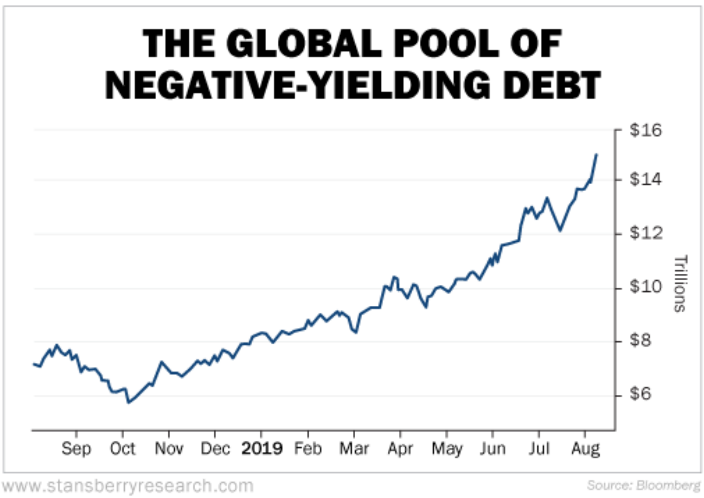
Despite this the Italian government, and Greece, a country whose ten year bonds traded with a yield of close to 50% seven and a half years ago, can borrow money for ten years at about the same rate as the US is paying.

These yields are positive however, unlike the ten year yields in Switzerland, the Netherlands, France, Japan or Germany where ten year yields range between minus ¼% to more than minus 1%.

Die Welt's senior economics editor recently tweeted;

> Totally absurd: Investors are paying Germany more and more to lend the country money. Berlin sold €2.345bn of 10y debt at fresh record low yield of -0.41% vs -0.26% at Jul auction. Bid-to-cover rose to 2 from 1.2 at July 10 auction.

Describing paying increasingly large amounts for the privilege of lending any institution money as 'absurd' may be an extreme understatement, particularly if the reason for these negative rates is the inherent weakness of the global economy. But it seems that an increasingly large consensus is growing that accepts the inevitability of these yields, that they may become even more negative, and that the trend to an even larger universe of negative yielding bonds can simply be extrapolated into the future.



As the title of this month's Strategy Thoughts points out, such extrapolations rarely end well.

Negative yields

Some commentators, such as PIMCO recently, have been rationalising the explosion in negative yielding debt. The argument seems to go along the lines of; individuals are living longer and so are valuing future spending more than current spending. I have no doubt that a smart economist can put together a seemingly plausible 'story' around this, but to me it sounds awfully like why things are ‘different this time’! Similar long term ‘rationalisations were used in 1999 to justify what were, with the obvious benefit of hindsight, clearly absurd valuations for technology start ups. Anyone who likened what was happening then to the 1970’s ‘nifty fifty’ bubble, or the price of RCA in the late 1920s, was dismissed as just ‘not getting it’. Well I didn’t ‘get’ the TMT valuations in 1999, nor the idea that US house prices would never go down in the mid 2000s and I don’t get this argument about people living longer justifying ludicrously low and increasingly negative interest rates.

According to the World Bank life expectancy at birth in Germany peaked in 2014 at 81.1 years, at the time long term interest rates were just below 2%. Since then life expectancy has actually fallen very slightly and yet those long term interest rates have plunged into negative territory. An even more extreme illustration of the ludicrousness of this rationalisation can be found in Spain where life expectancy at birth has similarly flatlined since 2014 and yet long term interest rates have plummeted from more than 4% to close to zero.

It is hard to see how this explosion in negative yielding bonds can end any better than those other ludicrously rationalised bubbles.

What should ‘junk’ bonds yield?

It isn’t just governments that can now borrow for the long term at negative rates, some corporate bond yields have now slipped into negative territory. Even some junk bond yields have gone negative, the ludicrousness of which was neatly summarised in the Wall Street Journal’s ‘oxymoron alert’.

> **Oxymoron Alert: Some ‘High Yield’ Bonds Go Negative** WSJ 14 July
>
> “It is a perverse situation,” said Colin Purdie, chief investment officer for credit at Aviva Investors. “It is called ‘high yield,’ so to get a negative yield is pretty unusual. But it’s not completely crazy. For some investors, there is an acceptance that it’s not about absolute returns, but relative returns.” Etftrends.com 16 July

The International Financial Review in early July reported;

> About 2% of the euro high-yield universe is now negative yielding, according to Bank of America Merrill Lynch.
>
> That percentage would rise to 10% if average yields fall by a further 35bp, said Barnaby Martin, European credit strategist at the bank.
>
> He said the first signs of negative yielding high-yield bonds emerged about two weeks ago in the wake of Mario Draghi's speech in Sintra where the ECB president hinted at a further dose of bond buying via the central bank's corporate sector purchase programme. There are now more than 10 high-yield bonds in negative territory.

An example of one of these euro junk bonds is;

> Irish paper packaging company Smurfit Kappa (BB+/BB+) has a €500m 3.25% June 2021 bid at -0.012%, according to Tradeweb data.

This bond was issued five years ago with a yield of 3.25%, it is currently trading with a yield below zero!

Unfortunately the rationalisation utilised above regarding relative returns, not absolute returns, justifying negative yields for anything, let alone junk bonds, is as nonsensical as the longer life expectancy mentioned at the start of this section.

Towards the end of all investment manias throughout history, from Tulips, to radio and then the internet, the absurd becomes rationalised and then that rationalisation becomes the accepted norm. When that point is reached the bubble bursts and everyone can see that the King is wearing no clothes.

Remarkably low cash rates globally have certainly supported more speculative asset markets, even if they have not resulted in the growth and inflation that central banks desire. However, the continued abundance of cheap money does not guarantee continued asset price appreciation. In early 2007 Paul McCully, then of PIMCO, made the following comments regarding the liquidity argument that was being used so widely back then to justify ever higher prices for just about everything;

> "At the end of the day liquidity isn't about money stock growth, but a risk seeking frame of mind. In other words liquidity isn't about money sitting on the sidelines per se, but rather about the risk appetite of those on the sidelines. And when risk appetite turns, no amount of liquidity on the sidelines matters, particularly when a crowd gathers there. This is the essence of modern day finance. The human condition is, in the end, momentum driven, not value driven."

It is not the availability of cheap money that drives prices ever higher, it is the ever growing levels of hope and expectation on the part of investors. Once those ever inflating expectations are disappointed, for whatever reason, markets reverse and no amount of cheap money can stop the fall. It is most important that all investors remember that interest rate cuts did not prevent the last two recessions, but still hope and expectations continue to be driven by the idea that lower interest rates, even more negative interest rates, will save both stock markets and economies.

In June I wrote

> **Don't worry, the Fed will come to the rescue!**
>
> With markets down sharply over the last five weeks a comforting proclamation was heard from a top strategist on CNBC. It echoed a headline a few days earlier in The Wall Street Journal;

> **Fed Would Consider Interest-Rate Cuts if Growth Outlook Darkens**
> WSJ 30 May

> A few days later, after a severe market swoon, stocks rallied when Fed chairman Powell explicitly supported the concept of the Fed riding to the rescue.

> **Powell says the Fed will 'act as appropriate to sustain the expansion** CNBC 4 June

> In the wake of this message US stocks bounced. The simplistic idea that somehow the Fed can prevent a bear market or recession is appealing, and understandably comforting, however, it flies in the face of both long term history and the evidence of the two severe bear markets and recessions since 2000.

I concluded that discussion with;

> History would suggest that those commentators seeking comfort in the prospect of an imminent rate cut should perhaps be careful what they wish for.

Since then those longing for a cut in interest rates in the US have got what they hoped for. Obviously, it is too early to say whether this action will 'sustain the expansion' but it hasn't helped the stock market. In the five trading days after the cut the Dow Jones Industrial Average fell almost 1,900 points, or 7%, from its high just days before, and still remains more than 1,000 points lower.

Brexit may not be the primary risk for Europe

While travelling through the UK over the last couple of months the media was understandably obsessed with the conservative leadership elections and the outlook for a no deal Brexit, particularly after Boris Johnson became the new Prime Minister. In the wake of Boris' ascension sterling fell and calls for even further falls and an even bleaker future abounded.

Pound warning: Sterling set for month of horror as new PM takes reigns

GBP/USD Forecast: How low can the pound go? Boris Johnson is breaking it down

Brexit Means Bad News for the British Pound

Pound-dollar parity? A look at the 200-year relationship of the currencies

Expectations for Brexit and sterling are obviously very depressed and, as the long term chart of the sterling / dollar exchange rate shows, these dire expectations come **after** sterling has already suffered a miserable, more than decade long, bear market that has seen the value of a pound fall by more than 40%. Sterling has recently recorded its lowest value against the US dollar in more than three decades, now is probably not the smartest time to be extrapolating what has already been happening for more than ten years.

It is important to remember that back in 2007, as sterling was recording a twenty six year high versus the dollar, expectations were quite different, as the BBC reported;

Pound hits 26-year US dollar high The pound is still some way off the $2.446 mark it reached in November 1980, but some analysts believe it could threaten those levels if economic conditions in the UK and US continue to diverge. James Hughes, a currency strategist from CMC Markets, said he believed the market had not yet factored in the likelihood of a further cut in US rates.

Expectations are obviously currently bleak, and possibly 180 degrees apart from those seen in 2007, but given the current situation in much of Europe it is quite likely that the biggest disappointments may lie in the near term future of mainland Europe rather than the UK.

Pound Dollar Exchange Rate (GBP USD) - Historical Chart

Conclusions

The widely anticipated 'melt up', discussed at length in the previous edition of Strategy Thoughts, has still failed to materialise, except in certain fixed income markets. The fact that ever lower rates are currently forecast and negative rates becoming increasingly accepted and rationalised, should be seen as a warning sign and an end of an extrapolation, rather than a justification to continually increase risk exposure in the pursuit of yield or return. It should also be a concern that interest rate cuts are not delivering what so many had hoped they would, and, just as through the last two bear markets and recessions, central banks are pushing on the proverbial string. It is becoming increasingly hard to see how, in the shadow of an increasing number of rationalised absurdities, things can end as well as so many hope and expect

Many markets are setting themselves up for disappointment, with very little room left for positive surprise. In such an environment preservation of capital continues to be the most sensible investment strategy.

13th August 2019