

1ST QUARTER MUSINGS

When central banks go all-in

After the first two weeks of the year metamorphosed from the worst ever for equity markets into another epic market reflation, risk assets managed to finish the quarter more or less unchanged notwithstanding a barrage of downbeat macro economic data and news. As with each preceding market drawdown, the easy money cacophony grew louder with each tick lower in the S&P until the monetary suzerains delivered their goodies.

And delivered they did! This will be remembered as the quarter when all major central banks took out their monetary bazookas: first off to the race was the PBOC with a mind-boggling credit expansion of over half a trillion dollar in January alone (that's almost the Swiss GDP) and a projected 3 trillion dollars for the full calendar year (add a Germany GDP to the credit tab). China credit bubble of 35 trillion dollars and counting is truly on its way to put to shame the US sub-prime bubble.

Then came super-Mario with a new cocktail consisting of: one more layer of QE extended to corporate debts (240 billion Euro annualized), further negative rates, new money-free facilities for the Eurozone faltering banks (LTROs) and an insane 'no limit' pledge to boot; not to be outdone, Kuroda-san joined this easy-money merrymaking with a run into negative rates just weeks after he pledged not to follow the ECB in the currency war pit; last but not least, after a puny 25 basis point increase last December, Janet promptly backpedaled on her tightening bias and adopted a strategy of talking of an exit path to normalization while walking an ever flat lining calendar.

Out of the 9 central banks having raised rates since 2011, 8 have already relented and reversed policy; Janet shall be next.

Who can honestly say that central bankers are running out of ammunitions after such a barrage of monetary fireworks?

From quantitative easing to quantitative pleasing

The power of the easy money printers is best summed up by the MSCI world stock index, down 12% and back to unchanged in a matter of weeks; that's a massive swing ... or by the volatility index VIX back down to 13, a level associated with goldilocks, from a peak of 28 in mid February.

Central banks are clearly underwriting risk premiums into a deteriorating macro economic framework where returns are exclusively provided-for by the easy-money leverage while traditional drivers formerly known as fundamentals (productivity gains, revenues, earnings and free cash flows) are not only not contributing, but detracting from valuations (S&P earnings are down 18% from their 2014 peak).

So, central banks are experimenting with quantitative policies that are clearly pleasing the markets but at a cost of inflicting severe damage to banks and savers, to pension funds and retirees, to insurances and annuities, to money market and fixed income funds; not to mention the resulting zombification of the economy, the systemic misallocation of capital, the likely unintended consequences (unknown unknown), financial volatility blow-outs and asset bubbles running out of greater fools (known known).

As this extraordinary monetary experiment is carried out during an expansionary phase, we can only guess how severe the underlying debt-deflation risk already is and wonder how possibly could the global economy even afford another recession without falling into a deflationary death spiral.

Helicopter money

Central banks are trapped in a perpetual money creation dynamic by their incestuous relationship with bubble-markets increasingly prone to scare the hell out of them through violent bursts of volatility. A sustained deleveraging would trigger a giant margin call as most assets are collateralized, hypothecated and re-hypothecated in the global debt pyramid: there are four times more liabilities/credit outstanding worldwide than assets/equity.

Planet finance is thus betting-it-all on central banks to stave off any risk of a deflationary deleveraging, notwithstanding increasing confirmation of malinvestment and bubble dynamics, both of which cannot be liquidated without triggering the dreaded deflationary vicious spiral of debt deflation requiring asset liquidation.

Central banks can and will extend some more the current expansion with ever increasing doses of monetary stimulus, but at a cost of compounding the severity, depth and duration of the next recession when it finally comes. Money inflation will eventually be required to pay for much of the debt, a stage famously described as helicopter-money by the father of modern QE, Ben Bernanke.

This is the stage when central banks start printing money to finance tax cuts (supply) and/or government expenditures (demand), both of which devalue outstanding money and credit purchasing power. We start seeing helicopter-money in our future as the world remains structurally growth-deficient (toxic mix of too much debt, declining demography and income deflation) to pay back its accumulated liabilities from current cash flows and savings. Helicopter money will be the equivalent of a debt jubilee.

Toward a debt jubilee?

The credit-fuelled growth model of the last 40 years has reached debt saturation and is on the verge of deflating; the global debt and entitlement pile keeps expanding but without delivering marginal growth. Meanwhile, protectionism is creeping under cover of

negative rates and currency wars as the global economic pie shrink, forcing nations into a zero-sum competitive global trade war-game.

It is our conviction that we are on a journey to a global monetary reset that will deflate the amount of outstanding debt to a level that can be sustained by the remaining real economic activity. The sheer size of the mostly non-productive debt accrued since the last crisis imply that the next credit default cycle is going to be materially more severe than any previous cycle, with significantly lower recovery rates.

We have no idea of the timing of this global debt jubilee (CBs will do whatever they can to delay the day of reckoning) or of the methodology that will be adopted (debt default by confiscation, deflation or inflation), but we are mathematically certain that we will not grow out of this debt pyramid.

Portfolio

Adam Smith invisible hand has been fully displaced by the long arm of the monetary suzerains that have suspended the laws of the markets to save them from themselves. Publicly traded markets have become their wards and their policy tools; we can only be positive if we believe in their narrative and capacity to deliver. The January swoon has proven beyond any doubt that equity markets cannot sustain current valuations without central bank support.

Reality is that most publicly traded assets are overly overpriced and disconnected from fundamentals, and that any value-investor should avoid them. Moreover, the advantages of a diversified portfolio have largely dissipated as correlations across publicly traded assets have increased dramatically; the causes are both the frenzied search for yield and the flattening of risk premiums.

Portfolio strategy should thus focus on two main directions: primacy of real assets over credit assets and avoidance of markets driven by central bank narratives. The latter should be limited to tactical plays only, which is essentially trading with stop loss discipline foremost in equities and currencies. The former should include publicly traded bonds and equities where risk premiums are still dictated by the invisible hand, mostly in emerging and developing markets.

The portfolio should consist of assets that can resist or even progress in a scenario of debt-deflation as much as in one of monetary reflation/inflation by increasing the allocation to real assets like productive private equity and real estate as well as gold and cash.

Thank you for your patience and enjoy the spring
Franco

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