Unwinding the great QE carry trade

Robert Gay | Fenwick Advisers | 13 February 2018

Let's be absolutely clear - the recent plunge in equity markets has almost nothing to do with the outlook for inflation or the changing of the guard at the US Federal Reserve. To rationalise a market selloff of this magnitude with chit chat about an uptick in US wage inflation merely distracts from the fragile mechanics of financial markets with overstretched valuations.

Sudden corrections in equities of this magnitude almost invariably involve short-covering by carry traders who have leveraged risk assets, using short-term funding, and are dependent on volatility remaining low. When that rosy scenario is disrupted for whatever reason, the exodus is swift and brutal. In the current case, the spark was the swift rise in short-term Treasury yields, as it became increasingly clear that central bankers everywhere are destined to unwind the great QE experiment of the past 10 years. This correction, however, is not the "big" event associated with financial crises, but rather a "heads up" that all is not well in the world of leveraged finance.

The epiphany

Ironically, a confluence of seemingly good news set the stage for the latest market rout. Global growth prospects have been revised up for 2018 as every major economy now is in expansion mode. Even though those growth prospects are puny by past norms, they nonetheless exceed much diminished potential growth nearly everywhere.

Similarly, although the relationship between inflation and the tightness of labour and product markets has weakened dramatically, any whiff of price pressures sends the unmistakable message that central banks cannot afford to persist with either negative real policy rates or their massive bond buying programs. The Fed already has telegraphed its intentions to reach a new normal of 2% to 2.5% by year end and, despite much double-talk, the ECB is not far behind. The Trump administration's oversized tax cut simply sealed the deal by providing fiscal stimulus when the economy already is operating at full employment.

In short, there was no escaping a significant increase in short-term rates that are the primary funding source for carry trades. When bond sentiment turned negative, it was only a matter of time until leveraged carry traders would be forced to bail out. Anyone who was long equity volatility would become a forced seller, and that is what has happened over the past few days.

Fundamentals and relative value

A market correction - even a severe one - that is characterised primarily as short-covering forced sellers, as I believe this one was, is not likely to cascade into a major financial crisis unless, of course, banks' balance sheets are impaired by the losers. As yet, that does not seem to be the case. The standard measure of equity volatility, VIX, spiked to 50 on 5 February, a level that is comparable to that reached August 2015 in the midst of a similar correction (Figure 1).

Figure 1: Equity Volatility (VIX)

Source: Bloomberg

By comparison, the VIX soared to 90 in 2008 at the onset of the Global Financial Crises. Absent collateral damage to the banks, we might expect a somewhat rocky road in the year ahead with ebbs and flows akin to those experienced in 2016.

Indeed, we may not yet have seen the end of this equity bubble. Financial markets, in essence, are a discounting mechanism with a relatively short horizon of less than one year. The consensus scenarios stills calls for a very gradual rise in policy rates over that horizon. Granted, US interest rates in particular probably have priced several rate hikes already, but European rates are still a long way from anything that might be perceived as neutral. This gross overvaluation is consistent with the ECB's oversized purchases in 2017 and contrasts with a much more moderate overvaluation of European equities. So, on a relative value basis, stocks may continue to outperform as long as inflation stays relatively low, growth prospects are favorable, and the ECB dawdles in normalising its policy rate.

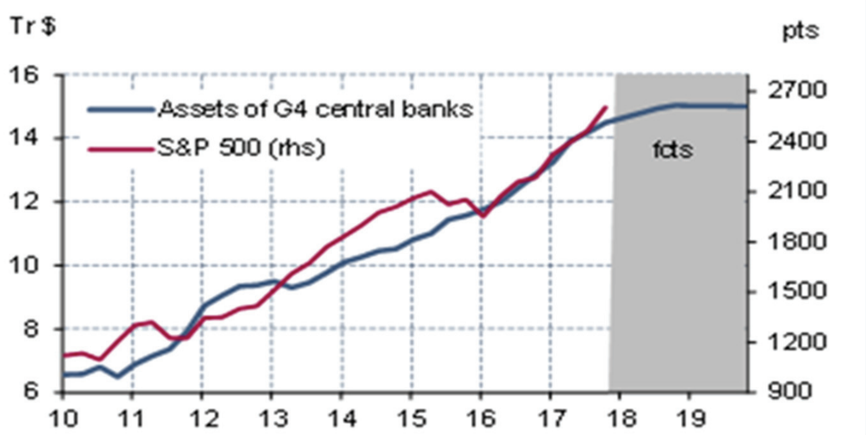
Indeed, there is a lingering risk that we will see another melt-up in equities like that experienced in 1999 at the height of the dotcom bubble. A standard dividend-discount model for equity valuations would suggest otherwise. Namely, higher policy rates should make equities look more expensive, except for the glitch that the ECB's policy rate is not likely to exceed the average European dividend yield anytime soon. There is plenty of time for another market misdirection.

The next meltdown

What then is the probable endgame for this circle of monetary stimulus that redounds to financial assets rather than the real economy? One possible turning point will occur later this year when central banks no longer will buy more bonds than will mature from their portfolio (Figure 2 overpage).

A more relevant comparison for financial asset pricing is central bank bond purchases relative to net new bond issuance. In 2017, for example, central banks purchased almost $2 trillion of QE for their own balance sheets, while governments of developed countries issued $1.3 trillion in net new debt. The difference in effect was fodder for higher asset prices, as central banks raised the bid to enhance the private sector to provide the difference.

Figure 2: The unwinding of QE
G4: central banks' assets and S&P500



Source: Oddo Securities, Thomson Reuter

For 2018, central banks plan to purchase $1.1 trillion in QE assets compared with government net debt issuance of $1.3 trillion, with the balance tipping negative sometime in the fall. By 2019, the net stimulus to asset prices will turn decidedly negative as the private sector will need to absorb an additional $800 billion of government bonds.

The irony of QE has been that it has lulled governments into believing that they could postpone any serious actions to curb their budget deficits. Some, like the US, had the hubris to think that they could cut taxes because times of plenty would bail out their profligacy. More likely, that single delusion is likely to tip the delicate scales of financial markets far more than the current of unwinding of carry trades.

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