Breaking Unconventional Monetary Policy

Nick Bullman | CheckRisk| 12 January 2014

The first Global WRAP of 2014 focuses on the top financial and geopolitical risks for the year ahead. Special attention is paid to the risk that CheckRisk views, above all others, as being the primary risk for investors which is the breaking of unconventional monetary policy (B.U.M.P.).

B.U.M.P

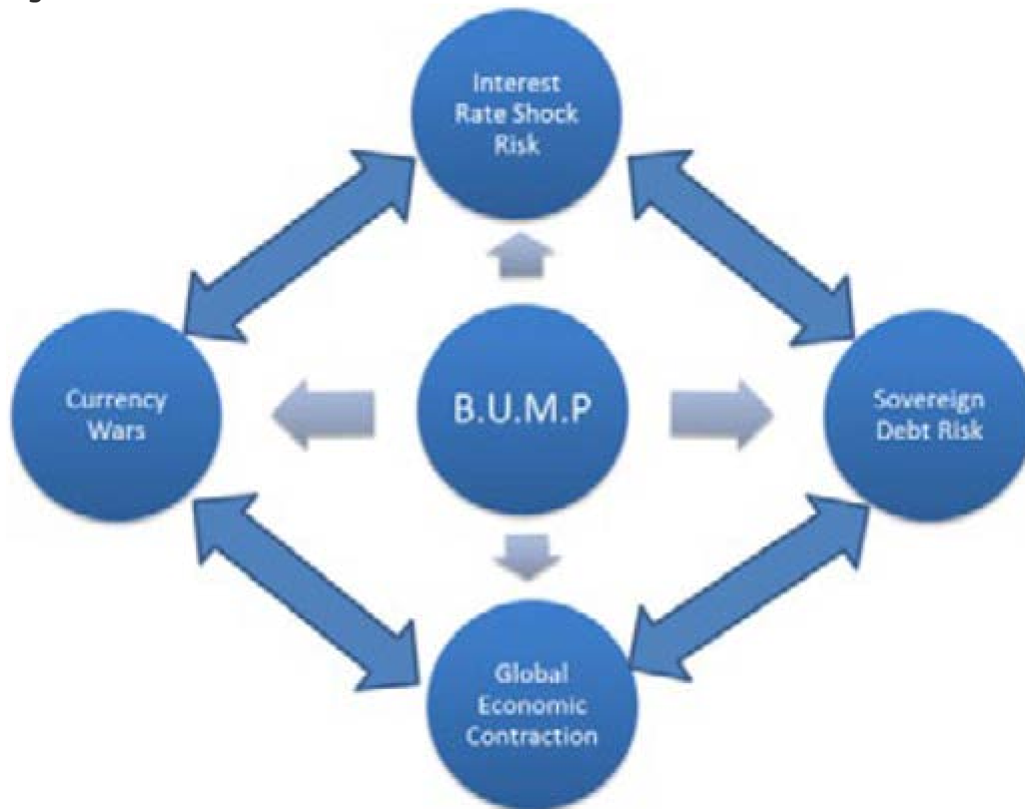
The time has come for the Fed to commence its exit from QE and unconventional monetary policy and to a large degree the Fed appears determined to do so before the end of 2014. B.U.M.P will have profound effects on equity and bond market sentiment and valuations. Handled incorrectly, it is like TNT and could cause major corrections in financial markets. The Fed and other central banks are now entering the bomb disposal phase. Whether they can manage to defuse the bomb without blowing themselves up is the question, given that the act of doing so has severe implications for economic growth. To mix metaphors, the Fed is walking a very fine line that is currently supportive of markets but it will require a miracle for the Fed to get through the process of deleveraging without a mishap.

Unconventional monetary policy has been at the centre of the transfer of risk from the private sector (meaning banks) to the public sector (meaning government and the taxpayer) since 2008. It is therefore reasonable to ask what might happen if it stops? In order to understand that question it is worth looking at the scale of QE that is unprecedented in the history of finance.

Firstly, global monetary aggregates are up $3 trillion for M2 money supply in 2013. That is a 4.6% year on year increase and again an historical first, let alone being 2x the global inflation rate. Secondly, the unconventional monetary policy approach has distorted the pricing of many financial assets and in particular bonds, equities and interest rates. This makes it a network risk and at the very heart of the financial system. Price discovery and liquidity are critical investment tools that have been made infinitely more difficult to judge accurately as a result of the unintentional consequences of recent monetary and fiscal policy.

For many investors 2013 was a vintage year for returns, based as it was on the backstop of QE. As the tide of QE now turns, and in the words of Warren Buffett, “it is time to find out who has been swimming naked.”

Figure 1: B.U.M.P



Sources: CheckRisk LLP.

It is only a question of time before investors recognise that while QE has been good for investment portfolios, it has been not good at all for nominal GDP growth. Nominal GDP growth is what is required to reduce the overall debt burden and without it the global financial system remains vulnerable to further shocks. The difference next time will be that investors will be savvy enough to recognise that the financial equivalent of taking an alcoholic on a pub crawl as a cure for the addiction just does not work. It is simply not possible to reduce debt by creating greater debt liabilities unless the unconventional monetary policy leads to significant increases in underlying GDP. So far the best that can be said for QE is that it may have averted a complete financial collapse by putting off the evil hour, but it has yet to show that the critical keys of GDP growth and inflation are enough to be even a qualified success.

This is a difficult concept to get across. Investment portfolios have done well because of QE and so there is a natural blocking of the perception of risk. The disparity between investment returns and economic reality cannot, however, last for ever. The clock is already ticking.

It was an acceptable strategy to ride the wave of money that the Fed and other central banks have allowed to flow to the market. It is however another level of risk to try to surf that wave

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all the way to the shore. This is mainly so because it is not clear how quickly the Fed will accelerate or decelerate its QE program. There is a veneer of control over the process but it is much more art than science. Secondly as mentioned earlier, the winds of deflation are starting to blow again. This time, however, much of the Fed's and other central banks ability to deal with the economic circumstance is exhausted. Thus a deflationary shock has the potential to be a much greater event next time around. Thirdly, B.U.M.P has a catalytic effect on deflation both being a generator of deflationary trends and an accelerator if they occur. The Fed is aware of this and is obviously going to tread warily. The ECB is also aware of the deflationary trap being sprung, and despite comments from Barrosso at the European Commission and Draghi at the ECB, it is clear to most observers that facts do not cease to exist just because they are being ignored.

Inflation and early warning indicators of inflation such as commodity prices, inflation linked bonds, global trade, shipping prices, and PMI data are the keys to estimating the correct exit point for investors who are essentially tied to the markets. For those with more flexibility, the question is not if but when. It is clear to us that governments and central banks will do everything possible to prop up the system and those attempts may or may not be wholly or partially successful. As an investor, it is critical to realise two things: firstly, that the liquidity currently being enjoyed in sovereign bonds, bonds and equities will evaporate at any sign of a pickup in deflation – for example, inflation falling below 1%, and secondly, it has been quite rare for stock markets to perform well in the initial stages of a financial shock. In fact, the experience has been anywhere between 8% to 40% corrections or bear markets. It may be possible to get out in time but given the asset allocation process at most institutions it is more likely that institutional investors will suffer in the same way as private retail investors.

Inflation in France, Italy and Germany is perilously close to deflation territory. In fact EU wide inflation is at its lowest recorded level of 0.7%. Given the margin for error it is fair to say the EU zone is one step away from deflation. In the US too inflation is stubbornly resisiting all monetary policy attempts to push it higher. The risk being that as B.U.M.P commences downside risks will re-emerge.

Figure 2: Global Inflation statistics

	Real GDP YoY		CPI YoY	
Countries	Value	Date	Value	Date
Australia	2.3%	09/13	2.2%	09/13
Belgium	0.4%	09/13	0.97%	12/13
Canada	2.7%	10/13	0.9%	11/13

China	7.8%	09/13	2.5%	12/13
Germany	0.6%	09/13	1.4%	12/13
France	0.2%	09/13	0.7%	11/13
United Kingdom	2.0%	09/13	2.1%	11/13
Italy	-1.8%	09/13	0.7%	12/13
Japan	2.4%	09/13	1.5%	11/13
Netherlands	-0.4%	09/13	1.7%	12/13
Sweden	0.3%	09/13	0.1%	11/13
Singapore	4.4%	12/13	2.6%	11/13
United States	2.0%	09/13	1.2%	11/13

Sources: Bloomberg LLP, CheckRisk LLP

B.U.M.P may also impact global debt levels considerably. Figure 3 shows the change in the structure of debt for governments, households and non-financial corporations. In every single case, government debt has been rising as a percentage of total debt. Households have generally been reducing overall debt but remain well above average and this is one of the reasons that the deleveraging cycle has potentially much further to go. We note that household debt in Japan has been reducing too, a worrying concern for Abenomics as he tries to encourage consumers to spend more.

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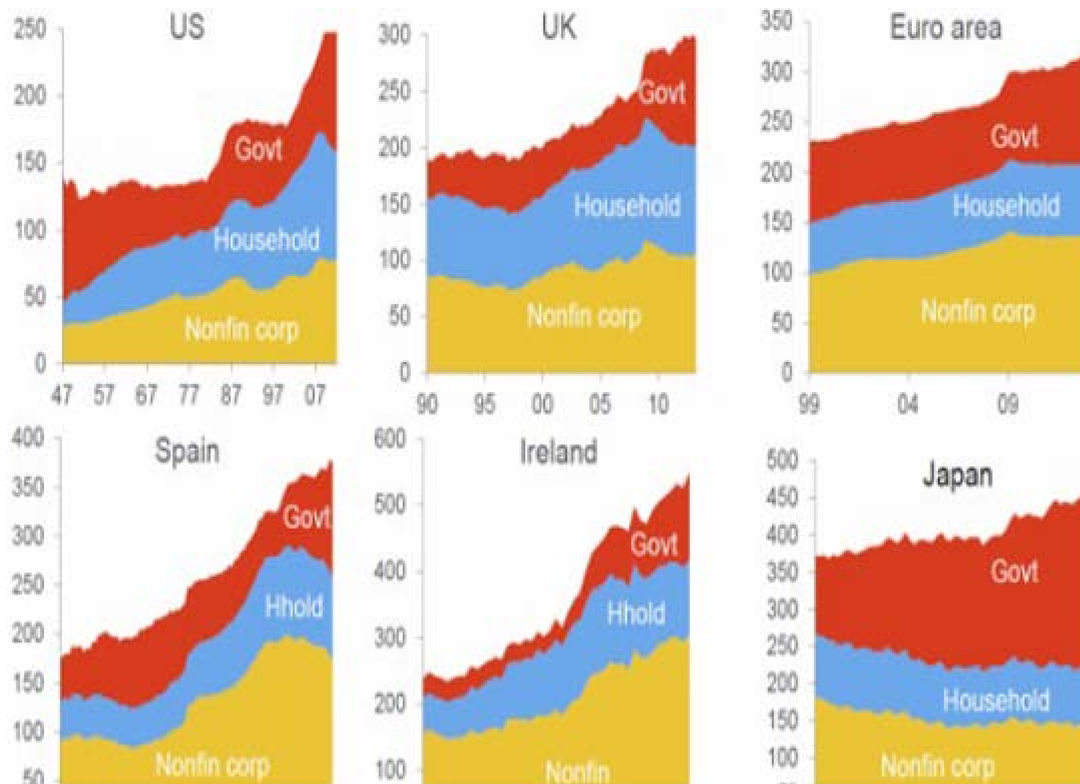
Figure 3: Graph example

Bond safety cushions (1996-2013)



Sources: CheckRIsk LLP

WHY IS B.U.M.P SUCH A RISK?

Looking at Figure 1 above, it is clear that B.U.M.P forms a nexus or central point of risk. In order for it qualify as a central node, B.U.M.P must be connected in both directions and also must act as a transmission mechanism for any of the other nodes.

For example, if sovereign debt risk increases we would expect that interest rate shock risk would increase and liquidity decrease; thus overall risks would increase substantially. If currency wars become entrenched then, because it is a zero sum game, we would expect that factor combined with

B.U.M.P to impact sovereign debt rollover and deflation. B.U.M.P is currently stimulating a somewhat false market in prices. A contraction in the level of global monetary aggregates is likely to lead to a further decrease in the level of consumer and industrial spending therefore weakening the global economic recovery.

The Fed will tread cautiously. A recent paper co-authored by Reinhart and Rogoff on behalf of the IMF called Financial and Sovereign Debt Crises: Some Lessons Learned and Those Forgotten, is instructive as the clear conclusion of the authors (not the IMF incidentally whose

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view the paper does not reflect) is that governments cannot solve the crisis by austerity alone, that without growth, debts cannot be wished away, that government financial repression is one of the possible outcomes as a result of the experiment in unconventional monetary policy, and that this has all happened before. It is well worth looking at the paper.

B.U.M.P is a risk because letting air out of an inflated balloon gently is no easy task. Central banks tend to overdo the control inputs in both directions because steering an economy takes time and the side effects are massive.

For the same reasons that QE boosted equity and bond markets but failed to propel most economies to escape velocity, so will B.U.M.P impact them on the downside. The primary risks that are connected by B.U.M.P are as follows:

- Interest rate shock risk
- Currency wars
- Global economic contraction
- Sovereign debt risks
- Liquidity Risk
- Geopolitical risk

CheckRisk has written about many of the risks numbered one through six above over the past year. For example, interest rate shock risk is where a government or central bank, more precisely, is unable to keep the medium and long end of their interest rate curve from rising. Bernanke's taper announcement in June of last year triggered a small interest rate shock risk event that greatly impacted emerging markets; or where sovereign debt risks are hidden in the 0% risk weighting that sovereign debt is awarded on bank balance sheets and Tier 1 capital ratios.

By far and away the biggest risk, however, is that they are all connected by the Fed's recognition that it must, at some point, exit and attempt to allow markets to reassert themselves. China does not have these problems but it needs Europe and the USA to be strong so as to drive their own economy and allow time for their export driven economy to become less important and replaced by domestic demand. In Europe, the opposite may end up being closer to the truth with the ECB having to take a more expansive and loose monetary role to attempt to stave off a Japan-style deflation. One can only hope that they will act sooner rather than later as deflation, once embedded is very hard to correct.

So far investors have been willing to give central banks the benefit of the doubt, but the important question is why would you have not? After all, printing money or using unconventional monetary policy is the easy part. It became obvious very quickly that the excess money supply was going to equity and bond markets and was effectively "guaranteed" by a government support policy. The next stage is much trickier. Governments will quickly

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find that investors are difficult to please and that economic growth is still below par. It leads us to believe that a likely scenario is for a short-term correction in equity and bonds followed by a re-energising of unconventional monetary policy.

From a risk perspective B.U.M.P is at the very heart of the world's financial system and as a node has high connectivity to all parts of the system, this means that for investors in London, Ireland, Australia and Asia there is going to be no where to hide if the US Fed gets the next phase wrong. The choices for the Fed are not great. They know they have to exit and to do so on tiptoes for fear of creating a new crisis. They desperately need to be bailed out by higher inflation and a healthy GDP growth rate. Inflation is in our opinion going to remain elusive for some time.to come. The greater chance is that we re-enter a deflationary cycle as a result of the Fed pulling back. For this reason we expect a see saw of indecision and volatility.

In other words B.U.M.P is going to prove too hard to achieve. Central Banks will run scared of their political masters and after a fall-back, QE or an equivalent will recommence. It will not be good for the long term but it may save the day this year. The other alternative is not good. Investors may get spooked badly enough to all try to exit at a similar time. A rout in equity prices is entirely possible in these circumstances. Either way it is going to be a bumpy year full of risk potential.

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