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# Global monetary policy - the view from Down Under

Dr Robert Gay | Fenwick Advisers | 16 November 2015

Each year, PortfolioConstruction Forum hosts 10 portfolio construction practitioners on its annual Research Roundtable International program, visiting a select group of fund managers in the US or UK over a six-day program. October saw the group visit Boston and New York. I joined the group in Boston, to exchange ideas and perspectives over the course of a two-hour workshop entitled "Global Monetary Policy... Where to from here?". [Publisher] Graham Rich had invited some impressive thinkers, including Dr Woody Brock and PIMCO's Fed watcher, Tony Crescenzi, to fan the fires of discussion. I rounded out that panel of experts.

Somewhat to my surprise, these learned insiders tended to share remarkably similar views on the medium term outlook, although not perhaps on the immediate outlook for 2016. Usually, consensus is shortsighted and opinionated - whereas the panel clearly wanted to take the high road and focus on what was fundamentally troublesome in world affairs. Several of the experts' views were widely accepted:

- First, central banks could not conceivably fix the ills of the global economy whose problems were structural. Governments had to make so sensible decisions, yet most of them were not.
- Second, US short-term interest rates would stay low for a long time; and,
- Third, policy rates at zero were a mixed blessing and the costs are beginning to outweigh the benefits. Governments that should deal with their mounting debt instead were able to kick the can down the road and financial markets know they are being taken for a roller coaster ride but are choosing to turn a blind eye.

Beyond that, however, there was not an overwhelming consensus on causes and consequences.

I thought it would be a good idea to poll the 18 worshop participants on some basic monetary policy issues. Surely, this capable group of knowledgeable financial professions would provide some valuable insights. Participants had to vote ‘yes’ or ‘no’ even though there is plenty of gray area in the questions. We three panelists were not allowed to vote - but here, I take the liberty of adding commentary around the participants' answers.

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**1. Are central banks doing the right thing? Y = 10; N = 8**

Sentiment may have been more favorable in the early years of the Great Financial Crisis. QE has diminishing returns, blunts incentives to de-lever and, ultimately, does little for Main Street.

**2. Does the world have a problem with too little growth? Y = 17; N = 1**

Almost everyone shares the fantasy that growth can solve a lot of problems – and it can, as long as spending and investments are not wasteful. The *quality* of growth may matter as much as the *quantity*. Dr Brock castigated government officials for their shortsighted attachment to populist transfers and lack of leadership on investments in infrastructure and public goods.

**3. Does the world have a problem with too little inflation? Y = 10; N = 8**

Deflation can be devastating for debtors and investors but efforts to force inflation up can be a fool's game. We may rue the day when our fears of deflation precluded sensible policy adjustments.

**4. Does the world have a problem with too much leverage? Y = 14; N = 4**

Too much leverage has been the root cause of almost every financial crisis of the past six decades and the next one will be no exception. It is only a matter of time before some source of sketchy loans or hidden leverage serves as the catalyst. Participants understood the dangers of too much debt – the 'No' votes simply implied we have not yet reached a tipping point. I agree, but will keep a watchful eye in the precarious years ahead.

**5. Do financial markets have a valuation problem? Y = 11; N = 7**

A world with policy rates at zero is an irresistible climate for carry trade bubbles. Even if the Fed exits ZIRP, the ECB and BOJ seem destined to fuel those leveraged trades for years to come. I judge that most everything we own – from property and equities to fixed income and foreign exchange – is distorted by the carry trade mentality or its flip side, the rush to the exit when underlying presumptions change. The recent market volatility was not the big event – just a heads up for things to come.

The mother of all carry trades may be yet to come as China throws open its fixed income markets to foreigners in the hopes of winning IMF support for including the yuan in the SDR basket. As I write this, the PBOC is offering a small slice (5 billion RMB) of 1-year debt in London so as to coincide with Xi's visit. The deal is four times oversubscribed at a projected yield of 3.1%. Australia's carry trade bubble was fueled by less yield spread.

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**6. Are financial markets inherently unstable? Y = 11; N = 7**

Any follower of Hyman Minsky would say 'Yes', but most investors are imbued with the comforting delusions of the efficient market theory that are peddled by Wall Street and are presumed in their products. History, of course, tells a different and sadly recurring story. Financial institutions are the Achilles Heel of capitalism, at least when regulators fail in their oversight duties. Now, the backlash from the last crisis is contributing to the setting for the next one, as an unintended consequence of the new regulations has been to reduce dealer inventories of securities and, hence, market liquidity.

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*Dr Robert Gay is managing partner of Fenwick Advisers, a financial consultancy serving global investment banks, hedge funds, and other fund managers and financial institutions including fixed income manager, Stratton Street Capital. Prior to forming Fenwick Advisers, Dr Gay served as international economist and global strategist Morgan Stanley, Bankers Trust and Commerzbank AG. He spent eight years as Senior Economist with the Board of Governors of the Federal Reserve System in Washington, DC, primarily during the chairmanship of Paul Volcker.*

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