Torschlusspanik!

GaveKal | 16 October 2014

The Germans, it is said, have a word for everything - and their word for what we saw in European and US markets on Wednesday and in Asia on Thursday morning is Torschlusspanik. Literally "gate-shut-panic", this describes the nasty crush that develops when everyone rushes at once for an exit that is fast closing - inevitably someone gets injured.

The stampede, in which investors dumped equities and peripheral eurozone bonds and sprinted for safety in high quality sovereigns, brought the cumulative fall in European stocks over the last four weeks to 13%, well on the way to bear market territory. The oil price, down 26% since midsummer to US$83.35 a barrel for Brent crude, is already there. Meanwhile the US treasury market has defied all predictions of a sell-off, with the yield on the 10-year note dipping briefly below 2% yesterday, a level last seen in May 2013 at the start of all the talk about tapering.

A confluence of factors has caused this turbulence. The US recovery may be holding up, but activity in the eurozone is fast deteriorating, while both China and Japan are decelerating. What's more, with US quantitative easing set to end this month, the European Central Bank appears either unwilling or unable to pick up the baton and launch an equivalent QE program of its own. Neither Beijing nor Tokyo is keen on further big stimulus efforts, leaving investors facing the uncomfortable realisation that once the Federal Reserve finally closes its spigot, there is no immediate alternative source of liquidity to support risk assets. With top quality bonds guaranteed buyers by new rules on bank balance sheets, US treasuries are the obvious place to hide. Stop-losses and margin calls have done the rest.

That explains the short-term moves.

More ominously, setting the current upheaval against longer term shifts in the economic landscape suggests that investors may have to get used to more such panics in the future.

Charles has long maintained that the expansionary monetary policy followed by the world's big central banks must lead sooner or later to a collapse in the velocity of money, and from there to deflation. And, as he explained last week, when all inflation has evaporated, the choice is between either a deflationary boom or a deflationary bust.

The economic history of the 19th century, much of which was spent in deflation, teaches that the move from deflationary boom to bust happens when stock markets crash. Indeed, in a deflationary environment, recessions are not caused by excess inventory or capital spending, as during periods of inflation, but by the collapse of asset prices pumped up too high by a general mood of optimism and expanded leverage. The late 19th century was littered with such market crashes in Europe and the US. With extensive debts linked to the inflated price of assets, margin calls typically came in thick and fast, leading to a true collapse in the velocity of money and, more often than not, major bank collapses. The 1890 collapse of Baring Brothers, Britain's largest bank, which in turn helped precipitate the 1893 Wall Street Panic and subsequent US recession, provides a good example.

This time around, it is likely that investors have borrowed trillions of US dollars to play the rise in asset prices engineered by central banks. On top of that, huge amounts have also been borrowed to develop new sources of energy which were only ever likely to break even at oil prices of US$80 a barrel or more, a crunch point that now appears dangerously close.

Charles's Wicksellian analysis suggests that real market interest rates are fast moving above the natural growth rate. If they were not, there would be no reason for bonds to outperform equities, as they have over the last 12 months. If his view is right, it implies that we may be on the brink of a new recession, and that the approaching slump may well be preceded by a genuine collapse in the shares of banks, where much of the bad debt is parked. In that case, it is no accident that bank shares are underperforming so badly.

The good news in all this, argues Charles, is that we are finally reaching the end of one of the most misconceived policy periods in economic history. The bad news is that asset prices will have to adjust to the new reality, hence the current Torschlusspanik.

Charles's long-standing advice to maintain a balanced "anti-fragile" portfolio holds good - don't hold the stocks of companies with negative cash flows; avoid companies with high debt levels; and, hedge equity holdings with very long-dated government bonds, preferably denominated in US dollars or renminbi.

GaveKal is one of the world's leading independent providers of global investment research. It also advises several funds with combined assets of more than US$2bn. In Australia, GaveKal Capital's GaveKal Asian Opportunities Fund is available through Certitude Global Investments.
