Its Fears Made Fools of the Fed

Lars J. Pedersen
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lars23jacob@gmail.com

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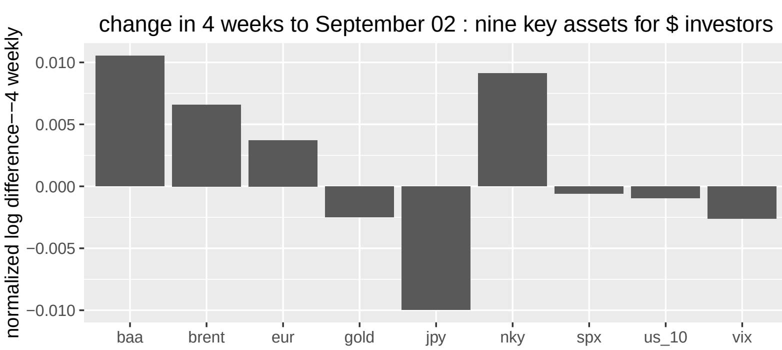
Credits rated BAA rose steadily in value as oil prices, and bankruptcy risks, stabilized. Other carry trades did well, too.

The latest drop in the US VIX index of equity volatility was another version of this carry trade, as investors reasoned US rate hikes were likely to be small and far between.

In line with stabilizing views, equities broadly recovered in the last week, except in Australia, where equities are commodity-centered and where the dip in oil prices was taken badly.



Post Brexit, central banks reacted or overreacted to fear of a shock. Markets then recovered to higher values than before the supposed shock, so many investors concluded that carry trades are back. Central banks are too fearful, according to this view, to rock the boat of asset market valuation bubbles.

It is a comforting but tentative view. Elsewhere, a weaker yen was enough to push up Japanese equities, at least over the span of time we record. In fact, both prices have mostly just been volatile in a range as investors seek new direction.

Oil prices, similarly, were increasingly volatile and uncertain. The index of US equity volatility, VIX, was itself highly volatile, ending the month down.

Fiscal policy at Jackson Hole We spent much of the month mentally huddled with the central bankers at Jackson Hole. What next if we hit another crisis? Looking back, we now see that the Fed was enormously constrained in stabilizing a system on the point of collapse in 2008-12. It was held back by a toxic political environment dominated by stale ideas of fiscal austerity dating back at least 45 years, to a time when fiscal spending was arguably a source of *inflation*. Today the issue is, rather, deflation.

In the face of this austerity constraint, the Federal Reserve had little choice in crisis but to adopt massive quantitative ease. It hoped that buying a big enough portfolio of bonds would lower long term yields enough to then trigger new private investment decisions. After the fact, we now know the main effect of quantitative ease was rather inflated asset values, some increased spending by the rich (with assets to be inflated), but also rising inequality and broad social and voter discontent.

After eight years of this, an important part of the financial system–government interest paying debt–has been replaced with central bank reserves. This has implications. Many have to do with the ways bank deposits and money market funds transform vast excess reserves into near-money for the public. Raising rates now requires that interest rates be managed up symmetrically for both classes of near-cash, using reverse repurchase agreements available equally to both. Similarly, US non-insured money market funds could become unstable at negative rates–if bank deposits hesitate in following market rates down. This risk may be the main reason US negative rates have been largely ruled out even in an emergency.

Looking ahead, conference participants gently tried to point out to politicians the advantages of having fiscal policy available ahead of another crisis. Professor Sims constructed a case for treating the fiscal and central bank sector as a single unit interacting with the private sector. For him, the massive replacement of bonds with money leads to a *reduction* in interest income to the private sector. He argues these income losses should be made up with larger primary public deficits to maintain a non-deflationary overall impact. Elsewhere, Ms.Yellen kept her gingerly phrased comments to politicians to her footnotes. There she mentions bigger automatic stabilizers (like Federal transfers to support state and local construction in a recession) and Federal spending on productivity-enhancing infrastructure should be considered.

Following this reasoning, one could even argue for fiscal spending *ahead* of any new crisis to push up inflation and allow nominal policy rates of interest to rise to, for example, 3%. At that point, asset prices will presumably have been held back and can recover on a quick rate cut back to zero, reinjecting wealth with some quick effect on demand.

United States

ACTIVITY	CREDIT	POLITICS
New home sales solid		
2Q inventory draw implies build ahead	Yellen: rate hikes very possible	Clinton plans infrastructure spending
Payroll steady	Jackson Hole Conference	Obama calls Trump "unfit"
Car inventories are high	Williams: need higher rates to cut if needed	
Surprise dip in ISM manf index	Fall in P2P lending	

Europe

ACTIVITY	CREDIT	POLITICS
German construction orders surge	IT fiscal spending after earthquake	
UK indicators mostly up after Brexit	Strong BoE response to Brexit	Renzi calls for EU fiscal support
Slow 2Q GDP	EU banks hurt by negative rates	Brexit declaration seems stalled to 2017
Delayed confidence weakness post-Brexit	Abengoa debt-equity swap	Italians vote on const. Reform: November
	UK company pension shortfall	Greek trial of statistician
	EU to charge Apple for tax evasion	

China

ACTIVITY	CREDIT	POLITICS
PPI inflation rises toward zero	Hong Kong-Shenzen financial link	
Steel company profits surge in July	Uber gives up competing with Didi	G-20 held in Hangzhu
G20 meeting and capacity cuts	Banks will swap loans for equity	Senior serving officers arrested
	IMF warns on credit risk	
	China Vanke hostile takeover underway	

US: after the drawdown, recovery. We still expect an end to de-stocking to give a strong impulse to the third quarter. It may be partly offset by flat car sales as car inventories jumped and production adjustments may be coming in the Fall. Hinting at that case, the ISM manufacturing PMI fell sharply. But cars may be offset by a solid housing sector, where construction is much called for to relieve a supply shortage, and by all the many service-side businesses that increasingly dominate this economy.

Payrolls gains were subdued. Ms. Yellen effectively promised to raise rates in September if job gains continued strong. Now what? For me, unusually strong gains in June and July were partly a recovery from an anomalously low May, and much higher than sustainable. Overall, I think this economy has been ready for a rate hike for some time, held off by the Fed's fear of a new financial shock. Only the most recent of these fears was of the supposed global impact of Britain's referendum to leave the European Union, the actual results of which now seem so negligible.

Meanwhile, global equities may yet have to deal with *both* US rate hikes and a possible big adjustment to tax rates. Apple's tax avoidance schemes in Ireland were found by the EU Commission to be unfair to other businesses. We knew that big companies can exploit laws meant to avoid double taxation of earnings to create double *non-taxation* of those earnings. In the Apple case avoidance reached exceptional levels. We now have the prospect that big multinational tax-avoidance opportunities are about to be cut back, either by the EU or by joint international efforts to cut out avoidance. Higher interest rates and lower after-tax earnings are not a good combination for equity valuations.

Europe: what Brexit? Mostly, the Brexit shock seems not to have mattered much. But in the last few weeks a few signs of weakness have popped up: Italian and French GDP growth was zero in the second quarter, IFO export expectations for Germany are now at the weak end of a range, and Italian consumer sentiment is clearly weakening. UK growth, however, which was expected to be most hurt by the uncertainties of Brexit, seem to have held up rather well. Overall, the proposal to exit Europe seems an ill-conceived idea framed by persons with no precise idea about how it can be effected. The legal complications and political sensitivities mean a announcement of Article 50 exit request may not take place until late 2017 after French and German election are over. After so long a delay, why bother at all?

Given this slight damage, if any, the Bank of England's emergency actions to cut rates and boost asset purchases may have been more than needed. It certainly gave global investors the sense that central bank asset buying at ever higher asset prices was a policy that can be relied upon. In fact, these actions did push down UK and European bond yields, jolt up global equities, and push down the pound.

European participants at Jackson Hole focused on the differences between European and US quantitative ease. Benoît Cœure pointed to Europe's unique fiscal constraints during the long wait for a constitutional reform that can allow Euro-wide public debt. In the meantime, the region's unique political incompleteness has driven policy into TLTRO operations to unify bank funding costs across Europe, and negative rates mostly to influence the value of the euro. Together with negative rates, even constrained buying of mostly non-government assets has created a shortage of low risk assets and supported the anomalous negative yields we find across much of Europe. Cœure points out that the obvious solution is more debt issuance by national or trans-national governments now. For all our differences we all come to fiscal spending.

China's recovery. Iron ore, coal and steel prices are all up sharply in line with recovery. Some upward pressure may have been imposed by required cosmetic shutdowns around Hangzhou for the G20 summit, and some may be due to final demand. But purchasing manager surveys remain mixed, possibly held back by heavy flooding. And, there are weaknesses. Exports are stagnant, private investment seems quite soggy, rust belt shutdowns are still seemingly inevitable, and consumer sentiment is shaky. But aggregate data seems to show these are exceptions to broad recovery, depending on consumption and public investment.

If China is indeed in a sustained recovery at last, it will depend on fiscal policy, as elsewhere. Fundamental new funding plans have been announced to support pensions at the national level, and to fund local government services. Meanwhile, direct government investment in housing and rails is ongoing. All this builds on a program of steady wage gains across the nation that should support consumer spending as soon as basic public services and social insurance look likely.

In the meantime, a suprising surge in home buying has just erupted in the big cities. The surge is apparently fuelled by rumors that restrictions on buying were about to be imposed. Record prices are being paid for fresh land in those cities, and some construction orders must be forthcoming, which could explain some of the surge in steel demand. The surge in home buying seems to follow the imposition of sales taxes on foreign buyers in Australia and Canada, provoking the sense that staying in China might be a good idea after all. After recent swings of speculative capital into commodities (which then fell), bitcoins (subject to large theft), and P2P credits (subject to mass embezzlement) it seems the fashion has switched back to local real estate.

China's frantic investment swings are the necessary result of an overheated financial system. But wrestling this excess credit and money growth into a more normal process is tough because of how China's key state banks can still plead for relief from losses, recently estimated by the IMF at 7% of GDP. Political decisions will set the size of losses, and determine who bears the loss, so there might be less panic than see in a free market solution. But still, how can investors predict the exact settlement? And, indeed, a sense of dread may be setting in that could explain early signs of a new wave of capital flight developing in July, and the apparent slow-down in new private investment.

Excessive fears of the impact of Brexit may have made fools of the Fed. That becomes clear as the supposed global shock of Britain's eventual new terms with Europe seems to have little effect. At the Fed, the test for an overdue raising of rates after that false alarm should be much lower than it might seem. And not really dependent on any one payroll report.

Jackson Hole pointed to the logic of more fiscal spending to fight deflation. If the objection to easy fiscal policy and expanding social spending was its inflationary result, then clearly we have here the perfect tool to stop deflation. Certainly neither US presidential candidate is talking about any form of austerity. Even in Europe, a recovery and super-low interest costs will allow for some fiscal expansion within Maastricht norms, if those are even observed. And we find a decisive turn toward fiscal expansion in Japan and China.

So, we are working our way gradually toward recovery, backed with fiscal policy, and away from deflation. Critical now will be the actual evidence of higher prices across the system. This is where the nasty surprises will come. When they do, we will see acceptance of a higher rate path, and some meaningful adjustment to asset values starting in core equity markets.