Why The Central Bank Panic?

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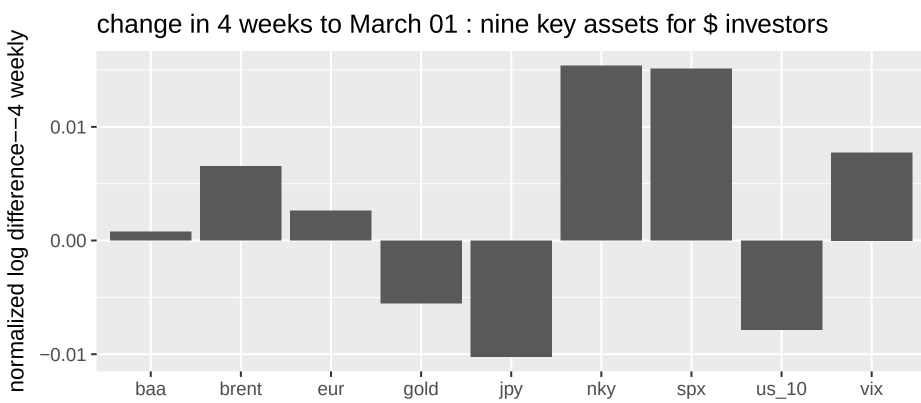
Investors have been buying equity, selling equity insurance (options), and selling yen for dollars–moving into structurally higher risk trades in key markets all month.

But just now, bond yields have just begun to tick back up, creating an isolated area of loss for bond holders. Losses became more pronounced in the last week of the month.

And oil prices keep edging up. This both promises to put pressure back on global inflation and hints at rather more final demand that was apparent during the flash sell-off of December.



Enormous gains in Chinese equity markets followed signs of progress in trade talks with the US. Perhaps even Mr. Trump has learned through observing equity prices that plans to dismantle global trade patterns are not a winning proposition. At the same time, inclusion of some Chinese stocks in global MSCI equity indices has pulled in funds once invested in other emerging equity markets, which fell.

But consistently softer trade and production news has increased the risk of a global recession. I do not believe it, seeing rather a mid-cycle inventory event, but outside the US some sectors are clearly in sharp contraction.

Leaping to compensate for the newly revealed economic risk, several central banks, including the Fed, have been panicked into announcing plans to adjust their quantitative ease plans. Earlier the idea was to wind down QE strategically and in the background, without reference to current conditions. (More below.)

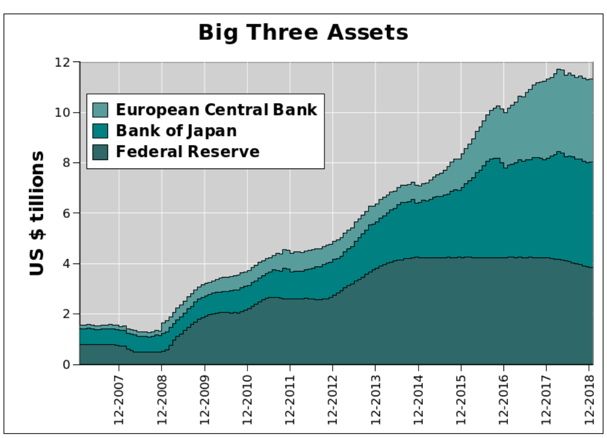
Where We Are on QE. Fright at the sharp equity and bond moves of December have been reverberating in central banking circles ever since. So far, the Fed has made a modest start in cutting down on its pile of bonds, the ECB has at least stopped buying, and the Bank of Japan has slipped into much slower buying. The first two, the Fed and the ECB, are now talking about delaying or even reversing these moves. Any delay would hold up the reversal of the massive balance holdings, built up to nearly $12 trillion between the big three. (See chart below: Big Three Quantitative Ease.)

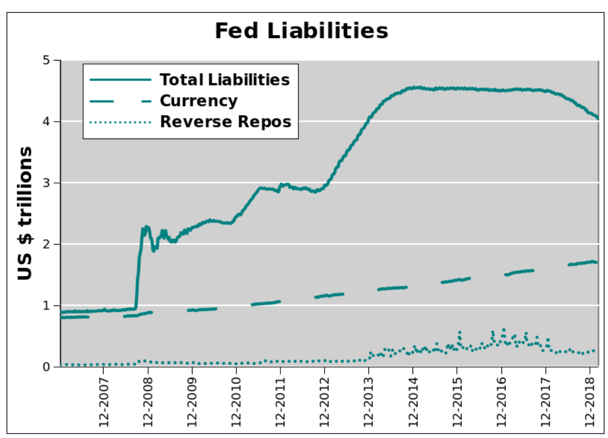
As shown, I measure all balance sheets in dollar terms. Finance is fungible, and official bond buying in Europe and Japan forces local investors to buy US corporate bonds, so the dollar total is relevant. Seen in this dollar-centric way, a rising dollar value has deflated the value of still-rising offshore central bank holdings, marking an important inflection point in big-three quantitative ease in early 2018. Earlier pauses in the pace of big-three bond buying in dollars, like this one, have corresponded to market disturbances.

In the US, the Fed's Powell is now suddenly looking at when to call off further reductions in the size of the Fed's balance sheet. Of course, the assets bought by the Fed equal its liabilities, as they do for any bank. Among the liabilities to be set against these great asset purchases are bank reserves, currency in circulation, and some smaller items. Noting that bank reserves have grown far in excess of the legally required amount, the Fed long ago adopted a "floor system" for setting interest rates, in which it offers to take up any excess reserves at the official rate, and pays a similar rate to all reserve holders. For reasons which elude me, the Fed now insists that this system, adopted to cope with excess reserves, now requires that some excess reserves be retained going forward. It is a thin and technical argument.

From that operational claim, Powell and others reason that minimum excess reserves will be needed of between $0.25 and $1.0 trillion. With currency liabilities rising toward $2.0, total liabilities, including excess reserves would need to be at least $2.25 to $3.0 trillion at the end of asset sales. Ignoring other smaller items, that gives you an equivalent rough target for the asset side of the Fed's balance sheet of $3.0 trillion, down from $4.5 trillion at its peak. To say that assets may stop running off this year, as Chairman Powell just did, is to say, that the portfolio adjustment could end earlier, at $3.5 trillion at current run-off rates. (See chart below: Fed Liabilities.)

Investors might ask why so large a residual balance sheet is needed for the Fed. And, why such large balances among the big three central banks might become a permanent feature of the financial landscape fully ten years after the financial crisis. What is it about our global system that requires monetization of assets, or so vast a commitment of central banks to stabilizing asset values? For these high balances, still close to $12 trillion in aggregate, remain a huge and distortionary force on global asset valuations.





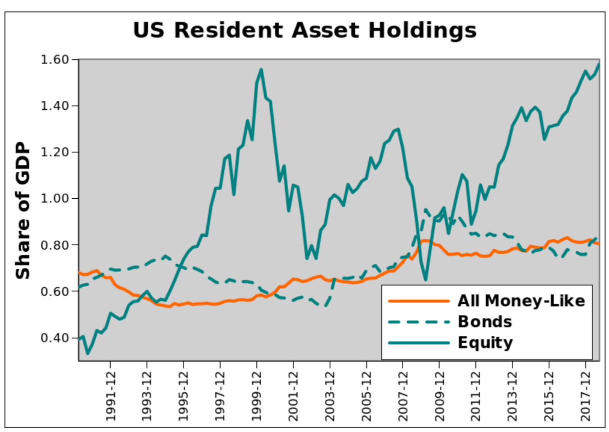
The Forever Bubble. One way to think about enormous central bank balance sheets is in terms of their impact on a supply chain from money-like instruments to longer-term and riskier credit. That chain of intermediation includes an ever-evolving variety of books of business, often outside of banks, that mitigate risk and earn return for capital taking risk. After 2008, as failing non-bank capital was wiped out, central banks also forced banks to derisk with capital write-offs and by requiring higher capital, reserves, and liquid assets.

From this intermediation-centered point of view, early Fed buying was understandably aimed at asset backed securities, including mortgage securities, that had turned toxic, destroying the capital bases holding them. ECB asset purchases of sovereign bonds similarly saved banks in weaker members of the monetary union. The ECB absorbed risk from its banks by taking on sovereign bonds, paying with excess reserves.

Later on, the objective of central bank buying shifted to targeting longer-duration government bonds. Now the objective turned to easing long-term rates, inciting investment and demand, to finally push up inflation to the point where negative real interest rates again become possible, if needed. Seen from the point of view of household and business asset holders, central bank intervention replaced bonds with bank deposits, money funds, mutual fund and exchange traded short term claims–all the direct and indirect short-term money-like assets available to the public and backed by the central bank liabilities issued to buy the bonds.[1] (See below.)

Asset holdings of US resident households and businesses ended up being pushed around in a big way. As government bonds were withdrawn, total bonds available to US investors, even including mortgage and corporate bonds held at mutual funds, have slipped as a share of GDP since 2008. As I see it, a chain of reactions went from overall bond scarcity, to extremely cheap rates for corporate bond issuers, to opening the door to bond-funded corporate equity buy-backs, bidding up equity values. Along the way, important intermediation risk has found its way onto corporate balance sheets, while equity values (on fewer outstanding shares) are driven to levels seen at earlier market tops.

As a political matter, the system seems drawn like a moth to fire back to earlier equity value peaks. Because only through rising equity values can spending be inefficiently teased out of reluctant average consumers. Ultimately, the Fed's latest panicky move is actually an important, if unrecognized, step toward asset price targeting. Only the implied target seems to be related to regaining prior equity peaks, not any reasonable or neutral long run average. It is a fateful path to follow, and full of potential risks for the Fed and for investors.



[1]Extracted from US Flow of Funds as short-term assets of households and businesses held at banks, mutual funds, and ETFs. Similarly, bonds and equity are identifiable holdings of each sector held directly and through mutual funds.

Macro Surprises. Asian and European trade reports have been falling sharply. Some of the damage is industry specific: in Asia, trade in tech parts has plunged; in Europe and China, surging car production has paused. But so far these are all production side adjustments only. Income gains are holding up broadly, and could bridge demand over sectoral output dips. Some elements of China's purchasing manager's surveys already bear out a recovery in orders and a reduction in inventories. Similarly in Europe, German orders bounced back, as did French production once the gilet jaune demonstrations settled down.

US data, released after a delay, clarifies how we got 3-4% growth during mid-year as a result of income tax cuts. Slightly lower taxes for the majority, amplified by optimistic income tax withholding changes, brought funds into consumer balances, allowing a surge in consumption. Inventories suddenly looked slim, and Chinese manufacturers leaped to get production through US customs ahead of any more tariffs. Matching surges in US imports and inventories in 3Q was also felt in a boost in Chinese and other offshore production.

Without new tax cuts, US consumption has stopped advancing quite so fast. Reading across to China, suddenly weaker exports to the US now reveal underlying weakness, particularly in car sales and potentially in housing. A similar export surge and fall-back linked to the US was felt in Europe. But the effects of expansive US fiscal policy may not be completely over. Farm-sector income supports went through in late 2018, and military spending will ramp up in 2019. In China, an incipient credit crunch amid rising bond repayment failures was met with a record-setting explosion of credit in January. In Europe, higher public spending will be necessary as a political matter. Amid these mixed signals it is not clear that we are entering a global recession.

Going forward, the key may be how US tax cuts, aimed mainly at company taxes and for the rich, will play out. *Further* shifts in income to high-income, high-savings, persons were expected to fund investment, providing a happy closure to the tax cut experiment. Unfortunately, US investment has been notably restrained, partly because a strident populist program trashed business rules and expectations, making all investment uncertain at home and abroad. Chinese manufacturers and European car producers, particularly, fear for their US markets. We can only hope that this moment of global weakness will bring anti-globalist political experiments to an end.

Meanwhile, inflation has slowed. Mostly, this is due to lower oil prices. After dropping to a point that imperiled Saudi finances, OPEC reached an agreement to cut oil production, followed by surprisingly deep Saudi and Gulf cuts. Together with US sanctions on Iran and Venezuela, the shortfall in global production could start to be felt in inventories shortly. If so, oil prices and global inflation may be positioned to rise on the first additional evidence of economic recovery.

We are at a delicate inflection point for the global economy. Understandably, panicky central banks led by the Fed seem prepared to counter any economic dip with renewed balance sheet measures, a possibility which I had earlier, and still, rejected as unsound.

But portfolio adjustments are only an option to be used by central banks if needed. By making them available, central banks help investor confidence by reducing the odds of a deep recession. But if it turns out this option is unneeded, and the global economy pulls out of a trade and inventory hiccup, we have room for new reactions.

Indeed, if global growth resumes after a mid-cycle pause, risks in long-dated government debt markets across the system have now been magnified. By over-reacting, central bank suggestions of renewed bond buying may have taken bond yields down to a place from which they have a very long way to rise. So, dear reader, be very aware of any sign of reduced recession risk after the central banks have panicked in this way.