The Market School

Scit Uti Foro

The Twilight Zone: The 2013 Macro Outlook and Ongoing Bubble

The markets, the world and the televised know-it-alls remain in a sort of Twilight Zone. Optimists and pessimists are pounding their fists, warning one and all that to be too much of either is unwise. This may suggest the road to fiscal wisdom is best paved in realism. But what is reality in a world whose markets are not driven by the invisible hands of commerce (and old-fashioned supply and demand), but rather by the bond-buying powers of global central bankers? As I've written before, the massive amount of experimental market "doping" by the central banks of Europe, Asia and the US have created a convergence of both risk and reward whose consequences have yet to fully play out. Japan, who invented the QE playbook (which the Fed and ECB have since tweaked) is anything but out of the woods. One wonders if the Rising Sun's story (slow growth, currency devaluation and potential hyper-inflation) is a harbinger of our own fates or simply a lesson to be learned from—like some sovereign case study for 1st year MBA's. In this matter, as in so many other market discussions, (from HY to equities, interest rates to deficit rates, yields to spreads) calm and fear interact in a growing debate where reasonable minds differ—and differ strongly. In the US, for example, many believe the worst is over and point to real evidence of economic recovery: i.e. improving housing numbers, increases in retail and auto sales and other consumer confidence indicators. GDP is elevating, government tax revenues as well. And employment, depending on how you interpret the numbers, might be on the rise. Others (like myself), however, feel the recovery is merely an inflation of assets based upon a policy of postponed pain--a false calm before a storm whose intensity could range from simple market corrections to a disaster beyond the scope of 08. Again: we live in a strange Twilight Zone of optimism and pessimism, evidence and no evidence.

The following paragraphs consider the evidence. The aim is to navigate this world awash in FED liquidity and examine how monetary intervention and the flattened economic cycles have converged to slow growth, avoid short-term risks and delay pain while simultaneously creating asset classes to both consider and avoid. In many ways, we are sailing in uncharted waters. Aggressive monetary policies and QE 1 through QE infinity are an entirely new phenomenon. History has not seen printing like this across such a swath of geographies. Bernanke's college thesis is getting an international test drive with miles of road still ahead. (My faith, by the way, in relying on headline-making "supermen" to solve macro woes is thin. Consider Greenspan's promiscuous money and the dangerous bubbles that followed or the mind of Larry Summers, who despite Harvard's best efforts at making people intelligent, deregulated the derivatives market that opened the door to disaster.) The lesson of bubbles, past, present and future is always this: behind every loose monetary system, a correction awaits. We can't time the arrival of this (likely a few years off, but who really knows?), nor its magnitude. We can, however, consider the best places to play offense or defense beneath the liquid-heavy clouds heading toward the stadium.

I. First the Macros

I like to talk about macros. But it's worth remembering that there is often a big gap between what the macros say and what the markets (and hence your investments) do. In 2000, for example, just one year after 20-somethings were becoming overnight tech millionaires, the world seemed like a macro-happy wonderland of US budget surpluses, trade hegemony, innovation and relative peace, yet what followed was the worst decade in US investment history with a ten-year cumulative decline of 24% in the S&P. Today, meanwhile, US debt to GDP numbers are distressing, growth is tepid to weak, world peace seems like a fantasy and interest rates are on the full respiratory mode zero-bound while the S&P trades at all time highs. So much for macros, right? Well, yes and no... Eventually, the market comes around to mirror economic realities—it's just impossible to time the intersection or predict the type of fender-bender (or death-crash) at the crossroads.

The USA:

In the US, things "appear" to be improving. Housing markets are rebounding, which is a critical component of consumer recovery and hence GDP growth. 70% of US household wealth resides in real estate. In short: real estate matters, and it's comforting to see the home price index and home sales figures simultaneously increasing—the first time since 2005. Energy is another big tailwind for the US. 2012 oil production was astounding and this country is on track to surpass Saudi Arabia as the world's largest oil producer by 2017 (assuming Chinese demand doesn't falter before then.)… Our lead in developing shale gas only adds to the strength of this tail wind (but looks like a bubble to me—similar to the dot.com frenzy). Meanwhile, we continue to lead the world in manufacturing, as the cost advantages of going offshore (i.e. to China) for cheap labor are diminishing. Our banks are recovering faster than European banks, and our citizens, like their banks, are deleveraging. Finally, unemployment has fallen from 10% in 2009 to 7.7% today.

Despite the foregoing positives, the US is far from full recovery. Much of the consumer confidence that is stirring improved growth (and hence improved real estate, retail and employment numbers) is paid for by a market and economy that has a steroid-like addiction to the FED and its printing policies. There is simply no denying the direct correlation of the QE stimuli to the market "recoveries" since 08.

One thus wonders how the markets—and the companies that rely on those markets to employ workers and produce goods for sale—will fair when the FED stops propping the demand curve and bond-issuance via artificial means. In other words, how will the US economy ride once we remove the FED's training-wheels? As I've written many times, even the most broke undergrad can throw a good party if he's using his dad's credit card. At some point, the bill still has to be paid. For the FED policies to make sense (and they were needed, brilliant and daring in 08 but dangerously long in the tooth by 2013 and counting), this country (and its markets) will need to be strong enough to operate without Uncle Sam's credit card in the coming years. We are not there. The risk of the bike falling over once the training wheels come off is still quit real, and the degree of pain that might result could be much more than a scraped knee. Right now—whether the Fed "tapers" or not—no one can really be sure of how our economy will do on its own two tires. At recent conferences in LA and Las Vegas, the highly paid pundits/speakers made compelling arguments that none of this really matters. Their optimism rested on two seemingly reasonable points: 1) the US recovery is happening now; and 2) even if things aren't so great in the US or the world, where else would you want to have your money? (This is the "we-are-the-best-horse-in-the-glue factory" argument).

Neither argument is comforting beyond first glance. First, to say that the US is already recovering may be a bit of a stretch, bordering even on hubris. The gauge of our recovery cannot be based on a few consumer indicators or a rising S&P. Even the improving employment figures feel almost as misleading as our bogus CPI, as the reason for the recent technical outperformance in employment figures may be directly linked to the unfortunate fact that a large number of people simply stopped looking for a job. Most importantly, declaring a recovery in the middle of massive central bank liquidity spree is akin to declaring sobriety in the middle of your third martini. We are simply not out of the woods, not even close. And there is still the lurking question: how will we do when the money stops pouring in? If interest rates spike? Finally, the argument that the US is the best horse in the international glue factory ignores history as well as humility. Just because the US economy is relatively stronger than the EU or Japan in certain areas, doesn't mean we are invulnerable to distress or irreplaceable for opportunity, as our analysis of other markets (below) will consider. The world's markets today are highly correlated, and stress in point A quickly impacts stresses at point B. If Japan, for example, as the US' second largest creditor (holding over $1T in treasuries) suffers increased currency and economic trauma, the impact on our own dollar would be directly tied to what the Rising Sun does to a T-Bill-sensitive greenback.

The EU.

Ah Europe. As a German-American who raised his kids in France, I hold a special admiration and bias for the EU's people and places. However, as a realist and reader of history, I also hold a special skepticism for the long-term viability of getting 27 nationalities, languages, cultures, war memories and forms of government to agree on a common economic union, let alone a common –and needed--fiscal policy. Candidly, I just don't see it. But I hope I'm wrong. The former French leader spoke at the SALT conference this month (May) and made a beautiful and compelling case for a successful EU. He wisely reminded the American audience that only 60 years ago, the Europeans were killing each other in waves. That Europe, he said, will never return. Europeans don't want to go backwards. Cooperation, he stressed, is the only prudent choice. Sarkozy's point is valid, wise and hopefully prophetic. I share the view that Europeans are tired of killing each other, but that doesn't mean they've evolved to the level of cooperation and shared cultural identity needed to share the painful costs of union. (Even our own union in the US did not come cheaply in dollars or human lives). Europeans simply don't share burdens and responsibilities equally, and this can lead to a corrosion of feelings as wallets thin. Greeks, for example, who statistically don't pay taxes, have twice the average median household wealth of Germans, who have the highest percentage of tax paying workers in the EU. There's something unfair here. (Unbelievably, the median household wealth in Germany is 51,000 Euros, whereas in Greece it is 102,000 Euros—and in Spain and Italy the figures are 183,000 Euros and 174,000 Euros respectively.) At some point, frustration of the harder working north European voters will result in a refusal to carry the south European periphery, who have little taste for taxes, austerity and financial oversight. In other words: keep your eyes on Greece.

As for ma chère France, they now spend almost 60% of their GDP on government bureaucracy and civilian dependence, a level of big-brother support that even Karl Marx would admire but which has inadvertently created a population that expects support rather earns it. The private sector in France, like its favorite movie stars, is leaving in droves. In Portugal, the jobless rate for those less than 25 years of age is now over 40%. Needless to say, their best minds are leaving as well, prompting obvious questions of who will be there to lead this nation's recovery?

Over a year ago, I was even more bearish on the European economy and union. (**See 11/15/11 White Paper: Europe, Austerity and the Printing to Come**.) The banking crisis was at its peak and poised for a collapse unless the EU borrowed the US model of central bank printing, which I assumed they would. And they did. The EU had a choice between devaluing their currency (i.e. printing money) or suffering short-term austerity for long-term growth as the wiser path to de-levering. Needless to say, like Japan and the US, Europe chose the immediate gratification of Central Bank painkillers over austerity. Will this work? As with the US model (above) or the Japanese example (below), the jury is still out, though in all examples/regions, no meaningful GDP growth has resulted from the central bank printing presses. In Europe, collective GDP has not grown in the last 5 years. The prospects, moreover, don't seem promising going forward. Monetary policies in Europe (as in the US) have worked to prevent painful rate hikes in the periphery nations which would have broken some of them, but even the most generous central bank policies in the EU can't save its poorest economies.

Asia.

Japan is sailing into a perfect storm of demographic, currency, and central banking thunderclouds which have recently prompted some fairly brazen policies (i.e. a currency devaluation lead by $75B printed per month—out of thin air) to save itself. The country has never fully recovered from the Nikkei crash in 1989. Its consequent monetary policies and QE programs became the model—adopted and improved upon by the US and Europe—to deal with a post bubble recovery. In many ways, one could thus argue that the fate of Japan foretells the fates of others who use its recipe book to bake a solution for their own distressed economies. Let's hope we don't follow the Japanese example too far. (Bernanke, to his credit, moved, bolder, faster and deeper than the BofJ in dealing with our own crash in 08—but perhaps for too long). To date, its policies just haven't worked. Japan faces massive challenges. Since 1980, its GDP has grown only .5% per year. Its debt to GDP is a staggering 2.4X. The country takes in $470B in annual tax revenues but pays out $99B per year in interest rate expenses alone! Imagine if the rate for its bonds increases by even a minor amount? The resulting toll paid on interest expenses could cripple the country. Currently, the yields on the ten-year JGB's of just .5% have been a gift to this otherwise teetering sovereign. Because yield is a component of price (and hence supply and demand), much of this yield "stability" is based upon the fact the Japanese households are the biggest owners of these bonds. As long as there is no massive sell off (thereby reducing price and increasing the yield if these households become net sellers of bonds), the government can limp along paying its debt at low rates. But a large sell-off is increasingly likely, as the aging Japanese population enters a phase of de-saving to survive into old age—meaning selling more JGB's. This demographic reality is no joke—and more diapers are sold in Japan today for aging adults than for infants. Meanwhile, the gravity of this reality is only exacerbated by a deliberate policy by Abe's government to de-value the Yen to make Japanese exports more competitive. A de-valued Yen helps exports but hurts domestic consumers. That is, a weaker currency means higher prices for goods purchased by Japan's aging population, thus further encouraging de-savings and potential bond sell-offs, which in turn cripple the sovereign's balance sheet through high interest expenses. (The massive devaluation of the Yen will also negatively impact European, Chinese, American and Korean exporters who now are at a competitive disadvantage; exporters, after all, like their currencies to be weaker, not stronger than their peers).

Looking next at China, we see a nation which as lead the world economy in the last five years by providing 40% of the global growth in GDP. This is a compelling statistic. It is therefore always a concern when this engine of global growth shows even the smallest signs of a misfire. Q1 growth for China was a mere 7.7%--which is of course much higher than the US and EU, but by China's historical standard, is a dramatic fall. Fitch recently downgraded China's sovereign debt, pointing out its extreme increase in credit to GDP—up 125% from 2008. In other words, China is getting deeper into debt—just like everyone else. I've written elsewhere about my concerns over China's lack of transparency, its state-owned banking and enterprise system, and the various "bridges to nowhere" concerns that reminded me of Stalin's doomed 5-year plans, namely: "You build it, doesn't mean they will come." Economies made from the top down won't work unless the consumer meets it somewhere in the middle from the bottom up. I've never been to China. And I'm told by one optimistic L/S manager that if I were to visit, I'd see lots of BMW's, Ralph Lauren shirts and Louis Vuitton bags being consumed by its massive and growing population of capitalists. I'm sure this is true in may key cities. But just as Beverly Hills, Malibu…Palm Beach and Park Avenue are not the only places to measure US economic health, Beijing and the BMW-filled streets of Shanghai are not the only measurements of China's economic viability. Massive shadow banking systems in China hide the deeper reality of over 140,000 state-owned enterprises (SOE's) backed by local governments which are for the most part unprofitable. Recent data shows that China's SOE's, as a group, are unprofitable the moment you take out rent-free land and direct government subsidies…I feel China too is just another "doped" economy. But as the examples of the US Federal Reserve, the ECB and even Lance Armstrong demonstrate: doping can work for a very long time—until it stops working. For now, China tightly controls its banks and sits on a $3.3 T foreign exchange reserve, so any disaster there is still a distant prospect. Maybe, in the interim, their economy will grow from the bottom up and meet the supply provided from the top down. After all, that's what so many of the sovereigns discussed herein are gambling on: dump a lot of money into the economy and then hope it grows on its own.

If this works, we may indeed learn to ride without training wheels—in the US, in Europe and Asia. But my guess, based on the evidence, is that a one or more of these regions may have gambled too much. My eyes are on Japan first.

II. The Asset Classes

John Maynard Keynes wrote "[t]here is no subtler, no surer means of overturning the existing basis of society than to debauch the currency." Thomas Jefferson was equally candid, declaring that he feared a private bank making governmental, fiat-currency based manipulations of the economy more than he feared a foreign standing army on American soil. As discussed above, we are currently witnessing a collective decision by the world's leading central banks (in the US, EU, and Asia) to pump liquidity into their markets and directly (i.e. Abe's Japan) or indirectly participate in a race to the bottom in devaluing regional currencies to support export-driven revenues. The monetary policies of the FED, ECB, BofJ et al, just like the policies of the Chinese-government-controlled banking systems, have resulted in government-driven (top down) GDP rather than consumer-driven GDP. I believe the latter is the only sustainable way to grow an economy, and that as a result, one or some of the countries/regions relying too heavily on top-down growth (through aggressive monetary polices and poor fiscal policies) will eventually experience failure. Global printing of money since 2008 is calculated at nearly $5T. Trillions matter. We are talking about massive amounts of money, predicted to reach $6-$7T by 2015. At some point, a levy will break. In Greece? In Japan? Spain? These are real risks.

On the positive side, however, I recognize that the original flood of liquidity post-08 has prevented a deflationary nightmare in the US and elsewhere—that sickening mélange of sinking asset prices yet constant debt/collateral values that force liquidations and ruin economies. QE, in proper doses, has indeed worked. The flip side to this good news, however, is that QE policies and the low rates that go with them have resulted in almost no returns for those seeking to save money. Investors are literally forced to put funds to work. This reality has prompted many investors to walk further and further out on the risk branch for less and less reward/return, because holding cash essentially promises negative real (inflation-adjusted) returns. This explains the massive influx of money, for example, into oil companies and E&P plays which assume oil (and other commodities) bought by the "China Miracle" will never wane…I think these are just bubbles. Oil in particular. It's a bubble—like everything else.

The impact of this liquidity-driven world is also daily being played out in the increasingly bizarre way individuals are investing in equities and fixed income (stocks and bonds, that is). Today, far too much risk is being taken for less reward, even (if not especially) in a rising S&P. Furthermore, the markets as a whole—here and abroad, debt and equity—are no longer natural. Central bankers (and politicians, most of whom are ignorant not only of many things, but particularly of history and economics) have perhaps interfered too greatly with the markets' fragile and inherent supply and demand currents. This interference runs an increasing risk of distorting markets at levels not fully understood or foreseeable. Of particular and obvious concern, is the inevitability of a rate hike, which will dramatically impact bond and equity flows, prices, and hence gains and losses. A 3% spike in Japan, for example, would result in interest expenses exceeding the country's actual tax revenues. In other words, all these historical and macro concerns matter. They impact countries as well as the asset classes within and among countries, which are increasingly co-dependent, correlated and hence co-vulnerable. It is to these asset classes we briefly turn.

Credit.

Liquidity-induced distortion is certainly evidenced in the bond markets, which are thin. When high yield (HY) shows only 5.7% spreads to treasuries, we may want to consider re-classifying this as the low yield (LY?) sector. Today, HY is a classic case of less reward for greater credit, duration, inflation and interest-rate risk—the four horseman of the credit apocalypse. In the brave, new post-08 world of top-down 0% interest rates (for now), one can suppose that even low yield is some yield, and hence attractive. Naturally, portfolios need a credit allocation (see Nov. 8, 2012 white paper on asset allocation), but in this environment, one should also look for exceptional managers able to locate good credit and realistic return in uncorrelated, niche opportunities (i.e. off the run ABS, performing bank loans from non-performing banks, distressed debt, direct lending etc.) rather than simply carpet bomb exposures to over-bought indexes etc. The current and bizarre enthusiasm for risk is reminiscent of the euphoric late 2006, early 2007 era (and remember what happened next?). The ongoing mania for HY is evidenced in record breaking new issuance numbers for Q1 of $119B. CLO issuance, moreover (which is just levered corporates at the end of the day), is ripping and frankly outstripping supply (March issuance of CLO was a post crisis high). The risk premium seems to have disappeared as central banks dope all the weak muscle indicators with artificial confidence and investors line up to take too much risk with a bemused smile? The old-fashioned warning signs of natural markets have been truncated by intervention, and we see a Twilight Zone high demand for a bond market that effectively offers high prices and low returns.

If one has to take risk in bonds, one should recognize that today the asymmetry with reward means the risk of getting it wrong is higher than ever. As in any asset class, smart investors must recognize that missing a rally is a wiser choice than participating in a sell-off/crash. Again, this means exiting the crowd and locating smarter, less correlated niche opportunities. Managers skilled in real estate instruments, relative value and cap structure arbitrage, for example, will squeeze safer yield from the credit market sponge today than simply riding the highs and lows of ETF-driven HY exposures to a potentially catastrophic (interest rate-driven nadir). HY is dangerously bi-polar, caught in a bear/bull tug-of-war between attractive spreads (around 520 bps, just below the 20 year median) and unattractive yield (today's yield-to-worst is 5.9% compared to a 20 year median of 9.76%). To repeat: the spreads are attractive, particularly when considering a default rate set at only 1%-2% trailing 12 month, but given how flat the yields are, one is not being paid for the duration risk of an interest rate spike, which no one can time but we all anticipate, someday…Managers with credit books designed to exploit the spreads but avoid/minimize duration risk via idiosyncratic trades expressing relative value or cap structure trades that do well in deteriorating markets will fair better over-all in protecting risk rather than chasing return. Oddly, so much of the money buying into the credit markets does not grasp this notion, and the declining volatility which this Twilight Zone euphoria has created in fact helps smarter managers by making their systemic hedges cheaper.

Equities.

Stocks were up and to the right for Q1 as investor euphoria over the fiscal cliff resolution prompted another risk-on rally. 2013 will likely be a banner year for bubbly markets and martini-obsessed FED/Market. I can't help but shrug, however, at the nature of this "resolution" (as well as the nervous triggers behind the rally). Dysfunction in Washington--and the market's faith in it--frankly astounds me. Let's keep it simple. The President's proposed budget for 2013, for example, allowed for a $1.1T deficit. The Republican's budget called for a $1.0T deficit. Red and Blue can't agree on anything—even the color of the sky. So what did the two parties agree to? A budget that allows for a deficit of $1.3T…And what have they done to tackle this number? Well, they passed a $35B tax hike (drop in the bucket solution), the meager benefits of which were then immediately quashed by the subsequent passage of a $50B hurricane relief bill. If our markets are being influenced by the wisdom of our government (and her debts), then woe to us. But few seem to notice as the Russell 2000, the Dow and the S&P indices hit all time highs on the tailwind of "sound Federal policies." The ironies abound.

It used to be that when the credit markets "zig," the equity markets would "zag" and thus portfolios were designed to have one allocation outperform while the other allocation lagged. More and more, however, the centrally-bank driven markets of the globe have become increasingly correlated, with the equity performance highly tied to the fixed income moves. When the music stops at the Central Banks of the world, all markets will race to find sustainable value. In short, they will rise and fall together. This is especially true when considering the undeniable correlations between HY markets and R2000 small cap stock as well as the shared behavior of investment grade credit and large cap equities. As equity indexes reach record highs in 2013, one cannot but wonder about the power of mean reversion and the scent of a correction in the air. Timing that is, again, arrogant and impossible—but recognizing the current weather patterns is neither. Markets do indeed "climb walls of worry" and as indexes peak in the equity market with every hint of "good news" in the world economy, investors keep nervously hitting the buy button, as if they know they are part of a herd, and feel safe there—but simultaneously are afraid of where the herd is headed. I won't time the correction—the great reversion to the mean. And long term portfolios properly allocated, hedged and time-horizon disciplined shouldn't bother to time or worry either, but ride it out—for it will be a bumpy one. Predicting cap-sizes and names for a one month or one year horizon has never been an interest of mine. But understanding—and bracing for reality—is something for which all investors must take responsibility. We are in interesting times.

Which brings me back to the opening theme: the Twilight Zone. The major markets of the US, Europe and Asia can not be observed, traded or anticipated using traditional indicators, cracks or positives—as so much has been glossed over by pain-avoiding policies of central bank-driven rather than fundamentals-driven markets. The resulting impact on supply and demand, interest rate moves, flatted yield curves and over-bought equities based on misunderstood "good news" all point toward a market that is, well: weird. Given the artificially low rates imposed from above, we live in a world that punishes savings and thus forces investors to put money to work –often times taking far more risk than the market deserves. Meanwhile, that very market seems to run on false rather than natural steam. When the central bankers (or "alchemists") of the world slowly or abruptly "taper" their liquidity injections, we will begin to emerge from this Twilight Zone. When we do, my guess is there will be more pain the pleasure—as we've been avoiding the former for too long, and the markets (like an ocean) have a way of reminding us who is in control.

It's rarely a central banker.