On the QT

It's been a while and lots of ships have passed under the bridge, including an unnecessary election in the UK, the sacking of 12 White House staff members for various "misdemeanours" but mainly for disagreeing with he who must be obeyed, an interest rate rise in the US and the "successful" launch of yet another North Korean missile. There are sure to have been far more important items on the agenda, but the one constant has been the rise and rise of the US stock market.

One thing that has changed and is unarguably the most important event so far this year is the central bank narrative. Before Bernanke became an ex master of the universe he opined that QE - quantitative easing - didn't work in the way the Fed had and anticipated i.e. cheap and plentiful money would promote economic growth as businesses borrowed to expand their operations.

They borrowed all right! To the tune of having a lot more debt than in 2008, now representing 45% of GDP. Not too shabby when compared with US government debt at "only" 100% but then they don't have the distinct advantage of being able to print money. Whilst the cheap money regime continues corporate management will continue to borrow to fund share buy backs that cosmetically enhance earnings per share. Fewer shares, same, or in the case of many US corporates lower earnings, and the value of those shares rise as we are currently seeing.

Interest rates need to rise to make the corporates turn to real investment in their businesses to grow earnings, without the need for financial chicanery. The Fed have been slowly turning the tanker around firstly by cutting off new QE, then by reducing the reinvestment of redemptions and they are now talking about "normalising their balance sheet" by selling back some of their holdings in US Treasuries and other assorted US debt. In other words, "QT" - quantitative tightening.

The ECB have also joined in. Such is central bank speak, they have not said, "yes we will reduce our balance sheet any time soon", but they are nearly on the same page as the Fed. Meanwhile Kurodasan is still trying to cap JGB yields. When he eventually fails, when not if, the BoJ will join the club too, but a lot of damage will have been done by then. Hubris always seems like a good idea at the time...

The Fed will probably raise at its September meeting into a storm of increasingly poor economic data. The "recessionistas" are repeatedly told that a GDP slowdown won't happen until the yield curve inverts i.e. short dated yields are higher than long dated, but what should short rates be in an environment where the market sets rates not the central bank? 3%? 4%? There's your inverted curve right now!

This brings us nicely along to the current state of the markets. How would they react to higher rates and/or a recession? Not well, I guess you would say. Here are some observations from Howard Marks at Oaktree.

"We have some of the highest equity valuations in history."

- The S&P 500 is selling at 25 times trailing-twelve-month earnings, compared to a long-term median of 15.

- The Shiller Cyclically Adjusted PE Ratio stands at almost 30 versus a historic median of 16. This multiple was exceeded only in 1929 and 2000 – both clearly bubbles.

- While the "p" in p/e ratios is high today, the "e" has probably been inflated by cost cutting, stock buybacks, and merger and acquisition activity. Thus, today's reported valuations, while high, may actually be understated relative to underlying profits.

"The so-called complacency index – VIX (the S&P500 volatility index) – is at an all-time low."

- What's the significance of the VIX, anyway? Most importantly, it doesn't say what volatility will be, only what investors think volatility will be.
- It's primarily an indicator of investor sentiment "Forecasts usually tell us more of the forecaster than of the future." – Warren Buffett.
- In a similar way, the VIX tells us more about people's mood today than it does about volatility tomorrow.

"There has been an elevation of the can't-lose group of stocks; the FANGs, reminiscent of the Nifty 50. When taken to the extreme – as it invariably is – this phenomenon satisfies some of the elements of a bubble including:

- trust in a virtuous circle incapable of being interrupted;
- conviction that, given the companies' fundamental merit, there's no price too high for their stocks; and
- the willing suspension of disbelief that allows investors to extrapolate these positive views to infinity.

"We have seen a movement of more than a trillion dollars into value agnostic investing aka passives."

- Passive funds do no research on the companies they buy and are ambivalent about valuation.
- They hold more and more of the increasingly expensive and less and less of the cheaper value stocks.
- Buy at the top sell at the bottom. What could go wrong?

"We have the lowest yields in history on low rated bonds and loans."

Netflix issued €1.3 billion of Eurobonds, the lowest-cost debt it ever issued. The interest rate was 3.625%, the covenants were few, and the rating was single-B. Netflix's GAAP earnings run about $200 million per quarter, but according to Grant's Interest Rate Observer, in the year that ended March 31, Netflix burned through $1.8 billion of free cash flow. It's an exciting company, but as Grant's reminded its readers, bondholders can't participate in gains, just losses.

"Yields on emerging market debt are lower still."

"We are witnessing the highest level of fundraising for private equity in history"

“The biggest fund of all time – Softbank Vision – has just raised $100 billion for levered tech investing.”

“Billions are pouring into digital currencies which are backed by nothing – not even a central bank promise…”

“I absolutely am not saying stocks are too high, the FANGs will falter, credit investing is risky, digital currencies are sure to end up worthless, or private equity commitments won’t pay off. All I’m saying is that for all the things listed above to simultaneously be gaining in popularity and attracting so much capital, credulousness must be high and risk aversion must be low. It’s not that these things are doomed, just that their returns may not fully justify their risk. And, more importantly, that they show the temperature of today’s market to be elevated. Not a nonsensical bubble – just high and therefore risky.”

“Try to think of the things that could knock today’s market off kilter, like a surprising spike in inflation, a significant slowdown in growth, central banks losing control, or the big tech stocks running into trouble. The good news is that they all seem unlikely. The bad news is that their unlikelihood causes all these concerns to be dismissed, leaving the markets susceptible should any of them occur. That means this is a market in which riskiness is being tolerated and perhaps ignored, and one in which most investors are happy to bear risk. Thus, it’s not one in which we should do so.”

On the QT I couldn’t agree more.

Clive Hale –The View from the Bridge – July 30th 2017
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