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A Cold Wind Starts To Blow (October 2018)

S&P World Equities (Chart 1)

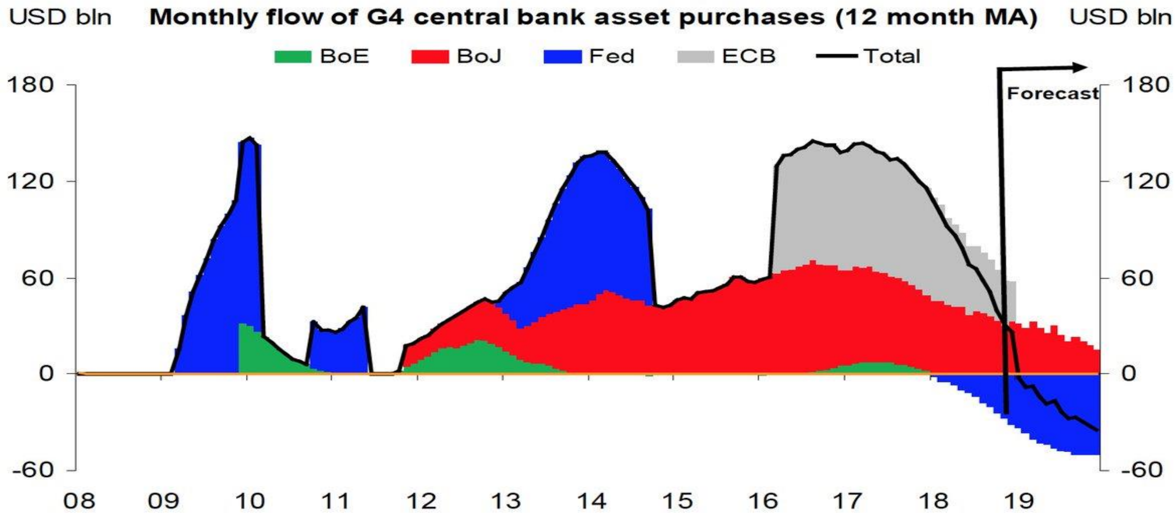
2018 has been a bad year for shares.

The key question is whether in 2018 we have witnessed a long term trend change in equities towards the downside or whether the drop is merely a correction in an otherwise continuing uptrend?

I do not claim to know the answer but there are reasons to suspect the former, mainly because of the ending (or more like drawing to a close) of Quantitative Easing. We have written about QE many times before.

Chart 2 shows the current and imminent state of affairs among the main Central Banks. It shows that the Bank of Japan (red) is still doing QE but at a falling rate, that the European Central Bank (grey) has been reducing the rate of QE and is about to stop, that the Bank Bank of England (green) has stopped QE and that the US Federal Reserve (blue) has begun to reverse QE (known as Quantitative tightening QT).The fall in share markets is mainly the consequence of this pattern of Central Bank activity. Everything else is a side show in my view.

Central Bank Balance Sheets (Chart 2)



Assumptions: Fed will redeem assets to the terminal cap of $ 50 bn consistent with the FOMC's Sep 2017 decision and the June 2017 addendum. ECB will buy EUR 15 bn worth assets in Oct, Nov and Dec 18 and then stop buying. BoJ to buy the average of 2018 so far in Oct, Nov and Dec 2018 and then stealth taper from Jan 2019 to bring monthly purchases to zero by Dec 2019. FX in the forecast assumed to be the same as Sep 2018.

Source: Fed, ECB, BoJ, BoE, Haver Analytics, DB Global Research

Quantitative Easing was a hopelessly optimistic experiment which was dressed up in academic language and implemented by bureaucrats who haven't worked in the real world. It is true that had QE not been implemented after the financial crash, several big named banks would have gone bust and that depositors and savers with sums greater than the guaranteed amounts would have suffered losses as those banks were liquidated. We are not naïve to this reality. It would have been painful and not particularly fair on the depositors since they played no part in those banks' downfalls. (That was baked into the cooking years earlier – at least since 1995, in fact.) However it would have been fairer on society overall for the rest of time had the bankruptcy route been taken. As it is, all savers and depositors have been fleeced anyway through minimal interest rates for many years and high effective rates of inflation. Low real wage growth, youth unemployment, bubbles in housing, increased income and wealth disparity and astronomical amounts of new debt throughout the economy have all been consequences of bailing the banks out through QE.

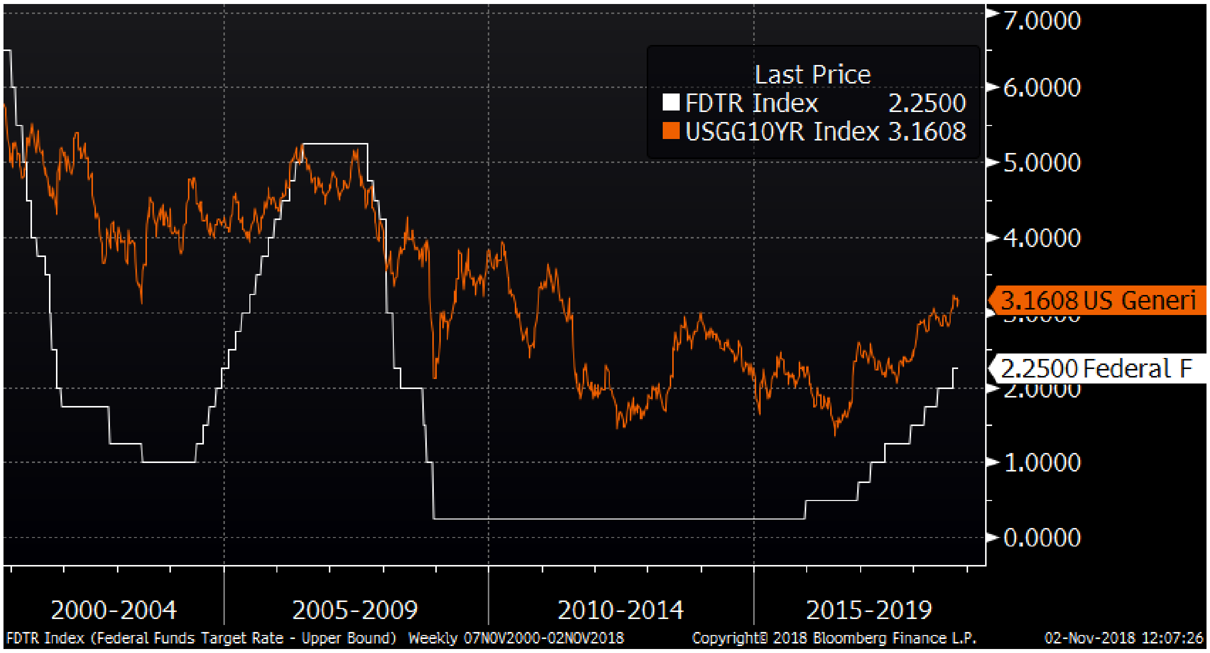
Despite all the technical soundbites, the Central Bank bureaucrats really only had one lever that they could pull which was the one which inflates the money supply. (Actually they had 2 or 3 levers but they are all connected and lead to the same outcome of inflating the money supply). It wasn't exactly coordinated internationally but it was implemented by central banks around the world in slightly different ways after the financial crisis in 2008 as chart 2 shows. The aim of the policy was the same throughout; it was to lift asset prices and in this respect, it succeeded. Put differently, continued falls in asset prices in 2009 would have shown the banks up for their nakedness and brought about their final demise. But the fall would have been natural and justified. Instead, in 2009 the bubble was given a huge and renewed burst of air.

The problem with the QE policy is that it has no equilibrium state. Even just to keep artificially inflated assets at their artificially elevated levels requires increasing boosting. If you do nothing the air gradually seeps from the balloon and prices fall. To continue to get assets to rise you need to raise the level of stimulus. And like a drug, you need increasing quantities of QE to achieve the same asset price fix in future. Standing still is no option while going into reverse by undoing some of the stimulus is going to pretty terminal (for asset prices). Ludwig von Mises wrote about this in the 1940's.

Central bankers have always sought to deny this. They have maintained that they could elegantly reverse QE (through QT – quantitative tightening and by raising interest rates) without adversely affecting asset prices *as long the economy was performing sufficiently robustly while they did it*. The thread running through the HLI monthly reports for the last 10 years has been that this is the single biggest flaw in the plan. As sure as eggs are eggs, if QE raised asset prices, then QT will lower them. And the act of lowering asset prices will itself cause the economy not to perform robustly.

Chart 2 shows how in the US QE stopped in 2015 and QT began in 2018; between the 2 dates the Federal Reserve neither expanded nor contracted its balance sheet. But chart 3 shows that during this period interest rates started to creep up, which has a similar effect to the contraction of the balance sheet.

US Long and short interest rates (Chart 3)



The low in US *short* interest rates was reached in 2015, (in long rates in 2016) since when the Federal reserve has raised them 8 times. *Long* bond yields have doubled since 2016 from a low of 1.35% to the current 3.16% a) because they take their cue from the Federal Funds Rate at the short end, b) because Federal Reserve stopped purchasing them to add to its balance sheet (the QE point in chart 2 above) and c) because foreigners have stopped buying US Treasuries, notably the Chinese and the Japanese, possibly in retaliation to hostile trade negotiations. Whatever the reasons, the US long bond yield is used to value all assets, at home and in many other parts of the world, using net present value methods and so when it goes up it is just a question of time before the values of assets fall.

This is what finally began to happen in October.

QT was the main driver of markets in October although there may well have have been one or two additional and somewhat related factors at play. Asia has always been especially sensitive to changes in Dollar liquidity and this has declined recently as lending conditions have worsened as interest rates have risen. Europe has come under further pressure politically and economically. Growth is slowing, inflation has taken a tick up and the Italian government's stand off with Brussels is upsetting the orderly regime. The last of these has been covered in previous reports.

Conclusion

Under normal circumstances the bubble would continue to deflate and so further caution would be warranted. There is a lot of air still to come out of the balloon following years of distortion and no amount of *unexpectedly strong growth statistics or sudden appeasement of trade rows with China* could really change this.

What would change it, if only for another temporary (and probably shorter lived) period would be a reversal of the QT tightening and renewed full scale bouts of money printing and bond buying QE. I would not put this possibility past policy makers if there were another full blown financial crash. These measures would find favour with some investors although by now I feel that many will have wisened up. There would likely be a surge of scepticism regarding the competence of the CB stewards of our economy, to my mind, not before time. This is when important narratives change and the common knowledge would then become one of CB incompetence and knee jerk policy making. No one would ever believe in the viability of their so-called economic models ever again. Instead they might look at the real questions and ask whether at all it is possible to borrow your way to prosperity?

Until then we prefer to hold on to value where we see it and try to get paid income where we can find it. Gold remains a stalwart and we may increase in due course. We are moving back into Sterling in anticipation of some upbeat comments about the UK’s course in the world.