RUBRICS ASSET MANAGEMENT

Where have the economic unicorns gone?

June 2019

FIXED INCOME MACRO VIEW

After a tumultuous Q4 '18, 2019 began with great optimism at the prospect of yet another central bank reflation. Indeed the market grew palpably giddy when January's aggregate social financing numbers were released in China. If this was a sign of things to come then the global economy was back in business. Such optimism, we felt (and in fact wrote at the time – Global Reflation Fades, March 2019) was misplaced.

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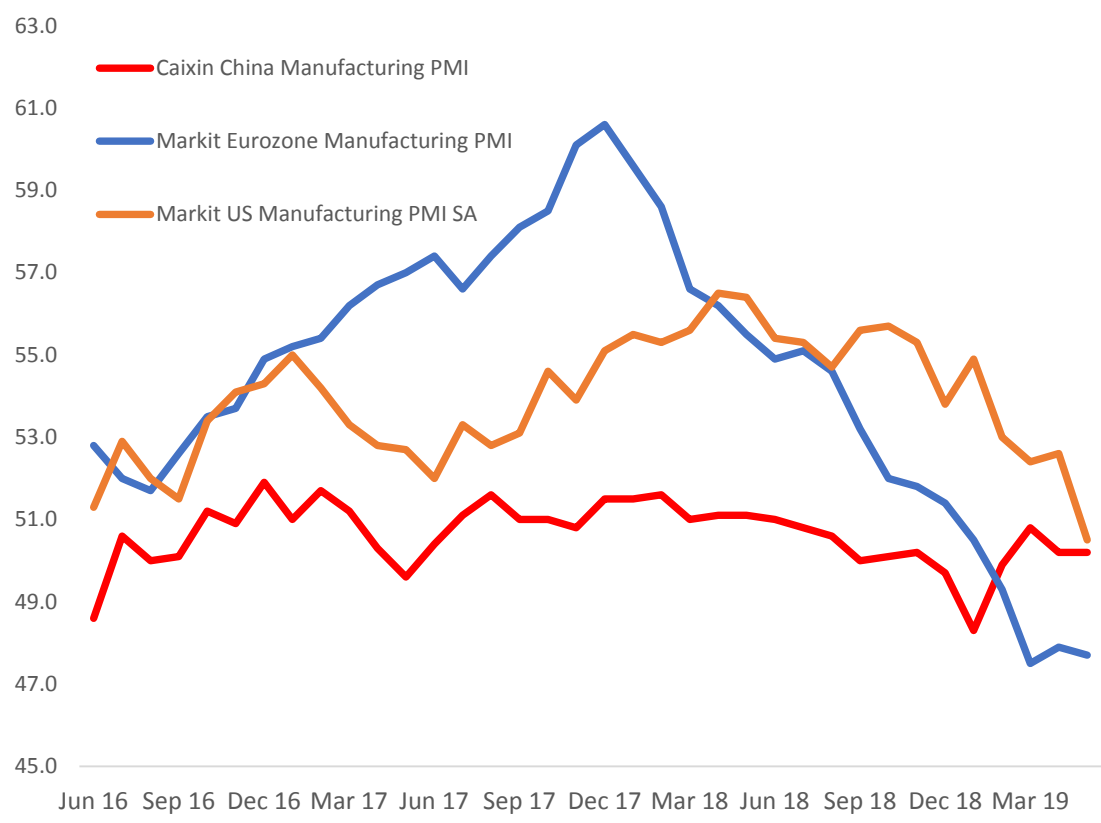

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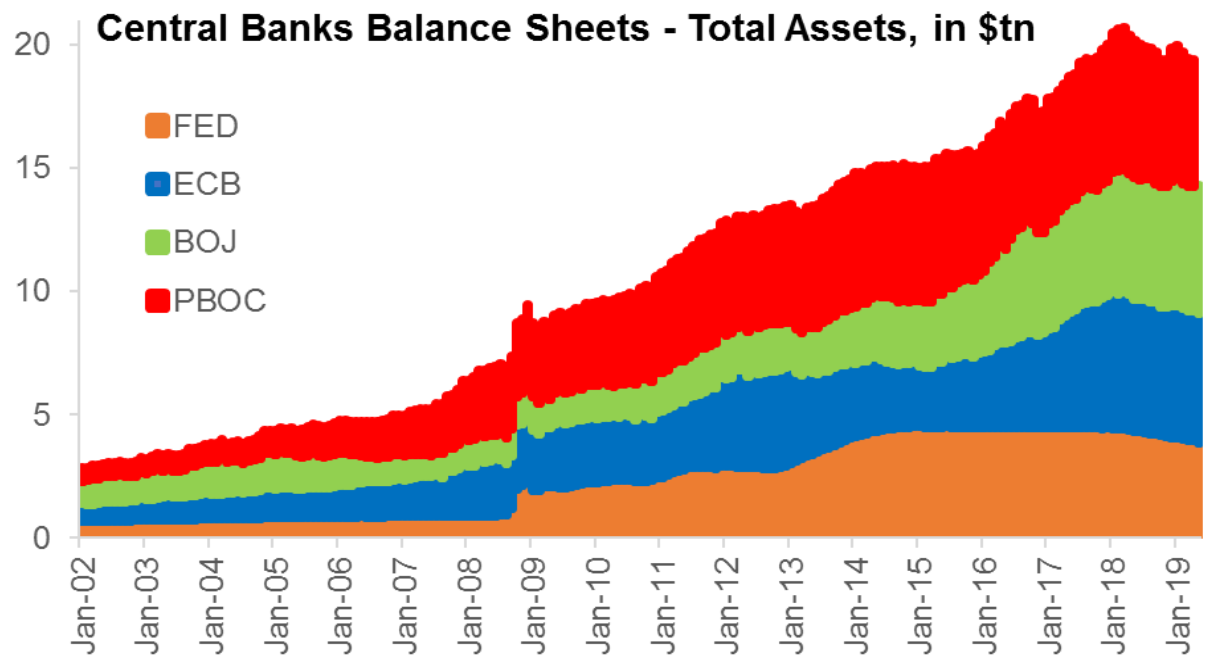
Fast forward five months and we have yet to significantly change our view. Without question some level of intervention was always likely - a stabilisation in monetary conditions after a period of US rate hikes and QT. However the kind of show stopping stimulus, to which the financial markets had become so acutely accustomed is going to be a difficult trick for the central banks to pull off this time. There is real concern today that we are pushing the capacity central banks have in stimulating real economic improvements.

In the US the Fed Funds market has gone from pricing 100bp of hikes by end 2020 to pricing in almost 100bp of rate cuts in the last 12 months. Meanwhile in Europe, markets are now pricing in the possibility of rate cuts from the ECB rather than timing the first rate hike. This has been corroborated somewhat by (amongst other things) global manufacturing PMI data which continues to show broad based weakness in the economy. Global bond markets have moved accordingly in pricing aggressive easing from central banks. All of which leaves the Fed with little firepower in terms of reflating market expectations further.

Source: Bloomberg,

Stimulus Impact

It is doubtful that any future stimulus will have anything like the impact of the post '08 global response. When all is said and done, there are only so many bonds corporates can issue, so many shares they can buy back. Credit expansion is critical for the efficient operation of the global financial system. But when interest rates hit the zero bound, it becomes increasingly difficult to keep the system going. If credit begins to contract, debt deflation beckons. After a near decade of $trillions in stimulus and zero to negative rates, we ask ourselves how much more credit can be created out of thin air, and furthermore who has the capacity to take it and use it for productive means?



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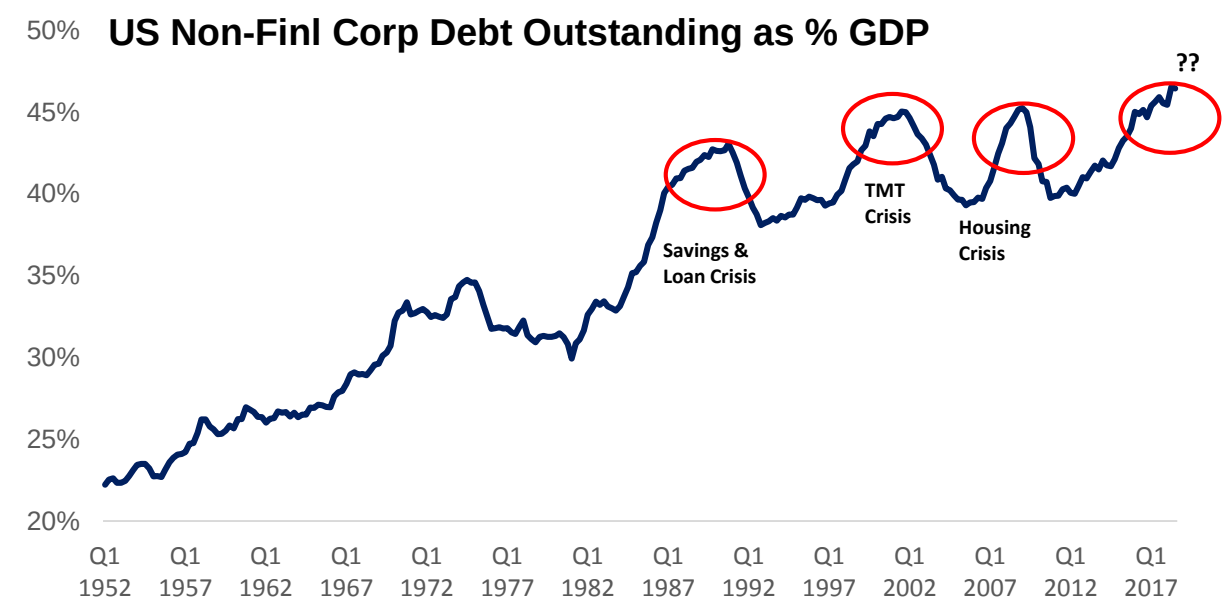

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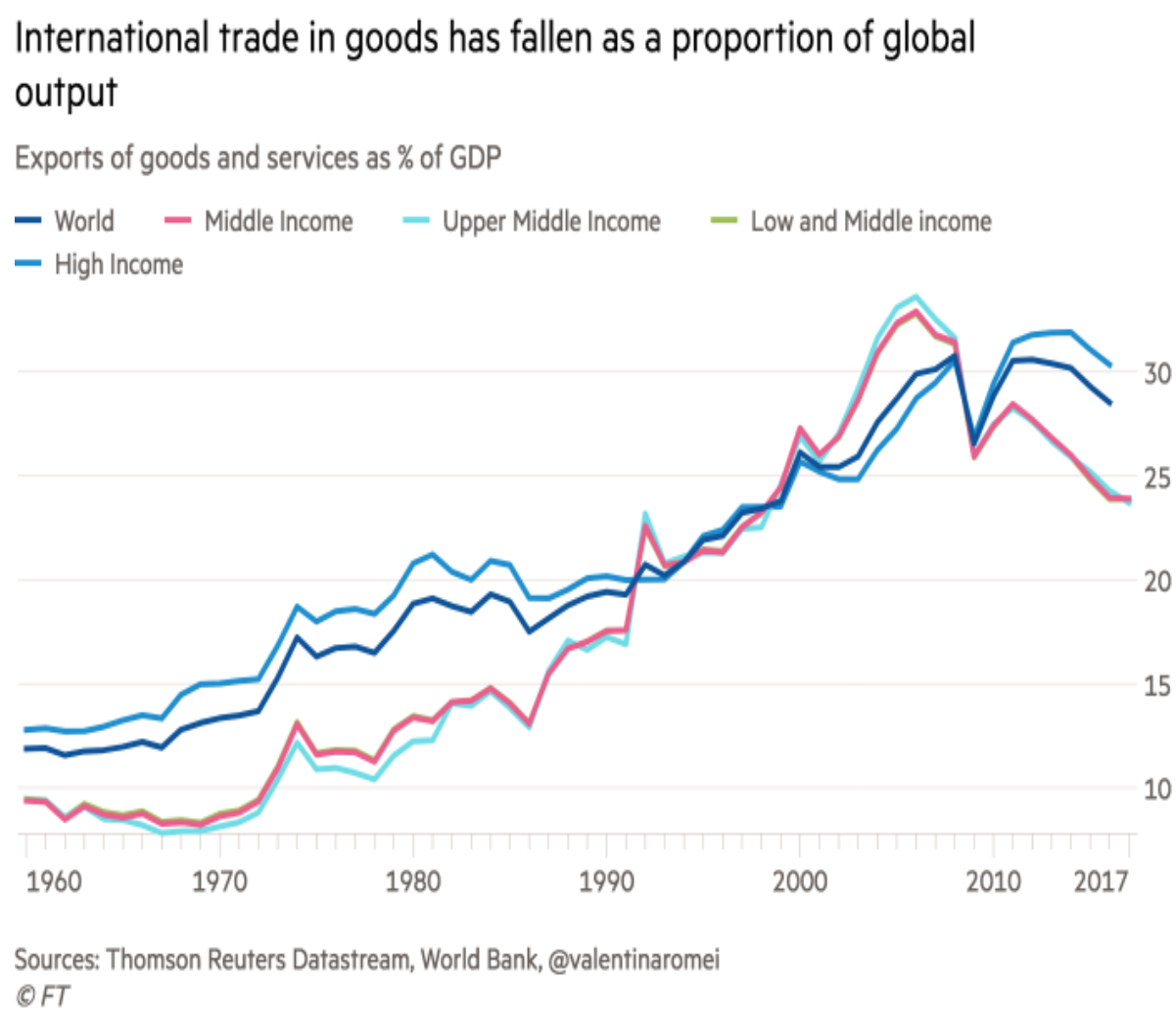
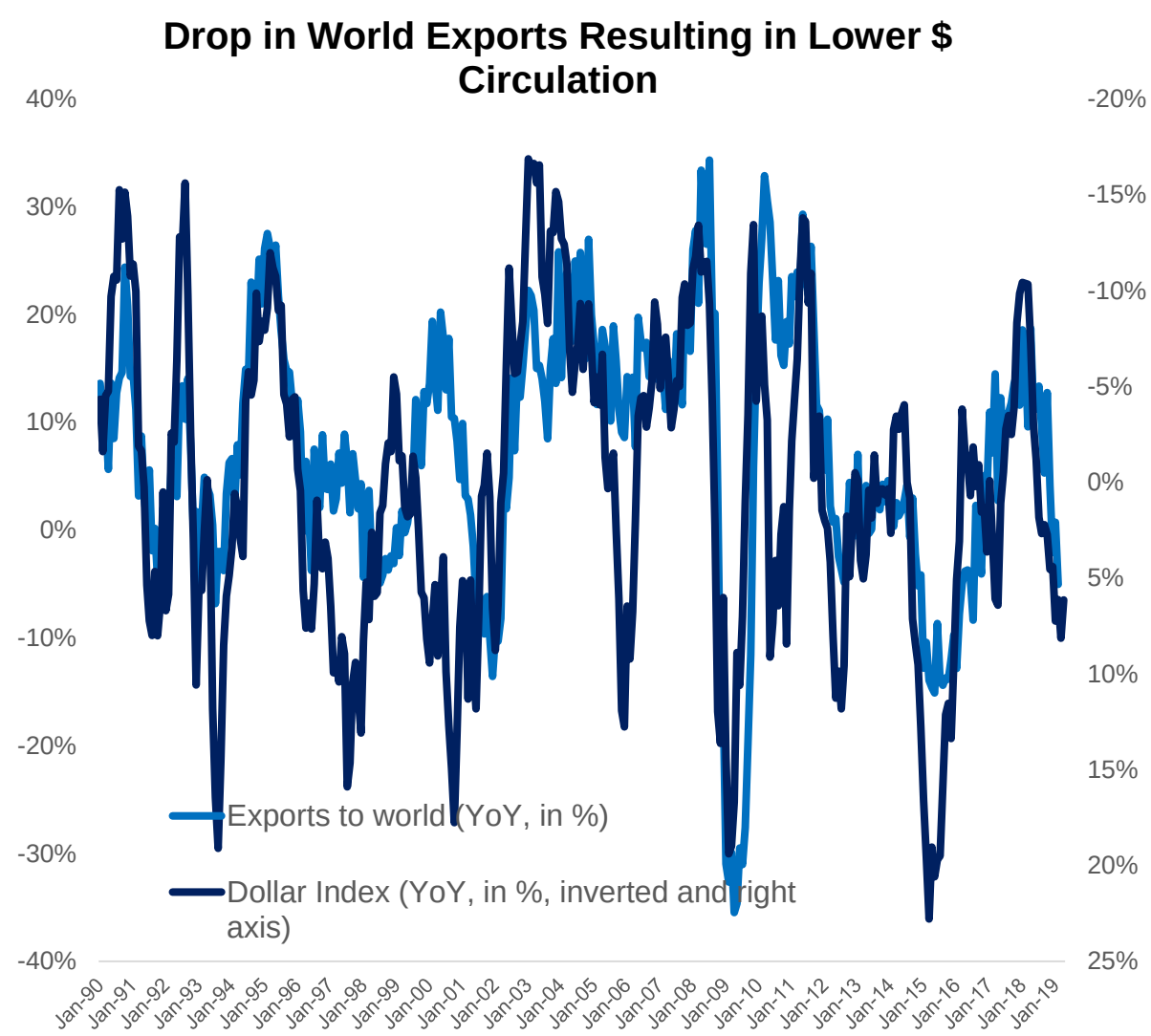


Limited Firepower

To reiterate our earlier point, given the headwinds from previous fiscal and monetary cycles, a full scale system reflation is unlikely to happen in our view. Most central banks have rates at negative or all-time lows and even in the US, which led the way with rate hikes in developed markets, the scope to cut rates is severely limited compared to previous cycles. Central bank balance sheets remain bloated and global debt to GDP metrics mean the capacity of economies to support additional debt is limited. Indeed the impact of such stimulus is also highly questionable given the lower marginal contribution to GDP of a unit of debt today. Recent US tax stimulus is a good example of the poor multiplier ill conceived giveaways can have. Better economics and politics is needed.

Impact of Trade War on the Global Economy/Dollar

Realistically, even without Trump's trade wars, things were going to be difficult. But given the escalation of the events with China (and potentially others) the economic backdrop has taken a decided turn for the worse. As we demonstrated in previous updates, one of the most powerful elements for the reflation of 2009/2012/2016 was the co-ordination of effort from the world's most powerful central banks. Such a level of coordination in today's environment seems fanciful in the extreme. What's more, the continuing decline in global trade could be even more problematic for capital markets than is currently appreciated. Even larger central bank liquidity injections might struggle to turn things around as quickly as they have in the past.



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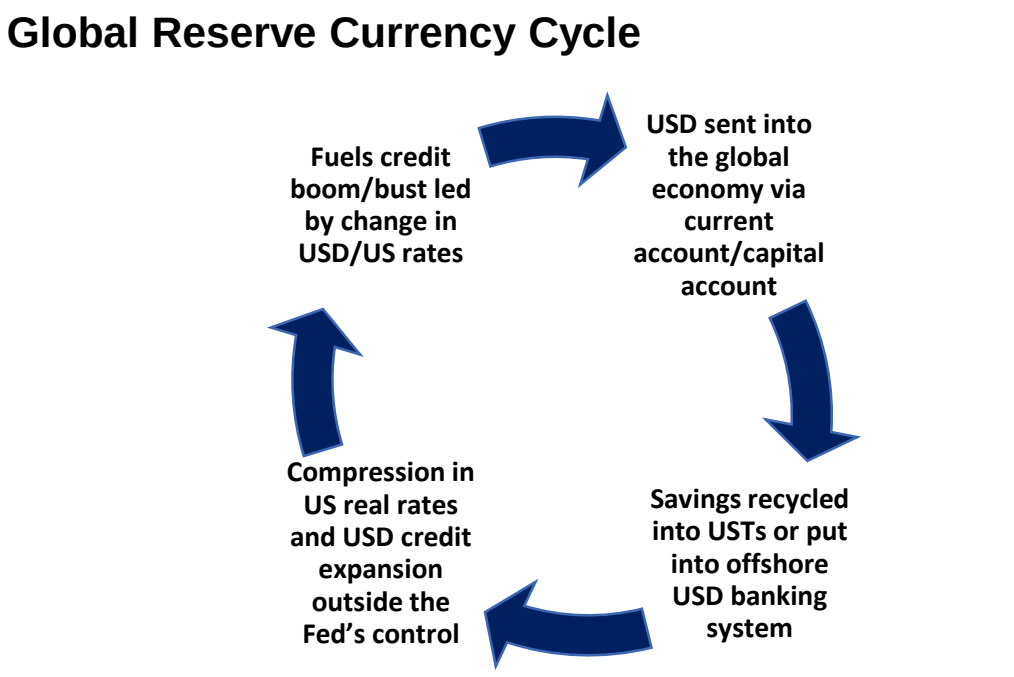
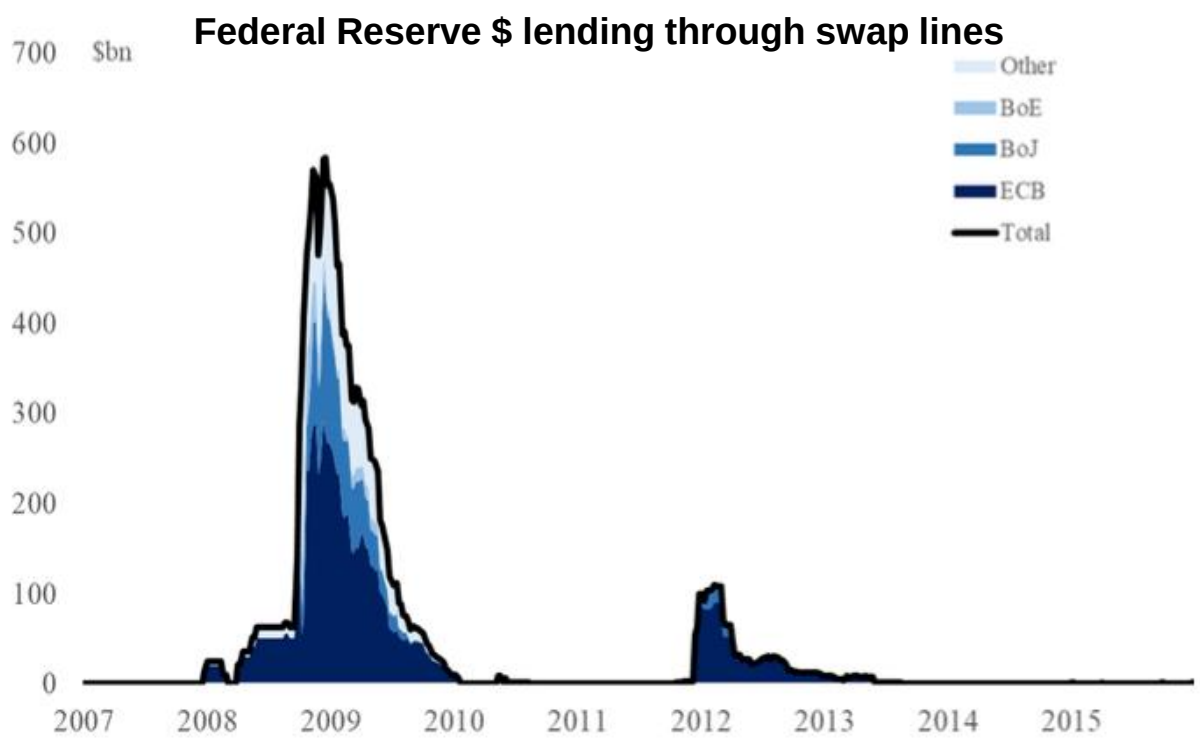




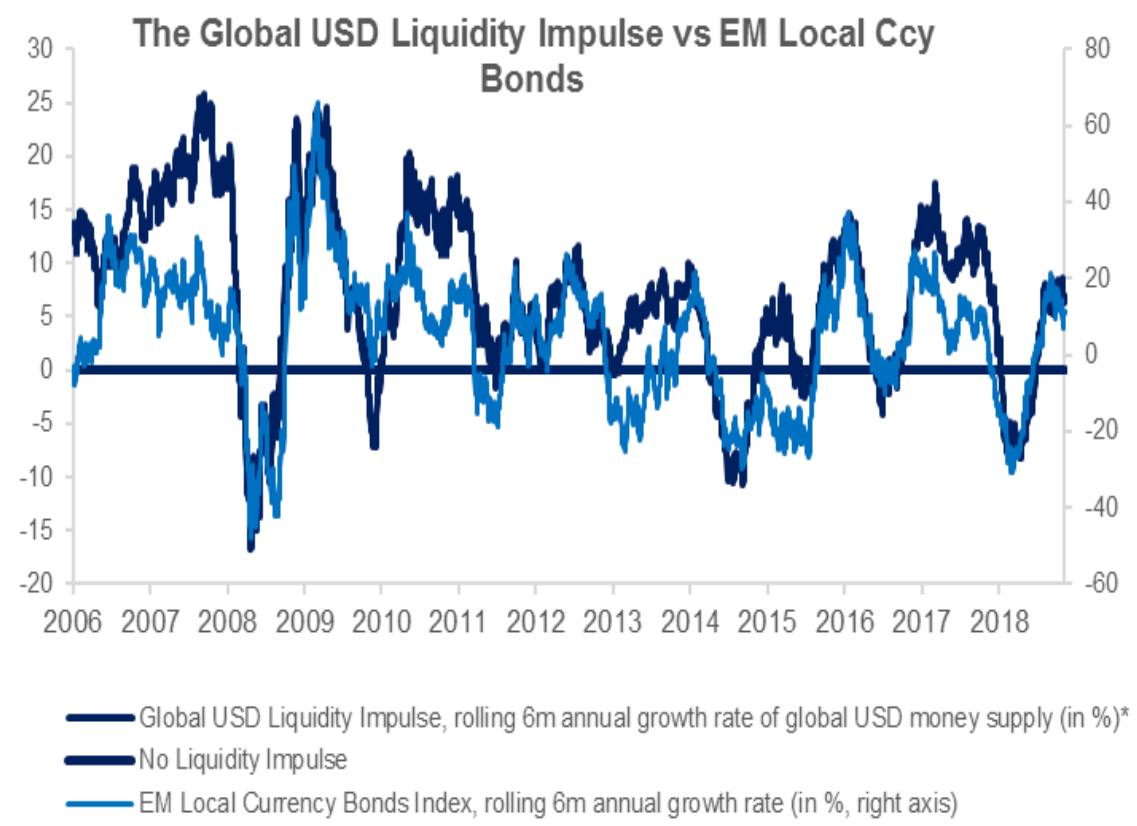
Source: "Central Bank Swap Lines" CEPR Paper - Bahaj S, R Reis (2018)

Political Pressure

In previous episodes of USD liquidity shortages, the dollar swap lines provided by the Fed were crucially important in alleviating stress in the system. This time around, we believe the Fed's ability to provide dollar funding to foreign central banks is greatly curtailed. Their lack of real firepower is clear, but as always, the markets will be the last to acknowledge this. In the current protectionist environment, it is unlikely that a similar level of coordination is achievable, leaving the economy and markets more vulnerable to shocks. The next contraction in risk assets may be closer then many expect.

Shortage of Dollars and EM

USD liquidity has been extremely important for emerging markets. Dollar shortages have hurt both on the local and hard currency investment side. The outstanding notional amount of USD debt securities issued by non-US issuers has continued to grow over time. Thus any shortage of dollars is likely to have a large impact on the ability of those issuers to finance principal and interest payments in USD.



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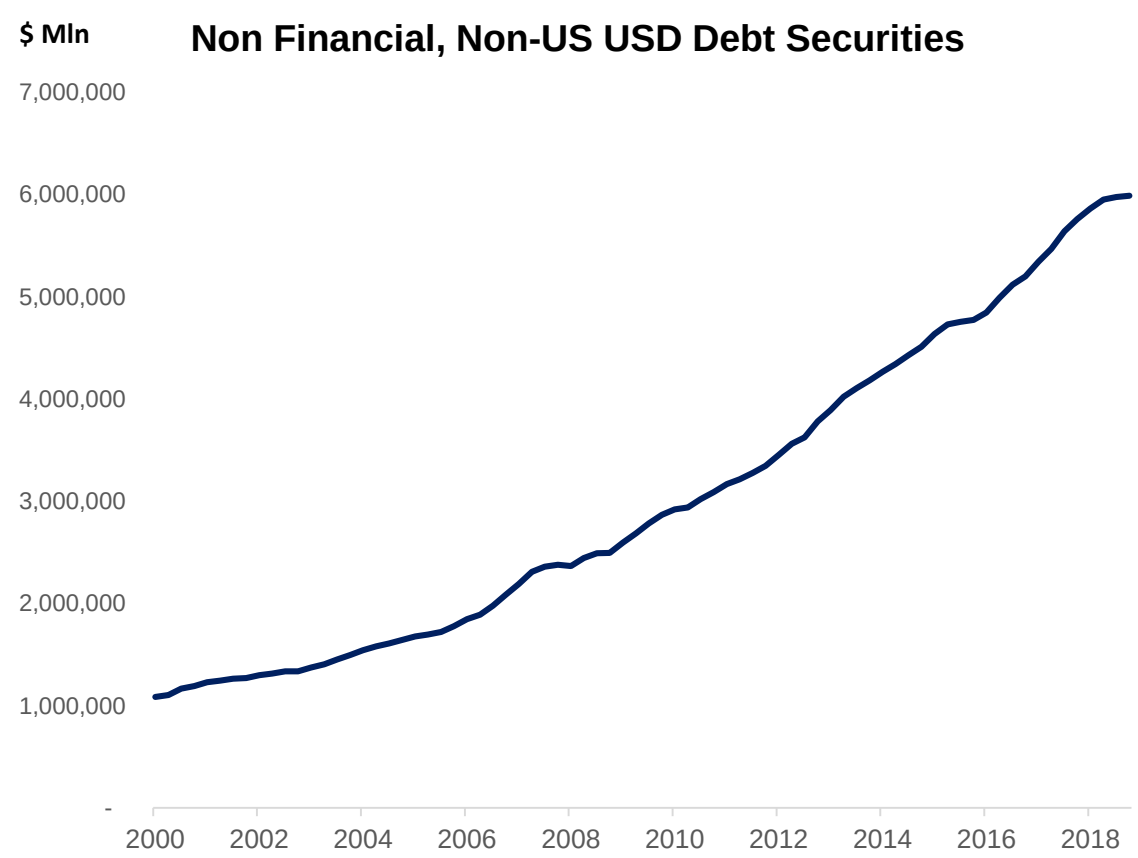
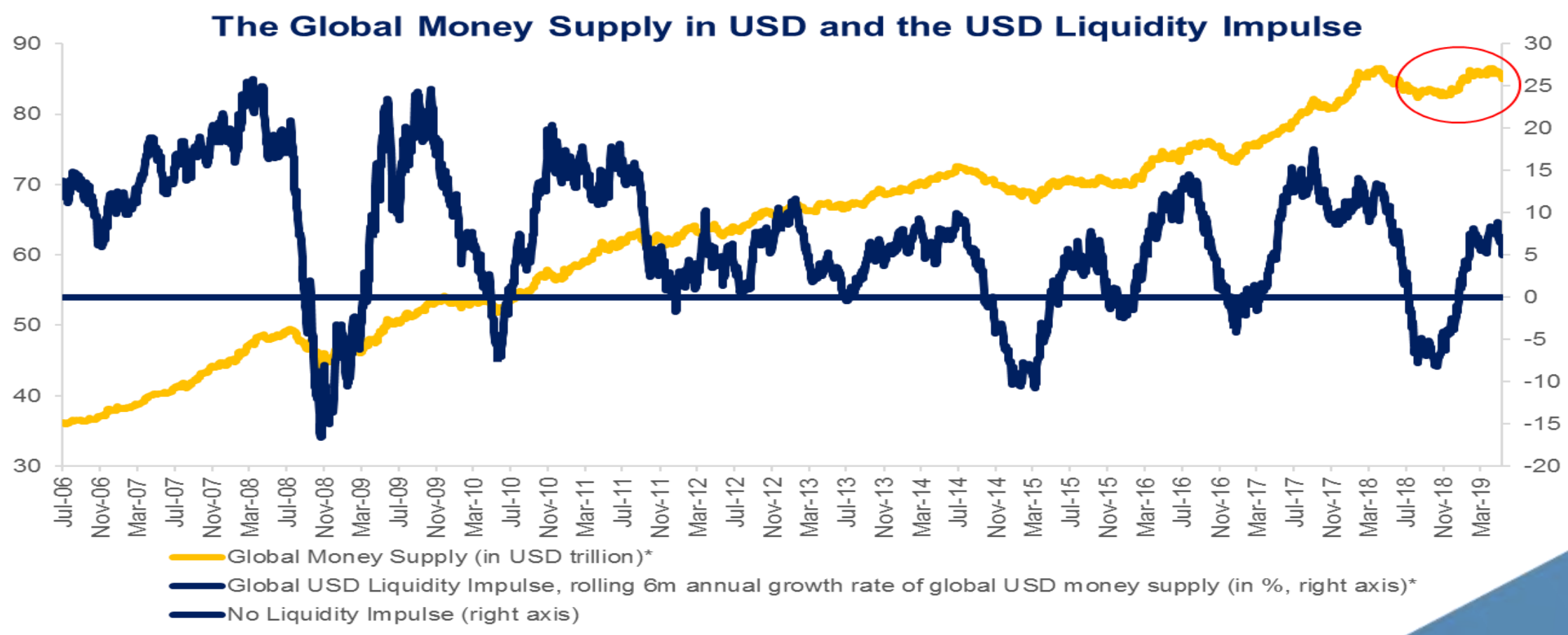


Source: BIS

Global Supply of US Dollars

Global trade plays a crucial role in supplying USDs to the international system. With this already in decline before the Trump presidency, and the current administration's limited understanding of the functioning of the global economy and protectionist leanings, the reversal of globalisation will create further challenges for the supply of USD to the system.



Source: Bloomberg, Rubrics Asset Management

CONCLUSION

There are so many question marks today around not just the outlook for economic growth or valuations in capital markets but bigger questions around what happens next to the global economy? Far more philosophical questions are starting to come up in areas where they were previously ignored. What is the extent of the structural problems (debt for one) in the global economy? Do central banks have any *effective* tools left? Is a new cold war between the US and China inevitable? Can we have any confidence anymore in the global leadership of the United States and what impact will that have on the status of the US Dollar?

Trump's trade wars are exacerbating issues that already existed before he was elected and will continue to exist after he is gone – few in the market today acknowledge this, which is a fundamental mistake in our view. Since the mid-90's it is no coincidence that sustained global growth has come against a backdrop of relatively peaceful co-ordination between the global super powers. The eventual rise of China and renewed self-assurance of Russia is testing that status quo. The United States at present seems ill-prepared to deal with the changing of this old world dynamic.

Turning inward, as Trump is promoting, is probably the least favourable outcome. The US should embrace these changes, or risk losing a seat at the negotiation table on what comes next - let alone being in a position to set the agenda as they did so successfully post WWW2. The outcome for global trade and the Dollar as the global reserve currency should be areas of major concern for the capital markets today. In the meantime, central banks will play with the capital markets and attempt to convince the world that they can prevent a recession indefinitely. This outcome would, as it has in previous cycles, encourage even more reckless investment activity. Recent developments at GAM and Woodford Equity Income Fund might become more common place in years to come.

IMPORTANT INFORMATION

June 2019

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