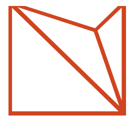


RUBRICS

Fleeting Euphoria or Enduring Optimism?

Fixed Income Macro View

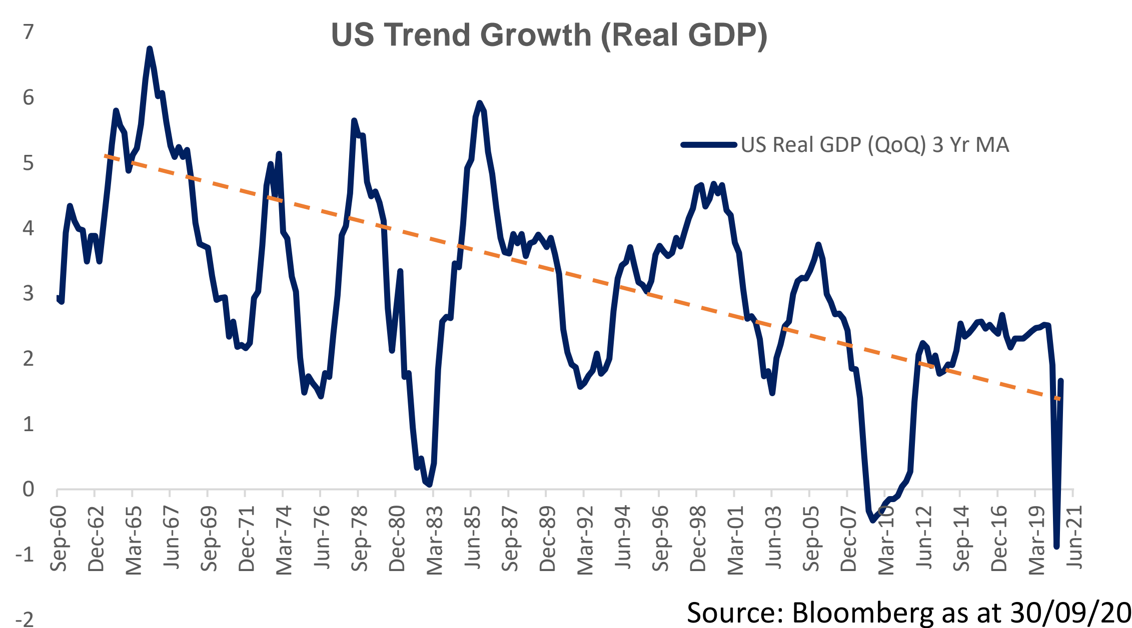
rubricsam.com

Rubrics Fixed Income Macro View

December 2020

Introduction

How long can euphoria last? According to Wall St quite some time, at least where financial markets are concerned. A combination of unbridled fiscal stimulus and the release of $1.4trln in pent-up savings is reason enough to be ecstatic, for the time being at least. Another way to answer the above question is to look to the past and previous patterns of economic behaviour. ***Though historical crises tend to have different origins, the outcomes are often eerily similar.*** The absence of real structural change and deteriorating demographics has resulted in a growth pattern that consistently reverts to the mean.



2018 was the last time Wall Street was as bullish for the forthcoming year. The near collapse in the financial markets and economic conditions that we saw in the 4th quarter in 2018 does therefore not bode well. Conventional wisdom however, tells us the Fed won't repeat the same mistake by prematurely removing stimulus. This begs the question: ***Is liquidity alone sufficient to suspend economic reality indefinitely?***

At first glance it might appear so, however looking at previous economic trends a different picture emerges.

Exhibit 3: Profit expectations at highest level since Feb'02

Source: BofA Global Fund Manager Survey

Source: BofA 30/11/20

The Old Normal

The pre-COVID economy was nowhere near as strong as either President Trump or the markets let on. Notwithstanding a $trillion dollar fiscal deficit and a re-opening of the monetary spigots, the US could only achieve 2.3% in trend GDP growth. Despite being close to full-employment, over 50% of US citizens did not have enough liquidity to last 3 months when the pandemic hit in March. The product of a system that favoured the asset rich over the living standards of the masses. Much of the broader positivity of the past decade was linked to a strong 'financial economy' (asset prices). Declining trend growth, excessive reliance on debt and lack of investment ultimately led to stagnant operating profits. This resulted in companies relying on financial engineering to boost earnings.

While the credit expansion required to drive this particular engine may have supported consumer demand at the margin, it also led to a build up of future problems. In the long run we are all dead, as Keynes would say, however once you hit the zero bound (in interest rates) the long-run hits you right between the eyes. By October 2019 the playbook had run its course, with Fed governors even speaking of how little room they had left. Once COVID hit, there can be no denying that swift action was required. Central banks and governments did not disappoint and swiftly used what little leverage they left. However questions remain over whether or not they have just doubled down on ineffective policies, and whether the medium term costs outweigh the benefits.

The New Normal

Looking ahead, there are certainly bright spots on the horizon. Thanks in large part to heavy stimulus, the rebound in economic data has been impressive. ***Various indicators linked to global trade (see chart above) are showing encouraging signs as a weak US dollar continues to lend support to the global reflation story.*** The difficult part however is sustaining this momentum. With many of the structural pre-COVID weaknesses still in existence, it is likely global growth will continue to face stiff headwinds in the years ahead.

Source: Bloomberg as at 30/11/20

Fiscal Challenges – The economy will need to adjust to life without 15%+ fiscal support. Thanks to government/central bank action throughout 2020, a great deal of the economic pain from the pandemic has yet to hit in terms of evictions, layoffs and bankruptcies. 2021 will be a year markets' reliance on fiscal transfers will rival the hitherto dependence on QE.

IMF Fiscal Projections	2018	2019	2020	2021	2022	2023	2024	2025
World	**-3.1**	**-3.9**	**-12.7**	**-7.6**	**-5.9**	**-5.1**	**-4.8**	**-4.5**
Advanced Economies	**-2.7**	**-3.3**	**-14.4**	**-6.9**	**-4.6**	**-3.7**	**-3.4**	**-3.3**
United States	-5.8	-6.3	-18.7	-8.7	-6.5	-5.6	-5.4	-5.5
Euro Area	-0.5	-0.6	-10.1	-5.0	-2.7	-2.1	-1.8	-1.8
Japan	-2.5	-3.3	-14.2	-6.4	-3.2	-2.8	-2.6	-2.7
United Kingdom	-2.3	-2.2	-16.5	-9.2	-7.1	-5.8	-5.1	-4.4
Canada	-0.4	-0.3	-19.9	-8.7	-5.4	-3.0	-1.4	-0.3
Others	1.3	0.0	-6.8	-4.3	-2.5	-1.6	-1.1	-0.8
Emerging Market and Middle-Income Economies	**-3.8**	**-4.9**	**-10.7**	**-9.2**	**-8.1**	**-7.5**	**-6.9**	**-6.3**
China	-4.7	-6.3	-11.9	-11.8	-10.9	-10.0	-9.1	-8.1
India	-6.3	-8.2	-13.1	-10.9	-10.0	-9.6	-9.3	-9.1
Brazil	-7.2	-6.0	-16.8	-6.5	-5.6	-5.6	-5.9	-5.9
Mexico	-2.2	-2.3	-5.8	-3.4	-2.6	-2.5	-2.5	-2.5

Source: IMF as 22/10/2020

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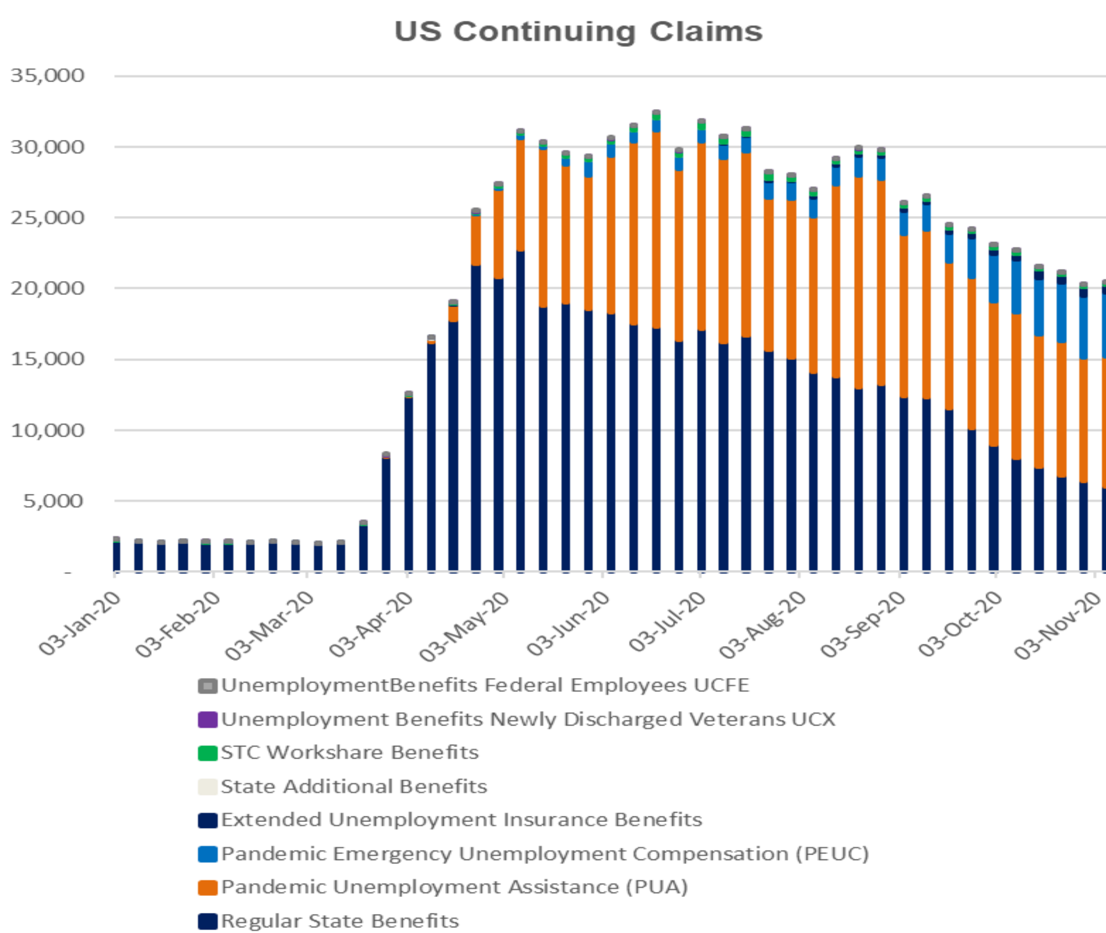
Labour Market Stress - Many business leaders may be unwilling to operate with such onerous debt loads. Across the corporate landscape from retail (Debenhams, Arcadia) to technology (IBM), layoff announcements are growing. Companies in the hospitality and leisure sector will likely see significant redundancies as the pressure of over-extended balance sheets comes to the fore.

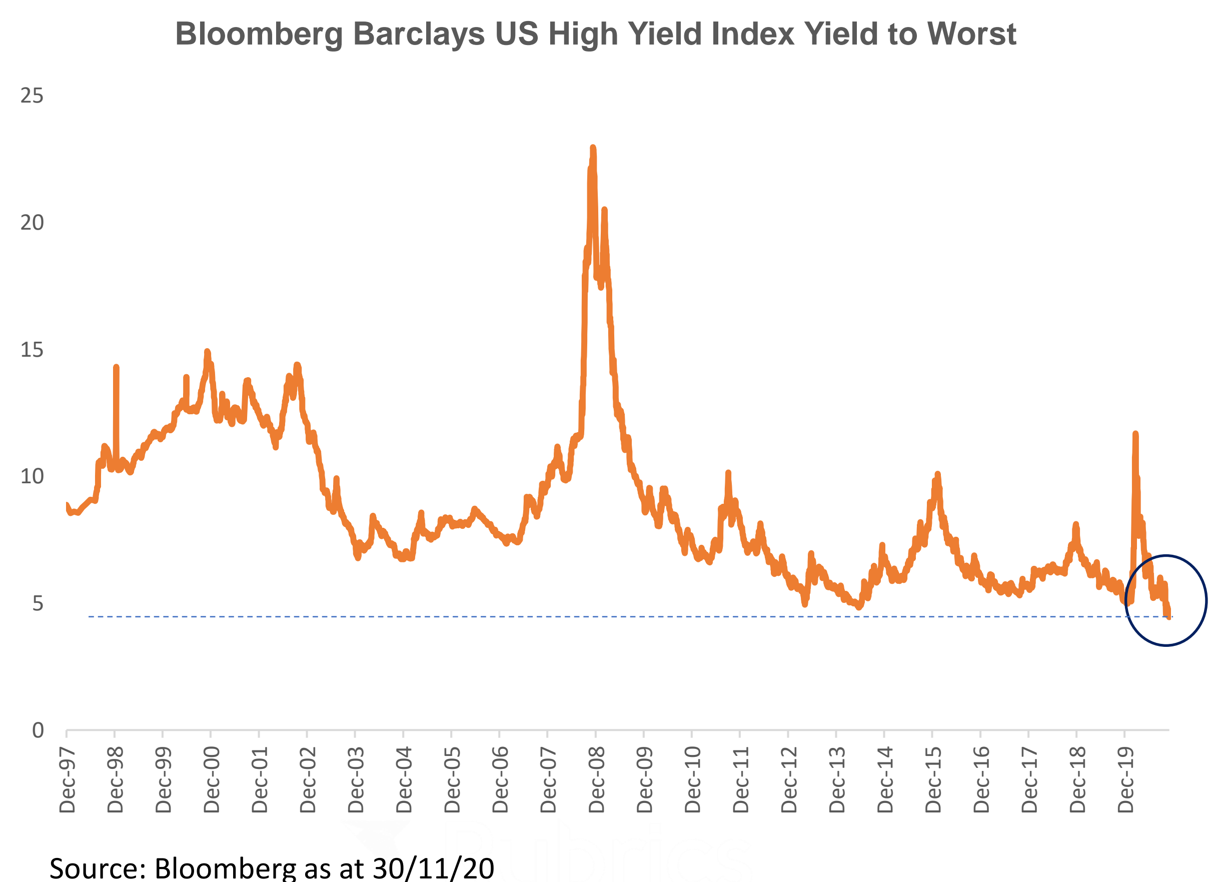


Source: Bloomberg as at 06/11/20

Weak Investment – The proliferation of debt at the corporate level has severely hampered the likelihood of a sustained investment cycle. In simple terms there are too many zombie firms dragging down the aggregate. Technology focused businesses may continue to thrive, but more labour-intensive operations will struggle. In addition, the current policy mix will likely continue to support further share buybacks over outright capital expenditure.

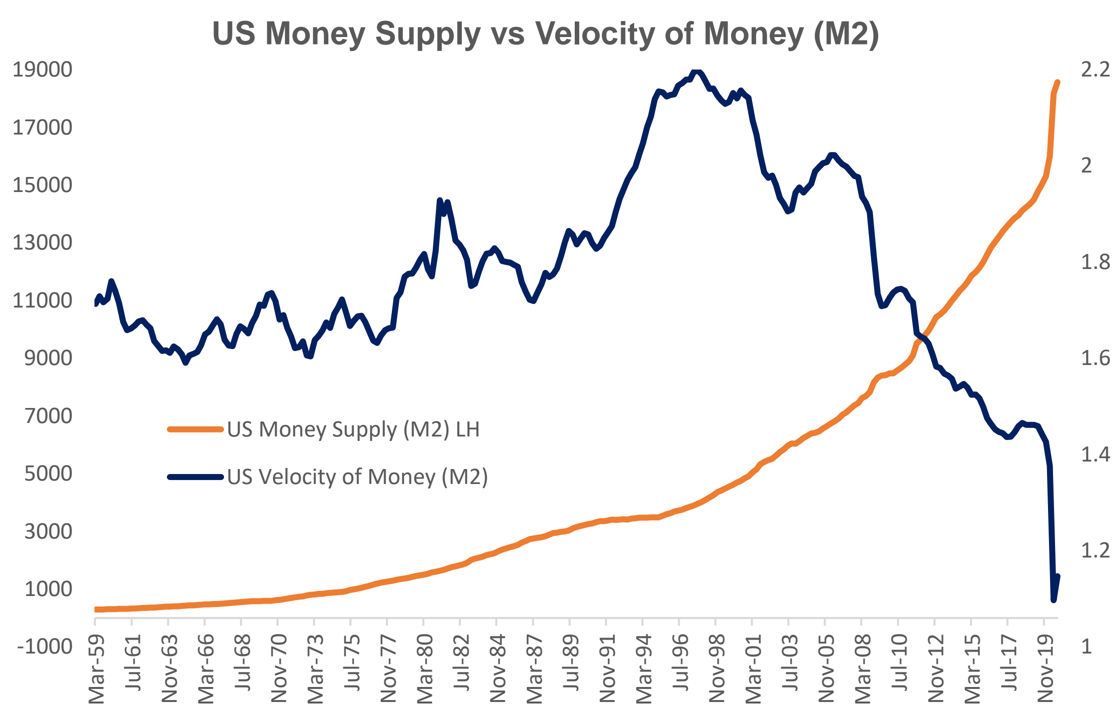
Source: Bloomberg as at 30/11/20

Over-Valued Financial Assets – Asset price gains in early 2021 will continue to sustain the feel-good factor, but outsized returns will be harder to come by. Bond yields are already at rock bottom, high yield coupons the lowest on record and equity valuations the highest ever seen. There is limited upside potential outside of adopting a creative pricing framework. Historically, over the medium term, it has been nigh on impossible to profit from buying assets at these lofty valuations.



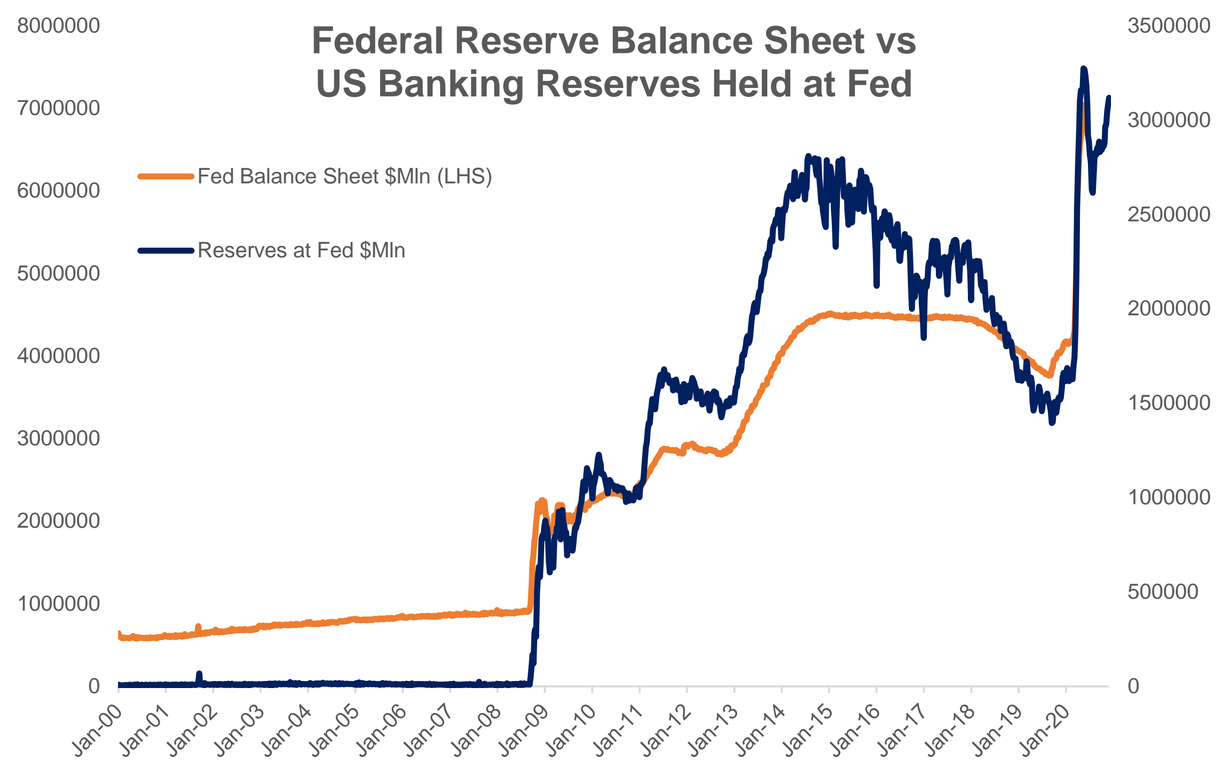
Source: Bloomberg as at 30/11/20

Inflation - There is much anticipation of an inflationary surge on the back of the recent explosion in money supply and fiscal transfers. If indeed the velocity of money does accelerate, there is no question we could see an inflationary break out. However as far as top down stimulus goes, we have already seen the movie. How much (non-financial) inflation did we get from the last 10 years of QE?



Source: Bloomberg as at 30/09/2020

The combination of fiscal and monetary is a more potent recipe, but this would need to continue on a much larger scale than is being predicted at present. ***Bank reserves are not the same as bank deposits and it's not until we can turn the former into the latter that we can produce a sustainable inflationary drive.*** Absent this, debt levels and demographics will continue to weigh heavily on the economy, resulting in a deflationary reversion to the mean over the medium term.



Source: Bloomberg as at 30/11/20

Policy Limitations

Central banks have worked tirelessly to keep financial conditions loose since 2008. They know all too well that the global economy is unable to deal with even a partial normalisation. This has given rise to a market ever-more dependent on low rates. However, as we have frequently pointed out, ***it is the combination of interest rates and growth that matters.*** Market perception of higher rates do play an important role, but the impact on asset prices is only really felt when downward revisions are made to growth expectations. Casting our minds back to December 2018, this was very much the theme. The higher the leverage, the more acute the effect of tight financial conditions. If central banks' ability to influence growth is diminished, even a constant zero rate and continuous QE may not be sufficient to keep financial conditions loose in the face of disappointing growth.

Financial Market Outlook

Financial conditions can no longer be managed easily by central banks. ***The global economy needs to find new drivers of economic activity that can sustain aggregate demand***, ***rather than relying on debt***. It is clear that some level of optimism is warranted, but in our view not to the extent that is currently evident in financial markets. Is it a coincidence that the last time bullishness hit these levels Bitcoin was similarly priced? While post-pandemic credit expansion has been exponential, spreads do not currently reflect default/restructuring risks. Additionally the decline in observed recovery rates has reduced potential future return further. Despite corporate profits rising from their current levels, longer term earnings growth will be hampered by an under-performing economy (debt deflation).

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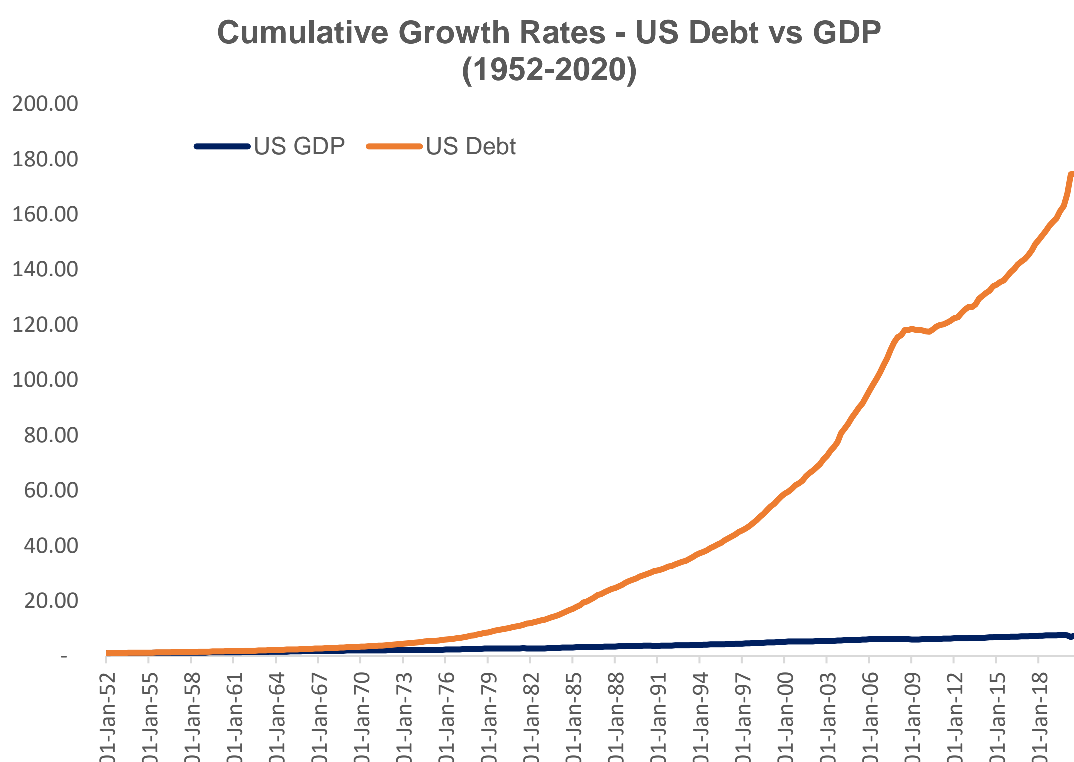


Source: Federal Reserve Bank of St Louis 30/11/20

Monetary Policy – Recent History

Central banks have played a key role in the economic development of the last 50 years. Just like the 1930s when central bankers like Montague Norman became household names, in the 1980s, 90s and 2000s the likes of Alan Greenspan (the Maestro) achieved similarly elevated status. Since the productivity boom of the 1990s, progressively looser monetary policy has given rise to an increasingly debt laden global economy. Things have now reached the point where even the mere mention of rate normalisation would seemingly tip markets into a tailspin. The following are some of the sub-optimal side effects of decades of ultra-loose policy:

Mal-incentives – *Asset prices over real productivity*

Misallocation – *Easy money saw capital redirected to unproductive activities*

Zombification – *Build up of businesses unable to do more than paydown the interest on existing debt*

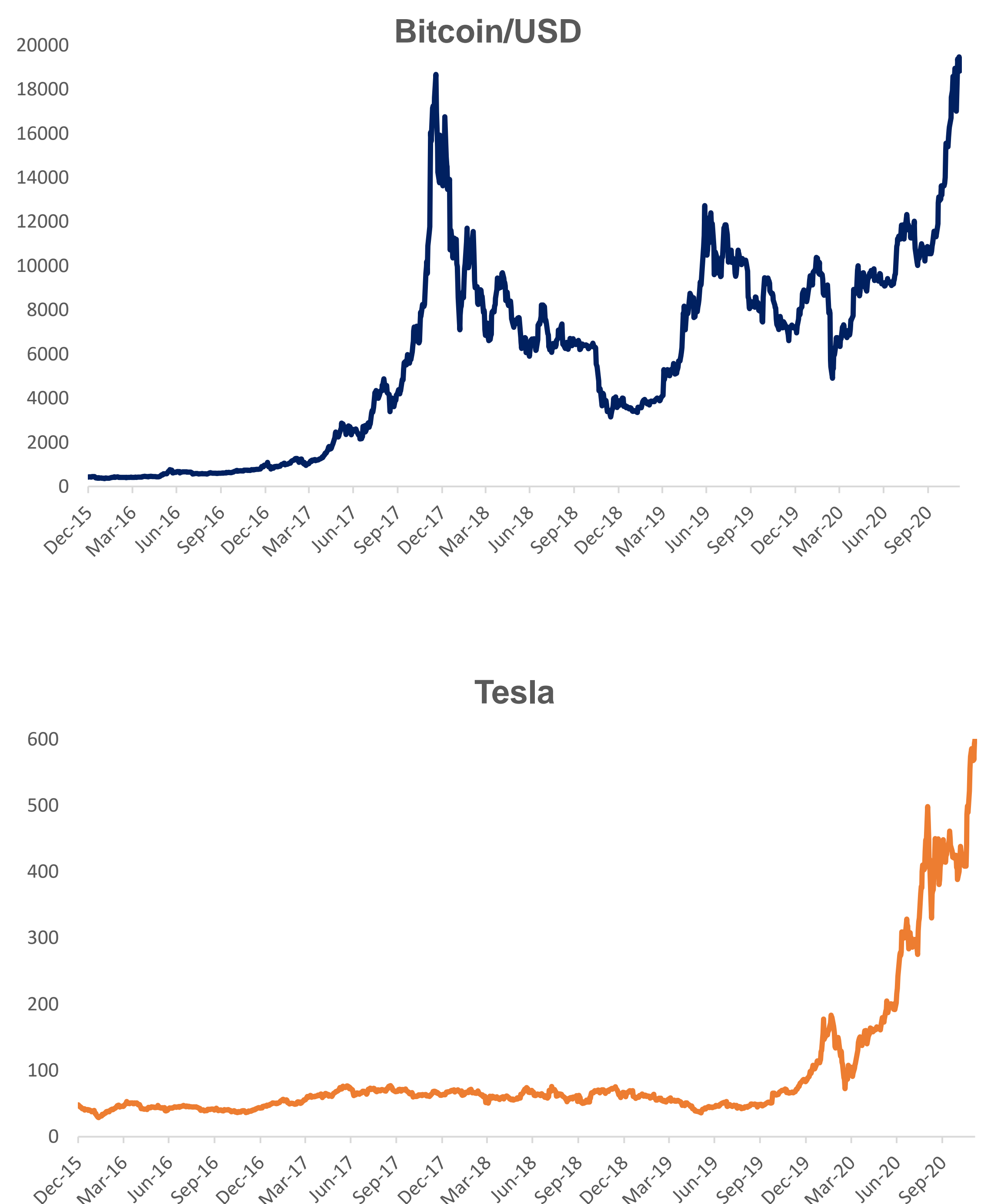
Inequality - *Disenfranchising of a significant proportion of the economy*

Debt Trap – *Increasing amounts of capital required just to service outstanding debt pile. Investment gets left behind.*

Commodity markets and local EM have the best opportunity to outperform in H1 2021. With so many dollars floating around the global economy there is a good chance that the recent positive momentum can continue into next year. A lot of responsibility in this respect has been placed on China to drive the recovery a la 2009. However they appear to be operating amongst a myriad of constraints that have resulted from a decade long credit fuelled expansion. The banking sector is warehousing a significant amount of bad loans and liquidity in the local credit market looks worryingly thin. However unlike their counterparts in the West it appears the Chinese authorities appear at least willing to confront the issue (to some degree anyway). This may weigh on the growth outlook sooner than the market thinks.

Much of the current macro analysis on future inflation and growth ignores the most critical component of this recovery. Namely continued fiscal support. Rather than relying on central bank largesse, markets will find themselves increasingly looking to governments to provide the next stimulus hit. An altogether more challenging proposition for a political administration than a central bank.

Asset prices are supposed to reflect future returns. Low interest rates can help justify high valuations but cannot in the end make up for a lack of demand. Over the past decade high financial asset prices have helped mask an underperforming real economy. Without that crutch it may well be exposed in the absence of a sustainable alternative. Bubble economics is not over yet, but it will take a lot more than low interest rates to support markets over the medium term.



Source: Bloomberg as at 30/11/2020

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