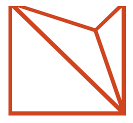


RUBRICS

Game Stop or End Game?

Fixed Income Macro View

rubricsam.com

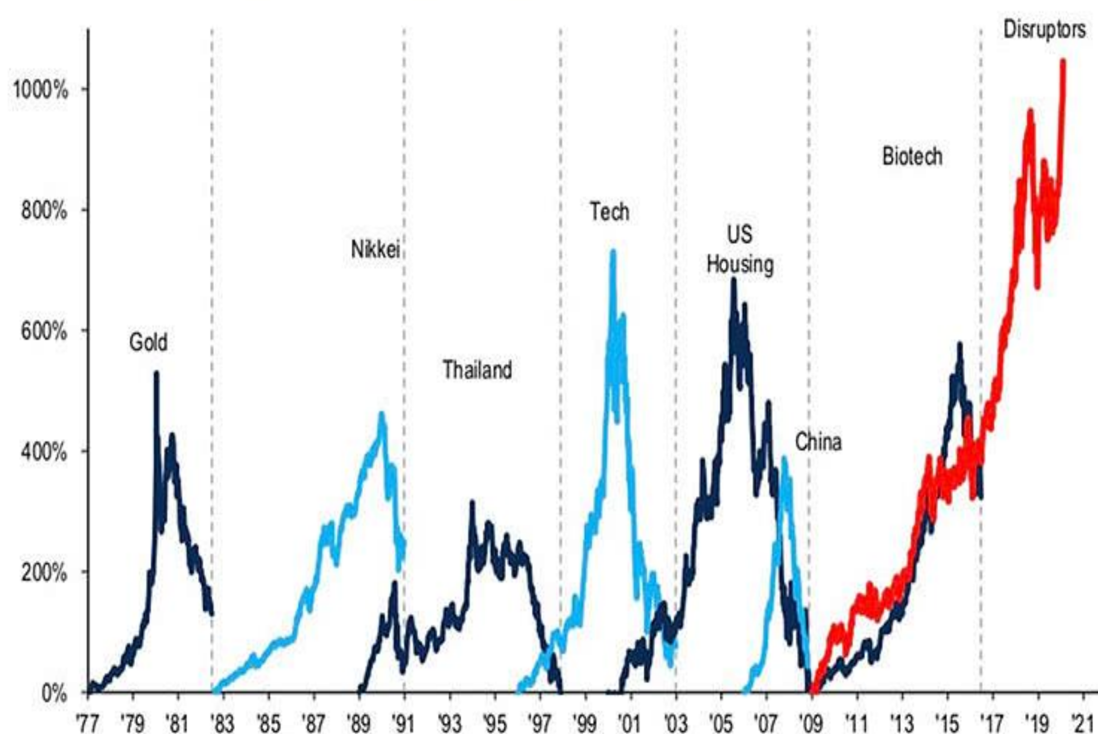
Rubrics Fixed Income Macro View

February 2021

Introduction

The current market phenomenon we are experiencing around market excesses is nothing particularly new. When loose markets conditions occur over an extended period of time financial discipline tends to break down. A bull market will eventually enter a mania phase where all kinds of negative externalities occur - market manipulation, fraud etc – as fear of financial loss is completely supplanted by fear of missing out (FOMO). However not since the late 1920's has the prevailing political and economic system been so baldly exposed by market dislocations. The gap between economic and market fundamentals has arguably never been as wide as it is today. With central banks and politicians at the very core of the system which has cultivated these conditions, their task in remedying the problem is all the more difficult.

Historic Bubbles – Last 40 years



Source: BofA Global Investment Strategy, Bloomberg. Note: Gold (XAU Curncy), Japanese Equities (NKY Index), Thai Equities (SET Index), Tech (NDX Index), US Housing (S5HOME Index), Commodities (SHCOMP Index), Disruptors (DJECOM Index + NYFANG Index constituents, equal weighted)

Source BofA 31/01/2021

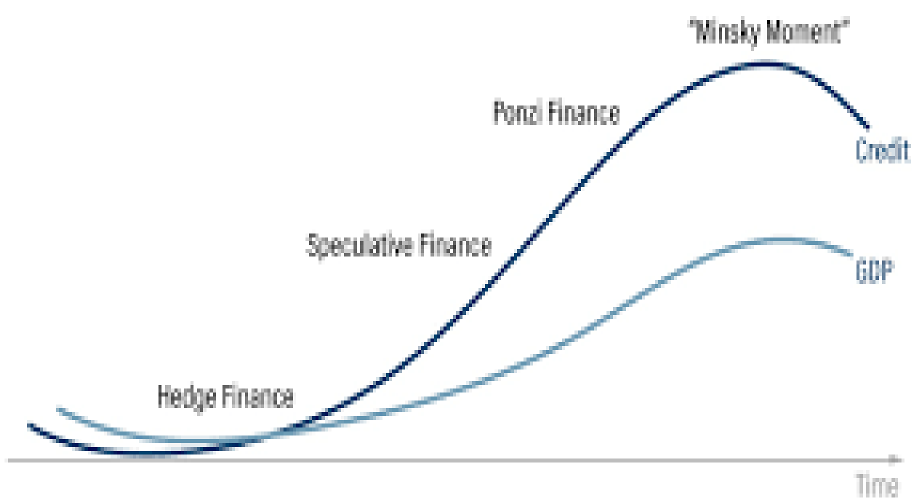
A Question of Incentives

A combination of geopolitical and technological developments have driven structural changes within the global economy that have made central banking policies increasingly counterproductive. The more central bankers pursued expansionary policies (negative real rates/credit expansion) the greater their side effects (misallocation of resources), as a growing array of policy alternatives was needed just to stand still. The antidote to this was inflation, however we were repeatedly told it was nowhere to be seen. It wasn't that all of the money wasn't creating hyperinflation, just that it was appearing in asset prices and not in oversupplied flat screen TVs or shale oil. Policy makers' steadfast refusal to acknowledge this was evidence of their misguided faith in an ineffective set of tools.

Over time loose conditions began to undermine market discipline. Risk and price discovery became a hinderance to investing in markets that became increasingly one way. Market participants were incentivised by central bank activity to take on more and more leveraged risk with little consideration for the downside. In a finite world where fundamentally good investment ideas are limited, excess capital found its way into businesses with little more than a visionary CEO going for them.

When that wasn't sufficient to satiate the demand of QE primed markets, Bitcoin and SPACs emerged to fill the void. It is difficult to say for sure when fundamentals started to take a back seat in investment decision making, but we do know that profitability within the wider S&P 500 US peaked in 2014*. Financial engineering has played a central role in driving valuations since then as retail and ESG focused investors provided abundant capital with profits made via share buybacks and non-GAAP accounting.

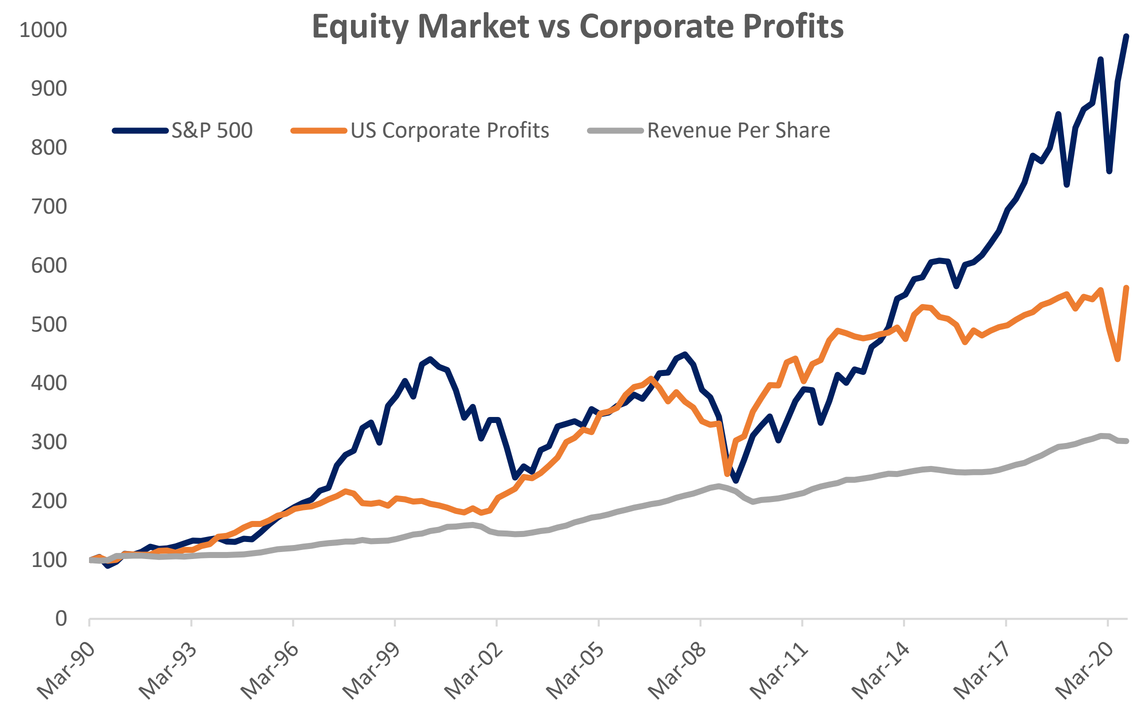
Minsky Cycle



Source www.softpanormama.org

Each of the factors of production within todays financial system are finite - with the one exception of capital. If we print enough money therefore, the percentage of real business opportunities to capital will continue to shrink over time and investments will tend towards pure speculation. This process was well articulated by Hyman Minsky. In recent history, every time we approached the so-called 'Minsky moment', central banks have doubled down on existing programmes and in doing so created even bigger problems down the line. Every bailout must grow exponentially, each QE programme infinitely greater than the last.

Equity Market vs Corporate Profits



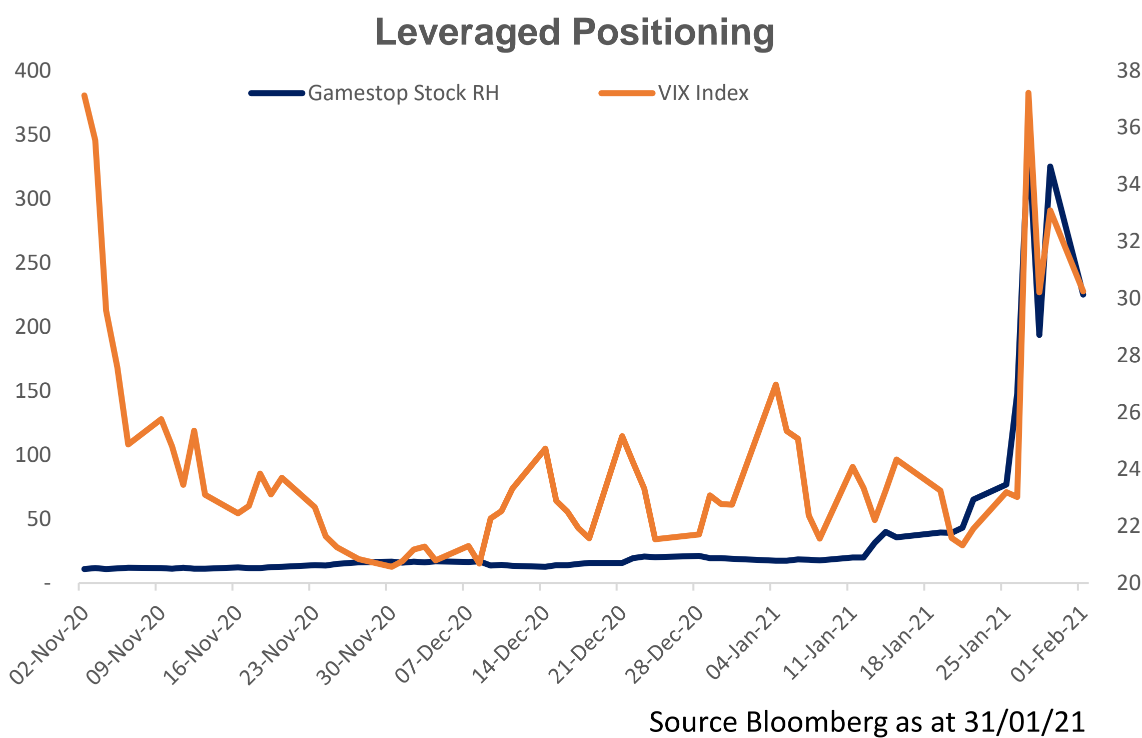
Source Bloomberg as at 31/01/21

Both retail and institutional investors have increasingly eschewed fundamentals in their decision making. Flow has become the predominant driver of markets in this environment – epitomised by the marked shift toward passive investing. Decisions are increasingly made by algorithms based primarily on momentum, price or more recently internet chatter. Companies like Tesla can flourish in this environment propelled by the momentum from inclusion in an ever expanding set of thematic ETFs and indices. The more return investors make the more they leverage themselves into these potentially dangerous investments. The short-term incentives of individual management teams at firms like Boeing and GE were driven primarily by this cycle at the expense of what was in the long-term interests of the business. Thus as markets became less efficient, broader economic outcomes and productivity became progressively less optimal.

Wild Markets

Reddit investors saw an opportunity in stocks like Gamestop where short interest exceeded 100% of the outstanding shares. With enough momentum these positions could be squeezed propelling prices upward in a violent manner - amplified by the use of options. At no stage did business fundamentals come into the equation.

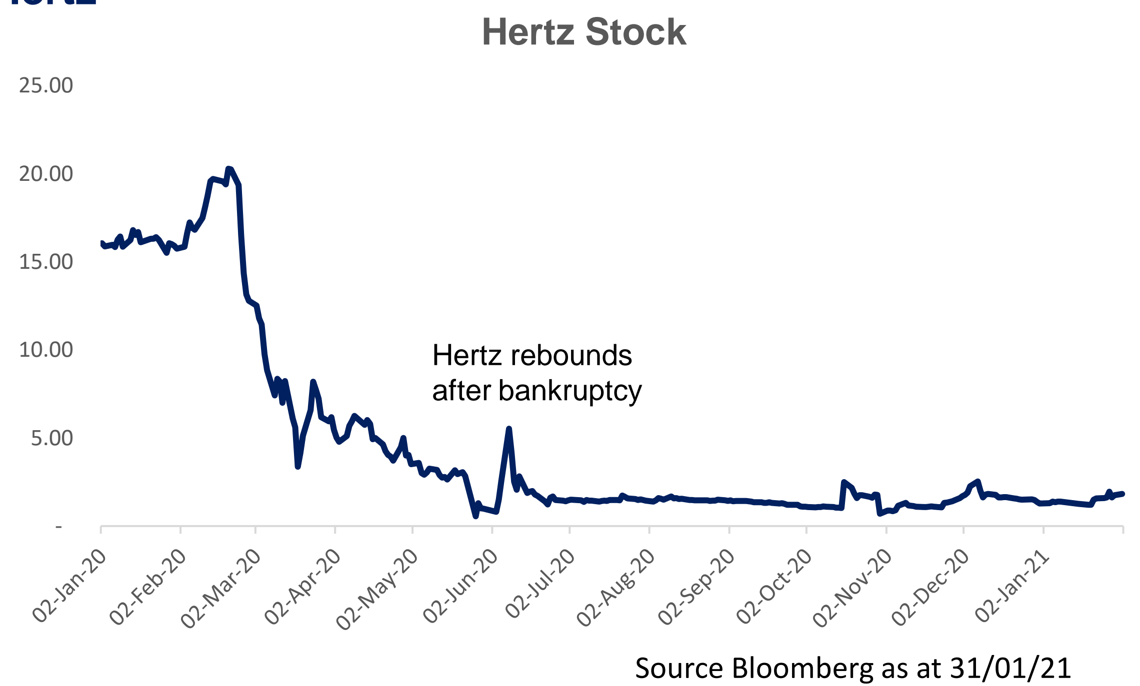
Gamestop vs VIX



Source Bloomberg as at 31/01/21

Many would argue that this is a demonstration of efficient markets, and they might even have a point. However these kinds of extreme moves are usually a worrying sign. Unwinding the excesses seen in the late 1990s with LTCM had enormous ramifications for global markets – in fact the origins of the Dotcom bubble can be traced back to that episode. While Excessive positioning in any market rarely ends well (US subprime market) market manipulation in itself can have much farther reaching real-world impacts. Enron's escapades in California's electricity market in the early 2000s demonstrated how market makers can have tangibly negative effects if allowed to go unchecked. Not only did this directly impact the economy through a spike in energy prices, but also played a major role in the election of Arnold Schwarzenegger's as Governor of California.

Hertz



Source Bloomberg as at 31/01/21

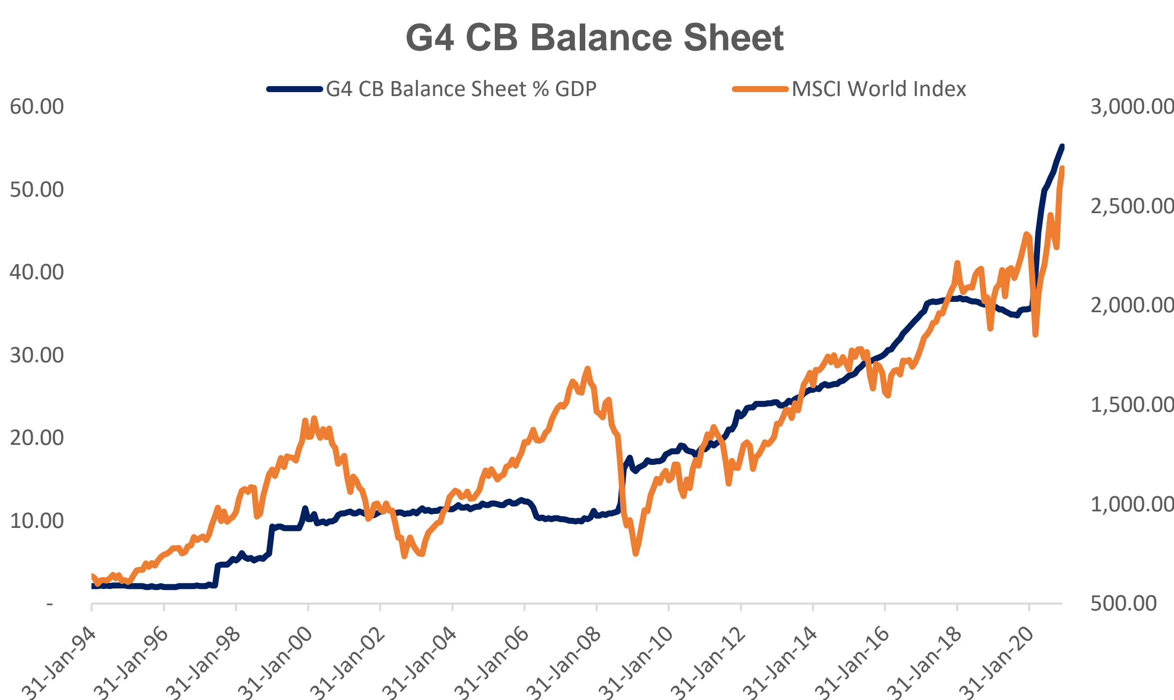
This was clearly not the first sign that the markets were getting out of control. The fact the SEC had to step in and prevent an already bust Hertz issuing worthless stock clearly illustrated how wild the market had become in 2020. Businesses that should have failed prior to Covid were given another lease of life through relentless bond issues and bailouts. Already high leverage ratios jumped even higher with zero impact on credit ratings or spreads – zombie businesses begetting zombie economies. Wall street peddled the rationale of zero interest rates and liquidity to justify anything that looked even remotely like a bubble. The problem is that in the long run solvency ultimately trumps liquidity.

Anger of the Masses

The pandemic quickly pushed central banks front and centre to enact more of their free money magic. Central bankers didn’t spike the punch bowl in March 2020, it was already 99% proof by the time the crisis hit, as emphasis quickly shifted from juicing the market to fully underwriting it in order to prevent the ultimate Minsky bust. With this action went any pretence of market orthodoxy. The core structures of capitalism had been whittled away to prevent a far worse outcome during the devastating health crisis experienced across the world. The inevitable side effects and limitations of these policies are already starting to reveal themselves in the likes of Gamestop. However another more serious downside has been building in the background for a long time - inequality. It is this which may ultimately drive a change in course, whether the authorities like it or not. Few would now accept that what is good for Wall St is good for Main St. Debt saturation has stifled the long-term benefits of loose monetary policy which may ultimately signal the end of current thinking. This would have serious ramifications for financial markets, on a par with Glass-Steagall or even the end of the Gold standard in the early 1970’s.

The political anger that has surrounded this unrelenting increase in inequality seems to be feeding current market dislocations. The newfound ability for the average Joe and Mary to beat the Wall St elites has added a whole new complexion to the story – the element of righteous anger. People can now use their college funds, pandemic checks and small savings to not only get rich quick but also disrupt the status quo – rage at the system that was once so rigged against them. The ability of social media to harness this anger both empowers and amplifies the movement, making it all the more powerful. As Trump’s supporters were emboldened in their attempt to tear down democracy, so capitalism is potentially now under the same threat. These latest developments have the potential to seriously alter the rules of the game, with major political consequences.

Central Banks Balance Sheets



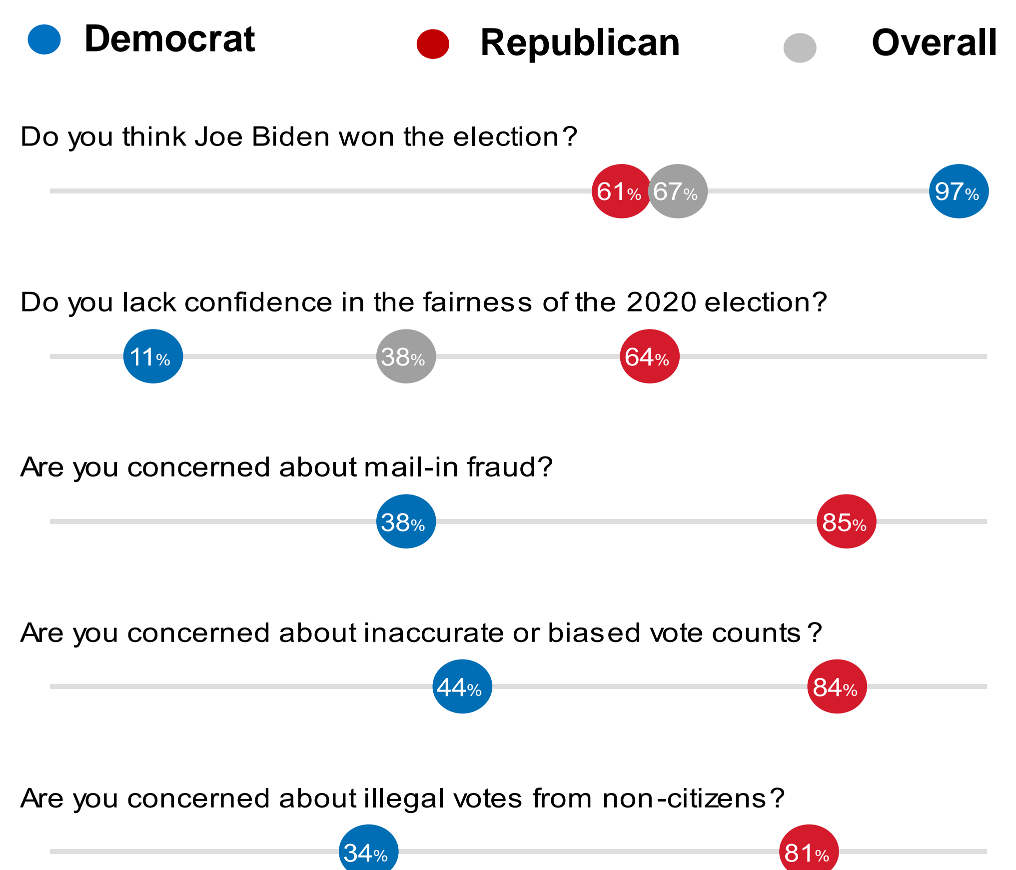
Source Bloomberg as at 31/01/21

When these distressed companies eventually fail, it won't take a Qanon conspirator to predict a lot of angry people intent on blaming the establishment.

Political Fallout

Social cohesion has been declining at a rapid pace in recent years for a variety of reasons. A key component of this is the collapse of social capital, or trust as it is more commonly known. The number of Americans who believe the recent presidential election was "stolen" provides a case in point. This is unsurprising when you consider how such a small percentage of the population continue to amass enormous wealth while the majority are seeing their prospects diminish. When institutions like the Federal Reserve are seen to be so clearly supporting the top 1%, it is difficult for the rest not to feel the system is working against them. As the current market madness creates more headline news, politicians and central bankers will become more and more uneasy. Recent questions to Powell and Biden explicitly about GameStop brought dismissive answers from both. They cannot answer the questions because the very tools they are using to prop up the system up are the ones causing the problems in the first place. For Biden the fact that much of the early pandemic payments are fuelling these activities is particularly problematic as he looks to secure co-operation on future funding from congress. For the Fed, who have promised a deluge of free money until zero unemployment for ethnic minorities, strong growth and the complete eradication of climate change are achieved, this is also problematic. Not only has the central banks' free money been undermining the efficient functioning of the system it has also unleashed a backlash where the 'free' and now wholly inefficient markets seem to be turning in on themselves. This is not the first time issues like Gamestop have appeared. Back in March of 2020 even the Treasury market stopped functioning under the height of the market collapse with potentially devastating consequences. Crisis management has taken on a whole new meaning.

Partisan Differences in Key Election Questions

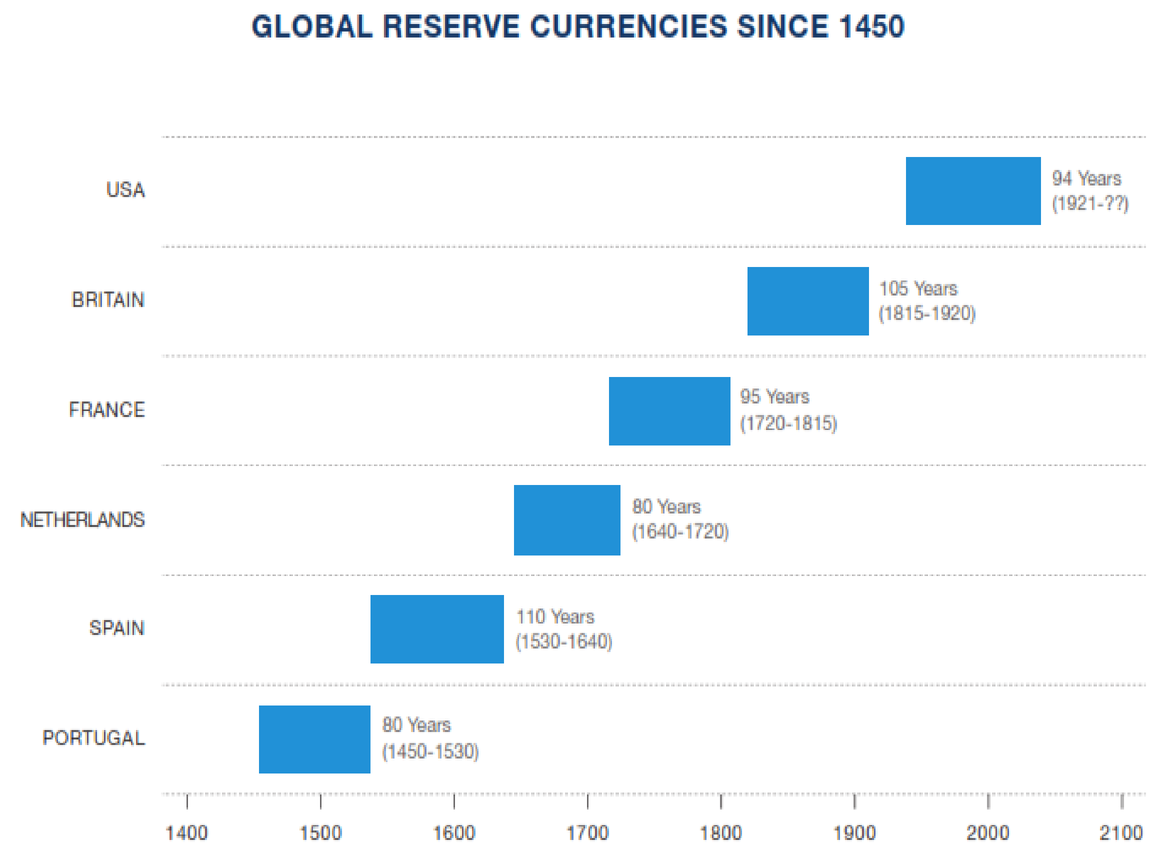


Source: NorthEastern University as at 11/12/2020

Conclusion

The post-truth word we now live in is angry and easily manipulated to act in an illogical way. This applies as much to financial markets as it does to politics. The likes of Elon Musk (as Trump did previously) are playing the role of pied piper on social media to leverage the grievance and rage of the masses. Politics and economics are now fighting the same battle which they could both lose without recognition that a change is required. The health crisis the pandemic has unleashed made it critical that we did not have a simultaneous full-blown financial crisis. However as number of bubbles and Ponzi-like investment strategies have expanded, so too has the level of pain that will be felt when the balloon eventually bursts. There was already trillions of surplus credit in the system well before the pandemic hit, but the excessive money printing post-Covid has been on an altogether different scale. The economic and social scarring from this crisis will make the recovery extremely challenging – as was the case post 2008. The damage both economically and politically will be very disruptive. At some stage the markets will wake up to this as the politicians and central bankers are today. We might yet see a Bretton Woods 2 on the horizon in the not-too-distant future.

Global Reserve Currencies Since 1450



Source Rubrics AM as at 31/01/21

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