RUBRICS

Decision Time

Fixed Income Macro View

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QE Implications

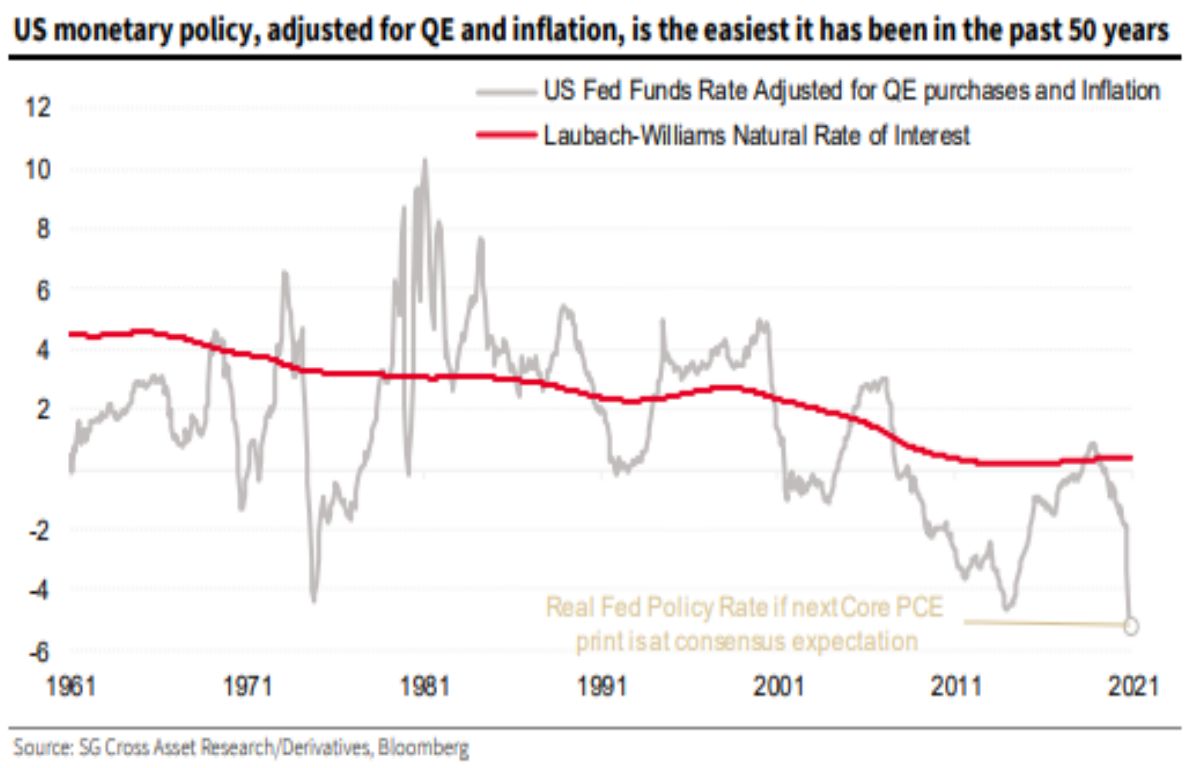
This month, the world watched on as the ultra wealthy fulfilled their childhood fantasies of reaching the stars. This cosmic display of wealth may well signify the high point in extreme wealth inequality and asset market exuberance that current economic policies have created.

Every boom in speculation like the one we are currently living through has a bell that rings at the top, but we're not sure we've heard the final bell toll just yet.

Recent interviews with Fed governor Powell were very insightful. In short, Powell failed to clearly answer, (even in Greenspan like rhetoric), the most basic of questions. Two questions stood out. Firstly, why is the Fed still buying $40bn of MBS a month when the housing market is booming? 'Oh, well because in 2008….well we will have a process to wind down in the future.' He couldn't give a coherent reason. Another interesting question was about what difference $60bn rather than $120bn of QE would make to the jobs market? Again Powell struggled to answer. The Fed, however, is not alone in being unable to answer even the most basic questions on the efficacy of current monetary policy. The House of Lords in the UK have just undertaken a review of the Bank of England's QE policies. This committee included none other than Mervin King, ex-BoE governor. Their report should come as no real surprise, the committee could not get any coherent or analytical answers as to why they were doing what there were doing.

The committee said basically they did not believe the bank of England understood, qualitatively, the impact that their policies were having nor how to unwind them. Basically they said the Bank of England was now addicted to the dangerous drug of QE.

Excessively Easy Monetary Policy



Source: Societe Generale Research as at 23/07/21

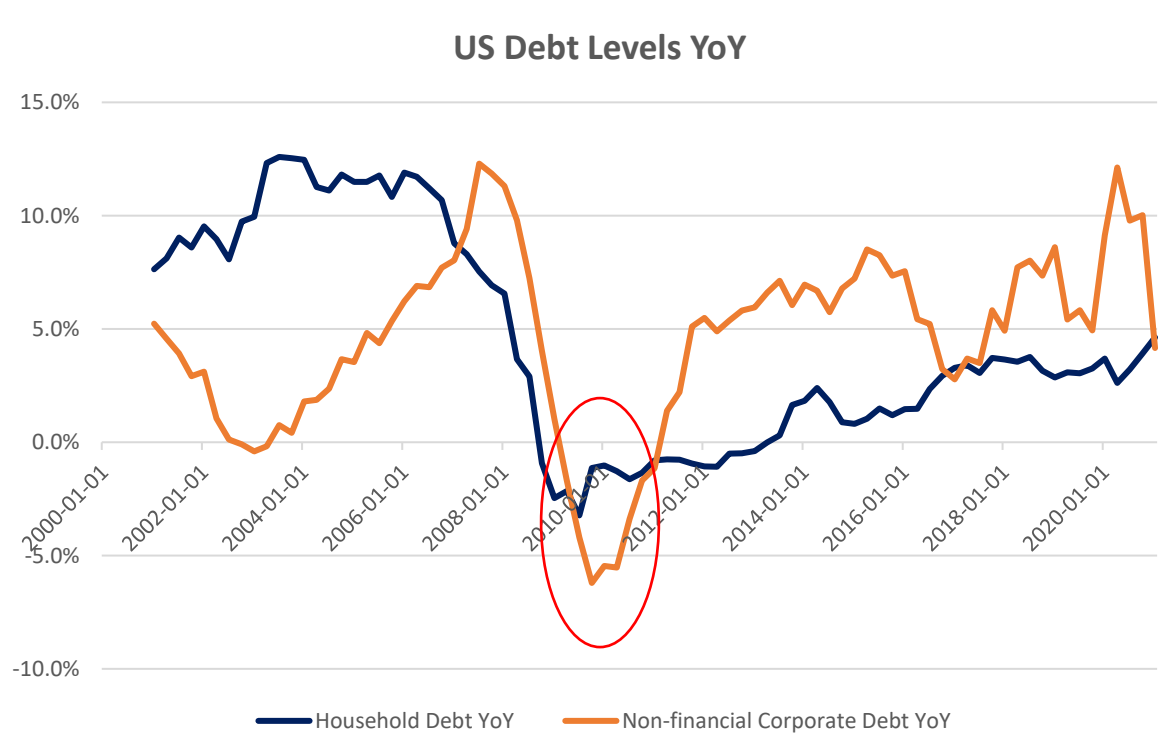
QE Mission Creep

The reality, of course, is the central bankers do know the answers but are unwilling to say. When QE was first launched in the US in 2008/2009 there were good reasons for the policies, including: (a) a collapsing banking sector; (b) distressed financial markets; and (c) contracting private sector balance sheets. Since that time, there has been significant mission creep in the deployment of QE, as it is used to address a variety of problems: low inflation; low aggregate demand; wealth effect; currency manipulation; equity market volatility; financial repression; deficit spending monetisation; and even repo market contortions.

Central bank pivots towards climate change and social justice may even see QE used to address these issues. With each iteration of QE, the costs increasingly outweigh the benefits and the transmission to the real economy becomes increasingly diluted. The size of the pandemic response dwarfs previous versions of QE, with increasingly significant side effects.

QE continues today not for any economic benefit of continued asset purchases, but purely to stave off the negative impacts on asset prices and financial stability that ending QE would bring. The highly leveraged and speculative financial markets would struggle to cope with a removal of monetary support. There is also considerable fear this would lead to a deflationary bust where such a highly leveraged economy would be overwhelmed with 1930's style, debt induced destruction. Of course many of these risks only exist due to the very policies central banks have been pushing in the first place. The exit from extraordinary monetary policy is fraught with difficulty, and the finger of blame can only be pointed at the central bankers.

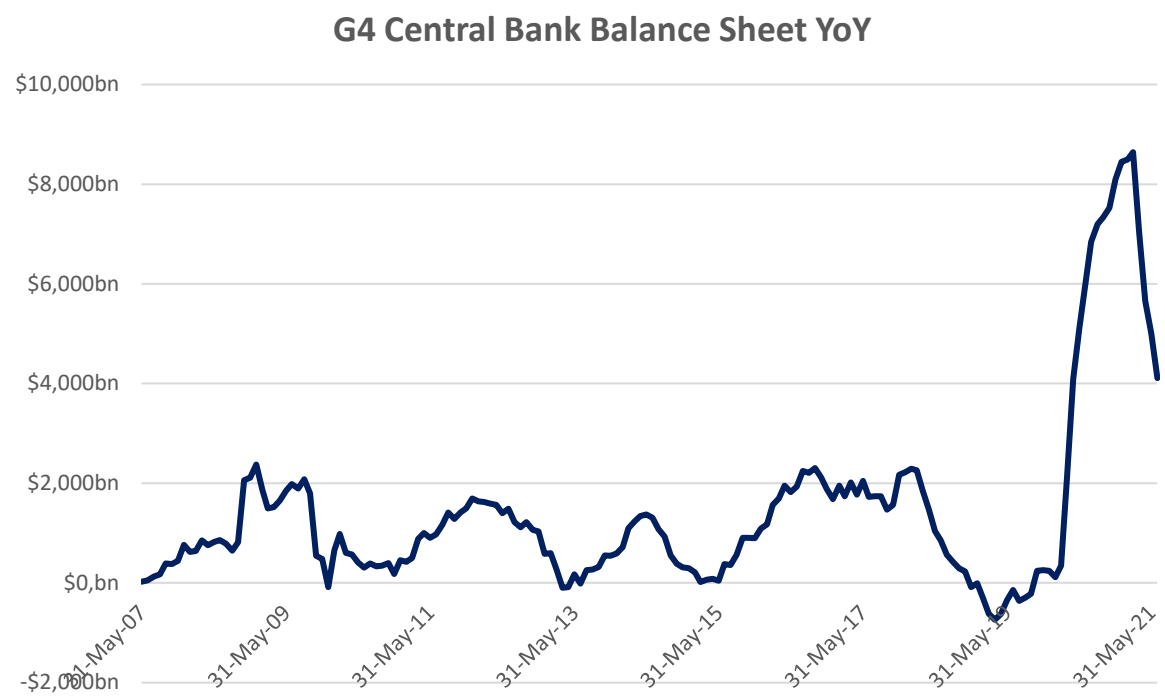
2008/2009 Balance Sheet Contraction



Source: Federal Reserve Bank of St. Louis as at 23/07/21

responsible and the political pressure to which they succumbed. The aim now is to run the economy hot enough to outrun the costs of the exit from accommodative monetary policy. This will come to a painful end if inflation rises like Lazarus from its decades long slumber.

Unprecedented Scale of Pandemic Response



Source: Bloomberg as at 23/07/21

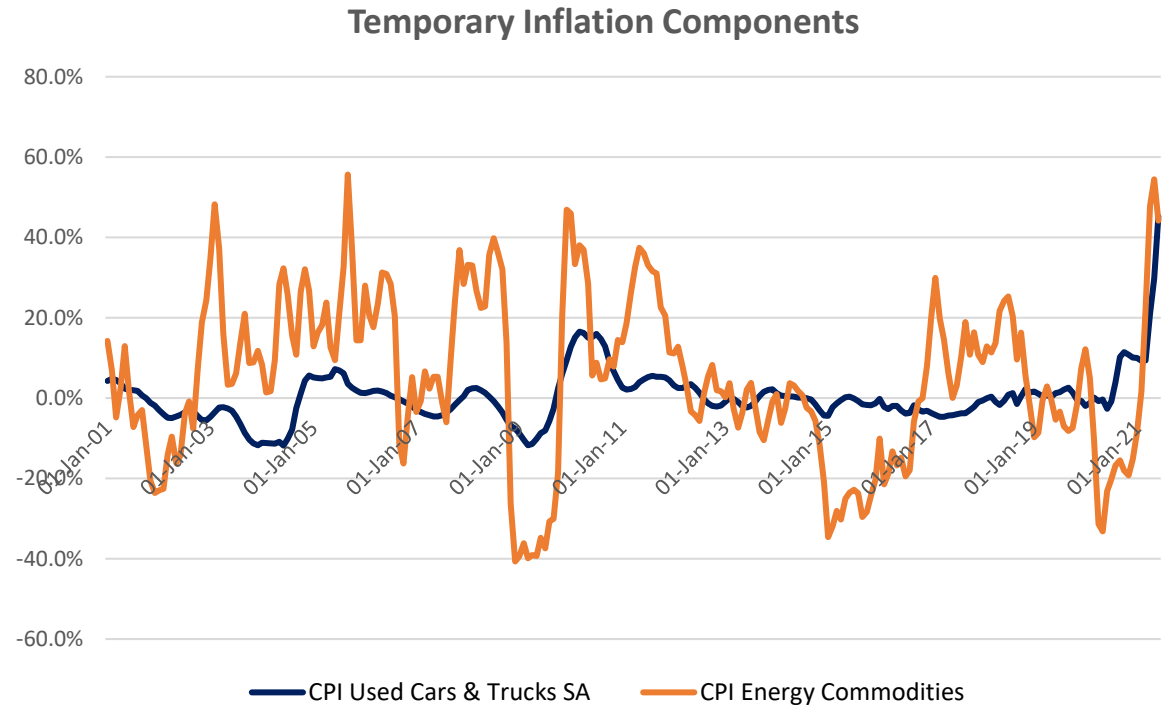
The End Game

There has been much talk recently about the one thing the central bankers should fear most and that is not deflation, but inflation. Of course there has been a united front in dismissing current inflationary bursts as transitory. While the jumps in inflation are far ahead of what was expected (a jump to 3% was predicted), we are being told we can trust the academics and their projections that the current bout of inflation won't last. Unfortunately the track record includes failing to identify the burst of the dot com bubble or the complete collapse of the financial system in 2008 or the impacts of the taper tantrums of 2014 and 2018. We remain sceptical that current official projections can be trusted given the history in recent decades.

Most of what central bankers point to is easy to see, like the transitory impact of second hand car prices and reopening bottlenecks. There are also significant structural changes going on in the economy which once again bring into question central banks' ability to understand the current nature of the economy moving forward, while continuing to use models from the past (hence they keep getting their outlooks so wrong). This has always been an Achilles heel of central bank modelling, using old data fundamentally fixed to a different type of economy which has undergone regime change. Take for example the run up to the 2008 crisis. Bernanke was so fixated on the lack of inflation that he even voted to drop interest rates below the one percent mark. Of course this 'deflation' was due to China's deflationary impact on global trade. The US Fed only made matters worse and didn't help one jot in the fight against China's exported deflation.

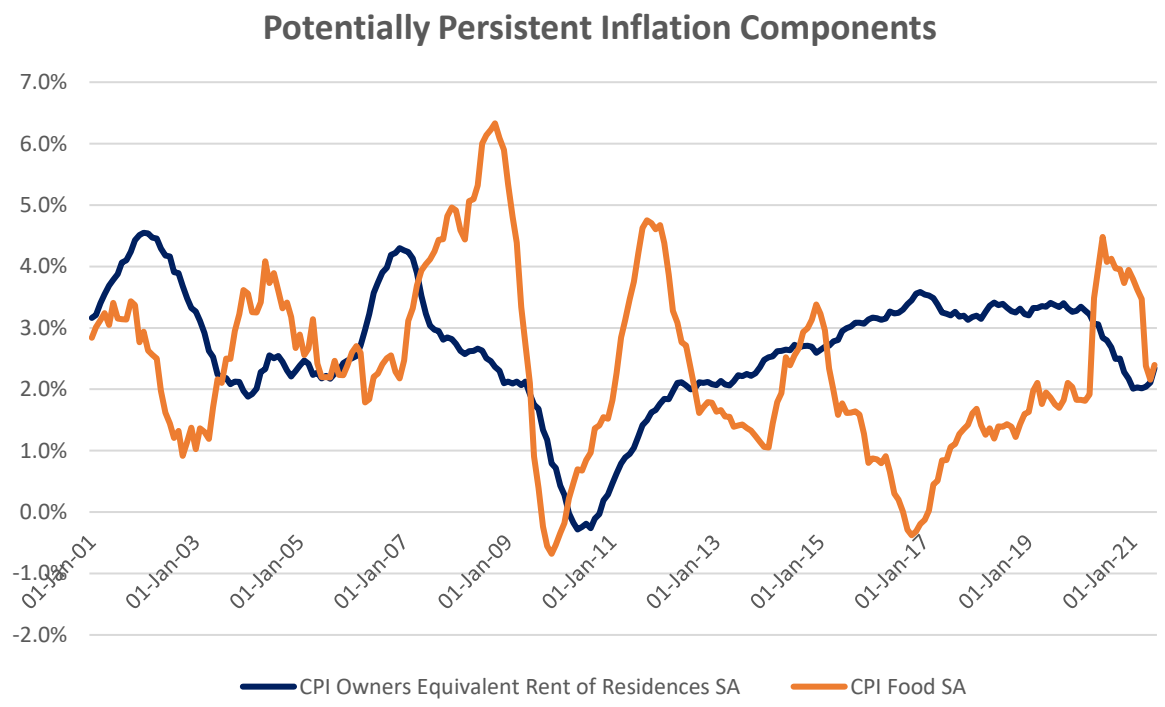
Fundamentally, the COVID-19 economic crisis is a supply-side crisis (demand and credit expansion was augmented by massive fiscal and monetary stimulus) while all the most recent recessions were based around demand side constraints; this crisis saw a jump in income unseen in any previous recessions. Thinking about this crisis in the same vein as the 2008-2019 model is ill-advised. Other critical factors about this current cycle include a far more active fiscal lever to economic policy as well as significant changes to geopolitics and globalisation. It is important to note that its not just the fiscal part that is critical in attempting to 'level-up' the economy; there is a slow but powerful movement of power away from capital focused legislation towards more labour positive policies; a reversal of the big transformation we saw at the end of the 70's and early 80's. Finally, as we can clearly see from all the extreme weather we are currently experiencing, climate change is going to be a major game changer for the global economy and business for decades to come.

Some Inflation Components Will Fall…



Source: Bloomberg as at 23/07/21

…While Others May Be Starting To Rise



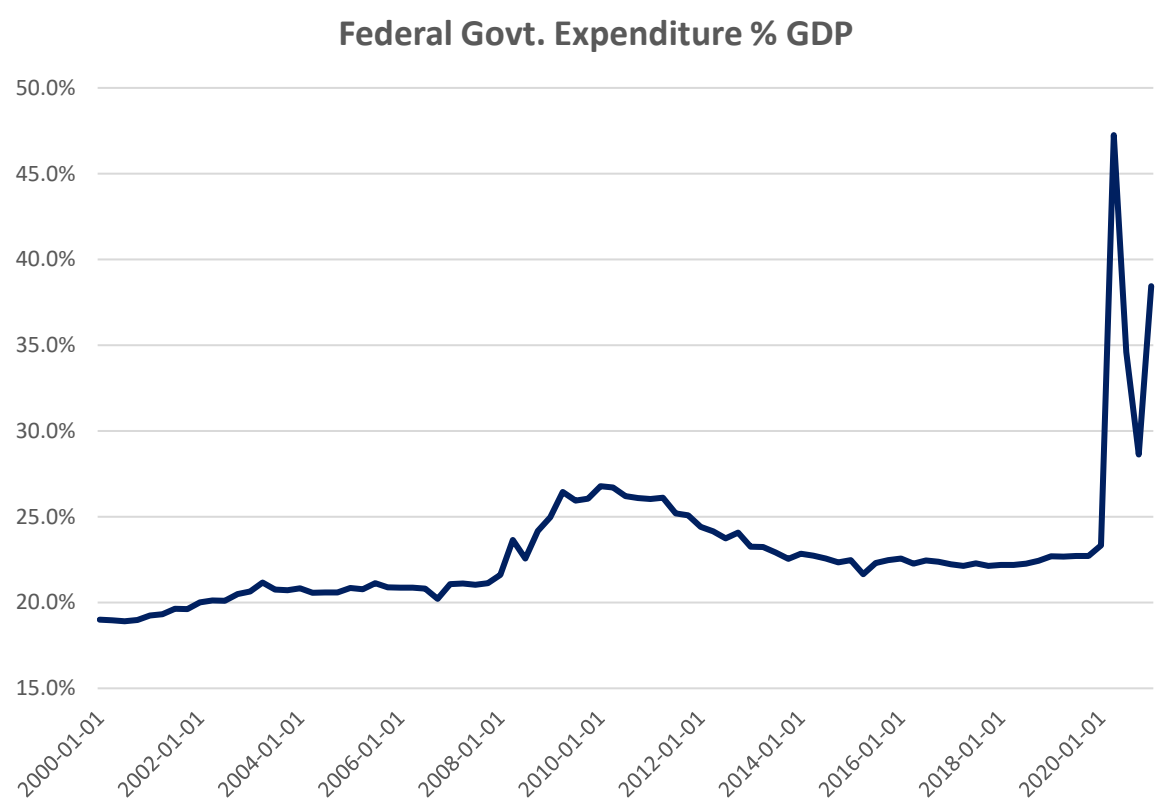
Source: Bloomberg as at 23/07/21

At Rubrics we have long felt that the overwhelming deflationary impulses of the debt, demographic and technological drivers in the economy had the upper hand over the last decade. Today, however, the outlook is far more balanced. What is clear after over a decade of excessive monetary stimulus is that these policies are starting to bring their own significant headwinds for central bankers and policy makers.

Rubrics Fixed Income Macro View

While high equity market valuations are seen as a positive, excessively high housing prices eventually have political consequences, especially coming so soon after the last housing bubble burst. While much of the underlying inflation seen in shops today can be dismissed, wider more structural inflationary impulses are certainly growing.

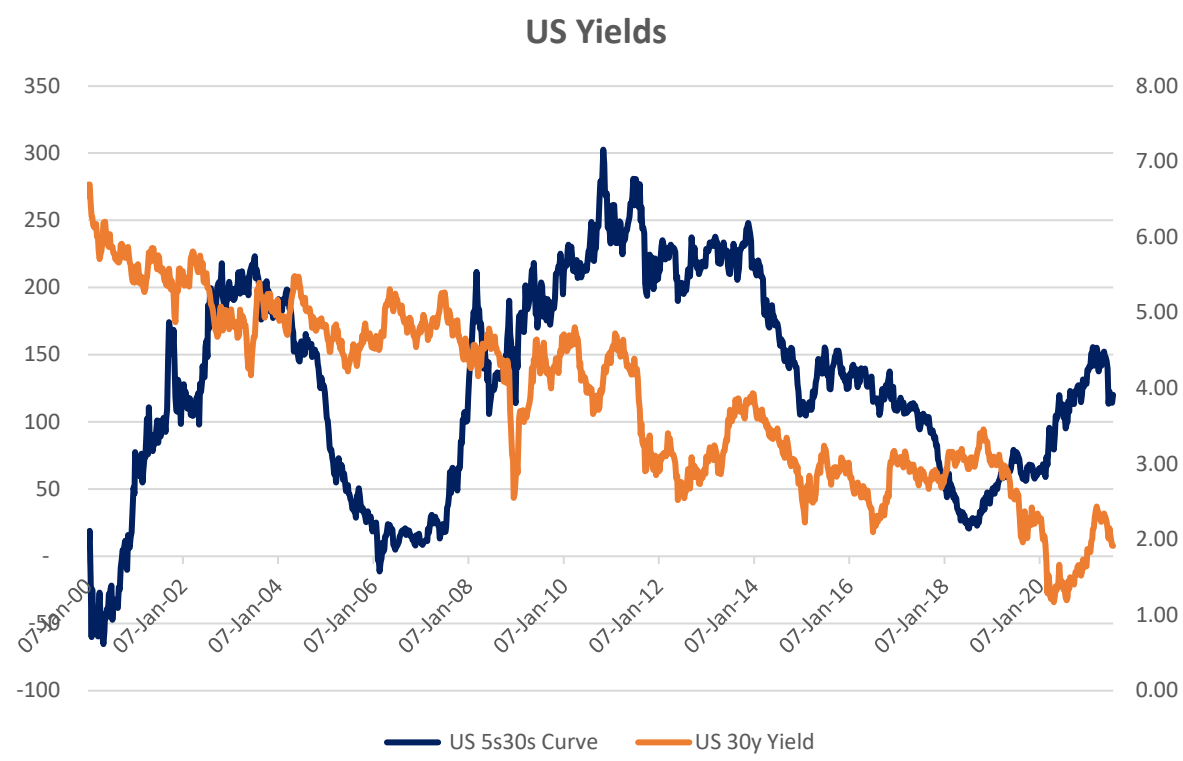
Massive COVID Fiscal Response



Source: Federal Reserve Bank of St. Louis as at 23/07/21

The question investors must ask themselves today is what happens first, a deflationary bust or stagflation? Both are equality damaging for your portfolio. Thanks to the excessive liquidity injected daily into capital markets, asset prices today only reflect this simple factor. We have read endless articles discussing for example why the bond market yields are falling so hard in front of such persistently high inflation numbers – nobody has come up with a quantifiably provable reason. Any attempted hypotheses flailed to present any corroborating evidence or data-points; other than the liquidity theory that is. Just like the equity market, the potential downside risks to the bond market are flashing red lights right now.

Bond Market Warning Signals



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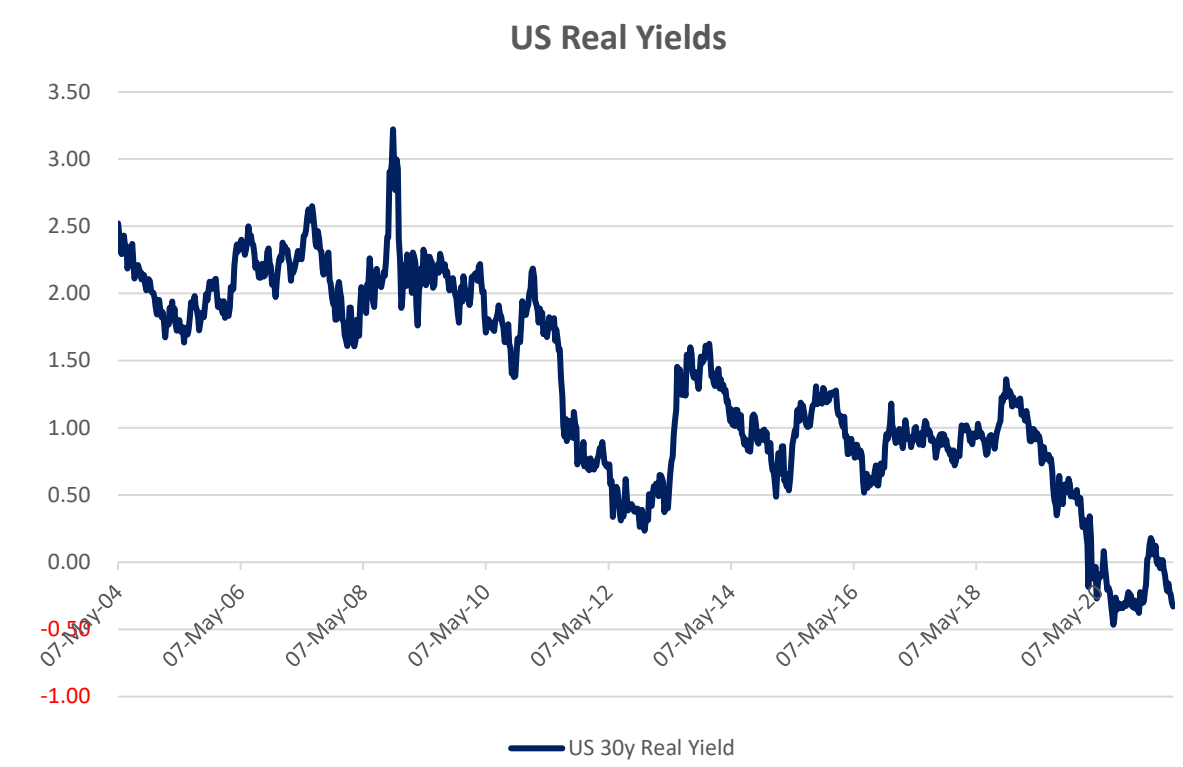
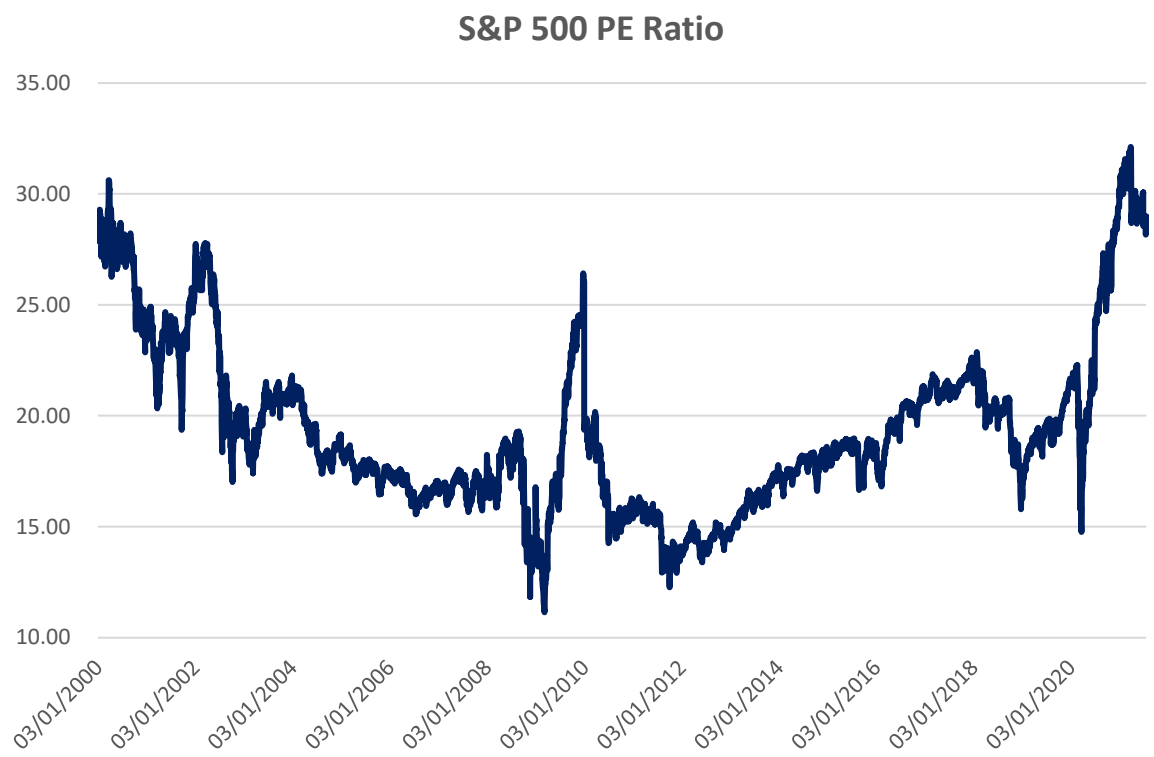


Source: Bloomberg as at 23/07/21

It is important to note that capital markets can stay at these dangerous junctures longer than one ever suspects. However, more than at any time in the recent past, events are starting to catch up to the current policy set. The extent of excess liquidity in the system today has created such a level of pure speculation across financial and real assets that the real world impact through the rising costs of living is causing a political headache. Any U-turns on the transitory inflation narrative would be politically disastrous. Economic history tells us that current policies cannot maintain the balance of a stable point of dis-equilibrium indefinitely.

Distorted Asset Market Valuations



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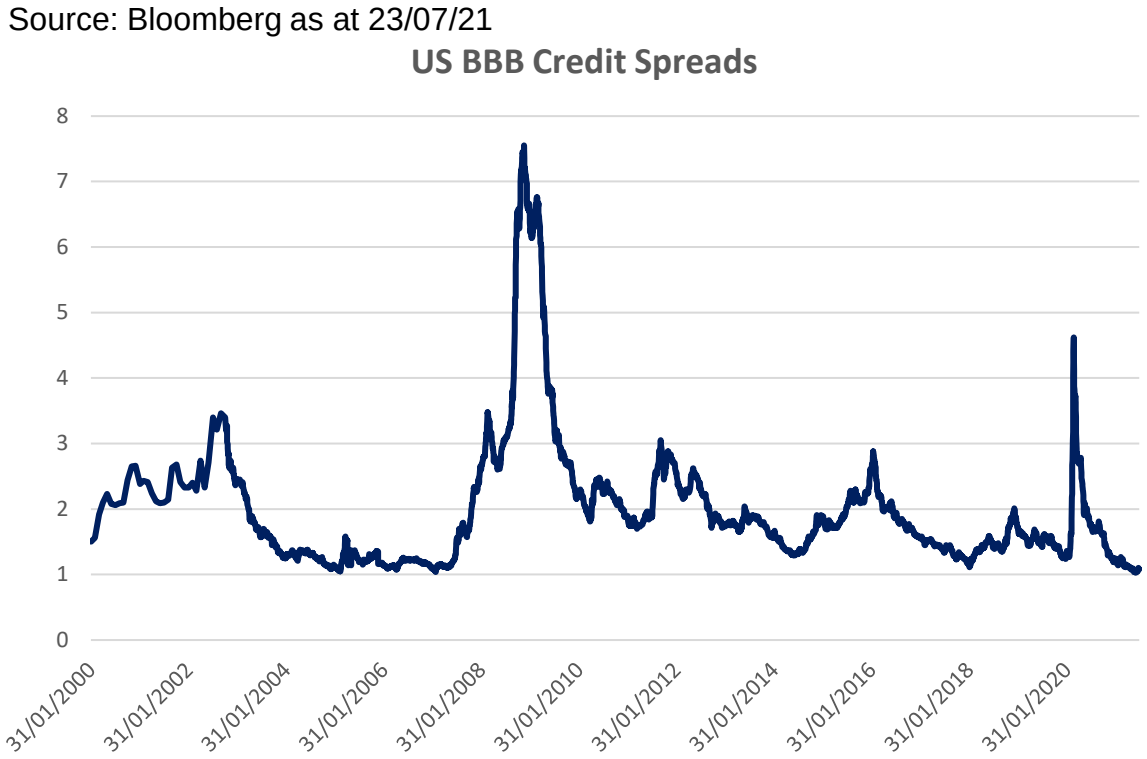

Source: Bloomberg as at 23/07/21

Market Impact of Policy Choices

One good piece of news for the bond market is that when it does decide to move back to a more stable point of equilibrium, it usually happens pretty quickly. We have seen this many times in the past. The key issue today will be the jobs market. Once the economy starts to take down some of the nine million or so job openings, the Fed will start to pull back on its stimulus. Jobs are today's main benchmark for the Fed. Once that happens and the unemployment rate drops, inflation will become a key indicator once again, but not until then. Another critical point for the central bankers will be an extension of the stimulus provided by fiscal policy. We expect by the end of September to see some sort of infrastructure bill come out of the Biden administration. Combined with improving jobs data it will be clear that, all things being equal, tapering will be announced for early 2022.

We also note that we may have already seen the peak of the economic data. PMI surveys have started to decline from recent highs, Q2 is likely to be the strongest print for GDP in 2021 and CPI may not eclipse its recent high print. GDP is likely to revert towards trend growth over time as the pandemic recovery fades. Inflation may however prove to be stickier than other economic variables and we could see persistent above trend inflation prints. We will need to see how inflation fares into 2022 to determine whether this really is a transitory burst of inflation or a more permanent change to the inflation regime.

All of this activity has the potential to bring significant year end volatility we would suspect. The impact of the Delta variant of COVID-19 is a known unknown at the moment, but so far the availability of reliable vaccines has mitigated its effects. The key risk today is that there are many Ponzi scheme like market structures with significant risks if liquidity ever dries up again. We got an example of how even the most liquid and established of markets can go wrong with the US treasury market in March 2020. The central banks will endlessly downplay the risks to their upcoming attempt to take a step back from the precipice; we all hope they are right this time.

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