GE & Bonds

Bye Bye Milton

For decades monetarists have been expecting inflation to flare up, even more so after the massive QE injection ($5 trillion) by the Fed. The theory behind their expectations is the so-called «Quantitative Theory of Money» captured by the following equation:

$$M/P = k.y$$

In Milton Friedman's quantitative equation,[1] all attempts by the Fed to boost GDP growth (g) via a loose monetary policy (M) in order to reduce unemployment is doomed in the long run because prices (P) would rise in the same proportion, increasing anew interest rates, reducing capital spending and raising unemployment. Put differently, all real variables like M/P remained unchanged by changes in nominal value such as the quantity of money (M). Hence, it is useless to expect monetary policy to stimulate real-output growth (y) over the long run because nominal price (P) adjustment would crush any such attempt.

But over the last forty years, prices have not made the expected adjustment, and those who have clung to the Monetarist Dogma and expected inflation to rise again, especially with Quantitative

[1] M. Friedman - «The Quantity Theory, a restatement» - University of Chicago Press - 1956

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Easing (QE), have been wrong not for years but for decades. Inflation never showed up "just around the corner", as expected. Such a monetary policy failure has forced the Bank of Japan to postpone its normalization many times. Just last month, January 2019, the Central Bank stressed again the need to reach its impossible inflation target before normalizing.[2]

Hello Charles

Question then: Where did the money go? Charles Gave[3] has provided us with an answer since 2014. The money went into investment assets: Cash, Bonds, Stocks, Real Estate. This is because the goal of monetary policy has changed. In the old days, it was geared towards output growth and unemployment with questionable success at least in the long run. But of late it has been targeted to managing the equilibrium between Assets and Claims in balance sheets. Indeed, in order to prevent a dynamics of Debt and Deflation unfolding and destroying the world economy, as explained long ago (1934) by Irving Fisher, the Fed intervened with massive liquidity injections, as, for example, during the 1987 (Greenspan) and 2007 (Bernanke) crises.

Such a shift in monetary-policy goals has had two consequences:

- First, investors have been used to that policy similar to the "Too big to fail" doctrine and no longer fear stock market crashes, since they expect the Fed to come to the rescue as it just did. Indeed, whenever the asset side suddenly shrinks sharply, equilibrium in the balance sheets needs to be restored either by reducing claims (margin calls) or by refueling assets (QE). Hence, the emergence of QEs not only in the U.S, but also in Europe and Japan during the past decade. Just of late, the Fed's Chairman Powell has

[2] Crédit Suisse – Investment Daily – 24/01/2019
[3] Charles Gave – La monnaie n'est plus au service de l'économie réelle – Monnaie et Finance - 01/12/2014

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provided us again with an illustration of such a dramatic change in monetary policy goals. In October of 2018, the Fed's rhetoric was all about the fed funds rate being "far from neutral" and the deleveraging of its balance sheet being on "autopilot". Hardly three months later the new rhetoric is all about "patience" in regards to further rate hikes in 2019 and to be "flexible" as far as balance sheet reduction is concerned. May be the Fed suddenly remembers that between 1929 and 1933 it withdrew 1/3 of its monetary base as a result of which it manufactured the greatest economic depression of the XX's century[4]. In our book the Fed is cornered and cannot anymore addressed economic risks like inflation but only with words. Investors should be extremely troubled with this situation.

World Debt

- Second, investors have been used to abundant liquidity, which has enabled them to live off debt especially when the cost of carrying that debt was so minimal. This is because liquidity creation from the Fed has been magnified by credit creation from the banks through their fractional reserve activity, resulting in the piling up of enormous debt. In fact, the combination of low interest rates for decades together with credit expansion from the banks has translated into a massive world debt: $160 trillion, i.e., $160,000 billion, so that world debt now far outpaces world GDP, which stands at $80 trillion. In relative terms, this means that the Debt/GDP ratio has reached 200% of world GDP.[5]

[4] Milton Friedman, *Two lucky people*: Memoirs
[5] Barry Ritholtz, https://ritholtz.com

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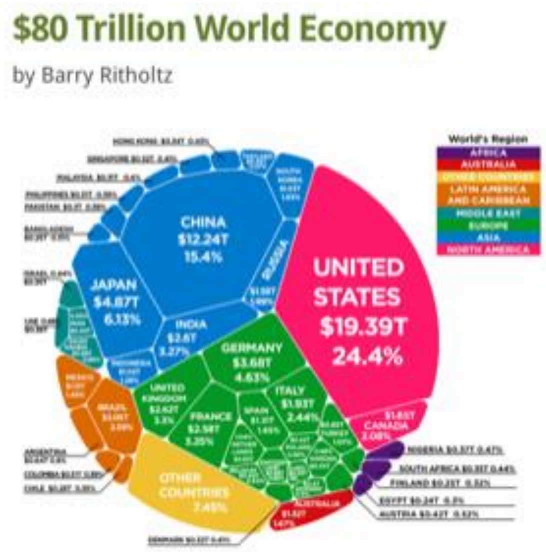

Bonds at Risk

Not surprisingly, in this new macro-context where interest rates have begun rising, cracks in the bond markets have surfaced everywhere for everyone to see.

- In the private sector, GE bonds have crashed by around 14 percent. Bonds issued by Ford, AT&T, Kinder Morgan, CVS, GM and Verizon now rank among the weakest performers at the end of 2018.

- In the public sector, the weaker countries have also been exposed, as the tide of low interest rates began receding. Venezuela has been flirting with several possible defaults. Italy has been under pressure to avoid a financial path that would lead to a similar outcome, and Turkey has had tremendous difficulties meeting its financial obligations.

"Defensive!"

For portfolio managers, if bonds are at risk, so are their "defensive" portfolios. In reality, these are the ones most at risk, since they generally hold 60% of bonds. After a stock market crash like the one in 2007, "dynamic" portfolios recovered quite nicely as the stock market embarked on a ten-year bull market, rising by 350% between 2009 and 2018. As a result, the stock market produced a 135% return between 2007 and 2018. The grandchildren of "defensive portfolios" will never be as blessed.

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Bond Vigilante

Not surprisingly, Bond Vigilantes have been on the lookout.

- The bond guru, Jeffrey Gundlach from DoubleLine, has warned us many times that, as far as the U.S. economy was concerned, it was "floating over an ocean of debt".[6] Why is he so concerned about the American economy and about the U.S. companies in particular? Because 2/3 of their capital expenditure is financed through bonds and only 1/3 via bank credit, unlike in Europe where financing is mostly carried out by banks.

- Just recently, the International Association of Credit Portfolio Managers (IACPM) reported that its 12-month credit-default outlook index tumbled to minus 71.1 from minus 47.2 over the last two quarters of 2018, suggesting that corporations will increasingly default, being squeezed between a slowing-down of economies and rising borrowing costs.[7]

- It is no wonder that in this context the bank Pictet[8] in Geneva is recommending an under-weight stance on credit – both investment grade and high yield – in early 2019.

Conclusion

Hence, monitoring the bond markets closely becomes "une ardente obligation". You do not want bond markets to collapse on the doorstep of your "defensive portfolios". Defaults, restructuring, moratoriums, deleveraging, gates, and even a Jubilee[9] could suddenly become the names of the game. Some already are. Gates are in place in French "Assurance-Vie" investments and the EU is entertaining the idea of a Jubilee on debts.

Philippe Coutaz, PhD

[6] H.Waller and James Ludden – Bloomberg - January 12, 2019
[7] L. Adler – Reuters – January 17, 2019
[8] : C. Donay – Perspectives Special Edition – Pictet – January 2019 – p5
[9] In the Jewish tradition, all debts are forgiven – the Jubilee – after fifty years.

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