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Spectrum Insights

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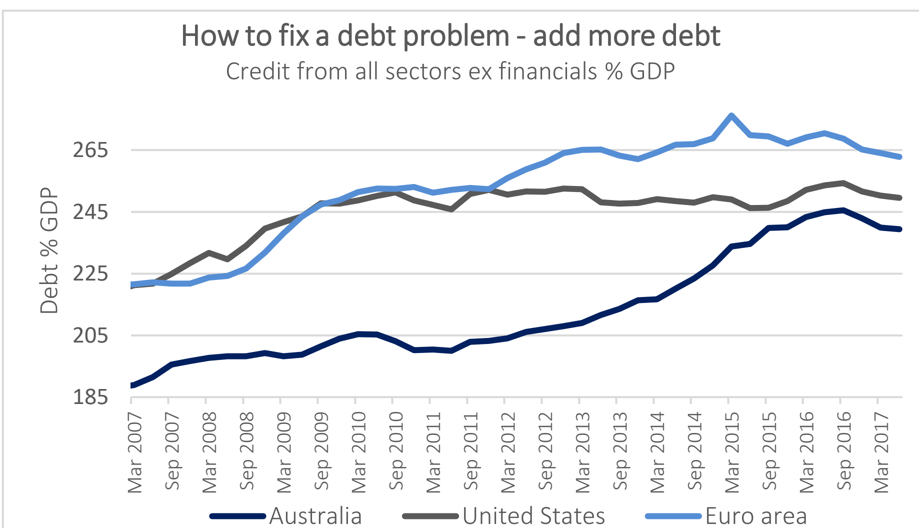
History will not be kind to them

Years from now, when historians look at the "big ease" after the "great recession" of 2008, we suspect the reviews of some central bankers of the recent era will not be favourable. Slashing interest rates and hammering bond yields well below their market levels has certainly provided stimuli to economies and asset prices. The global economy is currently expanding at around a reasonable 3.7%. This recovery, however, has come at a cost. Now, we have the dual dangers of elevated valuations and greater indebtedness than before the GFC.

Most key central banks are now, either in the process of slowing the pace of easy money, or taking it out of the system. It's seductive for many to believe that "this time is different" (1). When interest rates rise and credit is withdrawn, this time the markets and economies will hum along without any damage. History suggests this is unlikely. And should the angry mobs look to apportion the blame, central bankers may be a target.

When you have too much debt – add more

Excessive private sector debt was at the centre of the global financial crisis of 2007-8. One would have thought that the desired long-term outcome would not be greater leverage. But today indebtedness is now higher as a proportion of GDP in most key economies. Rather than increasing long term financial stability, central banks may have inadvertently made financial systems less robust.



Sources: BIS, Spectrum

(1) The sarcastic title of Reinhart and Rogoff's book "This time is different – Eight Centuries of Financial Folly"

The excess of it all

This is not to say major central banks were wrong to take drastic action over the last decade. Our view is, it was too much for too long - Australia included. To us nothing paints a clearer picture of the present market distortion than negative yielding bonds. According to Fitch, a rating agency, in early December 2017 there were around $10t of bonds around the world where you were guaranteed losses if you held them to maturity.

Sustained negative or low real and nominal bond yields cause distortions in markets. They push up valuations on assets. It makes borrowing cheap. It punishes savers. It encourages borrowing to make financial investments. And this is what happened in a large scale in much of the world – including Australia.

Why?

This is not to say that drastic central bank action was not warranted. Again, our view is that it was excessive and for too long. What drove them to this? We posit several possible reasons:

- Over reliance on central banks: the governments did little fiscal stimulus or economic reform. They relied heavily on central bankers to "save" the economies well past the initial emergency stages.
- Central bank "group think": Central bankers belong to a monetary policy religion. They believe that the all-powerful monetary policy can solve many of the problems of the world. Their vocation came after years of specializing in monetarism. To doubt the benefits of monetary policy would put at risk their *raison d'être*. Affirmation of their views was and is given in the echo chamber of central bank announcements around the world. Which leads us to the next issue.
- Too much confidence in a non-science: Economics is not a science. It is a social science. To apply monetary tools at untested levels for a prolonged period and to say there are no observable problems as inflation is low, suggests undue faith in their models and theory. As baseball legend Yogi Berra said, "In theory there is no difference between theory and practice. In practice there is."
- Looking at an incomplete world of inflation: Central banks look at price stability. The prices reviewed are primarily consumer prices. They give little attention to asset price inflation and do not target it. The belief that the only prices impact by their policies are those of consumed goods and services is neat but naïve. The world has changed since modern monetary policy was embraced. Central banks have no control where excess cash goes. It does not have to chase more widgets and therefore push up their price. Excess cash and credit can easily spill over to into asset prices. Think U.S 1920s, Japan in the late 1980s, Asia in the mid-1990's and the U.S the mid-2000's and the huge financial crashes that followed them.
- Tool reduction: In the past some central banks could lean on banks to tighten their lending growth through their regulatory arm. Now most bank regulators are separate from central banks.
- Politics: Rising asset prices and a growing economy are good for government revenues and votes. To stop the party and be unpopular may also lead to job insecurity for some.

The possible future historian's view

Starting this era's review with the team that gave us the "Greenspan put" (1987-2006) – where the common perception was that the U.S Federal Reserve would offset large asset price falls by cutting rates. This era also fostered a hyper-aggressive funding of the U.S housing market and, in turn, a sharp increase in housing prices. The outcome was the GFC. Enough said.

Then came "Helicopter Ben" Bernanke (2006-2014) who was also a devout believer in extreme monetary response in extreme circumstances. To be fair, the GFC was an extreme event. As U.S growth was not steadily expanding until 2014, it would be tough to be overly critical of the Bernanke period of ultra-easy money.

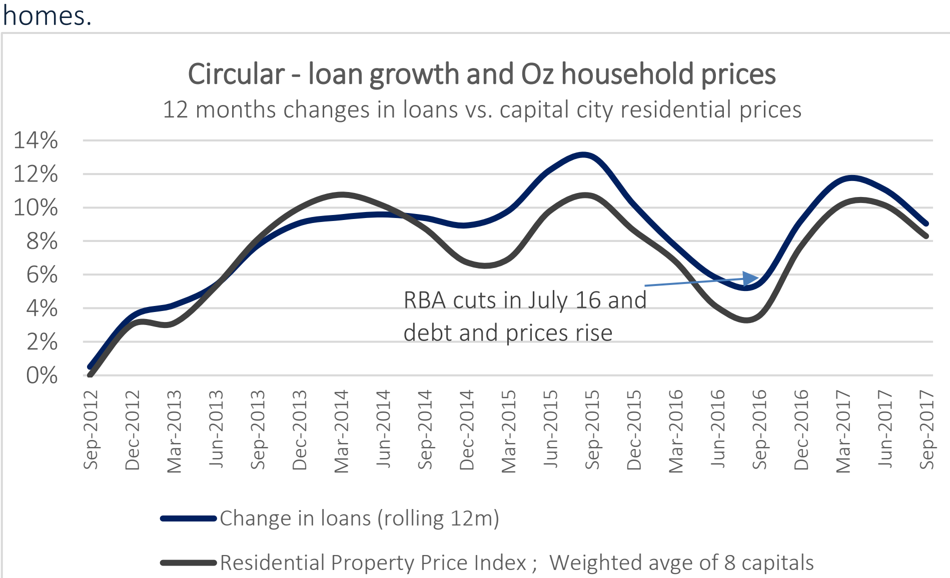
Likewise the current US Federal Reserve is attempting to unwind the ultra-loose policies of the past in a manner that does as little damage to the economy as possible.

Meanwhile, Europe was facing the possible break up of its binding currency – the Euro - several years after the start of the GFC. Then the ECB President, Draghi, promised that it was "ready to do whatever it takes" to preserve the Euro in mid-2012. The ECB's actions before and after this may have saved the currency. Hence that job, arguably, well done. But why is it still buying bonds, including corporate bonds when:-

- Eurozone GDP growth continues to rise and is currently at around 2.9%
- yields are negative on many of the EU's bonds and
- Credit spreads are so low that region's junk bonds yield less than US treasuries?

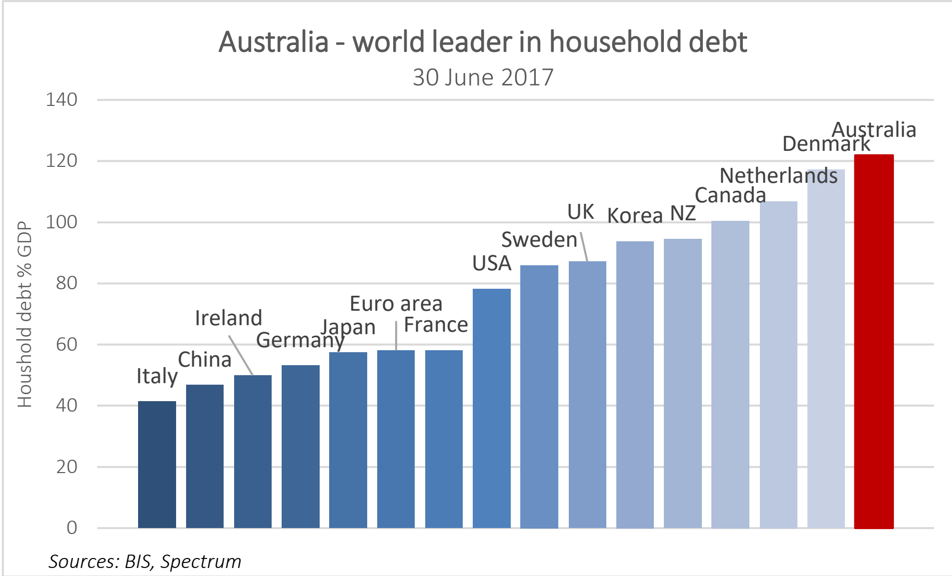
At present, it looks like waiting until at least until September this year. The longer it waits, though, the risk from the financial pain from unwinding grows every day.

And then we come to our own RBA. With low CPI readings it kept cutting rates past 2011. To its credit the RBA noted an issue with rising household debt. But in August 2016 it recorded "the risks associated with rising household sector leverage and rapid gains in housing prices had diminished". So as soon as there was a little slowing in the pace of the debt build what does the RBA do? It cut rates. And guess what happens? Aussies realise they can service more debt and take out bigger loans to buy more expensive homes.



Sources: ABS, Spectrum

Today, Australian's sit on top of the world when it comes to household indebtedness.

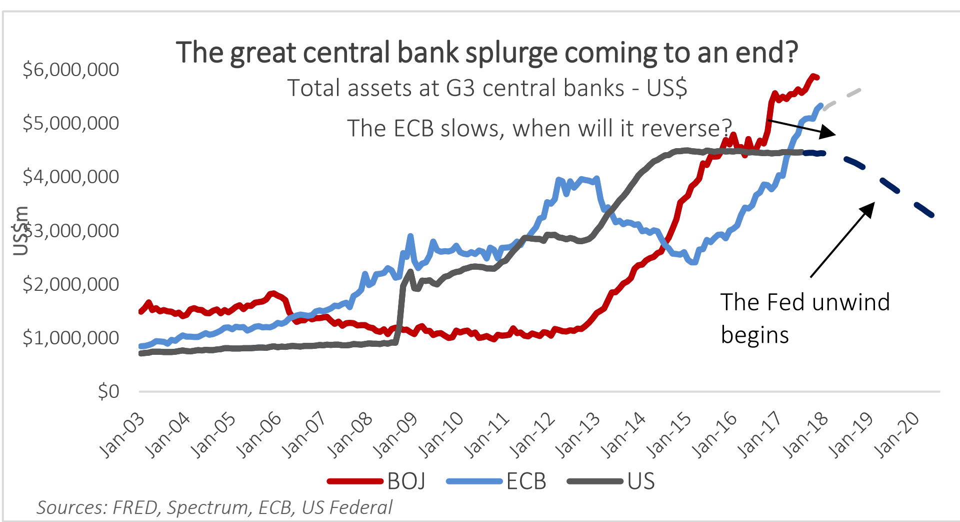


Australia also has the world's second and fifth least affordable cities. A remarkable achievement for the least densely populated continent.

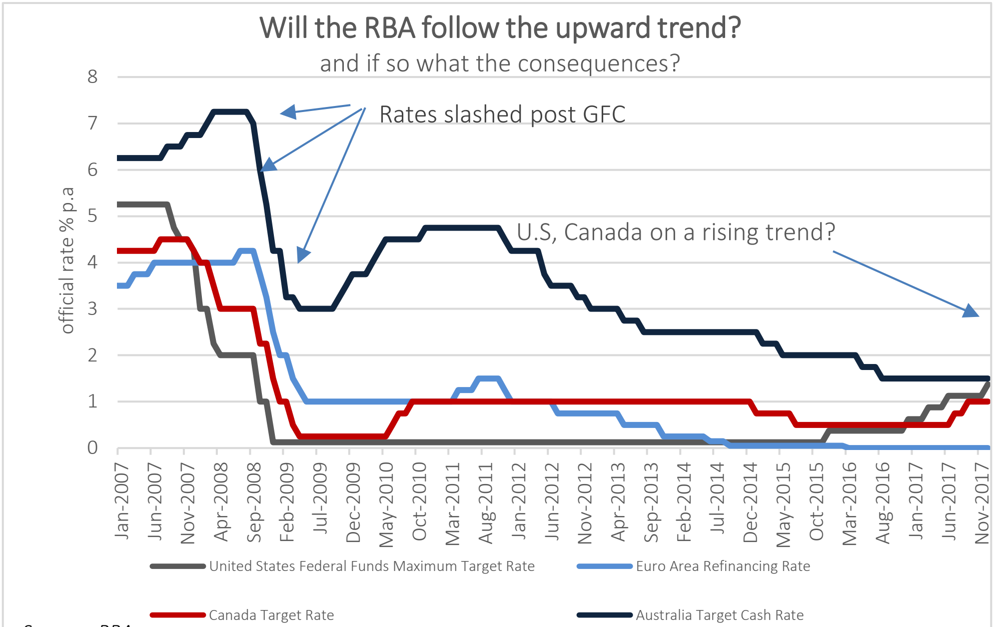
We suspect that history will view central bankers of the recent era of acting with undue confidence. They averted a prolonged recession or depression-like economy. But the term and depth of their policies is in turn made financial systems and some investments more vulnerable. The lack of weight given to circularity of growing credit and rising asset prices may be noted. The limited tools by not nudging the banks to curtail loan growth may also be discussed.

The risks of investing while the experiment is unwound

The easy money era has passed its peak. Now the flow of central bank funds into G3 markets is set to slow and then reverse. This reversal combined with lofty debt and valuation levels make a highly combustible cocktail for investors – Australian assets included.



Knowing the risks above is one thing. Navigating the investment landscape while generating positive returns is another. The above concerns form the foundation of our present strategy. Keep bond-yield-sensitive investments modest, risk levels relatively low and remain cautious on residential property related exposures.



Sources: RBA

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