minackadvisors

Down Under Daily, 11 February 2016

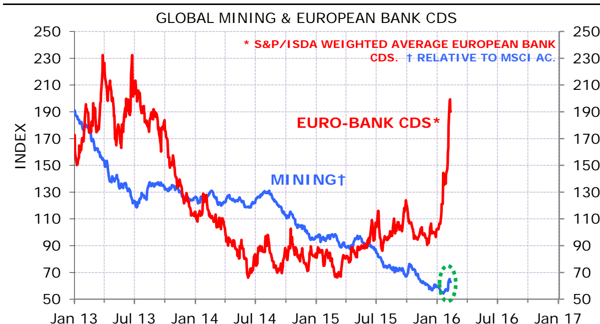
A Dangerous Shift

The focus of the risk-asset sell-off is shifting from macro weakness to financial stress. This is more serious as market fears of financial stress can be self-fulfilling. Two other factors are contributing to the weakness. First, lower prospective asset returns justify larger adverse reactions to downside risk. Second, the central bank bubble seems to be deflating. Central banks have long been over-rated in my view; markets seem to be starting to agree.

The equity sell-down is changing: it had been led by economically-sensitive sectors but is now shifting to financial risk (Exhibit 1). The bounce in sharply over sold macro plays presumably reflects lop-sided positioning: financial stress is not good for growth.

Exhibit 1

From A Growth Problem To A Bank Problem

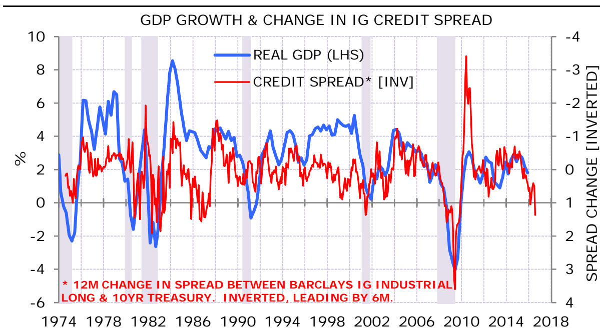


Source: MSCI, Bloomberg; Minack Advisors

This is a worrying shift. Equity declines may forecast macro weakness, but credit stress can cause it. Exhibit 2 shows how a 1%-plus widening in investment grade credit spreads has typically preceded recessions in the US. To be fair, the one false bear sign was in 1985 amidst falling oil prices.

Exhibit 2

Wider Spreads Signal Rising Recession Risk



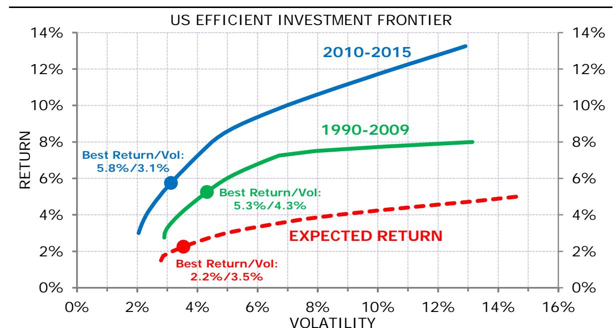
Source: Barclays, DataStream, BEA, NBER; Minack Advisors

There are two bigger picture issues that could also be contributing to the weakness in risk assets. The first is that lower prospective returns justify larger defensive responses to bearish risks. Investors would likely hold little cash if equities were expected to return 8% except in a 10% recession risk outcome. But they would be right to move more defensive with the same 10% recession risk if the expected equity return otherwise was only 4%.

In short, the weakness in risk assets since mid-2015 may not be solely because the risk of a bearish outcome has increased, but because the prospective returns in a base case outcome have fallen. Exhibit 3 shows one example of the poorer risk-reward trade-off now on offer. It shows an estimate of the best return for a given level of risk (as measured by volatility) from an optimised mix of US Treasury, equity and credit assets. This is from Andrew Sheets, Morgan Stanley's global cross asset strategist (Andrew.Sheets@morganstanely.com).

Exhibit 3

A Poorer Risk-Return Outlook



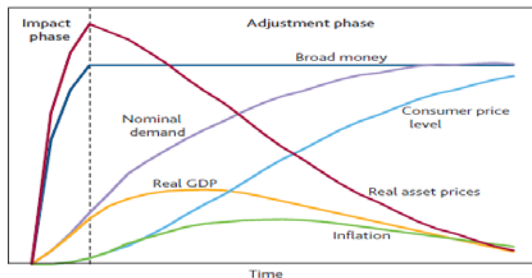
Source: Andrew Sheets (Andrew.sheets@morganstanley.com)/Morgan Stanley cross asset strategy team; Minack Advisors. Note: efficient frontier based on four assets: US stocks, 10 year Treasuries, investment grade and high yield bonds. Markers show points with the highest Sharpe ratios (ratio of return to volatility).

This change in asset behaviour was to be expected. Whether QE directly lifted asset prices – the central banks' view – or whether low risk-free rates, which would have occurred anyway, led to broad-based asset price re-rating – my view – the upshot is that the front-loading of asset returns, once complete, has left asset markets vulnerable to downside risk. Exhibit 4 shows a Bank of England paper with the stylised rise-and-fall impact of QE on asset prices. It seems that things are going according to plan...

minack

Exhibit 4

As You Sow, So Shall You Reap



Source: Michael Joyce, Matthew Tong and Robert Woods, The United Kingdom's quantitative easing policy: design, operation and impact, Bank of England Quarterly Bulletin, Q3 2011; Minack Advisors

The second corrosive factor for markets is the downgrading of perceived central bank potency. There are several recent hints of this decline. Mario Draghi's 'whatever it takes' comment in 2012 was, in my view, the single most important central bank action of the past 5 years. However, European bank stocks – a principal beneficiary of 'whatever it takes' – have now almost given up all their 'whatever it takes' gains, despite recent 'whatever it takes with steroids' comments from Mr. Draghi (Exhibit 5).

Exhibit 5

Whatever It Takes It Wasn't Enough

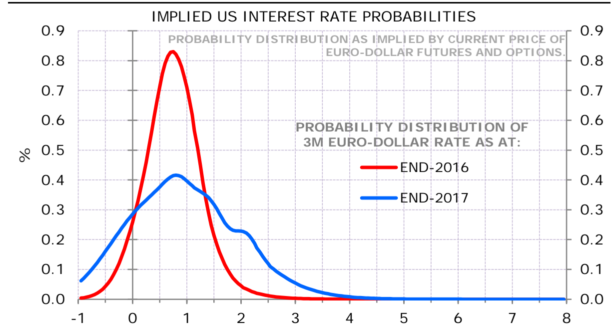
Source: MSCI, NBER; Minack Advisors

Likewise, the Bank of Japan's bazooka now seems to be firing blanks. The yen strengthened and equities fell after the cash rate was cut below zero – the opposite of what was presumably expected.

Most importantly, perceptions of the Federal Reserve also appear to be changing. Markets have never priced the Fed's dot-plot rate guidance. More tellingly, in my view, the market is now pricing a non-trivial chance that the Fed will have to completely reverse course. Current pricing of Euro-dollar futures and options now implies a reasonable chance of zero or negative rates ahead (Exhibit 6).

Exhibit 6

The Sub-Zero Risk

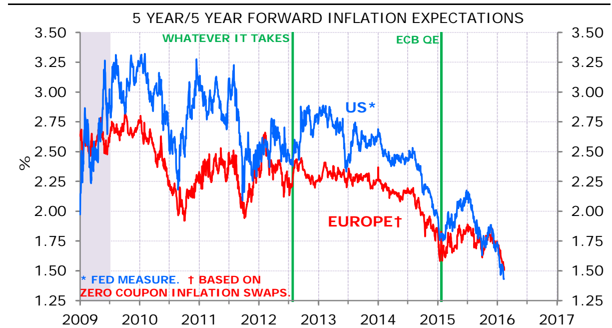


Source: Bloomberg; Minack Advisors

Medium-term inflation expectations are my crude measure of central bank credibility. Exhibit 7 shows the 5 year-5 year forward breakeven inflation rates for Europe and the US (an implicit forecast of inflation 6-10 years from now). These measures have been falling for 18 months. Markets are increasingly of the view that central banks will not be able to achieve their key policy aim: returning inflation to normal levels.

Exhibit 7

I Think They Can't



Source: Federal Reserve, Bloomberg, NBER; Minack Advisors

My medium-term view is that central banks will not be able to overcome the forces of disinflation. I didn't expect markets to agree with that until the next recession. However, if that is what is happening now, then this will be a more difficult year than I had been expecting.

minack

minackadvisors

Minack Advisors
Level 8, 167 Macquarie Street, Sydney NSW 2000, Australia
gerard@minackadvisors.com www.minackadvisors.com
Authorised Representative No. 443937
Minack Advisors Pty. Ltd. ABN: 84 163 503 044

© 2016 Minack Advisors Pty Ltd. This message and attachments are for the sole use of the addressee and are privileged, confidential and exempt from disclosure. If you are not the addressee, copying, dissemination, or distribution of this communication is strictly prohibited. In publishing research, Minack Advisors Pty Ltd is not soliciting any action based upon it. Minack Advisors Pty Ltd publications contain material based upon publicly available information, obtained from sources that it considers reliable. However, Minack Advisors Pty Ltd does not represent that it is accurate and it should not be relied on as such. Opinions expressed are current opinions as of the date appearing on Minack Advisors Pty Ltd publications only. All forecasts and statements about the future, even if presented as fact, should be treated as judgments, and neither Minack Advisors Pty Ltd nor its partners can be held responsible for any failure of those judgments to prove accurate. It should be assumed that, from time to time, Minack Advisors Pty Ltd and its partners will hold investments in securities and other positions, in equity, bond, currency and commodities markets, from which they will benefit if the forecasts and judgments about the future presented in this document do prove to be accurate. Minack Advisors Pty Ltd is not liable for any loss or damage resulting from the use of its product. Minack Advisors Pty Ltd is registered in Australia, ABN 84 163 503 044. Minack Advisors Pty Ltd is regulated by the Australian Securities and Investments Commission (ASIC), authorised representative number 443937.

minack