Global Strategy Weekly

I have seen the future and his name is Kevin

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With global financial markets constantly agonizing over the timing of the Fed's next rate hike, we are really missing the bigger picture. This far into the US economic cycle, the die is now cast. I see exactly what I saw before the 2008 Global Financial Crisis, but something is changed in me. I return from a recent trip to New York with excitement coursing though my veins for I have met a man named Kevin.

- I was in New York last week to speak at the Bank Credit Analyst annual conference. I don't normally do any outside speaking engagements, but the BCA Chief Economist, Martin Barnes and I go a long way back, 30 years in fact to when I was a strategist at Bank America Investment Management and Martin was a sell-side economist at Edinburgh-based broker Wood Mackenzie. Wow I can't believe that was 30 years ago!

- I was the first speaker and afterwards I enjoyed listening to every other speaker at the two-day event. Most notable of the outside economics speakers were Paul Volker, Larry Summers, and most significantly for me, ex Fed-Governor Kevin Warsh. Much to my own regret I had never familiarised myself with the views of Governor Warsh, who was at the Fed from 2006-11, and played a key role in navigating the Fed through the crisis. He got a rousing reception from the BCA audience as he talked a lot of sense – in particular on how the Yellen Fed has lost its way and current policy is deeply flawed. He explained that the Fed has been "captured" by a groupthink of academics led by the 'Secular Stagnation' ideas of his friend, Larry Summers. Rather than admitting they are wrong, this group, who failed to predict the current economic malaise, have constructed this theory to explain why ever more stimulus is required. In particular Warsh warned that the Fed had become the slave of the S&P (I think the cartoon below from the fine folks at Hedgeye sums up the situation nicely). Warsh's views were indeed a breath of fresh air for someone so close to policy (see here and here). I have recently seen his name mooted as a future Fed Chair, and should a vacancy (unexpectedly) arise, he would definitely be my choice.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

Source: Hedgeye Cartoons

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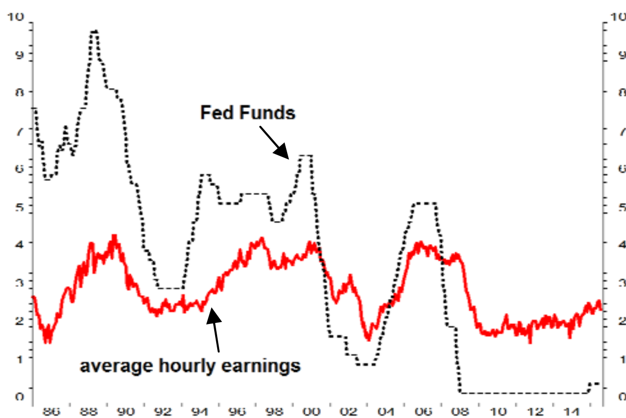
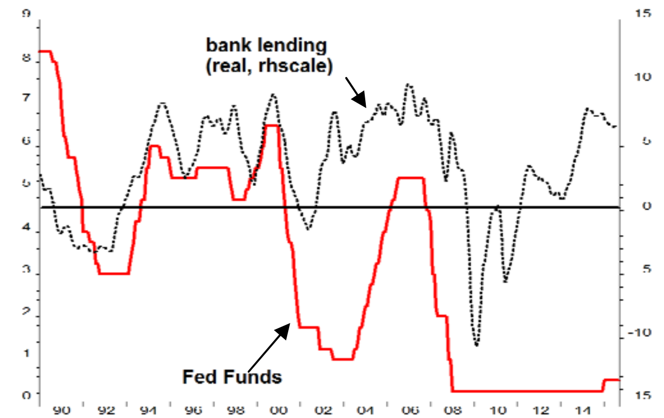
Yes, I am reinvigorated after my trip to New York. Not only did I meet someone close to policy circles who actually makes sense to me, but upon my return to the UK I was pleased to see that one of the most moronic economic policies of all time had been unceremoniously dumped – namely former UK Chancellor's George Osborne's 'help to buy', state subsidy for home buyers (link). This demonstrates to me that bad economic policy can indeed be reversed, albeit with a change in regime.

If Kevin Warsh is a young future potential Fed chair (he was the youngest ever Fed governor at 35 when he was appointed in 2006), I found listening to the vast experience of Paul Volker sobering indeed, given his concern at the current state of economic policy. Hence it was with particular interest that I listened to Larry Summers' presentation, as it is his view of 'secular stagnation' and the resultant policy prescriptions that have captured the Fed and policy makers around the world. Summers is definitely in the camp that says the Fed should not be raising rates and policy should, if anything, be easier and moving to facilitate infrastructure spending (aka helicopter money). Certainly the still-subdued rise in *nominal* wage inflation (left-hand chart below) does not warrant higher rates, but what surprised me is that Summers is relaxed about the surge in debt that we are so concerned about (see right-hand chart below).

Fed Funds and average hourly earnings (yoy%)



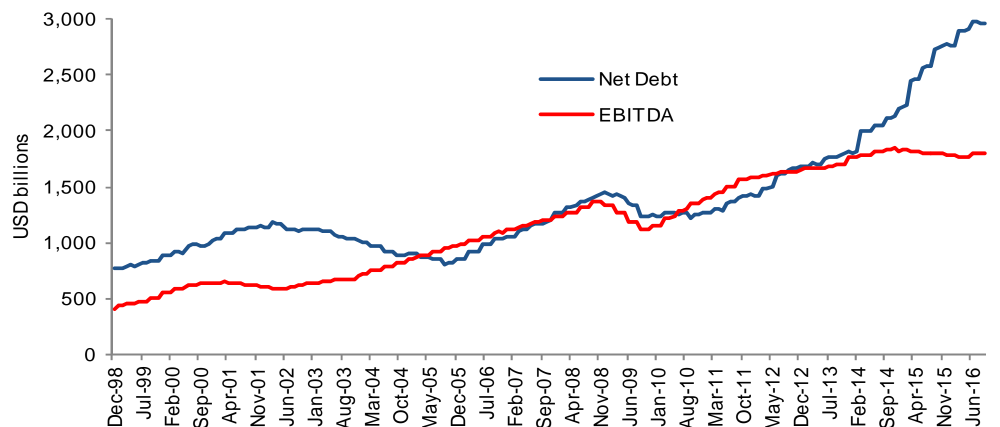
Fed Funds and bank lending (yoy%, real)



Source: Datastream

Summers' relaxed view on the debt build-up, particularly visible in the corporate sector, is in sharp contrast with our own view that this looks set to wreck the US economy. Summers was particularly dismissive of comparing debt to income as the former is a stock and the latter a flow concept. He thought it entirely appropriate in a world of lower interest rates that debt had reached record levels relative to income – belying, for example, the concerns expressed by the IMF this week. Should we worry about the chart below or not?

US corporate net debt and EBITDA (S&P1500 ex financials)



Source: Factset, SG Quant

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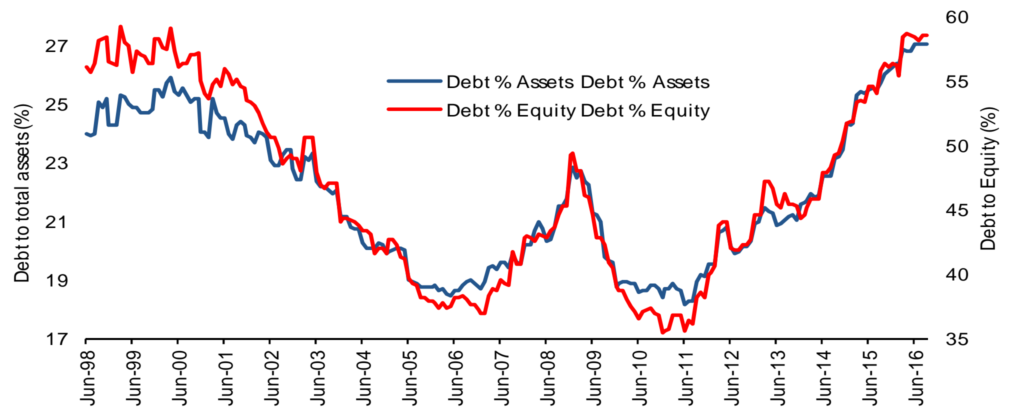
The charts above and below have just been updated by my colleague Andrew Lapthorne (and using the S&P 1500 ex financials universe). Summers' point was we shouldn't be too stressed about rising debt as 1) QE is driving up asset prices and higher debt does not look excessive relative to assets, and 2) rock-bottom interest rates mean the debt is easily serviceable.

Now on the first point, Andrew shows that quoted company corporate debt has rocketed relative to assets to now exceed the madness last seen at the height of the 2000 TMT bubble. Indeed the problem with Summers' analysis in my view is that *it is the higher debt that is being used to push up asset values* (via share buybacks), just as it did during the housing bubble in 2005-7. And by pushing asset values well beyond fundamentals you build debt structures on false asset values, which only become apparent when the asset bubble bursts. *And am I in any way reassured that the Fed sees no bubbles?* No, I am not. These dudes will never identify an asset bubble – at least before the event!

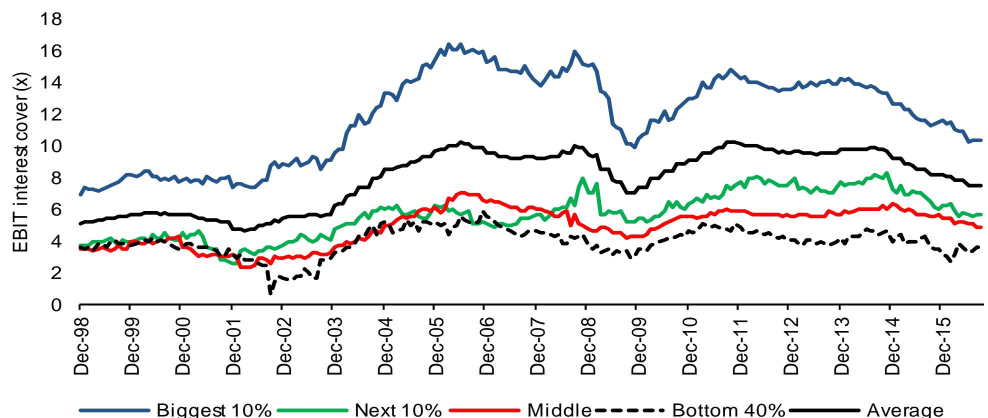
US median leverage ratios in the US are very high (ex energy and finacials S&P 1500 universe)



Source: : SG Cross Asset Research/Equity Quant, Thomson Reuters Datastream

Andrew notes that the way corporate bond pricing models work (eg Moody's KMV and Merton's 'distance to default' models) it is not just a company's ability to pay its coupon that affects its valuation. Investors are in effect always asking, can this company repay its principal TODAY, even though the repayment is not actually due for 30 years. If asset values collapse in the event of a recession, corporate bond spreads will explode irrespective of the fact that they can easily pay the interest. But hang on a second, let's just look at interest cover for the quoted sector, for Andrew finds that despite record low interest rates, cover has declined to levels last seen in the depths of the last recession (see chart below)! In the next recession a sharp decline in both profits and the equity market will reveal this Vortex of Debility. US corporate spreads will then explode as the economy is overwhelmed by corporate defaults and bankruptcies. And with the Fed having been the midwife of yet another financial crisis, what price do you give me for it to lose its independence?

US interest cover is not as comfortable as you think (US S&P 1500 ex financials universe)



Source: SG Cross Asset Research/Equity Quant, Factset

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