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Perils of the Icarus Trade as the world runs short of dollars

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Breugel's strange depiction of the Fall of Icarus, inspired by the poem from Ovid

Bank of America calls it the Icarus Trade. Global stock markets will surge by another 10pc in a parabolic 'melt-up' this quarter, akin to the final stage of the dotcom boom.

This will be followed by a mirror 'melt-down' later in 2017 as the US Federal Reserves squeezes global liquidity, and rising bond yields puncture the Trump reflation trade.

Michael Hartnett, the bank's investment strategist, says there will be a perfect moment for the 'Big Short' within a few months, but first we must all wait for the speculative fever to pass. The warning signs of a market top are not yet flashing red.

The Bull/Bear ratio is a frothy 3.4, but far from extreme. The cash reserves of money managers have fallen to a 19-month low of 4.8pc. The danger zone is nearer 4pc. Powerful rallies tend to draw all but the most steely resisters into the vortex first.

Bank of America recommends "laggard risk assets", singling out British assets as the ultimate unloved play. We in the UK may think that the headline rise of the FTSE-250 over the last twenty months is not so bad, but for sophisticated investors who think in dollar terms it has been a 20pc haircut. Britain PLC is cheap.

Picking the last pennies off tracks before an incoming train is only for the nimble and brave. Mr Hartnett says bond stress is creeping up on the markets. The peak-to-trough losses for holders of US Treasuries over the last five months are already greater than before the 1987 crash, the Orange County and Mexico blow-ups in 1994, and is not far short of the 'taper tantrum' in 2013.

The great unknown is where the pain threshold lies in a global system with debt ratios that are now roughly 40pc of GDP higher than just before the Lehman crisis. Bank of America fears a further rise in yields of 50 to 75 basis points may be enough to trigger a "financial event".

HSBC's latest global outlook is even darker. Indeed, it is astonishing. The bank expects yields on 10-year US Treasuries to push a little higher to 2.5pc before crashing back to historic lows of 1.35pc by the end of the year, taking global yields with them.

Markets will conclude by the summer that Trumpian stimulus does not add up to much, and that the reflation narrative is a hoax. "We believe that equities are walking a tightrope, and there is a fairly long way to fall," said the bank.

While I do not take a view on stock prices, HSBC's outlook is broadly in line with my own. The world cannot easily withstand the sort of Fed tightening now being etched into forecasts by the macro-economic fraternity.

The Institute of International Finance says debt has reached $217 trillion, a record ratio of 325pc of GDP. What is remarkable is that even in mature economies - trying to 'deleverage' - the ratio jumped by 6pc of GDP to 390pc over the first nine months of last year.

There is almost nowhere left to hide. Corporate debt in emerging markets has risen from $6.5 trillion to $25.5 trillion since Lehman, with the 'credit gap' signalling danger in China, Hong Kong, Singapore, Thailand, Saudi Arabia, Chile, Turkey, and Indonesia. Total off-shore dollar debt has risen fivefold to $10 trillion since 2000.

The financial system is clearly out of kilter. The pattern of the last 35 years is a steadily falling "natural" rate of interest, requiring ever more radical action by central banks at the trough of each cycle.

The policy elites badly misjudged the force of this 'Wicksellian' slide in the build-up to the global crisis in 2008. While the subprime saga makes for electrifying Holywood films, it was not the reason why the Western banking system collapsed.

The trigger of the crash was overly tight money. The European Central Bank raised rates into the teeth of the storm. Hawkish Fed rhetoric from March to August 2008 pushed up US borrowing costs sharply, ignoring warnings from some of their own staff that the money supply was by then imploding. Both banks under-estimated the fragility of the system.

Central bankers are more alert this time but they have not scrapped their infamous 'DSGE' models, and I suspect that political pressure - from Congress, or regional Fed banks, or from Germany - will cause them to over-tighten again. We may find that three US rate rises and even a smidgeon of ECB tapering are all it takes to detonate the next crisis.

Matisse's collage of Icarus has a dreamy feel

Markets seem to be betting that Donald Trump's fiscal largesse will be large enough to break the deflationary grip. HSBC says they are "cherry-picking the good bits" from his campaign.

We do not yet know whether his infrastructure plan really exists. There will certainly be tax cuts but circumstances are nothing like the Reagan stimulus of the early 1980s when the US was coming out of recession.

The Fed's Stanley Fischer has hinted strongly that rates will rise by 50 basis points to counter each 1pc of GDP in fiscal stimulus, given the late stage of the economic cycle and the incipient labour shortage.

So either it turns out that Trump is mostly bluster - and therefore little has changed - or we get real stimulus and the Fed goes on the war path. This would push the dollar to nose-bleed levels, squeezing emerging markets until the pips squeak.

HSBC warns that Mr Trump's ‘tax holiday’ for US corporate profits held overseas could make matter worse. A surge in repatriation at the wrong moment would withdrawing yet more dollar liquidity from the Asia, Latin America, and the Mid-East.

The key point is that world has changed since the Reagan era. The US is no longer the economic hegemon or buyer-of-last resort for global imports, but it is still the monetary hegemon through unprecedented levels of dollarisation.

This is a dangerous split. The global economy may face the full brunt of a dollar shock, without the trade benefits that used to offset such strong dollar episodes. This could happen even if Mr Trump resists the urge to start a few trade wars.

"The US now accounts for a much smaller share of global demand than it did over a decade ago and its high income level and ageing population mean that more than two-thirds of US consumer spending is now on services," said Janet Henry, HSBC's chief economist.

Whether you think the deflationary supercycle since 1980 has really touched bottom depends on what you think caused it in the first place. If it was a one-off shock caused by globalisation and the entry of the Communist world into the capitalist system, it will self-correct over time.

The counter view is that it stems from a deeper corrosion of monetary policy. The BIS calls it the bad habit of asymmetry: letting asset bubbles run their course, but pulling out all the stops to deal with busts. This amounts to slow intertemporal poison. It draws prosperity from the future. The trap eventually closes on central banks.

If such thinking is valid, the only way out is repudiation of debt, a jubilee of sorts. These are rarely gentle affairs.