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Taper relief

"The road to hell is paved with good intentions."

- Proverb.

"In the world of securities, courage becomes the supreme virtue after adequate knowledge and a tested judgment are at hand."

- Benjamin Graham.

As Ben Graham, the father of value investing, also observed, an investment operation "is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." Challenged to distil the secret of sound investing into just three words, he advocated: "Margin of safety". Unfortunately for all investors today, the "margin of safety" has all but disappeared. To appreciate just how far away we are from normality or any remotely normal "margin of safety", consider the chart below:

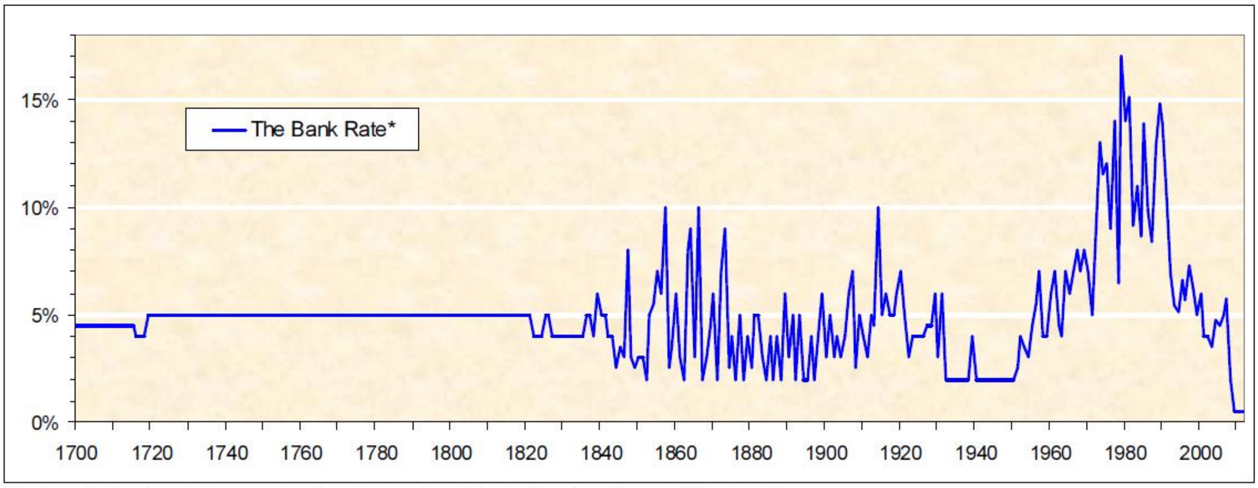
US 10 year Treasury bond yield, 1790 - 2013

Source: Global Financial Data / Barry Ritholtz

10 year US Treasury yields are at their lowest levels in more than two centuries. What makes current yields so much stranger is that they exist when the US has never been deeper in debt ($16 trillion and counting just for the on-balance sheet liabilities) and thus when the supply of Treasuries has never been as expansive. Have the laws of supply and demand been repealed ?

If the US bond market is in a bizarre bubble, it is hardly alone. Consider the even longer data series below, a favourite of MoneyWeek's Merryn Somerset-Webb, via Church House Investment Management. In the more than three centuries' history of the Bank of England, the base rate has never been this low. A knock-on effect is that any chart of Gilt yields strongly resembles that for US Treasuries, above.

UK Bank Rate (Base Rate) 1694 - 2013



**Variously the Bank Rate, Minimum Lending Rate, Minimum Band 1 Dealing Rate, Repo Rate and Official Bank Rate.*
***Source:* The Bank of England, Church House**

One of the tenets of (modern) portfolio theory is that there is such a thing as a risk-free asset, against which other investments can be assessed. Conventionally, the risk-free asset has been a short-term government security, which has typically offered a fixed rate of interest with negligible risk of default.

We know why western government bond yields are so low. In part they reflect the response of investors to most western economies having gone spectacularly ex-growth courtesy of decades of overspending and the fiscal impact of the Global Financial Crisis. In part they reflect financial repression: that heavily indebted western governments are aggressively coercing investors to hold that debt. And in part they reflect the fact that western governments, through their economic agents, the central banks, are rigging the market in their own debt: governments issue debt, only to have their central banks buy it right back, thus creating liquidity for commercial banks that can put that money to more productive use – like artificially inflating their stock markets. Because market manipulation is normally illegal, the monetary authorities have coined a phrase to give their market rigging an air of technical sophistication – quantitative easing, or QE.

As the cartoon below suggests, QE is founded on hope and not much else.

Source: The Sceptical Market Observer

Both the Federal Reserve and the Bank of England have taken to QE like ducks to water. But compared to the Bank of Japan, they are rank amateurs.

Most investors cannot fail to have noticed that the Japanese markets of late have been unusually volatile. Detlev Schlichter takes up the story:

"Japan has, for the past two-plus decades, been the global trendsetter in terms of macroeconomic deterioration and monetary policy. It was the first to have a major housing and banking bubble, the first to see that bubble burst, to respond with years of 1 percent interest rates, then zero rates, then various rounds of quantitative easing. The West has been following Japan each step on the way – usually with a lag of about ten years or so, although it seems to be catching up of late. Now Japan is the first developed nation to go 'all-in', to implement a no-holds-barred money-printing regime to (supposedly) 'stimulate' the economy. This is called Abenomics, after Japan's new prime minister, Shinzo Abe, the new poster-boy of policy hyper-activism. I expect the West to follow soon."

As Detlev points out, at first, the Japanese markets did exactly what the central bankers wanted them to do. The yen collapsed. Bond yields fell. Japanese stocks exploded higher.

"But in May things took a remarkable and abrupt turn for the worse. In just eight trading days the Nikkei stock market index collapsed by 15%. And, importantly, all of this started with bonds selling off."

Even a 15% sell-off by Japanese stocks has to be seen in the context of a roughly 80% rally during the preceding six months. Stock markets fluctuate, after all. But the sell-off in Japanese government bonds is entirely rational. The Bank of Japan had just promised to double the Japanese money supply and create inflation. They had, in other words, promised to impoverish holders of Japanese government bonds (JGBs).

Which makes the widespread adoption of such aggressive monetary stimulus internationally so dangerous. Markets do not exist in a vacuum – even for JGBs, which are mostly held by Japanese domestic investors and therefore widely reckoned to be irrelevant to investors outside Japan. Actions have consequences. The economy is not the machine that Keynes reckoned it to be when he said,

"we have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand. The result is that our possibilities of wealth may run to waste for a time – perhaps for a long time."

The great insight of the Austrian economists was to recognise that the economy is not a machine; or, if it is, it is a machine with 7 billion moving parts. The economy is not an engine: the economy is us. It is no surprise that the great Austrian economist Ludwig von Mises titled his magnum opus 'Human Action'. As opposed, say, to 'Piddling About With Gears'.

Detlev's conclusion:

"If market weakness is the result of concerns over an end to policy accommodation, then I don't think markets have that much to fear. However, the largest sell-offs occurred in Japan, and in Japan there is not only no risk of policy tightening, there policy-makers are just at the beginning of the largest, most loudly advertised money-printing operation in history. Japanese government bonds and Japanese stocks are hardly nose-diving because they fear an end to QE. Have those who deal in these assets finally realized that they are sitting on gigantic bubbles and are they trying to exit before everybody else does? Have central bankers there lost control over markets? After all, money printing must lead to higher inflation at some point. The combination in Japan of a gigantic pile of accumulated debt, high running budget deficits, an old and ageing population, near-zero interest rates and the prospect of rising inflation (indeed, that is the official goal of Abenomics !) are a toxic mix for the bond market. It is absurd to assume that you can destroy your currency and dispossess your bond investors and at the same time expect them to reward you with low market yields. Rising yields, however, will derail Abenomics and the whole economy, for that matter."

Look back at that chart of US Treasury yields. The period from 1945 shows the yield on benchmark Treasury bonds forming an almost perfect Alp in cross-section. The shape is quite beautiful. From the austerity post-war years through the go-go years of the 1960s and the stagflationary disaster of the 1970s, T-bond yields rose from roughly 2% to a grotesque 16% in the early 1980s. Then, largely under the influence of Paul Volcker at the Fed – the only Fed chairman in recent history to take genuinely tough decisions in the cause of fighting inflation – market interest rates entered a secular bull market that almost certainly was the driving factor in the coincident bull run for stocks. But we are now back to 1945 era yields. Do we think the future outlook is for higher yields, or lower ones ? What does the chart suggest ?

This is a nightmarish environment to be practising Ben Graham-style value investing – because the margin of safety has been destroyed by central bank market manipulation. There is no risk free rate, only the yield available on hopelessly rigged Treasury bonds (and Gilts, and JGBs..) The manipulation of bond markets has inevitable effects upon stock market valuations too; everything is relative. Cash as a meaningful investment choice has also been destroyed by central bank action (see, again, that chart of the UK base rate). This means that we – and in turn our clients – are forced to take more risk than we would prefer even if our intention is simply to keep our heads above water. Investors are now obsessed about the prospect of the Fed "tapering" down its bond purchase programme. Having painted itself into such a corner, having become the prime mover behind both bond and equity market momentum, the Fed may never be in a position to taper anything. Nevertheless, this is the hand we've been dealt and which we must play. We think there is now a significant risk that QE ends – whenever it does end – in a rolling currency crisis. Since central banks can barely afford to let market interest rates rise any time soon, they will keep the printing presses rolling instead – and most fiat currencies will be printed toward destruction. So the fundamental rationale for holding gold is (price notwithstanding) as robust as ever, and we continue otherwise to buy equities, bonds and uncorrelated assets on a highly selective basis – as close to Ben Graham investing as is possible in such a hopelessly distorted world. But as Detlev Schlichter and Pimco's Mohamed El-Erian now ask, are the markets now beginning to lose confidence in central bankers ? We certainly are.

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