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At play with the risk market wolves

"We have to turn the page on the bubble-and-bust mentality that created this mess."

- President Obama, weekly radio address, August 10, 2013.

The commentary is now off on its summer break. It will be back in mid-September.

In the 1964 Sidney Lumet film 'Fail-Safe', a group of US nuclear bombers is accidentally sent a "go code" ordering it to drop its payload on Moscow. A Russian jamming device prevents the US military from contacting the bombers until they've already reached the point of no return; thereafter, SAC protocols dictate that the pilots ignore any orders received from headquarters. The US President, played by Henry Fonda, desperately seeks some way of resolving the impasse and avoiding an escalation into a full-blown nuclear exchange. But how ?

For anyone looking to make sense of increasingly volatile asset markets, Doug Noland's latest Credit Bubble Bulletin makes for an excellent read. As he strongly implies, the current emerging markets fiasco, higher Treasury yields and increasingly "normal" market mayhem may now be conspiring to mark a major market top. Stock markets may have traded at higher overall valuations, but it's difficult to recall a market environment quite so precarious as today's:

"In the U.S., open-ended QE has had minimal impact on the unemployment rate, while exerting dramatic effects on stock prices, corporate debt issuance (especially riskier debt) and home prices (particularly at the upper-end). Going on five years of near-zero short-term rates and bond market interventions have coerced an unprecedented shift of saver assets from the safety of "money" to the risk market wolves. The belief that the Federal Reserve and global central banks would continue to backstop risk markets has been fundamental to epic market mispricing..

"The unfolding tightening of EM financial conditions portends trouble for the global economy. Emerging markets have begun to adjust to harsh new realities. Developed markets, if they were functioning normally, would have begun to adjust to mounting risks to global financial and economic systems. Instead, market players assume heightened fragilities will only extend the period of unprecedented developed central bank "money printing" and market intervention. This view was bolstered by Bernanke's comments that the Fed would "push back" against any tightening of financial conditions..

"As an analyst of Bubbles, I readily admit it is impossible to accurately predict the timing of their demise. Even in hindsight, I have no idea why technology stocks put in Bubble highs in March of 2000. It's not clear why stocks peaked again when they did in 2007. It's never been clear to me why the U.S. equities Bubble cracked when it did in late-1929. But all those major market tops were put in after speculative market melt-ups pushed the divergence between inflated securities price Bubbles and deteriorating fundamentals to precarious extremes. And all three speculative melt-ups were fueled in part by powerful short squeezes, squeezes made possible by traders shorting securities in response to deteriorating fundamental backdrops. A similar environment exists for a major top in 2013."

Future market historians will not look kindly on monetary policymakers who effectively forced savers from, in Noland's grimly accurate phrase, "the safety of money to the risk market wolves." But rather than simply resorting to a counsel of despair, we think there are sensible responses for investors to take in anticipation of what might prove to be stormy weather. Diversification, we believe, remains the last free lunch in finance, and sensible pan-asset class diversification the only logical response to what could prove to be the early stages of a secular bear market for equities and bonds (a disaster for most conventionally positioned portfolios). The second sensible portfolio response is to seek solace in valuation – doubly valid when any form of market timing, or the primacy of what used to be called fundamentals, have been made impossible courtesy of absurd if not outright surreal monetary stimulus. So while we fear the outlook for both bonds and equities as asset classes (the latter by way of their likely reaction to dramatically lower price levels in the former), compelling valuations – where they can be found, at least – take much of the sting away. Our single biggest concern is that a 30 year bull run in interest rates seems to have turned – and we question whether central bankers are in any position to put the genie back in the bottle now that the bond markets seem to have utterly lost faith in them. Where the bond market leads, can the stock market be far behind ? And if discredited central bankers are determined to prop up financial asset prices no matter what, can the outcome really be anything other than a disorderly inflationary mess ?

['Fail-Safe' Spoiler alert..] There is ultimately no way for the US President to call back his bombers and prevent them from completing their mission. Failing to prevent a nuclear attack on Moscow, he orders one of his generals to drop an equivalent nuclear payload over New York City, in the hope of appeasing the Soviets. After a sequence of problems accelerates within a culture of inflexible bureaucracy, the only "solution" is for the government to sacrifice millions of innocent lives. The hubris of the nuclear age politician has a natural corollary in the hubris of the interventionist central banker. As Blaise Pascal put it,

"All of humanity's problems stem from man's inability to sit quietly in a room alone."

Speaking in response to the current emerging markets crisis, the South African finance minister, Pravin Gordhan, warned of

"an inability to find coherent and cohesive responses across the globe to ensure that we reduce the volatility in currencies in particular, but also in sentiment."

The proximate cause of much of this currency volatility can be traced back to exceptionally low policy rates in developed markets as a means of tackling the financial crisis there. And, of course, to exceptionally accommodative monetary stimulus from western central banks, notably the US Federal Reserve. President Obama claims to want to "turn the page" on bubble and bust, but appears unable to understand that the very institution of the Federal Reserve is the one most responsible for them. One wonders whether British politicians are as equally ignorant of the terrible influence and fitness for purpose of the Bank of England. The same question goes in relation to the euro zone, and to Japan..

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