ESCALA
PARTNERS

September 2020

MONTHLY AGENDA - THE AGE OF ADMINISTERED MARKETS

Administered markets

The COVID-19 crisis has accelerated many structural trends that were evident previously – e-commerce, the cashless society, remote working - just to name a few.

In financial circles, the trend that has been super-charged post-COVID is the trend toward "administered markets". Governments are relaxing bankruptcy laws; central banks are relaxing access to funding; and banks are being directed on what to buy, who to lend to and how to use their free cashflow. Administrators around the world are now more deeply embedded and more intrinsically involved in the determination of market risk than ever before.

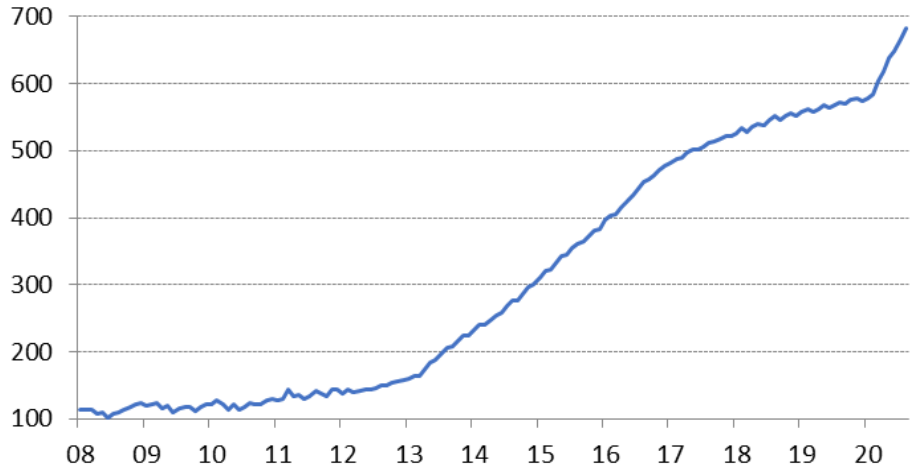
In our view this is not a trend that will abate anytime soon. Investors therefore need to adapt.

Not new

The intervention of governments and central banks in financial markets is not new. The Bank of England (BOE) and Bank of Japan (BOJ) have a long history of being involved in salvaging firms after economic downturns. Central bank involvement in currency management is also common though is mostly a tool used by emerging markets.

The BOJ was the first major central bank to undertake quantitative easing (QE) in March 2001. Quantitative easing involves unusually large purchases of assets by a central bank financed by money creation. Most of the assets purchased by the BOJ consisted of Japanese government bonds. This was later extended to include equities via exchange traded funds (ETFs). The BOJ now holds assets on its balance sheet worth almost 700 trillion yen, equivalent to 128% of its GDP (chart 1).

Chart 1: Bank of Japan balance sheet (trillion yen)



Source: Bloomberg

The level of central bank intervention took a step up after the Global Financial Crisis (GFC). Since that time, policymakers have been deliberately suppressing volatility, compressing risk premia, tamping down credit spreads and keeping the market wide-open for borrowers for the better part of two decades.

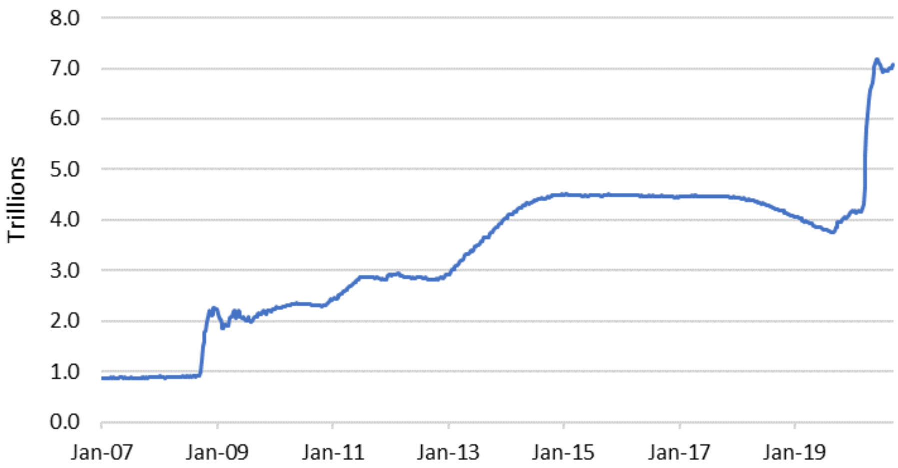
To QE-infinity and beyond

On the 24th March, in response to the COVID-19 crisis, the US Federal Reserve (the Fed) took quantitative easing to a whole new level. The Fed announced "QE infinity" - unlimited buying of government and mortgage-backed bonds. In addition, it announced it would purchase corporate bonds which later extended beyond investment grade to include high yield corporate bonds.

This move went well beyond even the QE announced after the GFC. At its peak during the COVID crisis, the Fed was buying $1.2 billion worth of bonds every hour. This compares with a purchase rate of $118 million per hour at the peak after the GFC (chart 2).

What was once a policy used only by the BOJ, in an attempt to stoke inflation, has now gone viral. Some 30 central banks around the world are now engaged in asset purchases of both government and private securities.

Chart 2: US Federal Reserve balance sheet (USD trillion)



Source: Bloomberg

If there is any doubt about this just consider the following:

– The Fed owns a third of all mortgage backed bonds in the US;

– The Fed now owns a total of 22,913 different financial securities;

– The Bank of Japan is the single largest owner of the Japanese equity market owning more than half of the country's exchange trade funds (ETFs);

– The central banks in Japan and Europe each own almost half of all their respective government bonds outstanding (chart 3).

With unlimited capacity to print money, central banks have unlimited capacity to intervene in asset markets.

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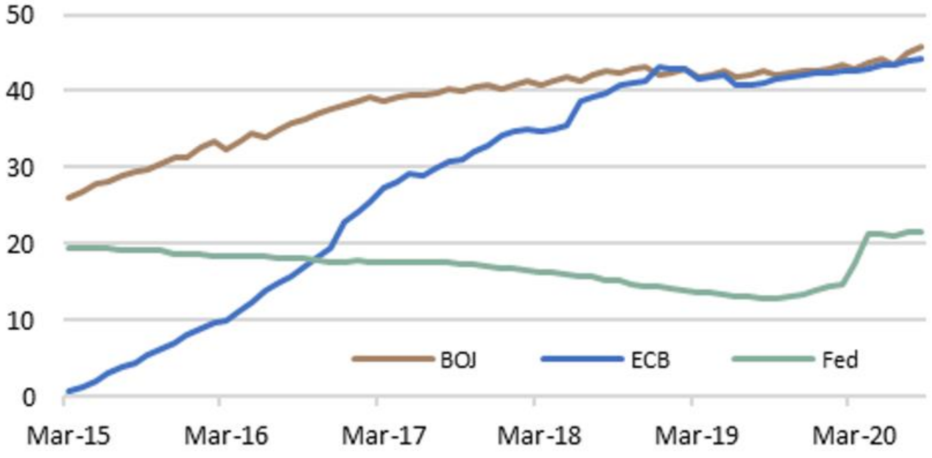
Chart 3: Share of ownership of all public bonds outstanding (%)



Source: Bloomberg

Distorted market pricing

Never before in its 106-year history has the US Federal Reserve played such a starring role in financial market price setting. While Chairman Powell is the third generation of QE-driven Fed Chairs, none of his predecessors took it to such a degree as he has.

Central bank asset purchase activity impairs price discovery. In this world, the price of an asset no longer represents the risk implied by its fundamentals. This applies to assets in both the bond and equity markets. A good example of this is the 896% rise in the Hertz share price in June after it was announced the US Federal Reserve was a buyer of its bonds. Hertz filed for bankruptcy in May. The Fed's policy is causing risk to be misrepresented in the marketplace.

It is very difficult for an investor to measure risk responsibly and accurately when the Fed is buying bonds in such scale and where the sole intention is to drive interest rates down, irrespective of the underlying fundamentals of the securities it is buying. Not only did the Fed purchase Hertz shares, it was also a buyer of JC Penney and Nieman Marcus shares.

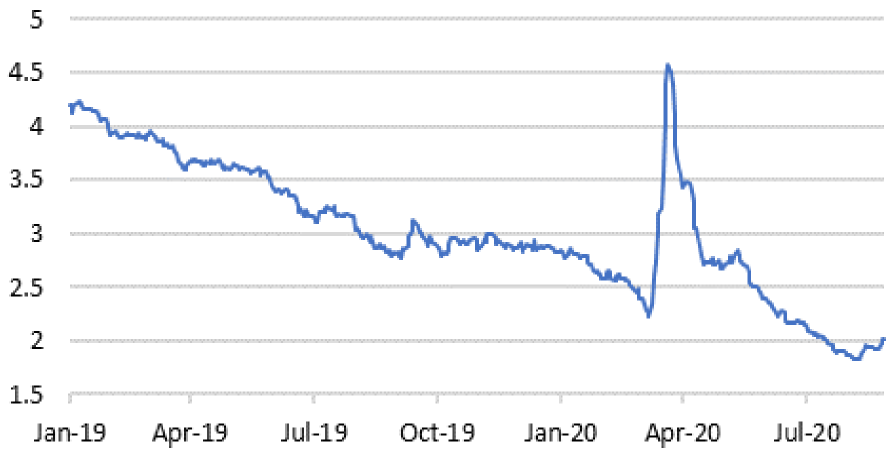
We have seen yields on corporate bonds come down significantly since the Fed began intervening because the additional risk premium earned for taking the risk of a defaulting borrower is no longer there (chart 4). If the borrower is protected from default, the lender should not receive any additional premium for buying default risk (because the risk no longer exists).

This is where the actions of the Federal Reserve affect investors. By interfering in the market, attempting to flatten the business cycle, pricing is distorted. The implication from this is that fundamentals, whilst still important, are relegated to the backseat. Central banks are not buying assets based on fundamentals. They are buying assets based on the need to supress interest rates in order to cushion an economic downturn.

It is not just the fixed income market that is being manipulated in this way. Interest rates in the US are arguably the most important interest rates in the world. It is against this interest rate that most other financial market instruments are priced – bonds and equities.

The market is driven more by the actions of central banks than the results of companies because the central bank has a bigger balance sheet than any company in the world. The term “don’t fight the Fed” is now part of the discussion of investment committees the world over.

Chart 4: Yield for US investment grade bonds (%)



Source: Bloomberg

Check-out anytime you like but you can never leave

When the Federal Reserve officially started its first quantitative easing program in 2009, an assurance was made that these would be "temporary measures" and that they would return back to normal when the financial conditions would allow it.

And so we wait, for more than a decade now.

The rationale for quantitative easing was two-fold. By lowering bond yields, it would encourage new investment which would drive economic growth. Second, it would drive a portfolio effect whereby investors, faced with such low interest rates, would be forced into allocating to riskier assets such as equities. The upward pressure this would put on riskier asset prices would create a wealth effect that would then lead to higher consumer spending.

In reality, the only real effect was to boost asset prices and encourage greater levels of corporate debt. Consumer spending didn't lift to any great degree because not all consumers owned the assets whose prices were lifting.

Once the decision is made to go down the path of quantitative easing it is difficult to turn back. The Bank of Japan has been purchasing financial assets since 2001. Nearly twenty years on it is still purchasing financial assets, competing with other investors to do it.

There are at least two reasons why it is hard to wind back quantitative easing particularly when the zero bound of official interest rates has been hit.

First, the act of buying assets to keep interest rates down interferes with the natural order of the business cycle. Underperforming companies are artificially sustained. A healthy economy is one where business are allowed to go bust. This ensures efficient allocation of resources and so drives potential economic growth higher. So ironically, the longer quantitative easing is maintained, the slower, more lethargic, less dynamic economic growth becomes, the more quantitative easing is relied upon as a stimulant.

Second, the policy itself creates such a distortion in the market, an imbalance that is based on artificial support, that its cessation would be too destabilising. It is far easier to inject liquidity into the system than to remove it because the issues created by the injection are not as immediately deleterious as those created when the liquidity is withdrawn. A collapse in the asset prices that have been so significantly supported by quantitative easing would have far reaching consequences. Interestingly, the US Federal Reserve has itself become too big to fail.

Incredibly, official interest rates in at least eighteen countries around the world have now been cut to zero. This leaves quantitative easing and fiscal policy as the two key policy tools that remain. The next downturn is likely to arrive before central banks have a chance to lift interest rates back to more normal levels which means further fiscal policy expansion is likely. In order to keep servicing costs for the government down, the central bank will need to continue to undertake quantitative easing.

In our view, we arrive at just one conclusion: the US Federal Reserve will take the global financial system even further down the path of administered markets in the years to come.

Investment implications

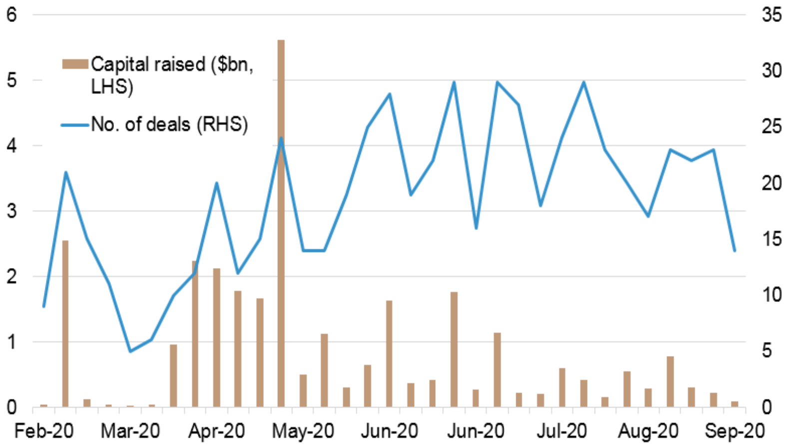
Whether we like it or not, we are operating in an environment of “administered markets”. That is, central banks are influencing market movements to such an extent that price discovery based on fundamentals is very difficult. How should investors adapt to this new age?

First, in this new world, we are likely to see periods of relative financial market stability interrupted by market tantrums. As Nouriel Roubini says, it will be a world characterised by “macro liquidity and market illiquidity”. Risk premiums will continue to be compressed as investors crowd into overvalued markets. These crowded positions are then susceptible to event risk, potentially leading to rapid and violent position unwinds. Ensuring you have an effective airbag for your portfolio in the form of a liquidity bucket will help cushion any impact this may cause.

Second, beware of currency volatility. In the 80s bond vigilantes could force the hand of the Federal Reserve. In an age where central banks are bigger participants in the bond market than any investor, bond vigilantes will become currency vigilantes. If US investors feel government deficits are getting too large, rather than sell bonds, they will sell the currency.

Third, trying to time the market in this environment will become more difficult. Company fundamentals and earnings profiles can be modelled, central bank reaction functions can’t. Indeed, sometimes it is not the central bank reaction that moves the market but rather the central banks reaction to the markets’ reaction. This is what George Soros called “reflexive relationships”.

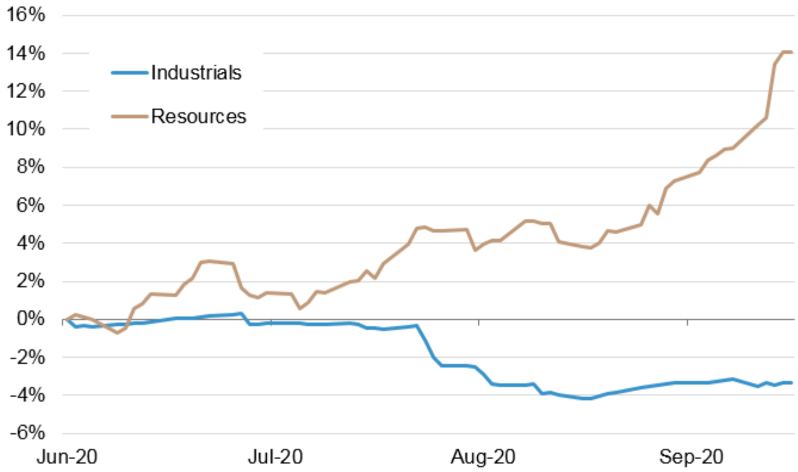
Chart 5: Australian Equity Market: Capital Raisings



Source: Bloomberg

A potential second wave of capital raisings by Australian companies did not eventuate through August's reporting season. With most large capital raisings occurring over April/May, company balance sheets are now in relatively good shape, with debt paid down and leverage reduced. Capital raisings have continued over the last few months, although generally these have been at the smaller end of the domestic equities market.

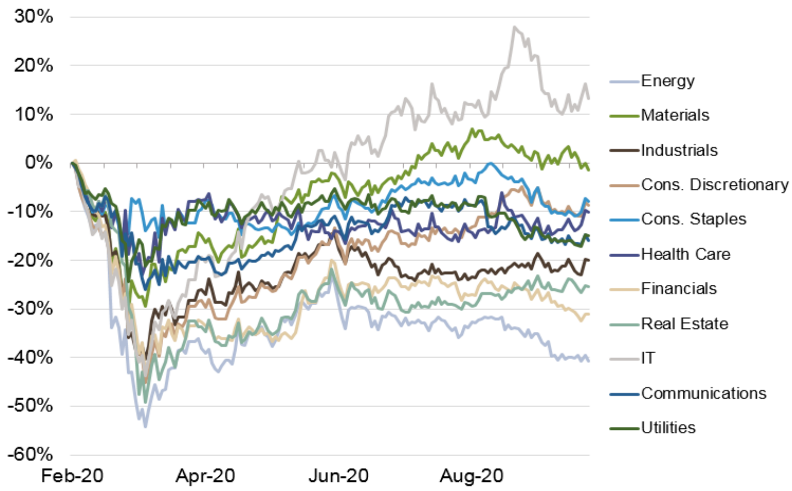
Chart 6: ASX 200: Earnings Revisions



Source: Bloomberg

With forward earnings downgrades filtering through the market as August's reporting season progressed, the recovery across industrials has stalled somewhat in the last two months. Further clouding the outlook has been the second round of lockdowns in Victoria. However, upgrades across the resources sector has supported the broader market in this time, with strengthening iron ore, gold and copper prices all leading to positive upgrades for mining companies.

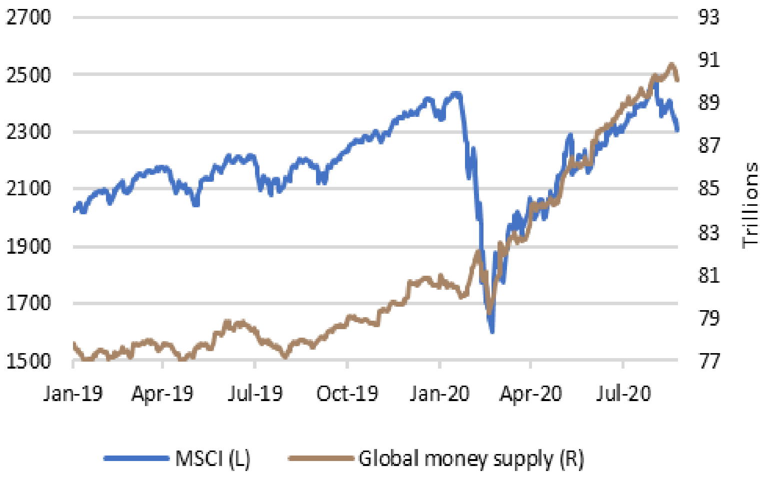
Chart 7: ASX 200: Sector Performance



Source: Bloomberg

The ASX 200 is lagging many other overseas equity markets in terms of performance since the beginning of the COVID-19 crisis. The structure of our domestic market explains some of this difference. IT is the only sector that is currently higher than at the beginning of the correction, although the sector is quite small in the Australian market. Meanwhile, the large financials sector has underperformed, with an expected rise in bad debts across the banks contributing to this outcome.

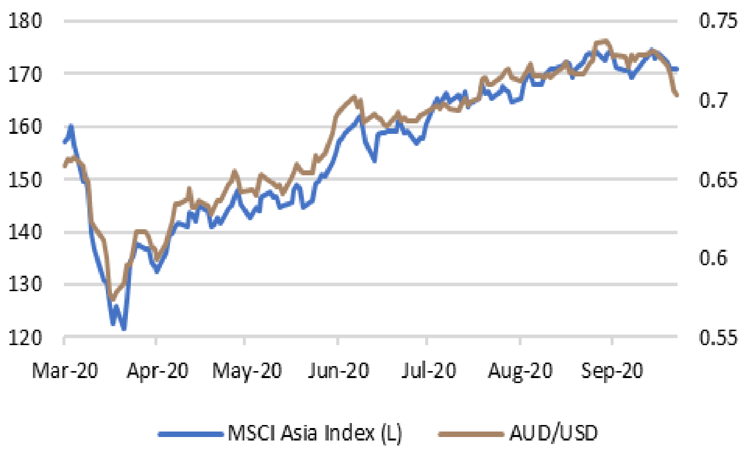
Chart 8: Global equities driven by global money supply



Source: Bloomberg

The correlation between the global money supply and global equities suggests that the correction underway will be of limited magnitude. The new high in money supply against a 7% correction in the SPX could be viewed as a bullish divergence.

Chart 9: Follow the Aussie



Source: Bloomberg

The message from a sliding AUD/USD is not a happy one for Asian stocks. The Aussie is viewed as a risk barometer, so its rapid slide this week will be read by equities as bearish. With the help from a strengthening USD, the Aussie may extend its decline. Even if stocks don't make a complete reversal of the past three months gain, the read across from the Aussie is that downward momentum is unlikely to pause just yet.

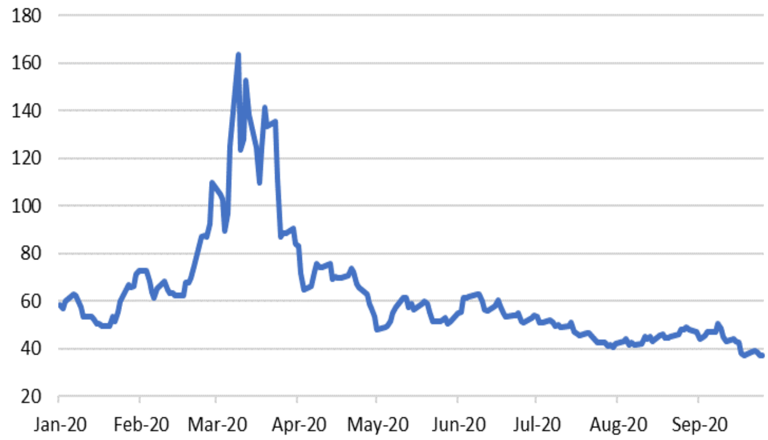
Chart 10: Feeling unloved – European banks

Source: Bloomberg

Rates, dividends and consolidation are the three big catalysts for European banking stocks. The prospect of rising rates has moved further away since the latest central bank comments. The other two may look more promising, yet they have failed to boost the sector's performance so far.

Valuations have been destroyed, a reflection of low profitability, as lenders remain under pressure from negative interest rates, increased regulatory and IT costs, and the potential impact on asset quality from the pandemic.

Chart 11: What's the fuss – bond market volatility low



Source: Bloomberg

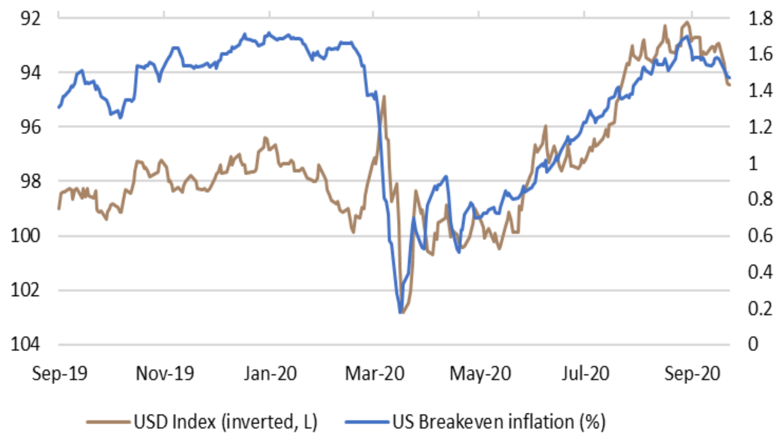
Equities have bounced around quite a bit over the past few months. Bond investors have been significantly calmer. Perhaps it's because most of the bonds are already priced for rates to be at zero for a long, long time. This naturally leads to a debate about whether compressed fixed-income volatility will manifest itself in other markets. For example, macro imbalances may materialise in currency markets.

Chart 12: Australian 3-year bond yield

Source: Bloomberg

Rate-cut fever has broken out in Australia. Australian government bonds are set for their best month since January after Bill Evans, the doyen of RBA forecasting, joined the chorus calling for fresh easing on Oct. 6 to coincide with the Federal Budget. Bank bill rates, 3y and 5y bond yields all dropped to records, setting holders up for disappointment if Governor Lowe sticks with his more-usual stance of calm optimism.

Chart 13: US dollar strengthens on renewed shutdown fears



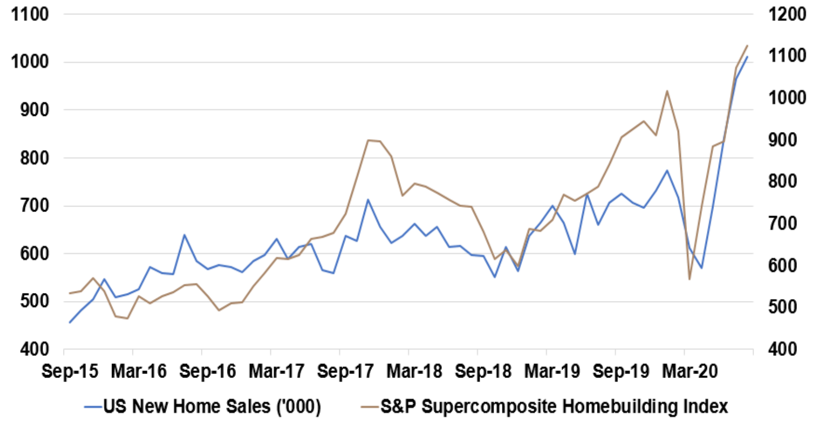
Source: Bloomberg

Overzealous dollar bears are quickly flipping to bulls as the prospect of shutdowns linked to a Covid resurgence and a pause in monetary stimulus undermines reflation bets.

The US dollar appears to be catching up to the recent drop in U.S. inflation expectations. It may not be a coincidence that dollar strength coincides with rising Trump approval ratings.

Asset Class View | **Alternatives**

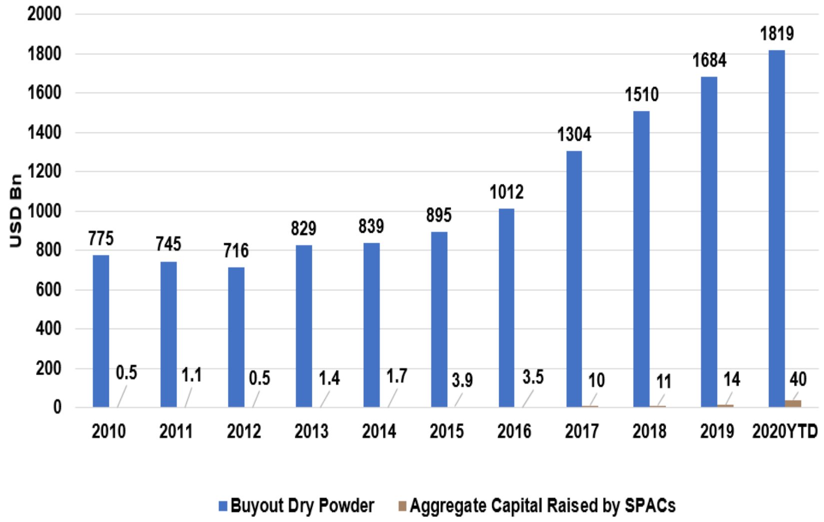
Chart 14: US home builders surge on new home sales



Source: Bloomberg

Sales of new homes rose to their highest levels since September 2006 in the US reaching an annualised figure of just over 1 million ahead of economist expectations of 890,000 for the month of August. 30-year mortgage rates in the US have been flagged as the main driver of the move. They are sitting at record lows of 2.91%, 195bps below the recent high of 4.86% set in October 2018. US based home builders have seen share prices surge in recent months. The S&P Supercomposite Homebuilding Index, which is a capitalisation-weighted index of US listed home builders, is up a staggering 147% since the March lows earlier this year and up 26% on a year to date basis.

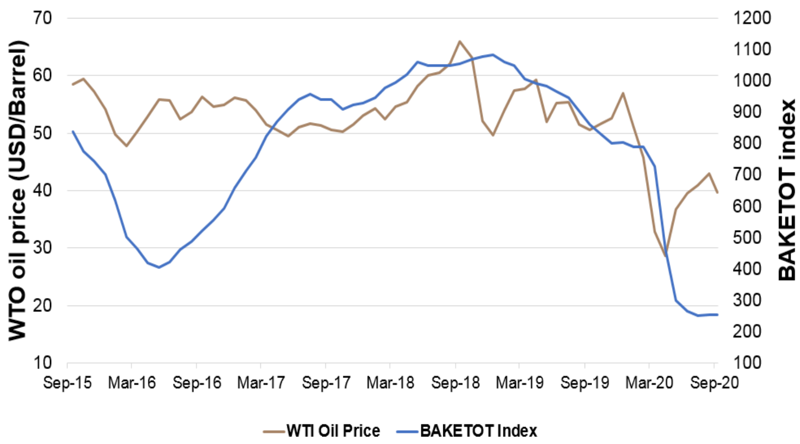
Chart 15: No big SPAC to private equity just yet



Source: Preqin

The recent activity in SPACs has garnered many headlines as of late, activity has tripled this year in the niche space which allows a publicly traded vehicle setup with the sole purpose of raising cash to acquire a private firm and take that firm public through the acquisition, offering a faster route to a public listing for the underlying company. The activity in SPACs however pales in comparison to the amount of cash sitting on the sidelines of large private equity firms, the $40bn raised year to date in SPACs is just 4% of the $851bn currently available to buyout funds globally. The track record of SPACs also raises concerns; of the 223 SPAC listings since the start of 2015, just 89 had taken a company public, with an average return of -18.8% and a median return of -36.1%. Five-year horizon equivalent returns on buyout funds was 16.2% as at Dec 2019.

Chart 16: Baker Hughes US oil & gas rig count



Source: Bloomberg

The most recent Baker Hughes US oil and gas rig index showed the number of operational rigs in the US continues to remain at multi-year lows – providing some structural support for oil prices. Consistent with this, a recent US Energy Information Administration (EIA) report showed U.S. distillate stockpiles declined the most since March 2020, pushing oil prices slightly higher. Gains were limited, however, by concerns around the pace of the economic recovery.

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