

The Bad Case Scenario. How Markets and the Economy Could Suffer.

Just to be clear, this is not my base (highest probability) case but market volatility is at the point where it is useful to consider what could go wrong, what if we are wrong about our base case, and how far could reality be from our expectations.

To reiterate, the global economy is actually in good shape, but, equity markets have become expensive, boosted by QE and other performance enhancers. Risk assets from equities to credit, are repricing fast, as expectations for a slowdown increase. And let's be clear, the consensus expectations are for a very shallow slowdown.

So what could go wrong?

Monetary Policy has reached its limits. We can't deal with the next recession.

The ECB is an excellent case in point. The European economy is already slowing and yet the ECB has yet to raise interest rates and is only at the end of this year, ceasing net purchases under its Asset Purchase Program (QE). It is far from beginning to reduce the size of its balance sheet and or raising interest rates. It may have to start easing policy before it gets a chance of tightening. This would be a blow to the credibility of the ECB, to central banks in general and to QE. It would be the second blow, actually, the first having come from the Bank of Japan, whose efforts have an exercise in

gradual and long term futility.

The Fed is in a better position. It has raised interest rates 8 times since 2015 at the time of writing and is almost certain to make another 25 bp hike on Dec 20. The Fed also has the luxury, if you can call it that, of a fiscal policy driven extension of growth. This may give it room to raise rates a bit further, perhaps another 1% or 1.25% before the cycle turns. Or the cycle may turn too soon. All told, a Fed Funds rate of 3% is too low to cut from. The Fed needs at least a 4.5% or 5.0% level to cut from. In a downturn, the Fed might have to resume QE, not just halt the balance sheet reduction, proving QE to be a slippery slope and placing the US economy forever in a state of opioid dependence.

QE Normalization is bad for markets:

Of the countries who have employed QE, only two have tried to normalize. China and the US. China's first attempt in 2015, precipitated a sharp slowdown and a capital markets decline. The US began this year and just take a look at the stock market. Europe will simply halt balance sheet expansion, but given that Europe is already in a slowdown, albeit just a deceleration in growth, it will be useful to monitor the European experience.

Trade war is stagflationary :

A trade war would slow growth while it raised prices as the economy became less efficient. It would present a real challenge to Fed policy. Depending on degree, it could be very damaging, since tariffs are a tax on the US economy and would slow it at a time when it was naturally slowing already. For China, a trade war would be damaging as well, and as the Chinese economy suffers, demand for imported goods would fall

as well.

Societal and Political Issues:

Political cracks are appearing across Europe. Cinque Stelle and Lega rule Italy, and both parties are extremist and populist. They do not want to play by the EU's rules and could eventually break it up. Alternative fur Deutschland holds 12% of the Bundestag's seats and is progressing at local elections which is an ominous sign given their brand of politics. Vox is a far right party in Spain which has recently won seats at the Andalusian regional elections. Most recently, gilet jaune has laid siege to Paris and forced the government to back down from unpopular policies. Generally, poverty and inequality are driving people to alternative solutions, alternative to mainstream capitalism. After all, the modern form of capitalism is itself an alternative to mainstream capitalism, the one that advocates fair play and eschews bailing out elites. The gilet jaunes' complaint is general and fundamental, that the cost of living is rising too quickly, an interesting complaint given how hard the ECB is trying to boost inflation and get Europe out of its deflationary rut. The plight of the majority of people is that they see costs of living outrunning wage growth, and wonder whose demand it is that bids up prices and why these price increases fail to find their way into official inflation data. The answer is simple and often found on Instagram or Facebook as the rich forget their place and flaunt their advantages unwisely in front of the poor.

War:

The rivalry between China and the US could lead to war. It is quite clear that the trade war between the two countries is but one battle in a broader struggle for supremacy. What if

that rivalry spills out of the commercial theatre into the geopolitical one? Proxy wars could be fought in Africa where Chinese assets are already installed. The South China Sea could be an accelerant if the US challenges Chinese hegemony in the region. Taiwan could be an excellent reason for America to protect free peoples from oppression.

Civil war is more likely but less predictable or easy to characterize. Modern lines of conflict are more within each country, between rich and poor, young and old, left and right, liberal and conservative. They are hard to characterize because one side cannot easily mobilize the organs of state against the other. The complaints of gilet jaunes are an example. In Britain, the Tory party is at war with itself. In America, partisanship has reached acute levels which threaten to divide the country.

Oil: Rising oil may be worse than falling oil.

The oil price has been volatile of late. Oil prices rose from 27 in 2016 to 85 in 2018 before falling over 30% in 2 months. A falling oil price is a threat to US shale and to a good portion of the high yield market, but the damage of rising oil prices is more serious. With a tight labour market in the US, and rising inflation, rising oil prices could raise inflation expectations complicating the job of the Fed. Imagine a rising oil price and a slowing economy and ask what the Fed is supposed to do in that scenario. A slowing economy may take some pressure off oil prices but the oil market is more sensitive to supply than it is to demand. With the chronic underinvestment in new reserves the risk is that oil prices rise above 100 at a time when the economy is coming off the boil. A stressed HY market could impair US shale's ability to grow its capacity. EM markets who are energy dependent such as India would suffer as well.

Financial markets lead the economy. Current market sentiment is poor and could tip the real economy into recession.

Consider the risk of an over leveraged economy, dependent on capital markets for price discovery and funding, where too much money has chased too little yield for too long and interest rates have been artificially depressed. What if there is a loss of confidence which leads market rates higher. It could be inflation or just a reversal of the optimistic outlook which triggers a change in direction. Bond markets fall, borrowing costs rise, the economy slows, which in turn triggers a re-pricing of credit risk and on and on. The government would find it more expensive to service its debts. Government could raise taxes but it would be hard to do with a slowing economy. They could cut taxes to try to spur the economy but that would make the fiscal position tougher and could lead to higher rates. What could trigger that loss of confidence? A trade war might. Societal turbulence might. Political upheaval might.

Increased buy backs reduce the sensitivity of the economy to the stock market. But while companies have been buying back shares, they have been issuing debt often to finance the buybacks. This is like a bank which keeps reducing its capital or its total loss absorption capacity and replacing it with debt. It increases the leverage of corporate America. The result is an economy which is less dependent on bank finance, but has swapped it for the bond market, a potentially less predictable source of funding, where liquidity is ample one day and absent the next, where pricing is at the whim of ETFs and retail or mutual funds or foreign investors who may not understand the business they fund as well as they should and could, in a slowdown, react hastily, triggering a recession. The corporate bond market has grown significantly over the

last decade. Loans and mortgages, however, which have to pass through bank underwriting, have seen slower growth as new capitalization rules and underwriting standards were imposed. Consumer debt has therefore grown less quickly, and its credit quality remained better, in the last decade. Meanwhile, corporate balance sheets have become more levered as QE and low interest rates pushed investors into the corporate bond market, weakening lending standards, depressing yields and encouraging borrowing.

The dependence of corporate America on the bond market has grown to over eight and a half trillion dollars, just a touch smaller than the mortgage market, and a near threefold increase in size in just a decade. No longer do financial markets merely reflect or measure the real economy. The real economy is dependent on financial markets for their funding and therefore sensitive to market yields. Whereas when credit was primarily funnelled through the banks, the Fed's control over the economy was better, the Fed's control now passes through the bond market. If the bond market tanks and yields rise, it would be a considerable brake on the economy when it least needs it.