Well That's A Good Start. Regime Change In A Central Bank Driven Market. Why Markets Are So Volatile.

The Euro Stoxx is down 12% year to date as I write this, Nikkei down 15.85% and China down 16-20% depending on the exchange and S&P500 down 9%. A barrel of oil (-20% YTD) is now cheaper than a barrel of fried chicken at a fast food restaurant.

I read in the newspapers that the collapsing oil price, WTI now trading below 29, is one of the factors for the rout in global equity markets, and I find this a bit strange. I understand that weak oil prices are not so good if you are in the middle or the periphery of the oil industry but for consumers, this is not such a bad thing. One argument goes that weak oil demand is an indication of a weak global economy yet we are increasingly seeing data favoring services over manufacturing almost across the globe, which could weaken that particular argument.

I also read that the slowing economy in China is responsible for the weakness in global equity markets. Yet China and the US have simultaneously turned away from one another, the US reshoring manufacturing and China turning to domestic consumption. I understand that this bodes ill for economies and industries supplying old economy China, heavy industry and somnambulistic state owned enterprises. But China world trade stagnated in 2011 and has not recovered. The world is less global from a trade perspective than it used to be. China's ability to export deflation is contained.

Emerging markets have been cited as a source of risk. Capital flows on the back of QE(N) supported unsustainable business models and propped up currencies and assets which are now retreating as capital flows reverse. Some emerging markets have again funded themselves in USD, but where credit creation has been greatest, China, debt has been raised mostly in local currency, and the Chinese government still has sufficient capacity to support its markets and economy, if it is smart about it. Even the biggest cache of ammunition is quickly depleted by a loss of confidence.

If there is a real problem that threatens to plunge us into the next crisis, it’s unlikely to be one of these. The oil price has been declining for 18 months and China has been slowing since 2012. Emerging markets do not suffer from a balance sheet problem but a business model and cash flow problem, not insignificant, but known and therefore unlikely to be a blindsiding impact. For that we have to look elsewhere.

But since the markets are looking a bit seasick, perhaps we should try to find some positives to sooth ourselves.

One, regulators have not been complacent. The banking sector is safer now than it was before. Banks have been forced to raise more capital, to deleverage and to be more prudent in lending practices. Not all regulators have been as successful and not all banks as cooperative, but by and large the system has been fortified.

Two, central banks have not been complacent, but they may have been one dimensional. Efforts to boost output through QE have been widespread and determined. The US has ended its QE activities but they have not reversed them. Plans to reverse them have, in fact, been placed on the back burner. Whether this is a good thing is another matter. The ECB has been slower to act and then less robust, but circumstances will likely pressure them to do more. The BoJ is already at the limits of credulity in its efforts and is attempting more subtle adjustments instead of outright increasing the expansion. The PBOC has the most complex problem and the most complex policies, but is supplying liquidity wherever and whenever it is required.

In the absence of cataclysmic risks it would seem rational to seek investments which offered good value. Chinese equities listed in Hong Kong are pretty cheap, so is Korea, Taiwan, Vietnam, the US auto, transportation and tech sectors, Brazil, Argentina, Russia, Turkey and just about any MENA stock market. Some of those markets are cheap for overwhelmingly compelling reasons, recession, stagflation, sovereign insolvency, broken business models, but not all of them are and value can be found. The same variation of valuations can be found in credit markets, with the same variation of credit and legal jurisdiction quality and economic strength. Generally, credit is cheap compared with benchmark sovereign and swap curves.

So, should we all go out and buy emerging, frontier and submerging market equities, leveraged loans, junk bonds, and structured credit junior tranches? It depends on your time frame. Too short, and you have volatility, too long and an unpalatable truth might emerge.

Since 2008 we have been playing a game of chicken with the central banks. The system broke, the central banks and governments stepped in to prop things up and reassure us that everything was alright, and we in turn knew that this was not the case but that the governments would have to keep the pretense up until everything was in fact alright. We always knew that one day, either everything was alright and our initially artificially elevated asset values were justified, or that things were not alright and the game was estimating when the wheels would come off the government QE machine and asset values would head lower in pretty short order.

When central banks are the determinants of asset prices, volatility is not a reflection of the risk in an asset but the risk of execution of central bank policy. A significant part of the volatility is likely due to the recent uncertainty in central bank policy. The Fed increased uncertainty when it failed to raise interest rates in September as it said it would resulting in speculation that the economy was in worse shape than suspected. At the same time, the BoJ failed to increase its asset purchases, as weak Japanese data suggested it would have to do, disappointing the market and leading to the unwinding of large consensus shorts in JPY. The ECB failed to increase its QE efforts enough, announcing a halfhearted extension to the asset purchase program from September 2016 to March 2017. The PBOC’s and CSRC’s multiple miscommunications and missteps led to a severe loss of confidence in the Chinese equity markets. So used have the markets become that they cannot make up their own minds about economic and commercial prospects they need central banks to show them the way. And when central banks themselves falter, investors understandably panic. This is unhealthy, but some change is coming, at least from the US.

The US Federal Reserve has a useful modus operandi. When it wants to do something, it telegraphs it well in advance, gets the market to price it in and then moves to align policy to the new market reality which it created, thus avoiding nasty surprises. This was not always the case, especially under Greenspan whose deliberate obfuscation may have hid bona fide confusion. From Bernanke onwards we are being fed information to manage us, to co-opt us into the deployment of policy. The Fed will now wean us off scrutinizing its actions as determinants of market behavior by itself becoming more data dependent in policy. With time, it is hoped, the market will try to gain an edge over the Fed by looking at the data.

We are in a period of adjustment, whether central banks still command markets or not, away from watching and front running central banks. It has been an easy 7 years, although many investors made it hard for themselves, relying on fundamentals instead of central banks in those early years after the crisis. Investors are as always slow to adjust. But the central banks are either losing their way, in part because there is no longer a clear and present danger, which is good, in part because policy has reached its limits, or recognizing that it is unhealthy to forever lead the market with a helping hand. Their messages are less clear and they seem less certain, even in Europe and Japan. The adjustment from policy focus to fundamental focus is a turbulent one with elevated volatility through the process.

The question then is, what will the fundamentals tell us? What valuations will we accept, under the assumption that central banks no longer drive asset prices. History is a guide but adjustments will need to be made to account for a loss of efficacy and certainty of central bank policy, a weaker credit transmission mechanism due to greater bank regulation, slower trend growth, slower global trade as countries seek greater self-sufficiency, the evolution of economies under innovation – the dominance of services over manufacturing, et al. Estimates for uncertainty around growth estimates will also need to be updated to take into account greater financial stability within the banking sector, the gradual withdrawal of central bank influence, income inequality and the risks of social unrest, increased geopolitical risk as countries become more insular, et al.

In the long run, growth will likely be lower, the loss of specialization by trade is an important factor as is credit creation which has run well ahead of itself and needs to be allowed or encouraged to mean revert, and asset markets will need to reflect this, likely with lower long run equilibrium valuations both in equities and credit. From the early 1980s we rerated in volatile fashion with booms and busts until we peaked in 2000. From there, valuations have fallen, again in volatile fashion. This long cycle derating is likely to continue, and again in volatile fashion.

In the medium term, an investor working with long term valuation assumptions will need patience and loss tolerance. The market will continue to adapt to the slowly changing reality of policy’s role in asset pricing, and in so doing will regularly overshoot in both directions providing good entry points and exit points to the lucky or smart investor. I’m happy to be either, I’m not fussy.