Exiting QE. The Game of Chicken. Welcome to the Hotel California.

The game of chicken is played when two cars are driven at each other at high speed. The one that flinches first, loses. The one that flinches last, wins. If neither flinch, they both lose.

Fundamentals are improving in the US and UK. Europe remains in poor shape and will do so as long as they remain on the EUR. The crisis of 2008 did not cause any of the ills in Europe; it just exposed them and removed the tailwinds that allowed Europe to maintain its economy under a suboptimal currency regime. Where central banks are able to monetize debt and print money, quantitative easing has allowed time for healing and 'animal spirits' to be revived. Emerging markets growth remains above developed markets growth but a more complex dynamic is brewing. Developed markets technology is allowing them to catch up with emerging markets where cost pressures and an inability to match the West in generating proprietary technology is hobbling their potential growth. Frontier markets are growing on the back of an advantageous demographic and low cost labor at the expense of emerging markets which are being squeezed from above and below. These are generalizations of course, which mask a richness of detail necessary to make more specific forecasts for the prospects of each country.

The implications for risk assets are even less clear. As companies are increasingly global, a country based analysis of macroeconomic prospects is less helpful in the analysis of companies' prospects. We cannot but generalize despite the risk of losing resolution.

The role of interest rates and liquidity in the current rally in risk assets is important. Interest rates have been unilaterally suppressed across the term structure across most of the major currencies while monetary bases have been substantially increased. Private sector companies which can, have taken the opportunity to liquefy their balance sheets through bond issuance. Smaller companies with no access to debt capital markets have found banks unable to supply adequate financing due to their own inadequate capital positions. This has been a partial contributing factor to the chronic unemployment as smaller companies are more likely to hire while larger ones are in rationalization mode. This structure is also likely to confound central bank efforts to target employment in the conduct of policy. It also creates an opportunity for providers of growth capital to small and medium sized enterprises.

As ‘animal spirits’ are revived, and or inflation begins to accelerate, an exit plan from QE will be sought and implemented. This poses a risk to risky assets. The question is how big a risk. If rates rise as a result of stronger economic growth then one can expect an orderly slow down in risk assets followed by a resumption of growth, which has been empirically supported in previous tightening cycles. The complication here is that the size of the money base is of unprecedented scale, asset sales may need to follow the raising of interest rates and the current level of interest rates introduces a high level of non linearity in private balance sheets which may prove unmanageable. Central banks will have to telegraph their intentions well in advance to help wean the private sector off easy money.

For now, the point of higher interest rates is likely far off, some 3 years at least. Yet yield curves may still steepen while central banks keep short rates low. Given that inflation is likely to be under control in the developed markets, their term structures will likely stay flat or at least relatively flat. Emerging markets, however, may face a less tractable problem, that of rising inflation, partially the product of developed market central bank policy, and slower growth, again partially the product of a less profligate developed market consumer and the growing trend of re-shoring of manufacturing. Already some such countries have begun to cut rates as growth has slowed.

Unfortunately, the purpose of this letter is not to advise on a particular trade or portfolio positioning but to highlight some of the current issues. The reader may extrapolate their own trading and investment strategies. We now end with the last bit of an old song…

Last thing I remember, I was

Running for the door

I had to find the passage back

To the place I was before

“Relax, ” said the night man,

“We are programmed to receive.

You can check-out any time you like,

But you can never leave! “