Volatility: Long Term Investors Can Skip This Post. Central Banks Vs Slowdown.

It is clear that the global economy is slowing, most acutely in Europe, but also in China and even in the US. This much is quite obvious from slower moving economic data. Yet for the first quarter, risk assets from equities to high yield credit have done well. This has mostly if not entirely been down to central bank policy, real or perceived. We know the ECB had been ignoring weak data to its peril and had to retract its optimistic appraisal, we know that the PBOC had been tight last year before loosening in the final quarter 2018 and following through this last quarter. The Fed, which miscommunicated in Sep 2018 has since made a radical turn and signalled loose policy.

I think there is a serious weakness in the global economy and financial system, which is excessive debt. Its not a forgone conclusion and there are serious arguments why chronic and high debt may be sustainable. I just don't think it is, and if you agree with me, then there is a day of reckoning somewhere in the future. Predicting this day is difficult given the efforts of central banks to defer, hopefully indefinitely, this event.

However, if I'm right, then a crisis must coincide with a sharp rise in interest rates, and FX volatility, which we do not see at this point or indeed in the near future. The volatility in the last week, is therefore most likely to be a short term phenomenon without much depth. It could signal a cap on market levels or it could see further declines, but not a bear market, and not a crisis. Such dips are tradable. It may even be possible, in less volatile asset markets, to sell with a view to re-buying in 3 to 6 months time. In fast moving markets like equities, its not so easy. I don’t even think we are in a Q4 2018 magnitude correction.

China is important. Its population and its fast paced growth, even as it slows, is a significant factor in global demand. China’s situation is not so bad. It certainly has over-leveraged corporate and local government sectors but household debt and central government debt remain well contained. The slowdown is also engineered and self inflicted, most importantly, it is a controlled demolition. The CBIRC and the PBOC are trying to regulate the non bank sector and to do it they need to first divert credit away from it into the regulated banks. This will take the burden off the non bank sector which they can then begin to regulate before allowing credit back into the newly regulated channel. 2018 saw a wobble as the regulators struggled to manage the deleveraging of one sector and the leveraging up of another. Deflating a more highly leveraged structure while inflating a less leveraged one led to net deleveraging at a faster rate than they expected. This has been corrected and the capitalisation and liquidity provision to the banking system has increased significantly.

India is in the midst of crucial elections which could determine its long term trajectory. India’s growth spurt in the last 5 years has been down to having a simple majority in the Lok Sabha for the first time in over 30 years, under a business friendly Prime Minister. If Modi’s management ceases, the risks to India are substantial. At 2.2 trillion USD nominal value, India is a significant player in the global economy, but its linkages are nowhere as ubiquitous and influential as China’s and poses less of a threat, or boost, to global growth. India is a domestic risk and opportunity.

The US has been the only country able to normalise monetary policy for any length of time in the last decade. The recent pause by the Fed is unfortunate, as it signals a Fed beholden to the President, investors, and asset owners, to the subordination of longer term stability and prudence. I do not deny that a slowdown looms but a recession is still a small risk. To back track on normalization because of a slowdown which appears to be a cyclical slowdown, one which should be expected in the normal cycle, is disappointing and could store up risks for the future. Moral hazard is the first and biggest risk, but the lack of latitude in policy is the other big one. The Fed should take the opportunity to normalize so that it can cut more effectively when the depth of recession necessitates it.

And finally, Europe. This is possibly the weakest link, not for Brexit and Italian debt but for the latent political tensions and dynamics that are likely to break cover at this year’s European Parliamentary elections. The Far Right is gaining foothold across Europe, German leadership is in flux, Italy is beginning to sway rather too easily to the League and Spain’s upcoming elections (end April) could easily see another hung parliament. In the meantime, the ECB has been too sanguine and too late and is also about to see a change of Chair. The focus on fiscal and monetary policy has distracted from balancing the economy away from exports, a position which is precarious in the wake of a Chinese US trade war.

So, some serious concerns on the horizon, but the markets should refocus on liquidity for the rest of the year while fretting about growth occasionally. A range bound market at worst, or at best, depending on your point of view.