Elstree

No recession and not much bubbling

- It looks to us that there is a very low risk of recession.
- We're not convinced that investors are getting aerated.
- Maybe the story of 2017 continues for a while yet.

Occams razor investing

It's a simplification, but not a gross simplification that, for Investment grade credit (and also hybrids) in a recession, on a mark to market basis, you lose real money and between recessions, stuff happens and you lose small amounts of money for a short period of time. As all that happens, credit margins saw tooth their way down from end of one recession until there is another recession. However, due to the "carry", you always do better than government bonds over any period longer than 6 months (albeit with higher volatility). Equities are slightly different in that you lose real money in a recession and you are also subject to inter recession events which can be 'kind of' nasty and long lived. From our previous articles, we have a working theory that inter recession "events" for investment grade credit occur every 3 years, last 5 months and cost you 3%. For equities the frequency of non-recessionary events is every few years, last 7 months and cost you 16%. We think inter recession events are driven by valuations and investor risk tolerance. If either or both are high, you are going to get worse "events". So it's really valuable if you can forecast recessions (or risk of recessions) and whether investor risk tolerance or valuations are high.

Markets gagging for pullbacks

There is a raft of commentary warning that everything is far too expensive and there are enough bubbles to make investing unwise (as has been the tone of commentary for the past 60% increase in the SPX). We don't believe in single factor answers, but there are 3 charts below that we think may be important in generating a view of where we are in the investment cycle.

Chart 1: monetary policy is still ridiculously expansionary

One of the big challenges for central bankers has been to measure just how expansionary monetary policy is. This is reasonably simple if cash rates are (say) 4% and the Central Bank wants to ease monetary policy; it puts them down to 3% and if that's not enough, then down to 2%. It's much harder if the cash rate is 0%, so you have to go out and buy bonds or other assets to put cash in the hands of the general public. But it's difficult to measure how effective your actions are. The US crossed through the 0% level in 2008 (the Zero Lower Boundary or 'ZLB') in 2008 and Europe and Japan are still there. There's no definitive answer on how to determine the stance of monetary policy after ZLB, but we know Central Banks look at a concept called the Shadow Short Rate, which was an idea that Fischer Black, the famous Nobel prize winner wrote about in 1995, when the concept of long term negative interest was unthinkable. So the idea died until about 2010 until it became relevant

Shadow Short rate? What is it?

We found this quite a difficult concept to get our heads around, but it works on bond yields to interpolate shorter rates. For example, if a 2 year bond trades at a yield of -1.0% (because the Fed has gone and bought every 2 year bond it can) and the 1 year bond trades at the same yield of -1.0%, mathematics imply (just trust us on this ☺) that the cash rate must be -2%. The concept (and how to calculate it) is not universally agreed as the appropriate measure for monetary policy looseness, but the chart below is really interesting (if the concept is even vaguely true). Its compiled

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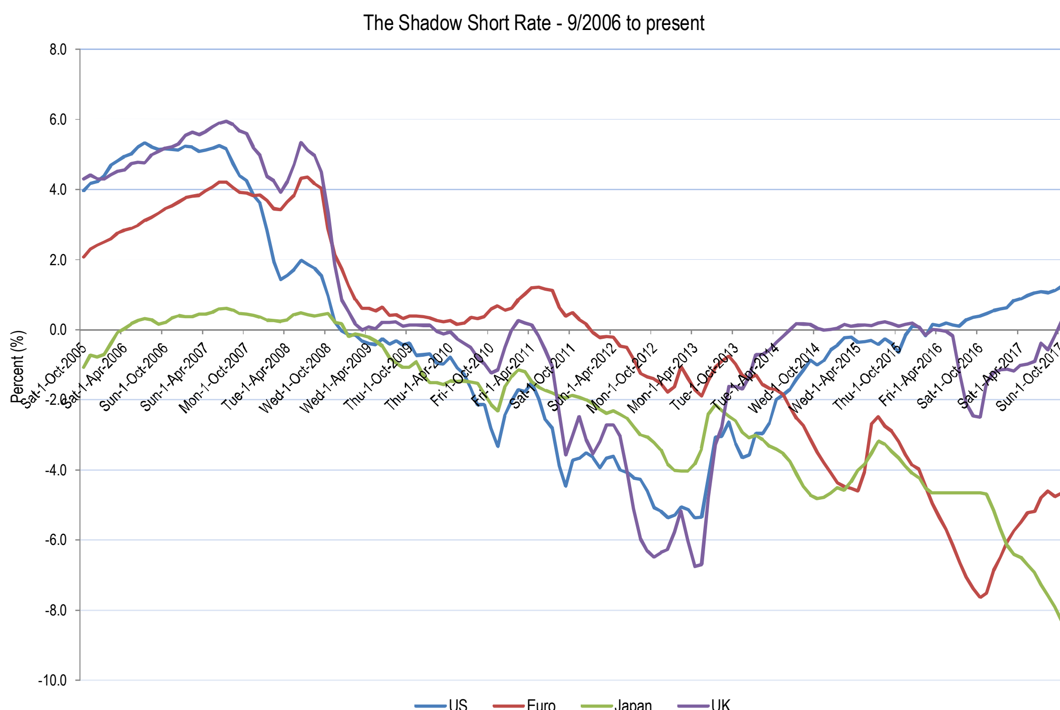
by a clever Kiwi working for the RBNZ and shows the Shadow Short rates for the US, Europe, Japan and UK since before the GFC. When actual cash rates are positive, the Shadow Short rate = cash rate. When cash rates are zero, the Shadow Short rate tries to work the effective cash rate.



So it looks like monetary policy is still loose

Yes (subject to the methodological caveats above). In the US and UK, monetary policy is loose but on a normalisation trend. It's still enormously stimulative in Europe and explosively stimulative in Japan. If you think the theory is half right, monetary policy is still very accommodative. Overall average "cash" rates for the 4 economies are still 8% below 2007 levels and 4% below immediate post GFC levels. (And guess why we haven't had a recession in 10 years?). So in world GDP terms you have 25% of the worlds' economies (Euro + Japan) that are clearly enormously stimulative and another 25% that are stimulative (US and UK). If you can make up your mind on how expansionary China monetary policy is, you've potentially got 65% of the world economy in stimulus mode. If that's a case, the world economy is not at risk of a recession.

So onto events

We think that "events"/shocks are influenced by valuations and risk tolerance. We still think that there are enough investors that are scarred by the GFC that risk tolerance is not as high as many commentators think. There are still a lot of hypersensitive investors, regulators and governments. The IMF publishes a Global Financial Stability Review every 6 months and in it, they do a neat little chart which summarises the "risks". A copy of the most recent is pictured below

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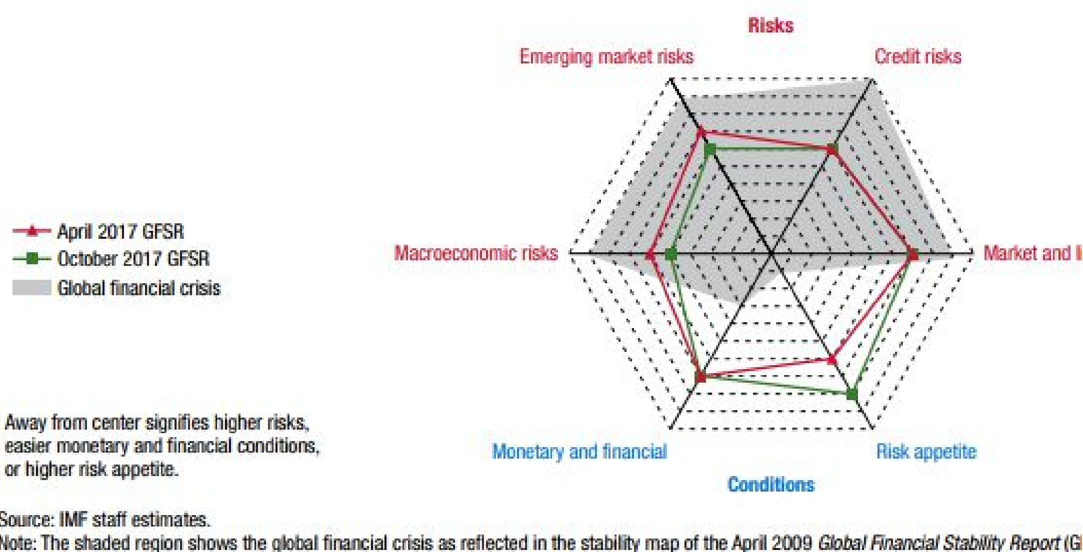
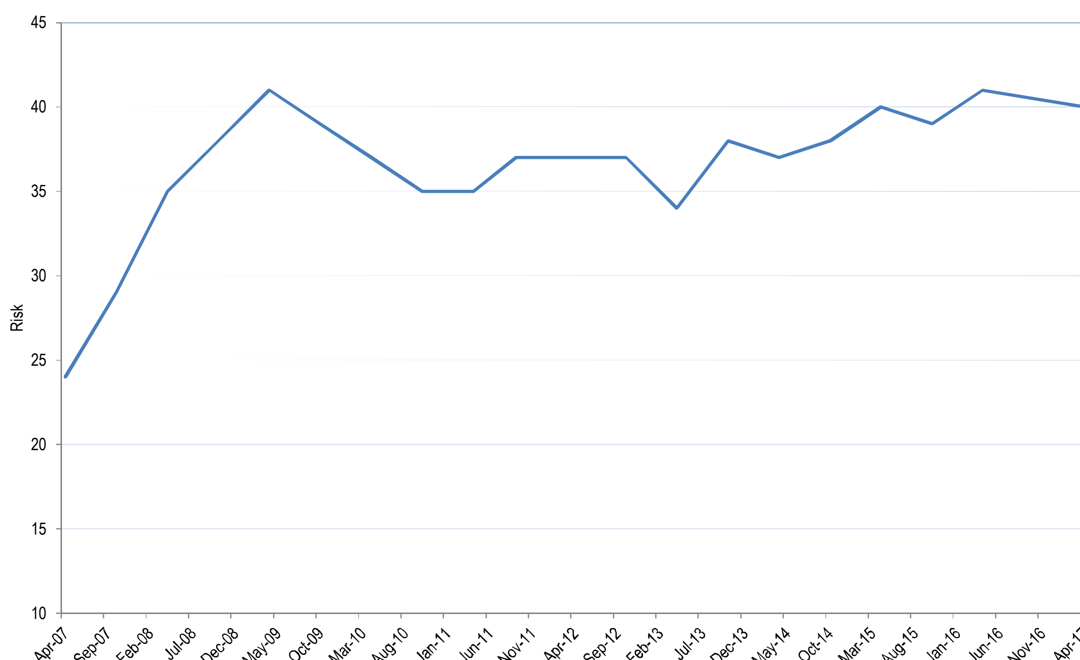


It's not quite clear whether the "risks" are what the market is pricing at the moment, what the IMF thinks they should be or what the IMF thinks will happen. Currently the IMF thinks risk appetite is high (risky), but macro-economic risks are low (less risk). If you add up all the risks they come to 39 (out of a possible 60). The chart below shows the sum of all the risks for each IMF GSFR risk chart since April 2007.



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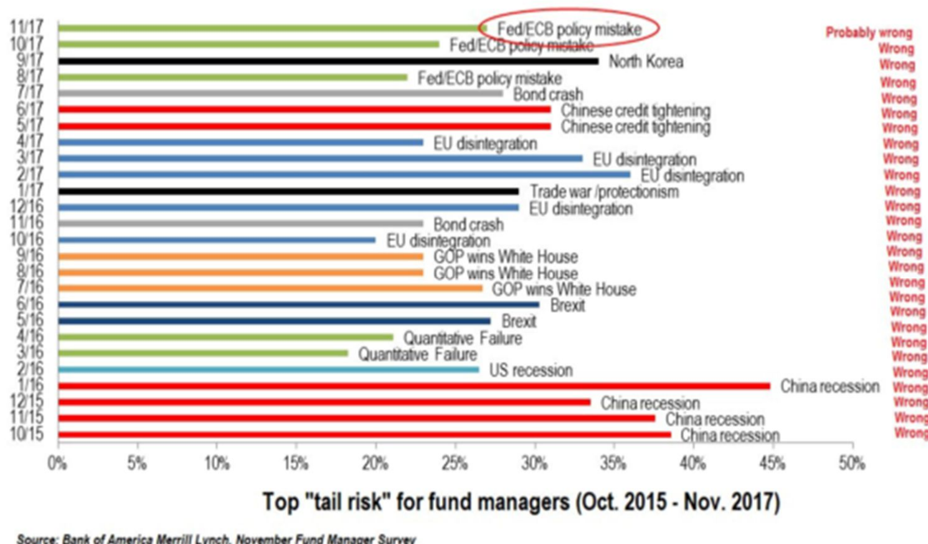
The inconsistency of the risk scores

As you can see, the risk score was low prior to the GFC. Even during 2008, it only got to the high 30s, but now it remains close to the peak GFC score and higher than 2008. We're getting old here and our memory fails us sometimes, but 2008 was a hell of a lot scarier and riskier than 2017 is. So what has happened? Why does the IMF think the world is now just as risky as 2009 and why have perceived risk levels never even approached pre GFC levels? Beats us. There are a lot of clever people at the IMF, the output is highly researched and so the only reason we can attribute it to is behavioural scar tissue from the GFC. At official levels at least, every situation is still seen through the prism of the GFC. We think that applies to lots of parts of investment markets as well.

So how is your fat tail risk management going?

We've seen a number of presentations recently where the key message is risk management and scenario analysis. The presentations are really well done, by smart people, with lots of effort and attendees are all furiously scribbling (approving?) comments on their PowerPoint printouts. One of the blogs we read had this great chart (we didn't save the name: apologies to the blogger) whereby the blogger tracks what the BofA/ML fund manager list as their top tail risks in a monthly survey.



If you've thought about it, It's in the market

As the graphic shows, if you are trying to manage tail risk, just forget about what everybody is telling you what tail risks are because they are 'already priced in the market'. Investors shouldn't confuse Knightian risk (or known unknowns in Cheney-en terms) which is what they are being sold as "tail risks" and tail risk management, with Knightian uncertainty (or unknown unknowns). On this one we're with the great Australian economist Don Stammer. For the last 30 years (at least) Stammer consistently proposed that there will be an "X" factor each year that no one predicts which will drive markets.

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So where does that leave us?

We don't believe in investment certitude, but it looks to us as though recession risk is low and that investor risk tolerance is still, structurally affected by the GFC. If we don't get a recession, investment grade credit (and hybrids) will be fine, notwithstanding valuations that are more expensive than at any time in the post GFC period. We note a recent survey of Australian CIOs who think a credit crisis is imminent and one of their top "tail risks". That might happen in high yield markets, but we really can't see one coming to broader credit markets. Clearly, we'll get an equity market "event", but if there's no recession, it's a decent chance it might be a while off and not as devastating as almost everybody expects.

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