Economics 101

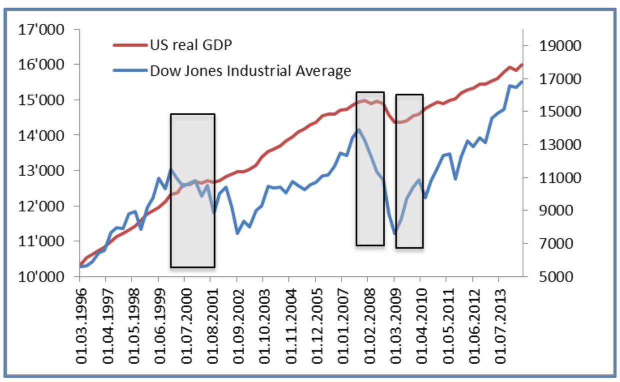
Market Signals

Being aware of distortions due to Central Banks activism

Foreword:

Corporate profits are mainly driven by sales and price. In most sectors the key factor behind the benefits is the price fluctuations of the underlying product: profits of an oil producer increase if the price for oil goes up – simple stuff.

In financial markets, however, we frequently observe that stocks change their trends weeks or even months before the price of the underlying key-profit-driver turns. Actually, applied to the whole economy stock market indices often reverse their trends ahead of a change of in growth patterns (gross domestic product).



Source data: Fed St. Louis

Such phenomenon has not gone unnoticed by many investors and analysts that, as a consequence, use financial market price signal as a forecasting tool.
In relation to that, nowadays depressed interest rate levels of most developed countries are repeatedly interpreted as sign that world economies do not gain track and tend towards deflation.

In the following, we will discuss the “predicting power” of current depressed yields to the economic state respectively we will bring up the argument why money managers may this time be wrongly advised if they interpret the interest rate levels as a signal for coming deflation.

The facts:

With the Great Recession starting in 2007 central banks ("CB") around the world began stimulus programs called quantitative easing ("QE"). They consist of buying credit instruments in the open markets from private economic agents like private investors, mutual and pension funds etc.

The natural effect is that the amount of available notes and bonds decreases what, from a simply supply-demand point of view, makes them scarcer, lifting up their prices respectively lower their yields.
Central banks pay those purchases by emitting their own (short-term) debts. So, the supply of "cash" is increasing what makes it more abundant and, again, from a simply supply-demand point-of-view, putting pressure on the price of money (lower money market rates).

Here an even more drastic example: imagine a central bank that is buying inflation protected fixed income instruments. This "crowding-out" effect will drive up prices respectively lowering the "implied inflation rate". Now, investors and analysts who extract their inflation forecast based on these instruments (a frequent method) would consequently come to the conclusion that deflation may be in the pipeline, while just the opposite could be true!

Yields are this low that a person with no memory of what happened over the last couple of years would definitely interpret the current situation as sign of a severe deflation, viewed in isolation.
But then we know that fast falling prices have always been hostile to corporate profits and economic growth. So, why then do stock markets go up…?

The hypothesis is that the price building in the credit market has been distorted by the massive QE-programs of very few and new market entrants, monopolists (FED, ECB and others), and is not mainly the result of the action of numerous investors like this is the case under normal circumstances. Due to this fact, market signals derived from interest rates or the yield curve may be misleading.

Based on this thesis many money managers hold notes and bonds for the wrong reasons!

Even worse, should it turn out that the gigantic expansion of CB balance sheets will be inflationary (like history proved it so many times) as opposed to deflationary the final consequences might become very dramatic.

Looking forward:

Financial markets have historically shown a high predictive value for the economic development (leading indicators). Investors therefore often rely on market price signals in order to anticipate future trends.

While such approach is helpful under “normal” circumstances, we argue that since central banks have distorted the supply-demand equation in money and credit markets, investors should no longer use the interest rate market signal to anticipate their economic assessment for asset allocation purposes or others.

The aim of this paper is to make reconsidering our clients the consequences of a possible false interpretation based on market signals. Viewing the current valuation of fixed income instruments through the glasses of central bank mechanics leads to the conclusion that this particular asset class might not signal deflation.

If and when CBs stop their interventionism can hardly be forecasted. Should the “financial repression”-thesis (*) come true the current path could last even longer – at the same time we should be aware that under such conditions the sowing of seeds for inflation (money printing) will become even more dramatic.

The day of reckoning might be postponed but will definitely not vanish. Fortunately, Gold, Silver and especially their mining shares that historically serve as excellent inflation hedges, trade again at very cheap absolute and relative levels. Allocating part of the assets in this sector is a fine way to protect portfolios against a potential, coming disaster in the fixed income market.

Buying an inflation hedge despite the market signal derived from historically low yields is no longer a contradiction…

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(*) Reinhardt-Rogoff https://www.imf.org/external/pubs/ft/wp/2013/wp13266.pdf