Kapstream
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Are investors too fearful?

Nick Maroutsos and Daniel Siluk discuss the prospects for markets and whether inflation and a flattening of the yield curve are causes for concern.

The global economy is demonstrating strong, synchronised growth. Based on UN population growth figures, another 700 million people will join the global workforce by 2030, potentially adding significant productivity and growth to the global economy[i]. Asset prices all over the world are either healthy or skyrocketing. So why isn't everyone a raging bull?

Is it risk of inflation?

In our view technology has simply made inflation obsolete. Sadly, for providers of unskilled, semi-skilled and someday soon, even very skilled labour, technology developments mean that every time labour costs rise significantly, companies (and governments) will replace those hardworking people who expect vacation days, health plans and retirement pensions with computers/automation who will do the jobs better, more cheaply and without complaint. These computers will never go on strike and never negotiate for a raise. This substitution effect is incredibly powerful and likely to depress future wage inflation.

Is it risk of a financial crisis?

Central banks around the world have been engaged in an on-the-job training program since the 1990s. They have studied the "Greenspan Put", graduated with honours from the Bernanke Helicopter Money School, received their Ph.Ds. from the Draghi "Do Whatever It Takes" Institute, and then had all doubts erased by radical laboratory work in the Japanese "No Matter What We Do Nor How Much We Spend There Can Be No Inflation Experiments". Volatility in markets tells us that the smartest and richest financial professionals judge risk in financial markets to be near record lows, reflecting full and extraordinary confidence that should there be any hiccup with financial market prices the central bankers are likely to buy assets until stability returns.

The Reserve Bank of Australia, the US Federal Reserve (Fed), the Bank of England, the Bank of Japan and the European Central Bank have all intervened immediately post-crisis, providing necessary refuelling of equity markets through cheap/free cash and bond buying. Will they be there forever? Time will tell, but a precedent appears to have been set. For now, we believe that central bankers will be predictable, boring and slow, both in raising rates and unwinding asset purchase schemes.

And yet, if you talk to government officials, financial professionals, people in the street, taxi drivers, or if you read any newspaper, you learn this is all incredibly fragile, unsatisfactory for many people and headed for doom. Many investors remain scared of investing in equities and risk assets, judging by the extraordinary amounts of cash deposits in Japan, Europe and the US despite little or no positive return being paid on them. So what in the world is going on? Our brains are telling us to be bullish in our investing and our stomachs are telling us to be careful.

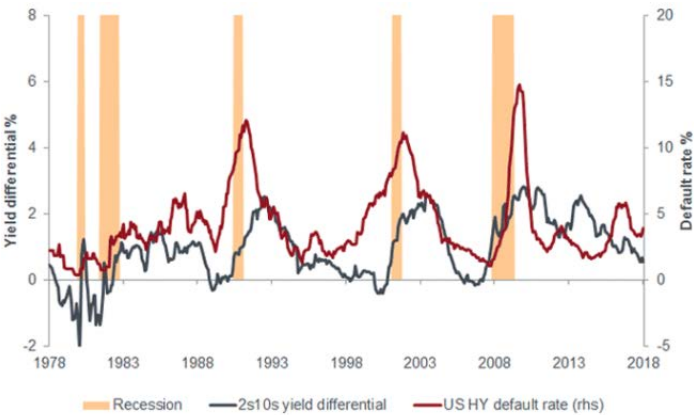
A Minsky Moment?

Hyman Minsky, the economist, lent his name (albeit posthumously) to the Minsky Moment. Minsky argued that crises were integral to financial markets. The longer economies performed well, the more participants become complacent, engaging in more risk taking and borrowing, which ultimately sows the seeds of the next period of instability.

Could the low levels of volatility indices portend the calm before the storm? Are President Trump's moves to de-regulate banks signs of a loosening of speculative constraints or is regulation simply passing to other sectors such as technology? Is the pick-up in merger and acquisition activity a sign of corporate hubris or just a sensible response by businesses to acquire growth while financing costs are cheap?

Pessimists point to the flattening of the US yield curve as a potential cause for concern. Historically, when the curve inverts and 10-year Treasury yields are below 2-year Treasury yields it has signalled a recession and been a good indicator of a pick-up in defaults in corporate bond markets. The lack of a positive term spread is essentially saying the market is gloomier about longer-term economic prospects than it is about the near term. In April 2018, this differential (commonly notated as 2s10s) fell to less than half a percentage point (50 basis points). The mid to late 1990s, however, showed that the 2s10s can flirt with going negative for several years without there being a recession. The question is whether the US Fed will push ahead with all of their projected rate rises if they think it will lead to an inverted yield curve.

Figure 1: US Treasury 10y minus 2y yield differential and the US high yield default rate



Source: FRED, Federal Reserve of St. Louis, Moody's US trailing 12 month default rate, 31 March 1978 to 31 March 2018

Conclusion

Making sense of where we are is challenging and one of the reasons we believe a flexible approach to fixed income investing is advantageous, as it gives managers greater freedom to respond to changes in the markets and economy. In our view, the strength of a synchronised global growth cycle is undeniable, almost as much as the certainty that there will be occasional corrections along the path – but central bankers will act to smooth the worst of those corrections with their new found tools of radical intervention and asset purchases. Populations will grow, and so will technology-driven productivity. The business cycle will continue to wax and wane, but through it all we believe global economic growth should be reasonably strong. Technically, yield curves will probably remain flatter as central-bank-driven low volatility remains a persistent feature of our new global reality.

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[i] *Source: UN Population Division, World Population Prospects, 2017 Revision, Age group 15-64, 2015 to 2030*