By Guy Haselmann,
Head of Macro Strategy, Scotiabank
September 29, 2014

Gimme Shelter

- For a long time, Fed printing via balance sheet expansion has been the key to understanding markets and the predominant driver that has **trumped all other matters**. Investors have been able to ignore significant global events, tensions, and economic conditions in faraway places, because a lower real and perceived risk premium from implicit Fed promises was the single most important aspect driving asset prices higher. This game is quickly coming to an end.
- As the Fed's asset purchase program ends next month, global events and global economic fundamentals will have to be taken into account and priced accordingly. Investors have become **too comfortable and entrenched** with the idea that Fed policy provided a win-win condition for taking risk; whereby, weak economic data meant more Fed printing, while strong data meant better fundamentals coupled with a Fed that would (still) only respond slowly and gradually. This cozy arrangement is ending and investors have not yet adequately recalibrated.
- Furthermore, at 80:1 leverage, the Fed's balance sheet is probably close to its **practical limit**. It stood around 20:1 pre-2008. As it currently stands, should the Republicans take the Senate during the mid-term election in November, criticisms will mount, potentially leading to a major restructuring of the institution.
- The Fed has always been over-promising on what it can actually deliver. Yet, it has been wildly successful at altering **investor behavior**. Over the past several years, Fed 'promises' spawned investor fears of underperforming peers and benchmarks, and steered investors away from risk management and fiduciary prudence and concerns about receiving adequate compensation for the risk. This needs to change. The rise in asset prices in recent years means that assets today offer lower yield with higher risk.
- The Fed zero interest rate policy has also fueled debt-financed share buyback activity by firms, amounting to over 7% of the total amount of the market capitalization of the S&P 500 over the last 18 months. This indiscriminate buying has **masked** true fundamental conditions, thus aiding complacency and distorting accurate valuations.
- Despite improved US economic progress, economic improvements were unlikely to ever get sustainably strong enough to justify valuations, so an adjustment down to **appropriate valuations** was inevitable and only a matter of time. A move into the 'right-tail' of the asset price distribution typically precedes 'busts' into the 'left-tail'. The longer and deeper the current phase lasts, the worse will be the ultimate fallout.
- Fed money printing should have stopped when money velocity continued to fall. Money, similar to US Treasury securities, is debt tied to the future taxing capacity of the US government, except it's a liability that just circulates around. Debt borrows from future output. Therefore, Fed and governmental actions that are taken today to prevent a depression could be **sowing the seeds** for causing a future one.
- The Fed seems to be doing all that it can, but it is not a stretch to argue that maybe the Fed simply does not possess the **proper tools** in which to influence, let alone achieve, its mandates. Unfortunately, 'doing all it can' while underestimating the unintended consequences may have calamitous implications for financial markets and the economy in the long run.
- The Fed can print, but it cannot increase demand, or determine where the dollars go. Fed tools cannot deal with soaring social welfare costs, an aging population, and skill mismatches. There has been a diminishing return of each dollar of newly printed debt, i.e., spending today barely buys any additional GDP. Keynesian spending measures may (similarly) be **counter-productive** in the long-run. Increasing debt levels depresses the money multiplier effects due to higher debt servicing levels (i.e., borrowing from future consumption).

- Fed policy is shifting and **no longer overwhelms all other factors**. Markets are no longer receiving quasi-coordinated one-way stimulus from central banks and governments. Over-indebtedness has become a focus. Some central banks are hiking rates to prevent capital outflows. Japan and the EU are (arguably) in recession. China is slowing and has credit and property bubbles to contend with. Protectionist actions and counter-measures are beginning to have far-reaching economic effects. Unrelenting violence between Shia and Sunnis rages. Hong Kong has spilled into mass civil disobedience. The list goes on.
- The risk / reward skew has dramatically shifted in recent months. Improving US fundamentals will not power (risk) asset prices higher, because prices have not been about valuation but rather only about Fed policy and investor behavior. Investors should move toward **capital preservation** strategies. In the meantime, long-dated Treasuries remain an excellent place to hide. I remain a bond bull and still expect a move under 3% for the long bond.
- "She was practiced at the art of deception / Well I could tell by her blood-stained hands / you can't always get what you want, but if you try sometime you just might find you get what you need." – The Rolling Stones