Newsflash: It’s the balance sheet, Stupid! (02/08/19)

The Fed will stop contracting its balance sheet two months early, and there was also some news on interest rates on Wednesday.

I put it this way because the market, fixated on interest-rate projections, is still failing to understand that the Fed has, since March 20th, committed to a balance sheet expansion which will see it soak up from one third to one half of the supply of Treasuries going forward. Subscribers will know from the 2Q 2019 report (Bonded: The New Normal - How The Fed Funds Up to Half the US Fiscal Deficit) just how this move to a major balance sheet expansion, major at least in terms of the scale of Treasury security purchases, is implicit in that March 20th announcement.

The fact that the commitment to such an expansion is not explicit in the March 20th announcement seems to have confused a market which, since the GFC, has been used to being led, month by month, as to the future size of the Fed’s balance sheet. The massive rally in the price of long-dated US Treasury securities following the Fed’s announcement on Wednesday, and again on Thursday, is a foretaste of how positive the major change in the Fed’s balance sheet will be for the price of Treasury securities.

There are much, much lower long-term interest rates to come in the US and plenty of profits to come for the owners of US Treasury securities. A bullish call on US Treasury securities thus needs to be re-iterated given the Fed’s decision to bring forward the time when that significant balance sheet expansion begins. Perhaps only then when the market begins to witness the scale of the new balance sheet expansion, will it realise just what this ‘new normal’ means for the Fed’s demand for Treasury securities. Perhaps investors have begun to work that out in the past two days, but for those who haven’t tangible evidence of the expansion will now be coming even sooner.

If the bullish outlook for the price of Treasury securities is driven primarily from a balance sheet expansion by the Fed, it has a significant tailwind from the lower global inflation outlook. The Solid Ground has long signalled that commodity prices are particularly vulnerable in the structural shift in relations between China and the developed world in general and the US in particular.

It was thus interesting to watch commodity prices decline as the Fed eased monetary policy on Wednesday. Oil and copper prices declined despite Fed easing. As the Cold War develops further the markets will have to deal with the growing realisation that China will not have the access to global commodities that it has taken for granted for many years. There will be an awful lot of excess supply of commodities, if China is increasingly excluded from commodity markets or if the RMB devalues as is increasingly likely. The near 5% decline in the price of Glencore since the Fed cut interest rates on Wednesday is another indication that the disinflationary impact of falling commodity prices is very likely to continue. Investors need to be very cautious about investing in commodities or in countries that rely upon commodity exports.

Meanwhile in Europe the disastrous decline of market-determined interest rates continue. As we tumble down the rabbit-hole of negative European government bond yields, the bizarre can sometimes seem normal - it is not. Every day we see a level of interest rates ever more destructive of the financial system.

Just focusing on ten-year government bond yields, let us note the new all-time lows:

<table>
<thead>
<tr>
<th>Country</th>
<th>Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Netherlands</td>
<td>-0.34%</td>
</tr>
<tr>
<td>Belgium</td>
<td>-0.13%</td>
</tr>
<tr>
<td>Denmark</td>
<td>-0.39%</td>
</tr>
<tr>
<td>Switzerland</td>
<td>-0.76%</td>
</tr>
<tr>
<td>France</td>
<td>-0.19%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>-0.11%</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.08%</td>
</tr>
</tbody>
</table>
Over many years of working in financial markets your analyst has heard the phrase ‘new all-time low’ on a regular basis. Often, upon investigation, it is a low that has often been exceeded before; albeit many years before. However, on this occasion one can say very clearly that these are indeed all-time lows as we have data on interest rates dating back to biblical times.

So, assuming that there is any information in these rates for investors, they are telling us that something is going to happen that has never happened before! Given the major decline in the general price levels during the 1930s and during the Gold Standard period, it is quite something if current bond prices are telling us to expect that we should expect something that we have never seen before.

It’s a glib answer to observe that bond yields are so distorted by central bank intervention that they actually tell us very little indeed. Well, perhaps, but they might also be telling us about something that has never happened before: the deflationary death-throes leading to the destruction of the currency of the world’s largest economy - The Eurozone. Or at least its end as a currency!

Your analyst sees that as probable, given the reflexive nature of these interest rates in destroying the stability of the Eurozone financial system. With monetary policy increasingly impotent, but as the cause of the problem, Eurozone policy makers will revert instinctively to controls.

The USD is rising, and gold is rising. An ominous combination, as it tightens global liquidity while signalling that investors are shifting to the safety of an economically inert metal which is much less susceptible to government manipulation than other forms of investment. Hiding wealth in unproductive shiny things, mainly held underground, is not a recipe for growth and inflation. For a financial system based upon the illusion of liquidity, the rise of both the dollar and the USD at the same time strongly suggests that a liquidity crisis is getting near.

History shows that all solvency crises begin with liquidity crises. At this level of interest rates in Europe the solvency issues are most pressing, just as the politicians of that federation seem determined to move to a trade war with the United Kingdom, and President Trump seems determined to move to a trade war with the Eurozone. The Solid Ground continues to foresee that the current economic downturn in Europe is the beginning of the end for the Euro, or at least a single currency that moves freely across the borders of the federation’s member states.

Flight capital from the Eurozone debacle will push the USD even higher and capital will also seek the safety of the UK and GBP as the scale of the structural collapse becomes ever more evident. With monetary policy implementation it is the nature of the European policy maker that they will respond with controls. The more controls there are, as the European answer, the more the UK will appear a haven of stability to the owners of capital.

When bond markets are telling you that something is about to happen that has never happened before, you have to ask what that might be, rather than just assume that they must be distorted and wrong. The Solid Ground has long argued that it is the de facto, if not de jure, disintegration of the Euro and also a devaluation of the RMB that can cause an economic and market adjustment that could be so unique. In the opinion of your analyst, most market practitioners prefer to dismiss new all-time lows on Eurozone bonds as simply a central bank induced distortion. It won’t be too long now before we know who is right and who is wrong. Holding European equities in general, and banks in particular, will be a dangerous sport in such circumstances, if your analyst is correct.

Anyone from the UK who writes about the prospects of a Euro disintegration can, and usually is, accused of a bias that undermines rational analysis. Well, once again perhaps that is true, so let us end with the opinion of someone from India:

‘The problem was that no one asked their people how much more Europe they wanted, and how much sovereignty they were willing to give away - so long as the economic benefits added up,'
leaders took assent largely for granted. The process of integration was, therefore, profoundly undemocratic. As the then prime minister of Luxembourg, and currently the president of the European Commission, Jean-Claude Juncker put it, “we decide on something, leave it lying around and wait and see what happens. If no one kicks up a fuss, because people don’t know what has been decided, we continue step by step until there is no turning back”. As integration moved forward, few among the public knew what they had signed up to. Indeed, sometimes leaders themselves did not know, since in the interest of quick integration, the terms of agreement were often left deliberately vague.’


The integration is bringing, through the agency of too low interest rates, not ‘economic benefits’ but financial and economic calamity, at least according to your analyst and the current bond yields. Just how well Rajan’s ‘profoundly undemocratic’ experiment will hold up under such circumstances should worry every investor and particularly every citizen of Europe. For investors the most likely conclusion is that it’s an experiment which is now highly likely to fail.
Important Legal and Regulatory Disclosures & Disclaimers

This research is for the use of named recipients only. If you are not the intended recipient, please notify us immediately; please do not copy or disclose its contents to any person or body as this will be unlawful.

Information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but Orlock Advisors Limited does not accept liability for any loss arising from the use hereof or make any representation as to its accuracy or completeness. Any information to which no source has been attributed should be taken as an estimate by Orlock Advisors Limited. This document is not to be relied upon as such or used in substitution for the exercise of independent judgement.

At Orlock Advisors Limited we are committed to protecting your privacy. Our Privacy Policy explains when and why we collect personal information about people who receive Russell Napier’s written research or contact us; how we use it, the conditions under which we may disclose it to others and how we keep it secure. It also contains information how to make a Subject Access Request.

If you wish to receive a copy of this policy or have any questions regarding it, please send an email to dataprotection@orlockadvisors.co.uk

© 2019 Orlock Advisors Limited

Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH
Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220