the advisor

Autumn 2020

Visibility

For several days in early September, Vancouver's skies were heavy with grey smoke from the American west coast wildfires. The air was so obscure at times the sun was blotted out and you could barely see the building next door; at other times you could actually move the smog with your hand. The acrid smoke was smelt and tasted, even through a covid face-mask. Not that the hazardous air quality warnings deterred fitness fanatics from jogging in the gloomy haze.

Attempts to discern what is going on in today's financial markets are similarly obscured. Not that it has deterred some investors from rushing headlong into high-flying stocks. Yet signals from the markets are ambiguous, befuddling, even contradictory.

Let us begin with the US Treasury bond market where, over the last decade, we have seen the transformation of "risk-free interest into interest-free risk". Interest rates are near the lowest levels in American history. How can this be when the government will likely run a $4 trillion deficit this year (double that of the 2008 recession) and when federal debt is now over 125% of GDP (vs 64% in 2008)?

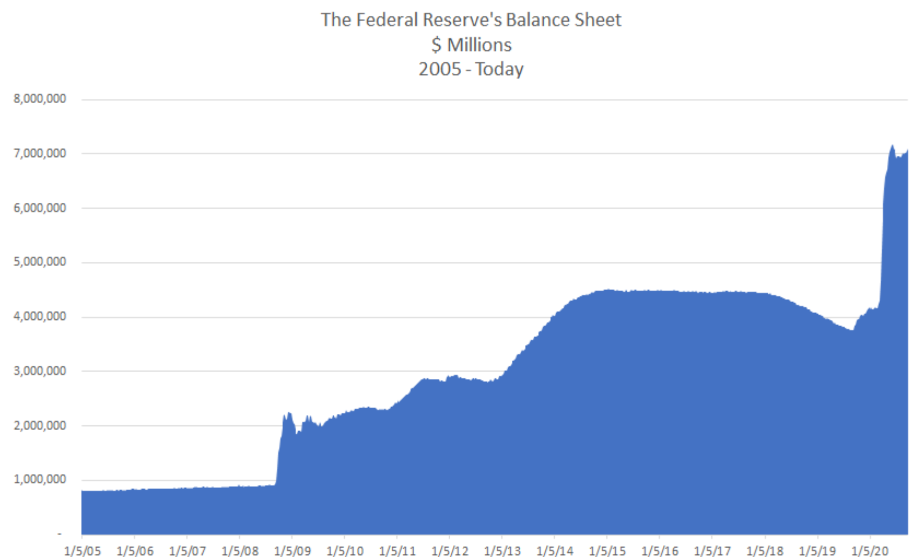
The world is drowning in a tsunami of Treasury bonds yielding next to nothing. As the American bond supply increases, foreign investors, the second largest holders of Treasuries, are not adding materially to their holdings; in fact, many have been selling down their inventory and seeking better returns elsewhere.

In response, the US Federal Reserve has been absorbing much of the Treasuries from foreign selling and from issuances to cover the federal government's deficit. The Fed's balance sheet has swollen enormously since February (see chart below) and it now holds 22% of all marketable Treasuries. Strangely, record low yields and the demand/supply dynamic elicits little fear in the bond market.

Treasury yields used to give us clear signals about inflation, disinflation and deflation expectations. Higher and rising yields offered protection against inflation concerns; low and falling yields signaled disinflation or deflationary pressures. Historically, changes in market interest rates used to inform investors on the appropriateness of the Fed's policy stance. No longer.

On August 27th, the Fed introduced the concept of "flexible average inflation targeting", implying policy will remain easier for longer. The MOVE Index, which measures Treasury market volatility, promptly slumped to its lowest reading on records that go back to 1992. Those inflation/deflation signals have been neatly quashed.

In currency markets, the US Dollar Index (DXY), a measure of the value of the dollar against a basket of foreign currencies, has experienced a lot of volatility this year. The DXY had an extraordinary rally (the dollar strengthened) of ten percent over a two week period off of its March lows. Since then volatility has subsided and the DXY once again sits near its March nadir. America is a net importer, so a weaker dollar should be inflationary (a stronger dollar would be deflationary). A weaker currency is usually the result of concerns over government deficits, debt or monetary policies. Continued dollar weakness ought to indi-



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cate potential inflationary pressures ahead. That signal too is mixed. (See chart below).

Deciphering the meaning of US dollar gyrations are confusing at the best of times. However, traditional signals are being deliberately manipulated by Fed actions. "The Fed recently conducted nearly $500 billion in FX dollar swaps with foreign central banks. The publicly stated purpose of the swaps is to provide foreign nations with dollars. The real purpose is to keep the currency transactions off of the FX markets. Ergo, the intent [must be] to reduce upward pressure on the dollar as foreign countries seek dollars to satisfy dollar debt obligations."[1]

In the precious metals space, gold and silver prices have been surging all year. This usually indicates anticipation of trouble, such as out-of-control deficits or currency weakness. However, it appears the explanation for rising prices this time could be real interest rates (the 10-year Treasury yield less the inflation rate).

Real long-term interest rates are a proxy for GDP growth prospects. As with nominal interest rates, real rates are at record lows. While there is usually an economic rationalisation for low real rates, such as dismal growth prospects, the actual reason may again lie with the Fed. The Fed has not only been buying Treasuries, corporate bonds and mortgages but also TIPs, inflation-protected bonds. By being an asset purchaser, the Fed affects all of these markets and distorts their signals. With real rates so low, gold and silver prices could be heralding inflation or they could be indicating deflation. These days it is difficult to know what real rates are signalling.

Another key signal worth monitoring is the credit spread or the difference between corporate bond yields and Treasury yields. The spread signifies default risk or risk of insolvency. Credit spreads used to widen (yields rise) with weaker expected economic growth and tighten (yields fall) with stronger economic growth. Typically, default risk increases when economic conditions are uncertain or weak, as they are now. Thanks to Fed interventions though, credit spreads are near record lows. Today's environment may be the riskiest in years but spreads suggest the future has never been more certain.[2]

In response to the coronavirus pandemic, the Fed announced three more years of near-zero interest rates. Zero bound interest rates fuel financial asset inflation while adding little economic value.

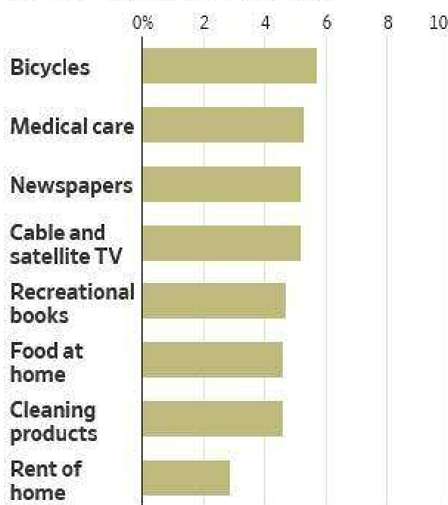
Zero interest rates may explain why companies don't invest in future development or in productivity-enhancing capabilities. Instead firms leverage themselves with ultra-cheap loans in order to convert their equity into debt via stock buybacks. While the Fed has not directly bought stocks, they have put into place the template to do so by buying high-yield corporate (junk) bonds. Already distorted by the Fed's influence over interest rates, these actions will further inflate stock prices.

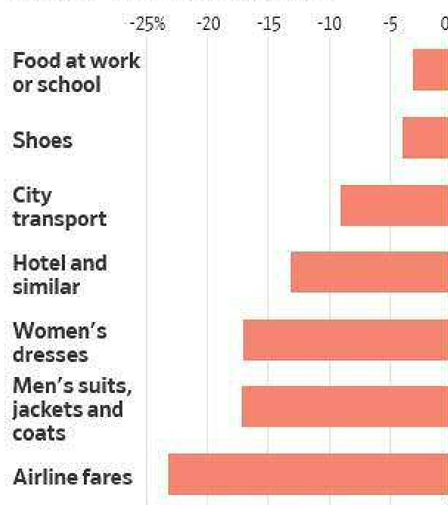
Consequently, valuations for many stocks are ridiculously expensive. Once interest rates stop falling and either flatline or rise, leveraged balance sheets will begin to destroy shareholder returns. In the meantime, due to covid-19, most companies have stopped providing revenue and earnings guidance. Why are so many stock valuations near all-time highs?

US Federal Reserve governors seem to think that they are the best arbiter of "free market" prices. By rendering many traditional market signals meaningless, confusing or contradictory, the Fed is responsible for making the current situation almost unnavigable.

On the autumnal equinox, lashing rains cleansed the smoke from Vancouver's skies leaving only clear, fresh air. Until something similar lifts the obscurity caused by Fed distortions, investors may want to proceed cautiously.

Visibility is limited.





Sources:

1. Michael Lebowitz, & Jack Scott, "The Markets are Sending Confounding Messages", 720 Global Research , 29 July 2020
2. Ibid
3. Chart page one, "Insight Tracker", American Action Forum, 28 September 2020
4. Chart page two, US Bureau of Labor Statistics

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