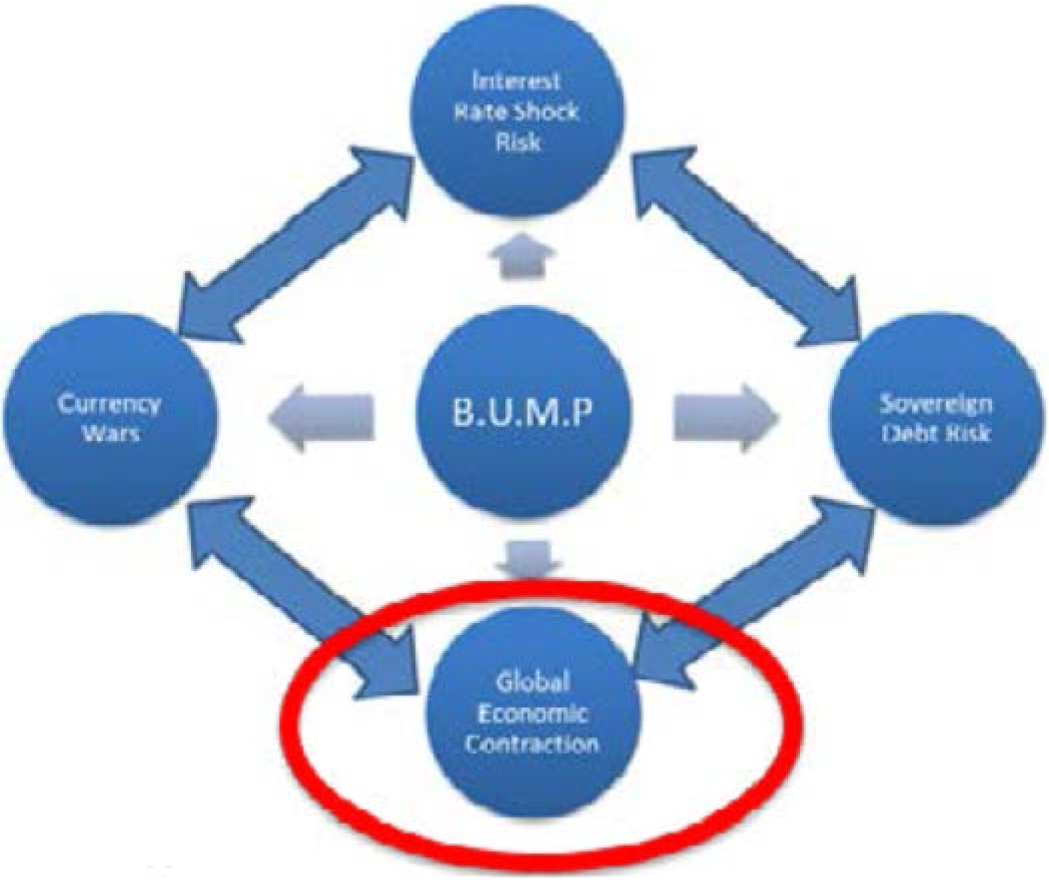
BUMP and the global economy

Nick Bullman | CheckRisk| 19 January 2014

This week's Global WRAP takes a more in depth look at the detail of B.U.M.P and its direct impact on the global economy with specific reference to the threat of deflation. This week's focus is therefore again on B.U.M.P and the satellite node of Global Economic Contraction.

Figure 1: B.U.M.P and Global Economic Contraction



Sources: CheckRisk LLP.

Since 2008, the world's central bankers have, as an unintended consequence of aggressive monetarist policies, handcuffed themselves to financial market performance. The growth in money supply has been nothing short of extraordinary. It is, therefore, not surprising that attempting to escape the handcuffs that they have so neatly placed on their wrists will take a supreme effort. It is entirely logical to suppose that if the increase in monetary stock powered the stock market recovery over the past few years then its end will have the opposite effect.

There are early warning signs of deflation in various parts of the world economy that should not be ignored because a deflationary shock at the present fragile stage of the global economic recovery would place doubt on the whole purpose of unconventional monetary policy. The effects of deflation are witnessed in complex economic forces with negative feedback loops that serve to reinforce the trend and make it incredibly hard to reverse. It is for this reason that central bankers fear it so much.

Simply put, deflation is the general lowering of prices in an economy. Initially, for the consumer, this may feel like a positive as savings go further. It is interesting to note too that consumer confidence usually rises at the start of a deflationary trend. If deflation persists, however, for any prolonged period of time then those lower prices begin to impact corporate profits.

As a result, corporations have to adjust for the loss of revenue by selling product at still cheaper prices, or cut back on production costs. The latter can be achieved by laying workers off, putting pressure on suppliers or reducing production capacity by closing factories or production facilities. Thus, unemployment increases and the economy can no longer expand. Consumers stop spending because the employment outlook feels less secure.

The second round effect is that equity market prices fall as people sell their holdings in corporations whose margins are in decline. Bond prices tend to be a safe haven as governments lower rates. If this is all starting to sound familiar then it should. The global economy narrowly missed a major deflationary crisis in 2008. The solution then was to pump prime the economy via a test of monetarist theory and a vast increase in global monetary aggregates.

That brings this to the present day in January 2014. The problem this time round is that the global economy has not recovered from the most recent decline. Interest rates, for the most part, are close to zero and in some cases negative interest rates already exist when adjusted for inflation. A deflationary shock, caused by the withdrawal of unconventional monetary policy is entirely plausible, as the global economy is naturally peaking according to a number of measures such as money supply, manufacturing output, and economic leading indicators that are showing the current cycle of economic growth is close to a peak. Deflation, once entrenched is a nightmare to dislodge.

For this reason, we believe that any steep corrections in equity markets and bond market prices below forecast economic growth or the missing of inflation targets, will eventually result in the Fed and other central bankers come back to the party with QE or other unconventional monetary policies. Effectively, the central banks are as locked into the drug of monetary easing as the markets that crave the support it brings.

If CheckRisk is correct, this means that while the short term outlook is one of high risk, any correction should be modest, unless caused by a shock risk, and that the central banks will be quick to step in. This does not make the investment environment low risk, it merely explains the likely course of events and outcomes. Longer term, of course, it is a disastrous approach that will eventually lead to massive shifts in global economic wealth, distribution of resources and geopolitical tensions.

IMF Managing Director, Christine Lagarde, has recently sent a warning shot across the bows of policy makers in advanced economies to fight signs of early deflation that would cripple a "feeble global recovery". While the IMF is expected to announce stronger economic expansion forecasts for 2014, it is clear that the global economy is below its 4% "potential" rate of growth.

> "With inflation running below many central banks' targets, we see rising risks of deflation, which could prove disastrous for the recovery." She said in Washington D.C on January 15th, "if inflation is the genie then deflation is the ogre that must be fought decisively."

There have been few forecasts that the IMF has made since pre-200 with which CheckRisk has been happy to agree and we have not been wrong as the IMF has consistently over-estimated global economic growth, inflation and underestimated the risks of QE. However, we agree with Lagarde's concerns on deflation. If anything she and the IMF underestimate the risk as one of the major risks associated with B.U.M.P must be to remove the impetus that QE has on the stock market and the economy. B.U.M.P is a catalyst for deflation.

Lagarde continued, with a direct reference to the Fed;

> "it will be critical to avoid premature withdrawal of monetary support and to return to an orderly budget process, including by promptly removing the debt ceiling threat."

Here Lagarde has somewhat lost the plot as you cannot "avoid the premature withdrawal of monetary support" and at the same time remove the debt ceiling threat or concerns of the overall debt level in the USA. They are mutually exclusive desires, as she no doubt well knows. And this is the central problem with trying to exit unconventional monetary policy

An interesting offshoot of the issue of the current relationship between money supply, the velocity of money, and the stock market is that while money supply is strongly positively correlated to stock market performance, there is also a strong negative correlation to the velocity of money. The former is a causal relationship whilst the latter is a combination of the formula's denominator M increasing and the nominator nT declining as a result of a slow economy. Velocity of money remains in the doldrums because there are still strong deleveraging and other forces inflicting the US and other economies as well as the massive increase in money supply. Ironically, as money supply starts to contract there is likely to be a pickup in the velocity of money; that will look very odd indeed.

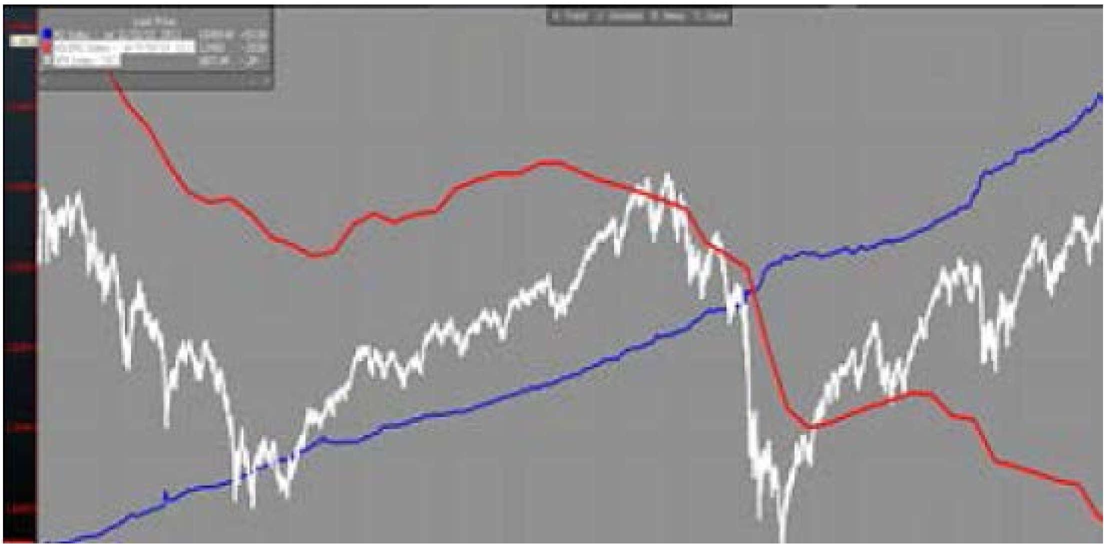
VELOCITY OF MONEY

$$V_{T} = \frac{nT}{M}$$

Vt is the velocity of money for all transactions in a given time frame,
nT is the nominal value of aggregate transactions in a given time frame and
M is the total of money in circulation on average in the economy

Figure 2 is one we have shown before, and of which we do not tire. It is the most indicative of trouble ahead. The red line is the velocity of money, the blue line money supply, and the white line the S&P 500 index. Given that global monetary growth appears to be peaking, it seems reasonable to expect a shortpterm correction.

Figure 2: Indicative US Data



Sources: Bloomberg LLP, CheckRisk LLP

The purpose of understanding macro risks is to avoid the pitfalls. 2014 is a year where a change is stirring and markets do not like uncertainty. B.U.M.P is a catalyst for slower economic growth and deflation. As a result, it is likely that central banks, if market instability returns, will not be able to continue with the policy of tapering or reducing unconventional monetary policy. In fact the ECB will have to increase its interventions because the EU is a couple of steps closer to a deflationary trap.

The natural outcomes of all of the above are that equity and bond market volatility will increase in 2014. If there is a correction in markets that is destabilising enough, the central banks and government response is likely to be to step in again and therefore on a purely non-financial risk, the markets are going to be supported. That being said, the US equity market does not look cheap on an historical basis and as a result there will be better opportunities to invest in the future.

Finally, with regard to B.U.M.P, global markets are tied at the hip with the performance of the US stock and bond markets. For the first half of 2014 and in the absence of a much stronger growth rate that correlation will remain intact and decoupling from the fate of the US will remain a myth.

Nicholas Bullman, BBA, is founder and managing partner of CheckRisk, a risk consultancy which uses a proprietary risk-based system for pre- and post-investment risk analysis. The firm advises on $30 billion of risk assets. Nick is a member of the PortfolioConstruction Forum core faculty of leading investment professionals and a regular speaker at PortfolioConstruction Forum programs.

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