Over the wire or under it, the Great Escape will be dangerous

Greg Bright | InvestorStrategyNews | 25 February 2014

You know the old joke about economists: you can lay 100 of them end to end and they'll still fail to reach a conclusion. You can probably say the same about fund managers.

At the annual PortfolioConstruction Forum Markets Summit last week, rapid-fire presentations from 18 economists, portfolio managers and investment strategists from various parts of the world failed to reach a consensus view on the biggest issue facing the financial world: whether governments, particularly the US Government, will be able to navigate the "Great Escape" from quantitative easing.

And perhaps that's the way it should be. There are some truths in investment, there are some rules, but there are no easy answers.

In his opening presentation on the unintended consequences of ultra-easy monetary policy, Woody Brock, president of New-York-based firm Strategic Economic Decisions, said there had been an over-utilisation of monetary policy because of a breakdown in macro economics.

Fiscal policy in the US this year resulted in a deficit of 3%, compared with about 10% some 10 years ago. “But, for the past five decades we haven't invested in infrastructure,” Brock said. "We have been borrowing from the children to allow governments to maintain their workforces. Had we used fiscal policy to boost growth, we wouldn't have needed zero interest rates for the past six years."

He said: “From 1995 to 2000 under [President] Clinton, there was a huge boom which saved Clinton from Monica [Lewinski]. He was saved by the inventor of the browser. But now, corporate investment is dead. Asset bubbles have replaced inventory cycles as the drivers of recessions.”

Brock was not as bullish on the US economy as other speakers such as Australian-based strategist Jonathan Pain, the editor of The Pain Report, Sydney-based Hamish Douglass, CEO and portfolio manager of Majellan Financial Group, and Hong-Kong-based Tai Hui, chief market strategist Asia for JP Morgan Asset Management.

Douglass dampened the mood, however, by pointing out there was very little correlation between GDP growth and investment markets, even with lag adjustments. While he was bullish on the US economy, he was more bearish on the US equity market.

On China, Jonathan Pain was the most bullish. He said: "My most ridiculous bet is for China to be the best performing market in the world and will be seen as a 'safe haven' within the next five years... I love what I see in China today. Chinese equities are exceptionally cheap."

Pain believes that pollution is the number one issue facing China, not concerns about a shadow-banking bubble and problem loans with state-owned enterprises and regional governments. He summed up his views with: "It's about volatility in the West and opportunity in the East".

However, Robert Gay, another top-level US-based strategist and former economist with the Federal Reserve during Paul Volker's tenure, thought that the US was ahead of the curve with its monetary policy while China was behind. A central bank's role is to control future inflation, which meant getting ahead of the curve, he argued.

And, unless the two largest central banks in the world – the Fed and the People's Bank of China (PBOC) – get their exits from clearly unsustainable monetary policies correct over the next two to three years, and in a graceful way, the world will be in trouble again, Gay said. "The Fed's message is hawkish and hence they are ahead of the curve. The two banks are at opposite ends of the spectrum... The RMB is going to the moon, as long as that lasts."

Gay also disagreed with Pain's assessment of the shadow-banking issue in China. "China is running to catch up because the credit bubble got away from them. Credit is an early indicator of an inflation problem. The PBOC is trying but it won't be there for several years. [China] has all the trappings of an overheated economy. But they don't see the inflation yet. They are in the 'la la year' [of the cycle]."

While US interest rates are expected to inch up from here, none of the Markets Summit presenters is expecting a normalisation of conditions any time soon. The long-term rate bottomed at 1.5% in the middle of 2012 and, at the current level of 2.75%, is still below the long-term average of 4.5%.

"We may take a very long time to get back there," said Russ Koesterich, San Francisco-based chief investment strategist for BlackRock. "Yields may be lower for a lot longer than people are used to."

He believes that the labour market recovery in the US is being overstated. In fact, even as the global economy recovers, he said, there are still many structural problems in the labour market, not just in the US.

The constrained middle class in the developed world is not a cyclical problem – it has been going on for some time. "There's a global wage arbitrage between the developed and the developing world," Koesterich said. "You generally see lower interest rates in older populations. Not only are expected returns lower [in developed countries] but the risk is higher because the duration has increased for bonds."

Ronald Temple, New York-based US equities portfolio manager with Lazard Asset Management, added that, in the past 11 years, China's labour costs had gone from near the bottom compared with other emerging markets, to near the top.

Temple was also a believer in the notion that China's shadow-banking debt was the elephant in the room. "There is a massive misallocation of capital, which is only slightly tapering," he said. The regional governments and banks which carried problem loans to state-owned enterprises had an incentive, due to the Chinese system of management remuneration and promotion, to roll over those bad loans. "As everyone knows," he said, "a rolling loan gathers no loss."

With that sort of preamble, Rob Mead, Sydney-based bond portfolio manager for PIMCO, had his work cut out for him to convince delegates of the benefits of an allocation to bonds in the current environment.

Mead's theme was a good one - "bonds represent a relatively cheap insurance policy against unexpected events". The Great Escape had been with us since last May, he said, when Federal Reserve chair, Ben Bernanke, uttered the word 'taper'.

Last year was a bad one for bond managers in Australia and elsewhere, Mead conceded, but an allocation to bonds still acted as a risk mitigant and liquidity buffer in portfolios, he argued. "As an insurance policy, what did it cost and what did it cover? It generated 2.00% to 2.25% or basically it preserved real wealth... although there was a massive opportunity cost. But thinking in terms of opportunity cost is reminiscent of 2007... risk assets are now more dependent on growth ratifying their prices by 20% 25% because of the re-rating of equities."

Yes, when building a portfolio, practitioners should focus on the highest conviction ideas, Mead said. But, he warned, they should also beware of completely eliminating the drivers which will protect portfolios.

Greg Bright is publisher of Investor Strategy News. Bright was a guest of PortfolioConstruction Forum at PortfolioConstruction Forum Markets Summit 2014.
