Faith in central bank omnipotence is fading fast

Dominic McCormick | Select Asset Management | 29 September 2015

At several conferences recently, I was surprised at how young many of the speakers and panellists were – although, of course, most were smart and dedicated investment professionals who knew their topics well. But, I wondered, where are the truly experienced, passionate, battled hardened industry veterans you want looking after investors' money when the financial world really experiences another very tough time, which seems increasingly likely.

Perhaps it's just getting that I'm getting older myself. But it is somewhat worrying how few of the current crop of active investment industry participants were heavily involved in investment markets through a range of prior crises such as the 1987 crash, Australia's last recession in 1990-91, the Asian crisis in 1997 or even the tech wreck from 2000. Even the global financial crisis (GFC) is now seven years ago.

Many in the investment industry have only ever worked in a world of persistently falling and/or extremely low interest rates – an environment that has created the perception that monetary policy and central banks are the most important drivers of financial markets. This has created complacency amongst investors that could easily be shattered.

Cracks are starting to appear.

I have longed worried that the end-game for the post-GFC financial asset bull market will come when investors lose confidence in central banks' ability to support markets and economies. We suspect we are we edging closer to this point, as "central bank omnipotence" is increasingly questioned. I wrote about a number of these issues back in October 2014 (see "US rate signal may be broken").

Just a few decades ago, your average central banker wouldn't dare mention financial markets, let alone offer opinions on their valuation or direction. However, this happens constantly today with Janet Yellen recently offering opinions on the market generally, or even on specific sectors like biotech. Financial markets are intimately entwined with monetary policy and they have increasingly impacted the direction and implementation of that policy.

Maybe this all began with Alan Greenspan's tentative remarks in 1996 – specifically his famous "irrational exuberance" comments. Perhaps it is an increasing recognition that, in the real world, financial markets are indeed an important input into mainstream economies and not just a simple linear reflection of them. Such "reflective" relationships, popularised by hedge fund manager, George Soros, are clearly a vital component of the real world.

However, it is a large step from understanding that such relationships exist, to thinking central banks can easily fine-tune these reflexive relationships and complex feedback loops to achieve specific inflation and growth/employment outcomes. Of course, it does seem that central banks have done quite a good job of convincing investors of just that - until recently, at least. However, confidence in this belief seems to be fading.

The problem is not just the reflexive feedback mechanisms between financial markets and economics but the complex three-way relationship between monetary policy, markets and economics that is causing concern.

A former US Treasury economist Bryan Carter highlighted the dilemma recently:

> "Short-end rates move higher as the Fed gets closer to hiking, and that causes the dollar to strengthen, and that causes global funding stresses. They are creating the conditions that are causing the external environment to be weak, and then they say they can't hike because of those same conditions that they have created."

We are now in this dangerous cycle where market volatility is an excuse for maintaining extreme monetary policy but that volatility is partly to do with uncertainty over the maintenance or removal of that monetary policy. The central bank emperors have no clothes because their policy moves are now at least partly controlled by financial market perceptions of central bank moves and the impacts. If the US or world can't handle even a 0.25% rise in US rates, things must be worse than we think.

Of course, Yellen did a partial backflip in a speech on 25 September in which she indicated that she is one of the Fed governors who believe rates should rise in 2015 - albeit data dependent. But this only adds to the confusion and dampens confidence that collectively, the members of the Fed know what they are doing.

What chance is there that the global volatility which the Federal Reserve seems worried about will dissipate in the ten weeks before their next meeting in December? (Assuming, of course, that they don't raise rates in October).

If, as I believe, a major factor in the post-GFC bull market in financial assets has been confidence that central banks will support economies and financial markets, the removal of that confidence (even without, or prior to, the removal of the accommodating monetary policy) could have a dramatic and negative effect on financial markets. Indeed, the removal of such dominant paradigms in the minds of market participants is often the trigger for market crashes or major bear markets. Therefore there is a real risk that, in coming months and quarters, we could see a major unwind of this "central bank bubble" resulting in serious impacts on many financial markets. The overvaluation of many assets as well as the complacency and overconfidence of many investors adds to the risks of such a scenario.

Why now? It seems we are at a tipping point where investors are realising central banks are out of ideas and increasingly out of ammunition. The flip/flopping over the initial rise in interest rates in the US is indicative of this.

So what does all this mean for investors?

- Buckle up for more volatility. Central banks have little powder left to deal with economic or financial market weakness and it seems investors' confidence in the "central bank put" is fading. Elevated valuations versus long-term history put a number of key markets at risk of major weakness.
- The broad consensus is that the current weakness is simply a correction and that buying the dip will work well as it has in recent years – that is, it will be a 15% to 20% fall that provides opportunities to buy cheap before the next upswing. While this could turn out to be the case, investors should at least be stress-testing their portfolios for significantly worse scenarios such as a major bear market (which may even encompass a crash) during which markets fall 40% to 60% from their highs.
- Don't deploy all cash too early in market weakness given there may be even better opportunities to add exposure down the track.
- However, it is important to have a watch list of investment ideas and the ability to implement them quickly, if required. True opportunities could come along much quicker than expected and pulling the trigger on investment ideas in the midst of the emotion and pessimism of a market crash/crisis is hard enough as it is. You don't want it made harder by uncertainty over the investment vehicles to use, or structural problems, or delays around implementation.
- In the meantime, various investors will approach the risk of significant market falls differently. Some will simply hold more cash, some will reduce market risk and increase market neutral and other alternative strategies, some will introduce specific directional hedges or short vehicles that make money if markets fall. A combination of these strategies could make sense.
- Changes in the perception and reality of central banks managing the current global fiat/paper money system are at the heart of this issue. Alternatives to paper money such as gold and some real assets (agriculture land, timber, certain commodities, etc) could be a major beneficiary of monetary uncertainty.

In the context of the last point consider the following quote:

> "Gold, unlike all other commodities, is a currency and the major thrust in the demand for gold is not for jewellery. It's not for anything other than an escape from what is perceived to be a fiat money system – paper money – that seems to be deteriorating."

Is this just a comment from some raving gold bug expecting Armageddon? Unfortunately not. It's actually from the man who arguably pioneered the conventional approach to central bank policy in recent decades, Alan Greenspan, speaking in 2011. Recent comments have continued his concerns. If he is worried, shouldn't we be too?

It's not that central banks aren't staffed with extremely intelligent people committed to doing the right thing. But the mainstream and investing community have come to expect far too much of them. And central banks themselves have generally done little to dispel the notion that they can deliver on these lofty expectations.

One of the biggest lessons you learn in investment markets is humility and the danger of hubris. Markets have a habit of coming along and kicking you in the teeth when you least expect it – and often when you are most confident you know what you are doing. The bull market in central bank omnipotence is probably over. A rally in central bank humility is likely, albeit accompanied by some chaos in financial markets and, possibly, in real economies.

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