

News that should shock nobody

Dr Woody Brock | SED | 14 April 2016

I awoke to read three pieces in the papers. These items contained news that would have surprised nobody had global economic and market commentators been doing their job of properly interpreting the news – which they have not.

TOPIC ONE – NEGATIVE INTEREST RATES

The front page lead story in the *Financial Times* on 11 April was entitled "Fears Grow Over Negative Interest Rates." Lawrence Fink, Chairman of BlackRock, wrote in his annual shareholder newsletter that:

"Negative interest rates risk hitting consumer spending and undermining the economic growth they are intended to encourage... Not enough attention is being given to the effect of negative rates on saving habits."

Indeed, one risk of negative rates (the only one he identifies) is that they lead to cash hoarding and to an increase in the savings rate needed by working age people to fund their retirement. Specifically, absent the normal *compounding* of wealth over time via positive interest, an increased savings rate is the only way for people to afford retirement. The long-term impact of negative rates on the savings rate *and hence on resulting lower growth* is a shocker. [Remember that, the more we save, the less will be growth in investment and consumption, causing GDP growth to fall. Hardly what the doctor ordered.]

Fink does not mention an even greater risk stemming from negative rates, one I emphasised in our recent essay on the true causes of inflation and deflation. Negative rates undermine the way in which pension funds and insurance companies can meet their annuity and insurance obligations. None of the executives of the firms that wrote my five annuity contracts dreamed that their asset-wealth might grow at 0% annually for the next 10 years. Suppose this were to happen. Then we would confront non-Fed-protected bankruptcies amounting to 50 or 100 times the amounts lost in the Lehman Brothers, Bear Sterns, and AIG disasters. Just consider the following maths. Should we experience 5% negative inflation for the next decade, wealth will *shrink* by 2.5% annually, assuming a real return on safe assets of 2.5%.

But wait, it is even worse. Ask any pension fund's manager to compute the firm's liabilities when discount rates are negative. Before expecting an answer, watch the poor manager dial G for God, for assistance in how to divide by zero.

Yes, as we wrote, negative interest rates are for many reasons a catastrophe.

Switzerland only introduced these recently, and already there is cash hoarding. But where were the warnings from the World Bank, the IMF, the Fed, and from supposedly unbiased commentators such as Martin Wolf and Lawrence Summers? Indeed, isn't Summers the pundit who keeps talking about the need to lower the "natural" interest rate even further? Incroyable!

TOPIC TWO – THE END OF OPEC

We provided three game theoretic reasons why OPEC was finished some sixteen months ago in our Jan 2015 *PROFILE* predicting the oil price collapse. Well, a lead story in today's press is that Daniel Yergin, author of *The Prize* and the eminence grise of oil prices, has proclaimed that OPEC is a spent force that will no longer control oil prices. Yergin's main idea is that the membership of the cartel is "too divided" to agree on what to do. And while this is true, there are deeper issues such as the simmering conflict between Saudi Arabia and Iran. Indeed, Iran is more interested in toppling the House of Saud than it is in eradicating the State of Israel.

In retaliation, Saudi Arabia departed from OPEC a year ago, claiming that it needed to protect its own market share (whatever that means) and "to teach the fracking industry a lesson." Of course, its real goal was to screw Iran and Russia through the wall by letting oil prices collapse – and its strategy worked perfectly. I never read much about any of this on the part of those macro-commentators who should have been focusing on the causality underlying the oil story, but instead focused primarily on Janet Yellen's next utterance.

TOPIC THREE – MISBEHAVING CURRENCY MARKETS

This is the subject of the 11 April lead *Financial Times* editorial. How can the yen have risen given all that the Japanese Monetary Authority has done to weaken it? How can the dollar have fallen after the US alone dared to tighten policy, and has promised to do so again? Are we in the world of Humpty-Dumpty?

Not at all. As we wrote in our essay 20 years ago on "Currency Market Misbehavior" and as we stressed when developing the theory of "Pricing Model Uncertainty (PMU)" a decade ago, currency markets have been and should have been particularly recalcitrant to market expectations. One reason lies in the role of PMU in the context of currency markets.

Recall the fundamental theorem here – the greater the degree to which an asset class lacks a persuasive pricing model that convincingly maps "news" into "price" then the more perverse the market's price behavior will be, often exhibiting trends that make no sense.

In this context, credit-risk-free government bonds have the least PMU. In their case, news about inflation should and does drive the behavior of long-government yields as expected, *ceteris paribus*. In this minimal PMU case, textbook theory works.

With currencies, however, no one agrees which of some six variables matter how much, when, and why. There is maximal PMU. In plain English, our main point was that, the more that benchmarked traders do not have a compelling model with which to price the news, the more they will simply follow whatever trend gets going. It is rational for them to do so.

Have any readers found it difficult to forecast currencies correctly — even when their bets on the news about fundamental proved correct? I'll bet you have. I sure have. This is precisely the point.



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Woody is a regular Faculty member at PortfolioConstruction Forum programs. This article is reproduced with permission.
