HALKIN SERVICES LIMITED

INTERNATIONAL
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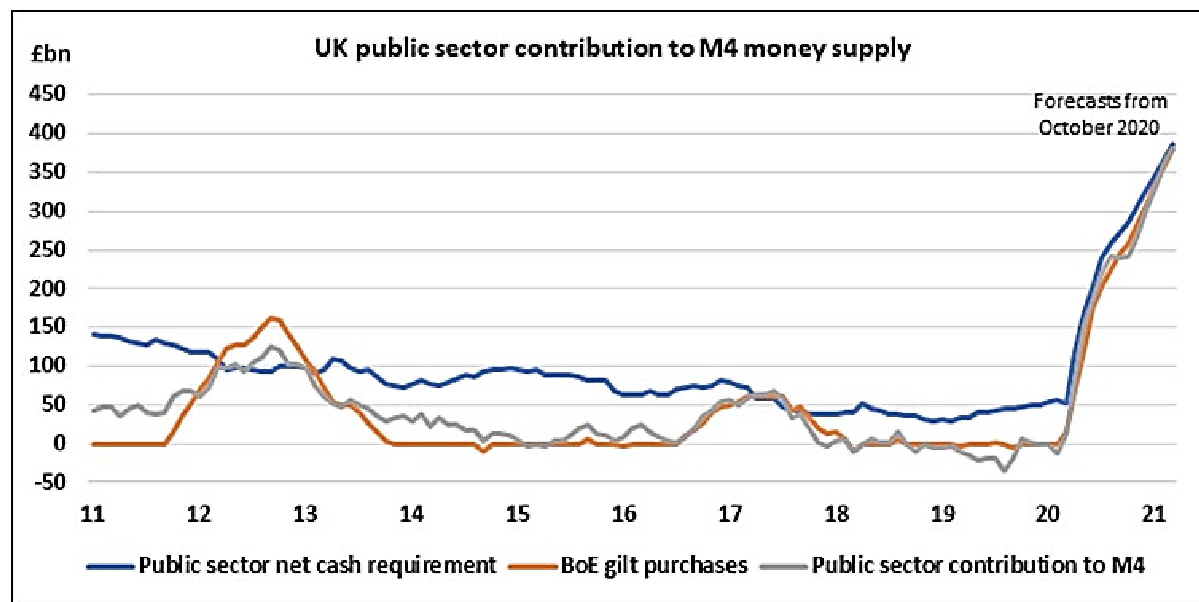
WANTED: A VACCINE FOR HUBRIS!

Despite the S&P500 striking out to a new high this week, VIX, the market expectation of equity volatility over the coming 30 days, remains elevated at around 25. The coincidence of all-time highs and high readings for the VIX is reminiscent of the circumstances of March-April 2000 when the dot-com bubble burst. A rising correlation between stock prices and volatility has often anticipated a market correction and more recently, in early September, the S&P500 fell 8 per cent in a week. Notwithstanding the market-friendly outcome of the US elections and the promising news of a coronavirus vaccine from Pfizer, this looks and feels like a very dangerous market. As John Authers pointed out in a Bloomberg post on Tuesday, the market-leading FANG stocks failed to impress. While they have strong balance sheets and extraordinary profitability, they are also beneficiaries of the "perception that they are Covid-19 insurance". That they can prosper even in a pandemic has suggested to some investors that they are defensive, but on Monday, they lagged the average stock by nearly 8 percentage points on the day. This is the largest negative divergence since the FANG acronym caught on in 2015. Charlie Morris points out that the Morgan Stanley Momentum Index suffered its largest daily fall (23.5 per cent) since its inception in 1999. While it may be much too soon to call time on Covid-19 and lockdowns, the power of the price recovery in the stocks most adversely affected by Covid-19 gives a strong indication that an important market tide has turned. Contrary to market hopes of a rotation into cyclicals, the evidence points to a belated revival of value. However, momentum crashes can occur not only when the whole market is ripe for correction, but also when the economy recovers at the end of a downturn. In 2009 and again in 2016, the out-of-favour stocks rallied on the sentiment that the bad news would become no worse. The rise in US bond yields, and the associated steepening of the yield curve, warn that real yields could edge higher in the coming weeks before there is clearer evidence of a surge in inflation.

TESTING UK MONETARY POLICY CREDIBILITY TO THE LIMITS

In early September, Ben Broadbent, the Bank's deputy governor for monetary policy, tackled head-on the issue of the (in)significance of government debt accumulation for the inflation outlook. Since former governor Mark Carney adopted a presidential style of leadership, Ben has been running the monetary policy show, to all intents and purposes. In his speech, Ben mounts a stout defence of UK monetary policy against the charge of fiscal dominance – a state where the central bank is forced to subjugate its objectives to those of the fiscal authority. We note, in passing, that one of the objectives of the fiscal authority is not to have its debt downgraded, as Moody's did last month (to Aa3). His argument is as follows: "If inflation rises materially above its target, and if it tends to do so in particular when the public finances are under strain, that may be evidence of 'fiscal dominance'. If, on the other hand, easier monetary policy is necessary simply to stabilise inflation, and succeeds in doing so, it's hard to see how it can qualify as 'monetary finance', no matter how the fiscal balance is behaving." There is a serious point of contention here. We have ample cause to doubt whether either element of monetary policy – conventional or unconventional – has traction over economic behaviour in current circumstances. The notion that the Bank of England – or any major central bank – is running an independent policy at present is ludicrous. Let them try to tighten policy during the pandemic and see how quickly the central bank is slapped down by the government. There is a significant experiment in monetary policy underway, which was lifted a few notches by the recent announcement of another £150bn of gilt purchases by the Bank. Broadbent argues that QE doesn't really monetise the government's debt because bank reserves pay interest. But when the interest rate is miniscule, this amounts to splitting hairs. The stark reality is that the Bank has facilitated the financing of a colossal budget deficit – which is likely to remain vast in 2021-22 and beyond – such that the annual growth of the broad money supply, currently 12 per cent, will likely climb to around 17 per cent by next March. As long as the Bank's inflation target (of 2 per cent) remains credible – among the general public as well as in the financial markets – then the extra liquidity will sit obediently as savings in bank accounts and other liquid instruments. (In the first half of 2020, households accumulated £120bn in savings, up from £22bn for the whole of 2019.) However, as inflationary concern builds, then the realisation will dawn that the purchasing power of savings is going to fall. According to the latest YouGov survey, the medium-term inflation expectation of the general public has increased to 3.6 per cent. The pricing of future inflation according to the Sterling 5Y5Y swap is also steady at 3.6 per cent. When the dam breaks, consumers will unleash a tide of spending that overwhelms tightly controlled supply chains and provokes inflation on a scale that today's central bankers will never have experienced. The velocity of money will switch from being a force that offsets money supply growth to one that amplifies it. Twenty-five years of success in anchoring inflation will be gone in twenty-five minutes. That's when we'll know that we have fiscal dominance. Ben insists: "Come what may, the MPC will respond to economic events as they unfold to ensure, in line with our remit, that the stability of inflation is maintained." To paraphrase Mike Tyson: "everyone has a remit until they get punched in the face."



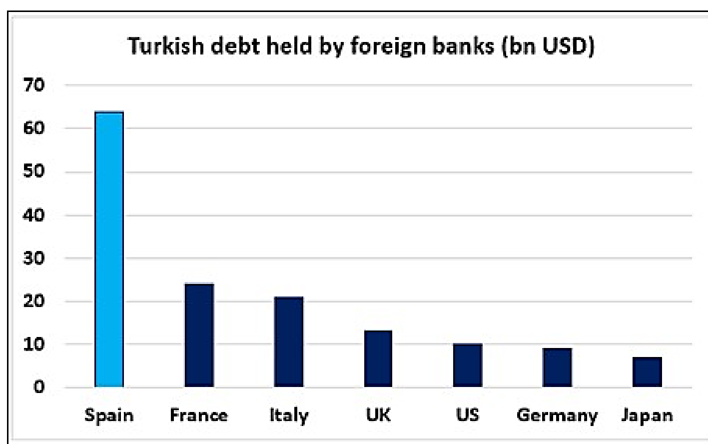
DIARY DATES

No definite dates to announce at present, but we are hoping to identify a speaker from the US credit rating industry and another one on commodities. If you have suggestions for Halkin speakers or topics, please send them along.

Peter Warburton

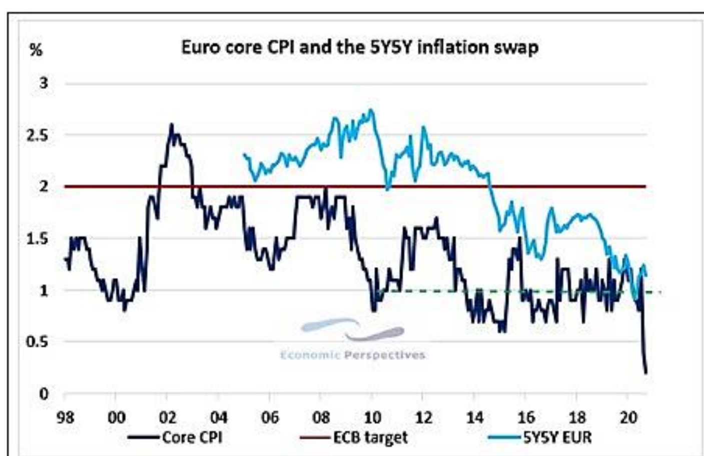
ARE SPANISH BANKS STILL FINE?

The economic uncertainty associated with the new series of pandemic-related lockdowns has dramatically reduced growth expectations for the end of 2020 and the start of 2021. With most of the European nations under a national lockdown, concerns over the default cycle for 2021 have been rising as investors are conscious that the provisions held by banks are way too low to absorb the Covid-19 losses. In addition, we also know that European banks are also moderately to significantly exposed to EM economies such as Turkey, which is currently experiencing a political and economic crisis. The chart on the right shows the Turkish debt held by foreign banks according to the Bank of International Settlements; for instance, Spain is heavily exposed with US$64bn of debt held in the banks' balance sheet (while German and Japanese banks are the least exposed ones). With the Turkish Lira down nearly 30 per cent since the start of the year and the CDS 5Y trading at 520bps, investors are increasingly speculating that Turkey may partially default on its debt if the situation continues to worsen in the medium term. Hence, we think that the lack of tourism, combined with dismal industrial activity and the mounting risk of crisis in some EM countries could significantly weigh on Spain's economy in the medium term and undermine the health of Spanish banks.



EURUSD: DO NOT UNDERESTIMATE THE ECB

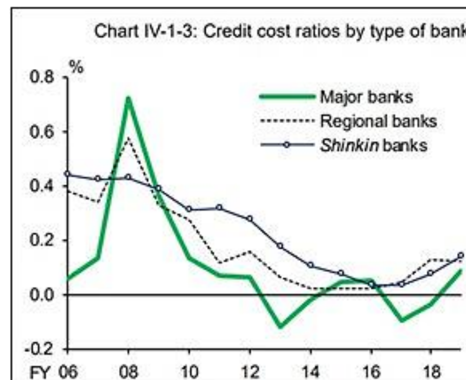
The Euro has experienced a tremendous rally amid the weak USD environment and is up nearly 18 big figures since its low reached in mid-March. The recent news on the Covid-19 vaccine combined with rising hopes of a second stimulus should support risky assets such as equities and weigh on the US Dollar in the near term, and could push the EURUSD exchange rate to the upside. However, even though the Euro still appears to be significantly undervalued according to a range of fair value metrics (PPP prices in a fair exchange rate at 1.42, implying that the Euro is 18 per cent undervalued against the USD), the market should not underestimate the ECB response to the Euro strength. We do not think that policymakers will be indifferent to further Euro appreciation as it will weigh on both the economic recovery and inflation expectations. The chart on the right shows that core CPI in the Euro area has not been above the 2 per cent threshold since 2002 and has been oscillating around 1 per cent in the past 12 years (before the Covid-19 shock). Hence, there is little room on the upside for EURUSD but a breach of the 1.25 resistance level is a likely trigger for action.



Yvan Berthoux

JAPAN: SAFE HAVEN OR GREEK SIREN

The mythical Greek Sirens lured sailors to shipwreck on the rocks of their island – the Bank of Japan recently released its Financial System Report, providing more information on whether Japan is the hoped-for safe-haven or a dangerous mirage. Investing in Japan has many appealing attributes: the Yen is traditionally a risk-off currency, performing well when the VIX is elevated, Japanese corporates have large cash holdings, as the report confirms, (meaning there is probably more security in dividend payments), and the country and its economy have not been as damaged as many of the other major economies due to the pandemic. The report suggests that despite the hit to the economy being as severe as the depths of the 2008 financial crisis, this is less severe than the damage in the US and Europe. In the report they say that despite the moderate economic recovery the Japanese financial system is likely to remain robust. They highlight three potential risks: an increase in credit costs at home and abroad; a deterioration in gains/losses on securities investment due to substantial adjustments in financial markets; and the destabilisation of foreign currency funding due to the tightening of foreign currency funding markets mainly for the U.S. Dollar. The report provides a heatmap, shown below, which is beginning to show signs of strain, though nowhere near as much as in the late 1980s when the Japanese bubble was bursting. Six out of the fourteen areas flagged red in the most recent data. Except for M2 growth rate, the other five red cells were due to the sudden slowing of the nominal GDP growth rate. Total credit to GDP ratio and the real estate loans to GDP ratio were red before the pandemic. One area that is highlighted as a potential danger, and it is not likely to be a purely Japanese concern, is the risk of an increase in corporate defaults. The current default rate is low, as are credit cost ratios, though there are signs that they are beginning to pick up, as shown above. “Firms can go bankrupt from funding difficulties if sales fall significantly to the point where net operating cash outflow during the year exceeds their cash reserves at the beginning of the fiscal year.” The historical data shows that default rates for firms facing cash shortages are around four times higher than for those without. For now, while there remain so many uncertainties in the global economy, cash-rich, Yen-denominated equities seem to have appeal. The Japanese economy has been stagnant for decades and it is unlikely that a global pandemic is going to improve productivity. Japan will probably not provide the most exciting returns, but it is also unlikely to see the most egregious drawdowns. For now, Japan seems to have more haven than siren credentials, especially considering the competition.



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Financial institutions	DI of lending attitudes of financial institutions																																									
	Growth rate of M2																																									
Financial markets	Equity weighting in institutional investors' portfolios																																									
	Stock purchases on margin to sales on margin ratio																																									
Private sector	Private investment to GDP ratio																																									
	Total credit to GDP ratio																																									
Household	Household investment to disposable income ratio																																									
	Household loans to GDP ratio																																									
Corporate	Business fixed investment to GDP ratio																																									
	Corporate credit to GDP ratio																																									
Real estate	Real estate firms' investment to GDP ratio																																									
	Real estate loans to GDP ratio																																									
Asset prices	Stock prices																																									
	Land prices to GDP ratio																																									

Tom Traill

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