SingAlliance

Letter n°16

Wall Street opposite "Main Street" (continued)
The economic and stock market consequences of liquidity injections.

"In financial matters, all that is pleasant is unhealthy, and all that is healthy is unpleasant"
Churchill (speech at the Waldorf in 1926)

With the Nasdaq up 19% this year, the Chinese market up 14.5%, the Swiss market down only 1.7%, the German market down 1%, investors can only be sympathetic to such figures, but after the astonishment caused by this global crisis, only a mind full of paradoxes will be able to understand them.. Policies have oscillated between farsightedness, and improvisation and have relegated the financial implications of the seemingly unlimited stimulus measures to the shadows. The extent of the crisis is still poorly circumscribed, the majority of government leaders are in harmony with the major principles of the market economy, the duration of this crisis and its repercussions are poorly assessed, the major American banks urged caution on the economic situation and increased their provisions by more than $30 billion during their second quarter results, but the markets are turning a blind eye, ***Churchill***'s word takes on its full value and comes at just the right time to question us. It pleases investors that these policies are convincing the markets, but some will regret that the long-term consequences of these financial indiscretions are being ignored.

Understanding the reason and the effects of this disconnection between the financial and real economy is the ambition of this note. Stimulation has taken two paths, firstly budgetary with the aid or guarantee plans mentioned in the previous note, then monetary with the injections made by the central banks, which are sometimes difficult to keep track of, and the activation of budgetary policies facilitated by the debt monetisation.

Let us rule out the risk of inflation and focus on the economic consequences, the biases brought to the market economy, the impact on investments and the stock market of these injection policies. Let us also question the opportunity or the risk of cancelling debts.

The absence of inflation:

No offence to some worried monetarist minds, or those who have been buying Treasury Inflation-Protected Securities (TIPS) for the past few weeks as inflation hedges, there is no resurgence of inflation. In the eurozone, the 2% inflation target has not been achieved over the last ten years and will not be achieved soon. In the US, the recent core PCE inflation index is at 1.7%, below the 2% target. Cash injections are unprecedented, but money is often not used, and bank deposits increased by $2.2 trillion in the first half of the year, which is three times higher than ever before, according to the Fed. The environment is deflationary, with overcapacities arising from competition from abounding "zombie" companies, wage increases are constrained by partial unemployment and despite the recent rise in commodity prices (oil and copper), this is not likely to reverse the trend. The price of crude was at $65/barrel at the beginning of the year, it is at $44 after having fallen to less than $20.

Nevertheless, betting on a disappearance of inflation would be presumptuous. Possible seeds include wage increases in certain sectors, such as healthcare in France, a decrease in productivity if health or climate standards are imposed, a possible return of protectionism or costly relocations in certain sectors. In addition, there is the possibility of cost inflation due to temporary disruption of supply, for example in the fruit and vegetable sector.

Without inflation, debt reduction will require an economic growth rate higher than the rate of debt.

The economic consequences:

Biases to the market economy: economic history offers several examples of bias. Setting a minimum wage has been one for decades. Today, faced with the prospect of an explosion in unemployment, the solution of state financing of temporary partial unemployment can be likened to a nationalisation of wages. Today, faced with the explosion in debt, the notion of risk is flouted. Worsening budget deficits and public debt are expected to be matched by a rise in long-term interest rates. However, this is not the case, due to central banks' caution to preserve confidence, and buy on the long end of the yield curve, or even to set a maximum long rate as in Japan. This "yield curve control" policy could be extended to other countries, as could one day, following the example of Japan, the purchase of shares by the central bank.

Deterioration of the countries' financial situations: the worsening of debt will lead to a downgrade of government and corporate ratings by rating agencies. Great Britain has already had its rating downgraded to AA-. Thanks to monetary injection policies, and despite a strong increase in public debt, the rate of 10-year US bonds, which exceeded 3.2% in November 2018, is at 0.58%. Thanks to monetary policies, a new crisis in indebted European countries such as Greece and Italy can be averted. Due to the same reason, gold, recommended in our previous notes, regains its safe haven status and at $1873/ounce, approaches its 2011 historical record of $1891/ounce. On the other hand, some emerging countries such as Turkey, Mexico and South Africa, have to bear very high rates, above 8% for the former and 5% for the other two.

In the end, notwithstanding these measures, the hierarchy of states will remain the same. Before the crisis, Germany had a public debt of less than 60% of GDP, Italy of 135% of GDP. The 10-year interest rate differential between the two countries has narrowed to 1.40%, but the debt differential will widen.

The question of debt cancellation: some are advocating debt cancellation, but this would not be without impact. Today, the ECB holds 20% of Italian and French public debt, more than 30% of German public debt and these percentages will increase. The temptation is great to write off some of these debts, but central banks would suffer a loss and would have to be recapitalised.

The preferred solution for a central bank is to hold the debts until maturity and reinvest the proceeds as this is equivalent to debt cancellation. On the other hand, if the ECB, like the Fed had done in 2019, were to commit to a reduction in its balance sheet, then there would be pressure on the debt of the most indebted countries.

The consequences on investment:

Since the 2000s, companies have been encouraged to go into debt because rates were low and interest charges were tax-deductible. In the United States, the debt of non-financial companies has risen sharply, reaching 75% of GDP, $16 trillion, and is particularly high in certain sectors such as automobiles, transport and shale oil. Worrisome is the latest OECD report on the evolution of corporate bonds issued in the world, it has registered an annual increase of EUR1.8 trillion/year since 2008, double the amount recorded between 2000 and 2007, standing at $13.5 trillion at the end of 2019, double that of 2008. Even before the crisis, the IMF had warned of the risks presented by some $19 trillion in loans to vulnerable companies in the world's eight largest economies.

The most indebted are often those that have gone private and are held by private equity firms. These companies now appear to be fragile, but central banks and governments seek to preserve them because jobs are at risk.

Experience has shown that lower interest rates do not affect the corporate investment rate because they give much more value to the expected evolution of final demand. Not only have negative rates failed to increase credit, but there are three hazards: they penalise depositors indiscriminately, they reduce banks' profitability and they erase the effect of credit spreads between borrowers, which may force them to tighten credit risk conditions.

Finally, there is the question of the survival of "zombie" firms: overcapacity persists, non-viable companies survive and feed deflationary pressures in the rest of the economy.

These are all situations that would be impossible to envisage if interest rates were kept at abusively low levels and out of step with economic reality. A shortcoming of this injection policy is that aid to businesses will not always benefit start-ups, and so bankruptcies are to be feared.

The stock market consequences:

The recent price appreciation takes into account the prospect of an upturn in profits, the median hypothesis of a recovery of losses by the end of 2022, weighted by risk-free government bond interest rates close to zero. For some sectors, such as pharmaceuticals and digital, the recovery will be faster because profits will be higher. For others such as tourism and air transport, losses will be erased more slowly, but they do not necessarily weigh much in the indices. The economic contrast between sectors exposed to the crisis and protected sectors is amortized on the stock market by liquidity injections.

By coincidence or consequence, since the low point on 25 March, the market's appreciation has been similar to the 35% inflation of central banks' balance sheets. While it is certainly fairer to reason in absolute than in percentage terms, the parallel is nevertheless striking.

Far from us is therefore the hypothesis of efficient markets developed by ***Eugène Fama*** in the 1970s, the idea of this professor from the University of Chicago was that stock price is a faithful reflection of the intrinsic value of a company, and still in 2007, he rejected the notion of a bubble. In the meantime, ***Andrei Shleifer*** of Harvard had in 1997 recalled that "the market can remain irrational longer than you can remain solvent". A suggestion of irrationality corroborated by recent market developments that does not reflect the evolution of profits. Before March 21, Wall Street had lost one-third of its capitalization in one month, almost the equivalent of what evaporated in one year in 2007, during the "subprime" crisis. Since then, the S&P has almost recovered, and the Nasdaq is at an all-time high.

Conclusion: "We're floating on a rudderless boat and we don't know where the port is, so we have to keep sailing" Isaiah Berlin.

Governments want to do everything they can, but should we worry about liquidity injections, should we cancel partial debt, what about the independence of central banks, the possible dictatorship of markets, the effectiveness of monetary policies on the evolution of the real economy, the possible impact of monetary policies on wealth inequalities, should we consider investing in the stock market to be without risk? These are seven key questions.

Should we be concerned about these injections? In wanting to ensure the budgetary solvency of countries, central banks are going beyond their historical mission to ensure price stability, or even in the case of the Fed, the quest for full employment. In their new role, they are proving to be effective, but what will happen if inflation rises? Will they manage to control real rates? Should we be alarmed by the ruin of savers? In the short term, no, because falling interest rates generate capital gains on bond portfolios. In the medium term, pension funds are being impacted by the loss of attractiveness of the bond markets, the fall in yields on commercial real estate affected by development of e-commerce and the bleak outlook for office real estate penalized by the success of teleworking. Therefore, pension funds are forced to diversify into more volatile equity markets.

Is it necessary to cancel part of the public debt? No, because the political management of a debt cancellation would be delicate. Everyone would believe in the possibility of free and infinite money; demands would multiply, and wage increases would cause inflation to return. One would prefer the current policy of buying back public debts to be held to maturity and reinvested in new debts. This is equivalent to a debt write-off but is more discreet.

What about central bank independence? In the statutes, central bank independence is set in stone even though the presidents of these institutions are appointed by the Executive Board. And every time pressure is exerted - in India with Modi's dismissal of the President of the central bank, in Turkey with the pressure exerted by Erdogan, in the United States when Trump called for a reduction in rates at the end of 2019, in Europe when Emmanuel Macron was indignant at the softness of the ECB's initial reaction at the beginning of the Covid-19 crisis - respect for independence is reminded. Nevertheless, central banks often anticipate the expectations of the Executive Board and in a highly indebted world, they do their utmost to lower rates to zero and prevent them from rising again. They finance budget deficits, buy all or part of the issued debt, hold it until maturity and ensure the solvency of countries.

Is it possible to speak of a market dictatorship? The rise or drop in the markets depends more on the liquidity injections by the central banks than on the evolution of economic indicators. In a world that is becoming more indebted every day, market expectations are increasingly important, and we can speak of a market dictatorship.

Before central bank meetings, figures circulate on market expectations and the risks of disappointment, and central banks seem to be listening.

What are the implications for wealth inequality? If the link is established between liquidity injections and stock market appreciation and not with the real economy, then equity holders are at an advantage over employees. Yet equity ownership is highly concentrated. The wealthiest 10% in each country own approximately 85% of the equities and 75% of the population do not own shares. The same is true for residential real estate assets in the United States, valued at $35 trillion, or 1.5x US GDP, because zero interest rates encourage appreciation.

How effective are liquidity injections on economic policy? The injections are more important with each crisis but the spillover effect on the real economy seems inefficient. The transmission belt of bank credit appears to be inefficient. Liquid private savings are abundant, needs are obvious (e.g. energy transition), but the returns hardly encourage savers to invest and the increase in credit volume is small in relation to debt buybacks. Businesses are fearful of the future and are investing less. Just as the effect of monetary policies is immediate on bond prices, on the narrowing of spreads between highly and lowly indebted governments or companies, the link between liquidity injections and stock market appreciation is obvious, but the link with the real economy is now weak. Wall Street is not Main Street. In a world of low interest rates, a decision to invest cannot be made conditional on lowering rates from one to zero.

Does this mean that there is no longer any risk of a crisis? Faced with the scale of indebtedness, central banks will have no other solution than to ensure the stability of long rates and prevent the spreads of the most indebted countries within the Eurozone from widening. Thanks to the central banks, the risks linked to debt seem to be eliminated, but a linear rise in the stock market cannot be imagined because there are still geopolitical risks, a threat of social crisis and the possibility of a financial crisis born from asset price bubbles.

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