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Behind the Curtain: Entering Oz-sterity and Other Macro Challenges

We are in a bull market in behavioral economics and we are in a bear market for regression-based economic forecasting (that relies on historical patterns repeating themselves).

DOUG KASS, AUGUST 2011

In a memorable scene from the beloved 1939 film classic, The Wizard of Oz, Dorothy and her ragtag companions finally arrive before the great Wizard, after putting an end to the wicked witch. Their only wish is that he fulfills his promises. As the Wizard begins to address the yellow brick road gang, amidst much smoke, flames and other theatrics, a strange thing happens. The dog, Toto, tugs on a nearby curtain, revealing an ordinary person — nothing like the all-powerful wizard whose authority was projected before them — speaking into a microphone, while operating various cranks and levers.

Investors are witnessing a similar scene unfold in the wonderful world of financial markets. Western policymakers are no longer seen as having the same effectiveness as they once did. In fact, many other consensus assumptions are also now being called into serious question. Others have simply proved to be wrong. Firstly, the hope that the United States (*and the wider Western world*) would enter a self-sustaining recovery this year has turned out to be false. Most economic figures are now pointing to a sustained slowdown, with consumer confidence hitting lows not seen since the early 1980s. Secondly, the notion that the emerging markets — most notably China — can lift developed markets out of their economic malaise is being questioned. In reality, many emerging market countries are now also joining the developed world in showing signs of economic fatigue.

Finally, and most importantly, confidence in Europe's policymakers has suffered a serious setback. In fact, combined with the political theatrics and brinksmanship surrounding the US debt ceiling debates, most Western policymakers are quickly losing credibility ... yanking levers and cranks with no discernible game plan. Even ECB president Trichet — long seen as the steward of monetary policy independence — has capitulated in recent weeks, buying Spanish and Italian bonds, ignoring a "no" vote from Germany's Bundesbank in the process. According to a translation of recent comments in German, Trichet had this to say: "*We observed that our decisions in the euro zone did not have the intended effect…that is why we decided to deviate from our monetary policy rules*." [1]

It wasn't always this way. In the past, central banker reputations approached near deity-like status, heralded as miracle workers (*recall Alan Greenspan's halo during the 1990s*). When markets wobbled, central bankers mechanically lowered interest rate levers and stability was quickly restored. Of course, those long-running policies promoted runaway credit formation, aided and abetted asset bubble creation and, ultimately, contributed to the global financial crisis. But today, the trick bag seems empty ... or, at least, the wizards are losing their magic potency.

We're Not In Kansas Anymore. To be sure, we are sympathetic with policymakers. No doubt, they face a highly challenging macro environment. Where can they turn for guidance? Rummaging through the annals of financial history yields no useful comparisons. Even reaching back to the late nineteenth century's dark days (*the original "Great Depression"*), the differences are obvious. Consider that the panic of 1873 sparked a global soft patch that lasted 23 years, with output declining for six straight years. Noticeably absent, however, was a coordinated counter-cyclical government fiscal and monetary response. Market forces were actually allowed to work on the downside. Debt was purged through default, and deflation ravaged the economy. To be sure, the initial social costs were excruciatingly painful, but ultimately cleared the way for recovery.

Contrast that with today's environment. The US only experienced a cumulative decrease in real GDP of 5.1% over the six quarters of contraction (*from 2007:Q4 to 2009:Q2*). Yet, the government administered more than USD 4 trillion in fiscal and monetary stimulus — equivalent to almost 30% of gross domestic product. That is an unprecedented federal response. According to Jim Grant, the average post-war response to recessions has been a mere 2.9% in counter-cyclical stimulus. Even during the 1930s depression, US per capita GDP fell a monstrous 31% between 1929 and 1933 — yet President Hoover's fiscal and monetary stimulus response amounted to just 8% of GDP.

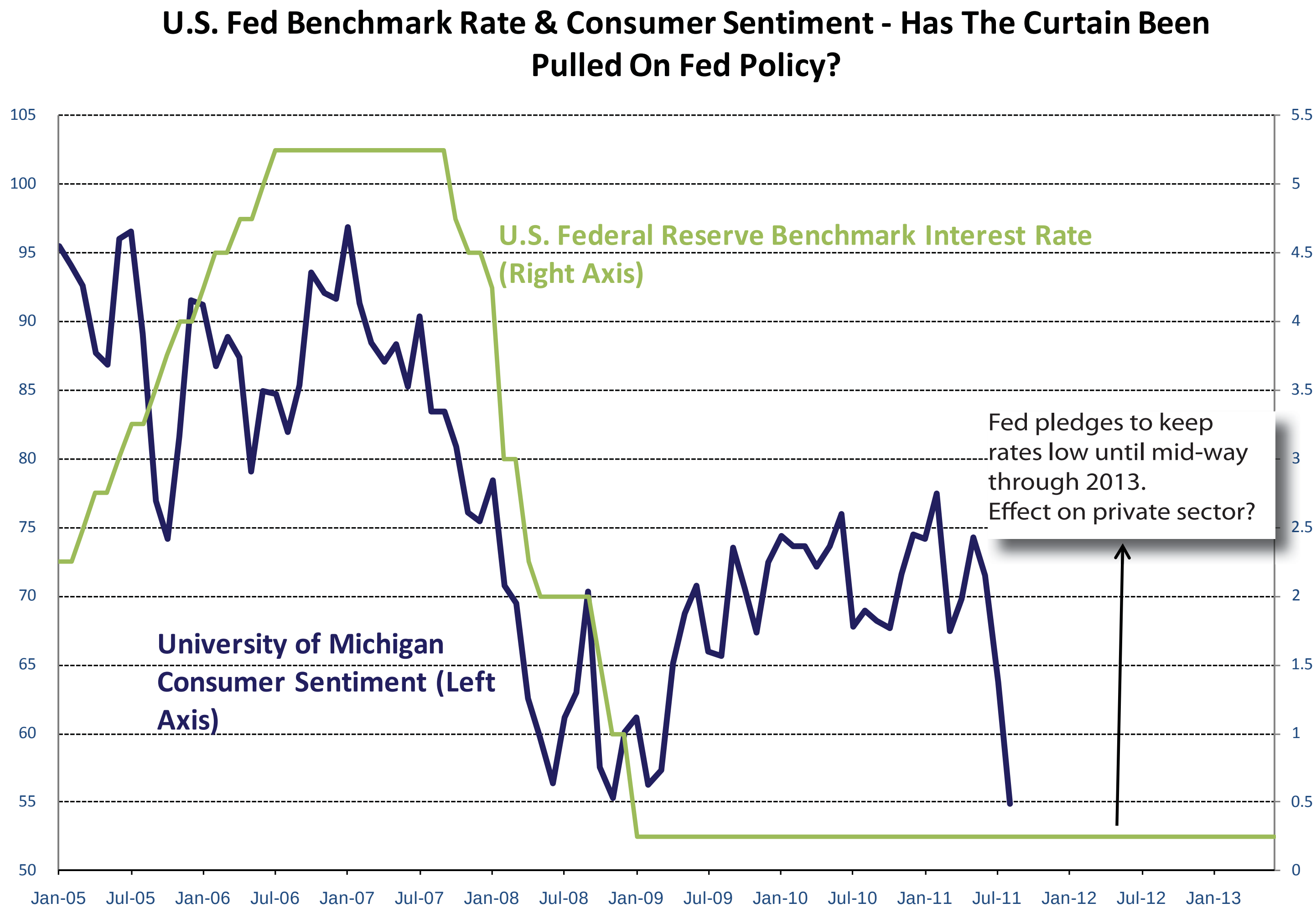
The reality is that current policies have not yet addressed fundamental problems left behind by a 30 year unrestrained credit expansion. Rather, they have opted for fiscal band-aids and monetary recklessness that support asset bubbles and unproductive private sector spending.

And therein lies today's central issue. Enormous government responses to the GFC have not succeeded in kick-starting a private sector led recovery. Even after pinning policy rates to zero and stretching fiscal deficits to irresponsible limits, the latest economic figures are not encouraging. While *ETFocus* is not in the business of government policymaking, we suggest that a different approach is clearly required.

Of course, a late 1800s-style economic purging would never occur in today's highly politically "do-whatever-it-takes" environment. We are not holding our breath for that scenario (*nor is it necessarily the right one*). Yet, crucially, official efforts need to target the restructuring of debts, namely residential mortgage debts in America and sovereign liabilities in the Eurozone. Until then, economies are likely to remain hostage to unrealistic liabilities and continuing systemic crises. That means a protracted period of economic stagnation and accompanying rolling asset bubbles is most likely. (*For more prescriptions to today's economic funk, colleague Wilfred Hahn's fertile mind goes inter-galactic in his latest Global Spin "Calling Mars: Interstellar Strategies Needed"* http://www.hahninvest.com/media/Global_Spin_2011-08.pdf).

The ETF Side Show — Pay No Attention. Perhaps surprising to some, the above can be a good environment for global tactical ETF investors where huge macro volatility becomes the norm. And that is the point of launch against the many uninformed ETF catcalls as of late. While Rome burns, ETF critics are back at it again. Apparently, according to the Economist, the rapid growth in ETFs is now increasing systemic risks, with "echoes of the subprime housing crisis" (*see http://www.economist.com/node/18864254*). This is misleading and sloppy reporting from an otherwise fine publication. Comparisons to collateralized debt obligations fail to understand the ETF's basic structure. An ETF is simply a "wrapper" for a variety of different investments. In its original form (*i.e. non-synthetic*), the underlying securities are always held in trust. Importantly, ETFs are not credit-generating vehicles, as in the case of sub-prime debt. They certainly do not "lower lending standards", nor are they involved in "reducing borrowing costs".

For *ETFocus*, the growth in ETFs can be attributed to two positive trends. First, retail money is leaving the long-only, index-hugging mutual fund complex in droves. We applaud this. Why embrace mediocrity and pay alpha-like prices for beta-driven returns? Secondly, investors are finally ratcheting down return expectations for developed world stocks and bonds. That leads smart investors in the direction of multi-asset class investing (*what we call "structured eclecticism"*) ... tactically increasing exposures to emerging market assets, commodities, alternative income-producing securities, and other opportunity-type ETFs. Combined with a risk-sensitive investment process, these improved portfolios should produce higher returns with lower draw-downs.



Outlook — Oz-sterity and Beyond. Turning back to the real systemic risks in global financial markets, where to next? Undoubtedly, the main fault-line lies in Europe. Here, a common currency union and high debt combined with austerity measures is proving to be a noxious concoction. Despite Trichet's move to buy Spanish and Italian debt, policymakers are still struggling to placate markets. Just last week, France, Belgium, Italy, and Spain initiated a short-selling ban on specific financial stocks. One only needs to look back to the unsuccessful US precedent in 2008 to see how these short-term fixes worked out (*see the US financial sector ETF, NYSE:XLF*). For now, risks still remain tilted to the downside.

The other macro risk factor relates to fears of a renewed global slowdown. This is gaining traction with the US finally entering the world of austerity (*Obama finally agreed to cut government spending by USD 2.1 trillion over the next decade*). But, here, there is some good news. Economies do not always move in lockstep with asset prices. Rather, financial markets are forward-looking, quickly discounting the probable future. That means that a persistent slowdown can quickly revise collective expectations and present opportunities earlier than many anticipate. This is happening now as markets rapidly re-price for a slower growth forecast.

The critical question for investors is how much of this news is already baked into prices. Between July 22 and August 8, the S&P 500 ETF (*NYSE:IVV*) fell nearly 17% — one of the worst 11-day periods in stock market history. Other global equity markets fell up to 25% and US 10-year Treasuries have fallen to near 2%. And, with emerging market equity fund outflows amounting to USD 7.7 billion, in the week ending August 10th, investors are running for the hills.

Are we there yet? In other words, are risks now well-compensated given the macro outlook? Although we may be close, more downward re-pricing likely lies ahead. Expectations are still being revised down. Central bankers are aware of this and are responding. In a truly unprecedented move, the Bernanke Fed pledged to keep rates low until mid-2013, simultaneously planting its boot squarely in the face of retirees and other savers. This will only create more volatility, as investors are forced farther out onto the risk curve. And, it virtually guarantees, for both investors and policymakers, that those looking to post-war precedents for guidance will be disappointed.

As Doug Kass has recently pointed out, "behavioural economics" — understanding human psychology and actions — becomes much more important in this environment. Most humans have difficulty recognizing that the paradigm is changing. We are accustomed to shifts of the cyclical variety, not structural or regime changes like the ones occurring today. That creates huge opportunity as market participants read the signals wrong, overshooting on the upside and undershooting on the downside.

Looking ahead, investors should continue to remain defensive and only cautiously take well-compensated risks. Emphasize high-quality, dividend payers within equity allocations. Favour fixed income from countries least at risk of waking the world's roving bond vigilantes. Overweight industries, like gold mining and health care, not coupled to a slow-growth outlook. And, above all, don't mindlessly follow the words of disconnected prognosticators down the well-trodden yellow brick road. The road less travelled is likely to be more rewarding.

Endnotes:

[1] http://uk.reuters.com/article/2011/08/08/uk-ecb-bondbuys-trichet-idUKTRE7774HH20110808