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Investors Mutual Market Musings

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In Japan, sales of nappies for adult incontinence outstripped sales of infant nappies a few years ago. Japan's ageing population is well known, but in many other developed countries the nature of society and how the economy needs to operate will also have to adapt to accommodate the same inexorable demographic forces as populations age.

In the post war era most developed countries have instituted a variety of welfare programmes which have given people a measure of financial security in their old age and access to free or cheap healthcare, along with other institutions such as free or subsidised education. Over time the cost of such policies has risen quite dramatically as people are living longer, requiring pensions for a more extended period. Older people tend to have higher healthcare needs, both in terms of pharmaceuticals to combat or mitigate diseases associated with old age, and surgical procedures. The variety of procedures has also risen, including, for example, successful multiple knee and hip replacements, and cardio-vascular surgery, contributing to high healthcare costs and greater longevity and the associated increased other costs such as pensions and care facilities.

As the population ages there are fewer people of working age who are paying tax while the demands on the fiscal purse are rising, while there are more old people, who are living longer and enjoying the benefits of modern medicine. These demographic changes are occurring at a time when most government budgets are in poor shape, despite historically low interest rates. Low rates allow governments to borrow relatively cheaply to fund deficits; those deficits would be significantly greater at more normal interest servicing costs.

Since the demise of Lehman brothers in 2008 and the associated panic in financial markets and world trade as credit and liquidity dried up, central bankers have lowered the interest rates they can control to almost zero and have also supplemented that policy with the "extraordinary measures" known as quantitative easing (QE). One of the features of quantitative easing is the purchase of government bonds by central banks. This essentially amounts to an arm of the government buying the debt of the government, a privilege of lending to oneself and spending the money not accessible to the private sector. According to John Mauldin, central banks have expanded their balance sheets by over US$9 trillion under quantitative easing. This has permitted governments to run deficits that may be greater than other lenders - i.e. private or foreign bond buyers - would allow, although, as pointed out in my last Market Musings, QE does not appear to have lowered interest rates as central bankers presumably hoped would occur with such a large volume of bond purchases.

Were interest rates to freely float without central bank intervention, it is likely the level would be set in a tug of war between two opposing forces. On the one hand most economies remain weak as a result of the central bank nurtured credit bubble bursting, and demand for credit is therefore subdued. On the other hand creditors would demand a reasonable level of interest to compensate them for the risk of default amidst such fragile economic conditions and from such overleveraged debtors.

However, we live in a world where central bankers pretend that they have the knowledge and understanding to guide economies to growth without significant inflation. The global financial crisis (GFC) took us close to a global depression. It was not foreseen and arguably was fostered by central bankers in the major economies operating under the same paradigm

and belief system as those controlling monetary policy today. I believe the credit bubble and subsequent crisis was the result of overly lax monetary policy. Credit growth outstripped income growth or GDP growth for many years prior to the GFC. Furthermore, central bankers such as Alan Greenspan campaigned against regulating derivatives and endorsed abolishing regulations on commercial and investment banks. Without central bank influence on rates, such high demand for credit would have naturally led to higher interest rates, and with historic regulations, there would arguably have been fewer at risk banks which were "too big to fail".

A prominent former major Australian bank CEO, with high level international access, has expressed his concern to me that the US Fed seems to believe their job is not to identify or prevent bubbles but to clean up and mitigate the aftermath. William McChesney Martin, the longest serving head of the US Federal Reserve, directed monetary policy during the Fifties and Sixties, a time of strong economic growth. He said the job of a central banker is to take away the punch bowl before the party gets started. The current crop of officials seems to think the punchbowl needs to be kept full at all times until no one can drink another drop.

Under the current central bank paradigm the way to achieve economic growth is to expand credit availability serving to inflate asset prices including shares, real estate and commodities, potentially lifting confidence and encouraging spending by consumers and businesses who should be happy to take on further leverage because of the benign conditions and boundless opportunities which the rising asset prices might be signalling.

It surely cannot be lost on many people that the intention of the policy being pursued is to encourage society to take more of the poison that almost killed them. Leverage still remains high in most economies and it is hardly surprising that there is some reluctance by societies to take on more debt. Furthermore, as populations age, credit will naturally grow more slowly given that older people are generally not in a phase of their lives where they can sustain much debt.

Central bankers in the US and Europe seem to believe that pursuing policies that Japan has attempted for many years, without notable success, is defensible because the Japanese simply did not go "over the top" sufficiently. Japan's central bankers lowered interest rates and bought assets but apparently did not do so aggressively enough. Needless to say, in all cases we cannot know the counter-factual: what would have happened if the policies were not implemented?

Nevertheless, we do know what has happened.

In the developed world, growth has continuously disappointed and employment has remained very weak. The unemployment rate is flattered by a significant drop in participation and a shift to part time hiring. Company profit growth overall has been uninspiring and there has been little pick up in investment because demand remains subdued. In America, profits have lifted thanks to major cost cutting amid a notable lack of sales growth and areas of investment such as shale gas have been strong, but neither is linked to stimulatory monetary policy.

A boom has been created: Speculation. Commodity prices have been much stronger than one might expect given how weak growth has been. Share prices have risen strongly despite the low profit growth as valuations have expanded. Margin debt to buy shares is once again touching the highs associated with the technology bubble of 2000 and the phase of the credit bubble interrupted by the GFC in 2007/8. Investment banking and financial sector profits

have expanded significantly. Income and wealth inequality has risen, presumably as the rich benefit from rising share prices, and finance and legal sector bonuses. Extraordinarily, since the start of the current expansion in 2009, real median US household income has fallen 4.3%, showing how narrow the apparent restoration of prosperity has been.

Low rates have had some interesting consequences. Hedge funds have chased yield on risky instruments and in more risky places. Money flowed into emerging markets such as Turkey, India and Indonesia. When the Fed mentioned potential future "tapering" of their QE programme, not an end to it as a frank and more honest admission of its ineffectiveness and distorting characteristics, the currencies and stockmarkets of India and Indonesia, amongst others, plummeted as hot money headed for the exits. In an opinion piece (Australian Financial Review, 28/8/2013), Stephen Roach from Yale and formerly a renowned Morgan Stanley strategist, notes:

The Fed insists that it is blameless - the same absurd position that it took in the aftermath of the Great Crisis of 2008-9, when it maintained that its excessive monetary accommodation had nothing to do with the property and credit bubbles that nearly pushed the world into the abyss. It remains steeped in denial: were it not for the interest rate suppression that QE has imposed on developed countries since 2009, the search for yield would not have flooded emerging economies with short-term "hot" money.

Also being chased is the somewhat superior yield on offer from junk bonds, euphemistically classed as "speculative" by Standard and Poors. Almost half of all corporate bonds they rate are in this category, as corporate issuers take advantage of the appetite from willing buyers. Junk bonds characteristically carry higher yields because the risk of non-payment of interest and partial or complete loss of capital is material. Yields dipped below 5% in early May (Barclays US Corporate High Yield), a modest premium to the yields on investment grade debt or US government debt. High yield bond funds have been attracting record inflows as investors desperately search for yield and abandon the relative safety of investment grade bonds and the safety of cash.

As highlighted in the excellent Oscar winning documentary, The Inside Job, the Fed and its staffers have very close links to the Wall Street investment banks such as Goldman Sachs. The Fed embarked on QE despite open letters from numerous noted economists warning them not to as the liquidity crisis had abated. In May this year, Fed chairman Bernanke alluded to a modest lessening (not withdrawal) of their stimulus (the "taper"), and stock markets sold off modestly. Fed members rushed out speeches to calm markets that tapering was not imminent or definite; the punch bowl would continue to be full. No further comment is required.

A Marketwatch.com commentator, William Watts, highlights the prevailing belief that the Fed knows what it is doing and is unconcerned even if it is stoking an asset price bubble (31/10/13). He cites Steven Barrow, a strategist from Standard Bank in London, who thinks the risk of a "bloodbath" is worth taking:

To some, delay does no more than store up bigger problems for the future in terms of potential asset bubbles. But to ourselves, delay is appropriate. We don't disagree that liquidity that's primarily funnelled into assets, like stocks and housing, rather than the real economy, could create a bloodbath but, to a significant extent, policymakers have little option but to try to create asset-price-related wealth effects given that policy rates can't go any lower and fiscal policy is tapped out as well.

This perspective ignores the volume of academic research from respected economists to show that such wealth effects are immaterial and that QE has not worked to improve the economy or the labour market; it has only worked to lift the share market and some asset prices. Hoisington Investment Management has an excellent summary of the research in their latest outlook (http://www.hoisingtonmgt.com/pdf/HIM2013Q3NP.pdf).

In my opening remarks I noted the problems many countries face as increasing segments of the population are older and close to or in retirement. People who have worked hard for many years and saved so that they can live comfortably in their retirement now face the unhappy reality that the income that they can generate on their savings is very low, even when they take on more risk than they would normally wish to take as they cannot afford to lose much capital. In lowering interest rates and trying to produce inflation the Fed and other central banks are punishing people for prudence and rewarding profligate borrowers.

The history of money is largely the story of a battle between the interests of savers and borrowers, or between creditors and debtors. Maintaining the integrity, value and purchasing power of money is obviously in the interests of creditors. Debtors, on the other hand, love inflation, default and the debasement of money as it reduces the real value of their debts and justifies their decision to pull forward their spending decisions. Throughout history, over-indebted kings and emperors would clip coins or confiscate the savings of their people through a variety of means. The Telegraph (UK) notes that the French government has had to back down after sparking "fresh fury ... over a plan for a blanket retroactive 15.5 per cent tax on millions of French savings plans". With most societies and governments struggling under excessive debt burdens, politicians are currently reluctant to favour the interests of prudent savers.

As our societies age, politicians will be under increasing pressure to pay more attention to the needs of older people. Suppressing interest rates and blowing bubbles in asset prices which are likely to unwind in an ugly fashion is not in the interests of people looking at a long retirement. Maintaining the integrity and value of money might become a successful vote winning platform.

Predicting the future, especially in such an unusual time, is nearly impossible. Nevertheless, we believe as custodians of retirement savings that it is important that we remain fully aware of the macroeconomic risks at all times. It is crucial to ensure that everything we invest in has a sustainable value and dividend capability that we can ascertain. The share prices of the companies we hold should not be overly impacted when the current optimism is tempered by the reality of a slow growth world, with many companies struggling to grow their earnings and dividends.