MONETARY SCENARIOS

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Global Monetary Viewpoint

Author:
Dr Brendan Brown

EXECUTIVE SUMMARY:
The accompaniment of the powerful risk-on rally in global markets since early January, by a further jump in the price of gold (against all the main fiat monies), tells us that monetary inflation is the joint explanation of both phenomena.

Strengthening monetary inflation, at a time when official inflation indices are in general coming in below forecast and below target and when the official inflation outlook is easing, may seem paradoxical.

\\The camouflage of monetary inflation in goods markets by digitalization and labour market structural change (amongst other factors) explains the puzzle.

Gold is a safe haven against inflation even when camouflaged. It is also a canary warning of monetary inflation. However, long term interest rates are not a canary, though the 5-year/30-year spread may sing!

Gold-yen move signals monetary inflation: is it time to flee the currency carry trades?

Danger!

The price of gold continues to rise against the main fiat monies – the US dollar, Japanese yen and euro. Yet “risk is on”.!

That combination signals a worsening in the inflation climate – not as measured by present and near-term forecasts of official consumer price indices - but as expressed by indicators in asset markets (for example, the speculative heat, evident in carry trades whether based on premiums for exchange risk, illiquidity, or credit risk) and as found in investors’ state of mind (especially about the long-run).

Since the low-point in early January, junk bond prices have re-bounded: Anecdotal evidence suggests speculative heat. One example: Uzbekistan made a highly successful first issue in the international bond market. Carry trades in all their various forms have returned to boom and bustle, from the contractions, late in 2018. The gold price is above $1340 per ounce at mid-week, up from just around $1200 in mid-December.

Source: Bloomberg

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It is absolutely no surprise that the resurgence of “risk-on” means a weaker yen.

There is an in-built Pavlovian reaction to bad news for traders in that currency, and some reason behind it.

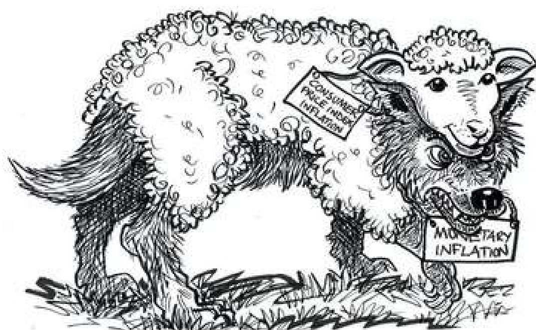
When risk is on, the desperation of Japanese investors for yield, given the massive financial and monetary repression in that country, fuels crowded trades into higher yielding foreign currency assets. And these depress the yen. Unlike the situation for Europe, swings towards risk-off do not raise a spectre of banking bankruptcy and monetary collapse (though Japanese specific risks, particularly related to highly leveraged bets on global Big Tech and China, should not be ignored); hence risk-off means usually a stronger yen at first.

The story of gold's relation to risk-on and risk-off episodes is more nuanced than for the Japanese yen.

If risk-on is driven by monetary inflation (and monetary inflation is a much broader concept than statistical studies of short-term movements in the official consumer price index) then gold would rise in price alongside a powerful price rally for risk-assets such as equity and high-risk credit paper.

Camouflaged inflation: gold as canary and haven

The present reality is that monetary inflation remains camouflaged in goods and services markets by a powerful downward rhythm of prices there reflecting such factors as digitalization, radical changes in the structure of the labour market, globalization. The gold market, though, is not fooled by that camouflage which indeed is the enabler of implicit inflation taxation in the form of suppressed interest rates (savers receiving well below the level of rates which would prevail under sound money including free markets in interest rates).



Long term interest rates, unlike gold, provide no shelter against the danger of camouflaged inflation. Central banks, in their pursuance of strategies to "provide stimulus and prevent financial market stress", are also likely to be manipulating down long-term interest rates.

(Even so, 30-year US Treasuries are less subject to possible manipulation than say 5-year; hence when inflation fears build and yet 5 year rates are stable or falling – reflecting an intensification of monetary inflation – the spread of 30-year yields over 5-year yields could widen significantly (as has happened since late October 2018, with that spread rising from a low of 15bp to 35bp now).

By contrast, if risk on is driven by growing optimism about the growth in the long-run of real economic prosperity (likely to mean higher real long-term interest rates) then the gold price would fall (together with the yen), whilst risk-assets (equities, especially), rise in price.

The story so far this year has been a rising threat of monetary inflation, never mind a downward drift in present and forecast official price inflation indices .

The Trump-Powell Fed has delivered its "put"; the ECB has responded by airing official leaks that a new long-term lending facility is on its way; speculation is rife about renewed monetary easing by the Bank of China (and gold is typically highly sensitive to Chinese monetary and market moves – suffering for example last summer when China stock and credit markets were falling and the dollar strong against the Chinese currency).

Japan PM Abe's central bank chief has been adamant that despite a present fall in asset purchases, the struggle to defeat "disinflationary forces" and achieve 2 per cent inflation is incessant and without remission. Governor Kuroda told the Diet twice this week (19/2 and 20/2) that any re-bound of the Japanese yen would require the Bank of Japan to consider new forms of monetary reflation to offset downward pressure on prices.

Carry trades boom under monetary inflation

In the search for symptoms of monetary inflation, a key area for examination are the so-called "carry trades".

These all take the form of investors (or traders) shifting from a low-yielding debt security (or deposit) into a higher yielding debt security based in part on a narrative that justifies expectations of net pick-up of income after taking expected adverse price moves into account. Under conditions of monetary inflation, which generates irrational forces symptomized by such catch-phrases as search for yield and positive feedback loops, the carry trades gain fantastically in popularity.

Here are some examples of such carry trades.

In the credit markets, the normal expectation is that the expected return (after factoring in chance of default) on high-risk credits is greater than on low-risk credits, in that capital market pricing ensures that there is some risk premium (deserved, according to the theory, because risk here is positive beta, meaning that returns are correlated to returns from the stock market portfolio).

Under conditions of income famine, as generated by monetary inflation, investors become prone to accepting popular narratives

(about which they would be sceptical in rational mode) which would seem to make net returns higher (from assuming credit risk). The momentum trade "kicks in", with desperate investors taking courage in their hunt for yield – in this case the carry trade – by initial speculative profits.

Examples of such narratives may include "emerging market risks have fallen in general as part of the process of those economies catching up with the advanced economies". (That narrative has been important in the carry trade boom with respect to emerging market credit and currency in the present cycle).

Or, the "skill of our central bankers and official institutions mean that the chances of another great recession and crash are now remote, so these bad way-out events should factor less than before into market pricing". (Such thinking can explain the popularity of various put writing strategies to enhance yield – and as corporate bond specialists know, risky bonds and their related equity are in principle tied together in pricing by an arbitrage thread which runs through the put options market – a subject for another day; bottom line low VIX reflects aggressive put-writing).

Currency carry trades – the concept and the distortions

Turning to the currency carry trades, the essence of these is to move out of low rate monies into high rate monies where the normal expectation would be a yield pick-up, adjusted for exchange rate changes.

For example, the normal expectation could be that interest rates in high savings economies are relatively low; yes, capital outflows should mean that rates tend to converge in the long-run (between the low and high savings economies) albeit with some differential persisting to reflect exchange rate expectations and exchange risk.

In particular, because domestic investors are risk averse, we can hypothesize that there will be some remaining risk premium on foreign currency returns versus the local high savings currency. That could be the opportunity for third party carry traders (defined as those in neither the country issuing the borrower currency or the country issuing the lender currency – for example a hedge fund in New York borrowing yen to buy Spanish mortgages).

Another normal story behind currency carry trades could be the higher returns to be expected on unpopular currencies, for example those subject to a significant risk of sudden depreciation. This is the basis of the so-called peso effect – stemming from the long period through the 1950s and 60s when the Mexican peso was fixed to the US dollar but with everyone realizing that a big devaluation was a risk at any time, albeit low, but reflect in higher interest rates in Mexico than the US.

Under conditions of monetary inflation, these "normal stories" and "normal expectations" become distorted.

Yield hungry Japanese investors, for example, put on their rose coloured spectacles in evaluating the plausible risk premium

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on foreign currency assets, which may indeed (if the spectacles were removed)have fallen below zero at now loft prices for foreign currencies versus the yen (especially taking account of long-run tendencies of a capital exporting currency such as the yen to appreciate as investment income revenues from abroad increase); and likewise, third party carry traders (shorting the yen to go into non-yen assets) may be basing estimates of returns on algorithms and momentum models which have applied in the recent past but have no link to fundamental reality.

When it comes to the peso currencies, the yield hungry investors may have become convinced that the devaluation event will not occur or that he or she can surely see the warning signs and get out first, when there is absolutely no rational basis for such a view.

The laboratory of history provides some examples.

Laboratory of history: examples of carry trade boom and bust

In the years 1925-8, the giant currency carry trade was to move out of ~~out of~~ dollars, pounds and Swiss francs, and into Reichsmarks; the speculative hypothesis was that the apparent German economic miracle (an illusion of asset inflation) meant that high interest rates in the Weimar Republic could persist and without any devaluation; the driver of excess optimism was the monetary inflation policy of the Federal Reserve (holding rates down so as to sustain stable wholesale prices at a time when rapid productivity growth and agricultural glut was putting downward pressure on these). Irrational exuberance in the US stock market and real estate market spilt over to the international bond and currency markets, as investors lulled by an environment of seemingly high returns become over-confident in their optimism and skills.

In the mid and late 1960s, under strong US monetary inflation (evident first in asset markets), the big carry trade was out of the Deutsche mark and Swiss franc into the US dollar and British pound. The gnomes of Zurich were in effect carry traders, moving out of the low or negative interest rate Swiss franc into Sterling or the dollar, convinced that neither would devalue; and their willingness to gamble in this, say for high returns, went along with a climate where booming stock markets and real estate markets from 1962 onwards had made investing success the new norm. The gnomes were only one part of a much bigger carry trade community. The Sterling devaluation of November 1967 followed by the Deutsche mark revaluation of 1969 led to a big unravelling of carry trades, though these did again emerge in force during the extended monetary inflation of 1970-3.

Fast forward to the great monetary inflations of 1993 to the present. The yen and the Swiss franc as the big savings surplus countries with the respective central banks perpetually fighting downward forces on prices became the focus (on the borrower side) of the most popular carry trades. And in the monetary inflation of 2003-7, the third party carry trade became highly

prominent (for example hedge funds as above). Popular loan currencies in the carry trade included emerging market currencies (for example Mexico in 1993-4, South East Asia in 1994-7, Eastern European currencies and the British pound in 2003-6.

The Crash of 2008 and its aftermath brought an implosion first of the yen carry trade and later of the Swiss franc carry trade, in part related to a big fall in asset markets, meaning lender of the yen or franc tried to call back their loans. On top, the momentum trades (people joining the carry trade to get on the bandwagon of what seemed a long running profits engine) unwound; these momentum engines are a familiar feature of asset inflations based on the strengthened irrational forces at work and positive feedback loops from capital gains to belief in dubious speculative hypotheses).

Both the Swiss National Bank and Bank of Japan responded to the unwind and the huge upward pressure on their currencies by in effect entering the carry trade themselves to relieve the previous carry traders of their position. And so both central banks have now huge carry trade positions themselves, matched by giant foreign exchange reserves.

The Swiss National Bank's reserves are now at over 100% of GDP, vs. under 10% in 2010; the Bank of Japan's at around 30% of GDP, vs. 8% in 2001. Alongside the Bank of Japan's position, we should consider the build up of foreign currency bonds in the Japanese public pension funds under the Abe Administration.

No doubt, the experience of the big losses on the Swiss franc and yen carry trades have curbed appetite for engaging in these same carry trades during the present monetary inflation cycle (compared to the previous cycle). On top, there is widespread awareness of the huge positions of the central banks in these and the acknowledgement that at some point there could be a forced unwind (perhaps under US pressure against the currency manipulators in Zurich and Tokyo).

Yes, in principle Japanese investors could be enthusiastic about the peso-type investment in foreign currencies at this point: higher yields than could be obtained domestically, subject to an eventual risk of sharp yen appreciation; and there has been some hot money ~~flowsespecially~~flows especially into emerging market currencies and commodity currencies, backed by their own speculative narratives.

Is there now a carry trade into the US dollar?

Does the yield hunting capital, flowing out of Japan and Europe (where rates went negative in 2015/16 and are still negative) and into the US dollar through recent years count as carry trade on the concepts as defined here?

The short answer is yes.

The US economy is widely seen as the dynamic frontier of the advanced economies – Big Tech, shale oil, de-regulation, and big tax cuts for big business. Business investment has showed some strength in important (patches) as above, albeit in aggregate

significantly weaker than what has been typical of previous long expansions.

By contrast, overall savings surpluses in the euro-zone and Japan have been bulging, in part explained by the perverse effects of negative rates (households have to save more to reach their pension accumulation targets) and in part related to a lack of robust speculative narratives such as have populated the US universe. So yes, a priori, risk-adjusted returns should be somewhat higher in dollars than in euros and yen, even taking account of expected dollar depreciation in the future. The desperation for yield accompanied by other irrational forces may have pushed the dollar to an expensive level in a long-run context.

Even so, the denouement of the carry trade into dollars is altogether less clear than for the earlier cited examples in the laboratory of history. Will monetary normalization ever occur in this cycle or next – and crucially before the euro implodes altogether? Are markets traditionally unable to confront extreme change, underestimating the potentially devastating downsides of PM Abe's radical monetary experimentation – the journey of Japan ultimately into hyperinflation (a topic for another day)? All of this makes verdicts on carry trade into the case of the dollar difficult.t

Investment strategy notes

Risk on, since early January this year, has become accompanied by monetary inflation on!. Gold is better placed in this situation than equities or credit. For if the risk-on gives way to risk-off, then gold could well well rise even further – reflecting lower interest rates, traditional safe haven demand, and ultimately the danger of greater monetary inflation in the future.

Big tech has made a big bounce back, during the risk on trade of recent weeks. But how fundamental is the accumulating bad news for this sector? And the speculative narratives are waning – whether the Messiah's journey to Eldorado, insatiable demand for luxury high-priced phones, or permanent monopoly for smart ads.

The Wall Street Journal editorial board and the big business tax-cutting conservatives will celebrate the looming "US-China trade deal" as the springboard to the second lap of US economic renaissance (with big supply side gains from lower corporate tax and de-regulation). According to them, if it had not been for the trade conflict, the US economy would still be booming. But it is not clear that the equity and wider capital and capital markets aree with the conservatives on this. Their cheer-leading could be followed by some seriously negative surprises.

There is a broad consensus in the media and marketplace that tariff wars are bad, and a US-China deal to prevent their intensification would be good news. But we should bear two doubts in mind. First the Trump tariff offensive was a strategy towards turning back Chinese economic warfare; if the offensive melts – and this is already occurring – it would not be good news for a "deal of the cronies" to allow aggression to continue.

Second, there are winners and losers from tariff war. We have heard a lot about the losers but not the gainers.

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