Weekly Market Summary

30th of June 2017

Tired of Central Bankers' Lies & Deceptions?!? Join the Club!
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Once again, I wish all our valuable clients & friends a very happy, peaceful and long Eid break!

Janet Yellen took office as Chair of the Board of Governors of the Federal Reserve System in February 2014 for a four-year term ending in January 2018. Graduating summa cum laude (“*with very great honor*”) from Pembroke College (Brown University) with a degree in economics in 1967, she went on to receive a Ph.D. in economics from Yale University in 1971 for a thesis titled “*Employment, Output and Capital Accumulation in an Open Economy: A Disequilibrium Approach”* under the supervision of James Tobin and Joseph Stiglitz. Yellen is married to George Akerlof, a Nobel prize-winning economist (seriously what is the probability of someone marrying a Nobel prize-winning chap?) and professor emeritus at the University of California, Berkeley. Their son, Robert Akerlof, teaches Economics at the University of Warwick in England!

However, the truth is that she is far from perfect: In a 2005 speech in San Francisco, Yellen argued against deflating the housing bubble because "*arguments against trying to deflate a bubble outweigh those in favour of it*" [Oops .. Wrong!] and predicted that the housing bubble "*could be large enough to feel like a good-sized bump in the road, but the economy would likely be able to absorb the shock*” [Oops.. Wrong Again!]. Still the best to come is reproduced below. From the New York Times - which captured a moment of a 2010 FCIC hearing – we get the following count:

Ms. Yellen told the Financial Crisis Inquiry Commission in 2010 that she and other San Francisco Fed officials pressed Washington for new guidance, sharing the problems they were seeing. But Ms. Yellen did not raise those concerns publicly, and she said that she had not explored the San Francisco Fed’s ability to act unilaterally, taking the view that it had to do what Washington said. “*For my own part*,” Ms. Yellen said, “*I did not see and did not appreciate what the risks were with securitization, the credit ratings agencies, the shadow banking system, the SIV’s — I didn’t see any of that coming until it happened ...I guess I thought that similar to the collapse of the stock market around the tech bubble, that most likely the economy could withstand* [the housing collapse] *and the Fed could move to support the economy the way it had after the tech bubble collapsed*”. Her startled interviewers noted that almost none of the officials who testified had offered a similar acknowledgment of an almost universal failure.

In that context, picture my astonishment (and the big accompanying smile ☺) when the Fed Chair showed up earlier this week proclaiming that another financial crisis in “*our lifetimes*” is highly unlikely (just as I was starting to pencil one around the corner, most likely around late 2017/early 2018!). Addressing an audience at the British Academy in London on global economic issues, Janet Yellen said on Tuesday that she believed banking regulators have made enough improvements to the financial system, watching more carefully for the type of systemic risks that struck the global economy in 2008. As such, the world is much safer now and will not experience another financial crisis anytime soon. “*Would I say there will never, ever be another financial crisis?*" Yellen asked. "*You know probably that would be going too far, but I do think we are much safer, and I hope that it will not be in our lifetimes and I don't believe it will be*."

Clearly earlier central bankers’ complacency was now shifting to outright delusion!!

In past week, the Institute of International Finance in Washington released figures showing that global debt has reached US$ 217 trillion (yes, 217,000,000,000,000!). That is 327% of world GDP, up from just 276% in 2007 – shortly before the western financial system collapsed – and 246% fifteen years ago. Claudio Borio from the Bank for International Settlements (BIS) – the body that serves as a bank for the central banks and fosters international monetary and financial cooperation – said nobody knows how long this can go on or what it will look like when the denouement arrives, but arrive it will. "*Financial booms can't go on indefinitely. They can fall under their own weight*”, he told The Telegraph earlier.

Both financial markets and policymakers appear to have quickly forgotten the risks that brought about the 2008 financial crash. The disconnect between the exuberance of stock market investors and bond investors who lend funds to nation states is surely a main destabilising factor. "*There is tension between stock markets, which have soared, and sovereign bond yields [the interest rate on the debt], which have not risen much as economic prospects have brightened. And, unfortunately, the unwelcome long-term developments we termed "the risky trinity" in last year's report are still with us: Unusually low productivity growth, unusually high debt, and unusually narrow room for policy manoeuvre*," Claudio Borio added.

Additionally, market volatility has all but vanished, ill-judged regulations have frozen out market-makers – leading to a frightening lack of liquidity - whilst margin debt on Wall Street has risen to record levels. In mature economies such as Canada and Sweden – which largely avoided the last bust but have since allowed huge borrowing and property booms - vulnerability to crashes has increased significantly. Credit too is so distorted that serial-defaulter Argentina has just launched a 100-year bond amid voracious demand. "*There is leverage all over the place and system is as lethal as ever. We haven't seen this much complacency since 1987*," said Marc Ostwald, a credit expert at ADM.

To my mind, these factors represent leading indicators of excessive market complacency and unjustified financial booms that - in a number of economies - look qualitatively similar to those that preceded the great financial crash of 2007/2008! And when US and European rates start rising from current depressed levels – and they will as soon as "magical" quantitative easing measures are withdrawn and central bankers start tightening benchmark yields - bankruptcy rates in highly-leveraged countries (mostly emerging countries – including China) will unquestionably shoot up. Add to that a maturing global cycle and a highly immature US President, and you have the perfect recipe for a fast approaching disaster☹.

Central bankers may pretend they are able to calibrate this delicate extraction, but this must been seen as a white lie and a necessary bluff to keep financial markets and traders reassured – at least for now! "*They have no idea how to unwind it*," says Professor Danny Blanchflower, a former UK MPC member (UK rate setter). After all, US Fed officials have admitted privately that QE was a foray into terra incognita (in other words a totally new experiment!) and undoing it is certainly fraught with hazard. Take for example the European central Bank President "Super" Mario Draghi (a former Goldman Sachs insider) who got a taste of just how difficult it will be to steer a course out of extraordinary stimulus without unsettling markets: His upbeat speech last Tuesday ("*deflationary forces have been replaced by reflationary ones*") - rightly interpreted by markets as a signal for an upcoming change in ECB monetary policy, specifically with regards to tapering/ending its bond purchases by late 2017 - sparked a rally in the euro and sharp jump in European bond yields, leading senior officials familiar with the central bank's strategy to attempt a damage limitation exercise and try to contain what they saw as an excessive market reaction (10-year German bund yields have almost doubled in the past 72 hours, jumping from 0.23% to 0.44%!), by signalling the following day that markets had "*misinterpreted*" Mr. Draghi's message (Seriously?!). That in turn triggered a fresh bout of volatility in FX and bond markets (Wednesday's large fluctuations in EUR/USD and European yields).

To conclude, the world economy has never been more sensitive to interest rate rises and addicted to low yields! So let us be very clear: It will now be much harder to exit current policies without producing a mini economic downturn or "God forbid" a major market meltdown. The Fed caused the dotcom bubble in the 1990s; it later caused the pre-Lehman subprime bubble. Whatever Ms. Yellen professes, central bankers across the globe have already baked another crisis into the pie! One can only pray that the next downturn won't be so severe, to a point that calls into question the political survival of capitalism.

Only time will tell! And believe me, it will happen during our lifetimes! So better brace for a bumpy summer and a more exciting second half for 2017.

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