Sovereign Risk and the "Macroprudential" Illusion

The scientific principle known as the Law of Conservation of Mass, discovered by Antoine Lavoisier in 1785, states that "matter is neither created nor destroyed." Julius Mayer extended the concept to energy in 1842 with the Second law of Thermo Dynamics. In 1904, Albert Einstein merged the two concepts with his elegant theorem "$E=mc^2$," which states that the total amount of mass and energy in the universe is constant.

If we cautiously extend the principles of the hard sciences to the world of finance and economics, we can posit that financial and market risk is neither created nor destroyed. Risk is always present; it seems to decline, from time to time, as it becomes hidden while moving to the weakest part of the financial system – or to "the dumbest guy in the room," to paraphrase the author Martin Mayer.

In 2008, the nexus of instability that had accumulated for decades was found in excessive leverage and securities fraud tied to real estate finance. Today, exposure to government debt is now increasingly seen as source of instability.[1] A director of one of the world's largest fund managers told Kroll Bond Rating Agency (KBRA) over lunch in New York: "the capital is in all of the wrong places."

Looking back at 2014, most financial professionals will remember the year as marking imposition of a number of new rules and regulations limiting private risk taking that are meant to keep the global financial system safe from the type of market breakdown seen in 2008. Capital requirements for banks have increased, liquidity rules have been promulgated, but all without any real focus on the twin causes of the 2008 crisis – namely securities fraud and inadequate disclosure of off balance-sheet leverage. Regulators have even coined the term "macroprudential" to describe a method of managing both markets and whole economies, as though top down management of democratic, free-market societies were actually possible.[2]

Seen from another perspective, 2014 was also the year in which public sector debt continued to increase. Governments from Washington to London and Tokyo steadfastly pretend that the accumulation of public and private debt, and related monetary expansion, is not a problem. At the same time, global regulators and their political sponsors in the major industrial nations steadfastly refuse to tackle the difficult problem of eliminating debt that is demonstrably uncollectible.

In nations such as Spain, for example, political pressure to address uncollectible debt has become so acute that the established political parties are at risk of being displaced by populist movements. Without restructuring and debt reduction, maintaining stable financial markets and achieving sustainable economic growth is likely to prove difficult or impossible.

The U.S. has seen more substantial restructuring than many other markets, in the form of bank failures and mortgage foreclosure and liquidation. But there is still an appreciable overhang of unresolved problem debt. In the U.S., for example, more than 12 million households still have mortgages that are underwater, with the debt in excess of the value of the house. Millions more households have too little equity in their homes to sell them. Rising home prices have helped to improve the household balance sheet. But as U.S. home prices start to level off and even fall in many parts of the nation, this "rising tide" can no longer be counted on to address the issue of excessive housing debt.[3] Additionally, many homeowners have received mortgage modifications which require them to make larger loan payments in the out years, putting renewed stress on the housing market.

[1] Satyajit Das, "'Coffin corner' threat to financial stability now ever present," *Financial Times*, October 30, 2014
[2] The term "macroprudential" was apparently coined by the International Monetary Fund and Bank for International Settlements in 2011, but is only vaguely defined. See "Key Aspects of Macroprudential Policy," International Monetary Fund, June 10, 2013.
[3] "U.S. Home Price Appreciation Continues to Slow," KBRA Macro-Market Research, October 1, 2014

KBRA believes that two important risk trends are emerging in the world of capital finance and investment.

- First, regulators in the industrial nations are busily trying to take risk out of the conventional banking system via higher capital requirements, limitations on explicit financial leverage and deterministic controls over entire markets and industry sectors – this even as the overall levels of public and private debt continue to grow faster than the underlying rate of economic growth.
- Second, these same central banks and government institutions are using radical expansion of the global supply of money to boost asset prices but also avoid a meaningful restructuring of both uncollectible public and private debt. With the notable exception of Germany, which is gradually paying down public debt and slowly restructuring private obligations, the other major industrial nations largely refuse to even consider large scale debt reduction.

Global central banks are keeping interest rates at or near zero and applying asset purchases fueled by monetary expansion to elevate asset prices and thereby increase capitalization rates to imply a higher present value for static future cash flows. The world is collectively disregarding an indisputable reality—"real" growth, either for individuals or collectively measure by GDP, is only generated by raising future cash flows. Unless asset valuations are supported by higher cash flows, "cap" rates eventually disintegrate under the pressure of rising real interest rates and higher risk premiums.

Macro Risk: Currency Wars

Coming out of the Great Depression of the 1930s, the post-WWII economic system was built upon the idea that government debt is the highest quality financial obligation available. The Basel bank capital accord and ratings structure applied to the debt issued by the OECD nations all depend upon the idea that official obligations of the major industrial nations have the lowest probability of default and are generally superior in credit terms to all private obligations. This assumption regarding the superior quality of official debt depends, at least implicitly, on the respective governments managing their fiscal and monetary affairs in a reasonable and responsible fashion that supports future private sector growth.

For the first time since the Bretton Woods Agreement, the monetary policies followed by the major industrial nations may be calling this key assumption into question. The Federal Open Market Committee (FOMC) in the U.S. has just completed a five-year experiment in debt monetization, buying all of the new issuance of the Treasury as well as the government sponsored housing enterprises, **Fannie Mae** and **Freddie Mac**. Justified in the name of fulfilling the **Federal Reserve Board's** (Fed) dual mandate to ensure job creation and price stability, "quantitative easing" or QE has provided enormous subsidies to public and private debtors, and increased equity valuations, while punishing new savers and traditional risk-averse creditors. Investors who owned Treasury debt in 2007 were rewarded by QE, but as low rates continue into the seventh year, individual and corporate investors are increasingly harmed.

It is the inability of QE to create new cash flows from the "real" economy that impairs the ability of monetary policy to assure job growth in the U.S. For example, at the start of QE, Fed officials talked about boosting housing as a major policy objective, but now housing is barely mentioned. One reason why overall economic growth in the industrial nations is so anemic is that the level of uncollectible debt remains too high. *The Credit Strategist* newsletter notes: "Three bouts of QE have failed to generate either sustainable economic growth or sustainable inflation expectations (inflation we have plenty of even if the official statistics don't measure it)." [4]

[4] "Growth Scare?" *The Credit Strategist*, November 1, 2014

QE has been largely unsuccessful in reviving solid economic growth, but the FOMC has facilitated a vast increase in the public debt of the U.S. Since 2009, the total debt of the U.S. has almost doubled to $18.8 trillion. Roughly $12.8 trillion of this total is held by the public (including the Fed), while the Fed's official holdings have grown to over $5 trillion as of the end of September 2014. The zero interest rate environment maintained by the FOMC has subsidized this expansion of the federal debt, setting up future generations for a shock when real interest rates move back into positive territory. Unless we are able to generate sufficient growth of future *private sector* revenues to offset the higher cost of maintaining the public debt as rates increase, the U.S. may soon face a fiscal crisis similar to the situation in Japan.

Japan, reacting to the end of Fed asset purchases and a slumping economy, has embarked upon yet another round of monetary ease via QE to devalue the yen. This is a similar gamble on higher asset prices leading to new investment and thus rising future cash flows. **The Bank of Japan's** (BOJ) latest asset purchase program includes not only government debt, but also the purchase of private assets such as REITs and ETFs (and is augmented by new policies that encourage Japanese institutions to increase their holdings of stock).

"Japan is substituting stocks for debt. Both are forms of long term claims. Japan had exhausted the use of the debt form. It had no choice but to try an alternate form," notes David Kotok, Chief Investment Officer of **Cumberland Advisers**. "Baskets of stocks, like the Nikkei 400 in Japan or S&P 500 in U.S., are constructed with weighting schemes that represent the entire economy. So a central acquisition reflects an alternate form of a long duration claim on the economy."

The BOJ may eventually start buying all manner of private financial assets in an effort to cheapen the Japanese currency and import inflation. Japan needs to push the yen down to at least 120 per dollar to generate the targeted 2% inflation, but currency wars are a zero sum game. If Japan cheapens the yen, then the dollar gets stronger and the U.S. imports deflation from Japan, China, Europe and elsewhere.

"When nations are at the zero boundary of interest rates, central banks can still produce monetary ease by cheapening the currency," notes author and financial analyst James Rickards. He argues that the concept now driving BOJ policy goes back to beggar-thy-neighbor policies of the 1920s and 1930s, but it gained intellectual rigor from two papers (2000 and 2002) by Lars Svensson who was a Professor of Economics at Princeton University and colleague of former Fed Chairman Ben Bernanke at the time.[5]

The EU, following the example set by Fed in the U.S., has resorted to its own version of quantitative easing rather than reduce debt in some of the weakest members of the European federation. Despite evidence of decelerating growth and outright deflation in many EU states, the leaders of the **European Central Bank** and the EU member nations are slow to take action to restructure bad debts and reduce overall debt loads.[6] Some observers hold out hope that a QE-type approach can help to boost growth in the EU nations, but with interest rates at or below zero in many EU states, there seems to be little that can be achieved through monetary action.

Economist Nouriel Roubini notes that while emerging economies are growing and showing relatively responsible fiscal policies, "Private and public debts in advanced economies are still high and rising – and are potentially unsustainable, especially in the eurozone and Japan." [7] But even as risk builds in the public sector, in the near term we believe that the greater immediate threat may come from the growing accumulation of risk and leverage among some of the largest Buy Side investment institutions.

[5] Lars E.O. Svensson, "The Zero Bound in an Open Economy: A Foolproof Way of Escaping from a Liquidity Trap," NBER Working Paper No. 7957, October 2000
[6] "As bad loans pile up, Greece eyes relief for struggling mortgage holders," *Associated Press*, November 3, 2014
[7] Nouriel Roubini, "The Single-Engine Global Economy," *Project Syndicate*, October 31, 2014.

KBRA believes that the fiscal situations in the EU and Japan may not be a problem tomorrow, next week or even next year, but the steady increase in government debt suggests that growth will remain extremely low in the EU and Japan for years to come unless policies shift to assure "real" growth. The *Economist* opines that growing public debt is important for two reasons:

> "First, when debt rises faster than economic output (as it has been doing in recent years), higher government debt implies more state interference in the economy and higher taxes in the future. Second, debt must be rolled over at regular intervals. This creates a recurring popularity test for individual governments, rather as reality TV show contestants face a public phone vote every week. Fail that vote, as various euro-zone governments have done, and the country (and its neighbours) can be plunged into crisis."

We believe that the fact that governments in all of the industrial nations are seeking to restrain risk in the private sector, at least superficially, while pursuing explicitly inflationary policies and the accumulation of debt in the public sector, presents investors with a troubling situation and few clear choices when it comes to asset allocation. In short, unless there is a 1) a slowdown in public debt accumulation and 2) a shift to sustainable policies that promote private sector growth in advanced economies, policies of monetary expansion will inevitably fail as fluctuating rates collide with artificially enhanced asset prices and unsustainable debt loads to generate future crises.

Conclusion

It may still be too early to conclude that the low interest rates and QE pursued by the Fed and other central banks will be ineffective in stimulating increased demand in the major industrial nations, but so far the greatest result seems to be a steady increase in asset prices, public debt, and moral hazard. The progression of the credit cycle featuring rising asset values suggests that the loosening of investment standards may have already reached a point where the Fed and other central banks need to reconsider their monetary policies in order to prevent a new round of financial crises and market instability. We believe that investors need to be aware of the implicit correlation between expansionary monetary policy and rising debt levels that leads to financial market contagion, especially when it comes to sovereign risk, and structure their allocation strategies accordingly.

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