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Monetary pain points

Socialists eventually run out of other people's money, as Margaret Thatcher observed, but central bankers print their own. Now in progress is a speculation on the consequences of the central bankers' ideas. Skipping down to the bottom line, we judge that the lingering effects of ZIRP and QE threaten the junk-bond market, while the push for still more radical intervention poses a risk to the dollar.

In November, the Federal Reserve announced a grand review of its so-called monetary-policy framework (the stock-market break upstaged the news). To advance that agenda, the system's regional bank presidents are wandering around the country on a folksy kind of listening—really, speaking—tour. A wampum-themed monetary powwow is slated for June 4–5 in Chicago.

By the sound of things, the new policy framework will resemble the old one in basic ways. Already decided, for instance, is that a 2% rate of inflation will stand as the Orwellian definition of "price stability."

But there are ample signs that the central bank is addressing the deficiencies of current operating methods by devising even more aggressive methods. In a March 8 speech at the Stanford Institute of Economic Policy Research, Chairman Jerome Powell listed three questions with which the policymakers are grappling:

1. Can the Federal Reserve best meet its statutory objectives with its existing monetary policy strategy, or should it consider strategies that aim to reverse past misses of the inflation objective?

2. Are the existing monetary policy tools adequate to achieve and maintain maximum employment and price stability, or should the toolkit be expanded?

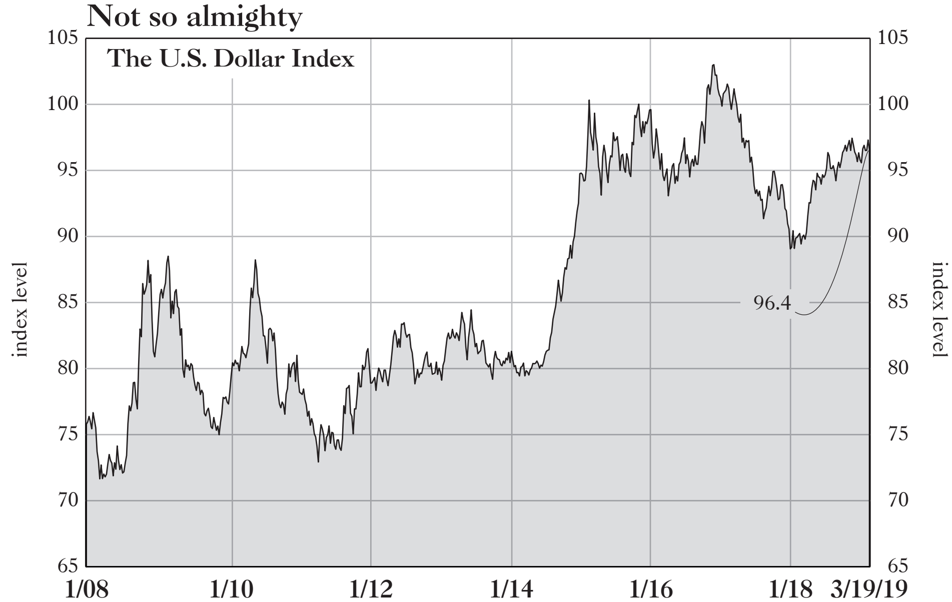
3. How can the [Federal Open Market Committee]'s communication of its policy framework and implementation be improved?

"In simple terms," observes colleague Evan Lorenz, "the Fed is frustrated that even with a 3.8% unemployment rate, the lowest level in 50 years, the year-over-year change in the price index for personal-consumption expenditures is below its self-imposed 2% bogey. In the three years through December, the PCE index has compounded by an average of 1.8%. So, for the want of two-tenths of a percent more inflation, the Fed is rethinking how to hot up the economy."

One idea is to target a multi-year average inflation rate, compensating for years of subpar inflation with years of superabundant inflation. So, for instance, the Fed might target a 2.2% rise in the PCE index over the next three years to make up for the inflation the U.S. economy failed to enjoy over the past three years. (For the record, since the Fed's birth year of 1913, the CPI has compounded at a 3.1% rate.)

Former Chairman Ben Bernanke recently took time off from his capital-introduction work at Citadel to write a paper with a pair of Federal Reserve staff Ph.D.s. Like texting tweens, the authors abbreviate lower-for-longer as "L4L" and effective lower bound as "ELB": "[F]ully credible L4L policies could substantially ameliorate the ELB prob-

Not so almighty



source: The Bloomberg

lem. In particular, during ELB episodes, such policies should lead to lower bond yields and higher expectations of inflation—both of which reduce long-term real interest rates—as well as to greater optimism about future growth, all of which should encourage spending and economic activity at the ELB."

Even more radical policies are in the wind. Fed Vice Chairman Richard Clarida has proposed taking a page out of the Fed's earlier history of financial repression. When push next comes to shove, he suggests, the FOMC could fix, or "peg," bond yields, as it did in the bad old days of the 1940s—and as the Bank of Japan does today. As for Japan, a knowledgeable friend advises Lorenz, "In the Asian time zone, when we are asleep, a U.S. Treasury is the preferred collateral over JGBs [Japanese government bonds]," an anomaly explained in part by the BoJ's destruction of anything resembling two-way trading in those negligibly-yielding securities.

Negative nominal interest rates appear to be getting a more respectful hearing at monetary headquarters. In June 2016, then Chair Janet Yellen said that she was in no hurry to impose subzero rates, with their "significant shortcomings," though the Fed had the legal authority to do so.

But the passing years have softened institutional resistance to experimental measures—indeed, there's nothing so novel anymore about the kind of rates that redirect the customary flow of payment from borrower to lender. "How Much Could Negative Rates Have Helped the Recovery?" asks economist Vasco Cúrdia in a recent publication of the Federal Reserve Bank of San Francisco, and he answers his own question, that it might have helped a lot. Following his public remarks on March 6, New York Fed President John Williams said that the FOMC will consider a negative intervention rate when the next recession rolls around.

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In 2010, the first year of recovery from the Great Recession, the default rate on high-yield bonds plunged to 3% from 12.1% in 2009. "We actually had the situation where the default rate went from a record level to below average the very next year," Marty Fridson, chief investment officer of Lehmann Livian Fridson Advisors LLC, told the crowd at our Spring 2014 Conference (*Grant's*, April 18, 2014). "I would submit that is physically impossible. But, it did actually happen and I think that the only conceivable explanation is the Fed's extraordinary intervention." That and, perhaps, the stock market's explosive reaction to the intervention.

Could the Fed repeat this feat of monetary statesmanship in the next business-cycle downturn? Let us see about that.

The post-crisis yield famine lowered the bar in corporate credit quality such that the speculative-grade wing of the market is junkier today than it was in the run-up to 2008. The percentage of speculative-grade issuers in the lowest rating category—Caa to C on the Moody's scale—is perhaps the best indicator of the vulnerability of the junk market to default, Fridson observes. On Jan. 1, 2007, one year before the start of the Great Recession, that percentage was 19.7%. When the recession began, on Jan. 1, 2008, it was 28.8%.

"As of the most recently reported date by Moody's, Jan. 1, 2018, that figure stood at a staggering 43.6%," Fridson advises Lorenz. "Assuming that NBER [National Bureau of Economic Research] will not retroactively declare that the United States was already in recession on Jan. 1, 2018, the Caa-C percentage is likely to be even higher than 43.6% by the time the next recession starts.

"But let's not even consider the further increase in the Caa-C component that's likely to occur by the time the next recession commences," Fridson goes on. "Let's weigh the Ba, B and Caa-C rating-specific default rates observed in the comparatively mild 2001 recession by the percentages that each rating category represented as a part of the speculative-grade universe on Jan. 1, 2018. The predicted one-year default rate from this calculation is 15.63%. That compares with a 12.1% peak calendar-year default rate in 2009."

That the rating agencies are becoming ever more lenient is an evergreen complaint in the bond market, though that does not mean it's never correct. According to CreditSights, gross leverage on single-A-rated corporate bonds jumped to 2.3 times earnings before interest, taxes, depreciation and amortization in 2018 from 1.5 times in 2007, while, over the same span, gross leverage on triple-B-rated issuers rose to 2.5 times from 2.2 times.

"A blow-up in high-yield defaults would cause special problems for such ETFs as the Invesco Senior Loan ETF (BKLN) and the iShares iBoxx High Yield Corporate Bond ETF (HYG; both on the NYSE Arca)," Lorenz points out. "As the names imply, the BKLN and HYG hold sub-investment-grade-rated loans and bonds, respectively. Loans and bonds are notoriously illiquid—they trade by appointment—whereas the sponsors of BKLN and HYG promise their investors daily liquidity. In addition to any losses from a higher default rate, BKLN and HYG may suffer dislocations due to a liquidity mismatch."

In the Dec. 14, 2018 issue, *Grant's* laid out an option strategy to profit by an accident in high-yield: the $22 strike Jan. 15, 2021 puts on BKLN (vs. a current price of $22.68), which now cost $2.25, and the $80 strike Jan. 17, 2020 puts on HYG ($85.80), which are priced at $1.76.

Still and all, it's complacency that rules today. The latest monthly soundings of professional investor sentiment by Bank of America Merrill Lynch show that the sum of the fears of corporate-bond buyers sits at a five-year low. "The most notable change in our fresh survey of U.S. credit investors is that most concerns have declined notably from December and January," BofA concludes.

Perhaps the bulls expect another miracle from the Federal Reserve. Edward Altman, professor of finance, emeritus, at New York University's Stern School of Business, tells Lorenz that he wouldn't count on it. Yes, the Fed may, indeed, pull out the stops in the next slump, says Altman, but there are not a lot of basis points of borrowing cost to cut. Besides, many an encumbered zombie company will prove unsalvageable, even with the proffered help of the fourth round of QE. "No amount of help from the Fed in terms of pumping liquidity will stop those firms from defaulting," Altman says. "People are simply not going to throw even low-cost money at these firms when they've been hanging on by their fingernails for a while and they fall down due to the weight of the economy. . . . I don't think the Fed will be as successful in the next round as they were in 2009."

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Still and all, the Bank of Powell enjoys more latitude for action than most other major central banks do. Federal Reserve assets represent 19% of U.S. GDP. For comparison, the assets of the European Central Bank represent 41% of the eurozone's GDP. Assets of the Bank of Japan and the Swiss National Bank represent 101% and 119% of their respective GDPs. The Fed targets a Fed funds rate of 2.25% to 2.5%, while the ECB, BOJ and SNB each target rates of less than zero.

Fiscal policy is another story, however. The International Monetary Fund projects that the U.S. budget deficit will reach 5% of GDP in 2019 compared with a surplus of 1.5% for Germany and a deficit of 2.8% for Japan. Over the past half-century, the typical recession raised the U.S. budget deficit by around 4% of GDP (*Grant's*, May 18, 2018). If past is prologue, then, even a humdrum downturn could push America's budgetary shortfall to $1.8 trillion, taking out the previous record deficit of $1.4 trillion set in fiscal year 2009.

"What are the implications of this setup?" Scott Bessent, the CEO and chief investment officer for Key Square Capital Management, asks in his second-quarter 2018 letter to limited partners. "When the recession hits, the Fed will shoulder much of the burden for stimulating the U.S. As one former FOMC board member explained to us, 'the Fed has hiked quietly and should cut loudly in the next downturn.' Unconventional tools such as asset purchases and yield curve targeting will also likely be employed. This will cause a plunge in U.S. interest rates to European and Japanese levels. While this will be positive for the U.S., it will likely create problems for Europe and Japan as the dollar plummets and foreign export industries shoulder the brunt of the adjustment. This will likely herald a return of the currency wars, and force Europe and Japan to think very creatively about new fiscal and monetary policy approaches."

To judge from its history, the Fed needs little reminder to cut loudly. "Going back to 1999, which covers the last three hiking cycles," Jon Hill and Ben Jeffery write in a March 8 BMO Capital Markets report, "the Fed has shown a clear preference for raising rates in 25 basis points increments, going with that option in 31 of 32 instances. However, when it comes to cutting rates, the FOMC has actually moved more frequently in 50 basis points increments than 25 basis points (and even was willing to move -75 basis points a few times in 2008)."

When the Fed is in the international policy-easing vanguard, the U.S. dollar has tended to fall hard. Recall that the first round of QE began in December 2008. The U.S. Dollar Index declined by 18.1% between March 5, 2009 and April 29, 2011. QE2 started in November 2010. The index declined by 17.5% between June 7, 2010 and April 29, 2011. Since mid-2014, the index has hovered around 95 vs. a prior level of around 80. During the past five or so years, the Bank of Japan, the ECB and other central banks have taken lead positions along the frontier of radical intervention.

On Feb. 19, governor Haruhiko Kuroda told the Japanese Diet that he would consider more monetary easing if the yen rallied. It was a comment to mark. Rarely has the BoJ chosen publicly to couple monetary policy with the exchange rate.

According to a Bloomberg survey last week, 37% of economists polled now expect the Bank of Japan to ease policy further, up from 18% as recently as January. While business activity is indeed slowing (last week the Finance Ministry's manufacturer survey found current business conditions to be at their weakest level since the second quarter of 2016), that fact would not seem to be the primary reason for the reversal in monetary-policy expectations. "The BoJ can't ignore clear dovish turns by the Federal Reserve and the European Central Bank," Hiroaki Muto, chief economist at Tokai Tokyo Research Center, tells Bloomberg.

"We posit that when the greenback begins its descent in the next few months or quarters, the decline will be deep with a rapid onset and a multi-year downward trajectory," Bessent wrote last year. "At present, our favorite expression of a weakening dollar is to own gold—we believe the bullion is potentially in the midst of both supply and demand shocks."

Bessent said it so we don't have to say it—again.

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