KPF GLOBAL INVESTMENT STRATEGIES LLC

# Quarterly Market Outlook & Strategy Letter

Second Quarter of 2016

***July 2016***

KPF GLOBAL INVESTMENT STRATEGIES LLC

**Executive Summary**

- The past few months have witnessed a mild but broad-based upswing in economic activity, helped by rising retail sales boosted by lower oil prices. Markets have largely discounted the recovery, aware of the many structural impediments to long-term growth. Still, it's given investors a reprieve from worries about the future.

- For many years, a rising tide of central bank liquidity lifted all Wall Street boats, despite a sluggish Main Street economy. That era is coming to an end, as corporate dividend cuts and delinquencies surge despite financing costs that are at historic lows. Monetary policy is no longer seen as effective in addressing long-term challenges, bringing heightened uncertainty and volatility to markets.

- High debt levels have curbed consumption growth, as aging households tighten their belts to pay down obligations in preparation for retirement. Unfortunately, the resulting slowdown in growth has reduced the economy's ability to service its debts—creating a vicious circle of slower growth and rising debt.

- There are three avenues through which unsustainable debt burdens are reduced: *deleveraging*, *default* and *monetization*. Household deleveraging has been ongoing since 2010, but has been more than offset by increased borrowing by corporations and the government. Default rates are nevertheless rising in both the public and private sectors, leading to an intensification of deflationary pressures, especially in Japan and Europe.

- The end-game of all unsustainable debt scenarios is *monetization,* a.k.a. "helicopter money" in which central banks issue currency to purchase government obligations that are never repaid. We believe that Japan will be the helicopter money pioneer, putting an end to the 30-year rally in the Japanese government bond (JGB) market. Monetization will also promote a weaker yen and stronger Japanese equity markets. Although it is unlikely that other central banks will quickly follow suit, such a step by the Bank of Japan could disrupt global bond markets, which are heavily leveraged and greatly overvalued.

- We have added currency-hedged exposure to the Japanese stock market to our clients' portfolios, and are rebalancing all fixed income exposures back to target weights. We maintain an underweight posture in US and European equity, tilting our international porfolios toward the emerging markets, with a focus on opportunities in Asia.

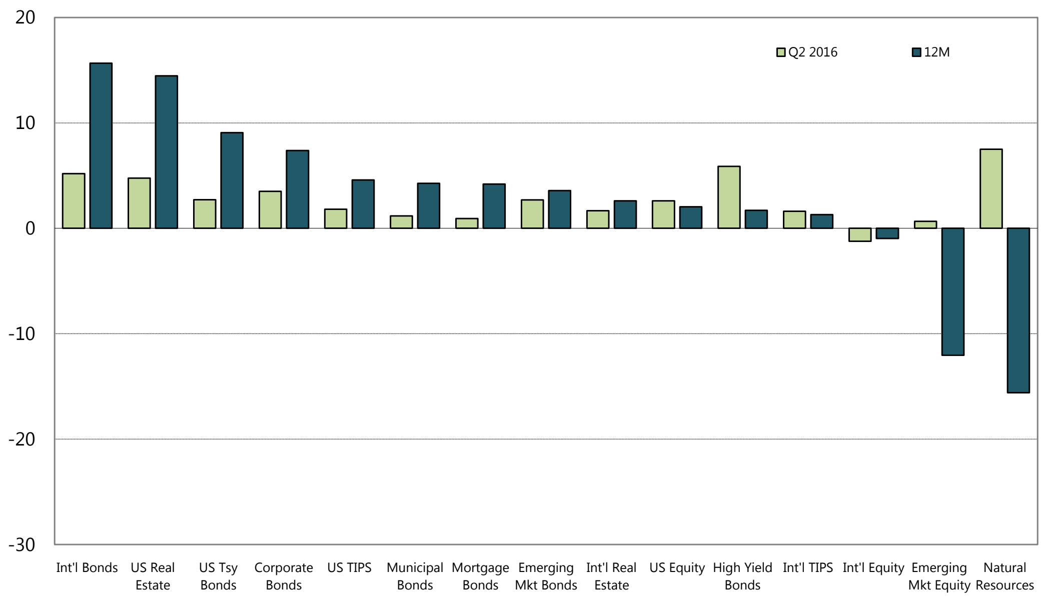
## Introduction

*"There is no use trying," said Alice. "One can't believe impossible things." "I daresay you haven't had much practice," said the Queen. "When I was your age, I always did it for half an hour a day. Why, sometimes I've believed as many as six impossible things before breakfast."*

*Lewis Carroll, Alice in Wonderland*

Financial markets followed a very different script in the second quarter of 2016 than the pattern of recent years. For quite some time, "bad news is good news" was the motto of professional investors, who welcomed easy monetary policy in response to any sign of economic softness. Lately, market volatility and other signs of financial stress have increased, even as economic fundamentals have shown tentative signs of improvement. Investor anxiety has been evident in the sharp drop in global bond yields and flattening of the yield curve, surge in gold prices, and sizable outflows from equity funds into bonds. Indeed, the best performing asset classes last quarter were bonds of all kinds, as well as commodities—especially gold (Figure 1).

Figure 1. Benchmark Asset Class Returns

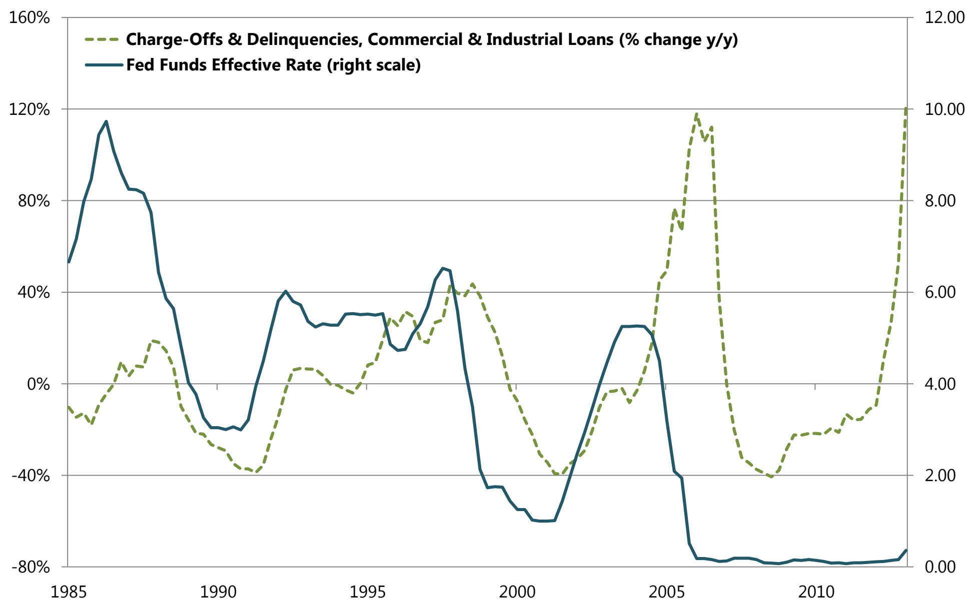



Source: Bloomberg

For many years now, a rising tide of central bank liquidity (engineered through interest rate cuts and purchases of government and private securities) lifted all Wall Street boats. This happened despite a sluggish Main Street economy. Indeed, as we have noted previously, well-intentioned monetary policies have damaged the "real" economy and promoted wide disparities in wealth.

That era is coming to an end, as investors are paying greater attention to the long-term headwinds facing the global economy. Fundamental challenges such as declining productivity growth, deteriorating corporate profitability, aging demographics, under-funded entitlement programs, and excess debt cannot be remedied by monetary policy. Not only are interest rates about as low as they can go, leaving policymakers with fewer tools to combat the next downturn, the negative consequences of "unconventional" policies are now becoming widely apparent.[1] It is striking that corporate delinquencies and dividend cuts are surging, even as the cost of financing has fallen to historic lows (Figures 2-3).

**Figure 2. United States: Loan Charge-Offs & Delinquencies Surge Despite Low Interest Rates**




*Source: St. Louis Fed, FRED Database*

But first, the good news: the upswing in economic activity has been mild but geographically broad-based, helped significantly by stronger retail sales in many countries. Better sales trends are the long-awaited consequence of the 2014-2015 decline in oil prices. Additional stimulus measures from China have boosted global capex spending. Finally, low interest rates have supported housing activity in the United States and elsewhere. Together, these trends have stimulated a manufacturing rebound in Asia. Higher commodity prices have also lent support to resource-producing companies and countries, although financing pressures remain intense.

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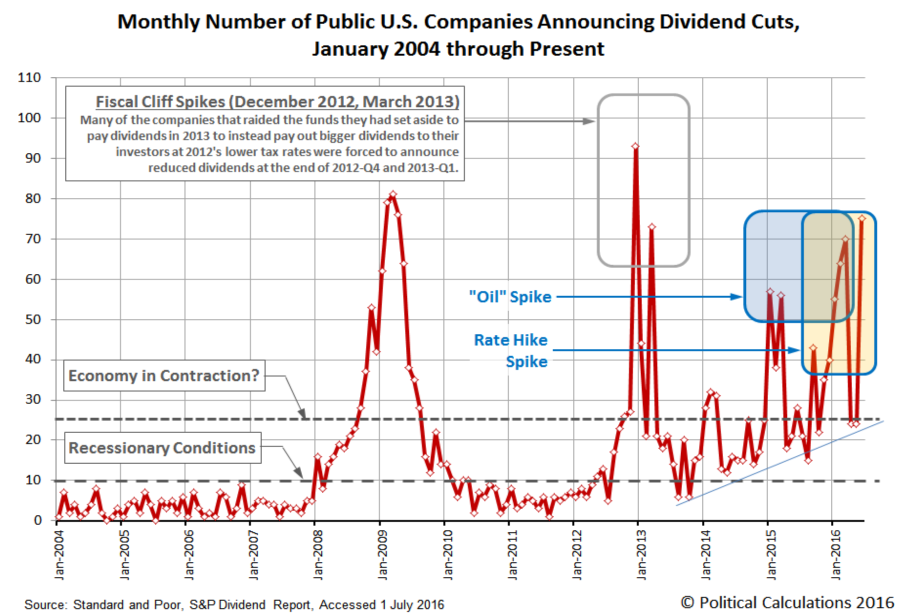
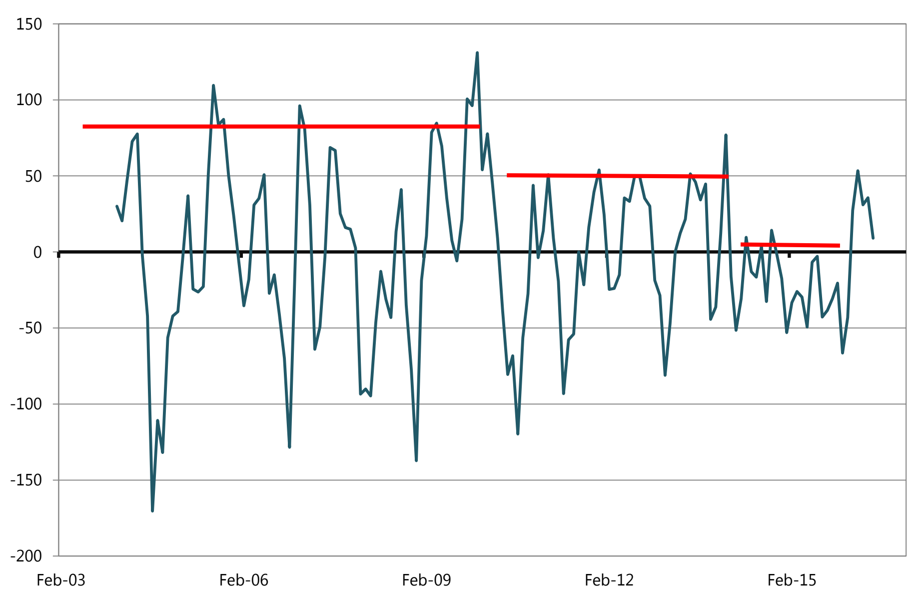
[1] See, for example, see Lisa Emsbo-Mattingly and Jacob Weinstein of Fidelity Investments: Potential Pitfalls of Negative Policy Rates May, 2016.

**Figure 3**




Thus, although the *structural* challenges we have been describing for some time are now obvious to everyone, *cyclical* activity has nevertheless improved. Given the progressive lowering of expectations over the past decade, the recent upturn in activity registers as a genuine surprise to investors (Figure 4). The Fed will undoubtedly try to rekindle expectations of further rate hikes, yet we (and the market) doubt there will be meaningful tightening in 2016. That is why the impact of Brexit on stocks has been mild—even as it boosted bond markets quite dramatically.

**Figure 4. United States: Citigroup Economic Surprise Index (change from one year ago)**

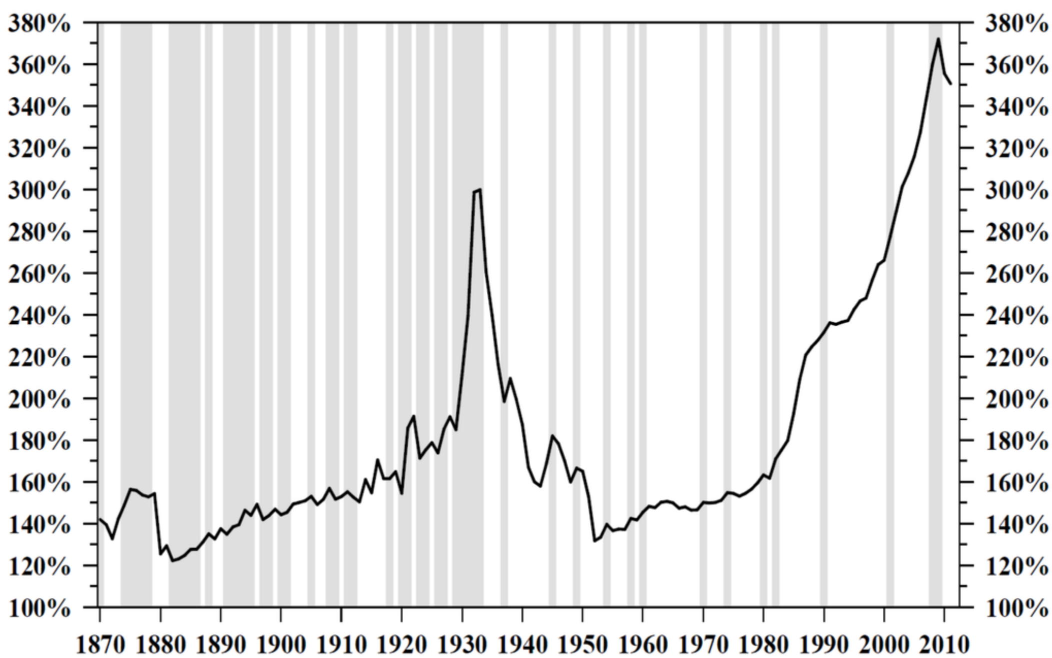


Investors have largely discounted the recent cyclical rebound because: (a) oil prices have again risen; (b) Chinese stimulus looks unsustainable given the country's massive debt burden; and (c) the benefits of low interest rates are diminishing. Additionally, the ongoing deterioration in corporate profitability poses risks to capital markets, investment spending and, eventually, employment growth. Despite stronger retail sales, business inventories remain extremely high, which will curb pricing power and create ongoing pressure on earnings.

The long-term problem, as we outlined last quarter, is that US households are heavily in debt and do not have the wherewithal to meaningfully increase their spending. The retirement savings deficit has grown so large that families have no choice but to marshall their resources in preparation for the future. And it's not just households that are in over their heads—corporate debt has risen substantially since 2007, while government debt has nearly doubled. Hoisington Investment Management has compiled total US debt figures going back to the 1870s, which illustrate just how dramatic the 3-decade increase in leverage has been (Figure 5).

Quite simply, it is not sustainable.

**Figure 5. U.S. Total Credit Market Debt as a % of GDP**




*Source: Hoisington Investment Management, Quarterly Review & Outlook, Q2, 2011. Drawn from data published by the Bureau of Economic Analysis, Federal Reserve & Census Bureau: Historical Statistics of the United States: Colonial Times to 1970.*

A rapidly rising debt-to-GDP ratio means that an economy's obligations are growing faster than its ability to service them, posing a high risk of future default. Unlike the 1930s, the US debt ratio skyrocketed even while the economy registered decent growth. Keep in mind that these figures *do not* include the unfunded liabilities of the Social Security and Medicare systems, which represent an additional $59 trillion, or 300% of US GDP.

There are three avenues—not mutually exclusive, and none attractive—through which unsustainable debt burdens are reduced: *deleveraging*, *default,* and *monetization*.

***Deleveraging*** is the course households have been pursuing since 2010, and involves a slow process of belt-tightening, as families boost savings in order to pay down debt. When this occurs at the national level, deleveraging can be counterproductive: weaker consumer demand creates a drag on growth, producing a slowly-expanding (or even shrinking) denominator for the debt-to-GDP ratio. However, since 2010 the government and corporate sectors have substantially *increased* their borrowing, cushioning the impact of household deleveraging on the economy—and postponing the day of reckoning.

***Default*** is the repudiation of obligations by borrowers who are unable or unwilling to service their debts. Already, default rates are rising in the private and public sectors. As noted above, more and more companies are cutting their dividends (usually a last resort when there are cash-flow problems), while corporate delinquencies and charge-offs are increasing. The high-yield default rate has doubled since 2014 and is on track to reach 6% before year end. Sub-prime auto loan defaults are rising, and the student loan default rate is already at 27% for those with payments due. Default rates in the municipal sector, which historically have been very low, are creeping upward. First there was Stockton California in 2012, then Detroit Michigan in 2013, and Puerto Rico in 2016. Now the city of Chicago, having been downgraded to "junk" by Moody's ratings service, is not far behind.

The combination of deleveraging and default creates pressures on growth that can lead to ***Deflation****,* which is a generalized and persistent decline in the price level. As we are early in the deleveraging process, the US economy has not yet fallen into a deflationary spiral. On the contrary, in many sectors of the economy, inflation is rising. However, policymakers are keenly aware of the risk of deflation stemming from slow growth and excess indebtedness, which is why they have kept interest rates so low. Unfortunately, these policies have encouraged more borrowing, exacerbating the problem. Moreover, low interest rates are eroding the profitability of commercial banks—as is evident from the sharp decline in their stock prices. Deflationary trends—which are well underway in Japan and Europe—will become more pronounced in the U.S. as deleveraging continues.

Which brings us to ***Monetization***—the end-game of all unsustainable debt scenarios. Governments rarely default on debts denominated in their own currency, since they can simply print more money to meet their obligations. What this means, in practical terms, is that a country's central bank issues currency in order to purchase government obligations that will never be repaid. The government could direct the funds to existing programs, including infrastructure, or make direct transfers to households (some have suggested non-transferable, time-limited spending vouchers). In Ben Bernanke's terminology, this is a money-financed fiscal program (MFFP), as distinct from conventional debt-financed stimulus.[2] More commonly, it is known as "helicopter money," after Milton Friedman's famous 1969 thought experiment.

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Central bank autonomy is supposed to prevent monetary authorities from becoming captive to governments, but experience suggests that autonomy is honored mainly in the breach. As Chicago economist Tom Sargent explained in a classic 1981 paper, once a country's debt burden reaches an unsustainable level, the credibility of monetary policy is inevitably lost.[3]

[2] For an explanation of how MFFP differs from open market operations and quantitative easing, see Ben Bernanke, [What Tools Does the Fed Have Left? Part 3: Helicopter Money. Brookings Institution]. April 2016.

[3] Thomas Sargent, *Some Unpleasant Monetarist Arithmetic*. Federal Reserve Bank of St. Louis Quarterly Review, Fall 1981.

Central banks simply cannot maintain a plausible commitment to fight inflation when they are obliged to monetize government debt. At first, the interests of the government and central bank are perceived as mutual—after all, when deflationary risks loom, a little inflation is viewed as benign, indeed desirable. However, the temptations of monetary finance grow with its successful use. A credible prospect of higher inflation could provoke a major upheaval in global bond markets, given extremely low yields and the leverage associated with long bond positions. As the interest burden of existing government debt rises, the pressure on the central bank to provide additional monetization would only intensify.

If monetization is successful in boosting inflation (and many think it will be), the *real* value of debt—both public and private—is gradually eroded. Inflation allows governments to renege on their promises to citizens in clandestine ways: through inadequate inflation-adjustment of government benefits and tax brackets, through income limits on promised transfers that become binding over time, and through the rationing of choice and availability in medical care. All of these modalities are already present in the United States.

Many economists believe inflation brings wealth "back to the center" of the income distribution, by boosting wages relative to debt service costs, and by eroding the value of financial assets held by the wealthy. Thus, inflation not only addresses excessive public sector debt (via transfers to the government), it effects a significant redistribution of private sector assets[4].

The "inflation solution" is particularly favored by US policymakers, since a substantial portion of our debt is held by foreigners. Higher inflation leads to currency depreciation, which reduces the value of US$ debts in foreign currency terms—and relative to a country's export capacity. The Chinese government and other creditors of the United States are keenly aware of this risk, which is why they have been trying to prevent their currencies from strengthening against the US dollar. Also, given the widespread nature of the excess debt problem, virtually all central banks welcome higher inflation. Inflation has many friends in high places!

Taxation, financial repression (negative interest rates and restrictions on withdrawals of cash), confiscation (bank bail-ins and civil asset forfeiture), and debt monetization—these are the tools of redistribution now being wielded by governments. These are by no means hypothetical policies; they are already in common use in the US and abroad. Needless to say, our goal is to anticipate and manage these risks, so as to keep our clients' assets out of harm's way.

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[4] For a sampling of research on this topic, see Michael Edgmand, Ronald Moowaw, and Kent Olson, *Economics and Contemporary Issues, 3rd ed*. Dryden Press, 1996. Chapter 13, or Matthias Doepke and Martin Schneider, *The Real Effects of Inflation Through the Redistribution of Nominal Wealth*, FRB Minneapolis Staff Report 355, Feb. 2005.

**KPF Global Strategy**

In the early stages of the *deleveraging-default-monetization* continuum, portfolios benefit from exposure to relatively safe assets: government bonds, high-quality stocks, the US$ and Japanese yen (long considered safe-haven currencies). By contrast, credit instruments, cyclical stocks, real assets and commodities tend to underperform in a deflationary environment. This is the pattern we've seen over the past few years, and our portfolio allocations have respected this reality.

However, things can change quickly—and they will, once the pain of deleveraging and default becomes intolerable, if only to leaders about to fall from grace! When central banks begin monetizing debt in earnest, we will see a reversal of the trends described above, beginning in the global bond markets. As inflation expectations grow, yields will rise and stock markets along with them. Real assets, cyclical investments and overseas markets will (at least for a time) outperform, assuming inflation remains in the "sweet spot" identified by central banks. However, there is a good chance yields won't stay at the "optimum" level, given uncertainty and the unwinding of leverage embedded in global bond markets. If not, equity investors, who have been discounting *low interest rates forever*, are in for a rude awakening.

We think the helicopter money pioneer will be Japan. Deflationary trends are well-entrenched there, despite decades of accommodative monetary policy. The BoJ's experiment with negative interest rates was a flop, and steps are already being taken to ease fiscal policy. There is good cooperation between the government and the central bank, and Prime Minister Abe's landslide victory in Sunday's national elections gives him a mandate to pursue further stimulus through "Abenomics." Additional monetary measures will likely be announced at the BoJ's policy board meeting at the end of this month. In this context, we believe we are near the end—if not at *the end*—of a 30-year rally in Japanese government bonds. Higher inflation expectations will also mean a weaker currency and better performance of Japanese stocks. Therefore, we have supplemented our Japan small-cap investments (denominated in yen) with a currency-hedged investment in large-cap stocks.

It seems unlikely that the Fed will quickly follow suit, given better conditions and the challenging political landscape in the US. Nor are the Europeans in any position to implement a debt monetization policy, given evident tensions between national governments and the European Central Bank. Nevertheless, if Japan were to move down this path, we anticipate heightened turbulence in bond markets, especially if the Fed were to reactivate tightening expectations. Therefore, we are rebalancing all of our clients' fixed income exposures back to target if they were overweight. Finally, we are maintaining our underweight positions in US and European equity, while tilting toward Japan and the emerging markts, with a focus on Asia.