Aviator Update – January 2022
Lindsey Lawrance

Crossroads

There's been a bit of volatility in the markets to begin the year. If you haven't learned previously, "volatility" is the investment adviser's preferred term for describing periods such as this. For some reason an accurate description of events – "a massive wave of selling that sees months' worth of gains evaporate in a matter of days" – just doesn't seem quite so comforting to their clients.

The Federal Reserve is the focal point at the moment. Are they going to appease markets by flipping to a more "dovish" stance? Or are they actually going to focus on what they are supposed to, being the rise in inflation? Will it even matter?

Commentators have been talking about the potential for a "policy mistake". I'm sorry, but the mistake has already been made.

Today, we're going to have a look over the recent history of monetary policy in order to see how we've arrived at this current juncture.

Part of the motivation for this is an excellent December article in Politico Magazine. I'm going to liberally quote from it today. The reason for this is because it discusses some key issues I have been speaking about for several years now - It's valuable for you to hear these issues presented by someone else and in slightly different language to what I use. The link is at the end of my update below.

The role of central banks

Central banks have a number of very important roles within the economy. Arguably the most important is acting as banker to the banks – being responsible for the stability of the banking system and ensuring the big electronic payments system (aka "the banking system") functions as it should.

The other key role is setting the "price of money" through official interest rates.

We'll largely skip over the mechanics under which interest rate policy is managed – we've covered that plenty of times before (and surely will again). Our main concern here is the basis under which central banks set interest rates – what's their goal/s?

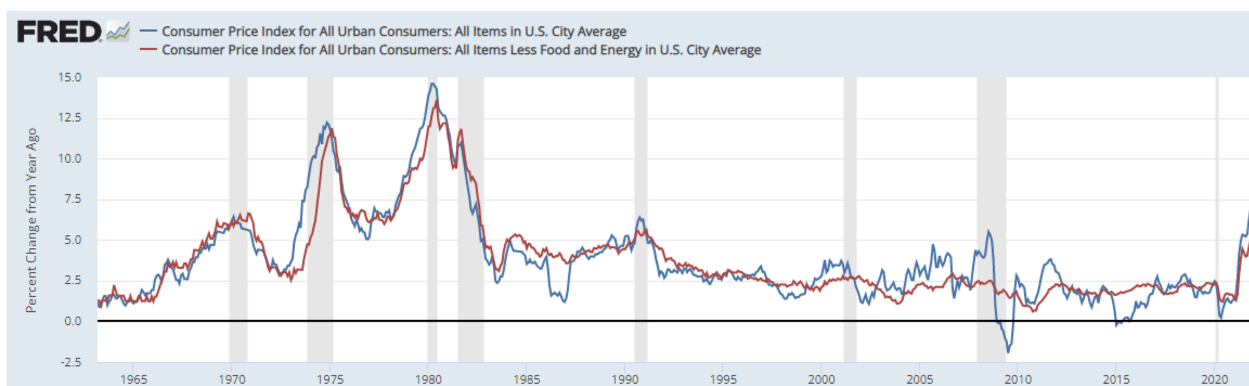
Almost all central banks have the same objectives when it comes to monetary policy decisions – employment and inflation.

For example, the U.S. Federal Reserve Act mandates that the Federal Reserve conduct monetary policy "*so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates*."

Employment and inflation – they're the measuring sticks.

A brief history of inflation

A couple of charts is about all we need here. Below is the U.S. CPI since the '60's:



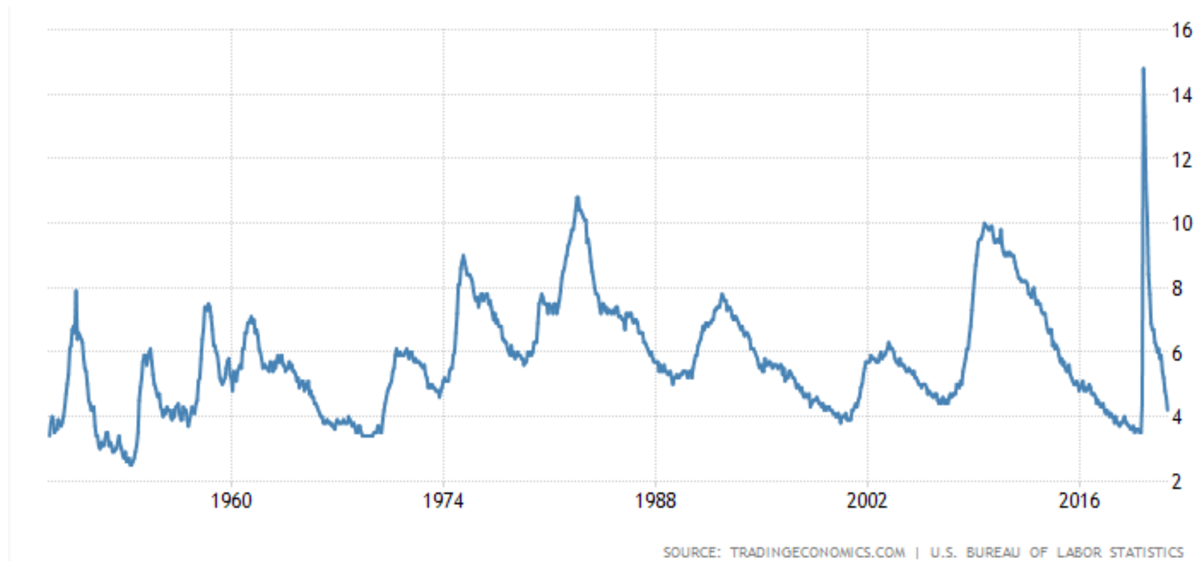
Here's a long-term chart of Australia's CPI:

One important observation can be made – notice that the charts broadly slope downwards. The relevant takeaway is the reality that inflation hasn't been "a problem" since the '80's. Aside from the odd "transitory" spike, inflation has trended lower for decades.

A brief history of unemployment

Once again, a couple of charts is enough to tell this story.

USA Unemployment rate



Australia unemployment rate:

A brief history of official interest rates

U.S. "Fed Funds Rate":

Australia Cash Rate:

Monetary Policy

Remember we've established that central banks effectively have two economic variables they are supposed to be concerned about – inflation and unemployment. The above charts serve as an important reference point as we begin to investigate recent monetary policy.

We begin our story in 2008. The GFC – "Global Financial Crisis". The U.S. economy took a big hit – look at the unemployment spike in the chart above – some of the highest rates since World War II.

Ben Bernanke was Federal Reserve Chairman. The Politico article describes the situation as follows:

"*The FOMC faced a terrible dilemma after the crash of 2008. The central bank had kept interest rates pegged at zero in the wake of the banking crisis, but it didn't seem to be enough to stoke strong growth. The unemployment rate was still 9.6 percent, close to the levels that characterize a deep recession. While members of the FOMC generally agreed that another recession was unlikely, the committee began considering new and experimental ways to exercise its power.*"

…

"*Bernanke pushed the FOMC to keep rates at zero throughout 2010. Then, in August of 2010, with unemployment high and growth sluggish, he publicly unveiled the plan to create $600 billion new bills through an experimental program called "quantitative easing." This program had been used once before, during the financial crash. But it had never been used in the way that Bernanke proposed it be used in 2010, as an economic stimulus plan to be employed outside of an emergency*."

"Quantitative Easing"

The Politico article does a pretty good job at simplistically describing what "Quantitative Easing" entails:

"*The Fed creates the money as it always has, by using its own team of financial traders who work at the Fed's regional bank in New York*."

"*These traders buy and sell assets from a select group of 24 financial firms called "primary dealers," an ultra-exclusive club that includes the likes of JPMorgan Chase and Goldman Sachs. The primary dealers have special bank vaults at the Fed, called reserve accounts. To execute quantitative easing, a trader at the New York Fed would call up one of the primary dealers, like JPMorgan Chase, and offer to buy $8 billion worth of Treasury bonds from the bank. JPMorgan would sell the Treasury bonds to the Fed trader. Then the Fed trader would hit a few keys and tell the Morgan banker to look inside their reserve account. Voila. The Fed had instantly created $8 billion out of thin air, in the reserve account, to complete the purchase*."

This is a reasonable description of QE. However, we need to be really careful to ensure we understand exactly what's transpired.

The Fed has bought $8 billion worth of Treasury bonds from the bank. It has paid for them by crediting the seller with $8 billion created "out of thin air". True enough.

They have bought Treasury bonds… paid for them with new base money (created electronically).

It's an asset-swap! No new "assets" are in the private sector! The bank had $8 billion of (interest-yielding) bonds and they swapped these for (zero-yielding) cash.

In fact, the bank is essentially worse-off from the transaction as they have swapped an interest-bearing asset with an asset that earns no interest. That's partly what it means to be a member of that "ultra-exclusive club" of primary dealers – you are obliged to trade with the Fed when they want to trade. It's not quite a matter of the Fed "offering to buy $8 billion worth of Treasury Bonds…" "No" isn't an option - they instruct the primary dealer to sell.

Equilibrium:

The Politico article insinuates that all this new money is there to be spent – a commonly-held belief. But this isn't true.

It's important to understand that the money created – "bank reserves" is a rather special form of money.

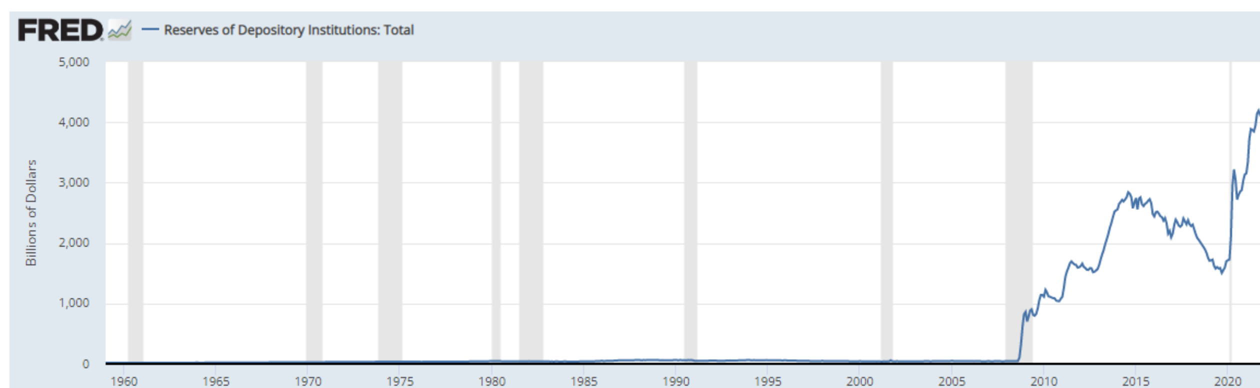
It's not somehow there to be spent.

The bank has very tight restrictions on what it can do with it. It's not "income" – they can't "spend it" in terms of paying for private jets or executive bonuses. The bank is even very constrained (from a regulatory perspective) in terms of investing the funds in things such as shares or bitcoin…

It also doesn't get "loaned out" to customers. We know this by now – repeat after me… Banks don't lend from reserves… banks are never "reserve constrained"… loans are made to willing, creditworthy borrowers with an eye on the bank's capital reserves.

The truth is, bank reserves basically just sit as bank reserves until such time as the central bank decides to drain them from the system.

Oh, you want some proof of this? Here you go:



This is a chart of the reserves within the U.S. banking system. If you want to do a bit of research you will discover that this closely reflects all that "new money" that's been pumped into the economy.

There's your "money-printing" – just sitting there in reserve accounts.

It's worth noting at this point that the Fed could unwind all this simply by doing the opposite transaction. It sits on a mountain of bonds that it has purchased. It can simply exchange those bonds for all those bank reserves sitting idle. The N.Y. Fed traders could do it in a morning and still make their lunch appointments.

Now, I'm not suggesting that such a massive undertaking would be completely without consequence – I'm simply highlighting how these transactions "work". The money is there – it hasn't been "spent" or loaned out or invested…

So how does Quantitative Easing work?

As I've long discussed, there's no discernible "link" between QE and the real economy. But for another opinion, let's return to the Politico article:

"*Inside the closed-door FOMC meetings, quantitative easing was debated during 2010 for being what it was - a large-scale experiment that carried unclear benefits and risks. There was more opposition to the plan than was publicly known at the time. Hoenig wasn't the only FOMC member with strong objections to the plan. The regional bank presidents Charles Plosser, Richard Fisher and Jeffrey Lacker expressed concerns about it, as did a Fed governor named Kevin Warsh*."

"*The Fed's own research on quantitative easing was surprisingly discouraging. If the Fed pumped $600 billion into the banking system in roughly eight months, it was expected to cut the unemployment rate by just .03 percent. While that wasn't much, it was something. The plan could create 750,000 new jobs by the end of 2012, a small change to the unemployment rate but a big deal to those 750,000 people*."

Yes, that's right. The Fed's own analysis suggested that Bernanke's Quantitative Easing idea wouldn't have any appreciable impact on the real economy.

However, in an environment where inflation appeared permanently tamed, Bernanke felt that it was worth doing.

Fast forward a decade and the Fed is still engaged in this dubious strategy of buying bonds from banks... replacing them with bank reserves. Further, with a decade of data behind it, it is still hotly debated whether all this has had any real impact on the economy at all. Yes, the economy improved during that period, but what proportion can be attributed to the Fed's actions versus what proportion occurred "naturally"?

Thomas Hoenig – the dissenter

Tom Hoenig, now a retired 75-year-old, had a working life filled with numbers. In the 1970's and '80's, he was a bank examiner. The '70's was characterised by "easy money policies" from the Federal Reserve and a period of rising inflation. Quoting from the Politico article:

"*It all came to an end in 1979, with a severity that has never been repeated. Paul Volcker became chair of the Federal Reserve and he was intent on beating inflation by hiking interest rates. Under Volcker, the Fed raised short-term interest rates from 10 percent in 1979 to 20 percent in 1981, the highest they have ever been. This unleashed massive economic havoc, pushing the unemployment rate to 10 percent and forcing homeowners to take out mortgages with 17 percent interest rates or higher. Volcker recognized that when he was fighting inflation, he was actually fighting two kinds: asset inflation and price inflation. He called them "cousins," and acknowledged that they had been created by the Fed*."

"*The real danger comes from [the Fed] encouraging or inadvertently tolerating rising inflation and its close cousin of extreme speculation and risk taking, in effect standing by while bubbles and excesses threaten financial markets," Volcker later wrote in his memoir*."

Hoenig's role as bank examiner basically meant he got to help clean up the mess left behind. "*This was the period when Hoenig travelled around the Midwest, auditing banks to determine if they were still solvent during the recession. Not surprisingly, Hoenig ended up arguing with a lot of bankers when his team declared that the value of the banks' assets were not sufficient to meet their liabilities*."

"*Hoenig carried these lessons with him. He was promoted to become the president of the Kansas City Fed, in 1991, which gave him a voting seat on the FOMC. He served there during the long tenure of Fed Chair Alan Greenspan, and then Greenspan's successor Ben Bernanke. Between 1991 and 2009, Hoenig rarely dissented*."

"*Then came 2010, when he believed the Fed was repeating many of the same mistakes it made in the 1970s*."

From the start of Bernanke's grand scheme in 2010 until his departure from the Fed in 2011, Hoenig voted against all the monetary policy decisions made by the Fed. The votes were routinely 11-to-1, with him being the only dissenter. Due to quirks in the way the FOMC panel is set, other members that had expressed similar concerns were no longer voting members. Handy for Bernanke.

Inflation and Inflation:

Note that Hoenig expressed relatively little concern about the type of inflation presently causing angst – inflation in goods and services. Hoenig's major concern was, to use Paul Volker's term, its "cousin" – asset price inflation. To quote from Politico;

"*The historical record shows that Hoenig was worried primarily that the Fed was taking a risky path that would deepen income inequality, stoke dangerous asset bubbles and enrich the biggest banks over everyone else. He also warned that it would suck the Fed into a money-printing quagmire that the central bank would not be able to escape without destabilizing the entire financial system*."

He did have company at the time, alas not from within the FOMC committee:

"*[Richard] Fisher, the Dallas Fed president, said he was "deeply concerned" about the plan. "I see considerable risk in conducting policy with the consequence of transferring income from the poor, those most dependent on fixed income, and the saver, to the rich," he said at the time*."

"Wealth Effect":

During his stint as Fed boss, Ben Bernanke made several references to rising share prices. It's fairly clear that, at least in part, his Quantitative Easing strategy was deliberately aimed at pushing asset prices higher.

The "wealth effect"… the idea that if you make people "feel" wealthier, they will spend more and thus the economy will benefit from higher asset prices.

It's true – it is real… to an extent.

Part of trouble however, is that you need to own assets to benefit from rising asset prices. And wealthier people own a lot more assets than poorer people.

Additionally, wealthier people tend to spend less of their income compared to poorer people. A multi-millionaire is unlikely to modify their spending patterns because they feel wealthier.

So whilst there might be some economic merits in pushing up asset prices, it invariably fuels inequality – there's no escaping the reality that it benefits "the have's" much more than "the have-not's".

The "wealth effect" is one of those dubious economic concepts. However, its real to an extent. Look around Australia at the moment – there's no doubt in my mind that many Aussies, having seen their real estate rapidly rise in value, are feeling a bit wealthier and more willing to spend – maybe a new Ram monster truck or some home renovations.

But it works in reverse also…

As evidenced from the last two asset bubbles (the 2000 tech wreck and the 2006 housing bubble), it's evident that the "anti-wealth-effect" associated with a period of rapidly *deflating* asset prices is in fact much more potent than the positive effects associated with the preceding asset price inflation. Oddly enough, central banks choose to sidestep any culpability on that side. Being academic economists, they seem to be strong adherents to the fallacy of "efficient markets" – asset prices can never become totally detached from fundamentals because investors won't allow it! Like Bernanke's famous comments from before the 2007 housing bust – strong house prices "largely reflect strong economic fundamentals"!

Equilibrium and Wealth Transfers:

Creation of paper wealth is one thing. There's also the "preservation" of created wealth.

It's valuable to once again remind ourselves of that all-important "equilibrium":

<u>Every asset has to be held by someone in the same form it was issued at all times until it is retired.</u>

All that "printed money"? It has to be held by someone in that form at all times. It's not "looking for a home". It's not sitting "on the sidelines".

Every government bond; Every corporate bond; Every share, has to be held by someone at all times. It's called a "stock exchange" for a reason. Every time someone takes some "cash on the sidelines" and puts it to work by buying shares, they exchange that cash for some shares that are being held by someone else.

The seller then holds the cash and the buyer holds the shares. Equilibrium prevails.

Said a slightly different way, the seller of shares has received a transfer of savings/cash from the buyer. The seller is safely in cash.

Due to regulatory reporting requirements, share transactions by corporate insiders are public information. Recently, share sales by U.S. corporate insiders have reached record extremes.

Now sure, people might need/want to liquidate some of their shares for reasons totally unrelated to current market price – maybe they want to buy another house, a luxury motor yacht or buy a professional sports team – all perfectly legitimate reasons for cashing out a few million… But I can guarantee you that some sales are being motivated by the insider believing the current market price of their company is impossible to justify – they believe its over-valued.

Now, think about it this way… Insiders generally sell their shares on the open market. The buyer has their (over-valued) shares and the seller has the buyer's cash. If the wealth of the buyer is lower than the seller (a high likelihood in this instance), the seller has in essence crystallised a transfer of savings from a "less wealthy" individual.

Take this one step further… If the buyer made a "good purchase" and the share price continues to rise, they will have made money… on paper, that is. They then have the opportunity to "crystallise" a transfer of savings from someone else by selling.

Equilibrium prevails after every transaction. Every asset being held by somebody at all times. When prices are rising, the holder of that asset enjoys that fulfilling sensation of making money. But the gains can only be realised by selling to somebody else.

Of course, the opposite to this is true also. When the price of an asset is falling, the holder of the asset is losing money on paper. If the pain gets too much, they sell. By selling at a loss, they have crystallised a "real" loss – their household financial position is forever impacted by that bad investment.

As investors, we all know this. That old saying of "it's only a loss when you sell" is cold comfort to someone whose portfolio is down 35%

You are here

It's funny… In most fields, spotting something early results in you being remembered as a "visionary" or a "pioneer". In finance, being early simply makes you "wrong"!

It's unquestionable that many of the concerns expressed by Tomas Hoenig (and others) more than a decade ago have come to fruition. Asset price bubbles. Record-breaking "inequality" and the social/political turmoil that comes with it.

Central banks globally (but particularly the U.S. Fed), **by robbing investors of a risk-free return for so long have completely distorted investors' perceptions about investing and risk.**

They have pushed investors "out on the risk curve", seeking an adequate return.

The price trends that have formed in many markets such as U.S. shares have recruited more participants as they have gone along… everyone emboldened by others that have produced stellar returns and justified by the knowledge that with zero interest rates "there is no alternative".

In the case of U.S. shares, it's manifested into an environment where it seems most investors truly believe shares only go up. Why not? For over a decade every little dip has been an opportunity to buy. They are cheered on by the sell-side analysts from Goldman Sachs and the commentators at Charles Schwab – extracting the handsome transaction and management fees that comes with servicing the growing army of retail investors – feeding them trade ideas. And now engrained in many investors' minds is;

"The Fed won't let share prices go down…". The "Fed Put" is alive and well.

Use your discretion

Refer back to those charts above. CPI inflation in the U.S. exceeds 7%. In Australia, our latest inflation numbers came in north of 3%. Unemployment is at historically low levels. And yet interest rates are zero (or thereabouts)?

The Fed's committee held their interest rate policy meeting in the last week of January. They did nothing. As has been the trend, analysts and commentators then dissect every word contained in the official statement as well as those said by chairman Powell:

"he said transitory… he said persistent… they removed the word "soon" from the statement… the word "sustained" appeared…"

It's ridiculous. It's also important to realise that things never used to be this way…

It might surprise you to learn that before 1994, the Fed didn't even issue any statement from its interest rate meeting – it just made its monetary policy decisions. It wasn't until around 2000 that the Fed commenced releasing a statement after every meeting.

Remember earlier we discussed the central banks' mandates and objectives – namely inflation and unemployment. For most of recent history, central bank decisions have been based on observable economic conditions and data. Market participants knew with a good deal of confidence "the data has done this so the Fed will do that". Monetary policy changes were relatively transparent and predictable.

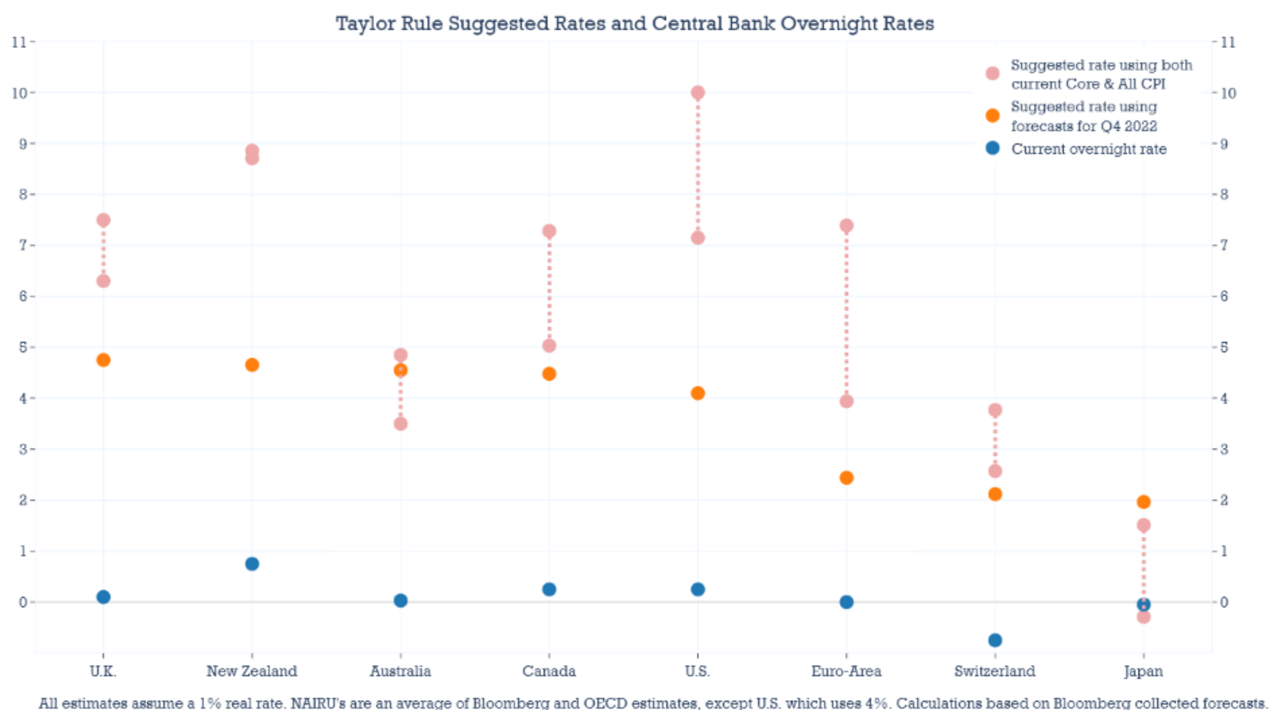
What's happened in the past 10+ years is the Federal Reserve has shifted to almost purely discretionary monetary policies. Its emboldened other Central Banks to do the same.

The outcome has been an environment where market participants have little clue what the Fed will do. They're left to over-analyse every word… every comment… in the hope of discerning what the Fed might do next. It almost feels like a spin of the 'chocolate wheel'.

This is really significant for investors. Not quite so much if you're a small investor - $1M, $10M or even $100M assets. But if you're managing billions, the risk-free rate and changes in the risk-free rate significantly impact markets and thus your portfolio decisions. When its unpredictable, it can exacerbate market volatility as big players need to respond to unexpected changes – "moving markets" as they do it.

Interest rates – here in Australia and in the U.S. – do not reflect current economic conditions. Look back at those charts above and around you here in Australia – a tight labour market, inflationary pressures, a housing market going ballistic… and yet official interest rates are less than 0.25% with little talk from our Reserve Bank about raising rates.

I posted this chart from Hussman Funds' Bill Hester last month. What it represents is where interest rates would hypothetically be if they were set using a "rules-based" mode We are well below the historical expectation:



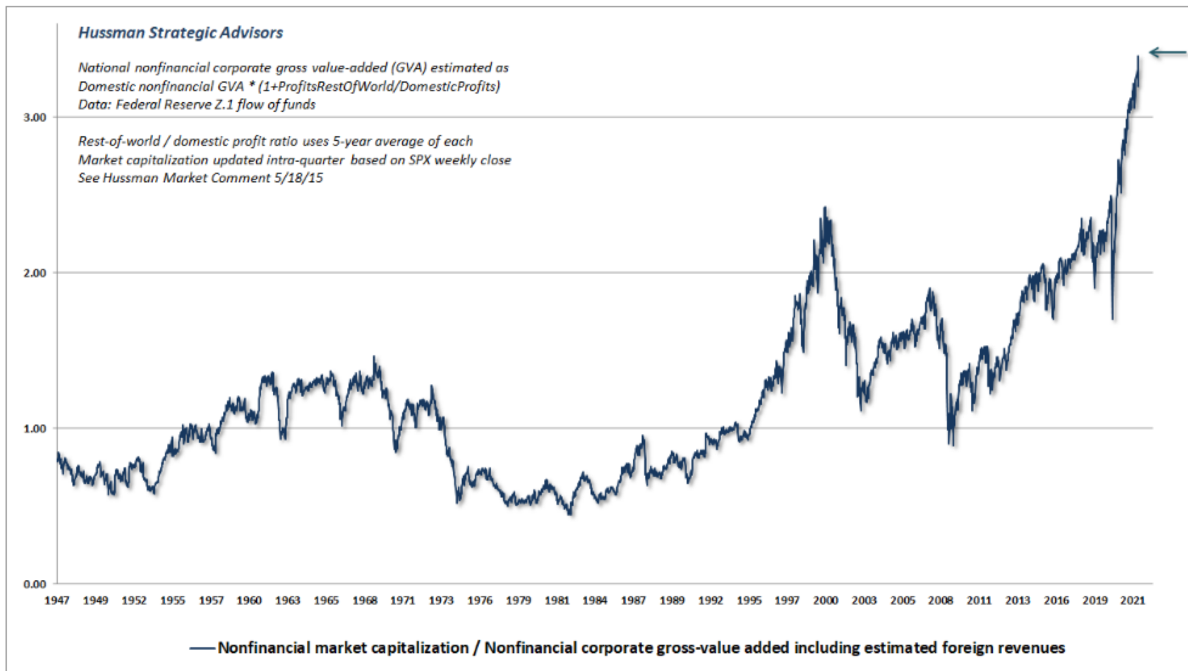
To reiterate what I said last month; this isn't to say official interest rates should be around 4% here in Australia. What it demonstrates is how "out of whack" interest rate policy has become relative to economic conditions – largely discretionary versus predictable and objective.

Central bankers globally are surely scared – scared that acting might have an adverse economic impact. It will – that's basically the point.

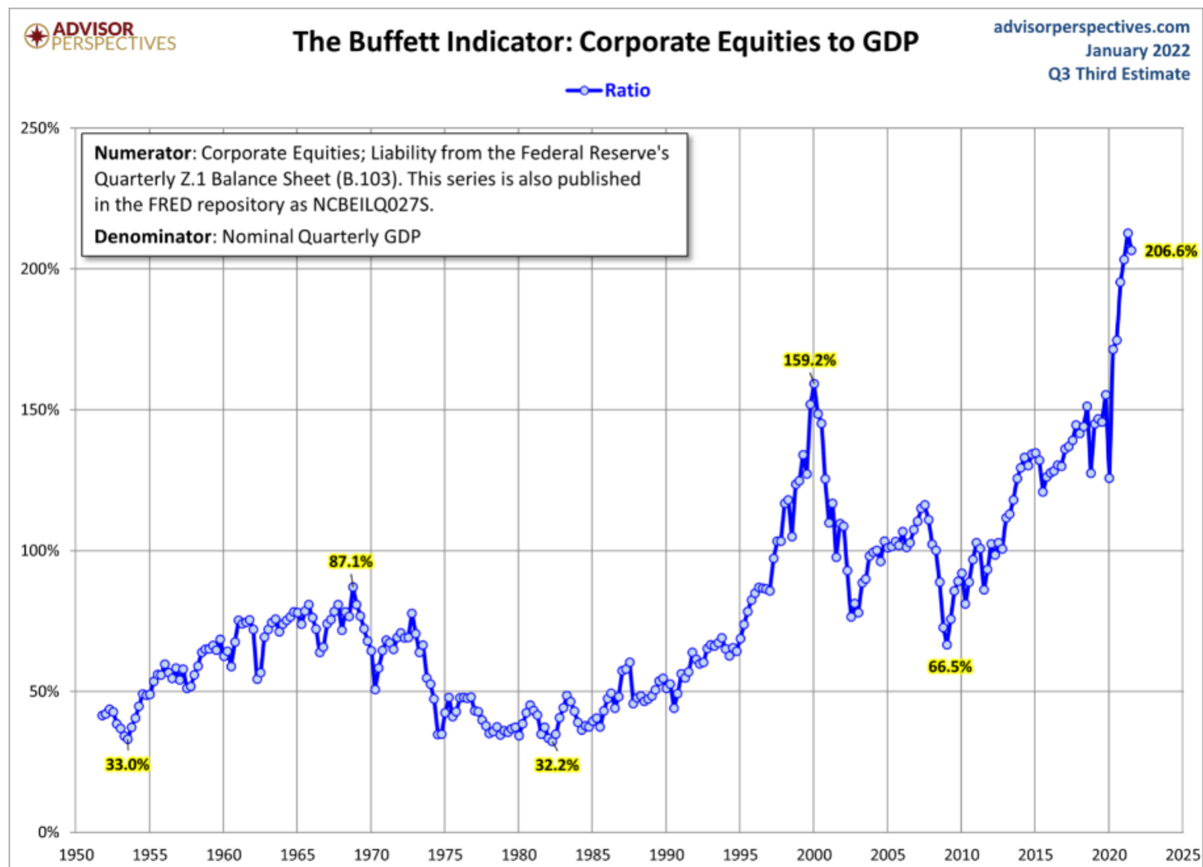
But what if they do nothing? Is the CPI inflation transitory? Will it go away on its own? Elevated inflation will cause tremendous pain within the real economy. And it will be felt the most by those with the least – further fuelling the angst between "the have's" and "have-not's". And, possibly in a repeat of the '70's; failing to act now might mean a need for vastly more significant action down the track.

The economy versus the markets

For several years now, I've frequently referred to the equity markets as "fragile". That's because you have had reliable U.S. equity valuation models doing this:

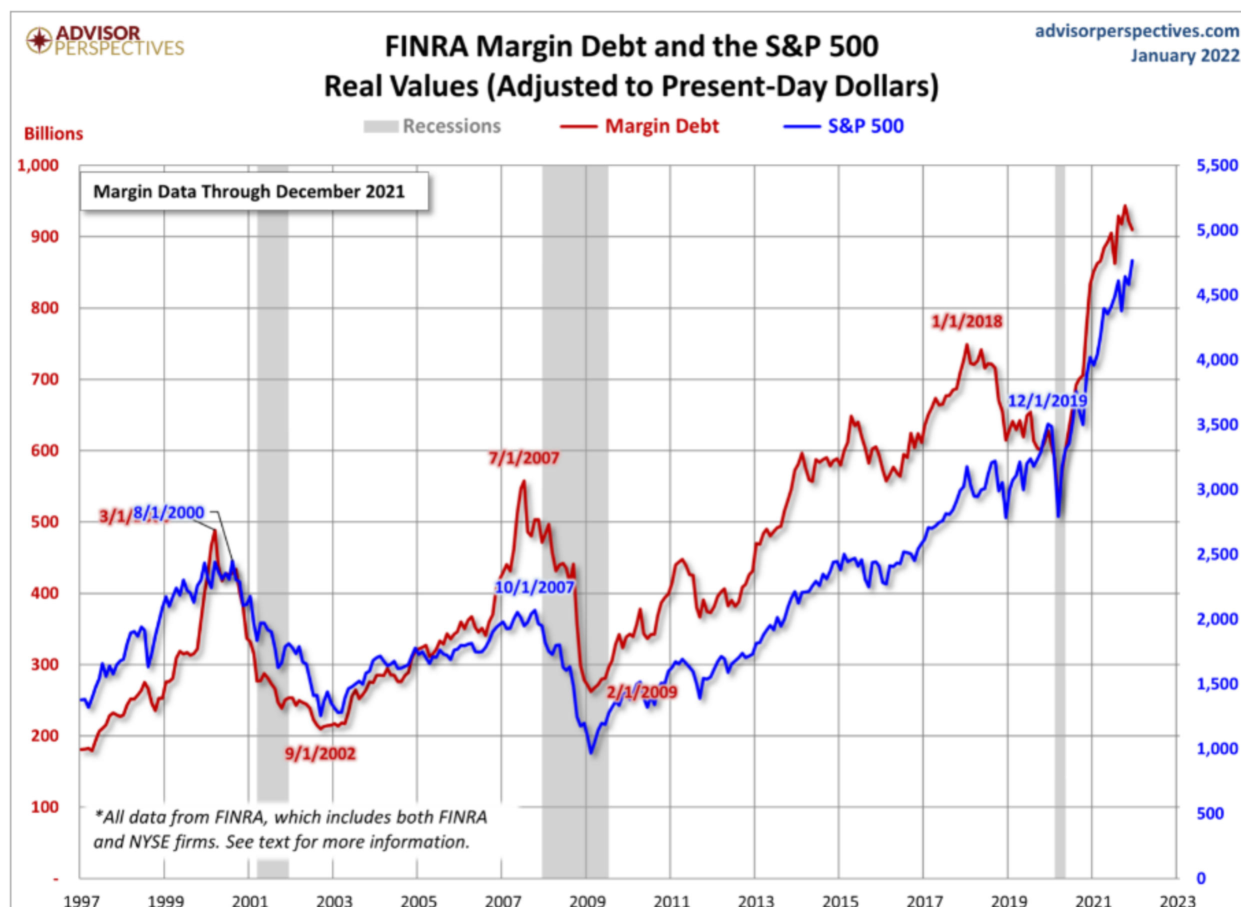


Here's another one:



Granted, these do not reflect the most recent mini-correction but it makes little difference – significant further falls are required simply to bring valuations back towards the highest levels ever recorded prior to last year!

There's the usual accompanying factors such as margin debt:



Earlier on I said that the Fed's "policy mistake" has been made. This is it - the Fed presided over this. A decade of excessively loose, discretionary monetary experiments which has resulted in a bubble in one of the world's key asset markets – being U.S. equities.

Smart financial historians see bubbles (or at least significant over-valuation) in many other asset markets. Australian and Canadian housing are two often mentioned. Just sayin'. (Fortunately, they don't realise that strong house prices "largely reflect strong fundamentals", right?)

With respect to U.S. equities – the market that tends to set the tone for the entire world – we know from history what to expect from here. Bubbles deflate back towards trend. Investors face the prospect of a particularly poor period of returns.

Whilst little is certain in financial markets, this outcome is pretty much baked in. A lot of people still want to believe that the Fed will save the day – that even if goods and services inflation persists, they will not meaningfully raise rates and this will be enough to keep markets happy.

If you believe this, what you're basically saying is "I believe this bubble will get bigger". You may absolutely be right – "buy the dip" if you like. Why not – it has worked for over a decade. Timing is uncertain and I'm not willing to say I absolutely believe the top is now in. I think it probably is, but it's not certain.

Unless CPI inflation magically settles in the next 2 months (and maybe even if it does), it seems that we're beginning a monetary tightening cycle. We're beginning this when key asset markets are as richly valued as they have ever been (in history!).

To briefly address where markets are positioned right now, I think it's too early to say this is the start of a major collapse. For some reason "now" just seems a bit too logical… too easy… "Fed begins tightening and market collapses" – just seems too easy. We know Mr Market likes to keep us guessing and there are surely some surprises in store. We can be pretty sure we know the destination but the journey is uncertain. And of course, as investors, the journey is more important than the destination.

Just remember, someone needs to hold every asset at every point in time. That, in essence is why over-valued markets have historically had a tendency to fall quickly – when everyone collectively realises the asset is hugely over-valued, the question becomes;

Sell to who? Who is the buyer, right now?

Lastly, here is the link I promised for further reading:

https://www.politico.com/news/magazine/2021/12/28/inflation-interest-rates-thomas-hoenig-federal-reserve-526177

We wish you a very prosperous and safe 2022. We're looking forward to a year of opportunity.

This document contains information which is the copyright of Aviator Capital Pty Ltd (AFSL 432803) or relevant third party. Any views expressed in this transmission are those of the individual, except where the individual specifically states them to be the views of Aviator Capital Pty Ltd. Except as required by law, Aviator Capital Pty Ltd does not represent, warrant and/or guarantee that the integrity of this document has been maintained nor is free of errors, interception or interference. You should not copy, disclose or distribute this document without the authority of Aviator Capital Pty Ltd. Aviator Capital Pty Ltd does not accept any liability for any investment decisions made on the basis of this information. This information is intended to provide general information only, without taking into account any particular person's objectives, financial situation, taxation or needs. It does not constitute financial advice and should not be taken as such. Aviator Capital Pty Ltd urges you to obtain professional advice before proceeding with any financial investment.