Central Bank Smackdown

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> Smackdown: smack·down, ʻsmak doun/, *noun*, US *informal*
>
> 1. a bitter contest or confrontation.
>
> "the age-old man versus nature smackdown"
>
> 2. a decisive or humiliating defeat or setback.

The term "smackdown" was first used by professional wrestler Dwayne Johnson (AKA The Rock) in 1997. Ten years later its use had become so ubiquitous that Merriam-Webster felt compelled to add it to their lexicon. It may be Dwayne Johnson's enduring contribution to Western Civilization, notwithstanding and apart from his roles in *The Fast and The Furious* movie series. All that said, it is quite the useful word for talking about confrontations that are more for show than actual physical altercations.

And so it is that on a beautiful July 4 weekend we will amuse ourselves by contemplating the serious smackdown that central bankers are visiting upon each other. If the ramifications of their antics were not so serious, they would actually be quite amusing. This week's shorter than usual letter will explore the implications of the contretemps among the world's central bankers and take a little dive into yesterday's generally positive employment report.

BIS: The Opening Riposte

The opening riposte came from the Bank for International Settlements, the "bank for central banks." In their annual report, released this week, they talked about "euphoric" financial markets that have become detached from reality. They clearly – clearly in central banker-speak, that is – fingered the culprit as the ultralow monetary policies being pursued around the world. These are creating capital markets that are "extraordinarily buoyant."

The report opens with this line: "A new policy compass is needed to help the global economy step out of the shadow of the Great Financial Crisis. This will involve adjustments to the current policy mix and to policy frameworks with the aim of restoring sustainable and balanced economic growth."

The *Financial Times* weighed in with this summary: "Leading central banks should not fall into the trap of raising rates 'too slowly and too late,' the BIS said, calling for policy makers to halt the steady rise in debt burdens around the world and embark on reforms to boost productivity. In its annual report, the BIS also warned of the risks brewing in emerging markets, setting out early warning indicators of possible banking crises in a number of jurisdictions, including most notably China."

"The risk of normalizing too late and too gradually should not be underestimated," the BIS said in a follow-up statement on Sunday. "Particularly for countries in the late stages of financial booms, the trade-off is now between the risk of bringing forward the downward leg of the cycle and that of suffering a bigger bust later on," the BIS report said.

The *Financial Times* noted that the BIS "has been a longstanding sceptic about the benefits of ultra-stimulative monetary and fiscal policies, and its latest intervention reflects mounting concern that the rebound in capital markets and real estate is built on fragile foundations."

The *New York Times* delved further into the story:

> There is a disappointing element of déjà vu in all this," Claudio Borio, head of the monetary and economic department at the BIS, said in an interview ahead of Sunday's release of the report. He described the report "as a call to action."
>
> The organization said governments should do more to improve the performance of their economies, such as reducing restrictions on hiring and firing. The report also urged banks to raise more capital as a cushion against risk and to speed efforts to deal with past problems. Countries that are growing quickly, like some emerging markets, must be alert to the danger of overheating, the group said.
>
> The signs of financial imbalances are there," Mr. Borio said. "That's why we are emphasizing it is important to take further action while the time is still there."
>
> The B.I.S. report said debt levels in many emerging markets, as well as Switzerland, "are well above the threshold that indicates potential trouble." (Source: *New York Times*)

Casual observers will be forgiven if they come away with the impression that the BIS document was seriously influenced by supply-siders and Austrian economists. Someone at the Bank for International Settlements seems to have channeled their inner Hayek. They pointed out that despite the easy monetary policies around the world, investment has remained weak and productivity growth has stagnated. There is even talk of secular (that is, chronic) stagnation. They talk about the need for further capitalization of many banks (which can be read, of European banks). They decry the rise of public and private debt.

Read this from their webpage introduction to the report:

> To return to sustainable and balanced growth, policies need to go beyond their traditional focus on the business cycle and take a longer-term perspective – one in which the financial cycle takes centre stage. They need to address head-on the structural deficiencies and resource misallocations masked by strong financial booms and revealed only in the subsequent busts. The only source of lasting prosperity is a stronger supply side. It is essential to move away from debt as the main engine of growth.

"Good policy is less a question of seeking to pump up growth at all costs than of removing the obstacles that hold it back," the BIS argued in the report, saying the recent upturn in the global economy offers a precious opportunity for reform and that policy needs to become more symmetrical in responding to both booms and busts.

Does "responding to both booms and busts" sound like any central bank in a country near you? No, I thought not. I will admit to being something of a hometown boy. I pull for the local teams and cheered on the US soccer team. But given the chance, based on this BIS document, I would replace my hometown team – the US Federal Reserve High Flyers – with the team from the Bank for International Settlements in Basel in a heartbeat. These guys (almost) restore my faith in the economics profession. It seems there is a bastion of understanding out there, beyond the halls of American academia. Just saying…

Yellen's Counter-Riposte

On July 2, two days after the release of the BIS report, Janet Yellen took the stage at the IMF conference and basically said (translated into my local Texas patois), "Kiss my grits." She was having nothing to do with risk and productivity and spent her time defending the low-rate environment she has been fostering in the US. With just a brief hat tip to the fact that monetary policy can contribute to risk-taking by going "too far, thereby contributing to fragility in the financial system," she proceeded to maintain that monetary policy should "focus primarily on price stability in full employment because the cost to society in terms of deviations from price stability in full employment that would arise would likely be significant." (You can read the speech here if you have nothing else to do and your recent entertainment options have been limited to watching the microwave cook.)

In other words, Janet has her dual mandate, and the rest of the world can go pound sand. When she did allude to the risk of financial instability, she hastened to say that it was not something that would require a *change* in monetary policy but would instead call for what she termed a "more robust macroprudential approach." In fact she used that word *macroprudential* no fewer than 29 times. For those not fluent in Fedspeak, what she meant is that we can deal with financial instability through increased regulation procedures, whatever the hell that means. Exactly what did macroprudential policy do for us during the last crisis?

Hold that thought as we move on to Mario Draghi, who piled on the next day, as if to reemphasize that the leading central bankers of the world are simply not going to pay any attention to increasing financial instability risk. (Interestingly, the voice recognition software that I use to dictate this letter insists upon transcribing *Draghi* as *druggie*. Given what he is pushing, maybe it knows more than the typical software package.)

Immediately following a European Central Bank meeting, Mario gave us the following statement:

> The key interest rates will remain at present levels for an extended period ... [and] the combination of monetary policy measures decided last month has led to a further easing of the monetary policy stance. The monetary operations to take place over the coming months will add to this accommodation and will support bank lending.

My friend Dennis Gartman summarized the actual meaning of Draghi's comments quite succinctly:

> [I]n other words, European-style quantitative easing is now the course that the Bank shall take. As we understand it ... and this is a bit confusing and shall take a while to fully comprehend what the ECB has done and shall be doing ... the Bank will be making as much as €1 trillion available to the banks in two early tranches and will make that money available for the next four years as long as the money is being used for direct lending operations.
>
> Mr. Draghi made it clear that the new program is complex and shall take some time for everyone to understand the program but said that he is quite "confident that banks will quickly understand" the program's details and will embrace it.

My own interpretation is that Mario said, "I'll see the Fed's tapering and raise it by €1 trillion."

Wow! A double-teamed double smackdown! Even The Rock would be impressed.

The Coming Liquidity Crisis

The next crisis is shaping up to look a lot like the last one, just with a different cause. It is going to be a liquidity crisis.

What was the cause of the last crisis? Everybody points to subprime debt, but that was really just a trigger. What happened was that everybody in the financial world became distrustful of everybody else's balance sheet and so decided to go to cash, but there was so much debt and so much invested in illiquid assets that everybody couldn't get out of the theater at the same time.

It is happening again today. The intense drive for yield is driving down interest rates and volatility, pushing up assets of all kinds, and setting us up for the same song, second verse of the 2008 crisis.

While I have been hinting around about that possibility for some time, it really crystallized for me this last week as I read about the enormous drop in quality of fixed-income paper of all types, coupled with the huge increase in junk paper. Then I read that that Kenya had just broken the African record for a sovereign debt sale. They raised $2 billion for "general budgetary purposes" and at a rate lower than they anticipated (6.875% for ten-year maturities). A commentator in the *Financial Times* noted wryly, "Kenya's gotten really, really lucky with the yield…. There's very strong global demand for African sovereign paper."

You bet there is, and on the corporate side of things, covenant-lite loans now amount to more than half of all corporate bonds outstanding, notes Barclays (and a dozen other sources). And meanwhile, the spread between AAA and subprime auto loans is the narrowest since 2007. "People just have to reach further and further," says fund manager David Schawel to Bloomberg. "The objective now is to reach a certain yield target instead of feeling good about the underlying credit."

French ten-year bonds (OATS) are paying 1.7%. Spanish (2.68%) and Italian (2.83%) debt are paying roughly the equivalent of US debt. German debt, at 1.27%, pays less than half of US debt at 2.64%. Somewhere in that equation, sovereign debt is spectacularly mispriced. Rated ten-year corporate bonds are paying between 3% and 3.4%. That is less than a 1% premium for bonds that are only single-A. Seriously?

The life insurance market is creating special-purpose vehicles (SPVs) for offloading their risk that are then guaranteed by the parent company. This is the subject of a very sobering report from the Minnesota branch of the Federal Reserve. Up to 25% of such debt may be subject to self-guarantees, and this debt is getting very high ratings. Whom are we kidding? (This is actually a very serious problem and needs an entire letter devoted to it. There's just not enough time on a Friday afternoon, with the grill beckoning.)

And we are going to have to deal with a run on everything, very similar to what happened last time, armed only with "macroprudential policy"? Precisely what additional rules are we going to enact? You are not allowed to sell what you own? Except if you say "Mother may I, with sugar on top?" A liquidity crisis cannot be dealt with by means of any regulatory policy I can think of, short of draconian limits on markets – really nasty limits, which sort of undermines the whole concept of a free market. But then, maybe I just have no imagination.

If I could sit down with Chairwoman Yellen and ask her a few questions, chief among them would be: "What can macroprudential policies do in a liquidity crisis brought on by a reach for yield encouraged by your bank? Can you tell me exactly what those policies are?"

There is a bull market in complacency. The illusion of central bank control is in full force. And one of the chief ironies is that a bull market can last longer than any of us can reasonably expect – and then end more abruptly than even the most cautious bulls suspect. The St. Louis Fed Financial Stress Index is at its lowest ebb since they began calculating the index. How much lower can it realistically go? The answer is that no one really knows.

I don't know what the trigger for the next debt crisis will be, but whatever it is, it will result in an even deeper liquidity crisis than we saw in '08. That is just the nature of the beast.

You need to look into your portfolios, deep into your portfolios, and see what your various investments did back in 2008-09. Then take a deep, long, serious look in the mirror. Ask yourself, "Can I withstand another shock like that?" Do you think you are smart enough to pull the trigger to get out in time? Do you have automatic triggers that will cause you to exit without having to be emotionally involved? Are there illiquid assets in your portfolio that you want to own right on through the next crisis? (Let me note that there are a lot of assets about which you might answer positively, with a full-throated yes, in that regard.) Would you rather be biased to cash today, when cash is in a true bear market and at its lowest value in years, if that cash will give you the buying power to purchase assets at prices that will once again look like 2009's? Think about how you will feel in the wake of the next crisis, when cash will be king!

You should be thinking of cash not as cash per se, but as an ***option*** on future deep-value trades. There are few truisms in the investment world that are really valid, but one of them is that you make your money when you buy. That you sold at a profit is just another way of saying that you were smart to buy when you did. There is going to come a time when buying opportunities are once again going to be all around you.

A Few Thoughts on the Nonfarm Payroll Number

First, this was a continuation of a five-month run of relatively good nonfarm payroll numbers. You can see the GDP recession in the January and February reports which gave us lower payroll numbers. That recession is gone away. There are no wage pressures in the latest report, with earnings rising a meager $0.06 an hour, or the more positive sounding 0.2% y/y. Unemployment fell to 6.1%, but the broader unemployment measure, U-6, barely budged, at 12.4%.

Joan McCullough ran U-6 down for us:

> Including this from EPI (Heidi Shierholz) who runs this calculation every month called "Missing Workers", a/k/a/ those who have dropped off the radar screen for a host of reasons.

June 2014: *5.98 mil (*roughly half of that number are of prime working age. Aint' that grand? SOS.)

UE Rate if you add those back into the labor force: 9.6%

Compare that number to the official rate of 6.1%

Ms. Shierholz also estimates that *"even if we saw June's rate of job growth every month from here on out, we still wouldn't get back to health in the labor market for another two and a half years."* … http://www.epi.org/publication/missing-workers/

That is still not be enough to take the bloom off the rose, but we should note that buried in the data is something that I've noted anecdotally among my own children and their friends (and which Joan again highlighted to me):

Now here's the big joke of the whole deal:

Employed persons at work part time:

Part time involuntarily	+275k
Because hours cut back	+72k
Because that's all they could find	+111k
Part time voluntarily	+840k

That is seriously pathetic and makes me wonder about the Retail adds +40k and the Leisure & Hospitality adds +39k. Low-paying, less than 40 hour a week jobs? You bet. Ditto Health care and social assistance, which clocked in with a hefty 33.7k.

But it also explains why, with 288k bodies added, the average workweek is not budging. Translation: they are hiring more workers instead of increasing the hours of existing workers. Which suggests that maybe this is more of what we have seen already: the quest to hire part time employees to avoid the benefits baloney.

Use your head. If we really created 288k jobs. And 275k folks were made involuntarily part-time, then this suggests that there are still way more candidates than there are openings.

When some of us pointed out, when the Affordable Care Act (Obamacare) was being debated way back in 2010, that the bill would result in an extraordinarily large number of temporary and part-time workers, we were called delusional and told we were just using that argument to oppose the ACA. It turns out, Mr. Krugman et al., that we were right. An unintended consequence of the ACA is a dramatic increase in part-time employment, especially among young people. There is no disputing this, unless you are willing to ignore the clear data from the BLS.

Precisely when young people are starting their careers and should be able to land "starter jobs" and look forward to establishing themselves, they now have to hold down multiple part-time jobs in order to simply survive. Gods forbid they have a kid or two.

I don't know when the topic of reform of the ACA will actually be allowed to come up in the House, let alone the Senate. I don't think there is anyone who thinks the increase in part-time jobs due to the ACA is a good thing. There are at least two or three different ways to fix it, but until both parties are willing to address some seriously needed reforms, we are stuck in a world where our kids will suffer because of the stubbornness of both the Republicans and the Democrats. This is one of those topics where I wish both parties could simply see past the forest to say this particular tree needs to be trimmed, and we will worry about the other trees later when one party gets enough power to adopt some further changes. For now, our kids and those with fewer skills are paying the price.

But it is July 4 as I wrap up this letter, and we are celebrating our independence. From taxation without representation, from overbearing government, from government in some distant locale unconcerned with our local problems and our personal concerns. From a government concerned with its own internal re-election interests rather than with real on-the-ground problems of the people. Sigh.

In any case, it's time to hit the send button as my family beckons and the grill awaits my magic touch.

Nantucket, New York City, Maine, San Antonio, and China (?)

I leave for Nantucket Island next Wednesday for a private conference. I'll be there four days and then on to New York City for a little media and lots of meetings, with a few dinners with friends, of course. Then a few weeks later, my youngest son, Trey, and I will head off to Grand Lake Stream, Maine, for our annual fishing trip at Leen's Lodge and Camp Kotok. This will be our eighth year to attend the gathering and get together with the many old friends who have made this weekend a very special part of their lives. It is hard to believe that Trey was just 12 when we first started going. He has grown up with these guys (and, lately, ladies). I'm sure we will rejoin our traditional fishing duel, which I won for the first time last year (by a rather small fish), but the memories are far more important than the fish.

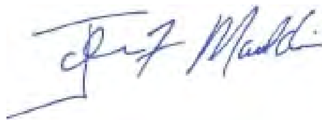
I'm scheduled to speak at a rather intriguing Casey Research conference up in the Texas Hill Country near San Antonio. It is quite the beautiful venue, and they have a rather remarkable lineup of speakers. I have been a regular there for a few years and enjoy getting to catch up with old friends without having to be responsible for the conference. It is really quite the relaxing time for me, and I actually get to sit down and enjoy some of the other speakers. Join me.

I am thinking about going to China sometime in September or October. I know I have a lot of readers in the region, and I would be interested in meeting key people who can give me insights into what is going on in the country. Drop me a note if you can help.

Sunday night my old friend Tony Sagami arrives in Dallas, and we get to spend the next few days together. I'm sure Tony remembers (he doesn't ever seem to forget anything) that we met sometime back in the mid-'80s on the conference circuit. We bonded over sushi and sake and have been blood brothers ever since. We have worked together for years on various projects and have seen our careers intertwine, but the real foundation is a true friendship that has stood the test of time and distance, as Tony keeps traveling to parts farther and farther afield. He now resides (more or less) in Bangkok, but Skype, email, and Facebook keep us connected, and we try to get together as often as possible. He is a remarkably good writer and a very astute investment analyst. I have learned a lot from Tony over the years. Ed D'Agostino (President of Mauldin Economics) is flying in the next evening to oversee a video that Tony and I will do together and will make available to you for free in the next few weeks.

As usual, the Mauldin family gathers just a tad bit late, but we all seem to eventually get in one place, sit down, and enjoy a meal with each other. I hope you are going to have a weekend with family and friends as well. I am off to grill steaks, and then we will watch multiple fireworks displays all over the city from the balcony of my high-rise apartment. (Last-minute note: we counted over a dozen major firework events – very cool!) Not quite the same as being right there, but more relaxed and no traffic getting home. You have a great week!

Your still a little kid who loves fireworks analyst,



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