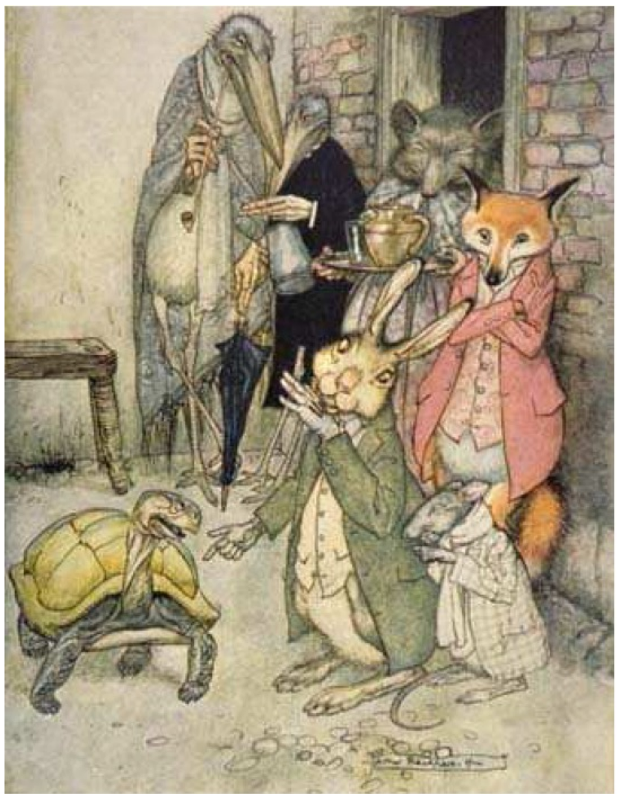
Convexity Maven

A Commentary by Harley Bassman

November 14, 2014

"The Tortoise and the ECB"



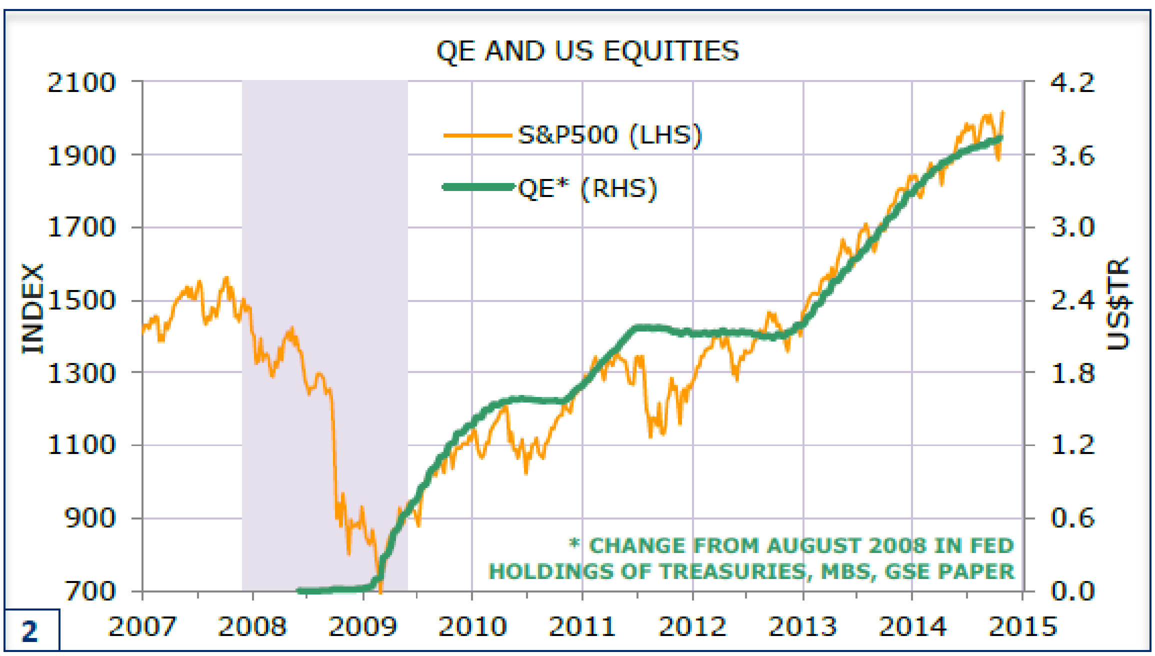
Aesop's Fables, The Tortoise and the Hare, Illustrated by Arthur Rackman – circa 1917

A popular definition of insanity is the act of taking the same action over and over again yet expecting a different result. And so, it has come to pass that the first and third largest economies on the planet have chosen to engage in a massive Quantitative Easing (QE) program as a means to spur Monetary Velocity (via increased Asset Velocity) yet some analysts insist the Eurozone may not follow suit.

As cited in this space in prior editions: The FED has implemented a grand scheme to Increase Monetary Velocity via Financial Repression (ZIRP and Asset Substitution) to create Inflation, depreciate nominal debt, and de-lever both the public and private economies of the United States.

While the philosophical merits of QE are certainly suspect, no one can doubt the results. To quote our former "dear leader" Ben Bernanke: "The problem with QE is that it works in practice, but it doesn't work in theory".

Thus, have we witnessed massive wealth creation via rising Equity share prices. Below we see the -harlequin line- tracing the expanding FED balance sheet seemingly leading the -saffron line- of the S&P 500 to new heights. While one could certainly argue that corporate share re-purchase programs have been the critical impetus for a rising Equity market, all I can say is "tut-tut". Of course, this was the dynamic of how QE would push stocks higher, the fact that it was Corporations instead of other investors effectuating the asset swap is irrelevant. Asset substitution was the entire purpose of QE; it just turns out that the credit channel for Corporations is not as gummed up as the mortgage refinance process is for individuals.

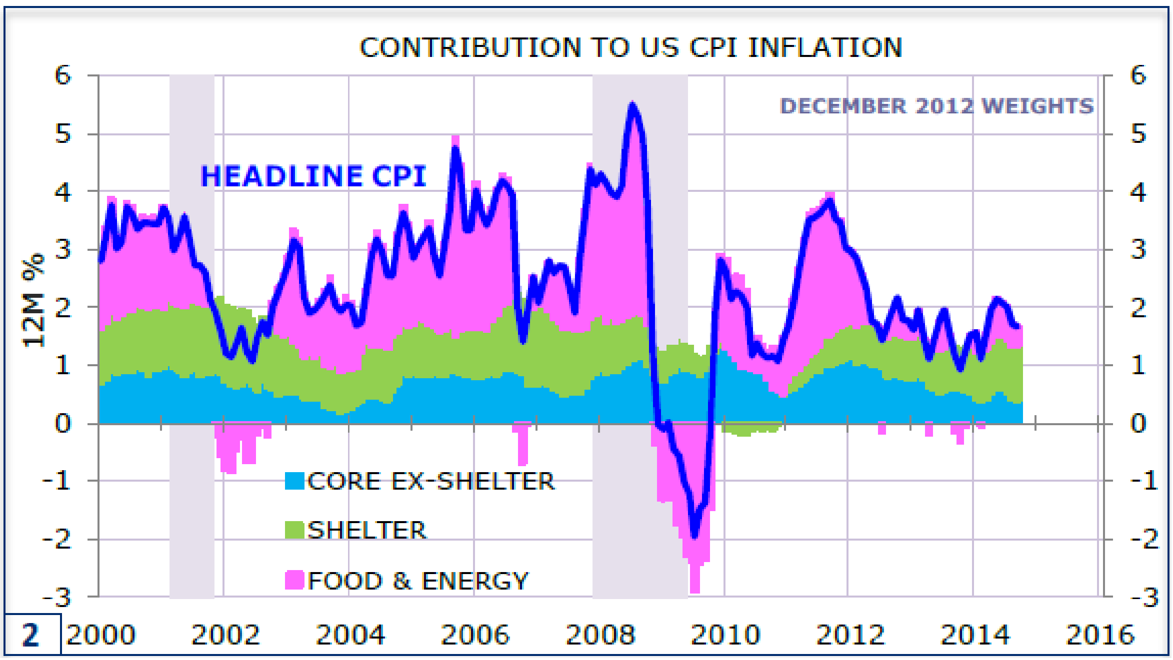


Minack Advisors – Federal Reserve, NBER. Bloomberg

There are many who are troubled by the FED's actions since the funding markets decided that Lehman should "sleep with the fishes", but I have no such qualms. Maybe James Grant is right and we should have followed a similar hands-off *policy* as President Harding did during the depression of 1920-21, or maybe Paul Krugman is correct and the $800 billion Fiscal stimulus of 2009 was completely inadequate for the size of the problem.

But I would retort that the FED recognized the checks and balances of our political system made it difficult to execute a prompt Fiscal solution, and therefore it fell upon them to take the public policy reins.

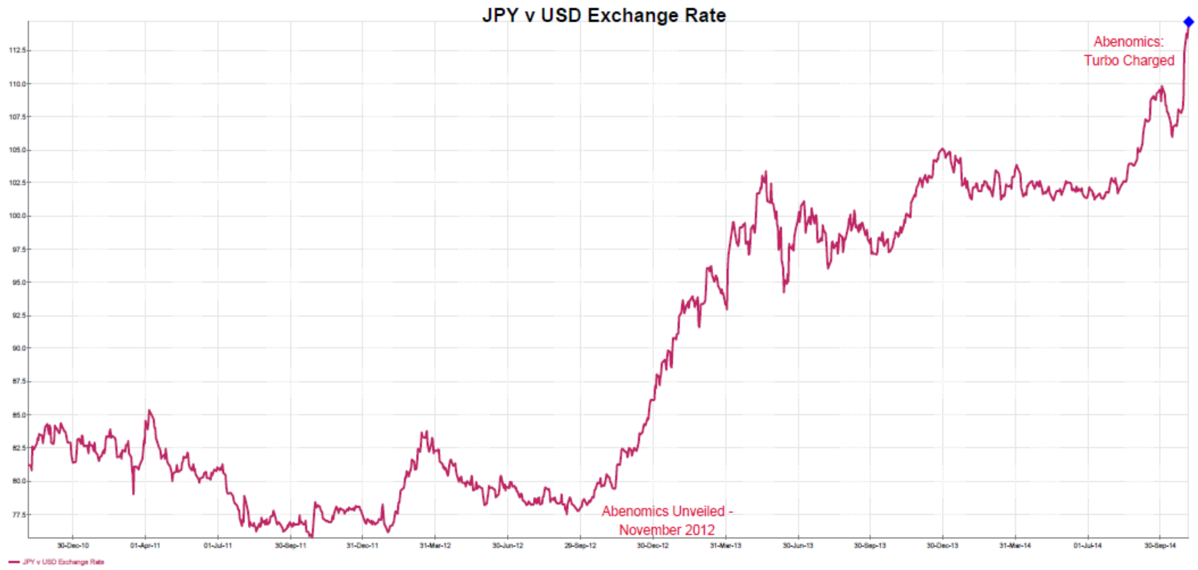
The chart below highlights how the FED's unique abilities to directly impact the funding markets quickly cut short the risk of a deflationary spiral. Away from the pampered 1%, most homes are purchased via a mortgage; as such, the retail mortgage rate will have a greater impact on the price of a house than any other input vector. Notice the -fern shading- that represents the housing component of CPI. It quickly changed direction as the dual liquidity measures of ZIRP and MBS-QE coursed through the market. The stabilization of housing prices may well have been the most important result of QE∞ (infinity).



Minack Advisors – BLS, NBER

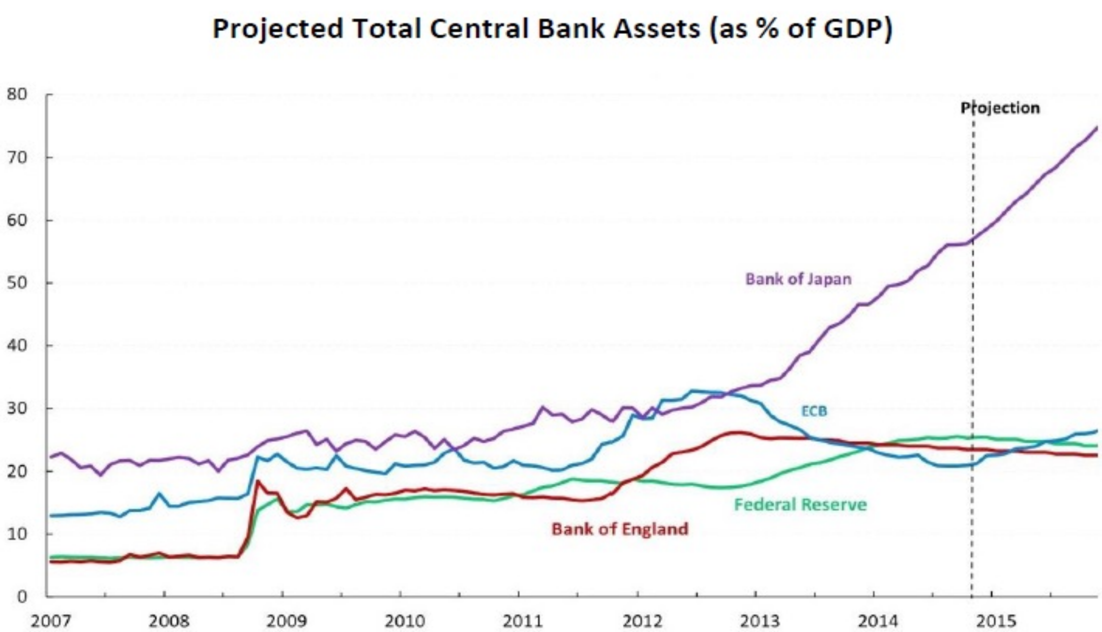
This lesson has not been lost on policymakers in Japan, where residential housing has been in decline for over a decade. The inability of Bank of Japan (BOJ) to break its decade long deflation is NOT proof that a Central Bank does not have the necessary tools to create inflation, but rather a demonstration that they had yet to try hard enough.

This was the entire point of Abenomics, to jolt the market into appreciating that there would soon be "all hands-on deck" coordination between the Ministry of Finance (MOF) and the BOJ to direct the twin barrels of Fiscal and Monetary Policy at deflationary expectations. As shown via the -Nippon line- on the next page, the JPY depreciated by over 25% in the four months after the policy change; and to reinforce the notion that Japanese officials want to encourage Asset Velocity as a means to create Monetary Velocity, the Government Pension Investment Fund (GPIF) will soon adjust their asset allocations and redirect their investment activities to increase their equity holdings at the expense of reduced JGB holdings. One might call this investment "leadership by example".



Credit Suisse - LOCUS

Not to place too fine a point on the fervency of Japanese determination, below is a chart of projected Total Central Bank Assets as a percentage of GDP for the major Developed Markets (DMs) updated to include the expanded parameters of the East Asian version of QE∞.

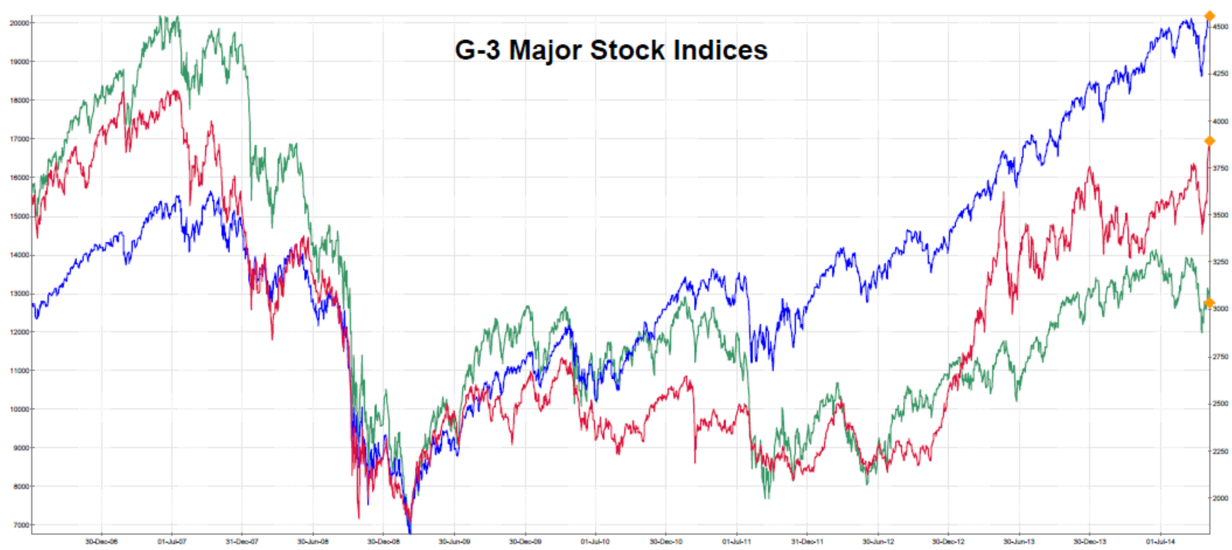


Credit Suisse

A small detail lost in the scale of this chart is the –picton line- representing the Central Bank Assets for the European Central Bank (ECB). Notice it has been declining consistently for nearly two years.

And thus, we reach the main point of this Viewpoint. Expansive Fiscal policy often works internally within a country's economy. Its goal is to revive "animal spirits" via pump priming as enhanced short-term Government spending substitutes for a local dip in private spending. This would be in contrast to aggressive Monetary Policy where the primary goal is to devalue the country's currency to make its economy more competitive externally relative to its trading partners.

This "beggar thy neighbor" policy is not completely independent as it can only be effective to the extent that other countries do not respond in kind. So, it is curious that the ECB continues to slumber while the Eurozone's trading partners dash ahead.
The chart below details the relative price changes for the three main DM Equity Indices since they all bottomed in the Spring of 2009. The -cobalt line- S&P 500 is up nearly 200% since its low while the -pepper line- Nikkei 225 is up 140%. The laggard has been the -asparagus line- European SX5E up barely 70%. More salient, since the beginning of this year, the S&P is up 10.3% and the NKY is up 6.7%, yet the SX5E is actually down 1.6%.



Credit Suisse - LOCUS

Not coincidental is the fact that almost all of the European Stock market's gains came soon after Mario Draghi's 2012 commitment to do "whatever it takes". This is similar to how the market reacted to the balance sheet expansion of the FED and the BOJ. So, we have to wonder how long the Europeans will effectively subsidize the US and Japan via relatively weak policies. For despite the ECB's latest announcement seeking a return of its balance sheet to 2012 levels, this is not nearly enough to offset the actions of the Eurozone's trading competitors.

We would suggest the answer is "not too long", and that investors should consider preparing for a stronger ECB policy by gaining exposure to the asset class that is most sensitive to an expanding balance sheet, namely European Equities.

As noted in the prologue, Asset Velocity is not a goal but rather a path to accelerating Monetary Velocity. Other paths include increasing total Wealth to stimulate spending or reducing risk aversion to accentuate animal spirits, both which would occur under an explicit QE∞. Thus, does encouraging (or more correctly bludgeoning) investors to trade into risky assets at the expense of safer ones fit into the master plan.

Before the FED initiated their version of QE∞, the Dividend Yield of the S&P towered 100bps over the 10-year swap rate (2.60% vs 1.60%); at the same time, the S&P sported a spot P/E of about 16, which translated into an earnings yield of 6.25% and a calculated Equity Risk Premium of 465bps (6.25% vs 1.60%). This is a rather amazing result when one considers that bonds can only return a fixed principal of fiat currency while Equities offer some "real return" protection.

A sharp poke of QE∞ was enough to send the S&P up 40%. Since the start of QE∞, the S&P dividend has flipped to 60bp below the ten-year rate and the Equity Risk Premium has been cut nearly in half. Similarly, in Japan, Abenomics has coincided with a compression of the Dividend to Rate spread from +180bp to +70bp.

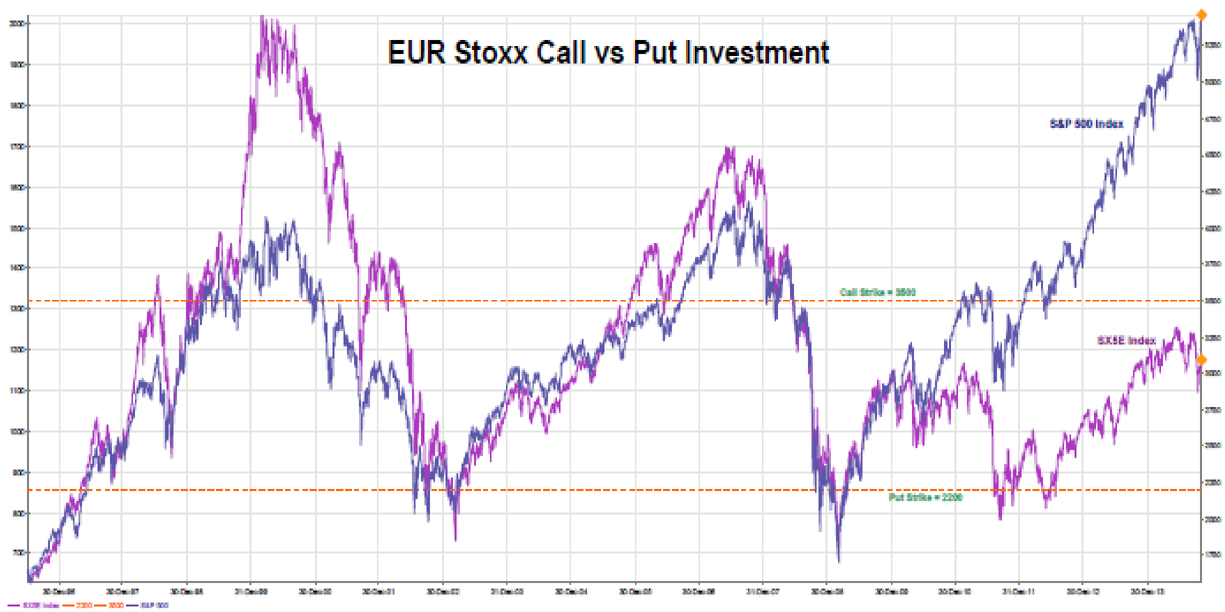
Relative to the US and Japan, the European equity market is a rally waiting for ignition. The SX5E sports a 3.75% dividend versus a 1.05% swap rate creating a +265bp rate differential. And while its 21.5 spot P/E may seem high, the puny EUR rate structure produces a wide +360bps Equity Risk Premium. It will only take a slight push by the ECB to motivate European stocks to follow the other developed markets.

While not a certainty, it seems highly unlikely that the ECB will indefinitely allow its main trading partners to competitively devalue versus the Euro. And since there is no reason to re-invent the wheel, an expansive QE policy that will accelerate Asset Velocity will almost certainly rerate their Equity market.

Sample Trade:

Buy 100mm SX5E December 2019 call; K = 3500; Ivol ~~ 19.50%; Dlt ~~ 0.32
Sell 100mm SX5E December 2019 put; K = 2200; Ivol ~~ 21.00%; Dlt ~~ 0.21
Costless entry at about a Spot Index level of 3075

Below, the -indigo line- is the S&P while the -wisteria line- is the SX5E. The -tangerine lines- mark the strikes of this sample. The value-added proposition is that one can look to purchase a 13.8% OTM call with the funds received from selling a 28.5% OTM put. The downside short strike is not too distant from the lows touched in 2002 and 2011; but the 'killer app" is owning the unlimited upside call option for fully five years. The brilliance here is creating a potentially safer manner to own long-dated leveraged upside.



Credit Suisse - LOCUS

Let's be clear, this is NOT an "Alpha RV" transaction, but rather a full "Beta" investment. Nonetheless, for accounts than can absorb such exposure, we believe this is a vastly superior manner to potentially profit from the day that the ECB finally pulls on its running shoes and joins the race to competitively depreciate its currency.

As such, all we can say is: "Run rabbit, run"

Harley S. Bassman
November 14, 2014