

The Capital Markets Trap

By Jan Dehn

Why is the US VIX index so low? VIX is low because investors are not selling US stocks even when they should due to excessive valuations. Why are they not selling stocks? Ironically, they are not selling because they see investments in the stock market as safer than the alternative of ploughing money into investments in the real economy. This counter-intuitive situation is a direct consequence of the enormity of the bubbles in financial markets in developed countries. Investors know that central banks will step in to support markets if the bubbles collapse, but they also know that policy makers have precious few, if any tools, at their disposal to rescue the real economy in the event of a serious economic downturn. Moreover, the fact that investments in the real economy tend to be far less liquid, even irreversible in some cases only strengthens the case for far more liquid financial assets.

Fear, not risk appetite, is now keeping investors in the US stock market. This anomalous situation has created a condition, which we call a Capital Markets Trap, a financial market equivalent of Keynes' Liquidity Trap. Whereas the classic Keynesian Liquidity Trap refers to a preference for hoarding cash over spending, a Capital Markets Trap describes a special set of circumstances under which investors prefer to 'hoard' financial market assets rather than invest them in the real economy. Like a Liquidity Trap, a Capital Markets Trap is self-reinforcing at a macroeconomic level. The more stocks investors accumulate, the bigger the asset price bubble and therefore the greater the potential damage in the real economy if and when the bubble collapses. In turn this increases the likelihood that central banks step in to support financial markets, thus generating a vicious cycle, whereby investors progressively have fewer incentives to invest in the real economy and progressively push stock prices further into bubble territory.

Numerous incentives also reinforce the Capital Markets Trap at the level of the individual investor. Corporates are obsessed with quarterly results and perceive a better risk return proposition in borrowing to buy back their own stock rather than to invest in the real economy or even expanding their own capital stock. Banks have become so restricted by new regulations that they now stay away from illiquid or lower rated investments and have much smaller prop books. The rise of passive investing, especially in large cap US stocks, means that companies are no longer being rewarded by active investors for making sensible longer-term/riskier investments which increase productivity (nor punished for not doing so).

Worryingly, Capital Markets Traps are fundamentally destabilising, because central bank policies become endogenous to the performance of financial markets due to the paramount importance of preventing financial crashes, which in turn can cause wider economic collapses. In our view, financial asset prices have already been pushed to such overvalued levels that central banks simply cannot tighten policies adequately without causing unacceptably huge wealth and economic losses.

Policy-makers in developed economies are directly responsible for this state of affairs due to their short-sighted regulatory reforms, insufficient attention to supply-side reforms and excessive use of fiscal and monetary stimulus. Be that as it may, now that Capital Market Traps are upon us and given the serious risks they pose what can be done to escape them? Keynes recommended a short sharp fiscal stimulus to break an economy out of a Liquidity Trap. A similar remedy could conceivably break an economy out of a Capital Markets Trap. Unfortunately, developed economies have been running fiscal deficits for so long that their debt burdens are already bordering on the unsustainable. The effectiveness of conventional fiscal stimulus is neutralised or even outright counteracted by high levels of debt because consumers and businesses increasingly associate more and more fiscal stimulus with higher future taxes, even debt crises, such as the European debt crisis in 2001/2012. This in turn makes them hoard even more cash and even more stocks. Modern-day Keynesians, such as Lawrence Summers and Paul Krugman who regularly advocate for more fiscal stimulus, tend to ignore these detrimental impacts which high levels of debt can have on the effectiveness of fiscal stimulus; but no amount of debt denial will make the symptoms of excessive debt – such as slow growth – go away.

A far more effective, but much more painful way to escape Capital Markets Traps is to engineer a truly dramatic increase in productivity. Most developed economies are rife with supply-side problems, including declining productivity, excessive debt levels, rising protectionist pressures and protracted neglect of reforms to cope with the pension and health implications of ageing populations. However, a big jump in productivity would require deep reforms, which seem unlikely in the current populist environment in many developed countries. Indeed, if anything, politicians look more likely to restrict immigration and trade.

If there are no reforms it seems reasonable that fears will persist and investors in developed markets will continue to maintain their allocations to stocks. After all, the main purpose of allocations is to mitigate losses in the event of an economic calamity due to the expected 'put' from central banks. But this also means steadily declining returns given excessive valuations and the sluggish economic backdrop.

What does this state of affairs in developed markets mean for Emerging Markets (EM) investors? In the basic 'nothing changes' scenario the main driver of capital flows will simply be the brutal force of better returns in EM compared to developed economies. Most developed markets bonds now trade with negative real yields and P/Es are very high. Investors in developed markets assets can reasonably expect flat to negative returns in the coming years.

By contrast, EM local currency bonds currently offer more than 200bps of positive real yields with considerable currency upside. Specifically, we expect EM local currency bonds to deliver some 50% return in Dollar terms over the period 2017-2021 with 30% coming from yield and 20% from FX. EM stocks can reasonably be expected to generate some 70% over the same period. We see nothing in developed countries, which can even come close to matching such returns.

EM allocations will find themselves in a tug of war between attractive relative returns at one end and the fears that sustain the Capital Markets Trap at the other. In this environment, the flows will come back to EM at a steady and moderate pace rather than in one big rush. This suggests an orderly outperformance versus developed markets in the years ahead.

What can happen to change this scenario? Barring a growth miracle making developed economies grow from under their debt burdens the only other way to exit the Capital Markets Trap is via inflation and/or financial repression and currency devaluation. But obviously it is going to be extremely tough to generate a growth impulse sufficient to create inflation in a world of cash and financial asset hoarding. Hence, to create inflation central banks may have to induce a shock to deflation expectations. This will require a far more aggressive set of policies on the part of the central banks than we have seen so far. As for the scope for devaluations, these are less dependent on the behaviour of individual economic agents and more dependent on policy-makers. Yet, they too could prove tough to engineer. The Dollar has weakened of late, but fear still makes many investors, particularly central banks, more rather than less inclined to hold Dollars, even if they know that a stronger Dollar only worsens the overvaluation of the Dollar, which is now one of the main reasons for sluggish economic performance in the US. Central banks may therefore have to engage with each other in a far more concerted manner in order to achieve a realignment of global currencies. Sadly, global currency accords require smart and far-sighted politicians, who are in short supply these days.

Appendix: The backdrop for the emergence of liquidity and capital market traps

The economic collapse, which followed the Subprime and Banking crises in developed economies in 2008/2009, gave way to a longer period of weak growth. The outlook remains gloomy.

The weak growth outlook is putting downwards pressure on the velocity of money circulation as consumers and companies hoard cash instead of spending it.

At first banks sought to breathe life into the economy by means of conventional monetary stimulus. Rates were cut sharply, but inflation remained soft as did growth. As nominal rates approached zero it became clear that even modest further declines in inflation could result in higher real rates, which could then weaken the economy yet further and lead to even more hoarding. In other words, the Keynesian Liquidity Trap was looming.

Two solutions were implemented in an attempt to escape the Liquidity Trap.

- First, governments engaged in major spending sprees.¹ The idea behind fiscal stimulus is simple. By increasing demand in the economy stimulus should push prices higher and thus drive down real interest rates, which in turn should stimulate growth. Moreover, fiscal stimulus should, according to some, positively impact 'animal spirits', that is, the willingness of entrepreneurs to put money to work on the back of government contracts. Workers would in turn be hired and investment would pick up to contribute further to demand and thus set in motion a positive spiral of activity to take the economy out of the Liquidity Trap.
- Second, central banks moved beyond conventional qualitative monetary easing by engaging in so-called Quantitative Easing (QE).² The whole point of QE was to drive down long-term bond yields and to push up stock prices. In turn, lower real bond yields should stimulate investment by driving down hurdle rates for corporate investment, while wealth effects from rising stock prices should shake consumers out of their fear-induced spending paralysis.

Sadly, neither fiscal stimulus nor QE has decisively restored economic health in developed economies. To the contrary, in much the same way that zero interest rate policies encouraged hoarding of money rather than pushed up spending, so QE has encouraged hoarding of capital within financial markets rather than pushed capital into the real economy. The result has been an almighty set of bubbles in both stock and bond markets across the entire developed world.

It was likely not the intention of the QE central banks to hurtle developed economies into Capital Markets Traps. The fact that it happened anyway reflects an underestimation of investor and consumer behaviour by central bankers. Investors and consumers took the (sensible) view that monetary authorities would not be able to solve the main underlying economic problems exposed by the calamity of 2008/2009, such as low productivity and excessive debt loads. They also understood that central bankers had – and should continue to have – considerable powers to support financial asset prices regardless of the state of the real economy.³ Hence, the view that ploughing money into stocks and bonds, even if they are grossly overvalued, is less risky than ploughing money into the real economy slowly began to take root.

¹ The US Emergency Economic Stabilisation Act of 2008 authorised USD 700bn to bail out US banks. The Economic Stimulus Act of 2008 then ushered in USD 152bn of stimulus, including tax breaks for low and middle income Americans and finally the American Recovery and Reinvestment Act of 2009 saw USD 787bn allocated towards rebates on business taxes. In 2009, Japan launched a USD 153bn fiscal stimulus and after taking office Prime Minister Shinzo Abe passed a stimulus of USD 250bn. The European Union passed a USD 200bn stimulus plan in 2008 and recommended national stimulus plans in member states of at least 1.2% of GDP. UK alone spent USD 850bn on bailing out banks in 2008.

² Between 2008 and 2013 the US Fed engaged in three separate QE exercises, which, to date, have taken the Fed's balance sheet to USD 4.25trillion, equivalent to more than 22% of US GDP. The Bank of England's asset purchases schemes has seen its balance sheet expand to more than 20% of GDP as of the end of 2016. ECB and Japan have also undertaken enormous balance sheet expansions.

³ Central banks can print an infinite amount of money for buy assets.

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