MACRO Voices
with hedge fund manager Erik Townsend

Simon White: Aftermath of the biggest monetary policy intervention in world history

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Erik: Joining me now is Simon White, cofounder of Variant Perception.

Simon, there is an old saying in finance that sometimes nothing happens for decades and then there are weeks during which decades happen. I think this is one of those weeks.

Monday morning just after 8am this week, we got news that the Federal Reserve made what I think was the biggest monetary intervention announcement in recorded history, announcing unlimited quantitative easing to react to the coronavirus crisis.

It was very, very controversial when QE2 was introduced several years ago. That was a spending program of $500 billion over the course of about eight months. And it was very controversial. A lot of people thought that was just too much and they shouldn't do it.

What the Fed announced this week is, first, they're going to spend more than that this week alone. And they're going to continue spending at that rate indefinitely.

The thing that I think is even more – we could do a whole show about that announcement, but what I think is even more newsworthy is the market's reaction. Of course, asset markets had to jerk higher on the news. That lasted, Simon, less than two hours before the move up in asset prices had fully retraced. Which really speaks volumes, in my mind.

It says that the Fed put has finally expired worthless. Please give us your interpretation of these events. And what are the knock-on effects and consequences as you expect them to play out in financial markets?

Simon: Well, thank you first of all, Erik, for having me.

I think that's an excellent starting question and one that can probably – of course there are many different avenues, but I think the first thing you say is absolutely correct. This is a gargantuan move from the Federal Reserve.

And what, really, this virus has exposed – in the same way it ruthlessly exposes the comorbidities that are existing conditions of people, is it exposed the comorbidities of the market.

So, in terms of broader long-term markets have been on a secular decline – aging societies – essentially, the virus is now just the trigger for the Japanification of the United States and of most of the Western countries.

It also was the trigger for many of the underlying imbalances that all of us probably in the markets knew were building. Essentially, one giant short-volatility position.

So when it comes to the Fed – monetary policy, it's been clear for some time, has been running out of road.

And what happened over the last week is essentially they threw the kitchen sink at everything. And, as you said, even this, in this particular situation, was not enough to salve people's confidence, which has been shaken. The damage done to sentiment over the last few weeks is vast.

And as part of the Fed's facilities, as you mentioned, they've now got QE infinity. They've got forward guidance. I would be surprised if we ever leave the zero-rate regime for the foreseeable future – for many, many, many years.

As a reminder by the way, in Japan, when it went through its seismic shift down in rates, the proximate cause there was the Kobe earthquake in 1995. They responded to that by slashing interest rates much lower. And interest rates have never seen these sort of levels again. That was, obviously, 25 years ago.

Fast-forward to the US. We'll have a similar trigger event. No one knows what it's going to be, but it was vulnerable and markets were fragile to that event. So the Fed has introduced swap lines.

We've been talking to our clients about the offshore dollar-funding pressures that have been building. So far, in that sense, it's not like 2008.

2008 was a broader dollar-funding issue, onshore and offshore. And, thus far, it's primarily been concentrated as an offshore problem. So the Fed has expanded its swap lines to deal with that.

We've had all sorts of the usual smorgasbord of alphabet soup, if you like, of different facilities – commercial paper facility, the money market facility. And this was something that we were watching for, again, as the PMCCF and the SMCCF, which is the Primary Market Corporate Credit Facility and the Secondary Market Corporate Credit Facility.

And these are really seismic moves.

They've managed to get round – not adjusting the Federal Reserve Act. They're in special investment vehicles. But this really is the Fed stepping in straight to investment-grade

businesses and, essentially, lending direct to them.

And I think the one fundamental difference with 2008 is 2008 is primarily a liquidity issue. And therefore the government, or the central bank, could rely on the banks to provide that liquidity to where it was needed, and obviously to themselves that needed it.

This time round, even with all the guarantees, we have a solvency issue. So we have a whole bunch of companies and people, essentially, who money in, money out. And the money in was more than the money out and they could keep things ticking over. And now we essentially have a whole bunch of companies that are essentially now just total liabilities.

In the UK, for instance, we had a loan guarantee scheme. I don't think that will work. Because the banks still have to keep 20% skin in the game. Now, if I'm a bank and a company comes to borrow from me and they say, look, we're losing £40,000 a week (or whatever it might be) and no one really knows how long this is going to go on for, even if I've only got 20% I'm probably not going to lend to them.

So the logical conclusion to this is what the Fed's just done, is you just have to lend to them direct. The same way in the UK – there's no point in the US at a facility where, essentially, the government lends companies money for them to pay their employees. And the workers, they're just going to lay them off anyway and the government has to pay them the unemployment benefits.

In the UK, we just went straight to the shortcut and we're paying them direct.

So, again, momentous changes are happening in front of our eyes. And we're going to be living with the aftereffects for a huge amount of time.

Go back to the credit facility in the Fed. As I say, I think that's a seismic shift as well. But it's also what needed to be done. The credit markets are the most direct link between markets and the economies.

It's when you get these nasty feedback loops developing between the two that you get recessions.

And if the credit markets were allowed to run rampant and allowed to continue to blow out as they were, then that's going to mean the recession is going to be much deeper and longer than anyone would like.

One problem, of course, is all the credit that's been offered to these companies, it's all investment-bait.

So that still leaves high yields, leveraged loans.

Leveraged loans is now a bigger market than high-yield. These aspects of the market are still in the lurch. And, as we speak, we're watching high-yield spreads continue to blow out.

And leveraged loans, they're harder to track because they're very illiquid, which is another major issue with where we've been in recent years. They are considerably under pressure as well.

Erik: Simon, you mentioned recessions. Now, I know you guys at Variant Perception do a lot of work modelling history and evaluating how economic transition changes occur. It seems to me a recession is different from an exogenous shock, which is the way I would describe this event.

Tell us a little bit about that. How do recessions and exogenous shocks compare, particularly with respect to whether the market anticipates them or not?

Simon: Yes, that's a very good question. And obviously, where we are today, very, very relevant. This is obviously a huge exogenous shock that may precipitate a recession.

The way recessions tend to develop – as you say, we've done a lot of work in this – they're not very linear processes. Economies don't go from a non-recessionary to a recessionary state in a linear fashion. It's usually in a highly non-linear fashion. And that's because you get these feedback loops developing between the real economy and markets.

Now, when it comes to an exogenous shock, that's obviously something like a true black swan event.

How markets respond to the two is actually very interesting.

So if you look at previous historic shocks – for instance, if you look at World War I or Pearl Harbor or even the first Gulf War, what you tended to need to see was a material improvement in the exogenous shock before the market actually turned up.

With recessions, however, the market is actually quite happy to front-run the business cycle. Markets are quite comfortable, if you like, with a run-of-the-mill recession where you basically have the business cycle has turned down for one reason – say there has been a housing market blowup – and then you get this recessionary process. And then the market begins to turn up.

So what you often see is the market tends to bottom before the recession is officially deemed to have ended.

But with exogenous shocks, it doesn't work like that.

So in World War I, they closed the market. They closed the market for, I think, nine months. And actually opening the market was the positive exogenous shock. The market sold off for a

little bit after that and then it rallied. And it actually rallied all through the rest of the war, right through into 1918.

Also if you look at Pearl Harbor, obviously that was an exogenous shock in 1941. The market didn't begin turning up until there was a subsequent battle where the first tactical advantage the US got over the Japanese. And after that, again, the market continued rallying all through the rest of the Second World War.

Similarly, in the first Gulf War, in the early 1990s, the market really didn't start turning up until Operation Desert Storm.

But with recessions, as I say, what you always see is that the market tends to turn up beforehand.

Obviously, it might be a moot point right now whether we're going to see a recession. Obviously, the question is how deep and how long the recession is going to be.

But we looked historically at pandemics.

So there's been three major pandemics in the 20th century. Obviously, the Spanish flu in 1918 to 1919. The so-called Asian flu in 1957. And the Hong Kong flu, which was in 1967. And all of these preceded recessions.

Obviously, you never know exactly why the recession happened. Certainly, the one coming out of the end of the First World War, the economy was in a different state back then because of the war.

But certainly the three previous pandemics we've had, there's been a recession that has closely followed.

What's different today, of course, is we've never experienced such draconian response to a pandemic. And that's really going to forge how different the dynamic goes forward.

So where we are today in terms of what's the market fixating on? The market seems to be fixating on the virus itself. And that's one of the reasons why (to your first question, Erik), about why was what the Fed did, why did the market not immediately jump on that?

Obviously, we're up today. But why did the market not immediately jump on that?

And I think what the market really needs to see here is three things, really.

A coordinated response between monetary policy – and, as we discussed, monetary policy has probably now shot all its ammo.

We need to see fiscal policy. And, unfortunately, there still seems to be some disagreement in Congress about getting a proper fiscal package through. We are hopeful it happens relatively soon.

This happened back in 2008, the TARP bill didn't go through (I think) September 28, 2008. But a week later, October 3, it did go through.

But also the third prong of that, there needs to be a real virus coordination response in the US. And that's obviously something that hasn't got so far.

We've had very draconian lockdowns in much of Europe. And so far that's not been the case, certainly on a national basis, in the US. And I think that's what's really needed to be seen before we get any chance of what's going to be a probably intermediate bottom.

Because I think we, given the damage done to sentiment, the chances are now we are in a bear market. And that means it's going to be very difficult to see a proper rise in markets for some considerable time.

Erik: Simon, a prediction that I've made for several years – I just have no idea what would cause it to someday come true – is that eventually – we've been blowing simultaneous bubbles in both stock and bond markets for the last market.

And I thought someday something was going to happen that would cause both stocks and bonds to sell off at the same time, forcing the unwind of the institutional risk-parity trade.

Now, needless to say, risk parity is the biggest thing in institutional finance. If it became necessary for institutions to unwind that trade, the market implications could be just profound in the sense of setting up a vicious cycle that reinforces that selling in both stock and bond markets.

Now, in the beginning of this crisis, it seemed like not only could Treasury yields only go down, but it was just – even for those of us who saw this event coming, we were just shocked at how quickly Treasury yields collapsed.

But all of a sudden they started backing up. And it makes me wonder if we're seeing the beginning of that event where stocks and bonds both sell off, causing yields to back up considerably.

Do you think that could be in play now? And how would we decide and monitor that? What clues should we watch in order to gauge whether that's starting to happen?

Simon: I think that's an excellent question, Erik. And I think it really gets to the heart of the matter.

At the start of this conversation, I mentioned that, really, the virus exposed a number of imbalances within economies and within markets. And, really, one of the biggest imbalances that's been brewing within markets has been this, essentially a short-volatility position. And one of the biggest, most egregious exemplars of that is the risk-parity trade.

Now these guys are essentially vol targeters. And they've been responsible for really keeping the market look like it's calm, if you like. They're creating this illusion of calm.

And that's essentially because they are, to use the parlance, they're long gamma. Which basically means that every time volatility goes down, they have to buy. And as they buy, that means volatility goes down further. So there is this illusion of stability.

But, adhering to the work of Minsky, stability breeds instability. And this has been brewing for several years now.

And the risk-parity strategies and risk-parity-like strategies, they're not insignificant. They're vast. Some estimates put them around about a trillion dollars. And I think some of the more violent down days that we've seen in this selloff have really been the risk-parity guys de-risking.

So, interestingly enough, one of the worst days that we saw over the last few weeks was when the S&P breached 20% on a close-to-close basis.

Now, this didn't happen in December 2018. And if it had have happened, we probably would have seen something similar back then. But we managed to just escape by the skin of our teeth. The S&P didn't quite sell down more than 20%.

This time it did. And we just saw this cascade move taking us right through – we're now, obviously, roughly down 30%. So we're just seeing this very big unwind happening.

You mentioned the bond yields. And that's part of it. Essentially, you have liability matchers, you have mortgage hedgers, and these guys have what's called negative convexity. And essentially what that means is, when bonds go higher, they have to essentially buy more to match their liabilities.

Now, what happened over recent weeks is the safe-haven buying obviously fueled higher debt. And then these guys have to come in.

And every time you've got yields making a new low, you've had them going through that low quite considerably. So, essentially, these guys were short gamma. And that's kind of what's happened. As I say, to use the parlance, if everybody is long gamma it's kind of self-equalizing. You have a stable equilibrium, if you like.

And when everybody goes the other way and you have the short-gamma trade, which means when price moves away from its equilibrium, people have to chase away from that equilibrium.

Stock buybacks is another example of that. That was something that was really keeping the market looking like it was stable. Basically, you had every time the market fell a little bit, these guys were in there always on the bids, always buying. And they support the market. So adding to that long-gamma thing.

And what this really is dependent on – and this is what you mentioned in your question, Erik – is the fact that the stock-bonds correlation over the last 20 years has basically been negative. And that allows these strategies like risk-parity to work. They work in the fact that one counterbalances the other, one asset counterbalances the other.

If you look back over history, stock-bond correlations being negative is an anomaly. Probably over the last 100 years, only 30% of the time have stock-bond correlations been negative.

And this is something we've been writing about, this gradual shift to MMT, which has now overnight become a pretty much very sudden shift. And it's going to help push that stock-bond correlation more and more positive. And that's something that we've been seeing over recent days.

We've had days where stocks and bonds have sold off at the same time. And this is just something that the market is not used to seeing.

And this has very long-term implications. If we're moving towards a more MMT-like world, then there are certain relationships that everyone has got very used to, have come to an end. We're in a different regime now.

The long boom in financial assets will draw to a close and real assets will begin to outperform. Obviously, things like precious metals, things like land, real estate, equities of companies that have access to real assets, certain sectors like potentially industry.

We should also expect to see cross-asset volatility should rise on average and also be subject to much more frequent episodic bursts higher. Because we just don't have these same people, the risk-parity guys, the convexity hedgers, there to stabilize the market like they once did.

And it also means over the longer term this whole leverage game is up. So basically borrowing on a short-term basis, taking on leverage, it's going to become over the next few years a much more dangerous game.

Because the risk of real rates rising is much higher because the risks of inflation rising is now much higher. You have unprecedented amounts of stimulus that's going to hit economies and markets in the coming years. And that's going to have a momentous effect on the markets and how people trade the market.

Erik: Let's just talk about some of the mechanics of how this occurs.

Because what seems at the surface to just plain not make sense here is we had Treasury yields trading on their own before there was any stimulus introduced – lower and lower and lower. We just couldn't believe it.

10-year US Treasuries getting down I think it was 31 basis points was the low. I don't remember what the number was, but really low.

Now we've got the biggest monetary bazooka shot in recorded history. We've got unlimited spending from the Fed. And that's buying up bonds.

Now of course it's lots of different maturities and so forth, but somehow that event has caused Treasuries at least to move up.

So is that [because] all of the buying that the Fed is doing is in other maturities and it's leading people to the conclusion that it has to lead to inflation and that's why the 10-year is backing up?

It just seems unbelievable that there could be so much government money being spent to buy bonds and bond prices are going down on the news. At least some bond prices are. How does that work?

Simon: It's exactly as you say. I mean, we're having to get used to inflation expectations again. For so long, they've been absent from longer-term yields.

If you look at the term premium, which is a reflection of inflation expectation, it's just been driven lower and lower and ever more negative in recent years. That's one of the reasons why the yield curve couldn't steepen.

Even when the Fed was cutting rates – say, last year – we didn't see the curve steepen. Because every time they cut rates, term premium fell as well. And, overall, the curve didn't really do that much.

Now we're in a different regime. Term premium now is going to start heading higher because people are going to start factoring in inflation expectation once again. Because the entire investment universe, the entire structure of the financial world has now changed.

You essentially have governments are going to step in. We're going to see, most likely, true forms of helicopter money. Not pretend helicopter money. Actual handing out checks to people to go and spend. We're seeing the Fed's set directly in to lending to companies.

All these things are going to lead, obviously, to a significantly higher budget deficit and significantly higher debt-to-GDP. And at that point, that's where you have to see inflation expectations rise.

Now, gold (unfortunately) always gets buffeted around, here. It's a bit like a kite in a hurricane sometimes. Because a lot of your risk-parity guys, who we just discussed, their inflation hedge, unfortunately, was gold.

Gold and probably silver as well are not particularly big markets. So these assets got knocked down pretty severely. But if you look at the way they've been trading over the last two or three days, they've been steadily, steadily rising.

And I think this is just a reflection of the fact that we are moving to a different world. Inflation is going to be back. That's not to say it's going to be there permanently. Or that it's going to shoot up drastically higher straight away.

But it means that the tail risks have shifted away from disinflation and deflation, which is essentially what central banks have spent the last 20 years micromanaging. And the tail risks are now going to shift to higher inflation.

So we need to price inflation again. And the whole investment world over the last 20 years was kind of predicated under that fact that inflation was tamed and inflation was never going to be a problem again.

But that's not going to be the case over the next 10-15-20 years.

Erik: Simon, I'd like to lay out my own personal thesis for what I think the next chapter of the coronavirus story is going to look like for the United States. Admittedly, some of this is my own opinion. But I'm really keen to get your reaction, because you guys are so good at thinking through scenarios. And tell me how this might play out in markets if I'm right.

Simon, what I see is the following. On Monday's press conference, all of a sudden Fauci is not present, Birx is not present, and the Trump administration has changed their tune.

It looks to me like maybe Lloyd Blankfein somehow got to Trump and persuaded him it's time to reopen the economy. So Trump makes a bunch of announcements saying, look, we're not going to shut down America. America was not meant to be shut down.

And the reporters start asking him questions. Does Dr. Fauci agree with you on this? How come he's not here? And he was very evasive. He was intentionally saying, well, he didn't not disagree with me. He wouldn't really answer the question directly as to why. It feels to me like there has been a falling out between the medical advisors and the Trump administration members who are more concerned about the economy.

What I'm afraid of, Simon, I've done a lot of research on this virus. I think we're headed down a path where the Trump administration is going to ignore its medical counsel and take us down the approach of we have to save the economy first, we can't shut it down.

I think, unfortunately, that will lead us to a situation where the outcome in the United States is not like Italy but considerably worse than Italy. Because, as much as the situation in Italy is awful, once they realized what was happening, they were pretty darned proactive in locking things down.

The US has taken the opposite approach of making it optional.

And I am very concerned that if the Trump administration continues on the tack that I think they're on, we could have a closer-to-Wuhan level of event in the United States before they eventually realize the errors of their ways and lock things down and follow the hammer prescription from "The Hammer and the Dance" article (which, by the way, listeners, is linked in your Research Roundup this week).

[If you don't have a Research Roundup email, that means you're not registered yet. Just go to MacroVoices.com and click on the red Looking for the Downloads? button.]

Simon, if I'm right, I think what happens is we get a false relief rally because, in reaction to what Trump says is going to happen, everybody thinks, okay, we're not going to have the shutdown after all.

Eventually, it's going to lead to a much deeper shutdown, which is going to damage the economy even more. And I'm convinced do even more damage to markets.

My question to you is, if I'm right about what I think is going on between Trump and his advisors, how far up can asset markets go on the leadership indicating that their intention is not to do this shutdown before the market eventually figures out that the shutdown is happening and will only be bigger as a result of this policy error?

Simon: Yes, it's something that has – obviously, every country is trying to find their own way through this. And I think right now we're clearly in uncharted waters. So no one actually knows –

I know that the UK was trying to steer the middle course, the same way that the US is right now, in terms of trying to delay the onset of more draconian measures, with the belief that you'll only use them when you really need to.

Because if you start too early and you enforce very kind of rigid quarantines, people tend to relax after a while. And that's exactly the point when you don't want them to because that's perhaps when the health service begins to become overwhelmed.

I think what people are now watching quite closely – because, if you like, this is where the virus went global is Italy – and, really, it's to say we don't know. No one really knows how this is going to play out.

But the one thing is I guess that all of us in financial markets tend to trace data, we tend to follow data. And that's something that we can look at and at least have some potentially sort of vague idea about what we think is going on.

So the only thing, I think, that might be mitigating in terms of places like the US and the UK, in terms of assumptions they've used – you mentioned "The Hammer and the Dance" that used an Imperial College paper that is basically what's guiding UK policy right now – and some of the assumptions – we don't know, but I think we have to be aware that every country is different.

In Italy, for instance, the spread may have been greater for a number of reasons. More interpersonal contact, more intergenerational contact. They've got the second highest median age . Also, quite interestingly, if you look at the size of the households.

When you go into lockdown, essentially your R0, your transmission, really it becomes much more important about who is in the household. So you try and limit people's activities outside, then obviously that part of your R0 is less relevant. And the part that's more relevant is how many people live in your house.

Now, in Hubei, in China, the average household has three people, which is quite high. In Italy it's 2.58.

Whereas in the US it's 2.52, slightly lower. But there's a big range there. So in Utah there's 3.12 all the way down to Maine which has 2.18 people. And the one that's kind of worrying to me is California is quite high – obviously California being the most populous state – 2.96.

So we have to see exactly how that plays out. The strength of the quarantining needs to be more serious, more aggressive if you like, in the places that have a higher household number. Because the WHO estimates that in China, 80% of transmission after lockdown came from households, from people in the households.

So how it's going to play out in different countries is, I think, going to vary. And that's something that will become very apparent in two weeks.

And I think we're all hopeful, we're all on the same page that we just don't want to see it get into the Italian stage where what happens is, once the health service becomes overwhelmed, then your death rate rockets up. Not purely because of the disease itself, but because anyone in a fragile state, whether they have COVID-19 or not, suddenly becomes hugely more vulnerable.

So I think as far as the market goes, it will be keeping a close eye, obviously, on what happens in Italy, and the UK, and the US.

But I – going back to my exogenous shocks analogy – yes, I think we need to see a material

improvement before the market can actually have any chance of bottoming. And the problem with this sort of exogenous shock is no one really knows how long it's going to go on for.

And, in that sense, we're really in bear market territory. Because in bear market territory, people's confidence gets shot so many times. We see so many rallies, and the rallies in bear markets can be massive.

I mean, in the 1990s in Japan, we saw 30% to 50% rallies. But it ended up being nothing and the market reversed.

So bear markets do a huge amount of damage. The average bear market length in the US is 18 months and the average decline is 42%. I think we're at roughly 30% now but, in terms of timeline, this has happened very, very swiftly.

So I think we're in agreement, Erik, in terms of if there is going to be some sort of bottom, there's a good chance it's an intermediate bottom. The real bottom comes when everybody has tried to buy the market, they've been massively disappointed, and we get to the point of revulsion. You won't touch the market even with a full hazmat suit on.

And that's the point where you really want to buy the market. But it does feel like we're a long way from that just yet.

Erik: Well, I strongly agree with you on that. I don't think that we're anywhere close to the final bottom. What I'm starting to think is that we're maybe at the beginning of a significant bear market rally, driven by what seems to me to be a change of sentiment in the Trump administration, that they're going to maybe not pay as much attention to the medical advisors and focus more on the economic advisors.

And I fear that that is going to be a very fatal strategy. But it could allow markets to correct up on false hope considerably from here.

Simon, I can't thank you enough for a terrific interview.

Before I let you go, for any listeners who are maybe not familiar with Variant Perception and what you guys do there, tell us a little bit about the firm and the services that you offer.

Simon: Thanks, Erik. Yes. Variant Perception, we've been around for about 10 years now. We really emphasize the fact that we have a data-driven approach and we sort of take the outsider perspective to stuff.

So, rather than us trying to pretend to be experts in X, Y, and Z, we really take a very agnostic approach to markets and to economies and use that to really come up with some of the best ideas.

We have many subscribers across the whole gamut, from asset managers to hedge funds to high-net-worth individuals. And we write regular reports and we also have regular contact with our clients. Really, we're trying to really help them try and find the best trading ideas.

So if you're interested, have a look at our page, variantperception.com, and you can sign up for a trial there.

Erik: Fantastic. We look forward to getting you back on in a few months for another update. Patrick Ceresna and I will be back as MacroVoices continues right after this message.