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# A False Sense of Stability

November 2018 by Peter Cecchini

John Nash, "Over the Top" (1918)

*"Stability breeds instability."*
**— Hyman Minsky's Financial Instability Hypothesis**

*"Look out below when fiscal stimulus dissipates and there's nothing left to support risk."*
**— Cantor Fitzgerald**


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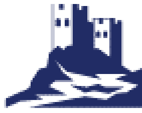


## Takeaways

- It's a matter of *when* rather than *if* – the **Minsky moment** is becoming more palpable. The stability caused by a decade of central bank financial suppression has led to the unintended consequence of creating a fragile global financial system – one more vulnerable to shocks. The most likely shock is to be one of central banks' own collective design.

- The **relationships amongst markets** are often 'reflexive.' Right now, the Fed is likely to stay the course and raise rates into 2019 based on domestic economic health – largely fueled by the impact of misguided and temporary fiscal policy – at exactly the same time the rest of the world slows. The feedback from the global slowdown, which has ironically been caused by higher U.S. rates, will bleed back into the U.S. economy by mid-2019.

## Overview

Hyman Minsky wrote eloquently about how **stability** (especially when managed by central authorities) breeds instability. Nassim Taleb has taken that concept and reframed and expanded upon it in his book *Antifragile: Things That Gain from Disorder.* Stability has been imposed upon markets through the globalization and coordination of rates policy that (until just recently in the U.S.) had overstayed its welcome. The rest of the developed world and China are still largely reliant upon it, with the U.S. the only important economy to have positive real rates.

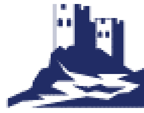
Said differently, **negative real rates** globally, as a product of both traditional and extraordinary monetary policy measures, have been responsible for the lack of financial asset volatility. For this reason, a potential **change in the rates regime** has been the focal point of our narrative for most of the year. In fact, we expected rates volatility early in the year to cause a pullback in U.S. equities and emerging markets while also acknowledging that U.S. equity markets had fundamental tailwinds. Specifically, we'd called for a S&P pullback to 2,500 followed by a rally to 2,865. This proved fairly prescient.

Quite clearly, the recent selloff is a function of **policy normalization** and accompanying rates volatility. Just three weeks ago, the question might have been when will we see rates impact equities more dramatically? Well, recent market action has answered that question.

We wrote earlier in the year: "When monetary policy overstays its welcome, it becomes self-defeating: prices fall as idle capacity comes on line [to meet new demand]. It also becomes self-perpetuating; a lack of pricing power forces central banks to keep rates low." This is why the Fed has been so preoccupied with the concept of a lower neutral rate.

It's really not so complicated. Unnaturally low rates – especially unnaturally low long-rates – have lowered hurdle rates for companies. As a result, they engage in activities that depend on low rates to earn a profit. This results in overcapacity, which is a common ingredient for eventual company defaults as rates rise.

In early October, **Fed Chairman Powell** confirmed his optimism on the U.S. economy during his interview with PBS's Judy Woodruff when he said that "there's no reason to think this cycle can't continue for quite



some time, effectively indefinitely." He characterized policy as still far from neutral. In our view, the Fed is likely to stay the course and raise rates relatively aggressively into 2019 based on domestic economic health – largely fueled by the impact of misguided and temporary fiscal policy – at exactly the same time the rest of the world slows.

We believe the feedback from the global slowdown, which has ironically been caused by higher U.S. rates, will bleed back into the U.S. economy by mid-2019.[1] This external slowdown will be accompanied by the burgeoning roll over in U.S. housing. (The subject of our next note).

Until recently, **U.S. sector dispersion** picked up due mostly to moves in the public REITs and homebuilders, which tend to suffer directly when rates rise. Broader indices managed to hold up due a rotation out of these sectors and into others. In early October, sector rotation stopped, and correlation began to pick up.

Until recently, volatility markets had continued to look fairly complacent. Early in the year, **global dispersion** also picked up as stresses continued to present in various economies in plodding succession, including India, Brazil, Indonesia, etc. Just as in the U.S., global dispersion has now become correlation.

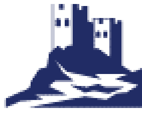
This is an unhealthy sign. We became increasingly concerned for U.S. equities in April, which is why we lowered our S&P target from 2,865 to 2,805. We stubbornly maintained that target in September at a level well below consensus even as many of our peers raised theirs as the market surpassed its late-January high. We maintain this target on what we think will be a hard bounce.

## Conclusion

**Global central bank balance sheet** growth has stalled in dollar terms and is now collectively flat on the year. This may be a bit deceiving because China's RRR moves are not captured, but nonetheless central banks are clearly far less accommodative.

Market participants have been lulled into a trance by 'fake news' based on temporary U.S. fiscal stimulus and the strong U.S. data it is producing. Like a bodybuilder on the wrong side of a steroid cycle, the U.S. economy will struggle if Congress exercises even a modicum of fiscal restraint. When U.S. consumers feel this good, it's rarely a good thing. Even companies are beginning to revise down estimates far faster than analysts. Look out below when the fiscal stimulus dissipates and there's nothing left to support risk-on.

That said, while the Minsky moment is nearer, we'd suggest it's not yet time for disaster. Risky credit markets in the U.S., in particular, have not responded to rates for various reasons. These reasons include low default rates, lack of a maturity wall until 2020, and little supply in the high yield market. While high yield CDX has widened to level we suggested earlier in the year (390bps), it still remains tight. **Despite this strategically bearish view, more tactically, we'd suggest its time for a rally – credit markets remain open and funds are likely to chase returns into year end. But, make no mistake, this is now a sell-the-rally market.**



*[1] We've consistently spoken about how higher U.S. rates lead to capital flight from emerging markets (EMs) in favor of higher returns from risk-free U.S. assets. This forces EMs to raise rates, which results in slower growth and even recession. India is in that position right now.*

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