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JORDI'S JOURNAL

Timely thoughts & musings on the financial markets

TIME TO PROTECT AGAINST THE NEXT PUNCH: THE REVENGE OF GLOBAL DEBT

By Jordi Visser, President & CIO

In March 2021, I wrote a paper titled "Lesson Learning is a Never-Ending Process." When it was published, YoY CPI had just come out at 1.7%, and the focus of the markets was the Fed being on hold through 2023. It was surprising to me that investors were complacent about the Fed remaining on hold despite rising inflation and a rapidly improving jobs market already showing shortages. I outlined why the Fed should begin resetting higher rate hike expectations so that they did not fall too far behind the curve, given the historic amount of stimulus injected into the system. This is an excerpt from the paper:

"Given that investors seem so dogmatic in their views that the Fed will not move regardless of the coming economic strength, I wonder if, instead, the real risk is the Fed does not move despite record economic strength and the market decides this is a mistake. This would not be the first time the market told the Fed or a government that they were making a policy mistake. For example, in December 2015, the Fed raised rates despite oil having fallen almost 40% in the prior 6 months and the S&P 500 proceeded to fall 12% in the following 8 weeks. The Fed took note and did not raise rates again until December 2016. This sounds simple, but the pressure point to watch is the unemployment rate. Remember that it peaked during the Great Financial Crisis

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at roughly 10%. When the Fed first warned about tapering, the unemployment rate was around 7.5% and it was near 5% when the Fed first raised rates in 2015. Comparatively, the unemployment rate peaked at 14.8%, though it is already down to 6.2%. If it continues downward to 4% over the summer—and I think this is likely—there is a risk that we are underestimating how the market may react. In this scenario, my guess is that rate volatility would rise significantly on the uncertainty of the Fed's potential response. In turn, the rate volatility would have an impact on credit spreads and equity risk premium. I leave you with the famous quote from Mike Tyson, who said that everyone has a plan until they get punched in the mouth. There are unknown outcomes on the probability distribution and, from my experience, if the consensus is all agreeing, prepare for a punch to the mouth."

Beginning in November 2021, when Fed Chairman Powell started to pivot from the "transitory inflation" mantra, we entered the expected process of rising rate volatility leading to widening credit spreads and increasing equity risk premium. More than a year removed from the dogmatic view that the Fed would remain on hold through 2023, the view has shifted to the belief that the Fed will raise rates in a more aggressive manner than is already priced into the markets to fight inflation. Over the last few weeks of hearing market participants' 2H2022 economic outlooks and probabilities for asset prices, I feel we are again at a point in time to remind all of us that lesson learning is a never-ending process.

Before we get into the what and why, I want to go back to another paper that I wrote in December 2020 titled, "The Year of Speed Chess and the Birth of Bitcoin as an Asset Class." Aside from my view on Bitcoin, this paper focused on exiting the pandemic and adapting to markets that would look more like speed chess than traditional chess. That was because we had just put a historic amount of global stimulus into the system, and we should expect movements in assets in the coming years to be more volatile where days would feel like weeks, months would feel like quarters, and quarters would feel like years. Here is an excerpt:

"For 2021, I think what stares us directly in the face is a need to think about a repositioning for a world of unlimited money. Some of it will be centered around a continued strong move in commodities. Given the speed seen this year and unexpected events, I would follow the advice of Winston Churchill and Steve Jobs and think in terms of three months at a time rather than annually.

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Adapting to a speed chess market requires new tools and shorter reaction, decision making, and measurement periods. This environment creates opportunities for behavioral alpha. Given the tension between growth or value in a world with extreme valuation volatility, expect to see explosive moves one way followed by sharp retracements the other way. This game of speed chess is much faster than the game based on mathematical valuations and is necessary to be present, self-aware, and ready to change your mind – even in the face of seemingly 'irrational.'"

This year has moved incredibly fast across asset classes, requiring rapid decisions to avoid trouble. On the first day of trading for 2022, the expectations for the Fed funds rate on the day of the December 2022 meeting were less than 85 bps. At the peak this May, they had reached near 2.9%. The abrupt change by the Fed forced the markets to adapt in a historic manner. At the close on Friday, May 20th, the S&P 500 Index (SPX) was down 18.14% YTD before dividends. At the same time, the YTD return for the Bloomberg US Government/Credit Bond Index (AGG) was down close to 10%. For the SPX, there are only three years in the past 80 years that finished worse than 18% for a year. In terms of the AGG index, there have been only five other years since 1973 where it closed the year down at all and the worst year before this was not even 4%. In each of the three prior years that the SPX was down more than 18%, the AGG index finished positive.

On May 4th, Former New York Federal Reserve President Bill Dudley said to CNN,

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"What's happening right now is exactly what the Federal Reserve wants to happen......They want a weaker stock market. They want higher bond yields.......... The stock market I think is finally catching onto that."

These types of words are not something we have seen from the Fed during times of asset falls which is why people are now talking about a world without a Fed put. However, Bill Dudley's line that he thinks the "stock market is finally catching onto that" may lack compassion for the average American feeling the pain in their retirement nest egg. The stock market is not an index that solely represents the wealthy in the country. 89% of Americans with an annual income of at least $100,000 and 61% with annual income above $40,000 own stocks. They also own bonds. Using a proxy index of consumer net worth and incorporating the fall YTD in both bonds and stocks, as of May 20th, I estimate consumer net worth to have fallen by more than 10 trillion dollars YTD. This would be worse than the entire fall for all of 2008 during the Great Financial Crisis.

The asset class in consumer portfolios that is still positive for now is housing, as prices have continued to rise. However, 30-year fixed-rate mortgages have risen over 200 bps YTD, reaching levels not seen since 2008. The most recent housing data has shown weakness driven by declining housing affordability. The rise in mortgage rates will leave the days of refinancing your mortgage at lower levels as likely over. At the same time, in a similar impact to corporations, for only the 5th time in the last 30 years, the current yields on investment grade debt have surpassed the current average coupons on that debt. Corporations that had already been struggling to survive during the period of low rates since the Great Financial Crisis are going to feel it. The days of refinancing debt at lower levels have entered a new world.

Last year at this time, it was clear the Fed was willing to risk being behind the inflation curve. In my opinion, because of comments like Bill Dudley's and the subsequent reaction of investors' expectations, the Fed has done more than enough. Since February, I have openly talked on podcasts and webinars about hitting peak inflation. Now that we have seen a significant rise in rates and a decline in asset prices, I think the risk has now shifted to one that both the Fed and those worried about inflation have forgotten: The Global Debt bubble.

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It was not that long ago that in periods where economic growth was slowing and assets were falling, the number one risk everyone would be talking about was the global debt bubble and the fears of a debt unwind. This time though, partly because of the inflation data, partly because of the Fed's commitment to fight it, and partly because of macro managers beating their chests that central bank-driven markets are back, the debt overhang has been forgotten. The one thing we know for a fact that has proven not to be transitory is debt.

"In 2020, we observed the largest one-year debt surge since World War II, with global debt rising to $226 trillion as the world was hit by a global health crisis and a deep recession. Debt was already elevated going into the crisis, but now governments must navigate a world of record-high public and private debt levels, new virus mutations, and rising inflation." -IMF, December 15, 2021

The inflation in the world today was mainly due to the unprecedented monetary and fiscal response to the global pandemic. As the above excerpt from an IMF article in December 2021 said, that response was financed through the largest global debt increase in the last 50 years during 2020, which increased further in 2021. According to the IMF, at the end of 2020, global debt as a percent of GDP reached 256%. Public and non-financial corporate debt each reached about 100% of GDP, and household debt comprised the balance of the 256%.

It appeared the central banks had chosen to reflate their way out of the debt bubble. From March 2009 to December 2020, the SPX reflated to the tune of over 17% a year total return with an average YoY CPI of less than 2%. However, this time, YoY CPI is currently above 8% and the SPX has returned an annualized 4.7% since the end of 2020. While Bill Dudley may say the Fed does not care about the stock market, deflation is not an option at this point of the debt accumulation cycle.

What I keep hearing from the few with confidence in the markets is that this period most resembles the 1970s, and we should expect a Volcker-like response from now until inflation expectations are under control. Aside from the technological deflationary trends over the past 40 years and the temporary nature of the delayed reopening from a global pandemic, the significant difference in how hard you can fight inflation this time is the global debt.

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Throughout the 1970s, global debt as a percent of GDP sat near 100% for the entire decade. Now, both public and non-financial corporate debt are just below 100% of GDP, leaving the world in a position where asset deflation is not an option for very long. At the same time, the aggressive movements by the Fed this year have led to a significant strengthening of the US dollar. Given the high percentage of global dollar debt and the high percent of dollar foreign exchange reserves, a strengthening dollar adds to the deflationary pressures.

Since April 2020, every webinar, podcast and paper from me has been focused on adapting to a post-pandemic world of structurally higher inflation. I don't want anyone reading this to think I am abandoning that belief. Packed within this belief, I believe we will be in an environment where real rates remain negative for the next five years. For this point, my view is not centered on inflation expectations but on interest rates remaining well below actual realized inflation.

My first lesson learned on managing money occurred in December 1994 when I traded Mexico for Morgan Stanley. The lesson was that the pendulum shift from inflation to deflation could be short and violent in emerging markets. Before the Great Financial Crisis, the inflation-deflation pendulum shifts in developed markets were slow-moving. With the rapid expansion of debt and movement to negative yields leading into the global pandemic, we should all expect the pendulums to be more similar to those I experienced in the 1990s in emerging markets. With the rapid rise in rates and the dollar, combined with the historic fall in assets, I expect the pendulum to shift away from inflation as US economic data is weaker in the coming weeks. A shift towards deflation and away from inflation, to me, is the catalyst that is necessary to cause investors to need to bob and weave as markets remind everyone to not be caught flat footed for a punch in a world where things change much faster these days. I have said it in my webinars and podcasts, but let me write it here as well: I think by the end of the year in this new world of speed chess, the SPX will finish the year up because for the first time ever, the global debt bubble will serve as a positive catalyst.

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ABOUT WEISS:

More than a market neutral pioneer, Weiss invests in people, partnerships, and a purposeful future. Our mission is to make our expertise in alternatives universally accessible. Jordi Visser is the President and CIO of Weiss. He joined the firm in 2005. Previously, Jordi was the founding Managing Partner of Anchor Point Asset Management, a global macro fund. A former Managing Director at Morgan Stanley, he traded various global equity derivative books for nine years. He opened the Morgan Stanley office in Sao Paulo, Brazil, and managed the derivative sales and trading effort there during the 1997–1998 emerging market crisis. Upon his return to New York in 1999, he managed index derivatives and ETF trading and was a member of the Equity Division Risk Committee. Jordi is a magna cum laude graduate of Manhattan College and a board member of the School of Business at Manhattan College.

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