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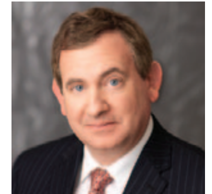

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Those Who Make Peaceful De-leveragings Impossible, Make Violent Ones Inevitable

The Duchess of Windsor whimsically remarked that you could never be too rich nor too thin. Modern central bankers have similar sentiments surrounding the bloat in their balance sheets and skinniness of their policy rates. While abundantly accommodative policy has catapulted the price of risk assets, the rising tide of asset prices has not, as was intended, lifted all boats. In short, capital market pricing has disconnected from economic fundamentals. Are we to assume then that the fundamentals will catch up? Or is the prudent investor supposed to start pruning risk from his portfolio?

A good starting point for a discussion is to restate the obvious: the Fed implemented extraordinary measures as a crisis management tool, yet now seems to lack institutional conviction as to when to normalize rates. Initially, zero rates were supposed to end when unemployment dropped below the 6.5% "trigger"; that "trigger" then became a "threshold" and that "threshold" then vanished into the policy ether even as unemployment metrics continued to improve. Unwilling to declare victory and withdraw, it's as if the Fed has forgotten the proper role of interest rates. Namely, that rates serve the role that prices do in any market, i.e., to ensure that scarce resources are put to their highest, best use. Artificially low rates mean that improperly qualified borrowers obtain loans and then use their newly acquired funds to "bid" resources away from those who might employ them more productively. Along the way, leverage accumulates, increasing financial risk and market volatility. One doesn't have to look too far or search too long to see the signs of building financial excess: issuance of covenant-lite loans have dramatically expanded, share repurchases have become a key driver of stock market valuations, and short maturity interest rates remain in negative real territory. To date, these imbalances have elicited mostly yawns from Fed officialdom, who (improperly) use inflation as the key metric in terms of assessing whether or when to tighten policy. Why raise rates, goes the thinking, when prices are tame and labor still slack?

Unfortunately, the thinking is specious. Does low inflation make the economy immune from financial de-leveragings and economic downturns? Obviously not, as the experiences of the housing meltdown (2008) and the recession of 2001-02 have shown us. A central bank that ignores credit market excesses, preferring to believe that it can dial up or down whatever level of wage growth or unemployment it considers optimal is a Fed that does not understand its limitations.

A central bank can expand credit and accrete aggregate demand. Yet, if growth were a simple problem of credit and demand management, we wouldn't be having this discussion today. If wealth followed in the wake of money printing, then Argentina and Zimbabwe would be members of the G-20. Or, consider the Eurozone, one central bank but 18 countries – some with Great Depression levels of unemployment (Spain, Greece) and others with fully employed labor forces (Germany, Austria). This disparity in the relative performance of one European nation's labor market versus that of another cannot be explained by interest rate

policy: rather, it's attributable to the relative competitiveness between states. In a global economy, those nations, businesses, and workforces that offer what the consumer wants at the price he is able and willing to pay, capture their "fair share" of global demand. Alternatively, nations that inefficiently deploy their productive resources end up with disappointing wage growth and painfully high unemployment. The Fed can boost aggregate demand until the cows come home, but can never *direct* nor *predict* which nations or workers will be the beneficiaries of the Fed's largesse. If American producers are not the most globally efficient suppliers, then the additional demand "manufactured" by the Fed slips right through the fingers of the U.S. supply chain. The continued stagnation of wages and falling rates of labor force participation suggest that the Fed's policies can't be effective absent a more competitive domestic economy; worse, such policies elevate financial risks by incentivizing leverage.

Artificially low rates provide a subsidy to current period activity and the Fed, recognizing this, is loath to pull the plug on zero rates. Their reluctance is understandable: since low rates have enabled activities that would not survive a rate rise, such a re-normalization of rates will necessarily be painful. Rising rates would price out marginal borrowers and so crowd out marginal activities. Default rates in the corporate and high yield loan market would rise, pushing risk premia wider. Higher capital costs would also have a dampening effect on asset prices generally. Hence, a Fed-led renormalization would "accomplish" what it always accomplishes: excesses in credit would be corrected at the "cost" of lower asset prices and, unfortunately, higher unemployment. Then why do it?

Because there are no free lunches. The Fed may prefer not to look too closely at an even expanding cohort of questionable loans, but "kicking the can" only means that the inevitable de-leveraging will be more painful. A central bank that constructs its policies predicated on the exigencies of the here and now while ignoring the longer-term ill effects of these policies is an institution in denial. Sustainable growth – whether a household, business, or a society – is a result of improvements to work process and product. The mere act of adding leverage to a business does not improve the efficiency of its factories nor do higher home prices increase the wages of the household that resides in the home. The Fed can multiply the quantity of funds in existence, but such an increase does not add to the nation's capital stock, enhance the skill of its labor force, nor expand its access to natural resources. The game of "pretend", then, ultimately has to end. For the investor, the question that matters is when and how.

When the endgame comes, leverage will be forced out of the system and asset prices will fall. If the Fed is willing to recognize that, in the end, its policies cannot dictate economic realities, then we should expect the rate rises to begin fairly soon, presumably in 2015. Such a path of pro-active and controlled de-leveraging means that while the pain will come sooner, the severity of such a de-leveraging will be relatively muted. Alternatively, if the Fed is unwilling to remove the punchbowl, then we can expect an environment that is more of the same until, of course, it is the capital markets themselves which call the "code red" and catalyze the de-leveraging. In that event, expect a "violent" de-leveraging. All investors should remember the words of John F. Kennedy that those who make peaceful change impossible make violent change inevitable. Will the Fed heed the friendly advice?

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