Global Monetary Viewpoint

MONETARY SCENARIOS

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Executive Summary

Haven assets have been rising and most recently falling in line with the perceived course of the Xi-Trump “trade war”.

Stories about the trade war are a lead economic narrative, even though its overall importance for business cycle prospects is wildly exaggerated.

Robert Shiller, in his new book, “Narrative Economics” provides key insights into the disease-like nature of narratives.

The concepts of safe haven assets and economic narratives are the subject of this viewpoint, with implications for asset allocation. Read on!

At the same time as the latest presidential tweet pointed to trade talks resuming with China, more important could be how the US President seeks to conclude pre-election deals elsewhere on the geopolitical stage.

Safe Havens and Narrative Economics: two concepts now driving markets

A main story line of late in global markets has been the rise and fall (or fall and rise) of haven asset prices.

By way of illustration, a US presidential tweet late last week, indicating that “trade war risks” have subsided somewhat, triggered a powerful “algorithmic” dominated selling of so-called “haven assets” – a broad brush term now including gold, yen, Swiss francs and long-maturity Treasury bonds.

Besides the tweet, there were also thickening rumours, based on diplomacy in London (meeting between US defence secretary and Israel PM) that President Trump is preparing to meet Iran President Rouhani – indicating a potential détente between Washington and Teheran. Hawk John Bolton (National Security Advisor) is said to have fallen out of favour.

Peace in our time ahead of Election Day

The hypothesis circulates in the marketplace (and beyond) that the US President is desperate to demonstrate deal progress on several geo-political fronts (Iran, Afghanistan, North Korea, China), ahead of the 2020 US elections, whilst keeping clear of new foreign military engagements.

The foes of the US know this only too well.

Accordingly, as haven asset prices decline in expectation of “peace in our time deals”, so risk-assets (those which gain from good news) rise in price – including most notably equities, high-yield credit, and in currency markets, both the Canadian dollar and Australian dollar.

We should not regard these as trends but the drama of day-to-day trading where often the bigger picture (including the deceptions of apparent deals) and bigger forces lose due proportion.

Real progress towards reducing the Iranian menace – and alongside rolling back Beijing’s military and economic “aggressive

behaviour" - would be cause for some serious and lasting decline in haven asset prices (at least, in principle, and all else the same), though market investors, like others, might remain dubious.

In practice, anyhow, the decline in haven asset prices in recent days appears to have been dominated by China-US tariff war news (talks to resume) fairly superficial in scope, underpinning the need for caution in interpreting such observed market behaviour.

Source: Bloomberg

Xi-Trump trade war – a flawed narrative

There is no denying the power of the Xi-Trump "tariff war" to determine market price movements in a big way at least over short periods of time. That is despite widespread scepticism (not just in Global Monetary Viewpoint) about its overall importance to the path of global prosperity.

It is far from obvious that the US economic "counter-offensive" against China, and any possible intensification, should be described as a "bad state of the world". For now, however, market dynamics are programmed to treat it as such.

This is an example perhaps of what Professor Robert Shiller would describe as in fact weak narratives (based on inaccuracies and sloppiness) which become strong and viral, due to their capacity to inflame flawed mental processes in a contagious process.

Robert Shiller and narrative economics

That is the subject of Professor Shiller's new book "Narrative Economics".

The hypothesis there is that narratives spread by contagion in a way similar to the spread of disease. Shiller deciphers and explores the factors which empower this spread. The key to

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spreading is that contagion occurs more rapidly than recovery - people becoming cured of the virus.

Shiller's principal concern is to analyse and even predict how narratives can go viral.

Some definitions:

An economic narrative is a contagious story that has the potential to change how people make economic decisions.

Narrative economics is the study of the viral spread of popular narratives that affect economic behaviour.

Shiller identifies Keynes as a "narrative economist" – whose huge talent for writing polemics and the celebrity nature of the Bloomberg set played a big role in explaining how the "Economic Consequences of the Peace" (1919) went viral and had such profound influence on events of his day.

This was all despite its theoretically flawed underpinnings (taking no account of global capital flows or German economic growth potential), as the German economic miracle of 1924-8 demonstrated, and as leading contemporary economists (for example Jacques Rueff) argued in a series of articles.

Later, the spread of the Hicksian version of Keynesian economics had much to do with the contagious power of the IS-LM diagram, with its close parallels to supply and demand curves, with which so many of us are familiar.

Central bankers and a TV celebrity power narratives

In today's setting, the top economic narrative (we might think of) is the Xi-Trump tariff war. The widespread telling of this story, not least in the financial media, almost makes it into a self-fulfilling prophesy in some respects.

How has the narrative been so powerful? Shiller would argue, presumably, that President Trump's former career as a TV celebrity and his fascination with the "art of the deal" play no small part.

Another prominent economic narrative today is the power of the central bankers to manipulate interest rates, and ultimately over-ride the built-in forces of the business cycle.

The central bankers have a huge propaganda and media circus at their disposal for this purpose. Shiller does not comment upon this narrative. He is largely in denial, more broadly about the role of monetary inflation in creating an environment where narratives flourish and can go viral.

Back to the weak narrative of the Xi-Trump trade war which has nonetheless "gone viral".

Why weak?

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There are gainers as well as losers from this "trade war"; but the losers shout from the roof tops, and include big tech and big finance US companies with much pull in Washington; whilst the gainers have reason in many cases to remain below the radar screen in line with economics of lobbying in Washington. .

A US-led effort to contain Beijing's aggressive strategies on the world stage, facilitated in part by a flawed entry procedure in WTO and subsequent abuse, could be viewed as good rather than bad news.

The slowdown in global trade has much more to do with long-running mal-investment during the past two decades, evidenced with supply chains which were over-built on a false narrative about ever-growing integration between China and the West, and the natural reversal of this rather than the present tariff-war ding-dong.

A real role for haven assets?

So back to these movements in haven asset prices, in response to Xi-Trump trade war news; yes, these correlations exist (between tweets and safe haven prices) – but they have little to do with the real content of safe-haven investing. They are look-alike without the substance.

At a basic level, how do we justify any interest in the subject of haven assets at all?

After all, if the intention is to limit our exposure to "bad states of the world", then we should appropriately apply limits to our holdings of good-news, risk assets such as equities, real estate or high yield credit (all do well in prosperous times and badly in lean times).

One rationale for introducing haven assets into a portfolio is to allow us to hold more good news assets than otherwise, for the same overall exposure to risk – enjoying greater gains during prosperous times, without being exposed as seriously in bad times. It is far from clear though in general terms, whether a portfolio of so-called haven assets allows us to do this.

As illustration, without any explicit consideration of haven assets and their composition, an investor may hold 60% good news risk assets and 40% "safe" monetary assets.

Could careful selection of so-called haven assets allow him or her to ramp up to 70 per cent risk assets, without any more pain in a range of bad states of the world and without interfering seriously with the income during good times?

In general, it is not possible. But, there are two over-riding considerations which leave space for haven investment and focus.

First: the simple views of portfolio construction in the finance literature do not correspond to reality.

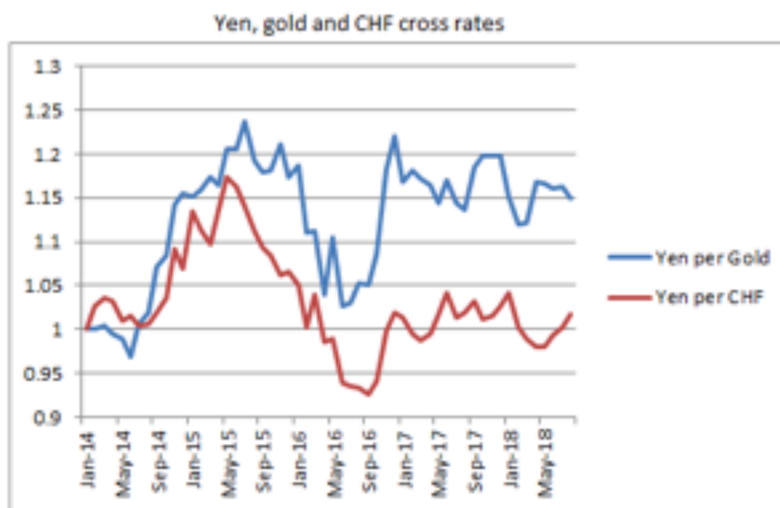
Few of us really believe that all risk/return characteristics are represented in the "two-parameter" models pioneered by Markowitz and Fama (all risk summarized by the combination of the market portfolio with riskless assets). Reality is more complex. We tend to be concerned about a range of scenario combinations and strive to work out how we would fare under those.

Second, the safe assets are not safe. We live in a world of radical monetary experimentation and more generally huge monetary danger.

All of this should be thought about carefully in portfolio construction, with a focus on how one's portfolio will fare over a cumulative destructive monetary cycle, where timing and extent of destruction is not known in advance.

Furthermore, the investor should be aware that though good-news risk assets may deliver high returns, persistently over the period of time during which good news holds, bad-news goods (otherwise described as safe havens) pay off usually, just in advance of the bad news becoming fully known. They do not continue to provide high income, so long as the bad news persists.

We should distinguish studying the role of safe-have assets in long term wealth accumulation strategies from speculative trades – where these are the focus of "bets" on whether particular bad news stories will grow in weight during coming days or weeks or months.



Source: Bloomberg

Safe haven assets – what strategy now?

Given the extent of near-term, bad states of the world, which are now pre-occupying investors, safe haven assets are understandably a present focus of considerable speculative interest, and also of longer term, more fundamental thinking.

Adding to the riddles has the strong price climb this year for both good news assets (equities) and safe havens (gold, long-maturity T-bonds, German government bonds, Swiss francs, yen) altogether.

How can we make sense of that?

The most direct answer is that both good news assets and bad news assets have been subject to a powerful dose of monetary inflation. Central banks (led by the US) have responded to a global slowdown in evidence since mid-2018 (coming into focus with the stock market sell-off of late 2018) by ostensibly monetary pump-priming (time will tell whether there has been any effective priming – in doubt here).

The central bank action has induced a re-bound of some risk-assets (especially US equities) but far from all; whilst the spectre of stepped up monetary inflation and radicalization has powered the gold boom.

We should also note that the central bank action has not been successful in turning around, let alone reversing, various bad news narratives (potential banking crisis in Europe, or looming global recession).

The view here is that the re-bound this year of some good news risk-assets, under the influence of perceived stepped up monetary inflation, is hazardous. The balance of probabilities is shifting towards bad news on a range of fronts.

First, on global peace there is much to fear, even though the Trump Administration will seek to deliver on its art of the deal before Election Day. In fact, the stark danger is that pressure to deliver will mean deeply flawed deals, together with increased danger (not less).

Second, the main scenario here is global recession ahead, before any meaningful economic rebound.

Yes, the US economy (through late 2018 and the first half of 2019) has been on the edge of global slowdown – in contrast to Asia and Europe being in the driving seat. But the signs are of slowdown spreading to the US – first via the manufacturing sector and second through confidence effects related to capital spending decisions.

At some point, the global slowdown and its impact on earnings could well short-circuit into sharp global asset market deflation, leading to a second round of strong recessionary forces (also affecting the US).

Third, banking and financial system risks are increasing, even though central bank balance sheets have vastly expanded meaning huge amounts of excess reserves at an aggregate level.

High reserves keep visible money market rates pressed down – in the case of Europe, falling to zero for most depositors (negative for footloose depositors and increasingly rare interbank depositors). But the danger of ultimate crisis, in which depositors may not get paid back in full, is illustrated by the extent to which yields on perceived safe bonds have fallen below zero.

Bottom line:

Even though we should expect speculation on “peace in our time” deals by President Trump ahead of Election Day to rock markets at some points, causing haven assets to tumble and good news assets to rise sharply, the case for fortifying macro-hedging strategies is powerful under present circumstances – whether monetary, financial, economic or geo-political.

Yes, powerful narratives, some poorly based but somehow successful in going viral, can grip markets and even exert influence for some time on macro-economic outcomes. The China “trade war” is one of these. But investors would do well to look beyond those narratives at fundamental factors at work.