Note from London & Capital's Chief Investment Officer, Pau Morilla-Giner.

FOMO + QE = FUEL FOR MARKETS, BUT FOR HOW LONG?

The herd is thundering back into risk-taking. The sudden improvement in investors' sentiment has come as the Fed has reversed its policy of five years, and started to expand its balance sheet again. It did this to restore liquidity to the repo market, where banks raise their short-term funding, and the Fed has protested repeatedly that this is not a return to "QE" asset purchases to boost the economy. For all these protestations, the market has treated it as a turning point.

Added to this, there is the age-old FOMO (fear of missing out): active managers are putting cash to work in a way that has not been seen for many years. The latest edition of Bank of America's fund manager survey shows that cash levels are their lowest in six years:

There is also a growing belief that we have a weaker dollar ahead: investors are braced for a weak dollar, which would flatten US company profits, while relieving the pressure on emerging markets:

While all this is happening in risk markets, $ 13 TRILLION worth of investors' money is held in zero or below-zero interest-rate-earning debt. That means that these investments are worthless for producing income (unless they are funded by liabilities that have even more negative interest rates). So these investments can at best be considered safe places to hold principal…. until they are no longer safe because they offer poor real returns (probable) or because rates rise and their prices go down (less probable as we doubt central bankers will allow it).

Thus far, investors have been happy about the rate/return decline because they pay more attention to the price gains that result from falling interest rates than the falling future rates of return.

QE: from cure to poison. What next?

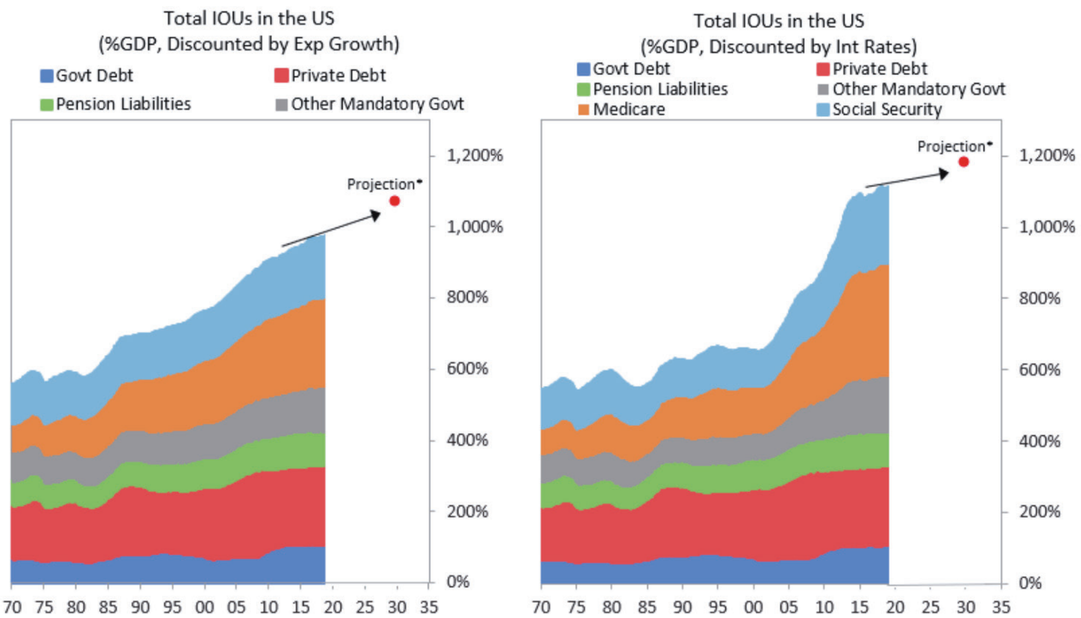
Since 2009, Central Banks have been lowering interest rates and doing QE in aggressive ways, with some minor tightenings that caused "taper tantrums." That has driven up asset prices both directly (from the actual buying of the assets) and indirectly (because the lowering of interest rates both raised P/Es and led to debt-financed stock buybacks and acquisitions).

Rates cannot be lowered much more and QE money is not taking growth and inflation much higher because the investors who are getting it, want to invest it rather than spend it: the "transmission mechanism" is not working. This is creating a "pushing on a string" dynamic: prices of financial assets have gone up while economic growth and inflation remain sluggish.

As money is essentially free for those who have money and creditworthiness, it is essentially unavailable to those who do not have money and creditworthiness, which contributes to the rising wealth, opportunity, and political gaps. Also contributing to these gaps are the technological advances that replace workers with machines. Because the "trickle-down" process of having money at the top, trickling down to workers and others by improving their earnings and creditworthiness is not working, the system of making capitalism work well for most people is broken. This has created discontent in the middle-classes of the Western World, who are gravitating towards populist politicians who promise to increase pressure to shift more of the money printing into the hands of those who are not investors/capitalists.

At the same time, pension and healthcare liability payments will increasingly start to be due while many of those who are obligated to pay them do not have enough money to meet their obligations. Right now many pension funds that have investments, which are intended to meet their pension obligations, use assumed returns that are agreed to with their regulators. They are typically much higher (around 7%) than the market returns are likely to be produced.

These charts show the wave of liabilities that is coming in US (same picture for UK, Europe and rest of Western World):



Source: Bridgewater Associates

It is likely that at some point in the next few years central banks will run out of stimulant to boost the markets and the economy when the economy is weak.

At the same time, the system liabilities (like pensions and healthcare) will be coming due, so it is unlikely that there will be enough money pushed into the system to meet those obligations.

The enormous amounts of money in low/negative returning investments will not be enough to fund the liabilities, even though the pile looks like a lot. That is because they do not provide adequate income, they are worthless for that purpose.

There will then be a battle over the following:

- How much of those promises won't be kept (which will make those who are owed them angry)
- How much they will be met with higher taxes (which will make the rich poorer, which will make them angry)
- How much they will be met via much bigger deficits that will be monetized (which will depreciate the value of money and depreciate the real returns of investments, which will hurt those with investments, especially those holding debt).

In such a world, governments are likely to continue printing money to pay their debts with devalued money. That's the easiest and least controversial way to reduce the debt burdens and without raising taxes. A similar event took place in the 1940s war years.

Asset Allocation Views

Determining the optimal asset allocation is not an easy task. On the one side, QE and FOMO can drive risk assets even higher, and a global economic recession is not imminent.

On the other, we have to prepare for when the paradigm truly shifts, recognising that a "Profit recession" is perfectly feasible even in absence of an economic one, and that a global economy growing at the lowest pace since Lehman Crisis is like walking on thinning ice.

Fixed Income

There is little doubt how far the Fed is willing to go to keep interest rates from rising.

This was Fed Chair Powell in June:

"Perhaps it is time to retire the term 'unconventional' when referring to tools used in the crisis. We know that tools like these are likely to be needed in some form in [the] future. Also, we have discussed targeting longer-term interest rates as a new tool to combat the next recession and a symmetrical inflation target."

Translation: We are considering printing helicopter money while anchoring long-rates to avoid a dangerous market signal and higher interest rates in a weak economy.

Allowing inflation to "run hot" and targeting (a great euphemism for "capping") interest rates will result in a lengthy period of negative real yields. This will lead to lessening the real, inflation-adjusted, burden of debt.

Overall, "lower for much longer" is good news for credit, at least in the short term. Having said this, we continue to focus our clients' exposure on mainly two areas:

- Sectors where leverage has not increased significantly (Financials mainly)
- Corporates whose earnings are not too cyclical/volatile (earnings are under threat under low economic growth conditions)

Equities

Equities have potential to continue to do well in short term, as Central Banks keep pumping money and investors are forced up the risk curve.

However, low growth might lead to a "profit recession", which will hit cyclical equities more, so stick to defensive equities that pay dividend (bond proxies): STAR Equities. These offer the best of both worlds: market upside for as long as animal spirits remain high, defensive properties when that stops (while paying us income!).

Gold

Gold has correctly anticipated the powerful shift in central bank monetary policy regimes. Although continued near-term volatility in gold is possible, given the rapid surge in the Fed's balance sheet (the Fed has undone seven months of QT in the past seven weeks and is expanding its balance sheet) and the many signals from Fed officials suggesting further financial repression, long-term investors should continue to accumulate gold.

In a world where the Fed is prepared to implement "yield curve control" and will refrain from raising rates unless "a really significant move up in inflation that's persistent", gold could become the strongest asset in the world.

FX

The Fed has begun monetizing US federal deficits and this is likely to continue. The near-vertical surge in its balance sheet appears to be a huge tell. The sharp reaction in several non-USD markets is another important clue suggesting the start of a shift in investor perceptions. A number of indicators that correctly signaled the late-2016 peak in the USD Index (DXY) are again signaling a likely decline in the USD.

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