Self-Inflicted Wounds: Dealing With The Powell Crash

By Vineer Bhansali| July 01, 2022

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The numbers are out. The first six months of 2022 have been one of the worst on record for financial assets. When investors receive their quarterly statements and have the courage to read them, they will be shocked, and with good reason. It seems like a sick joke that we went from all-time highs on stocks in January to the most precipitous selloff of all asset categories in a matter of half a year. What happened to diversification, 60/40, bitcoin…? What about all the promises from financial advisers, bankers and money managers? Is it just a matter of what goes up must come down, or something more consequential?

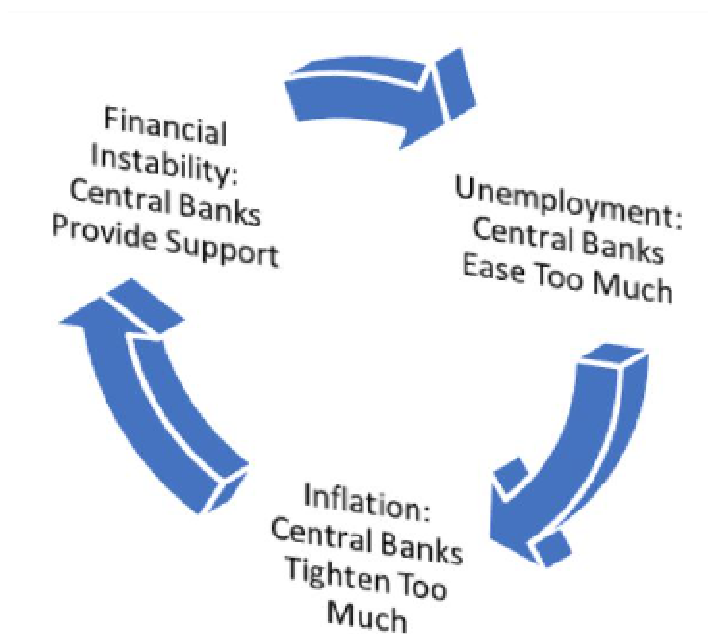
The not-so-funny thing about this selloff is that it is almost entirely caused by the actions of policymakers, globally. To recap – after declaring inflation "transitory", and printing trillions of dollars, Euros, and Yen, policymakers suddenly went "oops" and now are climbing on the bandwagon of inflation worries that many market participants, economists, and this author have been writing about for years.

> "…data-dependent central banks increasingly play a cyclical game of "whack-a-mole", where they go from addressing unemployment, to inflation, to financial stability."

If you google "self-inflicted wounds", you will find one definition to be "the act of intentionally

harming one's own body without meaning the injury to be fatal". And the most important reason for self-harm is given as a coping reaction to feelings of inadequacy, anger, distress and other painful emotions. Central bank leaders and literally thousands of economics PhDs at these banks collectively have been exactly wrong in their forecasts and actions. The feeling of inadequacy is being dealt, not with an admission of fault, but to go full tilt in the opposite direction to overcompensate for past mistakes. Like the guy who is on the phone at the stop light, and then guns his accelerator when he realizes he is holding up traffic.

My working hypothesis for the last three years has been that "data-dependent" central banks increasingly play a cyclical game of "whack-a-mole", where they go from addressing unemployment, to inflation, to financial stability. Currently (see schematic below) they are in the middle of dealing with the inflation to (self-inflicted) financial instability transition. And the next big problem, caused by aggressive tightening, will be illiquidity, financial instability, and the need for another string of bailouts. But the thing about self-inflicted wounds is that eventually it is possible to stop hurting yourself when you become aware. And that is where we are headed.



Source: LongTail Alpha

For now we are in a situation where inflation globally is running at about 9% (give or take, and depending on how precise you want to be, the measurement error can be a few percentage points on either side). Yields on nominal bonds are still in the 3% range in the US. So real yields are still very, very negative at -6% or so (Source: Bloomberg). Negative real yields result in a confiscatory tax via inflation, as many people whose wages are lagging prices of goods and services are finding out to their distress.

So wouldn't it make sense for the Fed and ECB and BOJ to keep tightening until inflation is conquered?

Recall that interest rates are only one way for the central banks to slow down the economy. The second way is the management of expectations by jawboning, also known as "forward guidance", which recently went out the window when the Fed reacted to a sudden rise in inflation expectations and raised 75 basis points instead of the expected 50 basis points.

The final way to tighten financial conditions is to sell the trillions of assets that they have accumulated. The Fed's and ECB's own research stretches credibility in this dimension, which is perhaps one reason they were purchasing billions of assets until just a few months ago at increasingly high prices and low yields. But they are much more sanguine about the impact of a reduction of the balance sheet. For instance, a number of governors have recently been quoted as saying that quantitative tightening, the opposite of the quantitative easing, is worth maybe only 25 to 50 basis points of rate increases. Huh?

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One reason why financial assets sold off in such a correlated manner over the last quarter is because of the impact of all the asset buying on the discount factor. As we all know, the price of all financial assets depends on three things and three things only. First, what is the cashflow

that will be received in the future? Second, what is the probability of receiving the cashflow? And finally, what is the discount factor? The discount factor is an exponential function of interest rates. By purchasing trillions of bonds, central banks drove interest rates to zero and even below zero. Now that inflation has gone to four times their target, central banks have had to abandon the low interest rate policy and the discount factor is coming back to bite.

Witness the performance of the German thirty-year "Bund" (DBR 0% of August 2050) that I previously have called the "God-Particle" of finance, since it was the first sovereign, real-life, long-maturity, pure zero coupon bond issued at negative yields. That security has fallen from a price of 103 in December of 2021 (negative yield) to about 65 today (yield of 1.5%) (Source: Bloomberg). If you apply this 40% decline to financial assets via the discounting effect, it is not hard to see why all financial assets are getting socked by the same common factor – rising interest yields. And the speed, as one should and did experience, is exponential. If central banks start to sell assets outright, as I suspect they might have to, they will likely accelerate the correlated selloff in asset prices.

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Investors obviously want to know (1) when will all this stop and (2) what to do in the interim? There is a saying on Wall Street that is too crass to repeat here in detail. But it involves a gorilla. And what it basically says is that things don't stop when *you* want them to stop, but when the gorilla wants it to stop. Picture, if you can, the central banks today as panicked and headless gorillas. The market selloff will only stop when they want it to stop. And when will that be? When they realize that asset prices are low enough to slow down demand and tip the economy into a deep recession and the political winds start blowing in the direction of bailing out what's left of investment and pension fund portfolios. For now, airports and freeways are full, cars are being sold at 25% above asking, oil is making records – the signs of demand surge are nowhere close to abating; to be sure, there are some cracks in

the speculative real estate market. But by the time the signs of a cratering economy are obvious, we will likely already be in a deep recession and the inflation-caused demand destruction will have done its damage. Self-inflicted.

In this environment, liquidity and safety are paramount. As I have written before, and perhaps advocated a bit too early, the front end of the yield curve is a prudent place to consider hiding out; e.g. two-year Treasury notes are the place where an investor can collect about 3% annual return with little risk to principal. In today's environment, these "twos" remain attractive, and the price is cheaper. The risk to this investment is that short-term rates keep going up, the economy does not break, and inflation keeps rising. In which case an investor would have lost the opportunity cost relative to inflation.

Unlike the market selloff of COVID, or the crash when the XIV ETF blew up, or even the financial crisis and the Russian debt crisis in the late 90s, the current selloff in the market is almost entirely caused by grossly miscalculated monetary policy coupled with extremely stimulative fiscal policy; i.e. helicopter money.

But that is also the silver lining. As soon as the central banks own up to their mistakes and pay attention to the financial markets instead of distorting them, both the economy and the financial markets will get back to serving their function. For now, I am not so confident that central banks "get it". For example, the Bank of Japan is still defending the 0.25% "yield curve control" target even as Japanese inflation exceeds 2.5%. Once the markets force the decision upon them, as they always have, the central banks will pivot. And at some distant point in the future, the last few years of central bank action will likely be taught in economics textbooks as what central banks should not to do. While their valiant action in 2020 certainly averted economic catastrophe, the inability to course-correct in time has certainly created the potential for the next one.

Important Disclosures

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