

Absolute Return Letter: Euthanasia of the economy?

November 7, 2013

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"Crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought."

Rudi Dornbusch, Economist.

In his masterpiece *The General Theory of Employment, Interest and Money* John Maynard Keynes referred to what he called the 'euthanasia of the rentier'. Keynes argued that interest rates should be lowered to the point where it secures full employment (through an increase in investments). At the same time he recognised that such a policy would probably destroy the livelihoods of those who lived off their investment income, hence the expression. Published in 1936, little did he know that his book referred to the implications of a policy which, three quarters of a century later, would be on everybody's lips. Welcome to QE.

Before I go any further, please allow me to inject a brief personal comment. This month's Absolute Return Letter is the last before my partner, Nick Rees, departs for the Canary Islands for the final preparations before he sets off to row, unaided, from La Gomera on 2 December on his conquest of the Atlantic. I don't think any of us can quite comprehend what a mammoth task it is to row 3,000 miles across the Atlantic. Nick and his rowing partner Ed will be in the boat for 50-60 days before arriving in Antigua in late January, and they probably won't speak to each other for 50-60 months thereafter! It is all done in support of Breakthrough Breast Cancer, one of the leading cancer research charities globally, and you can read more about the project [here](#). Many of you have already supported Nick, and for that he is eternally grateful but, if you have somehow missed it, it is not too late to make a contribution. So many people continue to be diagnosed with breast cancer every year, 1 in 8 women over the course of their lifetime. Nick's wife, Ellen, was one of them. Please [click here](#) if you would like to support this great cause.

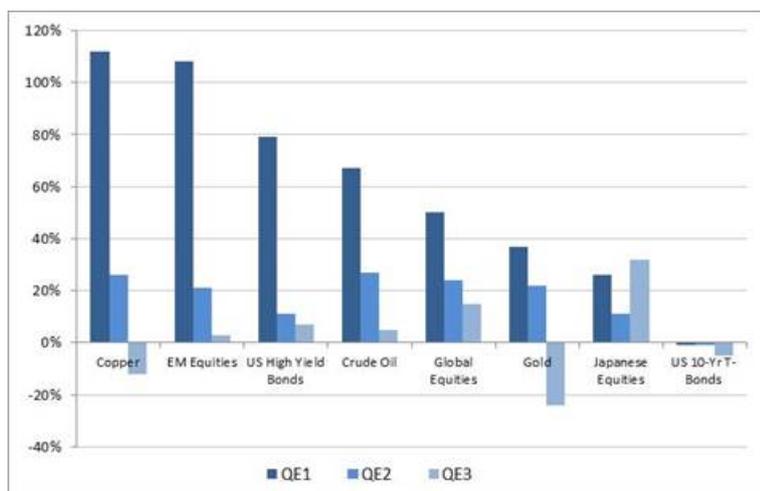
Now back to QE - the topic of this month's Absolute Return Letter. Over the past couple of years it has gradually become the consensus view that QE has failed because it hasn't created the economic growth that everyone was hoping for. I find that view overly simplistic and naïve in equal measures. QE - or broadly similar monetary policy initiatives - has saved the world from a nasty and potentially very damaging financial meltdown not once, but twice - following the Lehman bankruptcy in the autumn of 2008 and during the depths of the Eurozone crisis in the second half of 2011. It is not clear at all (because it is impossible to quantify) how much worse off we would have been without QE, but worse off - in terms of GDP growth - we almost certainly would have been. Estimates range from 5% to 15% below actual numbers, but nobody really knows.

QE's effect on asset prices

The second indisputable effect QE has had is on asset prices. The central banks' unprecedented buying of bonds have had a material, and overwhelmingly positive, effect on asset prices - to the point where more and more people worry that we are in the process of forming a new bubble. Chart 1 below, borrowed with gratitude from the Financial Times, illustrates very well how effective QE has been in terms of moving asset prices higher but, at the same time, it demonstrates the dilutive effect over time. QE2 did not deliver returns of the same magnitude as QE1 and QE3 has been even less effective, at least when measured in this way.

I do not wish to enter into a longer discussion about whether this is bubble territory or not, as that is the subject of next month's Absolute Return Letter, but let me make one thing clear. The current equity bull market is *not* a rally based on irrational behaviour. To the contrary, investors are behaving perfectly rationally. As policy makers continue to signal an intent to keep rates low for a very long time, investors merely respond to such intent. That, on the other hand, is not akin to saying that buying equities at current valuations is a virtually risk free proposition, but more about that next month.

Chart 1: The effect of QE on various asset classes



Source: *The license to print money is running out*, FT Money, 19-20 October 2013

Misguided inflation concerns

When QE was introduced in late 2008¹ there was plenty of concern that it would lead to higher inflation. Some even suggested it could lead to hyperinflation and the gold bugs suddenly found themselves with plenty of wind in their sails. As QE became QE2, the inflation protagonists gathered further momentum and the price of gold took another leap. Suddenly you were no longer considered an extremist by suggesting that the Fed would turn the USA into the United States of Zimbabwe.

And what happened? The reality is that almost exactly five years after the introduction of QE, the so-called 'money printing'² has had little or no effect on consumer price inflation. If anything, it looks as if QE has paved the road to Tokyo rather than Harare (chart 2).

Chart 2: Consumer price inflation in selected countries



Source: ECB, FRED, ONS

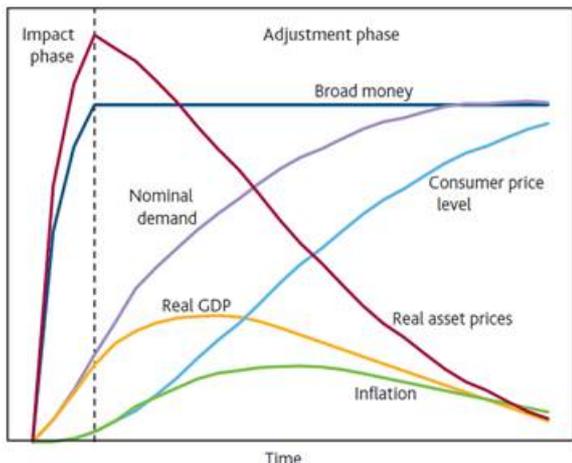
How could nearly everyone get it so horribly wrong? Could it be that we haven't seen the inflation ghost yet? Are we in the lull before the storm? Is it possible that QE is in fact long term deflationary? The reality is that we have seen plenty of inflation already from QE - just not in the places nearly everyone expected it to show up. Asset price inflation is also inflation, and we have had asset price inflation galore. Many emerging economies have struggled with consumer price inflation in recent times. It looks as if we have been very good at exporting it.

I rarely brag about my predictions when, occasionally, I turn out to be on-the-money, partly because my mum taught me always to be humble, and partly because it usually comes back and bites you in the tail if you get too big-headed. Having said that, I never believed the scare mongering, and I still don't. I am absolutely convinced that QE will generate little or no consumer price inflation in the western world, although I do recognise that some countries (for example the U.K.) have higher structural inflation rates

than others. This is *not* the lull before the storm.

Is it Japan all over again? I believe the jury is still out on that one. Good friend and business partner John Mauldin made me aware of a very interesting study presented by the Bank of England back in 2011 which appears to suggest that at least the U.K. central bank expects QE to deflate asset prices, consumer prices and economic growth in the long run (chart 3). That is not akin to saying that we have already fallen into the same deflation trap as Japan; however, given the disinflationary trend we are currently in, we are perhaps only one or two policy mistakes away from deflation – in particular in the Eurozone. Extending QE could be one such mistake.

Chart 3: The qualitative economic impact of QE



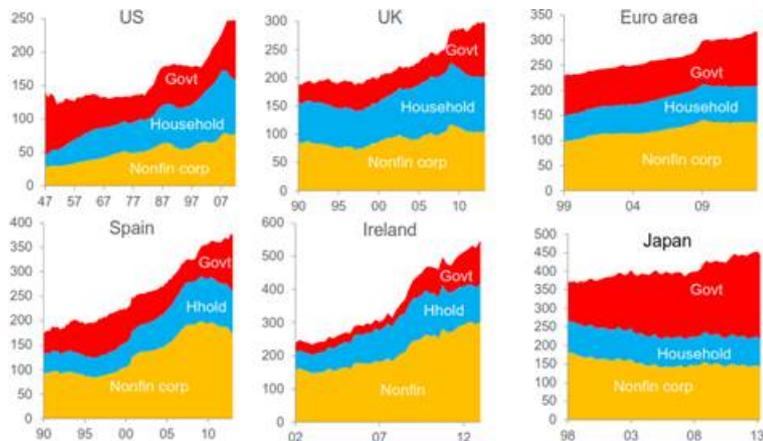
Source: Quarterly Bulletin, Bank of England, 2011 Q3

Does QE destroy economic growth?

Let’s take a closer look at a very important question raised by chart 3. Does QE actually destroy economic growth in the long run? In order to understand the dynamics at work, let’s start with a quick snapshot of how much the world has actually de-levered since the lofty levels of 2007 when the first signs of crisis began to materialise (chart 4).

For the sake of clarity I should mention that, in the following, I focus on QE. In reality, most countries have combined QE with various austerity measures which makes it difficult to distinguish the effect of one policy measure from another. Having said that, the U.S. hasn’t engaged in austerity to any meaningful degree which gives us good insight into the (side) effects of QE.

Chart 4: Gross debt as % of GDP (excl. financial sectors)



Source: Back to Black, Citi Research, October 2013.

The first, and very important observation, when looking at chart 4 is that total debt is higher almost everywhere since the outbreak of the crisis³. It is indeed a case of robbing Peter to pay Paul as Matt King of Citi Research so succinctly puts it. Where household debt has been reduced (for example in the U.S. and the U.K.) government debt has replaced it.

Italy's government debt has jumped from 121% to 132% of GDP over the past two years alone. Spain's debt-to-GDP has gone from 70% to 94% and Portugal from 108% to 124% over the same period. An interesting brand of austerity I might add! Expanding the government deficits at such speed would have been devastatingly expensive in the current environment without QE. And to those of you who want to jump at me and say that the ECB does not engage itself in QE (yes, I am aware that its charter strictly prohibits such activity), I say look at the ECB's balance sheet. It may not be QE in the legal sense of the word, but the end result is no different.

So, in effect, QE has permitted a number of crisis countries to fund their escalating deficits at rates which would have been impossible to obtain in a free market, but that's the least of my concerns. QE has also permitted banks in those same crisis countries to re-capitalise themselves without the use of tax payers' money. At one level that is good news, because using tax payers' money would only have made government deficits worse. However, there is a bothersome side effect of such an approach.

Think about it the following way. When deploying its capital, a commercial bank effectively has the choice between lending it to its customers or engaging in proprietary trading activities. With central banks underwriting the cost of capital in the banking industry by promising to keep policy rates at record low levels for some extended period, the choice is a relatively simple one. On a risk-adjusted basis, margins on lending simply cannot compete with the profits that can be made on proprietary activities. This in effect deprives the real economy of working and investment capital and thus has a detrimental effect on economic growth longer term. This, and other possible side effects of QE, was pointed out in a brilliant paper published by the Federal Reserve Bank of Dallas last year, which you can find [here](#).

For the economy to grow, not only is it necessary for banks to be willing to lend, but borrowers must also be willing to borrow. Many consumers were over-leveraged going into the crisis and are taking advantage of the lower interest rates to de-lever faster than they could otherwise hope to do, but that is not the only reason why consumers may refrain from borrowing at present. There are signs that QE may in fact be having a direct, and negative, effect on the appetite for borrowing.

Here is how it works. Seeking to impact inflation expectations forms an integral part of monetary policy, and policy makers have been very effective at anchoring those expectations around 2% in recent years. Needless to say, if inflation expectations had moved significantly as a result of QE, I would have had to write a very different letter this month.

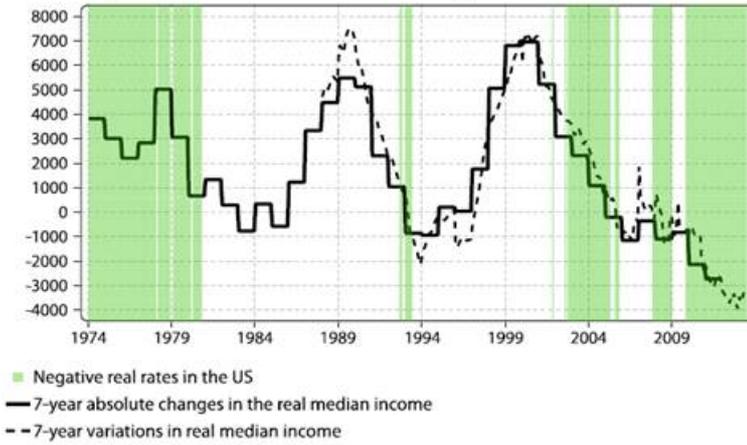
Behind all of this is some economic gobbledygook called the '*rational expectations hypothesis*' which suggests that economic agents (read: consumers and businesses) make rational decisions based on their expectations. So, when the Fed - and other central banks with it - keep ramming home the same message over and over again (and I paraphrase): "Folks, we will keep interest rates low for some considerable time to come", consumers and businesses only behave rationally when they postpone consumption and investment decisions. They have seen with their own eyes that central bankers have been able to talk interest rates down, so why borrow today if one can borrow more cheaply tomorrow?

QE's effect on income

Charles Gave of GaveKal Research produced a very interesting paper earlier this year, linking the low income growth to QE - another nail in the coffin for economic growth. Charles found that during periods of negative real interest rates (which is a direct follow-on effect from QE), income growth in the U.S. has been low or negative (chart 5). I am sure we will hear more from GaveKal on this topic in the future. It is the first time I have seen anyone present this hypothesis which, if true, has dramatic implications for monetary policy going forward. It is well known, for example, that President Obama has been keen to find ways to get income growth back on a more positive trajectory again.

Chart 5: The link from QE to income growth

Negative real rates and the relationship with income growth



Source: *The emergence of a U.S. underclass, GaveKal Research, July 2013*

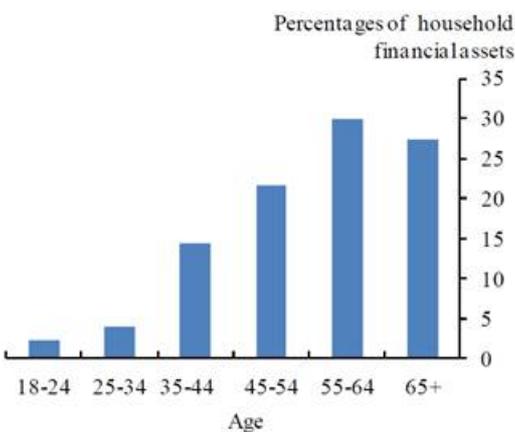
QE was meant to stimulate economic growth and I believe it worked well as a short term crisis management tool in 2008 and 2011. However, for policy makers to expect a longer lasting, and positive, effect on economic growth, they would have had to assume that the wealth effect (from rising asset prices) would kick in and stimulate economic growth through increased consumption. When making this calculation, they may have underestimated the power of demographics, though.

As I demonstrated in last month’s letter, middle-aged and old people, who control the majority of wealth (chart 6) do not create economic growth. Young people do, but QE may have deprived the younger – and income dependent – generations of growth capital for the reasons already discussed, whilst making the wealthy even wealthier. One could say that QE has increased inequalities in income and wealth.

Time to clean up the banks

When talking about the financial sector and how they have been able to take advantage of QE to re-capitalise their damaged balance sheets, it ought to be said that QE has effectively allowed banks to ignore their underlying problems. QE has become a life support machine for the financial sector at virtually no cost to them but at a significant cost to the rest of society. That cannot go on ad infinitum. At some point in the not so distant future it will be financial reckoning day for the sector which bodes particularly badly for the European banks, most of which are way behind their U.K. and U.S. peers in terms of cleaning up their balance sheets.

Chart 6: Distribution of UK household financial assets by age group



Source: *The distributional effects of asset purchases, Bank of England, July 2012.*

Note: Numbers exclude pension assets.

The IMF provided some very granular information on the state of European banks in their most recent Financial Stability Report. More than 50% of Spanish companies with loans in Spanish banks have an interest coverage ratio of less than one. In other words, the EBITDA of over half of all Spanish corporates does not even cover their interest expense (you would expect a healthy corporate borrower to have an interest coverage ratio of 3-5 times depending on the nature of the business). What’s worse, the situation in Italy and Portugal is only marginally better. All of these problems have been largely ignored since the ECB

stepped in with their brand of QE about two years ago and saved the European banking sector from a complete meltdown, but few, if any, of the underlying issues have yet been addressed.

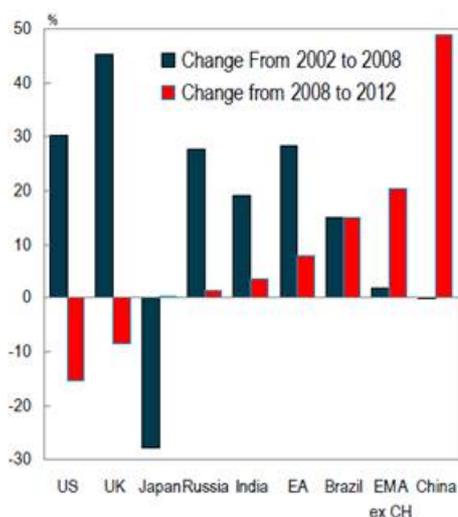
Other unintended consequences

Meanwhile, QE has left a trail of potential problems in the rest of the world. Ultra easy monetary policy in the West has resulted in a virtual credit explosion in many EM economies, many of which pursue a policy which is either directly or indirectly linked to U.S. monetary policy (chart 7). This is a key reason why I predicted in the September Absolute Return Letter (see here) that we may have to face a re-run of the EM crisis of 1997-98 before this crisis is well and truly over.

In China, the transformation currently taking place may have some unexpected consequences for inflation in our part of the world. From a peak of 10.1% of GDP in 2007, its current account surplus now stands at 2.5% of GDP and the surplus continues to trend down. In September, Chinese exports to the rest of the world dropped by 0.3% when compared to the same month last year, whereas imports grew by 7.4%.

Consequently, China is no longer building massive amounts of foreign exchange reserves, and it is quite likely that the Chinese balance of payments will turn negative in the foreseeable future. We had a foretaste of that in 2012 when they posted the first quarterly deficit since 1998. All of this is important in the context of inflation v. deflation because the renminbi may actually begin to weaken as capital outflows gather momentum – a nightmare scenario for us in the West as we would then begin to import deflation from China at a most inopportune time.

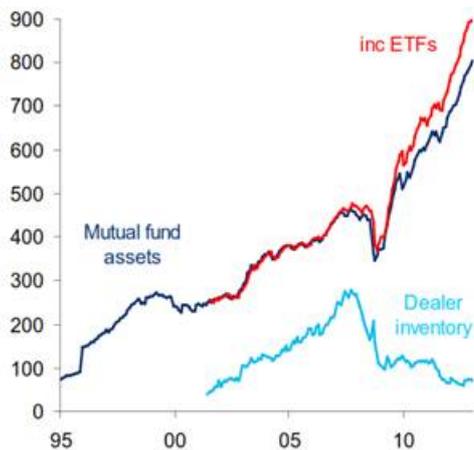
Chart 7: Change in private sector debt (gross, non-financial, % of GDP)



Source: *Global Economic Outlook and Risks, Citi Research, September 2013*

I could go on and on about how QE has created, and will continue to create, unintended consequences. I haven't really touched on how QE has distorted market mechanisms in the financial markets and the implications of that. For example, as a direct result of QE, dealer inventories have been dramatically reduced since 2008 during a period where assets under management in the mutual fund and ETF industry have exploded (chart 8). When the herd wants out of credit, who is going to provide the liquidity to facilitate that?

Chart 8: U.S. credit mutual fund assets v. dealer inventories



Source: *Back to Black*, Citi Research, October 2013.

I have failed to mention how QE has undermined the retirement plans for millions of people across Europe and the United States as their pension savings no longer provide a sufficient income to live on. I have not entered into any discussion about how QE could quite possibly undermine the credibility of central banks longer term and how that may impact the effectiveness of monetary policy and possibly even present a threat to global financial stability.

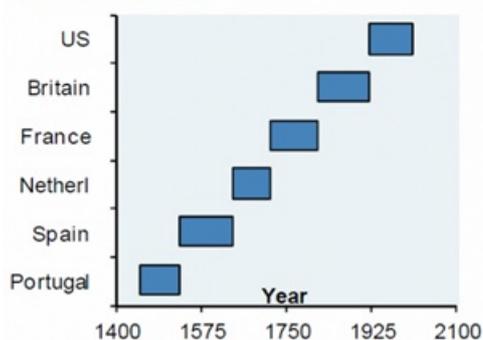
Could the U.S. lose its reserve currency status?

All of these are important issues that deserve a mention; however, I am running out of time and space. Allow me to leave you with one thought, though. Since the end of World War I, the U.S. dollar has retained its position as the reserve currency of choice. Such a position carries with it many advantages. Approximately 60% of the world's foreign exchange reserves are held in U.S. dollars today. In an era where the U.S. government spends considerably more than it earns, the status as the world's preferred reserve currency comes in quite handy. Having that status is equivalent to writing cheques that nobody cashes in. What a wonderful position to be in.

The Americans seem to take their status for granted. Perhaps they need a reminder that reserve currency regimes come and go (chart 9). Given its status as a large debtor nation with insufficient domestic savings to finance its deficits internally, it could prove very painful, should the rest of the world decide that it is time for a change. The longer QE goes on for, the more likely that is to happen.

Chart 9: Reserve currency regimes since the middle ages

(c37) Reserve currency status does not last forever



Source: JP Morgan via Zero Hedge

My good friend Simon Hunt reminded me the other day that, only a couple of weeks ago, an article in China's official news agency called for a new reserve currency to be created to replace the U.S. dollar. According to Simon, the renminbi's share of world trade has grown from zero in 2009 to around 17% in the first half of this year. Given its exponential rise, it could easily account for 40% or perhaps even 50% of world trade by 2017.

Conclusion

It is time to call it quits. QE proved to be a very effective crisis management tool, but we have probably reached a point where the use can no longer be justified on economic grounds. Just as John Maynard Keynes

talked about the euthanasia of the rentier back in 1936, we are now facing the euthanasia of the economy, unless we change course. The obvious problem facing policy makers, though, is that if financial markets are the patient, QE is the drug that keeps the underlying symptoms under control. We have already seen once how dependent the patient has become of this drug (think 22 May when Bernanke mentioned the mere possibility of tapering), and the market reaction clearly scared central bankers on both sides of the Atlantic.

The western world was very critical (and rightly so) of Japan in the 1990s for not dealing decisively with its sick banking industry. Twenty years later, Japan is still paying the price for its dithering. The problem is that we are now making precisely the same mistake. QE has proven effective of suppressing the underlying symptoms, but that doesn't mean we should stay on that medicine forever. In order to reinvigorate economic growth, and avoid falling into the Japanese deflation trap, we need a healthy banking industry. That will only happen if it is thoroughly cleaned up once and for all.

PS. To all those out there who think that the world is returning to normal, that everything will be safe and sound as long as we give it a bit more time (a strategy also known as kicking the can down the road), I suggest you read [this piece](#) in the FT.

Niels C. Jensen

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¹*QE was actually introduced in the United States all the way back in 1932, when Congress for the first time gave the Fed permission to buy Treasuries. Approximately \$1 billion (!) was acquired by the Fed back then.*

²*I deliberately use the term 'so-called money printing' because the techniques used by central banks today have little in common with the traditional money printing approach which caused hyper-inflation in the Weimar Republic in the 1920s and in Zimbabwe more recently, a topic I have discussed in depth before.*

³*A small number of countries within the eurozone have actually managed to reduce total debt since 2007, but it is a drop in the ocean.*

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