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"The Election, Money, and Markets"

Lawrence Goodman

After the Election: Realities, Opportunities, and Challenges for Investors

University of Virginia Investing Conference

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Thank you, Professor Warnock, for the gracious introduction and, Dean Bruner, for the kind invitation to participate in today's timely conference on the post-election investment environment and outlook. I am grateful to the University of Virginia for organizing such a terrific event as well as previous speakers and conference participants. The dialog over the last few days has been informative and especially needed during a heightened period of economic uncertainty and fragility.

It is a special privilege to evaluate challenges and investment opportunities at Thomas Jefferson's university. To be sure, history matters.

Today, I will touch on international monetary history, the present fiscal and monetary mix in the United States, as well as investment implications here and abroad. The bottom line or four key themes are 1) long term policy vision is needed more than ever; 2) fiscal challenges will remain a serious threat to the nation's credit quality despite a likely solution to the fiscal cliff. The "fiscal cliff" should be converted to a "fiscal opportunity"; 3) monetary policy will likely continue to propel and influence asset prices, but not the real economy; and 4) uncertainty will remain a fact-of-life due to the present policy mix…with investment implications for the pricing of volatility.

History Matters: Bretton Woods Transcripts

Over the last year, we at the Center for Financial Stability have experienced the joy of a once in a lifetime find. My colleague and friend – Kurt Schuler – found never before published, word for word discussions recorded by stenographers at the historic Bretton Woods Conference in 1944. The transcripts were tucked away in the depths of the library at the US Treasury.

Fortunately for us today, Kurt found tattered yellowed pages with lively and passionate quotes from John Maynard Keynes and other international leaders. Kurt spent more than a year with his co-editor Andrew Rosenberg, digitizing, editing, meticulously footnoting, and writing summaries of important meetings and characters at the famed conference. So, we are now granted a front row seat at this iconic and influential conference.

The relevance of the transcripts and the achievements by Bretton Woods' founding fathers extends well beyond historical interest. Two lessons immediately resonate.

First, the founding fathers of the Bretton Woods international monetary system were visionaries. They prioritized the long term. Whether it was related to debates about post war indebtedness – with John Maynard Keynes skillfully leading the UK's position on its liabilities to India – or discussion about the institutional framework, there was a tremendous sense of purpose and vision requisite to build the infrastructure for stability and growth into the long-term.

The Norwegian delegate, Wilhelm Keilhau, clearly noted a vision of the long-term importance of policies being negotiated at the conference. He stated:

> "When we now formulate the policies and purposes of the Fund, we give a fundamental law which may be in effect for hundreds of years."

Today, international financial markets would benefit from leadership and a long-term vision.

Second, at Bretton Woods, officials established clear parameters. They defined the rules of the game for participants in the international monetary system.

Louis Rasminsky from Canada, André Istel from France, and Edward Bernstein from the United States were instrumental is setting specific rules for the system of foreign exchange rates. While I am not advocating a return to fixed exchange rates, their approach is instructive and highly relevant for today. As the Alternate Chairman of the Foreign Exchange Control Board, Rasminsky noted strategically what he wanted to achieve via technical measures:

> "If a country…is a creditor country with a favorable balance of payments on current account… Anything that that country can do to increase the world supply of its currency is to the general advantage of the community."

Rasminsky and his colleagues were dedicated to creating an exchange rate system and mechanisms for adjustment to promote liquidity and long-term growth as well as prevent global imbalances. In other words, parameters were set and the rules of the game were clear. Rasminsky went on to have a distinguished career in international finance serving as an Executive Director at the IMF and ultimately the governor of the Bank of Canada.

Today, the rules of the international monetary game today seem to be changing with each passing day. Uncertainty stretches from optimal debt management strategies for advanced economies to the appropriate size of a central bank's balance sheet to questions of currency manipulation.

Clearer parameters would reduce uncertainty and improve the investment environment over the long-term.

Uncertainty, Markets, and Fundamentals: What does this mean for today?

For markets, finalization of the presidential election represents a step forward due to the evaporation of one of the many imponderables confronting investors. Nonetheless, policy uncertainty remains high due to major market distortions from previously implemented policies. The fiscal situation in the US is even worse than many realize and the highly accommodative monetary stance distorts financial market valuations. The approach to resolving these challenges will unequivocally drive investment opportunities moving forward.

Public Debt Management and the Fiscal Cliff

On the fiscal front, the topic of debts, deficits, and future entitlement spending covers the pages of many papers as well as airways. This is with good reason. Cumulative budget deficits coincident with

the Great Recession represent the largest fiscal expansion over the last century. In the last five years, cumulative fiscal deficits reached a record 40% of GDP. In contrast, the summation of deficits in the 1980 recession and beyond reached only 40% of GDP after 10 years.

Figure 1. Cumulative Deficits in Deep Downturns, % of GDP

Source: Office of Management and Budget, Historical Financial Statistics and Center for Financial Stability.

Similarly, comparisons between the present Great Recession and the Great Depression in the 1930s abound. However, in the 1930s, cumulative deficits only reached 30% of GDP in the 10 years coincident with the Great Depression, despite a deeper dive in the economy and strong New Deal stimulus. So the recent expansion of the public sector is unprecedented.

These problems are well known.

The Other Fiscal Problem

An equally severe, yet less well know problem relates to super sized maturities of principal falling due on US Treasury debt. This is what we at CFS call "The Other Fiscal Problem."

Over the years, the repayment of principal often triggers a crisis or abrupt policy shift rather than simply the size of the debt or deficit. Cash flow and the overall call on capital (fiscal deficit + debt repayments) for a nation matters.

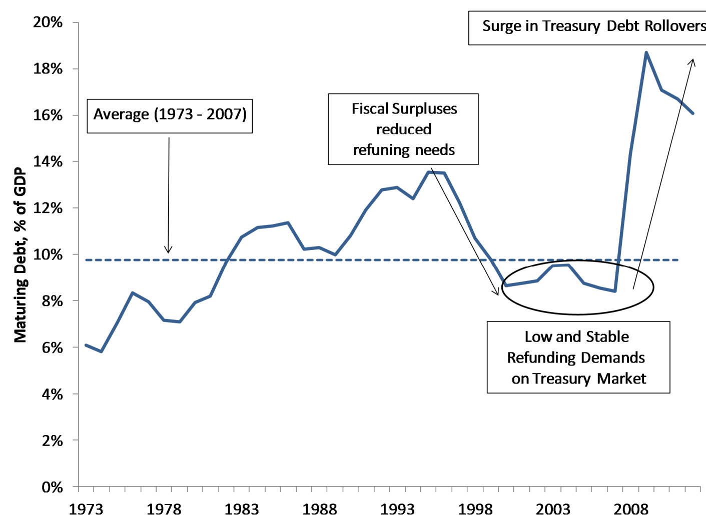
One of the key triggers for the Russia default and devaluation in 1998 was a relentless amortization profile faced by local currency securities such as GKOs and OFZs falling due over a short period of time. What also tipped the policy calculus at the time was the fact that Russia had earlier in the decade guaranteed payment on the debt of former Soviet states. Large principal payments on the former Soviet states assumed by Russia scheduled to be repaid the following year tipped the policy balance. So, diminished access to capital and a relentless maturity profile made default inevitable.

The problem extends again to Greece, which this morning faced a large Treasury-bill repayment, that meaningfully raised the level of fear among many market participants.

The United States is not Russia or Greece. However, the debt dynamics are similar and they have sadly been overlooked in recent years. The perspective that advanced economies do not experience funding shortfalls – even temporarily – is mistaken. The logic that advanced economies are immune to debt servicing difficulties is mistaken.

In the US, the maturity profile math is messy. Since 1973, roughly 10% of GDP has been refunded in private debt markets on average each year. Today, the refunding requirement is a full 6% of GDP higher than the average or 16%. So, the US Treasury call on capital markets is a stunning 23% of GDP – assuming that the budget deficit remains at 7% of GDP. This is a full 9% of GDP higher than the appropriate benchmark with an average refunding requirement of 10% and a safe budget deficit of 4% of GDP. So, the US is more dependent on placing Treasury paper than at any time in its recent past.

Figure 2. US Treasury Maturities Spike in Coming Year



Note: Interest bearing public debt held by private investors.
Source: US Treasury and Center for Financial Stability.

So, we close 2012 with a gigantic overall public funding requirement and a steep fiscal cliff.

Debate surrounding the fiscal cliff will prove contentious and continue to rattle markets. Noise related to the fiscal cliff will also likely be accentuated as the debt ceiling is rapidly coming into sight and is likely to be pierced early in the first quarter of 2013.

The National Association of Business Economists (NABE) recently conducted a survey of professional economists regarding their expectations for the outcome. Suffice it to say, the economists expect the bite of the fiscal cliff will be made less severe through perhaps preservation of the Alternative Minimum Tax (AMT) fix, reduction in the sequester, and possibly partial extension of tax cuts. So, investors should prepare for a debate that will suppress the price of risk and ultimately dent – but not destroy - an economy growing at the rate of roughly 2%, perhaps shaving as much as 0.5% to 1.5% from economic activity.

Although the fiscal cliff represents a challenge, I am optimistic that agreement will be struck.

But, fundamental problems will persist as savings from a watered down fiscal cliff (1% to 2% of GDP) will negligibly reduce the US government's 23% of GDP call on capital. In other words, the "Fiscal Cliff" will sadly not be recast as a "Fiscal Opportunity."

Accommodative Monetary Policy and the Financial Sector

The other macro distortion influencing financial markets radiates from nontraditional monetary measures. To be fair, overwhelming challenges exist for officials due to a weak economy and high levels of unemployment.

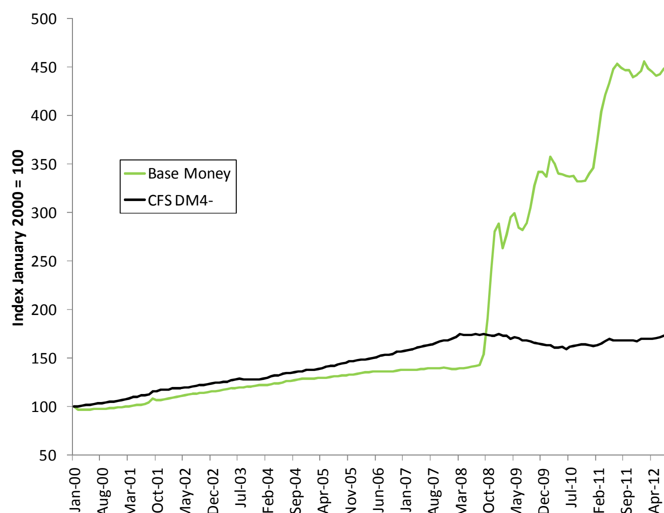
Under the leadership of Professor William A. Barnett, we (at the CFS) developed a major project to actually measure money. The Advances in Monetary and Financial Measurement (AMFM) project is designed to monitor actions by the Federal Reserve as well as the impact of monetary policy throughout the banking system.

As background, Bill, two Ph.D. economists, and our chief technology officer, labored for nearly a year and a half to bring Bill's theoretical insights to life and into practice. There is no more complete monetary mapping of the United States. We release a comprehensive set of liabilities in the financial system - which measures banking and shadow banking activities every month, free of charge as a service to the public.

The results are illuminating.

Our data highlight how recent nontraditional monetary measures are having a substantial impact on asset prices – but only a limited impact on the financial system and economy more broadly.

Figure 3. Slow Private Money Growth – Despite Fed Action



Source: Federal Reserve, Bloomberg, and the Center for Financial Stability.

The Federal Reserve stimulates the economy via expansion of public money or total reserves held by banks at the Fed. However, public money accounts for a scant 8% of total money, which we define as public and private money.

Private money, which takes into account liabilities in the financial sector, serves as stores of value or a means to enter transactions. In other words, private money accounts for a full 92% of total money and is vital to drive the US economy.

So, despite a stunning 110% growth on an average annual basis since 2008 in public or Fed money, money produced by the private sector stood at a standstill. Private money or CFS Divisia M4 barely budged, increasing by a scant 1% on average during the same period.

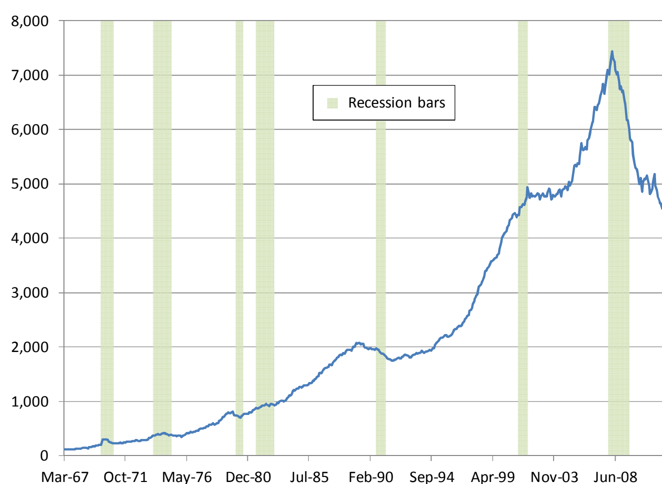
It is no wonder the economy is stuck in low gear. The monetary transmission mechanism is clogged.

Our belief is that this quandary is partially due to a needed transition to a smaller financial sector. However, policy and regulatory uncertainty are unequivocally hanging heavy over the economy and denting the monetary transmission mechanism.

The monetary wheels in the private sector stretch from deposits in small savings and loan institutions to large repo transactions to facilitate leverage in the hedge fund community. At present, participants in the financial economy are flocking to safety or deposits at insured institutions. In contrast, the shadow banking system has been hit hard.

The shadow banking system is not all bad. The shadow banking system embedded in the CFS monetary data contains institutional money market funds, commercial paper, and repurchase agreements. To be sure, our data evaluates the levered transactions – which helped to topple the US economy – but also the commercial paper and institutional money fund markets. These industries are vital to corporations and the overall economy. Unfortunately, these sources are plagued by deep regulatory and policy uncertainty.

Figure 4. CFS Shadow Banking (Real $ bn in 9/12)



Source: Federal Reserve, Bloomberg, and the Center for Financial Stability.

The CFS measure of the shadow banking system is down a stunning 40% in real terms from peak to trough in the recent financial crisis. In contrast, previous adjustments typically associated with recession

or bursting market bubbles coincided with a 13% to 25% collapse in shadow banking during the period from 1967 to the present.

So, a highly accommodative monetary stance will likely continue to influence markets, but have a limited impact on the overall economy. This may remain the case until uncertainties begin to clarify.

Investment Implications

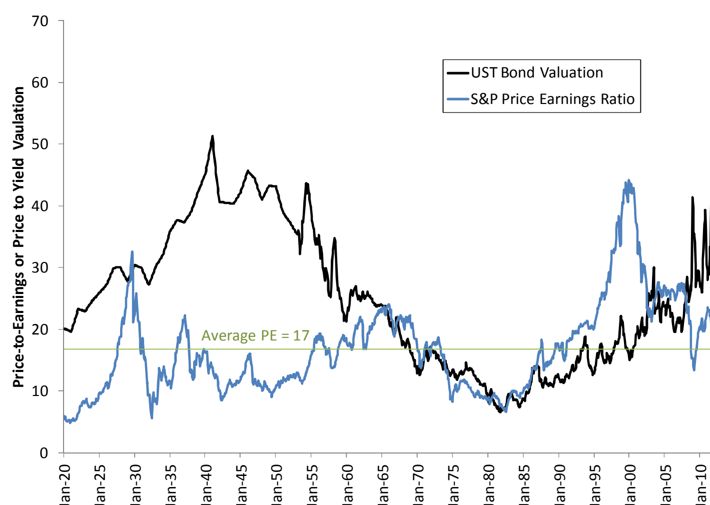
Based on the challenging macro environment, two main themes present between now and well into 2013. They include: distortions and alternative stores of value.

First, distortions exist between equity and fixed income markets. Bonds are overvalued and stocks are near their long-term average valuation. Similarly, on a relative basis, the dispersion between bond and stock valuations has never been this extreme – at least by our analysis which dates back to 1920. The most recent large distortion dates back to the late 1990s, when stock valuations - as measured by the long-term price earnings ratio - meaningfully exceeded comparable bond market metrics.

Stocks are fairly close to their long run valuation, so a meaningful move higher will be dependent on future economic and earnings growth. Here our monetary data suggests that the real economy has bottomed, yet will be trapped in below trend growth of 1% to 2% into next year. There may be modest upside for stocks into early next year especially if the actual bite of the fiscal cliff is less than the bark.

Bond valuations remain troublesome. To be sure, ultra low interest rates help keep a lid on Treasury interest payments. However, even a modest move higher of inflation on a sustained basis or question surrounding the credit quality of sovereign assets could readily reverse valuations that are already stretched and pulled to extremes.

Figure 5. Policy Distortions: Risks for Markets and Fed



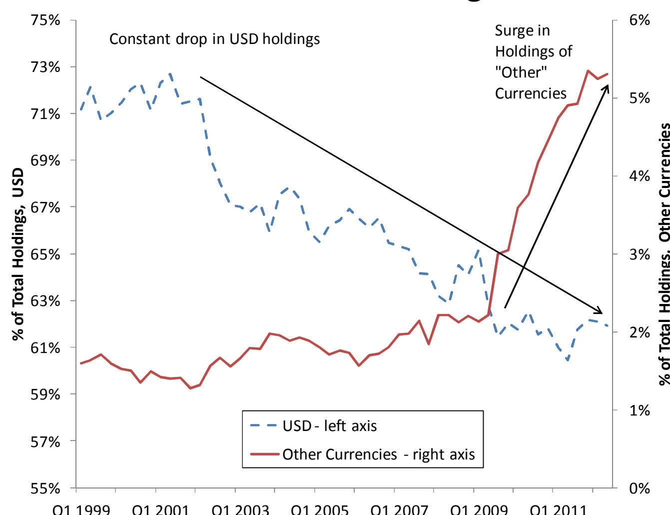
Source: Robert Shiller (Yale University), Bloomberg LP, and Center for Financial Stability.

Second, investors are searching for alternative stores of value, due to the ultra low US rate environment. So, high quality corporate and foreign markets will benefit.

On the corporate front, Exxon, Johnson & Johnson, Chevron, Walmart, and even Google are corporations dubbed by the market, as having a lower probability of default than the full faith and credit of the United States. Imagine a company such as Google, which was founded in 1998 and went public less than a decade ago, sports a lower probability of default than the US government. For instance, it costs 24 basis points to protect an investor from a default on $1 worth of Google debt. In contrast, the same investor would need to pay 37 basis points to protect against a sovereign default in the United States. Sadly, this is up from 7 basis points at the beginning of 2008 and 30 basis points on Halloween - before the election.

Even major central banks are diversifying their currency holdings away from US dollars. Since the embrace of easy monetary policy in 2003, the US dollar has fallen from accounting for 71% of central bank reserves to 61%. Although the euro was the beneficiary in the early days, gains in acceptance of the euro have ceased with “other currencies” such as the Australian dollar, Canadian dollar, Norwegian krone, Swedish krona, and New Zealand dollar gaining representation in central bank portfolios.

Figure 6. Reserve Currencies: Shifting “Stores of Value”



Note: Composition of World Central Bank Reserves. “Other” is largely AUD, CAD, NOK, SEK and NZD.
Source: Datastream, International Monetary Fund (COFER) and Center for Financial Stability.

To be sure, emerging market currencies will also begin to more actively fill the void for stores of value, especially stores of value that offer a return to the investor of above zero. Emerging markets are well poised to benefit from distortions, debt and deficits in advanced economies. However, there are wide dispersions in the fundamentals among various investable emerging economies. For example, Argentina has pursued a reckless policy path and is on the verge of a large currency devaluation and even more capital flight.

In contrast, most emerging economies have maintained increasingly clear and carefully communicated monetary policy strategies as well as developed growing local currency bond markets. Singapore, Korea, Taiwan, Chile, Mexico, and Poland are among the nations destined to re-price and continue to perform well.

My bet is that select emerging market currencies become reserve currencies over the next 10 years…and not just China. In fact, China's reserve currency status may be achieved surprisingly later than other nations who have been laying the groundwork for longer.

Conclusion

The investment environment is complex and highly uncertain. However, four fundamental forces will shape global macro investment opportunities.

First, on the policy front, a move toward vision and clearer rules of the game would improve global growth prospects and the investment environment over the long run. The delegates at Bretton Woods in 1944 should serve as an inspiration.

Second, uncertainty surrounding the fiscal cliff will keep markets under pressure into the near-term. However, a watered down resolution will likely provide some relief into early next year. Sadly, long-term structural problems will likely remain unaddressed.

Third, the ebbs and flows of monetary policy will influence asset values and the pricing of volatility. This warrants careful monitoring, which is provided by the CFS monetary and banking statistics.

Fourth and finally, the distortion between equities and bonds will narrow and select emerging markets will re-price.

So, I close with a wish of profitability for investors, strength for public officials, and much success for faculty and students at Darden.

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