The Unwind: What's Next for Global Markets

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May 27, 2015

Remarks at the Capital Markets Credit Analysts Society:
Twenty-Sixth Annual Dinner Meeting[1]

It is a pleasure to have the opportunity to address the Capital Markets Credit Analysts Society (CMCAS) annual dinner this evening. I would like to thank David Hendler, Paul Wood, and the CMCAS Board for the kind invitation.

Tonight, my remarks will focus on the "unwind" or exit from a historic economic experiment. I will first discuss three present day challenges for market participants and officials. Then, I will offer three potential pathways for the future. I will bypass the three handed economist syndrome and describe the most likely path for the future. Yet, the future is usually clouded due to the present policy mix.

My comments tonight are motivated by two personal experiences:

- **Henry Kissinger's "World Order":** Kissinger's latest book is extraordinary.[2] It is remarkable that a man of any age, let alone 91, can write a book so rich in history, context, and thinking about the future. Kissinger offers insights across a wide range of geostrategic shifts as well as the challenges they present for the next generation of leaders.

  In a somewhat less lofty way, major changes to financial policy have occurred in recent years. It is these structural shifts that will challenge markets and institutions into the future.

- **Bretton Woods 2014: The Founders and the Future:** Last fall, the Center for Financial Stability (CFS) hosted a working conference in honor of the 70th anniversary of the Bretton Woods agreement called "Bretton Woods 2014: The Founders and the Future."[3] Our conference paid tribute to the past, but focused on the future of finance and the international monetary system.

  The international monetary system is now at a crossroads. Whether we contemplate future reserve currencies or the institutions that govern the international monetary system (namely the IMF and the World Bank), the system is ready for a change.

[1] Remarks May 20, 2015.
[2] Henry Kissinger, "World Order," Penguin Press, 2014.
[3] Bretton Woods 2014: The Founders and the Future - http://www.centerforfinancialstability.org/bw2014.php.

It is within this broader context that future policy decisions and market moves will rest.

Never before has your role as credit analysts been this challenging. Never before have your services been more needed by financial institutions, corporations, and governments.

Never Before

Since the collapse in the subprime mortgage market and the fall of Lehman Brothers, a succession of "never befores" has overwhelmingly influenced financial markets movements. **Specifically, three "never befores" will constrain policy decisions and unduly influence future financial market fluctuations.**

For instance, "never before" has there been such:

- Large scale intervention by central banks and governments,
- Growth in the financial regulator apparatus and labyrinth of rules governing markets,
- Distortions across a wide range of financial markets.

Large Scale Intervention by Central Banks and Governments

Michael Lewis got the wrong market. In "Flash Boys,"[4] he noted that the stock market is "rigged" due to high frequency trading.[5] **The reality is that the market for sovereign debt has been "rigged" since 2011.**

In 2012, I was the first to illustrate how much of the fiscal deficit in the US was being financed by Federal Reserve purchases of US Treasury debt.[6] The piece – which appeared in *The Wall Street Journal* – was often cited and spawned much commentary. At the time, it was stunning to learn that the Fed was buying 61% of the Federal government's new funding requirement. Since then, purchases have ebbed and flowed largely as a function of the relative action or inaction of quantitative easing (QE). Purchases peaked at close to 80% of the US government's fresh funding requirement.

In Latin America, we used to refer to this as monetizing the debt.

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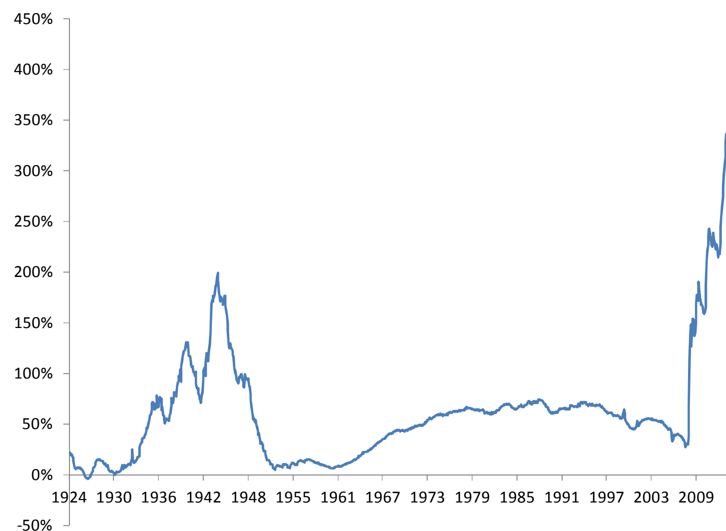
[4] Michael Lewis, "Flash Boys: A Wall Street Revolt," W.W. Norton & Company, Inc., 2014.
[5] Although we disagree that the equity market is rigged, "Flash Boys" raises substantive issues regarding high frequency trading. Hence, CFS senior fellow Brad Bondi is now leading a group with a wide range of interests to help articulate clear principles for rules governing market infrastructure.
[6] Lawrence Goodman, "Demand for U.S. Debt Is Not Limitless," *The Wall Street Journal*, March 28, 2012.

It is also clear that as the Fed engaged in QE or purchased Treasury debt, yields dropped. In contrast, during the hiatus between QE2 and QE3, yields increased. Ironically, during the hiatus from QE, economic growth and financial sector activity improved.

In the U.S., never before has such a monetary experiment been conducted.

In the last six and one-half years, the Fed's high powered money or monetary base expanded by nearly 400%. This is the largest cumulative six and one-half year expansion since the founding of the Fed in 1913. The second largest six and one-half year cumulative expansion ended in 1944 – helping the US exit the Great Depression and navigate a World War. It was only half the size of the present day monetary injection, with a 200% increase over the same period.

Figure 1. Largest surge in Money in the History of the Fed



Source: Federal Reserve Bank of St. Louis and Center for Financial Stability.

Growth in the Financial Regulator Apparatus and Labyrinth of Rules Governing Markets

Second, rapid development of the financial regulator apparatus and labyrinth of rules governing markets represents a major structural shift.

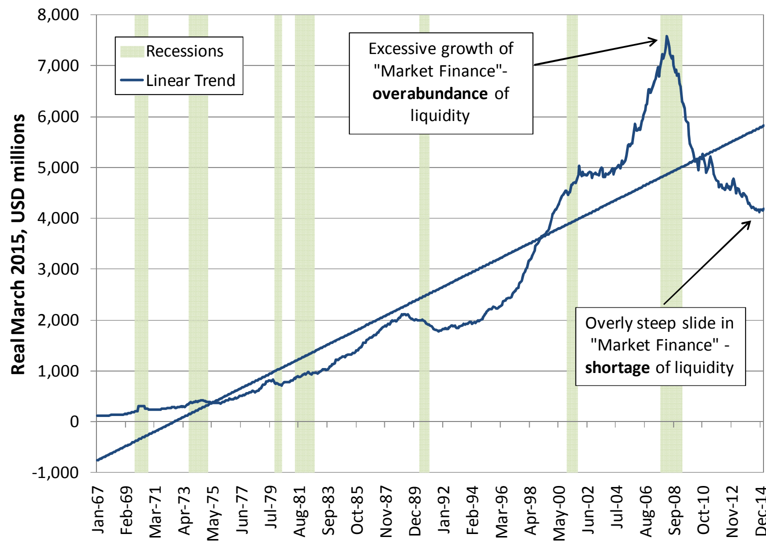
In remarks prepared for the "Bretton Woods: The Founders and the Future" conference, CFS Advisory Board member and inventor of financial futures and carbon trading, Richard Sandor noted that "at over 2,300 pages Dodd-Frank is longer than the Old Testament, New Testament, and the Koran combined."[7] So, yes, there has been a massive structural shift in the regulatory apparatus.

[7] Richard Sandor, "A New Bretton Woods must look to the East!," Bretton Woods 2014: Center for Financial Stability, September 3, 2014.

Richard's bogey for successful financial policy is for officials to achieve the same or better regulation without increasing transaction costs. It is unclear whether we have achieved this objective.

Regulatory changes have unequivocally impacted the functioning of markets and the economy. For instance, **since Dodd-Frank, there has been a collapse in available market liquidity despite the more than ample central bank liquidity.**

Figure 2. Plunge in Market Finance (Shadow Banking) Overshoots



Note: CFS definition of market finance includes: money market funds, repurchase agreements, and commercial paper.
Source: Federal Reserve Board, Bankrate, and the Center for Financial Stability.

Monetary and financial measurement is in CFS's DNA. We offer the broadest and most comprehensive measures of US monetary and financial liabilities on a monthly basis to the public. Monetary and financial data are the cornerstone of our Advances in Monetary and Financial Measurement (AMFM) project,[8] developed under the leadership of Professor William A. Barnett.[9]

Our data show that the availability of market finance is nearly 30% below a reasonable level to support liquid markets and economic growth! Of course, there was excessive growth in market finance and an overabundance of market finance prior to the financial crisis.[10] Yes, the

[8] See "http://www.centerforfinancialstability.org/amfm.php"

[9] William A. Barnett, "Getting It Wrong: How Faulty Monetary Statistics Undermine the Fed, the Financial System, and the Economy," MIT Press, 2012.

[10] The CFS definition of market finance includes: money market funds, repurchase agreements, and commercial paper.

overabundance of liquidity provided the fuel for well documented excesses.[11] Yet, this is now an old story.

The new story is that this shortage of financial market liquidity exposes markets and the economy to potentially unnecessary shocks.[12]

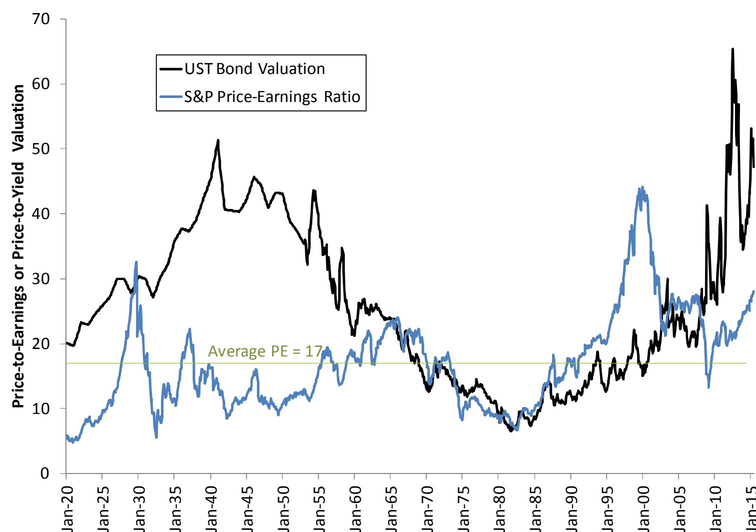
It is no wonder that in this environment that we have already experienced:

- A Treasury flash crash,
- Complaints of vanishing prices in G-10 FX,
- A plunge in EUR/CHF, and
- Ongoing fears in corporate bond markets.

Distortions across a Wide Range of Financial Markets

Third, distortions exist across a wide range of financial markets. They pose challenges for investors and officials alike. Market valuations are stretched and pulled.

Figure 3. Policy Distortions: Risks for Markets



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

For example, **never before – at least back to 1920 – has the US Treasury 10-year bond been this richly valued.** Despite intermittent corrections, lofty valuations remain. Similarly, the valuation gap between the bonds and stocks is also at extremes. Both are meaningfully overvalued – yet bonds are much more overvalued.

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[11] Lawrence Goodman, "Liquidity Shortage: Houston, We Have a Problem," Center for Financial Stability, February 25, 2015.

[12] Michael J. Casey, "Shadow-Credit Rise is Good Sign," *The Wall Street Journal*, March 28, 2015, p. C3.

Other examples of market distortions include 1) peculiar trends in currency markets and 2) lopsided trading positions in futures markets. But, in the interest of time, I will leave further comment to our discussion – if there is interest.

So, where do we go from here? What does this mean for you and your respective institutions?

The Unwind and the Future

The unwind will be a challenge.

In describing the Fed's calculus for an increase in the target federal funds rate, Federal Reserve Vice Chairman Stanley Fischer noted that "liftoff should occur when the expected return from raising the interest rate outweighs the expected costs of doing so."[13] My fear is that there may be incentive for the Fed to wait. At least for markets, **the longer the Fed waits, the more costly the exit or unwind becomes.**

Potential paths for global markets will likely be influenced by a wide range of factors. However, the interplay between valuation and fundamentals will likely prove critical. For instance, economic growth must pick up on a sustained basis before markets question the credibility of these experimental measures. Similarly, a minor unexpected shock can rapidly trigger a market correction.

Three basic paths are possible:

Growth Solution: The economy begins to grow at an annual rate of 2.5% to 4%. Growth appears increasingly stable and sustainable for future quarters. Similarly, the expansion of demand permits corporate earnings to catch up to presently high PE rations. Equity markets remain at highs and advance further. Similarly, restrained inflation limits the selloff in bonds.

Game remains the Same: Growth remains decisively below trend at around 2% or lower. Inflation also remains subdued. The Fed remains "data dependent," focusing meeting-to-meeting on the short-term dynamics underpinning its dual mandate. The Fed continues to surprise markets regarding its patience in lifting rates. So, the tug between markets and the Fed continues. Quiescent periods are followed by mini-bubbles, which burst, and then followed by a renewed commitment to accommodative monetary policy.

Unwind: The unwind scenario springs from the "game remains the same." Market participants lose patience with the potential for the fundamentals to improve sufficiently to eliminate present price distortions or the data changes. Markets correct.

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[13] Stanley Fischer, "Monetary Policy Lessons and the Way Ahead," Economic Club of New York, March 23, 2015.

Although I would like to believe that the first scenario comes to pass, the "never befores" discussed earlier render the "growth solution" unlikely. **My view is that we migrate from the "game remains the same" into the "unwind" scenario within the next 12 to 18 months, but how?**

A series of triggers can readily push markets from the uncomfortable present state to a steep selloff. Select early warning indicators will help navigate which scenario elapses over time. Indicators include: growth, CFS Divisia monetary aggregates and components, inflation, balance of payments and capital flows, Treasury bill and bond auctions, and possible policy actions to neutralize the three "never before."

Conclusion

In the wake of substantive shifts in the international landscape, three unprecedented challenges will shape future financial market fluctuations. They include:

- **Large scale intervention by central banks and governments,**
- **Growth in the financial regulator apparatus and labyrinth of rules governing markets,**
- **Distortions across a wide range of financial markets.**

A smooth and successful exit from challenges will be predicated largely on 1) the future evolution of economic growth as well as 2) potential new policies to immediately lessen present strains stemming from the three "never befores."

So, yes, never before has your work as credit analysts been this challenging.

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