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High time for greed to yield to fear

By Henny Sender

The dangers of a wholesale retreat from risky positions

There have been many false alarms in the past two years regarding the end of quantitative easing and the timing of the first Federal Reserve rate rises.

The consensus on the first rate rise seems to move just a bit further off into the future with each disappointing data point, whether on GDP growth or retail sales, which hit a six-year low in April.

"Investors remain trapped in the twilight zone, the transition period between the end of QE and the first rate hike, the start of policy normalisation," noted one recent research report from Bank of America Merrill Lynch. "The investment backdrop will probably continue to be cursed by mediocre returns, volatile trading rotation, correlation breakdowns and flash crashes." In addition to that sobering message, Merrill warned of this year's' "liquidity paradox".

"In a world of infinite central bank liquidity, asset markets can suddenly turn extremely illiquid. Reducing risk rather than maximising return is the smarter mid-2015 strategy," Merrill's strategists add.

Merrill is right to sound the alarm. Since it is QE that has driven the markets up, it is reasonable to assume that the end of QE and zero rates will trigger a downdraft in the markets in the absence of any fundamental reason to be optimistic about either economic prospects or corporate earnings, especially given the elevated levels at which shares and corporate debt now trade.

Rate rises remain some time away. And in a way QE has not ended since the Fed continues to reinvest the billions in proceeds from securities it already bought.

Yet already there have been extreme moves without any visible catalyst in markets: ranging from German Bunds to oil, Swiss francs and US Treasuries, while other markets such as high yield stubbornly refuse to rally any further. In other words, market behaviour seems to suggest that the end of zero rates has not been fully discounted yet, either in the developed world or in emerging markets, almost two years after the initial taper tantrum.

The problem, of course, is that if everyone tries to reduce risk at the same time, as per Merrill's counsel, they risk precipitating precisely the extreme market moves they seek to avoid. The most important players in financial dramas today are not the bankers, (despite the disclosure of questionable behaviour on the part of traders), but the asset managers, whether traditional or alternative.

Easy money has meant that asset managers have seen greater inflows and that they have little choice but to take on more risk to earn anything meaningful for their investors (if only to justify their fees, cynics might add.) At the same time, their positions have become more consensus driven and one-sided. Worryingly, it also is not clear to what extent they use borrowed money to magnify returns.

"Years of easy money have led to inflated asset values and encouraged lookalike yield-seeking trades," note analysts at BlackRock in a recent report. "Asset markets show rising correlations and low returns. There is limited diversification when QE has floated so many boats."

Moreover most securities are now priced for perfection; they are far more likely to lose value than rise in value. In addition, portfolios that seem diversified across various asset classes, shares, debt, commodities and currencies, can suddenly lose that diversification in times of stress.

In addition, the same regulators that tell investors to take risk and invest in riskier assets are telling banks at the same time: don't take risk; don't take a chance on losing money.

That message translates into: don't make markets for your buy side clients. The resulting lack of trading liquidity magnifies moves — particularly on the downside. The use of new products such as credit or leveraged loan exchange traded funds (particularly dangerous since these loans settle in 20 days while the ETFs promise instant liquidity) can only exacerbate the problem.

The combination of a swollen buy side and a shallow sell side could be a formula for a meltdown when managers try to unwind riskier positions. “A sell-off triggered by an unwinding of leverage and magnified by poor liquidity could sink many boats,” BlackRock adds.

A few weeks before the crisis in 1998, it was not clear that Long Term Capital Management was about to blow up either. It is high time for greed to yield to fear.

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