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Cheap money points to more taper tantrums

Dollar may retain haven status even if valuations reverse and drop

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Mid-Autumn Festival, which honours the full moon and is supposed to bring peace and prosperity in China, is a time for reflection. It is also a time for normally non-reflective types such as hedge fund managers to tally up their gains and losses as the final quarter of the year approaches.

"The biggest mistake many made," says one Singapore-based investor, "was to believe the Fed would raise rates four times and all go long the dollar. That was the pain trade of this year."

In fact, contrary to those who naively took the Fed at its word, liquidity continued to drive financial markets, saving those that seemed near death not long ago. Thus Glencore, the object of many short bets on the belief that it would prove insolvent less than a year ago, was able to borrow for virtually nothing, despite its less than stellar rating. Similarly, faith that Vedanta, an Indian commodities and energy group, would not go bust helped the bottom line of many distressed players. Last week, S&P Global Ratings upgraded the company.

Today, given the lacklustre economic fundamentals almost everywhere, "cheap money is the only thing driving [high] valuations", says another leading hedge fund investor with offices on both sides of the Pacific. If that is indeed the case — as is likely — it is hard not to conclude that the end of cheap money will cause valuations to reverse and drop. Indeed, it is disconcertingly easy to argue that the financial world is more vulnerable to a taper tantrum now than it was in the spring of 2013.

That is largely because cheap money policies have had multiple unfortunate side-effects that investors have chosen to ignore. Those policies have given rise to leverage, to the dangerous illusion that credit markets are liquid, and to greater correlations across asset classes and geographies as the prices of myriad assets march to the same drum beat of developed market central bankers. Moreover, those unconventional policies have taken the edge off geopolitical uncertainties that are more menacing now than they were at that time.

What, for example, is the right way to view prospects for the US dollar? It was expected to strengthen if the Fed followed its statement at the end of last year that it would raise rates four times in 2016, in contrast to the actions of the Bank of Japan and European Central Bank.

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During previous times of stress, the US currency retained its haven status, as it did even the week when Lehman Brothers collapsed eight years ago or in the aftermath of September 11.

Many economists believe that the dollar may even strengthen should Donald Trump win the US presidential election come November. That's because many money managers borrowed dollars to juice their investment returns in a world of low yields and would then have to buy those dollars back to meet margin calls in the wake of the uncertainty following that outcome. Others speculate that a Trump presidency would mean higher interest rates that would also support the dollar.

Many fund managers worry that certain investments and investment strategies are especially vulnerable. Real Estate Investment Trusts, for example, have been especially popular because their yields are far greater than those on 10-year Treasuries. But those yields can evaporate when rates rise, given that both many investors and many Reit managers use leverage.

Popular carry trades can also prove risky. Many fund managers now use the Canadian dollar to fund investments in the US corporate bond market, reflecting the expectation that Canada is likely to weaken its currency further by cutting rates. But the bond market that today looks so liquid is likely to be less liquid when rates finally move up and funds and retail investors all seek to dump the most levered names at the same time.

Also, strategies that have performed well in times of falling rates such as risk parity have stumbled in the past when rates moved in the opposite direction and stocks and bonds dropped in value in tandem.

Recent history — even the taper tantrum of three years ago — is an uncertain guide for the coming months. Algo traders and exchange traded funds are far bigger factors now and reinforce momentum-driven, one-way trades — and reinforce each other as well.

This year's mid-Autumn Festival could fail to prove more generous for those seeking prosperity.

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