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US monetary policy, not the economy, is the source of volatility

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When QE tide finally recedes, distressed debt skills will be relevant again

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As an uneasy consensus took hold over the past few days that the Federal Reserve will not abandon its almost zero interest rate policies come September, the dollar fell against both the yen and the euro (though emerging market currencies continued to slide on scary data from China).

There are few lessons to safely draw from the market turbulence of the past two weeks, but one takeaway is surely the fact that quantitative easing is all about supporting asset prices rather than anything to do with the real economy. If the US economy is really healing, and no longer needs such low rates, which was, after all, the original justification for the policy, why would the prospect of the end of almost zero interest rates spook the markets so badly?

Surely, the dollar should have rallied against other currencies, particularly on a week when GDP numbers for the quarter just past showed the Japanese economy shrank once again (all the more so since that disappointing performance instantly led to speculation that there would soon be even more QE from the land of the still not rising sun).

The disconnect between the markets and the real economy and the gap between fundamentals and valuations grows by the day as long as unconventional monetary policies remain in place. These policies do not merely support market levels — they largely determine them. And that in itself has become a source of volatility in the markets.
Fundamental research does not matter nearly as much as second guessing the Fed. Since prices are artificially supported by government and central bank actions, the market struggles to find the proper level in the absence of such policies.

While everything could change tomorrow, so far, shares have underperformed credit. There are good reasons for the disillusionment with the stock market at these levels in the (eventual) absence of Fed support. For one thing, share buybacks are tapering off and companies that have engaged in the practice are no longer outperforming the rest of the market. Moreover, it will become harder in future to turn revenues into bottom line profits.

But the relative outperformance of the credit markets may just mean they have further to fall. Bond prices have sunk to lows for the year, while both yield and spread are at 2015 wides to Treasury bonds, according to data from the LCD unit of Standard & Poor's. The drop last week on a single day was the steepest since December 2014. US high yield spreads widened almost half a percentage point in the week to Wednesday and 265 basis points over a year ago.

"The combination of high leverage, higher rates and slow(er) growth is not supportive for asset performance," notes a cross asset flash from BNP Paribas a few days ago. "Given the drop in equity prices of the borrower, (the lower the value of a company's assets, the greater the credit risks), further corrections in spreads remain likely."

Looking ahead then, it seems likely there will be all sorts of unpredictable contagions, across asset classes and across geographies. That means a greater likelihood that a downward spiral in US shares gets transmitted quickly to corporate debt. "Data to date suggest we will see the first example of back-to-back monthly outflows from both equity and bond mutual funds (in July and August 2015) since Q4 2008," a report this week from Credit Suisse suggests.

Similarly, a slide in Chinese markets hurts the earnings of those who sell to China in markets from Australia and Brazil to Indonesia and South Africa and also includes companies such as General Motors and Caterpillar in the US and the luxury makers of Europe. European companies are even more exposed to emerging markets than American firms, leading Stephen Jen of SLJ Macro to conclude that recent gains in the euro will prove temporary. Globalisation has its downside.

Meanwhile, Oaktree Capital Management, an alternative investment management firm, has just raised a new $10bn distressed debt fund, after waiting on the sidelines for years while even the most leveraged, distressed zombie borrowers had no problem raising capital. In 2008, in the wake of the global financial crisis, Oaktree made big gains deploying its capital. The world may not be back to 2008 but when the central bank monetary tide finally recedes, there will be a lot more opportunity for distressed investors whose skills appeared irrelevant not long ago.

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