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'Easing begets easing…..and volatility' according to the BIS

CENTRAL BANKS

by Gordon Kerr and John Butler, with Enrico Colombatto

Volatility breaks out from previously benign levels

Whilst the shrinking media segment that harbours any concerns about loose monetary policies again identified Greece as the main threat to stability, the Bank for International Settlements (BIS) commented in stark terms about quantitative easing and its likely impact on global financial stability.

The BIS Q1 Review spelled out the 'wave' of monetary easing undertaken in recent months by multiple central banks from both advanced and emerging market economies. These actions were described as 'largely unexpected'. Exceptionally cautionary words were reserved for the ECB on account of the unexpected size of its asset purchase programme.

The BIS then examined the already observed effects on financial markets, describing the overall impact as 'unprecedented'.

Price volatility across the spectrum has risen sharply from the flat, benign levels experienced in mid-2014. Both spot and forward (future price expectation) volatilities in all areas – equities, commodities, bonds and currency foreign exchange (FX) rates – rose toward long term historical averages. Exchange rate volatilities spiked after the Swiss National Bank abolished its cap on the Swiss franc/ euro FX rate. Yet asset prices continued rising. De-

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The Problems that Floored Austria's Bank Hypo Group Alpe Adria

FINANCIAL MARKETS

by Gordon Kerr and John Butler, with Enrico Colombatto

In our last Newsletter we remarked upon the collapse of Bank Hypo Alpe Adria (HGAA), and lauded Austria's government which, despite having already spent more than €5 billion in bailouts, has decided to ring-fence the rest of Austria from this deeply insolvent bank. This decision appears to have brought Carinthia to its knees.

We have previously warned that bailouts of failed banks are unlikely to work. We have argued that it is not possible for governments to calculate expected bank losses and hence the amount of capital required to refloat failed banks. Therefore, time and again the initial infusion of taxpayer funds has proved insufficient, and management of the failed bank keep coming back for more…and more and more.

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IREF's FFF Newsletter brings you monthly our analysts' exclusive inside scoop on latest trends in European central banking and financial markets, and their likely future impact.

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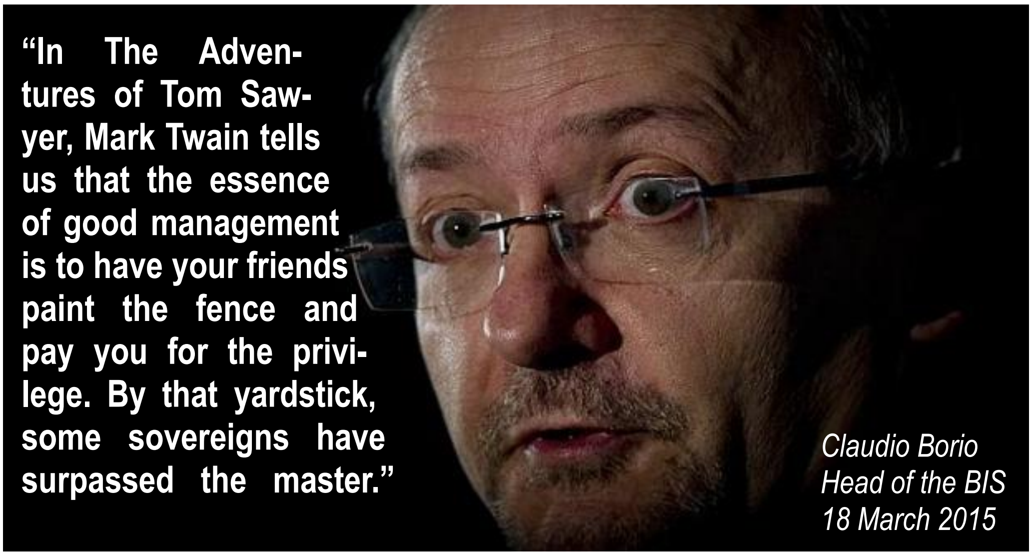
CENTRAL BANKS

(cont'd) Easing begets easing....



Claudio Borio
Head of the BIS
18 March 2015

clines in commodity prices drove down the exchange rates of 'net commodity exporters' such as Norway and Canada, which responded by lowering interest rates even further.

In short, whatever the problem, a central bank's response is always the same, lower interest rates and engage in monetary easing. Where is this likely to lead? To ever more negative interest rates. Some $2.4 trillion of term sovereign bonds are now trading at negative interest rates, of which Eurozone sovereigns account for $1.9 trillion, or 79%. Is this worrisome? Well, yes it is. In his "on-the record" remarks, BIS chief Claudio Borio observed: *"If this unprecedented journey continues, technical, economic, legal and even political boundaries may well be tested. The consequences should be watched closely, as the repercussions are bound to be significant, on the financial system and beyond."*

Whatever the problem, a central bank's response is always the same, lower interest rates and monetary ease. This is likely to lead to ever more negative interest rates.

In the latest quarterly review, the BIS chose to explain why central bank policies are not working

Regular readers will be aware that this is not the first time we have reported BIS criticism of central banks' loose policies. What is different this time is that the Basel-based institution has now stumbled upon a theory as to why such policies are not working.

The story has now moved on from concern specifically over the health of banks to a more general concern about overvalued asset values. In the latest report the BIS, observes that policies intended to address deflation have been formulated without considering their asymmetrical and potentially destabilising impact on asset prices. 'Fixed' asset prices (stocks, bonds, houses) are now experiencing extraordinary booms in the developed economies. Immediately after the ECB's announcement of quantitative easing, a combination of *'historically low interest rates and compressed risk premia'* (BIS again) led to a substantial movement of funds into more risky assets. In the ensuing four weeks, $19 billion flowed into European equity funds, the largest amount ever recorded in such a period. And this alongside growing expectations that Greece and possibly other countries may exit the Eurozone, threatening European financial asset values.

ECB and other public institutions own 80% of Greek debt. This makes the odds on a Greek default now more, rather than less, likely.

Major Asset Managers Now Fear that Interest Rates May Rise

Scott Minerd
CIO of Guggenheim Partners $200 billion AUM
(Assets Under Management)

Ray Dalio
founder of Bridgewater Associates
$163 billion AUM

Another way of measuring the likely future effects of these trends on financial markets is to listen to the views of major figures from the investment world. We consider the latest contributions from four.

Gundlach recently stated that there are "no fundamental reasons to raise rates", Dalio has called for the Federal Reserve to wait for the "whites of the eyes of inflation" before tightening rates, and Grantham, a specialist in spotting bubbles and investing based on the theory and anticipation that prices of everything will always revert to long term mean averages, has commented that we have "never seen anything like this before". He was born in 1938. Minerd goes one step farther, claiming in a recent editorial published in the Financial Times that quantitative easing (QE) has created

Jeffrey Gundlach, founder of DoubleLine Capital
$45.6 billion AUM

Jeremy Grantham
CIO of Grantham Mayo van Otterloo
$112 billion AUM

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FINANCIAL MARKETS

(cont'd) Problems with HGAA...

The History of HGAA Government Bailouts and reason for Wind Down/ Bail- in

Although Austria should indeed be praised for its action, the HGAA story is worth setting out.

In 2008 the bank was sold to Germany's Bayern LB, which itself failed and received €10 billion of bailouts from the German and Bavarian governments. In 2009 the Austrian Government bought it for a nominal sum and nationalised it. But losses began to materialise that greatly exceeded expectations, and a raft of criminal charges for breach of trust and falsifying accounting records were filed against various senior managers.

Although ownership was transferred to the regional government of Carinthia, the national government continued to support HGAA as new losses were declared on a quarterly, and sometimes monthly, basis from 2013 until early this year. In total, Austrian taxpayers injected €5.5 billion, all of which appears to have been lost. The state of Carinthia remains exposed to the tune of €10.2 billion in bond guarantees, and latest reports suggest a creditor bail-in and write down of at least 50 per cent. (A bail-in transfers the losses onto some bondholders who probably would have been wiped out under ordinary liquidation, unless protected by another taxpayer bailout.)

> *The state of Carinthia remains exposed to the tune of €10.2 billion in bond guarantees… has tried to help Carinthia by speeding through a special law to protect the bank and state from foreign, i.e. German creditors.*

The trigger for the March 2015 wind down decision appears to have been the discovery of a further €7.6 billion capital shortfall. Although Austria is not offering financial support, it has tried to help Carinthia by speeding through a special law to protect the bank and state from foreign, i.e. German creditors. Unsurprisingly, this move has not been welcomed by German banks who have filed objections with the European Union's antitrust and financial authorities, claiming that the new law constitutes both illegal state aid and, by disadvantaging other Eurozone creditors, breaches core EU Directives protecting the fundamental freedom of movement of capital. Thus, the HGAA saga has not only increased Austria's debt to GDP ratio by at least 6 percentage points to date, threatened the state of Carinthia with bankruptcy, but also created political strains between the two supposedly richest countries in the EU.

The Difference between Wind Down and Liquidation

The Carinthian authorities have decided to wind HGAA down slowly, rather than declare it insolvent. They believe that an orderly wind down will enable management to realise the bank's good assets and manage down losses from the bad ones. Your authors are sceptical; we are aware of multiple HGAA assets regarding which recoveries are being outstripped by losses, owing to fraudulent collusion between the bank's debtor, typically an equipment lessee and the equipment vendor, who are winning court claims against the bank as well as avoiding repaying their debts. Had Carinthia decided to liquidate it quickly, the bank would not have been exposed to further lawsuits from creditors beyond the date of liquidation.

> *We expect that the HGAA story will have taught a lesson to the financial authorities of other European countries – if you want to keep a bank afloat, you should immediately order a bail-in rather than expose your taxpayers to an endless series of bailouts*

We will watch the progress of the wind down closely.

What is the significance for Europe of the HGAA story? Is it an isolated case or are there other banks with HGAA – type problems waiting to appear on the scene and cause tough decisions to be taken by their national governments? In our view, there certainly are many other problem riddled banks waiting to surface. At least we expect that the HGAA story will have taught a lesson to the financial authorities of other European countries – if you want to keep a bank afloat, you should immediately order a bail-in rather than expose your taxpayers to an endless series of bailouts.

...Asset managers, from p2

massive resource misallocations that will depress economic growth rates for "generations to come."

These four investment stars have achieved fame and fortune by accurately reading the next moves of central banks, by leveraging up based on such instincts, and frequently by what are termed "carry trades"; ignoring the investment law that differential short term returns on similar assets in different markets will be negated when held for a period of time – as implied by forward market prices at the inception of the trade. This strategy worked well when volatility was low. However, as volatility has risen, the returns obtainable even on such risky leveraged positions have fallen and are themselves approaching zero, leaving only the chasing of overpriced assets ever higher as the only viable short-term yet doomed long-term strategy. These gentlemen are clever enough to know that this is almost guaranteed to be a losing, possibly career-ending game.

These asset managers have truly been highly successful in generating investment 'alpha' in nimble ways, but in today's environment they appear to be struggling. Their recent comments are consistent with our view that they have probably known all along that these policies were at best a band-aid and possibly just a sham and thus were bound to lead to the situation that prevails today. But for as long as they correctly read the runes, and managed to make money from leveraged bets that risk premia and volatility would contract and stay low for a while, they kept quiet. Now they speak. No doubt they are already in process of reducing positions and possibly they have manoeuvred into being outright short financial assets.

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