

KEYNES and... *The Markets!*

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THE FIXED-INCOME "MOTHER OF ALL BUBBLES ERA" DRAWS TO AN END

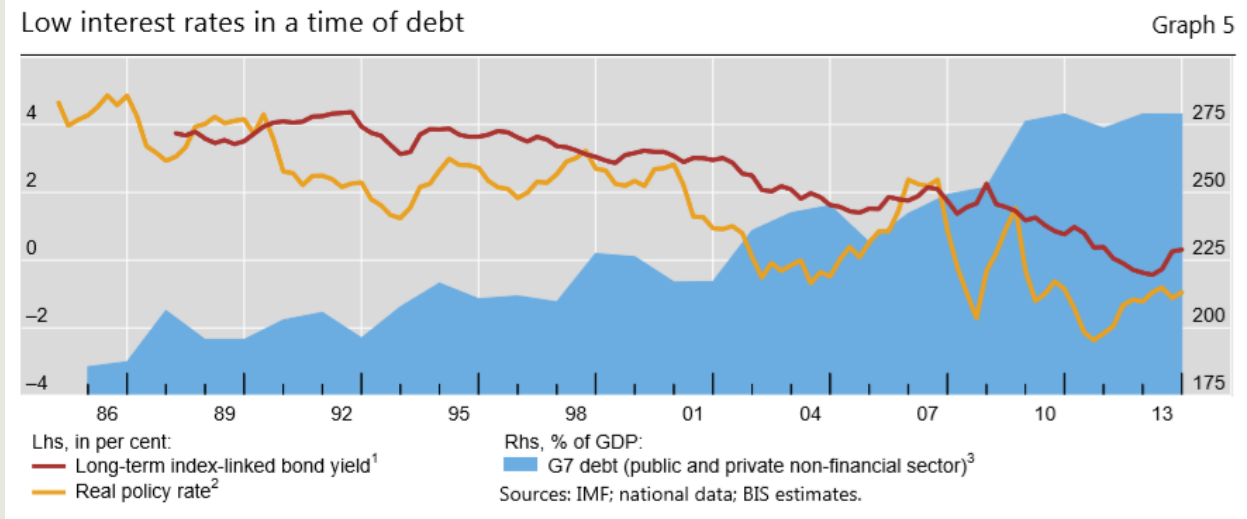


Similar to living organisms, financial markets thrive on energy. Yet, while the former obtain it from physical/chemical processes, the latter are prone to “briefly,” disregard real for psychological energy sources or “[Memes](#)”. In fact, “briefly” could mean decades, as in the case of “Don’t fight the Fed,” the Meme underlying a succession of “bubbles” since 1987. As logical as it sounds, the phrase “markets [money/equity/bond] don’t go up or down, they go wherever central bank wants them to go,” implies that less than 30 people, presiding G-7 central banks at some point or another during the past three decades, single-handedly sealed the financial fate of the world. Not possible, right? Yet, upon closer inspection, the dictum bears an undeniable truth: only centralization could have steered the global economy to the treacherous waters it is navigating today. In fact, the historic data confirms that what led G-7 economies to their present quandary, was not Irrational Markets (as implied by endless [controversy](#)), but Irrational Central Banking.

G-7 central banks:

1. Aggressively and persistently affected capital markets behavior over the past three decades, and
2. Repressed market volatility to validate, otherwise irrelevant inferences based on the probability distribution of returns (correlations, expected value, asset allocation, etc.). Below, we analyze the historical data behind these assertions and their most obvious implications.

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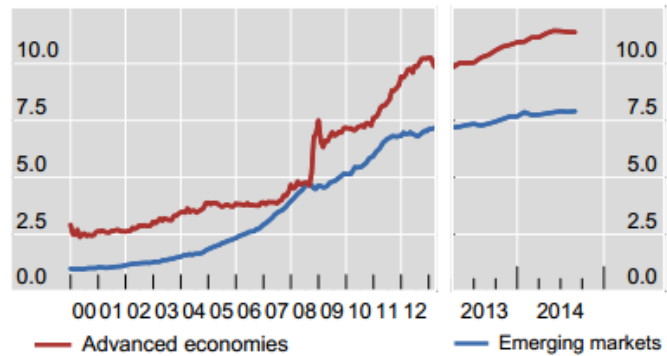
**G-7 CENTRAL BANKS
 AGGRESSIVELY AND PERSISTENTLY
 AFFECTED CAPITAL MARKETS
 BEHAVIOR OVER THE PAST THREE
 DECADES**

“Alan Greenspan,” the Wall Street Journal quotes, “said he is baffled by all the blame that has been piled on him. Since the recession, critics have said the increased money supply and low interest rates during his tenure of the Fed from 1987 to 2006 led to bubble investments.” Later in the article, Dr. Greenspan blames “finance, because of its vulnerability to spells of euphoria and irrational fear,” yet, he omitted that his New York University PhD dissertation (removed in 1987, at his request), aside from discussing soaring housing prices and their effect on consumer spending, anticipated a bursting housing bubble. It must be ironic then, that Dr. Greenspan’s policy of asymmetric monetary responses to financial cycles (aggressive against busts, but restrained against booms) coincides with the 1987 start of a snowballing cycle that has already taken G-7 debt from \$20 trn (180% of 1986 GDP) to \$100 trn (280% of 2013 GDP) (see [Graph 5](#)).

GRAPH 5 IMPLICATIONS

- Due to risk aversion, an issuer’s financing cost should increase, as debt rises (blue-shade area). Yet, as G-7 debt quintupled since 1987, real rates (in yellow) dropped by 500%. Is there better proof that interest rates come from G-7 central banks and not from market-equilibrium?
- As proverbial Ponzi schemers, G-7 central banks attract “fresh funds” (blue-shade peaks) to cover “runs on the bank” (volatility crises), by letting bankrupt, systemically important economic agents, raise new debt
- Once G-7 public and non-financial debt entered the infinite feedback loop of Ponzi financing in 1987, it lost the ability to normalize the economy (hands-off interest rates), without causing market havoc (volatility spikes)
- As G-7 debt reaches 300% of GDP, Central Banks grow assets by over 500% ([below](#)) and real interest rates drop by 500%, Irrational Central Banking has already compromised global economic solvency, irreversibly

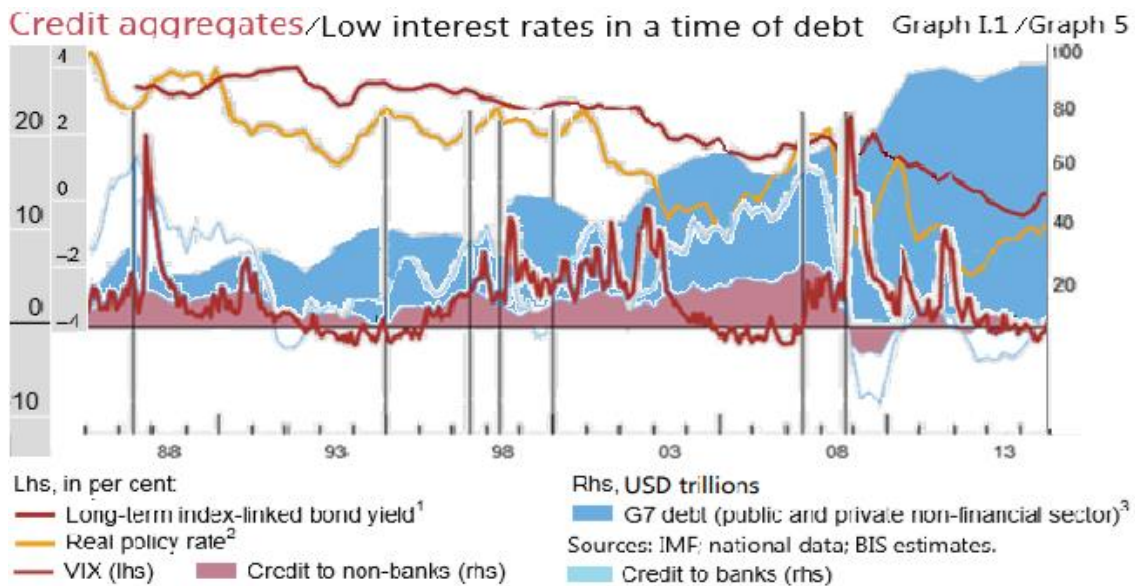
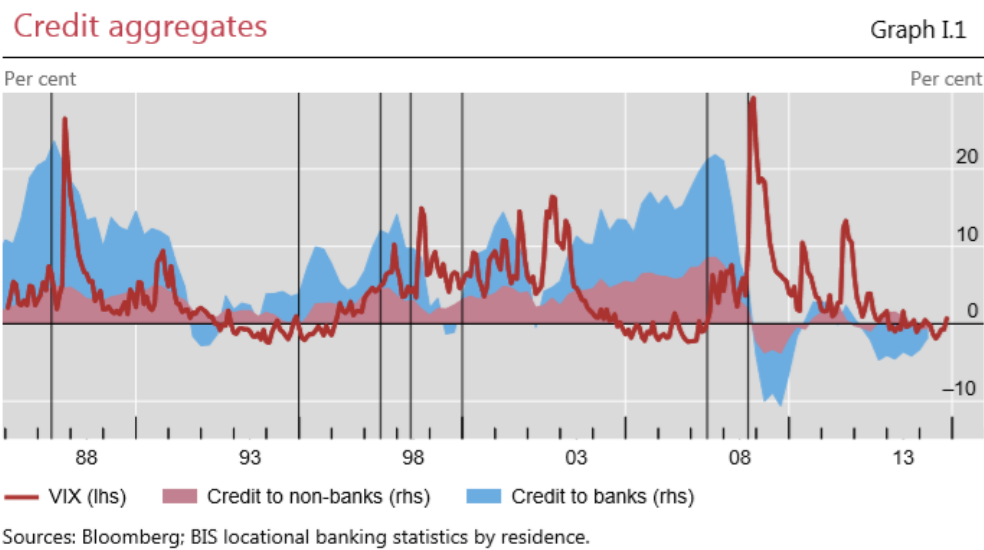
Central bank assets, in USD trillions



Sources: IMF, *International Financial Statistics*; OECD, *Main Economic Indicators*; Bloomberg; Consensus Economics; Datastream; BIS calculations.

SHORTING VOLATILY FROM CENTRAL BANK COMPROMISES SYSTEMIC SOLVENCY

[Graph I.1](#) shows that extreme volatility spikes follow the end of credit expansions (blue + red shaded tops), but volatility sinks, after asset-price corrections. Yet, by superimposing Graph I.1 over “Graph 5” (below), notice that following volatility spikes, even as credit aggregates contract, total debt increases. Likewise, as financial debt drops below zero (1991-92, 2000-01, 2008-10 & 2012-14), non-financial debt swells. This happens because G-7 sovereigns expand public debt, so their central banks can swap it for impaired banking loans (see how in our [June report](#)). In essence, central banks are shorting volatility to force real interest rates down, which automatically increases the Net Present Value of all income-producing assets, reduces fear (volatility) and spurs a new cycle of debt-leveraged investment.



SHORTING VOLATILITY FROM CENTRAL BANK LEADS TO ASSET-PRICE DISTORTIONS

- Absent Irrational Central Banking, unrepressed volatility renders asset allocation irrelevant; meaning that over the past three decades, alpha coming from classic fund management, actually came from shorting volatility within an “artificial stability bubble,” without which, alpha goes to zero
- Despite repressing historical (*realized*) volatility by absorbing incremental systemic risk, Irrational Central Banking has significantly *escalated implied volatility*, which in turn, exacerbates demand for what financial markets consider “riskless” assets
- Excess demand for riskless assets (not “search for yield”) allows G-7 sovereign debt issues and fixed-income assets in general, to exhibit the grossest mispricing among asset classes, practically assuring that investors with the lowest risk-tolerance, suffer the highest losses from the next volatility spike
- Twenty-seven years of repressing volatility have raised an increasingly fragile global financial system, predisposed to massive volatility spikes; the next one of which, might end Irrational Central Banking

COROLARY

In order to repress business and financial cycle downturns, G-7 nations are deliberately forcing interest rates down by issuing incremental debt, selling it to their central banks and swapping it for impaired debt (*to absorb systemic losses*). Overtime, asset prices rise as volatility drops, but only at the expense of decreased systemic solvency, which makes them prone to severe corrections upon the slightest sign of instability.