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Central Bank Extreme Monetary Policies and Your Portfolio

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OPUS WEALTH MANAGEMENT

SUMMARY: Central banks hold awesome responsibility in printing currency and setting short-term interest rates, which impacts the entire financial system. After the 2008 financial crisis, central banks implemented policies designed to restore fiscal health, but after 8 years, these actions have shown minimal results. What does all this mean for your portfolio?

Central banks have become a big deal since the last recession. Many money managers remember with longing a time when they didn't wait with baited breath for every Federal Reserve Board speech and decision. How did we come to this?

As the leverage in the financial system imploded in 2008, the central banks of the world acted as "the lender of last resort" to prevent total collapse. This effective rescue threw central banks into the forefront of the global economy, and given their inability to "handoff" the driver of economic growth to either the economies themselves or to fiscal help, they remain in the limelight.

While the reason central banks have taken such a prominent role is simple enough, much less understood is just what these powerful institutions are doing to the global economy, why they are doing it, whether their policies are achieving the desired results, and most importantly, what impact all this activity may have on your portfolio.

The Power of Central Banks

In most countries, a central bank is an independent government agency largely staffed by academics. In fact, many of the world's most prominent central bankers went to one school, the Massachusetts Institute of Technology (MIT), and trained under current Federal Reserve Vice Chairman Stanley Fischer. That list includes European Central Bank President Mario Draghi, former World Bank Chief Economist Larry Summers, former Council of Economic Advisers Chairman Greg Mankiw, and former Federal Reserve Chairman Ben Bernanke.

If the fact that the most powerful financial entities in the world are led by academics sharing the same financial training and philosophy sends shivers up your spine, it should. A group of similarly trained academics can easily be blindsided when their models don't account for a real-world effect. At least here in Dallas, we have bucked that trend by first having a portfolio manager, Richard Fisher, lead the Dallas Federal Reserve and now we have Robert Steven Kaplan (a former banker.)

Central banks' ability to print currency gives them awesome responsibility. Indeed, they are the only entities that can print money, although that is very different from printing wealth. In addition to this

function, central banks also set short-term interest rates. Through these two mechanisms, central banks, while not having complete control, greatly affect interest rates.

Why are interest rates so vitally important? Warren Buffett has said, "Interest rates act on asset values like gravity acts on physical matter." Interest rates are a constant force impacting everything in the financial world. Most of finance has to do with mobilizing assets for productive use in the future, and how we relate to the future—the mathematical bridge—is through interest rates. How your firm finances itself, how much financing it can get, your mortgage, your credit, your investments, almost everything you can think of financially is greatly influenced by interest rates. Which means the actions of the central banks are impacting the entire financial system. They are, in a way, manipulating gravity.

A Global Game of Hot Potato

Since the 2008 financial crisis, interest rates have been held at historic lows. This summer, when interest rates bottomed out, we were at the lowest interest rate environment in all of recorded human history (and we have data going back thousands of years.)

The central banks of the world used money printing and control of short-term interest rates to create a game of "hot potato," as market analyst Dr. John Hussman has called it. The central banks print money out of thin air and then buy bonds to get that cash into the system. Now, someone has to hold that cash, and since all the securities in the world also have to be held by someone, prices on risk assets get bid up until they are unattractive enough that individuals and organizations want to hold more cash. The idea is that as riskier assets get bid up (read: stocks) people feel wealthier, spend more and the economy regains momentum, leading out of crisis and back to a healthy economy.

While this logic sounds plausible, it has simply not happened after nearly 8 years. The common dogma is that "we just haven't done it enough; we haven't given it enough time." And so the central banks have pushed harder, to a point where we now have trillions of bonds globally trading at negative yields. Not only has this never happened in recorded history, it has never even been contemplated in the history of economics, to my knowledge.

Einstein said the definition of insanity is doing the same thing over and over and expecting different results. With several central banks in the world playing this game without significant positive effects, one wonders how long it will take for the dogma to change.

Many have argued that the current emergency monetary policies are completely overdoing it. It used to be that some central bankers' primary concern was to take away the punchbowl when the party was getting too crazy. But central banks can't seem to move away from being Atlas with the world on their shoulders. Succinctly put, paraphrasing acclaimed investor Seth Klarman, when you try to save everything, you end up not being able to save anything.

Extreme Policies, Meager Results

The difficult part of economics is you can never know the counterfactual. Where would we be currently if the central banks had not pursued these policies? We will never know. There is no economics lab where we can take the same initial conditions and give a placebo to a control group.

There is an argument to be made that what the Fed did during the crisis was absolutely needed because we were teetering on the edge of a deep depression. I'm sympathetic to that view, but at some point, you have to take the patient off his medication or the medicine itself becomes the problem.

Henry Hazlitt would remind us that there is no free lunch; there is a flip side to every coin. Current central bank policies have greatly influenced the reflation of the global stock markets, but at what cost? The great irony is that the financial crisis was due to excessive debt, and a low interest rate environment has encouraged trillions of dollars in new debt to be piled onto government, corporate and personal balance sheets.

The low interest rate environment has also starved savers of yield and robbed them of hundreds of billions of dollars of interest. This has led to another observable paradox. People now feel they need to save more since they're not getting the yield they used to. This is the exact opposite effect of what the central banks were attempting to achieve.

Yet another consequence is the fact that companies, partly due to uncertainty and partly because they consider debt-financed stock buybacks to be so attractive, have not invested in production capital like plants, factories, equipment and even jobs. Human productivity is based on two things: what we know and the tools we have to produce more. Without investment in these tools, our ability to increase our standard of living is severely impaired.

How Does This Impact Your Portfolio?

Opining on the current situation, Vice Chairman of Berkshire Hathaway Charlie Munger has said, "If you're not confused, you're an idiot." Jeremy Grantham has said, "I think of these political, social and financial experiments as Black Hole Experiments in which the further we push them, the more the laws of physics, finance, or politics begin to change in unknowable ways."

In a past paper, "Is the Global Economy Headed for a 'Worst Case' Scenario?" I contemplated what a worst case scenario arising from these policies might look like. Suffice it to say that I'm skeptical we can release this amount of "medicine" into a complex adaptive system like an economy for years without some severe side effects.

In addition to the thoughts I gave in "Investing in a Time of Great Uncertainty," I advise you to be mindful of the interest rate exposure in your portfolio. The technical term for this is "duration." It's the idea that a short bond, say one that matures in 2 years, isn't nearly as affected by a rise in interest rates as a 30-year bond. Think of it this way. Since prices and interest rates move in opposite directions, they act like a seesaw. The longer the arm, the more increasing rates decrease price.

The important realization is that a stock's "duration" is long. Technically, you buy a stock assuming cash flows are infinite. Using some highly simplified math, if the stock pays a yield of say 2%, as the S&P 500 roughly does today, that gives stocks a duration of about 50 years. In other words, stocks are very sensitive to interest rates. Mind the duration of your portfolio and make sure you understand the risks that are embedded in the securities you hold.

Sources:

1. Robert Jeremy –"British investor and co-founder and chief investment strategist of Grantham, Mayo, & van Otterloo (GMO)".
2. Dr. John Hussman – "Stock market analyst and mutual fund owner."
3. Seth Klarman "American billionaire who founded the Baupost Group, and the author of a book on value investing titled Margin of Safety".
4. Warren Buffett, "American business magnate, investor and philanthropist."
5. Charlie Mungar, "American businessman, lawyer, investor, and philanthropist."

About the Author

Loic LeMener is founder and President of Opus Wealth Management in Dallas, Texas, a boutique wealth management firm that specializes in personalized client solutions. Loic and his team provide their clients with a targeted needs evaluation to answer important questions that provide a better, more personalized experience. The team focuses on integrity and believes in the following "golden rule" – they won't do anything for you that they would not do for themselves or their loved ones.

Loic received his Masters in Business Administration from Southern Methodist University, studying Finance, Accounting and Portfolio Management. He also earned the Certified Financial Planner™ certification and the prestigious Chartered Financial Analyst® designation. In addition, he has been quoted in national publications such as Barron's.

In his free time, Loic is a devout reader, with his favorite topic being "value investing." His favorite investors are Warren Buffett, Ben Graham, Charlie Munger, Seth Klarman, Howard Marks, and Jeremy Grantham.