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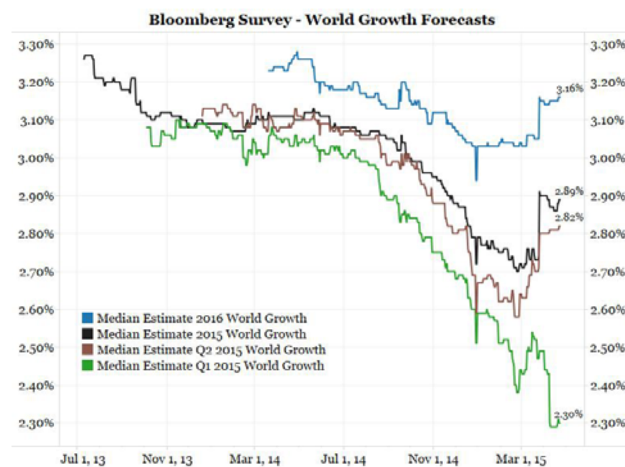
Both economics and capital markets analysis are, at their core, based upon the study of history. Everything that analysts, economists, strategists and investors know, or think that they know, is based upon the premise that the past offers some insight into the future, and that it is reasonable to expect for both markets and economies to react to a given set of influences in the future in much the same way as they have reacted to a comparable confluence of influences in the past.

We believe that history strongly supports the validity of this general premise and so we, like most of our analytical brethren, look to the past for guidance, as we attempt to anticipate the future. Even though two time periods are never exactly the same, and despite the fact that the ultimate resolution is rarely exactly the same as it has been before, past experience can be very insightful. As Mark Twain famously said, "History does not repeat itself, but it oftentimes rhymes".

It is extraordinarily rare to be confronted with a set of circumstances that have never existed before. However, these are not ordinary times and, as a result of the massive size and unprecedented nature of the programs being used by central bankers to facilitate a global recovery from the financial crisis, we are actually witnessing a multitude of macro-economic scenarios that are without historic precedent. This certainly increases uncertainty and reduces the level of confidence associated with most market and economic analysis.

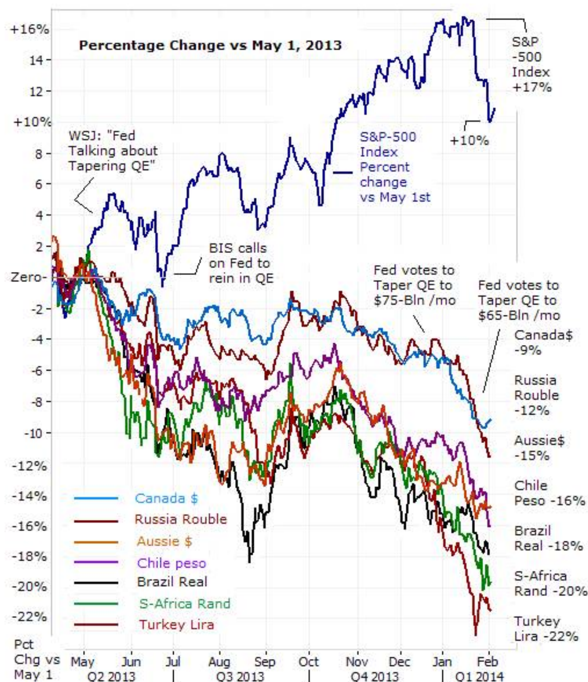
Investors generally hate uncertainty more than anything else. Indeed, there is an old Wall Street adage that, if given a choice of bad news or uncertainty, almost all investors would prefer bad news, as they at least know what the news is and thus can adjust related prices accordingly. When faced with uncertainly, it is quite common for investors to discount the worst case scenario into prices until such time when they get more clarity.



The current inability to look at the past for insight is manifesting itself in uncertainty on a global level. Further, it is an uncertainty that extends all of the way to the upper echelons of both governmental and international institutions, including the International Monetary Fund itself.

While investors hate uncertainty, and while increased uncertainty tends to depress both asset prices and economic activity for so long as it persists, that negative bias tends to give way to rational assessment as soon as greater clarity is achieved.

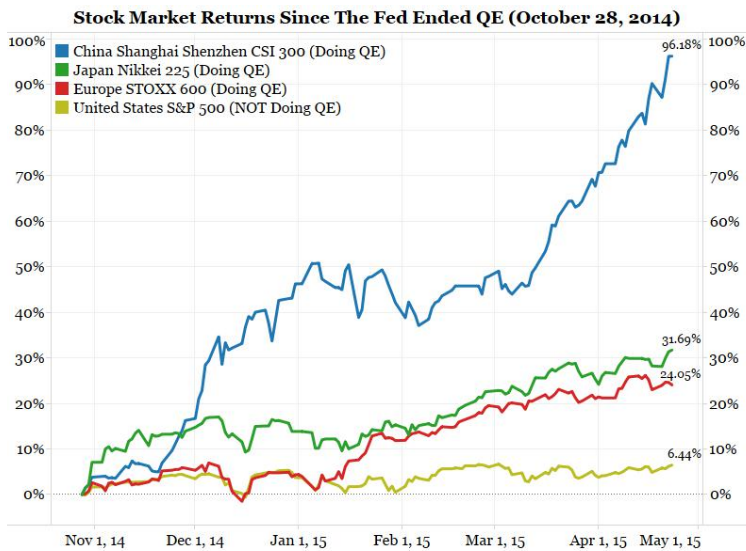
For example, similar fears were pervasive when it came to the end of the Federal Reserve's quantitative easing (QE) program because 1) there was a lack of historical precedent that could be relied upon for guidance, 2) these programs were largely attributed for pulling the domestic economy out of the depths of the financial crisis and 3) because the world had never seen such a massive money stimulus program before. The Fed's QE program was designed to inject money into the economy through what was essentially an accounting measure that created approximately $3.5 trillion of credit, which the Fed used to buy government bonds and mortgage-backed securities. To put this sum into some perspective, $3.5 trillion is roughly the size of the German economy (the fourth largest economy in the world).



Again, since such a massive and experimental program had never been seen before, there was no historical precedent that offered any insight into the expected impact of the termination of such a program. This produced a broad-based concern that the economy and the markets might simply collapse under their own weight once the Federal Reserve stopped injecting $85 billion a month into the economy.

Indeed, as soon as the Federal Reserve announced on May 22, 2013 that it would begin tapering back the size of its QE stimulus program, the markets essentially discounted the "worst case scenario" in an episode that has come to be known as the "taper tantrum".

The announcement caused stock prices to suffer steep losses, interest rates to soar, and currencies around the world (especially emerging market currencies) to plummet against the dollar.



In what bulls can only hope establishes a precedent for the ultimate unwinding of the other stimulus programs to be discussed, it has now been almost two years since the aforementioned announcement and more than six months since the last injection of liquidity on the part of the Fed, and yet the economy and the capital markets generally continue to improve. Reality turned out to be much less ominous than the worst case scenario that investors had priced into stocks and bonds, and both asset classes went on to set new all-time highs.

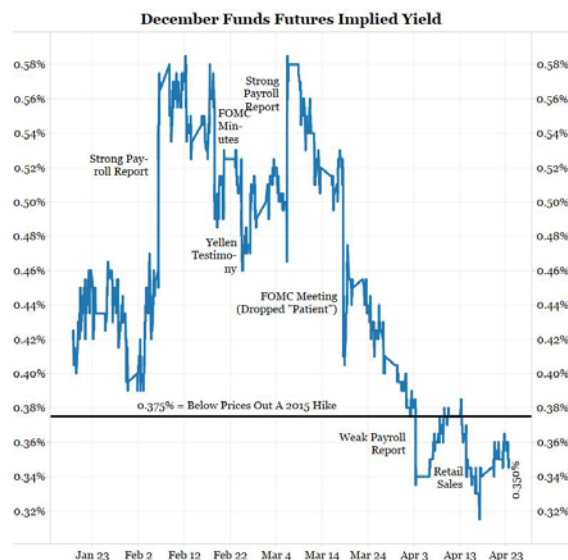
However, this is not to suggest that the end of QE has not had an impact. As you can see from the chart above, the economies that are accelerating and/or initiating their own QE programs (China, Japan, and Europe) are enjoying very strong bull markets in stocks. In contrast, the returns experienced in the domestic markets have been much more modest since the end of the American QE program.

Today, the list of unprecedented international situations is very global in scope, and includes all four of the world's largest economies. In this writing, we will concentrate on Europe and the U.S.

In the United States, the perceived risk is in regards to the anticipated increases in short-term domestic interest rates and the eventual shrinking of the Fed's balance sheet, which is likely to happen early in 2016, when more that $200 billion of Treasury securities being held on the Fed's balance sheet reach maturity.

The International Monetary Fund recently noted its concerns that the United States is poised to raise rates much more sharply than markets expect, thus risking a "potential storm" for global asset prices and a dollar shock for much of the developing world. The IMF went on to note its fear of a "cascade of disruptive adjustments" that will occur once the Federal Reserve finally tightens monetary policy for the first time in eight years.

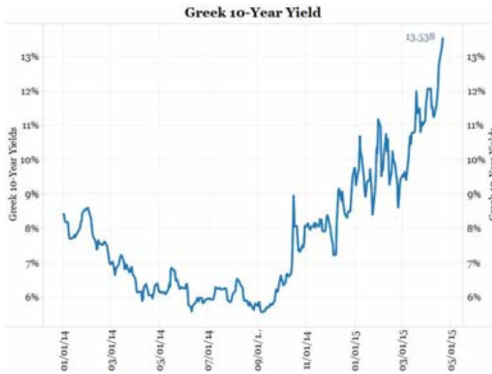
The Federal Reserve almost immediately took exception to the IMF warning and said that the market was rightly pricing in uncertainty over the pace of increases and Dennis Lockhart, the president of the Atlanta Federal Reserve, told the Financial Times that he did not see signs of a "dangerous misalignment" in rate expectations. Nonetheless, as the Wall Street Journal just noted, "we are in uncharted monetary territory with risks and outcomes we lack the foresight to predict."



Will the Fed prove to be correct, or will the IMF concerns prove to be justified? Just as had been the case when the Fed ceased expanding the size of the QE stimulus program, uncertainty remains quite high, largely because there is no historical precedent for reversing such a massive and unorthodox program.

However, from our perspective, it looks increasingly like this risk may be pushed into next year despite the fact that the Fed has made very clear their desire to "normalize monetary policy" (i.e. raise rates). Both the Fed Funds futures market and the Eurodollar markets are pushing rate expectations into 2016, and it will be very difficult for the Fed to raise rates while more and more European debt is yielding less than 0%, because a rate hike would likely strengthen the dollar and thus further weaken the competitiveness of the U.S. economy.

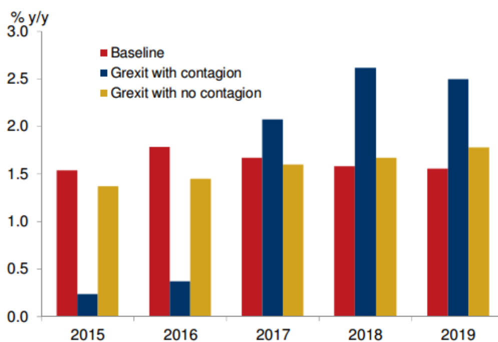
The fears related to a stronger dollar are further exacerbated by Greece-related risks, global quantitative easing, significant slowing in China and a growing debt crisis in Japan, which just had its sovereign debt downgraded.



On the other side of the Atlantic, as noted above, there are two major points of concern and contention that also revolve around unprecedented sets of influences. The first revolves around Greece and its possible default and/or departure from the euro currency bloc. The second involves the predominance of negative bond yields on an unprecedented scale.

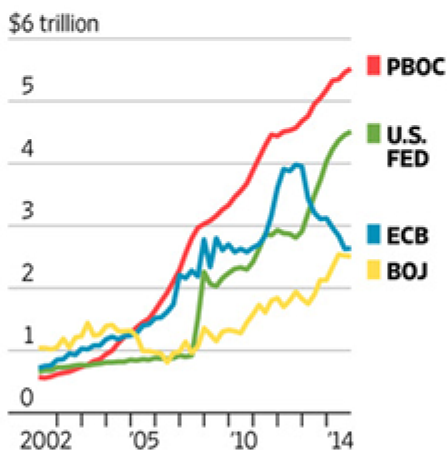
There are wildly divergent opinions on the potential impact of either a Greek sovereign debt default or its withdrawal/removal from the European Union. According to Financial Times reporter Gillian Tett, European "policy makers are now at pains to suggest that a Greek default, or even a eurozone exit, would not be disastrous; at last week's International Monetary Fund meetings German officials argued that the chance of a Greek exit had already been priced into the markets, and that shocks could be contained".

In sharp contrast, many American policy makers have been urging Europe to just forgive Greece's debt because they believe that the implications of a Greek default or departure are so potentially severe. Some are drawing parallels to the 2008 Lehman Brothers bankruptcy (which many believe catalyzed the financial crisis) and its similar contagion risks. As Jason Furman, chairman of the US Council of Economic Advisers, just warned, a "Greek exit would not just be bad for the Greek economy, it would be taking a very large and unnecessary risk with the global economy just when a lot of things are starting to go right".



We just do not know how the financial system would likely react to either of these scenarios, as there is simply no historical precident to guide us. There are however, certain things that we do know. First of all, as illustrated by the soaring yield on Greek sovereign debt, the market views default as a real risk. This is further confirmed by the soaring prices of Greek Credit Default Swaps (CDS), which act as insurance policies in the event of a Greek default. The third thing that we know is that the consensus economist opinion is that, regardless of whether or not a Greek departure (a "Grexit") would catalyze other countries to leave the European Union (i.e. "contagion"), Europe would be better off over the longer term not only without Greece, but also potentially minus Spain, Portugal and even Italy.

Europe's current yield structure is yet another example of an unprecidented confluence of events regarding which we have no historical experience on which to base future projections. At present, more than €2 trillion of eurozone government bonds trade on a negative interest rate, which accounts for more than 30% of all Eurozone sovereign debt. 70% of all German bonds, 50% of French bonds, and even 17% of Spanish debt (despite the fact that Spain was considered by many to be insolvent only a few years ago) now offer negative yields. In fact, there was a funny incident over recent weeks when Spanish adjustable mortgage rates went so deeply negative that mortgage companies actually owed money to homeowners.



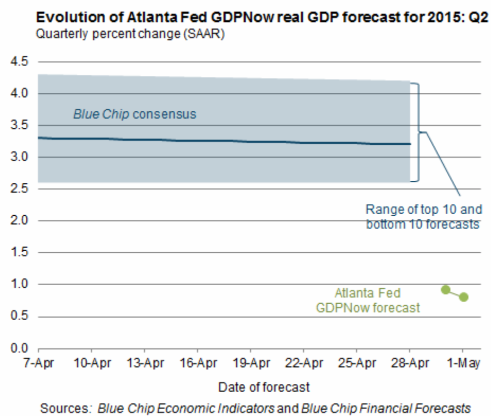
Logic dictates that this is clearly unsustainable as, in a free market (i.e. a market not so manipulated by the central banks), no one in their right mind would lock in guaranteed negative returns for two, five, or ten years. It is notable that two of America's top fixed income managers (Jeffrey Gundlach and Bill Gross) have recently announced that they are shorting (betting against) German government debt. Indeed, Gross just decribed it as the "short of a lifetime."

Then again, these are unusual times and it is similarly illogical that this condition exists today. We do know that the U.S. has kept interest rates close to 0% for over six years and that Japan has kept interest rates at similar levels since the bursting of their equity market and real estate bubbles in 1989, but we think that it is a very different thing to lock in low returns than it is to guarantee losses over prolonged periods of time. Again, there is simply no historical precident that can be relied upon for guidance.

Similarly unprecedented environments also exist in China and Japan. In China, the economy is slowing dramatically (regardless of whose estimates that you use) despite the fact that their monetary stimulus dwarfs that of every other country in the world, and despite the creation of massive bubbles in their real estate and shadow banking (i.e. non-traditional financial services) industries.

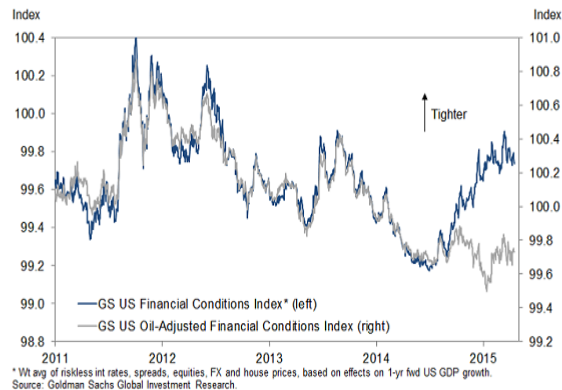
Japan, on the other hand, has just had the rating on its governement debt downgraded because they are running deficits that are essentially twice those (relative to the size of the economy) of the U.S., while they have shown no ability to raise taxes or otherwise generate revenues without cratering their economy. In addition, Japan's ability to self-finance this deficit through its very high savings rate will soon be called into question, as its aging population reaches retirement age and transitions from being a accumulator of savings to a consumer of savings.

In our opinion, there are two major elements that tie all of these scenarios together. First of all, where there is economic growth in the world, it seems to be almost entirely dependent on rising levels of debt. The combined public debt of the major industrialized economies has grown by close to 40% since the start of the crisis, while globally, the total debt of private non-financial sectors has risen by 30%, well above economic growth rates.



The second unifying element is that this is all part of economic central planning through monetary policy. This is not free market capitalism. This is about the central banks keeping the world so oversupplied with money that it cannot all be utilized in the real economy, and thus finds its way into the capital markets. The supply of money is higher than the availability of places to put it. Indeed, with more than 30% of all government debt in the eurozone paying a negative yield and global quantitative easing soaking up much of the remaining supply, the availability of places to put this excess money continues to shrink

Economics is about shortages and the process of allocating a limited amount of resources to the best possible use. In this environment, there is more money than there are places to put it, which means that virtually everything (excluding oil, which was driven lower by a supply/demand imbalance) goes up, regardless of whether or not it is a prudent allocation of resources. This should all change once this tide of monetary liquidity recedes, and money will again be allocated to investments and capital projects that deserve it, while those less-deserving investments and ventures adjust downwards in price, as capital flows to more worthy recipients.



In regard to the timing of these risks, we believe that it is increasingly likely that we will not need to worry about the impact of U.S. monetary tightening until at least 2016 due to a recent slowing in the domestic economy and the fact that some non-monetary policy factors are already starting to drag on the economy. It is significant the second quarter projections from the Atlanta Fed GDPNow forecast (which has been exceptionally accurate as of late) remains quite weak.

While we certainly view Greece as a near-term risk (which is a major reason why we have been advocating the use of currency hedges for European investments), we suspect that Europe will ultimately "kick" this issue further down the road through their so-called "pretend and extend" policies. As such, we believe that it will probably be sometime next year before we need to worry in earnest about these Greece-related risks.

In general, we believe that it still remains an environment that offers big upside return potential to risk market investors, for so long as the central banks continue to keep the world over-supplied with money. However, we also view it as a time of significant downside risk, as there is so much uncertainty on a macro level, and realistic potential for a significant macro-economic and/or policy miscalculation.