Asset Management

News or Noise: Feral Hogs vs. Central Bankers—An Update on Markets and Currency Wars

By David Fisher, Chief Investment Officer

Recently, Dallas Federal Reserve President Richard Fisher described the markets as being like "feral hogs" going after central banks. Normally, the world of currency and sovereign bond markets and the inner workings of central banks—and the ramifications of their decisions—is not exactly fertile ground for a compelling blog post. But when we read Fisher's words, we knew it was time for another update on the subject, especially since this topic is *the* story for 2013. As we have just hit the mid-year mark, it is only fitting that we go into some detail on the relationship between markets and central bank actions for the third time since January.

Revisiting the Biggest Story of 2013

In January, we wrote about how some very astute investors (including George Soros) were warning of the prospect of currency wars. We concluded then that there wasn't an imminent chance of a major breakout of currency conflict, but the situation needed to be monitored. Then in April, during a week when central bankers from Japan, the U.K. and Europe all held meetings and pushed forward with massive amounts of unconventional policy, we raised the prospect that bankers had gone wild. We concluded that the risks associated with an exit from such extreme policies required ongoing monitoring. In that post, we said, "We are concerned about [the exit] as markets tend to react violently when expectations change." In April, we didn't suspect this shift in expectations could come as soon as June, but it appears that we may be at that point. At the very least, we saw a glimpse of the new era last week.

Market Update

The inspiration for our April post was the first meeting of Bank of Japan governor Haruhiko Kuroda, who was hand picked by Prime Minister Shinzo Abe to implement the dramatic monetary reforms and reverse 20 years of Japanese economic stagnation. In that meeting, Kuroda said, "I will not use my fighting power in an incremental manner … Our stance is to take all the policy measures imaginable at this point to achieve the 2% [inflation] target in two years."[1] Those are strong words from a central banker, and they pushed the yen lower and the Japanese equity market higher. They also set off a period of volatility in the Japanese bond market. In the six weeks following that meeting, the Japanese equity market rose 25%, but since May 22 it has declined by a similar amount; now, there seems to be uncertainty as to what will come next. It is likely the markets are waiting until after Japan's July elections to see what comes of the so-called "third arrow" of Abe's reforms. These are the necessary structural reforms and will be the hardest to implement.

Since the April market highs around the globe, instability has been increasing, which has had the biggest impact on emerging economies. The currency and equity markets in most emerging countries are down much more than in the U.S. Moreover, the dollar has shown signs of strength and the commodity and precious metals markets have declined significantly. It appears the markets are beginning to sense a shift away from the one-way, easy-money policies that have been in place for almost five years. These shifts crystalized last week when the Federal Reserve announced that it saw some positive signs in the U.S. economy and hinted at a time frame for beginning to reverse course. The Fed announcement was the first credible and detailed sign that policies in force since 2007 could soon change.

In light of these recent trends, Fisher's reference to feral hogs is interesting. His comments came a few days after the Federal Reserve's announcement pushed 10-year U.S. Treasury rates higher by almost one-half of one percent in just a few days. In an interview with *The Financial Times,* he said, "Markets tend to test things … I don't think anyone can break the Fed … But I do believe that big money does organize itself somewhat like feral hogs. If they detect a weakness or a bad scent, they'll go after it."[2]

The last four years have been a period of extreme control by the Federal Reserve, but history tells us that markets are the ones that have the power. We sincerely hope the current rhetoric doesn't end with a showdown between markets and central banks. Contrary to what Mr. Fisher seems to indicate, we suspect the markets would come out on top, but central banks would lose credibility in the process. That wouldn't be a good for anyone.

The End of an Era

Why did the Federal Reserve choose its most recent meeting to announce the potential policy exit? In his remarks, Ben Bernanke cited positive momentum in the economy. In fairness, he did reiterate that policy change would only happen *if* this optimistic view of the economy actually transpired. The markets seemed to miss this point, however.

Another theory is that the Federal Reserve feels the risks of the current easy-money policies are starting to exceed the tangible benefits of maintaining such policies. With interest rates still near zero and the Fed injecting $85 billion a month into fixed-income markets it is no surprise that risk-taking has increased. Possibly, the Federal Reserve has become more concerned about the speculation it sees in the fixed-income, real estate and hedge fund trading markets. Last week's announcements may have been a warning to investors that it is time to begin to prepare for a policy reversal and those who are taking on more risk and leverage might want to rethink their positions. As usual, when the markets try to exit in unison the door ends up looking rather small.

We also need to look at the recent actions in China. The bank-lending rate in China is highly volatile and last week jumped by record amounts. A lack of liquidity in the banking system and bankers' willingness to pay up for increasingly scarce amounts of liquidity likely triggered this change. Chinese policymakers seem to be orchestrating these tight conditions as they become ever more concerned with the rate at which debt is growing in the country. The Chinese seem to be saying that a little pain now will help avoid more pain later. This happens to coincide with declining expectations for growth in China and a transition to an economy that is much more dependent on domestic consumption than infrastructure and exports.

Control Shifts from the Fed to the Market

What is playing out in China is similar to what is happening in the United States. In both cases, central bankers are saying they can now begin to reduce the pace of public credit creation as the private sector seems to be taking over. Without such a shift, the prospects for inflation would become unstable, potentially leading to rising rates due to higher inflation expectations. This brings us back to Fisher's comment about feral hogs. Rather than demonize the markets for being against the Fed, we should recognize it as a positive event when the markets take over.

In a recent research note, Charles Gave wrote that, "In simple terms, this means the control of the U.S. economy has just moved from the Fed to the bond market … and this, ladies and gentlemen, is extraordinarily good news."[3] It now appears the cosmic ball has been shaken and a new era is underway. How it will play out for the markets in the second half of 2013 and beyond remains to be seen.

Sources

1. Dvorak, Phred et. al. "Money Spigot Opens Wider." *The Wall Street Journal.* April 4, 2013.
2. Jones, Claire and Robin Wigglesworth. "Fed fights back against 'feral hogs.'" *Financial Times.* June 24, 2013.
3. Gave, Charles. "Volcker's Return." *GK Research.* Friday, June 21, 2013.

What Is News or Noise?

Like most of you, we are inundated with information on our phones, in our email inboxes and on the Internet. Clearly, the world doesn't need another investing blog to re-process stale information or reformat the day's useless headlines. Thus, in our investment blog, "News or Noise," we've taken up the challenge of sorting through the infinite bits of background noise and seeking the few truly newsworthy nuggets of information, so that we can focus on the stories today that are likely to be meaningful for investors in the future.