

Rebalancing and revolution – PAM Insight CIO Roundtable

08/03/2018 by: Tristan Blythe, Group Editor

There will be a “change of regime” in markets during 2018, attendees of the latest CIO Roundtable heard, co-hosted by PAM Insight, publishers of *thewealthnet*, and Algebris.

Alberto Gallo, portfolio manager of the Algebris Macro Credit Fund (UCITS) and head of macro strategies, said “we are at a very long cycle of QE where markets have been under monetary anaesthetic. But can the patient start walking without holding the hand of central banks when you withdraw the anaesthetic?”

He said that it was clear that there were some asset classes to avoid as the period QE had created “bubbles” and “made our financial system more fragile.” Mr Gallo said that he was “most worried” by the way in which central banks were not worried about this by-product of their policies. He said that they are still more concerned with “financial stability and building a buffer against the next crisis” which, he argued, they “should have done a while ago” rather than continuing with QE.

Mark Northway, investment manager at Sparrows Capital, noted that regulatory pressure focussed on “replacing market-making capacity with transparency” has “reduced dealing inventories and eliminated many traditional liquidity providers from the ecosystem”. “I think we will see that transparency does not equate to liquidity and that these trends will increase the propensity for very volatile markets.”

Mo Syed, managing director and head of global markets & investment product & platform at Coutts, said: “Banks’ liquidity concerns post the financial crisis are now behind us after a long period of reducing leverage and improving capital ratios. However, for UK banks, a combination of ring fencing, cross border regulations and the need to make the banks safer and more robust under stressed economic scenarios poses a challenge and an opportunity for banks in terms of balance sheet lending. From a liquidity and solvency perspective banks are now clearly stronger and healthier than before but it remains a challenging environment for improving returns on equity, the banks with efficient operating models and the right cost to serve will be the ultimate winners.”

Mr Gallo said that there are two types of “regimes” that could emerge in the year ahead. Either an inflationary boom or an inflationary bust. He added that there would be low levels of inflation but that the markets are not expecting it and are positioned for no inflation.

“An inflationary boom is an orderly transition, which central bankers told us would happen,” he explained. “Interest rates go up, inflation goes up and equities go up.”

However, an inflationary bust is the type of activity seen in early February. It is a “tantrum” where interest rates go up but there is a “violent rotation” into other assets.

Vikash Gupta, chief executive of VAR Capital, said that the lack of focus on market risks concerned him. Referring to the market volatility that occurred at the start of February, Mr Gupta said that his research suggested that it was triggered by risk parity funds unwinding their positions.

“Risk parity funds have enjoyed low volatility for some time,” he said. “If there is some volatility and they start unwinding their positions there is a danger such as we saw earlier in February. After a three percent drop the risk parity funds starting to unwind positions and this pushed prices further down. There was no cause of the crash other than the unwinding of positions.”

He added that these types of funds have grown greatly and if there was another “flash crash” they could cause wider problems. Mr Gupta added this was especially true “on the bonds side” because “they are highly leveraged.”

Mr Gallo said that current central bank policy is “keeping a lid” on volatility. Without this, he said volatility would be higher and at some stage the lid will be removed.

However, the market is discounting that the ECB and Bank of Japan will change policy direction. The change of board at the ECB could herald this change, Mr Gallo warned.

Is there a risk of another banking crisis, given the “indigestion of interest rates going up” and other factors, asked Kim Woolmer, investment director at JM Finn? Mr Gallo was not too concerned of the risk this occurring. One major reason for this has been the regulatory response to the last crisis, he said. The focus has been on raising capital requirements for banks and protecting them. However, now it feels like “they are fighting the last war which they lost” rather than focusing on current risks in the markets, especially liquidity issues.

In the long term, Mr Gallo said he was looking to “other types of rebalancing or even potential revolutions.”

“The end of QE comes together with the end of the longer term cycle of stability and debt,” Mr Gallo said. “This lasted from the post-World War Two stimulus and created a period of stability, growing public spending supporting private assets etc. The end of the neo-liberal economic model would also end the social contract between Government and the younger generations.”

He highlighted a number of “symptoms” of this and outcomes that have accumulated over time, such as rising inequality, the misallocation of resources to sectors that have low productivity levels and demographic changes.

He said there was a contradiction created whereby the economy is being loaded with debt for growth but these accumulated outcomes point to lower growth in the future. This he says leads to the question of what will happen at the next slowdown. Will QE be accepted as the panacea to all the problems, or will there be protest as inequality grows? He added that politics has become more extreme due to inequality and in the medium term a concern is attempted extreme solutions to the problems.

He added that there was no clear “safe haven asset class” or “risk free assets” any more, especially within fixed income. There are some “unloved” areas that will benefit from inflation and others areas, but the choice needs to be made carefully as, despite some commentators taking an opposite view, the economy is not ‘back to normal,’ Mr Gallo said.

Nicola Barber, partner and head of charities at James Hambro & Partners, said that the US dollar was also an important factor given the size of the trade deficit. However, it was not obvious that a weaker dollar to assist the deficit would materialise given the recent upward movement in both inflation and interest rates. Mr Gallo agreed with Ms Barber. He said if there is a lower deficit and increased issuance of treasuries it should have a weaker the dollar. However, at the same time companies may repatriate large amounts to the US which could absorb some of that affect.

Tom Becket, chief investment officer at PSigma Investment, questioned who would buy the increased levels of US treasuries, pointing out that although China has bought a large amount in the past it has indicated it may not do so in the future. Mr Gallo responded by saying “investors are being forced into a corner.” He said that in a normal environment investors would not buy it. However, investors are scared by possible future volatility so it may be something they would buy, despite the low returns. It provides a known level of return – which equity markets cannot offer.

The roundtable was sponsored by Algebris and took place at the offices of accountancy firm Dixon Wilson

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