

# The Great Contagion

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Hyperbole is such a vile term. Defined as "extravagant exaggeration," we are nothing short of drowning in it. What little is left of journalistic integrity is sacrificed daily at the altar of hyperbole. Politicians have raised their rhetoric to such deafening volumes their speech writers are at the risk of running low on exclamation points. Even the once ensconced billionaires' boys club members with a yen to pontificate clamor for any available turn at the podium. Along the way, grace and understatement have been condemned as signs of weakness. Go big or go home, baby! Loud and proud! (Can someone please hit mute?)

There are blessedly exceptions. Peggy Noonan personifies refinement in the written word. And then there is Bill Gates, whose dignified actions negate the need to generate noise pollution. At over \$35 billion, the vast sums he has donated distinguish him as the world's most generous philanthropist. It was thus a surprise to hear Gates' warnings that a pandemic could wipe out 33 million people in six months. As alarming a prospect as it is, Gates was simply pointing out a severe lack of vigilance: "We need to invest in other approaches like antiviral drugs and antibody therapies that can be stockpiled or rapidly

manufactured to stop the spread of pandemic diseases or treat people who have been exposed.” As unprepared as the world is, the United States in particular is vulnerable. The Bill & Melinda Gates Foundation pledged \$12 million to fund a challenge to devise a universal vaccine.

Given the opportunity, it would be instructive to ask Gates his views on the global economy and financial system’s preparedness for its next outbreak of contagion. His lack of expertise in the field could even work to his advantage. Perhaps he would simply determine that money has been so conspicuous in its abundance, at such ridiculously low prices, and for so very long that this will not end well. Using credit creation leading up to the financial crisis as a yardstick, he might add that this episode will take an even greater toll than the last. No hyperbole. Pure observation. Refreshingly simple and elegant.

Looking back to the last crisis is instructive to understanding what the future holds. The Federal Reserve and other central banks extended overly accommodative monetary policy in the aftermath of the 2001 recession. Politicians, for their part, looked the other way as happy homeowners made for compliant voters. This charade did not end well as documented in the first of this three-part series. I wrote ***The Great Abdication*** after being inside the Fed for nearly a decade throughout the financial crisis and the recession that ravaged the country as no other in modern time.

As is always the case when interest rates are suppressed for far too long, nefarious behavior broke out in the credit markets. Asset price bubbles, especially in US residential real estate, formed and swelled to magnificent proportions. As we know, when distortions stunt the price discovery mechanism and obfuscate the consequences of risk-taking for protracted periods of time, bubbles burst, and outbreaks of contagion ensue.

At the outset of the last crisis, following Bear Stearns’ rapid decline, systemic risk mutated in the least expected places. It always does. For every teetering AIG and Citigroup, there was a BNP Paribas or Belgian Fortis that followed. On the brink of collapse, the financial system threatened to bring down the global economy.

As for the source of systemic risk today, wouldn’t it be nice to be able to finish that sentence definitively? Last year, Janet Yellen stated that she did not think we would see another financial crisis in our lifetimes. The banking system was infinitely stronger than it was back in 2007. That’s true but such simplicity is dangerously misleading. As has been widely reported, debt has continued to amass in the years since the worst of the crisis passed. A credit crisis that began with untenable global debt of \$140 trillion was “resolved” by accumulating another \$70 trillion in credit. Got it.

Aside from commercial real estate, which will present formidable challenges to the conventional banking system, most of the debt build has occurred in the capital markets, the shadow banking system and critically, on central bank balance sheets. It follows that the next source of systemic risk will originate and spread from one of these conduits. Make no mistake – the interconnectivity between these credit

engines is tangible, the linkages strong and in fact, too strong. Central bankers have once again lulled themselves into a peaceful place where they believe they have beat the business cycle into submission. Call it the second coming of the Great Moderation, a subject I explored last year in the second installment in this series, ***The Greater Moderation***.

As for where we find ourselves today, years ago, my dear friend Peter Boockvar raised the idea of a central bank being a future source of systemic risk. It was the very conviction, the blind faith, the core of confidence investors place in central banks and the deity-like academics who rule them, that was a bubble in and of itself.

"In the mid 2000s, we had an easy-money driven credit bubble where rates were too low for too long," said Boockvar in a recent conversation. "That bubble revealed itself mostly in housing." OK, so maybe this is a warped way of looking at things, but it was somewhat comforting that the last bubble was so identifiable. The monster in the closet had form and even substance. We just couldn't foresee systemic risk starting in subprime and manifesting itself in Germany's Hypo Real Estate or Iceland's Glitnir.

But that's the nature of systemic risk. Acute upheavals in credit markets don't recognize national borders or financial market sovereignty.

"Today's bubble is in central bank balance sheets and the massive monetary inflation that's created oceans of liquidity," warned Boockvar. Although much of the liquidity created has made its way to excess reserves, it has nevertheless spilled into just about every asset class. The biggest risk to the economy and the financial markets is thus the reversal of these balance sheet builds and the 'normalizing' of interest rates."

The good news for steadfast bullish investors is that so few actually buy into Peter's way of thinking. The markets have been incredibly resilient in the face of the initial stages of quantitative tightening. It might appear that volatility has resurged. If you believe that, though, you're focused on the wrong target. It is not stock market volatility that will be the primary disruptor, but rather volatility in the credit markets.

For the most part, bonds remain in a comatose state.

For context sake, or in case you were absent for all of February, the VIX index, or so-called "fear gauge" is derived from options on the S&P 500. At its current 15-ish level, it's up about 50% from last year yet still below its 18-ish long-term average. It got as high as 38 earlier on this year. Expect traders to remain quietly quiescent as long as the VIX doesn't break above 20 which would imply yet another technical level had been breached, that of the 200-day moving average on the S&P 500.

Merrill Lynch's MOVE index is similarly constructed, at least in spirit. This bond market volatility proxy is a yield-curve-weighted index based on the movement on 1-month Treasury options weighted on the 2, 5, 10, and 30-year Treasury contracts. At 50, the MOVE is currently about half its long-term average of 96

or 1.7 standard deviations below its long-term average. Take your pick of the two. It's indisputable that the bond market is not near as nervous as its cousin, the stock market.

There are technical and fundamental reasons for the calm in the fixed income markets; one is both.

As you know, it's no longer polite cocktail conversation to gush about the homeownership rate. In fact, in a reversal from 2006, it's now a subject that invites hushed tones given the rate has stayed so low as rental and home prices pierce new highs. On a fundamental level, there is much less demand for mortgages. Technically, this translates into less risk that mortgage holders prepay their loans, which translates into less of a need for buyers of these mortgages to hedge against prepayment risk.

And then there's the age-old (well post-Greenspan era) reach for yield. At the risk of revealing what you can see with your own eyes, the reckless European Central Bank has managed to navigate an entire economic cycle without even beginning to normalize rates. The tapering of the ECB's balance sheet still appears to be on schedule for completion by year end barring a dovish fit of nerves that pushes Mario Draghi back into a holding pattern. Still, it can't help that it's beginning to look like global economic growth has peaked. That leaves investors contemplating a slowdown despite a third of European sovereign bonds still sporting negative yields. Where is an investor to look for a pick-up in yield?

This brings us back to volatility. For many, the flattening yield curve is something of an enigma. Why would the Federal Reserve be dead set on hiking rates if the yield curve is flattening? How can inflation be an imminent threat if long yields refuse to accede to the threat? Part of the answer is the relative value proposition vis-à-vis other even lower yielding sovereign debt, as just described. Reflecting this, volatility in the benchmark 10-year Treasury recently fell to a half-century low.

But it has to be more than this.

Could it be that QT is truly the non-event it was advertised to be, no agitators need apply? It is true that QT got off to quite the slow start, beginning at a barely detectable \$10 billion per month. But that was quarters ago. The monthly run-off rate is on track to rise to \$40 billion beginning in July and pick up to \$50 billion a month in the quarter beginning September.

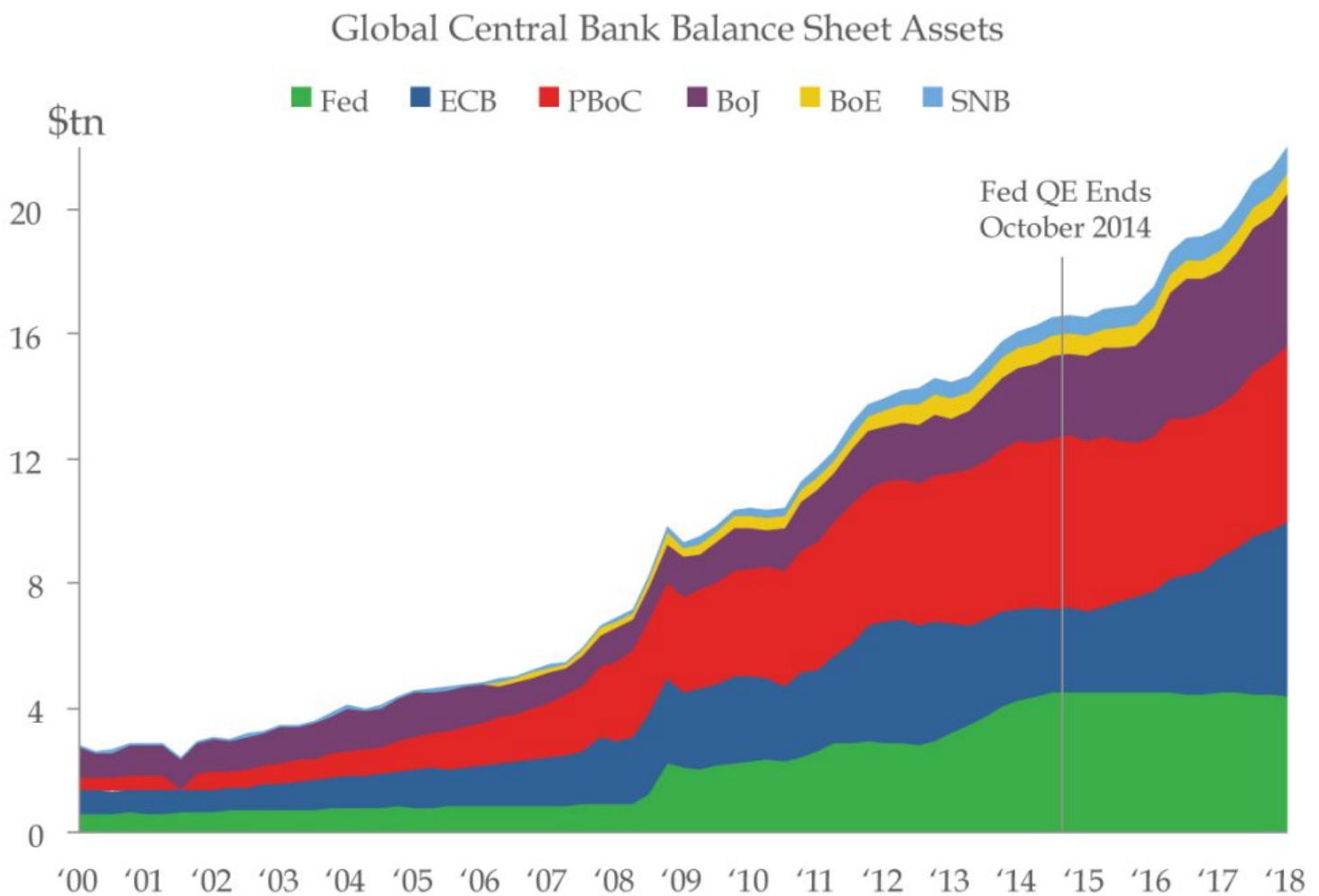
It's feasible that for now, at a still hard to register \$30 billion a month, investors are akin to the proverbial frog who thinks it's enjoying a warm bath even as the heat rises. There is even a veritable army of angry trolls on social media who insist the Fed's QT hasn't even begun — a conspiracy you may not know exists. These are the same folks who live for the markets to go "kaboom!" when in fact, they are withstanding a slow bleed, as if medieval doctors were applying leeches to the patient.

Any of you economically astute readers will have long since gleaned that what we are debating here is whether it's the flow of central bank liquidity into the markets that matter, or the stock of aggregate holdings amassed.

At the risk of showing my hand, those who insist it's the stock that matters, can be kindly referred to as the denialists, the buy-the-dip investors who remain fixated on the mammoth size of the aggregate central bank balance sheet. As investors have learned the easy way, fungible is fun. It doesn't matter which sugar daddy (country) has the check book out, it matters that he's in a spending state of mind.

At last check, the combined heft of the world's central banks weighed in at just over \$22 trillion. As you can see, global QE actually increased in size following the Fed's October 2014 taper. That ramp-up in unbridled international buying suited risk takers just fine. For the full year 2017, *global* QE climaxed, topping out at a record \$2 trillion.

## Quantitative Pleasing Goes Global



By all accounts, the collective balance sheet growth is expected to continue through next summer. But that's only half the story, which would leave Paul Harvey flat. It's equally important to know the **pace** of the growth. And **that** peaked in March 2017.

In recent years, the savviest investors, who may or may not be bored to tears, have seized upon the frog metaphor and sold bond market volatility to profit off the slow pace at which the water is coming to a boil. One veteran interest rates trader who must remain unnamed observed a distinct pattern in the “pancaking” of the yield curve, to borrow his technical terminology.

It goes something like this: The Fed hikes, which leads to higher yields, which hits equities, and triggers a flurry of (paranoid) dovish Fedpeak. This turn of events leads to declining volatility, easier financial conditions, higher equity prices and in due time, another Fed rate hike. That kind of describes the past two-and-a-half years since the Fed embarked upon its tightening campaign in December 2015. The subsequent record-slow-pace of rate hikes amounts to 1.5 percentage points in the fed funds rate. (Wash, Rinse, Repeat, Yawn.)

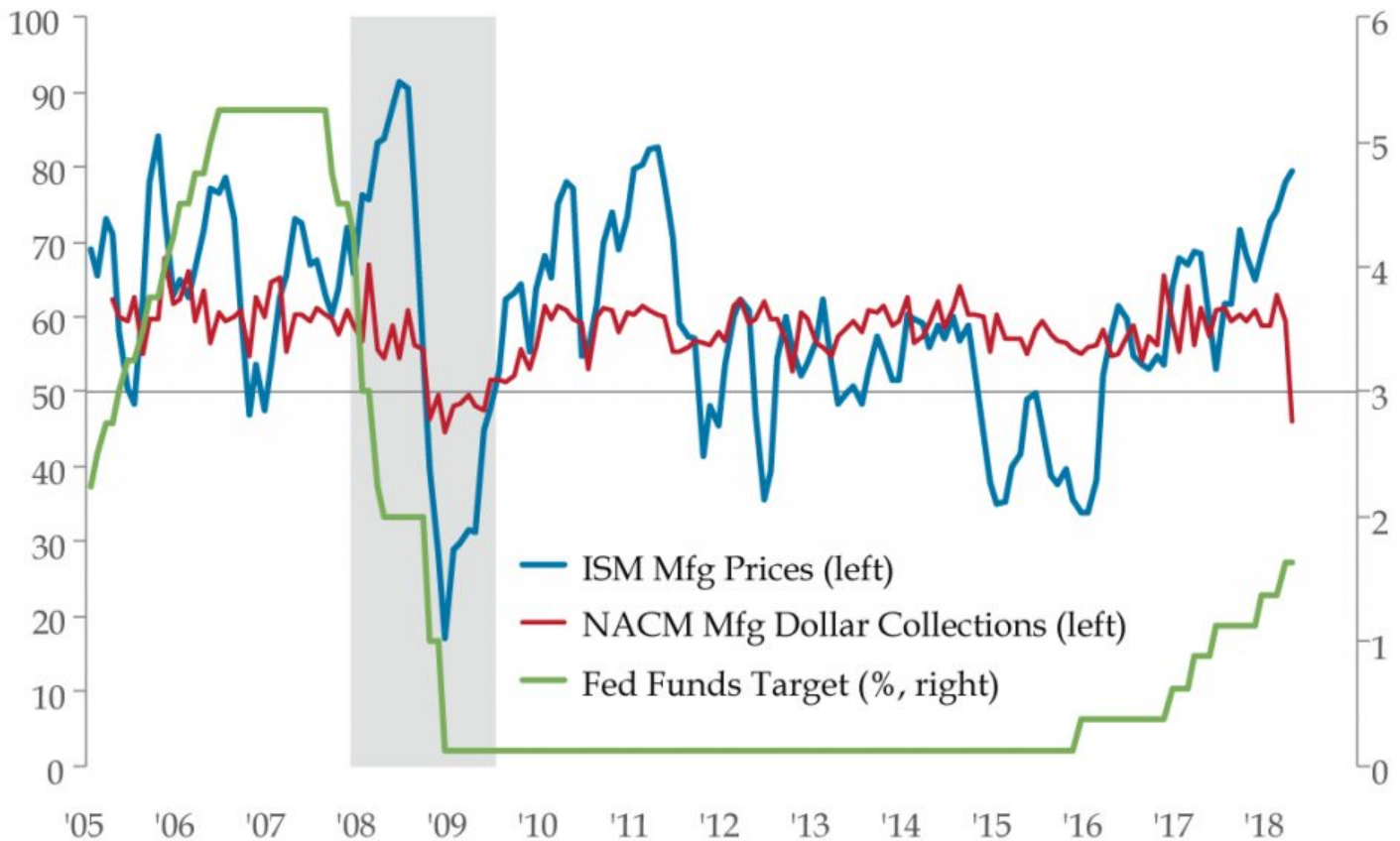
The question is what’s next?

For starters, you can hopefully see that the pace of tightening matters and matters a lot, just as 2017, the record year for QE, mattered enough to annihilate volatility and send risky asset markets to peak levels. It follows that the rapidity with which the flow recedes is of the greatest import.

*Full disclaimer: One month does not make a trend.* But a picture can still be worth a million, or is it a trillion, dollars. Be that as it may, it’s remarkable to see the spike in Prices Paid in the latest ISM manufacturing report; this sub-index is now at the highest level in seven years. As for that attendant line in crash mode, think of it as a cash crunch among manufacturers. According to the National Association of Credit Management, dollar collections suffered their worst one-month and two-month declines on record, and that was for both manufacturing and services though the factory sector is featured on the graph below.

## Can You Pass Along the Price Hikes or Will You Have to Borrow to Cover the Tab?

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Source: Federal Reserve, ISM, NACM

While there is little doubt we've got a three-alarm inflation scare on our hands, what is less apparent is what firms' coping mechanisms will be. Will they succeed in passing along these price hikes or will cash flows suffer to the extent they need to take on debt to pay their bills?

The question on most investors' minds is whether one Jay Powell will chase the inflation scare too far? Will the Fed do as it always has and tighten the economy into recession?

What would you say if I said that was a given and the least of our worries? What if I was to tell you QT mattered that much and more because of how very incestuous QE came to be in the end?

In the event you're thinking this is about to turn into some tirade about the Swiss owning a huge chunk of our stock market or Draghi buying U.S. corporate bonds, stop right there. Those are complicating factors. But they shouldn't be the focal point.

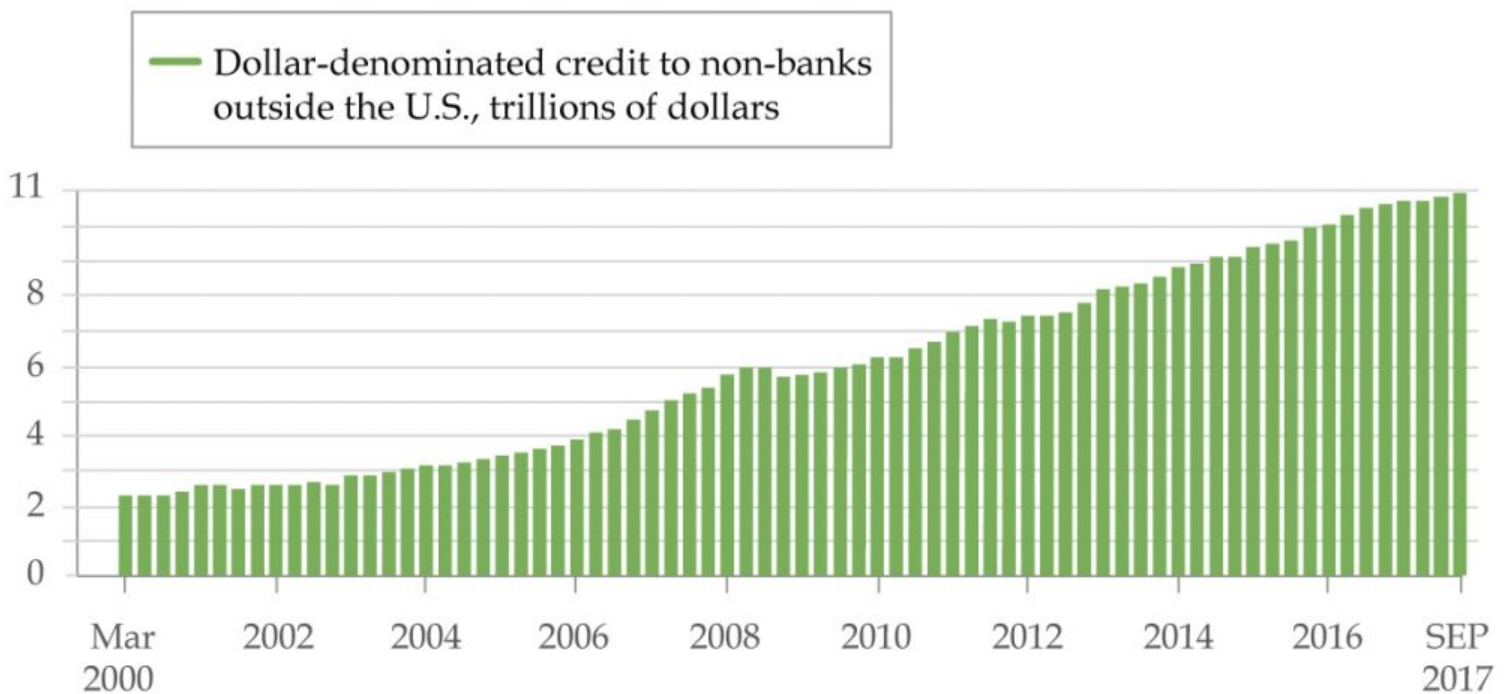
The conventional wisdom is that the United States is in the best position to withstand an economic setback. Our central bank has tightened the most and therefore it has more ammunition to fight the next war. While there is some merit to this assumption, the bigger picture involves the prism through which you view this relative strength.



Go back to the debt build, that unrepentant debt build that's taken place in recent years. Because so much of the credit issued has been in dollars, what happens in the United States cannot stay in the United States.

The vast majority of the \$50 trillion or so in dollar-denominated debt is domestic, issued from within. But according to the Bank for International Settlements (BIS), some \$11 trillion in debt denominated in dollars has been issued outside the country. As you can see, the growth rate of that debt, both developed and emerging market, took a baby step back during the financial crisis. But the pile-up resumed at an increasing pace shortly thereafter.

## Got Dollars? Borrowing in Dollars Is the Rage Outside Our Borders



Source: Bank for International Settlements

This is not a revelation in any way. But holistic matters when it comes to connectivity. The BIS worries that non-bank borrowers outside the U.S. have an equivalent amount of off-balance sheet dollar obligations in the form of FX forwards and currency swaps. Add it up and you arrive at double the dollar-denominated debt outstanding, or around \$22 trillion. It's starting to sound like real money and, purely coincidentally, equals the sum total of global central bank balance sheets.



Enter Tobias Adrian, formerly of the New York Fed and now at the International Monetary Fund. In a posting he penned in April, he voiced concern about the vulnerability of flows (there's that word again) to emerging markets. Adrian figures that flows could fall by \$60 billion a year to emerging markets, about a quarter of annual inflows in the seven years through 2017. Less credit-worthy emerging markets would suffer greater funding droughts.

If it only ended there. Adrian went on to write that, "Internationally active non-US banks rely on short-term or wholesale sources for about 70 percent of their dollar funding. Moreover, these dollar liabilities are not always evenly matched with dollar assets in terms of size or maturity. This could leave banks exposed to dollar funding problems in the event of a sudden tightening in financial conditions and strains in markets."

It might help if Adrian wasn't considered one of the world's preeminent experts on shadow banking. He witnessed what he describes today firsthand when we were both inside the Fed during the crisis. The cross-border linkages in dollar-denominated debt he's detailed cannot be dismissed out of hand.

The one thing you may note these banking-system and financial-market synapses have in common is the dollars traveling along them. The transmission mechanism is dangerously homogeneous, which is reflected in the nearly nine in ten global transactions last year being denominated in dollars. The glue that binds the global financial system helps explain the cross-border fungibility of monetary policy.

Société General's Albert Edwards has long been derided for criticizing the inherent unsustainability of the current generation of central bankers' approach to monetary policy. So have I. But we're not naïve as to QE's ameliorating effects: "Much of the continued resilience in US markets last year was put down to huge global QE despite the US starting to tap its foot on the brake," said Edwards. "Huge flows of QE came over from Europe in particular but also Japan. Bullish brokers, i.e. the vast majority, have been trying to reassure clients that the collapse in global QE back to close to zero does not represent a monetary tightening, but a return to neutral. Needless to say, quite a few of the savvier investors are not falling for this reassurance."

Edwards may be on to something. The divide between the S&P 500 and the combined Smart Money Flows Index and Ed Yardeni's Fundamental Stock Market Indicator is now at a cycle wide. Google both and thank me later.

Maybe it's a case of not waiting for the haunted house to whisper to you to "Get Out," Amityville Horror style. To wit, there is nothing new in Europe's money supply growth slowing; it's now slid to the lowest level since November 2014. In Japan, the growth rate of the Bank of Japan's monetary base has slid to 7.8%, the lowest since late 2012.

As difficult as it may be to discern the slow liquidity drain, something is amiss in the shortest-term lending rate markets. The pace at which LIBOR was rising has subsided for the moment. But the deluge of rising Treasury supply could easily reignite the rate at which short rates are rising, especially if the Fed nods to its preferred inflation gauge hitting its (arbitrary) 2% inflation target.

The most recent Economist warned that the biggest risk is the Fed acting “abruptly to see off inflation.” In Jitterbugs, which highlighted the recent rise in short rates, the newspaper echoed the IMF’s concerns centered on the financial system’s vulnerability to a sudden shock. “Threats to the economy can lurk in obscure corners of the market. They can also be found in Washington DC.”

While it’s impossible to pinpoint what agent will spread the contagion, we can make some educated guesses. Credit risk has been underpriced in the markets for years. At first investors just looked the other way. But today they wince if they’re in the compromised position of having to put money to work.

Just last week, WeWork Co. sold bonds into the high yield market. Such was the demand for fresh paper that instead of the originally planned \$500 million, the company was able to sell \$702 million, apparently a lucky number. The same cannot be said for the buyers who have seen their bonds decline in value every day since.

But it’s beyond companies that generate buzz but have challenged business models and shaky cash flows. It is companies such as Steinhoffs, Toys “R” Us and now American Tire Distributors that investors should not have had priced to perfection. On April 30, a report revealed Goodyear planned to drop the tire distributor; its bonds that traded as high as \$102 two weeks prior collapsed to 40 cents on the dollar.

Meanwhile, leveraged loan covenants, or better stated, the absence of them, are a shared joke among underwriters the same way toxic subprime mortgages were the last go around. And any frontier issuer that can substantiate a physical border can float a sovereign issue. These are accidents we know full well are waiting to happen.

As for the unknown, look no further than the vast universe of “investment grade” U.S. corporate bonds. This supposed safe haven is littered with tomorrow’s calamities, angels that will tumble from the heavens.

All of these products were born of central bankers with no self-control, individuals who’ve long since demonstrated that they are lacking in common sense. The fact is, they’ve gorged together and fed each other’s risky markets in concert. Now comes the time for the real discovery, the revelation of the feedback mechanisms that will infect each other’s markets and economies.

Could Mario Draghi blink? Could the Bank of Japan attempt to reup its QE? Could the Swiss buy more FAANG stocks? After all this time, you know the answers to all of these questions. But what if all of these counter-maneuvers don’t fend off the Fed? The Fed may well be first in, first out. But it also controls the

controls, which was purposefully redundant.

Dollar flows and dollar-denominated debt are global phenomena. Furthermore, Jay Powell has stated that QT is not up for negotiation; it will continue to run in the background, come what may. Granted, this commitment may not be set in stone and would surely be revisited if Powell was convinced recession was imminent. But will it be too late by then? Will contagion spread from one central bank balance sheet and one financial market to the next? If history teaches us one lesson, it is that “too late” often happens suddenly.

As for history’s other lessons, it is unquestionably disturbing to listen to the drum-beating and witness the tragedy of leaders killing their own people. But we’ve clearly forgotten that it is economic conflict that precedes geopolitical upsets, not the other way around, hence the red herring of most perma-bulls’ contentions that geopolitics is the only thing that can derail markets.

If you doubt my logic, know that I had many great leaders who shaped my way of thinking. One of them, the late Dick Jenrette, co-founded the firm I called home on Wall Street many moons ago. He truly had an open-door policy. I was privileged to know him and even learned a thing or two about planning ahead from him. Planning should be at the forefront of every central bankers’ and politicians’ minds these days.

In late April, Jenrette passed away at the age of 89. This excerpt from his Wall Street Journal obituary is particularly fitting to the subject at hand: “His advice to crisis managers was to make a plan and ignore the critics. He often quoted a proverb: ‘The dog barks but the caravan moves on.’” No hyperbole. Pure observation. Refreshingly simple and elegant.

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