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CAPITAL

Credit Snapshots – December 2019

We Need A Generation Like Paul Volcker

The passing of Paul Volcker this week has seen an outpouring of tributes to "the giant who slayed inflation". Whilst he is most well known for leading the Federal Reserve during the time when it rebased inflation to the low levels we accept as normal today, many who knew him have also commented on his humility and integrity. These characteristics combined with his tenacity allowed him to put the US through a necessary but painful recession to kill off the scourge of high inflation.

Whilst almost everyone today acknowledges the wisdom of his actions, at the time there was substantial political and social pressure put on him to relent. The road to low inflation involved almost doubling the overnight interest rate to 20%. He and the interest rate hikes were directly blamed for the recession of the early 1980s when unemployment topped 10%. Volcker showed he was willing to do whatever it took to break inflation; his single-mindedness ultimately broke the pervasive belief that high inflation would persist.

There's a strong parallel with what Paul Volcker did in the 1980s with what is required today. Whilst Volcker's challenge was to convince businesses and workers that the Federal Reserve would take tough actions to break inflation, the challenge today is for central banks to convince politicians and the public that excessive monetary stimulus is an evil that must be defeated. Ultra-low interest rates and quantitative easing have produced asset price bubbles, zombie companies, low productivity and malinvestment. Through their attempts to temporarily forestall a recession, central banks have created the necessary preconditions for a long and deep recession.

Whilst there are small signs that central banks are starting to acknowledge the error of their ways, the substantial destruction of the independence of central banks is another hurdle in the way of reform. Volcker was upfront about what needed to be done to defeat inflation and was appointed by Jimmy Carter to do that. Ronald Reagan reappointed him even though many blamed Volcker for the recession that marked much of Reagan's first term. Amongst the current crop of short term orientated politicians, who would be brave enough to appoint a central bank head who promised to prioritise long term financial stability and economic welfare?

Even greater than the legacy of breaking high inflation, Volcker left a legacy of doing what was right even though it was unpopular. Governments around the world have leant on monetary policy to fix their ills, rather than undertaking productivity reforms, tax reform and government spending reforms. The global economic outlook includes high levels of government, corporate and consumer debt, as well as extensive unfunded pension promises. To resolve these issues, we'll need a generation like Paul Volcker willing to confront the public and the political class with the inevitable and painful changes that lie ahead.

European Banks and Regulators are Ignoring the Warning Signs

If you want to search for weaknesses that could lead to another financial crisis, banks are a very good place to start. The last financial crisis saw banks around the world needing government bailouts to cover their solvency and liquidity deficiencies. Whilst banks in the US and Australia have substantially raised their capital levels, many European banks have failed to use the last decade to materially de-risk. The most obvious outworking of this is that European banks continue to receive taxpayer funded bailouts, with Germany's NordLB and Italy's Banca Popolare di Bari both receiving lifelines this month.

At a high level, strengthening weak banks isn't an overly complicated process. They need to hold more capital and they need to clear their balance sheets of bad loans. These two issues are intertwined in that a bank with an excess of non-performing loans (NPLs) will struggle to raise additional equity capital from shareholders until the NPL ratio is reduced. This is where regulators come in, they are meant to stop this situation from occurring and take swift action when it does. If shareholders won't contribute additional capital, the regulator needs to compel action. This could be via a forced merger, through a bail-in of subordinated capital and senior unsecured debt, or via a government takeover.

These actions are all a standard part of the playbook for the US banking regulator, the FDIC. They were all utilised after the onset of the financial crisis, often deployed at short notice (see FDIC Friday). The aim of rapid action is to maintain consumer and financial market confidence that the banking system will continue to function, thus reducing the severity of an accompanying recession.

Unlike the Americans, the Europeans generally prefer to delay action and hope the issue magically resolves itself. A quick review of the price to book ratios for European banks shows this approach isn't working out. There's a bunch of zombie banks that remain stuck at the bottom of the list with insufficient profitability to lift their ratios organically or to attract additional shareholder capital at anything other than a horrendous discount. Deutsche Bank is the poster child for this group, its last decent profit was in 2011 with several massive losses since then.

Deutsche Bank typifies the problems of many European banks in that it has failed to clear problem assets even though it has been through several waves of restructuring. The proposed merger with Commerzbank could have provided an avenue to reset its capital levels and reduce its costs. However, it would have required both parties to reassess the value of their assets, which could have resulted in asset write-downs. It is another missed opportunity by the two banks and their regulators.

Negative interest rates are also part of the problem, in that banks are struggling to earn a decent spread between their deposit and lending rates. Most European banks have voluntarily chosen not to pass on negative interest rates. This resolve is gradually breaking down as a growing group of banks in Germany and Denmark let all but the smallest depositors share the pain of errant central bank policy.

Now that savers are being directly punished for their prudence, central bankers and politicians should expect a far greater level of criticism of negative interest rates. It should not be forgotten that whilst banks have few friends and no votes, savers have many votes they can use to extract change. Sweden's decision to lift its overnight interest rate back to zero this week might be a turning point.

One final issue that lurks particularly amongst European banks is their gaming of capital ratios. European banks have become masters of finding assets that require little risk capital but can generate a decent margin. Government debt from Italy is one example, with pressure now being put on the ECB to allow for unlimited purchases of Greek government debt. This would substantially increase the already significant "doom loop" risk. This risk arises from the potential for a default on government debt to bankrupt the banks, and the converse situation where failing banks look for a taxpayer bailout and bankrupt the country.

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Another Big UK Fund Locks Up

This month the £341 billion fund manager M&G Investments announced it would block redemptions on its flagship property fund. As at 31 October, the fund had £2.5 billion under management, having paid out £992 million of investor redemptions in the previous 12 months. The fund's return of -8.2% over the last year would be at least in part due to the forced sale of a significant portion of its assets in order to meet the run of redemptions. The ructions in the UK office property market in the face of Brexit and the decline in bricks and mortar retail also put downward pressure on the asset valuations.

This lock-up follows hot on the heels of the demise of the £3.7 billion Woodford Equity Income Fund. This fund had concentrated holdings of highly illiquid stocks listed on second and third tier stock exchanges. Whilst the fund claimed it was liquid as the stocks were listed, some of its stocks rarely traded and were akin to private equity holdings.

In both cases, poor performance started a run of redemptions. The requirement to sell down holdings to meet the redemption requests added to the performance problems as illiquid holdings typically need to be sold at a discount to their book value when a rapid sale is required. Media reports of high levels of redemptions lead to further redemptions as investors fear being left holding the bag if they don't make an early exit.

Whilst some might want to dismiss these examples as just a UK problem, they are yet another reminder that illiquid assets in open ended funds are a disaster waiting to happen. Wind back the clock ten years and Australia saw the majority of its open ended mortgage, high income and property funds lock up. Almost all of these funds were eventually wound down, often taking three to seven years to return investor's capital. These sectors left a graveyard full of dead funds with only a handful of survivors still operating today.

Despite this history, Australian investors are charging back into open ended funds, particularly in the credit and property lending space. Every time the RBA cuts the Cash Rate another torrent of money starts looking for a new home that can deliver a positive return after factoring in tax rates and inflation. Unlisted property syndicates and direct ownership of investment property (both residential and commercial) are favourite hotspots for yield chasers. The wave of ASX listed hybrids and listed investment trusts focused on private debt are others, with the growth of these two sectors being boosted by sales commissions.

All these options come with the risk that investors could lose a meaningful portion of their capital in a substantial downturn. What sets open ended funds apart is investors can become captive to the actions of other investors. If enough investors ask to redeem, all remaining investors can be forced to exit their positions at a time and price that is sub-optimal. Those who planned to be long term investors can be dumped out of their positions at a time when they would never have chosen to sell. Those who planned to be short term investors are forced to stay around for an unknown length of time whilst their fund winds down.

The flip side of these risks is the opportunity for other investors to buy once in a generation bargains from forced sellers. Whilst this requires enormous discipline to execute, well prepared investors can make a decade's worth of outperformance in a few years. The preparation to execute this strategy begins now, with long dated and high risk positions exited whilst the market for low quality securities is wide open.

Written by Jonathan Rochford for Narrow Road Capital during December 2019. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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