36 South Views

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OCT19

A well-travelled path…

Central banks' biggest fear…coming soon to the big screen?

Central banks' biggest fear is presumed to be a repeat of 2008, a financial system implosion that shakes credit, equity and property markets to its foundations.

We think this may no longer be their BIGGEST fear; but another fear is on their doorstep…a runaway equity bull market.

At the zero bound, assets values tend to infinity…A melt-up is now a distinct possibility.

That we are in a mature bull market is well understood but as Soros once said, "When asset prices depart from reality it is the start of a bull market, not the end".

Given most investors' propensity to 'nickel and dime' the fees and go for passive investing strategies which have not only outperformed most other long only equity strategies but are also cheaper. This could turn a trickle to a flood of highly correlated "risk unaware" money into a very small number of high capitalisation stocks.

Asset managers are forced to follow suit or lose business to competitors.

It is a well-worn path…

A raging bull market in equities has second-order consequences though. Already the general financial asset price appreciation has benefited the top 5% disproportionately and this will only make the general population sense the unfairness of it all more keenly.

But more importantly…What will be the central banks' response?

If they raise interest rates they risk alienating the government especially the Treasury who will struggle to finance their already humongous debt at much higher rates. True to everybody else who is now addicted to low rates.

If they don't, they could be setting up the financial markets for the biggest boom and bust we will ever see in our lifetime, probably coupled with serious inflation.

Given this is likely to play out in a US election year, the stakes are even higher.

This has taken a lot longer to occur, longer than anyone imagined but with hindsight it makes sense.

Like a poker tournament where you can borrow unlimited amounts of non-recourse debt from the casino, even bad players will continue to play as long as the credit spigot is open.

We all think that it is now up to the central banks to decide to take away the Kool-Aid by raising interest rates but that assumption diminishes the role of uncertainty in life. It might be taken out of their hands…

Like Tim Low opined when commenting on the rabbit population explosion in Australia when there was no apparent end in sight. Nature has a way of restoring equilibrium. Climate change?[1]

Central bankers probably won't be in front of the next crisis but the upside is that at least they won't be to blame!

And a crisis maybe is what they need, low interest rates trump an overvalued equity market in keeping the Potemkin financial village intact.

Fortunately, complacency as measured by the price of volatility assets is at decades low making hedging the cheapest it has been, also in decades.

Unfortunately, it comes at a time, counterintuitively, where investors are the most disinclined to hedge using volatility assets!

Also a well-travelled path…

[1] Tim Low, *Feral Future: The Untold Story of Australia's Exotic Invaders* (Chicago: University of Chicago Press, 2002)

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