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BY RICHARD "JERRY" HAWORTH

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Angry elephants loose in the zoo

Most of the global deflationary drivers, except demand destruction, are now either neutral or reversing. i.e. globalisation, low cost labour, internet disintermediation and deregulation.

With inflation rising, central banks have raised rates in a way that seems very Volker-like but the reality is we are nowhere near positive real rates nor do I think we will see them in a very long time.

You can shoot an elephant by tracking it from 200 yards behind and taking pot-shots at its backside but you're only going to irritate it. You have to get in front of it and shoot it in the forehead. Same too with inflation, to really knock inflation you have to get in front of it. i.e. positive real rates.

I don't think it will happen anytime soon as it suits governments/central banks to have negative real rates to whittle away their debt burden.

The current narrative is that central banks are going to wait until the inflation elephant back-tracks past our position where they can get in a good position to send it heavenward.

I am not going to hold my breath because I might go blue before that happens.

I don't envy the task of central bankers…but hey … they made the dung pile in the first place by firstly creating so much debt in the first place and secondly by leaving rates at zero for way too long.

So it's their circus, their monkey. They must clean it up?

The problem is they know what to do but they cannot do it and remain solvent at the same time. Central banks have enormous debt piles which are now commanding eye watering interest charges. Add to that the losses from previous bond purchases that have turned most central bank balance sheets upside down and now treasury will be required to meet this shortfall on an annual basis.

I don't envy the task of central bankers…they have 'new dog on the block syndrome'. If they stand they get screwed and if they run they get bitten!

What is there to do?

The UK is a good case study. They had two options: let government stand aside, reduce taxes, attract new business and let the real economy grow - the resultant increased taxes from growth etc. would ameliorate the problem (the Liz Truss solution), or shrink government expenditure and increase taxes, opting for a period of very low growth. (the Rishi Sunak I am going in the opposite direction to Liz Truss on everything approach!).

We all know what happened… the bond vigilantes emerged from hibernation and torched Liz Truss' plan so the Tories went for plan B with Rishi Sunak. Not before they had exhausted every other possibility.

The new plan will send the economy into freefall and here's the rub, the UK will end up at the same place whichever option they take.

Sunak's government won't be able to save any money or reduce their debt burden, as they will have to pay for increased interest charges and central bank losses as well as increased social spending as people lose their jobs en masse. At some stage they will probably panic and increase fiscal spending to stop the free fall as well.

Is government spending versus private sector spending more efficient? Nope. What we will get is just further into the muck as governments burden the very sectors that could pull it out of its mess, and give money away to the very sectors who can't.

Either way, governments are not really in a position to take the proper medicine and hope to stay in power. Hence, further into the widening gyre we go.

The energy crisis is not going away any time soon and price caps and tax windfall profits are not the answer. They seem straight from Karl Marx's economic handbook. You want to incentivise oil and gas companies to solve issues at hand, it is probably not wise to hamstring them.

China seems to be an economic bug looking for a windshield due the inexplicable Covid restrictions (I have Covid as we speak, hence the maudlin nature of my musings this month), geopolitical tensions with the US especially with respect to semiconductors and a teetering-on-the-edge property market.

They will have no option but to throw unimaginable money at these problems, thus exporting even more inflation into the global vortex.

As the saying goes "the situation is hopeless but not serious".

Equity markets are in a slow-moving train crash and for good fundamental reasons, the pandemic relief adrenalin rush pushed valuations to nosebleed levels. It's simply not fighting the Fed and letting some well-deserved air out of its bubble.

Volatility in the equity space remains muted but one phenomenon has caught my attention.

The absolute explosion of trading in options with 0 or 1 days left to expiry. Over 50% of Chicago Board Options Exchange S&P volume is in these two trading days.

Every time I have observed this short-dated option trading phenomenon in any market, there has been a gap of 5% or more up or down within six months. These short-dated options don't obey ANY pricing model and to sell them is extremely dangerous and ultimately costly.

Volatility will be a net winner from all the uncertainty emerging from all these macro environments. There was a time before 2020 when I wished somebody would do something stupid to create some volatility, but now I find myself wishing somebody would do something intelligent to end it before we get trampled by a very angry elephant or worse.