

# Did Bernanke Signal Return of Risk-Off Market?

By A. Gary Shilling - Jun 27, 2013

Here's how I opened my Bloomberg View [column](#) in January: "I have structured my investment themes for 2013 in two ways. The first is geared toward the current 'risk on' climate, even though I doubt it will endure. The other is a 'risk off' scenario that I believe will unfold once investors recognize the unsustainability of what I call the Grand Disconnect between robust securities markets and subdued economic reality."

The shock that I predicted would end the disconnect may now have arrived in forecasts from the [Federal Reserve](#) and statements by central bank officials over the past two months, culminating in Fed Chairman [Ben S. Bernanke](#)'s comments on June 19. The Fed estimates that the [unemployment rate](#) could reach 6.5 percent to 6.8 percent by the end of 2014, from 7.6 percent in May. The central bank sees real gross domestic product growth at 3 percent to 3.5 percent next year, compared with 2.1 percent so far in the recovery. And it thinks that risks to the economy are diminishing, even as "fiscal policy is restraining economic growth." In addition, the [chairman said](#) the housing sector "is now obviously a support to growth."

So Bernanke said the [Fed's monthly purchases](#) of \$85 billion in securities could start to be wound down later this year and cease by mid-2014. Those purchases, he added, "are tied to what happens in the economy." The central bank would adjust its policies, he said, if "we overestimate what's happening," as the Fed did with two previous bond-buying programs that had to be restarted. He assured mortgage holders that the bank won't dump its huge mortgage portfolio. And the Fed clearly believes that economic growth is sustainable enough that it can wean markets from huge quantitative easing.

## Fed Damper

Yet after he spoke, [stocks](#) swooned. That was to be expected. Economies around the world are growing slowly at best and hold no interest for equity investors, whose entire focus has been on the money the U.S. central bank has been shoveling out. So at the first hint that the Fed's largesse will end, the [bull market](#) became vulnerable, especially after the explosive surge in late 2012, when individual investors jumped into a rally that professionals had been riding since March 2009.

Furthermore, investors are facing not one but two shocks that could end the disconnect. The other is a hard landing in China, which is suffering through a tough transition to a domestically driven economy, particularly now that its big export markets in Europe and [North America](#) have retrenched. The Chinese new export orders [index](#) fell to 44 in June from 48.9 in May (numbers below 50 indicate contraction).

In addition, [China's growth](#) is being slowed by its huge excess capacity and declining numbers of labor force entrants because of its one-child policy. Official growth data -- a 7.7 percent increase in real GDP in the first quarter compared with a year earlier -- are probably vastly overstated. Consider that manufacturing activity is declining, according to the [purchasing managers' index](#) released by HSBC Holdings Plc and Markit Economics. That sector, along with utilities and construction, accounts for 46 percent of China's GDP. Growth is probably close to the 5 percent to 6 percent hard-landing level.

Most important, debt has exploded and, as the Fed has, the Chinese central bank is trying to curb it. Total domestic credit from banks and other lenders leapt to 207 percent of GDP last year, from 145 percent in 2008; much of the increase came from shadow banking outfits. With foreign capital inflows drying up and end-of-the-quarter financing needs increasing -- and, at month's end, \$245 billion in payments from banks to retail investors in wealth-management products -- short-term [interest](#)

rates skyrocketed to 25 percent last week.

## China Crunch

The Chinese government blames speculators and shadow banking for the cash crunch, and sees no shortage of funds in the financial system. The People's Bank of China is controlled by the government and is determined to curtail informal lending by imposing market discipline, even if that means considerable pain to banks and other lenders.

The twin shocks of prospective tightening by the Fed and a hard landing in China appear to be suppressing the “risk-on” environment, which normally involves a mix I call the quartet -- long the riskier equities and commodities, and short Treasuries and the dollar. This year, however, commodities have declined, the dollar has been robust and Treasuries initially rose then dropped in early May, about three weeks before stocks nosedived.

A central feature of the disconnect was the zeal for yield as ultralow interest rates pushed investors into the highest-yielding vehicles they could find, regardless of risk -- [junk bonds](#), the leveraged loans that finance private-equity buyouts, developing country bonds, investor-owned single-family rentals, and high-dividend stocks such as utilities and consumer staples. Indeed, the correlation between the Standard & Poor's 500 Index and junk bonds rose to 66 percent in May from 56 percent three months before.

Now, as “risk-on” trades shift to “risk-off,” investors are dumping emerging-market assets and junk bonds, marking what may be the beginning of sustained declines. Stocks that pay high dividends outperformed the [S&P 500](#) in the first quarter “risk-on” days, though they recently have underperformed amid the general equity sell-off. Mortgage real estate investment trusts have experienced a similar trajectory. Pension funds, seeking high returns to meet their performance goals and avoid cuts in

retiree benefits, have moved into private equity, developing-country stocks and bonds, [hedge funds](#) and even commodities.

Near-junk Italian and Spanish bonds had been buoyed by European Central Bank President [Mario Draghi](#)'s promise to "do whatever it takes" to preserve the euro. Now, however, their prices are falling after Bernanke's statements, even as economic growth in the euro area looks less negative with the purchasing managers' index rising to 48.9 in June from 47.7 in May.

### Bernanke's Warning

In his [speech](#) last August at Jackson Hole, Wyoming, Bernanke said, "Some observers have raised concerns that, by driving longer-term yields lower, nontraditional policies could induce an imprudent reach for yield by some investors and thereby threaten financial stability." Yet he dismissed the threat: "We have seen little evidence thus far of unsafe buildup of risk or leverage."

In congressional testimony in May, however, he changed his tune. He said the Fed was worried about zeal for yield that, if it continued, might "undermine financial stability." If there has been no buildup of risk from the zeal for yield, what accounts for the recent sell-off of risky assets?

Until recently, investors seeking high yields were oblivious to the weak economic fundamentals of [developing countries](#). That is changing as we hear news of the drop in China's purchasing managers' index, the decline in Turkey's GDP growth to 2.5 percent in 2012 from 9.2 percent in 2010, the protests by Brazil's rising middle class and the International Monetary Fund's reduction in its growth forecast for [Russia](#) to 2.5 percent this year from 3.4 percent.

Also caught in the shift from "risk-on" to "risk-off" are closed-end bond funds. The average closed-end bond fund has fallen 10.7 percent in the past month, compared with a 3.4 percent

decline in open-end bond funds. About 61 percent of the \$276 billion in closed-end funds is in bond funds. The shift in investor attitudes pushed municipal closed-end funds from selling at a 2.1 percent premium to book value in January to selling at a 6.2 percent discount recently, even as the 2 percent premium on junk closed-end bonds turned into a 5.9 percent discount.

In the “risk-off” climate, developed country stocks probably have much further to drop, too. The sluggish U.S. economic recovery since mid-2009 has produced minimal sales volume growth and no increased pricing power as inflation rates fell to zero. So seeking to increase profit, companies resorted to cutting labor and other costs, pushing corporate profits’ share of national income to an all-time high. But that productivity growth has stalled, and businesses may not be able to find any further cost-cutting, at least for now.

### Stronger Dollar

The strengthening dollar is also squeezing export earnings and foreign profits of multinational companies. At the same time, [Robert Shiller](#)’s cyclically adjusted price/earning calculation indicates that the S&P 500 is 30 percent above its long-term trend. That means stocks need to fall 30 percent to get back to the norm.

Homebuilders’ stocks have plummeted and remain vulnerable as the recent jump in [mortgage rates](#) slows the housing sector. The Federal Housing Authority just announced that its mortgage endorsements for single-family-home purchases in May dropped 7.1 percent compared with a year earlier as the number of first-time homebuyers retreated.

As real wealth is destroyed, consumer discretionary spending on automobiles, appliances and vacations may weaken along with [consumer lending](#). To maintain sales, auto dealers have been forced to offer subsidized zero percent interest rates on loans and to increase the percentage of loans and leases to subprime

customers.

Slower Chinese growth in manufacturing undermines the rationale for the commodity bubble of the early 2000s. Until recently, China bought more than 40 percent of annual global output of copper, tin, lead and zinc. But commodity prices moved lower in early 2011, perhaps in anticipation of a hard landing in China. Cotton prices are dropping as Chinese manufacturing falls and weather conditions in U.S. cotton-producing areas improve. Higher interest rates are eliminating the incentive to store crude oil for sale in the futures market at higher prices. Meanwhile, gold buyers who thought quantitative easing would promote instant hyperinflation are finding instead that with inflation rates dropping to zero and higher interest carrying costs, [gold prices](#) have collapsed to about \$1,200 an ounce yesterday from a peak of about \$1,800 an ounce in October 2012.

The strong dollar makes many commodities more expensive for businesses that operate in weakening currencies. With the “risk-off” trade, the dollar should continue to gain as a haven, especially as protection from the euro.

The yen will probably continue to drop against the dollar as Prime Minister Shinzo Abe tries to revive the economy by turning deflation into 2 percent annual inflation and forcing the [Bank of Japan](#) to double its purchases of securities. As exports and prices continue to drop, commodity currencies such as the Australian dollar, the Brazilian real and the Russian ruble remain vulnerable.

### Competitive Devaluations

Currency devaluations in [Japan](#) and elsewhere will probably be matched by competitive devaluations worldwide. [South Korea](#), which competes with Japan, may be next. Russia wants a weaker ruble to revive its energy-export-dependent economy. No country wins in competitive devaluations as foreign trade is disrupted. In the end, however, most will end up devaluing

against the [U.S. dollar](#). Another reason to be long the buck.

So here's my "risk-off" quartet: short stocks and commodities, long the dollar and Treasuries. Yes, the Fed's recent statements mean Treasuries and other high-quality bonds have been trashed along with developed and developing country stocks, junk and emerging market bonds. Nevertheless, if stocks continue to decline, the safety of Treasuries and investment-grade bonds will probably outweigh concerns about the end of quantitative easing. Then the "risk-off" quartet will be fully in place.