MV CAPITAL MANAGEMENT

Weekly Market Flash

The Cost of Easy Money

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According to the teachings of traditional financial theory, investors make rational choices when deciding which assets to include in their portfolios, based on their particular return objectives and tolerance for risk. "Choice" implies evaluating the relative merits of the cash flow prospects for Company ABC versus Company XYZ, or the stability of securities backed by the full faith and credit of the United States government versus those issued by sovereign entities in volatile frontier markets, and assigning valuations accordingly. The safer the asset, the less return an investor should demand for holding it. Which is why it might have raised a few eyebrows earlier this week when the yield on 10-year government bonds issued by Greece – yes, that Greece – briefly fell below the yield on comparable US Treasury securities.

The Lagarde Put

If you have been following the goings-on in the capital marketplace for some years now, you may remember that back in 2012 Greece was on the verge of failing out of the single-currency Eurozone, and its government bonds were fetching yields of nearly 35 percent. But 2012 was also the year of the three most famous words pronounced on the European continent since "veni, vidi, vici" – "whatever it takes" per European Central Bank chief Mario Draghi. Draghi's term will end this coming October, and the ECB torch will most likely pass to Christine Lagarde, current head of the International Monetary Fund. Lagarde will ascend to the commanding heights of a world where those dog-eared pages of traditional finance textbooks are as good as worthless. Euro-denominated bonds issued by the Czech Republic trade at negative yields, while Japanese insurance companies, thirsting for positive yields, scour the likes of Kazakhstan and even Turkey for inclusions to their portfolios. "How low is too low?" will likely be one of the persistent questions to be faced by the new ECB chief. The first 10-year benchmark to come with a coupon of minus one percent may not be too far down the road.

It's the Fed's World, We Just Live In It

Back on this side of the Atlantic, "Fed funds cut in July" appears to have joined death and taxes as the only certainties in life. Equity markets were briefly unsettled earlier in the week by the better than expected jobs numbers that came out last Friday. Good news (e.g. jobs, wages, consumer confidence), after all, might throw a wrench into those rate cut expectations. Not to worry, though, as Fed Chair Powell made it perfectly clear that, come what may, the rate cut is in the post.

Now, from the standpoint of prolonging the economic growth cycle it may be entirely reasonable to produce a couple "insurance" rate cuts – a topic we discussed here a couple weeks back. The problem is that in the current market environment, these are not just one-off measures but rather part and parcel of a seemingly endless program of easy money all around the world. What this accomplishes in economic terms is up for debate; what is not debatable is that it has a distorting effect on asset prices. Not just in the form of negative interest rates and Greek bonds trading at par with Treasuries, but in the valuation of equities as well.

Back in the days when those old finance textbooks were relevant, there was a methodology for calculating the value of a company's equity by computing the net present value of a future stream of cash flows. The net present value figure was arrived at by assuming an appropriate cost of capital and then discounting

future cash flows back to the present at that cost of capital. All else being equal, a decline in interest rates will increase the value of those cash flows being discounted to the present (that's one big reason why stock prices reflexively rise on the news of interest rate cuts). When rates go to zero or turn negative, though, it can render meaningless that discount rate calculation. Market prices are distorted accordingly, and the ability of investors to make rational choices between assets of varying creditworthiness is likewise impaired.

The current bull market is in its eleventh year, the second-longest on record since the end of the Second World War. This longevity is almost entirely due to the presence of easy money. The market's inability to live without the Fed, ECB et al was made perfectly clear last fall, when fears about monetary tightening took equities just nanometers away from a bear market. A willingness to trade rational price discovery for the security of government intervention is the bargain investors have accepted. It's the TINA market – There Is No Alternative. What nobody wants to do is imagine what might come after TINA.

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