



Europe Takes the QE Baton

JOHN MAULDIN | September 7, 2014

If the wide, wide world of investing doesn't seem a little strange to you these days, it can only be because you're not paying attention. If you're paying attention, *strange* really isn't the word you're probably using in your day-to-day investing conversations; it may be more like *weird* or *bizarre*. It increasingly feels like we're living in the world dreamed up by the creators of DC Comics back in the 1960s, called Bizarro World. In popular culture "Bizarro World" has come to mean a situation or setting that is weirdly inverted or opposite from expectations.

As my Dad would say, "The whole situation seems about a half-bubble off dead center" (dating myself to a time when people used levels that actually had bubbles in them). But I suppose that now, were he with us, he might use the expression to refer to the little bubbles that are effervescing everywhere. In a Bizarro French version of very bubbly champagne (I can hardly believe I'm reporting this), the yield on French short-term bonds went negative this week. If you bought a short-term French bill, you actually paid for the privilege of holding it. I can almost understand German and Swiss yields being negative, but French?

And then Friday, as if to compound the hilarity, Irish short-term bond yields went negative. Specifically, roughly three years ago Irish two-year bonds yielded 23.5%. Today they yield -0.004%! In non-related un-news from Bizarro World, the Spanish sold 50-year bonds at 4% this week. Neither of these statistics yielded up by Bloomberg makes any sense at all. I mean, I understand how they can technically happen and why some institutions might even want 50-year Spanish bonds. But what rational person would pay for the privilege of owning an Irish bond? And does anyone really think that 4% covers the risk of holding Spanish debt for 50 years? What is the over-under bet spread on the euro's even existing in Spain in 50 years? Or 10, for that matter?

We might be able to lay the immediate, proximate cause of the bizarreness at the feet of ECB President Mario Draghi, who once again went all in last Monday for his fellow teammates in euroland. He gave them another round of rate cuts and the promise of more monetary easing, thus allowing them to once again dodge the responsibility of managing their own economies. The realist in me scratches my already well-scratched head and wonders exactly what sort of business is going to get all exuberant now that the main European Central Bank lending rate has dropped to 0.05% from an already negligible 0.15%. Wow, that should make a lot of deals look better on paper.

IN THIS ISSUE

The Age of Deleveraging [Page 2](#)

How Bizarre Is It? [Page 3](#)

Time to Ramp Up the Currency War [Page 9](#)

Europe Takes the QE Baton [Page 10](#)

Introducing Tony Sagami [Page 11](#)

San Antonio, Washington DC, Chicago, and Boston [Page 11](#)

We should note that lowering an already ridiculously low lending rate was not actually Signor Draghi's goal. This week we'll look at what is happening across the pond in Europe, where the above-mentioned negative rates are only one ingredient in a big pot of Bizarro soup. And we'll think about what it means for the US Federal Reserve to be so close to the end of its quantitative easing, even as the ECB takes the baton to add €1 trillion to the world's liquidity. And meanwhile, Japan just keeps plugging away. (Note: this letter will print longer than usual as there are a significant number of graphs. Word count is actually down, for which some readers may be grateful.)

But first, I'm glad that I can finally announce that my longtime friend Tony Sagami has officially come to work for us at Mauldin Economics. Tony has been writing our *Yield Shark* advisory since the very beginning, but for contractual reasons we could not publicize his name. I will say more at the end of the letter, but for those of you interested in figuring out how to increase the yield of your investments, Tony could be a godsend.

The Age of Deleveraging

Extremely low and even negative interest rates, slow growth, unusual moves by monetary and fiscal authorities, and the generally unseemly nature of the economic world actually all have a rational context and a comprehensible explanation. My co-author Jonathan Tepper and I laid out in some detail in our book *End Game* what the ending of the debt supercycle would look like. We followed up in our book *Code Red* with a discussion of one of the main side effects, which is a continual currency war (though of course it will not be called a currency war in public). Both books stand up well to the events that have followed them. They are still great handbooks to understand the current environment.

Such deleveraging periods are inherently deflationary and precipitate low rates. Yes, central banks have taken rates to extremes, but the low-rate regime we are in is a natural manifestation of that deleveraging environment. I've been doing a little personal research on what I was writing some 15 years ago (just curious), and I came across a prediction from almost exactly 15 years ago in which I boldly and confidently (note sarcasm) projected that the 10-year bond would go below 4% within a few years. That was a little edgy back then, as Ed Yardeni was suggesting it might go below 5% by the end of the following year. That all seems rather quaint right now. The Great Recession would send the 10-year yield below 2%.

Sidebar: The yield curve was also negative at the time, and I was calling for recession the next year. With central banks holding short-term rates at the zero bound, we no longer have traditional yield-curve data to signal a recession. What's a forecaster to do?

I was not the only one talking about deflation and deleveraging back then. Drs. Gary Shilling and Lacy Hunt (among others) had been writing about them for years. The debt supercycle was also a favorite topic of my friend Martin Barnes (and prior to him Tony Boeckh) at *Bank Credit Analyst*.

Ever-increasing leverage clearly spurs an economy and growth. That leverage can be sustained indefinitely if it is productive leverage capable of creating the cash flow to pay for itself. Even government leverage, if it is used for productive infrastructure investments, can be self-sustaining. But ever-increasing leverage for consumption has a limit. It's called a debt supercycle because that limit takes a long time to come about. Typically it takes about 60 or 70 years. Then something has to be done with the debt and leverage. Generally there is a restructuring through a very painful deflationary bursting of the debt bubble – unless governments print money and create an inflationary bubble. Either way, the debt gets dealt with, and generally not in a pleasant manner.

We are living through an age of deleveraging, which began in 2008. Gary Shilling summarized it this week in his monthly letter:

We continue to believe that slow worldwide growth is the result of the global financial deleveraging that followed the massive expansion of debt in the 1980s and 1990s and the 2008 financial crisis that inevitably followed, as detailed in our 2010 book, *The Age of Deleveraging: Investment strategies for a decade of slow growth and deflation*. We forecast back then that the result in the U.S. would be persistent 2% real GDP growth until the normal decade of deleveraging is completed. Since the process is now six years old, history suggests another four years or so to go.

We've also persistently noted that this deleveraging is so powerful that it has largely offset massive fiscal stimuli in the form of tax cuts and rebates as well as huge increases in federal spending that resulted in earlier trillion-dollar deficits. It has also swamped the cuts in major central bank interest rates to essentially zero that were followed by gigantic central bank security purchases and loans that skyrocketed their balance sheets. Without this deleveraging, all the financial and monetary stimuli would surely have pushed real GDP growth well above the robust 1982–2000 3.7% average instead of leaving it at a meager 2.2% since the recovery began in mid-2009.

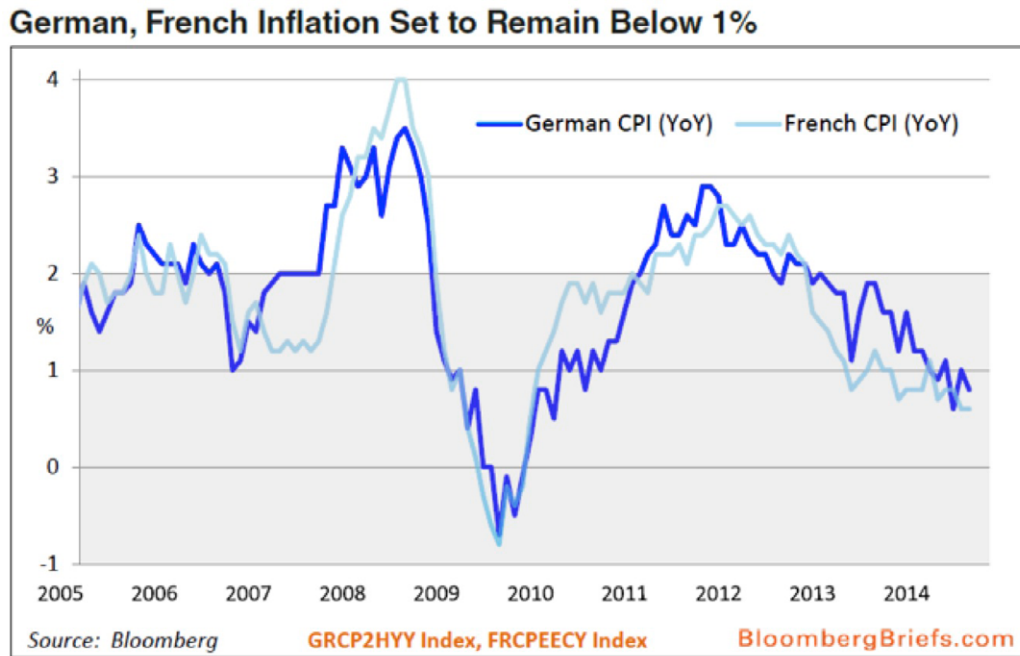
The problems the developed world faces today are the result of decisions made to accumulate large amounts of debt over the past 60 years. These problems cannot be solved simply by the application of easy-money policies. The solution will require significant reforms, especially labor reforms in Europe and Japan, and a restructuring of government obligations.

Mohammed El-Erian called it the New Normal. But it is not something that happens for just a short period of time and then we go back to normal. Gary Shilling cites research which suggests that such periods typically last 10 years – but that's if adjustments are allowed to happen. Central banks are fighting the usual adjustment process by providing easy money, which will prolong the period before the adjustments are made and we can indeed return to a “normal” market.

How Bizarre Is It?

We are going to quickly run through a number of charts, as telling the story visually will be better than spilling several times 1000 words (and easier on you). Note that many of these charts display processes unfolding over time. We try to go back prior to the Great Recession in many of these charts so that you can see the process. We are going to focus on Europe, since that is where the really significant anomalies have been occurring.

First, let's look at what Mario Draghi is faced with. He finds himself in an environment of low inflation, and expectations for inflation going forward are even lower. This chart depicts inflation in the two main European economies, Germany and France.

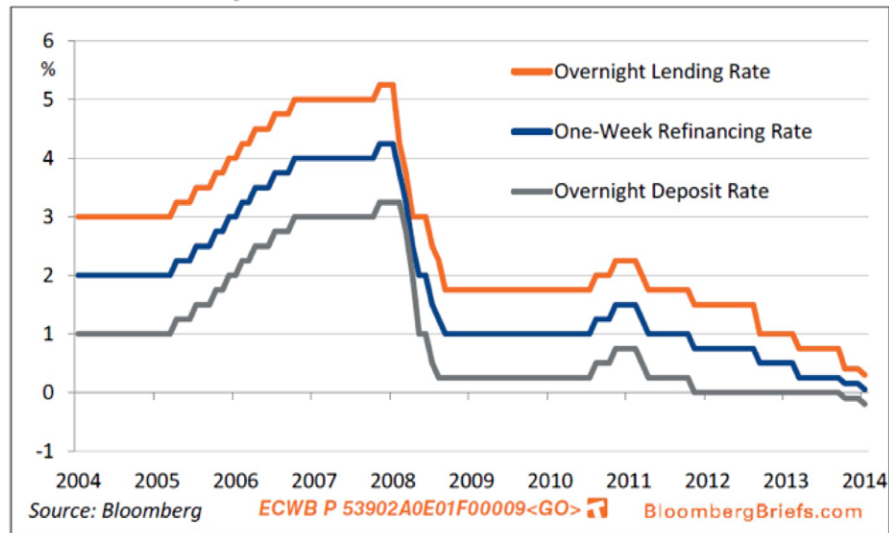


Note too that inflation expectations for the entire euro area are well below 1% for the next two years – notwithstanding the commitment of the European Central Bank to bring back inflation.



But as I noted at the beginning, ECB policy has already reached the zero bound. In fact the overnight rate is negative, making cash truly trash if it is deposited with the ECB.

ECB's Main Policy Rates Flirt With the Zero-Bound

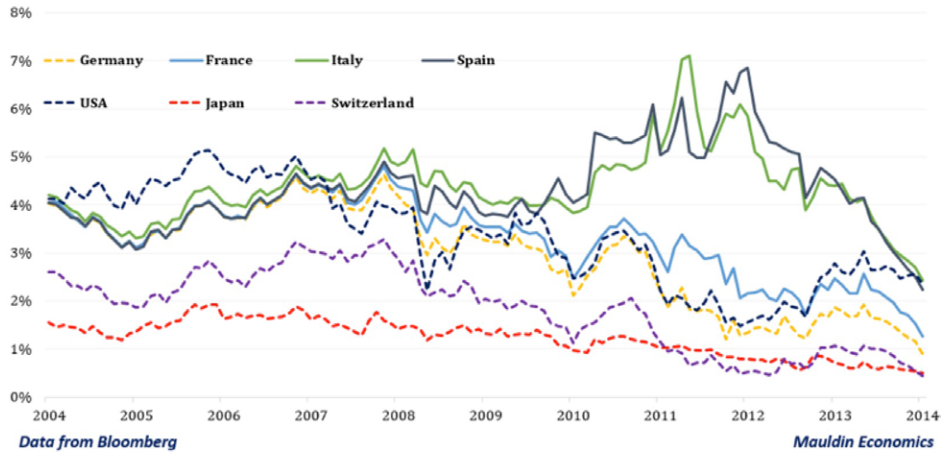


With inflation so low and a desperate scramble for yield going on in Europe, rates for 10-year sovereign debt have plummeted. It is not that Italy or Spain or Greece or Ireland or France is that much less risky than it was five years ago.

Note that banks can get deposits for essentially nothing. They can lever those deposits up (30 or 40 times), and the regulators make them reserve no capital against investments made in sovereign debt. Even after their experience with Greek debt, they essentially claim that there is no risk in sovereign debt. If your bank's profits are being squeezed and it's hard to find places to put money to work in the business sector, then the only game in town is to buy sovereign debt, which is what banks are doing. Which of course pushes down rates. Low interest rates in Europe are as much a result of regulatory policy as of monetary policy.

Next is a chart of 10-year bond yields. We've also included the US, Japan, and Switzerland. Note that Japan and Switzerland are in the 50-basis-point range. (Japan is at 0.52%, and Switzerland is at 0.45%). Italy and Spain now have 10-year bond yields below that of the US.

Nominal Interest Rates on 10 Year Sovereign Debt
(August 2004 - August 2014)



The following chart is a screenshot of a table from Bloomberg, listing 10-year bond yields around Europe. Note that Greece is at 5.48%. Hold that thought while you look at the table.

10-Year Government Bond Yields

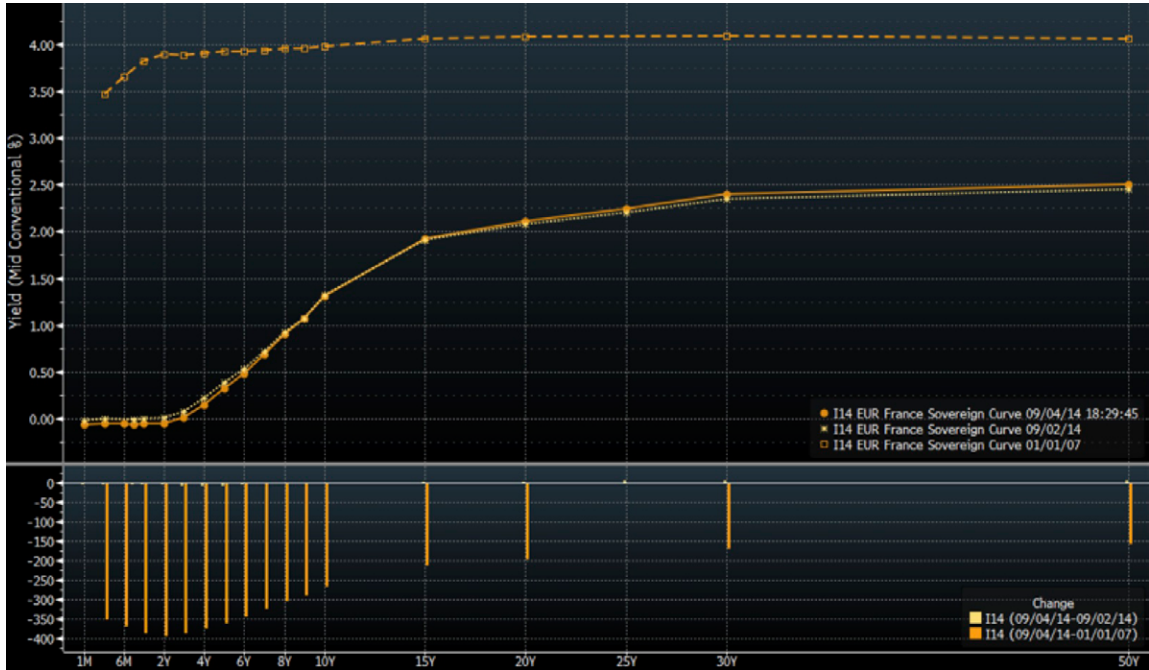
AMERICAS		Yield	1 Day	1 Month	1 Year	Time
United States	More US Treasuries	2.46%	+1	-1	-48	09/05/2014
Canada		2.11%	-1	+1	-65	09/05/2014
Mexico (USD)		3.26%	0	-17	-73	09/05/2014
Brazil (USD)		3.89%	+1	-35	-86	09/05/2014
Change shown in basis points						
EUROPE		Yield	1 Day	1 Month	1 Year	Time
Germany		0.93%	-4	-17	-102	09/05/2014
Britain	More UK Gilts	2.46%	-3	-5	-47	09/05/2014
France		1.25%	-5	-26	-129	09/05/2014
Italy		2.25%	-9	-56	-225	09/05/2014
Spain		2.04%	-12	-54	-248	09/05/2014
Netherlands		1.07%	-5	-23	-131	09/05/2014
Portugal		3.04%	-9	-73	-405	09/05/2014
Greece		5.48%	-8	-96	-489	09/05/2014
Switzerland		0.45%	-3	-1	-64	09/05/2014
Change shown in basis points						
ASIA		Yield	1 Day	1 Month	1 Year	Time
Japan	More Japanese Bonds	0.53%	+1	+2	-24	09/05/2014
Australia	More Australian Bonds	3.46%	+4	-5	-68	09/05/2014

This next chart requires a minute or two of analysis, and looking at it in black and white probably won't work. Essentially, this is the spread of the yields of 10-year bonds of various European countries over German bunds. Note that only two years ago Greek debt paid 25% per year more than German debt did. Anyone who bought Greek debt when that country was busy defaulting has scored big. (While I probably take far too much risk in my portfolio, I will readily admit to not having enough nerve to do something like that.) The other thing to note, and it is a little bit more difficult to see on this chart, is that for all intents and purposes the market is treating European-wide EFSF debt as German debt. There are only 10 basis points of difference.

Now let's take a little stroll through history and view a chart of the yield curve of French debt. The top dotted line is where the yield curve was on January 1, 2007. We took our first look at this chart last Tuesday in preparation for this letter, noting that short-term French debt was at the zero bound. It went negative on Thursday, and negative all the way out to two years! Note that a 50-year French note (which I'm not sure actually trades) yields a hypothetical 2.5%, only modestly more than a 30-year would yield. You might have to have the patience of Job, and I'm not sure quite how you would go about executing the trade, but that has to be one of the most loudly screaming shorts I've ever seen!

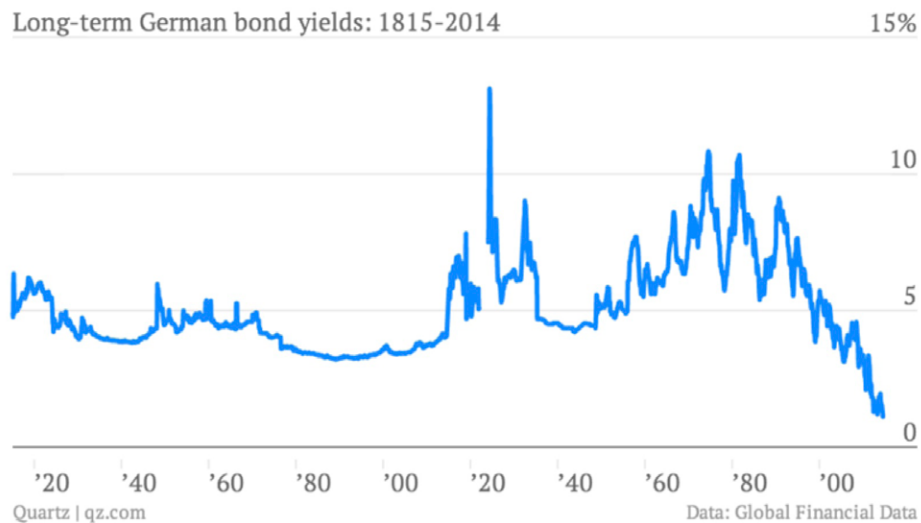


Here is the equivalent chart for the German yield curve going back to January 2007. Note that German debt has a negative yield out to three years!!!



While it should surprise no one, German long-term bond yields are at historic lows. I recall reading that Spanish bond yields are lower now than they have been at any other time in their history. I actually applaud the Spanish government for issuing 50-year bonds at 4%. I can almost guarantee you the day will come when Spain looks back at those 4% bonds with fondness. (I assume that the buyers are pension funds or insurance companies engaged in a desperate search for yield. I guess the extra 2% over a ten-year bond looks attractive ... at least in the short term.)

And finally, let's really widen our time horizon on German yields:

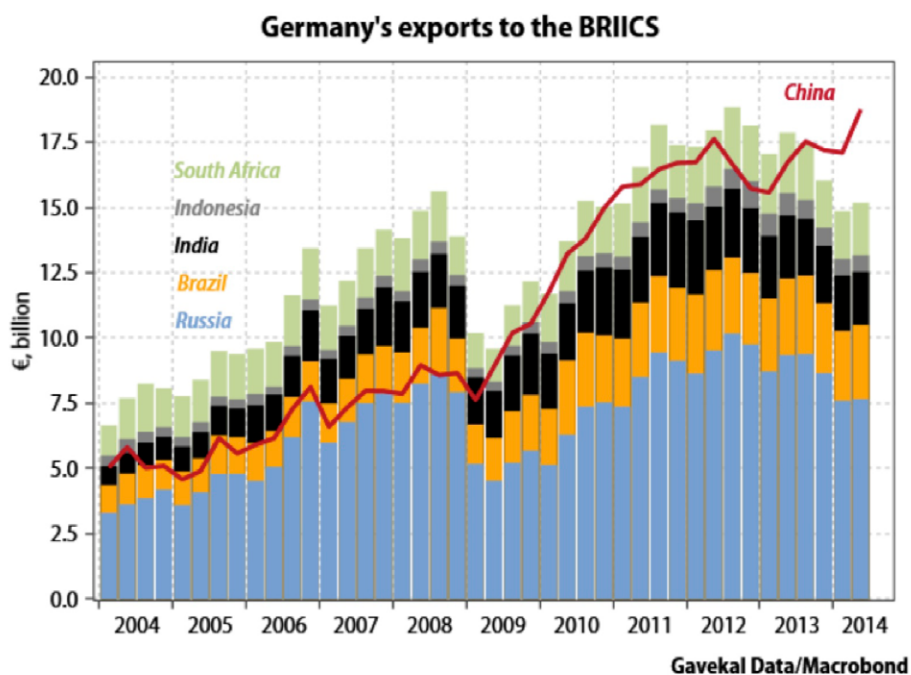


Time to Ramp up the Currency War

The yen hit a six-year low this week (over 105 to the dollar), creating even more of a problem for Germany and other European exporters to Asia. The chart below shows that Germany's exports to the BRIICS except China are down significantly over the past few years, partially due to competition from Japan as the yen has dropped against the euro.

The yen-versus-euro problem (at least from Germany's standpoint) is exacerbated by the remarkable appetite of Japanese investors for French bonds. This has been going on for over a year. In May and June of this year alone, Japanese investors bought \$29.3 billion worth of French notes maturing at one year or more (presumably, this was before rates went negative). Note that even with minimal yields, the Japanese investors are up because of the currency play. (Interestingly, Japanese investors are dumping German bonds, again a yield play.)

Japanese analysts say that Japanese investors are hesitant to take the risks on the higher-yielding Italian and Spanish bonds, but for some reason they see almost no risk in French bonds. (Obviously not many *Thoughts from the Frontline* readers in Japan.) This behavior, of course, helps to drive down the price of the yen relative to the euro. (Source, [Bloomberg](#))

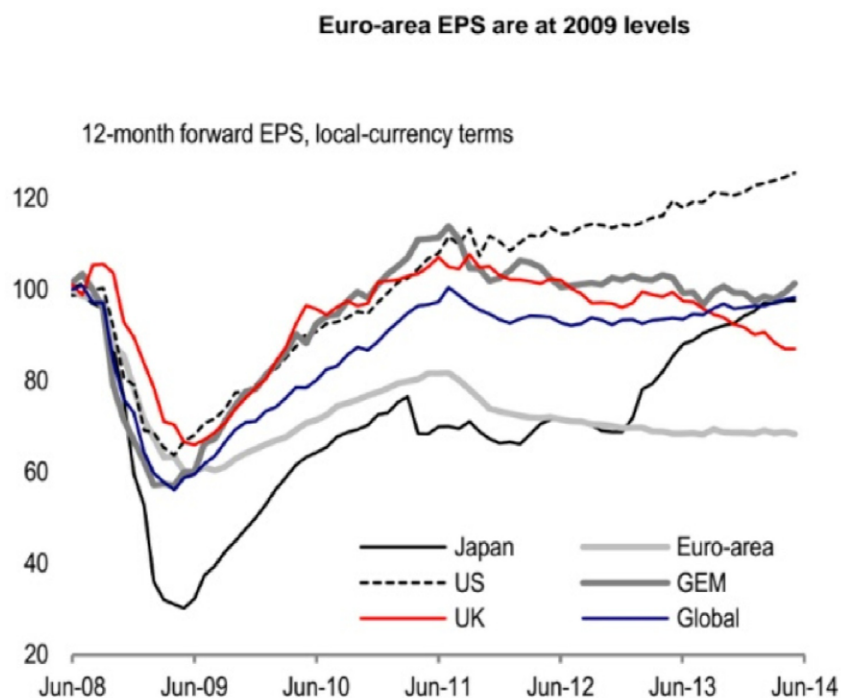


Interesting side note: the third-largest country holding of US treasuries behind Japan and China is now Belgium. When you first read that, you have to do a double-take. Digging a little deeper, you find out there's been a 41% surge in Belgian ownership of US bonds in just the first five months of this year. As it turns out, Euroclear Bank SA, a provider of security settlements for foreign lenders, is based in Belgium and is where countries can go to buy bonds they are not holding in their own treasuries. This buying surge is helping hold down US yields even as the Federal Reserve is reducing its QE program. Further, there is serious speculation, or rather speculation from serious sources, that Russian oligarchs are piling into US dollars by the tens of billions, again through Belgium.

Europe Takes the Baton

It is probably only a coincidence that just as the Fed ends QE, Europe will begin its own QE program. Note that the ECB has reduced its balance sheet by over \$1 trillion in the past few years (to the chagrin of much of European leadership). There is now “room” for the ECB to work through various asset-buying programs to increase its balance sheet by at least another trillion over the next year or so, taking the place of the Federal Reserve. Draghi intends to do so.

Risk-takers should take note. European earnings per share are significantly lower than those of any other developed economy. Indeed, while much of the rest of the world has seen earnings rise since the market bottom in 2009, the euro area has been roughly flat.



Both the US and Japanese stock markets took off when their respective central banks began QE programs. Will the same happen in Europe? QE in Europe will have a little bit different flavor than the straight-out bond buying of Japan or the US, but they will still be pushing money into the system. With yields at all-time lows, European investors may start looking at their own stock markets. Just saying.

Draghi also knows there is really no way to escape his current conundrum without reigniting European growth. One of the textbook ways to achieve easy growth is through currency devaluation; and as we wrote in *Code Red*, the ECB will step up and do what it can to cheapen the euro in competition with Japan.

Just as the world is getting fewer dollars (in a world where global trade is done in dollars), Draghi is going to flood the world with euros.

Bank of Japan Governor Kuroda has steered the BOJ to where it now owns 20% of all outstanding Japanese government debt and is buying 70% of all newly issued Japanese bonds. The BOJ hoped that by driving down long-term rates it could encourage Japanese banks to invest and lend more, but bond-hungry regional Japanese banks are still snapping up long-term Japanese bonds, even at 50 basis points of yield. Given the current environment, the Bank of Japan cannot stop its QE program without creating a spike in yields that the government of Japan could not afford. Hence I think it's unlikely that Japanese QE will end anytime soon, thus putting further pressure on the yen.

The BOJ is going to continue to buy massive quantities of bonds and erode the value of the yen over time in an effort to get 2% inflation.

In a world where populations in developed countries are growing older and are thus more interested in fixed-income securities, yields are going to be challenged for some time. Those planning retirement are going to generally need about twice what would have been suggested only 10 or 15 years ago in order to be able to achieve the same income. Welcome to the world of financial repression, brought to you by your friendly local central bank.

Introducing Tony Sagami

When we first launched Mauldin Economics some two years ago, my partners and I thought there was a need for a good fixed-income letter with a little different style and focus. My very first phone call was to my longtime friend Tony Sagami, to ask if he would write it. I have known Tony for almost 25 years. We have worked together, he has worked for me, and we have been competitors, but we've always been good friends.

Even though he now lives in Bangkok most of the year, we still visit regularly by email and Skype, and try to make a point of catching up in some part of the world at least twice a year. In addition to his talents as a writer, Tony brings a seasoned perspective and huge experience as a trader and investor. (Seasoned is a technical term for getting older, having made lots of instructive mistakes in your early years.) He has a way of taking my macro ideas and efficiently and effectively putting them to work. I know Yield Shark subscribers must be happy, because our renewal rates are very high by industry standards.

As I mentioned early in the letter, for contractual reasons we haven't been able to name Tony as the editor of *Yield Shark*. I'm really pleased that we can do so now. Tony was recently in Dallas, and we did a short video together so that I could introduce him. You can watch the video and learn more about Tony [here](#). You will soon be receiving information from my partners about a new newsletter that Tony will also be writing, which we are tentatively calling *The Rational Bear*.

San Antonio, Washington DC, Chicago, and Boston

My respite from travel will be over in a few weeks as I head to the [Casey Research Summit](#) in San Antonio, September 17-21. It actually takes place at a resort in the Hill Country north of San Antonio, which is a fun place to spend a weekend with friends. Then the end of the month will see me traveling to Washington DC for a few days.

I'll be back in Dallas in time for my 65th birthday on October 4, and then I get to spend another two weeks at home before the travel schedule picks back up. I will make a quick trip to Chicago, then swing back to Athens, Texas, before I head on to Cambridge, Massachusetts, for conferences. There are a few other trips [shaping up as well](#).

My time at home has been well spent, as I'm catching up on all sorts of projects, spending more time in the gym, and just enjoying being home. Surprisingly, being at home has allowed me to see more friends than usual as they've come through town. Dennis Gartman was in yesterday, and we spent two pleasant hours catching up over lunch. He is one of the truly consummate gentlemen in our business and a bottomless reservoir of great stories. A perfect evening would be Dennis Gartman and Art Cashin holding court at the Friends of Fermentation after the market closes. You'd just sit there and scribble notes.

The other thing about being home is that it makes me want to get on a plane and go see even more friends! Yesterday I caught up with George and Meredith Friedman on the phone, and we realized it has been well over a year since we've seen each other, which is unusual for us. I really enjoy them, and they are their own source of endless stories. George and Meredith travel much more than I do, and all over the world at that, doing speeches and research and the like; but we agreed that sometime in October we will make a visit happen, whoever is doing the flying. I think one of the reasons that God made planes was so that friends could see each other more often.

A special hat tip goes to my associate Worth Wray for finding and creating most of the charts for this week. Plus helping me think through the letter. He has been a huge help this last year.

You have a great week and take a friend who tells great stories to lunch. It will do wonders for your outlook on life.

Your still can't believe negative French interest rates analyst,



John Mauldin

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