Views from the Trading Floor

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I don't think the soft looking US data today, although worrying, changes much. I still think it reflects the bad weather, and that underlying growth in the US (and Europe!) is stronger than generally perceived. And, it's hard to get a full blown global crisis in an environment of accelerating growth and a very accommodative monetary policy.

Meanwhile, check out the discussion/debate below. I thought it very illuminating on an important and widely discussed, yet often misunderstood, topic. – *Andres Drobny*

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1) Sovereign Risk - Greece and the US

SG#1 sent this note to Niall Ferguson on Feb 12: I enjoyed reading your piece in yesterday's FT (*'A Greek Crisis is Coming to America',* **FT,** Feb 10, 2010), even though the argument is fundamentally flawed. You fail to distinguish between Greece, which uses an external currency (much like the gold standard) and the US, which does not…..

As distinct from Greece, whose membership in EMU means that it is not a sovereign but rather more like a US state or Canadian province, the US government runs both national fiscal and monetary policy and is the monopoly issuer of the currency. Federal 'debt' is simply an electronic credit to the accounts of private sector savers. There is no limit on the supply of these electronic credits, and more importantly, the sum of the 'debt' is simply the counterpart to the private sector's net financial assets.

There is no federal government 'debt' scenario which, on its own, can precipitate a fiscal crisis in the US. What is true is that if/when a self-sustaining private sector recovery takes hold and the large federal government deficit finds itself competing with the private sector for goods and services, it will be time to scale back the deficit. Failure to do so a that point would have undesirable consequences, not the least of which would be inflation.

Andres sent the following note to SG1 and Niall on Tues, Feb 23: Gentlemen, I just read the piece by John Makin discussing the issue of budget deficits and bond yields, which cites an interesting empirical study (http://www.aei.org/outlook/100935) relating to your discussion/debate.

I think it provides a neat compromise between you….it suggests that increased deficit/GDP (and considers to debt/GDP as well, which is offers and interesting comparison) have a small effect on bond yields, but not a large one. Now, a problem with such studies is that it may prove hard to distinguish between autonomous increases

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and automatic increases in these deficits, but I presume the underlying study understood this rather basic issue. I have not checked.

The conclusion, though, fits with Niall's premise, that rising deficit/gdp ratios place upward pressure on yields, but suggests the power is less than he thinks. It also fits with SG1's argument that deficits only raise yields if growth (and thus competing demand for funds) picks up, so the deficit effect is arguably on a second order one for a country like the US.

SG1 replied on Tuesday: By the way, have you been reading the Rogoff stuff? His work is so fundamentally flawed; how does it pass peer review?

Andres: I haven't been reading it, other than what's been in the press. And, his recent comments are often couched in conditional terms that protect him a little. for example today: 'fiscal policy won't be curbed until bond yields rise….' That may well be true. And, frankly, it would be dangerous if it weren't true (tightening too soon makes things worse, not better). But, he doesn't address what can cause yields to rise!

And, you have been right…..bond yields can rise simply due to the size of deficits if there is a currency restriction and monetary policy isn't free; eg, Argentina (2001) or Greece today. But, otherwise, they rise only when demand for funds rise (eg growth resumes) and monetary policy doesn't accommodate.

That's how you can explain Japan, Greece and the US all with the same model…….there are no exceptions or anomalies here, I think. Instead, different circumstances.

Niall Ferguson also replied on Tuesday: Thanks for the piece. There is a tiresome tendency for certain commentators (first Krugman, then DeLong and now Martin Wolf) to over-simplify my position.

I have never held that there is a simple relationship between debt/GDP ratios or deficits and nominal yields (see, **The Cash Nexus,** 2001). But, I have long maintained that the US is heading for a major fiscal crisis in the absence of radical reforms of both tax and spending (**Colossus,** 2004). The crisis has brought forward the day of reckoning.

At some point investors will wake up and see that they are underpricing the (political) risk of default and/or depreciation, because they are forgetting that the US Congress only does the right thing after all alternatives have been exhausted. A small rise in nominal yields is on the cards; if it is bigger than the rise in inflation, which is likely, real interest rates will rise, and the effect will be dampening on a highly leveraged economy. This is consistent with a number of studies, most recently Reinhart and Rogoff (2010).

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Andres: Niall, I still have a problem with all this. I agree that ultimately there has to be a check on deficit growth. But, unlike with Greece or Argentina, the US can fund a deficit by printing money. So, aren't the limits very different?

That is, a big deficit in the US (or UK) doesn't cause a crisis ***until the monetary authorities are no longer willing (say due to growth and fear of inflation) or able (currency crisis) to fund the deficit.*** Isn't that the lesson of Japan? They never had inflation or a currency crisis, so yields have remained remarkably low despite a horrific looking deficit.

I think that's the basic point SG1 was getting at. (By the way, at the first ever Drobny Conference, in 2002, one of the favorite trades was to sell JGB's! It was a very impressive presentation and seemingly convincing story…….)

SG1 on Wed: I was reminded recently of the fabulous piece that Prof Ferguson contributed last September – truly one of the best guest pieces in a long line of very good ones (see, *'Too Big to Live',* **DG Guest Piece,** Sept 29.2009). Re-reading it inspired me to send you this speech by the Governor of the Bank of Canada which I view as an easily accessible but very important reference document which explains the whole idea behind banking as well as its public purpose. The world would be a far better place if our policy makers and perhaps a few financial journalists would read these two papers (http://www.bank-banque-canada.ca/en/speeches/2009/sp300309.pdf).

As to the Rogoff and Reinhart paper (Jan 2010) – dreadful and misguided. I still don't understand how this can pass peer review. Says something about the state of economics.

The key distinction between true non-convertible fiat money regimes and all others is fundamental to analyzing and modeling outcomes. The most obvious contemporary example would be EMU on the one hand, versus the US, UK, Japan, Canada, etc on the other. EMU countries are compelled to respond pro-cyclically when there is a problem, whereas the true sovereigns can act counter-cyclically. For the latter group, the forces are largely self-equilibrating over time.

The founders of EMU knew this very well. As Issing and others have repeated in recent weeks, EMU won't be sustainable without a political process that creates a supranational fiscal structure. We had endless discussions and debates about this between 1992 and 1999, but ultimately the politicians decided to go for what was possible in the short run instead of what was structurally viable. One of my great fears then, as now, is the prospect of centrist leaders being discredited in the midst of a financial shock, giving rise to extremist voices. Professor Ferguson could probably tell us very eloquently about the consequences of this scenario based on historical precedents.

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Niall Ferguson replied on Wed: Of course the US is in a different position from Greece because it has monetary sovereignty. But, it is also in a different position from Japan. Last year, about 50% of the net Treasury issuance was bought by foreign investors. I don't believe the Chinese et al will have the same appetite for dollar-denominated bonds this year. Which is why I expect real yields to rise – partly through nominal yields rising (due to supply and demand, inflation fears, even default fears as the political polarization/gridlock worsens), partly through inflation surprising on the downside. Of course, the Euro crisis postpones this into the second half.

Andres afterthought: But, even if Niall is right, the US monetary authorities can make up any slack that emerges in demand for Treasuries, if the US private sector doesn't (there is less corporate supply to buy). So, until underlying demand for funds picks up, ie, growth is sustained, and the monetary authorities start to unwind the easy policy, yields can stay low.

Note that Niall's final salvo here is a very bearish story for US TIPs. Higher real yields and lower inflation is a terrible combo for them.

2) USD Laggards – HKD

SG#2 commented on Monday about the DGM that day: I'm the other way on the HKD. When it weakened 3 weeks ago, I bought it and still own it, looking for a return to 7.75. My thinking is that any talk of a yuan reval (or re-peg to a new basket) gives rise to speculation that the HKD will tag along, so 7.75 will act as a periodic attractor. It is hard to think about the HKD ignoring the yuan.

Andres replied: You are absolutely right that a China reval is a risk to my trade. I guess my trade fits best against a long CNY or Asian currency position. Or maybe the trade is to be long CNY or NJAsia vs HKD. If there is no China reval, it is the HKD, and HKD rates that look particularly exposed since they are now below those of the US, and expected to stay that way.

SG#3 commented on Tuesday: I am going to look at that HKD swap idea you raise. The negative carry is my concern, so perhaps paying 2yr and receiving 1yr will offset some of that, but I will need to discuss with the locals.

Andres afterthought: Here's another way to do it…..look how flat the Hibor curve is, especially compared to the US Libor curve. 1yr US is trading at 0.87%, compared with 0.40% for 6mth cash. That's still pretty flat if the FED are going to start hiking before year end. But, the equivalent Hibor rates are 0.35% for the 1yr and 0.24% for the 6mth. So, as a lower carry alternative, pay the 1yr and buy back 6mth. Or, buy USD/HKD 1yr

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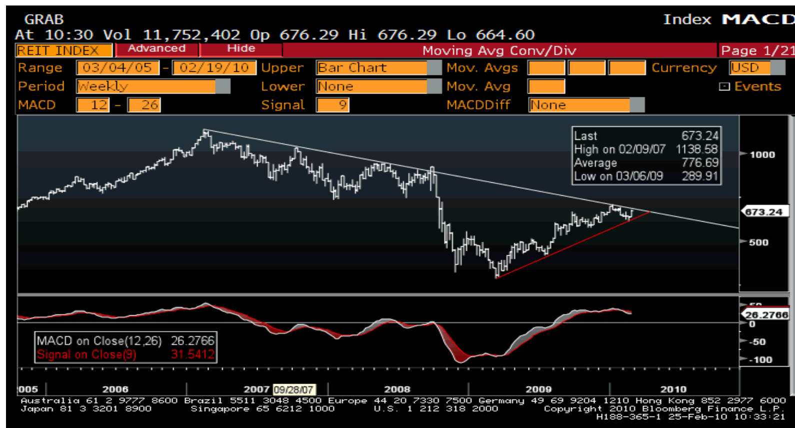
forward and buy it back 6mths. The bottom line is that the HK curve builds in HKD strength which would be very wrong if this is the start of a genuine USD bull market and/or we are near the start of a FED rate hiking regime.

SG#4 commented on Monday: If you are right about the potential for a US growth surprise and for a further bout of FED tightening fears, then think about selling US REIT's here. They are very interest rate sensitive and commercial real estate is hardly in a robust state. And, after a pretty fierce rally, the location to sell is excellent (picture below).



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