

## Not deja-vu 2011

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Jonathan Pain | The Pain Report | 20 February 2016

Many of you have written to me asking my view on Australian bank hybrids. For international readers, this might be a "I've got better things to do" moment, but I think not, as it speaks to the issue of the performance of bank stocks globally. The poster child, or the canary, in this regard is the plunge in Deutsche Bank's share price which recently fell below its January 2009 crash low. But the real "chatter" on the trading desks around the world has been the performance of Deutsche Bank's CoCo bonds (contingent convertible bonds) – in Australia, think bank hybrids.

So, let me brief. From the work I have done on this curious and exotic segment of the market, they are – and I choose my words carefully – fiendishly complex instruments. In short, there is an optionality embedded in the structure which makes it very difficult to value them. And, because I want to move on to other topics, [I refer you to article written by Pimco's Rob Mead](#), who does seem to understand these curious beasts, and has read the prospectus!

Now that I've got that out of the way, let's sit back, relax and enjoy the pictures. Global equity markets had a good week. In fact, mid-week the S&P 500 strung together its best three-day winning streak since October 2011 (Figure 1). And talking of 2011, quite a few investors think that the current decline in equity markets is analogous to that period, which we remember as the depths of the eurozone sovereign debt crisis (Figure 1).

Figure 1: S&P 500 Index – 26 Feb 2011 to 20 Feb 2016



Source: Bloomberg Finance L.P.

I wish I could feel that way too. Do you think the current environment is like 2011? I'm sorry, I don't.

In fact, everything – and I mean everything – is different. In 2011, China was doing just fine. Emerging market companies were happily borrowing lots of money and hadn't yet borrowed too much. The ECB hadn't yet launched QE and Kuroda hadn't yet arrived at the BOJ to launch the biggest shock-and-awe monetary campaign of all time. The FED was aggressively easing policy. Since 2011, we have had a Chinese stock market crash, an oil market and commodities crash and Donald Trump (to mention just a few!). I think the "it's 2011 all over again" cheerleader squad has lost the plot and is clutching at straws. There are simply too many differences to mention. You see, the simple and stark reality is that it really IS DIFFERENT THIS TIME. And yes, I know those are loaded and emotive words for all of us in the investment industry – but, really, you have to agree we have never been here before. We have no roadmap – well, no monetary roadmap. This time, investors appear to be losing faith in central banks' ability to influence markets. Just look at the reaction of the market to the BOJ move to a negative rate and the subsequent strengthening in the YEN, post 28 January.

Figure 2: Japanese Yen spot price



Source: Bloomberg Finance L.P.

And, as I have mentioned in previous Weeklies and *The Pain Report*, look at the performance of bank stocks in Japan (Figure 3) and Europe (Figure 4).

Figure 3: Tokyo Stock Exchange TOPIC Banks Index – 20 Feb 2015 to 20 Feb 2016



Source: Bloomberg Finance L.P.

Figure 4: STOXX Europe 600 Bank Price EUR – 20 Feb 2016 to 20 Feb 2016



Sources: Bloomberg Finance L.P.

These charts, as I have mentioned before, are telling me that the hissing sound you can hear is the deflation of a global credit bubble.

Now let me be very clear, as there is much discussion of late about the prospect of a US recession. I do not see a recession in America this year. I also believe that the US banking system is fundamentally sound – in fact, I think it is very robust, unlike in 2007/2008. I also do not believe that the crash in oil prices and indebtedness of oil and oil-related companies pose any kind of systemic risk to the US banking system. Most of the risk is held outside the banking system in various credit funds, ETFs and the like. I do recognise the weakness in the industrial and manufacturing sector in America, BUT the US consumer is in pretty good shape... ditto the US housing market. Having said all that, the US economy will not set the world on fire with sparkling economic performance. Quite to the contrary, GDP growth will be about 1.5% to 2% this year.

The problem THIS time is not in America. THIS time the winds of deflation come from the east, not the west. Stuck in the middle we have Europe. We have a migration crisis, a bad debt problem in Italy, issues in Portugal and, yes, we also have issues in Greece (but, really, who cares about Greece anymore?) The recovery in Europe is young and fragile and bank stocks are suggesting some trouble ahead – nothing systemic, as yet, but the problems in

the east could not have come at a worst time. Keep an eye on European truck sales, as you know, my favourite economic indicator.

And talking of economic indicators, and to make things even more complicated – oh boy and they are complicated – I feel that we have a data integrity problem across much of the world. We all know the China story and the integrity of the GDP figure. But here in Australia, we have the nonsense that the ABS issues each month in its employment report. Then there is the mother of all economic statistics, the US employment report.

In times such as these, I rely on the charts. Listen to what the market is telling you. Markets are looking forward, not backward. Right here and now, equity markets look like they want to move higher which is not surprising given how far we have fallen. The two Figures below (Dow Jones Transportation Index and the Russell 2000) tell me that markets want to go higher. Don't forget, it was these two markets which led the broader indices lower. But, both these markets could move a lot higher and still be in a downward channel.

Figure 5: Russell 2000 Index – 20 Feb 2015 to 20 Feb 2016



Sources: Bloomberg Finance L.P.

Figure 6: Dow Jones Transportation Index – 20 Feb 2015 to 20 Feb 2016



Sources: Bloomberg Finance L.P.

So, to try and sum up, the short term trend is higher, but the long term trend is lower. Also, it's worth mentioning that the Chinese appear super-determined to defend the Yuan and, most importantly, we at long last heard from PBOC Governor Zhou. Many say that part of the problem in markets is the lack of communication by Chinese policymakers. In the west, particularly in America, a day does not go by without a FED official saying this or that. In China, we can go months without any comment from the PBOC. Well, Governor Zhou has spoken in a long and detailed interview in the *Caixin Weekly* and his message was LOUD AND CLEAR – don't mess with my currency! Just let me devalue it quietly (he didn't say that bit!)

All in all, financial markets appear to be stabilising and the "chatter" of an imminent Chinese devaluation is fading. And on that note I am fading too... Have a good weekend.



*Jonathan Pain is Author of The Pain Report, an independent and global perspective of financial markets and world economy, free of Wall Street spin. A self- confessed market and economic data junkie who spends far too many hours thinking about what the world will look like in the years ahead, JP is a regular presenter at PortfolioConstruction Forum's professional development programs. Over the years, he has debuted new investment theses and challenged delegates about how to build better quality investor portfolios.*

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