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The ECB's open-ended QE; Fed's Liquidity Injection

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It is often said that September is the cruelest month for the stock market. This September, however, started off with a surge in equity prices and sovereign bond yields as the U.S. and China both sent out conciliatory signals ahead of the trade talks in October. However, several developments – an attack on Saudi Arabia's oil field that briefly sent oil prices surging, and the House's formal impeachment inquiry against President Trump – took the wind out of the rally's sails during the second half of the month. The spike in crude oil prices turned out to be ephemeral as investors did not expect the attack to have a lasting impact. The impeachment inquiry, on the other hand, will reverberate well into November 2020 and beyond, as it may have dealt a serious blow to former Vice President Biden's campaign, elevated Senator Warren to the top of the Democratic field, and fired up President Trump's loyal base.

The synchronized global easing cycle continued unabated. The European Central Bank (ECB) cut its benchmark interest rate further into negative territory and will restart asset purchases in November. The Fed, or the "Boneheads" according to President Trump's tweet, lowered the Fed funds rate by another 25 bps. These cuts were matched across the globe by Indonesia, Vietnam, Hong Kong, Brazil, Russia, etc. However, the central bank of Norway apparently missed the memo – it raised its main policy rate in order to defend the weak Norwegian krone. The U.S. Dollar Index (DXY) eked out another month of gain, while gold prices pulled back.

Weakness in global manufacturing has spread to the U.S., but American consumers and the job market have remained in solid shape. Economic data from India and Germany, however, were decidedly on the weaker side. The former responded with a surprise reduction in the corporate income tax rate from 30% to 25.2%. The latter inched closer to injecting fiscal stimulus by pledging a €54 billion program for climate solutions, though Chancellor Merkel continued to insist on a balanced budget. To keep the expansion going, the world economy now needs more fiscal than monetary stimulus. We believe there will be more spending on "green" initiatives around the globe as climate issues took center stage at the recently-concluded U.N. General Assembly.

EQUITY MARKETS INDICES[1]	8/30/19 Price	9/30/19 Price	MTD Change	YTD Change
MSCI All Country World	511	521	1.9%	14.3%
S&P 500	2926	2977	1.7%	18.7%
MSCI EAFE	1843	1889	2.5%	9.9%
Russell 2000	1495	1523	1.9%	13.0%
NASDAQ	7963	7999	0.5%	20.6%
TOPIX	1512	1588	5.0%	6.3%
KOSPI	1968	2063	4.8%	1.1%
Emerging Markets	984	1001	1.7%	3.6%
Fixed Income				
2-Year US Treasury Note	1.51%	1.62%	12	-87
10-Year US Treasury Note	1.50%	1.67%	17	-102
BarCap US Agg Corp Sprd	1.20%	1.15%	-5	-38
BarCap US Corp HY Sprd	3.93%	3.73%	-20	-153
USD Performance				
Chinese Renminbi (CNY/$)	7.16	7.15	-0.1%	3.9%
Brazil Real (Real/$)	4.15	4.16	0.3%	7.1%
British Pound ($/GBP)	1.22	1.23	-1.1%	3.8%
Euro ($/EUR)	1.10	1.09	0.8%	5.2%
Japanese Yen (Yen/$)	106.28	108.08	1.7%	-1.5%
Korean Won (KRW/$)	1211.35	1196.38	-1.2%	7.7%
US Dollar Index (DXY)	98.92	99.38	0.5%	3.3%
Commodities				
Gold	1520	1472	-3.2%	14.8%
Oil	55.1	54.1	-1.9%	19.1%
Natural Gas, Henry Hub	2.29	2.33	2.0%	-20.7%
Copper (cents/lb)	253	258	1.8%	-2.0%
CRB Index	170	174	2.1%	2.4%
Baltic Dry Index	2378	1823	-23.3%	43.4%

Source: Bloomberg.

German exports have been the big beneficiary of the ECB's unconventional monetary policies that have kept the euro artificially low. It's now time for Germany to convert some of her export bonanza into fiscal stimulus.

ROMMEL'S DILEMMA

75 years ago, on the chilly morning of October 14th, 1944, there was a sense of foreboding in the Rommel household nestled in the quiet village of Herrlingen, Germany. Field Marshall Erwin Rommel, who was convalescing from severe injuries incurred from a British air attack three months earlier, confided to his 15-year-old son Manfred that Hitler had dispatched two generals to meet him at noon. Rommel surmised that he would either be asked to take command of the Eastern front against the Soviet Union or be put on trial at the People's Court.

Johannes Erwin Eugen Rommel was the most admired German general of his generation. The Brits called him the "Desert Fox" for his deft and lightning fast maneuvering in the North African campaign. As Rommel pommelled the British Eighth Army in early 1942, British Prime Minister Winston Churchill shocked many by praising him at the House of Commons as a "very daring and skillful opponent" and a "great general."

By the spring of 1944, however, Rommel had concluded that the only way to salvage the country was to surrender to the Allied powers. He had secretly agreed to collaborate with a group of renegade officers who were plotting to overthrow Hitler. Unfortunately, the failed Operation Valkyrie in July to assassinate Hitler led the Führer to pursue a bloody witch hunt which eventually had more than 7,000 people arrested and nearly 5,000 executed.

At precisely noon, Generals Burgdorf and Maisel showed up at the door. After an hour of talk behind closed doors, Rommel went upstairs to bid his wife farewell. Manfred came out of his room to ask what was going on. With Mrs. Rommel sobbing in the background, Rommel told Manfred that Hitler had charged him with treason and wanted him dead. However, to avoid damaging the morale among the German populace that held him in high esteem, Rommel was given a choice – commit suicide in fifteen minutes or face trial at the People's Court. He would be given a state funeral after the suicide, and his family would receive full pension payments. The trial would mean a certain death sentence with dire consequences for his family. Rommel elected the former in order to save his family and staff.

Manfred helped his father put on a leather coat over his Afrika Korps uniform and handed him the field marshal's baton. Rommel calmly walked out of the house to a waiting car. He turned around, pushed the baton under his left arm and shook hands with Manfred and his aide Aldinger for the last time. The two generals followed him into the car and slammed shut the car doors. Rommel sat upright and looked straight ahead as the car drove away. The car stopped on a nearby hill and Maisel and the driver got out. Burgdorf handed Rommel a cyanide pill and a few minutes later, the legendary general dropped his baton, hunched forward, and passed away at the age of 52.

GERMANY AT A CROSSROADS

Manfred Rommel survived the war and wound up serving as a liberal mayor of Stuttgart for 22 years. He became a symbol of reconciliation for his friendship with the sons of his father's old nemeses, British Field Marshal Montgomery and General George S. Patton. Manfred was also honored with the "Guardian of Jerusalem" award for his work with Jewish institutions.

Germany rose from the ashes of WWII and later managed, albeit through a costly reunification, to become a global economic powerhouse and the most powerful country in the European Union. Germany's GDP now ranks fourth in the world, and "Made in Germany" is synonymous with quality and precision. The country has become the second most popular migration destination in the world after the U.S., and roughly 15% of its population are immigrants. Ironically, Germany's success has now put the country at a precarious crossroads.

Economically, Germany's overwhelming dependency on exports, which account for 47% of its GDP, means it does not have much control over its own destiny. As a case in point, despite healthy domestic demand, Germany may have slid into a technical recession due to weak exports to China and other trade-related issues. Its manufacturing sector is more exposed to Brexit than other European countries. The vaunted German auto brands, best known for performance and handling, will have to compete in the brave new world of autonomous driving and non-combustion engines. Germany also appears to have a systemic banking issue as judged by the steep share price declines of its largest publicly-traded banks.

Politically, the mainstream parties -- the center-left Social Democrats (SPD) and the center-right Christian Democratic Union (CDU), have been losing support to the fringe parties, especially the right-wing Alternative for Germany party (Alternative für Deutschland, or AfD). Founded as a populist Euroskeptic party in 2013, the AfD championed anti-immigration policies after Chancellor Merkel took in nearly one million migrants in 2015. AfD is now the country's largest opposition party and has made substantial gains to finish a strong second in the September regional elections in Saxony and Brandenburg. Chancellor Merkel may also face an early exit should the beleaguered SPD, currently mired in a protracted leadership contest, decide to pull out of the ruling coalition.

The good news for Germany is that it has plenty of fiscal firepower to stimulate the economy. Its government-debt-to-GDP has gone down from 81.8% at the end of 2010 to 61%, and it had a record budget surplus of €58 billion in 2018, which was 1.7% of its GDP. Ironically, a mild recession may be a blessing-in-disguise as it would pressure policymakers to finally loosen the purse strings to shore up domestic demand. The legendary speed limit-free autobahn is in desperate need of upgrade as the record-high summer heat has led to thermal expansion, creating deadly cracks on Germany's highways. Germany's big cities could also use some stimulus to address their chronic housing shortages. However, German politicians have yet to formally endorse a fiscal stimulus program.

COUNT DRAGHILA

The ECB President, Mario Draghi, delivered a big package of monetary stimuli at his penultimate ECB Governing Council meeting. He slashed the benchmark interest rate to negative 0.5%, and announced a new round of quantitative easing at €20 billion of bond purchases each month for an indefinite period. While he portrayed the decision as unanimous, word leaked out that there was unprecedented pushback from the central bank heads of France, the Netherlands and Germany. The following day, German newspaper Bild posted a photomontage of Draghi with fangs under the headline, "*So Count Draghila sucks our accounts dry; during his tenure, we lost billions.*"

Cutting the already negative benchmark rate does little to help the economy and will further hurt savers. Draghi admitted that he was concerned about the pension industry but said, "negative rates are necessary instruments of monetary policy. It has created a lot of positive effects. How do we speed up these effects so that interest rates can go up? The answer is fiscal policy." In short, he was signaling that monetary policies are close to their limits, and Germany should stop complaining and start spending. Indeed, German exports have been the big beneficiary of the ECB's unconventional monetary policies that have kept the euro artificially low. It's now time for Germany to convert some of her export bonanza into fiscal stimulus.

WeWON'T IPO

One of the most anticipated IPOs of the year just got yanked. Faced with a frosty reception over its various issues in governance, self-dealing, accounting, and huge losses, The We Company, better known as WeWork, wound up shelving the IPO and pushing out its controversial founder and CEO.

WeWork, founded in 2010, provides shared office spaces to freelancers, start-ups and corporations. It is essentially an office-leasing company that signs long-leases for office space and then subleases them on a short-term basis – a mundane and traditional business. However, it managed to cultivate a cult-like image with sententious mission and values statements as well as hip-looking offices jazzed up with complimentary coffee, beer, and various services to appeal to millennials. It became a darling of the Silicon Valley digerati and venture investors. Its largest investor, SoftBank, added to its stake in the company at a whopping $47 billion valuation early this year. Fawning investment bankers touted a public market valuation of $65 billion. In spite of the buzz, the company reportedly couldn't even get the IPO done at a $10 billion valuation.

WeWork's publicly traded competitor, IWG Plc, with $3.4 billion of sales and $150 million of net income in 2018, commands a market capitalization of $4.5 billion. In the first six months of 2019, The We Company generated $1.5 billion of sales but lost $905 million, which annualized to over $3 billion of sales and $1.8 billion of losses. So how in the world did Softbank and the bankers come up with the $47 billion and $65 billion valuations? It also begs the question on transparency, or the lack thereof, in the marking of private equity portfolios. Fidelity Investments' Contrafund mutual fund, an early investor in WeWork, reduced the value of its stake in the We Company by slashing the firm's valuation from $27.9 billion to $18.3 billion in March. Yet SoftBank and its $100 billion Vision Fund were allegedly trying to convince WeWork to shelve the IPO in order to avoid marking down their portfolios.

The good news is that investment bankers were unable to play IPO investors for suckers as was often the case. The bad news is that the supposedly astute private equity managers had apparently drunk the Kool-Aid and bought into the hype. The Kool-Aid could turn into cyanide pills if WeWork's co-working business model fails to weather the next recession. As the largest tenant in New York, Chicago and other major cities, WeWork could pose a financial stability risk if recession-induced decline in office space demand pushes the company into bankruptcy.

COUNTDOWN TO QE

For the first time since the Great Financial Crisis, the Fed had to intervene in the overnight funding market by injecting up to $100 billion each day to relieve a liquidity crunch. Interest rates for some overnight loans in the U.S. money market had shot up to as high as 10%. Some believed it was due to a combination of quarterly U.S. corporate tax payments and a surge in government debt issuance. Time will tell if there were other factors, and if the liquidity crunch will spread overseas. What is clear is that the world's demand for greenbacks remains strong, and the Fed may need to resume quantitative easing to meet the growing demand. Indeed, Fed Chairman Powell commented on September 18th that "it is certainly possible that we'll need to resume the organic growth of the balance sheet sooner than we thought." We love the phrase "*organic growth of the balance sheet,*" which can be taken as a euphemism for quantitative easing, or money printing. Investors will also love it as it will be a potential driver to lift financial asset prices. With the upcoming earnings reporting season looking mixed at best, investors will be looking to policymakers to help sustain the bull market.

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