Asset Price Volatility a Catalyst to Weakness in the Real Economy

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Executive Summary

- Many economists expect poor data to precede financial market weakness under the framework that buoyant asset markets reflect economic strength, and benign indicators would imply a rise in volatility is far from imminent.
- Rising financialization has amplified the impact of non-bank financing on the real economy, for yield-seeking institutional investors depressed risk-free returns and “moved up the ladder” in duration, credit and liquidity risks.
- As monetary authorities turn to quantitative tightening, heightened asset price volatility would threaten entities reliant on non-bank financing, thus turning weakness in asset markets into a constraint on real economic activities.

Rise of non-bank financing challenge old frameworks

Aftermath of the financial crisis created a perfect storm to reshape the landscape of business lending. Banks reduced their footprint as post-crisis regulatory measures constrained risk sentiment, while non-bank institutions such as asset managers and insurance companies reacted to policy-induced volatility suppression by “reaching for yield” and expanded into sectors vacated by retreating banks. As a result, non-bank financing via record corporate debt issuance, private equity, direct-lending, and venture capital have steadily shifted source of funding away from traditional channels.

Don't Bank On It
Global direct lender fundraising is surging

Source: Deloitte LLP

Unlike banks, asset managers’ risk perception are more closely coupled with asset market risk sentiment, and non-bank financing is considered simply an alternative to owning interest-bearing instruments such as Treasury bonds and dividend-yielding equities. Rather than looking at markets as bank loan officers, asset managers focus on relative value, and activities such as direct-lending would appear optically attractive if QE continued to depress term premium and kept risk-free returns artificially low.
Thus, the focus on relative value and a race to beat benchmark indices subverted the corporate funding model, which became correlated with equity investors’ focus on growth and away from the “boring” loan origination. This also exposed recipients of capital injections to non-traditional risk catalysts, as asset managers can rapidly pare down risk and retreat from a sector on negative outlook, decline in liquidity, or central bank tightening concerns (unlike banks that maintain credit lines on decade-old relationships).

Nevertheless, many economists and investors continue to expect asset prices to reflect changes in the real economy, not knowing the corporate funding channels are increasingly being driven by broader financial conditions. The record level in GS Financial Conditions Index is a testament of buoyant non-bank risk appetite despite Federal Reserve’s rate hikes:

![Graph showing GS Financial Conditions Index and other indices](image)

**Asset prices reflect risk sentiment rather than economic conditions**

Researchers at Bank for International Settlements recently found asset prices are much more volatile than economic fundamentals would imply, and there are limits to the predictive ability of asset prices for real activity. This is consistent with argument by Mohamed El-Erian that the West’s growth model was “based on finance as opposed to genuine growth drivers.” Along this line of thinking, policies such as Quantitative Easing would hyper-charge asset price valuation and channel “animal spirit” into risky investments, thus benefiting a subset of entities with access to the capital market but left parts of the real economy reliant on the traditional growth model, ultimately exacerbated inequality and empowered anti-establishment political candidates. El-Erian further commented that:

“When a sophisticated market economy like the one we have in advanced countries grows for a very long time at a slow pace and that growth is also not very inclusive, things start to break. They break economically, they break socially, they break politically, and they break financially. In order to say that the New Normal will last another five years, you have to say that these breakages won’t matter, but they do matter.”

In other words, finance-based growth model with “selective recovery” channeled easy money to “growth sectors,” and signs of uneven real growth with the underreported rural stagnation imply the economy is far from “firing on all cylinders.”
Asset price appreciation also created its own “virtuous cycle” where higher bond prices (lower bond yields) beget further buying by non-bank institutions, thus pushing risk premium even lower to give incentives for institutions to chase higher risk (higher return) projects with their excess cash:

“Yield-chasing may affect market dynamics to lower long-term rates, sparking even greater demand for long-dated bonds. To an outside observer, it would appear as if market participants’ preferences were changing with market prices themselves. Low rates beget low rates through higher value placed on long-dated bonds, and high rates beget high rates due to lower value placed on long-dated bonds.”

Therefore, while weaker economic conditions would beget policy easing, therefore warrant higher asset prices (driver behind the perverse “bad news is good news” market dynamic), the latter would play a much bigger role on non-bank lending and investing in the real economy. This goes against traditional economic framework, where many classically trained economists continue to view asset prices as a product of economic strength. Instead, rapid financialization has turned asset price appreciation as a catalyst behind non-banks’ risk appetite to inject funds into “high growth” companies and sectors in the real economy.

**Asset price volatility to precede economic weakness**

Given asset price appreciation’s present role on non-bank risk sentiment, one can take another step to argue that a decline in asset prices as a result of tighter unconventional monetary policy (such as ECB QE taper and Fed balance sheet unwind) would induce the reverse impact:

- Less bond-buying would push up high-quality long-term bonds given the correlation between global term premia
- Higher-yielding sovereign bonds would ease insurance companies and pension funds’ rush into venture capital and private equity investments, as well as reduce demand for high yield debt and direct lending by asset managers
- Higher funding costs would weigh on corporate business sentiment and constrain real economic activities, as major non-bank financial institutions reduce risk (thus reduce corporate funding and other risky investments)

Therefore, the elusive catalyst behind economic weakness may very well be hidden in plain sight – a decline in asset prices as a result of quantitative tightening. Rather than a product of economic strength, asset price appreciation has been a powerful source behind rapid growth in major metropolitan areas amid on-going rural decay.

In conclusion, investors would be ill-advised to focus on economic indicators to predict financial market conditions. Instead, the next financial crisis will likely originate from within the non-bank financial sector, where tighter monetary policy dent investor sentiment, and broader risk-off cut off funding for the presently high-flying start-ups and corporate giants; illiquid and risky assets (in terms of credit and duration – characteristics vulnerable to quantitative tightening) on non-bank financial institutions’ balance sheets would be at the ground zero of risk contagion.
References


