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Find the Trigger point

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Where is the Trigger Point that we all should fear?

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About the risk of a "Trigger Point"

- **What is a "Trigger point"?** As a renowned analyst said to me "It is simply that fleeting moment in which we move from a market environment dictated by a set of rules to a new one dictated by a different set of rules in just one second".

- **Why is it important to know when or where could this "trigger point" occur?** The old guys of this place called financial market assert that when this happens we enter a "transition phase" in the economic cycle, where neither the analytical endeavors nor the econometric models are useful to answer the short term & more "real" questions. Thus, in these "transition phases", the analyst must rely on psychology related aspects or acquire new tricks. Some even say "unlearn what has been learned". Certainly, a very painful exercise. In such environment, prices are made at the margin (the price agreed upon by the marginal seller & buyer).

- **Can we detect when a trigger point may happen?** No. We can not know when it could happen. But we do know what could be a trigger point.

- **Can we determine what could be a "Trigger Point" that we should fear in the US?** Yes. Here is the identification process:

  1. We have mentioned many times that to know whether market rates are harmful or beneficial for the economy **what matters is not the quantum of the interest rate** (ie, the 10yr UST yield). It is ridiculous to hear (as I have heard) that rates are too low because they are historically low.

  2. **What matters is the adequacy of the rates to the corresponding level of economic activity**. In other words. The spread between the magnitudes (1) market rate versus (2) activity rate. When the former far exceeds the latter, we are facing a "trigger point". Then, it is better you start to pray.

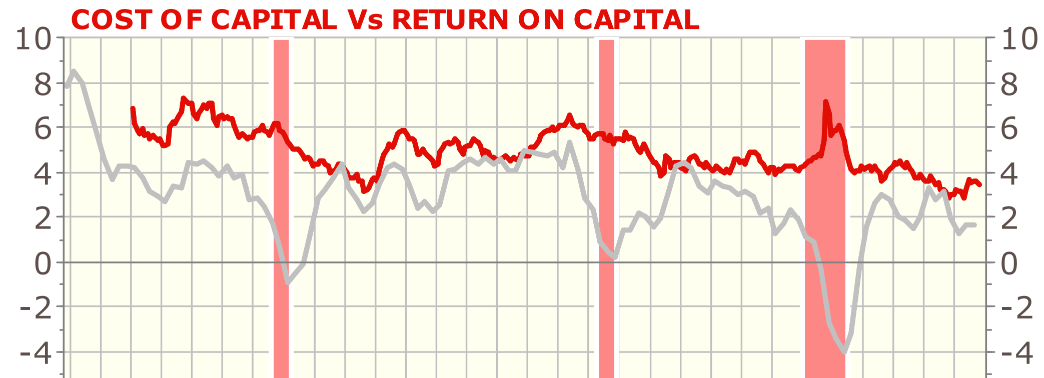
  3. Why? As Mr Knut Wicksell (founder of the Stockholm school) said, **the interest rates defines the cost of capital**, and the **activity rate defines the return on capital**. **When cost of capital significantly grows at a faster pace than the return on capital, violent adjustments occur:**

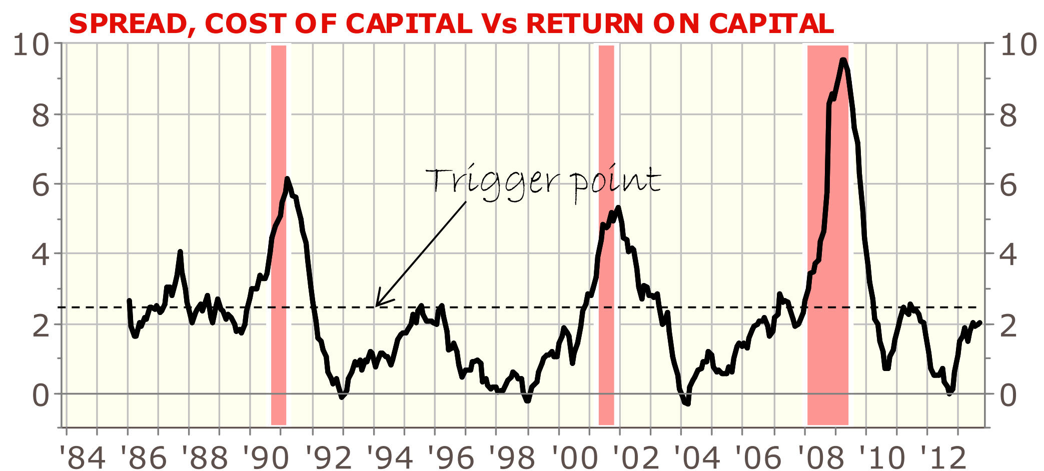
     - ✓ The spread between corporate bonds and government bonds explosively widens
     - ✓ The broad stock market dives
     - ✓ Financial stocks crater
     - ✓ Money velocity declines precipitously.

These adjustments comprise what could be called a "transition phase". The trigger point is when the condition is given.

What is the Trigger Point we all must fear?
"The Baa bond rates leapt ahead of the US growth rate by 250bp".

- For this discussion, I refer to the Baa bond rates (as the cost of borrowing of an average company in the US), and compare it with the real GDP pace (as a proxy for the average return on capital). The following conclusion could be drawn:
- Since 1929, **every time real Baa bond rates leapt ahead of the US growth rate by 250bp or more**, the economy was knocked flat on its back and the **violent adjustments mentioned unfold.**
- Nor, in the time period examined, do we have any example of a recession occurring when Baa rates were in an acceptable range relative to growth.
- **What are the instruments that we have to avoid that the feared "Transition Phase" is triggered?**
    1. Keep the 10 Yr Treasury yields low (so that the Baa bond yields –the cost of capital- remain well anchored)
    2. How? By temporarily keeping the QE (which means, avoiding the Tapering mechanism that could result in a jump in yields).
    3. Finally, seek at all costs an increase in GDP growth (and thus, in the Return on Capital), that reduces the spread between Cost of & Return on capital.





Baa Corp Real Bond Yield - deflated by 3yr avg CPI (Proxy for the Cost of Capit
Real GDP Growth (Proxy for the Return on Capital)
Recession Periods - United States
Baa Corp Bond Yield less Real GDP growth

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Conclusions

- **Are we near a "Trigger Point"?** Yes.
- **Could this Trigger point activate a "Transition Phase"?** Yes
- **What could we expect if this happens?** It is impossible to advance. When a "Transition phase" in the economic cycle takes place, neither the analytical endeavors nor the econometric models are useful to provide the answers to this sort of questions. Put simply, prices are made at the margin (by the marginal seller & buyer). Volatility explodes.
- **But, What might be an appropriate central scenario if we reach that point?** History suggest that when our "Trigger Point" is reached, we enter into a transition phase where severe discontinuities impact the economy, resulting in violent adjustments:
    - ✓ The spread between corporate bonds and government bonds explosively widens
    - ✓ The broad stock market dives
    - ✓ Financial stocks crater
    - ✓ Money velocity declines precipitously.
- **Can this be avoided?** Yes. Admittedly, we are near of what we have identified as a "Trigger Point" but we have not reached it yet. Additionally, we where in a very similar environment in 2011 but the US authorities were able to stabilize the situation.
- **What distance separates us from the "Trigger Point"?** Currently, the real cost of capital for an average company in the US remains around the 200 bp above its return on capital. Certainly a very dangerous stage. However, the red line is in the 250 bp. Why? Is that an arbitrary level? Whenever that line has been crossed, the above adjustments have always unleashed. It is not an arbitrary level.
- **Do we have a significant leeway?** Definitely NOT. Just a 50 bp movement in yields.
- **What is our current position in this regard?**
    - As we are so close to our "Trigger Point" (just a 50 bp shift in yields) , **I would assign a zero percent probability to a Tapering before year end**. Why? If the Fed starts immediately the tapering, the UST and the Baa bond yields will probably rise by more than 50 bp, leading us to cross the "red line".
    - **I would also assign a zero percent probability to the Tapering while the real GDP growth remains below the 3%.** A good point to start tapering would be when the spread between the cost of and the return on capital is between 0 and 50 bp. This will happen when GDP growth remains stable in the 3%-3.5% range.
    - Finally, I strongly believe that Mr Bernanke and Ms Yellen perfectly know this since they have spent the last years trying to reduce the entire yield curve, and thus, following the principles of the Stockholm school (founder of the thesis that I have explained). I strongly believe that the Fed will not allow yields to rise because they are already at a dangerously high level (although many are those that still think that yields are low). If I am true, then the famously "DO NOT FIGHT THE FED" applies. If I am wrong, be prepared for a transition phase.

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