

Was That The Whale?

By Louis-Vincent Gave

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Throughout this year, I have argued that the world has entered a new liquidity crisis and an exit would require either a collapse in energy prices (as lower energy prices free up liquidity), and/or a falling US dollar (which allows other central banks to re-inject liquidity), and/or a re-injection of liquidity by the Federal Reserve. My view was that these three conditions were unlikely to be met in the short term. So on we marched, with pain-inducing downturns in global equity and bond markets.

On this last point, an old Gavekal trope has it that liquidity crises resemble dynamite fishing. When a stick of dynamite is detonated under the sea (let alone 200kg equivalent, as seems to have occurred off Denmark's coast this week), everything in the vicinity is killed. The coral dies, little fish die and so do any whales in the vicinity. The tiddlers quickly come up to the surface, but it takes longer for any whale carcasses to emerge. Historically speaking, it is when the whales show up that policymakers shift gear and reinject liquidity. In my career, whales have included Mexico in 1994, Asia, Long-Term Capital Management and Russia in 1998, Enron and MCI-Worldcom in 2001-02, Lehman, AIG and Bernie Madoff in 2008 and the US repo market in 2018.

Now, in the past few weeks, the financial markets' waters were undeniably troubled. We have seen surging currency volatility, huge moves in government bond markets, especially in the US and the UK, and collapsing equity prices. The waters were sufficiently turbulent to suggest that a whale may soon show up. Indeed, on Monday, I speculated that the underfunded US pension fund system could be the surprise whale, whose troubles would force the Fed to change course? I was wrong—by one letter. It turns out that the whale was most likely the UK pension fund system.

Over the past 24 hours, the world has discovered that UK pension funds do not actually own a lot of the long-term government bonds on their balance sheets, because instead of buying long maturity bonds when yields were unattractively low, they bought swaps from investment banks and kept a small proportion of the bond's face value in cash. Unfortunately, when long-term interest rates jumped, one side of these swaps collapsed in value, forcing UK pension funds to post additional cash collateral. To do that the funds had to liquidate assets which they own outright. And in a liquidity crisis, one sells what one can—or what is liquid—not what one should. In this case, it was government bonds, thereby creating a self-reinforcing spiral. According to seemingly credible [news reports](#), about £1trn is exposed to this “death spiral”. And so the Bank of England stepped in to provide liquidity in a market gripped by a liquidity squeeze. The intervention will have left investors wondering if UK pension funds are indeed the whale, or alternatively a large dolphin. Other questions raised by this intervention include:

1. UK pension funds are among the most regulated entities in one of the world's more financially-regulated jurisdictions. So how could the BoE be caught unawares by this doom loop? Or was the BoE aware of the situation and the pension fund squeeze a revolt of the “Sir Humphreys” against a new UK government that started out by firing the Treasury's most senior civil servant? In other words, was the pension fund doom loop triggered by

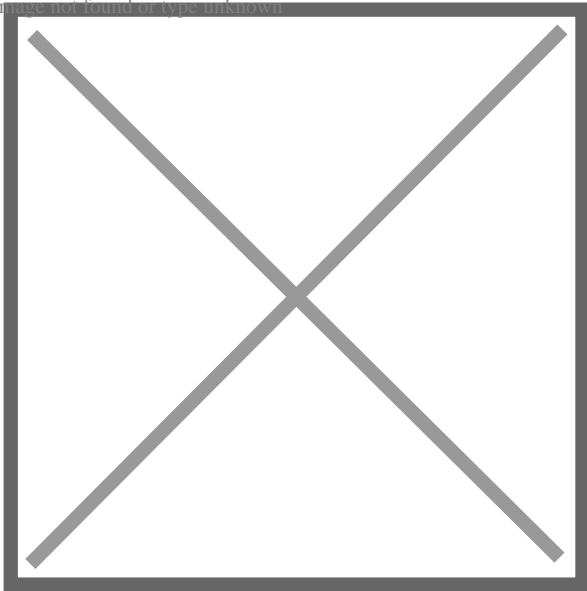
incompetence, or sabotage? Was this ignorance or apathy? As Jimmy Buffet would answer to such a question “I don’t know, and I don’t care”. The end result is the same. This morning, UK assets look less attractive than they did 48 hours ago. Except, of course, for the fact that the BoE is now committed to providing a backstop.

2. As the Fed watches, will its reaction be “those limeys don’t know what they are doing”, or will its board members think “there but for the grace of God go we?”. Is it a stretch to think that like their British counterparts, US pension funds have also liberally used interest rate swaps to match part of their long-term liabilities? And that the sudden sharp rise in interest rates might have triggered margin calls? After all, and as discussed in my Monday piece, markets have been behaving as if margin calls were being issued everywhere. Or are we to imagine that US pension funds are much better run, and much better regulated than their British counterparts?
3. Does the UK-US “special relationship” mean anything? Brits love this notion but from the outside the relationship often looks about as solid Johnny Depp and Amber Heard’s. Still, with the UK’s financial stability under threat, will the Fed want to pile on financial pain for a key US ally? This is especially the case in a challenging geopolitical environment when other European allies of the US, like Italy, Germany and France are hardly bellwethers of financial stability. Can Europe survive a bombing of some of its critical energy infrastructure and a further squeeze from the Fed? Is this a risk worth taking? If not, maybe the White House picks up the phone to ring Jay Powell to make the point that laying low for a while would be the sound neighborly thing to do?

Still, as was the case in the 2018 repo-crisis, the answer to today’s UK pension plan squeeze has to be a rapid cranking-up of the printing press to ensure the survival of our levered financial system. The UK pension fund crisis has been enough to change the BoE’s monetary policy. The wider question is whether it provides some short-term relief in today’s global liquidity crisis.

One encouraging sign is that the BoE’s liquidity injection and embrace of yield curve controls was met by a rebound in sterling (from a low of US\$1.035 on September 26 to US\$1.08 at the time of writing). This might seem counter-intuitive at first glance. After all, should not more money-printing lead to a weaker pound? Well, not if exchange rates over recent weeks have been driven by the unfolding liquidity crisis. The rally in the pound in the face of more pound printing could be a sign that the liquidity crisis is starting to shift to the rear view mirror. If so, then we are entering a different investment environment, possibly one that sees emerging markets massively outperform, along with commodities, cyclical, deep-value stocks and precious metals.

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