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Global perspectives: Shifting tides of policy

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- **Can a surfer tell if the tide is going in or out?** The novice would certainly have difficulty discerning the shifting tide from the chaos of the waves in the impact zone. Similarly, for investors buffeted by each switch in central bank rhetoric, it may be difficult to tell if the high watermark for global central bank influence has in fact passed.
- **ZIRP, NIRP, QE, QQE, forward guidance, credit easing, QQE with yield control, TLTROs and OMT.** The acronym glut only highlights that each of these policies were less effective than originally intended. Narrow policy objectives such as easing financial distress may have been achieved, but if the broad macro objectives were in sight then global bond yields would be rising not falling. Central banks appear to be running out of options.
- **If the monetary tide is going out, investors should remain cautious as any transition to a new regime is likely to lead to volatility.** Current yields on long-term bonds owe more to a central bank bid than fundamentals. We would now underweight this asset class, even if we cannot exclude the fact that yields may move temporarily lower during bouts of volatility. Developed equity markets remain significantly overvalued against historical valuation metrics, suggestive of only weak returns in the medium term; it remains difficult to make a compelling case for an aggressive positioning.
- **For investors, not all GDP growth is created equal.** Aggressive monetary policy has a mixed record in driving growth but has always been associated with rising asset prices. Fiscal stimulus creates greater certainty for growth but if monetary policy is de-emphasised, we would expect greater uncertainty in respect of the cost of money, rising inflation expectations and expanding risk premia. With global bond yields at record lows and global equity valuations close to record highs, the possibility of a switch to fiscal-led growth is not necessarily a positive for financial markets.
- **No guarantee of a smooth handover to expansionary fiscal policy.** The modern taboo surrounding the use of fiscal policy to support growth may be in the process of being reconsidered but the modest easing of global fiscal conditions currently expected is far from radical. Previous historical episodes suggest a crisis may be needed to trigger more aggressive fiscal responses.
- **Investors should focus on equity situations where the outcome is highly company or security specific, in our view.** With a cautious view on both equities and bonds, we believe investors should therefore by implication maintain higher tactical allocations to shorter duration investments, cash and precious metals.

Is the monetary tide turning?

Can a surfer waiting for a wave tell if the tide is going in or out? The novice would certainly have difficulty discerning the shifting tide from the chaos of the waves in the impact zone. The more experienced surfer might, however, sense the subtle reduction in the power in each wave as the tide turns. Similarly, for investors buffeted by each switch in central bank rhetoric, it may be difficult to discern if the high watermark for global central bank influence has passed. However, we believe we are close to the high water mark for monetary policy for the following three reasons.

The first is that extreme monetary policy has not worked as well as intended, in terms of generating sustainable GDP growth. This has led to a much longer period of financial repression than originally envisioned.

Second, while this may be denied in official circles central banks appear to have run out of runway in terms of policy options. Global interest rates and bond yields are close to record lows. From a quantitative perspective, diminishing liquidity in government bond markets where central banks have become major buy and hold investors and an undesirable flattening of the yield curve are becoming increasing concerns. To the uninitiated, what was intended to be a short-term counter-cyclical policy now appears structurally embedded, with no end in sight to the long period of ultra-low interest rates and central bank bond purchases.

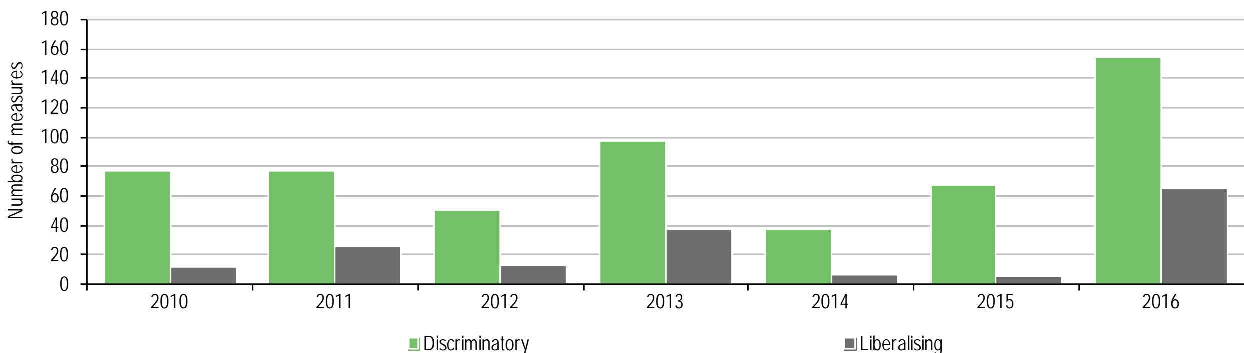
Third, the original academic criticisms of the use of unconventional monetary policy to drive growth at the lower bound for interest rates are now well understood by voters. This appears to have contributed to the anti-establishment political groundswell being felt in Europe and the US. Specific examples include the UK vote in favour of Brexit and support for unconventional political movements in Europe. In this context, the surprising popularity of the US presidential candidate Donald Trump and his attempts to politicise the US Federal Reserve should not be unexpected.

Political winds are changing

Although central banks still retain a high degree of credibility, confidence in central bankers' models and projections may already be in decline. Politicians are having to respond to concerns over slow growth, income inequality and the lack of productivity-led wage increases, which is correlated to the lack of real investment by the corporate sector.

The most obvious side-effect of using monetary policy to stimulate the economy has been the inflation of asset prices – whether bonds, equities, real estate or corporate credit. The risk that current policies have merely facilitated an extension of the credit cycle (one which is gathering speed in the corporate sector) is rarely addressed in official circles, in public at least. It is sometimes difficult to see a risk when it has been assumed out of your world view.

Exhibit 1: Protectionism on the increase in 2016



Source: Global Trade Alert. Note: Data show number of trade measures introduced in Jan-May period of each year.

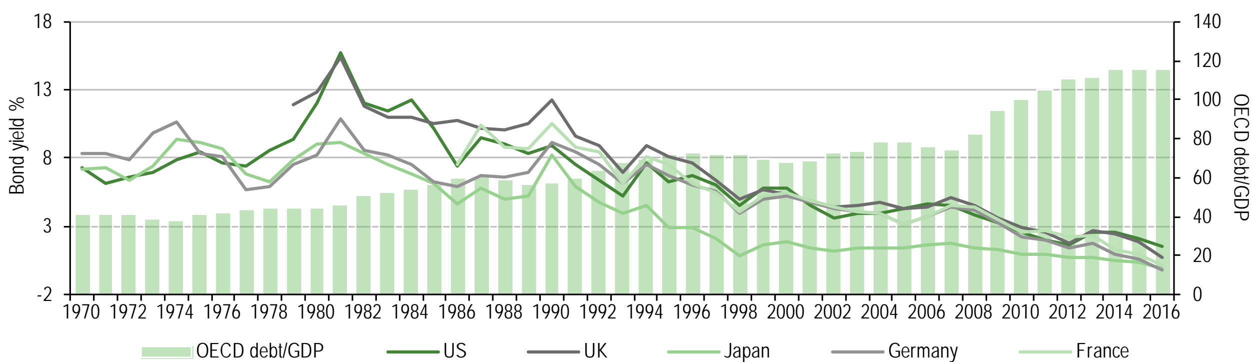
It is now political pressure, rather than financial market pressure, which is challenging the system - and new solutions are being demanded. There are even parallels with the inter-war period of the 1930s. Barriers to trade are rising and this trend has accelerated in the first half of 2016, Exhibit 1. The IMF as recently as this week warned of "economic malpractice" as populist politicians attempt to erect trade barriers and countries with the fiscal space, notably Germany, fail to expand fiscal policy to increase demand. Nevertheless, politically, nationalism is gaining increased support. Regional conflicts are drawing in major geopolitical players on opposing sides such as in Syria or Ukraine. Finally, financial repression is a further common factor between now and the economic landscape of the 1930s.

Our view that central bank stimulus may have peaked is not, however, based on arguably anecdotal politics. While central banks maintain their claim to have more ammunition, the primary policy tool of interest rate reductions has effectively been exhausted for some time. In addition, dabbling with negative interest rates has brought into play extensive and well-founded criticism in terms of the impact on the yield curve and the financial system.

Central banks run out of road - and corporate debt a concern

Further out on the yield curve, global bond yields are below 1% for 10-year maturities in all major markets apart from the US, Exhibit 2. Notwithstanding the BOE's recent re-introduction of QE it is clear that the bulk of the stimulus benefit from long-term rates falling from 3% in 2010 is in the rear view mirror. In the corporate credit markets, the ECB's QE has even pushed yields on newly issued corporate bonds below zero for Henkel and Sanofi, investment grade companies which would have been very unlikely to have rejected an investment proposal for lack of finance. Investors are faced with even lower rates on commercial bank deposits: Munich Re is reported to be keeping a token amount of cash (€10m) in vaults for this reason.

Exhibit 2: Global bond yields at record lows



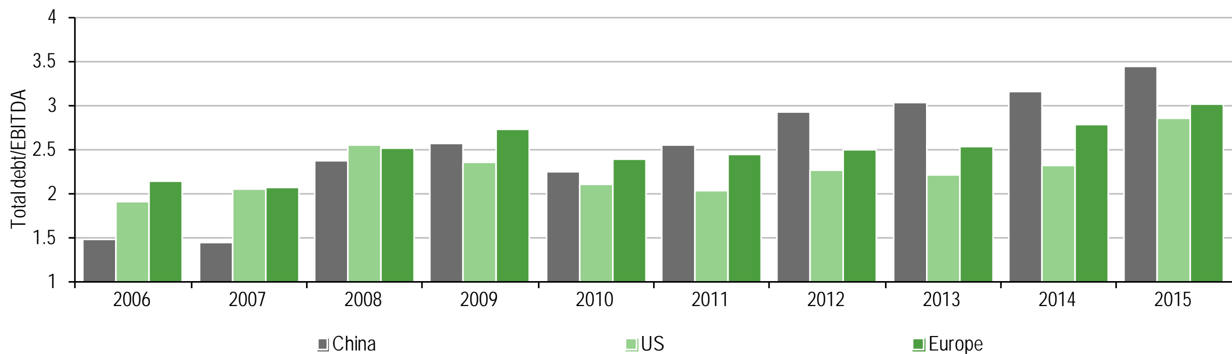
Source: Thomson Reuters Datastream

For equities, the most obvious sign of ultra-loose monetary policy has been the expansion of median valuation multiples at or close to cyclical highs, Exhibit 3. However, the sign that the corporate sector may not be responding as intended to ultra-loose monetary policy is the still remarkably low level of forecast sales growth. Ultra-low yields have instead proved to be a strong incentive to raise debt and retire equity. Total debt/EBITDA has risen almost as fast in the US and Europe in recent years as in China, where the corporate sector is often highlighted as a potential debt bubble. Notably, using the proceeds of debt sales to buy back shares rather than invest in fixed assets significantly increases financial fragility in the event of a downturn.

Exhibit 3: UK, US and Europe ex UK price/book ratios

Source: Thomson Reuters Datastream, Edison calculations

Exhibit 4: Growth in non-financial corporate leverage is a global question



Source: Thomson Reuters Datastream

Although central banks continue to insist there remains ample ammunition to respond to future shocks, the constraints are clearly within view. It is not clear if it is was ever originally intended that central banks would become such large players in government debt markets for example. Interest rates in the UK, Eurozone and Japan have reached the practical floor, when physical cash becomes a rational alternative to bank deposits.

It is not necessary to argue that unconventional monetary policy is wholly ineffective; it is merely necessary to argue that it is insufficient, inefficient or otherwise sub-optimal in order to justify a change of approach. The policy of providing cheap finance to the private sector has not enabled global interest rates to rise back towards levels consistent with targeted inflation and GDP growth, at least to date. Hence, the creation of demand through increased government spending, an economic lever not within the grasp of the world's central banks - and subject to political will and the democratic process - would appear to be the logical next step.

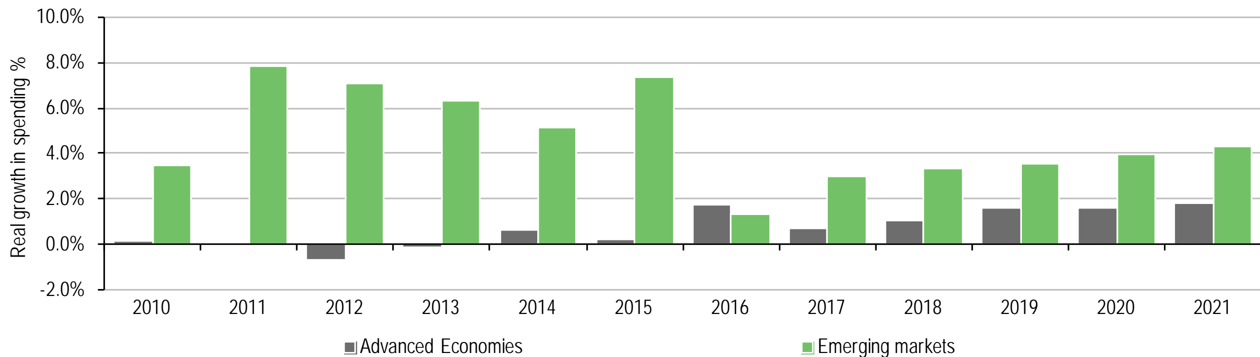
Any potential shift in favour of fiscal policy globally would significantly colour the investment outlook between now and the end of the decade - and investors need to be aware of the implications.

Preparing for the fiscal tide

The return of fiscal policy to the front line of stimulus efforts would mark a reversal of post-crisis fiscal thinking. In the early years after the financial crisis of 2008, the primary fiscal objective was to control government indebtedness through austerity to avoid sovereign instability. In this respect, the trouble within the periphery of Europe may have been an unfortunate distraction as it was arguably due to eurozone's imperfections rather than excess government debt per se.

However, the relative emphasis between growth and austerity has already shifted. Even before any new initiatives and after a long period of fiscal drag, government expenditure in developed markets is now forecast to grow by just under 2% in 2016, Exhibit 5.

Exhibit 5: Growth in government spending - finally turning positive in developed markets



Source: IMF, Edison calculations

The key difference between a monetary and fiscal stimulus in our view is that monetary stimulus puts the incentives in place for the private sector to invest, while fiscal stimulus dictates an increased level of spending. In some respects, monetary policy fixes the price of money with the uncertainty resting on whether the level of investment responds accordingly. Fiscal policy fixes the amount of investment with the uncertainty being the effect on the price of money.

As an aside, the option of helicopter money, in the sense of central banks directly financing government expenditure, would seem to pin down both variables, thus eliminating uncertainty entirely but at the cost of eliminating behavioural or pricing signals from the private sector. While guaranteed to generate economic activity in the short-run, such a shift away from market based mechanisms - a scenario in which the state in effect dictates the quantity and nature of economic activity and also the return it is prepared to offer for finance - seems at present a large step for western societies to take.

Low real rates support fixed asset investment

The case for fiscal restraint would appear to be much weaker than at any time during the post-crisis period. Notwithstanding the recent increase in risk premia within the eurozone banking system, financial volatility remains low and real interest rates for government borrowing are at record lows, having fallen significantly since 2009. In terms of the incremental debt burden for future generations, governments could now legitimately claim that very long-term borrowing at negative real rates will at least in part be self-amortising from the perspective of the ratio of debt/GDP.

Furthermore, in respect of any increased spending by governments, the focus is at present on infrastructure. If it can be demonstrated that, for example, improving the infrastructure of the US or UK can improve productivity, by implication growth in future tax revenues should follow. As a result, investment in NPV positive infrastructure projects could arguably improve the fiscal position over time. In this regard, infamous “bridges to nowhere” may unhelpfully mask the benefits of the typical infrastructure investment. Clearly, negative real rates are a significant help to the infrastructure investment case and risk/reward balance.

However, should the focus move towards tax cuts for the corporate sector, we remain unconvinced that this would be effective over the medium term, even if welcomed by investors in the short term. Once again, it is an incentive rather than an action and at this point would be likely to have a modest effect on actual investment due to deflationary perceptions. The private sector could also legitimately question why the government sector was so reluctant to invest .

We see relatively little appetite at present for a rapid increase in direct employment or a relaxation of wage restraint in the government sector, areas likely to remain a component of governments' commitment to fiscal sustainability. The final area of increased expenditure is defence and the changing nature of geopolitical conflicts in recent years, most evidently in Syria where two major powers are active in the conflict and on opposing sides cannot be ignored as national security moves up the political agenda worldwide. Defence is therefore likely to be a beneficiary of any move towards increased government spending. In the short term this will benefit activity in the defence sector but will not create the assets of infrastructure investment, nor the long-term productivity gains for the economy.

For investors, not all GDP growth is created equal

Investors who believe their investment performance has been a result of GDP or corporate profits growth may therefore feel that any move to a fiscal stimulus regime will continue to support portfolio values as monetary accommodation recedes. We are not so sure, as in terms of asset prices, not all GDP growth is equal. In our view, a unit of GDP growth created by unconventional monetary policy is likely to be associated with a much higher return on financial asset prices than a unit of GDP growth created by fiscal policy.

Our reasoning is that monetary policy is likely to be proportionately tighter in a fiscal-led growth environment to reflect the increased growth trajectory for the economy. Any money that is being injected or created (in the case of helicopter money) will also be used to finance real activity rather than being circulated unproductively in financial markets. Finally, we believe the increase in the velocity of money is likely to surprise to the upside as the increase in total wages is spent rather than saved, leading to increased inflation expectations.

Central banks' government bond purchase programmes have by design suppressed market pricing signals and therefore a significant degree of uncertainty exists in respect of where long-term yields may settle, in the absence or scaling back of a central bank bid. For example, based on current market prices, inflation in the US over the next 10 years is expected to average 1.5%. Using the current FOMC projection for long-term GDP growth of 1.8% would imply a 3.2% equilibrium yield on US 10-year government bonds rather than the 1.6% currently on offer, or a 14% decline in capital value. This may not sound so severe, until one considers the impact on other risk assets of such a large increase in risk-free rates.

The need for a good crisis?

In line with our view that any meaningful global fiscal stimulus may only achieve sufficient political support in the event of a financial or economic crisis, investors should also be aware of the possibility that the monetary tide may recede before there is anything substantive in its place. Therefore, in addition to our concerns about increased real yields and the impact on valuations of financial assets if monetary policy falls out of favour, it may also be dangerous to believe in a seamless transition towards a world in which fiscal policy is viewed as underwriting growth.

The next 12 to 18 months could prove significantly more difficult for investors if the tide goes out on monetary stimulus, leaving a gap for fiscal policy to fill. Paradoxically, this may be the crisis of confidence in financial markets and economic growth needed to create the necessary political support for growth-oriented fiscal policy.

Conclusions

With interest rates and long-term bond yields at record lows across the globe we believe the monetary policy high watermark has been reached. If true, this will have enormous medium-term implications for a generation of investors accustomed to riding the waves of central banker rhetoric.

In its place, the focus is likely to turn to fiscal measures to support growth, but only slowly. This process is at an early stage but we have noted an increase in speculative articles in relation to helicopter money. More relevant in our view is the growing political acceptance of the need to relax fiscal constraints to boost growth, notably in the UK and potentially in the US, even if less so within the core of the eurozone.

However, any transition to fiscal-led growth - such as large-scale infrastructure investment - is unlikely to be seamless, if it occurs at all. Furthermore, even if growth is successfully underwritten through fiscal stimulus, such a policy is unlikely to offer investors the same immediate benefits as ultra-loose monetary policy.

Key to this shift in policy for investors is the change in the nature of the investment risk. In recent years, central bankers have, through their policies, underwritten the price of money and capped risk premia, leading to strong returns on financial assets even as growth has fallen short.

In contrast, expansionary fiscal policy underwrites growth but leaves the price of money, and short-term returns, uncertain. The next option, helicopter money, arguably fixes both the price of money and the growth trajectory and eliminates private sector behavioural and pricing signals but appears from a political perspective significantly more difficult to implement in market-based economies.

If the monetary tide is going out, investors should remain cautious as the transition to a new regime is likely to lead to volatility. Medium-term, the opportunity for governments to take advantage of low long-term real rates is investors' opportunity cost and we would now underweight this asset class, even if yields may move lower in the short term during bouts of volatility.

In equities, developed markets remain significantly overvalued against historical valuation metrics, suggestive of only weak returns in the medium term. It is difficult to make a compelling case for an aggressive positioning in global equity markets at present. We have highlighted the significant increase in corporate debt on a global basis which may yet come back to haunt investors. In our view, investors should focus on equity situations where the outcome is highly company- or security-specific.

With an underweight view on both equities and bonds, we believe investors should on a tactical basis by implication maintain increased allocations to shorter duration investments, cash and precious metals.

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