Weekly Intelligence Report

Our views on this week's investment events - FOR PROFESSIONAL INVESTORS - 24 May 2016

Overview

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Due to the upcoming holiday in the U.K. and the U.S. on **May 30**, there will be no edition of the Weekly Intelligence Report next week.

Shifting perceptions of central bank policy, and reaction functions, have explained many of the moves in global markets during this post Great Financial Crisis era. Understanding central banks has been a critical success factor in anticipating swings in risk appetite, and much of our commentary, in previous Weekly Intelligence Reports, and in other pieces, have been devoted to the art and science of central bank watching. In the first of this week's articles, Steve Friedman takes a more measured look at the **recent market reaction to the publication last week of unexpectedly hawkish sounding minutes of the April Federal Open Market Committee meeting.**

The second of our pieces focuses on fiscal, rather than monetary policy. Richard Barwell analyses **the efficacy of fiscal policy in an over-indebted world**, and argues that many developed market countries still have room to ease fiscal policy further, and topically, takes a closer look at Japan's room for manoeuvre.

Lastly, Chi Lo tackles **the question of whether China's debt levels are excessive**, and finds fewer causes for alarm than many international commentators. Whilst in no way giving China's debt levels a clean bill of health, he does argue that structural differences in the composition of debt ownership should mitigate many of our worst concerns.

Of taper tantrums and rate resets

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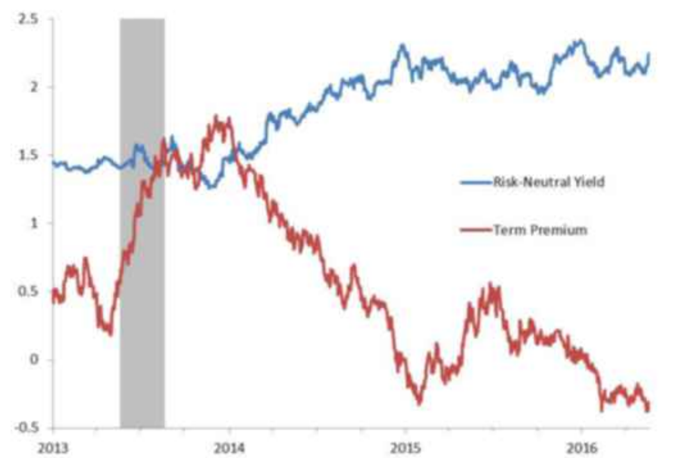
In recent months, many investors have greatly reduced the odds of the Federal Open Market Committee (FOMC) maintaining a steady dose of policy rate increases over the medium term. By the end of April, the combination of disappointing first quarter data, a foundering global growth environment, and a very cautious March speech from FOMC Chair Yellen all contributed to markets discounting just one or two rate increases by the end of next year – a far cry from the 150 basis points of policy tightening projected in the FOMC's policy rate "dot plot" released after the March meeting.

Against this backdrop the minutes from the FOMC's April meeting, released last week, caught most investors by surprise. The minutes revealed that as a whole, the Committee maintains a high degree of confidence in its projections for moderate growth and gradually firming inflation. In addition, low inflation expectations and downside risks from abroad – key elements from Yellen's March speech that led investors to discount a flatter trajectory for the policy rate – appeared to play little role in the meeting deliberations. And perhaps most importantly, the FOMC appears to have a relatively low bar for a June rate increase: at the time of the meeting, "most" participants viewed such a move as appropriate should incoming data prove consistent with "growth picking up in the second quarter, labor market conditions continuing to strengthen, and inflation making progress toward the Committee's two percent objective."

In the wake of the minutes release, a range of assets repriced to reflect higher odds of a June rate increase. The dollar appreciated against a range of currencies, global equities declined, and Treasury yields rose. The rise in longer-term yields has led to market discussion that should a June rate increase come about, long-term rates could rise sharply in a replay of the 2013 "taper tantrum". However, our view is that under current economic conditions, a large rate shock is highly unlikely.

10-year Treasury yield decomposition



Source: Federal Reserve Bank of New York
Note: Shading denotes 2013 Taper Tantrum

First of all, terminology matters. The taper tantrum was not simply a repricing of long-term rates due to perceptions of a hawkish FOMC. More accurately, the taper tantrum stemmed from a pronounced reduction in average market expectations for the amount of assets the Federal Reserve would ultimately purchase in its quantitative easing (QE) program. As such, and as seen in the shaded section of the chart, the taper tantrum led to a sharp increase in the term premium component of the 10-year nominal Treasury yield. The drift higher in the average expected short-term rate (the so-called risk-neutral yield) early in the taper tantrum was entirely modest by comparison.

The term premium is currently estimated to be well below zero and at a very stretched level even by the standards of the post-crisis period. Effectively, investors are paying to take on the risks associated with owning a long-term instrument that pays a fixed nominal return. As we have noted previously, one of the factors suppressing the term premium is the expectation that central banks globally will continue to rely on a range of unconventional measures, including QE, to stimulate growth. We see little reason for this expectation to shift meaningfully – both the European Central Bank and the Bank of Japan are continuing with their QE programs, and investors generally expect that both central banks will ultimately need to increase the amount of purchases beyond what has been announced this far. Second, a very low (and also likely negative) inflation risk premium has contributed to the low level of the term premium. With the Committee signaling its comfort with raising rates while inflation remains short of the two percent objective and with investors concerned that rate increases could prompt a new round of disinflationary dollar strength, this component of the term premium is unlikely to rise either. Finally, while elevated economic and political uncertainty could lead to a higher term premium in the months ahead, the associated "risk-off" sentiment would push the term premium in the opposite direction.

So if there are good reasons why the term premium may remain near multi-year lows, what are the prospects that the risk-neutral yield component of the 10-year Treasury yield will move higher? On the one hand, the FOMC's confidence in its economic outlook – and by implication, its projections for higher policy rates – implies that markets may be fundamentally mispricing the average policy rate over the next ten years. However, we do not subscribe to this view. The Committee remains stuck in a negative feedback loop with markets. Many investors still see somewhat elevated recession risks over the medium term, and are concerned that a higher policy rate will lead to unduly restrictive financial conditions that will choke off growth, particularly given the potential for renewed dollar appreciation should Federal Reserve policy diverge from the policy stance of other major central banks. In addition, any attempt to sustain even gradual policy rate increases could put renewed pressure on Chinese officials to devalue the yuan against the dollar, an outcome which could again increase downside risks to US growth. Investors also remain concerned that the waning of current stimulus in China will provide a headwind to global growth and the recovery in commodity prices in the second half of the year. Finally, even if moderate growth can be sustained as the FOMC raises rates, the expected rate path may remain anchored at relatively low levels given that investors have a much lower estimate of the longer-run equilibrium federal funds rate than the Committee[1].

The sobering reality for the FOMC is that markets will continue to attach little credibility to the median rate path expressed in the Committee's economic projections so long as inflation remains low and the Committee continues to act as if it has little tolerance for above-objective inflation. This, along with continued low levels of the term premium, will likely prevent a significant repricing of longer-term yields for the time being.

1 For example, the median respondent to the Federal Reserve Bank of New York's latest policy survey estimated the longer-run federal funds rate at 2.75 percent, 50 basis points below the median FOMC participant's projection made at the time of the March meeting.

The fiscal fascination

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An increasing number of investors have become increasingly concerned of late that central bankers are fast running out of monetary ammunition. Those investors are beginning to question whether central banks still have the capacity to support the economy and achieve their price stability mandates. We do not happen to share this pessimistic assessment; we do not believe that the monetary cupboard is bare (please read Central Bank Watch by Steve Friedman). However, this note is about the instrument that many of those investors do still believe in: fiscal policy.

Almost as soon as interest rates appeared to hit the lower bound in 2008/09 and central banks started supporting the economy through large scale asset purchase programmes, fiscal stimulus came back into fashion. Academic research published soon after the crash appeared to show that fiscal policy was far more powerful in these circumstances – a conclusion that seemingly chimed with the 'Keynesian common sense' that cutting taxes or increasing government spending is a more effective way to stimulate aggregate demand than 'pumping up asset prices'. The feeble recovery in activity since the crash has only further reinforced this view that fiscal policy has been too tight for our own good and that a fiscal shot in the arm is precisely what the global economy needs right now. However, the case for fiscal policy is more complex and less compelling than it first appears.

For a start, you need to assume that monetary policy is on auto-pilot or is ineffective if you want to argue that fiscal stimulus would be highly effective. The stance of monetary policy should already be calibrated to deliver the best possible path for output and inflation given the current macro outlook including the stance of fiscal policy. A loosening in the fiscal stance should therefore lead to central banks dialling back on monetary stimulus in response. Some investors may argue (incorrectly, in our view) that tighter monetary policy would have little impact on the real economy if it involves the central bank buying less bonds or cutting rates less into negative territory but we doubt that many would make the same argument for a rate hike.

We also need to worry about the impact of the fiscal stimulus on the people who will pay for it in the short run (investors) and the long run (taxpayers). If the macro outlook is sufficiently poor and the burden of debt is sufficiently high, then creditors may start to question whether public debt is sustainable and may start to demand greater compensation for the risk of losses either through restructuring or inflation (where the country concerned still has control over the printing press), leading to a contractionary tightening in financial conditions and deterioration in the public finances. Even in the absence of that fiscal crisis, households may choose to save more in anticipation of the taxes they will have to pay in the future when the government announces a fiscal stimulus today, and that could temper the boost to demand.

We also need to think hard about the design of any fiscal stimulus. Demand management is not the primary objective of fiscal policy. Finance ministers should instead focus on efficiency and equity – essentially, improving the supply side of the economy to increase the sustainable level of national income and trying to deliver a fairer distribution of that income across the population. A particular package of fiscal measures should be evaluated accordingly. Investment in public infrastructure projects with a high social rate of return or welfare payments to those with a high propensity to consume out of disposable income might score highly on these criteria even if the central bank crowds out the initial stimulus to aggregate demand.

The fascination with fiscal policy is currently fixated on Japan. As evidence mounts that the Japanese economy has failed to achieve escape velocity from the deflationary malaise of two lost decades investors are looking for ways in which Abenomics could be re-booted to deliver the necessary stimulus to demand and inflation. The Bank of Japan's experiment with negative interest rates in January and its decision to sit on its hands in April has encouraged many to conclude that the next iteration in the policy response will be fiscal not monetary.

The first item on the agenda is the two percentage point increase in the consumption tax that is slated for April 2017. Prime Minister Abe has signalled that barring some unforeseen event the tax hike will proceed as planned. However, the hike has already been postponed once and it seems likely that the government will do so again, most likely as part of a broader fiscal package. The government has already unveiled reconstruction measures worth almost ¥800 billion in response to the natural disaster in the Kumamoto Prefecture. Additional fiscal measures look set to follow in a supplementary budget where the focus will likely be on supporting the so-called second phase of Abenomics, which is intended to address the structural rigidities holding back the Japanese economy, including its demographic problem. Expenditures designed to increase labour force participation rates among women with young children and the elderly are one obvious element of that package.

One cannot divorce a discussion about the case for further fiscal stimulus in Japan from the fiscal backdrop. According to the latest set of International Monetary Fund projections, the primary balance was in deficit to the tune of almost five per cent of GDP in 2015 and is expected to remain so until 2021. Moreover, adjusting those numbers for the impact of the economic cycle – the drag on tax receipts and the boost to spending when the economy is weak – makes little difference: the public finances are structurally in deficit. Then there is the small matter of a ratio of general government gross debt to GDP of the order of 250%. In short, fiscal policy is already loose by standard metrics and there is already a formidable stock of debt to be paid for at some point. Adding to those deficits and that debt load is not to be sneezed at. Creditors may begin to wonder whether Japanese finance ministers will perpetually postpone implementing the painful fiscal measures that are required if Japan is to achieve the aspiration of a primary surplus in 2020.

One question that investors have to ponder is how the Bank of Japan might respond to such a hypothetical stimulus package. In theory if we are witnessing a shift in the fiscal – monetary mix in Japan and if we believe that this fiscal package will prove effective at stimulating demand then the knee-jerk market reaction may be for the yen to appreciate, as investors scale back their expectations of the additional monetary stimulus that the Bank of Japan will provide in the future. On the other hand it is theoretically possible (though far from certain) that the Bank of Japan may step up its asset purchase programme in response, neutralising the impact of the increased issuance that comes with fresh fiscal stimulus on the net supply of government bonds to private investors. In effect, we would get more fiscal easing and more monetary easing.

There is nothing particularly controversial about the latter outcome: the United States and the United Kingdom both engaged in a combination of discretionary fiscal stimulus and quantitative easing during the acute phase of the crisis. However, the difference here is that investors may expect that the bonds that the Bank of Japan buys will remain on the balance sheet for the foreseeable future, at which point the distinction between this policy and a pure helicopter drop starts to become academic (please read Central Bank Watch by Richard Barwell and Steve Friedman). Of course, if the bonds are going to remain on the central bank's balance sheet for the indefinite future then the original stimulus package has effectively been permanently money financed, and will therefore not have to be paid for through higher taxes. If households appreciate that fact then the standard Ricardian offset where the private sector saves more when the government spends more may not materialise, making the current stimulus package more effective. Indeed, Japan may have reached this point some time ago and the helicopter drops have already begun in all but name.

Does China have too much debt?

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Some observers argue that China's debt-to-GDP ratio, estimated at close to 250% in 2015, has reached a point that could soon trigger a systemic collapse. This ratio is high by international standards, but not excessively high. It ranks only in the middle of the world debt league, according to Bank for International Settlement's data, with countries such as Japan, Belgium, Portugal, Ireland, the Netherlands and Greece recording significantly higher debt ratios.

How much is too much?

Debt arises when an economy transforms its savings into investment. If all national savings are transformed into investment via the equity market, the economy incurs no debt. In reality, there is always a portion of national savings being transformed into investment via borrowing either through bank loans or bond issuance.

In a closed system, given a stable structure of financial intermediation between equity and debt financing, the higher the national savings the higher the level of debt. So debt is bound to arise and there is nothing good or bad about it. Empirical evidence shows that there is a positive relationship between a country's national savings and its debt level. China ranks high on the chart due to its high national savings (50% of GDP).

However, in an open system, a country can borrow foreign savings from abroad, and build up a debt stock larger than its stock of domestic savings. Generally, debt financed by borrowed savings is more susceptible to instability than debt financed by domestic savings.

In China's case, it only has a small (less than 15% GDP) foreign debt. It also has a net international investment position. Its debt is mostly domestically-financed and is denominated in local currency. Its capital account is still relatively closed.

Thus, China's debt is likely to be more stable than other countries that have similar or even lower debt ratios. Its high debt load is a reflection of its high savings, the bulk of which is intermediated through the banking system. This brings us to the structure of the financial system, which can affect a country's debt level.

A different financial structure

The US has a deep and highly liquid equity market, which has long been a key form of capital allocation in its economy. In China, debt financing (including mostly bank and shadow-bank loans) accounted for 95% of its total financing in 2015, while equity financing accounted for only 5%. An under- developed equity market suggests that China's growth would have to be funded by debt.

So China's debt ratio may not be as excessive as it seems due to its financing structure. However, this does not mean that China does not have a debt problem. Pessimists argue that a debt-currency crisis would result soon. They may be surprised. This is because China's debt is structurally different from that of the crisis countries. China's very small foreign debt, abnormally high domestic savings, under-developed financial system, implicit guarantee policy and closed capital account have acted as a "shield" that protects the Chinese system.

This is not to deny China's debt problem. But the presence of the "shield" means that no one can easily pull the plug on China's financial system. It helps buy time for Beijing to sort out the debt problem through structural reforms. It is likely, in my view, that Beijing's recent policy shift towards boosting GDP growth would stabilise the economy but at the cost of a rise in the debt-to-GDP ratio and slower structural reforms.

Beijing is facing a dilemma of structural adjustment racing against GDP growth. Opting for a "shock therapy" would risk killing the economy before giving structural reforms a chance to succeed.

For those interested in reading the full article on this topic, please click here.

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