INDEPENDENT
STRATEGY

Global

GLOBAL MARKETS

Central banks, money & madness — a history

INVESTMENT CONCLUSION

Central bankers' rhetoric often conveys a sense of omnipotence. But the evolution of the post-crisis economy clearly tells a different story. Unconventional policy tools are increasingly prevalent, but growth rates continue to weaken. And the debt overhang that triggered the crisis has worsened. Private sector deleveraging in developed markets (DMs) has been replaced by higher fiscal burdens while debt levels in emerging markets (EMs) have now converged with their more highly-indebted and wealthier peers, principally because of exploding corporate leverage. Meanwhile, hitting central banks' inflation targets remains a distant hope.

This is not a backdrop against which dreams are made. The long-end of the US yield curve is attractive. Not only does it offer a positive real yield, it is a natural hedge to the cyclical risks that global central banks are creating. Equities are vulnerable. We see a further 15% downside in the S&P towards the 2000/2007 highs at 1550/1600 before valuations begin to chime with the growth/earnings outlook.

Despite Fed discomfort with a strong dollar there is little it can do; competing currencies will continue to be a least ugly sister contest, the yen and the euro now joined by the renminbi. The other Asian EM currencies are high beta add-ons to the renminbi short.

Commodity-energy currencies will remain vulnerable too. And so do the currencies of the "misgoverned" like Turkey, Brazil and South Africa. Despite oil, Mexico looks increasingly attractive as a medium-term reform story, which ironically is being used as a surrogate EM currency short by many investors.

ANALYSIS

One thing the financial crisis has taught us is that the pain threshold of the modern generation is somewhat diminished from the days of old. While

15 February 2016

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the financial crisis was brutal, it was nothing like a Flanders field. Policy makers did everything possible to avoid the day of reckoning, desperate to prevent the crisis developing into another ‘great depression’. Creative destruction was taboo.

The tonic was unprecedented and aggressive monetary stimulus cushioned economies from the inevitable deleveraging that was needed. This allowed some afflicted governments — but not the Eurozone’s “austerity” economies — to run ‘counter-cyclical’ budget deficits, selling the debt to finance them (“indirectly”) to central banks. The feared hyperinflation that money printing risked has failed to materialise. And monetary policy makers were elevated to gods by markets as reward for reflating asset prices beyond their pre-crisis peaks.

But that is where the success story ends. Quantitative easing (QE) simply replaced one bubble with others. In DMs sovereign debt burdens jumped. But even more lethal may be the surge in corporate debt in many Asian economies.

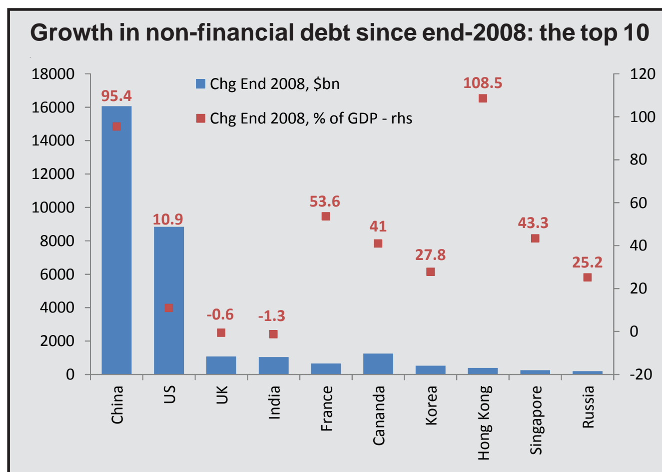

Figure 1. *Source: BIS, Independent Strategy*

China is the standout, it has added $16trn in non-financial debt since the end of 2008 (Figure 1), taking its total non-financial debt burden from 148% of GDP to above 244%. Much of the fault lies with State debt (State owned enterprises (SOEs), local government and local government financial vehicles). This splurge of investment hiked manufacturing capacity based on unrealisable expectations for exports and domestic demand. It also fuelled a further source of malinvestment: the last leg of the “commodity super-cycle”. The overcapacity created now drives deflation.

It is this overhang that global policy makers must now deal with. But it’s a riddle that the monetary policy doctrine of the past quarter century seems incapable of solving. The crux of the problem is that targeting an inflation rate (typically 2%) in a world where there is excess capacity and structural deflation does not work. That might work when dealing with a normal business cycle recession, but not a financial crisis where past credit excesses take much longer to work through. This is because credit bubbles build up stocks of unproductive assets and loans and divert other resources, particular labour, into low productivity sectors. In EM’s, apart

from excess capacity in commodities, this manifests itself as malinvestment in real estate — a resounding echo of the pre-crisis real estate/construction boom in DMs.

The legacy problems of the Great Credit Boom and Bust in DMs have been further exacerbated by a structural slowdown in trend growth rates. This change is partly demographic, as working age populations peak. But it's also due to fundamental changes in demand, away from mass consumption of manufactured goods (where the excess capacity lurks) towards services, in which the old "economy of things" is gradually replaced by the "economy of non-things". One example is the smartphone which has replaced a range of other individual devices and services: cameras, watches, GPS, movie editing software etc.

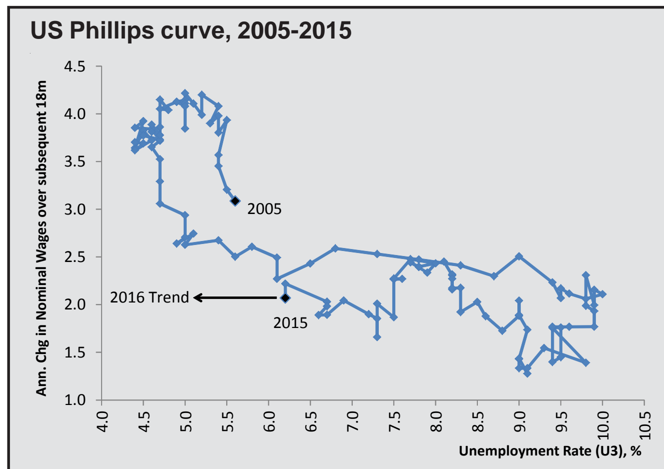

Figure 2. *Source: BLS, Independent Strategy*

On top of this, there are the disinflationary effects of new disruptive technologies (DTs), which drive the new 'economy of non-things' (see our reports, *A short paper on everything*, 23 October and *How we are changed*, 27 November 2015). These provide the high value-added and productivity-enhancing applications that the modern world increasingly craves. But they contribute to cost deflation both now and in the future. DTs also weaken the nominal pricing power of labour, which has lagged the improvement in employment (Figure 2) during the recovery, flattening the traditional Phillips curve relationships.

This is not necessarily bad for the consumer who is also the worker. His/her costs of consumption have fallen, insulating real incomes. Cheap — or free — and convenient internet services have also hefted living standards. But it fundamentally alters the traditional link between a tighter labour market and inflation and the upward path of nominal GDP growth, which has historically dictated the pace of debt absorption. It also helps explain woeful total factor productivity (TFP). The growth of lower-paid services jobs, which has been a feature of the US recovery, has more than outweighed rising productivity in the disruptive sectors. The increasing penetration of DTs will change that, but not immediately.

These are the modern challenges central bankers are trying to tackle with their traditional (rear-view) monetary policy toolbox. But it's square peg, round hole.

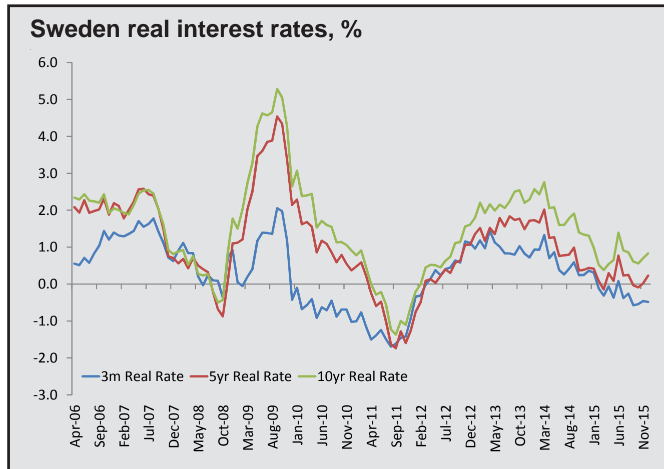

Figure 3. *Source: Stats Sweden, OCED*

The Riksbank's reflation charge

Sweden looks a likely candidate for the horrors list of the next generation of monetary policy text books. It is perhaps one of the only economies that is enjoying strong growth (real and nominal), has a continually improving labour market and a consumption boom. However, it also has undershooting inflation (Figure 3).

Monetary policy orthodoxy prioritises the latter over everything else. The Riksbank has deployed its full arsenal to try and bring inflation back on track. It has aggressively devalued the exchange rate, launched its own asset purchase programme and pushed interest rates into negative territory. Effectively, it has been slashing real rates as growth accelerates.

The result has been a renewed acceleration in credit, which now stands at 281% of GDP in the non-financial sector, a rise of 25% points on the pre-crisis peak and up from 212% a decade ago. Housing has been the prime beneficiary, where prices have risen by a quarter nationally and by 40% in Stockholm over the past three years, stretching earnings ratios to extremes (prices are 11.7x earnings in the capital). The Riksbank is aware of these 'secondary' risks but has tried to shift responsibility for that, calling on the legally under-powered regulatory authority Finansinspektionen to take steps on the macroprudential side in order to tighten mortgage credit availability. It's nice to know they are sleepwalking wide eyed into the next crisis, dreaming of a scapegoat.

That crisis might play out something like this: the highly indebted and overheating economy is hit by an external demand shock. This is the trigger for a rapid contraction in domestic demand, tipping the economy into outright deflation. Counter-cyclical buffers are ineffective as credit is maxed out. Fiscal stimulus helps but monetary policy, with rates already negative, becomes totally ineffective. The currency starts to appreciate as foreign investments are repatriated. This feeds the debt deflation spiral.

ECB firepower

In the short history of the ECB, Draghi has been a revolutionary. His fabled Outright Monetary Transactions (OMT) might have been a policy defined by words not practice, but it was highly effective at diffusing the

Eurozone debt crisis. And he has managed to sidestep German objections to quantitative easing with his Asset Purchase Programme (APP) alongside a move to a negative deposit rate.

Whether the combination of the APP and negative deposit rates is effective or not is another matter. If you look at lending rates and credit growth this latest reflationary policy is gradually starting to work; if you look at market-based inflation measures and equity markets it has just grazed the surface. Comparing ECB actions to those of other developed market central banks and factor in how woefully behind the curve the ECB was in launching its 'deflationary reaction', then one has to side with the market's guess of the price outlook.

At least, unlike in Sweden, the cost of the ECB pursuing its price stability mandate hasn't turned into anything too sinister credit wise. The overhang from the Eurozone debt crisis and the austere steer embedded in the region's fiscal policies have seen to that. And monetary policy was kept too tight for too long by the core-Eurozone view of the inflation target, which seems to be asymmetric (inflation above 2% is unacceptable but inflation close to zero is tolerable). So today, the region still suffers from the twin problems of a large output gap and woeful levels of productivity on the one hand and the structural deficiencies of the currency union on the other. These deficiencies include the lack of fiscal union and other similar burden sharing institutions, including the still structurally imperfect banking union.

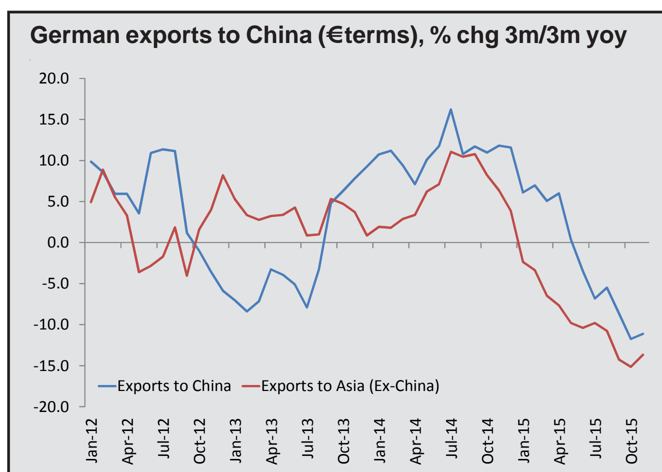

Figure 4. *Source: Destatis, Independent Strategy*

External risks are key for ECB monetary policy and Eurozone economy. A weaker euro might have helped price exporters back into the game, but there is no market-share story here, it's about defending volumes in a world of overcapacity. There has been no positive feedback loop from exports to investment.

The powerhouse that has carried the region through its various crises — Germany — is the economy now most exposed to this. Weakening demand for capital goods from China and Asia generally is starting to become evident (Figure 4). And that in turn creates risk for the feeder economies. While exports to China only account for 6% of total German overseas sales, adding in the rest of Asia increases this to 10%. That might still seem small, but it's a potentially large drag on

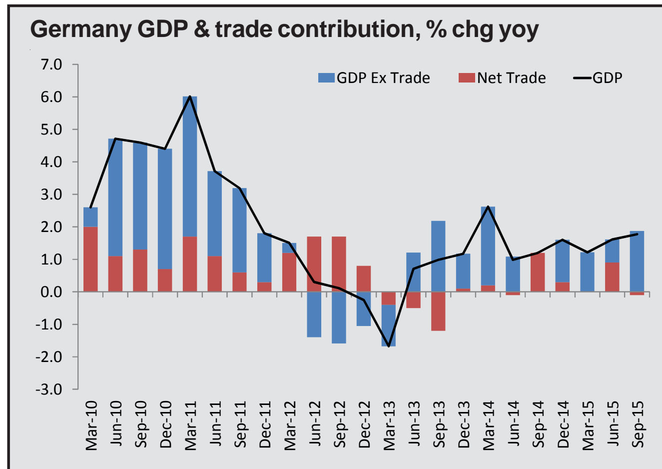

Figure 5. *Source: Destatis, Independent Strategy*

GDP where net trade has been contributing an average of 0.6% pts to the 1.5% pts of growth recorded over the last six years (Figure 5). There is some offset by recovering demand elsewhere. Exports to the US and particularly the UK have been brisk, rising at double digit rates on an annualised basis. Sales to the Eurozone have also been strong, helped by slowly recovering demand in the periphery. However, it seems unlikely that these rates of growth can be sustained as global demand growth in aggregate weakens. The double digit rates of growth seen to the UK and US seem most at risk.

So rather than APP and negative rates boosting demand, they have become tools to fight a rear-guard action against the slowdown in global growth and rebalancing away from manufacturing (where overinvestment is concentrated) towards services and those disruptive technologies, which need far less capital. The immediate effect is an erosion of ECB credibility. But longer-term it will need a complete reworking of its monetary policy framework. That must do three things:

- Place more onus on supporting growth (in particular facilitating adjustment processes between member states which the fixed exchange rate regime has made incredibly difficult)

- Cut, or just ditch, an obsolete inflation target

- Act as a direct financer of much needed productivity enhancing infrastructure investment

In fairness, the one thing the ECB has got right is its persistent calls on governments to fulfil their obligations to make the tough structural reforms needed to raise productivity and potential trend growth rates.

BoJ — land of the setting sun

What appear as new problems for Europe and the United States have been around for decades in Japan. Its demographic tipping point was reached long ago. The working age population is holding up for now, but only thanks to older workers remaining active for longer and part-time women (boosting female participation rates) — many of them caring for the rest of the aging population that can't go out to work anymore. One example of this 'new economy' is the hiring of seniors to sit in Tokyo

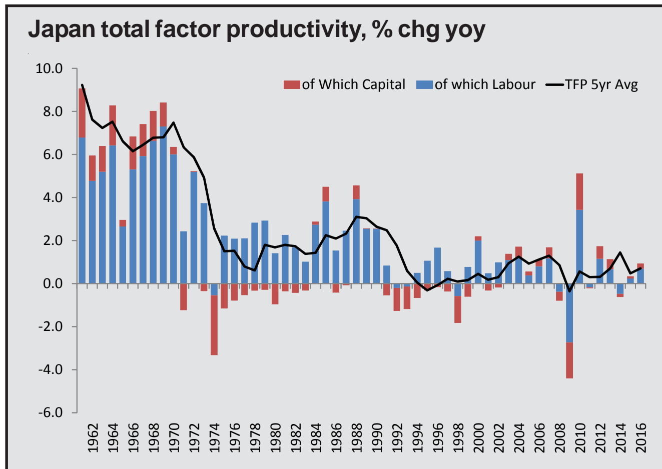

Figure 6. *Source: DG ECFIN Ameco*

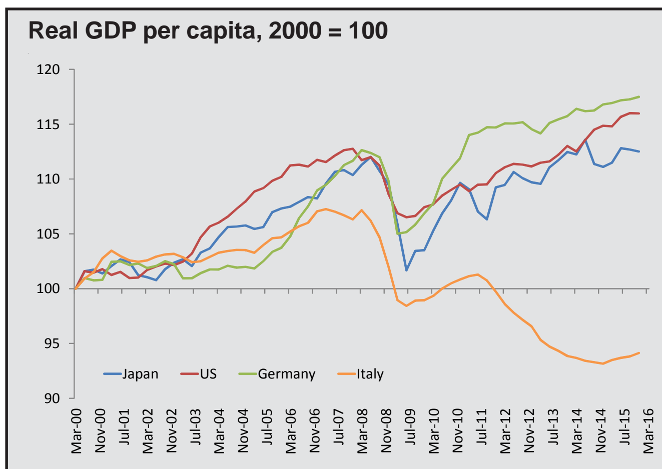

Figure 7. *Source: Oxford Economics*

delivery vans while the younger courier drops parcels off, the sole aim being to fend off overzealous local parking attendants. And they wonder why total factor productivity trend growth rates are a rounding error from zero (Figure 6)!

The deflation problem has been prevalent for as long. The world is well versed in the dangers of this, how it delays consumption and can trigger crushing debt deflation etc. There is not much evidence of that in Japan though.

Deflation has smoothed the adjustment path following the bursting of the 1980s bubble. It has been the only source of pricing power for workers who have enjoyed solid real increases in their savings (while the rest of the world sniggered at pitiful JGB yields). Real wages rose consistently despite the nominal contraction in GDP. Indeed, growth in real GDP per head might have lagged the US and Germany but it looks stellar when compared to somewhere like Italy (Figure 7) where inflation has averaged exactly the ECB's 2% target since the single currency started.

That hasn't allowed the Japanese to take a more favourable view of local price dynamics though. The 'three arrows' mantra of Abenomics placed it centre stage. This has since been boiled down to the 'one arrow' of Kurodanomics, namely quantitative and qualitative easing (QQE).

That BoJ campaign started with the adoption of a 2% inflation target accompanied by an aggressive monetary easing programme, which is adding 15% of GDP to the monetary base annually, to get it there. As a result, the BoJ's balance sheet is on course to hit 100% of GDP in Q3 2017. That is still 6-months before the inflation rate reaches target, based on the central bank's latest forecast. Promised structural reforms have lagged monetary policy execution. PM Abe's promises turned out to be funeral bakemeats, coldly furnishing forth the marriage table.

It has been QQE that has really revealed how structurally engrained the deflation mind-set is in Japan. Price shocks firstly from a weaker yen and then the sales tax hike depressed incomes and consumption. Strong

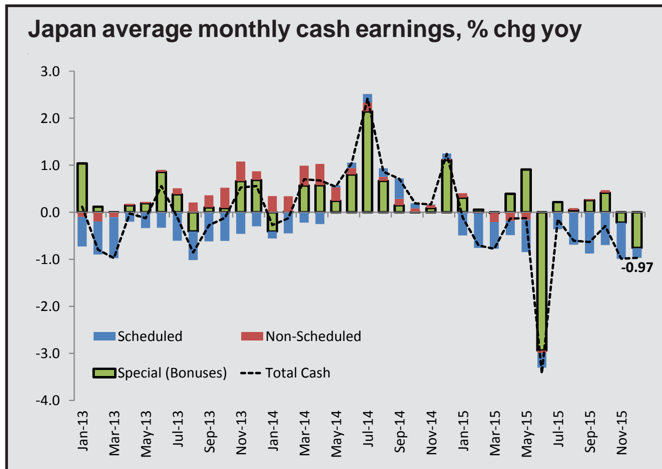

Figure 8. *Source: Ministry of Labour*

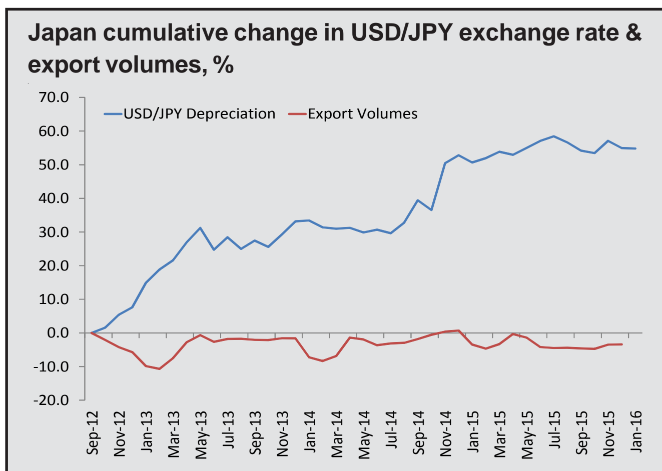

Figure 9. *Source: Japan Customs Office, Datastream*

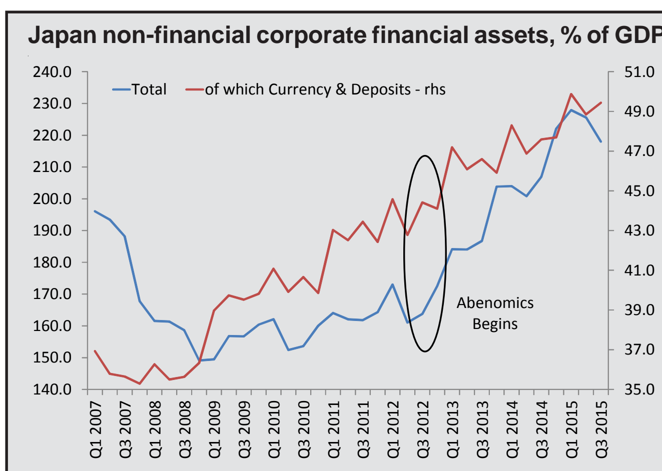

Figure 10. *Source: Datastream*

words from politicians that businesses should use FX windfalls from the devaluation to raise workers' base pay have amounted to nothing. Bonus payments rose initially, but then dropped back (Figure 8).

The export figures illustrate the failure of the yen devaluation strategy. Despite a 55% fall in the currency there has been zero increase in export volumes (Figure 9). This is partly because Japanese firms have for years battled a strong yen by outsourcing production to cheaper parts of the region. But excess capacity is equally a problem. The slowdown in China, where 18% of Japanese exports now head, versus 14% before the financial crisis, makes it more difficult to use yen weakness to grab market share. The coming devaluation of the renminbi will make things worse.

In many ways, a stronger yen would have provided a more effective cushion, allowing local consumers to benefit from the decline in commodity prices over corporations, which have merely hoarded the cash (Figure 10). This locks the country into high fiscal deficits and low investment and poor consumption growth.

The BoJ's policy dilemma is shared by other central bankers. Their initiatives are starting to influence markets less and less. A law of diminishing returns has set in. One reason is because so many central banks are doing the same policy things.

The law of diminishing returns then compounds pressure on the central bank to do more to meet its monetary policy commitments (in Japan's case that elusive inflation target). In fact, it's not too far from the toxic races to the bottom that have fed earlier global crises.

Another reason why the law of diminishing returns is gaining sway in markets relates to the efficacy of central banks' initiatives. Negative deposit rates are an example.

Central banks can print money and, by charging negative interest rates on it, they can encourage banks to lend it. That is meant to improve monetary policy transmission. But faced with weak credit demand it may fail.

Negative interest rates are also a tool to weaken exchange rates and promote growth by improving competitiveness. They can encourage capital to leave the country for places with positive interest rates and so depress the exchange rate. But central banks cannot control the quantities or direction of such flows (bond outflows may be matched by equity inflows) or the exchange rate impact of currency hedging of the capital.

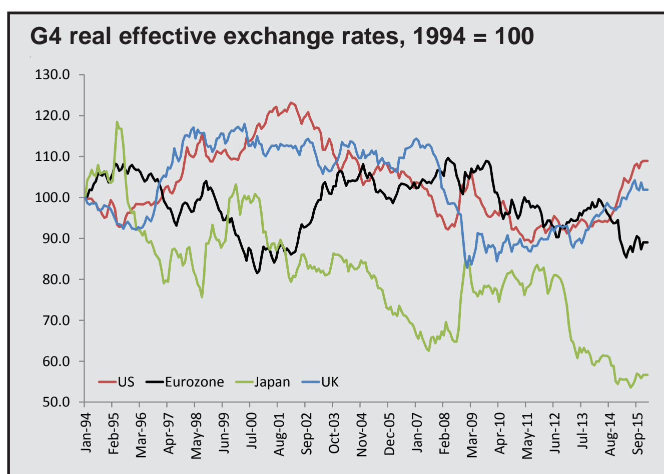

Figure 11. *Source: BIS, Independent Strategy*

The BoJ's latest coin-toss of negative interest rates (NIRP) risks falling equally flat for other reasons. First, for a start, the yen is not overvalued. On an REER basis it is undervalued (Figure 11). Unlike the euro the yen makes up less than 4% of global international reserves. The euro accounts for 20% and Sterling 5%. International reserves managers are unlikely to be sellers, as the yen is such a small percentage of their holdings. Add to this the fact that pension fund assets have already been internationalised. Returns have been poor. Payments to Japanese 'oldies' are rising. Portfolio capital may be repatriated. In any case it is unlikely to be exported.

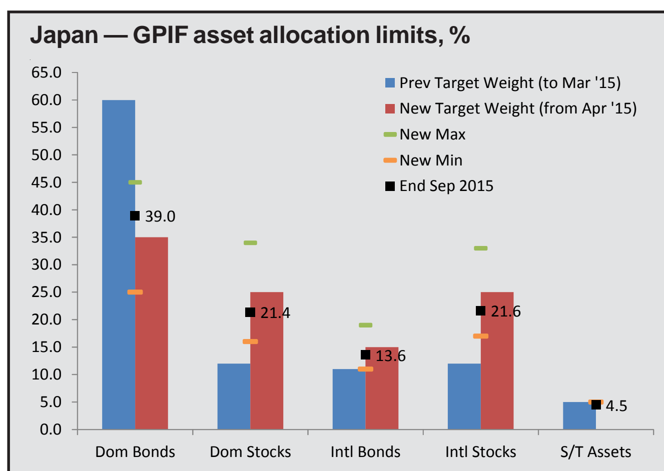

Figure 12. *Source: GPIF*

The Government Pension Investment Fund (GPIF) for example has reduced its weighting of domestic government bonds from 63.3% at the end of the 2011 financial year to just 38.9% at the end of September 2015 (Figure 12). Its overseas exposure rose from 20% to 35%. Even this tally flatters bond holdings as the September quarter saw heavy losses in equity markets, effectively reducing their weighting relative to fixed income, undoing some of these rotational effects.

Not that Kuroda is remotely aware of these risks, as he noted "it is no exaggeration that QQE with a Negative Interest Rate is the most powerful monetary policy framework in the history of modern central banking"[1]. A text book example of the 'god delusion'.

The PBoC's tough balancing act

China was the solution to deficient global growth post-GFC. Now it is the problem. Debt deflation stalks the corporate and local government sectors. Producer prices (in year on year terms) have been falling for 46 months. During this period non-financial debt has risen by 52% of GDP. Debt has gone up while the means to service it has gone down.

Most debt is in non-financial entities, concentrated in State Owned Enterprises (SEOs) and local governments (LGs). So it's really a contingent liability of government. In China's past, such problems have been neatly dealt with by shifting the bad debts into a state-owned asset management company, where they reside in perpetuity. The government certainly has deep-enough pockets to do this again. But doing so rips the heart out of the investment-led growth miracle that worked so well, at least until it didn't anymore.

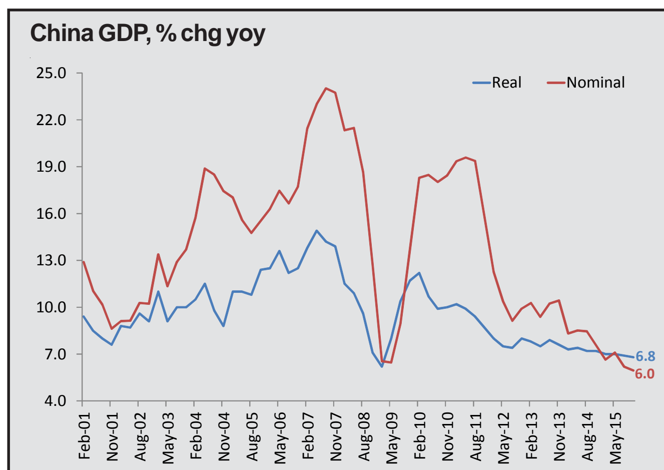

Figure 13. *Source: China NBS*

Hence the heavy emphasis in development plans on making the transition to a modern consumer-driven economy. But that takes time, which is not a commodity readily available, while at the same time trying to palliate a credit bubble and a structural slowdown in growth. Nominal GDP growth rates have plummeted (Figure 13) and that is what matters when scrambling to meet fixed income liabilities.

It also presents other conflicts, such as the fact that a consumer-led market economy needs more defined legal protections and rights, which directly conflicts with the Communist Party's control model. In the interim, they are faced with accelerating capital flight as locals seek safer-havens and higher returns abroad.

To date, policy has been set to manage the resulting exchange rate volatility, which essentially means managing a gradual depreciation, with all the pitfalls that creates (see our reports *China — Flawed or fatal*, 11 December and *Devaluation smoke and mirrors*, 18 December 2015). Lowering the exchange rate is an essential part of managing the risks of a hard landing. Devaluation, by hiking inflation expectations and allowing greater latitude for monetary policy, would provide (limited) breathing space to deal more forcefully with the issues of deflation, leverage and overcapacity issues plaguing manufacturing while enacting supply side

Figure 14. *Source: CBP, Independent Strategy*

measures to boost the services side of the economy, which remains far too small to take up the slack.

But even this comes with potentially self-defeating risks. It is simply difficult for an economy the size of China to play a market share game (exporting domestic deflation) in a world where everyone is already struggling to find sufficient demand for their own idle capacity (Figure 14). Any Chinese currency weakness will feed through to another round of Asian currency devaluations. Judging by the BoJ's decision to adopt negative rates (having suggested, in Davos, that the Chinese adopt capital controls!), the feared race to the bottom has begun.

Yellen — the central banker of last resort

As ever, the title of 'consumer of last resort' remains pinned to the USA. It is the one place which has had something like a normal recovery. Growth post-GFC may have been slower than pre- but it has been consistent. It has been accompanied by a strong recovery in employment, enough to motivate Yellen and the Federal Reserve finally to pull the trigger and begin normalising monetary policy.

The US might still be the world's largest economy, but its share of global GDP has diminished. At the time of the Asia crisis, the US accounted for 32% of world GDP. But by the GFC it was down to 29% and it stands at 27% today. In the same period, China's share has gone from less than 4% to 16%. So while the US's shoulders remain broad, everyone elses' have put on weight.

Tack on the fact that the US is suffering its own manufacturing recession and that the strong dollar continues to drag on exports (an effect likely to worsen as earlier currency appreciation continues to pass through) and the probability that the US can support everyone through this global transition diminishes. We still only put the probability of US recession this year at 20%-25% but over two years this rises to 45%.

So Yellen's brave move is unlikely to mark the start of anything that resembles a return to traditional monetary policy. Instead, the weight will shift back to meeting the inflation side of the Fed's dual mandate. External risks create a clear incentive to run the domestic labour market hot, in

the hope that eventually the Fed's beloved Phillips curve will spring back to life. If anything, a 'data driven' Fed is on the hook to revert back to a more stimulatory course if external headwinds bite into domestic growth. That means the Fed is likely to take a dim view of any further dollar gains. Unfortunately, that's the yardstick everyone else is using in the race to the bottom.

That will slow the pace of tightening but it doesn't change much for the dollar outlook. Other central banks are wedded to further easing and, with both the ECB and BoJ already on the wrong side of zero deposit rates, even a Fed pause isn't going to do much. The PBoC will continue to do more as it manages the growth slowdown. But in doing so, it stokes leverage in an economy that needs to deleverage. If, as we believe the renminbi is devalued 12-15% against the US dollar, the effect risks choking off growth in the one place where there is demand — the US — by triggering a further wave of dollar appreciation, heaping further pressure on American manufacturers, exports and investment. Monetary policy might never be technically out of bullets, but, if everyone is shooting at the same target, it's difficult to tot up the scores.

Investment outlook

The investment implications are straight forward, interest rates will continue to be depressed by the reach for yield triggered by unconventional monetary policy.

The long-end of the US yield curve still looks attractive. Not only does it offer a positive real yield, with a potential currency kicker to boost returns, but it is a natural hedge to the cyclical risks global central banks are creating.

Equity valuations are vulnerable. EM equities have much further to fall, as do their currencies. DM equities should fare better but do not price in growth risks at current levels. Profit margins have peaked. They will continue to get squeezed. This happens because low productivity, tightening labour markets and rising wage costs raise unit labour costs faster than output prices. We see a further 15% downside in the S&P towards the 2000/2007 highs at 1550/1600 before valuations begin to converge with the growth/earnings outlook.

Despite Fed discomfort with a strong dollar there is little it can do; currencies will continue to be driven by the relative monetary policy outlook.

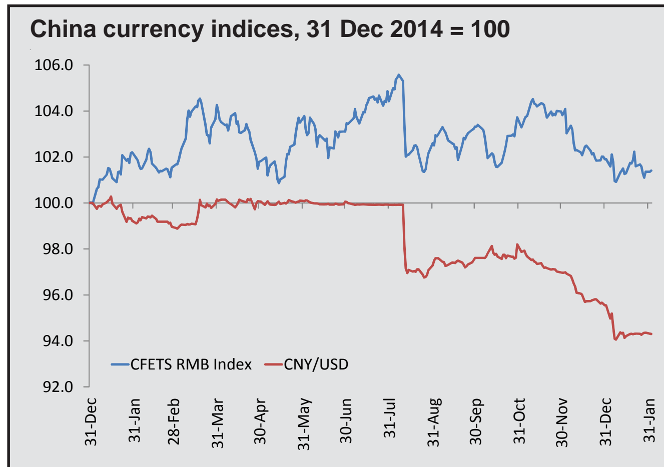

Figure 15. *Source: PBoC, Independent Strategy*

The ECB and BoJ will continue to print, to the detriment of the euro and yen. That means by default the Chinese renminbi will weaken versus the US dollar as the authorities now manage it against its broader CFETS trade-weighted basket (Figure 15). Efforts to deter speculators will be frequent, but ultimately futile. In fact, the needless burn of FX reserves actually raises the risk of a disorderly adjustment. We stay short renminbi — indeed, it is our highest conviction position. The other Asian EM currencies are high-beta add-ons.

Commodity currencies will remain vulnerable too, the boom they enjoyed was a positive terms of trade shock that is now being unwound. So living standards will retrace and economies will need to find new sources of growth. This will be a struggle for mono-producers like Russia, South Africa and Brazil. But it should be manageable for Mexico — which exports more cars than it does oil — and Canada. Australia's 'mining to dining' transition is also going better than expected.

Footnotes

[1] Introduction of "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate" Speech at the Kisaragi-kai Meeting in Tokyo, 3 February 2016

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