Market Perspective

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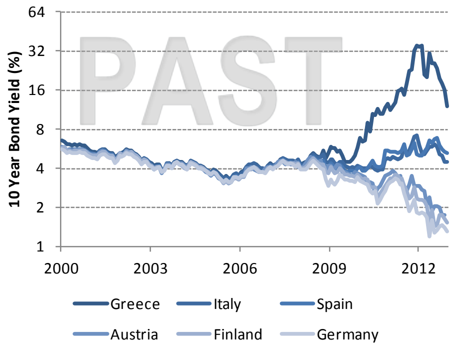
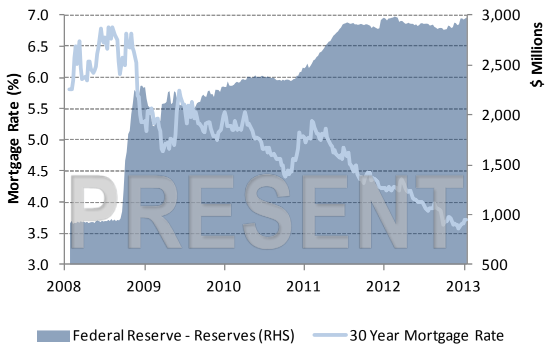
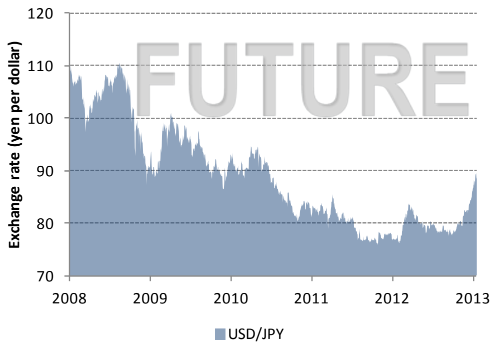
Strategist **Guy Foster CFA**

Investment Research

Monetary policy: past present and future…







A bullish economic case can be made for 2013. We have discussed it before:

- In the US the housing market is creating wealth and real incomes are no longer being eroded by soaring commodity prices.
- In the Eurozone meaningful gains in competitiveness are occurring far faster than many economists predicted, resulting in increasing investment (predominantly from the auto industry).
- Japan is seeking to address its long term battle with deflation through a ¥10 trillion stimulus package and attempted devaluation of the yen.

These factors will become more meaningful in the second half of 2013 and beyond.

For now, though, the global economy is digesting the 2% payroll tax increase for US employees stemming from the New Year's Day fiscal cliff deal. Furthermore, American businesses and consumers are pondering their economic future as sequestration looms. These factors are weighing on sentiment indices and depressing business investment. Forward-looking equity investors may be keen to discount the economic improvement now, but as far as the real economy is concerned, central bankers' actions (or inactions) remain crucial.

This is at a time when the role of the central bank has fallen under intense scrutiny. The US saw a presidential campaign which at times became a referendum on the policies of Ben Bernanke's Federal Reserve. In the UK, Paul Tucker, the Bank's own heir-apparent to succeed Mervyn King was overlooked in favour of the Canadian Mark Carney. Carney's appointment came despite him not applying when the position was advertised, requiring a sharp increase in salary and refusing to commit to the government's preferred employment term. All that before he publicly discussed targeting nominal GDP or employment as an alternative to inflation targeting.

We thought it would be worth examining the impact of current monetary stances on markets and economies. As the results are quite unusual.

Europe: Monetary Policy Past

European monetary policy continues to loosen by virtue of action the European Central Bank (ECB) took back in August. This easing mechanism is an example of the power of expectations as described in a speech which Mervyn King gave in 2005 when he said Diego Maradonna's (legitimate) goal against England in 1986:

> *"…was an example of the power of expectations in the modern theory of interest rates. Maradona ran 60 yards from inside his own half, beating five players before placing the ball in the English goal. The truly remarkable thing, however, is that, Maradona ran virtually in a straight line. How can you beat five players by running in a straight line?"*

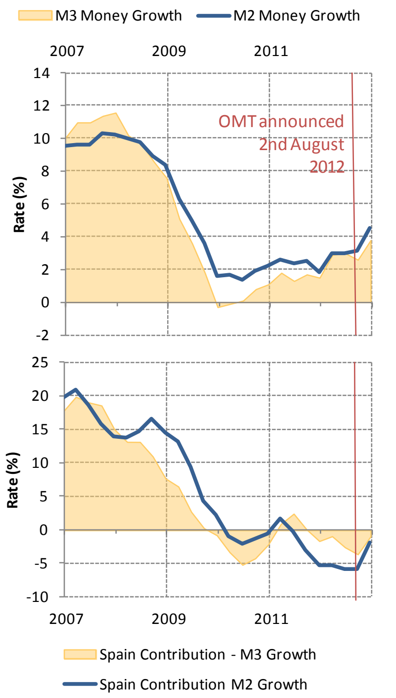
Jim Leavis at M&G has just used this example to suggest that forward guidance from policymakers might be misplaced and we would agree with that assessment. Committing to hold rates down for months or years risks causing longer yields to rise as investors see the central bank falling behind the curve.

Sir Mervyn obviously had to go some way beyond the harnessing of expectations in the conduct of UK monetary policy but his counterpart, Mario Draghi, at the ECB is making good use of them.

Europe is sometimes described as having committed to unlimited QE just like the US but the reality is that this couldn't be further from the truth. The Outright Monetary Transactions (OMT) programme is a combination of stick and carrot which pressures governments to implement competitiveness reforms. By doing so, the scheme becomes not just a monetary policy but a supply-side policy. This demonstrates extraordinary reach for central bank policy. And what makes this reach even more extraordinary is that Draghi has so far achieved Sir Mervyn's dream…the OMT has applied huge stimulus without actually doing anything. And what has the policy achieved?

It has accelerated the pace of monetary base expansion in the wider Eurozone. More specifically, however, it has reversed the pace of decline in specific periphery states where monetary conditions were tightening even as recession worsens.

Chart 1: Monetary Growth in the Eurozone



Source: ECB/Brewin Dolphin

The pain in Spain…

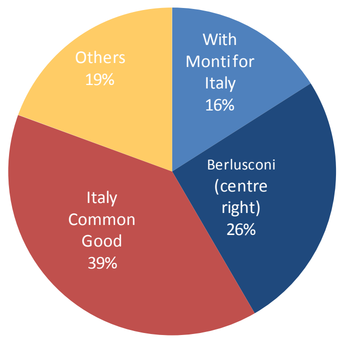
The reason for the reversals have been the arrest of deposit flight from the periphery – specifically Spain which was a key component of the *convertibility risk*[1] Draghi was at such pains to eliminate. But whether by design or default the effect provides stimulus to the ailing Eurozone. This means recovering bank lending and a lower cost of corporate borrowing as sovereign bond spreads decline. Depending upon how far this trend continues, it may serve to bolster lending in many other ways.

Spain still looks likely to need assistance at some stage as austerity is putting increasing pressure on households through wage and employment changes. But Prime Minister Rajoy is right to delay triggering the OMT for as long as possible. Indeed, it is not necessarily the case that Spain will need OMT support. More likely is a conventional bailout loan from the European Stability Mechanism. The presence of the OMT seems to be enough to tempt yield-hungry investors to support the secondary markets of any Eurozone country deemed to be on the right path in terms of competitiveness – even if the underlying economics look poor for the foreseeable future (and they do).

Monti getting the boot?

The risk to the ongoing passive stimulus accruing from the ECB's past actions is Italy. Italy is in danger of diving off the right track in February when the Italy Common Good coalition appears likely to be the largest party in the new parliament. They will probably fall short of a majority and will indeed need to form a coalition of coalitions in order to rule. Whether that is formed with Mario Monti at its head remains to be seen. Arguing for such a compromise is the fact that Monti is a non-ideological candidate and therefore would be a compromise between the left and right wings that secured the majority of the vote. The counter case is that, as Monti will have stood and likely received less than 20% of the vote, any government he leads will lack democratic legitimacy.

Chart 2: Italian share of the vote polling data



Source: Ipsos, Brewin Dolphin

We have seen this trend towards loosening without the so-called debasing or printing of new currency, and indeed without quite embracing a zero interest rate policy, as being supportive of the single currency – particularly when aligned with collapsing domestic demand and recovering export demand from the US and Asia.

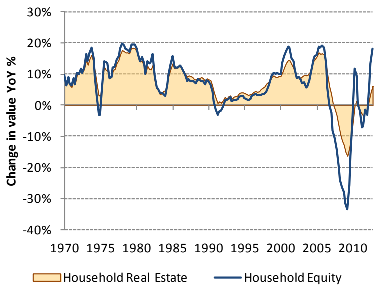
It is surprising that it has taken so long for European governments to start ruing the single currency's strength but Jean-Claude Juncker has made a start by describing recent strength as "dangerously high". Clearly a weaker currency would be beneficial to European trade in general although its benefits would likely accrue to Germany in particular. The optimum policy mix would be further fiscal tightening in Germany, which is expected to run an almost balanced budget in 2013 with a requisite loosening of monetary policy to continue the easing impact of the OMT whilst also weakening the currency. Ideologically, however, we doubt there is sufficient appetite for loosening in the eurozone – a point emphasised by ECB Governing Council member Ewald Nowotny who pointed out that the ECB targets price stability rather than exchange rates (as if the two were somehow unconnected).

[1] Convertibility risk is the risk that assets that are acquired whilst denominated in one currency convert into another currency (e.g. new drachma, new pesetas etc.)

America: Monetary Policy Present

The Federal Reserve continues to buy $40bn of US Agency Mortgage Backed Securities per month in addition to $45bn of treasuries. Drawing again on Sir Mervyn King's assessment of monetary policy, the Bank of England Governor has always argued that the stock of securities purchased under quantitative easing measures the size of stimulus applied to the economy. The market's preferred metric is the flow of new purchases (which the governor would argue measures the change in stimulus). In the States, however, we believe the correct measure of stimulus can be taken from borrowing costs. The low level of mortgage backed securities yields directly translates into lower borrowing costs – although regrettably not for all.

Chart 3: US real estate assets and household equity

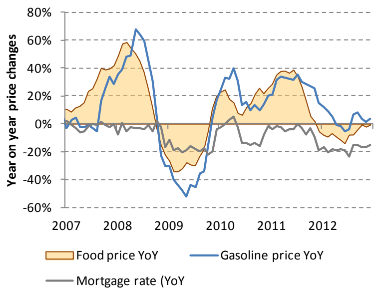


Source: Federal reserve

The low level of mortgage backed securities yields directly translates into lower borrowing costs – although regrettably not for all. Home equity remains a meaningful constraint on both the income effect (lower mortgage costs) and the wealth effect (rising house prices) of lower mortgage rates. Some relief is coming in this regard with modest gains in housing last year being multiplied in terms of their effect on home equity (a 5% rise in real estate has grown equity by nearly 20%).

Notwithstanding the fact that more people now qualify for mortgages, capital requirements and regulation are preventing some of these lower wholesale mortgage rates from feeding through to their intended recipients. Time will tell how much of a headwind this will be for the US mortgage market. Until the friction in the US mortgage market can be eased the full force of this incredible easing is not finding its way to investors.

Chart 4: US non-discretionary spending



Source: DOE, Food Agriculture Organisation, Freddie Mac

Deflationary pressure remains

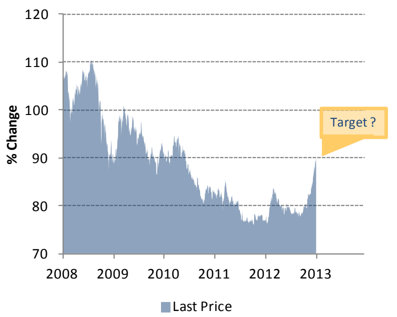
If the mortgage value could be released then we could see a repeat of the situation in Europe where no change in the rate of *actual* stimulus translates into a sharp increase in the *effective* stimulus (accepting that the actual rate of stimulus is actually quite high at the moment)! It is also unclear what it would take to keep yields at their current low levels as the economic environment improves, however, we assume that 2013 will be the year we start to find out – i.e. the year the economy improves and the Fed has to ease more to keep yields down.

What should be reassuring for investors is that the pass-through from the quite extraordinary rate of stimulus being applied to the US bond markets seems to be having minimal impact on the markets for energy and by implication agricultural commodities. This weakens the case that QE feeds through to commodity prices in general and may mean more of the explanation for high oil prices over the past decade is ascribed to…well…demand for oil exceeding supply! The counter argument might be that oil prices would be even lower without QE^n (the latest iteration of quantitative easing)

Japan: Monetary Policy Future

The Bank of Japan, meanwhile, remains the central bank from which investors are hoping for so much. They would need to be very young indeed not to have seen such hope dashed before on the rocks of Japanese conservatism.

Chart 5: Japanese authorities are comfortable with further easing

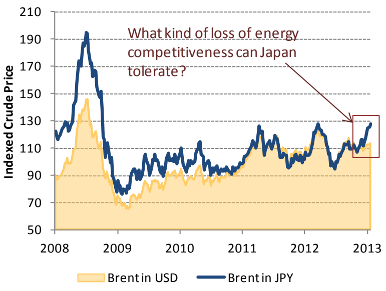


Source: Datastream

Already there are signs of policymakers getting cold feet over this recent policy drive. The idea of driving down the yen by implementing a 2% inflation target remains popular as investors continue to bet against the currency. But the problem Japan has with this policy is that it still runs an, admittedly much reduced, current account surplus.

A very rapid adjustment to the yen dollar rate threatens to meet the Bank of Japan's new inflation target by generating import inflation but that could choke-off demand Japanese domestic demand – thereby expanding the trade surplus, supporting the currency and further weakening Japanese growth. This may have been the reason for the recent warning from Japan's economy minister Akira Amari who warned "If the yen becomes too weak, import costs will jump and there would be a negative impact on people's lives."

Chart 6: Japan anticipates much easing to come...



Source: Datastream

The man with the plan, Abe's advisor Koichi Hamada, believes a yen dollar rate of 95-100 would not be overly damaging. That would make the total adjustment between 22% and 29% if it can be controlled. When assessing whether we find this credible bear in mind that due to exchange rate movements oil in yen has risen 37% since the middle of 2012. Added to the transition from corporate tax to value added tax real incomes in Japan are likely to fall under considerable strain.