Macro Matters.

On our way to the helicopters

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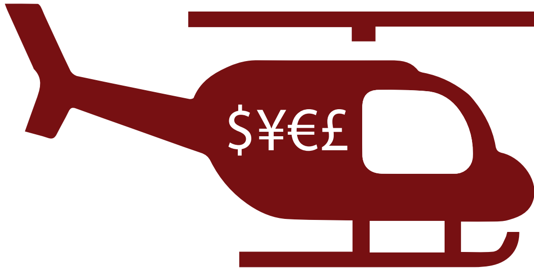

> "Let us suppose now that one day a helicopter flies over this community and drops an additional $1,000 in bills from the sky"
>
> **Milton Friedman**
> "The Optimum Quantity of Money", 1969

Emiel van den Heiligenberg - Head of Asset Allocation

Emiel joined LGIM in August 2013 as Head of Asset Allocation with responsibility for asset allocation, strategy and macro research.

He has wide experience in managing a range of multi-asset strategies, including absolute return, diversified growth funds, LDI and fiduciary, balanced mandates and multi-manager mandates.

Emiel graduated from Tilburg University with a Master's degree in economics and holds a post-graduate qualification from VBA/EFFAS (the European Federation of Financial Analysts Societies).

Muddling through

The global economy continues to muddle through, with strong consumption growth in developed markets being offset by weakness in corporate investment and emerging markets. The current run rate of US GDP growth, as measured by the Atlanta Fed's real time GDP estimate for the first quarter, runs at a disappointing 0.14% as we type[1].

Emerging market growth expectations have been downgraded almost continuously over the past three to four years. With emerging markets still suffering from the hangover of rapidly rising leverage and associated misallocation of capital, an unwind of the credit cycle might well lead to a crisis at some point. However, even today, weaker emerging market growth is proving deflationary for the rest of the world.

Recession not a real worry

Even though developed growth is unspectacular, we think the risks of a recession in developed markets within the next 12 months remains fairly low. The modest recovery so far since the financial crisis means there is little evidence of the traditional signs of excess demand, inflation, overheating and higher interest rates which have traditionally triggered recession.

The concern would be a broad tightening of credit conditions leading to capital investment cuts and layoffs which undermine household incomes. For the moment we see limited tightening outside of the energy sector.

Overestimated inflation and rising deflation risk

Given poor demographics, excessive leverage, lacklustre cyclical economic dynamics, and the fall in commodity prices, deflation risks are a real and present danger. Over the past few years, our global fixed income colleagues have discussed these risks extensively. They have focused on the 4 Ds: Debt, Deficits, Demographics and Deflation[2].

[1]See Atlanta Fed's website: www.frbatlanta.org/cqer/research/gdpnow

[2]See Fixed Income Compass January 2016: "Two more Ds for 2016"

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Recently, LGIM economist James Carrick added fuel to the deflationary fire by arguing that inflation is mis-measured in today's digital economy and substantially lower than the official numbers indicate[3]. This implies that policy makers and market pundits are looking at this through the wrong lens, meaning:

- Consumers experience lower-than-expected inflation which increases the propensity to save
- Corporates have less pricing power
- There will continue to be limited nominal wage pressure as real wage growth is underestimated
- Quantitative easing has been even less effective in raising inflation and monetary policy needs to be drastically recalibrated

Can Central Banks fight deflation?

"Whatever it takes" is the semi-official mantra of the European Central Bank (ECB), but it has also been true of the Federal Reserve, the Bank of Japan (BoJ), the Bank of England and the People's Bank of China. This has been enough to underpin global equity markets.

However, this might all change if investors lose faith in the ability of central banks to create nominal growth. The Bank of Japan got a serious nosebleed in terms of market credibility when their latest bazooka backfired. By cutting interest rates below zero, they hoped to stimulate financial conditions. Instead, investors feared the feedback loop between negative rates, lower bank profitability, and impaired credit creation. The yen strengthened and inflation expectations dropped.

Figure 1 shows the % of global bond markets with short-term rates below 0%. If negative rates are counterproductive, doesn't that mean that central banks have reached the end of their toolkit? Where do they go from here? In principle, a committed central bank can always create inflation. If additional asset purchases or interest rate cuts are no longer viable, they can fall back on the oldest (and most powerful) tool in the box: printing money.

Rather than trying to get the private sector to take on even more debt by pushing down interest rates or subsidising banks to increase lending, central banks can change tack and start to simply print money.

They can either directly finance fiscal spending, write off government debt, buy zero coupon perpetual government bonds (effectively the same) or hand money directly to the public. The likelihood that this will be the response to the next economic downturn has dramatically increased.

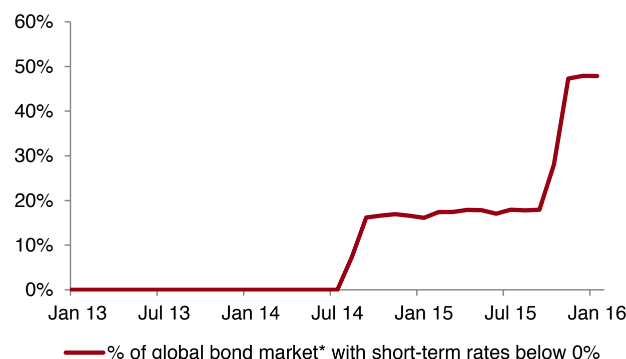
Is this a credible option?

It is controversial, but possible. In Ben Bernanke's 2002 playbook ("Deflation: making sure it doesn't happen here"), printing money is the ultimate weapon:

"A broad-based tax cut ... accommodated by a programme of open-market purchases ... would almost certainly be an effective stimulant to consumption and hence to prices.... "[4] A money-financed tax cut is essentially equivalent to Milton Friedman's famous 'helicopter drop' of money.

Handing out cash to individuals has happened before in recent history. In 1999, 31 million 'shopping coupons' worth 20,000 yen each were distributed to Japanese families with children and to the elderly. The coupons expired after six months and could only be used within the recipient's local community. In 2008, tax rebate cheques worth $300 per person were sent to the vast majority of US taxpayers. The difference with 'helicopter money' is that it is financed by the central bank rather than the debt markets and therefore never needs to be repaid by the taxpayer.

Figure 1. Pervasive negative interest rates



* Proportion of the JPM GBI Broad Index with 1 year yields below zero. GBI Broad covers Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Hong Kong, Hungary, Ireland, Israel, Italy, Japan, Mexico, Netherlands, New Zealand, Poland, Portugal, Singapore, South Africa, South Korea,

Source: Bloomberg

What are the side effects?

The difficulties with helicopter money are threefold. Firstly, it is difficult to calibrate the amount of money needed to generate reasonable but not excessive inflation. Past experience teaches us that once inflation starts to rise on money creation it is difficult to contain. It can rapidly lead to 'fiscal dominance' where monetary policy is determined by the needs of the exchequer. Germany in the 1920s, Japan in the 1940s and Brazil in the 1980s all slipped into hyperinflation under those circumstances.

Secondly, central banks can only be committed to their mandate as long as they have unequivocal political backing. Over the last few years, the political landscape has become more complex. Populist politics feeding on rising income inequality has put political constraints on policymakers. Congressman Ron Paul's campaign to "End the Fed", or Professor Hans-Werner Sinn's campaign against the ECB are good examples.

Lastly, we need to consider the unintended consequences of money creation and increased government-controlled spending. It goes against efficient markets, has long-term negative implications for productivity and might be difficult to reverse (as most spending is).

How likely is it?

Given these significant side effects, this might sound like a monetary bridge too far at the moment, but central bankers have taken many steps in the past years that seemed extremely unlikely beforehand.

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[3]See Fundamentals March 2016: "Bean Counter"

[4]Federal Reserve Board: Speech by Governor Ben Bernanke in 2002 before the National Economist Club in Washington

A recent interview with the ECB's chief economist, makes it clear that this option is definitely on the table. When asked whether they could "print cheques and send them to people", his answer was clear:

"Yes, all central banks can do it. You can issue currency and you distribute it to people."

In our view, the Bank of Japan is likely to be the first bank to cross the Rubicon and adopt a form of monetised fiscal spending.

So what?

We believe that helicopter money can successfully create inflation[5]. Whether central banks can contain it once inflation targets are reached is another matter. Given the risks attached to this strategy and given the political backlash some central banks might face, we believe the macro backdrop needs to get worse before central banks feel they have the support or mandate to take drastic new steps. In other words, one should expect rising volatility, more risk aversion and more deflationary pressure before we get to the next D (helicopter Drops).

In the run-up to this, if deflationary pressures intensify there will be clear regional differences. In this environment the US, the UK and some specific emerging markets, like India, are in a relative sweet spot.

As mentioned, we believe the BoJ is closest to starting their helicopters. This means we could buy out-of-the-money options on yen weakness, options on Nikkei strength and go long Japanese inflation, which trades currently close to zero. For portfolios with less flexibility in using options, we could hold short yen positions and long Nikkei positions.

Should central banks' move to helicopter drops become broad based, this could trigger the ultimate reflation trade which will be positive for risk assets in the first instance. Developed equities could rally hard, possibly creating new bubbles, while inflation-linked assets, real assets and commodities – particularly gold – would be likely prosper as well. It would be likely to be very bearish for nominal bonds. The world would become even more volatile and unpredictable.

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[5]See Willem H. Buiter (2015): "The Simple Analytics of Helicopter Money: Why It Works – Always"

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