MONETARY SCENARIOS

27/03/2019

Global Monetary Viewpoint

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EXECUTIVE SUMMARY:

Amongst the advanced economies, Germany and Japan have been the epicentres of economic slowdown, during 18 Q4 and 19 Q1, according to headline economic data.

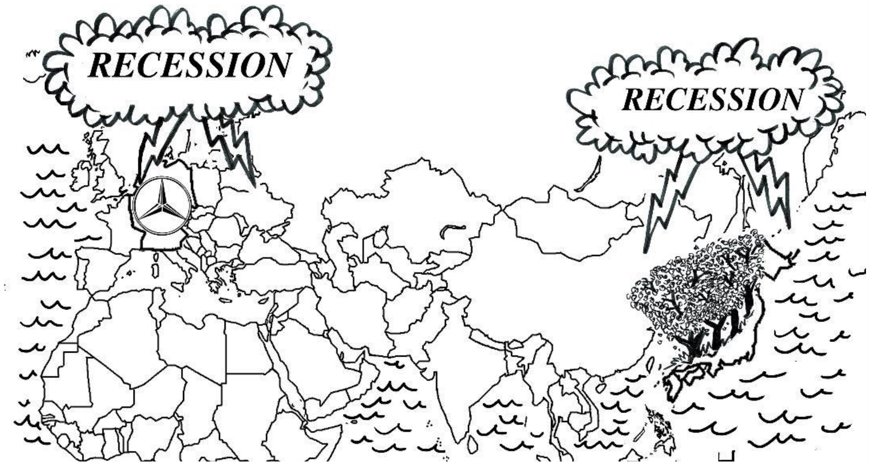
In fact, the US slow-down has been of similar proportion (3% p.a. GDP growth to 1.5%). Whereas boom in the construction sector has continued in Japan and Germany, and in the US, real estate has cooled.

Spring is bringing some optimism about potential green shoots, in Germany and China; in Japan, it is cherry blossom season. The view here is sceptical, given the attitude that real estate speculation can defy global contraction.

In currency markets, the continuing growth cycle slowdown and likely emergence of financial strains should favour the US currency, despite the fall in long-term US rates. Later, prepare for US currency offensive.

Sub-zero long rates in Germany and Japan: start of recession or of intensified "bubble"?

If a global recession emerges now, it would be the first time with long-term interest rates at zero (or even sub-zero levels), in major areas of the world economy (Europe and Japan).



The nearest example in history was the sharp recession in the US economy (the Roosevelt recession), from May 1937 to June 1938, which started with US short-term rates at virtually zero (but 10-year Treasury yields just above 2 per cent).

There had been the equivalent of QE from 1934 to mid-1936, followed by a rapid normalization (in the form of staged hikes in reserve requirements) and a blip in money market rates.

Stock and commodity markets were in a violent rise, through 1936, with volatile conditions through the first half of 1937 (with the Fed cutting rates to zero again in the Spring), followed by the Crash (late August to October).

Construction boom vs. export sector recession:

The optimists argue that both Japan and Germany are far from recession (except, according to some flimsy statistical measures which make little sense); powerful real estate construction booms will continue and get even larger.

1 Germany

In the case of Germany, there may have been some "one-off" factors in recent weak data (dislocation of Rhine traffic, due to below normal water levels and adjustment to changes in autoemission standards) which have now faded; this process could even mean some blip in the data during coming months.

The pessimists retort that the forces behind the pull-back, in German exports, transcend temporary factors (though they acknowledge that order books are near record levels in total, for the manufacturing sector). Supporting evidence includes the weakness in key European markets (Italy, France), along with emerging market economies (especially China).

As to the real estate and construction boom, forecasting that this will continue, just because it has been continuing for some considerable time, is not persuasive, though such sentiment is characteristic of boom-time.

There is plentiful evidence of such booms coming to unexpected ends, and turning into slump, even though interest rates remain at historical lows.

Look, for example, at the bursting of the Stockholm real estate bubble in the past year. Perhaps some tightening of credit regulations played a role, but observers mostly comment that over-supply and growing apprehension, about whether sky-high prices were sustainable, were the main factors.

We have the examples, now outside Europe, of serious downturns of once hot real estate markets in Sydney, Manhattan and London, record low interest rates notwithstanding.

Grounds for caution, on the German real estate and construction boom, include the large extent of foreign participation (at least in terms of flows into the market) – estimated at 50 per cent of transactions or more – and the high temperature in the commercial real estate market, especially offices helped by Brexit, in the case of Frankfurt, (with some signs of overall supply already evident, according to some experts). The buoyant letting demand in the commercial sector can suddenly ease, as history suggests, especially if global and German economic cycles turn downwards.

The long-standing debate lurks here – can asset inflation turn to deflation, without any explicit tightening of monetary policy by the central bank?

The pessimists point to potential sources of financial instability in Germany – including the conditions of the banks, the extent to which financial institutions there have got involved in "maniac strategies" out of desperation for yield (including, for example, huge positions in the currency and credit trades), and how this could all back-fire.

2 Japan

The debate between pessimists and optimists is broadly similar for Japan.

The macro-economic numbers have been surprisingly weak through the winter, driven by a downturn in the export sector (related especially to China and emerging markets) and related capital spending.

Yet, the real estate and construction boom remains in full swing, centred on parts of Tokyo and broadening out.

The Olympics are more than a year ahead. The further 2 percentage point hike in sales tax is programmed for this Autumn but will largely be offset at first by fiscal easing elsewhere; both households and businesses could pull some spending forward, into this Spring and Summer.

Unlike for Germany, real wage growth has remained very modest (in part, related to a continued decline in the proportion of the labour force in “regular” employment as against cheaper “irregular” – in effect temporary contracts; also headline rises in big company-agreed pay rises have remained in tight band).

The pessimists point to some pockets (or more) of excess, already visible in construction activity – especially, apartments to rent, and more generally, highly speculative lending by the regional banks who have been starved of lending opportunity but have abundant deposits). Furthermore, there is a large foreign buying element in Tokyo real estate (especially Chinese, often traded via Taiwanese companies), and some analysts see this as indicative of a presently high and unsustainable speculative temperature.

Also notable is the growing potential instability in the Japanese financial system going well beyond the regional banks. For example, cross-border lending, by Japanese banks, is up by more than 30% since 2010 and exceeds that of any other nation (including the US). Recall that Japanese mega-banks were large buyers of European bank assets, during the European sovereign debt crisis and its aftermath.

The dollar funding of this cross-border lending (and other foreign asset accumulation including credit paper) is far from secure (with the lenders likely to pull back in a global liquidity tightening). It could be argued though, that in a crisis, the Bank of Japan could deploy a part of its huge foreign exchange reserves, for the purpose of relieving any tightness of dollar funding.

Symptomatic of underlying fragility, in Japan’s international financial position, is the highly distorted pricing in the basis swap markets, involving the yen (mainly dollars vs. yen). This stems from the huge appetite for credit paper (including borderline investment grade, the BBB corporate bonds in particular), and in some cases, long-maturity government bonds outside Japan by Japanese life companies, trust companies, and asset managers, searching desperately for yield, but intent on hedging exchange risk exposure. Without access to secure or cheap dollar funding, they use yen funds, and cover the exchange risk in the basis swap markets (effectively lending yen and borrowing dollars there, in one combined swap transaction).

These distortions mean that dollar-based investors can earn attractive yields on JGBs, for example, when swapped into dollars (via the basis swaps) – an indication of the poor returns that Japanese investors are likely to make in the opposite direction (hedging dollar assets back into yen).

Pessimistic scenario is persuasive

Overall, the central scenario here is closer to the pessimistic take than the optimistic view.

Yes, the boom could have further to run in Japan and German construction. But in terms of the business cycle, that is less important than overall export sector strength or weakness. The balance of risks is towards further global weakening, notwithstanding the appearance of what could be interpreted provisionally as green shoots, this spring (whether in Germany, Japan or China).

Indeed, one could say that the Japanese and German economies are doubly vulnerable – not just to the revelation of serious mal-investment (or over-investment) in the key export sectors, but also to the shock of asset deflation in domestic real estate markets and in global equity and credit markets, with financial institutions vulnerable.

Suppose Germany and Japan do indeed sink into recession, in coming quarters, with long-term rates still negative at the peak of the cycle (on the eve of the recession), does that raise serious challenges for a subsequent recovery?

The pessimistic argument is "out there" that such low starting rates add a serious element of risk related to the subsequent recession, as the normal kick-start, which would come from a fall of interest rates, cannot apply in these circumstances.

On closer examination, there are indeed grounds for concern, but not those listed by the neo-Keynesians and related monetary radicals, who would meet the new situation by even greater monetary and fiscal abandon than in the recent past.

Pro-cyclical rate moves

Interest rates, and especially long-term rates, typically move pro-cyclically and exert a restraining influence both during recessionary and boom phases of the business cycle.

In a strong expansion phase, when apparent investment opportunity is expanding faster than available savings, rates in real terms rise (so reining back spending); conversely during the downturn, when investment opportunity dwindles relative to savings.

In this present cycle, the manipulation of long-term rates by central banks has stymied this stabilizing economic mechanism.

Correspondingly, some other mechanisms have loomed larger (in tending to brake cyclical momentum) within a context of dampened investment opportunity (where the dampening results from the manipulation).

The policies of interest rate manipulation, by promoting large uncertainty about the long-run future – concerns about an eventual crash in financial markets, especially equity and credit – tend to dampen investment in long-gestation projects, at least, in the advanced economies.

In the case of the great exporting nations, including Germany and Japan, the big corporations in this sector realize that present circumstances, favouring their business, may be transitory.

On top, long-term interest rate manipulation has tended to fuel monopoly power; companies that seem to have power to collect large monopoly rents now or in the near future have a special appeal to income-famished investors in many cases driven into irrational calculation (including lack of normal scepticism about story-telling). Speculative narratives about a given business having actual or potential monopoly power prove very popular.

Monopolists restrict supply and spending, in their pursuit of maximum rents.

Even without rates rising, there are some inbuilt factors which rein back spending, as the cycle gets mature.

These include a “sense of timing”. As the years run by, there is some unease, amongst business decision makers, that the next recession is on its way.

Growing mal-investment, which has occurred under the conditions of great monetary distortions, begins to cause the chickens to come home to roost (returns begin to disappoint).

Finally, the emerging market economies, where long-term rates have been less subject to manipulation, tend to follow a more traditional rate cycle, where indeed rate rises, together with balance of payments crises, begin to rein back activity. This, in turn, feeds back into the advanced economies, via their export sectors.

Stymied monetary policies

The restricted space, for long-term rates to perform a contracyclical function, is different in nature from the stymied scope for monetary policies.

Many of the economists, who complain about the latter, are thinking of central bank policies to inject stimulus, during the weak phase of the cycle. But the success of such policies (of stimulus) is very much in doubt. Sadly, this will not prevent the central bankers trying again in the next recession. We already have the spectacle of ECB Chief Draghi talking loud on this issue and promising much.

Yes, in some circumstances they can trigger a devaluation of the national currency and some asset price inflation. Sometimes, these could provide a temporary boost to the economy; but even that is uncertain, if everyone knows exactly what the central bank is up to.

It is now widely recognized that the so-called monetary stimulus, after the Great Crash of 2009, produced the slowest ever recovery of the US economy from the Great Recession. The ability of central bankers to fine-tune their monetary instruments, to produce a better than otherwise path of the economy through successive business cycles, is highly questionable.

This failure poses an over-riding political issue.

With the scope for monetary policy stimulus, dubious at best, and long-term interest rate declines, limited by the starting position, how do governments facing election timetables respond to economic downturn?

Political responses to recession

In the case of Germany, domestic and foreign (from G-20) pressures would lean towards tax cuts, given the starting position of fiscal surplus (even though this is illusory, given all the camouflaged commitments to other EU nations, especially in the context of EMU).

The size, and effectiveness of fiscal reflation, would be in doubt though, except amongst doctrinaire Keynesian school economists. Temporary fiscal boosts do not generate economic renaissance and may to a large extent be thwarted by rational private sector calculation.

Anyhow, for the US and Japan, the space for discretionary fiscal stimulus is limited by the weakness of their fiscal positions, on the eve of recession.

Most probably, the political pressures in the US would be in the direction of dollar devaluation, which incidentally would worsen the immediate recovery prospects in Germany and Japan. Amidst the other European countries, the option of cutting loose from the euro, and devaluing as a route out of recession, would likely increase in political attractiveness.

Anti-trust policies and de-regulation could emerge, as a part of economic recovery policies.

The opposite though is also possible, with government seeking to cooperate with Big Business to stabilize the economy.

On balance, going after the rental incomes of the big monopolists, and attacking their predatory behaviour (which inhibits small companies competing), is more likely to prove more popular than corporatist pacts.

The Great Depression saw both in succession – first the corporatist policies of President Hoover and President Roosevelt in his first term, followed by re-vamped anti-trust policies and their implementation.

Innate mechanisms of recovery operated by invisible hand

Beyond these policies are the innate mechanisms which guide the invisible hands, to produce economic recovery.

These include a cyclical fall in goods and services prices, which encourages businesses and households to bring forward spending. Alongside are the forces of creative destruction which become prominent, as the zombie companies fail.

A transitory cyclical fall in wages can stem present declines in profits, and underpin a turning point in the equity market, after the initial sharp falls.

Those economies, where there is still scope for powerful cyclical falls of interest rates, might lead the overall global economic recovery.

Market strategy update

The decline in long-term fixed-rates, led by the US in recent weeks, has reflected a growingly pessimistic assessment of global economic conditions.

The overall strength of equity markets is consistent with a dominant view that there will be no recession this time, and that a growth cycle upturn would likely emerge, within several quarters.

Specifically, US economic growth has slowed to say 1.5% p.a. in the two quarters, ending 2019Q1 and may plateau around this level (according to consensus view), before re-accelerating.

The view here is more pessimistic, putting a significant probability on overall recession emerging in several key areas of the global economy, this year and next.

Consistent with that view, the recent decline in US long-term rates (10-year down, from peak of near 3.20% in mid-2019 to around 2.40% now) does not mean a new lease of life for asset inflation, in its various forms – in fact the opposite.

Economic downturns cause speculative narratives to wane, even if not synchronously in real time.

The fall in US yields, which has surpassed that in Germany or Japan both in nominal terms, does not spell a weaker dollar, at this phase of the cycle. Arguably, the contemporaneous fall in inflation expectations means that the real yield decline is smaller; and the greater resilience of the US economy at this point, together with relative financial strength, should underpin the US currency.

The danger for the dollar comes with the launch of devaluation policies into the recession, when it arrives.

Before that, the force of financial flows – including a tendency for Japanese and German investors to cancel expensive hedges of their US exposures (for example in credit markets) – could add to the dollar's strength.