Ship of fools

At a recent investor conference in Tokyo, we were lucky enough to be addressed by Japan’s Prime Minister Shinzō Abe. The gist of the premier’s short speech was an assurance that the policies put in place to tackle Japan’s protracted economic malaise (the eponymous ‘Abenomics’) remained on track. Economic growth was picking up and the deflationary mindset, seen as so corrosive to Japan’s prosperity, was finally being expunged.

To us, the inconvenient truth is that the economic numbers emanating from Japan indicate nothing of the sort. Abenomics was launched in late 2012 and trumpeted a 2% per annum increase in consumer prices within 2 years, but the rate of increase in the Consumer Price Index (CPI) has been near 0% per annum over the last 12 months. Even excluding food and energy prices, the rate is currently only 0.5% per annum, while the growth in real GDP has averaged just 0.5% year on year for the last two years. In addition, export volumes have risen by less than 5% from their levels in 2012, despite the benefit of significant currency depreciation.

It seems to us that deflation is not, in itself, ‘the problem’, but rather a direct symptom of structural and societal factors affecting not just Japan, but most developed economies. Japan’s demographic challenges seem, however, particularly acute. It is hardly surprising that an economy that is seeing contraction in not just the working population, but also in the total population, is struggling to grow. This, allied with widespread domestic overcapacity (not to mention a global lack of pricing power), goes a long way we think to explaining why mild deflation has been an issue in Japan for two decades or so. Moreover, with relatively stagnant wage growth, some deflation in households’ costs has kept real incomes positive (in stark contrast to the U.S.).

Abenomics, as originally conceived, may have been a reasonable idea: implement painful structural reforms, and offset the discomfort with loose fiscal and monetary policy. The problem, we believe, is that, in practice, little structural reform has been achieved; monetary policy, via the Bank of Japan (BoJ), has been the main lever.

The Japanese example illustrates two important points that we believe are applicable to most of the world’s largest economic blocs. First, monetary policy is highly unlikely to be the answer if the economies face structural challenges; and most often such policy distracts policymakers from the politically difficult main event.

Second, by giving the helm over to the monetary maestros, we believe we are increasingly heading into perilous waters, with those on the bridge not entirely sure of their current location, far less where they are going. In this modern day ‘ship of fools’ the navigation method is largely the use of ‘models’ that approximate the world in terms of a framework of simple assumptions. Pesky details like human behavior, the structure of the financial system, and levels of debt are either excluded or considered unimportant.

Happy anniversary

Against this backdrop, the first quarter of 2016 marked the seventh anniversary of the bull market in the U.S. equity market’s S&P 500 index – currently the third longest ‘risk-on’ period in history. Who would have believed that in 2009?!

The FT’s Alphaville column notes, however, that: “…the ‘seven year glitch’ is that the underlying narrative of markets remains deflationary, despite 619 global interest rate cuts, $10.4 trillion of financial asset purchases by central banks, $9.0 trillion of government debt yielding 0% or less (equalling 23% of all government debt in the world), and now 489 million people living in countries with official policies of negative interest rates (Japan/Eurozone/Switzerland/Sweden/Denmark).”

To extend the navigation analogy, this was not where we were supposed to be by now! Higher financial asset prices were supposed to have created a ‘wealth effect’ which would boost the underlying economy, raise inflation expectations, and ‘normalize’ interest rates.

1 Source: Thomson Reuters Datastream, April 2016
2 Source: Thomson Reuters Datastream, April 2016
3 Source: Thomson Reuters Datastream, April 2016
4 Italphaville.ft.com/2016/03/09/2155783/happy-anniversary
At the outset, both the stimulus and the artificial boost to asset prices were expected to be temporary. Once the economy was ‘jump-started’, the stimulus could be wound down as economic activity and asset prices moved to some kind of sustainable equilibrium. As it has turned out, of course, policy has not been temporary, and neither asset prices nor economic activity have normalized. We regard asset prices and risk as remaining elevated, while the real economy (on a global basis) continues to languish. Moreover, we observe that almost all agencies and central banks continue to downgrade their expectations for growth, inflation and interest rates.

We have argued that these policies were never likely to work in the way they were intended. Contrary to official expectations, we believe that persistent use of ever-looser monetary policies actually exacerbates the deflationary headwinds the world faces. Put bluntly, in our view, persistent use of ever-cheaper money encourages both oversupply of goods and services and excess in the economy’s stock of liabilities (debts), which in turn require ever-lower interest rates in successive cycles. As time goes on, the distortions and vulnerabilities in the real economy and financial system (such as increasing misallocation of capital and investors herding en masse into risky assets) build to a level which triggers the next crisis.

Markets rebel, policymakers respond...repeat

In the eyes of policymakers, loose and unorthodox monetary policy influences the economy through several channels: ever-lower rates are thought to ease the availability of credit (the credit channel) and improve competitiveness (the currency channel). The dominant driver is, however, thought to be the portfolio-balance channel, through which investors and savers are ‘encouraged’ to migrate toward riskier assets, which in turn inflates their prices and thus creates the positive effects on wealth.

We have long questioned the wisdom of using financial-asset inflation as the dominant policy tool. Quite apart from whether it actually works (which we doubt), once embarked upon it is very hard to reverse. We think that investors quickly become conditioned to policymakers’ asymmetric responses to asset price movements. The underlying belief becomes that asset prices cannot be allowed to fall and that policymakers have no choice but to step in and support them on any set-back (the so-called Federal Reserve ‘put’).

In our view, such state manipulation of financial markets breeds unintended consequences that inevitably require further intervention, ultimately condemning policymakers to have to set policy to suit markets.

Certainly, whenever the gap between market expectations (as reflected in prices) and economic fundamentals has threatened to close, the authorities have seemed compelled to act. The market swoon last summer, for example, appeared to be reversed in the wake of increasing market controls and asset purchases by the People’s Bank of China (PBoC), as well as the U.S. Federal Reserve (Fed) stepping back (again) from raising rates in September.

Wind forward to January 2016, and the boost given to risk assets in the final quarter of 2015 had well and truly faded. Weak economic data fuelled a renewal of concerns about global growth, the credit cycle and the health of energy and commodity producers. Positioning by leveraged speculative players (an increasingly large part of today’s financial system and a further symptom of cheap money) became extreme.

In the wake of this most recent market tumble, we have seen each of the ‘big four’ central banks (the Fed, European Central Bank, BoJ and PBoC) either ease policy or step back from tightening. The same illiquidity that contributed to the sharp downside moves has also magnified the reversal; a more than 10% fall in the U.S. equity market has been met with an equally sharp ascent. Similar moves have been seen across geographic regions and across the spectrum of risk assets. As is also usual, investor sentiment has improved markedly in tandem with market prices. The narrative has once again appeared to swing back to a belief that China’s growth challenges are being addressed, that Mr Draghi will continue to do ‘whatever it takes’ in the eurozone, and that a slightly better tone to data confirms that the U.S. economy is indeed fixed.

Although disaster has been averted once again, we see very little as having changed in the real economy, where vulnerabilities remain. Growth expectations are still being downgraded, the profit cycle has peaked and is turning down, and risk assets continue to trade on well above average valuations.

In this context, we think the rollercoaster ride is likely to continue.

The Fed becomes more dovish

At its March meeting, the U.S. central bank decided not only to keep interest rates on hold, but also to downgrade its expectations for the pace of future rate rises (from four 0.25% hikes in 2016 to two).

To us, this is clearly a climb down for the Fed, although such behavior is not new for an institution that we believe consistently overestimates its impact on the real economy (and underplays its effect on the financial system), and which we see thus as having

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5 Source: Bloomberg data, April 2016
6 Source: Thomson Reuters Datastream, April 2016
been found to be perennially over-optimistic in its interest-rate forecasts.

As if to confirm what we have just said about central banks setting policy to suit the markets, this recent Fed decision comes despite the fact that the two variables that they see as most important – employment and domestic inflation – have actually been the most robust data points recently.7

Having gone to great lengths to convince markets that decisions about the pace of rate normalization would be data-dependent, this seems not to be the case. With unemployment below 5% and core CPI (at 2.3% per annum)8 currently above the Fed’s 2% target being insufficient to trigger a hike, we think investors could be forgiven for being conditioned to the belief that the U.S. central bank exists to support asset prices.

**Running out of ammo?**

What we find most remarkable is that risk assets are still responding positively when the authorities do more, despite little or no evidence to date that doing more actually improves the fundamental backdrop.

However, we detect some signs that the latest iterations of experimental monetary policy being applied outside the U.S. are losing potency. Imposing negative interest rates on some bank liabilities, for example, is not being seen as universally bullish. We see the clearest demonstration of this being in Japan, where the move to introduce negative interest rates in January was greeted by a 25% drop in equity prices in the bank sector.9

How widely could negative rates be adopted? At the current time it is hard to envisage their adoption in the UK or U.S., and their use may well be short-lived elsewhere. The genie is, however, out of the bottle; the monetary authorities see themselves as no longer bound by interest rates at zero. They strongly believe that they have not run out of ammunition: if economies continue to disappoint we should expect more exotic and experimental forms of stimulus.

In the minds of central bankers, the transition from low rates to no rates, to quantitative easing, to negative rates and beyond appears to represent a seamless continuum of increasing stimulus. Back in the real world, of course, this is clearly not the case; subsequent iterations tend to incentivize different behaviors and create additional unintended consequences. If banks, for example, are unable to pass on negative interest rates to ordinary depositors, their profitability could collapse. Penalizing deposits turns cash into a ‘hot potato’ that needs to be passed on as soon as possible. Unless physical cash is banned, the populace would have an incentive to hoard it outside the banking system. Numerous ‘alternative’ currencies would, we believe, be likely to develop. Debtors would clearly rejoice, although the moral hazard associated with being ‘paid’ to borrow could be immense; demand for such ‘loans’ would theoretically be unlimited.

In practice, however, ever-lower interest rates do not necessarily mean more credit growth. With an already-high stock of debt, the appetite for new borrowing is limited at any cost, and we think being penalized for holding precautionary savings is hardly likely to encourage large swaths of the population to go out and spend or take more risk. In addition, regulatory changes in banking appear also to be reining in banks’ appetite to take risks.

In such an upside-down world, we believe the current fashion for ever-more intervention would be likely to see the state increasingly involved in directing the flow of private credit into the economy (possibly by using so-called macro-prudential measures which were originally intended to control risks to financial instability) if the credit-driven economic model of the last three decades is to continue in a deflationary world.

To us, this would be a bizarre turn of events. Whereas the general expectation has been that globalization would increasingly see China adopting western-style market-driven capital allocation, developed-economy policymakers may find themselves increasingly opting for China-style state planning as the public sector is marshalled to take up the perceived and persistent ‘slack’ in demand!

**Investment policy**

We remain of the view that a combination of elevated risks and high financial asset prices (implying low expected returns) continues to present a generally unattractive opportunity set for investors, which leads our strategies to be cautiously positioned in general. Although markets have shown significant volatility in the year to date, and have rallied hard from their February lows, we remain reticent to speculate on which assets may, or may not, benefit from the injection of yet more monetary ‘stimulus’, when valuations are already stretched. As the experience in Japan so far this year perhaps demonstrates, attempting to pre-empt an extension of the policy-induced ‘risk-on’ rally can lead to unanticipated losses.

With the longer-term growth trajectory remaining challenged, we expect that the best opportunity for a rebound in corporate pricing power and profits is likely to be if a cycle of defaults is allowed to occur. Policy stimulus that simply enables existing credits to be rolled over can exacerbate downward pressure on profit margins. As such, we are maintaining a highly selective focus on companies that are able to

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7 Source: Thomson Reuters Datastream, April 2016
8 Source: Thomson Reuters Datastream, April 2016
9 Source: Bloomberg
Demonstrate pricing power, have stronger balance sheets, and are able to generate positive cash flows, and we are generally avoiding credit risk.

We continue to try to minimize complexity, counterparty risks and exposure to leverage. In this regard, we see the financial sector as generally challenged by this backdrop. While additional measures to raise asset valuations may provide temporary relief, we think the damage to business models from what appear to be increasingly permanent low interest rates remains an underappreciated problem. Against this backdrop, we believe the opportunities among more innovative businesses and companies that are less reliant on a policy-driven upswing in demand remain attractive, especially where costs decline as input prices moderate, and where balance sheets are not encumbered by excessive debts.

We are mindful that, at later stages of the economic cycle, it is possible for price pressures to rise. With government bond yields at low levels, and inflation risk premia below historic norms too, it is possible that investors could become more concerned that the Federal Reserve has fallen ‘behind the curve’ in not raising rates soon, or quickly, enough. While we see this as likely to be a temporary phenomenon, such a move could push yields higher and represent a near-term challenge to ‘bond-like’ equities.

The UK referendum on membership of the European Union (EU) also represents something of an unknown. We believe the uncertainties caused by this event are a clear negative to UK interest-rate expectations in the near term and to the immediate prospects for sterling and domestic UK assets. Should the June poll conclude with a vote to leave the EU, this uncertainty could be exacerbated both in the UK and across the EU, as both sides seek to negotiate exactly what a UK departure means.

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