HERMES
INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

Take Note, September 2017

UNCHARTED TERRITORY:
Preparing for monetary policy normalisation

After a decade of ultra-loose monetary conditions, the US Federal Reserve, European Central Bank and Bank of England have set the stage for a fourth quarter where all three could simultaneously begin to normalise policy. Here we assess how Hermes Investment Management is preparing for such a shift.

In the event of a financial crisis, specific policy tools – conventional and unconventional – can be deployed by central banks. The 2008 global financial crisis was no different.

After cutting benchmark US interest rates from 4.25%-0.25% in the space of a year, on November 25 2008 the Federal Reserve embarked on its first round of quantitative easing (QE) to stimulate growth and buoy inflation. Other central banks also employed unprecedented stimulus measures in an attempt to arrest the global economic downturn.

Their response to the global financial crisis ultimately shaped the post-crisis investment environment. And today, the extreme impacts of ultra-loose policies are evident:

$9tn: The outstanding amount of bonds that still trade with a negative yield

Bloated balance sheets: The six central banks that embarked on QE in the post-crisis era have amassed $15tn of financial assets – accounting for a fifth of their countries' total government debt[1].

Negative-yielding bonds: The outstanding amount of bonds that still trade with a negative yield is $9tn[2]. Swiss government bond yields all the way out to 10-year maturities are negative.

Mammoth global debt pile: Total global debt ballooned to $217tn as at Q1 2017, compared to $149tn in 2007[3].

A supercharged equity bull run: Equity indices have hit a series of record highs. The S&P 500 set a new record peak earlier this month, up almost 269% from its March 2009 nadir, marking the second-strongest cyclical bull market in US history[4].

In essence, central banks' response to the financial crisis turned the normal rules of financial markets upside down. It spurred investors to hunt for yield, resulting in an era of unprecedentedly low volatility. Since the crisis, high-yield bonds have become the best-performing asset. Furthermore, ultra-low interest rates have facilitated record amounts of corporate debt issuance. And a large portion of that debt has gone towards share buybacks, thereby boosting share prices – often in the absence of real business growth.

269%: The amount the S&P 500 index has gained since March 2009

[1] "Central banks hold a fifth of their governments' debt", published by Financial Times on 08 2017 [2] "Over $9tn of bonds trade with negative yields", published by Financial Times on 08 2017 [3] "Emerging market borrowing spree lifts global debt to record $217tn – IIF", published by Reuters on 06 2017 [4] "S&P 500 at 2,500 latest milestone for a supercharged bull run," published by Bloomberg on 09 2017

Start of the Great Unwinding?

But change is imminent. Recent economic data and hawkish statements from the Fed, ECB and BoE have set the stage for a fourth quarter where all three banks could simultaneously move to normalise policy after years of easy money.

In the US, concerns about soft inflation have eased after the US labour department released unexpectedly strong inflation data in August, making it likely the Fed could raise interest rates in December[5]. The Fed has raised interest rates twice this year – bringing the total number of rate hikes since the global financial crisis to four. The median projection for the federal funds rate is 1.4% at the end of this year and 2.1% by the end of 2018[6].

The US central bank has been making noise ahead of the removal of monetary largesse. Fed chair Janet Yellen is taking a measured approach towards monetary-policy tightening: it will be the policy equivalent of "watching paint dry" and will "run quietly in the background"[7]. That is in stark contrast with the 2013 'taper tantrum', when her predecessor Ben Bernanke abruptly suggested the Fed was considering scaling back its bond purchases and financial markets took fright.

At its September meeting, Yellen announced that the bank will begin to reduce the size of its $4.5tn balance sheet next month. The FOMC said the bank will "gradually decrease" its reinvestments by $10bn from October through December, rising over the course of next year to maximums of $50bn per month until the balance sheet is taken back to the $1tn considered "normal"[8]. Of course, this announcement was widely expected, as Yellen had already outlined the Fed's normalisation plans in June.

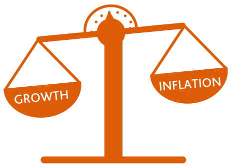
The ECB has also signalled that it would decide in October how to phase out its €60bn-a-month bond-buying programme. At its September meeting, ECB President Mario Draghi confirmed that policymakers had a "very, very preliminary discussion" about scaling back QE, which is scheduled to expire in December[9]. The eurozone is enjoying its strongest run of economic growth in more than a decade. And although inflation has lagged – as it has in the US economy – the latest economic data showed that inflation in the region has accelerated to a four-month high[10]. This makes an announcement about the reduction of monthly asset purchases at next month's meeting likely.

Earlier this month, the Bank of England gave its strongest guidance in a decade that it is poised to raise interest rates. In its September minutes, the Monetary Policy Committee noted: "some withdrawal of monetary stimulus is likely to be appropriate over the coming months in order to return inflation sustainably to target.[11]" It followed a sharp rise in inflation in August. At 2.9% it marked its joint-highest level in more than five years, reflecting a sharp depreciation in the pound following the referendum on EU membership[12].

The Bank of Japan has maintained its expansionary stance so far this year. And at its September meeting, new board member Goshi Kataoko voted in favour of more stimulus, as he believes the current policy is not loose enough to meet the inflation target of 2%[13]. But not everyone agrees. Former currency chief at the Ministry of Finance Hiroshi Watanabe thinks the central bank should start reducing its annual bond-target later this year: "Just as an endless intravenous drip becomes ineffective, monetary policy should be changed to reduce stimulus once the economy is no longer facing any headwinds.[14]"

BANK OF JAPAN

[5] US consumer inflation clocks biggest rise in seven months as Harvey pushes up gas prices," published by Financial Times on 09 2017 [6] Chair Yellen's press conference opening remarks," published by US Federal Reserve on 09 2017 [7] "The Fed wants to go on 'autopilot'", published by CNBC on 06 2017 [8] "Chair Yellen's press conference opening remarks," published by US Federal Reserve on 09 2017 [9] "ECB begins discussions on tapering QE despite stronger euro", published by Financial Times on 09 2017 [10] "Eurozone: inflation hits highest in four months," published by Reuters on 08 2017 [11] "Monetary Policy Summary and minutes of MPC meeting ending on 13 September 2017," published by Bank of England on 09 2017 [12] "UK consumer price inflation: August 2017", published by ONS on 09 2017 [13] "Statement on Monetary Policy", published by Bank of Japan on 09 2017 [14] "Why BOJ should stop being obsessed with 2% inflation goal", published by Bloomberg on 09 2017



A delicate balancing act

Investors have waited patiently for a shift in monetary policy. Yet the path towards monetary policy normalisation is not sign-posted. Instead, much will depend on how central bankers communicate these changes in policy to avoid an extreme market reaction – it is a delicate balancing act with ample scope for error.

For long-term investors, there are key considerations: will the reversal of QE push government bond yields higher? Will the imminent withdrawal of central bank stimulus puncture the buoyancy of global equity markets? What will it mean for other financial assets? And is a move towards simultaneous monetary policy normalisation the biggest danger facing markets in the fourth quarter?

At Hermes Investment Management, our investment teams are preparing for a shift in monetary policy. Here's how they're braced for a fourth-quarter move towards normalisation:

Fraser Lundie, CFA – Co-Head and Lead Credit Portfolio Manager

Credit, as an asset class, has benefitted strongly from the long-running bond bull market and, perhaps more importantly, from the negative relationship between government bonds and credit spreads. This served as an internal defence mechanism for corporate bonds, enabling a smoother return profile than what other asset classes could offer. We recognise that this is unlikely to continue as inflation expectations rise and central banks inch towards monetary policy normalisation. As such, this defence could well become a 'Texas hedge' – a financial hedge that increases rather than reducing risk.

As we emerge from this central bank-induced bubble, rather than hoping the status quo continues, we will use our mandate to invest worldwide and throughout capital structures to access an expansive set of opportunities and sources of liquidity. This includes applying the defensive strategies that are deployed in our Hermes Multi Strategy Credit and Absolute Return Credit capabilities.

The globalisation of credit markets continues. Increasingly, we analyse companies based on where they compete with each other, rather than where they are domiciled, what their comparative credit ratings are or what instruments they issue. Companies compete globally, and our analytical framework reflects this reality.

Gary Greenberg – Head of Hermes Emerging Markets

Emerging markets are now far more resilient to a withdrawal of US stimulus than during the 2013 'taper tantrum'. Yellen has provided consistent and clear notice of the removal of monetary largesse.

While inflationary pressures are picking up, inflation in emerging markets is trending below 5% – compared with more than 20% in the 1990s – thanks to improved policymaking. As such, a shift in US monetary policy is not currently a major concern for emerging markets. We believe the moves by the Fed are precautionary, and will run their course long before rates rise 1.25% from their current level, which is when emerging market economies would likely be impacted.

Emerging markets have experienced consistent capital outflows from 2012 through to 2015. Over the last year and a half, that has reversed: in the first six months of 2017, $160bn flowed into emerging market debt[15]. Yet this is by no means a crowded trade at this point.

As we move towards the global normalisation of interest rates, we've integrated a yield ratio analysis into our top-down approach. This allows us to perform scenario analysis under various interest rate regimes.

Lewis Grant – Senior Portfolio Manager, Hermes Global Equities

We consider macroeconomic events but are ultimately stock pickers. While macro factors can influence markets, these externalities – and the market's subsequent response – are impossible to forecast correctly on a consistent basis and do not ultimately determine the long-term performance of companies. Nevertheless, the significance of a shift towards monetary policy normalisation is a pivotal moment for financial markets and the level of guidance provided by central banks should ensure that investors are primed for such a policy shift.

Our proprietary risk management tools enable us to anticipate the potential impacts of macroeconomic risks. Looking ahead, the combination of soft inflation data and accommodative central bank rhetoric suggests that rate hikes will be gradual so as to not dampen economic growth. For the market, the pace of these changes matter: rising rates alone will not bring an end to the global equity rally, but there will be winners and losers.

First, let's look at the likely losers. The defensive, seemingly safe dividend payers – the bond-proxy stocks – have become incredibly overvalued in the low-rate environment. Already we have seen a pull-back in valuations as rate rises approach. These names are especially vulnerable if rates normalise at a faster pace than anticipated. As such, we continue to avoid investments whose valuations appear inflated solely due to a steady dividend stream.

Banks, insurers, brokerages and asset managers should be among the winners, given that they tend to perform well as interest rates rise. Banks, for instance, benefit from greater spreads on deposit accounts, while brokerages and fund managers typically attract more business as rising rates signal a strengthening economy and therefore greater investment activity. As we inch towards normalisation, our portfolios remain exposed to a range of well-managed companies in this sector, particularly retail-focused banks with strong deposit bases.

Preparation is key

As the fourth quarter beckons, the simultaneous tightening of crisis-era ultra-loose monetary policy looks increasingly likely. Long term investors, like ourselves, may look beyond macroeconomic events. But after a decade of unconventional monetary policy, a move towards normalisation is too important to ignore. The scale of the task ahead is gargantuan and the impacts on markets unknown.

Many investors will be hoping any market reaction is measured. But it is important to actively manage risks and assess the implications of such a pivotal policy shift. For long-term investors, across asset classes, preparation is key.

[15] Source: Institute of International Finance as at 07 2017

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