OUTCOMES
BEYOND
PERFORMANCE

AHEAD OF THE CURVE

How will the world respond to the next economic crisis?

Silvia Dall'Angelo
Senior Economist

Hermes Investment Management
May 2019

For professional investors only

www.hermes-investment.com

HERMES
INVESTMENT MANAGEMENT

The longest US economic expansion on record spanned a decade from March 1991 to March 2001. With the country's current period of sustained growth poised to surpass this 10-year record in July, we examine the possible response to the next crisis.

KEY POINTS

- US economic data have been solid recently. However, the US economy is showing signs of late-cycle dynamics and some financial-market indicators are flashing amber with respect to recession risk in the next 12 months.
- The longer the current accommodative setting for monetary policy lasts, the easier it is for financial imbalances to build up. In turn, this increases the system's vulnerability to shocks, such as the generalised increase in trade tariffs.
- Monetary policy – which had to do all of the heavy lifting in the aftermath of the global financial crisis – has reached its limits.
- Central banks will be unable to provide the same amount of stimulus that they deployed during previous crises, particularly in a context where the real equilibrium rate (r*) is low. In addition, they will hit the effective lower bound (ELB) more often.
- As a consequence, the discussion about the opportunity – and the desirability – of larger fiscal deficits has taken centre stage. In particular, the fact that interest rates are running below nominal growth rates in the US and most developed economies implies low fiscal costs of higher public debt.
- However, public debt as a share of GDP is already high across developed countries (at almost 100%), suggesting that the space for fiscal stimulus is limited. And while accommodative monetary policy is keeping rates low, high debts might lead to higher interest rates, notably when financial markets doubt their sustainability.
- In an increasingly fragmented international landscape, monetary and fiscal policies face other challenges. It is unclear whether the response to global challenges and crises going forward will feature the coordination that is needed to ensure effectiveness.

The current US economic expansion that began in 2009 will mark its 10-year anniversary in June. The following month, it will become the country's longest expansion on record, according to the National Bureau of Economic Research (see Chart 1).

At present, economic data and fundamentals are still positive, suggesting a recession is not imminent. Nevertheless, it is natural to think about the next downturn – and the possible response to it.

In this issue of *Ahead of the Curve*, we review the possible approaches to the next crisis – from both monetary and fiscal perspectives, with a particular focus on the latter – and we highlight the challenges that may lie ahead.

THE US IS IN A MATURE PHASE OF THE BUSINESS CYCLE

Given its standing on the world stage, economic developments in the US can hardly be confined to the domestic domain. Indeed, the business cycle in the US tends to lead cycles in other countries as well as that of the global economy.

Most economic data and the accommodative policy setting suggest that an imminent recession in the US is unlikely. However, some financial market indicators (in particular, the US yield curve) suggest otherwise.

Chart 1: The five longest economic expansions in US history (from 1854 to date)

Economic expansion	Duration in months
March 1991-March 2001	120
February 1961-December 1969	106
November 1982-July 1990	92
June 1938-February 1945	80
November 2001-December 2007	73

Source: National Bureau of Economic Research as at September 2010.

Recently, US economic data have been solid. The country's Q1 GDP surprised to the upside, recording economic growth north of 3% on a quarterly annualised basis (this partially reflected the impact from some temporary factors, such as the inventory cycle). In addition, employment growth has been solid, with the labour market adding 2.6m jobs over the last year.

Conversely, consumer and business surveys – which are running at elevated levels – have shown some cracks in recent months. In particular, the composite Institute for Supply Management's (ISM) index – a weighted average of the main survey that gauges activity in the manufacturing and services sectors – declined to 55.2 in April, compared to 56 in May and a cyclical high of 60.7 in September 2018.

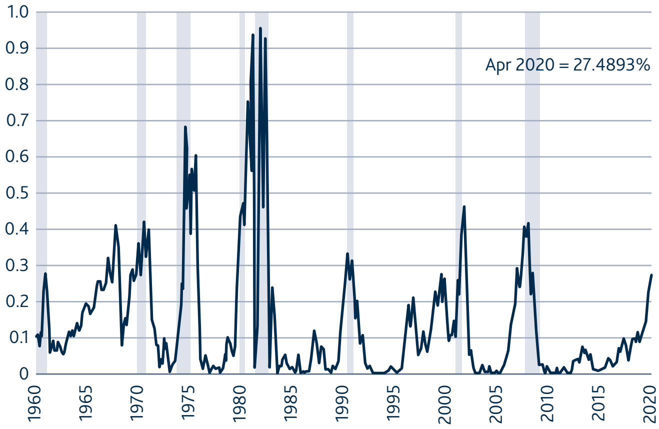
Over the last year, the expansionary fiscal stance has undoubtedly supported the country's economic performance. Fiscal policy has added on average 0.5pp to annualised quarterly growth since Q4 2017, according to the Hutchins Centre Fiscal Impact Measure.[1] This effect is likely to fade over the balance of the year, notably in H2 2019, given the profile of federal fiscal measures.

[1] "Hutchins Center Fiscal Impact Measure," published by the Brookings Institute in April 2019.

However, monetary policy is likely to remain accommodative for longer, following the US Federal Reserve's (Fed's) dovish turn earlier this year. The Fed Fund Rate is currently running at 2.25%-2.5%, which is slightly below the central bank's mid-point estimate of neutral (which is 2.75%). In addition, the Fed has announced plans to end its balance-sheet normalisation process in October, following a slower pace of runoffs in the coming months. This implies that the Fed's balance sheet will stabilise at about $3.75tn at the end of September – which is higher than Fed officials' expectations only a year ago.

In addition, recent yield-curve developments have been concerning. The US yield curve is Wall Street's favourite harbinger of recessions, owing to its strong track record: a yield-curve inversion – that is, when short-term yields rise above longer-term ones – has preceded all recessions since the end of the second world war. At the end of March, the spread between the 10-year US Treasury yield and the three-month bill rate briefly turned slightly negative. Consequently, the New York Fed's recession probability (12 months ahead) – which is based on that spread – spiked to almost 30%, marking a high for the current cycle (see Chart 2).

Chart 2. The probability of a recession in the next 12 months spiked to almost 30% in April



Source: New York Fed as at May 2019.

Former Fed Chair Janet Yellen has often said that "expansions do not die of old age".[2] But the current expansion looks increasingly tired and fragile. The US economy is showing signs of late-cycle dynamics and the US yield curve is flashing amber.

Furthermore, the longer the current accommodative setting for monetary policy lasts, the easier it is for financial imbalances to build up. In turn, this implies that the financial system is more vulnerable to even small shocks. And there is another crucial point we must consider: trade tensions between the US and China are ongoing and a further escalation involving more countries would likely lead to a recession.

MONETARY POLICY: THE EFFECTIVE LOWER BOUND ISSUE

There are limits to monetary policy, particularly in a world where it has become increasingly constrained by the effective lower bound (ELB) and inflation expectations have slipped to lower levels.

In the wake of the 2008 global financial crisis, monetary policy had to do all the heavy lifting. Both fiscal and monetary support measures were taken in the immediate response to the crisis. In addition, there was international coordination from institutions (central banks, notably) in major countries. However, as the recovery progressed in an excruciatingly slow fashion and government debt, as a share of GDP, surged in most countries, monetary policy became the only game in town. Central banks kept interest rates low and adopted unconventional measures such as Quantitative Easing (QE) – a quasi-fiscal policy.

In November 2008, the Fed resorted to QE for the first time, buying large amounts of Treasuries and mortgage-backed securities in an effort to exert downward pressure on long-term interest rates. More action was needed: a second round of QE followed in 2010-2011; the Fed announced Operation Twist – the purchase of long-term bonds financed by the sale of short-term paper, which aimed to increase the average maturity of the Fed's holdings – in 2011-2012; and a third open-ended round of QE took place in 2012-2014.

On the other side of the Atlantic, the Bank of England moved to adopt QE in 2009, while the European Central Bank (ECB) was late to the party, adopting it at the end of 2014. Indeed, the ECB also resorted to other unconventional measures, becoming the first major central bank to enter the world of negative interest rates in mid-2014. In this way, it played an integral role in shaping the response to the bloc's double-dip recession of 2008 and 2011-2012.

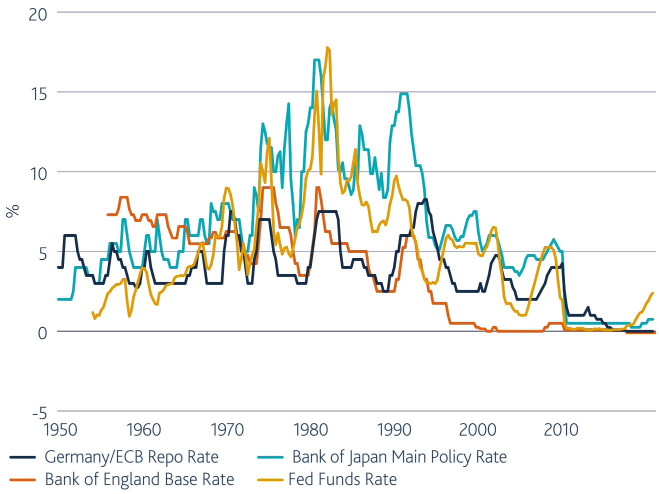
According to some critics[3], the ECB was tardy in adopting crisis-fighting policies, thereby dampening the effectiveness of such policies. But the peculiar and incomplete institutional environment in which the ECB operates implies that it would have needed political cover to implement such measures.

Today, we are navigating the late-expansion stage of the business cycle – and monetary policy space is extremely constrained. Worryingly, central banks have little ammunition to respond to the next downturn.

For a start, nominal policy rates globally have been trending downwards in recent decades; they are now running at levels that are low by historical standards (see Chart 3) and close to their lowest limit, the so-called ELB. In a world where it is possible to hold cash, the ELB is around zero or slightly negative.

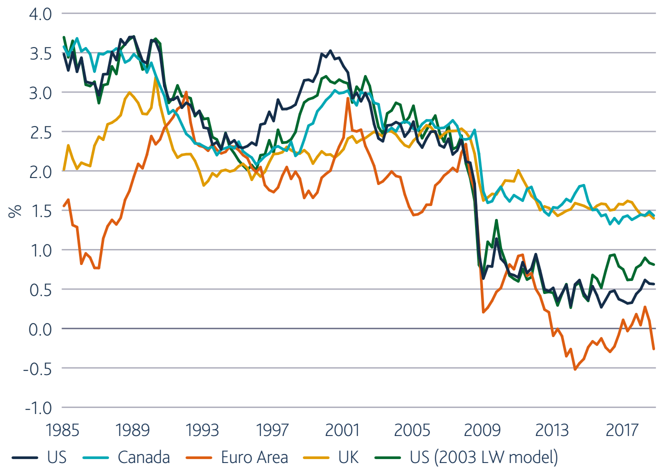
[2] See, for instance, "Transcript: Powell, Yellen and Bernanke in conversation in Atlanta," published by the Wall Street Journal on 4 January 2019.
[3] See, for instance, "The ECB's performance during the crisis: Lessons learned", by Ashoka Mody and Milan Nedeljkovic, published by Vox on 14 January 2019.

Chart 3. Policy rates have collapsed across major economies



Source: Reuters Datastream, based on National Sources, as at May 2019.

Chart 4. The equilibrium policy rate r* has trended down across the board



Source: New York Fed as at March 2019.

In order to adopt an accommodative monetary policy stance, central banks need to set their real policy rate below the equilibrium real rate – the interest rate that keeps the economy operating on an even keel – the so-called r*. R* is unobservable, but according to most estimates, it has trended down over the last few decades. The decline can be attributed to the emergence of structural factors that increase the supply of savings and/or depress the demand for investment. They include: slower trend growth (reflecting slow labour productivity growth and a declining labour force growth rate); demographics (an aging population adversely impacts the labour force and they tend to save more); weak investment (owing to low productivity and, possibly, elevated political and economic uncertainty); and international spill-overs from higher savings globally (the hypothesis of 'global saving glut' suggested by former Fed Chair Ben Bernanke).

According to the Laubach-Williams (LW) model, the estimate of r* for the US is now running at about 80bps, compared to approximately 300bps before the global financial crisis. Furthermore, the estimate of the natural rate of interest for advanced economies is similar (see Chart 4).

So, what does this mean?

Essentially, during the next recession, central banks will be unable to provide the same amount of stimulus that they deployed during previous crises. They will not be able to move the real policy rate significantly below a low r* by cutting nominal interest rates – and they will hit the ELB more often. For instance, the Fed previously responded to the financial crisis by cutting rates by an average of 500bps during its easing cycles. But, with the Federal Funds Rate currently at 2.25%-2.5%, such a move is no longer a viable option.

Low inflation expectations can be deemed as another constraint. When inflation expectations are below 2%, it means that the floor for the real interest rate is higher than it should be. In turn, a negative feedback loop would ensue between low inflation expectations and central banks' inability to lift them.

In addition, negative rates – currently deployed in the eurozone, Japan, Sweden, Switzerland, Denmark – have side effects. In particular, an extended period of negative rates could weigh on bank profitability[4], which would be especially damaging in regions where banks are the main lending channel.

At the same time, QE has probably reached its limits: although the first round of QE was successful, successive rounds (in the US and elsewhere) had a weaker impact on financial markets and the real economy, which suggests that the law of diminishing marginal returns applies to QE. Furthermore, QE has probably had adverse distributional effects, increasing wealth inequality by boosting asset prices.

In other words, major central banks only have limited options available to respond to the next crisis – that's despite reassurances that their toolboxes are still plentiful. What's more, these options will have shortfalls too. As such, the response to the next downturn needs to come from fiscal policy.

[4] See for instance, "Bank performance under negative interest rates," published by Vox in October 2018.

THE FED'S BIG RETHINK OF MONETARY POLICY

The Fed is aware that it will face limitations in a low-rate world going forward, so it is holding an official review of its strategy, including a series of town hall-style meetings called 'Fed Listens' and a research conference on 4-5 June in Chicago. The results of the review will be shared with the public in the first half of 2020.

As suggested by Fed Vice Chair Richard Clarida[5], the review will tackle three main questions:

1) Should the Fed adopt strategies that aim to reverse past misses of the inflation target?

The Fed may replace the current inflation targeting approach with price-level targeting or average inflation targeting over a cycle (in practice, they are very similar approaches). The consequences of such a decision would be significant: currently, the Fed tolerates a temporary and limited overshoot in inflation, but if it were to adopt an average inflation targeting approach, it would start to actively target higher inflation for a limited period, in order to make up for past undershooting. That would reinforce the current environment of accommodative monetary policy.

2) How can it enrich the available options in its monetary policy toolbox?

Clarida and Fed Governor Lael Brainard[6] have suggested that it may be possible to expand the Fed's toolbox to include a Bank of Japan-style Yield Curve Control (YCC) policy. However, Brainard has also made it clear that the Fed would focus on short/intermediate maturities rather than 10-year yields, stating: "We might turn to targeting slightly longer-term interest rates — initially one-year interest rates, for example, and if more stimulus is needed, perhaps moving out the curve to two-year rates"[7].

3) How can the central bank improve communication?

Communication has been an increasingly important aspect of the Fed's monetary policy since the mid-1990s. Indeed, academic research suggests that a better public understanding enhances the effectiveness of monetary policy.

FISCAL POLICY: BACK IN FASHION

Orthodox economic theories are usually wary about fiscal policy. That's because high public debt is usually associated with high costs, both in fiscal and welfare terms. High public debt has fiscal costs as it implies high distortionary taxes in the future. It also bears welfare costs insofar as it crowds out capital, decreasing capital accumulation and, in turn, weighing on output in the long run.

Indeed, these views have been corroborated by a number of empirical studies that found a negative relationship between government debt and subsequent per capita real GDP growth, especially when debt levels are high. That said, there is no consensus on the critical threshold for the debt-to-GDP ratio[8].

Interestingly, the tone of the intellectual debate has changed recently. After years of intense focus on monetary policy, the discussion about the opportunity – and even the desirability – of larger fiscal deficits has increased. Furthermore, advocates of a bolder fiscal policy response have emerged from both orthodox and heterodox schools of thoughts.

At the most extreme, the heterodox Modern Monetary Theory (MMT) has gained prominence: it has become popular among some politicians, receiving attention from investors and the media. According to MMT proponents, as long as a government has control of its currency, the only effective constraint to fiscal spending is inflation. In a context of low inflation, governments can simply print money to finance public spending.

In our view, there are risks to adopting an MMT approach. It could potentially result in the debasing of fiat currency and, in turn, hyperinflation.

More interestingly, some prominent members of more orthodox schools of thought have warmed up to the idea of higher fiscal deficits. In particular, former IMF Chief Economist Professor Olivier Blanchard has weighed in on the debate, highlighting that the fiscal and welfare costs of high public debt are low in current circumstances. For a start, as long as interest rates run below nominal interest rates, (see Chart 5) fiscal costs will be low[9]. Indeed, the government can roll over debt, issuing new debt to pay for the interest, and this debt will increase at the rate of interest. But as long as output growth outpaces the interest rate, the debt-to-GDP ratio will decline over time without the need to raise taxes.

[5] "The Federal Reserve's Review of its Monetary Policy, Strategy, Tools, and Communication Practices," published by the Fed in February 2019.

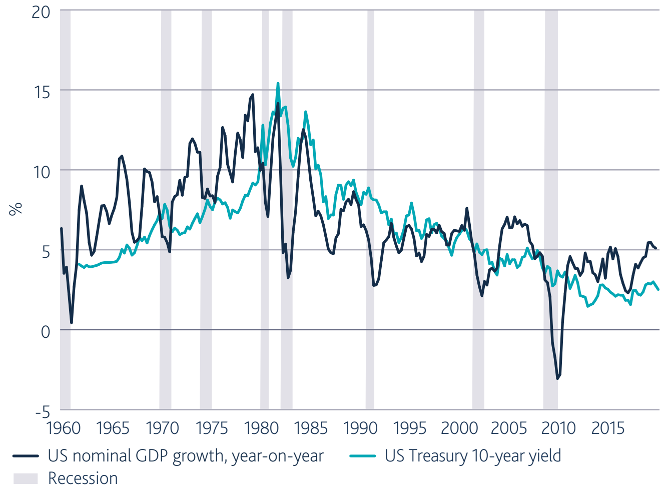
[6] "Fed Listens" in Richmond: How Does Monetary Policy Affect Your Community?" published by the Fed in May 2019.

[7] "Fed Listens" in Richmond: How Does Monetary Policy Affect Your Community?" published by the Fed in May 2019.

[8] See for instance, "Growth in a Time of Debt" by Reinhart and Rogoff (2010) and subsequent correction. More recently, "Does Public Debt Crowd Out Corporate Investment? International Evidence" by Huang, Panizza and Varghese (2018).

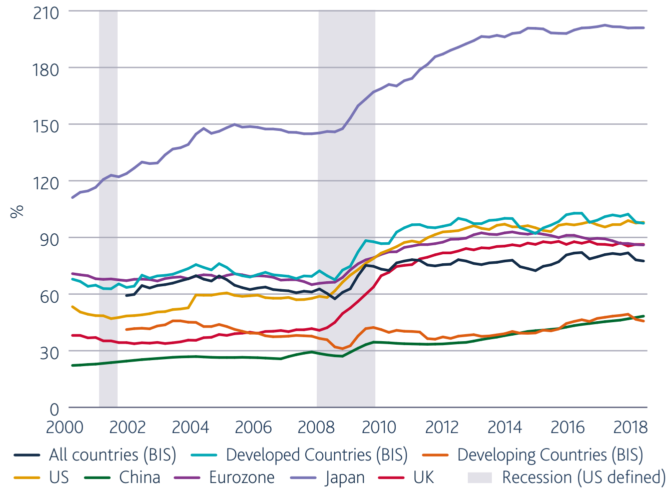
[9] See "Public Debt: Fiscal and Welfare Costs in a Time of Low Interest Rates" (https://piie.com/system/files/documents/wp19-4.pdf) and "Public Debt and Low Interest Rates" (https://piie.com/system/files/documents/pb19-2.pdf), published in February 2019.

Chart 5. US nominal GDP growth has generally been below the Treasury 10-year yield since the 1960s



Source: Reuters Datastream and the US Bureau of Economic Analysis as at May 2019.

Chart 6. Public debts as a share of GDP are running high, especially in developed countries



Source: Reuters Datastream, based on the Bank for International Settlements, as at March 2019.

Furthermore, the welfare costs of public debt are limited: the welfare costs stemming from the fact that the average rate of return to capital exceeds the GDP growth rate are partially offset by the fact that the safe rate is running below GDP growth (implying a welfare benefit of debt).

Blanchard goes on to suggest that the current configuration where growth rates exceed interest rates may persist. Indeed, it has been the norm (on average) in the US since the early 1950s. He concludes that public debt is not as dangerous as many perceive: it can be used, but it should only be used in the right way. In particular, two scenarios justify the use of fiscal policy. They are: weak private demand in a context of below-potential output and constrained monetary policy; and the funding of public infrastructure projects.

Similarly, Professor Larry Summers, who has long warned about the risks of secular stagnation, has championed a more active role of fiscal policy, notably to fund public infrastructures. While he criticised MMT, he also distanced himself from the doctrine of fiscal austerity that prevailed in the years following the crisis, endorsing a more balance approach to fiscal policy[10].

However, there is one main objection to higher fiscal deficits: public debt levels are high across most countries. The Bank for International Settlements estimates that public debt as a percentage of GDP averaged 98% in Q3 2018 across developed countries (see Chart 6). This suggests that room for fiscal expansion is limited. However, the ratio of debt-servicing to GDP is contained due to subdued interest rates, which is a mitigating factor.

Moreover, higher debt may lead to higher rates – reaching a point where interest rates exceed GDP growth rates, thereby implying high fiscal costs.

Low interest rates reflect structural factors (as mentioned already) and financial repression – that is, central banks keeping rates low. In this respect, fiscal and monetary policies are highly intertwined. The sustainability of public debts relies to some extent on loose monetary policy. This comes with risks: it poses an issue regarding the credibility and independence of central banks, which in turn could impair the effectiveness of monetary policy going forward.

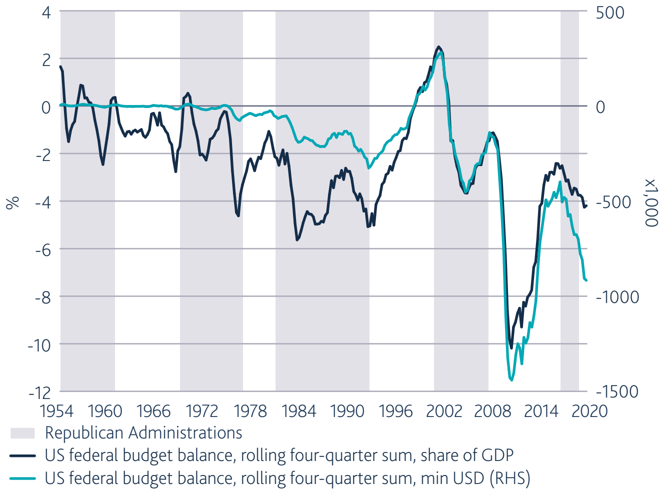
So far, Japan is an example of a country that has successfully coordinated monetary and fiscal policies. Its gross public debt is 238% of GDP (according to IMF estimates), while the Bank of Japan's YCC pins the 10-year interest rate at about 0.1%. In addition, the Bank of Japan is holding almost 50% of outstanding Japanese Government Bonds (JGBs), which points to potential debt monetisation. However, this approach is not universally available. Japan has a positive net international investment position – that is, it is a net creditor compared to the rest of the world. This means risks surrounding its high public-debt burden are limited.

In addition, financial markets and their perception of debt sustainability play a crucial role. If investors believe that debt is risky, they will require higher compensation to hold debt. The evaporation of trust in the entity issuing debt can compromise the sustainability of the debt itself.

[10] See "Who's Afraid of Budget Deficits?", published by Larry Summers and Jason Furman in January 2019.

At present, the US government enjoys full trust and investors generally see US Treasuries as the ultimate safe asset. That has been the case since the end of the second world war, when the US dollar emerged as the global reserve currency, a situation former French President Valéry Giscard D'Estaing defined as the US exorbitant privilege. Accordingly, the US has systematically run a fiscal deficit (it had a fiscal surplus in only 12 of the last 70 years). And despite the Treasury projecting a fiscal deficit of $1.1tn by the end of this year (see Chart 7), bond yields have not budged. Of course, that may change as new powers emerge to challenge the US position.

Chart 7. The US government has systematically run large deficits



Source: Reuters Datastream, based on the US Treasury and the US Bureau of Economic Analysis, as at May 2019.

FISCAL AND MONETARY POLICY CHALLENGES

Alas, monetary and fiscal policies face other challenges. To be effective during a financial crisis, international coordination is necessary. Indeed, in the aftermath of the Lehman collapse, there was a coordinated international policy response.

Today, some global challenges, such as tackling climate change, also call for coordinated policy efforts.

But in an increasingly fragmented international landscape where the fortunes of multilateralism are falling, it is unclear whether the response to current and future global challenges and crises will be effective.

HERMES INVESTMENT MANAGEMENT

OUTCOMES BEYOND PERFORMANCE

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit
Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | Denmark | Dublin | Frankfurt | New York | Singapore

For more information, visit **www.hermes-investment.com** or connect with us on social media: