

More of the Same

Global Matters Weekly

15 February 2021

– Richard Stutley, CFA

Quote: “just right, then, is a continuation of current policy and hence central bankers need to hold their nerve in the face of rising inflation and provide more of the same”

The tale of Goldilocks and the Three Bears was a popular analogy in markets in the years post the Great Financial Crisis, used to describe the global economy as not too hot, not too cold, but just right. Extending the idea to today's central bank policy: too hot would be embarking on helicopter money or large scale debt forgiveness; too cold would be abandoning tools like quantitative easing, possibly in response to criticism of QE's role in fuelling asset price bubbles; just right, then, is a continuation of current policy and hence central bankers need to hold their nerve in the face of rising inflation and provide more of the same.

Central bank policy used to revolve around managing short term interest rates. While the Bank of Japan embarked on quantitative easing to fight domestic deflation in the early 2000s, it wasn't until the Great Financial Crisis that the policy was adopted more widely. Having expanded their toolkit to include focusing on the term structure of interest rates, last year many central banks, including the US Federal Reserve, also began targeting the credit structure of interest rates by buying corporate debt.

Quantitative easing has been criticised for driving up asset prices while appearing to have only a limited impact on inflation. Higher asset prices favour current owners of those assets, hence the policy is also blamed for exacerbating wealth inequality. Lower interest rates are designed to encourage greater demand for money and greater spending: individuals will decide where that spending is ultimately directed. Where money finds its ways into assets, including land and premises, the marginal cost of production rises and companies will raise prices accordingly, thus delivering the desired inflation. Hence rising asset prices are part of the transmission mechanism of monetary policy and their appearance shouldn't stop central banks from doing quantitative easing, now or in the future.

There are those who advocate more aggressive policies, like helicopter money: sending households cheques in the mail. While appealingly egalitarian, handing out money blindly in this fashion has its drawbacks, as the Reddit trading experience perhaps shows (read my colleague Lorenzo La Posta's excellent blog from last week if you would like to know more about what happened).

Just right, then, is a continuation of current policy and hence central bankers need to hold their nerve in the face of rising inflation and provide more of the same

Quantitative easing does not alter the risk-based way in which capital is allocated throughout the economy, merely the price at which it flows. Another option being contemplated is large scale debt forgiveness. Here again, there are problems with administering such a policy: should we forgive government debt or corporate debt? Which corporates deserve it? The success of the financial system rests on the faith of participants – why else would you accept a voucher as a means of payment? – and while participants have so far accepted quantitative easing and negative interest rates, writing off debt may well be the final straw. Hence our view is that central banks should continue using the existing tool kit rather than adding more levers at this stage.

The primary goal of monetary policy is ensuring price stability (somewhat confusingly, defined as some inflation rather than zero inflation/constant prices). Inflation expectations derived from government bond markets have been rising sharply, suggesting at first glance that current policy may be too loose. Short term rises are to do with base effects (prices had been crushed this time last year) and some supply issues, most importantly affecting the price of shipping containers, both of which appear short term in nature to us. So far central banks are saying the right things in terms of looking through these rises and longer-term expectations remain reassuringly anchored. We are following inflation expectations and measures of slack in the labour market closely and agree with policymakers' assessment that there are no signs of capacity exhaustion currently.

It is a case of so far so good regarding central bank policy and we advocate more of the same rather than a premature tightening of financial conditions. However, the law of unintended consequences still holds and hence we will be watching central banks closely for signs of a policy mistake.

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The Marketplace

- Global equities rose 1.7% last week
- The US Senate acquitted former President Trump of incitement to insurrection
- Brent crude rose 5.2% last week to \$62.4 a barrel
- Gold rose 0.6% to \$1824.23 per ounce

Market Focus

US

- US equities rose 1.3% last week
- The trade deficit widened from \$577bn in 2019 to \$679bn in 2020, making it the largest annual trade deficit since 2008
- Speaker Pelosi said the House is aiming to vote on the full bill for Biden's stimulus package next week
- The number of job openings rose to 6.65m in December against 6.4m expected
- Consumer prices rose by 0.3% month-on-month in January as expected, whilst year-on-year core inflation fell to 1.4%, its lowest level since June
- In a call with his Chinese counterpart Xi Jinping, President Biden expressed concerns over China's "coercive and unfair economic practices" and growing restrictions on political freedoms in Hong Kong
- Weekly initial jobless claims for the week ending 6th February fell to 793k, against 760k expected. The number of continuing claims for the week ending 30th January fell to 4.545m, however this was higher than the 4.420m expected

Europe

- European equities rose 1.0% last week
- Draghi has been sworn in as the next Italian PM
- Germany factory orders fell -1.9% in December, against -1.0% expected
- Italian retail sales outperformed versus expectations, rising 2.5% over the month against 1.6%
- The European Commission downgraded their 2021 growth forecast for the Euro Area to 3.8% against 4.2% forecast in November, though they upgraded their 2022 forecast from 3.0% to 3.8%

Asia/Rest of The World

- The benchmark Global Emerging Markets index returned 2.4% last week
- Japanese equities rose 2.3% in the week
- China's January CPI figures came in at -0.3% year-on-year against 0% expected
- Japan's Health Ministry has approved the Pfizer-BioNTech vaccine, with vaccinations likely to begin later this week.

UK

- UK equities rose 1.6% last week
- The UK economy shrank by a record 9.9% in 2020, as the contraction was more than twice as much as the previous largest annual fall on record
- The economy grew by 1.2% in December, after shrinking by 2.3% in November

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Asset Class/Region	Currency	Currency returns			
		Week ending 12 Feb. 2021	Month to date	YTD 2020	12 months
Developed Market Equities					
United States	USD	1.3%	6.0%	4.9%	17.9%
United Kingdom	GBP	1.6%	2.6%	1.9%	-11.3%
Continental Europe	EUR	1.0%	4.8%	3.7%	0.8%
Japan	JPY	2.3%	6.9%	7.2%	15.2%
Asia Pacific (ex Japan)	USD	2.3%	7.1%	10.9%	34.8%
Australia	AUD	-0.5%	3.0%	3.4%	-1.2%
Global	USD	1.7%	5.9%	4.9%	17.6%
Emerging markets equities					
Emerging Europe	USD	1.0%	5.1%	2.7%	-8.3%
Emerging Asia	USD	2.6%	8.0%	12.6%	43.5%
Emerging Latin America	USD	0.3%	5.8%	-1.3%	-11.8%
BRICs	USD	3.5%	9.5%	13.7%	33.0%
China	USD	4.3%	10.0%	18.1%	49.9%
MENA countries	USD	2.2%	1.7%	3.8%	5.7%
South Africa	USD	5.5%	10.8%	13.8%	14.3%
India	USD	2.0%	11.7%	9.2%	23.4%
Global emerging markets	USD	2.4%	7.5%	10.8%	31.6%
Bonds					
US Treasuries	USD	-0.2%	-0.7%	-1.9%	4.3%
US Treasuries (inflation protected)	USD	-0.1%	-0.4%	-0.1%	9.6%
US Corporate (investment grade)	USD	-0.1%	-0.6%	-1.8%	5.5%
US High Yield	USD	0.3%	1.0%	1.3%	7.3%
UK Gilts	GBP	-0.3%	-2.6%	-4.2%	1.2%
UK Corporate (investment grade)	GBP	0.0%	-1.0%	-2.1%	4.1%
Euro Government Bonds	EUR	-0.2%	-0.5%	-1.1%	1.7%
Euro Corporate (investment grade)	EUR	0.0%	0.0%	-0.1%	1.6%
Euro High Yield	EUR	0.1%	0.9%	1.4%	2.7%
Japanese Government	JPY	-0.1%	-0.1%	-0.4%	-1.7%
Australian Government	AUD	-0.1%	-0.5%	-1.2%	1.1%
Global Government Bonds	USD	0.2%	-0.7%	-2.0%	7.0%
Global Bonds	USD	0.3%	-0.5%	-1.5%	7.4%
Global Convertible Bonds	USD	2.2%	5.4%	5.5%	27.9%
Emerging Market Bonds	USD	0.0%	0.2%	-1.6%	2.6%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	2.0%	5.5%	5.6%	-7.5%
Australian Property Securities	AUD	-2.0%	0.0%	-4.1%	-18.4%
Asia Property Securities	USD	2.4%	4.2%	4.2%	-6.7%
Global Property Securities	USD	1.6%	3.9%	2.8%	-6.2%
Currencies					
Euro	USD	0.7%	-0.1%	-0.8%	11.4%
UK Pound Sterling	USD	0.9%	1.1%	1.5%	6.9%
Japanese Yen	USD	0.4%	-0.2%	-1.5%	4.9%
Australian Dollar	USD	1.2%	1.5%	0.8%	15.1%
South African Rand	USD	2.0%	4.4%	0.8%	2.0%
Swiss Franc	USD	0.9%	-0.1%	-0.7%	9.7%
Chinese Yuan	USD	0.1%	-0.5%	1.1%	8.0%
Commodities & Alternatives					
Commodities	USD	2.9%	6.7%	11.2%	10.7%
Agricultural Commodities	USD	1.0%	1.4%	6.3%	27.2%
Oil	USD	5.2%	11.7%	20.5%	11.9%
Gold	USD	0.6%	-1.3%	-3.7%	16.3%
Hedge funds	USD	0.7%	2.3%	2.3%	7.5%

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