SPOTLIGHT | SEPTEMBER 2020

INVESTING AMIDST A NEW FED POLICY REGIME

Key points

- September saw the end of the US Federal Reserve's inflation containment policy regime in place since the 1970s. Coordinated fiscal and monetary policy actions taken in the 1940s provide a potential road map to understand what lies ahead for investors, with negative inflation adjusted interest rates and substantial and growing future deficits.
- Until such synchronisation occurs formally, likely post-US election, the US may resemble the Europe of the past decade with the economy relying on monetary life support, benefitting credit investors in the near term.
- Once policy coordination is deployed, a reflationary backdrop should provide a catalyst for the next stage of the US dollar bear market that has begun in 2020. This should drive further strength in the EUR/USD while the Australian dollar's fundamentals leave it well positioned.
- The negative inflation adjusted interest rate regime that will likely be targeted should also drive the next leg of the gold bull market that began in 2018 when the US Federal Reserve ended its brief rate hiking cycle.
- With stimulus targeted towards transformation stories among economies in Europe, China and potentially the US, this should provide an opportunity for investors to continue to align portfolios with policymakers under this new regime.
- Given the leverage in the global economy and the early signs of political reluctance in both the US and Europe to sustain the fiscal largesse likely needed to generate the growth and inflation required, risk management will be key as the global economy transitions to the post-pandemic world ahead.

Global Investment Committee

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The end of disinflationary-focused monetary policy…

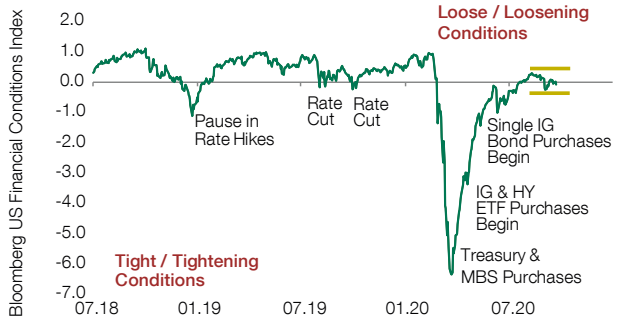
In early-September, the US Federal Reserve Chair Jerome Powell announced a shift in the inflation containment policy regime that had been in place since the 1970s. Recall how, facing rapidly rising and eventually double-digit inflation, then Fed Chair Paul Volcker adopted strategies which have evolved into the Fed's broader approach to pre-emptively contain inflationary pressures in the US economy.

Colloquially described by former Fed Chairman William McChesney Martin as 'taking the punchbowl away just when the party is getting started', the new longer-run goals for the American central bank focus instead on achieving above target inflation rates as inflation has been persistently running below its 2% target. Using the McChesney Martin analogy, the Fed will now run policy that allows the 'party' to continue much further into the evening than seen in previous cycles.

This shift is understandable as investors will recall that the Fed's counterparts in Japan pre-emptively tightened, in retrospect in error, in the early days of their ongoing battle with deflation. More recently, the Fed itself, confident that it had navigated the deflationary threats of the Global Financial Crisis, began to normalise policy in 2016 and accelerated its pace of tightening as 2017 US tax cuts spurred the economy in an attempt to pre-empt an inflationary surprise that never came.

Instead, burgeoning stress emerging as a result of its policies in the US overnight money markets ended the rate hiking cycle and triggered an easing approach even before the impact of the global pandemic was felt in early-2020.

Financial Conditions not inflation have now become the guard rails for Federal Reserve policy looking aheads



Sources: Bloomberg Finance L.P. and UBP

With inflation now less of a constraint on the Fed's level of policy easing, it has helpfully codified its reaction function which it had unofficially adopted in recent years (chart). This provides investors with a new framework for understanding the prospects of Fed policy action.

The Fed's policy setting committee's focus is now on the potential for financial system instability as the primary constraint for its new policy regime. Such instability could take the form of asset price bubbles or excessively tight financial conditions, either of which might threaten potentially systemic default cycles given the magnitude of debt underpinning the global economy.

For investors, this suggests that Fed policy action will be more proactive entering recession and during the early stages of recovery to 'minimize the welfare costs of employment' as outlined by current Fed Governor Lael Brainard in a recent speech.

With the US economy in the early stages of recovery from what may yet be the shortest recession in US history and with unemployment still high by historical standards, this policy shift provides the Federal Reserve with the flexibility to keep monetary policy and broader interest rate settings in the US economy supportive of growth. It can do this even as inflation technically breaches the 2% target in mid-2021 given the base effects of the deflationary shock of the lockdowns in 2020.

…and a shift in the balance of power and risk towards fiscal policy

The Fed's strategic shift likely represents a necessary change in policy focus. However, should the broader US policy response remain reliant solely on a 'lower for longer' monetary policy framework, the world's largest economy may end up making the same error as Japan and Europe before it – failing to deploy both its fiscal and monetary toolkits in a coordinated fashion to overcome the deflationary pressures (increasingly structural unemployment and high debt burdens) within their respective economies.

Fortunately, for investors, European policymakers appear to be learning from failed policy experiments of the past. With 'lower for longer' having served as the mantra for the European Central Bank since its 2011-12 sovereign crisis, the European Commission is now matching that monetary largesse. It did so earlier in the summer by committing to its first debt financed, supra-sovereign EUR 750 billion Recovery Fund, laying the foundation for Europe's first dalliance with fiscal-monetary policy coordination in 2021.

The Fed announcement in September indicates that it is following in the footsteps of the European Central Bank's 'lower for longer' regime, seeking to avoid the deflationary outcomes of Europe and Japan.

Worryingly however, the negotiations over a comparatively modest second round of fiscal support measures for US households and companies have stalled due to discussions about the need for fiscal responsibility given the nearly 15% of GDP budget deficit the US has incurred battling the pandemic.

Investors will recall that Japan, which similarly had sought a fiscal-monetary compact to attempt to drag itself out of deflation after three decades, succumbed to the political pressure both globally and locally to remedy their 'irresponsibly' large fiscal deficits that arose as a result of Abenomics in 2012. In response, just as Japan's reflationary policies were beginning to take root, a series of tax increases designed to stabilise the fiscal deficit combined with exogenous shocks leaves the country still continuing its battle with deflation in 2020.

With the prospect of a bridging fiscal stimulus package ahead of the November US elections seemingly fading, investors will need to see an election outcome which allows the White House and Congress to work together to deliver on the fiscal component to the American version of fiscal-monetary coordination.

With this in mind, the ideal scenario for investors from a policy coordination perspective will be a White House and Congress controlled by the same party – Democrat or Republican – given the likelihood of substantial fiscal stimulus from both parties. In contrast, a risk scenario from the election is a divided Congress that leaves the White House unable to implement meaningfully stimulative/transformative fiscal policy to reshape the US economy in the post-COVID 19 world.

1940s America may provide a potential template

With historically large budget deficits and debt-to-GDP for the US government already at all-time highs of near 130%, the reluctance to pursue continued let alone larger budget deficits looking ahead is understandable.

However, in the absence of such a fiscal stimulus, and without the domestic savings pool and current account surpluses that Japan and Europe carry, the US may be challenged to replicate even the 'lost decade(s)' that its allies across the oceans have experienced in the recent past.

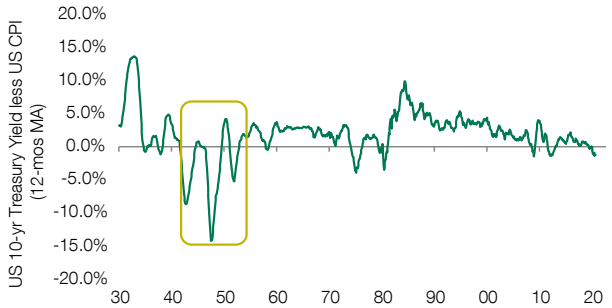
So, whether it arrives proactively, as Europe appears to be doing currently, or reactively to a shock caused by American fiscal inaction, we expect that US fiscal policy will ultimately be mobilised. Indeed, as former UK Prime Minister Winston Churchill noted, 'You can count on the Americans to do the right thing…after they have exhausted all the other possibilities'.

Ideally, American fiscal policy will begin proactively to match the now activist Fed policy. However, much like in the early days of the Global Financial Crisis, there is a risk that a shock to the economy may be required to spur the US Congress into action.

It is worth remembering that in the early-1940s as the US was still struggling to emerge from the Great Depression, the 1941 shock of the Japanese attack on Pearl Harbor was the trigger to mobilise policymakers into action.

In partnership with the Treasury, the US Federal Reserve formally agreed with the US Treasury to peg interest rates on long-term government debt at 2.5%, well below inflation rates at the time in order to facilitate US borrowing and its entry and prosecution of the war.

The 1940's policy road map suggests deeply negative inflation adjusted interest rates lies ahead



Sources: Bank of America, ICE, Bloomberg Finance L.P. and UBP

On its part, the US Treasury accelerated wartime spending with deficits reaching 25% of GDP bringing government debt to GDP from near 40% in the 1930s to nearly 120% of GDP by the end of World War II.

While the debt burden following this exercise was indeed substantial, the Fed policy regime remained in place until 1952, well beyond the end of the war. This allowed inflation to erode the nominal value of the debt that financed the fiscal stimulus supporting the war.

Consequently, by the early-1950s, total US Treasury debt outstanding remained at USD 270 billion, the same as in 1945 at the end of the WWII while the American debt burden eased from 120% to 70% of GDP, similar to Germany's pre-pandemic debt burden in 2018. It appears therefore that the simultaneous and prolonged commitment of both monetary AND fiscal authorities is critical to attempt even to replicate the American post-war success.

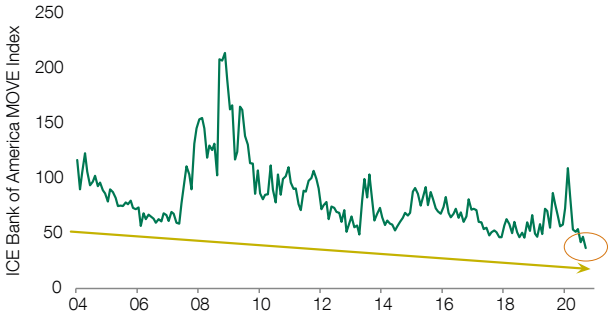
The new Fed policy regime…one month in

Nearly one month into the Federal Reserve's newest policy experiment, the US is looking increasingly like the Europe of the past decade from a policy and market perspective. Fiscal support has fallen victim to political infighting with the US relying on the Federal Reserve to pursue its new mandate simply to maintain economic stability.

The 10% decline in the S&P 500 and 13% fall in the NASDAQ in September may actually reflect 'success' in the deployment of the Fed's new, apparent dual mandate implied in its strategic policy shift in early-September.

Despite the sharp falls in equity markets, the Fed has suppressed bond market volatility via communications and direct intervention in credit markets leaving the Bank of America ICE MOVE Index plunging to all-time lows despite the equity market sell-off.

New Fed policy regime results in all-time lows in bond volatility



Sources: Bank of America, ICE, Bloomberg Finance L.P. and UBP

In June, a comparable equity sell-off resulted in a 100 bps widening in high yield credit spreads and a 20 bps widening in investment grade spreads. Indeed, the contrast of the current equity sell-off reveals the impact of the Fed's policy pivot. In September, investment grade spreads (where the Fed is active) have barely budged while high yield spreads have widened 62 bps, nearly 40% less than in June.

As a result, the Fed is likely not to be displeased with the fine policy line it has walked in recent weeks. For investors however, this suggests the prospect for proactive Fed policy measures is low without signs of significantly tightening financial conditions or an external shock going into year-end.

Instead, the Fed appears to have taken the stance that they will react quickly, like in March in the face of such a shock rather than moving pre-emptively in anticipation of a potential shock like it did in 1999 in preparation for the turn of the century.

With plans underway to expand and ease conditions of the USD 600 billion Main Street Lending programme that have left it virtually unused since launch, the Fed is laying the groundwork for a March-style response should it become needed, potentially replicating the Bank of England's Bounce Back Loan programme seeking to drive both liquidity and lending through the private sector.

Investing amidst a new policy regime

Once fiscal policies are aligned with the 'whatever it takes' monetary approach the US Federal Reserve has adopted, investors will be afforded the opportunity to align portfolios to the lead of policymakers.

At its core, we expect the coordinated monetary-fiscal policy actions will seek to target the negative inflation-adjusted interest rate regime seen in the 1940s. We believe that this will bring on the next stage in the US dollar bear market that began in 2020.

Amongst the G3, EUR/USD is likely rise over the medium-term, reflecting still elevated USD valuations, an expected deeply negative US real interest rate profile and substantial EU-US current account differentials. The EUR will also benefit from broad fiscal stimulus in 2021, allowing ECB policymakers more flexibility vis-à-vis EUR appreciation.

Outside of the G3 realm, the Australian dollar is likely to perform well, reflecting the more developed Asian economic rebound and Australia's improving terms of trade. In addition, the perennial Australian current account deficit is seeing a structural shift towards a current account surplus, the Aussie dollar should see cyclical and secular catalysts for strength ahead, we expect.

As fiscal policymakers take up the mantle of increased spending, the Fed will once again have to restart their balance sheet expansion begun in earnest following the lockdowns of early 2020. This should serve as the catalyst for the next leg of the gold bull market looking ahead.

For USD credit investors, much like their EUR counterparts have experienced since 2012, the combination of careful credit selection and a willingness to look through periodic bouts of volatility should allow credit investors to secure income in an era of sustained low nominal and potentially negative inflation adjusted interest rates for lower risk credits.

In particular, we see opportunities to move selectively away from the US yield and credit curve via European hybrid and Asian Investment Grade and Chinese local-currency government bond segments which offer attractive risk-return opportunities for income-oriented investors.

In equities, the market fall has begun to close the relative valuation gap seen between US equities and US credit highlighted. Though economic data are set to soften until fiscal support in earnest appears in early-2021, the prospect of 2020 earnings downgrades from current levels looks limited.

In the interim, relative valuations seem able to accommodate a further 5-10% fall before moving back into their relative valuation ranges that coincided with the late stage of the Fed tightening cycle in 2019.

So, a window has begun to reopen for investors to exploit the evolving opportunities to participate in the long-term transformation of the global economy that has begun in the post-pandemic era.

While technology and healthcare solutions have been the backbone of these transformation opportunities in the immediate aftermath of the pandemic, we expect these to broaden out in the months ahead to areas including FinTech (financial technology), Green and ESG driven by policy initiatives as the recovery broadens in the year ahead.

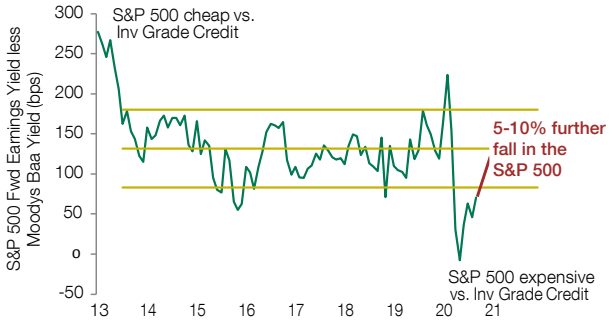
This long-cycle shift in the policy regime against the backdrop of the post-pandemic world will undoubtedly remain one that poses new risks for investors looking forward. With many investors having been reluctant to capitalise on opportunities offered by this shifting landscape since March, we view the construction and maintenance of an active 'risk-off' element within portfolios as key to being able to keep a medium- to long-term perspective on these developing themes.

In many ways, this 'risk-off' allocation replaces the government bond component of portfolios that historically has provided this cushion for investors. Active options and structured products strategies offer investors the ability to reshape unattractive risk-reward profiles created by the uncertainty of this new environment to ones more aligned with individual objectives and risk appetites.

In addition, alternative strategies such as long-short hedge funds offer the potential to play a key role in directly addressing unwanted risk exposure in both credit and equity.

Overall, for investors, this new environment requires prudence and balance – first, establishing a foundation of protection and preservation and then, aligning portfolios with longer-term policy trends to capitalise on growth generated by the accelerating transformation of the global economy.

A further 5-10% fall in equities would normalise relative valuations



Sources: Moody's, Bloomberg Finance L.P. and UBP

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