perpetual wealth

Wellershoff & Partners

Quarterly Macro Report

1st Quarter 2020

We are entering a second decade of monetary policy experimentation. Low interest rates may have sustained this unprecedented expansion, but so has subdued inflation. Central banks look to experiment with new tools to revive growth, but no tangible growth acceleration is in sight.

As we enter the new decade, monetary policy is in uncharted territory. Before the global financial crisis of 2007/08, the Taylor rule was one of the tools that central banks used for guidance when adjusting the level of short-term interest rates. This equation helped central banks set interest rates to achieve price stability across the cycle. For quite a while now, the Taylor rule has been signaling that today's central bank interest rates are too low. In other words, according to this measure, monetary policy has been—and still is—too accommodating. One explanation is that the correlations that used to apply for the Taylor rule have broken down. Whatever the case, it is clear that several big central banks have failed to achieve their inflation targets. In the case of the European Central Bank, the target has been missed for seven consecutive years. In the US, the Fed's preferred inflation indicator has been averaging below its two-percent target for more than a decade. That's a long time to miss a policy target.

Continuing monetary policy experimentation

Given that the old policy tools and levers no longer seem to work, central banks are in experimentation mode. One indication of some of the new uncertainties – and experimentation—around monetary policy came to us recently from the US, where the overnight repo rate spiked. This compelled the Fed to provide generous additional liquidity to the system – and to commit to do so for an extended period. This spike in rates may also be a signal for another long-feared development, name-

Fig. 1: Global growth sentiment indicator weakens further

The preliminary estimates for economic growth in the third quarter of 2019 show that rates in several countries were at or below their long-term sustainable trend levels. Globally, our forward-looking indicators do not suggest a near-term acceleration in growth.

Source: Thomson Reuters Datastream, Wellershoff & Partners

ly, that central banks might struggle to unwind the massive quantitative easing programs they undertook over the past decade, in response to the financial crisis. We recently witnessed something similar in the Eurozone, where the European Central Bank announced *more* quantitative easing.

Another indication of monetary policy experimentation is that the Fed has been thinking aloud about *changing* its inflation target to a so-called "make-up strategy". The idea behind is to "make up" for the recent stagnation in inflation by generating a period of accentuated higher inflation. One obvious risk with such a strategy is that it introduces new feedback loops into the monetary policy system. If central banks in the US, Europe and Japan have been unable to achieve their inflation targets over the past decade, we must ask why they now believe that this time they have the tools to target inflation with any more precision. After all, there may be other, global factors influencing inflation that are not less easy to model.

The bottom line is that we are entering a second decade of continuing monetary policy experimentation, with inevitable spillover effects on asset prices and economies. Low interest rates have lifted asset prices while vast central bank balance sheets must have buoyed the prices of the assets that they bought—from corporate bonds in Europe to equities in Japan. The decline in FX volatility in recent years—the levels in early December 2019 were comparable to those seen briefly in 2014—may also partly reflect the dampening effects of these central bank policies.

Inflationary consequences likely to take time

While the past decade of exceptional monetary measures has led to no notable global acceleration of headline consumer price inflation, the longer-term historical data makes a compelling case that an increase in base money, which is what many central banks have been engaging in, does eventually lead to some form of inflation. We have already witnessed an inflationary impact on selected asset prices, for example, real estate prices in some markets, which some central banks have tried to dampen by means of "macroprudential" measures.

Nonetheless, in advanced economies, the level of confidence in the central bank's ability to control inflation over the medium term remains high. From this we can conclude that any inflationary pressures from the increase in the monetary base in most advanced economies will take time to work their way through

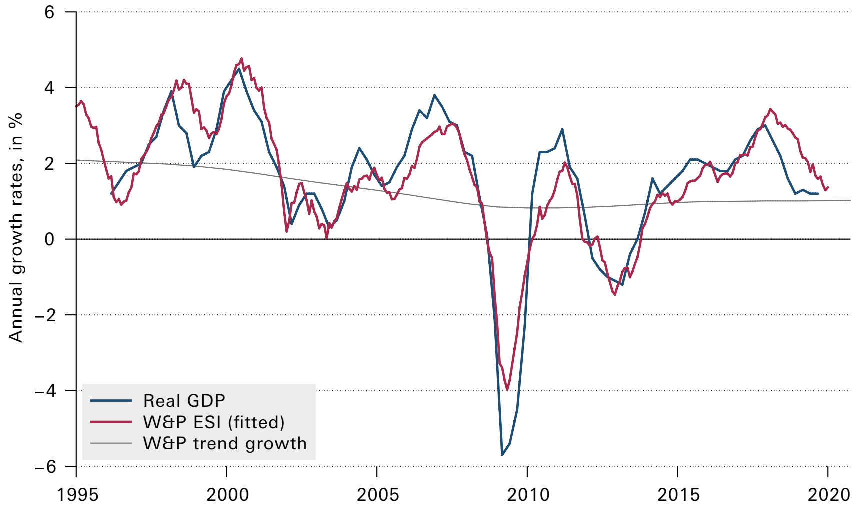
Table 1: Macroeconomic estimates

	Real GDP growth in %						Inflation in %					
	2017	2018	2019P	2020P	2019Δ	2020Δ	2017	2018	2019P	2020P	2019Δ	2020Δ
USA	2.4	2.9	2.3	1.7	0.0	-0.1	2.1	2.4	1.7	2.2	-0.1	0.2
Euro area	2.6	1.9	1.2	1.1	0.1	-0.1	1.5	1.8	1.3	1.5	0.0	0.1
Germany	2.8	1.5	0.6	0.8	0.1	0.0	1.5	1.7	1.5	1.9	0.0	0.3
France	2.4	1.7	1.3	1.2	0.0	0.1	1.0	1.9	1.2	1.7	0.0	0.4
Italy	1.8	0.7	0.2	0.4	0.1	0.0	1.2	1.1	0.8	1.2	0.1	0.3
Spain	3.0	2.6	3.5	1.7	1.5	-0.1	2.0	1.7	0.9	1.4	0.1	0.3
United Kingdom	1.8	1.4	1.3	0.8	0.0	-0.3	2.7	2.5	1.8	1.8	-0.1	-0.1
Switzerland	1.7	2.5	0.8	0.8	0.0	-0.3	0.5	0.9	0.3	0.5	-0.1	0.1
Japan	1.9	0.8	0.8	0.2	-0.2	0.0	0.5	1.0	0.6	0.6	0.0	-0.1
Brazil	1.1	1.1	1.1	1.7	0.3	-0.7	3.4	3.7	3.6	3.8	0.0	-0.3
China	6.9	6.6	6.1	5.3	-0.1	-0.7	-0.5	0.6	2.9	2.8	0.6	0.3
India	7.2	7.0	4.9	5.3	-2.1	-1.9	3.3	3.9	4.4	4.5	0.5	0.3
Russia	1.6	2.3	1.1	1.7	-0.1	-0.2	3.7	2.9	4.4	4.3	-0.6	-0.2
World (PPP)	3.8	3.6	3.0	3.2	-0.2	-0.3	3.2	3.6	3.6	3.6	0.0	-0.1

E Estimates Wellershoff & Partners   Δ Deviation from consensus economic forecasts

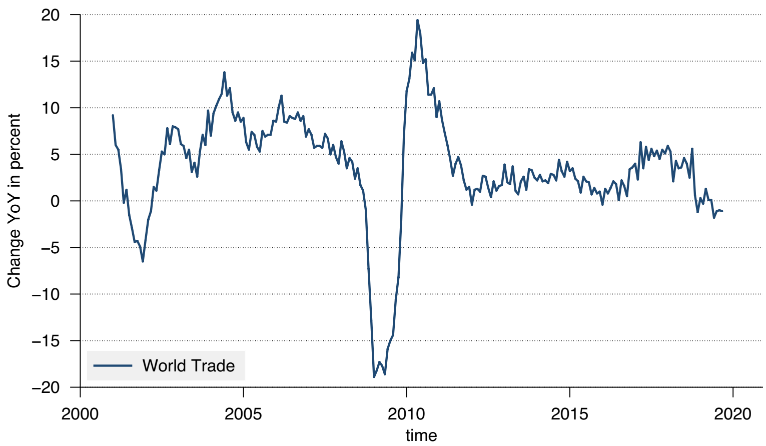
Source: Consensus Economics, Thomson Reuters Datastream, Wellershoff & Partners

Fig. 2: Euro area growth sentiment falling, but still above trend



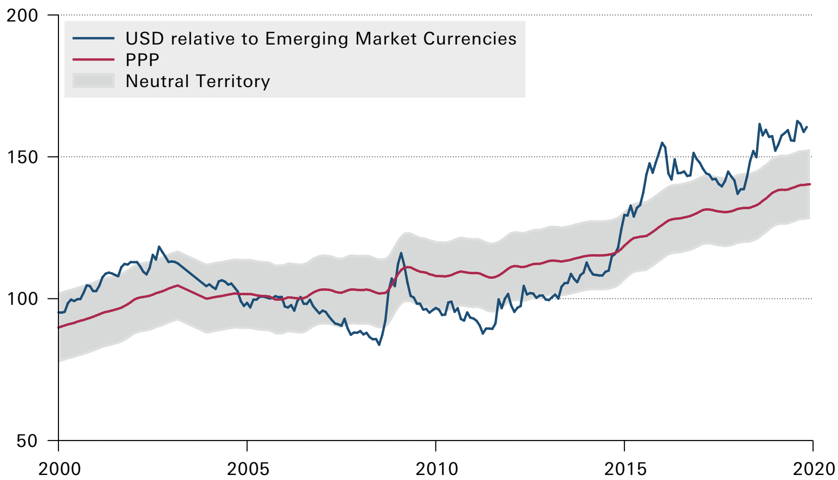
In Europe, annual growth in the third quarter was 1.2 percent, driven by France and Spain. Germany, which is more dependent on global trade, saw its growth rate slip below its long-term trend.

Fig. 3: World trade back in negative territory, weighing on Germany



In this chart we see that the year-on-year growth rate in global trade has turned negative. Lower trade volumes tend to hurt the largest exporting nations more.

Fig. 4: Emerging market currencies remain cheap relative to the USD



The US dollar has been strong relative to a basket of emerging market currencies for half a decade. Emerging market currencies remain undervalued.

Source: Thomson Reuters Datastream, Wellershoff & Partners

the system. There are currently also several countervailing global forces restraining consumer price inflation—including overcapacities in certain sectors, demographics, and technological changes that are driving down costs. The structure of the global economy is changing and—for now at least—these structural changes appear to have a dampening effect on inflation.

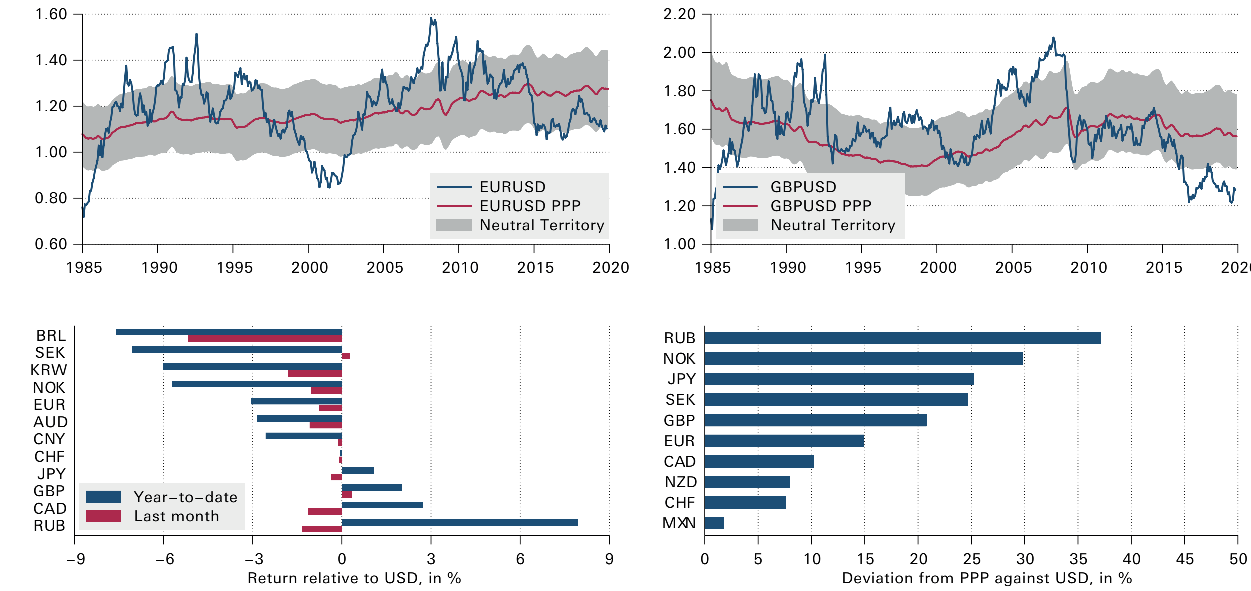
Despite this, we have to be mindful that as we enter the new decade, we are also starting from a position of much higher levels of government debt than just ten years ago—just as ageing populations push up the costs of pay-as-you-go social benefit systems, which have become the standard in most advanced economies. Low interest rates have also increased the liabilities of private pension systems while reducing their income from bonds. To the extent that low interest rates also lead to distortions—for example, by encouraging overinvestment in real estate—this will eventually lead to lower yields from those sources of income, too, compounding pressures on private pension systems and on the need for fiscal relief.

The recent speech of the incoming president of the European Central Bank, Christine Lagarde, calling for more government investment is consistent with the call to the state to do more, that is, to borrow more. Any recession in the coming decade will further increase the burden on both the monetary and fiscal authorities to do more. Seen from this perspective, the crisis that began in 2007 has never been fully recovered from but its effects are still being felt.

Near-term cyclical signals do not suggest a growth acceleration

As can be seen from the charts in this report, global growth slipped below its longer-term trend in the third quarter of 2019. Our forward-looking sentiment indicators do not point to any near-term acceleration either. While the volatile global trading backdrop is unhelpful, the hope is that consumption will remain supportive for the economy, as it has in several countries.

Fig. 5: FX performance and valuations



PPP estimates based on producer price indices
Positive deviations from PPP indicate an undervaluation against the respective currency and vice versa.

Source: Thomson Reuters Datastream, Wellershoff & Partners

Disclaimer

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