Stephen Miller - GSFM Advisor

INVESTMENT PERSPECTIVES

GSFM FUNDS MANAGEMENT

Beware: policy swings like a pendulum too!

There is an emerging global consensus that monetary policy is exhausted and that other arms of policy - notably fiscal policy - may need to be deployed should any downturn gather momentum. That consensus applies in a local context (despite some Canberra holdouts) and persists despite a now growing realisation that the RBA has war-gamed an Antipodean version of quantitative easing (QE).

Monetary policy works through lower interest rates. Whether conventional or unconventional, a lowering of the cost of financing consumption or investment leads to the stimulation of demand. However, if the economy is in a 'liquidity trap' situation so that the scope for privately determined interest rates to fall is limited then monetary policy can be rendered largely ineffective. That circumstance almost certainly applies in Europe and Japan and it would appear that it is not far off applying elsewhere, including here in Australia where banks are reluctant to pass on anywhere near the full amount of policy rate cuts.

A question for investors is whether that emerging consensus regarding the effectiveness of monetary policy ultimately manifests itself in a marked shift in the cast of macroeconomic policy and what that means for the prices of financial assets.

At this juncture, uncertainties attaching to the global economic and financial landscape are many and varied and weighted to the downside. These include:

- Trade and Investment tensions between the US and China (and the EU, and India, and Japan).
- Fears of 'currency wars' or 'competitive devaluation'.
- Potential for oil price spikes given tensions in the Middle-East (think of the alleged attacks by the Iranians on a Saudi oil facility last month).
- Europe teetering on recession, and growth slowing in China.
- Dysfunctional global politics and the rise of left/right 'populism.'
    - In the US, impeachment proceedings against the President, political gridlock and a polarising Presidential campaign.
    - In Europe, Merkel in government but not in power, the 'gilet jaunes' in France, Brexit.
    - In China, the Hong-Kong question.

There are also a series of structural challenges:

- Climate Change / the environment
- Growing concerns about inequality
- Cyberattacks
- 'Oligopolisation'

Were these uncertainties to manifest themselves in severe global economic headwinds, the most likely policy response is a fiscal one.

Back to the future? The return of monetary financing

Conventional fiscal policy involves the government borrowing money via bond issuance in order to finance spending and / or tax cuts. However, more recently, there have been calls involving some form of ‘monetary financing’ of government debt. The more extreme version of this is known as ‘modern monetary theory’ (MMT), but (partial) money financing of budget deficits was reasonably commonplace in a number of developed countries right up until the early 80s. However, its record was a long way from unimpeachable, culminating in the ‘stagflation’ of the 70s.

It came to an end when central banks got serious about controlling inflation after the mistakes of the 1970s. That those problems emerged gives an insight into the difficulties of monetary financing - once the inflation genie is out of the bottle it is a long and difficult exercise in getting it back in. And history is replete with examples of monetary financing gone very bad (think the Weimar Republic in Germany or, more recently, Zimbabwe or Venezuela).

Having said that there are credible and theoretically elegant expositions of how monetary financing might work, particularly in situations of severe recession. Such approaches essentially involve a rules-based ex-ante articulation of a set of circumstances where monetary policy and fiscal policy (i.e. monetary financing of fiscal deficits) would become jointly responsible for achieving the inflation target in circumstances where it subject to a meaningful downside miss.

If the central bank had determined that interest rates cannot be lowered further and that a significant downside miss on the inflation target was in the offing, it would employ a mechanism to credit private sector accounts directly on top of the more conventional fiscal levers of automatic stabilisers and discretionary spending.

Such approaches are not beyond the realm of plausibility.

However, there is a lot of “devil in the detail” of these proposals and serious questions as to how this might play out in practice. Bear in mind, that central banks earned their independence so as to free them from the constraints of short-term, politically expedient manipulation of monetary policy. In that context how the political-economy of monetary financing might function is an interesting question.

Nevertheless, despite the obvious difficulties that attach to monetary financing, the reality is that investors need to prepare themselves for its potential deployment.

Such approaches contain quite significant implications for the prices of financial assets. “Elegantly” implemented in a proactive way it might result in a higher inflation premium on government bonds (moderately higher yields and better performing inflation-linked bonds), a lessening of risk aversion and a lower equity risk premium, supporting prices of riskier assets.

Reaching a tipping point?

The bigger question might be whether policymakers can clear the “elegantly implemented” hurdle. If the political-economy of its implementation gets messy (a non-trivial probability), then the picture is way darker for investors with a world that looks increasingly like the 1970s – higher inflation and inflation expectations leading to sharply higher bond yields that lead to a ‘tipping point’ for riskier assets whose prices struggle in such an environment.

This piece is not to advocate monetary financing, and nor do I claim insight as to when or if it may be implemented and whether that implementation will be sufficiently “elegant”. Rather, the purpose of these ruminations is to remind investors that portfolio diversification remains a critical focus in the assembly of portfolios. There are a number of uncertainties that attach to the global economic environment and macroeconomic policy is at an inflection point. Uncorrelated sources of return away from conventional bond and equity beta should become a more intense focus.

The author is an Investment Strategy Consultant with GSFM. The views expressed are his own.

For more information about GSFM's investment strategies, please contact:

Damien McIntyre • dmcintyre@gsfm.com.au • (03) 9949 8852 • 0407 266 999

Stephen Fletcher • sfletcher@gsfm.com.au • (03) 9949 8828 • 0400 559 118

Shaun Thomas • sthomas@gsfm.com.au • (02) 9324 4355 • 0450 157 588

Steve Taylor • staylor@gsfm.com.au • (07) 3012 6159 • 0404 092 635

Huw O'Grady • hogrady@gsfm.com.au • (03) 9949 8825 • 0419 200 052

Stephen Higgins • shiggins@gsfm.com.au • (02) 9324 4330 • 0407 094 707

Matthew Ferguson • mferguson@gsfm.com.au • (02) 9324 4342 • 0449 103 640

Sam Mirls • smirls@gsfm.com.au • (02) 9324 4352 • 0422 777 909

gsfm.com.au

Important information

The information contained in this article reflects, as of the date of publication, the views of GSFM Pty Limited ABN 14 125 715 004 AFSL 317587 (GSFM) and sources believed by GSFM to be reliable. We do not represent that this information is accurate and complete, and it should not be relied upon as such. Any opinions expressed in this material reflect our judgment at this date, are subject to change and should not be relied upon as the basis of your investment decisions.

None of GSFM, its related bodies or associates nor any other person guarantees the repayment of capital or the performance of its Funds or any particular returns from any of its Fund. This document is issued on 5 July 2019. ©2019 GSFM Pty Limited.