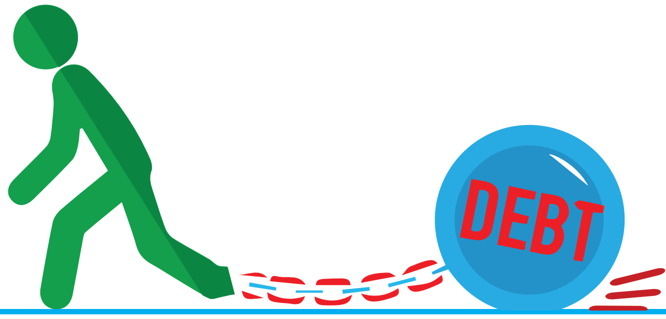
FIXED INCOME **COMPASS**

Financial repression

Even with increasingly distortionary policies, we don't believe that financial repression can succeed in setting the global economy on a sustainable course.



Financial repression has been ever present since the financial crisis, increasing in magnitude and breadth as time has elapsed. However, it is proving powerless to reflate the global economy, and is actually creating serious imbalances. Unchecked, we believe policymakers will apply increasingly powerful measures that ultimately threaten market stability. Portfolios need to be one step ahead on this dangerous path.

We define financial repression as governments and central bankers forcing asset valuations away from fair value. Slashing interest rates and injecting liquidity via quantitative easing (QE) at the start of the crisis stopped the global economy from a sharper contraction, but this has been followed by numerous measures that repress financial markets with questionable benefits for economic growth.

- Global central banks have boosted asset prices by engaging in multiple episodes of QE, buying government bonds, mortgages, corporate bonds and even equity markets.

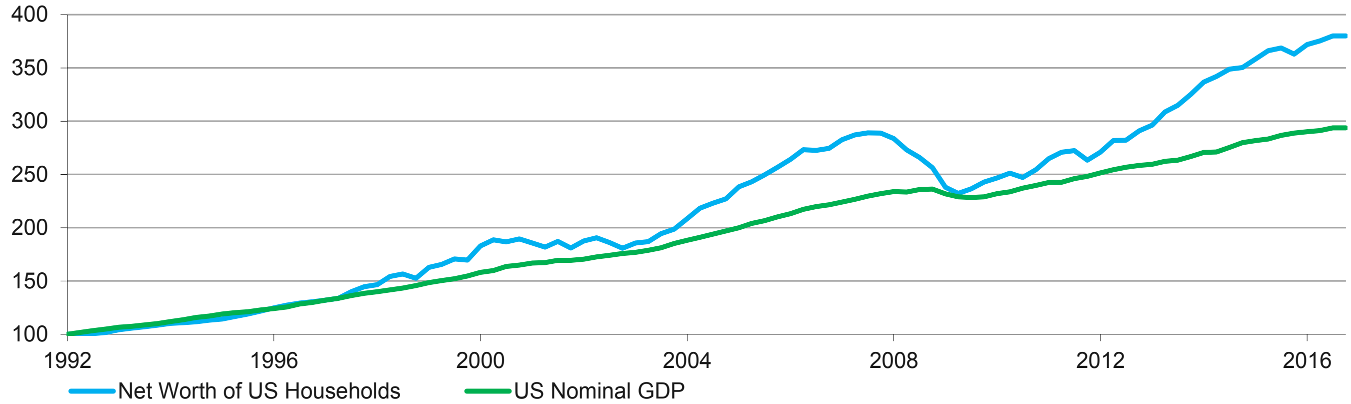
- Policymakers have provided cheap funding for banks, often with a target borrower in mind. In the UK, for example, this has been particularly beneficial for property prices.

- In a number of bond markets, interest rates are now negative. This changes the investment prospect for a bond investor - they no longer gradually accrue a positive return over time, rather they hope that someone will eventually accept an even more negative interest rate than they did.

- Central bankers also promised to keep interest rates low for an extended period of time, attempting to keep longer-dated yields at suppressed levels. By trying to keep interest rates below inflation, the aim is to bail out debtors to the detriment of savers.

Legal & General
INVESTMENT MANAGEMENT

Figure 1: Financial repression has boosted asset prices rather than GDP



Source: Bloomberg L.P. indexed to 100

NOT THE SOLUTION

Despite such interference, global growth has failed to get out of stall speed, encouraging ever more intervention. We think there are structural explanations for this failure, notably that excessive global debt represents sustained bad investment. Financial repression not only stops unproductive companies from defaulting, which would allow new entrants to boost productivity, but it also encourages further waves of bad investment at even less viable valuations. This policy is therefore making matters worse.

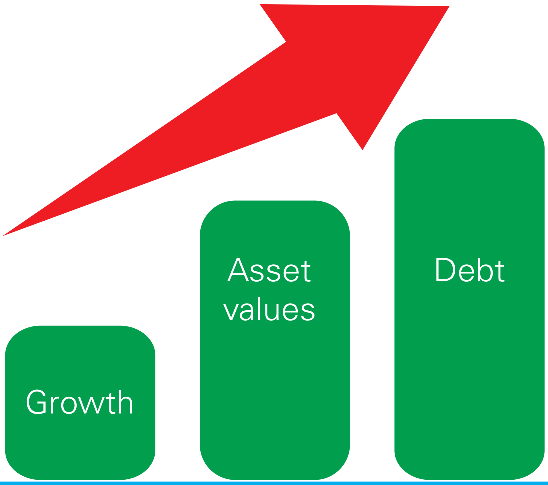
Importantly, those investors lucky enough to own assets funded with debt have received a massive boost, allowing them to acquire even more assets. Those saving in the hope of being able to buy an asset in the future have been left behind. This is what Theresa May was alluding to in her closing speech to the Conservative party conference when she described the impact of QE: “People with assets have got richer. People without them have suffered. People with mortgages have found their debts cheaper. People with savings have found themselves poorer.” She then promised to reverse this trend, but we suspect that the world will see more financial repression, not less, in the immediate future.

WHAT’S NEXT?

Even if it is corrosive over the longer term, there is little near-term incentive for policymakers to reverse financial repression. Almost by definition, such a withdrawal should lead to lower asset prices, and while rising asset prices have not resulted in economic growth, a significant fall likely guarantees a near-term recession as confidence and investment retrench. So we should expect financial repression to be with us for a protracted period of time and evolve as different policies are tried out.

Having started on this course first, the Japanese are likely to show us the way forward. This takes the form of the assets that central banks buy – starting with government debt, moving to corporate bonds and finally real estate and equities. But it can also be applied to new forms of financial repression.

As we discussed in the last Fixed Income Compass, Japan is well on its way to helicopter money, expanding its fiscal deficit with the central bank paying the bill. In this context, the Bank of Japan recently decided to shift from a set volume of government bond purchases to a yield target for long-dated debt. The plan is for fiscal spending to drive up nominal growth above the cost of government debt.

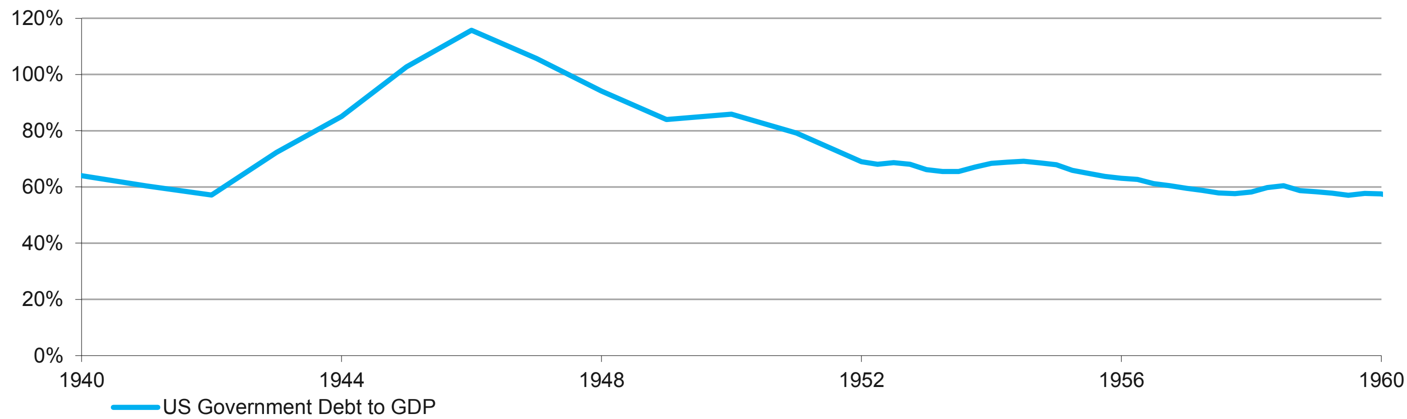


This is actually not a new idea. From 1942-1951, the yield on the long-term US treasury was capped at 2.5%. The initial driver of the policy was to control the cost of financing World War 2, which was also fiscal and monetary policy coordination of course. However, while the economy remained weak, the policy was impotent given that a 2.5% yield was too high. It was only when inflation rose that it came into its own. At this point, the Fed bought treasuries to stop the yield surpassing its target, increasing bank reserve requirements to offset the monetary stimulus. This worked well during the first period of higher inflation during 1947-48, but started to unravel as inflation increased once more at the start of the Korean War in 1950, with the yield target formally ending in March 1951. But the policy had proved successful in allowing nominal growth to surpass debt financing costs for long enough to set government finances on a sustainable path. At the end of the period, banks were allowed to swap their old 2.5% bonds for new debt with a higher coupon, effectively bailing them out.

Unfortunately, this past success of interest rate targeting is unlikely to be replicated today.

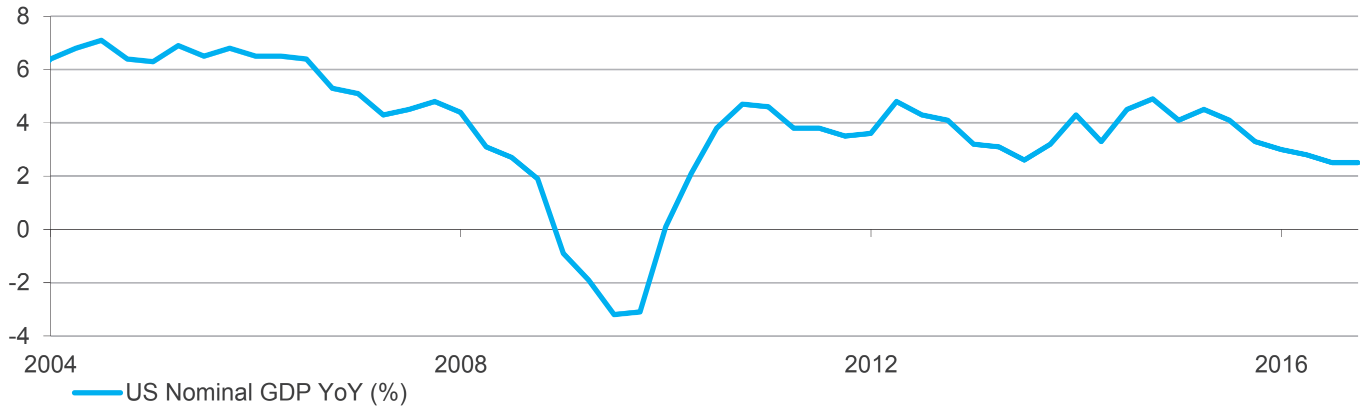
If the only problem was an overindebted government, then keeping interest rates low and encouraging consumption and business investment could help. But

Figure 2: Financial repression in the 1940s got government debt under control



Source: Deutsche Bank, Macrobond

Figure 3: Growth is vulnerable to downside shocks



Source: Bloomberg L.P

we are also living with private sector bad investment built up over many years of easy monetary policy. In contrast, prior to the 1942 policy, the US had experienced the great depression, wiping out capacity and resetting asset values. And, of course, there was little impediment to easy fiscal policy given the requirement to fund the war effort. In contrast, we expect that today's application of the policy will encourage further bad private investment, weighing down potential economic growth, while loose fiscal policy is hamstrung by political opposition and infighting. This economic asphyxiation is what we have termed secular strangulation.

WHAT WILL BRING FINANCIAL REPRESSION TO AN END?

Despite its shortcomings, it's pretty clear that financial repression has kept asset prices at elevated levels. Moreover, if policymakers are to continue with such policies, it's possible that valuations will remain dislocated from fundamental factors for some time to come. But as we believe financial repression will ultimately fail in setting the global economy on a sustainable course, it's crucial to consider how it will end in order to know what assets to avoid and what may still prove sensible investments.

Recession

Even sustained financial repression cannot stave off a recession forever. Global growth is failing to accelerate and downside shocks such as political upheaval, Chinese currency devaluation or commodity price volatility could easily tip the globe into recession.

A recession would likely send risky assets such as equities and credit sharply lower given a weaker growth trajectory, implied dividend cuts and higher defaults. Japan, for example, has suffered a number of recessions during their many years of financial repression, leading to significant falls in equity prices and ever lower bond yields. But a recession today in Europe or the US would probably elicit more aggressive policies. For example, the threat of a Brexit-related recession in the UK immediately led to more QE, with the Bank of England adding corporate bonds to their programme and the government considering fiscal stimulus. We would expect a global recession to result in barriers to both further monetary stimulus and helicopter money being broken down.

Figure 4: Global debt continues to grow

Source: BIS

Even with such support, some assets could still be vulnerable to a reassessment of the growth outlook. In particular, we would expect falls in equity valuations and weakness across default-sensitive assets such as high yield and emerging market debt, while G3 government debt could receive a boost.

Inflation

Central bankers across the globe are desperate to boost inflation in order to erode the debt overhang. Be careful what you wish for.

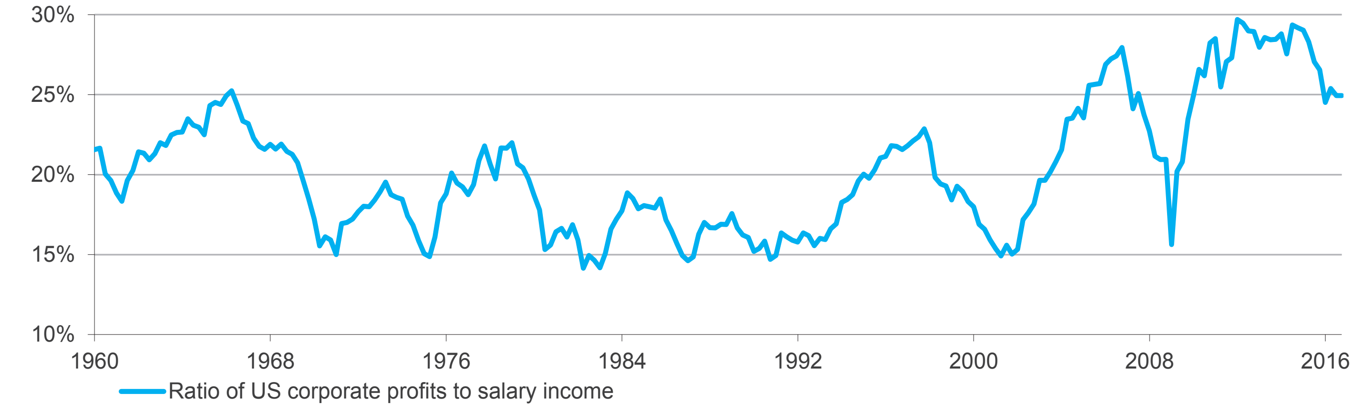
Back in 1951, rising inflation was an irresistible strain on financial repression, ultimately breaking the policy. By then, US government debt had been placed under control which meant there was no longer an acute problem, but this scenario is highly implausible any time soon given the broader debt problem, and the fact that it continues to build at a rapid rate.

Instead, if inflation were to rise in the coming months necessitating tighter monetary policy, we would expect to see a reversal of the recent grab-for-yield, with higher government bond yields, wider credit spreads and falling equity markets. In particular, if the inflation boost were to occur in the US, we would expect a rise in the US dollar which could again pressure commodities and emerging markets.

Such a negative shock would probably lead to weaker economic growth and falling price pressures. As a result, an inflation scare would prove temporary, and government bond yields could rally once more. Some risky investments would fare better than others, such as default-remote assets in developed markets, but we would expect more permanent losses across emerging markets and high yield debt, with equity valuations also subdued.

An alternative outcome would be stagflation where higher inflation and a tight labour market forces companies to increase wages. The ratio of corporate profits to wages has been increasing over many years as companies benefitted from trends such as globalisation, and a reversal of this could be bad news for companies already suffering from weak profit growth. In such a circumstance, we'd expect business investment to take another hit as corporations look to reduce costs, undermining future growth prospects. If higher inflation becomes entrenched, then central banks would have to tighten policy at the worse possible moment. Inflation protection or short-dated government debt in order to roll into higher yields seem the most sensible investments in this scenario.

Figure 5: Corporate profits are vulnerable to rising wages



Source: Bloomberg L.P.

Politics

If Theresa May is worried about the inequality of financial repression, then it is not controversial to suggest that social discord may end up undermining such policies. To many of the disenfranchised, it seems like there is an elite group of policymakers set on protecting the benefits they accrue from a broken system. This is dangerous enough for governments, but at least politicians with alternative ideas can rise to power. It is even more critical for unelected central banks and supranational bodies who may be trying to do the right thing, but are increasingly seen as acting in their own interest with little legitimacy. We believe that the Brexit vote was at least partly a reaction to this.

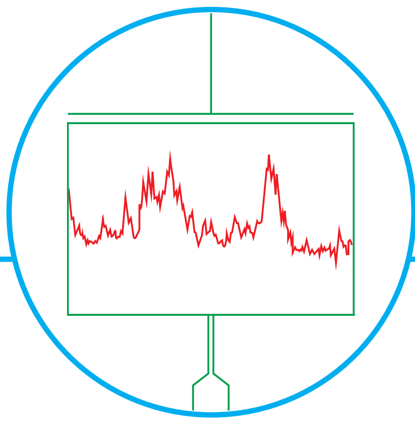
One policy now facing a backlash has been the march towards globalisation. Falling import prices initially benefitted richer countries, but now the focus is on lost jobs and domestic output. Moreover, as part of financial repression, central banks have appeared happy to weaken their currency in their quest for a larger slice of the global trade pie. By far the most important currency is, of course, the US dollar, but at some point the US may become fed up with other countries using reserves to manage their currencies as part of financial policy. This is seen today in the rise of anti-globalisation rhetoric during the US election and such complaints are only likely to build if economic growth continues to disappoint.

Without the ability to debase currencies, financial repression can lose its popularity. We have seen this across the European periphery, where countries that would normally devalue their currency in order to boost competitiveness have instead had to endure recessions, rising unemployment and falling nominal wages. The result has been a backlash against incumbent policymakers such as the European Central Bank and the rise of alternative parties such as Podemos in Spain and the Five Star Movement in Italy.

While countries are able to devalue versus the US dollar, it seems sensible to be exposed to US dollars versus emerging market currencies or via selling commodities that are denominated in US dollars. But taken to the extreme, the US may be forced to react, with trade barriers or even currency controls. Ultimately, this suggests the end of the primacy of the US dollar and a rise in associated geopolitical tension.

THE BOTTOM LINE

The ways financial repression can end are, of course, all interlinked, and we expect it to take various paths and be met with different challenges across the globe. From an investment point of view, it has paid to tactically trade the ebb and flow of markets, with new forms of repression leading to temporary opportunities. But we expect this policy to ultimately fail and result in significant market volatility that demands structural portfolio protection. We have a bias to be long the US dollar and to own G3 government bonds, while US investment grade debt should be a relative winner during periods of volatility. Against this, we are cautious towards default-sensitive bonds across high yield and emerging markets along with other assets that would suffer from US dollar strength. Policymakers will undoubtedly redouble their efforts to repress financial markets, but the backlash may be even more powerful.



Legal & General Investment Management Ltd,
One Coleman Street,
London, EC2R 5AA

www.lgim.com

Authorised and regulated by the Financial Conduct Authority.

M1171