Fixed Income Compass.

Quarterly outlook and positioning from LGIM's Fixed Income Team

Secular strangulation

For some time now, we have described how the world is dominated by the 4Ds of debt, deficits, demographics and deflation. These are weighing on growth, blunting monetary policy and resulting in dangerous global imbalances. With G7 government bond yields at all-time lows, it appears that this market has largely caught up with our prognosis of secular strangulation. While we still have a bias towards owning duration, the risks are now much more balanced, as policymakers look to extreme forms of intervention such as helicopter money.

In contrast, US equity markets are near all-time highs and credit spreads are in the middle of their recent range. This really is a staggering turn of events and reminds us just how distortionary monetary policy has become. The explanation for this divergence is that analysts use very low interest rates to discount future corporate cash flows, boosting today's valuations. But this ignores the link with our 4Ds and global growth. We believe equity markets and corporate bond spreads should reflect the same weak growth and subdued inflation environment that is implied by historically low government bond yields. As a result, earnings should be revised lower and defaults higher. When this association is re-established, the disruption for risky asset classes could be significant indeed.

We therefore continue to hold a cautious position across global credit portfolios, holding significant liquidity which we will look to deploy when valuations reflect our core structural outlook.

The UK's decision is not isolated

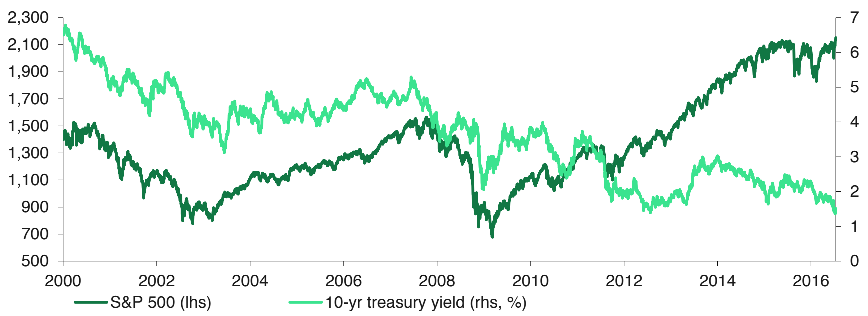
The 'leave' result of the UK referendum has been the catalyst for the latest decline in government bond yields. We do not think this will be an isolated incident; indeed, we believe the decision was influenced by the global imbalances that drive our long-term investment outlook. Rising asset prices despite disappointing economic growth disproportionately concentrates wealth in a small proportion of the global population and we believed it was just a matter of time before this unstable state of affairs was undermined. Indeed, the UK vote could well be a catalyst for further discontent.

While the UK has lost its AAA rating, we do not interpret this as increased default risk for UK government bonds. When you control the printing press, it's very easy to avoid a default on your own debt. That said, we think a UK recession is likely at this juncture, with global economic activity negatively impacted. We started the year with the view that 2016 economic activity had a good chance of reaching recessionary levels (defined as sub 2% growth), and we still believe that this is the case.

Currency volatility

Apart from falling interest rates, the most obvious impact of the UK's decision to leave the EU has been sterling weakness. The UK imports much more than it exports, which is paid for by large capital flows into the country. But with the value of UK assets under question in the wake of the referendum vote, the currency is instead bearing the brunt of this trade imbalance.

Figure 1: Yields at the lows, equities at the highs



Source: Bloomberg L.P.

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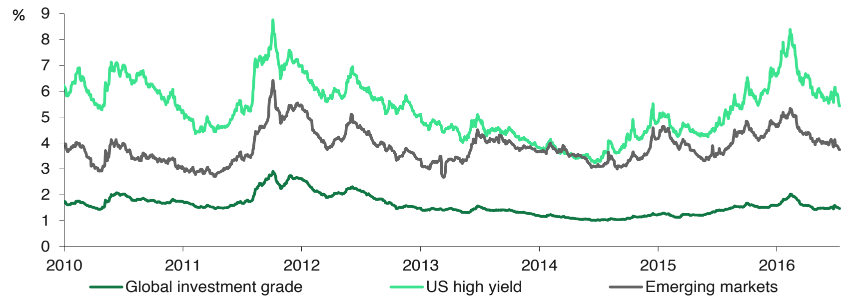
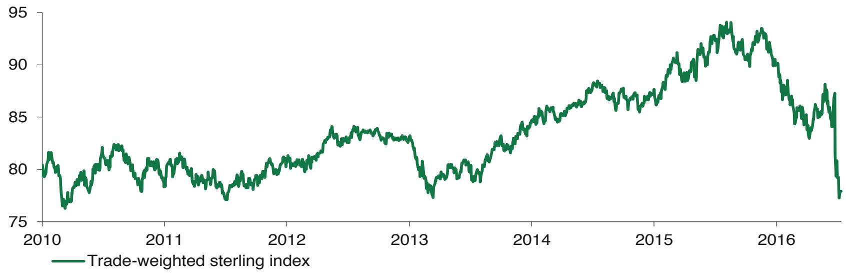
Figure 2: Corporate bond spreads do not appear attractive given the risks



Source: Bloomberg L.P., Barclays Indices

Figure 3: Sterling looks set to remain volatile



Source: Bloomberg L.P.

A weaker currency means rising import prices, thereby boosting inflation. But this is offset by the prospect of a recession in the UK, which could mean rising unemployment and lower wage growth. This is why the Bank of England can ignore the prospect of rising inflation, putting policy easing on the table instead.

The Fed is now unlikely to hike rates at all in 2016, in contrast to the four hikes indicated at the start of the year. The European Central Bank has only just started its latest policy: the purchase of non-financial corporate bonds as part of its ongoing quantitative easing programme. But it may also have to add bank debt to its programme before long given the difficulties faced by that sector.

Earnings stress across financials

Loose monetary policy helped to avoid a deeper economic contraction following the financial crisis, and it has also boosted asset prices over the years, broadly supporting bank and insurance balance sheets.

However, many institutions failed to take advantage of benign conditions to clean up their balance sheets. Moreover, the prospect of sustained weak growth and low inflation is not good news for the future credit quality of bank loans and insurance company assets. However, a more immediate concern is the impact on profitability of the current rate environment. For banks, the IMF's Global Financial Stability Report from April this year highlights the squeeze on net interest margins, given the combination of a zero interest rate floor on deposits and falling yields on loans. They suggest that Italian and Spanish banks would need to accelerate loan growth to an annual rate above 5% to offset declining net interest rate margins. With loan growth currently around zero, this is a very difficult proposition.

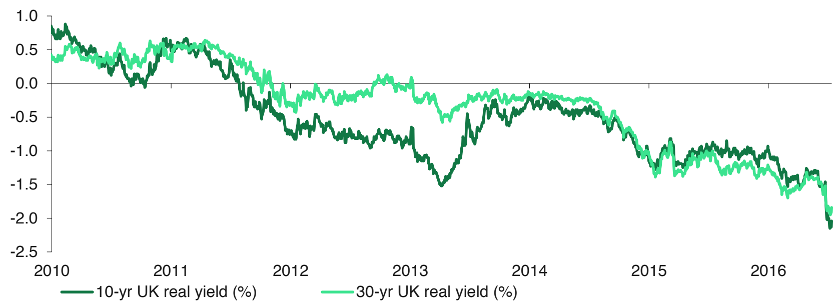
The same report also highlights the negative impact of low rates on life insurers and pension schemes. Low rates mean low returns, making it difficult for insurers to meet guaranteed returns. According to the European Insurance and Occupational Pensions Authority, more than half of European life insurers are guaranteeing an investment return to policyholders that exceeds the yield on the local 10-year government bond. Lower profitability, ultimately, can negatively impact solvency positions.

For pension schemes, those that have not fully hedged their interest rate exposure are taking heavy losses from the recent decline in real interest rates. And this is before we factor in the difficulties they face from increases in life expectancy.

Italian banks in focus

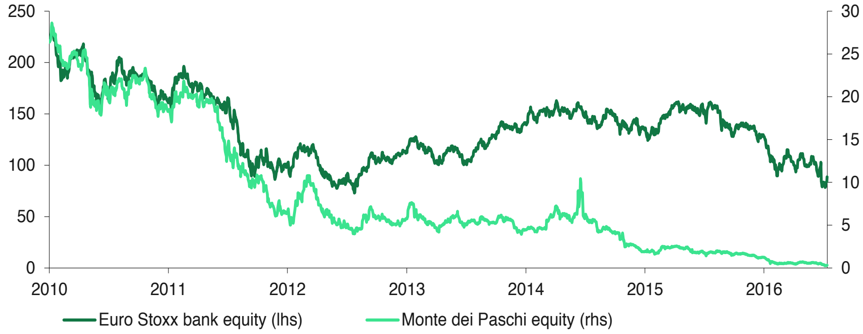
These systemic problems are currently most obvious in the Italian banking sector. With non-performing loans in the hundreds of billions, we estimate that Italian banks need around €40bn of fresh equity to bolster their solvency. This is virtually impossible to do in a smooth manner given the implied dilution to existing equity holders and the new European rules banning bailouts. In effect, the Italian government is facing the prospect of forcing losses onto retail holders of bank bonds just before a crucial constitutional referendum vote in October that could see the government collapse if it fails to pass. And the numbers are big, with about one-third, or €200bn, of outstanding Italian bank

Figure 4: UK real rates have fallen significantly



Source: Bloomberg L.P., Barclays index-linked swap RPI calculation

Figure 5: European bank equity under pressure



Source: Bloomberg L.P.

bonds held by retail investors. The recent collapse in equity prices is forcing the issue as investors head to the exit. We remain cautiously positioned with regard to European banks in general and Italian banks in particular.

Helicopter money

When able, policymakers have been determined to avoid the necessary structural reforms by kicking the can down the road with loose fiscal and monetary policy, even though such policy makes the situation worse.

As growth and inflation continue to disappoint, they are drawn into more extreme policy. Japan is currently under the spotlight, with recent currency strength threatening to torpedo Abenomics. As our Asset Allocation team discussed in their April Macro Matters publication, the next step may well be helicopter money.

There is a misconception about helicopter money that it is free money for all without any need to pay it back. This could be the case, but it could rapidly spiral into a state-sponsored Ponzi scheme, mimicking Zimbabwe in the 2000s or Germany in the 1920s. Instead, the monetary side of helicopter money is actually just central banks buying government bonds, which is the same quantitative easing we have witnessed for years now.

The key difference is that helicopter money implicitly finances a rise in the fiscal deficit, so governments spend more money in an attempt to boost consumption and improve the nation's infrastructure. In theory, this could be effective in moderation with each pound spent resulting in a pound of economic activity as opposed to current quantitative easing that can be undermined by the private sector saving rather than spending the extra money. Proponents of the secular stagnation theory see this effectiveness as a potential game changer. They believe that the world suffers from an excess of savings and insufficient demand even as economic slack abounds. This type of forced spending is therefore thought to be just the ticket, creating enough demand to close the output gap and create inflation.

Be careful what you wish for

However, we believe that even if helicopter money successfully creates inflation, the impact would be far from positive.

It is too simple to say that the world is experiencing significant excess capacity. Large debt/GDP ratios across the globe suggest that there has already been too much inefficient activity associated with debt, strangling potential future growth. If helicopter money were misdirected or done to excess, inflation could rise abruptly, requiring higher interest rates that would make debt servicing problematic. We have already had a taste of this in the last two years as pressure on the over-indebted energy sector more than offset the supposed benefit of cheaper oil, tightening credit conditions and bringing a number of countries into economic difficulty. The world needs low interest rates and increasing debt to maintain even current sluggish growth, and any disruption is extremely destabilising.

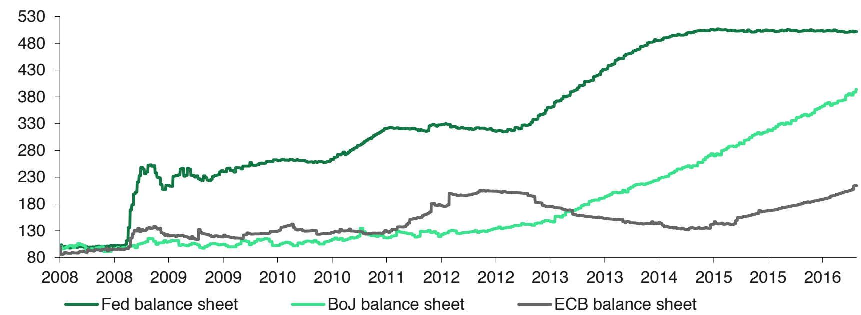
Taking Japan as the most likely country to enact helicopter money in the near term, its massive government debt burden suggests there eventually needs to be a wealth transfer from the population to the government. If the population were to believe that this will come solely through higher inflation, there is a risk that the policy creates uncontrolled inflation as people lose confidence in the currency. With government bond yields at such low levels, there is therefore a risk of a sharp re-pricing of this market with potentially catastrophic results.

Implementation problems

In any case, there are a number of reasons to believe that the practicalities of helicopter money would constrain the policy before we reach the stage of accelerating inflation.

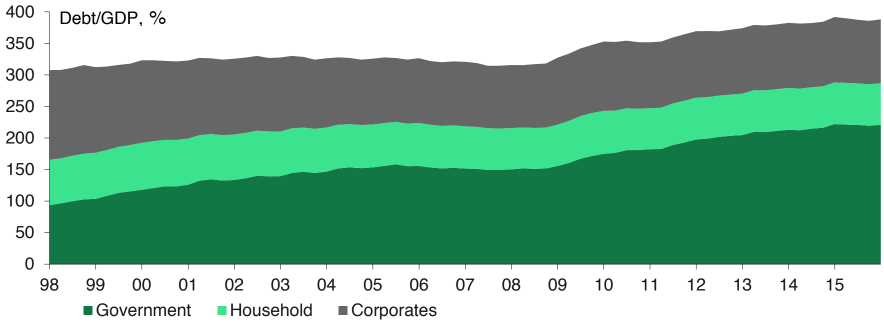
As we have seen in the aftermath of the UK's referendum, the currency channel is the most sensitive to large macro shifts. Significant exchange rate movements can

Figure 6: Central bank balance sheets set to expand further



Source: Bloomberg L.P., balance sheet indices rebased to 100

Figure 7: The Japanese debt mountain



Source: Bank for International Settlements

have detrimental consequences for political and financial stability. In other words, helicopter money by Japan would be likely to weaken the yen and improve Japan's export share. This could compel other countries, notably China, to also devalue their currency in a race to the bottom. To avoid this and to really stoke global inflation, we would need to see globally coordinated helicopter policy, which seems unlikely at present.

There is also the question of political support for such a policy. The issue revolves around whether large government expenditure undermines productivity. This is a very complicated topic of course, but it certainly isn't clear that diverting massive resources to government schemes is a good idea. There are probably some sensible projects that would enhance productivity, but it's easy for governments to become addicted to spending. Over the long term, this questions whether helicopter money undermines future growth and therefore just adds to the world's structural problems.

Depending on the dominant political views, it could be difficult for some countries to start helicopter money in the first place, and other countries would lack the political support to maintain the policy for a sufficient period of time.

Linked to this is the question of credibility. As the line between fiscal and monetary policy becomes blurred, a central bank's authority to make fiscal decisions and its independence in setting monetary policy will be questioned. This credibility has been hard-won over a number of decades and gives confidence to consumption and business investment. Its loss would have serious implications. The recent pick-up in academic debate of helicopter money is in part a reflection of central banks' desire to have a credible framework in place before the policy needs to be enacted.

In sum, given the amount of outstanding government debt and with yields at all-time low levels, we worry that helicopter money could be the catalyst to burst this bubble. But practicalities suggest there is every chance that it ends up on the scrapheap of failed monetary policy.

Secular strangulation

In recent years, policymakers' apparent obsession with asset prices rather than structural reform and productivity has inhibited their long-term success. The result of the UK's referendum highlights the fact that low bond yields, tight credit spreads and an equity market near all-time highs does not necessarily translate into sustainable growth and social concord.

Helicopter money is the latest in a line of policies that fails to counter the world's structural problems associated with our 4Ds. If it avoids pricking the government bond market bubble, there's every chance that such policy simply leads to another round of inefficient debt creation that boosts existing asset prices and intensifies wealth disparity.

Rather than secular stagnation, we see secular strangulation, with more extreme forms of monetary and fiscal policy simply tightening the noose. We do not believe there is an alternative to difficult structural reform that would go hand-in-hand with asset price volatility.

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