Japanification and US asset markets

- Slide in rates is less about acute growth fears than central bank inability to hit inflation targets
- Investors expect central banks to keep easing even if monetary stimulus is ineffective
- Economic weakness would likely steepen the drop in rates
- Fiscal policy is the last resort, slowed by institutional rigidity

Charge of the central bank brigade

Consider the following propositions:

1. The Phillips curve is flat
2. Technology and excess global supply keep price inflation low
3. US capital spending needs are not as high as in the past
4. US growth is adequate; neither much above potential or below
5. Global growth is soft and disinflation exported from EM
6. Monetary policy has a limited impact on inflation and growth
7. The Fed and other central banks keep easing to hit inflation targets
8. Fiscal stimulus is applied in economic crisis when monetary stimulus is exhausted

The first three propositions relate to structural forces that push inflation lower independent of the stance of monetary policy. The next two point to disappointing cyclical forces and unsatisfying growth (see MSV – Something wicked this way comes). The sixth is part of the secular stagnation thesis – real interest rates on their own cannot go low enough to provide enough stimulus to hit inflation targets. The last two provide rates and policy implications.

If these propositions all held, we think that US rates would head downwards, quickly if growth slowed and more slowly if the major manifestation were decelerating inflation.

Figure 1: Long-term inflation expectations falling

Inflation breakevens, %

Source: Bloomberg, Standard Chartered Research

Steve Englander
+1 212 667 0564
Steve.Englander@sc.com
Head, Global G10 FX Research and North America Macro Strategy
Standard Chartered Bank NY Branch

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The Fed and other central banks could keep easing to push up inflation, but the combination of global forces and technology would likely limit traction (see SMS – Burning down the House, Rates Alert – US and Europe: Lowering yield forecasts, Economic Alert – Fed pre-emptive July cut).

The drop in inflation would mean that low nominal rates were not particularly low real rates. In combination with monetary policy’s limited effectiveness, the prospects for successful stimulus and inflation pickup would be small.

An ultra-low rates outcome would emerge as inflation dropped and central banks struggled to push inflation back to target. Equities could be bid up close to infinity if the discount factor were low enough, but this has not been the experience in countries with persistent negative nominal and real rates. The conditions that generate such low rates may also raise the risk premium, pushing up the firm cost of capital. Persistently low inflation may be associated with expectations of economic stagnation and reduced profit opportunity, so the numerator of dividend discount models would also be affected.

Currency weakness has broadly been associated with the move to extremely low policy rates, particularly when accompanied with a move towards quantitative easing. The initial impact looks to be largest, but neither the EUR, JPY or USD has shown persistent weakness that extended beyond the initial impact. Past such easing moves were asynchronous in that the Fed moved aggressively and early, followed by the BoJ and subsequently by the ECB. It is unclear what the currency outlook would have been if the Fed (or any other major central bank) had been the only central bank to ease and had maintained its easing stance.

Nor is it clear how currencies would have reacted had central banks moved in synch with each other, cutting and expanding balance sheets simultaneously. Our first conjecture is that the best-performing currency would belong to the economy that looked least mired in a liquidity trap of persistently low rates and sluggish growth. Our second conjecture is that fiscal expansion would be associated with currency strength if monetary policy maxed out, at least initially.

Figure 2: Employment growth persists in low-inflation developed economies

Employment growth, % y/y

Source: Macrobond Standard Chartered Research
It seems likely that aggressive easing in the face of a sustained inflation deceleration would have the biggest currency impact at the beginning, when inflation is relatively high. If the easing were not enough to keep inflation from sliding, real interest rates would rise and support the currency (see the JPY discussion in MSV - Something wicked this way comes). The risk is that the run-up in real yields could reflect market expectations of a policy dead-end. So far this is not the case for the JPY, but may be relevant for the EUR down the road.

The move to lower rates would likely happen more quickly if accompanied by an economic downturn – in fact, it would probably happen lightning fast – but even with moderate growth, downside risk to rates remains if enough of our propositions hold.

Not as pessimistic as it looks
This outcome is less pessimistic than at first glance. A couple of countries have had persistently low inflation without immediate dire outcomes. For example, Japan has low unemployment, rising per-capita GDP and a rising investment share. This is atypical for an economy in distress. Looking more closely, the levels of short- and long-term rates and the ongoing buying of government debt could be construed as artificial, but not immediately unsustainable.

The perception of pessimism depends on how the question is framed. If the US, euro area and Japan had their current unemployment rates of 3.7%, 7.5% and 2.4%, but inflation were seen as durably at the target (World A), central banks’ policy rules would mandate a move to neutral to prevent inflation from rising. Many developed-market (DM) central banks sound as if there is nothing they would like better.

Currently, central banks see room to take these unemployment rates lower without violating inflation norms (World B). A world that can tolerate lower unemployment is likely to be better than World A, in which the cycle has clearly peaked and central banks can only allow economies to cruise. There may be an ideal world where policy can lower unemployment rates to the equilibrium level in a linear fashion (World C). Even if World C is better than World B, we argue that World B is unambiguously better than World A, as long as there are no major negative shocks.
If structural and technological factors, rather than demand shocks, drive disinflation momentum, economies could continue to have robust labour markets and grow at trend. This is true of Japan and has even been true of the euro area despite deep pessimism among investors and policy makers (Figure 2). For the moment, the US unemployment rate is the lowest since 1969, Japan’s since 1993, and even the euro area rate is at post-2008 lows.

Two caveats to this optimistic assessment: (1) if a demand shock occurs when inflation and nominal rates are close to zero, monetary policy could lose its effectiveness, leaving fiscal policy as the option for stimulus; (2) we assume that lower unemployment is a better outcome. Some might argue on normative grounds that slightly higher unemployment and higher real wages are preferable to low unemployment and low real wages.

Has monetary policy become less effective?

Many analysts, and a few central bankers, have argued that monetary policy is less effective in stimulating activity than in the past. We suspect that this is the case. Equipment and structures and residential investment as a share of GDP are at levels that were business-cycle troughs in the 1970s and 1980s (Fig 3). Given prolonged monetary stimulus, the lack of vigour is striking. The response is notably weak on the equipment and investment side, given the incentives in the recent tax bill. The weak response of sectors that are traditionally rate-sensitive indicates the diminished impact of monetary stimulus, even if it is not definitive.

We also assess the effectiveness of monetary policy by looking at how long it has taken the Fed to unwind peak stimulus in different downturns. We calculate real 3Y UST by subtracting core inflation over the prior 18 months from nominal 3Y yields. We smooth these real interest rates over a four-month period and gauge how long it took for real rates to increase 200bps from the trough (Figure 4). This is an imperfect measure, but it captures (1) when the Fed thought enough stimulus was in place to generate a rebound, and (2) how long it took for the Fed to withdraw a significant amount of stimulus, relative to the maximum stimulus period.

It took much longer in the aftermath of the 2008-09 downturn for the Fed to withdraw the 200bps of real interest rate decline than in previous recessions. In fact, it is
striking how much longer it has taken for stimulus to be withdrawn in the past two recessions, with the current recovery requiring by far the longest interval before stimulus could be withdrawn. That said, even if easing is ineffective, it is very likely that the Fed and other DM central banks will ease, even if there is little prospect that easing will achieve their goals.

**Structural disinflation drivers**

Much of the market’s pessimism on the ability of central banks to hit inflation targets is driven by structural and technological factors. In the US the accelerating fall in the prices of broad categories of retail goods is widely cited as an indication of ongoing pressures (Figure 5). The scale on the chart is index level, not rate of change so we are seeing outright and even accelerating deflation in these categories.

Import prices are also falling (Figure 6), but the pattern is sufficiently different from the path of declining retail prices that it is likely that both technology and weak foreign growth are driving prices down. USD strength is behind some of the import price weakness but is not closely linked to the overall retail price softness. We do not think it is the major driver of disinflationary trends.

Manufacturing employment growth has been remarkably strong over the past 30 months, close to the highs of the past 30 years and by far the strongest growth outside of immediate recovery from recession in decades. However, manufacturing wages are weak in relative terms (Figure 7).

Production jobs in durable goods manufacturing have gone from paying a 10% premium over average production worker hourly earnings to 7% less. Wages in non-durables have been below-average for a long time and have continued to drop. Much of the relative wage weakness probably reflects global competitive forces that are likely to persist even with some tariffs.

The strength of the aggregate demand for labour is not distributed evenly in the labour market. In recent years the lower deciles and the highest decile of wage distribution have seen strong wage increases relative to the middle quartiles (Figure 8). This is consistent with the anecdotal discussion that labour-market tightness is being experienced differently across skill groups, even if it is inconclusive evidence for overall disinflation.
The fiscal endgame
If our first seven propositions were broadly correct, we would expect the eighth to be correct as well. Fiscal policy would be needed if the negative shock were big enough and the interest rates close enough to the zero bound to leave little likelihood that monetary policy could reverse the shock. This may not be an immediate problem, but if rates kept drifting lower, at some point the negative shock could be big enough to overwhelm the ability of monetary policy to push back.

There are institutional difficulties in many countries preventing coordination of monetary and fiscal policies in normal circumstances. However, many countries have found room for fiscal stimulus when the shock is dramatic enough. If significant and persistent fiscal stimulus is needed to restore and maintain full employment, the low rates environment might not be permanent. But before this reversal, we would see both long- and short-term rates hit ultra-low levels before central banks exhaust their scope for easing.
 FX Alert

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