ESCALA
PARTNERS

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MONTHLY AGENDA: WHAT DOES IT MEAN WHEN GOVERNMENT GOES BIG?

Chief Investment Office

What does it mean when government goes big?

The policy response to COVID-19 has been unprecedented but so has the impact on economic activity. Whilst we are conscious not to extrapolate near term experiences too much into big structural shifts, it would be unrealistic to think that there will not be some economic, financial, and geopolitical implications that emerge over the coming years as a result of this crisis. We outline what the policy responses potentially mean for financial markets and economic growth going forward.

Suppression of risk and return

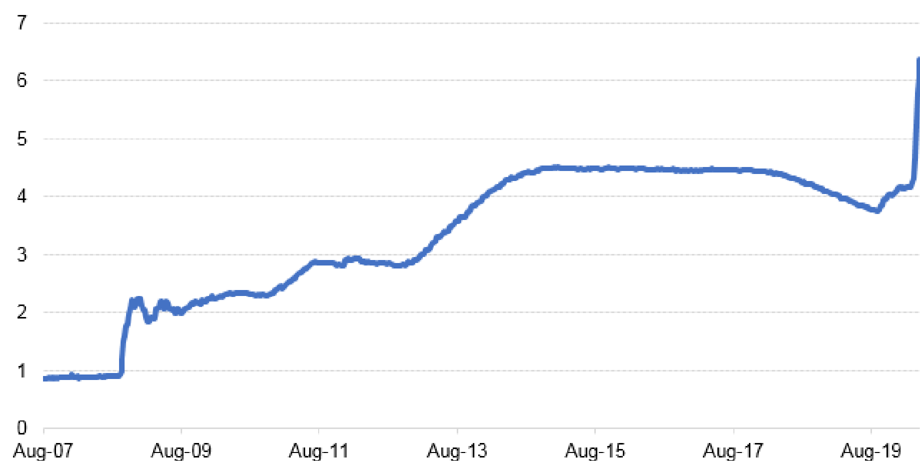
Suppression of risk

Effectively, the US Government and the Federal Reserve together have become the issuer, the buyer and the underwriter of risk in the marketplace.

As the issuer, the government uses bonds to fund its expenditure. US government bond issuance can be expected to increase significantly as a result of the current crisis. Some estimates have net issuance rising from around $400 billion in the past few years to over $1.5 trillion in the coming year. The level of public debt as a result is expected to rise to over 130% of GDP in the US from its current 105%.

The buyer of those bonds is now largely the US Federal Reserve. In the past seven weeks, the US central bank has purchased $2.2 trillion worth of bonds. That is, $315 billion per week or $1.3 trillion per month. That is ten times more than the Federal Reserve was buying at its peak following the Global Financial Crisis (GFC).

Chart 1. US Federal Reserve Balance Sheet ($US tn)



Source: Bloomberg

The government is also acting as an underwriter of risk by funding the Federal Reserve's purchases of commercial paper, investment grade credit and high yield bonds via a special purpose vehicle (SPV). Under the Federal Reserve Act, the SPV requires taxpayer backing from the Treasury Department to protect the central bank from losses.

So, the role of government in financial markets has suddenly become very substantial - both in terms of its depth and breadth. Compared to the GFC, the Federal Reserve is buying a broader array of financial assets in significantly greater amounts. We expect the size of the Federal Reserves' balance sheet to reach $10 trillion by the end of the year. That is up from $0.8 trillion before the GFC (Chart 1).

Having the government play such a large role in the price discovery of these financial assets will not only affect bond markets it will also affect equity and currency markets. Suppressing longer term bond yields artificially inflates equity market valuations and puts a floor under credit markets. In effect, by acting as a buyer of last resort, the Federal Reserve has reduced risk.

Suppression of returns

A buyer of last resort operating in the market may sound like a good thing given what it does to risk. The problem with this for investors is the quid pro quo. In exchange for taking risk, investors get paid a return. If the risk is lowered through government and central bank intervention, the return will also be lowered. This will occur naturally as investors gravitate to the asset being purchased by the authorities, suppressing its risk premium and hence return potential as a result.

The term "lower for longer" refers to an environment of lower inflation, lower interest rates, and lower returns. It sprang out of the policy response following the GFC. Fast forward a dozen years. That same policy response has been taken to new unprecedented heights. This inevitably leaves us in a lower for much, much longer environment.

Suppression of the business cycle

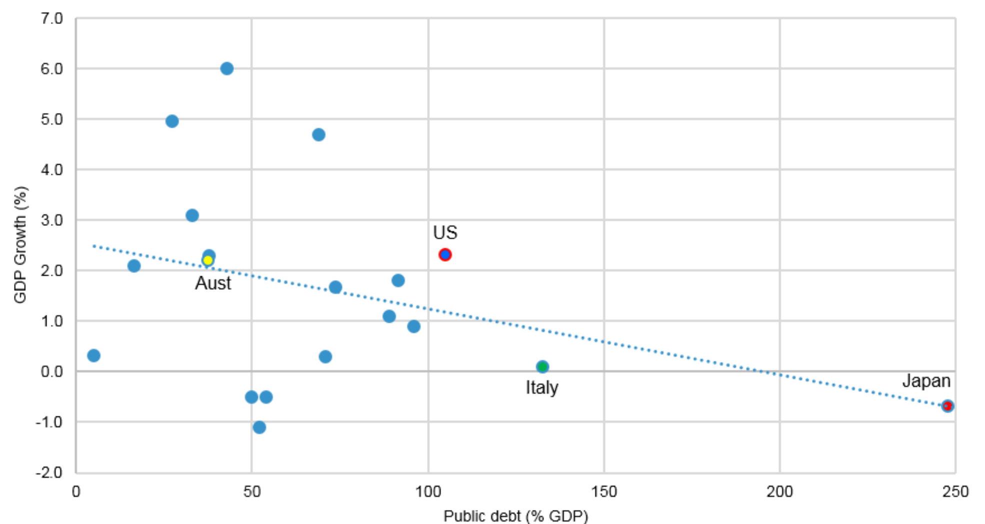
Suppression of the business cycle

In responding to COVID-19 many governments around the world have increased their debt levels substantially. How does this affect the workings of the economy?

In the 2009 book "This Time is Different", Professors Rogoff and Reinhart found that government debt levels above 90% of GDP are associated with lower levels of economic growth. This result is demonstrated in Chart 2 where there is clearly a negative relationship between the size of government debt and economic growth.

Among the G20, Japan stands out as having the highest level of public sector debt to GDP at 247% - more than 100 percentage points above the second highest, Italy.

Chart 2. G20 Public debt versus GDP Growth



Source: Bloomberg

Japan has been sitting with debt levels above 90% of GDP since the early 1990s when its massive property bubble burst. What has life been like in Japan in the 28 years since that time?

The table compares a number of indicators for Japan pre and post the explosion in its public debt level. The comparison shows how equity returns, economic growth,

inflation, productivity and cash rates are significantly lower in the period with high debt levels than in the earlier period when government debt was substantially lower.

Table 1.

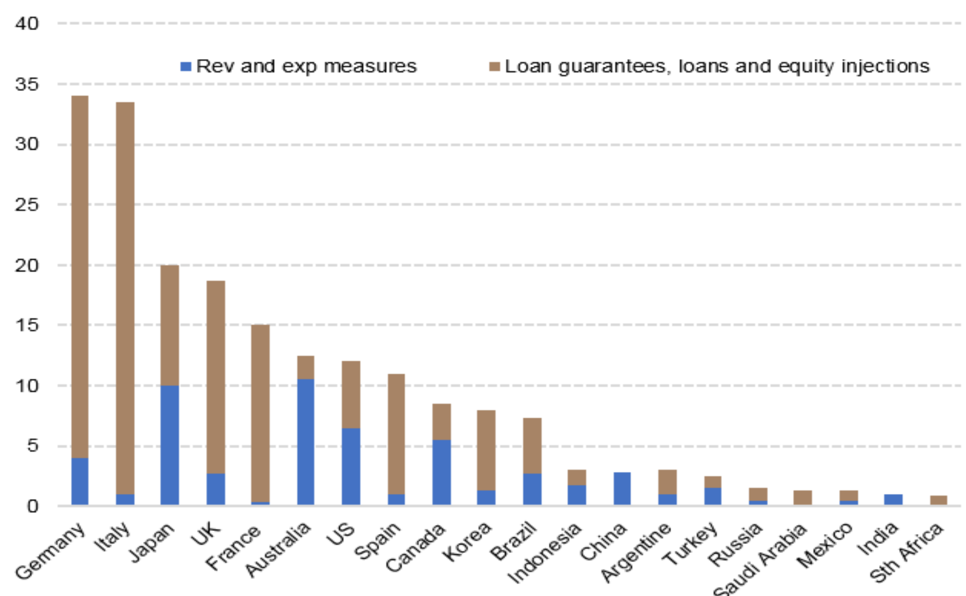
Japan	1991	2019
Public debt % GDP	39.6%	236.4%
10-yr bond yield	4.8%	-0.1%
28-year averages	**Pre-1991**	**Post-1991**
Equity returns	14.1%	2.5%
GDP	5.7%	0.9%
CPI	5.4%	0.3%
Productivity	1.4%	0.1%
Cash rates	5.4%	0.5%

Source: Bloomberg

The COVID-19 pandemic was a global crisis that has resulted in a global policy response. Governments around the world have spent no less than $12 trillion in aggregate. The chart below compares the fiscal measures announced by the G20 countries in response to the crisis. Notably, Australia tops the G20 for revenue and expenditure measures.

We can expect to see public debt levels rise substantially in the aftermath of this crisis. France, Canada and the UK will all likely move to debt levels closer to 100% of GDP. At the end of this, we are likely to see 60% of the G20 have debt levels consistent with lower economic growth. Interestingly, all of the countries in this cohort are developed economies. Government debt levels among G20 emerging market economies are surprisingly lower than that for developed markets. On its own, this would suggest the growth differential between emerging and developed economies will widen as a result of the crisis.

Chart 3. Fiscal measures announced in G20 countries (% GDP)



Source: DB Global Research

Lower risk doesn't mean lower volatility

Lower risk doesn't mean lower volatility

A style of investing that was very dominant the last time the US Federal Reserve was such a sizeable participant in financial markets was momentum-based investing. This is a style of investing that relies on the continuance of a trend - stocks that performed well in the past months are expected to continue to do well in the following period.

Between 2010-13, underlying market fundamentals, for the most part, took a backseat as investors made decisions on the basis of the Federal Reserve's asset purchase program. Underlying fundamentals were deemed of secondary importance. Herding behaviour became the norm as all investors marched to the beat of a single drum – namely the US Federal Reserve and its purchases of financial assets.

Momentum investing thrived during this period.

We should expect something similar to happen this time around. Investors need to be prepared for bouts of volatility, however. Flows into an investment opportunity that drive up asset prices can reverse sharply in a momentum driven environment. Such events occurred with regular frequency between 2010-13 and were known as "tantrums" because they didn't last long and were easily calmed by the central banks soothing words.

Unconventional monetary policies such as what has been implemented in response to the COVID-19 crisis can be hazardous by encouraging certain types of risk-taking that are not easily reversed in a controlled manner.

What are some implications for investors?

Implications for investors

a. Achieving income targets from yield alone will be much harder in a lower yielding environment. This may require income-oriented investors to become more focussed on total returns (income plus capital growth). This will necessarily mean being comfortable moving up the risk ladder. Overall asset allocations will likely change to reflect this. Allocations to so-called "defensive" assets are likely to fall in favour of growth assets.

b. Commensurate with this, risk management will become just as important as return management. If investors are required to take on more risk to achieve their return targets, risk systems need to be in the forefront. Investors will need to ensure they have adequate protection in their portfolio to mitigate against sudden bouts of volatility.

c. Asset allocations may also change as investors seek out alternative assets whose returns are not suppressed by the activity of the central bank. The rise in private market investing, a trend that was already underway prior to today, will likely receive an added boost in this environment.

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