



## Economic and Market Review

Third Quarter 2016

*“We think central banks are finally waking up to the limits and risks of prolonged QE and negative interest rates policy.”*

Alberto Gallo, Algebris Investments

*“Interest rates are lower for longer everywhere. It is a structural function of the dysfunctional global economy that we have.”*

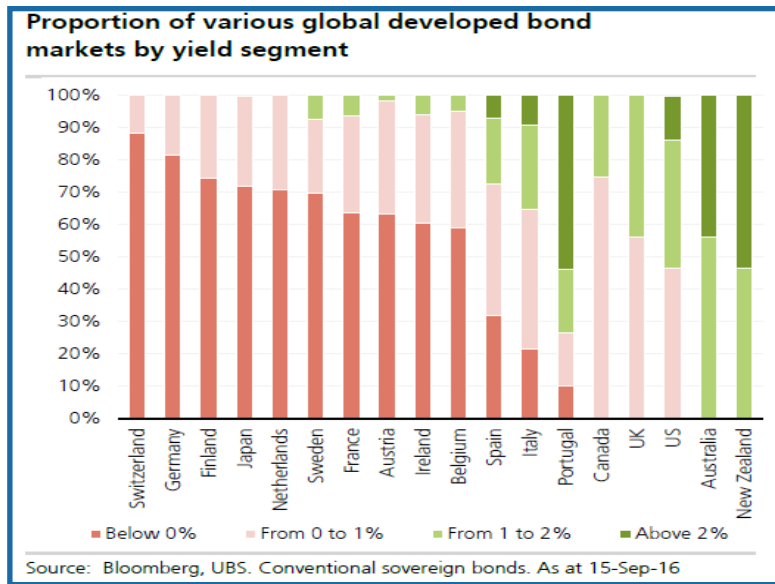
Michael Every, Rabobank International

The third quarter of 2016 saw another continuation of the **modern era of low rates, weak growth, and extraordinary monetary policy**. Across the world, policymakers are struggling with what International Monetary Fund (IMF) Managing Director Christine Lagarde has called **“the new mediocre”**. In early September, the IMF signaled another downgrade in its global growth outlook and blamed the failure of policymakers to fix deep-seated problems in the world’s biggest economies. Later that month, the IMF warned that a **“broad-based phenomenon” of low inflation**, stoked by a decline in commodity prices and wavering demand, risked deteriorating into a deflationary trap, particularly in advanced economies.

The world’s central banks and commercial banks currently hold a remarkable two thirds of the global government bond supply, a sum totaling about \$34 trillion. With banks holding bonds for regulatory reasons, pension funds holding them to match assets and liabilities, and central banks for policy goals, **enormous swaths of the global sovereign bond market are in the possession of actors who are unnatural sellers**. Cumulative bond buying since 2008 by the four major central banks alone – the Federal Reserve, Bank of Japan (BOJ), European Central Bank (ECB) and Bank of England (BoE) – currently totals more than \$8.6 trillion. Added to existing holdings on their balance sheets, that brings their grand total to roughly \$9.6 trillion. A report from ING Group shows that the Fed owns over 20 percent of the U.S. Treasury market, the BoE owns 30 percent of the UK gilt market and the BOJ owns about 40 percent of the Japanese Government Bond market. Moreover, the Fed, ECB, BOJ and BoE have all kept overnight interest rates close to zero for much of the past decade. The BOJ and ECB have forced an unprecedented level of government bonds into negative rates in a desperate attempt to spur risk-taking and investment. As of

the end of September, the **universe of negative yielding sovereign and corporate debt held steady at \$11.6 trillion** according to the Bloomberg Barclays Global Aggregate Index of investment-grade bonds. A chart showing various global sovereign bond markets by yield segment can be seen in **Figure 1**. Officials at the major central banks have suggested that too much is being asked of monetary policy. They argue that fiscal policymakers must embrace some combination of fiscal stimulus and structural reforms to increase growth. Unifying the world’s central banks is recognition it’s going to be a long hard journey to lift inflation to targeted levels, and that slow productivity growth and aging populations have cut potential growth and long-term borrowing costs.

**Figure 1**

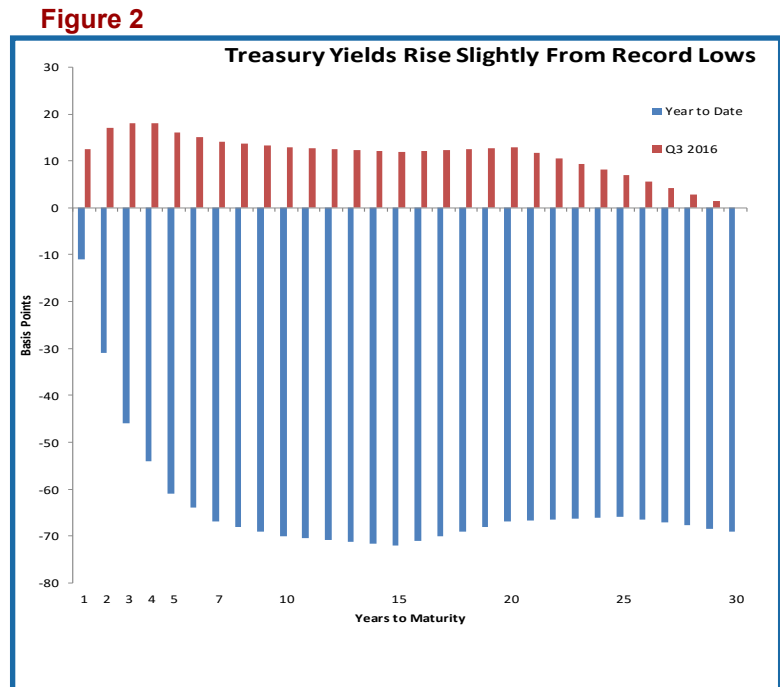


In early August, the Bank of England lowered interest rates for the first time since March 2009, part of a package of stimulus measures to help its economy after the United Kingdom’s Brexit vote to depart the European Union in June. The Monetary Policy Committee (MPC) voted to lower the benchmark rate to a record-low 0.25 percent. In addition, the central bank’s asset-purchase target was increased for the first time in four years, to 435 billion pounds. Also the MPC pledged to buy as much as 10 billion pounds of corporate bonds in the next eighteen months. Analysts see the central bank as willing to provide an array of stimulus policies because it sees the U.K. economy facing substantial headwinds from Brexit. The easing actions by the BoE, BOJ and other global central banks have certainly had an effect on the US Treasury market year to date. This past quarter, Treasury yields rose moderately from their all-time lows that were touched in early July. The average gain across the entire yield curve was 16 basis points. The Treasury market remains one of the few places left in the developed world where investors can get relatively attractive yields. Changes in the Treasury yield curve for the quarter and year-to-date can be seen in

**Figure 2.** Interestingly, one can see that since the Fed hiked rates last December, Treasury yields have declined considerably, even at the short end of the yield curve, defying conventional wisdom of what should happen after the Fed tightens. As the Fed prepares to possibly raise rates again this December, we would recommend investors **tune out short term noise and look at the long term big picture of where interest rates are going.**

In September, the Bank of Japan (BOJ) shifted its monetary policy framework from quantitative easing through massive Japanese government bond (JGB) buying to a new approach of targeting the yield curve. The central bank said it would adjust the volume of its bond purchases as needed in the short term

to control bond yields, while keeping it at about 80 trillion yen (\$780 billion) annually over the long term. In a central bank first, it will now target not just short-term interest rates, but long-term government bond yields as well. Many analysts saw the shift as a tacit admission by the BOJ that it had reached the limits of its JGBs purchases. The BOJ has certainly been the most daring of global central banks in its use of monetary stimulus to fight deflationary pressures and stagnation. The BOJ's attempt to steepen the yield curve was described as a move designed to help Japanese banks, pension funds and insurers endure in a negative rate environment. Additionally, the central bank pledged to keep its monetary base (bank cash reserves and currencies in circulation) growing until after inflation overshoots its 2 percent target. Many market participants remain skeptical as inflation indicators and expectations have dropped. Despite an aggressive stimulus program, now in its fourth year, prices in Japan fell by 0.5 percent during the most recent twelve-month period. **Japan's monetary adventures matter to all central banks because so many countries are coming to resemble Japan**, particularly pertaining to slow growth and too-low inflation. One can see the



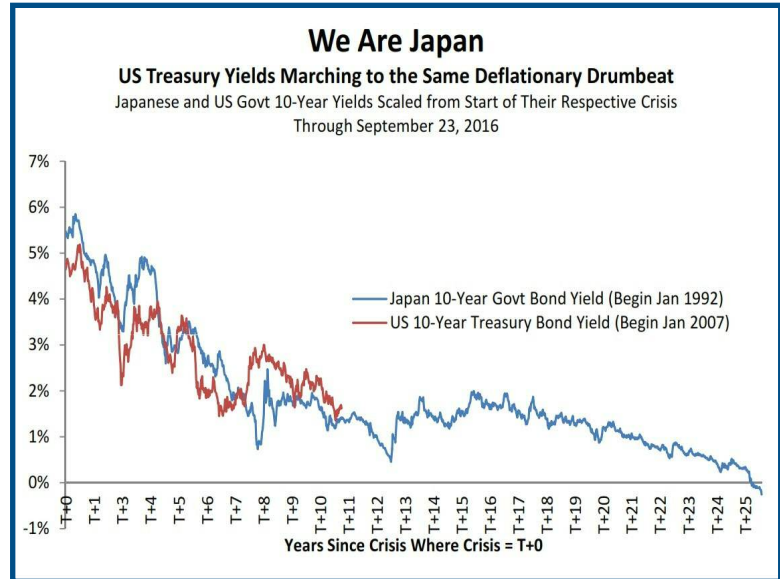
similarities between Japanese and US 10-Year bond yields when they are scaled from the start of their respective crises in **Figure 3**.

In mid-September, the Federal Reserve kept the target range for the benchmark federal funds rate unchanged at 0.25 percent to 0.50 percent. The Fed continued to settle into a new view that domestic growth would remain sluggish for the foreseeable future. In fact, officials said they expected that economic growth would not exceed 2 percent over the

next three years. Some analysts pointed to a rise in short-term bank borrowing costs as part of the reason for the Fed staying put. Banks' unsecured lending rates, like the dollar London interbank offered rate (Libor) have surged amidst an exodus from prime money-market funds ahead of new regulations. Three-month Libor has risen to about 0.85 percent as of late September, the highest level since 2009 according to ICE Benchmark data. Prime funds will soon face heavier regulation amid an overhaul of the \$2.6 trillion money-market industry that takes effect October 14. At their September meeting, 14 out of 17 Fed officials said they expected to raise the benchmark rate at least once this year. The futures market currently puts the odds of a Fed rate hike in December at about 60 percent.

Many see the Fed as being forced to reexamine its core assumptions about the economy after **trillions of dollars of quantitative easing (QE) and years of zero interest rate policy (ZIRP) have failed to generate a stronger recovery**. For years, Fed Chair Janet Yellen and other officials pointed to lingering headwinds from the financial crisis as the culprit for the sluggish pace of the economy's expansion. Seven years after the Great Recession officially ended, many of those headwinds have dissipated, yet unfortunately normal growth remains elusive. Increasingly, there is a nagging fear that the American economy has

**Figure 3**



permanently downshifted into an era of tepid growth that policymakers have little power to change. In fact, Fed officials have all but given up hope of attaining the 3 percent rate of growth once viewed as the baseline for a healthy economy. Last quarter we mentioned how Yellen had been warming up to former Treasury Secretary Lawrence Summers' view known as "secular stagnation". This view argues that deeper, long-lasting and secular (non-cyclical) forces are discouraging business investment and holding down interest rates. Meanwhile former Fed Chair Ben Bernanke has argued that the driving force behind low interest rates is a global

glut of savings aided by demographics, as aging populations are shrinking the workforce and customer base, sapping incentives for capital expansion. Average annual per-capita GDP growth over the preceding 10 years for Japan, the Euro area and the U.S. can be seen in **Figure 4**.

**Figure 4**

