Investment Intelligence Online

Highlights of John Greenwood live event 30 November 2017

This document is for Professional Clients only and is not for consumer use.

Introduction

Our live event with John Greenwood (JG), Chief Economist, Invesco Ltd, took place on Thursday 30 November 2017. Questions from the intermediary community were put to him by Paul Burden (PB), Independent Financial Journalist. This document summarises the main points of their discussion.

Global growth

PB – Can the synchronised growth we are seeing continue?

JG - Yes, I believe it can. We've been seeing fairly steady growth in the US, the Eurozone and Japan - all of them are growing roughly between 1.5% and 2.5%. China continues to grow somewhere between 6% and 7% on the official numbers. The important point is that none of them are showing signs of overheating.

The longest ever US business cycle expansion was in the 1990s. It ran from March 1991 to March 2001, exactly 10 years. The current expansion has been going since June 2009, which makes it eight years and five months. I'm confident that this expansion will be the longest in recorded US history. Of course, most economies tend to follow the US. All of that is good news for the expansion, and I think it can continue for several more years.

Overheating

PB - What is the synchronisation effect of all these economies? Is it in some general sense benign, neutral or coincidental?

JG - It really depends on the question of overheating. If you have strong growth everywhere, plus a rise in inflation and commodity prices, that's going to trigger actions by the central banks to curtail things. So, as long as we don't have the inflation problem, then I think the outlook will remain benign.

Debt concerns

PB - Are you worried about a renewed build-up in debt?

JG – Generally no in the advanced countries. In the US, UK and in countries like Spain and Ireland, we've seen a lot of deleveraging over the last seven or eight years - most of that in the financial and household sectors. There's been some build-up of debt in the non-financial corporate sector, but nothing to worry about in my view.

Government debt has continued to grow a little bit, but not drastically. In most countries, that's fairly under control. However, it's private sector debt which really matters. Deleveraging in the private sector enables the economy to grow and then over time government debt can be gradually reduced relative to the size of the economy.

Emerging markets are slightly different. We've got one or two worries over China, Turkey, and Brazil is still over-indebted, but none of those are in a crisis phase, I think, at the moment.

Inflation woes

PB - Are we starting to see potential for a broad based rise in inflation across the developed world?

JG - I'm very much at odds with the consensus of economists here. If you ask most economists that question, they will say, 'Well, we're getting near full employment, the output gap is closing and that means we're going to have inflation.'

The problem with that theory – well, it's not so much a theory as an observation – is that it has worked on numerous occasions in the past for a particular reason, and that is inflation is a process. It starts with money and credit, goes through to asset prices, then the real economy and finally inflation.

The Phillips curve and the output gap analysis really only looks at the last two elements. It says, 'Well, we're getting a tight labour market, therefore, we're going to have inflation.' That only works if you have excess money growth in the first place. The remarkable thing about this economic recovery over the last seven or eight years is that in almost all the advanced countries we've had very subdued growth of money and credit, and therefore inflation has remained subdued.

It's been a big puzzle for central bankers and economists at investment banks as to why inflation has remained so low. However, I'm quite sure that inflation is a monetary phenomenon. It's not caused simply by tight labour markets, which are a symptom of earlier strong demand. So, as long as we don't have excess money growth in the first place, there's no reason to expect an inflation outburst any time soon.

Policy error risk

PB - Are you concerned that the policymakers may look at the inflation picture and take action which you would regard as excessive or not needed?

JG - There's some risk of that but in most cases central banks are raising interest rates very slowly and cautiously. We're seeing that with the US Federal Reserve (Fed) and the Bank of Canada. The Bank of England has just done the one increase. I think the risk of that type of policy error - raising interest rates too rapidly and flattening or inverting the yield curve - is unlikely. In any case, even if interest rates were raised, what would be required to cause a policy mistake is a sharp slowdown in money and credit, and again I don't see the motive to do that from the central banks and I don't think it's likely.

Shrinkage of US Fed balance sheet

PB - What are your thoughts about the US Federal Reserve trying to normalise their balance sheet?

JG -Currently, they are shrinking the balance sheet at a rate of US$10 billion per month but by the end of next year they will have ramped that up to US$50 billion per month. If you annualise that, the Fed will be shrinking its balance sheet at US$600 billion a year and because the Fed is releasing that amount of securities - treasuries and mortgage-backed securities - that means the private sector is going to have to take up those securities.

If the US Treasury and the agencies that issue the mortgage-backed securities have to increase the size of their auctions and sell long-term bonds, not only will the Fed be raising interest rates at the short end, but we will also see some pressure at the long end of the market. So there's some risk there.

Fed Chair Janet Yellen has said that all this can happen 'in the background', which is code for 'no market impact', but I'm rather sceptical of that. The only way in which there would be no market impact is if the Treasury decided to issue almost entirely short-term bills and these were fully taken up by the banks in place of the excess reserves they're currently holding. That would amount to, in effect, a swap between the Fed and the banks. I think this is unlikely to happen but it is something we have to watch.

Fiscal policy

PB - With the monetary tap being turned off, do governments have much room to ease fiscal policy?

JG - I don't think they do have much room to ease fiscal policy, but in any case I question the assumption that fiscal policy is an equally potent weapon as monetary policy. That is simply not the case. Monetary policy almost always dominates. The only case where fiscal policy has measured up to monetary policy is where the two have been working hand in hand.

A good example of that was when China announced a huge fiscal stimulus in 2009 that went through to 2011. The economy recovered strongly. They announced a 4 trillion yuan (US$685 billion) expansion, about 6% of GDP at the time and the economy duly recovered. The problem was that most of that was financed through the banking system. Money and credit also expanded by 25%, so from a scientific point of view, you have to say that both monetary policy and fiscal policy were expansionary.

However, in the Eurozone there are tight limits on budgets. Elsewhere, government debt is high and there is a reluctance to add further to it. I don't think we will see much stimulus coming from the fiscal side.

Trump tax cuts

PB -Do you believe that the Trump administration will be able to implement their planned taxation strategy or will it get watered down?

JG - The extent to which they will be able to cut corporate and personal taxes (currently going through the Congress) looks like it's going to be quite small. The interesting question here is how much impact could this have on the economy? I think the answer is quite limited. The US economy is growing at just over 2% at the moment. We've had a couple of quarters of three percentage points of growth on an annualised basis, but over the year as a whole it's going to come out at 2.3% or 2.4%.

The Trump administration wants to see real GDP growth rise to 3.5% or 4%. I think that's completely out of the question. At best, I think we'll see the US continuing to grow at something like 2-2.5%, in line with its potential. Productivity growth is relatively low, and labour-force growth is low. If those two supply side constraints can't be lifted, then we're not going to see a radical change resulting from Trump's tax cuts.

US Fed leadership

PB - Are we going to see a change in the US Federal Reserve's policy under Jerome Powell?

JG - I don't think so. On interest rates, he is very much in line with the consensus. Therefore we'll likely see something like three interest rate hikes during 2018, including one this December – that'll take us to virtually 2% at the end of the year (2018).

On balance sheet reduction, he's endorsed the plan which was published last June and implemented from October, so I don't see any change on that. On bank regulation, the only thing he's indicated is that he would perhaps lighten regulation on smaller banks. He'll maintain the capital and liquidity requirements on all the large banks, the systemically important banks, so I don't think we'll see any change there.

Finally, on relations with the Congress, growth and taxation, he shares my view that even if taxes are reduced a bit, or even quite a lot, the fundamental growth rate of the US economy would not be changed radically.

Mr Powell is very much following the Yellen playbook. I thought his answers in his testimony just a couple of days ago were extremely fluent, precise, to the point and, most of all, delivered in a fairly straightforward language: none of the sort of theoretical arguments we used to get from Bernanke, Greenspan or even Yellen.

Powell experience

PB - It has been widely observed that Jerome Powell doesn't have a background in economics. As an economist, are you comfortable seeing a man run this important institution who comes from a quite different background than your own?

JG - Well, he's been in financial markets for most of the past 40 years and he's been actively participating in Fed debates for quite a time, so I don't think he's at all ignorant, no.

UK economy

PB - Why has the UK economy struggled recently and is that likely to continue?

JG - I think there are two reasons primarily for the slowdown in economic growth. Firstly, investment has undoubtedly slowed because of the uncertainties due to the whole Brexit process. Secondly, the knock that consumer spending has had from the increase in inflation - real spending power has been eroded by the depreciation of the pound, which has flowed through in the form of higher prices.

However, I'd expect the rise in inflation to be relatively short lived, subject to what the Bank of England does. Therefore, we ought to see some improvement, certainly after the Brexit process is over, but there will be a period of adjustment going forward.

Highlights of John Greenwood live event
30 November 2017

This document is for Professional Clients only and is not for consumer use.

UK Budget

PB – UK Chancellor Hammond didn't have a lot of wiggle room but do you think what he did do was particularly helpful or is its effect likely to be quite neutral?

JG - I don't think it's a budget which many people will remember. It was certainly not a radical one. As I said before, what matters is monetary policy. Fiscal policy has far less influence on what happens in the economy.

Brexit

PB - How much of a risk is a bad Brexit deal and no deal at all?

JG - I think the best Brexit would have been an arrangement whereby we could escape from the sort of regulations imposed by Brussels, excess immigration and, more importantly, free from some of the tariff regime the EU imposes.

It's important to remember that the EU is not a free-trade area. It is a customs union, a Zollverein, as they used to call it in Germany in the 19th century. It's an area which has tariff barriers against a whole range of things, particularly agricultural and various manufactured products.

Brexit would have given us the opportunity to cut many of those tariffs and to trade more freely. However, it seems to me that the deal which Mrs May and her cabinet are steering towards doesn't do any of those things at all. It looks as though we're going to mimic the regulatory and tariff structure of the EU, which will mean that the net benefit is likely to quite limited. Once we've paid the leaving dues, it looks as though the sort of deal we're going to have will be EU-light, but not be part of the EU.

A clean break by contrast, although likely to be more disruptive in the short term, would have been hugely beneficial to consumers over the longer term, especially for lower-income consumers. It has been estimated that our food prices would decline by 6-8%. For example, tariffs on oranges have been raised five times over the past two years in the EU. A clean break from the EU would allow us to buy oranges, and other commodities such as coffee, on the cheapest markets in the world. But instead of that it looks as though we're going to do pretty much the same deals as the EU has.

UK monetary policy

PB - How do you see UK monetary policy unfolding from here? Was the Monetary Policy Committee (MPC) right to raise interest rates recently?

JG - Yes, they were right to raise interest rates but I think we have to go back further to see why they had to do that. Out of concern the UK economy was going to tumble following the Brexit referendum outcome, the MPC cut interest rates, added a further tranche of quantitative easing (QE) and introduced a term-lending facility.

In retrospect, it turns out that credit had been growing rapidly before the referendum and continued to grow rapidly in the wake of it. That's why the British economy remained so buoyant until relatively recently - money and credit growth was strong and spending was too. In effect the cut in interest rates and the additional QE poured fuel on the fire.

So, I think that was a mistake in August 2016 and the decision to raise interest rates in November 2017 was correcting that error. With bank lending and credit growth fairly buoyant now, I believe the MPC should start to follow the US Fed and gradually raise UK interest rates. Again, I emphasise gradually, no urgency, as it would be a mistake to add domestically generated inflation to imported inflation.

Eurozone growth

PB - The Eurozone economy has been strong over the past year. Is that sustainable or will the region struggle for growth again in the future?

JG - I think the long-term growth potential for Europe is somewhere between 1.5% and 2% growth. At the moment they're growing a little faster at about 2.2% but that's because they're catching up with where they should have been if they'd had better policies earlier on. I think Europe will grow at something close to 2% over the long term, subject to what the European Central Bank (ECB) does.

ECB QE

PB - Is the ECB correct to be tapering its QE?

JG - They've announced a plan to do that from January and it will go through to September. I don't have a problem with that although they've done their asset purchases in a way which has not promoted as much money growth as it should have done. When the central banks in the US and UK stopped doing QE, the commercial banks took up the baton, ran with it and created credit. In Europe at the moment, credit creation is very, very weak. The risk is that next September, when the ECB potentially cuts QE from €30 billion a month down towards zero, the banks don't increase their lending. That would be a setback.

It's important that European banks are strengthened in terms of their capital and their liquidity positions, and are in a position to expand credit going forward. Otherwise, we could have a policy mistake.

Japan reforms

PB - Do you see Shinzō Abe's comprehensive victory as being supportive of further structural reforms?

JG - I think Mr Abe's victory in the Japanese election was more important for his defence and geopolitical position rather than for domestic structural reforms. There's a very limited amount he can do with labour-force reforms. He's trying to urge the companies to pay higher wages, but that has never really worked in any economy. I think the scope for more structural reforms is actually quite limited. The Japanese economy, like Europe, is highly regulated. It's difficult to see how many of those regulations would be overturned without generating a lot of political opposition.

Investment Intelligence Online

Highlights of John Greenwood live event 30 November 2017

This document is for Professional Clients only and is not for consumer use.

China outlook

PB - What is your view of China's economic fortunes over the medium term?

JG - I think the economy is something like Japan in the 1970s and 1980s. Japan came off a very strong growth rate up to 1973 - between 1949 and 1973 it averaged 9% per annum, very similar to what China had been achieving. Then Japan slowed to something like 4-5%. China is now in the mid stages, growing around 6-7%. I think gradually over time that number will come down towards 5% and 4% and so on.

However, the economy is still at a very low level of development. Per capita incomes are well below those in the developed West and therefore China has a long way to go to catch up. As we're not seeing huge liberalisation plans coming out of the government, I would expect the growth rate over the next few years to be something like 6%, possibly gradually shaving down towards 5%.

China reforms

PB - Did we see any evidence at the recent congress of an appetite within China for major change of any kind?

JG - No, not at all. That was a Communist Party congress. The really disappointing point from it was that Mr Xi [Chinese President], who accumulated a lot of additional power in that meeting, did not show any appetite for state-owned enterprise reform. If you look at the economy, most of the problems have been in the state-owned sector: the heavy industries which are suffering from excess capacity. However, there's no intention whatever to privatise or to liberalise in that area. So there's a risk that mistakes of over-investment could be repeated.

Debt levels in China

PB – Should we worry about the levels of corporate debt in China?

JG - I think it's an issue for growth because it means that companies that are heavily burdened with debt will be more cautious about investing going forward. Although it could act as a bit of a drag on growth I think that it would be small.

The real issue from a financial point of view is whether the size of the debt burden could trigger a run on the banks we saw in 2008 in the developed Western economies. The answer to that, I think, is no.

Shadow banking liabilities or shadow banking credit in the Chinese banking system only amounts to about 15% of total bank assets, whereas in the US in 2008 it was double the size of bank credit. For example, money outside the banking system was twice the volume of money in the US banking system.

Chinese banks on the whole are much better funded with deposits and are not so dependent on borrowed funds for their lending. Therefore, they're much less subject to a banking run. It's the liability side of bank balance sheets which matters more in my view. Of course the asset side matters but it's the way in which the banks are financed on the liability side which is really critical.

Commodities

PB – We've seen a decent recovery in many economically sensitive commodity prices. Can that continue?

JG - I think we'll see a gradual improvement in commodity prices, perhaps something like in line with global GDP growth, but I don't see a big inflationary surge leading to a spike in commodity prices. That's simply not in the cards because the advanced Western economies are not allowing that kind of inflation to emerge. There are only one or two countries in the emerging world, like Venezuela for instance, where inflation is a drastic problem. Elsewhere, in countries like Brazil, Russia or India, and indeed in China, inflation is very subdued.

Asset allocation

PB – What does all this mean for asset allocation?

JG - Well, at this stage in the cycle with interest rates rising and a potential for further increases at the long end of the bond market, the outlook for bonds is self-explanatory. The more interesting point is whether high valuations underlying equities, real estate and other risk assets, require some degree of caution.

Well, they always require caution but I think that high valuations on their own are not a reason for moving to cash. Given that the economies are going to continue to grow, earnings growth is also likely. I think we probably have one or two, maybe several, more years of decent earnings growth ahead. Historically that has spelt good news for equity and real estate markets.

Important information