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Markets

What would helicopter money mean for markets?

The Multi-Manager View: the team looks at one of the next possible policy weapons in the monetary arsenal - helicopter money - and considers its market implications.

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At the time of the above quote three years ago, most policymakers believed that with enough monetary stimulus, the US economy would recapture its pre-crisis trend rate of growth.

This has not happened. Although the US has performed like a thoroughbred relative to other developed economies, by its own standards it's been a bit of a donkey.

In its 2016 World Economic Outlook "Too Slow for Too Long", the IMF recently downgraded its global growth forecast to 3.2% – the fourth such downgrade in the last 12 months. This is perilously close to the 3% rate the institution considers recession territory.

Fearing an extended period of low growth and low inflation (secular stagnation), and with risks in its view tilted to the downside, it has endorsed central banks to step up their efforts to find a "more energetic" solution.

One merely has to consider the unprecedented monetary experiments undertaken by global central banks in recent years and the consequent trillions of dollars worth of bonds trading with negative yields to see how "energetic" policy has already been. Nevertheless, in the eyes of the IMF at least, more should be done. The question is what…

The policy petri dish

Japan has long been the poster child for an economy struggling with low growth and low inflation as a result of an aging demographic, weak productivity growth and an enormous debt mountain (sound familiar?). Accordingly, it has served as a useful petri dish for the unorthodox interventions of Western policymakers in recent years.

Japan was the first developed economy to essentially hit zero interest rates in the late 90s, it was the first to engage in quantitative easing in 2001, and earlier this year bungled a move to negative interest rates.

Today, having experienced four recessions in the last seven years in spite of its central bank "energetically" buying up 35% of all Japanese government bonds and 59% of its exchange-traded funds (ETF) market, speculation is building that it will soon pioneer the implementation of "helicopter money".

Get to the chopper?

The concept of helicopter money was first introduced by Milton Friedman in 1969. Ben Bernanke famously spoke of it in 2002 before becoming Federal Reserve (Fed) Chair, and recently published a blog on the subject titled "What tools does the Fed have left? Part 3".

Simply put, helicopter money describes an alliance between monetary and fiscal authorities to directly intervene in an economy to help stimulate nominal growth. Whereas quantitative easing (QE) has been an indirect attempt to stimulate growth (printing money to buy assets, thus lowering market interest rates, credit spreads and equity risk premiums), helicopter money would in effect be printing money to fund a fiscal splurge without raising already high debt/GDP ratios.

Bernanke's blog gives the example of $100 billion being printed to fund both a regeneration of US infrastructure and a tax cut for consumers. Although it is described as a 'last resort' policy, in the event of a downturn with rates already near zero, there would be few energetic options for the US Fed to pursue.

It is widely acknowledged that as things stand, such a policy would be politically impossible in the US. However, if it were seen to have been even remotely successful in Japan (admittedly a big "if"), such a programme would likely be seen as preferable to risking outright deflation.

Investors ought to remain open-minded in our view. Policies that were once considered reckless and at the very extremes of economic theory (QE, negative interest rates) are now not only deemed conventional but are more and more judged as inadequate!

From a long-term perspective, we know Japan's economy is in a perilous state. That is not new news. It may well be that its longer-term demographic decline can be arrested in time through financial incentives. That is one potential long-term solution to a long-term problem.

In the shorter-term however, with the renewed strength of its currency posing a major headache to its reflation efforts, helicopter money – if it is going to be unleashed anywhere – will happen in Japan first.

Bernanke, the IMF and the financial world at large will no doubt pay close attention to how the experiment pans out.

The market implications

An important competence in fund management is being able to separate what you think should happen from what you consider most likely to occur. We can all have views about whether something should or shouldn't come to pass. Ultimately though, it's just not that relevant.

The secular stagnation theme has been permeating market prices for some time now. After three-plus decades of disinflation and falling interest rates, investor psychology regarding deflation and low rates seems as entrenched as the fears of inflation were in the 80s. The overwhelming narrative today is as follows:

1. Sovereign debt/GDP ratios are too high
2. This is undermining nominal GDP growth, which is already too low
3. The global economy remains in a position of extreme vulnerability as a result
4. With the monetary arsenal already fully deployed, we have no credible safety net
5. So we should heavily overweight 'safe' assets for fear of falling into a deflationary abyss

As things stand, points 1 – 3 are not controversial in our view. As outlined above however, point 4 is not only debatable, but has the potential to be a game-changer for investor positioning.

As we have discussed in previous quarterlies, we have had an extremely bifurcated market in recent years, where the beneficiaries of low growth and low inflation – assets which are considered 'safe', even at record high valuations – have trousered the beneficiaries of higher growth and higher inflation – assets that are considered 'risky' despite having endured three-to-four year bear markets.

We suspect that if the Japanese do proceed as submitted above, the market's view towards inflation beneficiaries globally may well swing 180 degrees. Indeed, looking at the performance of the commodity complex this year (a classic inflation hedge), one could argue this process is already well underway.