The vanishing cycle

Just as the popularity of two-wheeled pedal power has been surging across London, a different type of cycle, the economic kind, has vanished from sight.

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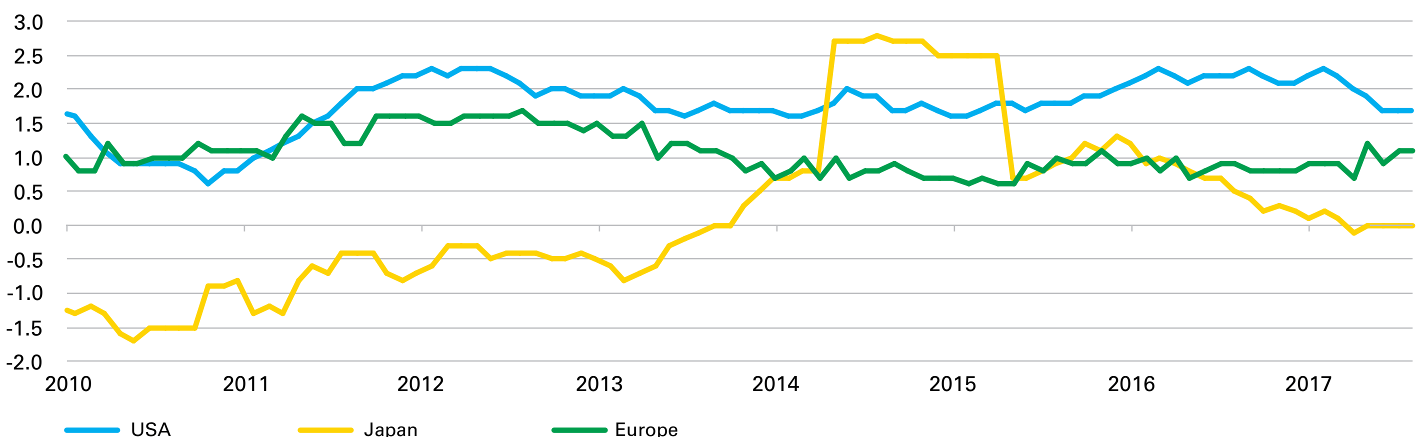
Unspectacular economic growth and weak inflation has allowed central bankers to motor on, boosting markets. However, our concern is that the economy is suffering mechanical problems, which should be reflected in market pricing as monetary policy is gradually tightened.

Economic theory suggests that loose monetary policy encourages growth, leading to a reduction in the unemployment rate which eventually forces wages up. As central banks see this feed into inflation, they hike interest rates in order to reduce growth to a sustainable level.

Of course, numerous recessions over many decades suggest policymakers often fail to achieve such a smooth landing. But in recent years, a more fundamental problem with this process has occurred: easy monetary policy doesn't seem to be leading to accelerating wages and inflation, no matter how hard central banks try. As Figure 1 shows, inflation continues to undershoot targets across key global economies, and, if anything, has deteriorated further in 2017. Indeed, it's only once a currency suffers significant weakness, like sterling following the EU referendum, that inflation finally shows up.

Figure 1: Core inflation remains subdued



Source: Bloomberg L.P.

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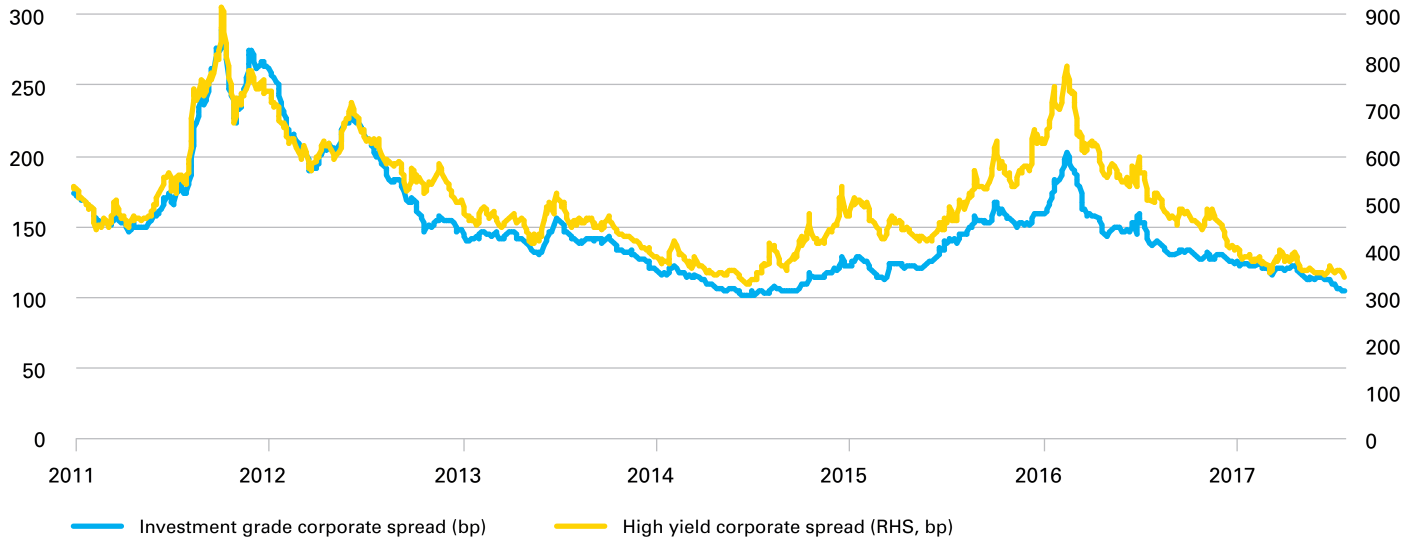
Figure 2: Global credit spreads near post-crisis lows



Source: Bloomberg L.P., Barclays indices

Investors don't appear to be worried about this. And in the short term, who can blame them? With no inflation pressure, central banks can maintain loose monetary policy, which has a good track record of boosting asset prices. This has helped both investment grade and high yield credit spreads tighten towards post-crisis lows, as shown in Figure 2.

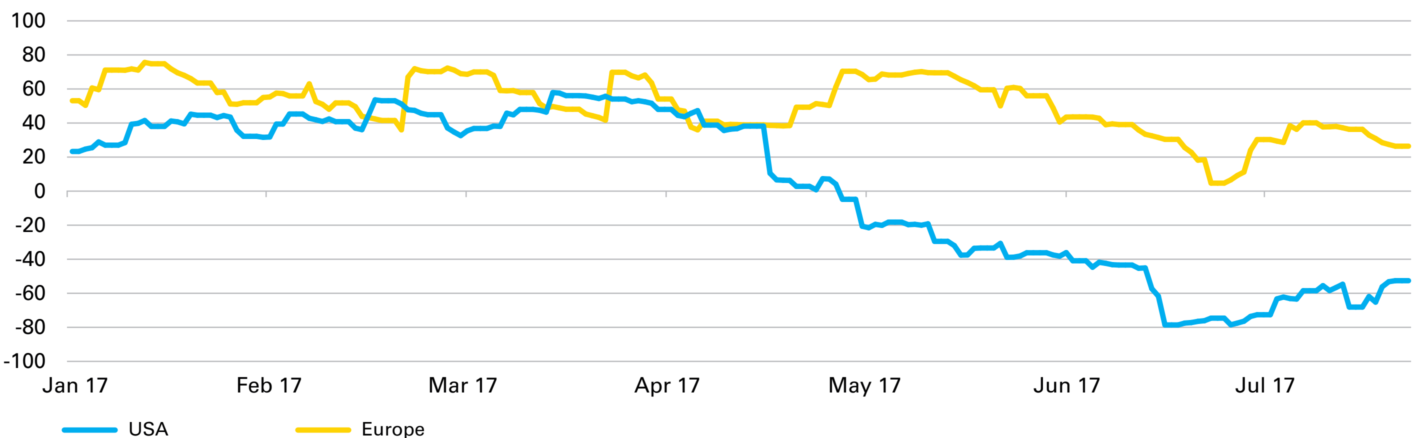
EUROPE'S TEMPORARY BOOST

Of course, this has not been the only driver of credit spreads in recent months. In Europe, credit has been supported by the French election's pro-EU result and the relatively calm resolution of a number of distressed banks in Italy and Spain. In addition, as Figure 3 highlights, economic growth has been stronger than many expected.

However, this does not solve the region's structural problems of dismal demographics, a lack of fiscal unity and unbalanced debt burdens.

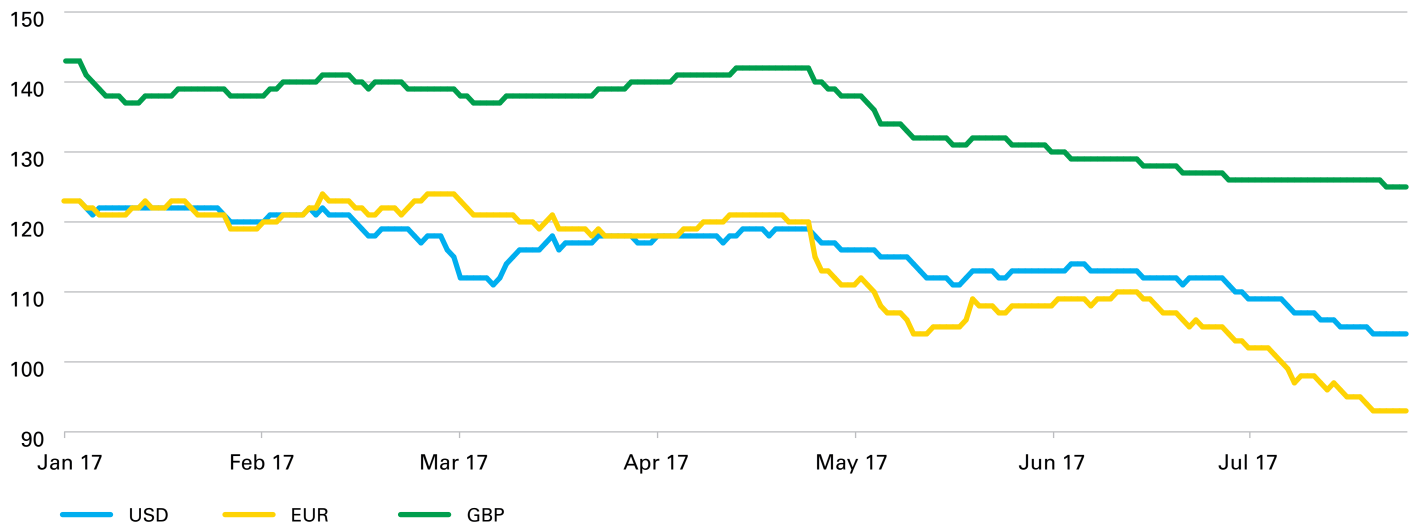
Indeed, for us, the key driver of European credit for more than a year now has been the ECB's quantitative easing programme. Even though the overall monthly purchases were reduced in April from €80bn to €60bn, the constant demand for corporate bonds continues to suppress spreads. Moreover, while Italian political risk has occasionally flared up in 2017, the ECB's demand for Italian government debt has subdued market volatility across peripheral bonds.

Figure 3: Positive economic surprises in Europe, negative in the USA



Source: Bloomberg L.P., Citi

Figure 4: Investment grade corporate bond spreads (bp)s



Source: Bloomberg L.P., Barclays indices

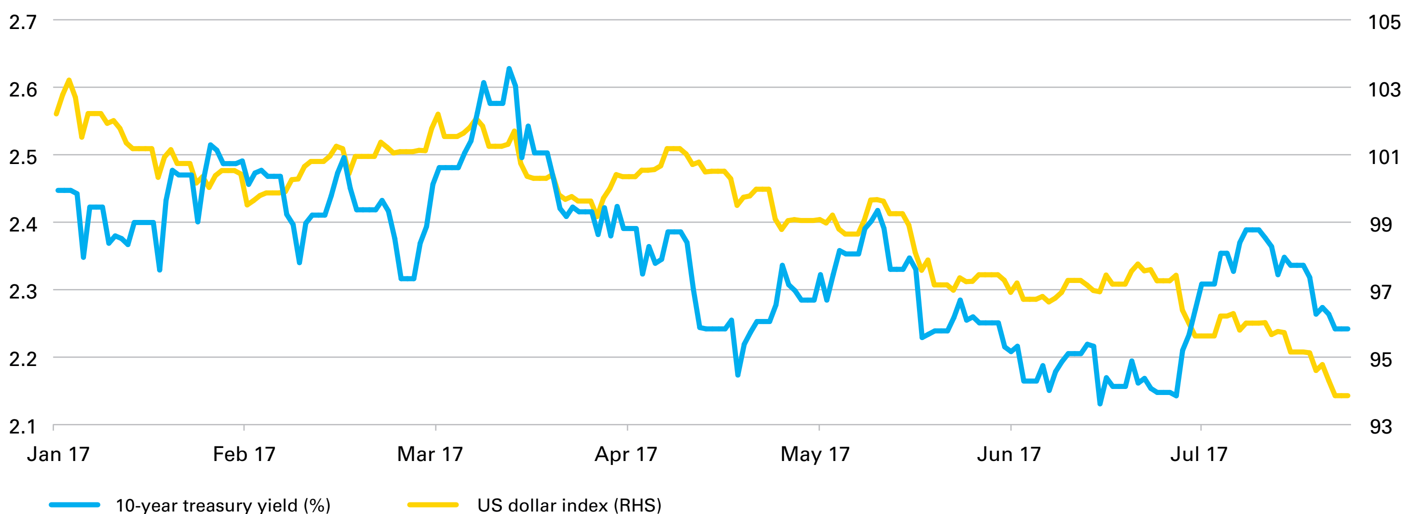
With little evidence of accelerating wages, the ECB would probably be keen to maintain this monetary support. But they are facing constraints in buying government debt, particularly from Germany. Therefore, by the end of 2017, they will likely announce a gradual tapering of asset purchases.

We have held cautious European credit positions across global credit portfolios this year, and have therefore been the wrong side of the region's strong performance (Figure 4). However, given tight valuations, structural problems and the upcoming withdrawal of monetary support, we retain our cautious stance.

US POLITICAL DISAPPOINTMENT

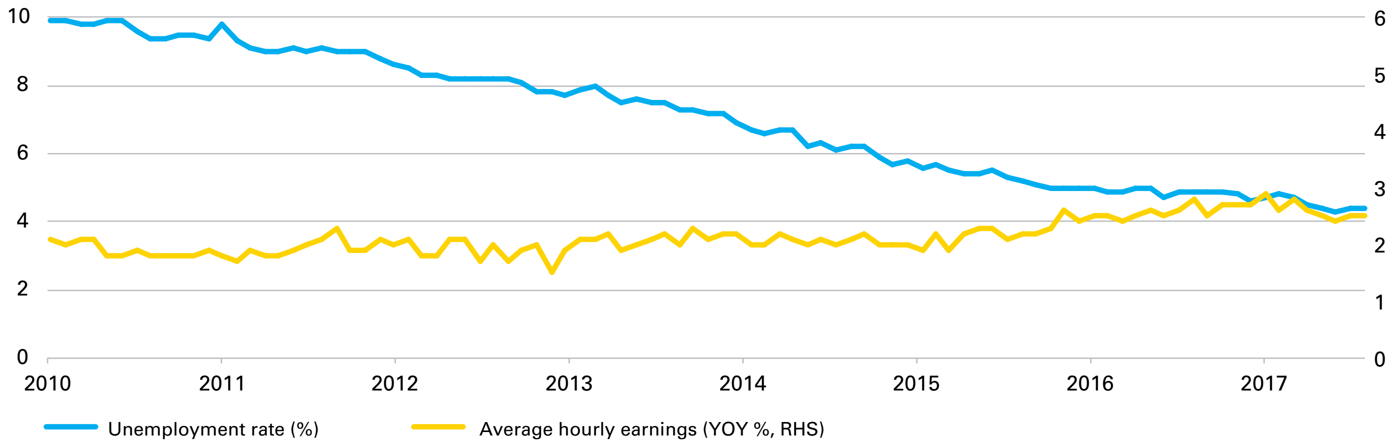
At the start of the year, expectations were high that not only would US wages accelerate in the face of falling unemployment, but that President Trump's tax reform and capital investment plans would provide a boost to economic growth and inflation. The ensuing months of disappointment on all counts has resulted in a decline in treasury yields as well as the US dollar falling versus many other currencies (Figure 5).

Figure 5: Trump and growth disappointments have led to lower yields and a weaker US dollar



Source: Bloomberg L.P.

Figure 6: US unemployment keeps falling, but wage inflation remains subdued



Source: Bloomberg L.P.

Congress' hesitancy to pass Donald Trump's policy ideas should have been expected given his Marmite-like popularity, but the underlying lack of wage inflation is more surprising. Unemployment has continued to fall and is now well through where most economists would expect wages to accelerate (Figure 6). As with all goods, labour supply drying up should lead to its cost increasing, and this should indeed happen at some point. But the fact that it has been so slow to react in this cycle suggests there is something else going on.

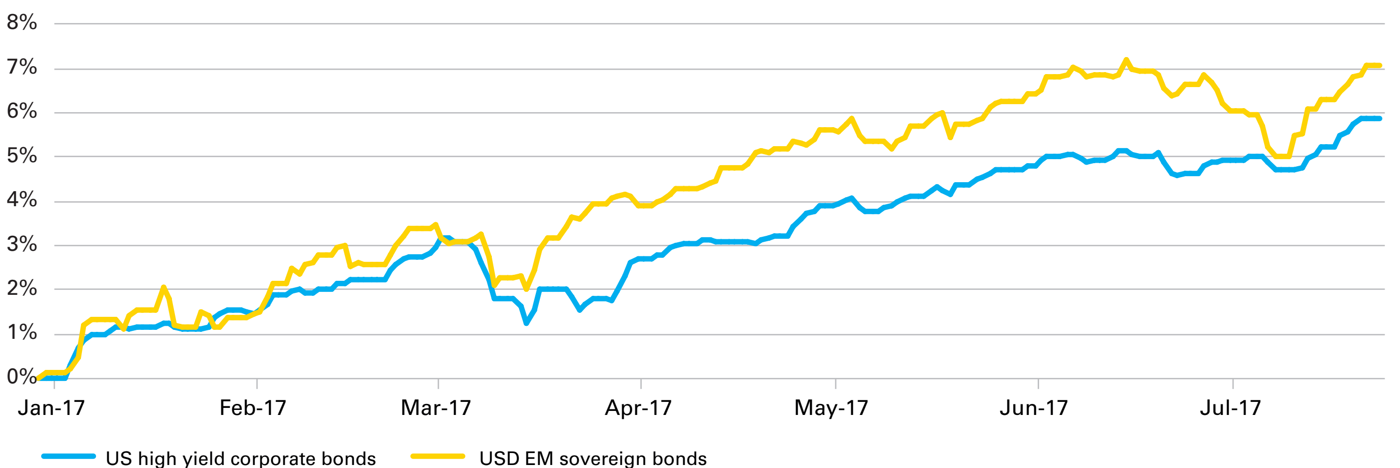
In broad terms, the global debt mountain discourages companies from increasing costs such as wages. Instead, easy central bank liquidity is encouraging companies to focus on financial returns via share buybacks or high dividends. In addition, as our recent Long-term Thinking publications highlight, deteriorating demographic trends weigh heavily on potential growth.

One important product of all this is rising inequality and the ascent of alternative politicians. But for financial markets' near-term outlook, the key dynamic is that central banks diagnose the lack of inflation as a problem of too little stimulus rather than a structural problem partially caused by their loose policy.

A BOOST FOR EMERGING MARKETS

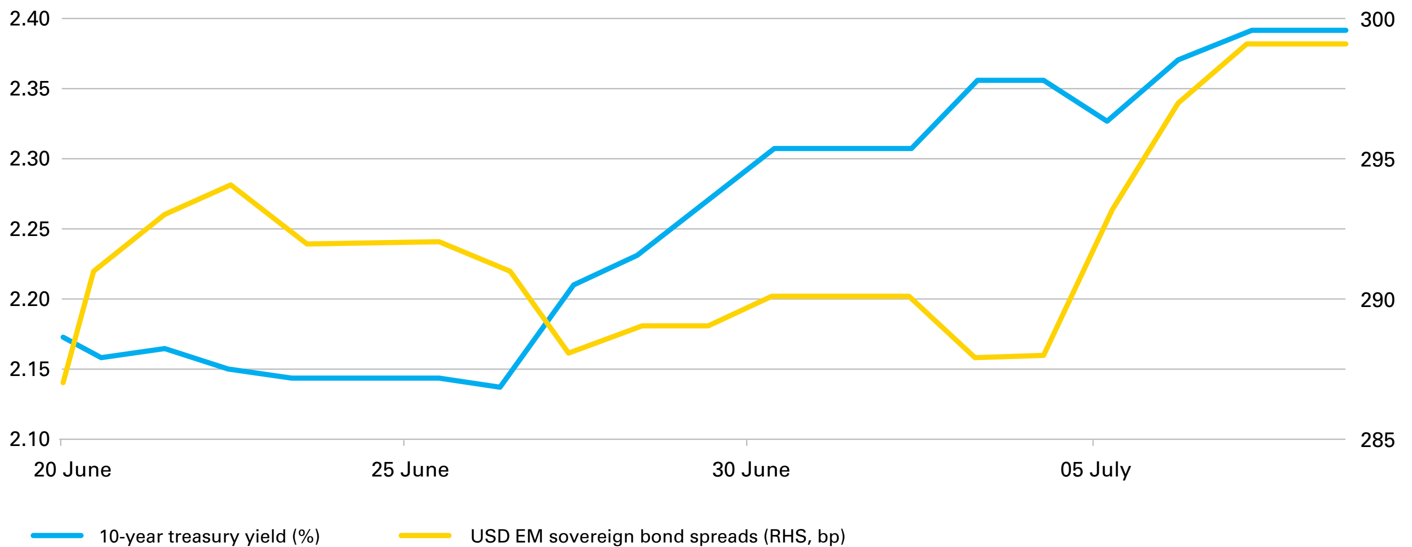
High yield corporate bonds have benefited from loose monetary policy, but Trump disappointment and subdued US inflation has been a particular boon for emerging markets (EM), as shown in Figure 7. All year, money has flowed into local currency EM debt attracted by a weaker dollar as well as dollar denominated EM bonds thanks to falling treasury yields. Investors have been largely able to ignore geopolitical headlines from North Korea or the Middle East and the recent drop in oil has only had a marginal impact on corporate bond markets.

Figure 7: Very strong total returns for high yield and EM bonds in 2017



Source: Bloomberg L.P., Barclays Indices

Figure 8: Emerging markets bonds suffered as Treasury yields rose



Source: Bloomberg L.P., Barclays Indices

Chinese interbank yields have increased this year as authorities attempted to slow the rampant increase of off-balance sheet lending, but the impact on broader credit markets have been minimal. Indeed, China has also benefitted from a weaker dollar, helping to reduce the flow of capital leaving the country.

CENTRAL BANK OUTLOOK

Unfortunately, the current positive backdrop for the market cannot last forever. One possibility is that unemployment in the US dips low enough that we finally witness accelerating wage inflation, causing interest rates to move higher in anticipation of monetary tightening from the Fed. But even if this does not happen, central bankers appear set to gradually close the liquidity taps in any case. As we set out in last quarter's outlook, The Fed and the Furious, a number of key central banks look set to taper their support in the coming months due to a combination of legal restrictions, difficulty sourcing bonds or departing governors wishing to secure their legacy by defining a clear exit path.

Instead, they should be questioning why loose monetary policy is not resulting in accelerating growth and inflation. So by taking away market support, they risk laying bare the structural problems that have interrupted this transmission mechanism.

MINI TANTRUM

In the last outlook, we discussed the similarities between the upcoming withdrawal of stimulus and the taper tantrum of 2013. Since then, markets suffered a mini-tantrum following seemingly coordinated hawkish comments from a number of central banks. Government bond yields spiked higher and credit markets weakened, particularly higher risk assets such as EM (Figure 8). While volatility has since reduced following more calming words from Janet Yellen, it serves to demonstrate how sensitive markets are to easy monetary policy and how many investors are keen to reduce portfolio exposure once the support is withdrawn. We think it is sensible to get ahead of the crowd.

INVESTMENT IMPLICATIONS

For credit markets overall, we are cautiously positioned in advance of the tapering of monetary support later this year.

Within investment grade credit, we generally prefer US dollar corporate bonds given the US economy's sounder structural footing. As described earlier, we remain cautiously positioned in euro credit where tight valuations are in stark contrast to the region's structural frailty. We are also defensively positioned in UK credit risk given difficult Brexit negotiations and the implications for domestic consumer confidence and business investment.

Both high yield and EM debt have performed well this year, but face headwinds as monetary policy is withdrawn. As the recent mini-tantrum demonstrated, both are very sensitive to rising treasury yields, and EM could doubly suffer if the US dollar starts to strengthen once more.

For government bond markets, we described in our recent article **UK yields to stay low?** why structural factors argue for low yields to persist. Indeed, this is our base case even if the withdrawal of monetary policy leads to some near-term volatility. Interestingly, US government bond curves have flattened in 2017, which is a sign that the Fed is getting close to its neutral interest rate even though it has only made a handful of hikes.

Putting it simply, maintenance of the global debt mountain needs yields to stay low. However, the inability of policymakers to face up to the structural problems causing the economic cycle to vanish is troubling. There is a growing tail risk that investors lose confidence in central banks' management of the situation, resulting in currency weakness and ultimately much higher yields. We think that central bank credibility will prove to be an important cyclical indicator in its own right. This needs very careful monitoring.

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