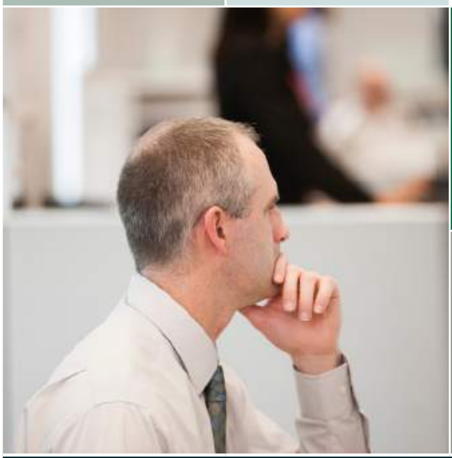
Manulife Asset Management



US Recession Isn't Nigh, But Be Worried Anyhow

February 2016

Introduction

A lot of investors in bank equities have had a pretty rubbish year so far. Oil investors have too. Anyone trying to find yield in sovereign debt has as well. In fact, it has been difficult to identify any asset class that is both safe and provides any returns worth writing home about in 2016.

There are a number of potential causes for the market volatility we have seen in 2016, but the common thread that weaves them together is central banks'inability to address a persistent lack of aggregate global demand. While the markets have been volatile, the macroeconomic environment has not been all bad. This has been particularly true in the United States, the major driver of the global recovery among developed nations.

Here, there is a competition between markets and macroeconomic fundamentals: will the markets tip the US into recession, or will economic fundamentals bring calm to the markets? While a recession in the US has become more likely this year, we still expect fundamentals to dominate in 2016.

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Triggers for Market Volatility

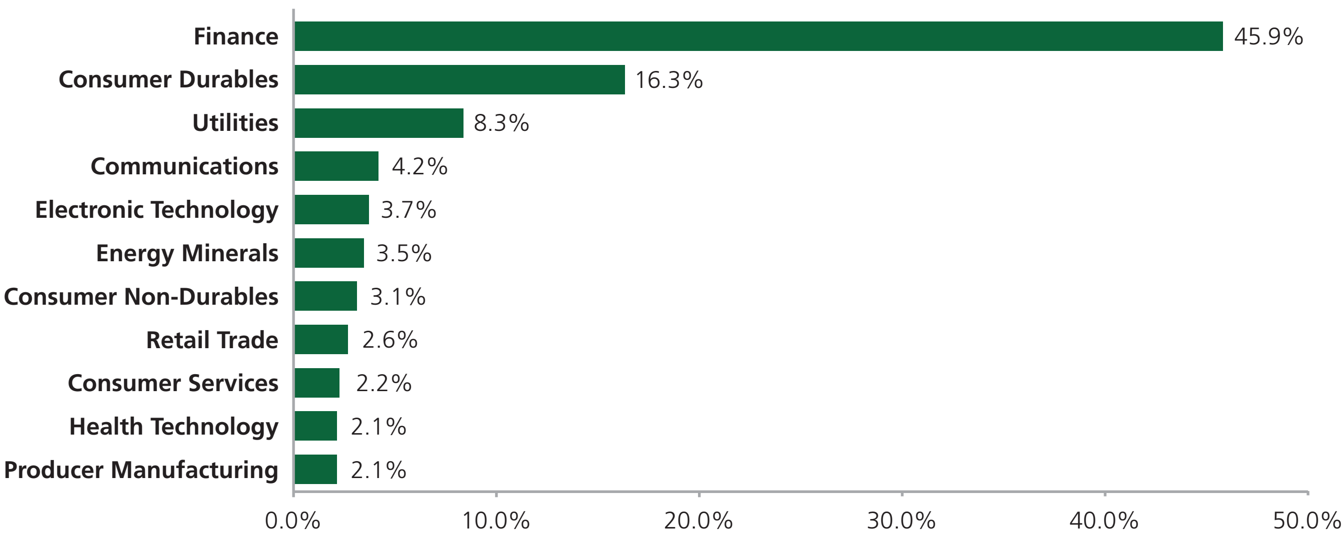
Among the various potential causes for the market volatility we have witnessed this year, all are related to central banks' inability to address the lack of global demand. The first market scare to greet us when we came back from our winter breaks was an equity market rout in China. One of the causes for the equities collapse was concern over China's ability to manage capital flows while cutting interest rates and allowing the renminbi to depreciate.

A **weaker renminbi** would make Chinese exports more competitive, allowing China to corner off more global aggregate demand for itself. A number of hedge funds are now betting against the renminbi[1] despite the Chinese government insisting that it does not want to see a significant depreciation[2], and the People's Bank of China (PBoC) has had to burn through its foreign currency reserves to prop up the currency. This has caused even more concern over the government and central bank's ability to defend or support the economy and the currency.

Another trigger for market volatility has been lower oil prices, which have fallen nearly 75%[3] since their recent peak in June 2014. As WTI (West Texas Intermediate) oil prices fall below the US$30/barrel, it is becoming increasingly clear that the substantial drop in prices is not indeed a net benefit to the global economy, particularly at such low levels.

In our view, oil prices have fallen due to oversupply rather than diminishing demand. Supply won't fall out of the market as long as producers are debt-financed; overleveraged producers do not have the luxury of cutting supply while they have debt to service. Instead, they will probably drown one another with supply until equity holders get wiped out and the debt holders become the new equity holders[4]. At this stage, supply will finally fall out of the market, and oil prices might begin to stabilize.

Top Ten Sectors holdings of Oil Related Sovereign Wealth Funds



Source: Strategas Research Partners, February 2016

Low oil prices have an impact on all other services and supply chains that crop up alongside the oil patch. This includes drillers, shippers and retail and leisure outfits that open up in oil towns. But it also includes financial services. According to Strategas Research Partners, sovereign wealth funds of many oil producing countries hold significant amounts of financial shares, a portion of which they have had to liquidate in order to release petrodollars (see chart). This has been one factor sending bank stocks lower.

1. Financial Times: *Hedge Funds Target A Weaker Renminbi*, Febraury 9, 2016
2. China Daily: *Li Stresses Stability of Renminbi*, February 6, 2016
3. All economic and market data from Manulife Asset Management and Bloomberg as of Feb 12, unless otherwise noted
4. Behavioral Macro: *Today, It Begins*, February 8, 2016

All About Financials

The adoption of **negative interest rate policy (NIRP)** by major central banks has also sent bank shares down. Japanese bank equities collapsed nearly 35% after the Bank of Japan (BoJ) announced NIRP[5], and European bank shares plummeted as well on the assumption that the European Central Bank (ECB) will have to respond to the BoJ's move with even more negative rates in Europe.

NIRP is designed to push banks to lend to riskier borrowers rather than incur a charge by parking their cash at the central bank overnight—a so-called "portfolio rebalancing effect." But this has been slow to happen, and with banks avoiding passing the costs off to savers, NIRP eats into bank profitability.

European banks have seen their shares plummet in part due to high **non-performing loans (NPLs)** – particularly in Italy—and a lack of clarity on how exactly addressing these NPLs and recapitalizing banks will go under new regulations and instruments. Because of the new **Bank Recovery and Resolution Directive (BRRD)**[6], bad banks such as NAMA[7] in Ireland and Sareb[8] in Spain are considered forms of state aid and are not allowed. The formula for removing NPLs from bank balance sheets is therefore much messier now. Italy has created a bad bank that is a Special Purpose Vehicle (SPV)[9] to which the NPLs are transferred and the senior tranche receives a state guarantee[10]. It is unclear who might be interested in buying any of the non-senior tranches of the SPV though.

Contingent Convertibles (CoCos) became a popular—and last year lucrative—way to raise Alternative Tier-1 Capital in Europe. CoCos are treated like bonds and, as such, do not dilute shareholders, but can be converted into equity when more capital is needed. The conditions under which the supervisor may demand more capital be raised remain unclear, however. Deutsche Bank has issued around 3.5 billion euros in CoCos but confessed that it had a loss of 6.8 billion euros[11] in 2015. Investors are therefore concerned that the CoCos may shut off their coupons to preserve capital, or may be converted into equity.

CoCos have never been converted, so we will be in unchartered territory if that happens. It seems more likely that policymakers will decide that losses in assets do not have to be realized until the NPLs are written down, and if they are not written down perhaps growth in the meantime can make some of them performing. European countries with banking crises such as Ireland and Spain were not served well by such an "extend or pretend" approach; it tends to result in higher losses once they are finally realized. This could turn into a systemic issue if a bank the size of Deutsche Bank undergoes significant bail-ins or bail-outs.

The recent market volatility has caused investors to dump equities and corporate bonds (particularly high yield) in favor of safe haven assets. There are precious few safe havens currently, but they include sovereign bonds in Japan, Germany, the UK and the US. Government borrowing costs in all of these countries have dropped significantly, with 10-year yields in Japan in particular plummeting into negative territory. Even the US has seen 10-year yields drop since the policy rate was hiked in December. Banks often make money by borrowing at the short end of the yield curve and selling at the long end. The **flattening of yield curves** has therefore also eaten into bank profitability.

5. Bank of Japan: *Introduction of "Quantitative & Qualitative Monetary Easing with a Negative Interest Rate"*, January 29, 2016
6. European Commission: *Bank Recovery and Resolution Directive – Delegated Regulation*, February 4, 2016
7. NAMA: National Asset Management Agency
8. Sareb - *The Management Company for Assets Arising from the Banking Sector Reorganization*
9. Special Purpose Vehicle can be defined as an entity formed by a government or a company for a particular project or a task, typically to hold assets and not to make a profit;
10. Ministry of Economy & Finance: *Guarantee on Securitization of Bank Non Performing Loans To Be Introduced Shortly*, January 27, 2016
11. Deutsche Bank: *Earnings Press Release*, January 28, 2016

Macroeconomic Data a Mixed Bag

Arguably, recent global macroeconomic data has provided reason to be pessimistic as well. The latest manufacturing Purchasing Managers Index (PMI) data in the Eurozone has shown that the expansion in the region could be slowing. This was underscored by a surprise fall in industrial production in Germany in December.

China has seen its manufacturing output contract every month for a year. Trade data has also shown a fall in both exports and imports, suggesting that Chinese demand is dwindling.

In Japan manufacturing PMI data suggests expansion, but industrial production has stagnated or contracted in five out of the past six months. Retail sales contracted in the final two months of 2015 as well.

In the US, the ISM manufacturing PMI has either reflected stagnation or a contraction in manufacturing for the past five months. Industrial production contracted in the last two months of 2015, as did durable goods orders. US exports sank to their lowest levels in years in the final few months of 2015, in part due to a loss of competitiveness from a stronger US dollar. Even jobs growth, long the brightest light in the US economic data, slowed in January to 151,000 jobs added to the economy.

United States–All Hail the Consumer

Still, the news is not all bad. This is particularly the case for the US, which has driven the economic recovery among developed countries. For starters, the manufacturing slump is not as bad as it may appear. Goods and manufacturing make up roughly two-thirds of the S&P 500 earnings, but manufacturing only accounts for about 12% of US GDP[12] and about 13% of employment[13]. Furthermore, while overall manufacturing performance has been lackluster, manufacturing job growth has accelerated, as has manufacturing job wage growth. The sector is suffering from a strong US dollar, but also from inventory destocking—a transitory phenomenon observed at regular non-recession intervals.

Furthermore, this recovery—like all others in the US—has been underpinned primarily by the consumer, and consumer demand has remained fairly resilient, albeit at fairly lackluster levels. Retails sales have bounced between growth of 1.5% and a contraction of less than 1% month-on-month for the past year. Consumer confidence is still floating around post-crisis highs. Two key indicators of consumer demand measured in volumes rather than values (and therefore stripping out the impact of a stronger US dollar) look strong: new car registrations and new home sales.

In January, the US went into full-employment as the economy added 151,000 jobs and the unemployment rate fell to 4.9%. Wage growth accelerated moderately to 2.5% year-on-year, though this was partly due to one-off factors. The Labor Force Participation Rate ticked up slightly, indicating that more Americans were looking for and finding jobs than getting fed up and leaving the work force[14].

12. World Bank: *Manufacturing as a percentage of GDP*
13. Bureau of Labor Statistics: *Employment by Major Industry Sector*
14. Bureau of Labor Statistics: *The Employment Situation*, February 5, 2016

Macro over Markets: No Recession in 2016

Which signals should be given more weight: market volatility suggesting the US is on the precipice of recession or macroeconomic indicators suggesting the US consumer will continue to push this recovery further? Some analysts argue that markets are forward looking and macroeconomic indicators (particularly employment) come with a lag, and therefore the markets portend the pain up ahead.

Still, I think that macroeconomic fundamentals are more likely to tame the markets than markets are likely to panic the consumer. Markets are driven by a large dollop of psychology, or confidence fairies. Confidence fairies tend to run out of steam and peter out unless they are backed up by fundamentals.

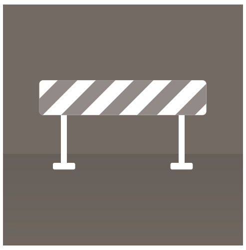
"Markets are driven by a large dollop of psychology, or confidence fairies."

There are two ways I could be completely wrong about this. The first is if there is a market mistake, and a market panic triggers a credit crunch, severely constraining consumers' ability to borrow. Market volatility and low rates could raise concerns about investments and pensions, and consumers could boost their savings to prepare for the future as well. With consumers spending less, companies would cut production and investment, further exacerbating market weakness. A new doom loop could spin between the economy and the markets. The main driver of the US recovery—the consumer—will have faltered, and the US could be quickly tipped into recession.

The second way we could see a recession in 2016 is if there is a policy mistake. In her testimony in Congress last week, Fed Chair Janet Yellen refused to remove the possibility of a further interest rate hike in March. According to the Federal Open Market Committee's projection[15], there should be four 25bps rate hikes this year. Currently, the markets believe it is more likely the Fed will cut rates than hike them in 2016. If the Fed were to stick to its guns and hike rates too quickly, the US consumer could face a credit crunch and the recovery could be razed off.

15. Federal Reserve: *Economic Projections*, December 16, 2015

Extrication Complication



The US is already in an earnings recession[16], but an economic recession and its negative feedback loop on the markets would hurt investors even further. In fact, there is nothing magic about the economy going into contractionary territory; even low growth could be damaging. If any consolation is to be found, it is that a US recession would not necessarily result in a drastic drop in living standards. One only needs to look at Japan over the past few decades to see this. Low real GDP growth is less damaging to living standards when we are in a low or no inflation environment.

The big question is what anyone could do about it if the US were to go into recession. If all of the triggers of the recent market volatility are down to central banks' inability to address the global dearth of aggregate demand, then one option is for other actors to step in.

Given the massive debt overhang that has accrued in most major economies, governments have had little space on their balance sheets to provide a fiscal stimulus to create demand. Monetary policy has been the only tool used, either to offer a stimulus or to generate a currency devaluation to capture more of the existing global demand. Governments could step in with a coordinated fiscal stimulus to accompany monetary stimulus and generate demand. The problem here is one of coordination. In Japan and China, governments are already providing a fiscal stimulus. This will be a very hard sell in an election year in the US. And in Europe, the German government is as wed to the idea of fiscal responsibility as ever. Any major easing of fiscal targets for most countries in Europe is extremely unlikely.

Another way to generate demand is to redistribute wealth—lower classes have a much larger propensity to spend, and so by redistributing wealth to them you can boost overall consumer demand. Wealth redistribution policies are politically toxic, and will be absolutely impossible in advance of an election in the US in 2016 as well as elections in Germany and France in 2017.

The second option for addressing the dearth of aggregate global demand is for central banks to do more of the same. The problem here is that most central banks aren't having much luck with the tools they have already deployed, and they don't have much more dry powder left. This is blatantly obvious if you look at the 5yr breakevens in the US, the one country in which the central bank thought the inflation target was close enough to striking distance to begin normalizing monetary policy. Inflation expectations in the US are at levels not seen since 2009 (see chart):

US 10-year inflation breakevens

Source: Bloomberg, Manulife Asset Management as of February 11, 2016

16. Factset: *Earnings Insight*, February 12, 2015

Conclusion

Central bank governors have done their best to jawbone their currencies lower, but this is getting less effective with each and every statement made. Rates for several major central banks are either at the zero lower bound, or are negative. The record for negative rates has been relatively poor. Cutting rates further into negative territory is unlikely to be more effective in terms of boosting lending or weakening currencies. The Japanese yen is significantly stronger than it was before the BoJ announced a NIRP, for example.

There is a limit to how negative central banks can cut rates as well. At some point people may decide the cost of holding cash is less than the cost of sticking cash in the banks. Quantitative easing has helped to compress bond yields but has failed to boost growth significantly. While the ECB and the BoJ are likely to announce an expansion and extension of their asset purchasing programs, it is unclear what impact this might have other than more compressed government borrowing costs and weaker currencies.

One policy that has not yet been tried is helicopter money. Helicopter money is a form of quantitative easing, but differs from what major central banks have tried in that it is permanent[17]. If the increase in the monetary base is permanent, then there should be a permanent rise in price levels in the future, creating an incentive to start spending more in the present while goods are relatively cheap. This permanent increase in the monetary base can be used for deficit financing. The idea was first mooted by Milton Friedman in 1948 and more recently by Ben Bernanke when providing policy advice on Japan[18]. It would likely boost spending in the short-term, but has the downside of being illegal. Outright monetary financing is in clear violation of the ECB's treaty in particular. For all central banks, however, outright monetary financing raises major concerns about central bank independence.

Six months ago, helicopter money was viewed with disdain and incredulity amongst the policymaker advisors with whom I have spoken. Increasingly, it is being viewed as a viable policy response to the low growth, low inflation environment in which we are stuck.

17. A detailed discussion of helicopter money, posted on Bruegel, can be found here: http://bruegel.org/2015/01/permanent-qe-and-helicopter-money/.
18. Federal Reserve: Remarks by Governor Ben Bernanke, *Deflation: Making Sure "It" Doesn't Happen Here*, November 21, 2002

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