

## Investing in a Policy Innovation World

FORBES ELWORTHY<sup>1</sup>

### Overview

It is a remarkable thing that over one quarter of world government bonds are now yielding negative interest rates e.g. French 5 year government bonds (“OATs” - Obligations Assimilables du Trésor) are costing investors 0.17% each year for the privilege of owning them.

This viewpoint reviews recent policy innovations including negative rates. I then categorise the macroeconomic policies of countries into four types:

1. ‘Good Housekeeping’ (New Zealand, Switzerland);
2. ‘Just QE’ (US, UK, Germany),
3. ‘Spend and Sterilise’ (Italy, France, Japan - until 2015),
4. ‘Print and Spend’ (China, Turkey, Hungary and Japan - post 2015),

as per the following matrix (Figure 2), developed further in this Viewpoint. I then argue that Japan, the US and the UK are shifting toward policies of direct stimulation of consumption using printed money i.e. ‘Print and Spend’. I predict this policy shift will eventually spark inflation in the US and UK. If not in Japan. After analysing possible impacts and risks of these policy trends I conclude with a summary of where I am currently investing our family’s capital.

### A Short History Of Policy Innovation

Long Term Capital Management defaulted on its debts in 1998 at a time the US economy was doing fine - so did not need lower interest rates. However, even so, to protect the financial markets from contagion, Alan Greenspan’s Federal Reserve lowered interest rates to low levels. A period of financial markets repair followed, which turned into an equities boom, which in turn collapsed in 2000. After which interest rates were again briefly lowered, to around 1%.

A period of ‘pump priming’ had begun. Each time markets swooned they were revived by monetary action. This support became known as the Greenspan Put. It became a good idea to ‘buy the dips’ on any market weakness. Those of us trading securities came to expect monetary loosening each time the markets fell. Naturally enough an even bigger market boom emerged. This time supported by leverage. That boom collapsed in 2008 and 2009.

The ensuing ‘Great Recession’ was revived largely by US deficit spending. However, after 2010 political tolerance for deficits receded and a new Policy Innovation emerged. This was Quantitative Easing – the non-sterilised i.e. ‘printed’ purchase of financial assets by central banks. Like the earlier post-1998 Policy

Innovations QE was primarily employed to reflate asset prices and boost financial markets. Which were deemed to be not shifting money around fast enough (the velocity of money had collapsed), hence their support during the downturns of 1998, 2000-2003 and 2008-now. 2015 saw a further Policy Innovation - negative interest rates. These have been so far confined to Japan and Europe but may be introduced to the US dollar if deflation and/or financial market volatility returns to the US in the future.

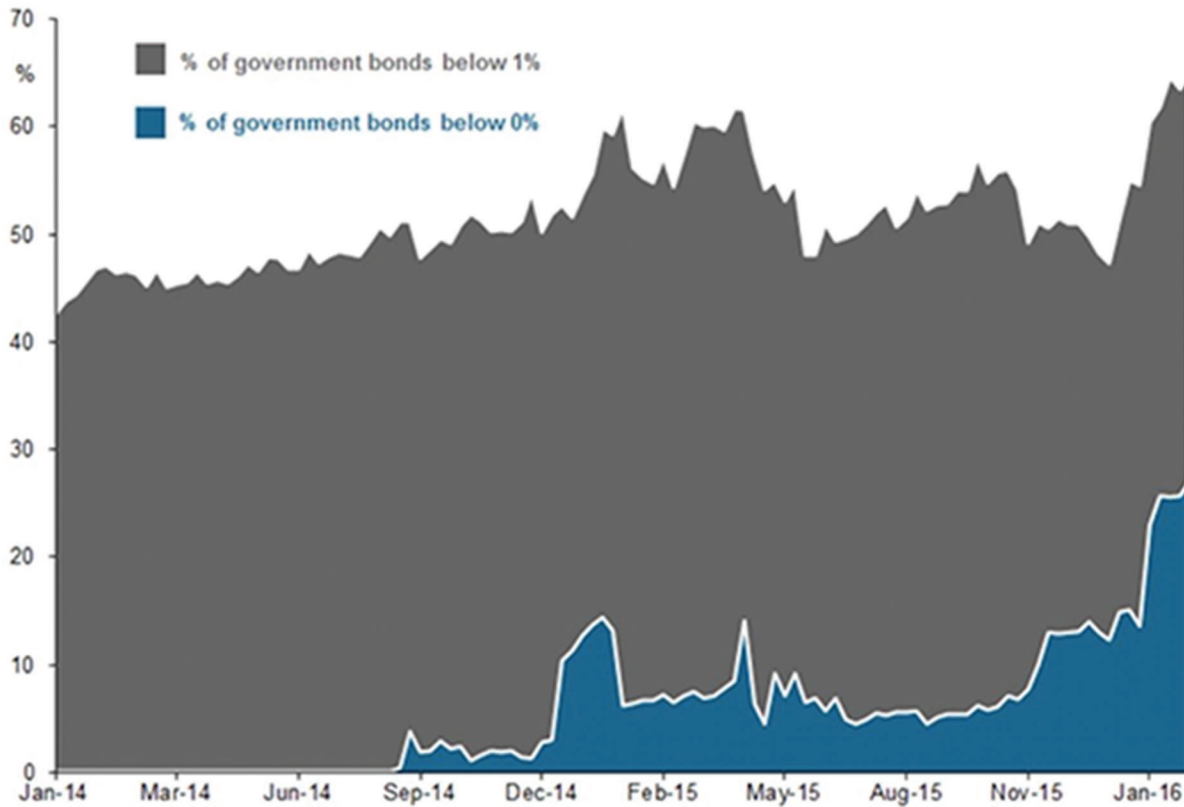
### What Have These Policy Innovations Got In Common?

Some common denominators of the above 18 years of Policy Innovations are:

- An asymmetric ‘policy ratchet’ lifts asset markets by actively supporting falling markets. Yet it does not discourage rising prices in boom periods.
- Fiscal and deregulatory measures to support growth seen in the 1970’s and 1980’s have been largely replaced by monetary interventions. Governments have come to see monetary support of the economy as the main transmission mechanism for macro policy.
- Central Bank balance sheets (i.e. ‘core money’) are growing as they are used to support markets. Further these asset purchases are increasingly non-sterilised, i.e. financed by printed money.
- As earlier Policies become ineffective new Policies are introduced.
- Few of the Policy makers (outside of Switzerland and Germany – rare countries with households with net savings) seek to preserve the value of currencies. Almost all of the Policies – and here the Germans have fallen into line with the rest of Europe - subordinate the role of money from a store of value to become ‘activist policy variable of choice’.
- In a related point governments compete to help their export industries by lowering the value of their currencies. Switzerland has been the typical example: higher interest rates than in Europe were acting like a magnet for its neighbours’ savers, thus overvaluing the Swiss Franc and hurting the Swiss economy. The SNB then had to weaken the Swiss Franc to keep the Swiss economy healthy.
- There is a distributional bias in the Policies. Leveraged people and organisations (mortgage borrowers, leveraged corporates, banks, hedge funds) are supported and repeatedly ‘rescued’ by policies supporting credit markets. Yet investors, especially those saving into

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**Figure 1:** Yield on Global Government Bonds  
 Source: Bloomberg, BofA/ML, JP Morgan AM. Index shown in the BofA/ML Global Government Bond index. Data as of 25 Feb 2016. Cited in DSG Asia

	<i>Fiscal Balance</i>	<i>Fiscal Deficit</i>
<i>Money-printing</i>	"Just QE"	"Print & Spend"
<i>Sterilisation of expenditures</i>	"Good Housekeepers"	"Spend but Sterilise"

**Figure 2:** Macroeconomic Policies

bank accounts and bonds, will see their interest returns undermined by the interventions<sup>2</sup>.

### Why Are These Policies So Popular?

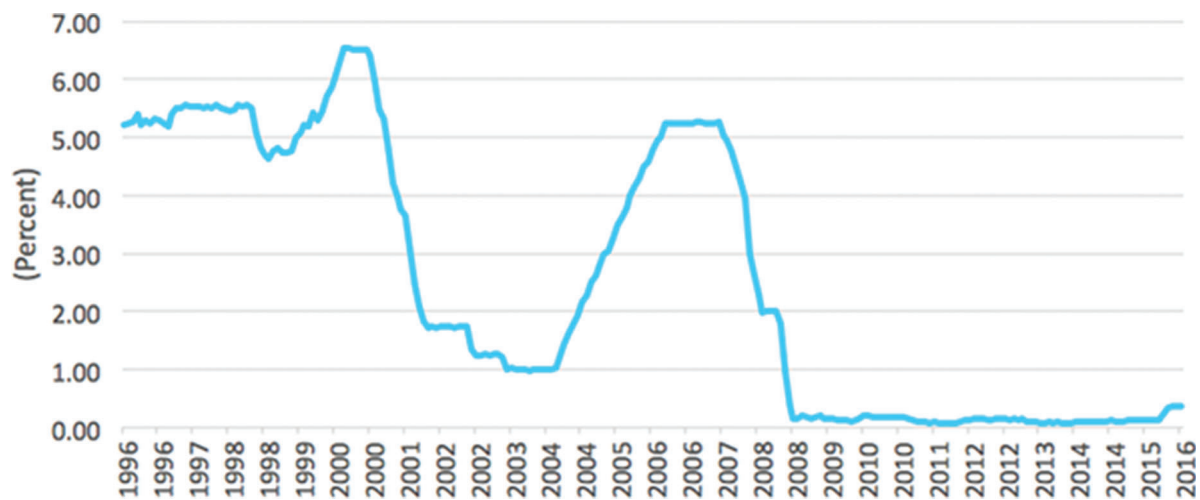
Outside of those rare countries with net positive household monetary savings these policies have a lot of appeal to most of the population – at least to the part owning houses and other assets – and to politicians. They are also supported by most professional economists. Some reasons include:

- Contrary to what a lot of us learned when studying economics (where we were taught that changes in

<sup>2</sup>This effect has been masked by the fact bond prices have risen making savers feel they are better off. The eventual 'euthanasia of the rentier', dear to Keynes (discussed in my Commentary of May 2015) will become more clear in coming years now that there will be no further capital gains to be had on bonds i.e. now that interest rates are at, below or approaching the zero bound.

nominal balances should not impact the real economy), it has become clear that injections of printed money into economies can, at least in the short term, boost real GDP. E.g. China's government credit support has boosted Chinese GDP while QE in the US and UK has boosted property prices, wealth and spending.

- The policies appear 'victimless'. In a world with vigorous global competition in many industries and hence widespread deflation the stimulation offers higher GDP but inflation remains low. Some are better off and few are worse off. Even rentiers (e.g. people saving into pension funds and insurance companies that buy mostly bonds) are not aware of their predicament as the fall in interest rates has been masked, thus far, by accounting increases in 'returns' as bond prices rose.
- The economics profession is the main source of the Policy Innovations. These central bankers and



**Figure 3:** Effective Federal Funds Rate  
 Source: Federal Reserve Bank of St.Louis

advisors judge success (and are judged and promoted in their jobs) by their ability to maintain short term GDP growth. Economists at the Bundesbank and BIS who express concerns about long term stability and also unintended consequences of the policies (such as zombification of large parts of the economy) have been side-lined. A resurgent Keynesian/Monetarist activist mainstream is firmly in power in economics policy circles.

## What Is Likely To Happen Next?

Given their apparent benefits, and also that populations have now got used to these measures being implemented without apparent disaster, it seems likely:

- Governments and Central Banks will continue to Innovate Policy.
- Bold new Innovations will be adopted each time GDP slows.
- The new policy measures will increasingly rely on printed money rather than taxes or government borrowing.

Recent discussions in Policy Innovation circles suggest that, when the next recession threatens, three new Policy directions are possible:

- The first is unfunded government 'fiscal' investment in social and infrastructure programmes. Here, as with QE, it is proposed governments will announce the money will not be recovered with taxes, but instead be irreversibly printed. This is to counter the risk that the populations worry that taxes will be raised to pay for the spending and cut back on their own expenditure, negating the boost to demand.
- The second is the 'helicopter drops' (basically taxes in reverse) that Milton Friedman prescribed as a cure for deflation (and for which Ben Bernanke has recently presented a 'how-to guide'<sup>3</sup>). This pure fiscal stimulus will transfer printed money directly into citizens' bank accounts. In the Financial Times last week an economist from JP Morgan argued this was a better route forward than deficit spending, as would avoid Governments developing bad

<sup>3</sup> *What tools does the Fed have left? Part 3: Helicopter money*, Ben Bernanke, <http://www.brookings.edu/blogs/ben-bernanke/posts/2016/04/11-helicopter-money>

spending disciplines. Some disagreed nevertheless. Goldman's economist countered she would prefer to see fiscal expansion as helicopter drops will create nervousness.

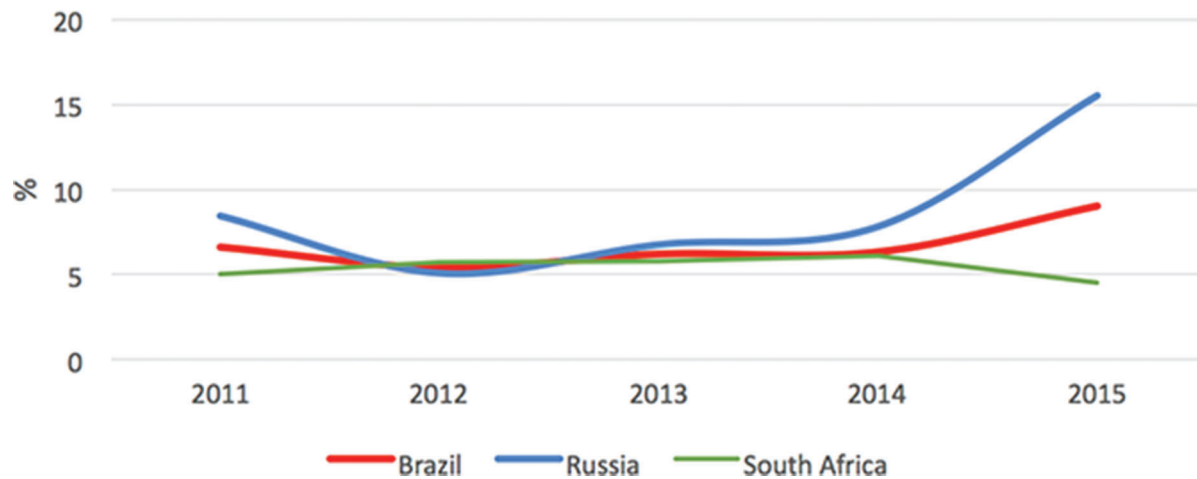
- A third possible Policy direction is capital controls. Where investors' rights to transfer capital offshore are restricted (as China and India do now). These Policies would again aim to force money out of passive savings (in this case offshore) and into domestic investment and consumption.
- Fourth and most dramatic would be limits on convertibility of various forms of saving and money – otherwise known as currency reform. At its mild end this might involve abolition of large denomination bank notes (to restrict paper savings in negative interest rate environments). A further step could be abolition of non-electronic money (all bank notes and coins). More dramatic still would be bans on or taxation of scarce assets that act as crypto-currencies (Roosevelt's confiscation and forced conversion into paper money of US citizens' gold in 1934 an example). At its most dramatic, currency reform might involve mandatory re-pricing of assets and liabilities. A biblical economy-wide debt jubilee. This would be an extreme form of confiscating value from savers and gifting it to credit borrowers.

## How Likely Are These Further Policy Innovations?

Politicians, the media and the citizenry of the major economies have become accustomed to government action to boost the economy, and will call loudly for medicine if GDP begins to falter; they expect intervention to solve the problem. Few (other than the 'This Time Is Different' Harvard economists Reinhart and Rogoff) are old enough to recall disastrous denouements to previous periods of government economic activism<sup>4</sup>.

Economists are aware Policies become 'stale' after a period. Households, eager to save against an uncertain future (and indeed avoid the depredations of Policy

<sup>4</sup> I saw it in New Zealand in the 1980s – when we came off our government supported investment binge of the 1970s – and suffered a 15-year economic hangover as we built integrity back into our economic system. However, evaluating the quality of the Policies is not the point of this Commentary. My aim is to predict what will happen, not what should happen.



**Figure 4:** Inflation Rates (annual change of CPI)

Source: OECD

Innovation), adjust their behaviour and find new ways of preserving wealth. So Policy Innovators, always eager to push capital out of passive saving into aggregate demand, need to find new ways of doing this.

Given the above political and institutional backdrop it seems likely the next time a recession beckons that some mixture of Deficit Spending and Helicopter Money will be employed in the developed countries. (I make guesses in which countries in the next section). Capital Controls and Currency Reform currently appear, to me, more distant prospects in OECD countries. But they will be worth watching out for.

### What's A Poor Investor To Do?

I have long predicted that, in the looming battle with deflation, inflation would eventually win. My argument has been based on the 'ratchet' in government policy in favour of economic expansion, even at the cost of monetary discipline. I urged purchase of real assets, which should benefit from the inflationary bias. So far I have been wrong about inflation – in almost all developed countries now running below central bank target rates in a globalised economy with vigorous supply competition in many sectors. Like Jeremy Grantham<sup>5</sup>. I hereby eat humble pie and acknowledge that my predictions of inflation in goods and services markets have not (yet) been fulfilled.

I was, however, right about real assets - equities and property, including farmland - which have risen in value since their lows of 2009 driven by falls in interest rates, lower risk premia and some (if modest) recovery in real GDP.

### Predictions For The Next 8 Years

Undaunted I continue to believe that we are right to expect inflation, eventually. Further I believe those who are brave and who continue to invest in the real economy, to invest in growing businesses, and in productivity and innovation will be rewarded. They will be helped by further Policy Innovations that are

<sup>5</sup> GMO 1Q 2016 Letter, *Always Cry Over Spilt Milk (An Admission of a Past Mistake on Resources)*, Jeremy Grantham, <https://www.gmo.com/docs/default-source/public-commentary/gmo-quarterly-letter.pdf>

(going to) systematically confiscate value from passive nominal savers and use this to boost consumption and investment.

I believe those who put their savings into passive, nominal investments are going to be on the wrong side of a history that is seeing governments systematically suborning money as a store of value.

### But What About Japan?

Of course my recommendation would have fared poorly in Japan during the past 27 years – where apparently the right thing to do was to sell real assets and to hold capital in e.g. government bonds. However, Japan is a different place. Japan has/had very high rates of saving. In a country with falling asset prices and with citizens saving as much as 30% of their income it takes many years of Policy Innovation to kill off that deflationary weight on consumption, and to boost demand and GDP growth.

The US and Europe do not have as large a savings buffer as Japan. They are likely to arrive within a few years at a place Japan is only just arriving after many years of 'medicine'. Further Japanese policy thinkers (for a good illustration see Richard Koo's *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*) relied entirely on sterilised i.e. bond market funded deficit spending to boost the economy until very recently. It is only in the past 3 years that Japan has lost its fear of inflation, and begun to print money and debase the currency via QE, ZIRP, NIRP & monetisation of the Yen in the face of government debts of 300% of GDP.

In the East, just as in the West, debts that cannot be repaid will not be repaid, and will be defaulted on, either via an outright restructure (like Greece) or via monetary debasement and inflation (far more likely in the case of sovereign currency issuers like Japan, UK, US).

### Categorising Policy Innovation

In Figure 2 Policies that fund (i.e. 'sterilise') government and central bank expenditures (via taxes, bond issuance or sale of FX reserves) are on the bottom row and those that see governments pay for capital, fiscal or FX interventions with printed money are on the top row.



Policies of fiscal balance are shown on the left and of fiscal deficit on the right.

As noted in the introduction 'Good Housekeepers' include Switzerland and New Zealand. These do not run fiscal deficits or seek to sterilise government or central bank investment with government bond issuance. 'Just QE' countries include the US, part of Europe and the UK. These monetise purchases of financial assets, but have maintained relative fiscal balance. 'Just QE' Polices do not cause goods and services inflation - only asset market inflation. In fact I have argued in an earlier Commentary these policies may be deflationary, as they drive investment in excess production capacity.

In the bottom right cell 'Spend but Sterilise' countries such as Japan pre-2015 (and the Euro-zone fiscal deficit countries such as Italy and France) run large fiscal deficits but sterilise these via issuance of government bonds, so that the core money supply does not increase. These Polices are, like 'Just QE', non-inflationary. They do not increase the amount of dollars chasing each good or service. Stimulation from the government spending more than it taxes is precisely off-set by bond issuance.

Finally 'Print and Spend' countries currently include, Brazil, South Africa and Russia. These countries run large official and unofficial fiscal deficits and fail to 'soak up' the extra money supply from the expenditures by issuing bonds. It should be no surprise that all of them are experiencing inflation in goods, service and wage prices.

## The Next Phase Will Be Inflationary

I argued above that the common denominator of current policy trends is debasement of money by governments in pursuit of GDP growth objectives. And then observed that, at least in developed countries, the polices were largely confined to the spending of extra currency in asset markets, thereby lifting asset but not goods and service prices. I expect this to change now that asset price rises have reached their natural limit (now that interest rates along the yield curve are approaching zero). In particular I expect a shift in Policy up and to the right on the earlier table (i.e. no more sterilisation or fiscal responsibility). Hence earlier 'Spend but Sterilise' countries such as Japan have recently shifted to 'Print and Spend' mode as they actively seek inflation. In the West 'Just QE' countries are beginning to talk about Fiscal and Helicopter interventions. If adopted these would shift them rightwards to 'Print and Spend'.

Direct monetary support to demand for goods and services while not increasing supply is likely, absent Policy Failure, to cause inflation to finally return to these economies. Financial traders often remind each other 'don't fight the Fed'. The Fed (and other central banks) have been signalling for a number of years they want to lift inflation rates. It may pay to listen.

## What are the risks of these policy trends?

There is a risk of Policy Failure of 'Print and Spend' policies. Rises in interest rates and/or falls in financial markets that occur as inflation rises may cause citizens to lift savings rates and/or engage in capital flight - channelling the printed money into other places and not into demand. In which case either continued

deflation or inflation with low growth i.e. Stagflation would be the likely result. Countries like Japan with risk averse (high savings) populations are particularly at risk of Policy Failure. Japanese citizens, discerning the government is attempting to default on their JGB savings via inflation, may prudently try to restore their position by saving the printed money.

Policy failure is less likely in countries which do not allow interest rates to rise until well after aggregate demand and inflation have begun to rise. The US and UK may be already on this pathway. Inflation expectations are higher in both countries. Indeed, core inflation is currently running at 2% in the US and 1.5% in UK.

The second risk of 'Print and Spend' is that it does cause inflation, and that this then lifts interest rates, which in turn causes crashes in financialised asset prices previously supported by low interest rate and QE policies. In other words, after many years of asset prices rising faster than goods & service prices the pendulum might now swing the other way. Goods, services and wage prices may rise while financial assets fall. Given the importance of equity and credit markets for private sector jobs any political joy from this rebalancing might be short lived (if unemployment rises). It would be likely to lead to a reduction in investment and therefore stagflation.

Because policy makers are keenly aware of the above risks, I predict they will carefully manage policy interest rates at levels below (i.e. lagging) inflation for a number of years. I.e. I expect a period of sustained negative real interest rates (indeed we are already there with 2% inflation in the US and 0.5% policy rates). It logically follows that this 'lag' in normalising interest rates is both very likely and also probably the biggest risk of all. If policy makers (as always favouring borrowers over lenders) allow inflation to run for quite a few years before raising rates, this could create volatile economic conditions, especially if inflation gets out of control (and expresses itself in various forms of boom and bust).

## What Assets Am I Buying In This Environment?

I split the investment world into four major asset types based on the degree to which they are financially leveraged and how much supply elasticity (ability to grow capacity) the assets are. For example, Old world assets such as Gold has very little financial leverage and supply remains constrained no matter the demand:

For reasons set out above I am currently avoiding assets in the bottom left of this table: 'Financialised Capital'. Any rises in inflation will mean that interest rates will eventually need to rise. Expectations of this may cause banks, insurers, hedge funds etc. to suffer quite badly. I expect the share of GDP devoted to financial activities may shrink in the face of inflation and rising interest rates.

'Big Business' (bottom right) should do well if growth returns along with inflation. For this reason, high quality (non-financial) stocks and private equity should be represented in portfolios. However, as noted there is a risk of Stagflation. Hopefully this only a minority chance, but Stagflation has traditionally challenged corporate profitability and valuations. This risk makes me cautious

<p><i>Low leverage sectors</i></p>	<p><b>Entrepreneurial Capital</b>          Small business          VC and IT sectors          Row crop &amp; pastoral farming          Permanent crop ag</p>	<p><b>Old Money</b>          Gold &amp; collectibles          Bare farmland          Planning constrained          Real Estate</p>
<p><i>High financial leverage sectors</i></p>	<p><b>Financialised Capital</b>          Mid-level private equity          Residential real estate          Commercial real estate          Shipping</p>	<p><b>Big Business</b>          Oligopolistic/large scale corporates &amp; utilities whether in PE or stock market ownership</p>
	<p><i>High capacity elasticity</i></p>	<p><i>Low capacity elasticity</i></p>

**Figure 5:** Major asset types

about corporate equity, although I do maintain some in our portfolio.

So much for the leveraged asset classes on the bottom row of the matrix. I now turn to typically unleveraged assets along the top row.

Entrepreneurial companies (top left), especially growth companies are a great way of riding technological change to create investment value irrespective of market conditions. However, there are risks here too and this is a difficult asset class to gain access to (many tech companies once listed are already mature, and over their growth phase). In order to 'do this ourselves' I am currently investing capital into our own 'Map of Agriculture' farm information and communication company. And also our Craigmores Sustainable investment management business, which is now growing steadily – with over NZ\$500m of farming assets under management.

However, I must admit I am becoming more and more drawn, in an uncertain world, to the 'Old Money' scarce (and inflation-proof) assets (top right), particularly farmland, but also some gold (accepting risks to gold in a phase of currency reform). These types of assets have zero or low physical and economic depreciation. Consequently, they have low yields and do not support much leverage, so are unlikely to be 'sold off' in a deleveraging. Being scarce, there is a sense in which Old Money assets act as real currencies as well as investments. Hence they traditionally do well in times of inflation.

Farmland prices in NZ, US and UK are currently falling after three years of good harvests and poor

commodity prices. This is creating opportunities for Craigmores in our favoured NZ and UK target regions. Craigmores is currently deploying two new NZ farming partnerships. New projects include senior unsecured farm debt and UK farm real estate projects.

### About the authors

**Craigmores Farming** is a New Zealand farmland investment manager founded by Forbes Elworthy and Mark Cox in 2009. The Group now manages over 11,000 hectares of NZ sheep, beef, dairy and horticultural farmland valued at NZD 500m.

**Forbes** was brought up on Craigmores Station in the South Island of New Zealand and worked as a shepherd in the early part of his career. He then trained in Agricultural Economics at Lincoln University in New Zealand where he was student president in 1984. He went to Oxford as a Rhodes Scholar in 1985. After some time at Goldman Sachs he completed an MBA at Harvard Business School in 1992. Forbes worked as a credit trader at Merrill Lynch from 1992 to 1999 where he headed a convertibles trading desk. He then led financial information publisher Credit Market Analysis which was acquired by Chicago Mercantile Exchange. Forbes returned full time to farming in 2005 to live on and manage Craigmores Station – a sheep, beef and deer property farmed by the Elworthy family since 1864. He now spends his time managing Craigmores and an agricultural research and analytics business Map of Agriculture (formerly Craigmores Research).