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Climbing the wall of money

Global Macro Outlook, November 2016

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Our BlackRock Macro GPS suggests that economists remain too pessimistic on the growth outlook for major economies in the months ahead. This comes against a backdrop of tepid risk appetite, according to gauges we introduce this month. We believe upgrades to growth forecasts and greater clarity on the policy agenda of US President-elect Donald Trump could help stir more investor hunger for risk. Highlights:

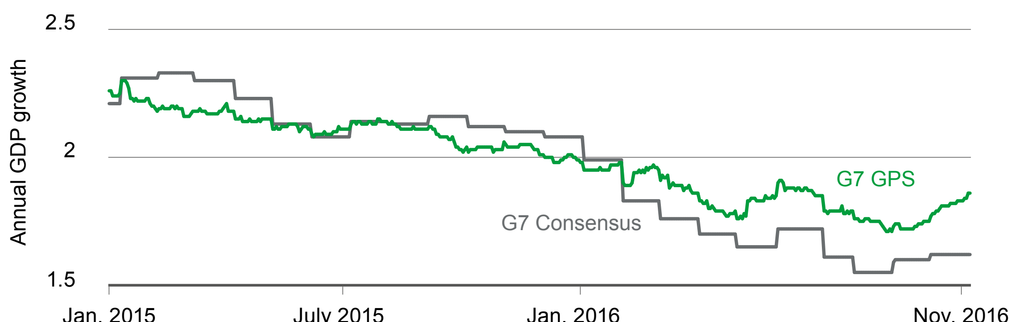
- Structural forces – ageing societies, weak productivity growth, persistent increases in savings – have created a low interest rate environment and pushed central banks towards loose monetary policy including asset purchases. One consequence: a build-up of money (physical currency and bank deposits) in the financial system.
- This so-called 'wall of money' was aimed at offsetting the post-crisis chill in risk taking. We find that by looking at some gauges of asset values relative to cash or perceived safe assets, risk appetite has improved but is well off peaks reached at the height of the dot-com bubble and early in the 2007-08 financial crisis.
- Our work suggests that current asset valuations do not imply the 'irrational exuberance' associated with recent bubbles as much as a growing realisation that interest rates will not climb back to higher historical levels.
- We see scope for investor optimism to lift equities and other risk assets, and see a mild rise in bond yields. But we don't expect renewed bouts of euphoria. We believe the structural factors at play should keep any yield rises contained.

GPS: upside ahead

Our *BlackRock Macro GPS*, seen in green in the chart below, points to brighter global growth forecasts. Recent solid figures – manufacturing PMIs, US average hourly earnings rising in October at the fastest pace since 2009 – have reinforced the upbeat GPS message. Some of its big data components (for example, consumer sentiment via Internet searches) are even more positive than the conventional data. The gap between our Macro GPS and the G7 consensus forecasts (the grey line in the chart) is the widest since early 2013, just before growth forecasts saw a string of upgrades.

Economic snapshot
BlackRock Macro GPS, 2015-2016

View GPS website



Sources: BlackRock Investment Institute and Consensus Economics, October 2016.
Notes: the GPS shows where the 12-month consensus GDP forecast may stand in three months' time for G7 economies. The grey line shows the current 12-month economic consensus forecast as measured by Consensus Economics.

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Unprecedented response

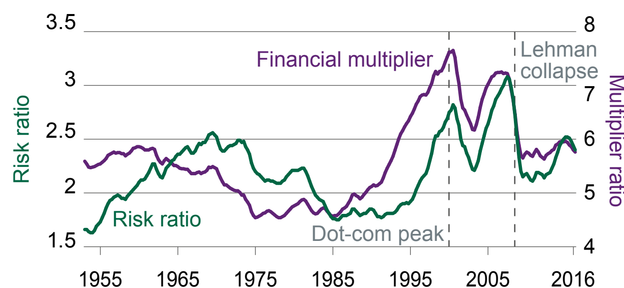
The response of major central banks to the 2007-08 financial crisis and ensuing sluggish growth environment has been unprecedented. One consequence is a build-up of money in the global financial system. We find that even with these actions, central banks have only offset the negative shocks from the crisis and broader structural factors. By looking at our new gauges of financial risk appetite, we find that investors still appear scarred by the crisis and remain reluctant to embrace risk. But if stronger confidence in the economic outlook spurs an improvement in risk appetite, this 'wall of money' in the economy could be made to work harder and provide a further boost to risk assets. If investors get carried away, central banks have plenty of tools to start taking away the punch bowl.

The reasons for low interest rates go beyond central banks. As highlighted in *A New Paradigm for Portfolios* in October 2016, we believe ageing societies, weak productivity growth and other global forces have pushed the neutral rate for major economies (r*) – that which neither stimulates nor restricts growth – to historically low levels. As the chart on the top right shows, developed economy (DM) central banks need to push real policy rates very low to achieve the same amount of stimulus.

Before the financial crisis, central banks targeted short-term interest rates and thus the 'price' of money, with the amount set by the market. As rates reached the lower bound, central banks shifted to targeting asset purchase quantities and let the market set the price – hence the name quantitative easing (QE). A new twist came from the Bank of Japan this year: adopting the conventional target approach with an unconventional target, 10-year bond yields. The result: yields touched record lows and money supply soared. What has this extra money meant for asset prices? To answer that question, it helps to think of money moving through the financial system at different speeds depending on investor sentiment.

How money morphs

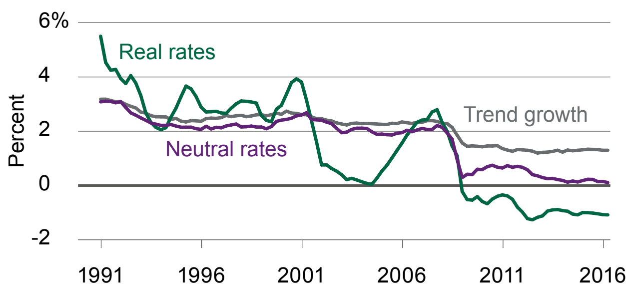
Gauges for US financial multiplier and risk ratio, 1955-2016



Sources: BlackRock Investment Institute, Federal Reserve, November 2016.
Notes: this chart shows gauges of a financial multiplier and a financial asset risk ratio based on U.S. flow of funds data. The financial multiplier is defined as the ratio between the market value of most financial assets – excluding assets such as securitisations or other intermediations to avoid double counting – and money (currency and deposits). The risk ratio is defined as the ratio between risk assets (such as equities, mortgages and corporate bonds) and less risky assets (government and agency bonds plus money) but excluding central bank holdings since those are effectively removed from the market.

Sustained low rates

DM real rates, neutral rates and trend growth, 1991-2016



Sources: BlackRock Investment Institute, Federal Reserve, BEA, Eurostat, Statistics Canada, Japan Cabinet Office, November 2016.
Notes: this chart shows the GDP-weighted averages of (1) estimates of the neutral rate, called r*; (2) estimates of trend GDP growth rates, and; (3) the real short-term rate for the economies of the US, Japan, eurozone, UK and Canada. Neutral rate estimates for the eurozone, UK and Canada are based on a model from an August 2016 Federal Reserve study (Holston, Laubach, Williams). For the US and Japan we derive the estimates via a similar methodology. R* is modelled as the sum of trend growth, which mostly explains its changes, and other factors that have historically played a smaller role, such as global excess savings. Trend GDP growth is modelled as having a 1-to-1 relationship with neutral rates.

Animal spirits

This gets to the essence of what John Maynard Keynes called 'animal spirits'. Optimistic investors tend to have a greater desire to use money to buy risk assets. Such buying should push up asset prices and their value relative to the amount of money in the financial system. The rate at which cash is used to bid up asset prices can be thought of as a 'financial multiplier' – a concept that is similar to the money multiplier but broader because it emphasises the key role of non-bank financing in the modern financial system. The financial multiplier can be gauged by looking at the ratio of overall asset values to money. A rising ratio suggests investors are comfortable using cash to buy financial assets at higher prices. Arguably, other assets can also be seen as money-like. Thus we look at another ratio: the value of risk assets to that of perceived safe assets (mainly money and government bonds) while excluding bonds bought by central banks – what we call the risk ratio. This shows more directly whether investors are venturing out the risk spectrum.

With both ratios, what jumps out is how their cyclical swings coincided with recent market booms and busts. The chart to the left shows a high-powered move in the financial multiplier and risk ratio before the dot-com peak in 2000, a drop in the early 2000s after that equity bubble burst, and a sharp run-up just before the 2007-08 crisis before collapsing again. Yet structural changes have also altered this relationship. Financial deregulation and technological innovations caused a shift up in the financial multiplier starting in the 1980s – money started to move faster. Eventually, more of that money moved into risk assets, pushing up the risk ratio to those highs. Now, post-crisis regulations requiring financial institutions to hold more capital and liquidity have slowed the speed of money, albeit at higher levels. Any moves by the new US administration to unwind those regulations (the Dodd-Frank law) could see a new structural rise in the multiplier and risk ratio.

Countering the chill

The drop in the financial multiplier is a key reason why central banks worked to offset the chill with QE programmes that injected more money into the system. One goal of central banks buying government bonds was to make risk assets look more attractive than perceived safe assets – what's known as the portfolio rebalancing channel. Removing government bonds from the market can be seen as prodding cautious investors to take more risk, ultimately hoping to stir animal spirits and economic growth. This set the conditions for bond and equity prices hitting record levels even with a soft global economy. In effect, central banks were creating money to offset the financial multiplier's slowdown.

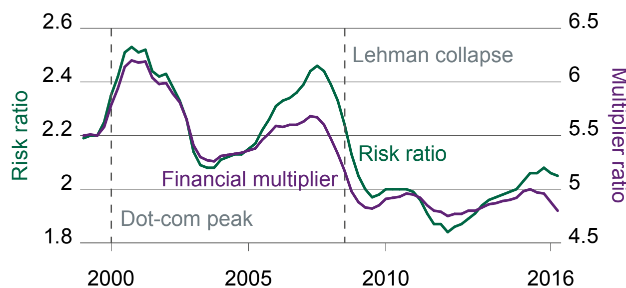
Standard metrics suggest stretched valuations in equities and other assets. We believe this raises legitimate worries about the risks of asset price bubbles. But what stands out by looking at this asset value-money relationship is that these valuations have occurred in an environment when the financial multiplier looks stuck near post-crisis lows. Each unit of money is not being used to generate higher asset values at anywhere near the pace seen during the dot-com bubble and the pre-crisis period. The bottom line: asset valuations may look expensive relative to history, but that is driven more by the outlook for sustained low interest rates than 'irrational exuberance'. While the risk ratio has recovered, it is well off the peaks and back at what we believe are more normal levels.

US M2 money supply (mainly physical currency and deposits) is $13.1 trillion, according to end-October Federal Reserve data. Tallying up individual central bank data, this global M2 'wall of money' is about $70 trillion as of mid-2016. Financial asset prices today reflect how much investors have been willing to put that money to work. If investors decide to make their money work harder, a higher financial multiplier and risk ratio could see asset prices rise rapidly. Investors turning more aggressive with their funds won't change the amount of money in the system – cash is simply transferred to the seller while the buyer acquires the financial asset (equity or bond) at a higher price. In a low-yield environment, investors have plenty of reasons to make their money work harder for higher returns. Yet they have appeared reluctant to do so.

Looking beyond the market moves after Trump's victory, we believe investors appear more focused on avoiding the pain of another risk asset sell-off than looking for a chance to cash in on a rally. If the risk environment turns too euphoric, we believe central banks stand ready to act. They would likely raise short-term rates to make money more attractive and reduce the financial multiplier. Central banks can also reduce money in the economy by raising rates on banks' excess reserves, thus encouraging banks to leave money at the central bank rather than lend it. Central banks could also adjust their balance sheets to drain funds from the system – letting asset holdings shrink naturally or even selling assets outright – though we view those responses as entailing bigger risks that could disrupt financial markets.

Dulled hunger for risk

Risk ratio and financial multiplier for G7 ex-US, 1999-2016



Sources: BlackRock Investment Institute, Bank of Japan, Bank of England, ECB, Statistics Canada, November 2016.
Notes: the risk ratio and financial multiplier are calculated using the same method as described on the page 2 chart based on data from Japan, the UK, Germany, France, Italy and Canada. ECB data starts in 1999.

Investment implications

Risk taking is not particularly buoyant, in our view. As the chart above shows, the restrained risk appetite story goes beyond the US. The financial multiplier for the G7 excluding the US has fallen steadily from its dot-com highs. It touched new lows during the height of the eurozone crisis and remains mired near there. The risk ratio has recovered more relative to 2012 lows but is also relatively subdued.

We believe investors remain ultra-cautious, partly by viewing asset valuations as rich. But we believe that basing views on historical valuations could be misleading.

We are in a low growth, low yield environment very different from the pre-crisis period. For that reason, we believe investors should take a more relative view of asset valuations in finding the appropriate risk/return balance rather than assuming valuations might revert to old means. We see this supporting our broad preference for more exposure to global risk assets – equities, credit and emerging markets.

Our BlackRock Macro GPS highlights that economic conditions may not be as downbeat as the consensus suggests. At some point, stronger confidence in the economic outlook may prompt money to shift into risk assets, providing some upside potential.

We think this implies some risk of higher bond yields if that money comes out of government bonds or other perceived safe havens. The bond sell-off after Trump's surprise victory, partly on expectations for higher inflation stemming from debt-financed tax cuts and infrastructure spending, highlights this risk (see our September 2016 Global Macro Outlook *Global fiscal policy: a material change in tone*).

Better investor risk appetite could be a reason for central banks to change tack on their liquidity policies, which may also lead to higher bond yields. Yet the structural factors restraining global growth and inflation should limit how far bond yields climb, in our view.

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