Asset Allocation in a world of financial repression

- Financial repression (policies that artificially lower governments’ borrowing costs) is already a key characteristic of the response to the coronavirus crisis. We suspect that it will become even more important as public debt soars to historically-high levels. Under those circumstances, returns from government bonds are likely to be very low but steady, while risky assets could perform much better.

- By way of background, financial repression covers a host of different policies which can hold down government’s borrowing costs, reducing the need for less palatable alternatives like austerity or default. (See here for more detail.) Such policies are almost never described as financial repression by policymakers themselves, and often have other, ostensibly unconnected, objectives. For example, forcing banks to hold more government bonds would usually be described as a prudential measure designed to ensure the health of the financial system. But it may also help to keep government bond yields under control.

- Central banks and governments have already been engaging in a partial form of financial repression since the global financial crisis, as we argued here. The former have mostly kept short-term rates at rock bottom, and have purchased government bonds. The latter have supported reforms to the financial system including the Basel III framework, which incentivises large financial institutions to hold far more government bonds.

- What has changed since the coronavirus outbreak is the scale of these measures. Central banks have been even more explicit than before about maintaining ultra-low short-term rates for years to come. More importantly, they have purchased government bonds at a record pace (or bought them outright for the first time) and abandoned or weakened quantitative constraints on the size of future purchases. In some cases, this already amounts to a de facto commitment to do whatever is required to keep yields low.

- Reflecting the scale of the economic crisis and the vast build-up of public debt that is underway, we think these measures are only likely to be strengthened. In our view, more central banks will move towards explicit targets for government bond yields, a policy previously adopted in the US during the Second World War as debt surged. Of course, the Bank of Japan was already targeting yields prior to the coronavirus, and Australia’s central bank has since followed. Though it may not be imminent, we think there is a chance that several others, including the Bank of Canada and the Fed, join their ranks eventually.

- The most obvious implication is that the returns from government bonds are likely to be mediocre, but very steady (in nominal terms) for years, as central banks keep their yields low and stable. That is what has happened in Japan since the introduction of yield curve control in September 2016. (We do not expect yields to fall further from here. That would probably require short-term rates to be pushed deep into negative territory, something that many policymakers seem to have concluded would be impractical or unhelpful.)

- Risky assets could outperform against such a backdrop, in spite of the damage caused by the coronavirus, as the poor returns available from safe assets make even highly-valued risky ones appealing. Admittedly, we have little history to guide us. The period from 1942 until about the late 1960s is about the only real modern example we have of financial repression on the scale, and with the global reach, that is now likely.

- But artificially-low government bond yields did appear to contribute to what was generally a very favourable environment for risky assets then, as Chart 1 shows. The (cyclically-adjusted) earnings yield of the US stock market declined from a wartime high of about 12% to nearly 4%, as Treasury yields remained very depressed. Corporate credit spreads fell to historic lows at the same time as well. (See Chart 1.) Only once Treasury yields began to surge at the very end of the 1960s did these trends start to reverse.

- Clearly, there is a danger of over-interpreting this comparison, given how much the world has changed. The global economy was recovering from the trauma of a world war then, and that period coincided almost exactly with the stability of the Bretton Woods system of pegged exchange rates and capital controls.

- What’s more, the authorities were able to deliver extremely low real interest rates after the war for a sustained period. This is because they were able to set nominal interest rates well below their prevailing equilibrium levels – which were much higher than they are now – and so engineer some inflation. Low real interest rates fuelled economic growth – a combination that not only liquified debt, but also propelled risky assets higher. The authorities may not be able to deliver such low real interest rates now. After all, nominal interest rates in much of the world are already at, or close to, their effective lower bounds. And the experience of Japan has shown just how hard it can be to engineer inflation in such circumstances.
Finally, the starting point for equities was also highly favourable after the war. The earnings yield of the stock market was very high relative to bond yields. As Chart 1 shows, the gap is nothing like as large today.

Having said all of that, central banks will probably strive to keep policy highly accommodative, even if it is harder to do so than in the past given the decline in the equilibrium level of interest rates. Some, most notably the Fed, have also gone further than ever before in providing support by other means, backstopping the financial system and supporting risky asset markets directly – for example by purchasing corporate and municipal bonds. Meanwhile, credit spreads still look high, although they have stopped rising. (See here, and Chart 2.) The upshot is that support from monetary authorities and comparatively appealing valuations will, in our view, continue to underpin demand for risky assets once the dust settles after coronavirus.


Sources: Shiller, CE

Chart 2: Moody’s US Baa Corporate Bond Yield Less Long US Treasury Yield (pp)

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Sources: FRED, Shiller, CE
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