1. Borrowers have less desire to borrow – and lenders less heart to lend.

The credit channel is by far the most powerful transmission channel for monetary policy. Corporate capital spending and households’ spending on housing and other durable goods is boosted by cheaper (lower interest rates in real terms) and easier access to credit, thereby lifting aggregate demand.

That certainly was the case from 1982 to 2007, a period during which monetary policy proved very effective in smoothing business cycles. When necessary, central banks successfully engineered a new credit cycle by easing monetary policy in times of economic weakness or financial stress. This 25-year span has been referred to as the Debt Super-Cycle. Given the willingness of both borrowers and lenders to embrace credit, the ratio of non-financial debt (both private and public) to GDP nearly doubled from 130% in 1982 to 250% by 2007. This exponential growth in credit resulted in stronger economic activity as spending was allowed to grow faster than income.

We are now seven years into the weakest economic recovery since the end of World War II.

Want the good news? We’re still the best house in a bad neighborhood. While the 1.2% annualized U.S. growth rate since 2008 has been disappointing, Japan’s and Europe’s economies have performed even worse.

The world has become addicted to cheap money.

New strategies to consider in a low-growth and debt-constrained environment

We’re not failing for lack of trying. All major economies have attempted an array of monetary policies, including:

• zero (ZIRP) and negative (NIRP) interest rate policy
• quantitative (QE) and quantitative and qualitative (QQE) easing
• verbal easing (talking rates down) and forward guidance (committing to easing in advance).

Historically, monetary policies have driven economic recovery by affecting three main transmission channels: credit, asset price and exchange rate.

While the asset price and exchange rate channels have worked for a while, the lackluster global economic rebound witnessed in recent years is a clear indication that the efficacy of monetary policies has been significantly impaired.
Since the financial crisis however, private sector debt has started to come down (mostly household debt) while government debt has continued to move higher, mostly as a result of automatic stabilizers.

We believe that the end of the Debt Super-Cycle is the main factor behind the reduced efficacy of the credit channel. High debt burden and economic uncertainties have reduced borrowers’ appetite for credit (credit demand) and those same economic uncertainties, as well as regulatory pressures, have made lenders less willing to extend credit (credit supply).

The end of the Debt Super-Cycle is a global phenomenon. It started in Japan already twenty years ago and the adjustment is still ongoing despite near-zero official interest rates since 1995. While credit growth is still relatively strong in China, the deleveraging cycle in emerging economies ex-China has already started. In all cases, a rapid increase in public debt levels has helped offset the private sector deleveraging, but public debt levels have now reached levels that significantly limit the likelihood and/or the potential benefits of accommodative fiscal policies going forward, despite evidence that fiscal stimulus is needed as a complement to monetary policy.

2. There’s a missing link between surging asset prices and economic growth.

While asset prices have been supported by extremely low rates and several rounds of quantitative easing, the actual growth in money supply has been disappointing. Indeed, central banks do not create money and the so-called liquidity flood has largely remained trapped as banks’ excess reserves with the central bank.

Moreover, the rapid increase in equity prices and drop in borrowing costs did not lead to a massive rebound in capital spending as companies remained cautious and relied too heavily on financial engineering (issuing debt to raise dividend payouts and buy back shares) in order to please shareholders in an environment of weak global growth.

While wealth effects have boosted consumer spending, limited growth in personal income has acted as an ongoing headwind offsetting these benefits.

As of today, it is difficult to see how this channel can provide any additional benefit given that valuations have already significantly expanded across most asset classes and investors have already largely reduced their cash holdings and switched into riskier investments.
3. **Beggar thy neighbor strategy is a zero-sum game.**

A weaker currency is usually one of the consequences of easy monetary policy due to the relative fall in domestic interest rates (versus rates in other economies) and the relative increase in inflation expectations. A weaker currency helps boost net exports, foreign-sourced corporate profits and imported inflation.

On the heels of the financial crisis, the Fed was the first major central bank to aggressively cut interest rates and expand its balance sheet. As a result, the dollar weakened sharply and both the US economy and corporate profits benefited from this trend.

However, things changed with the introduction of Abenomics in Japan at the end of 2012. The massive expansion of the Bank of Japan’s balance sheet produced a sharp Yen depreciation, despite ongoing policy accommodation in the US. In 2014 when the European Central Bank cut deposit rates in negative territory and initiated its own QE program, the Euro dropped precipitously. The point is that currency trends are a zero-sum game and competitive devaluations are not the solution on a global basis. The recent strength of the Japanese Yen, despite ongoing QE purchases and the implementation of negative deposit rates, is a clear sign that the limits of this exchange-rate channel in the current environment have been reached.

**There are no easy solutions.**

Monetary policy has not been effective in engineering a new credit cycle as credit demand is constrained by the end of the Debt Super-Cycle. High debt burdens represent a major headwind for growth and there is no easy fix in order to bring debt-to-GDP ratios lower. Indeed, there are only three solutions and none seems realistic or obvious in the current environment.

The perfect solution to deal with high debt burden is strong economic growth. However, this is highly unlikely in an environment of slowing potential growth rates, given weak productivity trends and poor demographics. And, obviously, stronger growth cannot be fueled by another wave of private-sector debt accumulation or fiscal stimulus, since the resulting increase in the numerator (Debt) would offset the increase in the denominator (GDP).

**Population trends mean structural headwinds.**

Another solution would be to write off some of the debt. Unfortunately, this is not a very likely scenario, unless we go through another major economic downturn, and in this case, the drop in GDP (the denominator) will offset the decline in overall debt levels.

Inflation would be another way to ease debt burdens, as debt is a “real” variable not impacted by inflation while GDP is a nominal variable and would move higher if inflation accelerates (everything being equal). As we have seen in the case of Japan, there is nothing worse than too little inflation or even deflation for highly indebted economies.
Time for some helicopter money?

In an environment where growth is constrained by high private sector burden and traditional fiscal stimulus (associated with higher public debt levels) is either unlikely to be implemented or unlikely to have a positive impact on spending, and where liquidity seems to be trapped at the central bank or in financial markets with limited spillover to the real economy, current monetary policies will not be successful in stimulating economic activity.

And in particular for those economies where a debt deflationary spiral is a more likely risk (Japan, Europe), monetary finance (a.k.a. helicopter money) is an option that I believe will be considered in the future (maybe and unfortunately only after another economic downturn).

In a nutshell, monetary finance is basically a combination of fiscal stimulus and quantitative easing implemented in a coordinated fashion and which does not lead to a rise in public-sector debt.

In practical terms, a government would implement a large fiscal stimulus and finance this stimulus by issuing government debt. The central bank would immediately purchase this debt from the government (and not in the secondary market as is currently the case under QE operations) and convert this debt into a zero-coupon perpetual bond. This means that there is no servicing cost for this debt and the debt will never have to be repaid. As a result, public debt levels will remain the same, additional public spending will automatically lead to stronger growth, and/or the propensity to spend any tax cut will be significantly higher. Moreover, the increase in the central bank’s balance sheet will be permanent, instead of temporary, which is currently the case under regular secondary market QE operations.

While it is clearly a very extreme solution which may be seen as unthinkable (this was also the consensus around negative interest rates not so long ago) and difficult to implement (my goal is not to bore you with all the implementations details and potential risks), a growing number of economists have advanced this tool as the only credible solution to boost growth and inflation in highly indebted economies faced with a liquidity trap.

The status quo means more money for nothing.

If central banks and governments are unwilling or unable to implement more radical policies that either stimulate growth and/or raise inflation, then debt levels will remain elevated and act as a significant headwind for economic activity and corporate profits.

The only solution left will therefore be to reduce the burden associated with high debt levels, i.e. to make it easier to live with leverage. Essentially, that means keeping interest rates low for longer.

In this scenario, official policy rates will remain extremely low for a considerable time.

Quantitative easing will remain an important policy tool in order to keep bond yields low across the curve. QE will also become a key (and maybe the only) tool during the next economic downturn, as there will likely be very little room to cut official policy rates by then.

Financial institutions will continue to face ongoing stringent regulatory pressures to encourage (force) them to hold more government securities. Persistently flat yield curves will also discourage the supply of credit.

Savers will continue to be penalized relative to creditors and this will encourage speculative behavior as investors continue their desperate search for yield, which will inevitably create financial distortions, boom/bust cycles and a structural increase in market volatility.

Persistently low rates will also enable unprofitable companies to stay in business and will limit productivity gains.
So What Does it Mean for Investors?

The long-term forecast remains cloudy — and bumpy.

Deleveraging pressures, demographics and softness in global trade result in weak growth prospects. Corporate profits will struggle in an environment of low nominal growth and downward pressures on margins.

As a consequence, monetary policies will either remain very accommodative for many years or new and highly unconventional tools will have to be implemented.

Such an environment will encourage financial imbalances, excessive risk-taking and asset bubbles. While monetary policies will provide some support in the medium terms, they will act as source of volatility in the short-term (uncertainty with respect to the normalization process in the US and additional easing overseas). Together, these factors support the implementation of strategies that can help investors stay the course and navigate more frequent bouts of turbulence.

Equities may still outperform bonds in a post-Debt Super-Cycle environment.

The Fed Funds Target rate has averaged -1% in real terms (adjusted for core inflation) in the current cycle, down from 4.5% in the 80’s, 3% in the 90’s and 1% between 2000 and 2007. This is a clear indication that the equilibrium level of real interest rates necessary to sustain decent economic performance has significantly moved lower in recent decades.

So in our post-Debt Super Cycle environment, interest rates and bond yields are likely to remain low. In turn, we should expect equities to outperform bonds, in particular equities that can act as bond substitutes.

The search for yield may lead investors into deeper waters.

Although volatility for these investments will likely increase, investors will be forced to venture deeper into higher-risk strategies in order to generate a decent level of investment income. Just keep in mind, the ride may get even bumpier.

International opportunities are worth considering.

Helicopter money — either the permanent monetization of budget deficits or central bank direct transfers to the private sector — is the most efficient tool to support growth and raise inflation in the current debt constrained and liquidity-trap environment.

In those economies where monetary finance will be implemented, equities should benefit and local currencies are likely to weaken. Japan and the Euro area, to a lesser extent, are the most likely economies where this tool will be considered.

In a low-growth environment, investors will need to look for areas where stronger growth can still be achieved.
Emerging markets already account for 58% of global GDP (in purchasing power parity terms). While their relative growth has softened in recent years, they remain a key driver of global economic activity. The ongoing deleveraging trends in emerging markets — coupled with the end of the commodity boom — will eventually refocus emerging market policymakers on structural reforms. Currently these markets under-owned, unloved and attractively priced.

China’s appetite for credit may lead to trouble – not immediately but eventually.

In China, the private sector continues to rapidly rack up debt. While that does not pose an immediate risk to financial markets, history suggests that credit excesses eventually lead to a destabilizing financial crisis.

In purchasing power parity terms, EM now contribute more to global GDP

China’s debt and GDP running neck and neck

Source for charts: FactSet as of 06/08/2016

Investment, trust, credit and banking services offered through Webster Private Bank, a division of Webster Bank, N.A. Investment products offered by Webster Private Bank are not FDIC or government insured; are not guaranteed by Webster Bank; may involve investment risks, including loss of principal amount invested; and are not deposits or other obligations of Webster Bank.

Webster Private Bank is not in the business of providing tax or legal advice. Consult with your independent attorney, tax consultant or other professional advisor for final recommendations and before changing or implementing any financial, tax or estate planning advice.

SEI Investments Management Corp. (SIMC) and Webster Private Bank are independent entities. SIMC is the investment advisor to the SEI Funds and co-advisor to the Individual Managed Account Program (IMAP). SEI Funds are distributed by SEI Investment Distribution Co. (SIDCO). SIMC and SIDCO are wholly owned subsidiaries of SEI Investments Company.

The Webster Symbol is registered in the U.S. Patent and Trademark Office. FN01453 6/16

We hope you’ve found this commentary helpful. When you’re ready to put these insights into action, visit www.WebsterBank.com/pb, contact your Webster Private Bank Portfolio Manager or email us at pbinfo@websterbank.com.