Navigating Uncertainty

THE **IMPLICATIONS** OF A NEW FISCAL ERA

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The implications of a new fiscal era

One of the long-term benefits of having a cyclical economy, structured around growth, moderation, recession and recovery, is that obsolete capital and labour, inefficient producers and under-utilized production capacity are periodically 'written-off' through downturns. This somewhat Darwinian process leaves behind survivors that are better equipped to thrive in the subsequent upcycle.

The downturn we are currently experiencing is far more severe than what is typically seen during a cyclical recession. The scale of the downturn in activity is so dramatic that it is putting productive, efficient and fully utilised capacity at risk of being 'written-off' from both labour and capital markets. This is particularly across sectors of the economy that cannot be effectively 'moth-balled' – a process that has both a physical and economic component.

To date, governments across all major economies have recognized this economic reality and have expanded their fiscal programmes accordingly, launching measures of unprecedented scope, structure and scale. At the time of the UK General Election in December it would have been unthinkable that a Conservative government would be paying 80% of wages across large swathes of the private sector before the end of the first quarter – such is the scale of the crisis and the response it has necessitated.

"Of course, fiscal expansion implies increasing sovereign debt..."

Of course, fiscal expansion implies increasing sovereign debt. The UK is only just through the long, drawn-out process of stabilising the nation's finances more than 10 years on from the Global Financial Crisis. Fiscal austerity has been extremely unpopular and was not as high on the agenda of the present (and relatively newly elected) government relative to its predecessors.

At Cardano, we've been considering the multiple economic dilemmas presented by the onset of a new fiscal era, and the range of potential implications for investors.

Scope of fiscal tools

Homing in on the UK government's actions to date, the measures have been in line with classical Keynesian principles in a bid to maintain spending. Spending has a much more immediate impact upon the economy than any initiative to temporarily reduce taxation could have. In addition to increased expenditures in social security channels and lower taxation receipts (so-called automatic stabilisers), we have also seen increases in departmental budgets, across the NHS and other social care channels.

Headline government activity has been targeted at keeping corporations liquid and solvent via loans and loan guarantees, taking on employers' payroll obligations through furlough schemes, replacing income lost by self-employed business owners that cannot operate and easing access to benefits programmes. In aggregate, the Office of Budget Responsibility initially estimated that the the total cost of the crisis would be £218bn.[1]

How much new UK Government debt is being issued?

New debt issuance has also been a major component of the government's response. The UK government deficit was already forecast at £55bn for the current fiscal year, with the unanticipated additional cost of £218bn increasing that amount to £273bn.[2]

[1] The Office of Budget Responsibility, 14th April 2020, "The OBR's coronavirus analysis" paragraph 6. [2] Ibid.

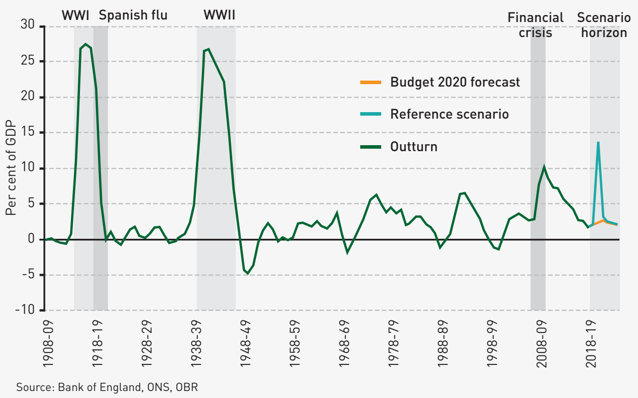
This sum will be funded through government borrowing, a sum that's close to 14% of the total of all public and private sector economic activity in the UK annually. In comparison, the UK's annual budget deficit reached circa 10% during the immediate aftermath of the Global Financial Crisis.[3]

Problems with increased borrowing

Clearly, this presents immediate questions about the viability of such a massive increase in government borrowing. After nearly ten years of austerity (see chart below), UK government debt has stabilised significantly. A return to austerity would be unpalatable to the public and potentially detrimental to the crisis recovery, particularly with Brexit still to be navigated. Given that the recently-elected Government came to power with a strong majority based on a mandate not to enforce austerity on the people, it seems likely that the Government is going to 'borrow big' now and potentially for some time to come.

The good news is that both fiscal and monetary policy is being deployed to address the economy's current problems. On the monetary policy front, the Bank of England has reignited its balance sheet enlargement programmes, provided liquidity support to the financial system, and in doing so, ensured that there is a willing buyer for any level of new Government debt issuance for the foreseeable future.

Public sector net borrowing: reference scenario versus Budget forecast



Source: Bank of England, ONS, OBR

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Immediate implications

In terms of immediate implications, high levels of fiscal and monetary policy support will ensure that the 'moth-balling' of production capacity is effective. It is important for the UK to remain internationally competitive through the upcoming recovery, without fiscal constraint acting as a brake.

The shape of the recovery will rest contingent on the public health framework and the pace at which restrictions on activity can be lifted. The current liberalisation trajectory evidences that restrictions will lift at a slower pace than the speed at which they were deployed.

Of course, this means that the timeline for the continuation of substantial fiscal and monetary policy support will also be extended. The continuation of both is the policy prescription. Expansion of government debt must be able to continue in an environment of low yields and flat yield curves for it to be most effective. The onus is therefore on the Bank of England to remain as accommodative as possible – there is little risk that such support will not be forthcoming.

The immediate future will see risk assets underpinned by official support, despite the depth of the recession, and a continuation of the low-yield environment for Government debt.

Theoretically, the government can continue to borrow money without the intention of ever paying it back. Government finances simply do not work like private sector lending and borrowing transactions. In the private sector, borrowing and lending works backwards and forwards along a time axis. Borrowing enables spending now and deferred payment, supported by lenders which do not need to call on the capital. The borrower pays the lender interest in order to compensate for the deferral of the lender's ability to use the money now (the time value of money), packaged up with an additional premium that reflects the risk that the borrower doesn't pay the lender back at all.

[3]The Office of Budget Responsibility, 14th April 2020, "The OBR's coronavirus analysis" paragraph 6.

Endless borrowing?

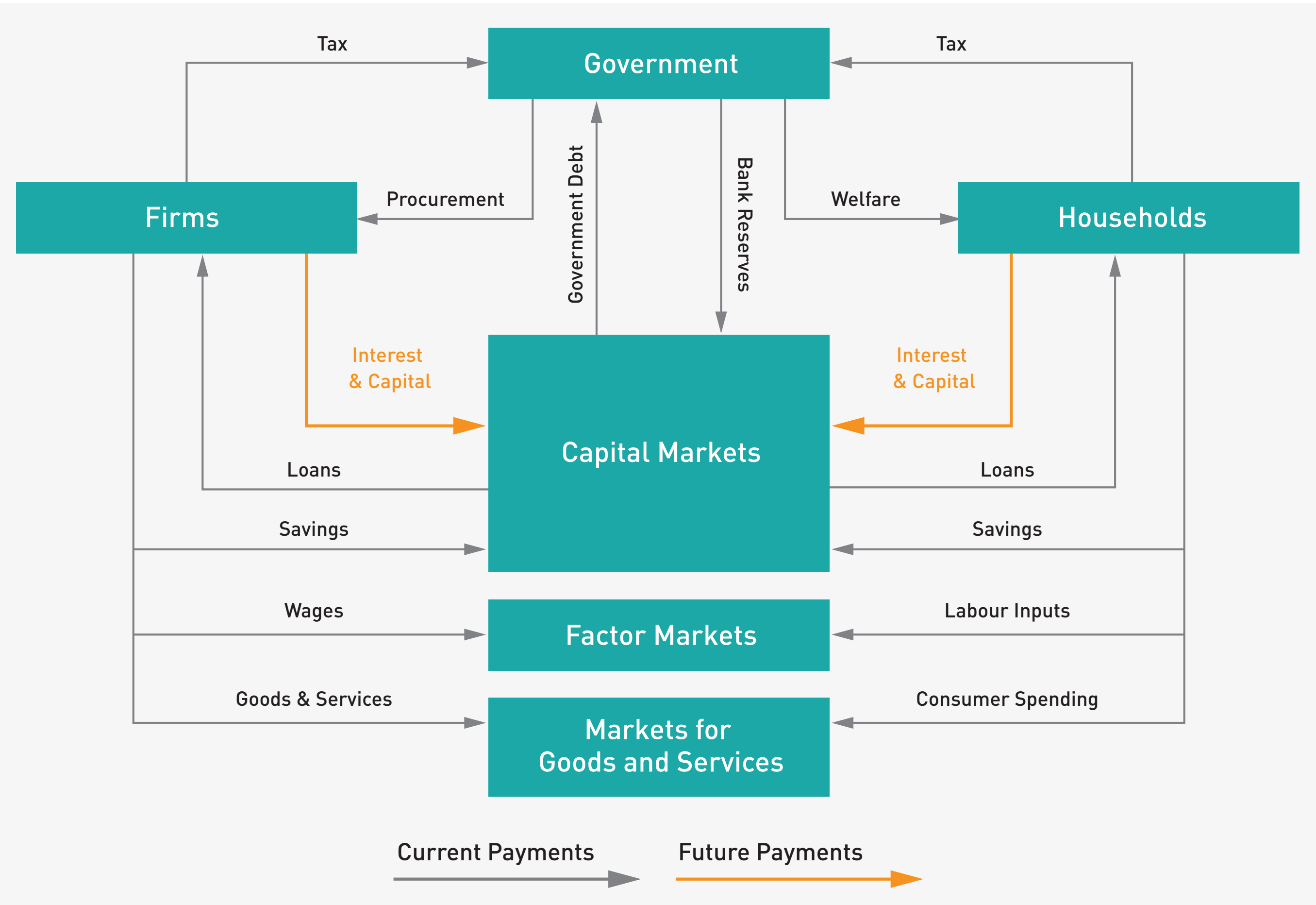
Provided that a government has full sovereignty over the issuance of its own currency and has a functioning banking system that enables it to transact with the private sector, government borrowing is somewhat different. For the sake of appearances, it is helpful to have an independent Central Bank too. This institution does not have to be completely independent, but the government must control its operational remit.

When a government borrows, the transfer of value is better thought of as moving sideways between the private sector and public sector, not backwards and forwards in time as it would in the private sector. As long as there are enough willing lenders to the government from the private sector (they are actually called savers rather than lenders in this context) then the government's ability to borrow is limitless.

Unlike private sector borrowing, there are no meaningful terms and conditions attached to government borrowing; there are no circumstances in which a lender can demand repayment against the government's wishes ahead of set maturity dates, which can be decades into the future. Even when maturity dates arise, the form of repayment made is limited to being money denominated in the currency of the government's sovereign issuance – bank notes will suffice, and they can always be printed.

These 'conditions' necessitate access to a wide market that has undoubted faith in the ability of your currency to continually retain the characteristics of money – medium of exchange, store of value, unit of account, standard of deferred payment.

Unlimited government borrowing should not be characterized as merely printing money. It is not possible for governments to print their way out of the problem; multiple countries have got into significant economic difficulties by attempting to, as we saw in Zimbabwe. But there is a fine balance to be struck in this regard, as most countries that suffer debt crises do so because they are unable to print money in the same currency that their debt is denominated - Mexico, Argentina, Greece to name but a few.



Growing out of debt

Western democracies typically aim to grow their way out of debt. The sustainability of any debt load can only really be judged with reference to the size of the economy that is supporting it. For instance, the US national debt is roughly 10 times higher than the Canadian national debt in nominal terms but, with a population and Gross Domestic Product both also roughly 10 times bigger, the US and Canada (both countries with similar demographics and at similar stages of development) have equally sustainable public debt loads.

It follows that if any country can grow its population and the overall level of its economic activity at a faster pace than its debt load is increasing, then it can improve its fiscal position without ever having to reduce or repay debt in nominal terms. This is why most economic statistics reference debt and borrowing in "% of GDP" terms.

This growth approach has been the go-to strategy since the end of World War 2. Of course, in the UK, and in most other Western democracies, the mid-20th century baby boom, the growth of consumerism and the deregulation of the availability of credit facilitated this growth in a way that might not be possible over the coming decades.

> **"Growing out of the debt will be a slow process given the UK's current demographics..."**

What do we expect this government to do?

Growing out of the debt will be a slow process given the UK's current demographics and any return to fiscal prudence or the return of austerity will be an unpalatable option in the near-term. Moreover, the present government was elected almost exclusively on the single promise to get Brexit done. It may have achieved that legally already, but the final framework and terms of the UK's exit and new global status is far from complete. The government may consider consolidation to be a nod to their fiscal conservatism but any action to seriously reverse the current growth of debt will be deferred and deferred and is unlikely to be seriously addressed until at least the run-up to the next Parliamentary elections in 2024.

Meanwhile, the Bank of England is going to have to maintain the pace of its monetary policy support. It seems less in favour of using negative interest rates relative to continental European peers, so will continue to use asset purchases rather than interest rate policy to ensure that there is always a ready and willing buyer for the government's increased issuance of debt. The Bank of England will not transact directly with the government via monetary financing, a practice avoided by most orthodox central banks.

> **"It is a neat solution, but kicks the can down the road indefinitely."**

Commercial banks buy government debt as it is issued, which is almost immediately bought by the Bank of England, marking up their reserves accordingly as it does so. Every time there is an interest payment or maturity proceeds to be paid by the government to the Bank of England, the Bank of England makes an equal and opposite transaction to buy more Government debt so that the size of the assets on its balance sheet never falls. This exchange can go on forever, limited only by the total amount of debt that there is to buy.

It is a neat solution, but kicks the can down the road indefinitely. It leaves the problem of addressing the debt burden to another day, another government and future generations to tackle when other more pressing matters are not occupying their attention and spending requirements.

Impact on the investment landscape

It remains incredibly difficult to gauge how asset markets will respond during the upcoming recovery phase. The nature and impact of the catalysts that will be delivered into the market have little by way of precedent in economic history. We can, however, be reassured that some of the worst downside risks are averted by official intervention.

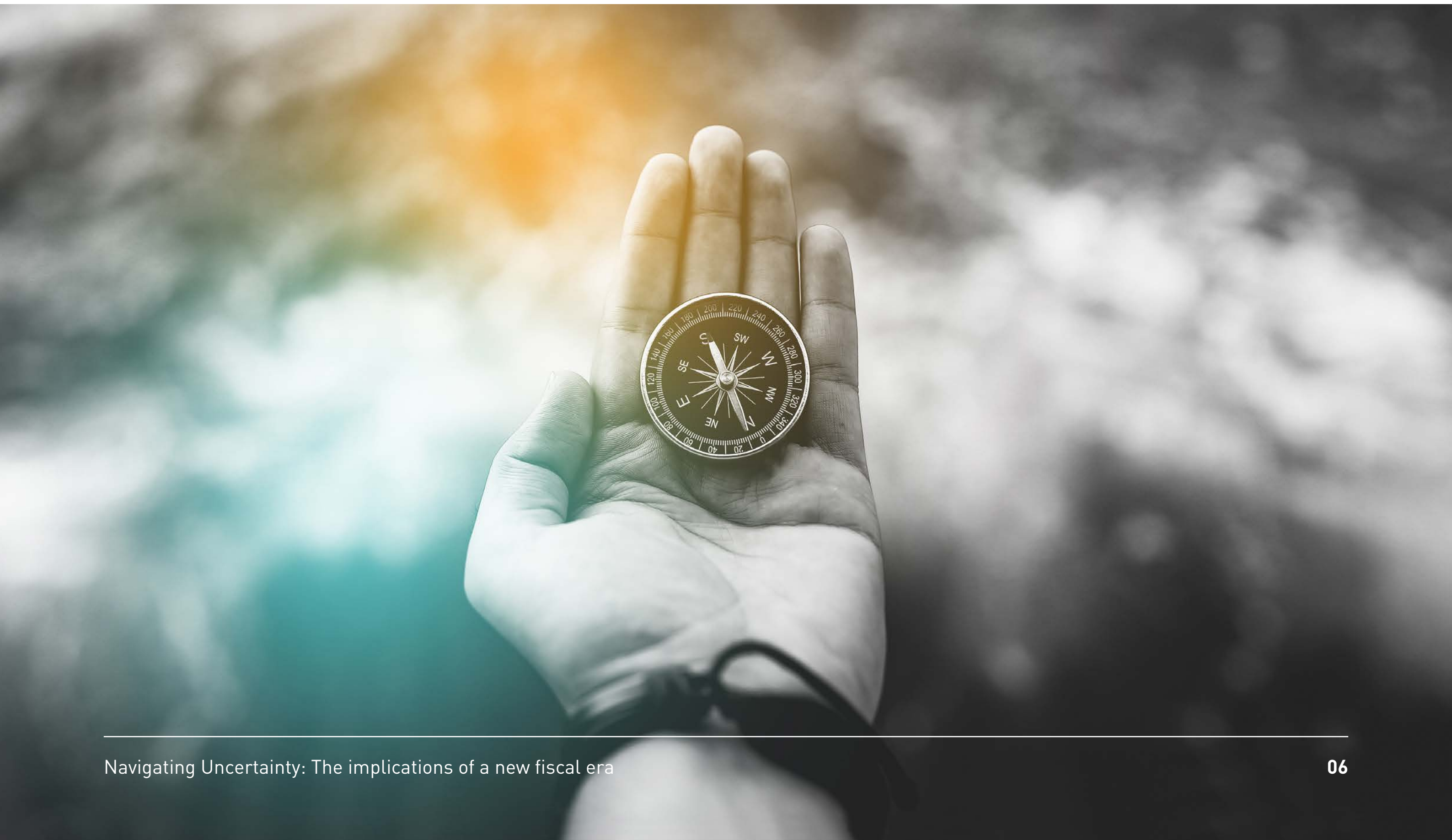
So, even whilst the timing and shape of the recovery is uncertain, the current policy provdes a 'backstop' suggesting that economic risks are now skewed to the upside. With such a powerful base effect being established, growth and inflation will be higher in the intermediate future, albeit muted by demographics over the longer term.

More importantly, the Bank of England's monetary policy approach appears set to keep gilt yields low. Curves will be pressured to stay flat and, absent of substantially negative yields emerging – a market feature that would be new for the UK – the potential for further downside protection from bond markets would be limited.

Whilst the diminished downside protection offered in bond markets will have implications for how we at Cardano will go about constructing recession clusters and stress protection in client portfolios, the implications for liability driven investors more generally will also be profound.

Liability-driven investors are likely to be faced with real yields becoming even more negative in the future without a compensating gain coming from bond returns. The most significant moves could arise once we are past the point that the deflationary, first order effects of the crisis are passed.

That could make for a challenging time ahead. Both astute portfolio construction and liability hedging will have an important role to play in the future.



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