Central banks, the age of populism and local authority investors

By Bob Swarup

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Bob Swarup analyses how politics is impacting the role of central bankers and the knock-on effects for local authority investors and their balance sheets.

Investing after the age of omniscience

In late August 2018, central bankers and economic policymakers from around the world met for their annual forum at Jackson Hole, Wyoming. The topic was "Changing Market Structures and Implications for Monetary Policy".

Unlike previous sessions, this one was not widely covered. That was with good reason – in the age of populism, of Brexit and Trumpism, of geopolitics and trade wars, there was plenty else to occupy broadsheets and commentators globally.

It also echoed a new reality – one captured obliquely by the forum's title. Today, central bankers are no longer drivers of policy, but rather struggling to understand how policy must evolve in a rapidly changing and uncertain world.

Politicians and populists are in charge now, and the central bankers – like the rest of us – are running hard to keep up, even as the ability to peer into the future with any confidence rapidly declines. With that comes the growing risk that we can no longer rely on monetary levers to bail us out of the next downturn.

The high inflation of the 1970s and 1980s underscored the need for monetary policy to be insulated from political and social pressures, as difficult and unpopular decisions had to be made to tackle the challenges of stagflation.

With their eyes on the shorter-term prize of the next opinion poll and the next election, politicians proved unable to look past their behavioural biases and to the bigger picture. In contrast, the success of Paul Volcker and his ilk in understanding and acting to contain the longer-term economic impact ushered in a golden age of central bankers.

The gilding on this age of omniscience was only enhanced by the great moderation [1] and stellar economic growth of the subsequent three decades. Independence and the forward guidance of the wise on the mount became the mantra of the day. The argument went that an independent central bank free of political pressures could focus on monetary policies for the long term, targeting low and stable inflation as well as long-term economic growth.

There is much central banks have achieved that they can justifiably be proud of. But over the last decade and in the aftermath of the last financial crisis, the gilding has faded.

Quantitative easing may have spared us the worst of the crisis and cushioned markets, but those same financial markets have also evolved a dependency culture that is now driven by monetary methadone and sentiment around policymakers. Meanwhile, society has not felt a recovery, with wages stagnating and affordability eroding.

In their disenfranchisement, populations have turned iconoclast. Populism has risen significantly and politicians – ever sensitive to these nuances – are now playing to the gallery increasingly, as referendums and elections evidence the frustration.

In this mix, monetary policy has lost its lustre and there is a growing sense that central bankers are unaccountable for their actions. In the UK, politicians have argued savers are being hit hard by the low interest rate environment – something many local authorities can empathise with – while Mark Carney often finds himself defending the Bank of England against accusations that central bank policies drove inequality. Others such as Ed Balls have argued publicly for a new layer of oversight for the Bank of England.

[1] As inflation fell and stayed low as well as stable.

There is some truth in that by failing to factor in the human element and appreciate the complexity of the whole socio-economic system (outside of their own narrow remit), central banks have provided a convenient excuse to their critics. They also fell prey to groupthink and their hype, showing their own behavioural biases.

But there is also disingenuity and danger lurking down this path. Politicians no longer had to make hard decisions in this age of omniscience. When trouble struck, one merely looked to the monetary lever to save the day. Structural reforms – always so courageous to consider and career-threatening to implement – could be put off to another day, and preferably after the next election.

Redistribution was never part of central bank policy. The very act of raising or lowering interest rates will always have unequal impacts across society, and extreme measures will have even more extreme impacts. But managing these, mitigating inequality and assuaging society is the preserve of politicians, not central banks. The latter by diktat is focused solely on inflation, monetary stability and unemployment.

Deciphering uncertainty

Today, the clock is ticking. We do not know the world post-Brexit, but we can easily identify some of the areas of concern for local authority investors, across pensions, treasury and the wider balance sheet.

As central banks have erred on the side of accommodativeness, cash has languished in the yield doldrums and yields have failed to account for inflation. Even in the face of modest inflation, the corrosive impact on local government balance sheets and liabilities has been profound.

Today, investors are losing -1.65% annually if they hold cash. That is also the drag that their investment portfolios must overcome before they can deliver returns that retain the councils' spending power tomorrow.

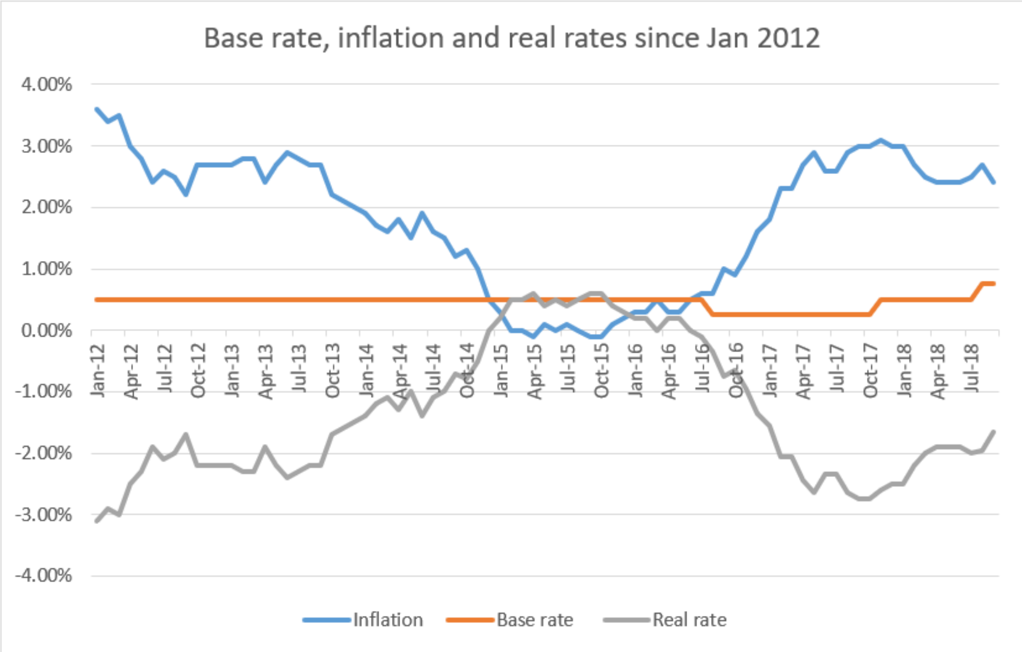

Figure 1: Inflation, base rates and real returns in the UK over recent years (Source: ONS, Camdor Global Advisors)

Post-Brexit, the pound will be both even more of a hostage to sentiment, and trapped on the fence between the big boys – the dollar, the euro, the yuan. That volatility will lead to whipsaws in input inflation and add to the economic conservatism of businesses and households in a post-Brexit world. For investors, it may also mean higher hedging costs and great basis risks for their investments overseas.

In more normal times, the Bank of England might raise interest rates to compensate but today, it faces a Catch-22 situation.

Economic uncertainty coupled with a fragile recovery and political deadlock has meant that the Old Lady's focus is on minimising disruption tomorrow. Future expectations of the real yield curve – in other words, future yields after adjusting for inflation – are therefore gloomy.

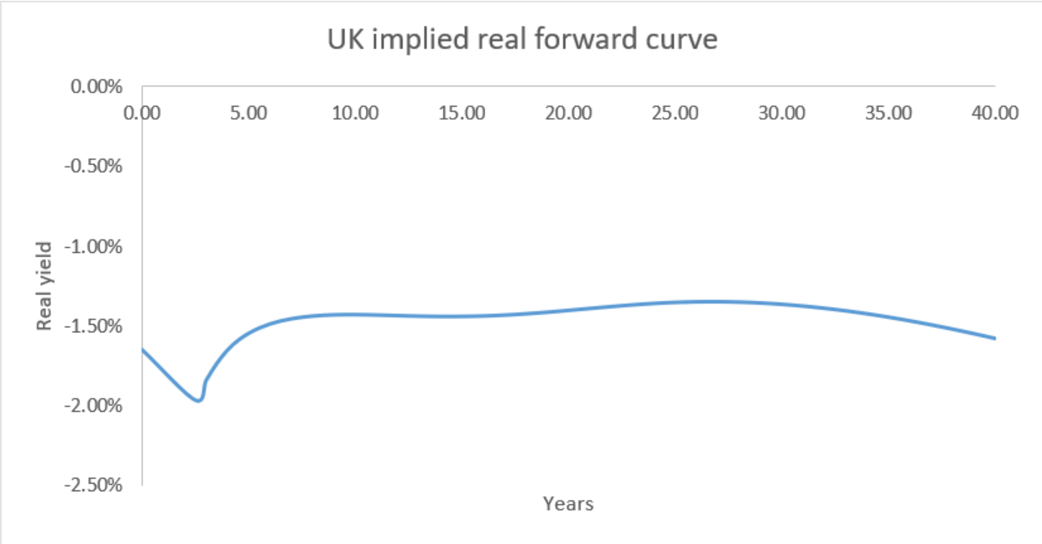

Figure 2: UK implied real forward curve for gilts (Source: Bank of England)

But fail to raise rates, and we run the risk of having limited monetary firepower to face a future recession – a growing worry, not just because of Brexit but also because of the maturity of the economic and credit cycle.

Regardless of the choice, the Bank of England will probably also run counter to the present worries over stagnant wages and affordability, and where policymakers are focused. As central banks generally ponder reversing out of their monetary cul-de-sac towards 'normalisation', their once praised independence of thought may be a political and social liability going forward. The tensions between Donald Trump and the Federal Reserve in the US indicate that may not be such a far-fetched notion any longer.

Here in the UK, the Bank of England finds itself stuck. Its choices are shrinking, along with its room for manoeuvre and margin for error.

For investors, dislocations bring opportunity and risk in equal measure. Brexit is a moment in time. The trends above are deeper than that, and their impact will play out over the longer-term. It is, therefore, important that investment decisions look past the headlines, ignore the noise and focus on fundamental analysis above all else. Risks will need to be discriminated between those that are rewarded and those that are not, with one being exploited and the other mitigated. That takes planning and thought.

There is a strong headwind, and our portfolios will need to outperform in real terms in the choppy waters ahead. And this time, we cannot necessarily rely on omniscience and monetary showers to bail out the ship when the storm hits.

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