

Investment Focus

Global Chess Game: A New Framework to Navigate Competitive Currency Devaluation and Policy Dominance

Introducing a new framework – the Global Chess Game

The goal of central banks from the hardest hit economies during the financial crisis has been to ease financial conditions, reflate asset prices and, ultimately, support inflation. Activism by major central banks created what we referred to as “policy dominance” and it became a core part of our investment thesis.¹ But this thesis, which relied on the consistency of easy policy to reflate asset prices, will be put to the test as the Federal Reserve (Fed) may reverse course and raise interest rates. In contrast, the People’s Bank of China (PBoC) and the European Central Bank (ECB) have moved in the opposite direction and adopted an easier monetary policy stance.

A new framework is, therefore, required to navigate this new regime of policy dominance in which major global central bank policy goals are currently at odds with each other. We call it the Global Chess Game (GCG) in which asset prices are mainly driven by the interactions of global central banks competing with each other to reach domestic inflation targets while simultaneously trying to maintain financial market stability. At the nexus of these competing goals is where we believe alpha and investment opportunities exist.

From an investment perspective, the GCG suggests that we will likely realize modest global growth without the risk of rapidly rising interest rates in the near term. This is because central banks from economies that are poised to recover, such as the US and UK, may have to increase policy rates more slowly to avoid a “lowflation trap”.²

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¹Global Fixed Income *Insights*, “Reflationary Central Bank Policies Make Positive Real Yields Attractive”, Jim Caron, September 2012.

Meanwhile, economies that are weakening may be able to ease policy rates more aggressively, coupled with a reduced risk of an inflationary outcome. Inflation and inflation expectations may remain low in the medium term as a result.

Broadly, this should be supportive of credit and carry-related investments as default risk may remain low given that central bank policy support will likely continue to be a dominant feature of the investment cycle. Additionally, this suggests a structural reduction in term premium that may be supportive of flat global yield curves. Of course, idiosyncratic risks will remain as the policy cycle is unsynchronized, which we believe is to the advantage of actively managed fixed income strategies.

Starting the Chess Game – The Opening Repertoire

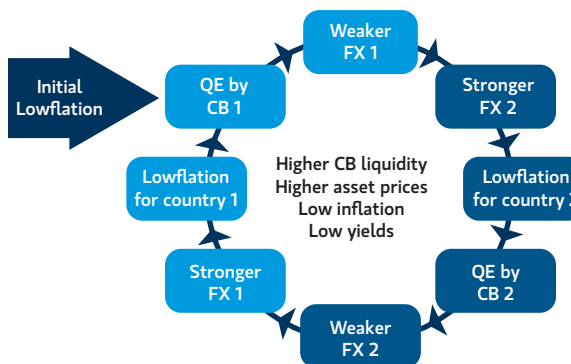
To illustrate our point, we make the analogy of a chess game to global central bank policies. At the beginning of the game, the global economy is at an arbitrary point of equilibrium, similar to a chess board, with the pieces representing policy tools that are used to achieve one’s goal—growth and inflation—the king. Once a central bank makes an initial move to achieve a new equilibrium, it sets in motion a sequence of moves from other central banks, which we refer to as the opening repertoire. Suddenly, the game becomes unbalanced and requires more policy changes until a new equilibrium is achieved.

Following the “crossing of the Rubicon” and the onset of the ECB’s Quantitative Easing (QE) program, President Mario Draghi was seen on a flight (in economy class) from Frankfurt to Rome playing chess on his iPad.³ With global deflationary pressures, persistent slack in major economies and with ECB aggressively devaluing the euro, the GCG has started and other global central banks have reacted. In this game, central banks compete against each other by easing monetary policies in an attempt to meet their domestic, inflation-targeting mandates. Lack of coordination among central banks may mean that monetary policy remains lower for longer, leading to a semi-permanent low-yielding environment. At the end of the GCG, we are likely left with more central bank money, higher asset prices, low inflation and low yields (*Display 1*).⁴ It is difficult for central banks not to play or to leave the Game—for such a decision, the price to pay is potential deflation.

Unconventional monetary policy is supposed to support the real economy and, ultimately, increase inflationary pressures. But what we observed after several years of ultra-low interest rates is something different. While economic growth has returned (albeit lower than pre-crisis levels), inflation has failed to appear. We would argue that part of the reason for low inflation is the same unconventional policies that are supposed to generate inflation—a low interest rate environment leading to a misallocation of resources which stifles economic growth.

The GCG is a useful framework to understand financial market movements in a world dominated by monetary policy. The implications of the GCG are clear: duration will likely trade in a range. When yields and currencies rise with improving fundamentals, it tends to lead to lower inflation and central bank interventions, thus binding yields in a tight range. In the currency markets, central banks less willing to play the GCG may see their currencies appreciate and bear the brunt of global deflation.

Display 1: The forecasted workings of the Global Chess Game with two central banks



Note: This chart is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. There is no assurance that this forecasted scenario will be achieved. This flow chart refers to a cycle that is catalysed by an initial lowflation impulse. It triggers an arbitrary first central bank (CB1) to engage in policy easing, which in turn, weakens its currency (FX1) relative to another currency (FX2). This creates low inflation in country 2 that prompts an easing policy response to weaken FX2. The chained reaction amongst the central banks are what we refer to as the Global Chess Game.

Source: Morgan Stanley Investment Management

Origins of the Global Chess Game

Since January 2015, many global central banks have cut interest rates or embarked on QE programs to counteract relative appreciation of their currencies and combat deflationary pressures.

In this environment, interaction among central banks rather than domestic fundamentals becomes the key driver of assets’ returns in our opinion. This leads us to a question: what is the optimal response of a central bank given actions of other major central banks? We argue that the GCG is a useful framework to understand fixed income markets in which central banks follow

² Lowflation means an ultralow inflationary environment where inflation remains persistently below the inflation target.

³ <http://www.bloomberg.com/news/articles/2015-01-26/draghi-plays-chess-in-economy-after-journey-to-trillion-euro-qe>

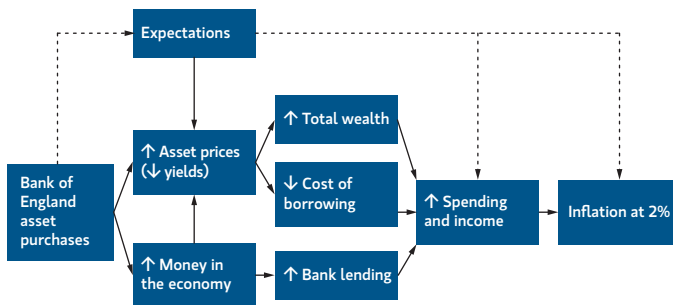
⁴ In this paper we do not attempt to explain initial lowflation, low growth environment. Rather, it is a given in this framework. The Secular Stagnation hypothesis (Summers, 2014), Savings Glut hypothesis (Bernanke, 2011) or demographic trends are all plausible explanations (Haldane, 2015). We argue, however, argue that the GCG exacerbates secular macroeconomic dynamics already in place which will likely maintain low yields.

their domestic inflation targets and operate at the zero interest rate lower bound. We also argue that this game is leading to excessively low policy rates which, in turn, will make them stickier. But how did we get to the GCG? And what are the potential implications for financial markets?

Can unconventional policies induce lowflation?

Unconventional monetary policy is supposed to support the real economy and, ultimately, increase inflationary pressures. For example, QE should increase asset prices via the portfolio rebalancing effect⁵ and support credit creation through the bank lending channel. The impact would, in turn, increase consumption, investments and, thus, inflation (see *Display 2*.) While the bank lending channel is likely to have limited effects on bank lending (see Joyce and Spaltro, 2014 and Butt et al., 2014) and therefore inflation, asset prices have strongly increased following QE and other unconventional policies. For example, U.S. equities prices, based on the S&P 500 Index, rose over 180 percent, catalyzed by the start of QE in the U.S. in November 2008.⁶

Display 2: Classic transmission mechanism of QE



Source: Benford et al. (2009)

But what we observed after several years of ultra-low interest rates is something different. While economic growth has returned (albeit lower than pre-crisis levels), inflation has failed to appear. Our composite inflation “pulse” suggests that inflationary pressures are not on the horizon for major

⁵ The portfolio rebalancing effect is the key transmission mechanism of QE to asset prices. When a central bank buys government bonds, it reduces risk-free bonds expected returns. Investors will then tend to move away from this asset class into riskier assets, e.g. corporate bonds and equities, thus lowering risk premia and supporting the real economy. This process of asset rotation is the so called portfolio rebalancing effect. See Benford et al. (2009) for a fuller description.

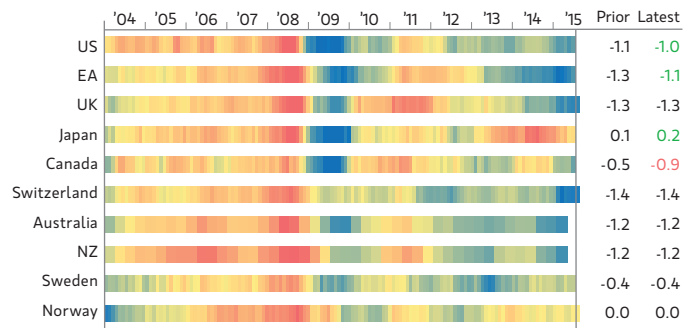
⁶ Source: S&P. Data as of August 19, 2015.

⁷ We use Principal Component Analysis to track several inflation indicators bucketed in goods inflation, producer prices inflation, wages inflation and inflation expectations

developed market economies (*Display 3*).⁷ We would argue that part of the reason for lowflation is the same unconventional policies that are supposed to generate inflation.

First, ultra-low interest rates tend to reduce the incentives to deleverage helping maintain the level of debt above its long term trends, diverting investments from more productive uses and, hence, stifling economic growth. This factor may even have contributed to very low rates of productivity growth in developed economies (see BIS, 2015). Low rates may also have labor force compositional effects—all things being equal, it helps low skilled labor force formation—weighing down on productivity and wages (see BoE, 2015). In other words, major central banks may have traded short-term output gains (recession was milder) with long term economic loss. Also in the world of central banking, there is no such thing as a free lunch.

Display 3: Inflation pulse is weak for major developed market economies



Note: Blue - Red scale varies for z-score range of [-1.65, 1.65]

Source: Bloomberg LP, Haver Analytics, Morgan Stanley Investment Management calculations. Data as of July 23, 2015. 'Latest' refers to the most recent monthly inflation data. 'Prior' refers to the second most recent monthly inflation data.

Second, the inflationary process of QE may have stopped at assets’ inflation and did not generate purchases of newly produced goods or services. As consumers and companies remain scarred after the financial crisis (see Haldane, 2015), increases in wealth may not coincide with increases in consumption or investments.

Third, low interest rates reduced banks’ net interest margins as the potential returns on the assets continues to drift lower, while it is challenging for banks to charge their customers for deposits. All things being equal, this reduces capital buffers, thus leading to a decline in lending supply. And initial empirical estimates tend to confirm that QE did not have a strong effect on the supply of loans (Butt et al., 2014 and Joyce and Spaltro, 2014) so that the effect on inflation via this channel should be muted.

If the effect of QE on inflation is limited, the depreciation of the currency remains an important (if not the most effective) tool to affect inflation and inflation expectations.

What does the limited ability to support inflation mean for monetary policy?

If central banks' unconventional monetary policy can do little to support inflation via the main transmission channels (e.g., asset prices and bank lending channel), the most likely adjustment will have to happen via the foreign exchange rate. That is why we saw an increase in attention by central banks to exchange rates. The Riksbank has been one of the most active central banks lately, focusing on currency movements where an appreciation of the Swedish currency triggered deposit rate cuts which are now deeply in negative territory (Riksbank, 2015). The Riksbank became one of the best players of the GCG. With lowflation, central banks seek to protect their domestic interests by devaluing their currencies and shifting deflationary pressures across the globe (*Display 4*).

Lack of coordination between central banks may lead to loose global monetary policy for global economic fundamentals, which in turn may exacerbate misallocation of resources and detract from long term growth. This suggests that the GCG may have compounded the lowflationary effects of QE.

It is difficult, however, to argue that central banks should raise rates to induce inflation as it will probably have the opposite effect. In the GCG world, an interest rate adjustment may be overdue but will also be a costly process as the currency will take the brunt of the adjustment, lowering further inflation and inflation expectations.

At the same time, maintaining low interest rates for extended periods has costs in terms of lower economic growth. Thus, raising policy rates slightly may be even beneficial from a cost-benefit analysis perspective.

And the benefits of such action could be even higher with more coordination across major central banks. They would jointly decide who needs easing the most, with the stronger countries able to absorb the resulting deflationary pressures. An alternative would be for central banks to focus on longer-term financial trends rather than short-term inflation and growth targets (BIS, 2015).

What does it mean for fixed income and currency markets?

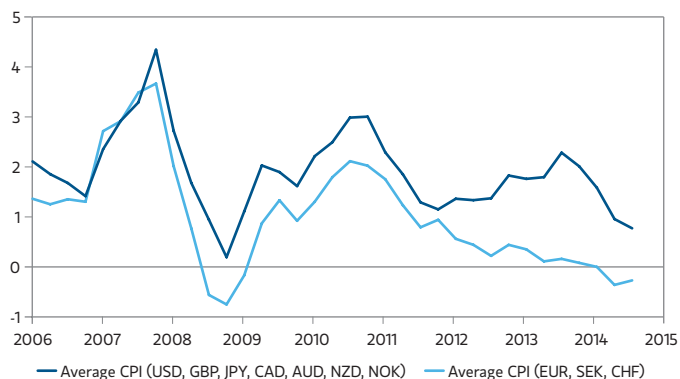
First, the GCG fixed income market will become more tactical. Fundamentals are important but lowflation and interaction among global central banks are key drivers of returns in our opinion. In order to generate return in a world of low risk premia (*Display 5*), timing reversals correctly will become a larger part of expected returns.

Second, if economic growth is structurally lower and central banks compete via adjustments in foreign exchange (a scenario in which we believe we are currently in the GCG), yields may remain lower than ordinary and potentially range bound. Signs of a strengthening economy (for example higher yields and a stronger currency) will be met by central bank intervention which will keep longer maturity bond yields from rising quickly.

Third, best opportunities (in terms of expected returns) are where central banks still have scope to lower policy rates and are in the process of adjusting toward the lowest central bank rate as inflation rates converge. These so called global satellites (e.g., Canada, New Zealand and Australia)⁸ provide some attractive investment opportunities in our opinion.

Currency markets will likely continue to be dominated by their relative monetary policy stances. We suggest investors consider longing the currencies for central banks less willing to play the GCG (i.e., US dollar, British pound) and shorting central banks keen to play (i.e., New Zealand dollar, Australian dollar and Canadian dollar). However, as with duration, currency positioning should remain tactical. As inflation converges quickly via adjustments in foreign exchange, central banks will likely change their stances to meet their domestic mandates.

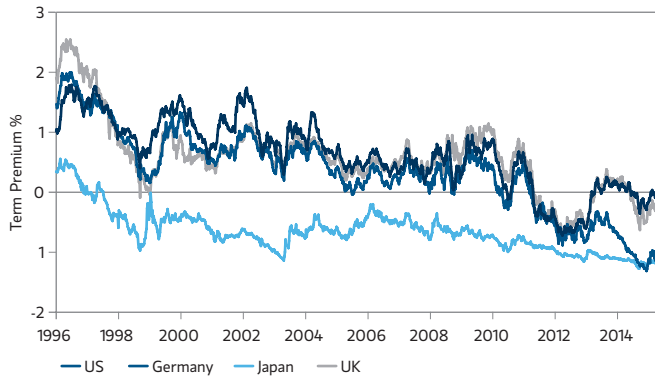
Display 4: Low inflation in Europe is shifting to other global economies



Source: Thomson Reuters Datastream. Data as of June 24, 2015.

⁸ Global Satellites are small and open economies whose policy is linked indirectly to major central banks' policy.

Display 5: Term premia for major sovereign bond curves



Source: Morgan Stanley Investment Management, Haver Analytics, Blue Chip Forecasts. Data as of August 7, 2015.

Conclusion

We believe that the Global Chess Game is a useful framework to inform our investment decisions where monetary policy becomes increasingly unsynchronized. The GCG has clear investment implications: 1) global inflation and growth are likely to remain subdued; 2) yields may remain range-bound; and 3) global satellites, such as Canada, New Zealand and Australia, provide good opportunities as central banks still have scope to ease monetary policy.

Developments in the interaction among major central banks remain highly uncertain. While the GCG started on an economy flight from Frankfurt, it is still unclear from which city the return flight will depart.

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Marco is a portfolio manager and member of the MSIM Global Fixed Income team. He joined Morgan Stanley in 2013 and has four years of investment experience. Prior to joining the firm, Marco was an economist at the Financial Stability Directorate of the Bank of England. While at the Bank, Marco published research on the effects of QE and macroprudential policies on the real economy. Previously, he worked in New York and London as a foreign exchange economist for a financial consultancy firm. Marco received a B.Sc. in economics (summa cum laude) from Catholic University, Milan, an M.Sc. from University College London and a Ph.D in economics and finance from University of London.

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Jim is a portfolio manager and senior member of the MSIM Global Fixed Income team and a member of the Asset Allocation Committee focusing on macro strategies. He joined Morgan Stanley in 2006 and has 23 years of investment experience. Prior to this role, Jim held the position of global head of interest rates, foreign exchange and emerging markets strategy with Morgan Stanley Research. He authored two interest rate publications, the monthly Global Perspectives and the weekly Interest Rate Strategist. Previously, he was a director at Merrill Lynch where he headed the U.S. interest rate strategy group. Prior to that, Jim held various trading positions. He headed the U.S. options trading desk at Sanwa Bank, was a proprietary trader at Tokai Securities and traded U.S. Treasuries at JP Morgan. Jim received a B.A. in physics from Bowdoin College, a B.S. in aeronautical engineering from the California Institute of Technology and an M.B.A in finance from New York University, Stern School of Business.

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⁹ Source: Assets under management as of June 30, 2015. Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices.

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