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Matthews Asia

Matthews Asia Perspective

How Low Can We Go?

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With the Chicago Board Options Exchange's Volatility Index (VIX)—a measure of the stock market's expectation of volatility based on S&P 500 index option—reaching levels last seen during the 2008 Global Financial Crisis (GFC), policymakers globally are being extra vigilant to prevent a repeat of the liquidity issues that froze banks and capital markets during the GFC. Are these measures going to be effective? Is monetary policy potent in the current times?

The current situation with the novel coronavirus is a serious demand shock as people are asked to stay home and practice social distancing. Without question, this has resulted in lower overall economic activity. Whether it is getting on the train to go to work, spending some time at the bar with a friend, or going out with family to see a movie, all these activities will see varying levels of curtailment. In 2008, the subprime mortgage crisis caused a serious liquidity issue in the banking system and the entire financial artery to the real economy which was severely impaired. One thing we do know is that this time around, policy makers are being extra proactive to prevent this demand shock from impairing the banking system.

The U.S. Federal Reserve (Fed) has restarted expansion of its balance sheet. Through various repo (repurchase agreement in the form of short-term borrowing in government securities) facilities, the Fed has announced to add US$1.5 trillion in short-term liquidity. Additionally, the Fed announced a US$700 billion quantitative easing program (QE) on Sunday to shelter the economy from the COVID-19 effects. While these actions from the Fed have resulted in financial stress indicators such as FRA-OIS (the difference between 3-month inter-bank lending rate (LIBOR) and the overnight index which is the risk-free rate set by central banks) and TED (the difference between the three-month treasury bill and the three-month LIBOR) spreads to be elevated, they are nowhere near the level it has seen during the GFC. Certain sectors such as energy and retail are significantly impacted but we do not yet see the banking system freezing up.

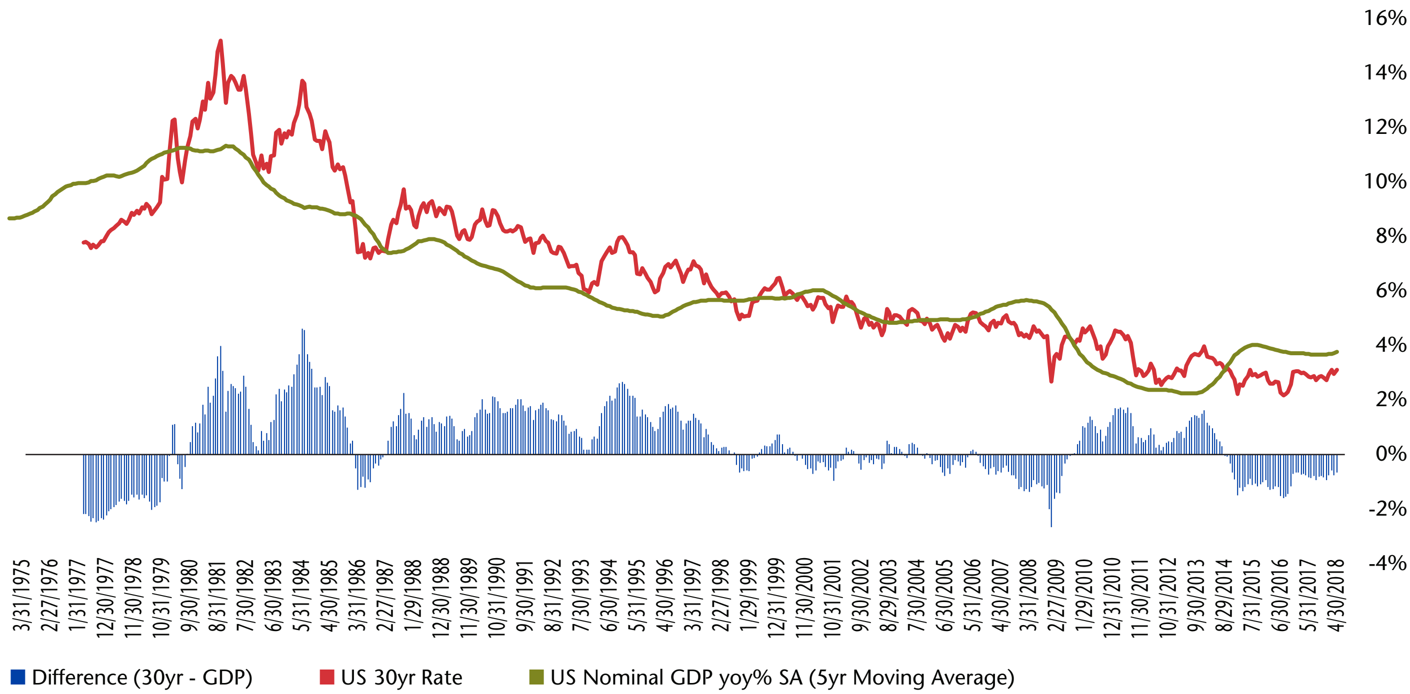
In addition to the measures noted, the Fed has also cut short-term interest rate (Fed Funds rate) to near zero, in an attempt to lower funding cost for the real economy. Many market participants believe the Fed is now out of "ammo" and would be powerless to cushion further economic shocks. However, based on the measures taken by the Fed as discussed above, we believe the Fed has more tools in its toolbox (such as yield curve control and asset purchases other than government bonds) than traditional interest rate cuts.

Looking at the long term, we also don't think zero interest rate is a black hole from which you can never escape. While the experience from Japan and Europe may suggest that economies are stuck in zero interest rate (or even negative interest rate) for a long time, the experience here in U.S. is quite different. The Fed practiced zero interest rate policy between 2009 and 2015 and eventually was able to raise short-term interest rate starting in 2015. During this period, the S&P 500 Index returned 14.8%, annualized.

Long-term economic growth depends on three variables: labor, capital and productivity. While every developed economy faces a structural problem of lower productivity, there is one variable that is significantly different in the case of the U.S.: labor. The country's long-term population growth should be due to net immigration. Currently, the U.S. is experiencing a population growth of 0.45% per year, of which net immigration contributes 0.39%. By comparison, Japan is seeing -0.2% population growth and the EU ex Turkey is seeing roughly 0% population growth. With expected labor growth, together with relatively higher overall productivity in the U.S., we believe these structural factors will underpin the long-term economic growth in the U.S, but also positive interest rates in the long end.

If long-term growth is meaningfully above zero, long-term interest rate would also be meaningfully above zero. Empirical history tells us there's a strong correlation between long-term U.S. interest rates and U.S. nominal GDP growth. This makes sense if one thinks of a country's long-term interest rate as its cost of capital and the nominal growth as a return on that capital. If the return on the capital is higher than that of the cost, the country borrows more until the marginal return converges to that of marginal cost. Importantly, as we expect U.S. nominal growth to stay meaningfully above zero, so should long-term U.S. interest rates.

Here you can see that U.S. long-term rates (30 year) is highly correlated with U.S. GDP growth (5 year average):



Source: Bloomberg

Bringing the focus to Asia, we believe in a world dominated by near zero interest rates, Asia stands out for investors looking for positive yields. China, in particular, is the only major economy still holding interest rate at substantially above zero. The 10 year Chinese government bonds is yielding ~2.7%, nearly 170 basis points (1.70%) above the equivalent maturity of U.S. Treasury bonds and in our view offer significant diversification benefits. Other Asia developing economies such as India, Malaysia, Indonesia and the Philippines also offer significantly positive interest rate. If long-term interest rate is determined by long-term economic growth rate, we are confident that Asia will continue to stand out as a beacon of hope, offering the potential for attractive returns in bonds and equities in a world dominated by near zero interest rates.

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The S&P 500 Index is a broad market-weighted index dominated by blue-chip stocks in the U.S.

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