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The world won't stay Japanese for long: prepare for inflation

Summary

- The Covid-19 crisis is short-term deflationary, but the policy reaction will breed inflation
- Policy-makers are engaging in a form of Modern Monetary Theory
- For most countries, "turning Japanese" is a phase not a destination
- Shocks of historical magnitude change stock market leadership
- Inflation and yield curve steepening will make winners out of losers and losers out of winners
- Deflation-dogged Japan would benefit greatly from a turn in the cycle

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Peter Tasker is a strategist for Arcus. The views and opinions expressed in this document are those of the author's alone and do not reflect the opinion of Arcus Investment Limited ("AIL"), Arcus Investment Asia Limited ("AIAL") or Arcus Research Limited, Japan Branch ("ARL") collectively referred to as "Arcus" or the "Arcus Group.

Covid-19 has completed the job, already well underway in recent years, of turning the world Japanese. Almost everywhere, economies are shrinking and long-term interest rates sinking to previously unimaginable levels.

Ironically, Japan – once the poster child for deflationary stagnation – is in a good place, relatively speaking. The International Monetary Fund's forecast of -5.2% Gross Domestic Product ("GDP") growth for Japan in 2020 looks ugly until you compare it with -7.5% for the Eurozone, -6.5% for the UK and -5.9% for the US[1]. Likewise, Japan's ten year bond yields may be a smidgeon above zero, but that is a better return than you get these days from German, French, Danish and Swiss bonds, all of which sport deeply negative yields.

At first sight, the above seems a perfect illustration of the accelerationist view of the pandemic, as recently voiced by Jerome Powell, Chairman of the Federal Reserve Bank in recent testimony before Congress. "Existing trends have sped up a lot," he noted, citing the surge in online shopping and tele-working.

It is a comforting hypothesis – the future has arrived a little quicker than expected, but the scenery is familiar. And in the short term at least, it has the merit of being observably true. The giants of the internet have gone from strength to strength; people are indeed spending even more time on social media; Zoom is ubiquitous; restaurants and cinemas may be dying, but streaming and delivery meals companies are going gangbusters, etc. etc.

Yet shocks of historical magnitude do not tamely confirm a pre-existing consensus. They shatter it and create new realities. In the world of investment, that means new winners and losers.

Such was the case with the Japanese Century confidently predicted by highly-esteemed academics and think-tankers in the late 1980s, but cancelled by the collapse of the Tokyo stock market in the early 1990s and the ensuing "lost decades" of stagnation. The winning investment thesis of Japan's 1980s – "buy owners of idle real estate" - became a recipe for financial disaster in the 1990s.

The Global Financial Crisis ("GFC") of 2008 had similarly momentous consequences, not least discrediting globalization and technocratic rule and paving the way for the rise of populism. Across the developed world, nominal GDP growth fell to the lowest level in many decades, while the financial system was flooded by extraordinary amounts of liquidity created by the central banks. The winners of the previous cycle - commodities, auto companies, banks, and cyclicals – plummeted and dominant internet companies became the only game in town.

None of this was easy to predict during the crisis or even in its aftermath; only in hindsight does the causality of events seems clear and inevitable. A crisis would not be worthy of the name if it did not deliver unexpected outcomes and, ultimately, new configurations in financial markets. The crucial point is not necessarily the trigger event itself, whether it be a financial meltdown or a pandemic, but the new beliefs it produces in policy-makers, investors and voters.

Some of these beliefs may turn out to be deeply misguided, such as the widespread view, from 2009 onwards, that the world was facing a government debt crisis, with Japan first in the firing line, and that fiscal austerity was therefore a priority. Nonetheless, that presumption proved hugely influential in forming the world we now live in. The fact it was wrong does not change that.

[1] Forecasts published by the International Monetary Fund in "World Economic Outlook, April 2020: The Great Lockdown" (April 2020).

Certain ideas can prove powerful enough to create intellectual regimes that last for many decades – such as Keynesianism, monetarism, Marxism, pacificism, environmentalism - until they are finally tested to breaking point. At the beginning, they are minority obsessions which seem extreme and even absurd. Only when the previous regime has been discredited by a crisis do they have the space to proliferate. If the analogy may be permitted in these difficult times, then, like an infectious disease they travel rapidly from host to host, with key institutions and individuals acting as vectors and "super spreaders".

Covid-19 is on the brink of generating such an intellectual pandemic. Whether Modern Monetary Theory ("MMT") is explicitly endorsed by political leaders is a second order question. By their actions, they have already legitimized the arguments of the MMT-ers, as recently acknowledged by President of the Dallas Fed Robert Kaplan.

The guiding principle of MMT holds that money is created by governments and they can create as much as they want, with inflation being the only constraint. This is exactly what has been tested in recent months. In order to offset the devastating economic effect of mandated lockdowns, governments have launched financial support programmes of eye-popping scale aimed at keeping companies with collapsing cashflows afloat and bolstering the finances of "furloughed" workers.

The volte-face has been too blatant to be ignored by anyone with a cursory interest in public affairs. Mainstream political parties, experts and technocratic institutions that previously trumpeted fiscal responsibility and agonized about debt-to-GDP ratios have suddenly conjured up financial resources equivalent to 20% and more of GDP. "We'll do whatever it takes" has replaced "there is no such thing as a free lunch".

The support programmes are labelled as temporary expedients, to be unwound as conditions normalize, but that was supposedly the case with the quantitative easing regime installed after the GFC of 2008 too. Rather than being unwound, Quantitative Easing ("QE") has been repeated and intensified by new variations such as negative policy rates and Japan's yield curve control, now under study elsewhere, which seeks to hold down the yields of ten year term bonds.

Even if conditions allow the stimulus to be withdrawn entirely, a crucial precedent will have been set. If vast amounts of money can be created and spent with no apparent ill-effects, why not a Green New Deal, as proposed by radical Democrats in the US, but also backed, to a greater or lesser extent, by Nobel Prizewinners Paul Krugman and Joseph Stiglitz and potential next president Joe Biden? Why not infrastructure bonds in the Eurozone? With interest rates at the lowest levels in history, almost any project will have a positive return?

Japan was able to weather its years of crisis and shattered expectations thanks to its stock of social capital, itself the result of shared values and a high degree of homogeneity. Few other wealthy countries can boast the same resilience. The last few weeks have seen more social unrest in the United States and the UK than Japan experienced in a quarter of a century.

In these and several other countries, the social contract – such as it is – only works when asset prices are rising and growth is positive. Decades of deflationary stagnation, accompanied by a Japan-style across-the-board declines of 75% in property values, would mean social collapse. Political leaders know this very well, which is why the post-Covid-19 economic support measures keep on getting bigger. And unlike the Central Bank-created liquidity of the past decade, this money will not just circulate within the financial system, but will actually be spent.

Understandably, investors, like policy-makers, are currently fixated with the near-term deflationary effects of the lockdowns, which have destroyed jobs and consumer demand. But is also possible that supply may be destroyed too, through bankruptcies and regulation-driven constraints on the service sector, such as social distancing.

Even before Covid-19, there were signs that, in the midst of eye-catching deflationary signals such as evaporating bond yields, some longer-term factors were moving in the opposite direction – such as increased economic nationalism and rising minimum wages. These will intensify. Expect higher pay for key workers and re-shoring production of medical supplies and other strategically vital items.

Generally, it takes a crisis to catalyze lasting change in the intellectual zeitgeist. That was certainly the case in the 1970s, when the second oil shock overturned the post-war Keynesian consensus and prepared the ground for monetarism and several decades of disinflation. Covid-19 could be the prompt for similar lasting change in the policy cycle and, as night follows day, stock market leadership.

In line with the biblical principle of the first becoming last and vice versa, one might expect highly rated companies with uncertain earnings power to fall from grace while beneficiaries of higher output prices and a steeper yield curve should see better times and more generous ratings. The effects would be felt globally. Japan, which has experienced deflation the longest, could be an unexpected winner from its disappearance.