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# Global CIO Outlook
# A New Policy Orthodoxy Is Emerging

**By Scott Minerd**
Global Chief Investment Officer and Chairman of Investments

There is a new debate emerging among policymakers in advanced economies. Two Federal Reserve Bank chief executives have taken the position that the natural rate of interest in the United States is much lower than previously assumed. These experts suggest the need for a slow pace of increases in short-term rates, with one Fed president projecting only one 25 basis point increase between now and 2019, and the other suggesting negative rates are increasingly possible in the next economic downturn.

Recently, U.K. gilts briefly joined the growing number of sovereign bonds that trade at negative yields. Investors should take note. Capital flows from regions of the world with slow growth and negative rates will continue to exert downward pressure on the term structure of the U.S. interest rates. As I have said before, it would be impudent for investors to rule out the possibility of negative rates in the United States.

As the world's major economies are mired with record low bond yields, practically non-existent inflationary pressure, and lackluster economic growth, policymakers cannot continue to simply do more of the same old thing hoping that even lower rates and more quantitative easing alone will reach the desired employment and inflation targets. After years of economic malaise in the wake of the financial crisis, the time has come to recognize that the current policy paradigm is nearing the limit of its effectiveness and perhaps already has exceeded it. I have written before of the unintended consequences of negative interest rates. One example is the unexpected strength of the yen after the Bank of Japan moved to negative overnight rates. The message is clear – the current monetary policy regime cannot succeed alone and aggressive fiscal policy must be added into the global policy mix. The chorus of monetary voices demanding fiscal action is growing.

Both of the aforementioned Federal Reserve Bank Presidents, James Bullard of St. Louis and John Williams of San Francisco, have evolved their views on the intractability of the current economic situation. Bullard believes that the best we can do in this environment is to assume that the current state of real output, employment, and inflation will continue over the next few years. He admits that over time economic regimes change, "The decline in the natural rate owes to a number of secular factors, including changes in the global supply and demand for funds, shifting demographics, slower trend productivity growth, and a general global savings glut."

but "the best that we can do today is to forecast that the current regime will persist and set policy appropriately for this regime." For him, the current "regime" means just one 25 basis point move between now and 2019. In the meantime, Bullard has stopped submitting longer-run forecasts to the Federal Open Market Committee's (FOMC) Summary of Economic Projections, almost in protest.

While Bullard may prescribe additional policy measures in the future, John Williams of the Federal Reserve Bank of San Francisco wants to become proactive now. He is one of the world's leading experts on the natural rate of interest, or the real short-term interest rate that would be neither expansionary nor contractionary if the economy were operating near its potential. Williams believes the natural rate of is currently very low and will likely stay that way for some time. The real natural rate, according to Williams, was in the 2.5 to 3.5 percent range for major economies for most of the 1990s, but it now hovers around zero for the United States and below zero in the euro area and Japan. He notes that the decline in the natural rate owes to a number of secular factors, including changes in the global supply and demand for funds, shifting demographics, slower trend productivity growth, and a general global savings glut.

"The critical implication of a lower natural rate of interest," says Williams in a **recent essay**, "is that conventional monetary policy has less room to stimulate the economy during an economic downturn, owing to a lower bound on how low interest rates can go." [1]

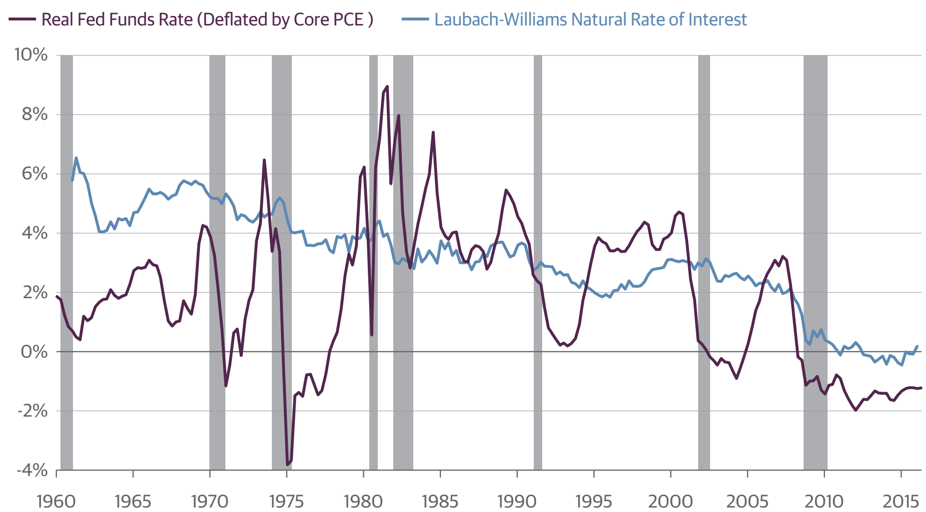
To address the problem, Williams has suggested a new orthodoxy for monetary and fiscal policy solutions. This new orthodoxy would expand unconventional monetary policy tools, including asset purchases and negative rates; create monetary policy frameworks that target either higher inflation rates or nominal GDP growth; increase long-term growth potential through targeted and scaled capital spending on infrastructure, education, and research; and make fiscal policy more countercyclical, including through changes to tax policy and federal grants to states.

Numerous indications suggest that this new combined monetary and fiscal policy strategy may be on the horizon. In the United States, both presidential candidates are touting programs that feature significant infrastructure spending in 2017 and beyond. In Japan, policymakers are announcing fiscal stimulus while simultaneously flirting with the use of helicopter money[2]. More broadly, a lower natural rate implies a slower baseline path of rate increases in coming years and a greater likelihood that a broader array of unconventional tools will be needed during the next recession. I fully expect elements of this new policy orthodoxy will be implemented, over time, here in the United States, as well as in Europe and Japan. The reality is that as low as rates are around the world, we now have leading regional Fed presidents updating their outlooks suggesting that the natural rate of interest is much lower than expected. Investors need to accept that low short- and long-term rates will likely be with us through the rest of this decade and possibly beyond. We live at a time where the unthinkable has become common.

Many policies implemented since the financial crisis would have been perceived as highly unorthodox or impossible to maintain just a decade ago. Clearly policy makers are beginning to shift the direction of future policy. This will be a major topic at the upcoming Jackson Hole Symposium where Fed Chair Janet Yellen will make a seminal speech. The outcome of this discussion will set the policy stage for years to come and impact the future direction for markets in the coming decades. Policies implemented in the near-term may be thought extreme by market participants today, but they will likely become commonplace in the emerging policy orthodoxy of tomorrow.

The natural rate of interest is the real federal funds target rate that would be neither expansionary nor contractionary if the economy were operating near its potential. A model estimate of the natural rate—developed by Thomas Laubach and John Williams, currently President of the San Francisco Fed—has fallen sharply since the crisis and stands only slightly above zero. A lower natural rate implies less need for policy to tighten and a greater likelihood that policy measures now considered unconventional will be employed in future cycles.

**A Low Natural Rate is Prompting Policy Makers to Rethink Existing Frameworks**




Source: Guggenheim Investments, Federal Reserve Board, Bureau of Economic Analysis, National Bureau of Economic Research, Haver Analytics.

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[1]Monetary Policy in a Low R-star World by John C. Williams, August 15, 2016. [2] "Helicopter money"—a metaphor for an increase in public spending or a tax cut that is financed by a permanent increase in the money stock.