14 July 2020

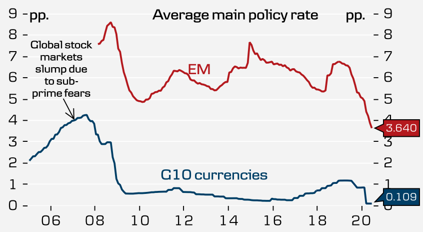
Global Macro Update

Tailwind from global monetary policy to the world economy

Key points

- This document takes a look at the global monetary policy expansion that has been carried out since the beginning of the COVID-19 shock; first looking at the various monetary policy initiatives, then assessing to what extent monetary policy is accommodative and finally discussing the possible impact on global equity markets.
- We see global monetary policy as slightly expansionary and supporting our base case of a gradual global recovery. Global money growth has picked up speed, with G4 real money surging to 14% y/y in May, double the peak during the global financial crisis. Many bigger emerging markets have also seen sharp rises in money growth on the back of aggressive rate cuts and fiscal stimulus.
- Easier financial conditions and rising inflation expectations (in the US notably) also provide signs of an accommodative stance.
- Monetary policy is set to become increasingly expansionary as virus concerns fade, as we expect the savings rate to fall back again and investments to pick up somewhat. Nevertheless, we expect major central banks to remain relatively dovish to ensure that output gaps are properly closed and inflation mandates met.
- In the event there is a second virus wave and a need for new lockdowns, we expect central banks in need to step up/extend stimuli. This is a key risk in the US right now. In such instances, central banks are likely to resort to QE programmes and lending facilities rather than rate cuts.
- The combination of sharp growth in money supply and few alternatives to equities will, in our base case of a macro acceleration, typically be associated with higher multiples on equities.

Central banks in both advanced and emerging market countries have cut policy rates in response to the crisis



Note: The chart is based on policy rates in the G10 countries and the 19 biggest emerging markets
Source: Macrobond Financial, Danske Bank

Global monetary expansion in perspective

In response to the COVID-19 pandemic, central banks around the world put in place a swathe of measures to avoid the tightening financial conditions and excess volatility in financial markets exaggerating the economic slowdown and leading to a more persistent recession. A distinct feature of the monetary policy response has been the rapid and comprehensive nature of the measures compared with previous crises. These measures have clearly helped lift market sentiment. The following key features of the global monetary and financial policy responses stand out so far.

Chief Analyst
Jakob Ekholdt Christensen
+45 45 12 85 30
jakc@danskebank.dk

Senior Analyst
Mikael Olai Milhøj
+45 45 12 76 07
milh@danskebank.com

Chief Strategist, ECB and Fixed Income
Piet Haines Christiansen
+45 45 13 20 21
phai@danskebank.com

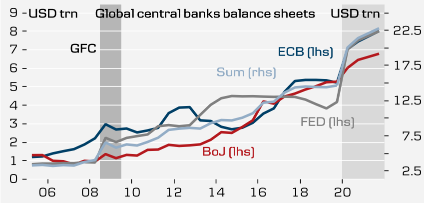
Senior Equity Strategist
Bjarne Breinholt Thomsen
+45 45 12 80 57
bt@danskebank.dk

- **Rate cuts:** Given that monetary policy rates were already low, G10 central banks had limited room to cut interest rates compared with the situation at the time of the Global Financial Crisis (GFC). Those like the Fed that had room cut their policy rates, so the average policy rate in the G10 is now close to zero. Many emerging markets (measured by the 20 largest emerging market countries, accounting for almost two-thirds of global GDP) have also undertaken numerous rate cuts to reach the lowest level on record. While G10 central banks relied more heavily on rate cuts in the global financial crisis in 2007-09, emerging market central bank rate cuts are on par with those in the GFC.

- **Relaunch of quantitative easing and liquidity facilities:** With the rates policy space limited, G10 central banks instead relaunched or expanded their QE programmes in response to the crisis. In most cases, these central banks went quite far, setting a high bar and flexibility for the programmes (for example, the ECB's Pandemic Emergency Purchase Programme gave the ECB flexibility to deviate from the capital key). In addition, they also set up liquidity facilities, such as the ECB charging interest below the deposit rate, in order to ensure that corporates and households have sufficient liquidity through the crisis until the economy is on secure footing again. As a result, G4 central banks' balance sheets are set to expand by USD7.0trn (or a 13pp increase relative to their total GDP) compared with just USD2.5trn during the GFC (7pp relative to the total GDP). In addition, some emerging markets, such as Poland and South Korea, where policy rates were already low going into the crisis, have launched their own QE programmes.

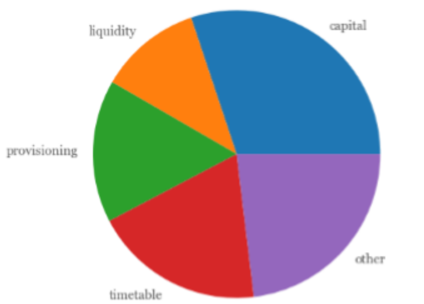
- **Easing of prudential regulation:** In order to improve the availability of bank lending to the economy, authorities have eased capital and liquidity requirements (see chart on the right). This is in stark contrast to the pro-cyclical tightening of prudential regulations in the aftermath of the GFC, curtailing the extension of credit. The Bank of International Settlements found in *a recent study* that the easing of capital buffers could release up to USD5trn of additional loans globally (6% of total loans outstanding), i.e. almost as much as the expansion of central bank balance sheets. However, the expansion in lending from this easing of prudential regulation may be temporary, as the pre-crisis rules may be reinstated once the crisis is over, but it does give a boost to money growth over at least the next year or so.

QE is leading to a significant expansion in the major central banks' balance sheets



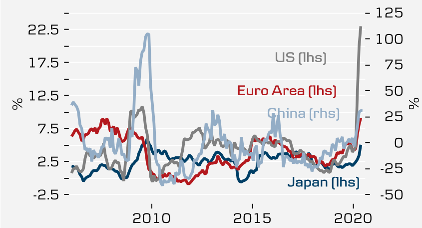
Source: Macrobond Financial, Danske Bank

Easing of prudential regulations in 33 of the world's largest economies



Source: Institute of International Finance, An aerial view of the bank prudential regulatory response to COVID-19

The monetary policy easing has led to a surge in G4 money growth



Source: Macrobond Financial, Danske Bank

Assessing the stance of global monetary policy

In assessing the monetary policy stance, it is useful to look at both the level of policy rates and more outcome-based indicators. In general, monetary policy is accommodative when the effective policy rate (also taking into account other liquidity-generating instruments such as QE and easing of prudential requirements for banks, in addition to the level of the policy rate) is lower than the natural interest rate, which levels out savings and investments in the long run (see Appendix 1 for a more detailed discussion of the evolution of the natural interest rate). However, the estimation of the level of the natural rate of interest is intrinsically difficult amid a shock as big as the COVID-19 outbreak and, although we believe this shock has temporarily weighed on the natural rate, it may move higher as the corona fears fade.

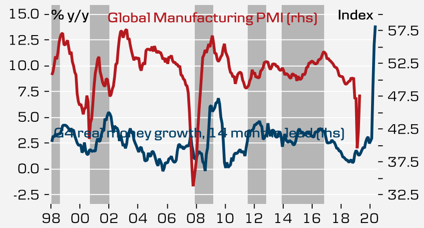
In a period such as the current one, where big structural changes are taking place, we believe **it is more useful to look at different outcome-based indicators of the monetary policy stance**. Below, we discuss some of the most important in our view and try to make a qualitative assessment of the degree to which the indicator is suggesting monetary policy is expansionary or not (from 1 to 5, where a score of 5 suggests a highly expansionary monetary policy).

- **Money growth (4):** As can be seen, money growth has surged on the back of the implemented measures. **A weighted average of G4 M2 real money supply grew by almost 14% on an annual basis in May, double the peak growth rate during the GFC** (7% in July 2009). The US is driving the surge in money growth but money growth is also quite high in the euro area and China by historical standards. As can be seen on the right, global monetary expansion tends to be an important leading indicator for global manufacturing PMI. **We note that part of the increase in money growth is the provisioning of liquidity to companies that will not necessarily translate into higher economic growth.** Furthermore, companies may pay back the loans, which would lead to lower money growth. Nevertheless, the part relating to lower rates and asset-purchase programmes will remain in place, supporting money growth going forward. Furthermore, banks have deposited a large amount of liquidity at the ECB, providing room for further increases in money expansion. Typically, a considerable increase in PMI manufacturing follows an expansion in the global money supply on the scale we have seen over the past three months, as shown in the chart on the right.
- **Easier financial conditions (3):** In the US and Europe, the forceful monetary policy easing, which has pushed down mortgage rates and lending rates, has eased financial conditions. The recovery in global equity markets and falling credit spreads have also helped ease financial conditions and, hence, the financing outlook for companies. A pickup in economic activity in three to six months typically follows easier financial conditions.
- **Increasing market-based inflation expectations (2-3):** Another way to gauge whether the monetary policy is accommodative is the extent to which financial markets expect the policy to be inflationary. A useful indicator is market-based inflation expectations, depicted for the euroarea and the US in the chart on the right. Indeed, financial markets are 'buying' into the reflation story, as these market-based inflation expectations are indeed increasing, especially in the US, albeit the level remains somewhat below pre-crisis levels.

Excess liquidity in the eurozone has jumped after the latest ECB liquidity allotment

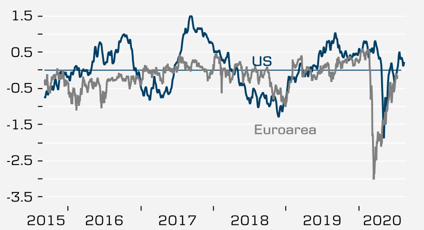
Source: Macrobond Financial, Danske Bank

Surges in money supply normally precedes rising global PMI



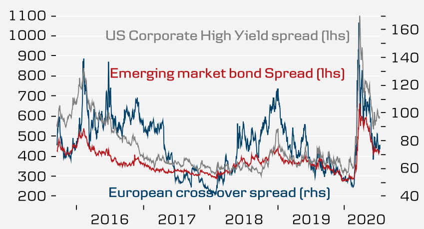
Source: Macrobond Financial, Danske Bank

Easier financial conditions in the US and euro area should support growth



Source: Macrobond Financial, Danske Bank

Credit spreads in advanced and emerging markets have tightened on the back of policy support



Note: The emerging market bond spread is the J.P Morgan EMBI index
Source: Macrobond Financial, Danske Bank

In conclusion, we believe that global monetary policy is somewhat expansionary and providing impetus to the global recovery. As we see the monetary policy transmission mechanism improving and the neutral rate moving higher as virus concerns fade (notably in the case of an effective vaccine), we believe that the monetary policy stance will be increasingly expansive (see the discussion in Appendix 1). This is even more the case in our positive scenario, where we observe a faster recovery, driven in part by a quick breakthrough on a COVID-19 vaccine.

Major central banks to maintain dovish stance

In the previous text, we argued that the monetary policy is slightly accommodative in our base case and in the case of fading virus concerns, will increasingly be so. A key uncertainty is whether the major central banks (in G4 countries) will maintain their accommodative stance when recovery takes hold. **We expect major central banks to remain dovish even as a gradual recovery gets underway.** As we argued in *Fed Monitor – Fed favours outcome-based forward guidance over yield curve control*, 1 July, we expect the Fed to strengthen forward guidance by adopting an asymmetric inflation target and possibly combining it with yield curve control in the autumn. It would aim this at preventing the market from prematurely pricing in rate hikes even as the US economic recovery firms. The same goes for the ECB, which we expect to keep its easing bias even after a gradual economic recovery has started. With the fiscal dominance reliant on low interest rates, we expect the easing measures to be in place until at least end-2022 and potentially longer via reinvestments of the PEPP. We also expect the People's Bank of China to maintain its current stance until the recovery in China has strengthened further.

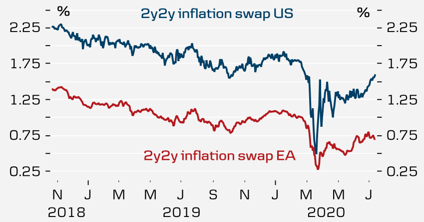
In the event that the virus problems flare up in a significant way in advanced economies and China (the US appears most at risk currently), we believe that further policy support would be needed, as much of the current monetary policy stance has already taken place and is priced in by financial markets. Given that the lower bound has been reached in the case of the ECB and Fed (Fed board members have signalled quite strongly that negative rates are not part of their playbook), we believe the additional easing will take the form of expanding and prolonging QE programmes.

Monetary policy a significant tailwind for equities

Since the low in global equity markets on 23 March, equities have rallied strongly and some indices are now at higher levels than before the COVID-19 recession started. **A large part of the explanation for the rally is found in the monetary policies carried out and, not least, the QE programmes.** Corporate credit demand has acted very differently from a classic economically led recession, as it increased rapidly going into the crisis. This rise is probably more from need than from corporates, as revenue went from 100 to zero in no time during the politically initiated lockdowns and many companies faced liquidity issues. At the same time, the central banks' significant bond purchases left yields at historical lows and limited investors' choice of high yield assets.

The combination of sharp growth in money supply and few alternatives to equities, together with macro acceleration, will in time typically be associated with higher multiples for equities. This is also why we would be careful about arguing that equities are expensive at the current level. Relative to bonds and in light of the explosion in money supply, we still find equities cheap and believe that valuations could be driven higher.

Reflation story getting traction especially in the US



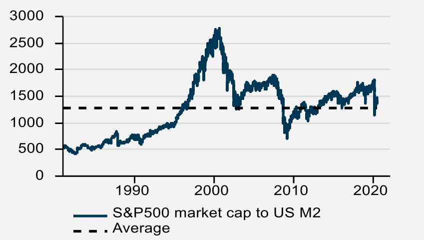
Note: The chart shows the 2Y2Y inflation swap implied inflation expectations
Source: Bloomberg, Macrobond Financial

Monetary policy stance in our different global macro scenarios

Scenario and probability	Stance of global monetary policy	Key scenario assumptions
Good case (15%)	**Highly expansionary**	No real virus problems, vaccine in 2020, fast recovery
Base-case (50%)	**Slightly expansionary**	Gradual opening up, localised virus outbreaks, vaccine in 2021
Worse case (35%)	**Slightly contractionary**	major continious virus outbreaks, new widespread lockdowns, vaccine delayed

Source: Danske Bank

Monetary supply M2 and S&P 500



Source: Refinitiv, Danske Bank

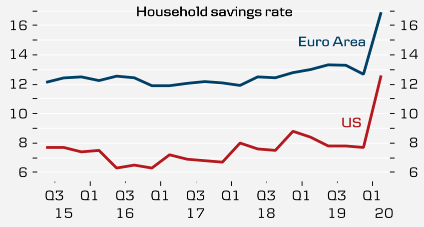
Appendix 1: The nexus between the global economy, monetary policy and the COVID-19 shock

One of the critical features of assessing the monetary policy stance is the natural rate of interest (NROI). The NROI is the real rate of interest that brings output into line with its potential or natural level in the absence of transitory shocks or nominal adjustment frictions. If the effective policy rate (also taking into account other liquidity generating instruments such as QE and easing of prudential requirements for banks in addition to the level of the policy rate) is lower than the NROI, then monetary policy is said to be expansionary.

There are very good reasons to believe that the corona shock has weighed heavily on NROI, as the shock has prompted a rise in precautionary savings (as consumers are uncertain about their future economic prospects) and forced savings (consumers being locked up at home cannot continue their normal spending habits) as well as lowering investments (see chart on the right). Both should drag the natural interest rate down. Higher government spending has to some extent compensated for the higher savings but near term, we see a lower natural interest rate (for a further discussion see *here*). Another unrelated point is that the transmission mechanism and hence the impact of monetary policy support on the real economy is also severely hampered during the corona shock, as companies and households are not able to spend and invest as much as easy liquidity situations would imply.

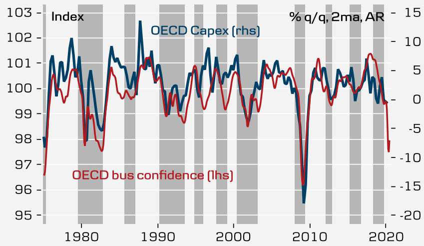
As the virus problems are contained and/or an effective vaccine is found and the economies open up again, we would expect the NROI to increase and hence monetary policy to become increasingly expansionary. Savings rates should fall back, as both the forced and precautionary savings would begin to fall. In our view, private investments will probably remain subdued for some time, as companies face low capacity utilisation and uncertainty remains high. Fiscal policies should remain quite loose at least for the next year, not least as governments around the world put fiscal recovery programmes in place (for example, the EU recovery fund) and increase investments in virus protection schemes and green technology and infrastructure. Hence, in our base case of a gradual recovery driven by higher private and public consumption as well as public investments, monetary policy would become increasingly a tailwind for the global economy. This is even more the case in our positive scenario, where we observe a faster recovery, driven in part by a quick breakthrough on a vaccine. However, in the event the virus keeps coming back, savings rates may not fall back and investment decisions may be dragged out even further and further monetary policy support may be needed.

A sharp rise in savings rate may temporary reduce the neutral interest rate...



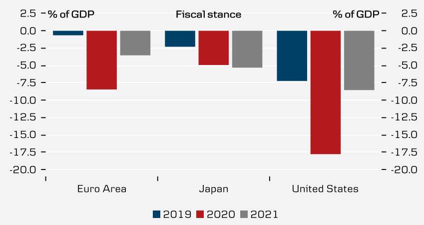
Source: US Bureau of Economic Analysis, Eurostat, Macrobond Financial, Danske Bank

...and global investments will also feel the pinch from the corona shock...



Source: US Bureau of Economic Analysis, Eurostat, Macrobond Financial, Danske Bank

...but sizeable fiscal expansion is mitigating downward pressure on the natural interest rate



Source: US Bureau of Economic Analysis, Eurostat, Macrobond Financial, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Jakob Ekholdt Christensen (Chief Analyst), Mikael Olai Milhøj (Senior Analyst), Piet Haines Christiansen (Chief Strategist) and Bjarne Breinholt Thomsen (Senior Equity Strategist).

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