Market Snapshot – July 2016

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Will Helicopter Money Fall From the Skies?

By Joe Zawawi

Stop – we know what you're thinking. When you hear the term "helicopter money" for the first time, it likely brings about the vision of a military chopper flying over your town with Stephen Poloz and Janet Yellen hanging out of the sides, dumping bags and bags of freshly printed bills over a frenzied crowd.

That visualization is, in many ways, close enough to the reality. Helicopter money is a policy tool that several central banks and governments have been considering as they further endeavour to spur on economic growth. So how does the idea of "helicopter money" work and could it actually assist in juicing the economy? We attempt to answer those questions in this piece.

What is Helicopter Money and How Does It Work?

Nobel Prize winning economist Milton Friedman discussed the theory of helicopter money in a 1969 paper in which he posited that handing cash directly over to the populace on a one time basis could be a way to stimulate growth. Clearly, dropping money from the sky would cause more problems than it would solve, so if actually implemented, helicopter "drops" would be carried out as more of a mix of fiscal and monetary policies working together.

The process of moving money into the hands of the people would potentially look like this: first, the central bank would credit funds directly to the Treasury's bank account in exchange for government bonds. The central bank would then agree to hold the bonds until maturity and all interest earned is returned to the government. The money at the Treasury would then be used to finance tax cuts, increase public spending, or even get transferred directly via checks or electronically to members of the public. This differs from conventional fiscal policy where increases in spending are funded by government debt.

So the idea of helicopter money involves direct investment and/or putting money directly into the pockets of consumers, instead of working to influence bond yields or sentiment which is the aim of traditional monetary policy. The theory maintains that the direct investments and the increased consumer spending that would come as a result of the windfall would achieve the desired intended goal of bolstering growth and inflation. If actually implemented, we believe helicopter money would likely be deployed via direct investment in things such as infrastructure builds. This would ensure that all of the money makes its way into the economy. The risk of a direct transfer of funds to the populace is that a good portion of the money would be saved or used to pay down debt.

Several prominent figures in the world of economics and finance have voiced compelling opinions in favour of the prospect of helicopter money. Former Fed Chairman Ben Bernanke has said that helicopter money could prove to be a valuable tool when monetary policy has reached its limits and when government debt is high. Bernanke also earned the nickname "Helicopter Ben" in 2002 when he stated that the idea would "almost certainly be an effective stimulant to consumption and hence to prices."

Ray Dalio, founder of Bridgewater Associates, has pointed out that stimulus would need to begin targeting spenders and consumers instead of investors and savers. Bill Gross, the legendary bond manager, has said that the only alternative to helicopter money is recession and that he suspects "politicians and central bankers will choose to fly instead of die."

The Argument for Helicopter Money

The main advantage of helicopter money is that it results in money-financed fiscal policy measures rather than debt-financed. Fiscal stimulus is generally seen as a powerful response to assist in boosting an economy in times when it is running below its potential and when inflation is low. This is because the intended benefits of tax cuts or government spending are experienced almost immediately and can be aimed directly at the public. However, governments are generally reluctant to increase spending when it is being financed by debt. Funding tax cuts or spending with debt raises servicing costs and potentially increases the public's future tax burden. Helicopter money addresses the issue of governments having to increase debt because the funds are supplied by the central bank.

Helicopter money is a direct injection of stimulus and in no way does it attempt to tinker around with interest rates in an effort to jumpstart growth. With quantitative easing (QE) for example, central banks aim to increase the money supply and reduce interest rates by purchasing assets such as government bonds from commercial banks. The intended effect is that the new money in reserve incentivizes banks to make more loans while lower rates drive more borrowing. These elements will then hopefully lead to a pick-up in consumer spending, and ultimately, economic growth and inflation. The issue, however, is that

a good portion of the increased money stock is not passed on through the credit system because banks end up hoarding the funds in order to shore up their own balance sheets. This was the experience after the last financial crisis. The proponents of helicopter money suggest that that all of the benefits would be passed onto spenders as the government is not likely to hoard the cash.

A final key reason helicopters may take to the skies is the fact that some central banks are simply out of ammunition. Stagnant growth and stubbornly low inflation persists even after long drawn out quantitative easing measures and zero/negative interest rate policies have been implemented by policy makers across the globe. Monetary policy may be reaching its limits as far as its objective to stimulate growth is concerned.

Criticisms

One of the main concerns raised with the concept of helicopter money is that the independence of central banks is brought into question. It is widely agreed that monetary policy should be carried out in a manner that is free of political influence to ensure that the long term economic health of a nation is considered and not just shorter term political goals. Helicopter money seemingly requires close coordination from both central bankers and politicians. So who oversees the governance of this policy? Furthermore, how would it be possible to ensure that lawmakers don't push for helicopter money to be deployed when it is unnecessary?

To address the above issues, Ben Bernanke hypothesized in a blog posting for The Brookings Institution that Congress could create a special Treasury account that only officials at the Fed would have authority to fill as they deemed necessary. The Fed would also be responsible for assessing the size of stimulus required in order to meet inflation and employment goals. The decision on how to spend the funds would be left to legislators. This process, he conjectured, would ensure the central bank maintains its independence.

Another criticism of helicopter money is that it is based on the assumption that consumers will actually spend the money they receive. Raghuram Rajan, Governor of the Reserve Bank of India, speculated that the poorest people are most likely to spend the money on more of life's essentials, however, most countries do not have a large enough population of people below the poverty line to have them alone sway consumer spending meaningfully. (As noted earlier, direct investment in infrastructure projects and the like would circumvent the issue of the money not being spent if passed on directly to the populace).

Where Could It Be Implemented?

Japan and the European Union appear to be the most likely candidates for helicopter money implementation given both the BoJ and ECB have put into place extensive quantitative easing measures for extended periods and have dropped policy rates into negative territory. In addition, governments in these regions are still working vigorously to reduce deficits.

European Central Bank President Mario Draghi has called the option a "very interesting concept" but has also questioned the legality of it given that the ECB is not permitted to fund sovereign states. Furthermore, a group of 18 members of the European Parliament released an open letter to Draghi calling on the ECB to further study the prospect of helicopter money. Bank of Japan's Governor Harukiko Kuroda has also had similar concerns regarding its lawfulness.

The option is likely further off from ever being considered here at home or in the U.S. given that central bankers still have other tools to turn to such as cutting rates to zero, negative, or even starting or re-starting (in the case of the U.S.) QE. In June, Federal Reserve Chairwoman Janet Yellen stated that the Fed "might legitimately consider" helicopter money if the U.S. was to experience a severe economic downturn.

The Bottom Line – Whatever it Takes

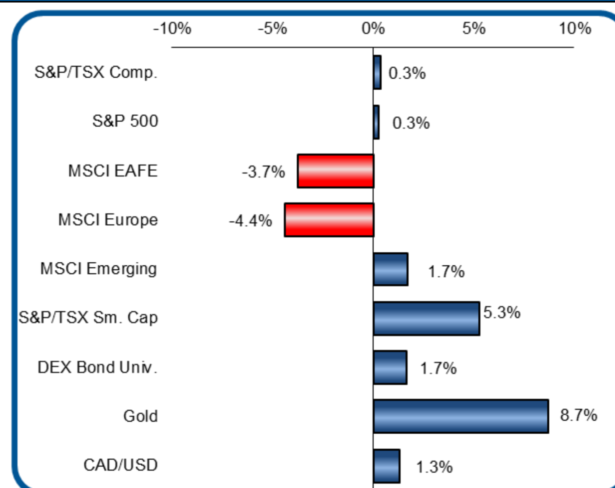
Helicopter money, by definition, is unconventional and it is a concept that has yet to be implemented anywhere in the world. That said, quantitative easing, zero interest rates and negative interest rates were all policies that had only been theorized before being implemented over the past few years.

If central bank officials are as committed as they claim to be of being supportive of the fundamentals of the economies under their watch, actions will continue to be needed so long as their mandates are undershot. We believe that helicopter money could very well be put into use eventually as a part of full-scale stimulative efforts by economies that are out of alternative policy measures. The main element currently missing before helicopter money is ever readied for deployment is agreement from central bankers and lawmakers that it is a viable option.

In times such as these where global economies are running well below target inflation rates, where growth is slow across the board, where unconventional stimulative measure have already been put into place (and where the effectiveness of such measures taken so far is debatable) and where governments are reluctant to incur debt in order to spend, we don't believe the notion of helicopter money will remain in the periphery of esoteric economics. Given the measures policy makers have rolled our since the financial crisis, it would seem that the idea of money "falling" from the skies at some point should not look like a stretch to anyone.

MONTHLY OVERVIEW

1 MONTH RETURNS



Source: Bloomberg, All Returns are TR and in Local Currency

Global equities were mixed during June. The S&P/TSX Composite finished the month up 0.3%, and its gain for the quarter was 2.1% to June 30. The materials sector posted the largest gain during the month, jumping 12.8% as precious metals continued to run. Canadian health care stocks were the biggest losers, shedding 21.3%, thanks primarily to the 30.4% decline in shares of Valeant Pharmaceuticals. In the U.S., the S&P 500 traded up 0.3% for the month, putting its second quarter performance firmly in the green at 2.5%. Losses were chalked up in Europe after the UK Referendum, with the Stoxx Europe 600 Index ending the month 4.8% lower. In Asia, the MSCI Asia Pacific Index lost 4.8%. (All returns in local currency terms)

The month of June was about one story: the UK referendum vote (Brexit). After months of advanced polling data swung views on the potential outcome in every direction and took investor sentiment with it, the result of the people's vote on June 23rd was in favour of leaving the European Union (EU); the trading bloc it had been a part of for over four decades. The surprise outcome rattled markets, sending the FTSE tumbling over 5% the next morning, and the major market indices in Spain, Italy and Greece down 11%, 11% and 13%, respectively. The British pound reached levels not seen since 1985 relative to USD, dropping 11% the day after the results came in. Government bond yields also set new records as investors scrambled to safety. British 10-year bond yields fell below 1% for the first time ever, yields on German 10-year bunds slid deeper into negative territory, and 10-year US treasury yields also tested all-time lows that had not been seen since 2012. Standard & Poor's stripped Britain of its AAA credit status the following week and downgraded it by two notches to AA. The credit rating agency also assigned the UK a negative outlook due to the weaker economic prospects.

UK Prime Minister David Cameron resigned following the historic referendum, stating that he will remain in office until October and will do his best to "steady the ship" over the coming weeks. Although the UK will remain in the EU for now, once Article 50 is invoked there will be a two-year window that begins within which the UK will enter talks with the rest of the EU to discuss all topics on the table such as a new trade deal and travel arrangements. The long term effects of this breakup on the economy are difficult to determine given all of the unknowns, however, most studies conducted by economists from various points on the political spectrum suggest that the impact would be negative.

South of the border, Fed talk became increasingly hawkish towards the end of May and into the start of June which seemed to be supported by the market, given that the better half of investors were pricing in the probability of a rate hike at the FOMC meeting on June 15th. That all changed after the May jobs report revealed that only 38,000 jobs were added through the month – the smallest monthly addition since 2011. In addition to putting the Fed on hold, FOMC participants' assessments of the appropriate future path of interest rates revealed that six participants now expect only one rate hike this year, as opposed to one in April. This was up from one participant in March. The market doesn't appear to buying into the Fed's plans, however, as fed futures data are not pricing in a rate hike until December of 2017.

Canadian economic data prints during June painted an encouraging picture overall. On the employment front, 13,800 positions were added in May as Ontario and Quebec helped to offset the employment slump in Alberta due to the wildfires, with each province adding nearly 22,000 jobs during the month. The unemployment rate dropped to 6.9% from 7.1%. Retail sales for April rose 0.9%, more than offsetting the 0.8% drop in March. The rise was mainly attributable to a 6% increase in sales at gas stations which is a function of the rise in crude prices. Through the first five months of the year household spending has remained resilient with retail sales up 5.3% in that period – the strongest level in six years. Headline manufacturing sales also bounced back in April; rising 1% after a 0.9% decline in March, and above consensus estimates that projected a rise of 0.6%. April GDP rose at an expected 0.1% pace after two consecutive months of declines. The gain was due to strong housing sales and a rise from service-producing industries.

MARKET OUTLOOK

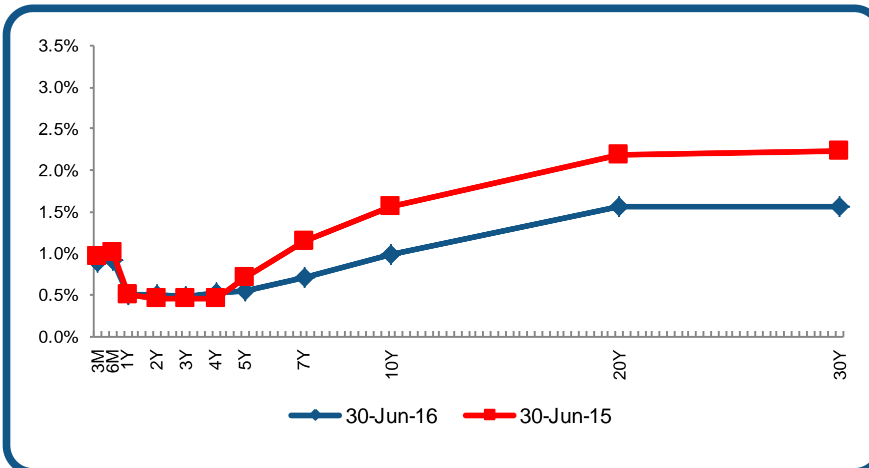
Although the immediate impacts on global economic growth as a result of the Brexit decision are yet to be seen, negative outlooks can work to weigh on investment activity within the UK and abroad. Furthermore, fears of a contagion-like effect within the EU as the prospect of other referendums continue to be discussed may also work to rock investors' sentiment and ultimately financial markets. Here at home, the return to positive monthly economic growth in Canada may not last long as it is widely expected that the decline in production as a result of the oil-sands shutdowns during May will weigh on growth in the coming months.

Monthly Market Statistics: June 2016

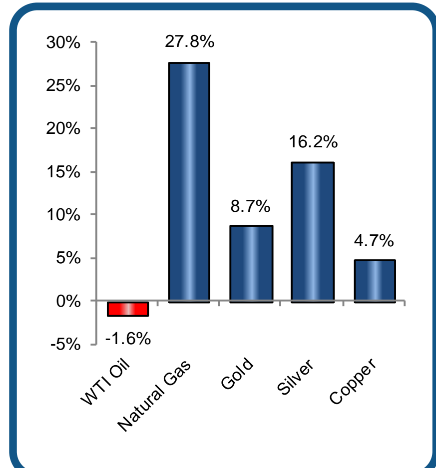
Total Return Index Returns (Annualized After One Year)

	Local Currency Returns							Canadian Dollar Returns						
	1M	3M	6M	YTD	1YR	3YR	5YR	1M	3M	6M	YTD	1YR	3YR	5YR
TSX Composite	0.3%	5.1%	9.8%	9.8%	-0.2%	8.3%	4.2%	0.3%	5.1%	9.8%	9.8%	-0.2%	8.3%	4.2%
S&P 500	0.3%	2.5%	3.8%	3.8%	4.0%	11.7%	12.1%	-0.7%	2.5%	-2.5%	-2.5%	8.1%	19.7%	19.0%
MSCI EAFE	-3.7%	-0.5%	-6.8%	-6.8%	-9.7%	6.3%	6.7%	-4.2%	-1.2%	-9.9%	-9.9%	-6.1%	9.9%	8.4%
MSCI World	-1.3%	1.5%	-0.3%	-0.3%	-2.1%	9.3%	9.4%	-2.0%	1.2%	-5.2%	-5.2%	1.7%	15.3%	13.8%
MSCI Pacific	-6.9%	-4.3%	-13.1%	-13.1%	-17.6%	4.5%	7.8%	-2.2%	0.9%	-8.8%	-8.8%	-4.3%	9.8%	9.5%
MSCI Emerging	1.7%	0.8%	3.6%	3.6%	-7.3%	4.1%	2.4%	3.1%	0.8%	0.1%	0.1%	-8.2%	5.9%	2.5%
TSX Small Cap	5.3%	17.9%	28.0%	28.0%	9.8%	7.7%	-0.1%	5.3%	17.9%	28.0%	28.0%	9.8%	7.7%	-0.1%
Global Small Cap	-2.3%	1.6%	0.7%	0.7%	-3.9%	9.6%	9.3%	-2.7%	1.8%	-3.7%	-3.7%	0.5%	15.9%	13.9%
CDA Bond Uni.	0.9%	2.6%	4.0%	4.0%	5.2%	5.6%	5.2%	0.9%	2.6%	4.0%	4.0%	5.2%	5.6%	5.2%
CDA 1-5 Yr Bond	0.4%	0.6%	1.1%	1.1%	1.6%	2.7%	2.7%	0.4%	0.6%	1.1%	1.1%	1.6%	2.7%	2.7%

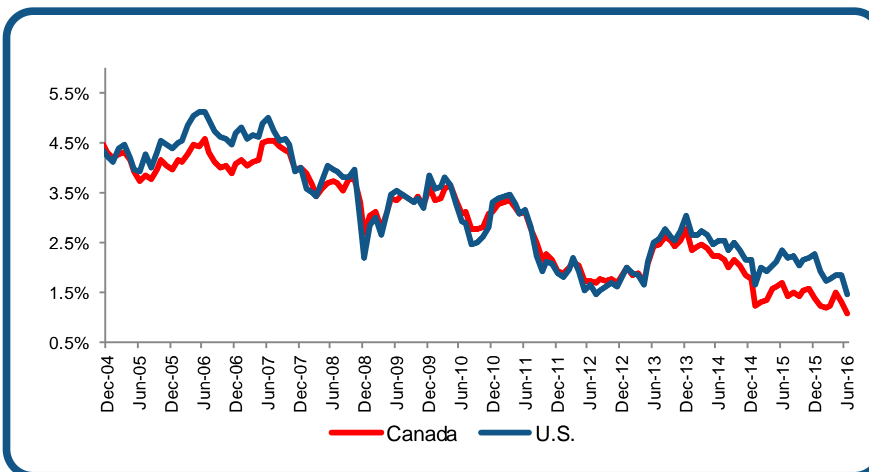
Canadian Yield Curve



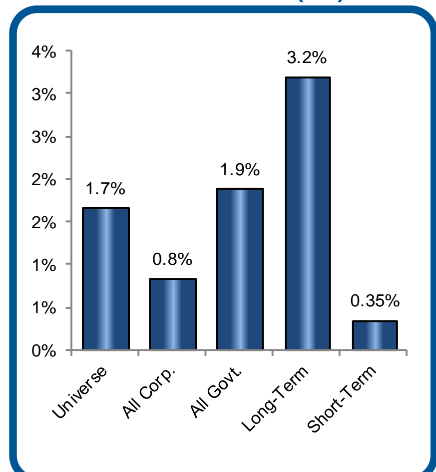
Commodities Performance (1M)



10YR Government Bond Yields



FTSE/TMX Bond ETFs (1M)



Source: Bloomberg, iShares.ca

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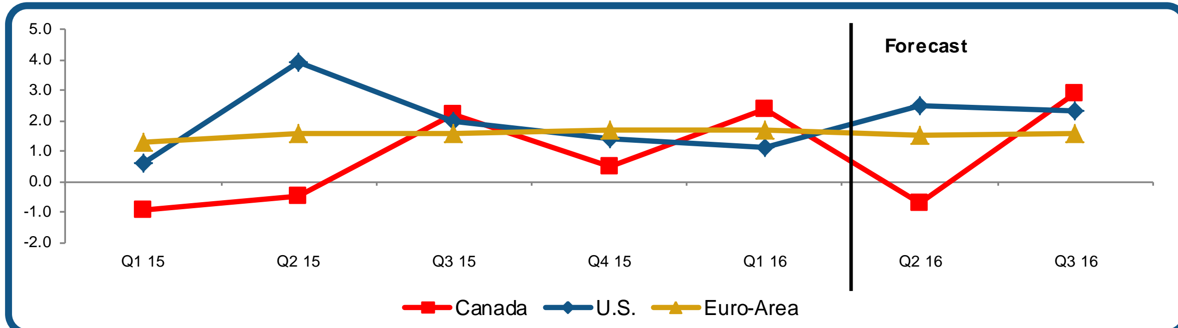
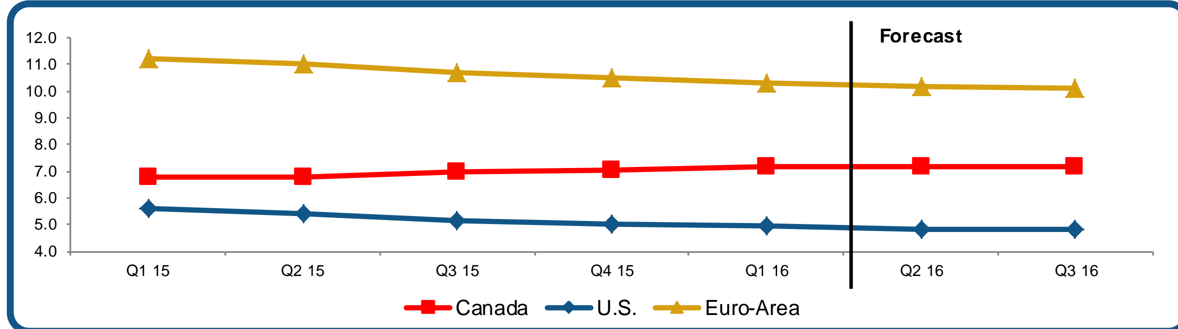
Economic Statistics

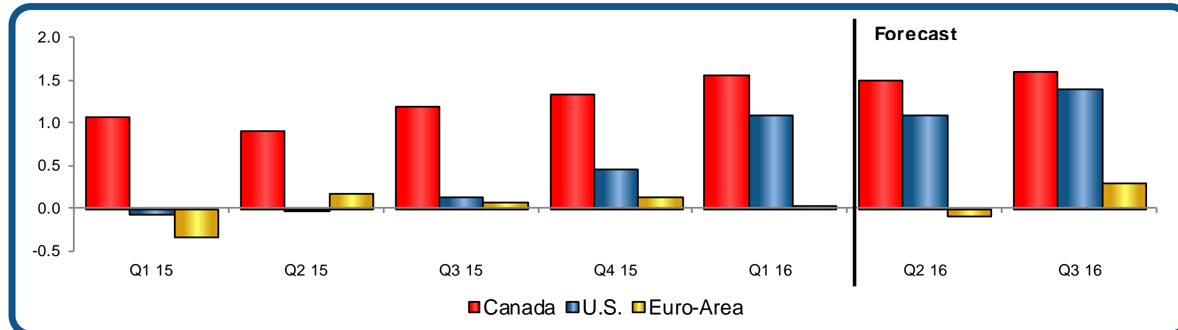
Real GDP (%)



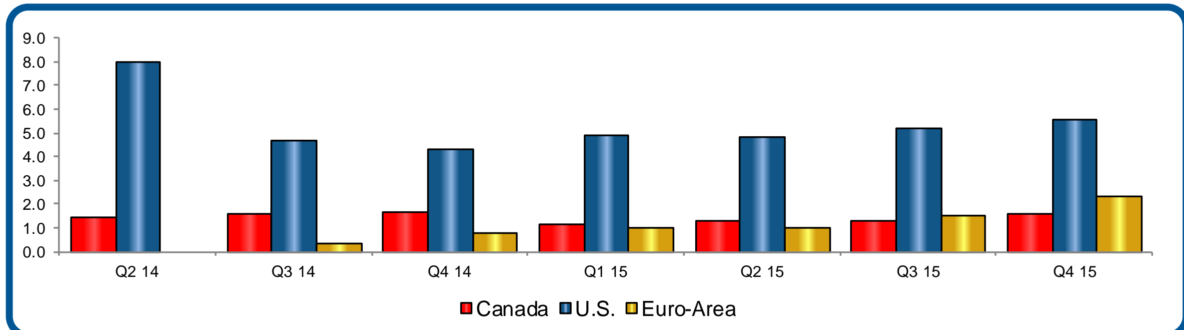
Unemployment Rate (%)



Consumer Prices (YoY %)



Housing Prices (YoY %)



Source: Bloomberg

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