MONETARY SCENARIOS

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Global Monetary Viewpoint

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EXECUTIVE SUMMARY:

Evidence suggests that US monetary inflation is waning, at present. The main counter-evidence comes from asset markets – but history and principle suggest that inflation symptoms here do not persist long beyond their fading in goods' markets.

The ECB, last week, joined the Fed in taking pre-emptive action against a feared transition of the business cycle into a weaker phase (nearer to recession, it seems. at this point than the US). It may well turn-out that this pre-emptive action is incapable of fulfilling its purpose. Fine-tuned contra-cyclical monetary policies have no general record of success.

Investment ideas, here, are negative on European currencies, positive on gold, positive on short and medium maturity fixed rate dollars and negative on equity/high yield credit.

Fed and ECB "data dependence" is futile: how asset inflation will end this time

The lesson of history is that fine-tuning monetary policy, with the intention of pre-empting the passage of the business cycle from expansion into recession phase, is an example of what King Solomon described as the futility of futilities. This lesson does not derive from a doom-premise of seven years of famine, following seven years of fat. Rather, there is the inability of even the most gifted policy makers to assess accurately, in real time, the current state of an economy, and where it is headed; and even if such an assessment could be made, there are no precision tools in the monetary tool box which could improve reliably the outcome.

A golden example

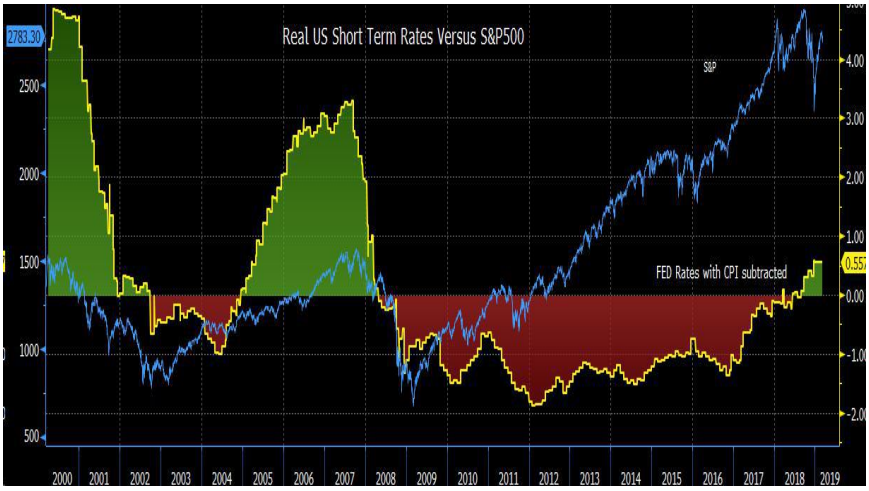
Indeed, under the gold standard regime, which reigned from say the late 1860s to 1914, no one claimed (or now claims in retrospect) that the intricate set of in-built, automatic rules meant that monetary conditions would ease, ahead of the transition from expansion to recession. The opposite would sometimes happen (as for example, when the demand for monetary base – largely gold coin – increased with economic and financial risks). In any case, the sheer power of momentum in the journey of the economy from expansion to recession would likely defy "twigs" in monetary conditions, even if in the appropriate direction.

The advocates of a sound money regime (of which the gold standard is the best example to date) make a different claim: the absence of monetary instability should result in a less violent business cycle, and that when recessions come, the invisible hands of recovery would operate more effectively. (Of course, US economic history under the gold standard in the decades before 1914 has examples of severe business recessions – an inherent cause was a deeply flawed and unstable banking system, as created by the Lincoln Administration during the Civil War).

Bogus claims of Powell Fed and Draghi ECB

The claim of our modern monetary bureaucrats, pursuing their "dual mandate" or equivalent - in the case of the US full employment and perpetual inflation of 2 per cent per annum - is much bolder. For the ECB, the dual mandate under the Draghi-Merkel axis is effectively perpetual 2 per cent inflation and doing whatever it takes, to keep Italy in the EMU. Armed with the best and brightest of econometricians and interest rate manipulators

they can fine tune monetary conditions, ahead of potential business cycle turning points – perhaps, a case of seeking utopia, to avoid a perceived dystopia.



Source:Bloomberg

Some top officials of the present 2 per cent inflation standard (notably, Fed Chief Powell) even boast that they have the elixir prepared in the new-Keynesian laboratory which will prevent this cycle ever moving on to its recession phase. Ex-President Obama economics adviser, Professor Larry Summers, has buttressed this claim by pronouncing that, because the next recession would be so bad (given that central banks have little if any scope for monetary easing), it is imperative for the central banks to prevent this occurring (as if they could).

We now have the spectacle of the "central bank watcher community" (whether in the media or market-place) apparently fixated on the chief monetary bureaucrats, in Washington and Frankfurt, whilst implicitly accepting their claim to having mastered the art of fine-tuning monetary conditions to the business cycle. The central bank chiefs tell us that their policy is data dependent.

The chiefs would have done well to follow the example of a recent (not the present!) Bank of Japan chief who, once appointed, made a point of re-reading Milton Friedman's works. They would have found an early essay documenting the three lags – first, between reality and when it shows up in the data; secondly, between that showing up and when the policy-makers respond; and thirdly, between the action and its impact.

On the basis of the data, ECB Chief Draghi last week announced that the overnight deposit rate is to remain at the present significant negative level (-40bp), into next year (gone all the chatter about a rate rise, before the chief retires later this year), and that monetary base expansion is to continue (reinvestment of income from bonds and who knows how much assistance to the weak banks through the new open-ended facility

for banks up to 30% of their eligible assets, albeit that those are in part replacing facilities due to expire in stages).

It would be too simplistic to say that Chief Draghi is pursuing an agenda only of contra-cyclical policy, driven by concern at the apparent near recessionary situation, in the euro-zone. He is also an Italian nationalist – devoted to the cause of keeping his country in the European Monetary Union.

This is not the poetic nationalism of Manzoni, but the crony nationalism of sustaining the present elites (corporate, banking, political) and a range of zombie companies (small and large) in Italy who gain from the status quo, even though now under threat. Too bad that his widely supposed ambition to become President of Italy has been thwarted by the Populists.

Chief Draghi would never lead an economic renaissance (unleashing creative destruction; to do so he would have to halt the drug train of cheap funds from Frankfurt and create an environment of sound money fostering free market capitalism), which could propel his country into an age of prosperity.

Anyone on their mark, in the US Congress, would be pressing the Administration to tackle this blatant exercise in currency manipulation. In effect a beggar your neighbour devaluation is the contra-cyclical tool now deployed by the ECB; it is a non-precision tool, with considerable risk of back-firing (including US retaliation), albeit, well camouflaged behind the mantra of the 2 per cent inflation standard. But who in Congress, these days, is on the case of sound money or international monetary reform? This is just not in the programme of the America First Republicans or the now mainstream Progressive Democrats.

Monetary inflation has ebbed, but its far-off danger has risen

Anyhow, the re-bound of equity and risky credit markets, since early this year, indicates that a dominant view around the world is that the central bankers in Washington and Frankfurt will succeed in re-fuelling the now spluttering economic expansion.

The overall strength of gold (despite a recent setback) does indicate, though, investor concerns about a pay-back further ahead for this success, in terms of inflation danger. The huge US budget deficit and the soft money officials appointed to the Fed, by the Trump Administration, add to the concerns. For now, however, monetary inflation may have waned or even paused

How could that be?

Can one really say that monetary inflation has waned or even died for this cycle when the ECB, Bank of Japan and Bank of China (in their various ways) are ostensibly pursuing radical monetary policies of ease (why is the Bank of China aiming for 3 per cent inflation, when official inflation is now one percent lower than that target – this point seems to have slipped the US negotiators)?

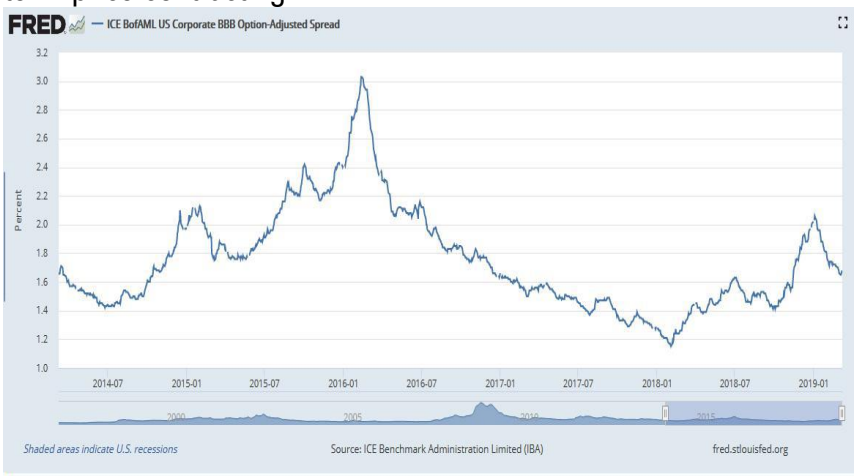
Moreover, the rate of core inflation, in the US, is around 2% year-on-year according to the various official measures (with the

overall CPI in February up 1.5% year-on-year); surely that means monetary inflation is still active?

The detection of monetary inflation in goods and services markets, however, should not overly depend on official consumer price trends, but include critically more sensitive measures. These acknowledge the natural rhythm of prices, lags, and inertia.

Under a sound money regime, there would be periods during which prices were rising or falling, on a sustained basis, albeit, that in the long run prices tended to revert to a constant mean. So, what would drive prices down – rapid productivity gains, fast-growing abundance of key commodities or accelerating technological change, amongst other factors. If, during such periods, the central bank was endeavouring to thwart this downward drift (and so indeed prices were broadly stable or rising slightly), that would be evidence of significant monetary inflation.

Inertia refers to a tendency of expectations to settle around a fixed number, perhaps the so-called inflation target. Active monetary inflation would be present, if this inertia seemed to breaking to the upside under the influence of strong policy action by the central bank. Finally, there is the problem of lags. Today's monetary inflation is likely to show up in actual price direction, only after some considerable period, if there is widespread long-term price contracting.



Back to the present situation: it is plausible that the natural rhythm of prices is no longer downwards, as in recent years. Globalization is in partial retreat, in the context especially of Beijing-Washington tensions. The influence of digitalization on retail prices could be waning; and as labour markets return to balance, after so many years of slack, we could expect an upward drift of labour costs. That would happen also under sound money, and should not be taken as evidence of monetary inflation.

Indeed, if measured official inflation remains unchanged or even falls, despite the natural rhythm of prices downwards coming to a halt, then that is evidence of less monetary inflation - that could well be the present situation.

It makes no difference to this assessment that chief monetary bureaucrats in the US, Europe, Japan or China claim to be pursuing a policy of monetary inflation. Yes, they might

believe their own mantras, but these can be false. In today's monetary environment, where the monetary base has been totally dislodged from the pivot of the system, there is no reliable clue as to monetary condition overall – only a combination of unreliable clues which together might provide a provisional insight.

Yes, the central bankers claim to have this divine insight into the "neutral" level of interest rates (they define this as the level at which the economy would move into line with their dual or other mandates). Accordingly, they measure whether their policies are stimulatory by whether rates are below neutral. For example, Fed officials pronounce that the cumulative rise of official rates, over the past 18 months, has brought real short-term rates again into positive territory, whilst the neutral level remains at historically low levels; in their opinion that would mean that policy is no longer intentionally inflationary.

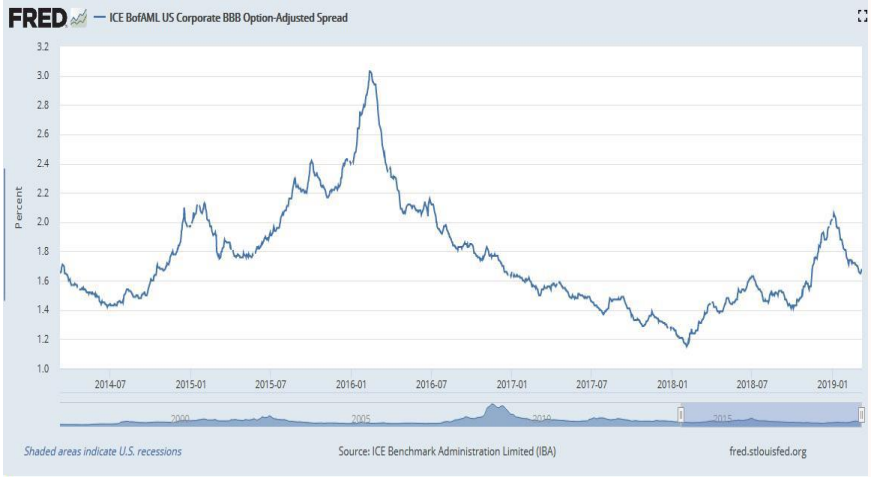
At times the central bankers do want to "breathe in inflation", meaning the creation of some monetary inflation for some time – such as when the inflation rate is significantly below target. That was the defence last week for Chief Draghi unleashing his newest experiment in monetary radicalism. But for ordinary mortals, outside the central bank towers, there is no self confidence in the ascertainment of neutral levels.

Perhaps the most salient fact, at present, suggesting that monetary inflation has ebbed in the advanced economies, is the overall significant slackening in the economic data (also in the emerging market economies). If monetary conditions were powering overall demand then we would not be seeing evidence which suggests a rise in recession risks.

Yet strong symptoms of asset inflation subsist – for how long?

Most of us have read at some stage the view that the stock market is a leading indicator of the business cycle and even a coincident indicator of monetary inflation. So how has the stock market been re-bounding so strongly this year, if indeed monetary inflation is ebbing.

A first point here is that the level of the stock market does not provide a reliable symptom of asset inflation. For example, an apparently high level could be explained by justifiable confidence in economic prosperity ahead including strong profits growth; or by high profits related to grown monopoly power.



Yes, asset inflation often goes along with speculative narratives and financial engineering practices which would bolster stock prices. But there is a danger (for the investigator of monetary inflation) of false positive tests here. A more reliable field, for assessing symptoms, is the "dark-art" of carry trades (especially into credit and currencies) where booms usually signify presence of irrational forces driven by asset inflation (hunger for yield, irrational exuberance, positive feedback loops).

We can say that in the early months of this year, there appears to have been a re-bound in such activities (camouflaged leverage in form of equity buy-backs, fall-back of high yield credit spreads to remarkably low levels). Such strengthening symptoms of asset inflation are unlikely to persist for long, if indeed monetary inflation is waning – and especially if that latter trend is accompanied by a continuing transition of the business cycle from expansion to recession.

There is the cautionary example of late 2007 and early 2008 when asset inflation symptoms continued (including a bubble forming in the energy markets) even after the early credit market quakes of mid-2007. A small cut in interest rates and much fanfare about the Fed and ECB's prompt action to provide liquidity seems to have lifted speculative temperatures, even though in the real economies (US and Europe), the business cycle peak had already occurred in late 2007.

Updates for investor strategy

The main scenario outlined here (fading overall monetary inflation, brief life for heightened asset inflation, intensifying global economic weakness) is evidently not in the mainstream for many investors (if it were, we would not now be seeing such strong asset inflation still).

Even some investors, who might agree with the assessment here, are convinced that the monopoly profit story overrides it, as regards Big Tech; indeed, in a world of softening corporate earnings, these actual or future monopolists could become a protected area of high cash flows.

That hypothesis is dubious, not least given the tendency of advertising revenues to be highly pro-cyclical (important for Google, Facebook and Amazon), but also given the possible assaults on monopoly power (whether from government or unforeseen technological competitors).

Accordingly, what should rational-sceptical investors do, in this present monetary climate?

The bottom line here is still to favour overweight position in short-maturity high quality US fixed-rate paper. Underweight or even short positions would be appropriate in risky credit paper. Yes the technicians might be right about another run-up in the S&P 500 in early Spring, but the potential for a big decline (measured relative to present levels) over the next 1-2 years looms larger than that for a big rise.

Pessimism on European currencies is warranted – though there is the potential speculative gain to be made in German short-maturity government bonds, should EMU collapse. The Brexit journey is now likely to include huge political turmoil, obvious in the UK, but also extending to the remaining EU (Germany and Italy at the forefront).

The likelihood of Washington imposing stiff tariffs on certain European exports also adds to European currency woes (except to the extent that this may hasten the break-up of the euro, as German exporters see it as advantageous for their government to negotiate a trade settlement which would include a revalued and independent re-incarnated Deutsche mark). Currency investors are unlikely to be bleary eyed about such a faint prospect, at present, and focus instead on the potential for credit and banking woes in Europe.

In itself, the present hypothesized ebbing of monetary inflation would detract from the attraction of gold. But investor demand for the yellow metal is plausibly more sensitive to the long-term inflation picture rather than immediate trends. There is every reason to fear new highly inflationary monetary experiments into the next cycle, driven by an intervening economic downturn and by the new leadership now installed or about to be installed, in the Fed and the ECB. Moreover, gold responds positively as a rule to a fall in real interest rates (into a recession), increased perceived dangers in credit markets, and asset deflation in general.

Finally, the geo-political outlook favours gold. Markets may well conclude, as we approach the 2020 US elections. that the threats from North Korea, Iran, China and Russia have not been contained or lessened. Indeed, the opposite may be the case. Some analysts (including for example Hudson Institute Scholar Mead) seem to be pinning their hopes now for success in rolling back Iran's destructive power turn on an alliance between Saudi Arabia and China with the latter freezing new investment into Iran or oil purchases from that country eventually – hardly a stable prospect?