MONETARY SCENARIOS

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Global Monetary Viewpoint

Author:
Dr Brendan Brown

EXECUTIVE SUMMARY: Judging by the 125bp fall in 2-yr Treasury bond yields since late last year, a modest Fed stimulus has occurred, though how significant is very much in doubt.

Market prices are now discounting a tame growth cycle upturn with global headwinds dispersing later this year; and Fed is assumed to ignore any small rise in inflation.

Investors in risk-assets will be substantially disappointed, if headwinds gather further, growth cycle upturn hopes fade, and speculative temperatures tumble.

Despite these highlighted risks, the US dollar is underpinned by lack of any serious fiat alternative. Even the already cheap pound could fall further, as the Johnson government backs a pre-election spree by Bank of England.

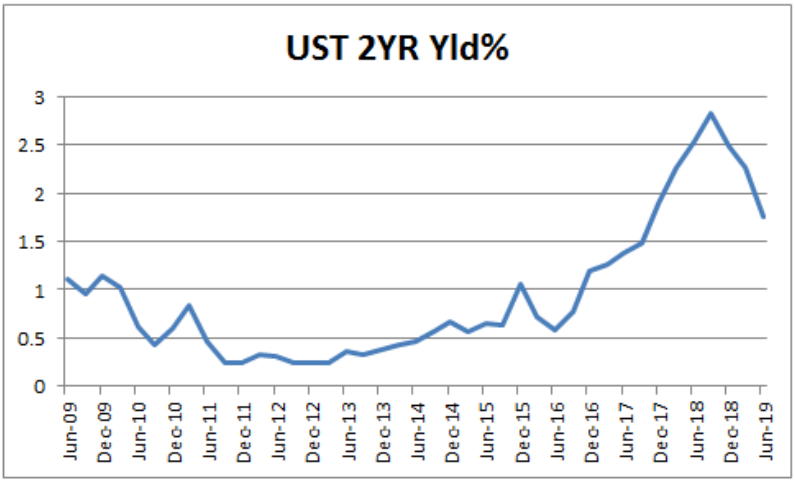
Brexit scenario: UK unilateral transition offer on EU exit 31.10

Fourth Fed "stimulus" in weakest ever super-long US expansion: a dangerous fake

Since the start of this year, global risk-asset markets in the main have been celebrating Fed stimulus.

Though the first actual 25bp rate cut is coming only next week, term rates have been falling since very late last year to discount the changed time profile of official rates in the US. (In December 2018, those infamous "dot plots" of Fed funds representing individual policy maker views, were trending upwards, and now they are trending down). That fall in term rates is widely seen as evidence of monetary stimulus – and as such, would be the fourth in this now longest-ever cyclical expansion.

Chart 1: 2-year US T-bond yield
"stimulus" apparent from fall in 2-year yield, this time; note, stimulus in 2010 and 2012 featured QE



Source: Bloomberg

In fact, the amount of Fed stimulus is very much in doubt as regards any growth impetus to the US and global macro-economy, but not in terms of driving asset inflation in the short-run. On balance, the sunny view of the Fed stimulus, now reflected in asset markets, is very likely to be contradicted by how the global economy and markets perform, from this Autumn. Any transitory lift to the US economy may already have occurred in late Spring and early Summer in response to all the Fed chatter matched by the modest slow descent in 2-year rates.

The sunshine outlook reflected in market prices today

What story about the economic outlook is consistent with present market prices, across markets for equities, credit, long-term interest rates, currencies and gold?

It runs something like this

The Fed stimulus, underway since the start of the year at least in terms of its Fed-speak component if not official rate moves, accompanied by foreign central bank policy action, is helping to disperse headwinds in the global economy (strongest in Asia, Europe, and Latin America, weakest in US) and turn another mid-cycle growth downturn into a new upturn. This growth cycle upturn will become apparent late this year or early next year.

The new upturn will not be vigorous, and so US rates (short and long) will remain low. Most likely, downward pressure on prices from digitalization will remain strong – meaning, the path of consumer prices in the US will be at or below target. Even if prices do gather pace a little – say rising by 2.5% p.a. or 2.75% p.a. in 2020 – the Fed will hold rates down for a long time to come, given all the official chatter about re-formulating the inflation target (to have some periods of overshooting rise in prices to compensate for when they were undershooting target).

By the way, let us not forget, President Trump will make a pre-election deal at some point with China President Xi, helping to give a direct fillip to business confidence globally and world trade. We have already heard the US President congratulate his opposite number on the crackdown to restore order in Hong Kong.

A sunny picture indeed! But what are the alternative plausible pictures for the US and global economy which investors should consider? (China deal is not a story for today, though readers know the view here is somewhat sceptical about its macro-economic impact relative to media hype about this).

Alternative scenarios to the market "consensus"

First scenario: miracle (by definition very unlikely!)

Starting on a bright note, we should not ignore ever the prospect of an economic miracle – defined as a surge in productivity growth and related general economic prosperity, due to some combination of maturing technological change and entrepreneurship. This would emerge independently of any so-called stimulus.

Examples in the US have included the 1880s, 1920s, 1960s, and 1990s, albeit that the latter three were tarnished by unstable monetary conditions and consequently ended in great recessions (1929-32, 1974-5, 2007-9), albeit delayed by bigger-than-ever monetary stimulus.

Realistically, a miracle is far from the central scenario at this stage, not least given an overhang of huge mal-investment and related potential financial instability. The more miraculous though, the more unexpected. If a miracle did occur centred on US then the dollar and dollar interest rates would climb far above present levels; gold prices would likely slump.

Second scenario: stimulus is a near-fake

The stimulus could turn out to be effectively a dud or worse.

Yes, the stimulus has fired up asset inflation this year – as judged by hunger for yield and its manifestations (in the various

carry trades, financial engineering boom, private equity bubble and so on). But does that translate into real economic rebound?

There are grounds for doubting this – not just the tiredness of some speculative narratives, but also because households and businesses know exactly what is going on.

Let us be realistic here. A 125bp rise in 2-year rates during 2018 and the reversal of that rise during the first half of 2019 – that is surely not the stuff of big movers of the US or global economy, unless we puff this up with a host of "smoke and mirror" effects from Fed-speak and its obsessive coverage.

Accordingly, the head winds, instead of dispersing this Autumn, could gather more strongly into a storm. The large emerging market economies already in weak growth mode at best could tumble into recession. Capital spending in the advanced economies, including the US, could plunge along with world trade declines (with or without a China deal) and sharp descents in speculative temperature (reversing big rises so far this year).

third scenario: inflation surprise

An alternative scenario is an economic rebound as in the present market picture, but the pick-up of consumer price inflation is sharper.

Factors in this outcome could be the slowdown in globalization and maturing of the digitalization revolution, meaning less downward pressure on prices – and who knows, resource shortage (most of all food?) adds to the visible effect.

Other scenarios: geo-politics and bubble-bursting

Geopolitics, already tense, could move into crisis mode including war. Britain exiting the EU could be accompanied by crisis for the whole Continent.

Amongst the headwinds which could turn into storm, we should not ignore the epicentre of the private equity bubble and potential rush for the exit. This could start well before any definitive arrival of recession.

More generally, a sudden plunge of speculative temperatures in equities or credit with no ostensible triggering factor is well within the realms of possibility, especially if the present Indian summer promoted by the Fed stimulus fades.

Monetary stimulus – phantom or for real?

Let us go back to the beginning: the stimulus. Is this really a stimulus?

A key problem here is that in a fiat money "system", where monetary base is no longer at the pivot, verifying whether the Fed is imparting a stimulus becomes especially difficult.

The paying of market interest rates on reserves at the Federal Reserve, as from late 2008, was the final and a decisive straw in dislodging the monetary base.

In the early years of the Federal Reserve, monetary stimulus was quite simple to identify. This is when the new institution boosted the monetary base by direct action (whether open market operations or gold purchases) and so initiated a period when

supply of reserves was above the normal path. This incidentally drove money market rates down to low levels.

Unlike under the gold standard, long-term rates even in this early regime under the Fed took some cue (much less than today) from changes in money market rates, as these were now stabilized for considerable periods by central bank action, rather than exhibiting huge volatility. Behavioural finance theorists would point to a type of anchoring here. (No rationale for long-term rates to be influenced by short-term money rates, but they become a point of reference). Some part of any stimulus effect did derive thereby from long-term rate manipulation in so far as this anchoring was possible, deliberate or non-deliberate.

The first such monetary stimulus (excluding wartime neutrality) was the Fed's reaction to the 1920 recession. The fact that money market rates fell alongside the monetary injection was evidence that the supply of monetary base had indeed increased relative to demand (about which there was no direct estimate).

In time, the emphasis of Fed policy switched from the supply of reserves to setting the interest rate in the Fed funds market. But right up until the start of the Greenspan era, the Fed continued to emphasize that changes in the supply of reserves was its primary tool of stimulus and indeed of overall monetary control.

When the FOMC changed the Fed funds rate, the official instruction to the New York desk conveyed the message that this was for the purpose of bringing the growth of monetary base on to a different and now desired path.

So yes, monetary stimulus was clear in its meaning. Whether it was effective or not in diffusing recession risk and promoting growth cycle or business cycle upturns – that was a different matter. Sometimes yes, sometimes no. No one could pretend that the monetary base was highly stable in its relation to output over short or medium periods of time; the so-called velocity could be volatile.

Take the historical example of the Fed affecting a big stimulus in Autumn 1929 (expanding the monetary base in response to the Crash).

This was not effective in preventing a steep recession, though arguably it contributed towards the signs of Spring which were first sighted in Spring 1930 and more decisively in early Spring 1931.

In today's fiat money system, identification of stimulus is doubly treacherous. As reserves pay interest at a market rate, the short-term money market rates do not tell us anything about supply of reserves relative to demand.

Furthermore, the distinctiveness of reserves as a high-powered money asset has virtually disappeared. Hence in judging monetary stimulus, we have to ascertain whether say 2- or 3- year interest rates have fallen significantly as a result of Fed policies – and whether this is indeed stimulatory. Contemporaneous shifts in inflation expectations and a range of

real factors (which for example may push up the neutral level of rates in real terms) blur vision here.

Judgement on 2019 stimulus – not big but harmful

The judgement here: 125bp rise in 2018 followed by similar fall in first half of 2019 is not symptomatic of big underlying change in monetary conditions which throughout this cycle have been inflationary (camouflaged in goods and services markets).

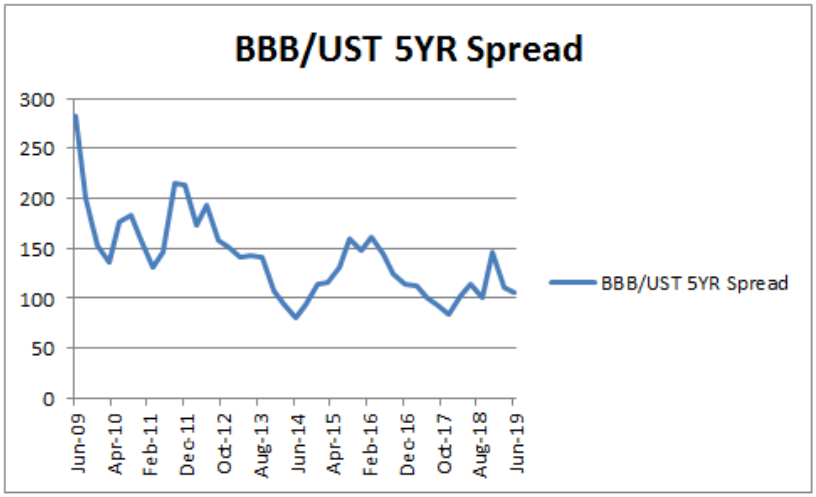
The end of this cyclical expansion is most unlikely to be driven by serious monetary tightening (unless we get to a big rise in goods and services inflation beyond the small rise feasible in the market picture for next year). Rather, the end will come from gathering forces of recession created endogenously from the asset inflation process itself; mal-investment, high leverage, fading speculative narratives - all of this will come home to roost.

The "monetary stimulus" of the first half of 2019 (continuing through the summer) has only made matters worse.

The new impetus to asset price inflation, on top of what is already in the system, means an extension of the period of time during which signals in the capital market are haywire – all adding to total cumulative economic costs. If this stimulus turns out to be effective in powering economic activity (not the central scenario here) this means a further build-up of mal- investment and financial leverage from already troublesome amounts.

Chart 2: US BBB corporate yield spreads

note, spreads fall during period of stimulus



Source: Bloomberg

Yes, the neo-Keynesian central bankers around the globe see their mission as extending the business cycle expansion. But this is this proving to be the weakest US super-long cycle ever.

Moreover, there is every reason to fear that the accumulation of mal-investment will bear down on economic performance well into the future beyond the next recession (as much capital spending during the last decade or more) turns out to be of very low productivity if at all.

We should consider all the eventual costs related to reversing over-leverage and unwinding the work of the financial engineers.

Implications of dud stimulus for investment strategy

On balance, the picture described at the start of this viewpoint, as broadly consistent with present capital market pricing, appears to be over-optimistic as regards extent and duration of any economic rebound ahead; it is also complacent about how long a stable plateau in asset price inflation can be sustained after a big further run-up this year, without a violent fall in speculative temperatures at some early point.

There is also (most probably) an underestimation of the potential risk of goods and services inflation picking up, suddenly in any new period of economic rebound – whether before the next recession or afterwards. The doubts here about the economic picture also go along with raised political uncertainty all over the world (especially Europe).

Accordingly, the view here is cautious on equity risk (prices reflect over-optimism especially on long-term earnings growth from an already extreme high level relative to national incomes, bloated by record corporate leverage and grown monopoly power which is transient) and on credit risks (not just due to spread widening but downgrades ahead as credit deteriorates). Raised political risk in the US goes along with potential anti-trust action and reversal of corporate tax-cuts that favoured Wall Street and Big Tech in particular.

On balance, the view here remains positive meanwhile on gold – given the pessimism on economic rebound, concern about asset deflation risks, and eventually higher goods and services inflation. This year we have seen serious evidence of a further degradation in the fiat money order led by the US - a Fed stimulus attempt far into an already record-long expansion aimed according to the cynics at sustaining asset inflation in the run-up to 2020 elections; alongside interest rates in Europe have plunged further into sub-zero territory and a French politico installed as ECB chief.

Any serious cooling of asset inflation and cyclical downturn encompassing the US would go along with some loss of interest rate divergence in favour of the US currency; it is not clear though that means dollar weakness, given the huge handicaps the euro and yen now have as international monies (negative rates and complete lack of investor trust). Further, were asset deflation to feature stressed financing conditions globally, the US dollar could get a powerful bid both against European and Japanese currencies – and across the emerging market world.

The Canadian dollar is vulnerable to a fall back in global economic optimism. The present market view that the Bank of Canada is a loner amongst central banks (not embarking on stimulus) and the Canadian economy an outlier (relatively strong on a sustained basis) is unlikely to be sustained.

Meaning for pound: PM Johnson will be hell-bent on winning an early general election. That means we should expect rampant monetary "stimulus", with rates pressed to zero. BoE Chief Carney will be a ready enabler during his last days at the post. This is a known negative for Sterling. Brexit is a known unknown.

Brexit scenario: latest

PM Johnson has to take UK out of EU by October 31; otherwise Conservative party faces serious risk of defeat at an inevitable early General election.

Many commentators suggest that leaving without a deal would precipitate a constitutional crisis or worse.

And so how can the new PM square the circle?

Here is an alternative that investors might consider.

If in coming weeks (into September), the new PM finds that there is no significant movement by the EU in negotiations (most importantly removing the Irish backstop), then his government concludes that a Withdrawal Agreement is dead in its original form.

Instead, London in October makes a unilateral offer to the EU. The UK will leave on 31.10, but will continue making budget contributions into the EU and stopping the clock on all customs arrangements (no tariffs, no border posts) during a 1 year period to allow serious negotiations on a trade deal to take place.

If the EU were immediately to turn down this offer and proceed to implement border posts etc, then PM Johnson could claim the high road in terms of UK public opinion. He had acted more than reasonably. There would be a general election fought on "the beaches of Dunkirk".

It is possible, of course, that the EU will in fact accept (maybe not formally but in practice) the UK unilateral offer. This could allow the Johnson government to open an election campaign based on its negotiating success. Problem: it is very difficult to see the EU and UK achieving a trade deal given the high bar to consent necessary within the EU (in terms of votes). A key factor will be how the political situation evolves in Germany – whether the present Merkel government is followed by a shift to the right or a shift to the euro centrist left.