Volume 102

THE PER STIRLING CAPITAL OUTLOOK

Performance • Perspective • Per Stirling

April 2019

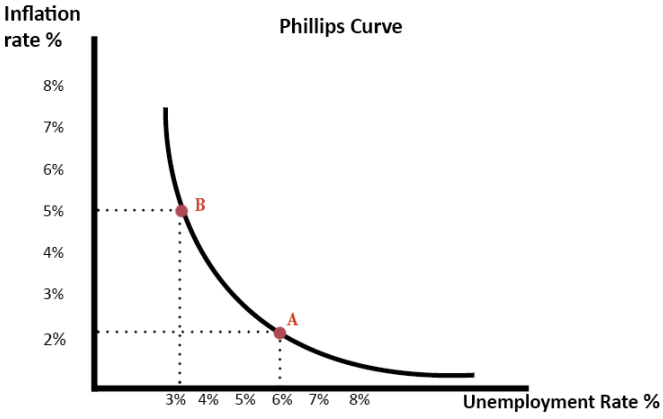
One of the core premises on which monetary policy is based is that there is a direct relationship between economic growth and inflation. More specifically, prevailing economic theory maintains that strong economic data ultimately leads to both "full employment" and the full utilization of an economy's productive capacity, and that both economic conditions, once they reach an extreme, are traditionally catalysts for undesirable levels of inflation.

This concept is perhaps best illustrated through the Phillips Curve, which maintains that there is a direct relationship between the unemployment rate and the inflation rate. This makes sense, as a low unemployment rate means that jobs are easier to find, which gives workers the confidence to either demand a raise or seek a higher paying job elsewhere, either of which pushes wage inflation higher when they occur *en masse*.

We are actually seeing this phenomenon play out in current labor markets, where an almost fifty-year-low in the unemployment rate is pushing average hourly earnings higher by between 3.2% and 3.4% per annum, which is significantly higher than the Core PCE (the Fed's preferred gauge of inflation), which sits at only 1.8%.

Economic theory also holds that there is a liquidity component to inflation, as an increase in the supply of currency available to purchase a relatively set supply of goods and services tends to increase the prices of those goods and services (i.e. the law of supply and demand).

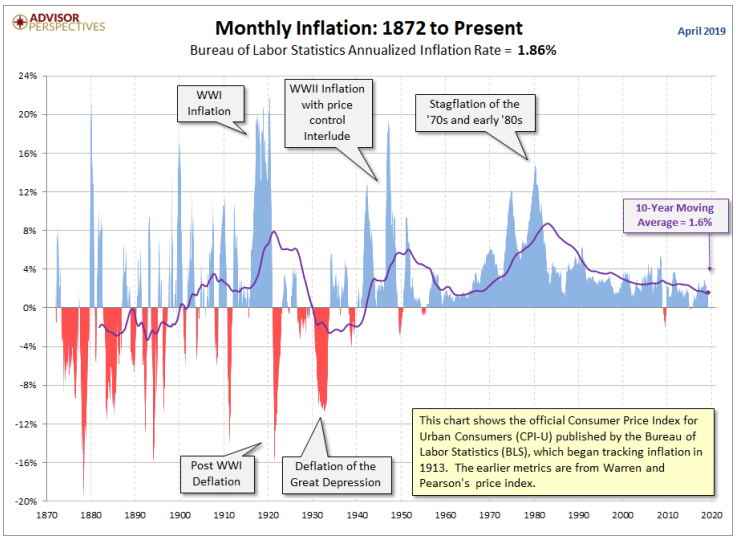
Finally, there is an acknowledged and direct relationship between growth and inflation on one hand, and money supply and interest rates on the other, such that higher interest rates and lower money supply slows the economy and tapers inflationary pressures, while lower rates and increased money supply stimulates both the economy and inflation.



For many decades the above-noted theories have largely been considered to be self-evident truths. After all, they form the very core of both modern capitalism and monetary policy theory.

However, for the first time in memory, these theories are being questioned, and not just by some economic crack-pot or some politician that has no understanding whatsoever of either economics or the capital markets (although we still have those), but by the Federal Reserve itself, which announced last November that it is undertaking an extensive review of its monetary policy framework, with a particular emphasis on how they address inflation.

Ironically, for most people born in the last thirty years, inflation is probably not even a consideration, whether they are contemplating a large purchase like a home, or even planning for their own future.

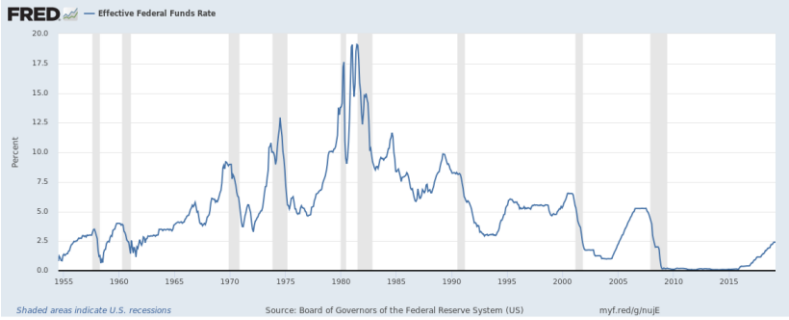


Moreover, the idea of battling inflation must seem a very foreign concept to many, as inflation has not manifested itself as a significantly negative influence since the economy battled the Federal Reserve's worst nightmare of a highly-inflationary recession (i.e. stagflation) in the 1970s and early 1980s.

At that time, the 1973 and 1979 oil embargos combined with the Federal Reserve's efforts to stimulate the economy out of the resulting and very deep recession to produce hyper-inflation, which peaked at around 15% (a level sufficient to double the overall cost of living every five years).

Prior to those oil shocks, and with the exception of the inflation created by World Wars I and II-related shortages, inflation has generally remained well under control since the inception of the Federal Reserve back at the end of 1913.

From its inception until the 1970s, the Federal Reserve pursued a variety of monetary policy objectives, and those goals varied depending upon prevailing economic conditions. As a result, Fed priorities changed over time. Further, prior to the 1970s, the world's central banks generally lacked the independence that they enjoy today, and were frequently forced to bend to the political will of elected officials, which sometimes exacerbated inflationary pressures.



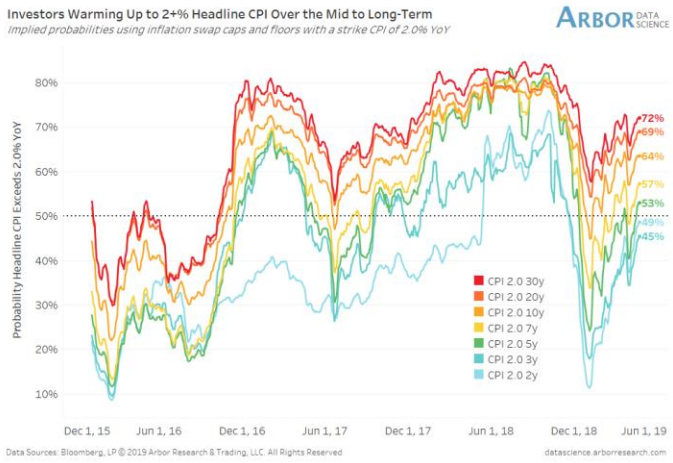
However, the hyper-inflation of the 1970s was so damaging to the global economy that central banks were given both their independence and a directive to manage inflation. Further, in 1977, Congress directed the Fed to pursue the so-called "dual mandate" to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates".

Under this new mandate, Paul Volcker became Chairman of the Federal Reserve in August of 1979, and increased the Federal Funds (i.e. Fed Funds) rate (currently at 2.5%) from 11% in 1979 to 20% by June of 1981. While this draconian, but ultimately necessary move, deserves most of the blame for the vicious 1980-1982 recession, the strategy also served to slash inflation from its 14.8% peak in March of 1980 to below 3% by 1983.

Since that time, a vigilant Fed, combined with increased automation, globalization and gains in economic productivity, has kept inflation largely quiescent for almost three decades.

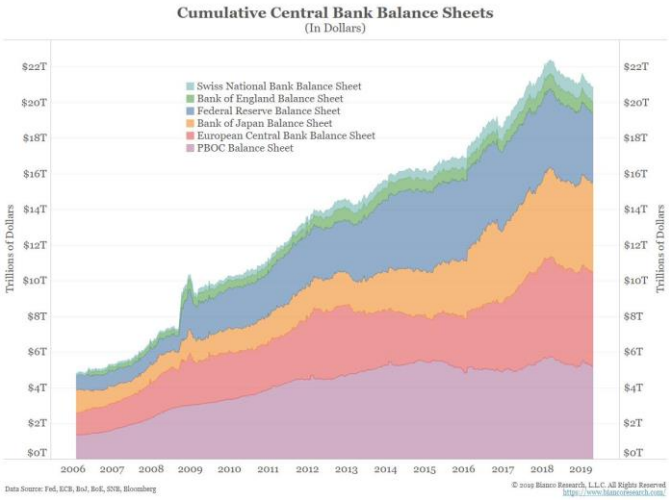
How much of the credit for this period of relatively stable prices belongs to the Fed, as opposed to these more technology-based and/or evolutionary factors, is a core component of the current debate over inflation, its causes and how it should be managed.

Of important note, one of the other major reasons why inflation has remained so low is that expectations for future inflation have remained remarkably low, and this has encouraged consumers to remain resistant to price increases. This condition still exists today, as is illustrated by the fact that the markets are not looking for the retail inflation rate (the Consumer Price Index) to exceed 2% for at least 3 years.



This lack of inflation, both realized and anticipated, when combined with the fact that the extraordinary and draconian emergency measures taken by the Fed during the financial crisis, including quantitative easing, asset purchases and near-0% interest rates, did not cause elevated levels of inflation, has caused many to increasingly question whether or not government spending and debt policies should remain so constrained by concerns about potential inflation.

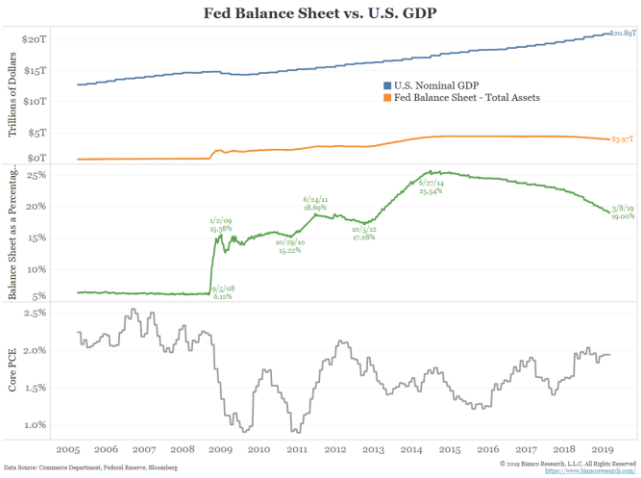
After all, classic economic theory dictates that, in light of the extraordinary and global nature of the monetary stimulus injected during the financial crisis, the world should be dealing with 1970s-style hyper-inflation, rather than the current and ongoing battle, on the part of the world's central banks, to lift inflation up to a desirable level.



According to legendary investor Sir John Templeton, "The four most dangerous words in investing are, it's different this time." While he may ultimately prove to be correct, there is a growing chorus of economists, strategists, politicians and policy-makers that are now starting to question just whether or not something is indeed "different this time". Indeed, at a March 20th press conference, Fed Chairman Powell characterized low inflation as "one of the major challenges of our time". Moreover, since the Fed introduced its 2% inflation target in 2012, inflation has only averaged 1.4%, and this is despite the fact that the world's major central banks have spent the past decade actively pursuing policies that are designed to produce higher inflation.

Further, Lawrence Summers, former Treasury Secretary for President Obama, posited during an April 15th presentation at the Peterson Institute that the major industrial economies will be mired in low inflation "for another 10 to 15 years, at least".

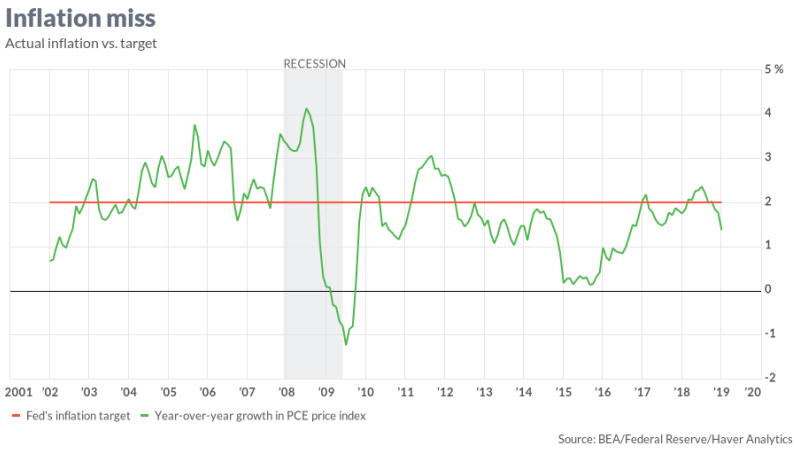
Yes, inflation and its causes are being questioned, and this questioning is leading to the introduction of a variety of unorthodox ideas (from both sides of the political aisle) that fly in the face of virtually every mainstream economic theorem.



This includes President Trump introducing a massive fiscal stimulus package very late in an economic cycle, when the economy was already at full capacity; his continuous efforts to compromise the independence of the Federal Reserve, and his recent jawboning the Fed to both cut interest rates by a massive 50 basis points and to reintroduce emergency quantitative easing measures at a time when the economy is already running at its capacity and labor shortages are common throughout.

The resulting proposals coming from the left wing of the Democratic party are even more unorthodox, and potentially much more dangerous, particularly if classic economic theory proves correct. The prime example is something called modern monetary policy, which is being supported by former Bernie Sanders campaign adviser, Professor Stephanie Kelton and Andres Bernal, who serves as adviser to Representative Alexandria Ocasio-Cortez.

This theory, which is being openly supported by a variety of Democratic presidential candidates, makes the assumption that, if a country can print its own currency and issue debt in its own currency, it can print as much money as it wants to pay for everything that it desires, and that it can do so without negative consequences. In other words, the boundless printing of money will not cause inflation, push interest rates higher, cause a currency to lose credibility as a unit of trade, or cause a country's debt to become a pariah with investors (particularly foreign investors).



To quote Professor Kelton, under this theory, "Anything that is technically feasible is financially affordable."

For proof of this position, supporters point to the fact that the Federal Reserve created $4 trillion of money out of thin air via quantitative easing, and used it to buy enough government and mortgage-backed securities to reliquify the economy, and not only drive interest rates to near zero percent, but to also keep them there for years. It was, according to classic economic theory, the perfect inflation-creating storm, and yet we still have an undesirably low level of inflation, both in the American economy and throughout most of the world.

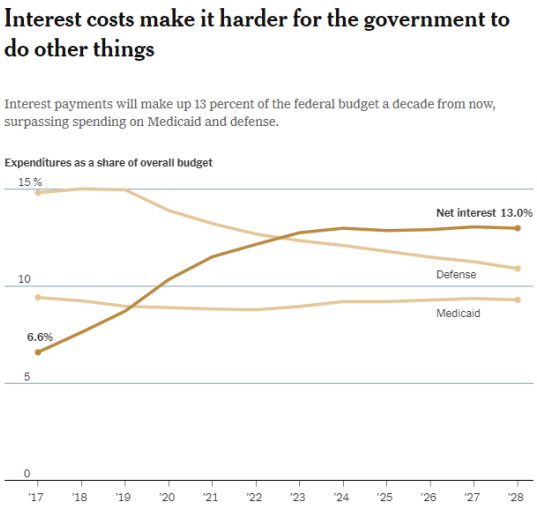
Supporters of this theory further point to the fact that President Trump pushed through a massive fiscal stimulus package (that primarily lowered taxes for corporations and more affluent tax-payers), and did so very late in an economic cycle, when the economy already faced labor shortages, when tariffs were increasing raw material costs, and when industrial capacity was already pushing peak levels (a sure-fire formula for problematic inflation), and yet the economy still can't maintain an inflation rate at or above the Fed's desired 2% target.

As their argument goes, "the government printed trillions of dollars to bail out both rich investors and the banks, without causing unhealthy levels of inflation, now they can do it to help the average American by just printing whatever money is necessary to pay for universal healthcare, free college for all, a universal living wage, etc."

It is a very appealing theory for obvious reasons, and the rationale seems at least reasonable at first glance, but seems to have serious flaws when subjected to closer inspection.

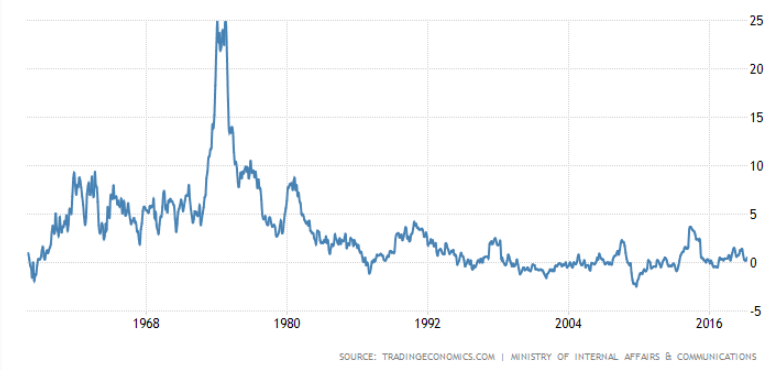
The first problem is found in the premise that the past is necessarily prelude. Indeed, the fact that quantitative easing, when employed in the midst of the worst financial crisis since the Great Depression, did not create unwanted levels of inflation is arguably irrelevant. At the time when quantitative easing was introduced, deflation was taking hold, and the prices of both financial and real assets around the world were in a steady and relentless decline. Indeed, with the benefit of hindsight, quantitative easing policies absolutely caused inflation.

It is largely a matter of the prevailing economic environment. Quantitative easing was introduced at a time of negative inflation (deflation), and it was able to reverse that trend and turn falling prices into slightly rising prices. However, conventional economic theory suggests a very different, and much more inflationary outcome, if it were to be reintroduced so late in one of the longest economic expansions in U.S. history, when prices are already rising, and industrial and labor capacity is already stretched to the limits.



There are a variety of other problems associated with modern monetary policy, including its impact on the deficit both on a relative basis, where all evidence suggests that sustained deficits above 120% of GDP (the size of the economy) dramatically retards growth, and on a cost-to-service basis, where interest payments alone (even if rates stay low) will force dramatic cuts in other important areas. Another problem is that the Fed would, in the future, need to use tax policy rather than interest rate policy to adjust economic growth and inflation.

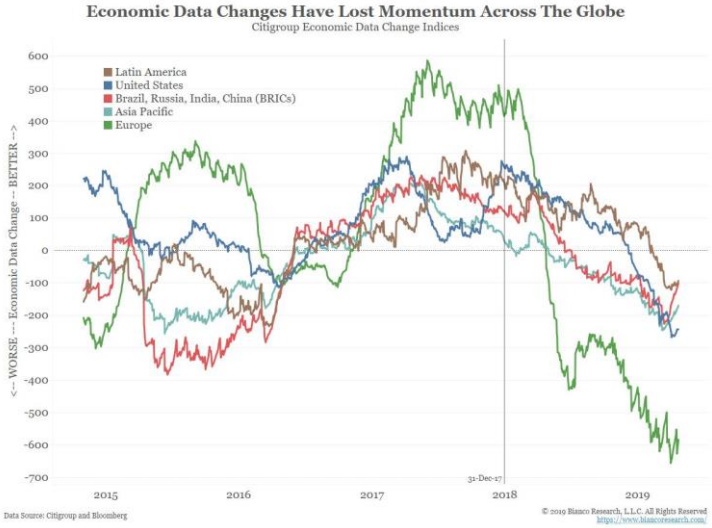
If anything, mainstream economic theory dictates that such a policy would not only cause the U.S. debt markets to lose all international credibility (remember that we can't finance our own deficits), and the dollar to lose its status as the world's reserve currency, but would represent the proverbial "road to ruin". After all, it is the unconstrained printing of money that explains much of what has made Venezuela and Zimbabwe the economic disasters that they are today.



However, there is an interesting and very speculative question about whether this time is in fact different, and that maybe, just maybe, what we should be reading is late 20th century Japanese history, rather than U.S. economics textbooks.

To explain, starting in 1989, Japan suffered through the simultaneous bursting of its real estate and equity market bubbles, and its economic experience since that time, while far from being a perfect comparison, has had eerie similarities to that of the global economy in the years since the financial crisis, with Japanese inflation (above) remaining mired near 0% and virtually no economic growth for decades. Indeed, the size of the Japanese economy is still over a half-trillion dollars smaller today than it was at its peak back in 1995.

Only time will tell, but it is at least possible that these seemingly irresponsible calls for extraordinary monetary policies and unbridled fiscal spending may be what is ultimately necessary to pull the world out of the economic quicksand that is impacting virtually everyone, with the partial exceptions of the United States and China.

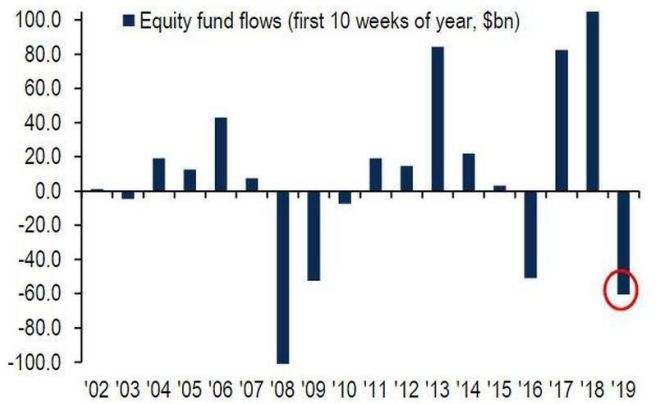


However, if the supporters of these unconventional economic policies turn out to be wrong, and their introduction brings about the return of inflation and higher interest rates, the consequences could be extraordinarily negative, as significantly higher interest rates would put at risk America's ability to service its debt without printing ever increasing quantities of money, which would almost certainly result in a vicious cycle.

In the meantime, we know that central banks around the world are adopting increasingly accommodative policies, and that the Fed has expressed a growing willingness to risk the onset of inflation by letting the economy run near full capacity, rather than pursuing its normal course of taking proactive steps to prevent unwanted levels of inflation by slowing down economic growth. Indeed, the Fed has expressed a willingness to let inflation run above their 2% target over extended periods, for so long as inflation averages the 2% target.

So, what does this mean for investors? First, it means that a recession is decreasingly likely over the foreseeable future, particularly since this approach is likely to steepen the yield curve (increase longer rates relative to shorter rates), which should increase lending in the economy. It also means that the anticipated period of falling corporate profits is likely to be both shorter and less deep than it otherwise would have been. Indeed, early indications are that analysts were too bearish early this year and over-estimated the decline in earnings.

Chart 1: Worst start to year for equity flows since 2008



Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

This more optimistic perspective is being supported by the strong rally in the equity, high-yield bond and leveraged loan markets, each of which is sending the message that a "soft landing" (i.e. a slowdown sufficient to lessen pressure on tight labor markets and fully-utilized economic capacity, but insufficient to cause an economic contraction) is in the offing.

Further, while the Fed has not lowered rates, its shift to a neutral policy, when expectations were for a tighter policy, has had much of the same impact as would a rate cut, as it changed the shape of the yield curve, which should facilitate lending activities and send a message of future growth. In addition, the Fed's pivot to a neutral policy provided the world's other central banks with the flexibility to either loosen their own monetary policies or, at minimum, delay the planned tightening of monetary conditions.

Fig. 3: Major short-term players' exposure to US equity market [Nomura estimates]

Global macro HFs still keep cautious stance on US equity market.

Note; Estimating multi-factor type rolling 30-days beta using each fund performance Index. Source: Bloomberg, Nomura

The message of the markets is that the world's major central banks have reversed course early enough in the economic slowdown for at least the world's two largest economies (the U.S. and China) to avoid recession. Moreover, there are early signs of the massive Chinese stimulus having a positive impact on Europe, with whom they share a much more important trading relationship than is the case with the U.S. This may nonetheless still prove very impactful on S&P 500 companies, whose earnings from Europe hit a record $284 billion in 2018, which compares to just $13.3 billion from China. This also illustrates the risks associated with President Trump's threatened trade war against Europe.

Importantly, an increased central bank tolerance for inflation is not a panacea for investors, as it means that businesses will face higher input costs. This too is already manifesting itself, which helps to explain why first quarter earnings are expected to decline by -1.8% despite corporate revenues rising by an expected 4.9%.

Those higher input costs will either continue to pinch corporate profits, or will ultimately be passed on to the consumer through higher retail prices (i.e. the long-awaited inflation).

In the meantime, the equity markets have rebounded to their old highs on the back of short-covering and share buybacks by domestic corporations. It was the strongest first quarter for equities since 1987, but also a time when hedge funds maintained the lowest net equity exposure in their history and there were net outflows from growth mutual funds and ETFs.

According to Blackrock CEO, Larry Fink, this has led to record amounts of sideline cash, which suggests that, if a sustained stock market breakout to new highs restores investor confidence after the dramatic fourth quarter decline, this store of sideline cash could come back into the market and drive prices higher over the foreseeable future.

At the same time, we do believe that the movement of sideline cash into the equity markets will need to be an important component of any ongoing advance, as most of the short-covering has already taken place, and with companies being less incentivized to continue buying back their own shares, now that prices are back at or near record highs.