MONETARY SCENARIOS

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Global Monetary Viewpoint

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EXECUTIVE SUMMARY:

The neo-Keynesian economic science with the short-run Phillips curve at its fulcrum and meant to underpin the 2 per cent inflation standard is broken.

The curve has been repeatedly re-estimated to take account of experience in this cycle – where reported inflation has been below predictions, based on the unemployment rate.

These latest estimates, however, could prove totally erroneous in the next cycle and lead to big monetary errors. Long maturity Treasuries hardly discount that risk.

Financial markets in the short-run are still hooked on the monthly US jobs data – even though their relationship to inflation is dubious. Incidentally the latest data point tol slowdown.

Currency alert: New trend ahead in C$/CHF as Swiss safe haven fades – read on!

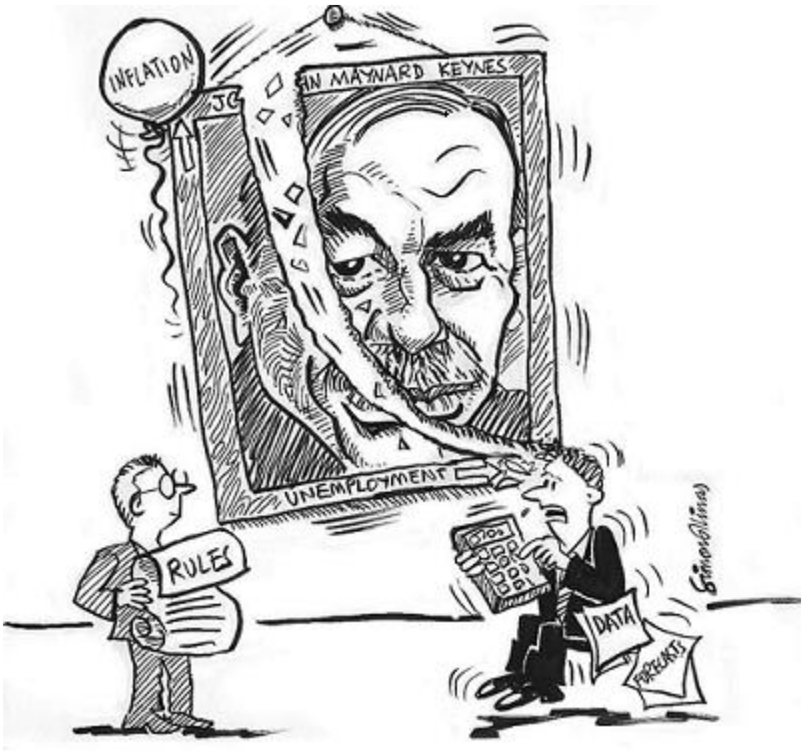
Neo-Keynesian failure means inflation peril

Currency alert: will Can$ and CHF weaken together?

Neo-Keynesian doctrine has at its core the so-called Phillips curve, which in modern reformulated form describes an inverse relationship between unemployment and inflation.

The discrediting of previous estimates of this relationship and contrived efforts of the new Keynesians to re-estimate continually means inflation peril in the future.

The factors special to this cycle which have lowered observed inflation may well not apply in a future cycle. Thereafter, the re-estimated curve now current amongst central bank econometricians may well trigger in the next cycle monetary error in a severely inflationary direction.



In principle, neo-Keynesians may not by then be in command of the central banks, most importantly the Federal Reserve.

We should note however, that President Trump has reinforced the neo-Keynesian dominance of US monetary policy, especially with his appointment of Professor Clarida as vice-Chair and of Chief Powell (who speaks metaphorically of "navigating the stars" – meaning that policy is based on the continuous attempts to

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measure and identify the size of the two stars (natural unemployment rate and neutral interest rate).

The short-run Phillips curve, which is core to neo-Keynesian doctrine, is only a distant relative of the notorious curve which the New Zealand economist derived from British experience in the 1950s – describing a sustained trade-off between unemployment and inflation (unemployment could be permanently lowered by raising the inflation rate).

As we shall see below, that older doctrine is repudiated today by neo-Keynesians and anti-Keynesians alike.

Before getting into the heart of the neo-Keynesian present predicament with their reformulated Phillips curve, just an explanation as to why jobs data gets such prominence in short-term trading.

One might imagine given the well-known flaws in the econometrics, and the poor predictive power of the jobs market data as regards inflation, that Jobs Friday (the day each month when US labour market data is released) would have faded into insignificance.

However, traders know that at the Fed, the data are still important for policy-making, rightly or wrongly. Accordingly, let us make a detour in the last Jobs Friday (February 1).

Jobs Friday data, February 1, 2019

The headline number for January was a bumper increase (by 304,000) in the payroll measure of employment. This result was offset in part by a big downward revision of the previously reported increase in December (from 312,000 to 222,000). The offset did not finish there. Employment, as measured by the alternative household survey, fell by 50,000 (after rising by only 142,000 in December). The year-on-year increase, in hourly wage rates, edged down to 3% year-on-year, whilst unemployment (based on the household survey measure of employment) rose to 4% in January from 3.7% in November.

On balance, therefore, there was a weak tone to the labour market data. In addition, the econometricians tell us that unemployment, not payroll employment, is a lead indicator of business cycle downturns. (Specifically, the payroll employment measure may still be strong in the early stage of slowdown whilst unemployment is already edging up – a puzzle perhaps explained by the greater ease of finding workers when the labour market starts to cool). Grounds for concern about the economic outlook increase when we look at the weekly index of leading indicators from the Economic Cycle Research Institute (ECRI), now as weak as just before the onset of the 2000-2 recession.

Phillips curve dogma

Even though unemployment has blipped up very slightly in the past two months (consistent with a tiny cooling of inflation according to their models), a big puzzle remains for the new-

Keynesians. Why at such a low level of unemployment has inflation remained so low?

This puzzle is unsettling for inflation-targeting central bankers. The origins of that regime (inflation-targeting) was the assertion that the previous monetarist regime was starting to fail. Monetarism had been based on the view that demand for money and especially the monetary base was stable over time. That seemed to the neo-Keynesians growingly untenable from the viewpoint of the early 1980s.

In principle, the critics of applied monetarism could have turned to proposals on how to reconstruct the monetary and banking systems such as to make the demand for money or monetary base more stable.

The critics were not inclined to move in that direction not least given their preference (and their political masters' preference) for a regime of discretionary policy making rather than rules.

(Discretion, for example, would be more consistent with implicit currency manipulation, for trade advantage).

Hence the critics of monetarism came to support the view that the central bank, by directly piloting a path for the short-term interest rate and making use of the latest state of the art econometrics, could achieve their target of "low inflation".

The neo-Keynesians and the monetarists by this point were both agreed that the original Phillips curve was flawed. Its basis was money illusion – that workers would be fooled by higher inflation into accepting lower real wages.

That had become implausible through the history of the late 1960s and early 1970s. If the central bank seriously tried to depress unemployment below the natural rate, then inflation would rise without limit.

In effect the Phillips curve was vertical at the natural unemployment rate.

The neo-Keynesians, though, remained firm in subscribing to the hypothesis that a short-run relationship existed between unemployment and inflation.

As the labour market tightened, wages would respond to demand pressure and start to rise at a quicker pace. In turn, wage inflation would lead on to general inflation, in part through a catch-up process (sometimes described as a wage-price spiral).

Late cycle rise in wages does not mean inflation

This last point was not at all self-evident

After all, in the classical business cycle literature, real wage rates tended to rise in the late phase of the cycle and profits contract.

Under a sound money regime (such as the gold standard) those tendencies would not translate into inflation.

Anyhow, the neo-Keynesians enjoyed power. Presidents Bill Clinton and George W. Bush nominated them to key positions in the economic policy-making process, including the Federal Reserve. President Obama followed suit. Why did these Presidents favour the neo-Keynesians? They seemed to offer low interest rates, asset market boom, and boasted of tools which could manage the economic cycle in line with election objectives.

In economic policy, might is right. And in the arena of central banking, the Taylor rule, built on neo-Keynesian principles, became highly influential.

Econometrics is broken, but no fixing of monetary dogma

The central bankers enjoyed acclaim at first, running monetary policy according to these neo-Keynesian guidelines through the "golden age of moderation" from the mid-1980s to the late 1990s. Doubts were raised by the crash and bust of the end-1990s and more seriously by the 2008 Crash and Great Recession. But still the neo-Keynesian fortress in the central bankers' club remained intact, because wider political forces kept it that way.

Yet in the real world, the doctrine has become increasingly untenable. Digitalization and globalization (especially the integration of low-cost emerging market economies including China with their advanced economies) have had huge impacts on the labour market which, in real time, few if any experts can understand. There have been profound changes on both the supply and demand side for labour.

More broadly and in line with these tendencies in the labour market and more widely in product markets, there has been a downward rhythm to prices (including wages); this means that under sound money – meaning no monetary inflation – prices would have been falling gently. No wonder that the past econometric relationship between unemployment, wages and officially measured goods and services inflation broke down.

Back to the labour market, on the demand side we have seen a flattening of rents across large segments of the market. Rents to skill whether as super-sales or talented middle management have been flattened by the progress of the online economy and the grown efficiency of overall control by the commanding heights.

As the labour market is broken as an inflation indicator, look elsewhere

Given that the labour market, and in particular the rate of unemployment, is no longer related to inflation in a stable and reliable fashion, there is surely a strong case for setting monetary policy which does not depend on estimations of the Phillips curve (short run). If monitoring sings of monetary inflation, it would be wise to look for other indicators of monetary inflation. Chief amongst those would be behaviour in asset (including credit) markets.

If there are many signs of the strong irrational forces which are typical of monetary inflation – for example crowded carry trades, yield-seeking behaviour, positive feedback loops, momentum-trading, camouflaged increases in leverage – at least a tentative diagnosis could be made to the effect that monetary inflation is present. But the neo-Keynesian central bankers have not bended in that direction. In fact, they turn such logic on its head.

If they see signs of asset inflation moderating (they would never use such a term and are in denial about its existence), as when credit spreads widen from abnormally low levels or booming carry trades unwind, they speak of tightening financial conditions and how those justify the next market put (in recent weeks the Powell put). A vicious circle results – unwinding asset inflation stimulates more monetary inflation until the Day of Reckoning when the unwinding is stronger than the central bankers' power to resist.

Are we near the Day or Reckoning?

Short answer: most likely nearer than Fed Chief Powell would have us to believe when he touted last week his institution's new elixir of policy tools which could extend apparently for ever an ageing business cycle expansion.

Even so, the strong re-bound of stock markets and related risk-assets during January highlights that many investors are not worried about a Day of Reckoning any time soon. They can be wrong, of course, and sometimes consumers are ahead of stock investors in worrying, as was famously the case in Summer 1929!

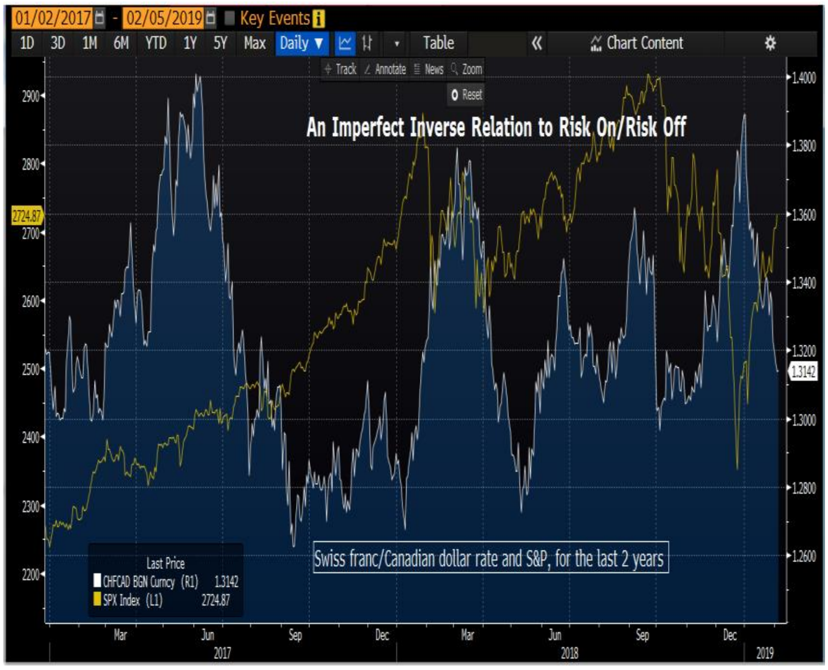
So what are the indicators to watch that the Fed's supposed elixir is not delivering – perhaps, its promised extension of late cyclical expansion, together with repeated Indian summers in asset markets? As previously highlighted here, the key information is likely to be fading speculative narratives (Facebook jump in stock price this week notwithstanding) and thinning camouflage of leverage – alongside keen intuition concerning data signals (and the sharp fall in consumer confidence in the US is notable).

CURRENCY ALERT: The C$ and CHF both weaker in downturn?

According to the algorithms and crude rules of thumb, the Canadian dollar tends to weaken when risk is off whilst the Swiss franc strengthens – and conversely into phases of risk on.

These tendencies are not immediately evident from a simple chart of the Canadian dollar/Swiss franc rate against the S&P 500, but the latter is not in itself a reliable measure of risk on, For example, a small movement of the S&P 500 in either direction may be just white noise; and some trend rise in the S&P 500 may be simply in line with earnings and the economy, without indicating any increased preference for risk-taking.

An Imperfect Inverse Relation to Risk On/Risk Off



Source: Bloomberg

Even so, beyond the crude data, the hypothesized tendencies make some sense.

The Canadian dollar is a commodity-linked currency which gains when the global business cycle (and particularly China) is driving commodity prices higher. Moreover, Canadian export industries in many cases are highly geared on the health of the US economy. Furthermore, in this present cycle, Canadian households have become so indebted and the housing market so inflated (think of Vancouver and Toronto), that there is much to fear about investment demand for the Canadian dollar in a global economic and market downturn.

By contrast, the Swiss franc is by historical record a safe-haven currency. In addition, the currency carry trades are typically short of the Swiss franc and long of assets which offer substantial yield carry. When bad news strikes in the global economy, the carry trades tend to contract, momentum trading is in retreat and the franc gains.

This time round though, both currencies could fall in an economic and market downturn.

Yes, the Canadian dollar should fall as usual vs. the US dollar and even more so given the special degree of speculative froth which formed in Canada during this cycle.

It is the Swiss franc's safe-haven feature which is in doubt, though there is no disputing the safe-haven feature of the 1000-Swiss franc banknote.

For example, the amount of third party carry trade (non-Swiss borrowing francs to finance investments in other currencies) has been reportedly quite small in this cycle. The franc shock of several years ago when the franc was suddenly un-pegged from the euro has left profound scars. Meanwhile, the virtual repeal of bank secrecy in Switzerland and its exposed weak bargaining power vs. the EU has taken its toll of the Swiss franc's reputation. On top, the Swiss National Bank today has absolutely no resemblance to the hard money central bank of the past.

In a global economic down-turn, the euro would have bouts of weakness against the dollar given the extent of banking and credit concerns in EMU. The Swiss franc would not plausibly defy that downward drift. Yes, ultimately Italy could exit EMU and a re-born Deutsche mark become anchor to the Swiss franc. But that is a long shot in terms of today's trading horizon.

A related question: if the Swiss franc is no longer safe-haven and we have raised doubts here about the safe-haven quality of the Japanese yen, is it possible that there is now no reliable safe-have currency? Answer: yes, that is quite possible – though short positions in the "good news" currencies, such as the Canadian dollar, can fit that same purpose.