Global Monetary Viewpoint

Thursday, 27 November 2019

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THE SUPERIOR RETURNS FROM MONETARY PESSIMISM 2002-2020

How should we define the monetary pessimist throughout the first two decades of the 21st century?

This is someone who believes that the two big shifts in the global monetary regime, led by the Federal Reserve, are taking a huge toll on economic prosperity and freedom. Evidently, the toll is not registering on a clock in continuous fashion; rather the cumulative size reveals itself by comparing snapshots at widely separated times, ideally at similar stages in respective business cycles.

For the record, the **first** shift occurred when President George W. Bush appointed renowned “inflationist” Professor Bernanke to the Fed in 2002 and extended Greenspan’s tenure as chief the following year for just a half-term, all on the presumption that these officials would pursue a policy suitable to winning the 2004 elections. Accordingly, in early 2003, the Fed announced for the first time in its history that it “was breathing inflation back into the economy”, because at 1 per cent it had fallen too low.

The **second** shift was after the 2008 crash and recession, when the Bernanke Fed under President Obama embarked on bouts of quantitative easing and persistent long-term rate manipulation. Due to US monetary hegemony, these shifts were eventually copied around the world, notably in Europe and Japan. Consequently, China took its cue from these monetary developments to institute aggressive monetary ease.

Under the general statement above about monetary pessimism, there are several variations, not universally shared by all exponents. There is much heterogeneity in monetary pessimism, with some common themes and some distinct beliefs.

As we shall see the five variants of monetary pessimism (out of seven), which have proved correct in the period 2000-2019, have been consistent with high cumulative returns from gold and from rolling over long-dated US Treasury bonds – superior to those from the S&P 500 (both for the 20 years as a whole and when comparing points at similar stages of the cycle).

Monetary repression tax, mal-investment (and related low productivity growth), growing monopoly power (and its depressing influence on economic dynamism) and long-run danger of high inflation - all aspects of monetary pessimism as detailed below - have held down interest rates and buoyed the yellow metal’s appeal.

Executive Summary

The powerful climb of the S&P 500 since the business cycle trough of 2009 and the last growth cycle trough of 2015/16, together with absence of recession, has made many investors resistant to pessimism.

Yet monetary pessimism, correctly formulated, has in fact been the basis of far superior returns measured over standardized time periods (similar stages in the cycle or growth cycle) in gold and long-maturity T-bonds, more so than US stocks.

This is a finding which has special relevance to formulating investment policies, under present conditions, where a new growth cycle upturn has become market consensus. Riding a cyclical upturn has no sound exit strategy, especially where the super returns over the years could be extinguished in days or weeks of violent price moves.

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Seven strands of monetary pessimism

We can distinguish seven strands of monetary pessimism in this century, some overlapping:

First, overall economic performance will be poor, meaning little if any gain in general prosperity. One factor here is the huge mal-investment – in effect the squandering of economic resources – resulting from "money out of control" causing haywire price signalling in capital markets.

Second, 2 per cent inflation targeting, at a time of powerful downward influences on prices from globalization and digitalization, means huge scope for governments to levy a monetary repression tax. This is equivalent to the amount by which rates manipulated by their central banks are below the free market rate, as in a hypothetical sound money regime. There is remarkable tolerance for this tax amongst citizens, given the sparkle of apparently high returns on an array of risk assets, reflecting rampant asset market inflation.

Third, a boom occurs in financial engineering (and related to this leverage), and this means large financial vulnerability. This, together with accumulating malinvestment, means a high likelihood of financial market crash and a Great Recession, albeit timing is largely unpredictable. Given the global extent of the wild monetary policies, and the capacity of the real economic environment to foster speculative narratives (which under conditions of monetary radicalism gain huge followings from investors, desperate for yield and discarding thereby normal scepticism), the far-off (from the start of the cycle) denouement seemed more plausible.

Fourth, though there are periods, possibly long, during which equity and related risk-on markets will have exciting speculative runs, these will end up with crashes. Only a few investors, mainly out of luck, will have timed their purchases and sales to make overall returns which are superior to having held and rolled over long-maturity Treasury bonds or gold, when measured over the long run (and not artificially from trough to peak of the cycle). Yes, there are periods when the risk-on investors seem to be well ahead, but very few will avoid the final crash which will sharply reduce any cumulative return. Almost certainly that crash, and the accompanying recession when it occurs, will take most people by surprise.

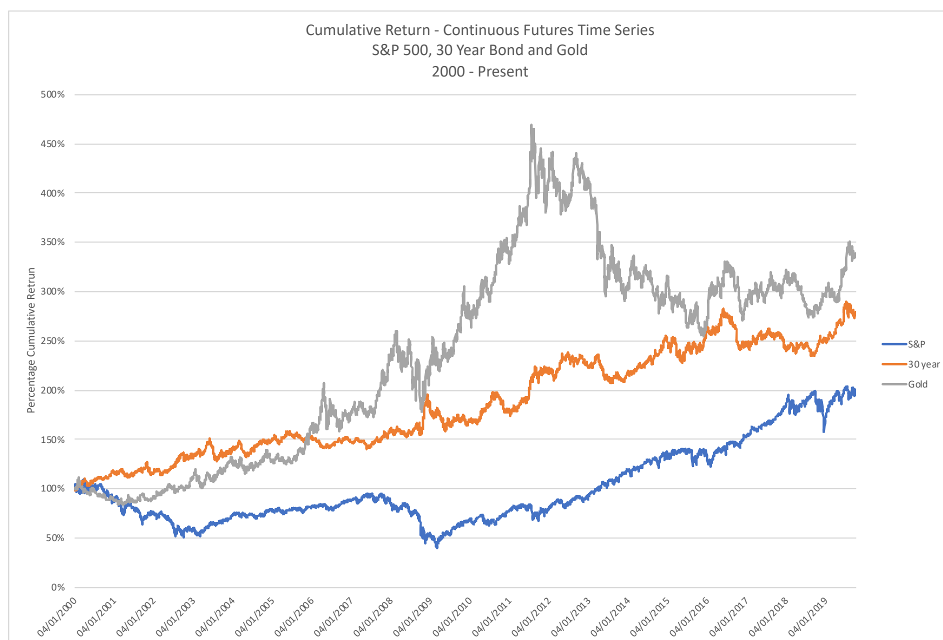
Fifth, alongside the malinvestment, there is tremendous growth in monopoly power, and this presents huge political and economic challenges to the future of free market capitalism in any form. The link between monetary inflation and growth in monopoly power comes via the hunt for yield and related irrationalities, including the abnormally fertile ground for speculative narratives. A big narrative

under the present digitalization revolution is the "winner takes all" and "star firms". Crony capitalists, empowered by asset inflation, penetrate the corridors of power in the regulatory state, and enhance their monopoly power. Along with this, the wealth distribution effects of the monetary policies will induce a raised level of challenge to liberal democracy.

Monopoly power, present and future, excites speculative interest in equities, and in the environment of asset inflation, investors tend to ignore the long-run likelihood of "reversion to the mean" (or alternatively that particular monopoly power is broken). Monopoly power drags down economic growth – as competitive forces and the invisible hand are weakened and monopolists tend to restrict supply and investment.

Sixth, rampant goods and services inflation breaks out. Some pessimists expected this to happen early under the new radical monetary policies (wrong forecast); the mainstream now expect this into the next cycle.

Seventh, monetary stimulus does not work, and the economic upturn will stall early on, quite likely in a crash and recession similar to the notorious 1937 crash and Roosevelt recession which followed.



The score card to date

Five of these variations in monetary pessimism have already been borne out by events, in whole or in part. One interpretation of the sixth has been proved wrong but another remains open.

One has been totally refuted by the evidence - an early failure of monetary stimulus as in 1937 or an early outbreak of high goods and services inflation. This, and the premature forecast of high

inflation, were popular in the years 2010-12 and accordingly, the price of gold then reach a fantastic peak.

In general, the investor who has been guided by monetary pessimism, whilst not becoming fixated on the two variants (which have been proved wrong), has already done well.

Cumulative productivity growth and advance in living standards (if any) have been sub-standard across the advanced economies, in the first two decades of this century (and may well yet end up being so across most of the emerging market economies), even without there yet having been a crash and recession to bring down the long-run average.

We can never be sure where the mal-investment will materialize. This long cyclical expansion has already revealed mal-investment in the shale oil/gas sector in the US, with the bankruptcy toll continuing to rise; other suspected areas of mal-investment include “over-digitalization” (over-application of digital technology) to the point where overall productivity gains have been small, especially if measured to net out the costs of resources applied to mitigating the downsides (for example, cybersecurity, viruses).

A good historical analogy for over-investment (or too rapid investment) in a new technology is the over-construction of railroads, in the mid nineteenth century (which Professor Fogel argued had poor economic returns, compared with a hypothetical (counter-factual) extension of canal network). We can also think of over-investment in global supply chains, in European and Asian export sectors, in construction (commercial and residential).

On the second strand, central banks in this cycle have been levying huge amounts of monetary repression tax for their political masters. For example, the real interest cost of US government debt would now be 1-2 per cent of GDP, higher under a sound money regime – in Japan and Europe, maybe double that.

On the third strand, one just has to read the financial stability reports from the IMF and BIS to realize the extent of presumed over-leverage, both in the advanced and emerging market world.

On the fourth strand, the triumph of gold and long maturity Treasury bonds, this is not true over all sub-periods, and in particular for the sub-period from Spring 2016 to present (November 2019), starting at the low-point of the then growth cycle downturn, when the S&P 500 has triumphed. But if we measure from peak to peak or trough to trough, the story is totally different. From the peak of late 2007 to today, gold and T-bonds have triumphed over the S&P 500, and the same is the case with respect to the 2000 peak until today.

With respect to the fifth strand, there has been tremendous growth in monopoly power and in the market’s fascination with present and future monopoly power. In many respects, the driver of earnings growth across the S&P 500 universe as a whole has been the take-off of monopoly rents, and their favouring by the Trump/Republican tax cuts. Furthermore, markets are on the look-out for the next ballooning of rents – for example, the possible eventual rents which Amazon could make in the on-line retail space (not in evidence yet). Markets are pricing in these monopoly-pumped profits subsisting into the long-run, rather than

discounting that these will wain along with power in accordance with historical experience.

The high profits are not just in the big tech sector – but across a range of sectors where the star firm has built itself on highly specific investment in technology (much intangible) and successfully prevented its know-how seeping out to a wider universe.

One does not have to be a Marxian, to be deeply pessimistic about what enhanced monopoly power means for the future of free market capitalism. It depresses economic dynamism, paralyses the invisible hands and creative destruction (all of which is consistent with lower than otherwise long-term interest rates). Asset inflation has enhanced monopoly power – by fuelling huge speculative capital flows into any entity which has it now (or might credibly have it a few years down the line), with investors unusually willing to follow such narratives.

Yes (sixth strand), the pessimists have not yet been proved right about high inflation. At the beginning of this cyclical expansion, some monetary pessimists thought that QE would rapidly usher in a new high inflation, and that was one factor in the explosion of the gold price, 2010-12. It was also one factor sustaining very long-term US interest rates.

Over this cycle, the perception of the inflation danger has shifted, but certainly not faded away. The realization has grown that the nature of technological change – with its spawning of star firms which retain technological advance, within the firm which becomes super-efficient, putting downward pressure on prices and wages as set in competitor firms – has been holding recorded consumer inflation back, even though monetary inflation is virulent (as evident in asset markets). The low or even negative rates, which central banks have pursued in this environment, are a form of monetary repression tax. The pessimists are right about the predicament this means for the ordinary saver – even if many of these are presently fooled into thinking that they have avoided the pain, by accumulating gains from speculative froth in asset markets driven by the monetary inflation.

But one day (and maybe in a day) these will evaporate, leaving savers naked of much of the wardrobe of assets they thought they had built up. As we move into the next cycle, high inflation in the goods and services market will come with a vengeance (as the disinflationary forces of this cycle wane), and governments press the central banks (via pattern of appointments for example) to hold down interest costs on the debt rather than fight inflation. The central bankers can fudge their deceptions (of inflation targeting mandates) by claiming that temporary factors are at work, and that they are looking at inflation averages over a long run.

Many of those celebrating the high cumulative returns on risk-assets (especially equities), over recent years, think they will make their exit before the next crash or that there will be no crash at all. Some may think there will be no recession at all – at least for another 10 years or so. A 20-year super long cyclical expansion is not an impossible outcome; certain small advanced OECD economies have shown such results. The weight of principle and history is against these people being so lucky. Recessions emerge often before the equity market takes note, and when it does, one, two or three black Fridays can ensue. After the first black Friday, the inclination of many investors would be to hold on or even buy the dip.

This brings us to where some monetary pessimists have made errors of judgement in market analysis – in their attempt to call the business cycle, so as to profit from their pessimism. This relates to the seventh strand above, in fact a particular sub-case of the second strand. For shorthand we could call this the "37 syndrome".

The pessimist error of expecting repeat of 1937

Some monetary pessimists, for example, put a strong likelihood on the QE policies in the US of 2010-13 leading on to a market crash and severe recession similar to what had happened with the Roosevelt QE policies of 1934-6. The huge growth of monetary base (driven by gold inflows) had already stalled by summer 1936 (after the collapse of the gold bloc in Europe) and then the Federal Reserve had briefly tightened policy in response to mounting concern about excess speculation and inflation through late that year.

There were some stock market pull-backs in early 1937: the Fed responded by suspending its small steps towards monetary normalization and indeed reversing them. The market recovered somewhat in the Spring – all a version of a modern Fed put. But it did not work. We now know that a new recession started in May 1937. The stock market crashed in August, and a severe recession lasted till mid-way through the following year.

This history became the speculative focus for some monetary pessimists, especially in late 2014 and early 2015, amidst the oil market crash and the mini-China crisis.

That particular cyclical view was wrong. The pessimists attacking a view on that particular cycle were wrong. Why was that? In hindsight we can see some important differences between 1937 and 2016. It was certainly not down to Fed skill. The Fed pulled back in early 1937 from a normalization agenda, just as it did in 2015/16. But in the earlier period there were also big negative factors at work, without parallel in the later period. Nazi Germany and post Popular Front France were hardly going to pull the globe forward – as Europe, China and Japan did in 2016.

At the same time, Asia in the earlier period was at war, with Japan's invasion of China in Summer 1937, coinciding with the Great Crash of that time. World War was imaginable, and was a factor holding back business investment globally. The sharp decline in business investment, from the low level to which it recovered to, in the US in 1936, showed how fragile business confidence was, so soon after the Great Depression. The commentaries of the time are not filled with the speculative narratives we can find in the recent period 2010-14 (emerging market economies converging with the advanced, the miracles of digitalization, China boom).

In summary, the track record and investment guidance from monetary pessimism has been overall insightful, though marred in some cases by false predictions of an early downturn similar to in 1937 or by an early emergency of high reported CPI inflation.

Given that equities have far outperformed gold and long-maturity US Treasuries, from the last growth cycle trough in early 2016 to now, it is in no way contradictory to the main monetary pessimist hypotheses; and the pessimists would not deny that a few investors will

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be lucky or very skilled in terms of getting out before the next downturn, but that will not be the general experience.

The monetary pessimists' warnings about monopoly power and its threat to free market liberal capitalism have been spot on – monopoly profit (actual or anticipated) has been a main driver of stock market gains. If monopoly capital is not broken (whether by natural forces of creative destruction, powerful assault from anti-trust law or from an unlikely change of monetary regime towards hardness) then this will ultimately produce a form of society and economy in which prosperity and human liberty will be restrained.

Bottom line:

As we look forward to 2020, there is considerable optimism in the marketplace that the Powell Fed has it right, and that the growth cycle slowdown from Spring 2018 to the present is drawing to a close, most likely by the end of Winter 2019/20.

The period of outperformance for the US equity market and many related assets since early 2016 (albeit with a setback in late 2018 subsequently reversed) could be extended, say for another year. This would not negate the main pessimist theses as discussed above. Moreover, the next Crash and Great Recession might nonetheless emerge in 2021, notwithstanding Powell's 2019 put.

Some monetary pessimists (including Global Monetary Viewpoint) do not go along with Chief Powell's dominant view about growth cycle upturn, starting say in Spring 2020.

Given the extent of accumulated mal-investment already out there and endogenous forces of slowdown at work, whether in the emerging markets (especially Asia including China) or the advanced economies (including consumers pulling back out of concern about their unsound finances, especially related to pensions provision which could be in great jeopardy when asset inflation turns to deflation), the small rate cuts or other monetary actions of 2019 would not succeed in launching a new sustained growth cycle upturn.

Instead, the statistical probability is rising of some type of credit or liquidity event which would suddenly bring down speculative temperatures, if indeed at the same time there is evidence of weakening in business conditions. Whether or not President Xi and Trump sign their piece of paper on phase 1 of a trade truce, it would make little difference, except on the day to these conclusions.

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