Global Monetary Viewpoint

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Great Recession will not bring US Money Reform unless Political Earthquake

False Optimism in Markets and Congress about Restoration of the 2 per cent Inflation Standard

The implicit narrative in the US T-bond market, equity markets, and even the gold market is that the collapse of the 2 per cent inflation standard in 2021-2 will be only a transitory event. Moreover, restoring the standard will occur in this narrative without any great economic pain – most likely not even a significant recession.

Accordingly, the five-year five-year forward inflation rate implicit in the US T-bond markets (conventional and inflation-protected) has edged down to 2.75% p.a. in recent weeks (from a peak above 3%), whilst the 5-year forward five-year real rate is at just below 50bp. We could say that the markets are pricing in a complete restoration of the good (in fact) bad old days of the 2 per cent inflation standard, never mind its recent collapse.

Correspondingly the gold price in dollar terms has receded somewhat from its Winter peak, though it is flat on its end-2021 level, during which same time the S&P 500 is down around 20% and the Bitcoin price by over 40 per cent. The fall in the S&P 500 is consistent with a measured response to the rise in interest rates and some sobering down of earnings growth expectations (on average across the equity universe) rather than reflecting a hard economic landing ahead.

Our view is that a hard landing is much more plausible than a soft one. The boom in consumer durable spending and business spending in the US during the pandemic go into reverse; most likely, business spending, exports and inventory spending will be the motors of the US transition into recession. It is also quite possible that residential construction will fall from present peak levels over the next 18 months. We should also consider all the possible feedback loops from financial distress back to the real economy – with the paths here largely unpredictable, especially as to timing.

Executive Summary

TRANSITORY – yes, that is still the verdict of markets on inflation in the acute sense that the collapse of the 2 per cent inflation standard in the US and Europe during 2021-2 is viewed (priced) as almost painlessly reversible. Specifically, successful and swift restoration of the 2 per cent standard, achievable without a hard economic landing, is now the mainstream view.

The view here is different. The 2 per cent inflation standard is a profoundly flawed regime – and the slightly below 2 per cent average inflation of the pre-pandemic decade was due to luck of coincident factors rather than monetary policy skill or regime quality. Though low inflation would be the corollary of a great recession, in our central scenario, we should expect one or more high inflation episodes within the next decade.

The vital immediate forces behind the slide of the US economy into a great recession are likely to include falling export demand (in general, excluding armaments), bulging inventories which have to be cut back, a sharp pull back in business spending across substantial areas of US economy, and at some point a pull-back in residential construction. Erosion of monetary wealth in real terms by present high inflation will also contribute to a cooling of consumer demand.

In currency markets, we should already plan a strategy for a world without negative interest rates; these could fade away in Switzerland as soon as late June and in the euro zone by the end of summer. The return of multi-currency choice free of the curse of negative rates could introduce a new important dynamic unfavourable to the US dollar.

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Turning to the restoration of the 2 per cent inflation standard, we should realize first that this was an utterly phoney standard. Central banks do not have the tools or broader means to hold inflation at 2 per cent over the medium-term. Moreover, their attempts to do so in the face of powerful changes in prices entirely consistent with broad money stability (whether up or down) engender monetary instability, which shows up as powerful episodes of asset inflation (and subsequent bust).

US inflation averaged 2 per cent during the second decade of the 21st century. This level was to Chief Powell's opinion and his colleagues when they launched the new inflation framework at 2 per cent plus, aiming to get inflation to a higher average level. The 2% historic average reflected primarily the combination of economic sclerosis (itself stemming from long-running asset inflation, mal-investment, and related build-up of monopoly capitalism) and resource abundance (the shale oil and gas bonanza in particular), not monetary skill.

In the next ten years, we should expect at least one and, more likely, two big mistakes where the Fed responds to apparent considerable economic weakness by a mega monetary stimulus. These mistakes will subsequently feed new inflation, likely to show up not just as asset inflation but in a new episode of high reported goods and services inflation.

Back to the present situation, there is a strong belief in the marketplace that the Powell Fed can yet find redemption despite its gross inflicting of high inflation on the US people and the world during the pandemic.

Here at MHA, we consider redemption high unlikely and indeed impossible. Great inflations tend to bring great recessions in their wake, and present a severely flawed monetary regime as presided over by the Powell Fed is unlikely to prove an exception to that rule.

It is possible that under the Biden Administration, we will have the triple record of Great Inflation, Great Recession, and severe geopolitical setbacks. The failure of the US-led economic war against Russia, with the latter effectively consolidating its territorial gains in the Donbas and South Ukraine, are poignant examples. Amongst all these failures, President Biden will be immersed in answering a thickening investigation into his corruption (including his relationship with Ukraine oligarchs) if, indeed, the Republicans win the mid-terms.

The armaments industries thrive from all these additional equipment deliveries to East European NATO countries, Ukraine, India,

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UAE/Saudi Arabia, now being made under the "waging economic war on Russia and otherwise degrading its military power" strategy). Money is no constraint, and it seems when trying to win allies (especially India) for the war – an objective unlikely to be achieved. That's fine as long as it benefits powerful interest (here, the armaments industry); it's a very different matter for reconstructing Ukraine!

Meanwhile, Amazon succeeded in winning its ten bn cloud computing contract with the NSA in early May (details classified information) notwithstanding its union-busting and freeing up Chair Bezos to comment on the Biden Administration's responsibility for high inflation, no doubt attuned to the likelihood of a Republican landslide victory in the mid-terms.

Studiously Bezos hits out at the Biden's great fiscal "stimulus" of 2021 without mentioning the Fed's culpability. (Hitting at the Fed would be to spoil the gift horse which kept on giving for so long in terms of inflating the value of Amazon stock). That great stimulus would not have generated high inflation if the Fed had been pursuing a strict monetary policy (for example, the Fed did in the early 80s in the context of the Reagan Administration's massive fiscal deficit). Instead, the Powell Fed bought all the bonds issued to finance the budget spree at a virtually pegged yield level close to zero.

Though Bezos does not make Fed criticism a point of his commentary, other public personalities do so. The general line of attack is that the Fed should have withdrawn its extreme stimulus from early 2021 onwards rather than only starting a year earlier. Ex Fed Chief Bernanke adds to this chorus this week on the occasion of his new book "US monetary policy for the 21st century: the Federal Reserve from the Great Inflation to Covid 19". In a CNBC interview, Bernanke explicitly criticizes Mr Powell for being too slow to recognize and act against the inflation danger.

The writer of this article does not have his copy of the new book yet, but a key question is whether Mr Bernanke honestly takes to task his own great inflation mistake of the mid-2010s. As part of the Greenspan Fed (appointed as its eminence grise at first by President Bush in 2002, under Chairman Greenspan, then becoming Chief in early 2006), he was an author of the tremendous monetary inflation which continued after a break from the mid-1990s to the mid-2000s.

Yes, the Greenspan-Bernanke Fed responded firmly when the monetary inflation showed a substantial rise in CPI inflation from 2004 onwards (previously much more prominent as asset inflation). Still, many criticize that "firmness" as becoming inflexible and too

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long-winded, adding to the severity of the bust which followed. Remember that even as global credit markets seized up first in Summer 2007, the Fed continued with its high-interest rate policy.

So are we now to believe that Chief Powell, having added fire to the long-running monetary inflation through the pandemic and failing to put this out through 2021, has now had his Damascus moment; on top of this, he is to be successful in navigating a soft landing!

Some in Congress realized Bernanke's mistakes – first in the inflation boom and then pursuing an emergency tightening of policy for too long. In opposing Bernanke's reappointment in 2009/10, Senator Bunning told him, "I voted against your appointment in 2005; I opposed you because I knew you would continue the legacy of Alan Greenspan, and I was right. But I did not know how right I would be and could not begin to imagine how wrong you would be in the following four years. Greenspan sold the independence of the Fed to Wall Street through the Greenspan Put. You bowed to political pressure of the Bush and Obama Administrations and turned the Fed into an arm of the Treasury. You are the definition of a moral hazard.

Today the leading Republican on the Senate Banking Committee, Senator Pat Tooney, joins with Wall Street in expressing confidence that Chief Powell, having just secured his confirmation as Fed Chair, will pull off a soft landing and excuses his abject record during his first term, sending him the following letter of congratulations: "I congratulate Chairman Powell on his confirmation to a second term as Fed Chairman. Chairman Powell has a record of acting thoughtfully and constructively, especially in difficult circumstances. While I strongly disagreed with his decision to continue with the Fed's emergency accommodative monetary policy long after the economic emergency had passed, I have been encouraged by the Fed's recent shift in policy. The Fed may need to accelerate its monetary tightening because it was so late to change course. I hope Chairman Powell and his colleagues at the Fed will move swiftly to ease the inflation tax that's plaguing American families every day".

What a let-down. What was ever thoughtful or constructive about his policy in his first term? And no mention of his aborted normalization program under President Trump (2018-19). So now Chief Powell says he will continue raising interest rates until there is clear evidence of inflation falling to target, and a warning, interest rates could move well above neutral before he is done. The mind boggles. Do we have a clue about where are neutral rates and much reason to doubt the validity of the concept?. It is feasible for the US and global economy to be sliding into a recession, ultimately a great recession, even with the nominal fed funds rate well behind the coincident CPI inflation rate.

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In assessing the extent of this recession, many in the marketplace are glued to the data. In particular, many are searching for evidence of a cooling of the US consumer durable spending boom. It is feasible that the sequence of US hard landing starts with continuing drag from the external sector (notwithstanding the armaments export boom) and then a reverse of the digitalization boom during the pandemic (as partly fuelled by the pandemic stock bubble). Inventory run-downs also could play a substantial transitory role.

Yes, real-time information can emerge ahead of data as bottom up information about particular stocks in the equity market. By the time the data presents a clear picture of the economic downturn, this may already be well under way. And in an environment where high consumer price inflation at a variable pace occurs, there is the additional problem of sorting out real from nominal variables in a reliable fashion.

Onsets and evolution of severe recessions typically include financial crises. This time around, many believe that this could be centred on "quasi- or near-banking institutions", including the private equity industry. So far, at an index level, the widening of credit spreads in markets has been most diminutive in the US corporate universe and greatest outside the US, whether in Europe, China or emerging markets. The US macro-indices of spreads are further complicated in their interpretation by the transformation of the shale oil and gas sector (from crisis point to success story) in the recent past, given the well-known high leverage and credit outstanding here.

What lies beyond the Great Recession Scenario?

More inflation.

Even if there is an in-depth Congressional investigation into the Federal Reserve related to the accusation that it has been responsible for the outbreak of high inflation and subsequently great recession, there is no basis for optimism that this investigation would be the pre-cursor to fundamental reform in the direction of sound money. Instead, there would be a new plan for establishing monetary inflation. The three critical explanatory variables of Fed induced monetary inflation remain I) underestimating the natural strength of the business recovery, ii) overestimating the likelihood and actual severity of the economic downturn, and iii) leaning against any fall in prices, even when due to sudden resource abundance or productivity growth surges.

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