Eriswell Market Insights

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Whither Inflation? Ask a Wise Irish Fool

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Bank strategists, financial journalists, and business TV channels are all aggressively ringing the inflation alarm, predicting that US Treasury bond yields will consequently rise sharply (prices move inversely to yield). A casual bystander might feel foolish for not seeing that this is obvious.

Less public are those, like us, who have since March 2021 walked a less popular path, arguing that further rises in US bond yields were highly unlikely.

With Treasury bond yields falling a hefty 40 basis points (0.4%) over the past 5 weeks to 1.95%, it is no longer clear who the fools really are.

Given that bond yields are vital to almost every asset class; we have re-edited a light-hearted note from mid-June, which sets out the key structures of our arguments. Central to them is a recognition that a lack of modern precedent requires us to go back much further than the 1970s where most modern economic analysis starts. Theories and models which fail to recognise this have struggled over the past 5 years, and they are still struggling today.

Feel free to contact us directly with any requests for further information, questions you may have, or if our explanations are totally unclear.

There's an old joke about a visitor to the West of Ireland asking an old man for directions to Dublin: *"Well Sir, if I were you, I wouldn't start from here",* came the reply.

Far from being anti-Irish, this joke is about the roughhewn insights of the 'Wise Fool'; if you want to achieve something, it's surely better to start from somewhere that maximises your chances of success. His emotions aroused, the visitor decided to ask the old man what he thinks about the outlook for inflation and US Treasury Bond yields.

The old man stops to think.

Aware that US and European interest rates are on the floor and that central bank balance sheets are bulging with assets. Aware that the Federal Reserve could pretty much muscle the USD yield curve into any shape it wanted. Aware that sustained demand-pull inflation is incredibly hard to produce in the midst of a protracted labour productivity stall. And aware that politicians are deploying full throttle to produce the inflation we are getting, the old man's mind starts to wander.

He knows that the monetary authorities with bulging balance sheets are in the parlance "locked and loaded" to fight inflation, if necessary. In the same way the US Army could technically crush domestic social unrest. But would it if this meant hurting too many citizens?

The old man's thoughts then drift to the USD natural real rate of interest (r*) still hovering around an almost unprecedented zero level. He realises that with inflation increasing, US CPI bounced to 5% in May, the Federal Reserve Bank (Fed) would need to hike rates by 200bps to return to monetary neutrality. A useful quantum of stimulus for a central bank wishing to retain firepower to fight future recessions. Firepower the Fed would very much like to retain.

Understanding that the Fed consequently needs a little inflation right now, it dawns on the old man that this need goes way beyond the Fed. With US and European public and private sector debt all at record levels, he calculates that almost 20-years of 4% NGDP growth would be required to reduce the real debt burden by 50%. The European Central Bank (ECB) needs some inflation even more.

But 4% trend-nominal-GDP (inflation + real growth) is a strange number right now: while eminently achievable in normal times, it is far from certain today, given the multiple semi-stable economic equilibria which stalk zero-r* worlds (see footnote). Some are good, some bad, the better ones mildly inflationary, the unpleasant ones deeply deflationary.

The old man's face now begins to darken. He remembers that in September 2019, USD money markets unexpectedly froze, and overnight USD interest rates briefly hit 10%. This spike was attributed to a coincidental US corporate tax payment date and the settlement date for $78bn Treasury notes. It, however, forced the Fed back into the breach with the addition of over $125 billion in liquidity and would mark the nadir of its tentative balance sheet normalisation program. The Fed had only managed to reduce its then record $4.5 trillion balance sheet in early 2015, to $3.8 trillion in August 2019. Beginning September 2019, its balance sheet was on the rise again, and the pandemic has pushed it up to $8 trillion and rising.

The old man knows that a vast central bank balance sheet with no reverse gear is a litmus test for monetisation. (Debt monetisation is the practice of a government borrowing money directly from its central bank instead of selling bonds to the private sector or raising taxes. Sometimes referred to as printing money to finance government spending. It is illegal for almost all central banks to engage in overt monetisation).

It is by now clear to him that vast tracts of the US credit market could freeze-over today as US money markets did in September 2019, should the market's rolling refinancing-need temporarily exceed the clearing capacity of the international debt markets. This seems likely at some point, given that the market's total clearing capacity is in itself largely a function of confidence in the Fed and other central banks.

Credit easing and simultaneous rate rises; is that even possible?, the old man wonders (Credit easing is when the central bank buys private sector debt to manage credit spreads and prevent financial markets from misfiring).

How would this work in practice?

He doesn't know if it would be legal for the Fed to interfere with managing private sector credit spreads while the direction of monetary policy travelled in the opposite direction. He is almost sure it wouldn't be legal for the ECB and is certain it would violate German Constitutional Law. Come to think of it, few central bank mandates stretch to altering the normal price discovery process within specific sectors and categories of borrowers: i.e., the central bank deciding who gets credit, who doesn't, and at what price.

More than a fig leaf would be required to deny that such activity is anything other than old-fashioned monetisation, with the twist that the central bank takes the political decision as to who gets it.

"Dear God!", the old man exclaims when, thinking about negatively yielding Greek debt, he realises that the ECB already decides who gets rich in the Euroarea and who doesn't, who was saved, and who was left to go bust and die on the pandemic battlefields.

One thing is , however, clear to the old man: Whatever creditor pecking order is ultimately established, it is hard to imagine that governments and their treasuries won't muscle themselves to the top of the monetisation queue.

By now the old man's eyes are soft and a tear rolls down his cheek. He briefly thinks of the Russian Revolution, before recalling that all the Reichsmarks in existence in early-1922 would have barely bought a beer and bratwurst just a year later. Economists say that the run-up to the great German inflation was surprisingly benign: prices were reasonably stable, stock markets were booming, and business failures were few and far between.

Just like today, easy money had suspended the Darwinian process of natural selection between strong and weak businesses.

But economists' gaze was too narrow back then, and it's even narrower today. The old man recalls the progressive dejection which overtook the German proletariat in 1921 and 1922 as they began to fear for their jobs and their ability to provide for their families. Others, meanwhile, grew filthy rich. German prices were rising all right, but it was the prices of prime real-estate, stocks, luxury items, and trophy assets, as opposed to the humble constituents of the workers' inflation basket.

This is the colour of monetisation, it always was, and always will be. This seems as obvious to the old man, as it must be to the Fed and other central banks currently engaging in 'tactical' monetisation to meet their given inflation mandates.

The old man can see that today's economic growth and recovery has shades of pre-Weimar inflation: the winners are similarly concentrated around the owners of capital including financial speculators, private equity, prime real estate, fine art, Bitcoin, luxury cars, yachts, junk bonds, and suchlike. All are supported by easy money. He knows that this process will continue, as it has always has; up until a point when the modern proletariat – those who sell their labour for a living – and especially the young, realise that they are getting a lousy deal while the holders of capital make hay.

It's hard to see what governments and central banks can do when that point is reached: damned by inflation if they monetise more, damned by social unrest if they don't.

Is there any precedent for today's circumstances? The old man's mind begins to wander, settling on the 1940s when the Fed was tasked with managing a restart of US economy from the ravages of war. Back then the Fed went a step further than today and took control of the entire yield curve, anchoring the short end at 0.75%, and the long end at 2.25%.

But then came a twist that many are forgetting today: Recognising that this Fed-dominated market had de facto turned all US Government debt into quasi 'demand obligations', investors deduced that only a 'horizontal' yield curve made theoretical sense. So, they began to sell the living daylights out of the short-end of the US curve (locked at 0.75%), buying the long-end (locked at 2.25%) with the proceeds. Net result was a tidy 1.5% annual gain at basically no risk. Not bad.

By December 1945, after the end of the war, the Federal Reserve would own an astonishing three-quarters of all outstanding US Treasury bills. By comparison, it owned fewer long-dated bonds than it did in early 1941. This was despite the US Government issuing massive quantities of longer-dated bonds to finance the war, which arbitrage bond investors had happily guzzled up.

Investors behaving in such a self-interested way makes sense to the old man. Because he realises that what most people, businesses, politicians, and governments crave more than anything else is wealth, power, and status. And because central bank money and credit are the biggest single influence on how wealth is rising and declining today, he knows that those who don't understand the arc of history, who don't understand where money and credit come from and how they truly work, have little chance in forecasting the journey of our economies and financial markets into an uncertain future.

Finally, recognising that the financial 'talking heads', TV experts, and frowning bank strategists rarely getting anything truly right, the old man lifted his head.

And having foreseen the dangers, the monetary battles, the debt restructurings, social change, and possibly even wars which lie up ahead, he replies:

"*Well Sir, I would short bonds and credit alright; but if I were you, I wouldn't start from here".*

Quite where he would start, he's not so sure. But being Irish, I know what he means!

Note: the causes and dynamics of economies where the natural real rate of interest (r*) falls to zero are complex. Two key points are however worth bearing in mind: (i) they occur in extremely rare circumstances when labour productivity stalls; labour productivity being the ability to produce more given the same inputs of labour and capital, and (ii) the rules of zero-r* economies are radically different to normal times. Painting red lipstick onto the economic models from the 1970s–2010s just doesn't cut it, and we've all seen the litany of terrible forecasts which followed.

For any enquiries or comments you may have, please contact us at info@eriswell.com. We look forward to hearing from you.

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