Things break

Chris Watling | Longview Economics | 07 February 2018

Every generation or so, things (in the economics world) break. As Charles Goodhart, professor at the LSE, reminds us:

> "…**since the 1950s** we have seen **three major "fashions" wax and wane**. From the 1950s to the mid-1970s, the focus was on labour markets and relative bargaining power, with little reference to aggregate demand. From the late 1970s to the 1990s, it was on money and monetary aggregates. And from the 1990s onwards, it has been on the NAIRU (non-accelerating inflation rate of unemployment) and the determinants of expectations – think of the prominence of forward-looking Phillips curves in today's dominant analytical frameworks. Could it be that we know less than we think? Might we have overestimated our ability to control inflation, or at least what it would take to do so?"[1]

Indeed, Goodhart goes further in an article in the UK's *Daily Telegraph* newspaper last year:

> "In most academic studies of the efficacy of monetary policy, none of the above matters. All that matters is the direct link between riskless official short-term rates, and future expectations thereof, and the real economy. An influential paper "Gauging the ability of the FOMC to respond to future recessions" was published this year by David Reifschneider, an economist at the Federal Reserve Board. In that paper, the words "bank", "money supply" and "credit" never appear! Has mainstream monetary economics lost its bearings?"[2]

Goodhart's (own) Law (from 1975) is consistent with that sentiment:

> "The observation... that when an empirical regularity starts to be exploited as a basis for economic policy, it is liable to break down."[3]

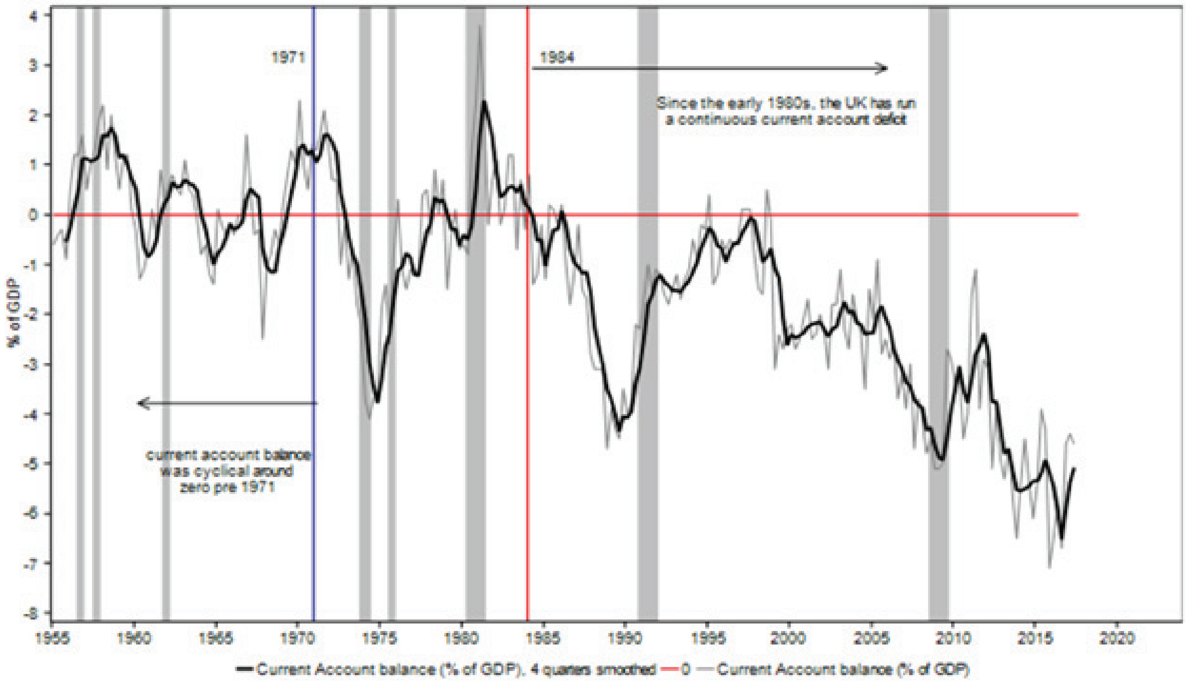
The first quote above highlights that we're probably at or close to one of those once-in-a-generation moments. Increasingly economists, policy makers, opinion formers and the electorate (through the ballot box) are questioning the efficacy of the current system. In the UK, the rise of Jeremy Corbyn is an illustration. In the US, Trump reflects the anti-establishment vote. In France, its Macron (and if he fails, probably Le Pen). In Austria, it's the 31-year old Christian Kurz whose party won the October election. All of these leaders represent a vote against the old order. All of them illustrate an electorate that doesn't view the current system as working for them and all of them have come from nowhere (politically speaking, at least).

At the heart of the failure of the current system is a failure of the current international monetary system, and the associated economic policies of the past 20 to 30 years. Indeed, the history of the world's international monetary order is a history of change - with change occurring on average every 40 years. This current system (i.e. the US$ fiat money system) is, therefore, long in the tooth at 46 years old.

Not only is it old in years, it's also the first international monetary system (other than during and immediately after war years) which has endured without a monetary anchor. The absence of a monetary anchor is one of the key factors which has facilitated the debt super cycle of the past

30 years, as the absence of that anchor allows money creation and the build up of large economic and financial imbalances. It's no coincidence, for example, that the UK's current account deficit is the largest on record (Figure 1). Under an anchored monetary system (e.g. like a gold standard), imbalances can't build to such high levels.

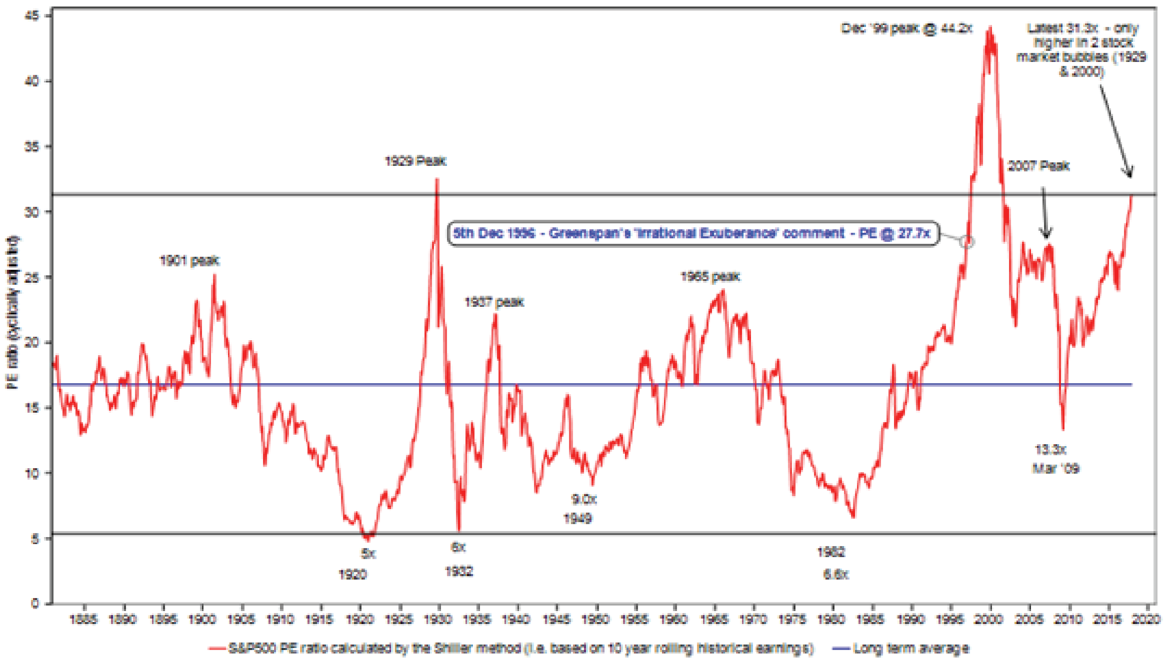
Figure 1: UK current account balance as a % of GDP)



Source: Longview Economics, Macrobond.

Equally, two major peaks in the Shiller PER (Figure 2 overpage) in the past 20 years are not related to changes in accounting standards and methodology, as many argue, but primarily linked to massive liquidity provision under this current system (especially since 1997). As central banks have removed assets from the global financial system - for example, the Swiss National Bank buying US equities with newly created money - the pool of available assets has shrunk. Economics 101 supports the expectation therefore that prices should be high and valuations rich, reflecting scarcity of supply.

Figure 2: US Shiller PER – 1880 to present



Source: Longview Economics, Macrobond.

Taking this line of thought to its logical conclusion, today's problems are here to stay until the root causes of the problem and the debt super cycle are addressed. At the moment, other than changing political winds, there's little concrete sign that any meaningful progress has been made on that front (albeit some policy makers are starting to question the current system).

As such, and as Stan Druckenmiller reminds us, liquidity remains the key to this bull run:

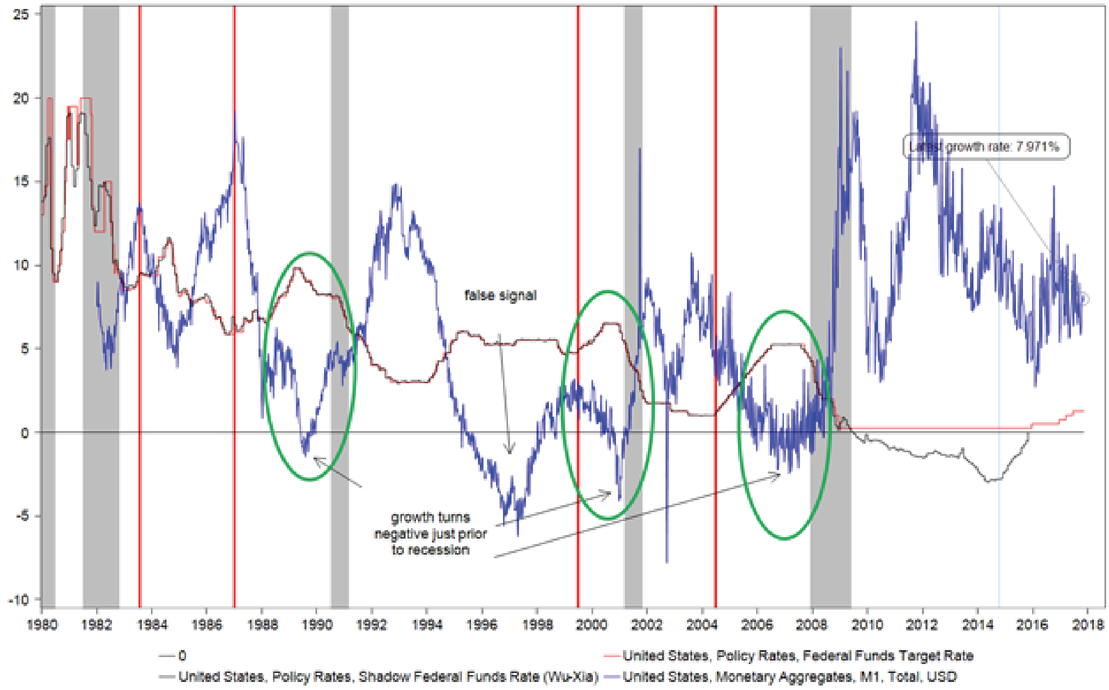
> "The major thing we look at is liquidity... Contrary to what a lot of the financial press has stated, looking at the great bull markets of this century, the best environment for stocks is a very dull, slow economy that the Federal Reserve is trying to get going... Once an economy reaches a certain level of acceleration… the Fed is no longer with you… The Fed, instead of trying to get the economy moving, reverts to acting like the central bankers they are and starts worrying about inflation and things getting too hot. So it tries to cool things off... shrinking liquidity..."[4]

And it's at that juncture that bull markets tend to end. Or, as Allan Meltzer, the renowned Fed historian (author of "A History of the Federal Reserve, Volumes I – III") puts it:

> "By following a Phillips Curve, FOMC actions increase variability. The Fed responds to the unemployment rate and ignores inflation until inflation rises. Then, it ignores unemployment until unemployment rises."

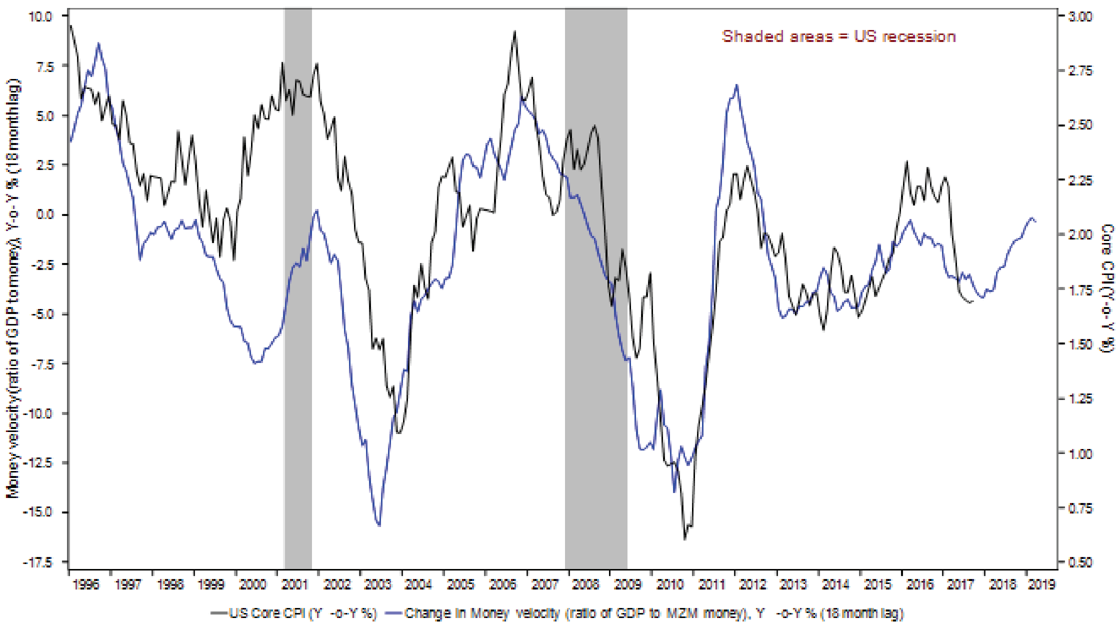
Hence, watching monetary (and equivalent) indicators is key. One of those with a good track record is M1 money supply growth. As the Fed overtightens, M1 money growth turns negative. Typically, that happens between six to 18 months ahead of a recession (Figure 3). It's also around that time that bull markets start topping out and bear markets begin. Currently, M1 is still growing at 8% per annum. For now, therefore, the bull trend should persist.

Figure 3: M1 money supply growth (Y-o-Y %) vs Fed Funds rate, shown with US recessions (in grey)



Source: Longview Economics, Macrobond

Figure 4: US Core CPI (Y-o-Y, %) vs Change in Money Velocity (using MZM*)



Source: Longview Economics, Macrobond. Note: *MZM is a broad measure of money – defined as M2 less small-denomination time deposits plus institutional money funds

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If our view on a re-acceleration next year of US inflation and credit growth is correct, however, over the course of 2018, the Fed should pick up the pace of rate hikes (relative to market expectations). Hence, all eyes should be on M1 and other monetary, financial and credit conditions indicators.

ENDNOTES

1. Claudio Borio, BIS, OMFIF lecture 22 September 2017, https://www.bis.org/speeches/sp170922.pdf.

2. Daily Telegraph, 3rd Oct 2016, "The internal contradictions of QE ... or should it be Quite Erroneous"

3. Oxford Dictionary of Economics, 2003 edition.

4. Druckenmiller 1988 Barrons interview.

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