NORTHEAST SEQUOIA
PRIVATE CLIENT GROUP

Is It Really Different This Time?

Driving into the office this morning, we were listening to Bloomberg Radio recap some of their more thought provoking interviews from the World Economic Forum, held in Davos, Switzerland. The one interview we can't stop re-watching is with Bob Prince, CIO of Bridgewater Associates.

Our big take-away from the interview was that following brief period in global ***monetary tightening*** (i.e. the raising the Fed Funds Rate while simultaneously shrinking the Federal Reserve's balance sheet) in late 2018, central banks quickly adapted to ease monetary conditions both here and abroad, in a move to reverse a sharp sell-off in global equities. These actions, according to Mr. Prince, ended the typical boom-bust cycle which will no longer be characterized by shifts in monetary policy (central banks lowering or raising interest rates to combat inflation or recession) and credit (ability for individuals or corporations to easily borrow money).

In Mr. Prince's view, central banks are stuck. Central banks cannot cut short term lending rates (our Fed Funds rate, for example), because there is not enough room to reduce rates further if the US or other developed economies enter a recession. Nor should they, as here in the U.S. the economy is exhibiting relatively solid employment trends, while several other economic data (in opposition to our more forward-looking or topping concerns) supports the case for a solid economy. At the same time, despite an inflation rate that is close to target, the U.S. will not dare raise rates, to avoid a 20% drop in equities like we saw in late 2018.

But in listening further to Mr. Prince, we were left confused as to what Bridgewater, institutional or individual investors should do, especially as most readers of this note do not run a global multi-strategy hedge fund. So, while we concur with Mr. Prince that central banks are stuck (a position we have held for the better part of 18 months), we believe investors still need to de-risk in the near-term.

When somebody of Mr. Prince's stature and experience uses words and phrases such as: stagnation, printing of money, geopolitical conflict, slow growth, and negative real interest rates; we scratch our heads into thinking, "Yes, now is the time I want to be overweight stocks!"

As we point out in our 2020 Outlook, we believe there are several unintended consequences of trying to ignite economic growth through monetary easing. First, lower central bank short rates pull down longer duration government and corporate credit yields. In turn, this results in reduced savings or, worse yet, causes investors to take on undue risk as they stretch for yield; this typically does not end well. Next, with so much liquidity in the global economy, the risk of inflation rises. Money is worth less when there is too much of it in the economy. Further, this compounds our initial concern, as the reduced savings level is worth even less. Also, labor is worth less as workers face reduced spending power, despite working the same number of hours. Third, with global rates already so low, there remains little slack to cut rates further if a recession were to take hold (as we pointed out earlier). For example, the typical Fed Funds interest rate cut here in the U.S. to promote growth during recessions is about 500bps or 5%. The current Fed-Funds rate post the recent “mid-cycle” adjustment is only 175bps, leaving five to six 0.25% cuts in short term rates if the economy stalls. Finally, we are also concerned regarding booming deficits and aggregate debt levels caused by next-to-nothing borrowing rates, **hence we doubt if anything is different this time**. Moreover, this could potentially lead to the acceptance of modern monetary theory (MMT), creating monetary imbalances and similar conditions that drove the 2007-2009 global market sell-off. We'd love to hear your thoughts.