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Saved by Zero

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"Maybe someday, saved by zero
I'll be more together
Stretched by fewer thoughts that leave me
Chasing after my dreams, disown me, loaded with danger
So maybe I'll win (saved by zero)
Maybe I'll win (saved by zero)

Saved by Zero
Artist: The Fixx
Album: Reach the Beach

Source: bigtrial.net

Background

I am showing my age when I tell you that I grew up listening to the band The Fixx during my high school days. Songs like "Red Skies," "One thing leads to another" and "Saved by Zero" were some of their bigger hits.

So, over the weekend I was catching up on reading, watching Tiger win the Masters for a fifth time and getting ready for Holy Week, when it occurred to me that the likelihood of central banks raising interest rates anytime soon looks relatively low. In fact, it appears that the ECB and the Fed are traveling down the path that the BOJ (Bank of Japan) took 20 years ago. Long before the U.S. and Europe embraced radical monetary policies over the last decade during the global financial crisis there was the Bank of Japan.

Back when the American economy was running hot under Federal Reserve Chairman Alan Greenspan and the Euro was making its debut on the world's stage, the BOJ adopted zero interest rates, taking central banking into uncharted waters.

Once the BOJ realized that was not working, it doubled down with a quantitative easing program to flood the banking system with cash. At the time, the BOJ's strategy was seen as both extreme and peculiar to Japan – that is until the financial crisis forced the Fed and ECB down similar paths.

Even though I still believe the US economy is growing (albeit slower this year) and there are positives domestically, the Fed was told by the equity markets in Q4 2018 (and the White House) not to raise interest rates. This happens concurrently as the European Central Bank (ECB) is once again contemplating negative interest rate policy (NIRP).

So, will economies be saved by zero?

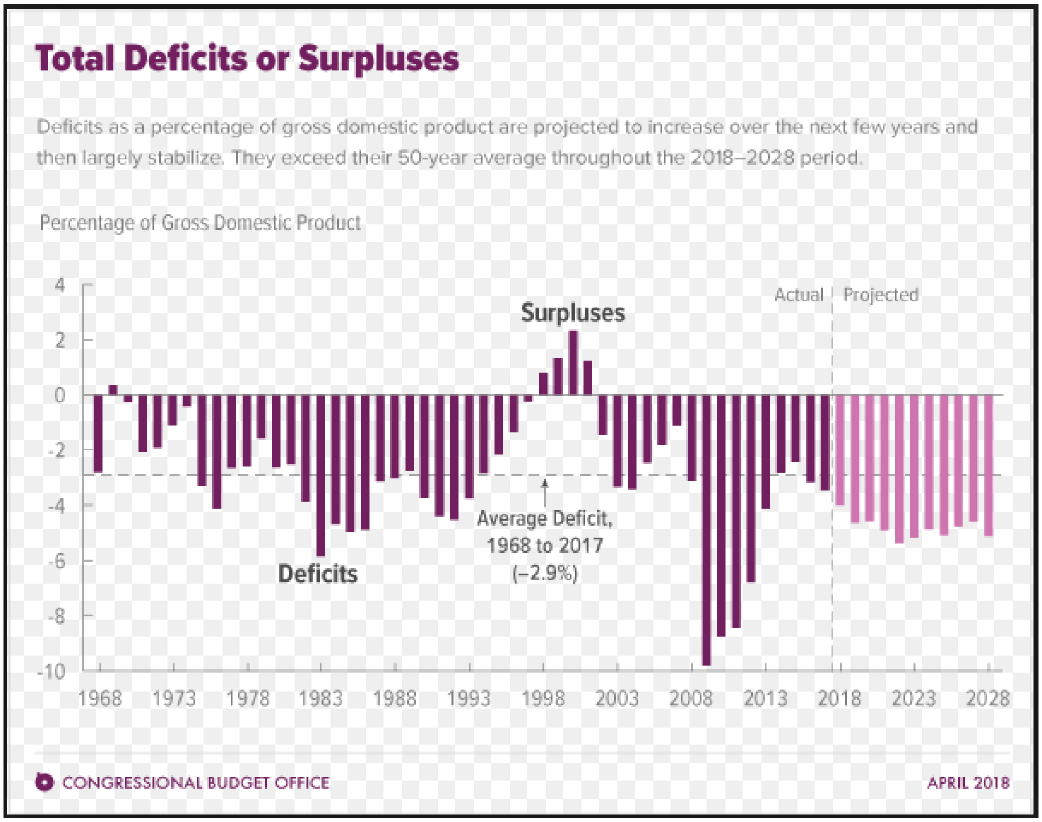
The New Normal

Ever since major central banks cut short-term rates down to zero and subsequently purchased huge volumes of bonds as part of their quantitative easing (QE) operations, central bankers and economist have debated when and how fast the "exit" from these unorthodox monetary policies would be.

But, like Japan, the ECB and Fed have learned that an exit plan is still far off in the distance. Developed-economy interest rates are stuck far below pre-crisis levels and are likely to remain so in the future. Germany's five-year bond yield of -0.38% and ten-year bond yield of 0.06% (as of April 16) signals market expectations that the European Central Bank will maintain zero policy rates not just until 2020 (the ECB's forward guidance) but out past 2024. After 20-years of zero rate policy Japanese bond yield imply zero or negative rates for even longer with the 10-year JGP priced at -0.03%. And while 10-year yields in the US and the United Kingdom are positive, both suggest minimal or no increases in policy rates for at least 5 years.

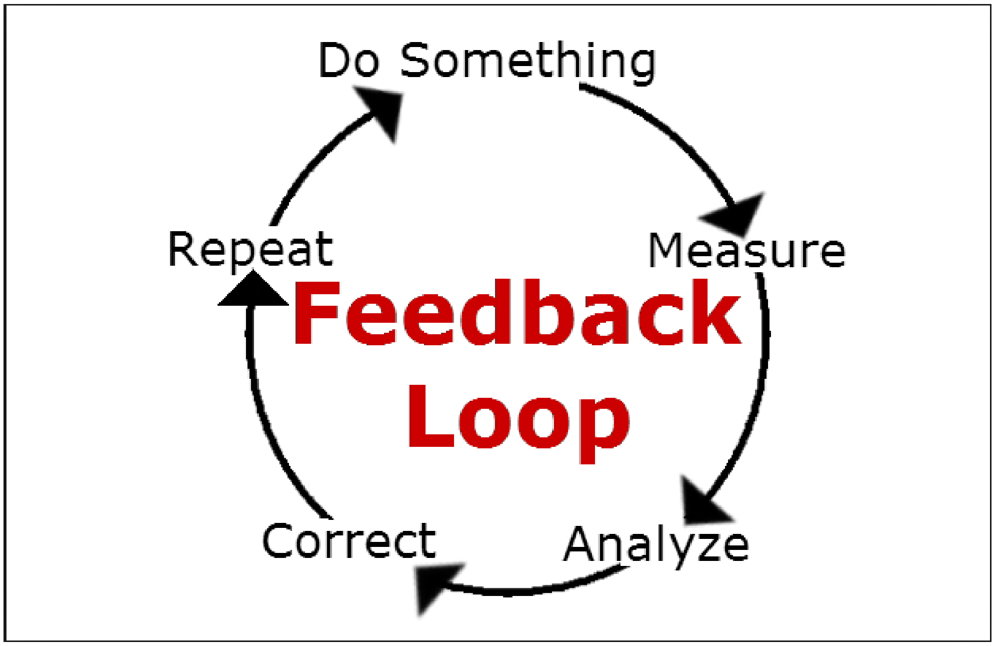
Now the truth is, some of these central bank actions have helped to increase money supply (M1 & M2) and created asset inflation in the form of higher equity markets. Over the last four years massive fiscal expansion has been partly or wholly financed by central bank money. As an example, the US fiscal deficit rose from 3.9% of GDP in 2015 to 4.7% in 2018 and is projected to be 4.5% in 2019. Over the same period, China's grew from below 1% in 2014 to over 4%, and Japan's remained around 4%. This helped the global economy recover somewhat in 2016-2017 because the world's largest economies rejected the idea that high public debt burdens made further fiscal expansion impossible.

But the impact of that stimulus has faded. US growth is slowing as the one-off impact of President Trump's tax cuts wear off. The US is now stuck with yearly budget deficits of over 1 trillion dollars (see the CBO's projections below). On the other side of the world, China is struggling to curb excessive leverage and to manage the impact of Trump's tariff increases on exports. They have now created tax incentives for businesses to try and stimulate the economy and confidence. In both Japan and the Eurozone, growth is slowing in the face of declining external demand.



Source: CBO

It seems to me that central banks have put themselves into a "feedback loop." Now for those of you who haven't heard that term, a "feedback loop" is a term commonly used in economics to refer to a situation where part of the output of a situation is used for a new input. Both positive and negative feedback loops may exist in economies.



Source: shsu.edu

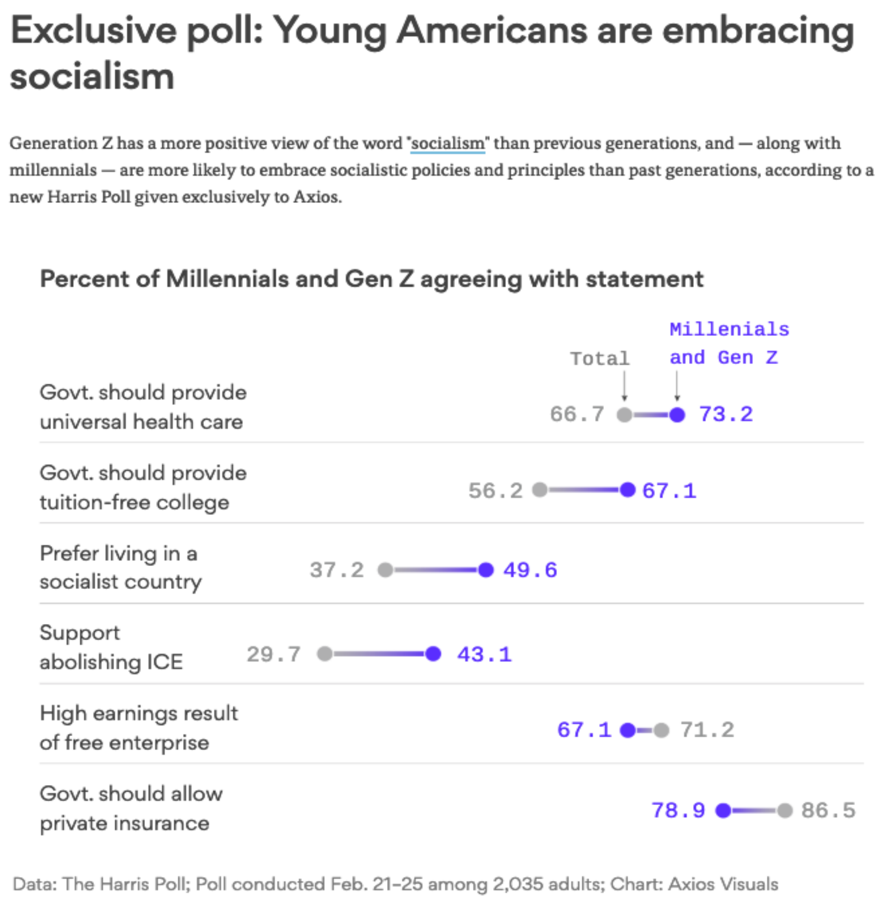
A Turn to the Left

When asked about the political and practical aspects of monetary policy, I always must disclaim that I "equally dislike both political parties" before answering. I explain to clients that low interest rates have distorted the economy and without the stabilization of interest to normal historical levels, it is likely that left-leaning proposed variants of monetary finance are likely going to gain traction. This is simply "cause and effect." Secondly, as I look at the population of young American's who come out of college with low-paying gig-economy jobs, insurmountable amounts of debt and priced out of starter homes, it's no wonder they like the idea of social programs.

So, it's not surprising that proponents of "modern monetary theory" (MMT) argue that money-financed fiscal expenditure should be the normal mechanism for managing nominal demand (i.e. government debt doesn't matter, and governments can print their way to economic prosperity). Or that monetary finance could be an option for financing socially and environmentally desirable investment, e.g. the "Green New Deal". Both are left leaning ideas and ones that 20 years ago would have been considered irrational.

In fact, many of the 2020 Democratic candidates are presenting progressive/social ideas as part of their platform. Presidential hopeful Andrew Yang went so far as to center his platform around a proposal of universal basic income that he calls "The Freedom Dividend," which would provide $1,000 every month to every American older than 18, independent of their work status or other factors.

These types of ideas are socialist in nature and young people are listening. As you can see in the illustration on the next page, Harris Poll did a recent study of Millennials and Gen Z about their views on things like the word "socialism" and universal healthcare (single-payer system). For those on the right, they should be very concerned that a more European style of economic governance is acceptable to the younger generation.



Source: The Harris Poll

Its important to understand that the insight behind these propositions – that governments and central banks together can always create nominal demand - was explained by Milton Friedman in an important 1948 essay. Friedman has again become the poster child for government intervention on almost everything economic. So, to understand Friedman is to understand why socialism is gaining traction in the US. But it's vital also to understand that excessive monetary finance is hugely harmful, creates a negative feedback loop and is dangerous to view as a costless rout to solving all the economies long-term challenges. This is something that needs to be explained as the second side of the argument to those wanting even more government intervention.

The "Zero" Cost

For those who think that Modern Monetary Theory (MMT) or a zero-rate policy is the answer, I will always point them to the cost of such a policy. Take for example the part of America that saves money.

American savers, those who save money, have missed out on an estimated $500 billion to $600 billion in interest on their bank accounts as a result of the Federal Reserve's, zero to low interest rate policy after 2008. The Fed Funds base rate affects what interest rate banks pay savers and what banks charge for loans to consumers. A lower fed funds rate means banks pay savers less in interest, even as they charge consumers less for auto loans and 30-year fixed mortgages.

This also forces those who rely on fixed income to move to riskier assets (equities or high-yield bonds) in order to achieve the necessary return on income to support their retirement. The world's safest bonds - $10 trillion worth – now offer *negative* interest rates (note: most of those bonds trade in the Eurozone), meaning investors pay to hold them. So low interest rates are making it difficult for investors to earn decent returns in fixed income (at least in absence of taking higher risk).

This is a distortion of the markets, pure and simple.

So Maybe We'll Win…Saved by Zero

One of the things I love about LCP is that we have very bright people working at our firm. Last week, I was with a colleague, and we debated the idea of zero rate policy and the risk of the US or Euroland falling into the same type of economic loop as Japan did following their zero-rate experiment 20 years ago.

My colleague thought it was likely and correctly pointed out that the US and Japan are very different (Japan has an economy based around saving versus one which is based around spending like that of the US) and innovation is far more robust in the US versus the land of the rising sun. All of these points are true.

But for all the macro-economic positives that are different between the two countries, there are two macro-economic issues that are undeniably similar; 1) As a whole, the US population is getting older like Japan's (note: in Japan, more adult diapers are sold then baby diapers). This generally creates a drag (over time) on an economy. 2) Politicians on both sides of the isle are embracing more government spending and entitlements. Although this may create a short-term stimulus, its like a drinking a can of Coke, the sugar and caffeine are just a temporary "pick-me-up." Japan's government did it, and now we are following suit.

Clearly if history teaches us anything, it is that a monetary sugar rush and bottoming out is exactly what Japan's economy has experienced in the last 20 years (see below) as evidenced by the Nikkei 225 Index.

Source: Macrotrend.com

Could things be different here in the US and could we be saved by a zero or low-rate policy? Anything is possible. I, like others, are skeptical the PhDs at the Federal Reserve know what they are doing. But maybe they get it right this time (what do they say about a blind squirrel and an acorn?). Perhaps investors and savers, themselves will correct these distortions. Maybe we will find candidates on either side of the isle that balance some of the challenges constituents face today with moderate capitalistic ideas versus looking to the government to try and solve for everything. Anything is possible.

But make no mistake, this will be a long process.

Until then it's important to understand history. It's important to understand the challenges that voters face, both young and old. Lastly, it's important to be nimble in the investing world and working with your Lakeview advisor to understand that a zero or low-rate world is where we are likely to be for a little while longer.

Until next time. Be well.

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