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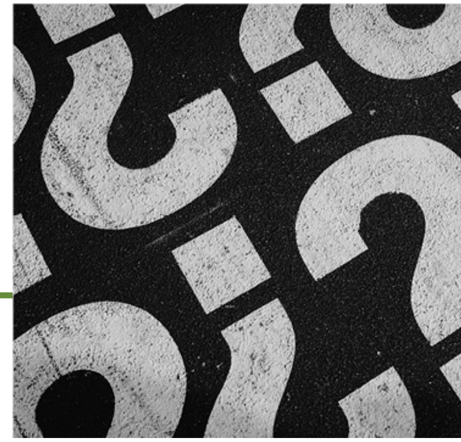
MARKET
SIGHT LINES



Tough Questions on Policy

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Albert Einstein once said, "Learn from yesterday, live for today, hope for tomorrow. The important thing is not to stop questioning." When my team and I try to make sense of the current macroeconomic and market environment, we often ask ourselves the question: "What do we, and others, think about ________?" We're fortunate to be surrounded by intelligent and capable colleagues, we subscribe to a number of quality research services, and we are able to draw from who we believe are the best minds of the "buy-side" investment industry, meaning those firms that provide us and our clients investment management products like mutual funds and separate account strategies. We draw on all of these experts as we formulate our questions and try to answer them.

In this week's Sight|Lines, we ask some initial, important questions about the current environment, our fiscal deficit and debt, and where we go from here. What is different about these questions? They will likely take years to answer.

"Learn from yesterday…" – What are some potentially analogous periods in U.S. history? How is this environment similar? Different?

The 2020 recession is unique, a forced shutdown leading to the shortest recession in history, just two months. Many, though, are comparing the current environment to the post-World War II era and the 1960s/1970s, each a period of high inflation.

During World War II, the U.S. built up significant debt to fund the war. Debt sat at 106.3% of GDP, compared to 100.1% today. And, in the post-war period, inflation rose significantly due to food shortages and the removal of the price controls implemented during the war. The Federal Reserve (Fed) was also not allowed (by the Treasury) to raise rates, which added to the inflationary pressures.

Inflation took hold from the mid-1960s to the late 1970s. Spending increased from President Lydon B. Johnson's Great Society programs, which were designed to fight hunger and poverty, and included Medicare, civil rights legislation, and federal aid for education. Ultimately, the Fed made policy errors during this period that contributed to inflation. Among them were: (i) a greater focus on maximizing employment, in response, in part, to the "painful memory" of very high unemployment in the 1930s, and (ii) the collapse of the Bretton Woods system, the final link of the U.S. dollar to gold.

But we've learned from the past: The Fed considers its 2% inflation target as a primary objective. Unlike the past periods like World War II and the 1960s/1970s, we expect the Fed to be aggressive to try to keep expected long-term inflation near its 2% target.

“…live for today…” – The Fed appears to be using all of its tools to support the recovery. Can it rebuild those tools before they are needed next?

Some argue that the Fed has a tool whenever needed – increasing the money supply by expanding its balance sheet – so that rebuilding tools may be unnecessary. But most observe that the Fed will eventually have to reign in its policy by eventually tapering its securities purchases and raising the fed funds rate. An important threshold question: Will the Fed have the nerve to tighten monetary policy and slow down the expansion, especially if such action risks triggering a recession? Many believe the Fed may tighten too late, risking higher inflation and/or a lack of monetary tools when needed.

“…live for today…” – What are some related risks in the current environment?

We, along with our experts, have identified a number of related “tail risks” in the current environment. They include: (i) runaway inflation; (ii) the development of asset bubbles and a corresponding, severe correction; and/or (iii) interestingly, the potential for amplified volatility, triggered by mechanical trading responding to a more modest move, and risking a much greater decline than fundamentals would suggest.

“…hope for tomorrow.” – What are some risks for monetary or fiscal “policy error” in the near to medium term?

As described above, on the monetary side, the Fed risks error by keeping its accommodative policy too long, triggering inflation and lacking tools to combat future economic trouble. On the fiscal side, a meaningful risk is the current focus on debt service, rather than debt levels. Despite the exploding levels of the deficit and debt, given lower interest rates, the cost of servicing the debt is not outsized, as a percent of GDP. As an issuer, the U.S. government enjoys the benefits of our reserve currency and demand for U.S. Treasury debt as a “safety” asset. Less demand, or other forces, could drive interest rates higher, spelling trouble for our debt servicing costs.

“…hope for tomorrow.” – How can our government reduce its debt back toward more traditional levels?

As we engage with our experts, their answers to this question signal uncertainty, meaning there is not yet a clear path to a solution. Some common ideas include: (i) austerity, meaning higher taxes and lower spending – not likely in the near-term political environment; (ii) growth, meaning if GDP growth exceeds debt servicing costs, debt as a percent of GDP will decline over time; or (iii) financial repression, meaning policies that direct funds to the government that otherwise would go elsewhere. One policy example is keeping interest rates below inflation, which rewards lenders at the expense of investors. Some say our government may just tolerate higher debt levels.

Conclusion

U.S. policymakers have taken historic action to combat the coronavirus pandemic. Most view these as necessary steps for recovery, but many are also asking how we will unwind this accommodative policy and pay for the excess spending. Above we have offered initial thoughts about some important questions. These questions will be expanded and refined over time, and ultimately it will take many years for us to learn the answers.

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