TAG ASSOCIATES

Beyond Wealth

Thought Leadership: Loose Fiscal and Monetary Policy

by Ted Katramados

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- Fiduciary that always acts in our clients' best interests
- Over $8B* in assets under management across all asset classes
- Over 70 TAG professionals deliver the highest level of personalized attention and service to 110 clients

- * As of 12/31/2019

Introduction

Investors are understandably concerned about what to make of the current state of global financial markets as the Coronavirus pandemic continues to ravage lives and the economy. There has been a lot of debate about the Federal Reserve response, the impact on markets, the inflationary and currency cost, the future, and how best to position portfolios to both protect capital and take advantage of opportunities. This piece looks at each of those topics.

Fiscal & Monetary Stimulus Response to Coronavirus

Thus far, there has been over $8 trillion of global fiscal and monetary stimulus in response to the economic fallout from the Coronavirus, and more is likely. Japan and the United States have led the way in terms of spending, but many nations are involved as the fiscal and monetary stimulus has in some ways been coordinated. In addition to transfer payments such as stimulus checks, other policies have included Quantitative Easing (QE) and loan guarantees. The world has been introduced to the concept of Modern Monetary Theory (MMT), dramatically increasing the money supply by giving money to mostly everyone in order to fight a deflationary shock, also known by its nickname, "helicopter money". For example the U.S. Government has distributed money to individuals and families via the stimulus checks mentioned above and to businesses through PPP (Paycheck Protection Program) loans. In the 8 weeks following the peak of the crisis in mid-March, U.S. money supply (as measured by M1, or money in circulation in the U.S.) increased by 25%. This is unprecedented in terms of size and speed.

In the U.S., one of the few bipartisan policies is expansionary fiscal and monetary policy. Only a few diminishing voices seem to care about debt, which has now exceeded the nation's GDP. The reason that the Congress and the Federal Reserve feel emboldened to pursue such a course is that they believe the U.S. Dollar is the only game in town. Generally, printing money weakens a country's currency to the point that it creates economic instability. In the case of the U.S. however, the dollar is the world's reserve currency and tends to strengthen in times of crisis, so no policy maker feels burdened by printing more of it. Until there's a groundswell of opposition to this approach, the policy is likely to continue.

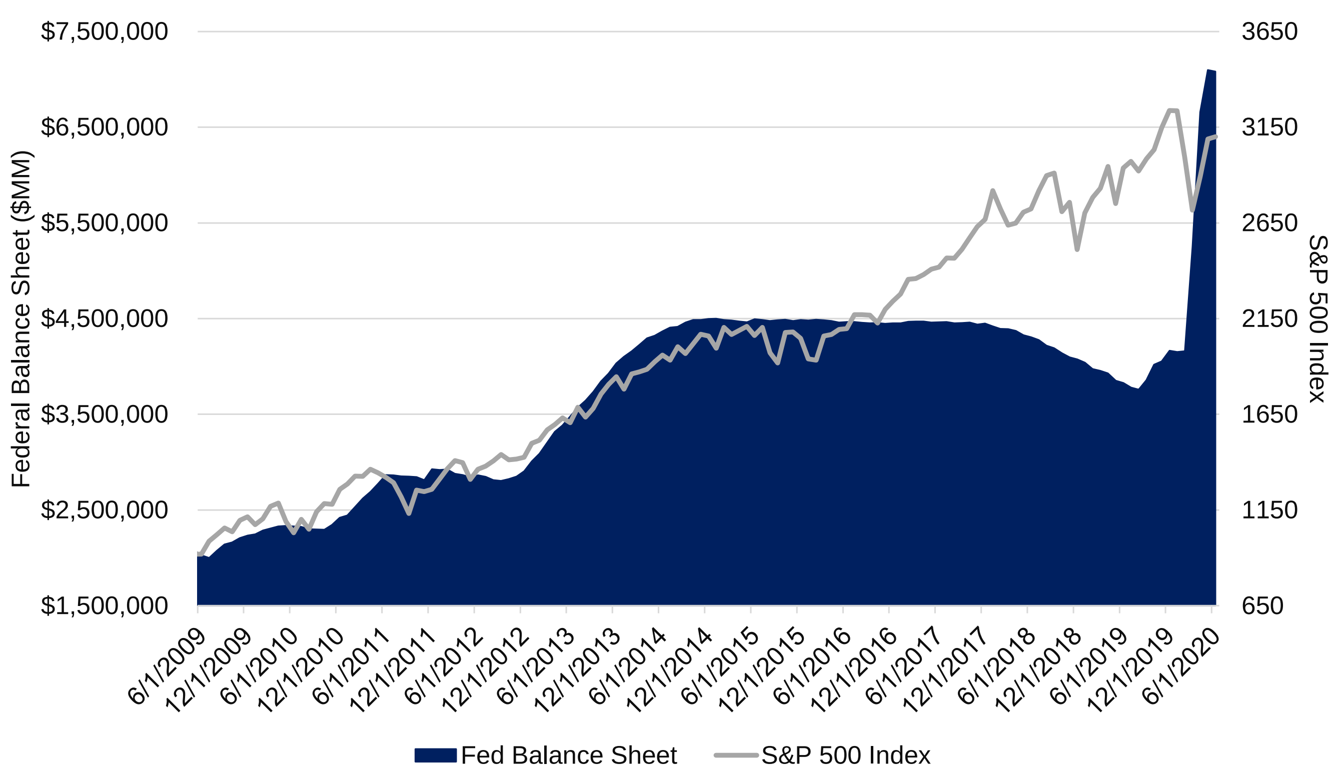
The Federal Reserve's balance sheet has exploded over the past decade. Prior to the financial crisis in 2008, the Fed's balance sheet sat at $1 trillion. Beginning that year, it increased to $4.5 trillion. The Fed claimed that it would eventually reduce its balance sheet as markets stabilized, but this never happened. Despite a record bull market in U.S. equities, decades-low unemployment, and low inflation, the Fed only unwound about 15% of its balance sheet by 2018-19 before market volatility and a repo funding crisis in September 2019 caused it to first halt its unwind, and then begin the QE program again. The Coronavirus pandemic has resulted in another explosion in the Fed's balance sheet to $6.5 trillion and counting. If this is never unwound, it would result in a permanent expansion of the money supply which could lead to inflation and a negative shock to financial markets.

Current Impact On Financial Assets

The Fed began its 2020 buying program in response to the Coronavirus crisis by purchasing U.S. Treasury and Agency securities, like it did in 2008-09. Unlike 2008-09, it then expanded its buying program to include investment grade corporate credit and high yield ETFs, which is new territory. Some market participants believe it is only a matter of time before the Fed purchases Equity ETFs similar to the Bank of Japan, which began doing so in 2013, and would be yet another unprecedented move.

Regardless of the specific instruments purchased, capital has found its way into U.S. equities and other risk assets for 12 years, leading to record-high prices and near-record valuations by several metrics. An interesting relationship to observe is that of the S&P 500 index and the Federal Reserve balance sheet, which have a correlation of almost 1.0 since 2008, indicating that equity returns since then may have been driven by more than markets fundamentals (see chart below). Although the S&P 500 Index continued to rise after the Fed stopped increasing its balance sheet in 2016 there was clearly more market volatility. It's obvious that the Fed buying programs had a direct impact on market values from 2009 through 2016 and again beginning in March 2020.

Federal Balance Sheet vs. S&P 500 Index



Provided by Bloomberg as of June 30, 2020

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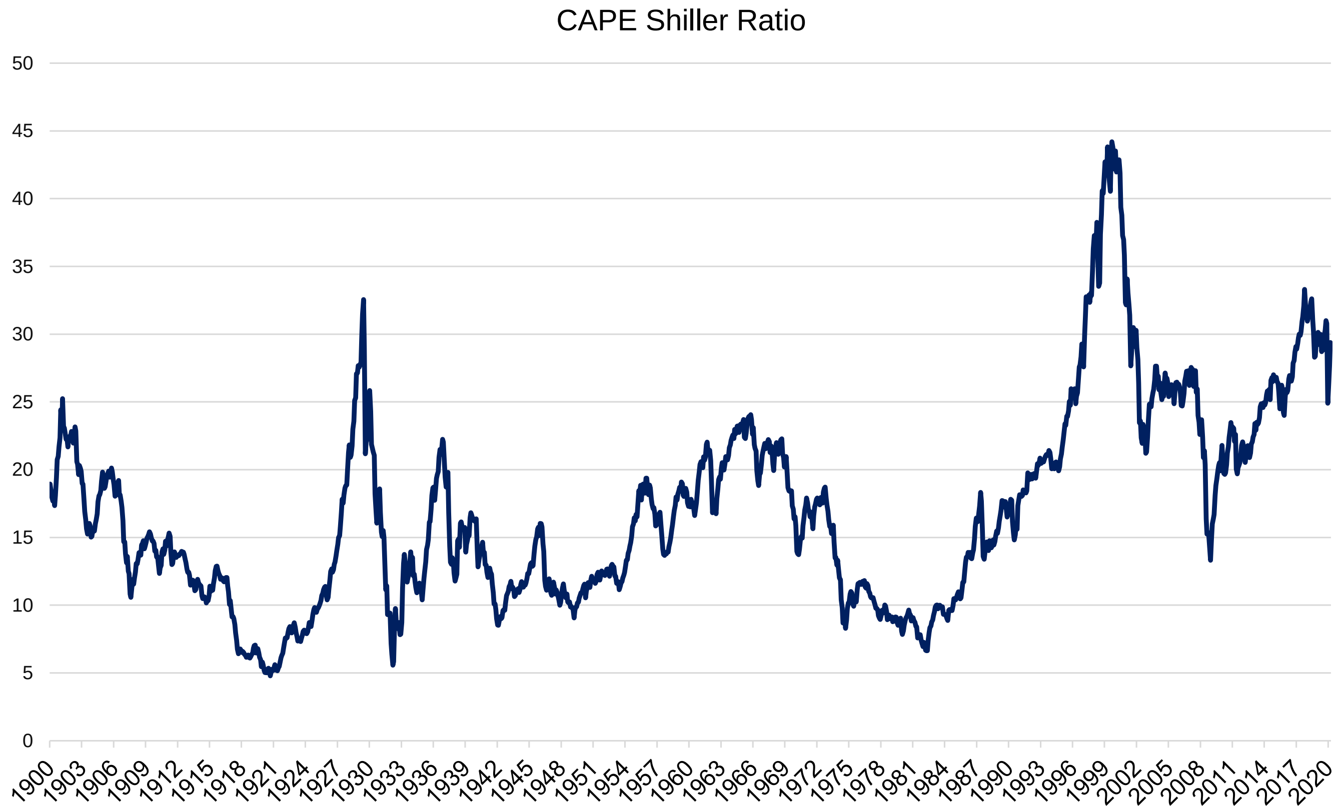
Despite the sharp selloff in equities in February and March of 2020, the sharp rally since has U.S. equities back within range of the all-time highs reached in February. By measures such as CAPE Shiller P/E (which seeks to cyclically-adjust earnings) and market capitalization-to-GDP (the so-called Buffett Indicator), U.S. equities are at or near their most expensive levels ever (see charts below).



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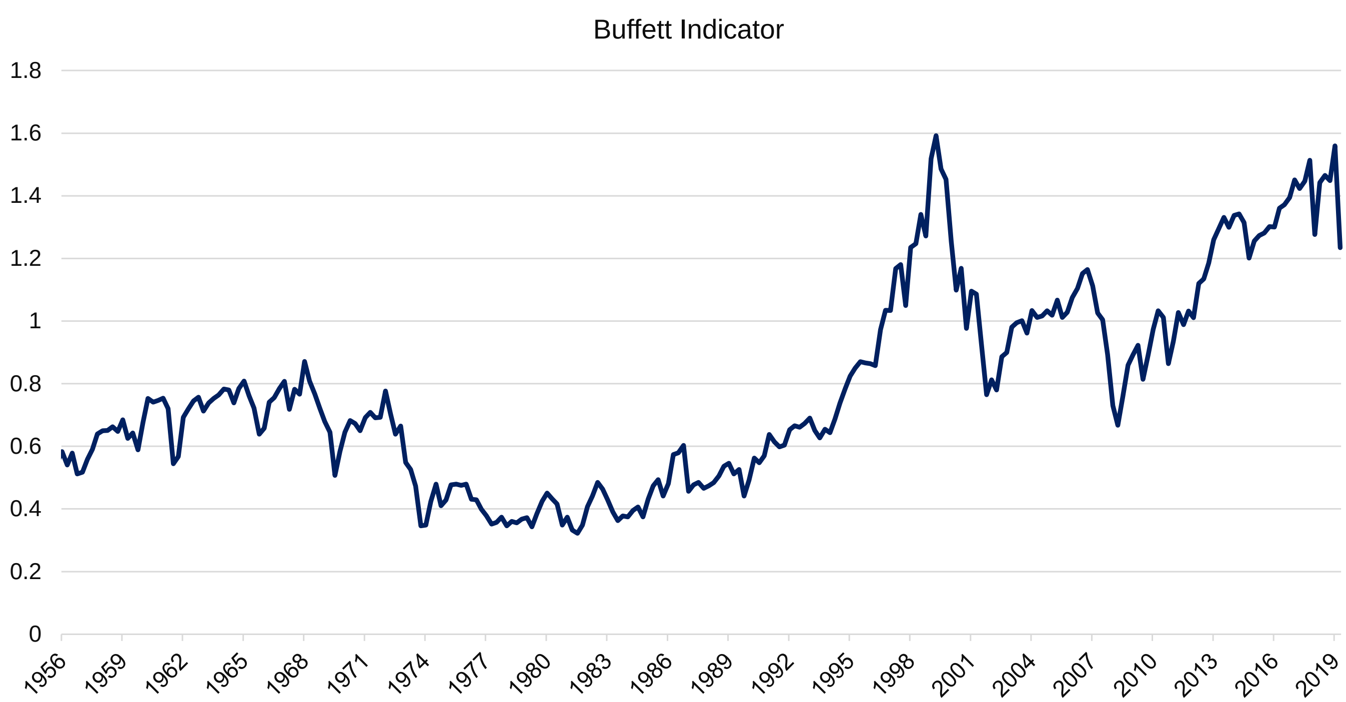

Provided by FRED, as of January 31, 2020

U.S. Treasury yields are also near all-time lows, meaning that their prices are near all-time highs. Despite these elevated levels for both stocks and bonds, the Federal Reserve continues to print money through its purchases of more and more securities. One wonders what exactly the Fed is supporting when price levels are so high to begin with. Precious metals, which historically serve as a check against devaluating currencies, have started to rise. While the price of commodities such as gold has appreciated significantly this year, there may still be meaningful upside given the amount of fiscal and monetary stimulus over the last 12 years.

Not all assets have rallied recently, however. Poor-quality corporate credit, CCC-rated debt and below, has not rallied as much as equities and higher quality high-yield debt (BB-rated and above). This is most likely because it is not included in any of the Fed's buying programs. It remains to be seen how this asset class will perform, but it is likely to struggle given the very real challenges facing many businesses in the wake of the pandemic.

The U.S. Dollar remains strong – for now – as many investors still view it as a safe-haven currency. However, it stands to reason that foreign investors would begin to look for an alternative reserve currency, particularly as the U.S. continues to expand its debt and money supply. This would be damaging for both the U.S. dollar and the U.S. economy as we will expand upon shortly.

What is the Cost?

Mathematically speaking, the constant accumulation of debt and increase in the money supply will have to result in inflation at some point, although it may take years. The problem with inflation is that it is often too late to do anything about it once it becomes evident that it's happening, and no monetary policy can turn that around quickly. This is the delicate balancing act that the Fed will need to perform if it is to extricate itself from this situation successfully.

Potential risks include the U.S. Dollar losing its reserve currency status, which would be devastating for the U.S. For example, losing reserve currency status would limit U.S. fiscal/monetary policy in terms of how much money could be spent. Being able to spend less would likely have a negative impact on the U.S. economy. Arguments against that point include the fact that there is currently no other currency that seems poised to replace the dollar. That has been borne out by relative dollar strength during the peak of the Coronavirus crisis in March 2020. Another risk is that other nations sell dollar assets, such as U.S. Treasuries, which could result in a selloff of what was once considered among the world's safest investments. A significant portion of U.S. Treasuries, currently 32% of outstanding U.S. Treasury debt, is owned by foreigners.

Depression

The Fed appears more concerned about a depression than about excess inflation, which explains its expansionary policies. The Fed believes that deflationary factors will prevent inflation, creating cover to continue its money printing policy. Examples of deflationary forces include equity market declines, bankruptcies, and an erosion of consumer demand caused by the Coronavirus-induced global lockdown.

The Fed appears to be motivated by a desire to avoid a 1930's replay at all costs. It is obvious that another depression would be terrible, but one could make the argument that hyperinflation would be worse.

Hyperinflation

Hyperinflation is a scenario that no one believes can happen in the U.S. However, those that have experienced it remain scarred from the devastating effects. For example, Germany experienced hyperinflation in the inter-war period of the 1920s and 1930s, with the dollar-German mark exchange rate reaching 4,200 billion by 1923. This led to economic and social ruin for Germany and ultimately sowed the seeds for World War II. That experience has caused German policymakers to resist money-printing until recently, almost 100 years later.

Other more recent examples of hyperinflation include Zimbabwe (90 sextillion percent), Venezuela (54 million percent), and Argentina (Peso has depreciated from 1:1 to 73:1 vs. USD in past 20 years). All are examples of what can happen with financial mismanagement, although in fairness, these currencies were relatively weak to begin with, unlike the dollar, so it is not a perfect comparison.

What Can Investors Do?

There are several ways to protect against an erosion in purchasing power caused by expansionary fiscal and monetary policy, though each one carries its own unique risks or limitations.

- One example is purchasing **TIPS**, inflation-linked U.S. Treasury bonds. TIPS adjust in price to inflation, designed to protect investors purchasing power. These have some potential drawbacks, however. The breakeven inflation rate on the 10-year TIP had fallen to 50 bps in mid-March, but has since risen to 134 bps, so, like a rising stock price, it offers less value now. Another potential problem would be if U.S. interest rates rise for reasons unrelated to inflation (e.g. foreign selling), as TIPS still carry interest rate risk.

- **Gold** is a traditional store of value and hedge against inflation. The most common way to own gold is through the ETF GLD. It is popular because it is extremely liquid. However, this can be risky because GLD may not necessarily be backed by physical gold in a crisis given its extensive ownership vs. the amount of actual gold available. Physical gold, while preferable, is hard to source now and commands a large premium over paper gold. A potential solution is another ETF, PHYS, which has tighter controls around its gold-backing.

- **Absolute return** investing, e.g. hedge fund strategies, offers an opportunity to make money in a variety of scenarios by combining a portfolio of varying strategies that are non-directional in nature. Among the risks is that hedge funds can be prone to illiquidity-induced drawdowns during periods of extreme asset price movements, e.g. in government bond or currency trading that would be impacted by an inflation scare.

- **Real assets** such as real estate, timber, farmland, etc. can protect against an erosion of buying power. But these assets are not always practical and/or may not always provide an ongoing yield.

- **Cryptocurrency**, the most popular of which is Bitcoin, is another potential hedge against inflation because it is not controlled by any government or central bank and has a finite supply. The limitations are that there are still several concerns that this medium is not ready for mainstream investment, primarily because of questions around cybersecurity, including the ability of criminals to hack into an account and steal an investor's holdings, as well as non-centralized trading platforms and lack of trade clearing and transaction trails.

Conclusion

The current market environment is puzzling in that many risk assets are soaring despite very challenging fundamentals. Central bank liquidity and loose fiscal policy are certainly two of the main factors behind this. Our view is that inflation will increase eventually; although, maybe not in the short-term. As a result, we would recommend including some blend of the five investments ideas above as part of a balanced opportunistic portfolio.

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Ted, who joined TAG in 2006, is a Director and Associate Portfolio Manager of the TAG Relative Value Fund. Ted focuses on manager research, portfolio construction and risk management. This includes sector allocation analysis and manager selection along with the maintenance of TAG's proprietary database. Ted has 20 years of hedge fund experience focusing on counterparty credit risk management and absolute return strategies. He began his hedge fund career at Lehman Brothers in 1997 where he was responsible for managing credit relationships with hedge fund managers, supporting sales/trading desk efforts with those managers by setting credit limits, approving trades, and determining trade terms. Ted continued in this capacity at Chase Manhattan Bank and Deutsche Bank through 2002, when he joined Citigroup's fund-of-funds group. From 2002 to 2006, Ted performed manager due diligence, research and risk management functions, becoming a senior analyst on the credit/event driven strategies team. From 1990 to 1997, he was a counter party credit risk analyst focusing on bank and non-bank financial institutions at the Federal Reserve Bank of New York and the Australia and New Zealand Banking Group. He is a member of TAG's Investment Committee

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