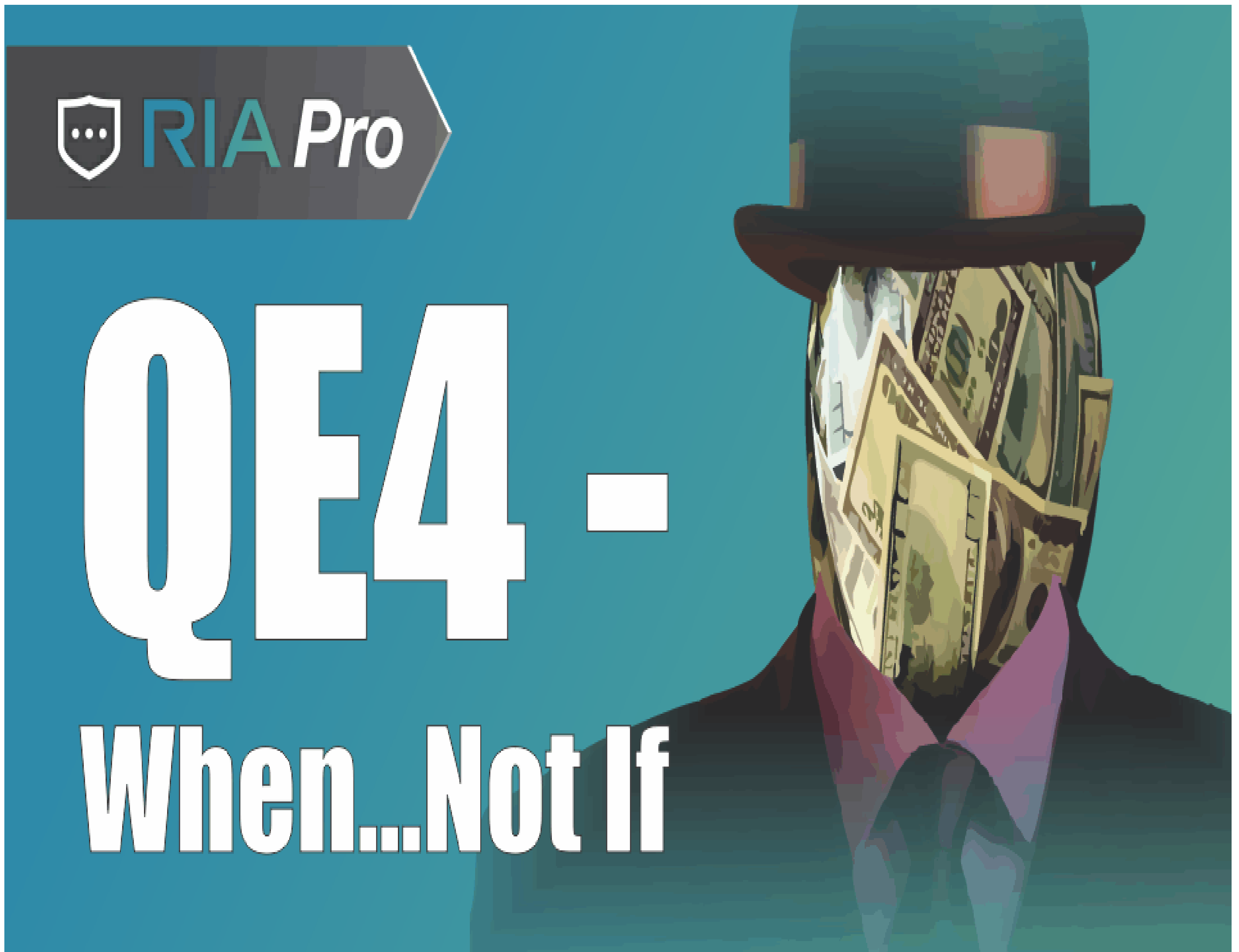
RIA Advice

QE4 - When, Not If - RIA Pro

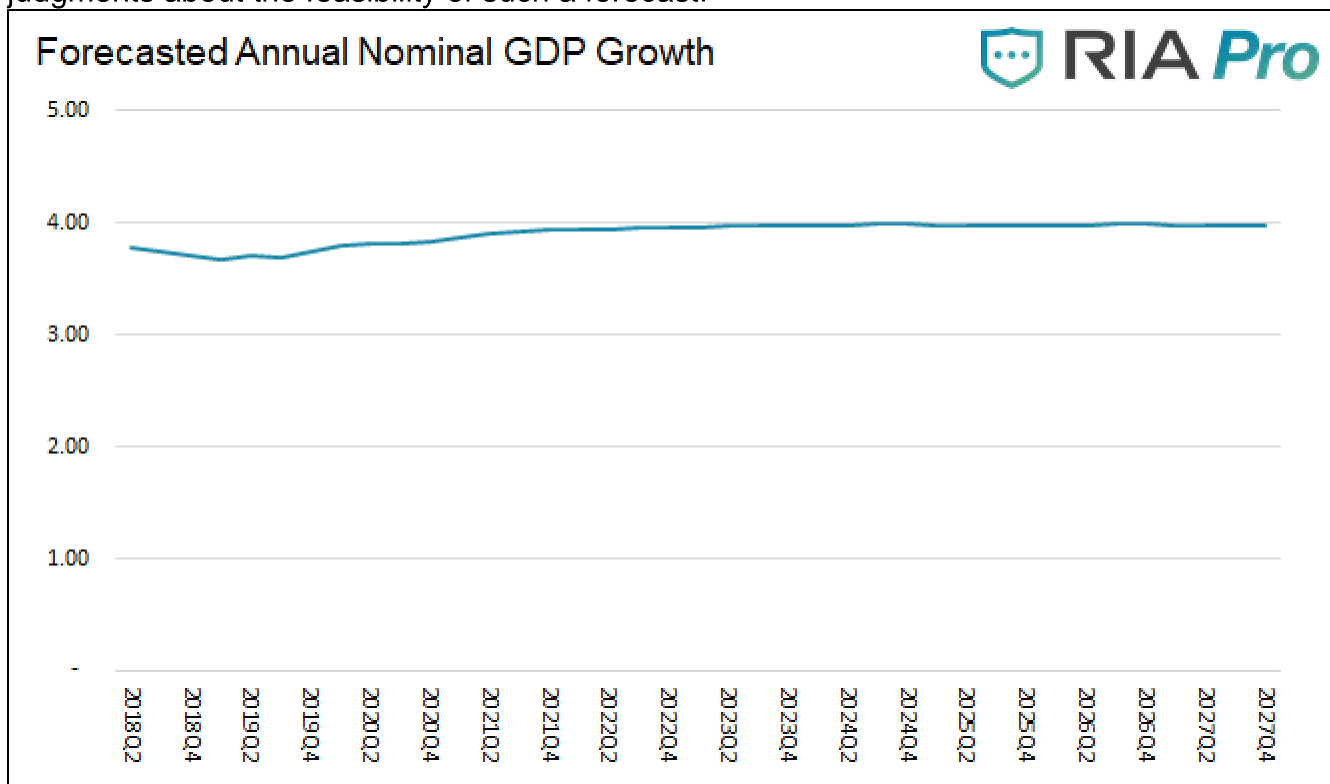


Many market prognosticators attribute the rise in interest rates to a consensus outlook for expanded economic growth and increasing inflationary pressures. In our article, Deficits Do Matter, we took this view to task by providing market-based evidence to show that those factors only account for about a third of the increase in interest rates. �Our perspective is that the rapidly growing forecasted supply of Treasury debt coupled with limited demand from the two largest holders of Treasury securities are currently the main drivers of higher yields. In this article we take that analysis a step further and ask a question that few seem to be considering; what if there is a recession in the coming year or two? In answering that question, from the perspective of the federal deficit and related debt issuance, the current fiscal situation is more precarious than perceived and points to a high probability that the Fed will need to re-initiate quantitative easing (QE) but for altogether different reasons than it has done so in the past.

Prior Recessions

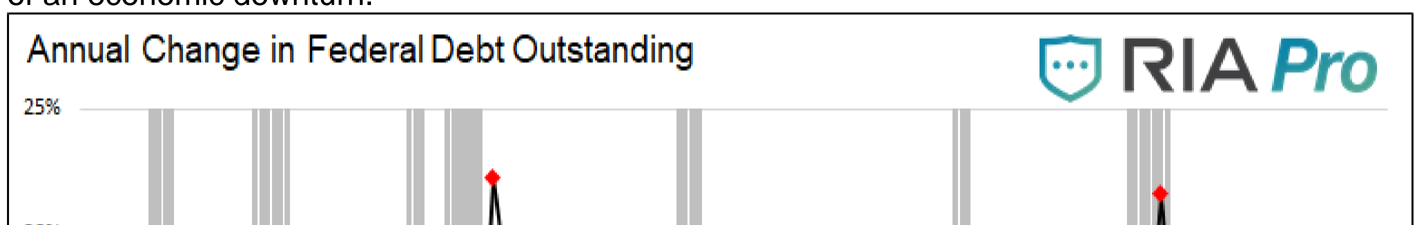
John Maynard Keynes, a cult-like figure in the economics community, asserted that to smooth the fluctuations in the business cycle governments should run deficits when economic activity slows

and surpluses when economic expansions resume. This simple concept is nothing more than the age-old ?save for a rainy day? adage. Despite strict adherence to many of Keynes theories, most politicians only seem to hear the part about running deficits. **Without regard for whether or not you agree with Keynes thinking, there is absolutely no logic or wisdom in the idea that debts can consistently grow faster than one?s ability to pay for them.�** The U.S. government is expected to borrow over $1 trillion per year in each of the next five years. This Congressional Budget Office (CBO) estimate is based on a host of assumptions all of which depend on a consistent nominal economic (GDP) growth rate varying closely around 3.90%. The obvious problem with this model is that even if such a growth rate is achieved quarter in and quarter out, economic growth would only be approximately $800 billion per year. In other words, the burden of debt will rise faster than the ability to fund it.� Furthermore, it seems to us more than a little short-sighted that no one is asking what if GDP growth is not as stable and optimistic as forecast. **Importantly, what if the economy enters a recession?** According to the National Bureau of Economic Research (NBER), there have been 34 recessions since 1857. The longest period between any of these recessions was 120 months. The current expansion just entered its 108th month. The average period of economic expansion is 56 months or about half the length of the current expansion. From a statistical point of view, one is tempting history if they are not expecting a recession within the next 24 months. The graph below shows the ridiculous CBO forecast of GDP growth for the next ten years. Given the degree of difficulty in projecting economic output (high) and their poor track record of forecasting it, it does not seem unfair to impose critical judgments about the feasibility of such a forecast.



The ?R? Word

Investors in all asset classes should be carefully considering what will happen to the nation?s debt outstanding if the rosy economic growth forecast, which in turn is built into economic, market and deficit forecasts, turns out to be wrong. The graph below offers some guidance in assessing how a recession might affect the amount of Treasury debt that would likely need to be issued in the event of an economic downturn.



The red dots on the graph show the peak growth rate of debt outstanding associated with each recession (gray bars) since 1967. As shown, the red dots range from an increase of debt from 9% to 22%, with an average over 15%. To put prior increases into current context, a conservative 10% increase in debt outstanding would roughly equate to an additional $2 trillion of debt issuance per year, which is about double the current annual issuance. A 20% increase would result in about $4 trillion of new debt.� Keep in mind that these massive estimates of new debt would occur alongside *declining* GDP output.

QE to the Rescue

The bond market is currently reflecting some anxiety at the prospect of digesting over $1 trillion a year of debt. This concern also appears to have spread to the stock market to some degree. Now consider how multiples of that number might affect bond yields, stock prices, and credit spreads. If $2, 3, or 4 trillion of additional debt needs to find a home, it is quite likely that interest rates would rise sharply to attract new investors. Plus, there is one other small problem. As interest rates rise, the interest expense on the debt increases and drives funding needs even higher.� This mushrooming debt issuance dynamic would crowd out investment dollars from other markets. The flow of funds from one market to another, as stated in the preceding paragraph, is how such a problem would resolve itself if free market forces were left to their own devices. Unfortunately, the government has a history of manipulating interest rates and allowing debt to build at faster rates than economic growth portends. While this buys temporary tranquility, the result is accumulating risk and consequences. During the financial crisis, QE helped the Fed accomplish their goals of stabilizing the equity markets and the banking sector. After the crisis, they initiated two more rounds of QE despite calmer markets and economic expansion. Through these actions, they removed over $3.5 trillion of government debt and mortgage-backed securities from public markets. By erasing this supply of securities/debt, investors were forced into other investment options. This tool not only made the government *appear* fiscally sound in what amounted to monetary policy creep into fiscal policy, but benefited all asset classes.

No Spare Tire

Despite recent rate hikes, there is very little room for a traditional monetary policy response in the event of a downturn. Add to that the recent fiscal policy actions that will ratchet deficits higher and the United States finds itself with limited fiscal space to combat a recession. **This confluence of events argues that the U.S. economy is now driving without a spare tire.** It also suggests that if the economy stalls, the likelihood of central banks reviving QE among other unconventional policies is high.

Summary

At this point, we are clearly observing a transition of U.S. policy away from reliance on monetary measures toward that of fiscal policy. This is not, however, an even-handed exchange. There is overlap as the Fed gradually reduces liquidity and Congress and the executive branch pass tax cuts and a newly expanded budget. It will be messy and fraught with risk as markets have begun to imply. The growth of debt is not unique to the Trump administration as government debt doubled under each of the last two presidents. As this debt burden extends beyond our ability to repay it, the consequences become more apparent, and the risks for both stocks and bonds rise. Despite the lack of concern from many in the financial media and Wall Street, the diagnosis is only getting worse and the treatment more extraordinary and experimental. The debasement of the currency which results from acute fiscal and monetary imprudence has meaningful ramifications for all investments. Investors should consider investment options that are likely to retain purchasing

power when said purchasing power is being destroyed by the central banks and other government authorities. To mention a few which have a precedence of performing well, commodities and natural resource stocks, Treasury inflation-protected securities (TIPS) and precious metals. There is also the other side of this equation which stresses what to underweight, short or avoid altogether. We would argue that anything currently leading the market higher (financials and technology stocks), and therefore seriously overvalued, is a good thing to reduce or sidestep altogether. In closing and to further emphasize the points above, former New York Fed President Bill Dudley often speaks of keeping extraordinary policies in the Fed ?toolkit.? Specifically, he stated that QE would be ?*useful to have in the toolkit for those times when the short-term interest rate tool may not be available,*? adding that the Fed is ?*quite likely*? to require large-scale asset purchases again because real rates will remain low due to slow productivity and labor-force growth. He also shared that ?*if LSAPs (large-scale asset purchases) are indeed not effective, then the Fed may need to take other measures*.? What these ?*other measures*? may be is anyone?s guess but arriving at plausible conclusions would require even more radical creative thought. **The only question in our mind is when, not if, QE4 will be initiated.**