A First Step Towards Embracing Modern Monetary Theory? April 2020

OVERVIEW

- **The decision of central banks to move to unlimited QE has essentially connected fiscal policy with monetary policy**
- **As countries issue more debt to stimulate their economies, the debt has a willing buyer in order to help keep borrowing costs down**
- **As money floods the system, concerns over inflation and currency devaluation are being raised**

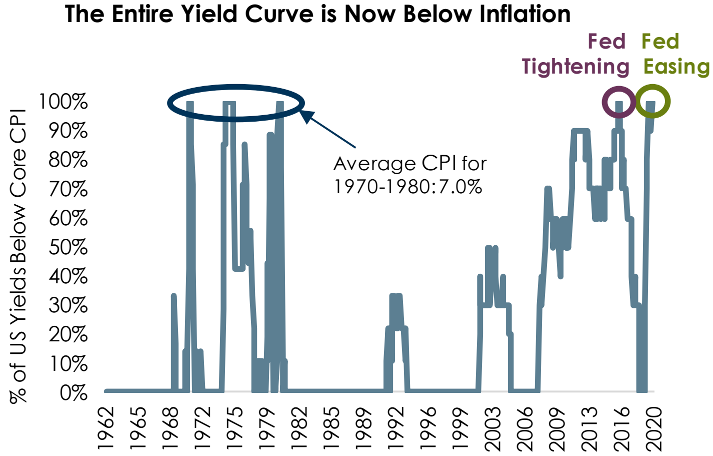
Background

Coming out of the Global Financial Crisis (GFC) in 2009, developed market central banks utilized Quantitative Easing (QE) as a way to stimulate their respective economies. Generally through the purchase of sovereign bonds, the central banks were able to reduce interest rates along the yield curve, essentially making it less desirable to hold safe-haven investments and consequently more attractive to favor risk assets. This action, in conjunction with reductions in key policy rates, encouraged investment and helped to revive economic growth. The new "normal," has been characterized by easy access to money via the bond market. Inflation has not returned, however, and therefore central banks have not materially increased rates. Enter COVID-19 volatility. With minimal ability to stimulate markets via lower rates, the central banks have become willing accessories to government stimulus packages, offering to buy as many bonds as needed to keep the cost of debt from rising too much and to help sustain well-functioning markets. This blurring of lines between central banks and treasury is somewhat new, and is one of the features of what is referred to as Modern Monetary Theory (MMT).

Implications of a Higher Debt Load

The most recent US stimulus package has an expected cost of $2.2 trillion, which is nearly 10% of GDP, significantly higher than the stimulus during the GFC. If faced with an extended COVID-19 scenario, it appears even more stimulus may be on the horizon. These actions, in addition to the Trump tax cut package of 2017, will take the US debt burden to record absolute levels and relative levels only previously seen in the WWII era. Consequently, there is concern about our ability to service the debt and what impact these circumstances may have on all types of assets. With a de facto purchaser (the Fed), the likelihood that risk-free rates will move materially upward in the foreseeable future is low, creating a world where no risk equals no real return. Furthermore, while central banks have been seemingly unable to stimulate inflation (realized or anticipated), sustained fiscal deficits may become the catalyst for an inflationary bounce-back in the years ahead.

The Entire Yield Curve is Now Below Inflation

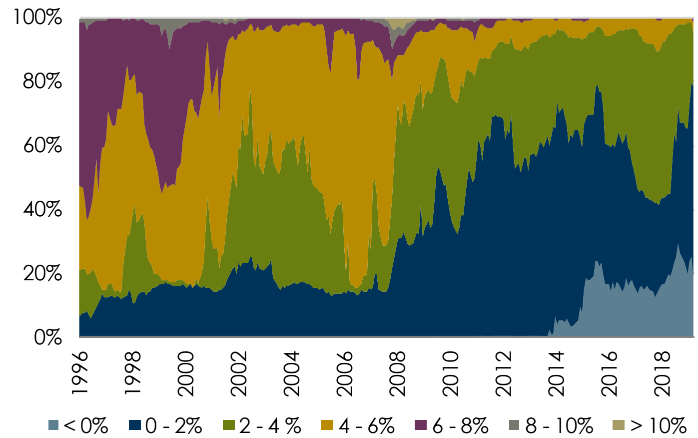


Source: Bloomberg (Using 30, 10, 7, 5, 3, 2, and 1 Yr US Treasury, 3 and 1-mo T Bills, and Fed Funds vs Core CPI)

Asset Class Impact

How is an extended era of paltry yields on government bonds and increased money supply likely to affect traditional asset classes? Equity holders may benefit, as the driving forces of corporate profitability and growth potential should still exist. There may be a resetting of valuations based on the new risk-free rate, but thereafter, traditional risk/return relationships should prevail. Bond holders will clearly have to adapt to a new yield paradigm, with additional credit risk likely being necessary to attain income levels previously viewed as commonplace. Shorter-term bonds and cash enhance portfolio liquidity and become increasingly valuable as opportunities come and go in periods of volatility. Real assets should do reasonably well in this environment, particularly those whose cash flow potential self-adjusts with rising inflation (TIPS or Real Estate). Commodities that have some inherent currency value, such as gold, may also thrive in an environment that questions the value of fiat currencies.

Percentage of Bond Market By Yield Bucket



Source: ICE BofA ML Indices, PIMCO (Using ICE BofA Global Broad Market Index)

ACG's Position

Eventually, central banks are likely to resist further balance sheet expansion, leading to more pure market-based yields, but how soon that will happen is not clear. In an era of unprecedented monetary and fiscal intervention the pathway to "normal" may be long and winding. Many point to the stagflation experience of the 1970's to cautiously highlight the risk of politicizing monetary policy, and believe price stability can only be achieved within the context of true central bank independence. While unexpected bouts of inflation can have severe consequences for financial assets, there is limited historical context for which to judge the outcome of deficit indifference and essentially limitless QE by global central banks. The challenge for investors is to identify an investment framework that offers the highest chance of success relative to their goals. Beholden to the time-tested benefits of diversification and discipline, we believe maintaining a long-term focus and following strategic allocations increases the probability of achieving return objectives while managing portfolio volatility.

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