2022 Global Outlook: The Success and Excesses Resulting from MP3 Policies

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BRIDGEWATER

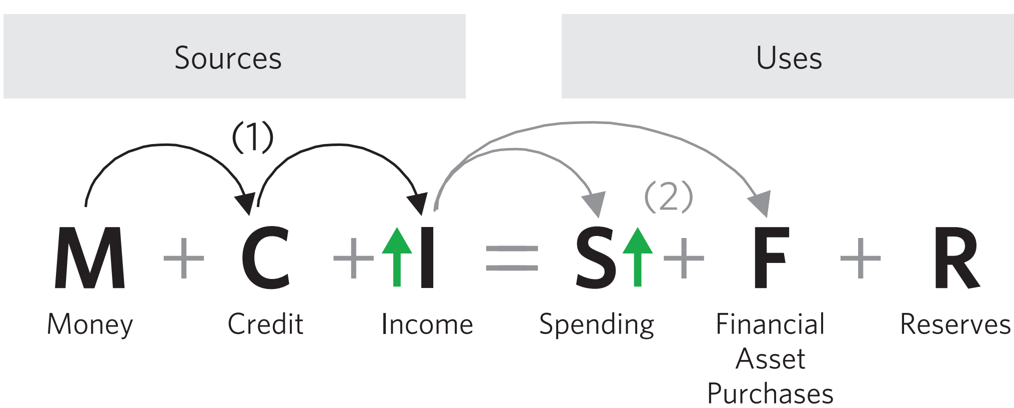
Monetary Policy 3 (coordinated monetary and fiscal policy) policies have worked, transitioning economies from collapse, to liftoff, to self-sustaining growth. The outcome has been fueled by a massive adrenaline shot of money and credit that is now producing a self-reinforcing cycle of high nominal spending and income growth that is outpacing supply, producing inflation. The policies have also produced a layer of excess liquidity that has driven asset prices higher and left a store of liquidity in the hands of people and the financial system that will continue to have impacts as it recirculates through the system.

As a result of these policies and their effects, policy makers—and particularly the Fed—will increasingly be confronted with a set of choices that will be as challenging as any since the 1970s. Because economies are now experiencing self-reinforcing growth, the natural workings of the economic machine will continue to sustain a high level of nominal growth that is likely to produce a level of inflation that is well in excess of policy targets. For central banks, asymmetric policy alternatives leave an unlimited ability to tighten and a limited ability to ease on their own, which encourages delay and falling further behind, which is likely to make it increasingly difficult to balance economic growth and inflation. Given the inertia in the system, it is unlikely that the current level of nominal spending growth and its impacts on inflation can be contained without aggressive monetary tightening in the very near term.

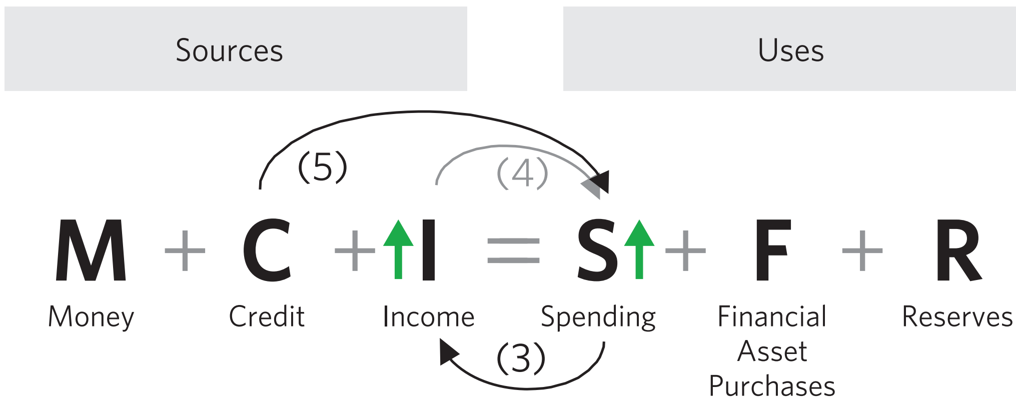
In contrast to this unfolding story, the markets are discounting a smooth reversion to the prior decades' low level of inflation, without the need for aggressive policy action—that it will mostly just naturally happen on its own. We see a coming clash between what is about to transpire and what is now being discounted. The inevitability of this clash is due to the mechanical influence of MP3 policies on nominal incomes, spending, asset prices, and inflation, as we describe below.

The Mechanics of MP3 and Their Impacts on Inflation

In the first phase of MP3 there was a massive shot of adrenaline in the form of central banks printing money to buy debt issued by governments. Governments then handed the money to people, which raised their received income to record levels even though their earned income had collapsed. That income went into a) spending, b) paying down debts, and c) the purchases of financial assets—actions which pushed interest rates to near zero, raised asset prices, and turned the first crank of the economic flywheel.

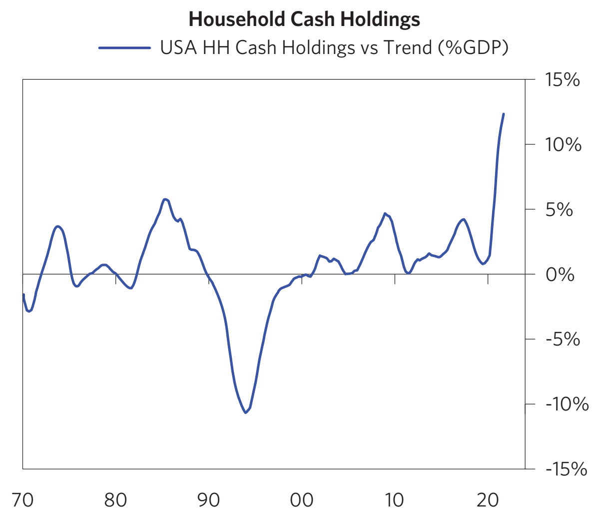


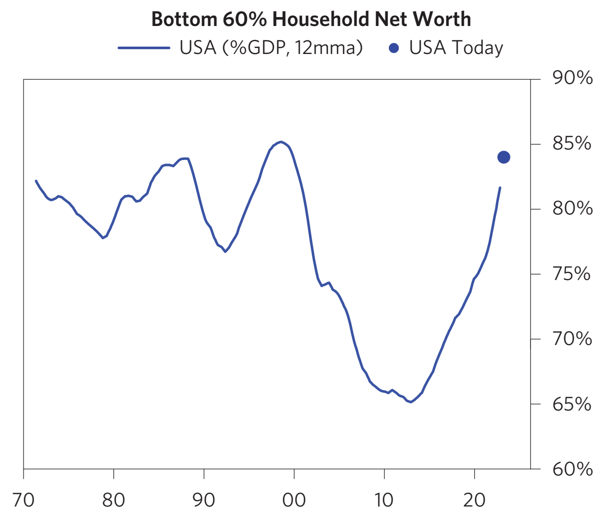
Then, even though less than all of the income that was received went into spending, enough of it was spent that nominal spending rose. One person's spending is another's income, so that rise in nominal spending produced a round of nominal income growth, which was spent. In not too many months, the continuous recirculation of spending and income produced a sufficient level of nominal spending to support a high growth of nominal income without the need for continued adrenaline shots. That is when the self-reinforcing process kicked in—a high level of nominal spending growth financed by a high level of nominal income growth, which is financed by nominal spending. The economic flywheel was turning on its own in a self-reinforcing, self-sustaining way. Now, even though nominal spending and income are self-sustaining, they are still being augmented by the flow of money and credit from the government, amplifying the pressure. The self-reinforcing turning of the flywheel is illustrated below, including the associated rise in private sector credit creation that is now occurring, supported by the rise in nominal incomes and excess liquidity in the banking system, reinforcing the growth in nominal spending.

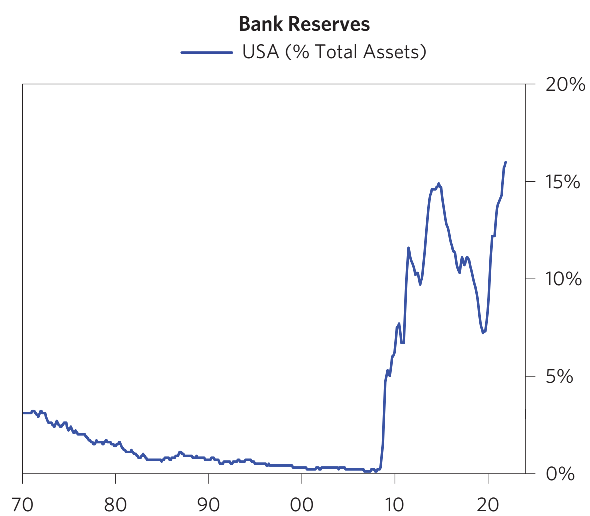


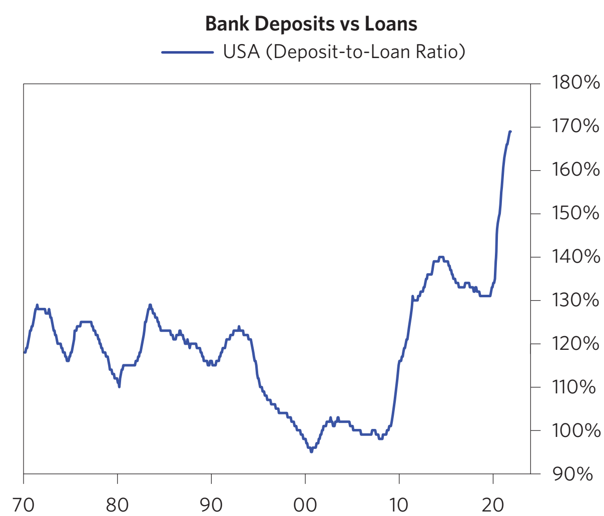
The impact of this process on inflation naturally follows. All prices, including the prices of financial assets, goods, and services, are formed by an exchange of money for quantity (P=$/Q). Once you load the system with a pile of money and credit and people spend it at a nominal growth rate of 6–8% per year, incomes rise comparably, which gets spent, and the flywheel turns. In the early stages of this process when unemployment is high, a lot of that spending goes to business profits and a lot of it goes to putting people back to work. But once you have low unemployment, it goes increasingly to higher wages because that nominal spending exceeds the supply of available labor (P labor = $ demand / Q labor) at the same time that living expenses are rising, putting labor in the position of both needing and successfully demanding raises, and at that point the mechanics of a self-reinforcing inflation cycle kick into place. If productivity rose commensurate with nominal spending, then you would have real growth. But such a level of productivity growth is highly unlikely. Therefore, the only way to lower inflation is to slow nominal spending by draining liquidity, i.e., raising interest rates and withdrawing reserves, and it cannot be counted on to slow on its own because of those self-reinforcing dynamics. These mechanics are why the saying "expansions don't die of old age, they're murdered" is true.

In addition to the recirculating flow of income and spending, wealth and balance sheets have dramatically changed as a result of these MP3 policies. This is a future source of lending, borrowing, spending, and income. Of particular importance is the fact that this increase in wealth has accumulated in the middle- and lower-income groups which were previously getting squeezed. Because MP3 policies directed money to the middle- and lower-income deciles through the fiscal pipe, these groups have received a lot of the printed money and have either paid down debt or accumulated cash in the bank. The biggest asset of the middle-income groups is their home, and home prices have risen well above mortgage balances. And looking at the banks, which are a source of stimulation or restraint, you see a giant pile of liquidity on bank balance sheets that is earning next to nothing. Banks have the incentive to produce an expansion of credit that would finance spending. Bank deposits are now well above loans to an extreme degree, and the average bank asset mix has shifted to include a lot more cash reserves at the central bank and more government bonds. The big wealth and balance sheet changes are shown in a sampling of charts below.









A Coming Policy Transition

What this all leads to is a coming policy transition that will be quite challenging for policy makers and for investors. Due to the strength of nominal spending outpacing the capacity to produce, central banks, and particularly the Fed, are now facing the greatest potential for a sustained rise in inflation in 40 years. That is challenging enough on its own, but the pandemic and near-zero interest rates make the choices facing policy makers especially difficult. The typical playbook for fighting rapid inflation is to tighten aggressively. But with COVID-19 and the risk of new variants constantly in the background, there will be continued questions about the sustainability of rising inflationary pressures, as well as ongoing uncertainty about the effects of the pandemic on economic growth. So while it is clear that unfolding conditions will soon require a policy transition, it is not clear how aggressively policy makers will pull the levers to tighten.

The challenge facing central banks is compounded by their asymmetric ability to tighten versus ease. Policy makers have the full arsenal of policies—MP1 (interest rates), MP2 (QE), and MP3—to moderate the upward pressure on inflation by slowing the flow of liquidity, credit, and spending. But with nominal rates near secular lows and asset prices high, they have only one form of policy to stimulate—MP3—and it requires fiscal coordination. And with the politics of fiscal spending now increasingly fraught, if the Fed overtightens, it may do so into a fiscal drag instead of a fiscal stimulus. Finally, the Fed will no doubt be worried about the sensitivity of the economy to rising rates after it was forced to quickly reverse course during the 2018 tightening. Taken together, this set of circumstances incentivizes staying accommodative for longer, which leaves more room for a more entrenched inflation process. And with the new philosophy of targeting an average inflation rate over time (which supports delayed action to contain inflation in its early stages), and without clear time frames or metrics, there is latitude for the Fed to justify a delay and still comply with its mission of price stability.

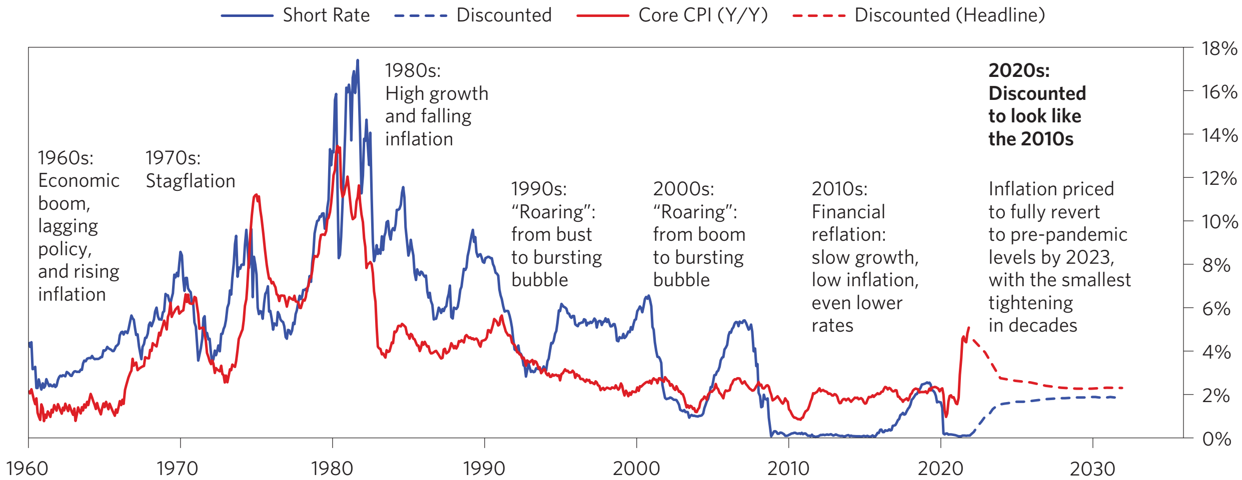
However, it is also important to consider that while asset markets (especially in the US) may be more sensitive to a rate rise than in the past, the real economy may actually be less sensitive to tighter policy. In terms of assets, high valuations and long durations, driven in large part by low interest rates and plentiful liquidity, mean that a moderate tightening could be painful—especially in the bubbliest segments of the US equity market. But in terms of the real economy, the improvement in household balance sheets, particularly those of the middle class, implies a greater degree of resilience to monetary tightening, as households are less dependent on low interest rates to fund spending. And considering the rise in inflation and nominal growth over the past year, there is more room to raise nominal rates without tightening conditions in real terms. Carrying this set of conditions forward, a diminished economic sensitivity to a rise in interest rates, combined with a cautious approach to raising them, would add to the risk of falling behind the curve and of asset markets getting even further ahead of themselves, followed by a more significant tightening with an even bigger impact on asset markets at that time.

For investors, these circumstances create two unique risks relative to the past four decades. First, there is the risk that asset values will fall in real terms due to a sustained rise in inflation. Second, there is the risk of central banks falling further behind the move in inflation and having to aggressively catch up. In the very near term, policy accommodation would tend to have benign effects along the lines of a mid-cycle transition. However, too much policy delay would risk overextending the moves, lowering yields, and lengthening durations, making the longer-term risk from falling behind and then catching up much bigger.

The Markets Are Discounting a Smooth Transition to Non-Inflationary Growth Without the Need for Aggressive Tightening

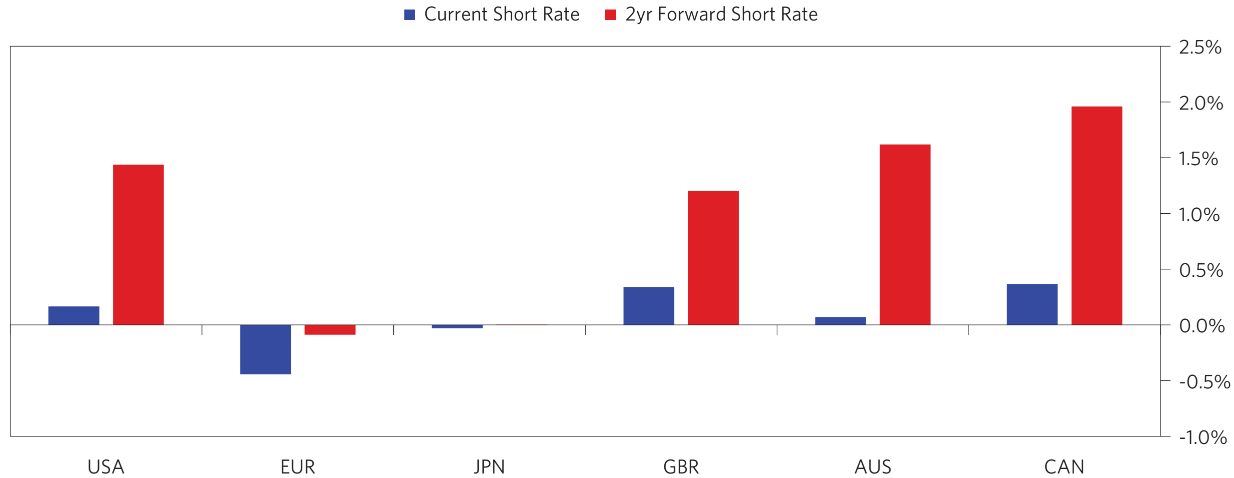
Despite this uniquely interesting and potentially volatile set of unfolding conditions, the markets are discounting neither a significant tightening nor higher inflation. In other words, current pricing suggests that the overall stance of policy will remain extremely easy indefinitely into an already hot economy, culminating in stable nominal rates between 0% and 2% and permanently negative real rates, both in the US and throughout the developed world. And this minimal tightening is priced to be enough to curb the strength of demand and put inflation back in the bottle. Because there is such a big difference between what is discounted and what we think is likely, we see the potential for large market moves, which of course implies significant risks from holding assets, as well as significant alpha opportunity from price change. As the chart below shows, US short rates are discounted to plateau below 2% after one of the smallest tightening cycles on record, while inflation fully reverts to the low levels that characterized the years before the pandemic. The discounting of a smooth transition to low inflation with a minimal rise in short-term interest rates is well conveyed below by the dashed lines, which show what is now discounted.

USA Short Rate and Inflation with Forward Discounting



This pricing is even tamer throughout the rest of the developed world. Current pricing suggests an extremely modest tightening cycle everywhere, with no major developed economy able to sustain rates even at 2.5% at any point in the next several years.

Short Rates and 2yr Forward Discounting



Data shown as of January 12, 2022. Please review the "Important Disclosures and Other Information" located at the end of this report.

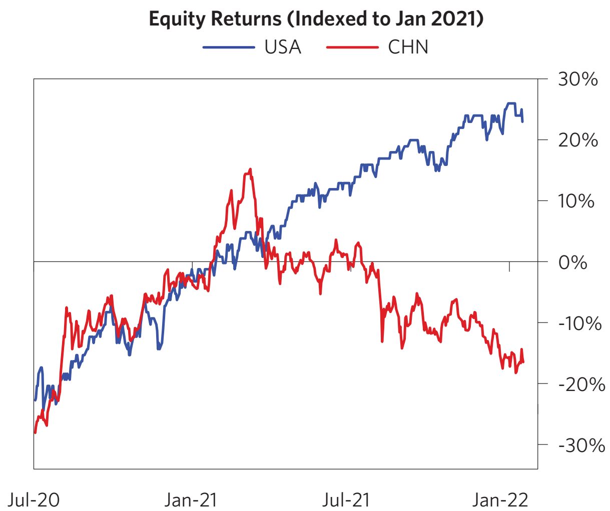
Conditions Differ Significantly Across Countries, with China and Asia Increasingly Decoupled from the West

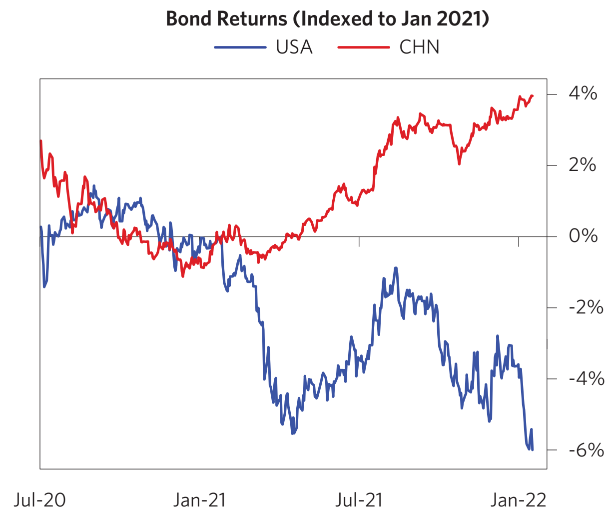
Debt monetization in the US and the more developed economies is a normal response to being in the latter stages of the long-term debt cycle with interest rates floored at zero. Secular conditions are different in China and in a number of other economies of Asia. China is the economic engine of this region and has attempted to preempt the instability caused by excessive indebtedness through a controlled deleveraging.

From a cyclical perspective we see the opposite set of conditions from the US and most of the developed world. China's inflation rate remains low or normal, they have not monetized government debt to support their economy, and their interest rate structure is more normal though dragged lower to some extent by the low level of yields everywhere else. From a cyclical standpoint, they are coming out of an economic slowdown prompted by a policy-driven deleveraging of their financial system and the domino effects from the fall of some overly indebted entities. Due to those conditions, their bond yields have fallen while bond yields have risen in the US and Europe. Their stock market has fallen while equity markets have risen in most of the developed world. And now they are transitioning to moderately stimulative monetary and fiscal policies at the same time as the next policy moves in the developed world are tightening. These markets are fundamentally diversifying because the economies are comparably big and are driven by an independent RMB monetary and credit system that is responsive to their own conditions, with markets driven by those policies and not the policies of the Fed or the ECB. Below are recent policy indications from the PBoC and China's government.

- On January 5, Premier Li said the government should implement "new and greater combined tax and fee cuts [in order to] ensure a stable start for the economy in Q1 [and] stabilize the macroeconomy."
- On December 27, the MoF reiterated that it would "strengthen the coordination and linkage of fiscal and monetary, employment, and other policies" and added that the government will "give play to the role of fiscal policy to stabilize investment and promote consumption."
- The PBoC recently added a new call to "take more proactive measures to boost support for the real economy" and "better stabilize the aggregate credit growth" as well as "bring down the overall financing costs for businesses."

And below, we show the opposite price action in China's stocks and bonds relative to the US.

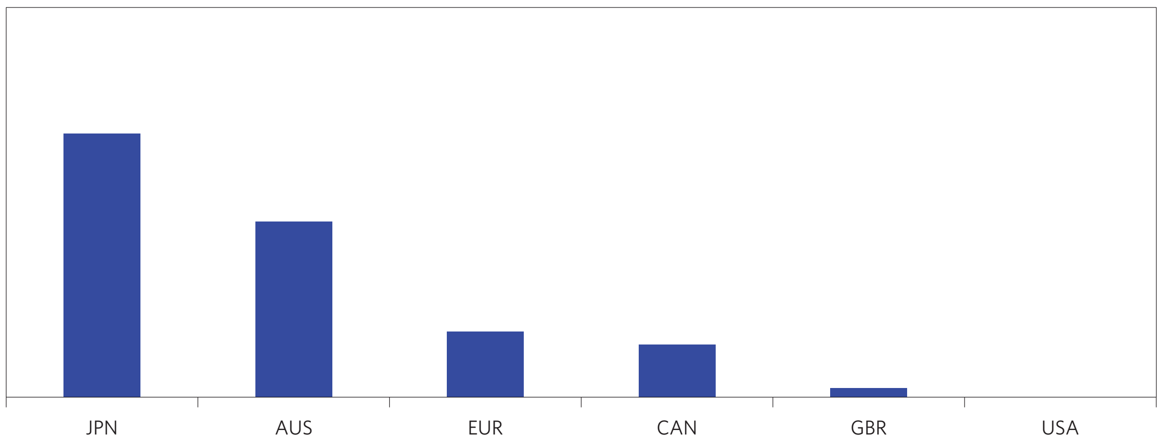




With bond yields still having room to fall, inflation still relatively low, and policy makers facing pressure to ease, Chinese assets remain attractive relative to cash, with the differences in conditions versus the West creating a high likelihood of continued diversification.

By contrast, we have grown significantly less bullish on assets versus cash across the developed world in aggregate, with significant differences across countries. We have described our long/short cash alphas, which take views on the attractiveness of funding assets with short positions in cash. An important component of these alphas is our "policy constraint gauge," which measures how close policy makers are to reaching the limits of their ability to ease through MP3—those limits being excessive inflation, asset bubbles, and/or currency weakness. The US is facing two of the three (high inflation and growing pockets of asset bubbles), with the UK, Canada, and Europe not far behind, as inflation is elevated there, too. Japan and Australia are closer to China in terms of still having room for stimulative policy to run.

Short Cash Signal Across Developed Economies



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