

## INVESTMENT TEAM

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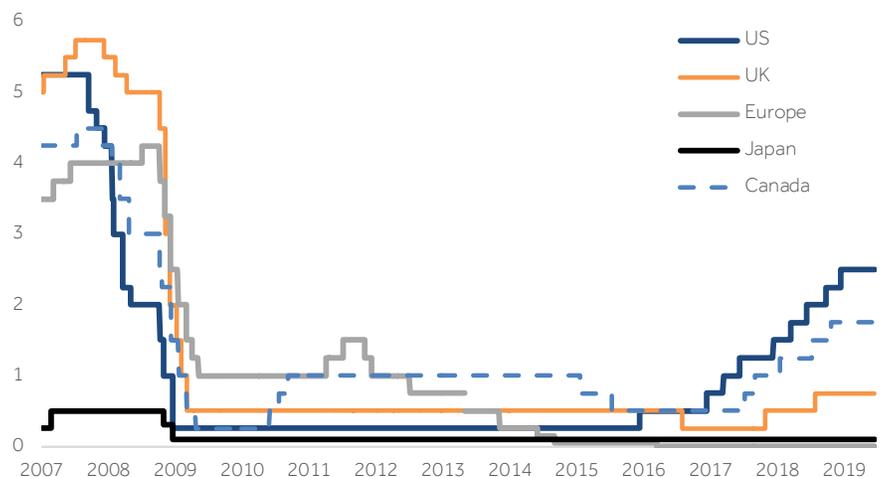
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## Breakeven

This week we continue to look above the weeds and consider the capacity for an active monetary policy response to the next economic or market shock. With interest rates below normal for this stage of an economic cycle, an increasingly actively discussed alternative to orthodox monetary policy is the controversial Modern Monetary Theory (MMT). MMT proponents argue that governments should borrow to fund government spending programs to increase demand and achieve full employment. This kind of fiscal pump priming is not new thinking at all, but the likely low level of effectiveness of further monetary easing in the face of a major economic shock is such that MMT is one of the few alternatives being discussed. If such a shock were to become manifest, then some form of MMT seems increasingly likely. Investors should start to consider the impact of such a breakup from the economic orthodoxy, and further, what might happen should it not breakeven.

One reason for the increasing speculation around MMT is the low level of interest rates relative to historic averages, implying a low level of central bank firepower to deal with the next crisis. Figure 1 shows central bank policy rates relative to the end of the last cycle. On average, US Fed policy rates have been cut by roughly 5% over the normal course of an easing cycle, there is less than half that available now, assuming policy rates stay above zero. Elsewhere in the developed world, central bankers have even less room for manoeuvre. Should central bankers need to deal with a major crisis soon, they are largely out of traditional ammunition. Japan and Europe are in a particularly weak spot.

Figure 1: Central Bank Policy Rates



Source: DataStream, Canaccord Genuity Wealth Management

Unless policy rates rise significantly before the end of this cycle, policy makers are likely to require more than the traditional monetary tools to have any hope of achieving their goals. Low interest rates reduce the effectiveness of monetary policy, but they also lower the cost of expansionary fiscal policy. That is, should a government borrow (issue bonds) to spend its way out of recession, the low levels of interest rates mean that the financing costs of that borrowing are also lower. That is a principal behind MMT, namely that governments can borrow with zero or low financing costs to spend and generate full employment. Further, it is argued that any government that can create its own currency should not default on its own currency debt. Not only that, but it can print money to manage interest rates (as has been demonstrated with Quantitative Easing, or QE), while inflation can be controlled by issuing bonds or raising taxes to drain excess liquidity.

Proponents of MMT have tended to be those with a left leaning political persuasion or those driven by a desire to see a social redistribution of wealth. Given the scale of QE since the credit crunch, where central banks printed money to buy financial assets, lowering interest rates and driving up asset prices, it is not hard to see why MMT might seem attractive. If QE is seen as being responsible for driving up asset prices, then to some it will feel a lot like the state sponsored scheme to give more money to those that already have a lot of it. MMT, by contrast, means increasing government spending to increase demand, and that is most effectively achieved through what economists call automatic stabilisers, of which unemployment insurance would be a good example.

Setting aside the politics for a moment, most developed economies came through the credit crunch with fiscal austerity programs in place, many of which are only now gradually unwinding. That has left many economies starved of much needed government investment, ranging from infrastructure projects to social care programs. Governments also abdicated almost entirely the policy response to the last crisis, leaving central bankers in charge of stabilising the economy. Next time, we suspect that governments will have to get their hands dirty, and address some of the socio-economic consequences of QE from the last crisis, which has likely driven much of the polarising politics around BREXIT and the move to electing populist anti-establishment leaders since.

MMT will likely prove too attractive to populist politicians, that want to break free of the economic orthodoxy that requires fully costed social spending, or as a way of delivering on a Green Budget. Investors should therefore start thinking carefully about how to position into new world of MMT and which governments are most exposed. TIPS might be one obvious place to start, but if the breakup from the economic orthodoxy goes wrong, inflation might be the least scary outcome. A breakup seems increasingly likely, but don't expect it to breakeven.

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