To subscribe to our Newsletters **www.palos.ca/register**

PALOS

Palos Weekly Commentary

Issue **No. 12** | **MARCH 21** 2019

CONTENTS

Macro View

By Hubert Marleau

The Weekly Narrative of March 21, 2019

The Modern Monetary Theory (MMT):

In the last few months, many readers of the macroeconomic section of the Palos Weekly Commentary have asked me to write about the development of a new economic principle called MMT that reflects a significant break with conventional economic orthodoxy. The theory is gaining political traction with both the extreme left and the extreme right; and the long-term implications on investment strategies are serious. Consequently, I decided to give it a shot and write a short critique on the subject.

What is the Modern Monetary Theory?

It's a school of thought championed by a merry band of contrarians and a cohort of fringe economists that explores the fiscal possibilities open to a government which issues its own currency and owns a central bank. MMT holds that such governments are not obliged to be constrained by budget deficits and debt. It is based on a belief that modern fiat money is purely a creature of the state and its value is it can be used to pay taxes. In their opinion, the actual mechanics of money creation stems from government spending. Money goes into the economy when the governments spend and is removed when they tax. Put differently, fiscal policy is the rudder and not monetary policy. In other words, advocates of the theory postulate that governments which have these two aforementioned characteristics (own central bank and currency) cannot default because they can print themselves out of their debt service and repayment by permitting their central banks to buy whatever volume of bonds, they decide to issue in order to finance their spending programs and/or deficits. The theory concludes that there is no natural equilibrium interest rate to match desired savings with desired investments, the government should have the sole mandated role to watch over price stability and full employment, and the central bank only exists to buy debt issued by the government.

The more moderate MMTers stipulate that the governments could spent money on any worthy projects for as long as inflation does not rise, for as long as there is slack in the economy and/or for as long as there is a pool of able bodies capable of working.

Macro View cont.

By Hubert Marleau

Why the Modern Monetary is appealing?

There are numerous reasons.

First, most of the millennials believe that the central banks have bailed out the baby boomers at the cost of pricing them out of the asset markets like stocks, bonds and real estate. David McWilliams of the FT summarized in a recent article that the central banks have underwritten the future wealth of the millennials to enrich the older generations. They are mad because the monetary experiment has made the baby boomers comfortable, leaving them, with a fragile stake in a society they are supposed to build. They, also, postulate that governments have done little to help them and that the biggest beneficiaries of the monetary and financial bailouts were those who should have been jailed.

Secondly, the extreme political left which views central planning as the way to enrich society loves the idea that big projects like Medicare For All and the Green New Deal in the U.S. could be financed without reverting to taxes but by forcing the monetary authorities to buy outright all the new obligations of governments.

Thirdly, the extreme political right that views state capitalism to solve the so-called secular stagnation, through trade protection, tax reductions and the promotion of domestic industries also loves the idea as much as the extreme left.

Fourthly, it is commonly believed that too much of the recovery effort from the Great Recession was left to the central banks, resulting in "pathological" levels of income and wealth inequality that benefited only those who owned assets. A process that is still going on that must be stopped in the opinion of the insurgents who view their antagonists as a calcified elite---an establishment sunk in classical neo-Keynesian and monetary economic principles.

Lastly, liberal democracy is in a world-wide decline because many are disappointed with the apparent incapability of liberal regimes to solve problems. They blamed, rightly or wrongly, the problems like repeated financial instability, open immigration, rising insecurity among lower income earners, aggravating technological changes and the failure to implementing global policies to arrest terrorism, tax avoidances and unfair trade practices on policies of the liberal establishment. And these same people fear the future impact of artificial intelligence, the growing disappearance of middle-class livelihoods, rising levels of poverty, more economic and climate change. It's a mix of right wing and left-wing fears.

The bottom line is that present political conditions favour on the one hand the radical right who are interested in speaking the language of the working class and on the other hand the radical left who want to increase taxes on both high wealth and high income. The radicals know that it will be difficult to reverse a 30-year trend towards lower taxation. Hence, their push for MMT. Munchau of Euro Intelligence wrote in the FT that " we have entered an age that

Macro View cont.

By Hubert Marleau

will favour radicalism over moderation whether it is left or right. The old rules are being rejected among the liberals and conservatives. Many investors think that MMT is popular only with the left-wing democrats - that is wrong. President Trump, the right-wing king of the hill, delivered an 80-minute-long State of the Union speech in which he did not use the words "debt" and "budget deficit." Moreover, the republicans pursued their tax agenda and higher military spending during the Trump presidential term without tax increases to pay for it.

Is there any validity to the Modern Monetary Theory?

The former chief economist of the International Monetary Fund, Olivier Blanchard, argued in a speech that for a country like the U.S., high public debt is not a problem. It is as if the Pope came out and endorsed the devil. Recent budgetary history is supportive of the idea. The U.S. swung from a $236 billion surplus in 2000 fiscal year to a $779 billion deficit in 2018. Theoretically, high deficits and debt should have caused interest rates and inflation to rise and crowded out capital from the private sector. It did not. One only must look at experience of the last twenty years. Quantitative easing throughout much of the 2010s was MMT in practice. Even though more than $10 trillion in debt has been monetized around the world since 2008, no government has defaulted, no currency has fallen apart, and no serious inflation has emerged. An argument that is used as proof that favours MMT.

Moreover, the Puritans of the Commonwealth of Massachusetts during the 17th century invented a forerunner of MMT, and they were successful in promoting economic activity. At first, they were unable to compel people to accept money at face value, despite the promise to redeem the money at a convenient time. Dror Goldberg, a leading historian of the epoch, showed that when the language on the bill was changed to " shall be accordingly accepted by the treasurer and receivers subordinate to him, in all public payments" --it worked. The reason is that the colonists could use the money to pay taxes. Money was injected in the economy through government spending and, in turn, circulated to grease the business transactions. When there was too much money around the government introduced taxes to remove some of it.

What is my take on the Modern Monetary Theory?

The idea of using a central bank's balance sheet as a "cash cow" to fund tax cuts for the wealthy or fund expansive social programs rests on several fundamental misconceptions. The proof of concept is inadequate because very little serious theoretical research has been conducted and I have not been able to find any mathematical studies or empirical work supporting the MMT's cohort in the economic community or academic circles. The lack of mathematical models is evidence of MMT's intellectual inferiority. The Economist wrote in its column on Free Exchange that it a way of avoiding scrutiny.

Macro View cont.

By Hubert Marleau

Larry Summers, Ken Rogoff, Paul Krugman, Jerome Powell, Larry Fink are saying that the MMT is fallacious, nonsense, ludicrous and just plain wrong. I agree. Yet, the debate is political, and many ambitious politicians think that although being complex and hysterical, they are willing to push the idea forward as part of their strategy to win votes.

I also have a hard time with the theory. How can any self-respecting citizen be willing to accept a currency that can be issued at will? I have difficulty in believing that politicians, turned lawmakers, would put in place tax policies that would protect the value of money. It so happens that we live in an open economy where money flows to countries whose financial perceptions are superior, economic prospects are above average and monetary risks are contained. And on top of it, the U.S. dollar is the world's reserve currency. It is based on the perception that the greenback will always be an anchor of value--and can be preserved only if it keeps its scarcity. Foreigners have sold $1 trillion in U.S. treasuries over the past four years because they fear that there might be an overabundance. Imagine a circumstance where the Fed would only buy long term maturities while foreigners buy only short-term maturities—-then out of nowhere a sudden change in the exchange value of dollar or in the cost of money occurs. Would it not spell a liquidity crisis?

Another big question is who is likely to be more independent? - Congress or Fed. I have doubts that any legislative body, left to its own devices, would be as autonomous and free as a central bank. Lawmakers are contingent upon elections for existence.

The theory is based on two accounting identities. Government spending makes money and government taxation removes it. While the mechanics are axiomatic, the unintended consequences like inflation or deflation would become more likely. Figuring out how much money the system needs is a difficult task. The balance between stable price and growth is delicate, suggesting flexibility and accuracy. Central banks are better equipped because they can increase or reduce the quantity of money at the push of a button by selling or buying bonds in the open market, without lags. However, legislative bodies debate and argue, delaying decisions and making them gruesome. The transfer of monetary power to a bunch of legislators by passing spending laws to create money or taxation laws to destroy it would tilt on the side of spending. Printing money to fund spending programs of legislators is certainly more politically appealing and tempting than introducing new taxes to deflate the economy. That is why it was agreed by western economies to establish a firewall between elected officials and their central banks---to prevent as much as possible the question of money from yielding to political pressure.

Conclusion:

Political supporters of the theory are not likely to change their opinions, thinking that flip-flopping is a bad thing in politics. Daniel Kahneman, a leading behavioural economist, has observed people tend to cling to their ideas especially if they get invested publicly and identify with them - think of Donald Trump and Alexandria Ocasio-Cortez. Investors should be aware that "people endeavour to live at the expense of everyone else" - Bastiat's insight. There are people who believe that the earth is flat, the moon lading is a hoax, Australia does not exist, and the modern monetary

Macro View cont.

By Hubert Marleau

theory is heaven on earth. This MMT is a total contradiction to the rule that money creation needs to be independently controlled if the political objective is to have social stability and economic prosperity. I doubt that MMT will ever become the U.S. economic policy. Nevertheless, putting one's head in the sand regarding MMT—it would be a mistake. In the event of this unlikely outcome, an investment portfolio including REITs, Commodities like copper and gold and Infrastructures could advisable.

Economic, Financial and Market Statistical Data that Matter for the Week ending March 21, 2019

- Canada:
  1) Prices of new homes are down 0.1% in February on a year over year basis.
  2) Canadians are employed but are working less hours.
  3) STCA Manufacturing Sales increased 1.0% in January.
  4) February home sales fell to 35k in February for a 9.1% decline to hit their lowest level since November 2012.
  5) Car registration decreased to 111,917 units in January from 118,185 in December. The peak was 220,436 in May do 2018.
  6) The IHS Markit MFG-PMI fell to 52.6 in February from 53 in January—-posting to weak expansion of output. It was 57.1 in June of 2018.
  7) Government spending accounted for 90% of the increase in government debt over 2010-1017.
  8) So far economic data for Q1 shows that the outlook is tilted to the downside. It looks as if Q1 will be flat.
  9) The Trudeau government delivered its fiscal year 2019-2020 budget on Tuesday. Canada will finish the current fiscal year with a $15.0 billion budget deficit, about $3 billion less than last November estimate. Given the projected $20 billion shortfall for this fiscal year, the deficit as a percentage of N-GDP will less than 1.0%, far less than most other western countries. Plus, the ratio of federal debt to N-GDP is less than 31%. The Loonie reacted positively to the budget because the increase spending should favourably narrow the interest rate spreads with the U.S. But only a bit and, therefore not enough to recreate a new path for the Loonie.

- The United States:
  1) Manufacturing output declined 0.4% in February for the second time in a row. On a year-over-year basis, industrial production was still up 1.5%. The capacity utilization rate decreased to 78.2% in February.
  2) The NY Fedès Empire State Manufacturing Index was 3.7, showing no sign of improvement since November last.

Macro View cont.

By Hubert Marleau

3) Job openings in January exceeded those without a job but actively seeking work for 11th straight months, hitting record highs.
4) The U of Michigan reported that consumer sentiment recovered in March to 97.8 versus 91.3 in the previous month.
5) Net Long-term capital flows fell for the second month in a row in January. Net outflows totalled $7.2 billion, down from $48.3 billion in December. It's interesting to note that foreign investors sold $135.2 billion worth of equities in the last eight months ended January 2019.
6) Homebuilder sentiment held steady in March. The NAHB Housing Market Index was 62, well above the 50-point threshold, indicating positive building conditions.
7) Factory orders rose 0.1% , less than what was expected but two consecutive monthly advances in a row.
8) Household financial burdens are low and holding steady. Financial obligations as a % of disposable income was 15.33 % in Q4/2018. It peaks two years ago at 15.75%.
9) The Redbook index of same-store sales (year-over-year) is off the peak but remains elevated, rising 4.9% in February. It was 4.4% in January.
10) Who is funding the US budget deficit ? Domestic pension funds, insurance and households. The rest of the world and the Fed are net sellers of Treasuries.
11) The Mortgage Bankers Association reported that application for mortgages increased 1.6% in the week ended March 15.
12) On Wednesday, the Fed decided to keep rates unchanged with no increase this year. The Fed's intention to stop the runoff of its treasury holdings in September still stands.
13) Jobless claims decreased to 221K from 230 last week. It shows that the recent soft patch for the economy may prove temporary.
14) The Philadelphia Fed's manufacturing index shot up in March to 13.7, significantly above consensus expectations. Demand conditions, new orders and shipments returned to positive territory. Another green shoot.

- China:
  1) Problems in China are dissipating. The global energy economist at Cornerstone Macro said that he sees evidence that things are picking up in China as a result of 67 discreet stimulus measures taken since last May.
  2) Economists at Morgan Stanley said that they saw "green shoots" such as retail sales growing at a 7.1% clip to date versus 6.7% at the end of last year and fixed asset investment in transportation growing at the annual rate of 7.5% in the January-February period from 5.6% in Q4/2018.

Macro View cont.

By Hubert Marleau

- The Euro-Zone:

  The ZEW Indicator of Economic Sentiment for Germany recorded a strong increase of 9.8 points in March. It suggests that the expectations for the medium-term economic development are less pessimistic than they were a month or two ago.

The Recession Risk as of March 21, 2019:

1) The NY FED' s yield curve model shows that the probability of a recession 12-months ahead is 25% - needs to be at 50% to trigger one.
2) Moody's Analytics is presently predicting that there is a 20 % chance of a recession in the next 12 months. The Outlook for U.S. Economic Growth in Q1 as of March 21, 2019
3) The March WSJ survey shows that the chance of having a recession in the next 12 months is 25%, last it was 24%
4) An index of CEO's compiled by the Business Roundtable declined for the fourth quarter in a row, falling 9.2 points to 95.2 - the long-term average is 82.4 and needs to be 50.0 to signal the onset of a recession.

The Economic Outlook for Q1 2019

1) Bloomberg's latest survey of economists shows plenty of downgrades to the current quarters. Yet forecasters are shifting some of the growth to the second quarter of 2019. U.S. GDP growth in the second quarter is expected to be 1.5% and as much as 2.6% in the fourth.
2) The WSJ March survey of economists thinks that Q1 growth to slow down to 1.4%. However, they are expecting a rebound to 2.6% in Q2.
3) Cleveland Fed yield curve model is predicting that the economic growth will average around 2.3% for the year
4) The NowCast Model of the NY Fed is pointing at a 1.0% growth
5) The Goldman's Current Activity Indicator slipped again in March to an annual rate of 1.2%.
6) The NowCasting Model of the Atlanta Fed increased its view on growth from 0.2% to 0.4%.
7) The High Frequency Economic Model of Moody's Analytics increased growth expectation to 0.4% from 0.6%.
8) The Business Roundtable has lowered its estimate of US growth for 2019 from 2.7% to 2.5%.
9) The Fed decreased its forecast for GDP growth to 1.9% and the PCE deflator to 1.8% for 2019--that is basically a two plus two economy. Two for inflation and two for growth.
10) The probability of a rate cut in 2019 is now 50% versus 2.5% at the end of February

Macro View cont.

By Hubert Marleau

The Outlook for Inflation in Q1 of 2019 as of March 21, 2019:

1) The NY Fed's inflation gauge shows that the median one-year expectation rate is 2.8%.
2) The Cleveland Fed's Inflation NowCasting Model expects the PCE Deflator to increase at the annual rate 1.0 % and the CPI at 0.7%.

Technical Perspectives as of March 21, 2019

1) Based on the Dow Theory, the trend for the S&P 500 is bearish with key resistance at 2857 and key support at 2708 - on Thursday morning the S&P 500 was 2826
2) Based on a 7-AM proprietary model, the trend for crude oil is neutral with key resistance at $63.50 and key support at $54.47 - on Thursday morning crude traded around $59.95
3) Based on a 7-AM proprietary model, the trend for gold is bullish with key resistance at $1344 and key support at $1242 - on Thursday morning gold was selling for $1316
4) Based on a 7am proprietary model, the trend for ten-year treasury yield recently is lower with key resistance at 2.83% and key support at 2.42% - on Thursday morning the yield was 2.53%
5) Based on a Palos proprietary model Currency Model, the trend for the Canadian dollar is undefinable with resistance at 76.02 us cents and key support at 74.12 us cents - on Thursday morning the Loonie was trading for 75.09 us cents, The Purchasing Power Parity Rate is 76.25 us cents. Rising oil prices is helping the Loonie while the monetary conditions dictate otherwise.
6) The Equity Risk Premium for the S&P 500 is 336 bps, the P/E multiple is 17.0x and the earning yield is 5.89% - 3.93% above inflation expectations.
7) The Rule of 20, which is the addition of the 12-month forward P/E multiple and 5-year inflation expectation, stands at 18.9 - market neutral
8) The Equity Risk Premium for the TSX 300 is 491 bps, the P/E multiple is 15.2x and the earning yield is 6.57% - 5.36% above inflation expectations. The TSX, foreign exchange adjusted, trades at 4.30 times the S&P 500 compared to 4.34x one month ago and 4.23x three months ago. The 5-year long term average is 5.75x.
9) The U.S. Palos Monetary Policy Index is 571 down from a recent high of 586 from last week. The index considers inflation, international trade, employment and growth. The current index suggests that the economy could take another rate hike. But the downward trend supports the idea that the monetary stance should be on an even keel.

Macro View cont.

By Hubert Marleau

10) The Canadian Palos Monetary Policy Index is 100, down from 130, supporting the BoC decision to maintain the its target rate at 1.75%. The downward trend supports the idea of a rate cut.
11) The St-Louis Fed Financial Stress Index continues to show steady amelioration. The touched -1.22 on March 14 compared to -0.62 on December 24. The more negative the index, the less stress there is. Financial conditions are good and above average.

Disclaimer:

PALOS

1 Place Ville Marie, Suite 1670
Montreal (QC) H3B 2B6, Canada

T. +1 (514) 397-0188
F. +1 (514) 397-0199

1 St. Clair Avenue East Suite 504
Toronto, Ontario M4T 2V7

T. +1 (647) 276-0110
F. +1 (647) 276-0110

www.palos.ca