

# Weekly Market Insights

April 15, 2019

## Earnings Surprises Buoy Stocks, Europe Remains Dormant and Modern Monetary Theory!

The story of the week, at least for investors, was the beginning of earnings season. It was a good start, particularly for financial stocks. Earnings outpaced expectations and did so with gusto. This, of course, is good news but should be tempered a bit by the fact that analysts were aggressive in reducing their first quarter earnings estimates, due to the poor economic performance for the fourth quarter 2018. In any case, the earnings were quite good and this leads to higher equity prices. That combination most often leads to business and consumer confidence. This gives us confidence in our view that the United States economy and the U.S. equity markets should be positive at least through the end of 2019.

Unfortunately, it doesn't appear as if Europe is in the same position. Most of Europe is in a slump and nothing in the economic statistics we look at indicates any real relief in sight. Luckily, we had the good fortune to participate in the IMF/World Bank meeting in Washington this past week. We will have more to report about this meeting in future weeks, but one point was certain. There was great concern about where the European Union economy is and will be in the immediate future. We were fortunate to participate in a rather small meeting with Christine Lagarde. Ms. Lagarde is the Chairwoman of the International Monetary Fund and was speaking in that role. She was pessimistic about the E.U.'s economic progress and the IMF's forecast for a weaker than normal recovery reflects her view. There were no voices raised to challenge the IMF forecast. This discouraging view does not include what may occur with Brexit. Many guess what the economic ramifications may be but, of course, no one knows.

### What's happening with Monetary Policy?

Debate, at least among economists and many financial analysts, has centered around two very interesting and important points: is there an attempt to politicize the Federal Reserve and what about Modern Monetary Theory? We have received a number of requests to spend some time writing about MMT, so we will.

Yes, it certainly appears to be an attempt to politicize the Fed. To a degree, it is very unusual for a president to nominate his own campaign workers to the Board of the Federal Reserve. Fed independence has always been considered sacrosanct. This does not mean other presidents haven't been frustrated and tried to influence the Federal Reserve. This is only the most obvious. Will it succeed? Highly unlikely. The Senate must approve of the nominees and, at this point, at least one is unlikely to win a Senate vote. Remember, Chairman Powell was nominated by this administration and clearly is not intimidated.

### Modern Monetary Theory

We are not sure if this theory is really new or not, but it is getting more and more attention.

We suspect this is because parties, both the Left and Right, are becoming more populist.

This is not the definitive explanation of Modern Monetary Theory. We are not sure there is one at this time, but the concept is certainly not new. This is in an effort to make readers more familiar with the concept.

# Weekly Market Insights (cont'd)

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In a nutshell, the theory goes like this. Assume a country issues its own currency. Then, it can run as large a deficit as it wants. The reason is the debt that it owes, it owes to itself. Therefore, it is a wash. In order to make it work, this is what occurs: the government issues debt to run the government and meet whatever federal debt occurs to meet the demands. The public buys the debt. The Federal Reserve then buys the debt from the original buyers and, therefore, monetizes the debt. Standard monetary theory argues this is a textbook prescription for inflation. It is very enticing for a number of reasons. Many needs can be addressed, investments will be easier to finance and politicians can have a field day. If readers would like to know how this works on the international stage, please read [Exorbitant Privilege](#), by Eswar S. Prasad. Again, not a particularly new theory. If it seems simple, we think in its basic form it is. To be fair, it can become more complicated as the model grows. But to some degree, it's all about "deficits don't matter." Interestingly, it can be argued that this, just as quantitative easing, is not really monetary policy at all, but is fiscal policy run by the Treasury.

Aside from the political temptations, other problems lie in wait. The most telling relates to money. It is important here to define the functions of money. We are sorry if this seems academic, but it is very important.

The five important functions of money are: 1) a medium of exchange; 2) a measure of value; 3) a standard of deferred payment; 4) a store of value; 5) transfer of value. All of these functions would be in danger with the aggressive use of MMT. They all relate to inflation. Think of inflation in other terms - it really is a devaluation of a country's currency. Now, think of what happens to the integrity of those functions if the value of a currency is falling, or even is at the risk of falling. The value of savings falls and lenders suffer. They get repaid with cheaper dollars and pull back while creditors are net beneficiaries. Remember, this theory is most aggressively pushed by populists of both parties. Democratic populists want large budgets and large governments, while Republican populists want large budgets and small governments. The U.S. and the world economies have lived through this in the past with very bad results.

Does this have to happen? No. The theory rests upon the view that all deficits will be directed towards productive resources, such as infrastructure and education. We, and most economists and politicians, think that assumption is herculean. It would be wonderful if it worked, but the probability of disaster is great.



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