Weekly Market Insights

February 24, 2020

Another elimination reality show, more Modern Monetary Theory, and twin dangers

Equity markets suffered a bit this past week. There were a number reasons for this, but it wasn't so much about the coronavirus as it was about some disappointing earnings. The Dow Jones Industrials lost 1.38%, the S&P 500 decreased 1.25%, and the NASDAQ declined 1.59%. We expect some downside surprises, with temporary economic disruption due to the coronavirus. We don't expect this to continue and wouldn't recommend investors to make any changes as a result.

The Reality Show

This past week, Americans were treated to another reality show, otherwise known as a candidate's debate. It was marked by bitter remarks by all candidates, particularly against former New York Mayor Michael Bloomberg. The rhetoric was aggressive and personal, with very little real policy discussion. We have come a long way from the dignified debates between John F. Kennedy and Richard Nixon, moderated by Howard K. Smith in the 1960 presidential campaign. One of the main topics was what the United States response should be to the second Taiwan Crisis. It concerned two Islands, Quemoy and Matsu.[1]

The Democrats are not doing themselves proud in these debates. It will be interesting to see if they can coalesce around the final candidate. It will be somewhat humiliating to take back all that was said; it is just a continuation of the Republican debates of four years ago.

Two Dangers

Although we continue to feel confident in our view that the U.S. equity markets are in good shape for the next twelve months, as always, there are serious concerns lurking in the future. They are old reoccurring problems, the federal budget and the U.S. debt load. We will be writing a lot about the budget during the next few months as Mr. Trump presents his budget to Congress. He has already presented one, but in true Washington fashion, it was just a preliminary shot across the bow. Of course, the budget and federal debt are intimately related. As we have written in the past, the budget has become something of a campaign tool. There is no question that the budget will not be in balance nor surplus. A growing budget that is in deficit is not necessarily a major problem. Most economists would prefer the budget to grow less than GDP, and it would be great if the deficit was caused by government spending on infrastructure. If that is the case, the deficit will be paid back in increased tax revenue due to the productive nature of the infrastructure spending.

Debt, of course, is the result of the deficit. Debt is growing faster than GDP and therein lies the problem. This can't go on forever. Is the current debt load disastrous? No, but Larry Kudlow, economic adviser to the President, spoke of a coming middle class tax cut. That may just push the debt load over the cliff.

Modern Monetary Theory

Although Modern Monetary Theory just recently began appearing in the headlines, its proponents tie its beginnings to the works of John Maynard Keynes, the founder of Keynesian macroeconomic theory. For those who are unfamiliar with Keynes' work, he came to prominence in the midst of the Great Depression, when largescale unemployment and lackluster production was plaguing the world economy. Classical economic theory argued that the Depression would be temporary, and that cuts in spending to offset reduced incomes would allow market forces to return the economy to a natural state of equilibrium. Keynes rejected this idea, and instead argued for policies of increased government spending and tax cuts to boost consumer confidence, leading to an increase in consumption and eventual economic recovery. Deficit spending was an unconventional and unpopular idea at the time; however, Keynes believed it necessary to boost the economy when market forces could not. As readers are well aware, governments around the world are no longer frightened by the idea of deficit spending, far from it. MMT uses Keynes' ideas on deficit spending, but takes it a step further. The size of that step is what is up for debate.

In its most simplistic form, Modern Monetary Theory postulates that a country that creates its own currency, like the U.S., does not have to worry about receiving sufficient revenues or taking on debt to fund government spending because it can always just issue more currency. Supporters of the theory believe currency to be a public monopoly for the government, and increases in unemployment to be evidence of insufficient supply of money in the markets. For this system to work in the U.S., there would have to be a strong coordination between the Treasury and the Fed. The Treasury would lead, and would direct the Fed to either issue more currency or credit its account at the Central Bank to fund spending increases.

Large increases in government spending without parallel increases in revenues would naturally lead to larger deficits. Traditional thinking says this rapid accumulation of debt would be harmful to the economy, likely leading to a rise in interest rates. MMT rejects this idea, and instead argues that countries can sustain much higher levels of debt than they do at present. Reason being, the increased government spending would flood the system with liquidity and decrease demand for cash, thereby driving interest rates down. MMT supporters also place a greater emphasis on sentiment, arguing that overwhelming optimism influenced by higher spending will inspire businesses and consumers to borrow, and invest regardless of interest rate levels.

Modern Monetary Theorists recognize that ramped up fiscal spending could result in increased inflation. They believe it unlikely, however, contending that spending dedicated to worthwhile projects like infrastructure, education, and R&D would lead to increased economic capacity, concluding that inflation would only arise if money growth were to outpace the increase in capacity.[2][3][4]

We have written in the past about our concerns with MMT, but here are a few more points to reinforce our opinion.

Due to its importance to the economic system, we repeat, MMT removes any semblance of independence from the Federal Reserve. This allows politicians to use the budget as a campaign tool. It strongly depends on the monetary stimulus to affect Aggregate Demand and Aggregate Supply equally. Aggregate Demand (AD) and Aggregate Supply (AS) simply represent GDP, but they come from different angles, AD from consumption and AS from production. If, for instance, the monetary effect is to move demand higher on the AD curve without affecting the AS curve, it may produce a powerful bout of inflation. Monetizing government debt can raise asset prices more than it expands the economy, which may result in worsened wealth inequality. We saw this when the Fed, having no choice, flooded the economy with money, raising asset prices and increasing wealth inequality.

[1]The Second Taiwan Strait Crisis, also called the 1958 Taiwan Strait Crisis, was a conflict that took place between the People's Republic of China (PRC) and the Republic of China (ROC). In this conflict, the PRC shelled the islands of Kinmen and the Matsu Islands ... First and Second Taiwan Strait Crisis, Quemoy and Matsu Islands of Taiwan ...
[2]Coy, Peter, Katia Dmitrieva, and Matthew Boesler, "Warren Buffett Hates It. AOC Is for It. A Beginner's Guide to Modern Monetary Theory." *Bloomberg Businessweek.* https://www.bloomberg.com/news/features/2019-03-21/modern-monetary-theory-beginner-s-guide.
[3]Ezrati, Milton, "What is Modern Monetary Theory?" *Forbes.* https://www.forbes.com/sites/jasonbisnoff/2020/02/21/heres-why-the-13-billion-e-trade-deal-makes-sense-for-morgan-stanley/#4520597178d8.
[4]"IS-LM and Making Sense of MMT," *Future Economics.* https://www.futureeconomics.org/2019/05/is-lm-and-making-sense-of-mmt/.

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