1919 INVESTMENT COUNSEL
Complexity to Clarity
100 YEARS

Weekly Market Insights

April 27, 2020

"Inflation is always and everywhere a monetary phenomenon"[1]

Equity markets, after trading in an erratic fashion this past week, closed relatively unchanged. The Dow -1.93%, the S&P 500 -1.32% and the NASDAQ -0.18%.

There are many important and interesting things we could write about this week, but we have received so many queries from clients and friends concerned about the budget and money supply regarding their impact on the future of inflation and the economy, that we will concentrate on that.

We will start with the budget, go to money supply, discuss the two in tandem, and then finally spend some time on Modern Monetary Theory (MMT).

The Deficit

As we all know, the budget deficit is headed for records that we would rather not achieve.

In theory, the consolidated budget of the United States should reflect the needs, wants and aspirations of the country. The budget is a useful tool to help the country, but as we all know, the budget often goes awry and reflects partisan political points. While the budget deficit is truly alarming, its growth is not as alarming as one might think. Most of the growth is vital to maintain the wellbeing of the country. We shouldn't be surprised nor alarmed if it continues to expand as the country tries to get over this crisis. If the option is massive personal and corporate bankruptcies or a large budget deficit, the answer is quite clear. The $64 question is how it is handled when the crisis ends. The country has the resources to reduce the deficit if treated as a long-term project. Voters and politicians must be vigilant and avoid falling into the complacency trap, "nothing is as permanent as a temporary government program."[2] If there are to be no economic dislocations, the adjustments should be reasonably slow and perceived to be fair. The emergency spending programs should be ended and a tax on both businesses and individuals should be enacted. After all, everyone benefited from the debt. No one will be thrilled, so our political leaders must be resolute.

Money Supply

At the onset of the 'Great Recession' the Federal Reserve started an unprecedented expansion of the U.S. money supply. The reason they were so aggressive was not just the seriousness of the recession, but the danger to the global banking system. Their efforts were partially successful. The banking system stood up to the challenge, but neither consumers nor businesses aggressively used the credit the Fed made available to them. Therefore, money remained in bank reserves rather than moving into the economy.

Ultimately, movements in money supply influences aggregate demand. As the money supply increases and interest rates fall, consumers and businesses become encouraged to spend and invest more. This stimulates economic growth and inflation. The Federal Reserve has done a yeoman's duty in attempting to maintain liquid markets and a more than ample money supply. In their efforts, as we all know, the Fed has pumped an enormous amount of money into the system. A reasonable question is—have we substituted a serious bout of inflation for a crushing recession? Again, the answer is unsatisfactory. It all depends on how the Fed responds.

Money supply was growing at an alarming rate well before the health crisis (see Chart A) and we have not seen much, if any, measured inflation. This makes one ask—has the relationship between the money supply and inflation changed? No, but the money must be used in order to create inflation. We have also produced Chart B, which shows the velocity of money. Don't worry about the definitions. It is the shape of the curve that matters. Just think of velocity as the rate at which consumers and businesses actually use the currency in circulation. These two charts tell us that although the Fed has been pumping money into the economy, consumers and businesses are not using it. As the basic money supply rose, the velocity slowed. Therefore, no inflation. It is highly unlikely that the economy will turn around so quickly—remember, the economy was growing at a relaxed pace before the crisis—that velocity will increase dramatically. There is a reasonable chance that the Fed, once the economy turns, can slowly reduce the money supply and not interfere with economic growth while avoiding a serious bout of inflation.

As always, economic projections are based on assumptions. Our assumptions are laid out above. Investors can easily follow the accuracy of these assumptions themselves. We will also be carefully following them and reporting them.

Modern Monetary Theory

Modern Monetary Theory (MMT) is not particularly new. It has been floating around since 1993. The basic tenant is a country that has its own currency can print all it wants, because it can always print more to pay off its debts. Most people have not heard of it, or if they have, they don't really know its basic tenants. There is a good reason for this. Almost no economists accept this as a legitimate economic theory. At best, it appears as a strange alchemy of economics and political theory. It is no surprise that MMT should be discussed now. The U.S. is deeply in debt, lots of expensive social needs have to be met, and we are in the midst of a presidential election. Very difficult decisions must be made, unless you buy into MMT, which will allow you to do all these things and not risk inflation nor currency depreciation. Some interesting points—there would be no independent Federal Reserve, all financial activity will be fiscal, and monetary policy will be the handmaiden of the Treasury Department.

The risks are hyperinflation, there is no Reserve currency that is not backed by an independent central bank—except possibly China—and financial policy can easily become a campaign tool for the sitting administration.

MMT is highly unlikely to become United States policy, but it is important for voters to know exactly what it is. When thinking about why MMT has resurfaced at this time, it's important to wonder if this is the truth or merely convenient.

Chart A

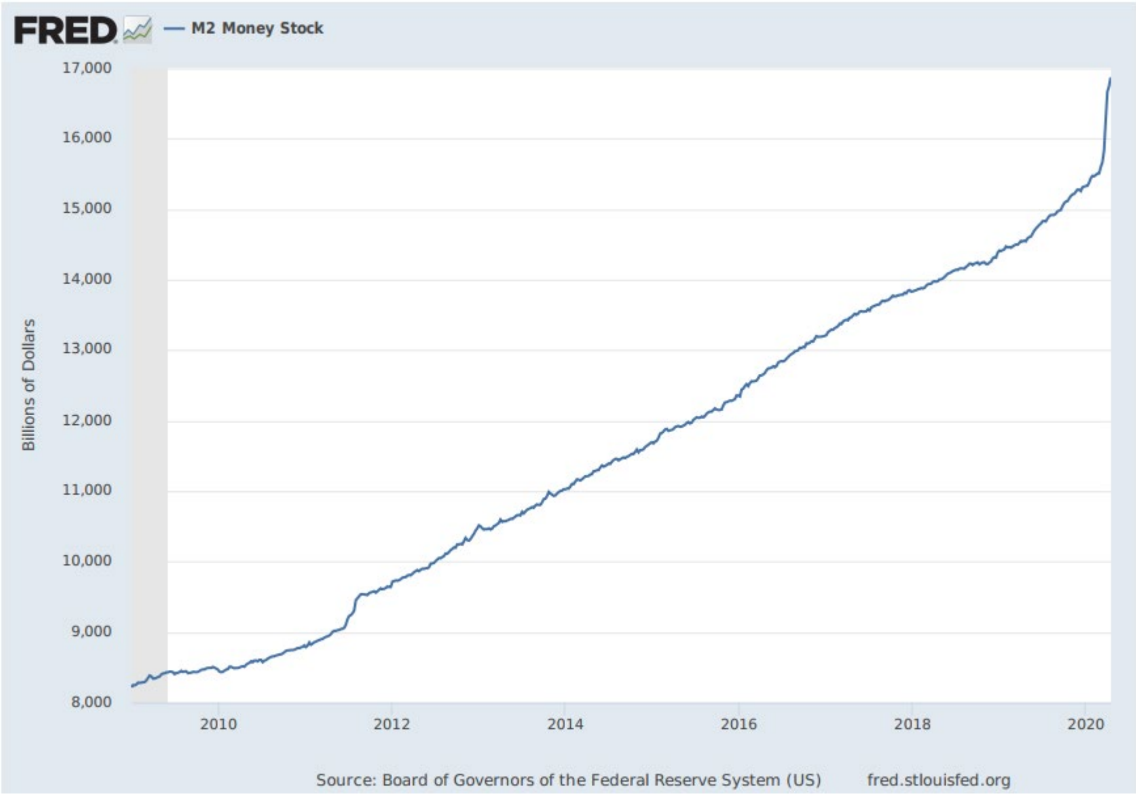
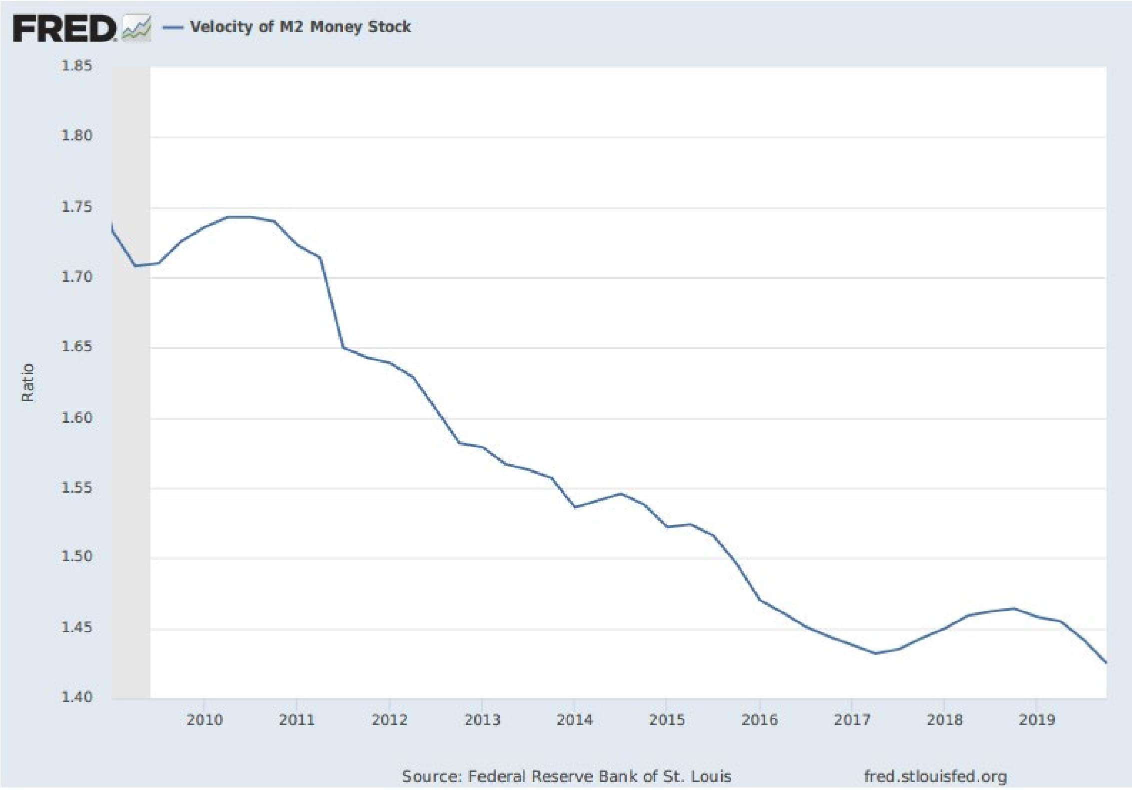


Chart B



[1] Milton Friedman and Anna Schwartz
[2] Milton Friedman

- Michael Olin Clark
moclark@1919ic.com

Please click [here]() for the updated Economic Release Calendar - April 2020.