Economic Viewpoint

Fed fantasy narratives: at this stage in the asset inflation cycle 25bp up or not likely makes no difference

MUFG Securities EMEA plc
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DR. BRENDAN BROWN
ECONOMIC RESEARCH
T +44 (0)20 7577 2712
BRENDAN.BROWN@MUFGSECURITIES.COM

KEY MESSAGES

- Whatever the Powell Fed decides today will make little difference to the course of asset inflation/deflation and the economic cycle ahead. Read on! Insert text here. Press return to add a new bullet.

The end of this cycle determined by monetary inflation history over many years, not by FOMC decision day!

All is vanity – that biblical saying certainly rings true with respect to Fed policy day. Despite the volumes of op-eds, media interviews, and everything else concerning what the Fed may decide tonight and what Chief Powell might say, the likely truth is that it makes absolutely no difference to the course of the business cycle or related asset cycle beyond; it is a show only for the 24-hour trading cycle.

And whilst on the subject of superficiality, let's put aside those financial media TV interviews from leading strategists saying that the market is wrong because the consensus of economists and the Fed assure us that growth next year in the US economy will be north of 2% p.a. According to these pundits there is no danger of recession unless the trade war heats up or the Fed makes a mistake. Absolute nonsense! And one further nonsense, the dangerous nature of a recession if it came in the context of so much unwinding of previous asset inflation makes it even more vital that the Fed attempt to steer the economy out of recession's way (aside: was it Professor Larry Summers saying that, really?).

Now to backtrack for some explanations!

The US and global economy are now in a situation which has been in important respects determined by many years (at least seven) of a great Fed-led monetary inflation (camouflaged in goods and services markets by a powerful downward rhythm of prices under influence of globalization and digitalization). On some diagnoses this could be the greatest monetary inflation ever – taking account of the follow-my-leader inflations in Europe, Japan and China. The massive distortions which have grown up as a result of this, including the mal-investment so much written about by Austrian school economists, may beat all past records, but we will only find that out (including the distribution) in the next recession and beyond. Moreover a painful process of asset deflation and recession is already virtually built into the global economic cake whatever micro-steps the Fed now takes to doesn't take. Past history and indeed economic principle (outside the Keynesian/neo-Keynesian box) suggest that monetary policy changes, even when apparently substantial, cannot diffuse the in-built time recession-bomb under such circumstances, nor can they wondrously produce economic recovery (indeed despite all the wonders of QE and negative rates this past economic cycle upturn has been the slowest ever following great recession).

Long-time readers of "Economic Viewpoint" have read already – many times – about the 1937 great asset deflation and slump as illustration of these points. Just to re-cap, the gigantic QE experiment (not called such) of the Roosevelt Administration produced a powerful asset inflation through late 1935, 1936 and early 1937. The Fed responded already in the second half of 1936 by very slightly nudging up short-term interest rates – and long-term interest rates rose in step. As the stock markets began to recede in the early months of 1937 and signs of economic slowdown ahead multiplied, the Fed came under huge political pressure to reverse its baby tightening steps, Indeed it did so, with long-term rates moving back correspondingly. Through the second quarter of 1937 it seemed that some stability and "market cheer" were returning. Then came one of the most devastating Wall Street crashes ever (from August to October 1937), and an economic slowdown/mild recession already under way but as yet hardly detected developed into one of the most violent economic downturns ever recorded (the so-called Roosevelt recession).

The purpose here is not to predict 2019 on the basis of 1936-7. Rather the purpose is to use this history as a warning against falsely pinning recession and crash at the end of an asset inflation process on the latest Fed policy mistake in fine tuning and against imagining that late cycle small easing can smother the in-built recession danger from the huge monetary inflation of previous years.

But hang on – what about the legendary Strong, Greenspan or Yellen puts?

Yes, a sudden easing of policy in a mid-cycle slowdown when speculative narratives are still riding high and asset inflation robust can extend the party. That is what happened in mid-1927, early 1988, late 1998, and most recently 2016/17. But if the narratives are already withering, the mal-investment beginning to become widely visible, and the secrets/camouflage of high leverage already becoming exposed, such "magic" is not possible. That is most likely the situation of end-2018. Who does not know about the tremendous mal-investment likely related to Big Tech – the vast negative sum games played at the expense of individuals who are negligent or fooled about the expropriation of their private information? And on the subject of leverage, despite the eloquent speeches from the barons of private equity, who does not know that this is a house of cards built on the mirage of forever over-priced risky debt and ever-rising equity values? The vast area of mal-investment extends of course into the volcano of emerging market economies.

No doubt whatever the Fed does tonight it will get blamed for the economic and market adversities that lie ahead. Yes, it is correct to blame these on monetary conduct; but not tonight's or even this year's. And the Trump Administration encouraged the Yellen Fed to continue steering a monetary inflation course through its first year (2017) in the pursuit of vote-gaining stock market euphoria. The looming downturns are all the greater due to that strategy.

Should the Powell Fed now be slashing interest rates? That might turn out to be the case when the history of this cycle becomes revealed – but let none of us imagine that this is the first time that the Fed makes mistakes in fine-tuning and don't confuse fine-tuning error with the big picture of vast flawed experimentation.

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