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MACROCOSM

Are You Feeling Stimulated Yet?

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Is it an experiment in Modern Monetary Theory? Or an experiment in inflation?

We said there would be a political bidding war for "stimulus" in the face of the Covid-2019 crisis (see "Powell Not to the Rescue" March 4, 2020), but hoo-boy, yesterday was really something else. You all saw the headlines rolling in. In the morning, Treasury Secretary Steven Mnuchin was talking about a $750 billion program. A half hour later, it was $850. An hour later, $1 trillion. We stopped reading the headlines at $1.2 trillion, with Mnuchin warning about a 20% unemployment rate if we don't do it. The Trump administration is talking about giving everyone $1000. Democrats want it to be $4,500.

- *Over our many client discussions the last several weeks, this has been an obsessive topic of interest, with the major question being how much and how soon, with some interest as to what the ideal form of it might be. But no client has asked how we are going to pay for it, considering how low Treasury yields have gotten.*
- *We said crazy-low yields had to back up* (again, see "Powell Not to the Rescue" March 4, 2020) – *and now they have*. It's actually been underway for about two weeks, and in a fairly orderly fashion. But in the context of yesterday's stimulus talk, it's being portrayed in the financial media as a sudden "plunge" because of an expected "debt deluge."
- It's only a "plunge" back to where we were two weeks ago, when US Treasury yields were making all-time lows in the entire history of the nation. So it's not like financing for stimulus has suddenly become prohibitively expensive.
- *We should probably just be grateful for a yield curve that's the steepest in over two years*. That signals an increasing degree of confidence in growth, and it reflects the reality that growth has to be financed somehow, even if it has to be by the public sector.
- *We expect that the next phase will be hand-wringing about the simultaneity of large new US debt issuance to finance the stimulus with the Fed's new QE program that will buy $500 billion in Treasuries* (see "Powell Flails Again: Wuhan Flu Over the Cuckoo's Nest" March 15, 2020). *The idea will be that this constitutes "monetization of debt," or an experiment in Modern Monetary Theory (MMT), and the question will be whether this leads, at long last, to inflation.*
- The fear of a resurgence of inflation would have to deal with the question of why there has been so little of it – indeed, by the Fed's

Update to strategic view

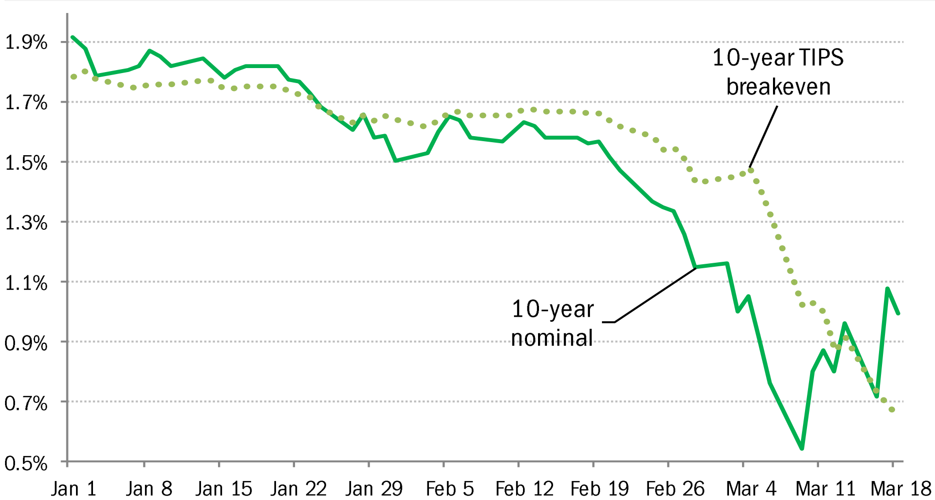
US BONDS, US FED, OIL, US MACRO: The "stimulus" bidding war we've been expected is here. Now with bond yields backing up, there is a question of how we are going to pay for it. But yields are still crazy-low by historical standards. The back-up was expected, and is a good sign that growth expectations are at least slightly improving. Financed in part by the Fed's new QE, US stimulus could be seen as an inflationary experiment with Modern Monetary Policy. But the same charge could have been made in 2008-2009, and if anything inflation has been too low since then. The real issue is the substance of the stimulus. Providing "bridge loans" to firms is key, as well as creating incentives for worker retention and eventual rehiring. With oil making new lows, leveraged US frackers will face the financing squeeze we predicted. The Fed's new commercial paper facility should help as will Trump's idea of refilling the SPR. But only production cuts by Saudi and Russia can durably raise prices.

[Strategy dashboard]

standards, *too* little of it – in the aftermath of a similar policy episode in the Global Financial Crisis.

- What seems like a "helicopter drop of money" then, and may be a similar one now, *should* have triggered a surge in inflation by all prior experience with such things, and yet it didn't. Why? We aren't even going to pretend we know – and we encourage all economists and market participants to use this experience as a lesson in how little we know about what causes inflation.
- The advocates of MMT have politicized the lesson, arguing that in the absence of troubling levels of inflation there is no limit to central bank-financed government spending. That leaves aside the crucial issue of whether government spending, however financed, is a good thing.
- *But the basic principle of their argument is not wrong* – it goes all the way back to the not-modern roots of monetary theory laid down over 120 years ago by Knut Wicksell. His idea was that *the only way you can tell when a central bank is too tight or too loose is by observing inflation*. If inflation is where you want it, then policy must be about right, even if the policy rate seems weirdly low or the balance sheet seems weirdly large.
- *The market evidence on that is encouraging right now*. While the 10-year yield has backed up from its crazy-lows last week, the 10-year TIPS breakeven hasn't budged (please see the chart below). At the moment at least, Mr. Market seems to be more worried about expected growth than expected inflation.

US Treasury yield



Source: Bloomberg, TrendMacro calculations

- *With all this in mind, we're not going to worry about inflation until we see the whites of its eyes. We would expect yields to keep backing up, though – and unless the inflation-compensation component becomes alarmingly dominant, we're going to see that as a desirable reflection of better growth prospects.*
- *So if we're going to go ahead and do a massive stimulus, we're going to be more concerned about how it is designed than how it is financed.*

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[About us]

Recommended Reading

Bernanke and Yellen: the Federal Reserve must reduce long-term damage from coronavirus
Ben Bernanke and Janet Yellen
Financial Times
March 18, 2020

A fiasco in the making? As the coronavirus pandemic takes hold, we are making decisions without reliable data
John P. A. Ionnidis
Stat
March 17, 2010

Is Zero Hedge a Russian Trojan Horse?
Seth Hettena
The New Republic
March 9, 2020

Coronavirus Isn't a Pandemic
Richard A. Epstein
Defining Ideas
March 16, 2020

[Reading home]

- Our own view is that we don't need "stimulus" *per se*, but rather "bridge loans" to finance illiquid firms and households through cash-flow difficulties during a short, sharp slowdown of economic activity. Such "tipping points" are what we warned about from the beginning of the Covid-2019 crisis (see "Another Damn Export from China" January 27, 2020).
- Our old friend former Fed Governor Kevin Warsh made this case forcefully this week on the editorial page of the *Wall Street Journal*. Whether or not the specific mechanisms he proposes on the fly are ideal, or even workable, directionally this is exactly right. *Economically, the pandemic is a potential liquidity crisis, and if treated as such it doesn't have to become a solvency crisis.*
- Warsh's former colleagues seem to have listened. Shortly after, the Fed reignited its financial crisis-era Commercial Paper Funding Facility and Primary Dealer Credit Facility.
- These are very positive developments, and former chairs Ben Bernanke and Janet Yellen are making good suggestions for how other crisis-era programs could be helpful.
- We agree, because giving everyone a grant of $1000 is, in some sense, a big dose of liquidity for the consumer sector. *But we are more concerned with firms.*
- *Firms need marginal incentives to retain workers through any possible slow-down, and then to re-hire any laid off workers as soon as possible in the aftermath. The idea of a payroll tax holiday is perfect for this – as a paper being circulated in Washington by our friend Arthur Laffer argues convincingly.*
- *Ultimately, though, for firms there is no substitute for credit support. The Fed's re-activation of the Commercial Paper Funding Facility is a big step in the right direction, not only for firms facing difficulty rolling maturing paper, but those who can make recourse to this market as a substitute for maturing longer-term financing.*
- *We are especially concerned for the energy sector, as we watch with horror oil prices make new lows, as of this writing, even lower than during the price-collapse that ended in Q1-2016. This is the highly leveraged US sector we've been most worried about from the beginning* (again, see "Another Damn Export from China"). *Now its troubles stemming initially from a pandemic-driven demand drop are horribly exacerbated by the suicidal price-war being conducted by Saudi Arabia and Russia* (see "Just What We Didn't Need: An Oil Price War" March 8, 2020).
- The price-war is indeed suicidal, and we suppose low prices like these are what it takes to get Saudi's and Russia's attention, and end it. There were already signs that they are talking (see "Is the Oil Shock Over Already?" March 10, 2020) – but so far there is no material evidence that they are going to do anything anytime soon to reduce production in line with reduced demand. Indeed, an OPEC technical meeting in Vienna planned for May has been cancelled. A tiny ray of light is the Iraq oil minister's plea today for an emergency meeting – as the second largest producer in OPEC, Iraq has some standing in this.
- *In the meantime, it's politically very difficult right now in the US to be seen as bailing out the fossil fuels industry – even though surely*

even the most green-leaning politicians understand what's at stake here. But certainly nothing can be done that is framed as overtly intended to increase energy prices to consumers.

- President Donald J. Trump's idea of restocking the US Strategic Petroleum Reserve – which has been depleted by 50 million barrels over the last three years to raise cash to fund various unrelated federal programs – is a smart finesse. The SPR could buy about 100 million without expanding existing capacity.
- *But the real issue is liquidity for the leveraged US frackers, one junk bond at a time. The good news is that they would be able to access any credit facility created by the Fed or the congress that is available to all comers – there wouldn't have to be an energy industry-specific bailout requiring a difficult vote.*
- *But US frackers don't have to just get through the virus-crisis, they have to get through a price-war between Russia and Saudi in which they are collateral damage*. Personal diplomacy between Trump and Saudi Price Mohammed Bin Salman could go a long way here – Saudi owes the Trump administration a great deal. *It would be political dynamite, but we wouldn't rule out threatening Saudi with sanctions.*
- But that's only going to be effective when tempers have cooled after what must have been a most contentious OPEC-Plus meeting two weeks ago (again, see "Just What We Didn't Need: An Oil Price War"). We're going to have to endure at least several more weeks of this.

Bottom line

The "stimulus" bidding war we've been expected is here. Now with bond yields backing up, there is a question of how we are going to pay for it. But yields are still crazy-low by historical standards. The back-up was expected, and is a good sign that growth expectations are at least slightly improving. Financed in part by the Fed's new QE, US stimulus could be seen as an inflationary experiment with Modern Monetary Policy. But the same charge could have been made in 2008-2009, and if anything inflation has been too low since then. The real issue is the substance of the stimulus. Providing "bridge loans" to firms is key, as well as creating incentives for worker retention and eventual rehiring. With oil making new lows, leveraged US frackers will face the financing squeeze we predicted. The Fed's new commercial paper facility should help as will Trump's idea of refilling the SPR. But only production cuts by Saudi and Russia can durably raise prices.