ALERT **March 04, 2020**

Mnuchin-Powell Fed adopts IPAD political strategy: A look past technical recession to inflation beyond (IPAD = Indefinite Postponement of Asset Deflation)

How to summarize the Fed-led global monetary response to COVID-19?

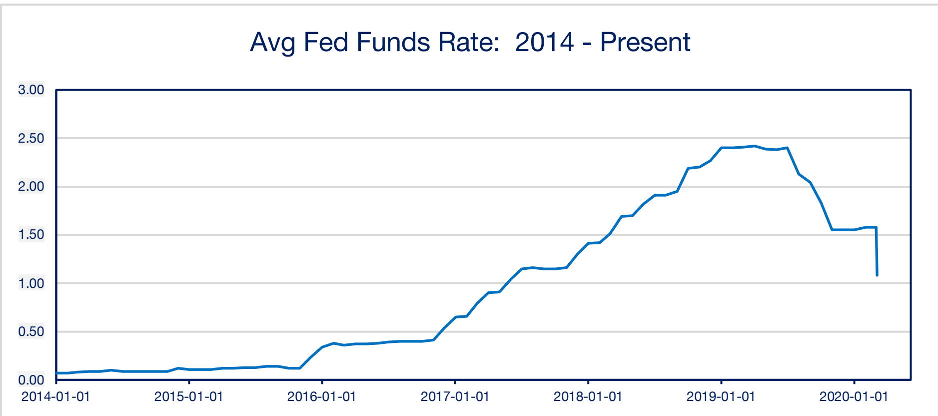
This is a political strategy.

As former Obama Chief Economic Advisor, Professor Summers has noted, the state of the US economy in the second quarter of the election year is the most important (economic) variable determining the outcome (of the election). In this respect things are not looking good for President Trump. The raised likelihood that his opponent will now be Joe Biden (rather than Bernie Sanders) – as already foreshadowed by the South Carolina primary last weekend and now highlighted dramatically by the results of Super Tuesday – has doubtless set the alarm bells ringing within Trump re-election headquarters. We had the intimation of this with the breaking news on Monday night that Treasury Secretary Mnuchin was calling for a 50bp Fed rate cut; doubtless the initiative of calling a G-7 finance ministers conference came from Washington (more on the exchange rate significance of this below).

A 50bp cut in the Fed funds rate between FOMC meetings has only occurred in the past in response to dramatic potential financial and economic collapse. As of now that is not the central or the probability weighted average scenario of how the COVID-19 threat will evolve. Rather we should view this monetary action as re-election driven policy of the Trump White House.

What is the best code-name for this policy? IPAD

That means indefinitely postpone asset deflation (the reversal of years of asset inflation as powered by the Fed under successive Administrations), or at least in practical terms postpone until beyond Election Day!



Source: FRED

100 Pall Mall, London SW1Y 5NQ | Telephone +44 (0)203 995 4488
macrohedgeadvisors.com | mha@macrohedgeadvisors.com

IPAD is not a dollar devaluation strategy in the mode of re-election gambits by Nixon in 1970-2 or Bush in 2003-4. By inviting a G-7 conference, the Trump Administration is turning its back on that, presumably out of concern that devaluation at this point could backfire into triggering a global asset price deflation shock probably preceded by a sudden plunge in long-term Treasury bond prices.

Key questions for investors are how this IPAD strategy will unfold in coming weeks and months. Will the Powell Fed continue its non-fuss implementation of this, though never admitting of course that its actions are politically driven? (Short answer here: yes). Could the IPAD strategy blow up – meaning that despite its aims asset deflation shock does occur? Could IPAD cause the dollar to slide against most foreign currencies? And how will long-term interest rates respond to a meaningful increase in long-term inflation risk? Read on!

And let's start by stepping back; the case for no monetary response to COVID-19 is strong and widely acknowledged even in the private rooms of the global central bankers' club.

After all, what we have here is essentially a supply shock (defined as severe dislocation impeding the input of resources into creating economic output; included in that concept is disturbance of the production process such that output in its normal high-standard form cannot be produced – think here of the inability of firms in entertainment, travel, and hospitality sectors to provide normal infection-free services (now these are delivered with some risk of infection together with risk of quarantines).

Following the maximum dislocation phase of the supply shock there comes a re-bound, as depleted inventories, previous orders gives rise to a fillip in production, and households come to terms with a new inferior delivery of services (now with some infection risk, but surely well down on the perceived levels of the dislocation phase). Also, the pervasive uncertainty which holds back capital spending decisions during the period of maximum dislocation gradually fades.

None of this provides a serious basis for monetary stimulus whose effects in any case would begin to percolate only well into the future (maybe as much as 18 to 36 months). We come back to the main driver of the Fed's present action being the Administration's concern that the spread of COVID-19 at the present time could prove to be the factor which precipitates a transformation of presently virulent asset inflation stoked by years of "radical monetary policy" into asset deflation; a lofty stock market is a key component of the Administration's election message. In turn an asset deflation shock could mean that the supply shock undergoes metamorphosis into a deep global recession.

We will never know whether this metamorphosis would have occurred without the Fed-led "stimulus" now in train. The view here is most likely not at this point. But the Powell Fed has evidently not been in a position to take chances in this matter. Global asset deflation shock at this point, one way or the other, is far from the central scenario – especially where this contains a receding of pandemic alarm. Hot speculative temperatures may well persist in FANG +; the narratives here are not likely to be dented by this epidemic scare unless this proceeds into worst form realization. Speculative narratives are much more at risk in certain areas of the global credit bubble – but given the now aggravated hunt for yield we should not look for a general blow-off so long as the central scenario remains economic rebound beyond the present supply shock lasting in acute form a few months more.

In fact the bursting of this long asset inflation most likely requires either the emergence of serious recession – not just a technical type recession large explained by the passage of supply shock – or a substantial acceleration of goods and services inflation (which would mean a run-up of long-term interest rates and concerns about heavy inflation taxation). We should not expect meanwhile that asset inflation will remain as virulent going forward – the extent of irrational premiums in valuations may well already have peaked across a broad span, with grown vulnerabilities to the downside over the medium-term. But the bizarre monetary stimulus in response to the supply shock of COVID-19 increases the likelihood of slow-burn even through the technical US (and global recession) which lies ahead. Beyond that we should acknowledge the growing danger from a long-run perspective of a rise in goods and services inflation.

Some of this will reflect the influence of stepped up monetary stimulus in the face of supply shock, some of this was pre-programmed due to early prolonged monetary excess, and some (in terms of the data) reflects an ebbing of non-monetary disinflation (slower globalization, maximum impact of digitalization on labour market structure already occurred).

An illustrative time line would be a soft 2020 for the global economy including the US largely due to the supply shock; a rebound which will likely come in two phases (first a catch-up phase maybe as soon as the third quarter of this year, when inventory depletion and unfulfilled orders are made good as dislocation eases; and then possibly after a further weak-gap an economic upturn driven by the delayed impact of present monetary ease and restored confidence) , goods and services inflation breaks to the upside into late 2021 and beyond. Longer term probabilistic vision can spot an ultimate asset deflation "shock" and great recession, most likely foreshadowed by goods and services inflation grinding higher.

Bottom line:

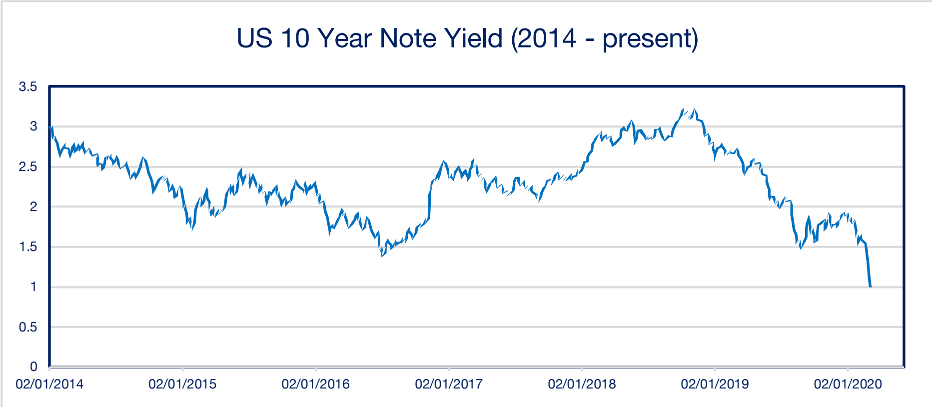
Other central banks now have open invitation from the White House to proceed with monetary easing, even though until now this would have been viewed (there) as a further twist in currency manipulation. They are likely to take advantage of this invitation in various ways – whether rate cuts or new aggressive QE operations.

In Europe, the ECB is most likely to announce radical plans for balance sheet expansion focused on emergency lending into Italy. This means that the dollar is not highly vulnerable – and indeed the grown credit risks could bring the euro under downward pressure. The Swiss franc is also suspect at present lofty safe haven valuations (and we should not overlook the key links between Switzerland and also Germany with Italy).

The likelihood that VP Biden is now the Democratic candidate in the presidential elections means a dramatic lessening in US political risk. The US is not now possibly on the way to Democratic Socialism. (In terms of US equity market valuations, there is a question mark over monopoly valuations given that a Biden Administration might well have to build alliances within the Democratic Party including the embrace of anti-trust action as sought by the Progressive Wing.)

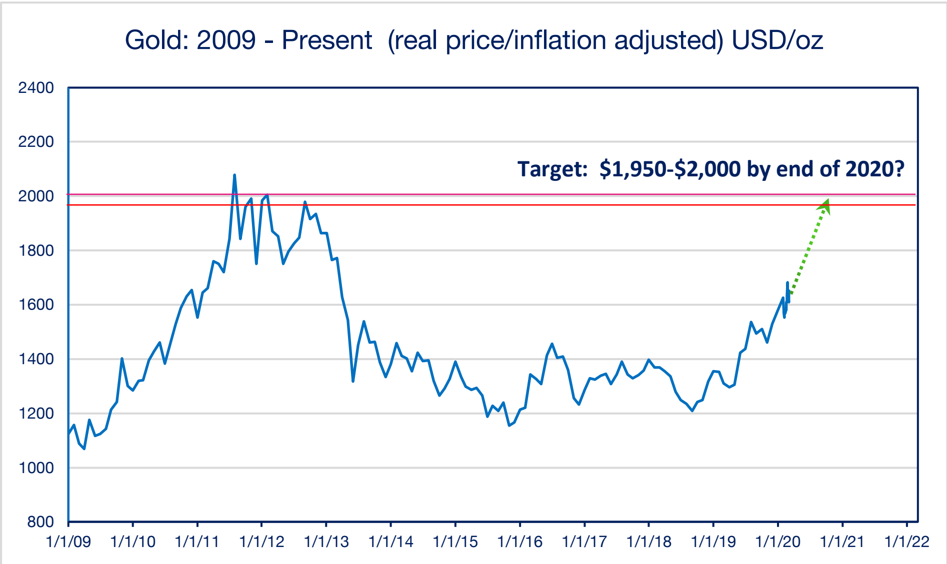
Pre-existing monetary conditions are already aggressively easy around the globe.

Currently circulating views that inflation risks and expectations are falling should be treated with great caution; they may be valid for the next few months but not beyond. Asset inflation remains elevated (as measured ideally by extent of distortion in price signals) and higher goods and services inflation lies ahead beyond the technical recession which looms. Accordingly, long-maturity bonds at super-depressed yield levels are unattractive.



Source: FRED

Yes, sub-1 per cent yields on safe US bonds in themselves mean less attraction of the dollar. But so long as investors consider asset deflation shock as a distant prospect, impressed by the IPAD strategy of the Fed and also optimistic about rebound beyond the immediate supply shock, global funds will surely continue to flow from interest income famine lands around the world into US risk assets, whether equities or credit, and also into Treasuries where the alternative is sub-zero rates. Political dangers loom larger in Europe (Germany and Italy) and Asia (Japan and China) now, in the wake of Super Tuesday, than in the US. Gold should get sustenance from the further degradation of fiat money led by the Federal Reserve's anti-covid19 stimulus.



Source: MacroTrends LLC

100 Pall Mall, London SW1Y 5NQ | Telephone +44 (0)203 995 4488
macrohedgeadvisors.com | mha@macrohedgeadvisors.com
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