THE BIG PICTURE OF GLOBAL ECONOMICS

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To Infinity and Beyond

- **Markets are still thinking about the potential impact of near zero interest rates for years to come.**
- **Strategists seen giving up trying to analyse what it implies for asset values.**
- **Difficult to see how the Fed will achieve its long-term goal of inflation without new tools.**
- **Nasdaq sell-off a correction from overbought rather than deep trouble.**

The markets are still struggling to absorb the implications of the Federal Reserve's seeming commitment to run near-zero rates for years to come. Some analysts have thrown in the towel, saying it has become impossible to forecast markets in such a scenario. Put very simply, if you divide the output growth of an economy by the discount rate to arrive at fair value then output divided by zero equals infinity. We surely live in some strange times.

Further reflections on the Fed

Even with the passage of a further week, economists and market commentators are still struggling to come to terms with Jay Powell's comments at Jackson Hole. Without defining the tools, the Fed would ultimately use; he is again asking us to believe that somehow this time monetary policy would work. A few thoughts-

1. Why should inflation somehow get closer to 2% this time when the Fed has not achieved its target before? And by the way, the Fed has never given a rationale for why the magical 2% figure is a valid or relevant target.
2. An ever-increasing amount of quantitative easing is no panacea. Japan has tried for two decades to throw money at the problem. Since the financial crisis, Japan has experimented with QE on a scale of three times that of the United States but has still failed to achieve its goals of inflation and growth.
3. For monetary policy to work, the velocity of money must increase. Instead, for the past fifteen years, the US velocity of money has been falling. Until the Fed is explicit is planning to aid an improvement in the velocity of money, QE may remain relatively impotent. This is close to the Keynesian concept of a liquidity trap. No matter how large the money supply, it makes little difference if it is hardly circulating through the real economy. This effect – policy pushing on a string – helps to explain the big “gap” between Wall Street and Main Street.
4. The idea that the Fed will drive the unemployment rate down to a level that creates inflation doesn't square with recent history. Instead, investment in technology is improving the productivity of workers which in turn reduces the demand for labour for a given level of GDP. The Phillips Curve promises a menu of choice between price level and unemployment rate: for higher levels of employment, inflation is supposed to be higher. This is not working, and has not worked, anywhere, for long enough for the entire notion to be questionable theoretically.
5. The US economy cannot afford interest rates to get back to anything close to normal. A level of interest rates that for example, starts to clear some of the enormous pension deficits. However, the US can't afford higher interest rates. The Government and corporate sectors have gone on a borrowing binge that cramps growth and limits the degree to which the Fed could raise rates in the future. Remember that every attempt to raise rates or moderate QE materially has led to a sell-off financial markets that have sent the Fed into reverse.
6. The good news for the financial markets is that the Fed is committed to the same policy of asset price inflation that it has deployed since the financial crisis.
7. The bad news is that somewhere out there in the future is the day when the markets say the "the emperor has no clothes" and US financial markets reprice to a risk premium of a failed economic experiment. For a country that needs foreign capital to fund its government deficits that day of reckoning could be earlier than they expect.

Nasdaq pauses for breath

The NASDAQ index finally succumbed to profit-taking after an extraordinary run. Even at last weeks close the index has some 17 percentage points above its 200-day moving average. The index has risen smartly since its low in late March. The NASDAQ surpassed it's February high in

early June and has subsequently risen a further 15%, even after its late setback. Profit upgrades have in part supported the rise in the index since mid-June to earnings forecasts for the NASDAQ index. Consensus earnings forecasts for the NASDAQ index have risen by ten percentage points since mid-June although the level of forecast earnings is still 20% below the forecast of early February. The Nasdaq index has also received significant support from smaller investors using the Robinhood platform in the United States. There is a substantial weighting of Nasdaq/tech stocks in the most heavily traded stocks on the platform.

The Nasdaq may see some further profit taking if there is a capitulation of recent buyers. Selling of the NASDAQ ishare ETF was particularly heavy on Thursday and Friday at close to twice the average daily volumes. However, there were some signs of investors using the setback as a buying opportunity with Tesla up 2.5% on Friday after its set back from a peak of 498, bottoming at 382 down 30%.

Even with the tech growth companies in trouble, the value stocks still didn't show any performance. The US value index continued its sideways movement of the last month. Banks, airlines and steel stocks all have shown little to suggest that they were about to break out to the upside.

Significant outflows from dollar cash funds will have to find a home, so we suspect that any sizeable setback in equities will not last long. Investors are taking the Fed at its word and the prospect of near-zero rates for potentially some years to come is pushing them to invest in either higher risk bonds or equity markets.

The Fed running such loose monetary policy is creating mayhem for equity strategists some of whom are reported to have virtually given up trying to predict where the index will be over the years to come. The Fed is taking the fear out of the equity market by saying it will be very accommodating of a pickup in employment and inflation. We also believe that the Fed is more likely to create asset price inflation than real goods and services inflation in the economy. For all the efforts of central banks in the major economies, the velocity of money has continued to fall. According to data from Bloomberg, the velocity of money in the United States today is barely half of what it was back in 2007. Assuming, thus, that the old relationship between money and inflation holds, money supply has to double before prices even feel pressure to rise. The assumption might need adjusting if the relationship is not linear, i.e. if there is diminishing effect to scale, money supply would have to expand even more to make up the difference, so to speak.

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