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"The Gift That Keeps On..."

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It has been said that the act of giving is a gift in itself. It is widely believed that giving can be psychologically more beneficial to the giver than the recipient. Our policymakers must truly believe in this power of giving and its benefits politically. Currently, both fiscal and monetary policies are designed to promote higher stock prices and lower interest rates. Markets are no longer a reflection of the state of economic conditions. Managed capitalism needs markets as a feedback mechanism. Policymakers are too reliant on price discovery to ensure that they are doing the right things. This system is designed to reward risk-taking by minimizing the risks. An unintended consequence is a gift to market participants in the form of higher returns.

The rebound this year in risks assets is attributable to a reversal in the actions of policymakers. First, the Fed was blamed for the weakness in stock prices in the fourth quarter of last year. Chairman Powell reacted to the weakness in equity prices and pressure from President Trump by reversing course on his policy of gradually raising interest rates. He now favors a more patient path. The Chinese leadership followed with a series of stimulus measures designed to promote consumption. And most recently, the Europeans announced an about-face on interest rates and a new round of loans to their battered banking institutions. Central banks may not be ready to hit the accelerator, but they have for sure taken their foot off the brake pedal.

It is increasingly clear that policies designed to promote inflation are failing. Despite tightening labor markets and selective increases in commodity prices, a general increase in inflation has been difficult to achieve. This is particularly problematic for policymakers attempting to minimize the negative shocks of a heavily indebted global economy. Complicating matters is the evolving slowdown in global growth. The failure of policymakers to grow or inflate away excessive debt levels is an early warning sign of another economic crisis. Recognition of a problem is the first step to a cure. Nevertheless, policymakers have been reluctant to accept that policies designed to promote debt are a source of deflation risk and not a cure. Investors meanwhile remain too complacent.

Throughout the recovery from the financial crisis, investors have been incentivized to buy the dip. Central banks are quick to react to drawdowns in equity prices. Lower rates are a shock absorber for risk; however, they can also be an inducement for speculation. It is only with the benefit of hindsight that the good can be separated from the bad behavior.

Unconventional central bank policies have not led to the anticipated inflationary shock feared for the real economy. In fact, the gradual pace of economic growth has led to few imbalances and has prolonged the expansion. In this Goldilocks economy, things are neither too hot, nor too cold. The economy has been warm enough to spur employment but not wages. It has not been cold enough to restrict the ability of debtors to meet their obligations. Policymakers should and will tolerate a faster pace of growth. They will risk inflation if they are lucky enough to experience it.

Meanwhile, ongoing trade negotiations complicate the outlook. This growing uncertainty has deterred private sector investment. Should it prove temporary, it could lead to a resurgence in economic activity and force central banks to reverse course yet again. Though, if it proves permanent, it will require central banks to be far more aggressive in their accommodation. More likely, it will drag on for many years with periods of conflict leading to periods of stability and then back to conflict. The dividing line between conflict and war, perhaps especially in the context of trade, is not clearly delineated. Only after the bullets start to fly is it easy to identify the winners and losers. Moreover, in a drawn-out conflict, there are unlikely to be any winners, only losers.

It is apparent that both monetary and fiscal policymakers now rely on the performance of the stock market as a guide to policymaking. Is it the tail wagging the dog? Perhaps. Stock prices reflect human emotion as much as economic logic. The volatility of stock prices incorporates the uncertainty of the valuation process and the range of possible outcomes. It is somewhat circular reasoning to assume that the mechanism which is supposed to reflect economic activity is being used to sustain economic activity. Maybe it is the best tool at our disposal. The transition to managed capitalism was so abrupt following the financial crisis that policymakers may not possess any better tools to provide prosperity. Attempts to tame markets have historically created problems. Human history is littered with attempts to provide upside potential and eliminate downside risks. Unfortunately, attempts to promote well-being in the short run most often mean expanding risks in the long run. Policymakers, even if well-intentioned, have a long history of failed interventions. The unintended consequences of their attempts to provide stability often lead to more extreme outcomes for both winners and losers. Markets, while not perfect, are at least fair.

The lack of fiscal and monetary discipline since the financial crisis is a significant contributor to the feeling of wealth disparity that the public is feeling. By targeting higher stock prices and lower interest rates, the policymakers have rewarded speculation and leverage. The wealthier segments of the population, who generally own financial assets, have disproportionately benefited versus the working class. Real wages for labor have lagged real returns on capital. Positive outcomes trickled up but did not trickle down. While perhaps impossible to prove, it is very possible that we would have been better off without their intervention. Maybe the gift that policymakers were giving was in truth better for them than for us.

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