Beneath the Surface

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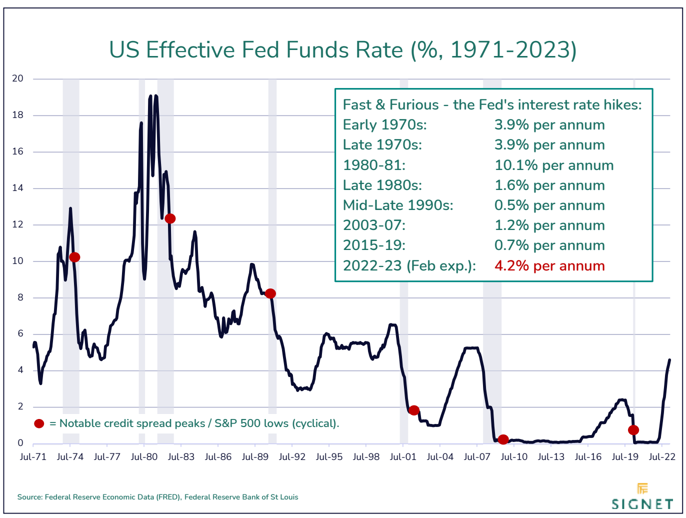
SIGNET

A Fool in the Shower: Aggressive Monetary Policy

- To reduce the possibility of deflation in the years following the Great Financial Recession (GFC), and arguably up until the beginning of 2022, the Fed conducted a risk management strategy where it held the Fed Funds rate below the optimal level that would have promoted a balanced and efficient economic growth rate. The cost of that strategy was an elevated possibility of the domestic, and international Eurodollar, economy overheating, with the associated over-extension of asset prices. The Federal Reserve was not alone in implementing this strategy either. When central banks suppress the true cost of capital – the price of risk – for long periods of time, they risk the misallocation of both capital and scarce resources. Borrowers, lenders, investors and regulators are lulled into complacency as asset prices rise. Leverage increases and securitization – often in the shadows – adds a distance and duration between borrowers and lenders, complicating the regulators' role, and concealing the underlying risks.

- Investor complacency and the drift towards risky assets were documented in 'Low Interest Rates and Risk Taking: Evidence from Individual Investment Decisions,' by Lian et al (2018). With even greater academic pedigree is Hyman Minsky's Financial Instability Hypothesis (1992), which suggests that when optimism is high, and ample liquidity is available, investors tend to shift from the conservative end of the Minsky investment 'spectrum' to the more speculative end. Practically, we can observe an element of that behaviour through the US margin debt-to-GDP ratio, which reached 4% in 2021 and remains close to its most elevated level since The Great Depression.

- Rather than claim a permanently high plateau in market variables, or economic cycles without the presence and consequences of hard recession, we should be prepared for the reversion to mean of key data. That reversion is usually triggered by monetary policy. Given the highly uncomfortable inflation data of the last two years, and the further concern for sticky inflation expectations, monetary policy has recently been exercised aggressively, which investors may be underestimating. Aggressive monetary policy is at risk of shocking the economy and asset prices, and this could be pronounced because most central banks are hiking from the 'zero bound'. The reason is because monetary policy operates with long and variable lags, which means that the consequences of recent hikes may be both delayed and unpredictable. Raising rates, as most central banks are now doing, should lead to slower growth and lower inflation, but it can take time for the full impact to be felt – perhaps up to two years.



- The Nobel prize-winning economist Milton Friedman believed that policy action should be conducted incrementally and with long lags, rather than rushed forcefully, in order to appraise the unpredictable repercussions of the action properly. Friedman used the 'fool in a shower' metaphor: a fool jumps into a shower and realises that the water is too cold. He turns on the hot water. However, the hot water takes a while to arrive and so the fool keeps on turning the hot water dial up, eventually scalding himself.

- The chart (left) plots the US Effective Federal Funds Rate (the Fed's administered hybrid interest rate) and it highlights the *speed* at which US monetary policy has been conducted over the last year. Interest rate hikes are currently running at 4.2% per annum, versus – for example – 1.2% per annum for the years 2003 to 2007 and 0.5% per annum during the 1990s. The aggressive nature of current policy has only been exceeded once, during the early 1980s under Paul Volcker, and that was between recessions. We must remain alert to a key policy error.

- **Therefore:** We are cautious going into 2023. Remain defensively invested. Fixed Income: there are opportunities to target quality and liquidity. Equities: target quality but there's no rush. Commodities: target precious metals.