Has MMT Infected Central Bankers?

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Have major central bankers and fiscal authorities effectively pursued Modern Monetary Theory in practice, if not in name, as debt monetization has lost its stigma? Equity investors cheer weaker-than-expected economic data and dire COVID-19 public health updates amid expectations of increased policy response. Central bank asset purchases push investors into risky assets and raise prices on investment-grade bonds, of which the global stock with negative yields has ballooned to about $18 trillion. Valuations are trickier than ever in equity and bond markets.

Top central banks are "already engaging in, at least in theory, short-term MMT," says Thornburg Portfolio Manager Jeff Klingelhofer, referring to Modern Monetary Theory and noting that major central bank balance sheets have already expanded more than $10 trillion in 2020. "Undeniably we are monetizing debt." U.S. fiscal stimulus has hit one-fifth of GDP, while Federal Reserve monetary injections of 29% of GDP mean that total U.S. policy support may reach nearly half of the country's economic output this year. More is on the way in Europe and elsewhere, as top monetary authorities appear ready to leverage central banks' balance sheets for social and environmental policy goals, in addition to their discrete monetary policy objectives.

While consumer spending and savings rates are both higher than they were pre-COVID-19, what are the economic and financial market risks in the rapid expansion of global debt ratios? Will inflation follow the virus' initial deflationary impact? How should fixed income portfolios, which face particular risks from potential inflation, be positioned for a likely economic rebound in 2021? What does normalization look like beyond the rebound?

Such Dire Headlines. Such Market Jubilance

U.S. benchmark equity indices hit fresh record highs on the same Friday in early December that U.S. COVID-19 infection, hospitalization and death rates also hit record highs. The market was cheered by a big miss in November payrolls data, which, together with the grim virus tallies, raised expectations that fresh fiscal stimulus had become more likely.

"Bad news is good news" and markets tend to "look through" current conditions are the usual explanatory nuggets of conventional wisdom. But how far into the future are investors actually looking? Many are tactically positioning for a 2021 recovery, fueled by vaccine roll-outs, a sea of policy stimulus, corporate re-stocking and a snap-back in global consumption. Comparisons against 2020 numbers will be easy. But what about the subsequent normalization in 2022, when comps won't be so easily flattered?

Not too many investors are looking that far down the road or watching out for the inevitable potholes ahead. While global growth and corporate profits are set to rebound in 2021, how much upside is left for stocks not just in the U.S. but globally? The MSCI ACWI Index has also been hitting record highs since early November. If stocks are priced to perfection, what happens if perfection proves elusive, either because prices have outrun business fundamentals, or the macro scenario isn't as supportive as expected, or the punch bowl is far too heavily spiked and financial bubbles emerge? The signals from flat to negative risk-free rates are distorted by major central bank asset purchases, which push investors into risky assets and pump up prices on "risk-free" sovereign and high-grade corporate bonds. The global stock of negative yielding investment-grade debt has ballooned to nearly $18 trillion, according to Bloomberg. Valuations are trickier than ever, in equity and bond markets.

What if all the debt monetization ultimately leaves economic conditions more challenging, with the global debt overhang far more towering than it was before the coronavirus rampaged around the world? What's the probability that in a couple years the global economy is back in an environment of low inflation, low interest rates and low growth? Or that long-dormant inflation roars back to life? Have major central bankers and fiscal authorities contracted Modern Monetary Theory in practice, if not in name, as debt monetization has lost its stigma?

Global Stimulus Hits 1/3 of Global GDP

As Thornburg's Co-Head of Investments and Portfolio Manager Jeff Klingelhofer points out, central banks in many parts of the developed world are in many ways "already engaging in, at least in theory, short-term MMT." His comments in the latest *Away from the Noise*[1] podcast are worth quoting at length: "We've seen central bank balance sheets around the world increase by over $10 trillion (this year), so undeniably we are monetizing debt. The question is, are we operating with the assumption that we never have to pay it back or… that we do? I would argue that broadly we're still operating with that (latter) assumption. But the reality is we won't actually try to pay it back, and therefore, we are certainly closer to MMT than we ever have been, if not in outright MMT."

The Institute of International Finance reckons total global debt has surged more than $15 trillion this year, and is on track to reach $277 trillion, or 365% of world GDP by the end 2020. While all segments—households, non-financial corporates, the financial sector, governments—have increased their indebtedness in 2020, advanced economy public sectors have been especially aggressive: global public debt rose more than 13% to $59.8 trillion in the third quarter from $52.7 trillion in the year-earlier quarter. The U.S. posted the biggest increase in its public debt, which rose 25% in the period to 127% of GDP.

In the 2008 financial crisis, U.S. fiscal stimulus amounted to $800 billion, but the real "bazooka" came from the U.S. Federal Reserve's "zero-lower bound" interest-rate policy and asset purchases, which quintupled its balance sheet from $900 billion early that year to more than $4 trillion by 2014.

Total fiscal stimulus this year alone amounts to roughly $4.2 trillion, or 20% of GDP, according to Cornerstone Macroeconomics. Together with monetary injections of $6.21 trillion, or 29% of GDP, and Washington will have thrown about $10.4 trillion, or the equivalent of nearly half of U.S. GDP, at countering the economic hit from COVID-19. Add to that the monetary and fiscal stimulus from the eurozone, Japan, China and elsewhere, and global stimulus totals about 33% of worldwide GDP.

More is on the way in Europe and elsewhere, as central bankers stray from their traditional bailiwicks of price and foreign exchange stability, facilitating market liquidity and an efficient payments system and supervising banking operations. While the Fed also has a mandate to foster full employment and the European Central bank is also tasked with supporting the "general economic policies" of the European Union, both institutions have been wading into social and environmental policy discussions, areas that MMT advocates argue can be financed via money printing of reserve currencies.

Leveraging Monetary Authorities

In 2014, then Fed chair Janet Yellen, whom President-elect Joe Biden has tapped to be the next U.S. Treasury Secretary, said, "the past few decades of widening inequality can be summed up as significant income and wealth gains for those at the very top and stagnant living standards for the majority. I think it is appropriate to ask whether this trend is compatible with values rooted in our nation's history, among them the high value Americans have traditionally placed on equality of opportunity." Current Fed Chair Jerome Powell recently told the Senate Banking Committee that inequality could worsen "if we don't act as quickly as possible." European Central Bank President Christine Lagarde frequently speaks of leveraging the eurozone's monetary authority to help in the fight against climate change and inequality.

While the current rebound in risk asset prices has exacerbated wealth inequality, policy stimulus in 2020 has been effective in supporting demand. Whereas stimulus in 2008/09 supported the supply side, with commercial banks recapitalized and paid interest on the deposits or excess reserves that they had parked at the central banks in the U.S., Europe and other advanced economies, this time around public loan guarantees for "Main Street" businesses, paycheck protection programs and supplemental unemployment benefits have directly benefited individuals and many smaller companies.

In the U.S., this is evident in retail spending and durable goods purchases, as well as in deposits at commercial banks. In fact, the sharp rise in deposits only leveled off after supplemental government transfer payments expired over the summer. But, M2 money supply continues to spike amid Fed asset purchases of roughly $120 billion per month, including $80 billion in Treasury securities and $40 billion in mortgage-backed securities.

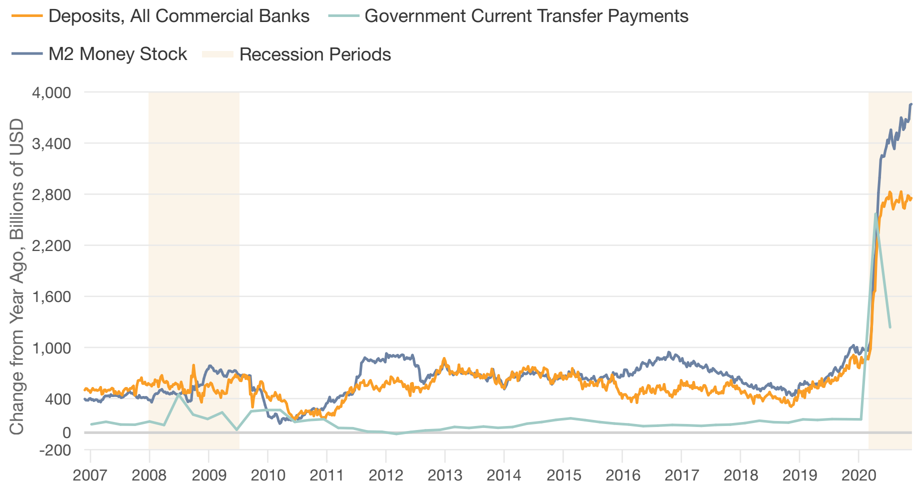
Rock-bottom and negative benchmark rates effectively enable the pursuit of MMT through debt monetization. Its defenders contend that only real constraint in an economy with a hard currency like the U.S. dollar or the Japanese yen is its productive capacity. Once exceeded, inflation should finally materialize and authorities can then deploy taxes and regulation to bring prices back into alignment with capacity, its backers argue.

No Pre-Identifiable Outcomes

Klingelhofer doesn't think it's that simple. "Clearly, we haven't understood what is driving low inflation, and I think it's hard for somebody to suggest that central banks…would see inflation coming and be able to slow it down preemptively."

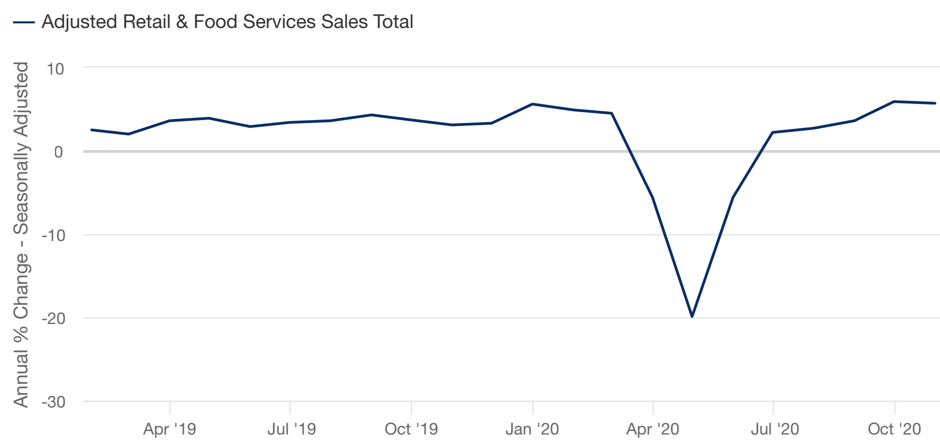
For now, COVID-19 has contributed to the deflationary environment of the last decade. The virus' hit to the retail services industry is deflationary:

Figure 1 | A Fork in the Money Flow



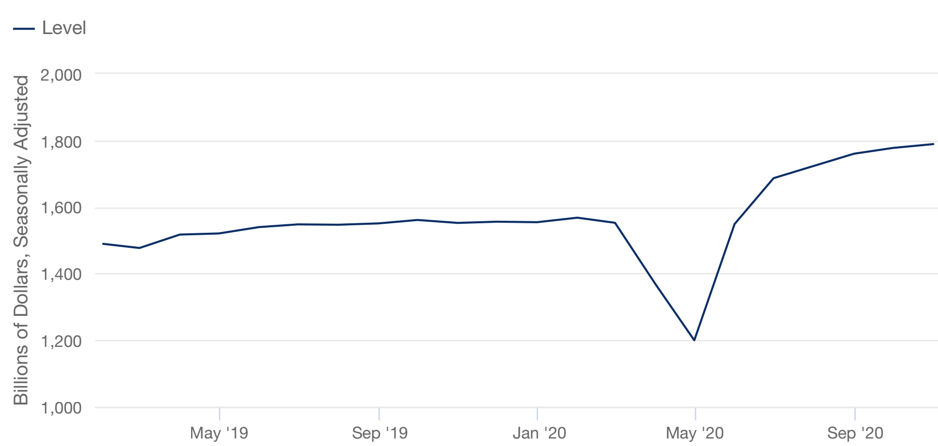
Source: St. Louis Federal Reserve

Figure 2 | Retail Sales: Bigger Than Before



Source: Bloomberg, U.S. Census Bureau

Figure 3 | Consumer Spending on Durable Goods

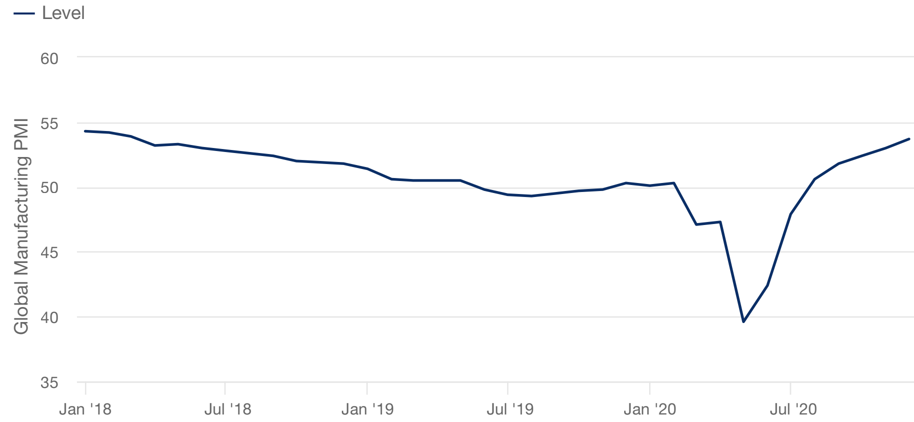


Source: Bloomberg, U.S. Bureau of Economic Analysis less business and leisure travel and "work from home" reduce the call on transportation fuels, occupancy at hotels and foot traffic at restaurants, bars and gyms. WFH also spurs deflationary corporate cost cuts in sales forces, office parks and commercial districts amid a demographic demand shift from urban centers to less pricey suburbs and towns. Tech investment in firms across sectors is being brought forward due to the virus' impact; productivity gains from the adoption of digital applications tends to be deflationary. Debt monetization in Japan[2], Europe and the U.S., it seems, has so far been deflationary. But major central banks have never before engaged in the fevered degrees of money printing that they have in response to the 2020 pandemic.

Signs are now growing that inflation is a real risk, as we first warned about in April[3] and more recently in our 2021 Markets Outlook[4]. Commodities prices are surging; global PMIs are at expansionary levels not seen since early 2018; and freight rates are galloping: the Platts Container Index is up more than 140% this year at a record high. And at 1.77%, U.S. two-year inflation breakevens have climbed to their highest level since April 2019.

Trying to call future inflation is a perilous exercise. Yet it's the key risk across financial asset classes, from richly priced equities to financially repressed fixed income. How does Klingelhofer balance the risk of potential inflation

Figure 4 | Global Manufacturing PMIs



Source: Bloomberg, Markit

and a steeper yield curve? How does he "look through" the current market, debt, and policy stimulus dynamics? Not by banking on a singular macro outcome.

"You're destined to fail if you are designing a portfolio for a very discrete outcome, simply because the world is incredibly complex and you generally don't get a pre-identifiable outcome," he points out. "Portfolio construction is a continuum…The system absolutely has many potential threats for an inflationary environment in the future as the world heals. I wouldn't say that's necessarily my base case, but it's not something to dismiss. I would also argue you're not compensated to step out in risk-free rates for significant duration. So, keeping cash flows very short to maturity allows us to reinvest if we do see a higher inflationary environment and thus ultimately higher rates would be available on bonds. We're staying short in duration and owning some direct, inflation protection within the portfolios."

1. "Is MMT Debt Monetization by Another Name?," https://www.thornburg.com/insight-commentary/podcasts/is-mmt-debt-monetization-by-another-name/.

2. "Is the Federal Reserve Taking the Measure of Japan's Yield Curve Control?," https://www.thornburg.com/wp-content/uploads/home/pdfs/TH4662_Is-the-Federal-Reserve-Taking-the-Measure-of-Japans-Yield-Curve-Control.pdf.

3. "How COVID-19's Deflation Shock May Spawn Inflation Outbreak," https://www.thornburg.com/insight-commentary/global-perspectives/market-insights/how-covid-19s-deflation-shock-may-spawn-inflation-outbreak/

4. "Outlook 2021: Reflation, Rotation and Reopening to Re-shape Equity, Bond Markets," https://www.thornburg.com/wp-content/uploads/home/pdfs/TH4715_C-O-2021-outlook.pdf

Important Information

Duration – A bond's sensitivity to interest rates. Bonds with longer durations experience greater price volatility than bonds with shorter durations.

M2 – The amount of money in circulation in notes and coin plus non-interest-bearing bank deposits, building-society deposits, and National Savings accounts.

Mortgage-backed Security – A type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must be grouped in one of the top two ratings as determined by a accredited credit rating agency and usually pay periodic payments that are similar to coupon payments. The mortgage must have originated from a regulated and authorized financial institution.

PMI (Purchasing Managers' Index) – An indicator of the economic health of the manufacturing sector and for the economy as a whole. The PMI Index is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment. A PMI of 50 or higher generally indicates that the industry is expanding.

Important Information (continued)

Riskless (or risk-free) Interest Rate – The theoretical rate of return of an investment with zero risk. The risk-free rate represents the interest that an investor would expect from an absolutely risk-free investment over a given period of time. Though a truly risk-free asset exists only in theory, in practice most professionals and academics use short-dated government bonds, such as a three-month U.S. Treasury bill.

Yield Curve – A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

The MSCI ACWI Net Total Return USD Index is a market capitalization weighted index that is representative of the market structure of 47 developed and emerging market countries in North and South America, Europe, Africa, the Middle East, and the Pacific Rim. The index is calculated with net dividends reinvested in U.S. dollars.

Platts Container Index reflects weighted average USD fees for carrying 40-foot equivalent unit (FEU) containers on various global shipping routes.

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