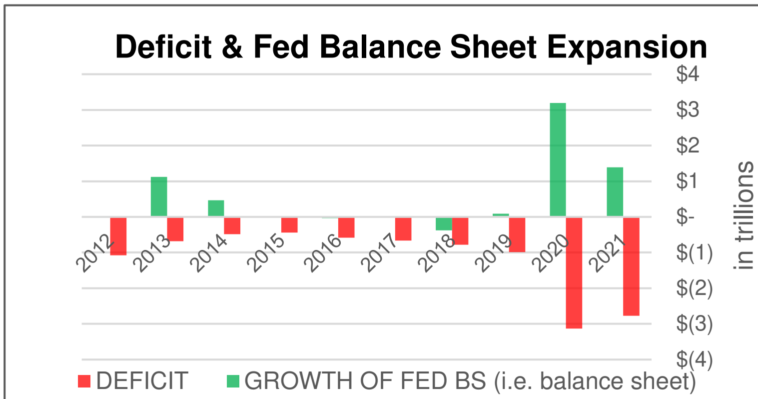
The Long & Short of It
Quarterly Newsletter
Fourth Quarter 2021

Crony Monetarism



Source: Office of Management and Budget. Federal Reserve.

Inflation ran at 7.0% in 2021. The last time inflation was this high, in June 1982, Treasury instruments maturing in one year yielded 14.3%. On 12/31/2021, Treasury instruments maturing in one year yielded 0.4%. Why are interest rates so low in the face of such high inflation? Because the Federal Reserve conjures trillions of dollars from thin air. Enough to purchase half of all Treasury debt issued during the last ten years, especially in the last two years (see table at right). These Fed purchases drive down interest rates and allow Congress to continue its deficit spending, which in turn helps members of Congress get reelected.

Merriam-Webster defines *crony capitalism* as "an economic system in which individuals and businesses with political connections and influence are favored (as through tax breaks, grants, and other forms of government assistance) in ways seen as suppressing open competition in a free market." In a June 19, 2014 *New York Times* editorial, Neil Irwin stated, "If there's one thing that populists on the left and right can agree upon, it is disdain for *crony capitalism* […] In short, we're all crony capitalists, whether we like it or not." Milton Friedman in 2003 at the Young America's Foundation's 25th Annual National Conservative Student Conference asserted that even freedom-loving businessmen are part of the problem: "In many ways business is the enemy of markets because businessmen are always seeking to get government to intervene on their behalf." Everyone seems willing to ignore abuse of the country's finances as long as they get in on some of the action.

We will not make an argument for or against any of it but merely point out that cronyism's spread to the Fed is a material change for the worse. The cost of government programs has become so large and the political will to curb spending so absent, that the Federal Reserve appears convinced it should help with the tab. Designed to be independent, today the Fed yields to the spending desires of Congress. Policymakers are more afraid of a business cycle than they are of mortgaging our country's future. Welcome to crony monetarism! The Fed prints the money, Congress spends it, and an irrationally exuberant stock market bellies up to the bar.

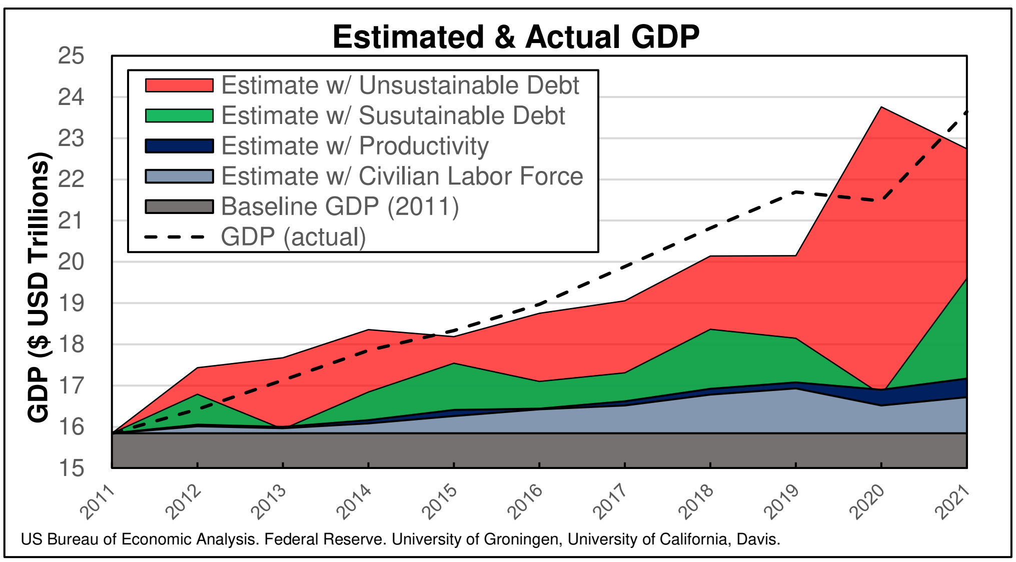
Stock markets kept the party going, adding about 9% in the fourth quarter of 2021, finishing the year nearly 30% higher, and delivering a third straight year of double-digit returns with the S&P 500 doubling in the last three years. The government's efforts to mitigate the negative effects of the pandemic on the financial markets succeeded, perhaps a bit too well.

Bonds, by contrast, generally turned in low single-digit losses for the year, which is remarkable given that inflation rose from a reported 1.2% in 2020 to 7.0% in 2021. When inflation runs high like this, buying bonds that pay low interest rates leads to a significant loss of purchasing power. The value of $1.00 in January of 2021 is $0.93 today. Having that cash in a bank or even invested in bonds would have not helped much or, in many cases, made it worse.

The Credit Cycle: Sustainability vs. Fragility

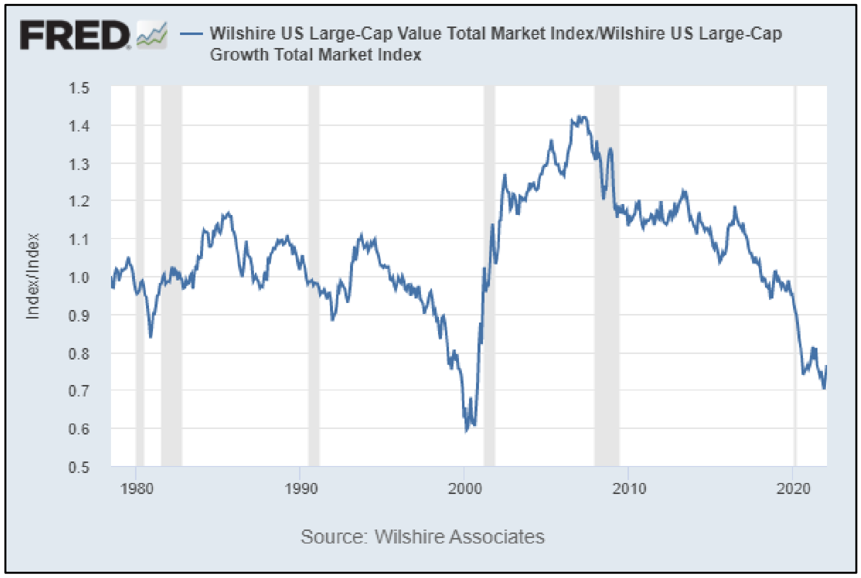
The credit cycle typically drives the business cycle, which drives the bull and bear stock market cycle. In the long run, an economy can sustain growth at a rate equal to the increase of its population or labor force plus the productivity of that labor force. Debt can also be used to enhance economic growth by borrowing against future income and moving future spending into the present. The sustainable rate at which debt can grow largely matches up with the expansion of the labor force and its productivity. As an economy heals from its last contraction, fear is slowly replaced with confidence, allowing credit to grow at a rate in excess of these sustainable levels. Long periods of stability and expansion lead short-term memories to forget about past down cycles and become overconfident, misjudging future downside potential. The result is excessive, unsustainable credit expansion and economic growth, some of which will painfully have to be walked back in the future.

The below chart is a rough visualization of Gross Domestic Product (GDP) growth over the last ten years. Baseline GDP from 2011 is plotted, and from there we make estimates of "sustainable" GDP levels by adding in the expected impact of: 1) growth of the civilian labor force, 2) productivity gains, and 3) a sustainable expansion of public and private debt at a rate equal to the growth of the labor force plus productivity gains. In this short window of time, we do not factor in interest rate changes and assume no multiplier effect, i.e., each dollar of new debt is spent once, creating one dollar of increased estimated GDP. This seems a reasonable and cautious assumption given the low level of monetary velocity these days. Under these conditions, the level of estimated GDP growth would have reached $19.6 trillion in 2021 (green), far short of the level predicted with this method using actual debt issuance (red) and even further short of reported GDP (dashed black line) that includes the fourth quarter estimate for this year from the Atlanta Federal Reserve's GDPNow model.



This demonstrates that trillions of dollars of debt issued, notably the acceleration of federal government debt in the last couple of years, have led to levels of GDP that are unsustainable, subject to inflation, or both. Think about the unusual and unnatural stability of the dashed black line showing actual GDP compared with the slower, more cyclical but sustainable growth of GDPE with sustainable debt (green). This suggests that we no longer have government simply moving money around, i.e., the normal picking of winners and losers of crony capitalism. We have a Federal Reserve conjuring massive amounts of cash for Congress to dole out so that "We the People" need not ever suffer the challenging, yet normal, economic outcomes in any given year. Until we do.

Recently, the Fed has dramatically reversed course and moved their plans to tighten interest rates forward to 2022 from sometime in late 2024. However, telegraphing their intentions to the market is not the same as action, or results. We agree with the old saying "Don't fight the Fed," but recognize it is really about the expansion of credit, ongoing in this cycle since 2008. When the credit expansion reverses, the party ends. The economy will then move toward its more sustainable, lower level of production and Mr. Market will not be happy.



The more monetary policy attempts to sustain growth at high levels, the more the dollar will be devalued. If monetary tightening is more effective than the Fed wishes, the credit cycle will end with a swoon. In that scenario, the dollar will remain strong but falling growth rates will favor the well-capitalized and out-of-favor. Assets that protect against economic uncertainty and a devaluing dollar should become more attractive to investors. As value-oriented investors, we recognize our bias. But after such a long period of monetary accommodation aiding growth-oriented management styles, it may be time for value-oriented strategies to outperform and eventually reclaim long-term dominance relative to growth.

The Fed's New Mandate

Under this crony monetarism, the Fed has moved from its historic dual mandate of moderate inflation and low unemployment to also stabilizing investment markets and pacifying Congress. The Fed's independence is lost, at least for now. Knowing what masters are being served will be critical for positioning investments in this tightening cycle. At Robinson Value Management our primary goal is to protect against the potential loss of purchasing power by investing in aggressively defensive stocks with staying power.

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