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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

This is a time of more questions than answers. Will trade issues be resolved? Is a recession coming? How will markets respond? Will the Federal Reserve have the tools to effectively manage the next recession? Are there other options to keep the economy and markets healthy? How will Modern Monetary Theory influence thinking?

The Economy

GDP, a lagging measure of economic growth, improved to 3.1% in the first quarter, maintaining an improving trend that began after the "profits recession" in 2015. Leading economic indicators, which tend to precede the economy by 1-2 years, continue to flatten though. The current estimate for second quarter GDP suggests some slowing, currently reading 1.5%, as the tariff war with China may have affected economic activity. However, unemployment continues to register a low 3.6%, and the ISM Purchasing Managers continue to see a modest expansion, a conclusion echoed by the Federal Reserve. The price of existing single family homes rose 3.4% over the last year, while the inventory of existing houses for sale has remained at almost the same level as a year ago.

The Markets

Bonds rallied during the quarter, suggesting that the prospects for inflation are lower as the outlook for economic strength becomes cloudier. Last quarter's *Outlook & Trends* discussed the "inversion" of the yield curve, when long-term bond yields drop below the cost of near-term borrowing. Inversions tend to lead recessions by 1- 2 years. The next shoe to drop will be when the Fed reduces short-term rates and the curve un-inverts. This action typically precedes a recession by 6-12 months. This timing could differ though, if the administration convinces the Fed to cut rates in order to preemptively boost the economy through the next election. Needless-to-say, in a recession, the stock market does not perform well, and bond yields will continue to drop, likely back to zero next time.

We also mentioned last time that the time-tested Dow Theory indicated the onset of a bear market during the December stock market decline. Even though the S&P 500 has set marginal new highs, the Dow Industrial Average has not yet. The other component required to give an all clear signal would be a new high in the Dow Transportation average. This index is also lagging, so caution remains warranted.

The Bigger Picture

When economic cycles are strong and have lasted a long time, there is a tendency, called "recency bias", to think that these conditions will remain in place well into the future. Over the last 30 to 40 years, extended expansion periods have persisted due to either government deficit spending or Federal Reserve support or both.

Keynesian economics suggests that governments should be savers during the good times and provide extra money to the economy in poor times. Unfortunately, politicians have not maintained the fiscal discipline to limit spending during the expansion phase. The result has been artificially long expansions, which are good for votes, but allow large economic imbalances to build, particularly in the financial markets. Misallocated resources then eventually lead to recessions and the nasty bear markets that bring natural economic forces back into balance.

Over the expansion periods, a major factor promoting the upward trend has been debt accumulation by individuals, government, and business. However, if income growth is insufficient to cover borrowing, more and more new debt must be used just to pay off old expiring debt plus its interest. Less and less money is available from new borrowing for productive use. The result is lower growth, so ever more new debt is required to produce accustomed growth rates. At some point, the process must grind to a halt or implode. The great long-term question is how today's profligate existence will affect our children and grandchildren. How will it stop? We may be seeing the beginnings of the process.

After 2008, the Federal Reserve printed sufficient money (QE) to drive short-term interest rates to zero for seven years. This allowed people, companies and the government to refinance their debt with lower rates. It also had the effects of exacerbating the wealth gap, promoting the acquisition of risky debt and investments, transferring wealth from savers to borrowers, and creating over-valued and fragile financial markets that are ripe for new failure.

Chances are that during the next downturn, interest rates will return to zero again. As a borrower, you might ask, "What is wrong with low interest"? If you are a retiree living on low-risk interest income, or whose pension needs to earn 7% to remain solvent, or as a holder of an insurance policy that promises payments based on higher rates, you might care whether this solution becomes the norm.

Because interest rates are already abnormally low, and the market's recent sharply negative reaction to the prospect of withdrawing life support is likely to keep a lid on Fed policy, they have less wiggle room. When rates approach the zero limit, what will be the source of more government support? Taxes have been cut. The Fed still has $3.8 trillion on its balance sheet left over from QE. The government now has a debt level of $22 trillion and an annual budget deficit of $3 trillion. Officials will need to think of new ways to restore growth and mitigate the impact of bad loans among companies and individuals.

Rather than biting the bullet and dealing with the issue directly, one palliative is to re-frame the problem. Enter Modern Monetary Theory, a politician's dream. MMT posits that, since a sovereign government has the sole right and ability to issue money in its own currency, it can do so as long as it does not cause inflation. Government debt liability does not matter, because the government can pay back the principle and interest from the unending supply of money that it can create. Theoretically, inflation can be controlled by greater regulation of industries where the inflation is occurring. If that is not sufficient, inflation can be brought back into check by higher taxes or by selling bonds. Both actions just take back some money out of the economy that the government had created earlier.

What if the actions to reduce the money supply to combat inflation cause a slowdown in economic activity and create less than full employment? The MMT prescription for this is a job guarantee for everyone. All people would be offered a government job at the prevailing minimum wage. The resulting pool of workers would increase in number in a poor economy, and decrease if an improving economy offered a better wage. The resulting higher government spending in poor times would help the economy recover. The theory suggests that this humane mechanism would automatically adjust the money supply to a level that maintains full employment.

Since a government can spend as much of its own money as it cares to without constraint other than inflation, there are currently politicians aligning their views with MMT and beginning to propose expensive programs such as student loan forgiveness, Medicare-for-all, and green infrastructure projects. Under the MMT definition, these ideas would be especially affordable right now, since deflationary economic and demographic forces are keeping inflation in check. The administration is likewise jawboning the Fed to preemptively reduce interest rates to continue the expansion, since inflation is not currently an issue, but recession may be.

Some elements of MMT are likely to continue to make their way into practice eventually. After all, politicians have relied upon deficit spending for centuries. There is many a slip between theory and eventual practice, however. Most all experiments are loaded with unforeseen effects and consequences. As we see it, a primary problem with this approach is that it is the opposite of a free market, which generally has worked pretty well. MMT relies upon politicians, who survive by distributing money and gathering votes, to be disciplined and regulate the economy in a centralized manner. They have not succeeded well in the Keynesian environment. Can we expect a change?

Elements of the economy and markets sometimes change at glacial speed and sometimes in a flash. We suggest that you develop, and keep a financial plan up-to date. If you would like to work with a fee-only, fiduciary investment advisor and Certified Financial Planner® to help you set your course, please send an e-mail or call.

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