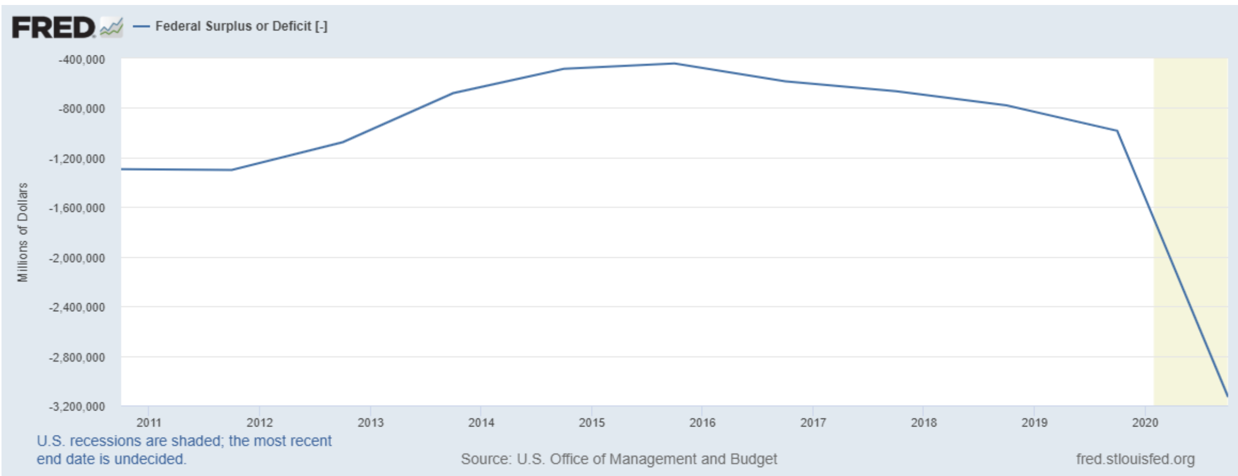
Congress and the Federal Reserve vs. Rational Investors – 3/5/2021

by Robert G. Kahl, CFA, CPA, MBA

It has become too easy for Congress to borrow trillions of dollars per year. Why should Congress reduce spending or raise taxes when the Federal Reserve will accommodate a higher level of borrowing? For the fiscal year ending September 2020, the US Government budget deficit reached $3.1 trillion or 15.0% of GDP. Prior to 2020, the only years when the US Government budget deficit exceeded 15% of GDP were 1943-1945. At the end of fiscal year 2020, federal total public debt was 127.3% of GDP.



The Congressional Budget Office (CBPO) is currently projecting a federal budget deficit of $2.3 trillion for fiscal year 2021. The US House of Representatives has passed H.R. 1319 – American Rescue Plan Act of 2021. The CBO estimates that it would increase the federal budget deficit by $1.92 trillion over the next 10 fiscal years. The budget impact would be $1.23 trillion for fiscal year 2021 and $440 billion in fiscal year 2022. The remaining years would have smaller impacts on the deficit. If the US Senate passes the legislation and it is signed by the President, the projected budget deficit for fiscal year 2020 would rise to $3.53 trillion.

During her nomination hearing on January 21, US Treasury Secretary Jane Yellen acknowledged that while "it's essential that we put the federal budget on a path that's sustainable," it is necessary to use debt financing now to avoid "a worse place fiscally and with respect to our debt situation." Essentially, more debt now will result in less debt in the future. A portion of the transcript follows.

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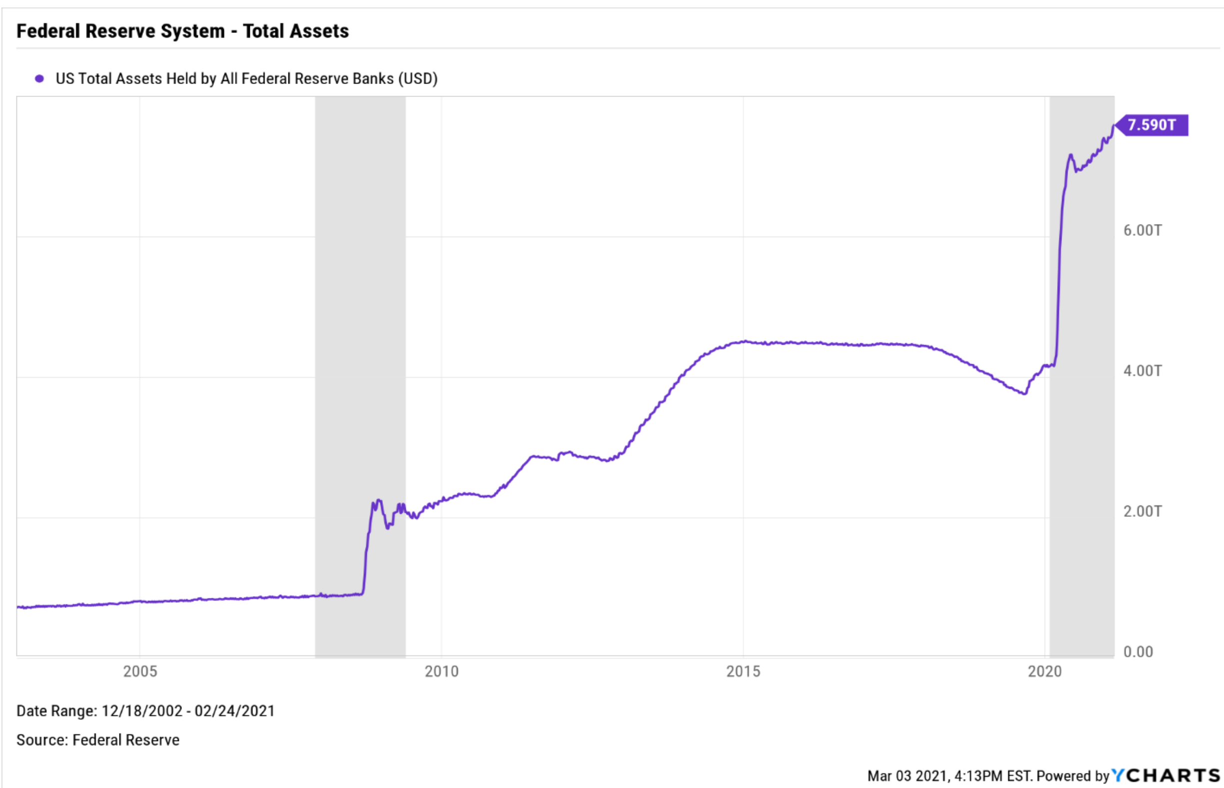
> Senator, I agree with you that it's essential that we put the federal budget on a path that's sustainable. And that we're responsible and make sure that what we do with respect to deficits and debt leave future generations better off. But the most important thing, in my view, that we can do today to put us on a path of fiscal sustainability is to defeat the pandemic, to provide relief to American people. And then to make long-term investments that will help the economy grow and benefit future generations. To avoid doing what we need to do now to address the pandemic and the economic damage that it's causing would likely leave us in a worse place fiscally and with respect to our debt situation than taking the steps that are necessary and doing that through deficit finance.

The Federal Reserve appears to be ready and willing to accommodate the additional deficit spending. As of February 24, the Federal Reserve System's balance sheet had



a total of $7.6 trillion of assets, including $4.8 trillion of US Treasury securities and $2.2 trillion of mortgage-backed securities.

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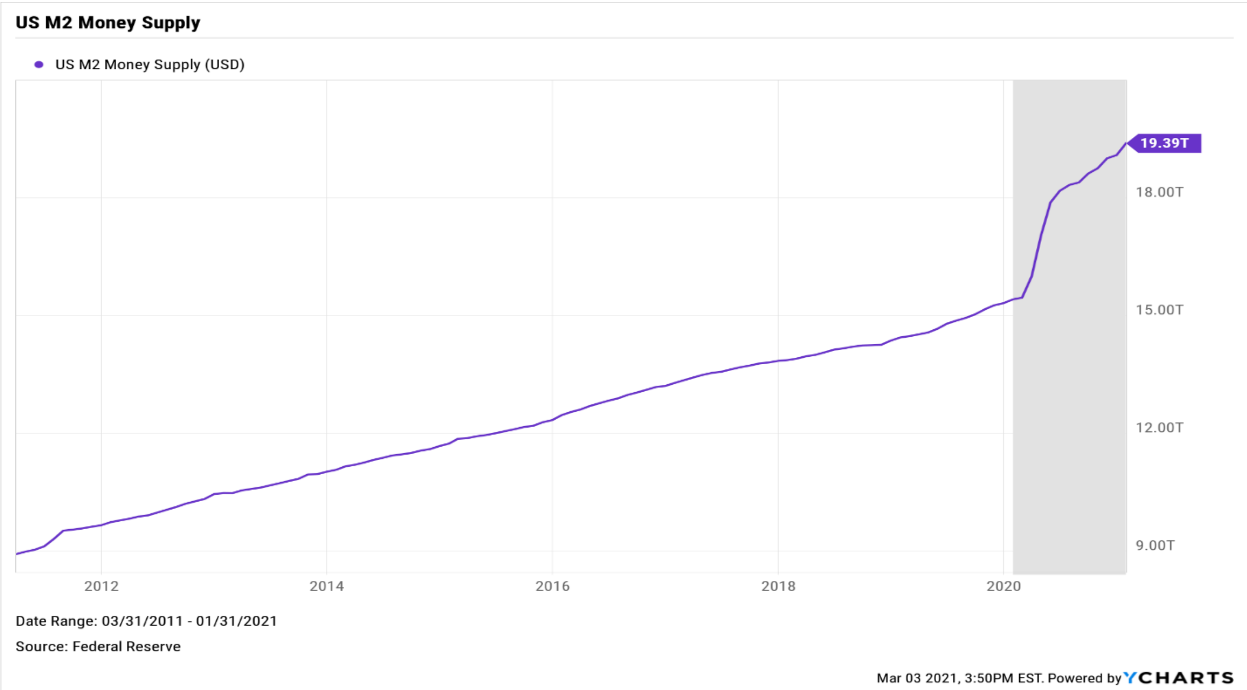
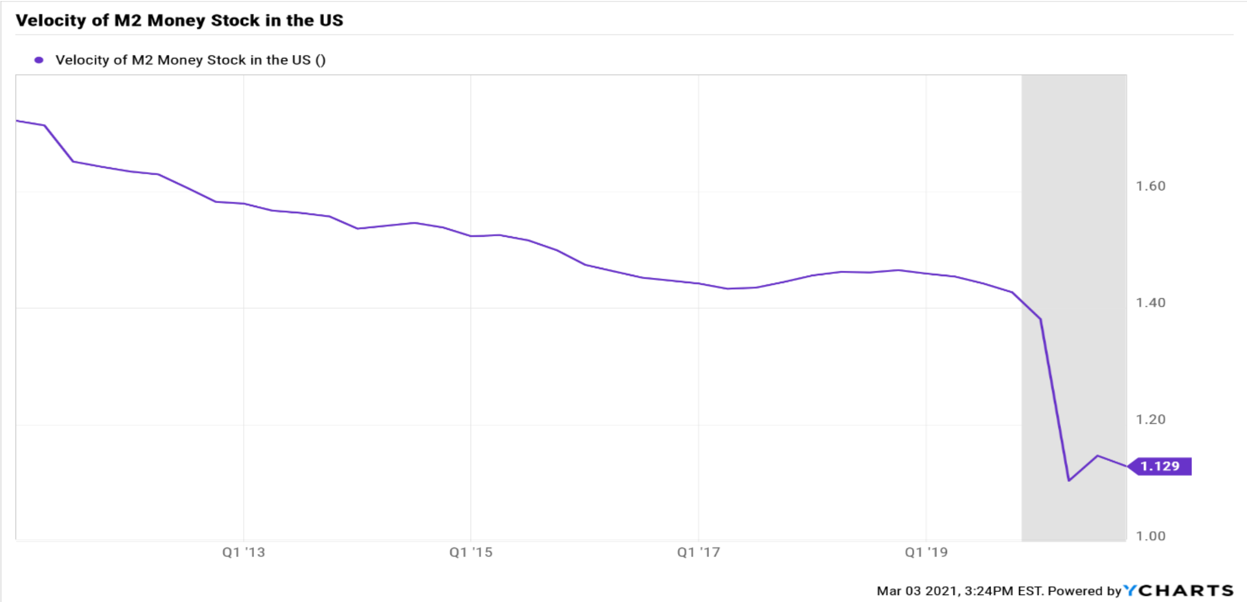
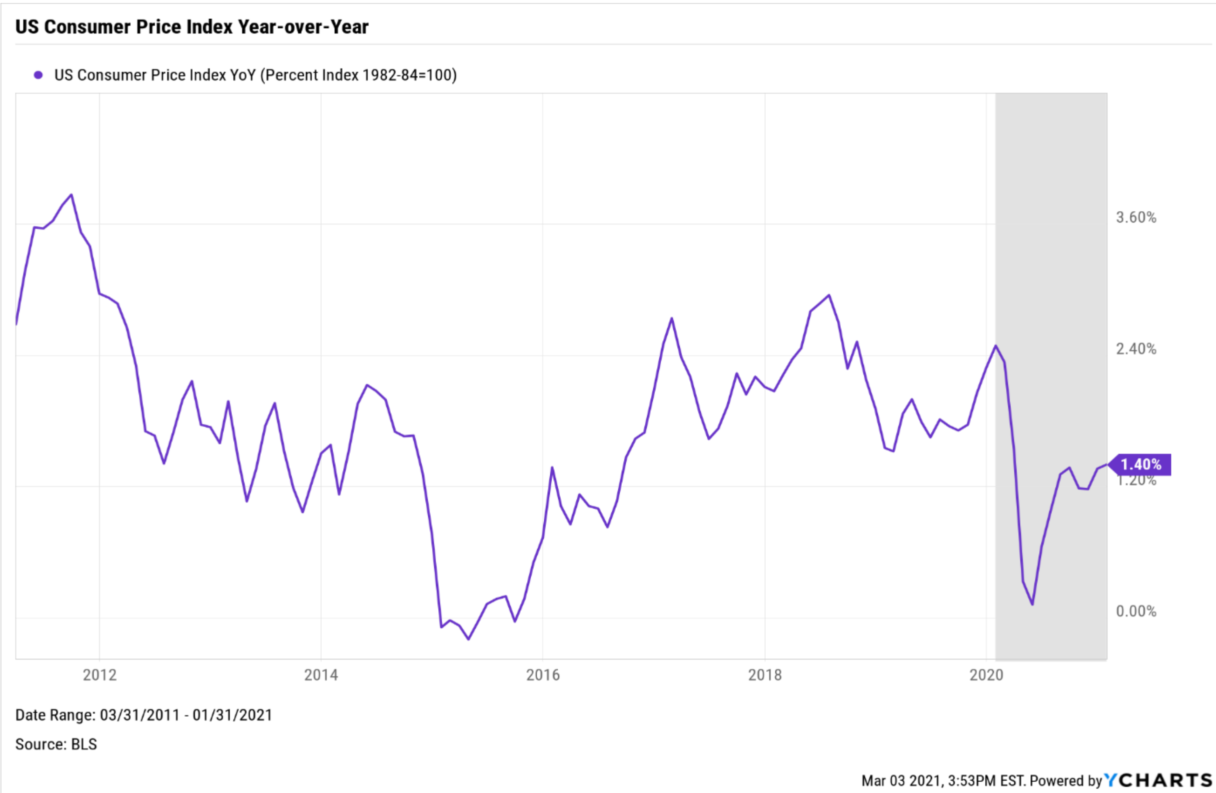
M2 money supply (cash, checking and savings accounts, money market funds, and CDs) has risen to $19.39 trillion.



While the velocity (turnover per quarter) of M2 money has slowed to 1.129.



The net result is modest inflation growth of 1.4% (CPI, year over year)



More financial commentators have raised red flags regarding the current US fiscal and monetary situation. Bank of America's Chief Investment Strategist, Michael Hartnett, recently warned that "the velocity of people will rise" as we extricate ourselves from the pandemic and "the velocity of money will rise." Hartnett's commentary included a comparison to the 1914-1923 period of Germany that resulted in hyperinflation.

Germany ran some huge budget deficits during World War I, reaching a high of 80% of GDP in 1916. By 1922, the German budget deficit was only 6% of GDP but the cumulative impact of prior years could not be reversed. The money supply increased at double digit rates from 1914-1921 but the change in velocity (turnover) of money was negative in each year during 1914-1918, so inflation was lower than the money supply growth. The tipping point was 1919, when the velocity of money increased 129% compared to the prior year. The velocity of money continued to rise and increased dramatically during 1922-1923. The inflation rate increased to 4,126 percent in 1922 and 85.5 billion percent in 1923.

Jens Parsson, author of a lengthy account of the German hyperinflation titled “Dying of Money: Lessons of the Great German and American Inflations,” describes the turn in psychology during the German hyperinflation of 1922-1923.

> The precise moment when the inflation turned upward toward the vertical climb was undoubtedly timed by no event but by the dawning psychological awareness of the German and foreign investor that Germany was not going to back its money. With that, the rush to get out of the mark was on. Like a dam bursting, the seas of marks flooded into the markets and drove prices beyond all bounds.

While the US government authorities insist that inflation can be easily controlled if necessary …

> I’ve spent many years studying inflation and worrying about inflation. And I can tell you we have the tools to deal with that risk if it materializes. – Janet Yellen, US Treasury Secretary, 2/7/2021

> It’s just flat out wrong that our team is, quote, dismissive of inflationary risks. Janet Yellen is our Treasury secretary, OK? She knows a little something about inflationary risks and has tracked that economic issue forever. - Jared Bernstein, Member of the White House Council of Economic Advisors, 2/7/2021

Many professional investors believe otherwise.

> It is fair to assume we are going back into an era of growing inflation. - Larry Fink, Chief Executive Officer, BlackRock, 1/27/2021

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We will see a rebound in growth and a rebound in inflation. With that, you're also going to see a pickup in deficits. - Ray Dalio, Founder, Bridgewater Associates, 1/27/2021

The US government is inviting inflation with its MMT (modern monetary theory)-tinged policies. Brisk debt/GDP, M2 increases while retail sales, PMI (Purchasing Managers Index) stage V recovery. Trillions more stimulus & re-opening to boost demand as employee and supply chain costs skyrocket. – Michael Burry, Founder of Scion Asset Management, Twitter post 2/20/2021

We are witnessing the Great Monetary Inflation (GMI)—an unprecedented expansion of every form of money unlike anything the developed world has ever seen…The best profit-maximizing strategy is to own the fastest horse. If I am forced to forecast, my bet is it will be Bitcoin…Bitcoin reminds me of gold when I first got into the business in 1976… Speaking of gold, in a low-carry world, gold remains a very attractive hedge against the Great Monetary Inflation. – Paul Tudor Jones, CEO of Tudor Investment Corp., 5/7/2020

The Cares Act added trillions of dollars in fiscal stimulus. How big was it? In three months, we increased the deficit more than if you took the last five recessions combined. And those were big ones. That was '73, '75, the '82 recession, the early '90s, the dotcom bust, and then of course the great financial crisis. If you added the increase in the deficit in all those five periods and combined them, we increased the deficit in the US more in three months in 2020 than we did in the cumulative total (of the five prior recessions).

The Fed, in six weeks, bought more Treasuries than they did in ten years under Bernanke and Yellen when people like me were screaming about how excessive QE was during that period. Corporate borrowing, which almost always goes down in a recession as corporations reliquefy and had already gone from 6 trillion to 10 trillion because of pre-money going into the period, actually went up 400 billion dollars. Just for that perspective,

> it went down 500 billion during the great financial crisis. So, this is sort of the background. And obviously, all this stimulus has flowed into financial markets in the commodities and the financial interest. So, it's sort of a bizarre background. - Stanley Druckenmiller, CEO, Duquesne Family Office, 1/29/2021

If you have any questions or comments, please contact me.

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