CROSSBRIDGE CAPITAL

Market Viewpoints

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Loyalty to the Nation all the time, loyalty to the Government when it deserves it.

- Mark Twain

As nominal growth has failed to accelerate, the supremacy of monetary policy and further accommodation is being put into question. This has led to renewed calls for "helicopter money" - or monetary finance - as a serious policy prescription. The implementation of such a policy would be contentious and concerns about any unexpected consequences to broader public confidence have kept even Japan's more adventurous policymakers away from it. The fear that governments could use monetary finance to spend irresponsibly has some justification, but governments can just as easily spend irresponsibly in normal times as well. In fact, they do and they have. Monetary finance is one way to repair balance sheets and bring back new growth. The other is systemic default. Pick your poison carefully. Policy makers also need to concentrate on reforms of regulations and tax rules that currently favour short-termism over long-term capital stock building and higher productivity growth. There is a need for incentives to encourage real investment opportunities in both the private and public sectors. This will add to the tax base, reduce government expenditure and create more consumers. Despite the outperformance of traditional reflation plays - Emerging Markets (EM), commodities and the modest uptick in the performance of financial stocks, I do not believe that reflation is afoot for investors to stay overweight equities. I continue to advise to sell equities in a rally. The let-up of the USD rally is the key factor driving EM and commodity assets.

Helicopter Money

Over the last few weeks the markets have recovered from the shock of *Brexit*, and equity markets have scaled new highs. However, despite this market optimism, US (and global) GDP growth are stagnating and there are fears of economies facing new shocks. This has led to renewed calls for "helicopter money" as a serious policy prescription for countries like Japan and the UK and, maybe even the US. As nominal growth has failed to accelerate, the supremacy of monetary policy, and further accommodation is being put into question.

So, what is helicopter money?

In 1969 US economist, Milton Friedman described one way a government could stimulate more spending and inflation. He said: "Let us suppose now that one day a helicopter flies over this community and drops an additional $1,000 in bills from the sky, which is, of course, hastily collected by members of the community." Friedman reasoned that people would naturally spend the money. The result would be higher prices, and if you kept doing it, inflation would ensue.

Of course "helicopter money" is a metaphor. Friedman never intended to suggest dropping wads of cash from helicopters. His key argument however, was to carry out a fiscal expansion that leads to an increase in public spending or a tax cut that would be financed by a permanent increase in the monetary base. This differs from any new money created by the current Quantitative Easing (QE) policies, which are deposited back at the central bank, with no net increase in the monetary base.

Even if policymakers were to agree on a "helicopter money" policy, the implementation of the policy would be contentious, and concerns about unexpected consequences to public confidence have kept even Japan's more adventurous policymakers away from it. Doubts have been raised whether governments can be weaned off fiscal spending once the spigot is open. Will it not bring hyperinflation down the line and, ultimately, who should decide how much to spend – the Treasury or the central bank?

There is precedence of monetary financing policies, mostly in weak economies. The most recent one was in Argentina (2014-15), where at one stage the central bank, by printing money, was funding government spending to the tune of 4.5% of GDP. Inflation was running at 30%. Japanese Finance Minister Korekiyo Takahashi used monetary-financed fiscal expansion to pull Japan's economy out of recession in the early 1930's. Takahashi rightly sought to tighten policy once adequate output and price growth had returned, but was then assassinated by those keen to use unconstrained monetary finance to support imperial expansion.

The fear that governments could use monetary finance to spend irresponsibly has some justification, but governments can just as easily spend irresponsibly in normal times as well. In fact, they do and they have. Spending increases before elections to boost economies and governments give money to favored constituencies to shore up support. The checks and balances in place that prevent governments from going overboard and wrecking the economy in normal times should work in the case of monetary financing as well. We have accepted the idea that, in a democracy, political systems can be trusted, therefore we should also allow elected governments to make spending decisions rather than putting the central banks in charge of everything. Monetary Finance is one way to repair a balance sheet and bring back new growth. The other is systemic default. Pick your poison carefully.

The 2% inflation target rethink?

The topic of this week's US central bank's (Fed) conference in Jackson Hole, Wyoming is "Designing Resilient Monetary Policy Frameworks for the Future." Last week, John Williams, San Francisco Fed President, made the case for a higher inflation target in the bank's newsletter. "There is simply not enough room for central banks to cut interest rates in response to an economic downturn when both natural rates and inflation are very low," he said. A higher inflation target "would imply a higher average level of interest rates and thereby give monetary policy more room to maneuver."

In April, Boston Fed President Eric Rosengren also expressed some concerns that 2% might be too low a number, but Williams has gone further in explicitly arguing for a need to revisit the current inflation objective. It is reasonable to think that some of the themes touched on by Williams - higher inflation target, nominal GDP or price-level targeting - will almost certainly be in the air when Fed officials and their foreign counterparts meet at this week's symposium.

The case for low inflation has rested on the belief that high inflation is damaging and causes more frequent recessions and that low inflation is a trivial risk, which central banks can easily deal with by cutting rates and/or printing more money. However, that hasn't worked. Since 2008, central banks around the world have cut interest rates to nearly zero and printed large amounts of money, and only lackluster nominal growth followed. Real interest rates have remained higher as inflation has failed to take off. The Fed instituted a formal 2% inflation target in 2012 under former Chairman Ben Bernanke, pursuant to a dual mandate under which it sought maximum employment and price stability. The Fed has struggled to hit its inflation goal ever since.

So is there a merit in increasing the inflation target to, say, 4%?

Perhaps there is, although I am yet to be fully convinced. On balance, stable to slight deflationary prices are more beneficial than inflationary ones as they force companies and individuals to be more careful with the use of debt. Higher inflation, strangely, encourages more debt-taking.

Williams is not yet pressing for a change in the target either, he's merely asking for it to be considered. "In stressing the need to study and consider new approaches to fiscal and monetary policy, I am not advocating an abrupt reversal of course; but now is the time for experts and policymakers around the world to carefully investigate the pros and cons of these proposals."

Instead of resorting to more extreme monetary experiments, I would counsel central banks and governments to address the reasons for the chronic underinvestment - lack of demand. Therefore, it's time to address the demand side and not the supply side alone. Having driven interest rates to zero, it should be clear by now that easy monetary policy alone doesn't do the trick, and indeed may be counterproductive. Policy makers need to concentrate on reforms of regulations and tax rules that currently favour short-termism over long-term capital stock building and higher productivity growth. There is a need for incentives to encourage real investment opportunities in both the private and public sectors. I.e. structural reforms that put incentives in place to get more people working. This will add to the tax base, reduce government expenditures and create more consumers.

Where to invest?

Equity markets have continued to inch higher and a week ago we saw all three major US indices - The S&P 500 (SPX), Dow and NASDAQ - touch new all-time highs on the same day, for the first time since 1999. However, we've also seen lots of sideways action since the SPX broke out to new highs in July. Despite the outperformance of traditional reflation plays - Emerging Markets (EM) and commodities, a modest uptick in the performance of financial stocks, I do not believe that reflation is afoot for investors to stay overweight equities. I continue to advise to sell in this rally. The let-up of the USD rally is the key factor driving EM and commodity assets.

Oil surged from its lows in February through late May, and then went through a consolidation phase in June and July. Over the last few weeks, we have seen Energy stocks surge. This breakout to the upside is technically bullish for the Energy sector (XLE) in the short term. Oil has recovered by +19% after experiencing a -22% decline. The next stop for oil will be its highs from June above the $50 mark.

One other sector to watch is Biotech. The Biotech sector had a great run higher from 2009 through mid-2015, until it went into a downturn. After peaking in July 2015, the sector entered a painful, protracted bear market, with the index falling -39% during that period. Over this same period, the SPX only fell -6%. Since its lows, the index is up +23%, which is above the threshold for a new bull market. The Biotech sector (IBB US), from a technical standpoint, is now looking much healthier and seems poised for another bull run.

The US economy has seen a record number of jobs created: over 1.25 million this year-to-date, and the unemployment rate is at 4.9%. However, the Q2 GDP growth came in at +1.2% (following from +0.8% growth in Q1) and wage growth hasn't picked up much. So what we have is: more workers, working fewer hours, making less money to generate less than usual growth. This can't be a good thing. In any case it seems weak GDP and steady job growth could persist through the rest of the year. That could pose a dilemma for the Fed - a labour market that has heated up to the point where rate increases are merited, yet a slow-growing economy suggesting it should stay its hand. On balance, I still believe the Fed will only raise interest rates once in 2016 and that will be in November/December.

In the US, among the sectors, I like Technology (XLK), Healthcare (XLH), Consumer (XLV) and Financials (XLF). Some of the stocks I hold/recommend holding: Starbucks (SBUX US), JP Morgan (JPM US), Bank of America (BAC US), Gilead Sciences (GILD US), Allergen (AGN UN), Biogen (BIIB), Amgen (AMGN), General Electric (GE), General Dynamics (GD US), Apple (AAPL US), Google (GOOG US), Amazon (AMZN US), Schlumberger (SLB US), Pepsi (PEP US), McDonalds (MCD US), Daimler (DAI GY), Airbus (AIR FP), Roche (ROG VX), Rio Tinto (RIO LN), Halliburton (HAL US), Walgreen Boots (WBA US), CVS Healthcare (CVS US), Home Depot (HD UN), CBS Corp (CBS US), Alibaba (BABA US), Pfizer (PFE US), Michael Kors (KORS US), Lloyds (LLOY LN), BNP Paribas (BNP FP), UBS (UBSN VX).

Best wishes,

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