



MORNING BRIEFING

February 6, 2019

Modern Monetary Theory

See the [collection](#) of the individual charts linked below.

(1) Why are bond yields so subdued? (2) Modern Monetary Theory is the flavor of the day. (3) Kelton says federal deficits don't matter until they matter to inflation. (4) Politicians, naturally, love MMT. (5) Link between deficits and inflation isn't what it once was. (6) Other than Starbucks's ex-CEO, does anyone hate deficits anymore? (7) Taking a walk on the supply side. (8) The CBO is so old school.

Bonds: Doing the Unexpected. Last year, the 10-year US Treasury bond yield peaked at 3.24% on November 8 ([Fig. 1](#)). Last year, when the yield first rose above 3.00% on May 14, there was lots of chatter about how it was likely to rise to 4.00% and even 5.00%. Those forecasts were based on the widespread perception that Trump's tax cuts would boost economic growth, inflation, and the federal deficits. In addition, the Fed had started to taper its balance sheet during October 2017, and was on track to pare its holdings of Treasuries and mortgage-related securities by \$50 billion per month ([Fig. 2](#)). It was also widely expected that the Fed would hike the federal funds rate four times in 2018, which is what happened, and that the rate-hiking would continue in 2019 into 2020.

Furthermore, the Bond Vigilante model, which correlates the bond yield with the y/y growth in nominal GDP, was bearish since the latter rose to 5.5% during Q3 ([Fig. 3](#)). But instead of moving higher toward 5.50%, the bond yield fell back below 3.00% and was at 2.70% yesterday.

What gives? The Dow Vigilantes screamed "*no mas*" at the Fed during the last three months of 2018, allowing the Bond Vigilantes to take another siesta. The Fed got the message, and the word "gradual" was first replaced with the word "patient" to describe the pace of monetary normalization by Fed Chairman Jerome Powell on January 4. The two-year Treasury yield, which tends to reflect the market's year-ahead forecast for the federal funds rate, dropped down to that rate (at 2.38%, the midpoint of the 2.25%-2.50% range) on January 3 ([Fig. 4](#) and [Fig. 5](#)).

Last year, I surmised that the bond yield might be "tethered" to the near-zero yields for comparable JGBs in Japan and Bunds in Germany ([Fig. 6](#)). I also argued that based on my 40 years' experience in our business, I've never found that supply-vs-demand analysis helped much in forecasting bond yields. It's always been about actual inflation, expected inflation, and how the Fed was likely to respond to both. The most recent bond rally was mostly driven by a drop in the expected inflation rate embodied in the yield spread between the 10-year Treasury bond and the comparable TIPS ([Fig. 7](#)). The spread dropped 30bps since October 9, 2018 through yesterday.

Meanwhile, the yield curve remains awfully flat, with the yield spread between the 10-year bond and the federal funds rate at only 36bps ([Fig. 8](#)). This suggests that Powell & Co. may pause rate-hiking for as long as the yield curve spread remains this close to zero. If they raise rates, they risk inverting the yield curve. That might stir up the Dow Vigilantes again.

So do federal deficits matter to the bond market? Apparently not. It's all about inflation. If deficits boost

inflation, then they will matter, as we see it. Now let's turn to how others see it.

Fiscal Policy I: Do Deficits Matter? Modern Monetary Theory (MMT) is an old concept that has resurfaced recently, as it seems to do whenever the topic of the federal budget deficit hits the news headlines. We last covered MMT last year in our 4/19 [Morning Briefing](#). That was soon after the Congressional Budget Office (CBO) sounded the alarm on the federal debt yet again.

First introduced in 1905 in Georg Knapp's "The State Theory of Money," the core principle of MMT is that deficits don't matter. In October, well-known MMT advocate and Stony Brook University professor Stephanie Kelton gave a 50-minute [talk](#) on the subject that's worth watching. She argued that when sovereign governments borrow in a national currency that they alone issue, that debt has no risk of default, as these governments can always print more money to make good on future promises. Countries run into trouble when they borrow in currencies that they themselves can't print. The US does not have that problem, so future generations of Americans needn't worry that their Social Security payments won't be covered in the future even as the national debt continues to rise into the trillions.

Melissa and I tend to be fiscal conservatives. So our instinct is to oppose MMT, since it justifies larger government deficits with debt continuing to pile up. However, the concept of running up the national debt (to an extent) without consequence has become popular among politicians on both sides of the aisle, so we need to give MMT some attention. Here's a refresher on MMT along with our current thinking about it:

(1) *MMT accounting.* MMT is based on an accounting identity that rearranges the variables of GDP. The focus is on the three sectors of the economy: the public, the foreign, and the private sectors. For the accounting to work, the three sectors in the economy must balance and cannot all run deficits at the same time. It's widely known that the US is currently running a public deficit and a trade deficit. Therefore, the US must be running a private-sector surplus.

In her talk, Kelton highlights an 8/5 *WSJ* [article](#) titled: "Why Trillion-Dollar Deficits Could Be the New Normal." She observes that the title is intended to invoke fear. Would you feel better if we replace the word "deficits" with the word "surpluses," she asks? You should feel better, Kelton said, because the federal deficits are fueling private surpluses!

(2) *Inflation is the brake.* MMT gets concerning only when (and if) it boosts inflation. In this scenario, even a sovereign government that creates its own currency cannot spend to infinity and beyond. Both human and physical capital are finite resources at a given point in time. As government spending increases, so does the competition for resources, which could cause inflation to overheat.

The question is at what point does that happen? No one knows. What we do know, observes Kelton, is that the seven periods in US history when the government ran surpluses and put a dent in the national debt were followed by a recession or a depression.

(3) *Secular forces keeping a lid on inflation.* Currently lending support to MMT is that inflation remains low despite huge federal deficits and mounting government debt. Growth is moderate and stable. Unemployment is historically low. So are inflation and interest rates.

As we see it, that's because of three key secular factors affecting the availability of resources—namely, globalization, technology, and aging populations. Globalization continues to increase the supply of labor and capital beyond borders, while technology continues to reduce the need for labor and capital, making existing resources more productive. Older populations consume less than younger ones, decreasing aggregate demand.

(4) *Weakened link between deficits and rates.* Opponents of MMT argue that putting the theory into practice would be fiscally irresponsible. They argue that the level of federal deficits may become unsustainable, causing the cost of borrowing to increase and “crowding out” private markets.

Countering that, MMT proponents say that the link between federal deficits and borrowing costs has weakened, likely for the reasons outlined above. Even CBO’s latest projections, in its [The Budget and Economic Outlook: 2019 to 2029](#) report, show the federal debt nearly doubles from 2019 to 2029 while interest rates rise less than 1 percentage point from 2.6% to 3.5% (see CBO’s Table 1-3).

Fiscal Policy II: Where Are the Deficit Hawks? Interestingly, the deficit hawks—who by definition prefer to keep a lid on the national debt—seem to have vanished on both sides of the aisle, or have they? (Starbucks’ ex-CEO Howard Shultz is exploring running for president in 2020 as a socially liberal deficit hawk and an Independent candidate.) Republicans have favored the recent tax cuts that add to the national debt. Anti-tax-cutting Democrats don’t mind increasing the deficit to fund socialist-like social programs. Let’s discuss:

(1) *How to pay for it.* Susan Kelton advised 2016 presidential candidate Bernie Sanders late in his campaign. Although he had Kelton on his team, Sanders continued to tout ways to “pay for” his ideas like increasing Wall Street transaction taxes to fund programs such as free higher education and Medicare for all. Kelton noted during the Q&A portion of her talk that Sanders felt strongly about consistent messaging. Did Sanders perhaps think MMT would be a hard concept for the average American to understand?

(2) *Hard to sell.* One reason MMT hasn’t caught on politically may be the questions it raises about how to handle government spending during normal times: What happens if running a federal deficit results in inflationary pressures? Should the government then raise taxes to rein in inflation (keeping central banks out of the discussion for the sake of simplicity)? How do politicians communicate that higher taxes reflect MMT mechanics and not government need for the tax-generating revenues?

(3) *Non-partisan deficit.* One point that Republicans and Democrats seem to agree on now is that adding to the federal debt isn’t a problem—a point made by a 9/15 *Washington Post* [article](#) titled “Deficit hawks are dead, and few in Washington can muster any outrage.” The article noted: “The Democrats have, across all factions of their party, lambasted the Republican tax-cut legislation of December and the \$1.5 trillion shortfall it is estimated to leave in the budget over the next decade. But they have not attacked that as money that should go to the U.S. treasury to pay down the overall \$21 trillion debt. Rather, they have almost universally pledged that the money be used for other federal spending, such as infrastructure or an expansion of the Affordable Care Act.”

(4) *The right question.* The real conversation, MMT advocates argue, is not about how to “pay” for programs that add to the deficit. Rather, politicians should be talking about the individual merits of government proposals to create incentives for the productive use of resources. Some partial supporters of MMT (like economist Larry Summers) don’t support unlimited federal spending even if inflation doesn’t show up. That’s because having debt constraints, although they may be artificial, promotes more rational decision-making and prioritization of government programs. That makes sense to us, but it also seems like a complex nuance to put into practice.

(5) *The other side.* Absent in the *Washington Post* article on the disappearing deficit hawks is the supply-side argument that tax cuts pay for themselves in economic growth and revenues, as self-proclaimed supply-sider Larry Kudlow, director of the US National Economic Council, contends (see our 1/17/17 [Morning Briefing](#) for more on Kudlow’s supply-side background). Kudlow has [said](#) that he

doesn't think running deficits of around 5% of GDP would be catastrophic. He doesn't mind adding to the national debt even if the tax cuts don't pay for themselves. But Kudlow also has said that he would prefer to run that deficit with lower taxes than higher government spending. In other words, it's not that the Republican Party has given up on fiscal conservatism but that they're more focused on the growth side of the tax-cut story than the deficit side.

We tend to agree with the supply-siders. However, we are coming around to the MMT view that it's perfectly okay to be on the more liberal side of the deficit question (even via tax cuts and well allocated higher spending) until inflationary pressures become a real risk. Suppose that federal deficits fueling the private sector increase productivity, as they should in theory. That dynamic would increase growth while keeping a lid on inflation. In such a scenario, the national debt becomes even less concerning.

Fiscal Policy III: CBO's Disconcerting Projections. CBO's 1/28 [The Budget and Economic Outlook: 2019 to 2029](#) projected that the Treasury debt held by the public would nearly double from \$16.6 trillion this year to \$28.7 trillion in 2029. Over this same period, the ratio of this debt to GDP would rise from 78% to 93%, according to the CBO.

The CBO report warns that this outlook increases the "likelihood of a fiscal crisis ... Specifically, the risk would rise of investors' being unwilling to finance the government's borrowing unless they were compensated with very high interest rates. If that occurred, interest rates on federal debt would rise suddenly and sharply relative to rates of return on other assets."

That's so old school! But that doesn't mean it won't happen one day. Think about that while sipping a cup of Starbucks venti latte.

CALENDARS

US. Wed: Merchandise Trade Balance -\$54.0b, Productivity & Unit Labor Costs 1.6%/1.7%, MBA Mortgage Applications, EIA Petroleum Status Report, Powell. **Thurs:** Jobless Claims 223k, Consumer Credit \$17.5k, EIA Natural Gas Report, Bullard, Clarida. (Econoday estimates)

Global. Wed: Germany Factory Orders 0.3% m/m/-6.7% y/y. **Thurs:** Germany Industrial Production 0.8% m/m/-3.3% y/y, Japan Leading & Coincident Indicators 97.9/102.2, Japan Household Spending 0.9%, Mexico CPI 4.5% y/y, BOE Bank Rate & Asset Purchase Target 0.75%/ £435b, Bank of Mexico Overnight Rate 8.25%, ECB Publishes Economic Bulletin, BOE Inflation Report. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q4 Earnings Season Monitor ([link](#)): With nearly 52% of the S&P 500 companies finished reporting earnings and revenues for Q4-2018, y/y revenue and earnings growth remains strong, but the surprise metrics have weakened relative to Q3's results due to Q4's trading turmoil and slowing growth in China. Of the 258 companies in the S&P 500 that have reported through mid-day Tuesday, just 73% exceeded industry analysts' earnings estimates. Collectively, the reporters have exceeded forecasts by an average of 3.5% and averaged a y/y earnings gain of 15.4%. If those results hold to the end of the quarter, it would mark the smallest earnings beat since Q2-2014 and the slowest y/y growth since Q3-2017. On the revenue side, just 61% of companies beat their Q4 sales estimates so far, with results coming in 0.5% above forecast and 8.1% higher than a year earlier. While that marks the smallest revenue beat since Q4-2016, revenue growth is the slowest in five quarters. Earnings growth is positive y/y for 77% of companies, vs a higher 86% at the same point in Q3, and Q4 revenues have risen y/y for 79% vs a higher 83% during Q3. Looking at earnings during the same point in the Q3-2018 reporting period, a higher percentage of companies (79%) in the S&P 500 had beaten consensus earnings

estimates by a greater 6.7%, and earnings were up a higher 25.9% y/y. With respect to revenues at this point in the Q3 season, a lower 57% had exceeded revenue forecasts by a higher 0.9%, and sales rose a greater 8.9% y/y. The results for Q4 are still subject to change as more companies report, but the slowdown in revenue and earnings growth from Q3 is becoming more apparent. Q4-2018 should mark the tenth straight quarter of positive y/y earnings growth and the 11th for revenue growth. Looking at the Q4 results ex-Financials and Real Estate, the earnings surprise improves to 4.2% from 3.5%, but earnings growth falls to 14.9% from 15.4%. The ex-Financials and Real Estate revenue surprise would be 0.6% instead of 0.5%, with revenue growth improving to 8.7% from 8.1%.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs ([link](#)): Global economic activity continued to deteriorate at the start of 2019, posting its slowest growth since September 2016. The JP Morgan Global Composite Output Index (C-PMI) slipped to a 28-month low of 52.1 in January; it was at a 3.5-year high of 54.8 last February. The Global M-PMI (to 50.7 from 51.4) continued to slide, falling to its lowest reading since June 2016, while the Global NM-PMI (52.6 from 53.0) remained on a volatile downtrend, posting its slowest growth since September 2016. Growth in the services industry outpaced manufacturing for the ninth month running. Looking at C-PMIs for the developed (52.3 from 52.7) and emerging (51.6 from 52.5) economies, growth slowed in both, with the emerging economies once again growing at a slower pace than the developed ones. Looking at January C-PMIs, the US (unchanged at 54.4) remained the main driver of global economic expansion, while the Eurozone (to 51.0 from 51.1) was the main source of the slowdown—recording its slowest pace since November 2014. Within the Eurozone, C-PMIs for both Spain (54.5, 7-month high) and Ireland (53.3, 67-month low) remained above the global average of 52.1—though Ireland’s is considerably below its 58.4 reading recorded just four months ago. Meanwhile, Germany’s C-PMI (52.1, 2-month high) remains in expansionary territory, while Italy’s (48.8, 62-month low) and France’s 48.2 (50-month low) moved further into contractionary territory. Rates of expansion slowed last month in China (50.9 from 52.2), Japan (50.9 from 52.0), the UK (50.3 from 51.4), Brazil (52.3 from 52.4), Russia (53.6 from 53.9), and Australia (51.2 from 52.9) while holding steady in India (53.6).

Global Non-Manufacturing PMIs ([link](#)): January saw the rate of expansion in the global services economy slow to a 28-month low, with both developed and emerging economies experiencing weaker growth last month. JP Morgan’s NM-PMI eased for the second month in January, to 52.6, after rising from a two-year low of 52.9 in September to a four-month high of 53.7 in November. The NM-PMI for emerging economies eased for the second month to 52.9 in January, after jumping the prior two months from 52.2 to 53.8 in November, remaining above growth in the developed economies. The latter saw their NM-PMI sink to a 28-month low of 52.5. Service sector activity expanded in all but two countries, France (47.8) and Italy (49.7), while the UK’s (50.1) was at a standstill. The US (54.2) remained one of the strongest performers, though its rate of expansion slowed slightly, with China (53.6) exhibiting a similar pattern. Meanwhile, rates of expansion were below the global average of 52.6 in the Eurozone (51.2), Japan (51.6), Australia (51.0), India (52.2), and Brazil (52.0).

US Non-Manufacturing PMIs ([link](#)): The ISM measure for January shows growth in the US service sector slowed for the second month, though remained at an elevated pace, while the IHS Markit measure was just below the Q4 average. ISM’s NM-PMI (to 56.7 from 58.0) sank to a six-month low after peaking at 60.8 in September. Of the four components, only employment (57.8 from 56.6) showed an acceleration, while both the business activity (59.7 from 61.2) and new orders (57.7 from 62.7) measures eased, but remained at high levels. The supplier deliveries component was unchanged at 51.5. January’s IHS Markit’s NM-PMI (54.2 from 54.4) slowed slightly for the third month, expanding at the slowest pace in four months. According to the report, “January data signaled a further upturn in business activity across the service sector. The rise in output was the slowest for four months, amid

one of the softest increases in new business seen for more than a year. Although only fractional, new export orders fell for the second successive month. In line with a slower rise in new business, employment growth eased to the second-weakest since June 2017. However, firms registered a stronger degree of confidence towards business activity levels over the coming 12 months.”

Eurozone Retail Sales ([link](#)): December retail sales contracted sharply from November's record high. Sales sank 1.6%, reversing the 1.6% advance during the two months through November. Automotive fuel was the only major category posting an increase, up 0.5% in December and a total of 2.4% the last four months of 2018. Sales of non-food products (excluding auto fuel) exhibited the biggest sales decline, plunging 2.7% after a two-month gain of 2.3%; spending on food, drinks & tobacco dipped 0.3% following a 0.5% setback in November. December sales for three of the four largest Eurozone economies are available: Germany saw the largest decline in sales, tumbling 4.3%—the sharpest monthly decline since May 2007—pushing the yearly growth rate down to a nine-year low of -2.2% y/y. Spending in Spain dropped 1.2%, after a 1.8% gain the prior two months; the yearly rate was basically flat, down 0.1% y/y. Meanwhile, French sales were stalled at record highs in December, edging down 0.1% after edging up 0.1% in November; sales were a solid 3.8% above a year ago. Among the other Eurozone economies for which data are available, the largest decreases in retail trade were observed in Estonia (-2.0%) and Slovakia (-1.7) and the biggest increases in Austria (0.7), Portugal (0.6) and Ireland (0.5). On a y/y basis, Slovenia (11.2% y/y) and Ireland (7.5) led the Eurozone, while Malta (-1.9) was the weakest behind Germany.

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