The monetary props of the global asset boom are rapidly crumbling

New Keynesian central bankers are dangerously close to pushing us into a recession

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Aclassic recession-scare is welling up both sides of the Atlantic, and for good reason.

There is a high risk that central banks will overreact to the greatest commodity price shock since 1915, tightening policy into the teeth of deepening economic slowdown.

The chief danger does not come from the "inversion" of the US yield curve, an early warning indicator of recessions through most of the post-War era.

It still matters that two-year Treasury yields briefly rose above 10-year yields this week. The move implies that bond markets are more worried about Fed overkill than bond markets are more worried about Fed overkill than they are about inflation. But the signal has lost meaning in the era of quantitative easing and excess global savings.

Bank of America says the 10-year "term premium" - the extra reward that investors demand for lending long - has collapsed to sub-zero levels from an historic average of 150 basis points. The yield curve would therefore have to invert far more deeply today to pack the same punch.

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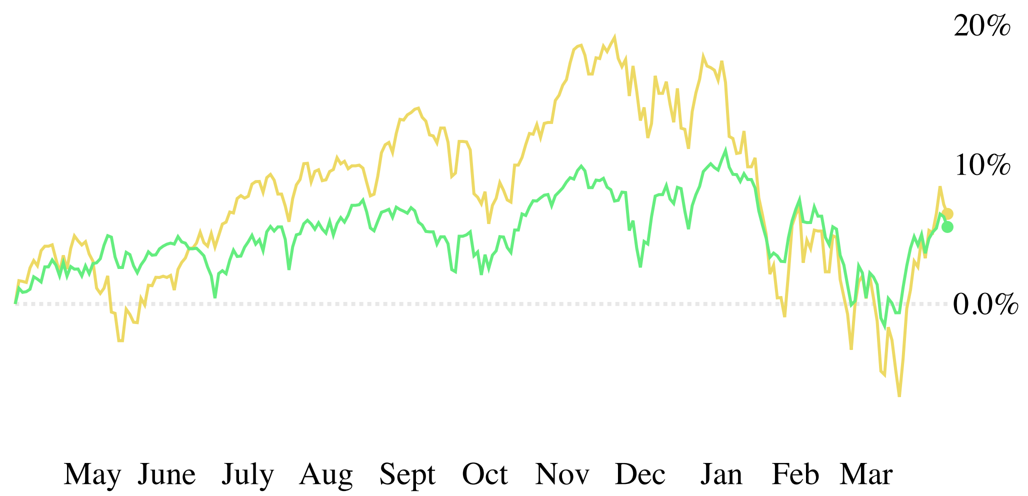
The greater danger comes from the rapid slowdown in US money supply growth, with parallel moves in Europe. This is a recipe for trouble because the Fed and the European Central Bank have stopped paying attention to money data.

“Money has disappeared from modern models of inflation,” says Lord Mervyn King, ex-Governor of the Bank of England.

Simon Ward from Janus Henderson says a key measure of the US money supply - six-month real M1 - has fallen to near zero from a peak of almost 25pc during the pandemic, when the Fed flooded the system with emergency liquidity. The broader M2+ measure has turned negative.

These signals imply that the underlying props of the Wall Street boom are crumbling.

From 1 Apr '21 to 31 Mar



S&P 500: 4019.9 → 4575.6 13.8%

NASDAQ Composite: 13480.1 → 14351.5 6.5%

Dow Jones Industrial Average: 33153.2 → 34985.6 5.5%

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The effect is compounded by a powerful downswing in the inventory cycle. Mr Ward said the closest parallel is the US recession of 1970, which led to a 35pc fall in equities.

Slowing money growth also implies that inflation will come down of its own accord gradually without the need for a violent squeeze by central banks.

The Fed has already carried nine "synthetic" rate rises since November under Wu Xia shadow rate, which includes the tightening effect of less QE.

This is the steepest rise in the Wu Xia rate since 1994 and constitutes a tightening shock. If the Fed really flips from bond purchases to bond sales (quantitative tightening) overnight as well as raising rates this year a further five times - as suggested by Fed rhetoric, and priced by futures markets - it risks pushing the economy over the brink.

The University of Michigan's sentiment index has dropped to 62.8, lower than it was at the onset of every recession for the last half a century. Job data is still strong but that is always lags turning points.

The Economic Cycle Research Institute in New York's weekly leading indicator of economic growth has fallen below zero. “The immune system is compromised,” said founder Lakshman Achuthan.

Mr Achuthan said the Fed is succumbing to the perennial pathology of central banks: having let inflation run loose it is now jamming on the brakes too hard after the cycle has already turned down.

In previous episodes the Fed blinked whenever the S&P 500 index fell by 10pc or so - the proverbial Fed "Put". This time inflation is so high that it might not blink until equities have fallen by 20pc or 25pc.

It will stick to its script until there is broken crockery everywhere, “meaning either a stock market crash, or a recession, or both,” he said.

Professor Tim Congdon from the Institute of International Monetary Research said this year’s inflation surge is the lagged result of a 30pc increase in the US broad money supply during the pandemic, not the result of supply chain disruption or rising commodity prices, as central banks will have us believe. The official narrative has the causality backwards.

Inflation will linger at uncomfortably high levels for mechanical reasons. The monetarist prescription is to treat what has happened as a one-off inflationary jump that cannot be reversed, and let matters run their course.

https://chase.telegraph.co.uk/content/telegraph/business/2022/04/01/monetary-props-global-asset-boom-rapidly-crumbling.html?wcmmode=disabled

The worst policy at this juncture is to compound one error with the opposite error.

Broad money growth has already slowed to 5pc (negative in real terms). This is the optimal level. It should not be allowed to slow further. Inflation will settle down without violent ructions or a needless recession.

The objective should be stability, not trigger-happy, stop-go, hyper-activism. Unfortunately, there is zero-chance that New Keynesian central banks will heed a single word of advice from monetarists.

Lest we forget, the Fed and the European Central Bank both over-tightened in early to mid-2008 when oil prices seemed to be spinning out of control. They did so after their economies had already slipped into recession, either by signalling a string of rate rises or in the case of the ECB by committing the pro-cyclical crime.

It was this that turned a manageable subprime/Club Med credit bust into the global financial crisis. The Lehman chain-reaction several months later was the avoidable consequence of this misjudgment.

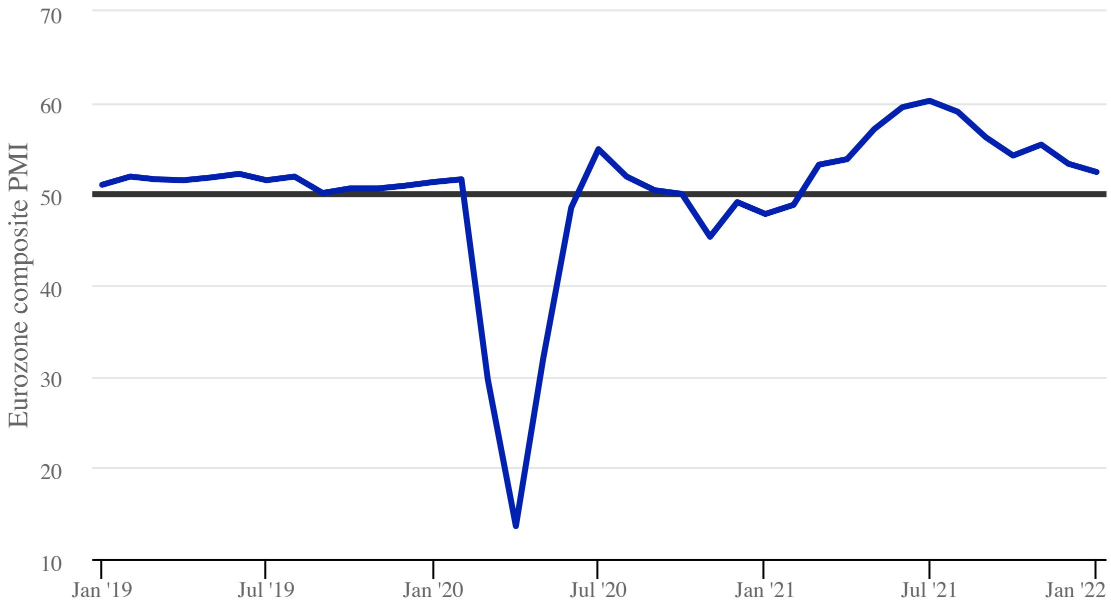
Fed insider Robert Hetzel gives us chapter and verse of what went wrong in The Great Recession: Market Failure or Policy Failure?, a book that the Fed establishment prefers not to talk about.

The central banks have never faced up to their own co-responsibility for the 2008-2012 debacle, propagating a narrative that it was all the fault of capitalists and hedge funds. Ergo, they will repeat the error.

In my view, the ECB will be the most cautious, as it must be given that Europe’s economy has hit a brick wall. The ECB is not an independent central bank any longer.

Eurozone growth is petering out

Private sector growth has slowed to its weakest in nine months



* Any score above 50 indicates growth

Source: IHS Markit

It is a fiscal agent, like the Banca d’Italia in the 1970s. Its de facto mandate is to keep insolvent Club Med states afloat and to mask the full extent of France’s deteriorating public debt profile. This ensures a dovish bias.

Yet both the ECB and Fed worship at the altar of 'inflation expectations', and therefore think they must breathe fire if there is any sign that these expectations are becoming "unhinged", another favourite term in their lexicon.

The prevailing view as inflation spirals to 40-year highs in the US and Europe is that they must pick between poisons: either they let inflation become embedded in social psychology, and risk a self-feeding dynamic; or they take drastic action before the matters get out of hand.

No matter that the Fed itself published a dissident paper last September ripping apart the soft science of inflation expectations, adding for good measure that much of mainstream economics is "replete with ideas that 'everyone knows' to be true, but that are actually arrant nonsense". Well, indeed.

The problem with this New Keynesian doctrinal architecture is that it ignores the role of money in the economy altogether, which is an odd thing to do for institutions that manage money.

The Fed is today embarking on a course that will deliberately induce quasi-recessionary conditions, or a "softish landing" in the euphemistic utterance of chairman Jay Powell.

He even has the backing of Nobel laureate Paul Krugman, high priest of ultra-stimulus, the guru who told us for two years that there was no risk of inflation.

"Prudence demands that we try to rein in prices now… it pains me to say that we can't safely let the economy keep running this hot," he says. You could knock me over with a feather.

The Fed has dusted down the episodes of 1965, 1984, and even 1994 as models of successful mid-cycle tightening, and is poised to go all in, guns blazing.

Let us hope that we are indeed at mid-cycle and not already in an enveloping recession. But even if the Fed is right, just remember that the Great Bond Massacre of 1994 set off the Mexican Tequila crisis and left a trail of havoc across the world.

Tin helmets are advised.