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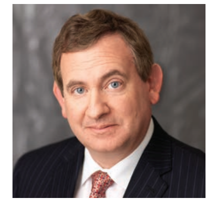

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The Fed's Maginot Line

It has been six years since the Fed zeroed out rates and still we wait for "assisted growth" to become "real growth." Beginning with the "recovery summer" of 2010, the Fed has proclaimed that cheap money would rocket the economy to escape velocity, launching an organic, self-sustaining economic recovery. Instead, central bank policy has vaulted asset prices into the stratosphere even as wages wait their turn on the launch pad. Low rates have failed to deliver the goodies, but the Fed has its story and is sticking to it.

Can sustainable growth be "bought" with easy credit? While the Fed asserts that its monetary machinations have facilitated a recovery that is steadily gaining traction, we aren't buying the narrative. Atomize the Fed's logic: why should an expansion of credit lead to sustainable economic growth? What can a credit line do for you? It lets you spend in excess of your earnings. Without credit, a person can only spend as much as he is currently earning (or has saved up from accumulated historical earnings). So if you lend me money, I can temporarily spend in excess of my earnings if I pledge to pay you back out of my future earnings. Your loan expanded my current period *spending capacity*; and, in exchange for your munificence, my balance sheet now reflects a payable due to you. If your loan lifted my current period consumption, then you made me more comfortable today; however, your loan did absolutely nothing in so far as increasing my *earnings capacity*. And, absent any benefit to my lifetime earnings capacity, your loan has enabled me to spend more today, but only by my having less to spend tomorrow. Of course, if I do not pay you back, then my inter-temporal shift in consumption becomes yours as you would have to write-down my payable to you, in which case your future spending is diminished. Either way, a loan whose purpose is to enhance current period consumption does not *sustainably* increase anyone's income.

But that ignores the "multiplier", right? Conventional economics reminds us that since each person's spending is someone else's income, a dollar's worth of borrowing is supposed to have a multiplier effect on incomes. See, a borrower takes his newly created spending capacity and, as he spends, that spending becomes another's income, which continued becomes an endless daisy chain of prosperity. Really? This is just a scaled up version of the same fallacy. If half the population borrows from the other half and spends it all in the current period, your economy will boom until the notes that financed the consumption come due. In the end, the totality of what you can spend (buy) is equal to the totality of what you can produce (earn). Credit only re-arranges who can consume and when.

So far we have only examined credit whose use of proceeds is to support current period consumption. What happens when a loan is created that provides some future period benefit such that the loan enables the individual to earn more (say a student loan) or the business to become more profitable? Such loans are definitionally self-financing and have the effect of moving resources in the direction of their highest, best use. This sort of credit formation is bona fide stimulative precisely because it adds to the *earnings capacity* of the economy. Here, win-win replaces the zero sum of consumption based loans. Now, the Fed may posit that low for longer enhances this sort of wealth producing activity by lowering the private sector's "hurdle" rate. Maybe so. But projects that can only be justified at artificially low Fed induced rates can't be all that additive to the wealth of the nation. Besides, were vast quantities of such positive IRR loans actually being originated, we'd see their macro effect in the form of a booming GDP.

Still there is one remaining turret in the Maginot Line of antiquated central bank theories: the wealth effect. Easy credit and cheap money lowers the discount rate on future earnings and, so, lifts the present value of the capital stock. Higher asset prices are supposed to enhance "confidence" even as they extend the supply of loanable collateral. But are higher asset prices "stimulative?" They are not. Alone, higher asset prices do not expand the economy's *earnings capacity*. If I pay a higher dollar price for a bond, the coupon rate I earn, i.e., my income from the bond, is not changed in the least. If an employee's house doubles in value, he is nonetheless no better at his job; and if the P/E of a stock doubles, the business may not be producing more or better products. Higher asset prices do not expand real output, so cannot be stimulative. But surely the Fed disagrees: after all, higher asset prices animate spirits and alter incentives to invest, they say. But without new income to support the higher asset prices manufactured by the Fed, in what sense are these higher asset prices either sustainable or proper guideposts for investing?

For investors, the salient observations are that while the Fed has the tools to smooth consumption and manage demand higher *within* a market cycle, long-term growth is more complicated than flooding the system with easy credit. Over time, more GDP is a result of business owners and entrepreneurs using their local knowledge and expertise to find ways to produce more, ever more efficiently. Be that as it may, capital markets are "buyers" of the Fed's narrative that more credit will keep the economy going...and going. This faith in the power of the Fed is reflected in elevated asset prices, skinny risk premia, and interest rates that are barely bobbing above water. In effect, investors who are substantially long risk are empowering the Fed's on-going suppression of market forces and, so long as this confidence can be sustained, so can the Fed's bulwark against market forces. Interestingly, it was events from exactly one hundred years ago this summer that led to the building of a bulwark against a different kind of enemy that, in time, would come to fail spectacularly, notwithstanding – maybe because of – the belief in its invincibility. They called it the Maginot Line.