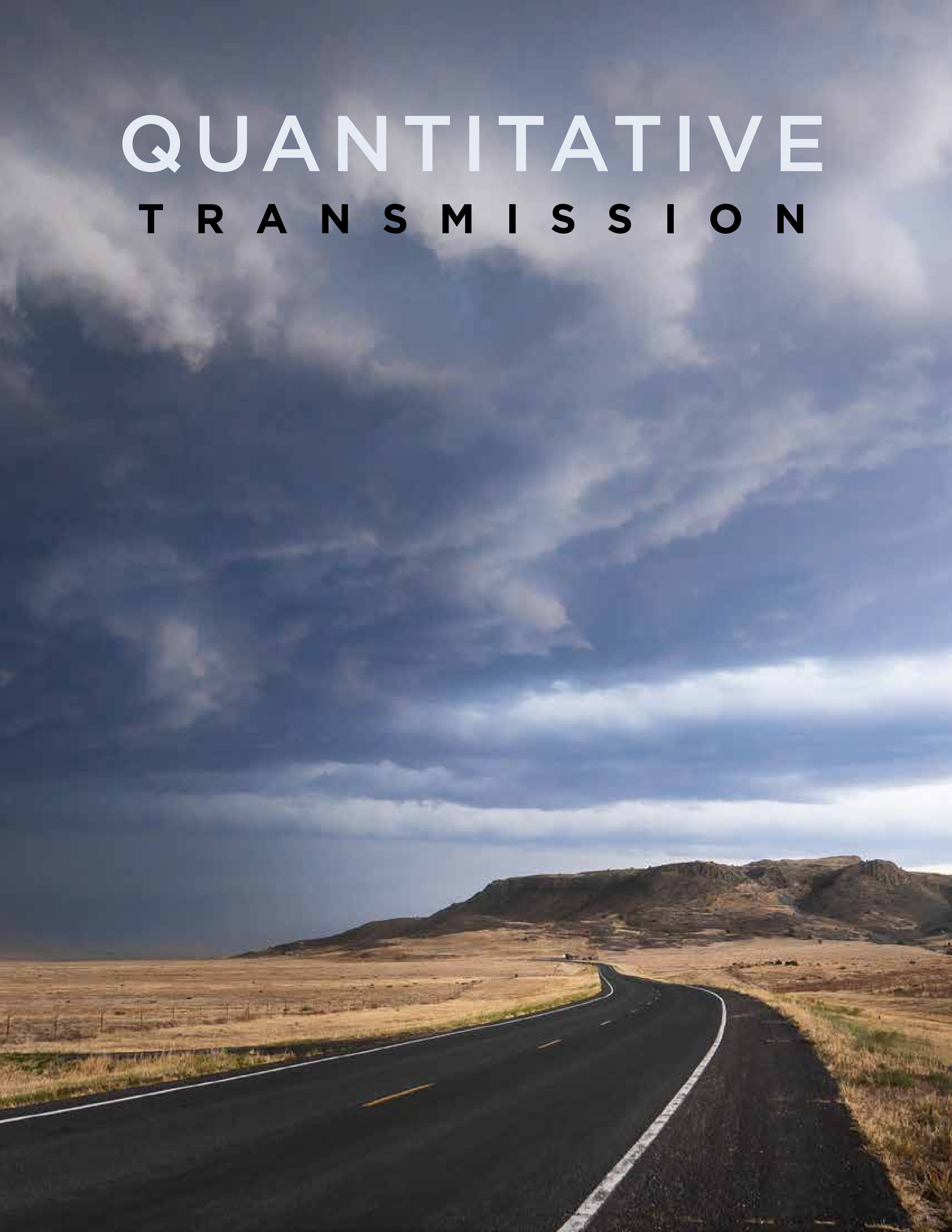
QUANTITATIVE TRANSMISSION



Last month we discussed inflation, its relationship to radical central bank policy, some of its curious (questionable) measurement anomalies and explored some implications for the markets of the inflation narrative. Usually when I write, the long (sometimes painful) process of it all naturally gets out everything I want or need to say about a topic but all month I have found myself thinking about this exact same stuff. Normally by now I'm on to new topics and questions but I realized the other day that I must have more to say here.

It's clear where I stand on this question of whether or not QE is benign when it comes to inflation. Obviously it is not. If that's true, there are a couple big follow-up questions worth exploring:

1. **How is QE inflationary?**
2. **Why are the central bankers going out of their way to convince us there is no inflation?**

Let's talk about the "How" first. It's worth a moment to review just what QE is and how it works. Even though on its face QE seems like just another form of money printing, if you study the way it actually operates you'll see that it is quite different.

The basic operation of QE looks like this:

Central Bank Creates Money (quite literally by clicking a few keys on a computer).

Then the Central Bank goes out into the Private Market (and this is a key point) and buys publicly traded securities—mostly government bonds but also mortgage-backed securities and, in some cases, like in Japan or Switzerland, even equities.

The most common form of QE involves a central bank buying government bonds from banks. This is a more complex transaction than that of traditional debt monetization. It doesn't function at all in the same way as the money printing that we've seen in past hyperinflations where beleaguered governments print actual currency and then use that currency to buy its debt securities directly or to directly fund government payroll and expenses. There's a separation here. In the United States, the Federal Reserve does not (and cannot) buy securities directly from the US Treasury.

So, what happens when the Fed buys securities from the banks? This transaction essentially does two things: 1. It improves the balance sheets of the banks. They get cash which improves their reserve ratios and lowers their cost of capital. The macroeconomic outcome is that the money supply goes up and interest rates come down. 2. It improves the liquidity of the market. The fact that there is a buyer for government bonds (effectively at any price) has a profound calming effect on the psychology of market participants. The goal of 1 is to prevent financial instability—i.e. a run on the banks—and reduce longer-term interest rates. The goal of 2 is to prevent market instability—i.e. a run on the stock market. The intent is to stimulate economic activity via stable and easy monetary conditions.

If you look up QE online this is the standard explanation that you will find. And while QE does operate this way and actually kind of works, it also does a few other things. First of all, it encourages spending in the economy via the power of the wealth effect. This is something that the architects of the program not only acknowledged but wanted. Ben Bernanke, Fed Chairman at the time, wrote about this in his 2010 Washington Post OpEd article introducing the theory to America. One of the outcomes of QE is that both the bond market and the stock market tend to do well. If anything, this is the true success story of QE. It worked even in the dark days of March 2020 when pandemic fears were causing markets around the world to crash. The FED, ECB and other central banks around the world managed to stabilize the market in a few weeks just by announcing bold QE programs. And while it's debatable just how potent the wealth effect may be, it does work in some degree to induce spending.

The other thing that QE does—and here's where problems start to arise—is to encourage speculation. By signaling to market participants that the Fed will ALWAYS be there as a backstop, QE introduces a kind of moral hazard to markets. This is what Mario Draghi was doing with his famous "whatever it takes" comment during an ECB press conference. The theory is that because the Fed is attempting to execute its policy mandate via market conditions, it has an incentive in ensuring those market conditions stay favorable. And as the Fed has intervened time and time again over the past decade this theory has evolved into one of the most widely held and powerful beliefs in all of market history.

Now there are certain speculative activities that are not necessarily inflationary. For instance, it isn't clear how even dramatically increased levels of stock market speculation could cause increased inflationary pressure. Maybe, if sustained over a long period of time and if the market goes high enough, stock market speculation might manifest inflation in certain areas of the economy like luxury goods. Something like this may have even happened over the past decade. But, on its own, this type of activity shouldn't manifest a broader inflation.

When it comes to assessing whether speculative activity is potentially inflationary, you have to look at the extent to which the activity generates spending in the real economy. There are types of speculation that are clearly inflationary, like real estate. Rarely, do real estate investors "buy and hold" like a stock market investor. There's almost always some kind of active strategy aiming at improving the underlying operating performance or value of a property. This usually entails things like spending money to improve an existing property or to develop a new one. The point is the speculation itself has consequences for the real economy. Real estate is particularly dangerous because the strategies in and of themselves are aiming at inflationary outcomes—e.g. raising rents or selling properties for higher prices—and given real estate's central position in the cost structure of modern life, changes here have big impacts.

There are some forms of speculative activity that might even be inflationary in the short-term but prove disinflationary or even deflationary in the long-term, like speculation in technology and innovation. In the short-term, these types of investments (bets) tend to generate real spending in the economy. Technology companies hire people, make real capital investments and buy real goods and services. This spending can introduce inflationary pressures into the economy. This usually manifests in the form of micro-inflationary flare-ups as increasingly well-funded start-ups compete for the same components, engineers…etc.. Prices in a small segment of the economy can move rapidly higher in response to this pressure.

However, when these speculations "work"—i.e. the companies actually innovate—these micro-inflationary pressures dissipate as the broader innovation introduces disinflationary and deflationary forces into the economy. I think this phenomenon essentially has been the savior of our experiments in radical central bank activism. Where would we be without innovation? I have a feeling that historians will probably interpret the past 20-years under this lens. For us, living through all this, it is the macroeconomic and political forces that loom so large upon our consciousness. But what's really going-on is that technology is transforming our economy and our way of life.

Going into the pandemic I think there were two areas where the inflationary potential of QE was being transmitted into the real economy: real estate and technology. In real estate, clearly inflation ruled the day. Across all property types we saw both rising rents and rising valuations. With technology things are a little harder to interpret. There have been many instances of momentary micro-inflationary flare-ups as a result of speculative activity—e.g. look at what happened with rare Earth metals—but on the whole it seems that there have been enough innovation wins to prevent any broad based inflation.

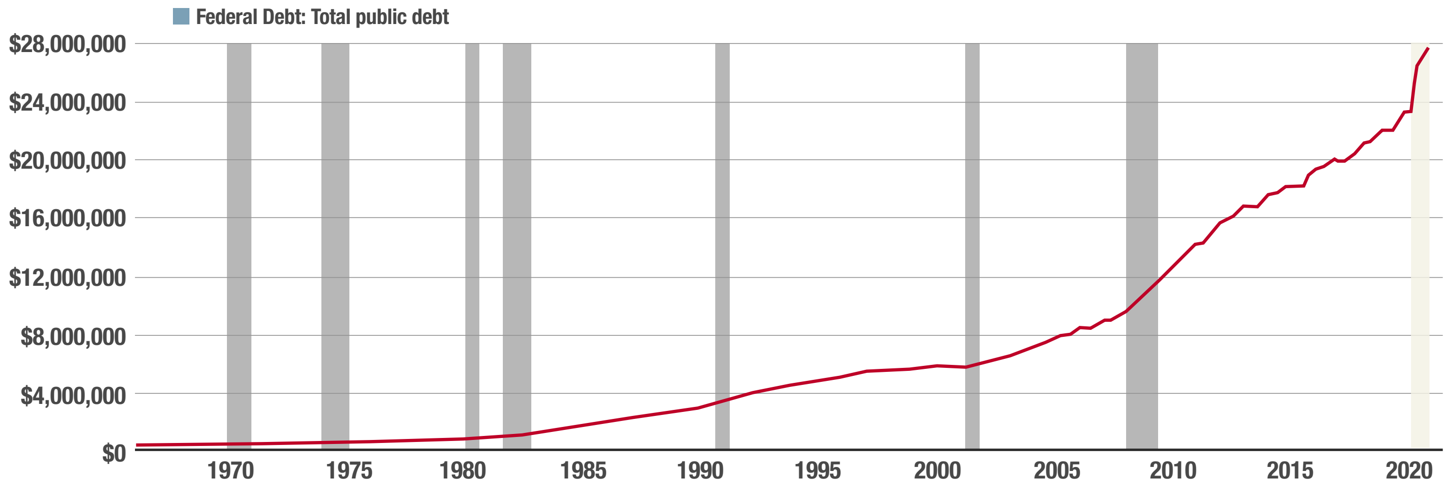
The pandemic, of course, has really changed things. More and more we are seeing these micro-inflationary flare-ups, most notably in places like housing, lumber and other construction materials, certain technology components like microchips and industrial commodities, especially those that are necessary in green energy technologies. These inflationary pulses, which have been decidedly more dramatic than in the pre-COVID era, are being written off as pandemic-induced supply chain anomalies. But I think something far more serious is happening here. One consequence of the pandemic is that QE is just no longer as benign at it used to be. The liquidity created this time around is finding its way into more and more sectors. The transmission mechanisms for QE-induced inflation are expanding in the face of a more dynamic economy. It's as-if the process of creative destruction itself—largely asleep since the Great Financial Crisis and the widespread adoption of too-big-to-fail policy measures in its aftermath—is finally fully awake and back in action. And with creative destruction on the loose, comes risk.

Let's close by talking a bit about why central bankers have been trying so hard to convince us all that there is no inflation. I, for one, believe that they absolutely knew that pre-pandemic QE was causing inflationary problems in certain sectors. It's impossible to look at the data in real estate for example and not see inflation. As we saw last month, the same is true for education, healthcare and food. For years they were able to keep the story under wraps by shifting the focus of the market to different or broader metrics, playing measurement games and obfuscating the narrative with non-sensical phrases like "structural problems with the economy" or "a persistent lack of Aggregate Demand."

Now though they cannot hide from it nor stop it. It's not just speculative activity anymore; its households, individuals and companies making decisive real life choices about where to live and what to buy or not buy. Whole industries are changing. Just look at Hollywood as an example, where the whole business model is evolving from the old theatre dominated model to streaming. Now this was already in the works pre-COVID but no one expected the change to happen this fast. And this is happening all across the economy. Each one of these accelerated evolutions provides another potential transmission mechanism for QE-induced inflation. Time will tell but I'm convinced we haven't seen anything yet.

Central bankers around the world today are scared and rightfully so. For the past 30-years they have carefully and methodically cultivated this reputation of being able to somehow control inflation. And this reputation has proven to be incredibly valuable and powerful. It's what gave the central bankers the political cover to pursue radical strategies like QE in the first place. But all the while, no one really stopped to challenge them. No one stopped to consider the obvious alternative explanations for "persistently low inflation"—the massive disinflationary and deflationary effects of both innovation and globalization. Well, maybe not "no one" but clearly not enough of us. And year after year, we kept building up more and more debts.

Here's the problem. There's really only one way to fight inflation: You have to raise interest rates. The chart below, which shows the incredible extent of our growing public debts (just one component of the total debt in our financial system by the way), demonstrates the impossibility of implementing anti-inflation measures:



Source: U.S. Department of the Treasury. Fiscal Service

What would a 5% rate on $26T due to our Federal budget deficit? What would it do to asset markets that have been propped up for years on the assumption that low discount rates are a permanent reality? The truth is this: we have no real practical way introducing inflation controlling policies without causing serious damage to our balance sheet, our economy and our asset markets. Central bankers are that the start of a nightmare of their own creation. What happens next is of supreme importance. ▫

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