Daddy, Where Do Dollars Come From? A Look at The Short and Long-Term Consequences of Fiscal and Monetary Stimulus.

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By Brian Luster

In yet another failed attempt at discussing household financial austerity over dinner, my wife cleverly shifted the conversation toward the subject of government stimulus and spending. Perhaps sensing the friction, my 8-year old son quickly interrupted, asking us how much we could buy with a trillion dollars. I responded by asking him if he understood what we could buy with a million dollars. "That's easy", he said, "a decent sized mansion" (he gets it from her side of the family). I then asked him if he knew what we could buy with a billion dollars. Ever the mathematician, he said, "1,000 mansions". So, I explained that a trillion dollars could buy us 1 million mansions. "Wow!", he said. "Where did the President get all that money?".

The average American has by now received some kind of economic stimulus in the form of either a check, an enhanced weekly unemployment benefit, or a forgivable PPP small business loan. Meanwhile, the Fed has slashed interest rates to zero, restarted quantitative easing, and begun to lend directly to businesses and provide support to state and local municipalities. By my calculation, over $9.5 Trillion has been allocated to support the US economy through fiscal and monetary stimulus efforts. And that is just in the United States. So, like my 8-year old son, we ask ourselves, <u>where is all this money coming from, and what are the short and long-term consequences of introducing this "liquidity" into the marketplace?</u>

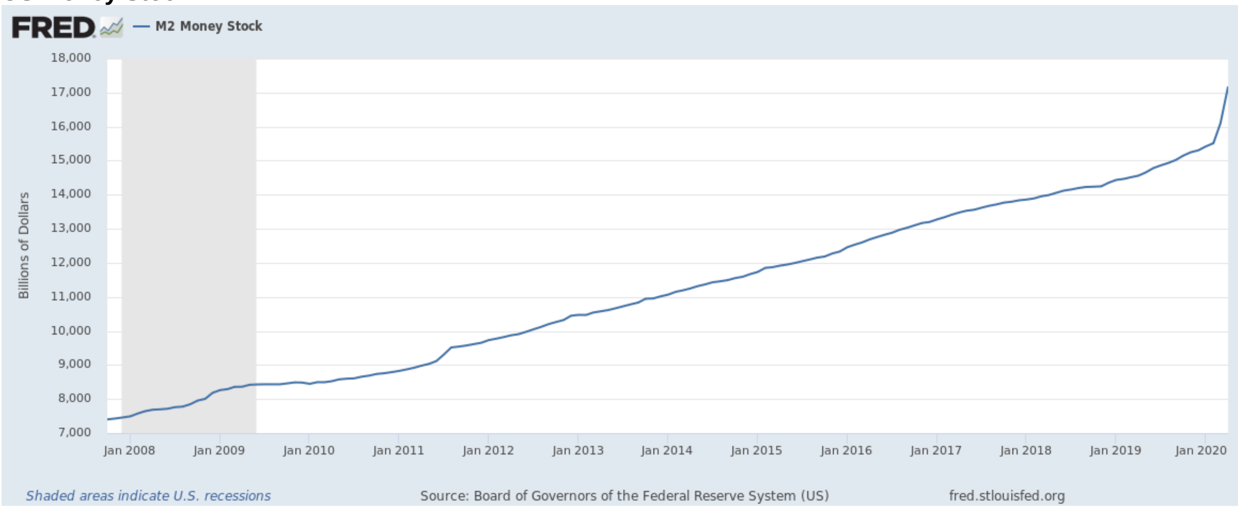
A Timeline of Fiscal Monetary and Fiscal Stimulus

March 3, 2020	Emergency Interest Rate Cut – 50bps to 1.0%
March 6, 2020	Phase 1 - $8.3 Billion
March 12, 2020	Expanded Reverse Repo Operations $1.5 Trillion
March 15, 2020	Open Market Purchases $700 Billion (UST, MBS)
March 15, 2020	Emergency Interest Rate Cut – 100bps to 0%
March 18, 2020	Phase 2 - $192 Billion
March 27, 2020	CARES Act - $1.8 Trillion
April 9, 2020	Municipal Liquidity Facility - $500 Billion
April 24, 2020	PPP and Healthcare Enhancement - $483 Billion

DADDY, WHERE DO DOLLARS COME FROM?

The concept of money creation is often misunderstood, even by most financial professionals (seriously, ask one). Today there is approximately $17.2 trillion of US money supply consisting of $4.8 trillion of physical currency, and the remainder in electronic currency stored in our checking accounts, savings accounts, CDs, and money market fund balances. Supply has grown substantially since the 2008 recession, when our money stock was a mere $7.5 Trillion. And yet every penny of it came from only two places – The Federal Reserve and commercial banks.

US Money Stock

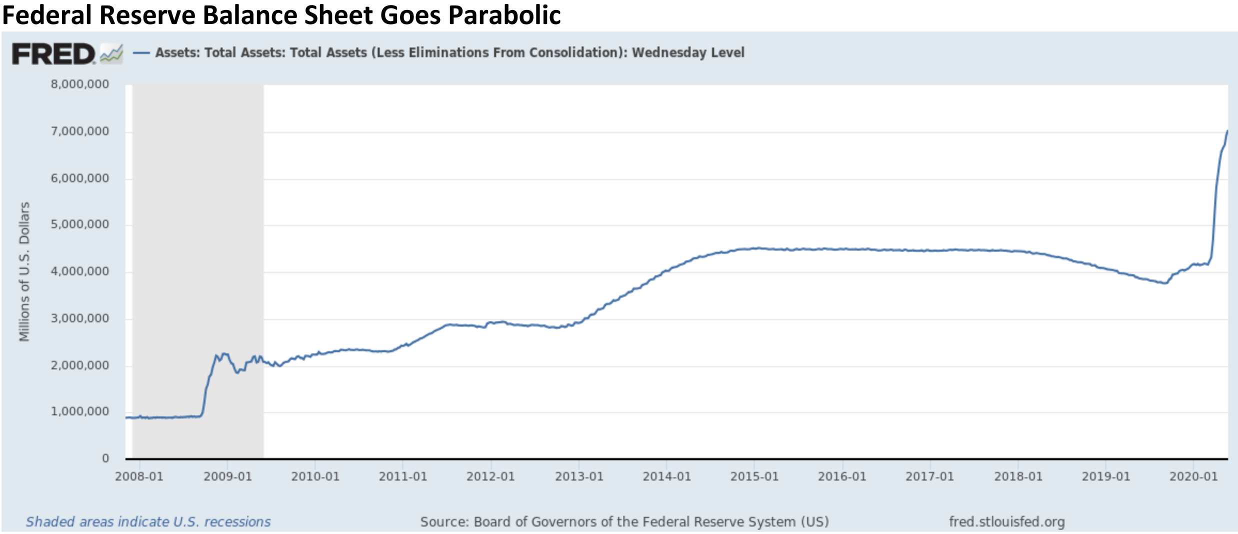


The Federal Reserve creates money by either lending to the Treasury in exchange for US Treasury bills, by lending directly to commercial banks, or by purchasing assets (i.e. bonds) from either the government or the commercial banks. In any case, the Federal Reserve is creating money that did not previously exist and getting it into the hands of the Government or the Private Sector through direct lending or asset purchases. The Government then uses that money to finance its budget (i.e. deficit spending) and the banks use it to lend to their customers. Thus, new money is born. Historically, about 10% of new money comes from the Federal Reserve. During the COVID recession, however, this mechanism has been the primary source of money creation.

The remaining 90% of new money is created by the commercial banks themselves. This is the business of banks. For every $100 consumers deposit into their savings accounts, banks retain $10, and lend out $90, thus increasing the money supply from $100 to $190. These bank loans often appear as personal, auto, home, credit card and small business loans to bank customers. As a result, if all of a bank's customers suddenly ran to the bank to simultaneously withdraw their deposits (a bank run), the bank would only have ~10% of their money available to withdraw.

As a result of the Federal Reserve acting as the primary driver of money creation to finance our COVID stimulus efforts, the Federal Reserve's Balance Sheet has risen parabolically, up nearly 70% year to date.

Federal Reserve Balance Sheet Goes Parabolic



Federal Governments, unlike the states, company CEOs, and my wife, are not required, and thus do not always feel obligated to balance their budgets. Instead, they can run budget deficits, borrowing money from the Central Bank through the issuance of US Treasury obligations. As long as there is a willing lender, the government can spend as much money as it pleases. And when you are your own lender, such as is the case in the United States, well…you get the idea.

So understanding that the US money supply has been significantly increased as a result of the fiscal response to COVID (government spending financed by the issuance of US Treasuries purchased by the US Federal Reserve), and that we were already entering this crisis with historically high levels of Federal debt and deficits coming out of the Great Financial Crisis of 2008, we can begin to appreciate that there will be short and long-term consequences of these actions on both the markets and the economy in the years ahead.

THE SHORT-TERM IMPACT OF RISING MONEY SUPPLY

In the face of "stay-at-home" orders and mandatory business closures, economic stimulus is a necessary and welcomed approach to avoiding a total economic collapse (i.e. depression). By directly injecting capital into the hands of Americans and American businesses, economic stimulus offsets lost wages for workers and lost profits for employers. Employees can feed their families and pay their bills despite being unemployed, while businesses can avoid bankruptcy despite being deprived of revenues…at least in the short-term.

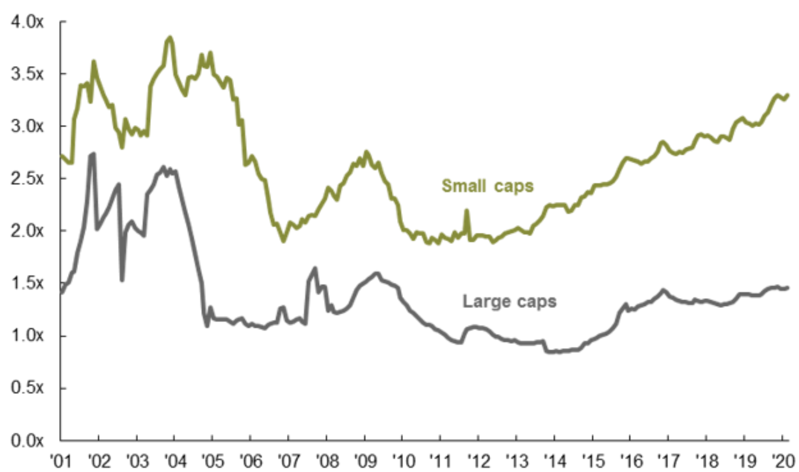
While overall, economic growth and household wealth have been destroyed since the beginning of COVID, fiscal stimulus continues to allow the economy to better weather temporary spikes in unemployment and negative GDP shocks. In this environment of rising unemployment, <u>disinflation (a reduction in the rate of inflation) or deflation (when prices actually fall) are amongst the biggest risks to the economy. As a result, in the short-term, we expect the rising money supply to dampen asset price declines and mitigate the depreciation of financial assets.</u>

<u>Overall, stimulus is nothing more than a short-term bridge until medical science can provide us with a vaccine or a treatment. In the interim, we would expect the economy to remain in a state of suspended animation, avoiding total economic collapse, supporting consumer spending, mitigating household and corporate wealth destruction, and avoiding deflation. Businesses will be forced to take on debt to manage through periods of weak demand and falling profits.</u> These conditions are likely to persist for the next 1-2 years. As a result, investors will migrate towards large cap stocks over small cap equities, with a bias towards the US over international equities, and preferring companies with strong balance sheets (lots of cash and limited amounts of debt). This explains why the S&P 500 has been significantly outperforming the Russell 2000 small cap index and MSCI All World (ex US) Index.

Summary of the short-term impact

- Avoid total economic collapse / depression
- Support consumer and consumer spending
- Mitigate household and corporate wealth destruction
- Cause disinflation yet avoid deflation
- Corporations will take on increased debt while experiencing large negative earnings hits
- Investors will prefer quality, strong balance sheets, and large cap over small cap (small cap were 1.3X more levered than large cap pre-COVID and are now approaching 1.9X levered)

Net debt to EBITDA for Large and Small Caps



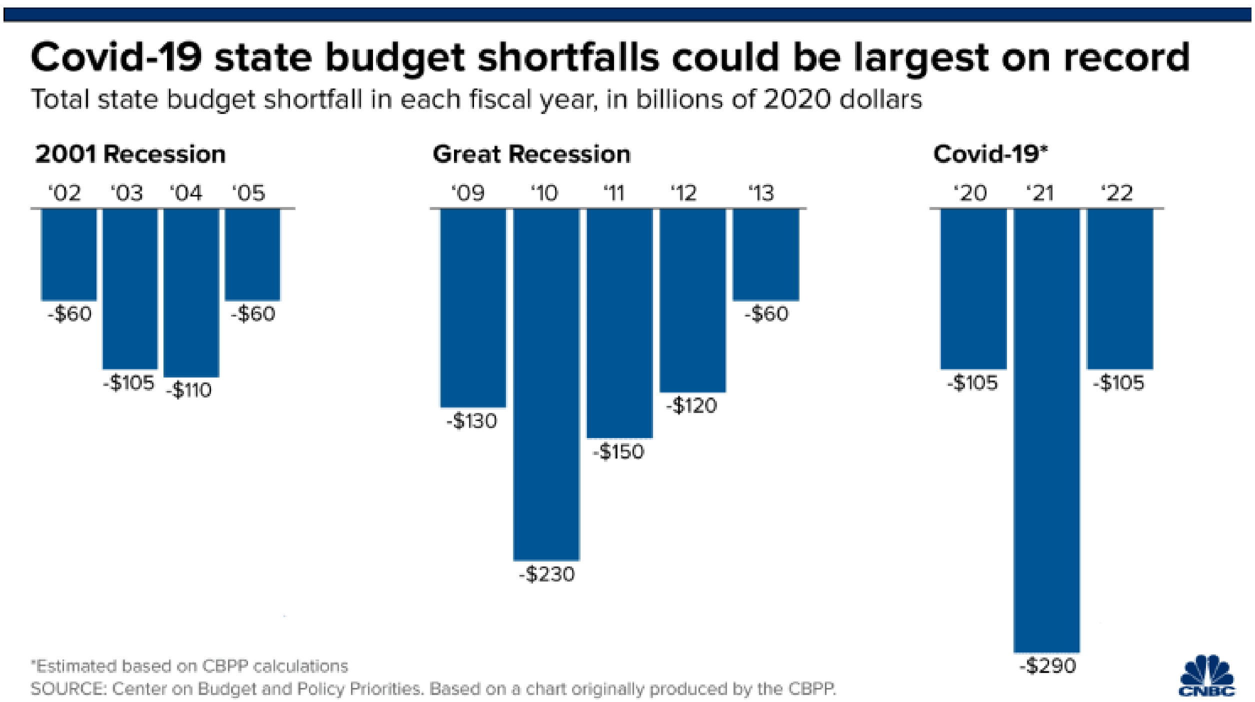
Source: FTSE Russell, Standard & Poor's, J.P. Morgan Asset Management.

THE LONG-TERM IMPACT OF RISING MONEY SUPPLY

As we described earlier, the Money Supply is increasing as a result of fiscal stimulus putting money directly into the hands of consumers and businesses through stimulus checks, emergency unemployment benefits, and PPP loans. All this newly created money will eventually create price inflation. This is Economics 101 – as the supply of money goes up faster than the demand for money, the price of money falls – thus inflation occurs. This is a divergence from the asset purchases (Quantitative Easing) that occurred after the Great Financial Crisis, which led to asset price inflation, yet limited price inflation because it did not expand the money supply. Of course, price inflation cannot occur without wage growth, and wage growth does not occur when the unemployment rate is elevated. Thus, price inflation is a long-term effect of this fiscal stimulus.

Similarly, the US has recognized the need to re-domesticate global supply chains, which will lead to cost inflation. This simply means that as the US shifts production away from low cost wage and low cost raw material markets (such as China), and brings production back into the US, producers will be forced to raise prices or suffer from lower profit margins. While this is not a direct result of fiscal stimulus, it is a direct result of COVID-19, and will only exacerbate the price inflation pressures mentioned above.

Meanwhile, States and the Federal Government will be forced to raise taxes, reduce spending, and eliminate entitlement program benefits in order to finance their budgets and support their economies (i.e. public transportation and infrastructure spending, pension obligations, healthcare, and unemployment) in the face of revenue shortfalls. These issues are unlikely to be directly addressed until we are well passed this crisis. And given that these tough, yet practical decisions are politically divisive, they are even more likely to be delayed as long as possible. At the state level, we could expect to see this in the form of corporate, excise and sales, property, and gross receipts tax hikes. At the Federal level, we could see marginal income tax rates rise back to levels before the Tax Cuts and Jobs Act was passed, as well as a reduction in lifetime gift and estate tax exemptions.



Low interest rates, increased government spending, and increased government debt would normally lead to a devaluation of the US dollar relative to our foreign peers. However, given this is a global pandemic, and that other Central Banks and governments are operating out of similar playbooks, it is unclear how currency valuations will play out over time. However, given the scope of US stimulus thus far, it is likely to have negative consequences for the value of the US dollar.

As we have restarted Quantitative Easing, and the Fed begins to purchase bonds and ETFs, we will begin to see asset inflation like what we had witnessed over the past decade. This will be very evident in the equities markets, as discussed in previous articles, where we described the near perfect correlation between a rising Federal Reserve Balance Sheet and the rising of the S&P 500. As investors are forced further up the risk spectrum and given increased liquidity, these resources will be redeployed into the equities and real estate markets, driving prices upward over the long-term, rewarding the wealthiest Americans that have exposure to these sectors.

From an investment perspective, as tax rates rise, there will be an increased emphasis on Tax Aware investment strategies, such as tax-managed equity and actively managed municipal bonds in investors' portfolios. The re-opening of economies will reveal that larger companies with less leverage were best positioned to weather the crisis. However, once this period passes, and a shake-out of winners and losers has transpired, investors will shift their portfolios towards the underperforming Small Cap and Emerging Markets sub asset classes, as well as towards REITs and commodities, all of which will benefit during the subsequent period of rising interest rates, rising oil prices, above trend earnings growth, and inflation that will occur during the next expansion. US Treasuries, however, may be long-term harmed as the general credit worthiness of the US could be harmed in the years to come.

Summary of the long-term impact

- Rising taxes
- Spending cuts / Entitlement program cuts
- Currency devaluation
- Price and asset inflation (increased money supply and re-domestication of production and supply chains)
- Tax Aware investment strategies will become more important in portfolios. REITs, small cap, commodities, and Emerging Markets will be long-term winners.

Conclusion

There is no doubt that stimulus and science have enabled us to avoid a depression. In doing so there will be short and long-term consequences from these efforts. Over the short-term, these consequences are largely positive for workers, businesses and large unlevered corporations. Over the long-term, however, local, state, and the federal government will be forced to raise taxes and reduce spending. The increased money supply combined with the re-domestication of global supply chains will lead to both price and asset price inflation, a phenomenon that will benefit those that own financial and real assets, further exacerbating the economic class divide amongst Americans. Savvy investors will shift towards smaller cap equities, REITs, Emerging Markets, and commodities as we emerge from this crisis and enter the next economic expansion. Yet future generations will ultimately be left with having to deal with the ramifications of all this debt and inflation.

As always, we look forward to answering any questions you may have for our team.

ABOUT THE AUTHOR

BRIAN LUSTER is a Principal and Chief Investment Officer of Collective Family Office located in York, Pennsylvania. With over 20 years of Wealth Management experience, Mr. Luster has previously served as Founder and CEO of a boutique Multi Family Office in New York City, as the Managing Member and Portfolio Manager of a long/short US event-driven value-oriented hedge fund in New York, and as a Senior Wealth Manager for BNY Mellon Wealth Management in Central Pennsylvania.

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