

The Turning Tide: Monetary Policy vs. the Real Economy

By BFI Capital Group

As the BFI Infinity team had predicted in the last quarter's issue of their InSights, the global monetary policy "U-turn", spearheaded by the Federal Reserve back in May, was always more than likely destined to be short lived. So far, the Fed's hawkishness has been in line with our expectations, as the US central bank and most of its peers are struggling to combat inflation.

However, the return of Quantitative Tightening might soon prove to be merely a brief anomaly, or but a little blip, in the grand scheme of things, as the world's central bankers appear set to soon return to business as usual. The first troubling signs of economic weakness or even a full-blown recession have been apparent for months, despite the denials by politicians and all the mainstream financial press analyses that use mainly wishful thinking to declare that "everything is under control".

Between a rock and a hard place

After more than a decade of extremely loose policies and reckless quantitative easing that artificially propped up equity markets, it can be argued that inflationary pressures were always inevitable. However, what ensured that these pressures would turn into a cost-of-living crisis, not just in the US but all over the West as well, was the central bankers' decision to "double down" on this strategy during the first two years of the pandemic. The unprecedented liquidity that flooded the system along with the massive spending unleashed by governments made sure that "saving the economy" from the lockdowns and the forced business closures would come at a very high price. And while the Ukraine/Russia war certainly hasn't helped, causing further disruptions and shortages, the real root of the inflationary woes plaguing almost every household today can be found in the chronic short-sightedness of policymakers.

Today, the Fed, along with most other central banks, finds itself in a very tight spot indeed. At the start of the year, with inflation already being a "clear and present threat", it was obvious which part of its "dual mandate" it should be focusing on; keeping prices in check was an apparent priority over pushing for "full employment". Now, however, it is becoming increasingly difficult to make that call. The US economy shrank in the first and second quarters, fueling the largely academic debate over whether the country is, or will soon be, in recession territory. Technically speaking, it is of course already, since a recession is identified by a drop in GDP in two successive quarters, but there are indicators that are far more worrying and that impact real people much more directly than official statistics.

For one thing, the US labor market has been sending mixed messages of late. While unemployment continues to be very low, there is a growing disconnect between job shortages and lay-offs. As the FT reports, "as industries from trucking to fast food complain of labor shortages, businesses as diverse as Coinbase, Goldman Sachs, Microsoft, Netflix, Robinhood, Shopify, Tesla, Twitter and Walmart have warned of job cuts in recent

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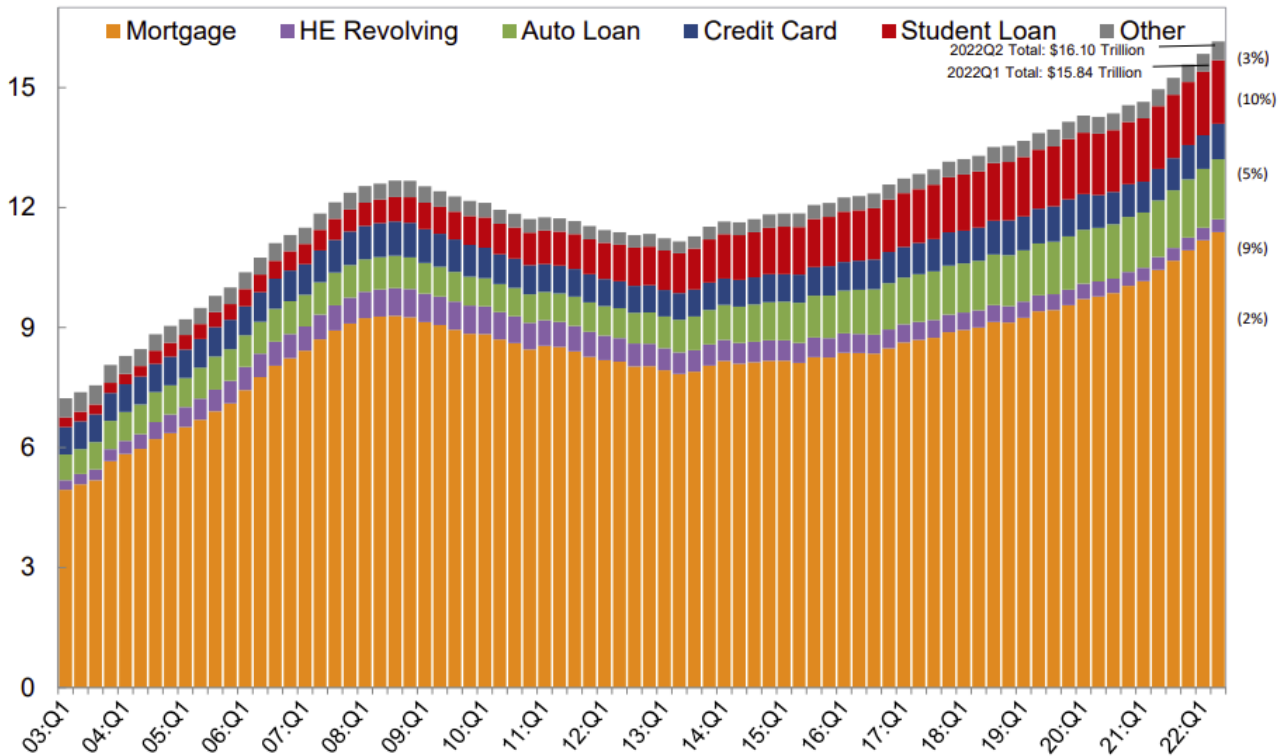
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weeks.” As for the “Great Resignation” phenomenon, it would appear there is a reversal there too. Almost 20 million Americans voluntarily left their jobs in the first five months of 2022, some looking for better offers, some starting their own work-from-home ventures and some just giving themselves a sabbatical using their “covid savings”.

But according to a recent survey by Joblist, an artificial intelligence job-search platform, “more than one-quarter of those who left work are reconsidering whether they made the right move”, while “about half of job-seekers anticipate that the labor market will get worse over the next six months.” Overall, there is a shift underway in the labor market, albeit in its early stages, that can only be exacerbated by more widespread hiring freezes and lay-offs once the Fed’s tightening starts to bite, and once companies really start to feel the end of the cheap credit era.

Another sign of serious trouble ahead can be found in the latest household debt data. According to the New York Federal Reserve, in the second quarter, the figure rose to an all-time high of \$16.15 trillion. Credit card balances soared by \$46 billion in the same period, a 13% increase over the past year and the largest jump in over 20 years. And while overall delinquency rates have so far been rather tame, Fed economists highlighted that they have already been edging higher for subprime borrowers.

Total Debt Balance and its Composition, in Trillions of Dollars



Source: New York Fed Consumer Credit Panel/Equifax

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Inflation has had a deep impact on consumers, from higher prices for the basic staples to energy and housing being at record highs, with the Fed's interest rate hikes only adding to their financial strain. As the debt pile keeps growing, any further hawkish steps from the central bank could easily prove not only practically catastrophic for the average household, but also politically untenable.

The path of least resistance

Since the grand unveiling of the Fed's plans for its "Great Unwinding" back in May, many conservative investors and policy observers have been arguing that it is all simply "too little, too late" and that the bank's quantitative tightening efforts and its rate hikes do not represent a serious attempt to fight inflation. Indeed, as Michael Maharrey, managing editor of Shiffgold, recently put it: "The plan announced in May was for \$30 billion in US Treasuries and \$17.5 billion in mortgage-backed securities to roll off the balance sheet in June, July, and August. That totals \$45 billion per month. In September, the Fed plans to increase the pace to \$95 billion per month. This isn't a particularly aggressive roll-off to begin with. At \$95 billion per month, it would take 7.8 years for the Fed to shrink its balance sheet back to pre-pandemic levels."

Still, even with such "half-measures", the Fed's tightening stance seriously threatened to plunge the economy into a recession. And with the tide now clearly turning, it is even harder to engineer the "soft landing" it was initially aiming for. Thankfully for the central bank, the latest inflation reading might provide a great excuse to give up the fight against climbing prices and to refocus on the second part of its mandate, once again easing its way to full employment. The headline US CPI index for July was unchanged from June, prompting President Biden and members of his administration to tout what they very misleadingly dubbed "July's 0% inflation". Of course, prices are still up 8.5% year-on-year, a number that actually makes sense to quote (even though we've heard from quite a few of our friends in the US that believe the number to be even higher).

Judging from recent statements by Fed Chair Powell on July 27, the central bank could already be preparing for "the U-turn from the U-turn". Seemingly forgetting about the Fed's 2% inflation target and just how far that is from the present reality, Powell said that after the latest rate hike, the central bank had already reached a "neutral" setting to bring price increases under control. To many observers, and certainly to the markets, this sounded a lot like a declaration that the "war on inflation" is basically over. According to this narrative, inflation already peaked in July, so now it's time for the Fed to prioritize the other part of its mandate. And of course, there's considerable pressure to do so. Economics aside, the easing path is much more popular with the markets, with companies looking forward to their next cheap borrowing binge, and with politicians seeking reelection from heavily indebted voters.

Investment implications

Naturally, it is still too early to tell when the policy reversal will take place, but it's an increasingly safe bet that it will happen in the next few quarters. It will also, most likely, have little to do with whether the fight against inflation is won or not. As economic conditions keep deteriorating and as equity markets start losing steam, it will become imperative for the Fed and for other central banks to go back to providing artificial support.

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The problem with this approach, of course, is that consumer price increases will not be contained. Even if they did peak in July, which is highly debatable, the real question is how fast are they going to fall again? The possible answers to this become even scarier once you factor in a potential return to monetary easing and rate cuts. And on top of it all, beyond Fed policy decisions, investors must also consider additional real-world challenges that could contribute to further shortages and price hikes.

Chief amongst those challenges is the fact that there's a war going on. It has already massively amplified a global energy crisis and exacerbated food shortages, so it's safe to assume that any more escalations or a protracted stalemate will only make things worse, especially given that winter is just around the corner and heating costs are already set to explode. Speaking of winter, there's also the Covid threat that has failed to make an appearance in many investment outlooks. We can expect another wave, and perhaps a fresh round of restrictions affecting businesses. But even if that's avoided this time around, there's always China's approach: the "Covid Zero policy", which requires business shutdowns and lock downs wherever and whenever an outbreak is spotted having already resulted in a significant economic slowdown.

Overall, it is clear to us that there are no good scenarios that investors can realistically look forward to. Either inflationary pressures will continue to ravage most advanced economies or the efforts to contain them by central banks will result in a hard landing. Whatever the case might be, it is essential for all rational, responsible investors and ordinary savers to prepare for what lies ahead. Given the set of challenges that we're facing, we see physical precious metals as one of the most indispensable parts of any portfolio. In either scenario, gold and silver are set to shine in the coming months and years, but even beyond performance considerations, in their physical form and stored in a safe and predictable jurisdiction, they are likely to prove vitally important in protecting one's wealth from increasingly desperate governments.

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