INSIDE PERSPECTIVES: AN AGF PODCAST SERIES

Stimulate the Economy First, Ask Questions Later

Speaker Key:

DP David Pett

KM Kevin McCreadie

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Time code	Speaker	Text
00:00:05	DP	Governments and central banks around the world have played a critical role in keeping the global economy on solid footing but where do low interest rates and debt loads leave us once the crisis is over? On this episode of Inside Perspectives, Kevin McCreadie, AGF's CEO and Chief Investment Officer, welcomes David Stonehouse, AGF's Head of North American and Specialty Investments, to discuss the potential impact that today's highly accommodative monetary and fiscal policies will have on the economy and markets going forward. I'm your host, David Pett. Let's get into it.
00:00:41		So, welcome guys. Thanks for doing this. David, this is your first time out. It's good to have you here. I want to get right into things and, for me, one of the most remarkable aspects of the past few months has been the crisis response of governments and central bankers around the world. We've never seen this amount of stimulus before, even during the financial crisis. My question to both of you is has it been worth it?
00:01:01	KM	David, I think you have to go back to what this event was. This was not a crisis created by a bubble bursting or an excess in the system. This was a health crisis which we, as governments around the world, had to take action to basically say we've got to put economies in the world in a coma, send people home. Normally, when you have a scenario where a bubble bursts you create a crisis in the financial system, you start laying people off, they stop buying things and you create a recession, and your way out of that recession is to lower interest rates and make it cheaper for people to borrow money to buy things.

00:01:32		If you think about this case, we actually wanted people to the opposite, go home, don't spend anything, don't go out, make sure we can stop the virus from spreading. And so instead of normally stimulating through making people buy things, you really wanted to stimulate the economy by replacing their incomes that they were going to lose by going home and, really, in that service sector of the economy, so think retail, restaurants, hospitality. And so you really had to replace people's income, not so much for what I call the knowledge workers who rarely go out, that work from home, but those who were in-hand contact, if you will. They had to be taken out and really moved away from their jobs.
00:02:07		If you think about that and the stimulus, a lot of it was really geared at placing and holding on to people's income in a different way and the second part of it was really on the monetary side to some extent but also really on the way of keeping markets functioning, so a lot of liquidity put in, various programmes by the Fed, the ECB, even the Bank of Canada. The combination of fiscal, monetary and what I'd say has been plumbing issues that really have gotten us to this place where we have now, sitting here, staring at a pretty good sizeable amount of debt to get to that place of replacing income and keeping the market going.
00:02:36	DP	And then, David, from your perspective, has the response been absolutely critical in terms of keeping the economy afloat and markets running smoothly?
	DS	Yes, absolutely. I would concur with Kevin's remarks. First of all, it was exogenous. It was not normally induced due to the typical economic cycle. Second, I think the central banks, in particular the Fed, have learned from past episodes where they haven't necessarily been quick to grasp the severity of previous downturns and have been reluctant to act too aggressively.
00:03:06		This time around, they moved extremely quickly because they could see what was happening and maybe, in some respects, ironically, this is almost not a beneficial way to go into recession but a visible one. Everybody could tell what was happening. Quite often, you're not sure if you're going into a recession until well after the fact. It was pretty apparent that this was going to be a very significant downdraft in very short order.
00:03:27		And so the central banks, first and foremost, focused on the liquidity side of things that Kevin alluded to, which was to make sure that the capital markets could function because one thing the central banks are certain of is that if you don't do that, there is feedback loop into the mainstream economy, there's a spillover effect and that would have exacerbated things, made them worse. And then second to Kevin's point, really, it was all about solvency, it's about don't term it stimulus so much as filling the gaping hole caused by the shutdown to enable small businesses and households to bridge the gap and get to the other side of the valley when things get back to normal again.

00:04:03	DP	And as much stimulus as we've already seen, do you expect to see even more over the coming weeks and months?
	KM	We're in July, the end of July now, and we're really looking at the fact that these programmes are expiring. So, you have to look at the economy with the same lens and say, yes, we've started to reopen things. It's been fits and starts. Canada is doing better than the US but the case increases of the virus are causing behaviour to change too, not policy change, perhaps.
00:04:27		Yes, you've seen some states say restaurants have to shut back, bars shutting back but you're also seeing people saying they're not comfortable. That is causing some flattening of this economic recovery and so you are going to need to do more because this is going to be longer. I think if you listened to the testimony of Fed Chairman, Powell, earlier in the month, he was pretty direct about the fact that we are going to be in this for a lot longer, which means rates are going to be here for a lot longer but we also need to do more because we're going to be here longer to get back to any kind of a normalised recovery.
00:04:55		When we get to the fall, we're going to be still in a place where we have to say can schools really open the way we want them? Can workers go back to work in some type of capacity? You've got to keep to the economy moving forward. But we're not there yet, so you're going to see, again, another aid package in the US of some size, probably another one in Canada before it's over and, in Europe, there's a fairly sizeable one that's on the table right now that has to be voted on and it will take time to get through. So, you are going to see a second wave of responses as this does drag out longer to get that momentum on the economic recovery.
00:05:25	DS	I would agree. The key points are what environment allows you to get back to a semblance of normalcy that we were used to last year and there's only two viable outcomes that ultimately get you back to a pretty normal environment. One is herd immunity with respect to the virus, and for that you need the majority of the population to have been exposed to it, and the other is a workable vaccine or more than one that society has confidence in and governments have confidence in.
00:05:54		Knowing that neither one of those two conditions is going to exist, at least for the next while, for the short-term, but knowing that all of the programmes that have been implemented are time-limited, what you're really left with is a need to keep rolling over those programmes until you get to one of those two outcomes.
	DP	But can governments keep spending at this rate? It seems to me that at some point, doesn't it become a problem that needs to be addressed?

	KM	I think the first thing you have to think about, liken this to going to the emergency room and you've had a heart attack or something tragic. You're not going to ask, at that point, how much does that drug cost, the thing that's going to save my life.
00:06:27		And so we're in the place where the cost will be borne later. We do have to be prudently thinking about it but I think you've got to get to the place where you save main street, and saving main street is about saving small businesses and whether they be which can't work from home, whether it be retailers that may have an online presence but you still have to sell through a store. Think about restaurants. If you can only have a third of the capacity until you get to some level of herd immunity, as David said, or that middle ground, not even a vaccine but some kind of drug from getting sick, that would also free up some economic growth meaning people can maybe go to not a third filled in restaurant but half or three-quarters.
00:07:02		And so I think the question of paying for it is a down-the-line question. I think you do know that rates, certainly on the monetary side, if you listen to what's coming out of the US Fed Chairman, there's no question that rates aren't going anywhere for a long time, certainly until the end of '21. And so I think the pace of the economy is going to be dictated on the virus and when you pay for this is going to be a lot longer down the line. No one is thinking about near-term raising taxes to cover this because obviously that will go against trying to get an economy restarted.
00:07:31	DP	And then if we consider the amount of monetary policy or the level of monetary policy today and stack that up against the fiscal policy response today, does one or the other give you some pause or make you a little bit concerned going forward in terms of whether it becomes an issue down the road?
	DS	That answer can change over time. So, there have been a lot of concerns about taking interest rates negative in certain jurisdictions over the course of the past decade but I would say, right now, more of the focus has been on the potential to overreach on the fiscal side.
00:08:04		But again, to Kevin's point, that's a backburner issue right now. That's taken a back seat to the more immediate needs of making sure that you keep the economy functioning because, if you don't, the cost is going to be greater still. I think there's widespread acceptance of the fact that while the extremities of these policies may be disconcerting, they're essential, they're necessary.

00:08:26		So, I think what the last dozen years since the global financial crisis have demonstrated is that this kind of very accommodative policy can go on a lot longer than people think and last longer than people think with fewer concerns about the ramifications of it. So, we're not as worried about very low interest rates being a problem in the current environment for the time being, not as worried about debt service costs because interest rates are so low.
00:08:50		We're not as worried about running up deficits because we've found out that those can be financed easily by some combination of a savings glut in the world, desire to invest even if yields are just modestly positive where in other parts of the world they're negative. The QE financing on the part of the central banks. There's a lot of ammunition to support high fiscal deficits and so it's clearly not a concern for today or even next quarter or next year. It's something that's way down the road and is just not troubling the markets for the time being.
00:09:22	KM	David, if I can add to that, which is I think the monetary side of it is kind of done. Rates are essentially zero around the world. Maybe you can target parts of the yield curve to try to keep rates fixed, so you want a 10-year at a certain number, but the monetary side is pretty much tapped out. Liquidity facilities that many of the central banks put in place are working. Overnight funding is actually working. So, you're going to see some of that start to peel back naturally. What you will see going forward, though, is this idea to keep main street afloat and that's going to a variety of ways to wean people off these packages, supplemental unemployment benefits, CERB in Canada, whatever the fiscal side of it, until you get to this place where you have either a therapy or vaccine or some type of larger herd immunity. So, the shift will be from monetary to fiscal as we move forward.
00:10:03	DS	Yes, and if you look at other jurisdictions of the world and different time periods, the post-Second World War environment and during the Second World War from a fiscal perspective, the Japanese experience of recent years, those examples have proven that this kind of operating environment can go on for a very prolonged period of time, for years.
	DP	And although, as you mentioned, there is precedent for the amount of spending that we've seen and the amount of easing that we've seen in recent weeks, it does feel like attitudes have changed.
00:10:30		It's not that long ago that Europe was in crisis because of high debt loads in countries like Greece and if I remember correctly, politicians in countries like Canada were touting the idea of balanced budget laws just a few years ago.

	DS	Well, I think when you look at what happened, most particularly in Europe coming out of the global financial crisis, the mindset back then was to try to use austerity to get your debt levels back onside and make sure that you had more of a sustainable level of debt.
00:11:02		And, yet, what we found was that wasn't working very well because it was causing another recession, so the more you either raise taxes or reduce spending, in other words practice austerity, the more you were hurting the economy. And once you get to a certain debt level, you're kind of chasing your tail and you're not able to get it out through just belt tightening alone. And so, after a while, there was a realisation that that approach just wasn't going to cut it.
00:11:29		So, I think, given the fact that financing has proven to be a low cost endeavour from an interest expense perspective and we haven't seen the sort the bond vigilantism that reared its head back in the 90s for the likes of Canada and even the US, to some extent, it's been more acceptable to move away from the notion of austerity to handle these economic downdrafts and move towards more government stimulus and deficit spending.
00:11:57	KM	Yes. If you look at it, with rates being here and they're going to be here for a long time, one could argue that not only do you pay for this much later, you can finance your way to pay for it much later at a lower cost too. So, you could see the issuance of very long-term bonds at very low rates. That would minimise some of the pain of the payback, right. But, in some ways, this very controversial view of what is monetary theory comes in play, which is that debt shouldn't bother you until you have to pay for it and you pay for it when the economies are better by raising taxes.
00:12:24		And so I think that it's a problem for tomorrow, much more tomorrow than it is going to be today. But having said that, David is right, the bond market is willing to accept that for now because there's basically a view to avoid deflation and get these economies moving. Were, in fact, you were to see some hints of inflation in the near term, probably okay, but with this amount of stimulus out there and were you to get a vaccine which would get people back to work, spending and all this pent up demand, pretty quickly you could see a quick bout of inflation.
00:12:54		And so I think those are the things to watch down the line but in the near-term I think you could sustain this spend, maybe not the current pacing of it, but I don't think it's a problem today, it's a problem for tomorrow.
	DS	That, I think, is the key monetary policy risk down the road, is inflation. Normally, what would happen here with stimulative rates is that you would see a great deal of credit expansion and a lot of money velocity, in other words a great deal of borrowing and lending going on, and that should result in a pretty substantial ratcheting up of inflation.

00:13:22		However, with debt loads being so high and now the current situation where we've got so much of the economy temporarily impaired, you're just not seeing, and you haven't over the past dozen years, that kind of traditional, historical response to extraordinarily low interest rates. And the other challenge this presents is that you're getting less productivity out of the economy because you're keeping afloat more organisations that may not have survived in a more normal interest rate environment that are not generating decent levels of profitability.
00:13:54		And that term zombie company comes to light here in that if you've got too much of the economy functioning sub-optimally, it's not beneficial. There are certainly challenges down the road associated with these policies but, as Kevin mentioned, they're really years off before they get addressed.
	KM	Yes. Let me touch on what happens in the path of this, maybe, just a view of what could happen. If you think about, as David said, the excess capacity of the zombie company who has a big debt burden, they need cash flow and to create cash flow they'll sell something at any price to be able to pay their debts, and so prices get cut.
00:14:29		So, think about all the excess office space, potentially, in a major downtown city. To get the next tenant to rent you get into a price war. And you could do this for a lot of industries right now. You can look at retailers that are stuck with all the spring and summer wardrobe. They need cash flow to buy their winter inventory. They're going to have to discount that. And so, in the near-term, it's a deflationary bout that we're trying to fight but in the long-term what happens is basically you get these economies moving again. Central banks are going to be little leery to start to raise rates right away.
00:14:57		And, if anything, because they have to finance this, they may want, basically, to keep rates low for a lot longer. And so that's where the transition becomes near-term deflationary, longer-term the fear of inflation, and you're seeing it with the move in gold is clearly related to people fearing that this stimulus turns into some larger inflation problem down the road and you've pushed gold to all-time highs on the back of that fear.
	DP	And so let's say down the road when this does become a bit more a concern and we swing back towards greater fiscal responsibility, how do governments deal with the debt loads that they already have?

00:15:29	DS	The typical options to deal with high debt loads, and this goes for governments as well as for individuals, although governments have the benefit of a currency and a printing press in the form of the central bank, you really have three major ways to deal with very high debt loads. One is austerity, which we talked about already and once the debt becomes too high, as mentioned, you can't service it effectively through austerity because then you tip yourself into recession and then you're not collecting the taxes and your output is going down, and therefore you're not generating the cash flow to service the debt, so it's a bit of a death spiral.
00:16:05		The optimal way to deal with things is inflation, and that's what Kevin was alluding to and that's, frankly, what's been tried for the last decade in terms of stimulative low policy rates and, yet, because you haven't had that transmission mechanism that I was talking about before with credit expansion and the willingness on the parts of the individuals and corporations to borrow for productive uses for spending in the economy, you just haven't been able to generate that much in the way of inflation so far.
00:16:33		And the third option is the least palatable one and that's default and that's something that governments obviously want to avoid at all cost. So, I do think inflation is eventually going to come but it's very difficult for it to come when debt levels are so high because you don't get a willingness to borrow substantially more on the part of corporations and consumers when those debt levels are that high. But that's ultimately where you would think that goes. It's an extension of the modern monetary theory that Kevin alluded to earlier.
00:17:03		What could well happen, ultimately, is that we just keep borrowing and stimulating to the point where all of the capacity of the economy is used up and normally what would put the brakes on is a raise in taxes or some sort of raise in interest rates to slow down economic activity. But this will be in the hands of the politicians and that's where the real Pandora's box lies because if you can get the instant gratification of boosting things in the near-term and not worrying about the long-term consequences.
00:17:33		That's where, ultimately, you could see this tip over into a substantially more inflationary environment down the road but I think for that to happen that debt load has to go down. And those three alternatives we talked about, it's difficult to see them working right now.
	DP	So, if the options that you've mentioned may not be the most effective, are there other alternatives that we may have to consider going forward?

00:17:54	DS	I think what it's likely to lead to is that the central banks just take on more and more of the debt of the economy and, to avoid problems with defaults, they're basically bailing out consumers, corporations. We've started to see helicopter money and we've seen these PPP programmes, CERB in Canada and even in other jurisdictions like Hong Kong where that helicopter money is being deployed, bailouts of industries. The beauty of those is that they don't require the creditor to take a big hit, to take a big haircut, and I think that that's where you ultimately start to see inflation rear its ugly head because you're essentially dealing with the debt by taking it on the central bank's balance sheet down the road.
00:18:33	KM	Well, we've transitioned basically from the consumer being overburdened with debt, to governments, so these are going to be longer-term problems. I will tell you, though, there are nearer-term problems. If, in fact, economic growth picks up much quicker than the market anticipates, you could see a pretty quick back-up in rates and at these low levels you pretty much, as interest rates rise, those bond prices drop, right. You could wipe out the coupon pretty quick and can leave bond investors with a pretty nasty sting.
00:18:59		So, I'd say that's the near-term thing to worry about, less so the inflation and long-term impact of how we pay for it right away, is watch the pace of the economy and given where we're starting from on rates, if things get better quicker, you could be in for a little bit of pain trade there for bond investors. Similarly, if things get a lot worse, we have a second wave, you could see longer-term bonds start to approach zero. We don't believe they're going to go negative in North America but you could see a bit more to go in terms of lower rates.
00:19:26	DS	To that point, if you see rates rise 1% that's a 9% principal decline right now on a 10-year bond and then you get your coupon back over a year, so you get a little back, not very much. I do think there's a self-limiting aspect to this because if you take interest rates up 3% or 4%, that debt burden is unsustainable, which is an extension of what we've been talking about for the last while here. What that means is recession, and what recession means in interest rates going lower.
00:19:52		So, I do believe that you can see cyclical rebounds which we've seen three times in the past dozen years since the crisis, where interest rates rise 1% or 2%, but I think that there is a ceiling there where the debt burden, the service costs become overwhelming and tip you into recession and drive down interest rates again. To see this really take off in a new regime, a brand new direction which we haven't seen for several decades, you've got to get past that very high level of debt dragging down the economy as soon as interest expenses become unsustainable and for that debt, one way or another, it has to be taken down.

00:20:30	DP	Wow, there's just so much to consider on this topic but unfortunately we're out of time, guys. Thanks for being with us again, David and Kevin, until next time. For a full transcript of today's episode, visit AGF.com/podcast and don't forget to subscribe to hear more from us at Apple Podcasts, Spotify, Google Play Music, Stitcher, Podcast Addict and Pocket Casts.
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