

BY RICHARD "JERRY" HAWORTH

Governmental parenting 101

Central banks are definitely the bad, strict parent as their monetary tightening should have chastised the economy and all borrower/economy "children" and brought them into line.

Financial experts and prognosticators all agree that this is inevitable.

However, the children are still misbehaving in that they are ignoring the chastisement and still running around like sugar-higher dervishes.

How is this possible that this behavior has been gone on much longer than we would expect?

The answer must lie with the other parent. . . . the good, kind, generous parent. . . Government at large, who, via fiscal spending is keeping the children's party supplied with candy.

The Budget. *CBO projects a federal budget deficit of \$1.4 trillion for 2023. (Deficits and spending have been adjusted to exclude the effects of shifts that occur in the timing of certain payments when October 1 falls on a weekend.) In the agency's projections, deficits generally increase over the coming years; the shortfall in 2033 is \$2.7 trillion.*

This amount of stimulus is unprecedented given the seemingly robust state of the economy and the brutal reality that it is in direct contrast and opposition to the goals of monetary policy which is to cool the said economy to aid the fight against inflation.

And the USA is not alone, this seeming conflicting policy is in evidence all around the world except in China who is tackling a property bubble in earnest by expansive fiscal AND easy monetary policies.

Not exactly a playbook to fight inflation.

Against this backdrop the stubborn and persistent rise in both bond yields and equity prices makes a modicum of sense.

Two distinct pathways emerge. . . .

Bad parent (central banks) can win the day, the children become subdued and a calm descends.

The economy will cool, equity and bond yields will descend from their lofty highs.

If the bad parent does *too* good a job, the good parent (government) will step again to rally the children and encourage them via freshly minted candy to get hyperactive again.

This will put a higher floor on inflation which will emerge again with a vengeance.

The other pathway is where the children ignore bad parent and party on regardless.

In this scenario inflation will remain stubbornly high as will interest rates. Inflation might even start to accelerate again.

If bad parent puts their foot down i.e., raises interest rates again Volker style ("All you children in bed now!"), the party/economy will deflate faster than a minor cryptocurrency. The fallout to the world economy will be exaggerated.

I often quip that taking one step down every day for 30 days is preferable to procrastinating for 29 days and then having to leap from a great height.

If bad parent does nothing, I expect the party to accelerate in scope, length and general bad behavior. Inflation will most likely accelerate to double digits.

I fundamentally do not believe that government will reduce fiscal spending to combat inflation but generally do the opposite e.g., the inaptly named Inflation Reduction Act. Seemingly the more you spend, the lower inflation will be??

The only way historically that government fiscal spending has been curtailed is via higher and higher bond yields (crimping good parents' ability to buy candy) or by currency depreciation (imported candy gets more and more expensive).

We the children lose irrespective. . . . we end up severely chastised and grounded with good parent severely curtailed in their ability to hand out candy.

Broccoli for supper kids . . .

Disclosure

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ⁱ <https://www.cbo.gov/publication/58946>