Free Range Money & the Taxpayers Yachts: Global Broad Money Growth Reaches a 32 Year High (06/08/20)

People disagreeing on all just about everything, yeah
Makes you stop and all wonder why
Why only yesterday I saw somebody on the street
Who just couldn’t help but cry
Oh, this ol’ river keeps on rollin’, though
No matter what gets in the way and which way the wind does blow
And as long as it does I’ll just sit here
And watch the river flow

Watching The River Flow, Bob Dylan, 1971

This will not be the first time that *The Solid Ground* has raised the issue of the difference between flows and stocks. In the world of the agent there is a focus on flows, the main determinants of revenue and commission, with little concern for the impact on stocks. For over two decades this perverse incentive has lead agents to gear up the global financial system to the ultimate detriment of the principals they represent who own the stocks. So it is with some reluctance that I would now like to speak up on behalf of the flow. Money, newly created and launched into the world, is highly unlikely to remain frozen as a stock and is much more likely to flow. If you believe instead that it can be so permanently frozen, then you can believe that the current boom in broad money growth cannot be inflationary. If, however, you believe that money, like water, will ultimately flow then the deluge of newly created money should have you considering that this ol’ river might keep rolling though. With 16% more money in the world than there was this time last year that’s a flow likely to get somebody wet. It’s a flow likely to boost nominal GDP growth and with it, *The Solid Ground* argues, key constituents of that bucket of equities we call value stocks.

According to the OECD Total M3 statistic there was 16% more money in the world at the end of May 2020 than there was in May last year. This is the highest growth of total broad money recorded since 1988. Based on individual country monthly data the growth in the supply of the world’s money accelerated further in June. The last time broad money growth was this high OECD total inflation was 10%. This time of course is different. Well, it’s different according to the price of Index Linked Bonds (ILBs) where breakeven inflation rates indicate that there will be record low inflation over the next five years, the lowest at least since the nineteen thirties. Japan will see average price declines of 0.26% over the next five years and Italy will see annual inflation of just 0.36% over the next four years. In those developed world countries, where ILBs exist, only in the UK are breakeven inflation rates on five year ILBs above 1.5% per annum. Total OECD inflation was above 1.5% as recently as December 2019 when M3 growth was just 5.3%.

Can we have global broad money growth at a thirty-two year high and expect record low post-WWII inflation? Inflation expectations may have risen since March but they have risen only marginally despite the surge in broad money growth. In the opinion of this analyst the even more important change in 2020, than accelerating board money growth, is that most of this surge in new money has been created by government action, in the form of government credit guarantees, rather than central bank action. While central bankers might have the incentive to one day slow the creation of money, history suggests that governments find ending such largesse significantly more difficult. It is because of the difference in incentives for money creation in the hands of government that politicians voluntarily relinquished control of the supply of money to independent central bankers from the late nineteen seventies onwards. Now they have seized it back and the markets are reacting as if the recent surge in broad money growth is a temporary phenomenon based upon emergency measures that will be halted or even reversed. Your analyst has no such faith in democratically elected governments to pull the rug from under any reflation by relinquishing their newly discovered power to push money to those who vote for them.
This is not just about the fact the OECD total broad money growth has reached a thirty-two year high, it is about who has created that money and how unlikely they are to stop. Based upon feedback on recent Solid Ground research, this has clearly been a silent revolution in money creation. The monetary fireworks of the central bankers have distracted investors from the fact that these same central bankers have seen their main power, the power to control the supply of money, usurped. Few if any investors can foresee this move to money creation by government being the new normal. Their opinions are reflected in the break-even inflation rates priced into ILBs. The more sustainable these high levels of broad money growth prove, the less these policies will be seen as temporary, and the more inflation expectations will have to reset higher. Data for June clearly show a continued acceleration in broad money growth and as yet limited reactions in ILB prices. Time marches on.

While broad money growth continues to accelerate globally, there are three countries where the current high levels of growth particularly catch the eye. The growth in US M2 in June has moved slightly higher, to 23% year on year, which remains the highest level ever recorded in the US in peace-time. In Canada broad money growth has jumped to 16% year on year, the highest level recorded since 1980. In Japan the June growth rate of broad money of 5.9% is the highest rate recorded since 1991. Thus in three of the world’s largest economies broad money growth has reached levels not seen for thirty years or more. The Solid Ground believes this is important not just because of the level of growth now being reported, but because in many countries further acceleration in broad money growth is now likely. More government support for small businesses and households is on its way and with it more money creation.

While the data for the US, Canada and Japan stand out as very high by historical standards, it is the pace of acceleration across the world’s largest economies that is potentially as important. Over the period from December 2019 to June 2020 the growth in broad money has almost doubled or more in the US, Japan, Canada, the Eurozone, Australia, the UK, Mexico and Brazil. The Solid Ground expects more government intervention to spur bank lending growth, primarily through the creation of bank credit guarantee schemes, and that the growth in broad money will continue to accelerate. Crucially, this form of money has a very different impact on the economy than the form of money created in the decade of QE we lived through post-GFC. While the QE money was couped up in the battery farm of Wall Street this commercial bank created stuff is the free range money that will roam haphazardly but with considerable elan through Main Street.

The freshly created money provided by commercial banks is flowing to corporations and onwards to their employees. In particular it is flowing to the small companies, with no access to the credit markets, that need this money to simply stay alive. They stay alive by letting that money flow and not by freezing it. Whatever costs need to be covered while revenues are depressed or even non-existent are paid using the freshly created money. While one day it is expected that it will be paid back, this day is many years in the future - six years in the case of the large UK bounce back loan programme. Maybe in six years this incredibly cheap funding will be repaid; your analyst expects it is more likely that it is rolled over, but for six years this is newly created money that can bounce around the real economy unlike QE.

The various QE programmes rolled out around the world involved the exchange of newly created central bank money, known as commercial bank reserves. Savings institutions were the main recipients of that QE money received in exchange for government bonds, corporate bonds and in some cases equities. The liquidity this created in those savings institutions could by law only be used for one thing - the purchase of more savings assets. This liquidity could not and did not flow to the private sector to cover their ongoing costs but instead had to ricochet around the asset markets as savings institutions sought to reduce their liquidity. It was a form of money that was frozen - at least frozen into the asset markets and not flowing through the goods and services economy. As the QE money could not directly flow to those legally able and willing to spend money rather than save it, the impact on economic activity was very limited though it had an explosive impact on asset prices. Its impact, for it continues, is thus entirely different from the money creation that is now pouring money into the hands of corporations and households who have to spend money to survive. Money in their hands is highly unlikely to be frozen more than temporarily.
As part of a monetary policy that held down the discount rate and boosted the liquidity of savings institutions, QE led to an explosion in equity valuations for those companies exhibiting high levels of growth independent from the lackluster growth of nominal GDP. As this form of liquidity did little to boost nominal GDP growth, the valuation of many equities, reliant more on general economic growth to boost their revenues and profits, languished. One set of equities, growth stocks, saw the net present value of their rapidly growing future cash flows bid up by the newly created QE liquidity while another set, value stocks, gained little from the lower discount rate and excess liquidity as nominal GDP growth languished and with it their earnings. To be sure there were also clear cases where some value stocks became increasingly structurally redundant as new technology left then pursuing obsolete business models. Many of the stocks in the value bucket also found themselves with too much debt and struggled to cope in a new era of low nominal GDP growth and low revenue growth. As The Solid Ground long forecast, QE combined with low interest rates resulted in debt rising much more quickly than nominal GDP with a result that a further debt deflation followed. That adjustment, now upon us, has further penalized the value stocks that rely upon accelerating nominal GDP to boost revenues, create profits and also service debt. Now, finally, there has been a shift in monetary policy and it is the contention of The Solid Ground that this shift is positive for many of the stocks, probably most, in the value bucket. Positive that is if the money newly created flows rather than freezes.

In the opening months of the Covid-19 induced monetary revolution the outperformance of growth stocks has accelerated. It is not difficult to see why as central bank balance sheets have ballooned yet again and even more QE has been administered despite clear evidence of its failure to create higher nominal GDP growth over the past decade. There are probably few central bankers who can believe it’s a form of money that materially impacts demand for goods and services but its clearly a form of money that can be used to rig desired prices in credit markets and beyond. As The Solid Ground long argued, it was a policy that would create ever more debt, as interest rates stayed low and savings institutions looked around to find more assets to replace the credit assets they had sold to the central banks. That process is underway again today. However, as discussed above, something else is also underway that did not happen during the past decade of QE - a rapid acceleration in broad money growth. While the impacts from more QE, flushing savings institutions with funds they need to invest, are almost instantaneous in pushing the price of growth stocks higher, the impact from the boom in broad money on nominal economic activity, inflation and interest rates will be delayed. Your analyst is only too aware of the delay given the recent discussions with investors and their reluctance to accept that the surge in broad money growth will feed through to much higher nominal GDP growth. In that delay is the opportunity for investors to shift their portfolios towards the stocks within the value universe that will be the key beneficiaries of the higher nominal GDP growth that will result from the boom in broad money.

According to the IMF the world economy grew in nominal terms at just 1.9% last year compared to an average of 4.9% so far this millennia. In 2020 we have probably experienced the largest nominal GDP contraction at least since the 1930s . The slowing flow of nominal GDP and then its evaporation in 1Q 2020 has produced dreadful impacts on value stocks. What if the change in monetary policy now means that nominal GDP growth can go to levels well above those experienced in the past twenty years? With OECD total broad money growing at 16% per annum perhaps nominal GDP growth will not reach 16% as the rate at which money circulates in the economy has clearly slowed and the savings rate has clearly risen. However, as the threat from COVID-19 passes, perhaps not until next year, the savings rate will decline and the circulation of money will rise. Already in the confused partially open and partially closed United States the savings rate has declined from 33.5% in April to 19.0% in June. It might well rise again before it falls but it will fall and if it returns to levels even somewhat above the 7.2% level it reached in December 2019, it might do so as the total amount of US dollars in circulation has increased by over 30% from the end of 2019 to the middle of 2021! If the key determinant destroying returns from value stocks has been ever lower nominal GDP growth, then the deluge of money pumped into the global economy augurs better times ahead.

The new money created through government bank credit guarantees is in the hands of people and corporations who will spend it on the goods and services that impact nominal GDP. It is just a matter of working out when they will spend it. There are signs that those with quite a lot of it are not waiting for the full end to lockdown to pass their money on in return for goods and services. In the UK Car Dealer
Magazine reports that small company directors are utilizing their government guaranteed bounce back loans to fund deposits on supercars:

Tom Hartley, director of Tom Hartley Cars, told Car Dealer Magazine that there’s a definite trend in small company owners splashing out and has heard similar stories from across the motor trade.

Saba Amari, of Amari Supercars said they had seen an increasing number of company directors using the Bounce Back Loans to fund new supercar purchases.

‘We absolutely have had customers who say they are using the Bounce Back Loan money to boost their deposits for supercar purchases but we have always advised them responsibly and suggested this is not the right thing to do with a government-backed loan,’ she told Car Dealer Magazine.

In the US demand for boats is booming as the New York Times reports:

The run on boats is happening across the country. Chuck Cashman, the chief revenue officer of the boat dealership MarineMax, which has 64 locations in 23 states, says sales are up in every single category. Nearly three quarters of queries online are from first-time boat buyers, an unusually high number, he said. The company prides itself in its inventory, but Mr. Cashman said some customers are buying “like you would a car, where you take what’s there at the time because it’s close enough. In this social isolation, there’s so few things you can do that are exciting, and boating is one of them.”

Kelly’s Port, a boat dealership in Osage Beach, Mo., is down to less than five percent of its usual inventory. The 44-year-old company, whose average sale is $100,000, has since broken every record “dude, by the hour or by the day or the weekend or any way you want to count it, from sales to gas to service to stowage,” said Ryan Kelly, a partner.

“We know there are a lot of people hurting right now,” Mr. Kelly said. “But speaking on dollars and cents, we’ve never ever, ever seen boat sales like this.”

Money has suddenly been found for this big-ticket item in the middle of the worst recession since the war. Could the flow of funds through the Small Business Administration be providing part of the funding for such purchases? Only time will tell but if it isn’t we will soon have The Main Street Lending Programme to provide further financial support for small business owners. The least likely thing for this funding to do is to freeze on the balance sheet. If Fred Schwed Jr. were around today he might have call to enquire - ‘Where are the taxpayers yachts’?

There is other evidence that money in the hands of small businesses and households is unlikely to stay long at rest. Bloomberg reports some remarkable rises in house prices in the new so-called ‘Zoom Towns’. With knowledge workers now enfranchised to work remotely, many are making lifestyle choices to live in smaller towns with their bosses finally prepared to endorse the move. Their savings, mounting up in recent low consumption months, are now once again beginning to flow- just to places you probably never heard of before.

Of course, for every example of money flowing in one sector of the economy we can point to somewhere where it has ceased to flow. However, for this analyst flow is an accurate description of what money in the hands of small businesses and households does. Like a liquid money in such hands almost always finds ways of diverting its direction if impeded. It continues to flow and the more of it that is created, the more it will positively impact economic activity even if savings rates finally settle at somewhat higher rates than they were last December. As anyone who has ever had a leak in their building will know water is going somewhere but you don’t always know where. Today it is supercars and boats and who knows where it will appear tomorrow but it will flow somewhere. If savings are frozen desire, then debt is instant gratification. Government backed debt is currently available to just about any small business that wants it and its cheap long dated funding that brings instant gratification for some. The Solid Ground strongly believes that government money so provided will manifest itself as a flow, sometimes driven by instant gratification, often just by the need to cover costs and survive, but little is likely to remain as frozen
desire. With money finally finding its way into the hands of those who chose to spend, it investors need to prepare now for much higher rates of nominal GDP growth going forward. The more evidence amasses that the river still flows, the more you will one day be forced to do something about the deluge. Today the advice of The Solid Ground is to prepare for higher inflation and don't 'just sit here, and watch the river flow.'
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