INTERVIEW

Distinguishing Deflation

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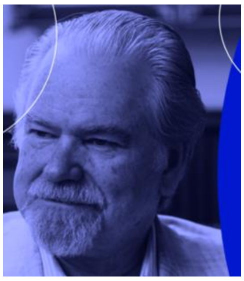

Rob Arnott

Founder and Chairman, Research Affiliates

Interviewed by

Jamie McDonald, ex-portfolio manager, Point 72

Jamie: Rob, it's great to have you back talking with us again. It's always such a pleasure. Thank you so much.

Rob: Well, thank you. It's a privilege.

Jamie: Now, Rob, as we sit here, the market is facing quite a few macro headwinds and I'd love to talk them through with you. Why don't we start with the Fed? 'Because they seem to be front and centre of most macroeconomic debates. Do you feel we're at a point where they're pausing? Do you think they are going to be easing? And how do you feel about the general interest rate environment right now?

Rob: You know, I think the whole focus on Fed policy is misguided. Whatever they do; continue tightening, pause, skip, and continue, reverse course, it has an effect over such a long period of time that it is almost an irrelevant conversation. What makes it even more problematical is, have you noticed how well these folks can forecast inflation, GDP, unemployment? Their forecasts are worse, less useful than an extrapolation of recent trends. It's worse than a coin toss. Now they have 400 PhD economists. Harvard and MIT, between the two of them, have 100. So, with four times as many PhD economists as Harvard and MIT put together, they can't forecast a damn thing. Now, if they can't forecast anything, why on earth do we think they have a clue about how to manage anything? I view the current situation with soaring interest rates with the worst bond market in history last year as entirely the Fed's doing. And we're looking to the Fed to fix what they broke. So, I think there's a lot of deep structural error. It comes back to inflation itself. Inflation. Jay Powell declared that inflation was transitory in March of 2021. It was already 4%, half of which had happened in three months. 8% annualised for three months. So, it was 4% and accelerating. And he says this is transitory. He retired the term transitory that November. So, it had a nice eight-month lifespan. Now, roll the clock forward eight months from then, mid-year of 2022. Think back to mid-2022. The inflation was peaking at 9.1. What do you think the Fed funds rate was? Make a guess.

Jamie: 3%?

Rob: 1.2

Jamie: Was it really that low?

Rob: They were 800 basis points behind the curve. And we expect these people to fix the mess that they're making. Australia's been called the lucky country because it went for 30 years without a recession. What did they do? Well, the long rate is set by the market. The long rate is the market's assessment of what the cost of capital should be for debt that is free of any default risk. You can think of interest rates as the reward for deferring consumption. Now, if you think of it as the reward for deferring consumption, it has to be above expected inflation. It has to be positive in real terms, otherwise, you're not rewarding deferred consumption. You're rewarding acceleration of consumption, which in a neo-Keynesian world is seen as a good thing, but it's not. It means there's no investment for the future.

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Should the cost, the reward for deferring consumption be greater for 30 days than for 30 years? Obviously not. So an inverted yield curve is a perversion of the purpose of interest rates. And so, what we've had is negative real interest rates, then inversion. Deeply flawed policies. Put this on top of blowout deficit spending globally that's beyond anything seen before in history. We've tried two heroic and horrific experiments. One being negative interest rates, negative real interest rates for a sustained period, and negative nominal rates in many parts of the world. And this yield curve inversion is in a context of blowout spending. So, think about that lucky country. What did Australia do for 25 of those 30 years without a recession? They had short rates, almost always a notch below long rates. It's almost as if their routine meeting was to say, "What's the long bond yielding? Okay, should we nudge this up or down to stay just under it?"

Rob: Now in 1973, a US colonel in Vietnam, who was famously quoted as saying, "We had to destroy the village in order to save it." In war, that's a bad idea. In government policy relating to the economy, that's a bad idea. Why should you have to destroy the economy to save it from inflation? Now inflation is just a matter of supply and demand. If demand is elevated and supply is suppressed, you're going to have inflation. It's that simple. So, if you have supply depressed because of supply chain disruptions, because of people pretending to work from home, but not necessarily, because of people paid to not work, then the supply of goods and services is diminished. If you have airdrops of money into people's bank accounts, you have elevated demand. So of course, you're going to get inflation. Are we dealing with any of these? Yes, in modest ways. The airdrops of money are diminishing. The supply chain disruptions are fixing slowly but surely, but the problems are still there.

Jamie: Let me ask you about that specifically. Which one of the levers controlling inflation right now do you think is the most important? As you say, we've had this unprecedented stimulus packages for not just the past few years, but for several years. You know, we have supply tensions still going on. I know the US is currently in intense discussions with China and then there is this huge deflationary pressure of technology. I'm interested on your views about which of these thematics or which of these headwinds or tailwinds do you think will come out on top?

Rob: I was talking with a central banker, a senior central banker. It was in a session where direct quotes are not allowed, or at least attributed quotes are not allowed. But anyway, I was saying, "It's clear to me that central bankers over the world are allergic to deflation. Is any distinction made between the types of deflation? Deflation can be a crashing economy. Deflation can be technological innovation revolutionising some industry and leading to a surge in productivity, and hence economic activity." And to my astonishment, he said, "It doesn't matter. Deflation is deflation." Now, it seems to me the argument is often sticky wages. You get deflation, you can't reduce salaries. Well, what if you don't have to reduce salaries because its productivity surge? What if you have productivity suddenly grow 5% a year, some humungous number? And so, you have 3% deflation and 2% wage inflation. What's wrong with that? There's absolutely nothing wrong with that. So, we do have issues with misunderstanding of the role of interest rates, the role of money, and the nature of the macro economy. All of this goes hand in hand with a global takeover of Central Bank policy by neo-Keynesians. They'll argue that we have a host of different views represented and argued tremendously. A little like arguing over where to place deck chairs on a Titanic. If you have only one set of views ranging from neo-Keynesian to hardcore MMT to Marxist or whatever, that whole spectrum, you can argue that there's a spectrum. But Keynes himself would be excommunicated from the neo-Keynesian community. He would have the view that you are welcome to use deficit spending to stimulate your way out of a recession, and then to use the subsequent economic expansion to replenish your coffers for the next round. That idea has been out the window on a bipartisan basis, and on a global basis for the last dozen years or more.

Jamie: I was listening to Stan Druckenmiller talk recently, and he was saying that he feels like monetary policy makers are sitting on the Santa Monica pier and there's a 10-foot wave coming their way, and that's what they're focused on. But there's a 200-foot wave about a mile behind it they should be focusing on. And that's really that the deficit in the US is around 7% of GDP now, which is huge. I mean, France is like two to 3%. And by his calculations, in order to reduce that deficit gap, you would need to either raise taxes by 40% into perpetuity or cut spending by 35% into perpetuity. I mean, these are really big moves.

Rob: Huge numbers.

Jamie: In order to, and my question is, has the US been able to get away with this huge amount of spending because it's the reserve currency? Because like in the UK where I'm from, if they tried to get away with this, spending to stimulate, typically the home currency gets hit hard as Sterling did. But does America just have this get out of jail free card?

Rob: To some extent, that's true. Reserve currency status is, what was it termed? An exorbitant privilege or an extravagant privilege. Our reserve currency status is not at immediate risk, although we're sure sowing a lot of seeds for potential eventual demise. The UK, the pound was the reserve currency for well over 150 years. And the US has been reserve currency since the 1920s, more or less. Now, are we putting that at risk? Yes, we are. But Larry Summers put it very succinctly. He said, what are you going to replace it with? Japan's a nursing home, Europe is a museum, and China's a jail. Well, his comment was an exaggeration on all three counts. It makes the point in a very vivid way. The definition of reserve currency is very simple. It's what currency do people like to transact in? And if most transactions have the dollar on one side of the trade, then it's by definition the reserve currency. Right now, I think the last number I saw was 60 to 70% with the euro, and the yen far behind the euro. I think that was in the 20's to 30's, and pound and yen in the 10's to 20's. So, it's not at risk, but the policies we're pursuing do have the risk of debasing the currency even as a reserve currency. Reserve currency status does not mean that the purchasing power of the dollar can't tumble anyway. It just means that it is a preferred vehicle for transactions.

Jamie: Well, such an important thing to discuss. Rob, it's been so fantastic chatting to you. Thank you so much for your time. It's always such a great conversation**.**

Rob: Well, I have thoroughly enjoyed this nearly two-decade long partnership, and I look forward to many years to come.

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