GUGGENHEIM

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Global CIO Outlook
Forget Raising Rates, Shrink the Balance Sheet

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For all the hoopla about the Federal Reserve (Fed) raising short-term rates, policymakers may be missing the best opportunity since the Great Financial Crisis to "normalize" monetary policy.

In the wake of the housing bubble collapse, the Fed had little choice but to flood the financial system with cash, which resulted in short-term rates plunging to zero. Appropriately, central banks around the world followed Economist Editor Walter Bagehot's famous dictum in his 1873 book Lombard Street that in times of crisis they should undertake to lend liberally. In other words, the Fed left no room for doubt that it would provide sufficient credit to avoid systemic financial collapse, which it had failed to do in the late 1920s and early 1930s in the wake of the 1929 stock market crash.

The surfeit of liquidity provided by the Fed through numerous financing schemes and quantitative easing (QE) ultimately stabilized the financial system and supported a slow recovery until the COVID Pandemic of 2020.

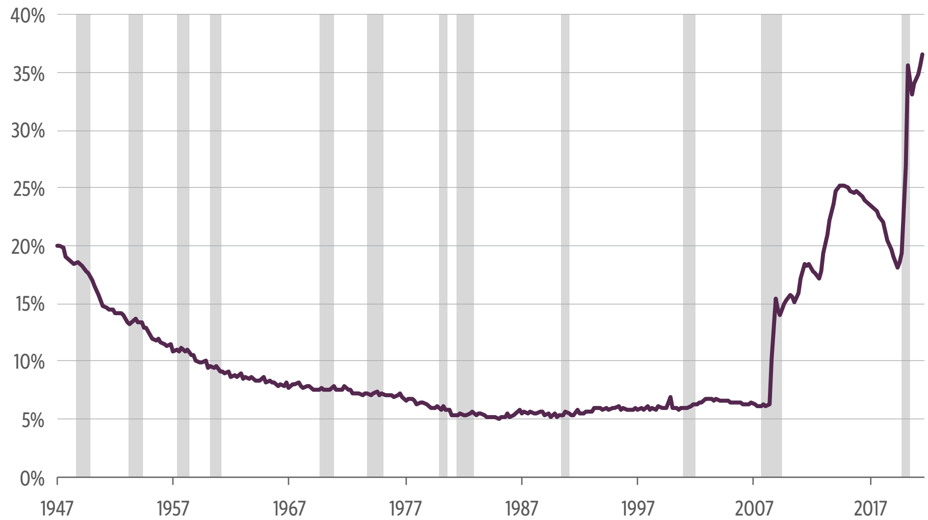
Before the pandemic, financial assets appreciated to new highs as risk premia collapsed to levels that made investments in stocks and bonds vulnerable to virtually any exogenous shock. It was clear then that such a shock was virtually inevitable and would necessitate another round of monetary accommodation far in excess of the level in the wake of the housing crisis.

During the interlude between 2009 and 2020, policymakers became increasingly focused on subdued inflation, which struggled to stay near the prescribed target of 2 percent even late in the cycle, a period that was perceived to constitute full employment. Despite missing the desired target by only three tenths of 1 percent, after considerable deliberation the Fed altered its policy framework to define the 2 percent target as an average which would allow for a period of overshoot after periods of undershooting. This new policy strategy also gave the central bank more flexibility to attempt to address other issues beyond their mandate, including income inequality and climate change.

When the COVID crisis hit in March 2020, risk asset prices plunged from their February highs at the fastest pace in history. The Fed pulled out all the stops to avoid a wholesale collapse by reducing rates to zero, arranging for the purchase of corporate debt using central bank financing and expanding its balance sheet to record highs through large scale asset purchases.

Fed Balance Sheet Spiked in an Effort to Contain COVID's Impact

Federal Reserve Assets, % of GDP

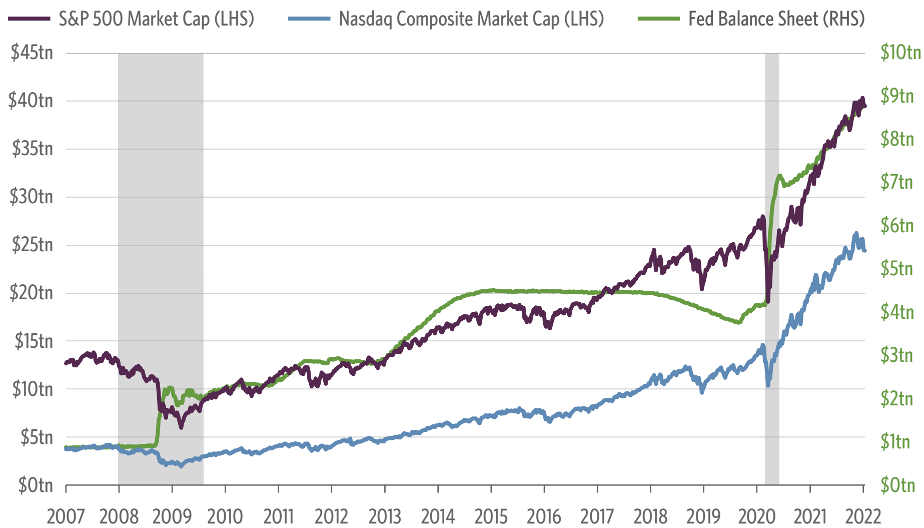


Source: Guggenheim Investments, Haver Analytics. Data as of 9.30.2021.

As liquidity overwhelmed the markets, both stocks and bonds took off in a rally of historic proportions. The S&P 500 index rose from 2386.13 on March 16, 2020 to 4766.18 on Dec. 31, 2021, a 99.8 percent increase in less two years. Even more dramatic, the tech-heavy Nasdaq Composite Index appreciated 126.6 percent during the same time while crypto currencies such as Bitcoin increased over 844 percent and some of its farcical progeny increased even more.

Clearly the markets have become a speculator's paradise. Meme stocks, CCC bonds, art, houses, almost anything that can be named has skyrocketed. And if there were not enough opportunities for speculation, new avenues like non-fungible tokens and virtual real estate are available for those who have the courage to invest.

Financial Markets Soared with Fed Balance Sheet Expansion

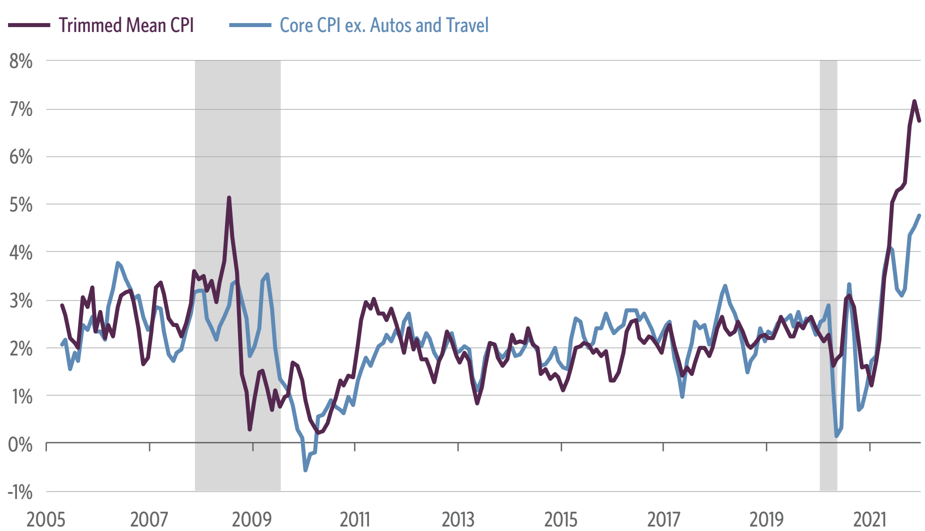


Source: Guggenheim Investments, Bloomberg. Data as of 01/12/2022. Shaded areas represent periods of recession.

Meanwhile, the Fed has discovered that its more liberal inflation policy has succeeded all too well, with CPI inflation at 7 percent for the first time in decades. The surge in prices—first written off as transient due to supply chain and other pandemic dislocations—now may prove to be a resilient and sustainable feature of the post-pandemic recovery.

Inflation Has Moved Beyond Transitory Categories

3-Month Annualized Change



Source: Guggenheim Investments, Haver Analytics. Data as of 12.31.2021.

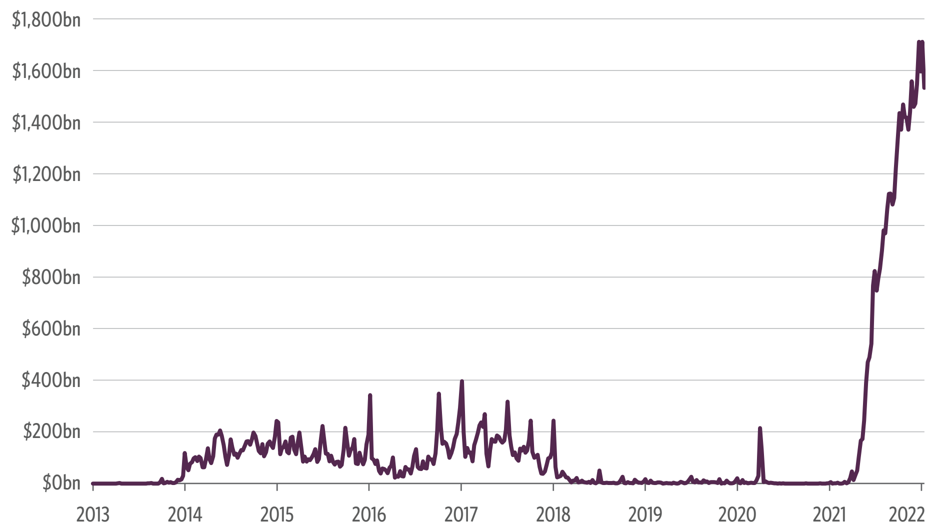
Policymakers have now determined that the answer is to begin a rapid reversal of the stimulus that it continues to supply. This includes a rapid reduction in asset purchases, which will probably sunset in March, along with an almost immediate liftoff in the fed funds rate. Some market participants are calling for hike of 50 basis points as early as March and many economists are pushing for 100 basis points before year end, while numerous Fed officials are pushing for balance sheet reduction as soon as possible.

What amazes me is that the Fed would even consider an attempt to raise rates and reduce the balance sheet simultaneously given how badly the last episode of balance sheet reduction played out in the markets while the Fed raised rates in 2018. That effort abruptly ended with the famous "Powell Pivot" after the stock market fell sharply when Fed Chair Jerome Powell announced that balance sheet reduction was on autopilot.

Changes in money supply are a powerful driver of economic output, asset prices, and inflation. Interest rates are the byproduct of monetary liquidity, economic output, and inflation expectations. Short-term market rates can be manipulated through changes in the stock of money. Today, that stock of money is so large that the Fed had to ramp up reverse repo (RRP)operations to sop up cash that would have driven short-term rates below zero. That facility now has daily volume of over $1.5 trillion. Any program to raise rates will require the Fed to raise the rate of interest paid on RRP operations by the amount of the increase in the overnight target rate.

Usage of the Fed's Overnight RRP Facility

Weekly Average



Source: Guggenheim Investments, Haver Analytics. Data as of 1.12.2022.

In essence, the Fed will establish an artificial rate that is not set by market forces. Without market forces, the Fed will have no ability to recognize what the true demand for money would be if interest rates could freely float. (This is an argument I presented at The Hoover Institution's 2019 Monetary Policy Conference.)

A freely floating short-term rate would signal when policy had become too restrictive if inflation falls below target (which means that the Fed needs to increase the size of its balance sheet) or that policy has become too accommodative if inflation is increasing above target (in which case the Fed needs to reduce the size of its balance sheet).

By abandoning the policy of set ranges for pegging short-term rates, the Fed could allow market forces to determine the appropriate overnight rate while monitoring inflation and adjusting the balance sheet to determine the appropriate level of money supply—just as Paul Volcker did to successfully vanquish inflation in the early 1980s.

Market pundits advocating a "shock and awe" policy of a 50 basis point increase in rates, or former Fed officials speculating that a 4 percent overnight rate could be necessary to contain inflation, reflects a degree of hubris which could do even more harm to the financial markets and the economy.

Who knows what the "right" level of interest rates should be? Can you imagine what would happen to the housing market if rates rose to 4 percent or higher, or to equities in the event of a sudden, unexpected rise in interest rates associated with "shock and awe"? Perhaps that's a great idea if you are short stocks. The market is already waffling with the talk of three or even four quarter-point rate hikes along with balance sheet reduction even before the Fed has taken action along these lines. An unexpected shock is not going to immediately flow through to inflation, but it will immediately impact already overvalued financial asset prices and undermine confidence and destabilize the economy.

The simple fact is that no individual or committee is smarter than the market. As the Fed's balance sheet shrinks, the excess liquidity stored in its standing repo facility will slowly decline. As the cash balances at the reverse repo facility dissipate, short-term rates will begin to move higher. This will allow financial markets to find a new equilibrium as the Fed reduces its balance sheet as inflation declines.

Milton Friedman's seminal work on inflation concluded that "inflation is always and everywhere a monetary phenomenon." The great monetary policy mistake of the late 1960s and 1970s was that the Fed pegged short-term rates while ignoring unhampered money growth, which essentially accommodated federal spending and deficits to finance the Great Society and the Vietnam War.

Does any of this sound familiar? Perhaps we should heed the wisdom of Mark Twain, who said, "History doesn't repeat itself, but it often rhymes," and go with a proven solution by controlling money supply growth through the Fed's balance sheet rather than repeating the mistakes of the 1970s.

Important Notices and Disclosures:

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