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Something to Think About

COMMON CENTS

Although China has been in the headlines, it seems people the most worried about future US economic growth are increasingly focused on two things: 1) the strength of the dollar relative to other major trading currencies, and; 2) low energy prices. Apparently, folks no longer believe we can simply import and consume our way to prosperity. Further, low energy prices are causing all kinds of havoc for any number of people (and countries) who have lent money or amassed large stockpiles of cash in the past, and greased the global economy with their largesse.

To hear how some people tell it, the whole thing is circular and a veritable witch's brew. Let's just say the world has changed dramatically in a very short period of time. As anyone who has been in this industry long enough will tell you, we have always believed low energy prices and a strong dollar are good for growth. Apparently, not so any longer.

Maybe this time is different. While I ordinarily find that not to be the case, would that things are truly different this time around, because the solution to what ails us is surprisingly simple: debase the dern dollar, and I mean take it out back and shoot it. Let's not tiptoe around the issue with arcane monetary policy sleights of hand.

While the global supply of fossil fuels is growing at a faster rate than global demand, there seems to be little argument about that, it seems as though crude oil prices move inversely to the strength of the US dollar. We can have a chicken vs. egg debate until the cows come home, and the fact remains: when the dollar is strong, crude oil prices go down. When the dollar is weak, the inverse is true. While it doesn't always rain when it is cloudy, it rains even less when the sky is sunny, if you catch my drift.

Taking a look at month end crude oil prices and the strength of the US dollar relative to other major trading currencies (as defined by the DXY index on Bloomberg), over the last 30 years there has been a negative correlation of 0.66 between the two. For the past 20 years, the negative correlation has been 0.78, and has been negative 0.77 over the last decade.

By comparison, the correlation between stocks and bonds (as defined by the SPY and AGG exchange traded funds) over the last decade has been about 0.06, or basically zero. Therefore, stocks and bonds are more correlated, by a significant margin, than crude prices and the US dollar. Again, we run the risk of a chicken vs. egg argument here, but the numbers are what the numbers are, particularly when the negative correlation is as strong as it is.

So, what is the remedy for an economy beset with a strong currency and low energy prices? I will go out on a limb here and say it isn't a tighter monetary policy, especially in a globalized economy where the official definitions of inflation don't really exist, or at least not to anything approaching troubling. It is amazing, really, how stubborn inflation, or lack thereof, has been in light of the accommodative monetary policies central banks have enacted since 2008. Baffling actually might be a better word.

It doesn't seem like all that long ago when people were buying gold due to the perceived threat of hyperinflation. Now, strangely enough, gold has rallied this year as investors fret over the prospect of, gasp, deflation. Yes, we have fallen through the looking glass. Crazy.

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Turn those machines back on!

Mortimer Duke

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Now, let me ask you a simple question: how can a central bank immediately debase its currency, thereby causing inflation, or potentially even hyperinflation, in the process? After all, if low energy prices are bad for global growth, then, conversely, higher energy prices must be good for it. If so, since the dollar and crude are strongly negatively correlated, what, then must be beneficial for global economic growth? That's right, a weak dollar. If that is indeed the case, the best possible medicine for global economic growth would be, you guessed it, higher rates of inflation in the United States.

This is so contrary to everything we have ever believed, I almost feel like a heretic typing it out. But actually, weirdly enough, it makes some sense in an almost Bizarro World way. You see, higher energy prices would allow petrodollar economies to refund their sovereign investment funds, which have been a nice source of liquidity for the global markets for some years now. It would also allow various governments to pay back their mountains of debt with increasingly worthless currency units, let alone borrowers facing default on their energy plays….which has been cause for alarm for many.

So how to do this? Well, it ain't raising the overnight lending target and increasing capital requirements at money center banks. Nope. Apparently, it also ain't quantitative easing, as that hasn't produced the desired, if I can call it that, results when it comes to inflation. After all, the banking system creates money in the economy by lending it out. According to the Federal Reserve, the US banking system has about $2.3 trillion in excess reserves. So, most of that money the Fed supposedly created with their quantitative easing programs is just sitting around gathering the financial equivalent of dust. Besides, do we really want more debt in the economy? Didn't that cause this mess in the first place? Finally, running massive public budget deficits don't seem to have done the trick either, as everyone everywhere is in the red.

What to do? What to do? Well, the one trick we haven't tried is really ramping up the printing presses, and I mean putting them into overdrive. Sure, we have printed out cash over the last 8 years, a decent amount of it too. However, the annualized growth rate for cash in circulation has been around 7%, or so, since the end of 2007. By comparison, the annualized growth rate for the Federal Reserve's total balance sheet has about 22%.

As a result, on December 26, 2007, currency in circulation represented about a 89.2% claim against the assets on the Federal Reserve's balance sheet. As of February 10, 2016, this number was 31.3%. As a result, the Federal Reserve has created the potential for more money in the system, a lot more actually, but the average person doesn't really have much more folding cash, generally speaking.

Further, a lot of the money the powers that be prints ends up overseas. Consider this snippet from the Federal Reserve Bank in San Francisco all the way back in 2003:

> Where in the world is all of that U.S. currency? While currency in the hands of the public is a key component of the money supply measures, you might be surprised to learn that most of the U.S. currency is circulating overseas. According to the Preface of a March 2003 Report to the Congress by the Secretary of the Treasury, about 60 percent of the outstanding U.S. currency was held overseas; in 2003 that was about $370 billion!

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While some analysts have taken issue with that 60% figure over the years, it is generally assumed at least 35% of the face value of US currency in circulation ends up overseas, with some estimates topping 65%. Really? Yeah, a crisp $100 bill is a preferred store of value in many formerly third world countries. We basically keep most of the $1s, $5s, $10s, $20s, and $50s here, and ship a good chunk of the $100s overseas.

And who says we don't export anything?

In the end, the recent concerns over global deflation and economic Armageddon due to low energy prices don't keep me up at night. The United States can put that to bed by simply implying it is going to ramp up the printing presses, and flood the world with actual currency units...not computer blips or excess reserves in the banking system. Of course, that would have negative economic repercussions as well. However, if the worst case scenario is going to happen, you have to put all the cards on the table?

Negative interest rates? Intuitively, that would encourage banks to take on more risk, and no one really wants that, at least politically. More quantitative easing? Frankly, what would really be the point? Higher interest rates? Gee, a strong dollar is already a problem, or so the prevailing zeitgeist would lead us to believe. Cranking out a few extra sheets of dead presidents? Hmm.

I am not being completely in earnest. Still, it would seem a slight increase, or the threat of it, in the amount of currency in circulation would be an interesting tactic in a world beset with a depression in commodity prices and deflation fears. Oh, I am not talking about littering the streets in banknotes like the Weimar Republic, Hungary, and Zimbabwe did; far from it. But what would happen if we increased the growth rate in currency from 7% to 9% or even 10%? Perhaps couple that with another 0.25% rate hike or two, just to keep everyone honest? This would coordination between the Treasury and the Federal Reserve, but they could do it no problem. Instead of auctioning off umpteen Bills, Notes, and Bonds, the Treasury literally pays some bills with newly minted cash?

Admittedly, as I type, this is crackpot stuff. However, five years ago, so would have arguing that a strong dollar and low energy prices are bad for US economic growth. So, if the world's central bankers really, and I mean really, want to 'get back' to their long-term inflation targets, perhaps they should quit all the mental gymnastics and clever tricks, and just do what governments have always done to pay the bills….physically print it or mint it.

Hey, if that is too scary to contemplate and a slippery slope, and it sort of is, then perhaps we should quit worrying about the current solution. I suppose you could say, in this instance, it is a tossup if the disease is worse than the cure or vice versa.

Have a great weekend.