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End of Empire?

Fixed Income Macro View

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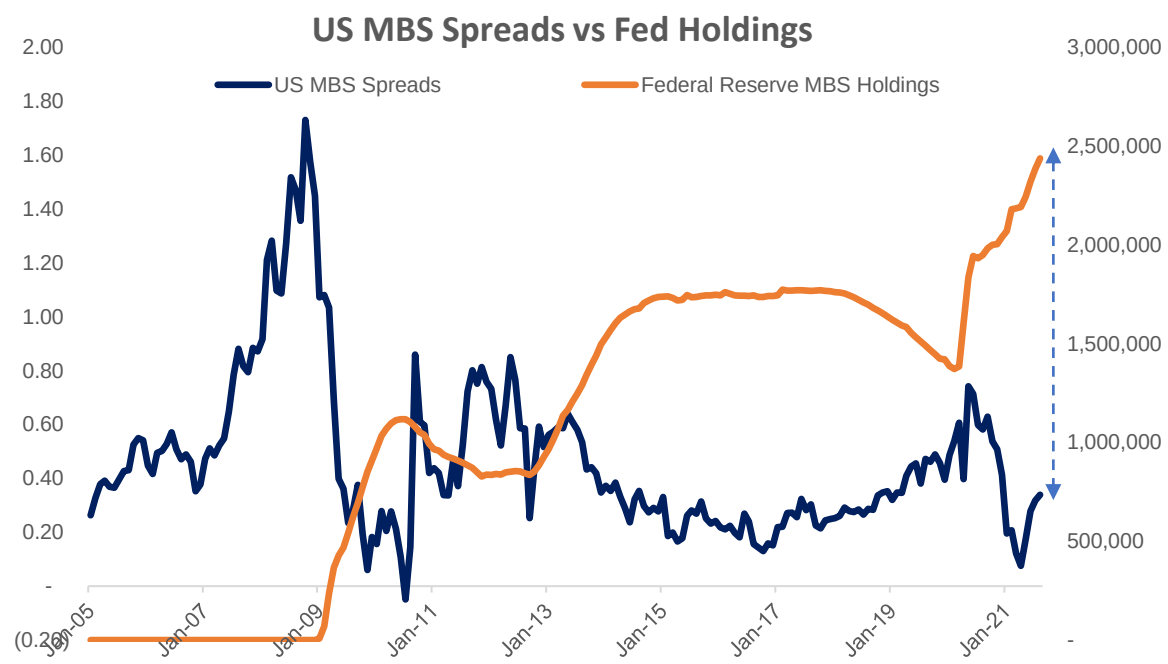
September 2021

End of Empire

How does an empire die? Slowly at first, plagued by a prolonged period of decay, before some kind of catalyzing event hastens its demise. Increasingly, America's role as the pre-eminent global superpower is being questioned, with the chaotic retreat from Afghanistan thought by some to represent a tipping point. It is certainly tempting to buy into this view, given the almost poetic symmetry with failed British and Soviet undertakings in the same region. However perhaps the greater significance lies not in the void left by the US retreat, or the chastening manner of the exit, but rather what it says about America's long term decision making process and to what extent similar mistakes are being made and repeated elsewhere. As long time critics of US monetary policy, ***we find the similarities between America's Afghani misadventure and the Fed's steadfast adherence to increasingly fraught monetary policy particularly striking***. In the following analysis we highlight some of the most relevant comparisons which we believe represent a cause for concern both for the future economic welfare and geopolitical supremacy of the US.

Why is the Fed still purchasing MBS?

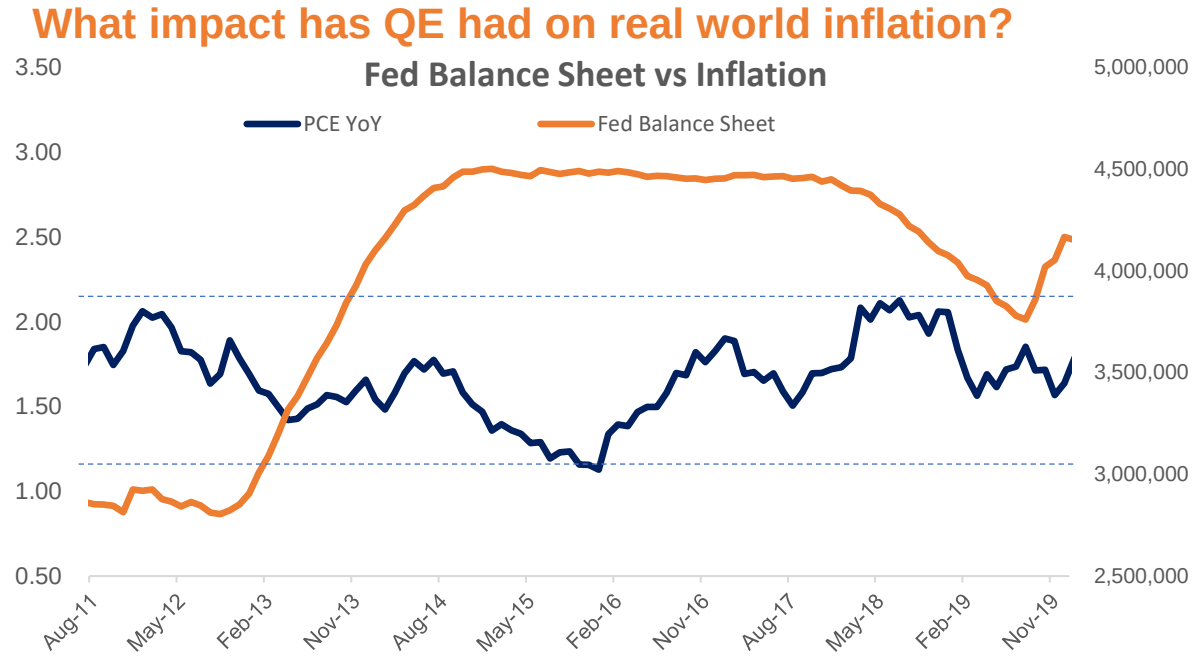


Source: Bloomberg as at 31/08/21

1. Mission Creep

President Biden has been categorical on one point – the mission in Afghanistan was successful in achieving its original stated objective. The problem is that this was achieved 17 years ago. Since then the mission took on a life of its own as the introduction of additional humanitarian and strategic goals shifted the goal posts decidedly. If this all sounds eerily familiar, I'm not surprised. The Fed's decisive action in 2008 was successful in shoring up the banking system. What followed was an increasingly broad policy remit encompassing inflation, employment and now climate change and social goals. With the objectives constantly shifting, were the generals/policy makers ever likely to achieve them?

What impact has QE had on real world inflation?



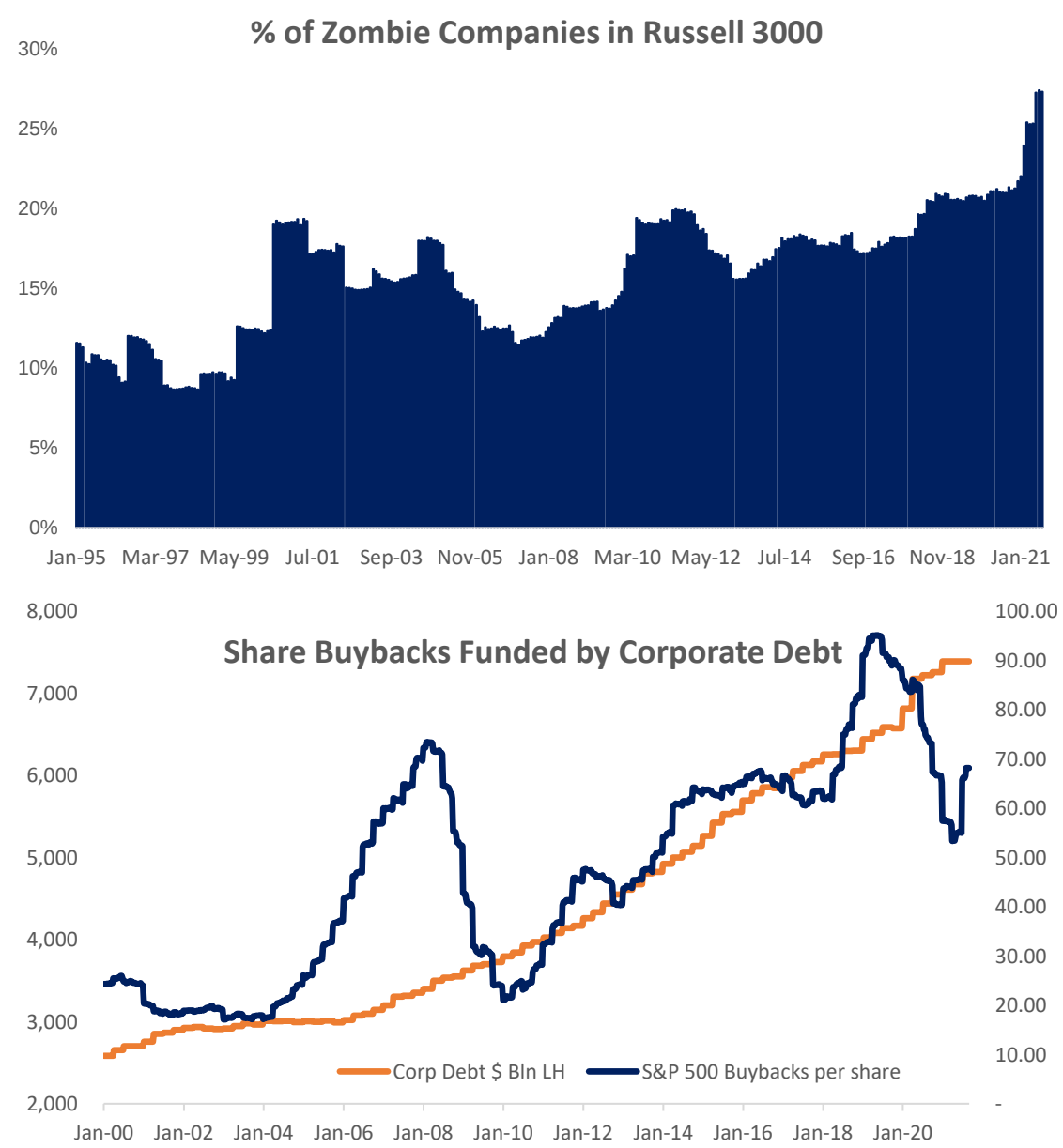
2. Inappropriate Policy Tools

Equally as relevant was the suitability of the policy tools employed. Ballistic missiles and twisted torture techniques served only to inspire a recruitment drive for America's enemies in Afghanistan. In a similar vein, Quantitative Easing and negative interest rates have encouraged mal-investment and debt saturation ultimately driving trend growth lower. Spurred on by constantly evolving targets, balance sheets continue to rise, so much so that it is difficult to remember just why these policies were introduced in the first place.

3. Shaky Foundations

An enduring edifice begins with solid foundations, growing from the ground up. We reap what we sow. Easy money alone does not create solid foundations, in fact quite the opposite – it creates bad incentives. Without a solid structure in place, it was not long before the newly formed Afghan economy was racked by corruption fuelled by $ billions in US support. Likewise the incentives set by Fed policy have encouraged the financialisation of the economy. Where once the term engineering was synonymous with mechanical activity, today its resonance lies with financial operations. Investment has been superseded by speculation, the pursuit of profit by the quest for capital gains. In the absence of US funding, the Afghan economy faces total collapse. Would a similar fate befall the US (global) financial system were the Fed to turn their back?

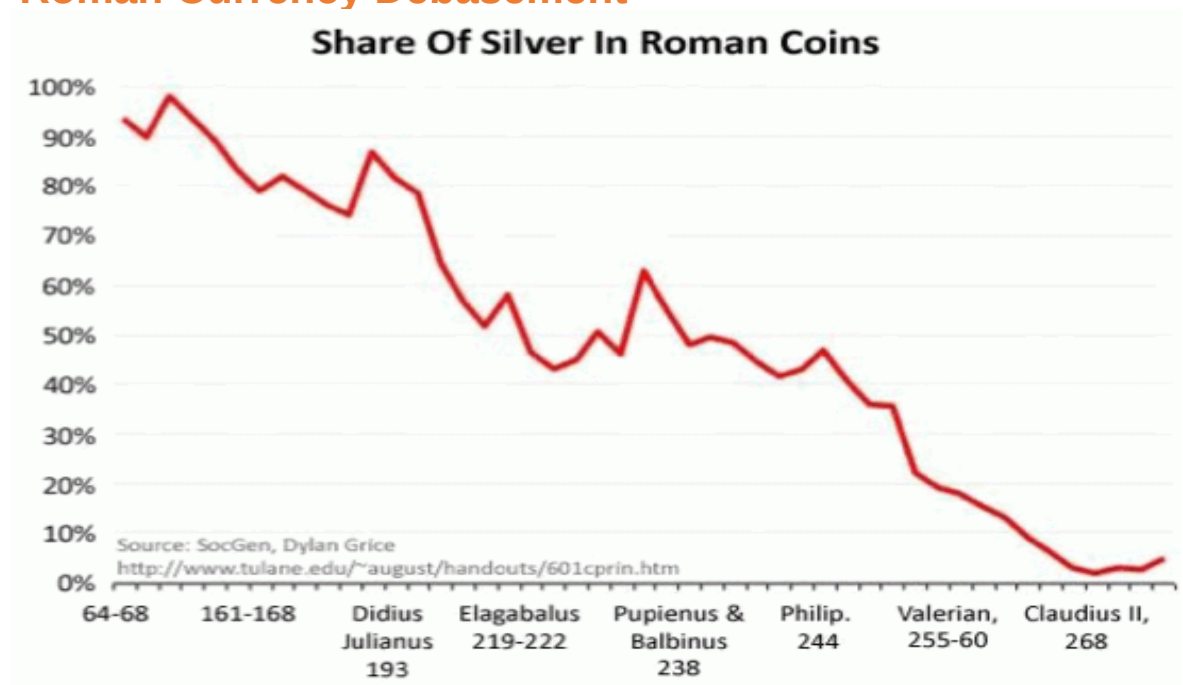
Corporate Zombification



Source: Bloomberg as at 31/08/21

4. Failure to Learn from History

Roman Currency Debasement



Source: Socgen, Dylan Grice May 2011

History is replete with military failure in Afghanistan, whether it be the British war of 1839-42 or more recently the Soviet Union failure in the 1980s. It is therefore not difficult to understand why it is known as the Graveyard for Empires. History also provides a clear signpost as to the fate of countries who rely excessively on currency debasement, in particular those in the position of monetary hegemony. The debasement of coins marked the beginning of the end for the Roman Empire while further back again the Ming Dynasty in China ended in a debt jubilee and the burning of all paper money. Will the monetary authorities learn the hard lessons that the military complex failed to?

5. Zero Accountability

Recently a 17 year marine veteran[1] asked a simple and telling question – where is the accountability for the failures in Afghanistan? This is not the first time such questions have been asked and left unanswered on US foreign policy. Remember the WMDs (or lack thereof)? The Bush administration was never held to account on the original 'big lie' or indeed the broader failure to achieve its strategic objectives.

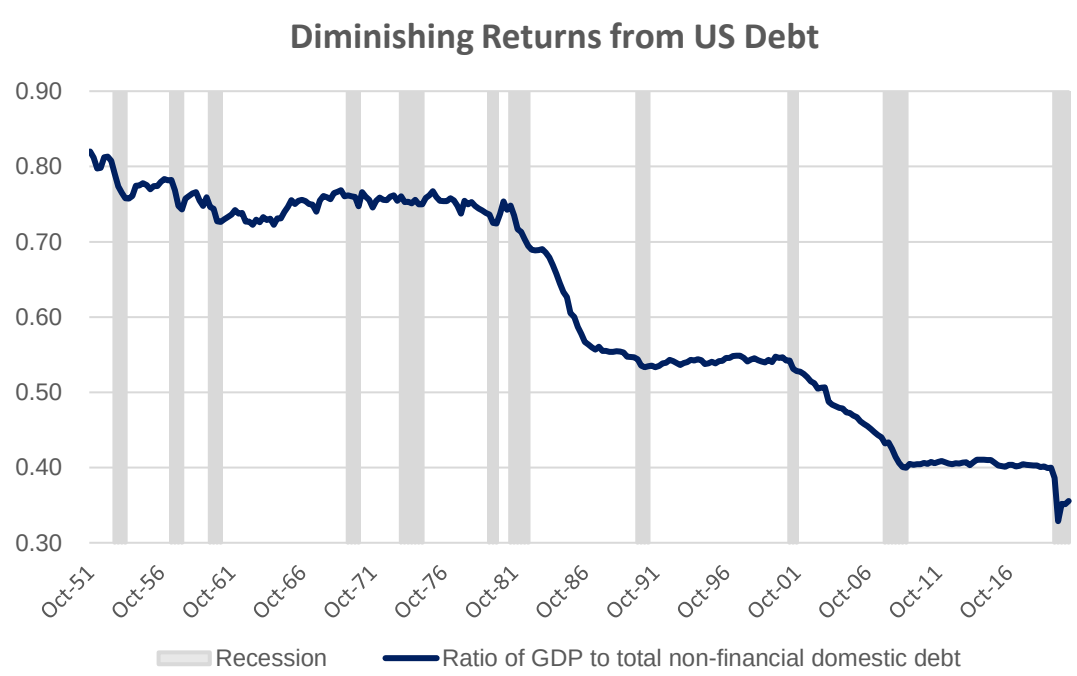
1. https://www.theguardian.com/us-news/2021/aug/27/us-marines-stuart-scheller-video

As regards the economy, since the mid 1980s we have lurched from one monetarily induced crisis to the next with little or no real reflection on what went wrong nor any hint of a policy change. Time and again the same old group think has re-emerged and led to the doubling down on failed policies – more liquidity.

6. Taking the Easy Option

As laid out in the Washington Post's 2019 expose, it had long been conceded that US withdrawal from Afghanistan would result in the Taliban wresting back control, however no administration was prepared to call time on the war. Both Obama and Trump had in essence passed the buck until Biden knew that politically he had no choice. The decision making on monetary policy has close parallels. Central bank chiefs are by now aware of the ineffectiveness of current policy tools and the growing malignancy of their side effects. However we have reached the point where it is not the cost of carrying on that matters, rather the cost of withdrawal. How many central bankers have been critical of policy either before or after their time in the hot seat, in stark contrast to their actions taken when in charge?

Diminishing Return on Debt

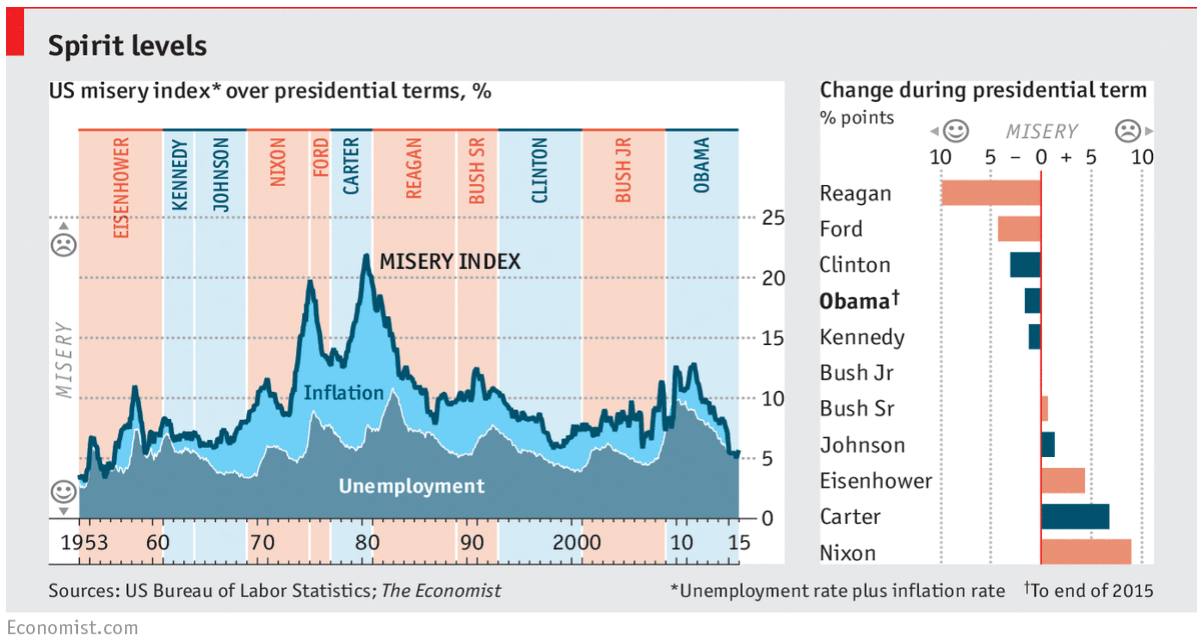


Source: Federal Reserve Bank St Louis as at 30/06/21
Source: Washington Post – Afghan Papers – 09/12/2019

7. The End was Inevitable

Geopolitical regimes and financial systems eventually come to an end. The 'American Century' was coined by Time publisher Henry Luce where he described the would be role of the US in the 20th century. Prophetic words. Time will tell if the chaos in Kabul marks the end of Luce's prominent America or whether it represents merely a moment in time. History has tended to show that as political empires end, so too does the reserve currency status of the empire itself and the 'exorbitant privileges' that come with it. For every dollar of growth that the US now creates, it needs to borrow 5. An unsustainable number. The costs of this impossible imbalance are really beginning to show as the world moves from demand side crises to supply side shocks - arguably exacerbated by central bank policy. As wars and financial circumstances evolve, so too must policy. The fact that 73% of Americans wanted out of Afghanistan, always meant that pre-election promises were going create tremendous political pressure to withdraw. As the failures of QE and the inflationary costs of currency debasement start to ratchet up pressure on the Fed, will they ignore it indefinitely or eventually succumb? As Jimmy Carter can attest, you ignore inflation at your peril.

Stagflation and Previous US Administrations



Source: Economist February 2016

Conclusion - Is Inflation the Tipping Point?

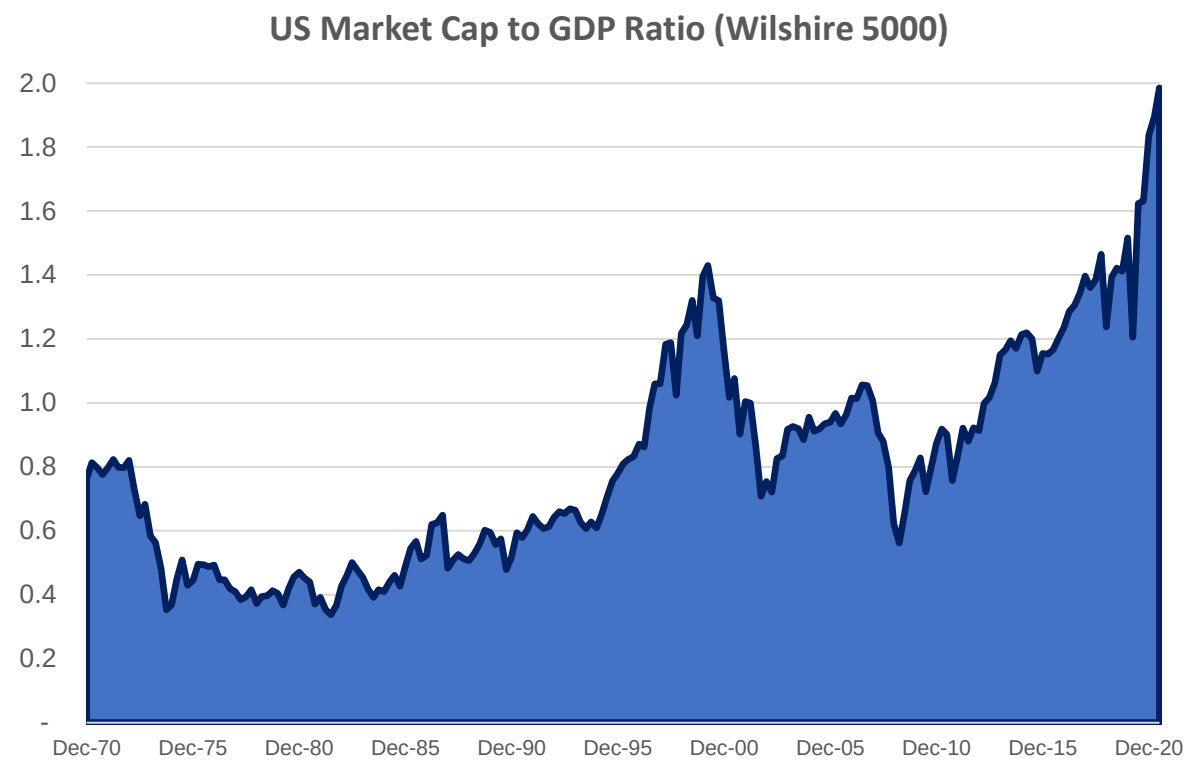
There is understandably much debate about the potential impact of accelerating inflation on central banks' ability to support financial markets. As things stand, the Fed and financial markets are more than happy to buy the transitory inflation story. The longer term premise posits that the structural deflationary forces of the last two decades will re-assert themselves (debt overhang, demographics etc). In the more immediate term, the benign inflation story requires, among other things, anchored inflation expectations and gentle wage growth.

While there is undoubtedly merit to the deflationary argument, the underlying dynamics of the global economy are changing, The labour force is showing early signs of once again collaborating to pressure employers for higher wages[1] (e.g Amazon, Starbucks), just as was seen in the 1950s. This has some backing from the White House and Congress too. Are we on the cusp of a sustained push for higher wages? Inflation expectations (at a consumer level at least) are showing signs of coming unstuck. The latest U Michigan consumer confidence data saw 25% of respondents expect inflation rising to 8% or above. In addition, the broader macro deflation brought on by the onset of globalisation is increasingly looking to have run its course, with the likely reversal of this trend now potentially creating inflationary impetus over the coming years. The winds of change are stirring, but are the central banks willing to take notice or are they too scared of what they might see?

1. https://www.nytimes.com/2021/08/30/business/starbucks-coffee-buffalo-union.html

Perhaps the biggest reason for the market's collective inflation anxiety is not the economic damage it can cause but rather the action it can require the Fed to take. In our minds however this should not be the focus. The Fed can scotch inflation if they so wish, they're just unwilling to brandish the pin and burst the bubble. Inflation or not, the bigger issue is the damage that has been done to the global economy over an extended period of QE and negative rates. With each passing year the underlying economy becomes weaker, less productive and more susceptible to crises – the fallout from which gets progressively larger requiring intervention an order of magnitude higher than before.

Market Excess



Source: Bloomberg as at 30/06/2021

The Fed, over the next 6 months, data and Delta permitting – will try a snail's pace slowing of asset purchases in the hope that the market barely notices. No doubt original forecasts for American troop withdrawals from Afghanistan had a similarly optimistic outcome. However as we have learned time and again, the real world does not always accommodate our best laid plans.

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