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ROCKEFELLER
CAPITAL MANAGEMENT

Theoretical Heterodoxy

MMT going mainstream; a reality-bending economic discourse

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The breath-taking equity rally off last Christmas Eve's bottom continued unabated through April, with the S&P 500 Index and the Nasdaq Composite hitting new record closing highs. The two major drivers of late were the optimism over China's reflation and a better-than-expected earnings reporting season. With roughly half of the S&P 500 companies having reported results, the Index's EPS growth for the first quarter was tracking about flat rather than the expected 2% decline from a year ago. The improved sentiment drove U.S. Treasury yields higher and re-steepened the yield curve. In spite of the elevated investor sentiment, economic data remained lackluster around the globe. South Korea's real GDP declined 0.3% sequentially in the first quarter, and Japanese and German exports were still weak. The U.S. economy again demonstrated its exceptionalism with a strong annualized 3.2% real GDP growth in the first quarter. However, more than half of the growth was due to inventory build-up and net exports, while consumer spending and capital expenditures were on the softer side.

The U.S. Dollar Index (DXY) briefly climbed above its multi-month trading range as foreign central banks – Swedish Riksbank, the Bank of Japan, the Bank of Canada, the Reserve Bank of Australia, etc. – followed the Fed's lead in turning more dovish. However, a slightly better-than-expected Eurozone GDP report injected some life into the ailing euro ahead of the upcoming European Parliament Elections. Gold pulled back slightly on investors' waning need for safe havens.

Oil prices got a boost from the Trump Administration's decision to end the waivers that allowed several countries to purchase Iranian oil without triggering U.S. sanctions. The WTI crude oil price has surged more than 40% year-to-date, and U.S. gasoline prices have now risen for twelve consecutive weeks. With the U.S. job market remaining tight, the combination of rising fuel prices and upward wage pressure may create some complications for the Fed's dovish stance. We would urge a degree of caution as the red hot IPO market of late reminded us of the dot-com IPO frenzy that ended in tears. After a nearly uninterrupted 25% rally off the S&P 500 Index's December nadir, it would be healthy to see the bull taking a breather.

EQUITY MARKETS INDICES[1]	3/29/19 Price	4/30/19 Price	MTD Change	YTD Change
MSCI All Country World	509	525	3.2%	15.2%
S&P 500	2834	2946	3.9%	17.5%
MSCI EAFE	1875	1921	2.5%	11.7%
Russell 2000®[2]	1540	1591	3.3%	18.0%
NASDAQ	7729	8095	4.7%	22.0%
TOPIX	1592	1618	1.7%	8.3%
KOSPI	2141	2204	2.9%	8.0%
Emerging Markets	1058	1079	2.0%	11.7%
FIXED INCOME				
2-Year US Treasury Note	2.26%	2.27%	0	-22
10-Year US Treasury Note	2.41%	2.50%	10	-18
BarCap US Agg Corp Sprd	1.19%	1.11%	-8	-42
BarCap US Corp HY Sprd	3.91%	3.58%	-33	-168
CURRENCIES				
Australian *(AUD/$)*	1.41	1.42	0.7%	0.0%
Brazilian Real *(Real)*	3.92	3.92	-0.1%	1.0%
British Pound *($/GBP)*	1.30	1.30	0.0%	-2.1%
Euro *($/Euro)*	1.12	1.12	0.0%	2.2%
Japanese Yen *(Yen/$)*	110.86	111.42	0.5%	1.6%
Korean Won *(KRW/$)*	1135.18	1168.15	2.9%	5.1%
U.S. Dollar Index *(DXY)*	97.28	97.48	0.2%	1.4%
COMMODITIES				
Gold	1292	1284	-0.7%	0.1%
Oil	60.1	63.9	6.3%	40.7%
Natural Gas, Henry Hub	2.66	2.58	-3.3%	-12.4%
Copper *(cents/lb)*	294	290	-1.2%	10.3%
CRB Index	184	184	0.3%	8.5%
Baltic Dry Index	689	1011	46.7%	-20.5%

Modern Monetary Theory is a seductive political propaganda that promises something for nothing; it is a hipper 21st century reformulation of some of the ideas from the Communist Manifesto of the mid-19th century.

LIGHTS ALL ASKEW IN THE HEAVEN

Last month, the Event Horizon Telescope, an international collaboration that linked up ground-based radio telescopes from multiple locations across the globe to effectively create a giant virtual telescope, released the first ever photos of a black hole, which was once thought to be un-seeable. It was further proof of Albert Einstein's theory of general relativity which had predicted the existence of such a phenomenon more than a century ago. Interestingly, this month marks the 100th anniversary of a celestial experiment that first validated Einstein's revolutionary theory.

For over two centuries before Einstein introduced general relativity in 1915, the discipline of physics was built on Sir Isaac Newton's seminal 1687 publication regarding the law of universal gravitation, which explained not only the behavior of falling apples on earth but also the motion of planets and other celestial bodies. However, while Newtonian physics was precise with terrestrial phenomena, it was not as accurate in calculating certain celestial trajectories such as the precession of Mercury's orbit. Newton was also at a loss to explain how one body may act on anther through a vacuum without the mediation of anything. The deficiencies in Newtonian physics were finally resolved by Einstein's field equations, the mathematical formulation of general relativity. Einstein theorized that space and time collectively form a four-dimensional space-time continuum. Gravity, rather than being an intrinsic force within an object, was instead the warping of the space-time continuum by the object. The curvature of the warping determined the path that the object would travel at. Astrophysicist, John Archibald Wheeler, who coined the term *black hole*, may have offered the most elegant summary: "matter tells space-time how to curve, and space-time tells matter how to move."

Although Einstein had correctly explained the anomaly in Mercury's orbit, the theory of general relativity was first greeted with skepticism in the scientific community. One issue was that there was no easy way in the mid-1910s to test the validity of Einstein's theory, which deviated from Newtonian physics only at extremely high speeds. Sir Frank Watson Dyson, an English astronomer, however, conceived an ingenious celestial experiment that would make use of the upcoming total solar eclipse on May 29th, 1919 to test the theory. He figured that the sun would be crossing the Hyades star cluster during the eclipse and the star cluster would be visible due to the darkening sun. According to the theory of general relativity, the light from the star cluster would be bent by the warping of the space-time around the sun, giving the star cluster a gravity-shifted position in the sky at 1.75 arc seconds from its known position. On the day of the eclipse in 1919, expedition teams stationed in Sobral, Brazil and Príncipe Island off West Africa took pictures of the darkened sun and the star cluster during the six-minute long eclipse. The results from both locations were sent back to England for analysis.

On November 16th, 1919, Dyson announced at a joint meeting of the Royal Society and the Royal Astronomical Society that the Hyades star cluster's gravity-shifted position observed during the eclipse did match what Einstein's theory had predicted. The next morning, Einstein was prominently featured on the front page of major newspapers and a star was born.

RISE OF MMT

The beauty of science is that its mathematical formulations offer precise answers (except for quantum physics' probabilistic nature that Einstein never fully embraced). Economics, on the other hand, does not have the luxury of precision. It is built on empirical observations and common sense. However, just as Newtonian physics breaks down when an object's movement starts to approach the speed of light, years of unconventional monetary policies and debt build-up in major economies seemed to have discredited some long-held economic theories. It has emboldened some left-leaning economists to espouse a heterodox theory dubbed the Modern Monetary Theory (MMT), whose potential impact on the bond market was discussed in our latest *Global Foresight* publication.

Conventional theory holds that government spending is funded by tax revenues and borrowing, with money printing as a third but extreme option. These three funding sources place a limit on spending since too much taxation would choke off the private sector's animal spirits, excessive borrowing would increase the cost of financing, and money printing has historically led to runaway inflation. Continued and excessive budget deficit is thereby viewed as fiscal mismanagement, and austerity policies may be needed at times to restore a government's credibility with the capital market. MMT proponents (MMTers), however, have turned these policy orthodoxies upside down. They argue that the role of government is to spend as much as needed to guarantee jobs for everyone. Government spending would be funded by money printing as long as inflation remains in check. A budget deficit is viewed as an inconsequential accounting mirage since the government would be printing rather than borrowing money. Budget deficits, to MMTers, actually create wealth since what the government spends above its tax revenues adds to the private sector's monetary savings. Interest rates would not play much of a role since the government could print money at will. When inflation eventually picks up as a result of the economy reaching its full capacity, increased taxation and bond issuance would be used to remove excess money from circulation. In short, fiscal spending would be the driver of the economy, with taxation as a tool to tame inflation. Monetary policies will be rendered rather useless in this framework.

These unorthodox and unproven theories have generated fierce debates among liberal economists, with sharp criticisms – voodoo economics, modern monetary nonsense, etc. – coming from heavyweights such as Paul Krugman, Larry Summers, and Kenneth Rogoff. However, MMT proponents would point out that many developed economies have already been printing money and running up national debts for years. Indeed, it's been twenty years since the Bank of Japan initiated the zero-interest rate policy, ten years since the Fed kicked off quantitative easing, and five years since the European Central Banks brought its benchmark rate below zero. They have enabled governments to run up large deficits and debts on the cheap. Central banks have also "printed" trillions of dollars via quantitative easing. MMTers are merely going a step further by having the government spend the newly minted money to create jobs. They are in effect saying that, instead of relying on the traditional monetary transmission mechanism via the banking system, government spending can be more effective and targeted in pumping money directly into the real economy.

The issue with MMT is that it has refused to acknowledge that unrestrained government spending would lead to runaway inflation. MMT supporters can argue that years of ultra-loose monetary policies in developed markets have yet to trigger much inflation, but that belies the fact that the velocity of money has dropped materially due to subdued business confidence after the Great Financial Crisis. When confronted with the history of hyperinflation in the Weimar Republic and Zimbabwe, MMTers would point to the damage done to these countries' productive capacity as the real cause of inflation. Some MMT supporters even claimed that excess demand was rarely a cause of inflation, and blamed greed and speculation – businesses raising profit margins, passing on costs, or stockpiling commodities – as the root cause. As such, MMT's remedy to fight inflation is to regulate business pricing power and raise taxes to drain excess money from the system.

Herein lies the MMT Trojan horse whose real agenda is to expand the power of central planners and marginalize the private sector. Combating inflation with tax hikes is in effect an insidious scheme to expropriate private wealth over time – in the name of cooling the runaway inflation stoked by money-printing funded spending, MMTers will have the perfect pretext to levy heavy taxes on not only income but also wealth. It may not be a stretch to say that MMT is a hipper 21st century reformulation of some of the ideas from the *Communist Manifesto* of the mid-19th century. It is no coincidence that the political support for MMT has come from the socialist wing of the Democratic Party. They are pushing a seductive political propaganda that promises something for nothing. In reality, if spending funded by money printing was indeed efficacious with little side effects, various empires throughout history would not have fallen by the wayside. Those who believe in the government's omnipotence in micro-managing the economy to achieve and maintain full employment may want to read up on the economic history of the Soviet Union. A discussion with Argentina's long-suffering bourgeoisie may also help to discredit MMT's sugar-coated view on inflation.

A Broader Global View

Speaking of centrally planned economies, I recently made another trip to China to get an on-the-ground view of its economy. In contrast to the pervasive caution and bearishness among the business people I had met with last November, sentiment has clearly improved. Various tax cuts were starting to spur consumption growth, and some entrepreneurs were getting calls from multiple banks with loan offerings. Chinese banks have issued a record 5.81 trillion yuan of new loans during the first quarter, a 20% year-on-year increase. The country's aggregate financing, which also includes bond issuance, IPOs, and off-balance sheet lending, surged a whopping 40% from a year ago to 8.2 trillion yuan in the first three months of 2019. The aggressive liquidity injections have stabilized the economy and some of that money has found its way into China's stock markets. However, the nascent green shoots have prompted policymakers to signal less stimulus ahead as they try to avoid the asset bubbles that have accompanied past easing cycles.

Interestingly, the success of China's centralized economic planning could be used by MMT acolytes as justification for more state intervention in the U.S. While some investors may worry that China has become too dependent on debt-fueled growth, MMTers would not be alarmed as debt and deficits don't matter to them. That said, China has violated one of MMT's key tenets – keeping the debt domestically funded. Chinese institutions have piled up U.S. Dollar-denominated debt in recent years to take advantage of the lower interest rates. Chinese banks now reportedly face a U.S. Dollar shortage, which could sow the seeds of financial instability. Ironically, China may root for MMTers to gain power, as the increased U.S. Dollar liquidity from money printing would be initially stimulative to the global financial system. It would likely alleviate the U.S. Dollar funding issue for China as well as many other borrowers. However, the subsequent surge in inflation and the potential collapse of the U.S. Dollar will likely lead to global financial chaos. The greenback may wind up losing its global reserve currency status, which could mark the end of the U.S. hegemony and create an opening for China to assert its global supremacy.

In the final analysis, while it may be politically expedient to tout MMT on the campaign trail or Twittersphere, would any politicians really dare to put this radical theory into practice? The experiment may result in a socioeconomic black hole that crushes not only our prosperity but also our liberty.

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