MAI VIEW

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Politics & Investing

Frank Zappa said politics is the entertainment branch of industry. We have noted that unprincipled centrists pose a threat to sustainability and have offended all by suggesting conservatives can be as economically impractical as progressives. That may not be how to win friends and influence people, but it does leave us free to objectively analyze political influences over economies and markets.

Central Banks

They say politics is about making choices, and so the debate about whether central banks are political is a non-starter. They are. Central banks ultimately exist to ensure the safety and soundness of banks by avoiding credit deflation. They are primarily charged with the task of maintaining economic liquidity, which all political parties endorse. The question of whether they have partisan leanings is less important.

Central bank policies are meant to steer broader populations towards popular perceptions they feel will sustain economies and asset prices – asset prices used to collateralize liabilities (i.e., bank assets). This modus operandi necessarily harms a portion of the population. For example, targeting inflation harms savers that do not want to risk their wealth in the markets and financial repression harms retirees living on fixed income. Crafting and executing monetary policy is a political act, choosing one constituency over another. Thus, central banks are political bodies and make choices that prioritize special interests over broad populations, in order of importance: 1) bank profits; 2) pleasing legislative authorities that maintain their charters; 3) abiding by economic mandates constructed to please the first and second priorities, and; 4) promoting the economic hopes, dreams and wherewithal of the broad population.

An apolitical central bank would not have economic policies or mandates, but rather would exclusively oversee bank soundness and safety. This would imply central banks would have to occasionally limit bank balance sheet expansion (facetiously, what used to be called “restricting credit”). As bank and non-bank balance sheets became chock full of debt, they discovered that falling asset prices contemporaneously threatens output growth, credit deflation and bank solvency.

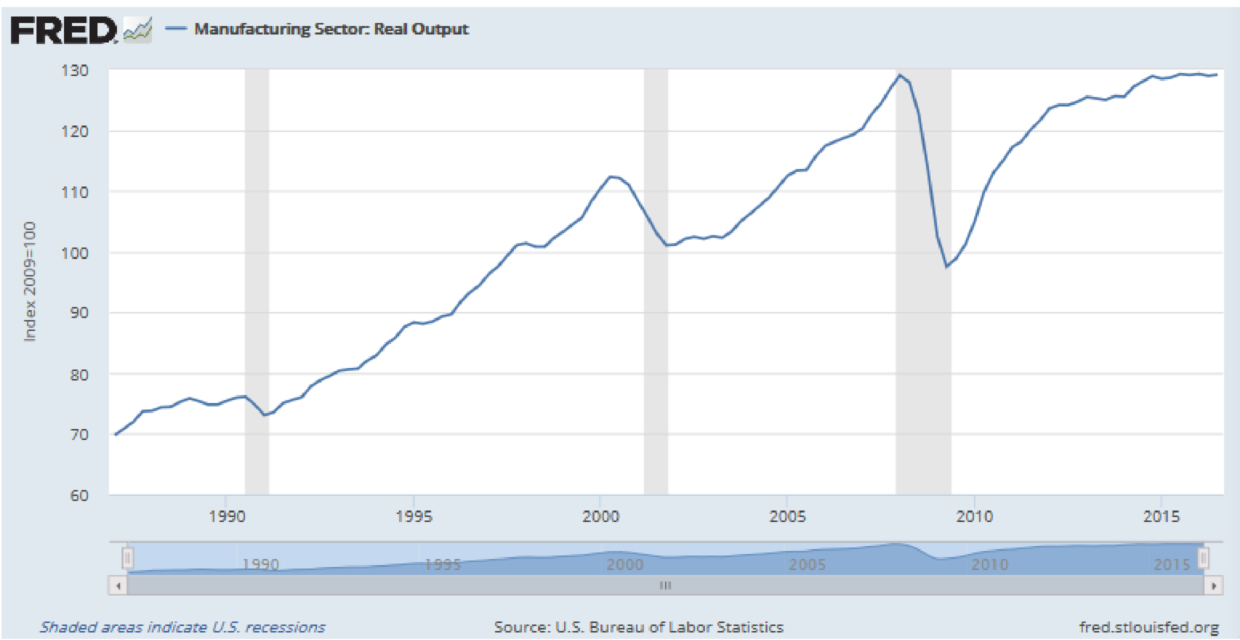
The credit crisis forced central banks to execute the first two priorities to the limit by re-liquefying their banking systems and giving cover to politicians otherwise at risk of taking the blame for it. The third and fourth priorities could no longer be met by dropping interest rates further or by creating more base money, so they resorted to emphasizing “communications”. Countless econometric models published by behavioral political economists and central bankers are based on the idea that growth and inflation are mostly derived from the expectation of them. Accordingly, central banks sought to increase capital spending and consumption by targeting inflation, which in turn diminishes the propensity to save. This benefitted investors and widened wealth and income gaps. Again, choices. It all seems political to us.

Politicians

The most visible form of politics that affects economies and markets comes directly from elected officials through promises of fiscal and regulatory initiatives and, occasionally, actual policy follow-through. Given the waning efficacy of the Fed's economic influence, Donald Trump's election could not have been better timed for equity investors. Confidence stemming from his ability to reduce regulations and taxes and enact fiscal growth initiatives produced a stock market rally. Let's look at perception and reality.

One of Mr. Trump's stated goals is to increase the US manufacturing base. Yesterday, he met with CEOs of manufacturing companies and asked for suggestions to increase revenues and US jobs. The result of his efforts may ultimately be legislation that reduces corporate taxes and increases import tariffs, which could improve manufacturing conditions in the US. But would his success be enough to move the needle?

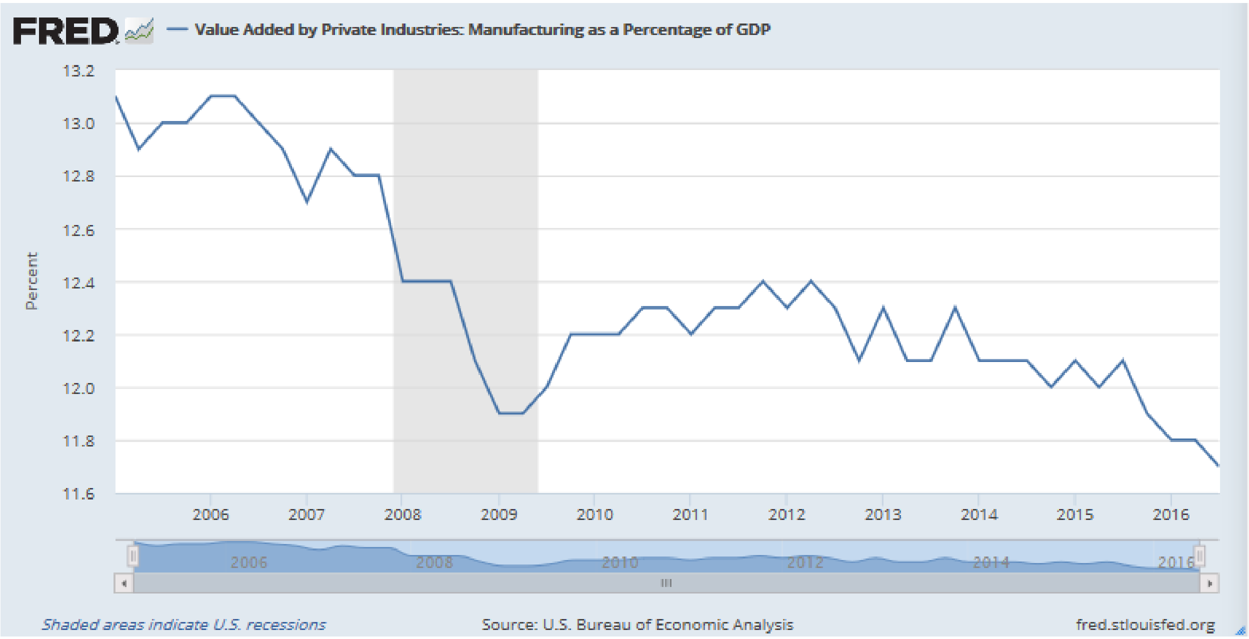
The graph below shows the growth of real output in the manufacturing sector since 1987. It grew in the 1980s during the first leg of the great secular leveraging period and even accelerated in the 1990s when emerging economies like China and the former Soviet bloc began participating in global trade. Two major dynamics brought about this growth: 1) the leveraging of household balance sheets, which gave US consumers increasing disposable income, and; 2) the ability of US manufacturers to use their rising stock prices and strong dollar as currency to buy cheap plant, equipment and labor abroad.



Source: St. Louis Fed

It is interesting that since 1999, and especially since 2012, US manufacturing growth has struggled amid extraordinary globalization. We would argue this is because it is bumping up against the global cost structure of production, which includes lower cost economies with which the US cannot compete.

The graph below puts a finer point on this. It shows the trend of US manufacturing as a percentage of US GDP. Since 2005, the contribution of manufacturing to the US economy has dropped from 13.1% to 11.7%. It is unclear whether we should be more concerned with the declining trend of manufacturing or the absolute low contribution level of manufacturing within the US economy.



Source: St. Louis Fed

US real GDP is about $17 trillion of which manufacturing is about $2 trillion. Doubling the manufacturing base to $4 trillion would be great on its own, but there are other considerations. First, total US dollar denominated debt is upwards of $60 trillion. Annual interest on that debt is about $3 trillion. Are we to believe that increasing the manufacturing base through deficit-funded fiscal initiatives and restrictive trade policies would increase real output? The excitement from renewing a sentimental part of the American narrative is politically compelling, but growing US manufacturing revenue and jobs would, at best, be small potatoes as an economic driver.

President Trump's initial emphasis on renewing the US manufacturing base is largely symbolic. Even if his administration were to successfully use tax incentives, protectionist measures and immigration policies to re-patriate factories and labor, and even if government were to spend big on fiscal stimulus, it still would not solve the structural leverage problem facing the US economy. In fact, we think the process of bringing the US manufacturing base back through job-centric policies would actually reduce global trade and lower US GDP over time. Zappa was right, but a fresh approach to confidence-based politics that does not address major structural issues does not provide the basis for investor optimism.

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