Toward Effective Economic Policy for the 21st Century
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Rick Rieder and Russ Brownback highlight their view that effective monetary and fiscal policy in the 21st Century needs to draw not only traditional economic theory, but also from the lessons of finance and other disciplines.

We think the evidence is mounting that the global financial economy has overtaken the global real economy, both in size and in influence. Yet economic policy is struggling to evolve in ways that incorporate more of the traditional theories and insights that are embedded in the study of finance. Thus, to more adequately grasp the economic realities we are witnessing today, we think a merger of these two subjects is required; in higher education as well as in macro analysis. Further, when that more comprehensive view of the economy is married to sound analysis from a range of other fields, such as demography for instance, only then can an investor more appropriately assess the many unprecedented influences that dominate today’s investment landscape.

Learning lessons from Economics, Finance, and other disciplines

Recently, for many market observers, historic rate rallies, ongoing trade tensions and an inversion of the U.S. Treasury yield curve spawned feverish speculation that a U.S., or global, recession is looming. A student in the Economics department would likely argue that the solution to recession fears is to lower global policy rate levels in order to “pull forward” demand, encourage more consumption, or incentivize borrowing for corporate expansion. The flaw in this reasoning is that modern economic theory was developed during a time of unprecedented global demographic growth. When demographically-driven demand was naturally expanding, as it did impressively during the 20th Century, it was far easier to pull aggregate demand forward. In contrast, today’s more tepid demographic dynamics are mandating a more difficult economic growth path. Indeed, aggregate demand curves are shifting to the left today in some regions, meaning that policy makers now face a Herculean task when it comes to pulling demand forward because the equilibrium level of economic output is declining. As a result, we think it’s time to re-think our economic lessons and the “conventional” policy responses.

In our view, a more nuanced policy toolkit is necessary today, combining economics and finance curricula in ways that incentivize new capital investment. A borrower’s desire for incremental capital (to create capacity and invest for expansion) will be catalyzed by three possible drivers: 1) observable aggregate demand growth, 2) harvestable pricing power and 3) potential efficiency gains. Simply lowering interest rate costs only feeds the impulse to invest for growth if at least one of these drivers exists. In a world of aging demographics, aggregate demand growth is limited. At the same moment, technological innovation is destroying any potential for pricing power. Thus, policy makers today should focus on incentivizing investment in parts of the global economy that can actually generate systemic gains in efficiency.
As it pertains to systemic pricing power, just as demand curves are shifting to the left, supply curves are flattening and becoming more elastic (see graph), meaning that if lower policy rates could in fact pull future demand forward, prices would still struggle to rise in response. This transformation around supply curves is prevalent across both goods and services sectors, and is not solely a developed market phenomenon. Indeed, it’s quite clear that emerging economies today are completely skipping traditional commodity intensive industrial investments in favor of modern, capital-light and technology-heavy infrastructure. India, for example, is likely to skip the “landline” phase of telecommunication entirely, as the vast majority of its population goes straight from “no phone” to “smartphone,” precluding the need for investment in landline infrastructure and the ability of lower central bank rates to stimulate such investment.

If reductions in positive policy rates have lost effectiveness in stimulating investment, making negative interest rates more negative is actually counterproductive, in our view. The cost of debt has been persistently low, or negative, in Europe over the past year, and economic textbooks would suggest that leverage (i.e. credit creation) should have been increasing as companies take advantage of cheaper financing to invest in projects, or buy back stock. However, the opposite is occurring and companies are deleveraging instead. The exorbitant cost of European equity capital combined with dimming growth potential is leading to pervasive corporate retrenchment. Policy makers would be well served to incorporate the Capital Asset Pricing Model from finance theory lessons, and re-envision policy initiatives in ways that seek to optimize the systemic weighted-average-cost-of-capital (WACC) as well as raise the European-wide growth potential. Successful initiatives such as these would not only stimulate domestic demand but attract foreign investment as well, leading to a further virtuous improvement in the WACC, and could create even more growth opportunities.

Finally, contemporary financial theory teaches the importance of ensuring adequate liquidity to prevent sudden adverse shocks from becoming existential. Given the dominance of the financial economy today, we are steadfast in our belief that effective monetary policy must create sufficient global liquidity as a necessary compliment to interest rate and fiscal policy. Since early 2018, the combined policies of the world’s major central banks have severely diminished the previously buoyant liquidity levels that had been an instrumental influence in pulling the global economy from the depths of the Global Financial Crisis over the past decade. But now that the Fed has ceased its balance sheet runoff, just as the ECB resumes asset purchases, we are hopeful the global liquidity paradigm can inflect positively and begin to positively impact the nascent rate-cutting cycle proliferating across the globe now.

**Investment implications**

So, what does all this mean for investors? Until fiscal and monetary policy develop into a 21st Century model that more effectively can combine the lessons learned from both economics and finance, we think investors would be best served by focusing on durable income, and growth-oriented entities, which can generate the cash flows required to meet return targets. So, we are discarding risk in lower-quality, and less dynamic, economic entities, like we’d throw out an obsolete textbook, and instead we’re favoring front-end duration and quality income that continue to work as central banks react to

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*Source: BlackRock, as of September 2019. Illustrative purposes only.*
adverse economic conditions through the interest rate channel, or quantitative easing. Moreover, we’re aiming to position in the equities of companies that consistently invest to generate return-on-assets (ROA) that exceed their WACC, an investment factor that might be appropriately labeled the “success” factor – transcending the more generic factor labels like “growth” or “momentum.”

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