Quarterly Point of View
First, Do No Harm

January 12, 2022

Years of easy money and never-ending monetary stimulus are working to undermine the characteristics and sustainability of free-market capitalism. We've written often in the past of our concern that the Federal Reserve has been overstepping its dual mandate – that of a safe and stable monetary system and maximum employment – and have, on an ever-more frequent basis, intervened to support the capital markets under the guise of meeting its two goals.

In the spring of 2016, we used the following analogy regarding hyper-accommodative Fed policies, still in place seven years after the Global Financial Crisis (GFC):

> *Recovering from major surgery is a process that takes time, and pain associated with a surgical procedure often requires the prescription of pain killers. Pain can interfere with a patient's ability to participate in recuperative activities, such as deep breathing and walking, which help prevent complications that could delay a recovery, or prevent it altogether. The goal with any treatment utilizing pain killers in recovery, however, is to taper as quickly as the patient's physical and emotional state allows - not to foster a condition where the substance becomes a necessary and permanent part of life. Side effects can create problems, at times worse than the original issue for which surgery was required.*

The Fed never tapered the market 'patient' off the painkillers prescribed during the GFC. As another crisis unfolded a dozen years later, this time the COVID-19 global pandemic, a colossal round of additional 'medication' was administered, and with it an expanding list of deleterious side effects.

Constant government intervention, chiefly in the form of artificially low interest rates carried out through ZIRP and QE (Zero Interest Rate Policy and Quantitative Easing), has created some significant side-effect risks, in our view. The first is that 'free money' has invited an extreme degree of speculation and distorted decision making, creating bubbles in pockets of multiple financial markets. Secondly, it has generated an immense level of moral hazard, as market participants continually lack incentive to guard against risks, believing they will ultimately be 'backstopped' by the Fed. Both conditions foster genuine structural risks.

There is another side effect to these policies, however, that doesn't get the attention it deserves, yet poses significant challenges to our economic system, and to society. It's been argued by some for years that low interest rate policies were necessary to lift those on the lower rungs of the socio-economic ladder. While loose policy and easy money have likely helped create upward wage pressure in lower-income segments of employment recently, the weight of overall evidence indicates the opposite has happened with wealth across socio-economic groups – inequality has widened dramatically.

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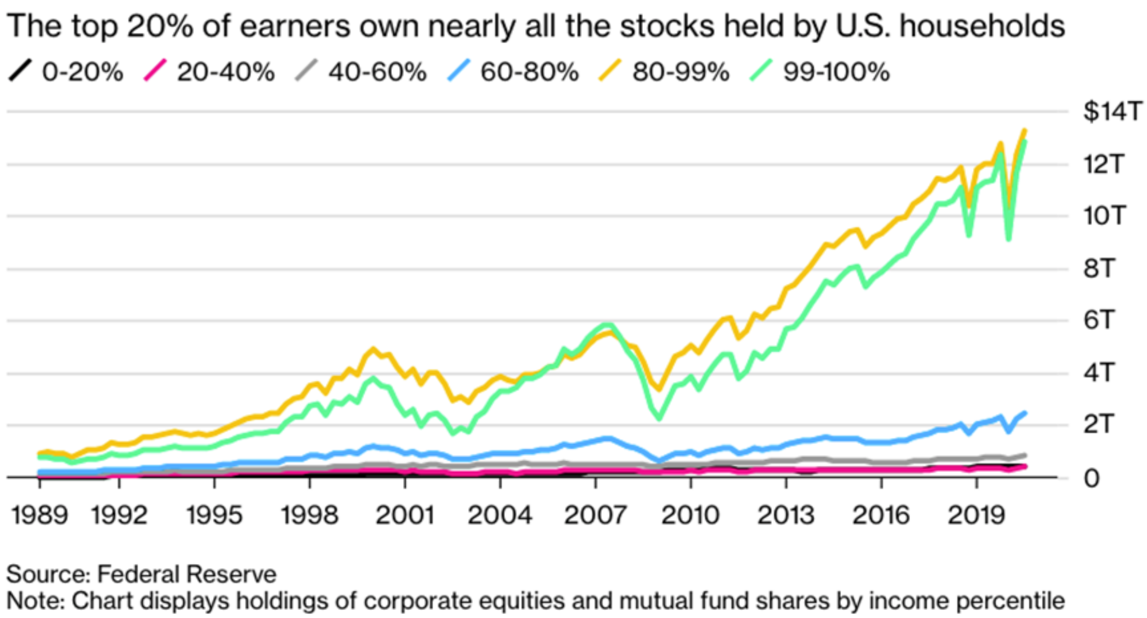

As the chart above illustrates, the highest 20% of American households by income own the vast majority of all U.S. stocks – and the wealth from those assets has accelerated at a jarring pace since the Global Financial Crisis – when massive monetary stimulus became the norm. The bottom 80% have hardly benefitted on a relative basis.[1]

Reinforcing that evidence, the total worth of the top 400 wealthiest Americans reached almost 20% of total U.S. GDP in May of last year. This figure is up from less than 10% at the start of the previous decade, and just 3% in the mid-1980's.[2] The rich have gotten exponentially richer, and it has come during an age that the Federal Reserve has become ever more active with 'stimulus', purported to help all.

The impact of ultra-low-rate Fed policy is felt beyond the stock market and is clearly evident when examining the income generated from the average savings account. When I entered the business in 1996, someone with $100,000 deposited in a money-market savings account was earning roughly $5,000 a year in interest. Today, that same saver is earning just $70, annually.[3] What's more alarming is what this means on a 'real' (after inflation) basis. Given that Core CPI is currently running at 5.5%, a saver is now witnessing a $5,430 per year deterioration in the purchasing power of that account.

Middle and lower-income Americans have therefore been squeezed disproportionately, in both directions, by monetary policy of the last few decades. They did not own the risk assets that benefitted the most in the first place, and any assistance from assets they may have had in savings vehicles were then crushed by interest income that declined to virtually zero – even negative in real terms.

Acting in tandem with other factors, these issues have contributed to inflamed social resentment over the expanding inequalities in income and wealth. In a study by Cambridge University and the Bennett Institute for Public Policy, a growing disillusionment with this form of capitalism led polling to show – for the first time on record – that a majority of Americans say they are dissatisfied with their system of government.[4]

This dissatisfaction cannot be considered lightly, as it undermines the strength and resilience of our economic system, not to mention society broadly. The growing practice of government intervention has given rise to a generation of Americans that view the system as one of crony capitalism, or even socialism for the rich and powerful. This has served to weaken our free market system, not strengthen it. However unintended the side effects of Fed policy may be, speculative bubbles and moral hazard are genuine risks to stability, and when rapidly rising wealth inequality is added to the mix, it creates a much more fragile system.

These are big issues with no easy solution. Undoubtedly, any government attempt to 'fix' with policy, will likely only serve to make matters worse, creating additional undesirable 'side-effects.' Considering our medical analogy again, I'm reminded of the Hippocratic Oath historically taken by physicians, which emphasizes, "First, do no harm." The Federal Reserve needs to urgently consider this ethic.

Those in leadership would be wise to return to foundational concepts of capitalism, succinctly voiced here by author and political analyst, Yuval Levin:

> *Properly understood, the case for capitalism is not a case for license or for laissez faire. It is a case for national wealth as a moral good; for the interest of the mass of consumers as the guide of policy; For clear and uniform rules of competition imposed upon all; for letting markets set prices, letting buyers make choices, and letting producers experiment, innovate, and make what they think they can sell – all while protecting consumers and punishing abuses. It is a case for avoiding concentrations of power, for keeping business and government separate, and for letting those who can meet their own needs to do so. It is a case for humility about our ability to know, and therefore about our capacity to do.*[5]

As we look to exit this latest crisis, the Fed and government authorities need to soberly reassess the efficacy of their policies, looking instead toward a return to business and market fundamentals unmarred by constant intervention.

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Respectfully,

Cameron K Martin
Chief Investment Officer
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1. Bloomberg, 1/17/2021
2. The Rise in Income and Wealth Inequality in America, Saez & Zucman, 2020.
3. JPMorgan Guide to the Markets, 12/31/2021.
4. Financial Times, 7/24/2020.
5. There's No Free Lunch, 250 Economic Truths, David L. Bahnsen, 2021.

Statistical and analytical data provided by Factset.

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