The Cost of Capital Will Be higher in 2021 Because the Growth in Money and Credit Will Likely Fuel a Jump in Inflation, Not Real Economic Growth

By

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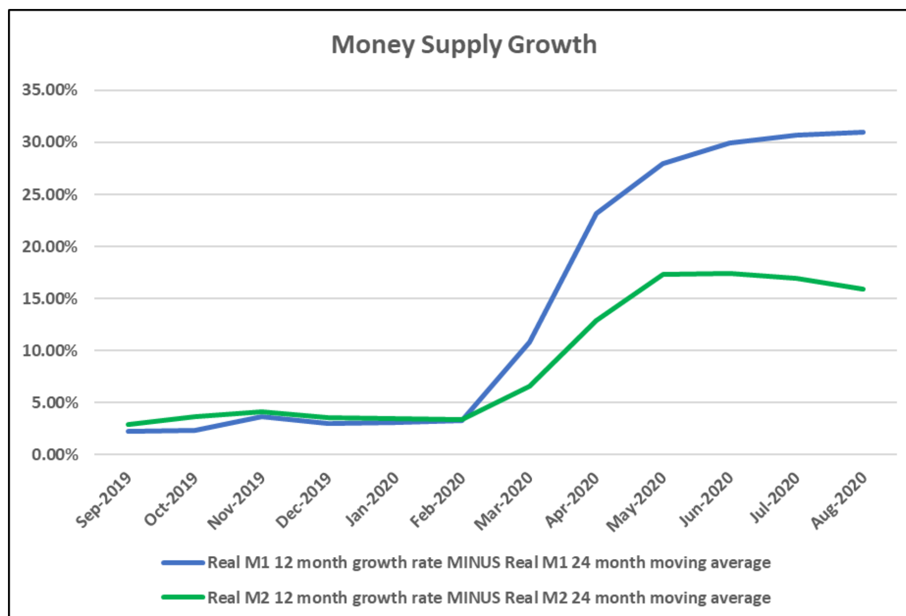
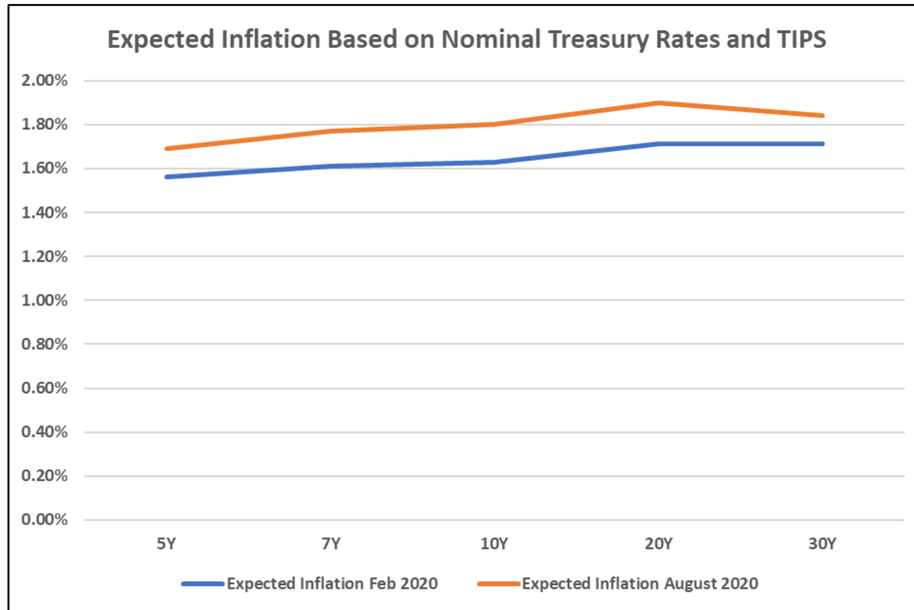
The Fed has driven down interest rates to the lowest levels in history. Fiscal policy is the most expansive it has been in the post-war period. All of this is done for good reason: keep the economy afloat until the pandemic runs its course. But I am not sure that market participants are sufficiently sensitized to the inflationary implications of the monetary and fiscal stimulus double whammy. Below is the growth in money-M1 and M2- in real terms. I express the growth as the difference from its 24-month moving average in order to show the magnitude of the shift in Fed policy.



I have been watching these measures for more years than I care to admit to, and I have never seen such an explosion in real money balances. Normally this would not have near-term inflationary repercussions since during periods of economic weakness there is excess productive capacity to meet incremental demand. However, this time is different; idle productive capacity cannot be fully accessed, and global supply chains have been compromised. This means that incremental demand driven by both monetary and fiscal stimulus does not result in more output but rather a queued up- extended wait times- which will eventually result in a bump up- and perhaps a significant bump up- in inflation . But market participants do not expect this as a comparison between the pre-pandemic inflation yield curve and the current inflation yield curve indicate.



If I am right, what all this means is that long-term interest rates will rise. While the Fed will certainly try to moderate the increase and politicians talk the fear of inflation down, market participants will do what they always do- look at the data and evaluate whether inflation risk has increased and to the extent they believe that it has, they will reprice risky assets accordingly. The cost of capital will rise. The Fed will then be faced with a Hobson’s choice- keep monetary growth on its expansive path in the hope that the inflation spurt is short-lived or restrain monetary growth significantly lifting short rates. In either case the cost of capital will rise, and valuations will likely decline.