White Paper Report
The ABCs of the Easy Money Regime

As inflation has soared to multi-decade highs, global central banks are frantically raising interest rates and reversing a multi decade long regime of easy money and negative interest rates. Investors have felt the pain of this abrupt paradigm shift. Global equities as measured by the MSCI AC World Index have lost almost $20 trillion worth of market cap since January (2022).[1] That is roughly the equivalent of wiping the size of the U.S. economy off the map! The global bond market has lost ~$10 trillion in market value and as central banks are raising interest rates, the amount of negative yielding debt around the world has fallen 90% (from $18 trillion to just under $2 trillion) **(Chart 1 – next page).**[2] Lastly, the party is over for investments inflated by speculation and years of excess liquidity (e.g., Bitcoin is down nearly 70%).[1]

In this white paper we will help investors understand the abrupt end to this easy monetary policy regime. We will address the origins and causes of the decades long period of easy money, the effect it has had on investments, risk appetite and speculation. Finally, we will explain why it is rapidly changing this year and how we are suggesting dealing with the negative fallout in investors' portfolios as global central banks unwind this regime.

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Past performance is not indicative of future returns

Chart 1

Amount of Negative Yielding Debt Plummeting

Estimate Data as of June 17, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

A.

Understanding the Origins of the Easy Money Regime

To understand why the global economy was able to get away with such accommodative policy for so many decades, one can go back to an eerily similar time. The inflation era of the 1970s and 1980s. The aggressive actions to decimate the double-digit inflation of the 1970s and 1980s caused at least three recessions (1973-1975, 1980, 1981-1982). Eventually the Fed's persistent rate hikes conquered that inflation regime and the U.S. settled into a more reasonable level of price stability. As a result, it also started a 40+ year bull market in bonds as interest rates fell alongside inflation (yields falling = prices rising). **(Chart 2 – next page).**

In the decades to follow, technological advancements and innovation, globalization (which led to global price and wage competition), weaker demographics (aging baby boomers,) and the diminishing presence of labor unions (which reduced wage pressures) caused the overall growth in inflation to slow. While central banks had to tweak monetary policy along the way when things overheated, by-and-large the slower level of inflation allowed for the real interest rate environment to become more and more accommodative over the past few decades. **(Chart 3 – next page).**

Take all those factors and then throw in one of the most complex economic recessions since the Great Depression, the Great Recession of 2007-2009. That recession and the collapse in the global economy whipsawed central bankers who went from enjoying decades of price stability to having to combat something completely unexpected: the fateful risk of deflation (i.e., an actual decline in prices). The Great Recession was a turning point in the global interest rate environment and central bank policy. To avoid a global depression, a collapse of the banking system and a deflationary spiral, the Federal Reserve and many other central banks around the world cut their benchmark rates to zero (in some instances implementing a negative interest rate policy) and were forced to apply emergency policy measures that had never been used before. This included "printing money" through expanding their balance sheets, otherwise known as quantitative easing (QE). In its simplest form, quantitative easing is a nontraditional monetary policy tool which allows a central bank to make large scale purchases of financial assets by creating bank reserves on their balance sheet. With those reserves they buy assets off a bank's balance sheet to free up money for them to lend and ultimately stimulate the economy. The goal is to avoid deflation (which is dangerous and very arduous to recover from) as the money supply increases. The Fed was successful in increasing the money supply but the money that was printed did not filter into the economy the way that it was intended to. Instead, it was used to shore up banks. Subsequent strict banking regulations in the aftermath of the Great Recession coupled with consumers' unwillingness to take on debt limited the ability for the money to move through the economy. Therefore, inflation and even economic growth remained muted and central banks were able to keep interest rates near historic lows for the decade to follow.

Chart 2

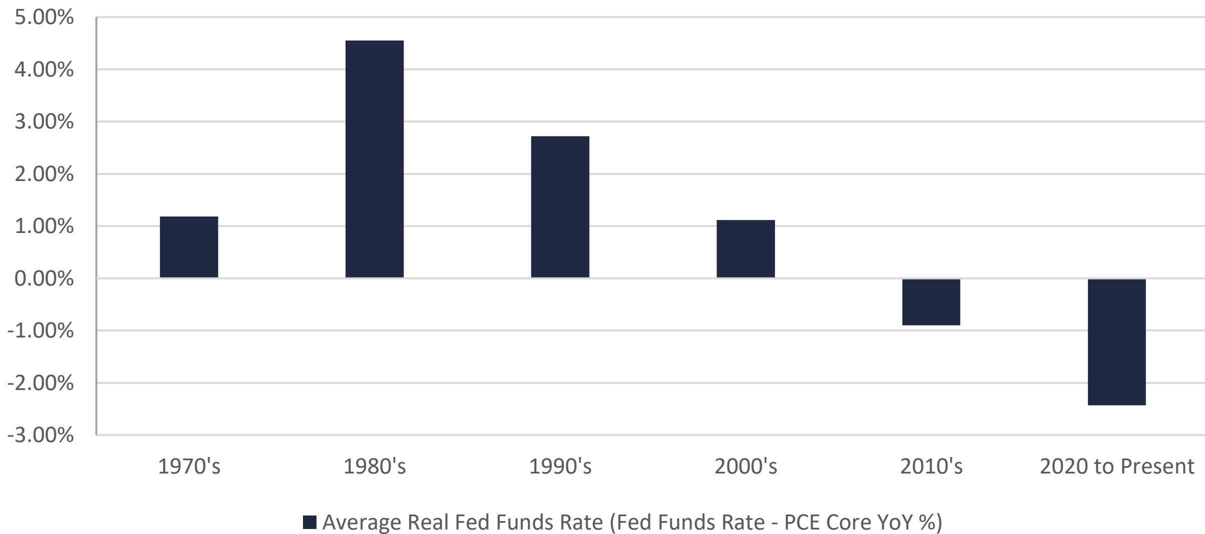
Multi-Decade Long Bond Bull Market

Data as of June 14, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 3

Years of Accommodative Monetary Policy

Estimate data is average for each time and 2020 to present is through May 2022. PCE means Personal Consumption Expenditure. Source: Bloomberg Finance LP, Verdence Capital Advisors.



B.

Understanding the Result of the Easy Money in the Economy and Asset Classes

Companies and households have taken advantage of this low interest rate regime. Companies restructured balance sheets to reduce higher interest rate debt, bought back equity shares, improved profit margins and increased dividends. Households paid down debt and drove the household debt service ratio to a record low. **(Chart 4 – next page).** They purchased homes and automobiles with record low financing.

From an investment perspective, historically low bond yields fueled risk taking by investors to achieve attractive returns and income. Part of this risk taking was in paying premium prices for companies that could deliver attractive earnings growth in a low economic growth and low inflationary environment, primarily large cap mega technology and growth companies. The price to earnings multiple, or the amount of money an investor is willing to pay for each dollar of earnings growth, rose to excessive levels as investors chased returns. The P/E multiple on the heavily growth weighted S&P 500 Index rose to levels not seen since the dotcom bubble. **(Chart 5 – next page).**

Investors also plowed money into high yielding fixed income to get yield in their portfolios, often sacrificing credit quality. As a result, the extra yield investors earned to own high yield debt compared to Treasuries sank to levels not seen since before the Great Recession. Beyond creating a bubble in select areas of the equity (e.g., growth and tech) and bond markets, the evolving financial markets found new ways to capture the speculative frenzy. The rise of crypto currencies, non-fungible tokens (NFTs), blank check companies and other “get rich quick” schemes came about simply because their basis for valuation was the misperception that prices would most certainly keep going higher.

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Chart 4

Households Take Advantage of Easy Money

Data is as of 4Q21. Household debt service ratio is the total required household debt payments to disposable income. Source: Bloomberg Finance LP, Verdence Capital Advisors.

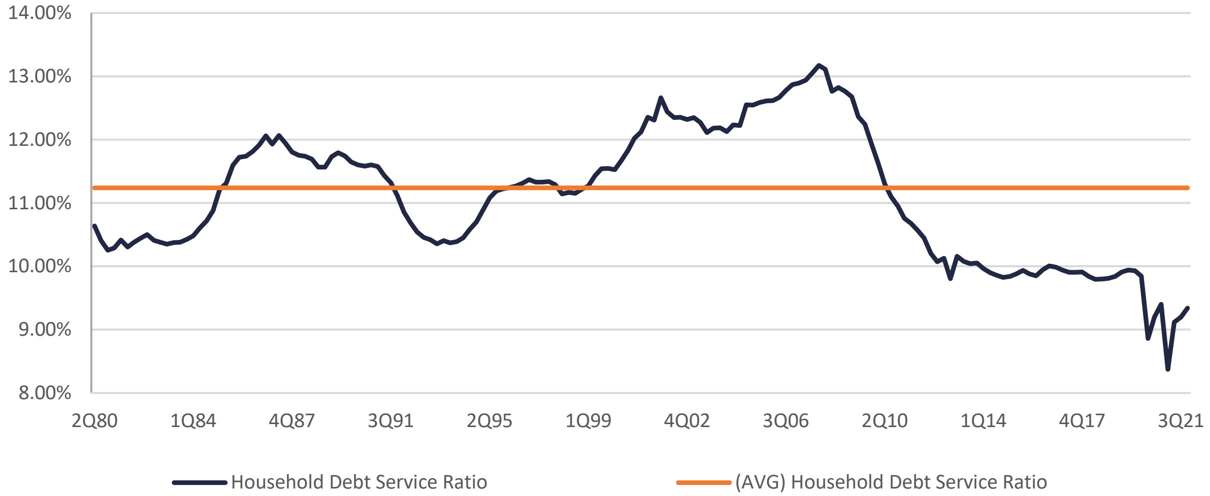

Chart 5

Equity Valuations Rise to Levels Not Seen Since the Dotcom Bubble

Data is as of June 15, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

C.

Understanding Why Central Banks are Reversing the Decades Old Regime of Easy Money Now

Now knowing why we have had such accommodative policy let's turn our attention to the global pivot towards removing this easy money. The answer is relatively simple, we finally have inflation. The magnitude of stimulus from not only monetary policy but also fiscal policy that was implemented in the aftermath of the COVID pandemic makes the stimulus in the aftermath of the Great Recession look like a blip on the radar. **(Chart 6).** Policy on so many levels during the pandemic is proving to have dangerous ramifications. To be fair, we were in unchartered territory and unfortunately decisions had to be made in a rapid manner from a public health perspective. However, shutting down a global economy, handing out stimulus checks to keep people indoors and driving interest rates to historically low levels has had disastrous repercussions. The supply chain remains in disarray, fueling inflation while the massive increase in the money supply has resulted in too much money chasing too few goods. As a result, we are dealing with inflation running at multi-decade highs. **(Chart 7 – next page).** To make it worse, the brutal war between Russia and Ukraine that started earlier this year left central bankers apprehensive to act earlier and are now finding themselves having to be more aggressive in a shorter time frame than they had anticipated. As a result, we are seeing the decade's old regime of easy money unwind. Central banks around the world are rapidly raising interest rates and yields on bonds are rising in unison.

Chart 6

Money Supply Increase Makes 2008 Look Like Nothing

Data is as of June 15, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

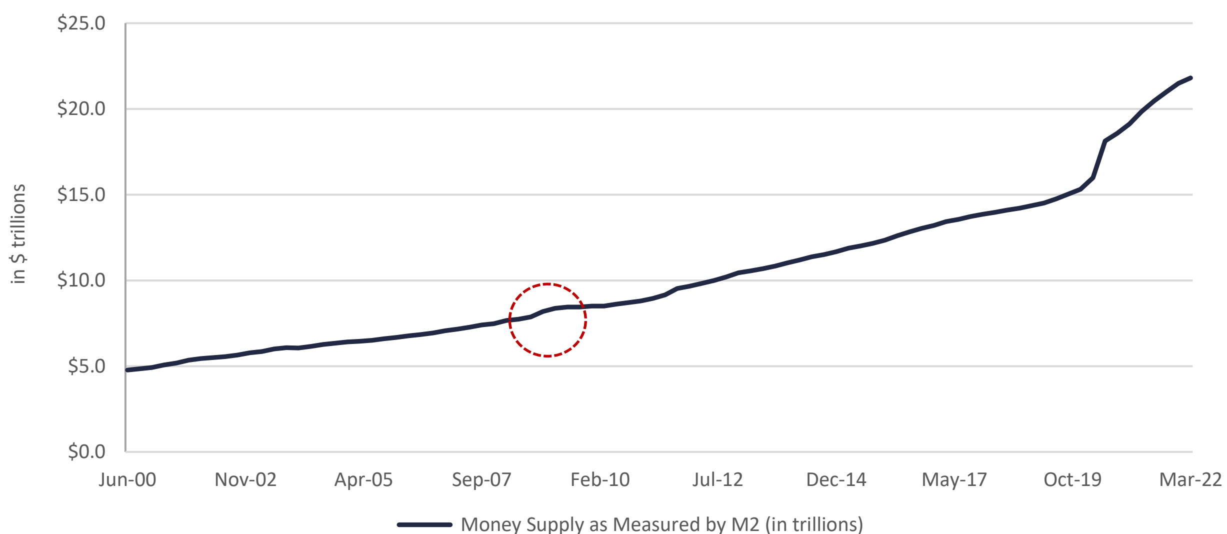

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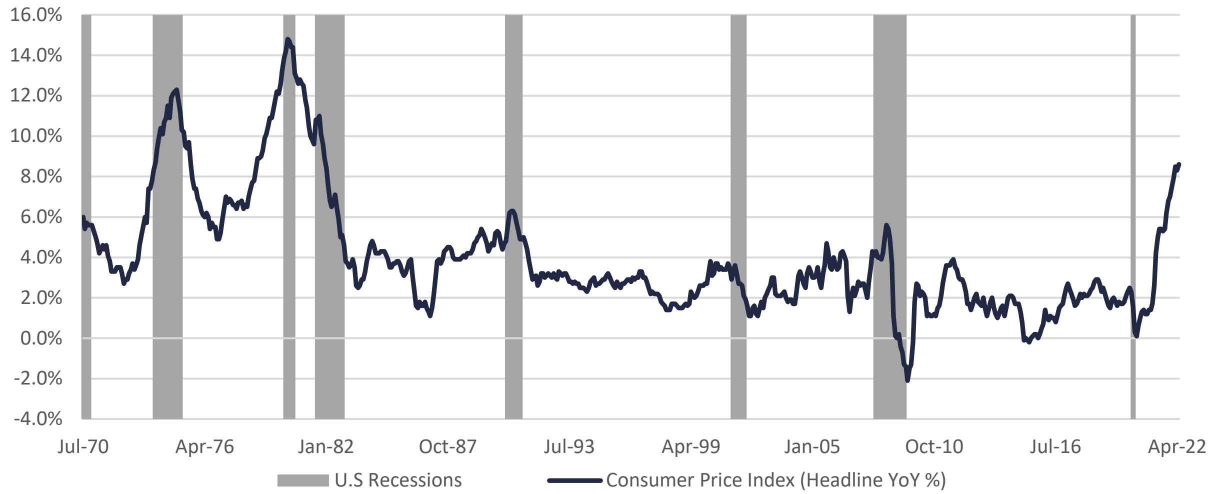
Chart 7

Inflation Running at Multi-Decade Highs

Data is as of May 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Our View

Unfortunately, most of the investments that flourished under the decade's old regime of easy money have fallen dramatically this year and face the possibility of more downside. Especially those with unrealistic valuations (e.g., mega cap technology), highly speculative investments (e.g., cryptocurrency) and those that rallied on false perceptions that the world would never return to normal after COVID (e.g., stay at home stocks). In addition, the 40+ year bull market in bonds is over and fixed income investors are dealing with equity-like losses in their bond portfolios (double digit declines to start the year).

Central bank tightening cycles and recessions are part of any long-term investing cycle. Unfortunately, bear markets are also a normal part of investing. We understand a bear market can be unnerving while we are in it, but history has proven that often in the depths of the bear market opportunities are found. There will be companies and sectors that are unfairly penalized as analysts struggle to assess what the earnings environment will look like in this new interest rate regime. We believe this is where active management will do better than passive investing. Focusing on fundamentals like cash flow, a company's cost of capital and earnings potential will be important as we navigate through what higher rates mean for the economy and corporate margins. We continue to favor equities over bonds and are gradually putting dry power to work in areas of the market that may be reflecting the negative effect of higher interest rates and growing risk of a recession (e.g., small, and midcap stocks as well as international), those that have pricing power and can even benefit from higher interest rates (e.g., value sectors).

If you have any questions or concerns, please feel free to reach out to your financial advisor.

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1. All return data mentioned is as of June 17, 2022.
2. Using the Bloomberg Global Aggregate Index as of June 17, 2022 for market loss.

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