The Fed has surrendered, and here's what comes next

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the towel, and central banks are committed to defying the business cycle. But where does this leave us in terms of positioning for 2019, 2020 and beyond?

If you are familiar with my research over the last 20 years, you know that I am no fan of central banks; they are glorified bureaucrats with an academic sense of infallibility who believe they have a supreme power's insight into the economy and markets. But yesterday marked a new low for world central bankers as the US Federal Open Market Committee completely threw in the towel.

Anyone who ever thought the Fed or other central banks are truly 'independent' should spend $20 on the great 2018 Paul Volcker book "**Keeping at It**". In it, Volcker tells the story of how both Jimmy Carter and Ronald Reagan tried (with partial success) to force easing on him and the Fed in the 1980s.

(Also have a look at Nixon and his relationship with **Volcker's predecessor as Fed chair, Arthur Burns**...)

Current chair Jerome Powell saw himself as a new Volcker, but last night he cemented his panicky shift since the December FOMC meeting, and instead cut the figure of Alan "the Maestro" Greenspan, who set our whole sorry era of central bank serial bubble blowing in motion.

The Fed's mission ever since has been a determined exercise in defying the business cycle, and replacing it with an ever-expanding credit cycle.

This latest FOMC meeting has set in motion a race to the bottom, with the European Central bank currently in the lead, but the Fed and the Bank of England are gaining fast.

I am presently in London, and on my way to China and Hong Kong with **Saxo's Gateway to China events**. I am joined at these events by the impressive Dr. Charles Su of CIB Research, China. He and I agree on many things, but one in particular:

Monetary policy is dead.

My view has long been that monetary policy is misguided and unproductive, but the difference now is that we are reaching the most major inflection point since the global financial crisis as central bank policy medicine rapidly loses what little potency it had. In the meantime, the harm to the patient has only been adding up: the economic system is suffering fatigue from QE-driven inequality, malinvestment, a lack of productivity, never-ending cheap money and a *total lack of accountability*.

The next policy steps will see central banks operating as mere auxiliaries to governments' fiscal impulse. The policy framework is dressed up as "Modern Monetary Theory", and it will be arriving soon and in force, perhaps after a summer of non-improvement or worse to the current economic landscape. What would this mean? No real improvement in data, a credit impulse too weak and small to do anything but to stabilise said data and a geopolitical agenda that continues to move away from a multilateral framework and devolves into a range of haphazard nationalistic agendas.

For the record, MMT is neither modern, monetary nor a theory. It is a the political narrative for use by central bankers and politicians alike. The orthodox version of MMT aims to maintain full employment as its prime policy objective, with tax rates modulated to cool off any inflation threat that comes from spending beyond revenue constraints (in MMT, a government doesn't have to worry about balanced budgets, as the central bank is merely there to maintain targeted interest rates all along the curve if necessary).

Most importantly, however, MMT is the natural policy response to the imbalances of QE and to the cries of populists. Given the rise of Trumpism and democratic socialism in the US and populist revolts of all stripes across Europe, we know that when budget talks start in May (in Europe, after the Parliamentary elections) and October (in the US), governments around the world will be talking up the MMT agenda: infrastructure investment, reducing inequality, and reforming the tax code to favour more employment at the low end.

We also know that the labour market is very tight as it is and if there is another push on fiscal spending, the supply of labour and resources will come up short. Tor Svelland of Svelland Capital, who joins Charles and I at the Gateway to China event, has made exactly this point. The assumption of a continuous flow of resources stands at odds with the reality of massive underinvestment.

Central bankers and indirect politicians are hoping/wishing for inflation, and in 2020 they will get it – in spades. Unfortunately, it will be the wrong kind: headline inflation with no real growth or productivity. A repeat of the 1970s, maybe?

Get ready for bigger government and massive policy interventions on a new level and of a new nature. These will be driven by a fiscal impulse to stimulate demand rather than to pump up asset prices. It will lead to stagflation of either the light or even the heavy type, depending on how far MMT is taken. With all of these '70s throwbacks preparing to take the stage, we can't help but wonder if '**Paul Breitner hair**' is ready for a comeback as well!

Last night, a client asked an excellent question: how much of this scenario is already priced in? Here is my take: Saxo's macro theme since December has been the coming **global policy panic**, and this has now been fully realised. The Fed proved slower to cave than even the ECB, but last night saw them give up entirely. The US-China trade deal, another key uncertainty, is priced for perfection despite plenty of things that can go wrong.

The Brexit deal, however, is extremely mispriced. The UK's biggest challenge may not even be the circus act known as Brexit, but rather the collapsing UK credit cycle which our economist Christopher Dembik has put at risking a 2% drop in UK GDP. If nothing changes over the next six to nine months, and nothing will change, the UK economy will be in free fall. Forget Brexit, UK assets are simply mispriced from the lack of credit juice in the pipeline.

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China is also misunderstood and mispriced. If our two talks so far with clients on China and its opening up of its markets have taught me anything, it is that the western 'reservation' on anything Chinese is entirely built on bias. Governance is the word that keeps coming back in discussions. I am no fan of Chinese-style governance, but... less than 10% of global AUM is currently in China. This year alone will see the inclusion of China's bonds in global indices like Barclays, Russell, and S&P and the allocation to China in the MSCI's emerging markets index will quadruple from 5% to 20%. The overall China-bound inflow over the next three to five years will exceed $1 trillion using very conservative estimates.

China is perhaps *the* country in the world least likely to treat inbound capital poorly. It has transitioned from being a capital exporter to now being an importer. It has a semi-closed capital account, which means little money flows out, but a massive inflow is beginning to stream in as global investors acquire Chinese assets.

China and its growth model now need to share the burden of becoming an industrialised country, and Beijing knows that only the only way keep the capital flowing in 2019 is to treat investors well. On the domestic front, meanwhile, the CPC seems to be signaling that it wants domestic investors to move excess savings from the 'frothy' and less productive housing market to the equity market, where capital can flow to more productive enterprises. Foreign investors are more likely to want to participate in the more liquid and familiar equity market.

2019 for China is like 2018 for the US. The first 10 months of 2018 saw the US stock market near-entirely driven by the buy-back programmes fueled by Trump's tax reform. US companies plowed over $1 trillion into buybacks over the year. This year, the Chinese government is telling its 90 million domestic retail investors to raise their allocation to the stock market while global capital allocators/investors will need to increase their exposure to China as its capital markets are reweighted.

But where does this leave me on asset allocation at the moment?

Equities: the Fed, ECB, BOE and BOJ have all given up because they only believe in credit cycles. The price of money going down is not enough for growth as it's only the second derivative of the growth engine; the first derivative is quantity of money. This is stabilising but because of base effects (a very high starting point), it will not be enough. For now, however, the market is euphoric due to the usual lack of integrity from merry bureaucrats. A new high could be on the cards, but... slowly change overweight to China from the US mainly, but also MSCI.

Fixed income: 250 bps in 10-year maturities... where are all the sell side analysts calling for 400 bps? The FOMC panic took out the 260 bps floor – is 200 next? Probably. Observe how the two/10-year yield curve is now attacking 10 bps. My economic studies really only taught me three useful things (but then, I'm a terrible economist):

• The yield curve is never wrong.
• Say's law (supply creates its own demand).
• Productivity is everything.

An inversion of the 2/10 is coming, I don't see 200 bps before the late summer, however, when concern about the lack of growth overtakes the global policy panic in place.

Commodities: it's all structural – Tor Svelland taught me that. We like all commodities, especially all sectors that have a foot in infrastructure. This is due to the coming of MMT, partly, but its mainly due to widespread underinvestment.

Cash: love it!

Forex: Underweight the two credit monsters: GBP and AUD. Overweight the US dollar, NOK, CHF, JPY. I like carry (for the summer) in TRY, ZAR and BRL.

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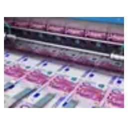

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