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MARKET INSIGHTS

James Thorne, *Chief Market Strategist*

WELLINGTON-ALTUS

MONEY FOR NOTHING:

The Illusion of Easy Wealth in Today's Economy

There are moments in life that leave a lasting impression. For me, two significant memories from the 1985 Live Aid concert stand out: Queen's iconic performance and Dire Straits, featuring Sting, introducing the world to their classic song *Money for Nothing*. Since the late 1980s, following Japan's economic miracle, the idea of creating "money for nothing" has become a go-to strategy for many involved in crafting fiscal policy. However, this tactic ultimately solves nothing. Should investors be concerned?

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> That ain't workin', that's the way you do it; Money for nothing and your chicks for free.
>
> \- Dire Straits

For more insights from James Thorne, please visit wellington-altus.ca/market-insights
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My investing philosophy is straightforward: central bankers look to the past, the consensus focuses on the present, but investors must look five to six quarters into the future. Ultimately, interest rates and global liquidity will dictate how investors should position their portfolios. With global debt levels not seen since the Napoleonic Wars and monetary policies constraining the private sector, we are entering a new era where policymakers may once again embrace the notion of "money for nothing."

Just as a worn-out record player needle skips and scratches across a vinyl disc played too many times, policymakers repeated fiscal irresponsibility will eventually cause the credit market to revolt, distorting the economic melody and potentially bringing the financial symphony to a discordant halt. Investors should be prepared. In 2025, a fiscal crisis awaits if policymakers do not address the elephant in the room—unsustainable fiscal spending. Yes, a Liz Truss moment[1] is a significant tail risk, and it's folly for investors and policymakers to assume otherwise.

The Mirage of Monetary Magic

Our current economy, marked by extreme fiscal deficits, resembles a wartime economy. As we approach the upcoming U.S. presidential election, investors anticipate a switch back to a peacetime economy. Some believe this transition can be eased by the U.S. Federal Reserve's "easy money" policies, speaking with a certainty that suggests they're reading from an economic prophecy. Yet, like promises of "money for nothing" in that iconic Dire Straits song, their predictions dance around the truth—glamorous, catchy, but ultimately hollow.

In his recent address, U.S. Federal Reserve Chair Jerome Powell painted an economic picture that, while superficially impressive, fails under scrutiny. Powell's portrayal suggests a perfect balance: a labour market soft landing, inflation tamed to 2.2 per cent, and the dual mandate fulfilled. However, this narrative glosses over the underlying fragilities and distortions in the economic fabric. It's as if he's singing a sweet tune, while the band plays on, oblivious to the cracks forming beneath the stage.

The 0.5 percentage point cut in the federal funds rate (FFR), along with hints of future reductions, is presented as a calculated move. However, it raises questions about the Federal Reserve's foresight and timing. The central bank's playbook suggests the FFR should match the natural rate (r*), currently estimated at 2.75 per cent. This implies the Federal Reserve may still be too tight, potentially stifling economic growth. It feels like a high-stakes game of musical chairs, and when the music stops, will anyone be left standing?

Notably absent from Powell's address was any meaningful discussion of the alarming fiscal situation. The projected 25 per cent growth in the fiscal deficit for 2024 and a debt-to-gross domestic product (GDP) ratio of 125 per cent evoke wartime economics. This level of spending is unsustainable and will likely need addressing post-election, one way or another. I differ from the consensus—the level of fiscal irresponsibility will be dealt with, if not by the new administration, then by credit markets creating a Liz Truss moment in the U.S. The U.K.'s recent austerity budget serves as a canary in the coal mine, warning of potential credit market revolts if fiscal issues remain unaddressed. It's a financial reality check that hits harder than a guitar riff!

The Japan Paradox and China's Monetary Mirage

Japan's economic journey over the last few decades starkly contrasts the claims of monetary policy enthusiasts. Despite one of the highest debt-to-GDP ratios globally and near-zero interest rates for decades, Japan has struggled with low inflation and sluggish growth. This paradox challenges the conventional wisdom that loose monetary policy is a cure-all for economic ills—it's like trying to find a hit song in a sea of karaoke flops!

Recent developments in China further underscore the limitations of monetary policy. Despite launching bold stimulus packages and lowering interest rates, China grapples with deflationary pressures and economic challenges. This highlights that monetary policy alone cannot generate sustained economic growth amid structural issues. It's a reminder that you

[1] In 2022, U.K. Prime Minister Liz Truss announced a series of underfunded tax cuts that triggered a drastic drop in the British Pound, skyrocketing government borrowing costs, and a revolt in credit markets, resulting in her resignation after 45 days in office.

can't just throw money at a problem and expect it to miraculously transform into something spectacular.

The Four Horsemen of Deflation

While many focus on the potential of monetary policy, they overlook what we call "the four horsemen of deflation," which are excess capacity, extreme debt levels, demographics, and innovation. These forces form solid foundations beneath our economic landscape—foundations that monetary policy alone cannot overcome.

Current economic stability is largely propped up by unsustainable fiscal spending. The private sector shows signs of strain, obscured by government expenditure levels typical of national emergencies. As fiscal spending inevitably contracts post-election, the true state of the private sector and the broader economy will come to light. The potential for a delayed but significant economic downturn in late 2025 remains a serious concern. It's like waiting for the encore at a concert—exciting, because you know a big drop is coming!

The Imperative of Structural Reforms

The key lesson from Japan and China's experiences is the necessity of comprehensive structural reforms alongside monetary policy. These may include addressing bad debts, reforming labour markets, improving corporate governance, and enhancing productivity and innovation. Monetary policy, while important, is no substitute for these crucial reforms.

The election of Shigeru Ishiba as Japan's new Prime Minister marks a significant shift away from the monetary-focused policies of former Prime Minister Shinzo Abe's "Abenomics." Ishiba's willingness to tackle structural reforms reflects a recognition that "easy money" alone is insufficient. His approach could provide new insights into managing a high-debt, low-inflation economy beyond the limitations of monetary policy. It's like trading your old guitar for a shiny new model—time to strum a different tune!

Building on Solid Ground

As we transition from a wartime-like economy to a peacetime economy, it's crucial to dismantle the castles in the air built by monetary policy enthusiasts. We must rebuild our understanding on the solid ground of historical evidence and economic reality. Loose monetary policy does not guarantee economic prosperity or high inflation. Historical evidence suggests a more intricate relationship between monetary policy, debt, economic growth, and inflation.

Moving forward, policymakers must resist the temptation to be swayed by the grand but unsupported promises of monetary magic. Instead, they should focus on crafting nuanced policies that account for this complexity. The key to managing our economic challenges lies in a combination of factors: gradual fiscal consolidation, maintaining central bank independence and credibility, implementing structural reforms, and leveraging global economic forces. Negative real interest rates and increased money supply can be tools in this process, but they are not all-encompassing solutions. After all, just like the song suggests, real success requires effort—not just dreams of "money for nothing."

Investment Implications

While the Federal Reserve dwells in history and Wall Street clings to the present, true market visionaries peer 18 months into the future, recognizing that the ebb and flow of global liquidity—not corporate spreadsheets—dictates the market's pulse. As we enter an era of global reflation, risk assets may benefit. The S&P 500 could reach 6,000 by year-end, with a potential for 7,000 by late 2025 or early 2026 if conditions align favourably.

Gold and bitcoin look attractive in this environment, while artificial intelligence (AI) developments could boost the U.S. economy. However, Saudi Arabia's defence of market share poses a headwind for oil prices. China's recent stimulus measures, while not addressing fundamental issues, may offer tactical opportunities for investors.

The big question remains: when will investors realize that growth in the private sector is weak and a soft landing is not a certainty? With inflation at target and the labour market balanced, the FFR should be at the natural rate of 2.75 per cent right now. With 18-month

lags in monetary policy and an era of austerity before us, a hard landing is still possible, with interest rates below two per cent in 2026.

Moreover, when will investors recognize that the "transmission mechanism" for FFR cuts is broken, and that interest rate cuts are not a magic bullet capable of fixing underlying economic issues? Money for nothing, fixes nothing, history is crystal clear on that.

In conclusion, as we navigate these complex economic waters, we must remain vigilant against both inflationary and deflationary risks, always grounding our policies and expectations in empirical evidence rather than the illusion of easy money. The transition from a wartime to a peacetime economy will likely bring significant challenges, and the true test of our economic resilience may not be apparent until late 2025. Investors and policymakers alike would do well to look beyond the current economic mirage and prepare for the realities of a post-stimulus world.

Just remember, in the end, there's no such thing as "money for nothing" when building a sustainable economy—it's all about hard work and the right tune.

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