THE DANA VIEWPOINT

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We Are Not Japan

Are we? Japan has been the opposite of an economic success story for the last 25 years. Japan's debt to GDP level is 235%, its GDP growth rate has averaged below 1% for the last 20 years, and its inflation rate has been flat to negative for significant periods. The U.S. has struggled to produce a strong recovery from the last few economic downturns, even though fiscal and monetary stimulus has provided what should have been a significant tailwind. European GDP and debt cycles have begun to look more like Japan recently, and the United States is struggling with similar debt and growth issues.

If we look back on the recent experience of Japan and Europe, we can begin to see a relationship between overall government debt levels, inflation, and growth. Over the last few decades, the correlation has not been what was expected. The U.S. has a current debt-to-GDP level of about 100%, inflation below 2%, and an economic growth rate below 3% in 2018. In the recent past, the current level of economic and monetary stimulus would have produced significantly higher levels of inflation and GDP growth. Between 1980 and 2000, the U.S. regularly produced average GDP growth above 4%. Since 2000, we have had only two years with annual GDP growth above 3%.

Portugal has a debt-to-GDP level of 127%, but a 10-year government bond yield of only 1.27%. Japan has the highest debt-to-GDP level of the developed world, yet their 10-year government bond yield is actually negative. For countries with reasonably developed economies, as debt levels grow, it seems that inflation levels and potential GDP growth is suppressed. Countries get less "bang for their buck" in terms of economic growth for a given level of fiscal or monetary stimulus. Since the early 1980s, the U.S. debt-to-GDP level has grown, but real economic growth and inflation have trended downward. Maybe we *are* like Japan.

Modern Monetary Theory (MMT) has been in the news lately. It postulates that countries with their own currency don't need to issue bonds but can simply print money to cover their deficits. This is a seductive proposition as it suggests governments can spend as much as they want without a problem, until there is a problem. Currency and debt are basically a confidence game. Now more than ever, the level of confidence can be fleeting. There has been little confidence in Greece's ability to pay its debts without assistance from the European Union. Greek interest rates fluctuate directly in relation to the probability of the next bailout.

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Most developed countries have begun to employ some version of stimulus that moves towards MMT over the last few cycles: more debt, more money printing, larger fiscal deficits. Each time it is done, the level of success decreases. Since most developed countries have not been disciplined through inflation for their profligate spending, purveyors of MMT think they have found a free lunch. There is a saying that entities go bankrupt slowly, and then all at once.

In the U.S. markets, we can react to the slower growth, lower inflation environment in our investment portfolios. In the fixed income markets, we manage our credit risk carefully and ensure that our duration is not too low. Among equities, larger, more established companies generally fare better than smaller companies as larger companies can fund themselves through debt offerings, and they typically have an easier time navigating the regulatory environment. Growth is rarer, highly sought after, and rewarded by market participants. We have seen this trend over the past two decades with the successful growing stronger and some industries taking on a winner-take-all environment.

Zimbabwe offers an extreme example of a government that printed money with abandon; the result was an inflation rate that surpassed 200,000,000% when the government stopped publishing the inflation figures in 2008. The largest denomination bill printed by the Reserve Bank of Zimbabwe was a $100 Trillion (100,000,000,000,000) in 2008; the currency ceased to exist as a unit of exchange in 2009. Now the South African rand, the British pound, and the U.S. dollar are all accepted currencies in Zimbabwe. Ironically, the image on the back of every piece of Zimbabwean currency was a pile of rocks. The U.S. is in better relative shape, but we should heed to observable lessons of other countries and plot our own better course.

Random Thought for March 2019: “Sound policy condemns the practice of accumulating debts” - Alexander Hamilton, New York Ratifying Convention, U.S. Constitution, 1788

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