Southern Capital Perspective

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Southern Capital Services, Inc.

Registered Investment Advisor Since 1982

MONEY AND THE MARKETS

by Terry E. Nager, CFP®, CLU®, ChFC®

Money, defined as national currencies, has a very powerful effect on the economies and the markets of the world. There are two distinct governmental policies that impact the value and the supply of money in each individual nation. These two policies are 1) fiscal and 2) monetary.

FISCAL POLICY

"Fiscal policy *(as explained by econlib.org)* is the use of government spending and TAXATION to influence the economy. When the government decides on 1) the goods and services it purchases, 2) the transfer payments it distributes, or 3) the taxes it collects, it is engaging in fiscal policy. The primary economic impact of any change in the government budget is felt by particular groups — a tax cut for families with children, for example, raises their disposable income.

"Fiscal policy is said to be tight or contractionary when revenue is higher than spending (i.e., the government budget is in surplus) and loose or expansionary when spending is higher than revenue (i.e., the budget is in deficit). Often, the focus is not on the level of the deficit, but on the *change* in the deficit. Thus, a reduction of the deficit from $200 billion to $100 billion is said to be contractionary fiscal policy, even though the budget is still in deficit."

MONETARY POLICY

"Monetary policy *(explained by Kimberly Amadeo on thebalance.com)* is how central banks manage liquidly to create economic growth. Liquidity is how much there is in the money supply. That includes credit, cash, checks, and money market mutual funds. The most important of these is credit. It includes loans, bonds, and mortgages."

Objectives of Monetary Policy

"The primary objective of central banks is to manage inflation. The second is to reduce unemployment, but only after they have controlled inflation."

Currencies fluctuate in value. They are quoted in terms of their relative value to the currencies of other nations — or the monetary union called the Eurozone. Supply and demand ultimately determine price of a currency. Inflation or deflation, the underlying strength of the economy, the level of interest rates, and the amount of foreign exchange reserve holdings all influence the supply-demand equation.

When the Value of Money Steadily Declines

"Inflation is when the value of money steadily declines over time. Once people expect that prices will rise, they are more likely to buy now before prices go higher. That increases demand, which tells producers they can safely pass on more costs. They drive prices up more, and inflation becomes a self-fulfilling prophecy. That's why the Federal Reserve watches inflation like a hawk. It will reduce the money supply or raise interest rates to curb inflation. A healthy economy can sustain a core inflation rate of 2 percent. Core inflation is the price of everything except food and gas prices, which are very volatile. The Consumer Price Index is the most common measure of inflation."

When it Increases

"Deflation is when the value of money increases. That sounds like a

Southern Capital Services, Inc.
southerncapitalservices.com

THE SUMMIT, SUITE 203-B
29000 US HWY 98
DAPHNE, AL 36526

251.626.1140 (Office)
888.438.6410 (Tollfree)
251.626.3257 (Fax)
850.858.3000 (Pensacola)

great thing, but it is worse for the economy than inflation. Why? Think about what happened to the housing market from 2007 to 2011. That was massive deflation. Prices dropped more than 20 percent. Many people could not sell their houses for what they owed on their mortgages. Buyers were afraid that the price would drop right after they purchased it. No one knew when prices would turn back up.

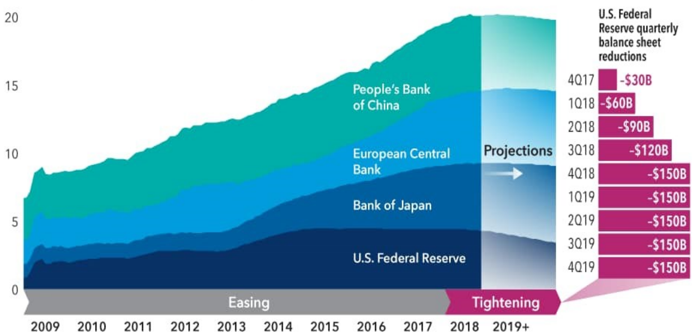
"True, the value of money increased. You received more house for the dollar in 2011 that in 2006. But families lost homes. Construction workers lost jobs. Builders went bankrupt. That's what makes deflation so dangerous. It's a fear-driven downward spiral."

GLOBAL MONETARY POLICY: THE FOUR MAJOR CENTRAL BANKS

There is much discussion regarding the Fed (Federal Reserve Board) reducing the money supply and raising interest rates in order to combat the dangers of inflation arising from the strong US economy. This is undeniably accurate; they have raised interest rate three times so far in 2018 and plan one more hike in December. Next year, the Fed plans another 2 or 3 more one-quarter percent rate increases. Fed Chairman Powell has also begun shrinking the Fed's balance sheet by not making additional bond and mortgage purchases as the ones that they hold mature and are paid off. Presently, the Fed's balance sheet is under $4.2 trillion — down from a high of over $4.5 trillion — which means the money supply has been reduced by $300 billion.

The European Central Bank (ECB) has a $5.3 trillion balance sheet. The Bank of Japan (BOJ) has a $5.0 trillion balance sheet, and the People's Bank of China (PBOC) has an estimated $5.3 trillion. Altogether, the world's central banks hold about $19.8 trillion in assets, and a substantial portion of them were added in the last ten years since the 2008 meltdown. The following graph shows that the totals are hovering near the all-time highs, and the projections show that even with the US shrinking its balance sheet will not significantly lower the overall total.

Central bank assets (USD trillions)



Sources: Capital Group, U.S. Federal Reserve, Thomson Reuters. PBoC assets are as of 4/30/18. Other data and projections are as of 5/31/18.

The implication for the markets is that the abundant liquidity injected after the crash of 2008 will remain mostly intact. Although the US is reducing its balance sheet and the ECB is planning to stop adding to theirs, it may not be enough to offset the additions from Japan and China. Remember that money is like water … it will flow everywhere and be available to all no matter what country it was created in.

OUTLOOK

The third quarter of 2018 was a good one. The final numbers for Gross Domestic Product (GDP), corporate profit increases and unemployment rates are yet to come in but are expected to remain very strong. The equity markets definitely liked the economic news and outlook.

Looking forward to the fourth quarter of 2018 and into 2019, the prospects for the US economy look favorable.
Fiscal policy: the tax cuts are still providing stimulus and the rollback of regulations makes the business environment beneficial.
Monetary policy: the vast money creation by the world's central banks is till in place. Since money has to be invested somewhere, it has been and continues to be, supportive of market values.

Nevertheless, stock market valuations are not cheap and the stock market could be subject to a normal correction such as we experience in late January and February of this year. However, as noted above, favorable fiscal and monetary policies should bode well for the markets in spite of all of the political wrangling in Washington. Therefore, notwithstanding a possible short-term pull back, we remain positive for our outlook.