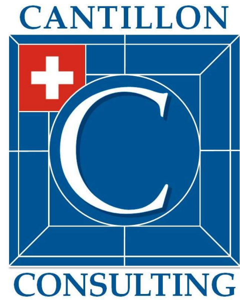
Money, Macro &
Markets

Sean Corrigan



Flattening Curves: The Austrian explanation

During any sustained excess of credit the combination of lower-than-warranted real interest rates, of shrunken risk premiums, and of higher-than-sustainable equity valuations tends to promote the purchase of capital goods (if sometimes only those disembodied types represented by equity shareholdings). This occurs as, on the one hand, the lower hurdle rates will make all manner of pending, capital-intensive undertakings suddenly seem viable, and, on the other, the lowered discount rate will have the greatest impact on the worth of those durable assets that give off a modest but long-lived stream of income – much as a long-maturity, low-coupon bond will rally most in the same circumstances.

Here, too, a certain reinforcement may arise, for capital-intensive projects tend to be commodity-intensive ones, too, while a heightened demand for commodities is hardly likely to be satisfied without the aid of an increased complement of specialized capital equipment. After all, it takes a good deal more paraphernalia to open up a mine shaft than a mortgage brokerage!

However, the fact that all this boost to activity has not been predicated upon saving – i.e., upon a decision to forego consumption today in order to enjoy more or better consumption tomorrow – means that we will soon be caught burning the candle at both ends.

Since no one is voluntarily saving any more and since the increase in money incomes has been earned in the course of activities that do not yet give rise to more consumer goods on which to spend them, the inevitable consequence is that final goods prices eventually begin to rise – a consequence of the fact that we have been led astray in our collective timetabling of the delivery of sufficient of these consumer goods to meet income earners' swelling demands.

Artificially lowered interest rates – rates that therefore do not correspond to any increase in genuine saving and hence are not matched by a pool of unutilized resources – lead to far too much effort being devoted to projects that will take too protracted an interval to mature into the goods and services people need in their daily lives.

Yet, at the same time, each newly created dollar being expended on such projects will eventually end up in the hands of an employee, a shareholder, a creditor, or a tax recipient wanting such goods now and brooking no delay in their provision.

This is the point at which the less-specialized (or, if you prefer, the more-versatile) "factors" (people, machines, raw materials) will be bid away from work on the longer-horizon, more slowly amortizing undertakings and will be enticed away instead into activities that seek to fulfil the wants of the swelling mass of eager, would-be consumers.

Effectively, since selling prices have gone up in this sector, real factor costs – wages, for example – must have locally fallen: ergo, more employment will be offered and on better terms here than in the now less-favoured lines of work.

Even if the central bank does *not* now move to temper the boom, it is at this critical juncture that — if no further intervention to re-energize it by injecting yet more producer credit preferentially into the system occurs – the great ocean roller of the boom is likely to topple over and crash.

Certainly, this may be the point where the dreaded omen of a negative yield curve may appear as misled entrepreneurs, strung all along the chain from the malinvested higher-order goods, now clamour for short-term credits.

Given its topicality, we must here interrupt the chain of reasoning to insist that the inverted curve loses its significance if it is not being driven from the short end, but if it is rather a side effect of the indiscriminate rush for longer-maturity, riskier instruments on the part of leveraged speculators and mercantilist central bankers (the first of whom may be using lower yielding foreign currency borrowings to finance their exposures, while the latter – printing up the wherewithal as needed – have effectively no carry costs at all!).

Be that as it may, the stringency on the short-term money market may arise because hard-pressed businessmen want to join the bidding war for the factors they so urgently need to complete the transformation of their wares to saleable final goods, factors for which their own cash flow is now far too meagre to encompass, even if they do manage to finish the productive process and realise their own sales.

Alternatively, it may be that they wish to finance a store of unsold inventory, being unwilling, just yet, to admit defeat and to clear it out at whatever disappointingly lowly price the market will currently bear. In William Hutt's formulation, entrepreneurs 'withhold' supply rather than face up to the realities of changed relative prices and faulty estimations.

Anxious to salvage anything they can from the wreckage of their plans, the struggling producers will be willing to pay interest not merely up to the level of their expected profit, as before, but even up to the full extent of their (foregone) depreciation allowances as well – a phenomenon Hayek termed as "*investment that raises the demand for capital*"

Assuming no fresh influx of funds, short-term money rates will soar as the desperation mounts and as error-stricken businessmen seek to unblock the stream of products now languishing, uncompleted, on what we might envisage as an idled assembly line whose workers have all been tempted away to better-paid work serving beers in the bar across the road from the factory.

Inevitably, then, the fatal divide between entrained investment and the *ex ante* desire to save will all come to reveal the false premises on which the boom was launched.

.

With costs rising and selling prices falling for all those firms suffering the effects of this excruciating dislocation, discretionary spending will be cut – especially that earmarked for new capital outlays – business services deemed "non-essential" will be curtailed and, finally, redundancy notices will be issued.

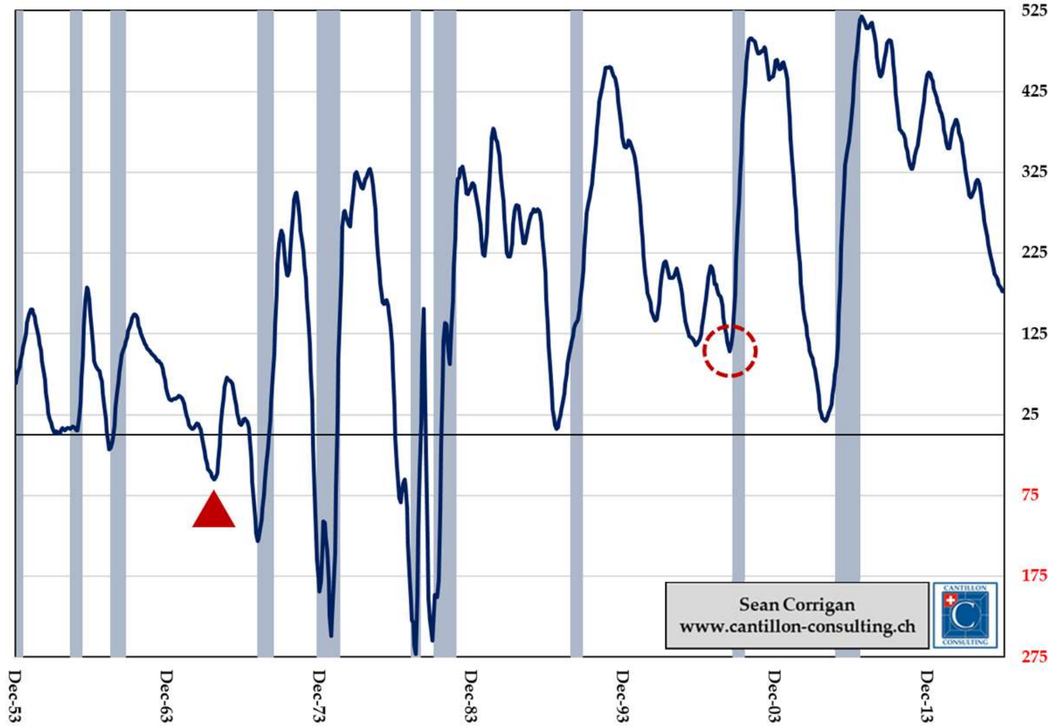
Thus will end the investment boom and then – and only then – will the malign influence of rising unemployment and falling incomes be felt on a consumer sector that has thus far been positively humming along to the tinkle of cash registers as boom-swollen incomes are spent.

The recession has now truly arrived, though not, you will note, from any lack of "effective demand," but rather due to a surfeit of *defective* – that is, mutually incompatible – demand.

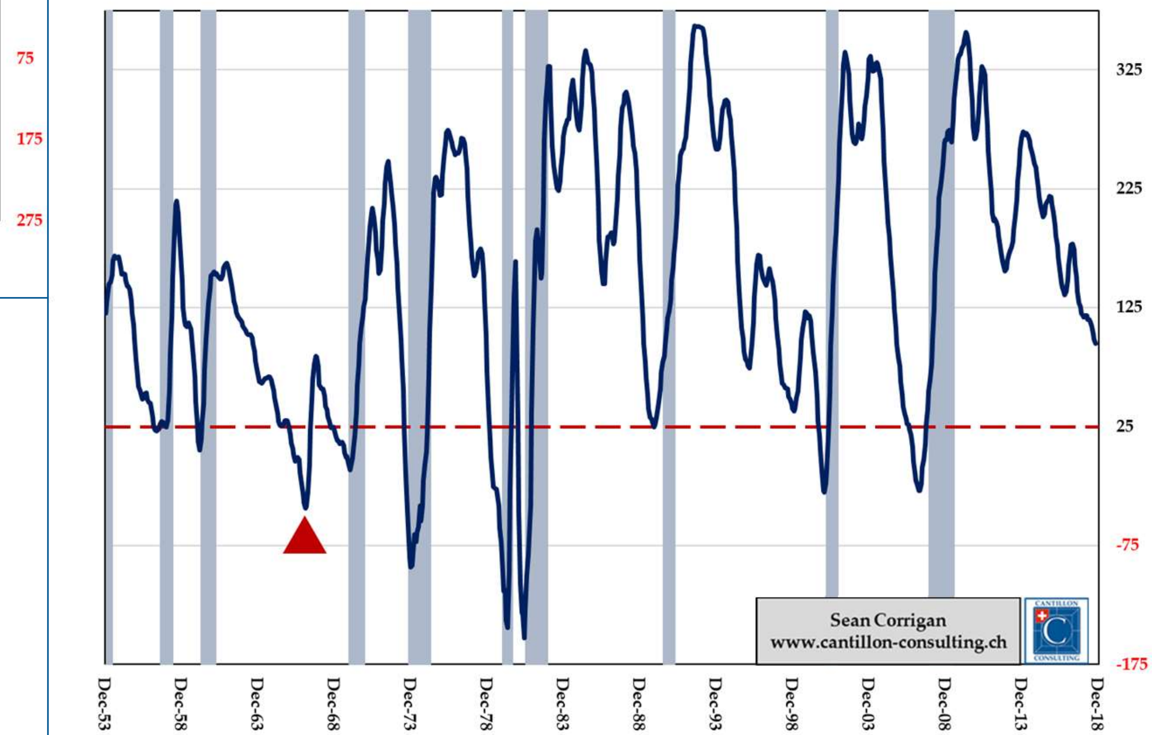
Pessimism abounds that we are on the cusp of just such a revulsion today though, save in China and one or two other emerging markets, it is hard to see such a pathology fully at work. It should be borne in mind that the bond market is not some all-knowing oracle, nor some jealous deity to rain thunderbolts on our heads the moment sacrilege is committed by our daring to price a security of longer maturity at a lower yield than that of a shorter.

The death spasms of a classic Austrian boom can indeed drive a curve inversion – as we hope we have explained here - but not all reversals unfold in this manner, nor are all curve inversions necessarily harbingers of doom.

[*Adapted from 'Globalisation and the Cycle', first published in December 2006 and released in re-edited form in June 2017*]



Too much attention has been focused on the shape of the yield curve as if it has magical properties or as if long and short maturities are like the famous 'Ghostbusters' beams – never to be crossed lest 'total protonic inversion' occurs. There are genuine boom-to-bust economic circumstances which also tend to drive an inversion (Hayek in 1937, q.v.) but these do not seem to be present today.



And what's so special about 2yrs v 10yrs, anyway? Look instead at 3-months v long-term paper. Since the Korean War there has been only one false reading here (and that an OECD-designated 'recession') and only one partial miss in 2000.

NEITHER OF THESE IS CLOSE TO THE DANGER ZONE TODAY

Money, Macro & Markets Monitor

Insight & Support for the Managers of Wealth

www. cantillon-consulting.ch

Disclaimer

All content is intended to give general advice only. The investments and instruments mentioned therein are not necessarily suitable for every individual and you should use this information in conjunction with other advice and research to determine its suitability for your own circumstances and risk preferences. The value of all securities and investments, as well as the income derived from them, can fall as well as rise. Your investments December be subject to sudden, often substantial, declines in value which December not be recoverable; others December expire worthless after a specified period. You should not buy any of the securities or other investments mentioned with money you cannot afford to lose. In some cases there December be significant charges which December reduce the value of your investment. You run an extra risk of losing money when you buy shares in certain securities where there is a large difference or 'spread' between the buying price and the selling price, a circumstance which means that, should you sell them immediately, you December get back much less than you paid for them. In the case of investment trusts and certain other funds, these December use or propose to use the borrowing of money in order to increase the size of their exposures and/or invest in other securities with a similar strategy. As a result, movements in the price of the securities December be more volatile than the movements in the prices of those underlying investments. Some investments December involve a high degree of such borrowing (often referred to as 'gearing' or 'leverage') This means that a small movement in the price of the underlying asset December have a disproportionately large effect on that of your investment. Accordingly, a relatively small adverse movement in the price of the underlying asset can result in the loss of the entirety of your original investment. Changes in rates of exchange December have an adverse effect on the value or price of the investment and you should be aware that additional dealing, transaction, and custody charges for certain instruments December result when these are not traded in your home currency. Some investments December not be quoted on a recognised investment exchange and, as a result, you December find them to be 'illiquid'. You December not easily be able to trade your illiquid investments and, in certain circumstances, it December become difficult, if not impossible to sell the investment in a timely manner and/or at its indicative price. Investment in any of the assets mentioned December have tax consequences regarding which you should consult your tax adviser. All reasonable care has been taken to ensure that all statements of fact and opinion contained in the either written or spoken form are fair and accurate in all material respects. All data is from sources considered to be reliable but its accuracy cannot be guaranteed. Investors should seek appropriate professional advice if any points are unclear.

Copyright ©2018 Cantillon Consulting Sàrl. Any disclosure, copy, reproduction by any means, distribution, or other action which relies on the contents of such materials, the prior written consent of Cantillon Consulting, is strictly prohibited and could lead to legal action.