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Prescient Jay Powell

Riddle me this, poses longtime reader William Hobi: Quantitative easing and zero-percent interest rates preceded the 2021 inflation surprise by a full decade. If, indeed, QE and ZIRP did not cause the "great retirement," the offshore traffic jam at the Port of Los Angeles or the worldwide semiconductor famine, how would less QE and higher interest rates make those wrong things right?

The nomination of Jerome Powell for a second four-year term at the top of the American central bank brings to mind a chain of associations that could help to answer this timely question. Thinking of the nominee, we recalled the eloquent line he took in Federal Open Market Committee deliberations in 2012 and 2013 against the early QE experiments. In so many words, then–Governor Powell contended that such a policy—buying bonds with newly printed money for the purpose of quashing interest rates and lifting stock prices—would store up trouble in the shape of misallocated capital and financial fragility.

Thus, the connection between inflation on Wall Street and inflation on Main Street is one element of the Hobi conundrum. The connection—the friendly, intimate connection—between the Fed and the financing of the Treasury's immense borrowings is a second element. The connection between ultralow borrowing costs and record-high indebtedness is a third.

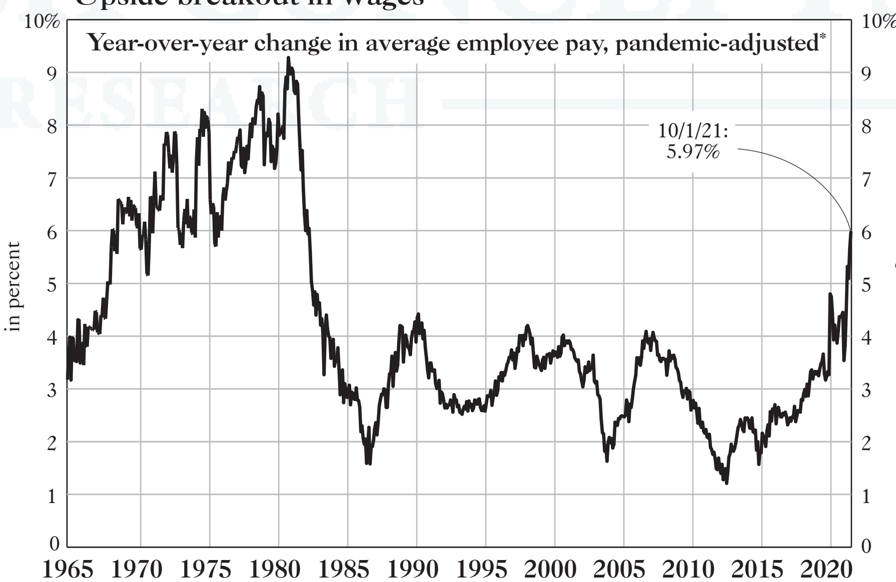
It will be many a moon before a fair-minded court of inquiry can apportion blame for today's 6%-plus running CPI. Pending clarity, investors must get on with the money-making (and capital-preserving) business at hand.

Like the mighty Mississippi, inflation has many tributaries. Money is at the headwater but is joined by the streams of politics, confidence, credit, wealth, expectations, demographics, etc. For 10 years, the Fed's QE operations infused bank accounts with dollars, but the money belonged to the Fed's customers, i.e., commercial banks, rather than to consumers. It was probably no coincidence that the CPI hotted up when stimulus dollars made a beeline for the people who could actually spend them. "Over the past 18 months," observes Ed Hyman, founder and chairman of Evercore ISI, "starting with the first stimulus checks, personal saving over a normal, i.e., over an 8%, savings rate has accumulated to $2.2 trillion. If this excess saving were to be spent over the next three years, it would lift consumer spending by almost 5% per year."

Thus, it was by circumventing QE that the government helped to ignite the spending that lifted the prices in a supply-constrained, pandemic-addled economy. But it was the Fed, in its purchase of $120 billion's worth of Treasurys and mortgages every month, that helped to finance the government.

The theorists who dogmatize about the one and only source of inflation would be hard-pressed, while gazing at the Mississippi from the vantage point

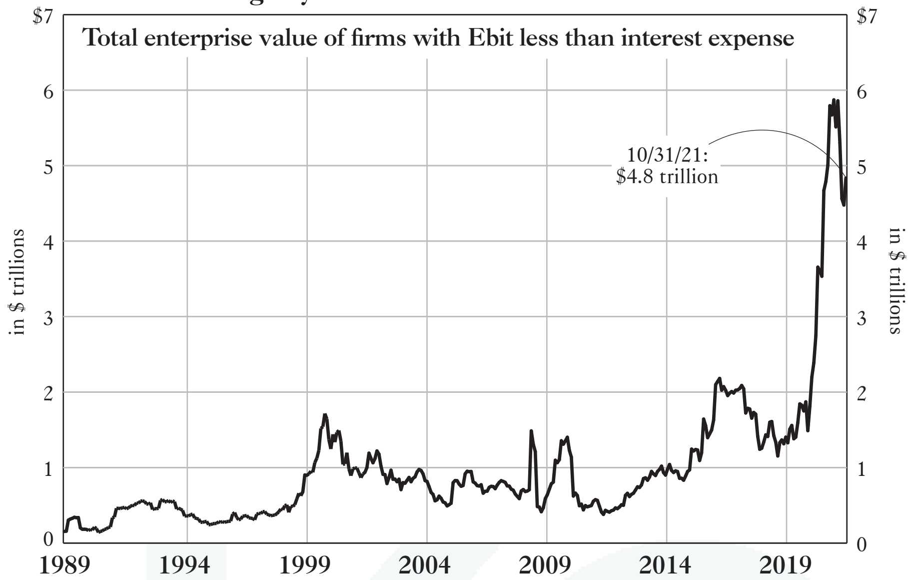
Upside breakout in wages



* Compositionally adjusted for industry and type of worker.

sources: Federal Reserve Bank of Atlanta, Bureau of Labor Statistics

Picture of fragility



source: Kailash Capital, LLC

of New Orleans, to identify the contributions of each tributary—it all looks like water. So, too, in deconstructing the causes of inflation, as the example of the housing boom makes plain.

According to John Burns Real Estate Consulting, LLC, house prices nationally will spurt by 20% this year, with Austin, Texas, and Boise, Idaho, each recording leaps of 36%. "Remove the punch bowl of low rates," says Burns's director of research, Rick Palacios, Jr., "and housing's ascent since spring 2020 likely reverts to a more normalized growth trajectory." So blame or credit the Fed for its deeply negative real mortgage rates.

Crypto, too, is a kind of house-price catnip. "Have you or someone you know used profits from crypto and/or NFTs to help with the down payment of a home purchase?" Palacios asked in a Sept. 4 Twitter survey (the self-selected respondents, of whom there were 385, had 72 hours in which to think it over). "To my amazement," Palacios reports, "20% of respondents indicated yes, they had indeed used profits from crypto and/or NFTs to help with the down payment on a home purchase." Insofar as radical monetary methods provoked the speculative frenzy in alternative currencies, the Fed once more stands accused of aiding and abetting the impairment of the currency.

Since March, Deutsche Bank Securities notes, core CPI has practically tripled, to 4.5% from 1.6%, yet the 10-year Treasury yield has remained the same. On form, we should be looking at a 7% yield, the analysis continues, rather than the actual 1.6% or thereabouts. Why long-dated securities denominated in the depreciating paper of a big-spending government should prove a desirable inflation haven is a mystery we commend to the curriculum committee of the CFA Institute. DB, however, has already formed its opinion, as follows: "It appears as if the market variables have achieved their autonomy from the economic fundamentals and their disagreement can no longer be interpreted as a temporary dislocation that is likely to converge, but emergence of an altogether new framework."

A permanent low yield plateau, then? If so, debt's the reason, many contend. A lucid exposition of the debt-trap theory popped up in the Monday op-ed page of the *Financial Times* under the byline of Ruchir Sharma, the recently retired chief global strategist at Morgan Stanley Investment Management. Inflation will prove no flash in the pan, Sharma posits, and central banks will finally raise their short-term rates to counter it. The bankers may wish they hadn't.

"In fact," writes Sharma,

> surging short-term rates are putting the world's government bond markets on track for their worst year of returns since 1949. Yet the yield on 10-year government bonds is now well below the rate of inflation in every developed country. The market is likely intuiting that, no matter what happens in the near term, interest rates can't move higher because the world is far too indebted. . . .
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> The number of countries in which total debt amounts to more than 300% of GDP has risen over the past two decades from a half dozen to two dozen, including the United States. An aggressive rate rise could also deflate elevated asset prices, which is usually deflationary for the economy as well.

Quite so, the newly renominated Fed chairman was saying only nine years ago. A private equity man in civilian life, Powell brought canny, market-wise observations to Fed discussions about QE. By October 2012, the central bank's balance sheet was on track to grow to $4 trillion by 2014, up fourfold since the 2007–09 crisis. "First question," Powell addressed his FOMC confrères, "why stop at $4 trillion? The market in most cases will cheer us for doing more. It will never be enough for the market. Our models will always tell us that we are helping the economy."

The new governor—he was completing only his fifth month on the board—boldly pushed on: "I think we are actually at a point of encouraging risk-taking, and that should give us pause. Investors really do understand now that we will be there to prevent serious losses. . . . Meanwhile, we look like we are blowing a fixed income duration bubble right across the credit spectrum that will result in big losses when rates come up down the road. You can almost say that that is our strategy." Ben S. Bernanke, Ph.D., had said it, famously, in a *Washington Post* op-ed two years earlier. The jist of Bernanke's argument was that the bounty of high stock and bond prices would trickle down into the pockets of all Americans.

Fresh from the world of leveraged finance, Powell told the meeting that deals were being done with as small a margin of safety as that from the ill-omened years of 2005–07. "You've got the return of dividend deals," he said, "and in a dividend deal, ownership doesn't change hands, but fixed-income investors fund a large onetime dividend to private equity investors, and it typically involves structural subordination, peak leverage levels, payment-in-kind bonds and no covenants. So this is a very peaky, bubbly structure, and we're seeing more and more of these."

Powell persisted in this cautionary vein. At the March 19–20, 2013 FOMC meeting, he got off a particularly apt line about what was known, outside the Eccles Building, as the "Fed put." Said Powell: "Investors will assume that the Fed has bounded their downside and take more risk through leveraged credit risk and duration."

In the nature of things, a contrarian is usually shamed before he is vindicated. Perhaps Governor Powell grew tired of warning about the financial pileup that didn't happen. And now that his predictive moment may finally have arrived, Chairman Powell will likely wish that it hadn't. Even a mild recession, as the startling nearby graph highlights, would test the capital structures of wide swaths of companies in the public equities market (excluded are financial institutions and real estate investment trusts).

Governor Powell was not imagining things when he warned against imprudent practices in private equity so many years ago. Nor did he err in questioning the Federal Reserve's explicit public sponsorship of rising stock and bond prices. What he perhaps did not anticipate is that he would be tending the monetary henhouse when the chickens came home to roost.

Private equity deal volume this year, at $1.1 trillion, is already 40% over the full-year 2007 level. As to valuation, median LBO enterprise value of 12.8 times Ebitda during the first nine months of the year compares with 10.3 times for 2007. Concerning leverage, median debt to Ebitda reached 6.5 times in the year to date, up from 5.7 times Ebitda across 2007, though the vogue in Ebitda "add-backs" certainly understates current readings. Governor Powell had mentioned the impairment of protection in the fine print of leveraged-loan documents—perhaps 50% of the deals in 2013 were classified covenant-lite. Now 90% are so denoted.

Finally, as to the peaky and bubbly phenomenon of dividend recap transactions, the year through Oct. 20 brought $58.5 billion's worth, which topped the previous full-year record of $51.1 billion, set in 2013.

The bond market seems to be betting that a belated move from the Federal Reserve to tackle a now-nontransitory inflation will blow a hole through a uniquely highly leveraged, and almost uniquely highly valued, financial structure. We concur: It's a clear and present danger. At least, though, Chairman Powell will be able to say he told you so.

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