

PALOS

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Palos Weekly Commentary

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Macro View

By *Hubert Marleau*

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Narrative Economics -- A Book Review

If you happen to be an investor who wishes to understand what is going on behind economic series like GDP, Interest Rates, Money Supply, Inflation, Profits and market data points such as Currency Values, Stock Prices Bond prices and Real Estate Prices, you may check out Robert Shiller's new book: Narrative Economics-How Stories Go Viral and Drive major Economic Events. The narratives that played important roles in the economy over the past 150 years and based on contemporaneous and primary sources are much more engaging than the above statistics that economists use to describe them. There is more explanation in the stories than in the numbers themselves.

Robert Shiller is a Yale professor and Nobel Prize-winning economist who boldly predicted the dotcom bust of 2000, and courageously anticipated the financial crisis of 2008. He wrote the widely acclaimed book called "Irrational Exuberance". His new ground-breaking book on narrative economics is a must read because Shiller's many examples are convincing as to the importance of narratives in individual decision-making and on aggregate economic phenomena. It essentially offers a new way to think about the economy and it's change. He basically lays the foundation for a way of understanding the ebb and flow of how new exogenous or re-emerging perennial stories driven as much by feeling as fact. He sites Imperialism, Protectionism, Keynesian General Theory, hinking, Liberalism and Laissez-Faire, Supply-Side Economics and the Laffer Curve, Depression, Sunspots, the Chicago School, Roaring 20s and Libertarianism. He suggests that these have helped to propel economic events that have led to war, to tariffs, government intervention, to peace, to tax reliefs, to frugality, to business cycles and manipulated currency, to free choice, to conspicuous consumption, inequalities and mass unemployment and currency stories like the bitcoin mania.

Macro View cont.

By Hubert Marleau

He shows how to take stories seriously because they drive our lives. Thus, he argues that we need to incorporate the contagion of narratives into economic theory. According to Forbes, we otherwise risk being blind to the very real, very palpable, very important mechanisms for economic change, as well as a crucial element for economic forecasting. Ultimately, narratives are major vectors of rapid change in culture, in zeitgeist, and in economic behaviour.

When a man of Robert Shiller's stature is willing to risk his esteemed reputation on the idea that volatile human emotion counts for more than investors think in the objective valuation of stocks, bonds, commodities, currencies and real estate, one should listen to what he has to say. By narrative economics, he means the study of the spread and dynamics of popular accounts of events, particularly those of human interest and emotion, and how these change through time explain economic fluctuations. He notes: "The human brain has always been highly tuned towards narratives, whether factual or not, to justify ongoing actions, even such actions as spending and investing. Stories motivate and connect activities to deeply felt values and needs. Narratives "go viral" and spread far, even worldwide, with economic impact." He argues that stories people tell can affect or even cause major economic events and therefore merit the attention of investors. Indeed, ideas can and have gone viral and moved markets---whether it's the belief that tech stocks can only go up, that housing prices never fall, or that some firms are too big to fail.

Sonia Jaffe of the Science Magazine made a succinct appraisal: "An analogy to epidemic dynamics runs throughout the book. Shiller references research from fields as diverse as marketing and neuroscience to describe how a narrative's rate of "contagion" and "recovery" (how soon it is forgotten) are affected by human interest, celebrity, and a story's visual imagery or ability to evoke intense emotion." Contagion and recovery rates, he argues, affect the prevalence and durability--the virality--of the associated narrative. Narratives evolve over time, potentially changing their contagiousness and their effect on people's behaviour. Mutations arise when, for example, a slight change in wording or an association with a celebrity changes how contagious a narrative is; a small, random event can have compounding effects that lead to disproportionate influence.

Macro View cont.

By Hubert Marleau

Put simply, stories and their underlying ideas and sentiment--that are transmitted through word-of-mouth contagion, including print, digital and social media-- resemble a form of disease that more or less follow contagion models described by epidemiologists. In this connection, such narratives are often self-fulfilling prophecies. Shiller analyzed many economic narratives that have affected people's economic behaviour-- including decisions that individuals who hear stories they want to emulate---using a rich array of historical examples and data analytics platforms like GoogleNgrams and ProQuest News which make it possible to track narratives in books and newspaper articles going back more than a century and, in turn, measure that in a reassuringly rigorous and quantitative fashion.

He found that narratives tend to emulate epidemic curves similar to outbreaks of infectious diseases which were bell-shaped. Consequently, understanding the influence of narratives by digitizing and assembling existing texts from the past and actively collecting data would immensely help investors to establish rational investment strategies.

At the New York Stock Exchange last week, Bob Pisini, a commentator with the CNBC, asked Mr. Shiller why two recent narratives have gone viral this year:

"We are going to have a recession in 2020":

Robert Shiller said: "People are fascinated by this idea of a business cycle, so they say that we're overdue for a recession or they say that we've got an inverted yield curve. It's remembered as a visual stimulus. These are the stories that have been amplified and they've gotten to the point where they may be self-fulfilling prophecy. The inverted yield curve causes a recession because one thinks it will."

"Tariffs and trade wars are bad for the global economy":

Robert Shiller said: "the modern version of it came in in the Great Depression. And it was about retaliation. Back then, if you go back 200 years, tariffs were just there as a way to--they didn't have an income tax, they had to raise money somehow, so it wasn't so narrative-based. But then they start to think, yes, it'll be a war--a trade war and that sounds really bad. And that got people scared."

Macro View cont.

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He also pointed out that there are other current economic accounts that have gone viral like “Machines Will Take Over All Our Jobs” that are actually quite old. Labour saving machines started in the 1830s, technological unemployment finds its root in the 1920s, automation goes back to the late 1950s and artificial intelligence became a topic of concern in the 1980s. Other narratives that are very contagious are patriotism, nationalism and identity. These are usually heated ones because they are related to tribal loyalties, giving reason to fight as a unit for a furious cause.

P.S. Edward Luce of the Financial Times; Narratives start small, get big and then ping-pong around in ways that we do not expect. By walking about here, there and everywhere like John Maynard Keynes did with a polymathic appetite and voracious curiosity about the whole world in all its forms--people, history, arts, investing, travelling, one's knowledge increases. His economics were inspired by the hunches that came from other pursuits.

How Banks Work and Monetary policy: A Precis of the Bank of England Authoritative Paper on Money Creation

Investors should have a clear understanding on how the banking system works in order to comprehend money creation. In a modern economy, the majority of money supply is created by commercial banks making loans. Interestingly, many investors are ill-informed in believing that banks act as simple intermediaries, lending out deposits that savers place with them and/or their reserves held with the central bank.

Bank reserves at the central banks can only be lent between banks, since the private sectors do not have access to reserve accounts at central banks. The question that many investors posed: Where do reserve requirements come in? U.S. banks are required to hold reserves equivalent to 10% of eligible deposits. Banks need reserves to make payments on behalf of customers. When you pay your credit card or service your mortgage from your bank account, the bank uses its own reserves to settle your payment. Reserves are not cash, not equity or anything easy to sell. They are electronically base money created by the central bank, and only banks hold them.

Macro View cont.

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Put simply, reserves are bank assets financed with deposits and liabilities of central banks matched with government bonds.

Reserves are intended to ensure that banks have enough reserves to meet customers' demands to withdraw funds, either as physical cash or making electronic payments or meeting regulatory liquidity needs. Bottom line, the more deposits a bank has, the more reserves it needs. Canadian banks do not have a fixed reserve requirement ratio, but they are forced by Canadian regulators to have enough high-quality assets to cover expected deposit withdrawals and other payments for a given period of time. Reserve and liquidity requirements serve the same purpose, to minimize the risk that a bank will run out of money it needs to pay its clients.

In Normal Times: commercial banks create money, in the form of bank deposits which account for about 98% of the money supply by making loans. The other 2% consists of notes and coins in circulation. When a bank makes a loan to someone, it credits his bank account with a deposit of the size of the loan. At that moment, new money is created. While it is important to note that the lender has an asset in the form of a loan and a liability in the form of a deposit, the borrower has a liability in the form of a loan and an asset in the form of a deposit. The amount that was lent is equal to the deposit; thus, the balance sheet increased as new money and loans are created. So there you are, bank deposits are simply a record of how much the bank itself owes its customers, so they are a liability of the bank, not an asset that can be lent out. In practice, banks are not able to create money freely without limit. There are several factors that may subsequently restraint the amount of lending.

Prudent regulations are imposed on banks that act as a constraint on their activities in order to maintain the resilience of the financial system. The private sectors who received money from the lending activities of banks could decide to use the deposit to pay-off an existing debt and as a result destroy money. Banks can be deterred from lending if reserve requirements are raised or expensive to borrow or difficult to obtain from each other. Regulators set minimum capital requirements to make sure that banks would remain solvent if asset values were to fall considerably. e.g. the 2007-08 financial crisis. That is why there are "stress tests" which compelled the banks to be more prudent in their lending practices.

Macro View cont.

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Ultimately, banks' decisions on how much to lend are dependent on profitable lending opportunities available to them which is crucially a function of interest rates set by central banks. It is these lending decisions that determine how many bank deposits are created by the banking system and how much banks need to hold in reserves in the case of American banks and highly liquid assets in the case of Canadian banks. Although, central banks do not directly control the quantity of either the base or broad money, it is still able to influence the amount of money in the economy by setting monetary policy through the interest rate that it pays on reserves held by banks with the central bank. As a rule, the primary objective of a central bank is to ensure monetary stability by keeping the price inflation on track to meet the self-imposed 2% target which is sometimes set by the Government.

In Exceptional Times: when interest rates are at their effective lower bound and money creation and spending are too low to be consistent with monetary policy objectives, central banks can respond by undertaking a series of asset purchases known as quantitative easing (QE). QE involves a shift in the focus of monetary policy to the quantity of money. The direct purchase of assets from non-bank financial companies (e.g. pension funds) by the central bank is financed by a corresponding amount of central bank reserves. The sellers of the assets are left with newly created bank deposits that they can use to buy higher yielding assets, raising the value of those assets and lowering the cost of raising funds. It is a misconception to believe that QE gives the bank free money and provides banks with more reserves to make loans.

The link between QE and quantities of money works in the following way. For example, a pension fund which sells a bond to a central bank uses a bank as an intermediary. The bank credits the pension fund's account with a bank deposit that stems from the sale of bonds to the central bank and the central bank finances the purchase by crediting reserves to the pension fund's bank. The new deposit liabilities are matched with an asset in the form of new reserves. Since banks cannot create loans with either deposits or reserves, QE only reduces the cost of money and enlarges the volume of profitable opportunities opened to banks.

In Extraordinary Circumstances: when neither the policy rate nor QE works to raise the money supply, a central bank could directly credit the bank accounts of households. These newly created deposits would in such circumstances be financed with bank reserves. For as long as consumers do not pay off debts with the given deposit, the central is printing. It's called "helicopter Money".

Macro View cont.

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Conclusion: whatever method is used by the Fed--it's really about getting various measures of money supply to grow at a similar rate to nominal spending, which determines inflationary pressure in the economy in the medium term. So setting monetary policy appropriately to meet the inflation target should ultimately ensure a stable rate of credit and money creation consistent with meeting the Fed's target. In this regard, I watch the path of MZM (transactional money with zero maturity) versus that of N-GDP. Making allowance for the velocity of money, a faster rate of increase in MZM than N-GDP should bring about higher consumer prices. In the twelve months ended September 2019, MZM increased 6.6% compared to 4.0% for N-GDP. If the U.S. economy is indeed operating at full employment as many believe, the latest increase in the money supply, if sustainable, should bring about a higher rate of inflation than the current 1.7%. It may be sustainable because in the last six months, MZM ran at the annual rate of 9.5%. That is considerably faster than N-GDP growth. Moreover, the Fed is about to embark upon another round of QE with purchases of treasury bills.

Looking at the 11 Sectors of the S&P 500 by the Numbers:

Name	Index Weight	10-Yr Annualized Total Return	Current Dividend Yield	P/E	P/B	P/S	Comment	Dependency
S&P 500 INFO TECH INDEX	22.0%	17.10%	1.4%	23.27	7.71	4.59	Growth	Future
S&P 500 HEALTH CARE IDX	13.7%	14.21%	1.8%	19.60	4.13	1.69	Growth	Age
S&P 500 FINANCIALS INDEX	13.0%	10.74%	2.2%	13.47	1.43	2.34	Neutral	Interest Rates
S&P 500 COMM SVC	10.4%	9.49%	1.4%	20.47	3.31	2.99	Growth	Innovation
S&P 500 CONS DISCRET IDX	10.1%	17.67%	1.3%	23.95	7.99	1.74	Growth	Inequality
S&P 500 INDUSTRIALS IDX	9.3%	13.40%	1.9%	18.40	4.87	1.76	Cyclical	Exports
S&P 500 CONS STAPLES IDX	7.5%	12.28%	2.8%	21.32	6.06	1.57	Defensive	Population
S&P 500 ENERGY INDEX	4.4%	3.32%	4.0%	15.62	1.54	1.06	Cyclical	Gas & Oil
S&P 500 UTILITIES INDEX	3.6%	12.50%	3.0%	21.84	2.37	2.74	Defensive	Bond Yields
S&P 500 REAL ESTATE IDX	3.2%	12.17%	3.0%	51.82	3.94	7.33	Defensive	Population
S&P 500 MATERIALS INDEX	2.7%	9.22%	2.2%	18.92	2.34	1.70	Cyclical	Global

Source: Bloomberg

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