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## **Unintended consequences**

Published on: 27 August, 2021 | Author: Investment Team

Gordon Pepper, a founder of Greenwell Montagu's gilt-edged business in the 1970s had the unusual background of a Cambridge economics degree, actuarial training and, as a young graduate, a job on the floor of the old stock exchange as a dealer.

He was the widely respected author of Greenwell's *Monetary Bulletin*, required reading in those days, and of a series of influential books, the most notable of which was his Money, Credit and Asset Prices published in 1994. He was regarded as the guru of the gilt market and his particular insights revealed that liquidity and credit availability were as important in pricing assets as any idea of fundamental "value."

By keeping careful track of small shifts in official liquidity policy, investors could predict and act on what became a key market-based signal in terms of asset price volatility and direction.

The legacy of some of these ideas read straight through to the policies of Quantitative Easing adopted by the major developed economies around the world. That the immense credit creation provided by central banks around the world led to rapid asset price inflation would be no surprise to Pepper.

The problem, is, of course, that excess credit creation can lead to the type of financial bubbles that have become wearyingly familiar since the turn of the century. At the same time the financial response to Covid has broken historic records for the scale of monetary and fiscal interventions in the working of the economy.

The key question, then, is are we in the midst of another financial bubble.

First things first, as the Covid crisis impacted, growth in Broad Money (money available for spending and investing known as M3 & M4) accelerated sharply. In most major economies it doubled.

In the US annual growth in the money supply surged from a post-2000 average of 9.4% to 20.52% from January 2020.

In the UK and Europe growth touched 10% but oddly, the Japanese restricted growth in money to 6.34%.

The impact of this surge in money supply can be seen in housing markets. In the 12 months to June, US house prices, unusually, rose by an astonishing 16%. In the UK, the ONS recently reported an annualised rise in prices of 13% and even in staid Europe, German house prices are rising by double digits.

As we have noted previously, we try and identify "financial imbalances," since through both theory and experience we have learned that such imbalances eventually come back into balance, sometimes violently.

The interesting issue here is though we know the world generally is highly indebted, we would also expect household leverage or debt to be expanding creating the kind of dangerous imbalance that we have seen before.

But, that is not what we are seeing.

According to data compiled by Eurostat at the OECD, consumers and households have shown considerable prudence in handling their personal balance sheets by running down their debts since the global financial crisis.

Again, interestingly, and unusually, US households have led the way. US household debt has fallen from 134% of income in 2007 to just 95% today.

UK consumers have been less puritanical but in a world of stagnant income growth, UK households have still reduced their borrowings in aggregate from 157% of income in 2007 to 135% today (2020).

The combination of rising asset prices, in this case property and falling borrowing, has acted to strengthen household balance sheets throughout the Covid crisis which should support a resumption in spending as the Covid pandemic abates and thus allow the post-Covid recovery to continue.

The downside to this picture is that it helps those who are asset and income rich but penalises those who are not or who are just starting out. It exacerbates and entrenches wealth inequalities which, as we have seen, resolve themselves in the political sphere as opposed to the economic.

As Gordon Pepper showed all those years ago, it pays to keep an eye on financial flows because small shifts can have large impacts.

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