Key Private Bank

Key Questions

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How Much Stimulus Is Too Much?

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How much stimulus would trigger inflation might be the bigger question.

Early into my investment career (nearly thirty years ago), interest rates climbed nearly three hundred basis points (3%) from late 1993 to late 1994 over concerns that the federal government's spending had become excessive. The rise in rates was an unmistakable message that policymakers didn't want to hear: Stop spending. But listen they did: Interest rates fell steadily over the subsequent four years, ultimately declining to well below their previous level.

Large bond investors can influence interest rates by deciding whether to buy or sell a government's or a corporation's debt: All things being equal, if they chose to buy, bond prices rise, and interest rates fall. Conversely, if they chose to sell, bond prices fall, and interest rates rise. In theory, therefore, they can wield tremendous power.

This power was not lost on policymakers. James Carville, an adviser to President Clinton in the mid-1990s, famously said: "I used to think that if there was reincarnation, I wanted to come back as the president or the Pope. But now I want to come back as the bond market. You can intimidate everybody."

In the first fifteen years following Carville's quip, politicians generally respected this principle. In fact, through the benefit of hindsight, some have argued that the $800 billion in fiscal support in response to the Global Financial Crisis (GFC) should have been far larger. But policymakers at the time were concerned that the bond market would again express its displeasure and interest rates would rise meaningfully.

In reality, however, interest rates fell and have stayed low ever since. Thus, when COVID-19 first hit the economy, policymakers were emboldened to "go big," which is exactly what they did by injecting over $3 trillion of fiscal support into the economy -– roughly four times the amount added in response to the GFC.

Last week the US Senate pushed forward to prime the pump again by approving an additional $1.9 trillion in fiscal relief. All told, COVID-related stimulus spending will increase the federal debt to nearly 130% of GDP, exceeding the level reached during World War II. It's a figure that may rise even further as many policymakers believe more spending is needed in the form of infrastructure outlays. All of this plausibly invites an important question: How much spending is too much?

The short answer is that it is hard to precisely define the amount at which spending becomes too much spending and bond investors revolt as they've done before. Interest rates have risen recently, prompting some to posit that a mini-revolt may already be underway. But, in my view, such thinking overlooks the fact that expectations for future economic growth have also risen, which could help explain modestly higher interest rates.

Additionally, those who feel we have already gone past a tipping point and are spending beyond our means are minimizing the fact that many sectors of the economy are still severely impaired from the fallout of COVID-19. Significant economic segments such as leisure and hospitality aren't going to fully rebound until widespread vaccinations allow restrictions to be lifted, for instance.

Moreover, many of those who worked in sectors like leisure and hospitality were already at the bottom of the income distribution and presumably had less savings to survive on. Extending enhanced unemployment benefits could be pivotal for those who have been hit the hardest and have little chance of returning to employment until restrictions have been fully lifted. This is what Federal Reserve officials likely mean when they highlight the need to broaden the definition of “full and inclusive employment.”

Another argument for greater spending is based on the simple premise “because we can.” Under this rationale, some economists argue that because the US controls its own currency, it can print unlimited money until inflation becomes an issue. And thus, while some might feel compelled to wonder how much spending is too much, perhaps the bigger issue revolves around this question: How much spending would trigger inflation?

Unfortunately, this question is also difficult to answer with precision. But we may find out later this year. The latest dose of fiscal stimulus that Congress appears poised to pass will come at a time when inflationary pressures already appear to be building.

Inventories for many goods look unusually lean because spending rebounded from the initial lockdowns faster than production did. Those shortages, which have been exacerbated by ongoing supply chain problems in some sectors, are putting upward pressure on the prices of goods.

Conversely, prices in the services sector have remained somewhat suppressed, though they too could rise as more things re-open.

To be clear, e-commerce and globalization have both been responsible for considerable pricing pressure on many goods and services, and these disinflationary forces have not disappeared. But when massive fiscal stimulus is being added to the economy when pent-up demand may be rising, a bout of higher inflation may be unavoidable.

Under such a scenario, bonds may come under pressure, equities may be volatile, and real assets and certain absolute return strategies might offer some salutary benefits that may be worthy of consideration.

For more information, please contact your Key Private Bank Advisor.

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