Conference Roundup
Charles Gave Asks What Kind of Monetary Regime We're In

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Are we in a Wicksellian or a Keynesian monetary regime? No, I'm not speaking a foreign language. Charles Gave,[1] the legendary French investment manager, consultant, and onetime co-founder (with Hugh Eaton) of Cursitor-Eaton Asset Management, bases his macro forecasts and thus his investment strategy on the type of monetary and fiscal regime we're in. According to Gave, there are two principal ones: Keynesian — named, of course, after John Maynard Keynes — and Wicksellian, named after Knut Wicksell, a 19th century Swedish economist who is lesser known but just as important.

Charles Gave
Source:
https://antoinedoyen.photoshelter.com/gallery-image/Charles-Gave-2018/G00001HXN7qKzPM4/I0000WW1kgyGKNqU

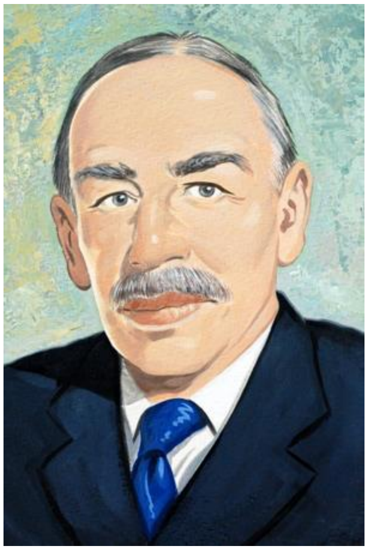
In a Keynesian regime we have easy money, government budget deficits, and negative returns on fixed-interest assets. In a Wicksellian regime we have tight money, budget surpluses, and positive fixed-income returns. These are broad generalizations, but they frame the discussion.

Charles presented these ideas at the Spring 2021 virtual meeting of the Foundation Financial Officers Group semiannual conference. This organization, which I help lead, will return to a mixed in-person and virtual meeting format with a conference in October 2021 in Laguna Beach, California.

About John Maynard Keynes

Everyone knows who Keynes (1883-1946) was, so I'll skip the biography. But many people confuse what is now called "Keynesian economics" with the economics of Keynes. The confusion is so general that a Swedish-American professor, Axel Leijonhufvud, felt the need in 1968 to write a book called *On Keynesian Economics and the Economics of Keynes*. Here, I concentrate on the economics of Keynes because that is what Charles Gave did in his conference presentation.

[1] Pronounced *gahv*.



John Maynard Keynes
Source:
https://www.washingtonpost.com/wp-srv/special/opinions/outlook/whats-in-a-name/images/keynesLG.jpg

Keynes believed that the economy is naturally unstable and prone to booms, busts, and depressions; the Great Depression that occurred late in his career was proof of that instability. To stabilize the economy, Keynes recommended deficit spending by the government during or before the start of a downturn, and a government budget that results in a surplus the rest of the time.

"Keynesian economics," in contrast, seems to be used as an excuse to run a deficit all the time. Keynes rolls over in his grave each time that an American or British government votes to run a deficit during boom times. In the *economics of Keynes*, the accumulated savings from the surpluses are the resources used to pay for the deficit spending when it is needed. Note that this is a fiscal, not a monetary, recommendation.

Keynes viewed gold, and the gold standard, as a "barbarous relic" and favored fiat money, what we have now. This fact will come into play when I return to Charles Gave and his Keynesian and Wicksellian regimes: gold goes *up* in price in a Keynesian regime because governments place no value on maintaining the commodity value of their currencies. Such a regime is usually inflationary.

About Knut Wicksell

Called, in full, Johan Gustaf Knut Wicksell, he lived from 1851 to 1926 and was a late contributor to the "marginal revolution" that transformed classical into neoclassical economics in the last quarter of the 19th century. Wicksell's primary contribution to finance is the idea of the "natural rate of interest," the rate that causes prices to be stable (zero inflation). This idea survives to the present and influences central bank policy worldwide: a central bank interest rate below the natural rate is (supposedly) expansionary and a central bank rate above it is contractionary.

Knut Wicksell
Source:
https://gavekal.com/images/Books/CG-StagnationOrBust.png

Wicksell was also an early advocate of the quantity theory of money, $MV = PQ$. At one level, this just an accounting identity: the number of (say) dollars in the economy, M, multiplied by the number of times each dollar is used for transacting in a given year, V, is equal to the sum of the transaction amounts, $P \times Q$. But it can also be seen as a *theory* of how the price level is set. Specifically, it says that an increase in the money supply (M) should lead to higher prices (*P*) — that is, inflation — all other things being equal.[2] Milton Friedman is the person most closely associated with monetarism in this price-determining sense.

The monetary aspect of Wicksell's work is important to the current argument because, in Gave's framing, a Wicksellian regime is one in which fiat monies thrive and commodity monies, such as gold, go down. Classic monetarists such as Gave tend to be Wicksellian, favoring policies that cause fiat-money currencies to be stable in value or even rise (relative to the goods for which they're being exchanged).

Money versus stuff: Deciding which monetary regime we're in

Gave begins by reminding us that the three functions of money are (1) a store of value, (2) a unit of account, and (3) a medium of exchange. Focusing on the store-of-value attribute, he writes,

> Either the monetary policy followed by the central bank aims at [promoting] the "store of value" function of the currency and we are in a "Wicksellian time," or it doesn't and we are in a "Keynesian time." The performance of gold versus the total return of an index made of five currencies [identifies] the two monetary policies.
>
> The methodology is 100% market-driven, ignores subjective interpretations or anticipations, and ignores measures such as growth, inflation, liquidity, government spending, and debt.

Gave is not a gold bug.[3] He is just sensibly reducing the determination of which regime we are in, to an easy-to-calculate, one-variable indicator. In this calculation, gold is presumably a proxy for all real assets ("stuff"), and the currency basket is a proxy for all central-bank liabilities (forms of "money"). Wicksellian: good for fiat currencies. Keynesian: good for gold.

Using the monetary-regime information to make a forecast

Now, how can we use this information to make a forecast? He writes:

> 'Wicksell': currencies paid more than gold → start of a Wicksellian time
>
> > The natural rate of the economy drives interest rates, currencies remunerate well enough savings, and gold is useless
>
> 'Keynes': currencies paid less than gold → start of a Keynesian time.
>
> > Interest rates are maintained artificially low, currencies debase, and gold resurfaces and the bond markets suffer capital losses

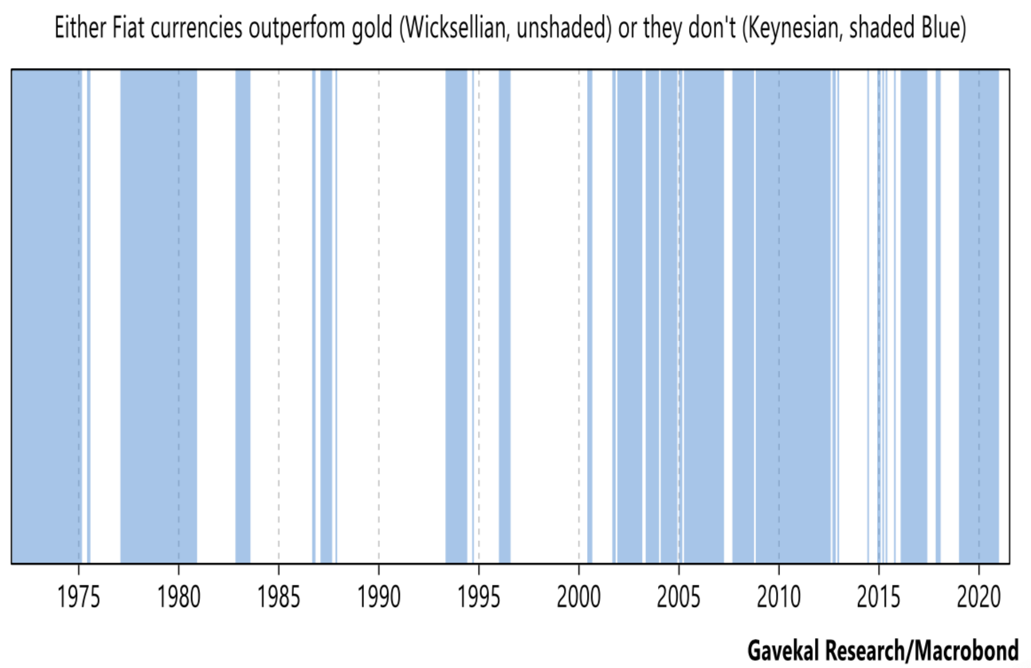
[2] For a thorough discussion, see Coleman, Oliver, and Siegel (2021).

[3] But he is bullish on gold at this time.

Note that Gave converts the horse race result into a forecast by stating that the winner over the lookback 12-month period marks the *start* of a period of dominance for that regime. At the outset, the period is indefinitely long, and you only know when it's over by continuing to look back 12 months on a rolling basis until you observe that the winner has flipped to the other regime.

We can thus construct a time series of Wicksellian versus Keynesian regimes over a long period of time:

EXHIBIT 1
WICKSELLIAN VS. KEYNESIAN REGIMES, 1971-2021



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The long periods of dominance by a regime are the only ones that matter. The short ones or flip-flops are due to the volatility of gold prices and/or exchange rates and can be ignored. It is not a big surprise that the 1970s were Keynesian, with high inflation, rising bond yields, and plunging bond prices, and the 1980s and 1990s were Wicksellian. (Thank you, Paul Volcker; also, Alan Greenspan was not so bad.[4]) Since about 2002, monetary policy has mostly, although not entirely, been Keynesian.

INTERPRETATION FOR MARKET DIRECTION

What, if anything, can these monetary-regime forecasts tell us about how to invest? (Note that these are just one man's, or one firm's, opinions; they are not my opinions or those of AJO Vista, although I have some sympathy with them or I would not have written this up.)

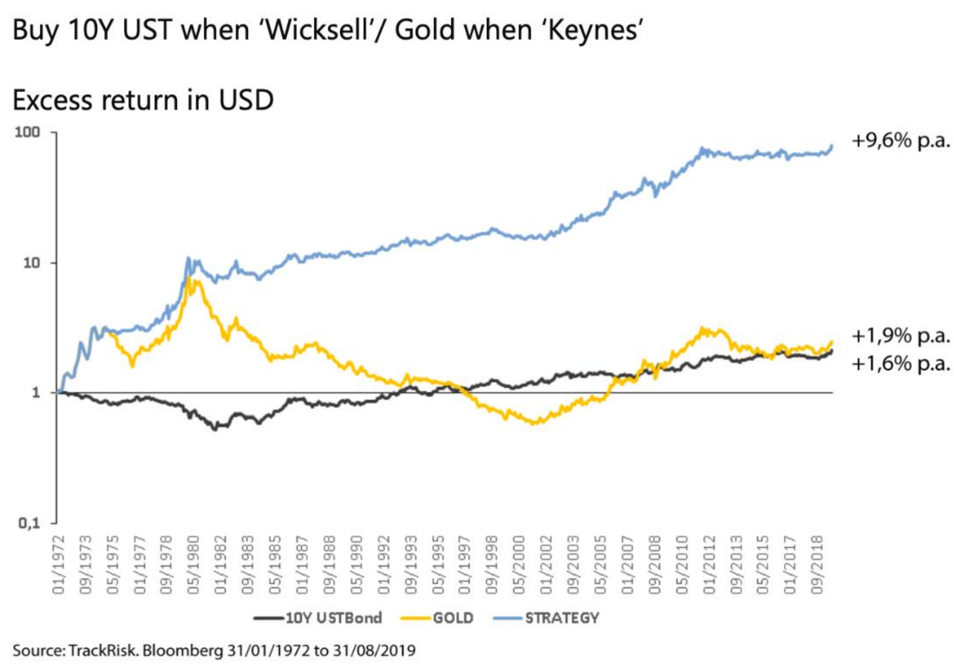
[4] I argue in Siegel (2017), reprinted as an AJO communication, that Greenspan was, in fact, quite good.

First, Gave finds that gold has high excess returns (excess above the cash rate), and bonds negative excess returns, in Keynesian periods. The opposite occurs in Wicksellian periods. This is simply a continuation of the returns used over the 12-month lookback period to discern which kind of regime we're in.

Gave tests a strategy of moving between two kinds of "antifragile" assets (what we'd ordinary call safe assets) depending on which regime we're in. (Gave adopts Nassim Taleb's terminology in which merely "robust" assets are those that hold their value in bad times, while "antifragile" assets are even better: they positively benefit from bad times. Because there is no free lunch, antifragile assets may underperform in good times.) His antifragile assets are 10-year Treasury bonds for Wicksellian times and gold for Keynesian times.

The results over 1972-2019 are in Exhibit 2. The black line is bonds and the gold line is (naturally) gold. Neither asset produced a great return, although both were positive when summed over the whole period. But the strategy of switching between bonds and gold based on the monetary-regime signal, represented by the blue line, generated a compound annual excess return of 9.6%, comparable to a U.S. equity index fund. And all that without investing in any equities at all![5]

Exhibit 2
Backtested strategy of moving between Treasuries and gold based on monetary-regime signals



Note: Assumes no transaction costs, taxes, or other frictions. Excess return is return over cash rate.

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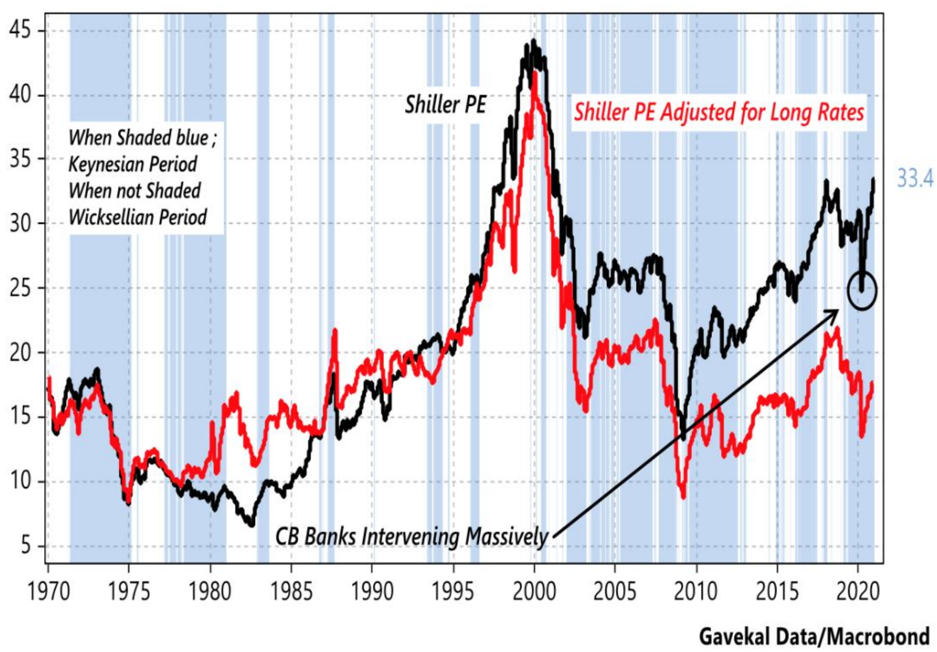
[5] Some people, including Coleman, Oliver, and Siegel (2021), would say that holding bonds (government debt) is like holding equity in the government. (Siegel is me.) The value of this "equity" moves with the present value of expected future primary surpluses of the government, where the primary surplus is revenues minus all expenses *except interest on the debt itself*. From where we stand right now, the expectation of future primary surpluses doesn't look too good, although we can grow our way out of the problem in the very long run (Siegel 2015, Sexauer and Van Ark 2010).

Within the bond market, Gave counsels the investor to reduce the duration during a Keynesian period. This advice would have paid off handsomely in the 1970s, with their environment of rising inflation rates and rising nominal yields. Increasing the duration during a Wicksellian period, likewise, would have been the right thing to do in the 1980s and 1990s.

MONETARY REGIMES AND THE STOCK MARKET

But what about the stock market? Gave's analysis seems to take the position, which I've seen expressed elsewhere, that a stock is like a bond but with more risk and more growth. (This analogy is obvious when stocks and bonds are highly correlated, as they were in much of the twentieth century, but they have been negatively correlated so far in the twenty-first.) Exhibit 3 shows the Shiller PE ratio of the stock market over the same historical period as before; showing the PE instead of the stock price or total return removes the effect of secular earnings growth, and focuses directly on stock valuation instead.

EXHIBIT 3
MONETARY REGIMES AND STOCK VALUATION



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The black line shows that the "pure" Shiller PE, that is, the stock index level divided by 10 years' average real (inflation-adjusted) earnings, generally fell during Keynesian periods and rose during Wicksellian periods. The huge rise in stock prices since March 2020 is an exception; so are the decline during the Keynesian period after the dot-com crash in 2000, and the rebound after 2008. But the rule is fairly robust, especially if you allow for an understandable lag between large market moves and changes in central-bank policy.

The red line adjusts the Shiller PE for changes in the long bond yield, with the result that the stock market looks much less expensive with the adjustment than without it (because very low yields on long bonds also imply low discount rates for future cash flows to stockholders). I do not know exactly how the adjustment was made. This adjustment makes the Keynesian policies of the 2000s and 2010s less salutary for stocks, so that the result conforms more closely to Gave's intuition.

Conclusion

There is much more to Gave's analysis, but we should save some of that for him to explain, if you are a client of his excellent consulting firm, Gavekal™. (The name Gavekal consists of Gave *père et fils*, Charles and Louis-Vincent, and Anatole Kaletsky, their friend and business partner. Gavekal does not manage money, so there is no conflict of interest with AJO Vista.)

To close, there is some hope for tactical asset allocation using macro forecasts. This is true, of course, only if the relation between future monetary policies and equity and bond valuations mirrors those during the 40-year period studied. Because these changes reflect fundamental discount math and other well-established pricing relationships, I'd venture that the forecasts in this analysis are better than random and can be used to guide investment policy and strategy in the future.

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