

## Free Money, Investment And Employment

Two bubbles ago, September 2002 to be precise, I entitled a piece in a pseudo-academic journal, “Let’s Fix This When It’s Over.” The argument was monetary policy has no deterministic outcomes (what’s a deterministic outcome? Turn your steering wheel clockwise, and if the car goes to the right, you have produced a deterministic outcome. If the car goes to the left or backwards, academicians call it a “stochastic outcome,” which sound so much more eloquent than the alternatives) and therefore we should stop trying to achieve multiple and often conflicting policy objectives with a tool so ill-suited for the purpose.

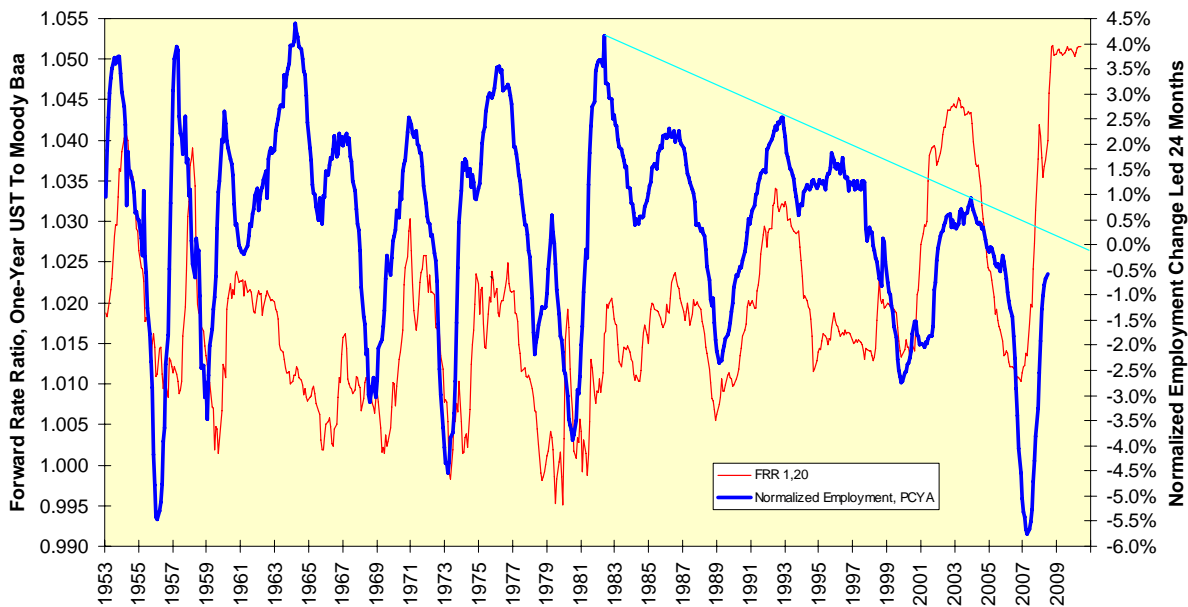
A staff economist at the Chicago Federal Reserve wrote me and, without disagreeing, asked, “But how will business know how to adjust their levels of output and employment. I almost fell out of my chair; is the Federal Reserve so arrogant as to believe businesses make such decisions on the overnight interbank lending rate?”

Yes.

### The Evidence

Corporations make employment and investment decisions based on their longer-term costs of capital. Let’s use the Moody’s Baa-rated series available on the Federal Reserve’s Website; this uses bonds ranging between 20 and 30 years. The forward rate ratio between the one-year Treasury and this index ( $FRR_{1,20}$ ) will approximate the steepness between short-term Treasuries and long-term corporate markets. This is the rate at which we can lock in borrowing for 19 years starting one from now, divided by the 20-year rate itself. It leads year-over-year changes in nonfarm payrolls normalized to the civilian population by 24 months.

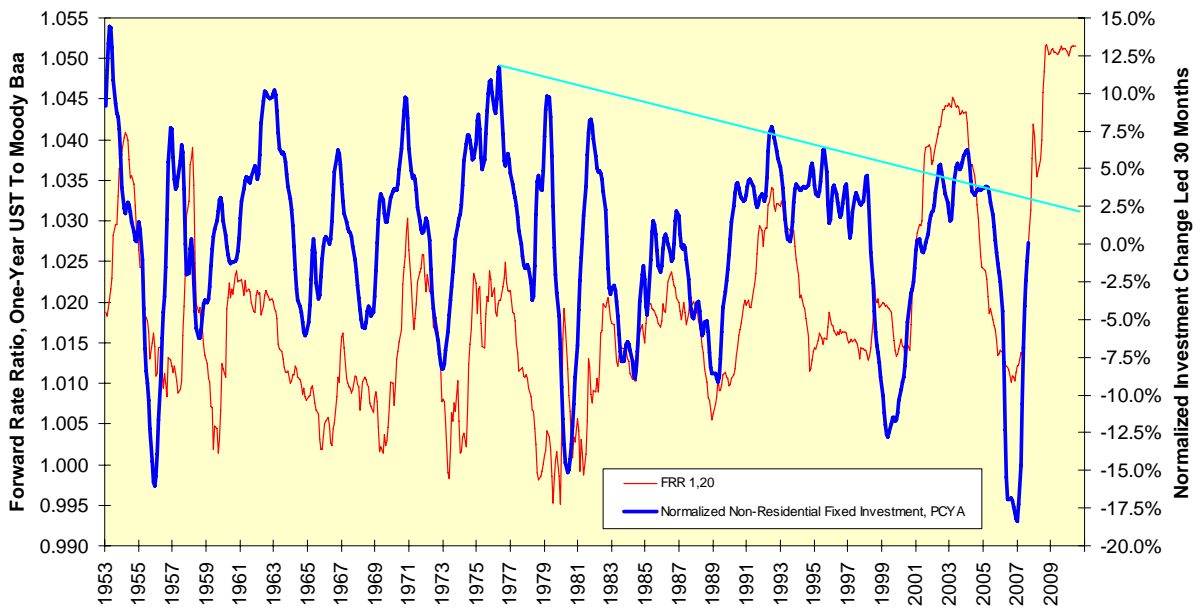
**Steeper Carry To Corporate Bonds Leads Normalized Employment Changes**



The same downward-sloping trendline for employment growth used in a recent discussion of [productivity](#) is overlaid on this chart. The combination of this trendline and the lag from the  $FRR_{1,20}$  points to heavy resistance to further gains in employment by the first quarter.

What about year-over-year changes in non-residential fixed investment normalized to GDP? Here the  $FRR_{1,20}$  leads the investment cycle by 30 months. That cycle has been hitting a series of lower highs since 1976; once again, the trendline and the lead-time point to a peak in the first quarter.

## Steeper Carry To Corporate Bonds Leads Normalized Investment Changes



### Rational Expectation

The analysis could be carried further in other charts, but I can summarize them simply as saying we are at a combination of Treasury yield curve steepness and Baa-rated yields that has led to year-over-year declines in both employment and investment in every six month-ahead period since 1953. The reason here is simple: If actual corporate managers as opposed to the simple automatons posited by my Federal Reserve correspondent believe the cost of capital is artificially low, they will delay hiring and investment.

This is very akin to the argument that tax rebates do not work as they are seen as temporary, or that currencies supported by high short-term interest rates are destined to collapse once those rates fall. Any investor looking at financial assets juiced by money-printing should conclude the world in which those new hires and new machines will function may look very different than today's world. It is far better to buy paper assets with spare cash and contract for productive assets overseas. This is why the QE2 strategy, to the extent it relies on lowering the cost of capital to change behavior, is doomed to fail.