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Bathtub Economics Explained

The fastest market correction in history, that started in the last week of February and bottomed in late March, led to the fastest bounce back over a five-week period, since about 1987 [1]. However, at the time of this writing, most of the major market indexes are still below their **February 2020 peaks levels.**

Many market observers and commentators attribute this quick market rebound to the amount of money created by Central Banks globally, to support the global economy with cash injections. So, what does Quantitative Easing or money printing really mean? And more importantly, how might this affect **the asset allocation strategy for investors in the long term?**

First, the US Federal Reserve, arguably the key global Central Bank, from which all other Central Banks take their cues, has created an estimated $5 - $6 Trillion dollars to support the U.S. economy. These cash injections to a variety of industries - airlines, travel and many others – have amounted to about 30% of total US GDP or economic activity in an economy estimated to be around $22 Trillion dollars in 2019.[2]

The catch is that creating money or credit out of thin air usually has consequences in the medium to long term that can have long lasting economic impacts.

And here we get to a discussion of bathtub economics. Printing money in just the right amounts, not too much and not too little is a delicate balancing act.

Think of the economy as a bathtub. A bathtub has a certain capacity for water (or money). If you create too much water, then there is uncontrolled spillage outside of the bathtub. If there is too little water flowing into the bathtub, then a slow leak will cause the money supply (water) to drop in volume.

Too little money causes credit to contract affecting consumer borrowing ability. Too little cash in the system could cause interest rates to rise quickly.

Since the 2008 credit crisis, there has been a general rise in global debt levels among all types of borrowers - consumers, students, corporations, Governments and the financial industry. In past years, interest rates have risen to reduce demand for additional borrowing. However, in our current world, any substantial rise in interest rates could cause governmental debt servicing costs to rise significantly and possibly even cause some severe financial hardships for some countries.

For the consumer, this also means that excess "free money" in the system may result in rising prices for goods and products. When there is extra money chasing a limited amount of goods (ie. real estate) prices tend to rise because of the competition between consumer demand and the available supply of money.

Over the past 10 years, this price inflation has been witnessed in the various asset classes that rose dramatically in response to a "bathtub full of money". During this past decade, in one of the slowest recoveries ever from an economic crisis, assets including real estate, stocks, bonds hit new record levels.

The current round of Central Bank money creation has created some short-term economic stability, but there may be some unforeseen negative impacts for over the next several years - **which is precisely why proper asset allocation is vital for a successful long-term financial strategy.**

Call us today to discuss your options and some strategies [1] to protect your assets and perhaps to take advantage of this historical time.

[1]BusinessInsider.com

[2]Debt Clock USA

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