Bubble, Bubble, Toil and Trouble

Around the middle of the 1990s, the so called “maestro” – Fed Chairman Alan Greenspan – ushered in the “New Economy” boom. Generous credit and money expansion resulted in a pumping up of asset prices, in particular stock prices. In 2000 that wave of speculation focused on technology. Remember the dot.com bubble? Then came the bust!

The next Fed-induced wave of speculation focused on mortgage securities, which financed a housing bubble. I don’t need to remind everyone how that ended. Many are still recovering from the debacle!

Despite the two previous boom-bust cycles, the Fed has done it again. As a result of the Fed’s unprecedented ZIRP and QE policies (or if you prefer “fake money out of thin air”) the Fed’s feckless money printers have generated the third bubble in 15 years.

In 2008 the Fed lowered Fed Funds rates to zero for the first time in its history. At the same time, the Fed initiated the greatest monetary experiment of all time via three massive QE programs, which increased their balance sheet to $4.5 trillion from $800 billion.

With returns to investors in money market funds at zero, investors had to chase yield in both the stock and bond markets. Combined with massive liquidity injections, the S&P rose over 200%. Other assets have demonstrated similar bubble price action, including art and collectibles. And last, but not least, housing now appears to be in an “echo bubble.”

Bubble Machine

A further example of distortion caused by zero rate policy is near record low yields in U.S. corporate bonds, combined with record high issuance (now over $2 trillion for three years running). Much of the debt sale proceeds have been used to fund share repurchases, which has
artificially propped up earnings, while leaving corporate balance sheets more leveraged and revenues lagging.

“The larger problem with repurchases is that debt-financed buybacks effectively put investors on margin. As corporations have borrowed in order to aggressively buy back their stock near the highest market valuations in history, existing stockholders have quietly become heavily leveraged, without even realizing it.” - John Hussmann

How Big is the Bubble?

As shown above, since QE and ZIRP were launched, the equity market has risen by over 200%. Should the market continue on its merry way by April 2016, the bull market in the S&P 500 would become the second longest bull market of all time. Yet the Fed is still manning the emergency fire hoses!

According to the “Oracle of Omaha” – Warren Buffet himself – the single best valuation metric in determining whether stocks are over or undervalued is the ratio of stock value as a percent of GDP. If so, we should all take note. The market is now at the second bubbliest level of all time. In fact, the aggregate market cap of the U.S. equity market is at 150% of GDP – the second highest valuation EVER!

![Flash Warning: U.S. stock-market value as a percentage of gross national product](image)

After six years, even its own research department at the St. Louis Fed has just confessed that the whole rigmarole of QE and ZIRP has had no favorable impact on the “main street” economy. In a White Paper dissecting Fed actions since the financial crisis, Stephen D. Williamson, vice president of the St. Louis Fed, found fault with…
...the zero interest rates in place since 2008 that were designed to spark good inflation actually have resulted in just the opposite. And he believes the “forward guidance” the Fed has used to communicate its intentions has instead been a muddle of broken vows that has served only to confuse investors. Finally, he asserts that quantitative easing, or the monthly debt purchases that swelled the central bank’s balance sheet past the $4.5 trillion mark, have at best a tenuous link to actual economic improvements. Williamson said: “There is no work, to my knowledge, that establishes a link from QE to the ultimate goals of the Fed – inflation and real economic activity. Indeed, casual evidence suggests that QE has been ineffective in increasing inflation.”

It is undeniable that ZIRP is the mother’s milk of Wall Street speculation, and the reason the market is where it is today. To wit, since QE stopped in October 2014, the equity market has traded sideways. Further, as we have highlighted numerous times in this space, since those programs only affect the top 20% of the population with money to invest, it does little to create real prosperity across the broad economy.

So in a nutshell, QE and ZIRP inflate financial bubbles with no effect on the real economy. During the entire 80 months of ZIRP our brilliant monetary politburo has been “pushing on a string.”

As the Federal Open Market Committee Minutes showed last week, the U.S. Federal Reserve is playing with the idea of raising interest rates, possibly as early as September this year. After a six-year period of virtually zero interest rates, a ramping up of borrowing costs could have tremendous consequences. Credit and liquidity conditions around the world will tighten, giving credit-hungry governments, corporations and speculators a painful awakening after having been surfing the wave of easy credit for quite some time. It will be like taking away the punch bowl on which all the party fun rests.
Nine Reasons Why the Fed Should Not Raise Rates

You could sum up the reasons that the world doesn't look ready for a rate hike by the Federal Reserve easily:

1) **The U.S. recovery is weak.** As shown below, GDP is the most reliable of all the economic indicators since it constitutes the top line revenues of the economy. From this stream, everything must be paid. Current nominal GDP growth shows the economy’s inability to sustain progress in growth. The change over the four quarters ending December 31, 2014, was only 3.7%, which is barely above the average entry point for all recessions since 1948.

   ![](image)

   **Economy Cannot Reach ‘Escape Velocity’**

   And the slow momentum continues. If we look at 2015, the first quarter “real” GDP came in at 0.6%, second quarter at 2.3%, and the third quarter (Atlanta GDP now) estimate is 1.3%. On average, GDP growth is averaging just over 1% annually for three quarters. Needless to say, this is well below the consensus Wall Street forecast and well below the long term growth rate of 3.5%. **Not once in history has the Fed hiked with such anemic growth.**

2) **Inflation is nowhere to be seen.** Inflation wasn't brewing in July and with oil prices moving lower, inflation may not be showing much pressure in August either. The consumer price index rose only 0.1% in July as did the core, both under expectations. Overall inflation is up 0.2%, which is very low and ONLY the second positive reading of the year. The core is steady at plus 1.8%, which is just under the Fed's 2% target.
Secondly, the downward trend in inflationary pressures is historically consistent with declines in the Fed funds rate. The Fed generally LOWERS borrowing costs in an attempt to CREATE inflation, not vice versa. With very low levels of inflation, interest rates, and economic growth currently, there is little historical precedent that would suggest the Fed would lift rates in such a weak environment.

No Inflation in Sight

3) **Monetary velocity** is a key indicator to underlying economic activity. Historically, peaks and declines in monetary velocity have been an early indicator of a weaker economic environment in the future. Furthermore, Fed rate hikes have been coincident with a rise in monetary velocity as an increase in economic activity was able to absorb the impact of higher borrowing costs. The key point is that monetary velocity suggests that the Fed should remain on hold for now.
4) **Wages have been flat for five years.** Retail sales rose by 2.4% in the year to July. Historically, the Fed has generally started a rate hike campaign coincident with a turn up in wage growth and increases in employment and lowered rates as wages fell. With wage growth currently on the decline, an increase in rates would likely depress growth further.

![Average Hourly Earnings (Yoy)](image)

5) **Commodity prices**, as measured by Bloomberg Commodity Index, suggest that the Fed should not engage in hiking rates anytime soon. Historically, the Fed funds rate has risen coincident with rising commodity prices brought about by stronger economic activity. As economic activity gains strength, higher borrowing costs can be levied. With global commodity demand languishing and prices slumping, there is little room to raise interest rates without further crimping already weak economic activity.

![Commodity Prices Collapse](image)
6) **Speaking of commodities, crude oil (arguably the most important commodity in the world) has seen its price collapse to where it was in 2004.** Before that, crude previously topped near $41 in September of 1990! Recall the hyperinflation talk in June of 2008 when crude hit $147? It's been yet another round trip in crude.

![Crude Oil Prices Have Collapsed](image)

7) **Growth in Europe and Japan is anemic.** Japan's economy contracted at a 1.6% annual pace in the April-June quarter in the latest setback for the country's "Abenomics" growth strategy. Meanwhile, Europe is limping along with growth approaching a whopping 1%. Thus, the central banks in Europe and Japan are far more likely to ease than hike interest rates any time soon.

![Japan GDP QoQ SA](image)

8) **Emerging markets are crashing.** Led by China’s furious expansion, emerging markets (EM) now account for approximately half of the world’s economy, which may come as a shock to some. But with global growth slowing, China has been left with significant overcapacity in manufacturing, exemplified by news last week that its key purchasing managers’ indexes fell to a six and a half-year low in August, indicating the contraction was worse than estimated. That followed news of an 8% plunge in exports in July, which
arguably was the factor that tipped Chinese officials to allow the yuan to be devalued last week.

China’s commodity suppliers in Latin America, the rest of Asia, and Australia have experienced the impact first hand. Copper from Chile, iron ore from Australia, and oil from Russia have all seen less demand. And emerging market currencies (some that are hardly household names) have slumped as a result, with the most dramatic example being last week’s devaluation by Kazakhstan of its currency, the tenge, by 23%. (As a side note, while virtually no one, including myself, knew anything about the tenge – one could have made a similar comment when the Thai baht was devalued in 97-98 that led to the Asian crisis.)

The Bank Credit Analyst (BCA) released a report titled “The Coming Bloodbath in Emerging Markets.” In essence, BCA asserts that emerging markets face structural problems of their own making, which will require structural solutions. Those changes won’t be forthcoming until the crisis point is reached in the financial and political bloodbath they foresee. In other words, prepare for more pain!

9) **U.S. interest rate hikes** usually mean a stronger dollar. As shown in the graph below the trade weighted U.S. dollar has already experienced one of the sharpest rallies ever by appreciating by over 25% in 12 months.

A stronger dollar is disinflationary in that imports to the U.S. are cheaper. Cheaper imports force domestic producers to lower their prices to compete. Meanwhile, a rising dollar makes U.S. exports less competitive on the global stage.

Further, those countries with dollar-denominated debt (*think EM*) will struggle more to service it. Higher U.S. rates will suck in capital from around the world, pulling the rug out from under many emerging and developed markets.
So Why Raise Rates Now?

As we discussed last week, the Fed may not want to raise rates, but they might anyways. The economic recovery (as weak as it has been) that began in 2009 is long in the tooth at 74 months long. The average recovery cycle lasts 60 months.

Given that we are closer to the next recession than not, the potential risk of hiking rates in a weak economic environment could very well accelerate the onset of a recession. However, from the Fed's perspective, it just might be the “lesser of two evils.” Being caught at the "zero bound" at the onset of a recession leaves few options for the Federal Reserve to stabilize an economic and market decline.

Market Outlook and Portfolio Strategy

To close the week, the U.S. stock markets that saw the Dow Jones Industrial Average plunge more than 500 points (3%) taking it into correction territory, or down more than 10% from its last high. The S&P also dropped by 3%. The Nasdaq Composite fared even worse, with a 6.8% shellacking. More to the point, according to Wilshire and Associates the U.S. stock market lost some $1.4 trillion in value last week with more than half of it coming in Friday’s rout. Since its recent high back on June 23, the Wilshire 5000 is down a cool $2 trillion in value.

And in the credit markets, the backdrop looks “eerily similar” to the 1998 emerging-market crisis. In fact, spreads of Baa-rated (lower-investment-grade) corporates over Treasuries actually are wider now than their peak then. Different then was the economy: Nominal gross-domestic-product growth was cooking at over 6%, while the U6 “underemployment rate” (taking in part-timers who want full-time work and those not actively looking for a job, but who want one) was 8%, compared with current nominal growth of just over 3% and a U6 jobless rate of 10.4%.
The long end of the curve (10- and 30-year) is acting as if rate hikes are not coming or alternatively a recession approaches. The 10-year benchmark Treasury yield fell to 2.05% and the yield curve continues to bull flatten, despite many still believing that the Fed will hike rates in September.

It should be noted that there is not a high correlation between increases in the Fed Funds rate and the 10-year Treasury rate. While many bond bears are suggesting that long rates are about to start a long-term rise, there is sufficient evidence that they would decline even with the onset of a higher Fed funds rate. We continue to favor yield curve flattening strategies.
In assessing what lies ahead, investors would be well advised to consider that the catalyst for this market retreat came from outside the developed world. It largely reflected concerns about slowing growth in emerging economies (China in particular, but also Brazil, Russia and Turkey), compounding the entrenched economic sluggishness in Europe and Japan.

Furthermore, there is less confidence that central banks (repeatedly the markets’ best friend) can act as an effective stabilizer. Moreover, the Federal Reserve’s minutes released on Wednesday highlights the policy challenges in a world that has come to over-rely on central banks. Indeed, as we have discussed ad-nauseam in this space, the cult of central banks has driven a wedge between asset prices and economic fundamentals.

If the markets lose faith in the central banks to prop up the markets, then watch out below! Yes, the People’s Bank of China could loosen monetary policy. And yes, the Fed could hold off hiking rates in September. But the impact on global growth would likely be limited unless there are major structural policy changes.

Otherwise, prices need to fall a lot more before wary investors get off the sidelines.

According to Band of America: "The Only Reason to Be Bullish Right Now Is There Are No Reasons to Be Bullish"

Caveat Emptor!

In terms of relative value in the fixed income markets, please click here for the Relative Value Analysis report.
More Information

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