SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC REVIEW & INVESTMENT STRATEGY: 2014/IV

Inflated Concerns?

This month, if all goes according to plan, the Federal Reserve will end its bond-buying/money-printing program known as Quantitative Easing (QE), which it has been gradually reducing ("tapering") for the past year. The end of QE, prompted by the gradual improvement in U.S. growth and employment, has markets focused on how soon the Fed will start to raise short-term interest rates (from near-zero, where they've been for the past five years) or risk rising inflation, and what the impact of those decisions will be on the value of stocks, bonds, and other investment assets. Our view is that even as the growth outlook remains steady, a number of factors will keep U.S. inflation and interest rates in check for the immediate future–a combination that should continue to boost U.S. share prices.

Since the Fed initiated its first round of QE in September 2008, the nation's base money supply has multiplied almost fivefold. Many economists predicted that this unprecedented money-printing would unleash rampant inflation; yet six years on, core consumer inflation remains below the Fed's target rate of 2%. So where's the inflation? Some argue that asset prices have been inflated, creating a stock market bubble. Is this correct?

One way of answering these questions is to focus on where all that new money the Fed created actually went: 84% of it ended up as excess bank reserves. The velocity of money–the amount of GDP each unit of money generates–collapsed. When economists talk about velocity, they usually mean the rate at which households and companies spend their bank balances (the broad money supply, M2) per year. That pace has fallen, from 2.0 in 2007 to 1.6 in 2013. But what really collapsed was the money multiplier–the number of times banks lend and re-lend the "base money" they get from the Fed to create those circulating bank balances–from 8.5 in 2007 to 3.3 in 2013. So while the monetary base exploded by 367% over the past six years, the amount of money actually available to be spent (or invested) only grew by 48%–an average of 6.7% per year. As a result, the velocity of the monetary base plummeted from 17.0 in 2007 to 5.1 in 2013–even lower than the depths it reached during the Great Depression. This is what Keynes called a "liquidity trap": when the Fed gave people more money–a lot more money–they held onto most of it rather than lending or spending it.

Fed officials (and most economists) don't talk about the money supply or velocity anymore; it's unfashionable. They talk about output gaps and slack labor markets. They argue that inflation can't happen unless unemployment (including discouraged job seekers) falls to a level where companies have to start competing for workers by raising wages. But it's really just a different way of saying the same thing. When the central bank adds more money to an economy operating significantly below capacity, one of two things happens. Either it creates more purchasing power that draws on those idle resources and grows the economy along with the money supply, or it just sits there, because nobody is confident enough to put it to use, and velocity plummets. In either case, inflation will not accelerate until the economy hits some capacity constraint, which prevents it from growing as fast as the money supply. For some economies, that constraint might be energy, infrastructure, or cropland; for the U.S., it has usually been labor.

There is much disagreement about when the U.S. economy will begin to encounter capacity constraints, giving rise to inflation. At 5.9%, the official unemployment rate is already well below the 6.5% originally laid out by Bernanke's Fed as the threshold for starting to raise interest rates. His successor Janet Yellen appears convinced that, given the absence of noticeable wage pressure, and a substantial decline in the labor participation rate, a great deal of slack remains in the labor market. A confluence of demographic and technological changes makes it hard to tell for certain. Are the benchmarks we used in the past still relevant? Yellen says she will play it by ear.

Assuming the Fed is right, that would be good news for stocks. Share prices, as a multiple of earnings, are directly related to growth expectations and inversely to the cost of capital. Often the two factors balance each other out. When the economy is weak, the Fed may cut the cost of capital (interest rates) almost to zero, but this may not entirely compensate for worries over future earnings growth. When the economy is charging ahead on all cylinders, confident growth expectations may be counter-balanced by higher interest rates meant to head off inflation. But when an economy is growing steadily, yet has significant unused capacity (either due to a past recession, or strong productivity gains), the cost of capital can remain low even as growth expectations rise, boosting P/E multiples. In other words, the economy–and the market–has room to run.

That does not <ahem> mean that the fivefold increase in the nation's monetary base since 2008 is inconsequential. After the Great Depression, it took four decades for the velocity of base money to recover to its 1929 level. Overlaying this recovery (beginning in 1940) onto the current base money supply, and assuming an average 3% real GDP growth per annum, produces just over 2% annual inflation over the next 20 years. But that overlay also generates spikes of double-digit inflation in years when velocity first begins to recover.* The exercise is not predictive, but it does illustrate how exposed a large monetary overhang leaves the economy to surprising price volatility when it finally *does* encounter capacity constraints and cannot grow as fast as people's willingness to lend and spend a virtually limitless supply of money. Inflation (or the rising interest rates necessary to fend it off) is not a problem today, but it could easily become one tomorrow. What should investors do? Keep one's eyes peeled for early signs, and meanwhile, "make hay while the sun shines."

*This analysis is emphatically *not* based on the notion that the U.S. will retrace its actual inflation experience following World War II. Inflation is a function of velocity, economic growth, and the money supply. Only velocity is assumed to recover at a historical pace. The other variables—the size and anticipated growth of the money supply, and the potential constraints on growth—are entirely different.

Dollar Wise

The end of Fed QE does not take place in a vacuum. The policies of other central banks have an impact. The Bank of Japan remains committed to its campaign of quantitative easing (the "first arrow" of Abenomics), while an anxious European Central Bank (ECB) is turning to more aggressive easing measures to revive lending and combat the risk of outright deflation in the slowing Eurozone. As the market anticipates Fed tightening, these loose-money policies overseas tend to strengthen the Dollar and exert a downward counter-pressure on rising U.S. interest rates.

In effect, QE anywhere is QE everywhere. The transmission mechanism may vary, but money is mobile. Inject money into one economy, pushing interest rates down, and it will seek out higher rates of return somewhere else. An immediate response to the prospect of European QE may be for investors to pour money into European bonds, to get out in front of a bond rally as the ECB pushes yields down. Even then, they are likely to short the Euro (borrow Euros) in order to do so. Once the lower yields are priced into the market, though, the hunt for yield will turn elsewhere. Maybe, if investors are confident that the ECB's actions will reignite growth, they might move their money into European equities. If not, they will look abroad. Already, the spread between German Bunds and higher-yielding U.S. Treasuries is the widest it has been in 15 years; even Italian and Spanish 10-year bonds yield less than Treasuries. The gap in returns creates an incentive for capital to flow from Europe to the U.S., bidding up the Dollar and bidding up U.S. bond prices, which keeps U.S. interest rates lower than they might have been, in the absence of Fed QE purchases.

If the U.S. economy were approaching capacity constraints, and required higher interest rates, this influx of capital might spur inflation, unless the Fed were to tighten. As it stands, though, the stronger Dollar will help keep inflation in check by reducing the dollar-price of imported commodities, including oil, which has already fallen well below its long-time floor of $100/barrel. The strong Dollar is not the only factor at work here. China's investment boom is faltering, despite forlorn efforts to keep it afloat with ever-expanding credit. A fall-off in China's massive capacity build-out will reduce the real cost of energy and other material inputs, while reflating the price of many finished goods by reining in rampant oversupply. The effect is like a large tax cut accompanied–down the road–by a big revenue boost for U.S. businesses as the Chinese produce less and consume more. (For Europe and Japan, on the other hand, a reduction in real energy and other input costs may only partially weigh against higher import prices due to their weakened currencies).

The effect of a stronger Dollar is not uniformly positive. Oil prices below $80/barrel could spell trouble for heavily-leveraged participants in the U.S. shale drilling boom, or investors who bought their high-yield bonds at thin spreads. U.S. companies may see the Dollar value of their overseas revenues (in foreign currency) decline. In some emerging markets, a rising Dollar could derail the "carry trade" (where speculators borrow at low U.S. interest rates to invest at higher returns abroad), causing an outflow of capital and forcing them to raise interest rates. Of course, the advent of European QE could mean the supply of cheap Dollars is merely replaced by a supply of cheap Euros. That would make the ECB's job (stimulating Europe's domestic economy) a lot harder, but it could help cushion emerging markets from the negative impact of the end of Fed QE on liquidity and valuations.

Room to Run

Last month, we warned against the popular thesis that emerging markets were a cheap "buy". Our concerns were quickly realized. The MSCI Emerging Market index, which was up +7.8% year-to-date at the start of September, gave up all its gains and ended the month down -0.6% on the year. Brazil saw the steepest slide, for precisely the reason we mentioned: when it became clear that Dilma Rousseff would probably disappoint investors by winning re-election, the market swung from a +20.2% gain to a -2.8% loss. We called the rebound in Chinese share prices, driven by hopes of new government stimulus, a dead cat bounce; when the numbers disappointed, the MSCI China index turned from a +4.0% gain to a -1.7% loss. We were far more positive about India, but given its +25.4% gain year-to-date, worried that it had become overvalued and was due for a correction; in September, it retreated -2.5%. In our view, the larger BRICS countries face difficult economic challenges ahead, which is why we have been and continue to be underweight emerging markets, and why we emphasize the importance of active management when diversification calls for emerging markets exposure.

To be sure, the S&P 500 also retreated last month, by a more modest -1.6%. Often the U.S. stock market seemed to be reacting perversely, rising on news of a weak August jobs report and falling on news of strong retail sales and improved consumer confidence, for fear of how the Fed might respond. We have argued that without growth, low interest rates won't help stocks, and that higher interest rates won't harm equity valuations so long as they arise in response to accelerating growth. To this we now add: the economy has room to run, without raising rates, before we need to start worrying about inflation. So take a deep breath and repeat after me: *good news is good news*.

And there is plenty of good news, especially if one looks past monthly volatility, at year-on-year (y/y) trends. Lower oil prices helped narrow the U.S. trade deficit, which was down 1.5% y/y in August. Durable goods orders in August fell back from an extraordinary surge in aircraft sales in July, but were still up 8.9% y/y. Industrial production also slipped in August, but stood 4.1% higher than a year ago. Auto sales in September couldn't match a blockbuster August, but were still up 6.5% y/y. Existing home sales are still in a slump, in large part due to limited supply, but new home sales surged 18% in August, up 33% versus a year ago. New housing starts, up 8% y/y, are struggling to keep pace. Meanwhile, Q2 GDP growth was revised upwards, from 4.2% to 4.6%. The September employment report showed a gain of 248,000 jobs, while the initially disappointing August number was revised upwards, confirming that job creation remains on track.

Nothing in the latest economic data justifies a sustained downturn in U.S. equities. The strong Dollar may dent U.S. corporate earnings from overseas, but our earnings projections for 2014 were always more conservative than the market consensus. As things stand, if Q3 earnings for the S&P 500 come in on target, the 12-month trailing P/E ratio will have actually *fallen* slightly, from 17.2 at the beginning of the year to 17.1 at the close of September. In other words, all of the market's gains so far this year–and then some–have come from earnings improvement, not rising valuation multiples.

To recap: The U.S. economy appears to have room left to grow without provoking inflation or higher interest rates. Monetary easing in other major economies will also keep U.S. interest rates and input costs low. Low cost of capital plus a steady growth outlook should translate into higher U.S. equity valuations. Yet recent market uncertainty has kept valuation multiples flat year-to-date, despite robust earnings growth. Current conditions strongly favor U.S. over non-U.S. assets and U.S. equities over real assets, and are unusually supportive of bond prices, given the stage of the business cycle. U.S. stocks may not be "on sale," but this bull market, like the economy, still has room to run.

October 9, 2014

Patrick Chovanec
Managing Director, Chief Strategist

SILVERCREST
ASSET MANAGEMENT GROUP

ECONOMIC FORECAST
(As of October 9, 2014)

	2012	2013	Estimated 2014	Projected 2015
Real GDP (Y-O-Y)	2.3%	2.2%	2.2%	3.0%
Consumption Expenditures	1.8%	2.4%	2.3%	2.8%
Business Fixed Investment	7.2%	3.0%	5.7%	6.5%
Inventory Investment (Billions)	$57.0	$63.5	$75.0	$55.0
Residential Investment	13.5%	11.9%	2.3%	6.5%
Government Spending * (Billions) (a)	$2,953.9	$2,894.5	$2,875.0	$2,875.0
Trade Balance-Goods & Services (Bil.)	($452.5)	($420.4)	($437.0)	($420.0)
Federal Budget*: Unified (Billions)	($1,087.0)	($679.5)	($492.0)	($469.0)
Gross Federal Debt* (Billions)	$16,050	$16,719	$17,735	$18,405
Consumption Price Deflator	1.8%	1.2%	1.6%	2.3%
Producer Price Index (Finished Goods)	1.9%	1.2%	1.4%	1.6%
Consumer Price Index	2.1%	1.5%	1.8%	2.4%
Industrial Production	3.8%	2.9%	3.9%	3.6%
Real Disposable Income	3.0%	(0.2%)	2.2%	2.9%
Hourly Compensation	2.7%	1.1%	2.4%	2.7%
Unit Labor Cost (Non-Farm)	1.7%	0.3%	0.8%	0.7%
Productivity Growth (Non-Farm)	1.0%	0.9%	0.9%	0.6%
Personal Savings Rate (% DPI)	7.2%	4.9%	5.2%	5.6%
Capacity Utilization – Total Industry	77.3%	78.0%	79.0%	79.4%
Trade Weighted $ Exchange Rate (b)	3.8%	3.4%	1.4%	1.5%
Vehicle Sales (Million Units)	14.4	15.5	16.2	17.0
Housing Starts (Million Units)	0.781	0.925	1.050	1.180
Civilian Employment (Millions)	142.5	143.9	146.4	148.5
Civilian Unemployment Rate	8.1%	7.4%	6.3%	5.8%
Corporate Profits – After Tax – NIPA	17.7%	4.7%	6.7%	6.0%
S&P-500 Earnings-Operating	$104.29	$107.30	$114.00	$118.0
S&P-500 Dividends	$31.25	$34.99	$39.50	$43.00
90 Day U.S. Treasuries-Yield (%)	0.01-0.11	0.02-0.12	0.01-0.08	0.08-0.30
10-Year U.S. Treasuries-Yield (%)	1.39-2.38	1.55-3.00	2.35-3.10	3.00-3.40

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2005 dollars; (b) Fed Major Currency Exchange Rate.*