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1Q 2014: Desperately Seeking Demand

We have just completed a year that saw sluggish growth and soaring stock prices. That combination makes a lot of people anxious.

It shouldn't, necessarily. Pessimists point out that the S&P 500's total return of 32.4% in 2013 was driven mainly by rising price-to-earning (P/E) ratios, presumably inflated by Fed money-printing, rather than corporate earnings growth. But history offers repeated examples of years (including 1982 and 1991) which saw surges in P/E valuations that, far from being harbingers of doom, anticipated sustained periods of well-grounded performance. As my colleague Stan Nabi has often noted, for the past 50 years, with only one exception in the high interest rate environment of the late 1970s, U.S. stocks have never seen a bull market where the forward-looking P/E did not eventually exceed 17x. Today, using a very cautious, below-consensus estimate of S&P 500 earnings for 2014 of $111, Stan estimates forward P/E at 16.6x, or even 15.5x if adjusted for companies' unusually large net cash holdings. For all the talk of a Fed-induced "bubble," stock valuations do not appear to have become detached from reality, and may have some remaining upside.

This upside, however, depends on the "anticipation" built into higher stock prices being realized, not necessarily in immediate earnings growth, but in greater confidence that the economy is on the right path and gaining momentum.

The main obstacle to stronger economic growth is lack of sufficient demand. Though consumer spending is rising, the economy is still operating way below capacity. U.S. non-financial corporations are sitting on a record $1.25 trillion in cash because they are unsure where to invest it. Portfolio investors are in the same boat, with $2.7 trillion parked in U.S. money market funds. Former Treasury Secretary Larry Summers posits that the U.S., like Japan since the 1990s, has entered an era of "secular stagnation" where the "natural interest rate" (the rate where the desire to save is matched by the willingness to invest) has fallen below zero, meaning return expectations are so low or uncertain that investors essentially must be *paid* to put their money to work (or penalized, via inflation or other means, for not doing so).

There are many domestic reasons, in the U.S., why demand is depressed. They include cyclical causes like the wealth effect from assets that lost value during the financial crisis, especially housing, as well as the delay in household formation due to high unemployment among young people. There are also structural reasons, which may prove more persistent. We are in the midst of a technological revolution that, alongside globalization, is reducing the need for and the value of the sort of routine mental and physical labor that long provided the foundation for mass middle-class employment in the U.S. Take these two examples:

- Three listed companies, each with roughly the same market valuation ($33 billion): Twitter, the latest example of cutting-edge U.S. innovation, employs 2,000 people. John Deere, which typifies the kind of high value-add manufacturing where the U.S. retains a competitive advantage, employs 67,000 people. Hon Hai, the Taiwanese company that handles the outsourced assembly of iPhones, iPods, and similar products in mainland China, employs 1.3 million people.

- The now-defunct Blockbuster video rental chain had 60,000 employees at its peak in 2004. Netflix, which replaced it online, has 2,000 employees.

These kinds of efficiency gains are good for the U.S. economy. They mean we are doing more with less. But they also mean the rewards to value-creation are often spread among fewer people, and many people with more mundane skills may struggle to add much value at all. Before the crisis, the impact on consumer purchasing power was masked by easy access to consumer credit: what people could not earn, they could borrow. Not anymore.

The conventional response, among economists, is that the government must take action to boost domestic demand *in the United States*, with either monetary or fiscal stimulus, or by redistributing wealth. But the limits of intervention are also apparent. While Fed QE was essential to preventing a credit collapse during the financial crisis, a nearly fourfold increase in the base money supply has done less than one might expect to get people lending and spending again. The case for more aggressive policies must be weighed against legitimate concerns they could destabilize the economy's future by piling up too much debt, distorting incentives, or inflating asset bubbles. In any case, the political impasse in Washington makes any agreement on these matters nearly impossible.

So America's hands seem to be tied, so far as boosting demand goes. But that's not the entire story. To understand where demand – and growth – will come from, we have to look at things from a *global* perspective.

For the past several decades, the U.S. has served as the world's consumer of last resort. That allowed developing countries – namely Japan, and later China – to turbo-charge growth by producing more than they consumed, confident in the knowledge that Americans would provide the demand by consuming more than they produced. (A parallel pattern emerged within the EU, with Germany playing net producer and the rest of Europe net consumer). The surplus countries kept the game going by taking their export proceeds and lending them back to their customers so the deficit countries could keep buying. This is the global growth model we all became comfortable with.

There's no use pointing fingers: the arrangement, as long as it lasted, suited everyone just fine. But the 2008 financial crisis, followed by the Eurozone crisis, made it clear that the deficit countries of the world could no longer afford to go into greater and greater debt to make up the consumption gap. This lesson was temporarily obscured when China responded to a collapse in export demand by engineering a credit-fueled investment boom that, incidentally, propped up German machinery exports. This boom, however, is already faltering under a mounting burden of overcapacity and bad debt. The resulting correction will usher in profound changes in the way demand drives growth across the global economy.

Listen to most market commentators: while they may *say* that the financial crisis showed us the error of our ways, their every word belies a tacit wish to return to the world we knew before 2008. "When," they ask, "will the U.S. consumer start spending again? When will Chinese output get back on track?" Europe, they dare to hope, will turn out okay as long as more countries learn to imitate Germany. Maybe a cheaper Yen will give a renewed boost to Japan's exports.

These hopes are misplaced. We're not going back to the past. The old growth model is broken. Here's what will replace it, with a number of positive implications:

- China faces a major correction. As its credit binge is either brought under control, or buckles under its own weight, GDP growth will fall, perhaps abruptly. We may see signs of financial stress, or instability. The end of China's investment boom will hurt metals and mining, as well as makers of capital goods, on a global basis. We already see capital exiting China, flowing into corporate acquisitions, foreign real estate, and gold; a "hard landing" would accelerate this trend. Assuming China can avoid mass capital flight, however, it can draw on its $3.7 trillion in foreign exchange reserves to cushion the blow by sustaining consumption levels. Far from being a catastrophe, a correction that forced China to transform its huge accumulated savings into *demand* could turn the Chinese consumer into a major driver of global growth.

- For the past several years, Germany was able to largely ignore the impact of austerity on European demand because China's investment boom helped drive its exports. In such circumstances, the Germans were able to convince themselves that the solution to the Eurozone's woes is for every country in the EU to run a surplus (with whom, exactly, is unclear). The correction in China will force a change in this strategy. It will become increasingly evident that other Europeans can't earn their way out of Germany's debt until the Germans start saving less and buying more. Until the EU's leaders recognize this, Europe is simply marking time between crises.

- Twenty years ago, Japan reached the limits of its export-led growth model and faced the same adjustment China faces today. It failed to make the leap, and its economy has been stuck in low gear ever since. Abenomics is an experiment, a calculated bet that printing money will spark controlled inflation which, along with much-needed structural reforms, will help Japan break through to a consumption-driven economy. Investors, who bid up the Nikkei stock index 57% in 2013 – its steepest rise in 40 years – are betting the experiment will succeed. I'm cautiously optimistic, but I suspect all the good news is already priced into the market, while the toughest choices are yet to be faced. Meanwhile, the risk of some kind of armed conflict with China, over disputed islands in the East China Sea, is quite real and cannot be ignored.

- Of all the major economies, the U.S. is furthest along in adjusting to the new reality. The American consumer isn't going to re-leverage and drive global demand, and the government is in no position to replace him. Domestic demand will grow, but mainly on the back of a *production* story driven by global rebalancing, which we are already seeing take shape. The U.S. will capitalize on traditional strengths in agriculture and technology, as well as new ones, such as its energy cost advantage from shale oil and gas. Stagnant wages may be hurting domestic demand, but they are making the U.S. more competitive. Long-standing trends are starting to reverse: the U.S. is seeing an increase in manufacturing jobs (partly due to reshoring) and significant improvement to its trade balance.

As the U.S. economy gradually gains momentum, the Fed will have to taper, then unwind, its QE bond purchases. Interest rates will rise. Bond investors need to be aware of this, and plan accordingly, keeping their money in short-term instruments or ones whose credit quality stands to benefit from growth. Rising rates will make dividend stocks less attractive, unless their dividends also rise (as they well could, given many companies' strong balance sheets). Higher interest rates will be kinder to growth stocks. With the Equity Risk Premium (ERP, the extra return investors demand to hold riskier stocks instead of bonds) at historic highs, stock prices should be cushioned from a moderate rise in interest rates, so long as that rise is driven by real economic growth.

The unanswered question remains inflation. If you bet on inflation these past few years – by buying gold or TIPS – you would have lost. Most economists, who see insufficient demand stifling growth for the foreseeable future, are more worried about deflation. But if rebalancing does unlock new sources of global demand, and the U.S. economy accelerates faster than expected, the $2.8 trillion that the Fed has pumped into the banking system, most of it sitting idle on bank balance sheets, is going to circulate and multiply like the proverbial loaves and fishes. Inflationary pressure could pick up, which would force the Fed to raise interest rates sooner and higher than anticipated. If rates spiked in response to inflation rather than growth, the ERP spread would *not* shield stock prices, which would also take a hit. It's not a prediction, but it's something to watch for. The "canary in the coal mine" would be a rapid decline in excess bank reserves relative to the monetary base.

The shift to a new global growth model is a positive story, but it's also an extremely disruptive one. People who don't see it coming will be inclined to panic in reaction to the changes it involves. Investors who understand it will find opportunity where others see only uncertainty and upheaval.

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