MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

Back Where We Started, Again

In the October 2014 issue of *Consilium*, entitled "No More Head Fakes", we indicated our belief that a long-awaited period of faster economic growth had finally arrived. It had been our view up until that time that the US economy was poised for stronger performance. All the necessary ingredients for a breakout from several years of sub-standard post-recession growth were in place. Indeed, at that point a stronger economy was a necessary precondition for further stock market gains on the basis of earnings expansion.

We also noted at that time that the economy was accelerating just as the Federal Reserve was ending its massive bond-buying program (known as "quantitative easing", or QE), and was laying the groundwork for the first increase in short term interest rates since 2006. Economists were nearly unanimous in their view that the Fed would begin a process of "normalizing" interest rate policy in 2015. The only uncertainties involved the pace of rate hikes, and the markets' response to them.

Unfortunately, none of the key actors in this evolving drama stuck to their scripts! First, real GDP growth almost immediately decelerated, falling back into the 2%-or-less range that has characterized our economy for much of the last seven years. Second, the Fed spent most of 2015 preparing the markets for multiple rate hikes, but in the end was frightened into inaction due to market volatility. The Fed finally moved in December, only to be met with another significant selloff in risk assets around the world in January and early February.

Following the March meeting of the Federal Open Market Committee, Chairwoman Janet Yellen revealed that the markets' hyper-sensitivity to potential rate hikes had gotten the Fed's attention, and said that she believed the Fed should "proceed cautiously" in adjusting policy. She indicated that this view was a reflection of the "asymmetric" ability of the Fed to respond to economic disturbances – in other words, that the Fed had relatively few conventional tools to prod the economy if it weakened, but plenty of options if the economy overheated. Therefore, it was better to risk an overheating by standing pat than to spur a market selloff by tightening.

To summarize: in the last 18 months, the Fed has gone from being confident that the economy was strong enough to be taken off "life support" by ending QE and raising short-term interest rates, to a position that suggests rate hikes may be off the table as long as the market threatens a violent response. *The Fed appears to be a hostage to its own policy*. One cannot help but notice that stock markets around the world have made little or no forward progress since the Fed announced the end of QE on October 29, 2014.

At the core of the Fed's thinking is a strong belief in the power of markets (stocks and other risk assets) to *drive* economic activity, not just *reflect* economic activity. Specifically, interviews and public comments by current and former Fed officials, as well as representatives of other central banks around the world, indicate that monetary authorities hoped that QE would push asset prices higher and, in turn, promote more aggressive spending and investing. There is a theoretical basis for belief in a "wealth effect", that higher asset prices make economic participants feel more confident about spending and investing. The Fed was motivated by this belief in the last cycle as well; it has acknowledged that it specifically attempted to inflate the previously moribund housing sector with very low interest rates in response to the recession and market downturn in 2000-2002.

Sources: Baseline, FactSet, Federal Reserve Board of Governors, Federal Reserve Bank of St. Louis

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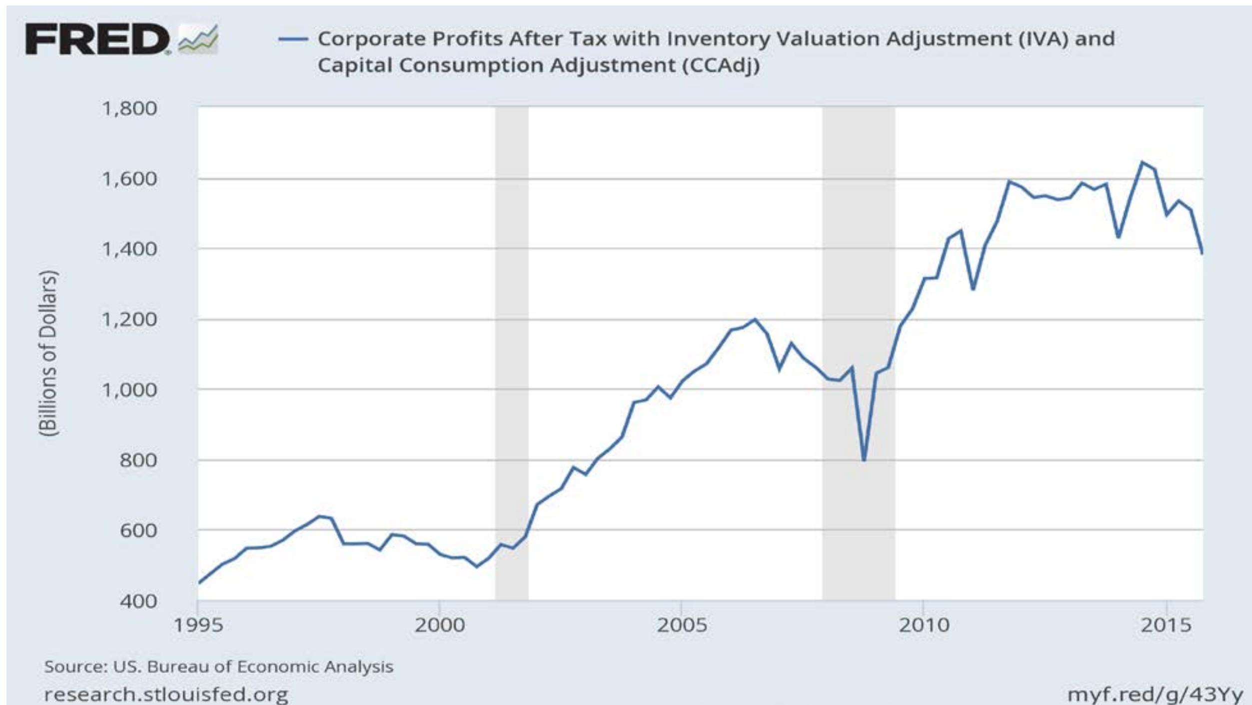
But does the wealth effect work in practice? Has massive monetary stimulus and a tripling of the S&P 500 filtered down to the real economy? It is impossible to know how the economy would have performed absent QE and a multi-year period of zero-interest rate policy. We can say with some confidence that every incremental dollar of monetary stimulus has produced a smaller and smaller economic response. If the economy were responding as it had in past cycles, inflation and economic growth would be much higher than they are today. Instead, in early 2016, real GDP growth has slowed to less than 1% – sufficiently weak that the Fed views the economy as being vulnerable to market shocks.

Equity investors face a quandary. Valuations are high – adjusted for debt, the S&P 500 trades at its highest level in 13 years. High valuations are not necessarily an impediment to higher stock prices, but they require strong underlying earnings growth for justification, and corporate profits peaked two years ago (shown below). With tax, fiscal, and regulatory policy in shackles, it is difficult to imagine what could spontaneously ignite meaningfully stronger growth at this time. On the other hand, the greatest risk to the stock market is the threat of recession. While the possibility of a downturn has risen somewhat, it remains unlikely in the near-term.



Meager growth with high valuations, offset by a Fed that appears unwilling to permit a significant decline – these are the conditions that have generated near-zero returns in the equity market for some time. For now, risks appear balanced. But from a distance, the relationship between the equity market and the Fed is beginning to appear dysfunctional, with addict/enabler and codependency features. This arrangement is unsustainable, and is inconsistent with expectations of good long-term investment returns. In the context of this environment which is challenging to long-term investors, we continue to monitor client portfolio exposures and make appropriate adjustments to improve potential returns and reduce unnecessary risks.

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After a decade in our current location, Mid-Continent Capital will be moving a few blocks north on Wacker Drive at the end of June. You will be receiving an official notice shortly. Owing to steady growth in clients and personnel, this is our third move in the firm's 33 years, and we will begin packing up the offices and workspaces of our 18 employees soon. We are excited about being able to welcome you to our new surroundings, and we thank you for your continued support.