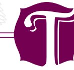


Tough Love?

With the stock market's quick and negative reaction to a possible change in Federal Reserve (Fed) policy later this year, you would have thought that (Uncle) Ben Bernanke sat the market down for a straight talk on the dangers of easy money addiction and the importance of living within one's means. Neither a borrower nor a lender be. Shape up or ship out.

Well, if that were the lecture, Bernanke and the whole Fed would pretty much be out of a job. While Bernanke himself does indeed appear to be out of a job next year, I am pretty sure the Fed, and other central bankers around the world, will still be here. I don't think they are quite ready to tell their respective financial markets that it is time to close the books on the easy money addiction the banks themselves have created. After all, when investors nickname the third round (QE3) of easing "quantitative easing infinity", it doesn't really suggest that the path to frugal living is just around the corner.

Of course, I could be wrong. But I will believe it when I see it. Don't get me wrong, I do think interest rates will continue to go up as the Fed tapers off its buying. The 10-year US Treasury has gone from a 1.6 percent yield in early May to 2.5 percent recently. As you and I start to set interest rates again on US Treasury securities, we should demand, at the very least, a return that covers the expected rate of inflation plus an additional amount for the time value of money. The Fed's goal has been to force rates down, not make money on its investments. So, ending QE3 will be easier said than done. However, I do not think the Fed is saying QE3 is ending quite yet. But let's assume for the sake of argument, the Fed is indeed signaling QE3 is finished.

Before the market and economic meltdown of 2008, the Fed held just over $800 billion in largely short-term US Treasury securities. Just what does the Fed do with the $3.4 trillion in bonds it currently owns, some much longer term in maturity than it has historically held, including mortgage-backed bonds supporting the housing market? Reduce these holdings too fast and the Fed risks both a very sharp spike in interest rates and an economic slowdown as it potentially shrinks the supply of money used for loans. Too slow and easy money persists long past when it should. My bet is the Fed is slower to respond as a result. If the Fed were to sell bonds at the same rate it is now buying bonds, it would take about two and one-half years to get back to the pre-meltdown level. Importantly, even without QE3, the Fed has targeted the Fed Funds rate at .25 percent. Most Fed governors and the market itself expects this rate to continue for at least the next 12 months. That is still easing in my book.

BREAKING THE CYCLE

Other central banks are aggressively easing so there may also be some pressure on the Fed to keep easing as well, even if not to the current extent. Yet, our easing has likely encouraged easing overseas. If we can not break the cycle, we should at least put the brakes on it. Japan is now easing to a degree that makes it hard to tell if we are witnessing a slow motion train wreck or brilliance never seen before. Only time will tell. The European Central Bank has ramped up their easing in recent months as well. But, is all of this easing truly extraordinary or run-of-the-mill lever-pulling for these bankers?

The Bank of England (BOE) is instructive from an historical perspective. Since 2009 its Bank Rate, similar to our Fed Funds Rate, has been set at .5 percent. This is the lowest rate it has set - ever. Prior to 2009, the lowest rate was 2 percent. Our Fed has been around since 1913 and has survived recessions, depressions, world wars, and upset politicians. The BOE was established in 1694. It has survived the South Sea Bubble of 1720, numerous wars in the 1700's (including the American Revolution), the Panic of 1873, the depression of 1919 that followed World War I, and so much more--including much worse unemployment than currently exists. Throughout both the 1920's and 1930's, Britain's unemployment rate consistently averaged in the double digits. The lowest interest rate over this entire time period? *Two percent until 2009*. Maybe the current policy is superior to actions taken over the past 300 plus years. However, is keeping rates at or near zero percent during periods of modest growth and relative calm the smart thing to do? What will our central bankers do during the next crisis?

ARE INTEREST RATES DRIVING STOCK PRICES?

Interest rates are certainly important to the stock market. The stock market has rallied when the Fed signaled it would start a new round of QE. It has gone down when QE1 and QE2 ended and hints that QE3 will be tapered back. Lower interest rates and the Fed buying large quantities of bonds can lead to higher equity valuations, such as price/earnings (P/E) ratios. Conversely, if rates rise too far too fast, stock valuations will shrink and stock prices will go down. Historically, the early stage of a rise in interest rates, in *normal* recoveries, is not damaging as the increase reflects a strengthening economy. Of course, this is not a normal environment with interest rates rising from a Fed-induced historically low level. No one can really say with much confidence how this plays out, not even the Fed.

Interest rates have not been the only driver of good stock market returns. Since the Fed started with QE1 in November 2008, the market has returned 14.0 percent per year through June 30 (see Chart 1). Starting from the top of the chart, earnings increased by 8.3 percent per year on average. The majority of this growth was not due to companies selling more (1.6 percent annual growth) but due to higher profit margins (6.6 percent "return"). Expanding profit margins were the biggest single driver of returns and margins are now at historically high levels. The changing level of valuations as measured by the P/E ratio over this time period has contributed roughly 2.9 percent of the return per year. Why have margins expanded so sharply?

Chart 1

S&P 500 Return & Sources

10/31/2008 to 6/30/2013

Sales Growth	1.6%	
x Profit Margin Change	6.6%	
= Earnings Growth	**8.3%**	
Earnings Growth	8.3%	
x P/E Change	2.9%	(13.7 to 15.7)
= Price Change	**11.4%**	
Price Change	11.4%	
+ Dividend Return	2.5%	
= Total Return (Average Annual)	**14.0%**	

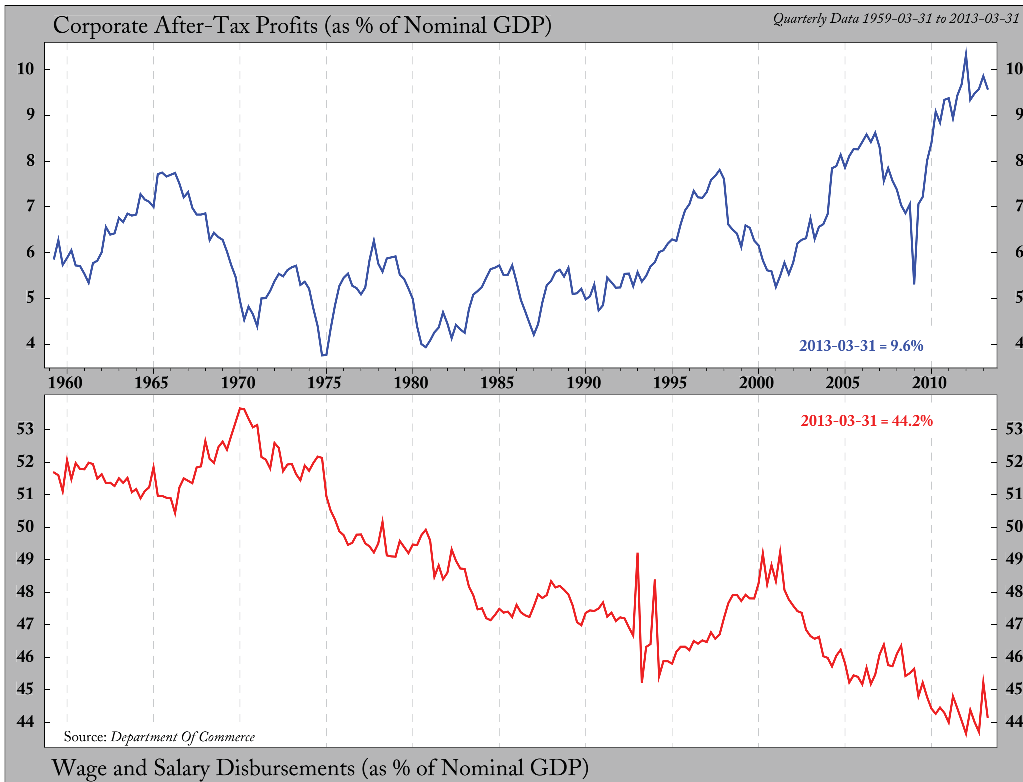
* *above figures are each component's contribution to total return, calculated as compound annual growth rates. Source: Bloomberg*

EMPLOYMENT IS GOOD

Below, Chart 2 shows how corporate profits are taking an increasingly greater share of what we produce while the allocation to wages is shrinking (both as a percent of GDP). The fact that this relationship is both strong and negative is not surprising. Employee compensation is generally the largest expense of the average company and in many cases most of the expense. So, with weak employment growth and weak wage growth, margins have taken off. Where do margins go from here? It seems to me that margins will no longer provide the gas for the market. There is only so much cost control possible before companies end up not having any customers, or at least happy ones. Due to fewer people generating a paycheck that allows them to buy goods and services produced, most companies have seen a modest sales increase. Ultimately, employment and wage growth need to pick up. This is the way the economy should work - the consumer buys goods and services from companies which allows companies to pay their employees to produce the goods and services. This cycle breaks down when too few consumers are employed. When employment picks up, margins may go down, but company sales should increase (along with GDP), thus allowing us to achieve a better balance in the economy. What is the evidence that margins have actually peaked? Modest signs of strengthening in the labor markets.

If this strengthening does not continue, we will further "hollow out" and become more dependent upon the Fed and other parts of our government for our economy. For most people, this is not a prescription for good, only for the privileged few. I do not think our destiny is a downward path. It is too easy to draw a straight line to Armageddon when times are bad. Our pendulum has always swung back into balance, and we will get there again. First, we need to get to the point where the Fed is off the front page every day. This starts with the Fed tapering its buying and getting out of crisis mode. As equity investors with a time horizon longer than a few months, we applaud this move. We continue to look for buying opportunities while some in the market think they have just heard the worst news ever. Now, the next step is to adopt fiscal policies that support and encourage Main

Chart 2



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