Quarterly Market Outlook & Strategy

The Fed's Failure

Third Quarter of 2019

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October 2019

Executive Summary

- The US economy is slowing, as corporations and consumers confront the blowback from intensifying trade conflict, which has triggered a global manufacturing recession. Until recently, weakness was confined to the industrial sector, but is now spreading to the services economy. The Fed has made two precautionary rate cuts in an effort to forestall recession, and has promised to do more if the economy continues to weaken.

- Corporate earnings are in sequential decline as we enter the fourth quarter. The combination of weaker overseas demand, a strong US$, and rising domestic labor costs are pressuring margins. The stock market has remained elevated thanks to low interest rates, which continue to fuel debt-funded stock buybacks. The passive investing juggernaut has also buoyed the market—although many segments are performing poorly. Both passive investing and stock buybacks are liquidity-dependent, price-insensitive, and increasingly divergent from fundamentals.

- A continuation of the Federal Reserve's easy-money policies cannot prevent recession in an economy that is fully-loaded with debt. There is no evidence that business capital spending responds to changes in interest rates, and most US households cannot afford to borrow much more. The central bank has abused its "exorbitant privilege" of issuing money to drive up asset prices, worsening a wealth divide that is becoming politically contentious.

- Leaders in the policy, academic and financial communities are beginning to question the wisdom of continuing with a monetary strategy that is at best ineffective, and at worst counterproductive. Unfortunately, most central bankers have been unwilling to acknowledge that their policies are no longer working. We fear a loss of Fed credibility that could spiral into a crisis of confidence when the Emperor is seen to be naked.

- We doubt the Fed will experiment with negative interest rates, as have been tried in Europe and Japan. It is more likely that public opinion will induce the central bank to shift its focus away from the financial sector and toward the real economy. *Modern Monetary Theory* is just another name for the "helicopter money" Fed Chairman Bernanke proposed several years ago. Getting money into the hands of ordinary people and businesses is probably better than the "socialism for capitalists" we have seen in recent decades. That said, it is a poor remedy for the political and governance failures that have brought us to this point.

- US stocks have delivered a total return since early 2018 that is barely above gains in the bond market. Paladin client portfolios remain underweight US equity, with a tilt toward high-quality value stocks. We remain overweight short-duration bonds and cash, as we survey the international landscape for attractively-priced equity investments. We have taken profit on our long US$ and gold investments, and have deployed alternative portfolio hedges including a long position in the Japanese yen.

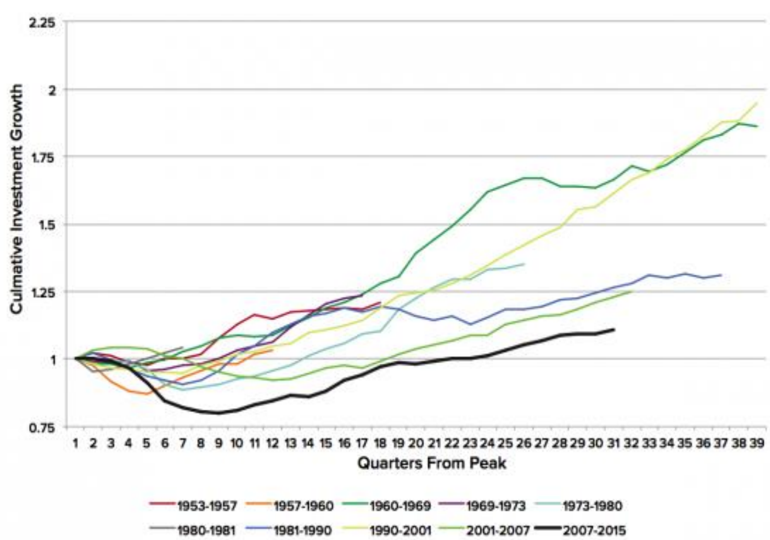
How Did We Get Here?

In late September, the US Federal Reserve cut interest rates for the second time in two months, bringing its overnight rate down to 2%. It did so with US unemployment at its lowest level in 50 years. Growth has been chugging along at 2%, a level economists agree fulfills our potential as a mature economy. Core inflation accelerated in August to 2½%, the highest in a decade, and above the Fed's target. The central bank's stated mandate is to achieve a balance of full employment and price stability. It would seem that policymakers have succeeded. And yet, according to the Fed, the only way the economy can continue to function is by driving real (i.e., inflation-adjusted) interest rates deeper into negative territory. Oh, and if that doesn't work, the Fed has offered to supply fresh liquidity to the financial markets, on top of the $3.5 trillion in assets purchased since 2008. Because obviously what the financial system needs now—with stocks hovering near all-time highs, bond yields close to historic lows, and homes unaffordable for all but the wealthiest—is more money, right?

Does this make sense? If so, what the hell is wrong with us?

Chairman Powell explained the Fed's decision by pointing to uncertainty created by the so-called "trade war," which has accentuated the ongoing slowdown in the global economy. The rate cut—which drew three dissenting votes from the FOMC—was billed as a precautionary measure, to protect the US economy against the risk of recession. Unfortunately, lower interest rates will not fix a broken system. Fundamental imbalances related to the unequal distribution of income and wealth in our country have created fragilities in both the real economy and financial markets—not to speak of our politics. Throwing more money at the problem is not the solution. Rather, it *defines* the problem.

Figure 1. U.S. Investment Spending In Recession & Recovery, 1953-Present



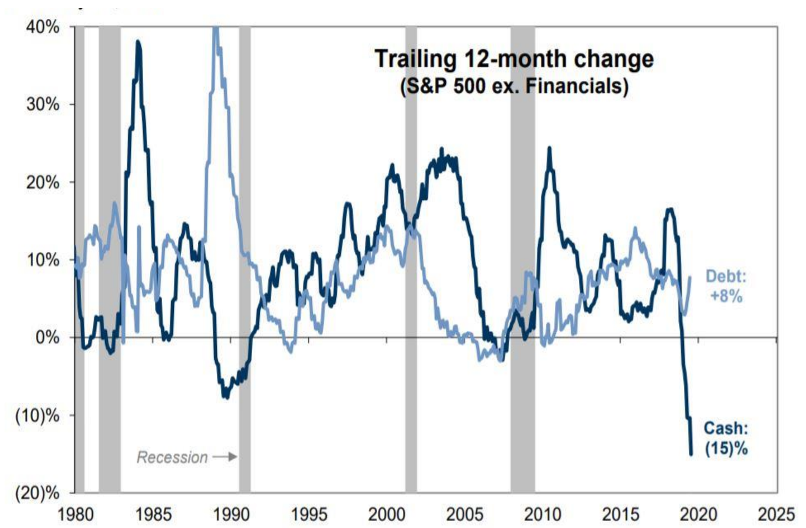
Source: J.W. Mason, "Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment." The Roosevelt Institute, 2015

US businesses are not starved for capital. Funds have been flowing to qualified borrowers (and many who probably *shouldn't* be borrowing) for over a decade, as is evident from elevated corporate debt ratios. Unfortunately, little of this money has been directed toward investment, whose growth is well behind the pace of past recoveries (Figure 1). Nor is there any evidence that interest rates play a meaningful role in capital spending decisions. Servaas Storm illustrates the ineffectiveness of monetary policy in stimulating investment, which, evidence suggests, is driven primarily by aggregate demand.[1]

Rather than investing, companies have been distributing capital to shareholders though dividends and repurchases; low interest rates provide the jet fuel for debt-financed stock buybacks.[2] So long as a company's borrowing cost is below its earnings yield, there will be pressure on C-suite executives to "return" capital to shareholders—even if there's no capital to return. Goldman Sachs calculates that dividends and stock buybacks now account for 104% of S&P 500 companies' free cash flow, meaning they are paying out more than they have on hand. Over the past year, cash balances have dropped 15%, while gross debt rose 8% (Figure 2).

Figure 2. Trailing 12-month Change in Cash & Gross Debt

As of July 25, 2019



Source: Compustat, FactSet, and Goldman Sachs Global Investment Research

Like leveraged buyouts, debt-funded stock buybacks can damage corporate balance sheets, leaving companies less resilient to shocks. This problem is well known in the retail sector, but has also afflicted blue-chip leaders such as HP, Cisco, Exxon, GE, Boeing, Citibank and IBM.

[1] Servaas Storm, "Summers and the Road to Damascus," Institute for New Economic Thinking, September 3, 2019.
[2] J.W. Mason of the Roosevelt Institute has demonstrated a declining correlation between corporate borrowing and capital investment from the 1960s to today. By contrast, there's been a rising correlation between corporate borrowing and payouts to shareholders. Private equity has been implicated in the shift in business strategy.

Profits Without Prosperity

In an acclaimed 2014 Harvard Business Review article, William Lazonick described how the focus of corporate management has shifted over the past four decades, from value *creation* to value *extraction*. Among the many examples he cites: pharmaceutical companies claim to need the profits generated by high drug prices (i.e., patent protection) to fund vital R&D. In reality, these companies have been pocketing government subsidies while channeling money to shareholders. From 2003 to 2012, Pfizer distributed *150%* of its profits.

Not all buybacks are bad, of course. When a company is sitting on a large cash cushion and its share price is below intrinsic value, a stock tender can represent good value for both the company and its shareholders. However, that's not been the case lately. Massive share buybacks are occurring in the most expensive stock market in decades (Figures 3 & 5) and at a time when corporate borrowing—but not earnings—is growing (Figures 4 and 5).

Figure 3. S&P 500 Price-to-Sales Ratio

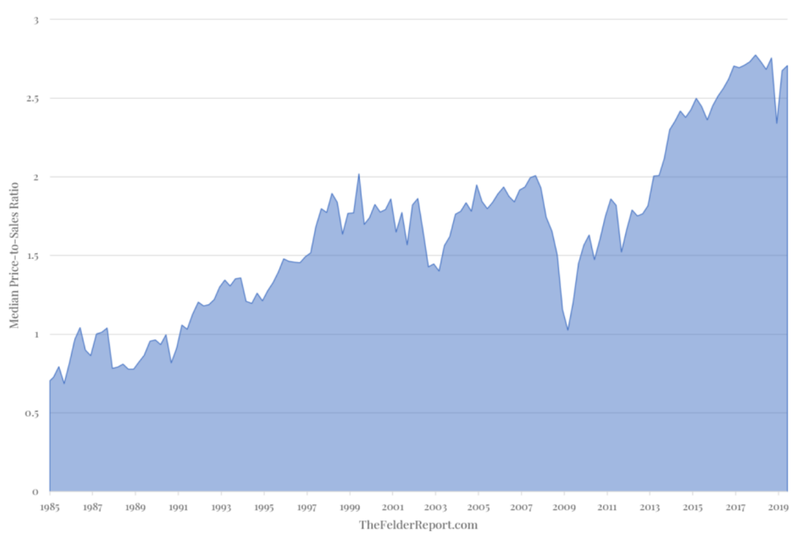
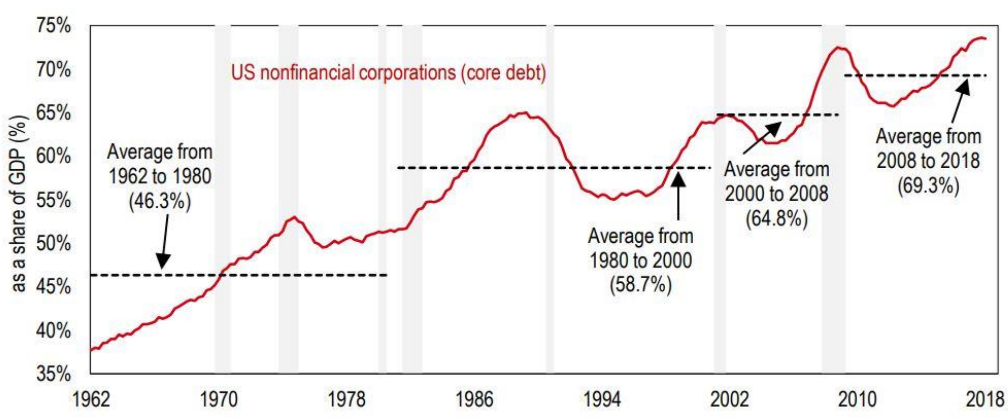
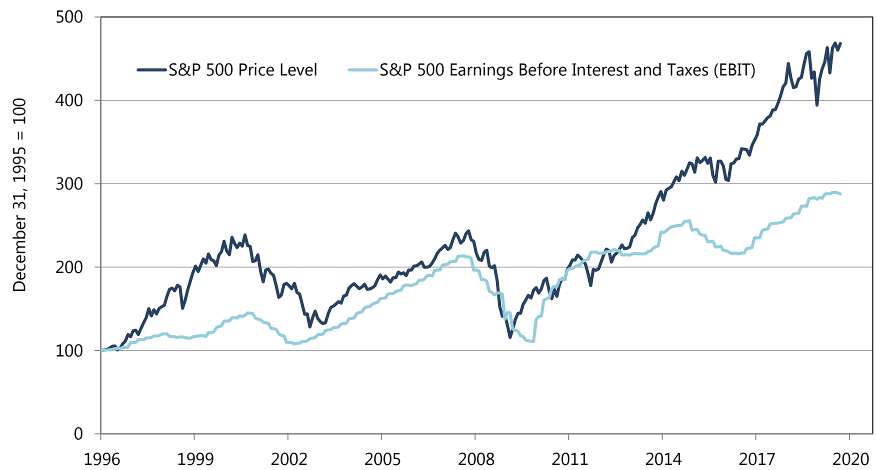


Figure 4. US Non-Financial Corporate Debt/GDP (in %)



Source: HSBC, BIS total credit statistics

Figure 5. S&P Prices Outpace Earnings



Source: Bloomberg

No one doubts that central banks play a vital role as lender of last resort in financial crises, supplying ample (but temporary) liquidity to banks. However, there is no evidence that a prolonged period of low interest rates and/or large-scale asset purchases has produced a sustained upturn in business investment in the US, or in any of the other countries that have tried it.[3] What Fed policy has done is to inflate stock prices while encouraging companies to borrow large amounts of money to repurchase their shares. This self-reinforcing loop has dramatically increased the risk of corporate bond defaults when earnings disappoint.

Nor have low interest rates provided real support to households. It's true that reduced debt service has helped families save a higher proportion of their incomes; the personal savings rate rose from a low of 2% in 2006 to 8% in 2019. Even so, the ratio of household debt (mortgages, student loans, auto loans, credit cards) to income remains higher than in prior decades. The net worth of the median US household (aged 52) was under $100k in 2016, down from $140k in 2007—despite the markets' recovery. That's far less than is needed for a secure retirement. Even with Social Security benefits, experts say an income multiple of 10-15x (at least $550,000 for the median family) must be saved in order to retire comfortably.

Averages can be misleading, given the unequal distribution of income and wealth in this country. Half of US families have a net worth of less than $40,000, *including* whatever equity they may have in their homes. Encouraging more debt-financed consumption is not going to help most Americans, who need to be saving closer to 15-20% of their income in order to build a secure retirement for themselves. Most US families need more money—but not more borrowed money.

[3] The same can be said for corporate tax cuts. Although they certainly boosted earnings and buybacks, there's no evidence the additional profits were directed toward increased investment and hiring. Nor did lower taxes elicit repatriation of capital to the US. For a review of the evidence, see Jeff Spross: here and here.

Borrowing to finance current spending (beyond what's needed to smooth short-term fluctuations in income) is not sustainable. Debt accumulation must eventually be matched by business and/or household income growth—resulting from investments in human or physical capital—in order to repay the obligation. That has not been happening in the United States. Instead, as our society ages, we are hearing stories of mortgages and even college loans stretching into retirement years. Sub-prime auto terms that continue beyond the useful life of a car. Minimal emergency savings. Roughly a third of Americans say they don't expect ever to retire, because they cannot afford to do so. Many others intend to work as long as they can, even in "retirement." More borrowing is not going to address any of these problems.

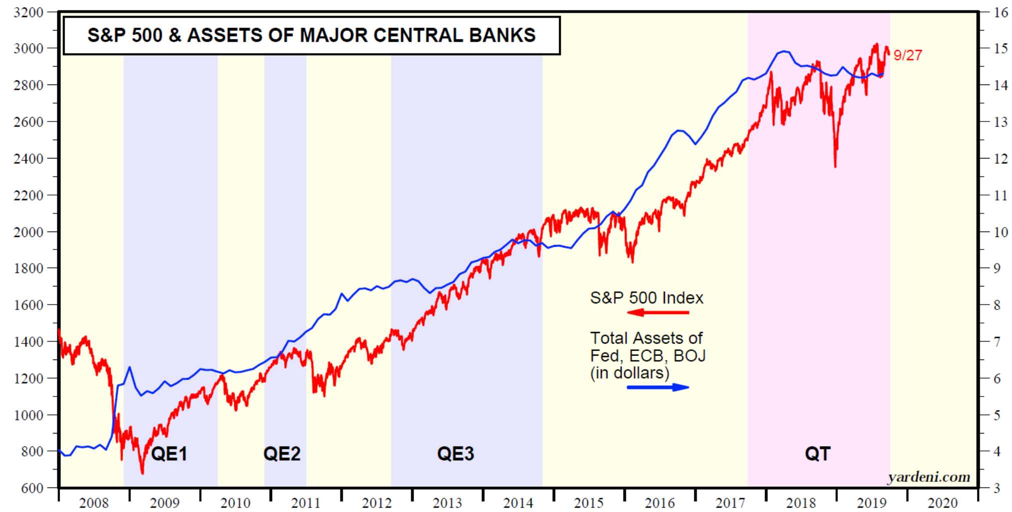
Financial Markets Know Best?

If easy money is not helping the economy, why does the US Federal Reserve (and the European Central Bank, and the Bank of Japan) continue with a policy of flooding the markets with cheap financing? Is it because, to the hammer, every problem looks like a nail? There is undoubtedly some truth to that interpretation. Unaccountable institutions are liable to engage in self-serving justifications for ineffective policies. After all, if a strategy isn't working, perhaps it simply hasn't been tried hard enough!

Another explanation is that the Fed has been coopted into believing financial markets know best—so the Fed must always listen and respond to the markets' signals. For decades, there's been an unhealthy symbiosis between the Fed and stock and bond investors. The central bank sets policy in light of "financial conditions" which are, in turn, dependent on investor expectations of Fed policy. The trigger for the about-face in the Fed's tightening plans last December was not weakness in the economy, but weakness in stocks. Apparently, equity investors "knew" that the economy needed additional support from the Fed, and when the Fed delivered, the market rallied in response. The symbiosis was evident again in September, when the Fed was blamed for not stepping more quickly into the repo market even though, as Matt Levine points out, *banks stood to benefit from the spread between repo rates and their borrowing costs*. Because, apparently, 24 hours of volatility in short-term funding markets is way too much.

One might have thought the financial crisis of 2008-09 had revealed how dangerous this feedback loop is. Coming out of the recession of 2000-02, the Fed kept short-term interest rates too low for too long, promoting excessive risk-taking that produced a housing bubble of epic proportions. Instead of learning from its mistake, the Fed came right back with more of the same medicine that almost killed the patient. The European Central Bank and Bank of Japan followed suit, not wanting to see their currencies appreciate vs. the US dollar. It's an open secret among investment professionals that much of the rise of asset prices since 2012—against a backdrop of slow growth and stagnant corporate earnings—owes to central bank liquidity (Figure 6). When the Fed stepped back in 2015, foreign central banks stepped forward to fill the breach, driving their short-term rates into negative territory. A substantial interest-rate differential triggered massive capital flows into the United States, which propelled the stock market and US dollar higher.

Figure 6: Central Banks Drove Stocks Higher



Note: QE1 (11/25/08) = Fed starts buying $1.24tn in mortgage securities. QE1 expanded (3/16/2009) = Fed starts buying $300bn in Treasuries. QE2 (11/3/10) = Fed starts buying $600bn in Treasuries. QE3 (9/13/12) = Fed starts buying $40bn/month in mortgage securities (open ended). QE3 expanded (12/12/12) = Fed starts buying $45bn/month in Treasuries. Fed terminated QE net purchases (10/1/14). Fed reduced holdings (10/1/17-9/30/2019).
Source: Federal Reserve Board, Standard & Poor's and Haver Analytics.

None of this is subtle, mind you. The Fed explicitly sought to inflate the prices of financial assets, in order to create a positive "wealth effect" on personal consumption. That's been great for the minority of Americans who actually own such assets, but not so good for those who would like to be able to afford to buy them. First-time homebuyers have been priced out of real estate markets all over the country. People who hope to retire are forced to pay up for investments whose prices are so high their expected returns are now approaching zero—requiring twice the savings effort. It is disingenuous for central bankers to claim they played no role in the rise of inequality; their $3.5 trillion in liquidity injections were directed toward those who own financial assets—i.e., the wealthiest Americans.

If Fed policy were merely ineffective, it might continue indefinitely, drawing little notice or concern. However, a growing chorus of voices—senior members of the policy, academic and investment communities—now agree that easy money has become a dangerous drug. Once effective in stimulating the economy, pervasive liquidity has become counterproductive to growth, corrosive of business practices, and damaging to social cohesion. Former US Treasury Secretary Larry Summers has acknowledged that "there is something unhealthy about an economy in which corporations can profitably borrow and invest, even if the project in question pays a zero return." [4] Economists at Princeton University have shown how a prolonged period of extremely low rates can curb growth by increasing industry concentration.[5] Others have attributed declining labor and capital shares in national income to such concentration.[6] We have been eating our seed corn, rather than investing in a better future.

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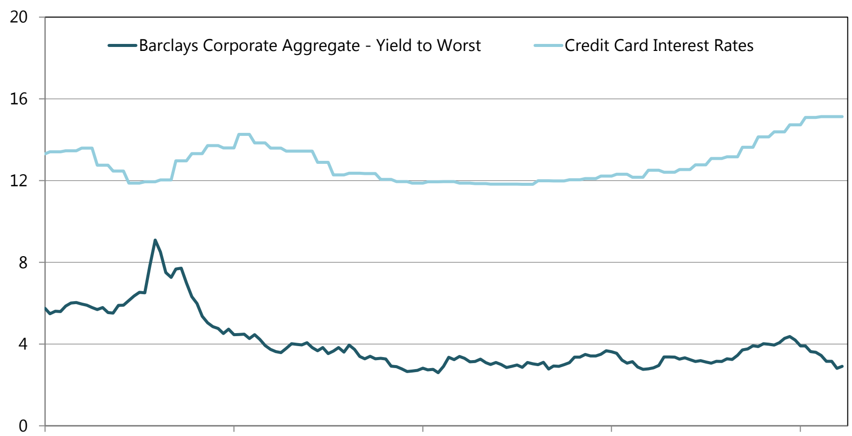
[4] Larry Summers and Anna Stansbury, "Whither Central Banking," Project Syndicate, August 23, 2019.
[5] Ernest Liu, Atif Mian & Amir Sufi, "Lower Interest Rates, Market Power, and Productivity Growth," SSRN Research Papers, February 9, 2019.
[6] See Simcha Barkai, "Declining Labor and Capital Shares," Stigler Center Working Paper, 2017.

Money for Nothing

Money for Nothing

Matthew Stoller of the Open Markets Institute describes a “counterfeit capitalism” in which central banks entrench monopoly power by making it possible for investors to fund loss-making companies that defeat or acquire potential rivals. Firms such as Uber, Lyft, Tesla, Spotify, AirBnB and WeWork—and pretty much the entirety of the fracking industry—seek to “disrupt” traditional competitors by setting prices below the cost of production. Losses are funded by private equity, in the hopes that these companies will eventually dominate their market segment. This would (in theory, some day) allow them to earn monopoly rents, thus rewarding early investors. They are taking a page from the Amazon playbook, even as the retail behemoth confronts a social backlash against its business model and methods. It’s logical, I suppose, that real corporate borrowing rates are set to zero, if our central bankers are determined to finance loss-making companies that drive profitable ones out of business. Meanwhile, borrowing costs for ordinary households continue to rise (Figure 7).

Figure 7. Borrowing Costs for US Corporations vs. Households



Source: Federal Reserve Bank of St. Louis FRED database

Some central bankers are beginning to acknowledge that monetary policy may be on the wrong track. Dissenting from the FOMC’s July and September rate cuts was Boston Fed President Eric Rosengren, who warned that “one potential cost of increased accommodation is that very low rates can encourage households and firms to take excessive risks. This could show up in the form of increased leverage, with prices for risky assets reaching levels that may not be sustainable over time.” Former Vice Chairman and NY Fed President William Dudley went much further. In a late-August Bloomberg column Dudley admonished the Fed not to accommodate President Trump’s trade conflict with China via easier monetary settings, since a recession would be an appropriate remedy for misguided policy.

Concerns over the effects of Fed policy among financial market participants (who have gained the most from a long period of easy money!) have also been escalating. Ray Dalio, the storied head of Bridgewater Investments, recently summed up the problem this way:

"There has been a wave of stock buybacks, mergers, acquisitions, private equity and venture capital investing that has been funded by both cheap money and credit and the enormous amount of cash that was pushed into the system. That pushed up equities and other asset prices and drove down future returns. It has also made cash nearly worthless. The gains in asset prices benefited those who have investments much more than those who don't, which increased the wealth gap, which is creating political anti-capitalist sentiment and increasing pressure to shift more of the money printing into the hands of those who are not investors/capitalists."

Howard Marks, the billionaire co-founder of distressed investment manager Oaktree Capital, is similarly concerned: "Quantitative easing is generally considered to have contributed to the past decade's low prospective investment returns, resultant risk-taking, asset inflation, and increasing wealth divide. As with any other prescription, shouldn't we worry about possible side effects like these? Can government actions permanently raise the level of demand in an economy, or do they mostly accelerate future demand into the present? If the latter, can QE elevate GDP forever above what it otherwise would have been? I doubt it."

Even private equity pioneer Mitt Romney has been critical of the direction macroeconomic policy has been taking. In a letter to US Treasury Secretary Mnuchin, opposing President Trump's proposed capital gains tax cut, Romney reminds us that, "In 2018, 91% of Americans reported no long-term positive gains, while the top 1% of income earners paid 72% of all capital gains tax…Investors are not starved for capital, but rather productive investments that are increasingly difficult to find. This retroactive tax cut creates a windfall for those who have already invested in capital assets…rather than encouraging future capital formation."

Why are these investors worried? They know that our current system is not merely unsustainable, it is unstable. The current tension between asset prices, economic value and social values will likely resolve itself through a market crash or political upheaval—perhaps both.

A More Modern Money?

It is unlikely that the Fed will experiment, as other countries have done, with negative interest rates. They know such policies are ineffective in stimulating the economy, for the reasons described above. They also know that negative rates wreaked havoc with foreign banking systems. Indeed, the only reason they have been sustained abroad is because positive yields are still available in the United States. Perhaps most importantly, negative interest rates would require the abolition of cash, which would not be readily tolerated in this country. My guess is that Americans would sooner give up their guns than their greenbacks.

Those with a sense of history are betting we will eventually see a shift in Fed policy, one that channels liquidity away from the financial system (and large-firm beneficiaries) toward the government budget (and ordinary people and businesses). This is the Money-Financed Fiscal Program that Fed Chairman Bernanke proposed several years ago—better known as "helicopter money."

What's now been dubbed [*Modern Monetary Theory* (MMT)] is a strategy, supported by progressive groups, to gear policy toward the funding of public services, infrastructure investments, and income transfers. The idea is to get money into the real economy rather than the financial markets. Proponents of MMT argue that the strategy needn't be inflationary, so long as resources flow to investments that improve the productive capacity of the economy, thereby releasing bottlenecks on growth. That certainly would be desirable. Given the nation's crumbling infrastructure, pressing educational needs, and broken health care system, the social returns to public investment spending could be very high indeed.

That said, MMT begs the question of *why* our political and corporate governance systems have failed in recent years to allocate resources more effectively—and how redirecting the money spigot from banks to the budget would address those problems. The critical question for MMT advocates is: can monetary policy deliver only "good inflation" that raises productivity and output, along with demand? That supports wages but not prices? Absent fundamental change in how the productive energies of our economy are harnessed and shared, even modestly higher inflation could end up hurting the very people MMT is meant to help.

Paladin Investment Strategy

The slowdown in global manufacturing that began in 2018 has now spread to US industry. The negative impact on foreign producers (especially, Germany, Japan and China) of higher interest rates and oil prices, together with escalating trade tensions, are now blowing back to the US. Waning foreign demand, a strong dollar, and rising domestic labor costs have eroded US profit margins, especially among multinationals. However, the US economy is dominated by services and is therefore somewhat insulated from global trends. Household spending has (so far) continued to expand, helped by steady job growth and rising wages, which are supporting consumption. The housing market has slowed, but remains underpinned by the Fed's low-interest rate policy. Easy financing has continued to incentivize share buybacks, which will likely continue so as long as corporate borrowing costs remain below the equity earnings yield.

The blanket promise of Fed liquidity has also sustained flows into passive equity investments, which recently eclipsed actively-managed funds in terms of assets. Both stock buybacks and passive investing are being driven primarily by liquidity conditions, rather than business or economic fundamentals. This price-insensitive buying has helped the stock market to trade sideways over the past two years, despite deteriorating corporate profitability.

While it's anyone's guess as to when we'll see a realignment of stock prices and fundamentals, what *is* clear is that the risk vs. reward of investing in US equities remains poor. Moreover, it appears that "animal spirits" are now waning, as evidenced by the substantial haircuts the public markets have imposed on speculative companies like Uber, WeWork, Netflix, and Tesla. Investors are starting to prioritize companies that actually generate cash profits.

CEOs are starting to recognize the prospect of lean years ahead. Schwab's highly-publicized move to zero-commission stock trading (followed shortly thereafter by TD Ameritrade and now Fidelity) is likely to be the first of many adjustments that ripple across industries. These classic signs of a maturing market cycle are harbingers of diminished pricing power, shrinking margins and multiples, and softer capital spending and hiring.

Lower commissions are, of course, a good thing for Paladin clients. Our US equity covered call strategy with Van Hulzen, and our *Paladin Partners* accounts trade almost exclusively in ETFs, individual stocks and options at TD Ameritrade, and will benefit from the elimination of trading commissions. Covered calls remain a welcome source of income in a world where capital appreciation is difficult to come by, and where interest rates (once again) offer dismal rewards for savers.

Our client portfolios remain underweight global equities (with tilts toward high-quality income and value stocks) and overweight short-duration fixed income and cash. We've taken profit on most of our opportunistic investment in gold, and built a sizable long position in the Japanese yen. These investments reflect our view that the dollar bull market is mature, a theme we'll build upon in the coming year. For now, we're sticking with safe-haven hedges, as we await better prices in cyclical sectors, such as emerging market equities, foreign currencies, and real assets.