August 4, 2014

Correction – Price and Time

Stock prices started retreating this past week, driven by newfound concerns that good economic news is bad news for the stock market. What? Normally, good economic news is good news for the market, right?

Goodness knows that there has been enough bad news recently to drive asset prices lower – concerns about China's banking system, military action in the Gaza strip, the ISIS invasion of Iraq, Putin's support of rebel activities in Ukraine, Argentina's default problems – the list goes on.

Now, the markets have something real – something economically ***tangible over which to worry.***

Good News is Bad News?

Last week, good economic news was released in spades. Starting on Wednesday, Washington reported that our economy grew by 4.0% during the second quarter. Aside from the fact that a full 1.6% of that growth came from inventory accumulation, most were stunned by the outright size of that number. One of the more important portions of the report showed final sales growth came in at +2.1%, up from a "snow-influenced" -1% in the first quarter. It appears the pundits who said the first quarter economic contraction was an abnormality due to inventory write-down and weather were correct (we were in that crowd). Whatever the case, a 4% number for GDP growth is big – big enough that it has to have gotten the Federal Reserve's attention. Rising GDP eventually fosters an upward push in inflationary trends, according to the *Phillips Curve Theory* (more on this later).

On Thursday, news showed that the Employment Cost Index rose by 0.7% during the second quarter, more than twice the growth rate of the first quarter's 0.3% uptick. The report showed that wages rose by 0.6% for the quarter and benefit costs rose by 1.0%. American workers are starting to get pay increases. Good news, right? Well, the Dow Jones average fell by more than 300 points on that news. Most economists agree that an upward push in inflation normally doesn't stick unless it is accompanied by a rise in wage/labor costs.

Inflation bottomed last October at a 12-month rate of 1.0%. The latest inflation report shows the 12-month rate of change is now at 2.1%. In a separate report, the Cincinnati Fed believes the number is closer to 2.3%. Janet Yellen, Chairman of the Fed, says this is all noise. Apparently, the noise is loud enough to have caught the attention of stock market participants, as the Dow declined by almost 2% in one day.

Friday's market activity was choppy, driven by varying interpretations of the release of the June labor report. The U.S. economy created more than 200,000 jobs during the month of June, the sixth straight month where job creation was stronger than 200,000. Our economy has not created over 200,000 jobs per month for six straight months since 1997. Good news, again. The Dow Jones average reacted by declining another 69 points.

Why the Reaction?

The Federal Reserve has two mandates assigned by Congress – to provide policies that focus on achieving a full employment economy and, at the same time, maintain a stable pricing environment (low inflation). These two mandates tend to conflict with each other. Normally, if our economy is at full employment, inflation risks are rising. If inflation risks aren't a real problem, more than likely our economy isn't anywhere near full employment. The trick at the Fed is to create policies that accommodate both of these goals at the same time.

Since the crash in asset values and the Great Recession of 2008-2009, the world has lived on a lifeline of cheap capital. Central banks worldwide have driven short-term interest rates to zero and infused massive amounts of liquidity into banking systems, attempting to kick-start economic activity (and, perhaps a little inflation, as well) by driving asset prices higher and letting something we economists call the "wealth effect" drive increased consumption. The richer we all feel, the more we are going to consume – right?

The Fed has launched three campaigns (dubbed Quantitative Easing) in an attempt to kick-start the economy. The news this past week suggests that the Fed may have been successful in its latest attempt, QE3. Inflation is rising, wages seem to be pushing upward and overall GDP growth is back above 2.0%. The Fed has been focusing on the full employment mandate since 2009 and asset values have risen while these policies have been in effect.

Now, the stock market is fretting over a major shift at the Fed away from monetary accommodation to monetary tightening, as inflation starts to catch on. It is the ***uncertainty caused by this potential shift in major policy initiatives at the Fed that is currently driving asset values to the downside. The timing of these policy shifts and the magnitude of the shifts are making investors nervous. The Fed's main tool in fighting inflation in the past has been a rise in interest rates.***

The Market's Thought on Timing

No more than two months ago, the general consensus among economists was that the Fed would start raising interest rates in the second half of 2015. Earlier this month, shifts in that sentiment took place. Now, the financial futures market is pricing a Fed Funds rate of 0.75% by the end of 2015 (currently at 0% - 0.25%), indicating that most believe the Fed will start raising rates during the first half of 2015. By the end of 2016, the financial futures market is suggesting Fed Funds will be at 1.75%.

Our Thought on Timing

In our March 24, 2014, piece, entitled *Inflation – Where Art Thou?,* we outlined the following thoughts as to the unemployment rate and potential inflation:

Along with the strong relationship between inflation and labor costs, there has also been a negative correlation between inflation and unemployment trends. If unemployment levels are low, inflation tends to rise. This relationship of higher inflation/higher unemployment has been represented in the "Phillips Curve" concept.


Milton Friedman

The late, renowned economist Milton Friedman (pictured here) believed the Phillips Curve concept was flawed. He introduced the economic world to a concept called NAIRU (Non-Accelerating Inflation Rate of Unemployment), which states that a decrease in unemployment from a high level does not in itself create inflationary pressure. Rather, unemployment levels need to be at a certain rate (lower than the Phillips Curve would at times represent) prior to the building of inflationary pressures due to rising wages. The NAIRU concept has become standard thinking at the Fed. Economists at the Federal Reserve have long held that the critical threshold in the NAIRU level is roughly 5%. In other words, unemployment levels can fall to 5% without having an impact on inflation. The official unemployment rate is now at 6.7%.

It is our contention that while over the long-term, 5% unemployment may be the non-inflationary level in our economy, in the short term, the actual level of NAIRU is much higher. We believe (as do the economic staff at other firms) the NAIRU level is around 6.5% - 7% – roughly where unemployment currently stands. If we are correct, we may start to see rising labor cost pressures, and attendant inflationary pressures, building by the end of this year. Are the decision makers at the Fed thinking the same thing? Perhaps this was one of the factors that drove Yellen to her comments regarding raising interest rates last week – that the Fed may be thinking that inflation, driven by NAIRU and rising labor costs, is on the horizon.

As stated above, we suggest NAIRU is probably around 6.5% - 7%. Since that report, unemployment has fallen from 6.7% to 6.2% (6.1% last month) and trailing 12-month inflation has risen from 1.1% to today's 2.1%. Additionally and importantly, wage costs are rising, suggesting the recent upward push in building inflationary pressure may be more than just noise. It appears at this time that our thoughts on the actual NAIRU level have been reasonably accurate.

Let's assume the current upward push in inflation is more than something transitory. Let's assume inflation will rise an average of 2.6% over the next two to four years (our current long-term inflation assumption at Mariner). This is up from a low 12-month inflation rate of 1.1% reached last October. ***If this upward push in inflation had happened during the last two Fed regimes (Volcker and Greenspan), the move to higher interest rates would have been somewhat swift. These regimes at the Fed were very "hawkish" by today's standards. The current regime is very "dovish" (as was the Bernanke Fed), as compared to Greenspan and Volcker. Yellen and the other main drivers of monetary policy (Dudley and Evans, for example) are going to be much more accommodative and tolerant of higher inflation than in the past. Consequently, we will probably need to see inflation and labor costs rise more rapidly before monetary policies start to become tighter. We believe we are a solid six to nine months away from the Fed moving short-term rates to the upside.***

Current Stock Market Activities

We believe it is understandable that the market has corrected to the downside. In our July 28th piece, *Rarified Territory – Market Correction Ahead?,* we addressed the possibility that stock prices may be set for a price correction of some type. In that piece, we outlined why a correction may occur. The table was set, with stock valuations stretched and investor sentiment at an extreme. We were only looking for a catalyst that would spark the downward shift. It appears that catalyst may be at hand.

And, frankly, that catalyst is not bad news. On balance, it is good economic news.

In our latest piece, we outlined why we recommend taking advantage of a market correction, rather than running from it. We stand by that view. We also stand by the view that the world's stock markets have entered into a new ***secular bull environment, an environment where corrections can take two forms – price or time.***

Comparing periods in the past when stocks have been in a secular bull environment versus a secular bear environment, we find that market overvaluation is typically corrected by ***price only*** during secular bear markets – such as the period from 2000 to 2012. Historically, stock overvaluation can be corrected, not only by price, but also ***by time*** in a secular bull market. The market "marks time" while corporate fundamentals (profits, cash flow) improve. This type of correction normally only happens in a secular bull environment. Investors, by and large, have patience. Are we currently experiencing a time correction? Below is data regarding how global stock markets have been performing since the peak in stock prices at the beginning of the month through July 31st and performance data year-to-date:

Index	Recent Price Change	Price Change – Year to Date
S&P 500 (U.S. Large Capitalization Stocks)	-3.3%	+4.2%
Russell 2000 (U.S. Small Cap Stocks)	-8.2%	-4.2%
EAFE Index (Foreign Developed Stocks)	-3.9%	+0.1%

It is interesting to note that the "correction" has been extremely limited in magnitude, at least, so far. ***Note that from the highs reached at the beginning of July, all of the popular stock indexes, except small cap U.S., are within 4% of those old, all-time highs. Not exactly a price swoon – again, not yet.***

What I find as interesting in the recent data is the fact that ***all indexes noted are within 5% of where they stood at the beginning of the year. Over the last seven months, all of the major indexes listed have traded within a relatively narrow range. At the same time, corporate earnings have risen nicely.*** So, in many cases, the overall market, particularly numerous individual stocks, has experienced a ***time correction*** so far this year, rather than a ***severe price correction*** since the old highs – at least, so far.

Bottom Line

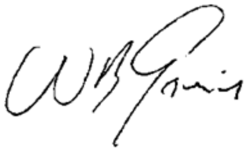
Are we seeing the start of the long-awaited ***price correction*** many have been anticipating? Frankly, we don't know. Nobody knows. ***If we are, indeed, seeing a price correction of 5% to 15%, we would advise most investors to consider the following:***

1. Resist the temptation to sell significant portions of your existing stock portfolio in fear of significant price declines
2. Use price declines as an opportunity to add to existing stock portfolios

Why do we make these recommendations? First, consider the news events that triggered the recent stock price weakness: Economic growth acceleration. Job creation. An end to the Federal Reserve levering its balance sheet. These are all positive economic developments. Eventually, this news will be viewed positively by investors.

Also, consider our view that we have entered a new, secular bull market. Historically, stock overvaluation can be corrected in two fashions during a secular bull market – by either price or time. If the current environment is primarily a time correction, prices shouldn't swoon terribly to the downside. Indeed, we maintain our view that stock prices should be higher in a year than they are today.

We will be back next week.



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