MACROLENS
Markets in High Resolution

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Bubblephobia

The last economic cycle was characterized by easy-money "bubbles." This one is not.

A recent Bloomberg story entitled Fed Risks Stoking Financial Bubble in Drive to Lift Inflation encapsulates the widespread narrative that the Fed is pumping up asset prices in an unsustainable fashion. Popularized on ZeroHedge and flogged by a wide array of retail-oriented research providers, the line of reasoning runs directly from "rates appear low and the Fed did QE" to "asset prices are in a bubble" without so much as a second thought.

The foundational error here is assessing the stance of monetary policy based on the "low-looking" level of interest rates, a problem Milton Friedman pointed out half a century ago:

> *As an empirical matter, low interest rates are a sign that monetary policy has been tight – in the sense that the quantity of money has grown slowly; high interest rates are a sign that monetary policy has been easy – in the sense that the quantity of money has grown rapidly. The broadest facts of experience run in precisely the opposite direction from that which the financial community and academic economists have generally taken for granted. (Check out the Macrolens review of Friedman's landmark 1967 address here).*

Two more modern errors in thinking which we'll address today are the idea that "money is going into stocks, not the real economy" and "inflation is held down by the Amazon effect."

To begin, money does not "go into" stocks. Money is a medium of *exchange*. If the Fed creates money to excess, I may *exchange* it for an equity security, thereby bidding up, ever so slightly, the price of that equity. The previous equity holder now has the money, which he may then choose to *exchange* for a different equity security, thereby bidding up that price ever so slightly. And so on, and so on.

In this manner it is possible for money, if supplied in excess, to "inflate" the equity market. However, it is implausible to the extreme that money supplied in excess would in this way inflate the equity market, *but absolutely nothing else*.

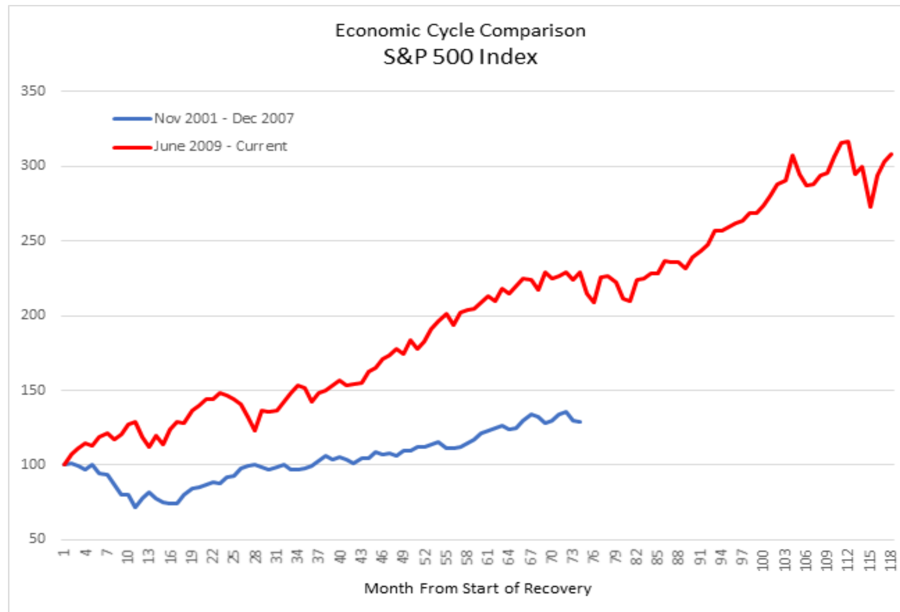
In this ongoing chain of exchanges of money for stock, at some point an equity seller would see equity values rising relative to the universe of alternatives and decide not to buy another equity with his newfound liquidity but *something else*: real estate, or gold, or foreign assets, or commodities, or goods and services. And that's exactly what happened – *last time*.

The following exhibits compare the behavior of key asset market and liquidity indicators over the past two economic cycles, indexed to 100 in the month the U.S. economy exited recession.

Copyright 2019 Macrolens llc. All rights reserved. This material has been prepared using sources believed to be reliable. No guarantee, representation or warranty, express or implied, is made as to its accuracy or completeness. For information purposes only; not to be deemed a recommendation for buying or selling specific securities or to constitute personalized investment advice.

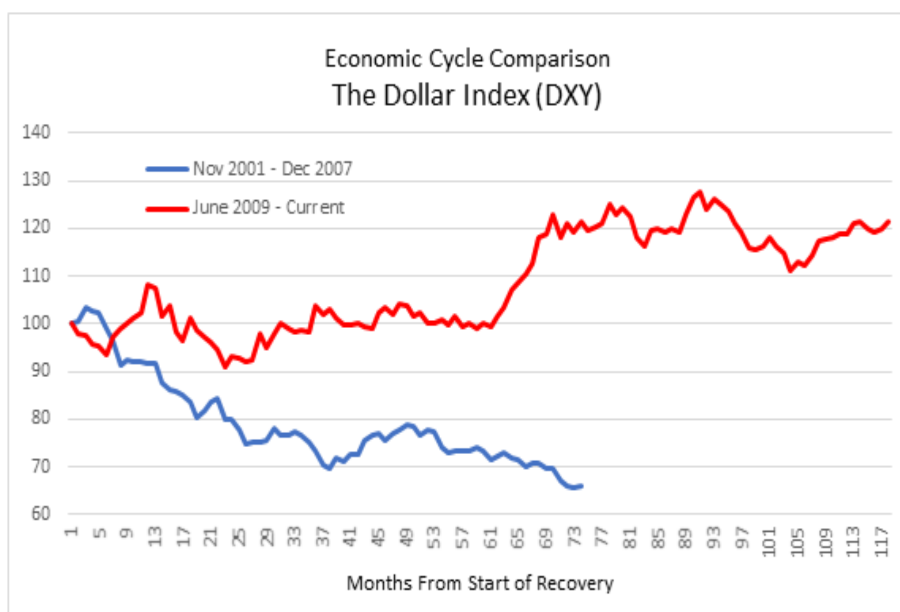
Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Equity market performance in the 2001-2007 cycle was dented by the fact that stocks fell 25% in the first year of recovery, but there's no denying the much more favorable equity market action in the current cycle:



Yet virtually all indicators of liquidity conditions show a markedly different profile in the current cycle relative to the 2001-2007 cycle.

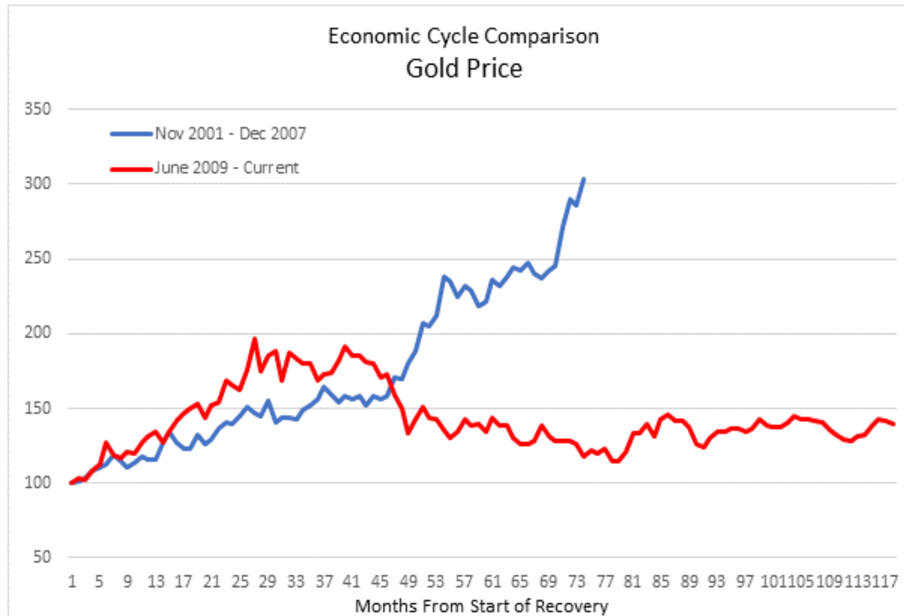
Strong Dollar vs. weak Dollar:



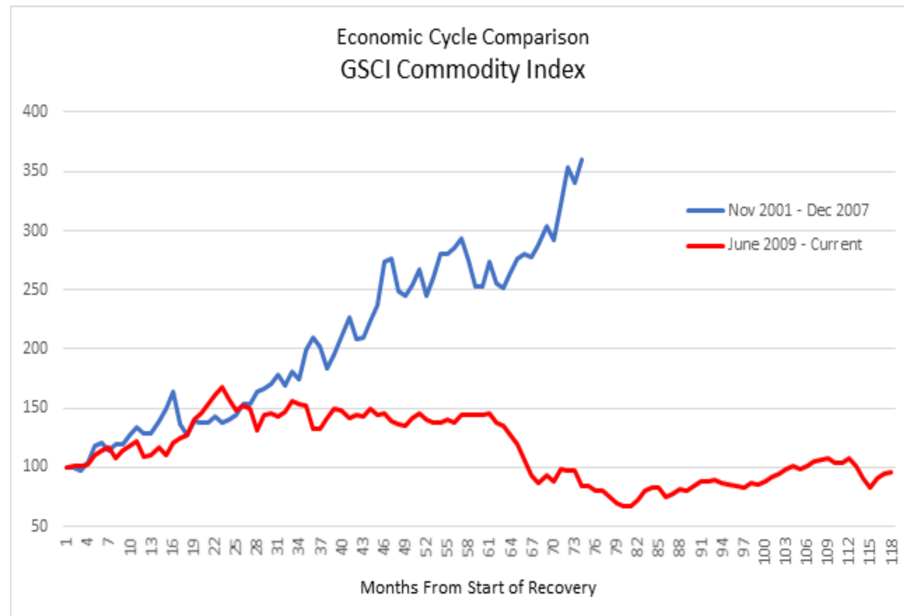
Copyright 2019 Macrolens llc. All rights reserved. This material has been prepared using sources believed to be reliable. No guarantee, representation or warranty, express or implied, is made as to its accuracy or completeness. For information purposes only; not to be deemed a recommendation for buying or selling specific securities or to constitute personalized investment advice.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Stable Gold prices vs. soaring Gold prices:



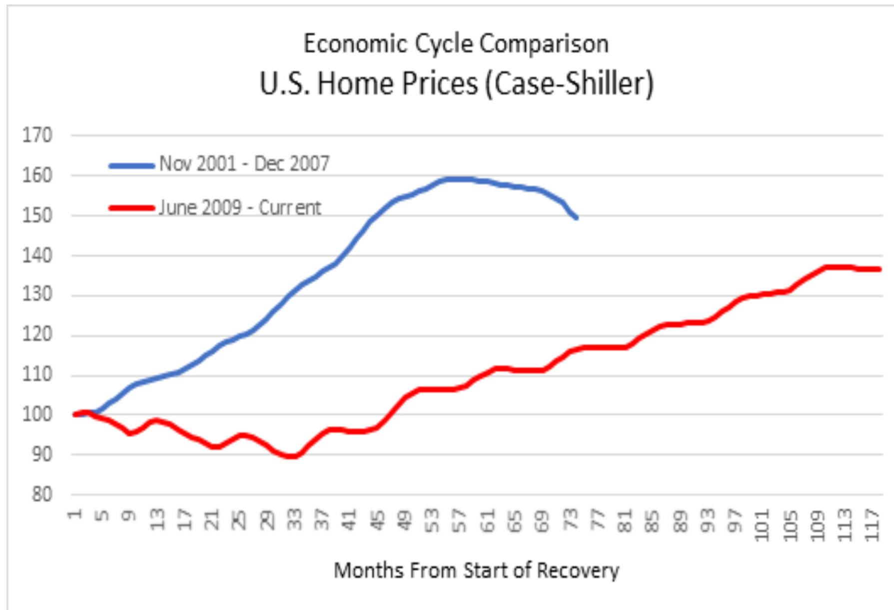
Stable commodity prices vs. soaring commodity prices:



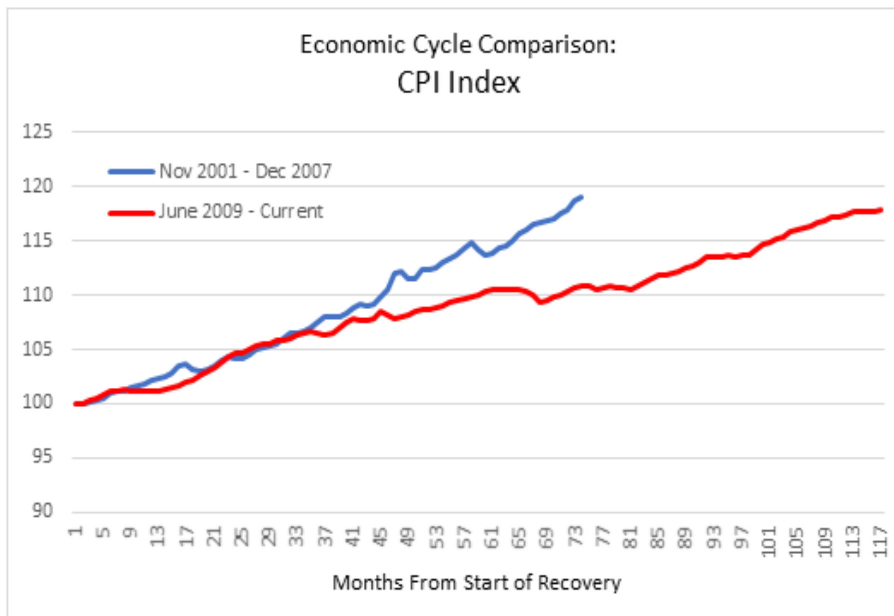
Copyright 2019 Macrolens llc. All rights reserved. This material has been prepared using sources believed to be reliable. No guarantee, representation or warranty, express or implied, is made as to its accuracy or completeness. For information purposes only; not to be deemed a recommendation for buying or selling specific securities or to constitute personalized investment advice.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Restrained home prices vs. "bubbly" home prices:



And a more restrained inflation rate:



Copyright 2019 Macrolens llc. All rights reserved. This material has been prepared using sources believed to be reliable. No guarantee, representation or warranty, express or implied, is made as to its accuracy or completeness. For information purposes only; not to be deemed a recommendation for buying or selling specific securities or to constitute personalized investment advice.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

Overly-easy monetary policy can certainly inflate equity prices but it can't inflate *just* equity prices. In the 2001-2007 cycle easy money inflated everything. In this cycle there simply has not been easy money.

A common retort to that assertion is also alluded to in the Bloomberg story. To paraphrase, "the Fed has been running easy money but we don't get the inflation cuz Amazon." This too was a viable refrain *during the previous cycle*.

An online retail revolution only happens once. Once we're all up and running on Amazon Prime or some other price-aggregation platform then a new, more efficient world of retail price discovery is upon us, *but the effect of squeezing margins behind us*. It's plausible to assert that we were in the midst of that one-off margin squeeze as Amazon was "growing up" in the 2001-2007 period. Today, margins are duly squeezed, we have a lower price *level* than we would have absent Amazon, but *the effect on price changes is behind us*.

As a paper presented at last year's Jackson Hole conference points out, Amazon may no longer be effecting inflation *levels*, but it may have permanently altered inflation *dymnamics*:

> *online competition has raised both the frequency of price changes and the degree of uniform pricing across locations. These changes make retail prices more sensitive to aggregate "nationwide" shocks, increasing the pass-through of both gas prices and nominal exchange rate fluctuations.*

In other words, prices may be less "sticky." A little bit of monetary error – in olden times perhaps lost in the stickiness of the brick & mortar retail complex – now has a more rapid and direct effect on retail prices. And if the Fed is erring today, it's to the tight side, not the easy side.

Hence continued low inflation, which itself helps to explain equity valuations that to some appear "bubbly."

There is a well-worn relationship between equity multiples and inflation levels, illustrated by the old Peter Lynch "rule of 20" guidepost which suggests the "fair value" multiple for U.S. equities is 20 minus the inflation rate.

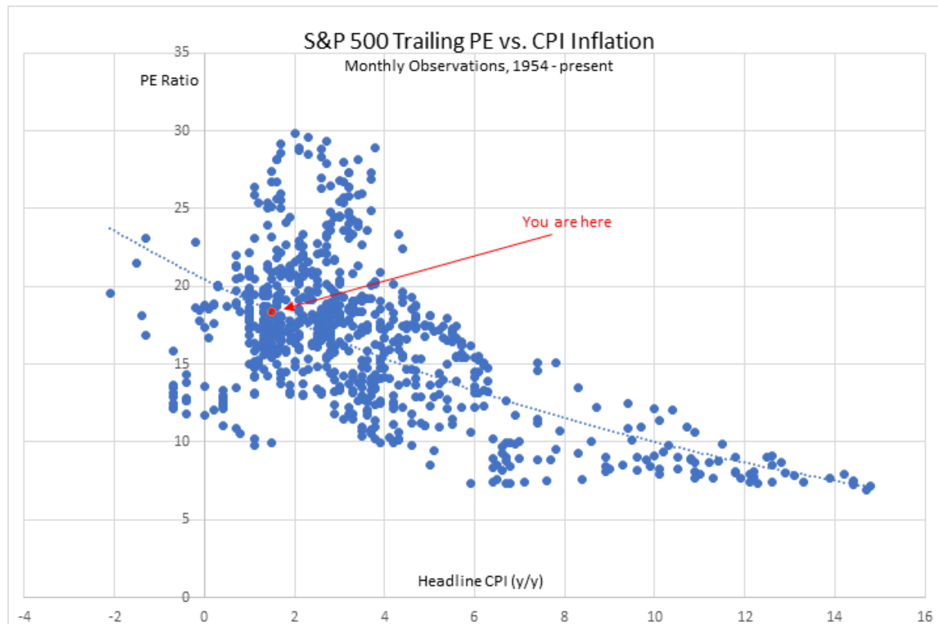
There is a some debate in the literature as to exactly *why* lower inflation tends to produce higher PE's, the most plausible explanation to my mind being the non-indexation of capital gains.

But it is also the case that a benign inflation environment presents the central bank with degrees of policy freedom that it does not enjoy in an environment of high inflation.

Copyright 2019 Macrolens llc. All rights reserved. This material has been prepared using sources believed to be reliable. No guarantee, representation or warranty, express or implied, is made as to its accuracy or completeness. For information purposes only; not to be deemed a recommendation for buying or selling specific securities or to constitute personalized investment advice.

Brian McCarthy
Chief Strategist
(o) 203-614-8600
brian.mccarthy@macrolens.com

In other words, absent inflation risk the central bank can step in to support asset markets if it needs to.



If the Fed were to step in to backstop asset markets *despite rising price pressures* or amidst other indications that policy was already easy, that would present a serious moral hazard problem.

However, absent an extant inflation problem, the central can (and should) step in to prevent a deflationary financial accident.

Not stepping in to prevent a downward market spiral and credit crunch in the presence of widespread market-based indications that policy is already tight, and absent any hint of inflation pressure, would be dereliction of duty.

The Fed didn't "pump up" asset markets in December. They stepped back from the brink of a monetary error that would have destroyed them wholly unnecessarily.

Don't allow the "Noughties narrative" that the Fed is "fostering asset market bubbles" to distort your market outlook.

Copyright 2019 Macrolens llc. All rights reserved. This material has been prepared using sources believed to be reliable. No guarantee, representation or warranty, express or implied, is made as to its accuracy or completeness. For information purposes only; not to be deemed a recommendation for buying or selling specific securities or to constitute personalized investment advice.