September 2014

The 7th Inning Stretch
Markets at Inflections as Money Printing Comes to a Close!

[1]

Developed stock markets from Europe to North America took a long needed pause from their July highs, as investors digested tensions in Iraq, Ukraine, and Gaza, as well as another default in Argentina.

The question on investors' minds is: what is in store over the next several months? Many Wall Street strategists have argued that a correction, by definition, a 10% pull back in stock value, is long overdue. In fact, it has been almost three years since the last correction, making this the fourth longest uninterrupted bull market since WWII.[2] Some are even calling

1 NBF Research
2 CNN Money

for a 20% to 30% bear market collapse, like Marc Faber of the Gloom, Boom & Doom report (although, he has been predicting this for the past three years according to CNBC).[3]

Major stock market declines have historically been associated with one of the three following events:

A. U.S. or global economic recession,
B. rapidly rising interest rates, or
C. a major war.

Considering a reported 4% GDP growth and the creation of 200,000+ jobs per month in Q2, it is clear that the U.S. is not in recession, despite the (weather–related) Q1 contraction. As for interest rates, the U.S. remains at 0% while German rates have recently fallen into negative territory. This means the recent decline in stocks is in all likelihood due to concerns over war – perhaps in the Ukraine or Iraq – and, while I am certainly no expert on wars, it seems improbable that these conflicts will result in the next world war. Putting aside the world war theory, it's probably more reasonable to focus on the other two market catalysts: economic recession and interest rates.

Falling U.S. bond yields and 0% interest rates are likely two of the greatest contributors to the post-2009 economic recovery. The other great contributor has been the $4.4 trillion dollar monetary base expansion undertaken by the U.S. government. This monetary policy is more commonly known as Quantitative Easing ("QE") which, very loosely, just means printing more money!
In order to understand the effects of QE, one must understand what drives the overall money supply.

Money Supply = Monetary Base X Money Multiplier.

In a 2009 Wall Street Journal article, Scott Patterson wrote about Nassim Taleb, author of the 2007 bestseller "The Black Swan", who predicted that "the massive stimulus efforts of global governments will lead to hyperinflation".[4]

I recently had a meeting with National Bank CEO, Louis Vachon, who pointed out that "most people completely underestimated how deflationary the [2009] crisis actually was". The deflation that Mr. Vachon alluded to was related directly to the massive decline in the money multiplier.

The money multiplier is the turnover rate of money. In the 1930s, people hoarded money which led to deflation. Over the past five years, the U.S. created $4.4 trillion dollars of money supply, yet, as recently as last summer, both U.S. and Canadian inflation (CPI) stood at just 1%.

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[3] CNBC August 11, 2014
[4] Patterson, S. (2009, June 1). Black Swan Fund Makes a Big Bet on Inflation. *The Wall Street Journal.*

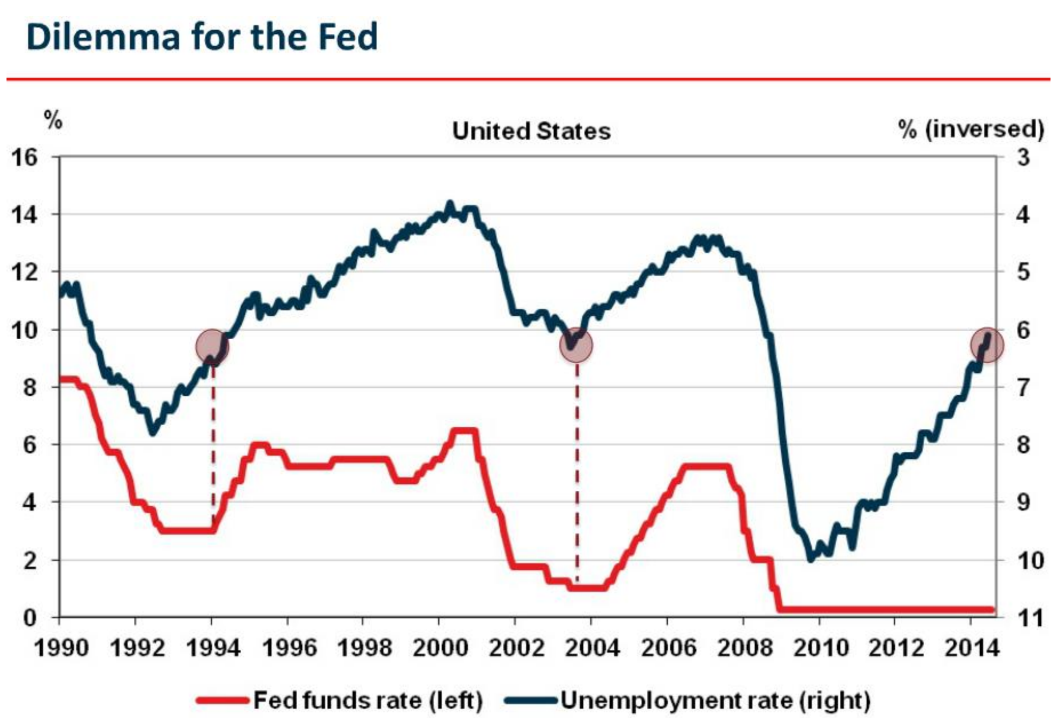
Janet Yellen, the U.S. Federal Reserve chairperson, has indicated that QE will end in October. The question is: will the global economic expansion be able to continue without it?

The reason I believe the U.S. can continue to grow is that credit conditions in the U.S. have begun to ease, which has led to an upturn in the money multiplier. Deflationary recessions such as the 1930s and the past contraction have been associated with falling money supplies. Total M2 U.S. money supply is now expanding at 7%, up from 6% just a few months ago, which is consistent with economic expansion. Furthermore, should the U.S. economy begin to contract, Yellen has indicated that QE could be back on the table.

With U.S. stock values in line with recent earnings, the market appears neither cheap nor in bubble territory. Even if the economy continues to simply muddle along, people have little incentive to sell in favour of 0% percent cash or 2.4% 10-year bonds.

WHAT TO WATCH FOR

As I noted above, I will be closely monitoring the economic indicators, as well as money supply. The wild card in the equation is timing the U.S. interest rate rise. Investors may have become a little too complacent with 0% rates. As the chart below indicates, the depression level interest rates are not consistent with a 6% unemployment rate. In fact, 6% is not great, but it is about average for the past fifty years, whereas interest rates have averaged slightly above 5%.



The current inflation rates in Canada and the U.S. are 2.1% and 2.0% respectively. Short term interest rates (0%-1%, a negative real return) continue to make blue chip stocks an appealing option, especially considering the relatively low price to earnings ratio.

With little to no growth in Europe or South America, a Chinese banking system which is proving to be problematic, and political unrest in the Ukraine, it is likely that global investment flows will continue to trend towards U.S. equities.

Record low interest rates cannot last forever, and inflation rates have recently been trending up. It is when these interest rates begin to move higher that we will start shifting portfolios to a more defensive position.

Sincerely,

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[5] NBF Research