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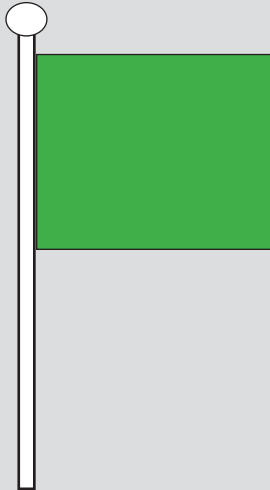
Money Forecast Letter



What can recent history teach us about peak growth?

November, 2018

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In my last *Investment Letter*, I examined the recent weakness in the stock market and gave my opinion on the validity of Wall Street's view that America has reached a point of "peak growth" for this economic cycle. Long-time readers know that I have a reflexive distrust of catchy Wall Street phrases. I find them lazy and shallow. When I hear so-called experts start parroting each other while using phrases like peak growth, stagflation or cyclical decline, I immediately suspect these analysts and pundits have failed to examine what is happening out in "the real world".

Stop for a moment and ask yourself how many times over the past ten years you have heard famous, Noble prize-winning economists explain why the American economy can no longer grow faster than 2% a year. How many times since the Fed announced it would embark on a program of quantitative easing back in 2008 have you heard economic pundits predict it would lead to rapidly rising inflation here in the U.S.? How many times in just the past five years have you heard these same pundits declare the current economic recovery over, based on nothing more than one or two data points related to a very narrow slice of the economic picture?

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Percent

9
8
7
6
5
4
3
2
1
0

1990 1995 2000 2005 2010 2015

Source: Board of Governors of the Federal Reserve System (US)

The problem, as I see it, is that many working on Wall Street do not approach investing like those working on Main Street. To them, three months is an eternity. The biggest drawback to this way of thinking is that you quickly become convinced that the past does not matter. In the *Investment Letter*, I explored the concept of institutional memory. For those of you who did not see that letter, I will repeat the definition here: Institutional memory is the entire body of knowledge accumulated by an organization or a society that provides historical context and guidance for decision makers. Once you train yourself to think only about events that affect the price of a stock or a bond for the next minute, hour or day, you run the risk of losing the precious institutional memory that can help you understand "the big picture".

I suspect the reason so many money managers believe we are on the cusp of a new recession is that they can no longer gaze backwards and put our current situation into proper context. They see the Fed raising interest rates and immediately fall into the trap of assuming rising rates must produce an economic slowdown. I want to take some time this month to show you a few charts. I hope they will give you an understanding as to how the Fed has messed with our understanding of "normal" over the past ten years.

As you know, one of the ways the Fed controls short-term interest rates is by controlling the fed funds rate. The fed funds rate is the rate of interest that banks charge each other for overnight loans. Banks need to use this system of overnight loans to assure that they meet reserve requirements. They must keep adequate reserves, either

FRED
All Federal Reserve Banks: Total Assets
4,800,000
4,400,000
4,000,000
3,600,000
3,200,000
2,800,000
2,400,000
2,000,000
1,600,000
1,200,000
800,000
Millions of Dollars
2008
2010
2012
2014
2016
2018
Source: Board of Governors of the Federal Reserve System (US)

in their vaults or on deposit with the Fed, to assure that the banking system remains liquid. Nothing is worse for the banking system than a situation where a customer goes to the bank to withdraw money and discovers the bank can't come up with the cash. In the past, such a situation usually produced a run on the bank, as nervous depositors looked to get their cash out before the bank closed its doors for good. Today, thanks to federal deposit guarantees, depositors do not need to worry so much about the safety of their money, but the Fed still uses the overnight loan rate to influence the amount of new loans a bank is willing to make. When they increase the overnight rate, a bank looking to borrow money from another bank to meet reserve requirements discovers the cost of that loan has gone up. When the cost of borrowing reserves goes up, banks find it less profitable to borrow these funds. In banking, that translates into fewer loans and, in theory, slower economic growth. When the Fed goes the other way, when it lowers the cost of overnight loans, the expectation is the banks will find it more profitable to make more loans because the cost of the reserves standing behind them is lower.

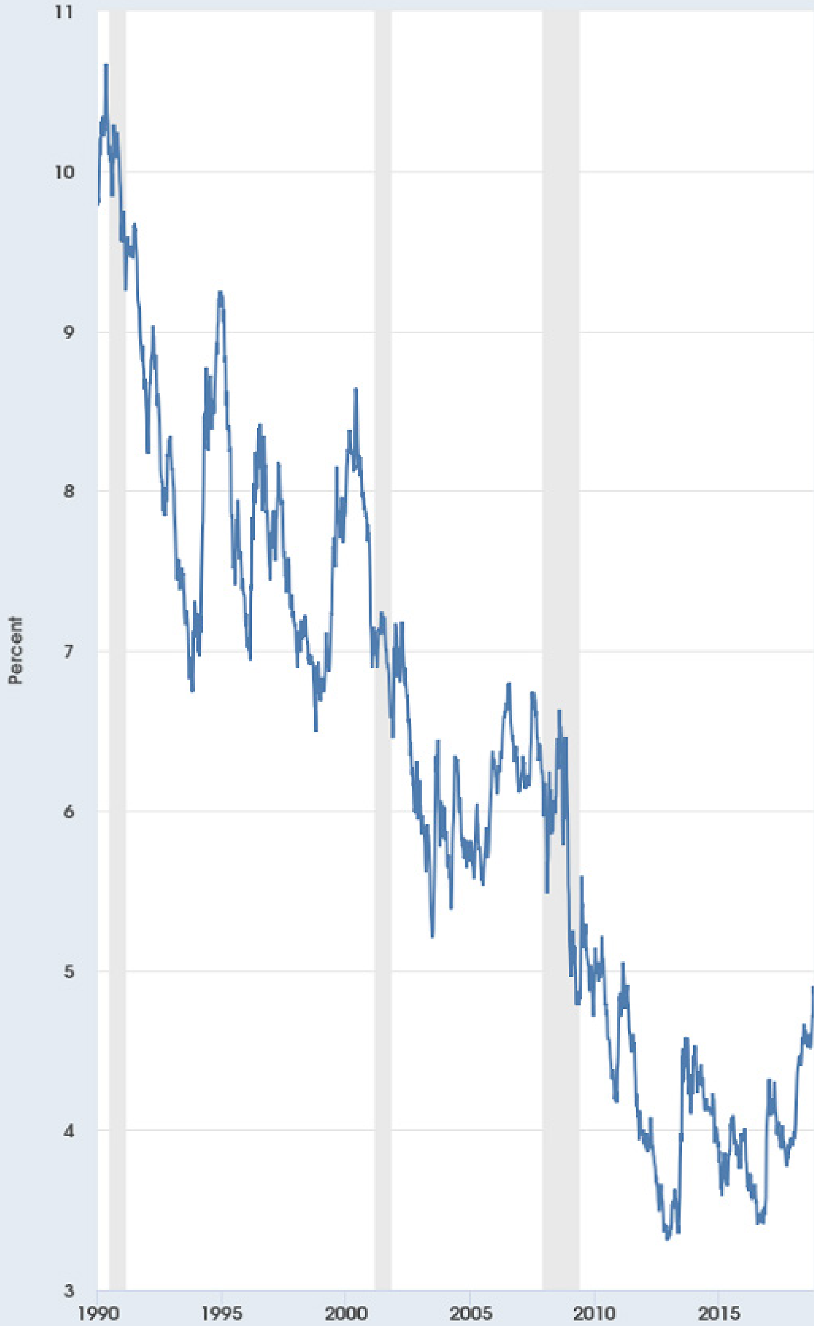
Back in 2008, this system broke down. Consumers and businesses were so fearful about the future they did not want to take on the risks associated with borrowing more money. As you can see from the chart on page two, the Fed attempted to counter this fear by essentially driving the fed funds rate down to zero. However, this failed to stimulate new demand for loans. Desperate to stimulate borrowing and thus economic activity, the Fed decided to try something radical.

Source: Board of Governors of the Federal Reserve System (US)

The Fed decided that it would undertake a massive bond-buying program designed to overwhelm the normal supply and demand signals of the free market. On page four, you see a chart tracking total Federal Reserve Bank assets. As with most of the other charts we will be dealing with in this issue, I want you to note the difference between pre-2009 and post-2009 levels. Two thousand-nine is the year the Fed began its bond acquisition program in hopes of driving long-term rates lower. Notice how this program lead to an explosion in assets held by the Fed. This is important because the Fed paid for these assets by creating money out of thin air. During the three distinctive periods of bond purchasing programs, the Fed injected $3.7 trillion into America's banking system by simply writing checks to buy up both U.S. Treasury bonds and Mortgage-backed securities.

As you can see from the charts on pages six and eight, the plan worked just as designed. The purchase of government bonds drove the 10-year bond rate down below 2.5%. When rates began moving higher, the Fed doubled down on the program and managed to drive the 10-year rate below 1.5%. When the economy continued to stumble and rates began moving higher once again, the Fed instituted a third round of asset purchases that once again drove the 10-year rate back down to 1.5%.

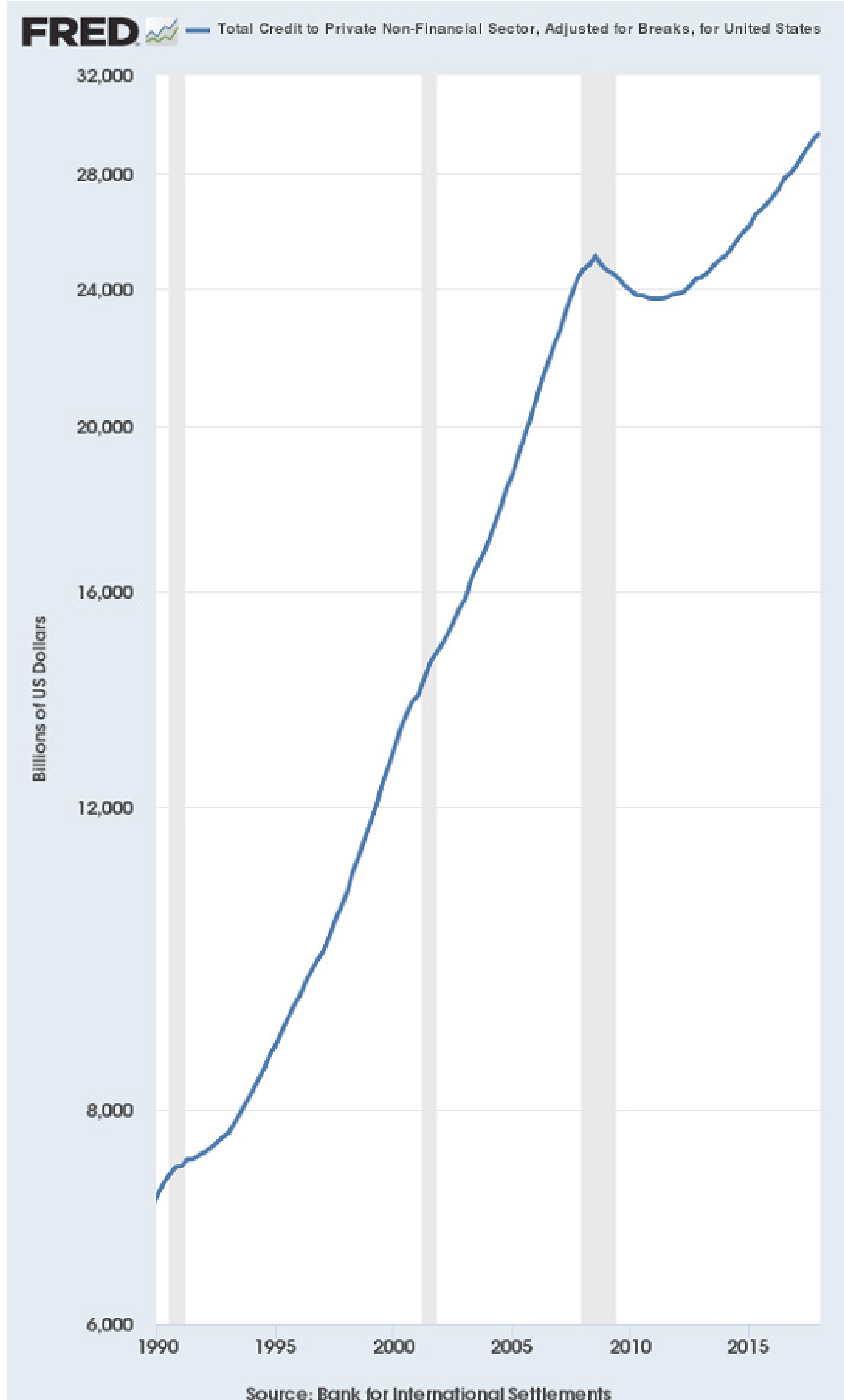
The second part of the Fed's plan centered on making it cheaper to get a mortgage. Real estate prices were in a freefall and the Fed believed that lower mortgage rates would help end the carnage in the housing market and spur new demand for houses. Towards that end, it began buying up


FRED
30-Year Fixed Rate Mortgage Average in the United States
11
10
9
8
7
6
5
4
3
Percent
1990
1995
2000
2005
2010
2015
Source: Freddie Mac

mortgage-backed securities. Mortgage-backed securities were simply investment vehicles that allowed banks to sell their mortgages to investors interested in producing steady income streams generated from the principal and interest payment portions of every mortgage. By selling these mortgages to third parties, the banks were able to put that cash back in their vaults and use it for yet more mortgages. During the financial panic, most investors lost interest in mortgage-backed securities. Too many homeowners were defaulting on their loans and the steady income streams promised by these securities suddenly looked very uncertain. The Fed, with its bottomless checkbook, was not concerned about defaults. They scooped up some $1.7 trillion worth of these securities, flooding the banks with new mortgage money. Those interested in borrowing money to buy a home watched as the interest rate on a 30-year fixed-rate mortgage plunged from 6.5% in 2009 to just 3.5% in 2012.

Alas, while the Fed could lead the horses to water, they could not make them drink it. That is to say, while the Fed was successful at making new loans cheaper than ever, they could not entice those in the private sector to borrow more money.

On page ten, you see the chart that tracks total credit to the private sector since 1990. Again, pay particular attention to the year 2009. Notice how long it took the credit cycle to bottom out after the Fed instituted its plan to drive rates lower. On page twelve, you will see the same measure of credit expressed as a percentage of GDP. This chart makes it clear that even though the dollar amount of new loans


FRED
Total Credit to Private Non-Financial Sector, Adjusted for Breaks, for United States
32,000
28,000
24,000
20,000
16,000
12,000
8,000
6,000
Billions of US Dollars
1990
1995
2000
2005
2010
2015
Source: Bank for International Settlements

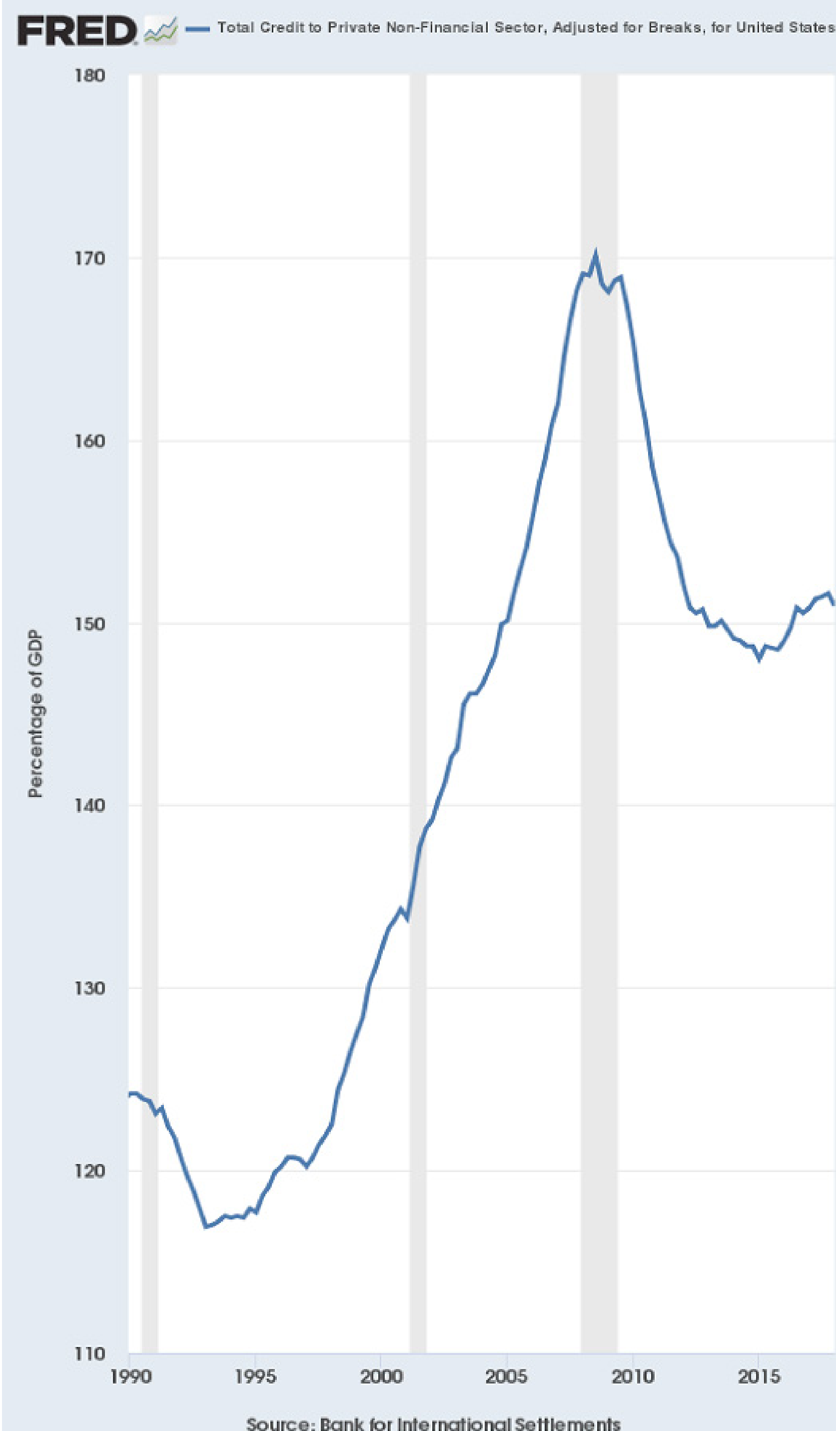
suggests that new loan activity has recovered, Americans are still exhibiting great caution when it comes to taking on new debt.

I think the chart on page twelve is instrumental to understanding why those forecasting another great economic implosion have it so wrong. By only concentrating on the dollar figures involved in the rise of debt since 2014, they lose sight of just how measured the accumulation of new debt has been when measured against the growth of the economy. This chart tells me two things. First, the American private sector (especially households) learned their lesson during the last recession. Second, the reluctance on the part of consumers to embrace a life of over-indebtedness during the past few years suggests the next recession – whenever it comes – will not be a replay of the "Great Recession" we experienced ten years ago.

It is important to recognize that recent increases in interest rates have not yet returned us to levels historically seen as neutral when considering our level of growth. The same holds true when you consider the recent rebound in private sector debt; more debt does not have to mean too much debt. Understanding this should help you resist the urge to assume that a 10% stock market correction or short-term decline in economic data must be proof that the economy will soon spiral back down into the abyss.

There is another reason to be wary of those who refuse to recognize that interest rates are still well below "neutral" levels.

It is becoming quite popular to criticize the Fed for its

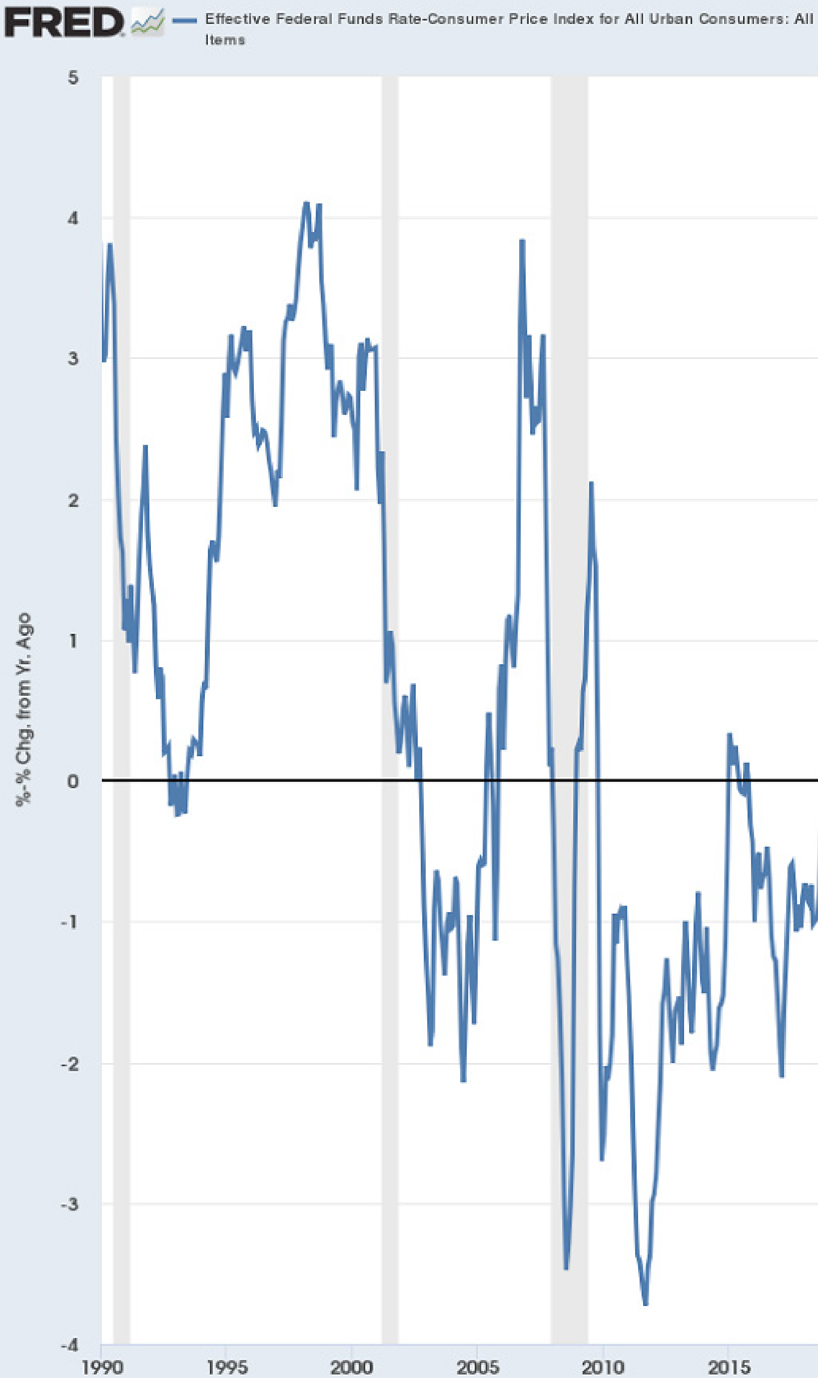

FRED
Total Credit to Private Non-Financial Sector, Adjusted for Breaks, for United States
180
170
160
150
140
130
120
110
Percentage of GDP
1990
1995
2000
2005
2010
2015
Source: Bank for International Settlements

insistence that they still have a ways to go before they can slow or even stop their program of rate hikes. President Donald Trump has been quite vocal in his criticism of Chairman Powell's insistence that more must be done, but he is not alone. Many Fed followers, people who have proven to be more sober in their approach to Fed criticisms – are echoing the President's concerns. They point to the eight quarter-point hikes in the fed funds rate since December 2015 and suggest the Fed risks bringing on a new recession if they don't stop now.

It does not bother the critics that - despite the eight hikes in rates - the inflation-adjusted fed funds rate is still below zero and some three percentage points below where it was before the last recession hit (see the chart on page fourteen). Nor do they seem to be aware of the chart on page six, which shows that the yield on the 10-year bond remains at least two full percentage points below the levels seen before quantitative easing by the Fed perverted the free market for long-term interest rates.

When the recently confirmed Vice Chairman of the Fed, Richard Clarida, gave a speech before the Peterson Institute for International economics, he stunned the crowd when he suggested the Fed still has a ways to go before rates are no longer "accommodative."

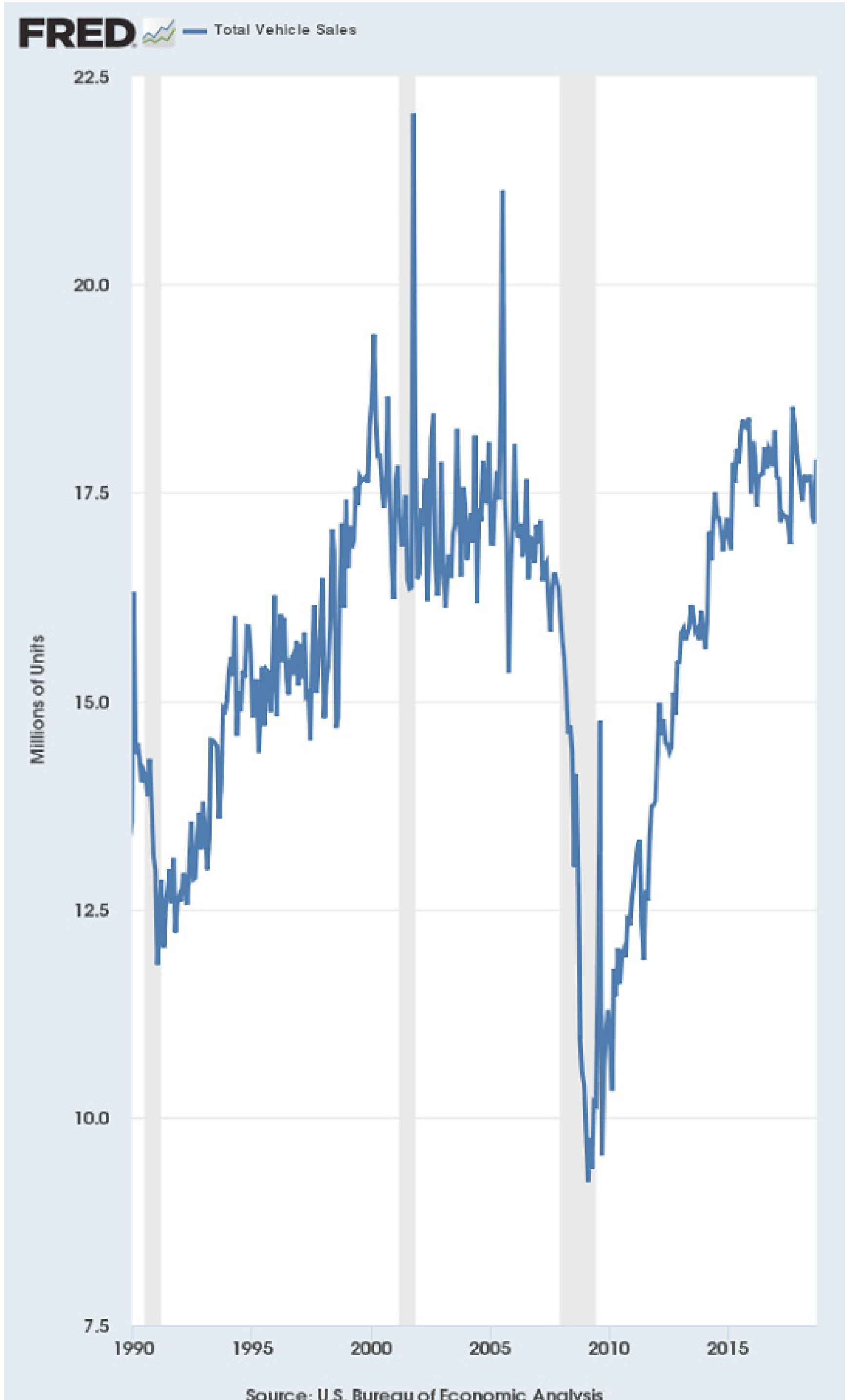
Echoing what I have been saying in this letter for some time, he told the audience that despite recent increases, the fed funds rate remains too low: *"I supported the FOMC's decision last month to raise the target for the federal funds rate to a range of 2 to 2-1/4 percent. With*


FRED
Effective Federal Funds Rate-Consumer Price Index for All Urban Consumers: All Items
5
4
3
2
1
0
-1
-2
-3
-4
%-% Chg. from Yr. Ago
1990
1995
2000
2005
2010
2015
Sources: BLS, Board of Governors

the economy growing briskly, the labor market operating in the vicinity of full employment, and inflation running close to 2 percent, I saw our decision as another step in removing the extraordinary degree of accommodation put in place in the aftermath of the Global Financial Crisis. However, even after our September decision, I believe U.S. monetary policy remains accommodative. The funds rate is just now--for the first time in a decade--above the Fed's inflation objective, but the inflation-adjusted real funds rate remains below the range of estimates for the longer-run neutral real rate, often referred to as r, computed from the projections submitted by Board members and the Reserve Bank presidents."*

He reminded his audience why it was important for the Fed to continue raising rates. *"The reason for this is because, as Milton Friedman argued in his classic American Economic Association presidential address, a central bank that seeks to consistently keep real interest rates below r* will eventually face rising inflation and inflation expectations, while a central bank that seeks to keep real interest rates above r* will eventually face falling inflation and inflation expectations. My own and others' research suggests that the failure of the Fed to respect this principle contributed to the Great Inflation of the 1970s, while the incorporation of this principle into Fed policy in the 1990s and 2000s contributed to the achievement of stable and low inflation during and since those years."*

I must confess it is nice to see someone from the Fed finally acknowledge the need to bring inflation-adjusted rates back towards normal levels. Perhaps, if they say it often


FRED
Total Vehicle Sales
22.5
20.0
17.5
15.0
12.5
10.0
7.5
Millions of Units
1990
1995
2000
2005
2010
2015
Source: U.S. Bureau of Economic Analysis

enough, Wall Street will realize that their fear of higher rates is misplaced. Eventually, maybe we could shift the debate from whether the Fed should push rates higher to one about how high rates need to go.

Until this happens, you need to keep in mind that those warning about "peak growth" are basing their assumptions on "facts" that are not yet in evidence.

Evidence of Wall Street's persistent gloom appears daily in the financial press headlines. Here is a random sampling of some of the headlines I have seen during the past couple of weeks. Weeks marked by a declining stock market and rising worries about future profit growth.

The housing market has peaked; No hiding place for investors in market wobble; Growth jitters send investors heading for tech exit; For Investors, risks are becoming too hard to ignore; Morgan Stanley says a multiyear bear market is already here as earnings growth wanes.

My favorite headline, however, was this one: "Auto dealers see slowing sales, sparking fears that a long-expected decline is here."

I must confess, this sounded bad and I was briefly concerned as I began to read the copy. Briefly is the operative word here. After quoting a couple of dealers who offered anecdotal evidence of a "possible" slowdown, the article finished up by noting "For more than a year, analysts have said auto sales are primed to slow down for a variety of reasons, including a surge in 3-year old models

FRED
New One Family Houses Sold: United States
1,400
1,200
1,000
800
600
400
200
Thousands
1990
1995
2000
2005
2010
2015
Source: U.S. Bureau of the Census

entering the used car market. That wave of pre-owned models with relatively low mileage gives potential buyers an attractive option at a far lower price. Still auto sales have remained robust and are on pace to top 17 million vehicles for a fourth-straight year, which would be a record for the industry. Dave Fisher, chairman and CEO of the Suburban Collection, which has more than 50 retail stores in Michigan, California and Florida, said if sales are slowing around the country, he's not seeing it. 'We will be up over last year. People are still buying,' he said."

If you look at the chart on page sixteen, you will see that Mr. Fisher is exactly right. This long-term chart shows that there are two phases to auto sales. During good times, sales average around 17.5 million new vehicles a year. Some years are higher; some a little lower. Most likely, the variation has something to do with the introduction of popular new models - especially in the light-truck category. These so-called "peak" sales can last a decade and only end when the economy experiences a recession. Given that there is zero indication of a pending recession - based on current growth, employment and wage numbers - fears of a collapse in auto sales seems far-fetched.

The same thing is true with housing. Those predicting that peak housing has come and gone offer up recent figures that show new home sales declining during the past few months. On page eighteen, I show a chart of new home sales stretching back to 1990. I look at this chart and two things immediately stand out to me. The first is the absolute level of new home sales during the past six years. Despite record low mortgage rates and equally low unemployment

FRED
Median Sales Price of Houses Sold for the United States
15.0
12.5
10.0
7.5
5.0
2.5
0.0
-2.5
Percent Change from Year Ago
Q1 2012
Q1 2013
Q1 2014
Q1 2015
Q1 2016
Q1 2017
Q1 2018
Source: U.S. Bureau of the Census

statistics, new one family home sales remain well below the levels achieved back in the late 1990s; before the madness in the housing market broke out. Common sense suggests that this housing market has all sorts of room to grow. The second is the level of volatility present in these numbers over the years. It is quite common to see sales decline for several months in a row, even during booming economic times. That suggests to me that the reports of peak housing are coming from those predisposed to see every brief downturn as evidence of impending doom.

Part of the reason for this is obvious to discern from the chart. The housing collapse that began back in 2007 was one for the history books. It scarred a generation of homebuyers and left many banks on the brink of extinction. It would be incredible if there were not a tendency for all interested parties to flinch when presented with even a small sign of market weakness.

I again ask you to think of all the charts in this letter that show just how massive the Fed's intervention in the bond market was.

The historically low interest rates they manufactured did little to boost home sales, but it did manage to reignite growth in home prices. Americans have never experienced a period where home prices skyrocketed while home sales remained this low. In other words, in the case of real estate… this time it really is different. Usually I hate to write those words. That's because it is almost never true. People who say this time it's different usually end up eating their words when the markets prove them wrong.

However, I can't help but think that the Fed has managed – thanks to its decade-long interference with the bond market – to distort the housing market. Low rates have allowed many buyers with financial resources to buy the home they want, while those lacking sufficient resources have been shut out by prices that grew much faster than they would have under a normal interest rate environment.

I continue to believe it is possible that the process of normalizing interest rates can reverse this trend. If the Fed's misguided efforts to boost home sales through lower rates can produce higher prices without higher sales, why can't the reversal of that process produce the opposite situation, where home sales rise while home prices fall? I sat down and calculated just how far home prices must fall in order for someone to buy a house for the same monthly mortgage payment after the interest rate on their mortgage jumped from 3.5% to 5%. It turns out that prices need to decline by just 10% to make that happen. On page twenty, I offer you the latest home price chart from the Fed; note that the year-over-year change in the median price of a home dropped from +9% to -1% in just two quarters.

The world did not end during those two quarters, and I am very curious to see if higher mortgage rates force home sellers to begin dropping their asking prices by 10% in the coming year. After a decade of huge price gains, the sellers would hardly notice it, but it could make all the difference to those looking to buy. Should this happen, the idea of peak housing could quickly fade away and home sales could resume their quest for more normal sales levels.

— David C. Jennett

David C. Jennett's

Investment Letter

Today, as the Fed begins the transition from an accommodative monetary policy to a neutral monetary policy, Investment Letter Editor David C. Jennett is keenly aware that investors are worried about another 1987-type market crash. He is also aware of the fact that the fear of an impending market crash back in 1987 led then Editor Adrian Van Eck to create the Investment Letter in the first place.

After he began publishing the *Money Forecast Letter*, readers asked Adrian if he would provide them with specific investment advice, informed by the forecasts they were seeing in his letter. For years, Editor Adrian Van Eck resisted this suggestion. However, in 1987, as it became clear to him that the stock market was heading for a major, fed-induced correction, he felt obligated to warn his readers about a coming "time out" in the markets. Thus, *The Investment Letter* was born.

He asked David C. Jennett to take up the task of translating his forecasts into actionable investment advice. For more than thirty years now, Editor David C. Jennet has been providing readers of the *Money Forecast Letter* timely advice on stocks, bonds, gold and real estate. His advice has proven so helpful, nearly three out of every four readers of the *Money Forecast Letter* rely on *The Investment Letter* to help them make the most out of their investments.

Recent market action had David concerned that the Fed might be setting this market up for yet another 1987-type crash. A concern shared by his readers.

If you too are worried about recent market action, I urge you to consider subscribing to *The Investment Letter* today. With a thirty-year track record of helping readers navigate through good markets and bad, this letter will prove invaluable in helping you determine the best course of action for your investments: today, tomorrow and throughout the next year.

As a bonus for subscribing, David will send you the recent Investment Letter where he shared his thoughts about the stock market during a time of rising rates.

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