Daily Note

FED'S PROBLEM IS THE BUBBLE THAT DIDN'T INFLATE

Steven Blitz

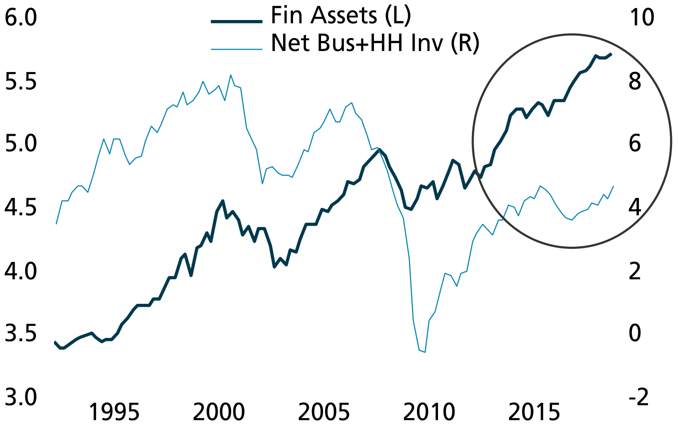
- **Fed boosted capital markets, but capital spending failed to follow**
- **The consequence is a bloated level of financial assets - and a market structure unable to handle a major reversal of asset flows**
- **Economic headwinds: Q4 and Q1 real growth looks to be sub-2%**
- **Fed's only choice is to keep markets afloat any which way it can**

What "patience" really means is that the Fed has no choice but to keep markets afloat, and then wait and hope for the best. FOMC members and their acolytes can talk about inflation's path confounding their models, but the core problem is that after a decade of pumping up financial wealth with extraordinary policies, this wealth never translated into capital spending to anywhere near the extent expected. This is especially evident during the past three years or so (see circled area in chart below).

The economy's balance sheet is consequently unhealthily overweight financial assets. Indeed, they are at a record post-war level. There is no bubble in asset values per se, or in the amount of capital the buy-side is managing. The buy-side's size merely reflects the failure of households and business to turn their pump-primed wealth into capital spending. At the same time, the Fed and others changed regulations governing the behaviour of banks and brokers and this permanently drained market liquidity. We are left with an economy that can ill afford the loss

Financial Assets and Capital Spending

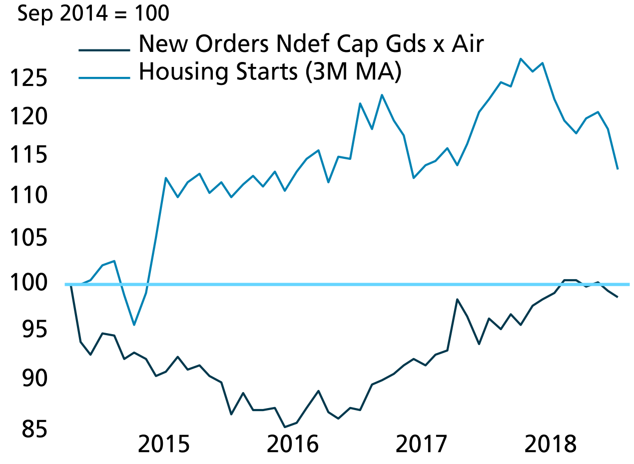
Expressed as a percent of GDP



Source: Thomson Reuters Datastream, TS Lombard

Indicators of Capital Spending

Sep 2014 = 100



Source: Thomson Reuters Datastream, TS Lombard in wealth from a bear market and with market structures unable to handle a massive reversal in the flow of investment monies (December can be thought of as a dress rehearsal).

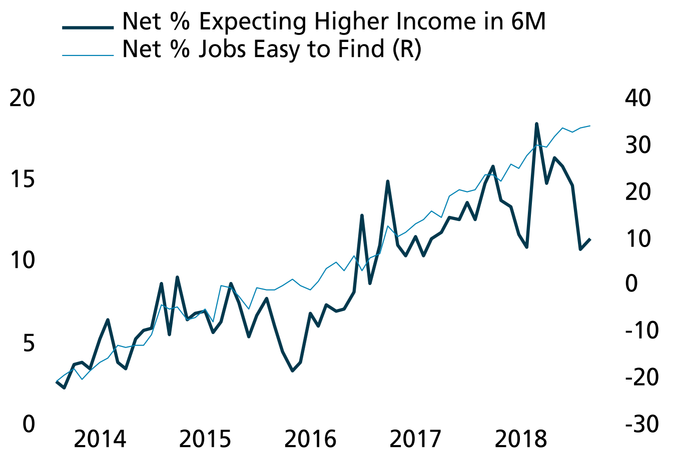
The headwinds facing the economy are, by our reckoning, strong enough to prompt the Fed to ease by summer as the coming cut in QT will prove insufficient to reverse growing disinflationary momentum. Starting with the capital sector, we see in the chart above that spending on capital equipment failed to breach the last nominal high in 2014 and has begun to fade – a move underscored by reduced capex expectations in surveys conducted by regional Federal Reserve banks. Housing construction, on the downswing since last March, looks set to continue to drop based on a survey of new-home builders.

Consumer expectations for the job market remain strong, but there has been a sharp drop in expectations of wage hikes. This seems odd considering the momentum for raises coming out of last year, but the latest NFIB survey of small businesses showed a sharp drop in plans to increase pay. Consumer sentiment historically picks up on this. We have already seen a slowdown in retail spending, and the most recent data from Redbook indicates a steady but slower pace of sales. Adding to the prospect of weaker Q1 and Q2 spending is a reduction in income tax refunds, a source of spring purchases.

The inventory picture at the wholesale level does not look good, with sales flat and inventory soaring. The flat trajectory for sales is a surprise, the surge in inventory is not. Firms purposely boosted inventory in anticipation of the planned January jump in tariffs on Chinese goods to 25% from 10%. The increase never occurred, but the inventory build-up did. Consequently, firms should work down inventory levels this quarter, meaning reduced orders for production – which received a boost in Q4 for the same tariff-related reasons.

Based on recent capital spending, consumer purchases and the inventory/sales ratio, real GDP growth in Q4 and Q1 should come in below 2% and closer to 1.5%. The Fed will have to work hard to lean against these numbers to keep markets afloat, knowing full well that even a mild recession will take them back to the zero bound and QE in a flash. These are among the main reasons why we have called for the FOMC to announce at their March meeting when and how QT will end and why we believe the next move in the fed funds rate will be a cut, probably during summer. The patience Chairman Powell proffered in testimony is not balanced: The Fed can wait for growth to resume, they can't be nearly as patient if markets begin to falter in the face of the mounting probability of sub-2% real growth for consecutive quarters.

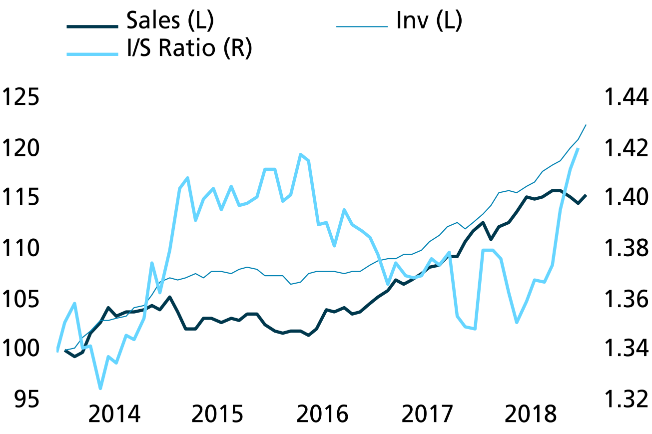
Consumer Net Expectations: Income & Jobs



Source: Thomson Reuters Datastream, TS Lombard

Wholesale Sales & Inv (ex autos & petroleum)

Sales and Inventory Rebased to 100=Dec 2013



Source: Thomson Reuters Datastream, TS Lombard