# Upside Risks

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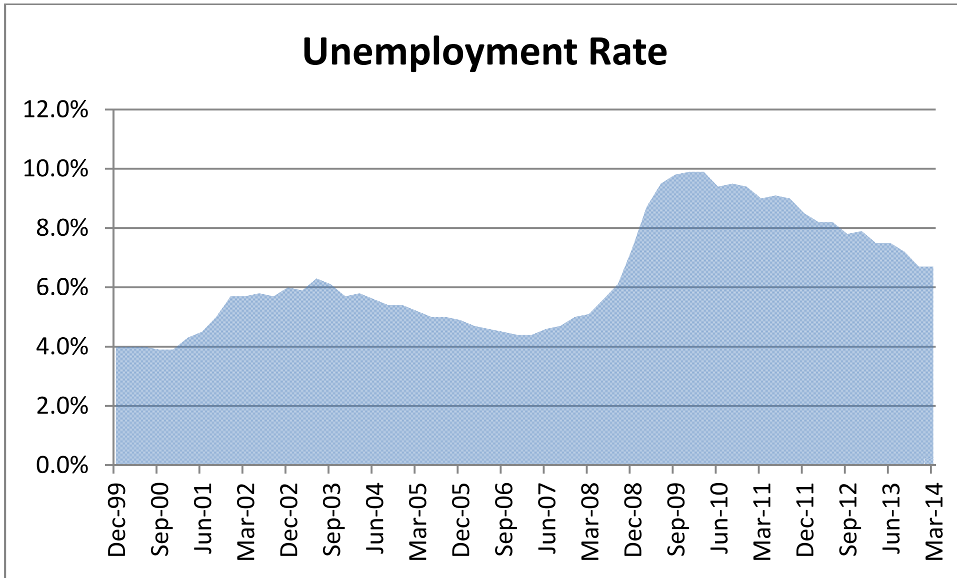
*Strengthening and sustainable economic growth is our base case as consumers and businesses are on increasingly solid footing. Contrarian as it may seem, investors need to pay attention to the forgotten notion that economic growth in the 3%-3.5% is normal. Were we to approach the upper bounds of normal – or even the perception that it is near – the Federal Reserve would likely be forced to address (i.e. liquidate) its puffed-up balance sheet or take other measures unpalatable in market terms. We believe the risks of this are low in 2014, but will occur sometime before the Fed's large bond inventory "self-liquidates" to normal levels. While we are not recommending any tactical shifts in asset allocation, we believe that selectivity and a modest cash reserve is appropriate for most investors. The good news is that there are plenty of attractively priced businesses that will continue to grow soundly and strongly regardless of the risks.*

## Continued Economic Growth is the Safe Bet

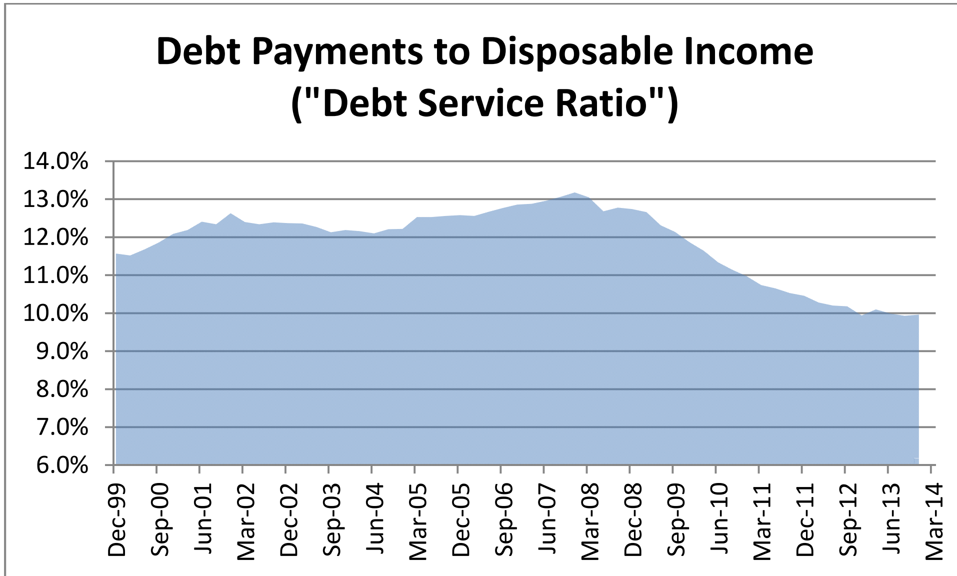
On many scores, the U.S. economy has improved significantly over the past few years.

- Unemployment has fallen steadily;
- Banks have greatly reduced leverage and cleaned up balance sheets;
- The housing sector is running smoothly;
- Economic growth has been modest but stable .

Further, evidence is mounting that continued economic growth is the safe bet as consumers (who represent the bulk of the economy) become ever so gainfully employed while at the same time have lower financial obligations.

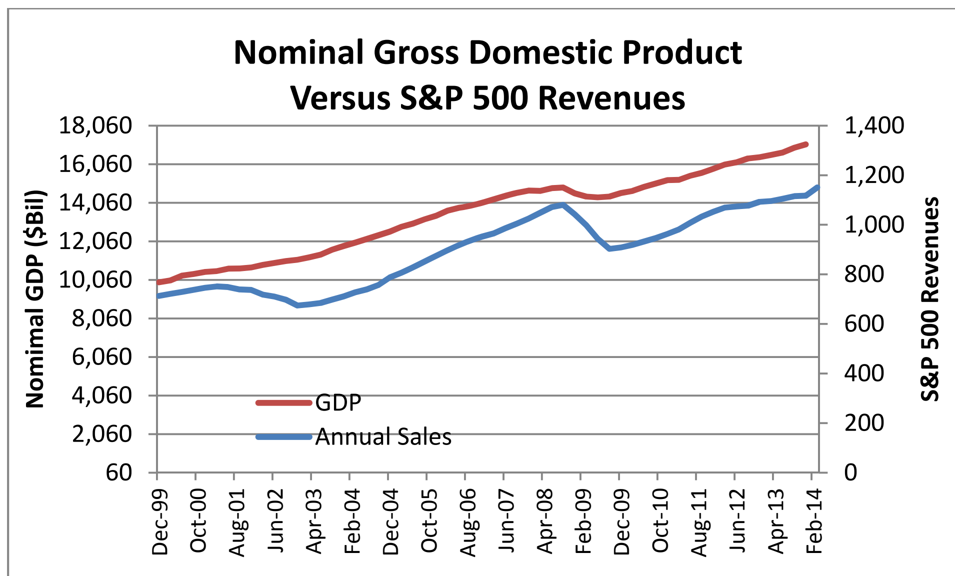



Source: Bureau of Labor Statistics.




Source: Federal Reserve.

Also, consider that both businesses and the economy are larger than ever.




Source: Standard and Poor's, Bureau of Economic Analysis.

## If the economy heats up before the Federal Reserve expects, they will be forced to make unpleasant decisions

We argue that economic risks are to the upside. Upside economic surprises run contrary to thinking at the Federal Reserve. In fact, their plans rely squarely on slow economic growth with low inflation for a long time. Specifically, the Fed plans on:

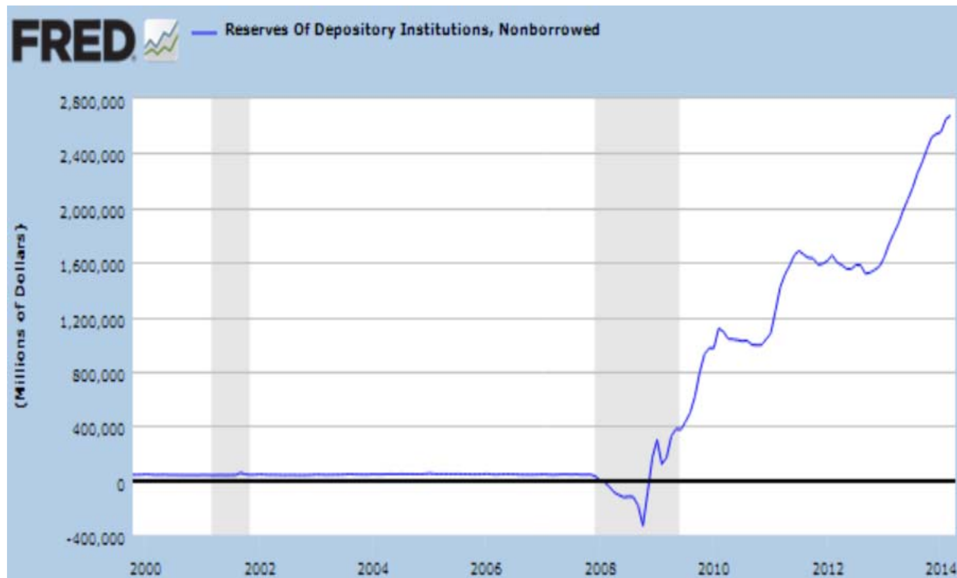
Step 1. Gradually reducing the current bond buying program through 2014;

Step 2. Raise Fed Funds rate target to historically normal levels in 2015-2017;

Step 3. Allowing excess reserves (large bond inventory resulting from quantitative easing – aka Large Scale Asset Purchase Program) roll off the balance sheet over the next several years.

Should the economy pick up steam to what most would consider healthy, priorities at the Fed would likely have to change as the risks to price stability (inflation) increase. Essentially, in a robust economy, the demand for money grows, banks lend more, goods-and-services are sought after, and companies compete for new hires.

In this case, the Federal Reserve would need to be prepared to cool things off; traditionally by raising interest rates. The added risk, in the domain of Federal Reserve banking, is that new Chairman Janet Yellen has inherited a massive inventory of bonds – thanks to the former Chairman's bond-buying proclivities (via its Large Scale Asset Purchase program). This massive inventory also contributes towards excess (non-borrowed) reserves for commercial banks, which in turn translates into potential bank lending. The levels of excess reserves today are unthinkable on pre-2008 terms.



Source: Federal Reserve. Technical Note: These are excess (aka Non-borrowed) reserves from Fed Release H.3, which reflect a portion of the Federal Reserve balance sheet (approximately $4 trillion) commonly cited from Fed Release H.4.1.

Up to 2008, excess bank reserves were insignificant. Since then, these reserves have blossomed to north of $2.5 trillion. New bank loans translate into new cash (or money supply), which ripple through the economy. In a hot economy, this would act as an accelerant to inflation. Therefore, in an ideal world, excess reserves should come down before the economy heats up.

In order to reduce excess reserves expeditiously, the Federal Reserve would have to sell bonds – essentially, reversing the activities of the former Chairman. Bond selling would put pressure on asset prices including stocks and bonds – the exact opposite effect we've seen with quantitative easing related bond buying.

The good news is that the chances of the Federal Reserve having to take action soon seem low; in 2014 at least. Specifically, various measures of slack in the economy are noted below:

- Industrial capacity utilization stands at 80% (versus a fuller level of approximately 85%);
- Unemployment is currently 6.7% versus a fuller level of 5%;
- Growth in bank lending is currently just above 5% (versus fuller levels of 8%-10%);
- Economic growth remains below its potential ("output gap") – currently 2.7% growth versus a fuller level of 3%-4% ;
- Inflation remains below the Federal Reserve target level of 2%.

## Low Bond Yields – Another Sign of Slack

As we have highlighted in previous newsletters, bond yields have been historically low. Slack in the economy in conjunction with the massive bond buying on the part of the Federal Reserve has led us to a low yield environment. However, when both of these factors change – meaning solid economic growth and the end of quantitative easing – we expect interest rates to normalize.

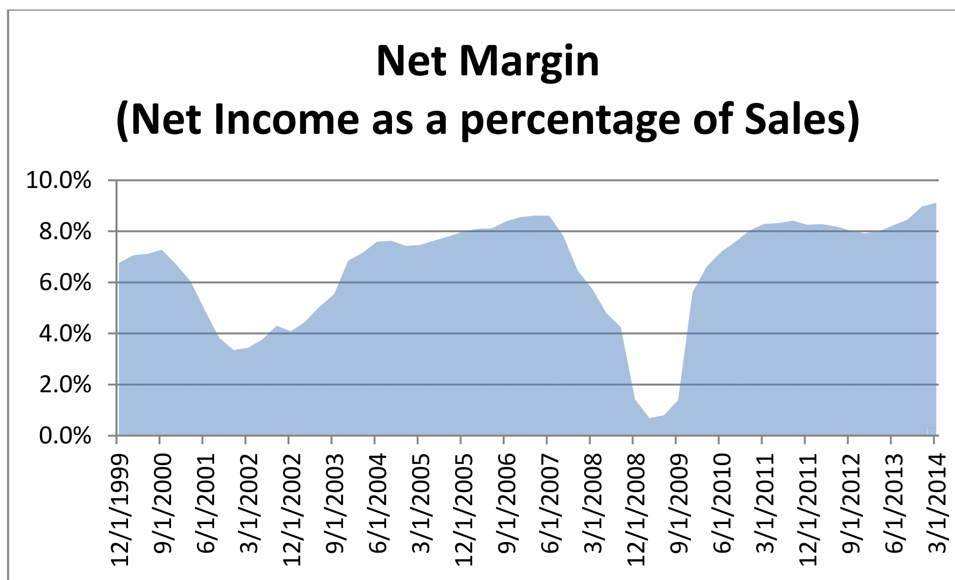
In our analysis, normal yields provide a level of interest that is approximately 2%-2.5% above expected inflation for intermediate treasury bonds (our proxy for the bond market). This puts intermediate treasury yields in the 4% range – versus current levels of 2.6%. As a result, we expect rates to drift up as the economic growth stabilizes to historically normal levels (i.e. 3%+).

## Business profit margins are at record high levels

A beneficial side-effect from slack in the economy: businesses are flush with cash since business costs are low – specifically related to:

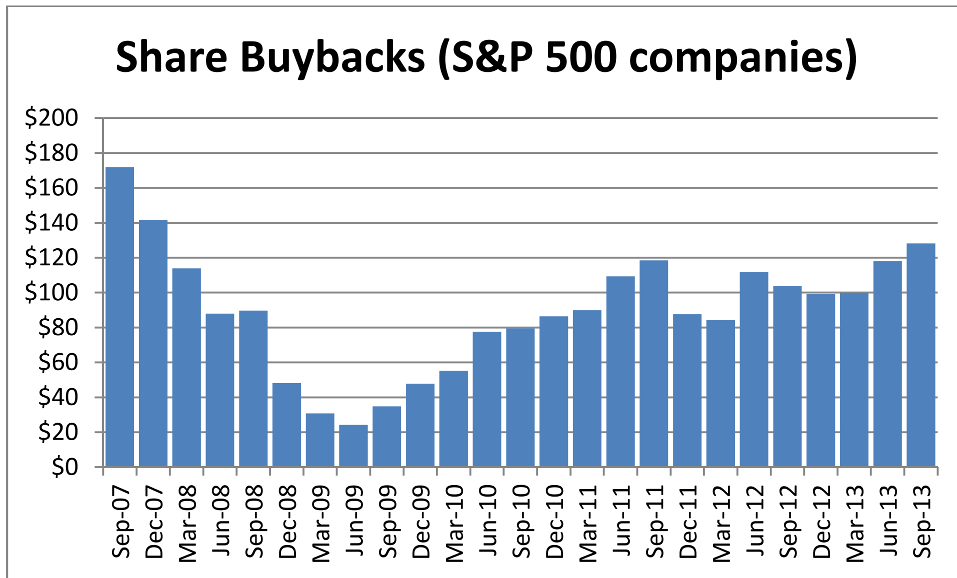
- Low labor costs given higher levels of unemployment
- Low interest expenses given record low interest rates

This has contributed to record high profit margins (net income as a percentage of sales)



Source: Standard and Poor's.

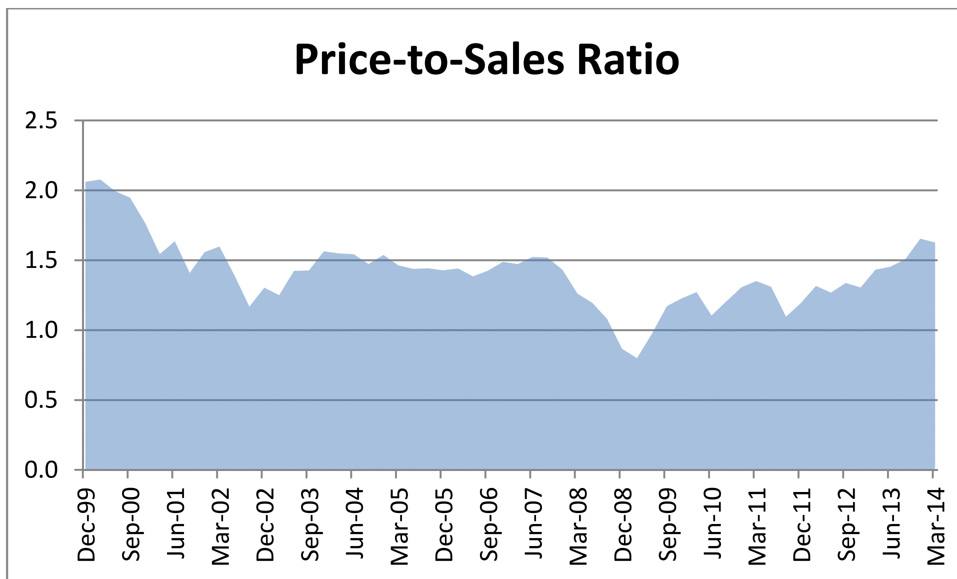
High margins mean that high levels of cash flow into businesses. This in turn accelerates share buybacks as corporate managers consider different options for the use of retained earnings – and buybacks are always the crowd-pleaser.




Source: Standard and Poor's.

Share buybacks, in conjunction with the stock-buying frenzy produced indirectly via the Federal Reserve's Large Scale Asset Purchase Program, contributed greatly to excellent stock market returns last year and fuller fundamental valuations (i.e. higher price-to-earnings ratios, etc.).

On many scores, the stock prices appear fairly (some would say fully) valued as a group – though not near bubble territory. Specifically, consider the Price-to-Sales ratio for the S&P 500, which is higher than that of pre-crisis levels (early 2008), but still shy of early 2000 bubble levels. [Note, however, that record profit margins help to justify a high price-to-sales ratio]




Source: Standard and Poor's.

Our view is that the economy will continue to grow and economic slack will tighten. This means that earnings growth will continue, but will be governed somewhat by revenue growth as margins moderate.

In conclusion, returns in the stock market will hinge more on growth and dividends and less on fundamental valuation changes. Further, should economic growth approach undeniably robust levels, the Federal Reserve will likely be forced to take actions undesirable to asset valuations.

On the positive side, there are plenty of attractively-priced businesses that will continue to grow soundly and strongly regardless of market risks or Fed activity. It is these individual businesses that present attractive entry points in today's market and even more so in the case of a general market decline. Owning stock in a strong and sound growing business is a good way to enhance wealth. Doing so at unusually attractive entry points translates into compounding wealth at unusually attractive rates.

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