Infomail

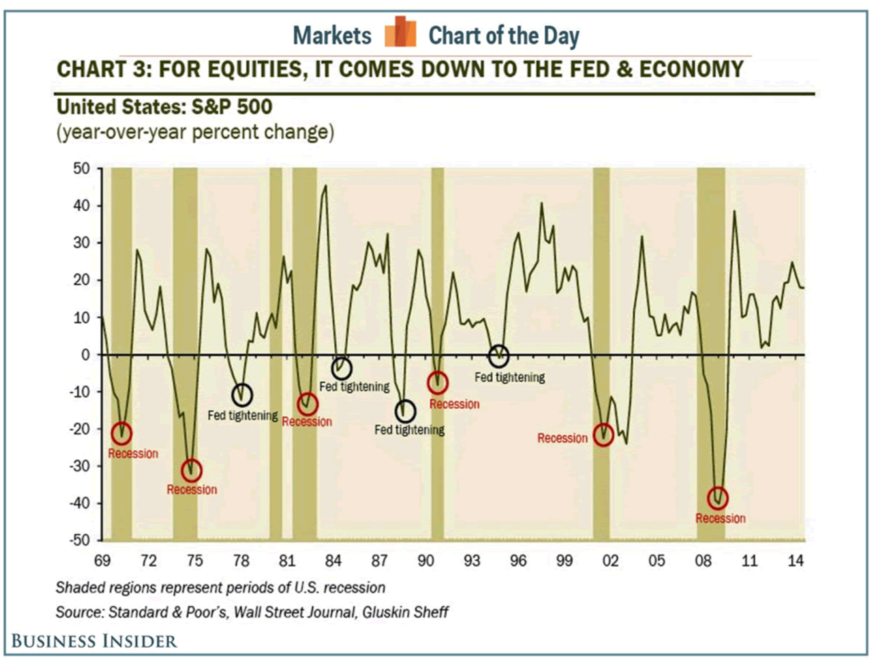
September 8, 2015

The Fed is in a Box

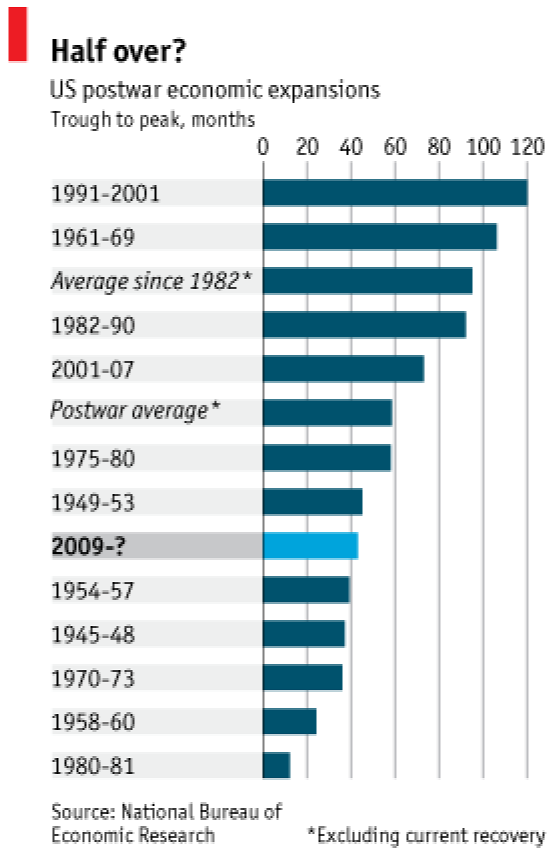
> "More money is lost worrying about a crash than is actually lost in a crash"
> Peter Lynch, Legendary Fidelity Manager

If you are a regular viewer of CNBC, Bloomberg or BNN, you know you will hear an economist, analyst, market commentator or some other 'talking head" talk about how long the economy has been expanding and how long this bull market has been going on – often referring that It may be "over" or "ending" due to its age.

Economic expansions (and bull markets) do not die of old age. They die because of tightening, often in the form of higher interest rates and/or higher inflation. <u>Every</u> single recovery over the past 60 years was preceded by a Fed easing cycle and some form of lower inflation. <u>Every</u> single contraction……well……you know what I was going to say.



So let's get one item out of the way. This expansion cycle is in no shape or form one of the longest on record, in fact it would rank #7:



The intention of Fed policy over the past 30 years has been to "self-correct" business cycles into a more steady and predictable state by adjusting interest rates higher or lower depending on the cycle. As I've mentioned many times, those rate increases tend to take the stairs higher and the elevator when going down.

So as we are on the verge of perhaps the first Fed interest rate increase in ten years, what can we expect as the day of reckoning quickly approaches?

In all analysis with the benefit of hindsight, the Fed probably should have raised interest rates a nominal amount at some point in 2012. Interest rates which are held lower than the "natural" or nominal rate may have short term benefits, but economic growth remains sluggish, so have they really helped as intended?

Having started in the industry when boom/bust cycles were still the norm, it is no doubt sustainable, consistent growth is better for an economy, but the expansion of credit and debt due to lower interest rates (estimated to be over $50 trillion over the past 30 years) has made the world a lot more indebted, and now with demographics working against it as well.

When the price of money (ie. Interest rates) are set too low, destructive behavior sets in. When money is cheap, the lure of easy profit becomes too enticing. Speculation increases……in real estate, art, and yes, even stock markets. Since the cost of money falls, that borrowed money is deployed into ever less productive assets where the objective of that borrowed money is simply to outperform one's borrowing costs.

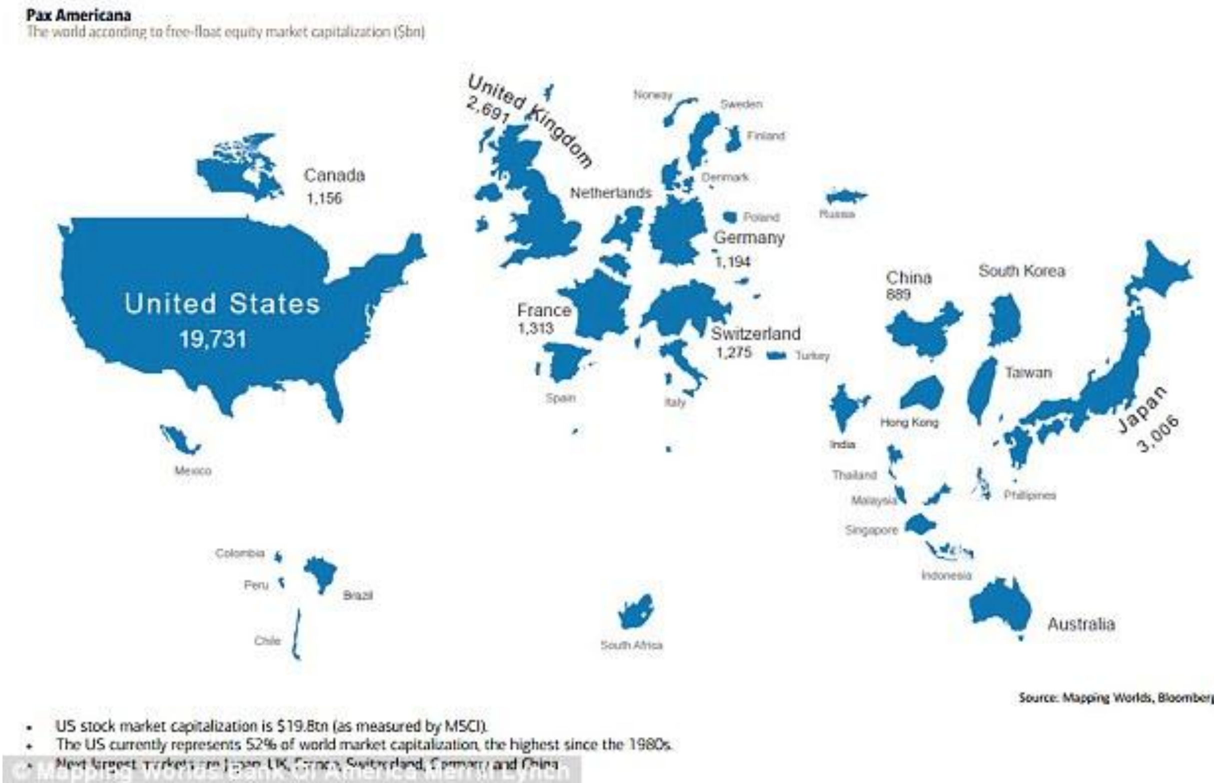
And what happens when those costs begin to rise?

I've learned sustainable growth is best served by interest rates which allows capital to be deployed efficiently. This would explain why corporations, with the unordinary low rates, have chosen share buybacks and mergers and acquisitions which have surpassed capital expenditures and research and development.

The long run consequences of recent Fed policy could mean lower long-term potential for growth, as todays consumption has been paid with huge amounts of accumulated debt, which means tomorrow's revenues will have to be steered towards servicing that debt (Special note to Ontario's Liberals). Future revenues will also have to somehow replenish the deficient levels of research and development and infrastructure which have fallen short the past few years.

So while pundits will blame China for this resent market choppiness, I think it's more about the Fed and what they are going to say/do.

Folks, let's keep things in perspective. As the chart below shows, the size of various stock markets across the world:



So how big is China’s market? It’s about 4.5% of the USA.

Our market, yep, little old Canada, has a bigger market capitalization than China. So does the land of chocolates, clocks and secret bank accounts……Switzerland!

So, yes, while China’s economy, now #2, is important to the world, especially to commodity exporters like Canada, it’s stock market’s moves on a day to day basis do not mean much, especially given foreigners only own a small amount of Chinese equities (mainly due to tight control regulations imposed by the Chinese government).

So this is a correction in an ongoing bull market. I believe that, for the mere fact that the USA is nowhere near a recession. Unemployment, housing, inflation and bank lending numbers all look good. Lower oil prices help as well, as 70% of USA GDP is consumer driven.

Market corrections are normal. On average you have:

- 3 corrections of 5% per year
- 1 correction of 10% per year
- 1 correction of 20% every 3 years

Corrections are normal, and the factors that would make this a bigger event do not appear to be present. We remain in lower rates for longer, slower growth for longer and a continued grinding higher bull market.

Finally, the recent volatility has pushed investor sentiment to levels not seen since March 2009, which for the record was the very bottom of the 2008-09 Financial Crisis.

Stay the course and stay tuned,

Vito Finucci
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