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Worrying About Rising Confidence

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis concludes that the U.S. economy probably is going to achieve faster growth, in part due to the recent tax cuts, but that expected rising interest rates will likely constrain equity growth.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Worrying about rising confidence**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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Thursday, January 11, 2018

Worrying About Rising Confidence

Confidence is high and risk-taking is on the rise, and that is something to worry about.

It is not because equity prices are soaring and, therefore, downside bubble-popping risks are greater. It is because more confidence and a greater willingness to take on risk mean that the demand for money is declining, but the Fed—at least for now—is reluctant to move aggressively to offset the decline in money demand by boosting short-term rates and draining excess reserves. As Milton Friedman taught us years ago, inflation is a monetary phenomenon which results from an excess of money relative to the demand for it.

Today we have declining money demand at a time when the supply of money remains abundant (e.g., $2 trillion of excess bank reserves) and interest rates remain very low. It is likely that because of this we are seeing the early signs of rising inflation in the form of higher prices for sensitive assets such as gold and commodities, and a decline in the value of the dollar.

Here is what we know so far: The boost to confidence began just over a year ago, coincident with the surprise election of Donald Trump, who promised to take radical measures to boost the economy by cutting tax and regulatory burdens. Confidence at both the consumer and small business levels promptly surged. The growth of bank savings accounts began to slow, the dollar began to decline, and gold began to rise—all such changes being symptomatic of declining money demand and the rational result of rising confidence. Now, in the past month or so, inflation expectations, as embodied in TIPS and Treasury prices, have risen from about 1.8% to 2.0%.

None of this is, as yet, scary or off the charts, but it is worrisome. It is not too late for the Fed to step up the pace of its rate hikes and reserve-draining operations, but since the market is not expecting this to happen, the reality of an unexpected rise in interest rates would be, at the very least, a headwind for the equity market and/or fodder for sell-offs and consolidations. And if the Fed does not react with faster rate hikes and more reserve draining, then inflation could become embedded and difficult to tame—and before too long we would be worried about another recession.

I am not saying we are on the cusp of disaster. What I am saying is that we now have accumulating evidence and reason to be concerned about the risk of rising inflation and higher interest rates. It is great news that the economy is doing better and tax reform has passed; there is every reason to believe that the economy is headed for at least several years of much stronger growth. But the coast is not completely clear.

In a best-case scenario, I would like to see the bond market signal the Fed that higher rates are warranted. The collective wisdom of the bond market is arguably better than that of a handful of Fed governors. One key thing to watch for is higher real yields, since that would be an indication that the market is pricing in stronger growth, and stronger growth and higher nominal and real yields go happily hand-in-hand.

So far, however, real yields remain quite subdued. To date, the move to higher yields is concentrated in the nominal space, and that means that rising inflation expectations—not stronger growth—are what is driving yields higher.

Here is the evidence of declining money demand:

Chart #1

Small business optimism (Chart #1) surged almost immediately following the November 2016 elections. It is now about as high as it has been in decades. One reason for increased business optimism is undoubtedly the huge reduction in regulatory burdens that the Trump administration has managed to achieve in one short year. Under Trump's leadership, there has been a one-third reduction in the number of pages in last year's Federal Register compared to Obama's last year, and the number of rules in the 2017 Federal Register was the lowest since records were first kept in the mid-1970s. And that low figure, of course, includes all the rules that Trump issued to get rid of other rules, so the reality is even better than the numbers suggest. (HT: Warren Smith)

Chart #2

As Chart #2 shows, consumer confidence began rising to healthy levels a few years ago. It is not yet at extremely high levels, but it is significantly better now that it was during most of the recovery years.

Chart #3

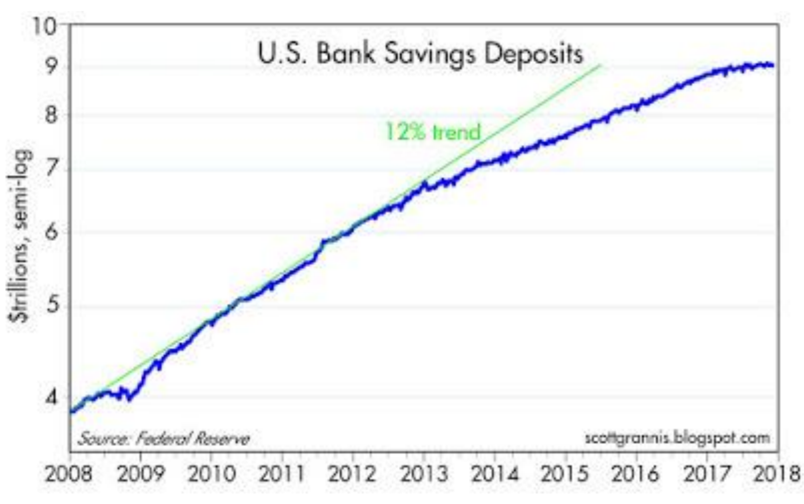

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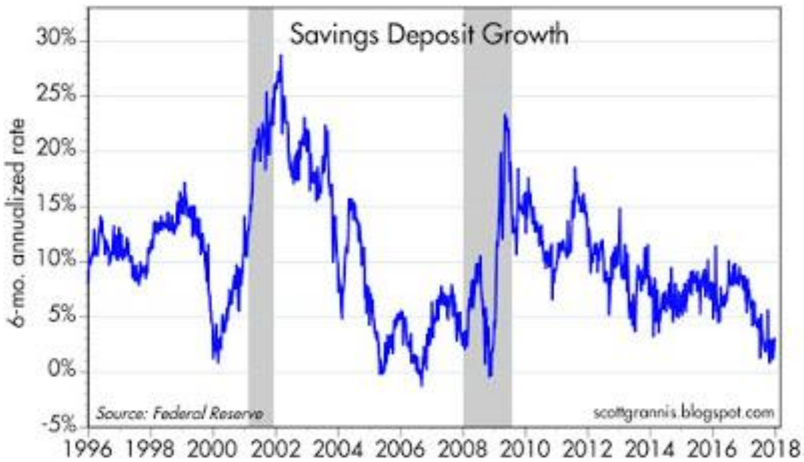
Chart #4



Charts #3 and #4 are the most important of all the charts in this post. What they show is a significant reduction in the growth of bank savings deposits in recent years. The slow-down accelerated in the past year, as growth rates fell from 8% in late 2016 to 3% in late 2017.

Savings accounts in the current business cycle have been excellent indicators of money demand because they have paid extremely low rates of interest; no one has put money in a savings account in order to get huge interest rate rewards. What they are looking for is safety and liquidity. Yet despite paying almost nothing, bank savings account more than doubled in the past 9 years.

This can only be because people had an overwhelming desire to keep their money safe while they increased their holdings of money. But now, people are becoming less and less risk averse, and the demand for cash and cash equivalents (like savings accounts) is declining in favor of increased demand for equities and other risky assets.

With more confidence comes less desire for safety and a greater desire to take on risk.

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Chart #5

Chart #5 shows how the public's desire to hold on to money increased dramatically beginning in the Great Recession. Think of M2 as a proxy for the amount of cash and cash equivalents the average person wants to hold, and nominal GDP as a proxy for the average person's annual income. The ratio of M2 to GDP peaked about six months ago, after reaching an all-time high, because there was a huge move on the part of the public to boost their stores of safe cash and cash equivalents. Since it is apparent that the public wants to shed some of its cash holdings, the only way that can happen is if there is a faster increase in nominal and real GDP. The extra amount of money that could be shed could translate into trillions of dollars of additional real and nominal GDP.

Chart #6

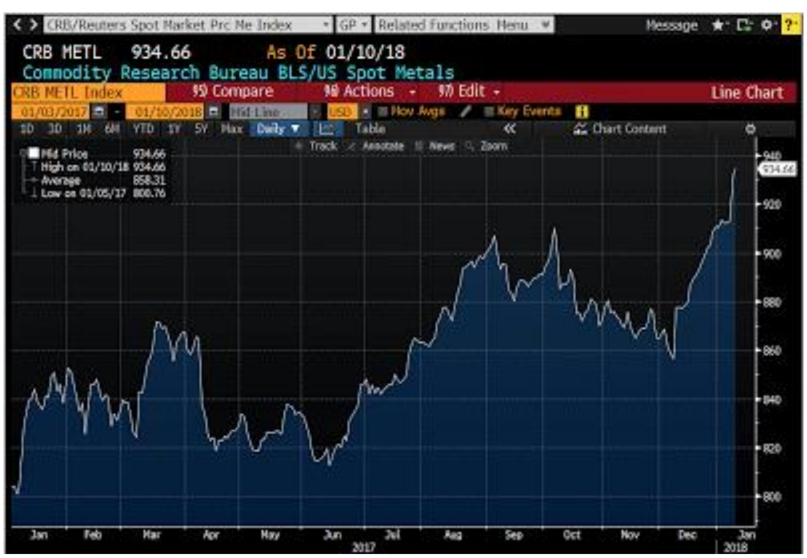

Chart #7

Chart #6 shows an index of industrial metals prices, which have increased by almost 17% since the beginning of 2017. This undoubtedly has a lot to do with improving global growth fundamentals, as well as the decline in the value of the dollar, shown in Chart #7 (the dollar has dropped over 10% since early last year vis-a-vis other major currencies).

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Now a look at how inflation expectations are rising. They have increased of late, but over the past year they have not changed much, and current expectations are not out of line with historical experience:

Chart #8

Chart #8 shows the evolution over the past year of inflation expectations for the next 5 years. The top portion of the chart shows nominal yields for 5-yr Treasuries and the real yield on 5-yr TIPS. The difference between the two—the market's expected average annual rate of inflation over the next 5 years—is shown on the bottom panel. Note that current inflation expectations are about 2%, which is modestly higher than the 1.6% average rate of CPI inflation over the past 10 years and modestly lower than the 2.15% average over the past 20 years. Current expectations are not out of line with the past, but they are near the high end of past trends.

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Chart #9

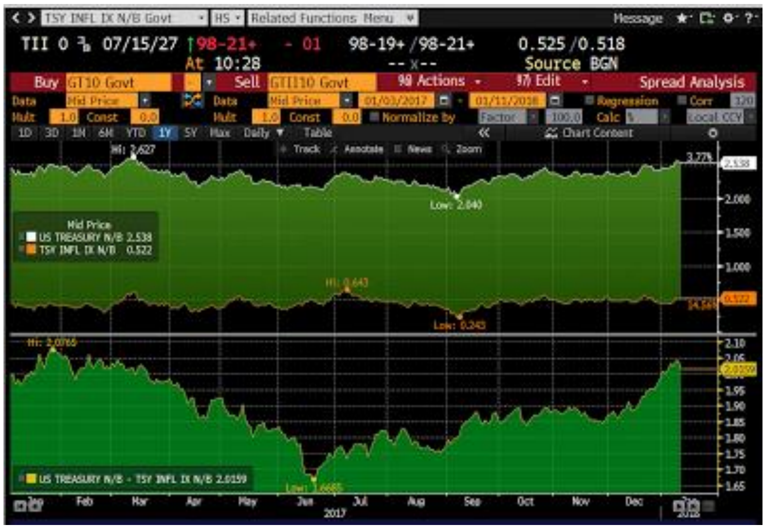

Chart #9 shows the same analysis for 10-yr Treasuries and 10-yr TIPS. Note also that over the past month or so, real yields have been relatively flat, while nominal yields have risen: that is what happens when the market expects inflation to rise but economic growth to remain modest.

Chart #10

Chart #10 compares the year-over-year rate of core CPI inflation and the 5-yr Treasury yield. It suggests that if future inflation averages 2%, as the bond market currently expects, then we might expect the 5-yr Treasury yield to rise from their current level of 2.3% to about 3.5% (with 5-yr real yields on TIPS moving up from their current 0.3% to 1.5%). Those moves are significantly higher than what the bond market is currently expecting. Put another way, the current level of Treasury yields is still unusually low given a 2% inflation world.

Chart #11

Chart #12

Charts #11 and #12 give you historical context for the relationship between 10-yr Treasury yields and inflation. More often than not, 10-yr yields trade at least 1-2 percentage points higher than the annual rate of inflation. Currently, 10-yr Treasury yields are about 2.5%, whereas the current trend of CPI inflation is about 2%. Were things to get back to "normal," in a 2% inflation world we might therefore expect to see 10-yr yields at 3.5% to 4%.

So there is plenty of justification for yields to move higher by much more than the market expects.

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The only thing keeping yields from rising significantly is the market's belief (as evidenced by 5-yr real yields of only 0.3%) that the economy is still stuck in a "new normal" rut; that due to capacity constraints and demographics, it would be very difficult for the economy to grow by much more than 2% per year for the foreseeable future.

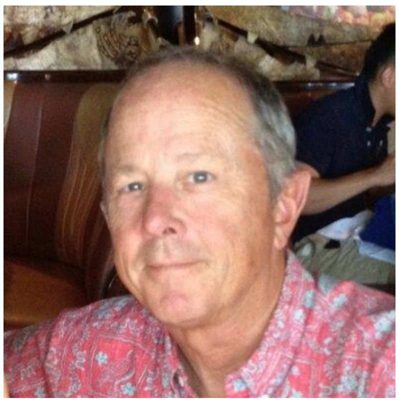
This year will prove whether the "new normal" view will prevail, or whether significant tax and regulatory reform will unleash a new wave of growth.

My money is on faster growth and higher interest rates. Faster growth will be very welcome, but higher interest rates will hurt, and they could very well keep future equity gains at modest levels (by putting downward pressure on PE ratios) even as the economy improves.

So even though the economy looks set to surprise on the upside, it does not necessarily follow that equity valuation will also surprise on the upside.

BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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