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by Gregory Gann

Crucial Financial Data You Are **not** Receiving

A) The End of Quantitative Easing

The mass build-up of worldwide debt came to a head for whatever reason in 2008. We were on the verge of a great depression. The crisis called for swift emergency action. It initiated in the United States in a grand experiment known as Quantitative Easing, and was mimicked across the globe. Quantitative Easing is the process of printing money and using that money to buy assets from banks with intentions of cleaning up the banks' balance sheets and to lower interest rates. Interest rates declined to the lowest levels in history with many rates actually turning negative. This meant that lenders were paying borrowers to lend from them. (Unbelievable).

The U.S. formally ended this process in 2014. And, from the date the program ended in 2014 until the election in November, 2016, the U.S. stock market stalled. The gains that were made while Quantitative Easing was in force did not evaporate, but they did not expand. That is until the election day and throughout 2017 when the market was pricing in stimulus from tax reform.

B) Share Buybacks and Dividends

Lowering corporate taxes is considered economic stimulus. Normally, you receive an economic stimulus when things are slowing down. The market rallied like a "dot com" year from the election day throughout 2017 out of belief that with Republicans in control of both Congress and the White House, a massive tax break was to be realized. What have corporations done with the windfall of cash resulting from lower tax rates? By and large, it has all been spent on dividends and stock buybacks. In lieu of investing in plants, equipment or other capital expenditures, companies are buying an inordinate amount of their own shares of stock. This means that there are far fewer shareholders than previously, and as a result, even if earnings remain flat, with fewer shareholders with whom to divide earnings, shares escalate. JP Morgan estimates that share buybacks in 2018 will exceed those of 2017 by 52%, and 2017 was previously a record breaking year. Notwithstanding the boost stocks get through buybacks and their magnitude, the U.S. stock market has been vacillating all year between gains and losses. It is unrealistic to expect records to continually be beaten, especially when their impetus was spurred by a one-time tax policy.

C) Interest Rates are Rising on Account of Two Forces

The Federal Reserve has been actively increasing interest rates to achieve more "normal" levels. They are also clearly telegraphing that they will continue to do so. A great number of the government bonds which the Fed purchased through its money printing and bond buying Quantitative Easing program have matured. The cash that becomes available when such a federal bond matures has been reinvested every month by the Fed into new bond purchases. However, what is not well recognized is the fact that beginning last fall, the Fed has been curtailing its policy of rolling cash from bonds that mature into new bond purchases. This is significantly reducing liquidity into the economy and also resulting in rising interest rates. Last quarter, this resulted in $30 billion per month being pulled out of the system. This quarter it has increased to $40 billion per month, and next quarter it increases another $10 billion to $50 billion per month.

D) Interest Rate Differentials are Suppressing

The difference in interest rates paid on long term Treasuries versus short term Treasuries is narrowing, and it is narrowing dramatically. In normal times, one should receive significantly more interest for tying his money up for a longer period of time. When this narrows and eventually inverts, it is a tell-tale sign of a likely impending recession. So, a narrowing is a very powerful leading indicator. Right now, a 30 year Treasury yields 2.97%. A 10 year Treasury yields 2.86%. Think about that. Spreads have narrowed to the point of getting a mere .11% interest for locking in your money for 20 additional years. A 2 year Treasury is currently yielding 2.61%. This means that the spread between the 2 year and the 10 year is only .25%.

E) Conclusion:

As we usher in the longest bull market in history, it is easy and natural to feel euphoric and complacent. Quantitative Easing, historically low interest rates, share buybacks and tax reform are individually as well as collectively responsible. But we are now on the other side. You should make sure that your investments are aligned accordingly.

Best,

Greg Gann

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