Credit Bubble Bulletin

Chronicling History's Greatest Financial Bubble

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Weekly Commentary: Fanning the Flames

The Federal Reserve abandoned "data dependent" - at least for next week's FOMC meeting. December futures imply a 1.78% Fed funds rate, up six bps for the week but still 62 bps below today's 2.40% effective rate. Unless the Federal Reserve has completely caved to the markets, the Committee statement and Chairman Powell's press conference should emphasize its commitment to "data dependent" and the possibility of a second-half recovery in growth momentum. By the reaction to Draghi's marginally less than super-duper dovishness, markets will not be overjoyed if the Fed attempts walking back its "an ounce of prevention…" "insurance" rate cut cycle.

For posterity, I'll document the data backdrop heading into what is widely believed to be the beginning of a series of cuts. Second quarter GDP was reported at a stronger-than-expected 2.1% rate, down from Q1's 3.1% but ahead of the 1.8% consensus forecast. Personal Consumption bounced back strongly, jumping to a 4.3% annual rate from Q1's 0.9%. It's worth noting there have been only four stronger quarters of Personal Consumption growth over the past 13 years.

Personal Income increased 5.4% annualized, down from Q1's 6.1% - but strong nonetheless. Employee Compensation expanded 4.7% annualized. Receipts on Assets (Interest Income and Dividend Income) increased 9.0% annualized, more than reversing Q1's 6.1% annualized contraction. Overall Disposable Income increased an annualized 4.9%, up from Q1's 4.8% and Q4 '18's 4.2%.

Government Spending jumped to a 5.0% annualized growth rate (Q1 2.9%), led by a 7.9% annualized expansion in federal government expenditures (strongest reading since Q2 ’09). With federal deficit spending near 4.5% of GDP, fiscal stimulus has become a powerful force in the real economy.

Dropping 5.2%, Exports were a drag on growth. Reversing Q1’s 6.2% growth rate, Gross Private Investment declined 5.5% annualized. Non-Residential Fixed Investment declined 0.6%, with Residential Investment down 1.5%.

At 2.3%, Q2’s GDP Price Index recovered strongly from Q1’s 1.1%. Q2 PCE (Personal Consumption Expenditures) rose to 2.3%, the strongest reading since Q1 ’18. Core PCE rose 1.8%, the largest price gain since Q1 18’s 2.1%. It’s worth mentioning Q2’s increase in Core PCE was above the 1.7% quarterly average going all the way back to 2004.

June Durable Goods Orders were up a stronger-than-expected 1.9% (estimates 0.7%), with the 1.9% rise in Non-Defense Capital Goods Orders way ahead of the 0.2% consensus forecast. Weekly Jobless Claims declined to the lowest level in eight weeks. And let's not forget the 224,000 gain in June Non-Farm Payrolls.

And while the 50 reading for the Markit U.S. Manufacturing PMI missed the 51 estimate, Markit’s Services PMI was reported at 52.2 – besting estimates (51.8) and ahead of June’s 51.5.

Global manufacturing is weak, and the U.S. manufacturing sector has weakened. Google’s Q2 revenues were up 19% y-o-y to $38.94 billion. Microsoft saw revenues jump 12% y-o-y to $33.7 billion, while Facebook’s quarterly revenues surged 28% y-o-y to $16.89 billion. Combined, these three posted 18% y-o-y revenue growth. My point: the nature of economic output has changed momentously, and each year manufacturing accounts for a smaller piece of the greater U.S. economy.

The Fed made a mistake by pre-committing to next week's cut. Despite the obvious risks associated with weak global manufacturing, trade war frictions and China fragilities, U.S. financial conditions have been extraordinarily loose for months now. Investment-grade Credit default swap

(CDS) prices dropped this week to the lowest level since the multi-year lows set in February 2018. Junk bond spreads narrowed this week to near November lows. Corporate debt issuance is running at record pace.

And, of course, stock prices have surged to all-time highs. The Semiconductors ended the week with a y-t-d gain of 38.0%. The Nasdaq100's 2.3% advance this week pushed y-t-d gains to 26.7%. It will be some weeks before we have Fed Q2 Z.1 data, but Household Net Worth and Net Worth to GDP likely jumped to all-time highs. Equities and Total (equities and bonds) Securities as a percentage of GDP will both be near record levels.

July 25 – Wall Street Journal (Jessica Menton): "Investors are piling into safe-haven bonds at a record pace, a sign that caution remains despite stocks pushing toward records. Mutual funds and exchange-traded funds tracking bonds posted $12.1 billion of inflows for the week ended July 17, the 28th consecutive week of inflows. That brings the total so far this year to $254 billion, on pace for a record $455 billion on an annualized basis in 2019, according to a Bank of America Merrill Lynch analysis of EPFR Global data. That compares with $1.7 trillion in bond inflows over the past 10 years…"

The Fed is about to lower rates in the throes of manic securities markets activity. They will surely cite global risks and below-target inflation. FT: "Powell Seeks a Cure for the Disease of Low Inflation." "Jay Powell this month stressed the Fed's determination to fight the sluggish inflation numbers dogging the US economy, warning Congress that downbeat prices could lead to an 'unhealthy dynamic' of lower interest rates and less room to act in a downturn. 'We've seen it in Japan. We're now seeing it in Europe,' Mr Powell said in his testimony. 'And that's why we think it's so important that we defend our 2% inflation goal here in the United States and we're committed to doing that'."

The issue is not some "disease of low inflation." There's plenty of inflation, it's just neither uniform nor necessarily in all the avenues central bankers prefer. There has been strong inflation in securities prices, with the term "hyperinflation" fitting for some global bond markets (i.e. Italy, Greece, Portugal, Spain, Slovenia, etc.). Global stock prices are locked in a powerful late-cycle (speculative) inflation dynamic. Global real estate markets remain in a strong inflationary environment, along with asset prices more generally. The price dynamic for high-end collectables is hyperinflationary.

The world has changed greatly in 30 years – the nature of economic output, economic structure, finance, monetary policy and "globalization", to name broad categories that have profoundly altered

inflation dynamics. Individual country inflation dynamics are no longer dominated by domestic Credit

growth, financial conditions and monetary policy. Today, the impact of a central bank's monetary stimulus works through various channels, perhaps stimulating asset prices, spending, imports and even investment – with a very unpredictable effect on an aggregate measure of consumer prices. As much as the Fed – and other central banks – rue the loss of influence over consumer prices, momentous changes in financial and economic structures ensure the system has been fundamentally and irreversibly altered.

With individual central banks having lost command over consumer price inflation, there has been gravitation to concerted global monetary stimulus. "If we all stimulate together, then we can spur a

more systemic boost of inflation globally." Such an approach is doomed to fail. There is today a strong inflationary bias in securities and asset prices. At the same time, the legacy from historic Chinese and EM booms is unprecedented overcapacity throughout manufacturing. The disinflationary dynamic in many goods markets ensures that monetary stimulus will spur powerful flows to speculative Bubbles with muted impact on aggregate consumer price indices. Finance will flow in force to – and exacerbate – areas with strong inflationary biases (i.e. assets markets).

There's actually a strong case to be made that further stimulating asset Bubbles at this stage of the cycle only exacerbates disinflationary dynamics at work in goods and (some) services. There is today in the

U.S. and globally a proliferation of new companies and products. The flood of finance into new technologies and startups ensures an even greater supply of goods and services (with many tech, cloud and web-based products/services enjoying essentially unlimited supply). The extreme financing backdrop creates aggressive companies flush cash and under no pressure to achieve profitability. It's great for consumers, but it's also an unsustainable Bubble that creates escalating risk to a deteriorating financing environment.

Playing a dangerous game, the Fed is now moving from accommodating this Bubble to actively stimulating it – from pushing back against a tightening of financial conditions to pushing forward already extraordinarily loose conditions. I often think these days of Joseph Schumpeter's "Creative Destruction."

Today's policy and financing backdrops ensure an extraordinary amount of "creative" along with extraordinarily little "destruction." The combination of bountiful new technologies, financial innovation, loose finance, speculative Bubbles, and an accommodative central bank is reminiscent of the "Roaring Twenties." The Federal Reserve in the late-twenties became increasingly concerned with waning consumer prices and worsening global fragilities. The primary focus should have been speculative market Bubbles and egregious financial excess, more generally.

Why are central bankers so fixated on somewhat below-target (an arbitrary target at that) consumer price inflation? Sure, they fear expectations of deflationary conditions could be self-fulfilling. But it goes

beyond that. The entire contemporary doctrine of tolerating Credit excess and asset inflation – even directly using both for post-Bubble reflation – rests upon the notion that the consequences of financial excess (i.e. debt and speculative Bubbles) can be remedied by inflating the general price level.

Excessive debt can always be reduced through inflation – merely inflated away. Excessive asset prices can be at least partially mitigated by inflating consumer prices and corporate earnings. Understandably, central bankers are terrified at the thought of markets losing confidence in their capacity to manage a steadily inflating consumer price index. A world where central bank reflationary measures are viewed as ineffective is a world with suddenly elevated fear of unsustainable debt levels and asset Bubbles. Deficits do Matter.

Maintaining the pretense of effectively orchestrating higher inflation has become paramount to contemporary central banking doctrine. Central bankers pay lip service to ever widening wealth disparities. They surely recognize their activist reflationary policy measures are a primary contributor. Loose monetary policy fuels robust asset inflation, much to the benefit of the wealthy. At the same time, average workers with bank deposits receive essentially no return on their savings. Worsening wealth disparities then only work to exacerbate the extreme dispersion of inflationary effects, with more "money" flowing into assets markets relative to the extra purchasing power available to drive aggregate consumer price inflation. Focused on below target CPI – while ignoring assets inflation and Bubbles – monetary stimulus only intensifies inequalities and attendant social and geopolitical tensions.

It's somewhat difficult for me to believe the Fed will be reducing already low rates in the current market environment. Alan Greenspan weighed in.

July 24 – Bloomberg (Alister Bull): "Former Federal Reserve Chairman Alan Greenspan endorsed the idea that the U.S. central bank should be open to an insurance interest-rate cut, to counter risks to the economic outlook, even if the probability of the worst happening was relatively low. 'Forecasting is very tricky. Certain forecast outcomes have far more negative affects than others,' he told David Westin in an interview… 'It pays to act to see if you could fend it off.'"

Whatever happened to William McChesney Martin's, the job of the Fed is to "take away the punch bowl just as the party gets going." Or even the imperative for the Federal Reserve to "lean against the wind." Wednesday the Fed will be spiking the punch – again – for one of the longest parties ever. Instead of "leaning against the wind", they'll be Fanning the Flames.

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