



What If the Fed Has It All Wrong?

John Mauldin | September 24, 2012

As long-time readers know, I get a large volume of research sent my way. I can't get to all of it every week, but I really do try. And today's Outside the Box, from a new (to me) source, hooked me from the first few paragraphs.

Correlation is not causation, as we all know. That brings us to the Fed, where many market observers are seeing causation when there might be other reasons for stock market movements. What if the victory lap Bernanke has taken due to stock market results is perhaps a little too early or out of place entirely? And what might that potentially say about future market performance and correlations?

Denis Ouellet wrote today's Outside the Box and graciously gave me permission to use it. I asked him a little about who he is. Turns out he lives in Montreal (but winters in Florida), is almost 60, and has retired after nearly 35 years in the investment business as an analyst and head of research for a brokerage company, an equity manager for various investment organizations (pension, mutual, and hedge funds), head of global equity investments at a major pension fund, and chairman of the equity investment committee of a major pension and mutual fund investment organization. Like me, he travels around the world and has lots of kids (just 5 in his case). His blog is [New\\$ to Use](#).

I leave on Wednesday for Atlanta and will eventually end up in New York on Sunday to start a 36-hour marathon of meetings and interviews, plus a speech or two. On Tuesday morning I am with Tom Keene on Bloomberg at 7-7:30 AM.

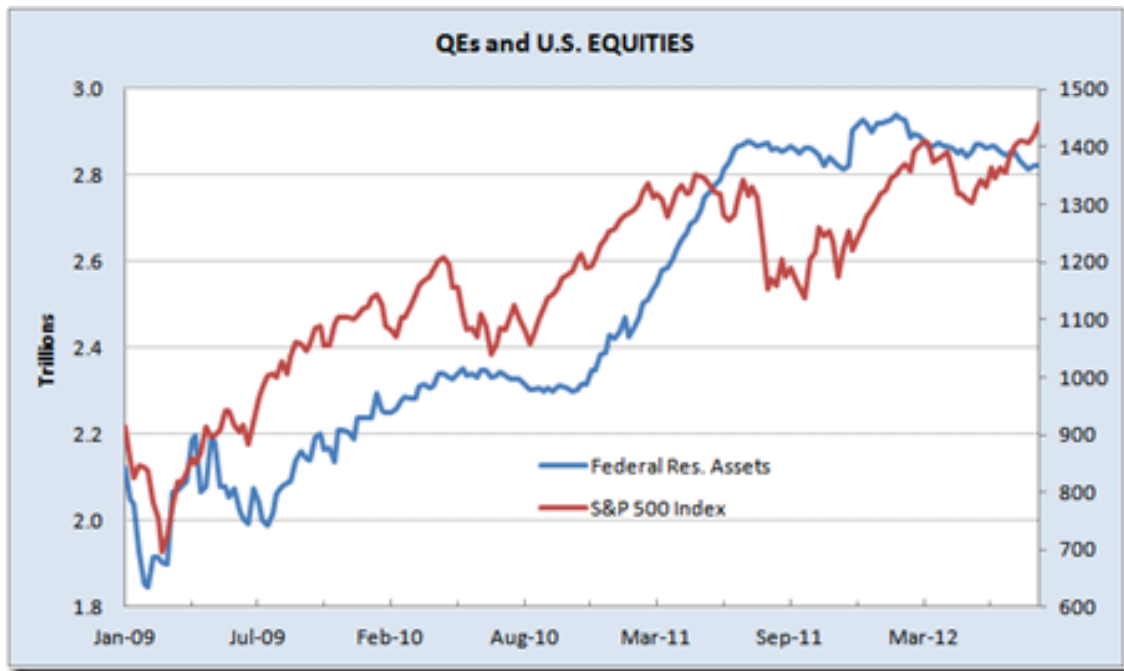
Your always paying attention to earnings analyst,

John Mauldin, Editor
Outside the Box

What If the Fed Has It All Wrong?

By Denis Ouellet

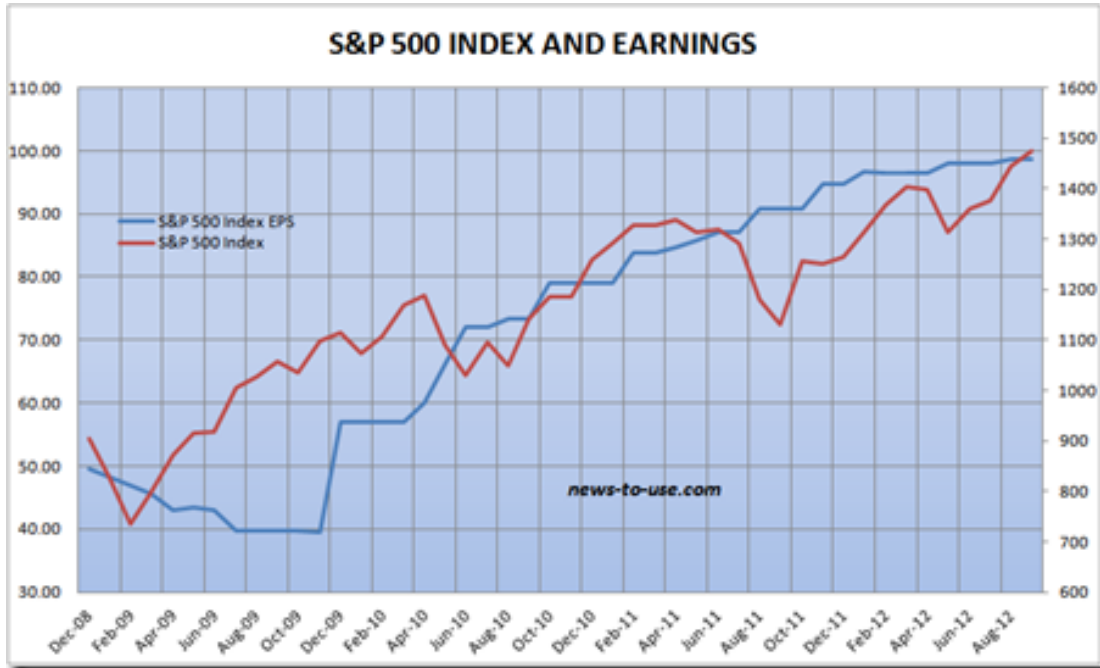
This is the 4th major intervention from the Fed since 2009, each one *apparently* inflating asset prices without having a definitive impact on the economy other than, most importantly, preventing a lethal debt-deflation spiral.



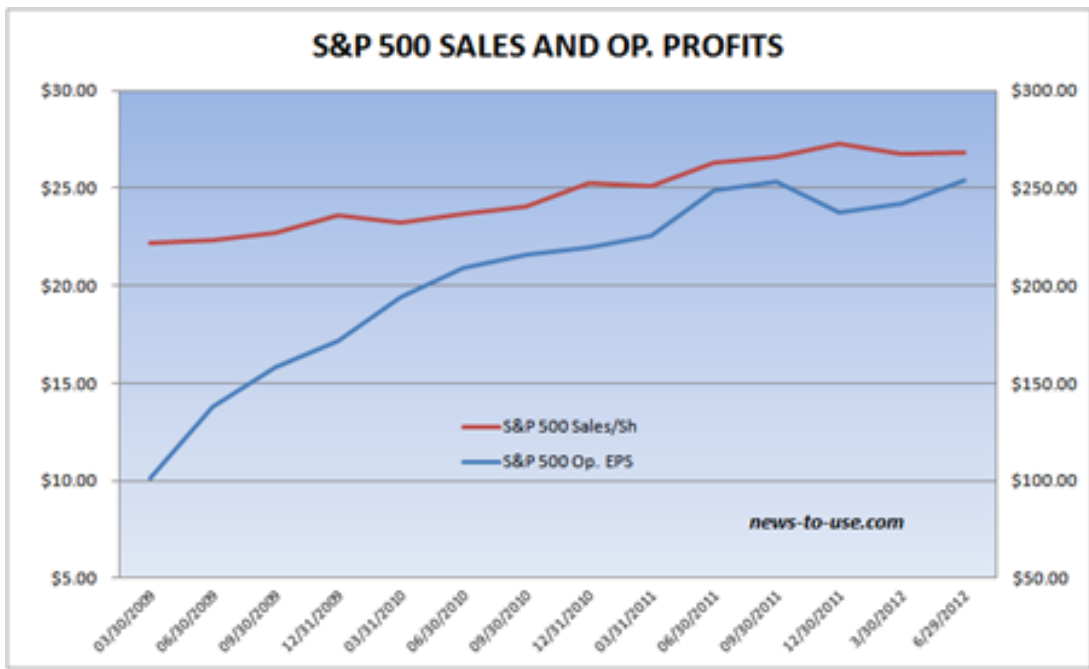
The chart above is used extensively to illustrate the close relationship between QEs and equity prices. Hence investors' Pavlovian reaction to last week's FOMC announcement of an open-ended and unlimited money printing program. Virtually every asset class rose, giving credence to Ben Bernanke's attempt to create a stimulating wealth effect.

What if the Fed has it all wrong?

Correlation does not imply causation. Could there be another reason for the spectacular rise in equity prices since 2009? Let's try earnings, just in case that intuitive, time-tested, relationship might still be working:



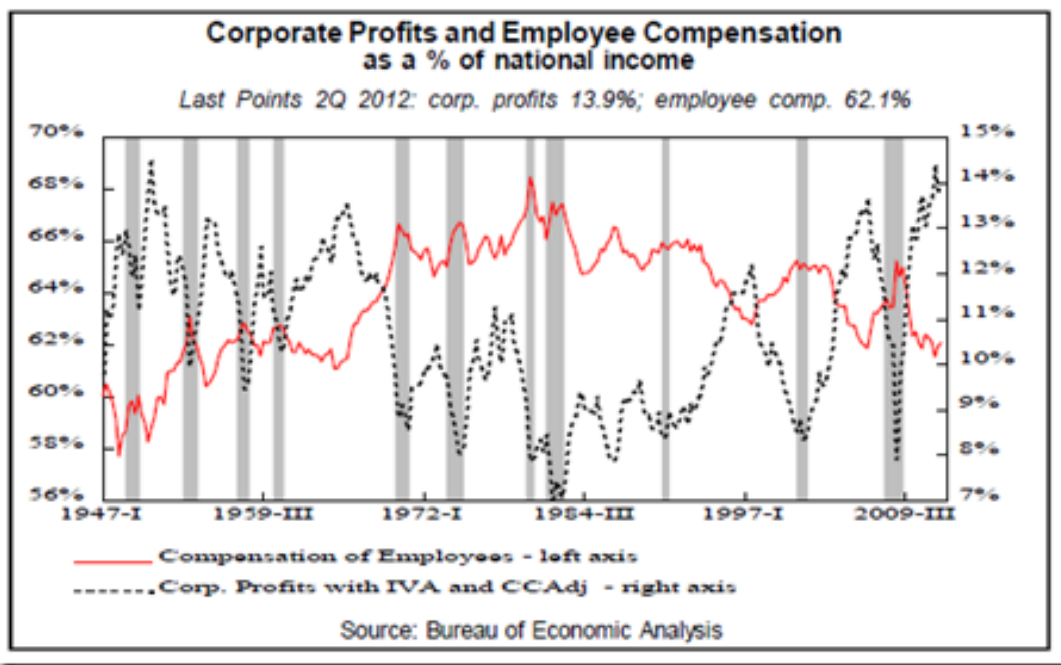
If there were a direct link between QEs and corporate profits, it should be apparent in S&P 500 company revenues. Yet, Index sales have only grown 16.5% during the last 3.5 years, nothing close to the 60% jump in Fed assets. Given that the Fed is now totally focused on growing employment, I doubt that it would take credit for the spectacular jump in profit margins since 2009, since most of it emanated from cost cutting (mostly labor) and rising productivity.



Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.JohnMauldin.com

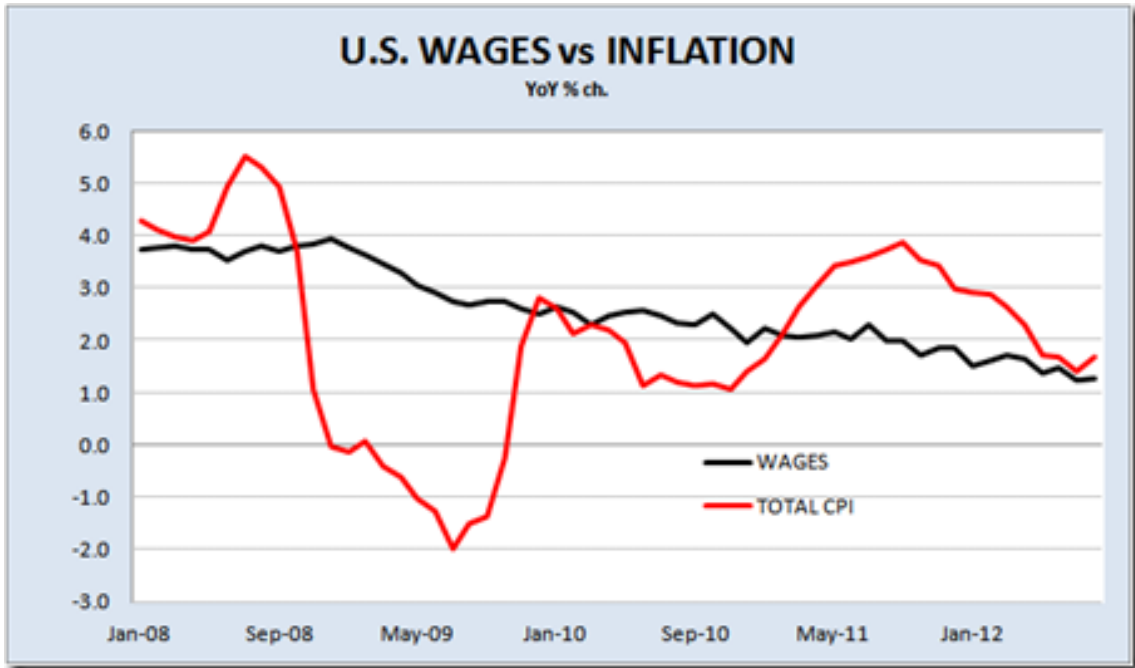
Some recent facts point to weaker earnings ahead:

- Quarterly sales and earnings have peaked in the last 9-12 months.
- Corporate profit margins are at an all-time high.

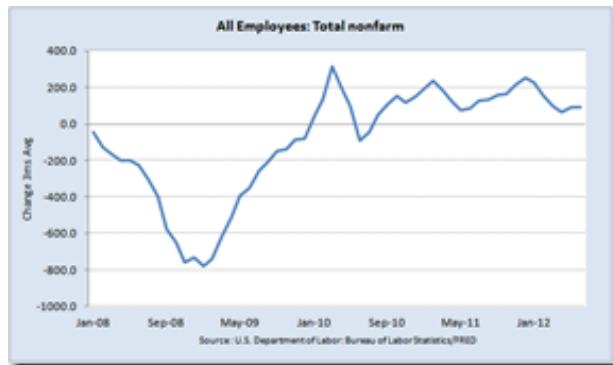
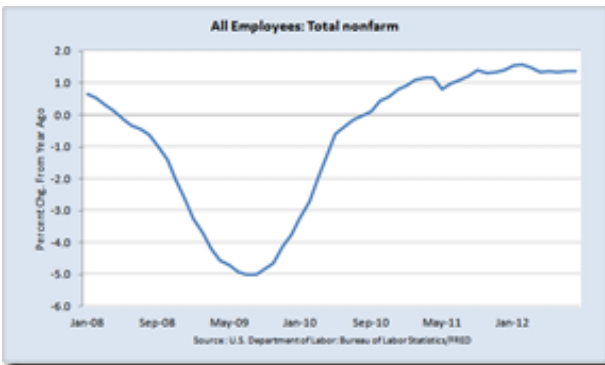


It is therefore dangerous to assume that margins will expand any further. From now on, corporations need to increase sales in order to grow their earnings. Unfortunately, demand is waning.

American wages, currently at a 50-year low as a percentage of GDP, are rising very slowly, so slowly that it is hampering consumer spending and the overall economy. At the time of previous QEs, also designed to create a wealth effect, wages were rising at a much faster clip than today. Furthermore, real wages were rising during 2009 and 2010, partly offsetting slow employment growth.



Today, employment growth remains below 1.5% YoY, a rate insufficient to reduce unemployment. Nominal wages are growing 1.2% while inflation is 1.7% and threatens to accelerate, in large part due to the impact that the Fed's actions are having on commodity prices, particularly oil prices.

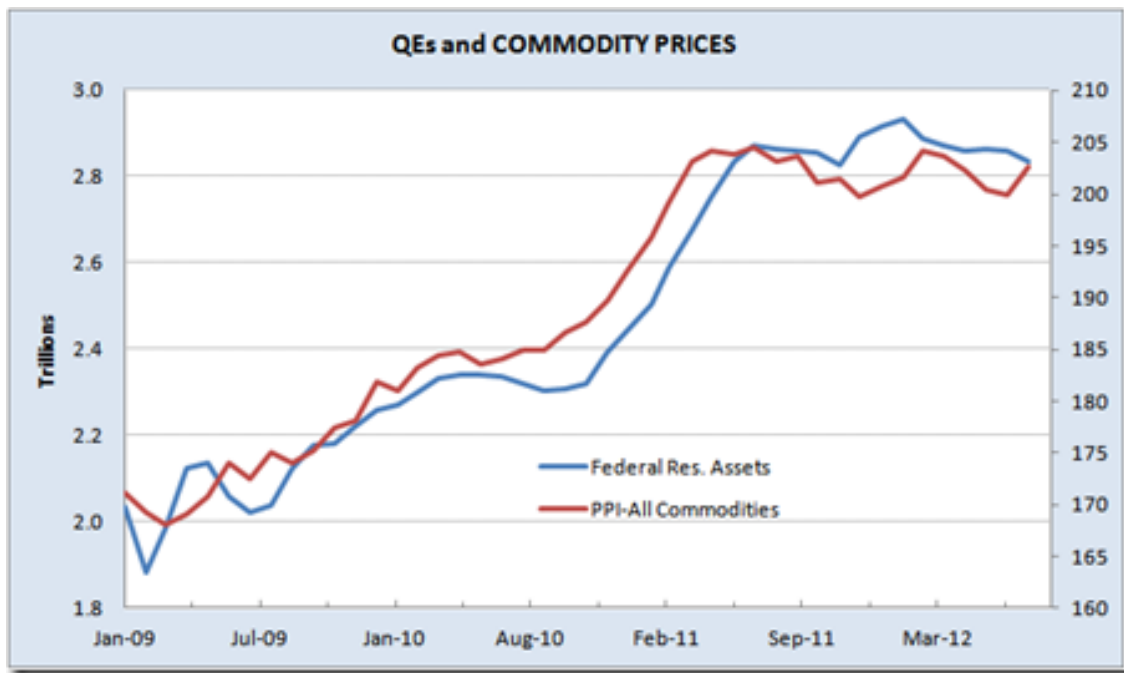


The US economy got lucky in 2011, when gasoline prices dropped 18% to \$3.20/gal. just in time for the back-to-school season and Christmas. It's luck extended into 2012, when the U.S. experienced an extraordinarily warm winter. Unless something else extraordinary happens soon (SPR releases?), the exact opposite will happen to oil prices. Gasoline has jumped 16% since July, adding to the squeeze just as we enter the most important shopping period of the year (chart below from gasbuddy.com).

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.JohnMauldin.com



The following chart plots the Fed's printing with commodity prices. Unlike the relationship with equity prices, it is difficult to find anything other than excess financial liquidity to explain the spectacular rise in commodity prices. Considering how world economies have been doing lately, why is it that commodity prices have not declined significantly?



The Fed's balance sheet is set to grow another \$800 billion by the end of 2013, the same amount it has increased since 2009, a period during which commodity prices jumped 20%.

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.JohnMauldin.com

The Fed wants to grow employment faster, but jobs don't grow out of thin air. Corporations create jobs when they have the means, they see a need, and there is visibility to commit. Needless to say, the last two conditions are far from being met these days. The Fed can't offset negative US politics, the European mess, nor the Chinese slowdown.

Bringing mortgage rates down further might help the slowly recovering housing sector and restart construction employment, but low wages and rising inflation remain a problem that might be perversely aggravated by the very actions the Fed is taking.

Wages are not about to accelerate, but inflation and taxation are problematic. If the American consumer can't spend, who will provide the needed spark?

Higher P/E Ratios to the Rescue?

Earnings have stalled, corporations are cutting guidance, and analysts are busy revising their estimates downward. Q3'12 estimates have been cut 8% since March and are now below Q2 earnings, which are themselves coming in much lower than originally expected. Q3 earnings are now seen down YoY.

If so, trailing 12-month EPS peaked last quarter and will decline in Q3. The earnings tailwind has disappeared.

There have been eight periods since 1935 when equities have risen in the face of declining earnings (see [Banking \[Betting\] On Bankers?](#)). *In all cases, inflation declined along with earnings.*

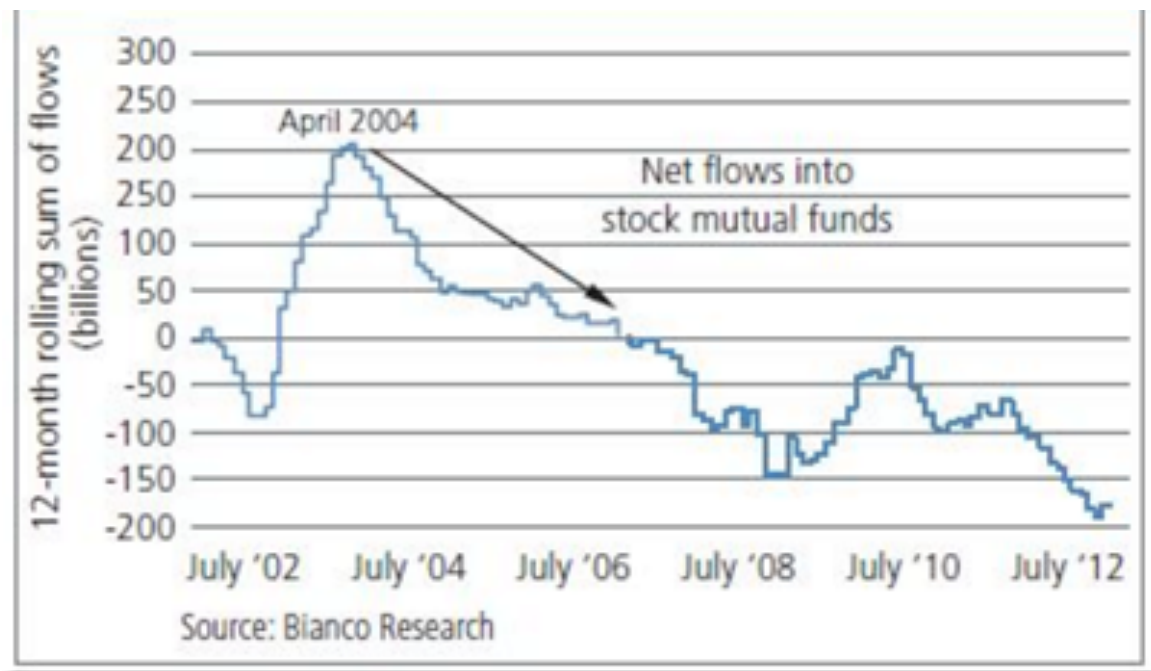
The dependable [Rule of 20](#) says that "Fair trailing P/E = 20 minus inflation." Lower inflation begets higher P/Es. A fair P/E is thus 18.3 at the current 1.7% inflation level, 23% above the current 14.8x P/E, pointing to 1800 as fair value on the S&P 500, based on trailing EPS of \$98.69. If this undervaluation is narrowed by the liquidity pumped out by the Fed, could it create enough wealth effect to push US consumers into a spending spree, in spite of negative real labor income growth?

The problem with Bernanke's wealth effect thesis lies with the new reality in America. Income and assets have lately been so significantly redistributed that only a tiny few actually feel a wealth effect from rising equity prices. Here are some sad facts:

- Last year, the top 20% of households took in 51.1% of all income in 2011, up from 50.2% in 2010 and the highest share since at least 1967, according to the Census Bureau. After the top, each quintile of income earners saw their share of income decrease, with the biggest drop among middle-income earners. The **middle fifth of households took in 14.3% of all income last year.** ([WSJ](#))



- In 2007, the top 20% of income earners had 53% of their financial holdings in stocks (directly and indirectly), down from 59% in 2001. Middle-income earners had 38% of their financial assets in stocks in 2007, down spectacularly from 47% in 2001.
- Stock holdings have obviously declined since 2007:



- US house values remain 30% below their 2006 peak level and now match their 2003 level.
- Total residential mortgage debt has only declined 7.5% since 2008. Some 1.5 million homes are in foreclosure, but 10.8 million homes remain in negative equity.

The “wealthy few” may feel wealthier if stocks advance, but they could nevertheless have much less after-tax income to spend when politicians finally address the looming fiscal cliff nestled within the rapidly growing mountain of debt.

Keep in mind that it is these wealthy people who run American corporations, keeping them lean and mean and flush with cash. They remember how profits literally disappeared in 18 months in 2007-08. They remember how financial markets totally froze in 2008. They see the humongous budget deficits and the debt piling on, and the not-so-distant day of reckoning. They realize that all the QEs in the world can’t offset inept and irresponsible politicians on either side of the Atlantic. Yet, they are the ones targeted by the so-called wealth effect!

Call that pushing on a golden string.

Meanwhile, the less affluent, the other 80% – some 250 million people – are little concerned by an eventual wealth effect but highly, directly, and immediately impacted by the side effects of all these QEs, namely rising commodity prices and near-zero interest rates. Consider that:

- 15% of the US population lives in poverty.
- 44% of those 46.2 million poor Americans are in “deep poverty,” which is half the level of the poverty line, defined as \$22,811 for a family of four.
- More than 45 million Americans are in the food-stamps program, which is 15% of the population, compared with the 7.9% participation from 1970-2000. Food-stamps enrollment has been rising at a rate of 400,000 per month over the past four years. Just last month (August), nearly twice as many people went on the food-stamps program (173,000) than managed to find a new job (96,000).
- More than 11 million Americans are collecting federal disability checks.
- 11.2% of the labor force is out of work, if we include the 7 million people no longer seeking employment. This number (over 17 million workers) is unchanged since 2009.
- Full-time employment remains 1.4 million below its 2009 level. Needless to say, part-timers earn and spend considerably less.
- Most of the 43.5 million American retirees must cope with nominal interest rates, near zero through 2015, when inflation is around 2.0%.

Call that pushing on a chafed string.

Betting on Bankers?

Now that US and European central banks have delivered the financial heroin needed to

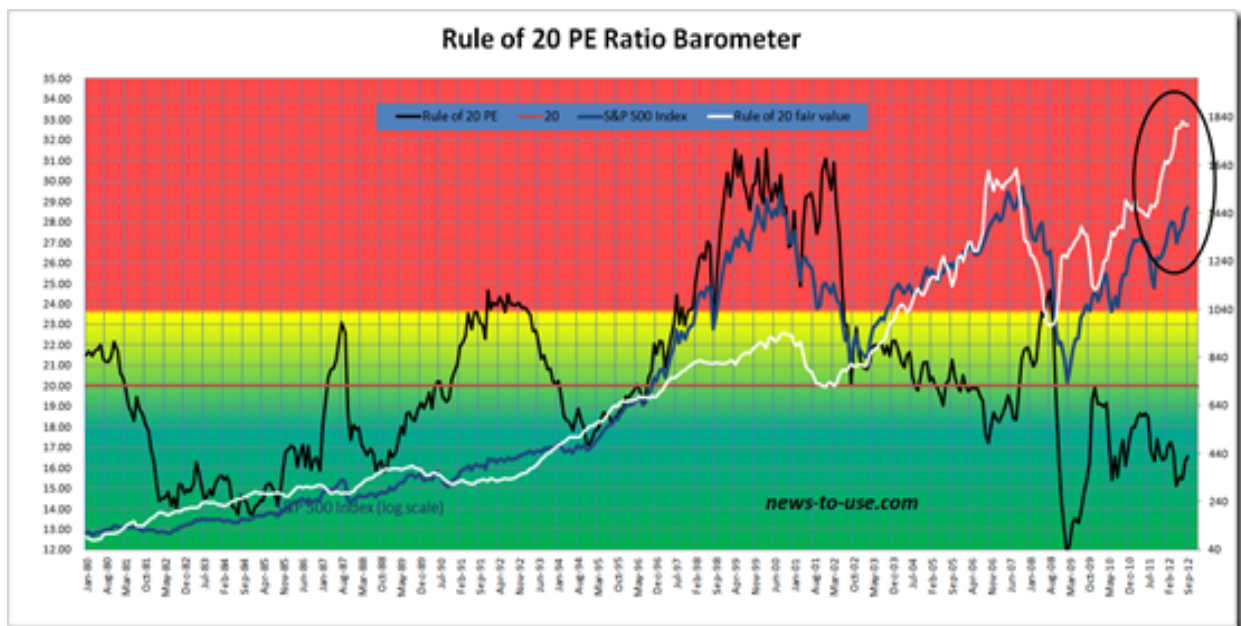
compensate for inept and irresponsible politicians, should we jump back in equities?

Will professional investors drive equities higher?

The risk here is that, much like businesspeople, investors may remain cautious, given the numerous and highly complex difficulties the US and the world are facing. They will also consider that, at the time of previous QE program launches, equity markets were similarly undervalued, but many economic trends were then more positive:

- Earnings were in a strong uptrend on rising margins.
- Oil prices were much lower.
- US real wages were rising (not in 2011).
- The 2011-12 winter was one of the mildest on record in the US.
- Europe was not in recession.
- China was still growing strongly.

Interestingly, the undervaluation of equities, as measured by the Rule of 20, narrowed from 40% to 0% during QE1, from 23% to 7% during QE2, and from 19% to 14% during Operation Twist (see the black line in chart below). The recent rally has narrowed the undervaluation from 27% to 19%. It would be very surprising if we got near fair value anytime soon. If 10% undervaluation (average of QE2 and OT) is the best we can hope for, the resulting 16.5 P/E (90% of 20 minus 1.7% inflation) brings the S&P 500 to 1625, just about 10% above current levels.



That assumes that inflation stays constant at 1.7% YoY. However, gasoline prices are +7% YoY in September, after rising 1.8% in August.. If they remain unchanged until year-end, gas prices will

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.JohnMauldin.com

be +18% YoY. Not only would that considerably disrupt Christmas sales, it would also help raise inflation (gasoline is 5.5% of the CPI, energy is 9.7%). If inflation rises to 2.0%, a 10% undervaluation would get the S&P 500 Index to 1565, a mere 6% above current levels.

If the Fed has it all wrong, simply pushing on golden or chafed strings, and the only effect of QE3 is to boost inflation, only God(ot) knows what will happen.

While the Fed waits for the wealth effect to take effect, the European Central Bank is also waiting for its own Godot, following Draghi's magic with the ECB rules and regulations. Super Mario's "whatever it takes" promise is powerful but not without pitfalls:

- When, if ever, will the eurozone achieve the necessary banking and fiscal unions?
- Will Spain and Italy surrender before it is too late?
- Will ever more austerity finally work?
- When will the debt spiral stop?
- How much longer will the Germans put up with the situation, accepting that the ECB ruins its balance sheet by taking on unlimited risk on behalf of the German taxpayers, risking their fiscal sovereignty to save the "reckless Southerners"?
- How much longer will the hordes of unemployed young Europeans put up with the situation?

Central bankers have indeed delivered. In truth however, they are merely experimenting with totally unproven ways and means, hoping to gain enough time until more responsible politicians emerge. Given the significant risks still facing us until Godot shows up, investors should await more evidence that either earnings will resume their uptrend or some kind of miracle will happen.

Equity holdings should be trimmed to conservative levels. Sustainable income should be favored. Cash earns essentially nothing but is safe for now. Gold remains attractive for many, many obvious reasons.

Copyright 2012 John Mauldin. All Rights Reserved.

Share Your Thoughts on This Article

Post a Comment

Like *Outside the Box*? Then we think you'll love John's premium product, *Over My Shoulder*. Each week John Mauldin sends his *Over My Shoulder* subscribers the most interesting items that he personally cherry picks from the dozens of books, reports, and

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.JohnMauldin.com

articles he reads each week as part of his research. [Learn more about Over My Shoulder](#)

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting <http://www.mauldineconomics.com>.

Please write to subscribers@mauldineconomics.com to inform us of any reproductions, including when and where copy will be reproduced. You must keep the letter intact, from introduction to disclaimers. If you would like to quote brief portions only, please reference <http://www.mauldineconomics.com>.

To subscribe to John Mauldin's e-letter, please click here: <http://www.mauldineconomics.com/subscribe/>

To change your email address, please click here: <http://www.mauldineconomics.com/change-address>

If you would ALSO like changes applied to the Mauldin Circle e-letter, please include your old and new email address along with a note requesting the change for both e-letters and send your request to compliance@2000wave.com.

To unsubscribe, please refer to the bottom of the email.

Outside the Box and JohnMauldin.com is not an offering for any investment. It represents only the opinions of John Mauldin and those that he interviews. Any views expressed are provided for information purposes only and should not be construed in any way as an offer, an endorsement, or inducement to invest and is not in any way a testimony of, or associated with, Mauldin's other firms. John Mauldin is the Chairman of Mauldin Economics, LLC. He also is the President of Millennium Wave Advisors, LLC (MWA) which is an investment advisory firm registered with multiple states, President and registered representative of Millennium Wave Securities, LLC, (MWS) member FINRA, SIPC. MWS is also a Commodity Pool Operator (CPO) and a Commodity Trading Advisor (CTA) registered with the CFTC, as well as an Introducing Broker (IB) and NFA Member. Millennium Wave Investments is a dba of MWA LLC and MWS LLC. This message may contain information that is confidential or privileged and is intended only for the individual or entity named above and does not constitute an offer for or advice about any alternative investment product. Such advice can only be made when accompanied by a prospectus or similar offering document. Past performance is not indicative of future performance. Please make sure to review important disclosures at the end of each article. Mauldin companies may have a marketing relationship with products and services mentioned in this letter for a fee.

Note: Joining the Mauldin Circle is not an offering for any investment. It represents only the opinions of John Mauldin and Millennium Wave Investments. It is intended solely for investors who have registered with Millennium Wave Investments and its partners at www.MauldinCircle.com or directly related websites. The Mauldin Circle may send out material that is provided on a confidential basis, and subscribers to the Mauldin Circle are not to send this letter to anyone other than their professional investment counselors. Investors should discuss any investment with their personal investment counsel. John Mauldin is the President of Millennium Wave Advisors, LLC (MWA), which is an investment advisory firm registered with multiple states. John Mauldin is a registered representative of Millennium Wave Securities, LLC, (MWS), an FINRA registered broker-dealer. MWS is also a Commodity Pool Operator (CPO) and a Commodity Trading Advisor (CTA) registered with the CFTC, as well as an Introducing Broker (IB). Millennium Wave Investments is a dba of MWA LLC and MWS LLC. Millennium Wave Investments cooperates in the consulting on and marketing of private and non-private investment offerings with other independent firms such as Altegris Investments; Capital Management Group; Absolute Return Partners, LLP; Fynn Capital; Nicola Wealth Management; and Plexus Asset Management. Investment offerings recommended by Mauldin may pay a portion of their fees to these independent firms, who will share 1/3 of those fees with MWS and thus with Mauldin. Any views expressed herein are provided for information purposes only and should not be construed in any way as an offer, an endorsement, or inducement to invest with any CTA, fund, or program mentioned here or elsewhere. Before seeking any advisor's services or making an investment in a fund, investors must read and examine thoroughly the respective disclosure document or offering memorandum. Since these firms and Mauldin receive fees from the funds they recommend/market, they only recommend/market products with which they have been able to negotiate fee

Outside the Box is a free weekly economic e-letter by best-selling author and renowned financial expert, John Mauldin. You can learn more and get your free subscription by visiting www.JohnMauldin.com

arrangements.

PAST RESULTS ARE NOT INDICATIVE OF FUTURE RESULTS. THERE IS RISK OF LOSS AS WELL AS THE OPPORTUNITY FOR GAIN WHEN INVESTING IN MANAGED FUNDS. WHEN CONSIDERING ALTERNATIVE INVESTMENTS, INCLUDING HEDGE FUNDS, YOU SHOULD CONSIDER VARIOUS RISKS INCLUDING THE FACT THAT SOME PRODUCTS: OFTEN ENGAGE IN LEVERAGING AND OTHER SPECULATIVE INVESTMENT PRACTICES THAT MAY INCREASE THE RISK OF INVESTMENT LOSS, CAN BE ILLIQUID, ARE NOT REQUIRED TO PROVIDE PERIODIC PRICING OR VALUATION INFORMATION TO INVESTORS, MAY INVOLVE COMPLEX TAX STRUCTURES AND DELAYS IN DISTRIBUTING IMPORTANT TAX INFORMATION, ARE NOT SUBJECT TO THE SAME REGULATORY REQUIREMENTS AS MUTUAL FUNDS, OFTEN CHARGE HIGH FEES, AND IN MANY CASES THE UNDERLYING INVESTMENTS ARE NOT TRANSPARENT AND ARE KNOWN ONLY TO THE INVESTMENT MANAGER. Alternative investment performance can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, alternative investment fund and account managers have total trading authority over their funds or accounts; the use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, and none is expected to develop.

All material presented herein is believed to be reliable but we cannot attest to its accuracy. Opinions expressed in these reports may change without prior notice. John Mauldin and/or the staffs may or may not have investments in any funds cited above as well as economic interest. John Mauldin can be reached at 800-829-7273.