Down Under Daily, 7 March 2014

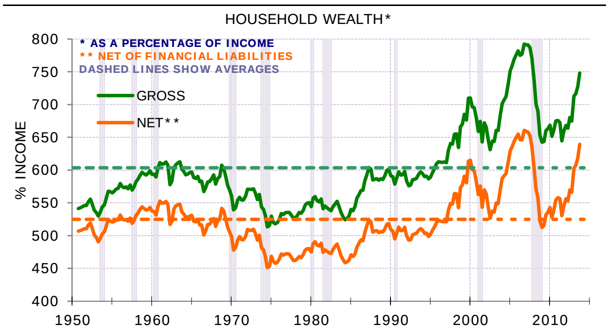
Fed Winning The Battle

The Fed is winning the battle: wealth effects are starting to work in the US. This eases, for a while, what I had seen as the most important trade-off in the US: either labour income lifted, supporting growth but compressing margins, or the US consumer risked rolling over. Falling savings, however, support growth *and* profits.

US household wealth, net of household debt, is approaching all-time highs (Exhibit 1). Of course, this is just asset price inflation: in aggregate Americans are not better off. But asset inflation has become a key lever for policy makers as conventional monetary channels seem blocked.

Exhibit 1

Feeling Richer…

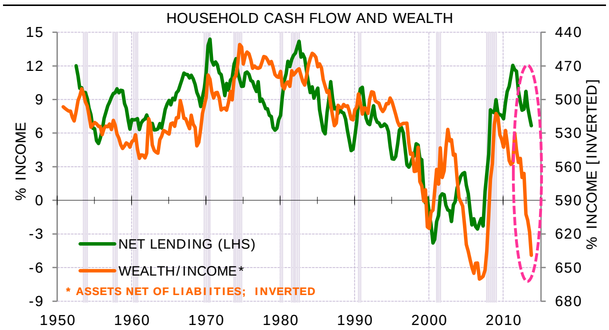


Source: Federal Reserve, BEA, NBER; Minack Advisors

The 'wealth effect' is just the effect of changing asset values on saving. In this cycle saving has remained high, despite rising asset prices – until now. Exhibit 2 shows saving now starting to fall. (The saving rate measure is net lending. This, in my view, is a better measure of saving than the standard household saving rate.)

Exhibit 2

…Saving Less

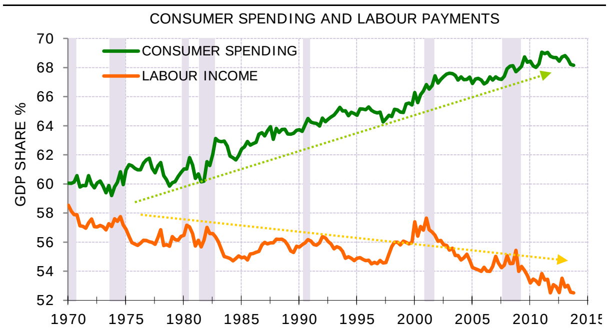


Source: Federal Reserve, NBER; Minack Advisors

The decline in saving is allowing the gap between what consumers spend and what they are paid by business to widen. Exhibit 3 shows labour income at multi-decade lows as a share of GDP while consumer spending is near all-time highs.

Exhibit 3

Staying Stretched

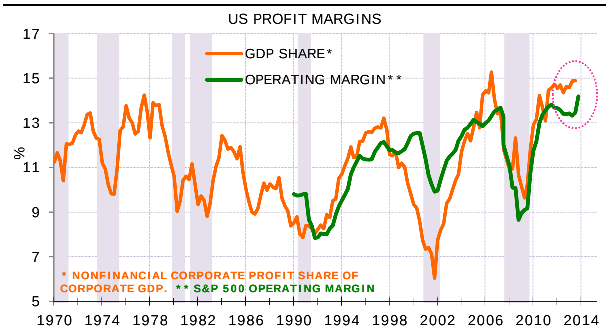


Source: BEA, NBER; Minack Advisors

Consumer spending is the largest single driver of corporate revenue, while labour is the corporate sector's largest single cost. So when the gap between consumer spending and labour income widens it is great for margins. Falling savings will let the gap widen further. The drop in household saving in the second half of 2013 coincided with operating margins hitting cycle highs (Exhibit 4).

Exhibit 4

Margins Rise



Source: BEA, NBER, Bloomberg, Standard & Poor's; Minack Advisors

If this continues it suggests that US earnings will do better than I had expected, at least for a while. It weakens the case to be under-weight US equities. None of this, however, changes that fact that US equities continue to look expensive. Finally, the Fed won the wealth effect battle in both of the prior two cycles, but both cycles ended badly. This will too.

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