Canaccord Genuity Capital Markets

Macro Strategy

US Equity Research
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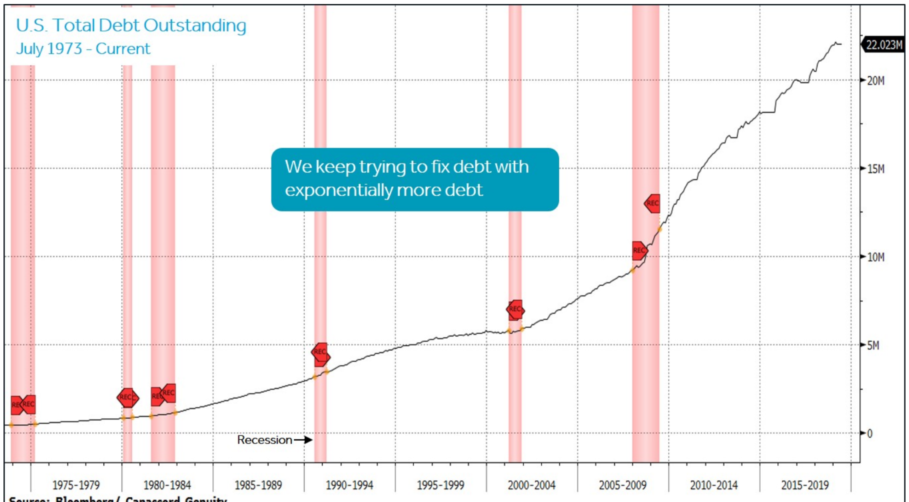
Macro Update

A generational change at the Fed

The U.S. and the world have literally tried to fix an excessive amount of debt by causing exponentially more debt (Figure 1). For the better part of the last 40 years the Fed has been worried about a potential inflation-driven rise in rates because the sheer size of the debt would make it less affordable and lead to economic catastrophe. This generational fear was born out of the stubbornly higher level of inflation from the late 1960s to mid-1980s (Figure 2) and had the following impact on their thinking:

- The Fed created numerous recessions as they over-tightened to slow economic growth and a *potential* spike in inflation.
- The response to each recession was to drop rates to even lower levels for longer, which significantly increased traditional bank and especially shadow bank lending given a much steeper yield curve.
- This caused improved economic growth by making the cost of debt much cheaper and more available, again leading to fear of an inflation spike.

Figure 1: At $22 trillion, U.S. total debt continues to grow exponentially



Source: Bloomberg/ Canaccord Genuity
DEBPTOTL Index (US Total Debt Outstanding) Recession shading Monthly 31DEC1960- Copyright© 2019 Bloomberg Finance L.P. 29-Jul-2019 11:55:14

What the Fed misses – the peak Fed Funds rate is lower every cycle. The result of this circular pattern was that the increased size of the debt relative to the prior cycle meant that it took less of a rise in the Real Fed Funds Rate to shut down economic activity. In other words, the Fed thought rates were still accommodative, but the sheer size of the debt meant the over-tightening took place at a lower level of peak rates than the prior cycle(s), which caused a credit-driven recession that took longer to recover from (Figure 3).

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Figure 2: Chasing the ghosts of higher inflation

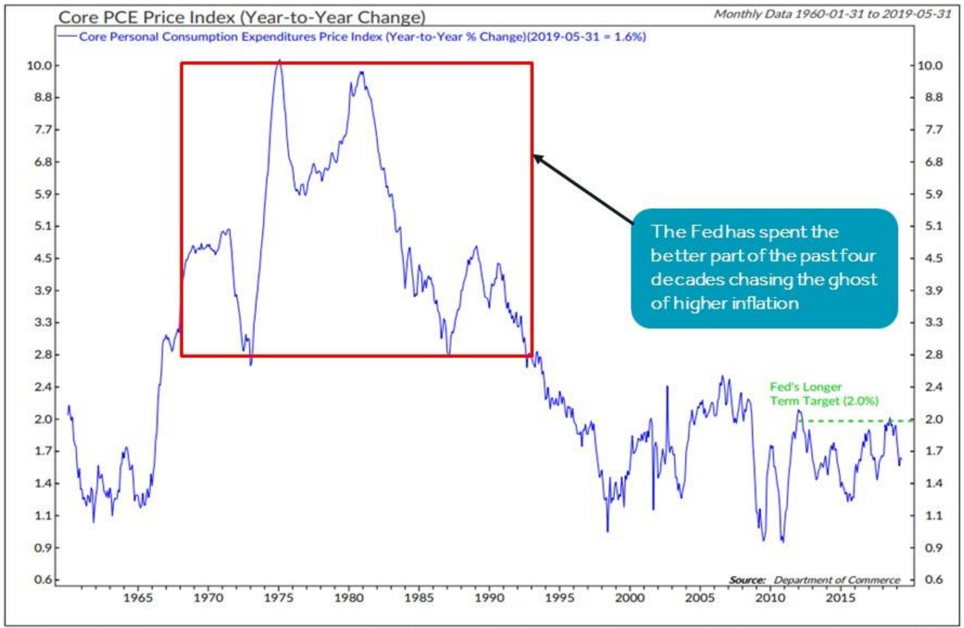

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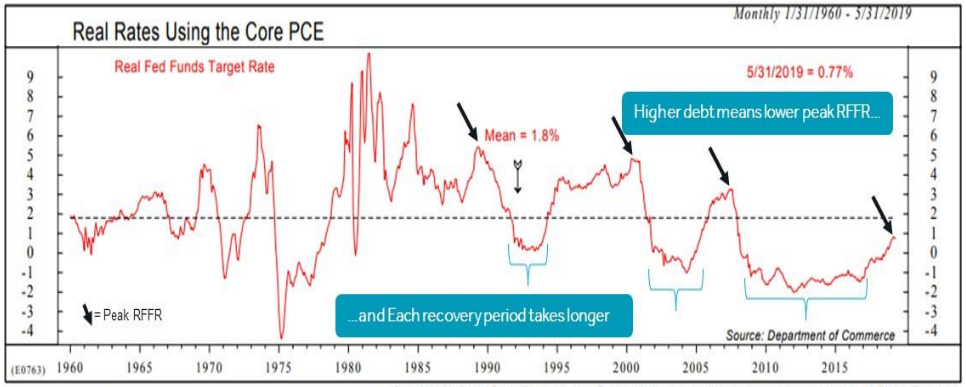
Figure 3: Each cycle has seen a low peak in rates and longer period to recover



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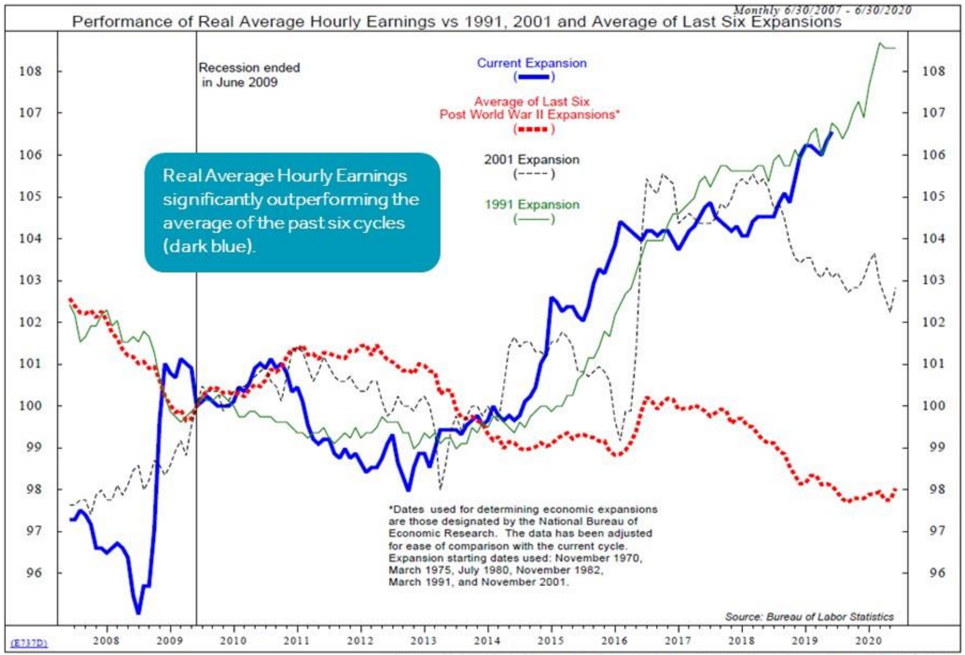
The Fed is focused on inflation, and for good reason. Just days before a likely initial rate cut by the Fed, many wonder how the Fed can be lowering interest rates while the economy seems to be on solid footing. Over recent months, it has become clear through Fed comments they are more focused on reaching an average 2% Core PCE, which currently stands at well below their stated goal at just 1.6%. The Fed has spent decades worried about higher inflation when the economy reaches full employment, yet when it reached the historically low current level, there was no sign of it.

The inflation monster that hasn't come. We believe the inability to generate more sustained inflation in a full employment economy is going to cause a generational shift in how the Fed views monetary policy. The labor inflation boogey man of historically full employment, higher average hourly earnings (Figure 4), and low productivity happened this cycle and the best they got was an average Core PCE of 1.62% and 1.58% over the past five and 10 years, respectively. This despite years of a

Zero Interest Rate Policy, Quantitative Easing, and massive fiscal stimulus. Indeed, the risk has shifted from a fear of higher inflation to fear of ending up like Japan and Europe with negative rates that don't stimulate growth.

Figure 4: Average Hourly Earnings have outperformed this cycle – yet no inflation spike



Real Average Hourly Earnings significantly outperforming the average of the past six cycles (dark blue).

*Dates used for determining economic expansions are those designated by the National Bureau of Economic Research. The data has been adjusted for ease of comparison with the current cycle. Expansion starting dates used: November 1970, March 1975, July 1980, November 1982, March 1991, and November 2001.

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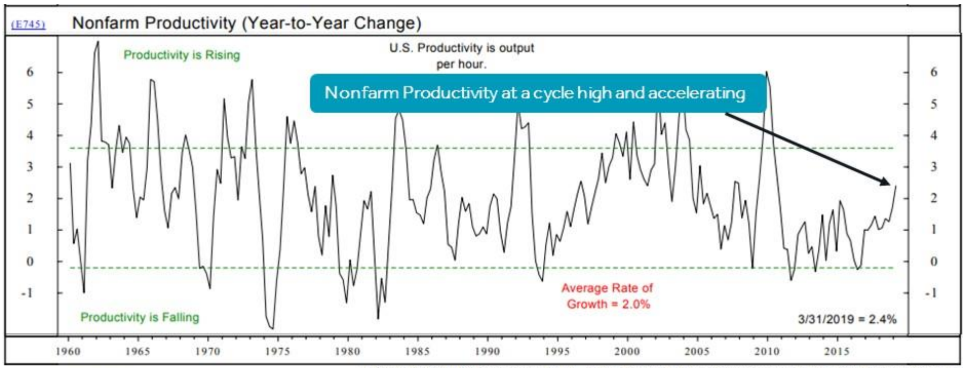
High productivity and slowing Unit Labor Costs should scare the Fed even more. With economic growth slowing and Nonfarm Productivity surging to a cycle high (Figure 5) the Fed is likely becoming very concerned about the resulting slowdown in Nonfarm Unit Labor Costs. There is a 0.89 correlation coefficient between Nonfarm Unit Labor costs and the Core PCE (Figure 5), which means their favored measure of core inflation is likely to drop even further rather than reaching toward their 2% goal.

Figure 5: Nonfarm Productivity surging to a cycle high



U.S. Productivity is output per hour.

Nonfarm Productivity at a cycle high and accelerating

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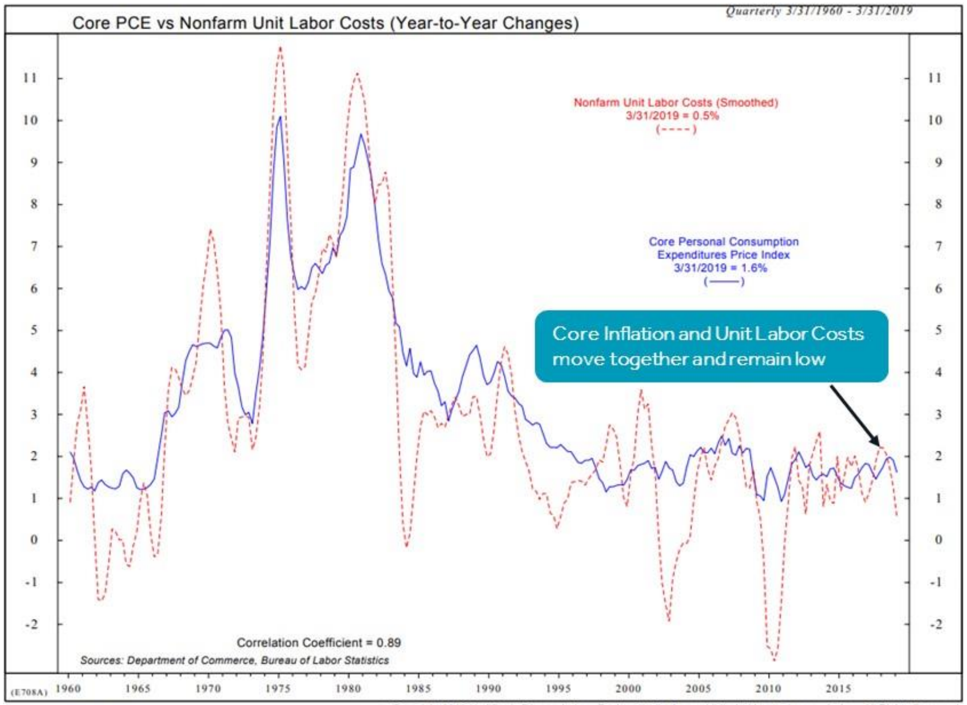
Figure 6: Dropping Nonfarm Unit Labor Costs should scare the Fed



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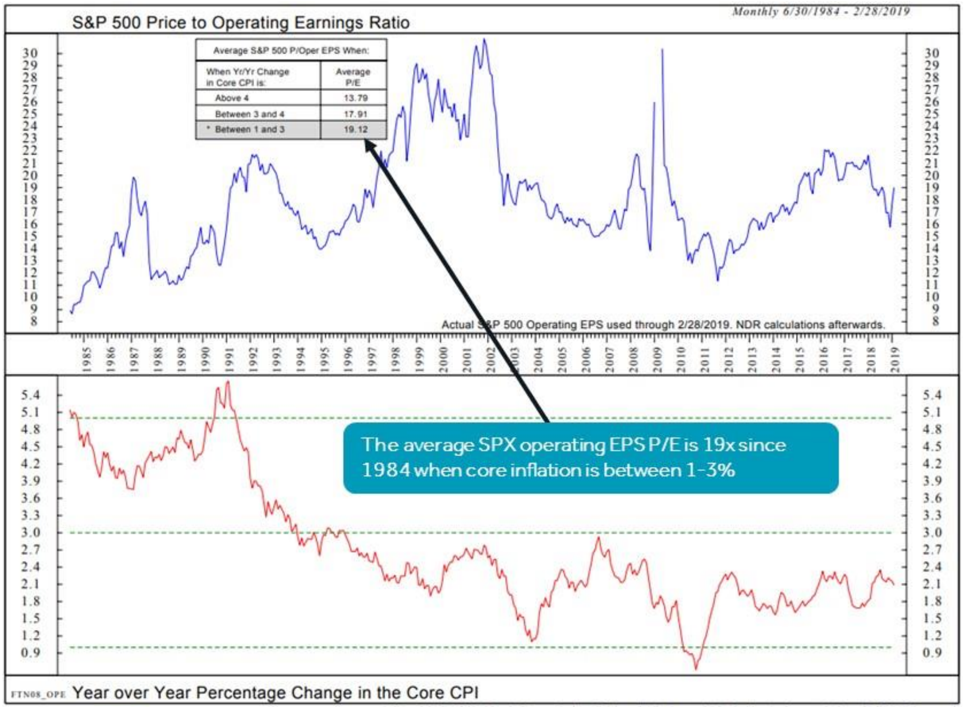
Summary – Expect more aggressive rate cuts and market multiple expansion. The implication of a generational shift in how the Fed fears LOWER inflation more than higher inflation suggests an adoption of more aggressive rate cuts now vs. taking a wait and see mode. Fed Chair Powell and other regional presidents such as Neel Kashkari and James Bullard have made it clear the risk is to not ease enough and wait too long to address the implications of stubbornly low inflation that could cause sustainably lower rates and poor growth. Ultimately, this likely means our 2020 S&P 500 (SPX) target of 3350 based on a multiple expansion to 19x our SPX Operating EPS estimate of $176 could likely be overly conservative. Again, our multiple assumption is based on the average multiple of 19x when the Core PCE is between 1-3% (Figure 7), and if the Fed becomes more accommodative investors are more likely to return to that level sooner rather than later. It is also important to remember this is not an academic study; the SPX Operating Earnings P/E was over 19x from the third quarter of 2016 until the market saw a 19.8% drop late last year (Figure 8).

Figure 7: Lower Core PCE equals higher valuations



Average S&P 500 P/Oper EPS When:	
When Yr/Yr Change in Core CPI is:	Average P/E
Above 4	13.79
Between 3 and 4	17.91
* Between 1 and 3	19.12

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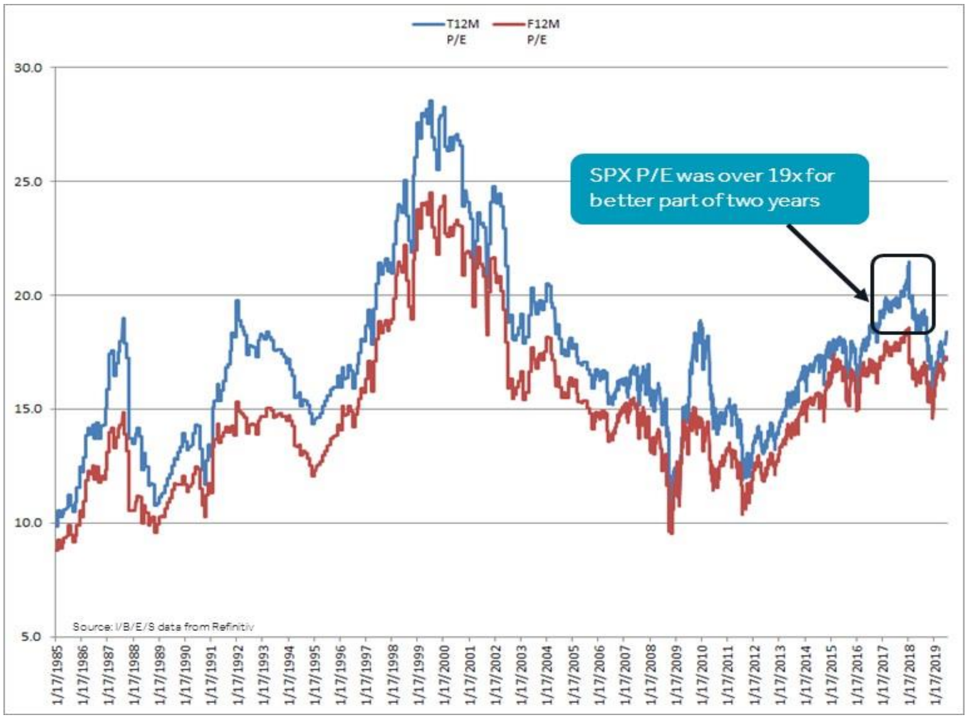
Figure 8: SPX Operating Earnings P/E was over 19x from 3Q/16 to 3Q/18



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Date and time of first dissemination: July 29, 2019, 13:01 ET

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Distribution of Ratings:

Global Stock Ratings (as of 07/29/19)

Rating	Coverage Universe		IB Clients
	#	%	%
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Hold	200	22.81%	36.00%
Sell	26	2.96%	19.23%
Speculative Buy	130	14.82%	75.38%
	877*	100.0%	

*Total includes stocks that are Under Review

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