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October 12, 2016

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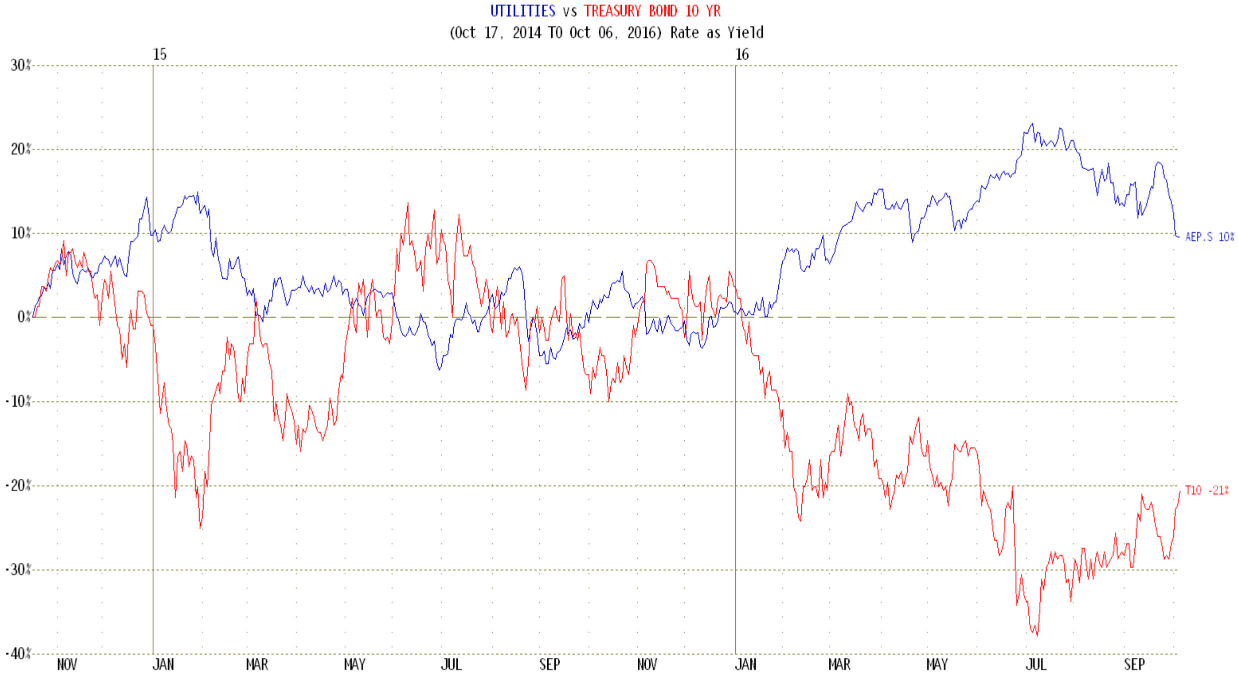
Cyclical vs. Secular Forces

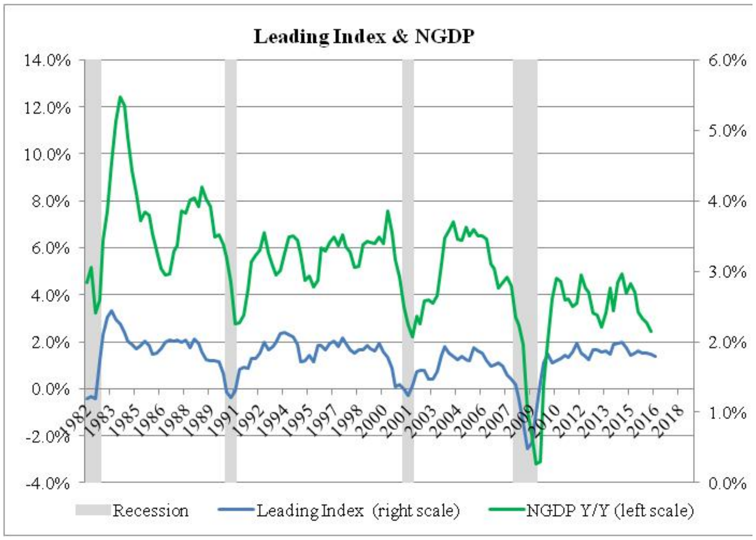
Since mid-summer, there has been a reversal in an important trend: U.S. Treasury bond yields have risen while defensive stocks have declined in value as investors re-embraced more risky investments. We think this reversal is only temporary. U.S. treasuries and high yielding defensive stocks were star performers during the first half of 2016 after investors became alarmed by capital outflows from China and the possibility of a currency crisis (see Chart 1 below). Bond yields fell (red line) and defensive stocks like utilities (blue line) rose. Since July, those trends have reversed due to several medium term cyclical factors. Unemployment in the U.S. has fallen to a point where some analysts are starting to expect inflation to accelerate (we don't). Employment growth is increasing expectations that the Fed will raise short term rates. Also, the Chinese government has pulled out all its tools to keep growth up and to prevent capital flows out of the country. Investors have become more complacent and confident that the cyclical expansion justifies higher interest rates. Our contrary view is that the secular forces which are putting downward pressure on interest rates continue and will reassert themselves in the months ahead.

Chart 1



Cyclical indicators continue to point toward ongoing economic expansion. For example, notice in Chart 2 that the Leading Index of the U.S. (blue line) leads nominal GDP (NGDP) growth by about six months. In recent quarters, NGDP has decelerated toward about 2% while the Leading Index has held steady. This suggests to us that NGDP is likely to modestly reaccelerate in the current quarter and in early 2017. Also, the PMI manufacturing index rebounded to 51.5 in September from the dip to 49.4 in August. The ISM new orders index jumped to 55.1 in September from the unusual decline to 49.1 in August (see Chart 3).

Chart 2



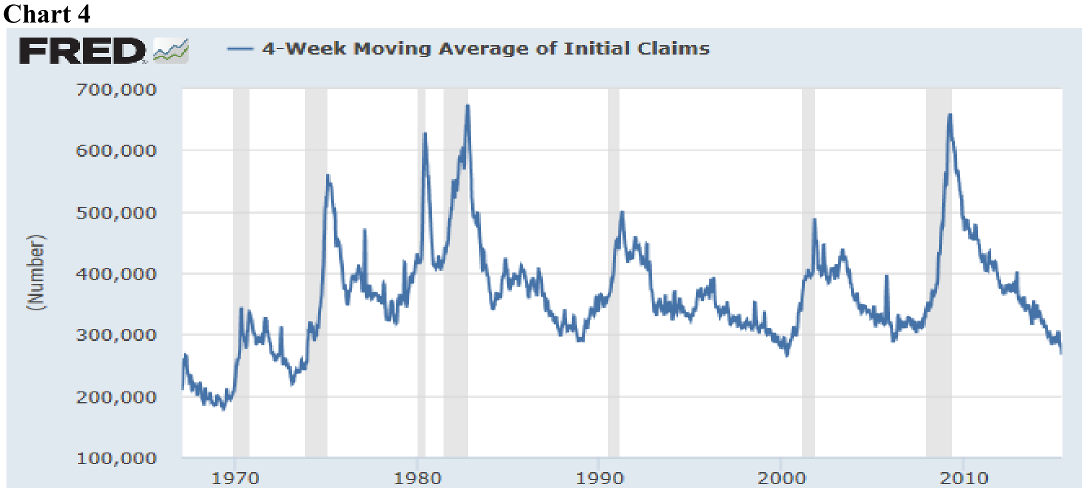
Source: Federal Reserve, FVCM

Chart 3

Source: Institute for Supply Management, FVCM

With recent data pointing toward ongoing growth, futures contracts on the Fed Funds rate are indicating about a 2/3rds chance that the Federal Reserve will raise interest rates in December. Traditionally, the Fed has raised interest rates to prevent excesses or bottlenecks from developing that will lead to higher inflation. Specifically, some mainstream economists believe that inflation springs from inadequate labor. Indeed, initial claims for unemployment recently fell to their lowest level since 1973 (see Chart 4 below) and wages are showing slow but steady increases of about 2.5% year over year. But there is controversy about the so-called Phillips Curve, which is supposed to measure the tradeoff between inflation and unemployment. In the 1970s, for example, there was both high unemployment and high inflation. Recently, we have had low levels of both.

Chart 4



Source: Federal Reserve

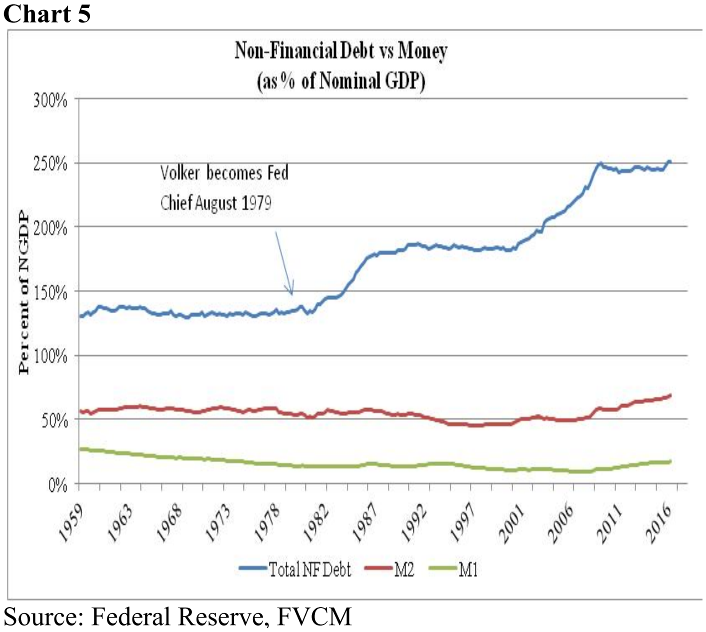
Even with an unemployment rate of only 5% and initial claims for unemployment at a nearly 45 year low, a rate hike by the Fed is by no means guaranteed. Last August, at a meeting of global bankers at the annual Jackson Hole symposium, Janet Yellen, the Chairman of the Federal Reserve said that "Our ability to predict how the federal funds rate will evolve over time is quite limited because monetary policy will need to respond to whatever disturbances may buffet the economy," as well as "Of course, our decisions always depend on the degree to which incoming data continues to confirm the Committee's outlook." What she means by this is that any threats to U.S. growth, such as an exogenous shock from China, or even softening economic data locally would lead the Fed to again postpone a rate hike. Because of the factors discussed below, we think the Fed has good reason to be cautious. We would not even rule out a QE4 at some point in the next few years.

The Power of the Secular Debt Cycle

When Paul Volker was appointed Chairman of the Federal Reserve in 1979, a chain of events was started that has led to a secular contraction in nominal economic activity. Through the latter part of the 1960s and the 1970s, spending and inflation steadily increased. Debt also increased, but no faster than nominal income so debt held steady as a percent of GDP. Volker decided to attack inflation by limiting growth in the money supply and allowing interest rates to spike. By 1981, Volker's policies resulted in a 19% Fed Funds rate, the U.S. was in recession, and nominal spending and inflation began a long period of decline that continues to this day.

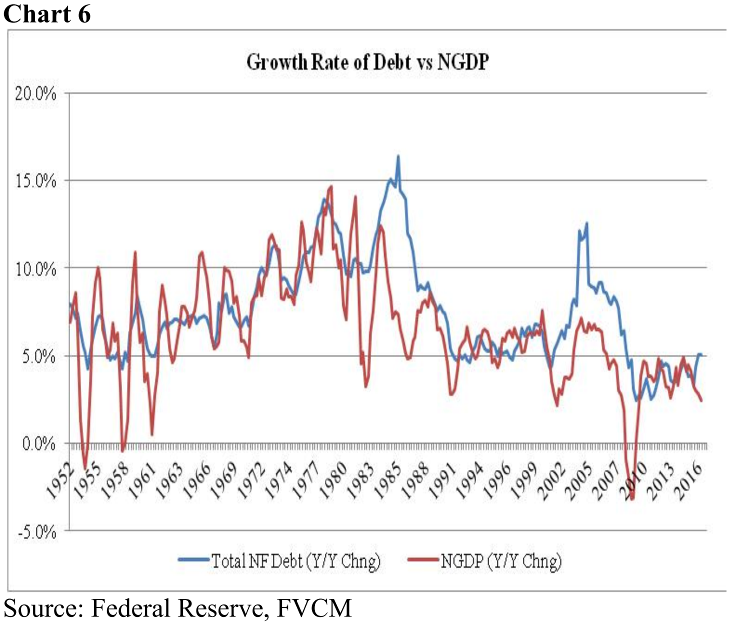
Volker's policies seem to have had an unintended compounding effect that has resulted in rising debt and persistent disinflationary pressures that still exist. After holding steady at about 130% of GDP for decades, total debt rose to about 185% in the 1980s (see Chart 5). If we look at the actual growth rates in debt (see the blue line in Chart 6) and compare it to the growth in nominal GDP (the red line), it seems that borrowers had a delayed response to the decline in nominal GDP growth spurred by Volker. An *unanticipated* decline in inflation and nominal income resulted in a higher plateau of debt. Again, Alan Greenspan started raising the Fed Funds rate in June 2004 when it was 1.0%. Rate increases didn't stop until Fed Funds hit 5.25% in June 2006 under Ben Bernanke, and helped trigger the end of the "housing bubble." Nominal GDP growth actually went negative and, again like in the 1980s, the growth rate of debt followed NGDP downward but only with a lag that resulted in debt reaching its current plateau of about 250% of GDP.

Chart 5



Source: Federal Reserve, FVCM

Chart 6



Source: Federal Reserve, FVCM

The Secular Debt Cycle, Wealth Inequality & Spending

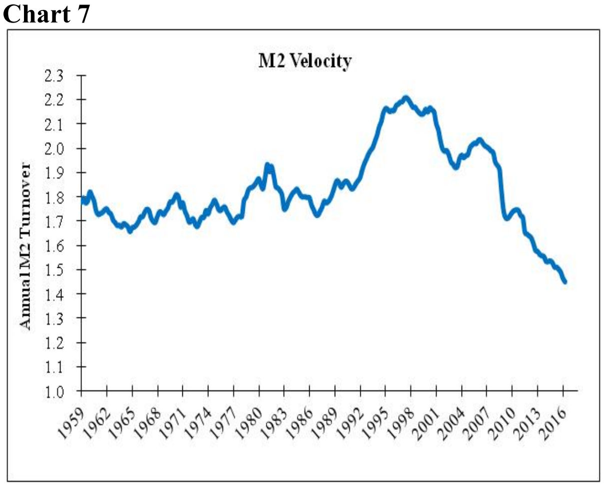
One person's debt is another person's asset. Because people with high incomes save more, they accumulate more financial assets. On the other side of the same coin are the rising debt levels, primarily of the middle class. The uber wealthy like Warren Buffett do not make their income from a wage or salary, their income derives primarily from interest on bonds, stocks or from other investments. Over the past decades, the financial assets of the wealthy have risen relative to nominal GDP in parallel with the observed rise in debt.

Debt is disinflationary and has put downward pressure on spending and interest rates. As debt rose relative to national income, spending by those in debt has been constrained by the need to make payments on their outstanding debt. One could argue that interest paid by debtors is income for creditors. But as previously discussed, those in debt are more likely to spend their income, whereas creditors--those who hold securities as assets--have a higher propensity to save. Because of this dynamic, high debt levels depress new spending and inflation, which puts downward pressure on interest rates. Consider also that lenders are having an increasingly hard time finding qualified borrowers for incremental lending. From this perspective, lenders have to offer more attractive terms, i.e., lower interest rates, to entice additional borrowing. The wealthy may complain about the low returns on their bond portfolios, but the middle class can rejoice about the low interest rate on their mortgage or car payment. The downward pressure on interest rates is the mechanism that the markets have to normalize an increasingly lopsided relationship between creditors and debtors.

Special central bank activity, like quantitative easing (QE), reflects the Fed's effort to offset the depressing effect of high levels of debt. There are only three ways for an economy, in terms of nominal spending, to expand. Because of forces affecting possibilities #1 and #2 below, it has more become the responsibility of central banks to stimulate spending (#3):

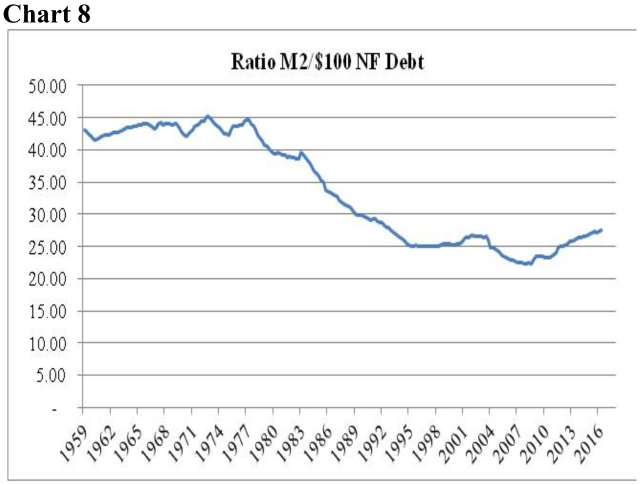
1. **People in the aggregate decide to hold smaller cash balances.** If the demand for money declines and people reduce their cash balances, money gets passed around like a hot potato. Spending goes up as the circulation of the existing money supply accelerates. However, since the beginning of the last decade the demand for money has been increasing and cash has been hoarded. As people try to build cash balances, the velocity of money (turnover) declines and spending contracts. As shown in Chart 7, the turnover of the M2 money supply has been declining since the end of the tech bubble in 2000. Why has the demand for money been increasing? One clue is seen in Chart 8. The M2 money supply has declined sharply relative to nonfinancial debt during the last several decades. Bank deposits are a "long" position in money, whereas debt is a "short" position. The shorts are getting "squeezed." In other words, high debt levels encourage people to accumulate cash, which in turn puts downward pressure on economic activity and inflation, which puts even greater pressure on those in debt.

Chart 7



Source: Federal Reserve, FVCM

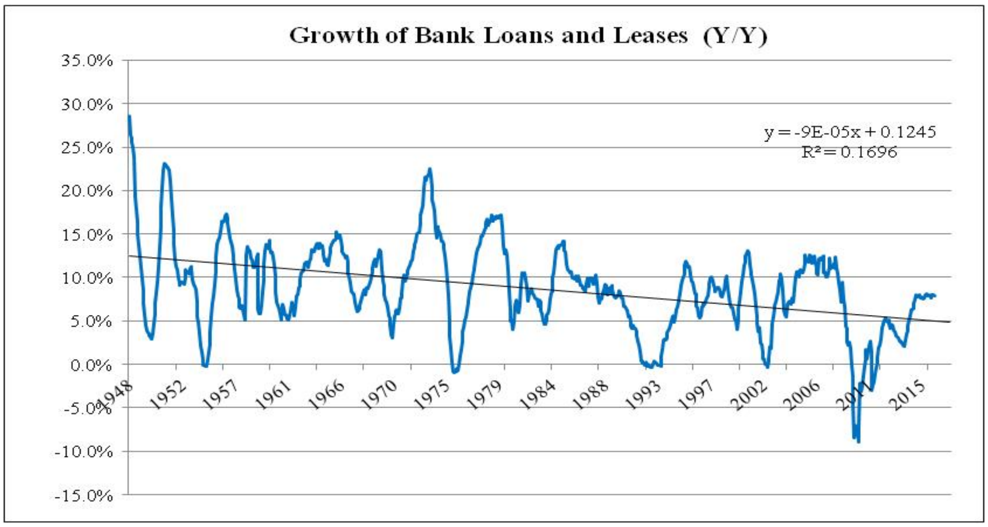
Chart 8



Source: Federal Reserve, FVCM

2. **The money supply and spending increase through bank lending.** When a bank has excess reserves with the Fed, it can make a loan to the public that results in the creation of a new bank deposit (money!) which can be spent. As seen in chart 9, the growth rate of new loans has been decelerating as the overall level of debt has increased. Lending actually contracted during the last recession. Loan growth turned positive in 2011 as the new business expansion got underway. However, with aggregate debt levels still very high, we shouldn't be surprised to see bank loan growth lose momentum and perhaps decline again when the current business cycle comes to an end. This downward trend in new lending, and the resultant downward trend in new spending, is disinflationary and provides an environment ripe for depressed interest rates.

Chart 9



Source: The Federal Reserve, FVCM

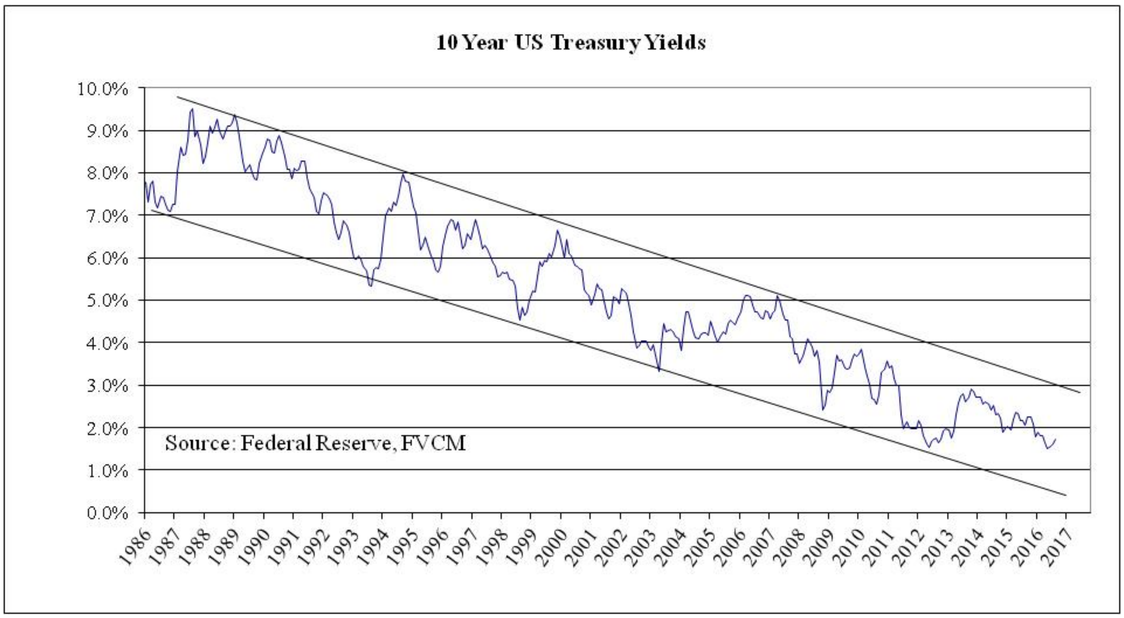
3. **The money supply increases through central bank open market operations, i.e., "QE."** If private commercial banks can't or don't want to make loans, the central bank can effectively make loans by purchasing debt securities. When the Federal Reserve buys a U.S. treasury security from the public, it has effectively created money. The person who has sold the security to the Fed now has more money in their bank account in exchange for the treasury security. One way this is short-circuited, however, is when the Fed buys a treasury security from a bank. In that case, the Fed gets the security and the bank gets an increase in its reserve deposit at the Fed. Bank reserves deposited at the Fed are not money because they can't be spent. But in either case, QE increases the supply of loanable funds at the same time it reduces debt held by the public and thus depresses interest rates. And, unquestionably, the Fed's policy of QE enabled the money supply to expand at a time when bank lending has been depressed and the demand for cash was increasing.

   Special Note: U.S. treasury securities purchased by the Federal Reserve are still counted as "federal debt held by the public" even though the Fed is part of the federal government and it pays income to the U.S. treasury. If you exclude U.S. treasury debt held by the Federal Reserve, total federal debt held by the public falls from 75.6% of GDP to 62.2%.

Yields Down: The Trend is Your Friend

We started this report by noting that U.S. treasury bonds and defensive, high yield stocks have recently turned lower. We think this is only a short term trend. As seen in Chart 10, the yield on long term U.S. treasury bonds have been in a downward channel for decades. As we have tried to argue, this trend was triggered by Paul Volker's Federal Reserve and has been reinforced by high relative debt levels. For now, these strong, multi-decade forces appear to remain in place. Consequently, while yields are very low, there is no indication that the long term downward trend has been broken. Furthermore, while the indicators we have shown suggest that the current cyclical expansion will continue into 2017, the very low level of unemployment does represent a potential headwind to ongoing cyclical expansion. Investors are likely to return to defensive securities as the current cyclical expansion continues to extend and thoughts turn to the inevitable next recession. In this scenario, companies with strong secular growth prospects should also do well as they are partly resistant to cyclical factors. Our investment strategy of Growth at a Reasonable Price (GARP) is designed to hit this sweet spot.

Chart 10



Defensive, high yielding stocks are also attractive because of a few big risk factors that are on the horizon. Both candidates for the U.S. presidency have been speaking against international trade, especially the North American Free Trade Agreement (NAFTA). This is unfortunate. There are few things that nearly all economists can agree on and one of them is the benefit of free trade. As Milton Friedman put it, "the most important single central fact about a free market is that no exchange takes place unless both parties benefit." Trade restrictions would unquestionably hurt the U.S. and global economy. Our hope is that the current anti-trade talk is populist rhetoric that will begin to evaporate after the election and the new President comes to face reality.

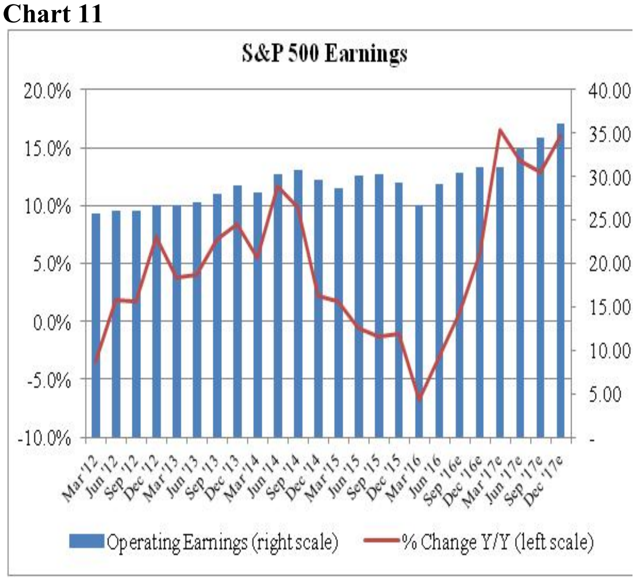
Risks to growth also emanate from outside the U.S. For example, the Chinese have done an amazing job of postponing a cyclical downturn in that country through fiscal stimulus. China's budget deficit is expected to reach about 5% of GDP this year—up from 2% last year—and is likely to increase in 2017 as they use spending on infrastructure to offset declining private investment. One must be concerned, however, of rapidly rising debt and large increases in real estate values in major cities. We are skeptical of most data from China, but it does appear to be a country taking extreme measures to maintain growth. It is hard to know when China's bubble will burst, but we think it will happen. Separately, European banks are under-capitalized and the level of non-performing loans is high. It is difficult to see how this problem will be resolved, but European banks represent a risk to the global financial system.

S&P 500 Earnings: Coming Rebound Should Push Prices Higher

Earnings growth for the S&P 500 (SPX) is expected to turn positive during the quarter just ended after having declined for five consecutive quarters. Corporate earnings had been depressed by the decline in oil prices and the sharp rise in the US dollar, both of which began in mid 2014 and both of which have stabilized over the past year. The initial numbers aren't big, but the consensus forecast is that operating earnings for the SPX will be up 0.7%, year-to-year, for the third quarter ended in September, and up 5.9% for the quarter ending in December 2016 (see Chart 11). Even more interesting, based on the sum of quarterly consensus forecasts, earnings are expected to be up 14.8% in 2017 following decreases of 0.3% and 0.8%, respectively, for full years 2014 and 2015.

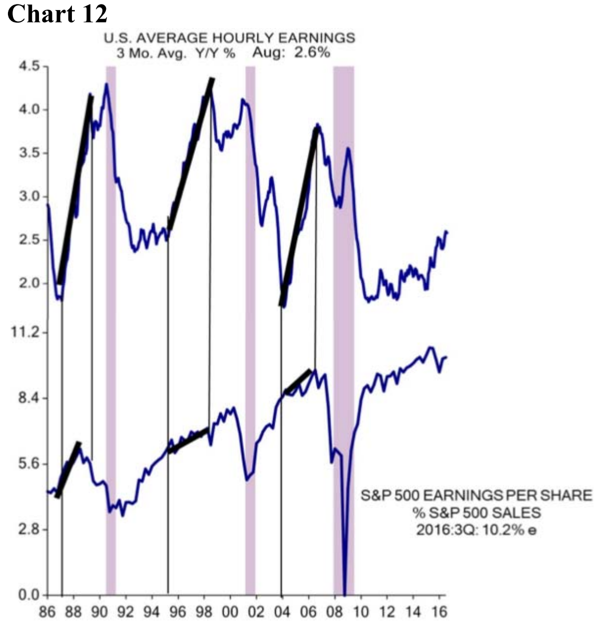
Tight labor markets are starting to drive wages higher, but corporate profit margins could still expand. In contemplating the likelihood that a forecast of 14.8% earnings growth could come to fruition in 2017, the chart below (12) from Evercore ISI is helpful. As shown, there were three periods in recent decades where profit margins expanded at the same time that wages were accelerating. In our view, this counterintuitive fact likely reflects the power of operating leverage on business profits. Wages tend to rise because the business cycle is a relatively mature phase of expansion and unemployment rates are low. But at the same time, business operating rates are high and rising. The benefits of higher sales and production volumes (higher wages are spent after all) and operating rates on margins, more than offset the effect of a cyclical rise in wages. Note: Wages have been in a secular declining trend as a percent of national income and corporate profits for decades.

Chart 11



Source: First Call, FVCM

Chart 12



Source: Evercore ISI

Stocks still have great upside potential and offer the best prospects for the year ahead. The year 2015 started with the SPX at 2058.9, which was 17.4 times the 118.23 in operating earnings for that year (see Table 1 below). Somewhat coincidentally, 2016 also started with the index at 17.4 times the current consensus estimate for 2016. If 2017 starts the year at 17.4 times the consensus earnings, the SPX would be at 2,342.74, or about 10% above the current level. Is a 17.4 P/E justified? As we have argued in past reports, the fair P/E depends on the rate of inflation, just as bond yields are a function of inflation. In the current environment, stocks are reasonably valued and stock investors continue to have the possibility of earning moderate returns going forward which should exceed bond and other asset classes. The downside, of course, is volatility. As we have noted, there are risks facing global business and equity investors have to be willing to ride through potential volatility.

Table 1 **S&P 500**	**2014**	**2015**	**2016(e)**	**2017(e)**
Index Price (Beginning of Year)	1,848.36	2,058.90	2,043.94	2,342.74
Index Earnings (forward)	118.64	118.23	117.33	134.64
P/E Ratio	15.6	17.4	17.4	17.4

Note: The Index Price shown for the beginning of 2017 is the 134.64 sum of consensus quarterly estimates for 2017 multiplied by the 17.4 P/E ratio experienced in 2015 and estimated for 2016.
Source: Thomson Baseline-First Call, FVCM