Rates Going Up For The Wrong Reason
Don's Blog 2018.02.20

Is it possible we are in a bull trap? Of course, only time will tell. Please note chart #1. What we do know is markets can go down as well as up. Note chart #2 which compares the downtrend in the 10-year government and action in the stock market. It seems equity buyers turn to sellers when it appears that long interest rates are rising. Think about this—is 3% interest rates on $20,000,000 debt the same as 6% of $10,000,000? That is where we approximately are after 10 years as concerns the government. The point is, at least as far as the non-money printing private sector is concerned, we are there. It is the same. Servicing debt can force the selling of other assets if there is no to little income. Rising debt levels and rising interest rates is the worst of all worlds for our extremely over-levered economy. Things are changing. Maybe 2018 is that year where we hit the proverbial brick wall. Or again, maybe I am crying wolf once more.

The reason why interest rates are rising is the fear of inflation. As you know, I don't believe we have broken the march toward deflation, however I don't make the market. Why no inflation? The answer is Amazon and those that are forging ahead with the same business model. A banker friend of mine mentioned that banks were facing two major problems—deposits and Amazon. Deposits in the short-run as the money supply is slowing down, but the real gorilla in the room long-term is Amazon. They are going after the clearing system first (back office work), then moving up from there. One third of all customers don't ever go to the bank anymore. If you want to fill a need, find a use for the thousands of branch banks which are looking like small shopping centers. Maybe we can turn them into police stations.

Why the fear of inflation? Unemployment is 4% which of course, is very low. We continue to hear Wall Street talk about the tight labor market due to 4%, which in fact is more like 8% when properly accounted for. Real wages are going up they say—cost-push inflation is on the way ala the late 1970s hogwash. Please note charts 3 & 4. Also, of course, they say the economy is humming. However, consumer spending is 70% of the economy. So, what about charts 5 & 6? The small amount of increase in retail sales taking place comes from savings. Note chart #7. You have seen some of these charts before. I repeat them for emphasis. I can't find charts which confirm a major acceleration in economic activity. It may be in the tech area somewhere; but again, that leads to lower prices—not higher.

Final Thought

Many have compared the recent drop in the stock market to the 1987 experience. Note the following comparisons made by David Rosenberg.

Similarities and Differences

While comparing 1987 to today is helpful, the economic, political and market backdrops are quite different. There are however some similarities worth mentioning.

Currently:

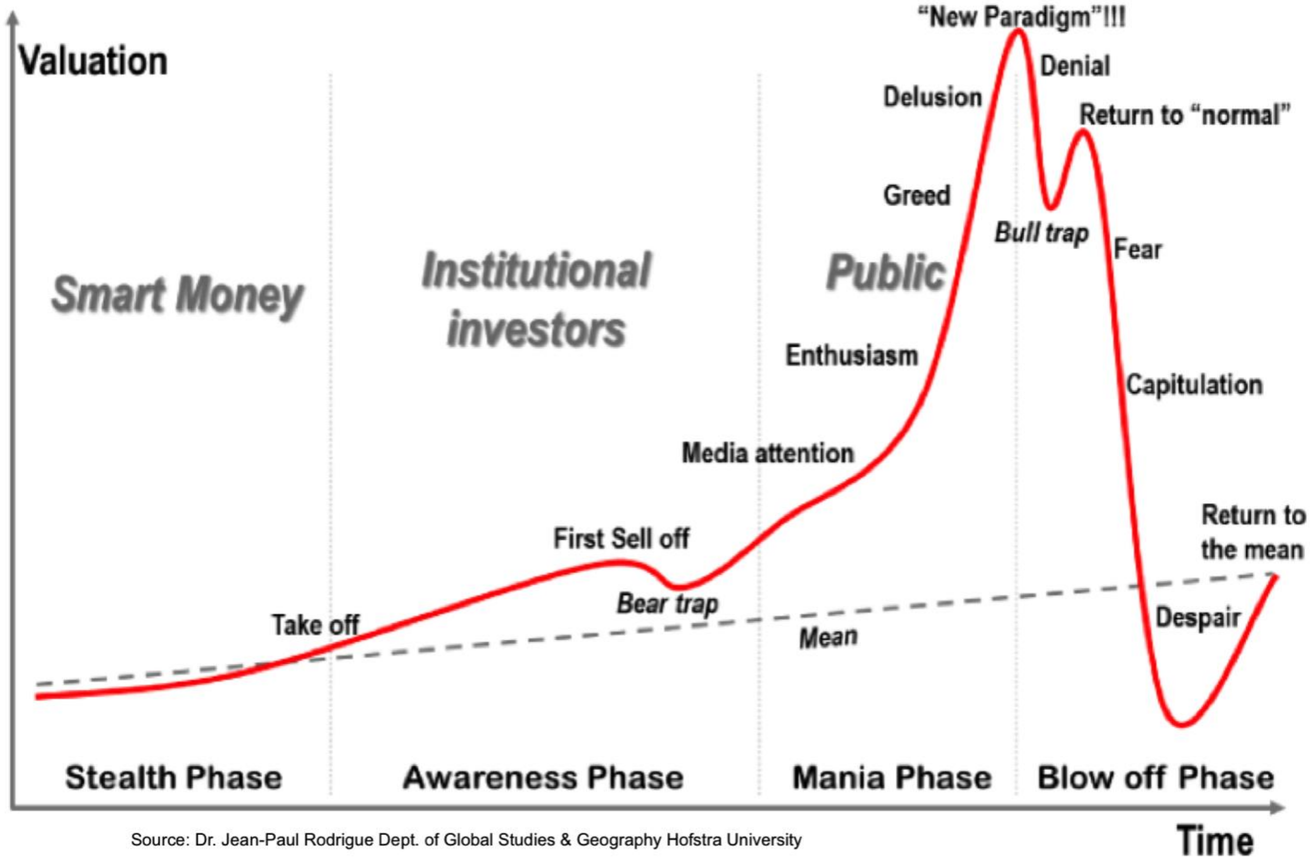
- Interest rates are rising
- Federal deficits are increasing
- Weaker dollar policy was recently affirmed by Treasury Secretary Mnuchin
- Equity valuations are above almost every instance of the last 100+ years, regardless of how those valuations are measured
- Sentiment and expectations are at or near record levels.
- The use of margin is helping investors lever their holdings.
- Trading strategies such as short volatility positions can have a snowball effect, like portfolio insurance, if they are unwound

There are also vast differences. The economic backdrop of 1987 and today are nearly opposite.

- In 1987 baby boomers were on the verge of becoming an economic support engine. Today they are retiring and do not have the same economic effect.
- Debt to GDP has grown enormously since 1987.
- The amount of monetary stimulus in the system today is extreme, leaving one to question how much more can the Fed do.
- Productivity growth was robust in 1987, and today it has nearly ground to a halt.

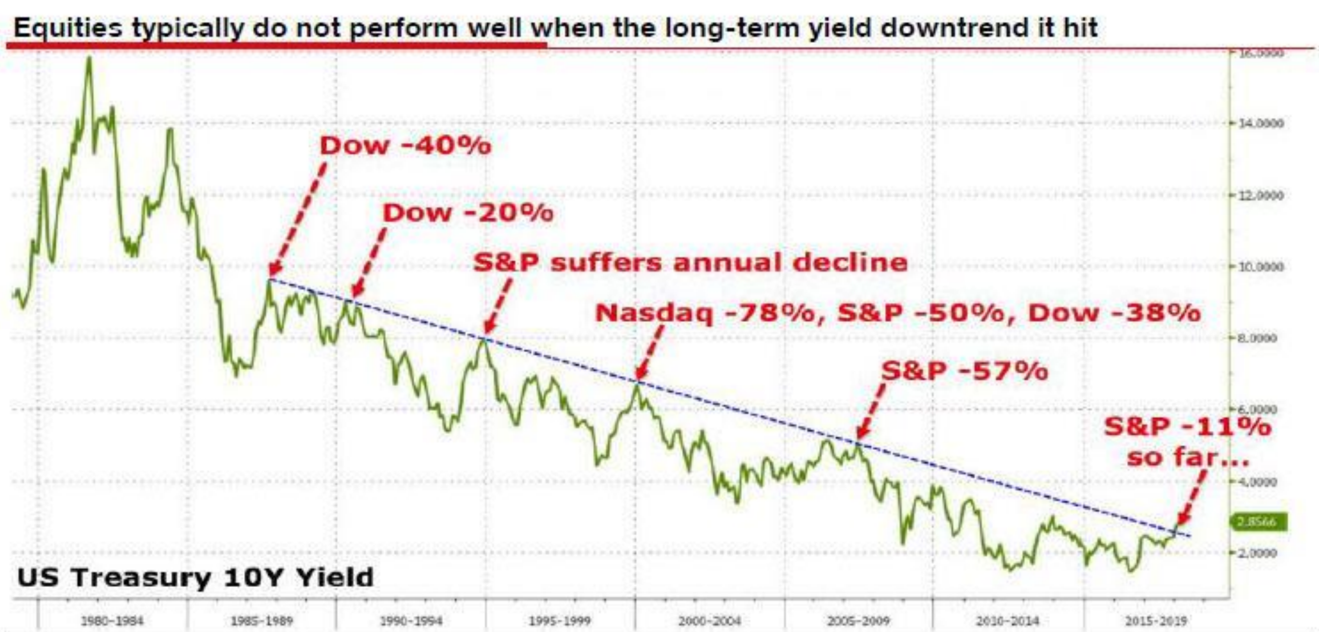
https://realinvestmentadvice.com/1987

Chart 1



Source: Dr. Jean-Paul Rodrigue Dept. of Global Studies & Geography Hofstra University

Chart 2



Source: Zero Hedge, @MarkArbeter

Chart 3

Chart 4

Chart 5

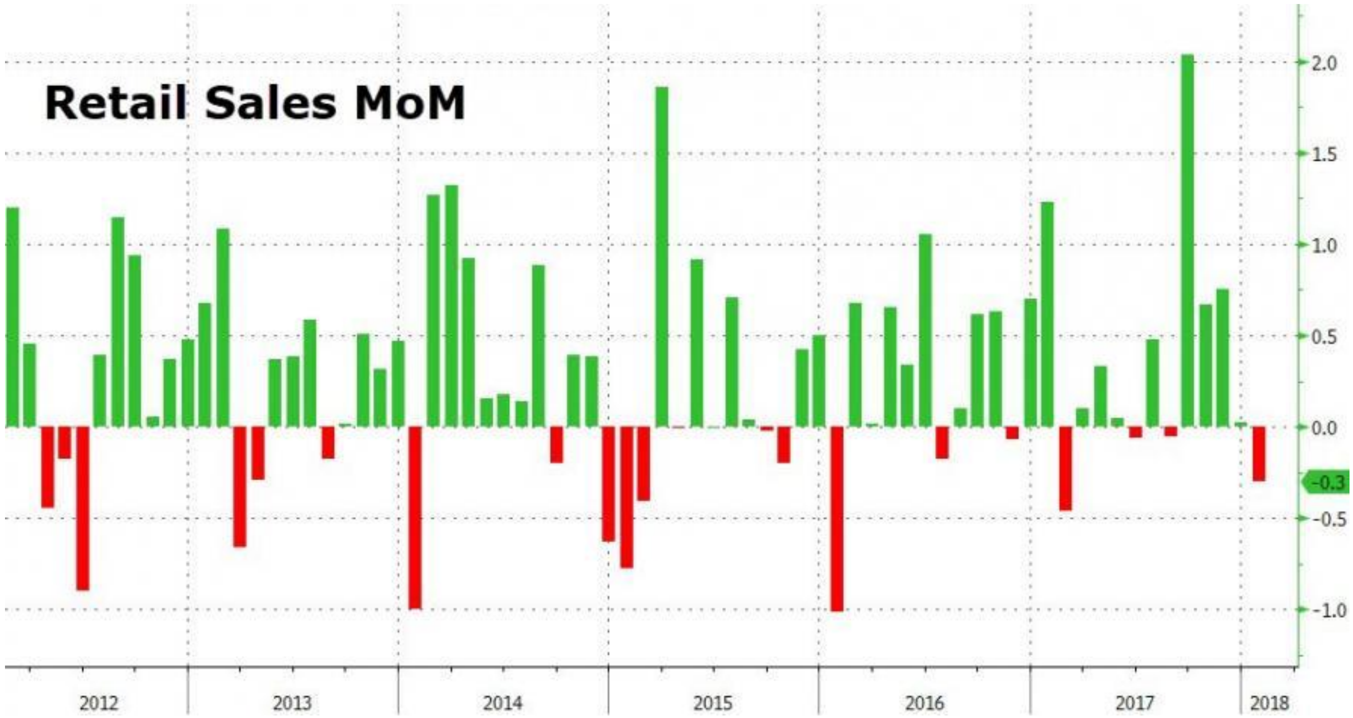
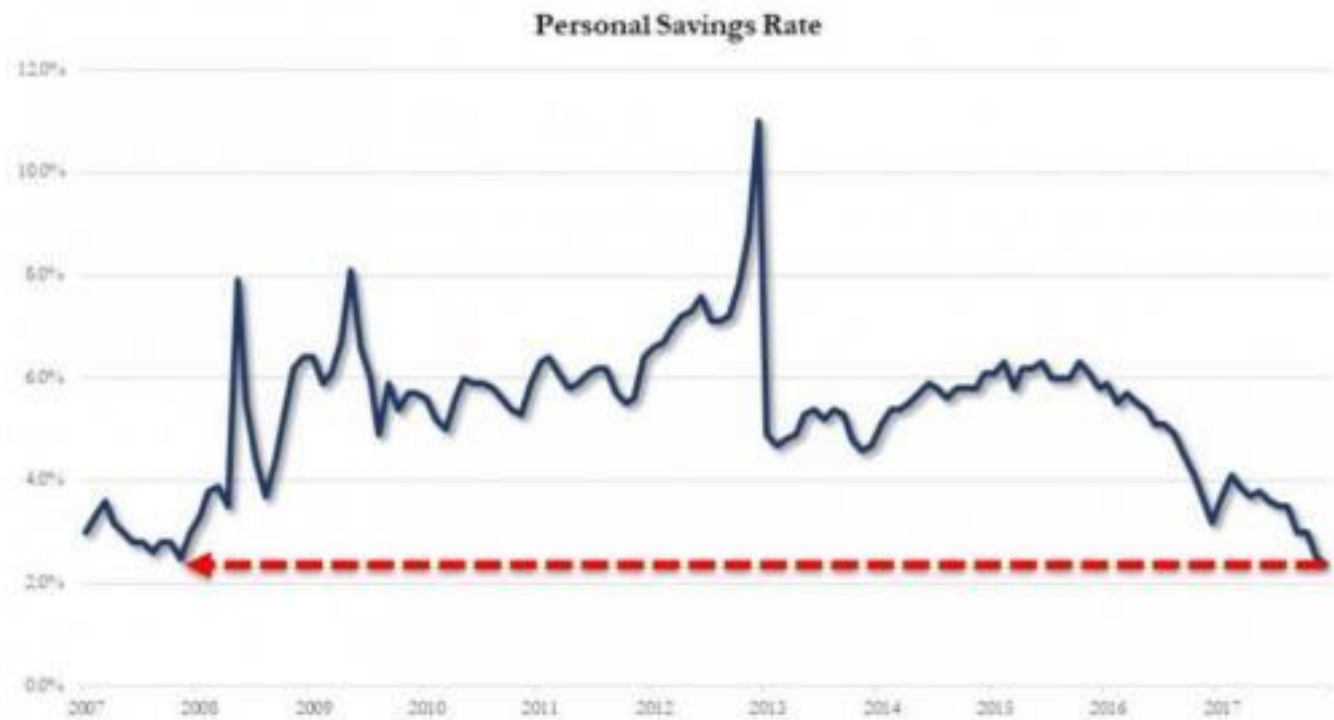


Chart 6

Chart 7



Adapted from ZeroHedge