MV Capital Management Weekly Market Flash

The Growth Debate

October 17, 2014

There were not too many headline macroeconomic numbers out this week, a week in which a large dose of volatility returned to global equity and commodity markets. One data point that did stand out was a 14 year record low number of claims for unemployment benefits. The seasonally adjusted number of jobless claims stood at 264,000, the lowest since April 2000. This, along with another report of growth in the manufacturing sector, added more data to a long string of upbeat numbers for the U.S. economy. Yet concerns abound that growth is too slow, too uneven and too dependent on monetary stimulus to sustain itself. This week's pullback - 7.4% in the S&P 500 following double-digit falls in riskier assets – has brought the growth debate back to the center of discussion.

When Doves Cry

The market volatility has, predictably, elicited dovish cooing from some corners of the Fed (though not from Chairwoman Yellen herself). Talk is on the table of extending the current round of bond purchases past the planned sell-by date of October 29, and even potentially a new easing program if conditions warrant. We would be surprised to see either of those outcomes from the next Fed meeting, and still expect the first rate cut to take place sometime in 2015. But the Fed has a dilemma. On the one hand, it is aware of the risks that come with too much easy money, including the risk that there may not be much more that monetary stimulus can do to boost wages or get inflation closer to its 2% target level. On the other hand, the Fed is clearly sensitive to how markets react to its policy decisions. If the 7.4% hiccup in the S&P 500 were to spill into larger losses (even if for no clear reasons, as can happen from time to time) then the likelihood of some kind of QE4(ever?) would increase.

Weaning the Patient

The first bout of QE in 2009 was necessary to restore liquidity to financial markets that had been devastated by the 2008 crash. The second and third rounds, in 2010 and 2012, were arguably less urgently necessary but, we believe, were the right thing to do in support of economic growth and in the absence of effective policymaking anywhere else in the government. And there is a good case to make that growth even in the U.S. has not quite reached escape velocity. But the longer the patient stays on morphine, the harder it becomes to wean the patient off the drug. The economy should be able to handle continued growth without more Fed bond buying and with overnight rates 0.25-0.5% higher than where they are today. Unless falling asset prices are a clearer manifestation of a real, imminent crisis than we see today, they should not be the prime motivating factor in further monetary easing.

Where We Go From Here

Investors will be reading the smoke signals from the October 28-29 FOMC meeting with extra scrutiny. In the meantime we may see some continuing volatility in the markets. A testing of the recent lows is not out of the question. But wherever the growth debate eventually takes us, we see few compelling reasons in the here and now to change the fundamental picture we have seen for a while, with steady U.S. growth at the center and mostly manageable problems where they do exist. That picture could change. If it doesn't, though, we would expect further price damage to be limited.

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