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Manhattan Atlantic Capital

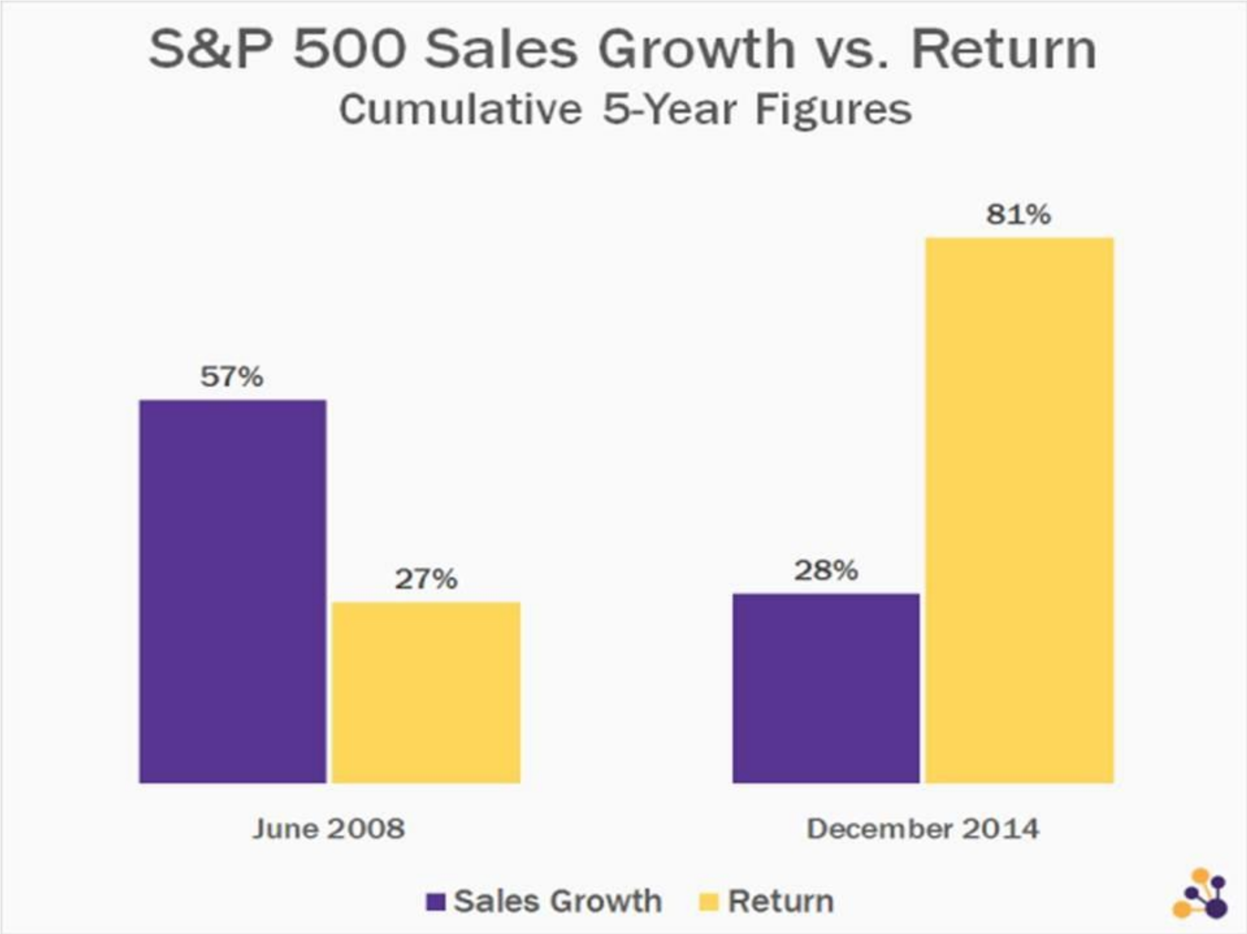
## Why the Fed Should Raise Rates

The purpose of the Federal Reserve's quantitative easing bond buying program, adding more than $3.5 trillion to its balance sheet, was to bend the yield curve downward and to reduce the cost of capital so that corporations could build factories and engage in projects that create jobs.

But some economic policies are moored, with varying degrees, to the law of unintended consequences. C Level executives whose pay is linked to stock appreciation are likelier than not to engage in share buy backs with low yield debt. Why? Not only are share buy backs accretive to Earnings per Share and provide higher returns than the low cost of borrowing, they increase company share prices. With an increased share price, acquisitions of relatively cheaper stocks of potential target companies look attractive. As a defensive measure, potential target companies might borrow capital for share buy backs of their own to reduce multiple arbitrage, company multiples trading at a discount to industry average, fueling the disproportionate increase in price relative to earnings. Goldman Sachs expects "stock buybacks [to] surge by 18 percent in 2015, exceeding $600 billion and accounting for nearly 30 percent of total cash spending."

Company valuation should be driven by sales growth and not cheap debt as this creates distortions. The above chart suggests that returns are not driven by sales, but by cheap debt as fluctuation of securities(stock, bonds) valuations on company balance sheets are registered as gains or losses against profit.

In light of the market's recent gyrations, some Federal Open Market Committee (FOMC) member(s) might pause at the prospect of a rate hike. Pause is also warranted for S&P 500 valuation. The above price to earnings P/E chart suggests that the S&P 500 might be overvalued. A month prior to the 2008 Great Recession the peak P/E ratio reached seventeen from 2002/03 recession trough of nine, a change of eight over a six year period. As of July 2015, the S&P 500 P/E ratio reached 25 from its 2008 Great Recession trough of 8, a change of seventeen over a seven year period (Noteworthy, earnings could be distorted by the inclusion of non recurring items, the size of goodwill on balance sheets and so on).The rise of interest rates would curtail such embedded and impending distortions. Moreover, a low yield environment could incentivize risk adverse investors(fixed income) to seek higher returns in equities and thus create further distortions and systemic risk.

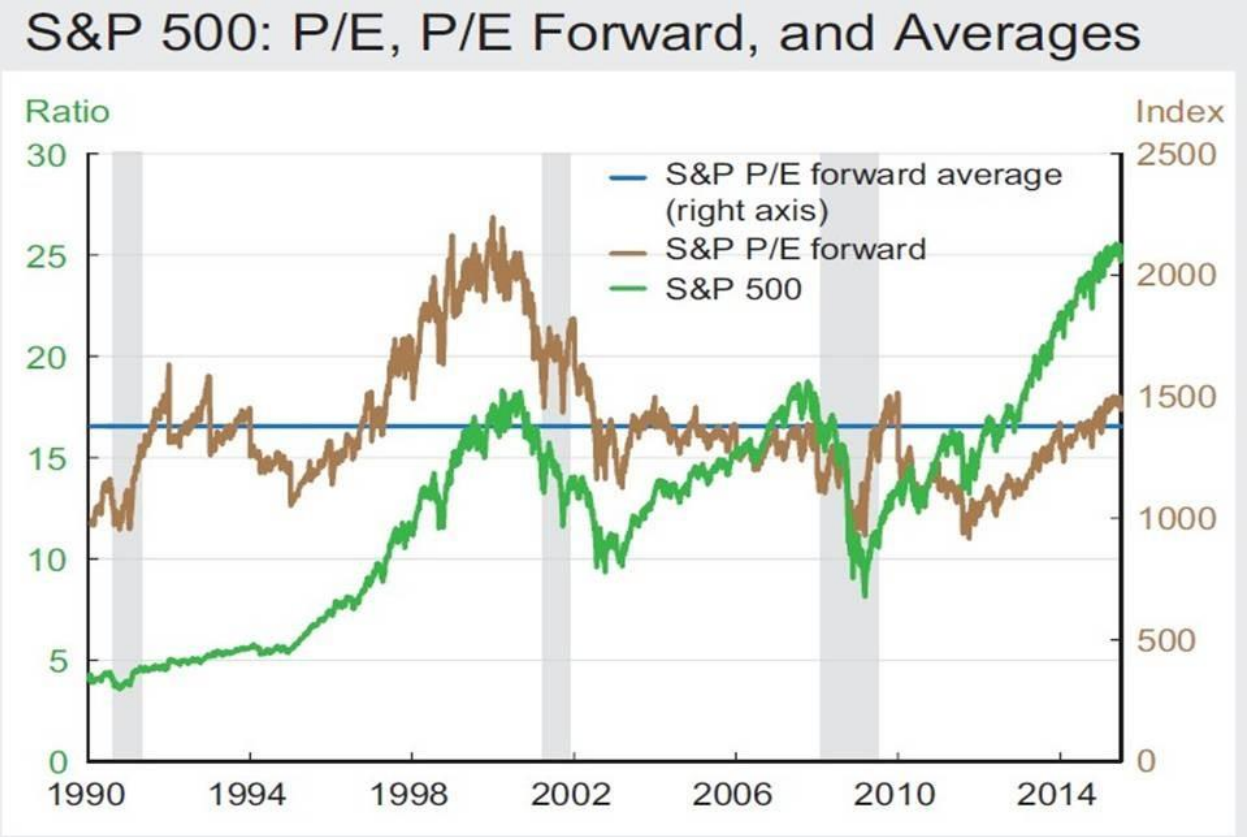



Rate hikes might prove worrisome to over leveraged companies. But there is cumulative evidence to suggest that U.S. firms have strong balance sheets. Excluding financials, S&P 500 balance sheets have increased cash from $760 billion in 2008 to just over $1.4 trillion in 2014. A moderate rise in interest rates will have minuscule effect on corporate profits and no effect on cash flow from operations.

Detractors worry, and rightly so, about raised interest rates deflationary impact. This is cause for concern as the Chinese economy slows despite low commodity prices. We know how to deal with inflation, but not deflation. Further, low productivity, a forward indicator of low wages, is presenting a conundrum: The increased use of automated technology to replace workers was expected to increase productivity, but the contrary holds. This conundrum occasions the law of diminishing marginal productivity— increasing one input and holding other inputs constant may initially increase output before output leakage ensues with further inputs. Such puzzles make recessions all the more difficult to predict. A year before each of the last five recessions , the Fed was found wanting in its diagnostic powers. All the more reason for it to raise rates because the rate lever with extremely low rates is not a viable lever in a recession.

Deflationary pressures are due to lack of demand. If the private sector will not stimulate demand, the government must come to the fore. But the U.S. Congress provides the most deflationary pressure by not approving infrastructure spending in a low interest rate environment. Infrastructure spending should be accompanied by the consolidation of U.S. pension funds providing operating synergies, reducing portfolio risks and serving as a conduit between the public and private sector by accepting government funded infrastructure projects onto its balance sheet in due course.

This will provide the much needed upward pressure on inflation.




Notes: Shaded bars indicate recessions. Last observation: July 2015.
Source: Bloomberg LP.