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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Everything seemed to be going along so nicely in the markets. Cooler heads had finally prevailed, and the Federal Reserve seemed to be 'on board' with the reality of the situation. That is, it appeared the powers that be understood rampant inflation in the United States would be hard to come by with the rest of the world opting for or exploring negative interest rates in order to spur economic growth. In essence, even with rates as low as they are and have been in our country, rates are lower most everywhere else (developed economies), meaning the US dollar is attractive by comparison.

While our politicians might bloviate how a strong dollar is good for economic growth, you know, it sure hurts our exporters, in general, and multinational companies when it comes to translating their foreign earnings back into the reporting currency.

For example, Apple reported a 'negative' currency impact of $411 million for its fiscal year which ended in September 2015. It you assume that would have dropped straight to the bottom line had the dollar remain constant, Apple's earnings per share would have been $0.07/share higher for its 2015 fiscal year than reported. That might not sound like much, but the company has in excess of 5.554 billion shares currently outstanding. Plus there is the pesky old Price/Earnings multiple (P/E), which is the amount of $ investors are willing to pay for each $1 of earnings per share (EPS). For Apple, I came up with about $5 billion using a 13 P/E ($.07 * 13 * 5.544 billion).

According to my Bloomberg's Excel spreadsheet functions, companies in the S&P 500 have reported well over $100 billion in negative currency translation effects over the last 12 months, as of their most recent reporting period. Throw a multiplier on that, and you come up with some real money. I tried to do just that, but kept wondering: should I use current the current P/E, end of the year, or end of each individual reporting period? What about some of those energy companies, like ConocoPhillips, which currently have a negative P/E, but are good companies all the same? What should I use there, because I can't use an equation with #N/A N/A in one of the cells.

Oh, I got into the weeds in a hurry, and kept coming up with figures in excess of $1 trillion in 'lost' market capitalization, no matter what I did. In fact, they were so gaudy, I didn't feel comfortable including them. Of course, these are/were 'back of the envelope' scribblings, an inexact science at best, and I have no way of knowing how these stocks would have actually performed had the dollar been weaker. That would have been a whole different kettle of fish, and the past is past.

Still, the fact remains: due to General Accepted Accounting Principles (GAAP), a strong reporting currency will depress the earnings of foreign subsidiaries, which will likely cause the reported EPS to be lower than it would have been otherwise for multinational corporations. This will often, if not ordinarily, have a negative impact on the company's stock performance, in relative if not absolute terms. Obviously, that impacts 401K balances, etc.

Welcome to the wonderful world of globalization my friends!

Now, perhaps the Fed had lulled us to sleep with its dovish comments. Perhaps it should have jolted us from our slumber. Perhaps we really DO need to raise rates, and we could debate that until

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Kant

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the cows come home. However, the Fed has other options it can use to slow things down other than raising the overnight lending target, believe it or not. Perhaps...perhaps...perhaps.

However, didn't the Fed's FOMC meet last week, and pretty much telegraph 'policy accommodation,' if we want to call it that, for the foreseeable future. If not that, didn't the statement pretty much suggest we should all just quit worrying for the time being? If so, and I think so, what the heck happened this week? Because, apparently, a few folks at the Fed didn't get the message.

On Tuesday night, Philadelphia Fed President/CEO Dr. Patrick Harper was 'over the tapes' during the Q&A at a presentation in New York with comments suggesting the Fed should be more aggressive in 2016. The streaming news items while he spoke included gems like "strong case Fed needs to continue to raise rates," and "would rather see Fed raise rates more than twice in 2016." I will spare you the rest of them, as they are but variations on a theme.

Then, there was St. Louis Fed President/CEO Dr. James Bullard, an FOMC voting member, who took his show to Bloomberg on Wednesday. Brother, what a difference a week makes, as Bullard, somewhat of an inflation chameleon in the past, sounded very hawkish, and called into question some of the processes the Fed uses in setting policy, etc. While not an outright mutiny, you could argue Truman fired McArthur for less.

These two followed both San Francisco bigwig John Williams and Atlanta's Dennis Lockhart, non-voting members, who have also, recently, been public with their desire for the FOMC to consider rate hikes sooner rather than later. I mean, that is 4 of the Federal Reserve's more visible, heavier hitters being pretty vocal. While all stopped short, maybe just barely, of calling for an immediate change to US monetary policy, it is pretty apparent Fed Chairman Janet Yellen isn't in control the way Bernanke arguably was, and certainly not like Alan Greenspan definitely was.

I have been doing this a pretty long, and I can't remember at time when ancillary, awkward word choice, Fed officials have been: 1) so visible, and; 2) seemingly so contrary to the official party line.

The upshot is, thanks largely to Bullard and Harker, the markets fell to the mat on Wednesday, and stayed flat on their back on Thursday. To that end, the S&P 500 closed Tuesday at 2,049.80, and at 2,035.94 yesterday. While that might not sound like much of a difference, it represents about $125 billion in market capitalization. Divide that by estimated population of the United States, and, voila, it also represents around $388.75 per person in our country. ($125,471,440,545 / 322,762,018).

Good times.

The thing is, they didn't HAVE to say anything. They made their comments in a very public manner of their own volition. They weren't deposed. They weren't under oath, and they weren't under any obligation to make any comments or suggestions contrary to the statement the FOMC released last week. No one had a gun to their head, and, yet, they were compelled to opine on a sensitive subject with remarks they should have foreseen would result in the paper loss of literally billions of dollars. To what end? What did they or do they serve to gain? Unfortunately, this is getting to be something of a regular occurrence.

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Something to Think About Cont.

Since I made literally hundreds of public presentations on the US economy during my career, and been the so-called keynote speaker at any number of breakfasts, lunches, and dinners, I understand the compulsion to say something weighty, you know, something with some teeth. After all, 'these people' have asked me to add some value to their conferences or meetings. As such, there is some pressure, real or imagined (usually imagined), to come up with something more, dare I say, insightful than: "Thank you for having me here today. Our forecast for 2016 is for 2% GDP growth with the CPI coming in around the same. However, we all know some regions will grow more rapidly than others, and inflation exists where you want to look for it. Well, that concludes my prepared remarks….are there any questions?"

I mean Bullard and Harker are intellectual heavyweights, PhDs and all that. So are most of the rest of the Board members. This is no small meeting of IQs, the Federal Reserve. I imagine many of the folks at the Fed would have a difficult time making pedestrian small talk with someone with, say, a 100 IQ or the cashier in the check-out line at the grocery. They are paid to think in theories and abstracts; to execute a dizzying floor routine of mental gymnastics and to lift the heaviest mental boulders known to man to ensure our standard of living.

This is no small task, and, well, I imagine it would be incredibly difficult, if not outright impossible, for Fed officials to not have some feeling of self-importance. Hey, what I say matters, hot doggit! You know, I am kind of a big deal. Indeed, but a big deal for whom the economy and the markets exist more in academic theories and abstracts than in reality, perhaps?

Trust me, while they SHOULD have known their comments would have a negative impact, I strongly suspect, if not believe whole-heartedly, neither Bullard or Harker would: 1) have put a dollar amount to the reaction their comments would generate, and; 2) have considered a market sell-off a significant enough concern to worry about, given the longer-term and absolute importance of their theoretical opinions.

As Immanuel Kant said:

> "Experience without theory is blind, but theory without experience is mere intellectual play."

Therein lies the root problem.

Very few Fed officials have any practical experience either making loans or investing money. William Dudley was an investment bank economist, but wasn't necessarily in the trenches making calls. Robert Kaplan and Dennis Lockhart should draw straws as to who has the best private sector experience (both are pretty strong), and Jerome Powell's and Kashkari's CVs are also robust. Still, even these five individuals, as bright as they may be, have been at the Fed, in academia, or in the bureaucracy for large chunks of their career. What's more? It appears as though Lockhart might be the only US central banker that has, gasp, made an actual commercial loan….although Kaplan was an investment banker, which is usually a different animal.

However, Yellen? Fischer? Brainhard? Bullard? George? Mester? Rosengren? Tarullo? Evans? Harker? Strine? Lacker? All these folks are career Fed economists, academics, and/or bureaucrats. In other words, theorists, who can outvote the folks with the private sector experience every time. Again, they are brilliant people, but people with "theory without experience." As Kant suggested, that is mere intellectual play, for which these hold immense power, influence, and maintain a comfortable, safe career with an attractive pension.

In the end, here is the drill: as US companies become increasingly multinational, and; as we become an energy exporter and massive exporter of other commodities, you know, a weaker dollar isn't as bad as our politicians would lead you to believe. In fact, a weak dollar would actually be good, as it would help us reduce our current account deficit while increasing EPS, and therefore equity prices longer term. As a result, perhaps the Fed should drop that employment mandate, as it CAN'T control whether companies hire or fire people. In its place, it should develop an acceptable range for the US dollar in the global currency markets and an acceptable range for 12-month inflation, and have at it. Change the overnight lending target every month if need be….the markets are already going to know when the Fed is going to act, so it won't be a surprise, and that would be nice.

Unfortunately, it would dry up speaking engagements for Fed officials in between FOMC meetings. Bummer.