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Why the Fed should scale back QE now

Commentary: Key economic indicators point to U.S. recovery and growth

By Michael Sincere

(MarketWatch) — Whenever I get the chance, I speak with Bernard Baumohl, chief economist at the Economic Outlook Group and author of *"The Secrets of Economic Indicators."*

Baumohl uses economic indicators to forecast where the U.S. economy is headed and to identify potential risks. Here is a transcript of a recent telephone interview:

Sincere: How is the economy doing?

Baumohl: The best leading indicators tell us the economy is — finally — beginning to gain fresh traction. And it's about time. After all, we've had short-term rates near zero for nearly five years, with longer-term rates hovering at historic lows. The Fed has also pumped $3 trillion of liquidity into the economy. Never have we seen credit so cheap and banks so flush with funds to lend.

With all this stimulus, you would think the economy would have expanded faster, much sooner. Yet over the past six months, it grew at a lethargic 1.1% annual rate, and in the last four quarters just 1.6%. That's not much bang for the buck! Fortunately, we see more energetic growth ahead with the rise in household wealth, strength in real estate and auto sales, and higher consumer confidence. The worst is clearly over.

What is holding companies back on hiring?

A: Look, labor is expensive, so companies have been terribly cautious about hiring. Many employers were worried the sequester-mandated government spending cuts and higher payroll taxes this year would hurt the economy. They also grew concerned about the slowdown in China's own economy.

To ramp up hiring, employers would need to be convinced the U.S. economic expansion is real and sustainable. Companies want to see stronger demand for the products they make. I believe that is now happening.

We are seeing life after the sequester and the payroll tax increase. Business leaders have begun to express more confidence about the economic outlook and that should lead to greater hiring in the coming months. The employment report, number of job openings and small-business hiring plans are all looking better.

What is your outlook for the second half of the year?

A: The second half will be brighter, and 2014 should be even better. The recent uptick in longer-term rates will not materially impact the U.S. economy. Furthermore, Europe is expected to come out of recession late summer and Japan is on the comeback, both good for U.S. exports.

Nor do we see China's economy having a crash landing, which I define as growth less than 6%. Yes, economic activity will decelerate there, but it is a delicately managed slowdown as China's leadership tries to end the reckless lending and excessive financial speculation in their country. That will curb some economic growth in the short run, but the goal is to have a healthier, more balanced Chinese economy. That is also in the interest of the U.S.

Is there anything that keeps you up at night?

A: I have many concerns about events outside of the U.S, but only one that stems domestically: Who will replace Ben Bernanke, assuming he leaves the Fed in January? Will the next person share the same philosophy on the role and timing of quantitative easing? There's a 70% chance either Janet Yellen or Christina Romer will take over. If so, the markets should react favorably since both hold views similar to Bernanke's. It would be a smooth transition.

The second concern I have are the multitude of foreign risks that could potentially derail the U.S. economy.

The geopolitical pot is now boiling furiously and it has already driven energy prices higher. Both WTI and Brent are over $100 a barrel largely because of eruptions in the Middle East. The bloodshed in Syria is getting worse and even spreading to Lebanon. Will the U.S. get drawn more deeply into that conflict? Egypt has exploded as well and it controls shipping along the Suez Canal. Will the violence disrupt oil traffic on the Canal? Is Iran still resolute in secretly building a nuclear weapon and what will Israel do about it? If conditions in the Middle East get much worse, it could trigger an oil price spike and that would boomerang right back onto our economy. Gasoline prices are already on the rise.

Another concern is a new financial blowup in Europe. But that threat is much less. The region has learned important lessons in crisis management the last three years. With all the problems they've had, it's impressive the sovereign debt crisis had not led to a breakup of the euro zone. So I'm fairly certain Europe will eventually get its act together on reducing debt and achieving a banking and fiscal union.

Is the Fed providing too much stimulus?

A: We are approaching a crossroad where the Fed must begin to scale back on the amount of stimulus it provides. Look, the U.S. had a terrible recession in 2008 and 2009, and the economy had to be placed in intensive care and given emergency monetary infusion. But now, some four years later, economic indicators suggest the economy has made enough progress to emerge from intensive care and move on to standing on its own, albeit with crutches still supplied by the Fed.

After all, we have seen a sharp rebound in home and auto purchases this year as Americans took advantage of cheap credit. This is part of the recovery process. But there is also a growing anxiety that if the Fed continues its current dose of quantitative easing, we could see some unpleasant side effects. For example, margin debt is at record levels and this has fired up stock prices and led to some excessive risk taking in the financial markets.

I think the time has come for the Fed to show some tough love and begin to dial back on quantitative easing. The economy needs to re-learn how to operate in a more normalized interest rate environment, difficult as this adjustment may be.

What is going to happen with interest rates?

A: Certainly short-term rates will remain near zero for at least another two years. Longer debt, however, will creep higher. I expect the 10-year Treasury yield will end the year at 3.3%, and that will keep mortgage rates below 6%.

With the price of notes and bonds headed lower, the return to fixed income investors will erode in both nominal and real terms. A healthier U.S. economy, strong corporate earnings, and the expectation of higher inflation over the next 18 months essentially means the 30-year bull market in bonds is over.

What is your forecast for the stock market?

A: We're quite optimistic about equity prices, for several reasons.

First, the Fed will not be abandoning the economy. QE will continue, if slightly less in magnitude, for at least another year. Second, profit margins are at record levels. As economic growth accelerates beyond a 3% pace, it will lift revenues and profits. We expect to see more earning surprises. Third, mortgage rates will remain well below 7%, which I view as the pain threshold for homebuyers. This means the critical housing industry will continue to do well and contribute to GDP. Fourth, both consumer and business confidence levels are at multi-year highs. A lot of pent-up demand in both these sectors will be unleashed between now and through 2014.

Finally, I expect to see the economies of Europe, Japan and even China do better as well. Make no mistake; the fundamentals of the global economy are improving. As a result, we have a year-end target of 15,800 for the Dow, and 1,720 for the S&P 500

The two major risks here are if President Obama picks a more controversial person to replace Ben Bernanke — and a calamitous eruption in the Middle East.

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