

## Ed Hyman: The Key Threat to Economy Recovery

By Robert Huebscher

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Ed Hyman is not worried about China, quantitative easing or fiscal deficits. Equity market performance this year will be strong, Hyman predicts, and the US economic recovery will proceed.

But the caveat in his outlook – and it is an immense one – is its dependence on the price of oil remaining sufficiently stable.

Hyman has been rated Institutional Investor's number one Wall Street economist for each of the past 30 years. He is the founder and chairman of NY-based ISI Insight, a global economic consulting firm.

Hyman was also the keynote speaker at the Boston Security Analyst Society's annual dinner. That was last Tuesday, a day when the price of gasoline was up \$.30 – a “nightmare,” according to Hyman.

“If they start to have that ‘Egypt thing’ in Saudi Arabia,” he said, “oil is really going to go up.”

The immediate impact of a rise in gas prices would be a slowdown in consumer spending. Hyman said that gas spiked in both 2005 and 2006 – by almost a dollar – and both times retail sales went negative for the next three months. The medium-term effect of those two episodes was “benign,” he said, and that could be the case this time.

Hyman's forecast this year is for 5.5% GDP growth, \$97/share EPS on the S&P and 2.0% inflation, with similar numbers in 2012, all of which he conditioned on crises in the Middle East not getting out-of-hand.

### Putting oil aside...

Four drivers underlie Hyman's forecast for the economy and the market.

Number one on his list is Fed Chairman Bernanke, whose “whole game plan is to get the stock market up,” Hyman said. Bernanke also intends to do what he can to lower unemployment, he added.

Indeed, Hyman said, the “only game in town is the stock market,” and the Fed's goal is to build wealth and consumer confidence by boosting equity performance.



Bernanke's equity-market orientation comes from his association with a group of key thought leaders. Ken Rogoff, co-author of the popular book *This Time is Different*, got his PhD at MIT a year after Bernanke, and the two are best friends. Rogoff also introduced former economic advisor Larry Summers to his second wife. All three are close to President Obama and share the same goal – avoiding a prolonged recession, which, as Rogoff has documented, typically follows a financial crisis.

"I guarantee Bernanke is watching the stock market like a hawk," he said, "and he is probably more upset about the S&P being down 20 points than he is about gasoline being up \$.30. But the combination is pretty bad. "

If the equity market stumbles, Hyman said the Fed will do another round of quantitative easing.

He knows this from experience. Last spring the Fed temporarily halted its quantitative easing and its balance sheet stopped expanding. That was premature, Hyman said, and "the market rolled over. The economy weakened and the double-dip risk came up."

The second key factor in Hyman's outlook is that Obama is moving to the political middle. Hyman said Obama is taking his cues from Bill Clinton. Following Clinton's rebuke in the 1994 election, Clinton took a trip to Asia. Obama did the same last year, taking also the opportunity to read Clinton's biography.

In the year following the 1994 elections, as Clinton moved to the center, the market went up 30%.

Hyman pointed to dozen policy decision by Obama since last year's election, ranging from scrapping capital gains taxes on investments in small businesses to loosening the rules for some health insurance policies. Each one, he said, represented a step closer to the political middle and an important catalyst to a bull market in equities.

Obama won't get reelected, Hyman said, if unemployment doesn't decrease, and, moreover, there's no way toward lower unemployment if the S&P drops to 1,000.

Hyman also cited a series of exceptionally positive economic indicators, which together comprised his third driver of market returns.

His firm surveys a number of industries, including home building, trucking, consumer credit and automotive lending. The results of those surveys have improved steadily over the last several months and are now consistently positive.

Rising inflation is unlikely. Inflation is unlikely without wage growth, Hyman said, and "every CEO in America tonight is thinking about not increasing wages if they have to worry about input costs, like gasoline." Higher oil prices will lead to lower wages, he said.



Additionally, CEOs are focused on improving productivity, through technology and other means, and that will hinder growth in wages.

Hyman's fourth positive factor, one which I will not dwell on because it is familiar to our readers, is that money is coming out of bonds and into equities, especially into emerging market equities.

### **The two possibilities**

Two outcomes are possible over the near term, according to Hyman.

The economy could go back into recession, he said, or there could be a "benign, commodities-specific, supply-demand adjustment." The door just opened to the latter, Hyman said, while the former would happen if oil goes above \$150. Hyman did not say which outcome he considered more likely.

Regardless of which of those two comes to pass, a key investment implication of Hyman's outlook is that commodities will perform strongly. Emerging markets consume more than four times the value of commodities as developed markets, he said, and half of projected global growth will come from emerging markets.

Hyman noted that hoarding of commodities is a growing trend in emerging markets. Some in China are stockpiling cotton, and Hyman fears a rice shortage in that country.

Gold prices are going up, Hyman said. All the factors driving strong equity performance, like continued quantitative easing, will drive gold prices higher.

Americans are not worried about a complete meltdown, Hyman said. But those in Argentina and China have experienced major political and economic upheaval, and they want to own gold, he said, because it is a store of value.

Gasoline prices will dictate the ultimate trajectory of the economy and the markets. On this point Hyman is "scared to death." He said every \$10 increase in the price of oil would slow GDP growth by 0.3%.

If you ascribe to Hyman's analysis, owning oil-related assets makes sense as a diversifier to a core equity allocation. If oil prices spike, either because of geopolitics or because of supply-demand imbalances, gains in oil-related assets will offset losses in other equities. The reverse would be true in Hyman's "benign adjustment" scenario.



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