Economic Discussion

A Review of the Economy and Financial Markets

February 2015

The Economy and Politics

January has been a momentous month. The 114th Congress has been seated with Republicans controlling both houses. President Obama has delivered his State of the Union address. All parties have said they will work together, but time will tell if the talk is more than lip service. Both parties have staked out positions on immigration and taxes that show little evidence of reconciliation.

On the international scene fighting continues in Ukraine, the advance of ISIS in Iraq seems to have stalled but unrest and fighting continues. ISIS brutally executed a captured Jordanian pilot. Jordanians are outraged as are other Arab nations. Militants have taken over the capital city and forced the president's resignation. They are trying to form a new coalition government. Instability reigns in the Middle East.

The price of oil is at a low level although it has advanced in recent days. At the time of this writing the West Texas Intermediate price is $51.69. The effects of the low price are widespread. Revenue to producing countries is reduced and consuming nations benefit. In the U.S., which is both, consumers are happy but there are layoffs in exploration industries. On balance there probably is global economic benefit from the price decline.

Despite the conciliatory rhetoric prevalent as the new Congress was seated, one has to remember that liberals and conservatives hold fundamentally different world views. Those with a liberal bent are distrustful of markets and believe that power begets power. If government does not direct economic activity, the wealthy get wealthier to the detriment of the non-wealthy. Conservatives, on the other hand, believe that government does not do a very good job of allocating resources and that over-regulation stifles innovation and entrepreneurship. The most dedicated liberals and conservatives will find little middle ground. Tension will continue between the two points of view.

Our economic system has had a mixed nature for many decades. Commerce is carried out in an essentially free marketplace with government regulation defining the outer bounds of behavior. Also, fortunately, not all legislators and other elected officials are stridently doctrinaire in their economic philosophies. Some will find the middle ground.

Although economic activity in the U.S. has been better in recent quarters, the recovery is not robust. Europe is struggling just to maintain growth. The Eurozone as a whole will have grown less than 1% when 2014 numbers are in and likely will be only slightly over that in 2015. Japan barely grew in 2014 and may grow 1% in 2015. Emerging markets will grow at around 5%, down from historical levels. Within that group there is wide variance. China's economy is growing at around 7%. Russia's is virtually a train wreck. The fall in oil prices and economic sanctions have taken a toll. Growth for 2015 will probably be significantly negative.

Inflation has been low in all developed nations. In the U.S. the consumer price index increased 0.8% in the year ended 12/31/14. The drop in the oil price has influenced that number. The year-over-year change in the CPI–ex food and energy (commonly called core inflation) increased 1.6%. The Personal Consumption Expenditures (PCE) price index rose 1.1% and its core component increased 1.4%. The latter is the Federal Open Market Committee's (FOMC) preferred measure. All

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of these measures have been trending down over the past few years.

Traditional economic models are inadequate to explain current phenomena and to guide policy. Keynesian inspired spending stimulus programs did little to boost growth in the first years following the Great Recession of 2008-2009. In more recent years, monetary easing has been the main thrust. In the U.S., the FOMC has created massive additions to the money supply in a series of programs known as quantitative easing (QE) but growth has been substandard. The European Central Bank (ECB) now has resorted to its own version of QE. It is too soon to judge its effectiveness there.

Europe's situation is complicated by the seemingly intractable Greek economy. The Greek government has borrowed extensively to fund social programs, pensions and other government services. Reportedly, corruption and graft run rampant. In order to get funding from the European Economic Community, Greece agreed to austerity measures. In recent weeks, the Greek people elected a new prime minister who ran on an anti-austerity platform. The new government has sought debt extensions and even principal reductions. Its European lenders have been reluctant to allow modification of the terms of bail-out loans already extended.

At this juncture the outcome is uncertain. It is possible that Greece may exit the euro and return to having its own currency. If that occurred, there would probably be a substantial currency devaluation. That is tantamount to a reduction of the principal owed. It should be noted that Ireland, Portugal and Spain have accepted austerity measures and are well along the way to economic improvement. Just like a hangover, the sins of the prior day can't be swept aside without a painful period of recovery.

The inefficacy of common economic theories can be partially explained by the early-twentieth century work of Irving Fisher. Fisher attributes most depressions to a speculative bubble in asset prices fueled in its later stages by extensive borrowing. When borrowers get nervous and start to sell, prices fall. Values often decline below the principal amount of the loan the asset collateralizes. Deflation occurs, reflecting decreased asset prices. Deflation also <u>increases</u> the burden of debt, exacerbating the decline of economic activity. This will go on, according to Fisher, until low asset prices and low interest rates rekindle profit-seeking desires. Fisher notes that in deeper stages of decline, the velocity of money declines.[1] The velocity of money is the rate at which it is spent or invested. Later monetarist economists thought velocity was constant.

The U.S. experience since the Great Recession has been a substantial decline in velocity with no sign of an early return to normal levels. This is the central mystery to our sluggish recovery. The economy has moved past the time when velocity should have picked up.

Fisher's suggested remedy for deflation sounds a lot like quantitative easing, but he would have expected to see velocity increase as a result. There are three factors more influential now than when when Fisher wrote his book: government mandates on employers, regulatory activity and the high proportion of government spending relative to GDP. Before World War II government spending was about 15% of GDP. Now it is over 20%. It also is plausible that employer mandates for various insurances and benefits such as social security, unemployment insurance, family leave, and now health care along with greater regulatory reach is suppressing the desire of businesses to hire and invest.

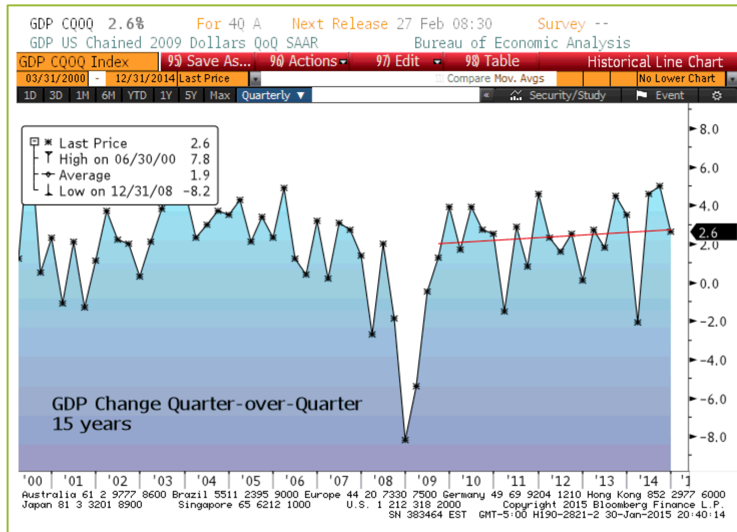


Chart I

Actual U.S. economic performance has improved, although it is still choppy. The first estimate of fourth quarter 2014 growth was 2.6% (annual rate). The pattern of quarter-over-quarter growth is shown in Chart I. After quarters of 4.6% and 5.0% advances, the recent report was mildly disappointing.

On the other hand, the January employment report, released on February 6th, was encouraging. In the month, 257,000 jobs were added and the prior two months were revised upward. The unemployment rate was 5.7%. The labor participation rate increased to 62.9%. It is still low by recent historical standards.

The reasons for the recent improvement are unclear. Perhaps FOMC easy money policies are starting to take hold. It's curious that it would occur as they were reducing their long term bond purchasing program. It has been little noted in the press, but the growth of government spending has been reduced in the past couple of years and a year ago Congress did not extend unemployment benefits any further.

In retrospect, maybe the infamous "sequester" did limit growth in government spending, thus reducing the level of annual deficits. Regardless of the benefit, it is a poor way to budget. It uses a "meat-axe" approach to non-mandatory areas while leaving mandatory areas untouched. A way must be found to constrain the cumulative effect of annual deficits as part of a carefully executed budgeting process.

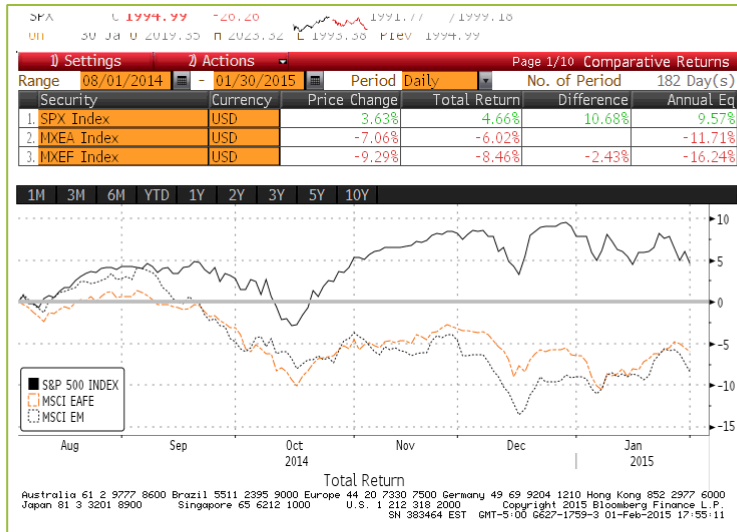
The Congressional Budget Office (CBO) estimates the U.S. fiscal deficit will be approximately 2.5% of GDP for the next three years and then increase through 2025. Total debt held by the public is now 74.1% of GDP and is expected to increase to 78.7% in 2025. In its longer term outlook the CBO states,

"Such large and growing federal debt would have serious negative consequences, including increasing federal spending for interest payments; restraining economic growth in the long term; giving policymakers less flexibility to respond to unexpected challenges; and eventually heightening the risk of a fiscal crisis."[2]

Now is the time to address the issue. The slippery slope gets ever steeper. It may seem absurd to compare the U.S. fiscal situation to that of Greece, but the differences are only in degree, not in fundamentals.

Subject to scheduled revisions of the fourth quarter of 2014, growth for the year was 2½%. The middle quarters gave it a real boost. It appears that the momentum will carry into 2015. It is difficult to accurately assess the effect of lower oil prices, a strong U.S. dollar and slower growth throughout the developed world. Expectations for 2¾% to 3% growth are reasonable. The next two years could be the peak of the cycle. The consensus long term growth estimate from FOMC members is 2% annually.

Financial Markets and Interest Rates



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Range 08/01/2014 - 01/30/2015 Period Daily No. of Period 182 Day(s)

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1.	SPX Index	USD	3.63%	4.66%	10.68%	9.57%
2.	MXEA Index	USD	-7.06%	-6.02%		-11.71%
3.	MXEF Index	USD	-9.29%	-8.46%	-2.43%	-16.24%

Chart II

U.S. financial markets have thrived in the environment of moderate growth and easy monetary policy. Foreign equity markets have not fared as well. Chart II tracks the S&P 500 index of domestic stocks (black line), the MSCI EAFE index of foreign developed markets (red line) and the MSCI index of emerging market issues (gray line) over the last six months. Domestic stocks have advanced over that period but have been in a trading range for December and January. Foreign stocks (developed and emerging) are down over the full period. Developed foreign equities are up slightly since mid-December and emerging markets have also gained since then. Over the six month period, foreign stocks have been under pressure both from slower economic growth and the stronger U.S. dollar. Over the past year, the daily prices of the trade-weighted U.S. dollar and the dollar denominated price of the MSCI EAFE index are negatively correlated with an r^2 of 0.70. That means that 70% of the decline in the EAFE price can be attributed to the rising dollar.

The accommodative monetary policy implemented by the FOMC has provided support to domestic stock prices. It is somewhat ironic that the dollar has appreciated, but the reason probably is that other central banks also have been very accommodative and sluggish growth overseas has put pressure on earnings.

When the FOMC moves from accommodative to neutral policy, the resulting reduced liquidity will put downward pressure on U.S. stock prices. Countervailing upward pressure comes from the positive relative valuation of stocks to bonds. This positive valuation leaves room for considerable rate increases before stock would be overvalued. Confused? You're not alone. Over the long term stocks will be rewarding. In the short-term price movements will be volatile.

Stocks will provide the highest return among financial assets. Within the stock asset classes the choices are more difficult. U.S stocks have had a good run and might ready for a pause. On a strictly valuation basis looking at price-to-earnings (P/E) ratios and yields, foreign stocks are more attractive than domestic issues. Emerging markets are the most attractive.

Unfortunately, investing isn't as simple as running numbers through formulae. Depressed oil prices and the strong dollar will help domestic stocks for a while longer. It will take a while for foreign developed markets to move. There are too many uncertainties, political and economic, that will hold them back. The uncertainties apply to emerging markets also. The valuation numbers make a stronger case for emerging than for developed.

The bond markets are a fascinating place. Rates refuse to go up! Chart III, on the next page, traces the yield on the ten year U.S. Treasury note for the past year.

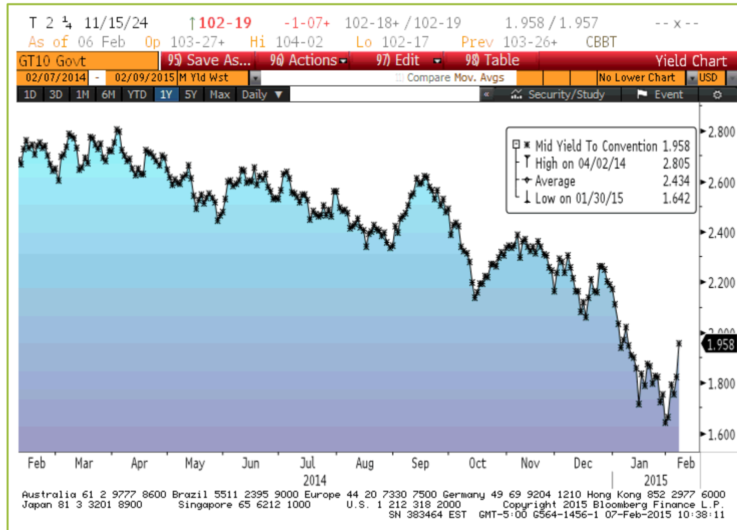

Chart III

The note's yield has fallen steadily. During this time the FOMC was reducing its massive buying program. Even though the Treasury bond market is large, the size of the FOMC's program surely should have had an effect.

The FOMC has said that it is targeting a full employment and inflation of 2%. Full employment is not defined. Most commentators consider an unemployment rate of just over 5% full employment. The committee also has said it can "be patient" in starting to raise the fed funds rate.[3]

Frankly, it's a mystery that rates have stayed this low for such an extended time. With the U.S. economy apparently on a sustainable growth track and unemployment coming down, it seems that loan demand would push interest rates up. Whenever the velocity of money returns to normal levels inflation will return and interest rates will increase.

Bond investors have to be prepared for higher rates without knowing when it will occur. The risk of higher rates can be avoided by investing only in cash equivalents but yields on those investments are nil.

The objective for bond investors is to capture yield while still controlling the risk of rising interest rates. Chart IV is the current Treasury yield curve with the time axis expressed in modified duration rather than the more common yield to maturity. Duration is an accurate measure of price sensitivity relative to yield. (Price sensitivity is a measure of risk.) The data points above the red line provide more return relative to risk than those below the line. The three and five year maturities are the most attractive.

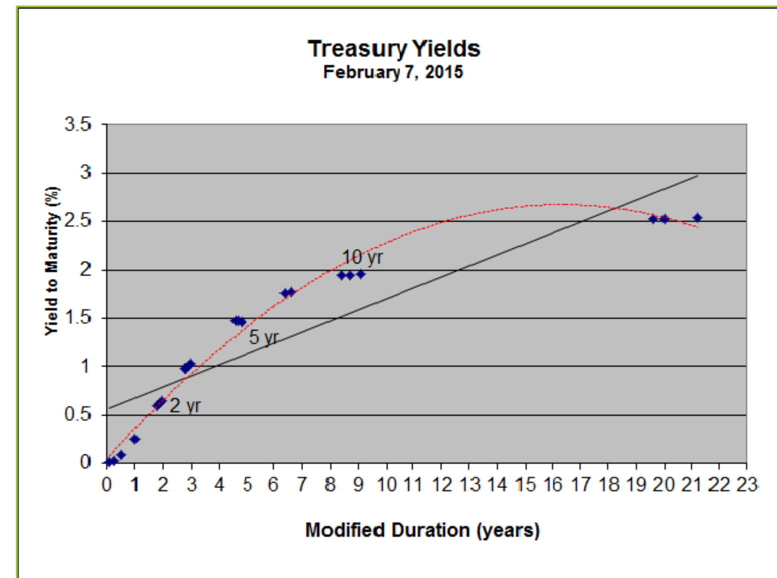

Chart IV

Asset Allocation

The object of asset allocation is to achieve the optimal return for a given level of risk. Stocks are the vehicle that produces return while bonds control risk. In today's environment, stocks should be modestly over-weighted with bonds being commensurately under-weighted. Cash should be held only to cover anticipated liquidity needs. Within the stock category, domestic and emerging market stocks should have a small over-weight with the offsetting under-weight in developed foreign issues. The bond portion of a portfolio should concentrate maturities in the three-to-five year range.

February 7, 2015
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[1] Booms and Depressions. First Principles Revisited. Irving Fisher, Originally published 1932, annotated and adapted for electronic form in 2011 by Michael Schemmann.
[2] The Budget and Economic Outlook: 2015-2025, The Congressional Budget Office, Washington, D.C. January 2015.
[3] The rate at which banks lend to each other from business day to business day.