Economic Discussion

A Review of the Economy and Financial Markets

January 2015

The Economy

The U.S. economy had a strong third quarter according to the final revision released by the Commerce Department on December 23rd. It grew 5.0% on an annualized basis. This follows the second quarter's advance of 4.6%. Growth in the second and third quarters followed a first quarter contraction of -2.10%. Year-over-year growth to 9/30/14 was 2.7%. Chart I shows the quarterly Real GDP change (in annual rates) over the past fifteen years.

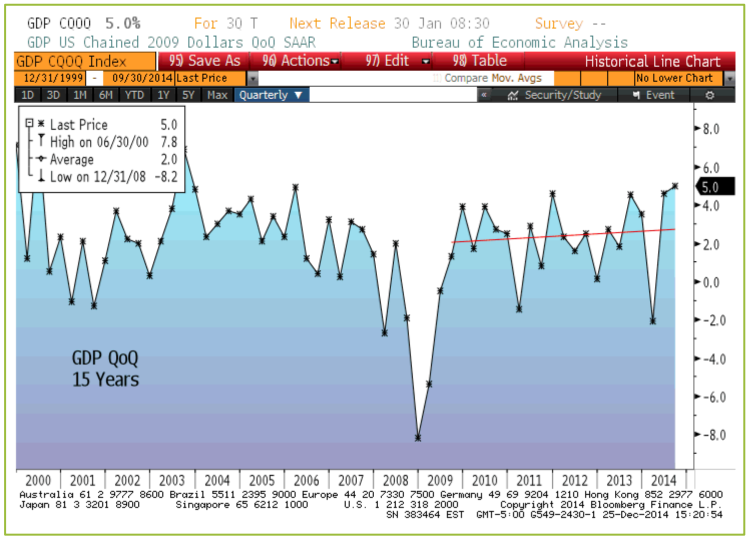

Chart I

Job creation has improved. In December 252,000 jobs were created, according to the Labor Department and the prior two month's numbers were increased. The unemployment rate dropped to 5.6%. These gains are tempered by a slight decline in average hourly earnings. Also, the labor force participation rate dropped 0.1% to 62.7%.

Because news coverage concentrates on the short term changes, it might be helpful to look at a larger picture. Chart II shows total U.S. nonfarm employment from 1999 through 2014.

Chart II

Employment now exceeds the pre-recession level of 2007. There are a total of 147 million people employed. To put the chart into perspective, the number of employed persons increased 0.7% per annum over the 16 years covered by the chart. Over the same period U.S. total population increased about 0.9% per year. Our population has grown faster than employment.

As noted earlier, the labor participation rate is 62.7%. This is the lowest level since the late 1970's. The high point was 67.3% in January 2000. In the 1950's and 1960's the rate was lower. It increased through the 1970's, 80's and 90's.

There has been a pronounced decline in the labor participation rate since 2007. Certainly the recession had an impact, but the prolonged decline begs a further explanation. At this point we can only speculate. Are there simply not enough jobs? If so, why are people immigrating to the U.S.? Have our post-recession recovery strategies stifled job creation? Are we witnessing a major demographic shift as we did in the 1970's when many households became two earner units? Analysis of employment data is important because these data are a significant driver of economic policy.

For the moment, it appears the economic recovery is on track. The recovery is not robust, however. Housing activity has leveled out. Existing home sales, building permits and housing starts declined in November. Durable goods orders also fell.

The U.S. and United Kingdom economies are the strongest among the large developed nations. The Eurozone and Japan will struggle to grow 1% in 2015. Emerging economies will show about 5% growth this year as a whole, but predictions vary greatly from country to country The Russian economy will contract 1% or more. China's is likely to grow 7%.

In the developed world inflation is very low. In fact, its low level is worrisome to economists. It is bringing no pressure on the Federal Open Market Committee (FOMC) to start raising short term rates. European inflation went negative in the year ended November 30th. The European Central Bank (ECB) is considering the purchase of sovereign[1] bonds in its version of quantitative easing.

The biggest economic news of the past month has been the oil price decline. See Chart III.

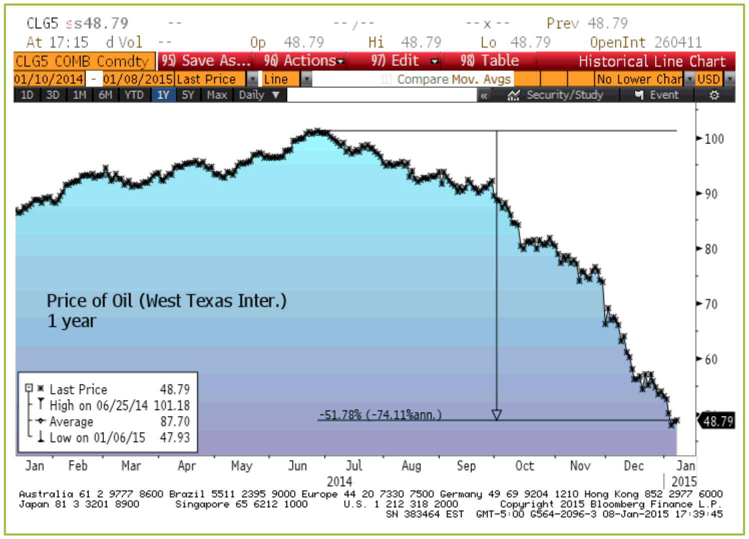

Chart III

The current price is below $50 a barrel. It was double that level six months ago. This kind of drop was not predicted by any credible source. Other commodities have declined in value, but oil has been the most dramatic. Considering the surprise with which this drop came, it is difficult to take any "expert's" opinion seriously. The main factors driving the decline appear to have been significant increases in North American production, principally due to "fracking" and the Saudis' decision to maintain production at current levels.

A price change of this magnitude for so significant a commodity will have far reaching effects. Consumers are enjoying visits to the filling station. The lower fuel cost will surely free funds for other uses. The low price may, on the other hand, cause some of the exploration and production in American oil fields to be suspended.

In the geopolitical arena, significant oil producing countries will see much less value derived from foreign trade. Russia is paying a heavy price. The price decline combined with economic sanctions is likely to result in recession in 2015. Whether that will make Vladimir Putin more or less aggressive remains to be seen. ISIS has used oil revenues to finance their war-faring ways. Will lower revenues weaken them?

Inflation/deflation is a much more complex phenomenon than fluctuations in the price of commodities, even oil. Deflation is feared by central banks. Because money increases in value in a deflationary period, investment in tangible assets is discouraged. The oil price decline surely has influenced recent inflation reports, but inflation was low before that occurred.

Low inflation, or even deflation, often follows a deep recession. It is especially true when the decline resulted from an asset price bubble as we had in the 2005-2007 period. Irving Fisher, a mid-twentieth century economist, documented the process in his book, Booms and Depressions. Fisher observed that assets are liquidated in order to reduce debts. This selling pressure depresses asset prices. It ends when debt levels are stabilized. It seems, five years into a recovery, this process should have run its course. Government debt, however, has replaced private debt and the total debt level has not declined. A critical part of the process described by Fisher has not occurred.

Economists are finding it necessary to restructure their models. There will be a period of uncertainty while this process plays out. It will be difficult to develop and implement investment strategy in a volatile environment.

The U.S. economy is likely to have grown 2.00% in 2014 and should advance 2.75% in 2015. Inflation for 2014 will likely have been 1.65% when the final numbers are in. In 2015 the CPI probably will advance between 1.75% and 2.00%.

Looking at the last seven years one has to question the efficacy of economic policy. Yes, we have a modest recovery that, after five years, appears to be self-sustaining. Has this recovery developed because of, or in spite of, economic policies? The U.S. president and Congress have not been able to put together a cohesive fiscal policy. There was a “stimulus package” that triggered some infrastructure spending, but the effect seemed to be short-lived. Remember “shovel ready” and first-time home buyer programs? It was difficult to find projects that were ready for speedy implementation. The first-time home buyer program may have only accelerated activity thus moving purchases up from later periods rather than increasing home ownership.

One reason that the Keynsian-esque stimulus may have had limited effect is that government spending already was at a high level. Keynes’ main thesis was that full employment was not a natural equilibrium point. Therefore, when private demand would fall, the government should step in, and using previously accumulated surplus, fill the demand void. The deficit spending was intended to be temporary. The resulting acrimony between fiscal conservatives and liberal spenders led to the shutdown of many government functions as funding was withheld by the Congress. The stand-off was resolved by the “sequester.”

Because of the failure of fiscal policy, the task fell to the Federal Open Market Committee (FOMC), the implementers of monetary policy. Traditional monetary policy holds that increasing the money supply reduces the relative value of financial assets and investment will move into tangible goods. However, if money supply grows faster than an economy’s ability to produce, inflation will result.

The FOMC expanded the money supply at a prodigious rate, using traditional tools such as reducing short-term rates and unconventional means by purchasing longer-term securities. The latter process is called "quantitative easing" or QE, for short.

After five years or more of this sort of policy, the U. S. economy is recovering at a barely sustainable pace. Inflation, however, is low. One effect has been to elevate prices of financial assets. U.S. stock prices are at all-time high levels. Foreign equities have faltered in recent months, but are above the lows of 2008-2009. Interest rates are low and that means that bond prices are high. It would seem that investment in fixed assets would be an attractive alternative, but that hasn't happened.

The high level of government debt may be a reason, as explained by Irving Fisher. Depending on the measurement, U.S. government debt now stands at 82% or 106%.[2] Private borrowers liquidate assets to reduce debt. What do governments do? In the past they devalued their currency either by fiat or, more gradually, by inflation. Five years ago Greece found they couldn't do that because they were euro participants. They are a sovereign nation but they don't have a sovereign currency. European governments and the European Central Bank initiated programs that helped Greece on the understanding that austerity measures would be adopted to fix its fiscal mess.

In the past couple of weeks Greek elections have shaken confidence in the ability of Greece and her European compatriots to accomplish this. It appears the Greek people are unwilling to accept the austerity measures needed to restore the country's fiscal integrity. Greece's gross government debt is 175% of its GDP. Interest cost is crippling and lenders are reluctant to continue to extend credit. Speculation has again risen that Greece may exit the euro common currency. The Greek experience should be a sobering lesson for governments around the globe.

Economic policies around the world are not working well. What should governments, and the U.S. in particular, do? Adopting fiscal policies that balance budgets by limiting spending to a level at which the citizenry is willing to be taxed would be a good start. If that were combined with comprehensive tax reforms that reduce deductions and other preferences so economic decisions were made for economic, not tax, reasons, we would have a much smoother running economy.

Financial Markets and Interest Rates

As noted above, both bond and stock markets have performed well for several years. Stock markets around the world have advanced, but the U.S. market has led the charge. Chart IV shows the total returns of the S&P 500 index of domestic stocks (black line), the MSCI EAFE index of developed foreign equities (red line) and the MSCI Emerging Market index (gray line) over the last five years.

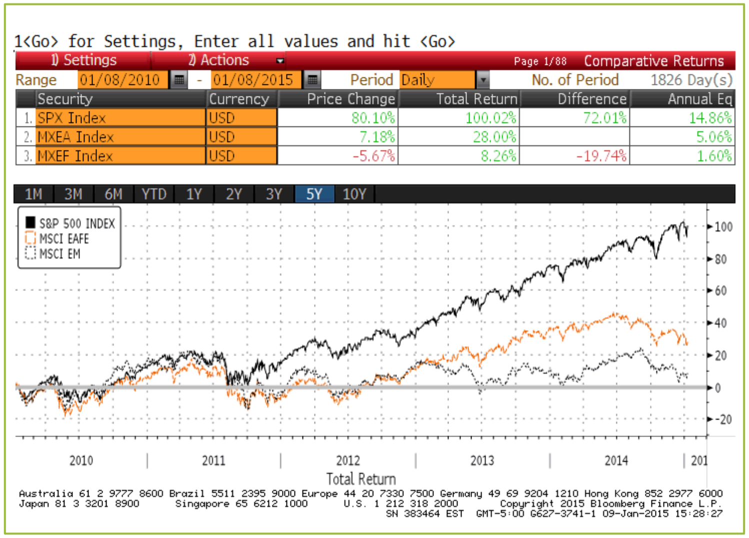

Chart IV

Developed markets have outpaced emerging ones over this period, but it should be noted that emerging equities have been the best performer for the past ten years.

In spite of the significant advances of recent years, equity valuations are not stretched. It might be suspected that stocks look good only because bond rates are so lows. Even when the risk premium[3] is doubled, stocks are fair values. Within the stock categories, domestic stocks and emerging market issues should be favored.

Nevertheless, there are strains. Doubts about recoveries in Europe and Japan make investors nervous. Renewed comments about the viability of the European common currency regime are unsettling. The VIX index, which measures stock price volatility, shows that price fluctuations have increased in the last three months. Chart V, which follows, shows this graphically.

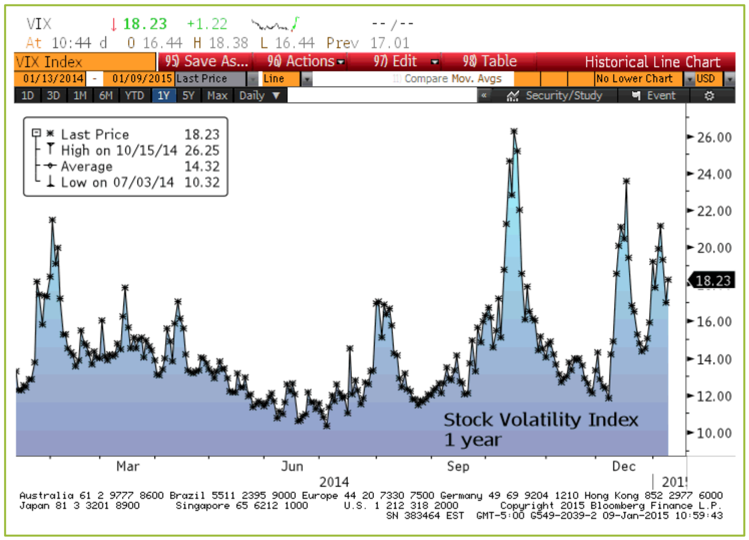

Chart V

Bond yields seem likely to increase over the next year or two. Remember, that has been the conventional forecast for the last several years. As this is being written, the ten-year Treasury note is yielding 1.96%. In recent weeks the yield has fallen as geopolitical events and the oil price drop have made investors nervous.

Chart VI compares the U.S. Treasury yield curve as it stands now (black line) and three (red line), six (yellow line) and nine (green line) months ago.

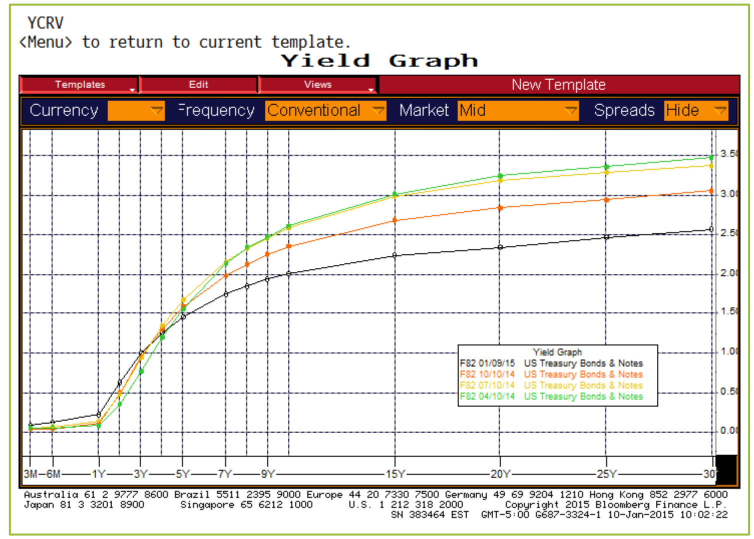

Chart VI

Rates have fallen across the curve in the last six months, even as the FOMC was reducing its bond buying program. All other things being equal, one would expect rates to increase as purchases by one buyer of $85 billion per month were reduced to zero over the course of about a year. What wasn't equal? The unexpected faltering of economic growth in Europe, Japan and China is one factor. The low level of inflation in Europe and the sudden drop in oil prices are additional ones.

Uncertainty about the global economic outlook and political events in Eastern Europe and the Middle East causes investors to seek lower risk investments. This phenomenon is known as flight-to-quality. Chart VII, on the next page, shows the sovereign bond yield curves for the U.S. (yellow line), Germany (black line), Switzerland (green line) and Italy (red line). The differences among these curves may be due somewhat to economic activity, but the main factor is probably differing perceptions of fiscal responsibility.

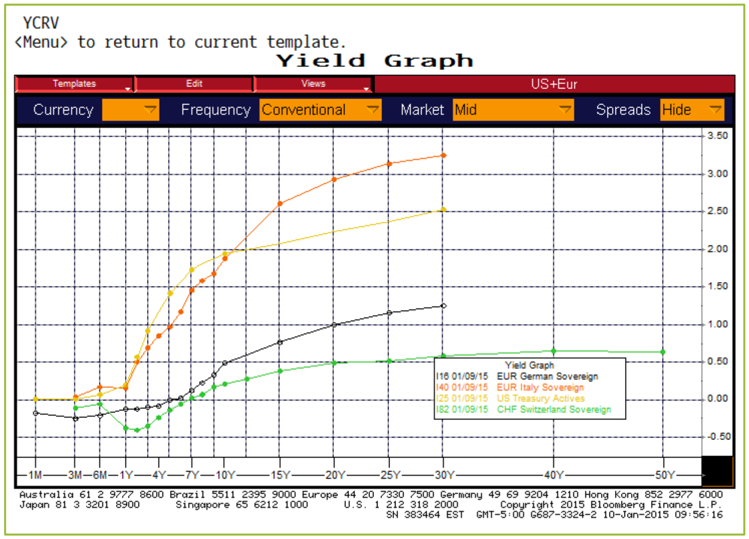

Chart VII

At the present time, the ten-year Treasury is oversold by about 20-30 basis points. Without exogenous events, the note would be selling at a yield of about 2.25%. At the end of 2015, the ten-year note is likely to yield about 2.90% and probably will increase further into 2016. The curve is likely to become steeper as longer rates increase and subsequently flatten when the FOMC allows short-term rates to increase.

The dilemma for bond investors has not changed. If rates are likely to increase, buying should be deferred but short term investments yield next to nothing. Compounding the confusion is the unreliability of forecasts. We have been told for years that rates will increase but the ten-year Treasury yields less now than it did in January 2009.

Bond investors should concentrate maturities in the 3-to-5 year portion of the curve. Because of economic uncertainties, investors' bias should be toward higher quality.

Strategy and Tactics

The long-term, strategic outlook is unchanged. Stocks should be over-weighted relative to bonds. Within the stock classes, domestic and emerging market issues should be favored. Less emphasis should be given to developed foreign equities. Bonds are a necessary part of properly constructed portfolios, but should be modestly under-weight from an account's normal mid-point. High quality issues should be used and maturities should be focused in three to five year maturities.

The wide fluctuations seen recently in stock prices and bond yields require a more careful tactical approach. Sharp price drops would be buying opportunities and upward spikes are opportunities to capture gains. This is true for both stocks and bonds.

Large liquidations are not warranted. If portfolio allocations get more than two or three percentage points away from the current allocation profile, rebalancing should be done. If, however, there are significant additions of cash, they needn't be immediately invested. It would be wise to place new funds over a period of time, watching for periods of weakness to make buys.

January 10, 2015
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[1] Sovereign debt refers to bonds and notes issued by governments.
[2] Fiscal Monitor, April 2014, International Monetary Fund.
[3] The risk premium is the additional return investors are likely to demand in order to own stocks instead of bonds.