Economic Discussion

A Review of the Economy and Financial Markets

January 2016

The Year Turns

The year of 2015 is now behind us and 2016 starts anew. This is a presidential election year. The first primaries/caucuses are less than a month away. We can hope that, as the field narrows, discussion will turn toward issues and away from personalities. Thus far, campaign rhetoric brings to mind Shakespeare's line, "…full of sound and fury, signifying nothing."[1]

International events are unsettling. The situation in the Middle East is volatile. It is encouraging that the Iraqi military was able to retake Ramadi. The execution by Saudi Arabia of a number of alleged terrorists including a Shiite cleric has sparked protests and has caused Iran to break off diplomatic relations with the Saudis. Russia continues to jockey for a position of influence in the region by supporting the Syrian government. North Korea claims to have detonated a hydrogen bomb and geologists detected seismic activity in the region. China continues to assert claims on the disputed Spratly Islands.

Oil prices have tested new lows. Benefits are mixed. Exporters are hurt, Russia and Venezuela in particular. Consumers around the world are enjoying lower prices. The low price is one of the factors driving record auto sales. China is struggling to maintain growth and to contain speculation in its stock markets. China devalued its currency to maintain growth. The Shanghai markets tumbled. Equity markets around the world fell in response. As the first week of the year progressed the situation remained unresolved.

The U.S. Congress got through December without too much in the way of histrionics and passed a budget without a government shutdown or bond default. They did not make headway on corralling the fiscal deficit. The Congressional Budget Office (CBO) projects deficits through 2025.

Financial markets had a sloppy year. The S&P 500 index of domestic stocks fell -0.73% on price alone. When divided payments are added back it advanced 1.37%. The MSCI EAFE index of foreign domestic stocks was off -0.21% after dividends. The MSCI emerging market index was off -14.83% after taking dividend payments into account. Essentially, developed markets had a flat year and emerging market stocks tanked. Chart I shows the performance of these indices during 2015.

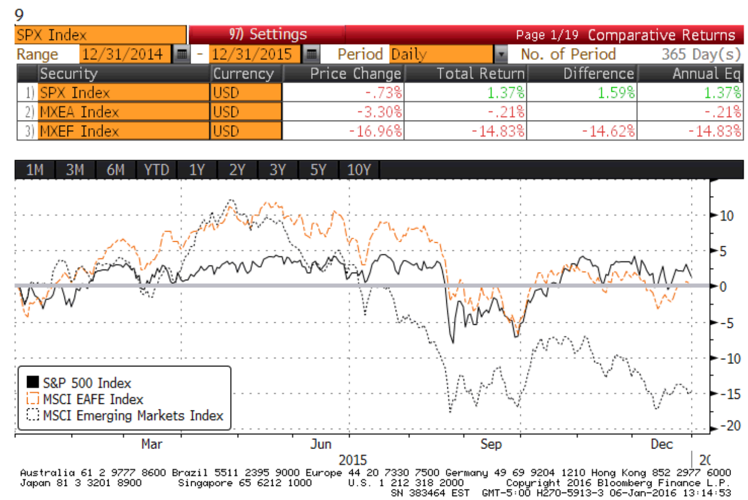

Chart I

The Federal Open Market Committee (FOMC) raised its target for the fed funds rate[2] from a range of 0.00% to 0.25% to a range of 0.25% to 0.50%. This is the first rate change since February 2008. There is an interesting aspect to the target rate that is seldom noted. The Federal Reserve started paying interest on bank reserves after the financial crisis. Reserves are liquid balances that banks are required to maintain. The rate paid is the top end of the target range. There is still fed funds activity among banks. They would tend to be the larger banks, some of which look to the fed funds market for short term borrowing. The effective fed funds rate is the market determined rate for this activity. Chart II, which follows, shows this rate over the past five years.

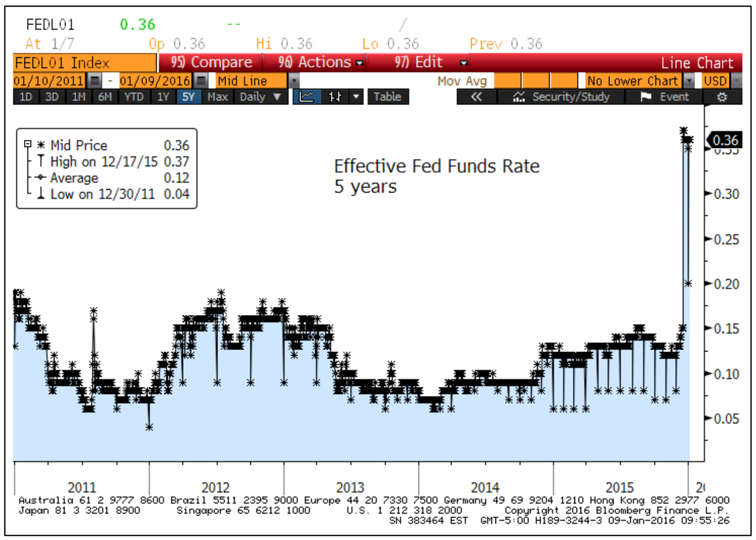

Chart II

As you can see, the market determined rate has stayed within the FOMC's target range. It moved up immediately upon the FOMC's rate change announcement.

The FOMC minutes indicated some hesitancy in making the move because of low inflation reports. The FOMC's target for inflation is 2%. The FOMC's preferred inflation indicator is the Personal Consumption Expenditures (PCE) deflator. Its year-over-year change through November was 0.4%. It was influenced by falling energy prices, but the core PCE deflator rose 1.3% in the same time period. Chart III shows the PCE Deflator full index and the index excluding food and energy over the past eight years.

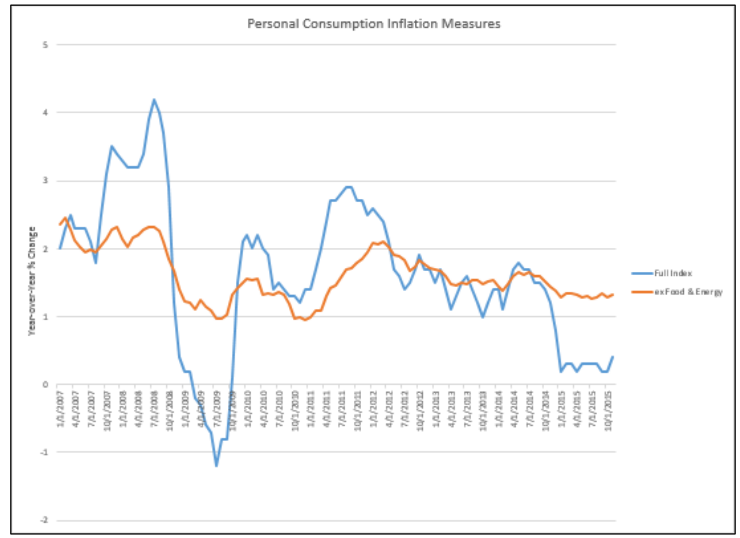

Chart III

The blue line is the full index and the orange(ish) line is the core measure. The very low numbers for the full index will not continue because the year earlier data will be lower. The core line is still well below the 2% target.

Economic growth in the third quarter (3Q) of 2015 was 2.0%. Year over year GDP grew 2.1%. Forecasts for 2016 are in the area of 2.5%. Chart IV tracks the quarter-over-quarter change (annualized) for the past fifteen years.

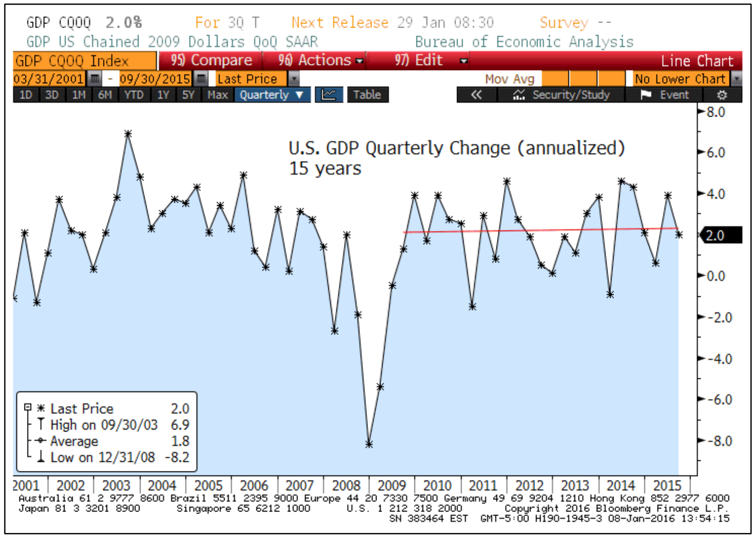

Chart IV

The red line represents the trend since the recovery began in late 2009. The line is virtually flat at just over 2%. This is well below the U.S. economy's long term trend of 3%.

Employment numbers for December 2015 were reported on January 8th. It was a positive report with the addition of 292,000 jobs and the unemployment rate staying at 5.0%. Optimism is dampened by the following data. The average work week was unchanged at 34.5 hours and average hourly earnings were down slightly. The labor force participation rate ticked up 0.1% to 62.6%.

Nevertheless, the U.S. economy is among the strongest in the world. Europe seems to be regaining its footing, but growth is likely to be well under 2%. Japan might grow about 1%. China is the big question mark among emerging economies. Consensus forecasts are about 6.5% for 2016. That is lower than recent years. Also, there is considerable uncertainty about China's economic data and the ineffectiveness of the government's attempts to keep growth moving has unsettled markets around the world.

Higher interest rates (even a little), a stronger U.S. dollar and slowing emerging markets make us doubt the optimism of the 2.50% forecasts for 2016 U.S. growth. It is more likely to be around 2%. Inflation numbers will gravitate upward to 1.50% or 1.75%.

Economic growth in the U.S. will be locked in the 2% area until structural changes are made in our fiscal policy. Policy makers will have to recognize the danger posed by deficits expanding into the distant future. Tax policy will have to be refocused on revenue generation, not redistribution. The crazy quilt of incentives and disincentives we now have will have to be changed into a much simpler tax code. Unfortunately, there is not much hope for major changes of this sort in an election year.

Financial Markets and Interest Rates

Stock markets stumbled in the first week of the year. The S&P 500 fell 6% in the first five trading days. Over the same time, developed foreign markets were down 6.2% and emerging market equities fell 6.8%. The Shanghai Composite index fell 10.8%. The primary negative factor appears to be China's policy movements and lack of confidence in their efficacy.

In a market like this, one should not try to catch a falling knife. The drop is probably an over-reaction to economic events. This is a good time to sit tight and let the dust settle. There is earnings support for stock prices, even in our slower than consensus economic outlook. Panic selling would be a mistake.

Regular readers know that we generally follow a valuation approach, basing our investing strategy on fundamentals like interest rates, price-to-earnings (P/E) ratios and expected growth rates. Fundamental value will win out over time. In a market like we are experiencing, fundamentals mean nothing. The disciplined investor is advised to hold steady until the smoke clears.

The bond market has followed a different path than stocks, although it is also confusing. Conventional wisdom would predict higher interest rates now that the FOMC has made its long awaited move toward higher rates. It is not so, however. In the past three months the ten year U.S. Treasury note has ranged from a low yield of 1.973% in October to a high point of 2.344% on November 10th. On January 8th it closed at 2.116%. Chart V shows the Treasury yield curve for the current time and each of the last three months.

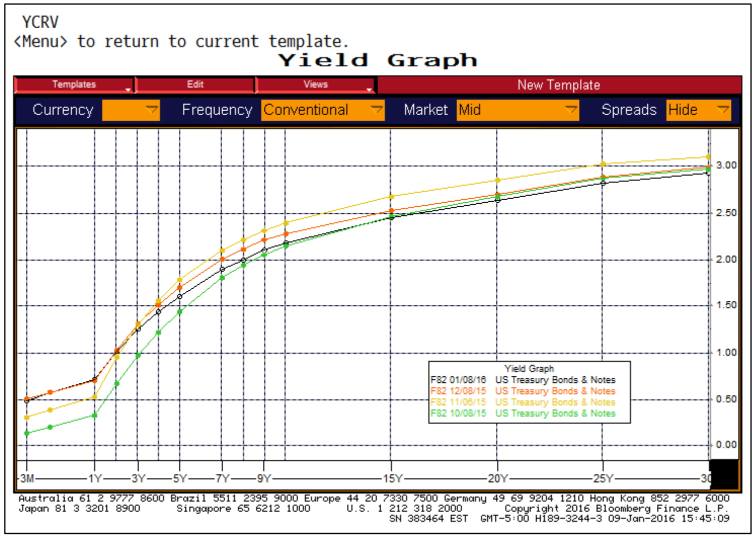

Chart V

The black line is the curve on January 8th. The red line is December 8th, the gold line represents November 8th and the red line October 8th. Since October the curve has flattened as long rates fell while short rates increased. In between there were some undulations, as the graph shows.

The past week has seen an aberration in Treasury rates. Treasury securities are considered among the safest in the world. In times of turmoil investors move funds from other investments to them in a phenomenon called "flight to safety." At the present level of 2.12% the ten year yield is probably 20 basis points[3] below a "normalized" level.

For years the investing world has been anticipating that rates would increase. Now that the FOMC has made its first move it may happen. Rates are likely to increase over the next year. We look for fed funds to be 0.85% and the ten year Treasury to yield 2.75% at year end. That will require U.S. GDP growth of 2% or more and for the global economy to stabilize.

With rates where they are investors should stay in the short-term end of the maturity range. They might want to extend into intermediate term securities if rates move to a "normal" level. That would mean the ten year Treasury at 2.30% or higher.

At this juncture, there should be no changes in asset allocation strategy from a month ago. It could take two to six weeks for markets to stabilize. When that happens, asset allocation strategy should be revisited.

January 9, 2016
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[1] Macbeth, William Shakespeare, Act 5, Scene 5.
[2] The fed funds rate is the rate at which U.S. banks lend to each other from one business day to the next. It is also called the overnight lending rate.

[3] A basis point is 0.01% of yield. Thus, adding 20 basis points to the ten year Treasury yield of 2.12% would produce a yield of 2.32%.