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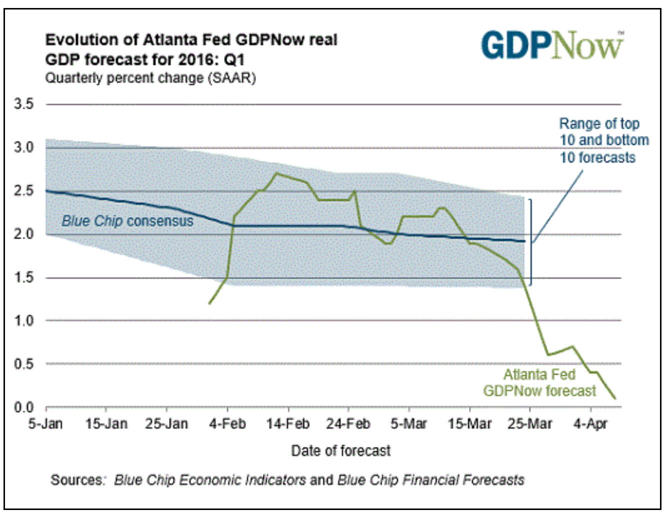
ECONOMIC BRIEFING • APRIL 2016

THE US ECONOMY: Muddling Through

As we have mentioned many a time, throughout the current economic cycle from 2009 to present, we have experienced some of the lowest economic growth rates seen in the last sixty years. Despite unprecedented financial stimulus from the US and global central banks, getting to or above an annual 2.5% GDP growth rate has remained elusive. We have essentially been "muddling through" as a total economy.

Where do we stand now? The forward looking Atlanta Fed GDP Now model is anticipating a 0.1% US GDP number for the first quarter of 2016. This is down from close to a 2.6% number as of early February of this year. Although the macro economy has slowed in the final month of the quarter, we continue to muddle through.



Why have we found ourselves in this very slow growth environment?

One of the key reasons in our minds has been lack of income growth, necessarily affecting final demand in the economy. We see this lack of income growth on many fronts. For those living on fixed incomes, interest rates have dropped from the mid-5% level eight years ago to close to zero today. The ability to earn a reasonable interest rate on safe securities (US Treasuries, bank CDs, etc.) has been taken away, as has the spending power formerly available with these returns. Particularly impacted have been retirees and those formerly invested in very safe assets.

However, it is not just interest rates that are causing stifled income growth. Lack of income growth has also been expressed in the labor markets. This is the first economic cycle in more than a half century where median inflation adjusted family income has actually declined. We have never seen this before in the modern economy. Inflation adjusted median household income today stands where we saw it in 1996.

Although we have seen job growth in the current economic cycle, firming meaningfully over the last year, subdued growth in wages has been a keynote character point of the current cycle. A few weeks back we saw March job gains in the US total over 200,000. However, as we look underneath the headlines, close to two-thirds of the gains came in minimum wage jobs. Those jobs do not support the type of wage growth necessary to really drive overall consumption in the current economy. The following chart reveals just how subdued US wage growth has been since 2009 compared with historical precedent. As you can see, we have not seen anything like this in the past 50 years.

The key reason we are seeing such slow macro US economic growth is that US final demand, the very demand supported by income and wage growth, has been restrained. All we have to do is look at recent corporate revenue and earnings data to see this.

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The NFIB (National Federation of Independent Business) is one of the largest small business lobbying organizations in the US. Each month they publish their Small Business Survey, packed with important data concerning US small business conditions. In their most recent publications, when asked their most important problem, "poor sales" has been the overwhelming response of the US small business community for a good while now.

The BCA (Bank Credit Analyst) has long been a respected research source on Wall Street. They recently looked at 60 different industry groups in the US. Consistent with deflationary top line pressures, 32 of these industries said they have been cutting prices for at least one quarter now. Another 9 reported the inability to raise prices even 1%. We are looking at two-thirds of US industry groups studied unable to keep pricing up with already subdued US inflation rates. If this is not a corporate profit headwind, we do not know what is.

The above data does not mean that we are necessarily headed for another "Great Recession," but we are simply trying to explain the dynamics behind the very slow growth economic cycle of the moment that may lead ultimately lead us into a recession in the future. We believe the current lack of income growth is a large contributor to the overall slow growth of the US economy and unfortunately we see little to change these circumstances any time soon. Is the US alone in this set of circumstances? Not at all, as what we have described is a global phenomenon. So for now, we continue to "muddle through" as the current cycle matures. Remember, this discussion is not about expressing optimism or pessimism, but rather viewing the factual reality of the moment.

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INTEREST RATES: The US Fed – The Central Banker To The World?

After seven long years of keeping US short term interest rates very near 0%, in late 2015 the US Fed laid out its intention to begin "normalizing" interest rates in the US. In fact, the Fed actually raised the official Fed Funds rate to 0.25% in December, also intimating at least four more interest rate hikes to come in 2016. As we stand here at the end of the first quarter of 2016, that has all changed. It is widely speculated that the Fed may now only do two interest rate hikes this year, if that. So what changed?

First, we began the year with one of the greatest early year declines in the US stock market on record, although equity market weakness was global in nature. Although the Fed will never admit this publicly, there are very scared of a meaningful stock market decline. You may remember in 2009 the Fed spoke of the "wealth effect" when they first initiated quantitative easing (money printing). They believed that if they could influence the price of US stocks and real estate to move higher, it would encourage an increase in consumption (remember, consumption drives over 70% of the US GDP number), as consumers felt more wealthy. If consumption moved higher, the result would be positive economic growth. This was the Fed's primary rationale for quantitative easing. In the clarity of hindsight and despite three attempts at quantitative easing, the whole idea of the wealth effect driving consumption and economic growth did not work out. Real estate and stock prices rose, but consumption has remained subdued throughout this cycle.

Due in large part to global monetary policy, we now find ourselves in a stock market environment of very high valuations. Using Warren Buffet's favorite stock market valuation guide (total market capitalization relative to GDP), we are witnessing the second most highly valued market in history, taking a backseat only to the year 2000. What the Fed is certainly worried about in terms of where we stand today is the potential for a "reverse wealth effect." Although US consumption has not responded favorably to a rise in equity and real estate prices, the key issue of the moment now becomes how consumers would respond to a potential contraction in stock prices, especially at the higher end wealth demographic? Would consumption actually fall if stock prices contracted and consumers felt "less wealthy"?

We saw exactly this phenomenon in the last two US bear markets in 2000-02 and 2007-09. Certainly, the meaningful January stock price correction did not go unnoticed by the Fed. To be honest, this is also a big problem for central bankers in Europe, Japan and China, who immediately promised ever more stimulus as global equity markets corrected.

In addition to wealth effect concerns very much domestic in nature, the Fed is also worried about contributing to a stronger Dollar relative to foreign currencies in terms of the global economy. For now, the Fed is the only central bank that has actually begun interest rate increases. Academically, the higher a nation's interest rates, the more upward pressure on its currency.

A higher Dollar, from here, would negatively impact the revenues and profits of large US multinational corporations. We also need to remember that countries like China have pegged their currency to the US Dollar. A higher Dollar, by definition, would drag the Chinese Yuan higher, academically making China less economically competitive in the global environment with a higher currency. In addition, Dollar denominated debt held by those outside the US would actually increase in value if the Dollar were to gain more ground. The emerging market economies would specifically be at risk given their very large US Dollar debt exposure at close to $6 trillion.

With respect to Europe and Japan, they would not mind seeing a higher Dollar (and lower Euro and Yen values). Rather, the issue for them is potential capital flight from Europe and Japan to the US (to the US Dollar). All else being equal, a higher currency value driven by higher interest rates for any country would attract global capital. That capital would achieve a higher rate of return on investment and would enjoy the gain of the higher currency value itself. The Fed not raising interest rates academically forestalls capital moving from lower valued currencies to a higher valued currency, in this case the US Dollar.

Finally, the Fed is fully aware of an important issue set for mid-year, which is the vote in England whether to break ties with the European Union. It has been nicknamed the BREXIT (Britain existing the EU). In Europe, this would be seen as a very politically unacceptable outcome. How to stop it? Keep the Euro from falling hard as a currency value. How does one help in this cause? Do not allow the Dollar to appreciate.

In one sense, is the Fed trying to play the role of central banker to the world? Trying to help Europe not experience capital flight? Trying to help China remain competitive economically? Trying to help the emerging market economies by keeping a lid on their Dollar denominated debt load? In addition, also trying to support historically high US equity market valuations? We believe the answer is "yes" to all of these questions.

The current situation described above sets up a longer term dilemma. Trying to juggle all of these balls in the air at one time successfully will be extremely tough to accomplish. Although it happened many decades ago, there is some precedent for these circumstances. In 1927, conditions in the foreign markets and economies, especially Europe, was very tough. Issues with war caused European capital to flood US Dollar markets. In an effort to help Europe, the US Fed actually dropped interest rates, trying to push down the value of the Dollar and dissuade Europeans from moving even more capital out of Europe. The Fed decision at the time backfired as European capital flooded the US, contributing to the "roaring twenties" environment and the spike in the US stock market leading up to the 1929 peak. Yes, it was a very different time, but there certainly are some important parallels to draw. The key point being, the Fed is going to have a very difficult time supporting all of the varied interests of the global economies. Just because the Fed would like to see a stable or declining Dollar does not mean this will happen as global capital will move as it sees fit.

So what does this mean for us as investors? It means we can expect the Fed to keep interest rates lower for longer, regardless of employment rates, inflationary pressures, etc. They have shown us clearly that they have no appetite for declining asset values, especially stock prices. Over the very short term, the Fed and global central bankers can and will impact asset prices and currency values. Over the longer term, fundamental values and global capital movement will trump short term central bank decision making. We simply need to remember that central bankers are not omniscient and cannot control free market forces indefinitely. At some point, the Fed will need to choose - do they support US interests, or the interests of the global economy? We're not there yet, but this is the tension in which investors need to make decisions.

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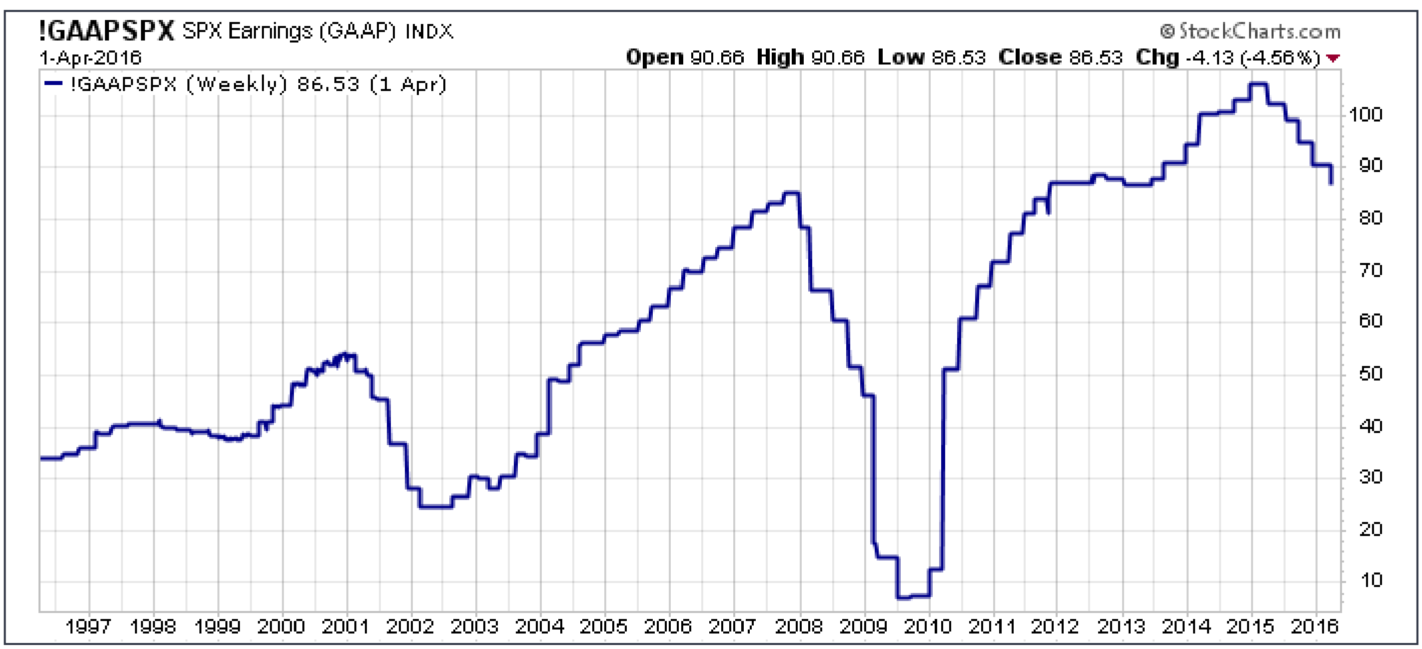
THE US STOCK MARKET: Corporate Earnings

We all know it has been quite the roller coaster ride for US stocks in the first quarter of this year. After an early year 10% decline in price, the US markets recovered all of that by the closing bell ending the first quarter. In the early part of the year, investors were concerned with a meaningful slowing in China, a European financial system that remains in very tough shape, and historically high equity valuations in a slowing global economic environment, to list a few of the serious concerns.

What changed investor's minds about these early year concerns? In two words, central banks. In the aftermath of the January stock market correction, the European central bank went deeper into negative interest rate territory and increased their money printing activities. The Bank of Japan went to negative interest rates for the first time in their history, promising to do more if necessary. The People's Bank of China increased stimulus measures as well as devalued their currency. Finally, the US Fed backed down on planned interest rate increases for 2016. We have seen exactly this type of Pavlovian response over the entire cycle to date - every time central bankers promise ever more stimulus, investors respond by increasing investment risk and markets move higher.

In spite of the above, there is one very important issue that cannot be overlooked, nor solved by central banks conducting their own versions of unprecedented monetary policy. That issue is that US corporate earnings peaked over five quarters ago and have been steadily declining in every quarter since. As of the end of the first quarter of this year, analyst earnings expectations had fallen by 9.6% relative to where they stood at the beginning of the quarter, which is the largest quarterly drop in estimates since 2009.

The following chart shows us the history of S&P 500 GAAP (generally accepted accounting principles) earnings over the last two decades. The contraction in earnings for the current cycle that is occurring is clear. From a long term perspective, it is corporate earnings that support stock prices, not monetary promises by central banks, as monetary promises are about the short term, but actual earnings underpin the longer term.



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Although anything can happen, history tells us that once corporate earnings fail to recover within a year, it is a good bet we have seen the peak for the current cycle and a higher peak will not be seen until the next economic cycle (post-recession).

A bit of additional concern is the fact that with earnings contraction, we have also seen a contraction in corporate cash flow – the lifeblood of any enterprise. Cash flow from profit drives dividend growth, employment, business expansion and stock buybacks. Corporate profit trends have historically been very reliable indicators of future economic activity. For now, we believe we have already seen the peak in stock buybacks and business investment for this cycle, purely as a result of already in place profits contraction.

As we look at individual sectors in the US markets, financial and utility sector profits peaked over two years ago. Manufacturing sector profits peaked a year ago and more recently we have seen a peak in retail industry profitability. What has held up for now is wholesale trade, transportation and information technology, but the longer term trend is clear. Although this is only two decades of experience, history shows us that once we have seen five quarters of earnings decline, the final end of the decline has come at the end of the total economic cycle. Will it be so again?

The drop in corporate profits so far is a warning, not a death knell. It is a warning that we are in a very aged cycle. It's a warning to investors that investment selectivity is absolutely vital at this point in the market cycle. It is also a reminder of our closely held belief that risk management is the key to successful investment outcomes. As of now, corporate profits are down double digits from the highs, yet the market itself has declined 3-4% from its high of last year.

We are looking at yet another corporate profits reporting season directly ahead and we will be monitoring the numbers closely. What will be more important than the earnings themselves ("yesterday's news"), is the forward guidance companies convey regarding future earnings. Please remember, central banks can help support short term investor sentiment as they have done by taking unprecedented actions in an effort to support asset prices. Unfortunately, in the longer term they cannot change the course of real world economic and corporate profit cycles. One of these most important indicators for investors is the very direction of profits, and for now, real world profits are running in the opposite direction of central bank promises.