CAPITAL PLANNING ADVISORS™
YOUR FAMILY, YOUR BUSINESS, YOUR WEALTH

CAPITAL INSIGHTS

ECONOMIC BRIEFING • AUGUST 2016

IT'S PROBABLY NOTHING

We've suggested a good number of times during the current economic and financial market cycle that we are seeing many economic data points that simply have no precedent in expansion periods over the last half century. No wonder it seems so confusing for investors, economic commentators and financial market pundits alike. The "rules" of prior cycles seem to no longer apply and this seems especially true when looking at the historical "linkage" between the real economy and the financial markets.

You've heard the old adage that "pictures speak louder than words." This month's commentary will be heavy on the visuals and light on the commentary. It's very easy to "talk" about the unprecedented nature of the economic cycle of the moment, but seeing the data trends spread over multiple decades can often be more impactful.

Why go through this exercise at all? Historically, the linkage between the direction of the real economy and financial markets has been very tight. Financial markets do well during economic expansions and not so well while corporate earnings are contracting into and throughout actual recessionary periods. This defines the very nature of cycles. So let's look at a number of headline economic statistics of the moment with longer term historical context. We all know financial markets currently rest at all-time highs, but what about real economic numbers?

US GDP

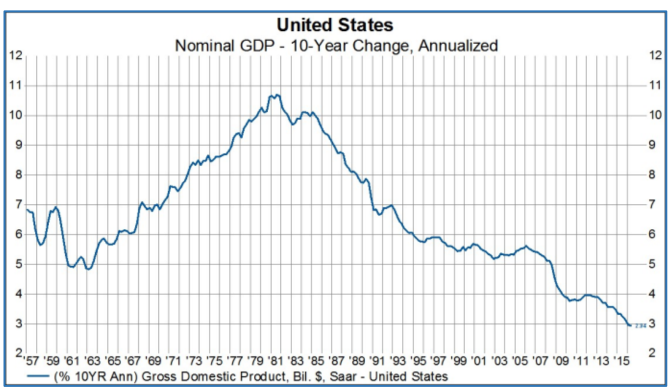


Chart Source: US Bureau of Economic Analysis

Here's a fact for you. President Obama will be the first sitting US President to never have experienced real 3% GDP growth throughout his entire tenure. Of course this applies to the period over which US GDP records have been kept (since 1871). The chart we are showing you is the 10-year rate of change in US GDP going back to the mid-1950's. Never in any cycle over this period have 10-year growth rates in US GDP dipped as low as we see in the current expansion period. Yet during this cycle we have experienced one of the top bull markets for both US stocks and bonds on record.

US HOUSING

To suggest housing has been an important sector of the US economy is an understatement, especially over the adult lifetimes of the baby boomer generation – representing one of the strongest demographic demand points for housing in the modern era.

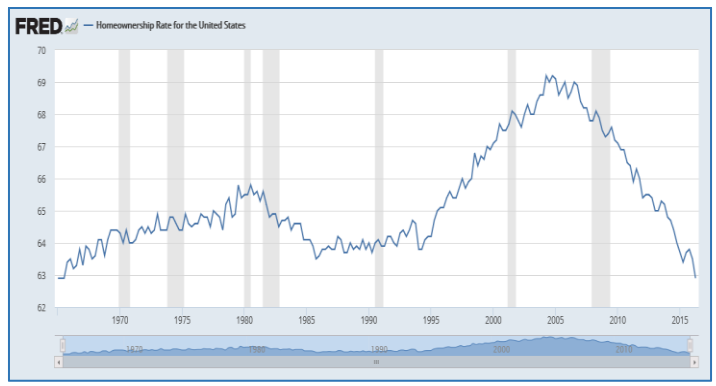


Chart Source: St. Louis Fed

Although we need to recognize that the prior few economic cycles witnessed very strong demand for housing, naturally explained by the need of the boomers to lock down housing costs as they approached retirement years, what has occurred in the current cycle is without precedent over the last half century at least. The homeownership rate in the US currently rests at a level last seen in 1965. Just as an FYI, the gray bars in the chart represent historical US recessions.

Certainly the millennials are driving a big part of this, but so is lack of affordability as residential real estate prices have been bid up in the current cycle as "income substitute" investment vehicles. This is in a world where rate of return on traditional, safe, income oriented investments like CDs and bonds is gone. Housing has helped underpin every economic cycle in recent memory, except the current cycle.

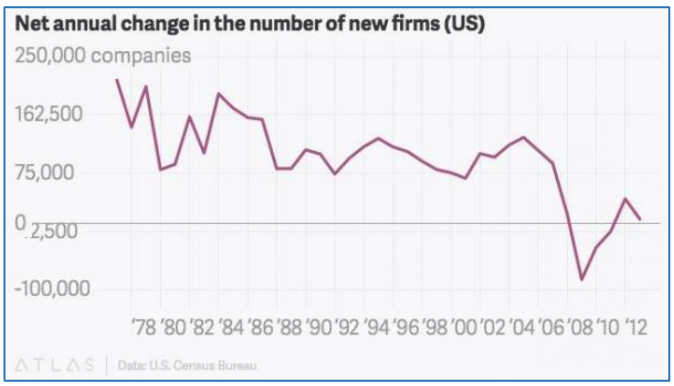
ROSEVILLE OFFICE: (916) 286-7650
WALNUT CREEK OFFICE: (925) 524-2800
CAPITALPLANNINGADVISORS.COM

WRITTEN BY: BRIAN J. PRETTI CFA, CFP®
TERRY CHIU CFA, CFP®
Capital Planning Advisors

US JOB GROWTH

The current cycle for job growth has been just plain anemic relative to historical experience. Growth in manufacturing jobs has almost been non-existent since 2009, as the service sector has shown strength. Yet the bulk of new service sector job growth has been seen in hospitality (hotels), eating and drinking establishments (bars and restaurants) as well as temp help, all at the lower end of the wage and benefit spectrum.

Living in California, we constantly hear about startups and growth in new tech related ventures. Close to home this is true, but across the US net new business startups in the current cycle have shown us the lowest level of growth in four decades at least.



Data Source: US Census Bureau

Why is this important? Historically, new startups and small businesses have accounted for the bulk of new hiring in each US economic cycle. We have never seen anything like this in the modern economy.

HOUSEHOLD INCOME

We've shown you a number of times in these pages that wage growth in the current cycle rests at one of the lowest levels on record. Even more important to households than gross wages is the inflation adjusted purchasing power of their total income, of which wages are clearly a big part. To this point, the current cycle is the first economic cycle on record over the last half century whereby inflation adjusted household income has actually fallen.

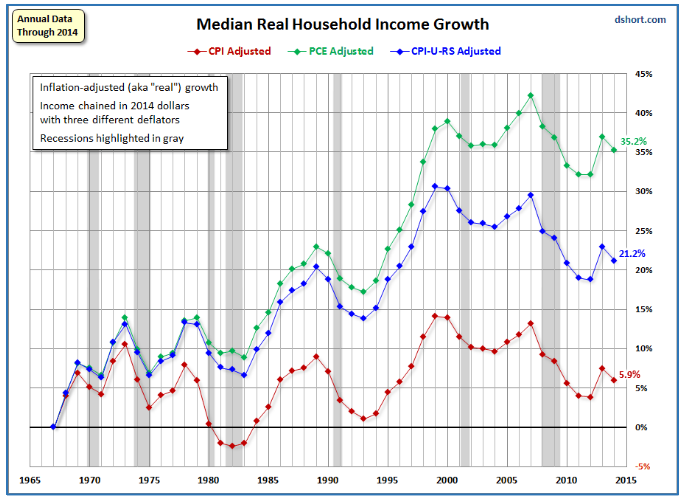


Chart Source: Advisor Perspectives – Doug Short

The chart above is a bit busy as it depicts inflation adjusted household income being depicted in three different calculations. The first (red line) adjusts household income for inflation using the simple headline CPI. The next (green line) uses the "personal consumption deflator" to adjust for inflation. The US Fed has come right out and said this is their preferred method. Finally, the data in blue again uses the US CPI data, expect this time the food and energy cost portion of the CPI are not factored into the inflation calculation. Regardless of methodology, the message is the same in each data point. Never in the last half century has inflation adjusted household income fallen, except in the current cycle. For now, US inflation adjusted household income rests where we saw it in the mid-1990's.

We have suggested to you many a time that the Fed, and really global central bankers, engaging in quantitative easing and dropping interest rates to zero has positively impacted asset prices, but not so much real economies. We see this dramatically in the relationship between household net worth (primarily financial asset and real estate prices) and disposable household income (largely driven by wages). Notice the dates we last saw current levels.

Data Source: US Federal Reserve

Financial assets have performed spectacularly, but the real economy as characterized by wages and income not so much. These types of extremes are rare historically.

As a quick note, remember that Warren Buffett, Bill Gates, Mark Zuckerberg, Jeff Bezos, Larry Ellison, etc. are counted as part of US "households" in this data. Billionaire households, but households nonetheless.

US MANUFACTURING SECTOR

To the point, the US manufacturing sector is having a tough time at the moment. The following chart shows us that the year-over-year change in US factory orders has recorded 20 straight months of decline through June of this year (the red bars in the chart depict historic recessions). In the recorded history of US factory orders, when was the last time this occurred? Never. That's either inside or outside of a recession. Brand new territory for the very important US manufacturing sector.

Data Source: US Census Bureau

The "sister" of factory orders that is total US industrial production has recorded 9 straight months of downturn through June of this year. In the last 100 years, this has never occurred outside of recession. Every single segment of industrial production is currently in decline. Yet stocks and bonds rest at record highs.

Could one argue that manufacturing is no longer important in the new "tech" economy? Perhaps, but the coincident direction of the two data points in the chart below argues otherwise over the entire period of the new tech economy.

Data Source: S&P and US Census Bureau

Are we worrying too much about the apparent disconnect and dichotomy between real economic and financial market outcomes in the current cycle?

These "pictures" attest to the unique and unprecedented environment of the moment. In large part, this dichotomy between the reality of the economy and financial markets has been aided and abetted by central bankers providing almost unlimited liquidity to the financial markets themselves. Although we're not there yet, when this seemingly unending emergency liquidity ultimately subsides, the decades' long linkage between real economic outcomes and financial asset prices that have historically reflected those real outcomes will be reestablished.

In the meantime, it's probably nothing, right?