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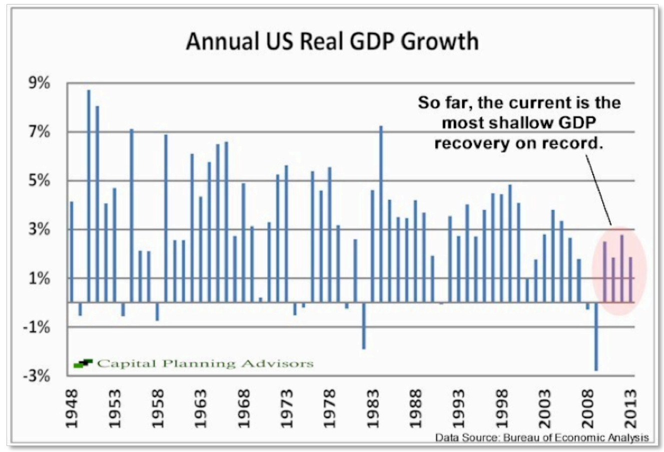
CAPITAL INSIGHTS

Economic Briefing • Spring 2014

THE US ECONOMY WHETHER IT'S THE WEATHER

As we entered 2014, economists and financial market prognosticators were not only filled with hope and good cheer, but thoughts of accelerating activity in the US economy. The negative impact of US government budget related sequestration drags felt in 2013 will be much less so in the current year. Moreover, the economy as a whole continues to benefit from the recent US energy production boom as well as subdued headline inflationary pressures. But almost throughout the first quarter Old Man Winter has had other ideas, blanketing much of the nation and real economy in a temporary freeze. Blaming the harsh winter weather for the reality of subdued economic statistics has become close to a daily occurrence as of late. Looking forward, the question of whether it's only the weather impacting economic activity will be answered in very short order, so stay tuned.



So far, the current is the most shallow GDP recovery on record.

The fact is that the whole idea of subdued economic growth is not just a reality of the first quarter of this year, but really something that characterizes the entire current economic cycle to date. The numbers in the chart here bear this out. We've never seen an economic expansion anywhere over official Fed records dating back to 1948 where we have not experienced at least one quarter of 3% real GDP growth or greater until the current.

Slow growth is not bad, per se; it's just dissimilar than economic cycles past. The current cycle, now close to five years in length, looks and feels very different than what we've experienced in recent history for good reason. Households and the financial sector have lived through a needed process of balance sheet repair, having gorged far too heavily at the trough of credit expansion for decades prior. It's simply time for the private sector to take a breather in terms of debt acceleration, especially for the aging baby boom generation. Let's face it, the last thing the boomers need at this point in their lives is more leverage. To offset soft credit expansion in the private sector, US government debt has doubled since the first quarter of 2009 (an increase of $8.5 trillion) and our friends at the Federal Reserve have printed over $3.5 trillion, all in the hopes of making the US economy currently running at quite the slow trot move just a bit faster. So far, even the historic magnitude of that stimulative prodding has not achieved the desired result. What can we expect ahead? Probably a good bit of more of the same. A "muddle through" economy that's not too hot and not too cold in the aggregate.

It's very easy to talk about "the economy" as a monolith, but we believe it's important in this cycle to dig a bit deeper. What we see when we take a detailed look under the hood of the headlines is more the story of the tale of two economies. The high end domestic and global wealth demographic is doing quite well. Those that own equities and real estate have felt a recovery in values unlike those not heavily levered to these asset classes. For example, 2013 witnessed record sales for Mercedes, BMW, Ferrari and the likes of Maserati. But not so much for domestic lower end car manufacturers, although sales were well off the lows of the early cycle due to pent up demand. Housing prices have recovered from 2009-2010 lows quite smartly, but actual new home sales and housing starts rest much closer to five decade lows than not. Housing has experienced an investment cycle as opposed to more of a production cycle in character. This is neither good nor bad, but simply the fingerprint character of our current experience.

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In today's world, absolutely nothing occurs in isolation. The global economies and financial markets are inextricably interconnected unlike anything experienced in modern times. What we are seeing right now is that the major economy China is slowing. China realizes it must balance between what has primarily been an investment led and export driven model toward encouraging more internal consumption. As part of this process, excess credit must be throttled and we have recently seen the first two corporate bond defaults in recent Chinese history over the last few months as part of this process. This achieving of longer term balance cannot occur without some short term pain that is slower growth for a time. The Japanese economy, despite massive money printing stimulus over the last year and one half, remains relatively moribund for now as per recent statistics. And finally Europe has not yet even begun to reconcile its banking system issues, as we watch Euro area credit creation contract leading to subpar growth.

Why is the rhythm and character of major global economies important to the US specifically? Because slow growth in major foreign economies means that at the margin, global capital migrates to and invests in geographic areas offering incremental real growth. For now that destination of choice for global capital is the US. It's a big plus for the US being able to continue incremental growth in the current cycle. Not shooting the lights out, but moving the economic ball forward a few yards at a time. By example, low domestic energy costs means that global manufacturers with high variable energy cost structures are attracted to the US in siting greenfield manufacturing facilities. Think chemicals, aluminum, glass, etc. This incrementally allows the US economy in a mature economic cycle to continue advancing at a pace in excess of global peers.

Also, think specifically about our own home state of California. Increasing globalization and the rise in global standards of living means agricultural products are increasingly in demand worldwide, levitating ag prices. As such, it's again hard to think of the US economy without dividing it into its component parts and along geographic lines. We believe a meaningful theme of this very different cycle is the geographic concentration of wealth. The San Francisco Bay area to the Silicon Valley is literally a poster child for this thesis. But we are not alone. We see exactly this same concentration of global wealth in areas like London, New York, Beijing, Dubai, etc. During periods of subdued macro global economic growth, capital concentrates geographically. So again, when we talk about the monolith that is the macro US economy, it's in general terms. In the current cycle, it's much more about a series of micro economies experiencing very different outcomes.

The harsh winter effects on the macro US economy in the first quarter are set to dissipate in the months ahead. We'll have a much clearer picture of the true trajectory and character of the economy as the clouds part and the skies clear. For now we expect a pickup in activity relative to last year, but only at the margin. Personally we'd be very happy to see a 2.5% GDP growth number that is achievable. Compared to many of our global developed economy brethren, that will be enough to continue to attract the true economic benefit of global capital migration, ultimately supporting investment and spending gains. ■

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THE US EQUITY MARKET GOING WITH THE FLOW?

Although the final official tally for 2013 has not yet been revealed, US GDP growth will register something near the 2% level. Growth in S&P 500 earnings per share, likewise in the final calculation stage, may come in near 5%. But absent corporate stock buybacks, there would have been little in the way of S&P earnings growth. And yet equity prices both in the US and among major global blue chips racked up very heady gains. We have to turn the clock back 19 years to 1996 to see similar price gains, and that was in the midst of the US tech boom. Why have equity price advances far outpaced growth in either the economy or corporate earnings themselves?

We need to remember that the current is a very special and unprecedented economic and financial market cycle globally. Never have we witnessed the largesse of global central bank monetary expansion we see today across the major developed economies. We submit to you that central bank actions had a major impact on equity prices in the prior year. Understanding and monitoring that impact is critically important in the outlook for stock prices not only now, but as we move forward. To the point, global capital has been set in motion by these unprecedented actions. This, in conjunction with remembering just how meaningfully interrelated are global financial markets and economies, is key to the larger equation. Let's try to make some sense of what is occurring across the fabric of the global landscape and how this is impacting US stock prices.

In late 2012, Shinzo Abe was elected as Japanese Prime Minister, having run on a political platform advocating unlimited money printing in the hope of sparking accelerating economic growth. Since that time the value of the Japanese Yen has declined close to 25% against major global currencies. Important in that as a Japanese citizen whose net worth is denominated in Yen, one would have lost 25% of one's "global" purchasing power via currency debasement. To protect against this this type of currency related purchasing power loss, one would act to move money to another currency with less downside volatility such as the US dollar, attractive given that the US capital market is the deepest and broadest globally. How would this be accomplished? By purchasing US bonds, US stocks, real estate, or an actual business, a foreign investor can "buy" the dollar. In 2013, US bonds had a tough year. Moreover when contemplating buying an actual business, an investor is giving up liquidity. So you can see that US stocks and real estate (although real estate is likewise not instantaneously liquid) were an attractive destination for Yen based investment capital seeking protection against currency debasement in the home country. Are you staring to get the picture?

Although the European central bank has promised it will do "whatever it takes" to hold the Euro currency together and stimulate economic growth, little has been done in real terms to reconcile critical banking system issues currently compromising Euro area credit expansion and economic growth. Likewise, tax rates have risen, France being a poster child for this outcome. The International Monetary Fund has sent up a number of trial balloon remedy proposals for the Euro zone and the banking system specifically. One being a potential 10% one-time deposit tax inside the banking system. Another being a potential percentage of net worth wealth tax. In recent months we have seen a proposal from the European Central Bank for possible negative interest rates (yes, it would cost one money to maintain a bank deposit). Although none of these proposals have actually been enacted, they are the very definition of capital confiscation. Faced with even the potential for domestic capital confiscation what is the natural reaction of European capital in protecting itself? That's right, move. Move to a perceived safer destination out of the Eurozone. The natural destination for now being the US capital markets, the same destination target of Japanese capital looking to avoid currency debasement. Is this all starting to make some sense in explaining and understanding recent outcomes in US financial markets?

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Finally what is occurring in China is causing Yuan based capital to seek out safer environs. First, the economy is slowing as runaway credit acceleration is being reigned in. Global capital always seeks its highest and best use, and for now better returns are found abroad. More importantly and very much a long term positive, the current leadership is cracking down on corruption. Naturally the elite are moving their capital out of the country to escape potential confiscation as a result of this crackdown. Again, where to move capital? The default choice is the US dollar and US capital markets. As you know, we have seen Asian capital be a very meaningful participant in California real estate in recent years.

The key point being, we need to realize that at the current time, US GDP and corporate earnings growth are not the key drivers of US financial market outcomes and US stock prices specifically. Rather, the weight and movement of global capital is having very meaningful bearing on asset price outcomes. Yen, Euro and Yuan based capital is not moving to US dollar based assets because it is wildly optimistic or sees irresistible return potential, but is rather moving to US equities and real estate seeking safety. Seeking safety against home country currency debasement and potential confiscation. Seeking capital protection within a much greater global context. We suggest to you this is the key macro of the moment. In terms of equities, some of the safest balance sheets in the world can be found in major US and global blue chips, the exact assets experiencing meaningful price gains last year.

As investors looking to prudently allocate assets globally, a key exercise is identifying and monitoring the real drivers of asset prices at any point in time. In this manner we can not only participate in rewarding asset price movements, but much more importantly manage capital risk on an ongoing basis by tracking the correct macro variables driving asset prices at any point in time. It will not be this way indefinitely, but for now we need to understand and respect the weight and movement of global capital as being very important to US financial market outcomes. ■

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THE US INTEREST RATE OUTLOOK THE TAPER CHASE

Amidst the cacophony and white noise of the day-to-day we tend to place importance in decision making on what has happened over the recent past, sometimes to a fault. In the field of psychology, this is called “recency bias”. As investors this is a bias against which we need to guard as the only one guarantee we know of in the financial markets is change itself. So let’s step way back and first remember where we’ve come from in terms of interest rate levels. US interest rates in general have been declining for over three decades. From levels in the high teens, the 10 year US Treasury hit 1.45% in May of last year. We’ve become used to declining levels of rates as a trend. After three decades of reinforcement it’s easy to understand why. So here comes a very bold statement. Unless the US or global economy is set to experience a deflationary collapse or depression any time soon, we believe 2013 witnessed a generational nadir for US interest rates.

Does this mean interest rates are now headed for the sky? Of course not, at least not right away. Remember, it took three decades for interest rates to decline to this low point, and three decades prior to ascend from lows seen in the 1940’s to the highs of the late 1970’s and early 1980’s. In one sense, the history of the trend of US interest rate cycles have been generational bookends. Battleships move faster point-to-point.

What’s important to us at the moment is asking a few key questions very much germane to really all investments, but particularly important to US Treasuries and US interest rates right now. Just who will be the next buyer of US Treasuries and what interest level will they demand? The reason these are key questions relates directly to the US Fed’s quantitative easing of the last five years and quite necessarily to the “tapering” of Fed bond buying in recent months. Let’s set the stage just a bit with some historical context.

From the mid-1990’s to the middle part of the last decade, the two single largest buyers of US Treasuries on planet Earth were Japan and China. They were very much practicing a form of mercantilist economics. US consumers readily bought their exports, and in turn Japan and China accumulated Treasury bonds with these trade related proceeds, all with the intention of helping to push US interest rates ever lower to spark yet more credit driven consumption of their exports in the US.

Quite the elegant global recycling program. But all of that came to an end with the significant global economic downturn of 2007-2008. In the wake of the great global recession, the Fed decided economic stimulus would be delivered via their printing of money to buy US Treasury and mortgage backed bonds. Not only was this the expression of a direct intent to stimulate, but was important in that the Fed supplanted what was the former magnitude of Asian Treasury buying. Remember, in the absence of buying, prices go down. And in the world of bonds, that means interest rates go up.

But we all know that the Fed’s quantitative easing could not last forever. It was a program that necessarily delivered temporary and artificial results. The US Federal Reserve officially sets the Federal Funds rate (think money market interest rates). But the free markets set longer term interest rates necessarily via organic supply and demand for US Treasury bonds at any point in time. The Fed’s quantitative easing temporarily suspended a true free market environment for longer term interest rates for a time. But that time is now coming to an end as the Fed has earnestly begun to taper their bond purchasing activity. From $85 billion in monthly purchases in December of last year, the recent decision at the March FOMC meeting was yet a further step by step reduction to a current $55 billion. It is our thinking that by the end of this year, that number will fall to zero. The Fed is on a course to conclude the program of quantitative easing. Although the Fed now remains committed to keeping short term interest rates (the Fed Funds rate) low for a while longer, the recent consensus among Fed members is that short rates will be at 1% by late 2015 and 2% a year later. The battleship is turning, but slowly.

What this tells us as investors is that risks are present in bond investments. We need to be conscious of that and manage appropriately. The free ride of declining interest rates for three plus decades is over. Is the world about to come to an end for bond investors? Far from it, but as really in all investment activities, risk management now plays a key role in managing the bond component of investment portfolios ahead. Selectivity, and thinking in global terms will be important. The battleship that is US interest rates moves relatively slowly, but it’s clear to us it has made a decisive and perhaps generational turn. ■

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