

Investment Commentary—July 2013

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For several quarters we've believed the world economy was gradually reaccelerating after an extended lull. The lull set in around mid-2010 when a reasonably vigorous global recovery¹ from the financial crisis began to stumble, largely the result of a sovereign debt crisis centered in southern Europe that plunged the eurozone into a recession, triggering ripple effects across the globe.

Our view that the multi-year slowdown was ending rested on several premises. First, the U.S. private sector is picking up, due mainly to rapid increases in homebuilding. Second, we believed deceleration in China was coming to an end. Further, the contraction in Europe, though ongoing, appears a bit milder. Finally, Shinzo Abe's aggressive pro-growth policies in Japan offer the possibility of growth from a long-dormant source. We remain comfortable with three of these assumptions, but in China the bottom keeps slipping away, now apparently postponed until late in the year at best.

Recall that as part of a tightly choreographed change in leadership, Xi Jinping succeeded Hu Jintao as General Secretary of the Communist Party last fall. One of the challenges confronting Mr. Xi is an overreliance on infrastructure investment to sustain China's rapid economic growth. In the wake of the financial crisis, Mr. Hu initiated a huge amount of fiscal stimulus and loosened credit. Again last fall, prior to the transition in power, officials announced a new, smaller wave, of infrastructure spending and continued to provide easy credit to the banking system. Concerns have been building that the bulk of stimulus spending over the last several years has been unproductive, leading to vast tracts of empty apartment buildings and piles of loans that will eventually sour. Xi hinted early in his tenure that he would address these excesses when he launched a vigorous anti-corruption campaign aimed at provincial officials who for years have siphoned off construction funds to support lavish lifestyles.

In late June Xi's laudable efforts to rein in excesses created turmoil in Chinese financial markets. Officials have been particularly concerned that the rise of a shadow banking system is fueling a property bubble. With fears of a bubble in mind the People's Bank of China tightened credit and rates on interbank loans surged. After a few days, the PBOC offered soothing words, but Xi's determination to tamp down overheated property markets and his willingness, if necessary, to tolerate prolonged weakness—to the extent that GDP growth in the range of 7% can be called such—is unmistakable.

¹ Note the word global. Although the recovery in the U.S. has not at any point been vigorous, the pace of global GDP growth in 2009 was pretty robust thanks to China and other emerging markets.

As markets were dealing with tightening in Beijing, a more tentative and nuanced tap on the brakes from the U.S. Federal Reserve Board wreaked havoc with bond markets in the U.S. and elsewhere. Last December, chairman Ben Bernanke linked an increase in the federal funds rate to specific targets for unemployment and inflation, stating that exceptionally low rates (i.e. the current target of 0 to 0.25%) would continue until unemployment reaches 6.5% or inflation expectations exceed 2.5%. While clarifying when the fed funds rate would begin to increase, he left open the question of when the latest round of bond purchases (QE3) would end or even begin to taper off. As this tapering will demarcate a transition from monetary easing to the very first steps in monetary tightening², the matter is delicate. And, as it turns out, the initial communication with capital markets on the subject was rather disruptive.

Trouble in the bond market began on May 22nd when Bernanke indicated to the congressional Joint Economic Committee that if faced with evidence of sustained economic growth the Fed might cut the pace of bond purchases at one of the next few meetings. No rational bond investor with a calendar should have been surprised. Bernanke had already signaled that an increase in the federal funds rate was likely to begin in about two years. Presumably QE3 would have to end well before that and assuming, as is only reasonable, that the Fed would prefer a very gradual wind down of bond purchases, tapering would have to begin well before the end of QE3. Nonetheless, Bernanke's testimony triggered a selloff in the bond market. The carnage continued when he indicated at a June press conference that tapering would begin by year-end if the U.S. economy performs in line with the Fed forecast. The behavior of the bond market was typical for the end of a bull market. Investors in an aging bull know that good times will be ending soon but reassure themselves that they can and will get out just before everything turns south. But relying on your ability to get out in time makes you hypersensitive to what everyone else is thinking. Bond investors surely knew that tapering of bond purchases was in the offing but figured as long as no one said it out loud, everything would be ok. When Bernanke gave voice to the obvious, everyone rushed for the exits sending the yield on the benchmark 10-year Treasury up over 70 basis points (0.7%) in six weeks.

If the premise of QE3 was that lower interest rates would spur the economy, it stands to reason that the sharp rise in rates will dampen growth. On the margins this is surely true, but we're sanguine nonetheless. Most importantly—and we know we're a broken record on this subject—homebuilding bottomed in 2011 and took off last year. In spite of rapid increases over the last eighteen months, housing starts remain, for the sixth straight year, dramatically below long term averages. If we haven't fully worked off the glut of housing built during the boom, we're very close to it and homebuilding is likely to be a major engine of economic growth for several years to come. Rising mortgage rates certainly don't help potential homebuyers, but even with thirty-year mortgages over four percent, affordability, as measured by the ratio of monthly mortgage payments to income for example, remain very high by historical standards. And while less

² Technically, as Bernanke observed, the Fed will still be easing when tapering starts as any level of bond buying constitutes an effort to lower rates. But for all practical purposes the starter's pistol on a lengthy round of tightening will have sounded.

significant than the impact of homebuilding, those rising home prices also benefit the economy by making consumers feel a bit wealthier.

Right now much of the economic lift from housing is being offset by fiscal contraction—specifically the lingering effects of the January 1 increase in the federal payroll tax (back to rates that prevailed prior to Jan. 1, 2011) and the still growing impact of the so-called sequester, a sharp cut in federal spending mandated by the 2011 debt-ceiling deal. By the fourth quarter the effects of this fiscal contraction on GDP will be waning³. One quarter ago we noted that most economic indicators softened in early April. Data continued to weaken for another month or so but seem now to have stabilized. Most encouraging, the June employment report indicating that job creation is running at a pretty respectable clip of 200,000 per month (although it should be noted that the quality of the jobs could have been better). The Fed's own economic forecast—the one on which the expectation of tapering is based—implies GDP growth in the second half around 3%. That seems optimistic but we do seem to be headed in that direction as the impact of fiscal contraction lessens later in the year. None of which is to say that the U.S. economy is certain to break out of the stubborn pattern of 2% GDP growth that has prevailed for several years. But if we don't, that's much more likely to be the result of weakness overseas and/or a stronger dollar hurting exports rather than the domestic impact of rising rates.

Although Bernanke has given no hint of it, he, like counterparts in Beijing, may have had his eye on asset bubbles. Bond prices have been sky high for some time and in the last few quarters ominous signs of bubble behavior accumulated. In the high yield bond and loan markets, for example, spreads had gotten very tight, and terms and conditions had become extremely favorable for borrowers. That sort of thing tends not to end well, and if the Fed wanted to nip it in the bud, more power to them. All in all, we view the actions of regulators in Washington and Beijing positively, even if it causes some short-term pain. Fair warning: given the massive amount of stimulus—monetary in the U.S., fiscal in China--that has been applied over the last several years, the process of weaning the patient off the medication will be lengthy and further disruptions should be anticipated.

Until conditions in China stabilize we'd expect global economic growth to be roughly flat at around 3%, and for the time being we'll put talk of reacceleration aside. From a bigger picture perspective though, the fact that authorities have the confidence to focus on exit strategies is healthy and good news for long-term equities investors, even if it is, on occasion, nerve-wracking.

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Boston, MA*

³ The fiscal drag has been very significant of late. JP Morgan Chase estimated recently that federal tax and spending policies will lower 2013 U.S. GDP by 1.8 percentage points —so even if growth clocks in at an unexciting 2.0% this year, that would suggest a very healthy private sector.