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Investment Commentary—October 2014

Three months ago in these pages we offered two scenarios for the stock market. If the U.S. economic recovery continues to chug along at a modest 2% or so, as it has for the last five years, the economic foundation of the bull market is intact: tepid growth, high profit margins, low interest rates. If, however, GDP moves into a higher gear and job creation continues to accelerate, then, we cautioned, interest rates could begin to climb rapidly and the stock market could suffer some indigestion. So, which is it? Are the bond bulls right--the recovery will limp along and interest rates will remain low for the foreseeable future? Or do the bond bears have the better crystal ball—the recovery will accelerate and rising rates are around the bend[1]?

GDP statistics have been confusing, with an annualized decline of 2.1% in Q1 followed by a strong 4.6% in Q2. This data was muddied by the severe winter weather and some unusual zigs and zags in healthcare spending. The ISM (Institute of Supply Management) indices provide a clearer picture. These indices, which combine data such as new orders, sales/shipments, employment and so forth, have been *nearly as strong over the last six months as they have been at any time over the last twenty years*. ISM tracks the manufacturing and services sectors separately, but Goldman Sachs's economic team does us the favor of tracking the same type of data in a single index. With a reading of 50 suggesting trend growth[2], the Goldman Sachs Analyst Index has averaged 60.3 year to date after averaging 44.9 in 2012 and 49.9 in 2013. This suggests underlying growth in the economy is running at or above 3.0%, noticeably stronger than the roughly 2.0% pace that has characterized the recovery thus far[3].

If the economy has moved from a somewhat lackluster 2.0% pace to a more robust 3.0% or so, then the recovery is accelerating and the bond bears carry the day, right? Maybe, maybe not. Certainly if the bond bears are winning the debate, they have nothing to show for it in their bond portfolios. With the yield on the benchmark 10-year Treasury declining from 3.04% at the beginning of the year to 2.52% at the end of the third quarter, the bond market appears to be siding with the bond bulls. Why is that happening if the U.S.

[1] If you're wondering why this essay—ostensibly about the stock market--would focus on a bond market debate, welcome to the world of incipient Fed tightening, where the precise timing and course of the Fed's transition away from monetary stimulus becomes all important across capital markets.

[2] To be more specific, Goldman instructs us that "a reading above 50 theoretically signals growth while an index level below 50 signals contraction. However, our analysis suggests that a GSAI of 50 appears more consistent with trend growth than no growth." Trend growth in this context refers to the rate at which the U.S. economy is likely to grow over a full economic cycle—currently that would be something like 2.5%.

[3] Not to mention that initial jobless claims (as measured by a four-week rolling average) are within a whisker of a fourteen-year low and job openings have been surging.

economy is so strong? The answer appears to lie across the Atlantic. Over the last year or so the European economy seemed to be turning a corner, but recent data casts doubt on that notion. And fears of a triple-dip recession over there have caused interest rates to fall significantly over here. Before we get to that though, let's consider an argument one hears from the bond bulls –that the U.S. economy remains overleveraged and therefore susceptible to persistent weakness.

Leading up to the financial crisis, businesses, especially financial services companies, and consumers, especially homeowners, took on way more debt than their earning power and balance sheets could sustain. In a typical recession, a reversal of consumer and business psychology can resuscitate "animal spirits" almost overnight—boom can quickly follow bust. It's different when a debt bubble bursts. Credit dries up and overextended borrowers are forced by newly cautious lenders to rein in spending and repair their balance sheets. That deleveraging process takes a great deal of time and has contributed to a lackluster recovery. Despite being six years into the deleveraging process, pessimists on the economy are quick to point out that debt ratios are still quite high by historical standards and much of the excess debt has simply been shifted from financial services firms and consumers to the federal government. All true, but there are two key points to bear in mind.

First, consumer balance sheets are just that. And balance sheets have assets in addition to liabilities. On the liability side, things have improved but, yes, the mountain of debt remains substantial. After peaking at 134% of disposable income in 2007, household debt has been whittled to an improved but not optimal 107%. But look at household net worth, i.e. assets minus liabilities, as a percentage of GDP. That is at an all-time record high. Sure, a somewhat lofty stock market is inflating wealth, but no more so (in fact, considerably less so we would argue) than it was inflated by the housing bubble circa 2008 or by the bubble in tech stocks circa 1999. In aggregate, household balance sheets are in pretty good shape. Is that skewed toward the more affluent among us? Absolutely. But so is consumer spending, with the first quintile and the first two quintiles accounting for nearly 40% and over 60%, respectively.

The other key point is that while a lot of debt was transferred from households to the federal government, *that piper has already been paid*. The U.S. Treasury reports that the fiscal 2014 deficit was 2.8% of GDP. That is down dramatically from 9.8% of GDP five years ago. As Paul Krugman has repeatedly pointed out, a rapidly plunging deficit has been one of the primary reasons for the subpar recovery. But that is in the past. No one is expecting the deficit to materially shrink further.

So we're not buying the idea that excess leverage continues to be an albatross around the neck of the U.S. economy. Unfortunately though, the economic picture outside of the U.S. is less rosy. China continues to come to grips with an unbalanced economy that relies too much on infrastructure investment and not enough on consumer spending. The result is a very gradual deceleration of GDP growth. Meantime Japan saw a dramatic economic contraction in the second quarter as a long-anticipated increase in the Japanese consumption tax kicked in. Still, the story in China is old and the one in Japan well-anticipated. It is the slowdown in Europe that took capital markets by surprise.

Three months ago the euro zone appeared to be gradually recovering from a double-dip recession brought on by the sovereign debt crisis in southern Europe and ensuing fears of a collapse of the euro. European central bank chief Mario Draghi famously assured investors in the summer of 2012 that the bank would do "whatever it takes" to preserve the currency union. Some semblance of confidence was restored and economic growth in Europe gradually accelerated with year-over-year GDP growth improving for five straight quarters. Until the disappointing second quarter numbers came in showing anemic overall growth and a slight but surprising contraction in Germany. As the huge swing in U.S. GDP from Q1 to Q2 (-2.1% to +4.6%) showed, GDP can bounce around for any number of reasons. Is the drop in Europe from 2.4% to 0.7% really that big of a deal? Perhaps not, but there are several important reasons the numbers set many investors on edge.

Most importantly, and putting it impolitely, Europe is still a mess. Greece, Italy and other countries still struggle with enormous government debt. Inflation-phobic Germans continue to insist on counterproductive austerity. And six years after the financial crisis European regulators have yet to force banks onto sounder footing. As if these problems weren't sufficient, there are psychological factors at work as well. Soothing as it was to hear that Mario Draghi will do whatever it takes, suspicions lurk that the European Central Bank may someday run out of tricks. Further, with Vladimir Putin riding a surge of Russian nationalism that is hard for many investors to comprehend much less predict, the possibility of further fallout from Ukraine lingers.

And beyond all of that lies the threat of deflation. The debate in the U.S. is whether inflation will remain subdued or will soon begin to pick up. The question is quite different in Europe where core inflation has steadily ticked down over the last two years, from around 1.4% to 0.8%. Several countries in Europe are experiencing outright deflation (negative inflation). If it takes hold in the euro zone overall, several problems would ensue. First, the chances of a triple-dip recession would increase and it could be a nasty one. Falling prices encourage consumers to postpone large purchases, knowing that their euro will go farther next week, next month or next year. In addition, deflation would wreak havoc with governments burdened by excess debt. Just as debtors benefit from inflation as they are able to pay off old debts with less valuable currency, they suffer when deflation forces them to pay off loans with more valuable currency. Finally, there is the risk that deflation and ensuing economic problems would be exported to the U.S. and elsewhere.

While deflation in Europe is a significant and valid concern, on balance we don't expect it to take hold. For starters, the euro has fallen dramatically in the last six months, down eight percent against the dollar in that time. A cheaper euro not only benefits European exporters but also makes imported goods more expensive, providing a boost to inflation. In addition, when Mario Draghi spoke about doing whatever it takes, one thing he certainly had in mind was the threat of deflation. While having to answer to eighteen central bankers from member countries, most notably the head of the Bundesbank, complicates matters, we expect that in the end Draghi will be able to do what it takes and create a bit more inflation in Europe. Which isn't to say that Europe's problems will be solved. Far from it. But our baseline assumption is that Europe will muddle along in the coming years.

Greece and Italy will probably remain and become wards of the union respectively, although Spain and Portugal may, as Ireland already has, get their houses in order. The European economy will grow at glacial speed, held back by needless austerity and a problematic banking system. Most importantly though for U.S. investors, just as Japan's seemingly endless economic quagmire has not held the global economy captive, we expect that Europe's woes will, to some degree, fade into the background as the years go by.

If we're right and Europe is able to fend off the specter of deflation, what then for U.S. stocks? We come back to the impressive strength of the U.S. economy. To repeat what we noted earlier, the ISM indices, which tend to provide a pretty accurate picture of the underlying health of the economy, have been nearly as strong over the last six months as they have been at any time over the last twenty years. It may not feel that way as we digest the latest news on Ebola and ISIS, but them's the facts. Absent widespread deflation in Europe or an external shock of that magnitude, our guess is that a strong U.S. economy leads to accelerating wage inflation at some point next year, forcing the Fed to play catch-up with interest rates. Ironically, we are in the midst right now of some stock market turmoil based on fears that weakness in China and Europe will drag the U.S. economy down. That seems unlikely to us. In fact, we suspect that at some point in the next twelve months investors will be preoccupied with the worry that a too-strong job market will lead to inflation and aggressive Fed tightening.

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