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Market Commentary
Byron Wien

Getting to Tomorrow
March 2014

We started off the year with a scare from the emerging markets. The Argentine peso was devalued by more than 20%, but other currencies in the developing world had declined sharply as well. Equities in these countries fell also, with many markets down 10% or more. In the developed world equities declined about 5%, but in Japan fell twice that. At the beginning of the year I feared a sell-off and when people asked me why, I fumbled for a credible answer. My thinking was that sentiment was much too optimistic. Everyone had made money in the stock market in 2013, although few had done as well as the Standard & Poor's 500. People were generally positive about the outlook for 2014 and there was a background of complacency. When these conditions prevail, something always comes along to shake confidence. It is just hard to see what it is going to be in advance.

I continue to be constructive on equities and expect the economy in the United States to expand by more than the 1.9% real growth rate reported for 2013. What worries me overall is the nature of the policy responses I see across the world. Almost every leader seems to be pursuing a policy program likely to produce favorable results in the short term, but possibly creating more serious problems later on. There is a widespread unwillingness to make the hard choices. No leader appears to be willing to take the political risk that may be involved in dealing with the fundamental problems facing his or her country. Perhaps for many it is extraordinarily difficult to implement programs targeted to long-term goals. While the immediate conditions may not be favorable for the financial markets, the current policies may have less positive long-term implications.

Let's start with Japan. Shinzo Abe's first two arrows – fiscal stimulus and monetary expansion – are clearly working. The deflationary recession has ended and the economy is growing. The third arrow – dismantling regulation and producing sustainable growth – is proving harder to achieve. In the meantime the aging population grows larger and the work force is reaching a peak. This could be countered by implementing a liberal immigration policy, but the country has no appetite for that. At some point the stimulative programs will have to be scaled back and the question is: will the economy have developed enough natural momentum by that time to continue to grow? Concern about that may be the principal factor behind the recent sell-off.

In China, the Third Plenum in November outlined a plan by the new leaders, Xi and Li, to reduce corruption and rebalance the economy. Growth had been moving along at a 7+% real rate but that was largely a result of the generous credit provided by the banking and shadow banking system. The government's objective is to reduce spending on investment-sensitive projects like infrastructure and state-owned enterprises from 45% of GDP to 35% and increase the consumer component from 35% to 45%. The latter balance existed before leadership in the 1990s decided to invest in state-owned businesses that would produce goods for export, thereby increasing foreign exchange reserves. The government also made investments in infrastructure that would make China more competitive globally

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and pave the way for growth. The problem with trying to become more of a consumer economy is that growth is likely to slow down as investment is reduced. Some economists focusing on China think it might even drop to a level of 4%. This would create both political and social problems since fewer higher-paying industrial jobs would be created and the migration from the countryside to the city would slow. The question is whether the new leaders have the will to push through this rebalancing, which is clearly in China's long-term interest but is likely to create some short-term unrest.

In Europe it would appear that progress is being made. Two years ago we were all wondering whether the European Union would endure and whether the euro would continue as the continent's basic currency. Today, having seen the Union survive sovereign debt crises in Italy, Spain, Portugal and Greece, most observers feel the worst is over. While Europe may move from a modest recession over the past few years to some growth in 2014, the debt problems are far from being resolved. Moreover, the European Union has a structure that is unlikely to be sustainable over the long term. You cannot have a common currency without some form of fiscal convergence, and little progress has been made on that. A banking union, for example, has been on the table for several years without an agreement having been signed. There is still no formal way to ensure fiscal discipline among European Union members. There seems to be a belief that Europe can "muddle through" for eternity.

Here in the United States we are celebrating the drop in the unemployment rate to below 7%, but the participation rate is only 63%. If it were 66%, as it was in the years before the 2008-9 financial crises, the unemployment rate would return to double digits. As far back as 1980, policy makers failed to recognize that two factors – globalization and technology – would have a negative impact on employment. Manufacturing would continue to move to low-labor-cost areas abroad and technology would enable us to produce goods and provide services domestically with fewer workers. At this point we have the resources to alleviate this problem. We are on the way to reducing the budget deficit from $1.5 trillion, or 10% of GDP, in 2010 to $450 billion, or less than 3%, now. We could invest where funds are badly needed: infrastructure (maintenance has been deferred for two decades), job retraining (we have 4 million job openings but most of the applicants lack the technical skills needed to qualify for them) and research and development (as a high-cost producer, it is only through innovation that we can produce the must-have products that can compete effectively in world markets). Congress, however, is not willing to approve budget increases to support these programs. We have not even been able to pass legislation on gun control and immigration, where there is agreement by many members of both parties (as well as the general public) that changes must be made. If we cannot get that done, remedial steps to sustain the long-term growth of the economy are unlikely to be taken. None of this is new, but these issues recede from investor consciousness as long as the economic and market performance are favorable.

The decline in the indexes in January has unsettled some investors who are students of market history. Since 1950 (according to Strategas Research), there have been 24 instances of a January decline. The full-year return in those years has been a negative 4% with the median a negative 4.8%, but the market had a positive return in 46% of those instances, so I am not backing away from my favorable outlook for the year. As is often the case, the fundamental background deteriorated somewhat along with the market. Much of this was blamed on the bad weather. Retail sales declined by .4% in January, the most in ten months. The weather discouraged shoppers from buying anything but cold weather gear. Auto and appliance sales were particularly hard hit. Weak consumer sales have caused some economists to revise their forecasts for first quarter real growth to 2% or below. They may be right, but I still expect the economy to pick up later in the year, with the full year coming in at 3% or above. Contributing to the view that the economy is softening was the sharp decline in the Institute of Supply Management (ISM) factory index for January, which dropped from 55 to 51, close to the level (50) which indicates the manufacturing sector is no longer expanding. I think weather may have had something to do with this also and believe we will see stronger data later in the year. A study by Bianco Research shows that the correlation between the ISM factory index and GDP has declined sharply in this cycle. The ISM index for non-manufacturing was 54 in January, only a slight uptick, but services are much more important to overall growth.

The payroll report was disappointing for both December and January. Weather was blamed for the weak January report but Bianco Research reported that only 262,000 people were out of work because of weather in January, well below the January weather-related out-of-work average of 415,000. The increase in construction jobs also supports the view that weather played less of a role in the employment

report than generally assumed. The big problem in unemployment is the share of workers with a part-time job who would like to be at it full-time. This has declined from over 17% of the work force to 13%, but it is still higher than the peak of 10% in 2003. Jobless claims are also higher, but vehicle production and industrial production data generally are favorable. If it ever stops snowing, the tone of the economy should improve.

I was recently at a small dinner with some Nobel Prize–winning economists, one of whom was complaining about the low level of productivity in the U.S. economy. The year-over-year productivity number for the U.S. economy for 2013 was 1.7%, but the fourth quarter number was stronger at 3.2%. Productivity had reached 4% in 2010 as the economy recovered from the recession. It usually peaks around that level. When the recession ended, companies had considerable cash on their balance sheets and, in many cases, they used that money to buy capital equipment to enable them to manufacture the products or provide the services with fewer workers. That is the key reason why profitability has improved so dramatically in this cycle while wages have remained essentially flat. We may have reached the point where additional equipment does not have a significant incremental benefit. Capital equipment purchases soared at the end of the recession in 2009 as companies bought this labor-saving equipment, but leveled off in the 2010-11 period and declined year-over-year in 2012. They have picked up in the past year, but are still below the immediate post-recession level. We do know that few new plants have been built. With operating rates at 79%, manufacturers have the capacity to meet the level of current demand without constructing new facilities. A significant pick-up in new orders could change that, but that is not in sight at this point.

An insight into when that is likely to happen may be gleaned from bank credit. Borrowing surged after the recession ended in 2009 but peaked at the beginning of 2012 and began trending down on a year-over-year, but still positive, basis. This is true of commercial and industrial loans as well as loans to consumers. This is something to watch because an improvement in lending activity would not only indicate a more confident outlook, but the possibility of further declines in the unemployment rate.

There has been some good news recently, however. Congress increased the debt ceiling without the threat of a government shutdown. The Republicans know they would be blamed for a disruption of services and payments and they want to avoid that in an election year. They believe they have a lot going for them with the disastrous start to the Affordable Care Act last October and cost problems associated with that legislation for both consumers and the government. The big hope for the Republicans is that they will gain control of the Senate. Looking at mid-term elections back to 1918, the average loss of Senate seats by the President's party in the sixth year of his term is six, which would shift control to the Republicans if it happens this year. However, an analysis of the likely outcome in November by a responsible Washington observer group shows that of the 34 seats up for election, 16 are likely to go to Democrats and 16 to Republicans. Only two are uncertain, so a shift in Senate control is a long shot. There also may be some relationship between a market correction this year and the mid-term election, according to a Strategas study. There has been a serious correction, generally more than 10%, in every mid-term election year back to 1962. That's the bad news. But a year later the market has done well in every instance. In eight of the 13 examples, the recovery has been more than 30%.

Finally, the recent economic reports coming out of China are positive, which benefits all the countries that do business there. Let's hope that encourages the leadership to pursue the rebalancing program and that they set an example for others. And since everyone is down on the emerging markets now, it may be time to take a hard look at some of them. Also, Europe, surprisingly, had growth in the fourth quarter and I believe there are some opportunities there.

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