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Economic Review & Investment Strategy: 2015/III

We're Not Surprised

Two stories are dominating market news at the moment: Greece's high-stakes debt standoff and potential exit from the Euro, and the sharp sell-off in China's (until now) high-flying stock market. In recent weeks, the daily shifts in fortune in Greece and China have contributed to volatile ups and downs in U.S. and other markets around the globe. From our perspective, however, neither of these developments comes as a particular surprise, or significantly alters our view of investing.

For some time, we have warned that all is not well with Europe. Debt burdens and unemployment rates are actually higher now than at the peak of the Euro crisis in 2010. Some countries (Spain, Portugal) have implemented meaningful tax and labor market reforms, but others (Italy, France) have dragged their feet, and the Eurozone looks almost entirely to external demand—including a widening trade surplus with the United States—to drive growth. The inherent restrictions of a single currency severely limit the options available for fixing Europe's imbalances—between savings and consumption, supply and demand—in a constructive way. The meltdown in Greece is just the most extreme eruption of a set of deeper issues that is dragging down (in less dramatic ways) on the Eurozone economy as a whole.

The implication is not that investors should avoid Europe, but that they should temper some of the unalloyed enthusiasm that accompanied the announcement of the ECB's QE bond-buying program earlier this year. Through early April, the Euro Stoxx 50 index rose +21.7%. It has since fallen -10.7%, and many of its early gains were both driven and diluted by a falling currency. A U.S. investor who did not protect against this currency risk would have seen just +0.4% in dollar gains at mid-year, hardly better than the S&P 500 (+0.2%). Selective investment in European shares based on fundamentals might have done better, and there is sound sense in diversification, but Europe's equity markets have not outperformed in real terms as much as newspaper headlines this year might suggest.

For months now, we have been quite vocal in warning about the risks posed by the steep and unjustified run-up in mainland Chinese share prices. Those prices nearly tripled over a 12-month period where the Chinese economy and corporate earnings were clearly deteriorating, fueled by a four-fold explosion in margin lending to 12% of the market's total float and 3.5% of GDP—according to Goldman Sachs, "both easily the highest in the history of global stock markets." The result, near its peak, was a median valuation of 85x earnings. We said it would end in tears, and it has, with the Shanghai Composite index plummeting -27.9% in a few short weeks, despite desperate (and reckless) government attempts to prop up prices. We believe it

could fall much farther, possibly erasing all of the past 12 months' gains, in a gut-wrenching replay of China's 2007 stock market bubble.

We also believe, however, that the bursting of China's latest stock market bubble is more a symptom of the country's economic troubles than a cause. An economic downturn in China isn't a new risk, it's a process that is already well underway, one that has been part of our strategic view for some time. China is undergoing a wrenching adjustment from one kind of growth model (based on exports and investment) to another (based on domestic consumption) which will produce winners and losers, both inside and outside of China. The speculative stock-buying frenzy of the past several months, and the temptation (and pressure) to jump aboard, was a distraction from the sounder strategy of capitalizing on these more lasting and significant trends.

Idle Speculation

No matter what part of the world we're talking about, productivity is the key to an economy's future prosperity. That's why many economists are concerned about U.S. labor productivity growth, which has lagged in recent years. They worry that this trend reflects a decline in innovation, and bodes poorly for future growth. We think there is another, more encouraging explanation: the economy is in rehiring mode.

"Labor productivity" measures output per hour worked, in the for-profit business sector. That's a good way to measure how productive actual workers are, with important consequences for wages and profits. At any moment, though, there are many people in the economy who aren't working for businesses, either by choice or because they can't find a job. To tell how productive the whole economy is, it's really better to look at output per person, or real GDP per capita.

A simple story can illustrate. Imagine a fisherman, Homer, with a wife Marge and a son named Bart. In a 10-hour fishing trip, Homer can catch 10 fish. Bart is less skilled at fishing: he can only catch half as many fish per trip (Marge stays at home, where she has more important fish to fry). If Homer goes out alone in his boat, and leaves Bart to spend his day staring at the sea, the family's labor productivity is 1.0 fish per hour actually worked, and each family member will get to eat 3.3 fish. If he takes Bart along, the family will catch 15 fish for 20 hours worked between them. Their labor productivity falls to 0.75 fish per hour, but their total output rises to 5 fish per person. The family is better off, because Bart's (admittedly less productive) hours are no longer going to waste.

In the 2nd quarter of 2009, just as the U.S. economy was taking a nosedive, labor productivity shot up at an annual rate of +7.9%. This wasn't a sudden burst of healthy innovation; it was hard-pressed businesses tightening their belts by laying off their less-productive workers. That year, labor productivity rose +3.2%, the highest rate since 2000, but real GDP per capita fell -3.7%, the worst since the Great Depression, as a large number of *potential* labor hours were literally *unemployed*. What was great for productivity statistics was terrible for the economy.

Over the past few years, employers have steadily hired back many of the people who were let go. Output rose, but so did hours worked. Bringing less productive workers back into the workforce—some of them in less skilled jobs than before—may have kept "labor productivity" (output/hours worked) flat, but it was a far more productive use of available resources than leaving them unemployed. Since 2010, U.S. labor productivity has risen just +2.8%, but real GDP per capita has risen twice that (+5.6%). In the absence of real wage gains (due to high unemployment) or consumers taking on more debt, the steady recovery in the number of people earning paychecks has been a key driver of consumption growth. What was "bad" for productivity statistics was good for the economy.[*]

We don't want to overstate our case, and imply that things couldn't be better. Recent labor productivity gains have been notably slower than prior U.S. recoveries—possibly because the initial job cuts were so much deeper (6.5% of the workforce) than in prior recessions. Still, this recovery has been a sluggish one, even measured by per capita GDP. And ultimately, the economy's health does depend on increasing the value that each one of us can generate in an hour, a day, or a year. But proclaiming "the death of innovation", with all its dire consequences for the future, while the U.S. is still playing catch-up on employment, strikes us as idle speculation—or rather, speculation that ignores the unmeasured cost of idled workers.

Keeping Our Balance

Given all the uncertainty roiling global markets right now, the U.S. economy is proving quite resilient. All three of the headwinds that damaged growth in Q1—the strong dollar, the collapse in oil prices, and consumer hesitation—have either stabilized or improved, and the economy appears on track to grow by at least +2.2% in Q2.

Consumption, in particular, has come back strong. Retail sales surged +1.2% from April to May, compared with a disappointing +0.2% in April. Even setting aside higher gasoline prices and record car-buying, sales grew by a solid +0.7%. Auto sales reached an annual rate of 17.2 million in June, down from a super-strong May but still very robust. Both leading consumer sentiment surveys (University of Michigan and the Conference Board) show confidence returning close to post-crisis highs in June. The economy added 223,000 more jobs in June, continuing the steady pace of hiring that, as we mentioned, has been key to driving consumption growth.

The U.S. housing market is also seeing a rebound, after a lackluster patch last year. Existing home sales in May were up +5.2% from April and +9.2% from a year ago, and prices were up +7.9% from the year before. New home sales rose +2.2% in May, on top of a strong April, up +19.5% from the year before. New housing starts fell -11.1% from an astonishing +22.1% surge in April, but were still up +5.1% from a year ago. Construction spending rose a solid +0.8% in May, up +8.2% from the year before.

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[*] In the first quarter of this year, GDP fell -0.2%, while jobs rose by 586,000. As a result, labor productivity fell by -3.1%. Would it *really* have been better for the economy if jobs had fallen as well?

Manufacturing is the weak spot at the moment. Industrial production fell -0.2% in May, on top of a -0.5% decline in April. Durable goods orders fell -2.2% in May (on top of a -1.7% decline in April), down -3.0% from a year ago. New orders for energy equipment, in particular, took a big hit, down -22.2% from April to May. The ISM Manufacturing survey offers some hope of a turnaround, rising from 52.8 in April to 53.5 in May. The sub-indices for employment and new orders were strong, but new export orders fell into contraction territory (49.5), suggesting continued headwinds from a strong dollar and slower growth abroad.

Virtually every major equity index around the world lost ground in June, with the exception of unhappy Brazil, still down -10.4% year-to-date. The other, happier exception was the small-cap Russell 2000, up +0.4% in June. In our last quarterly note, we observed that the environment "for the first time in a while, favors small-cap stocks, which are less exposed to currency movements and should benefit from increased M&A activity." This indeed proved to be true, with the Russell 2000 up +4.1% year-to-date, outperforming both the S&P 500 (+0.2%) and DJIA (-1.1%).

Over the past few months, we cautioned that U.S. large-cap equity valuations had become a bit stretched by poor earnings performance in 4Q14 and 1Q15, and could see a short-term correction. June's -2.1% decline in the S&P 500 index relieved some of that overhang, reducing the 12-month trailing P/E ratio from 18.9x to 18.6x operating earnings. Operating earnings per share (EPS) will have to meet expectations and recover by 10% in Q2 and another 5% in Q3 just to keep these elevated multiples from expanding much further. For all the good news in the U.S. economy, much of it seems to have already been priced into the market.

With this in mind, we reiterate the two guiding strategies that we have mentioned before: (1) greater diversification among markets; and (2) greater selectivity within markets. With waves tossing to and fro, this is not a market where you want to lose your balance.

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ECONOMIC FORECAST

(As of July 7, 2015)

	2013	2014	Estimated 2015	Projected 2016
Real GDP (Y-O-Y)	2.2%	2.4%	2.4%	3.0%
Consumption Expenditures	2.4%	2.5%	2.5%	2.5%
Business Fixed Investment	3.0%	6.3%	4.0%	6.0%
Inventory Investment (Billions)	$63.5	$70.6	$80.0	$55.0
Residential Investment	11.9%	1.6%	7.0%	10.0%
Government Spending * (Billions) (a)	$2,894.5	$2,889.7	$2,920.0	$2,950.0
Trade Balance-Goods & Services (Bil.)	($478.4)	($508.3)	($530.0)	($480.0)
Federal Budget*: Unified (Billions)	($679.5)	($484.6)	($486.0)	($455.0)
Gross Federal Debt* (Billions)	$16,719	$17,794	$18,486	$19,127
Consumption Price Deflator	1.2%	1.3%	0.5%	2.3%
Producer Price Index (Finished Goods)	1.2%	1.9%	(3.0%)	1.6%
Consumer Price Index	1.5%	1.6%	1.0%	2.4%
Industrial Production	2.9%	4.2%	2.5%	4.0%
Real Disposable Income	(0.2%)	2.5%	2.9%	3.2%
Hourly Compensation	1.1%	2.6%	2.7%	3.0%
Unit Labor Cost (Non-Farm)	0.3%	1.8%	2.0%	2.5%
Productivity Growth (Non-Farm)	0.9%	0.7%	0.5%	1.5%
Personal Savings Rate (% DPI)	4.9%	4.9%	5.0%	5.0%
Capacity Utilization – Total Industry	78.0%	79.1%	78.5%	79.5%
Trade Weighted $ Exchange Rate (b)	3.3%	3.3%	1.5%	0.5%
Vehicle Sales (Million Units)	15.9	16.8	17.2	17.0
Housing Starts (Million Units)	0.925	1.003	1.180	1.350
Civilian Employment (Millions)	143.9	146.3	149.0	151.7
Civilian Unemployment Rate	7.4%	6.2%	5.3%	5.0%
Corporate Profits – After Tax	4.7%	3.8%	3.0%	4.0%
S&P-500 Earnings-Operating	$107.30	$113.01	$113.50	$119.18
S&P-500 Dividends	$34.99	$39.44	$43.00	$47.00
90 Day U.S. Treasuries-Yield (%)	0.02-0.12	0.01-0.08	0.01-0.90	0.90-2.40
10-Year U.S. Treasuries-Yield (%)	1.55-3.00	2.07-3.01	1.90-3.40	2.40-4.50

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2005 dollars; (b) Fed Major Currency Exchange Rate.*