Q2 2013 Commentary

"If you are not confused about the economy, you don't understand it very well."

Charlie Munger, Vice-Chairman Berkshire Hathaway

We know of no monetary policy that has been so controversial and hotly debated as the interventionist policies as practiced in the most recent four years by Ben Bernanke and the Federal Reserve. Quantitative easing was first introduced in late 2008 during the worst of the financial crisis to support and correct a market failure. The Fed desired to lower interest rates (via the outright purchase of Treasury Bonds and Mortgage Backed Securities) and increase the availability of credit for homebuyers to help support the housing market and improve financial market conditions. With conventional monetary policy already moving interest rates near the zero bound, the risk of a liquidity trap was paramount. A student of the Great Depression, Bernanke may have feared a deflationary spiral such as that which had enveloped Japan for over two decades. Though necessary in arresting a greater downturn in the economy and stabilizing the financial system, this first bout of QE was not sufficient to spur economic growth.

Subsequent rounds of quantitative easing have targeted financial asset appreciation in hopes of generating "escape velocity" for the economy via the wealth effect (whereby increased wealth spurs increased spending). While stabilizing our economy, these policies may have introduced many ancillary costs and perils the most concerning of which may be encouraging greater risk-taking behavior thus perversely de-stabilizing the global markets. For example, this policy unleashed massive capital flows into emerging markets (estimated at $8T in 2012 from $4T in 2008) seeking yields and growth not available domestically and often accompanied by the increased use of leverage to increase returns. This excess liquidity accelerated lending, credit growth and domestic demand in these economies creating greater instability.

Though we continue to have serious concerns as to the sustainability of much of the economic improvement to date, it is hard to argue that the U.S. economy has not navigated fairly well through the most acute part of fiscal retrenchment. Viewing the U.S. economy through the prism of trends rather than absolute levels one cannot ignore the following positives: an unfolding housing recovery; private employment growth that is only 1.4% below the level of 2008; real gross domestic product that has increased over 8% from the trough and is now 3% above its pre-recession peak; extremely low inflation levels; and a Federal budget deficit that has declined from 10.1% of GDP in 2009 to an estimate by the CBO of 4.7% for this quarter and which is projected to decline to 2% of GDP by 2015. Much of this has been achieved while facing the headwind of a federal fiscal policy that has restrained growth since 2011 with estimates by as much as 1.25%-2% annually. Factoring in the longer term benefits of our exploding energy renaissance, key growth drivers in technology (digitalization, 3-D printing, etc…) along with the major ancillary benefits for manufacturing and even favorable demographics versus other developed economies (including China) gives much to be optimistic about over the next decade. But as much of this economic improvement has fragile underpinnings tied to our current near zero interest rate policy, the road towards these positive outcomes promises to be more uncertain and volatile as we have recently witnessed.

With lower budget deficits to be funded and a declining marginal benefit to the economy from each round of QE, Bernanke seemingly offered up a trial balloon to Congress in late May suggesting that a "step down in our pace of purchase" of fixed income securities might be forthcoming from the current level of $85B per month pace. Though this is far from a traditional tightening and has nothing to do with increasing short term interest rates (which we expect to remain at current levels until 2015), the markets have perceived this as a de-facto tightening and it has elicited some powerful almost Pavlovian responses. Ten Year U.S. Treasury yields rose from 1.6% in early May to end the quarter about 2.5%. One immediate response to this increase in rates was the liquidation of many leveraged positions and outflows of capital from the emerging markets placing greater pressure on their currencies and capital markets while increasing interest rates globally. Emerging market stocks and bonds along with developed market equities suffered a quick 10% decline into the end of the 2nd quarter. This has seemingly caused a huge capital flight to the U.S. and fostered a pronounced de-coupling of returns between the U.S. and global markets.

For the quarter as a whole, the S&P 500 absorbed a 6% decline from its peak but still managed to register a 2.9% gain and now 13.8% for the YTD period, just slightly behind the more domestically-oriented Russell 2000 Small Cap Index of 3.1% for 2Q and 15.9% YTD. The MSCI EAFE index of international developed markets declined 1% for the quarter and is now up 4.1% for the year with the MSCI Emerging Markets suffering the most damage down -8.1% for 2Q and -9.6% YTD. More indicative of the global market performance is a look at the MSCI All Country Index which is up only 6% for the year but actually down when excluding the U.S. With a credit crunch in China, continuing recession in Europe and political turmoil roiling Egypt, Turkey, Brazil and others, it is easy to understand the movement of capital to the United States as we represent the "cleanest dirty shirt in the laundry".

Though representing almost 9% of global GDP (down from almost 18% in 1994), Japan has largely been irrelevant on the world stage while experiencing a 20 year spiral of deflation. In fact the nominal GDP of Japan in 2012 is virtually unchanged from 1991 and Gross Debt/GDP levels are now at an astounding 245%. Population growth has been 0% for the past 2 decades and this aging demography has turned what was a massive trade surplus and high private savings rate into a current deficit financed by these private savings. We are not optimistic about the end game for Japan as an increase in inflation to the targeted 2% level (with the commensurate increase in Japanese bond yields) is estimated to devour as much as 80% in government revenues from interest expense alone while the working age population is estimated to shrink from the current 81.7MM to 67.7MM by 2030. Analyst John Mauldin has referred to Japan as "a bug in search of a windshield".

To break this deflationary spiral, Prime Minister Abe Shinzo and the Bank of Japan (BOJ) have undertaken a massive QE program targeting 2% inflation via a mix of reflationary policies (money printing) and government spending to encourage private investment. The most important component may be the dramatic devaluation of the Yen which has weakened about 24% against the dollar since this campaign commenced. With this regime shift, Japan is irrelevant no more. In their attempt to increase global competitiveness via Yen devaluation, Japan is in essence exporting deflation and undertaking a currency war. While lifting their expected GDP growth in 2013 to an IMF-estimated 2% (4.1% annualized rate in 1Q), there is a concurrent and commensurate negative impact on their primary Asian and European trading partners. Global trade is shrinking as evidenced by the most recent export data from China showing a 3.1% year-over-year decline.

China has been the primary engine of global growth coming out of the Great Recession. To mitigate the economic downturn in 2008, the Peoples Bank of China (PBOC) embarked on an infrastructure and housing boom most of which were local government, debt-financed vehicles that generated no cash flow or return on investment, the proverbial "bridges to nowhere". A recent Barron's article noted one of these trophies, the New South China Mall as being 2 times the size of our Mall of America in Minnesota. We marvel at the cranes in the sky until it is noted that this mall, which was built in 2005, is still 99% vacant.

Mindful of the carnage that leveraged, unconstrained credit growth caused to the developed markets in the last decade, the PBOC has recently pulled in the reins on the shadow banking system in China by allowing interbank lending rates to soar and causing a liquidity squeeze. How committed they are to this in the face of slowing domestic growth will be critical for global growth in the quarters ahead.

The Eurozone (EZ) continues to be mired in a deep recession though we will note some recent signs of stabilization as the pace of manufacturing output has ticked up (though still in contraction mode) in the end of the 2nd quarter. EZ GDP experienced the 6th consecutive quarterly decline in 1Q of -0.9% on an annualized basis following a -2.3% in 4Q 2012. The long-awaited recovery has failed to take hold and debt ratios, specifically across the southern tier of Europe, are rising at an accelerated pace. The European bond markets have also been hit hard by tapering talk emanating from the Federal Reserve and borrowing costs across Europe are up more than 70 basis points. Unlike Japan, the ECB and Mario Draghi are doing little to offset this unexpected tightening and may need to get in front of a deflationary trap with more aggressive policy actions.

Total Eurozone Gross Domestic Product is now fully 6% lower than it was in 2009 and total unemployment in the region is now at an all-time high of 12.1% with over 40% unemployment among the under 25 year old group in Italy, Spain, Portugal and Greece. The more educated and technologically astute rising middle class is being squeezed and political risk is still very high especially in Greece and Portugal while new bouts of sometimes violent demonstrations of civil unrest have also erupted in Egypt, Brazil, Turkey and Indonesia. The United Kingdom may have been the lone bright spot in Europe as their economy expanded 1.3% in the 1st quarter after declining in 3 of the prior 4 quarters.

Of all the direct and indirect impacts of Quantitative Easing and interest rate policies, what Federal Reserve Chairman Ben Bernanke may be most pleased with is increasing home values. Over the last 12 month period, the Case-Shiller Index estimates home values on a national level have increased 12.1% (though still off 27% from the peak in 2006). These increases have dramatically reduced the number of mortgages in a negative equity position which further improves the potential supply in the market (underwater homeowners are usually in no position to sell their homes) and the overall confidence of the consumer. Low interest rates allow many additional homeowners to refinance a mortgage and they are then much more willing to redeploy the savings elsewhere in the economy. Rising home values stimulate everything from construction activity and remodeling to increased durable purchases. Nowhere is this better illustrated than in the renaissance we have witnessed in the U.S. auto industry with a June selling pace of an annualized 16MM vehicles, a 5 year high. Additionally, the resurgence in new home building (impacted greatly by the current lack of inventory of existing homes) in turn spurs more hiring, manufacturing activity, production of construction materials, etc. Housing is by far the largest single asset on the balance sheet of U.S. households accounting for over 25% of total net worth. Though Residential Investment accounts for less than 3% of GDP, the multiplier impacts to the economy are great and if continued could be a game changer.

Nonetheless, we are still dubious of the sustainability in this area as the recovery in housing remains disconnected from traditional economic drivers. Job and wage growth along with expanding and available credit are required for a normal functioning housing market. Though both of these areas have improved modestly, they are still inconsistent with the levels of price appreciation we are witnessing. According to the Wall Street Journal, since the bottom in home prices in 2011 the average new home price is up over 17% while per capita income is up only 2.8%. This recovery is still heavily supported by both “mom and pop” and private equity investors as evidenced by the number of all cash sales (32%) and the lack of first time buyers (28% versus historical average over 40%). This is best exemplified by the total dollars of new purchase mortgage originations which are averaging $130B on an annual basis, the same levels from the early 1990’s showing the dominance of all cash sales.

Of greater import is the dramatic rise in mortgage rates since late May with a 30-year fixed rate moving from less than 3.5% to over 4.5% as the quarter ended. Affordability is highly dependent on price and interest rates. Despite being 26% lower in price than at the 2006 peak, the average homebuyer is now paying 3.2 times the median income versus 2.6 times before the bubble. What has increased housing affordability has been historically low interest rates that have now risen enough in just over a month to increase the monthly payment by 15%-20%. According to Zillow, homeowners in 24 of the 30 largest Metro markets are now paying more for their homes relative to incomes (factoring out interest rates) than between 1985 and 1999 when rates ranged from 6% to 13%. We feel we are already witnessing the early stages of a turn in this market as mortgage applications for purchase are already -28% over the last month with refinance applications down -40%. This is critical to the state of the consumer and in turn the economy over the next couple of quarters.

Employment growth has continued to march forward though with much more of a “just in time” workforce than ever before. Nonfarm Payrolls have averaged a little over 200K per month in 2013 after averaging almost 180K in the prior 2 years. In total we have now added back over 5.1MM of the jobs lost to the recession though still about 2.4MM below the levels of 2007. Additionally, new claims for unemployment are at a 5 year low. We also may be witnessing the early stages of some wage growth though we are postulating that this may be a bifurcated market. Those with education and marketable skills are in demand and may be commanding increasing wage power. For those without the requisite skill sets, this remains a very difficult job market.

Unemployment rates for college graduates are down to 3.8% with an average annual income according to the Census Bureau of $59,415 ($87,981 for an advanced degree) while they remain at 11.1% for those with a High School degree with an average annual salary of $32,493. Temporary jobs were always a very good indicator as to a turn in the job market as increased temp hiring usually presaged an increase in full time positions. The number of temporary workers is now 2.7MM up 50% since the recession. Along with freelancers, contract workers and consultants, they now make up over 12% of the total workforce. This lack of job security has a clear impact on major purchases.

Average hourly earnings have increased 2.2% year over year. With inflation continuing in a downward trend towards 1% over the last year, the average worker has finally seen some real wage gains. But here is where the stratification appears most pronounced. In the most recent nonfarm payroll report there were 75K new jobs in the area of Leisure & Hospitality of the total of 195K new jobs created. The average hourly wage was $13.46 and the average weekly hours were 26.1. This means that roughly 40% of the jobs created paid wages of approximately $18K per year, a level below the poverty line. To still generate some wage growth in aggregate may mean that the depleted pool of skilled labor finally has some wage power and, therefore, parts of the job market may be much tighter than previously assumed.

The amelioration of the job market along with strong increases in home values and the stock market has engendered the highest reading for the Consumer Confidence Index since January of 2008. Though the income side of the consumers financial statements have been weak, the near zero interest rate policy of the Fed has allowed the consumer to repair their balance sheets. The debt service ratio (ratio of debt payments to disposable personal income) has dropped from 14% in 2007 to 10.5% the lowest in 30 years. Delinquency rates on credit cards are the fewest since 1990 and gross credit card debt is now at a 10-year low. Additionally, the consumer's inability to access credit is dissipating and the most recent Consumer Credit report noted an increase in revolving credit (generally credit cards) of $6B. Improved debt ratios and increased optimism has fostered consumer spending at a fairly stable pace of 2% since the beginning of the recovery and we are roughly on the same pace in 2013. Context on this is required as it must be noted that from1990-2007, consumer spending averaged over 3.5%. It is possible that the consumer deleveraging cycle is in the very mature stages though (as with most of the improved economic data) still highly dependent on the current low rate environment. The recent move up in interest rates might pressure much of this improvement.

In aggregate, despite stabilization in many economic areas, strong housing data, and continued modest improvement in employment, the economy is still mired in a very slow growth mode with little acceleration to date. Gross Domestic Product has averaged only 2% annual growth during the recovery. More disappointingly, we expect the 2Q GDP to be close to 1% which follows on the heels of 1.8% growth in the 1st quarter of 2013 and 0.4% during the final quarter of 2012, a collective pace barely above 1%. We entered 2013 with a way below consensus growth projection of 1.5% for GDP. Though we are not yet altering that estimate, we do now possess modestly improving confidence in the back half of the year as the private sector continues to heal and much of the fiscal drag subsides. However, that is an isolationist view. With China, the largest global growth engine over the last decade, slowing markedly; Europe still mired in recession with renewed civil unrest; world trade declining; and interest rates rising, we cannot rule out a further economic downturn over the next couple of quarters.

For the markets, we cannot ignore the extent to which asset prices have totally disconnected from underlying fundamentals. Either the economy soon validates these levels or the markets are eventually at risk. Profit margins are still near record highs but should come under pressure as early as this reporting season as a very strong dollar and weakening global trade place even dramatically reduced earnings expectations at risk. We feel we must resist focusing on what is cheap only in relative terms (stocks versus bonds) and maintain low risk postures in portfolios.