Q3 2013 Commentary

"Never underestimate the power of stupid people in large groups."

George Carlin

When Federal Reserve Chairman Ben Bernanke seemingly surprised the markets in late May by suggesting that a “step down in our pace of purchase” of fixed income securities (QE) might be forthcoming from the current pace of $85B per month, the questions posed by many in the markets centered on the perception of a weakening economy. Can the U.S. economy maintain the current slow pace of growth as the Fed withdraws stimulus? Are we on a sustainable foundation or are we just addicted to easy money and continuing to inflate assets from housing to equities and fixed income with no commensurate and sustainable impact on growth?

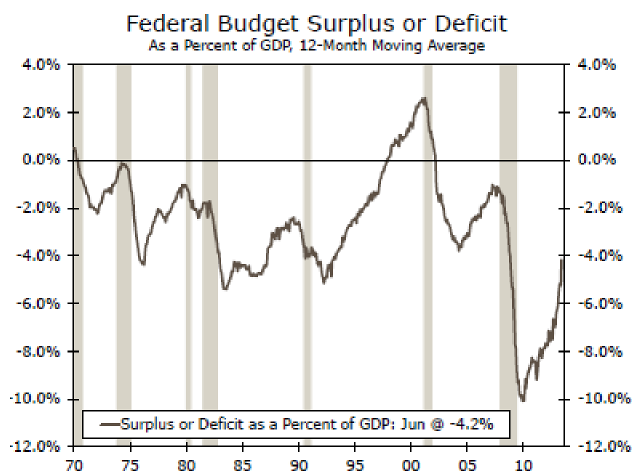
Indeed, just the mention of a forthcoming taper seemed to shock the interest rate sensitive areas of the economy and the markets quickly and dramatically. These areas (specifically housing) have been a key to the slow but steady recovery that we have enjoyed, and an almost immediate 14% decline in home mortgage applications and a 66% year over year decline in refinancing activity (a key to improving consumer cash flow amid slow wage growth) resulted in an 18% drop in the index of housing affordability to levels last witnessed in 2009. Our view has continued to be that while the U.S. economy remained fragile, any benefits of the most recent rounds of Quantitative Easing were clearly diminishing. A policy originated during and designed as response to a deep recession and early post-crisis recovery appeared to be now succeeding mostly in elevating financial markets to an even greater degree of disconnect from the underlying economic fundamentals. If we have learned anything from the vacillation of their position , it's that the Federal Reserve is making this up as it goes and has no better idea of how this will end than it did in 2008 when it assured us all was well and there was nothing to see here so move along.

Though we had little doubt that the FOMC may have been startled by the subsequent rapid rise in interest rates with the 10-year Treasury yield rising from 1.63% in May to almost 3% in September, we were more convinced of a greater concern of Chairman Bernanke. The continuing failure of fiscal policy and a dysfunctional Congress had forced monetary policy (the province of the Federal Reserve) to effectively pull double duty and the suppression of interest rates by our central bank have clearly helped the U.S. economy navigate very well through the most acute part of fiscal retrenchment in 2013. We noted in our 2Q commentary that federal fiscal policy has restrained growth since 2011 with estimates of a reduction of as much as 1.25%-2% annually. Moreover, we feel this to have been a greater concern for Bernanke leading him to effectively take out an additional insurance policy against the Congressional gridlock that is now currently upon us. Unfortunately, and in a perverse circle, it may be that the easy monetary policy is actually enabling such gridlock.

The government shutdown that went into effect on October 1st represents the first such stalemate since late 1995 during the Clinton Administration with the larger concern of the looming debt ceiling limit estimated to be breached by October 17th. The current stare down represents a culmination of over two years of fights since the Budget Control Act of 2011 capping Federal spending (sequestration) and the implementation of the Affordable Care Act (ACA). Opponents of the ACA acknowledge the expansion of health coverage but fear it does so as the cost of accelerating federal healthcare spending that already comprises 17.9% of GDP. They want any agreement on lifting the debt limit to be tied to an agreement on further spending cuts.

While the current shutdown continues to place on exhibit our failures of leadership for the world to see and lower what has been improving consumer confidence, the negative economic impact is both small (estimated to be only between a 0.1%-0.2% of GDP for each week of the shutdown) and reversible. It is the failure to lift the debt ceiling, however, that is feared to possibly have the effect of plunging the U.S. into another recession. A U.S. debt default (even a temporary and only technical one) could threaten an already tepid recovery via a sharp rise in interest rates and plunging consumer and business confidence. When we consider what happened in the markets when Bernanke first broached the potential for imminent tapering, what might be the impact of a default?

Ironically, the fight over further spending cuts comes at a time when our budget deficit (as seen below on the chart from Wells Fargo) has been plummeting. The Congressional Budget Office (CBO) now estimates the fiscal 2013 deficit to be 4% of GDP down from 7% in 2012 and over 10% during 2009. The CBO also estimates a further reduction of the deficit under current law to 2.1% of GDP by 2015.



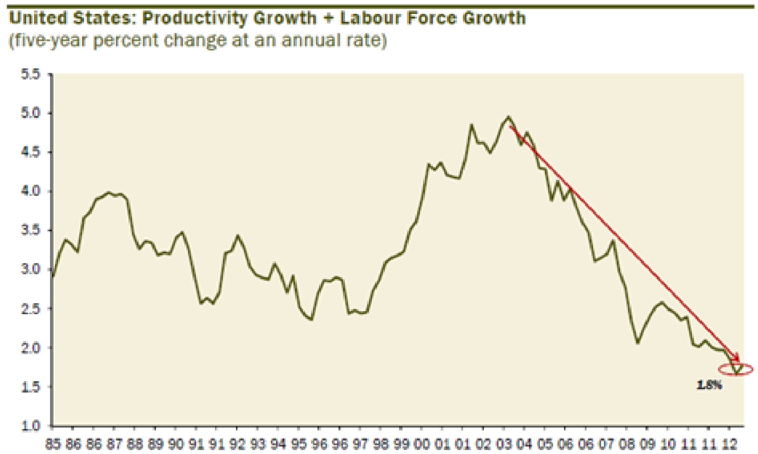
Unfortunately the deficit still remains one of the highest in 45 years and, more importantly, one cannot ignore long term structural challenges as the net interest expense of the government debt is projected to more than double as rates rise over the next decade. We agree that this needs to be addressed but are concerned that the economy remains too fragile to accommodate further current fiscal retrenchment.

At the same time as the partial federal government furloughs, the fortunes of most local and state municipalities appear to be on the upswing and are now adding to overall economic growth. Cities in aggregate are hiring again as local governments (which represent 65% of the total government workforce) have increased hiring in 8 of the last 10 months. Most municipalities are exhibiting improving fiscal health due to rising tax revenues and even voter-approved tax increases. But just like our federal government, this improvement also hides some serious longer term concerns as there remains the specter of crises within the state pension system with perhaps as few (depending on actuarial assumptions of future returns) as 50% of state plans being fully funded.

Despite the headwinds of fiscal retrenchment (which should continue to detract about 1% from growth into early 2014), gross domestic product has continued to increase at a very slow but steady pace near the recovery average of 2.2% on an annualized pace. Following a slow 1Q reading of 1.1%, 2Q GDP posted a 2.5% gain. The Institute of Supply Management (ISM) manufacturing index posted a strong expansionary reading of 55.8 for the third quarter as a whole compared with a 50.2% 2Q reading. This continues a pattern of stronger durables spending in the face of slowing growth in services. The strength in the more interest sensitive areas of housing and autos continue to lead the recovery but discretionary spending remains challenged and services comprise over 85% of the U.S. economy. We are expecting a modest slowing for the remainder of 2013 consistent with our full year expectation for GDP growth of less than 2%.

While economists and the Federal Reserve continue to push out their expectations of a return to the normal historical range of 3%-3.5% GDP growth, we remain dubious of that expectation. Real GDP growth is dependent upon labor force growth (working age population) and productivity. Studies by Robert Arnott and Research Affiliates remind us that the 20th century average of 3%+ real GDP growth was partly due to a major demographic tailwind. While many point to our declining labor force participation rate from 66% levels pre-recession to the current 63.2% as the reason for the drop in the unemployment rate, we feel that misses the bigger picture. We note that the decline actually commenced in 2000 from a peak of 67.3% indicating more of a demographic impact than economic. If so, then much of the decline is structural in nature due to this aging demography (and many moving to Social Security Disability Insurance from which few will return to the work force), truncating the impact of a typical cyclical recovery.

Michael Feroli, Chief Economist of JP Morgan estimates that productivity growth has averaged just 0.7% over the last three years (0.9% in the most recent quarter) and 1.9% in the decade ending in 2012. This is in sharp contrast with the decade ending in 2005 that averaged 2.9%. Feroli posits that much of the decline is due to underspending on technology and R&D along with incrementally less dramatic change in current technology. He also notes the slowing in the growth of the labor supply. Labor supply increases which were 2.5% annually in the late 1970s through the 1980s have dropped in the most recent 10 year period to 0.8%. When we combine the impacts of structural demographic headwinds to labor force growth (see chart from Gluskin Sheff below) with more benign productivity growth, we are left with lower long term potential GDP growth than many might expect. We have little doubt that there will be quarters and even years of growth exceeding this level. However, absent major changes in immigration patterns and/or game changing technologies which add rather than subtract from employment growth, we subscribe to the belief that future expectations of long term national growth may need to be tempered.

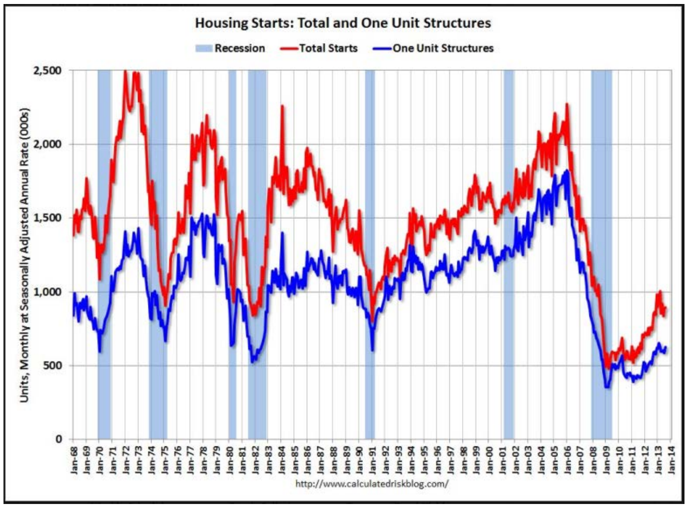


The expansion noted above in the ISM manufacturing data is reflective of strong rebounds in both the auto and housing sectors. We have previously noted that during a typical post-recession recovery, auto and housing gains would be driven by broader economic growth manifested in improving labor and wages. This cycle has been quite unique in that regard. Autos and housing have remained primary drivers of GDP growth with autos having rebounded from a recession low of just over 9MM vehicle sales on an annualized basis to the recent levels over 15.5MM which is near pre-recession levels. Interestingly, it is worth noting that this has not corresponded with expected levels of employment as total auto plant workers are 682K in the U.S. which, though up from the trough of 561K in 2009 remains way below the 1.1MM in the year 2000. Sales, production and profitability have far exceeded hiring.

Housing has remained one of the bright spots in the economic recovery. The most recent data on home prices provided by the Case-Shiller index show year over year increases nationally to be a gain of 12.4% though still about 23% below the 2006 peak. The traditional drivers of housing demand of household formation along with employment and wage growth have been absent during much of this period. According to Trulia, household formation averaged over 1.5MM per year in the decade prior to the recession before plummeting to 500K. Though it has recovered somewhat to the annual level of approximately 1.0MM, household formation remains almost 2.5MM below the cumulative historic trend and the traditional 1st time home buyer remains absent from the equation. Studies from the Pew Research Center note that fully 36% of the 18-31 year old market ("Millennials") lived with their parents in 2012, up from 31% over a decade ago.

Household formation is critical to a normally functioning housing market as it determines the number of new homes built and impacts employment. Much of this recovery has been driven by investors flipping and converting single family homes into rentals. In August Realty Trac noted that over 45% of total home purchases were all cash versus the 10% historical average. While there are clear positives in that much of the overhang of excess supply has now cleared, at some point the economics will no longer work for the investor. Indeed, recent reports indicate that some major institutional buyers (Oaktree Capital, Och Ziff Capital and Carrington Mortgage) are already exiting the market. The question may be to whom they sell as they have been the largest demand support in the market.

Though Housing Starts have rebounded from less than 500K on an annualized rate during the recession to the most recent figure of 891K, this remains significantly below the 20-year average of almost 1.37MM. More importantly for both employment and spending is how the market is evolving. As depicted on the chart below the rebound in the single family construction market is almost unnoticeable.



As with the auto industry, housing has been a critical contributor to recent GDP data as residential construction over the last 2 years has moved from a drag of about 1.1% to a positive contribution of 0.4% to gross domestic product. Housing contributes in three important ways to overall growth with the most direct is from residential construction. However, there are also indirect but meaningful contributions from consumption via the wealth effect (rising home prices) and mortgage equity withdrawal along with the multiplier impact via increases in employment in housing and housing-related industries. In this area is where the dominant growth in multi-family units (rentals) versus traditional recovery in single family units has much less of an economic multiplier effect on spending and employment. Total construction employment in the U.S. may have bottomed during the early stages of the recovery at 5.4MM but has only rebounded to 5.788MM as of August 2013. This compares with the 2006 peak of 7.7MM.

The lack of job recovery in these two critical areas of autos and housing that have shown such strong improvement does go a long way in explaining why our employment hole that was much deeper is taking much longer from which to emerge and with much lower quality of jobs. Though jobless claims are at lows (4-week averages of 305K) not seen since 2007, we are not seeing strong hiring. Despite 42 consecutive months of gains in private sector hiring, we have remained range bound in nonfarm payroll growth averaging about 180K per month. Sixty percent of the net job losses experienced during the recession were in middle income occupations whereas they represented less than 25% of net jobs created during the recovery with most new jobs created in retail, leisure and hospitality and temporary help agencies.

Technology (and outsourcing) has continued to replace routine jobs while increasing demand for non-routine manual jobs that cannot be automated (such as those mentioned above). The employment growth that we have had has been concentrated at the high and low end of traditional middle-income jobs. This bifurcation has been a major contributor to growing income inequality and these trends will most likely continue.

Sentier Research has updated their data based on recent information from the Census Bureau and reports that Real Median Household Income was $52,098 for the quarter ending June 2013 down from $54,478 (-4.4%) when the recovery *began* and 8% lower from $56,648 at the 2000 peak. Looking at just the midpoint only gives us a part of the issue. Analysis by Professor Emmanuel Saez of the University of California shows that the average inflation-adjusted income per family actually rose 6% from 2009-2012. But during this period the income of the top 1% of earners rose 31.4% (95% of the total gain) while the bottom 99% saw growth of 0.4%.

The analysis in aggregate is a little more promising. We are seeing significant progress in deleveraging and reducing consumer debt which has been able to support modest spending in the current environment with the Debt Service Ratio (debt payments to disposable personal income) dropping to a 30-year low. With Household Net Worth now hitting new nominal highs of $74.82T (+6% in 2013) due to the rising housing and financial markets, real consumer spending is now up 1.9% over the last year (8% on durables but only 1.1% on services) though still below historic trends. These remain just enough to continue to support a slow, but still fragile recovery.

Much has been made of the return to growth for the Eurozone (EZ) during the second quarter as the EZ broke a record 6 quarter contraction in posting a 1.3% annualized GDP (though still -0.7% y/y) and the last 2 months have reported expansion in overall manufacturing growth. This is clearly welcome news but not surprising. There is a clear distinction that needs to be drawn between stabilizing and growing. Germany and France represent just under 50% of the Eurozone GDP and without their contributions, the region would have suffered a 7th quarter of decline. The Eurozone has clearly succeeded for now in stabilizing their sovereign bond markets but still large debt overhangs continue to clog the engine of corporate credit, thus stunting growth. A surprisingly strong Euro along with still weak trading partners conspires to limit export growth. Their remains for now too little demand to generate sufficient job creation and the unemployment rate for the EZ remains at 12.0% just 0.1% below the all-time high.

We posited last quarter about how committed China would be to pulling in the reins on lending to combat developing imbalances if it meant slowing economic growth. It lasted about a month and the Peoples Bank of China (PBOC) has now returned to a "pro-growth" policy. China has set their growth floor at 7.5% with an inflation cap of 3.5%. Our money is on whatever they set. This is clearly critical to global growth which the International Monetary Fund estimates at only 3.1% for 2013 and 3.8% for 2014.

The about face of the Federal Reserve in reducing QE was extremely welcome news for the Emerging Markets in aggregate. Artificially low global rates following the recession led massive amounts of capital to flow to developing nations such as India, Thailand and Indonesia boosting growth and capital market returns. Asian consumers ran up debt for consumption (another U.S. export) as imports soared. Unfortunately, these flows also increased the value of local currencies reducing export competitiveness. As global growth slowed, export engines sputtered creating large current account deficits and declining currencies. Subsequent rising interest rate increases to support the falling currencies had the perverse impact of strangling domestic economic growth. Most emerging economies still possess ample stock of foreign currency reserves and greater currency flexibility to prevent such a crisis as befell the region in 1998. Nonetheless, the short term economic and market risks are not low. However, the valuations of the emerging economies as a whole are down to the levels seen only during the 1998 and 2007 crises and represent greater value for longer term investors.

With the Standard & Poors 500 index posting a gain of over 19% through the end of the 3rd quarter, the extent to which asset prices have disconnected from underlying fundamentals is concerning. We have discussed over the last 2 years how profit margins have been at or near all-time high levels. Though having declined from the peak of about 10% in late 2011, corporate profit margins remain just south of 9% in the recent quarter, a full 50% higher than the historical average of 5.9%. The key influences have been historically low levels of labor costs, reduced taxes (higher sales and profits outside the U.S. with lower tax rates) and dramatically reduced interest expenses.

How important is the lever of profit margins when performing any valuation analysis? Just note that the modest decline from the recent peak of 10% experienced from 2011 through 2Q 2013 has corresponded with earnings growth during this 6 quarter period that has declined to a 2% annualized rate. This has led to an expansion of the P/E multiple for the S&P 500 from 13.0x at the end of 2011 to its current multiple of 16.5x. But any analysis that looks only at P/E ratios without accounting for this extreme level of historical margins has limited usefulness. Use of the normalized 10-year earnings (as created by Robert Shiller) suggests current valuations to be at levels only exceeded at market peaks in 2000 and 2007. To us this is a greater focus than the events unfolding in D.C.

At Coho we remain focused upon our companies and industries and less on Washington as we try to follow one of Warren Buffet's tenets that investors should "buy stock in businesses that are so wonderful that an idiot can run them because sooner or later, one will".