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# STAYING THE COURSE

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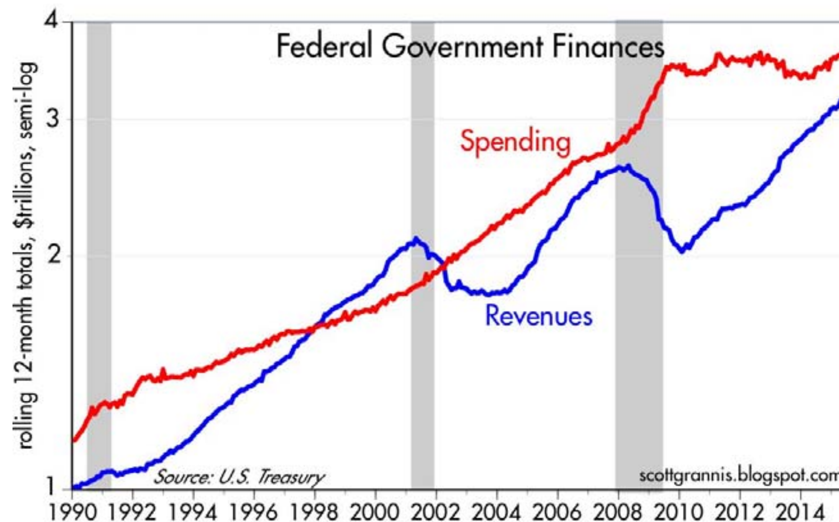
## THE DOMESTIC ECONOMY & MARKETS: JUST STAND THERE, DON'T DO SOMETHING!

The U.S. economy continues to bump along missing first quarter growth estimates with a 0.2% decline in GDP induced by a combination of another cold winter and a West Coast dock strike. As a result, the Federal Reserve modified its estimate for full-year economic growth to 2% from 2.7%. Since the end of the last recession in 2009, the economy has managed only a 2% growth rate -- well below the potential growth rate of 3.5% and the weakest economic expansion since the great depression of the 1930s. Before falling prey to the politicians' critique of this slow rate of growth, consider the parallel benefits that have accompanied this recovery: (1) the budget deficit has shrunk by over $1 trillion and (2) the Congressional Budget Office continues to underestimate rising tax revenues. The following exhibit shows how growth in federal government spending has been held at bay while revenues continue to surge. Since government spending is one of the four components used in calculating GDP (the other three are consumer, corporate, and net exports), the data suggest that the slow economy is primarily attributable to the reduction in federal government spending. What if government spending was "normal"? The domestic economy would likely be growing faster.

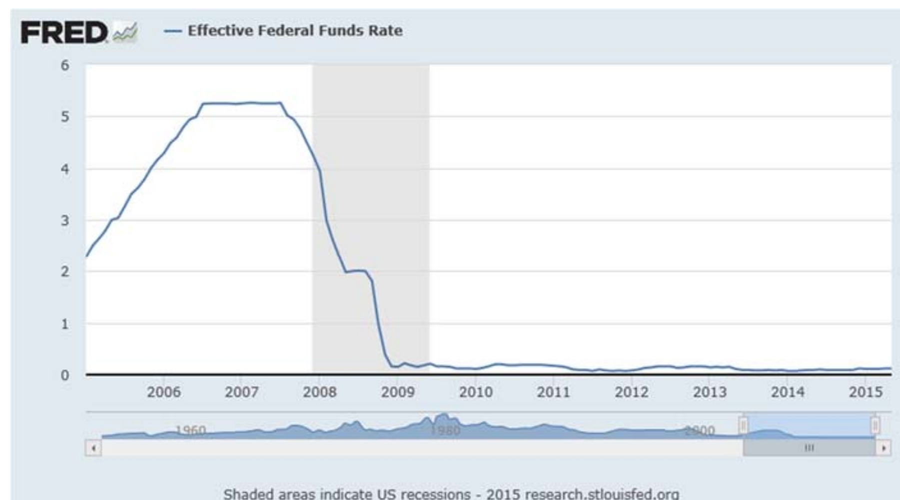



The good news is that the "caps" (limits) placed by Congress, otherwise known as a "sequester" on spending, has taken the government out of the GDP growth equation. The inability for Congress to come up with an expansion in spending has created a less worrisome environment about the deficit and federal debt but has kept the economy in a slow growth mode. In other words, stability in fiscal policy has led to a prolonged expansion that is characterized by strong corporate profit growth and less intrusion in the private sector. Also, since the extension of the Bush tax rate cuts at the beginning of 2013, there have been no changes in tax policy that could

negatively affect economic activity. The best news of all is that federal government spending has experienced very little or no growth for the past six years (see red line in the chart above)! This has allowed the magnitude of government influence on the economy to shrink from over 24% of GDP to now just over 20%.

Besides the influence of fiscal policy, monetary policy is often given credit for influencing economic growth through decisions that affect interest rates. In the old days, the Fed would change the fed funds rate target (the interest rate that banks have to pay to other banks when borrowing overnight to meet reserve requirements) on a monthly or even a weekly basis to impact the financial system. Changing interest rates in the short-term can have a detrimental effect on the conduct of business. Imagine if the Bureau of Weights and Measures changed the number of inches in a foot once a month but the builder never knew how much of a change there would be. Our guess is that very few buildings would be constructed as no one would know how many inches were in a foot.

The Federal Reserve acted as the safety net under the economy during the 2008-2009 recession. It lowered the fed funds rate from over 5% to zero and from 2009 until the present that target rate has remained unchanged as evidenced by the graph below. Over the past five years, with regard to affecting the economy through changing interest rates, the Fed has done nothing even though it bought billions of dollars of mortgage securities and increased the money supply dramatically. Many economists feared that these low interest rates would lead to an increase in inflation.




Using the consumer price index (ex the volatile food and energy components) as a broad measure of inflation, that rate has hovered at or below 2% for the last ten years. Our friend Scott Grannis makes the point: “The prevailing inflation perspective is that it is dangerously low, and for years central banks have been trying very hard—without much success—to get it to rise. The reality—at least in the U.S.—is that the underlying "core" rate of consumer inflation has been running at close to 2% for over a decade. Energy prices have been the principal cause of variations from this trend.”

Reflecting on the first half of 2015, while plagued with geopolitical events, progress for the U.S. stock market as measured by the S&P 500 index has been minimal. Looking back on more than 50 years of data, we found this tortoise-like performance rather rare. The professionals at the eagle-eyed Bespoke Investment Group outline this fact even better:

"Barring the type of volatility we have been seeing in China over the last few days, 2015 will go down as the first year in the S&P 500's history where the index was never up or down more than 3.5% YTD on a closing basis during the first half. Furthermore, as of this writing (6-30-15), the S&P 500 is up just 5 bps YTD. How's that for uneventful?"

Bespoke goes on to say:

"Besides 2015, the only two other years where the S&P 500 was never up or down more than even 5% during the first half of the year were in 2004 and 1993. For these years, in the second half of each of the ten years the S&P 500 traded higher for an average gain of 6%. The performance for those ten years compares to an average gain of 3.6% with positive returns 62% of the time.

The S&P 500 was up 1.2% year-to-date through June 30th. If our friends at Bespoke are right on the historical odds, and the S&P 500 rallies 6% in the second half of this year, that would imply a 7%+ improvement for the index for all of 2015. Add to that the 2% dividend distribution and the potential total return is 9%+--that is pretty close to the 10 - 12% total return we anticipated for 2015. We think that a 9%+ return is possible because the global economy should get stronger in the back half of this year.

### THE GLOBAL ECONOMY & MARKETS: A CONCURRENCE OF BAD NEWS

The global economic backdrop so far this year has centered on a concurrence of bad news among countries, namely Greece, China and Puerto Rico. Stock markets tend to lead economic activity and foreign markets have provided plenty of ammunition for a recovering global economy going forward. Turmoil in Greece is not new but has come to a head in the last two weeks. Our friend and respected Wall Street economist, Brian Westbury, sums up the Greece situation well:

"When Greece joined the Eurozone back in 2001, it had the chance of a century to right its financial ship. Interest rates fell on Greek debt even as the economy performed relatively well. Lawmakers could have used the windfall to de-regulate the economy, privatize, and reduce its long-term spending commitments. Instead, the government used the windfall to pass out more "free" treats to voters all the while receiving intellectual and political cover for this bad behavior from leading academics around the world. But, eventually, you run out of other people's money when you don't grow or pay it back. Now the bill is coming due and yet, the "Debt-Heads" in Greece who grew dependent on the treats of that bygone era, defiantly told the IMF, the ECB and other European governments—the only ones left crazy enough to lend to them—that they wouldn't downsize the bloated Greek government and they expected more money anyway. Don't let anyone tell you Greece is sticking up for its "dignity" by fighting "austerity." The current Greek government is sticking up for socialism by fighting reality."

At this writing, the solution to the situation in Greece is unclear but change has to come. Interestingly, 9 of the 28 member countries of the Eurozone do not use the Euro as their currency of exchange. So, at the end of the day Greece may go back to using the drachma which may not be so bad after all. Since late 2011, Greece's current account has swung from a deficit of nearly 10% of GDP to a current account surplus of just over 3%. Meanwhile, the value of the Euro has fallen by around 15% in the past three-and-a-half years. Add those two together and the result would relate to a decline of around 10% in the drachma to be realigned with other nations. Many economists are crunching the numbers on this data, but in general, a currency devaluation would be initially painful but ultimately make exports more competitive and boost the economy. Time will tell.

Puerto Rico is also facing a similar situation as Greece. High taxes, regulation and redistribution designed to buy votes have led to a private sector that is too small to generate the required revenue to sustain the system. Puerto Rico applies the same minimum wage rules used here in the United States—these wages are way too high. Puerto Rico is facing a painful restructuring or bankruptcy too. Recently Hillary Clinton called for a federal bailout of Puerto Rico to alleviate the hardships that will befall the people of the island. Improvements in the U.S. budget may well be given as a reason to launch such a bailout.

China is a different story. Since hitting a 7-year high less than a month ago, Chinese stocks have suffered a precipitous decline sparked by a clampdown on margin finance—the use of borrowed money to buy shares—in response to worries about an equity bubble. Almost $3 trillion has been wiped off the value of listed companies as retail investors have rushed to unwind leveraged bets on the market. The Shenzhen is now up 36% this year, having been up 122% less than a month ago. The sell-off began on June 12th and is the country's steepest decline in stocks since 1992. The government announced a series of controversial emergency measures in early July including the launch of a stabilization fund worth $19 billion to prevent further declines in stock prices.

This "decline" in Chinese stocks has remained contained to local markets and will unlikely spread to U.S. stock markets. The key issue is whether or not the market downturn will have a negative "wealth effect" dampening consumer sentiment just when the Chinese government is counting on consumption to make up for the decline in investment to meet a GDP growth target of "about 7%" for 2015. Many investors are concerned that the growth rate in China has been declining but our view is that anything above 5% is great in today's global economic environment. Free markets experience disappointments and the capitalist Chinese economy is no different. The question becomes: "What will a Communist government do to alleviate the pressures associated with an economic disappointment?" The latest tactic has been to use monetary policy as a safety net under a sagging financial sector.

## CONCLUSION:

In the domestic economy and markets, the first half of 2015 was affected by nature and labor conflict, not by decisions emanating from the federal government. The stability in both fiscal and monetary policy has allowed the economy to progress nicely with the consumer gaining momentum through rising employment, lower energy prices and low inflation. As economic data continue to improve, even in the face of a strong dollar in international currency markets, growth

should accelerate for the balance of 2015. Action on the president's trade program should be a long-term contributor to growth as well.

Foreign economies have experienced mixed growth for the first half but generally favorable stock market returns. Late in June crises in Greece, China and Puerto Rico pressured and continue to weigh on financial markets. Nevertheless, foreign markets actually outperformed domestic stock markets for the first half of this year. Below is a summary of regional stock market returns for the first half of 2015 and annual returns going back three years. In 2013 and 2014, the U.S. stock market substantially outperformed the rest of the world. In the first half of this year, our market gave back some of that outperformance against Europe and emerging markets.

| Returns in Local Currency | United States | Europe | Emerging Markets | World Markets |
|---|---|---|---|---|
| **2012** | 16% | 16% | 17% | 16% |
| **2013** | 33% | 22% | 4% | 26% |
| **2014** | 13% | 5% | 6% | 10% |
| **First Half of 2015** | 1% | 8% | 6% | 5% |

Data Source: MSCI, January 1 to June 30, 2015 including dividends.

Even though stock market volatility increases during times of international financial uncertainty, we do not see such volatility as long-lived. European crises traumatized markets of 2011 yet a shift in monetary policy at the ECB resolved most of those financial issues. This time around we don't think a monetary solution is in the cards and that the fallout of a Greek bankruptcy will keep markets in flux until we get some type of permanent solution.

Outside of Congress' approval of fast track trade authority for the president, we see little chance of major legislation coming out of either the House or Senate that would meet with the president's approval. So, fiscal policy is likely to remain in neutral until 2017 at the earliest. Monetary policy is unlikely to change given the perceived risks to the markets due to the financial problems in Greece, China and Puerto Rico. If the U.S. stock market falls into a short-term correction (a decline of 7-10%) then the Fed is likely to keep any change in monetary policy on hold.

The strong dollar has become a major plus for foreign economies where local companies compete with U.S. imports. The dollar's strength has breathed new competitive life into these local companies and, as their business picks up, their economies recover as well. The latest forecast of European economic growth by the OECD indicates an increased expectation of 2.1% growth for 2015 and 2.6% for 2016.

*July 8, 2015*