Financial Markets Perspective

July 2016

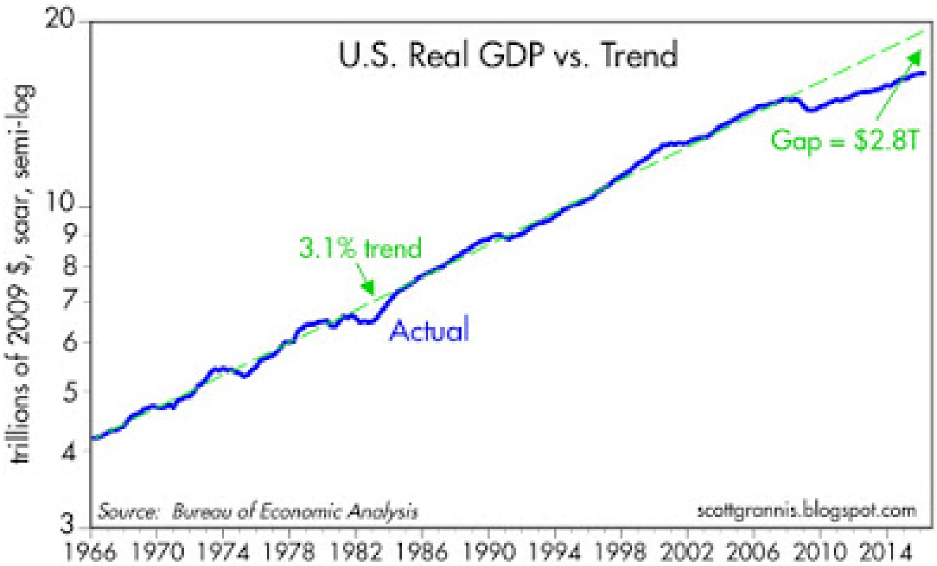
The Fiscal Policy Vacuum

Note: Fiscal policy is the decision by the federal government to spend and to tax. Policies that reduce spending and increase tax rates will reduce economic activity. When the economy is weak, the federal government should either lower taxes (or tax rates that impede output) or increase spending to stimulate the economy. The indicators of economic growth, inflation and interest rates play an important role in formulating our investment philosophy and are critical when making investments in common stocks that benefit from a growing economy.

The final economic growth rate (GDP) for the first quarter of 2016 was revised to 1.1% even though last winter was mild in comparison with the previous two years. Over the past eight years, real economic growth has been averaging about two percent--the slowest rate of growth since the depression in the 1930s. Growth in Europe has not been much better where perceived national bankruptcies have kept the European Union on the brink of recession. The recent BREXIT decision could push the overall continent into a prolonged recession especially if there are negative economic consequences from the breakup. On the political front, the US is confronted with two presidential nominees, one of whom wants to raise taxes on the rich and the other who wants to cut spending, neither policy is conducive to economic growth. No wonder that US equity markets have moved sideways since mid-2015—until this writing.

Politicians around the globe seem to believe that the economic elixir that will bail out bad fiscal policy is monetary policy that keeps short term interest rates at or near zero for an extended period of time. Exhibit #1 tracks the long-term economic growth trend vs. the actual growth rate. This divergence reveals that the US experiment with low interest rates since 2008 has been an abject failure. Monetary stimulus has not had the intended effect of moving economic growth higher.

Exhibit #1



The chart above summarizes the problem that has persisted for the past six years: disappointingly slow growth. The economy is 10% or more below where it could have been if this had been a "normal" recovery. We are missing out on almost $2 trillion per year in annual income, and that is not insignificant.

The current economic recovery is the worst by historical standards as measured over the last 65 years and there have been two other economic expansions that have lasted much longer. The current expansion is limping along yet inflation is low, interest rates are at record lows, monetary policy is easy, and the consumer and corporate America have never been in better shape. Given these positive economic statistics, we expect to see a continuation of slow growth until such time that government implements pro-growth policies of increasing the after-tax rewards of working and investing and taking risk.

In Europe, the monetary experiment has morphed into a policy of negative interest rates where savers have to pay borrowers (banks) to take their money. The idea that low or negative interest rates imply better growth prospects makes little sense. Here is the problem with attempting to manipulate interest rates to affect the economy: there are two sides to the interest rate equation; a borrower and a lender. When interest rates are held low, borrowing is encouraged but income to lenders is also lower. When there are more lenders than borrowers, the net effect can be negative for the economy. Essentially, the Federal Reserve's power lies in its ability to provide a financial safety net under the economy. In times of financial crises, the Fed can take action to nullify that predicament.

Over the past few months, the elixir from low interest rates shows signs of wearing off. Car sales that were running at an annual rate of $17+ million have begun to decline. Home sales have also been wavering although further declines in mortgage rates may stimulate a round of refinancing that has little economic effect. Employment numbers were surprisingly favorable in a recent reporting period yet rising government regulations could undermine further growth as fewer people start new businesses.

By allowing the Bush tax cuts to expire, the current administration allowed the subsequent substantial tax increases to dampen the recovery. Without fracking to unlock significant oil and gas resources in the U.S., the economy could have fallen into what we call a fiscal recession, triggered by those higher taxes and slowing spending.

While the media continues to monitor the day-to-day machinations of the members of the Federal Reserve who debate the likelihood of a ¼ of 1% increase in the Fed funds rate, a policy change that appears meaningless in the overall economic picture, any discussion about fiscal policy adjustments to accelerate economic growth has been missing from either the Congress or the Administration. The outlook for any type of fiscal response for the balance of 2016 appears non-existent. The Congress seems to be focused on eliminating the deficit by cutting spending rather than by reducing taxes while the president battles Congress over implementing a variety of projects that don't appear to have any redeeming economic features.

The economy will have to await a new administration and a new Congress in early 2017 before there will be any type of fiscal policy action. In the meantime, there are forces that will keep the US economy on a growth path for the balance of 2016.

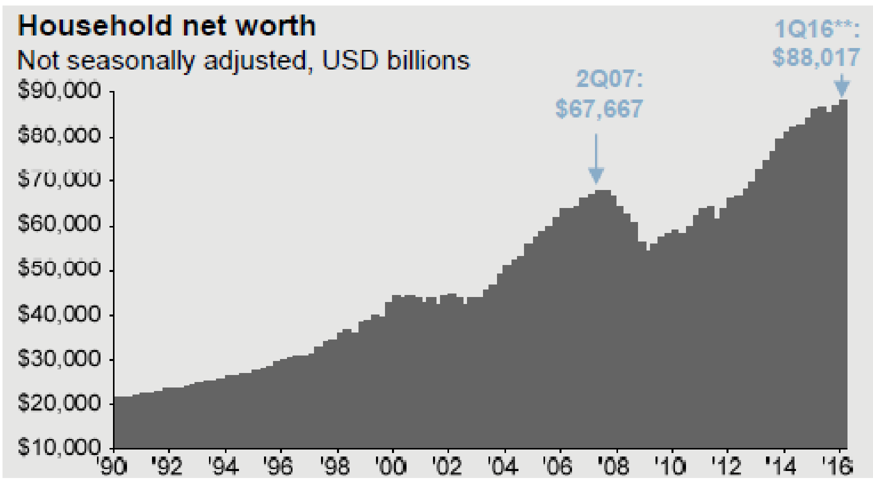
REBUILDING OF THE CONSUMER

The consumer (service sector) accounts for about 70% of all jobs in the US economy while manufacturing accounts for about 9% and government about 15%. So the health of the service sector tells us a lot about the health of the overall economy. The latest news on the health of this sector shows it is doing just fine. Last year we voiced optimism that the energy renaissance (lower oil prices due to increased domestic production) would supercharge the consumer and related spending that would lift the economy to a higher growth rate. Unfortunately, the heavy weight of plunging oil prices early this year threatened to destabilize the economy by undermining the viability of oil companies and the financial institutions that backed them. Fortunately, oil prices have recovered from a low of $26 a barrel to a range of $45 to $55 a barrel allowing the energy sector to survive and begin to rebuild plant and equipment. Even though oil prices bounced back, the consumer is still benefiting from year-over-year lower oil and gasoline prices.

The consumer did not respond by increased spending as expected but has been rebuilding resources for another day. Consider the changing burden of debt service—the interest and principal paid by consumers on loans. After peaking at 13.2% of disposable income in the fourth quarter of 2007, that liability has fallen to 10.2% in the first quarter of 2016.

Another solid measure of an improving consumer is overall household net worth. After plunging from a high of $67,667 billion in 2009, the subsequent recovery has taken that statistic to a new all-time high of $88,017 in the first quarter of 2016 and well above the record high in the second quarter of 2007 as reflected in Exhibit #2. This ongoing accumulation of wealth is not a house of cards built on a bulging debt bubble, regardless of what the scaremongers say. The typical household has cut its leverage by over 30% (from 22% to 15%) since the onset of the Great Recession in 2008. Household liabilities today are the same as they were in early 2008 (about $14.5 trillion), but financial assets have increased by one-third since then, thanks to significant gains in savings deposits, bonds, and equities.

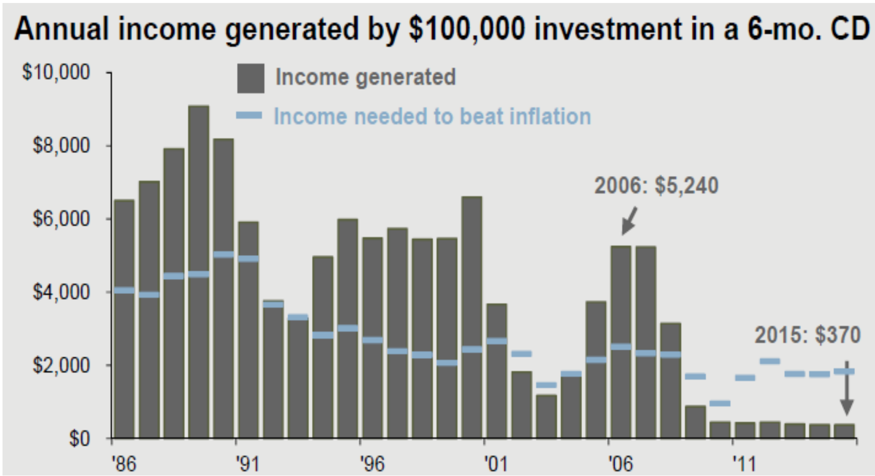
Exhibit #2



Courtesy of JP Morgan Asset Management

The consumer has also benefited from higher home prices and rising earned income. Unfortunately, individuals relying on income generated from bonds and CDs have suffered. Exhibit #3 reflects the decline in income on CDs since 1986 and the income needed on an after inflation basis. The income generated by a $100,000 investment in a 6-month CD remains below the level needed to beat inflation. Most market observers do not expect this situation to change in the foreseeable future.

Exhibit #3



Courtesy of JP Morgan Asset Management

CONCLUSIONS:

The US stock market remains in a long-term uptrend that is likely to continue given few signs that the economy is peaking out or heating up. Corporate profits are rising, inflation remains low, interest rates are likely to stay low for some time to come and corporations have never been wealthier. Low interest rates reflect that foreign investors are parking their capital in US government securities.

Exhibit #4

Courtesy of JP Morgan Asset Management

We do not see fundamentals justifying a major stock market decline. As you can see from Exhibit #4, the current bull market that began on March 9, 2009 has experienced a number of serious corrections that did not impact the long term uptrend. The recent BREXIT panic highlighted that market liquidity is not sufficient to offset short-term fear. We have these periodic, unpredictable stock price declines that may or may not be well founded. We had expected a relatively normal market advance this year but the combination of an unexpected decline in oil prices and the BREXIT confusion has kept pressure on the overall stock market. Michael Antonelli, a trader at Robert W. Baird & Co., puts this near-term stock market volatility into perspective: "Big swings often just reflect human emotions. The two can disconnect in the short-term because of the immediate effect sentiment has on stocks. Then that nervousness wanes, and people capitulate, and that's when you see the market come back."

Remember that our goal is to put financial market events into perspective for you.

Diane V. Nugent, *President/CEO*
Thomas E. Nugent, *Executive Vice-President*

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