Financial Markets Perspective

April 2019

# The Decade-Long Economic Expansion

### *A Once in a Lifetime Experience*

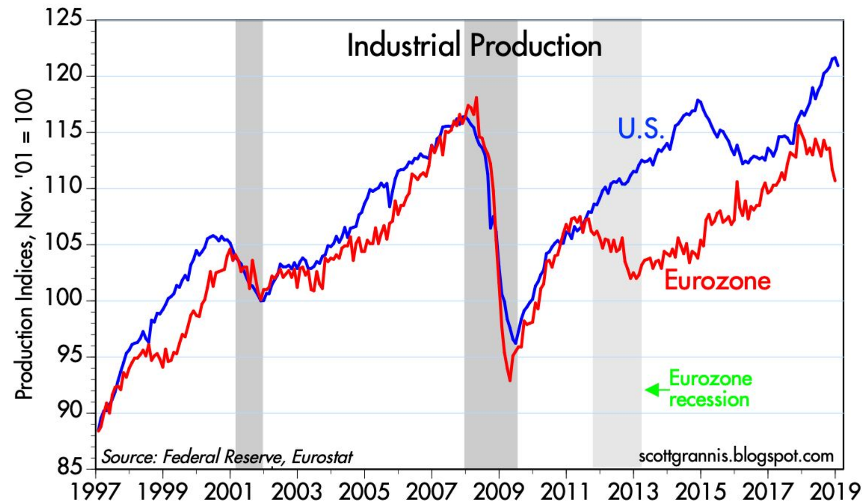
We are nine months away from the end of the first decade of the 21st century. In contrast with the last decade of the 20th century, we have experienced a string of favorable economic data, a record bull market in stocks, a trend to lower interest rates and continued low inflation. The first decade of the 2000s mimicked the 1930s with two stifling bear markets, a global military crisis and a meltdown in the residential housing industry. Ironically, the decade following the 1930s experienced an average annual return for stocks of about 9.5%. As we end the decade following the 2000s, the average annual return for the 2010s is about 9.5%!

There is still debate whether the stimulus provided by the Tax Cuts and Jobs Act of 2017 is working to grow the economy or not; as some of the president's opponents tout that it's just a "sugar high." The nonpartisan Joint Committee on Taxation expected the benefits of the tax cut to last only one year. The committee expected that the tax law would stoke inflation and force the Federal Reserve to raise interest rates. The Fed has since raised rates, but inflation did not go up –instead inflation has been coming down and has remained relatively stable. At the end of 2018, the fourth quarter inflation rate was 1.7%, revised lower from 1.8%. In hindsight, the Fed was too quick to act and possibly contributed to the stock market selloff in the fourth quarter of last year. Rather than inflation, the risk might be deflation as interest rates have been declining even more this year. The recent request by Larry Kudlow, economic advisor to president Trump, to lower the Fed funds rate by 50 basis points is a testament to the Fed's overreach in attempting to suppress inflation by raising interest rates too quickly.

We are concerned about the recent sharp increase in the price of oil to over $64 a barrel, up from a 2018 price of ~$42, a whopping 50%+ increase. International tensions plus reduced supply from OPEC nations are contributing to this increase. This sharp rise will be reflected in upcoming measures of inflation, such as the consumer price index, probably as early as May. If the trend continues, the Fed's strategy to remain patient will be pressured. On the other hand, the rise in oil prices encourages increased production from domestic producers, which is already at a multi-year high, that might stem the price rise. The bottom line: we are focusing on oil prices as a key inflation driver as we evaluate potential rate increases.

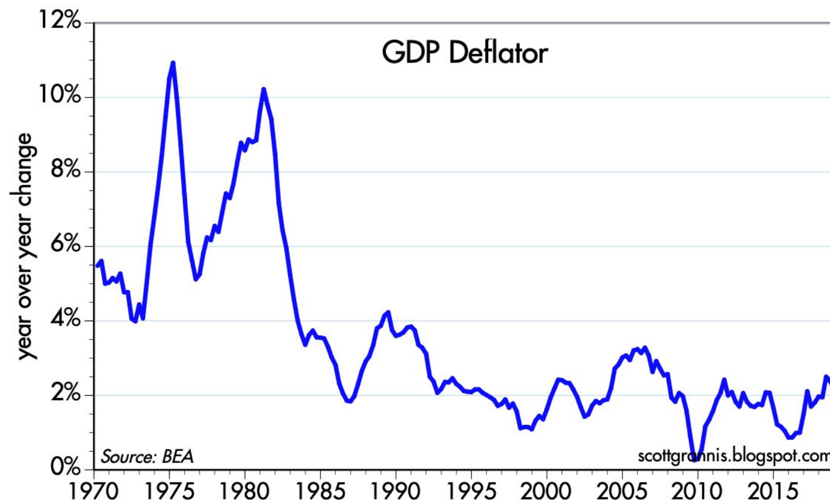
An important broad indicator of the economic health of America is the growth in industrial production. From a production standpoint, exhibit #1 indicates that we are doing quite well, as industrial production recently reached a record high. In Europe, where governments continue to rely on monetary policy to maintain economic stability, the story is a very different one. Since each member of the Eurozone has their own fiscal policy, there is no centralized mechanism to reduce taxes, lower regulation or impose spending policies across the region. As a result, monetary policy is the only mechanism to influence the Eurozone economy. While both the U.S. and European economies rallied after the last recession, the Eurozone has been noticeably weaker, and that softness could be traced back to the lack of any universal fiscal stimulus. There has been a considerable downturn in the health of the Eurozone as measured by industrial production.

*Exhibit #1*




After ten years of economic growth, economists and market observers could have expected to see an acceleration in inflation. Since the beginning of this decade, prices have remained relatively stable (as measured by the broad-based GDP deflator - Exhibit #2). The latest readings on this measure suggest that inflation is declining, not increasing. Many economists have been brainwashed by the surge in inflation back in the 1970s when OPEC exerted price controls on oil exports forcing U.S. prices to rise accordingly. After the quantitative easing program implemented by the Federal Reserve at the beginning of this decade, economists forecasted a surge in inflation due to the Fed's purchases of mortgage backed securities, a fiscal stimulus. As we now know, inflation never surfaced, even as the Fed grew its balance sheet to record levels.

Exhibit #2




## *More Growth, Less Inflation*

The Energy Renaissance created by fracking technology and leading to a surge in domestic oil and gas production has all but insured that oil induced inflation is a thing of the past. Another inflation measure is reflected in commodity prices. We are heading into the tenth year of an economic expansion and we still have low inflation -- even in the commodities arena where one would expect to see prices increasing due to demand pressures. Commodity prices peaked in 2012, right around the time fracking technology began to take hold (Exhibit #3). Gold, a

commodity that usually benefits from rising uncertainty, also peaked around the same time around $1,900 an ounce; and, has traded lower ever since (currently selling around $1,300 an ounce). Given all the global turmoil, trade wars, contentious political infighting (including Brexit), the stability in the price of gold is surprising.

*Exhibit #3*

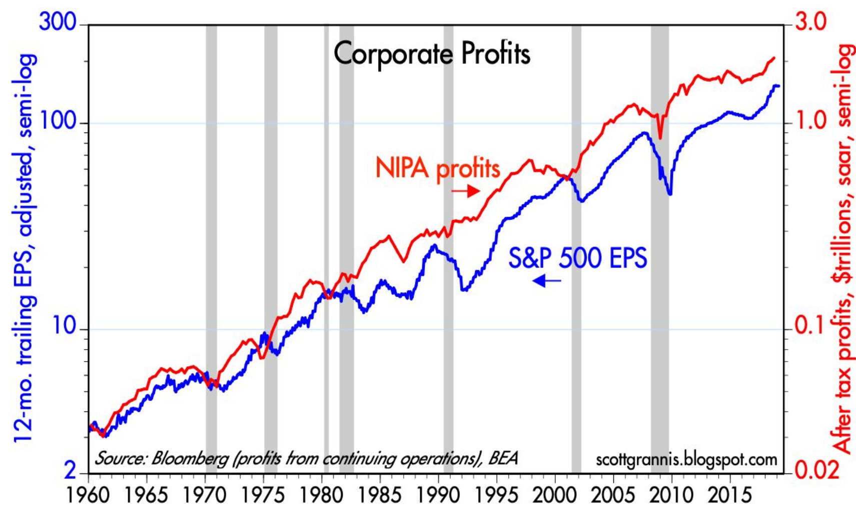
Another popular measure of inflation is based on the Fed Funds rate. While the Federal Reserve has pushed the Fed funds rate higher (short-term rates), long-term interest rates have been falling, leading some economists to fear an imminent recession. Exhibit #4 presents the history of 20-year Treasuries going back to 1994. This rate is used by large pension funds to make asset allocation assumptions about future rates of return. The chart demonstrates that investors poured money into long-term fixed income securities expecting reasonably high returns. Add in the end of OPEC-dominated oil markets and one can see that long-term interest rates may not bounce back to anywhere near the levels experienced during the early 1990s. There are two reasons why we expect the continuation of low, long-term interest rates: increasing wealth around the world seeking investments in safe securities and rising corporate profitability that leads to less borrowing and greater saving.

*Exhibit #4*

### *Growing Corporate Wealth*

Corporate profits are an essential element in a continuing stock market rally. Exhibit #5 documents the ongoing rise in corporate profits, including expectations for continued increases in both 2019 and 2020. The sharp reduction in corporate marginal tax rates from 35% to 21% allows corporations to keep 20% more of their pre-tax income. Reduced regulations have also allowed corporations to lower the costs that contribute negatively to profitability. Low interest rates have also lessened the costs of borrowing.

*Exhibit #5*




For investors, the bottom line is higher stock prices. Companies are buying back their own stock, acquiring other companies and increasing dividends; all actions that generally increase stock prices. Corporate earnings will also be aided by continued advances in productivity through new technologies such as 5G communications speed, automated vehicles and advances in robotics and artificial intelligence.

The main threat to continued growth in corporate wealth is government intervention. One proposal to limit a company's ability to buy back stock is another example of the camel getting his nose under the tent. Once the government encroaches on corporate rights then financial markets will be affected in a negative way.

## Conclusions:

One year ago, we made the following forecasts about the global economy and financial markets:

### *1. Solid Global Growth*

As the year of 2018 wore on, expectations for global growth were reduced. While the U.S. had the ability to implement fiscal stimulus, Europe did not because they do not have a central entity that can implement fiscal policy. Reliance on monetary policy (e.g., low to negative interest rates) has not been enough to generate continued economic expansion. The latest forecast from the Organization for Economic Cooperation and Development (OECD) indicates that the world economy will grow at 3.3% in 2019 down from an estimate of 3.6%. However, since virtually all stock markets around the world rallied in the first quarter, the forecasters may be a little too pessimistic in their outlook.

*2. Accelerating Domestic Activity*

The U.S. economy performed well in 2018 (2.9% annual GDP growth), the best growth rate since 2005. However, threats of tariff wars introduced some uncertainty into the growth equation and the fourth quarter of 2018 slowed to a 2.2% growth rate.

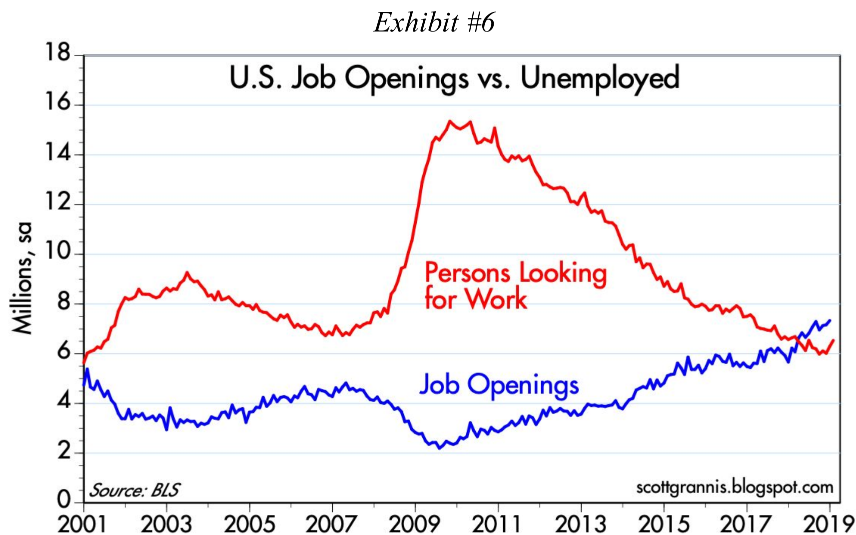
*3. Improved Capital Spending*

According to data obtained from the Federal Reserve Bank of St. Louis, Real Gross Private Domestic Investment measured in billions of dollars, rose from $3.25 for the fourth quarter of 2017 to a recent high of $3.47 at the end of 2018.

*4. Strong Employment and Higher Incomes*

Exhibit #6 compares job openings (which have jumped over the past year to record highs) to the number of people actively looking for a job. This chart paints an amazing picture: more job openings than people looking for work! An additional measure of rising wealth is growth in wages. Wage growth recently came in at 4.1%, showing that consumers have more money in their pockets this year than they did last even as inflation has remained steady.

*Exhibit #6*




Finally, the latest unemployment rate came in at 3.8%--the lowest level since 1969! One problem is that we cannot expect employment levels to continue to decrease as we are running out of people who can work. The unemployment rate is unlikely to fall much below current levels and it certainly can't go below zero! While some economists see the dark side in strong employment in the form of rising wage inflation, we do not concur. Rather, we see a wealthier and happier work force that can and will likely spend to maintain and improve their standards of living resulting in continued economic growth.

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