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Market Commentary

Romancing the Markets

This is the month of St. Valentine's Day, and it occurred to me that romances sometimes move in cycles, not unlike the **business cycle**. Think about it, after an initial meeting and getting-to-know-each-other period, a new romantic relationship may develop into something very intense. Then, eventually, it will probably either settle into something stable and lasting, crash like the Titanic or simply fizzle out.

The point is that the economy doesn't just stay the same forever. It changes. And since many of our decisions as investors depend on the business cycle, let's take a few minutes to decide where we are in the current economic expansion.

The New Year has gotten off to a relatively slow economic start. January's **U.S. manufacturing data** disappointed, though this was at least partly due to extremely cold weather in much of the country. Numbers could easily rebound as spring arrives. The December and January jobs reports also came in surprisingly weak. While the unemployment rate declined to 6.6%, its lowest point since 2008, many people have simply left the job market. At 63%, the labor force participation rate is at its lowest point in decades. This is partly due to demographic change (an aging population). We will have to wait and see how many people come back into the labor force as the economy keeps improving.

The Federal Reserve under new Chair Janet Yellen appears to understand that the expansion still needs **monetary support**. She testified before the House Financial Services Committee this month that she would not base monetary actions on the unemployment rate alone. Simply hitting 6.5% unemployment will not mean a monetary pullback, as had previously been thought.

Nonetheless, tapering of the stimulus level will likely continue unless data continues to come in soft. And as aggregate demand grows both in the U.S. and globally (as we think it will), we expect a gradual pick-up in inflation in both developed and emerging markets. The Federal Reserve, for its part, would like to see about a **2% inflation rate** for the U.S.

The recovery/expansion has been underway quite a while now (since July 2009). In fact, in terms of average post-WWII business cycle length, we might reasonably expect to be in the late stage of growth ahead of the next downturn. The flaw in this line of reasoning is that this expansion has not been average at all. The preceding collapse was more severe, and the recovery weaker than the historical norm. That means there is still a considerable **output gap** left to make up. In other words, unused slack still exists in the economy, therefore the current expansion could continue longer than usual. More on this below.

Figure 1. The S&P 500 in 2014
(daily adjusted close, source: Yahoo! Finance)

U.S. stocks stand close to their level at the start of this year, though volatility has been significant (see Figure 1 on previous page). As we stated last month, we expect 2014 returns to moderate from those of 2013 as multiples no longer signal bargain prices. But solid returns are still possible from earnings

growth, which is forecast to be in the 8-10% range over the next couple of years. International developed markets could see even better earnings expansion (and returns).

I was reading legendary investor **Bob Farrell's 10 rules** for investing recently, and was reminded of how much faith he put in long-run consistency over the short-term emotions that sway so many investors back and forth to losses. This year has gotten off to a volatile start, and we could see more of that. If we do, it will be important to remember that long-term resolve is the path to beating the returns garnered by emotion-driven investors.

The U.S. government's fiscal year began last October, and the **federal budget deficit** has fallen significantly compared to year-before values. An improving economy, as well as sequester spending cuts, helped. The deficit is important because declines help mitigate upward pressure on interest rates, which helps sustain the expansion. In other news from Washington, a new debt ceiling increase passed without a political standoff or conditions. This gives the impression that government and political gridlock may not be a big risk in 2014.

In **Japan**, this will be an important year for the ultimate outcome of Prime Minister Abe's reforms. Structural changes will aim to increase the number of foreigners and females in the workforce, among other things. Fiscal reforms will include a cut in the effective corporate tax rate from 38% to 35.6%, with the intent of creating real economic growth. Rising tensions with China remain a significant risk factor.

Bad feelings have smoldered between the two since World War II. Recent heightened rhetoric has begun to impact economic flows. For instance, China's **foreign direct investment** in Japan fell 23.5% last year. Yet it remains hard to see tensions escalating into actual armed conflict. Everyone has too much to lose. Stranger things have happened though, so the situation bears close watching.

Emerging Markets remain something of a wild card in the global picture. January was another difficult month for EMs and we expect there could be more difficulty through the first half of the year, with prospects likely improving in the second half.

In bond markets, the recent soft economic data has helped Treasury rates decline in 2014. We, and most other observers, still expect such declines to be the exception rather than the rule going forward, and for 2014 to be an up year for interest rates. With **corporate earnings** still strong and forecasted default rates low, we continue to favor the high yield sector of the market.

Oil supply has tightened up globally under stronger than expected demand. But prices, while not likely to fall in the near term, may not be able to rise much either with the growing **U.S. shale production** capacity.

Remember above that we said this expansion stage could continue for awhile? A recent Goldman Sachs cluster analysis related a number of current economic variables to their own values in past periods, as well as the stage of the business cycle. The analysis suggested that we may only be around the middle of the current expansion. In other words, economic romance appears to be alive and well!

Those are the most prominent and pressing issues on our radar right now. Going forward, we can always be certain of uncertainty, so we will be monitoring the situation closely and getting back to you as the situation warrants. We send thanks to those of you who are our clients. We value the trust you have placed in our firm and we sincerely appreciate your business. Please do not hesitate to call or email us if you have any questions or concerns.

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