Smith Affiliated Capital

THIRD QUARTER 2015 INVESTMENT COMMENTARY

RESTRAINED LONG TERM GROWTH

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More of The Same: Lumpy Growth, Wage Stagnation, Uncertain Policy Prospects and Turbulent Global Markets Point to a Strong Safe-Haven Bid and Lower Yields Than Normal.

We'd like to say the economy is moving two steps forward and one step back, a pattern that would generate an erratic but impressive growth over time, but the sum of the gains made during this recovery – now six years old – has been anything but impressive. Compared to previous upturns, just about every key measure of economic performance has fallen short—far short. That includes the cumulative growth in output, incomes, jobs, business investment, housing and personal consumption. Since 1960, none of the 11 recoveries has suffered more than one quarterly contraction in real GDP; this one has seen three, including the 0.2 percent decline in the first quarter.

To be sure, all three of the setbacks during the current recovery can be blamed on extraneous factors – the Japanese tsunami that disrupted supply chains in the first quarter of 2011, extremely cold and snowy weather in the first quarter of 2014 and weather again, along with a West Coast port labor dispute, in the first quarter of this year. The point is, when an economy is cruising at a slower pace than it should, it is more vulnerable to outside shocks. Many reputable economists view the persistent subpar growth of this recovery as being the "new normal", i.e., a 2 percent growth rate is the new 4 percent of the past. No doubt the modest rebound in the second quarter may disabuse some of that notion. But even if the pace speeds up to 2 ½ - 3 percent for the quarter, growth for the entire first half of the year would still fall short of the 2.2 percent average registered during the six-year recovery.

Modest Spring Bounce

Waiting for the much-heralded rebound in economic activity is becoming ever more like waiting for Godot. With the harsh weather of the winter months over and the West Coast port dispute resolved, the so-called transitory forces that stifled growth in the first quarter has long been removed. Consumers did reopen their wallets and purses in March, but the gain was modest at best. Continuing the erratic pattern, spending stagnated in April, before posting a solid increase in May. While positive for the period, the spending rebound during the spring months was not nearly as robust as expected. With demand lagging, the output side of the ledger remained sluggish as well. May was the sixth consecutive month that industrial production failed to increase, the longest such stretch of stagnation outside of a recession in the postwar period. Simply put, growth resumed in the second quarter, but the rebound pales next to last years' experience, when real GDP surged by a 4.6 percent annual rate following the weather-induced contraction over the winter.

For the most part, economists are expecting only modest growth for the quarter, with the consensus pegging a GDP increase in the 2 – 2 ½ percent range. That would be commensurate with the average growth rate since the recovery began. But as noted earlier, the current recovery has been much weaker than past upturns and such a modest rebound would not make up the ground lost over the past six years. Hence, output remains well below where it should be if the economy were operating at its full potential. Put another way, after six years of recovery, there's still a good deal of slack in the product and labor markets and that, as much as anything, is keeping a lid on wages and prices.

Secular Stagnation Looking More Credible

The stubborn refusal of the economy to break out of its prolonged and erratic growth pattern is giving credence to the notion that it is mired in secular stagnation. That is, given the current state of global economic and demographic forces, the growth potential of the U.S. has been significantly reduced. As a result, its citizens are doomed to an era of

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lower living standards and less employment than would be the case if the economy operated at the higher noninflationary speed limit it enjoyed in years past.

In our view, there are no such catalysts on the near-term horizon that would jump-start the economy's growth engine into a sustained higher gear. Just the opposite is the case, as the crucial trends that determine the economy's potential growth rate, labor force and productivity growth, are slowing dramatically. The CBO expects the labor force to increase by about 0.5 percent a year over the foreseeable future, less than half its historical pace. To compensate for this shortfall, productivity growth would have to accelerate from its sixty-year average of roughly 1.5 percent a year. But it is going in the wrong direction, averaging about half-percent over the past two years. One reason: Companies are not motivated to invest in productivity-enhancing plant, equipment and technology despite historically low borrowing costs and ample available cash. Instead, they are channeling their record profits into nonproductive uses, such as mergers and acquisitions, stock buybacks and shareholder-friendly dividend payouts. The lackluster pace of capital spending since the end of the recession has contributed importantly to the subpar performance of the recovery, even as it diminishes the economy's long-term growth prospects.

Groundhog Day For Workers

Simply put, the economy's tepid first-half performance creates a sense that we are witnessing "more of the same". If nothing else, this Groundhog Day pattern instills a sense of resignation in the minds of business leaders and households that the economy is in a rut. That mentality itself could impair growth.

To eradicate that mentality, it would be necessary to string together more than two consecutive quarters of above-trend growth, raising hopes that the economy is finally poised to achieve "escape velocity." But that hasn't happened in this recovery yet and there is no guarantee that it will, given the array of headwinds that loom ahead. That's not to deny some of the positive trends underway, particularly in the job market. But even here the gains have been lumpy and far from satisfying. The 223,000 increase in nonfarm payrolls in June just about met expectations, but the previous two months were revised down, yielding an average monthly increase of 208 thousand over the first half of the year. That's considerably slower than the 258 thousand monthly average registered for all of 2014.

What's more, the details behind the headline increase depicted more weakness than strength. The unemployment rate did slip again, to a seven-year low of 5.3 percent from 5.5 percent, but the decline reflected another drop in the labor force participation rate, which fell to the lowest level since 1977. In other words, the lower unemployment rate is entirely due to people leaving the labor force, not jobseekers finding work. And all of the job gains were in the service sector, such as retail, health services, leisure and hospitality and temporary jobs, not in the higher paying manufacturing and construction industries. Indeed, perhaps the most important component of the June jobs report – worker earnings – continues to show the most distressing Groundhog Day pattern.

Recall that the May jobs report generated a lot of optimism, not only because of the blockbuster payroll gain (which, as noted, was revised down in the June report) but also because of nascent signs that wage gains were starting to accelerate. The year-over-year increase in average hourly earnings rose to 2.3 percent, finally topping the upper end of the tepid 2.0-2.2 percent range seen over the past several years. But once again, that proved to be another head-fake. Instead of breaking out of that narrow range, workers received no increase in hourly earnings in June, returning the year-over-year gain to 2.0 percent.

More than anything, the inability of workers to obtain meaningful wage increases signifies that there is still a considerable amount of slack in the labor force, certainly much more than indicated by the unemployment rate. If that weren't the case, wage growth would not be stagnant and labor costs would be putting upward pressure on prices. Reflecting this slack, there are still more than 6.5 million people working part-time who would prefer full-time positions. That number has been declining but remains historically high as a share of total employment. According to a recent analysis by the Federal Reserve Bank of Atlanta, at the current pace of decline it would take 10 years before the part-time share of total employment returns to prerecession levels.

Policy and Rates

With household purchasing power still constrained by stagnant wage growth, we do not expect consumer spending to contribute much momentum heading into the second half of the year. Some spark may come from the housing sector, where sales and building activity have strengthened in recent months. But this sector has a much smaller footprint in the economy than was the case prior to the housing collapse, limiting its thrust. The other swing sector, capital spending, is still in the doldrums and the weakness in durable goods orders suggests it will remain there for the immediate future.

It is widely assumed that the Federal Reserve is committed to raising short-term interest rates later this year, perhaps as early as September. Through our lens, the odds are that the liftoff date will be delayed at least until December. It's possible that the Fed will be satisfied with some key labor market metrics by the fall, but it will be reluctant to move in the face of stagnant wages, the most visible metric of slack in the labor force. Nor in the absence of wage acceleration will the Fed feel confident that inflation is moving towards its 2 percent target. As it is, the inflation trend is moving in the wrong direction, as the core PCE deflator – the Fed's preferred gauge – receded to 1.2 percent in May from a nearby peak of 1.5 percent.

The bond market has already priced in a rate hike and is not likely to overreact to an actual move when it occurs. Indeed, an array of developments should counter any upward pressure on long-term rates. The abrupt slowdown in China is reinforcing global goods deflation even as it drags down growth among emerging market nations. The woes of China are amplified by the turmoil in Greece and Puerto Rico, heightening the uncertainty that always generates a strong safe-haven bid for U.S. Treasuries. The increased demand For Treasuries, in turn, drives up the dollar, which reduces import prices and puts further downward pressure on inflation, even as it hurts exports and growth prospects.

There is still plenty of time and data for the Fed to digest between now and September, so nothing is set in stone. We suspect that the uncertainty regarding the aforementioned developments will only intensify over the summer, setting the stage for heightened market volatility. The Fed, of course, is sensitive to global economic and financial market developments and will monitor them as well as domestic data closely before taking any action. Even if, as is likely, the Fed begins to normalize policy later this year, the timing of the liftoff date is much less important than the entire trajectory of the rate cycle. Unlike the last tightening cycle that began in 2004 and included quarter-point rate increases in each and every one of 24 subsequent policy meetings, this one will be much slower and wind up lower than past ones. At its June 17 meeting, the Fed projected the long-term equilibrium funds rate at 3.50 percent, down from 4 percent projected in the spring of 2014. That lowered endpoint is consistent with our view that the economy's potential growth rate and inflation prospects are lower than in years past. The new "normal" for long-term rates should also be taken down a notch to a level not much higher than where they are now.

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***Note: Please see additional financial data on page 4**

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	6/30/2014	3/31/2015	6/30/2015	Last Quarter (1)	Last Year (2)
6-Mo. Bill	0.06	0.11	0.06	0.05	0.12
2-Yr. Note	0.46	0.56	0.65	0.50	0.97
5-Yr. Note	1.63	1.38	1.65	1.74	3.92
10-Yr. Note	2.53	1.93	2.35	2.60	9.91
30-Yr. Note	3.36	2.54	3.12	5.05	25.73

Municipal Bonds	Yields (%)			Total Return (%)	
	6/30/2014	3/31/2015	6/30/2015	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	3.57	2.81	3.28	1.67	10.63
ML G.O. 22+ Index	3.25	2.60	3.14	1.69	11.03

Equities	Levels			US $ Terms (%)	
	6/30/2014	3/31/2015	6/30/2015	Last Quarter (1)	Last Year (2)
S&P 500	1,960.23	2,067.89	2,063.11	0.28	7.41
DJIA	16,826.60	17,776.12	17,619.51	-0.29	7.19
NIKKEI (Tokyo)	15,162.10	19,206.99	20,235.73	5.43	35.67

Commodities	US $			Percent Change (%)	
	6/30/2014	3/31/2015	6/30/2015	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,327.33	1,183.68	1,172.42	-0.95	-11.67
CRB Future Com. Pr. Index*	308.22	211.85	227.17	7.23	-26.30
West Texas Intermediate Crude ($ per bbl)	105.37	47.60	59.47	24.94	-43.56

Currencies	Levels			Percent Change (%)	
	6/30/2014	3/31/2015	6/30/2015	Last Quarter (1)	Last Year (2)
Yen	101.33	120.13	122.50	-1.97	-20.89
Sterling	1.71	1.48	1.57	6.03	-8.15
Euro	1.37	1.07	1.11	3.88	-18.59

Foreign Bond Markets	Levels			US $ Total Return (%)	
	6/30/2014	3/31/2015	6/30/2015	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	0.18	0.01	-0.04	N/A	N/A
ML German 10-Yr.+ Bond Index	1.97	0.47	1.35	-12.61	11.16
3-Mo. LIBOR Yen Fixing (3)	0.13	0.10	0.10	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	1.16	0.89	0.98	-0.72	5.10

Source: Bloomberg Financial Data

Notes: 1) 6/30/2014 thru 3/31/2015 2)6/30/2014 thru 6/30/2015

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index