Smith Affiliated Capital

FOURTH QUARTER 2013 INVESTMENT COMMENTARY

"No Time for Tapering Amid Fragile Recovery, Dysfunctional Government and Unfolding Longer-Term Trends Pointing to Slow Growth Beyond 2013"

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The Federal Reserve's decision not to taper on September 18 was greeted with shock! shock! in the financial markets. Fed critics complained that they were deceived, misled and, worse, betrayed after they had implicitly given the central bank a pass to reduce asset purchases, having paved the way by driving bond yields higher over the summer. From our lens, nothing could be further from reality. To be sure, the Fed's already-imperfect communication skills took another big hit. But its policy response fit perfectly with prevailing conditions.

Indeed, the Fed's inadequate communication skills are only surpassed by its dismal forecasting record. Last June, when Bernanke publicly hinted that a pullback could begin before the end of 2013, the Fed's staff projected a significant acceleration in growth over the second half of the year, substantial improvement in the labor market, and a pickup in inflation. On all three counts, the Fed gets a zero for accuracy. Growth slowed in the third quarter, job gains withered and inflation remained dormant. To be fair, Bernanke did emphasize back then that any policy decision would be data-dependent, something that the chairman forcefully reminded pundits in defense of the stand-pat stance taken at the September FOMC meeting.

We suspect that the budget/debt-ceiling debacle in Washington also weighed heavily in the Fed's decision. The fiscal austerity already in place siphoned some of the winds from the economy's sails over the first half of the year, and policy makers feared more economic carnage would come from prospective shenanigans by politicians aimed at pleasing the more extreme wings of the voting public. While the shutdown now underway should not do much damage if it only lasts a short while, more lasting repercussions would be felt if the legislative clowns fail to raise the debt ceiling in a timely manner, bringing on an unprecedented default. In any event, consumer confidence is already starting to sag and businesses could well hold off hiring and spending decisions until there is more clarity on fiscal issues as well as the cost implications of the unfolding Affordable Care Act.

The Fed Misread the Economic Tea Leaves

In retrospect, it seems almost folly that the Fed would even consider scaling back bond purchases last June. Yes, growth did pick up modestly in the second quarter relative to the first, but offsetting quarterly gyrations have been a common feature throughout the recovery. Looking at the economy's performance on a year-over-year basis, the trend should have been obvious. Real GDP increased by only 1.6 percent in the twelve months through the second quarter, a tad better than the 1.3 percent annual gain in the first quarter but much weaker than the 3.3 percent cycle peak reached in the first quarter of 2012. In current dollars, the performance is even more downbeat. Nominal GDP registered a 3.1 percent increase in the January-June period compared to a year earlier. That's not only weaker than the 4.6 percent gain in 2012, it is the slimmest year-over-year increase outside of a recession in the postwar period.

Deflationary Trends

To be sure, the historically slow growth rate in nominal GDP reflects in part the unusual decline in inflation, something that normally does not occur four years after the end of a recession. As much as the weakness in real growth, the periodic threats of deflation during the recovery have prompted the Fed to retain its turbocharged easy policy longer than it otherwise would. Indeed, the GDP deflator – the broadest measure of prices in the economy – increased by only a 0.7 percent annual rate in the second quarter, the slimmest gain since the third quarter of 2009 and less than half the 1.7 percent average increase over the 14 quarters of the recovery. The Fed's preferred inflation gauge – the PCE less energy and food – has increased at a 1.2 percent annual rate over the last several months, much less than the 2 percent target.

No doubt, the continued ebbing of inflation this year worries the Fed as much as weak growth and fiscal follies do. Several officials — including, most vociferously, St. Louis Fed President Bullard — believe that inflation is too low and the economic data too inconclusive to justify a change in policy. In public, Fed chairman Bernanke still believes that transitory forces have been primarily responsible for holding down inflation, which he expects to move up towards its 2 percent target over the second half of the year. In light of the recent growth slowdown, the absence of wage or other cost pressures and considerable slack in the labor and product markets, that prospect is looking increasingly remote.

Hiring Still Tepid

Nothing is more symbolic of the summer doldrums than the disappointing performance of the job market. True, the unemployment rate continued to fall, receding to 7.3 percent in August from 7.6 percent in June; but that's hardly a meaningful measure of improving conditions. The entire drop was due to a growing fraction of the nonworking population choosing not to search for a job. The share of the adult population in the labor force slipped to a fresh 35-year low of 63.2 percent in August from 63.6 percent in June. Simply put, the unemployment rate is dropping for the wrong reason.

The right reason would be for companies to hire workers at a faster pace than the population is growing, sopping up the dropouts as well as unemployed individuals who are still searching for a job. Sadly, that is not happening. The employment to population ratio stood at 58.6 percent in August, down from 58.7 percent in June. When the recovery began in July 2009, the employed share of the population stood at 59.3 percent. Clearly, the economy's job engine is not running on all cylinders and time is running short for many left behind. Of the 11.3 million out-of-work job seekers, fully 4.3 million have been unemployed for at least six months. The job prospects for these long-term unemployed dim with each passing day, as idleness erodes job skills and feelings of self-worth, attributes that makes them seem less desirable to prospective employers.

To be sure, things look better for individuals with jobs, thanks to the steep falloff in firings as the recovery progressed. Indeed, the number of workers laid off this summer was the lowest since data collections for this series began in 2001, a trend fully corroborated by the steep decline in initial applications for unemployment benefits. But the hiring pace is only just inching off its cycle lows and remains far below prerecession levels. Companies may be holding on to their workers, but are only reluctantly expanding payrolls. Not surprisingly, at his post-FOMC press conference on September 18, Chairman Bernanke abandoned his earlier assertion that bond-purchases would cease when the unemployment rate fell to 7 percent. That folly of adhering to a meaningless target amid overwhelming evidence of weak labor conditions has finally brought the chairman to his senses.

Main Growth Drivers on Shaky Legs

The Fed is counting on faster growth to spur more hiring, but both the near-term outlook and even beyond is looking less promising than the advanced stage of past upturns. Although figures for September are not yet available, virtually all tracking models see the third quarter slowing markedly from the 2.5 percent annual rate posted in the April-June period. With employment gains lackluster and wages stagnant, the main growth driver going forward – consumer spending – will not be providing much thrust over the second half of the year. Auto sales are thriving, thanks to pent-up demand and the need to replace an aging fleet, but these purchases are coming at the expense of most everything else.

Housing and related purchases have been another bright spot that the Fed is relying on to propel the recovery into higher gear. But even here, signs of fraying are becoming evident. With mortgage rates up by more than one percentage point since April, average monthly payments on a typical $200 thousand loan have increased by 15 percent. That burden is weighing heavily on first-time homebuyers. This cohort tends to be younger and earn less than the median income; hence, they do not have the higher credit scores demanded by banks. Not only is the unemployment rate in the 20-24 year age group at 13 percent, these potentially new entrants to the housing market are burdened with a huge amount of student loans that virtually shuts them out of the mortgage market. Worse, only 40 percent of people in their early 20s hold a full-time job, down from 54 percent just prior to the recession.

At best, assuming the fiscal debacle does not do more permanent damage, growth will pick up modestly later this year and 2014. But to eradicate the global oversupply of labor and product capacity, a much stronger acceleration than anyone perceives will be needed. Despite five years of massive monetary stimulus, the economy is still unable to find its way to a sustainable recovery path that generates a comparable amount of growth and employment gains seen in past upturns. That dismal underperformance is set to continue over the foreseeable future.

Slow Growth the New Normal

The nation's potential growth rate – the fastest long-term rate that can be sustained in a noninflationary environment – is the product of two trends: the growth in the nation's labor force and growth in labor productivity. These determinants have slowed considerably in recent years, partly in response to the economy's subpar performance. However, both the labor force and productivity are destined to grow at a slower pace in the years ahead.

Over the past decade, the labor force has grown at a 0.7 percent annual rate, less than half the 1.5 percent average annual increase over the previous fifty years. Some of that slowdown is cyclical, reflecting the impact of the Great Recession and weak recovery that caused millions of workers to drop out of the job market. However, the slowdown is also the product of longer-term demographic forces. For example, the labor force grew by a 2.5 percent pace during the 1970s and early 1980s, due largely to the mass entrance of women into the workplace; that trend reached a saturation point in the mid-1980s. For another, the working-age population is aging, with an ever-increasing number of baby boomers exiting the labor force for retirement. Finally, immigration laws have toughened significantly since 9/11, resulting in a sharp reduction in net migration to the U.S. Taking all these factors into account, the Congressional Budget Office projects the labor force to grow at a 0.6 percent pace over the next five years, far slower than the 1.5 percent long-term trend.

Meanwhile, the other variable in the growth equation, productivity, is also undergoing a fundamental slowdown. No doubt, the drop-off over the past year or so is typical of an aging recovery. After surging by nearly 4 percent in 2009 and 2010, labor productivity has since slowed considerably and showed no gain over the first half of 2013 compared to a year ago. But there has been a notable downshift in productivity growth since before the last recession – averaging 1.5 percent a year since 2005 compared to 2.5 percent over the previous sixty years – that may reflect more fundamental forces. For example, business investment spending – particularly on productivity-enhancing high-tech equipment and software – has taken the smallest share of GDP over the past five years than any comparable period since 1960s. According to a recent study by the Federal Reserve Bank of Atlanta, research and development spending – the most important source of productivity growth -- has increased by an average of 1.1 percent over the past five years, far below the 50-year average of 4.6 percent.

The recent slump in capital and R&D spending indicates that productivity growth will stay in the 1 –1 ½ percent range over the next several years. Combine that with the CBO's projection for the labor force puts the potential growth rate of the U.S. economy at about 2 percent, well under the 3.5 percent long-term trend. Simply put, there is nothing on the near or medium term horizon that would prompt the Fed to pull back on its asset-purchase program. Growth remains sluggish with no signs of a meaningful pickup. Indeed, if the demand for housing and autos falter, the economy would be a few hiccups away from falling into a recession. A long-lasting government shutdown that heightens confidence-shattering jitters over the debt ceiling could well be the final straw sending the economy over the cliff. Meanwhile, outside of the housing market, price pressures remain firmly bottled up, removing another motivation to slacken the pace of QE.

Just as the bond market priced in a tapering during the summer, driving the 10-year Treasury yield up to near 3 percent, it now recognizes that fundamental forces will keep the Fed on the sidelines at least through the remainder of the year and probably into 2014. At his post-FOMC press conference, Bernanke noted that the economy was too fragile to withstand higher rates and is no doubt relieved that the 10-year Treasury yield has since fallen by about 35 basis points. We suspect that both the Fed as well as unfolding fundamentals will underpin the need for sustained low rates over the foreseeable future.

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Rates and Total Returns Quarterly And Annual Comparisons

US Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	09/30/2012	06/30/2013	09/30/2013	Last Quarter (1)	Last Year (2)
6-mo. Bill	0.13	0.09	0.03	0.06	0.22
2-Yr. Note	0.23	0.36	0.32	0.22	0.28
5-Yr. Note	0.63	1.40	1.38	0.69	-1.59
10-yr. Note	1.63	2.49	2.61	-0.66	-5.71
30-Yr. Note	2.82	3.50	3.69	-3.16	-13.01

Municipal Bonds	Yields (%)			Total Return (%)	
	09/30/2012	06/30/2013	09/30/2013	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	3.37	4.37	4.80	-1.89	-5.13
Ml G.O. 22+ Index	3.19	4.25	4.66	-2.99	-6.66

Equities	Levels			US $ Terms (%)	
	09/30/2012	06/30/2013	09/30/2013	Last Quarter (1)	Last Year (2)
S&P 500	1,440.67	1,606.28	1,681.55	5.25	19.33
DJIA	13,437.13	14,909.60	15,129.67	2.12	15.59
NIKKEI (Tokyo)	8,870.16	13,677.32	14,455.80	6.27	65.64

Commodities	US $			Percent Change (%)	
	09/30/2012	06/30/2013	09/30/2013	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,772.10	1,223.70	1,328.94	8.60	-25.01
CRB Future Com. Pr. Index*	309.30	275.62	285.54	3.60	-7.68
West Texas Intermediate Crude ($ per bbl)	92.19	97.23	102.33	5.25	11.00

Currencies	Levels			Percent Change (%)	
	09/30/2012	06/30/2013	09/30/2013	Last Quarter (1)	Last Year (2)
Yen	82.87	86.75	91.22	-5.15	-10.08
Sterling	1.6008	1.6255	1.5198	6.50	5.06
Euro	1.3343	1.3193	1.2819	2.83	3.93

Foreign Bond Markets	Levels			US $ Total Return (%)	
	09/30/2012	06/30/2013	09/30/2013	Last Quarter (1)	Last Year (2)
3-mo. LIBOR DEM Fixing (3)	0.15	0.15	0.16	N/A	N/A
ML German 10-yr.+ Bond Index	2.07	2.30	2.41	-1.10	-2.62
3-mo. LIBOR Yen Fixing (3)	0.19	0.16	0.15	N/A	N/A
ML Japanese 10-yr.+ Bond Index	1.48	1.44	1.29	2.72	4.59

Source: Bloomberg Financial Data

Notes: 1) 06/30/2013 thru 09/30/2013 2) 09/30/2012 thru 09/30/2013)

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index