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A GLASS HALF FULL?
INVESTMENT STRATEGY
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A Glass Half Empty

Employment:

It has been five years since the Great Recession ended on June 30th, 2009, and yet instead of being at the peak of this cycle, it "feels" like the US economy is still in its recovery stage. Even though the unemployment rate has fallen to 6.3% the labor force participation rate has also fallen to 62.8%, a 36-year low. This is well below the 66.4% rate seen in 2007, and **without that drop, the labor force would be almost 9 million people larger today.** As a result, if these drop outs were still in the labor force, but were unemployed (as they in effect are today having dropped out), **the unemployment rate would be about 11%.** Thus, a **significant part of the decline in the official unemployment rate to 6.3% is due to the *departure* of people from the labor force rather than their employment**. (Remember, the labor force is the sum of employed and unemployed individuals and if you are not actively looking for a job you drop out of the labor force.)

Once the participation rate stabilizes the economy should start printing 3% growth numbers on a more consistent basis. But since the end of the Great Recession the labor force has only grown by an annual rate of around 0.1% and over the last three calendar years by around 0.3%, a far cry from the 1% rate needed to stabilize the participation rate. This decline in the participation rate is partly due to the planned retirements of baby boomers and partly due to departures from the labor force by discouraged workers. Either way, it has had and may for a while longer continue to have a dampening effect on economic growth.

We suspect that most of the decline in the participation rate is secular rather than cyclical for two reasons. First, the downward trend started already in 2000 - long before the Great Recession, and second, the baby boomers continue to phase out of the labor force. The statistics show a sharp drop in the participation rate once individuals reach age 60. **This then is the key question for the US economy – will the participation rate now stabilize?**

Global Gross National and Domestic Product (GNP & GDP):

There remains a huge production gap, i.e., a gap between what we can produce and what we are producing. Business capital investment is weak – why, because businesses report soft consumer demand for products. One can see this in the GDP statistics where consumer demand represents 70% of the economy – and it has been growing over the last three years at a rate just over 2%, compared to a growth rate of 3.5% during the 10-years leading up to the prior recession. We suspect this slower growth in spending has something to do with the aging of the US population and the declining participation rate.

In fact, during the first quarter GDP growth was a NEGATIVE 2.9%. We can't recall ever seeing a quarter that bad during an economic expansion. The weak US economic recovery has been dampened by the lingering effects abroad of the last recession which have produced a continued recession like environment in Europe. China, the second largest economy in the world has been going through its own restructuring, and its growth too has slowed as its major export markets, Europe and the US have been experiencing slow growth or recession. Japan, with its aged population and stagnant economy has provided little support to global growth. Economic recovery from the Great Recession has been a long, slow process.

A Glass Half Full

Low Inflation, Low Interest Rates:

Because of the production gap and the ready availability of labor, the US is experiencing a low level of inflation as neither businesses nor labor can demand higher prices for the same product. In fact, the great concern in Europe as well as Japan has been the possibility of deflation – a declining price environment. Within the Eurozone, inflation rates are lower among the peripheral countries than the core countries raising the relative competitiveness of the peripherals. That is good news, as is the fact that low inflation means extremely low interest rates – which have allowed businesses, consumers, and governments to restructure their debt at lower interest rates.

Exceptionally low interest rates have also encouraged businesses, which are having a hard time increasing their sales, to do so through acquisitions at low financing costs. The corollary to low interest rates has been the steady rise of the stock markets which have risen rather persistently through the last five years. In view of the level of interest rates, even considering what they may become in a year's time, the valuation of the US stock market does not appear to be excessive.

Improving Employment:

Last year 194,000 net new jobs were created on average each month (per the employment report that comes out monthly). This year we are running at 37,000 jobs **more** per month, an annual rate of 444,000 more jobs, or almost 20% more than last year. Better, but not great.

GDP Growth:

The economic growth of the second quarter probably comes in at 3% to 3.5% - an average rate of growth in US economic history, but good in contrast to the negative growth of the first quarter. We have seen the first increase in consumer demand in the auto sector as consumers have been forced to buy new cars as cars on the road today average 11.4 years, a point beyond which it does not make economic sense to maintain most autos. While the availability of non-revolving credit has helped vehicle sales, we have been disappointed by the housing recovery as the difficulty in getting mortgages has hurt particularly the first time home buyers as strict lending standards have prevented many from obtaining mortgages. Last month, first time home buyers accounted for only 27% of existing home sales, well below the 40% level you expect to see in a healthy market.

As both job growth and housing recovers we would expect better consumer spending in the US, and as a result greater capital investment by businesses. How quickly this occurs is this question.

Energy Independence:

The discovery in the US of large quantities of gas and oil along with it, has been improving our trade balance for several years. It creates a long term competitive advantage because it lowers the cost structure of doing business and getting goods to market. For example, domestic natural gas prices have in recent years been around one fourth of the global average.

The Federal Reserve:

Because of the US Government's deficit as well as the amount of government debt, Congress and the President have little room to provide stimulative spending. It falls then to the Federal Reserve to support the economy through low interest rates which it has vowed to do for as long as possible until the economic recovery is firmly entrenched, employment is full, and before inflation rises significantly above

2%. In her last press conference, Chair Yellen implied that low interest rates could continue well past mid 2015 into 2016. Thus we have had a rally in both bond and stock markets that may continue.

Looking Forward: How Does it All Play Out:

We, however, are of the view that the market place will anticipate the Federal Reserve's normalization of interest rates well before action by the Fed. Such anticipation will be triggered by relatively strong growth of 3.5% which will produce signs of a declining production gap – the protection against product and labor shortages as well as inflation. Geopolitical events, particularly if they affect the oil supply, could add to market volatility.

Having said that, we are nowhere near the end of the economic cycle, global debt notwithstanding. Valuations are not excessive, particularly in light of absolute interest rate levels, but the US Treasury market remains in "bubble" status. When it adjusts it will not be pretty, and even the Federal Reserve with its almost $4.4 trillion balance sheet will experience losses.

When the market place anticipates that the Federal Reserve is within six months of normalizing (raising) short term interest rates, we continue to expect a decline in both bond and stock markets in the US, abroad perhaps, but maybe not in Europe because of the European Central Bank's need to support growth there. The potential divergence in monetary policy between the Fed on the one side and the ECB and Bank of Japan on the other side may remain in place for a few years, thereby, putting downward pressure on both the Euro and the Yen relative to the dollar and creating opportunities to invest in exporting companies based in those regions.

While Greece has made great strides in correcting some of the problems with its economy, we are not impressed with progress in either Italy or Spain. After a six year long recession, the Greek economy is expected to grow in 2014 and the unemployment rate may turn somewhat lower, to around 26%. Furthermore, the country is now not only receiving funding from the Troika (the ECB, IMF, and European Commission) in exchange for structural reforms, but has also managed to tap the bond markets again. Italy has yet to make the necessary labor law reforms to improve its competitiveness. Nevertheless, the strong showing by the new, pro-reform Prime Minister, Matteo Renzi, in the European parliamentary elections last month raises the potential for action. As far as Spain goes, it sits with its real estate problem contained but unresolved. According to the Dallas Fed's International House Price Database, Spanish real house prices have now declined for 26 consecutive quarters.

Strategy:

Our first tactic is to maintain at least some cash in portfolios even if it means underperforming for a while in order to have dry powder to take advantage of any market decline. Secondly, Texas Industries has now been purchased by Martin Marietta, Inc., (symbol MLM) and we will cut back the new position of MLM to a normal position of no more than 5%. We will either preserve the cash or redeploy it in companies that benefit from consumer spending and business capital investment.

Abroad, we look to add positions in Brazil, Europe and China.

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