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IT AIN'T OVER 'TIL THE FAT LADY SINGS
INVESTMENT STRATEGY
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Our title comes from a reference to the hefty opera singers often found in the Wagnerian Opera "Ring Cycle" (4 operas lasting some 14 hours in total) and perhaps generally in opera. Our heroine, Brunhilde takes ten minutes to finish the last of the 4 operas, and thus, we conclude by analogy, the current economic cycle isn't over yet, but it certainly has been an operatic cycle since recovery began in June, 2009.

Historically, most but not all recoveries have been about five years long, and we are now at six plus! Normally, as the economic cycle accelerates, production bottlenecks develop, labor and commodity prices rise, and inflation jumps only to be snuffed out by sharply higher interest rates that cause a relatively brief recession.

Shouldn't this cycle be over because it's now six years old? No! "The fat lady hasn't sung, yet", and for us the Fat Lady is the inflation rate! The recovery in economic growth since the end of the last recession has been tepid, averaging 2.0% annually instead of the usual 3%-4%; as a result, job creation, until the last two years has also been subpar. The good news was that corporate profitability improved significantly with only a modest improvement in sales. This may be attributable to lean staffs and modest commodity costs as well as technological innovation. Both we and the Federal Reserve have consistently overestimated GDP growth in this cycle.

The slow growth may be attributable to a decline in population growth to 0.5% from 1% during this time – humans, after all are the first form of capital! An aging population has reduced the labor force participation rate. Banks have been super cautious with loans, leading to a slow recovery in both housing and investment. Psychologically business have been unwilling to invest, and consumers to spend.

The recent drop in oil prices over the last year due to Saudi Arabia's production policies and rising production from the US and prospectively Iran and Brazil (?), have added a potential 1% increase to US GDP growth via consumption. Similar benefits may be seen in both Europe and China as well as other net oil consumers.

The negative side of the sharp commodity price declines is not only the loss of employment and profits in the US, but many countries depend on substantial revenues from commodity sales (priced in dollars) for hard currency to pay for dollar debt service, imports and expenses. Russia, Venezuela, Canada, Mexico, Australia and Brazil come to mind. All of them are in recession now. And if the commodity price decline lasts, it is quite possible that we get a "sovereign default" which would temporarily rock financial markets.

Therefore, while we expect 1.5%-2.5% growth for the US and Europe during 2016, we consider China's growth of 6% (if it is that low) to be the equivalent of 0% growth in the US. At less than 6%, China is in the equivalent of a US recession. Nonetheless, 6% growth does contribute significantly to global GDP. Its recent growth rate of 7% was less than their estimated 7.5% but many think their growth rate is significantly less than even 7%.

Inflation has remained very low this cycle – with the US averaging around 1.7% over the last five years, Europe 0.5%, and China being well below its 3.5% target, Japan, until very recently has experienced a small deflation during most of the recovery. We continue to look for both labor and commodity price pressures on the horizon, but so far so good. The Fat Lady is not in sight.

Finally, we note that the devaluation of the renminbi by China has probably less to do with competitive devaluation than it does with the fact that its currency is pegged to the US dollar which has strengthened over the last year. Given that exports constitute 36% of its GDP one can see how the Chinese are very sensitive about the strength of their currency which maybe over valued given the significant slowdown in its economy.

However, the strength of the dollar combined with low commodity prices is a problem for many emerging markets as they often have dollar denominated debt which they service with dollar denominated commodity export

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revenues. This was the fear in 1997 – that several Asian economies could not generate enough revenues to pay their dollar debt, would default, trade would contract, and the whole world dumped into a recession – it was an overreaction as the US stock market declined, as we recall, about 20% over a three month period. More recently we have experienced a correction of 12% driven by somewhat similar fears.

Our bottom line is that this too shall pass: growth may be slowed “on the round about” as reduced trade revenues result in lost global growth, but there should be some counter balancing pick up “on the straightaway” from consumer spending. As this is seen to occur we would expect the stock market to reach new highs during the next 6-12 months.

Whether the Fed raises rates by a quarter of a percent is basically immaterial if that is all they do. A quarter of a percent is meaningless to earnings of consumers and costs to business. The US economy is certainly strong enough to handle it; whether the psychology of investors is sufficiently strong is another question. If the US Central bank does increase rates from 0% to 0.25%, and notes that they will continue to be “data dependent” but that the US economy is strong enough to withstand the increase, we might see a rally.

Lastly, we now expect to see fiscal stimulus in countries experiencing lower than normal growth as they come to realize than monetary stimulus alone is not enough. The bull market “ain’t over ‘til the Fat Lady sings!”

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