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# Second Quarter 2015 Economic Commentary

***Chicago - a facade of skyscrapers facing a lake and behind the facade every type of dubiousness.*** -E. M. Forster

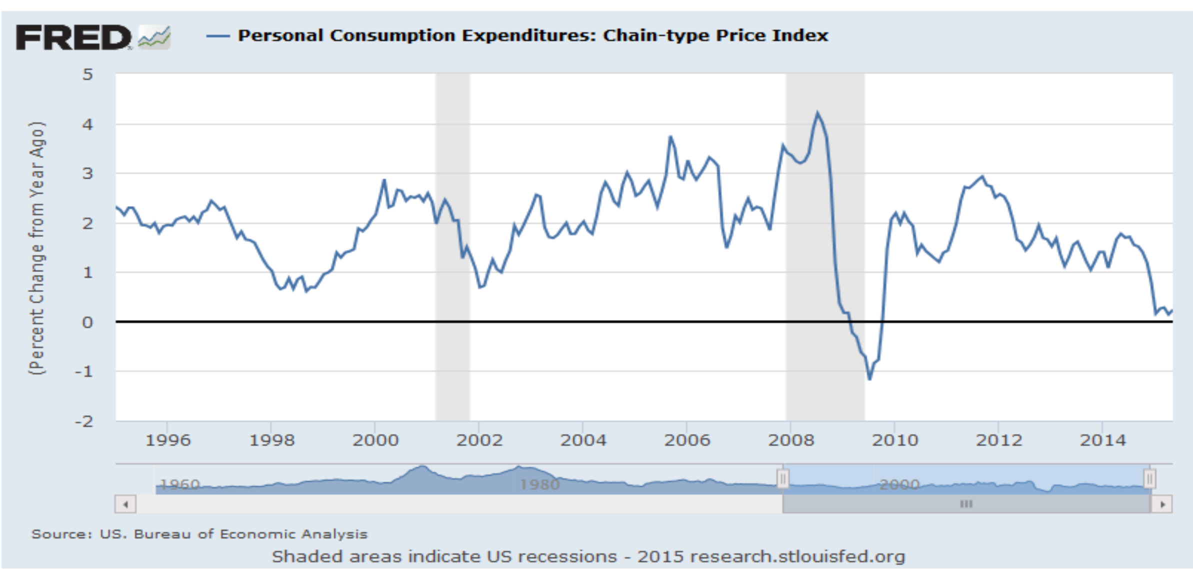
***Oh! Let us never, never doubt what nobody is sure about.*** – Hilaire Beloc

Here in the dog days of summer, I am sure that most of you are growing somewhat weary of the debate as to when the Fed will raise rates. As we wrote last quarter, "Is it finally time for an economic spring thaw and is the outcome being stuck in the mud?"

Unfortunately, the modest pace of economic growth continues. GDP for the second quarter came in weaker than expected at 2.3%, versus most economists' forecasts which looked for closer to 3%.

The pickup in GDP growth in the second quarter reflected an upturn in exports, an acceleration in personal consumption, a deceleration in imports, and an upturn in state and local government spending that were partly offset by downturns in private inventory investment, in nonresidential fixed investment, and in federal government spending and a deceleration in residential fixed investment.

Consumer spending was +2.9% as compared to +1.8% for the first quarter which was encouraging, yet retail sales averaged year over year increases of only 0.9% for the quarter, far from scintillating. Looking at the BEA's series of personal consumption expenditures, we continue to see little follow through following the great recession:



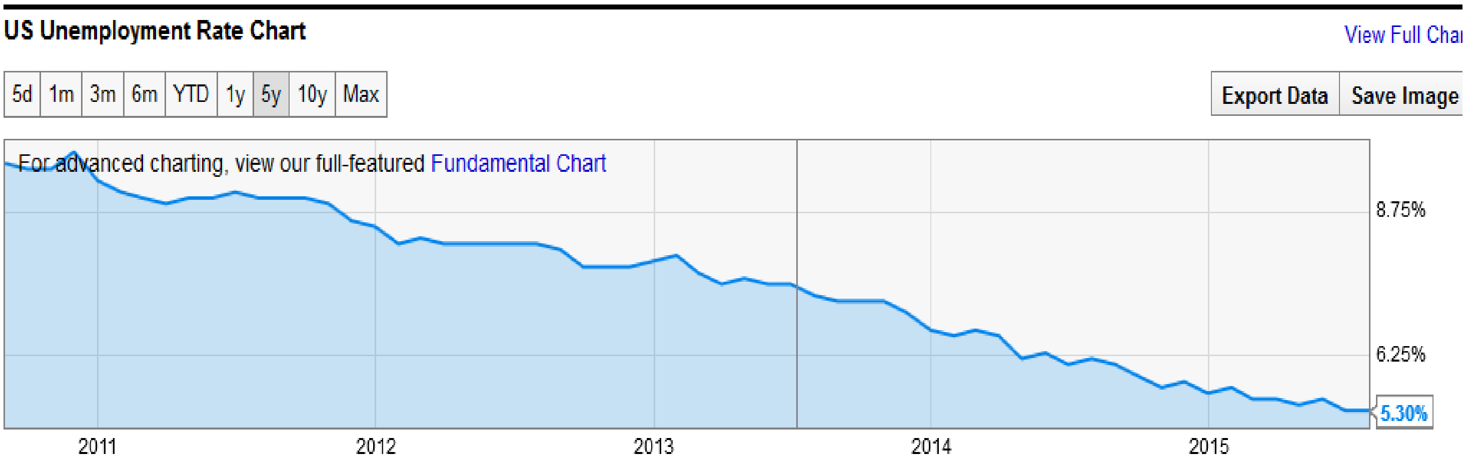

Source: St. Louis Fed, BEA

GDP growth since the end of the Great Recession in the second quarter of 2009 has averaged 2.1% per year, a full percentage point below the average over the entire 1947-2015 period. And that 3.1% includes both recessions and expansions.

Furthermore, there was a benchmark revision of the last three years of data that didn't help. Although the new data revise the weak numbers for the first quarters of 2015 and 2014 up a bit, the BEA (Bureau of Economic Analysis) that publishes, revises and rehashes GDP data now estimates that annual GDP growth averaged 1.9% over 2012:Q1-2015:Q1, down 0.3% from the 2.2% that had initially been reported for that period.

Weakness was particularly pronounced in nonresidential fixed investment, which fell 0.6%. It's interesting to speculate on the role of oil prices in the recent GDP numbers. The fall in oil prices since last summer was supposed to be a boon for oil consumers and a bane for oil producers. Usually consumers respond pretty quickly to windfalls in spending power, whereas oil producers take significantly longer to cut back their investments. But this time the consumer response was more subdued, while the lead times for adjusting modern fracking drilling are much shorter than for conventional oil which represents most of the historical economic data. Lower investment in the oil patch may be having an effect on the GDP aggregates.

The employment picture looks decent and near full employment levels when one focuses on improving unemployment rates.




Source: Ycharts

While the unemployment rate has been falling sharply in the last four years, the Employment-to-Population ratio or EPOP has moved much less, having risen by just 1.1 percentage points from its low point in 2011 as compared to the 3.5% drop in unemployment. Only a small portion of this decline can be explained by demographics as the EPOP for prime-age men (ages 25-54) is still down by almost three percentage points from its pre-recession level. This is almost certainly an indication of ongoing weakness in the labor market.

Prime-Age EPOP Ratio


Source: Center for Economic and Policy Research-June 2015 Issue Brief

This is primarily a story of lower employment growth among women over age 55. Employment growth for women over age 55 had averaged 679,000 in the two years from July 2011 to July 2013; it has averaged just 374,000 in the last two years. This likely reflects the impact of the Affordable Care Act, as many pre-Medicare age women no longer need to rely on their jobs to get insurance for themselves or family members. Younger workers, between the ages of 25-34, may have been the beneficiaries of this decision as there has been a notable uptick in employment growth among this group. For those of you still involved in the care and feeding of your college grad kids, there may be hope!

In addition to the healthy job growth in July, the increases for May and June in the establishment data were also revised up slightly to bring the 3-month average to 235,000. However, there is still no evidence of this job growth leading to wage pressures. The average hourly wage rose 5 cents in July, but this followed a drop of 1 cent in June. This brings the annual growth rate for the last three months compared to the prior three months to just 1.9 percent, compared with a 2.1 percent increase over the last year.

More specifically, by examining changes to the prime-age EPOP ratio since 2007, it appears that the labor market has only recovered about half the employment that was lost during the recession and its aftermath. Dissecting this further, Black Americans experienced the greatest loss in employment, with the prime-age EPOP ratio for black Americans falling over 8 percentage points between 2007 and November 2011. Between April 2014 and March 2015, employment amongst prime-age black Americans was over 4 percentage points lower than in 2007. The problem is even more severe for black men: prime-age black men saw their employment rate fall over 10 percentage points between 2007 and October 2011. Between April 2014 and March 2015, the prime-age EPOP ratio for black men was 4.8 percentage points below its 2007 level. This suggests that black Americans generally, and black men more specifically, have the most to gain from true recovery. They will also therefore have the most to lose if the recovery is halted.

The Fed and other central banks are also keeping an eye on inflation, or at least its alter ego, deflation. Commodities have shown tremendous weakness:


Source: Barrons, August 8, 2015 “Time to Buy Commodities:

This deflation in input costs for manufacturing should benefit the industrial side of the economy as well as stimulate the consumer. Though Barron’s magazine was calling for a bottom, we think commodity prices may stay low for some time. We have had a decade of investment in commodity productive capacity and hence supply for most commodities, especially oil. The divergence in economic growth between the relatively strong U.S. and the rest of the world continues to lift the dollar (as other currencies are practicing devaluation). Finally, there is deleveraging as emerging economies focus more on balancing their fiscal situation rather than expand in commodity-intensive spending such as infrastructure or housing.

Will the Fed raise rates in September? The argument for a rate hike runs as follows: Basically the Fed has accepted that wage growth, labor participation rates and inflation all remain weak. And they are comfortable enough to say, “Look, we’ve been on zero for seven years. The supply side is permanently weak. Monetary policy has done all it can. We need to normalize policy.”

If the FOMC is guided by a desire to “normalize”, the Fed would look through the inflation data, using the fact that oil prices are declining and that this should aid consumers as a reason to hike in September. If this rationale were deployed, a September hike to 0.25% as possible. This is only a 0.10% rise, by the way since today’s number is officially between 0 and 0.25% and presently sits at 0.15%. Given international distresses, especially now from China, I think the much expected September rate hike will be deferred to later in the year if not early 2016.

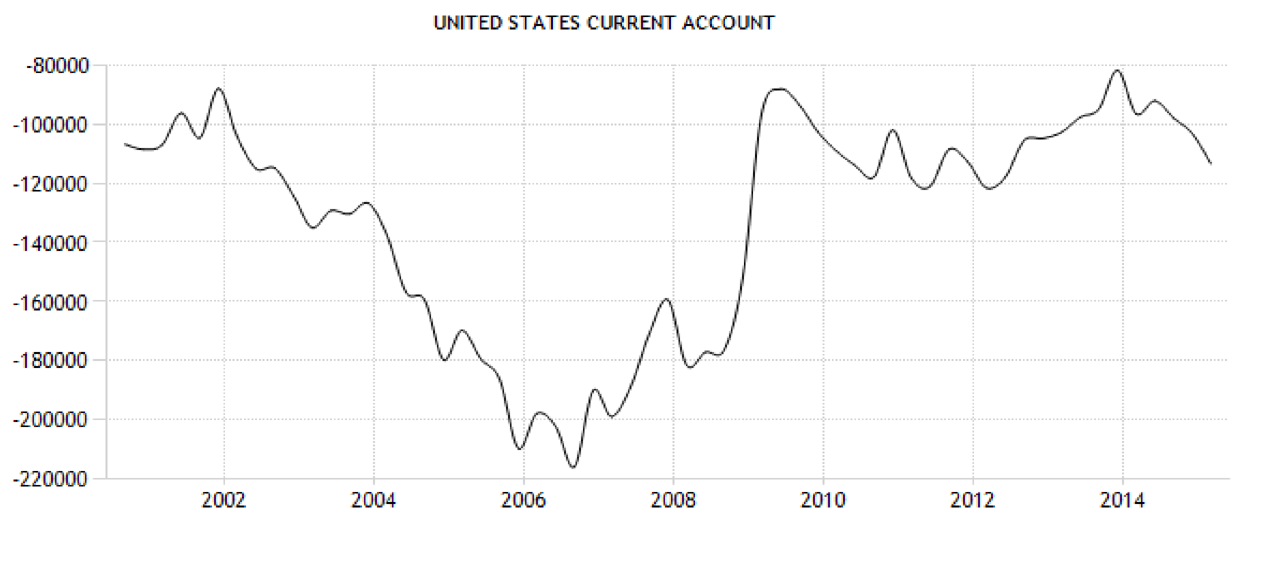
Will 25 basis points make much of a difference in market psychology? I say no. At this point in the cycle, the stock market “internals” are more attuned to economic growth than rates or even earnings. But a second rate hike could have an impact, especially if it has an impact on the real economy. Let’s also remember that the Fed has always been unlikely to reverse course on a dime once rate hikes have begun. So they will likely be off the zero bound for some time to come, until the economy weakens considerably.

Internationally, much of the focus in the second quarter was on the Greece debt crisis and the surprise Greek referendum urging voters to say no to austerity. Greece ultimately struck a deal with creditors in that will see the nation receive its third bailout after marathon talks in Athens. The agreement between the left wing Syriza government and its creditors means the Greeks will avoid a much-feared "Grexit" and will help the country remain in the Eurozone and avoid bankruptcy. In July, Prime Minister Tsipras managed to push enforced reforms on VAT, pensions and the selling of national assets through parliament despite fierce opposition from his own party. While the deal keeps Greece in the single currency, the International Monetary Fund (IMF) predicts that its debt would peak at a crippling 200% of GDP, leading to decades of the type of austerity measures despised by most Greeks. Greek banks were closed from June 29th through July 20th. European bank regulations encourage banks to invest heavily in their own country's bonds, even when they have lousy ratings. The flawed banking architecture of Europe's currency union pretends that sovereign default will never happen. Wise or well-advised Europeans have known about these flaws for years, but the system was never fixed because it allows indebted countries to finance large debts. When Europeans can put their money into well-diversified pan-European banks, protected from interference from national governments, inevitable sovereign defaults will not spark runs, or destroy local banks and economies. The Greek tragedy will not end until regulators recognize that sovereign debt can be risky and that countries must stop using national banks to fund national deficits. Greece is about poor fiscal management that was exacerbated by an interest rate policy geared to a slow-growth core Europe. The path to fiscal adjustment is Herculean and Greece remains damaged goods and its eventual recovery remains uncertain.

Developments in China have been of much greater importance. Let's look at the changing roles of China and the US in the global economy:

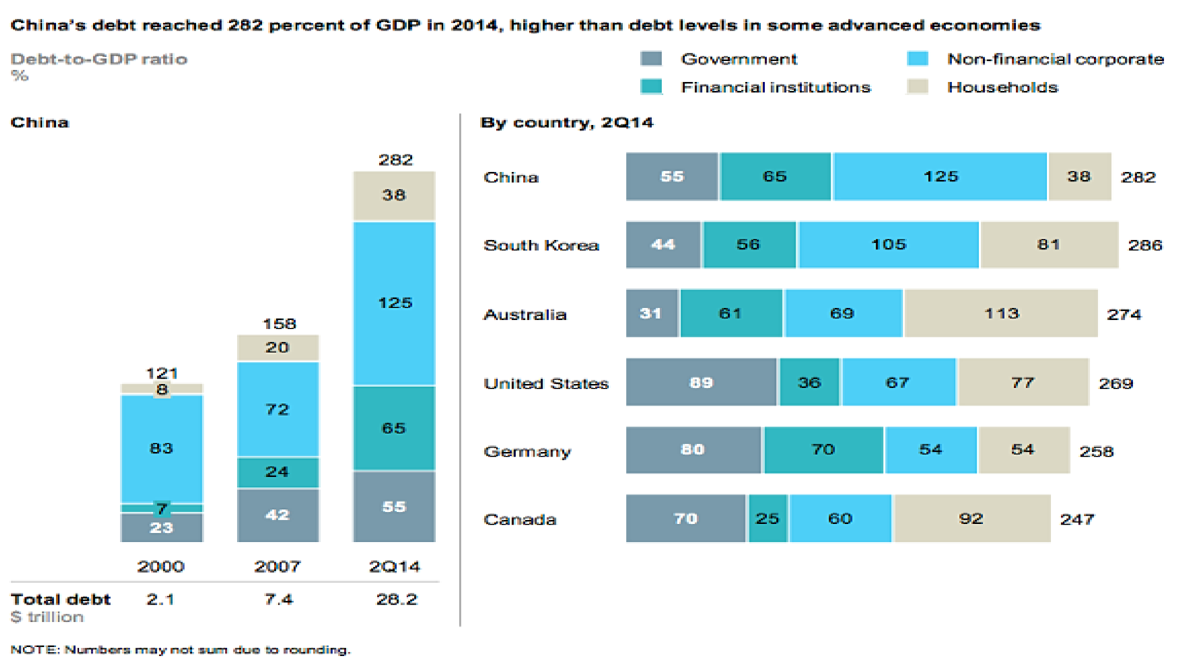
China Stocks Crash

When the global economy turned down in late 2007, the US could no longer be the marginal buyer of last resort. While the US runs a current account deficit almost as a matter of course due to the US dollar's position as the world's major reserve currency that other countries need to accumulate, there was an enormous increase in US current account deficits in the period leading up to the crisis despite US dollar weakness. In the new millennium, the US consumer had become the marginal buyer of first and last resort. Then all of that went into reverse when the domestic subprime crisis crossed the borders and blew up into a global economic crisis.




Source: [www.tradingeconomics.com](http://www.tradingeconomics.com), BEA

China picked up the slack where the US had left off. The Chinese became the new marginal buyers of last resort. The global economy benefitted as the Chinese economy stepped up the stimulus, largely through borrowing at every level:




Source: McKinsey Global Institute Analysis

In the meantime, the benefit for emerging markets was huge. These countries also piled on debt, often via corporate borrowers funding in US dollars due to low US interest rates. There are $9 trillion of US dollar debt by entities outside the US, with emerging market share doubling since the Lehman crisis to half the total amount. Overall, global debt levels are $57 trillion, 40% higher than at the time of the crisis. While the growth in government debt has been the greatest, both corporate and household debt is on the rise. And only in the former housing bubble economies of the US, UK, Ireland and Spain have households in the OECD deleveraged.

This creates a fault line for the global economy due to two factors. First there is the US dollar index, which has been rising as the Federal Reserve has signaled less accommodation and an imminent rate hike cycle…eventually – in contrast to every other major central bank. Policy divergence means a higher US dollar, causing emerging market currencies to hit a 15-year low and helping to precipitate a plunge in commodity prices. At the same time, China has a debt crisis to deal with and that necessarily means slower growth whether or not the losses associated with non-performing loans are socialized.

Mirroring our opening quotation, at Value Architects we have viewed the façade of Chinese growth with a lot of dubiousness. The growth numbers proclaimed by the national accounts make no sense to us relative to other metrics of economic activity. We have questioned and remained unconvinced of the merits of many Chinese equities as we have found the accounting unreliable, and the corporate governance chancy and untrustworthy at best.

In China itself, the debt burden has become unsustainable. With $20.8 trillion of additional debt, the country has accounted for more than one-third of total debt growth since 2007. The Chinese government is trying to work this problem out without precipitating a hard landing. And so the innovations are piling up. For example, Chinese-style QE is taking form with the People's Bank of China putting money into state lenders that then go out and fund government-backed programs.

The Chinese, tethered to a rising US dollar that is backed by policy divergence, are thus fighting against an appreciating currency even as credit growth slows. This necessarily means a big slowdown in import growth or an outright decline in imports and a slowdown in exports at the same time.

The reason commodity prices are declining is not just because of supply and currency, it is also because of demand. It's about China's disappearance as the marginal buyer of last resort. I believe the decline of China as buyer of last resort could well be an event of similar magnitude to the decline in the US in that role eight years ago. And I do not believe the Chinese will reverse this trend by pumping in enough stimulus to reverse the decline in credit growth. For economies leveraged to commodities and for non-US debtors indebted in US dollars, the advent of China as deflation exporter will be a very painful experience. The Chinese producer price deflation is unrelenting with July down 5.4%. In terms of crisis, I expect this combination of policy divergence and slowing growth in China to be the trigger. We are not there yet, especially since the US economy is growing. But the markers of stress and coming weakness – like a flattening yield curve in the US – are increasing.

The just announced devaluation of the Chinese currency is a bearish sign. It says that the Chinese government is so concerned about growth that they are willing to risk a political backlash in the middle of a heated and xenophobic Republican pre-election presidential primary campaign in the US. In terms of markers, I am most concerned about Dollar-Euro because I believe the US and Eurozone economies are close in terms of potential economic growth in the coming quarters. And to the degree that the euro weakens against the US dollar, it would signal a destabilizing level of policy divergence despite similar economic trajectories. Euro-Dollar weakness means the potential US tightening campaign is becoming excessive and will destabilize emerging markets, commodities, and energy and shale producers. We already see the pain in Canada, where Stephen Harper has tacitly admitted to recession. For commodity-dependent countries, euro weakness means more Fed tightening and that means pain.

The People's Bank of China can claim the first move was a devaluation and every subsequent move is a price fix adjusted to accommodate market signals. I'm not at all sure that I believe them. Given the likely one-way movement in the Chinese currency, we should consider the possibility that we are about to see a major competitive currency devaluation – something in the order of magnitude that the South Korean Won, the Euro and the Japanese Yen have seen i.e. 10-15% or more.

As we have said, the Fed's next move toward tightening is problematic and questionable. The Fed could stop its hiking campaign if the Chinese move leads to enough market stress. It's not clear the Fed will do this. Even so, policy divergence will remain in place to a degree since the Fed would still have a tightening bias. Even if the Fed doesn't raise rates, it can't lower them. And in a crisis, the US dollar is a safe haven asset that rises. That means lots of pain for those with dollar liabilities and insufficient dollar income, forced deleveraging and a crisis in emerging markets at a minimum. The deflationary impulse from China will make this a lot worse.

Finally, our second quotation, "Let us never, never doubt what nobody is sure about". For us, we have always believed that when everyone is going right, we should look left. The certainty and inevitability of rising rates was universal. The best investors understand that the more you know, the more you know that there is even more you do not know. Creating a taxonomy that categorizes your lack of knowledge is helpful since problems in life most often come from not knowing what you are doing. There are three categories: (1) you may know the potential future states and the probability that those potential future states may come to pass. This is known as "risk" and is rare. (2) you may know the potential future states, but not the probability that any of those potential future states will happen. This is uncertainty and is most common. (3) you may encounter future states that you had no prior idea were even possible. This is the domain of "ignorance." This third domain (Black Swans) impacts people's lives way more than they imagine since even though events in this domain do not happen that often, when they do, it produces massive disruptive change.

You simply can't follow the crowd and beat the crowd. Being contrarian for its own sake is, of course, unwise. When we say that we should "look" left, this does not necessarily mean we should "go" left. But sometimes that look left will give you enough confidence to place contrarian bets since you will see that the odds are substantially in your favor.

We have had the courage to go left in both our equity and fixed income approaches relative to the consensus viewpoint over many years. We tend to think more about losing money as opposed to making money. Our focus is on protecting what you have, remaining in control. This desire not to lose money is another way of saying that we want to find opportunities with a lot more upside than downside. In other words, we are looking for asymmetry of potential outcomes: big upside and small downside. That's optionality. We want to find odds-on bets that are very substantially in your favor.

As always, we appreciate your confidence and your trust.

**Richard Konrad, CFA, CFP®**
**Managing Member**