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"I'd call it a new version of voodoo economics, but I'm afraid that would give witch doctors a bad name.

-Geraldine Ferraro

Some years ago, Mohamed El-Erian the former CEO of PIMCO, one of the largest investment management companies in the world, as well as the former head of the Harvard Endowment developed the phrase, "the new normal" as a depiction of the economic conditions that have followed the crisis of 2008.

In a speech that El-Erian presented to the IMF (International Monetary Fund) in 2010, he supported this depiction based on three hypotheses:

- First, the international monetary system suffered a "sudden stop", the adverse impact of which is still being felt today.
- Second, the causes of the crisis were many years in the making and included balance sheet excesses, risk management failures at virtually every level of society, antiquated infrastructures, and outmoded governance and incentive systems in both the public and private sectors.
- Third, the dynamics coming out of the crisis management phase: particularly the combination of deleveraging, re-regulation, debt overhangs and structural challenges in key industrial countries are interacting with an accelerating secular realignment of the global economy to create what at the time Fed Reserve Chairman Ben Bernanke correctly called an "unusually uncertain outlook."

In many ways, we still seem mired in the new normal: flatter yield curves, lower rate levels, and lower levels of productivity and growth. While most countries, especially the US, have done well in the crisis management phase (I think in terms of "winning the war"), they have not done as well in the post-crisis phase (thus, are not succeeding in "securing the peace"). Too many industrial countries find themselves in a rather unsettling situation in which expectations involve an unusually broad range of potential outcomes and equally unusually high risks. Sadly, a once-promising global response has now been replaced by inadequately coordinated national economic policies and growing frictions among countries. Extraordinary international collaboration has given way to solely domestic agendas.

Growth in advanced economies is projected to remain modest for 2016, in line if not slower than 2015 outcomes. Unfavorable demographic trends, low productivity growth, and legacies from the global financial crisis continue to hamper a more robust pickup in activity. While very accommodative monetary policy and lower oil prices will support domestic demand, still-weak external demand, further exchange rate appreciation—especially in the United States—and somewhat tighter financial conditions will weigh on the recovery. In the Euro area, the risk of a de-anchoring of inflation expectations is a concern amid large debt overhangs in several countries.

Activity softened toward the end of 2015 in advanced economies, and stresses in several large emerging market economies showed no signs of abating. Adding to these headwinds are concerns about the global impact of the unwinding of prior excesses in China's economy as it transitions to a more balanced growth path after a decade of strong credit and investment growth, along with signs of distress in other large emerging markets, particularly relating to falling commodity prices.

Persistent slow growth has scarring effects that themselves can reduce potential output and with it, consumption and investment. Consecutive downgrades of future economic prospects carry the risk of a world economy that reaches stalling speed and falls into widespread secular stagnation. Adding to this list are several pressures with origins in political, geopolitical, or natural developments.

In both the United States and Europe, the political discussion is turning increasingly inward. The causes are complex but certainly reflect growing income inequality as well as structural shifts, some connected with globalization, that are seen as having favored certain economic elites while leaving others behind. Fear of terrorism also plays a role. The result could be a turn toward more nationalistic policies, including protectionist ones.

In the United Kingdom, the planned June referendum on European Union membership has already created uncertainty for investors; a "Brexit" could do severe regional and global damage by disrupting established trading relationships.

Monetary policy in advanced economies remains very accommodative, but with asymmetric shifts in the policy stance. In December the U.S. Federal Reserve raised policy rates above the "zero lower bound" for the first time since 2009, and it has communicated that any future policy actions will remain data dependent. So far, there has been a reluctance to raise rates and markets which had anticipated four hikes this year are not questioning whether it is politically feasible to have another hike prior to the November elections.

On the other hand, the European Central Bank (ECB) announced a package of further easing measures in March, comprising an expansion of its asset purchase program, including purchases of corporate bonds, new longer-term refinancing operations, and a further reduction in all policy rates. And in late January the Bank of Japan introduced a negative interest rate on marginal excess reserves. In the United Kingdom, policy rates remain on hold at 50 basis points, and with a more subdued inflation outlook, expectations of interest rate increases have moved farther into the future.

Speaking of Japan, at the end of April, investors were disappointed by the Bank of Japan's decision not to add to its huge economic stimulus program. In our view, Japan has reached a policy impasse. The economy is grinding to a halt and another recession seems in the cards. Consumer demand is dead in the water, with household spending down 5.3% from a year earlier. Most of the industry is riddled with gloom and the economy is stuck in deflation with core CPI down -0.3% year-over-year. Government finances are in a mess, with government debt to GDP at 230%, leaving little room for further fiscal reflation. And now the Bank of Japan is seemingly throwing in the towel on further interest rate cuts.

Abenomics was supposed to break the deflationary cycle. It hasn't succeeded. And to make matters worse, the yen soared the most in eight months and stocks tanked because the Bank of Japan added no new stimulus measures despite the awful data. We believe that the political constraints to doing more than has been already attempted are large. Let's remember that Japan has pursued quantitative easing (QE) longer than any other central bank, for about 25 years. In its stimulus efforts unlike other central banks, the Bank of Japan moved beyond ownership of bonds or mortgages and owns Japanese equities by holding 55% of all Nikkei 225 ETF contracts. And this makes the central bank a top 10 owner of the shares of 90% of the Nikkei. That's a remarkable level of market support and stimulus and in my view, a clear demonstration of the ineffectiveness of applying QE as a long term solution rather than a short term buttress. Harkening back to the Geraldine Ferraro quote at the beginning, has QE turned into voodoo economics?

Negative rates, as we've seen in Europe and Japan moreover, have begun to impair the health of the banking system. Charging banks for the privilege of holding reserves raises their cost of doing business. Because households can resort to safe-deposit boxes, it's hard for banks to charge depositors for safekeeping their funds.

In a weak economy, moreover, banks have little ability to pass on their costs via higher lending rates. In Europe, where experimentation with negative interest rates has gone furthest, bank distress is clearly visible.

The solution is straightforward in my opinion. It is to fix the problem of deficient demand not by attempting to further loosen monetary conditions, but by boosting public spending. Governments should borrow to invest in research, education, and infrastructure. Currently, such investments cost little, given low interest rates. Productive public investment would also enhance the returns on private investment, encouraging firms to undertake additional projects.

Many have spoken of a "savings glut." Others talk of secular stagnation in terms of the "natural rate of interest" having moved into very low or negative range which in their theoretical framework means the tendency to save falls short of the tendencies to invest. The obvious response to an excess of savings over investment is to run a corresponding budget deficit which enables the savings to be realized and supports aggregate demand. Some, such as Germany and the Netherlands are able to combine high savings with low investment through a current account surplus, but others need a budget deficit.

In the early days of the great recession there was some mild stimulus and the automatic stabilizers were allowed to operate. But for the past five years the obsession has been on "fiscal consolidation." Constraints have been placed on fiscal policy, notably in Europe's Economic and Monetary Union (EMU) but elsewhere, with rules on balanced budget playing a key role in the "fiscal compact" signed by almost all EU countries (and the UK has adopted a similar rule). In practice, and in part because of the lack of growth, balanced budgets have not been achieved. For example, the UK government promised in 2010 the elimination of budget deficit by 2016, but the deficit remains at around 4% of GDP. Most countries of EMU continue to have substantial budget deficits despite the "fiscal compact." Any notions of "expansionary fiscal consolidation" should now be firmly dismissed.

A time when interest rates are close to zero and when there is precious little sign of revival of bank lending and of investment is surely precisely the time for fiscal expansion in my opinion. Fiscal consolidation and quantitative easing have been tried and have not worked. Public investment has a central role to play here reversing the tendencies to cut back on investment in infrastructure which is showing up now in the poor state of infrastructure in many industrialized countries, particularly here. Public investment also serves to provide a stimulus for private investment – and to bring a revival of "animal spirits" and overall confidence. A case of a win-win situation where public investment can be used to address environmental and climate change concerns, and provide employment.

The global economy today resembles what game theorists call a "collective action problem". This is a situation where countries will end up worse off by pursuing their own interest than by cooperating. Negative interest rate policies go beyond monetary stimulus, but rather are a barely-concealed attempt to cheapen their currencies to bolster exports and inflation: a typical beggar-thy-neighbor strategy to increase demand for one's nations exports at the expense of others' export share.

A new paper by Gauti Eggertsson and Neil Mehrotra of Brown University and Larry Summers of Harvard University warns that such actions become a zero-sum game in "secular stagnation," when interest rates are near zero and central banks can no longer restore full employment. Instead, easier monetary policy works mostly by bolstering exports and dampening imports, inflicting "negative externalities"—collateral damage—on a country's trading partners.

On the other hand, these three economists argue that fiscal stimulus has "positive externalities". Increased borrowing puts upward pressure on interest rates and the currency, drawing in imports. By pushing interest rates higher, it restores some of the potency that monetary policy loses when rates hit zero. The problem, they note, is that fiscal stimulus is less attractive to any one country precisely because its benefits are shared with others. If countries cooperated to "achieve more significant fiscal expansion," everyone would grow faster.

In March of this year, Canadian Prime Minister Justin Trudeau's Liberals introduced a budget that sharply boosts spending on a raft of initiatives from infrastructure to social benefits. Because of that fiscal stimulus, the Bank of Canada has refrained from cutting interest rates, helping send the Canadian dollar sharply higher.

The higher dollar will be a drag on Canada's trade sector, diluting the budget's stimulative impact: but Canada's loss is the world's gain. In fact, Canada is faithfully executing the formula that finance ministers and central bankers from the top 20 economies agreed to pursue at their just-concluded meetings in Washington: namely, rely less on monetary and more on fiscal policy to rejuvenate growth. The problem is that Canada is virtually alone in being both willing and able with its low federal debt at just 31% of GDP, it is the lowest among the G-7 industrialized countries.

The International Monetary Fund, the Organization for Economic Cooperation and Development and the U.S. Treasury Department for the past year have urged any country not drowning in debt to stimulate their economies by borrowing. The IMF this month recommended the G-20 stand ready to implement coordinated stimulus equal to 1% to 1.5% of GDP. Most other G-7 nations are constrained politically being tied up in elections, or are hampered by their current debt burden. For countries where nominal interest rates are at or near zero, fiscal stimulus should be a no-brainer. As long as the interest rate at which a government borrows is less than the sum of inflation, labor-force growth, and labor-productivity growth, the amortization cost of extra liabilities will be negative. Meanwhile, the upside of extra spending could be significant.

The intervention of government in economic processes is an important part of the "Keynesian" arsenal for battling low economic demand and is perceived by many to have been utilized by FDR in the "New Deal" to push the economy out of the depression. However, what few of us realize is that despite the quadrupling of government spending during the 1930's, the impact was hampered by rapidly rising tax rates which kept deficits relatively low. The Keynesian fiscal multiplier for large industrial economies or for coordinated expansion is believed to be roughly two-in other words, for every extra dollar of fiscal expansion, this would boost real GDP by about two dollars. Because of higher taxation in the 1930's, the impact was reduced to around $1.25 to $1.30 for every dollar of spending. In an election year where certain candidates have endorsed heavier government spending *with* concomitant tax increases, this is a valuable lesson in economic history that need not be repeated.

Aversion to fiscal expansion reflects raw ideology, not pragmatic considerations. Few competent economists have failed to conclude that the United States, Germany, and the United Kingdom have large enough fiscal multipliers, strong enough spillovers of infrastructure, investment, and other demand-boosting programs, and sufficient financial space to make substantially more expansionary policies optimal.

Thus, it is disturbing to see the refusal of policymakers, particularly in the US and Germany, to even contemplate such action, despite available fiscal space (as record-low treasury-bond yields and virtually every other economic indicator indicate). In Germany, ideological aversion to budget deficits runs deep. Ultimately, hostility to the use of fiscal policy, as with many things German, can be traced to the 1920s, when budget deficits led to hyperinflation. The circumstances today may be entirely different from those in the 1920s, but there is still guilt by association, as every German schoolboy and girl learns at an early age.

It seems quite clear to me that the zero interest rate policy, or worse yet, negative interest rate policy has proven to be ineffectual and that we need to find the political will to pursue fiscal stimulus. But in an election year environment, such policy action is not going to happen despite the need.

Middle-class Americans are struggling, as are middle-class Japanese and Europeans. Easy money, asset purchases, and negative interest rate policies of central banks across the developed world are intended to ignite the "animal spirits" of the private sector. Are they instead stifling economic and wage growth? Are they stimulating asset hoarding and bubbles, which fuel widening gaps between the haves and the have-nots, and feed class resentment? Are they leaving inflationary pressures unchecked and hollowing out opportunities for the middle class? These are provocative suggestions, which go against neo-Keynesian theoretical dogma, but they fit the objective evidence we see all around us. Sometimes common sense trumps theory.

Years of solid job gains are failing to produce a breakout in wages, suppressing the spark needed for a sustained pickup in economic growth. U.S. employers for the past four years created more than 200,000 jobs a month on average. That has driven the unemployment rate down to 5% last month from above 8% in early 2012.

But wages have shown little progress. Wages and salaries for private-sectors workers advanced 2% in the first quarter from a year earlier, the Labor Department said Friday. The measure has grown near that rate, on average, since the start of 2012. The U.S. economy, like much of the globe, is stuck in a slow-growth rut. Turmoil overseas and still-weak commodity prices are preventing the manufacturing, trade and energy sectors from supporting growth. That leaves U.S. consumers to boost the expansion. But without accelerating wages, it's difficult for them to step up spending.

Economists harbor little hope for a significant economic rebound this spring, though they do expect some pickup after the past quarter's disappointing winter performance when the economy expanded at a 0.5% pace. Forecasting firm Macroeconomic Advisers projects GDP to advance at a 2.1% pace in the second quarter and the Federal Reserve Bank of Atlanta's GDPNow forecast suggests 1.8%. Such an acceleration from the sluggish Q4 2015 and Q1-2016 pace would only bring growth roughly back in line with the overall pace of the lackluster expansion.

Overall compensation for all workers, a figure that includes benefits, rose 1.9% from a year earlier, the Labor Department said. Federal Reserve officials watch the gauge for signs of labor-cost inflation. The reading has been consistently stronger than overall inflation. Consumer prices rose 0.8% from a year earlier in March, a separate Commerce Department report said Friday. But the compensation growth remains small compared with the pace of increases during the previous expansion. From 2002 through 2007 compensation averaged better than 3% annual growth.

Another measure of wages, average hourly earnings for private-sector workers, shows slightly stronger gains, up 2.3% in March from a year earlier. But that, too, is little changed from recent years. Four years ago, in March 2012, the annual gain was 2.1%. Some employers that hire low-wage workers say they are seeing increased pressures tied to minimum-wage increases in 26 states since the start of 2014. But other firms say there's been little change.

Several factors seem to be constraining wage growth. The unemployment rate might not fully reflect the degree of slack in the labor market. Some older workers and those displaced during the recession have returned to the workforce recently, and that makes it difficult for existing workers to demand higher pay. Productivity growth in many service fields has been low, meaning even small wage gains can feel expensive for employers in those sectors. That could partially reflect global cost pressures due to services that can more easily be provided from overseas, via the Internet and call centers, she said.

Weak wage gains are at least partially responsible for lackluster spending. Overall consumer outlays increased just 0.1% in March from February. Accounting for price increases, spending was flat for the second time in three months, Commerce Department data showed. The same report showed consumers are increasing savings at a faster rate than spending, a potential sign of shaky confidence.

Since 1995, households have expected inflation to be, on average, 3.0%, whereas realized inflation as measured by "official" Bureau of Labor Statistics data has been around 2.2%, leaving an inflation "gap" of almost 0.8%. Though we often speak of inflation being an issue of the past, for many families, the experience is quite different.

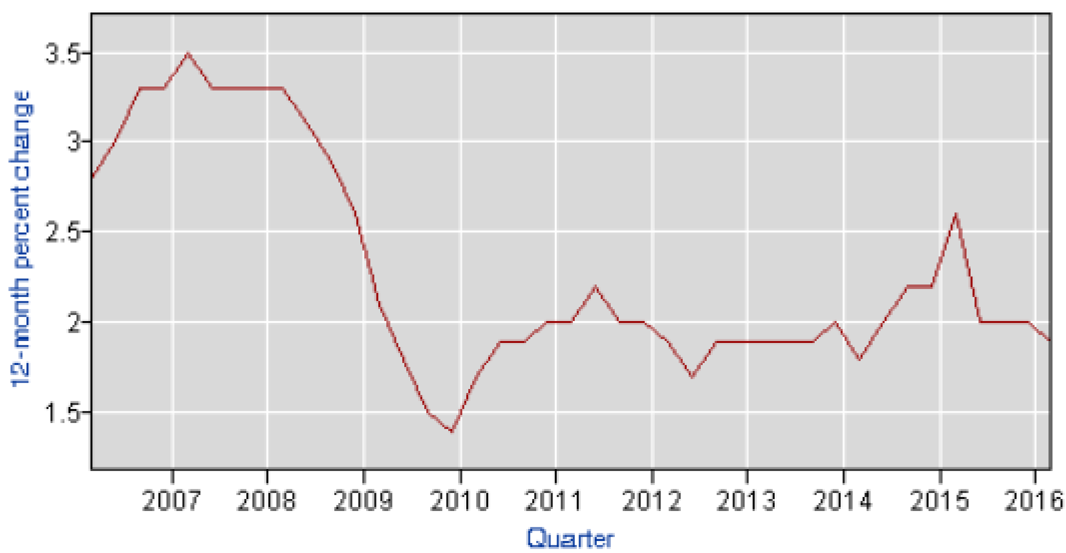
What explains this gap? The four most critical consumption inputs for the average American are rent, food, energy, and medical care, in approximately that order. These "four horsemen" have been galloping along at a faster rate than headline CPI. According to the BLS definition, they compose about 60% of the aggregate population's consumption basket, but for struggling middle-class Americans, it's closer to 80%. For the working poor, spending on these four categories can stretch to as much as 90% of total spending. Families have definitely been feeling the inflation gap, that difference between headline CPI and inflation in the prices of goods they most frequently consume. The reported CPI inflation over the past 10 years ending December 2015 was about 1.9% a year. If we focus on the "big four" over the last decade, the inflation that Americans experienced was about 0.5% more. Let's call this 0.5% difference a "measurement bias."

These considerations have a direct bearing on our prosperity. How much real growth, for example, has occurred in the past decade? Officially, GDP has grown 1.4% a year, over and above inflation. Over the same period, the U.S. population has grown by 0.9% a year. Thus, real per capita GDP has risen by a scant 0.5% a year. Subtract the 0.5% measurement bias—probably a conservative estimate—and the average American has experienced zero growth in personal spending power over the past decade. With wealth and income concentration, if the average is flat, then median per capita spending power must be lower. Comparing 2015 with 2005, this feels about right. The official statistics do not.

Since 1995, the average year-over-year inflation rate for energy has been 3.9%, for food, 2.6%, for shelter, 2.7%; and for medical care, 3.6%. If we strip out all other items and recalculate the index based exclusively on these four components, we find the average rate has been about 2.9%, right in line with households' expectations.

Little wonder that despite unemployment levels that are down to levels considered full employment, concerns have shifted to wage growth.

Total Compensation for Civilian Workers 12 Month Percentage Change



Bureau of Labor Statistics

Most of the time when looking at wage growth, we want to focus on real, inflation-adjusted wage growth—because we don't know how much more goods and services higher wages can buy without accounting for inflation. Nominal wage growth doesn't mean much, in terms of boosting the purchasing power and well-being of workers, if inflation eats away at the gains. Consequently, though government statistics for inflation suggest that wage growth is essentially staying in line with inflation, the perception of most workers is that actual inflation is higher and therefore, they feel squeezed and behind the eight ball. Anemic GDP growth doesn't argue for stronger real wage gains either.

The poor performance of American workers' wages in recent decades—particularly their failure to grow at anywhere near the pace of overall productivity—is a central economic challenge. Indeed, it's hard to think of a more important economic development in recent decades. It is at the root of the large rise in overall income inequality that has attracted so much attention in recent years. A range of other economic challenges—reducing poverty, increasing mobility, and spurring a more complete recovery from the Great Recession—also rely largely on boosting hourly wage growth for the vast majority.

So the new normal as El-Erian called it, is being felt on many fronts as secular stagnation. Slow growth, financial instability and capital market uncertainty will have further economic consequences as well as potentially political ones. We are in an unstable situation where there are many things that can go wrong and fewer that can go right. Needless to say, mitigating secular stagnation is of paramount importance in reigniting growth and capital markets' returns.

As always, thank you for your confidence and trust!

Rick Konrad

Richard H. Konrad, CFA, CFP®

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