Third Quarter 2016 Economic Commentary

"Legislators in Congress are concerned with these first three priorities before anything else, re-election, re-election, re-election."

-Michael Bloomberg

Aren't you glad it's almost over? In roughly two weeks, the seemingly interminable US political campaign, nowadays truly a blood sport will culminate with the election. The 2016 campaign was announced by Hillary Clinton 577 days before the election, and by Donald Trump, 513 days prior to the election. By way of comparison, the longest Canadian federal election campaign has been 78 days with the average length, 46 days. Americans have shown a lot of perseverance and patience in withstanding this agonizingly slow endurance contest. US politics has become much too partisan, and the rivals are more interested in attacking each other, 'drawing blood', than they are in focusing on political, let alone economic issues. Democracy can work properly only if all citizens' operative principle is: "I may hate what you stand for, but as long as you are elected fairly and govern constitutionally, I will defend to the death your right to compete and win". If democracy is to be any sport at all, all players must abide by the rules of the game.

This election season has left all of us a little worse for the wear, suffering daily trauma just by being engaged. Someone described it as "*like being banged around like tennis shoes in the dryer*." Politicians use "*bad data and worse analysis to make pronouncements about future inevitabilities, present impossibilities, and past failures*" as Rebecca Solnit of Harper's Magazine declared.

This environment makes it easy to be cynical about politics, the future of this country, and that of the world economy. Though the Bloomberg quote above is probably appropriate for many politicians, I refuse to believe that everyone is motivated by ill intentions or their own self-interest. I believe this is true for many leaders both corporate and political. Cynicism is a trump card (no pun intended). It shuts down any and all conversation. It is the absence of a solution. It is the rejection of nuance. It's essentially giving up, and I don't like to give up. Especially not when there will be work to be done no matter the result this cycle.

New Jersey Senator Cory Booker, a politician who I believe deserves some admiration in a recent interview said:

"I often say cynicism is a refuge for cowards. That it is a toxic spiritual state; that it so clouds our ability to see faint possibilities and hope amidst the glaring problems, that we often wipe our hands of any engagement whatsoever."

The problem with cynicism is that it is a cul-de-sac; the more cynical you become, the less you work to change things. The less you work to change things, the more your cynicism is justified. Nothing is built. Nothing is changed. And you still feel uncomfortable and disappointed.

As I re-read some of our quarterly writing of the last year, we have at times been guilty of too much cynicism. So far in this millennium, we have experienced a great deal of volatility, a mix of fear and possibility, peril and exuberance. As analysts and investment managers, it is our job to be skeptical, and suspicious. We are by nature rational and empirical: thinking and seeing before believing. But all of us need to avoid the temptation of cynicism. There will be a November 9th, 10th, 11th and beyond. We have to be careful not to throw a wet blanket on hope and possibilities.

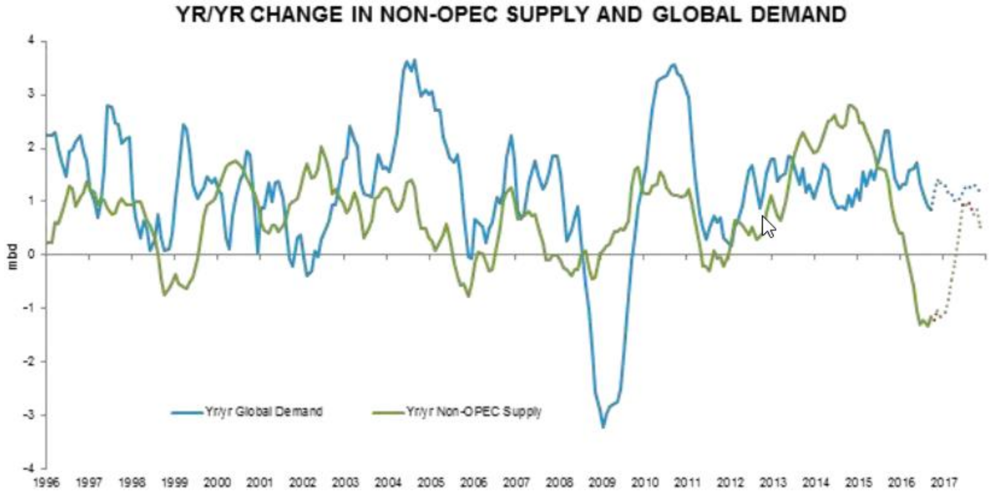
Most investors started this year with a viewpoint through somewhat rose-colored glasses. The European economy had surprised everybody by growing above trend and the Fed's first interest-rate hike had not derailed markets as many had feared. The world economy was also picking up, reaching escape velocity – ready to propel itself out of a scenario of disappointing and low growth rates. The Fed was expected to be just the first of the central banks to start the process of monetary normalization, with the Bank of England set to follow its example.

Our viewpoint in the first quarter was that monetary policy had provided very little impetus for growth and that we believed that growth would only come from some fiscal stimulus to accompany the low interest rate environment:

"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."

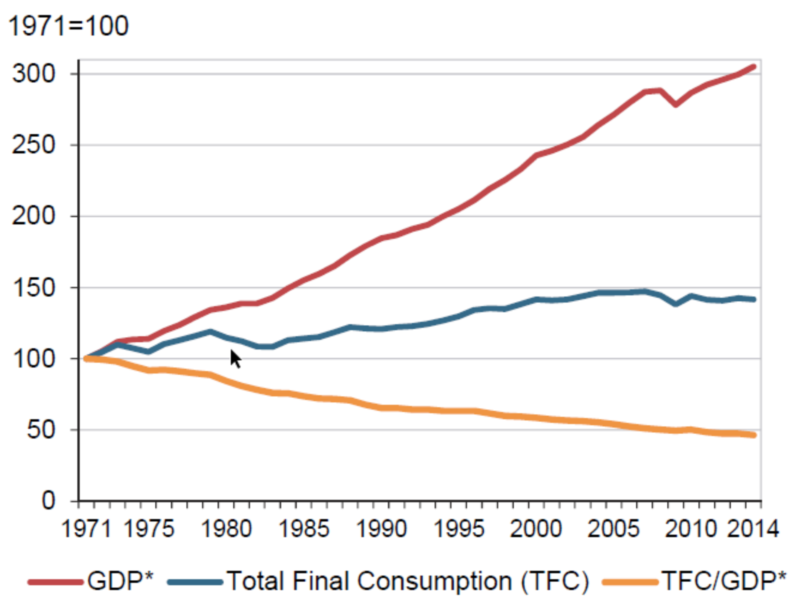
Sure, there were issues; there always are. The price of oil for example. It had been declining for over a year, with no end in sight. Positive for consumers, perhaps, but the financial markets focused more on what the consequences would be for markets like US high yield. Spreads widened, investors started to withdraw funds, leading to temporary liquidity concerns. It also raised the question of whether this was a one-off event, resulting from developments in the US shale sector, or were there more structural issues at play? Numerous economists were telling us that debt levels had been increasing for years, and that this was bound to lead to an adverse debt cycle before long. But was this the Armageddon that had been feared, though the collapse of oil had serious repercussions for leveraged exploration companies, for business development corporations and banks that had been energy lenders, and for the overall equity markets at the beginning of this year?

It has been a wild ride in energy prices from their $26 low in the first quarter, rising about 90%. Oil inventories remain elevated relative to history but we are starting to see drawdowns in both the States and in OECD countries. Global demand growth has slowed slightly, but non-OPEC oil supply is shrinking at a record pace.



Have the determinants of oil price changed over time? Ultimately, inventories play a role in smoothing oil consumption patterns, but prior price surges have been caused by unexpected increases in world oil consumption driven by the global business cycle. As you can see from the above chart, global demand for oil since the overshoot period following the great recession has drifted between 1% and 2% and currently seems to be at the lower end of that range. The role of energy efficiency is an important and current issue as countries desire to improve their usage of energy to address the goals of reduced greenhouse gas emissions and continued energy security. Economic structure and technological based efficiency are key determinants in reducing the energy intensity of economies. Energy intensity is on a declining basis, looking across all energy sources as you can see from the following chart. Between 1971 and 2014 (the latest statistics from the international Energy Agency), total primary energy supply (TPES) has increased by 2.5 times. Demand, on the other hand has increased by 2.2 times.

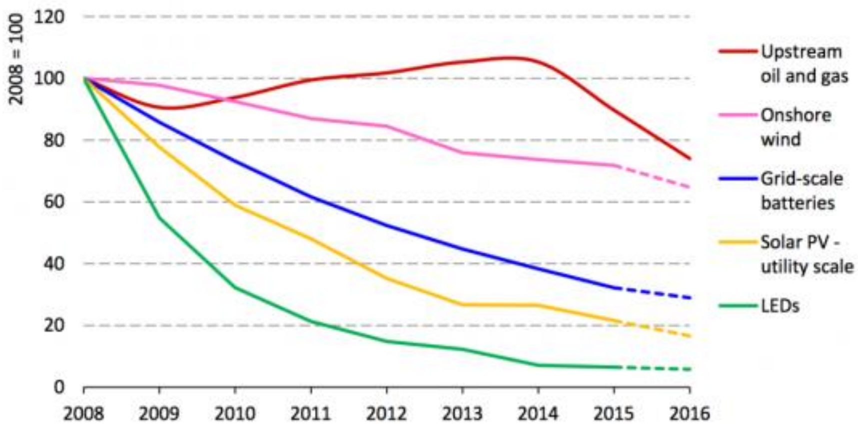
Figure 22. Final energy intensity in OECD 1971-2014



*GDP based on 2010 USD PPP.

In general, a reorientation of the energy system toward renewables is changing demand for fossil fuel. Last year, world energy investment amounted to about 2.4% of world GDP with about half going toward fossil fuel extraction and distribution. Renewables accounted for about 17% of the total, the vast majority of this in the electricity sector but almost 70% of the investment in power stations went towards renewables.

This is good news for “greens” but for consumers in general. Cost reductions have taken place in oil extraction, but these have been outpaced by those for new energy technologies. Costs for onshore wind are down by nearly 40% since 2008, solar by more than 80%, LEDs more than 90% and grid-scale batteries by 70%.



Energy cost developments 2008-2015, by technology. Source: World Energy Investment 2016, IEA.

There are other positive items relating to the consumer. Mortgage data is encouraging as far as the housing market. The delinquency rate (loans 30 or more days past due) is down about 12% from last year. The number of foreclosures in inventory is 509,000 properties but that is a drop of 228,000 from a year ago. Non-current mortgages arre predominantly from energy producing states such as Mississippi and Louisiana but the dimensions are far less drastic than prior periods. In Mississippi, about 11.16% of mortgages are delinquent, which on the surface seems disturbing, but this is less than half of the prior peak of 23.24%. Louisiana’s deliquency rate is running at 10.32%, but this is about one-third the rate of the previous peak of 30.43%.

New household formation is improving and closing in on its long-term average of 1.2 million units annually. In the years during and since the Financial Crisis and Great Recession, new household formation slowed dramatically as young adults remained living with parents and fewer people immigrated into the U.S. From 2008 through 2010, only 509 thousand net new households were formed on average, but from 2011 on that figure increased to nearly 1.2 million households per year – the long-run average going back to 1990. The number of households headed by someone 50 or older has grown the fastest as the overall population ages, but the number of younger households has also been increasing in recent years. Most new households being formed are renter households. The biggest gains in “headship” – the percent of people that head their own household – happen in one’s 20s and early 30s. More household formation usually coincides with increases in consumer spending on not just housing, but also on adjacent products and services including furniture, electronics, kitchen products, and groceries, to name just a few.

Despite this, the home ownership rate is unlikely to revert to previous highs seen during the housing boom in the early 2000s. The Millenial homebuyer market is a large segment- about one quarter of the total American population. It's only now growing into its purchase potential. The millennial generation favors renting over buying property for a number of reasons. They wait to commit to homes; desire to live in trendier, more expensive areas; or want the freedom to pick up and go with relative ease.

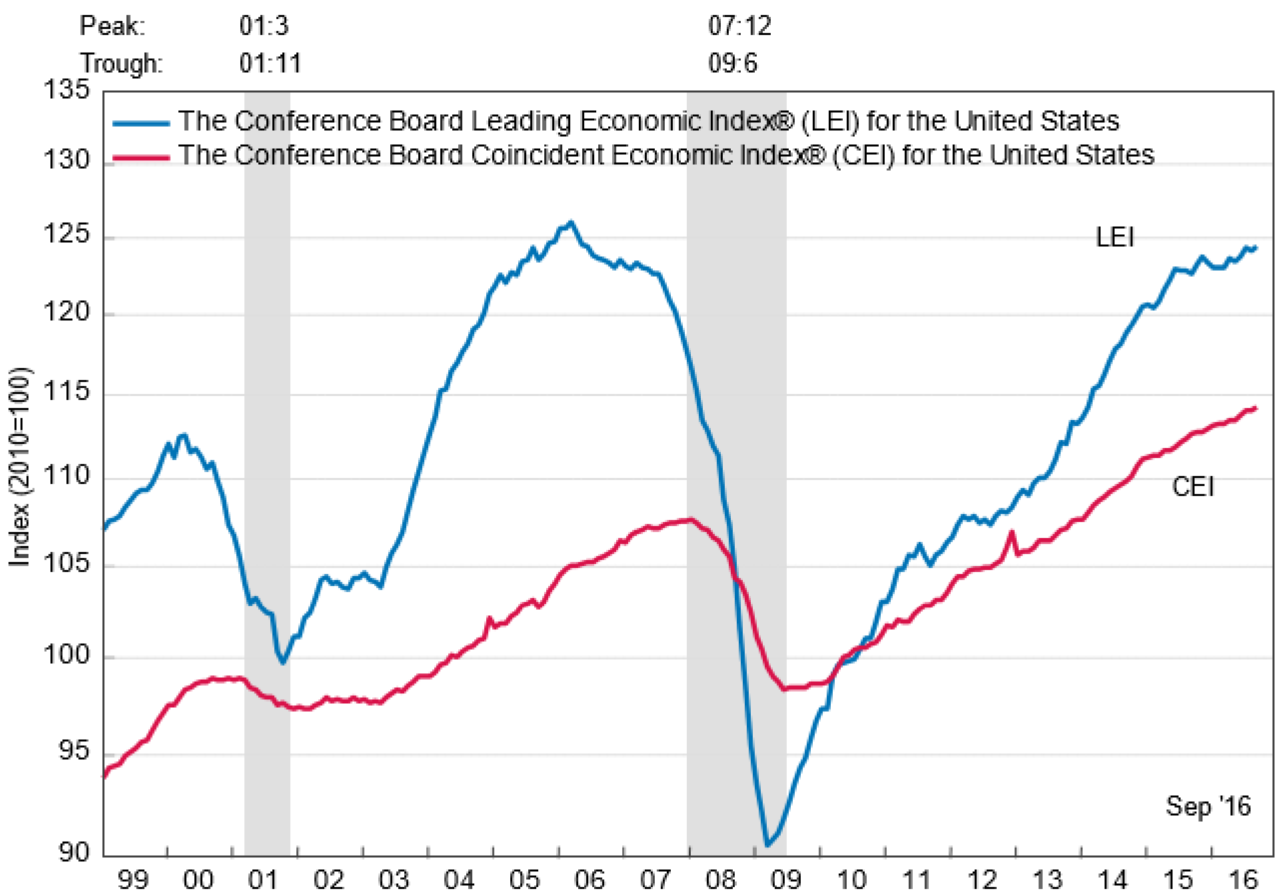
A survey found that 10 percent of millennials don't feel ready to manage a property and prefer having a landlord to take care of maintenance issues. Many millennials like the ideals of minimalist living—fewer possessions and smaller spaces—because it provides them with the flexibility and financial stability they crave. Similarly, they also value energy-efficient appliances to help keep their bills and carbon footprints low. Millennials are comfortable in small spaces because they see their living quarters as a home base, not necessarily where they want to spend all their time.

In a recent Forbes survey, only 19% of those surveyed rated thir highest financial priority as purchasing a home. Millenials were hit hard by student debt, compounded by the consequences of the "Great Recession." As a result, they tend to be debt-averse. While 80% of respondents still "believe in the American Dream." Only 5% reported that they felt the dream was "owning your own home." But there are other dreams…44% stated that "funding an entrepreneurial venture" was, instead, their highest financial aspiration. Yet, despite the lack of participation in direct ownership of housing by Millenials, overall construction spending has recovered nicely from its lows:

Leading Economic Indicators provide a fairly broad-based look at our economy. The Conference Board is a global, independent business research association that provides this tool to examine the business cycle, using inputs from multiple sectors which consider factors ranging from manufacturing such as new orders, to consumer confidence and from the performance of the stock market to interest rate spreads.

We thought for this quarterly, rather than discuss individual elements of the economy, we would simplify the outlook with a single graphic:

***The Conference Board Leading Economic Index®* (LEI) for the U.S. increased in September**



Latest LEI Trough March 2009, Latest CEI Trough June 2009
Shaded areas represent recessions as determined by the NBER Business Cycle Dating Committee.
Source: The Conference Board

Though the pace of improvement is measured, and we have experience a few monthly "squiggles", this index suggests that the economy should continue expanding at a moderate pace through early 2017.

So, economic growth in the US remains somewhat subdued for this year as a result of modest GDP growth in the first two quarters. We do expect some improvement for the second half. Although employment growth and stronger housing trends support consumer spending, faster wage acceleration is the key to sustain income levels and support consumption as the key driver of growth. Continued weak capital spending and investment remains a key source of slow U.S. growth, which is one cause of slow productivity growth. The combination of rising wage levels and low productivity provides an increased threat to corporate profits in the coming quarters.

As far as the Eurozone, despite increased political risks, the short-term economic environment in Europe is relatively favorable compared to other mature economies. Domestic demand and improving labor markets continue to drive the current moderate recovery, but the effects of pent-up demand remain a positive influence. Investment and productivity are projected to somewhat improve, paving the way for some growth acceleration towards the end of the decade.

Asia-Pacific growth remains enigmatic largely due to the lack of reliability of authentic Chinese GDP measures. Whereas in other countries GDP serves primarily as an ex-post performance measure, China's government has traditionally been strongly focused on targeting aggregate GDP growth via industrial policies and central planning. When the Chinese economy is genuinely in a high-growth mode, an overstated growth rate by one or two percentage points may not be a problem for business planning. Opportunity cost is, after all, not a direct loss to business.However, when,in reality,the economy is slowing down markedly, the impacts of overstated growth measures are farther reaching and more risky in that they potentially undermine efficacy in business, policy,and household planning,both inside and outside of China. For business, growth projections that fail todepict downward trends or low-growth levels necessarily undermine the responsiveness businesses need to appropriately adjust planning,budgeting,and operations to assure competitiveness and sustainability through difficult times.This scenario is now clearly playing out in China.

As the *Economist* magazine has pointed out, China has had uncannily stable growth with third quarter growth once again hitting year-over-year growth of 6.7%. Quoting the magazine, " That is uncanny tranquillity for a $10 trillion economy which is supposed to be going through a wrenching transition from heavy industries to modern services." Total credit has grown by 16% this year, more than twice the pace of GDP, meaning that the economy continues to leverage up. With the biggest creditors being state-owned banks and the biggest debtors being state-owned companies, there is little transparency. They are too cosy with one another and cannot shift to a more realistic portrayal of their financial situation. In our view, growth rates for China, India, and Southeast Asia are unlikely to see significant improvement for next year.

Bottom-line, the US economic trend remains mildly positive, essentially mirroring a Goldilocks economy-strong enough to keep recession risk muted but too soft to fully dismiss growth concerns. But macroeconomic momentum has picked up after flattening earlier in the year. Labor markets are settling into a slower-but-still-healthy rate of growth as payrolls continue to expand. We believe that the Eurozone's growth is improving despite the long-overlooked problems of some of its major banks. Finally, our greatest uncertainty relates to the Asia Pacific region, not only because of China but also Japan's continued mire. The BoJ has buoyed financial assets, but it has failed to drum up a similar eagerness on the part of consumers or companies to buy real assets or consumer goods. Geez, sounds a lot like the failure of quantitative easing everywhere!

As always, we appreciate your confidence and trust!

Rick Konrad

Richard H. Konrad, CFA, CFP®

Managing Member