ECONOMIC OUTLOOK

bounty management
unique investment insight

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Escaping From A Low Growth Trap
Is Productivity A Key?

"Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker." Paul Krugman, *The Age of Diminishing Expectations*

For many years after the financial crisis eight years ago, economists and policy makers expected a rapid recovery of output and employment back to pre-recession levels. Unorthodox monetary policies, including extremely low or negative interest rates and quantitative easing in Europe, Japan, China, and the U.S., have lifted many asset prices, but failed to produce strong growth. Economists have struggled to explain why we are stuck in a low growth trap. One study by economists Carmen Reinhart and Kenneth Rogoff looked at financial and debt crises over eight centuries and found that after a debt boom and bust, a slow and protracted recovery was the norm as economies deleveraged. More recently, the concept of "secular stagnation" has gained traction with the argument that an imbalance between a high desire to save and a decreased willingness to invest pulls down real interest rates, promoting growth from bubble-prone sources. On the saving side, population aging, uncertainty about retirement assets, and caution all play a role. On the investment side, trends may be depressed by low growth populations, globalization, or technology making better use of the existing capital stock without making the economy more productive or creating a much bigger economic pie.

Waves of inventions provided giant steps in productivity and standards of living in the past two centuries starting with steam engines and railroads (18^{th}-19^{th} century), then electricity and oil-driven engines (late 19^{th} to early 20^{th} century), and finally computers and the web from the 1990s to mid-2000s. By the early 2000's, businesses had already incorporated most of the productivity payoff from information technology. New equipment did not offer the same potential to cut costs, so companies bought less of it. As the last decade's sub-par growth persists, it is long-term structural factors like productivity and population growth that should come into focus. U.S. productivity is on track to decline in 2016 for the first time in 35 years. The last five years have averaged a meager 0.5% y/y, compared to a 20-year average around 2%, and nearly 3% in the late-1960s. On the demographic front, the working age share of the population will fall from a high of 67% in the late 2000's to 60% in the next 20 years. The productivity slowdown is not a clear-cut issue with obvious solutions. Economists recommend spending on infrastructure, raising labor force participation, and gearing tax, regulations, and trade policy to incentivize investment. On a positive note, no one foresaw how the information revolution would revitalize productivity in the 1990's and the next breakthrough may hold a similar surprise.

U.S. Economy

The U.S. economy eked out roughly 1.1% growth on average over the last three quarters (1.4% in Q2). Consumer spending accounted for the majority of gains as business investment subtracted from growth for a third straight quarter and inventory investment plunged. Second half growth estimates have been pared back as well, and the much-touted Atlanta Fed GDPNow estimate for Q3 slipped to 1.9% on October 14th, from as high as 3.8% in early August. The Federal Reserve blinked in September, putting off a 2016 rate hike as inflation remains below 2% and there is room for further improvement in jobs. The Federal Reserve's growth projections, lowered to 1.8% for 2016, continue to decline and there is increasing acceptance that there may not be much tightening in the future. Our 2016 U.S. growth forecast at the start of the year in the range of 1.5% to 2.0% seems to be on target.

Employment and Wages

Job growth rebounded from a dismal spring to an average 232,000 per month in June through August. The year-to-date average is 178,000 compared with 229,000 last year. Average hourly earnings growth continues to hold around 2.5% y/y (2.4% in August) with 40% of net job gains in 2016 in education, health care, and leisure and hospitality services, despite these lower-paying sectors only comprising 24% of the workforce. Job openings hit a fresh high of 5.9 million in July, though evidence on recruiting intensity per job vacancy suggests firms are leaving vacancies open longer, waiting for applicants with skills that may be in shorter supply. As the jobless rate moves below 5%, Fed officials have taken pains to point out that demographic trends mean job growth of 100,000 per month, or below, is all that's required keep unemployment stable.

Consumer and Manufacturing

In September, the government reported that household income rose 5.2% in 2015, the largest one-year increase since 1967. Although the increase is welcome news, median income is still 1.6% below 2007, 2.4% below the peak of the late 1990's, and only 1.2% total (0.03% per year) since 1979. Consumer spending, the engine of U.S. growth, posted a strong 4.3% rise in the second quarter. The September Conference Board Consumer Confidence Index hit a new post-recession high at 104.1, and light vehicle sales averaged 17.4 million in the third quarter (Q2 17.1 million). Online shopping continues to dominate retail trends, rising 10.9% y/y in August (now 10.2% of total retail sales), while sales at general merchandise (-0.7% y/y) and apparel/accessory stores (-0.3% y/y) contract. For housing data, national 5% annual price appreciation is still outstripping income growth, a function of tight supply and lower mortgage rates. U.S. manufacturing production remains tepid, falling to -0.4% y/y in August (July -0.1%), averaging just 0.1% y/y in 2016. Equipment investment fell in each of the three quarters through Q2, a y/y decline of 1.7% - more indicative of recession than expansion.

World Economy

Europe

According to the World Trade Organization (WTO), global trade will grow more slowly than expected in 2016, expanding by 1.7%, well below the April forecast of 2.8%. The European Central Bank (ECB) remained on autopilot in September, keeping deposit rates below 0% and maintaining asset purchases at €80 billion per month. One notable change is European central banks are now buying corporate debt - the ECB bought €28 billion in corporate bonds since June. The Bank of England joined the party by announcing a plan to buy £10 billion in corporate debt in the next 18 months. In Italy, Brexit-like anti-EU sentiment continues to run under the surface with a constitutional referendum set for December. The economy is just emerging from contraction in 2012-2014, and remains racked by high debt and non-performing loans in addition to a fragile banking system. The unemployment rate in Italy has been steady at 10.1% from April to August, matching the lowest since 2011. Current unemployment reflects a wide disparity among countries, ranging from 4.2% in Germany, to 10.5% in France, and 19.5% in Spain.

Japan

Japan remains stuck in a swamp of no growth and deflation. In September, the BOJ added “quantitative and qualitative easing with yield curve control” to its toolkit, and committed to keep buying assets until inflation overshoots 2%. Fine-tuning may help mitigate certain aspects of the poorly-received negative interest rate policy on banks, but targeting a 10-year government bond rate around 0%, and a short rate at -0.1%, is hardly steep enough to boost bank profitability. Banks are unlikely to lend more aggressively to lock in low rates if the stated policy of the central bank is to boost inflation. As a result, capping yields can instead be seen as a prerequisite in order to support government fiscal expansion ahead, “helicopter money” in practice, if not name. The last round of stimulus in August even included cash handouts of $150 each to 22 million people.

China and Developing World

Emerging market risks remained on the backburner in the third quarter, helped by signs of a flatter Fed tightening cycle and currency stabilization. Slow-growth conditions across developed economies and slowdowns in key emerging markets are to blame for contracting trade volume, as is rising protectionist sentiment around the globe. China is still in the middle of a housing boom with average prices up over 30% in the past year. The cost of China's building spree is enormous - consulting firm McKinsey calculates that from 2000-2014 China added $26.1 trillion to its debt, a figure greater than the GDP of the U.S., Japan, and Germany combined. Many countries in commodity producing emerging markets are still in the process of adjusting to the new reality of lower commodity prices and are being forced to cut spending. Vehicle sales fell in Russia (August -18% y/y), but continue to rise in Mexico (22% y/y) and accelerated in China to 24% y/y (9.6% y/y in Q2). Even with the Olympics, economic pain in Brazil continued though the second quarter with a sixth consecutive q/q GDP decline.

Currency and Commodities

The British pound has lost 18% of its value versus the dollar since the referendum. The dollar fell 1.1% versus the euro in Q3 and 1.8% versus the yen. Gold fell 0.5% in Q3 (up 15% in 2016), and West Texas Intermediate crude was little-changed at about $50/barrel, after rising 26% in the second quarter. Prices rebounded in late September on a tentative OPEC agreement to curtail production. Although positive for the oil market, U.S. producers may view any rise in prices as reason to boost supply. Oil explorers discovered only about 10% as much oil as they have annually since 1960 spurring concern for meeting future demand. Global spending on drilling has been cut to $40 billion this year from $100 billion in 2014. Through August there were 209 wells drilled, down from 1,167 in 2014. The annual average since 1960 is about 1,500. Although the current supply/demand balance favors lower oil prices, lower current exploration will push up prices in a few years.

Investment Perspective

What keeps us up at night? As 2016 winds down, market volatility reflects the anxiety over several issues including central banks' negative interest rates, the U.S. Presidential election, and fear in Europe from both Brexit and a wobbly banking sector. In the past few months, Deutsche Bank (DB), the largest bank in Germany, was hit with a $14 billion penalty (DB has an $18 billion market cap!) by the U.S. Justice Department stemming from their part in the mortgage bubble and bust eight years ago. Even though the ultimate payment will be much less, a whiff of panic that a Lehman style event could take place in Europe worries investors. Deutsche Bank, like many banks in Europe and elsewhere, has been hurt by a string of negative factors including tougher regulations, higher capital requirements, negative interest rates, lower trading income, and an over-banked market. And this is the largest bank in Germany in the strongest economy in Europe! The latest news on Brexit is that Europe will likely take a tough stand against the U.K. to show other EU members the costs of separating from the EU. Finally, the U.S. presidential election in November and the Federal Reserve meetings in November and December are well known triggers of anxiety.

For all the talk of equity risk, bond risk may be the larger concern, but more difficult to understand especially after a 30 year bull market with progressively lower rates. As a sign of a slow and weak global economy, almost 40% of advanced economy government bonds carry negative yields. Even some European corporate bonds were issued this year at negative rates. Negative rates may be a way to spur loan growth, but squeeze bank profits and make it difficult for pension plans and insurance companies to meet their long-term obligations. The risk with negative rates is one-sided: the upside to the buyer would be a loss by holding bonds to maturity and the downside would be a loss greater than the move in rates. Who wants to take this risk?

Although we continue to favor equities, we are cautious due to valuation and market stresses. Corporate profits are projected to contract -2.1% in the 3rd quarter (down from the +0.3% forecast in June), extending the losing streak to six consecutive quarters of lower earnings. The thesis that the second half of the year would make up for the slow start to 2016 is starting to unravel as analysts lower their forecasts. The probability of the Fed raising rates in December is currently about 60%, but the Fed may be reluctant to impose tighter conditions for fear of tipping the economy into recession. Equities continue to be supported by artificial government support and corporate share repurchases to the tune of $1.7 trillion for the past three years according to Goldman Sachs. During these times of uncertainty, we feel it is important to maintain our disciple of finding and holding individual quality companies with strong financials, a favorable competitive position, and growth at a reasonable valuation. Generating a future stream of income includes returning cash to shareholders in the form of dividends. While the world seeks the next invention for higher productivity and a growing pie for all, we will continue to invest with diligence, patience, and remain vigilant as ever.

September 30, 2016
DJIA: 18,253.85
S&P 500: 2,168.27

About Bounty Management
Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. Since 1971, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.