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HALF TIME

Introduction

I believe we are about halfway through the business cycle of a gradual accelerating economy. Distorted by the credit issues of 2008-2017 (?), it nonetheless has enough similarity to call this long slow recovery unique but still very much a business cycle.

As always the opinions expressed are based on my study of events and are not to be construed as investment advice. Various levels of risk lie behind many of these judgments and the reader is told in advance that I make no warranty as to the risk, return or likelihood of what follows.

Of further importance is the “Common Knowledge” I have been writing about. This is simply what people think other people think. In our case it’s what investors think other investors think. Truth is irrelevant. The point is that perception is reality. When this reaches fever pitch, when all investors are in this mode, you set the stage for useless information. To wit: 2013. I have tried to keep what is popular or Common Knowledge out of what follows.

Only very recently have some investors shifted to real investing – selection and analysis. I’d like to think that I’ve always been of that school if for no other reason that I start with a top-down overview of the economy which most often keeps me and my clients out of trouble but has the potential to make me miss “Common Knowledge” trends. Still trying to decide if missing short term trends is bad or good, however.

Taxes and Government Spending

By definition government spending is taxation. The state local and Federal government spending comes from tax receipts. That spending can be wages for government employees, transfer payments like welfare, subsidies to otherwise fad businesses (solar, Tesla, etc.) and military equipment, to name a few. Borrowing is simply taxing, deferred.

This movement of resources, be they cash collected in taxes or spending on non-productive assets, by definition, excludes private use of the same resources.

We have, then, two factors to consider:

1) the rate of taxation – the percentage share of your income or corporate profits taken as a tax and
2) the extent of government spending of those dollars as a portion of the whole economy – as a percentage of our total GDP.

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We have good news and bad news. The good news is that all government spending as a share of GDP has fallen from a bit over 39% to a bit below 34% over the last 4 years or so. The (broad) trend for the last 45 years has been between 31% and 34%.

This trend of a falling share of all economic activity is, in my opinion, very likely to continue primarily because the broad economy is beginning to grow faster than government spending. The struggle to allocate resources between the private sector and the government sector will diminish and I view that as very positive.

Allocation then, of skilled labor, of available credit, of plant and equipment capacity to the private sector is extremely important when you recall that all growth begins with increased supply.

Henry Ford figured it out: Pay a decent wage to build big plants that produce cars that cost less and less and the workers will have the money to buy them.

The question that remains is just what the government does with rising taxes if it's not expected to spend more. One major factor is no longer burdening the banks but rather freeing them to do more lending instead of holding reserves at the Fed.

The bad news is best seen in the recently published budget proposal from the Obama Administration: Significant further taxes are targeted for programs that will assist Democrats facing reelection. Once again "shovel ready" appears and, I suspect, once again new taxes will become subsidies, welfare boosts and, obviously, funding for new programs such as schooling for four-year-olds. Transfer payments will dominate.

In spite of a decent proposal from David Camp to reform the tax code, I think Republican resistance to one of their own coupled with Democrats buying votes, will give us higher personal tax rates.

I don't see that changing if the administration changes, by the way – Republicans have a lot of "catching up" to do.

Inflation

Start with California's Central Valley looking like a 1930s Oklahoma dust bowl. Add in the well-being of the California snail darter which requires millions of gallons of fresh water to survive. Seems the totally useless critter suffers and dies if its habitat waters are too salty. The fresh water flow provided them, incidentally, is simply dumped in the ocean after passing over their habitat. This state's farmers produce the lion's share of fruit and vegetables for the nation, so this water shortage will show up in prices. (Many believe the real basis of the water fight out here and the constant cuts to farm water supplies is the desire of the hard left to return the Central Valley to the marsh it used to be). Add in the

record draught in Brazil for further pressure on food prices. Don't forget the rise in health insurance costs, energy and especially housing.

The housing component of the Consumer Price Index (CPI) is not the simple increase in some "average" home price. That would be too unsophisticated. No, your employees at the Bureau of Labor Statistics calculate what your home would rent for if you occupied it as a renter, not an owner. This mumbo-jumbo uses property valuations and capitalizes those numbers to create a "market rent" that is supposed to capture the current cost of capital and home values among other things.

A rise in interest rates will further push this component of the CPI up. Rising home prices, about 30% of the CPI, will certainly impact it upwards. All in all about 60% of the CPI (food, energy, housing) will show significant upward movement. The Washington answer is to measure the CPI without these elements because "they are volatile numbers" . . . you've all seen the headlines, " *. . . ex food and energy, the CPI rose only fractionally which troubles the Fed as it might signal deflation,"* etc.

The issue of less product in the package for the same price or the issue of "ignoring" food and energy prices because they are too seasonal or too volatile can only be ignored to a point. We are at that point.

Many products, particularly electronics, continue to fall in price. This deflationary trend in goods, however, does not migrate easily to services where legal, accounting, medical, etc. charges continue to rise.

Last, we have the Fed trying hard to push inflation up to 2.5% from a current 1.5% or so (their number, not mine). As always, they will still be pushing when it begins to move up because of what they monitor for clues to inflation and their agenda to ease our debt burden at the expense of consumers who don't mind lower prices.

Disaster? No. Hyperinflation? No. Maybe 4% plus by year end? Yes. So let's expect 5% on the 10-year Treasury 12 or 18 months from now and 6.5% on the 30-year. Rates rise with inflation because interest rates are the price of money and we can debate which comes first, but linked they are.

A note about yields. If inflation is zero, the 2% stated coupon printed on a bond, for example on a Treasury Note, is both the real and the nominal yield. If inflation is minus 1%, the real yield on that 2% coupon is 3%, the nominal is still 2%. If inflation is 2%, the real yield is zero.

The best tracking device for this is the Treasury Inflation Protected Securities (TIPS). TIPS are as close as we can get to a real, inflation-adjusted yield in the market place. TIP yields have moved from a minus 87 basis points (-0.87%) a year ago to <u>plus</u> 60 basis points

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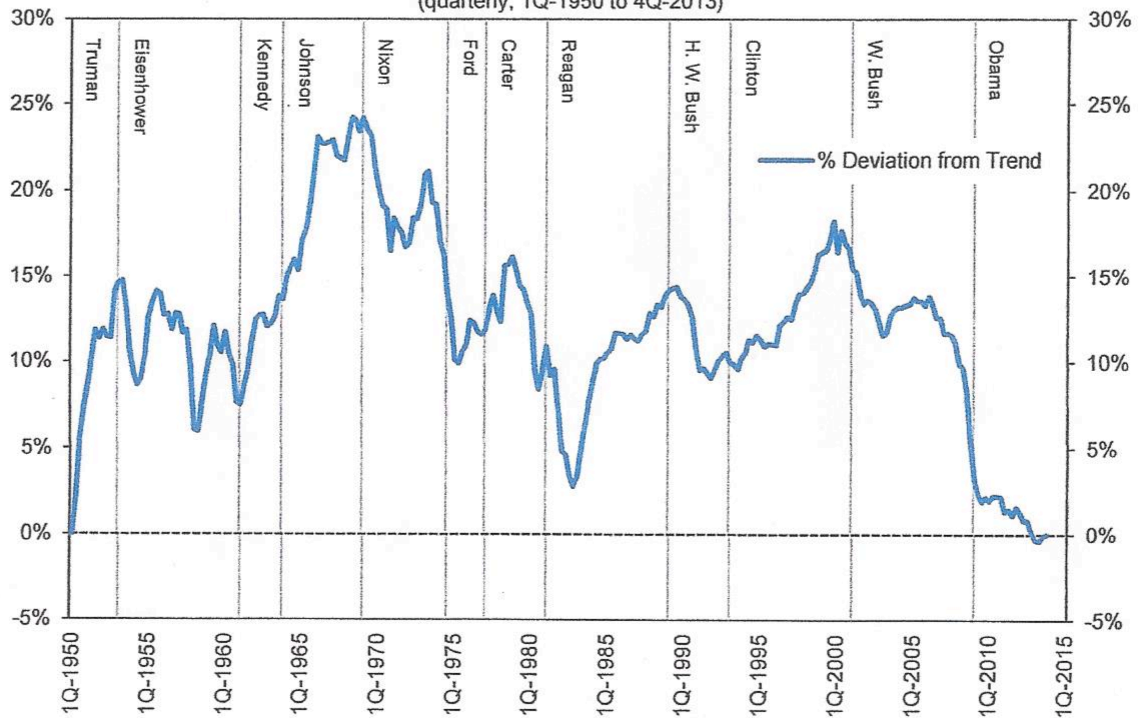
(+0.60%) today – a huge 1.47% move in a climate of near-zero nominal rates. That tells me the expected return on my capital in 3, 5, 10 years is rising quickly.

Business Spending and Productivity

Art Laffer did a study of the output per adult worker from 1950 to date (data from Bureau of Labor Statistics, Bureau of Economic Analysis).

His team found that for those 65 years, adult worker output grew at a long-term trend of 1.9% per year. (This, by the way, is real output, meaning inflation adjusted.) That long trend has numerous sub-trends often reflecting the tax policy of the administration in place at the time. Kennedy cuts in '61? Dramatic rise in output. Nixon, Ford, Carter? This unholy trio had abysmal ignorance about taxation and economic policy – and output reflected it. To come to the point, real output per adult today is the lowest it has been relative to trend in 65 years. The chart below spells it out – under-rated Kennedy, over-rated Bush, under-rated Clinton – interesting read. The flaw in charts like this is the lag effect – policies in one administration may not fully kick in until the next. Johnson was a major beneficiary of this, as was Ford, in a different direction. Whatever Bush Jr. damaged, the current administration sure didn't fix, stimulus and QEternity notwithstanding.



It's pretty clear that for 5 years or more we've done nothing to improve worker productivity. This in spite of massive layoffs, huge stimulus and even greater automation. One may cautiously assume QE does not work. One may also conclude that our capital stock – machines, plants, et al, now being 22 years old on average – a record since WWII – may be a factor. Clearly what automation that has occurred was more as replacement than new productive stock. As this can't go on much longer we like the capital goods stocks which, incidentally, begin to show life right about this point in the business cycle.

At the moment, though, if you define recovery as some positive improvement in how we work, how we grow more with the same work force, we are dead in the water.

A business owner offered very low-cost money thanks to Fed policy and aware that his top line is nearly static, has an easy call: Maintain output with automation whenever and wherever he can. If he can reduce his cost of production his margins improve. If he can eliminate rising wage pressures or benefit costs ready to spiral, he will. If he can permanently cut his unskilled-labor pool, he will. If he can draw on a part-time pool in a bind, he will. Of course, what will bite him will be the scarcity of skilled folks to build, run, service and replace all those neat new machines. Treading water comes to mind – superficially more automated but subject to new pressures when the economy returns to something closer to its long-term growth rate.

Labor

An old labor force now retiring. That's the shorthand version. Limited immigration of skilled labor has led to shortages (4,000,000 is a good estimate) of people to fill those open jobs.

Labor's share of cash profits has fallen for nearly the last two decades; wages have been flat while corporate profits have risen. (I am not unaware of the health and life insurance benefits that some lump into wages). A key reflection of that lackluster wage picture is the number of people electing unemployment compensation, disability checks and non-traditional "industries." Employed people, as a share of the population, is under 60% by most measures, down from its peak 14 years ago at almost 65%. The disturbing thing about 60% is that, through the '50s, '60s and most of the '70s, it was below 60% – generally around 55% to 58%. What changed, of course, was women entering the work force in meaningful numbers. Government employment grew, part-time workers grew, unions gave up members – all forces working below the surface.

In my opinion, the trend is a lower-still participation rate. I would not be surprised to see 56%-58%. The primary causes are two-fold: Lack of marketable skills and accelerating automation of jobs. That genie is out of the bottle and the entitlement mentality of Washington feeds it with everything from tax credits to "free" healthcare.

Which begs the question about the unemployment rate. I've said that as an aggregate number it's worthless. D. Rosenberg notes that over 30% of the private workforce is

already under 5% unemployed. College degree? Under 3.5%. Hospitals? Under 3%. So also beverage and tobacco employees. And utility workers. Insurance workers. Tolerate 4% and you find machinery workers, HVAC experts, teachers. The point is simple: The pressure for wages to rise for skilled workers will be one of the bigger stories of 2014. A permanent unemployed class is with us for some time to come and, with all the safety nets not likely to actively seek work. Take the net away, you will see a different outcome.

The overall still-modest trend up in wages is hiding sharply rising wages in some areas and declining wages in a huge industry – financial services. Here the bonuses at the top are bigger but the work force is growing smaller. This is a service industry – personal and private – that believes it can automate its delivery system. I expect continued sharp growth in small money management firms, for example, and more small, very personal "local" banks. Major institutions, with their push for market share and the last dollar of efficiency tend to mass serve their clients and in so doing feed the growth of firms willing to actually know your name.

Housing

We all realize that both housing and auto production have sizeable downstream dependents if I may coin a phrase. For every builder of homes there are the permanent crew, the periodic day-labor crew and, most important, the suppliers of all the building materials. Then the suppliers of the raw materials for the suppliers: loggers, gypsum manufacturers, raw plastics for plumbing – you can build a list.

It's also true in autos. In both sectors of the economy labor ranges from skilled tradesmen to semi-skilled fabricators to unskilled.

Picture, if you would, an enormous seesaw with our economy represented by a supply elephant and a demand elephant facing each other. At first glance they are so placed that the seesaw appears in perfect balance between supply and demand. Static equilibrium, of course, cannot exist in a dynamic economy no matter how pathetically slow that dynamism may be. If either elephant so much as inhales, shifting internal weight in the process, everything changes. That image is our economy – great mass influenced by very marginal changes.

It is difficult to convey how tiny marginal shifts can transmit themselves up and down the supply chain – as the auto manufacturers found out when key suppliers couldn't deliver enough door clips, for example.

That unbalanced image is housing today – huge, with skilled and particularly unskilled downstream dependents still waiting. Since 1950, housing has averaged about 4.7% of our entire national production of goods and services – GDP. It had a time in late 2005 and early 2006 when it touched 6.6% because if you could breathe then you were eligible for a mortgage. Today, it's 3.1%. This is not a housing recovery. A marginal change from 4.7%

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to 3.1% in the big picture of the economy doesn't strike you as serious? Put another way, annual new housing starts over the long term average about 8.6 new houses per 1,000 adults. Today, that number is 4.0 per 1,000, up from 2 per 1,000 a year ago.

Include the fact of an aging population settling in place by choice or because they can't move for various reasons and struggling 25- to 34-year-olds barely able to make rent and you can see we have had a very poor recovery with little hope to see that 8.6 again anytime soon.

Sales of new homes tell the same story: 3 per 1,000 adults historically and 1.68 today – which is up from the low of 1.1. Five years at or very near 1.68 is not a recovery – it barely covers replacing the existing stock, which by the way, is very old. Worst, our framers, drywall pros, electricians and the like are seeing actual construction stalled at 2.4 per 1,000 adults against its long-term average of 3.4 and peak of 4.5 in early 2007. Having been hired in a high and unsustainable rate, downstream workers have a very long wait ahead of them. (Art Laffer data throughout)

In brief, there can be no broad economic recovery without housing at least back to trend and the formation group, aged 25 to 34, far more confident about their future.

By the way, evaluating housing by using the value of new construction or price increases in homes tells very little – it comes down to head count.

Best estimate? Housing remains weak, has enjoyed its "recovery" at the usual time in the business cycle and I don't expect much improvement going forward. To me, the much-hyped "shortages" of new and used homes reflect sound inventory control by builders, not excessive demand. As for used homes, well, a lot like the stock market – owners holding out for the last dime. I was going to say greedy, but it's their decision to wait for higher prices if they want.

Stocks

We have falling government spending as the only (?) major plus. It will be a few years (see the Quarterly ***2017*****,** January 2012) before a full recovery, but full recovery is being telegraphed by both the yield curve and TIPS however much they are managed into shape by Fed actions. Both tell me that investors expect significantly higher returns in those out years. To me, it reflects some of the positives we've listed before:

- rising wages, for some
- U. S. manufacturing less threatened by low-cost foreign labor
- lower cost energy
- out-migration from bonds as rates rise
- stable, if not improving, corporate profits – one way or another
- continual merger/acquisition activity as the strong grow stronger

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- less institutional emphasis on non-traditional assets (temporarily)
- stock buy backs for better or worse

That and more guide me to think we face a volatile 2 or 3 years in stocks where emphasis has to be placed first on a weak economy as the backdrop. Foolish stock selection comes quickly when investors see the tape report a 3.7% GDP number and extrapolate that to the hereafter – that is simply not the trend. The reverse is true also – when investors see they were too optimistic they over react the other way and sell as if a recession was underway. In the "better" news column is the recent 9.8% overall rise in corporate earnings from, I think, 493 of the S&P 500. As to "all-time highs" mean a big correction: would that it was that predictable. If it were that much a lock-step thing no one would ever invest because all new highs would be the Common Knowledge reason to sell, thus precluding investing for any reason.

Valuations assigned to these improving earnings, however, must reflect "muddle" growth and selection remains key, as I've written of late. Selection means some sectors – some industries – should do much better than others and defining those industries first and then moving down to individual securities seems particularly prudent. In a climate of cost-push inflation – the bad kind – only the most efficient companies in the needed sectors will offer opportunity. A continual focus on dividends so as to have a stable component in your total-return goal is critical. Firms with hard assets, firms in basics (clean air/water), firms offering security or automation or healthcare – all are worth studying. One test will be how they control rising costs because wildly growing sales won't be there to save them.

The next few years have one very clear message, to me at least; trying to time yourself in and out of the stock market virtually guarantees you'll end up with significant losses.

Events drive investment decisions. To quote Kyle Bass, today's event is macroeconomics.

So, the old tried but true: Invest in firms that make sense to <u>you</u>, don't trade; diversify, don't bet the farm; be industry specific, not buying every sector to match some mythical index; ignore the locker-room success stories because you'll never hear the loss stories; be sure your sources have some clue of how the world works and aren't reading shibboleths from a book – or worse, *USA Today*. Have fun; there is money to be made in all markets.

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