Advisory Service

Trends

April 2013 Research Report

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Trends

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What to expect

More slow growth

In brief, 1) The U.S. economy is expected to grow at about the 2%/yr pace, on average, for the year 2013, 2) A mild capital spending upgrade is underway which may average near the 4.0% growth rate, 3) Consumer spending, which is 71% of GDP, is expected to average near the 2%/yr range, 4) Net exports are a small plus for U.S. growth and 5) Residential construction, which is 2.6% of GDP, is expected to have double-digit growth.

Growth

Economic Growth

Global – near 3% this year

Global growth, adjusted for inflation, is expected to be in the 2.5% to 3% pace this year with China and India in the lead. The Euro area remains in recession this year and probably next. Issues in the U.S. continue to build. The two key leaders in the U.S., President Obama and Chairman Bernanke, are both encouraging bigger and bigger problems for the U.S. with their policies.

Fixed

Fixed Income

Buyers are lining up for 10-year Treasuries at nearly a zero inflation-adjusted yield. The 10-year Treasury yield typically provides investors with a 1.5% to 2% after-inflation yield which implies a 3.5% to 4.0% nominal 10-year yield with 2% inflation. Easy money won't prevent bond yields from rising.

Equities

Equities

The mid-point S&P 500 estimated operating earnings for 2013 are approximately $111 per share, well above where earnings peaked in 2007Q2 at around $91.50/share.

About half the S&P expected increase

Earnings in 2013 are estimated to be up 15% from 2012 earnings, according to S&P numbers. Earnings will be lucky to increase at half that pace. Nominal GDP may only expand by 4% in comparison. Earnings growth at 5% to 6% instead of the S&P forecast may be closer to the pace of earnings increase. Equity fundamentals in terms of valuations, interest rates, the dollar value and compensation costs, however, remain positive for equities.

Special Topic — **Special Topic – Economic Policies and Capital Markets** (pp. 5 -12)

2%/month after inflation

- Easy money helped push up equity prices by over 2%/month after inflation since the trough in March 2009. The sub sector -- REITS have had an even better run.

Massive

- The Fed has printed a massive amount of money relative to the size of the U.S. economy, from under 6% of GDP in 2008 to near 18% of GDP. It is climbing more this year.

Massive

- President Obama has added a massive overhang of outstanding Treasury debt to the economy from 76% of GDP in 2008 to over 100% of GDP and excessive debt is still being added.

Robust profits

- Equities have had a very nice run since their trough and probably have further to go. Corporate profit margins have had dramatic gains and are above the pre-recession peak.
- Capital markets are the positive side of the ledger.
- The real part of the economy is on the negative side of the ledger.

Real economy -- not good

- GDP per capita, inflation-adjusted, and total employment remain below their pre-recession peaks and are general indicators of how weak this economic expansion has been.

4th year of expansion

- This is the 4th year of expansion and main street America remains underwater compared to the pre-recession highs. Why? Adverse fiscal, monetary and regulatory policies.

Crushed

- Households and businesses are being crushed with excessive regulations such as ObamaCare and piles and piles of Treasury debt.
- And excessive money messes up the price signals so households and businesses hold cash and near-cash and wait for the next shoe to drop.

	2010	2011	2012	2013f	2014f
Real GDP (%)	2.4	1.8	2.2	2.0	2.2
Treasury bond(%)	3.2	2.8	1.8	2.2	2.6
Vehicle sales(mm)	11.6	12.8	14.5	15.5	15.9
Housing starts(mm)	0.59	0.61	0.78	0.96	1.14
CPI (%) (y/y)	1.6	3.1	2.1	2.0	2.2
S&P 500 earnings($/s)	83.77	96.44	96.99	111.56	122.46
S&P 500 dividends($/s)	22.73	26.43	31.24	33.40	34.74

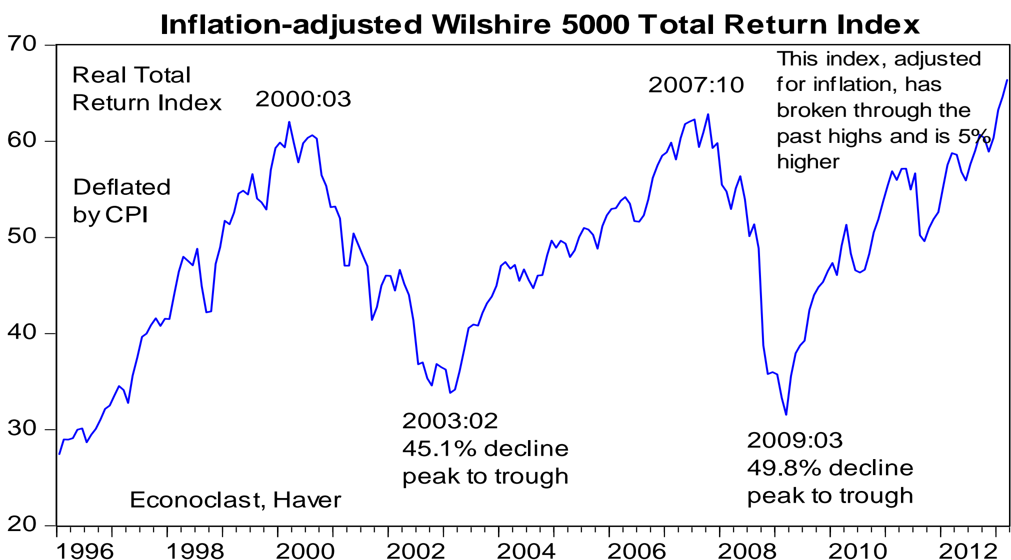
Special Topic **Special Topic --Economic Policies and Capital Markets**

Monetary Policy **Monetary Policy and Equities**

The Fed's quantitative easing, to date, is a plus for the equity market and has helped push the Wilshire 5000 total return index, adjusted for inflation, above the 2007 high by 5%.

From the trough in 2009 this Wilshire total return index gained, on average, 2.3% per month after inflation.

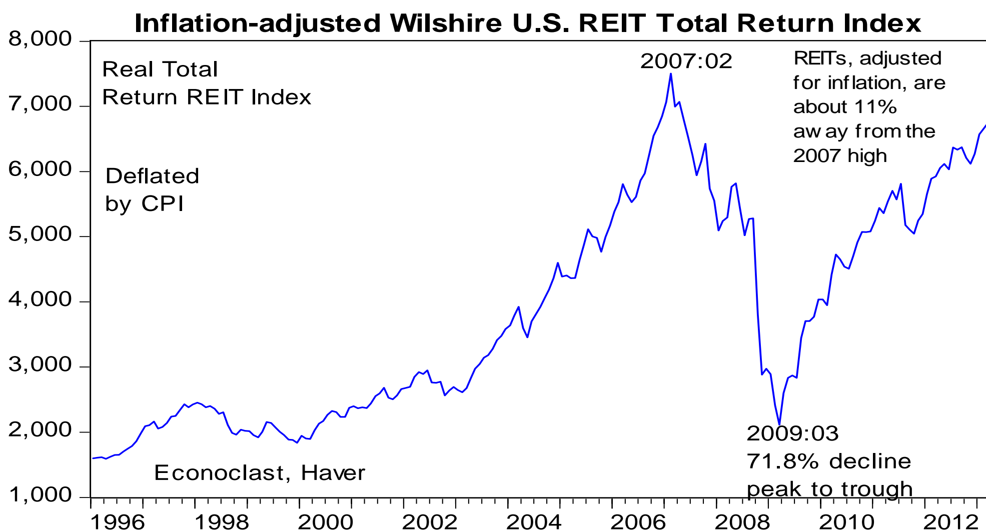
Nice run



REITS **Monetary Policy and REITS**

REITS have had an even better run from their trough driven by the Fed's excess liquidity.

Even better



REITS -- continued

From the trough in 2009 the Wilshire total return REIT index gained, on average, **4.6% per month after inflation** on the back of excess money. Bernanke's flood of new money pumped up excess reserves for the banking system along with pumping up capital market values.

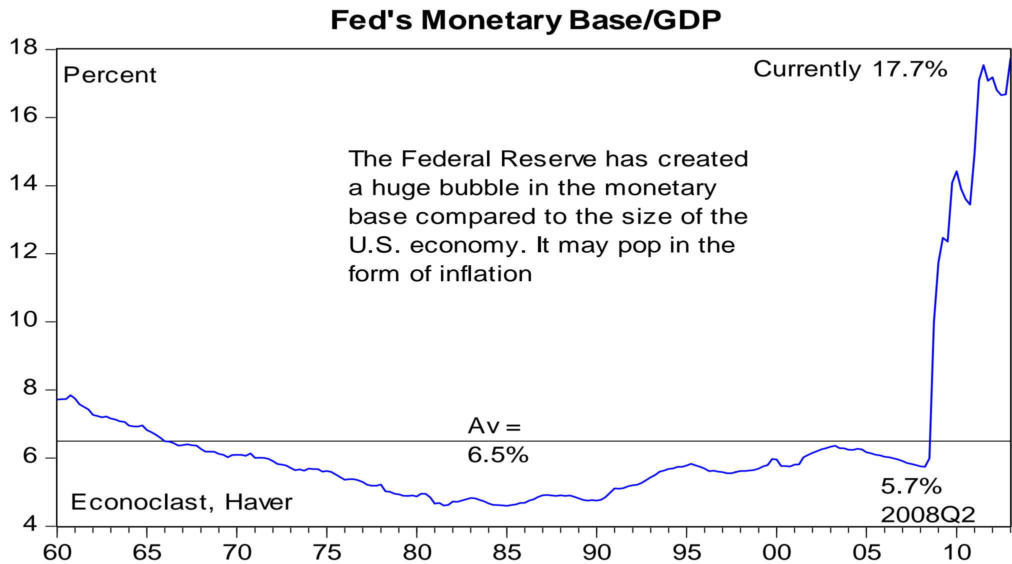
Many banks were on their deathbed and the Wilshire equity indices were beaten down to levels that existed many years earlier. A flood of new money helped prop them up.

Easy Money

Fed and Easy Money

The below illustrates the magnitude of the new money that the Fed pumped in, and the Fed is expected to pump in another $1 trillion this year. It is possible that the Fed can somehow gradually reduce the amount of its monetary base over a 10-year period, once the Fed decides to stop pumping.

It is already an enormous bubble



Plot

The Plot

Fed think

Musings from Bernanke could lead one to think that the Fed won't make any attempt to shrink its balance sheet once the Fed stops pumping in new money. The group think at the Fed may be to use the interest rate that the Fed pays banks for excess reserves in an attempt to control the pace of bank lending and secondarily inflation.

In normal times the Fed's operating target is the federal funds rate. It isn't a major stretch to think that the Fed could switch its operating target to the interest rate its pays on excess reserves. If the Fed makes such a switch the Fed could argue that it doesn't need to drastically reduce the monetary base in

order to control inflation. Could it work? Who knows?

Realistic?

Realistic?

The Fed, in its easy money policy, has embarked on a trip no central bank has ever been on in terms of the magnitude of new money created. The first part of the Fed's trip – easy money – is the one that improves the net worth of many households and businesses and helps make banks healthy.

It is the Fed's hope

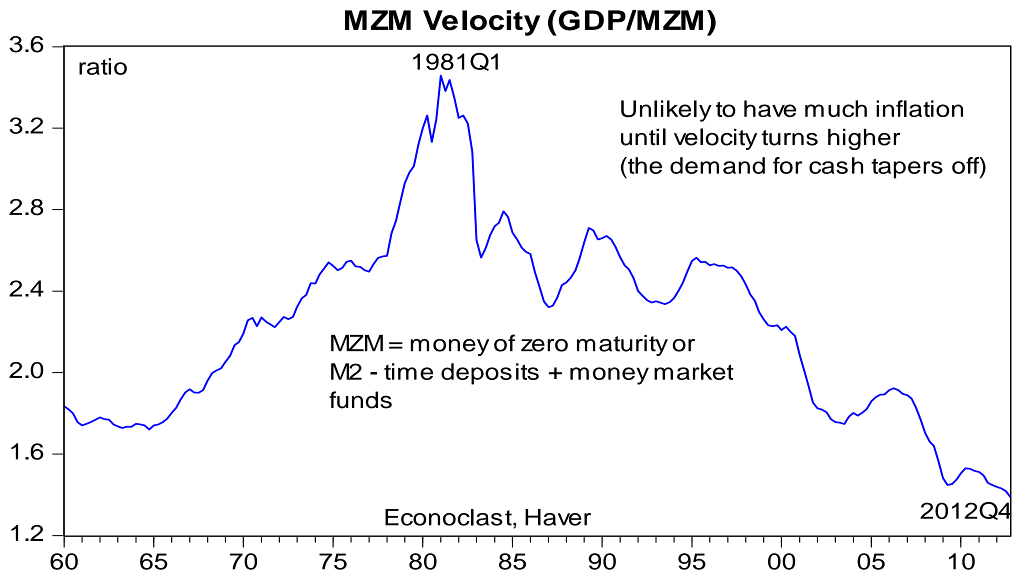
The return home part of the trip – pulling out the monetary base – is going to be the difficult one because capital markets and the real economy are likely to be adversely impacted. That is probably why the Fed appears to be drifting toward the idea of changing the Fed's operating target from the federal funds rate to the interest rate on excess reserves, once the Fed stops pumping in new money.

Velocity

Declining Velocity

Velocity of MZM or the number of times that MZM money turns over in given period has been in a long term decline. That decline reflects a combination of subdued inflation expectations and low or negative real interest rates.

Downward trend likely to continue



Why

Why the Decline

Two reasons

MZM velocity has fallen from 3.5 in 1981 to 1.4 at the end of 2012. Inflation expectations fell dramatically over that time period. Real interest rates have collapsed the past few years. Result: both households and businesses hold more cash and near cash. Velocity of MZM is likely to decline more unless real interest rates or inflation expectations increase.

Real Economy **The Real Economy -- Weak**

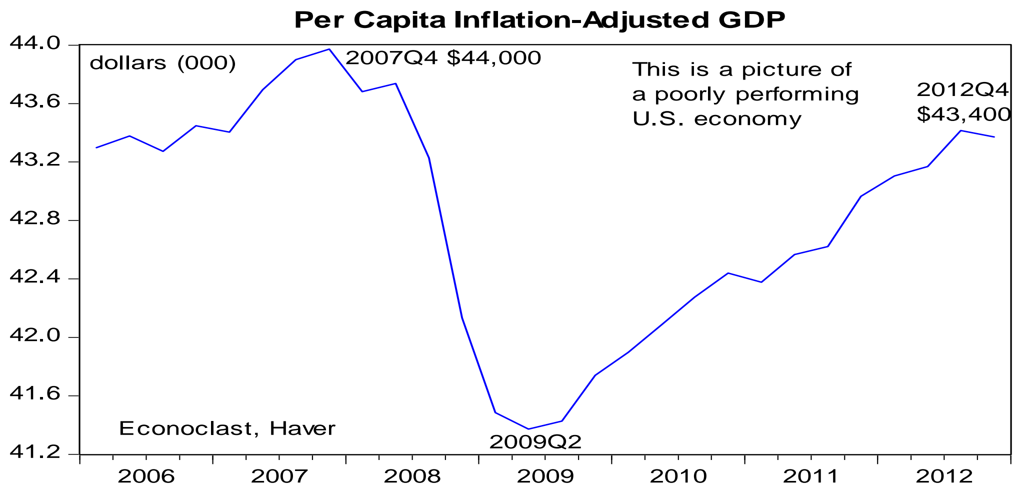
How is the real economy doing? Not well is the short answer.

Per Capita GDP Real GDP per Capita

Per capita real GDP remains below the 2007 high as the U.S. economy struggles to grow under the weight of excessive government regulations, in particular ObamaCare, and outstanding Treasury debt of over 100% of GDP. Plus the excessive money printing by the Fed, while propping up capital markets in the short term, creates mounting uncertainties for businesses and households.

Main street is below the 2007 peak

Policy portfolio is depressing growth

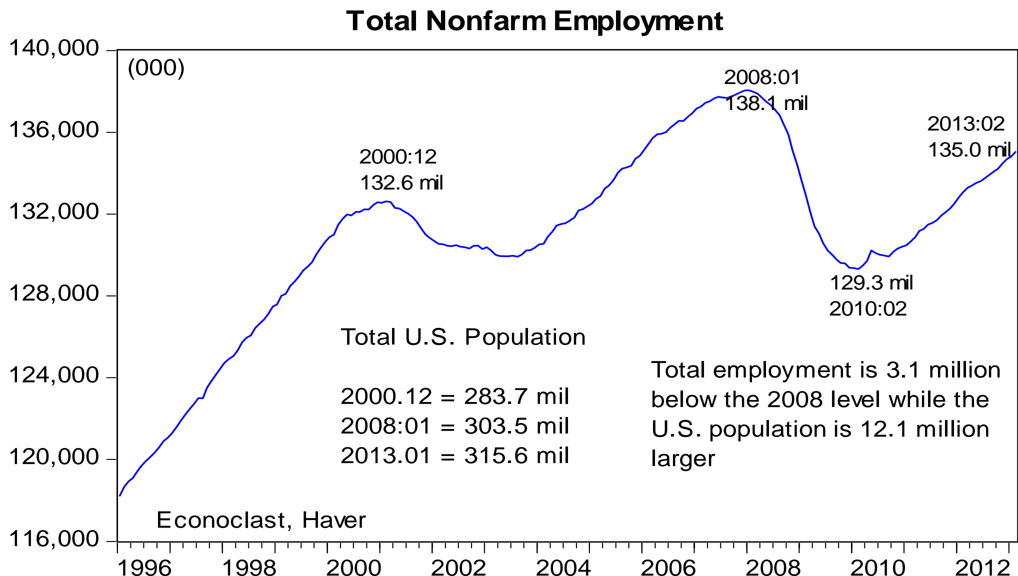


Anemic Anemic Employment

One more key measure of the real economy, the number employed, is sub-par.

This is a very dismal record

It reflects adverse growth policies



Transfer Payments

Transfer Payment Economy

Sixty percent of U.S. households, on average, receive more in transfer payments than what those households pay in Federal taxes, as has been discussed in prior Econoclast reports. That means 40% of U.S. households, on average, pay for all the attributes of this country plus pay for part or most of the transfer payments that the other 60% of the households receive.

Transfer payments are the growth part of the U.S. economy

The above numbers are from the Congressional Budget Office and the value of transfer payments includes both the value of cash payments and in-kind payments. The magnitude of transfer payments in this economy blunts incentives, at the margin, for work, business formation and economic growth. The incentive, at the margin, for some households is to work less as transfer payments could be reduced by earning more.

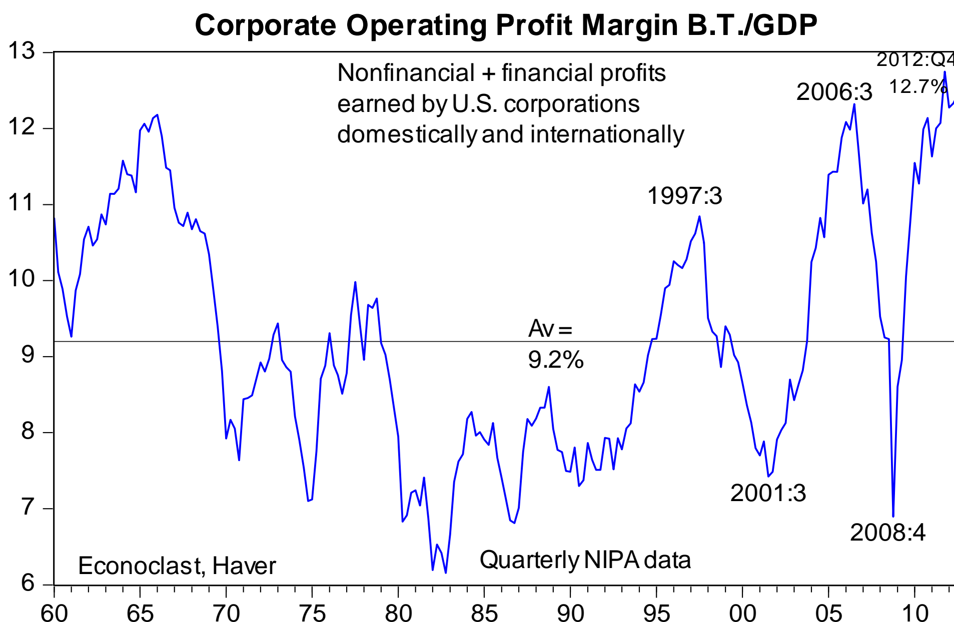
The massive transfer payment issue provides one more answer as to why the real economy is not doing well. Point: easy money helps prop up the capital markets while the real economy struggles. The large Federal deficit, excessive regulations and ObamaCare are stifling business formation and economic growth.

Equity

Equity Implications

Corporate profits are holding up very well given the slow pace of growth in the economy. Part of the reason is that compensation costs remain relatively low at this stage of the business cycle – the fourth year of economic expansion. Compensation costs remain subdued as the economy, in terms of per capita real GDP, remains below its 2007 peak.

Corporate profit margins are robust

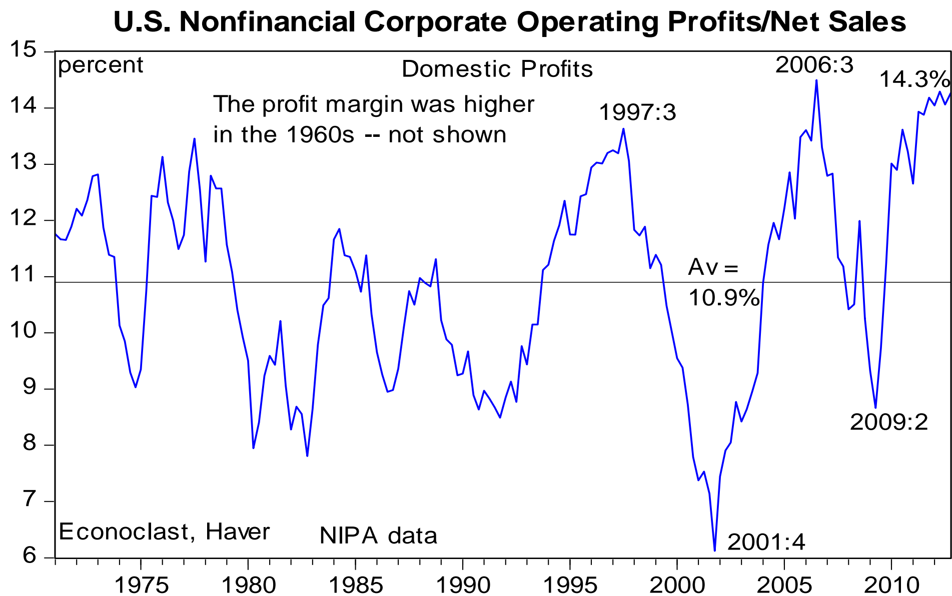


Nonfinancial **Nonfinancial Corporate Profits**

Nonfinancial profits

Nonfinancial profits for our domestic economy are also holding up well in part because compensation costs are below their average. The profit margin is slightly over three percentage points above its average. Compensation costs, in comparison, are about four percentage points below its average. Profit margins in the 1960s were higher for this sector.

Strong but not back to pre-recession highs



Compensation

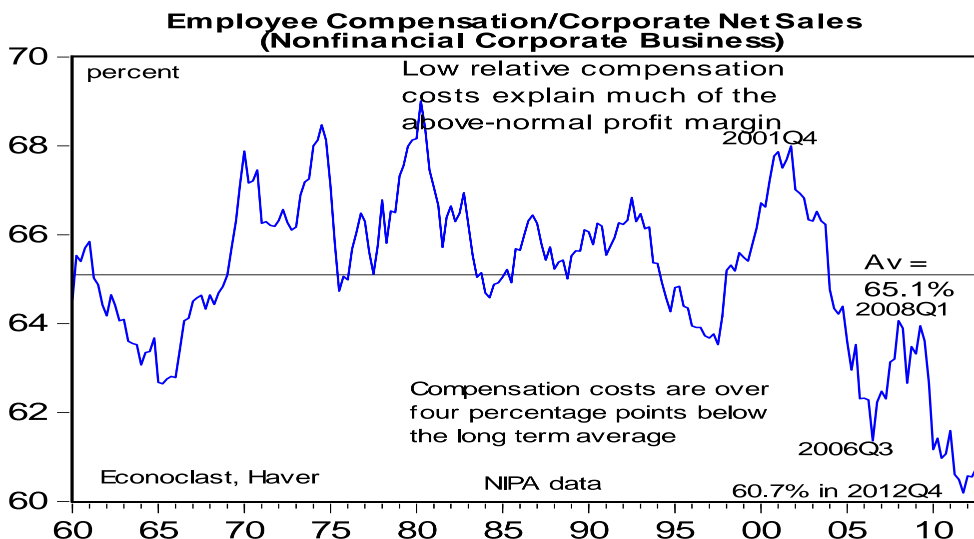
Compensation Costs

A slow-growing U.S. economy that retards growth and business formation allows compensation costs – wages, salaries and benefits – to remain significantly below their longer term average. This is another measure of how anemic the U.S. economy is.

Well below the long term average

This explains part of the robust profit margins

Compensation costs reflect the global labor market and weak U.S. economy

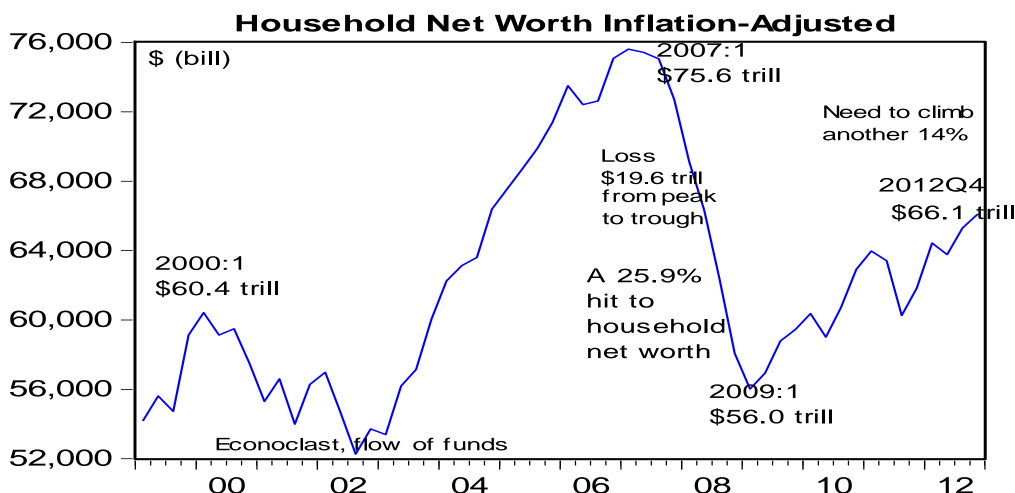


Net Worth **Household Net Worth**

Personal consumption accounts for nearly 71% of economic output. Household net worth, inflation adjusted, has improved nearly $10 trillion since its trough but most of that gain has been in the equities. Owner's equity in household real estate, in comparison, hasn't made much of a move.

Consumption is 71% of GDP

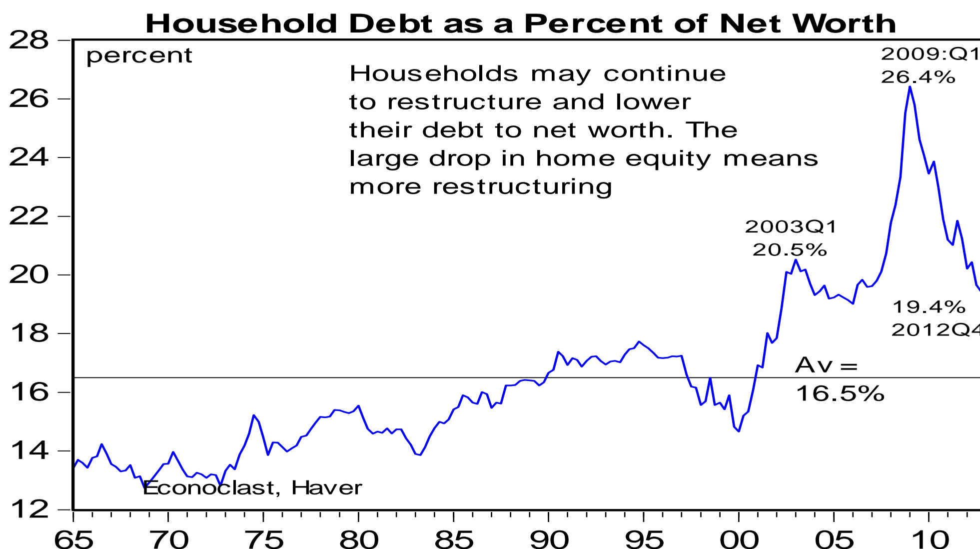
Net worth is about $10 trillion less than the pre-recession high



Debt **Household Debt Adjustment**

Households have been delevering since 2009 to reduce their reliance on debt. More delevering appears to be ahead which is a plus for the U.S. economy. Further delevering could allow for a sustained economic expansion even if it is at a slow pace which is a positive for the equity market. Both households and nonfinancial corporations are restructuring to perhaps allow this expansion to continue for quite some time. Issues – lack of restructuring by the Federal government and excessively easy money.

Households are moving to get their balance sheets in order by reducing their debt burden

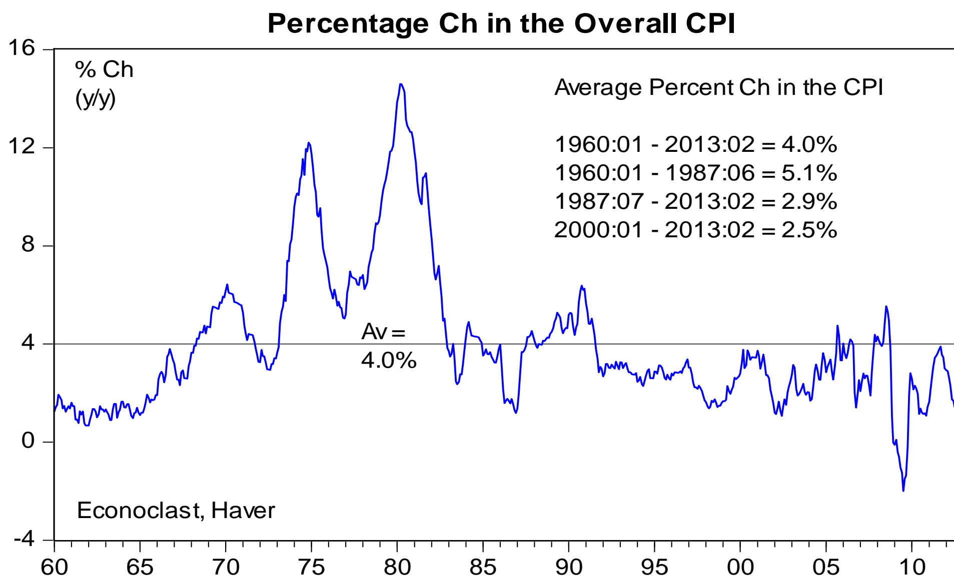


Fixed Income **Fixed Income**

Inflation

Consumer Inflation continues at a modest level. Consumer inflation over the past year has averaged about 2% and probably won't vary much from that for this year.

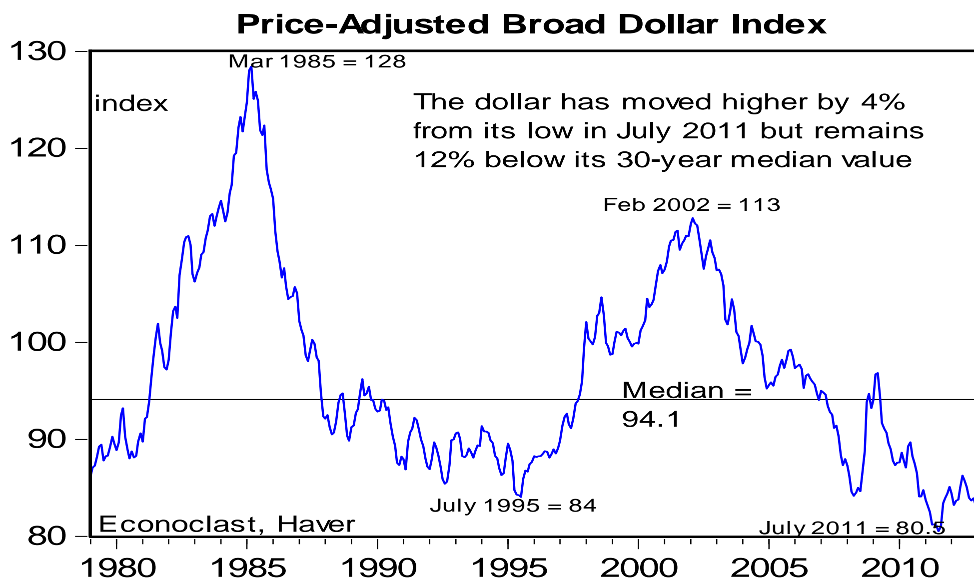
So far ok



Dollar

Inflation-adjusted Dollar Index – The dollar has held up well as currencies of other developed economies are under pressure.

About 12% below its median



<u>Fair-Value</u>

<u>Fair Value</u> -- Yields on 10-year Treasuries need to eventually climb to 3.5% to 4% in order to provide investors with an after-inflation yield of 1.5% to 2% with inflation in the 2% range. But that may be a few years away. However another Treasury downgrade could move yields higher as buyers disappear.

Econoclast Economic Scenarios

	Base Case – 75%	Surprise Case – 25%
GDP	Real growth may average near the 2% pace in both 2013 and 2014. Household balance sheets remain under pressure. Those owning housing as the primary asset have major damage. Housing prices are in the early stage of recovery.	Fiscal policy creates a massive debt overhang and the economy sinks into a multi-year deflationary recession -- the U.S. morphs into Japan Lite. The recession covers all sectors of the economy and adverse fiscal policy results in an extended recession-deflation cycle.
Inflation	Overall consumer inflation is expected to be in the 2.0% range in 2013 and 2014. U.S. core inflation may also be near the 2% range.	High household debt levels and housing deflation result in a nasty combination of deflation and a Japanese style economy.
Commodities	Emerging market economies gain global GDP share. Iraq oil production is near 3.3 mmbd and can increase more if there is political stability.	Emerging market economies have good growth. Gold prices move sharply higher from here as the sovereign debt issues implode economies.
Federal budget deficit **Current account deficit**	Federal outlays create a Federal deficit in 2013 of near $1.0 trillion. The current account deficit as a percent of GDP continues to shrink.	An even larger Federal budget deficit as U.S. economic growth slows. Slower U.S. growth means a smaller current account deficit.
Political parameters	Tax revenue needs to increase unless Federal outlays, currently at 24%, are reduced to near 20% of GDP. Excessive Federal outlays and regulations act to inhibit economic growth. EPA regulations limit domestic oil and gas production.	Policies are implemented that push the U.S. into a prolonged recession. Trade fears dominate and mini-Smoot Hawley tariffs are implemented. Foreign policy is inept.

Capital Market Implications

	Base Case – 75%	Surprise Case – 25%
Fixed Income	Fair value – Ten-year Treasury bond yields need to move higher to provide investors a positive inflation-adjusted rate of return but that is ahead of us. Demand for cash and near-cash remains high. Inflation expectations except for gold prices are modest. Gold prices likely reflect the large excess supply of sovereign debt.	Overweight Treasuries as yields move toward the 1.0% yield level in recession and deflation. Credit spreads widen with losses spreading. U.S. equities enter a new bear market
Equities	Equities are expected to provide a midpoint annual total return of 6% to 8%/yr over the next several years. Dividends of 2%/yr. and earnings growth of 4% to 6%/yr. Massive Federal outlays could derail the positive equity gains.	It may be hard to earn a positive total return on equities for several years. Event risk, since 9/11, is a way of life. Middle East conflicts reinforce that. Preventing Iran from having nuclear weapons may spike oil prices. Pakistan, Afghanistan and Iran are long term problem areas.
Currency	The dollar and euro are too far apart as the euro needs to devalue. But the Fed wants to devalue the dollar. Europe and the U.S. have major issues.	The dollar goes into a major multi-year decline. Buy gold.

Michael Cosgrove completed this research report on April 3, 2013.

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(Volume 35:04)

Weighting of Market Sectors Reflects the "Sector & Segment" Report Fundamentals April 2013

Market Sector	*Weighting*	Comment
Consumer Discretionary	Over	Household financial conditions are slowly improving
Industrials	Over	Global economic growth is a plus for profits
Health	Neutral	Demographics drive increased relative global spending
Consumer Staples	Neutral	Companies are pushing through price increases
Information Technology	Neutral	A modest capital spending upgrade is occurring
Energy	Neutral	Middle East issues place a premium on oil prices
Materials	Neutral	This sector depends on China and may have upside
Financials	Neutral	Equity prices reflect the improvement in pricing
Utilities	Under	Clean energy regulations increase costs for this sector
Telecom	Under	Their dividend yields are preferred to bonds
Allocation to equities **Note: See the Sector & Segment Report for a ranking of 99 industry segments.**	Neutral	Equities can move higher with modest growth in the economy. Equities could achieve a total return, before inflation, of 6% to 8% per year over the next few years. The disposable income stream of U.S. taxpayers is impaired due to the higher taxes embedded in the Federal outstanding debt and underfunded entitlements
Bonds – 10-year Treasury	Under	Ten-year Treasury yields need to move higher to compensate investors for inflation. Overall CPI inflation may average near 2.0% in 2013.
Current Allocation		15% cash; 15% bonds; 55% U.S. equities; 15% foreign equities.
Normal Allocation		5% cash; 25% bonds; 55% U.S. equities; 15% foreign equities.

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