CROSSROADS

by Charlie Smith

Last year at this time, we were moderately bullish. Our base case for the U.S economy included economic growth again averaging less than 3% for 2013, as consumer deleveraging continued and government deleveraging got started. We thought corporate earnings (as measured by the S&P 500) could rise 4% for the year, reaching $105. Home prices would plateau, and bank lending would rise about 5%. We also said long-term U.S. interest rates would end a 30-year decline, marking the end of a long bull market for bonds. We put fair value on the S&P 500 at 1500, estimating about a 7% total return for the year.

Fast forward 12 months, and our biggest miss turned out to be housing. Prices for the average U.S. home increased nearly 15% during the year, double the rate of our most bullish forecast. Corporate earnings came in better than we thought as well, with S&P 500 profits rising into the neighborhood of $109, depending on upcoming fourth quarter results. Thanks to all the "taper" talk from Federal Reserve Chairman Ben Bernanke during the summer, our bearish outlook on interest rates worked as well; bonds had their worst year since the early 1990s. Our guess on the magnitude of the rise in stock prices was not nearly as good. U.S. stocks jumped 30% during the year, well ahead of our 7% estimate.

So should we be in a celebratory mood after a 30% year for U.S. stocks? Certainly. Should we be anticipating a repeat performance in 2014? Not hardly. The booming stock market appears to be discounting a better economy, but at the same time reflects ongoing money printing by the Federal Reserve. Our task in the New Year will be to tease out what is "real" from the massive inflationary efforts emanating from Washington. With this in mind, here are our thoughts on the various conflicting signals as we enter 2014.

Road to Health?

U.S. economic surprises were generally positive in the second half of 2013, so much so that accelerating growth was a top theme among investment strategists at year end. Most are looking for growth above 3% at an annual rate during the fourth quarter. After a 4.1% gain in the third quarter, it would be the best back-to-back quarterly performance in two years, and it would put the gain for the year at about 2.7%, the best since 2007. The assumption is that the Fed recognizes this improvement, and therefore has room to ever-so-slightly reduce monetary accommodation via reducing bond purchases. Thus the $10 billion monthly "taper", formally announced on December 18th.

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The second positive signal comes from the fiscal side of the house. After seemingly endless hand-wringing over the deficit and the fiscal cliff at the end of 2012, Congress defaulted to the "sequester" in January of last year. When combined with a tax increase on high earners, it worked. It really worked. The federal deficit fell from over $1 trillion in fiscal 2012 to $660 billion in 2013, a 40% decline. And after 3 months of fiscal 2014, another

40% decline appears to be in the works. Extrapolation is a dangerous game any time D.C. politics are involved, but pro-rating the first quarter deficit numbers over the rest of fiscal 2014 yields an estimated deficit of $400 billion, just over 2% of Gross Domestic Product (GDP). In retrospect the fear mongering over a collapse in the economy due to fiscal drag was obviously way overdone. Economic growth has remained sluggish, but positive, and now appears to be accelerating, despite the vast decline in the Federal deficit. Maybe all the Keynesian economists who've been pounding the table for more spending and greater deficits simply had their signs crossed? Who knows?

One of the keys to a stronger 2014 could be how corporate managements react to the improving fiscal situation. Executives have been complaining about economic and fiscal "uncertainty" since the recovery began nearly 5 years ago, and capital spending remains weak. One would think that an improvement in the deficit of this magnitude would be greeted in the C-suite with open wallets. There is little sign of it, however. For whatever reason, capital spending remains at multi-decade lows relative to the size of the economy. Perhaps a still-deleveraging consumer can't pump up sales growth enough to justify new capacity? Maybe technology has advanced to the point where a dollar of capital buys a much bigger boost in capacity than it did 10 or 20 years ago? Maybe the introduction of cheap foreign manufacturing capacity has permanently reduced the need for domestic projects? Whatever the cause, there has yet to be a revival of real investment spending in the U.S., the plunging Federal deficit notwithstanding.

The final indicator that 2014 might be better is Europe. After GDP declined steadily across most of the Continent for the better part of 5 years, 2013 brought a hint of economic stability to the Eurozone. Europe is "better" in the way that a man who has been hit by a truck is "better" after being dragged to the berm, but at least the risk of runaway bank failures has passed. European Central Bank President Mario Draghi vowed to do whatever he could to save the financial system in July of 2012, and thus far he has succeeded without having to crank the printing presses at anywhere near the rate of his U.S. counterparts. Perhaps nearly $4 trillion in money creation on the part of the U.S. Federal Reserve is enough to save both economies!

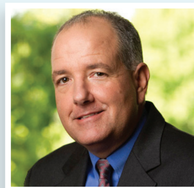
Or Road to Perdition?

The best (and most immediate) counter to the "better economy" meme was the ugly December employment report. On January 3rd, 2014 the Labor Department reported that only 74 thousand net new jobs were created in December. This against a consensus estimate of over 200 thousand. One month obviously does not a trend make (as market pundits have repeated ad nauseam since the announcement), but this report, combined with mixed holiday results from a string of retailers, has caused some questioning of the bull thesis. Ongoing weakness in labor force participation (a new 36-year low!) remains a concern as well, as millions of couch potatoes watch their remaining job skills fade into the cushions like so much loose change. The unemployment rate has fallen to 6.7%, but only because people are leaving the labor market in droves. Again, a single weak month can be explained away by bad weather, faulty seasonal adjustments or a myriad of other factors. Retail sales for December (ex autos and gas) were actually up a modest 0.6%, better than expected. Both these key indicators of consumer health bear watching in the New Year.

Another red flag is China. The Chinese economy is downshifting to a 7% growth rate—and may go even lower if authorities are forced to rein in the "shadow" banking system. In the final week of 2013, for the second time in six months, Chinese interbank lending rates spiked above 10 percent, prompting fears of a credit crunch that could cripple the world's second-largest economy. The People's Bank of China quickly injected $50 billion into the system, just as they did last summer when the same thing happened. These rumblings within China's financial system are symptomatic of the bad debts building up after a 5-year investment boom. Total debt has risen from 125 percent of GDP in 2008, to 215 percent in 2012. An additional $15 trillion of new credit has been provided during this period—an amount equaling the size of the entire U.S. banking sector. Much of this money has gone into projects with nebulous return prospects, designed more to pump up GDP statistics than generate profits. Bad debts are rising, and policy-makers face the Hobson's choice of slowing the economy now via tighter money, or letting it crash later of its own dead weight. The implications are real for global investors. China's growth has fueled worldwide demand for metals and machinery. China is also the world's largest automobile market, the largest oil importer, and the largest buyer of gold. Any sustained weakness in these demand vectors would send tremors through world markets.

Finally, there are a couple other nagging "issues" with the U.S. economy. Housing is doing better, but to some extent has become a victim of its own success. Home prices rebounded far faster than many thought possible in 2012 and 2013. Mortgage rates are also a full point higher than a year ago. This combination has made home affordability a problem, particularly for first-time buyers. Unless income growth picks up, or mortgage credit is made more freely available (we know how that ends!), the "echo" housing boom may not last. Also, the economic recovery itself is getting long in the tooth. The average U.S. postwar recovery has lasted 45 months. This recovery is now 52 months old. Talk of "green shoots" was fine when economic growth was first emerging from the tundra of the financial crisis, but today the statistics are working against us.

On balance, we're thinking real economic growth might accelerate moderately in 2014. Perhaps a 3% year is finally in the cards, particularly if capital spending revives. Corporate earnings should continue to rise moderately as well. Perhaps instead of doing more with less, as has been the case throughout the recovery, corporate managers will find a way to do "more with more", benefitting labor as well. Our estimate is the S&P 500 can earn about $114 per share in this environment. Put a 17 multiple (quite reasonable given 2% annual inflation) on this number, and you get a target of 1938, 90 points higher than the 2013 close. Happy New Year!



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