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Sinai-Husby Economic and Market Perspectives

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The Economy and A Sustainable Rebound—Normalizing If Not Already Normalized

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A New Place!

The U.S. business cycle is normalizing after many, many years of Reinhardt-Rogoff (RR) patterns.[1] That is, a large range of monthly data, more useful and relevant than real GDP, a poor summary statistic for depicting the economy, suggests a widespread, well-entrenched, cumulative and interactive move upward in the economy and labor market.

On the evidence and observed internal mechanisms of the business cycle, it has effectively normalized, finally leaving the path of depressed, anemic and aberrant growth shown in the U.S. since 2007.

The new and better place is quite different from where the economy has been and changes the contextual backdrop for financial markets, policymakers, businesses, trader and investor decisions. The business cycle upturn is chronologically old but functionally young. By that is meant that the real economy, the labor market, household and business spending and saving, sector balance sheets and sectoral financial positions, financial intermediaries, asset prices and the financial system are not showing what usually is seen in a chronologically *and* functionally old expansion.

Conditions for the "real economy" augur for a better expansion going forward—1) jobs and hiring significantly up to a stronger pace and the case for a considerable length of time; 2) disposable income and other consumer fundamentals improving; 3) business profits showing renewed growth; 4) financial intermediaries lending to both businesses and households; and 5) state and local government outlays turning positive. The labor market is moving toward "full employment" and price inflation has picked up. The stock market keeps making new highs. Interest rates are extraordinarily low but will move higher later this year or next. *These all are characteristics of a normal business cycle upturn and expansion.*

On DE forecasts and analyses, the Federal Reserve *may* be behind the curve of the business cycle as it relates to full employment and inflation. On price inflation, major new offsetting

*Based on DE Multiclient Teleconferences with Allen Sinai, July 30 and August 1, 2014.

[1] See V. Reinhardt and K. Rogoff, *This Time is Different.* Princeton University Press, 2009. Also A. Sinai, "Macroeconomic Policies in an 'Aberrant' Business Cycle," Decision Economics, Inc., *Economic Studies Series #74*, May 6, 2013.

forces to an acceleration are in-place and in a tug-of-war with the more basic macroeconomic fundamentals of demand-pull. Nevertheless, preemptive monetary policy *does* have a place, especially if the business cycle has normalized.[2]

Many decisionmakers at the Federal Reserve do not share concern on future price inflation and will continue to argue for grinding down perceived labor market slack so long as the data permit. But the combination of rising inflation and a falling unemployment rate in recent months *does* raise the possibility that the economy might be closer to full employment than is generally thought.

DE's view on Fed policy is little-changed, with recent data arguing more for an earlier rather than later interest rate hike. But, if so, it should be noted that the *first increases in a policy rate also are signs of a normal business cycle*.

Asset allocation implications of a sustainable rebound for the economy in a normalized business cycle are positive Equities and negative Fixed Income, the latter because interest rates should rise.

DE's *strategic* equity asset allocation remains unchanged at 80% (vs. a Neutral 55%), Strongly Overweight. Repeated new highs in major equity market indices have been expected and are occurring, occasionally punctuated by adjustments or small Corrections. The setting of new highs should continue. The Fixed Income allocation is Strongly Underweight (15% vs. a Neutral 35%; 20% previously). In a normal business cycle, interest rates tend to rise although the extent depends upon Federal Reserve policy. *DE is raising its Cash & Equivalent allocation to 5% (Neutral 10%) from zero previously. The increased returns to-come on Cash and Equivalent lead to the new allocation. This allocation shift into Cash and Equivalent is the first in many, many years, over 5-1/2.* Alternatives are Overweight (7% vs. 5% Neutral), allocated from other categories at investor discretion, on expectation of an improved U.S. and Global business climate.

Recent Data—Solid Gains in the Economy, Employment, and Other Data Suggest a Sustained Rebound

Q2 real GDP was strong, both in the Advance (July 30) and Second Reports (August 27), widespread so, rising 4.2% at an annual rate, with several "engines of growth" firing and historic data revisions signaling that the U.S. economy is in a new and better place after languishing for many years.

The engines of growth are mainly aggregate consumption, business capital spending, and state and local government outlays—all of which appear to have picked up in pace. *With household and business sector financial positions increasingly stronger, similarly for states and localities, higher real economic growth likely can be sustained.*

With data revisions, the second half of 2013 now shows 4% growth (3.3% previously) and y/y real GDP up 2.4%—even with the first quarter decline. If the first quarter had just been flat, rather than positive as is the case in almost all quarters in any expansion, over the past year a 3.1% growth rate would have been registered. *Going forward, real economic growth well above the near 2% average per annum pace of recent years remains the DE Baseline*

[2] See A. Sinai, "Preemption, Changing Structure, and U.S. Monetary Policy," *American Economic Review*, May 2004, pp. 49-52.

expectation—a range from as low as 2-1/2% to as high as 4%.

The balance of risks has shifted more to the upside. Odds on a more negative DE Macro Risk Scenario, "Disappointment Again," have dropped to 0%. "Delayed Takeoff," the upside Scenario, has odds at 20% rather than a previous 15%. A myriad of geopolitical risks are included in an "EMG Troubles" Scenario, 10% odds vs. 5% before, heavily Europe-centric. The Baseline Prospect probability remains 70%. Another possibility that might be considered is "The Consumer Disappoints." But this Scenario has no probability assignment since there has been only a short period of an increased personal savings rate that might signal disappointing aggregate consumer spending to-come.

Increased consumer spending, a pick up in business capital spending, higher growth of incomes, more saving and stable, albeit, higher consumer price inflation are main takeaways from the reports on Q2 GDP, July income and consumption, saving and consumer price inflation. In Q2, consumer spending advanced at a 2.5% annual rate, after rising 1.2% in Q1. The personal saving rate rose to 5.7%, up from 4.9%. Nominal disposable income was up 4.2% from a year ago (2.5% in real terms), sufficient to support *both* increased consumer spending and saving.

Business capital spending rebounded to a 9.4% annual rate after a meager rise of 1.6% in Q1 and large 10.4% gain in Q4. There was a big rebound in Equipment spending (10.7%, after -1% in Q1). But, the gain was also the result of a pick up in Structures outlays, to 9.4% from 2.9%.

State and Local Government expenditures rose 2.9%, at an annual rate, more than offsetting the 1.3% drop in Q1. The federal government sector was a net drag; federal government purchases were down 0.9%, annualized.

A lower year-on-year inflation rate was expected in June and July. And, indeed, that did happen. Price inflation in the key deflator for consumption goods rose 0.1% in July and was 1.6% year-over-year after 1.8% y/y two months previously. Earlier in the year this inflation rate was just 0.9% y/y.

The labor market report for July (released August 5) also showed solid gains—mainly in jobs and by the Fed's redefinition of "full employment" in some other related statistics.

The pace of decline in "Slack"—a component in the Federal Reserve's new definition of full employment—was much slower than it had been, but continued.

Thus, the economy as reflected in both the second GDP Report for the first quarter and in the July employment report, and reports on consumption, saving, and consumer price inflation indicated a rebound and one that can be sustained.

Why? There are three main reasons.

The labor market is key, growing cumulatively in strength, already this way for some time.

Measures of the labor market other than the downward-biased unemployment rate are improving and probably will continue to do so. The labor force participation rate may have reached bottom. The labor force finally is beginning to turn up. Over the past year, the number of discouraged workers has declined, overall and as a percent of the workforce. Hires, Quits and Openings have moved in the right direction. Wage inflation, on some

measures, may be starting to turn up. A negative is that the number of part-time workers who wish full-time work or are working part-time for economic reasons has continued to rise.

A second reason is that the financial positions of various sectors in the economy have become healthy. This is an extremely important ingredient in the business cycle!

Households have seen much reduced debt relative to income and assets and a huge increase in household sector wealth, about $25 trillion between 2009:2 and 2014:1, and more secure collateral because of rising prices of real estate and equities. A strong financial position for households historically has been a prerequisite to stepped-up gains in spending. *This time, households probably will hesitate to spend on memories of the disastrous downturn and negative financial fallout that occurred. The personal savings rate is likely to keep rising as a consequence.* With rising jobs, rising incomes and rising wealth, more funds will be available for both spending and saving—if saved supporting the household balance sheet which, in turn, will fuel more spending later.

The business sector, nonfinancial corporate business, in aggregate, is stronger than in many years.

More than anything, profits and cash flow have been building on the striking ability of U.S. companies to generate strong earnings, no matter what. Profit margins continue to defy most expectations, although not DE's, quarter-after-quarter reaching historically high levels.

Business outlays on hiring, capital goods, buybacks, dividend increases, acquisitions, or funding new businesses are on the upswing, not yet showing the strong impetus to growth in real GDP that has always occurred in prior business expansions. But, the business sector is setting up for that.

Typically, not until business is quite sure that sales and profits will be *permanently* higher does this sector provides a major "kick" up in the business expansion.

A third factor is increased lending, both to businesses and to households, by banks and nonbank financial intermediaries.

In July, commercial and industrial (C&I) loans at commercial banks were up 10.9% from a year ago. Nonfinancial corporate paper outstanding stood 42% over a year ago.

Aggregate bank profits in the second quarter were very strong, in part from increased loans to consumers. In July, commercial bank loans outstanding to households were 3.7% over a year ago, not high but positive. Excess reserves at commercial banks, while still very, very high, are starting to decline. Monetary growth has picked up.

All of this is "standard operating procedure" in early stage normal business cycle upturn behavior.

Thus, for aggregate spending, some 85%-to-90% of the economy now seems to be firing-up—and able to do so in a sustained way with support from the financial system—consumption, the business sector, and state and local government. Strong financial positions for the household and business sectors indicate an ability to sustain spending.

Main Engines of Renewed Growth

Household Sector Normalized

The household sector, with aggregate consumption some 68% of real GDP, has to provide the main engine for renewed growth.

Incomes are rising and so has household wealth, the latter by $25 trillion over the past four years. With lags, that increase in wealth should drive up *both* consumption and personal saving, the latter as measured in the National Income and Product Accounts (NIPA).

Initially, personal savings rise, the household balance sheet improves, and then consumption spending gathers steam. The lags before the economy benefits can be long, with the process gains in household sector net worth, saving in the household balance sheet, movements in household finance toward strength, and then a pick up in consumer spending. *During this period, the personal savings rate rises—a sign of latent strength not weakness.*

DE is using a lower propensity-to-consumer household wealth than previously, given an unprecedented unequal distribution of income and wealth across income groups. Since jobs and employment growth, although improving, have been subpar, the linkages between higher household real net worth, consumer spending, and the economy are weaker and take much longer, but certainly still exist.

On this view, an increase in the personal savings rate (NIPA) does not necessarily suggest coming weakness in consumption and the economy, but simply represents where the funds go from increased wealth for given levels of income.

The backdrop for consumer spending thus continues to suggest a sustainable rebound at a pace above that seen in recent years. How much so is in question. Jobs and employment, higher incomes, increased wealth, improved consumer sentiment, mended household financial conditions, and increased lending by banks and financial intermediaries are all supportive.

The shock of the financial crisis still lingers, showing in an increased personal savings rate and a continuing rebuilding of the household sector balance sheet that probably will go beyond previous equilibrium states.

Should consumption lag or stay soft, increased personal saving can feed or improve balance sheets to support stronger spending later.

Reflecting the improving fundamentals around the consumer, consumer sentiment has been rising. *This pattern also is characteristic of a normalized business cycle*, although current levels, as measured by the University of Michigan/Reuters Consumer Sentiment and the Conference Board Index, are not yet those typically seen in the heart of the expansion stage. The former typically averages over 90 in expansions (currently 82.5, just below a 2013 high of 85.1) and the latter well over 100 (currently 92.4, a post-recession high).

Finally, for households, low borrowing costs and increased lending by financial intermediaries are supportive. Whatever debt households are taking on is in-line with rises of income, assets and wealth.

Normalizing Business Sector Behavior

For the business sector, developments are characteristic of early- to mid-business cycle expansion territory, not the late stages.

Business spending, both for hiring and on capital goods, is moderately strong but not so much as later during an expansion.

After slowing down, profits growth appears to have renewed, for the S&P500 Operating EPS running somewhere between 7%-and-10% y/y, after languishing in low single-digits for a few quarters last year.

The aggregate balance sheet of the nonfinancial corporate sector is in superb shape, an early business expansion characteristic. The long period of exceptionally low interest rates has permitted numerous rounds of refinancing so that interest costs and the maturity structure of corporate debt are representative of early expansion.

Company earnings reports have been excellent, with high profit margins more than just the result of cost-cutting measures. Renewed earnings growth has been a prerequisite for DE's continued bullish stance on equities. Actual Q2 earnings growth of 9.2% y/y was above DE's 8% above-Consensus expectation (which was 6.2%) and qualifies as "renewed" growth.

Revenue growth still lagged in Q2, but showed signs of tilting up. Firmer U.S. and Global economic growth and a gradual uptrend in inflation should support company revenues.

Monetary Policy—Contextual Change?

The most recent GDP data revealed a 2.3% annual rate of change for the PCE price deflator in Q2, accelerating from 1% in 2013:Q4 and 1.4% in Q1. The core rate, ex-Food and Energy, rose 2% in the quarter. On a monthly basis, the July year-on-year PCE was 1.6%; ex-Food and Energy, 1.5%.

Together with the latest 6.2% unemployment rate, the pattern of unemployment and inflation provides a classic sign of a normal business cycle, one where the labor market continues to tighten and price inflation picks up. Price inflation is still below the 2% Federal Reserve definition of price stability, but movement appears to be in the direction of 2%, or perhaps more.

For the Federal Reserve, movement toward 2% inflation, if it continues, with the unemployment rate nearer 6% presents a different contextual backdrop for decisions than when the unemployment rate was nearer 10%. Most other measures of labor market slack are continuing to close the gap with historical norms. In the current vicinity of various labor market metrics, inflation should gradually work higher. Fed debate will increasingly focus on the potential tradeoff between a tightening labor market and accelerating price inflation possibly from a too accommodative monetary policy.

DE expects a 5.8% unemployment rate by yearend 2014. The Fed will have to grapple with a sub-6% unemployment rate very likely throughout next year.

How soon, how fast, and how to communicate a shift in the contextual backdrop for Fed policymaking to markets without creating undue volatility is one of the tasks facing the central bank.

This phase of Federal Reserve monetary policy also is characteristic of what happens in a normal business cycle upturn—transition from easy money to less accommodation and then later tightening, which will be indicated by the current Federal Reserve as "normalizing" monetary policy.

DE expects Fed debate on the timing and conditions surrounding an initial interest rate hike to contribute significantly more volatility to financial markets.

Asset Allocation Shifts

Recommended Asset Allocation weightings reflect a further move away from Fixed Income and for the first time in many years an allocation to Cash and Equivalent.

Broad *Strategic* Asset Allocations (1-3 year horizon) are—

- Strongly Overweight Equities (80% vs. Neutral 55%, unch.);
- Strongly Underweight Fixed Income (15% vs. Neutral 35%, previously 20%);
- Underweight but an Allocation to Cash & Equivalent (5%, previously 0%);
- Overweight Alternatives (7% vs. a Neutral 5%, unch.). Preferred Alternatives are Private Equity and Venture Capital because of the expected stronger U.S. and Global business climate.

Equities—Strategically Strongly Overweight; Tactically Sensitive to Adjustments or Correction in September or October

The economic data reports and Fed prospect are clearly supportive of DE's recent tactically and strategically bullish Strong Overweight in Equities—*a secular bull market still in-train*.

Concerns are EMG troubles, geopolitical risks and problems which can crop up at almost any time, also uncertainty over what the Federal Reserve will do and say in the next few months and next year—

1) when the first interest rate hike;
2) how much, what interest rates;
3) the path thereafter, shorter- and longer-run;
4) how the Federal Reserve will unwind the balance sheet, if it does;
5) what will drive the Fed to action or inaction, that is its Forward Guidance;
6) how various Members will feel about the 2% price stable inflation rate;
7) communications and issues of transparency;
8) the role of financial instability in Fed deliberations;
9) the diverse views of various Members.

Most of these central bank issues do not appear to have been settled, but many of them will have to be by no later than the September 16-17 FOMC Meeting. The Jackson Hole Symposium, while instructive on much research and questions relating to labor markets, offered very, very little on the main questions and issues surrounding current Federal Reserve deliberations and decisions.

At the next FOMC Meeting, new forecasts will be provided by the various central bank Members; there will be a Statement likely to be at least changed some on Forward Guidance; and a Press Conference. These many questions and issues suggest significant communications on Fed deliberations including possibly changes in Forward Guidance. December likely would be too late for this.

The uncertainty around so many issues and questions for the Federal Reserve is bound to create additional asset price volatility.

Perspectives on the Markets

Some DE forecasts and perspectives—in summary.

Fair value for the equity market currently is assessed at 2032. This is based on higher S&P500 Operating Earnings estimates than before, $119-$120 for 2014 (previously $117) and about $130 (previously $127) for 2015. The long range estimate for S&P500 Operating EPS in 2016 is $140.

Given that two-thirds of the year is past and looking ahead into the earnings prospect for 2015 gives a "Forward Earnings" estimate of $127. At a 16 P-E ratio, the result is 2032.

As time passes and more of next year's earnings come into sight, the DE fair value strategic estimates will continue to rise. By yearend, pricing all of 2015 earnings as currently estimated, the S&P500 fair value would be near 2100.

Thus, a directional view to 2050 in the S&P 500 is justified. Weighing against this, however, are the myriad of risks, macro risks, ranging from geopolitical in all of its various forms to uncertainty over the next set of earnings results and particularly to uncertainty over Federal Reserve policy.

September/October, with valuations that are at the high end of fair value, could be a time of vulnerability for some sort of adjustment or correction, depending upon the economic data, inflation, ups-and-downs surrounding Federal Reserve monetary policy, geopolitics, the coming U.S. Election, and others; hence, the *tactical* sensitivity to a possible Correction of some sort during this time span.

The fundamentals of interest rates suggest rising yields but tactically probably not yet any significant increase. Much depends on "safe haven" global flows-of-funds, which now favor U.S. Treasuries, German bunds, the U.S. dollar, and Japanese yen.

All things considered, U.S. investments in the current geopolitical climate show great appeal and undoubtedly the "safe haven" monies flowing into the U.S. are a big part of a 10-year U.S. Treasury yield that probably is 20-30 basis points below where it should be.

Rising interest rates await a clearer definition and expectation on Federal Reserve actions. For sure, short-term interest rates will rise in 2015—the questions are when and by how much. At that time, if the economy is doing as is expected in DE projections, the 10-year Treasury yield likely will move toward 2-3/4%-to-3%. The DE expectation on short-term interest rates is 25 basis points for the federal funds rate in March, 50 basis points by June, and 125 basis points in the fourth quarter.

The shift of interest rates during 2015 cannot help but be a source of volatility throughout various asset markets, likely to support the dollar but also likely to provide the basis for a potential Correction in the equity market.

DE projections on the U.S. dollar remain essentially unchanged—a directional view on dollar/yen to 110-115 and for dollar/euro toward 1.15 and perhaps below. The latter is new, down from 1.25. Dollar/pound sterling is assessed in a range of 1.65-to-1.55, with a

downward tilt over time.

The expected strength in the dollar stems from expectations of rising U.S. interest rates fueled by a sustained rebound in the U.S. economy, a stronger business cycle uptrend, and ongoing geopolitical risks.

Weakness from the euro side of the cross with the U.S. dollar is expected from a clear move to QE by the ECB, one that will be sustained for quite some time in order to restore upward thrust in a faltering economy and to reverse the downward tendency of price inflation.

For dollar/yen, the expectation is for a further easing by the Bank of Japan (BOJ) in the fourth quarter on a faltering economy and reversal in the path of price inflation down and away from the 2% BOJ target.

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