



## **Slow Improvement**

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During the first six months of the year, the market has been able to edge its way higher, but the movement has been sluggish. Both professional and non-professional investors are concerned with the slowdown in world growth, especially in China, the Fed interest rate hikes, and of course, the twin deficits, trade and Federal. Non-professional investors generally seem to have interest in the market, but they have remained on the sidelines, leaving them unprepared for any market rise. The prevailing logic for most individuals seems to be “nothing is going on, so why get off the bench?” As economic improvements occur, the market is climbing this “wall of worry.” Bull markets usually occur as bad news improves. Bear markets usually occur as new problems begin to develop and then as these problems continue to grow. In this context, some problems are acceptable, assuming they are waning. To sort out the strength and direction of the problems, we need to understand the future of the economic landscape and the key to the improving economy is the consumer. As the fundamental economic indicators improve, so will the market. Over the next eighteen months, these fundamentals will continue to improve so the eventual move is up.

### *Consumer Income*

Two issues concern investors regarding the consumer. First, the consumer has spent most of the wealth created by the housing boom during which time consumers were able to refinance their mortgages, increase their amount of debt and spend the proceeds. Mortgages, as a percent of home values, have risen to a very high level for the middle-class segment of the population. Since mortgage interest is not deductible beyond a million dollar mortgage, wealthy individuals with multi-million dollar homes are not leveraging up the way those with cheaper homes have done. The leveraging of debt also explains why cheaper houses have gone up the most in value. The refinancing game might not be over completely, but the huge amount of refinancing seen a few years ago will not be repeated and will not be a very big factor in consumer spending going forward. As short-term rates increase and long-term rates decline, we should begin to see more 30-year fixed rate mortgages. Unless we are on the verge of a big decline in housing prices, the added mortgage debt on the consumer is also not a problem because as long as the mortgage payments are manageable, there will still be plenty of equity in the house. Fortunately, a large decline is unlikely as consumers typically refuse to sell their homes at lower prices unless absolutely forced. This has the effect of decreasing the volume of housing sales as opposed to decreasing prices. Thus, the weakness is manifested in a lengthy period of flat prices and low liquidity, with a few forced fire sales along the way. With the economy slowing, mortgage rates will remain stable, also not putting any downward pressure on the market.

The second concern investors have in relation to consumer income is that the job creation level has been lower than previous economic cycles, which could lead to lagging consumer income growth. If job creation is slow and the consumer stops monetizing their home, where does the economic demand come from?

Job creation was very slow initially as the economy started recovering a few years ago. The economy itself did not have a sharp snapback like most economic recoveries, but slowly built momentum after the recession. Once job growth picked up though, it seemed to be on the same recovery rate as previous recessions. The key point is that there was a delay, not a poor job market that will persist throughout the entire economic cycle. If there is any lack of job growth, it is a testament to the ongoing growth in productivity, as the economy has grown at a very acceptable rate so far. Economists have speculated that employees have been promoted to higher paying jobs or switched to better paying jobs as consumer income growth is quite high on a per employee basis. As a result, total consumer income is growing at a solid number in real terms. Compensation growth and productivity both provide a solid foundation for increased consumer spending in spite of a lack of major mortgage refinancing volume.

Businesses are flush with cash, regardless of how you measure it; as a percent of assets, total dollar amount, or percent of GDP. This provides a solid base for increasing capital spending, company buyouts, stock buybacks, and future hires. All of these factors bode well for the stock market and for the continuance of strong consumer income figures.

### *Deficits*

Much consternation has been created over the Federal budget deficit. As always in an economic recovery, the government has over-estimated the deficit. Some feel the current administration purposely estimated a large deficit, just to generate positive news when the actual deficit turns out to be much smaller. Perhaps, but the pattern seems to hold true regardless of who is in power. The deficit estimates of over \$400 billion a year are now around \$350 billion and ISI projects \$325 billion. As a percent of GDP, this number is historically quite high and is a major market concern for some, but the end of the last cycle generated budget surpluses not seen for decades, which paid off much of the outstanding Federal debt. The Federal debt outstanding is very low, historically. Thus, the government can afford **this** cycle's high operating deficit because the outstanding debt is so low (see picture).

Two years ago when state and local governments had such deficits, there were gloomy pictures of their budgets. Today, state and local governments are running large surpluses. So large, in fact, that combined with the Federal Government's deficit, total government budgets are around break-even. This does not help to stimulate the economy, but it means a lack of supply of net bond issuance that will help keep long-term interest rates low. Government deficits are not a problem.

### *Global Economy*

Who would have predicted that as oil hit \$60 a barrel and the Fed raised short-term interest rates, that long-term bond rates would remain near their lows. Fears of

accelerating inflation have since subsided. Asian and European economies have slowed considerably, generating fears of recessions overseas. Central banks around the world are on the verge of **lowering** interest rates and some already have. With our short-term rates increasing, the dollar has started to recover, further mitigating any inflationary pressure. Import prices are declining and, except for oil, all other commodities have been declining recently.

The newest development in the capital markets has been the realization that inflation will remain benign for at least a year and that long-term interest rates will remain at the current low level. The amount of world savings is considered very high, in sharp contrast to the United States, keeping world bond rates very low. Asian governments, which are buying U.S. bonds, help keep the ten-year government yield near four percent. In the face of this, the Fed looks like they may finally be close to the end of raising short-term interest rates. If the U.S. economy gets real sluggish, the Fed might actually lower rates within the next year. This has been a typical mid-cycle pattern.

All these factors paint an improving picture for the stock market. With bond rates and inflation low, stock valuations remain compelling, especially versus bonds (see picture). The consumer, even without a large increase in refinancing, and the capital spending of businesses will keep the economy moving. The trigger for stocks might be the end of the Fed's restrictive actions, from which the market should make a nice move up.

#### *Potential Problems*

What could go wrong? China is always a concern. Chinese authorities are trying to slow their economy. Their banking system is weak, and real estate prices are out of control in the central cities. The Chinese financial system is thin, inexperienced, and fragile. China's relentless economic growth is what has kept them out of trouble, and there has yet to be any major pressure on the system. The potential for overshooting the slowdown attempt by the government has sent the Chinese stock market into a one-year decline. The good news is this is a storm that can be seen coming, especially because the U.S. exports to China are far below our other trading partners. China's rippled effect throughout the world economy would thus hit the United States last. If you monitor the situation, investment exposures can be adjusted with Chinese developments.

The real economic concern right now is the lack of U.S. money supply growth. Without money growth, nominal GDP should slow to a crawl in about ten months. MZM, M2 and M3 money definitions are all barely in positive territory versus a year ago (see picture). You cannot have strong GDP without growing the money supply. There is a disconnect between the behavior of money and the economic data. Money growth is weak, but economic indicators are still strong. Some have speculated that money velocity has increased, enabling the same amount of money to support more economic activity. Velocity of money tends to be stable for long periods, but has changed slowly up and down over time. It is possible for velocity to have changed, but I suspect that the slow money growth is very temporary.

Back in the mid-nineties the Fed raised short-term rates mid-cycle as they are now, slowing money supply down to growth levels of less than one percent, year over year. It was a brief spike down in money growth that was so short in duration, the economy continued to expand, even though it slowed considerably. Assuming continued economic growth, I expect to see money supply growth to begin to accelerate soon. We will see an economic slowdown for sure in any case, but if money growth does not pick up soon, a potential slowdown next year could turn into a recession.

This begs the question, if inflation is low and money growth is rapidly slowing, why would the Fed be raising interest rates. My best guess is that they are trying to rein in a housing market that is now over-heated with speculation (see picture). It wants to avoid a crash by preventing it from getting too far like the stock bubble of the late nineties. They are even willing to flirt with a recession to get the job done. It is true that real interest rates are not high, but if money has already slowed, why would the Fed tighten its monetary policies further? Once again, expect weak economic numbers and do not own stocks dependent on GDP growth. Keep your eye on the money growth, and this should not bite your portfolio.

So there are worries, but I think they are only potential problems that you can monitor and adjust investments accordingly, if need be. Barring any of these negative developments, the outlook is quite good for the market. Maintaining low interest rates will help the financial sector enormously. Energy prices will remain high, so it is a good idea to overweight one's portfolio in the energy sector. Health care always has opportunities. Technology will have a dramatic move, but should make only modest headway over the next year due to the weak economic environment. The timing is key on technology and I have not sorted that out yet. Small companies still are performing well which is counter-intuitive since they are more vulnerable to economic slowdowns. Look for value, yield and earnings unaffected by a slower environment. I expect the S&P 500 to be around 1400 by the end of 2006, a move of seventeen percent over the next eighteen months.