BOTTOM OF THE FIFTH

I had hoped to have a double entendre around the title of this Quarter's Economic Outlook. One meaning would have been the Fed finally raising rates, ending Quantitative Easing (QE) and not refilling the punch bowl of excessive printing. No luck – Janet marches on with easy money and very low interest rates . . . the punch bowl is brim full.

The other meaning is to call attention to where we are in this weak business cycle. The October 2013 Quarterly Outlook (*Perception Meets Reality*) spelled out a rough outline of the business (and credit) cycle.

In April of this year, the Quarterly (*Half Time*) theorized we were at the midpoint. My intention is to suggest we are moving so slowly as to be only a bit past that – the bottom of the fifth inning, if you would, top of the sixth, maybe.

We'll explore the Trilogy of Land Labor and Capital after a brief look at the current business cycle. (A Trilogy is a pretty abstract notion. You can apply it to almost any three things.) [Jonathan Demme] (Credit – Ben Hunt)

THE CYCLE

The collapse of 2.9% in the first quarter GDP was initially heavily attributed to weather – the obvious and convenient excuse. Since then, data around open jobs, average work week and the like leads me to think it was mostly a decrease in worker productivity. Inflation adjusted business output per hour worked for that quarter declined at a 3.5% annual rate – the worst productivity number since 1990. Productivity overall since 2005 has declined more than 8% from its overall trend or, in dollars, about $1 trillion less output from just doing trend growth. Put another way, hours worked rose, but output didn't rise nearly as much. That rise in hours worked sort of flies in the face of the early analysis that folks couldn't get to work because of the weather. Virtually all increase in our standard of living, by the way, comes from productivity growth so this is a very serious problem.

The irony of it all is that historically, when the economy does a face plant like the first quarter, all kinds of data around it supports or explains the decline. Perhaps a rise in interest costs so high as to stifle demand – but not this time with the Fed sitting on less than 1% for a market rate.

In fact, a flop like Q1 implies end of cycle, not midpoint, but not this time.

Perhaps a massive accumulation of inventories triggered it – some, yes, but not this time.

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Perhaps consumers had a nationwide panic at some event that sent them into a "no spending" mode – but not this time.

Historically, when GDP falls that sharply, unemployment goes up – a lot. Not this time, as it fell instead.

We are left with fairly solid evidence that it was worker productivity and my question is this: Do the workers know? Do they know about all the open jobs, the wage increases for the skilled? Or do they still think the only jobs are at McDonald's? More on this point in a bit. Point is, the cycle is well but a factor – productivity, isn't. Capital spending on equipment is needed, but my view is workers will get raises first.

CAPITAL

The liquidity of U. S. corporations – some $1.3 trillion – is concentrated in the tech sector, but this does not say it's only there. Most firms have been hoarding cash after trimming payroll.

To date, corporations have used cash built up over the last 6 years to either buy back shares, thus "improving" earnings, or raising dividends.

Let us assume they are aware of three things: 1) they have stockholder pressure around creating rising earnings and rising dividends, 2) they see worker productivity as flat at best, but key to #1, and 3) they sense wage pressure in proportion to the unfilled slots in their firm.

I suppose self-interest is in there, but I think that is covered by #2.

Money is cheap, growth is weak, wage pressure is coming – it all adds up to a very long capital-spending cycle and it's begun. Toss inflation in the mix and a robot looks even better.

LAND

In centuries past, when basic economics was being developed, the trilogy of land, labor and capital was just that, as land – agrarian-focused – was the means and source of production. Not until well into the Industrial Revolution, with the advent of steam power, electricity, trains and the like, did land become a very minor factor in national wealth creation. Old habits die hard and land, today, refers now to the plants, equipment and infrastructure of the productive capacity of our nation.

[An imbedded irony: When agricultural land was the major productive base of the nation, the crop cycles brought about the destruction of many small banks whose role in many small towns was to collect savings and issue loans – often mortgages and farm equipment

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– to farmers. Their regular collapse with bad crops had a great deal to do with the creation of today's Federal Reserve Bank – the title says it all. They are still trying to save banks issuing mortgages.]

The capital-spending cycle or new "land" investments, is motivated by a number of factors: 1) increased demand warranting additional equipment, 2) falling worker productivity and/or rising worker costs, be they wages or required health care, 3) new, more efficient machines or technology, 4) low-cost loans to acquire new machines or technology, and my personal favorite, 5) worn out, old equipment. A sixth one might be that guys like "bright shiny things," but we all know there is no fooling around in business . . .

As you review just these few reasons for new equipment, it's fairly clear that a trend of some duration is in place. It is key to future growth because as new equipment is ordered, built and shipped, workers are needed. First, supply, etc.

LABOR

We've touched on factors like retirement numbers, wage rates and the need for skills in prior Weekly and Quarterly pieces.

The Common Knowledge, as I hear it, is that there remain tens of thousands, millions, of people who cannot find any work beyond the most menial. Proof, it is said, is found in the applications for welfare, disability insurance and much-extended unemployment benefits or other social programs. No one discusses, by the way, the willy-nilly way said social benefits are distributed without any real effort to determine the legitimacy of the claims.

To put some facts around the myth of "only menial jobs" or "no progress on jobs" – the liberal lament – I excerpt below D. Rosenberg's comments on the last year alone in the U. S. job market:

- 2.4 million full-time jobs have been created, 509k part-time jobs have been replaced by these full-time positions.

- The number of people complaining that they are working part-time for economic reasons has plunged 648k.

- The U6 unemployment rate has come down even faster than the headline U3 rate – to 12.2% from 13.8% a year ago.

- The number of people in the first-time home buyer cohort finding a new job (+418k) in the past year exceeded anything we saw in 2003, 2004 and through to the fall of 2005 (I don't recall as many economic bellyachers back then).

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- The number of people who have left the labor force because of discouragement has plummeted 83k in the past year.

- Those who left the workforce and say they want a job dropped 210k, those who withdrew from their job search and say they actually don't want to work surged 2.3 million – the discouraged worker argument is more myth than reality.

- Voluntary job leavers rose 875k in the past year and the quit rate based on this measure has risen to a cycle-high 8.9% from 8.1% a year ago, 7.2% two years ago, and 6.4% three years ago – this is the worker confidence proxy that leads wage growth, just as an aside.

- There are now 3.6 job openings for every person classified as being in the pool of available labor, down sharply from nearly 10 at the 2009 peak – in other words, fewer folks competing for the jobs being posted means that wages are inevitably going to be bid higher, which is exactly what the Fed wants to see happen.

- Labor force re-entrants are down 469k and have tripled the decline in new entrants to the labor force, adding credence to the view that the participation rate decline has more to do with disincentives to work than with a lack of job opportunities – afar all, there are 4.5 million job openings not being filled at the moment.

- Manufacturing job postings are up 11.5% over the past year and in professional & technical services, job openings have surged 20%. So no – it isn't all about labor demand in low-quality retail.

As a people, we are generous to a fault. We help people we don't even know. We are particularly good at spending other people's money via incentives not to work. The academic sophisticates among us preach theory, the rest of us get our hands dirty so they can do so. Okay – enough for now, but the damage is near permanent – folks are heavily incented not to work.

You may see, I hope, that

1) a round of expenditures are due on new equipment, but

2) before it is in place pressure on wages will be sizeable and

3) money – lots of it – is available as a loan or from corporate balance sheets.

CAPITAL PART TWO

Two issues remain: The huge amount of debt out there and investing at this point of the cycle, given prior comments. Perhaps inflation is more a factor in investing, but stocks are

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the asset of choice in any case. The question then is whether all that debt is an inhibitor of a capital spending cycle.

First, this:

◊ Companies go bankrupt, not nations. Nations default, print, move on. Companies fail and are gone for good leaving pieces to be picked over. Going forward, it behooves us all to accept (reluctantly in my case) that Greece and others like it survived, their many firms did not . . . a big difference.

And this:

◊ The massive amount of debt out there is public debt, not private. Public debt – national debt – is all political and has outlets ranging from default to devaluation.

  Private debt, today, is not a bubble like public debt, not out of line historically. More than sufficient capital, as I have written too many times, is available, with balance sheets to carry it.

Investing in a building, for example, a private investor may overextend himself and find cash flow cannot service the debt he has acquired. Accordingly, the private debt is at cash-flow risk with bankruptcy the alternative. National debt has no cash flow problem – at all. They can print via bonds, say, and sell them to their Central Bank which, in turn, prints a few tons of new money. (Not entirely an accurate flow, but you get the idea.)

Going forward into the next 4 innings of our business cycle, a cautionary move for us all is to therefore monitor the growth in private debt and debt service – cash flow. Not now a bubble, if it becomes one, the next recession will be a bad one.

More likely is the scenario of weak players bought by stronger players with their overpriced stock, fewer corporations of mid-size and many acquisitions by the top 100 or 200 worldwide. Additionally, the smaller number of new companies being formed is a troubling trend for innovation, but at least not adding to the "failure" pile.

All of which lets me close this mid-year Outlook on stocks.

My take on stocks at this point is a focus, as already expressed, on industrial recovery, fracking, biotech and technology at large.

With inflation a factor, I want most, if not all, of my stocks to have high dividends and a growth rate to support it. We own "growth" via technology, but the core portfolio is trying to grow by compounding on reinvested dividends.

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Inflation favors hard assets: Numbers-matching cars, top-tier art or real estate, collectable jewelry, watches and items with precious metals. Gold benefits, near all commodities rise in price benefitting companies in that world (. . . be careful around Chinese demand) and, of course, mining companies. When you look at the Toronto Stock Exchange, for example, you find mining stocks are +/-70% of all the listings versus 14% of our S&P. (Thanks, D. Rosenberg)

The consumer stocks in general <u>tend</u> to be negatively correlated to inflation. Exceptions exist at the high end, but again, 3/5 of this nation are middle class and likely not saving for a Bentley.

We still have the Fed "put" – the flow of cheap money that is the major, if not the only, driver of our rising stock markets. The race is between the recovery continuing to build in strength and the damage being done <u>with</u> the cheap money to the dollar on the world stage.

At 200 miles per hour, side by side, my guess is the economy will further expand before we blow up the currency. I'll worry about the downstream impact of that expansion later. Why this view? Primarily because I think the Democrats have lost the Senate and that will be a major stimulus to a pro-growth agenda in Washington. There are simply too many hard-left Democrats coming into a midpoint with Republicans on too many issues, not the least of which is to save their personal free ride.

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