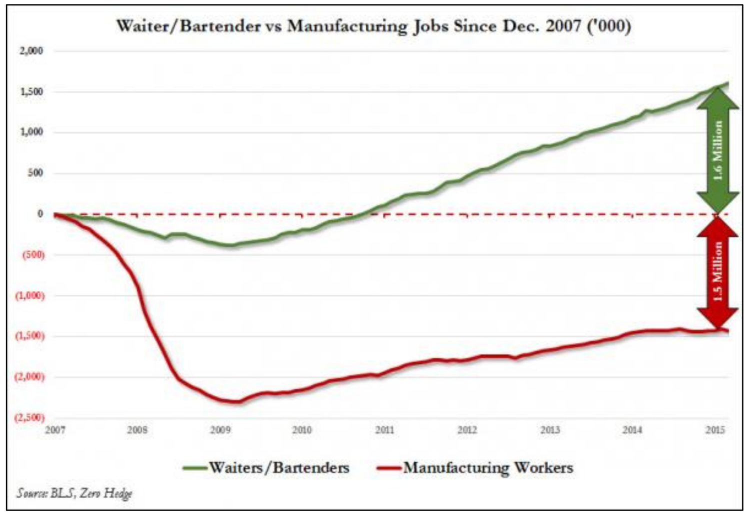
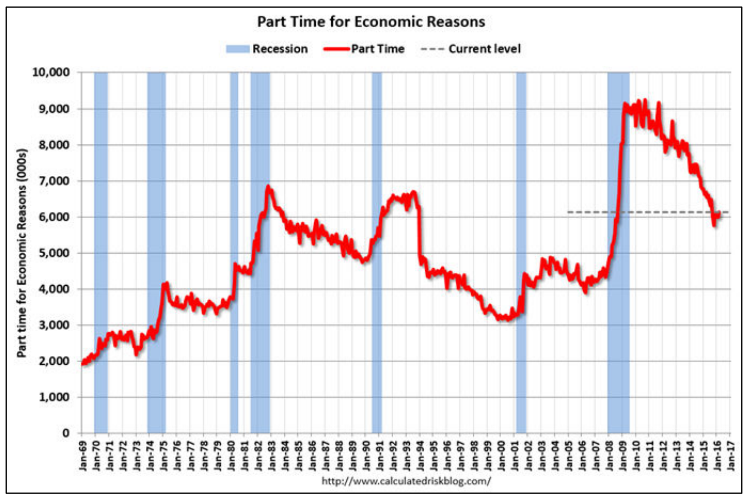
The Long & Short of It

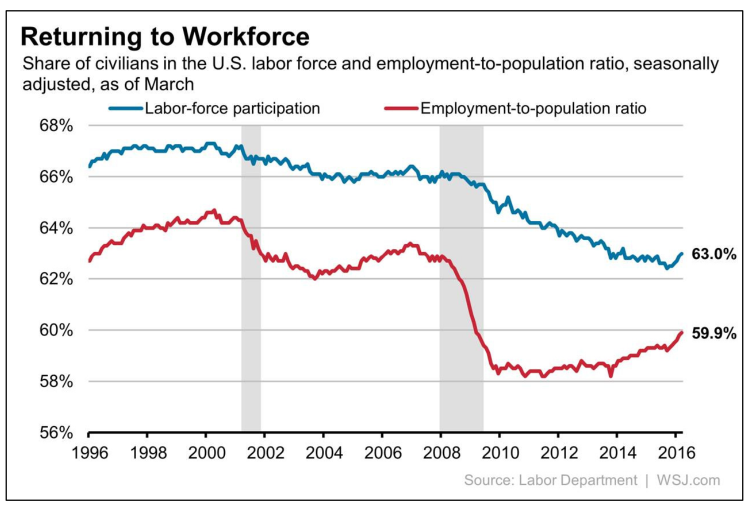
Quarterly Newsletter
First Quarter 2016

America's Service Economy

As we enter the presidential push for November, many politicians talk about jobs: their quantity and their quality. America appears to have entered a new phase of structural unemployment where businesses don't want to hire the types of workers that are available. Workers either lack the skills or have the wrong skills or just don't want to work. From 2007 to 2015, the U.S. added 1.6 million waiters and bartenders and lost 1.5 million manufacturing workers—almost a one-for-one transition (see "Waiter/Bartender" chart at right). People with manufacturing skills aren't in demand. Americans are really good at serving food, but this is unlikely what David Ricardo had in mind when describing comparative advantage in his 1817 book <u>On the Principles of Political Economy and Taxation</u>. As the quality of jobs being created continues to diminish, the United States becomes more of a low-pay service economy, producing jobs that fail to improve the living standards of the average American.





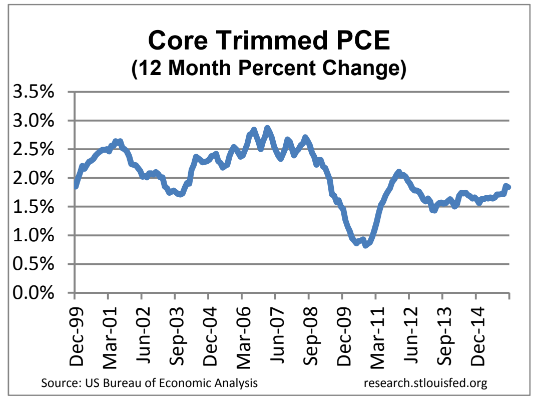


Why does this matter to the stock market? We have talked a lot in these pages about the Federal Reserve and its role in the management of inflation. However, the Fed has a dual mandate that also includes maximizing employment.

After peaking near 10% in 2010, the unemployment rate has moved down to 5%, very near the Fed's 4.75% "full employment" target. Late in an economic expansion, increasing labor costs typically begin to signal that constraints are being hit, indicating the "beginning of the end" for an economic expansion. But because of the large number of people in part-time work who would like full-time positions (see "Part Time for Economic Reasons") and those currently not in the workforce (see "Returning to Workforce"), most Federal Reserve board members believe there is more slack in the unemployment rate than the 0.25% would indicate. As a result, they do not believe labor is on the cusp of creating an inflation problem.

The Fed (Again)

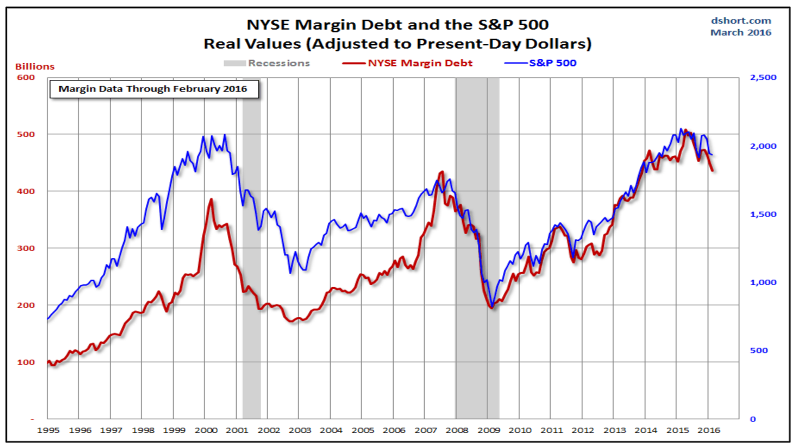
Every economic discussion these days seems focused on the Fed and for good reason. Late 2015's first federal funds rate increase in almost a decade resulted in significant stock market volatility in January and early February. It was the kind of volatile quarter that can produce a lot of damage for emotional investors. During the quarter, the stock market dropped 9%, putting it 13% below the November 3, 2015 closing high. But by quarter end, the stock market had mostly recovered. Larger, high-quality companies showed modest positive returns (e.g., the S&P 500 returned 1.4%) while smaller, lower-quality names remained down (e.g., the NASDAQ Composite Index returned -2.4%). International stocks had dropped about 10% before recovering to post returns of -2.9% by quarter end. Bonds turned in solid results, with safety and quality again leading the way. Long-term U.S. Treasury bond prices returned about 8.2% while junk bond prices rose about 1.1%. The dollar took a pause from its recent rise, dropping 4.5% during the quarter.



Stability arrived in mid-February as it became clear that the Federal Reserve would watch the “data” and allow more time before another increase in the fed funds rate. On the inflation side, the Fed will monitor Core Trimmed Personal Consumption Expenditure (PCE), which is targeted to remain between 1.5% and 2.5%. Since 2009, a crucial issue is that inflation and inflationary expectations have been running too low, leaving the Fed focused on the risk of deflation. But more recently, PCE has stayed safely within the preferred range (see “Core Trimmed PCE”) and is now rising at a modest pace. While many Fed watchers believe these measures understate inflation, they remain the numbers that guide Fed policy.

Debt-Dependent Expansion

Most investors seem to expect the stimulus programs in China and Europe to create some “wind in the sails” effect for the world economy. Unfortunately, if we get any sort of economic boom, it will be likely be debt-driven and thus temporary. We believe that debt levels remain high and that the only way for this debt-driven growth to accelerate is for interest rates to decline, allowing for lower-interest burdens and thus even greater levels of debt.



Interest rates could decline over the next year without the Fed taking any further action. With policy uncertainty in Washington created by the election, we see investors being cautious, growth and inflation pressures easing, and interest rates declining, which could eventually stimulate some borrowing and nominal economic growth. Margin debt levels are already declining (see “NYSE Margin Debt”), reflecting the cautiousness we think will continue. The risk is that caution could turn into fear. It is a great time to be defensive in one’s investment posture. Stay tuned.

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