MV Capital Management Thought Leadership

Health Check on the Economy

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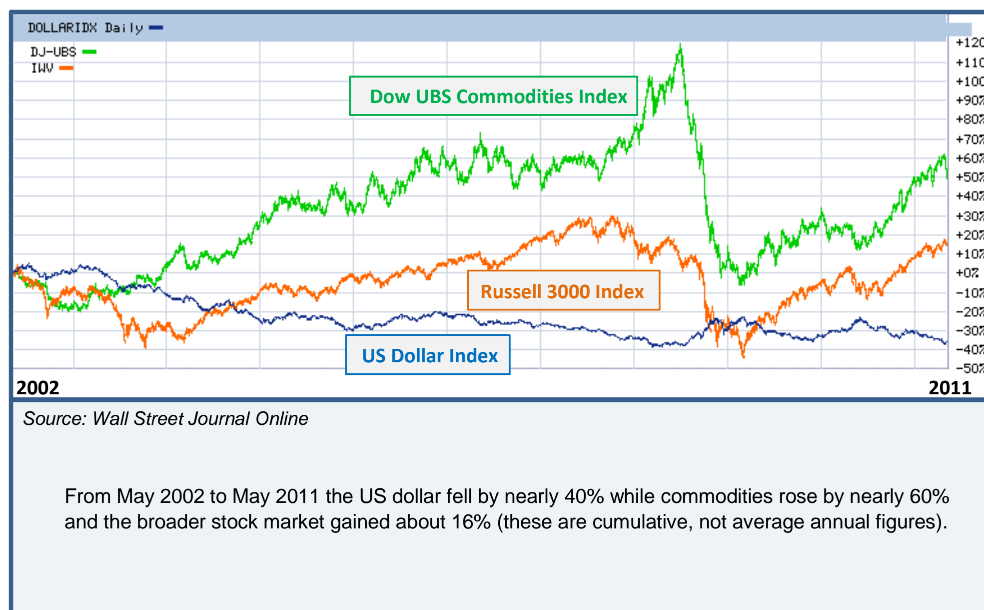
It never makes sense to go for too long without a health check, neither for a person nor for an economy. Now, we all know that how healthy we are on any given day depends on some things that are part of the here and now – have we been eating sensibly recently, not running around in cold weather with no coat on, getting enough sleep at night? – and also other things that are more chronic and long-term in nature, such as natural metabolism levels, respiratory functions, susceptibility to allergies and so on. So it is with the economy. We tend to become preoccupied with the here and now – last week's new jobless claims, factory purchasing orders, the latest reading from the Consumer Confidence Index – but these provide only a partial picture of the real health of the economy. You may tell your doctor that you have a bad case of heartburn because you ate too many hot dogs at the ball game a couple nights ago, but if your doctor doesn't know that you have been suffering from chronic gastro-intestinal maladies for the last ten years then she is not going to have a fuller picture as to how badly you might be feeling today – or how to prescribe the right medicine to cure what ails you.

With that in mind let us consider the following "medical chart" for the economy:

Figure 1: Ten-year trends in commodities, equities and the US dollar



Like any medical chart, the information in this picture is by no means crystal-clear, but we can take away a few broad conclusions: (a) risk asset markets (including equities and commodities) have been extremely volatile; (b) the US dollar has been in a long-term decline with periodic spurts upwards; (c) commodities have alternated between freefall during recessionary periods (2001-02 and 2008-09) and a relentlessly upwards trajectory otherwise; and (d) particularly in the last three years, the price movements of equities and commodities appear much more closely correlated than we would expect based on historical norms.

This picture of longer-term health trends is helpful when we consider what has been going on with the economy more recently. The economic growth picture has turned somewhat muted with the latest GDP readout showing first quarter real growth at an annualized 1.8%, which is below-line for the 3 – 3.5% consensus estimates for 2011. Inflation has turned up with the Consumer Price Index growing at a 4.7% clip, the lion's share of which is due to the resurgence of energy and food prices. Job creation, which had been sailing along nicely in recent months, seems to have hit a bit of a speed bump recently. Economy-watchers have turned their binoculars to June, when the Fed's quantitative easing program is due to run its course. In some quarters there is concern that without the massive bond-buying stimulus that is QE2, the economy will be unable to stand on its own two feet. The bearish view points out that while S&P 500 corporate profits are now higher than they were in 2007, the unemployment rate is nearly twice what it was then. Profits ran strongly ahead of jobs, and there is a valid question as to how much longer that decoupling can be sustained. All this has perhaps contributed to the downturn in risk asset prices (both equities and commodities) in recent days – although it is just as plausible (if not more so) that investors are simply taking money off the table after sustained run-ups. After all, the S&P 500 sits at more than double its level at the trough prices hit during March '09.

Looking at these recent data points we would say that the economy has hit a couple bumps along its road to health but that the journey continues apace. When we look at those longer term charts, though, we feel like the doctor who sees that her heartburn patient has symptoms of longer-term problems. A combination of sustained multi-year rises in commodities prices and weakness in the value of the US dollar is a recipe – not for rampant inflation necessarily, but for something more like the stagflation that beset the economy in the 1970s. Rampant inflation would require one more element to be in place – wage increases that would lead to destructive wage-price spirals. This was the inflationary picture of the early 1970s, when Nixon's wage-price indexation policy and OPEC-orchestrated run-ups in oil prices created economic turmoil, recession and collapses in stock prices. That's *not* what we have today – there is no wage indexation and real household income levels have in fact been in sustained decline. But higher food and gas prices have the ability to choke off household spending, which in turn acts a brake on how fast an economy 70% dependent on consumer spending can grow – hence the specter of stagflation.

The other thing that good doctors do when they look at medical charts is to see what the charts *aren't* telling them explicitly, but that are plausible conclusions to derive from the data they see. We see chronic commodities price inflation and dollar weakness and think: what does this imply for Ben Bernanke's toolkit of economic remedies? Let's put aside QE2 and focus on the core element of the Bernanke doctrine – zero percent interest rates. All indications are that the Fed does not want to raise rates any time in the near future, being concerned that raising rates would choke off the incentives of companies to continue borrowing for business expansion in economically sensitive areas like capital equipment investment and payrolls. But how much longer can US Treasury securities pay out historically low levels of interest when the currency in which Treasuries are denominated – the US dollar – is at historically low levels itself? Not to mention, of course, the recently increased odds that Uncle Sam could lose its triple-A rating sometime in the next few years. In fact, if we look at the US dollar component of the chart in Figure 1, we see that more often than not the currency reverses its long-term decline primarily when investors are in safe-haven mode and buying US government debt. If that safe haven corrector mechanism is no longer as predictable as it has been in the past, what is to stop the dollar from going into freefall – something which could actually push the stagflation we talked about in the previous paragraph to the much worse scenario of rampant inflation.

The message here is not all doom and gloom, though. One effect of the weak US dollar has been to make the price of US exports to other countries more internationally competitive, and that has shown up in the performance of the US manufacturing sector, which has been going gangbusters recently. In fact the manufacturing sector has been the star of the economic recovery so far, and the recent surprising strength in GM's earnings seems a fitting touchstone for this performance. This is the kind of organic activity that an economy needs in order to enjoy sustainable growth.

So what do we conclude about our patient? The immediate prognosis is that there are some areas of weakness but the patient should be healthy enough to get over the bumps – but not without some changes to long-term habits. The short-term bouts of heartburn are going to keep getting worse the longer the unhealthy long-term trends continue unabated. Now then – not as doctors but as investment managers – what do we prescribe?

There are risks to every conceivable investable asset class – to bonds, stocks, commodities, currencies and what have you. Among risk assets we believe that the anything-goes phase of the bull run may be in its waning phases – and we will maintain tactical increases in higher quality and larger-cap stocks. We will continue to maintain diversity across geographical regions (US, non-US and emerging) as this provides an inherent hedge mechanism across currencies. Despite the fact that Treasury yields have come back down to levels last seen late in 2010, we are not convinced that the picture for fixed income has improved. We continue to shorten duration exposure and are more comfortable with credit quality risk than interest rate risk. In commodities we have been maintaining more concentration in energy and agriculture, which we think are more attractive for intermediate-term value than precious metals. Finally, we continue to maintain appropriate levels of exposure to low volatility hedge strategies in order to diversify our sources of volatility management.

This presumably is more along the lines of preventative medicine than a sure-fire cure. But in the investment world, even more so than the medical world, there is no such thing as a magic cure-all. Good health takes patience and the ability to stay the course with a long-term regimen.

With warm regards,

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