Monthly Commentary

July 2015

Annual checkup

I recently had my annual physical. I've been going to the same doctor for years and the routine is much the same. He goes through a laundry list of potential symptoms, checks out a few things and then reassures me that I am in fine health for a man of my age. However, this time, while doing all his checking, he did say he was a little concerned about my blood pressure, which was on the high side. No sign that it had done me any harm yet, and to be honest I feel fine, but it could cause problems down the line. So he gave me a prescription and we agreed to monitor the condition carefully.

A similar report could be delivered on the U.S. economy and financial markets today. July is the 74th month of economic expansion, making this now, the fifth-longest expansion since 1900. The bull market in stocks is even older, having started three months earlier, and we have arguably been in a bull market for bonds for 34 years, ever since yields peaked in September of 1981.

Moreover, many of the ailments which markets have fretted over in recent months have turned out to be nothing. The first quarter did see a 0.2% annualized decline in real GDP, but this appears to have been largely due to weather effects, strike effects and statistical noise. The Chinese stock market took a tumble following a monster rally. However, although there are legitimate concerns about Chinese growth, heavy government intervention looks to have stabilized the situation for now. And the Greek crisis which has raged all year appears to be dissipating, with the Greek economy in even worse shape, but with little impact on the global economy.

All of this is somewhat reassuring and investors are generally feeling pretty good, with steady economic growth, U.S. stock prices close to all-time highs and long-term interest rates still very low. However, it is not quite a clean bill of health, as we now have both somewhat higher-than-average valuations and the prospect of an economic growth slowdown in the next few years.

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On the valuation front, as this is being written, the S&P 500 is selling at roughly 16.6 times forward expected earnings, or about 6% above the 25-year average. This is by no means alarming. However, it does mean that if valuations were to return to their long-term average over the next four years, stock prices would have to rise an average of 2% less than earnings each year. On the bond side, a nominal 10-year yield of 2.35% equates to a roughly 0.6% real yield once you subtract out core CPI inflation. That is almost two percentage points below the average real yield since 1958.

Meanwhile, the economy is suffering from a severe lack of supply. Like high blood pressure, this can present no real symptoms for a very long time. In particular, as the economy is recovering from a deep recession, demand growth can be met by hiring laid-off workers. However, at the worst of the recession, the unemployment rate was 10.0%. It is now 5.3% and, under the very best of circumstances, it is unlikely to dip much below 4.0%. In other words, we are nearly 80% of the way to "full employment."

When we get there, which should be within the next two years, based on labor force and productivity trends, the growth rate of the economy will have to slow sharply to about 1.5% per year. If the economy has too much demand growth as we approach this point, then both inflation and interest rates could rise, harming both the bond market and the stock market. If demand slows down as well, the threat of overheating will diminish. However, an economy that is achieving real GDP growth of just 1.5% and nominal GDP growth of about 4% is not an economy that will deliver more than mid-single digit earnings growth.

There are too many unknowns in this scenario to make an exact prediction of long-term outcomes for U.S. stock and bond investors. However, it is only prudent to consider both careful monitoring and a prescription. The most effective monitors are market prices and the monthly employment report. If stock prices continue to rise and long-term yields remain low, even as the employment report shows a tightening job market and anemic labor supply, then the eventual risks to both bond and stock markets will rise.

As for a prescription, it is relatively simple at this stage. Given the super-low yields on cash, it still makes sense for long-term investors to be in long-term assets. However, this should also be a time to be a little underweight fixed income overall, while looking at global opportunities in both equities and fixed income. It also makes sense to have a broad and active approach in asset allocation across stocks, bonds and alternative assets and in hiring managers who can focus on what is still good value in markets that, after a very long run, are no longer so cheap.

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