BUTLER, LANZ & WAGLER

January Newsletter 2015

In December, *Ingram's* magazine asked Chris Butler seven questions relating to the economy and what to expect in 2015. They were great questions. And while you should all go out and buy the issue of Ingram's scheduled to hit the newsstands in mid-January, the questions and answers were well worth addressing in their entirety in this month's newsletter. It's doubtful the magazine will include all of the answers in their entirety.

The questions asked by Ingram's were the following:

1) What's your overall sense of where the U.S. and/or regional economy is headed in 2015?
2) How important is what we're seeing with the current slide in oil prices? Is that trend something you believe will fundamentally influence economic activity for more than the short term?
3) What other factors do you see that could promote or hinder economic growth?
4) What do you consider the greatest economic risk factor the nation might face in the coming year?
5) Which sectors do you believe are best-positioned to take advantage of any growth? And which are the most likely to lag?
6) Unemployment is near that long-sought 6 percent threshold that was seen as a target for ending Quantitative Easing, but what role does the broader U-6 jobless rate play in that calculus?
7) What do you see as the most urgent public-policy initiative needed now to broaden the economic recovery?

What's your overall sense of where the U.S. and/or regional economy is headed in 2015?

We do not cover the regional economy primarily because the regional economy has little to no impact on the major investment asset classes that investors traditionally follow and utilize in their portfolios. Further, the regional economy has very little data to analyze when compared to the national economy.

The question is actually posed in the most sensible way possible. People do want to know where the economy is headed. Yet, it's almost impossible to make a prediction - or "point estimate" - of any value. Will the economy grow at 2%, 4% or -2% in real terms? Attempting to make those point estimate predictions are probably futile. To know why, we must take a step back.

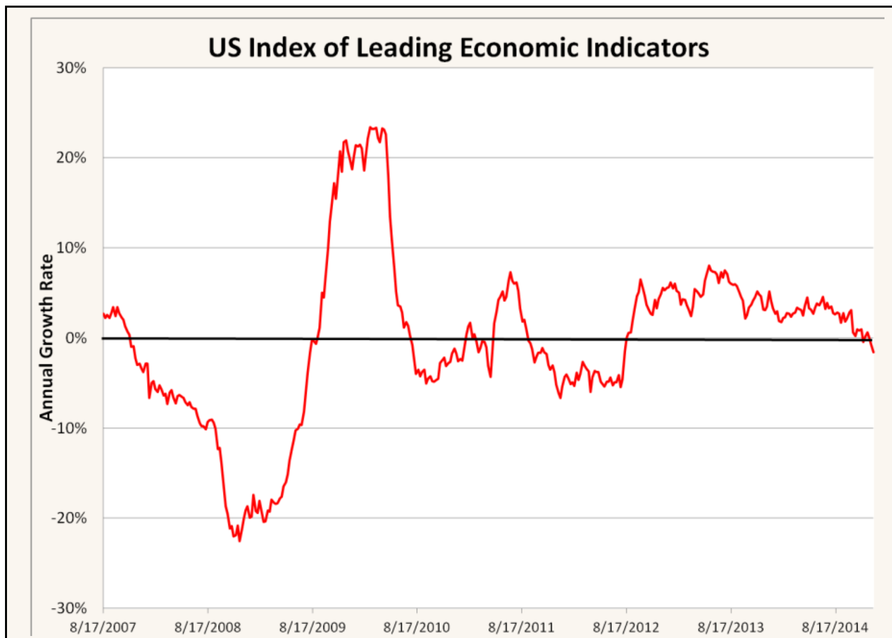
Very few people understand the genesis of economic forecasting. Economics, as a legitimate social science, is broadly believed to have started with the publication of Adam Smith's 1776 book *An Inquiry into the Nature and Causes of the Wealth of Nations*. To be clear, Adam Smith did not start economics as we know it today. He started a study that was known as "political economy." In the early 1900s, in an effort to make economics more "legitimate," the mathematical methods used by the physical sciences were adopted by those studying political economy. Once mathematized, the discipline came to be known simply "economics."

That was, in retrospect, an unfortunate turn of events. Those studying political economy tacitly understood that the difference in national economies - structure and performance - hinged significantly on the political systems of those countries. Economics stripped out the attention to political systems in favor of a more "legitimate" and mathematical approach. The problem with this development is that the mathematical tools borrowed from the physical sciences (like physics, for example) were originally developed to "predict" the movements of unthinking particles or objects. For example, given the exact weight of a brick, the exact wind conditions, and the exact height of a building, physicists can predict the exact time a brick will hit the ground if dropped from the top of a building. Unfortunately, economics does not study unthinking particles and objects. It studies human behavior with money. Human beings have unique thinking patterns, are subject to errors in logic, make mistakes and are

sometimes quite emotional. Therefore, predicting human behavior is not at all like predicting when a rocket will land on Mars. Yet, still, economists have fooled themselves, and others, into thinking that because their mathematical tools are state-of-the-art, they too can make predictions like the physicist.

The dismal track records of economist predictions are well known. Yet, they are still asked to make predictions. We are not saying that math doesn't have a place in economics and finance. Math is a very important tool in the analysis of economic phenomena. We are just dubious as to its usefulness in making predictions.

At the risk of sounding too nihilistic, we should probably point out that investors don't need to make predictions, *per se*. The do need to develop expectations about the future, but not too far out and certainly with the understanding that when those expectations change (and they invariably do) the strategy employed by the investor should change as well. It is enough for investors to be hyper aware of what's going on currently and how that generally plays itself out. That's not the same thing as saying, "The S&P 500 will close at 2,500 on December 31, 2015 at 3:00 PM Central." Investors are better served by noting current trends and assuming they will continue indefinitely. And when those trends change, it will force a change in the investor's strategy.



In summary, then, we can't make accurate predictions as to the level of GDP growth in 2015. But that doesn't mean we can't make some observations about current trends. Economically speaking, the one trend of which investors, policy-makers and businesses ought to be keenly aware is the trend in the growth rate of leading economic indicators.

As you can see, the trend in the growth rate of leading economic indicators has been down since May 2013. It's now as negative as it's been since the early fall of 2012. Does this mean we should expect a recession in 2015? Not necessarily. But it does mean that those who are expecting fantastic economic growth are likely to be disappointed, at least for the first two or three quarters of 2015.

How important is what we're seeing with the current slide in oil prices? Is that trend something you believe will fundamentally influence economic activity for more than the short term?

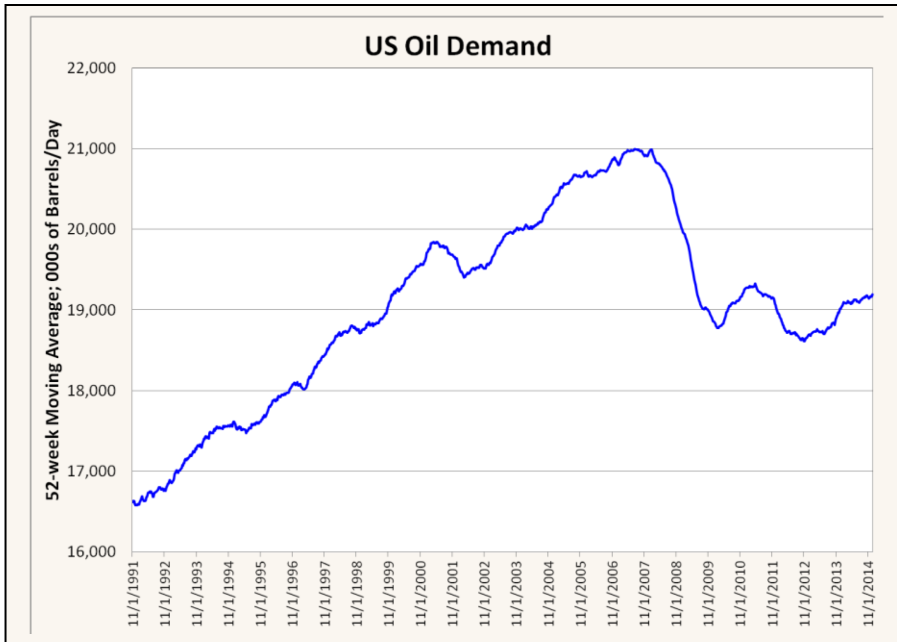
Since we devoted the entire December issue to answering this question, we will keep our response here short.

To answer the question of the impact of lower oil prices on the economy, one must understand if the lower oil prices are due to supply or demand issues (or both). For the most part, the financial and mainstream media have portrayed this to be a supply issue and it's easy to see why. OPEC made international headlines in late November when they announced their refusal to reduce production. That sure sounds like a supply issue. But demand for oil has not remained constant. It's been dropping for several years, and has been dropping even more lately as global economic growth has been slowing in places that usually contribute significantly to the global economy, like China, Japan and Europe. This really needs to be framed as a demand story first. Demand for oil has been slowing and supply has not been reduced to adjust to that. Supply could be reduced tomorrow by OPEC given the proper incentives to do so. But demand cannot just turn around on a dime.

For more detail on both global and US economic releases, subscribe to *The Capitalist Pigs Podcast*. You can do this by going to www.thecapitalistpigs.com and hit the "Podcast" tab. Or you can find us on Apple iTunes. Either way, you'll get a detailed analysis of what releases came out for the week and what it means to investors. To be fully informed as to what's going on in the markets, you've got to know what's going on in the economy.

For the past several years, there's been a global shift to cheaper or more environmentally friendly alternatives to oil. Also, the world is employing their oil in more efficient engines. We're just using less oil whatever the economy is doing – booming, slowing or collapsing. Add to that the fact that several important global economies are slowing or already in a recession and the demand outlook for oil seems difficult to change from mildly bearish over the next six months or so.

The chart to the right shows that even though our economy has recovered, we've not recovered our previous demand for oil. US oil demand is where it was 14 years ago. And the US economy has boomed relative to other major economies.



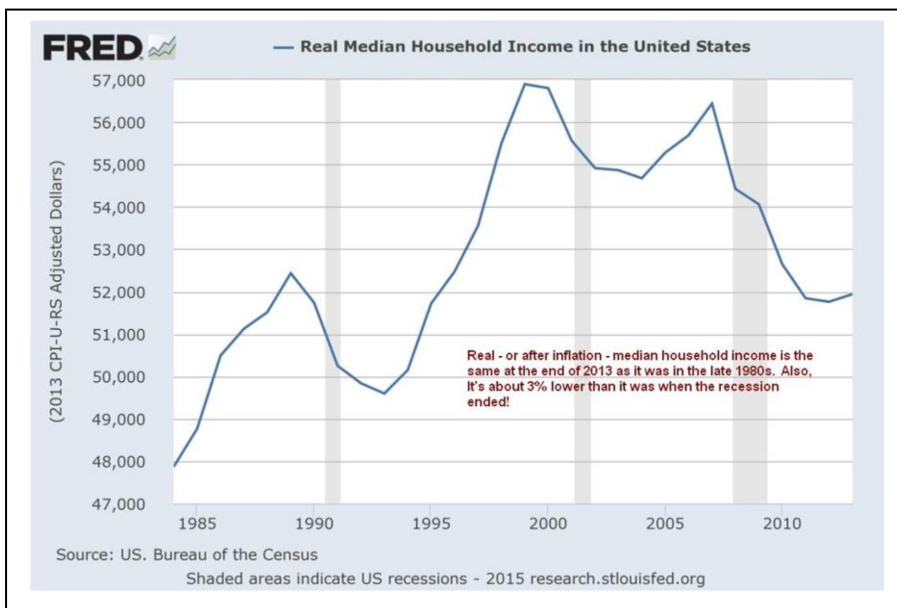
For the US, if we cut oil production, we might actually see that since our economy is much more dependent on oil production than it once was, we'll inadvertently be destroying demand for oil as our economy slows due to that very cut in production. Depending on how it's measured the breakeven price of oil in the US's shale oil and gas "miracle," is anywhere between $57 and $100 per barrel. Obviously, the longer oil prices remain low, the more likely it is that higher-cost production facilities will be shut down. That reduces supply and allows the price of oil to rise. I believe this is what OPEC desires. They want the higher-cost producers in the US to shut down and have the excess global supply eliminated through that supply reduction.

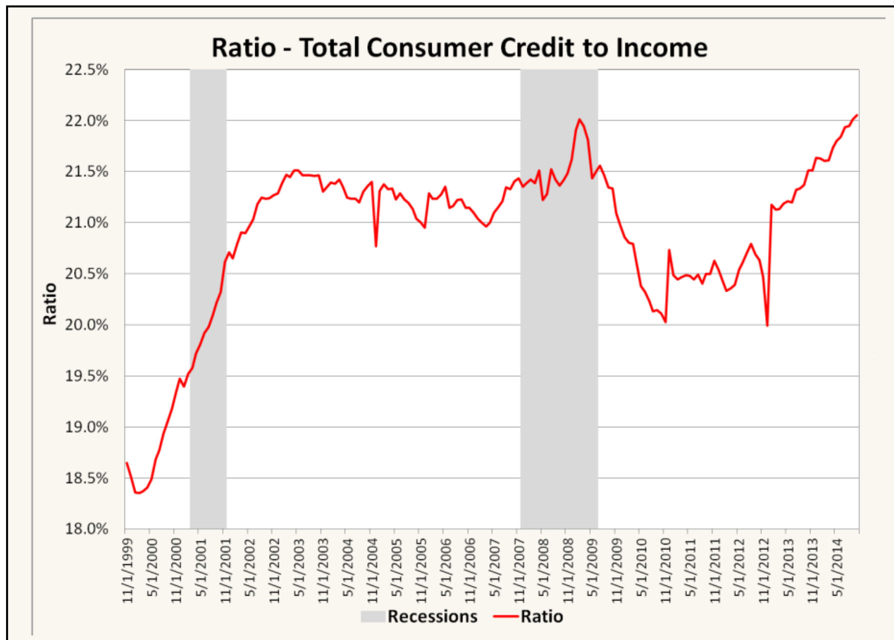
I think that for current low prices in oil to end up being a simple short-term blip, we will have to see higher cost producers shut down and the slowing economies of the world turn on a dime. It could happen, but it seems unlikely. I'd keep an eye on oil demand over the next six months.

What other factors do you see that could promote or hinder economic growth?

There are reasons for optimism in the US. Above all else, business spending is very good. Also, manufacturing has been strong and currently remains so. Of course, manufacturing will likely suffer if oil production does.

On the other hand, the primary risks I see are a failure of the consumer to remain healthy and a stubborn refusal of businesses to invest in their own organic growth.



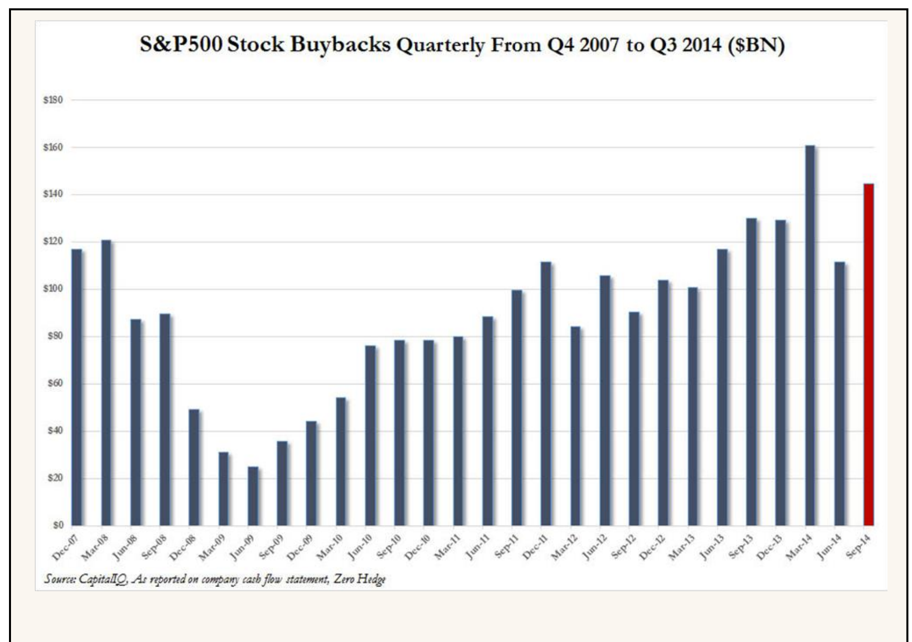


Not only have real household incomes remained below their previous peaks, but they are now more saddled with consumer debt (as a ratio against income) than ever before, as surprising as that may sound.

One potential mitigating factor is the new consumer credit added since the end of the last recession will be at comparatively low interest rates.

As a result of our current monetary policy, firms are not as incented as they once were to grow their businesses. They've discovered they can increase profit per share by simply buying back their own shares. In many cases, these firms have taken advantage of low interest rates to issue bonds or take on other forms of debt to finance stock share buy-back programs.

Q1 and Q3 2014 have seen record stock buy-backs. Imagine if that capital were used to produce goods and services, or hire additional labor or invest in more efficient capital. But keeping interest rates low was supposed to induce business investment. It has - at least, a little. Unfortunately low rates have created the perverse incentive to do the exact opposite of production. It's led to non-productive uses of capital like buying shares back from the public to quickly and easily boost profits on a per-share basis.



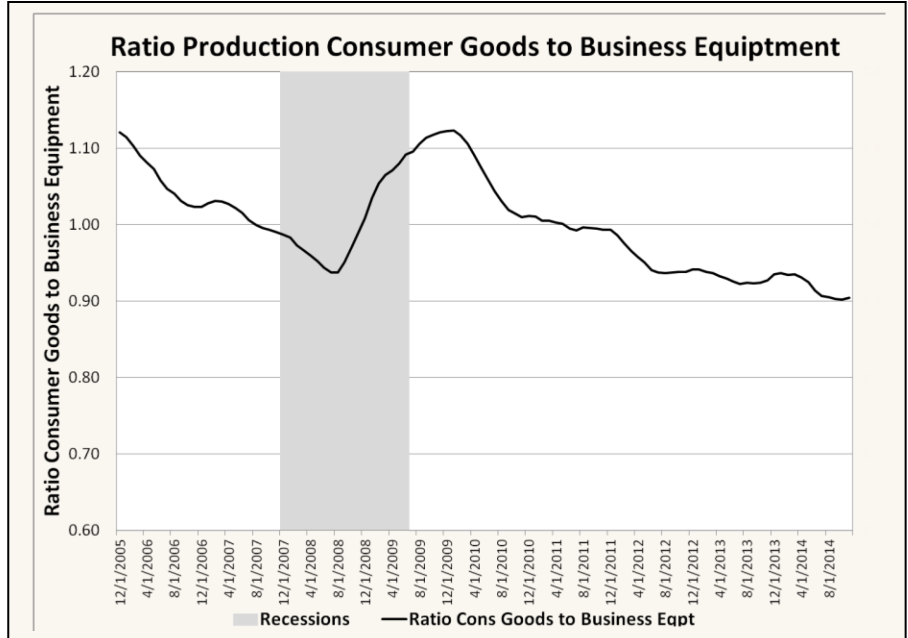
What do you consider the greatest economic risk factor the nation might face in the coming year?

Without a doubt, the major concern is the Fed. They may have exhausted all *credible* monetary policy options. They've expanded their balance sheet by $5 trillion and still cannot generate the inflation they desire. That tells me that global deflationary forces are much more overwhelming than the Fed has counted on. Hiking interest rates in such an environment, as many believe the Fed will do around the middle of 2015 simply as a "normalization" move could prove to be a mistake. I don't think the Fed will hike rates absent stronger US inflation numbers, but there may be pressure to do so before the economy is ready for it.

The Fed needs to raise rates to maintain credibility, but if done too quickly, they risk destroying their credibility. A central bank with no credibility is a weak central bank. Right now, global central banks are enjoying unprecedented power. Seemingly everyone, everywhere, is fully confident that the Fed can and will always bail out the economy and the markets when something goes wrong. The concern is that if the Fed or another central bank makes a mistake, like hiking rates too quickly, the fall-out will be more disastrous than expected because there will be a shock to the global belief system that had central bankers worshipped as if demigods.

The bottom line is central banks can only print money. Printing more money is not the same thing as printing more wealth. If it were, Zimbabwe would be the wealthiest nation on earth. Yet, somehow, when the Fed or the Bank of Japan print money, we successfully fool ourselves into thinking the outcome will be different. We tend to believe that the Fed and Bank of Japan can create wealth by creating fiat currency and we tend to believe that they can create CPI inflation. So far, both central banks have failed on both counts.

When a central bank keeps interest rates artificially low, it affects the allocation of precious resources amongst their most efficient uses. Artificially low interest rates distort the economy's productive structure. Five years into these distortions, I'm concerned about the corrective process that usually follows.



One way to visualize these distortions is to look at what we're currently producing in this country. Specifically, I like to look at the production of consumer goods to the production of business equipment. Right now, that ratio is at an all-time low, or at least as far back as we have data.

Without getting too far into the weeds here, it's quite likely we're producing way too much business equipment at the expense of the consumer. And by the way, when interest rates are lower than what they should be, there is a financial incentive to invest in long-lived business assets like machines and equipment. It's those machines and equipment that, when liquidated *en masse*, cause a recession. So, signs of over-investment in those things begs our attention.

Which sectors do you believe are best-positioned to take advantage of any growth? And which are the most likely to lag?

This is a difficult question to answer. If the economy grows at a decent rate in 2015, I would expect existing trends to only amplify. That is, I would expect to see that manufacturing continues to lead, with or without oil producers at full capacity utilization.

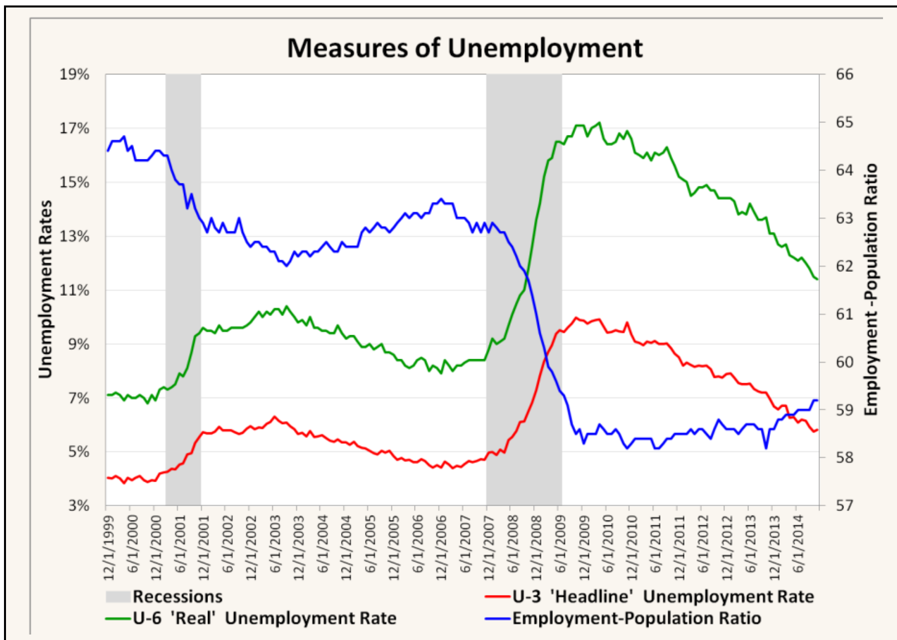
But sectors related to the consumer will be dicey. Certainly, wages can turn around. And even if they don't, the consumer can continue to take on more credit. But the proliferation in consumer credit post-recession has been non-revolving credit. That means *not* credit cards. Specifically, the mounting consumer credit is for automobiles and student loans. We've seen recent strength in the use of credit cards but not like we would expect in a normal recovery. If that kind of revolving credit use picks up, yes, I think the consumer can support various retail sectors.

However, better jobs with better wages in 2015 will be more of a factor for retail than consumer credit. That type of job growth has been absent, so far, in this recovery.

Most of you know that you can hear Butler, Lanz & Wagler's Chris Butler every Saturday morning at 8:00 on KCMO AM and 103.7 FM on *The Capitalist Pigs* radio show. But you can also hear Chris every Friday morning at 8:35 on Greg Knapp's KCMO Morning Show on the same stations.

Unemployment is near that long-sought 6 percent threshold that was seen as a target for ending Quantitative Easing, but what role does the broader U-6 jobless rate play in that calculus?

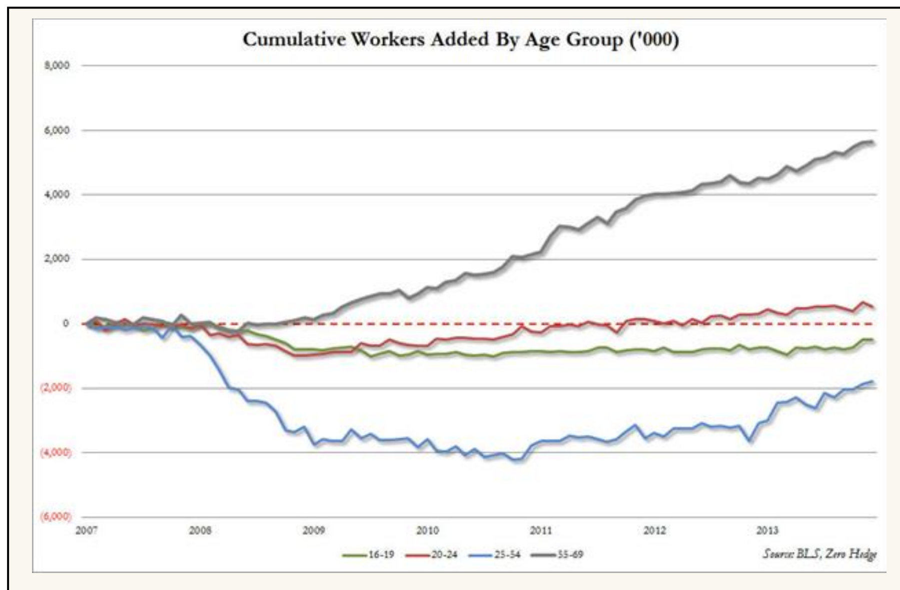
U-3 is the unemployment rate most people hear about once per month when the "Employment Situation" report is released. It's 5.8% in December. U-6, often called "real unemployment," is released with U-3, but includes discouraged workers and those working part-time for economic reasons. U-6 does not usually warrant a mention by the non-financial media. U-6 unemployment is 11.4% currently.



The much more popular U-3 unemployment number, the number that makes the headlines, is what seems to be driving Federal Reserve policy. But they are well aware of the structural changes in the employment sector of our economy. The broader U-6 unemployment rate is still above 10%, but because it utilizes a broader definition of unemployment, it's *always* above U-3. I think the Fed follows U-6 as well as U-3 and many other employment metrics.

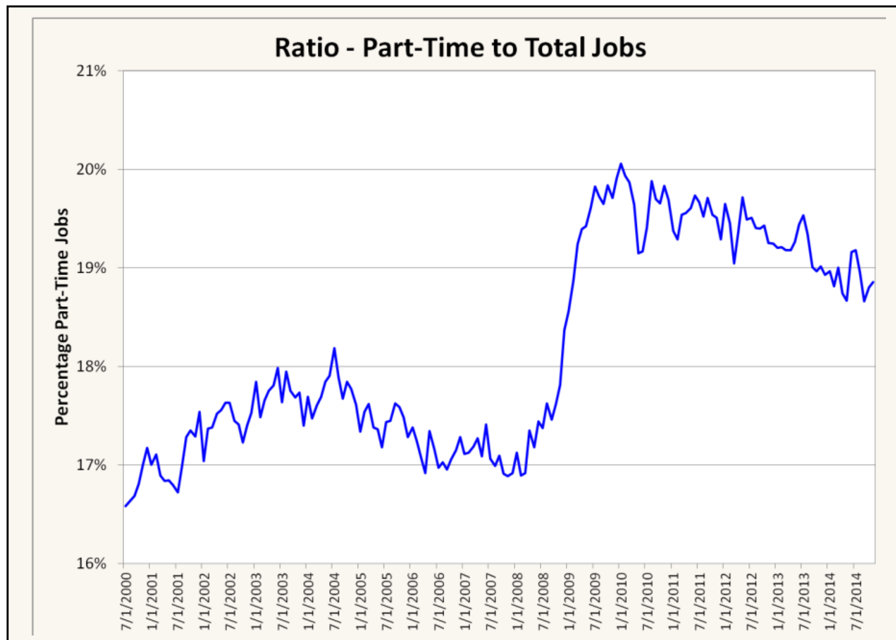
When the Fed first tied monetary policy to U-3, I'm not sure anyone understood the degree to which employment in the US was changing. Certainly, though, over the last two years, it's become more evident.

Note that U-3 has recovered pre-recession levels. U-6 has not. And the employment-to-population ratio has barely budged off its lows. Clearly, there's something different in this recovery as it relates to jobs.

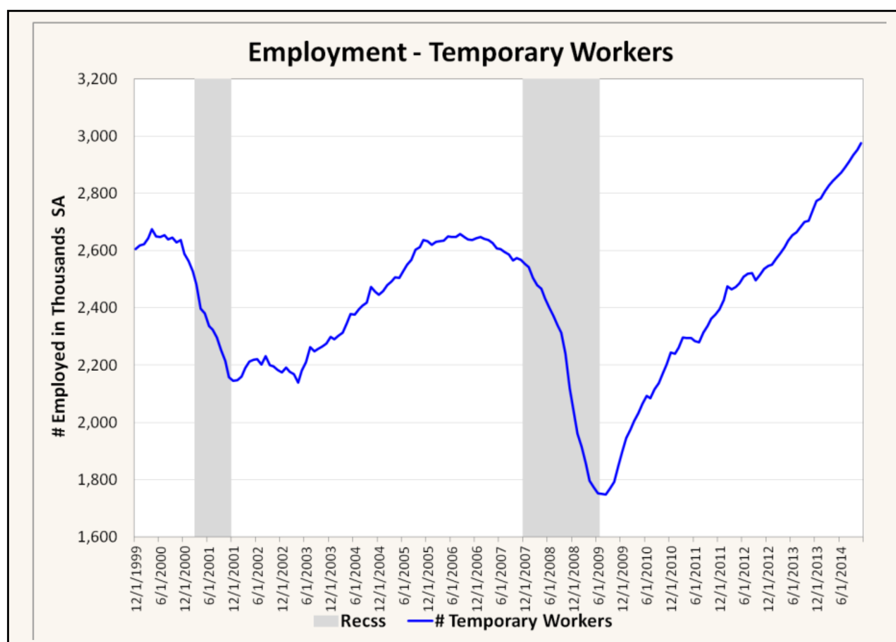


Pundits have claimed that the stubborn refusal of the E-P ratio to budge is because the population has aged and retired. At first blush, that makes sense. But the facts don't bear that out. Since the end of the last recession, it's actually the more aged who have gotten the lion's share of the jobs. It seems as though fewer older folks are retiring than what we might have normally expected. They are, in fact, working. Which means the anemic employment-to-population ratio shows that there are more able-bodied people not working, for whatever reason, than should be the case for a recovery.

Add to the mix the fact that part-time jobs have gained in their proportionate share of total jobs and that temp jobs are at an all-time high, and one much conclude that the standard U-3 measure of unemployment is not adequate in assessing employment health in the US right now.



The Fed will likely use any measure of employment that justifies whatever policy actions they deem appropriate. But it's also quite likely they are fully aware of, and are troubled by, the structural changes in our employment sector. And, of course, that would imply they also understand the limitations of relying on U-3 exclusively in the current environment. We would be shocked if the Fed made a major monetary policy decision based solely on U-3 when every other employment metric is showing weakness.



What do you see as the most urgent public-policy initiative needed now to broaden the economic recovery?

We believe that there has been a dramatic loss of confidence in US markets and both fiscal and monetary policy-making since the end of the last recession. The number of exchange break-downs and disruptions needs to end. This undermines confidence in our capital markets. Also, I think investors' concern over the dominance of High Frequency Trading (HFT) is growing and needs to be addressed. Attempts at "fixing" banks and ending bailouts have seemed ham-fisted at best and dunderheaded at worst. Frankly, it shows us that we've been more concerned with earning political brownie points than finding the best possible solutions to those perceived problems.

Further, the fact that quantitative easing has led, maybe more than any other single factor, to a growing wedge between the upper 1% of incomes and the rest of the nation is starting to be recognized. QE has not done a thing for the real economy. But it has inflated asset prices. Those that benefit from inflated asset prices are those who own assets in the first place. There has, therefore, been an asymmetrical pay-off from QE.

What doesn't get discussed much is that monetary policy has created perverse incentives for corporate America. They would rather buy back shares of their own stock, financed through cheap debt, and increase dividends for stockholders than make capital expenditures to grow their business and the economy. In this sense, the Fed's monetary policy has probably hindered real economic growth for the sake of asset price inflation.

For these reasons, we think that we should take steps to shore up the exchanges, engage in a public debate about HFT and move to normalize monetary policy sooner rather than later. It's quite possible that "normalization" would result in slower economic growth for a while, or maybe even a recession, but the incentives as they currently exist – mainly artificially low interest rates – have really distorted markets and, I believe, hamstrung the normal real economy function of entrepreneurial risk-taking. Non-productive activities are starting to overwhelm the productive ones.

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