October 6, 2014

The U.S. is Taking the Growth Gold

The U.S. economy is working. In relation to other economies, our overall economic growth rate has been outright stellar. Last Friday, the September jobs report showed that 248,000 jobs were created during the month. The unemployment rate fell an additional .2% to 5.9%, the lowest level of unemployment since the summer of 2008. Unemployment peaked in 2010 at 10.0%. Consequently, unemployment has fallen 41% from its peak.

What about the rest of the world? Well, Europe hasn't fared as well. The Eurozone unemployment rate currently stands at 11.5%. Their unemployment rate peaked at 11.9% during the last recession. The unemployment rate in Europe has fallen only 3% from its peak. Compare that to the 41% decline in U.S. unemployment and it looks like the U.S. is winning the employment race gold. What about Japan? Historically, Japan has had a very low unemployment rate. Currently at 3.5%, Japan's unemployment rate has fallen 35% from its high a few years ago, comparable to the improvement seen in the U.S., but not quite as big of an improvement as ours.

Why is Europe struggling? I have written on this extensively in the past, but in summary, Europe has the following structural problems:

- Inflexible labor laws. Due to labor protection laws, it is very difficult for businesses to shed jobs during difficult periods. This leads to employers acting very cautiously when thinking of expanding their labor force.
- Bad demographics. Older workers tend to demand higher wages than their younger comrades. The average age of the workforce in Europe is much older than other parts of the world. This leads to an overall high labor cost in Europe.
- Central bank (ECB) policies. Monetary policies lends to currency valuation bias. There are many individual government fiscal policies at work in Europe, but only one monetary policy. Consequently, Europe's monetary policy is one size fits all. This gives export advantages to one country, (Germany, for example) while other less efficient countries (Italy, for example) struggle. This leads to uneven growth prospects and further uncertainty.
- An over-reliance on government to grow the economy. European political systems tend to have a stronger socialist leaning than the U.S. This is viewed as a catalyst for growth in many European countries. Perhaps the best illustration of this is France, a country where 40% of the workforce is employed by the government. Add to that the 9.7% of the workforce that is unemployed and almost 50% of the workforce gets a monthly check from the government.

With the above hurdles, it is easy to see why Europe's growth rate has been anemic for a long period of time.

The Manufacturing Picture

The PMI Indexes (Purchasing Managers Index) are polling data showing the overall strength of the manufacturing side of the economy. These polls are conducted by the ISM (Institute of Supply Management) and are non-government economic data. The data tends to be fairly pure on a global scale without the urge of policy makers to monkey with the numbers.

The U.S. PMI index is currently at 56.6 (a reading above 50 indicates expansion within the manufacturing side of the economy). This strong of a reading has historically suggested that overall real GDP should be growing at a 4.6% clip. Since 2009, a reading at this level has accompanied GDP growth of 2.6%. Below is a list of the most recent PMI readings from the major economies around the globe:

U.S.	56.6	China	50.2
Japan	51.7	Germany	49.9
U.K.	51.6	France	48.8

As can be seen, the major manufacturing bases are showing signs of weakness. These readings below 50 are new – this wasn't the picture a few months ago. It appearsthe economic sanctions against Russia are having a negative effect on European economic growth. ***On a global scale, the J.P. Morgan Global Manufacturing PMI index is currently reading 52.2 with two of the last three months showing signs of deterioration.***

All of the above data leads to three conclusions***. First, U.S. growth has been leading, and will probably continue to lead, the developed world. Second, this growth leadership will probably lead the Federal Reserve to take monetary action (raise interest rates) prior to other central banks. Third, the U.S. dollar has been rallying strongly in relation to other currencies. This is very important as global capital flows follow currency strength.***

Curriencies – Why Exchange Rates Matter

Global currencies exchange markets stand out as one of the most important, but least understood, markets in the world. There is significant variation in opinion as to why currency markets move in relation to each other (how much Euro does a dollar buy etc.). I have always viewed two major factors having the most impact on currency valuation movement.

1. **Relative growth**. Capital follows growth – pure and simple. With free exchange rates, investors around the world are free to move capital from one country to the next. Investors like to move capital to where it is going to be treated the best – and this normally accompanies economic and corporate profit growth. Strong relative economic growth tends to lead to higher currency values.

2. **Central bank policies**. Capital tends to flow to currencies that are backed by central banks which display and exercise strong anti-inflationary policies. If the outlook is calling for inflation to start accelerating, central bankers need to start raising interest rates. If this doesn't happen, the value of a nation's currency may indeed swoon.

Some say a weak dollar – or weak currency – has benefits. Over short periods of time, this is probably correct, as a weak dollar allows exporters of goods and services to lower their prices on a global competitive stage, which increases the competitiveness of exporters relative to their competition. This benefit tends to be temporary in nature. The real long-term cost of a weak currency is the debauching of a nation's wealth or savings pool. For example, if a currency is halved in value, that currency will buy only half of the goods and services it would have bought prior to the devaluation, leading to a lowering in comparative wealth and standards of living for all. Over the longer term, all nations should desire a strong currency.

It is not possible for all countries to have strong currencies. They are valued relative to each other. Consequently, for one currency to be strong, other currencies have to be weak. Due to the factors (employment, manufacturing growth) mentioned above, the U.S. dollar has been very strong in relation to the other major global currencies. Note the changes that have taken place in exchange rates when comparing the value of the dollar to the euro and the yen over various time periods.

	Current Exchange Rate	Change During 2014	Change From Multi-Year Low
Dollar to Euro	$1.25 to 1	+10.1%	+21.9%
Dollar to Yen	$1 to 110	+9.0%	+41.0%

The Impact

With relatively strong economic growth and a strong currency, the world's excess savings have been flowing to the U.S. over the last few years. ***This activity has helped fuel rising asset values in the U.S. Will this strength continue? Frankly, we don't know, but we suspect the factors that have led to currency strength in the U.S. will continue.***

The world's equity markets have been on a downward trajectory over the last few weeks. This downward move has been fueled by rising concerns of growth from China, renewed concerns regarding European growth (or the lack thereof) and the grab-bag of geo/political strains the world is currently facing. While barely affecting U.S. large capitalization (S&P 500) stocks, many other risk-based markets have not fared nearly as well.

Country Index	Date of Recent Peak	Price Change from Recent Peak
S&P 500 Index (U.S. Large Cap)	September 19th	-3.02%
Russell 2000 Index (U.S. Small Cap)	March 21st	-9.67%
EAFE Index (Foreign Developed Stocks)	June 19th	-11.46%
MSCI EMU Index (European Stocks)	June 6th	-15.32%

(Note: the data reflected on the foreign markets mentioned above are returns priced in U.S. dollars)

Portfolio Action

Is now the time for investors to consider buying some quality assets? "Market timing" is a tricky thing and is something most investors should avoid. Is the market going to rise or fall? Frankly, I don't know, but I do believe the U.S. equity market has entered a long-term secular bull environment. And, historically, I do know that stock prices, on an annual basis, have risen 4 out of 5 years. These are factors that favor being in the stock market rather than sitting on the sidelines.

The REIT (Real Estate Investment Trust) index has suffered a much greater downward draft than many of the indexes listed above. As measured by the Vanguard REIT Index Fund ETF, REIT prices peaked on September 8th and have declined since then – until last Friday. Longer term, we like real estate as an asset class. The average REIT yields roughly 4% in dividends – while not great; the yield looks downright attractive relative to 10-year U.S. Treasury yields at 2.5%. Additionally, unlike bonds whose income is normally the same year after year until maturity, REIT's dividends have outpaced the growth in inflation over the last 10 years.

Are real estate prices cheap? No, they're not. The average Price-to-Book Value ratio of the REIT index is at 2.3x – higher than the average P/BV ratio for REITs over the last 10 years. However, the REIT Index (as measured by the Vanguard REIT ETF) corrected in price during September. From its high on September 8th, the REIT Index declined by 8.7% through late last week. It appears to me that while still not cheap, investors interested in attempting to take advantage of lower prices may find REITs interesting.

Bottom Line

We remain concerned about further downward volatility in risk-based assets over the short-term, but enough downward pressure has been exerted in select asset classes to peak our interest. REITs and other select assets are obviously on sale now, as compared to a few weeks ago.

Prior to making any changes in a portfolio, investors need to speak with their Wealth Advisors as to the suitability of specific ideas for their portfolios and individual financial situations.

We will be back next week.

William B. Greiner, CFA
Chief Investment Officer

More Information

FirstPoint Financial
FirstPoint TV
Market Insight

P. S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.