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WEALTH MANAGEMENT

The U.S. Economy: Poised for Growth?
September 19th, 2013

Dear Clients and Friends,

Yesterday, the Federal Reserve decided to delay the beginning of the end of quantitative easing (QE).

(QE definition: The U.S. Treasury prints new money and gives it to the Federal Reserve. The Fed uses this money to purchase U.S. government bonds in the marketplace. These purchases manipulate interest rates lower thereby incentivizing capital holders to take more risk for higher returns which hopefully stimulates economic growth.)

The markets were very surprised by this as nearly all Fed watchers were expecting at least a small reduction in QE. In explaining its course of action, the Fed cited economic conditions that are currently too weak and/or fragile to begin removing QE. Ironically, the bond and stock markets rallied on this news.

We have been here before. I have noted in past commentaries how uncomfortable it is to be living in a world where bad news is good news --- as economic weakness is rewarded with higher market prices. The Fed is clearly continuing its effort to get the economy to react positively to its manipulation of the markets. This experiment is truly unprecedented. Further, it is also being run by Central banks all over the world! The quintessential question is --- will it work?

The obvious answer is that it has been working. Asset prices are rising. However, the real risk in the Fed's game is how to effectuate a removal of QE from the economy without causing "withdrawals". Judging from the market's consistently negative reaction to "QE tapering" over the past several months, the answer to this question is pivotal in managing risk.

Regarding the management of this risk --- I have come to a new conclusion. I would like to submit that **the downside risk to QE removal is actually on the wane** --- at least in the near term. That is because the U.S. economy is poised to grow, perhaps even more rapidly than many expect. I do not know if this is a result of the Fed's QE policy, or in spite of it. We will eventually get to know the answer to that question --- but certainly not in any timeframe that will be useful to us in allocating capital. Here are seven reasons why I am bullish on the U.S. economy:

1) **Manufacturing on-shoring trend:** I have written in recent commentaries that much of the emerging world is suffering from severe inflation and/or developing a substantial middle class. This translates into higher labor costs for their

manufacturing sector --- which translates into the re-emergence of U.S. based manufacturing. “Made in America” is coming back into vogue.

2) **Housing rebound continues:** Housing is clearly contributing to GDP growth again. The supply demand imbalances in this sector of the economy appear to favor several more years of substantial growth.
3) **Energy revolution:** Shale gas and oil exploration is quickly removing our dependence on foreign oil. Recovery rates of oil and natural gas in these shale plays are coming in strong. New shale discoveries are occurring around the country. I believe this is far more than a short-term trend.
4) **Shrinking federal deficit:** Tax rates are higher. IRS receipts are up. “Sequestration” is in place. The Federal deficit is shrinking.
5) **Labor unions are getting crushed:** Unions are losing power. Labor is becoming more “flexible” relative to other developed economies.
6) **What if the consumer does finally re-emerge?** The consumer has been de-leveraging essentially since 2008. If this trend even mildly reverses, economic activity can surprise to the upside.
7) **A Yellen Fed:** It is likely that Janet Yellen will replace Ben Bernanke as Fed chair early next year. Ms. Yellen has been supportive of Bernanke’s policies and will likely continue a very similar course of action. This continuity of care is worth noting and may provide a more stable environment for the economy.

The net result is an economy that could surprise to the upside. This is very powerful against a backdrop of muted economic growth expectations and continued QE due to those muted expectations.

Generally, markets are at-risk for what they least expect. It appears to me that the least expected risk currently is --- strong economic growth. Further, the state of the U.S. economy is excellent --- relative to the rest of the world. Additionally, the dollar’s status as the world’s reserve currency provides an extra cushion of safety. To borrow a phrase from Bill Gross of PIMCO --- at a minimum, America is likely to continue to be “the cleanest dirty shirt”.

Of course, there are always downside risks:

1) **A real taper move:** If the Fed reverses course in the near future and removes QE too quickly, the economy could suffer. This seems highly unlikely, and as such, the current accommodative Fed will continue to provide a tail wind to risk assets.

2) **Re-emergence of sovereign credit risks:** The Eurozone hasn't really solved their well-documented problems. People just seem to be ignoring them. Japan is still early in its QE efforts. If either of these or other sovereign risks bubble up in a material way, the markets and economy would likely negatively react.
3) **Valuation Bubble:** Eventually, we will have another old-fashion stock market correction in response to stocks being too expensive within the context of a normal economic slow-down. This is perhaps the most likely scenario, but in my opinion is not imminent. Stocks are somewhere between fairly valued and expensive, depending on which valuation model you use. However, broadly speaking, stocks do not yet appear extremely overvalued.

All of this leads to a base case for risk assets to move higher in price. Whether the economy is responding to QE or vice versa is not as important as the fact that one way or another it is gaining momentum. At a minimum, the negative side effects of QE removal appear to be shifted further out in time. In fact, it may be possible to exit QE with relatively less pain than is anticipated, if the economy strengthens enough. With a de-levered consumer, declining fiscal deficits, and the possibility that entrepreneurial spirit in the U.S. is on the rise, it is entirely possible that markets are likely closer to the beginning of a bull market than an end.

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