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H. Bradlee Perry
Marble Harbor Investment Counsel Advisory Board Member
Investment Consultant

A New, and More Uncertain, Investment Environment

Often in our investment lives, new developments creep up on us unexpectedly. Many take a long time to emerge, and others come more quickly – as has happened since the recent financial crash.

Today we can see some very important new factors in the equation which make it clear that we are in a changed investment world. This world appears likely to be more difficult and uncertain than the generally comfortable environment that prevailed during the last two decades of the 20th century – before the bursting of the technology bubble in 2000-2002 and then the big financial crash in 2008-2009.

In what now looks like a nostalgic view, the Princeton economics professor, Ben Bernanke, labeled the late 1900s' placid period "The Great Moderation" – shortly before he became Chairman of the Federal Reserve Bank in 2006. Unfortunately, though, no "moderation" prevailed during his eight years in that position.

Many changes have caused this shift in the environment, all of them negative to some degree. I don't want to over-dramatize this situation, but it deserves careful consideration. So let's examine realistically these notable changes and see what they portend for the future. Successful investors are always sweeping their eyes across the entire world, looking through binoculars to find important information – while most others merely focus on a few current short-term events, usually local ones, peering through microscopes. Here, we'll take a broad view.

1. <u>Slowing real economic growth around the world</u>. Two things produce economic growth: larger numbers of workers producing goods and services and increasing productivity per worker. But in recent years most nations' workforces have been expanding more slowly, due to lower birth rates and the retirement of increasing numbers of older workers (such as the many "baby-boomers" born in America after World War II). These demographic trends seem quite certain to continue; but the other factor, slowing productivity growth, may not be so immutable.

Productivity gains depend mostly on innovation, – which can develop more efficient production equipment and work techniques, as well as new products whose value and utility per dollar of production labor costs are higher than for older products. For example, compare the very efficient semiconductor chips for modern computers with the complex, cumbersome old vacuum tubes used in mainframe computers many years ago.

In the U.S. annual productivity gains for the total economy have slowed from well over 2% through the late 1990s to as low as 1% from 2000 to 2007, before the financial crisis pushed the economy into the "Great Recession," causing productivity gains to fall below 1% for a while.

Economists and engineers are unable to explain fully the slump since 2000. But one problem is that productivity gains are easier to attain in manufacturing than in services. However, manufacturing has now declined to only 8% of total U.S. employment, while the services sector of the U.S. economy has ballooned to comprise 85% of all employment. As sort of "intangible" activities, services are getting harder to make more productive, now that computers have provided much of the efficiency-boosting advantage they seem to be capable of.

Hence, the economists at the Federal Reserve, looking at these population and productivity trends, are now predicting that real U.S. economic growth (before inflation), over the next few years at least, will average just 2.0-2.3%, quite a bit below the pre-2000 rate of 3%. Maybe new innovations later on will further enhance overall worker productivity, but we cannot foresee now how that will happen. Meanwhile, even America's new ability to substantially increase its oil and gas production, beneficial as that is, doesn't look as if it can do much to offset the current adverse work force and productivity trends that will restrain economic growth.

Confirming the Fed's outlook for the U.S., the economic staff of the International Monetary Fund has just released a report saying that the majority of the world's leading economies should expect an extended period of significantly lower growth rates. The IMF's analysis cites the same labor force and productivity factors for its global outlook that I have mentioned as affecting the U.S. And in today's uncertain world I think this is one change that is likely to persist for some time.

2. Greatly increased involvement of the government in business and the financial markets. In some respects government can play a constructive role in the economy. As I wrote several years ago, it has been invaluable in carrying out and funding basic research. Breakthroughs in medical research and the invention of the Internet (solely by the Defense Department's Defense Advanced Research Projects Agency), are two examples of that useful work. Also, building infrastructure (roads, airports, waterways, etc.) is essential to the efficiency of the country.

But in their regulatory activities, all governments have gone way beyond the limits of helpfulness, to become a heavy burden on their economies – adding greatly to business's costs and their ability to operate efficiently. Furthermore, in governments' efforts to limit financial excesses (especially in the U.S.), the regulatory burden has increased a lot recently – laudable as the governments' intentions have been.

One necessary government action that had to be taken in recent years to revive the U.S. economy was a huge jump in the money supply. In this process, the Federal Reserve has increased its balance sheet from $1 trillion to a staggering $4.5 trillion since 2009. This has been done by their buying of U.S. Treasury bonds and mortgage obligations in the markets. The extra cash those bondholders received flowed into the money supply, hopefully to be used by lenders to enable consumers and businesses to spend more money and thus increase economic activity.

Similar actions have been taken in other nations, so central banks have become a much greater factor in business and finance than ever before. (We all have to be "Fed watchers" now.) The risk in this situation is that they'll remain bigger participants in trying to manage countries' economic and financial affairs, sometimes in unpredictable ways that may not always be successful. Certainly, this has to be a concern as we see many nations having increasingly dysfunctional governments today (including the U.S.) which more and more are making unwise, politically-driven decisions – or being stalled in gridlock and doing nothing useful.

3. Increased globalization in business and finance. World trade has been growing for a long time, more than doubling in the past fifteen years – in part because China has become a huge trader as the economic reforms initiated there by Deng Xiaoping in the late 1970s came to full flower in the 21st century.

Along with burgeoning international trade came much larger flows of money between countries, not only to finance imports and exports, but also for financing multi-national businesses, cross-border lending, and investing in foreign stocks and bonds. In this process, a substantial shift has taken place in the balance of the world economy and its finances from the high-income, more established Western nations to the emerging countries, particularly China and its Asian neighbors. Today we count less and they count more in the global economy – and they have less experience operating in it.

At times differentials in various countries' economic and financial conditions arise that cause big money flows between countries. Sometimes these can greatly affect currency values. One such change, which was unexpected, has just occurred. The relatively stronger economic recovery in the U.S. than anywhere else, and the prospect that this may soon boost American interest rates, has caused large amounts of foreign money to flow into the U.S. – thereby increasing the value of the dollar versus other major currencies by 20% in the past year. That's a big move for any currency.

This may be a source of pride for Americans, but it also creates problems for us. First, it will make U.S. goods more expensive for foreign buyers, and thus reduce our exports, and make foreign goods cheaper in the U.S., thereby boosting imports. The resulting decline in our balance of trade will reduce U.S. GDP.

Second, it will make the foreign profits of our big multinational companies – which normally amount to more than one-third of their total earnings – worth less when translated into dollars. So their reported profits will be reduced – but moderately in most cases, with a hit of 5-10% in the current year of the currency shift, and then no significant impact on year-to-year earnings growth thereafter if the dollar appreciates no more – a reasonable assumption. However, looking to the future of the highly globalized world we'll have to expect more sizable currency fluctuations from now on – some favorable, some not.

4. <u>Greater influence of major geopolitical events around the world</u>. With the demise of the Soviet Union in 1991, the close of the long and stressful Cold War and the resulting "Peace Dividend" were expected to bring greater tranquility and prosperity to the world. But that happy dream didn't last very long. A dozen years later, the U.S. invaded Iraq to topple Saddam Hussein and seize his dangerous "weapons of mass destruction."

Of course, those proved to be non-existent, but that unfortunate war (which was aimed partly at protecting vital Middle East oil reserves) touched off major multi-national turmoil in the Middle East, which continues dangerously today and has stimulated much terrorist activity elsewhere. And now China, having attained great economic success, is flexing its powerful muscles in East Asia. Finally, the post-1991 taming of Russia has run its course, and that country has again become seriously disruptive to world order.

None of these activities has yet had a major effect on any developed nation's economy (other than inflating the U.S. defense budget), but in the current issue of *The Atlantic*, Chrystia Freeland assesses the current situation very well. "The postwar geopolitical system is breaking down, and what comes next could be highly volatile – especially for big corporations" that have built, cheered, and profited from the globalized economy. "War, or at least geopolitics, is figuring more and more prominently in the thinking and fortunes of large businesses … The intensity of concern over global instability is much higher now than in any recent period."

5. <u>The Financial Collapse in 2008-2009</u>. Obviously the impact of this huge, and almost totally unexpected, event has changed many things. The irresponsible lending that took place in the early 2000's, aided in the U.S. by much too loose monetary policy by the Fed, and the total failure of regulators to see the problems developing and to do anything to forestall them, have led to a basic weakening of the economy and the financial system in the U.S. and around the world. At best, it will take many years to correct these dislocations.

6. <u>Greater Importance of Debt In the Economy.</u> A tremendous surge of debt was one of the most important consequences of the buildup to the 2008-2009 financial collapse, and it's hard to see how much of the newer debt can perhaps ever be paid down. In fact, that is one of the conclusions in the IMF report I referred to in connection with future economic growth. It states that, "Slower growth in most economies will make it difficult to reduce the high levels of debt accumulated prior to and during the financial crisis."

Responsible borrowing is an essential means of financing economic growth, but debt can become a difficult burden when it gets too high; and it looks as if that burden will persist indefinitely in the U.S. and many other countries, especially in their government and consumer sectors.

U.S. businesses generally did not borrow heavily in the early 2000s, so they entered the financial crisis with strong balance sheets. But in the past few years they have issued tons of new bonds – both to "warehouse money" for future needs since interest rates have been incredibly low, and to raise cash to buy in large amounts of their stock (with the aim of artificially boosting their earnings per share and thus their stock prices). This has weakened corporate balance sheets.

Total American government, consumer, and business debt rose from 1.7 times U.S. GDP in 1985 to 1.9 times in 1995, and an unprecedented 2.3 times in 2008-2009 – a one-third increase in that ratio. And in many foreign countries the rise has been to much higher levels – 2.9 times on average for the twenty most indebted nations.

But notably in the U.S., the country with the best economic recovery, our debt ratio hasn't declined at all since the crash, despite efforts to readjust our finances to a more sustainable level. Our continuing high debt, and that elsewhere in much of the world, will certainly restrain future economic growth for a long time.

7. <u>Development over many years of new, complex, and typically risky financial instruments</u>, whose trading volume has become huge. These include a variety of derivatives: financial assets that "derive" their prices from the prices of underlying assets like stocks, bonds (and their interest rates), and commodities (way beyond the

long-prevalent agricultural futures). These instruments are used to hedge against adverse future price changes, and they are also a fertile area for pure traders to make just plain "bets" on future price moves, like the sports bets so popular in Las Vegas.

Also, the investment bankers developed a lucrative business putting together large pooled funds of financial instruments – often of dubious quality, as occurred with low-grade mortgages and inferior-quality corporate loans in the early 2000's – and selling shares in the funds to investors who were seeking high returns but couldn't analyze the risks in the supposedly well-diversified packages. This business died after the pooled funds collapsed in the crash, but it has since revived, now with risky low-grade auto loans and a new wave of weak corporate loans.

By their nature, most of the new financial instruments are risky, and their price volatility has added considerably to fluctuations in the financial markets.

8. <u>Much greater short-term trading by investors</u> – or I should say "supposed investors." As the volume of investment money has expanded greatly in the past fifteen years, mainly for institutional and individuals' pension funds, a race has developed among some professional investment management firms to "capture" (that is their word) more assets to manage and thereby boost their fee income and profits. Many believe the best way to do that is by pressing hard to achieve superior short-term investment performance.

Unfortunately, such "performance" has become a vital sales tool to attract money from institutions and individual investors who have under-funded their pension plans and are currently struggling to catch up. So the now-seemingly "old fashioned" *marathon* of steady, long-term investing has been largely superseded by a frenzied series of short-term trading *sprints*. These require successful short-term forecasts of events and market price moves, but as I wrote a year ago in "The Risks and Failures of Forecasts," such predictions are far more often wrong than right.

Also risky for investors is much greater use of leverage: utilizing borrowed money to buy investments. This greatly increases the returns on successful purchases, but it produces as much as 100% losses on bad selections – even if market prices decline as little as 25% on a moderately leveraged ($3 of debt to $1 of equity) investment. This happens enough to be a costly problem.

So the massive short-term trading that so many professionals, notably hedge funds and high-speed computer traders, plus a number of other institutional investors and individuals, now engage in has produced a huge increase in portfolio turnover. Today, the average mutual fund turns over 85% of its holdings in a single year in eager searches to "find something better." They aren't *investing*, they are merely *trading*. And by holding stocks for an average of just fourteen months, they are not *buying* stocks for the long-term, they are just *renting* them for very short periods.

To show how far this change has come, today's mutual funds' turnover of 85% compares with rates of under 50% prior to 1985. And an even greater surge of portfolio churning has occurred in the overall investment field. Last year the turnover of all the stocks listed on the New York Stock Exchange was 300% versus "just" 200% ten years earlier. So stocks are now being rented for very short times – on average just four months.

All this trading is very counter-productive. Actually every study of portfolio turnover that I've ever seen shows that the higher trading activity is, the *worse* investment performance is. In fact, the lowest decile of turnover usually outperforms the highest decile of churning by a ratio of at least two-to-one. Game, set, match!

9. <u>More volatile and riskier financial markets.</u> The net result of changes 7 and 8 is that markets have become far more volatile (not all the time, but fairly often). And this has created large risks that weren't there a decade or two ago. So as I've said frequently, true investors have to concentrate on the most predictable, solid, highest-quality companies and bond issuers – and base their decisions on *facts*, not *guesses* about the unpredictable future. And they must use great valuation discipline in buying or selling all investments.

Finally, as investors plan their investment programs, they must be even more realistic as to what future returns stocks can reasonably be expected to produce in this new world of greater uncertainty. Sure, equity returns will probably be lower, but this doesn't mean we should give up on good stocks. In fact, today, even after the strong financial markets of recent years, equities are the least overvalued of any type of investment – selling at price/earnings ratios that average only 20% above their historical norm (now 18 versus 15 over the long-term past) – while bonds, for example, are far more overpriced. With only a little luck, the expected slower rate of economic growth should still enable stocks to produce 5-6% total annual returns, way down from 10% in the glorious decades prior to 2000, but still better than most, or all, other investment sectors.

We should have lower expectations, but count on good companies as the most reliable workhorses in the barn. They'll plod through the heavy, uneven investment turf and ultimately get their sector of the field adequately plowed to produce a decent crop. And who knows, maybe the next major surprise will be a positive one, lifting stocks more – uncertain as that seems now.

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Marble Harbor Investment Counsel, LLC
101 Federal Street, Suite 2505
Boston, MA 02110
617-956-6710
www.MarbleHarborIC.com