MARKET PERSPECTIVE

BY RICHARD SKEPPSTROM

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Interest-rate constipation

U.S. economic growth was nearly 4 percent in the second quarter and the U.S. Federal Reserve decided to leave rates at 0. It was rumored to be a close call but labor conditions aren't perfect: too many aren't looking for work, international markets are unsettled and inflation remains just below target. I didn't believe 0.25 percent made any difference anyway but equities weren't thrilled. You might think that after watching these things for 20-some years, I'd know if the news were good or bad; however, I'm not even sure what the news was in this case. Some countries aren't well-run? Some people would rather not work? In any case, the Fed still believes it imprudent to pay interest on savings. Congrats to the borrowers.

For years we've been told that rate increases would begin in 2015; we're running out of months. Appropriately, Fed Chair Janet Yellen had an answer: perhaps October. I have to admit to being dumbfounded by what exactly she thinks could change from September to October. European and emerging-market problems will not be resolved next month. U.S. growth is adequate and the economy is on solid footing. As an aside, Yellen's follow-up speech ended awkwardly as she stumbled through several lengthy pauses later attributed to dehydration. My cynical view: She didn't quite believe what she was reading. Frankly, I'm beginning to have my doubts too. The longer this drags on, the more permanent it seems. But whatever she actually believes, managing our escape from the black hole of 0 percent interest-rate policy must be intensely stressful. Proper hydration is in order.

And just when I'd almost completely bent my mind to the probability of low rates forever, I came across a very interesting article arguing just the opposite. The article, by A. Evans-Pritchard of the Telegraph, illuminated the work of Charles Goodhart, emeritus professor at the London School of Economics and a former senior official at the Bank of England. Goodhart's conclusion is that the global economy is at a critical inflection point with respect to abundant, cheap labor and that has profound implications for a whole host of nettlesome issues, including interest rates, markets, wages and inequality.

It's a relatively simple thesis. The entrance of China and other emerging markets into the global economy in the latter part of the last century more than doubled the global labor pool. That happened to coincide with the maturing of technologies that permitted companies to move operations anywhere, which they gladly did. That phenomenon, combined with China's staggering growth, formed a "sweet spot" for labor arbitrage that depressed wages, prices and inflation globally; was a boon to corporate margins; and drove inequality. Central banks carelessly overreacted to the low inflation with excessive easing, setting off a series of asset bubbles, further exacerbating excess capacity and income inequality. But Goodhart argues that is all about to reverse and it hinges on the global dependency ratio – dependents vs. workers –bottoming and beginning an inexorable rise. He has a number of tables and graphs and analysis to support his conclusion. Suffice it to say, he's an emeritus and he believes we are there. As the global workforce ages and China slows, labor becomes more dear, wages rise, corporate margins shrink, inequality reverses, the global savings glut evaporates (workers save, retirees consume) and interest rates rise.

I have to say it's an elegant theory but I wonder if it will all work out so neatly. Managements will resist labor inflation with every bit of their formidable resources. Surely that will accelerate the substitution of capital/technology for labor. And as Ambrose-Pritchard points out, Goodhart doesn't seem to believe the emergence of Africa or India can change the trajectory. What I can endorse is the notion that we are no longer in that so-called "sweet spot." Unfortunately, the ongoing commodity bust and Chinese problems (both the result of overinvestment) are masking where we truly are but this should run its course over the next year or two. Beware. If he's right, you're going to lose money in bonds.

Markets

Equity markets have a nasty tone to them. The long advance finally petered out with the slowing of global growth; uncertain, but menacing, problems in China; the bursting of the global commodity-investment bubble; and the end of U.S. quantitative easing (QE). For a while, the market was content to simply rotate away from the deep cyclicals (e.g., industrials, materials and energy) and chase growth (e.g., biotechnology and select technology) but that stopped working and/or faltered badly beginning in July, which left no warm and fuzzy way to buy dips. Add to that the stench of bankruptcy wafting around the commodity complex and you have a retest of the August lows. I added to my U.S. equities during the August swoon and I'm satisfied at the moment with my allocation to stocks. Let's see where this goes. As I've counseled several times, I see modest returns ahead.

Thank you for taking the time to read this month's Market Perspective. I hope you found it helpful.

Strategic Return Portfolio	
Equities	67%
Bonds	14%
Gold	2%
Cash & similar	17%
Total	**100%**

as of Sept. 30, 2015

Richard, an investment professional with more than two decades of experience, manages Eagle's Strategic Return Portfolio. His views are his own and may not reflect those of other Eagle portfolio managers.

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