Slocum, Gordon & Co. LLP
Investment Management and Counsel

Viewpoints

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This Economic Commentary is designed to present the Firm's current views on timely topics that we feel may be of interest to our clients. Viewpoints is also available electronically on our website: slocumgordon.com.

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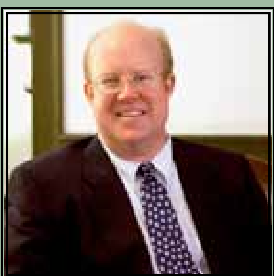
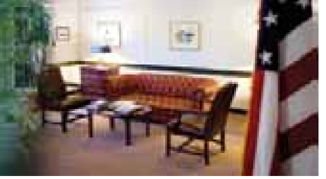


Kenneth M. P. Lindh

Twenty-five years ago, long before the Internet or anything remotely close to the digital world we now take for granted, we had a Dow Jones Newswire teletype machine clanking away in the front reception room in our office. Whenever there was a significant news story, bells would ring, beckoning someone to read the printing headlines. A memorable moment occurred the day President Reagan was shot. The bells would not cease ringing, demanding that the market-moving news would be noticed.

Every Friday afternoon back then, professional investors would huddle around their DJ newswires to read the all-important weekly statistic of the reported money supply figures (M1 and M2) that would seemingly govern the mood and the consequent investment strategy of the moment. Noted economists would chime in immediately to suggest that the expanding figures were troublesome, or the contracting figures were troublesome. It was the financial equivalent of a blood pressure reading, and everyone in the business hung on those reports for internal guidance. Money supply readings can be useful information for judging the ultimate direction of the economy: too much money is inflationary and too little is recessionary.

What interests us at this point in time is that the money supply is hardly ever mentioned. It has become confused by so many new forms of money and how it is held. Bank deposits have morphed into money



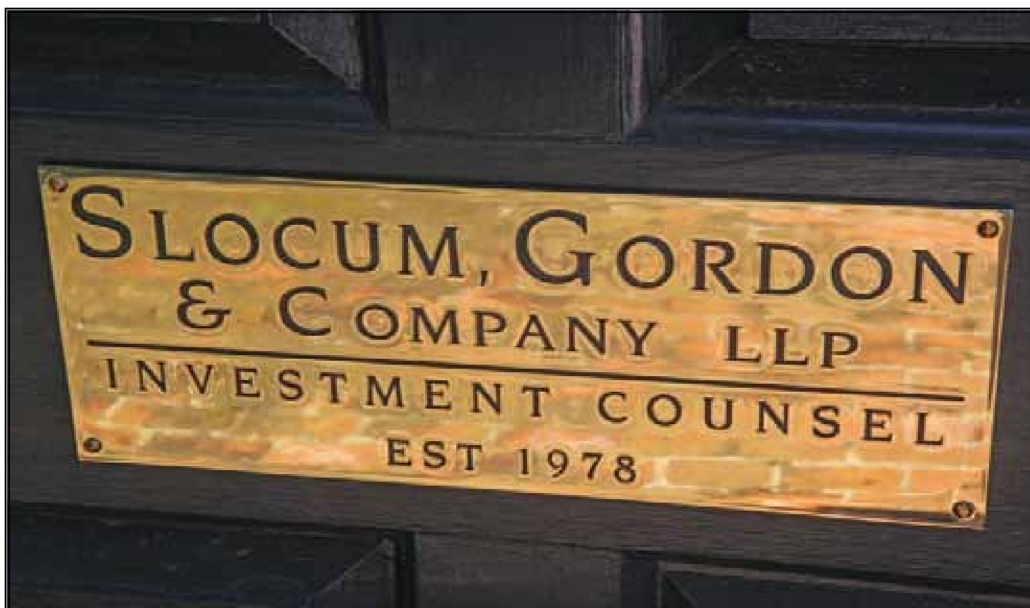
accounts, and electronic payments have changed the nature of more traditional check clearing facilities that banks provided. The Fed has been hard at work expanding the money supply to regain economic momentum after the great recession, but the fact remains that very little of it has found its way into the real economy, meaning into consumers' spending patterns and corporations' capital investment plans. Instead, much of that liquidity has gone into financial assets such as stocks and high yield bonds. With global economic conditions so lackluster, money supply expansion like we

are seeing from all central banks would normally boost growth everywhere. The problem is that it takes time to work through the still large overhang of global debt and overbuilding that occurred right up to the 2007 collapse. Deflation has been the trickier issue, and as evidenced by falling commodity prices, demand for these natural resources that had been so strong in the last decade in China and the emerging markets has cooled dramatically, placing commodity-rich exporting countries (and companies) in a tough position.

While the market is currently reacting negatively to this global slowdown and continued deleveraging, there is a silver lining here. Lower input costs in the manufacturing process of nearly all goods have been a boon to consumers. Lower oil prices result in immediate savings at the gas pump as well as a world of products that have petroleum as a feedstock. Lower prices in general, as long as they are not representative of a global recession, are generally good for the US as a commodity-consuming nation. So the next question may be whether or not we are entering a recession and therefore a bear market. There can be no certainty, but we think the answer is no.

The major recessions and bear markets of the modern era (1929,1974,1987, 2000, 2007) have generally had a common set of factors associated with them as pre-conditions which led to a less accommodative Federal Reserve policy: a booming economy, commodity inflation, irresponsible bank lending, over-leveraged households, and an inverted yield curve (short term interest rates higher than long term rates). Today, while there are any number of global issues to contend with, all of which are very well known to the markets, there is a clear lack of the pre-conditions of those earlier bear market episodes. In fact, far from a booming economy, the current recovery has been anemic, just ahead of stall speed, leading the Fed to refrain from a normal tightening regime that would typically accompany a mature expansion. The yield curve is positively sloping and not inverted; there is hardly loose credit at banks these days; and households have been clearing up outstanding debt and improving balance sheets. Banks are as well capitalized as ever, and in general, stock prices, while not cheap, are fairly valued in the context of currently low interest rates and inflation. Economic activity in the US has been slowly improving, suggesting that what this recovery has lacked in strength will be made up in length. Monetary policy from the Fed has been and will remain very friendly, and liquidity is plentiful.

So we are suggesting that this current bad patch in the market should be kept in perspective. Stock market declines of 10% usually happen at some point in most years, and 20% declines happen every five years or so. The last one was in 2011, so no surprise there. Dividends are improving, and large capitalization US companies have substantial financial strength to justify their market valuations. Clearly, issues that can spook markets will always be there, such as the slowing in China, geopolitical tensions, or turmoil in foreign markets, but the US is looking stronger than its global counterparts at the moment and should be able to weather this slow period. We know it is not easy, but we should try to ignore the noise while our portfolios collect their dividends.



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