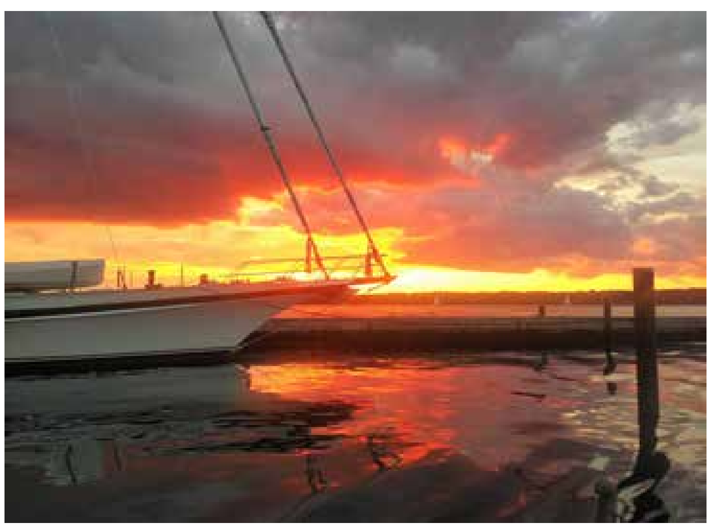
This economic commentary is designed to present the firm's current views on timely topics that we feel may be of interest to our clients. Viewpoints is also available electronically on our website: SLOCUMGORDON.COM.

Let's Get Fiscal

Since the financial crisis of 2008, monetary policy alone has shouldered the burden of fostering growth and avoiding deflation in developed economies. More recently, many Central Banks have turned modern financial theory on its head by lowering deposit rates below zero in an effort to rejuvenate economic activity. Consequently over $13 trillion in sovereign debt currently trades at negative yields, including the 10-year bonds in Japan and Switzerland. By comparison, the 1.7% yield on the US 10-year seems quite appealing!



Despite the accommodative actions taken by central banks, businesses and consumers have retrenched in a number of ways. Capital expenditures remain subdued as corporations grapple with excess production capacity and heightened political and economic uncertainty. At the same time, households have come to recognize the dangers of the borrow-to-spend mentality that characterized the US consumer during the quarter-century leading up to the global financial crisis. All the while, the flood of money supplied by central banks has found a home in stocks, bonds and other risk-assets that lie outside the real economy.

We maintain our position that the Fed will hesitate to raise rates at the pace implied by market prices for several reasons. First, a rate increase would come at a time when the central banks of the rest of the world are moving in an opposite direction, and potentially lead to further distortion in capital flows. Inflation has also yet to achieve levels that would imply the economy is overheating, and there is little need to restrain an economy when growth and inflation are hovering below 2%. Furthermore, deflationary forces exist in various segments of the economy, most notably commodities and durable goods. Finally, higher rates would further strengthen the dollar to the detriment of US exporters.

Against this backdrop, we believe fiscal policy is the only macroeconomic tool left to combat the potential for secular stagnation. Policymakers have become more aware that the era of easy growth, enjoyed by corporations and households alike, has ended. Concerns over rising budget deficits and calls for austerity measures have taken a back seat to fears of inadequate growth and an increase in structural unemployment. As a result, the stage has been set for government to spur aggregate demand with an infrastructure spending plan, a rare idea that both presidential candidates support! Such stimulus would not necessarily be limited to repairing roads and bridges, but would ideally address all of the aging systems that enable the efficient movement of energy, food, water, people, and information.

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Decades of chronic underinvestment in infrastructure are now catching up with countries around the world. In the United States, infrastructure spending as a percentage of GDP has actually declined since the financial crisis. Although any increase in government spending carries the risk of inefficient resource allocation, we believe infrastructure investments present the clearest path to private-sector productivity and labor-force participation improvements. The McKinsey Global Institute has estimated a 20% rate of return on infrastructure projects. Hypothetically, if the actual return is only half of that and the government collects 25 cents on every dollar of GDP, the government will earn 2.5% on its investments, a figure that far exceeds its current cost of borrowing. Such a strategy contrasts to protectionist policy proposals, also gaining popularity on both sides of the political aisle, aimed at promoting domestic production by discouraging trade. Protectionism does little to enhance the competitiveness of domestic industries and could lead to a dangerous cascade of retaliatory measures from trading partners. An uptick in protectionist or nationalistic policies will amplify the headwinds for global growth.

We are currently in the 88th month of the US business cycle, the fourth longest out of 11 economic expansions since World War II. The cycle generally reverses after a long series of interest rate increases or the bursting of a speculative asset bubble. Neither of these seem imminent from our perspective, and although equity multiples are richer than historical averages, which will challenge price appreciation, dividend yields are significantly above Treasury and corporate bond yields and suggest prices are not yet in overextended territory. Central Bank policy has forced investors to climb further out on the limb to find fruitful investment returns, and we do not see this behavior changing in the near future.

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In this context, we believe defensively positioned, income generating US equities represent the preferred asset class in an income-starved world. We remind our clients that the pursuit of high returns in a low-return environment is the riskiest of endeavors, and returns can at times be maximized by patience and inactivity. In the meantime we continue our hunt for truffles on the forest floor.

-Peter Hatfield, CFA