Investment Dashboard 2018

Part 2: Economies: US and International

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Inflation: The Fed Cares about History, and So Should You

Those who forget the lessons of history are doomed to repeat them. Such is the case with inflation.

Source: US Bureau of Labor Statistics and YCharts.

Inflation is a hot topic again.

The Fed has worried in the past about the lack of inflation.[i] Now, the Fed is also wary of the re-emergence of inflation.[ii]

How the Fed perceives inflation – or its absence – has a major influence on many asset classes. If the Fed becomes more worried about inflation, it is likely to press ahead with more aggressive interest rate hikes. More interest rate hikes might put pressure on bonds and can spill over into stocks, commodities, and other areas. The converse can also be true.

What Is Inflation?

The chart above gives a long period of history to ponder inflation.

The blue line represents the annual change in prices as measured by the US Bureau of Labor Statistics. This data, known as “core inflation”, measures the year-over-year change in a basket of consumer goods and services. The reason it is known as “core” is because it excludes more volatile items such as food and energy. (As an old boss once quipped, core inflation is a valid measure “if you don’t eat and you don’t drive.”)

Core inflation has been a positive number since the late 1950’s. Prices in the US tend to rise. Population growth and psychology are two factors that have led to price increases over time.

(Contrast with Japan, which has had decades of deflation, or falling prices. The population is aging and in decline. A vicious circle of stagnation has reinforced the mindset of price deflation. However, recent signs might point to the end of deflation, a subject for a future article.)

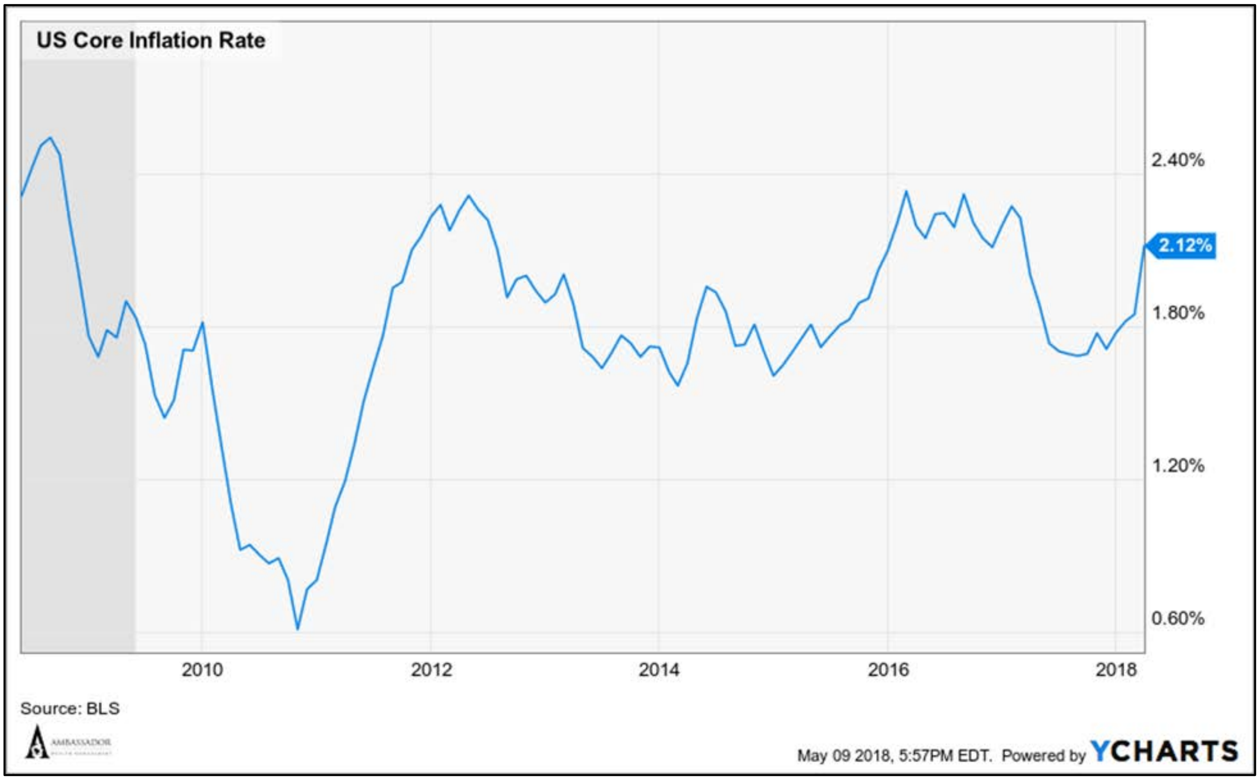
Inflation: Where Have We Been

Core inflation has been fairly stable this century. Such stability has not always been the case, particularly from the 1960’s to the 1990’s.

1963 was a significant year for the United States. The assassination of John F. Kennedy led to the ascent of Lyndon B. Johnson as President. President Johnson commenced his “Great Society” program to end poverty. He enlarged government spending to build more schools and provide subsidies to the poor and elderly.

Inflation: Recent History — De-, Dis-, or Just Plain In-flation?

Which should we fear more: rising prices or falling prices?



Source: US Bureau of Labor Statistics and YCharts.

Last time, we took a look at a [mini-history of core price inflation over the last 50 years](). Periods of calm prices at times have been interrupted by price spikes. Past price spikes have often aroused the ire of the Fed, which has raised interest rates to douse inflation. Such measures at times have also doused the exuberance of financial markets.

This installment will examine the recent history of core inflation. (As a reminder, core inflation excludes more volatile price categories such as food and energy.)

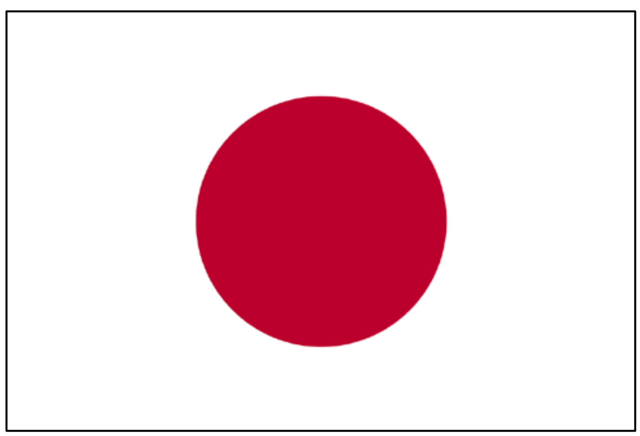
The chart above includes price data recorded by the US Bureau of Labor Statistics. The blue line represents annual changes in core price inflation. The data spans the last decade from the end of the Great Recession in 2009 to 2018.

Core inflation appears relatively calm for the last decade. It ranged from a low of 0.6% to a high of 2.4%. However, the apparent calmness in this data masks one of the fears of the Fed.

Pop Goes the Housing Bubble

The bursting of the housing bubble scared market watchers, including the Fed. Just as Chicken Little worried that the sky was falling, so watchers were afraid that prices would keep falling. Not only home prices, but wages and other goods and services ran the risk of extended price declines. Extended price declines, or deflation, potentially could paralyze purchasers. Instead of consuming, purchasers would sit on their hands and wait for lower prices, e.g. more deflation. The greater the delay in consumption, the worse for the economy. The worse for the economy, the more delay in consumption. In other words, we potentially faced a nasty vicious cycle.

Was the US becoming like Japan? Would we need two decades to pull out of it?



The period from 2008 to 2010 was a tough time for core inflation. Core inflation declined from 2.5% to a low of 0.6%. As we shall see later, the impact of the Great Recession damaged more than simply home prices and the stock market. Consequently, the Fed took extreme measures in hopes of preventing Japanese-style deflation and longer-term economic stagnation. Slashing short-term interest rates and successive rounds of Quantitative Easing (in effect, one branch of the Federal Government buying up a significant part of debt issued by another branch of the Federal Government) caused rates to fall to historical lows. The Fed hoped to spur economic demand by making borrowing cheap. It sought to stop the bleeding from the housing market.

Eventually, the Fed got what it wanted. The American consumer reduced their expectations for price decreases. The economy has staged a prolonged but tepid recovery.

At least for inflation, the efforts seemed to have paid off. Core inflation has rebounded back to around 2.4%. Core inflation has stayed positive and closer to recent historical ranges.

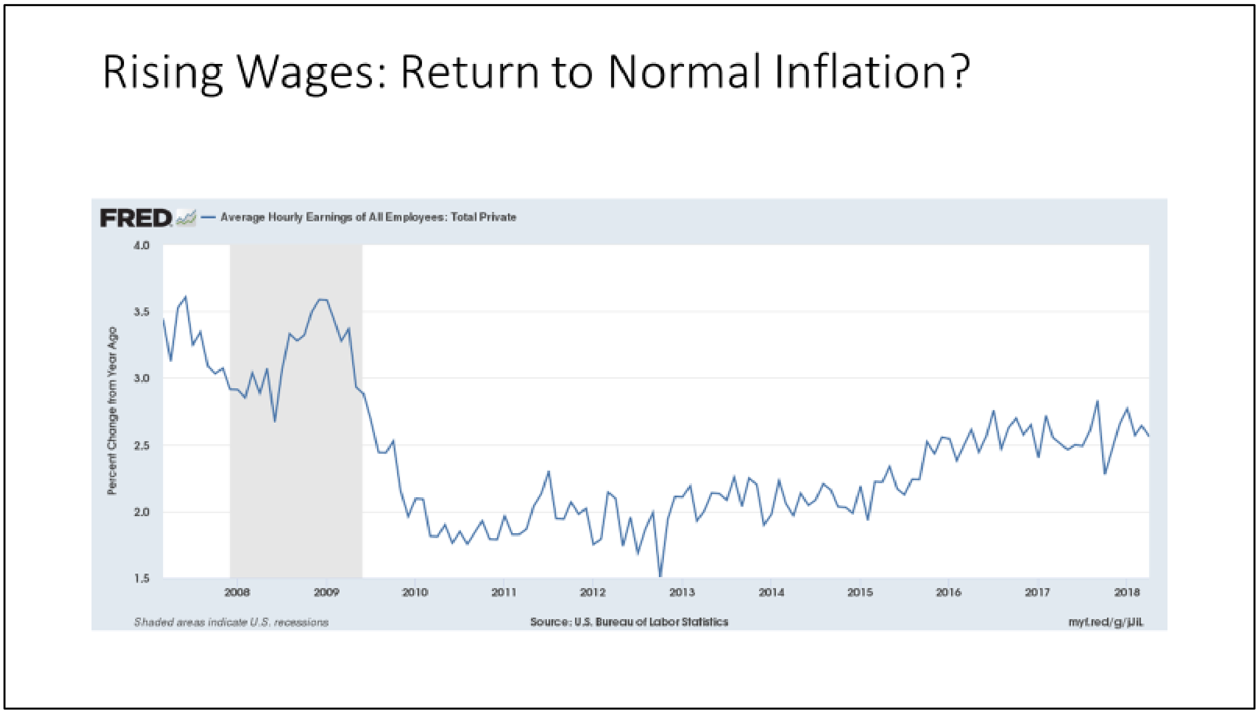
Inflation: Now What?

History has shown that what the Fed gives, the Fed ultimately takes away. The Fed loosened interest rates in a dramatic response to a dramatic crisis. The threat of deflation justified such a response. However, the threat might be shifting from deflation (falling prices) to inflation (accelerated price increases).

Will the Fed need to respond in a different way? What are the implications for markets?

Inflation: Wages Are Key

Are wage hikes on the horizon? If so, what are the implications for inflation, interest rates, and your investments?



Source: US Bureau of Labor Statistics and YCharts.

The Fed reacts to changes in inflation. **Over the last 50 years** prior to this century, the Fed worried most about spikes in inflation and responded with higher interest rates. Following the bursting of the housing bubble, the Fed cut interest rates to prevent Japan-style **deflation.**

One of the key drivers to future core inflation is the direction of wage inflation. As workers earn more money, they tend to spend most of it on goods and services. If the amount of goods and services does not grow enough to satisfy consumer demand, prices rise, and higher inflation results.

The Fed Watches Your Wages

The chart above includes price data recorded by the US Bureau of Labor Statistics. The blue line represents annual changes in hourly wages for employees in the private sector. The data spans the last decade from the burst of the housing bubble in 2007 to 2018. The area shaded in gray from 2008 to 2009 represents economic recession.

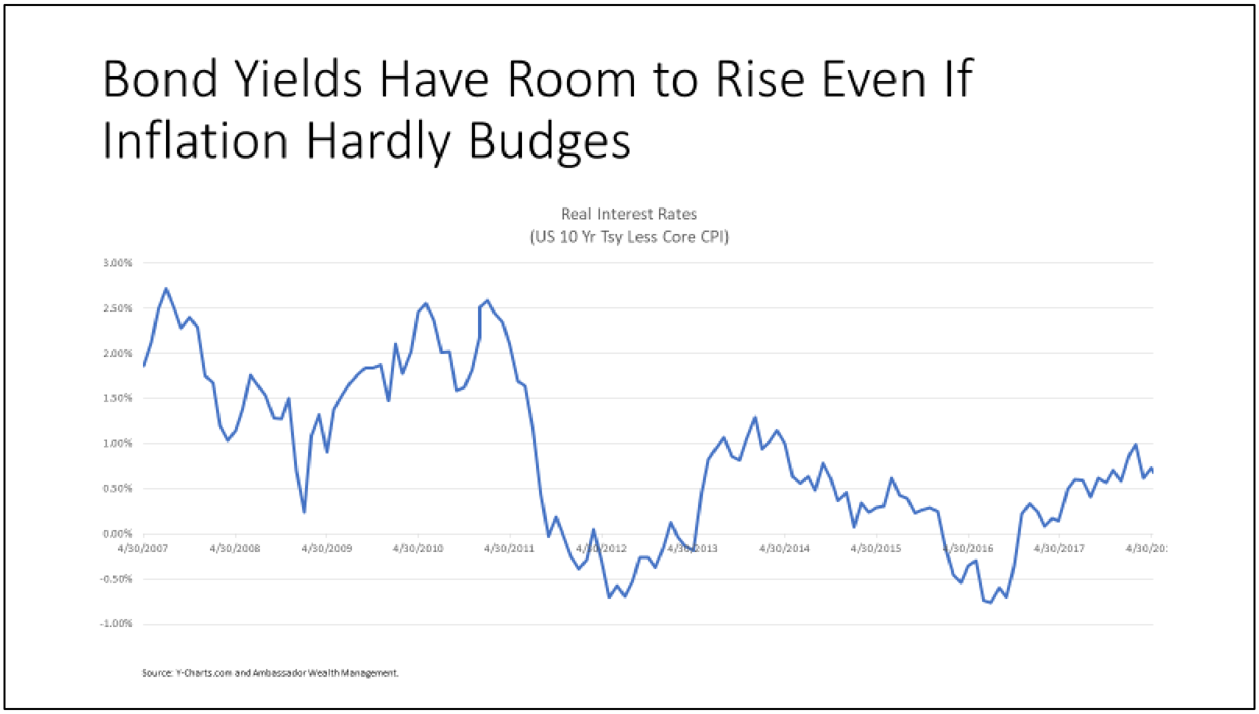
Prior to the housing collapse, wages were rising roughly 3.5% at the peak. Since the Great Recession of 08-09, wage growth decelerated by over 1%. Rising unemployment coupled with job scarcity put pressure on wages. Additionally, workers were forced to leave jobs with higher pay in sectors such as construction, FIRE (Financial and Real Estate), and manufacturing. Consequently, wage growth plummeted in 2012 to a low of 1.5%.

Starting in 2016, however, wages began to recover. The length of the economic recovery has led to some normalization in wage growth. Wage growth has averaged around the mid to high 2's since that time. This is still below the torrid pace prior to 2008.

SOURCE: US BUREAU OF LABOR STATISTICS

Jobs in the construction sector provide one important tale of what has been driving wage growth. Over 2 million construction jobs, or nearly 1 out of 4, vanished in 4 years from 2007 to 2011. Job declines in this labor-intensive industry pressured wages. The anemic jobs recovery has also weighed on wage gains. Construction jobs are still nearly 10% below the levels prior to 2006. However, the scope of job gains has been steady even if unspectacular.

Consequently, wage gains have improved to a 2.7% annual rate, though slightly below the mid 3's prior to recession. Yet, interest rates (adjusted for inflation) are still well below levels prior to the recession.



SOURCE: YCHARTS.COM AND AMBASSADOR WEALTH MANAGEMENT.

The Fed monitors such developments among other things.

Improvement in wage growth might lead to an uptick in inflation.

The Fed might further change its posture of a low interest rate policy and exert upward pressure on rates.

However, there is another critical factor to monitor with regard to wages.

Inflation and Wages: Will Workers Show Up for Work?

Are we on the cusp of labor shortages and wage inflation?

SOURCE: US BUREAU OF LABOR STATISTICS AND YCHARTS.

Wage inflation is a key component to gauging the direction of interest rates.

As workers earn more money, they tend to spend most of it on goods and services. If the amount of goods and services does not grow enough to satisfy consumer demand, prices rise, and higher inflation results.

Higher inflation might lead to higher interest rates and more financial market volatility.

Is this possible in the near future?

(For example, every $4 of $10 of revenue of large companies in the S&P 500 come from overseas, according to Strategas Research.)

Continued robust performance in earnings might help to ignite further gains in stocks. Conversely, any deterioration could take the sizzle off earnings surprises. (Higher oil prices, for example, might help the energy sector, but they can also hurt other sectors of the market, such as consumer stocks in that input costs might rise and thus hurt profit margins.)

More Workers Means Less Wage Pressure

A greater supply of workers available to work means employers feel less pressure to raise wages to retain their workers. One measure of labor supply is the unemployment rate, currently near a cyclical low of 4.1%. One other factor the Fed keys on for gauging future inflation is the labor participation rate. How many people who could work are actually working or seeking jobs?

When the number is high, that suggests more applicants competing for jobs, which might mean wage pressures are low. When the number is low, however, it might suggest the opposite if employer hiring needs keep rising.

Let us look at where we are today in terms of historical trends.

Labor Participation: A Brief History Lesson

The chart above includes data recorded by the US Bureau of Labor Statistics spanning over 70 years from the end of the Second World War to today. "The labor force participation rate. This measure is the number of people in the labor force as a percentage of the civilian noninstitutional population 16 years old and over. In other words, it is **the percentage of the population that is either working or actively seeking work**."[iii]

Labor participation has changed over time. The all-time low was 58% in 1954. The record high rate of labor participation was 67% in 2000. Labor participation tends to trend in the same direction for many years.

Many reasons account for why workers show up in the labor force more often than less.

Demographics play a key role. For example, a major driver of the rise in labor force participation from 1954 to 2000 was driven by women entering the labor force. Many married women went from being full-time homemakers to part-time or full-time workers.

The ethic of many Baby Boomers to work also contributed to strong participation growth among young workers during this time period.

Economic cycles also play a significant role. A growing economy contributed to higher labor participation from the 1960's to the beginning of the 21st century.

Less robust economic activity with dimmer job prospects pushed down labor participation since 2000.

Indeed, labor participation declined dramatically from 67% in the year 2000 to current levels of around 63%. This fall accelerated more noticeably after the Great Recession of 2008.

The aging of the US population has played a role in lower labor participation. For instance, the US Census cites the median age of Americans as rising from 35.3 years old in 2000 to 37.9 years in 2016.[iv] Pew Research calculates that 10,000 Baby Boomers in the US turn 65 every day from now until 2019.[v]

Combining the Great Recession and diminished job prospects with aging demographics might account for a sizable part of the decline in labor participation among older workers. Rather than looking for a new job late in their careers, some older workers simply retired.

The Great Recession also took a toll on younger workers. Labor participation swooned dramatically for workers aged 16 to 25. One factor has been poor job prospects for young people without a college degree. Another factor has been discouraged young workers who chose or were forced to stay or move back in with parents.

Yet, the Federal Reserve Bank of St. Louis gives some reason for hope in more young workers returning to work. Their research suggests many young people opted to stay in school longer.[vi]

If jobs are available for these future graduates, that potentially might help the participation rate to rise once school is over.

Jobs recoveries in past history result in more workers looking for work. More job seekers might suggest tame wage pressures.

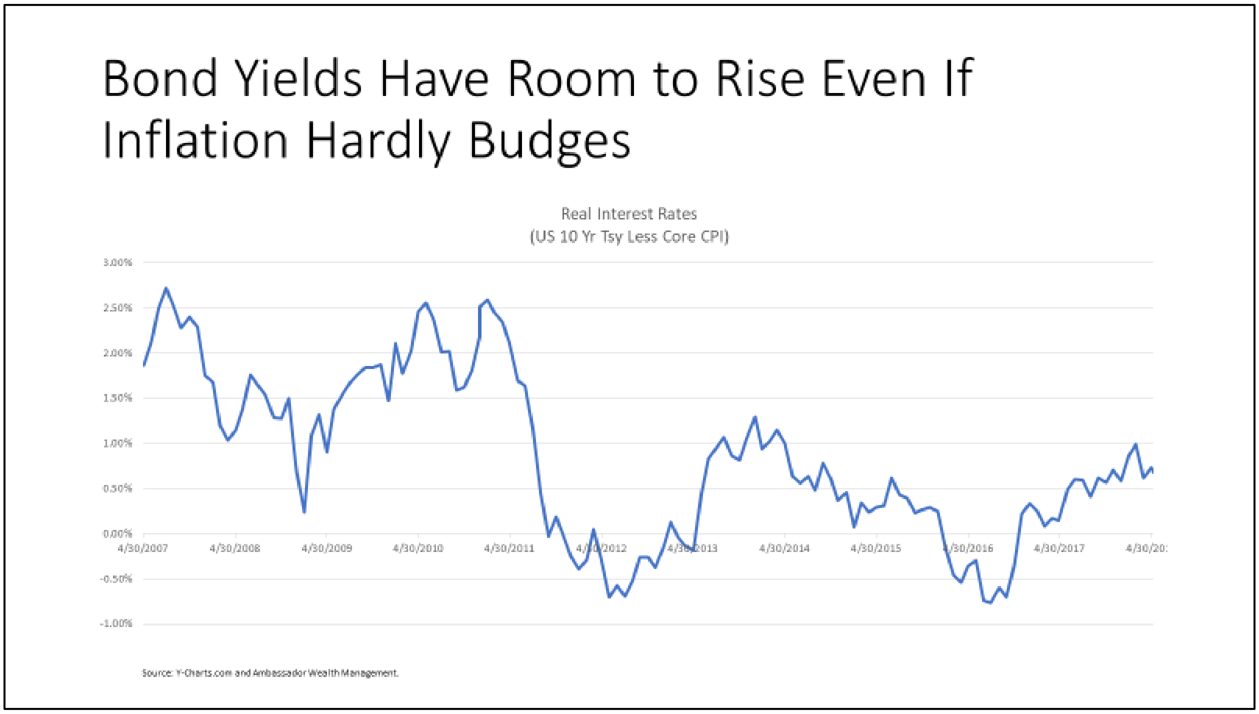
We believe it appears a close call whether we see wholescale wage pressures soon or not. The outflow of older workers reduces supply; however, an influx of younger workers in many professions tend to earn less than their more experienced peers. That might suggest a more stable wage outlook net.

The fate of this question might have big implications for future interest rates and their impact on your investments.

Inflation and Bonds: Toast of the Town or Simply Toast?

Bonds have treated investors very well for the last two decades. Inflation has been hard to find.

Is this about to change?



Source: YCharts and Ambassador Wealth Management.

Up until this year, long term US Treasury yields were the "toast of the town" for a long while. Going back three decades, bond yields for the most part have declined (and prices risen). Bond yields touched new multi-decade lows even after the trough of the Great Recession in 2008.

Have bond investors enjoyed too much of a good thing?

Today, bond yields appear too low, even if inflation behaves. If inflation were to rear its ugly head, then bonds could be "toast".

Let us see why.

“Real” vs. “Nominal” Bond Yields

The chart above examines yields on US Treasury bonds maturing in 10 years – with a twist.

Traditional charts display prices in **nominal terms**. For example, an investor buying a US Treasury Bond with the intent to hold it to maturity in 10 years, the investor would receive interest of around 3.1% per year. (Of course, this does not take into account any fluctuations in price from market volatility. This is why bond investors should focus on total return, price return plus yield, and not just yield.)

However, many bond investors also look at bonds in terms of **real returns.** Real returns consider how the income an investor receives tomorrow is impacted by the prices that investor will pay to support his or her lifestyle (or fund someone else’s liability). In other words, take the nominal yield and subtract annual inflation to calculate the bond yield in real terms.

The chart above shows yields on US Treasury bonds with maturities of 10 years in **real terms**. (Sometimes, this presentation of bond yields is referred to as **“real bond yields”**.) The rate of annual inflation is “core inflation” excluding food and energy. This index is published monthly by the US Bureau of Labor Statistics.

Nominal yields have risen from roughly 2.5% last summer to 3.1%. Yet, when we look at bond yields in **real terms**, the increase appears quite modest (and yields quite low), even compared to recent history.

Currently, real yields are at 0.6%. In other words, investing in the 10-Year Treasury would yield an investor income growing 0.6% above inflation (assuming it stayed constant). **That seems low**.

Only 7 years ago in 2010, investors could have earned real yields as high as 2.5% above inflation. That was a time where the Fed was not hiking interest rates. Markets worried about the duration and sustainability of economic growth. (Even some questioned whether the US was really in as bad shape as **Japan 2 decades ago**.)

Today is a different story. The Fed is entering its third year of tightening. The economy is entering the second longest duration of recovery in recorded US history. (Of course, the size of the recovery is also weak by historic standards.) Inflation might also be ticking upward (and certainly not negative, which was the fear only 7 years ago).

What is the conclusion? Real bond yields might potentially have room to move up, even if we just look at recent history. Even if core inflation stays tame, simply the premium on nominal yields to inflation could simply rise toward 2.5% from current levels. Keep in mind that the Fed has begun to shed some of the bonds it bought in earlier, multiple bond-buying sprees of Quantitative Easing less than a decade ago.

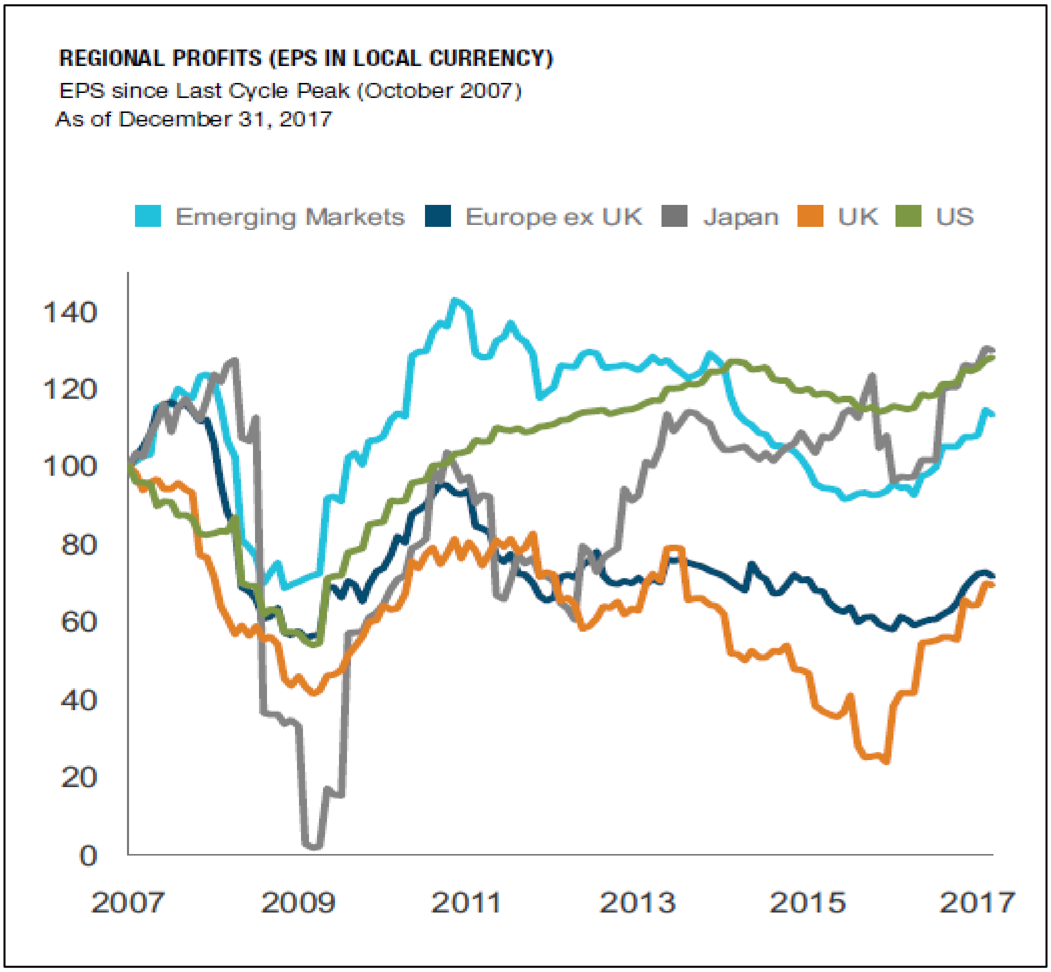
If inflation ticked upward, that could put additional pressure on long duration bonds.

Bond investors might be in for interesting times ahead…

Japan: The Sun Also Rises?

One of the least loved stock market ideas in the world might be Japan. Our hunch is that you have heard more about Bitcoin than Japan for an investment thesis.

Does Japan deserve to remain in the doghouse?



Source: FactSet and T. Rowe Price.

Japan has been a dull market so far this year after posting a solid gain in 2017.

Japanese companies posted solid earnings due to demand from export markets as well as incremental improvements in corporate governance and continued low interest rates. Financial markets appreciated that fact and propelled emerging markets to a gain of over 22% in 2017.[vii]

However, 2018 has been a much less exciting year for Japanese stocks. Nearly six months after the solid rally in 2017, Japan is essentially flat in US Dollar terms.

Corporate profits remain solid, but concerns over the strength of the Japanese Yen from last year have restrained sentiment on future growth in profits. (Over two thirds of public company profits as measured by the iShares MSCI Japan ETF come from outside Japan.) Concerns on whether current Prime Minister Abe will remain in power have also played a role in lackluster performance. Questions on global growth in light of recent US protectionist measures might also be a risk.

Even with these issues, Japan might still offer attractive investment characteristics. This might be the case especially in the current scenario of moderate global growth with various assets "long in the tooth" in terms of their bull markets.

Japan – High Corporate Profits, But Less Investor Love?

The chart above compares public company profits across a range of markets.

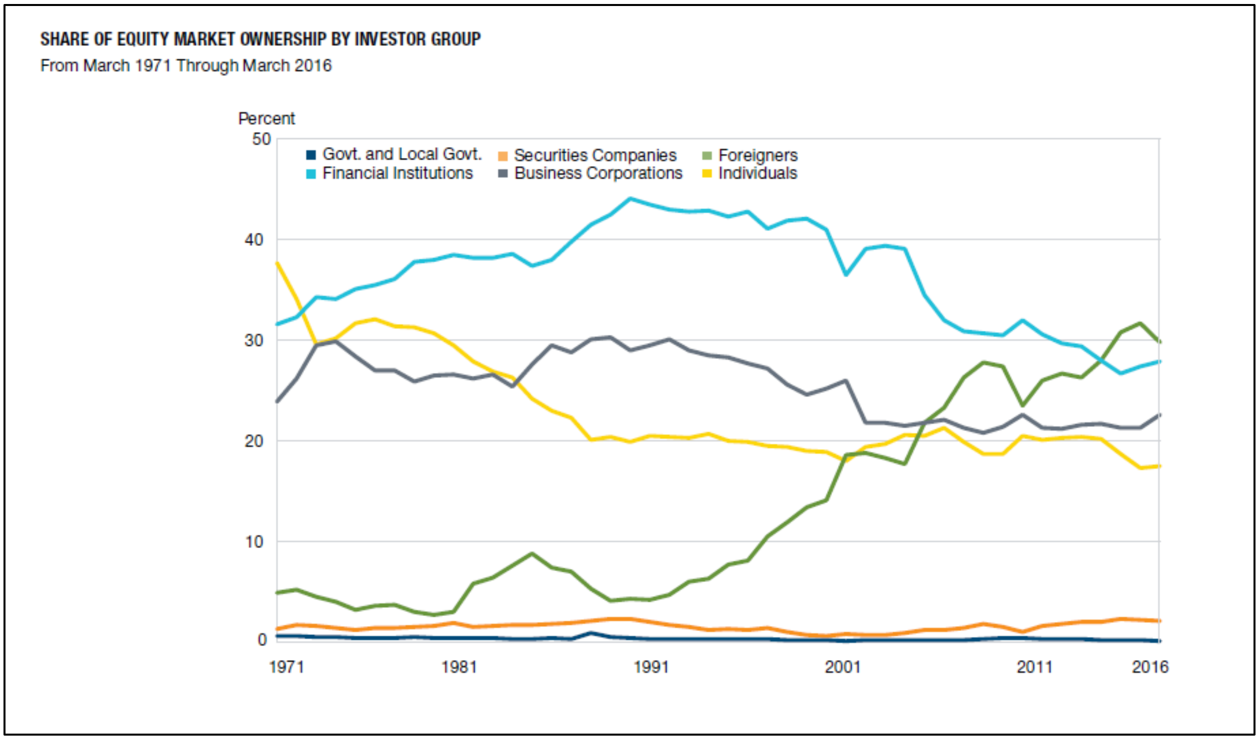
Data recorded by Factset and T. Rowe Price tracks corporate profits across major companies around the world. The lines begin at 2007, the year before the Global Financial Crisis of 2008 which triggered recession in many economies around the world. Hence, profit levels as of 2007 are considered the prior "peak" for global companies.

The extent to which a line moves above the levels of profits for 2007 indicates a new higher level of "peak" profits. Various colored lines represent different regions of the world. The green line represents US companies. The gray line represents Japanese companies. Light blue shows emerging market corporate profits, while the dark blue represents European companies.

Japan nearly ties the US in terms of achieving record profits. This contrasts with Europe, which remains well below profits even of 2011, when the Greek debt crisis reared its ugly head and resulted in major profit dilution for most European banks.

Part of the recovery in Japanese corporate profits stems from currency depreciation. When the Japanese Yen falls relative to the US Dollar, profits earned overseas rise for Japanese companies due to currency translation effects.

However, other factors might also be at work. Improving corporate governance is one.



Source: Tokyo Stock Exchange and T. Rowe Price.

Up until the early 1990's, Japanese banks increased their ownership of publicly-traded companies from 30% to nearly 50%, according to the Tokyo Stock exchange. Up until the eve of the Global Financial Crisis, banks still owned nearly 40% of Japanese companies. This proved to be an overhang for corporates:

1. Japanese banks held shares not because they believed in the share appreciation potential of companies. Rather, they were part of a cross-shareholding system whereby corporates and banks would hold shares in each other. Managements of banks were less reluctant to dispose of managements in their corporate shareholdings. With a credo of lifetime employment, this lead to stagnation in economic innovation and a brake for growth in corporate profits.

2. Bank stakes in Japanese corporations were also rationalized as a hedge against credit losses on loans by the banks to these corporations. The so-called "keiretsu" structure incented company managements to hoard excess cash on balance sheet, even if it meant denying shareholders of rewards from potential dividends and share buybacks. This also depressed profitability, given a depressed level of interest rates.

However, the gradual unwinding of corporate stock ownership by banks was accelerated with the ascent of current Prime Minister Shinzo Abe in 2013. Along with a dramatic change in central bank monetary policy, he encouraged private companies to improve their corporate governance.

Consequently, as banks and corporations unwound their "keiretsu" cross-shareholding structures, Japanese companies now had to find other supporters for their shares. An increasing share of companies raised dividends and started stock buyback programs to garner shareholder support for their stock. A number of corporate boards began to invite outside directors that allowed for third-party activist shareholders to press for further change.

The extent to which these trends can continue might help Japanese companies to improve their profitability and remain attractive investments.

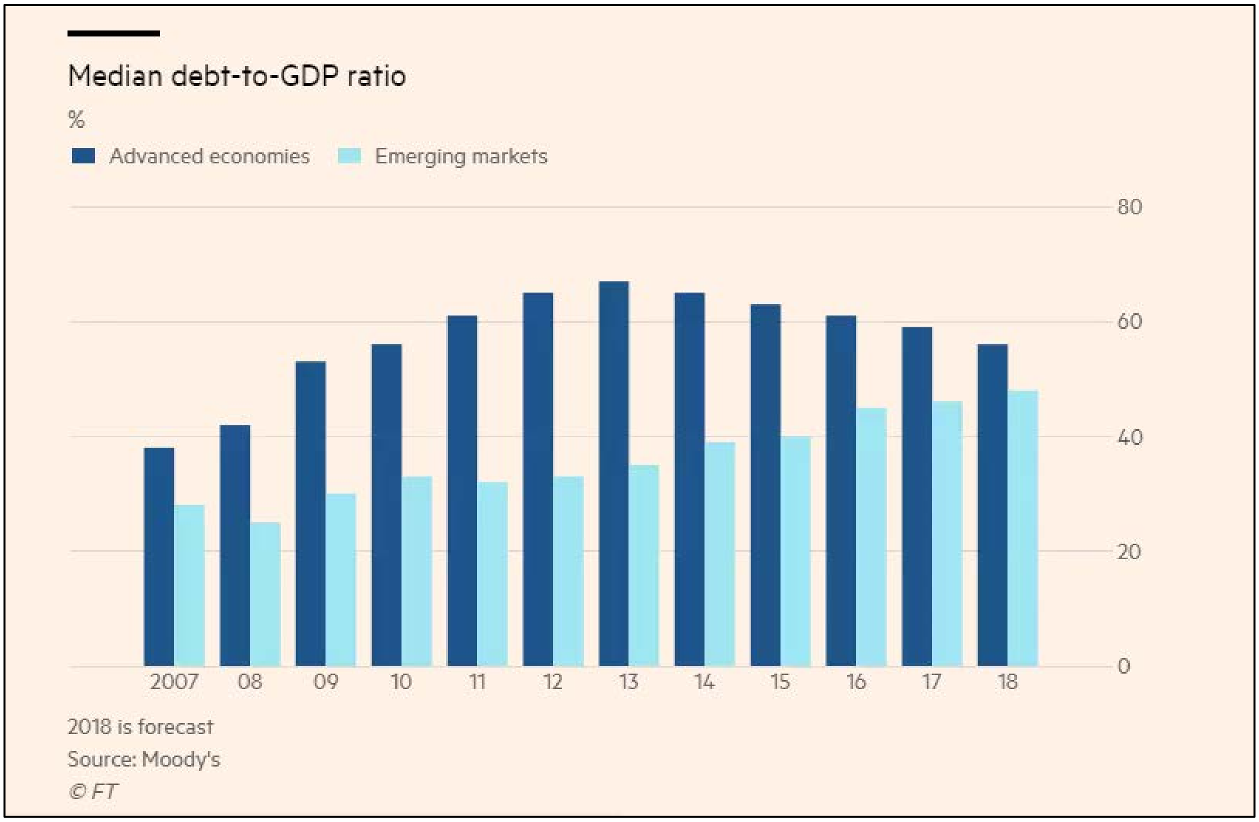
> *"Try not to become a man of success, but rather try to become a man of value."*

- Albert Einstein

Emerging Markets: Debt Still Rising

Emerging markets had a banner year in 2017. The last six months has treated them less kindly.

Can superior economic growth overcome rising debt in emerging markets?



Source: Moody's and Financial Times. https://www.ft.com/content/efe21772-5767-11e8-bdb7-f6677d2e1ce8 accessed on June 18, 2018.

Emerging markets[viii] have stumbled thus far in 2018 after enjoying solid appreciation in 2017.

Stated economic growth in places like China and India remains well above that of developed economies. Financial markets appreciated that fact and propelled emerging markets to a gain of over 45% in 2017.[ix]

However, 2018 has been a rockier story for emerging markets. Nearly six months after the solid rally in 2017, emerging markets have declined roughly -4%.

Several reasons include fears of capital outflows following the US Federal Reserve's intentions to keep raising interest rates in 2018. Threats of further tariffs by the US on China also have caused concerns over deterioration in emerging market growth rates. Political unrest in Brazil has also weighed on sentiment.

However, the biggest potential overhang to emerging markets might be debt.

Emerging Market Debt Rising with Growth – What Gives?

The chart above compares total government debt in emerging markets vs. developed economies.

Moody's, a global debt rating agency, tracks the level of national debt (akin to Treasury bonds in the US) relative to Gross Domestic Product (the level of economic output for a given country). Averages are then computed for both emerging markets (the light blue bars) vs. developed (the dark bars).

A couple of trends bear watching:

(1) Emerging markets have lower debt to GDP than developed markets. This trend has been in place since 2007, the eve of the Global Financial Crisis. There is a big "but".

(2) But emerging market levels have closed the gap with developed markets. While developed markets witnessed a decline in debt since the peak in 2013, emerging markets have actually grown consistently since 2007. The gap has narrowed from roughly 30% in 2013 to only 10% in 2018. This is notable given the gap in interest costs emerging markets pay relative to developed markets.

A growing debt to GDP ratio implies that economic growth is dependent upon debt issuance. Debt issuance, particularly in emerging markets, can be a fickle source of funding growth. Flows of capital into emerging market debt has been historically volatile. Interest rates can rise sharply if foreign outflows were to occur. Because the size of emerging market debt markets is much smaller and less liquid than in developed markets, interest rates can spike more sharply if investors were to pull out capital. Spikes in interest rates can depress future economic growth.

Developed countries in Europe and the US were most affected by the 2008 Financial Crisis. In efforts to prop up their economies and save their banking systems, central banks and governments collaborated to inject money into their economies. Consequently, many developed countries suffered from rising debt to GDP levels. As economic growth has returned, debt to GDP has started to decline.

In contrast, debt to GDP in emerging markets has risen despite economic growth. One factor is China, where fiscal deficits and other stimulus attempted to prop up high growth rates. Question exists as to when and how much will growth in China slow. China cannot continue its rate of debt expansion. Other economies in Asia and Latin America also experienced growth in fiscal spending and domestic credit expansions. The idea was this stimulus would offset declining growth in world trade. Unfortunately, emerging markets might now have entered a phase where they have less ammunition to confront a global environment of rising interest rates and positive, but not spectacular, global growth.

Growth and interest rates are the key factors to watch for emerging markets.

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[i] See "Fighting Deflation in the U.S. and Japan", National Bureau of Economic Research on http://www.nber.org/digest/jun05/w10938.html accessed on May 18, 2018.
[ii] See "Fed's Kaplan sees US inflation rising but not 'running away'", CNBC.com, May 15, 2018 on https://www.cnbc.com/2018/05/15/feds-kaplan-sees-us-inflation-rising-but-not-running-away.html accessed on May 18, 2018.
[iii] "How the Government Measures Unemployment – Bureau of Labor Statistics", https://www.bls.gov/cps/cps_htgm.htm accessed on May 22, 2018.
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[vi] Maria E. Cannon, Marianna Kudlyak, and Yang Liu, "Youth Labor Force Participation Continues to Fall, but It Might Be for a Good Reason", Federal Reserve Bank of St. Louis, January 2015 on https://www.stlouisfed.org/publications/regional-economist/january-2015/youth-labor-force accessed on May 22, 2018.
[vii] As measured by the return in the iShares Japan ETF (symbol: EWJ).
[viii] For a definition, see Kimberly Amadeo, "What Are Emerging Markets? Five Defining Characteristics", March 22, 2018, the balance on https://www.thebalance.com/what-are-emerging-markets-3305927 accessed on June 18, 2018.
[ix] As measured by the return in the iShares Core Emerging Markets ETF (symbol: IEMG).

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