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• One Man's Opinions – Fall 2013

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The stock market has recently climbed to new highs. Since then it has backed off a couple of percent, digesting its substantial gains of the past ten months. At its peak we were up approximately 20% so far this year, a very good rally. We have probably seen most of the gains for 2013. But I expect higher stock prices by year end and into 2014. I remain optimistic for long term holders of U.S. stocks as our economy finally picks up more momentum. There are a number of reasons for my optimism. Let us look at some of them.

Demographics: The immigration debate in Washington is not about throwing illegal immigrants out; it is about how to give them some sort of legal status and a path to citizenship while still legally attracting highly educated and skilled newcomers. Only Canada, Australia, and a few others are as open as we are to immigration. Immigrants keep our population growing. Because of aging populations and low fertility rates in all the major countries, immigrants are needed to replace us old timers as we pass on. The U.S. working age population is projected to rise about 2 million per year, which should produce 1.4 million new job seekers. This is about the same growth as is projected for labor demand; which would allow a return to our long term Gross National Product historic growth of 3.5%.

Entrepreneurial Spirit: The American entrepreneurial spirit, observed by European scholars as far back as the early 1800s, is unique and far ahead of other major countries. It starts with our universal educational system which, for all its faults, encourages free inquiry and the challenging of accepted doctrines and practices. Remember, back in the late 19th century the head of the U.S. Patent office recommended closing down his bureaucracy because he believed all possible worthwhile inventions were already in existence. Among many other things, this spirit has driven oil and gas production in the U.S. ever higher, creating a global energy supply cushion. This gives us a huge advantage over other major countries, especially China and Japan.

Labor Flexibility: Improving U.S flexible labor markets are another major advantage. U.S. wages are flexible on the downside, as 33% of our people who were unemployed for more than six months go back to work for less money than they formerly earned. This factor is unheard of in Europe and lifetime employment is the rule in Japan. China is increasing its minimum wage 25% per year to provide more consumer spending as it strives to shift more to more reliance on domestic demand

Less Reliance on Foreign Financing: There has been a sharp decline in the need for foreign financing of our government, business, and individual debt to balance deficits. On balance the United States should soon meet most of its internal needs here at home. The Federal Reserve Board is creating almost unlimited dollars to allow banks to finance any foreseeable deficits.

Strong Dollar: The U.S. dollars remains the reserve currency of choice world wide. If our current trade deficits disappeared completely, many Asian, Latin American, and other trading partners would be in severe trouble trying to use their own currencies in international trade. As long as developing countries remain exporters on balance, our dollar should remain their main reserve currency. Switching elsewhere would be difficult, even for China.

Since ancient times dominant global currencies have had six characteristics in common. Right now the U.S. dollar looks likely remain the winner in five of these six. They are:

1. Rapid growth in their economy and Gross National Product per capita, driven by solid productivity growth. This is probably the most necessary condition for a currency to dominate international trade as the primary reserve currency. In the 19th century the British pound occupied this position. Since World War I our dollar has reigned supreme. It is also necessary for the dominant country to support a globally dominant military structure while satisfying its citizens with acceptable and growing standards of living.

2. A comparatively large economy, preferably the world's biggest. This was true of Rome 2000 years ago, which had an unusually effective administration and centralized control. This was largely because of the Roman army which dominated the civilized part of the world with brutal control and effectiveness as necessary to grow its economy. During and after the dark ages we saw less important dominant smaller countries, like the Italian city-states, Portugal, Holland, and Spain, providing their currencies to enable international trade.

3. In modern times, deep and broad financial markets are necessary. Money can be, and is, transferred anywhere on earth in a split second. It wants to be where the action is. This requires not only a powerful and large economy but also deep and broad markets in which to invest. The U.S. trumps all others in this regard. As proof just look at the mad rush into U.S. treasury bonds when the Panic of 2008 hit the developed world.

   In spite of journalists frequent warnings of how China will soon overtake us, the numbers they point to are per capita numbers, not absolute ones. Our economy is in fact, four times larger than those of China, Japan, or the U.K. and we are three times larger than the entire euro zone. For example the Euro commands only 24% of world reserve currency reserves now versus 29% five years ago. The U.S. dollar commands 62%.

4. Free and open financial markets and domestic economies are necessary for foreign investors to be willing to hold currencies which they are convinced they can invest their financial or tangible assets with few restrictions. Such free and open markets persist here, less so in Europe and not much in China, whose currency only ranks 13th in the world in international transactions

5. A lack of competitive substitutes for these attributes is necessary for a primal global currency. A currency loses primacy when its issuer relaxes its efforts and allows upstarts to surpass it in productivity growth and, ultimately, surpass it in GDP per capita or per employee. This is how the Dutch lost out to England in the 1700s (the English Channel helped), and the Brits lost out to the U.S. a little more than a century later. World War II finished the job and most of the British Empire disappeared.

6. These days the value of a reserve currency internationally is vital. This requires a country to demonstrate credibility since money is notoriously liquid and cautious. It will instantly run from uncertainty over risks of confiscation, debasement, and out of control governments. Here the U.S. has lost ground these past 30 years as the dollar has declined over 75% in value due to inflation. But competing currencies have also suffered the same fate or worse. The current outlook is for relative strength in the dollar as our current account deficit continues to decline and U.S. production becomes more competitive and our energy needs

become satisfied domestically. The relative outlook for the U.S. dollar appears to look stronger and stronger as our economy limps its way to a more normal speed again.

The near term stock market outlook remains positive. I believe stocks have still more room on the upside next year. Here are some of the things that will help this become a reality.

1. Our fiscal drag is largely behind us. Tax increases and sequester cuts faced us last January. These cost the country approximately 1.75% in nominal Gross National Product growth. There will be much less of a drag from this source in 2014.

2. We are now five years removed from the financial “Crisis of 2008-09.” The public, banks, and corporations have paid down their debt and de-levered, leaving less risk in the economy. This is normal in the first five years after a severe crisis. These years involve crisis, a hesitant public, cautious private businesses, and substantial cash buildup in public companies. Beyond five years we can expect the economic expansion to pick up some speed. We are approaching this phase now. It is especially evident in housing, which is rebounding from a very deep recession.

3. The public is feeling better these days and consumer optimism is getting stronger. Homes are selling and home prices are up. This, along with strong stock market gains, has added significantly to household net worth, which continues to rebound.

4. As business owners and executives see sales continuing to expand they are very likely to pick up capital spending. This year a 2.25% increase in capital spending appears likely, but forecasters are calling for six percent in 2014 and in 2015. Uncertainty about our government leadership and it policies have diminished as this year wears on and we somehow manage to stumble through one Washington crisis after another. The record levels of corporate cash sitting idle in company coffers should be used for more capital spending in coming months.

5. Where else is the public going to invest their increasing savings if not in the stock market? Bond yields are still very low thanks to the Federal Reserve and its policies. Risks to investors in bonds of more than a few years maturity remain very high and appear to be almost inevitable. Real estate is stronger, especially in housing where there is plenty of mortgage money available. But money to finance other real estate purchases is still very tight. Real estate purchases normally use borrowed money to enhance yields from purchased properties. These type loans are still being discouraged by bank regulators.

6. U.S. stocks are mostly fairly valued, especially compared to foreign stocks, many of which are just now reviving from recession. Price to earnings ratios remain below historic levels, while the outlook for moderate U.S. earnings increases in the next few years ahead seems likely.

7. The U.S. dollar, in spite of, or perhaps because of, its performance in recent years remains the world’s strongest currency. More so by comparison with competing currencies rather than because of any superior management by U.S. leaders.

Wise investors look for good value whenever and wherever it can be found. For now, quality U.S. stocks and multi-national stocks operating extensively here offer safer havens for investment dollars, than finding them in more tumultuous countries.

Please call 317-571-1112 with any questions or comments.

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