The MONARCH GROUP of RAYMOND JAMES®

# Point of View

## Economy – Markets – Investment Strategy

## November 2016

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Gross Domestic Product (GDP) is the annual market value of all goods and services produced domestically by the US.

The ISM Manufacturing Index is made up of over 300 manufacturing firms and monitors their employment, inventories, orders, and deliveries.

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# Important Information

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## Mules, Pachyderms & Markets

Since 1953, the S&P 500 index has averaged 22% gains in each of 10 terms under Republican presidents, and 46% under the eight terms of presidents who were Democrats. [The S&P composite index expanded from 90 stocks to 500 stocks in 1957.]

| President | Party | Term | Inauguration date | S&P 500 close | Gain* |
|---|---|---|---|---|---|
| Eisenhower | R | 1 | 1/20/53 | 26.14 | 70% |
| | | 2 | 1/21/57 | 44.4 | 29% |
| Kennedy | D | | 1/20/61 | 59.77 | 17% |
| Johnson | D | 1 | 11/22/63 | 69.74 | 24% |
| | | 2 | 1/20/65 | 86.6 | 17% |
| Nixon | R | 1 | 1/20/69 | 101.69 | 17% |
| | | 2 | 1/20/73 | 118.78 | -32% |
| Ford | R | | 8/9/74 | 80.86 | 27% |
| Carter | D | | 1/20/77 | 102.97 | 28% |
| Reagan | R | 1 | 1/20/81 | 131.65 | 33% |
| | | 2 | 1/21/85 | 175.23 | 64% |
| Bush | R | | 1/20/89 | 286.63 | 51% |
| Clinton | D | 1 | 1/20/93 | 433.37 | 79% |
| | | 2 | 1/20/97 | 776.7 | 73% |
| Bush | R | 1 | 1/20/01 | 1342.54 | -12% |
| | | 2 | 1/20/05 | 1175.41 | -31% |
| Obama | D | 1 | 1/20/09 | 805.22 | 85% |
| | | 2 | 1/21/13 | 1485.98 | 41%** |

*Gain calculated between inauguration dates

**Gain calculated from inauguration date to 11/2/16 close

**INVESTOR'S CORNER**

# The New President And Stocks: Does It Matter Who's Elected?

**BY ALAN R. ELLIOTT**
INVESTOR'S BUSINESS DAILY

If there is one thing the stock market does not like, it is unpredictability. And few periods of time have been less predictable than this year's presidential race.

So how much of a difference does a president make? Arguments vary. So do presidencies. The office of George W. Bush, in particular, felt the impact of the unwinding tech, telecom and power-generation booms, followed by the 9/11 attacks and, later, the housing and financial system meltdowns. The result: The S&P 500 declined more than 40% across his two terms.

Upheaval and tragedy don't always instantly translate into market declines. The S&P 500 only took a one-day dive after John F. Kennedy was assassinated on Nov. 22, 1963. It rebounded within a day and rose 24% during Lyndon Johnson's two-year first term.

When Richard Nixon's administration unraveled in 1973-74, the sloppy meltdown left the S&P 500 down 31% across Nixon's 18-month second term.

The index snapped back and rose 27% under Gerald Ford, then added 28% during the rocky single-term presidency of Jimmy Carter.

The S&P 500 advanced 118% across the two terms of both Gen. Dwight Eisenhower and Gov. Ronald Reagan. Another governor and two-term president, William J. Clinton, saw the S&P 500 gain 210% on his watch. The S&P 500 is up 161% so far under Barack Obama's two terms.

Over the past 18 presidential terms, the S&P 500 has declined three times. The average decline across those three terms, 25%, is far smaller than the average gain of 44% across the 15 rising terms.

My opinion:

Real, material policy change happens at a pretty glacial pace here in our democratic system of checks and balances, despite all of the heat around election rhetoric.

The stock market moves on corporate earnings, which move on the economic cycle. The economy has a fundamental engine of growth which, left unimpeded by the Fed, will drive earnings steadily higher.

The Fed is still a substantial ways away from actually trying to engineer an economic slowdown.

Bottom line: there's no reason to think the current economic expansion and rising stock market trend don't have a good deal further to run.

Source: *Investor's Business Daily,* November 7, 2016.

# Tax Relief Is Likely No Matter Who Wins

No matter the outcome of Tuesday's election, American companies with substantial overseas earnings, and their investors, could emerge as big winners.

Corporate-tax overhaul that would make it easier for U.S. firms to repatriate foreign earnings has emerged as a rare issue of bipartisan consensus in Washington. Progress on this issue is possible no matter who controls the White House and Congress next year. Investors in big, widely held companies like **Apple** Inc. would stand to benefit.

Under current law, American companies with overseas earnings pay no U.S. federal tax on these profits unless and until they repatriate the money, at which time they pay the relatively high corporate tax rate of 35%. This creates a perverse incentive for U.S. companies to house money abroad rather than reinvest it at home.

Republican candidate Donald Trump has proposed that past earnings stashed abroad could be repatriated at a special rate of just 10%. Republicans in the House of Representatives have an even more generous proposal that would allow repatriation of accumulated foreign earnings at a rate of just 3.5% to 8.75%. They also would change the basis of tax law such that much revenue earned overseas wouldn't be taxed at all going forward.

Hillary Clinton hasn't made any specific proposals on how to tax overseas earnings. Nonetheless, there is substantial scope for bipartisan agreement on this issue.

Even in a divided-government scenario, for example with Mrs. Clinton as president and a Republican-controlled Congress, it seems likely that companies can look forward to a one-time break on repatriated earnings and a lower tax rate on foreign earnings going forward.

The last time there was such a repatriation tax holiday was in a law passed in 2004, and the effects were significant. Companies brought home $299 billion of overseas earnings in 2005, up from $82 billion the previous year, according to the Bureau of Economic Analysis. That level hasn't been reached in any year since.

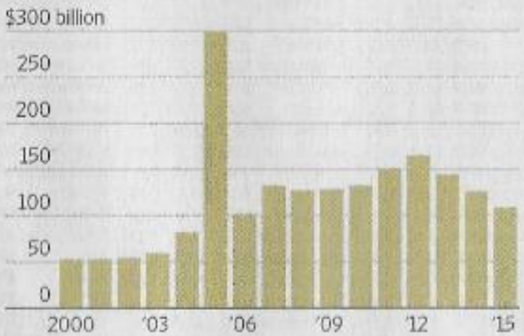
A similar tax holiday now, and a settlement on how to treat foreign earnings in the future, would disproportionately benefit American companies with big global operations. This includes technology companies like Apple, which has $92 billion of earnings invested overseas and gets almost two-thirds of its revenue from outside the U.S., according to Goldman.

**General Electric** has $104 billion stashed abroad and derives 55% of sales from overseas. Other likely winners include oil majors like **Exxon Mobil** Corp. and consumer giants like **PepsiCo**.

It has been a long and dispiriting campaign season. But as it draws to a close, investors in some of America's top companies can look forward to at least one positive outcome. *—Aaron Back*

**Bringing It Home**

Overseas earnings repatriated by U.S. companies. Repatriations surged in 2005 due to a one-time tax holiday.




Source: Commerce Department THE WALL STREET JOURNAL.

STEPHEN VOSS FOR THE WALL STREET JOURNAL

The Treasury building in Washington

One bit of good, bipartisan, news.

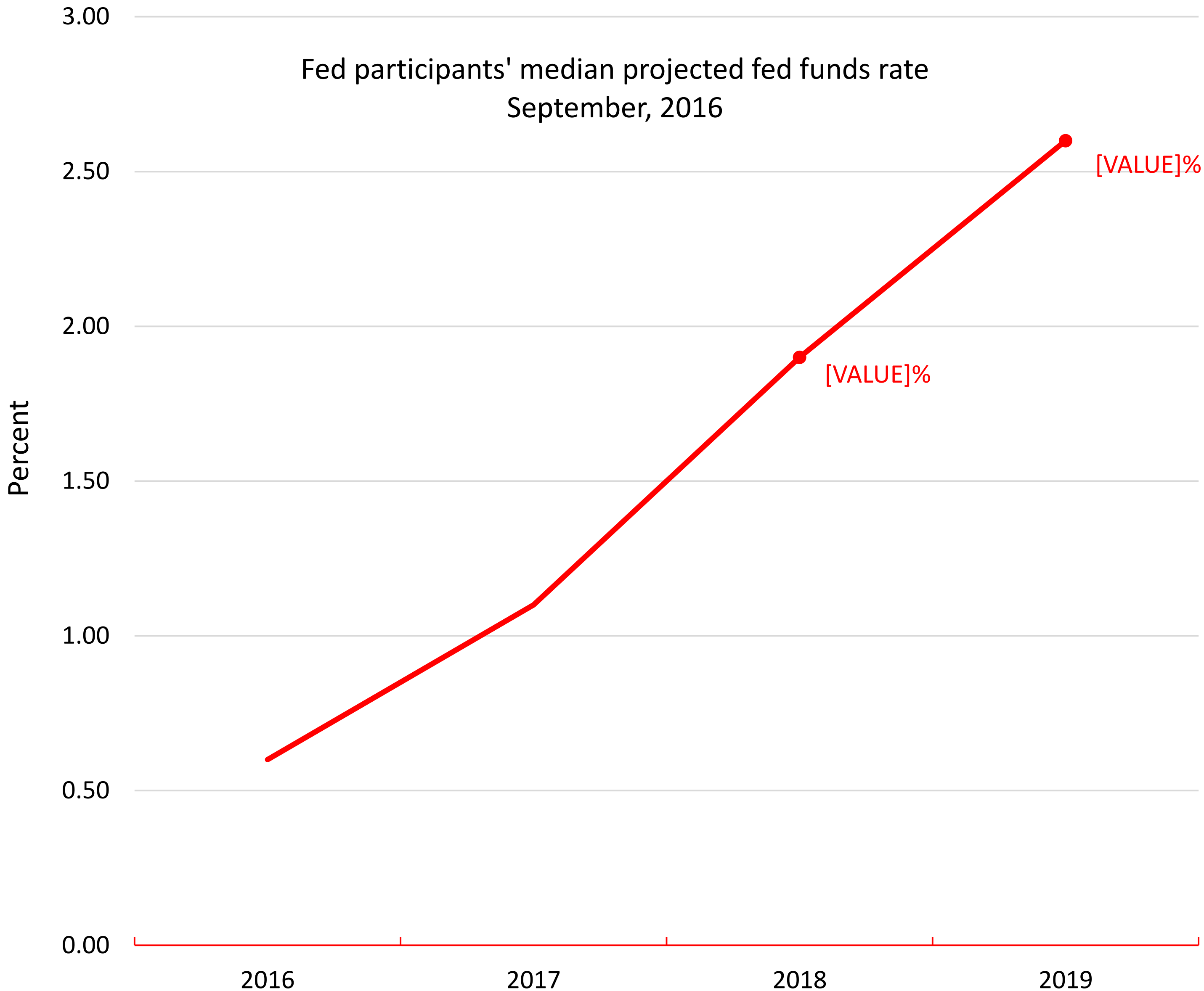


Source: *The Wall Street Journal*, November 8, 2016.

# Fed policy

- twin mandate points to continued dovish policy
- the Fed manages the yield curve
- the Fed has created every recession since the 1950s
- the Fed is constrained by ECB policy
- hysteresis and a “high pressure economy”
- labor force participation rate may be maxed out

# Fed funds rate – projected "normalization"



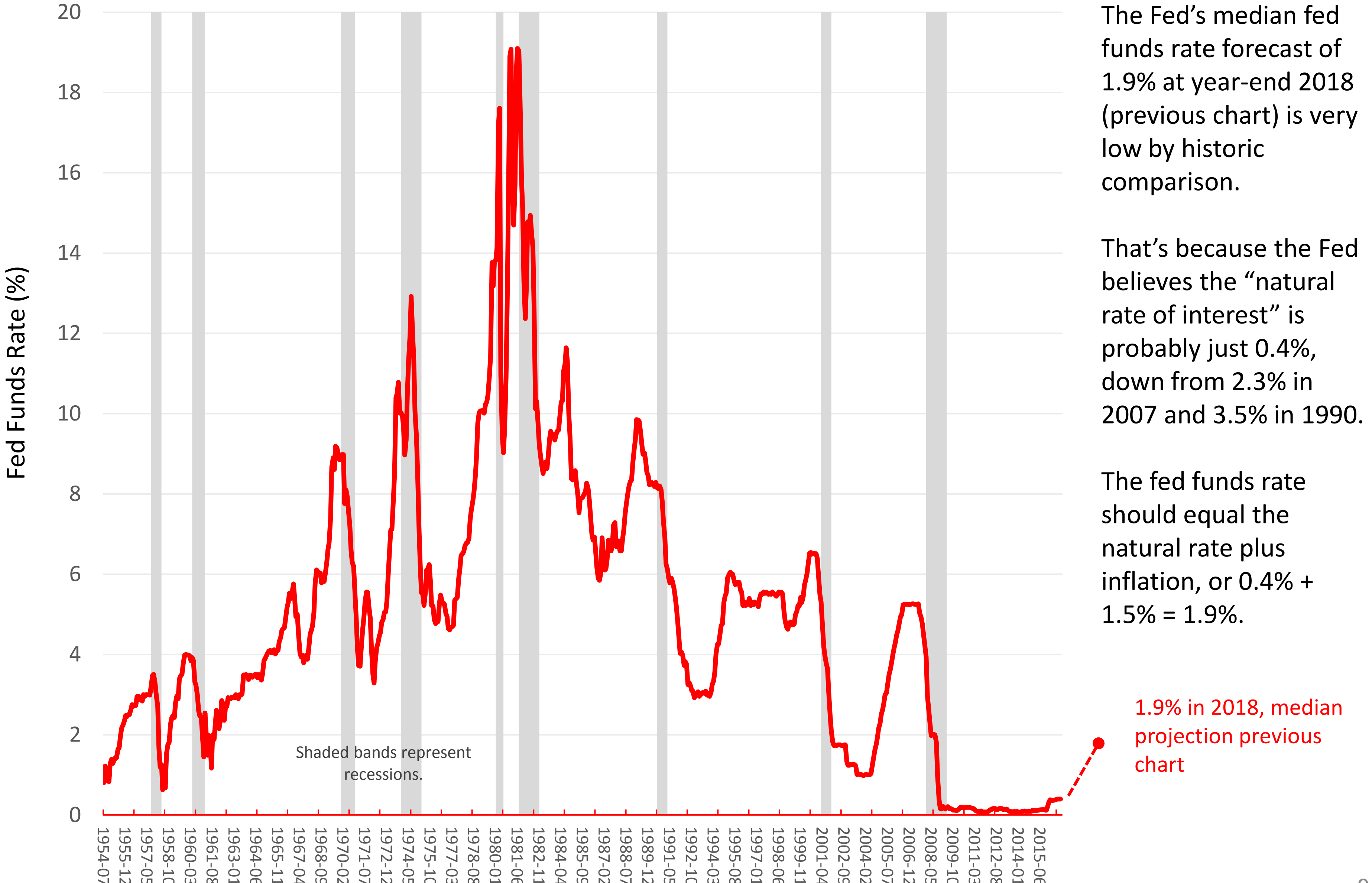

"Our ability to predict how the federal funds rate will evolve over time is quite limited because monetary policy will need to respond to whatever disturbances might buffet the economy."

Chair Janet Yellen
Jackson Hole
August 26, 2016



Source: Federal Reserve, September 21, 2016.

# Fed funds rate




Source: Federal Reserve. Data through October 2016.

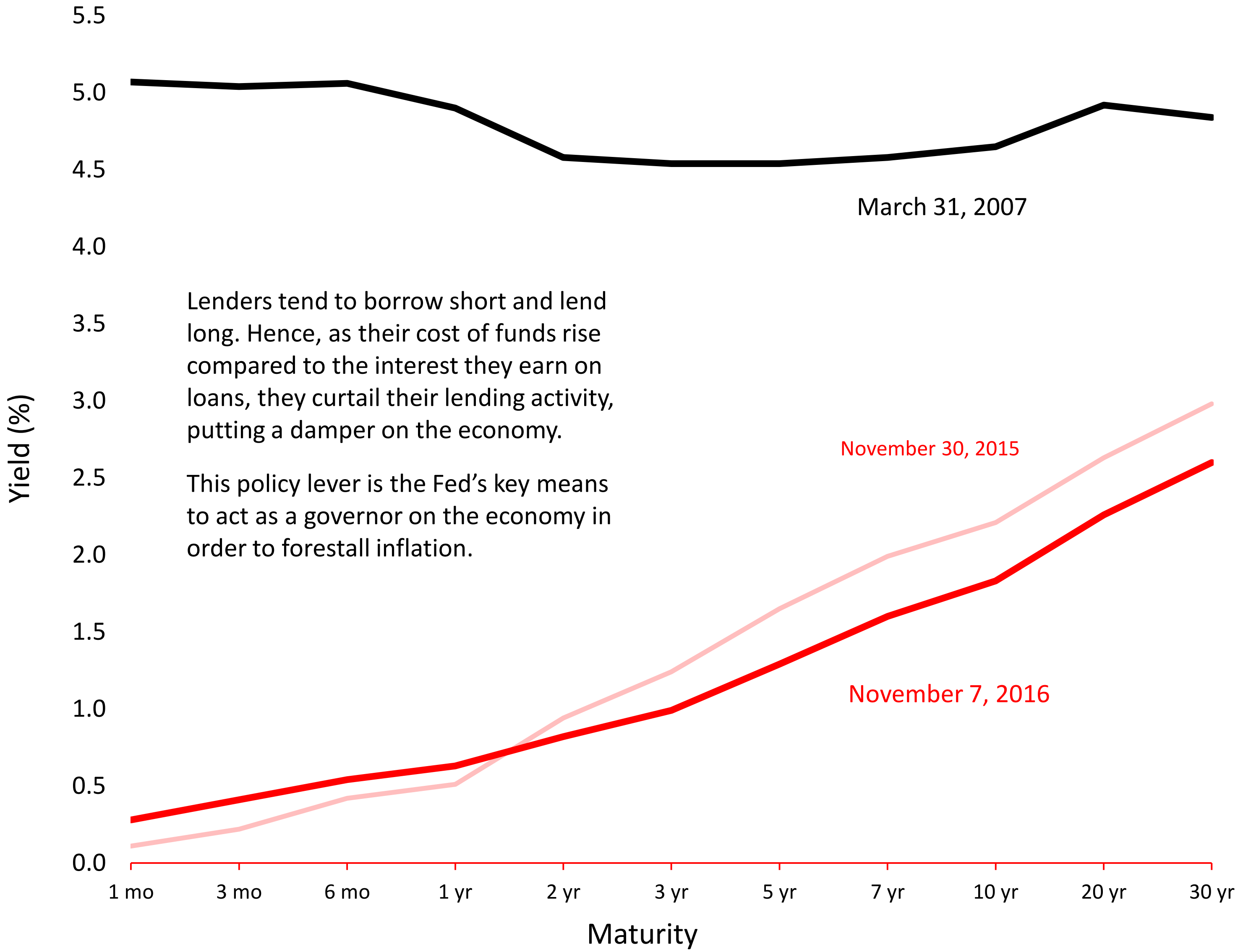
The Fed's median fed funds rate forecast of 1.9% at year-end 2018 (previous chart) is very low by historic comparison.

That's because the Fed believes the "natural rate of interest" is probably just 0.4%, down from 2.3% in 2007 and 3.5% in 1990.

The fed funds rate should equal the natural rate plus inflation, or 0.4% + 1.5% = 1.9%.

Federal Reserve policy

# Fed's key policy lever is the yield curve




Lenders tend to borrow short and lend long. Hence, as their cost of funds rise compared to the interest they earn on loans, they curtail their lending activity, putting a damper on the economy.

This policy lever is the Fed's key means to act as a governor on the economy in order to forestall inflation.

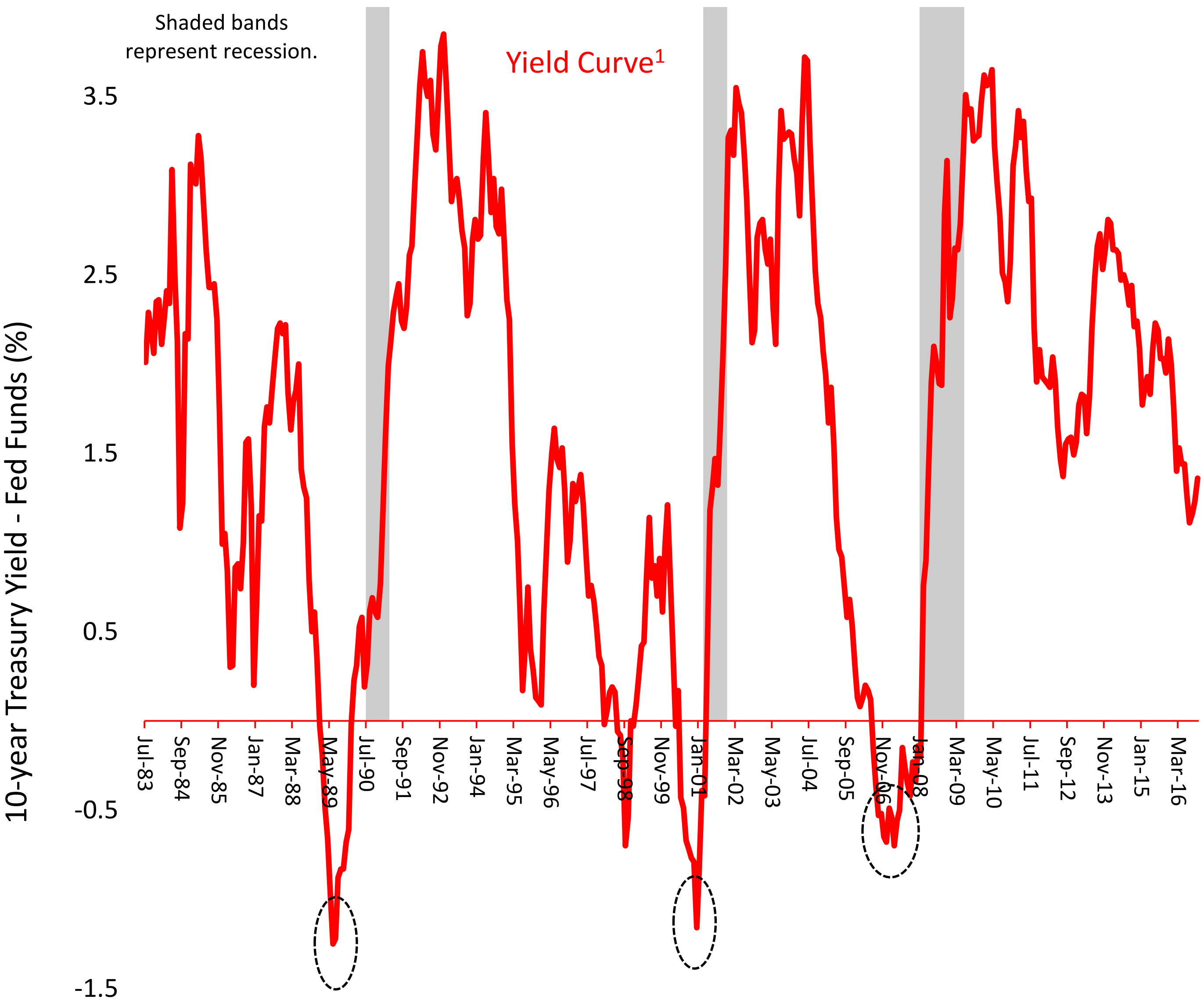
This is an inverted (negative) yield curve resulting from the Fed's raising the Fed Funds target rate (1 mo. maturity) to 5.23%.

Today's is a positive yield curve resulting from the Fed's pushing the Fed Funds target rate down to 0.4%.

Yield Curve, *n.* A measure of interest rates on bonds at various maturities; predicting where the yield curve is headed is about as easy as forecasting exactly where a fistful of feathers will land in a hurricane.[1]

Source: U.S. Department of the Treasury.
[1]Jason Zweig, *The Devil's Financial Dictionary* (New York, NY: PublicAffairs™, 2015), 229-230.

# Fed's key policy lever is the yield curve




Steep yield curves – high bond yields compared to Fed Funds rates – are consistent with strong GDP growth.

Flat or negative yield curves have preceded recessions.

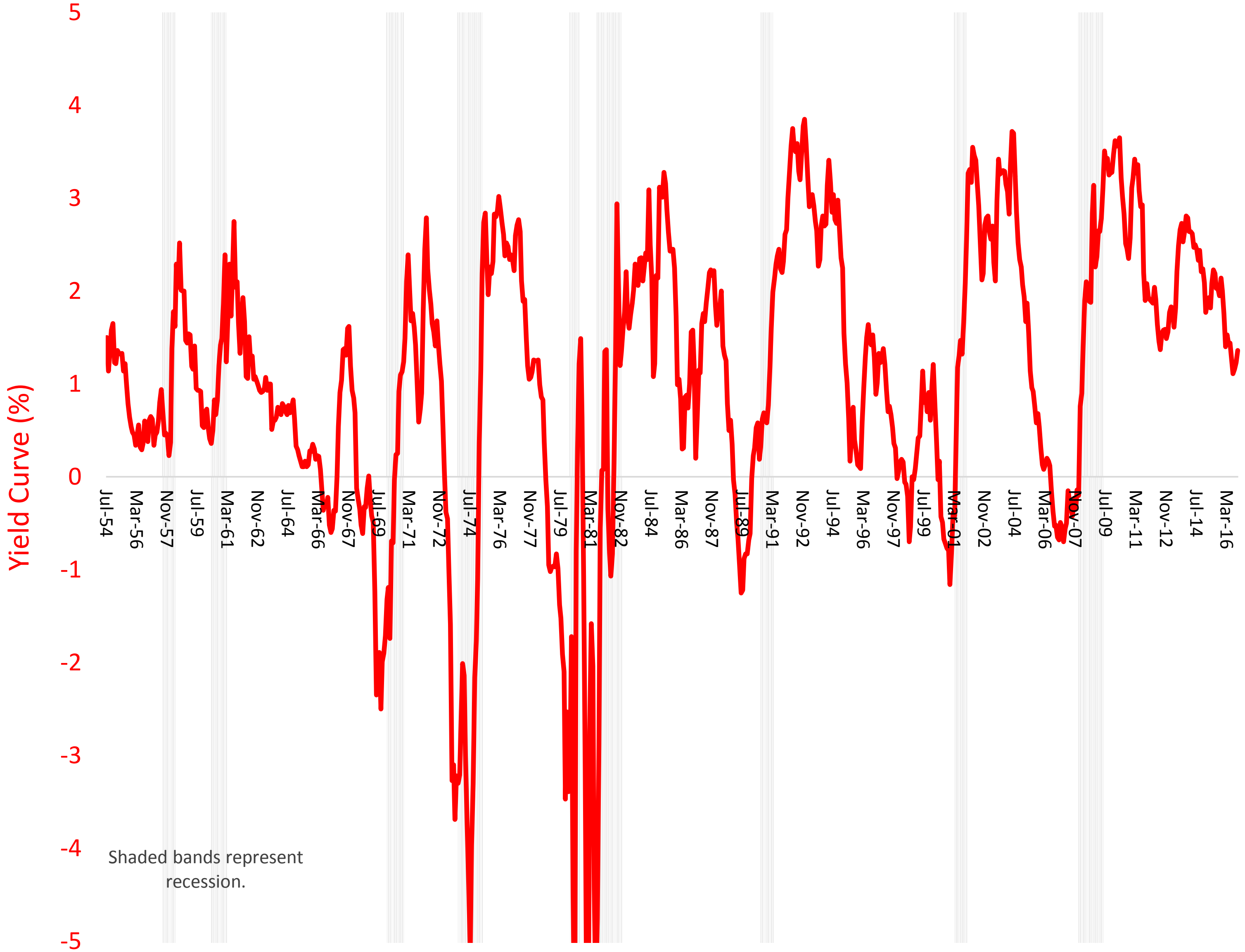
Today the yield curve is positive but less than half as steep as immediately post-recession.

The Fed has been saying that rate hikes are likely to be very gradual from here.

Sources: NBER, Federal Reserve. Data through October 2016. [1]The interest rate on the 10-year Treasury bond (long term) minus the fed funds rate (short term).

# Federal Reserve policy

# The Fed has engineered every recession since 1954

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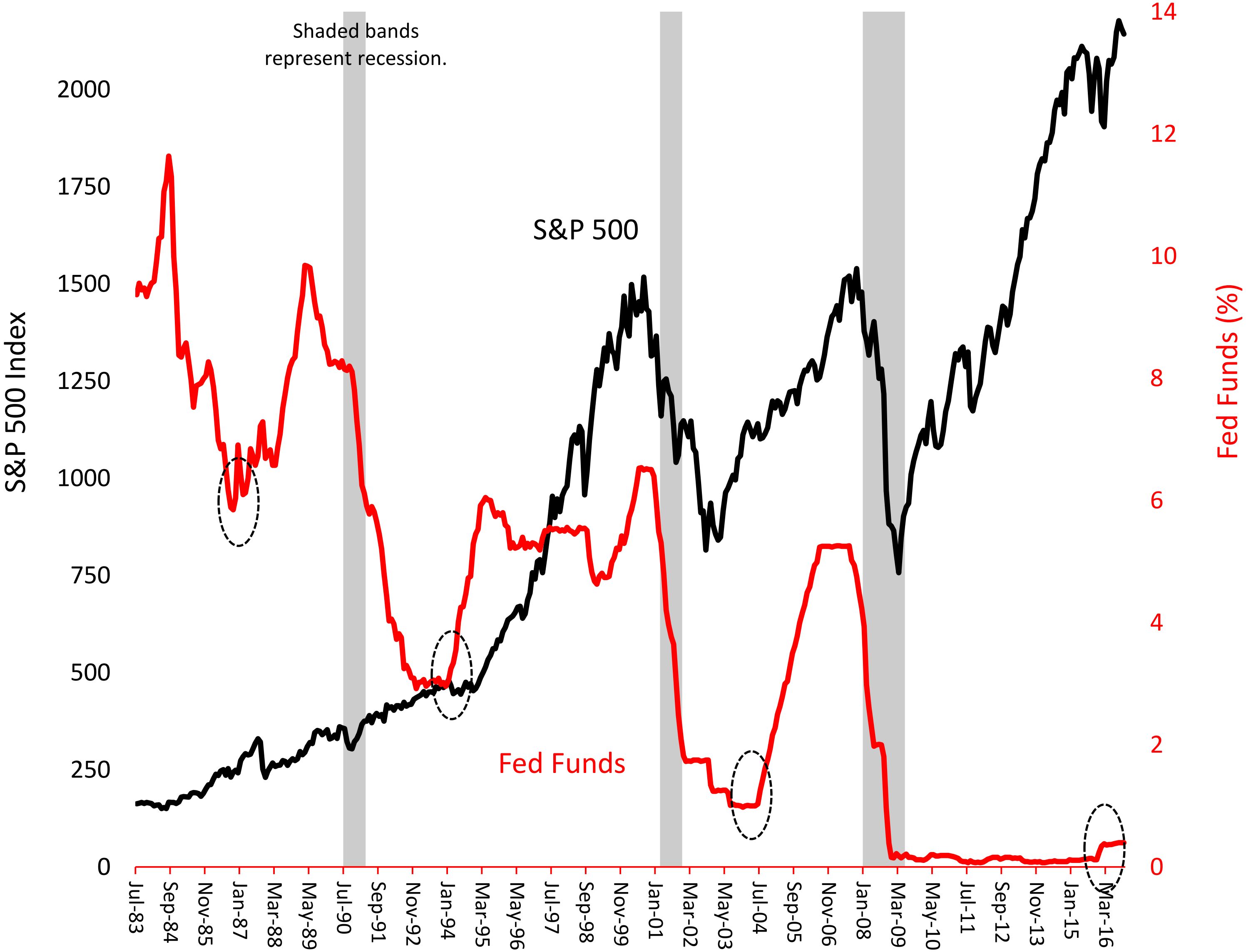
# Federal Reserve policy

## … it's the *last* rate hike that matters




Initial fed funds rate hikes have caused the stock market to stutter.

<u>But, following the initial stutter stocks have continued higher even as the Fed has repeatedly hiked rates</u> … until fed funds have approximated bond yields.

Sources: NBER, Federal Reserve and Standard & Poor's. Data through October 2016.

# Dual mandate, dovish Fed

*Release date: November 2, 2016*

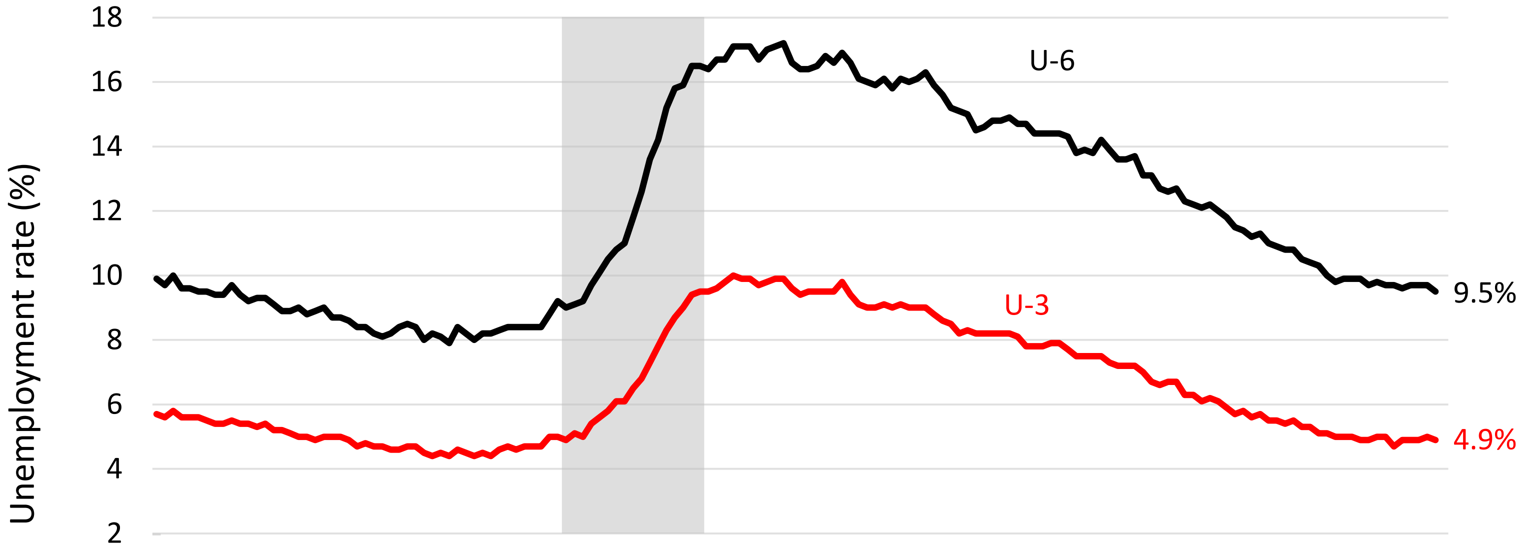
Information received since the Federal Open Market Committee met in September indicates that the labor market has continued to strengthen and growth of economic activity has picked up from the modest pace seen in the first half of this year. Although the unemployment rate is little changed in recent months, job gains have been solid. Household spending has been rising moderately but business fixed investment has remained soft. Inflation has increased somewhat since earlier this year but is still below the Committee's 2 percent longer-run objective, partly reflecting earlier declines in energy prices and in prices of non-energy imports. Market-based measures of inflation compensation have moved up but remain low; most survey-based measures of longer-term inflation expectations are little changed, on balance, in recent months.

Against this backdrop, the Committee decided to maintain the target range for the federal funds rate at 1/4 to 1/2 percent. <u>The Committee judges that the case for an increase in the federal funds rate has continued to strengthen but decided, for the time being, to wait for some further evidence of continued progress toward its objectives</u>. The stance of monetary policy remains accommodative, thereby supporting further improvement in labor market conditions and a return to 2 percent inflation.

Source: Federal Reserve.

Federal Reserve policy

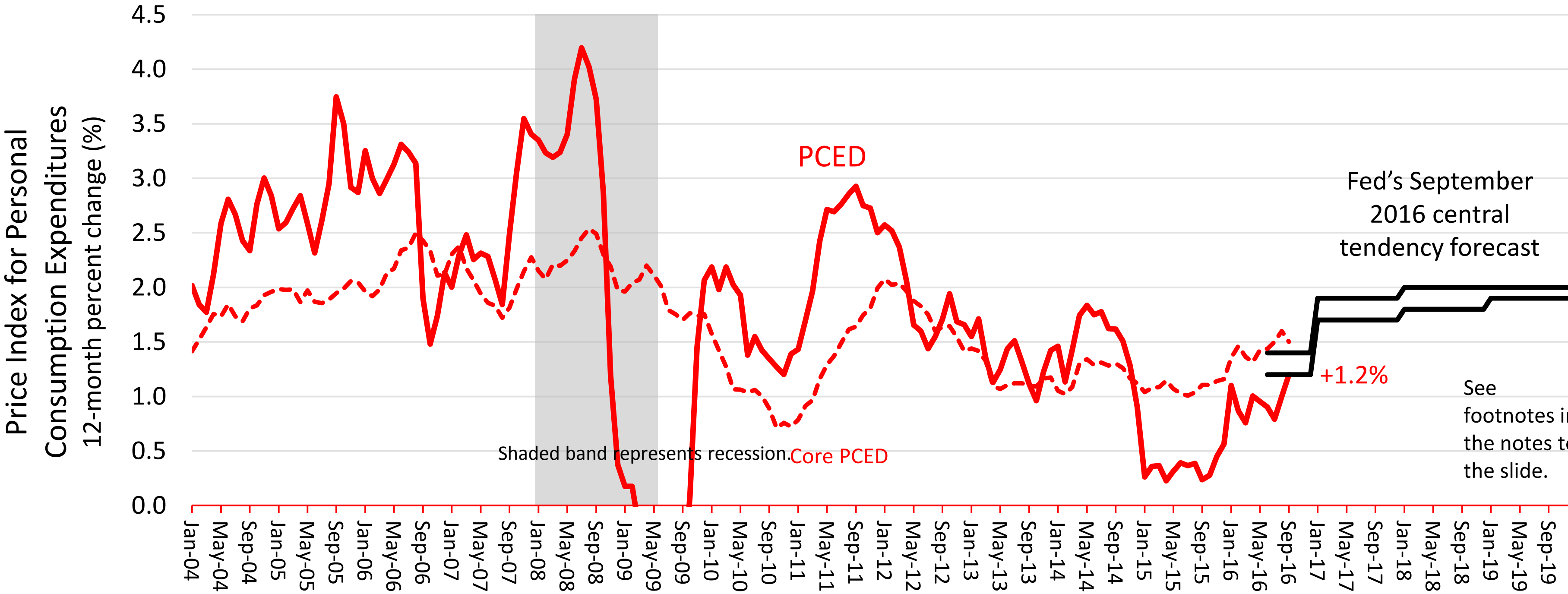
# Dual mandate, dovish Fed



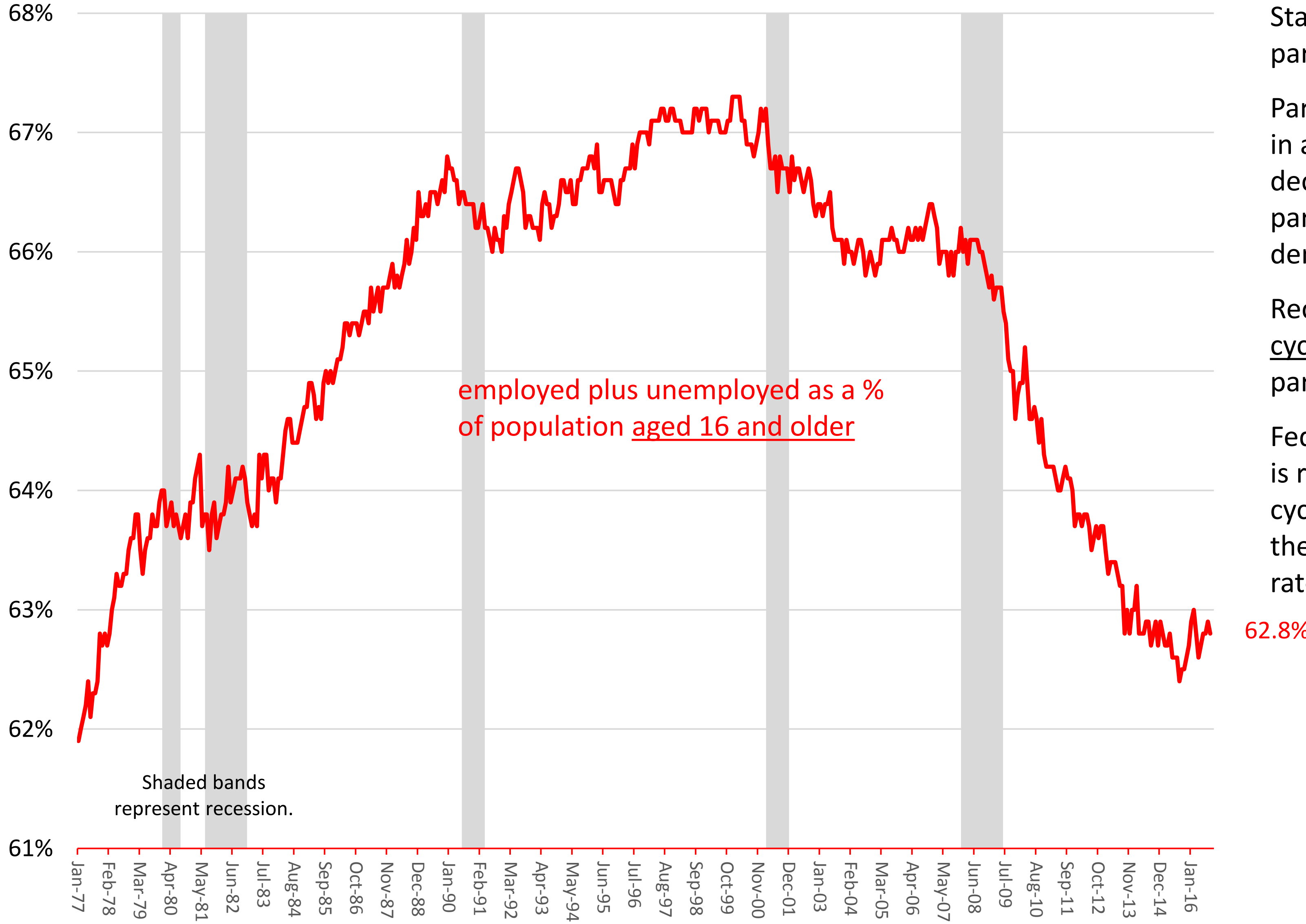

Fed's dual mandate:

- full employment
- 2% inflation

With inflation still well below 2% the Fed might stay very dovish for awhile yet. It may take until well into 2017 to regain full employment.



# Economic data - jobs
## Labor force participation rate[1]




Stabilization in the participation rate.

Participation rate is in a structural decline driven partially by demographics.

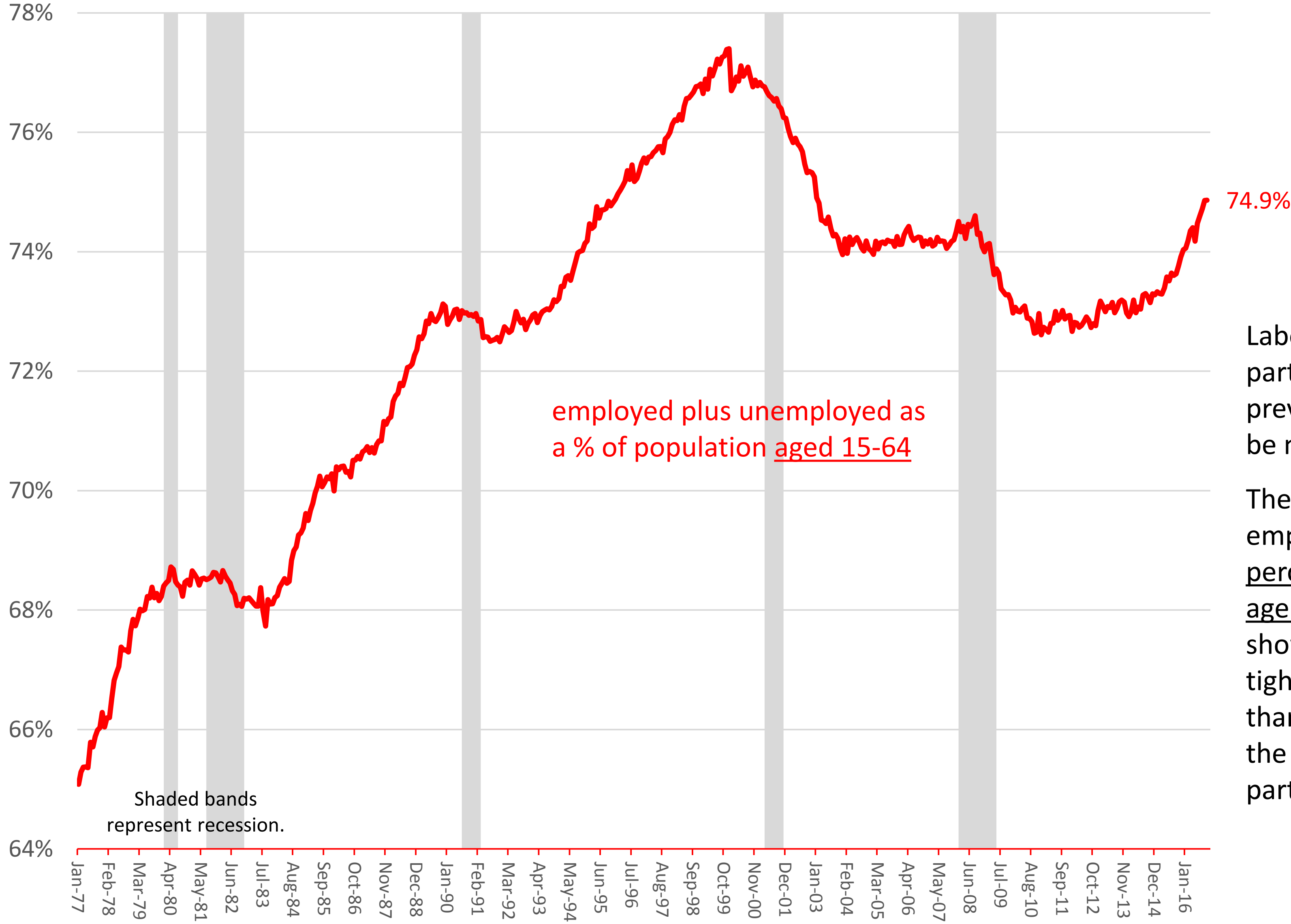
Recessions drive cyclical slides in the participation rate.

Fed believes there is room for more cyclical recovery in the participation rate.

Source: Bureau of Labor Statistics. Participation rate data through October 2016.

[1]Labor force participation rate: the proportion of the civilian noninstitutional population 16 years of age and older either at work or actively seeking work.

# Employed and unemployed as a % of population aged 15-64




Labor force participation rate, previous slide, may be maxed out.

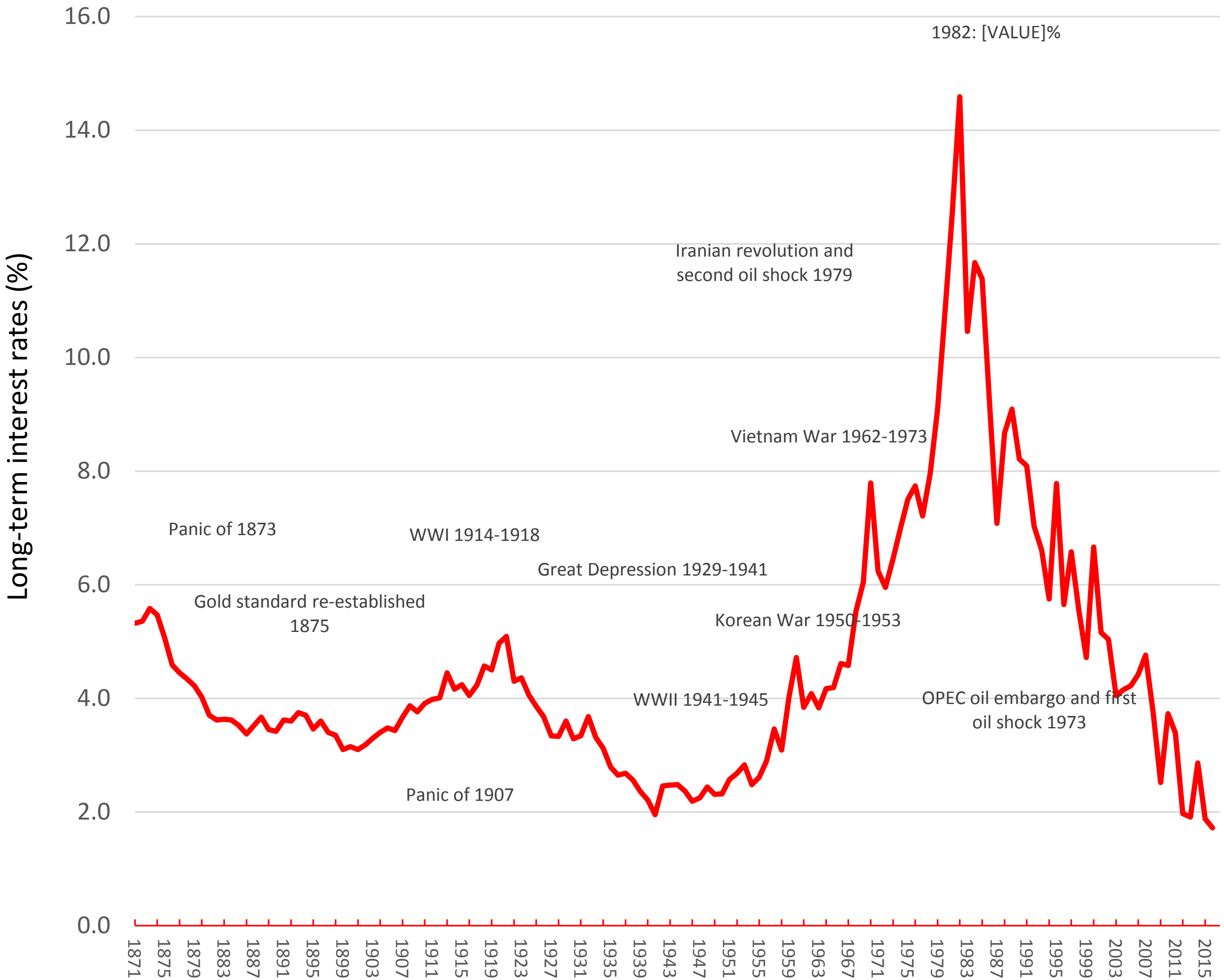
The number of employed as a percent of working age population shows much tighter labor force than suggested by the labor force participation rate.

Source: Bureau of Labor Statistics and Federal Reserve Bank of St. Louis. Employed and unemployed data through October 2016; working age population data through March 2015.

# Bond Yields

- lowest yields in history
- forecasts have grossly missed
- forecast for steady rise to 3.35%
- pressure on yields from declining federal deficit
- pressure on yields from ECB’s QE capping euro bond yields
- ECB’s QE to last through September 2017

# All-time low bond yields

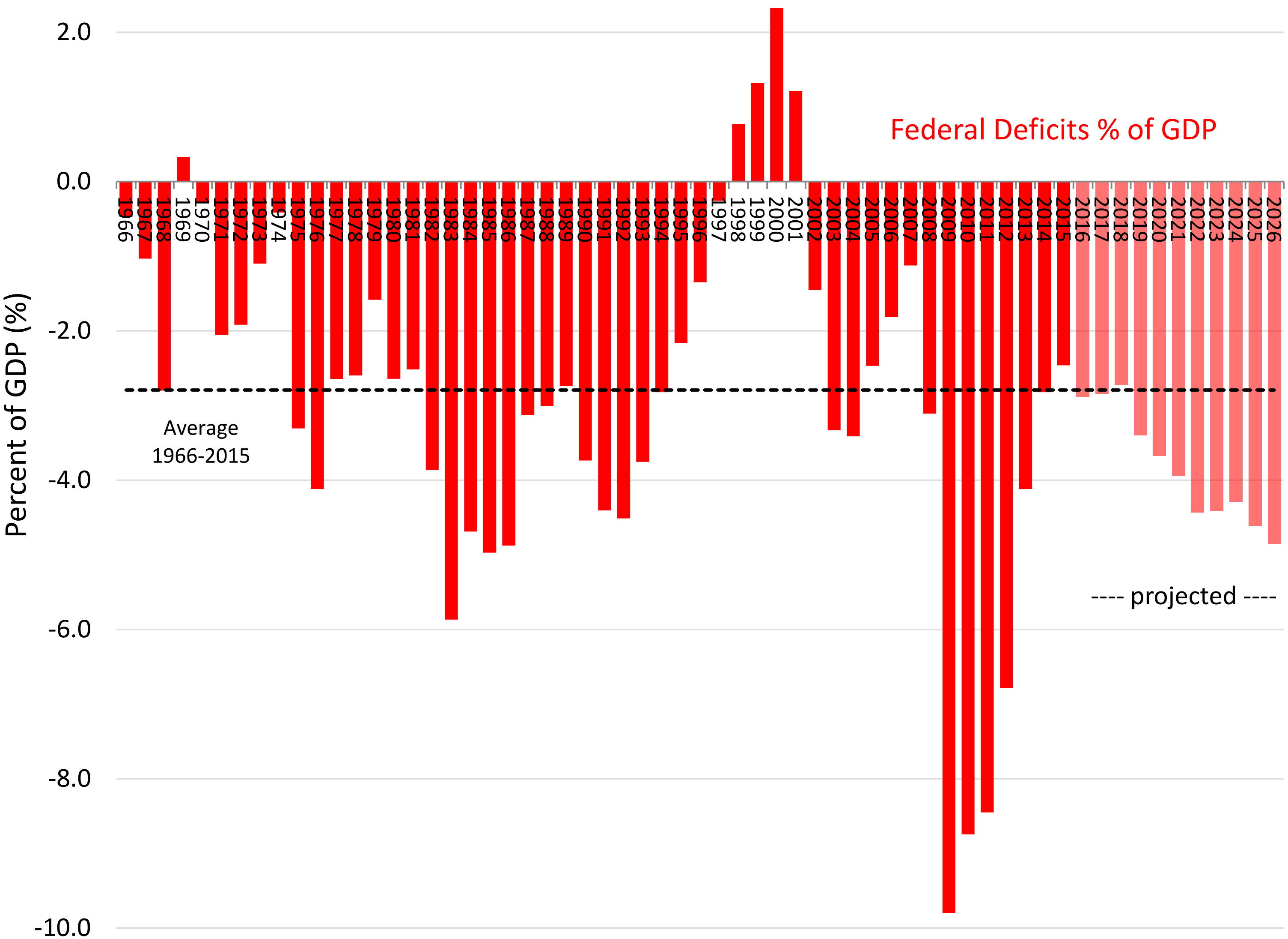



Lowest long-term interest rates in U.S. history.

Source: Online Data Robert Shiller. Data through October 2016.

Federal deficit and debt

# Federal deficits % of GDP

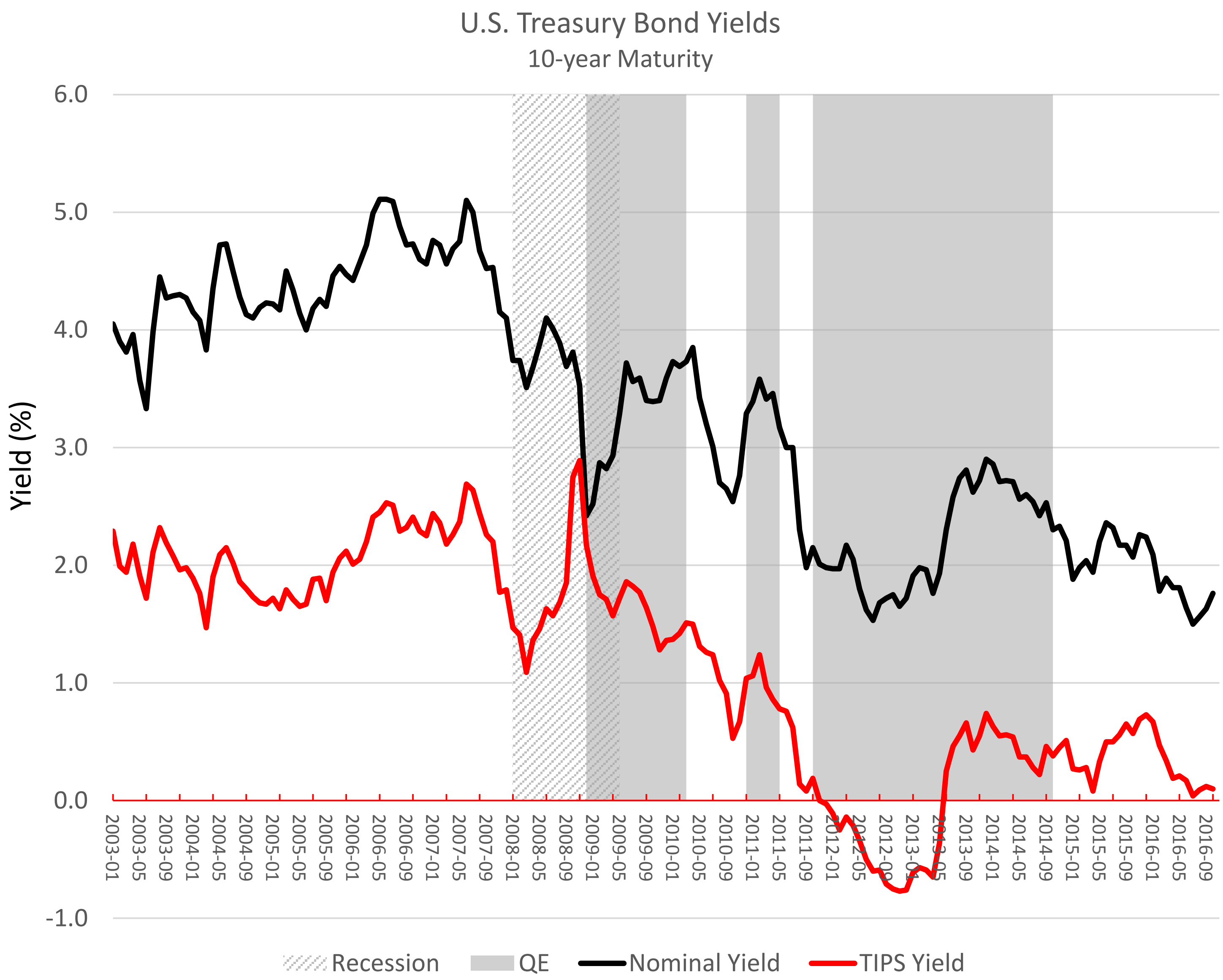



One reason yields have dropped is the improvement in the federal deficit.

CBO is projecting low growth in federal borrowing requirements through 2018.

Source: Congressional Budget Office, *Updated Budget Projections: 2016 to 2026,* dated March 2016.

# U.S. Treasury bond yields – nominal and TIPS




<u>However, bond yields no longer make sense fundamentally. With the 10-year TIPS yield at almost 0% an investor is receiving zero term premium for making a 10-year loan to Uncle Sam.</u>

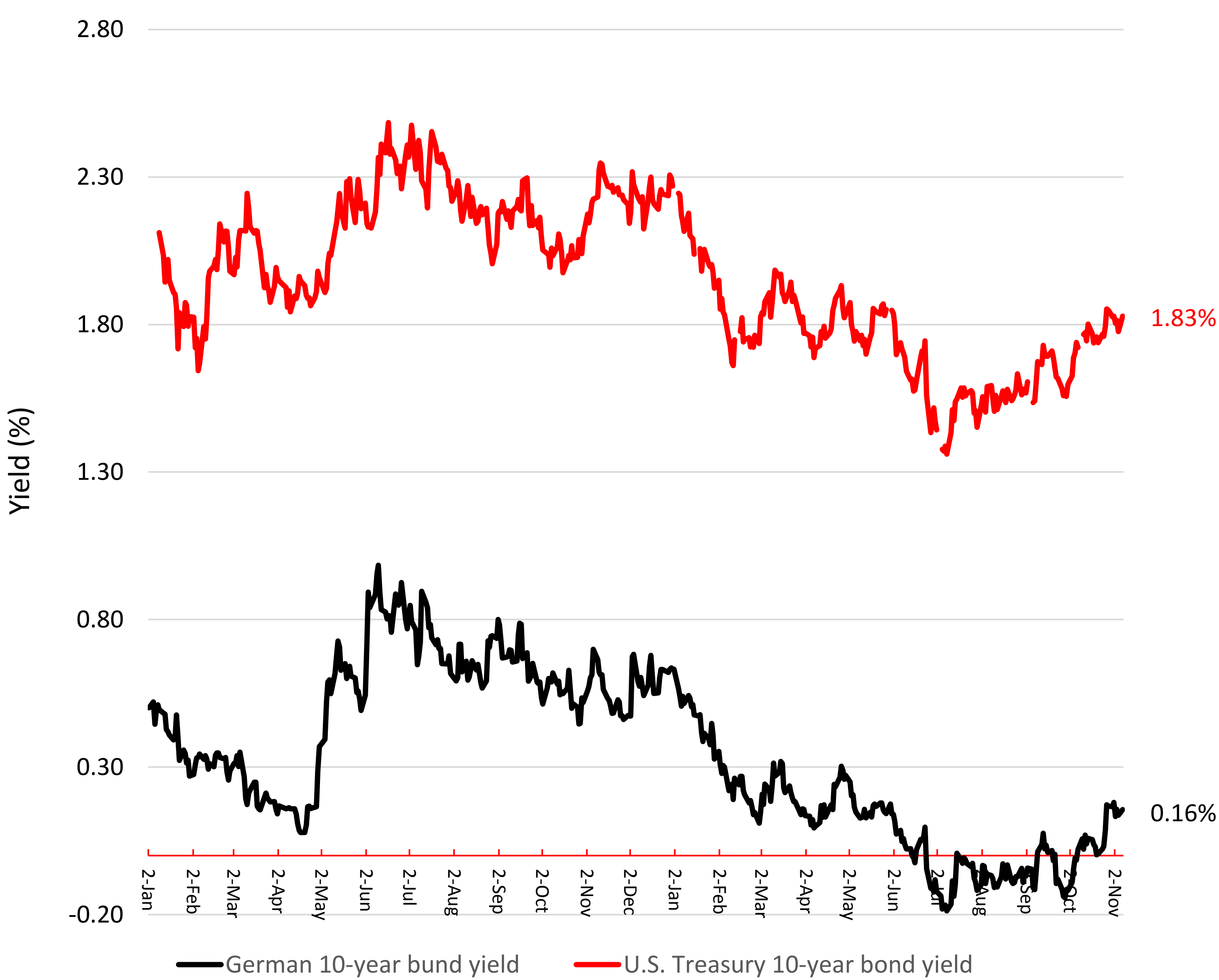
Quantitative easing (QE) has driven bond yields steadily lower.

Although the Federal Reserve is no longer purchasing bonds (QE), the ECB is, having a like effect on U.S. bond yields.

See next chart.

Source: Federal Reserve. Data through October 2016.

# U.S. Treasury bond yield vs. German bund yield




Yields moving in lock-step.

<u>The ECB is in control of U.S. Treasury yields</u>.

The ECB plans to continue their QE program until further notice.

Source: *The Wall Street Journal*. Data through November 7, 2016.

# ECB’s quantitative easing

# Europe Central Bank Hints at More Bond Buys

FRANKFURT—The European Central Bank kicked back a decision on whether to boost its €1.7 trillion ($1.86 trillion) stimulus, disappointing investors who had hoped for greater clarity from Frankfurt and raising the stakes for its next policy meeting in December.

*By Todd Buell in Frankfurt and Paul Hannon in London*

At a short news conference, ECB President Mario Draghi said policy makers hadn’t even discussed whether to extend the central bank’s €80 billion-a-month bond-purchase program, which is due to end in five months.

As that deadline approaches, investors have been growing nervous. Financial markets were rattled this month by a media report suggesting the ECB might start to wind down, or taper, its bond purchases—the opposite of what many economists had been expecting.

Mr. Draghi brushed off that report Thursday as “uninformed” and strongly suggested the ECB would announce an extension of its so-called quantitative-easing program at a policy meeting Dec. 8.

“It’s quite clear that our decisions in December will tell [financial markets] what we [plan to] do in the coming months,” Mr. Draghi said.

Still, some investors were disappointed by the lack of clearer guidance.

“An already nervous market will not take much comfort from [Mr. Draghi’s] obfuscation,” said James Athey, a fixed-income manager at Aberdeen Asset Management PLC.

Markets were volatile during Mr. Draghi’s remarks. The euro jumped half a cent against the dollar before reversing its gains.

The sharp movements show how dependent financial markets have become on the actions of central banks, which have taken unprecedented action in recent years to support weak growth and inflation.

The ECB’s balance sheet has swelled to almost €3.5 trillion, a record, as it launched and repeatedly expanded its stimulus. Its policy measures include large-scale bond purchases, negative interest rates and cheap loans for banks.

The ECB left its policy mix unchanged Thursday.

Despite that aggressive action, eurozone inflation has continued to hover close to zero, far below the ECB’s target of just under 2%.

With inflation so low, economists expect the ECB to extend its bond-purchase program by at least six months, or around half a trillion euros, before it ends in March.

Mr. Draghi said nothing on Thursday to damp such hopes. He painted a picture of a steady but slow economic recovery in the eurozone, and warned that there were no signs yet that inflation was picking up sustainably.

The ECB remains “committed to preserving the very substantial degree of monetary [stimulus] which is necessary” to push inflation toward its target, Mr. Draghi said.

Policy makers discussed the possible changes to QE this week, he said, though he wouldn’t comment on which options were most likely.

The ECB has restricted itself to buying government bonds in proportion to the size of each economy. It can’t buy more than 33% of most individual bond issues, or bonds yielding less than minus 0.4%. That rules out a large share of German government bonds.

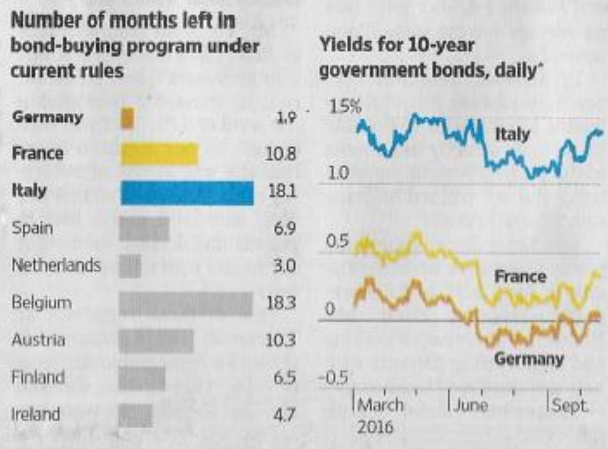
Mr. Draghi also indicated that, when the time comes to end its bond purchases, the ECB would wind them down gradually, rather than bring the program to an abrupt halt.

“My perception is that a sudden stop is not in anybody’s mind,” he said.

◆ Heard: Battered European banking shares block ECB... C1

### Tight Bonds

The ECB is likely running short of bonds to buy, but a recent spike in yields has bought time.




*Through Wednesday
Source: Jeffries (months); TradeWeb (bonds)

THE WALL STREET JOURNAL.

### U.K. Policy Row Draws Rebuke

A top German central-bank official waded into a clash between U.K. Prime Minister Theresa May and Bank of England Gov. Mark Carney over ultralow interest rates, calling on politicians to stay out of monetary-policy decisions.

The comments, in a speech in London, were an unusually public rebuke to a foreign government from Germany’s Bundesbank.

Andreas Dombret, who sits on the Bundesbank’s executive board, pointed to recent criticism of central banks by politicians, specifically on “the handling of Brexit as well as conducting monetary policy and setting interest rates more generally.”

He added that “in light of this criticism, it may be time for a friendly reminder that central-bank independence is not debatable.”

The BOE cut its main rate to 0.25% in August and launched a new government-bond purchase program to shore up the economy after the U.K. vote to leave the European Union.

Mrs. May appeared to criticize the central bank’s decisions this month, arguing that emergency measures had caused “some bad side effects.” Mr. Carney stressed recently that the BOE is “not going to take instruction on our policies from the political side.”

—*Tom Fairless*

<u>The ECB is in control of U.S. Treasury yields</u>.

The ECB plans to extend, <u>probably through September</u>, then gradually taper its QE program.

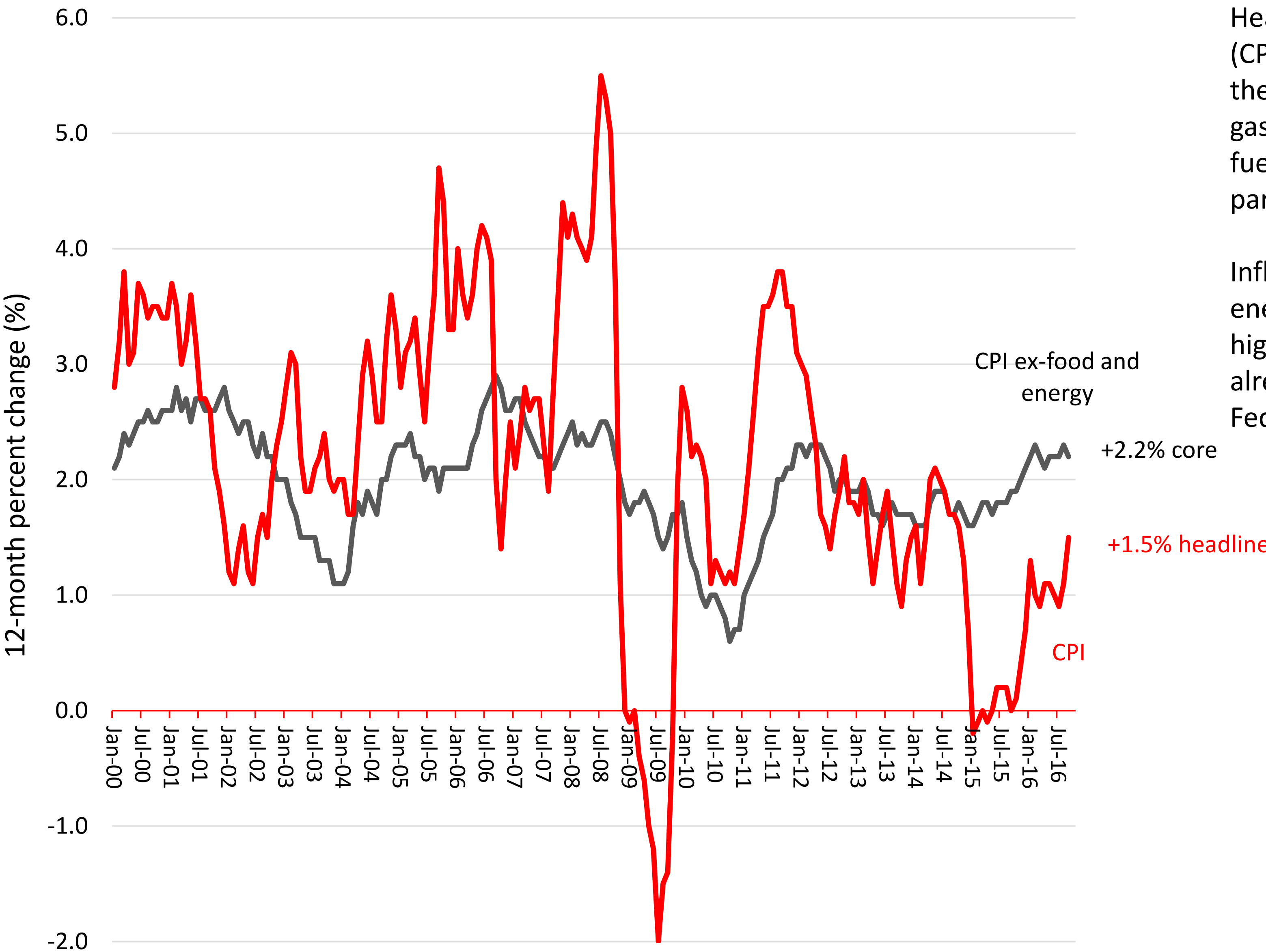
Source: *The Wall Street Journal*. October 21, 2016.

# Inflation

- PCED headline +1.2%, more in the core but still far from the Fed’s +2% target
- employment costs steady and still tame
- productivity and declining unit labor costs
- how you experience inflation depends on what you consume

Inflation

# CPI – headline and core



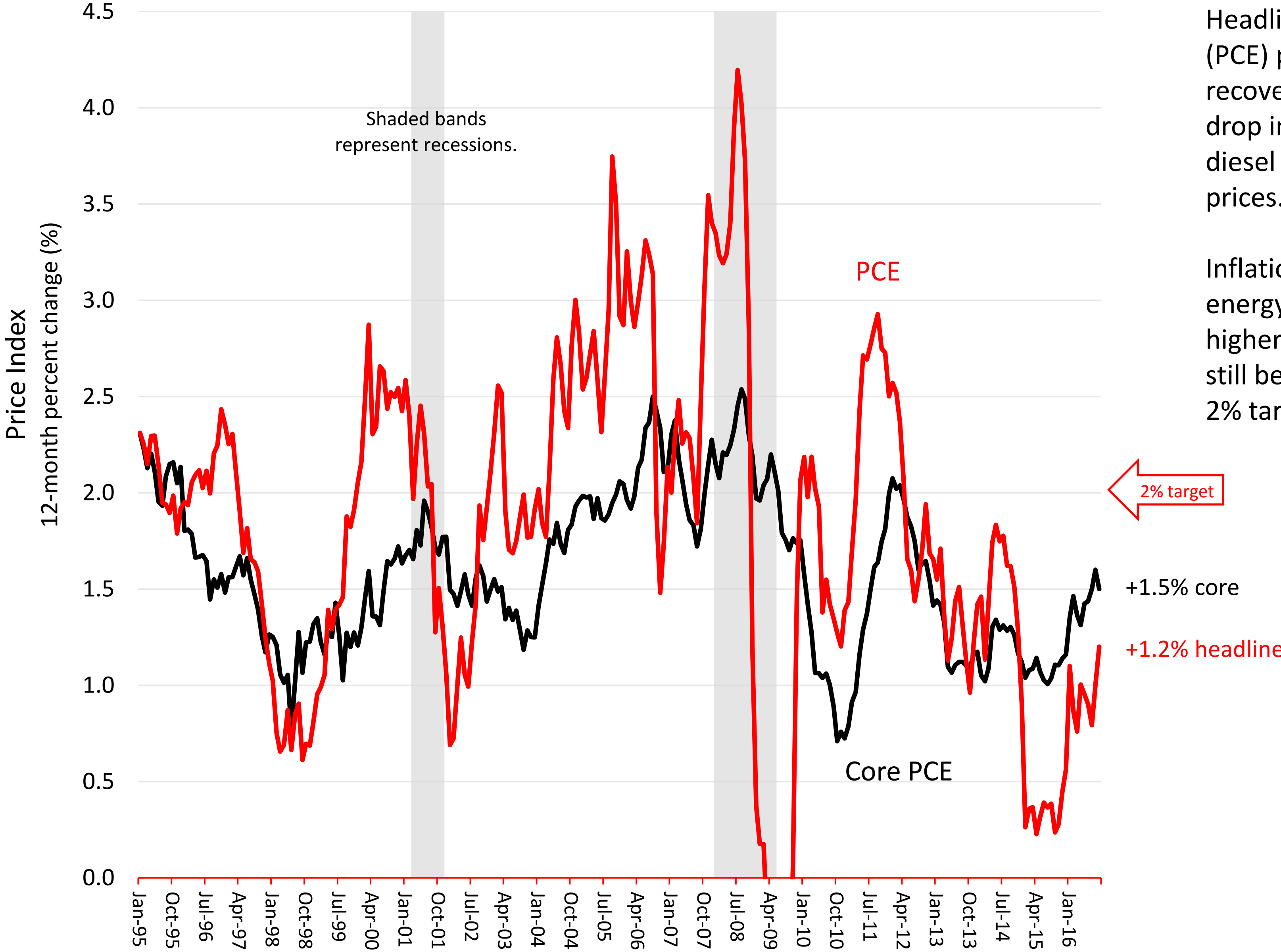

Source: BLS. Data through September 2016.

Headline inflation (CPI) plunged with the plunge in gasoline, diesel and fuel oil prices, and has partially recovered.

Inflation ex-food and energy (core CPI) is higher than core and already above the Fed's 2% target.

Inflation

# PCE – headline and core

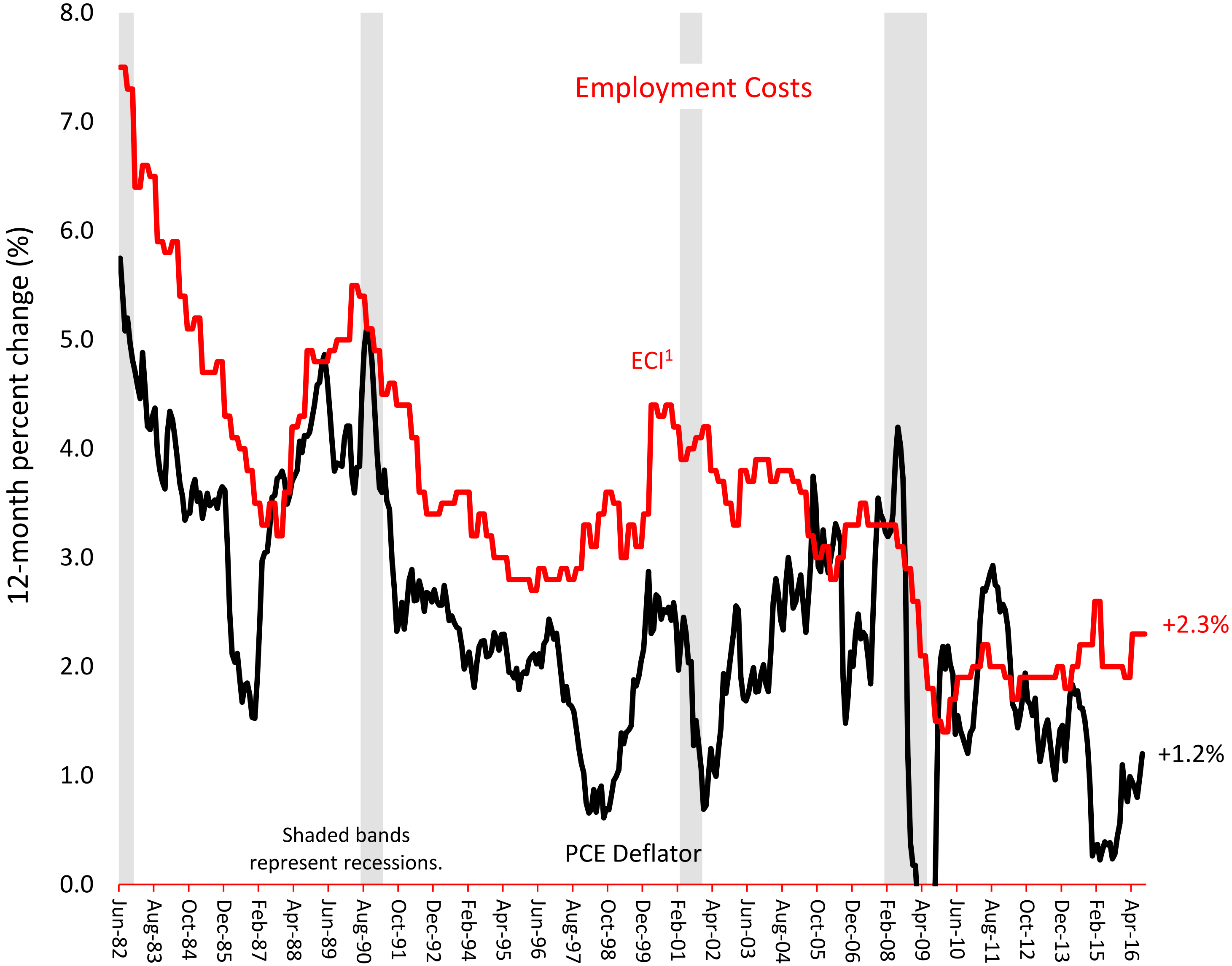



Source: NBER, Federal Reserve Bank of St. Louis. Data through September 2016.

Headline inflation (PCE) plunged and recovered with the drop in gasoline, diesel and fuel oil prices.

Inflation ex-food and energy (core PCE) is higher than core but still below the Fed's 2% target.

# Employment cost index and inflation



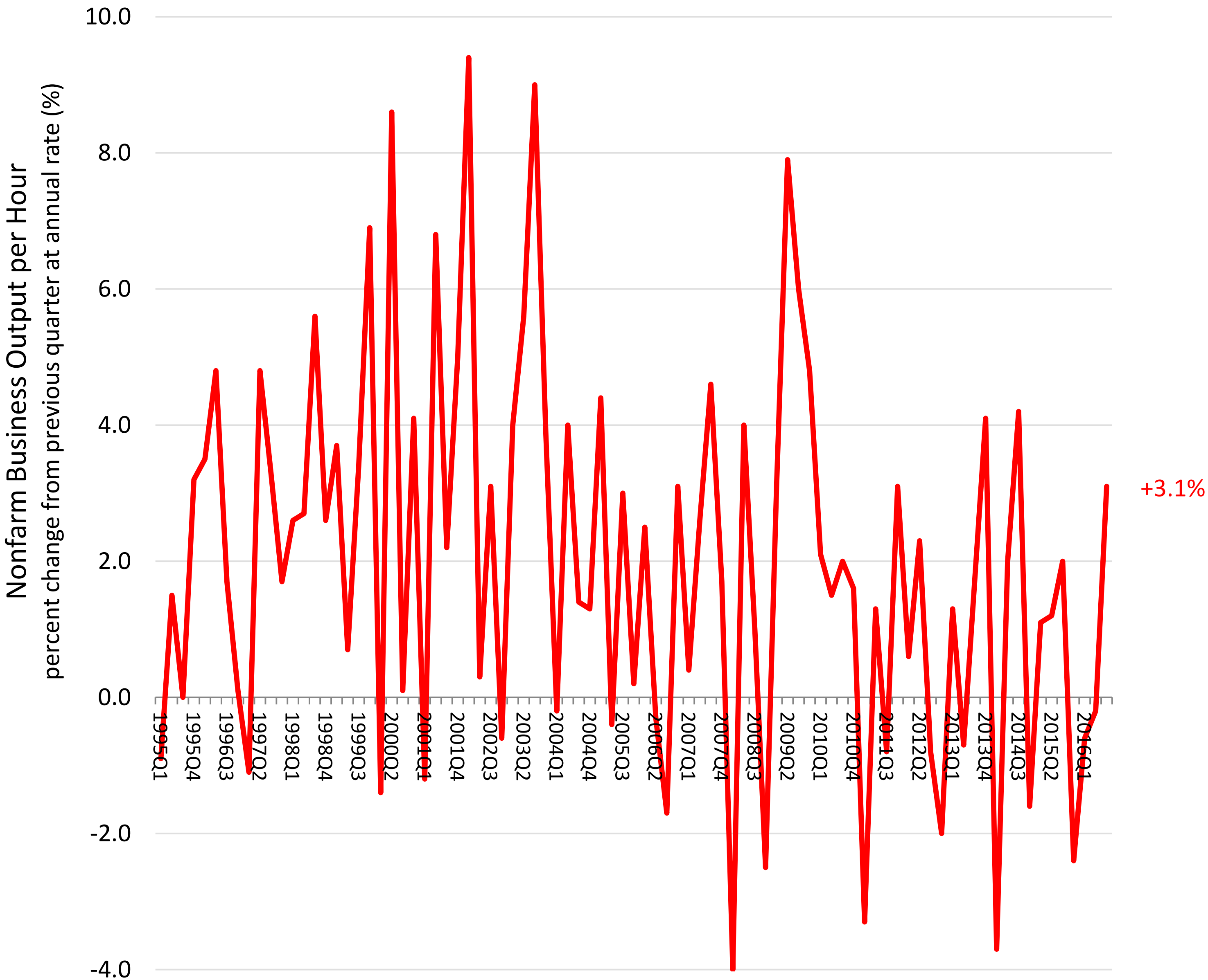

Because wages, salaries and benefits are companies' biggest single cost, they are also the biggest single inflation factor for the economy as a whole.

Inflation (PCE deflator) generally runs lower than measured ECI inflation because higher employment costs can be offset by productivity gains.

See next two charts.

Source: Bureau of Labor Statistics. Quarterly ECI data through September 2016; monthly PCE data through September 2016.
[1] Employment Cost Index. The BLS 's ECI is built with fixed weights for individual industries and occupations.

# Productivity



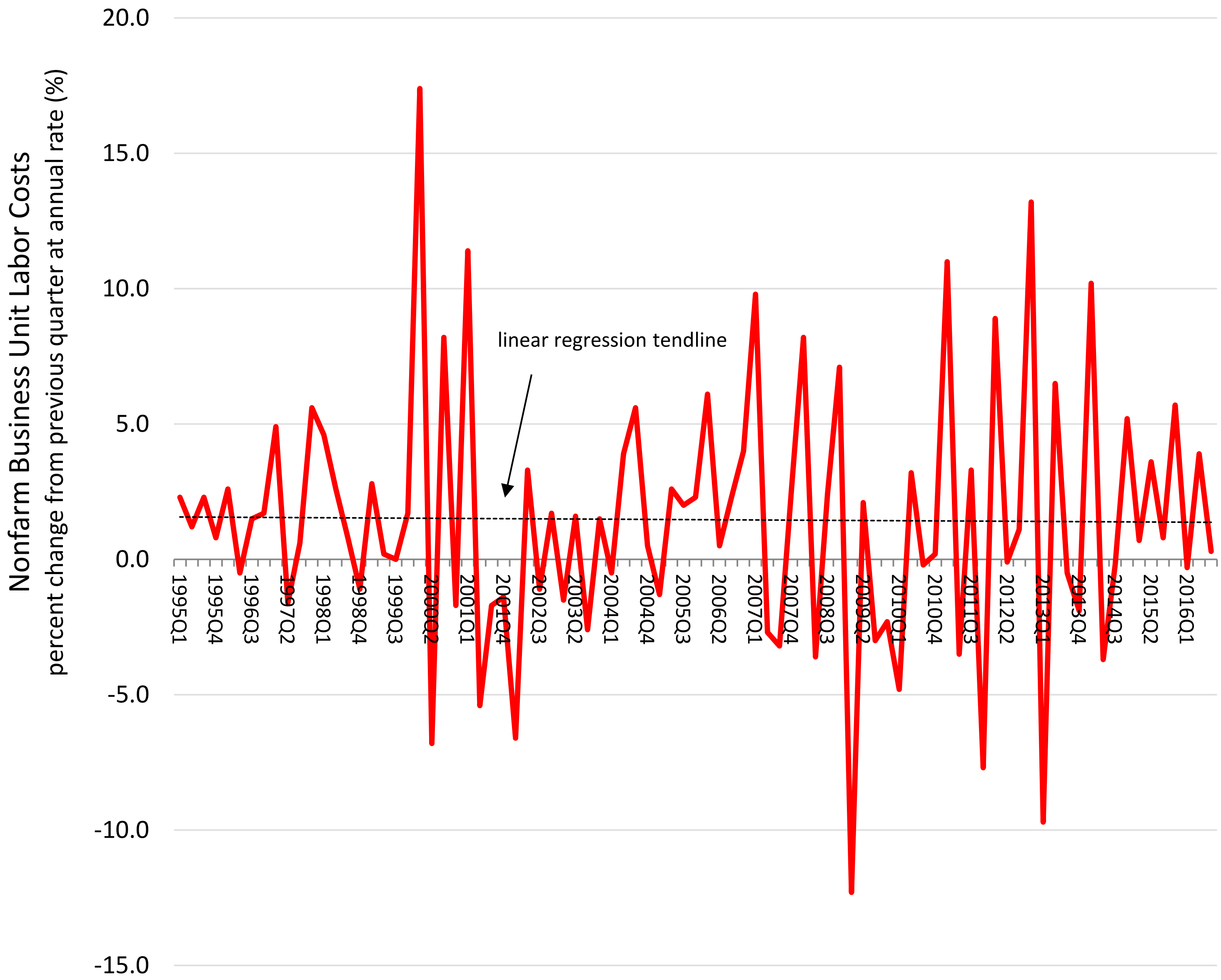

Productivity gains have averaged only +0.7% per year for the last five years, not fully recovered from pre-recession.

But, is the trend improving?

<u>Productivity gains offset wage gains</u>.

Source: Bureau of Labor Statistics, quarterly data through September 2016.

# Unit labor costs




Source: Bureau of Labor Statistics, quarterly data through September 2016.

Labor costs are, by far, the biggest driver of inflation.

Productivity gains have largely offset higher employment costs such that unit labor costs have been trending at a low-inflationary 1% (dotted line).

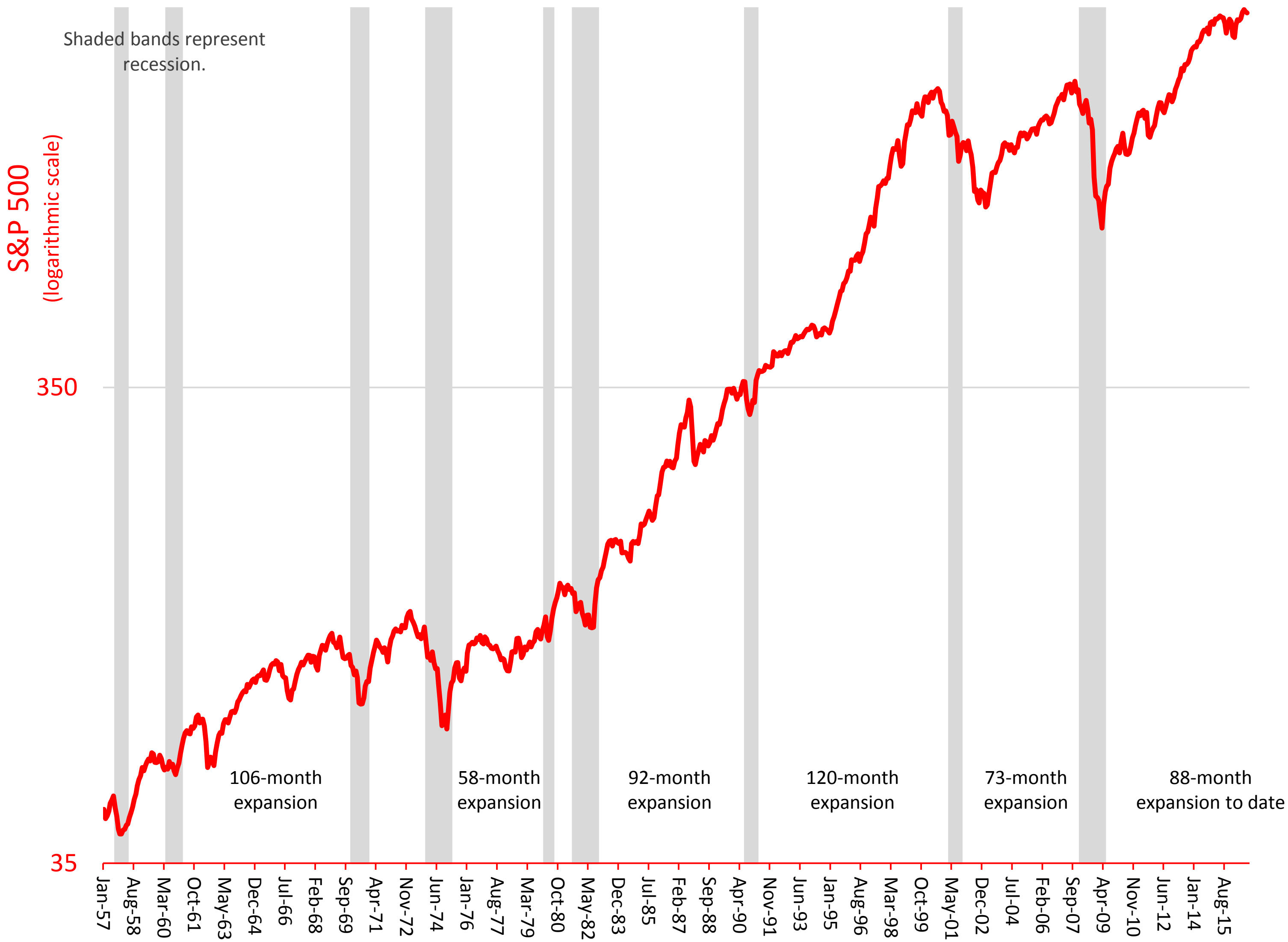
This is a key measure for the Fed.

<u>In the latest quarter, even though average hourly earnings are accelerating, unit labor costs got pounded down by strong productivity gain</u>.

# Stock Market

- near record highs
- driven by earnings turnaround
- following the anniversary of $USD surge
- and energy prices bottoming
- stocks are fully-, but not over-valued
- margins are likely sustainable
- Fed is accommodative
- inflation is tame
- lack of irrational exuberance

# S&P 500 vs. expansions



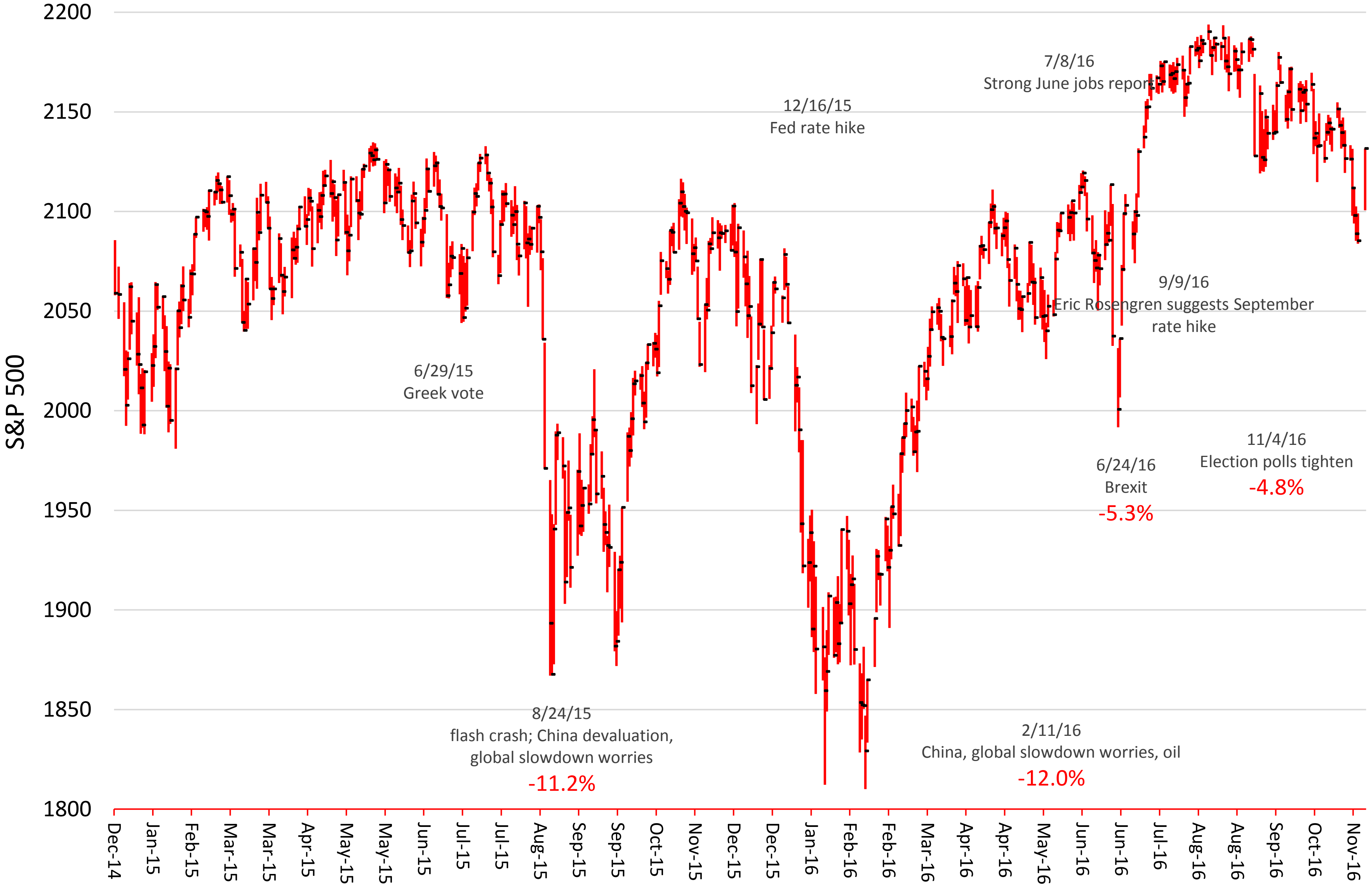

Length of the current expansion has lots of precedent.

Recessions trigger bear markets … but not every bear market was accompanied by recession.

Source: Standard and Poor's Corporation, National Bureau of Economic Research. Data through September 2016.

Market data

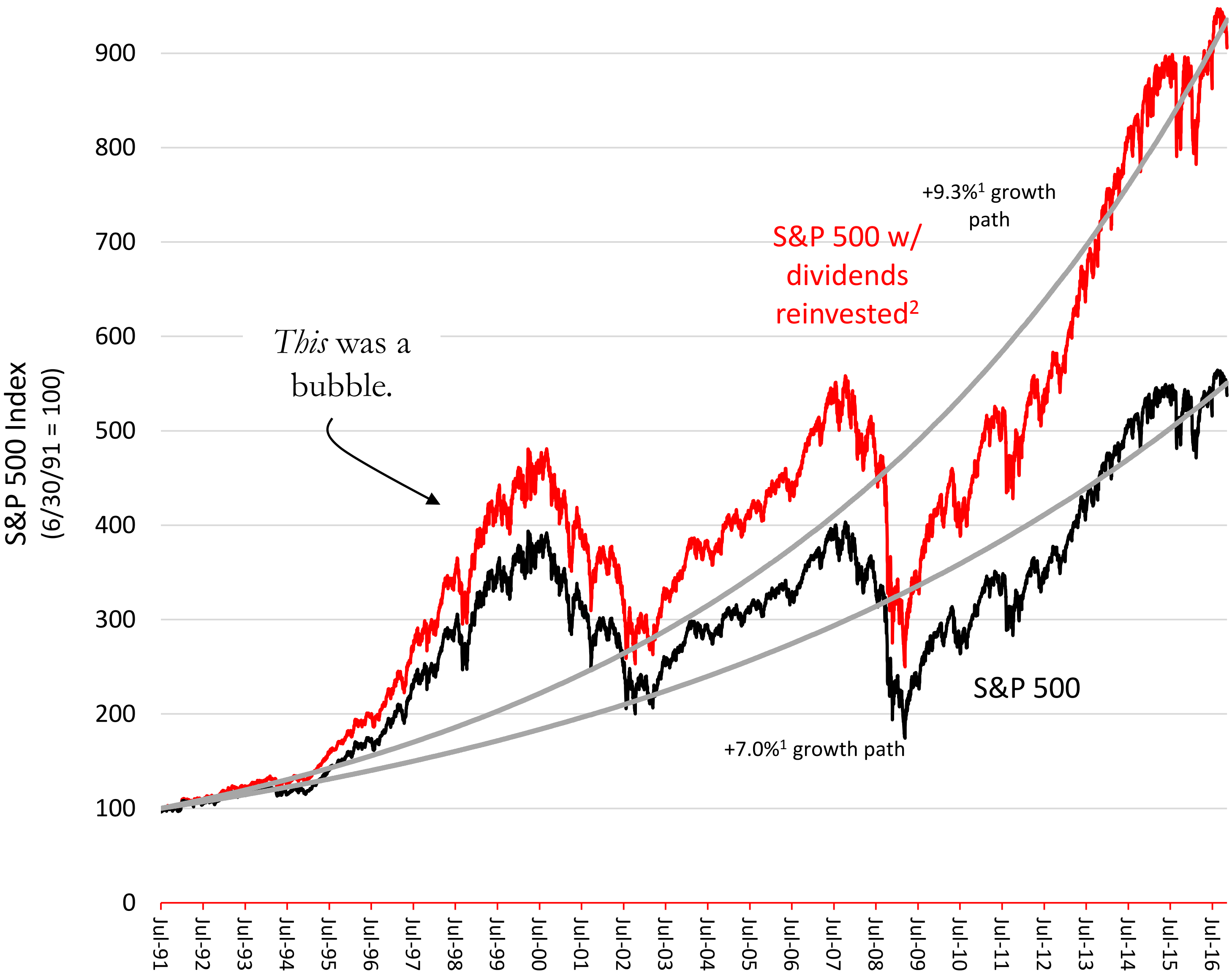
# S&P 500




Source: Standard & Poor's. data through November 7, 2016.

Stock market arithmetic

# Total return = 7.0% earnings-driven price + 2.3% dividends reinvested

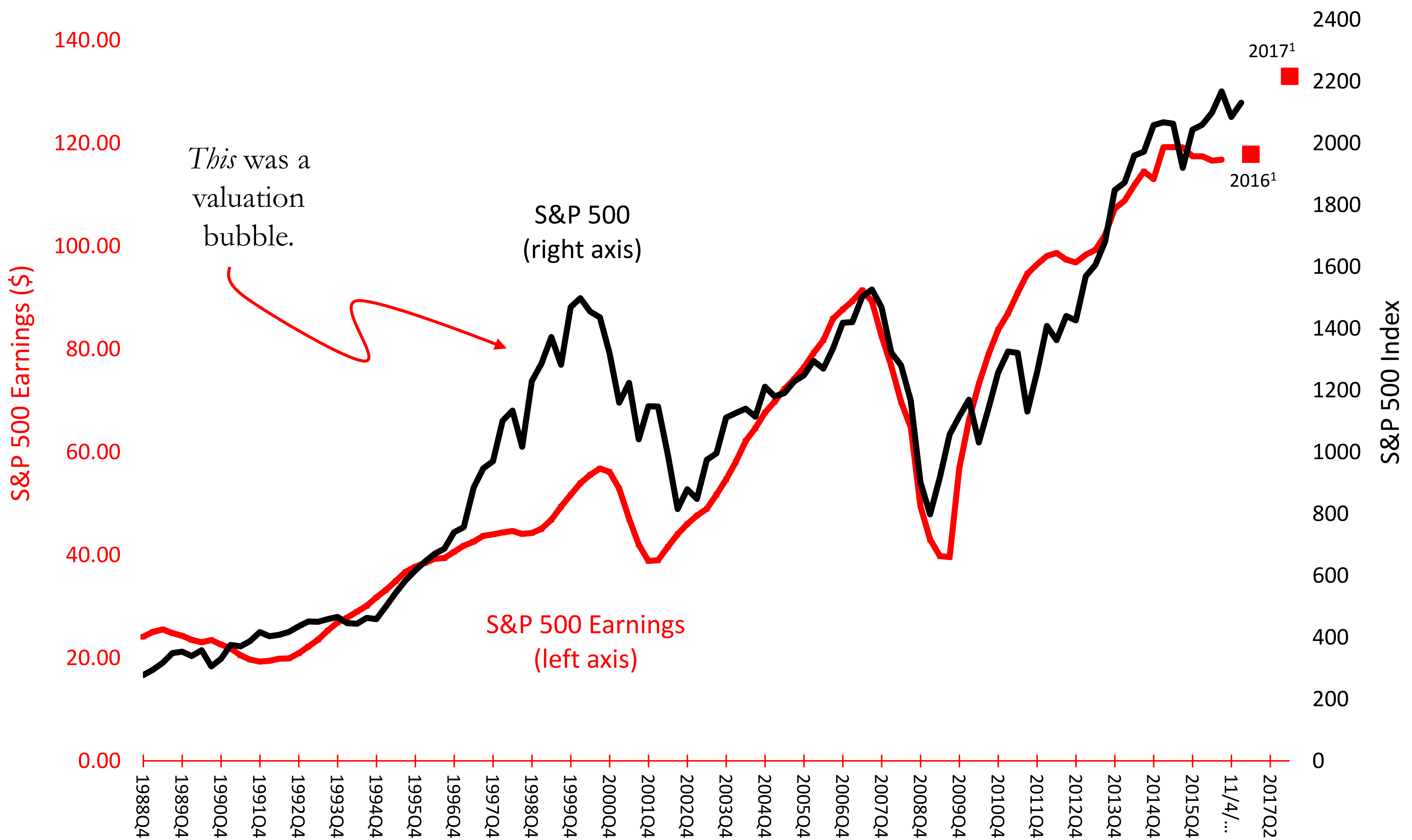



The 2011-2014 run higher put these two indices slightly above their long-term trajectories. Today they are in line.

+9.3% per year S&P 500 total return over the last 25 years is right in line with the stock market's long-term returns going back to 1926, or back even further to 1871.[3]

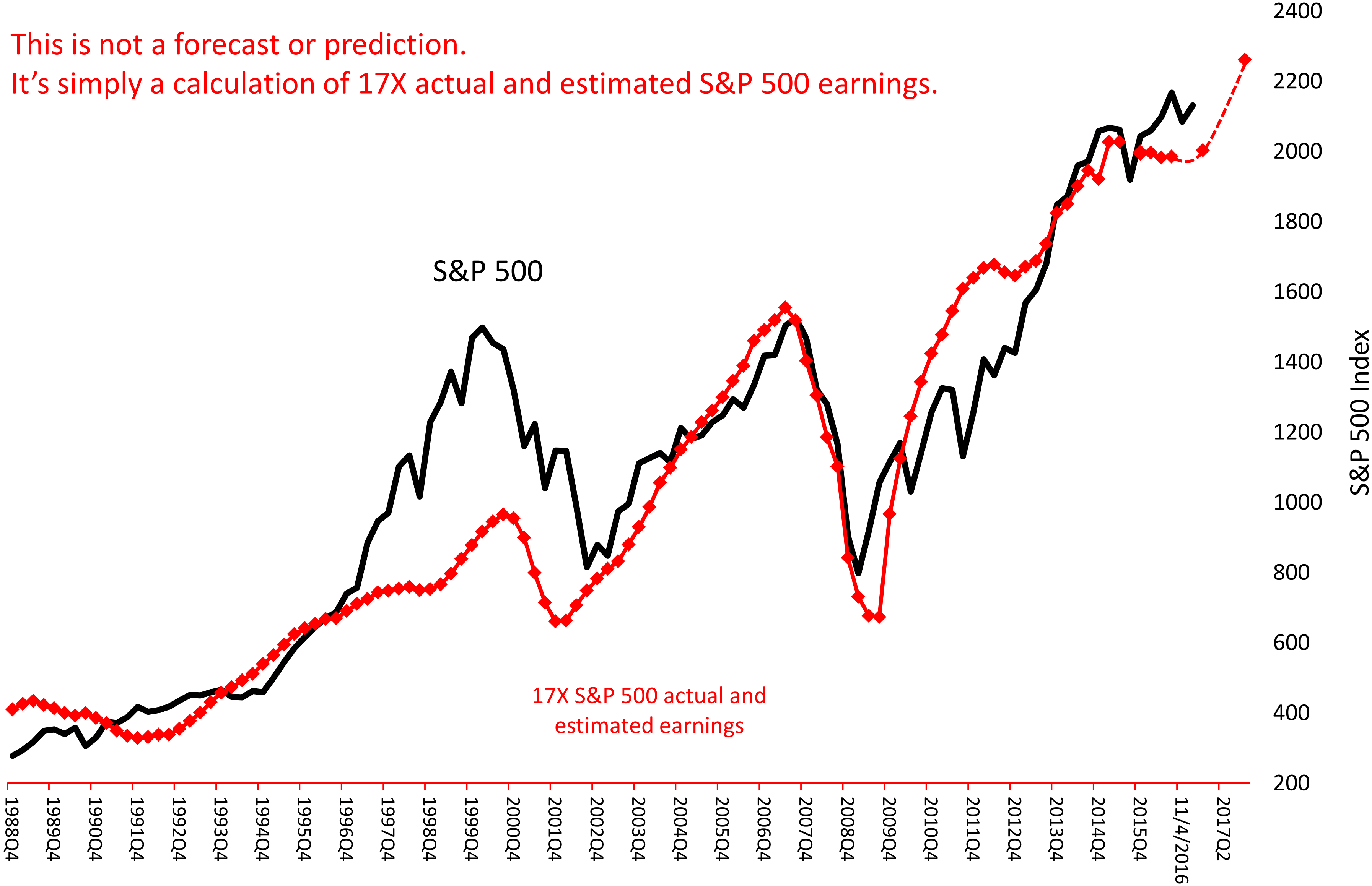
Source: Standard and Poor's. Data through November 4, 2016.[1] Compound annual growth rate. [2] S&P 500 total return index.
[3] per Professor Jeremy Siegel's seminal *Stocks for the Long Run*, first published in 1994.

# S&P 500 vs. actual and estimated earnings



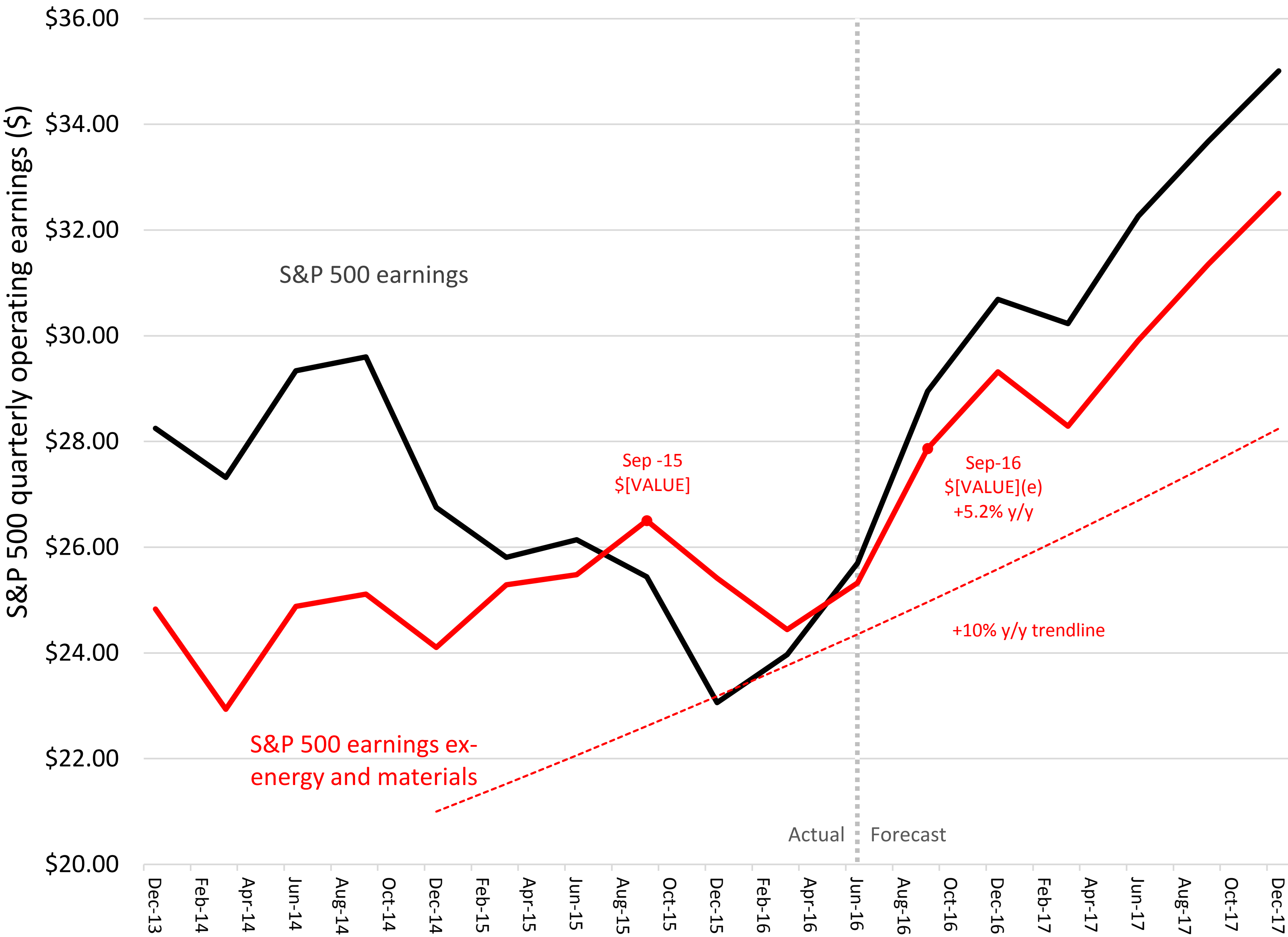

[1] 2015 (actual), 2016 (estimated) and 2017 (estimated) bottom-up S&P 500 operating earnings per share as of November 1, 2016: for 2015, $117.46; for 2016(e), $117.86; for 2017(e), $133.01. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through November 7, 2016; and actual operating earnings data through 2014.

# S&P 500 vs. 17X actual and estimated earnings




[1] 2015 (actual), 2016 (estimated) and 2017 (estimated) bottom-up S&P 500 operating earnings per share as of November 1, 2016: for 2015, $117.46; for 2016(e), $117.86; for 2017(e), $133.01. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S survey of consensus estimates. Standard and Poor's for index price data through November 7, 2016; and actual operating earnings data through 2014.

# S&P 500 earnings recession – and recovery




According to Standard & Poor's forecasts, earnings are on a +10% growth trajectory through the end of 2017.

Source:
Standard & Poor's

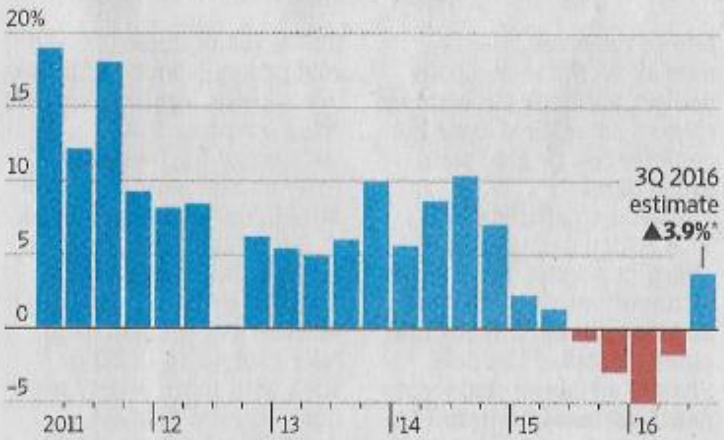
Source: Standard & Poor's. Earnings estimates are based on the Capital IQ consensus forecast. Actual earnings through Q2 2016. Data as of November 3, 2016.

# S&P 500 earnings recovery

# Profits Perk Up but Caution Rules

## Eye on Earnings

Profits for S&P 500 firms are expected to rise this quarter, after four quarters of declines, but executives are cautious about 2017.




*Reflects actual results for 423 companies and consensus estimates for the rest. Results are adjusted from generally accepted accounting principles.

Source: Thomson Reuters

THE WALL STREET JOURNAL.

BY THEO FRANCIS
AND KATE LINEBAUGH

This is the corporate landscape that will greet the next president: improving profits buoyed by rising employment and business spending—yet tempered by the elusiveness of a more resilient recovery.

Earnings for the biggest U.S. companies began to rebound in the third quarter, a glimmer of growth after four straight quarters of contractions. But some executives are already expressing caution about the coming year.

**Delphi Automotive** PLC, the big car-parts maker, forecast flat auto sales in the new year, though it expects its own business to fare better. **Whole Foods Markets** Inc. projected negative to flat sales at grocery stores open at least a year, warning that food-pricing trends could worsen before they improve. Drugmaker **AmerisourceBergen** Corp. said its fiscal 2017 growth would lag behind that of recent years, in part due to pressure on generic-drug prices and uncertain prospects for brand-name price increases.

"The outlook for GDP, corporate profits and corporate investment is more favorable in 2017," said W. Edward Walter, chief executive of **Host Hotels & Resorts** Inc. "But the concept that it will be better next year has been offered frequently during this recovery and generally hasn't come to fruition."

With 85% of S&P 500 companies reporting results for the quarter, adjusted earnings—excluding write-downs, restructurings and other items considered unusual—are expected to rise 3.9% from last year's third quarter, according to Thomson Reuters. Revenues are expected to increase 2.6%.

Excluding the beleaguered energy sector, earnings are expected to rise 7.5%, with revenues up 4.5%, Thomson Reuters said. The figures reflect actual results for companies that have reported and analyst expectations for others.

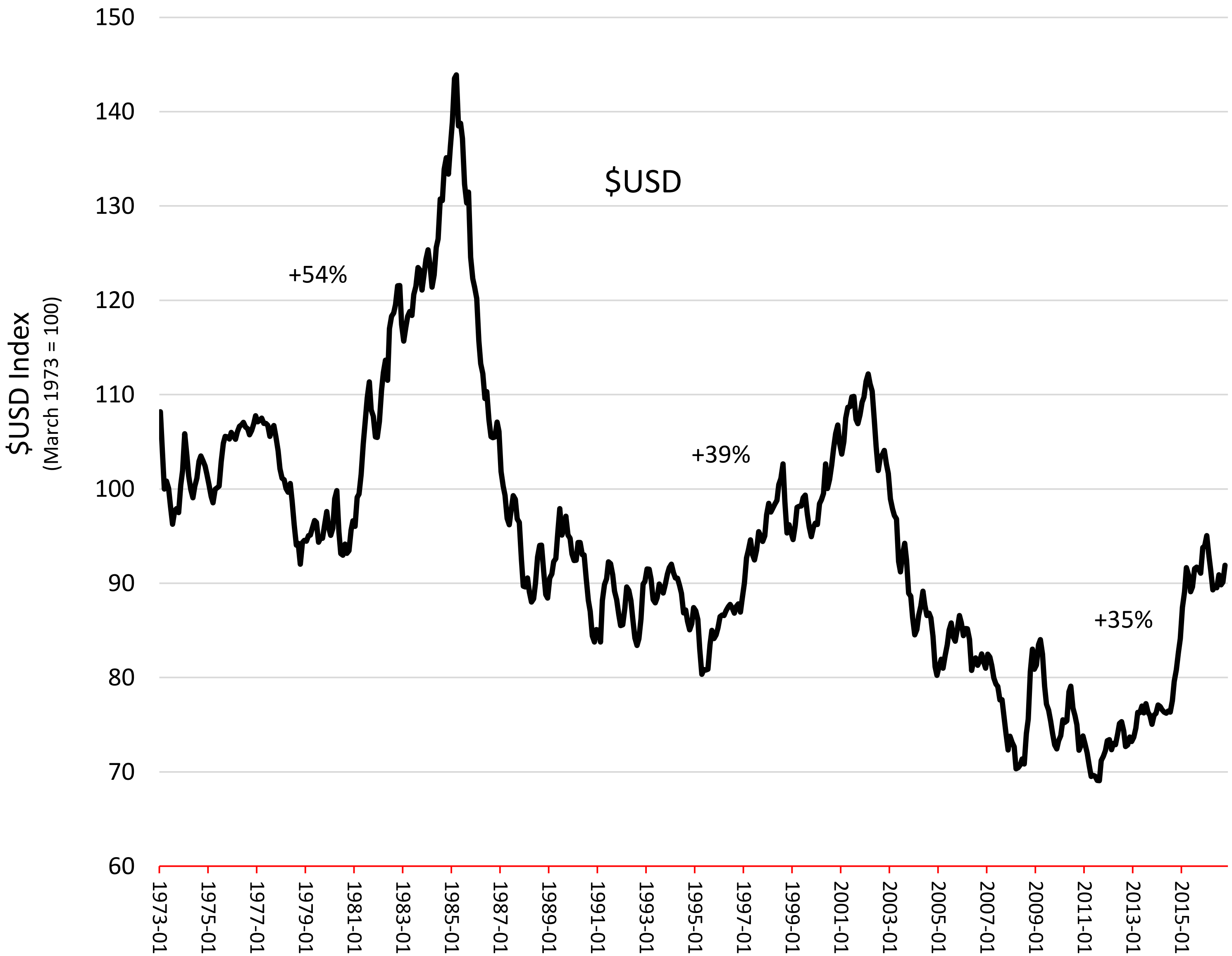
Third-quarter improvements were led by technology, basic materials, financial and

*Please see RESULTS page B2*

Source:
Thomson Reuters

Source: *The Wall Street Journal*, November 7, 2016.

# U.S. Dollar index



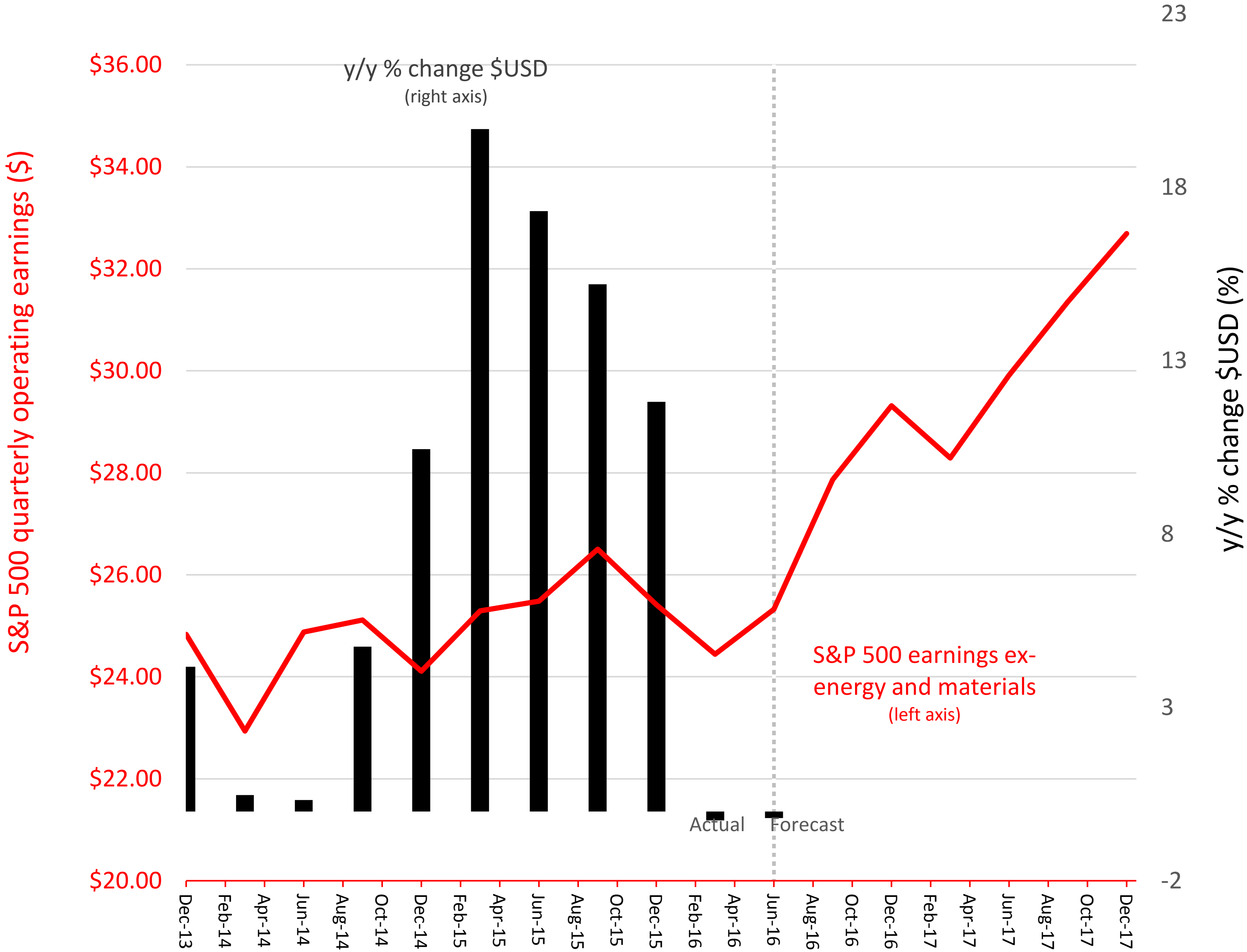

<u>$USD stabilization for over a year.</u>

"… no model projecting directional movements in exchange rates is significantly superior to tossing a coin."

-- Alan Greenspan[1]

Source: Federal Reserve major currencies index. Data through October 2016. [1]Federal Reserve, Remarks by Chairman Alan Greenspan before the Economic Club of New York, March 2, 2004.

# S&P 500 earnings & the $USD

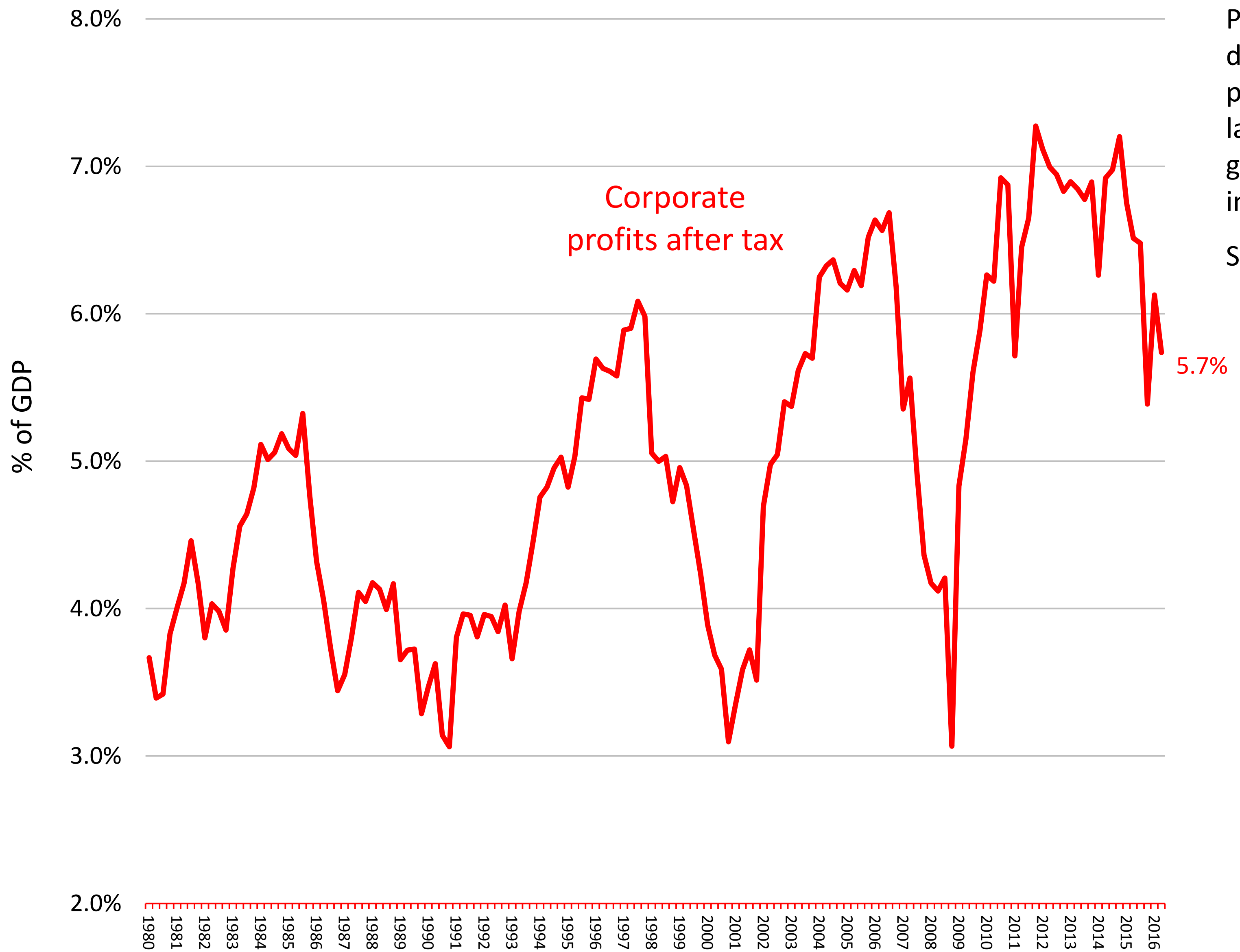



<u>2014-15 surge in the $USD was a key cause of the earnings recession</u>.

With $USD and oil price stabilization earnings are forecast to surge in 2016 and 2017.

Sources: Federal Reserve and Standard & Poor's. Earnings estimates are based on the Capital IQ consensus forecast as of November 3, 2016. Actual earnings data through Q2 2016; actual $USD data through Q2 2016.

# Corporate profit margins off peak, likely sustainable

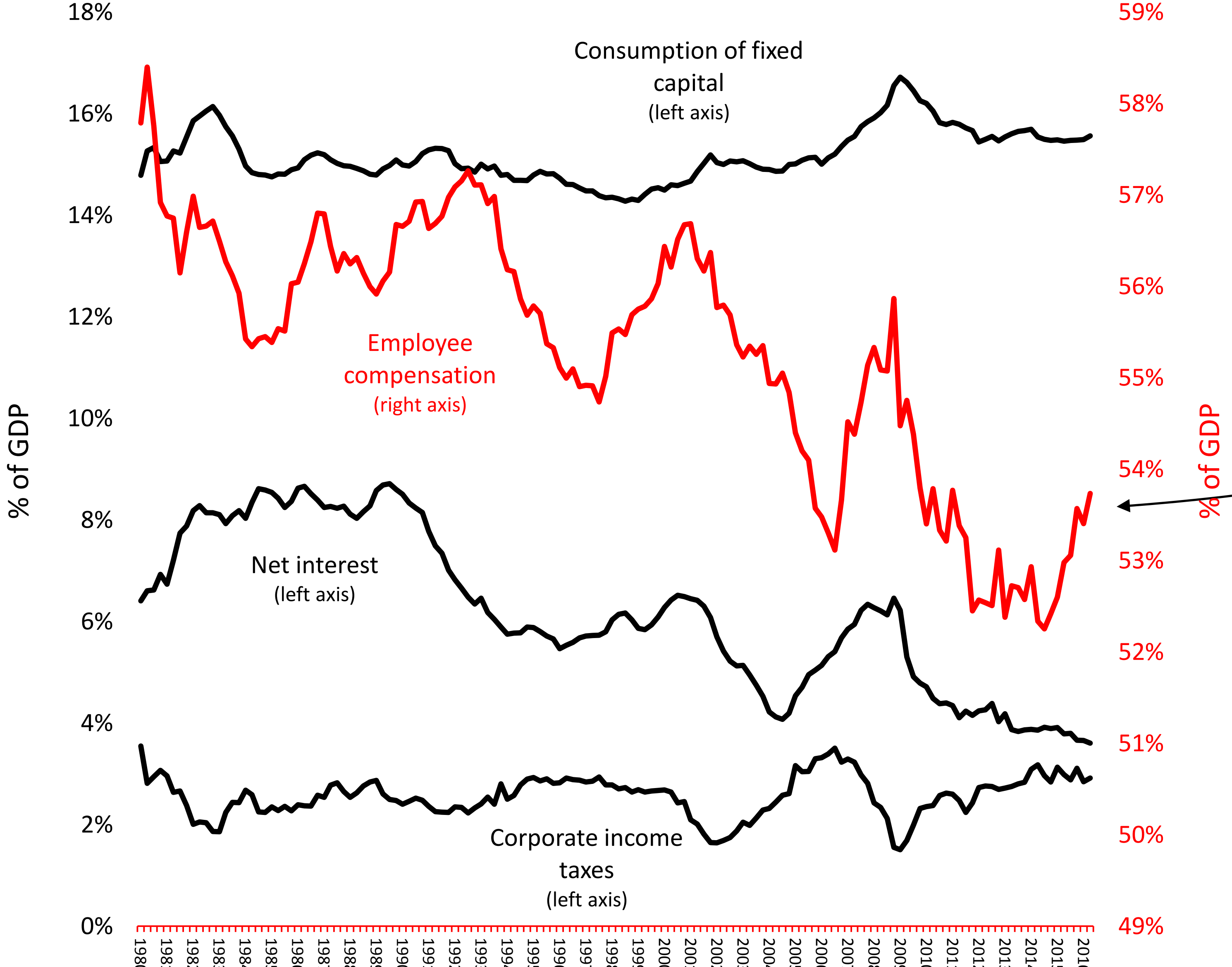



Profit margins are down from 7.3% peak in 2011 as labor's share of gross domestic income picks up.

See next slide.

Source: BEA. Quarterly data through June 2016.

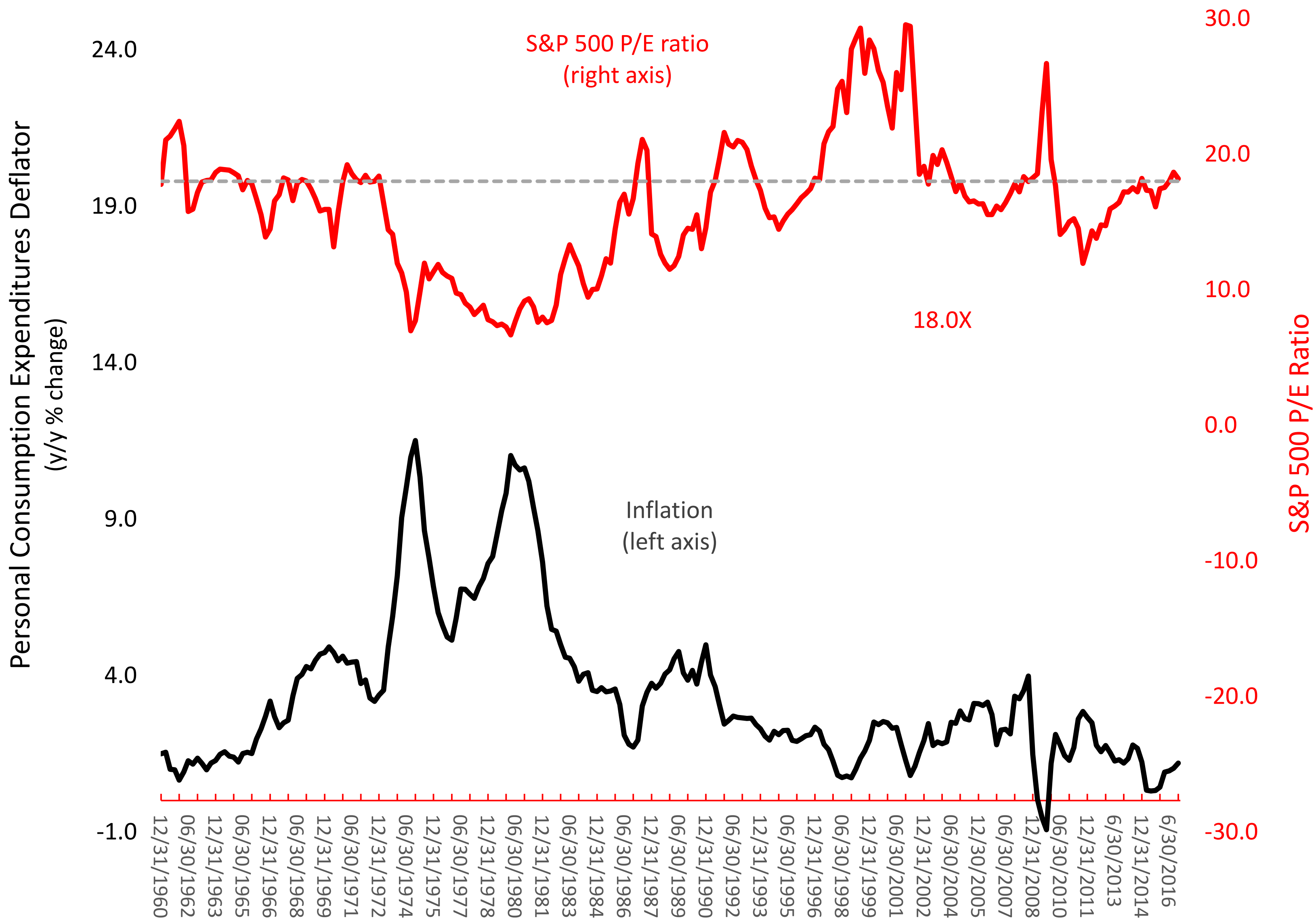
# Corporate cost inputs




Labor's share of gross domestic income is rising.

Source: BEA. Quarterly data through June 2016.

# S&P 500 P/E ratio vs. inflation



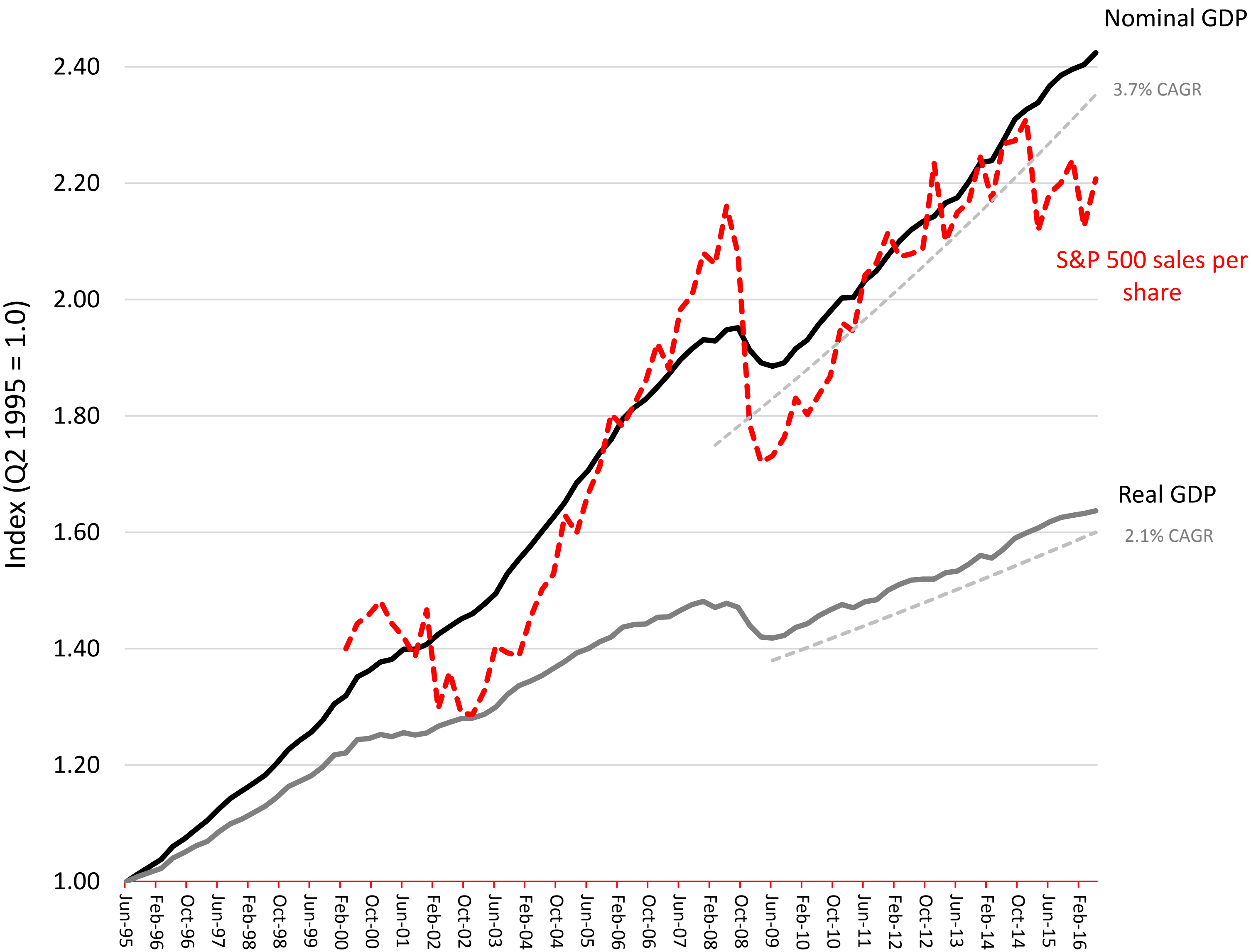

The S&P 500's latest P/E ratio (11/7/16) on trailing 12-months operating earnings is 18.2X.

It is 16.0X on consensus bottom-up 2017 operating earnings.

Sources: Standard & Poor's Corporation and Thomson Reuters I/B/E/S earnings estimates, BEA. Stock price data through November 7, 2016; inflation data through September 2016. Top panel, latest data point: 2132 ÷ trailing operating earnings of $116.80 through 9/30/16 = 18.2X.

Stock market arithmetic

# What drives 7% S&P 500 earnings growth?




Nominal GDP, a measure of the U.S. economy's total sales, is conceptually similar (though not equal) to S&P 500 companies' total sales.

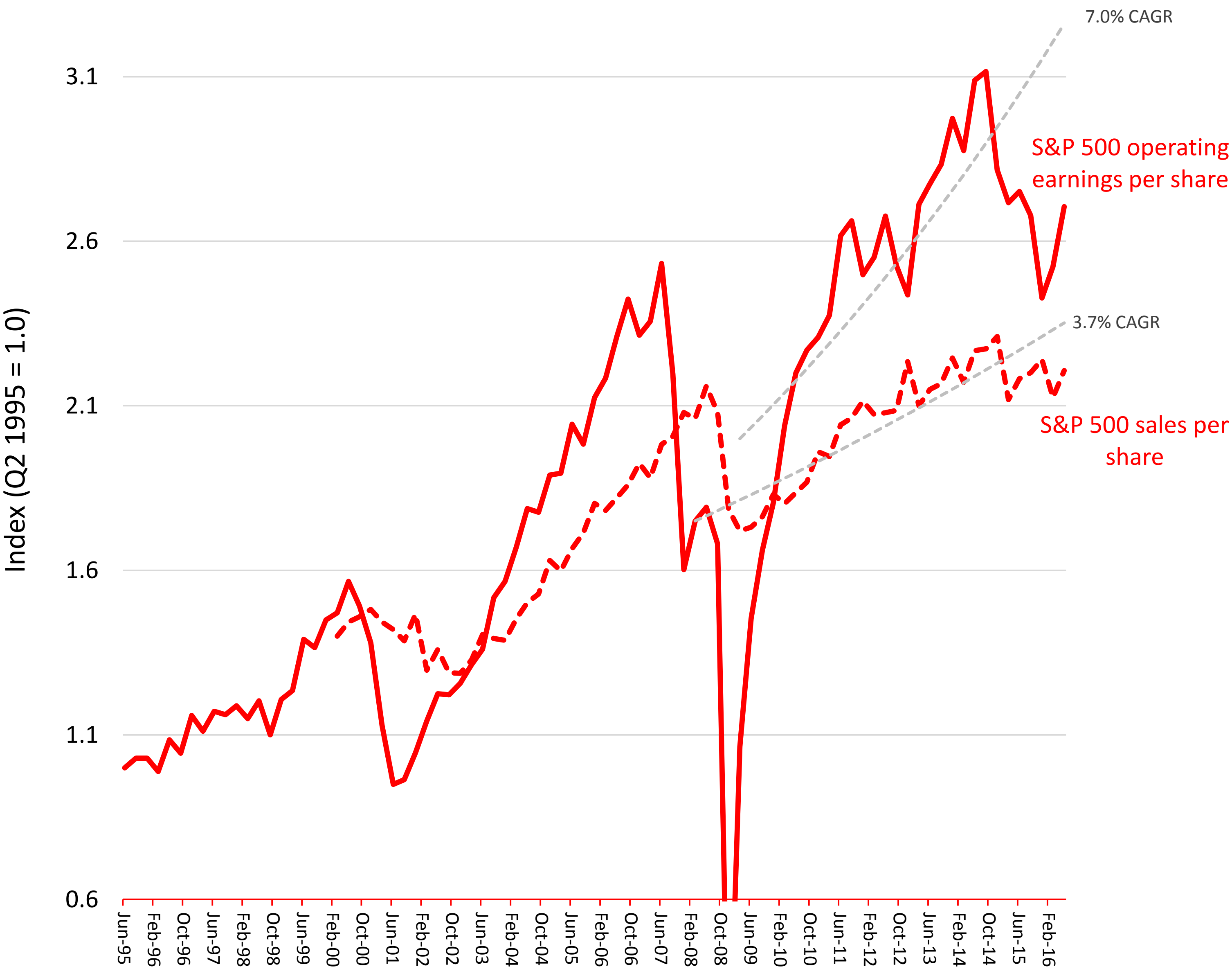
Sales drive earnings, next chart.



Sources: BEA and Standard and Poor's. GDP data through June 2016. S&P data through June 2016.
CAGR = compound annual growth rate.

# Stock market arithmetic

## What drives 7% S&P 500 earnings growth?



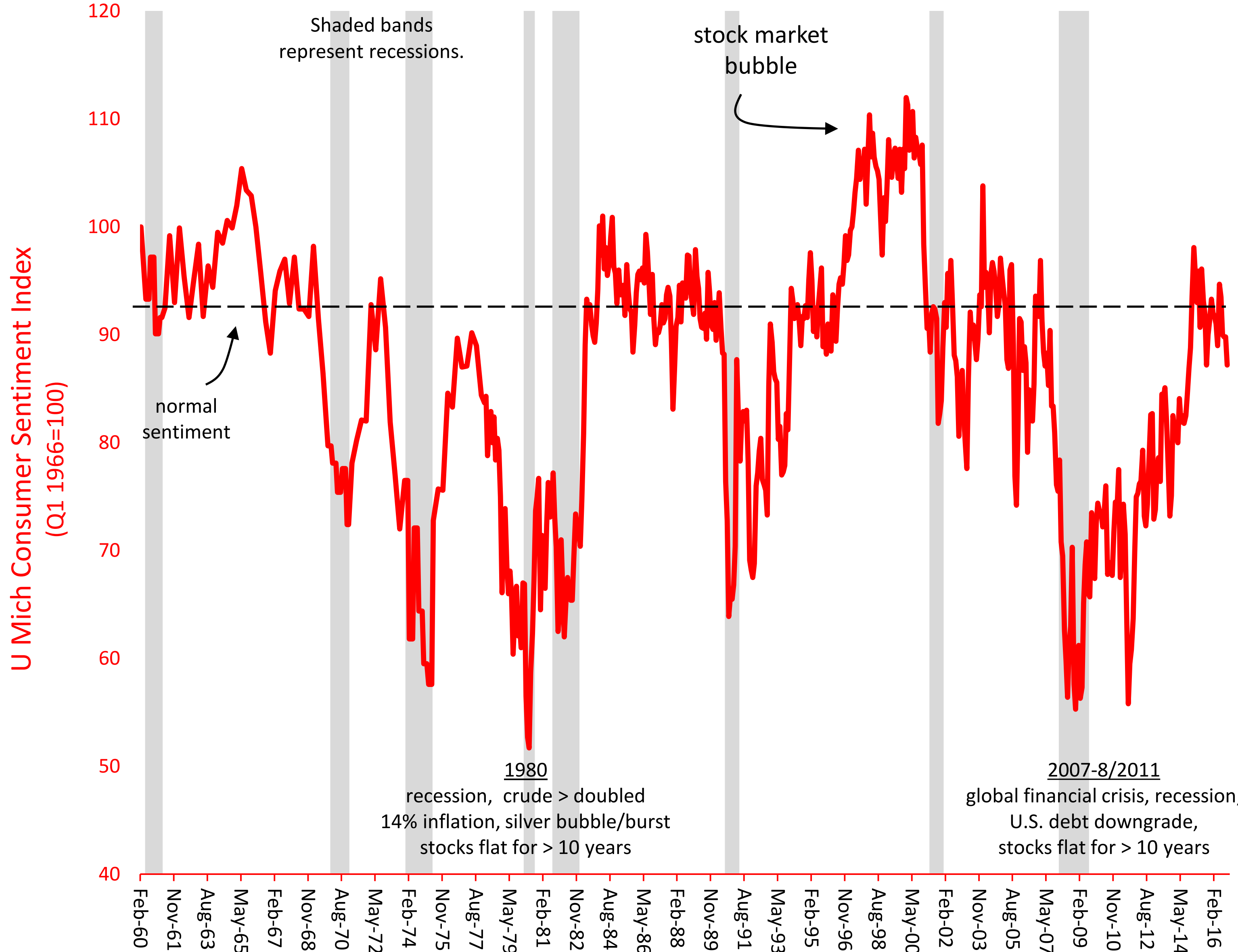

Sales drive earnings. Earnings drive stock prices.

S&P 500 earnings trended higher at approximately +7.0% during this recovery until the oil price collapse and $USD surge.

Source: Standard and Poor's. Data through June 2016. CAGR = Compound annual growth rate.

Consumer sentiment

# Good for consumer spending but not irrationally exuberant




Consumer sentiment has normalized following the recession and financial crisis collapse.

You have to go back a generation – more than 30 years – to find consumer sentiment as low as it got through the recent crisis.

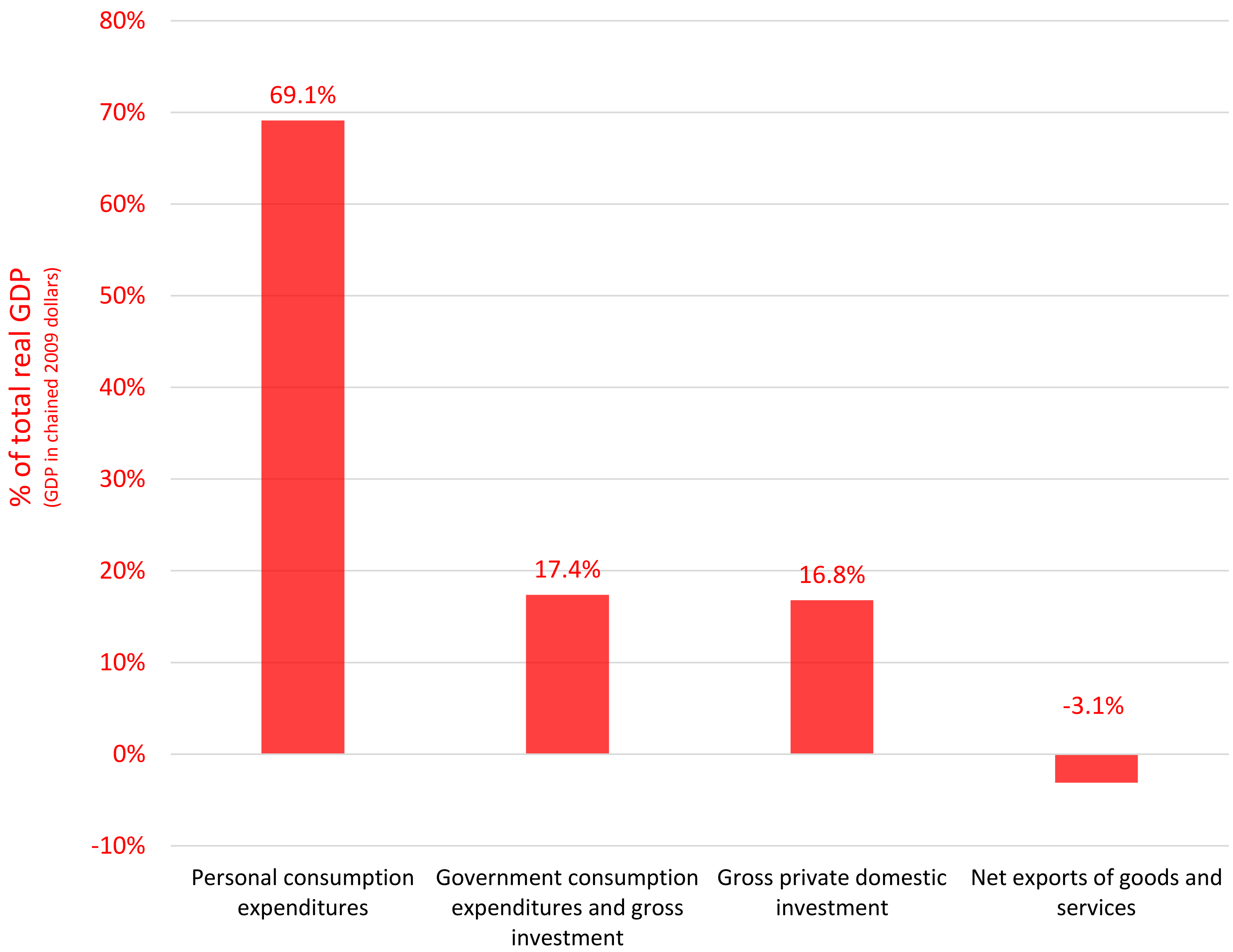
October at 87.2 is normal but not exuberant.

Source: The University of Michigan Survey Research Center, data through October 2016.

# Economy

- +2.9% Q3 GDP – strength in "C", recovery in "I", booming net exports
- strong growth in: personal income, DPI, real DPI, real DPI per capita, retail sales
- strong household balance sheets, savings rate and record low household financial obligations ratio
- rising LEI, strong PMIs, good hiring, record high job openings, declining unemployment rate, record low weekly unemployment claims, strong car sales, rising housing starts
- no inflation threat
- Can you say "Goldilocks"?

# GDP breakdown




Consumer spending drives the U.S. economy.

Source: BEA. Data through September 2016.

Myth: companies haven't been reinvesting in their businesses

# Gross private domestic investment (the "I" in GDP = C+I+G+net exports)

# Firms Dial Back Investment

Spending slowdown is risk to economy even as other indicators show strength

By Eric Morath

Companies are pulling back on investments despite a solid labor market and a strengthening housing sector.

Spending on some of the building blocks of businesses—such as machines, computers and steel—is slipping. Such expenditures are an important ingredient in improving employee productivity, workers' wages and corporate profits. A lack of investment risks trapping the economy in a low-growth mode.

The Commerce Department said Thursday orders for nondefense capital goods excluding aircraft—an important proxy for business investment—fell a seasonally adjusted 0.8% in April. The measure has declined nearly 12% since touching a postrecession peak in September 2014.

The decline stands in contrast to measures of housing, consumer spending and employment, which are all improving this spring.

The Labor Department said Thursday that initial claims for jobless benefits fell for the second straight week, a sign that hiring strengthened in May. Earlier this month, government data showed that retail spending broke out in April.

"The U.S. consumer appears to have more confidence than businesses in terms of investing for the future, given the demand for housing," said Diane Swonk, economist at DS Economics. "It's disturbing that businesses' cash flow has improved dramatically and they have access to cheap debt, but they've deployed that on dividends and buybacks instead of investing in the future."

Overall U.S. economic growth slowed in the first quarter to a 0.5% annualized advance, though economists surveyed by The Wall Street Journal project that gross domestic product will be revised to a 1% increase when the government publishes revisions on Friday.

Better consumer spending and housing activity is expected to propel stronger growth in the second quarter, with forecasting firm Macroeconomic Advisers on Thursday estimating GDP will increase at a 2.5% pace. The Federal Reserve Bank of Atlanta's GDPNow model projects the second-quarter's growth rate at 2.9%.

Even with a second-quarter improvement, many economists expect growth for the year will remain near the roughly 2% rate recorded for most of the expansion.

The slowdown in business investment coincides with lower productivity gains since the middle of 2014. Steady hiring could indicate businesses are spending on labor instead of capital. But without equipment and other investments, it is difficult for productivity to improve over time.

Despite a recent rise in oil prices, "equipment and rental demand continues to remain at reduced levels," David Meyer, chief executive of Titan Machinery Inc., told investors Thursday.

The West Fargo, N.D., manufacturer of construction and agricultural equipment reported a drop-off in first-quarter sales from a year earlier, partly because of weaker commodity prices. Reduced profits from the farming sector "is impacting purchases of construction equipment by customers in the agriculture industry," Mr. Meyer said.

Multiple factors are holding back stronger investment: The energy sector is retrenching amid low oil prices. A strong dollar and economic weakness overseas have depressed demand for U.S. exports. And while consumer spending is rising, retailers are closing stores as shopping shifts online.

Potential long-run growth in the U.S. has dropped from about 3% to about 2% since the recession ended, "with much of the decline a function of slower productivity growth," Federal Reserve governor Jerome Powell said in a speech Thursday. The productivity decline is in part driven by low capital investment, he said.

*—Ben Leubsdorf contributed to this article.*

LUKE SHARRETT/BLOOMBERG NEWS

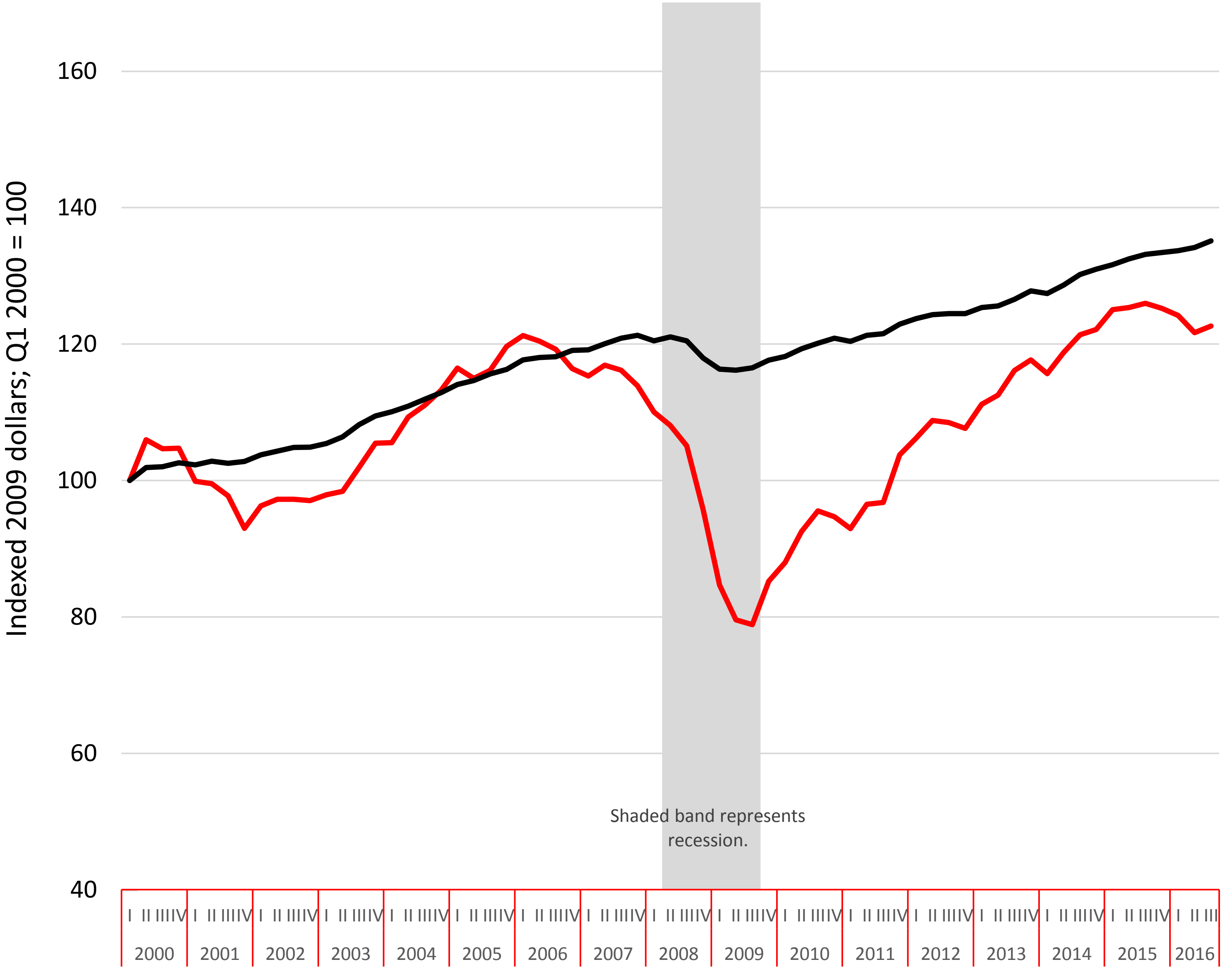
**A worker prepares an engine at Mack Truck Inc. in Macungie, Pa.**

The standard narrative, but wrong.

Source: *The Wall Street Journal*, May 27, 2016.

Myth: companies haven't been reinvesting in their businesses

# Gross private domestic investment (the "I" in GDP = C+I+G+net exports)

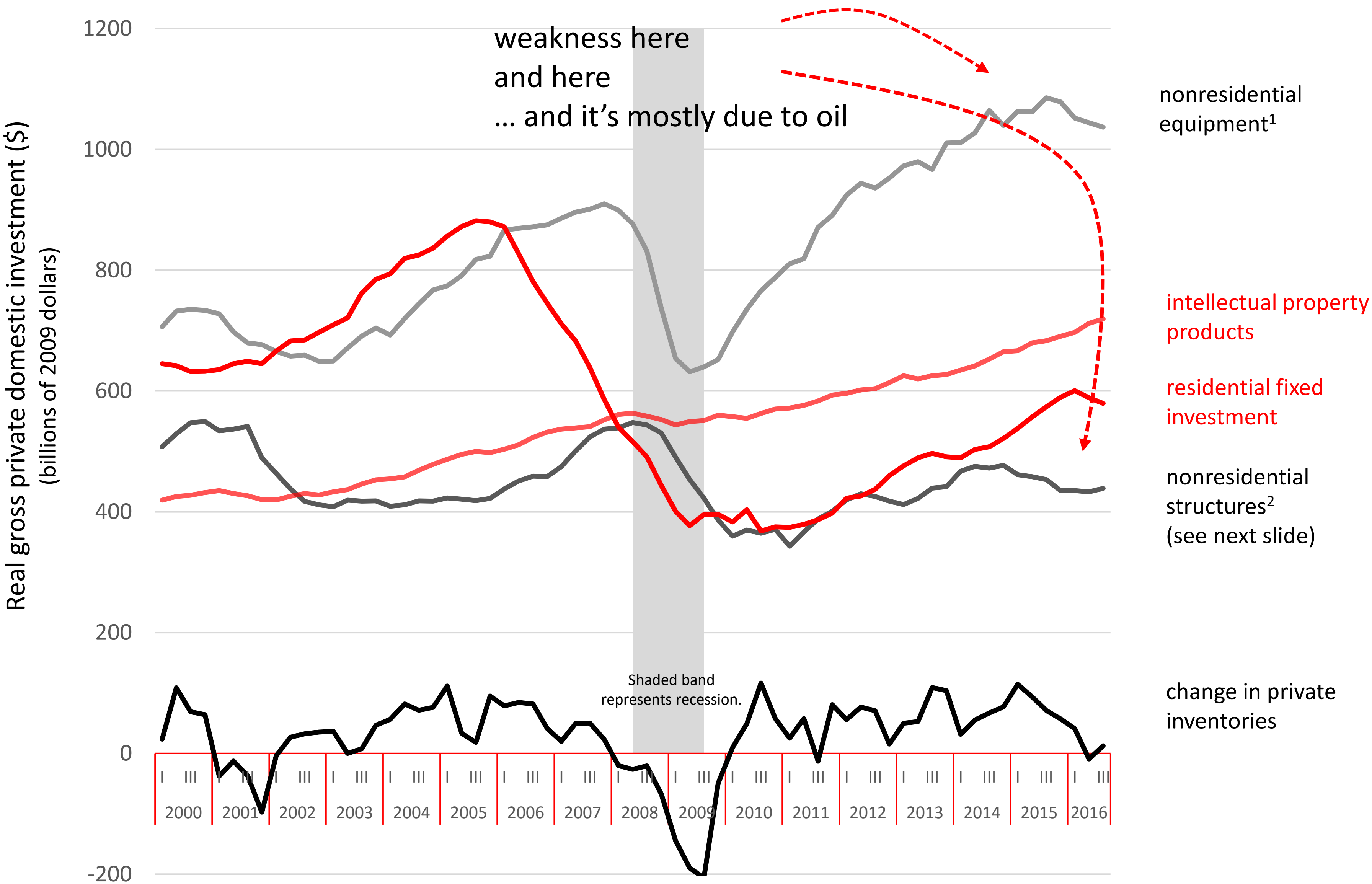



Total investment flow plunged during the recession, hasn't recovered as fast as total GDP, and has lately rolled over.

Sources: BEA. Data through September 2016.

# Myth: companies haven't been reinvesting in their businesses

# Detail behind the "I" in GDP = C+I+G+net exports



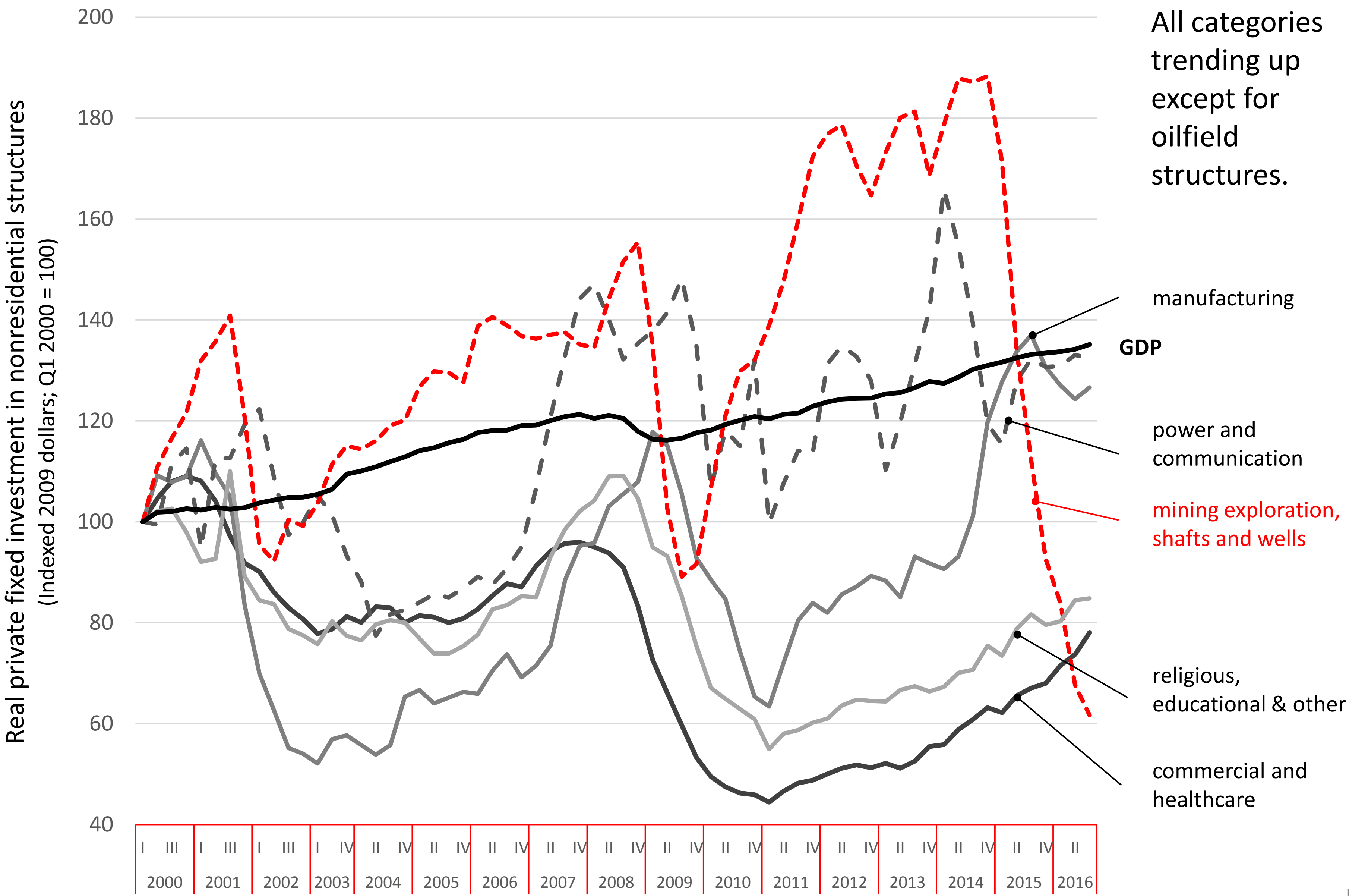

Sources: BEA. Data through September 2016.

[1]Weakness in transportation and "other" equipment, which includes mining and oilfield machinery.

[2] Weakness due to the collapse in mining exploration shafts and wells.

Myth: companies haven't been reinvesting in their businesses

# Detail behind investment in nonresidential structures

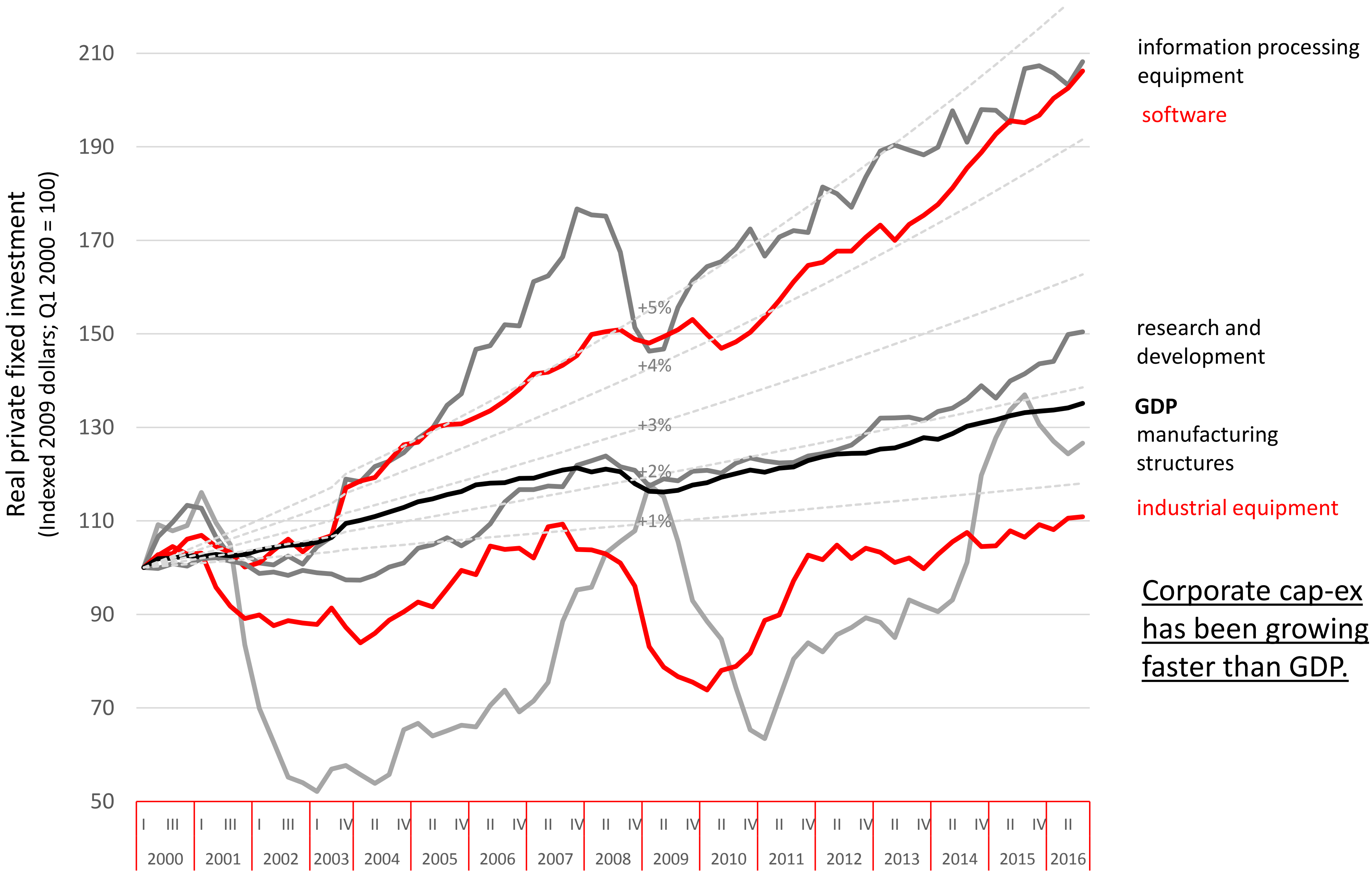



All categories trending up except for oilfield structures.

Sources: BEA. Data through September 2016.

Myth: companies haven’t been reinvesting in their businesses

# Components of corporate cap-ex

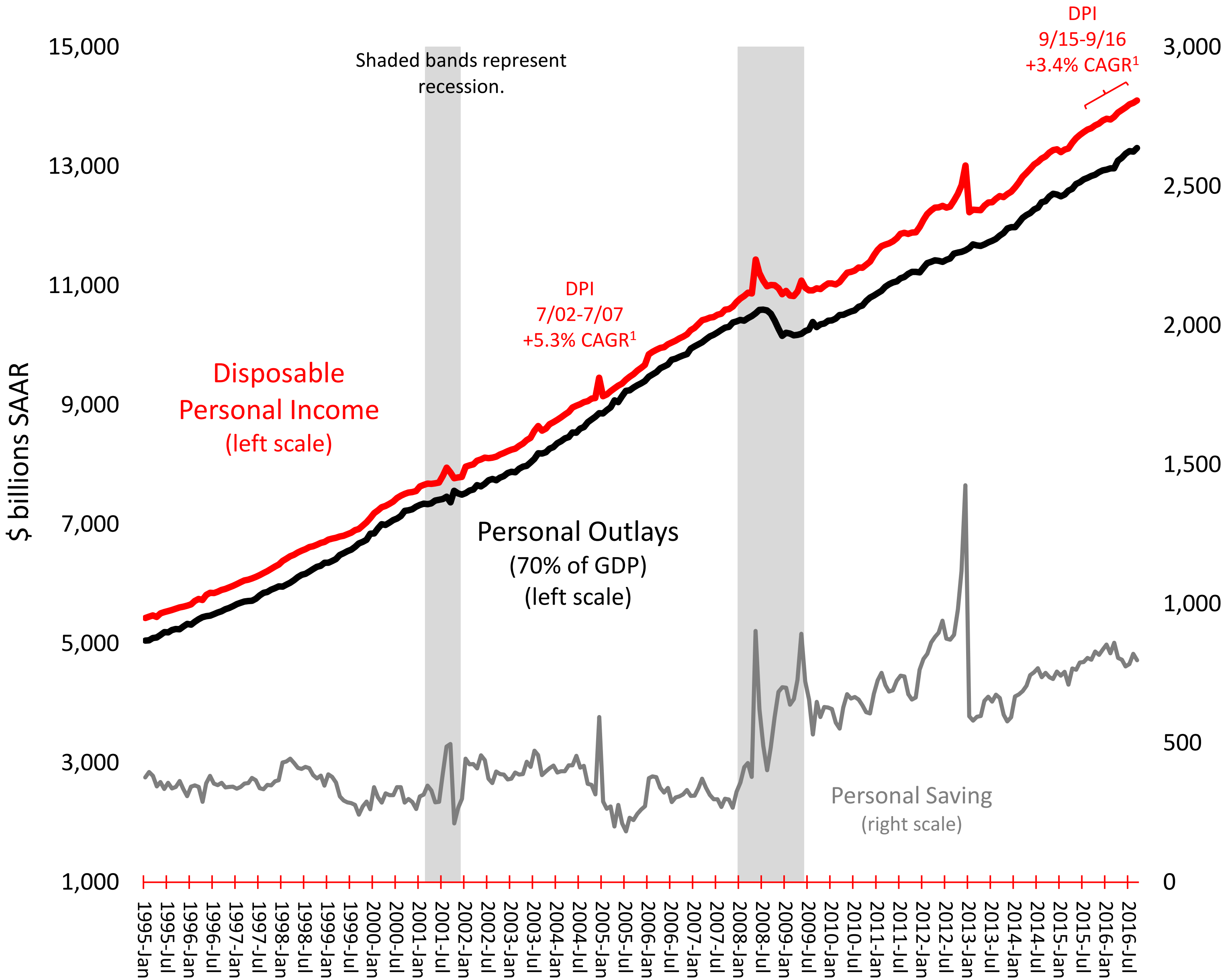



Corporate cap-ex has been growing faster than GDP.

Source: BEA. Data through September 2016. Dotted lines indicate compound annual growth rate trajectories at rates indicated. In order to simplify this chart, it does not include the transportation and catch-all “other” equipment categories.

Economic data – consumer spending

# Consumer income, spending and saving



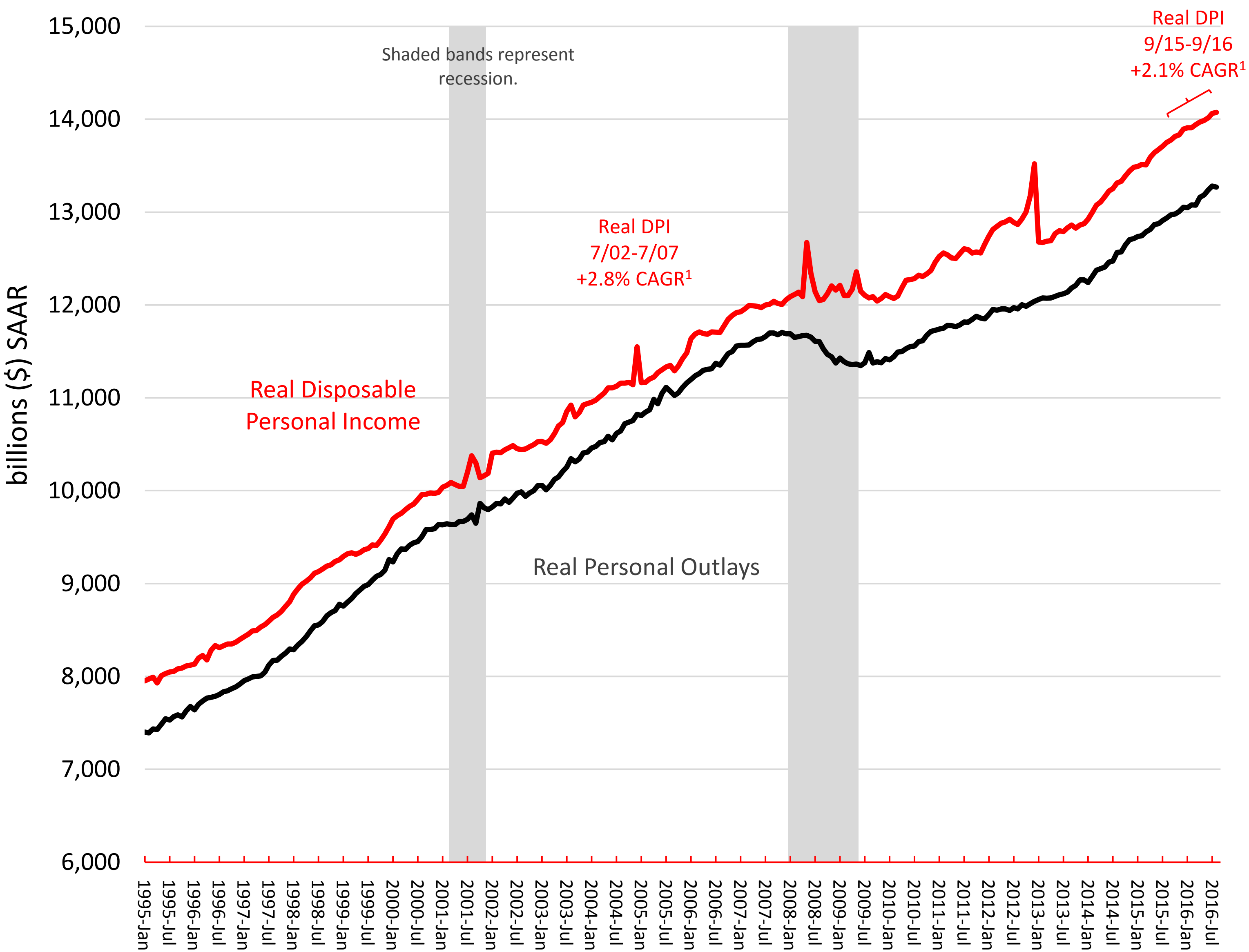

Nominal DPI drives spending, spending drives GDP and corporate earnings.

The savings rate (5.7%) has recently run higher and has remained substantially higher than it was pre-crisis.

Source: Bureau of Economic Analysis, monthly data through September 2016. [1]Compound annual growth rate.

Economic data – consumer spending

# Real consumer income and spending

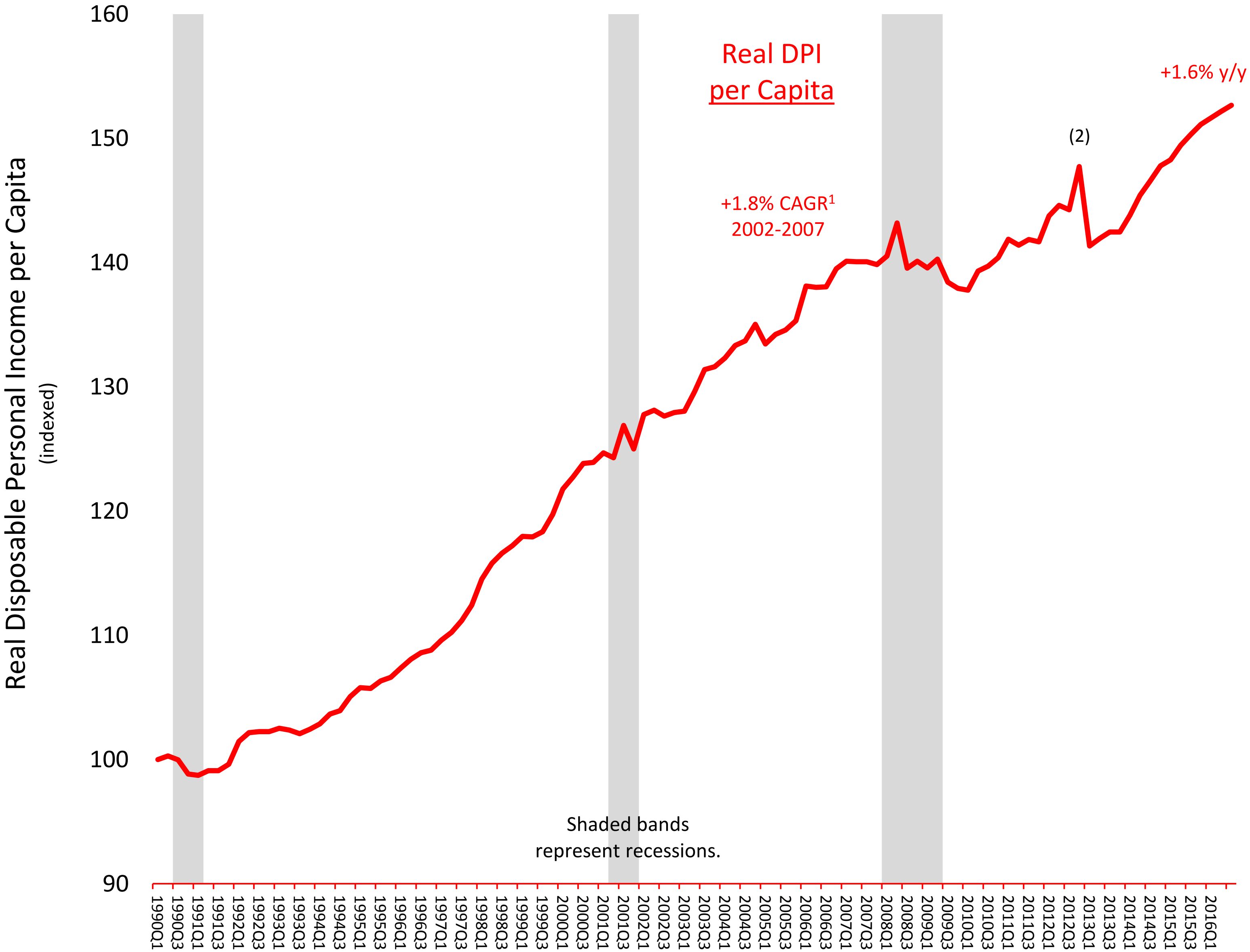



Real DPI is far higher than pre-recession.

<u>Income stagnation is a fiction.</u>

Source: Bureau of Economic Analysis, monthly data through August 2016. [1]Compound annual growth rate.

# Real per capita purchasing power

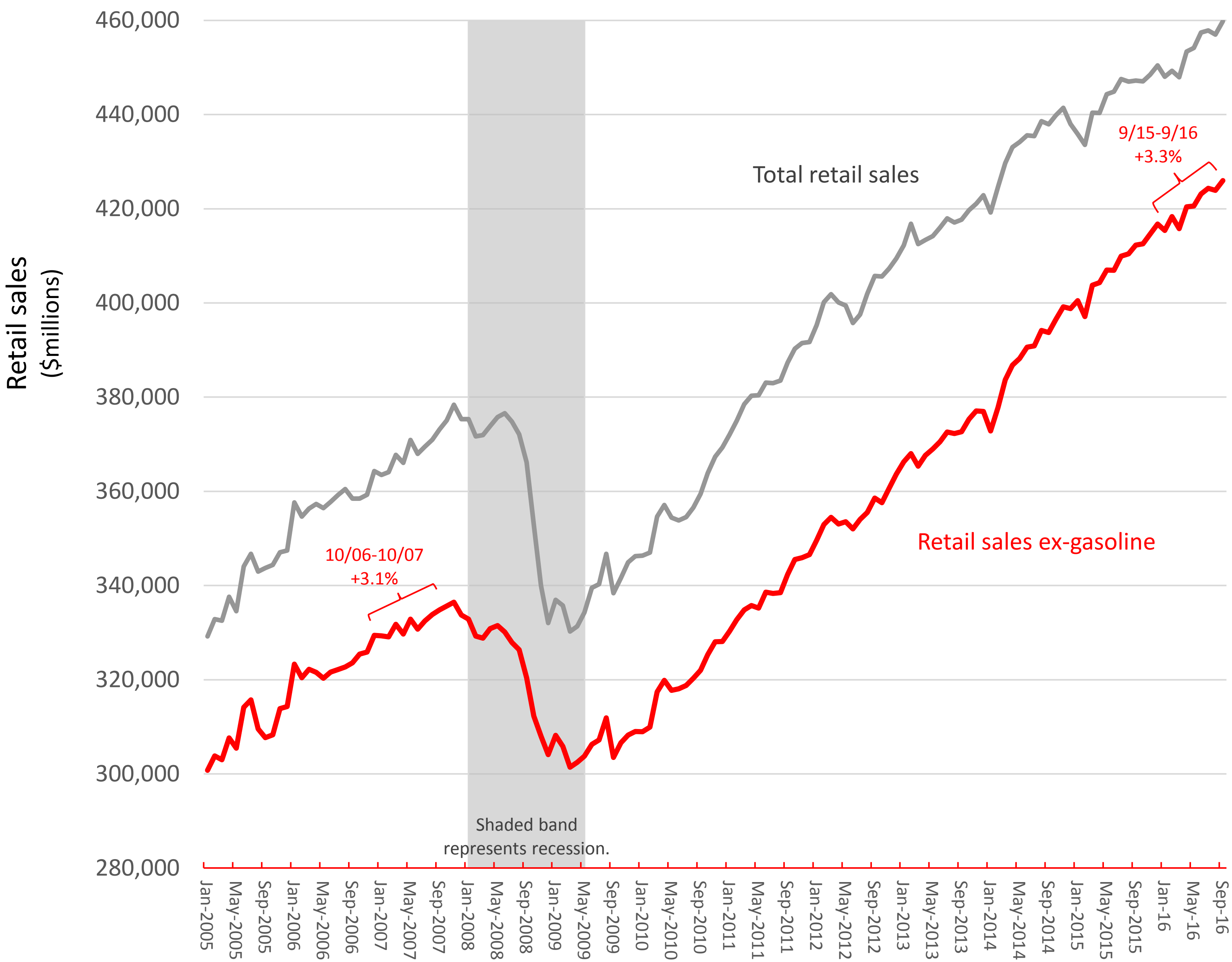



Real per capita after-tax income is growing slower than pre-recession.

But, income stagnation is a fiction.

Source: Bureau of Economic Analysis, quarterly data through September 2016. [1]Compound annual growth rate. [2]Surge in compensation paid prior to 2013 tax hike.

# Retail sales



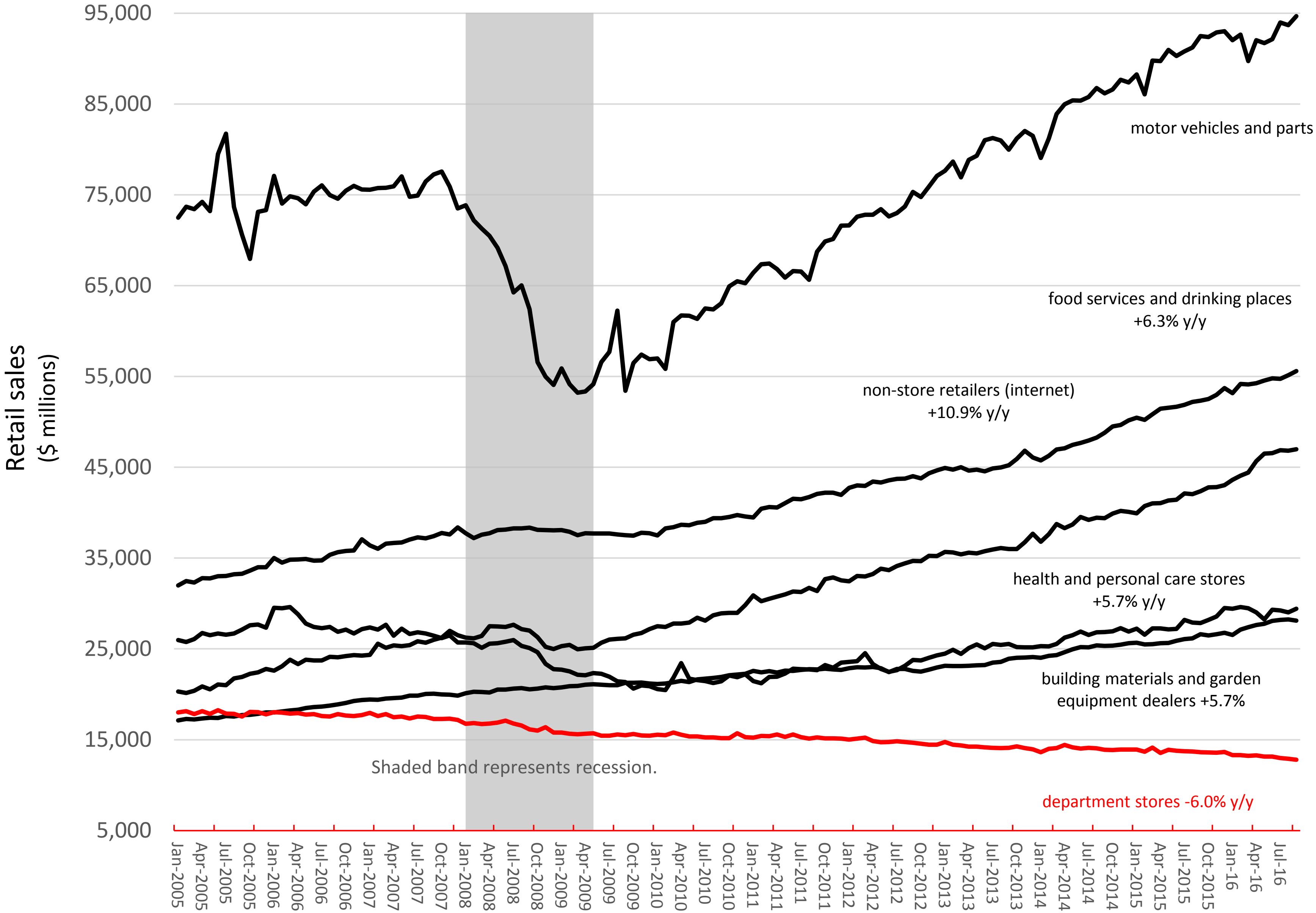

Source: U.S. Census Bureau. Data through September 2016.

<u>Strong retail sales growth</u>.

Despite soft comp-store sales at Macy's, Nordstrom, Kohl's, Gap and more.

# Retail sales by category

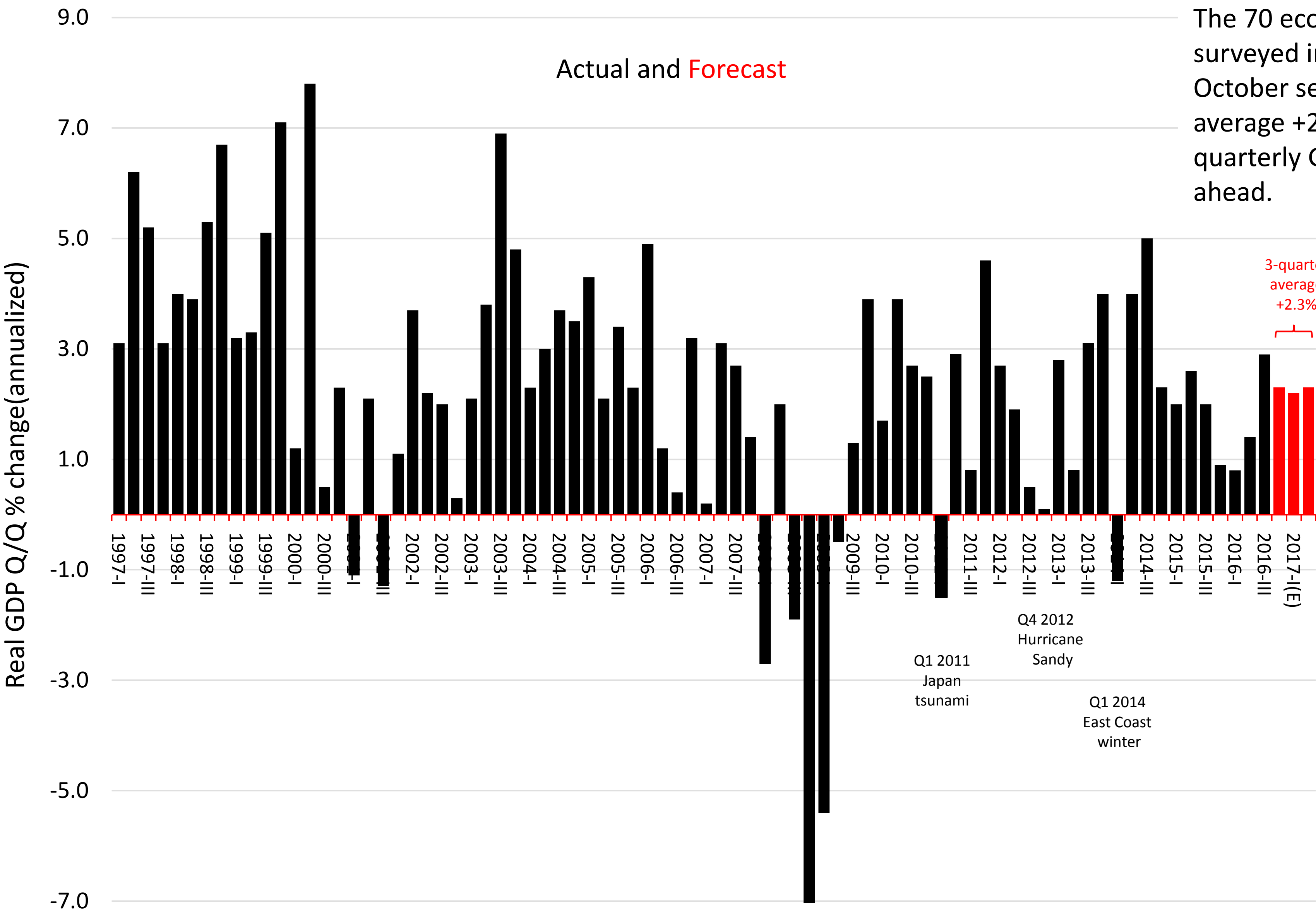
*Department stores are a dying retail format.*




Source: U.S. Census Bureau. Data through September. In order to simplify this chart, not all retail categories are included.

# Consensus GDP forecast

## Pick-up in growth expected

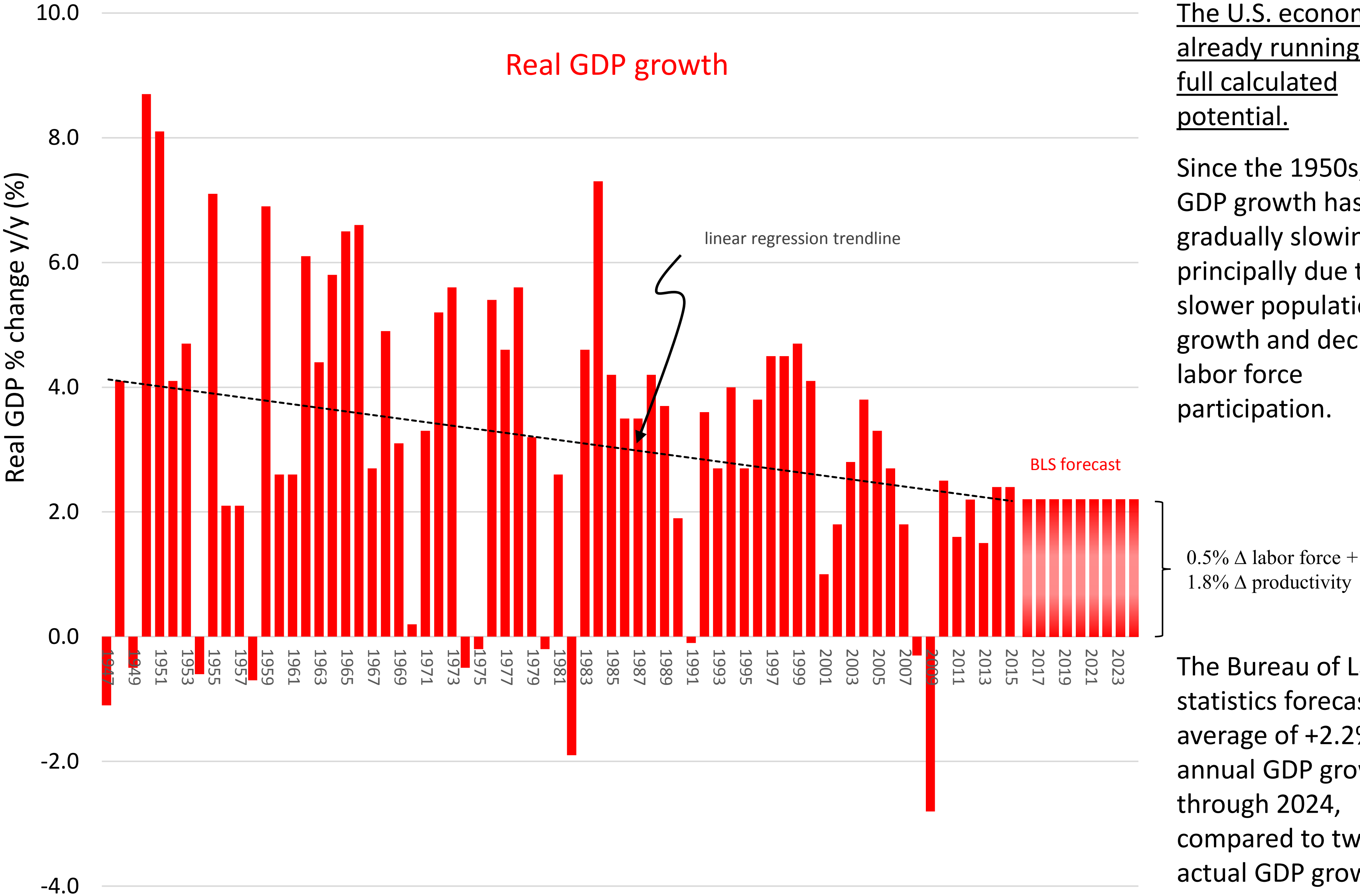



The 70 economists surveyed in early October see an average +2.3% rate of quarterly GDP growth ahead.

Sources: Bureau of Economic Analysis, actual data through September 2016; *The Wall Street Journal* survey taken October 2016.

"Secular stagnation. Anemic. Limping along. Flirting with recession. Stall speed. Sub-par. Struggling. Stuck in first gear."

# GDP growth potential = Δ productivity + Δ labor force




Sources: BEA, BLS. Annual data through 2015. BLS forecast through 2024 dated December 8, 2015.

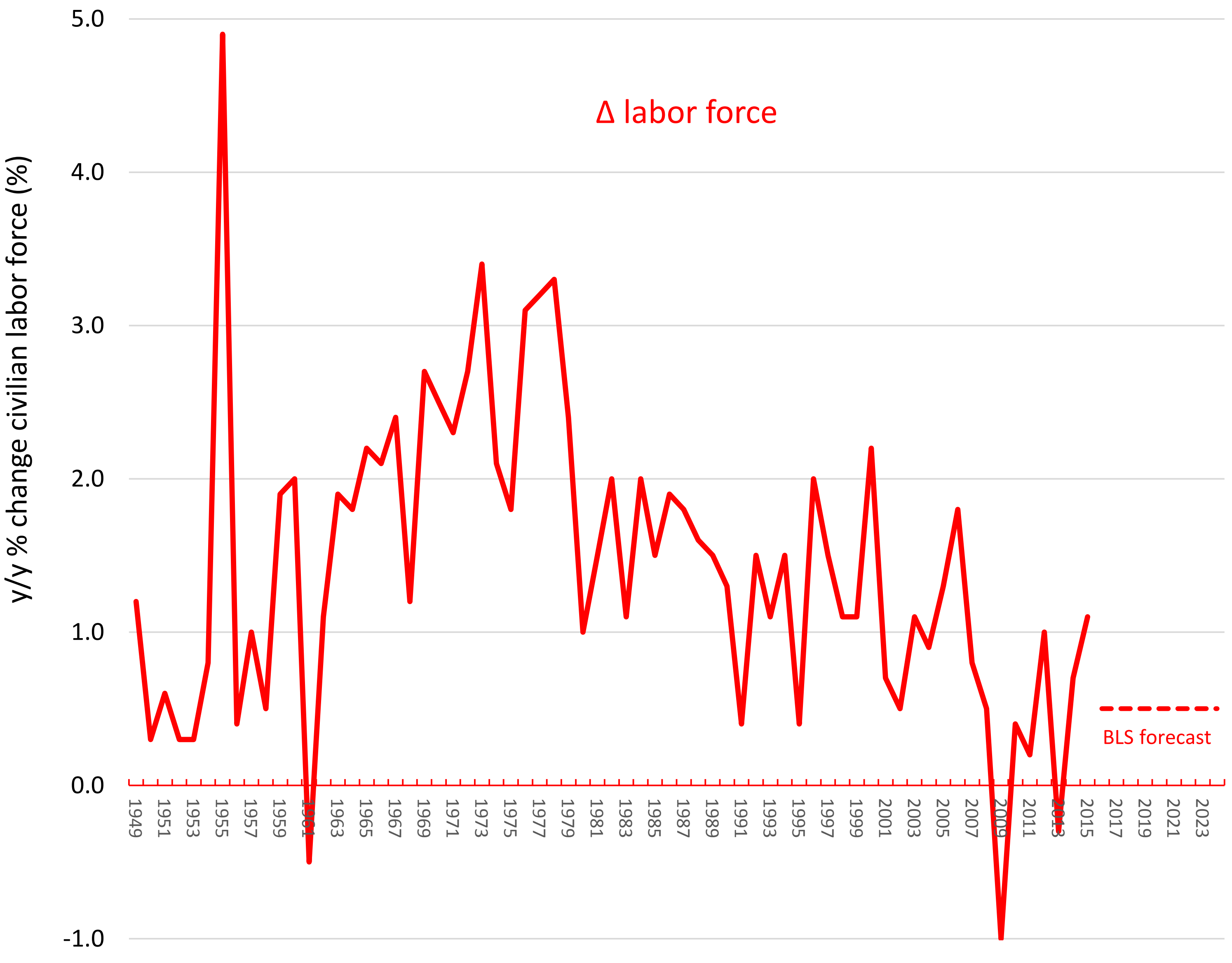
<u>The U.S. economy is already running at its full calculated potential.</u>

Since the 1950s, U.S. GDP growth has been gradually slowing, principally due to slower population growth and declining labor force participation.

The Bureau of Labor statistics forecasts an average of +2.2% annual GDP growth through 2024, compared to two-year actual GDP growth of +2.4%.

GDP growth potential = Δ productivity + Δ labor force

# Labor force




Source: BLS. Annual data through 2015. BLS forecast through 2024 dated December 8, 2015.

The labor force surged post-WWII, peaking in the late 1970s. Since then the U.S. has seen gradually slowing growth in the labor force partly due to the aging population and partly due to a declining participation rate. (See next slide.)

The Bureau of Labor Statistics forecasts annual labor force growth of +0.5% through 2024.

# GDP growth potential = Δ productivity + Δ labor force

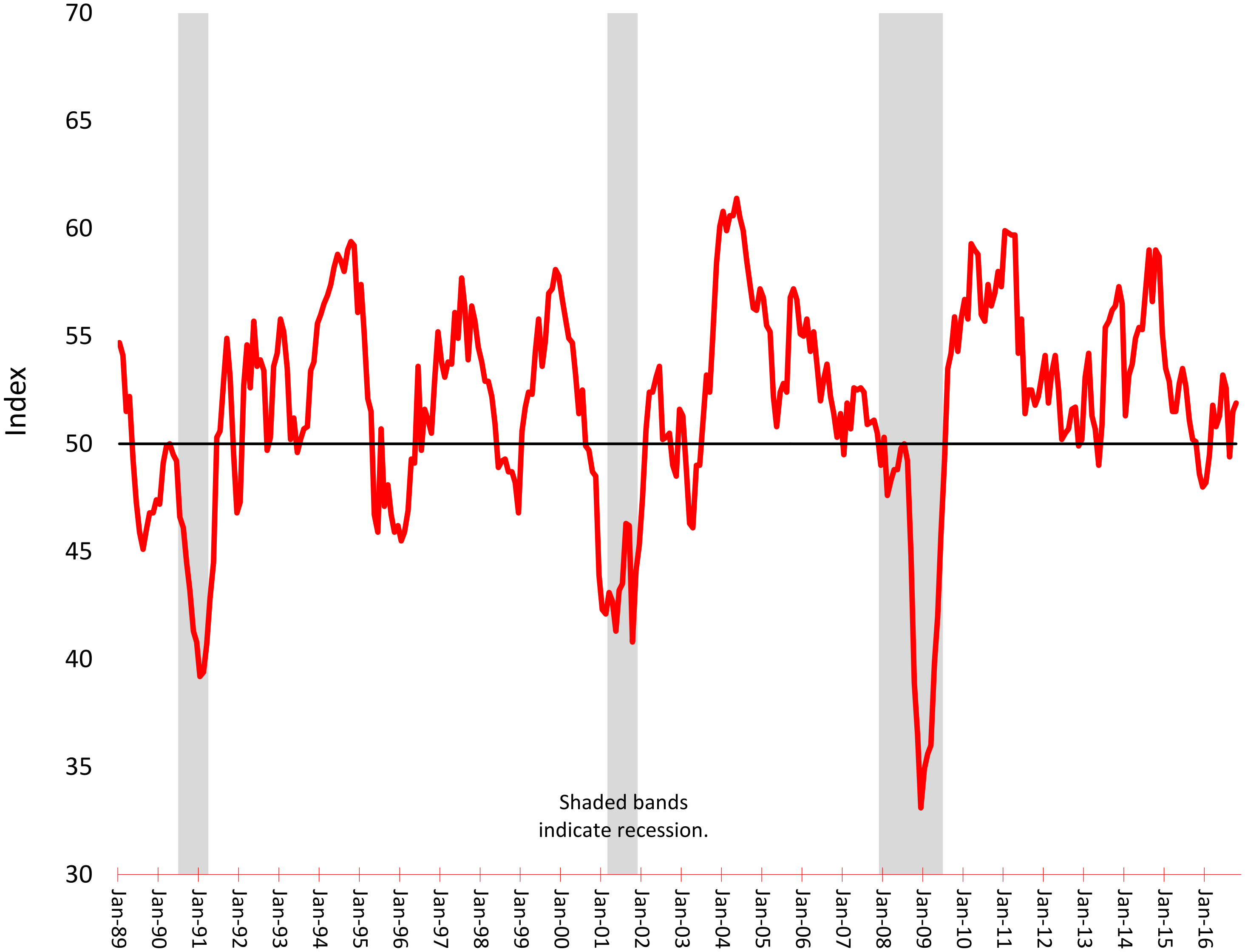
## Productivity


Labor force productivity gains are driven by the application of automation, technology and improved work methods.

The Bureau of Labor Statistics forecasts continued annual productivity gains of +1.8% through 2024.

Source: BLS. Annual data through 2015. BLS forecast through 2024 dated December 8, 2015.

# ISM manufacturing purchasing managers index




51.9 in October.

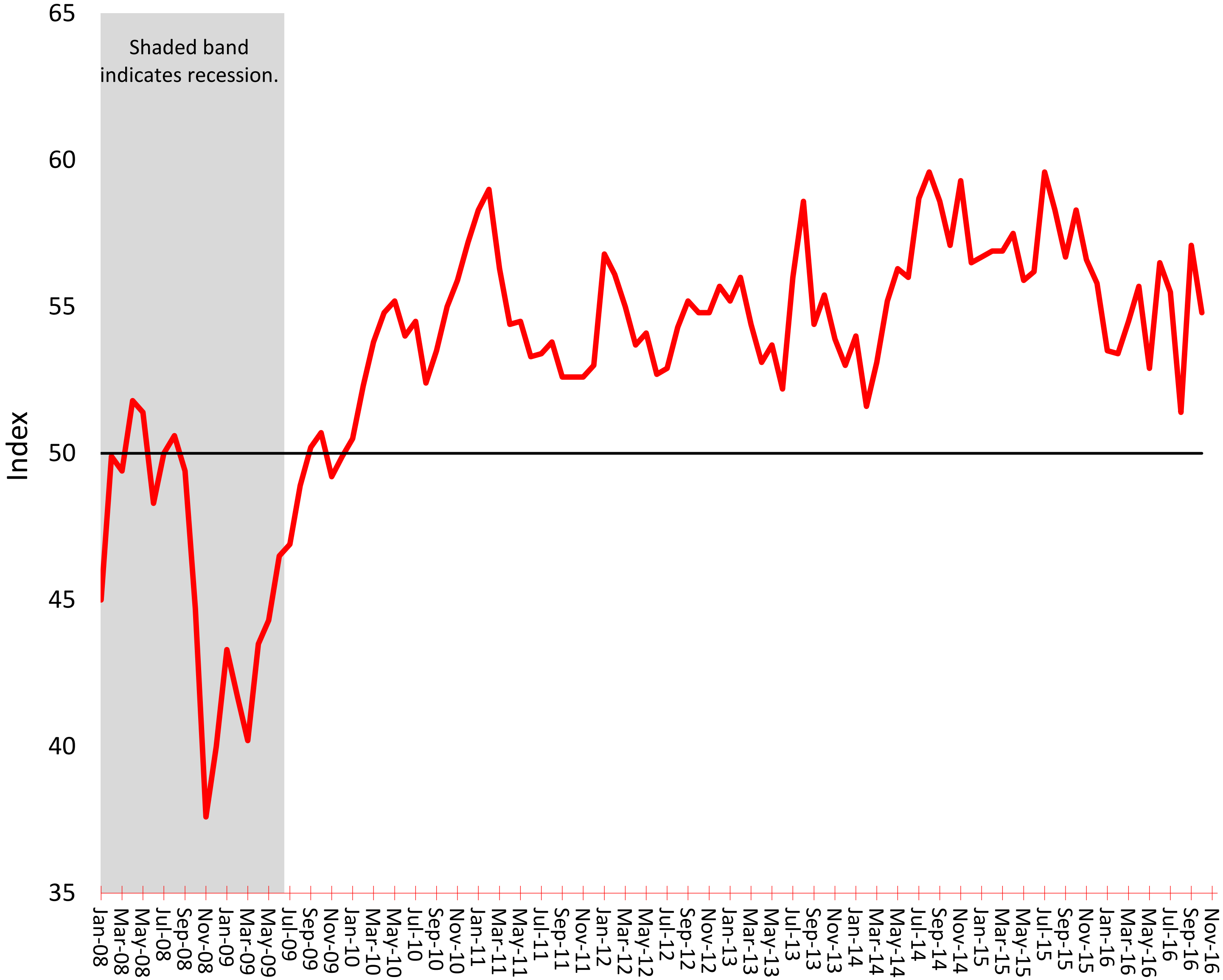
New orders at 52.1.

Note the historic volatility in the manufacturing PMI.

Note how this indicator has slumped well below 50 even during periods of strong economic expansion, eg. 1995, 1999, 2003, 2013.

Source: Copyright 2016, Institute for Supply Management; data through October 2016.
ISM: “A reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting. A PMI in excess of 43.1 percent, over a period of time, generally indicates an expansion of the overall economy.”

# ISM non-manufacturing purchasing managers index



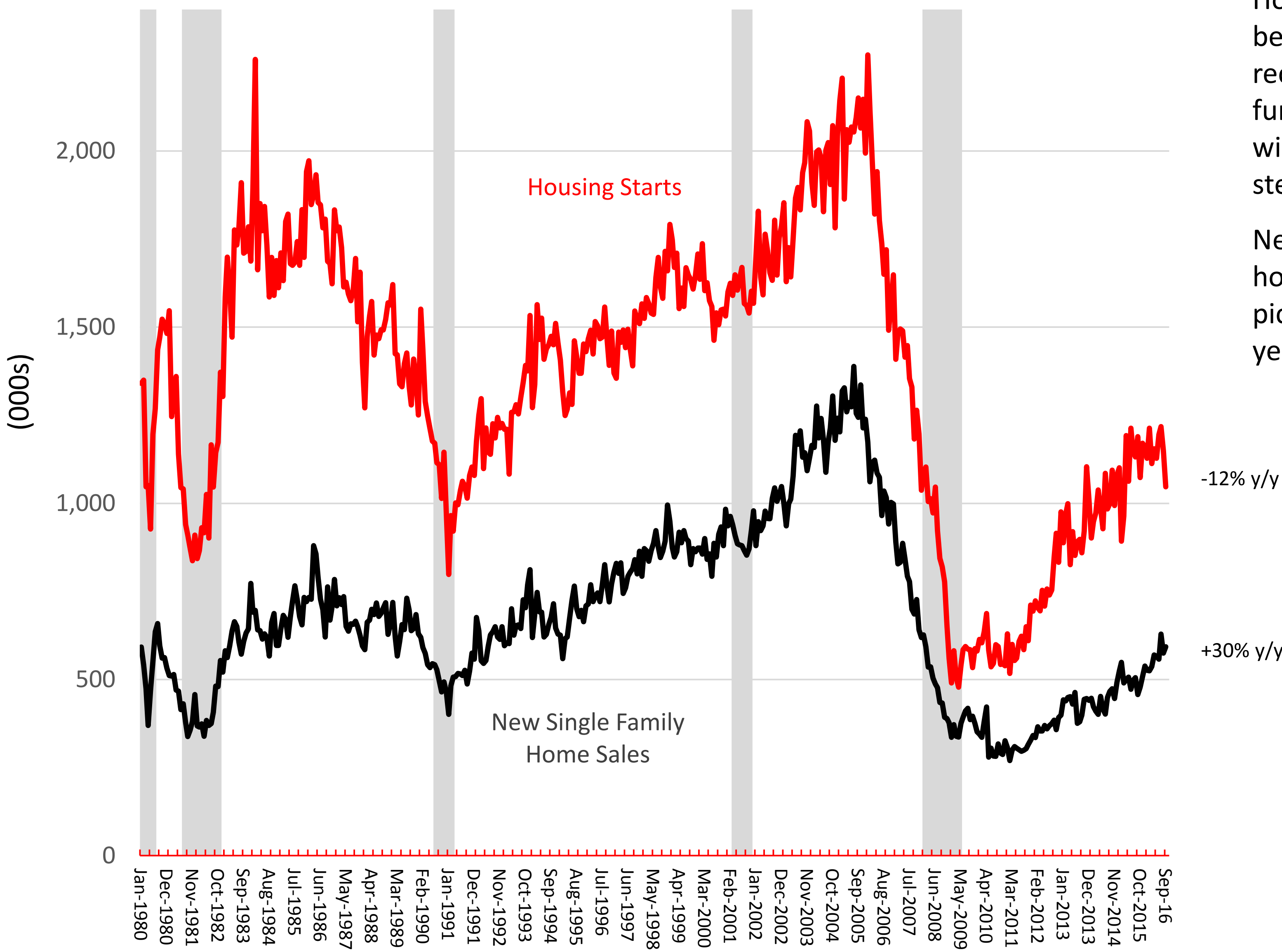

Non-manufacturing captures the vast majority of the U.S. economy.

54.8 in October.

Solid new orders at 57.7.

Source: Copyright 2016, Institute for Supply Management; data through October 2016. This data series was created in 2008. ISM: “A reading above 50 percent indicates that the non-manufacturing economy is generally expanding; below 50 percent indicates that it is generally contracting.”

# Housing starts and new home sales

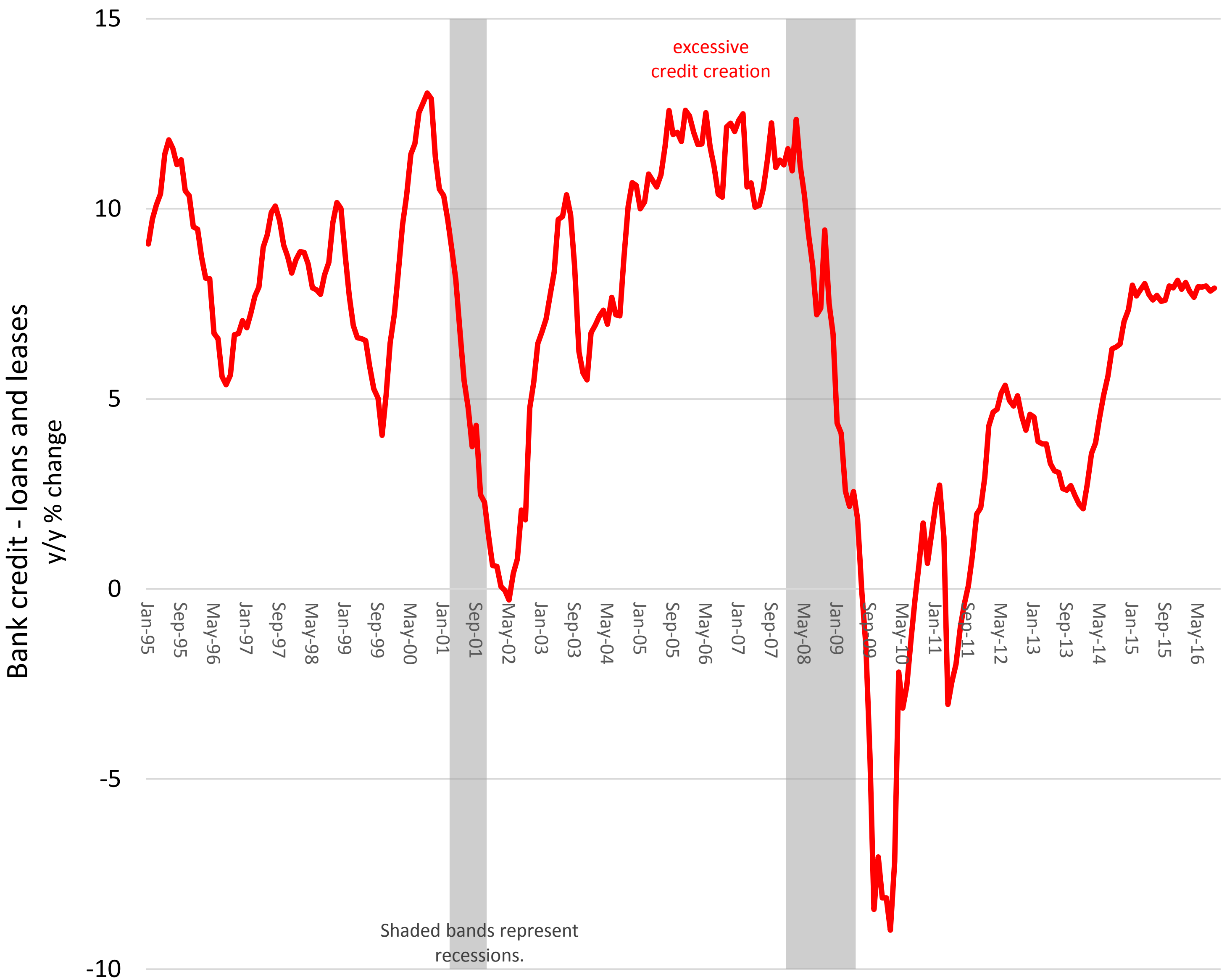



Housing starts have been slower to recover but fundamental demand will drive them steadily higher.

New single family home sales really picking up: +30% year/year.

Source: U.S. Census Bureau, starts data through September 2016, sales data through September 2016..

# Bank credit – recovery in a key economic driver



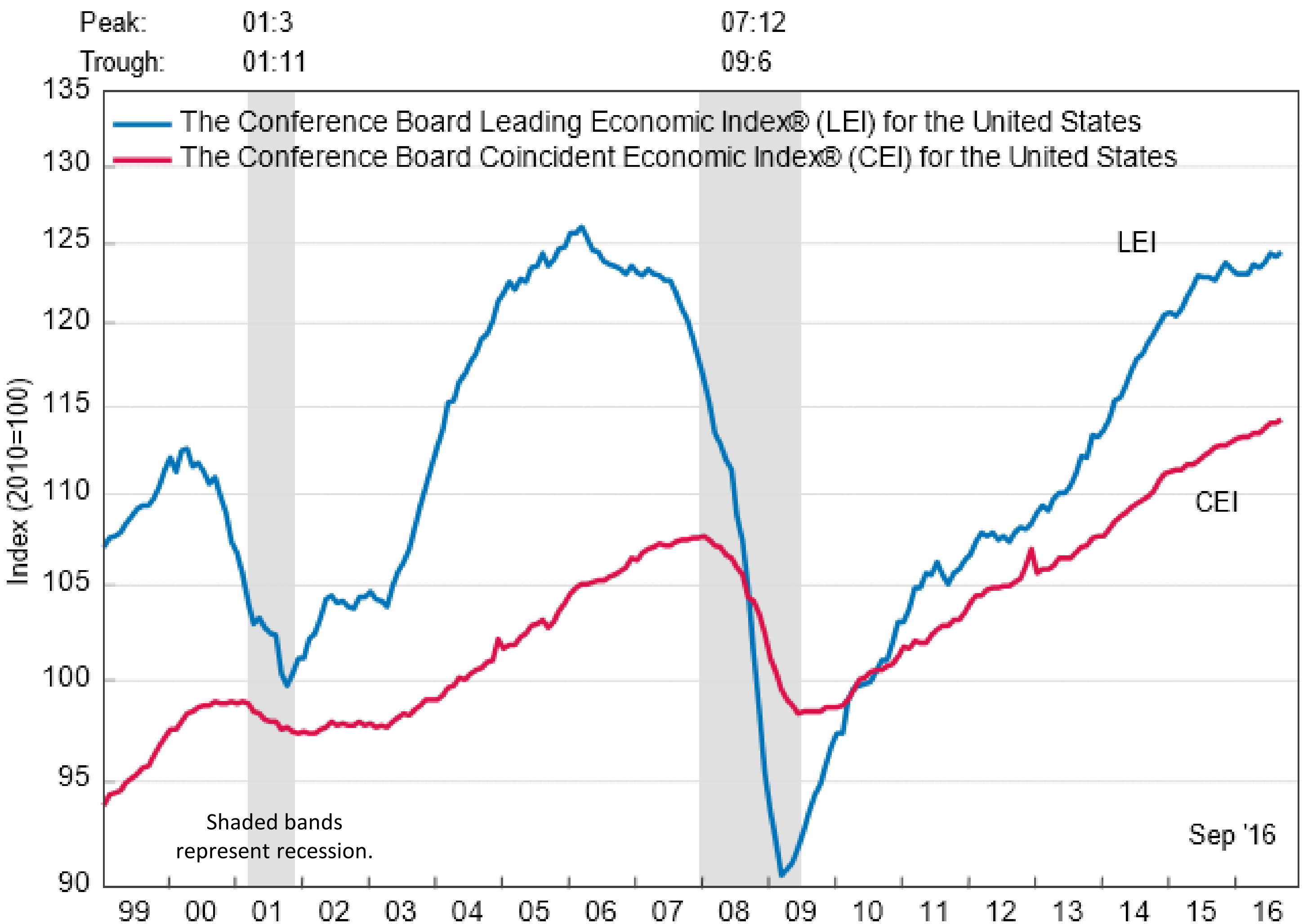

Bank credit is the lifeblood of economic expansion.

<u>The rate of bank credit creation is looking healthy but not excessive</u>.

Source: Federal Reserve, schedule H8. Data through September 2016, released October 28, 2016.

Economic data

# U.S. index of leading economic indicators




"The U.S. LEI increased in September, reversing its August decline, which together with the pickup in the six-month growth rate suggests that the economy should continue expanding at a moderate pace through early 2017."

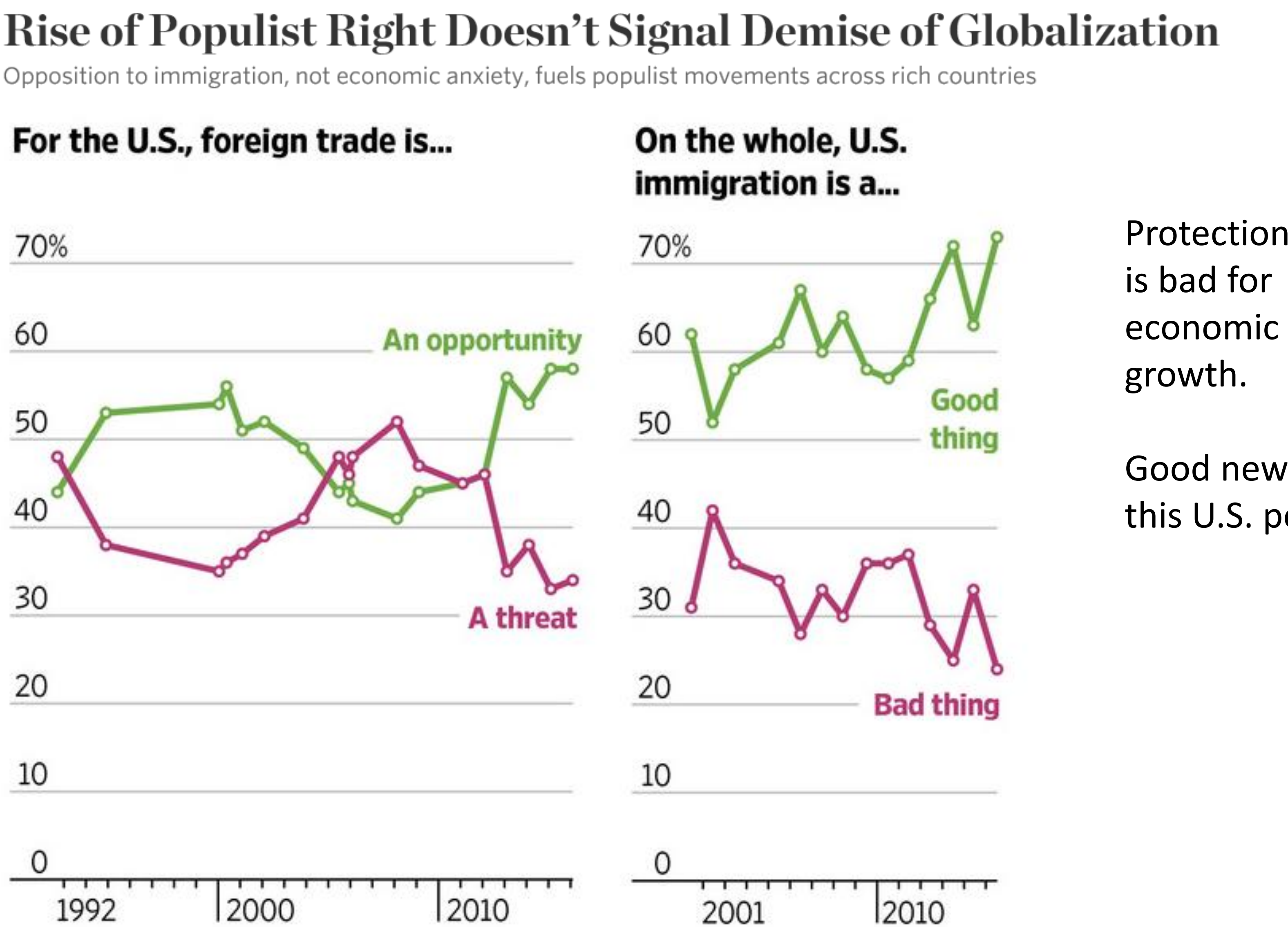
This chart shows how the LEI has definitively rolled over well in advance of the last two recessions.

The Conference Board Leading Economic Index® (LEI) components: 1) average weekly hours worked, manufacturing; 2) average weekly initial unemployment claims; 3) manufacturers' new orders – consumer goods and materials; 4) ISM index of new orders; 5) manufacturers' new orders, nondefense capital goods; 6) building permits – new private housing units; 7) stock prices, S&P 500; 8) Leading Credit Index™; 9) interest rate spread; 10-year Treasury less fed funds; 10) index of consumer expectations.



Source: ©The Conference Board. Data through September, released October 20, 2016.

# Good news in this poll




Protectionism is bad for economic growth.

Good news in this U.S. poll.

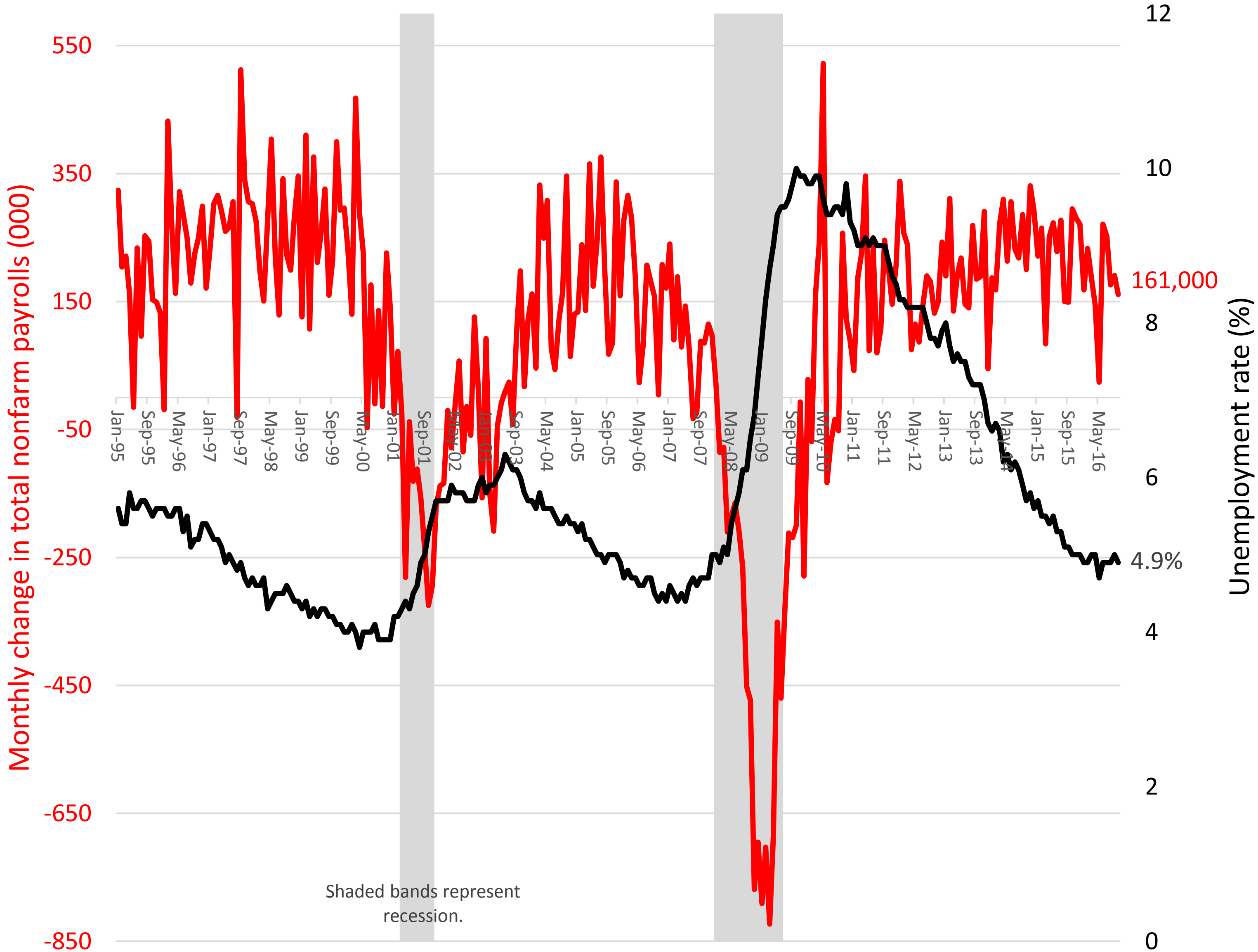
Source: *The Wall Street Journal*, June 8, 2016. Gallup opinion poll.

# Jobs

- job formation has not been “anemic”
- new jobs will be limited at full-employment
- good news in full-time employed
- record job openings
- strong relative U.S. job formation forecast long-term
- strong real wage and income growth
- mean and median incomes bottomed
- myth: “… but we’re not creating good jobs”

Economic data - jobs

# Net new job formation and the unemployment rate



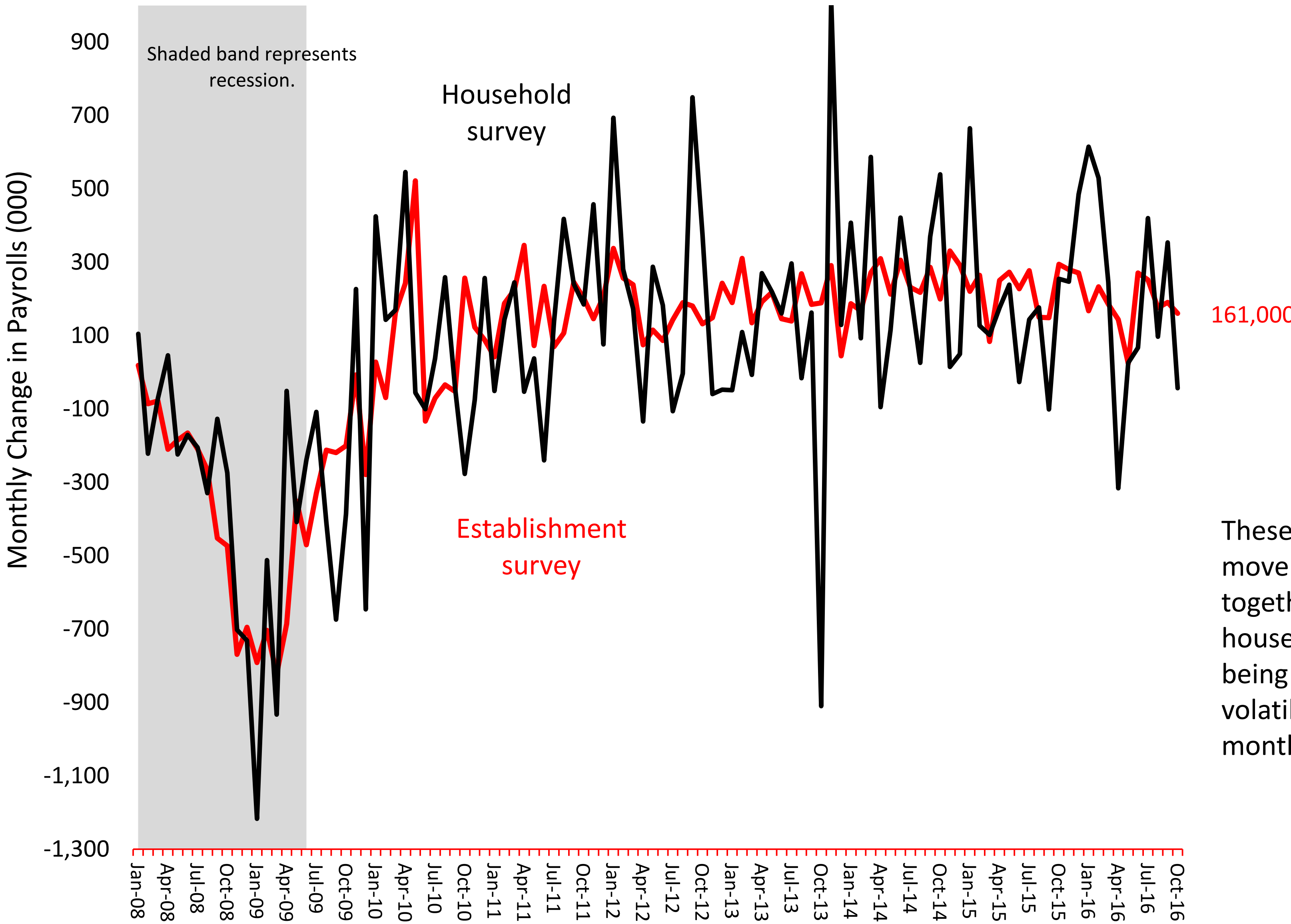

*Job growth stronger for longer* in this recovery due to the depth of the last recession.

Job growth will decline as the unemployment rate sinks further.

Source: Bureau of Labor Statistics. Data through October 2016.

Economic data - jobs

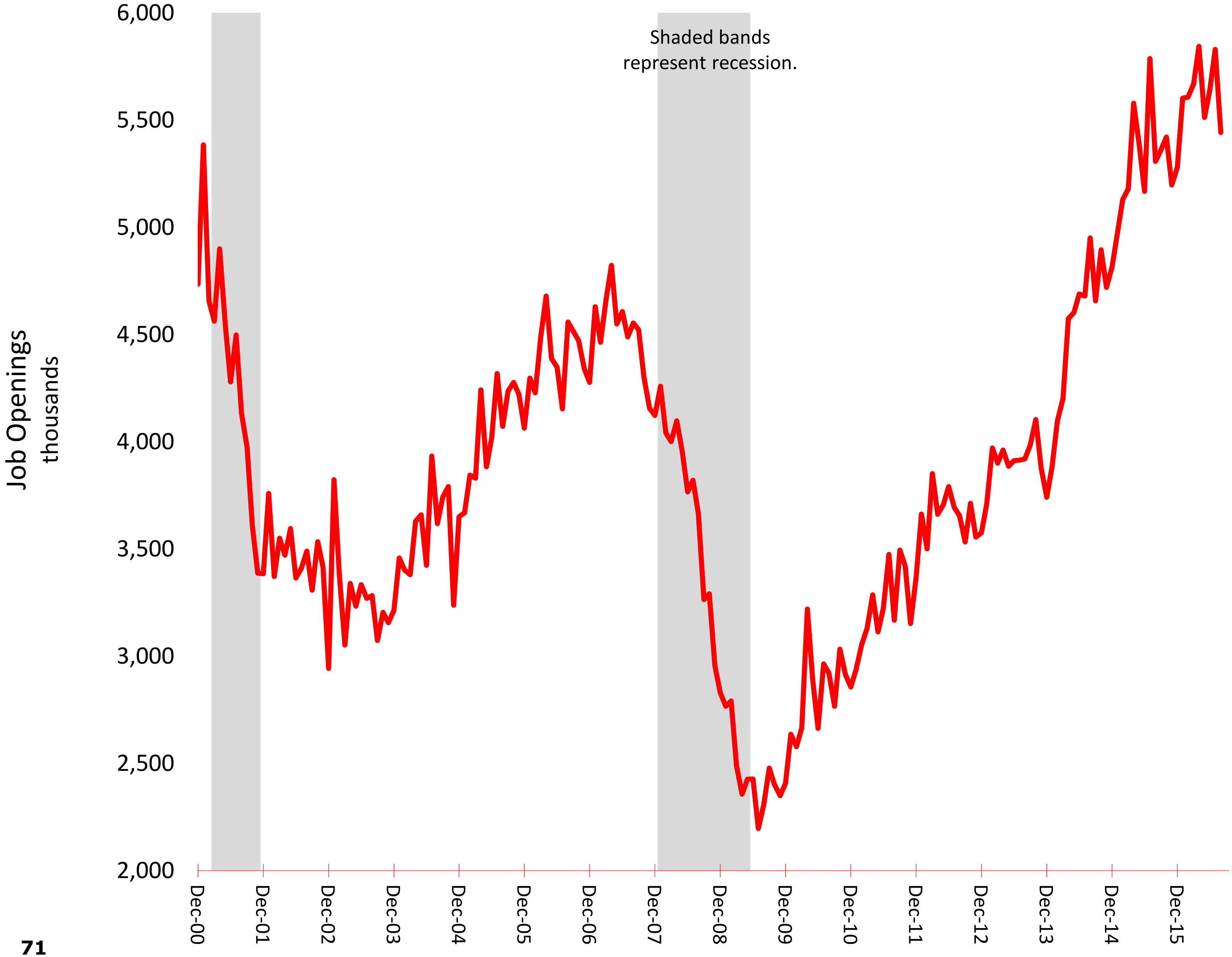
# Net new job formation




These two surveys move approximately together, the household survey being much more volatile month-to-month.

Source: Bureau of Labor Statistics. Data through October 2016.

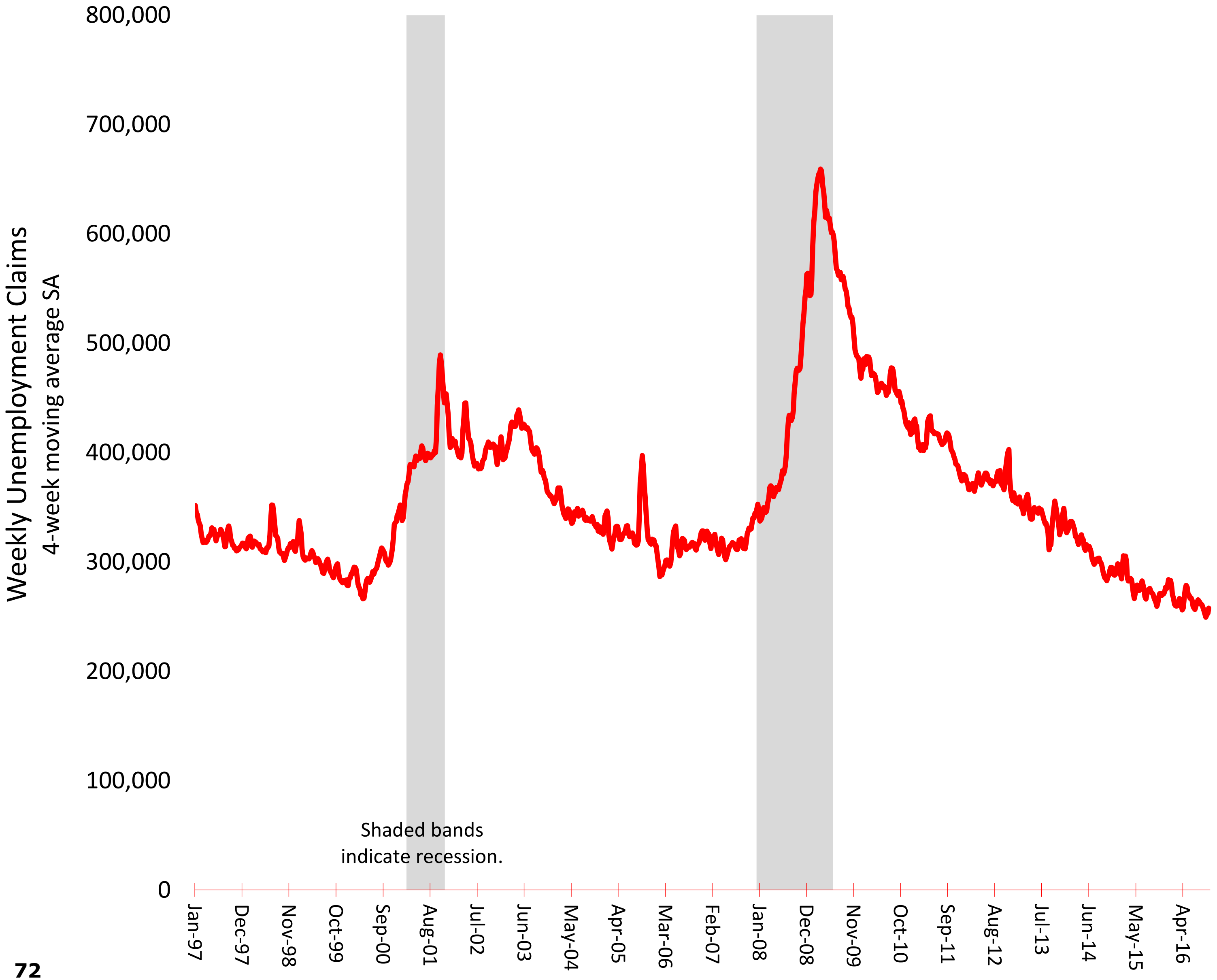
# Job openings – record high




Record high job openings.

Source: U.S. Department of Labor, NBER. Data through August 2016, released October 12, 2016.

# Weekly unemployment claims

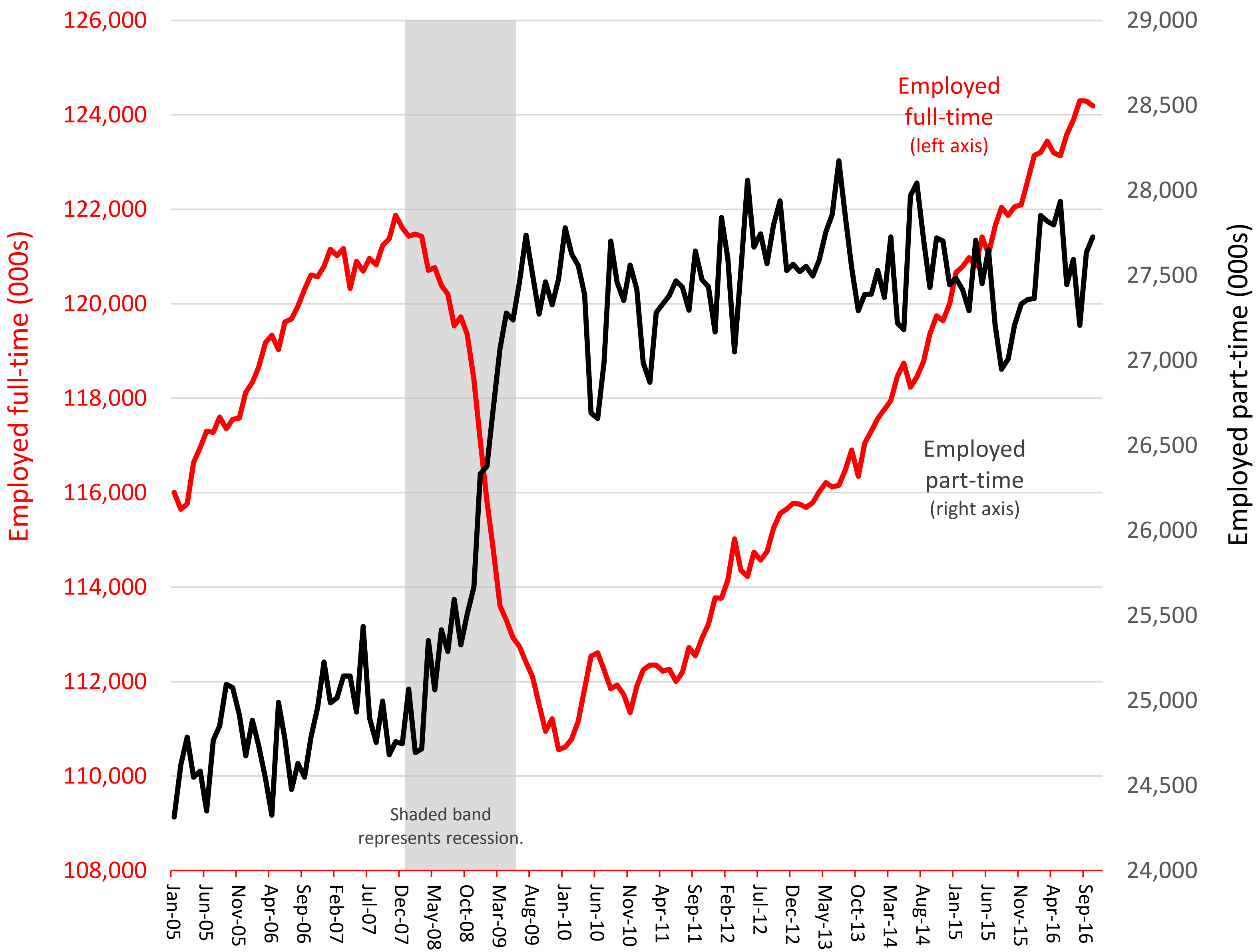



Downward slide, <u>well below pre-recession lows</u>.

Source: U.S. Department of Labor, NBER, data through the week of October 29, 2016.

Economic data - jobs

# Employed full-time vs. part-time




Good news in full-time jobs recovery.

Source: Bureau of Labor Statistics. Data through October 2016.

Long-term growth prospects

# Will our children be better or worse off the us?

## Future Shock

### America's next generation will do better than ever

As U.S. POLITICAL ARMIES CLASH ON Matthew Arnold's "darkling plain," the economy endures, and the next generation has a bright future. Donald Trump calls for "making America great again," but Warren Buffett knows that "again" has nothing to do with it. Some edited observations from his annual letter to shareholders follow:

"Many Americans now believe that their children will not live as well as they themselves do. That view is dead wrong: The babies being born in America today are the luckiest crop in history.

"American gross domestic product per capita is now about $56,000. America's 2% of overall growth produces about 1.2% of annual per capita growth. In 25 years, that rate of growth leads to a gain of 34.4% in real GDP per capita, a $19,000 increase. Today's politicians need not shed tears for tomorrow's children.

"Though the pie to be shared by the next generation will be far larger, how it will be divided will remain fiercely contentious—in particular, between those with talents that are valued highly by the marketplace and the equally decent hard-working Americans who lack the skills the market prizes.

"The good news, however, is that even members of the 'losing' sides will almost certainly enjoy far more goods and services in the future than they have in the past. The quality of their increased bounty will also dramatically improve. Nothing rivals the market system in producing what people want.

"America's golden goose of commerce and innovation will continue to lay more and larger eggs. America's kids will live far better than their parents did." ■

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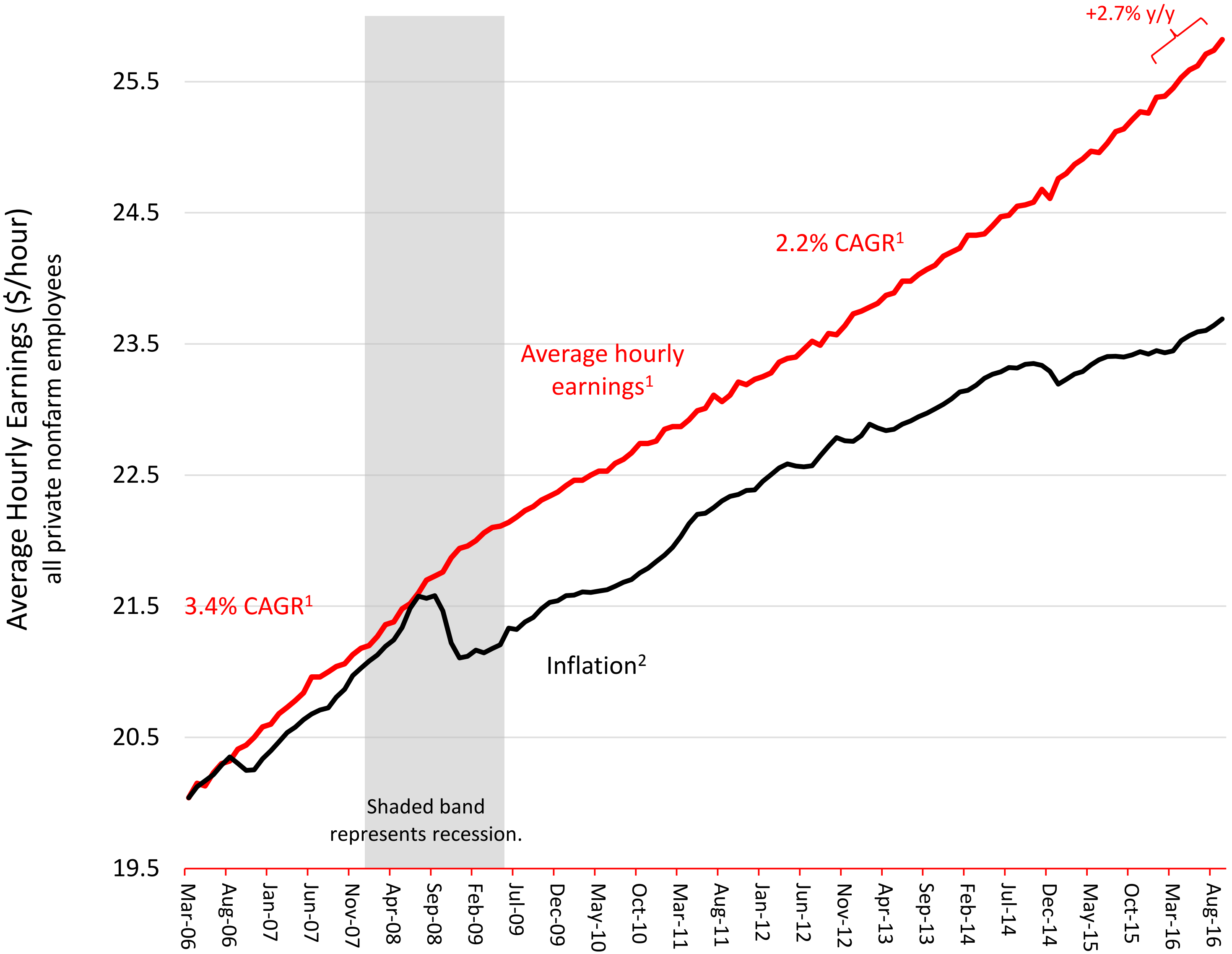
Editorial page editor THOMAS G. DONLAN receives e-mail at tg.donlan@barrons.com.

Warren Buffet: "America's golden goose … will continue to lay more and larger eggs."



Source: *Barron's*, March 7, 2016.

# Average hourly earnings vs. inflation




AHE growth has picked up.

AHE growth has outstripped inflation.

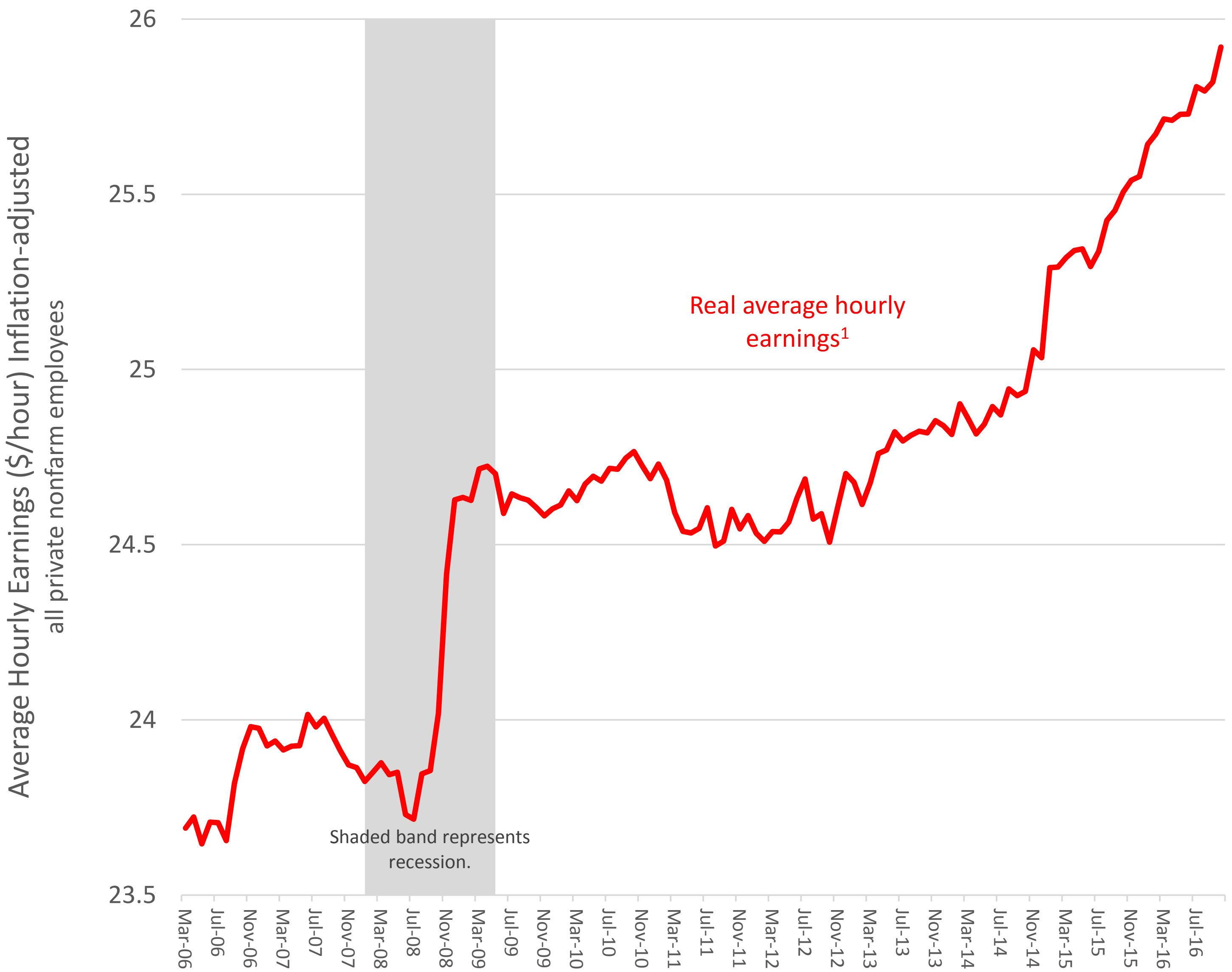
Real wages have grown … at a better clip than pre-recession because inflation has been declining.

<u>Wage stagnation is a fiction.</u>

Source: BLS, BEA. AHE data through October 2016. Inflation data through September 2016. AHE includes 100% of non-farm private employees, and excludes benefits and employers' share of payroll taxes. [1] Compound annual growth rate March 2006 through December 2008 = 3.4%; CAGR December 2008 through June 2016 = 2.1%. [2] March 2006 average hourly earnings of $20.04 inflated by the personal consumption expenditures deflator (PCED).

Wages – middle class wage stagnation?

# Real average hourly earnings



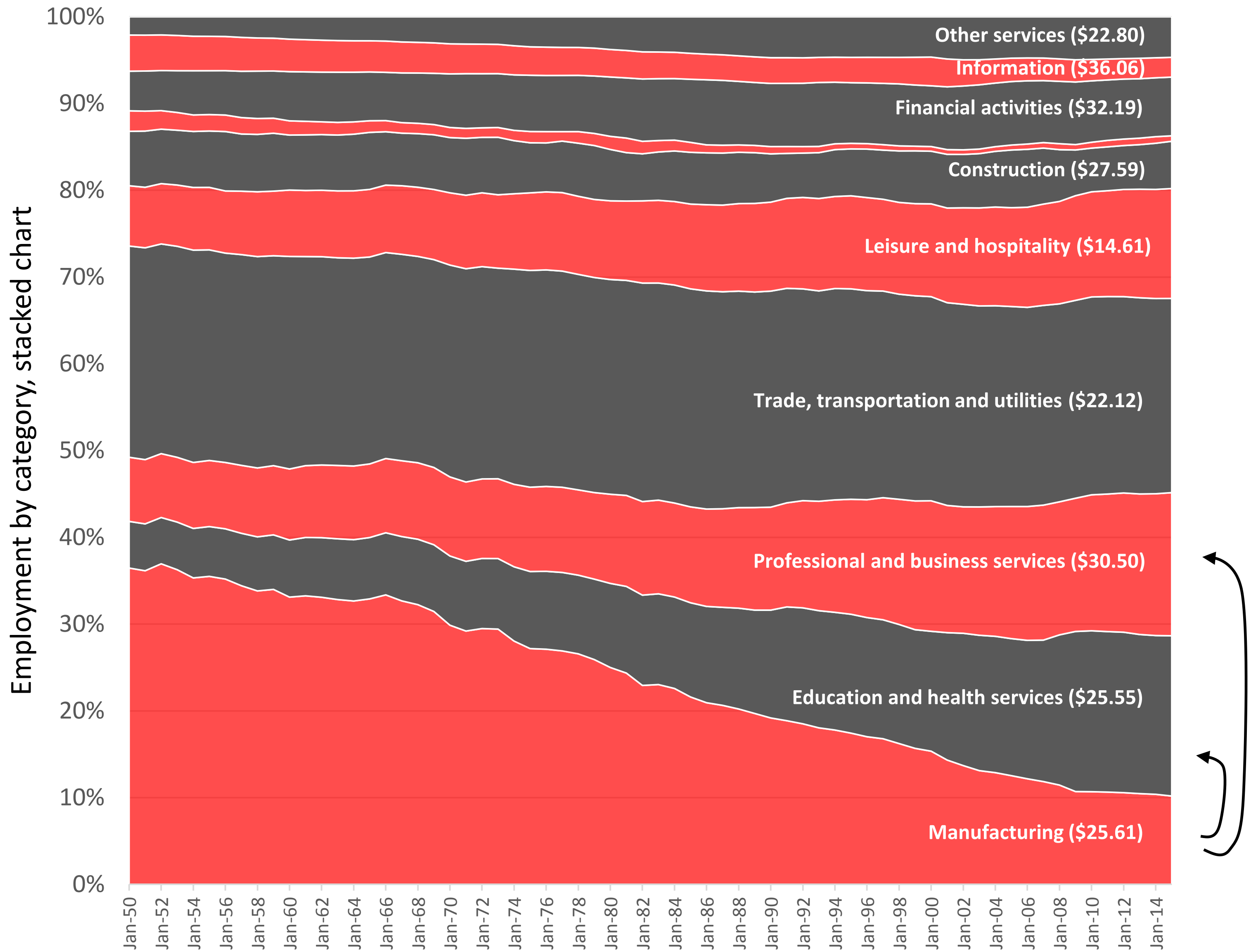

Real AHE growth picked up since 2014.

<u>Wage stagnation is a fiction.</u>

Source: BLS, BEA. AHE data through October 2016. Inflation data through September 2016. AHE includes 100% of non-farm private employees, and excludes benefits and employers' share of payroll taxes. [1] Average hourly earnings divided by the personal consumption expenditures deflator (PCED).

Jobs … "but the jobs we're creating aren't 'good' jobs."

# All jobs by category (average hourly earnings in parentheses)

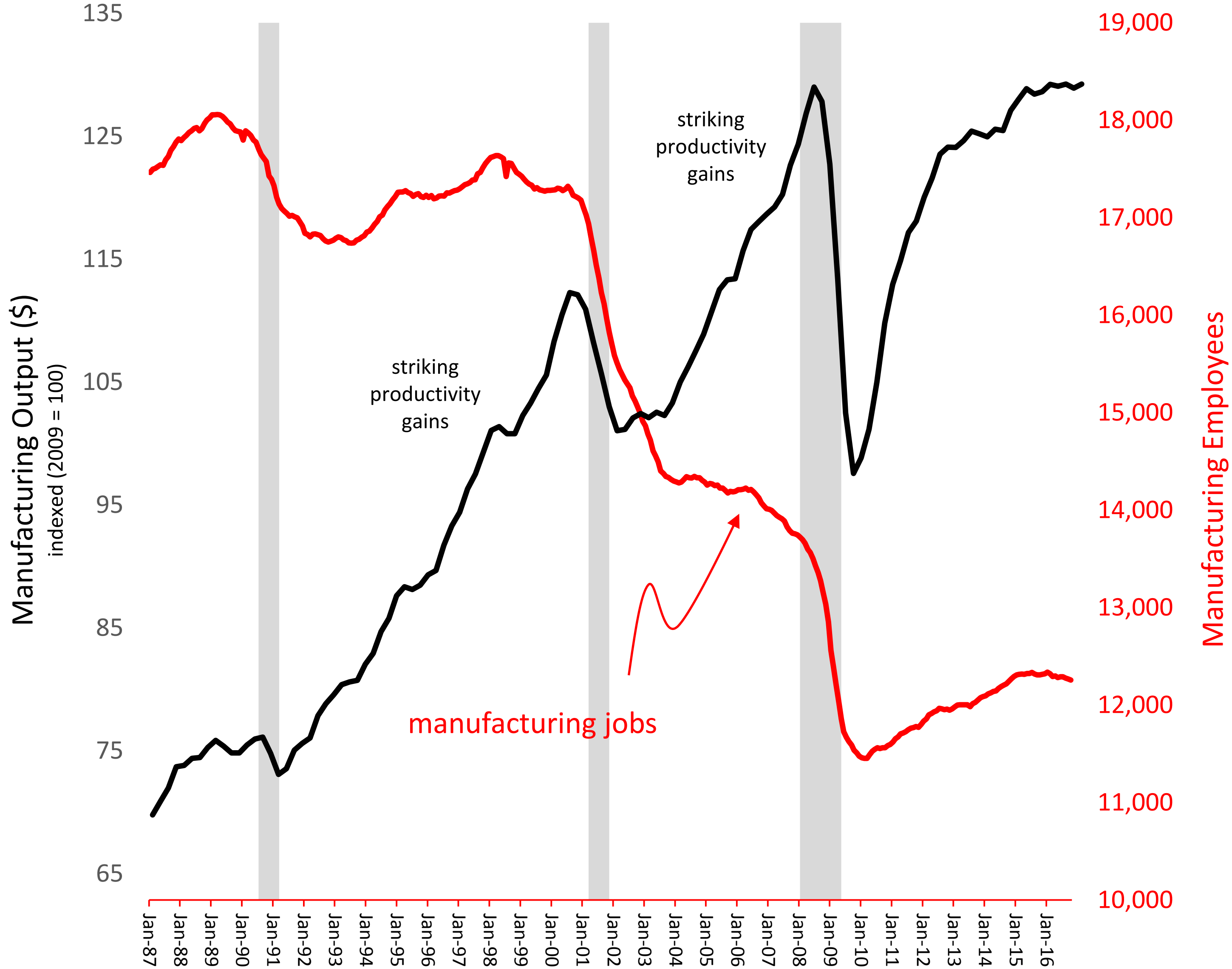



In 1950, manufacturing jobs were 37% of total jobs. Today that figure is 10%.

Some manufacturing jobs have been replaced by lower-paying jobs in leisure and hospitality; but many more have been replaced by equal- or higher-paying jobs in health services and professional and business services.

Source: Bureau of Labor Statistics. Employment data through December 2015, AHE data through January 2016. Mining and logging ($31.77) is the small sliver, fourth from the top.

# Manufacturing employment and output

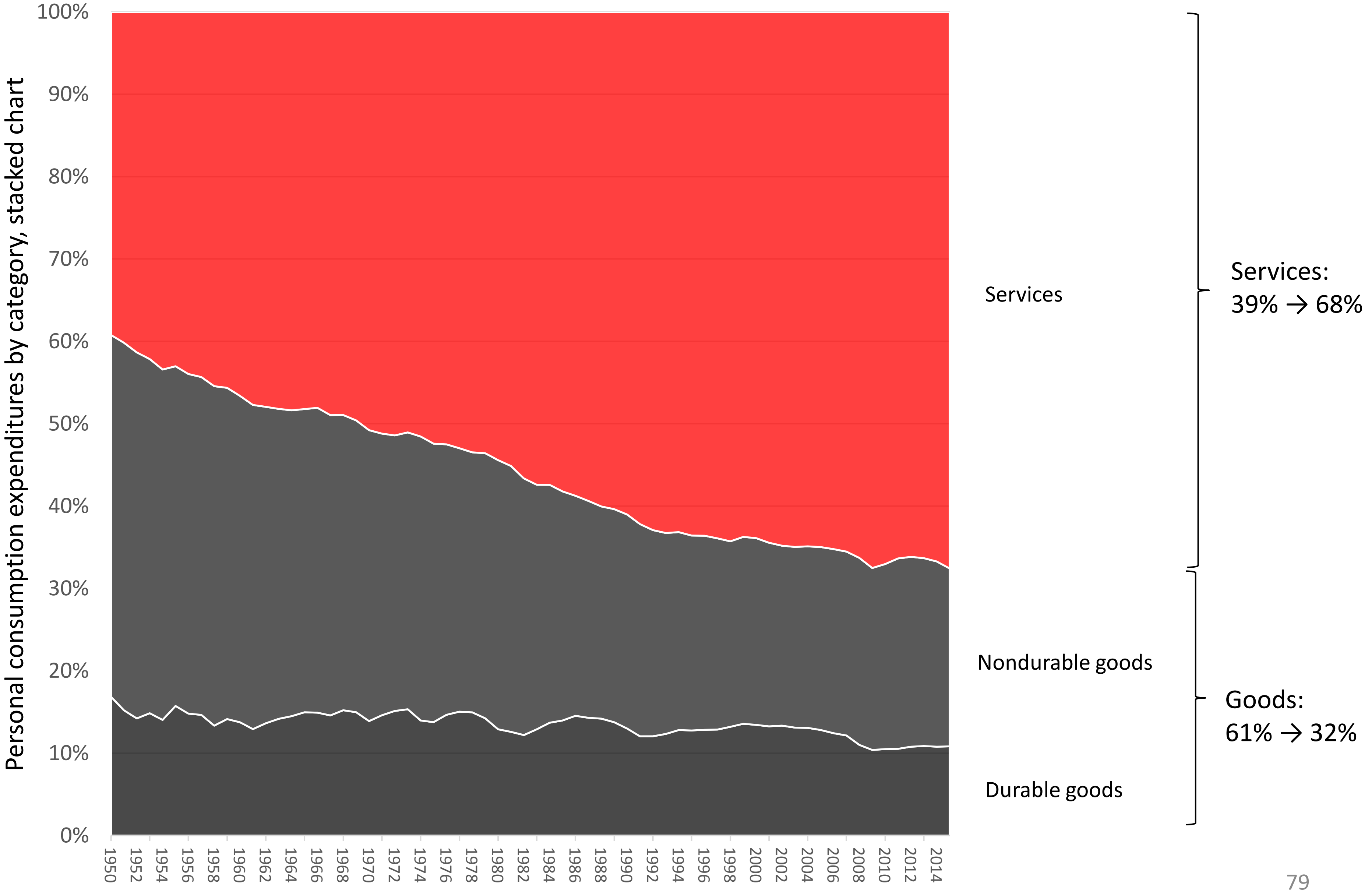



"Research shows that the automation of U.S. factories is a much bigger factor than foreign trade in the loss of factory jobs. … A study … last year found that trade accounted for just 13 percent of America's lost jobs – 88 percent were taken by robots and other homegrown factors that reduce factories' need for human labor." [1]

Source: Bureau of Labor Statistics. Employment data through October 2016. Manufacturing output data through September 2016.
[1] Paul Wiseman, "The Main Thieves Who Took Those Lost Factory Jobs? Robots", Associated Press, November 2, 2016.

Jobs are "following the money"

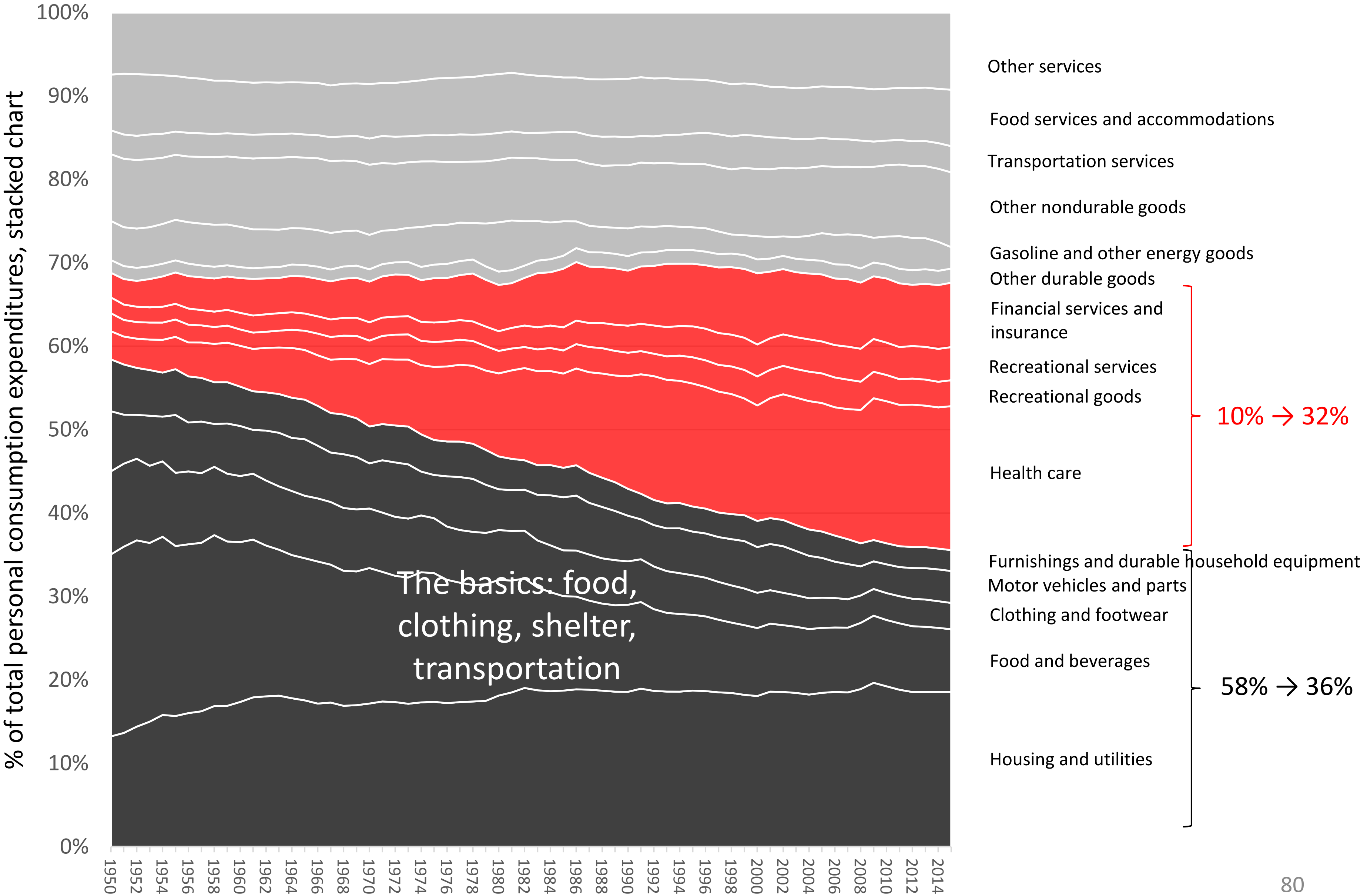
# Personal consumption expenditures by category




Source: BEA. Annual data through 2015.

Rising standard of living

# Personal consumption expenditures by category




Source: BEA. Annual data through 2015.

# Crude oil

- price rebound with cut in global supply
- oversupply gap has closed
- U.S. rig count collapse, production down only slightly (so far)

# Debt

- global sovereign
- U.S. Government
- corporate
- household
- student loans

# Global Debt

THE WALL STREET JOURNAL.

By KEN BROWN

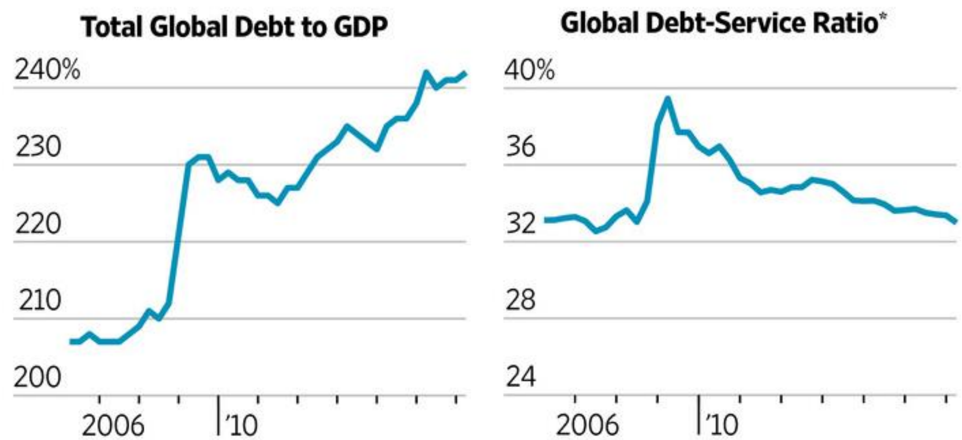
May 25, 2016 11:52 a.m. ET

Global debt—including households, businesses and governments—has risen from 221% of GDP at the end of 2008 to 242% at the end of the first quarter.

But for all the hand-wringing, a near-term debt crisis is unlikely. Lower interest rates mean debt payments are far lower than they were before the crisis. In the U.S., household debt compared with the overall economy is way down. And overseas, loans can easily be rolled over.

## Rising Debt, Lighter Burden

The surge in debt overseas has been tempered by lower interest rates, meaning interest payments are well below peak levels.




*Global debt-service ratio shows how interest payments have changed relative to debt outstanding and the size of the global economy.

Sources: New York Fed Consumer Credit Panel/Equifax (debt composition; mortgages); J.P. Morgan (debt-to-GDP ratio; debt service ratio)

THE WALL STREET JOURNAL.

Published in *The Wall Street Journal* newsstand copy May 26, 2016.

# Global sovereign debt

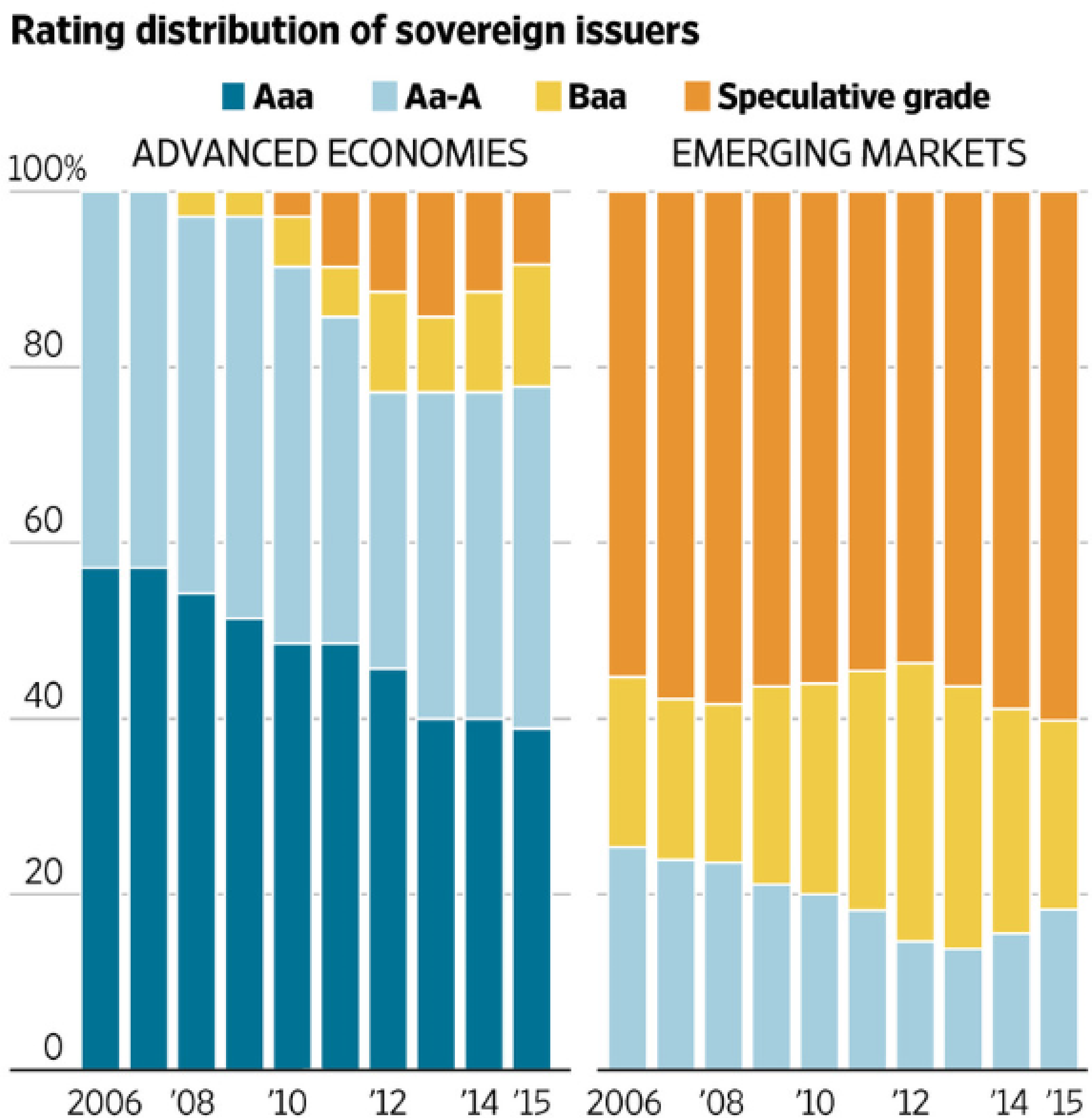
THE WALL STREET JOURNAL.

By GREG IP

May 25, 2016 1:29 p.m. ET

Trends in global credit quality:

- among advanced economies: fewer speculative grade
- among emerging markets: small increase in Aa-A




Published in *The Wall Street Journal* newsstand copy May 26, 2016. Source: Moody's Investors Service.

# Federal budget

- CBO’s March 2016 forecast
- looks good for a few years …
- … but the entitlements problem hasn’t gone away
- rising debt/GDP ratio
- low U.S. tax burden allows flexibility to solve long-term entitlements problem

# Corporate balance sheets

- corporate assets growing almost as fast as corporate debt, leaving strong balance sheet ratios
- corporate interest coverage ratio at record high

## Corporate balance sheets
# Surging bond issuance

# The Hidden Danger of Share Buybacks

by David Ader

THE BOND MARKET SHOULD BE CONCERNED ABOUT STOCK BUY-backs, but not because of their bullish effect on share prices. Instead, bondholders should be anxious about where the cash to pay for them comes from. It isn't widely appreciated that the money has been borrowed in the credit markets, and that the borrowers have taken on a large amount of debt to support the buybacks. That's cause for worry on several fronts.

The first is simply that outstanding corporate debt is now at a record high. Many pooh-pooh this, arguing that the debt was issued when rates were low and corporate borrowing was cheaper than usual relative to government borrowing, which carries less credit risk. That's fair.

*Companies are issuing massive amounts of debt to buy stocks, as the market shrinks.*

But what happens in a recession or a recession for earnings? Those tight spreads between corporate and government rates will widen and, given the level of corporate indebtedness, could cause credit downgrades. That will put further pressure on the debtors. According to the Federal Reserve's flow of funds data, outstanding nonfinancial corporate debt is 45.3% of GDP. That nearly matches the level seen in the first quarter of 2009 (45.4%) and exceeds the prior peak of 44.9% achieved in the third quarter of 2001 (see chart below.)

The result of the buybacks is that net equity issuance has been negative for the last several years and bears a striking resemblance to the period leading up to the 2008 financial crisis. The sheer level of buybacks is staggering. A Deutsche Bank report notes that Standard & Poor's 500 companies pay out two-thirds of their earnings through buybacks and dividends. FactSet further notes that those same companies spent $166.3 billion on share buybacks in the first quarter, a post-recession high and one only surpassed by $178.5 billion in the third quarter of 2007. Keep the latter date in mind.

Buyback activity correlates well with the performance of the S&P 500, which shouldn't be surprising; we've seen it in the run-up to the last two recessions. But what has been overlooked is that this activity was financed and shows a strong inverse correlation with nonfinancial corporate borrowing. In other words, companies are issuing massive amounts of debt to buy stocks in a market whose outstanding supply of shares is shrinking. This can't last.

In the first quarter, nonfinancial corporate borrowing hit $724 billion. That's the second-highest on record and is surpassed only by, again, the third quarter of 2007 with $807 billion. The similarities should give pause.

Managers of big bond portfolios have taken on added credit risk in the last few years to gain incremental yield. Now these investors are overweight corporate bonds and concerned about performance. As long as the rate differential between creditworthy and less-creditworthy borrowers remains tight, all is well. But if the Fed tightens, or if a slowdown in earnings or the economy unfolds, a lot of investors will rush to rebalance.

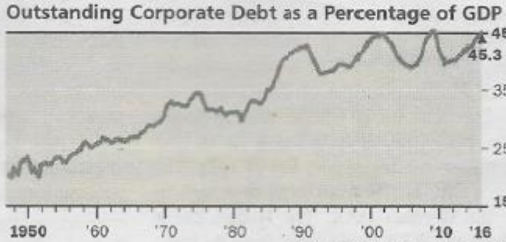
Closely related to our worry about borrowing to buy back stock is concern about what it isn't being used for, with rates so low. The latest report on gross domestic product provides insight. There we see that total private domestic investment fell for the third quarter in a row, and it was soft in the preceding three quarters. Contrast that with the low unemployment and recent acceleration in the Employment Cost Index, and you have a recipe for softening productivity gains.

We should be paying more attention; if Corporate America doesn't have confidence in growth and isn't investing to improve productivity (with repercussions for profits and hiring), then those overly invested for current credit conditions should consider shifting to higher-rated corporate bonds with short durations or to Treasury bonds of like durations. ■

### Buybacks Push Corporate Debt Near Highs

Debt is back near levels seen prior to our last two recessions (see below). The surge is caused in part by massive corporate borrowing to buy back shares.

**Outstanding Corporate Debt as a Percentage of GDP**




Sources: Federal Reserve; Flow of Funds

**Nonfarm payroll employment** rose by 255,000 in July, well above the consensus estimate of 180,000. The unemployment rate held steady at 4.9%, accompanied by a huge increase in the labor force. The upbeat jobs data in this first month of the summer quarter made a September interest-rate hike by the Federal Reserve a bit more likely, and held out hope that economic growth in the third quarter will accelerate from the dismal rates of the first two quarters.

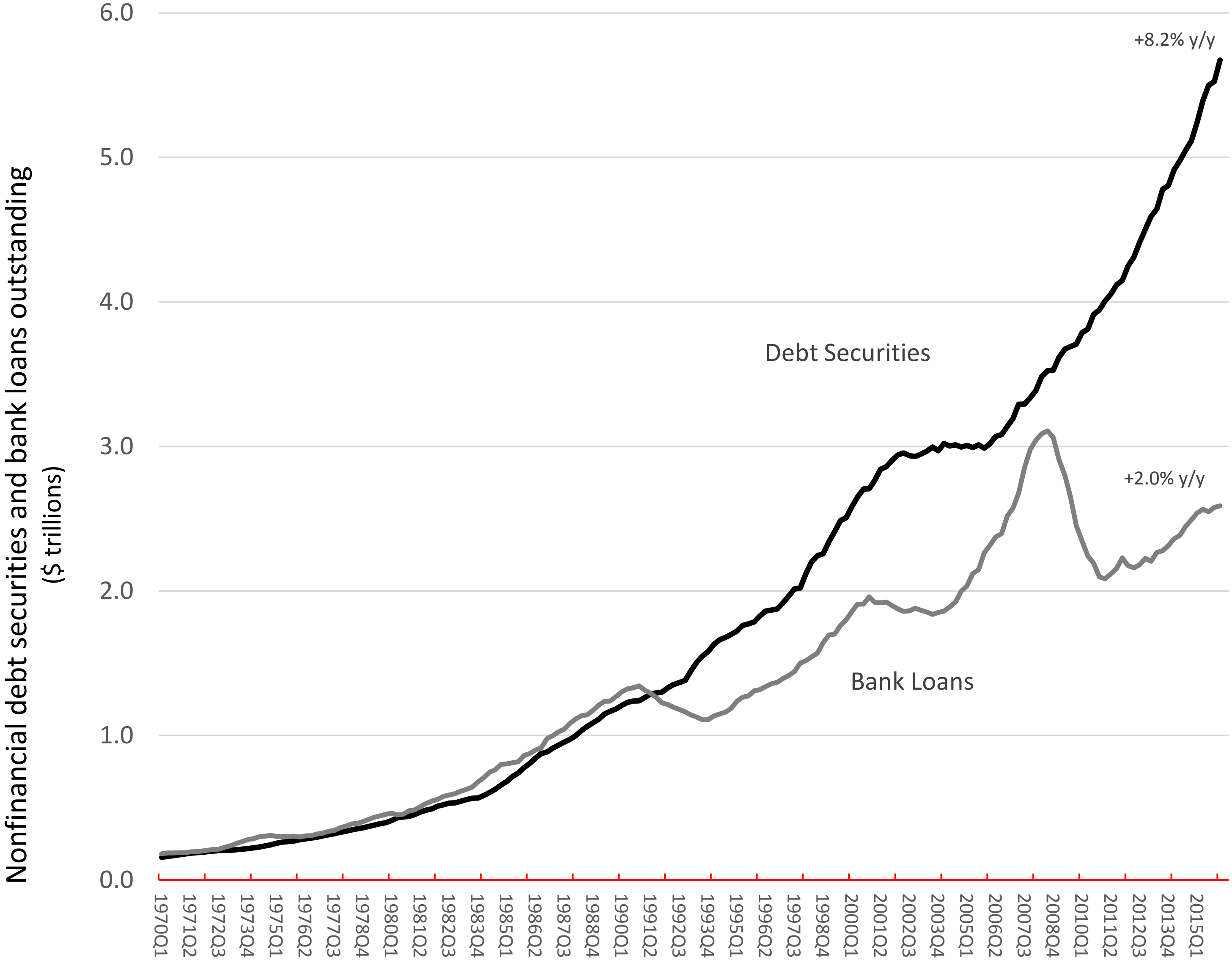
–GENE EPSTEIN

DAVID ADER has been a government-bond strategist at Greenwich Capital, RBS, and most recently CRT LLC.

A really stupid analysis.

Source: *Barron's,* August 8, 2016

# Surging bond issuance




Companies issuing bonds at a rapid clip ...

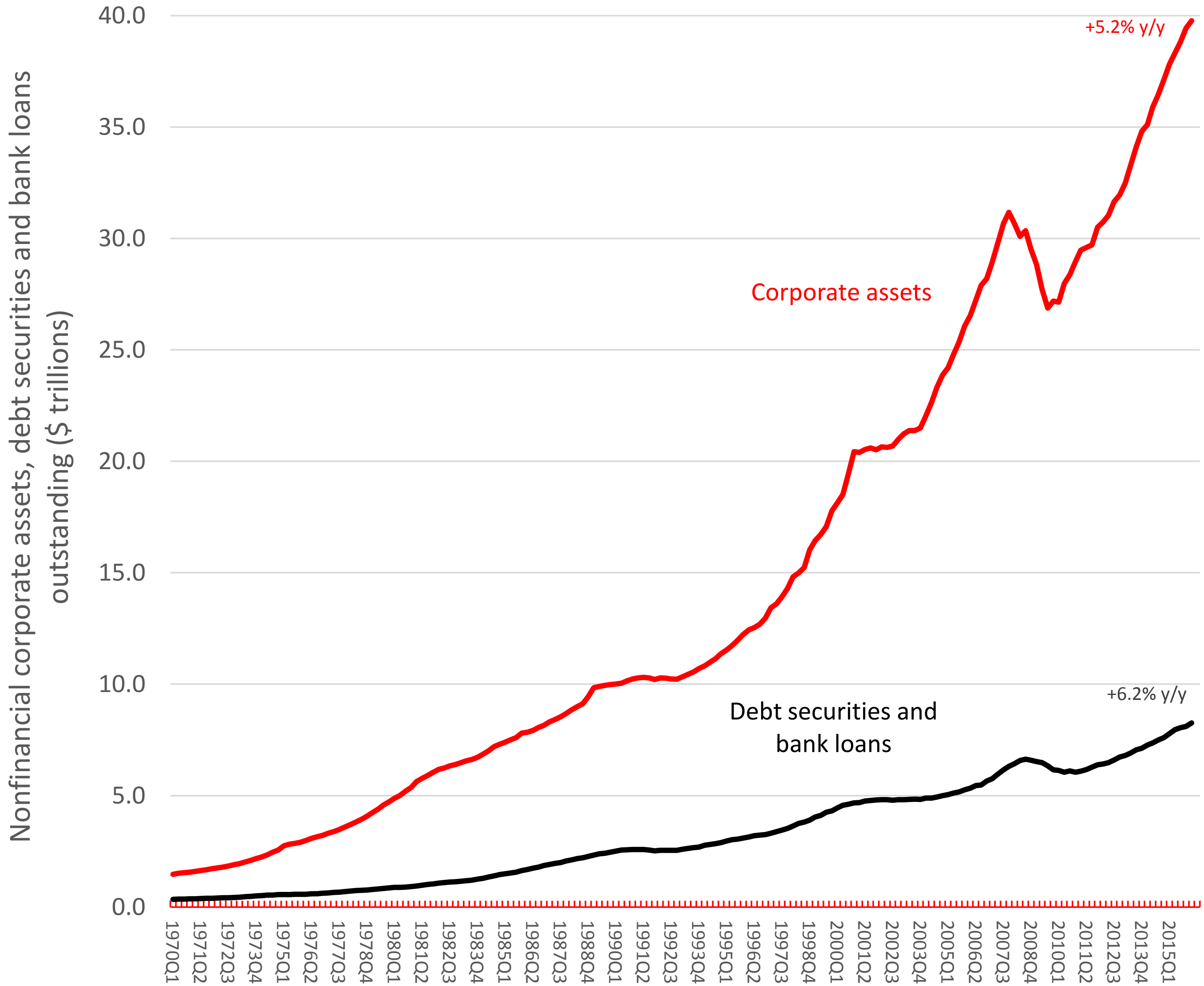
... while some bond proceeds are being used to pay down bank lines of credit.



Source: Federal Reserve. Financial Accounts of the United States schedule Z.1, B.103. Data through March 2016.
[1]Standard and Poor's estimates high yield comprises roughly 15% of the overall corporate bond market.

Corporate balance sheets

# Assets rising

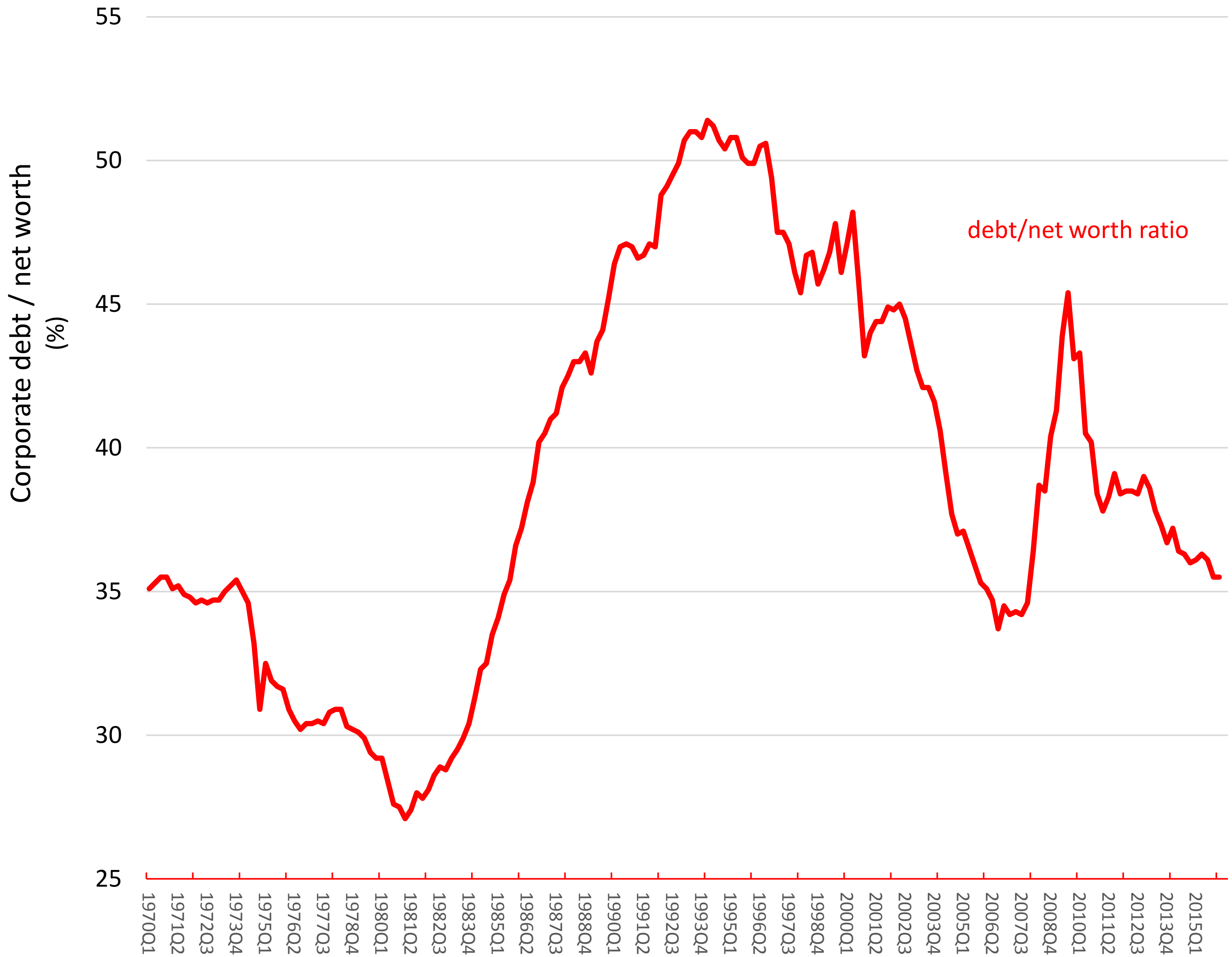



Assets are growing almost as fast as corporate debt ...

Source: Federal Reserve. Financial Accounts of the United States schedule Z.1, B.103. Data through March 2016.

Corporate balance sheets

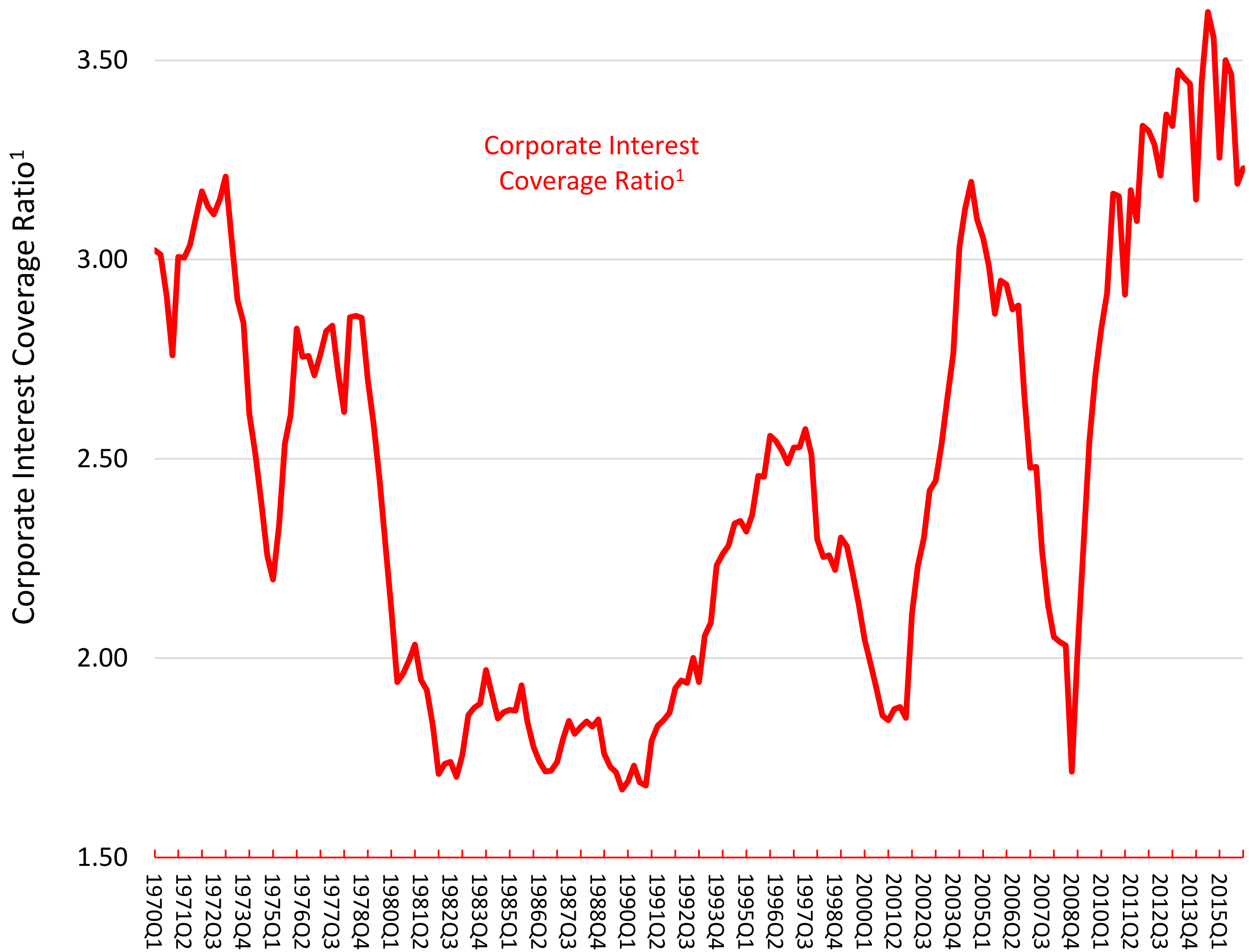
# Low ratio of debt-to-net worth




… so, debt-to-net worth is low …

Source: Federal Reserve. Financial Accounts of the United States schedule Z.1, B.103. Data through March 2016.

# Record high corporate interest coverage ratio




… and, interest coverage ratio is near a record high.

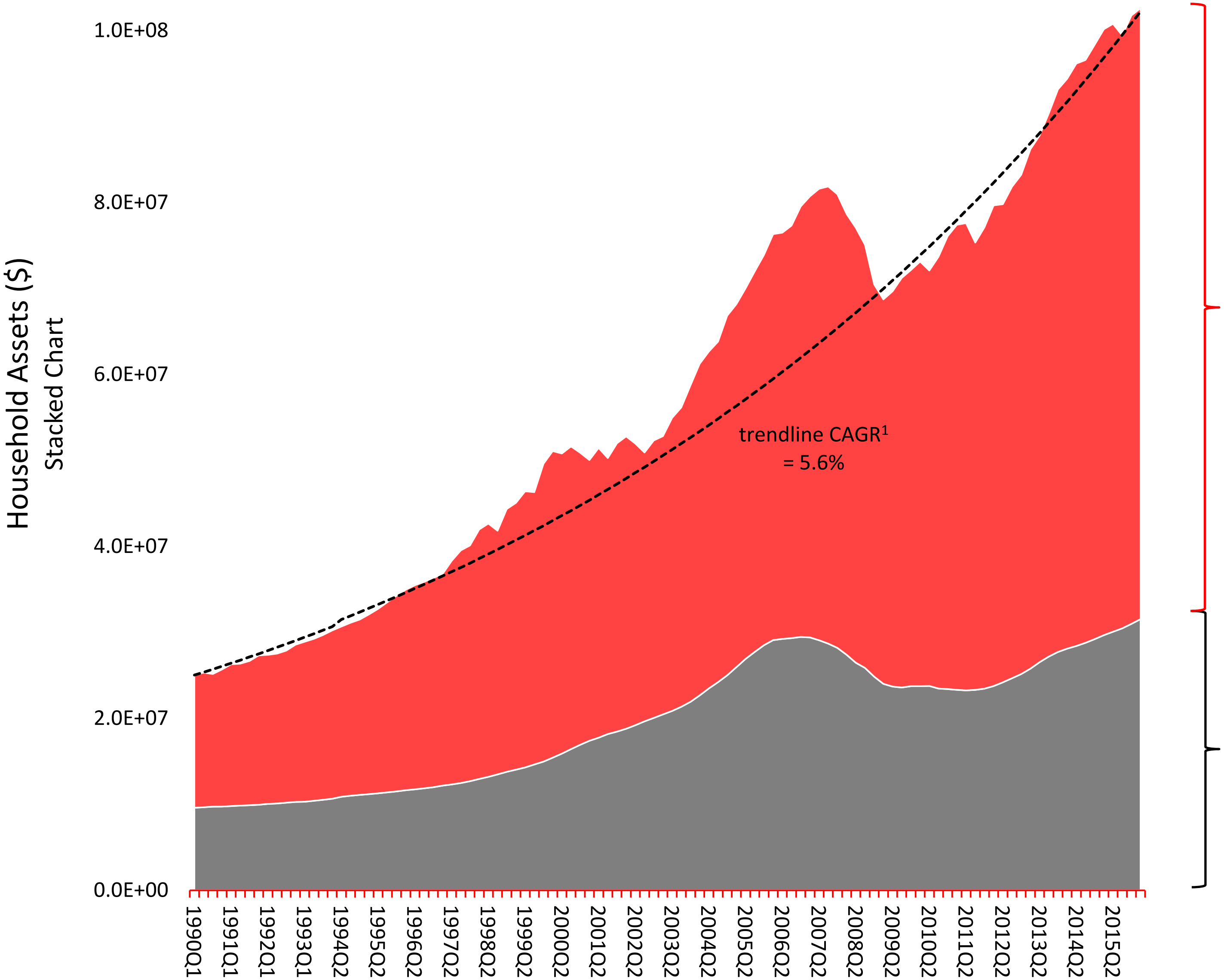
Source: BEA. Data through March 2016.
[1]Corporate net income before taxes and interest expense, divided by interest expense.

# Household balance sheets

- fully repaired
- financial obligations ratio at record low means that consumers are in record good shape to spend money
- student debt growing fast but still just 10% of household debt

Consumer balance sheets

# Household assets



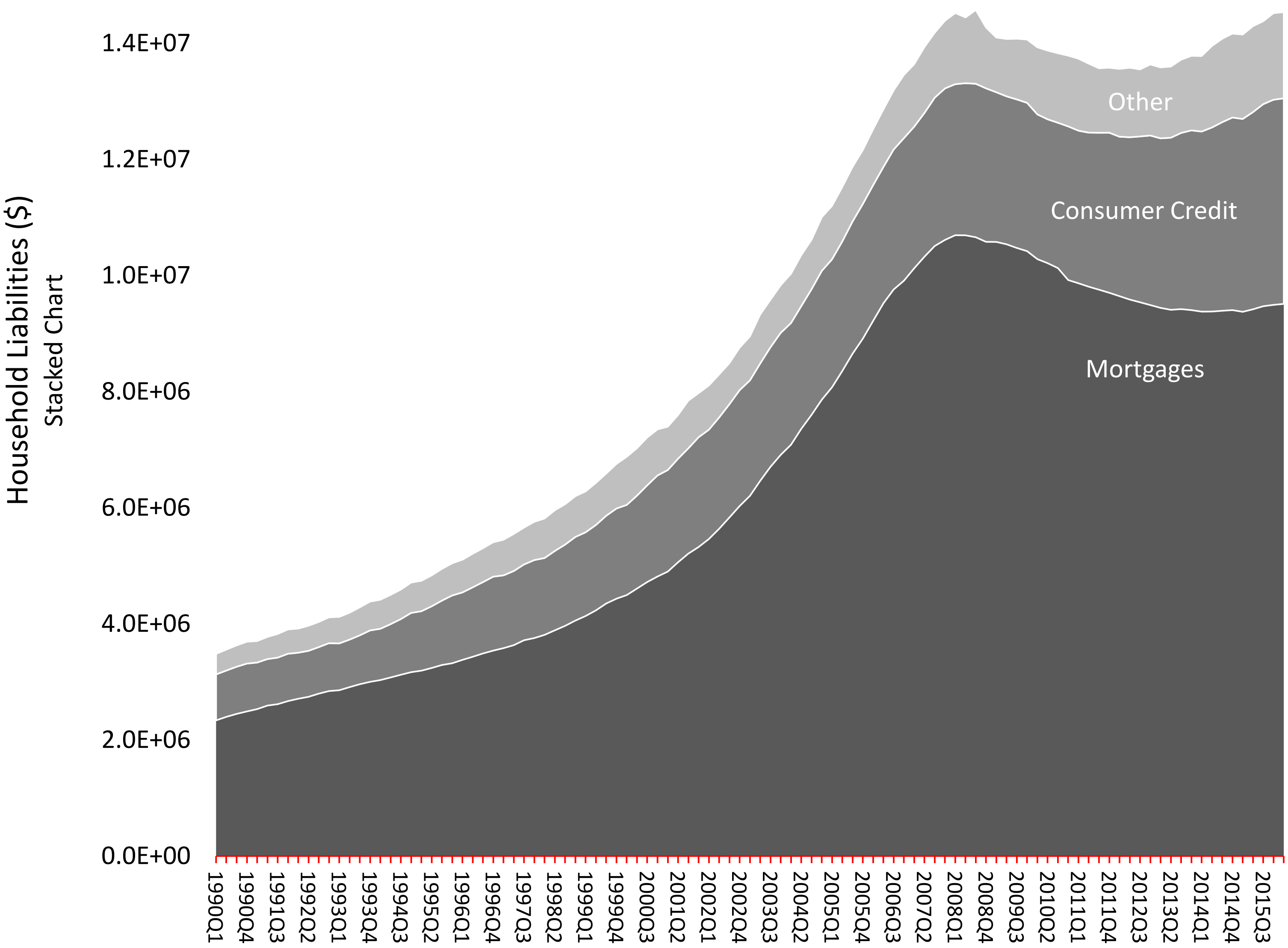

Post-recession, the total value of household assets has reverted to its long-term growth trend.

Financial assets = 69% of total household assets.

Non-financial assets = 31% of total household assets.

Source: Federal Reserve. Financial Accounts of the United States Schedule Z.1, B.103. Data through March 2016, released June 9, 2016.
[1]Compound annual growth rate. $8.0E+07 = $80 trillion.

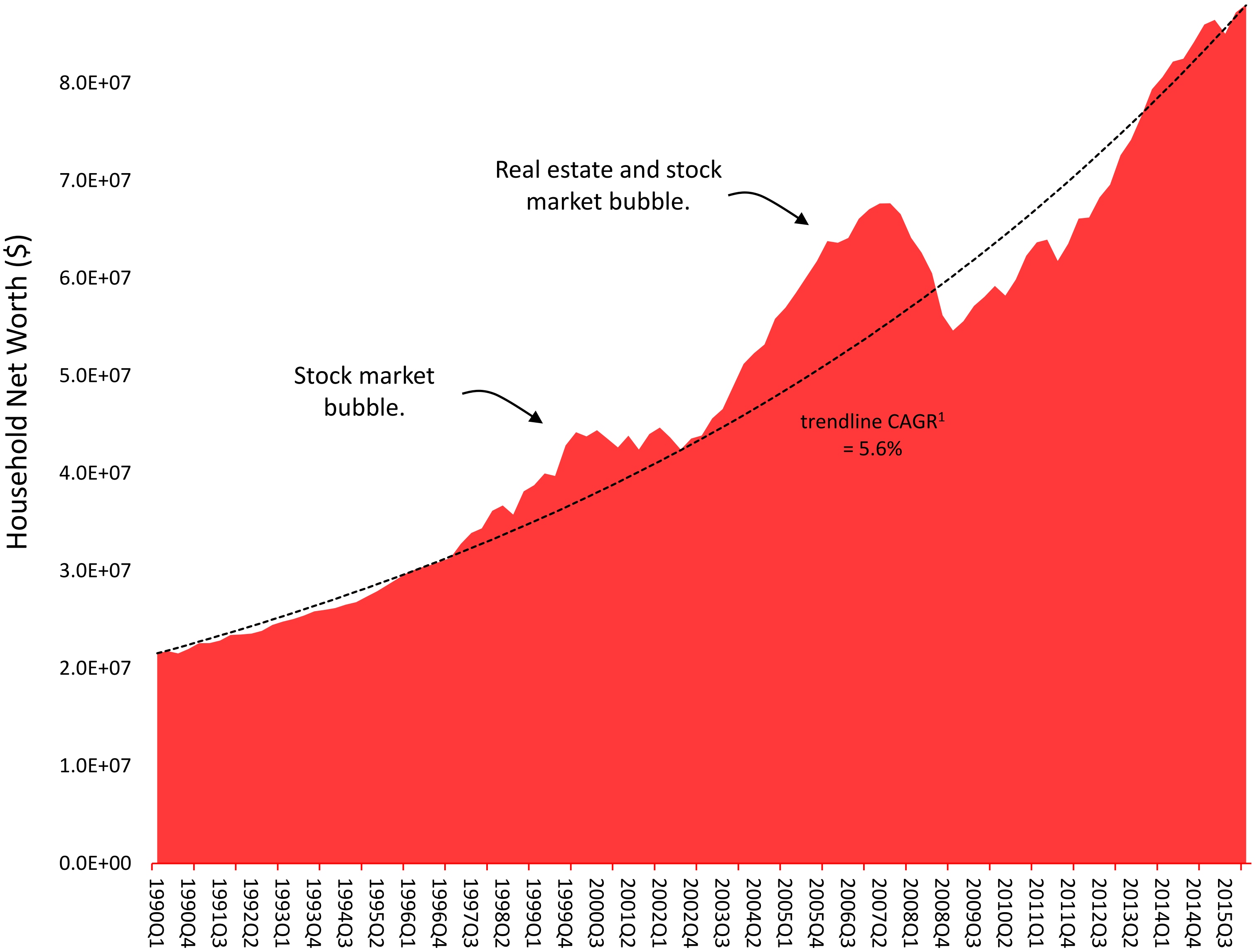
# Household liabilities




Households paid down their debts and consumer credit and mortgages are expanding again.

Source: Federal Reserve. Data through June 2016.
$1.4E+07 = $14 trillion.

# Household net worth

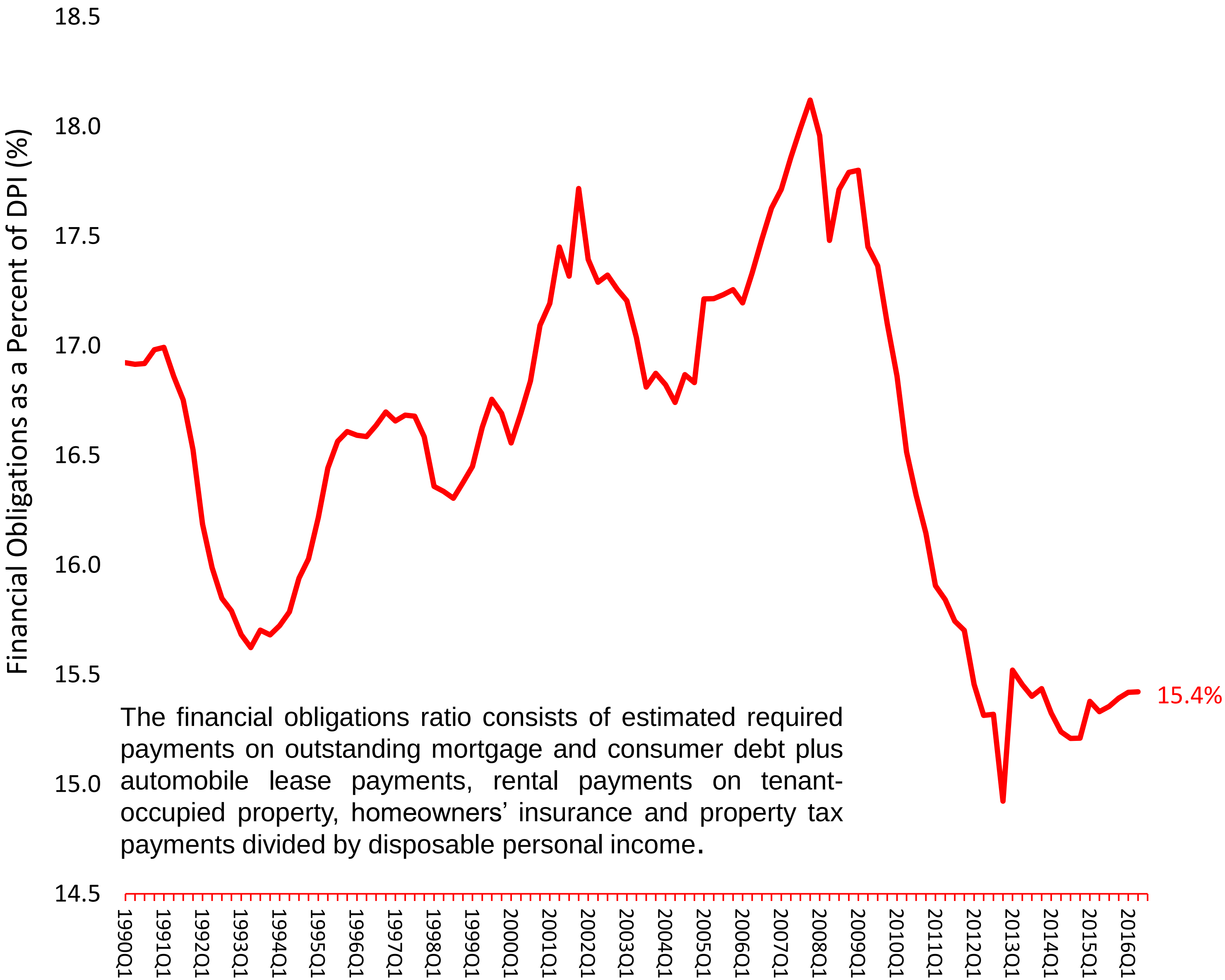



Household net worth has fully recovered.

Source: Federal Reserve. Data through June 2016. [1]Compound annual growth rate.
$8.0E+07 = $80 trillion.

Consumer balance sheets

# Financial obligations ratio – record low



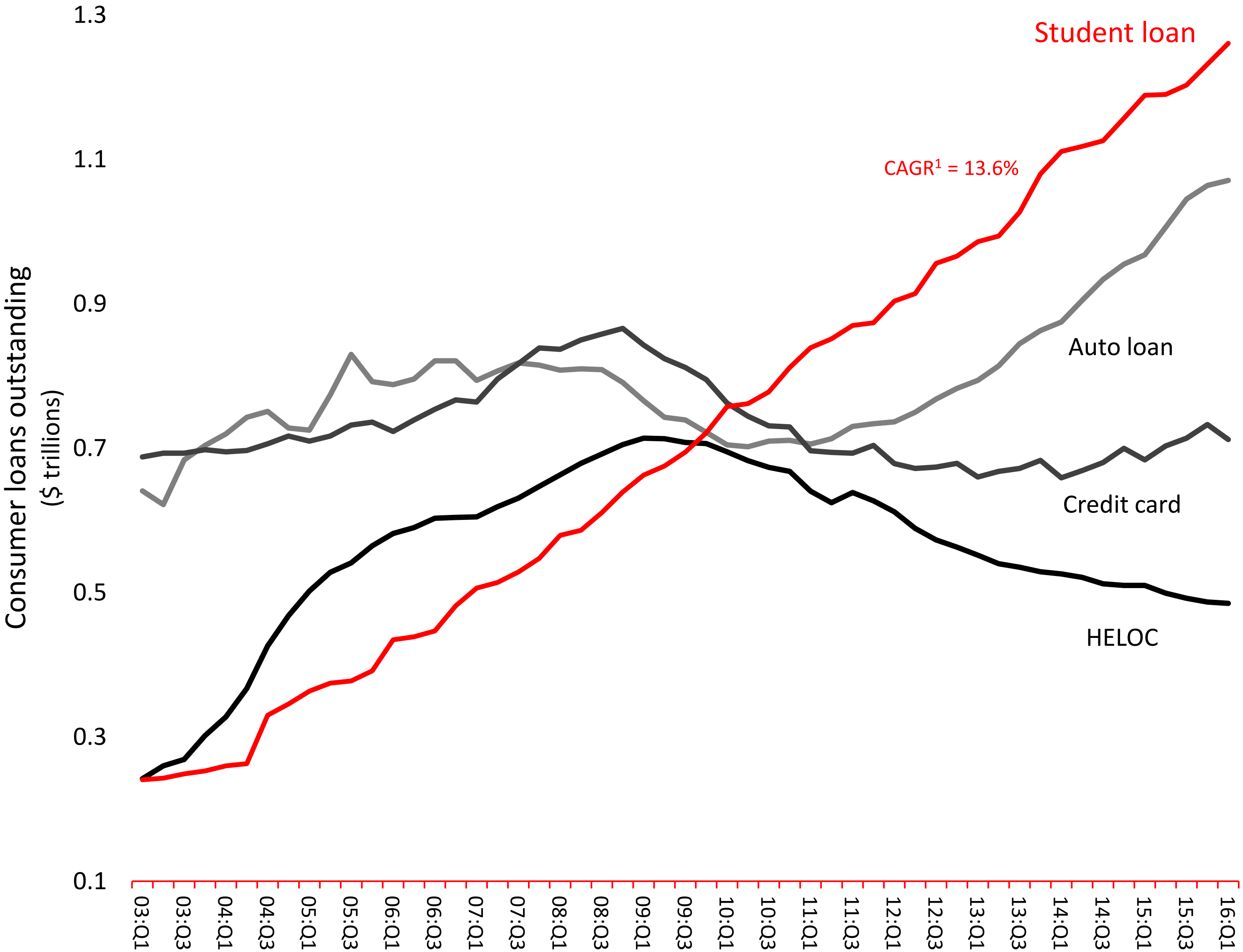

The financial obligations ratio consists of estimated required payments on outstanding mortgage and consumer debt plus automobile lease payments, rental payments on tenant-occupied property, homeowners' insurance and property tax payments divided by disposable personal income.

Comparing consumers' monthly flow of income to their fixed recurring monthly expenses, including debt service, gives a more accurate measure of consumers' financial health.

Here's the stunner: consumers' ability to cover the monthly "nut" has seldom been better as incomes have recovered, household debt has been reduced and interest rates remain low.

Source: Federal Reserve, data through June 2016; released September 26, 2016.

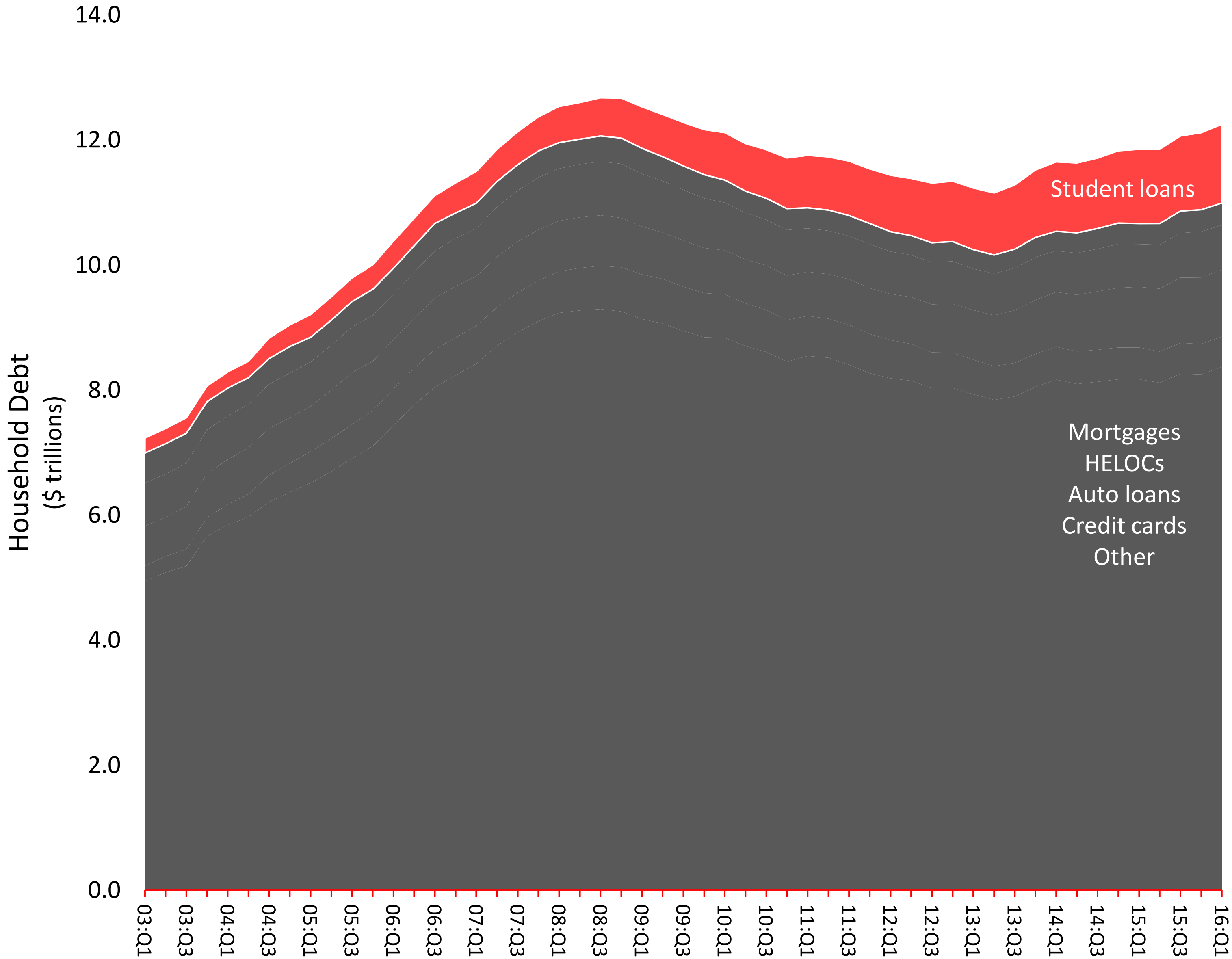
# Runaway growth in student loans




Student loans $1.3 trillion and growing 3X faster[2] than total household debt.

Source: Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit*, May 2016. Data through Q1 2016.
[1] CAGR = compound annual growth rate. [2] 13.6% CAGR compared to 4.1% CAGR for total household debt, including mortgages.

# Household debt composition

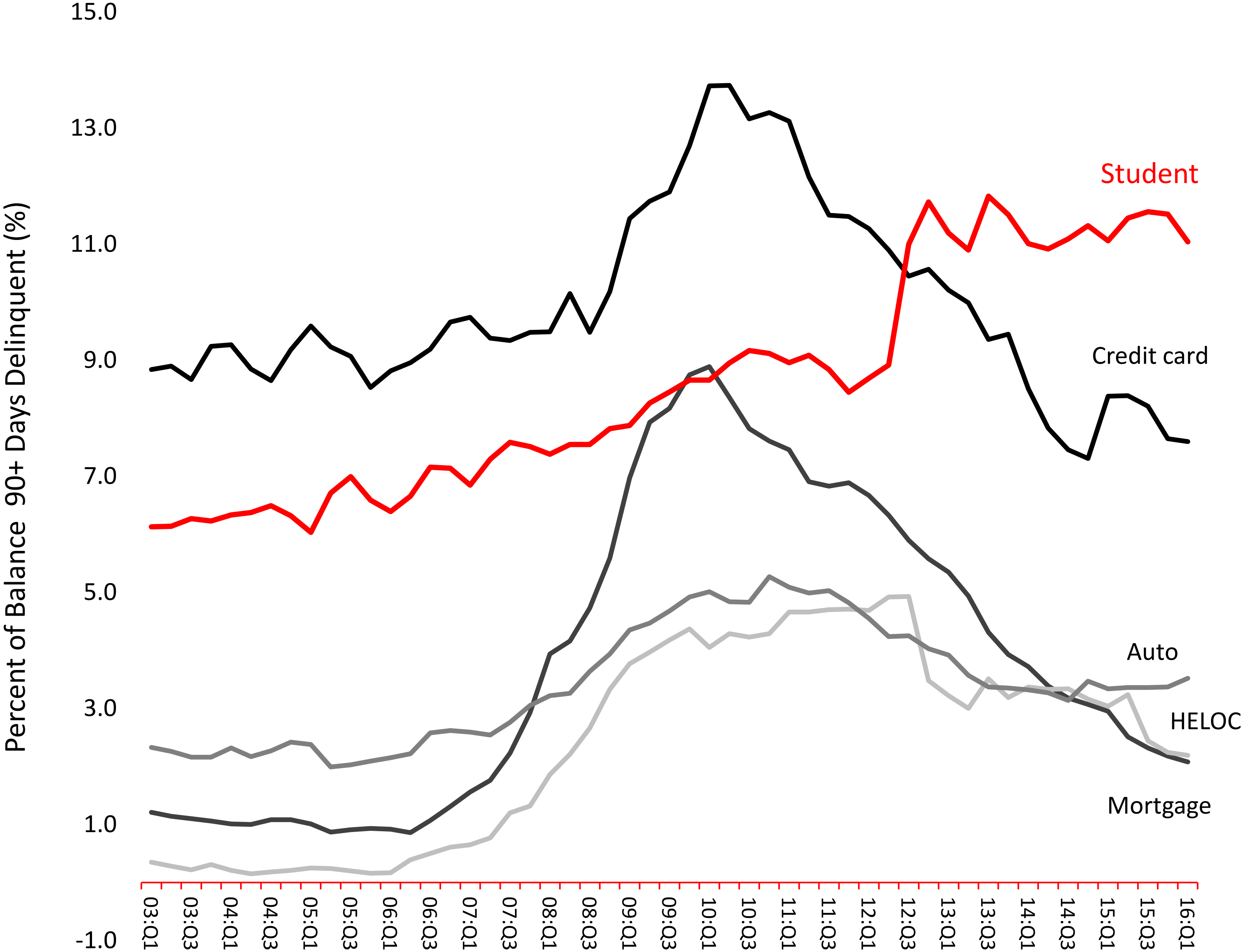



Student loans comprise 10% of total household debt outstanding.

Source: Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit*, May 2016. Data through Q1 2016.

Consumer balance sheets

# Household debt delinquency rates




Student loan delinquency rate is high but stabilized.

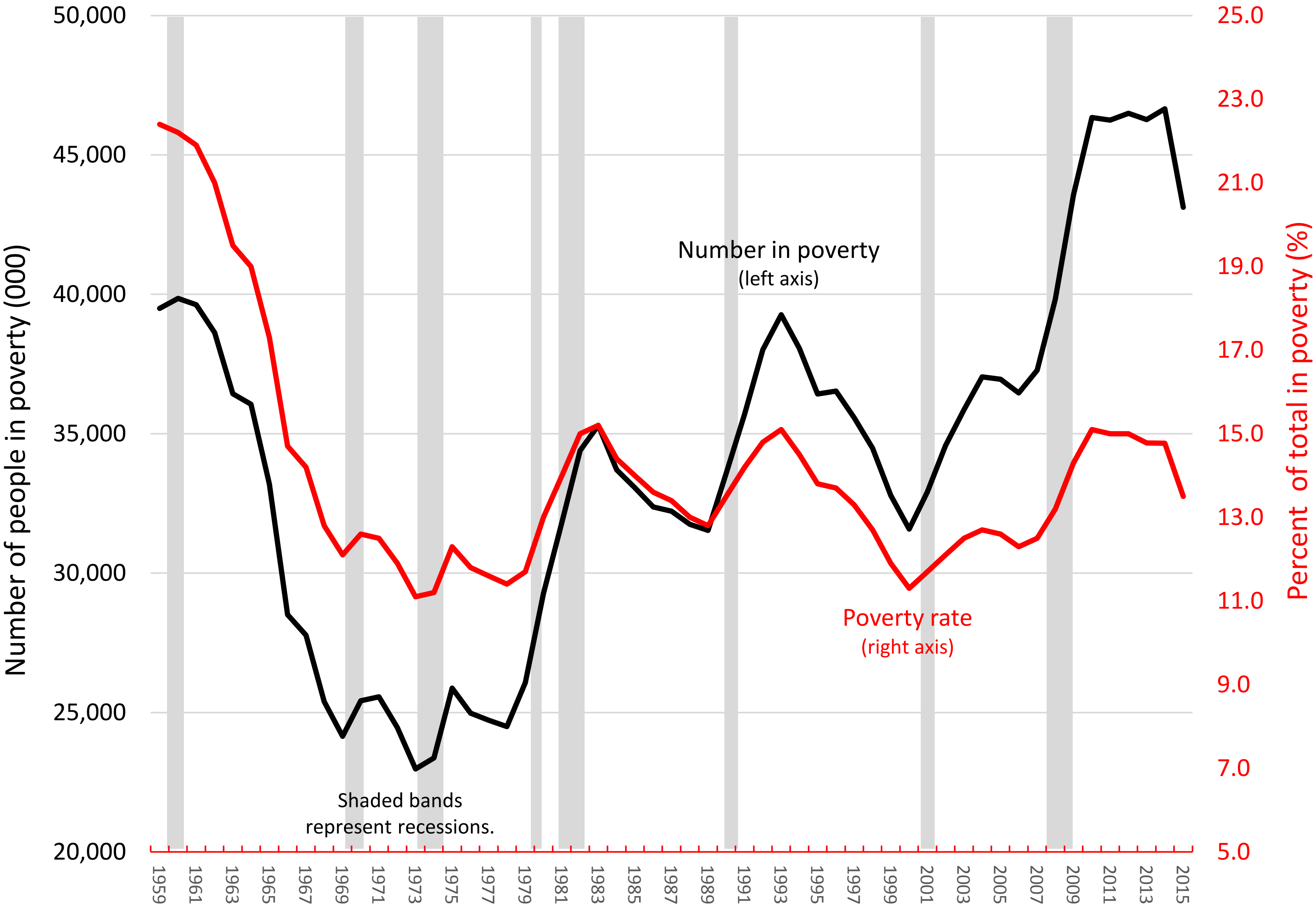
Source: Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit*, May 2016. Data through Q1 2016.

# Distribution of:

- income
- spending
- taxes
- transfer payments (income redistribution)
- Gini index

Rising income inequality?

# Poverty rate – coming down



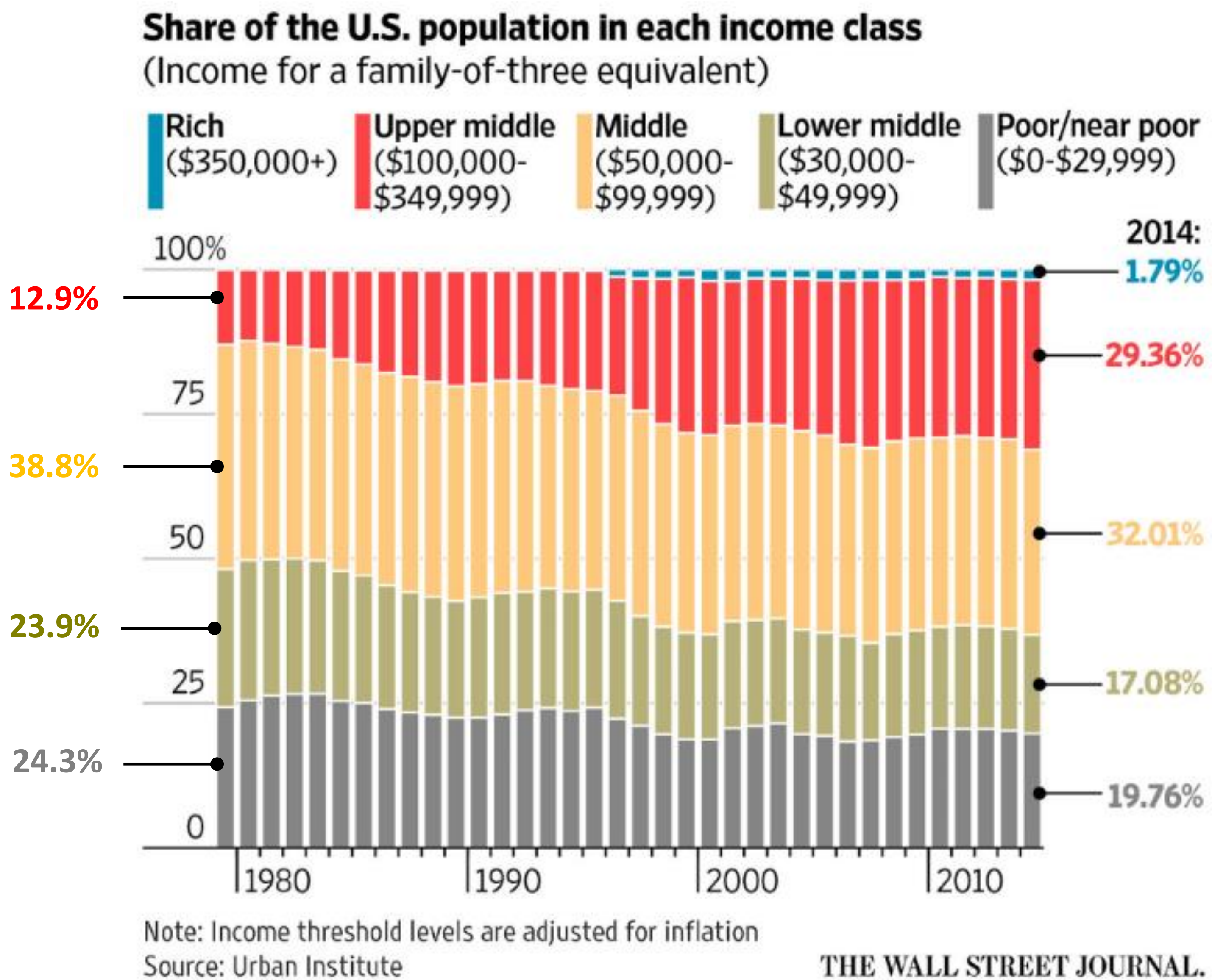

Recessions bring increased poverty.

<u>The poverty rate dropped in 2015.</u>

Source: U.S. Census Bureau. Income and Poverty in the United States: 2015, issued September 2016.

[1] The Census Bureau's income estimates are based solely on money income before taxes and do not include the value of non-cash benefits such as food stamps, Medicare, Medicaid, public housing and employer-provided fringe benefits.

# Income distribution – behind the Gini index






Source: *The Wall Street Journal,* June 22, 2016; Urban Institute, *The Growing Size and Incomes of the Upper Middle Class*, by Stephen J. Rose, June, 2016.

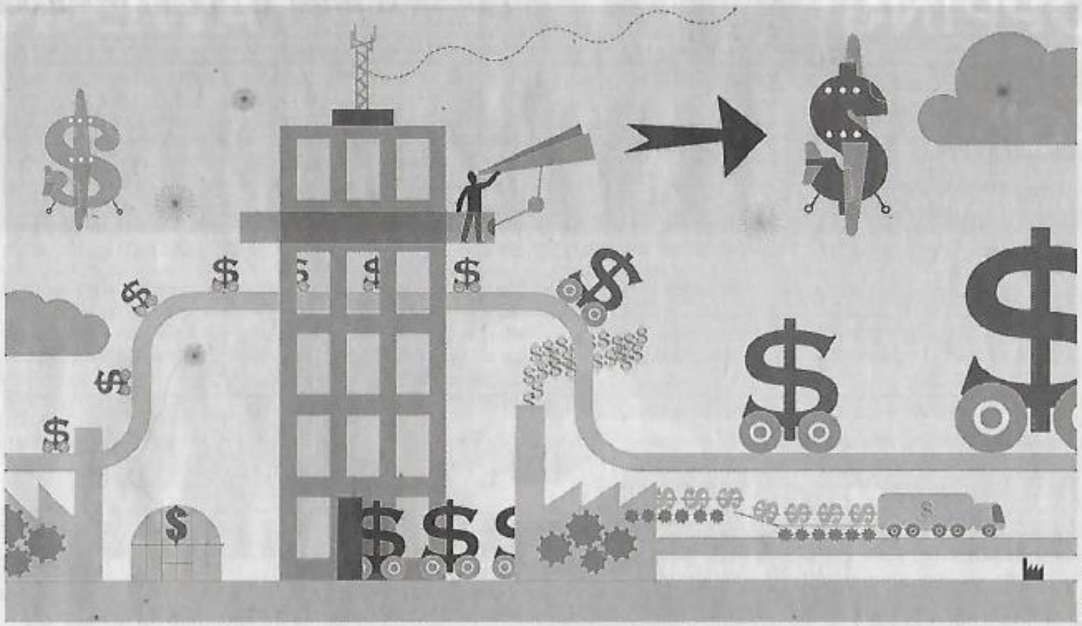
# The Myth of the Great Wages 'Decoupling'

By Donald J. Boudreaux
And Liya Palagashvili

Many pundits, politicians and economists claim that wages have fallen behind productivity gains over the last generation. This "decoupling" explains allegedly stagnant (or in some versions of the story, declining) middle-class incomes and is held out as a crisis of the market economy.

This story, though, is built on an illusion. There is no great decoupling of worker pay from productivity. Nor have workers' incomes stagnated over the past four decades.

**There is no disconnect between productivity and worker pay if you use more accurate measures.**



The illusion is the result of two mistakes that are routinely made when pay is compared with productivity. First, the value of fringe benefits—such as health insurance and pension contributions—is often excluded from calculations of worker pay. Because fringe benefits today make up a larger share of the typical employee's pay than they did 40 years ago (about 19% today compared with 10% back then), excluding them fosters the illusion that the workers' slice of the (bigger) pie is shrinking.

The second mistake is to use the Consumer Price Index (CPI) to adjust workers' pay for inflation while using a different measure—for example the GDP deflator, which converts the current prices of all domestically produced final goods and services into constant dollars—to adjust the value of economic output for inflation. But as Harvard's Martin Feldstein noted in a National Bureau of Economic Research paper in 2008, it is misleading to use different deflators.

Different inflation adjustments give conflicting estimates of just how much the dollar's purchasing power has fallen. So to accurately compare the real (that is, inflation-adjusted) value of output to the real value of worker pay requires that these values both be calculated using the same price index.

Consider, for instance, that between 1970-2006 the CPI rose at an average annual rate of 4.3%, while the GDP deflator rose only 3.8%. Economists believe that such a difference arises because the CPI is especially prone to overestimate inflation. Therefore, much of the increase in the real purchasing power of workers' pay is mistakenly labeled by the CPI as mere inflation.

Mr. Feldstein and a number of other careful economists—including Richard Anderson of the St. Louis Federal Reserve Bank and Edward Lazear of the Stanford University Graduate School of Business—have compared worker pay (including the value of fringe benefits) with productivity using a consistent adjustment for inflation. They move in tandem. And in a study last year, João Paulo Pessoa and John Van Reenen of the London School of Economics compared worker compensation and productivity in both the United States and the United Kingdom from 1972-2010. There was no decoupling in either country.

The empirical reality in both countries is consistent with economic reasoning. Firms cannot afford a misalignment of their workers' pay and productivity increases—the employees will move to other firms eager to hire these now more productive workers. Higher economy-wide productivity, after all, means that workers add more to the bottom lines of employers throughout the economy. To secure the services of these more-productive workers, firms bid up worker pay. This competition for labor services is what links pay to productivity.

Competitive markets also deliver the goods, so to speak, to workers *in their role as consumers*. Higher productivity means the prices of consumer goods and services decline as output increases. As this happens, workers' spending power—their real income—is enhanced.

The claim that ordinary Americans are stagnating economically while only "the rich" are gaining is also incorrect. True enough, membership in the middle class seems to be declining—but this is because more American households are moving up.

The Census Bureau in 2012 compiled data on the percentage of U.S. households earning annual incomes, measured in 2009 dollars, in different income categories (for example, annual incomes between \$25,000 and \$35,000). These data reveal that between 1975 and 2009, the percentage of households in the low- and middle-income categories fell. The only two categories that saw an increase were households earning between \$75,000 and \$100,000 annually, and households earning more than \$100,000 annually. Remarkably, the share of American households earning annual incomes in excess of \$100,000 went to 20.1% in 2009 from 8.4% in 1975. Over these same years, households earning annual incomes of \$50,000 or less fell to 50.1% from 58.4%.

This household-income trend can't just be dismissed, as some analysts do, by noting that it was amplified by the greater number of married women in the workforce. The increase in income earned by these women itself reflects greater economic productivity. Women's increased employment has been facilitated by lower-priced and higher-quality home appliances, prepared meals and other modern conveniences.

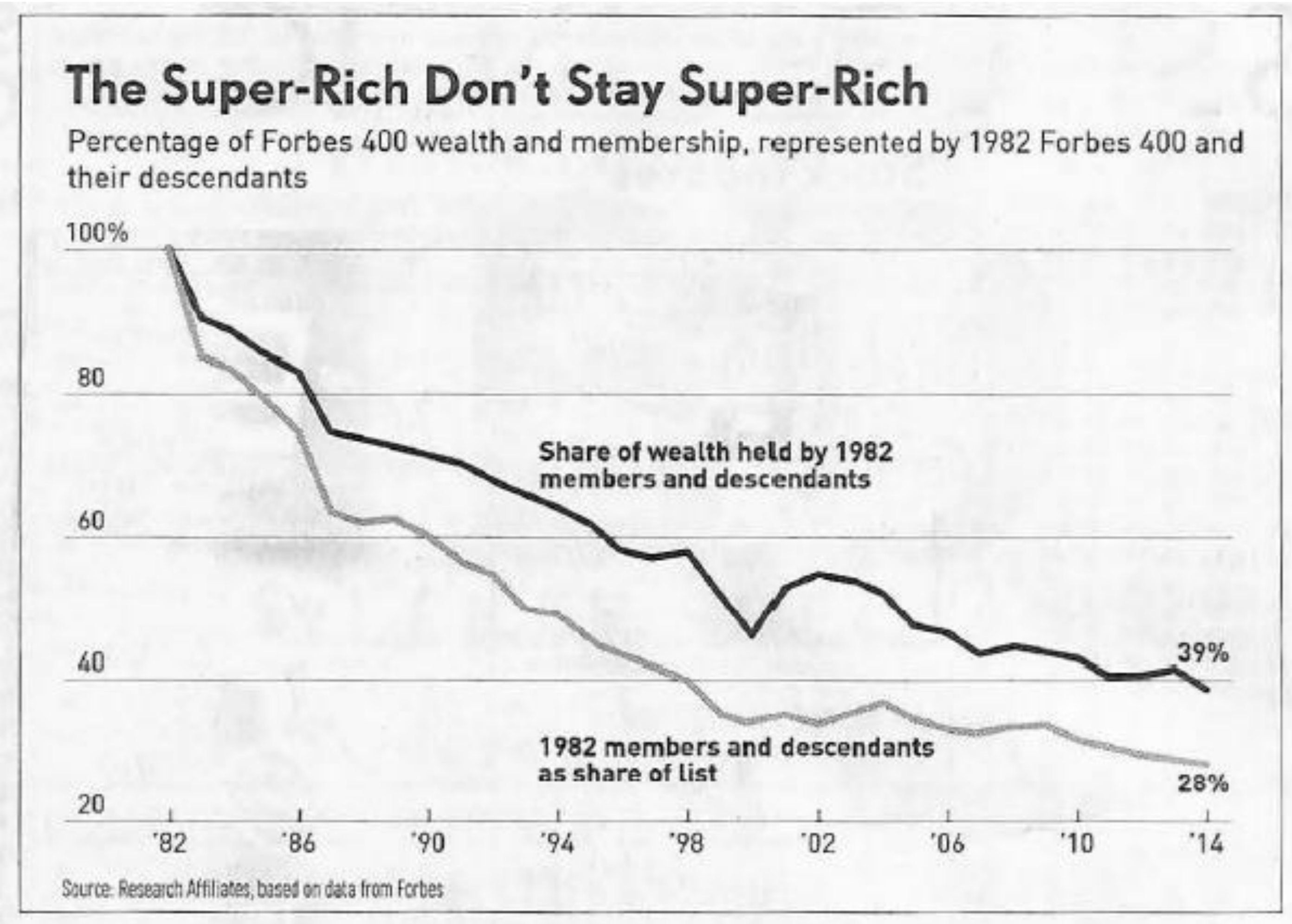
Households in the past enjoyed income earned in the market by the husband, with meal preparation, dishwashing and the like performed by the wife. The women who engaged in this household production were not paid a wage in the market, but their work had real economic value to the household (and to the economy). Households today enjoy market incomes earned by both spouses, while the time necessary for household work has been reduced thanks to microwave ovens, automatic dishwashers and other inventions that are themselves reflections of a thriving marketplace.

Middle-class stagnation and the "decoupling" of pay and productivity are illusions. Yes, the U.S. economy is in the doldrums, thanks to a variety of factors, most significantly the effect of growth-deadening government policies like ObamaCare and the Dodd-Frank Act. But by any sensible measure, most Americans are today better paid and more prosperous than in the past.

*Mr. Boudreaux is an economics professor at George Mason University, where Ms. Palagashvili is a graduate student in economics; she is also a visiting Ph.D. fellow in the economics department at New York University.*

Source: *The Wall Street Journal,* March 7, 2014.

# Changing shares of wealth



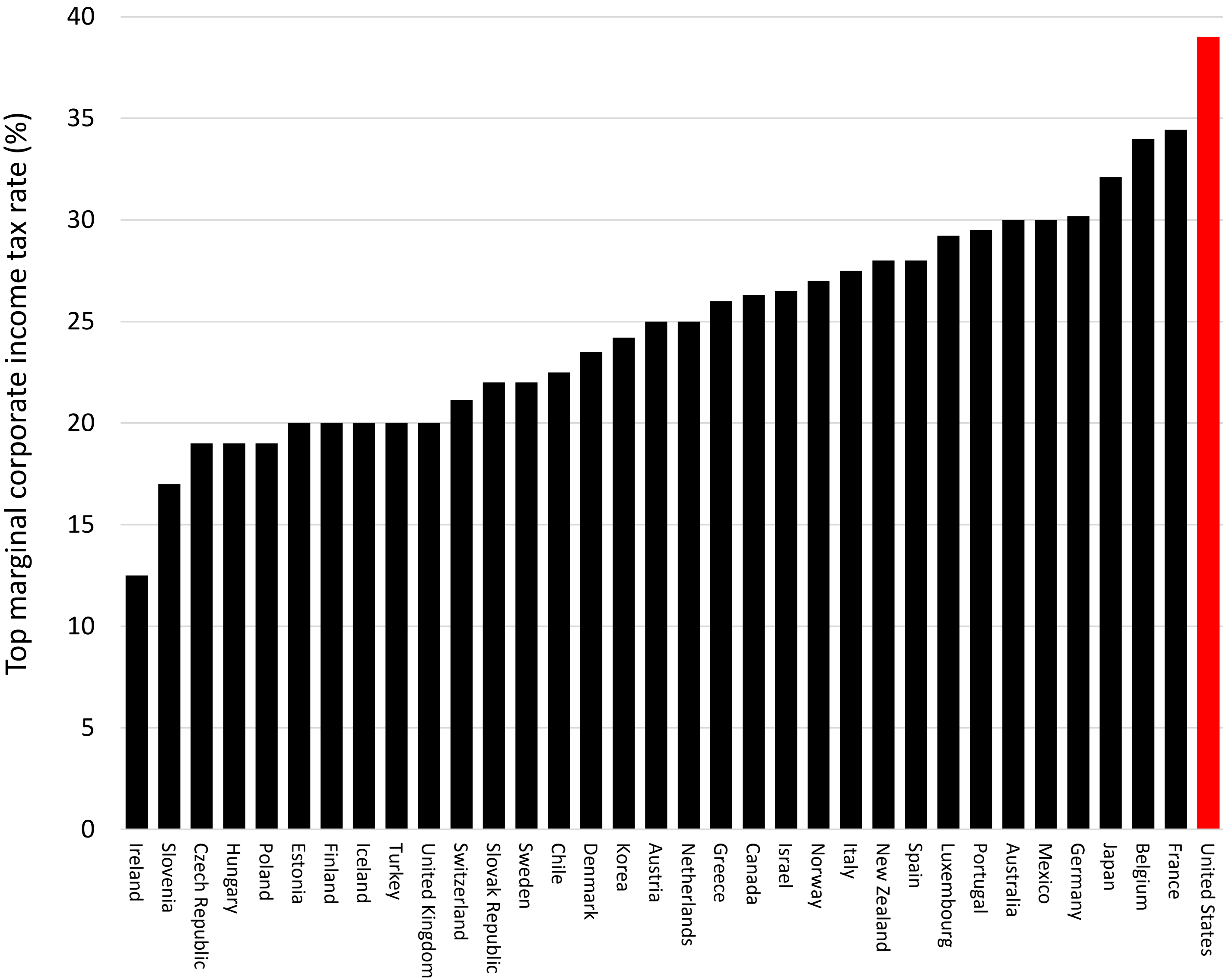

Is U.S. capitalism creating vast dynasties of wealth hoarded and passed down by a select few families?

"… only one-fourth of the wealthy families in 2014 were on the 1982 list, and their aggregate wealth equals just 39% of the total wealth held by today's elite.

… Great wealth, once established, dissipates at 3% to 6% per year, through spending, charitable giving and taxes, the pace accelerating with each generation."

Source: *Investor's Business Daily,* June 8, 2015.

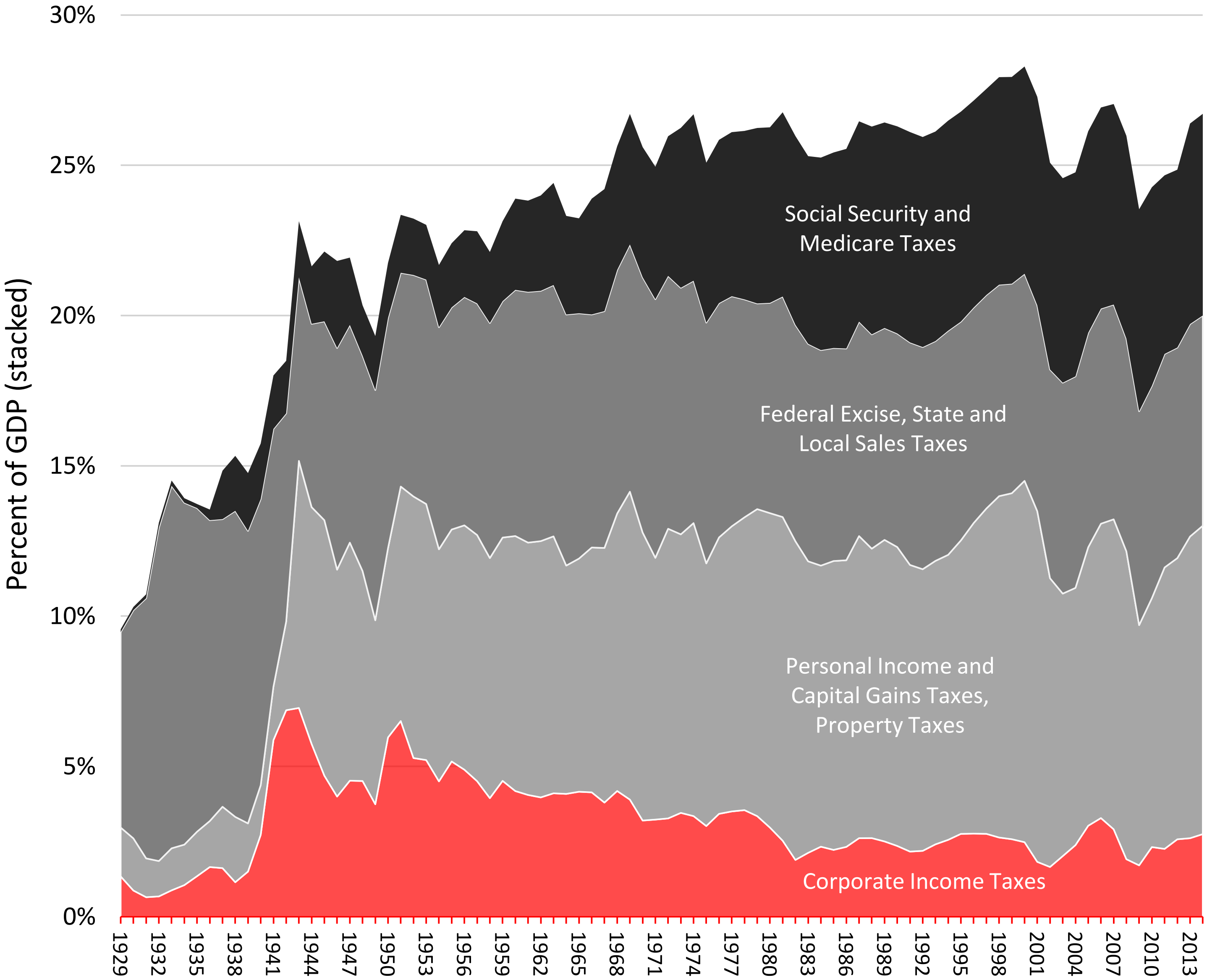
# Corporate income tax rates[1] – comparison




The U.S. has the highest corporate income tax rate among developed economies.

[1] Top marginal federal plus state and local corporate income tax rates.
Source: OECD Tax Database, 2015, Table II.1. Does not include non-OECD countries such as China, Brazil, India and Russia.

# Tax revenue by source

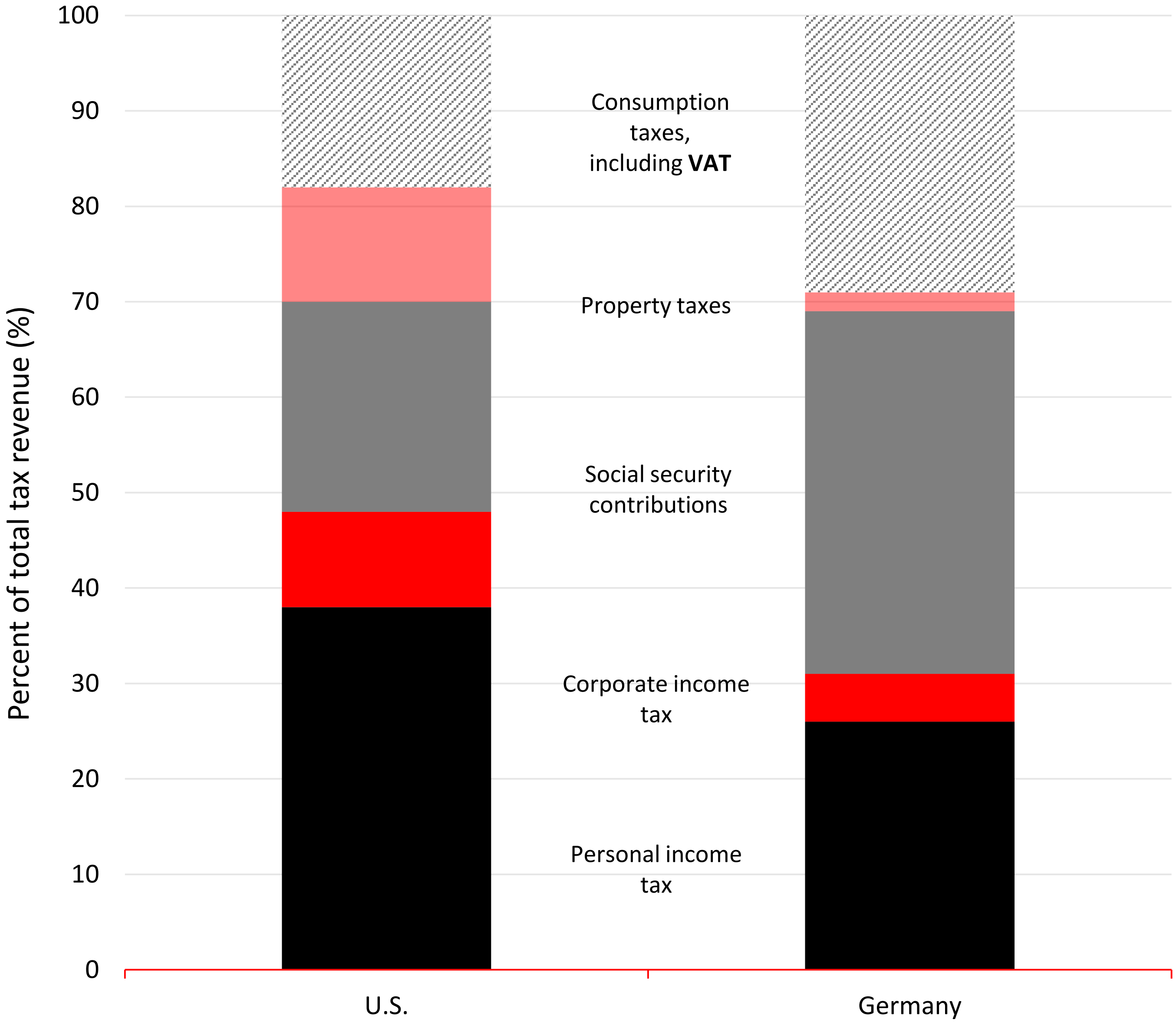



<u>Cutting corporate income tax revenues means raising rates elsewhere – a tough political problem</u>.

Corporate income taxes amount to 2.7% of GDP and comprise 10.3% of total tax revenues.

Source: BEA. Data through December 31, 2014.

# Tax structure U.S. vs. Germany

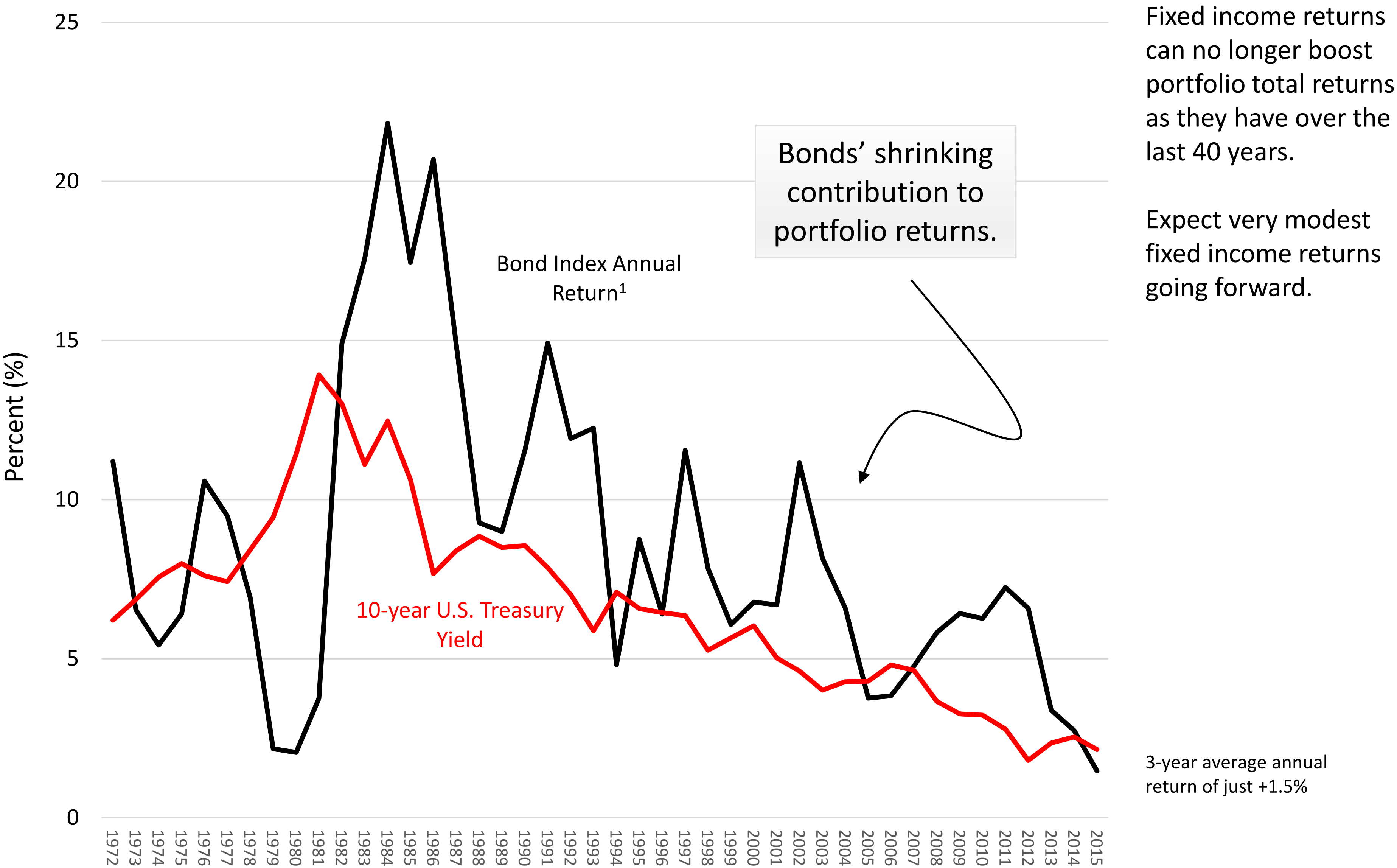



The U.S. takes a very different approach to raising tax revenues compared to all other developed economies.

Source: OECD Revenue Statistics 2014, data through 2013.

## Investment Strategy

# Declining bond returns



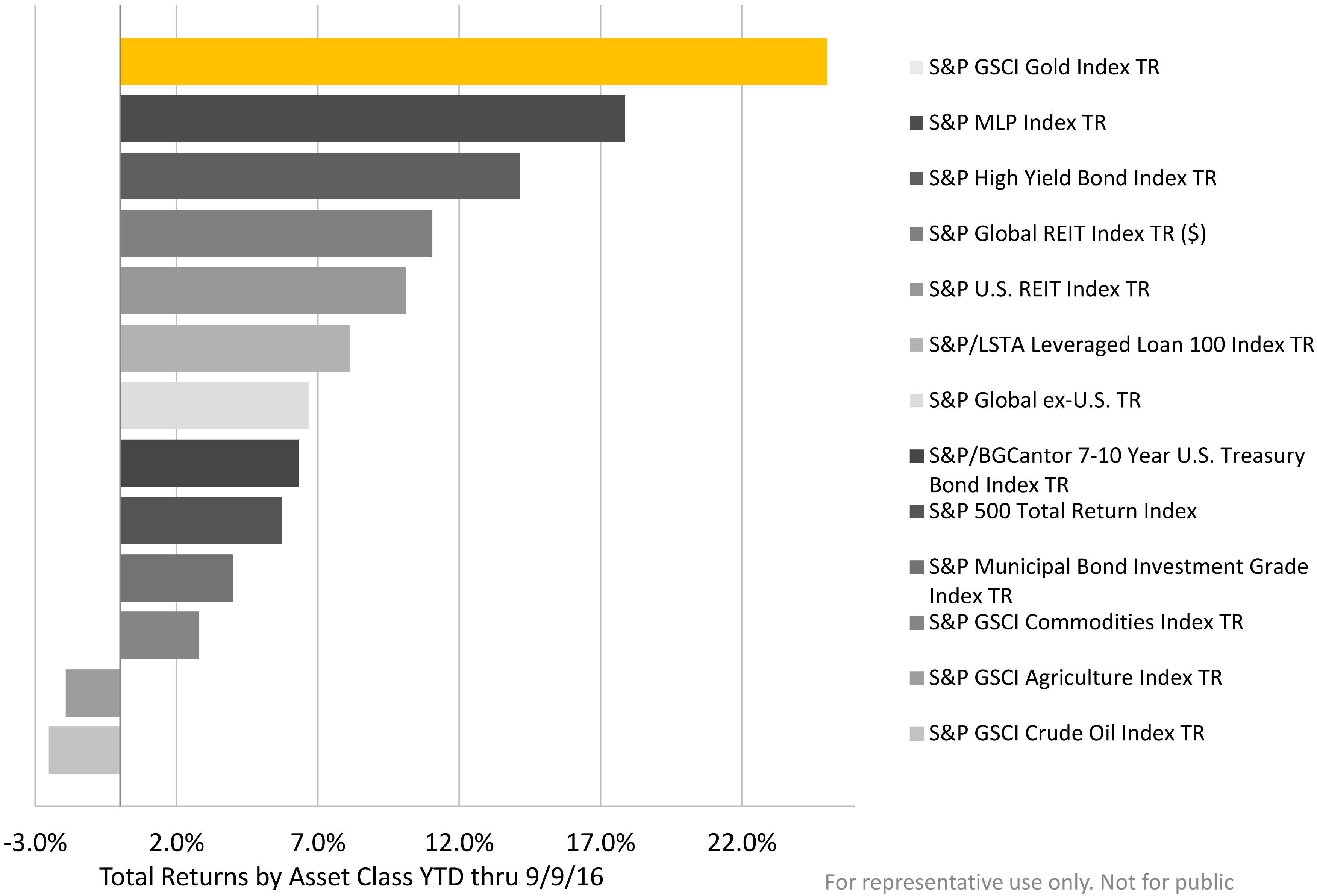

Fixed income returns can no longer boost portfolio total returns as they have over the last 40 years.

Expect very modest fixed income returns going forward.

Source: Federal Reserve and ©2015 The 7Twelve ™ Portfolio powerpoint presentation, by Craig Israelsen. Used with permission.

[1] 3-year average annual return of the U.S. Aggregate Bond index represented by the Ibbotson Intermediate Term Bond Index from 1970-75 and the Barclays Capital Aggregate Bond index starting in 1976. Annual data through 2015.

# Gold is hot! … year-to-date asset class returns

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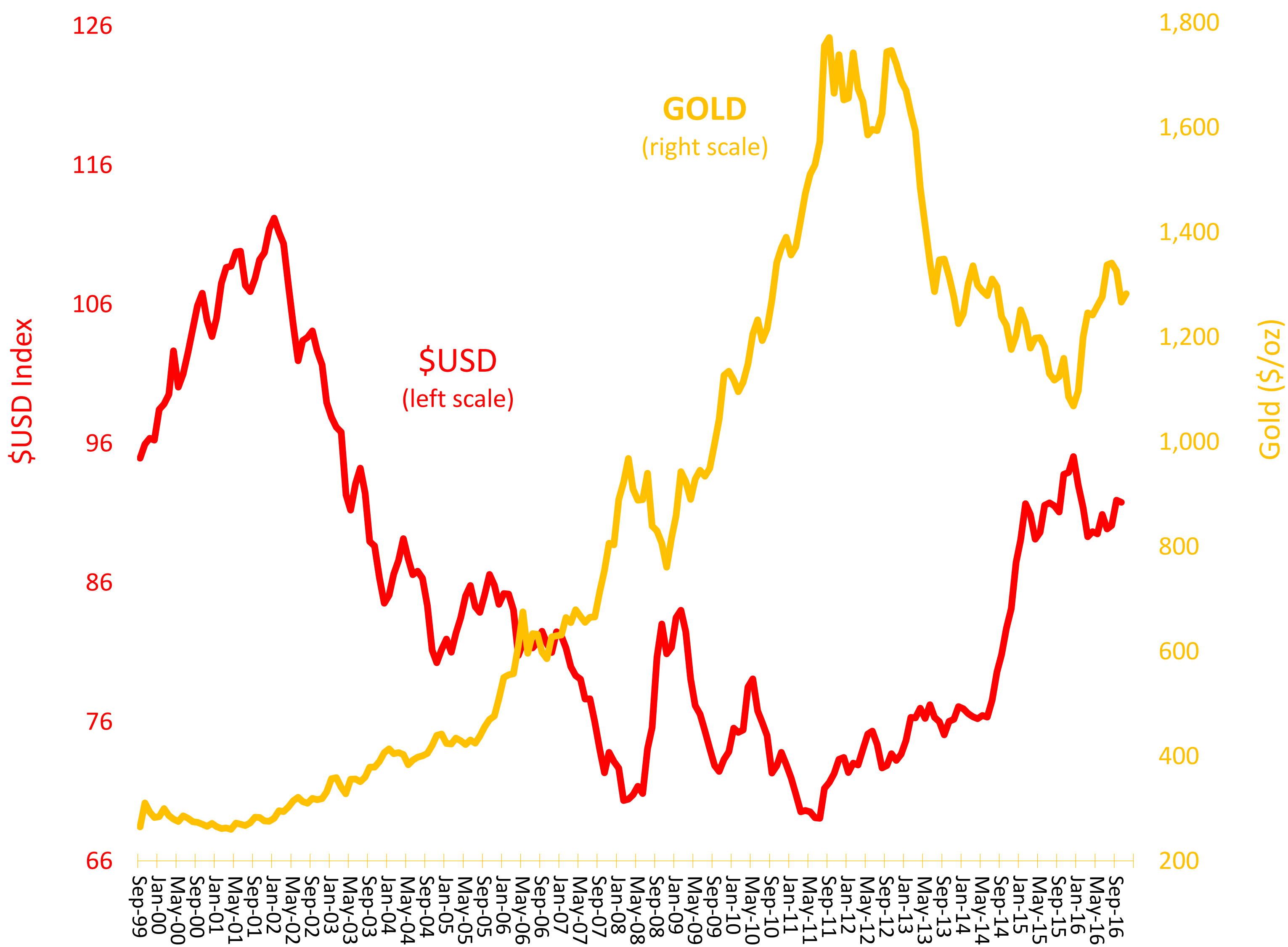
Source: Standard & Poor's Corporation. Data through September 9, 2016.

# Gold vs. the $USD




Gold has generally trended inversely to the dollar.

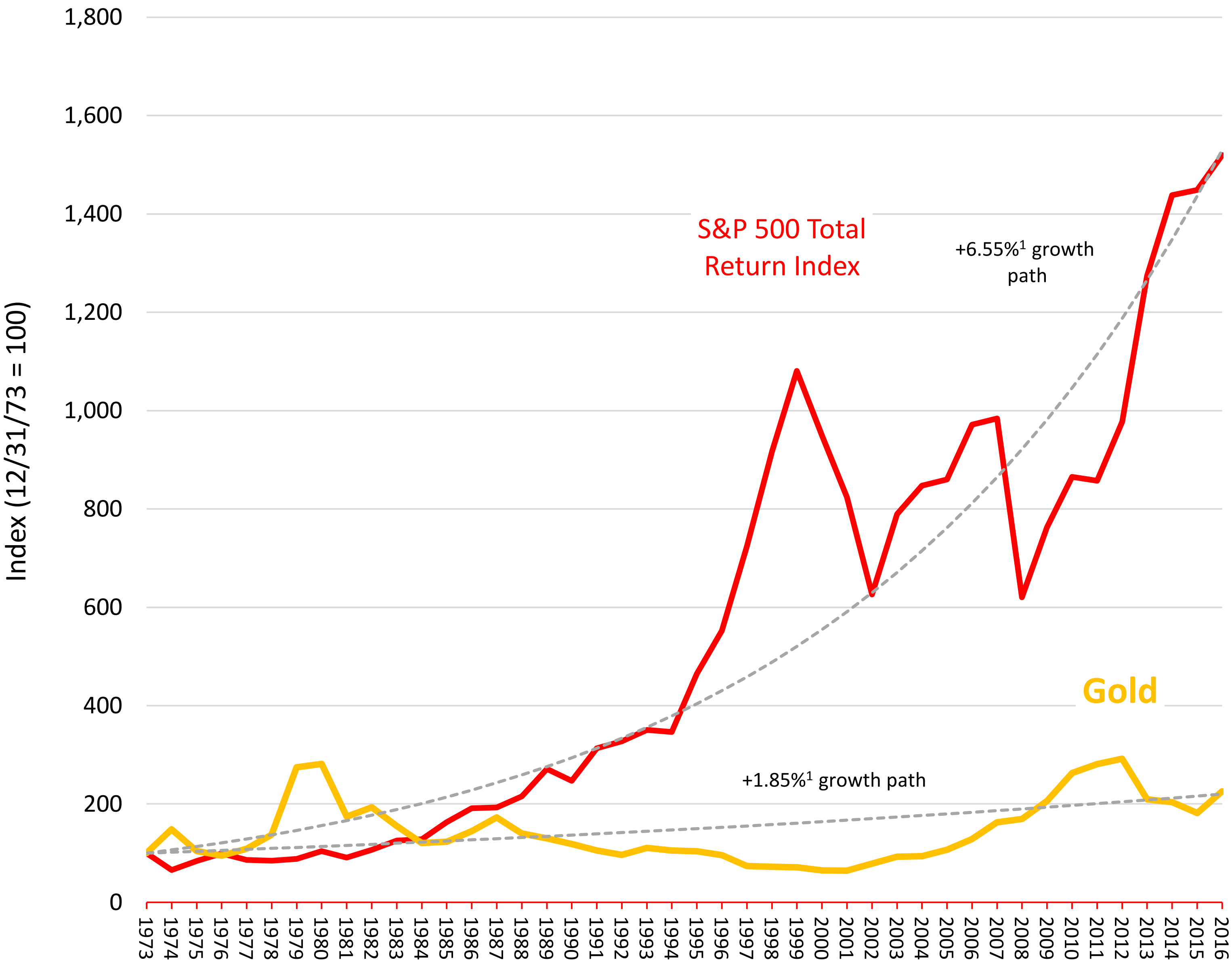
Until 2011, gold trended relentlessly higher as investors sought a safe haven from possible paper currency "debasement" and geopolitical risks.

Gold then plunged with the dollar's surge on low U.S. inflation and strong U.S. GDP growth relative to Europe and Japan.

Sources: Federal Reserve major currencies dollar index and London spot prices. $USD data through October 2016; gold data through November 8, 2016.

Market data

# Gold vs. stocks, adjusted for inflation




Long-term, gold has been a poor investment.

<u>Stocks are the only asset class in which you get to invest in human ingenuity, creativity and drive to create wealth.</u>

Whereas gold is a static and lifeless store of value.

This chart illustrates the stark contrast between the long-term, after-inflation returns for stocks and gold.



Sources: Standard & Poor's, usagold.com, BLS. Data through September 9, 2016. [1]Compound annual growth rate.

# Gold

## Gold: It's Still a Pet Rock

By Jason Zweig
July 8, 2016

… let's review what gold is and what it isn't.

Gold is insurance against chaos. Continually traded for millennia, it has tended to do well during periods of financial stress. Gold has also preserved its purchasing power over remarkably long periods. The same quantity of gold that a Roman centurion earned annually under Emperor Augustus (27 B.C. to A.D. 14) would cover one year's pay ($46,500 to $65,000) for a U.S. Army captain today.

And the world is certainly in chaos, with the British voting to exit the European Union, central banks struggling to revive economic growth and roughly $12 trillion in government debt carrying negative yields.

"Just like Brexit came out of the blue, there will be other surprises that will show that the surface calm and sanguine view are not sustainable," says John Hathaway, portfolio manager of the $1.7 billion Tocqueville Gold Fund. "When investors ask, 'How do I protect capital?' it all comes back to gold."

With central banks around the world holding about 33,000 metric tons, gold is also an implicit form of money. Like most nations, the U.S. went off the gold standard decades ago. But if markets lose faith in national currencies, policymakers could — in theory — again choose to make money convertible to gold.

However, some important popular beliefs about gold aren't supported by historical evidence.

While gold is a reliable store of value over extremely long periods, most investors don't lock their money up for a couple thousand years at a time. In the shorter term, gold fluctuates so wildly that it is a surprisingly poor hedge against increases in the cost of living.

From its peak of more than $800 as inflation raged in 1980, gold fell relentlessly over the next two decades even as the cost of living continued to rise. Adjusted for inflation, gold remains 35% below its record highs of 1980, says Claude Erb, a former commodities and fixed-income portfolio manager at TCW, the Los Angeles-based investment firm, who has extensively researched gold's historical performance.

And gold is a partial, not a perfect, hedge against chaos. In October 2008, for instance, when U.S. stocks fell 16.8% and corporate bonds lost 4.5%, gold dropped 18.5%; in September 2011, as U.S. stocks fell 7% and corporate bonds gained 1%, gold dropped 11.4%.

In October 2008, the depths of the global financial crisis, the gold price was 30% lower than it is now. In August 2011, when Standard & Poor's downgraded the U.S.'s credit rating, gold was nearly 40% higher than it is now. Is today's chaos that much worse than the financial crisis? Was the summer of 2011 so much darker than today?

The future can always be different from the past. But if gold shoots far up from here, it won't be following the precedents of the past. It will be violating them.

So am I a moron? On many things, yes. On gold, I don't think so.

Source: *The Wall Street Journal,* July 8-9, 2016