Cyclical Forces Driving the Economy and Markets

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Where Is the Economy Headed?

- Sense of drift with no major implosions or explosions (except the weather)
- Secular forces of the twin D’s not good, but won’t be faced again for a few years (2016 and thereafter)
- But more immediately, the forces of cyclical recovery are underway
The Cyclical Movement

Private Sector Employment Outside of Financials

Source: Haver Analytics, Gluskin Sheff
What Makes an Economic Cycle?

- Booms don’t go to infinity and busts don’t go to zero so the economy cycles back and forth.
- Primarily, the build up of the capital stock by consumers, businesses and governments drive the booms and recessions come from an air pocket in new expenditures on durables.
- But at some point, all parties must face physical and economic obsolescence.
For Example:
Aging Auto Stock Implies Deferred Demand
Same aging for US residential assets

Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff
Much the Same with US Business:
Average Age of Fixed Assets

Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff
Available US Corporate Financial Resources

- Retained cash very large in absolute terms and relative to debt service
- Fed’s QE made terms so cheap, 2013 was a banner year for corporate financing
  - Over a Trillion in high quality debt issuance
  - Record Junk issuance
  - Record “PIK” issuance
- Don’t need more financing to purchase P & E
Flip side of Older and Scarce Capital: Inputs More Expensive and Cost More

- Plant and Equipment Now at 79.2% Utilization
- At the edge of the 80% rule of thumb for efficient plant & equipment
- The last 20% is older vintage plant and equipment
- Implication less efficient and higher cost of inputs and production
Cost-Push Inflation

- Business will first try to substitute labor for scarce capital
- But today “effective” labor is also scarce despite the Fed’s unemployment concerns
- This is the concept of the “Natural” Rate of Unemployment which is high
- It means those ready, willing and able to seek employment
Those in the Labor Force Who Do Not Want a Job Now

United States
(year-over-year change, thousands)

Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff
Record Drop Out of the Labor Force Has Occurred Which Is a Story in Itself

- Varying reasons:
  - Schooling and Training
  - Unemployment support
  - Drugs
  - Demographics
Where We Are

- Reasons for reasonably healthy demand
- Reasons for restricted supply
- Implies
  - Cost-push inflation as opposed to money driven demand inflation alone
  - Costs will shrink profit margins from historical highs
Labor Cost to GDP at Low and Profit Margin at Post WWII high

**HAPPY INVESTORS, UNHAPPY WORKERS**
Share of US corporate value added, 1970–2013

Sources: Bureau of Economic Analysis and BlackRock Investment Institute, October 2013. Notes: based on national accounts data. Non-financial companies are excluded in all calculations. The corporate profit share is after tax.
Too late to Chase Market Indices

- P/E only topped by profit growth expectations booms of the Roaring 1920s and the Roaring tech boom years (Shiller data)
Too Little and Too Late for Bonds and Fixed Income

- Yields are close to all time lows
- Two good reasons why bond prices will fall and interest rates will rise: The two big buyers are done:
  - The Fed’s QE is being eased out
  - Rising inflation will drive private buyers away
- The flip side of rising rates is negative total returns to fixed income
- Note the stress that has come over Bill Gross and PIMCO as of late that is front page WSJ
Not Enough Extra Yield to Cover Risk of Rising Yields
Nor Does Junk Debt Have Enough Extra Yield to Cover Risks

United States: High Yield Corporate Bond Yields off Treasuries (percentage points)

Source: Bank of America Merrill Lynch, Haver Analytics, Gluskin Sheff
Need Investor Income Streams Financed Out of Rising Revenues

- Energy pipelines
- Commercial real estate in growth areas
- Could be from health care
- Could be from:
  - Financials
  - Cable/Media
  - Oil and Gas
  - Road and Rail
  - Health Care and Bio Tech
  - Tech
In Summary

- We are midway in a cyclical recovery when resources get scarce and expensive
- Growth has already been priced into equities
- Fixed income becomes vulnerable to more inflation
- Opportunities in dividend paying top-line growth industries
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