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"It's the Economy, Stupid"

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A quote from a past presidential campaign provides an answer to bull market deniers who question the validity of the current market's optimism. That's not to say that the skeptics don't have their point: this past quarter has provided enough troubling news to satisfy the most pessimistic doomsday prophets. The litany of ills reads like a biblical description of the end of days: hurricanes, floods, rolling balls of fire ants, violent mobs attacking statues and each other, governments too dysfunctional to confront looming crises and world rulers threatening nuclear Armageddon. Nevertheless, the world economy and its markets have chosen to ignore these troubling signs -- some might say bury their heads -- and to focus instead on the positive signs appearing in financial statistics. History is full of prophesies of doom that never materialize and economic booms that thrive against backdrops of fear and existential angst: the era of the Cold War, which from 1950 to 1989 held the world in constant fear of nuclear annihilation, was witness to unprecedented economic growth and multiple bull markets. Although the first correct prophecy of the end of the world will have a profound effect on the economy and markets, until that happens or until the financial news turns negative, we can expect a continued disconnect between what is reported on the front page and what is reported in the financial section.

And the reports from the financial pages remain significantly promising. U.S. GDP for the second quarter of 2017 registered 3.1%, the highest rate since the first quarter of 2015. Although GDP has probably taken a hit in the third quarter due to disruptions from hurricanes in Houston and Florida, these negatives will likely reverse in the fourth quarter as infrastructure and home rebuilding moves into full swing. And although it's not included directly in the calculation of U.S. GDP, the hurricane that devastated Puerto Rico will generate similar negative and then positive results. It is, after all, an ill wind that blows no good. The unemployment rate has likely hit bottom at near 4% -- probably a full employment level -- while gains in employment continue at a strong or at least moderate pace of between 150,000 to 200,000 a month. Consumer confidence remains robust due to low unemployment and increasing home and stock prices. Corporate profit growth, which finally began appearing after the third quarter of 2016, continues to show progress. As a result of improving profitability, capital expenditures (key to productivity growth, low inflation and increasing real standards of living) have also returned to an upward slope after a slowdown in the 2014-2016 periods. All in all, the economic data describes an economy that is somewhere near the halfway point in its cycle. And the element of the economy, which for the last fifty years has marked the beginning of the end of almost every economic cycle, inflation, is virtually nonexistent.

In highly simplified terms, inflation is caused by a sustained mismatch between the demand and supply for goods and services. Low inflation is normal in a healthy and balanced economy where demand increases only slightly faster than supply. High inflation is evidence of an unhealthy and unbalanced economy where rapidly increasing wealth and low barriers for borrowing cause the demand for goods and services to outpace supply, leading to ever increasing prices for temporarily limited supplies. Once inflation reaches a high enough level --

when the prices for goods and services have finally surpassed the willingness of consumers to pay and inventories swell to unsustainable levels -- businesses begin reducing employment numbers, cutting expenditures and selling off inventories at fire sale prices; suddenly the wolf is at the door. The usual breeding ground for high inflation is an economy in the late stages of expansion with low unemployment, low productivity growth and low borrowing costs; in other words, an environment not unlike the current situation. The great mystery about the current situation among economists is why inflation is still at a very low level (below 2%). In particular, it is a question for the Federal Reserve which is charged by Congress to maintain the proper balance between full employment and stable prices.

There are multiple possible explanations for the absence of inflation at this stage in the economic cycle. It's possible that productivity growth has been much stronger than the official statistics indicate: in this argument, the fault lies in the inability of existing measurements to quantify the productivity improvements generated by the universal proliferation of powerful and portable computers (smart phones). It's possible that the increasing viability of emerging markets have dramatically altered the timing of inflationary pressures: cheap labor, plentiful raw materials and advanced manufacturing processes in what used to be called the third world may have extended the length of economic cycles in the developed world. It's possible that the increasing availability of oil, due to new production technologies, acts as a damper on production costs and pushes back the timing of cost push inflation. It's possible that all or none of these factors are responsible for the delay of inflation; perhaps historians will someday laugh that we were unable to see the true causes that were right in front of us. But whatever the reason for inflation's delay, the delay is surely temporary: despite technology and emerging markets, inflation is not an obsolete term. And indeed, there are signs in September that inflation may be moving above its recent range (between 1.5% and 2%). This will surely provide comfort to the Federal Reserve and allow it to resume its incremental approach towards higher short term interest rates. The consensus expectation is that the Fed will lift the overnight rate by .25% to 1.5% before the end of 2017 with three more increases in 2018.

The markets continue to reflect the optimism of the financial pages. The S&P 500, despite the disasters of September, was up 1.9% for the month, 4% for the quarter and 12.5% so far for 2017. Underpinning the market's rise -- and its future gains -- are three expectations: continued growth in corporate earnings per share, continued moderation by the Fed in its lifting of rates and success in the passage of a pro-growth tax reform package by Congress. The odds of this last item occurring, given the dysfunction in Washington, seem low and, for that reason, a disappointment here may not be enough to derail market appreciation. On the other hand, if tax reform does actually materialize, the positive effects could be enormous. We'll see. Barring the end of days, 2017 has the possibility of ending up as a very satisfactory year.

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