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Coming upon final act of interest-rate saga

Interest-rate predictions

Where will the 10-year Treasury be in three years? Will it be closer to 2 percent or 5 percent? I'm now wrestling with this question because the fiscal drag on the economy from the sequester will gradually fade over the coming months. The U.S. Federal Reserve's tapering talk suggests it sees stronger growth ahead and there have been signs of economic stabilization in Europe and China. We could be close to moving on from the 2008 crisis, in which case interest rates should normalize. Or it could be another false dawn with growth disappointing and rates rolling over again. There are legions of smart prognosticators on both sides of this argument. I wish I could point to something definitive. I can't. I've tried to dress up my lack of conviction for those of you who wish to continue reading.

Historically speaking, financial crises typically take many years to overcome so our experience so far is fairly normal. A housing collapse and associated deleveraging leaves a bloody mess but until very recently it appeared that housing and the auto industry were recovering. I hedged in that last sentence because the recent sharp back-up in mortgage rates is having some negative effects on housing. Only time will tell how much, but we've certainly had robust housing markets with rates much higher than they are today. I should point out that mortgage-lending standards are tighter today, which is something of a drag relative to previous cycles.

Complicating matters, there is credible academic research pointing to a permanent impairment of growth when government debt levels approach 100 percent of gross domestic product (GDP). We and much of Europe are there with little prospect of dialing it back. One can fantasize about fiscal discipline but the deficit is structural. Conservatives have no interest in raising taxes to fully fund entitlement promises and the majority of voters want their Social Security, Medicare, Medicaid and the rest. In fact, you can think of the deficit as a giant transfer payment to the less-privileged. Cutting it off could be inhumane and dangerous. Unfortunately, this type

of deficit spending provides little economic benefit because it's largely consumed and does not go into productive assets. That completely crowds out other discretionary spending options that could have higher economic utility. Most mature economies face this dilemma. If high debt levels are an absolute governor on economic growth, then we'll be stuck with low rates.

There are also negative consequences for having short rates pegged at zero. It severely penalizes savers, suggests persistent economic weakness and encourages the replacement of human capital (artificially depressing financing costs). Very low interest rates may also be self-reinforcing for reasons that are not well understood. Japan's experience may or may not be relevant. They've suffered decades of very low growth, incurred government debt in excess of 200 percent of their GDP and have a huge structural deficit and yet their borrowing costs remain extremely low at 0.7 percent for the 10-year.

My hope is that sometime later this year or early next it becomes obvious that the U.S. economy can grow in excess of 3 percent. If that fails to materialize, we could be looking at a much longer period of low growth and rates. To put some dates to this, we should know the fate of the economy by the time we know the winner of the Super Bowl.

Stock-market foolishness

The stock market appears to favor economic weakness and quantitative easing to robust growth. That made some sense while corporate profits and valuations were depressed but that is no longer the case. If economic growth stalls, profits will remain stalled and the market will cease going up. It may not go down much but big gains from here will require a normalized economy: stronger, sustained economic growth, hiring and higher interest rates.

Thank you for taking the time to read this month's Market Perspective. I hope you found it helpful.

Strategic Return Portfolio	
Equities	63%
Bonds	7%
Gold	2%
Cash	28%
Total	100%

as of Aug. 30, 2013