CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Slow Growth around the World

Global economies are suffer from weak demand. It is not at all clear what will bring about revival of demand and economic growth.

The deflationary effects of falling prices for oil and other commodities is a further drag on economies.

Economic news has improved since our early October letter, especially in the very robust employment report that showed remarkable job growth in October and revised upwards the earlier-reported job gains in August and September. This report seems to have convinced the Federal Reserve Board that the US economy is sufficiently strong so that the Fed may begin to raise short-term interest rates. Since the financial crisis of 2007 to 2009, short-term rates have stood essentially at zero. The present expectation is that the process of 'normalizing' interest rates will be very gradual; it may be two years before rates rise even to two percent.

Indeed, because of the deflationary pressures and very slow economic growth around the world, the risks to economies remain. A dreary process has unfolded for the last few years in which expectations for economic growth have been marked down each time a new quarterly projection is released. For example, Japan, which, since 2012, has employed the aggressive monetary and fiscal policies among all developed countries in its effort to restore economic growth and put an end to deflation there, has just reported its second quarter of economic contraction. Thus, Japan is once again in recession. The European Union, for most of the last four years obsessed with its debt crises in several countries, has insisted upon fiscal austerity as the remedy for its problems. Stagnant growth and high unemployment have been the result. Only in the last year has the European Central Bank belatedly commenced its bond purchasing schemes (referred to as 'quantitative easing'). The result is that Europe has slipped back and forth between recession and modest growth, while its unemployment has remained very high. For 2015, Europe's overall growth may be 1.5%, while its unemployment remains above 10%--and well above 20% in Spain and Greece.

The huge decline in commodities prices over the last eighteen months both <u>reflects</u> the slowing demand for goods around the world and, because it inhibits growth in resource-rich countries, <u>causes</u> economic weakness. In the last year, industrial commodities--iron ore, copper, and the like--have declined in price by 28%; crude oil has fallen in price by 44%. These declines cause inflation to fall further and to threaten a deflationary world in which overall prices fall. Deflation causes people to hold off on purchases, in the expectation that, if they wait, the price of the item sought to be purchased will be lower in the future than it is now. Thus deflation causes economic growth to contract. Moreover, the experience in Japan over the last twenty five years shows how difficult it is to end deflation. Policy makers, especially central bankers, are very anxious to prevent deflation and to bring inflation back to a safer level, generally seen to be about two percent.

By

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Stock markets have largely recovered from the sharp selling in August.

Central bankers and policy makers in the major countries face a difficult dilemma, how to foster economic growth in the global environment characterized by weak demand and deflationary pressures. Although the Fed is anxious to raise rates from the zero level, its members are mindful of the several risks that presents to the US economy. If the Fed is raising rates while the other major central banks of Europe and Japan are still engaged in extraordinary policies of quantitative easing, the risk is that the value of the US dollar will rise further against other foreign currencies. In the last year, in anticipation of this, the dollar has already risen sharply.

A stronger dollar can have two bad effects: it raises the cost of goods that America produce for export, since it will take more Euros or Yen to buy the US dol--denominated goods. This will necessarily restrain US exports, hence weakening the US economy. Perhaps more worrisome is the effect that the rising dollar may have in the developing countries, by drawing capital from those countries back to America, making it harder for those economies to service their debt and sustain their economies. Concern about this is widespread among the international agencies like the International Monetary Fund (the IMF) and the World Bank, as well as central bankers in the developing economies and finance ministers around the world. The Asian currency crisis that began in 1997 caused long-term damage to many countries and their people and, at its worst--when Russia defaulted on its Soviet-era debt--it gave rise to a short-lived but quite deep sell off in equity markets around the world.

Investment markets. After the sharp and sudden global stock market selling in August, markets have recovered a good deal of ground. The US stock market has come back to within one percent of its high set last May. Perhaps the mood is exemplified best by the action in stock markets in the week after the Paris terrorist attacks of November 13. The US market rose by more than three percent; other developed markets were not far behind.

It is hard to see how the US stock market can move substantially higher in coming months, given that profits of US companies overall have stopped rising. It also seems unlikely that US stocks will see a bear market in the coming months. The fairly strong US economy is a plus and the strength in the US dollar does draw capital to the US, some of which finds its way into American stocks. The markets in Europe and Japan continue to look like favorable places to invest. While their central banks are engaged in aggressive monetary policies that stimulate their stock markets. As reported, since the market's high in May, we have sold some equity positions and raised some cash. It seems right to maintain the relatively conservative stance in your portfolios.

A closing comment on the rather insouciant stance of stock markets in the aftermath of the terrorist attacks in Paris and Turkey's shooting down a Russian war plane: The dreadful Paris events of a couple of weeks ago did little damage to Paris' infrastructure and its economy. Reports are that tourism has dropped off. If the number of visitors to Paris falls by a lot and for a long time, that will depress the economy of Paris to a degree. The reaction in financial markets shows little fear that the economic impact of the attacks will be large. Turkey, a member of NATO, shot down a Russian fighter plane for violating its airspace. The markets yawned, suggesting the belief that cooler heads will prevail, despite the harsh language by the presidents of Russia and Turkey. Financial markets are not wise and they are often wrong in their apparent judgments. They might, however, be characterized as dispassionate realists.

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