

**Commonsensibly it seems to me that the more finance-based and highly levered an economy is the lower and lower real yield levels must be in order to prevent a Lehman-like earthquake. If the price of money is the basis for an economy's prosperity – and it is increasingly so in developed global economies – then central banks must lower the cost of money to maintain that prosperity – and keep it low.**

Bill Gross, *Investment Outlook*, June 2014  
(Before his move from Pimco to Janus)

My older daughter, AnnaMarie, just started as a freshman at Whitman College in Walla Walla, WA. Without any prompting from her proud father, she enrolled in Introduction to Macroeconomics as one of her fall courses. In her first few weeks of class, they focused on some of the basic building blocks of economic study: land, labor and capital; the relationship of supply and demand in a market economy; and the components of gross domestic product (GDP). Then, as my daughter enthusiastically related to me (and to her professor's great credit), they took a sharp turn out of the sterile academic world and drove right into the chaotic intersection of economics and humanity. Through a case study on the black market kidney trade, the students explored the elements of needs, wants, laws, regulations, exploitation, altruism, science and morality through an economic lens. I would love to be sitting in class with them, trying to unravel the economic puzzles and hearing some fresh perspectives – although my daughter would probably prefer that I do not participate.

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It looks to me like the Eurozone's future is once again at high risk (the Eurozone is a chaotic intersection of 18 European countries committed to the Euro as their common currency). When you start with a world of no or low growth, high and growing debt and general disinflation, and add to that the complications of managing a never ending process of unification, it is not surprising that the Eurozone is struggling. While the real GDPs of the US and Japan have both recovered from the 2008-2009 financial crisis to levels above their respective 2007 GDPs, the Eurozone's real GDP is still below where it was in 2007. Looking at the three largest economies in the Eurozone, Germany has surpassed its 2007 GDP, with particular strength in 2010 and 2011, but it has been weakening more recently (Russia is not helping) and is now threatening to enter a new recession. France has yet to fully recover and has been struggling to grow for more than three years now. And finally, after a very shallow recovery in 2010 and 2011, Italy's economy has recently sunk to a level last seen in 2000 (that is a Depression with a capital "D"). For France and Italy (and Spain and Greece and Ireland, etc.), it is likely that many of their citizens and politicians are thinking about whether they would have had a more robust recovery if they had stayed out of the Eurozone and kept their own currencies and monetary policies. With a new round of economic weakness, it is easy to see how it could become politically popular to leave the Eurozone.

All of the elements of the developed world's economic malaise cannot be fully addressed by monetary policy and competitive currency devaluations. While those type of actions can certainly buy some time, they do nothing to specifically address aging demographics and the growing weight of our social

safety nets. They do nothing to specifically address the economic disruptions of advancing technology on employment. They do nothing to enact pragmatic tax reforms or immigration policies. Lower interest rates certainly enable governments to support more debt, but they don't require that the new debt be used to make investments in our future – in infrastructure, in education or job training. To address our real structural issues it is not only going to take time, it is going to take a long-term perspective and perseverance. And it is going to take real change, not just talking about change and not just political posturing. It is also going to take economic growth. When France and Italy, et al, consider their options, I hope they also consider that all of the political will needed to change could be directed to addressing their own internal structural issues as well as those of the Eurozone. The political skeptic in me thinks that it will likely take a new crisis to inspire real change. The world citizen in me hopes that the change will be in a positive direction.

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October marks the end of the Federal Reserve's (Fed's) latest quantitative easing program (QE3) – please! The combined bond purchase programs have facilitated the Fed injecting over \$3.5 trillion into our economy. The original objective was to help provide liquidity to the mortgage market, and then it morphed into suppressing interest rates along the yield curve to support mortgage and other debt refinancing as well as to encourage additional borrowings – all to help stimulate aggregate demand. Additionally, the Fed used the programs as a signal to the financial markets that it would do whatever it takes to support our economy and encourage investors to take more risk and to help produce additional aggregate demand through a stock market wealth effect. While it is hard to know what the costs and benefits of the QE programs have been and will be, all else being equal I believe that the absence of quantitative easing will lead to higher levels of volatility in the financial markets – which I view as a positive. A lack of volatility over time leads to a complacency relative to the inherent risks of financial markets, a mispricing of assets and poor capital allocation decisions. In the end, volatility promotes discipline and creates the opportunities to earn more than risk free returns.

As I write this on October 14<sup>th</sup>, it looks like the end of QE3 and weakening in Europe have already contributed to some increase in the stock market's volatility. Since the beginning of September, the S&P 500 has dropped 6% and small capitalization stocks have dropped 10%. The energy sector has been the biggest loser with a 19% drop over that time, as oil prices fell in reaction to global slowdown fears and a plentiful supply. I don't see the global economy falling off the edge any time soon, but it is important to note that a good portion of US business earnings come from Europe and the rest of the world. Internally, the US economy continues to show signs of economic strength in both manufacturing and services, and bank loan growth has finally started to accelerate. If we can maintain that momentum, we might provide the Federal Reserve the window that it needs to take its next step back to "normalization" and raise our short-term interest rates above 0%. (I know I will be celebrating if we can get there!) No matter what happens, future macroeconomics classes are going to have one amazing case study to dissect.

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John McCorvie, CFA