Economic Update

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Forgetful

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Since writing our last update, two major events have had a large impact on the near term economic outlook or, at the very least, the psyche of those who are paid to debate it. The ongoing political unrest in the Middle East and the Japanese disaster lie outside the realm of normal economic analysis - “exogenous” events as economists like to call them – and as a result, usher in a different flavor of uncertainty than most investors are accustomed to or can at least recall.

I met the first practicing economist of my career during my job as a credit analyst at PNC Bank in Pittsburgh twenty years ago. Stuart Hoffman, an economist who continues in this role today, would visit our department on a monthly basis to provide an update on the economic outlook.

Normally, the update would be a routine event, but with the Gulf War just underway, discussing such topics as GDP growth and inflation seemed insensitive and out of touch considering the potential loss of life to our servicemen and the prospects for the first military draft since Vietnam. At the same time, as a young guy on a fixed budget and a girlfriend two hours away, I had personally felt the economics of uncertainty in the surge of gas prices to $1.54 from $1.12 per gallon. I was interested in learning more.

I guess you could say that this was the first time I experienced the other side of the discipline, where economics was no longer just an art form whose laws were subject to considerable debate, but also a science where the case studies and subjects were real life patients facing the diseases of actual unemployment, inflation and war.

Today, as then, it feels odd to be discussing subjects as mundane as the economy and investment strategy in the face of the real disasters faced by those in Japan and the Middle East, but at times, I’ve learned that economics can be that way. In discussing and reviewing our outlook, I don’t mean to minimize the loss of human life to recent events. My prayers are with those facing hard times.

Having said all of this, what do I make of the recent events and their likely impact on the economy and stock market?

They are not unprecedented.

In fact, I am amazed by just how forgetful we can become.

As bad as it feels today, ten months ago, we had similar versions of unrest in Greece that eventually spread throughout Europe and an energy related disaster in the Gulf that exacted a heavy toll on wildlife and jobs in the region. Leading indicators of the economy, which had been increasing off the Great Recession lows, started to tick down as uncertainty surrounding the events likely trickled their way into the ordering patterns of purchasing managers in corporate America.

The S&P 500 fell by roughly 16% from April to July last summer, and then moved sideways until people started to discount the prospects of the Fed engaging in QE2. As the markets picked back up following the recognition that the Fed would stay easy given high unemployment and very little inflation and the elections afforded a more balanced political agenda, leading economic indicators began to follow suit, the economy firmed once again, and the stock market finished up 15% for the year. Who'd have thunk it?

Today, the situation, while different, nevertheless rhymes. Political unrest that started in Egypt has spread to other African nations and the earthquake and tsunami in Japan have led to a brewing energy related, nuclear disaster. The stock market has fallen about 6% from its highs, but has been pretty resilient all things considered. Leading economic indicators coming out today and in recent weeks have continued to move in a positive fashion and are now, for the most part, in record territory.

While I wouldn't be surprised to see leading indicators pull back a bit in coming months and for the markets to correct further given the events of recent weeks, I would also bet that a year from now, the economy and stock markets will be in better shape than they are today. Today's events likely imply that the Fed will stay on hold even longer, giving the economic recovery even more time to become self-sustaining, provided that unemployment remains above and inflation below ideal levels. My guess is that a year from now, we won't be talking about Egypt or Japan, but that doesn't mean tomorrow won't have worries of its own.

Finally, I would point out that a crisis rarely goes to waste. While a large part of Japan has been destroyed by the earthquake and tsunami, the situation was much worse following World War II. At the end of the war, we know that the allies came in and rebuilt the country's infrastructure from the ground up, using state of the art technology at the time, some of which was likely better than our own. This new infrastructure likely played an instrumental role in enabling Japan to emerge from the war as a productivity leader in the automobile industry, giving our own car makers a real run for their money, and eventually establishing the Japanese economy as the second largest in the world.

Unlike fiscal infrastructure projects which sometimes end up building roads and bridges to nowhere, Japan, faced with real losses, will not only build entirely new Greenfield infrastructure projects, but do so in ways that may make the most economic sense for everyone involved based on underlying economic demand rather than simply the desire to provide jobs. Japan has been in a relative economic funk for almost two decades now, with deflationary pressures, high rates of saving and declining birth rates. The current difficulties could end up marking a turning point for the country as they finally begin to spend, and through that, grow once again.

As for the unrest in the Middle East, would it really be a bad thing in the long run if the long standing monarchs, dictators and theocrats in the area were replaced by more democratic forms of government, where the creativity of those populations can more fully be recognized? As much as the Middle East seems to hate the United States, what do they really want in the end? Likely, greater freedoms. While there is always the risk that one dictatorship is replaced by another, the crisis, once again, represents an opportunity for positive change.

As I pointed out in the last update, I think the coming decade could be a surprisingly good one for the United States and particularly our industrial complex, and not simply because we may be the best house in a bad neighborhood. I still believe that our economy is the most competitive in the world and that because of that competition, both economically and politically, our institutions and businesses are continually challenged to adapt and change with the times, or die, even in the absence of clear cut crises like those experienced in the last couple of years.

I'm not yet willing to throw in the towel on my more bullish thesis for the U.S. and world economies at this stage of the game. And while I may be a complete Pollyanna for saying so, the crisis may actually end up doing more to help the prospects for personal freedom, global innovation, and worldwide living standards than hurt it, albeit not without painful human sacrifice for which I am sad.

Kindest Regards,

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Happy St. Patrick's Day!