

# Quiet Counsel

Winter 2017  
Investment Outlook



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INVESTMENT COUNSEL LTD.

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## The Reality Show Meets Reality

### The reality show

Staying grounded to economic realities was a core theme during a presentation we recently made to the Canadian Benefits & Pension Institute. Although this follow-up note is primarily focused on the U.S. economy, there's still considerable crossover to our Canadian outlook.

It's certainly been difficult to ignore the torrent of news from U.S. politics as it flows into the economy and financial markets. The last few months have created a **reality TV show** atmosphere, with dramatic emphasis on big personalities, bold promises and 'alternative facts'. The dominant narratives concerning economic growth have also changed. But investors should ask: **are these new forces really capable of altering structural trends in the global economy?**

### Meets reality

We continue to believe that certain trends - slower labour force growth, slower productivity growth and subdued inflationary pressures - are structural in nature:



The Great Recession of 2008 simply highlighted these forces, which have been unfolding over several years. However, as we look forward to 2017, understanding how these realities will continue to constrain economic growth is critical for managing your investments.



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### Unprecedented really means there's no precedent

The actions taken by global central banks since 2008 are unprecedented. And when there's no precedent for what's been done, there's also no historical playbook for what should follow. Phrases like **normalization, returning to normal and the new normal** all implicitly assume that you can forecast where an economy is going if it's been there before. Currently, this premise is unrealistic, if not deceiving.

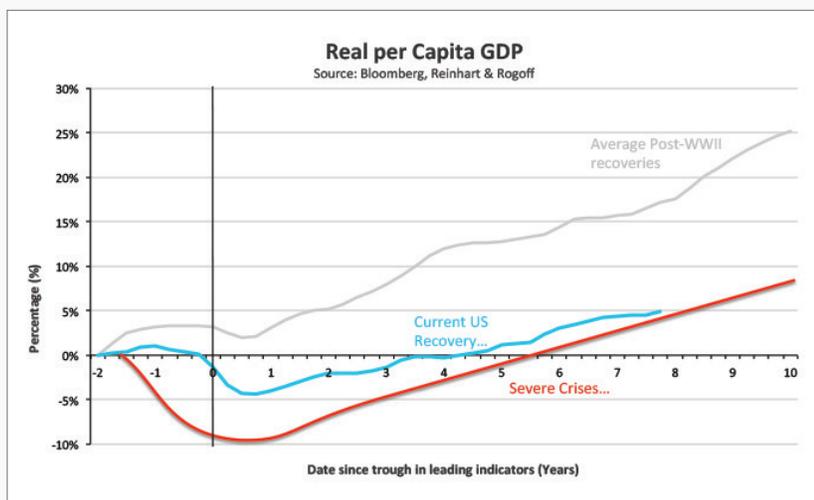
The shock treatments that central banks have applied since 2008 - exploding their balance sheets with debt purchases and pursuing negative interest rates - probably avoided a global depression. But what if these monetary actions continue to play a role in **restraining** economic growth?

## Driving slower, by default

A helpful analogy: if a car is stripped of safety features like air bags and seatbelts, drivers are more likely to slow down and proceed cautiously. In the same vein, consumers, businesses and governments know that central banks cannot respond with the same firepower if another crisis erupts.

With approximately ¼ of assets in global government bond indices now offering **negative yields**, rising interest rates now come with unknown and unintended consequences. In theory, rates should rise because growth is accelerating. In reality, current radical monetary policies are untested theories.

Still, we continue to monitor empirical research<sup>1</sup> on economies that have been hit by a recession and banking crisis at the same time. This analysis suggests that an extended period of slower economic growth, decidedly below prior trendlines, is what follows. With that in mind, we believe the U.S. economy is still tracking a sustainable path after the 2008 financial crisis:



## Choosing not to participate

While U.S. unemployment rates have returned to pre-2008 levels, there's a missing piece to this puzzle that confuses many investors. With all these people back at work, why is economic growth not responding like it did during previous cycles?

Part of the explanation lies with the fact that there are less people in the overall workforce. This reality shows up in what economists refer to as the **labor force participation rate**. We think one data point in this survey is particularly striking:

**The share of men and women age 25 to 54 in the workforce reached a three-decade low in late 2015.**

1: This Time is Different - Eight Centuries of Financial Folly, by Carmen Reinhart and Kenneth Rogoff, 2011

2: Nine Things to Consider About U.S. Manufacturing Jobs, The Brookings Institution, January 12, 2017

3: Contracted - The End of Employees, The Wall Street Journal, February 2, 2017

Demographics play some role in this trend. As baby boomers get closer to retirement age, work can seem less appealing. With home prices and savings recovering from the Great Recession, and early pensions (or severances) beckoning, the math for working longer has changed.

## Making more stuff, with less people, at lower wages

Total output from U.S. manufacturing increased more than 250% from 1980 to 2015 **but the manufacturing workforce decreased by roughly 40%**, based on analysis from the Brookings Institution<sup>2</sup>.

The U.S. Bureau of Labor Statistics estimates that average wages for 'production and non-supervisory employees in manufacturing' **are now lower than they were in 1985**, after adjusting for inflation.

The popular / populist reasons for losing these jobs and wages are usually targeted at globalization and free trade with developing, lower wage countries. Emotional and localized arguments are difficult to counter. But empirical and unbiased studies have proven that the clear majority of these jobs would have been lost to automation even as global trade expanded.

## It's not my gig

It's also been suggested (in frustrated tones) that American companies **have never tried harder to employ fewer workers** in traditional, full-time jobs that come with salaries, benefits and some structure.

According to staffing firms cited in a recent **Wall Street Journal** report<sup>3</sup>,

it's estimated that somewhere between 20% and 50% of all people working at large corporations are outsourced contractors and not actually employees. At Google's parent company Alphabet, for example, temporary workers, vendors and contractors represent approximately half of their total workforce.

Often referred to as the **gig economy**, these kinds of arrangements favor younger, more flexible workers with specialized skills; or those workers who don't want, or can't get, permanent employment that comes with benefits and some semblance of security.

Whether older or less qualified workers are opting out of working or being pushed out is debatable. What's clear, however, is that non-workers spend less and produce less while asking more from their savings and governments (like healthcare).

### **It all flows into lower productivity growth**

Automation. Global trade. Outsourcing. An aging population. No matter how you arrange (or deny) these variables, the calculus continues to produce a similar outcome that is unlikely to change except at the margin. Services will also continue to expand their share of U.S. economic activity relative to manufacturing, albeit at slower pace. Unfortunately, average productivity growth in the service sector is inherently weaker, averaging 1.0% per year since 1987 vs. 2.7% per year in manufacturing. **This drag on GDP growth is extremely difficult to legislate away.**

### **You can't ignore Black Swans**

Most investors are familiar with the expression **Black Swans** as a way of explaining shocking events like terrorist attacks, bank failures or geopolitical crises. Black Swans are almost always seen as negative events for investors. Since 2008, anticipating and explaining 'bad' Black Swans has become a cottage industry, with a generous supply of events filling the analytical pipeline: Brexit, Grexit, Eurozone malaise, Russian misadventures, high oil prices, collapsing oil prices, Ebola, inflation, deflation, U.S. government shutdowns, Obamacare, Chinese debt, President Trump, etc.

### **This list is not exhaustive, by the way, but it is exhausting to read.**

Since the Great Recession, pronounced levels of fear and uncertainty in the global economy have rarely been in remission before a new crisis emerged or an old one returned. Given this context, it's not surprising that exuberance can overwhelm experience when a positive Black Swan appears. Enter President Trump and his promises of massive tax cuts, huge infrastructure spending, on-shoring of manufacturing jobs, deregulation – it's all possible with a stroke of a pen, right?

### **You can't ignore Black Elephants**

**Black Elephants** are persistent, long-term, structural issues impacting an economy that sometimes investors and politicians try to ignore or explain away by blaming things like regulations (e.g., Obamacare) and globalization. A primary goal of this note is to remind investors about Black Elephants facing the

global economy – primarily aging populations, shrinking manufacturing jobs and declining productivity growth – that were structural headwinds before the Great Recession. Short-term, cyclical deviations in these trends are possible. But tax cuts and huge infrastructure spending cannot fundamentally alter the long-term growth rate in the world's largest economy.

### **Do something!**

During the early days of his first term, when the U.S. economy was still bleeding jobs, President Obama said there is no such thing as 'shovel-ready', meaning that his desire for massive fiscal stimulus via spending on roads, bridges and airports still needed to wind through a bureaucratic process of local approvals. After all, the U.S. wasn't China, even though he controlled both Houses of Congress.

President Trump will also learn that he doesn't control the budget process, the dollar or the bond market's reaction to everything.

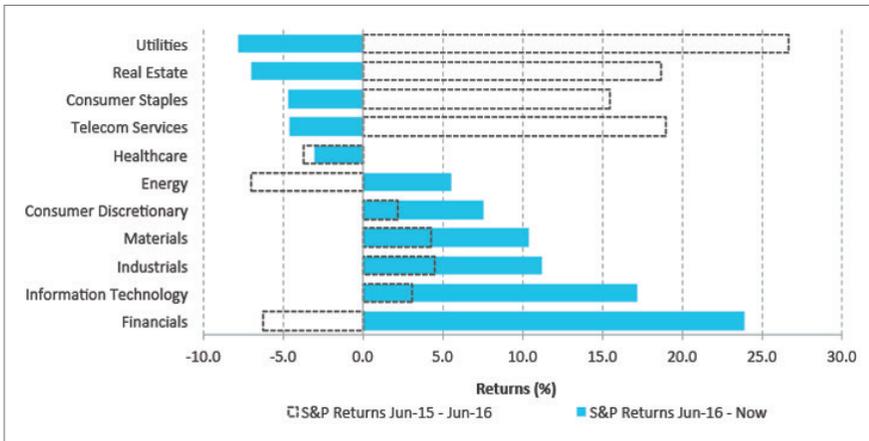
### **Reality will bite.**

### **Equities outlook**

Primarily because of the structural pressures we've discussed, we're anticipating slower earnings growth combined with some downward adjustment to current valuation multiples. As such, we believe that Canadian and global equities are fairly valued at this point.

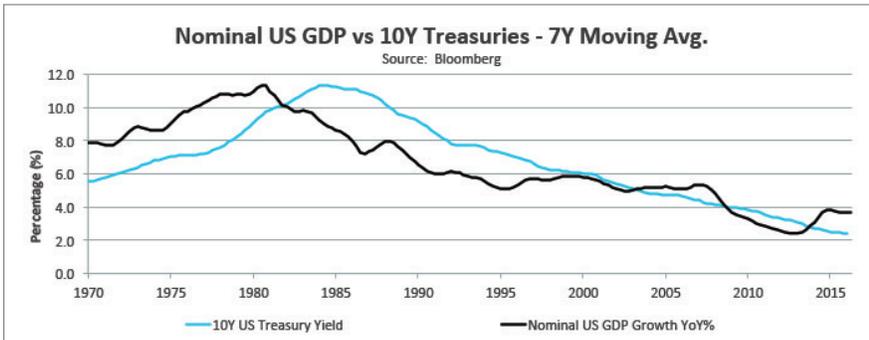
However, active management and a value-driven process can still exploit opportunities when narratives shift and economic realities reassert themselves. Sector returns from before and after the U.S. election are a case in point,

as defensive / yield-driven stocks (which were benefiting from a slow growth narrative) were eclipsed by surging growth / cyclical stocks:



### Fixed income outlook

Long-term returns in fixed income are significantly impacted by the starting point of 10-year yields, which is approximately 2.5% in the U.S. and 1.7% in Canada. These yields are tethered to current expectations about nominal GDP growth. And for reasons discussed in this note, we believe that this link between slower growth in trend GDP and forward returns in fixed income will remain intact:



### Final thoughts

We recognize that forecasting during unprecedented times is, as we said before, difficult. This reminds us of a story told by Nobel Laureate economist Kenneth Arrow. During World War II, Arrow produced long-range weather forecasts. When he told his commander that the forecasts were basically useless, the officer replied with jarring candor: "the General is well-aware that the forecasts are useless but he still needs them for planning purposes."

Our lesson from this cryptic quote is that we should continue to prepare and plan for certain scenarios, in 2017 and beyond - but always with humility and an open, curious mindset.

This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

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