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ALTERNATING CURRENTS: A BALANCING ACT

The news about the world's economies continues to vacillate: faster growth, slower growth — the situation seems to change daily. In the United States, the reason for this is the slower speed of the economy compared with other periods. We are not struggling at "stall speed," but we are not in a robust expansion either. The result is a constant flow of mixed messages — good news, then bad news, then more good news, overall balancing each other out to create a growth rate of around 2%. But is that bad news or good news?

This past spring, the manufacturing sector showed a disturbing slowing trend. But that current reversed direction in June, as manufacturing indices in the US all moved forward.

In another example, new home construction gained ground steadily all spring. Then suddenly housing stocks fell and new orders dropped. The consumer cycle, though more consistent, has also shown vacillation.

Do not overreact

The first lesson is that one should not overreact to either the good news or the bad. Rather, the watchful investor needs to look at the driving trends of income from paychecks, corporate cash flow and the affordability of products, keeping these fundamental drivers in mind.

This summer, we are seeing what appears to be the same pattern of volatility in Europe. We saw weakening economic data in June, followed by news in August that the eurozone is now out of recession. In the emerging world, the news from China, for example, has been mostly bad this whole year. But now, suddenly, it has thrown up a couple of leading indicators that seem to suggest that its economy is poised to accelerate.

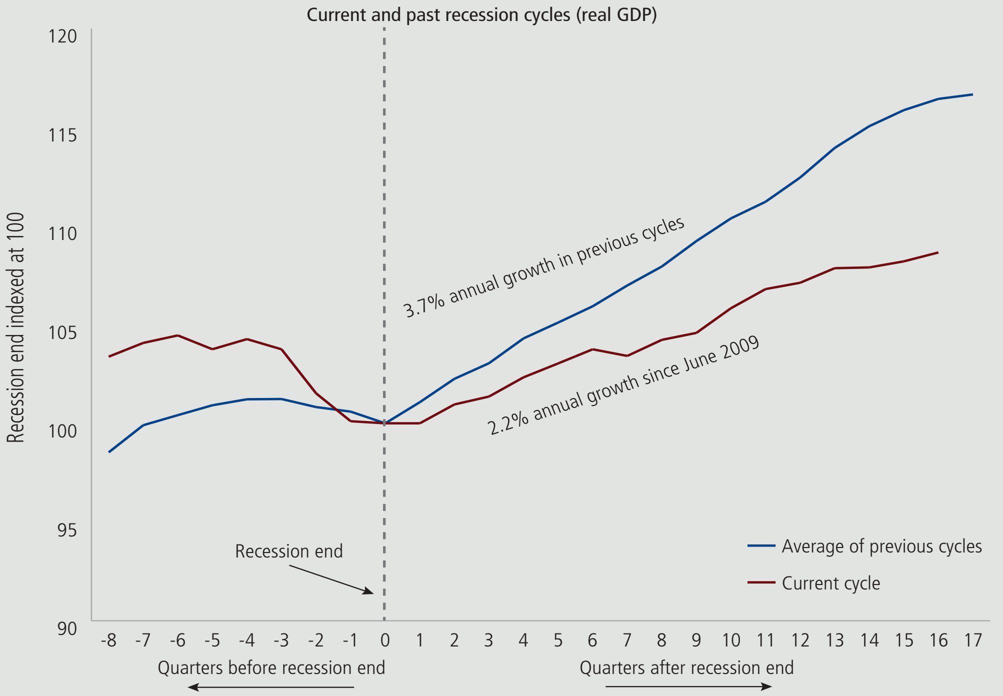
It is as if the world were operating on alternating, not direct, current. One explanation may lie in the nature of this particular business cycle, now four years old. In the United States, cycles often begin to take on a "growth fury," as growth expansions encourage rising confidence, which soon begets rising credit demands. Then, credit standards are loosened and all boats seem to rise with the incoming tide. In these historical cycles, the US real growth rate has sometimes hit 5% or 6% for individual quarters. This cycle, however, is decidedly different, with no 5% or 6 % growth in sight. It is an expansion with crosscurrents that balance each other out to create a mediocre run rate. We have seen a distinct, alternating pattern of good news, then bad news. This mixed picture may provide investors with important, positive information, rather than confusion.

A longer cycle?

A second, more important, lesson may be that this particular cycle is going to be longer, more durable and more organically sustainable. This cycle is distinctly different from the euphoric periods of recent decades. There's a noted absence of the hyper-excitement of companies borrowing to expand their businesses and consumers rushing out to spend more and more with their credit cards and home equity loans. Those cycles ended badly. If this is truly a slower, more measured economic pace — and it seems to be — then the biggest threat to stocks would be a correction, rather than an imminent recession. It may be that the next horrid recession is farther in the distance than previously thought.

Wealth effects help the economy, and we can see that consumer net worth is rising faster than consumer debt. The same is true for S&P 500 companies. A debt cycle has not yet formed. Typically, business cycles ride a wave of credit expansion, and a period of hyperactivity occurs, in which credit leads the charge. This is followed by a severe pullback, as the US Federal Reserve pulls money out of the system and raises rates, usually to halt inflationary pressures. A lot of growth in previous cycles was not organic, but driven by debt and fueled by confidence and speculation. Right now, the tepid 2% US growth rate is organic, not speculative. Further, it is not leading to bubbles that are threatening the system.

SLOWER BUT MORE SUSTAINABLE GROWTH IN CURRENT CYCLE



Average length of last 6 expansions: 17.6 quarters (4.4 years). Current expansion: 16 quarters (4 years).

Source: Ned Davis Research, data as of 6/30/13.

Outside the United States, China's growth rate is receding as its leaders try to engineer a fundamental economic change toward the Chinese consumer while trying to rein in a borrowing binge that has created excesses that have not yet been worked off. In Europe, growth seems to have resumed after the second of two recessions in five years. Predictors for Euro growth see better times coming in late 2013, but a much more muted recovery seems likely, as government debt problems persist.

The US currently shows no signs of entering another recession. The country took its medicine in 2009, fixing the banks, allowing prices to reset and permitting labor costs to fall relative to foreign competition. This allowed the healing forces of low rates, population growth and an innovative business climate to take hold.

Going slow might not be a bad thing. The US economy is on a cautious Sunday drive, slowing down here, picking up speed a bit there, guardedly rounding the next bend. No decisive breakout in either economic direction seems to take hold for long. One sector seems to accelerate and offsets another sector that is slowing. All in all, the US is balancing out into a sustainable, sober rate of growth that could last for years, well beyond the length of a typical business cycle. It is this environment plus any good news from abroad that will make investors look twice at stocks and less lovingly at long-term bonds. When the cycle moves to the manic phase, this will change. And reverse. Then we can worry. For now, the alternating currents seem to be keeping things in balance.

Past performance is no guarantee of future results.

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