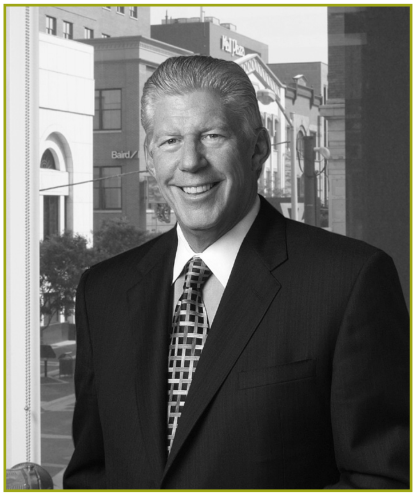
GREENLEAF TRUST

Perspectives
A Greenleaf Trust Newsletter

ORIGINALLY PUBLISHED FEBRUARY 2014



William D. Johnston
Chairman, Greenleaf Trust

Economic Commentary

The Federal Reserve's announcement that they will reduce their asset purchasing from banks to $65 billion in February as well as continue that trend throughout 2014, fully exiting the program by December, gave financial markets pause in January, which trimmed the Dow and S&P 500 by about 5%. First let's examine what the Fed is seeing that tells them 2014 is the year to end purchasing assets from banks and, secondly, let's review the market and economic implications of doing so.

Evidence of continued economic improvement is growing, though it remains far from robust. Unemployment dipped to 6.7% and the underlying data reveals some sustainability. There are 1.3 million more people working than there were a year ago and on the non-farm payroll side, that number is over 2.2 million. U-6 unemployment is now down to 13% and current private job growth trends suggest this year's unemployment rate may finish at 6%. Full recovery from an employment standpoint? No, but better than the incremental progress of the last four years and setting the stage for the possibility of mid 5% by the end of 2015. Average duration of unemployment is now 37 weeks, down a full five weeks from its high in 2012. As we know, small business optimism is key because that is where most job growth is derived from. The help wanted index and online placement of job ads rose to 5.3 million for the month, which is an increase of over 400,000 year over year. What the Fed knows is that, especially in a recovery of incremental improvement, jobs matter a lot. The trend in place should put more consumer dollars in the economy simply as a function of employment and that drives economic growth.

> "Evidence of continued economic improvement is growing, though it remains far from robust."

In every indicator across both residential and commercial construction we see positive incremental growth. To be certain, this spending of growth is geographically uneven as is the entire economic recovery. It follows that where population, income and employment growth occur so does the spending rate associated with construction. Housing values retreated in the second half of 2013 but that retreat followed a significant increase in 2012 and the first half of 2013. November's Case - Schiller housing survey of ten key markets shows a return to growth over the previous survey.

Consumer confidence for January came in at 80.7%, a full 38 points higher than January of 2012. We have offered before that consumers gain confidence not only when they are employed but when their neighbors, friends and relatives are employed as well. The growth in employment is largely responsible for this growth in confidence and when confident, consumers spend more. We don't expect to see great January economic numbers especially in auto and retail. The polar vortex winter weather hit high density population belts very hard and thus, consumers were not out in droves. As the winter weather normalizes we expect to see the return of stronger consumer purchasing results.

Production continued its incremental improvement with factory order backlog, durable as well as non-durable goods growth. The purchasing manager's index came in at 57.6% which is a significant year-over-year growth of 7.6 points. This is a leading indicator and while we would like to see this number above 60%, it is a decent distance above the near-recessionary level of 49.0%. The inventory-to-sales ratio remained constant which should mean that factory orders will be in lockstep with consumer demand. Any increase on the demand side should result in more production. Factory utilization was constant at 79.2%, revealing capacity to do more. Although we expect autos to retreat in January, industry surveys still remain confident that total production could reach 17 million units in 2014.

Personal income grew while the personal savings rate declined in the last reporting period and consumer debt increased slightly. All totaled the latest data as well as trends in place of GDP growth give the Federal Reserve the chance to ratchet down and perhaps fully dismantle the asset purchase program that has cured the balance sheet of most of our large commercial banks and kept interest rates artificially low during the fifty seven months of our economic recovery.

IMPLICATIONS FOR THE ECONOMY AND FINANCIAL MARKETS

We think the Fed has it right on the economy. We are fifty seven months into a historic recovery and the evidence of sustainability seems clear. The transition between purchasing assets from banks thereby providing them liquidity to selling bank's assets and removing levels of liquidity is gradual as well as artful and requires really good data. We also expect some market nervousness. Short-term investors have very little patience and they often act with herd-like mentality, so we should not be surprised with equity market sell-offs of five to ten percent as this transition is executed by the Fed. The balance required is clear for all to see, tighten too much on the liquidity lever and the economic engine slows, tighten too little into economic growth expansion and inflation eats at asset values. The Fed has the targets in their sight and it is now up to the leadership of Chairperson Yellen to make certain those targets are hit. We like the trends in place and the Fed's announced strategy.

Long-term investors' willingness to take risk by purchasing stocks has always been about valuations. A central or key valuation dating back to "The Prudent Investor" thesis put forth by Graham and Dodd was the relationship between risk-less yield, i.e., treasury securities and the price of stocks as measured by their yield or dividend. This ratio or relationship is often referred to as the "yield gap." Theoretically, when this yield spread or gap is low or narrow, investors are being paid well for their investment risk in owning stocks and thus, their risk is lower. Conversely, if the gap or spread is wide, investors are accepting greater risk. There is a bit more to it and many other valuations enter into risk assessment but as the Fed exits its asset purchase program, you are likely to hear more or perhaps read more about the yield gap and enhanced risk to equities if dividend rates don't keep pace with increased interest rates on treasury securities.

"… the Fed has kept interest rates artificially low and over the next year we will be returning to market driven pricing of treasuries… Transparency and balance will go a long way in calming the jittery nerves of investors."

One assumption that some investors make is that the transition the Fed is making will immediately increase fixed income yields and that bonds will be stiffer competition for stocks globally. This argument is one of extremes and falls short on the evidence. Bonds have at times been very stiff competition for equities but we are not currently in that scenario nor are we likely to be there for quite some time. Currently, the yield gap of stocks to treasuries is at 1% and even if treasury yields increased to 4% on the ten year maturity, which is currently yielding 2.84%, the yield gap would still be only 2.3%, which from a historical perspective is very low. To be certain the Fed has kept interest rates artificially low and over the next year we will be returning to market driven pricing of treasuries and those values will be driven by many factors that include domestic and global economic performance and geo-political happenings. Transparency and balance will go a long way in calming the jittery nerves of investors. Increased volatility in the transition of policy execution is possible, but in the longer term the 2014 equity market performance will have a lot more to do with the economy and the collective performance of companies increasing revenue and earnings than it does about increasing rates on the ten year Treasury bond.

As many of you know one of my favorite authors and global thinkers is Thomas Friedman, who has authored many books during the past fifteen years providing really good insight into the impact of globalization. Last week Mr. Friedman was responding to questions on a blog called the "World Post" and he said that as he was revisiting his 2004 book *The World is Flat* and realized that in 2004, "Facebook didn't exist, Twitter was still a sound a bird made, a cloud was something in the sky and 4G was a parking spot." He was referencing the rapidity of change that continues to affect all of us globally. He went on to suggest that the forces of the 21st century made the world connected and flat but what has happened in the last seven years has been at warp speed and we have gone from connected to hyper-connected and from inter-connected to interdependent; in only one decade, we have seen this fundamental nonlinear explosion of the tools to create, connect, compete and collaborate globally. There are now three to four billion people globally wired to platforms that are racing towards universal connectivity. What are the implications of going through a global recession and recovery while simultaneously going through a technical revolution? What are the implications for governance, transparency, equality, power, employment, education, and access to technology as a global right? Knowledge is power, those with it have it. What happens to average, what happens to the global, not just the US, middle class? Mr. Friedman always provides insight that makes me squirm a little. In the next issue we will tackle some of these questions and see if we get more or less comfortable as a result of doing so.

"There are now three to four billion people globally wired to platforms that are racing towards universal connectivity."