U.S. EXPANSION SAGS & LOWER SPEED LIMITS FOR THE WORLD

RECAP FROM LAST TIME

Last quarter, Goldman Sachs released commentary that suggested that if the Federal Reserve were to increase interest rates this year, stocks might take investors on a bumpy ride to nowhere. Meanwhile, Zacks Investment Research was more sanguine about the matter. Although it agreed that rising rates certainly would present a headwind to general economic activity, Zacks concluded that the Fed would begin raising interest rates only if it thought the U.S. economy was functioning well enough to sustain the insult.

I shared some data pertaining to the performance of stocks during three periods in which the Fed implemented a series of interest-rate increases. It’s worth remembering, so here’s a summary of that data, again. The Fed raised short-term borrowing rates (the “Federal Funds” rate) seven times during 1994—1995, six times during 1999—2000, and 17 times during 2004—2006. During those three rising-rate cycles, large domestic equities produced average annual returns of 6.0%, 6.5%, and 5.25%, respectively. While those returns are admittedly modest in relation to the risks associated with owning equities, I would like to reiterate that while investors definitely do not prefer rising rates, they are not necessarily ruinous.

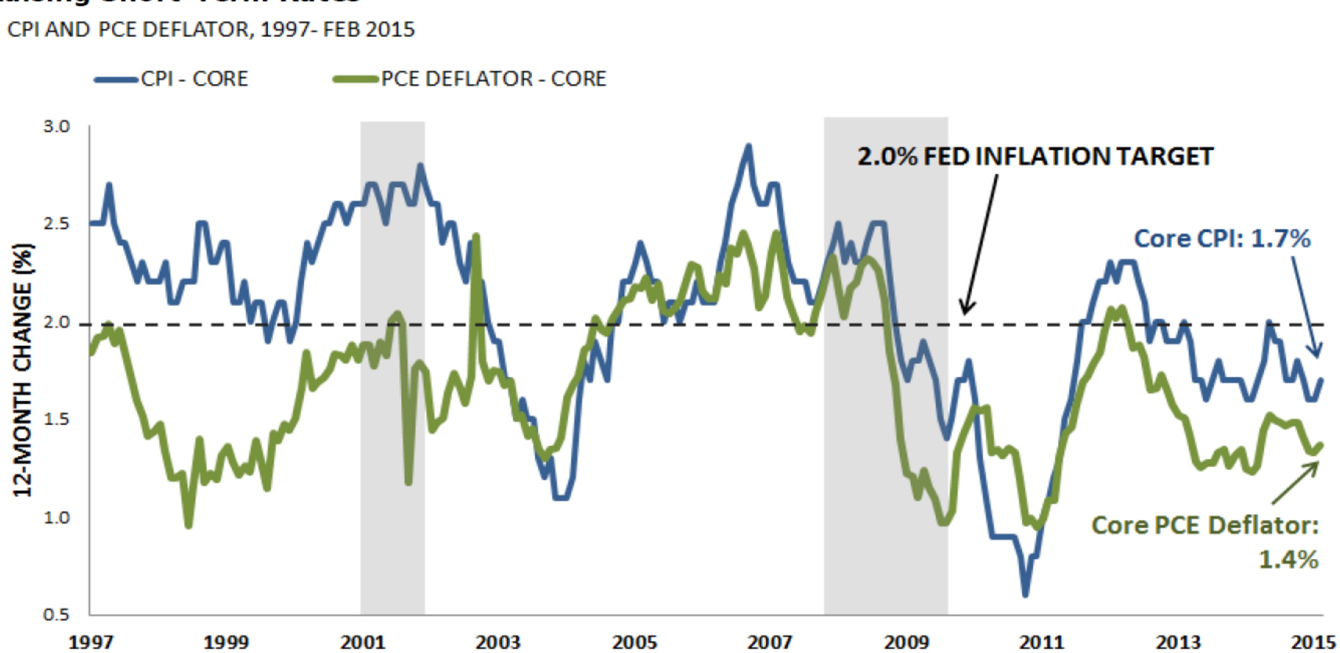
I also summarized the results of a study that spanned two decades and 21 years that showed that low-risk (high-quality) stocks produced consistently higher returns than their high-risk (low-quality) counterparts — to dispel the oft-made assumption that risk and reward necessarily go hand in hand. I was heartened to learn of this study because we have long preferred higher quality, dividend-paying equities over lower quality, growth stocks. I subsequently likened the results of this study to settling for a comfortable sedan and then being surprised to find that it’s also faster than your neighbor’s hot rod.

In support of what I characterized as an investment outlook that seemed to be at least decent, I mentioned that quarterly corporate earnings are expected to increase only modestly during 2015, maybe around 7%.

CALAMOS: ECONOMIC EXPANSION SLOWING, BUT RECESSION STILL NOT LIKELY

A recent commentary from mutual fund sponsor, Calamos Investments, concluded that although there still seems to be no hint of the next recession within the U.S., weakness in durable goods orders, personal spending, housing starts, and exports suggest that the economic expansion within the U.S. has lost some steam. And although the level of unemployment has fallen to 5.5% due to 12 consecutive months of strong job growth, a further slowing of the current expansion seems to be confirmed by the fact that those employment gains have not been accompanied by commensurate improvements in productivity or wage growth. Countering the positive impact cheap energy has on consumer purchasing power, a strong U.S. Dollar thwarting corporate earnings by reducing the competitiveness and profitability of U.S. exports. Against this backdrop, Calamos expects the Fed to take a cautious approach with respect to raising interest

Low Inflation and Sluggish Economic Growth Suggest Fed Will Remain Patient About Raising Short-Term Rates

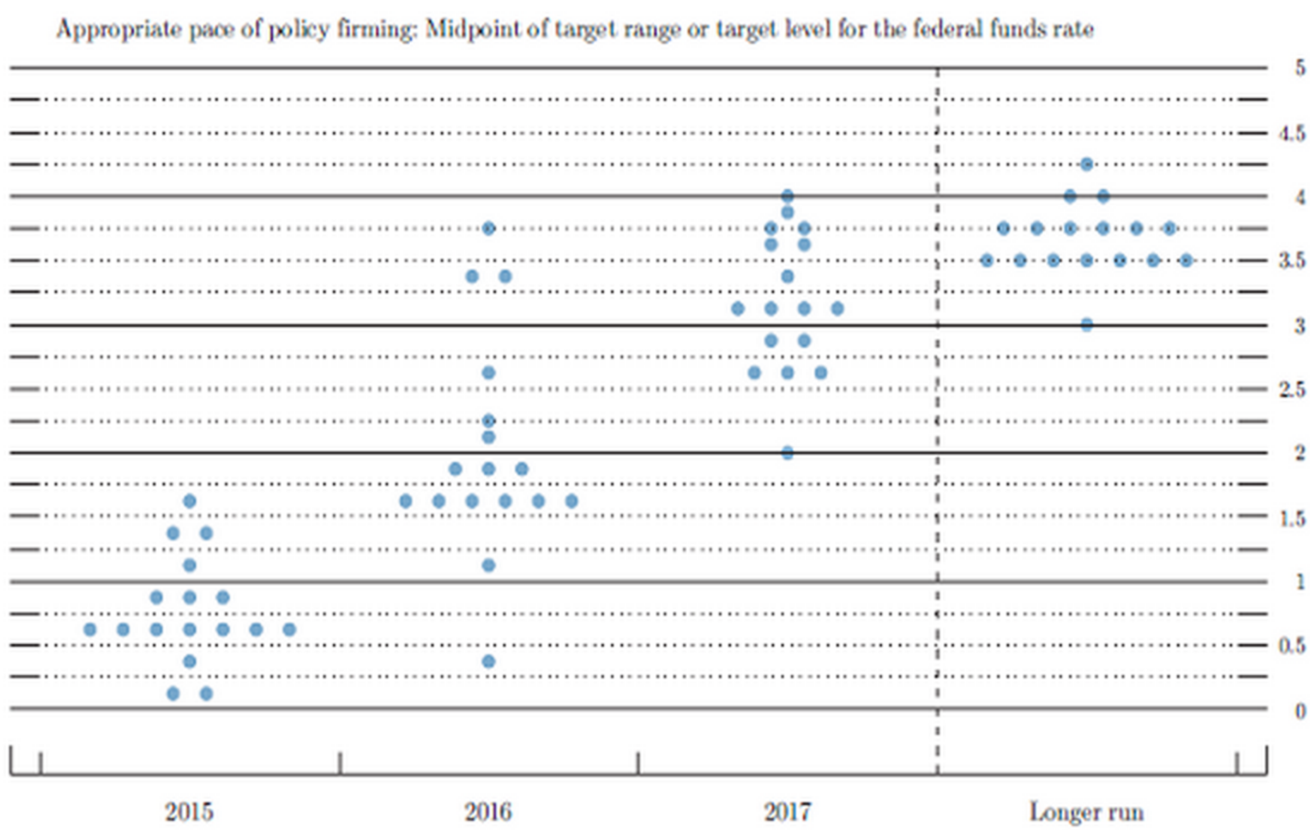


Sources: Bureau of Labor Statistics and Federal Reserve Bank of St. Louis. Recessions indicated by shaded areas.

rates, but only to the extent inflation remains muted. At 1.7%, the core Consumer Price Index is below the Fed's target of 2.0% and Fed Chair Janet Yellen's preferred inflation measure, the core Personal Consumption Expenditures Deflator, is an even lower 1.4%. Consequently, the Fed seems to have quite a bit of wiggle room to further defer any eventual rate hikes. (Refer to the graph on the previous page.)

LORD ABBETT: RATES TO RISE GRADUALLY … INVESTMENT CLIMATE STILL OK

Lord Abbett, another mutual fund complex, feels that investors have paid too much attention to when the first rate hike might occur and not enough attention to the magnitude and pace of any forthcoming hikes. In short, Lord Abbett suspects that investors may be falsely assuming that once the Fed does begin raising interest rates, it will follow some predetermined path that lacks flexibility. However, on the chance inflation does remain muted, Lord Abbett also thinks the Fed will have the flexibility to raise rates in small, palatable increments over an extended period of time. If so, Calamos and Lord Abbett think the investment climate could remain decently good.



Were such a scenario to unfold, it would imply a very gradual return to a more normal interest-rate environment while still providing a supportive backdrop for stocks and other so-called “risk” assets.

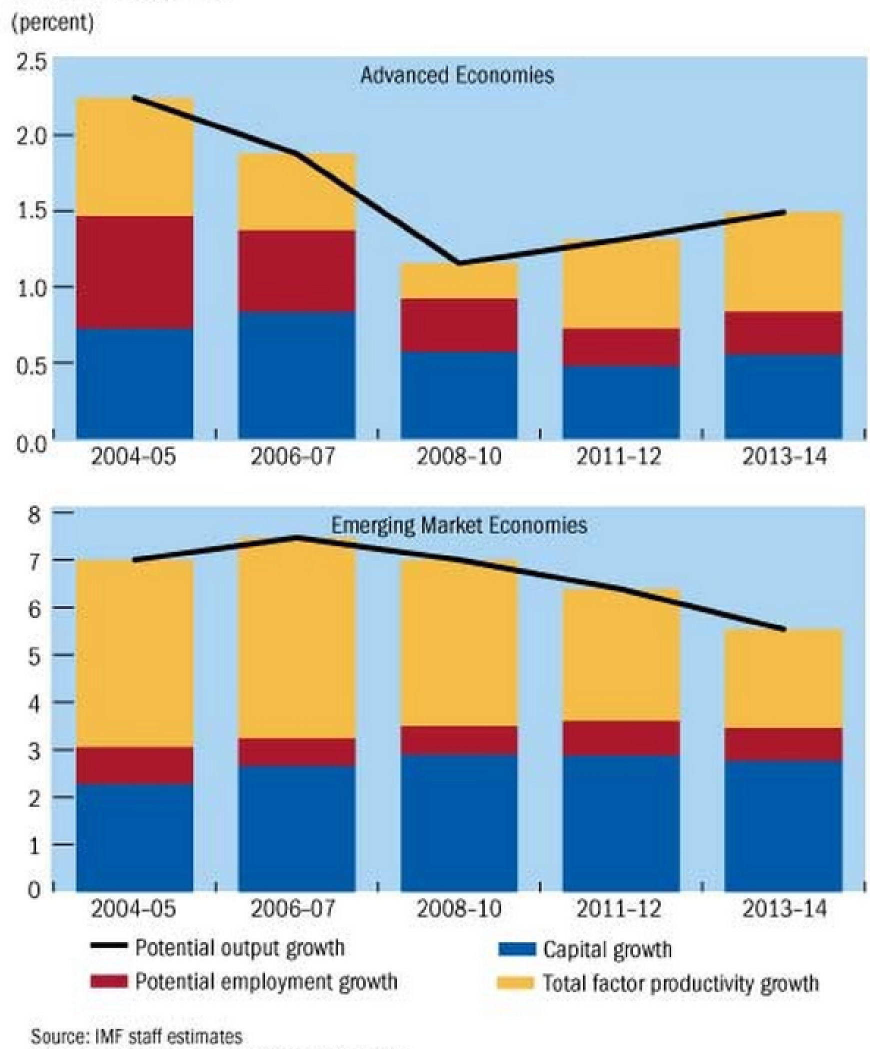
So far, Calamos and Lord Abbett have been correct. As of March 18th, the various members of the Fed’s Open Market Committee (FOMC) did somewhat reduce their year-end expectations for short-term rates. The graphic at the bottom of the previous page shows where each FOMC member thinks short-term rates ought to be over the next few years, and beyond. (The popular press refers to this graphic as the “Dot Plot.”) Lord Abbett figures we’ll have increased market volatility prior to that first rate hike. So far, we have.

Despite increased wariness about growth within the U.S. economy, both Calamos and Lord Abbett continue to see investment opportunities. Although equities do not appear to be on sale in this country, and although the strong U.S. Dollar may further pinch corporate earnings growth, both fund complexes believe that equities remain relatively attractive versus other asset classes and the erosive effects of inflation.

IMF: EXPECT LOWER SPEED LIMITS FOR THE WORLD’S ECONOMIES

The productive capacity of a given economy is determined by the availability of capital and labor, the quality of that labor, and the efficiency with which the two are integrated. The productive capacity of a given economy also governs the returns that are available to reward that labor and capital and bears directly on the level of wealth that resides within that economy.

The International Monetary Fund (IMF) recently published a study that assessed the rate at which the productive capacity of various economies around the world might be expected to grow and concluded that although it expects productivity to continue to improve throughout the world, it expects those future improvements to occur at a reduced rate.

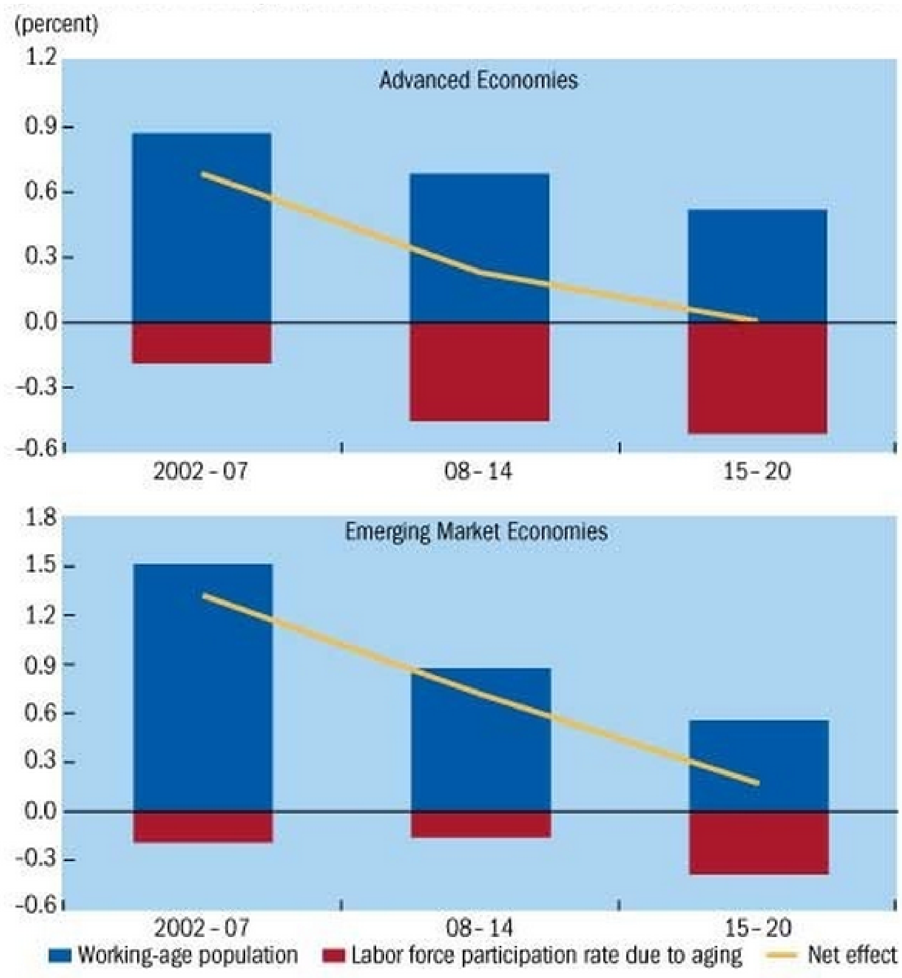


To the extent the productive capacity of a given economy might be expected to grow at some reduced rate, it is reasonable to expect capital and labor to then be rewarded somewhat less generously. This study doesn't contain actionable investment advice nor does it imply that investors will no longer be rewarded for risking their capital, but I think it is worth understanding that productivity improvements seem set to slow for the world, as a whole. Here's a view of the matter from 50,000 feet.

In its study, the IMF segregated the world's economies into two baskets — advanced economies such as the U.S. and Germany, and emerging economies such as China and India, as captured in the blurry graphs, above. (I know … they're all blurry.) In an effort to understand why the rate of productivity growth has slowed since the mid-2000s, the IMF disaggregated the overall rate of productivity growth (black lines) into its component pieces — employment growth (red areas), and capital growth (blue areas).

ADVANCED ECONOMIES: DEMOGRAPHIC HEADWINDS AND LESS TECH TAILWIND

With respect to the advanced economies, the IMF has concluded that the financial crisis' effects on capital growth explain only a minor portion of the decline in productivity growth. The major offender has been and is likely to continue to be related to the impact of a working-age population that is growing more slowly than the population as a whole. As fewer young workers are added, the workforce becomes more aged. Of course, old folks don't have as much steam as young folks do, so the impact of an aging workforce (blue areas, below) tends to also express itself in terms of a declining labor participation rate (red areas). The net impact on productivity growth is captured in the yellow lines, below.



Source: IMF staff estimate.
Note: Economy groups are defined in Annex 3.1.

While the future run-rate of productivity growth within the world's more advanced economies may continue to rebound somewhat due to improvements in capital growth, any such improvement is likely to be overwhelmed by the persistent demographic headwinds presented by a population that grows ever more aged. Technology-related gains could conceivably overcome these demographic issues, but the IMF considers this unlikely since the rate of technological advancement is already quite high.

EMERGING ECONOMIES: LOW-HANGING FRUIT ALREADY PLUCKED

The IMF also expects incremental productivity gains within the world's emerging economies to slow, but for a different reason. Whereas the IMF expects labor and capital to contribute to future productivity gains largely as they have in the past, it expects gains from improved efficiencies to slow simply because emerging economies are already so much further along the technological and educational frontier than they once were. As emerging economies strive to close the gap against more advanced economies, later gains are likely to be more difficult and smaller than earlier ones.

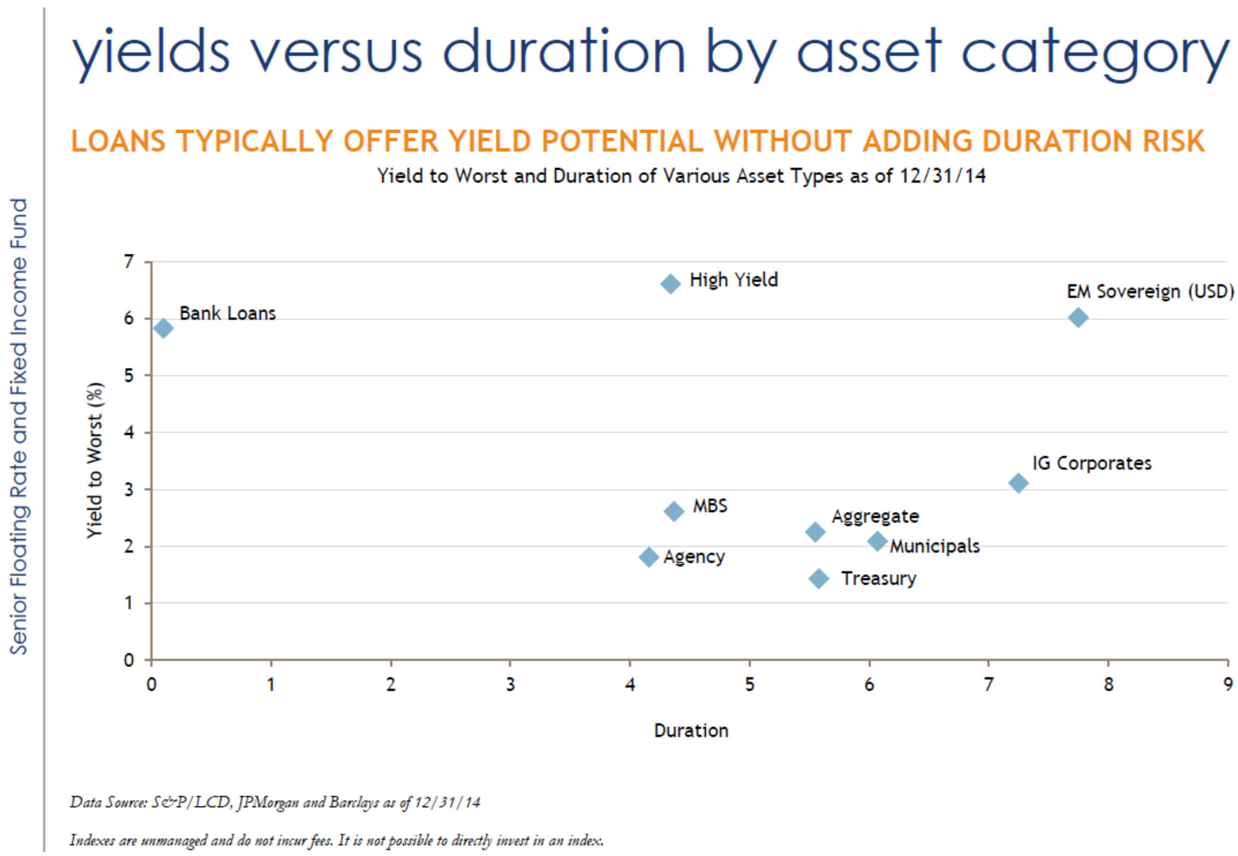
LOWER PRODUCTIVITY GROWTH … AN UNAMBIGUOUS LONG-TERM NEGATIVE

The inescapable conclusion is that worldwide productivity is likely to improve, but less briskly than in the past. As is the case with high levels of societal debt, an expected deceleration in worldwide productivity does not automatically equate to lower returns for investors. However, even if its negative effects are offset by other important positives such as continued increases in health, civility, democratization, and improved legal systems, a long-term reduction in productivity growth is an unambiguous negative.

A QUICK CASE FOR FLOATING-RATE INSTRUMENTS (BANK LOANS)

Even though I've spent considerable time explaining that interest rates might not increase very much or very fast for quite some time, we continue to favor floating-rate securities due to interest-rate protection they provide. (The amount of interest they pay adjusts relatively often, which allows their market values to remain more stable.)

With the exception of the financial crisis, floating-rate instruments have tended to not only provide solidly positive returns in a variety of economic climates, they have usually done so with a relatively low degree of variability. During the financial crisis of 2008/9, they did lose around 30% of their market value, but this was because there was unrelenting selling pressure in an environment in which buyers were temporarily scarce, not because issuers were defaulting on their obligations to pay. In a nutshell, the next blurry graph illustrates why we favor floating-rate instruments (often referred to under the alias of "bank loans").



Think of the "Yield-to-Worst (%)" axis simply as yield or income and think of the "Duration" axis as a measure of interest-rate risk. In general, we prefer instruments that provide a lot of the former with little of the latter. Stated more simply, we like our blue dots to be as high and as far to the left as possible.

— Glenn Wessel