The World’s Most Valuable Natural Resource

Ring out the old, ring in the new. Ring out the false, ring in the true.

If only it was as easy as turning to a new calendar to put the old and false behind. Instead, investors are greeted by a New Year with yet another bout of intensified fear, uncertainty and doubt resonating around these two aspects of the investment climate.

The old aspect
The current expansion is long in the tooth compared to the duration of the “average” post-war U.S. expansion.
With a demonstrated loss of economic momentum, crashing natural resource prices, the Federal Reserve raising interest rates, weak general corporate earnings, rapidly deteriorating geopolitics, the Chinese slowdown, isn’t the domestic expansion vulnerable to lapse into recession?

Some Wall Street economists think so, and assign a two-thirds probability to recession as a result of the expansion’s old age.¹

The false aspect

Meanwhile there is a related anxiety shared by some pundits about potentially false—as in artificial—underpinnings within the investment environment. They worry that the real support for the economy (and stock prices) has been the extraordinary bond buying and zero-interest-rate actions of central banks.

And now, with the U.S. Federal Reserve (“Fed”) moving away from crisis monetary policies, some fret that the primary props keeping the U.S. from economic stagnation have been removed.

We have a different perspective on these issues as we now discuss.

How stretched is the financial spandex?

We believe the evidence is clear that economic expansions do not die of old age.

Recessions arise less from a lack of vim and vigor and more from accumulated excesses (typically debt and unwanted inflation) that require a correction.

Information is important, but understanding and perspective are the keys to better decision-making.

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¹Global G10 Rates Outlook, Citi Research, December 1, 2015, page 22
Now, consider the business cycle within the athlete and spandex context. Early in a business expansion, the financial system is typically very lean after the cleansing of the prior recession. As an expansion ages, the financial spandex typically becomes increasingly stretched as debt accumulates, financial leverage increases and typically, inflation increases.

Policymakers (usually the Fed) move to address the accumulating excesses, and their actions stress the financial spandex still further. Finally, the system cannot tolerate additional burdens, and recession sets in to correct the excesses.

The silver lining within the current expansion’s subpar growth and the prevailing cautious economic behavior on the part of consumers and businesses, is that few serious excesses have accumulated to this point.

Consider: the savings rate is rising, consumer financial burdens are historically modest, the banking system is better capitalized than has been the case for many decades, housing starts remain below their 1960’s levels (despite a significantly larger population base currently) and lower energy costs are a budget-booster for most consumers. Yes, the Fed just raised rates, but a quarter of a percent (25 basis points) from a near-zero base!

Contrast this state-of-the-spandex with that prevailing at the peak of the prior U.S. expansion. Back then debt was widespread in the midst of the massive housing bubble, financial companies were highly levered (20:1/30:1 debt-to-equity), the Fed raised rates 17 times and by 425 basis points, oil prices rose from around $20 to nearly $140 with the price of natural gas registering an almost identical seven-fold advance.

Very different backdrops indeed!

Implications for investors?

Our assessment of the state of the financial spandex suggests the U.S. economy is not at serious risk of recession anytime soon. Fear, uncertainty and doubt about many issues will likely continue to keep economic activity subdued as has been the case since the 2008 Financial Panic. But the underlying fundamentals should also continue to provide “pushback” to bad news and offer economic resiliency.

For investors, stock “bear markets”—prolonged incidents marked by both cratering corporate earnings and stock prices—are typically coincident with recessions. With no recession emerging, general corporate earnings should continue rising providing support beneath U.S. traded stocks.

Of course, even an ongoing expansion does not preclude the stock market from experiencing lots of volatility and nasty “corrections” along the way. Investors have already had to endure several such episodes within the present bull market that began in 2009. And, as we’ve noted in the past, 10% declines historically occur more frequently than do New Year’s eves. But pushback from corporate earnings fundamentals should render corrections transitory events.
What about the recent loss in economic momentum?

The last time the economy experienced the “bust” phase of a major natural resource boom/bust cycle was back in the 1980s. The bust also took place in the context of an ongoing economic expansion that was marked by what were called at the time “rolling recessions” within the most vulnerable economic sectors (energy and agriculture).

A similar pattern is unfolding this time around with the commodity bust creating significant headwinds. These “first order” economic effects of the bust are painful as company oil and gas exploration budgets are being abruptly gutted and farm incomes (and equipment orders) decline along with crop prices. The associated adjustments have been so large as to cast a dim pall on the overall economy and corporate earnings in general.

A recent Forbes article quantified the impact on corporate earnings:\(^2\)

“The energy sector has had a major negative impact to the stock market’s earnings and revenue growth in 2015. Energy companies are forecast to have earnings decline by -66%, so if they are removed from the total, earnings would be essentially flat year over year.

From a revenue perspective the S&P 500 companies are projected to see revenue decline by -3%. Energy is also a culprit for the fourth quarter with revenue dropping -36% year over year. Without its (energy) impact revenue would increase 1% year over year.

The stronger dollar (incidentally) has also had a major negative impact to the S&P 500’s revenue. Depending on the industry and company, the stronger dollar has negatively impacted most large U.S. companies’ revenue by 4% to 8%. If the dollar had been flat, the commentary around 5% to 9% revenue growth would be very different than what is currently being espoused. And earnings would also be growing in the mid to high single-digit range.”

As the New Year progresses, the impact of 2015’s early surge in the trade-weighted value of the dollar and the commodity bust’s negative first order effects on corporate earnings should diminish even if the rates of change involved simply moderate (let alone reverse to any degree). Secondly, the “second order” effects of lower commodity prices—a favorable impact on the budgets of energy and other commodity users—will likely become more pronounced.

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\(^2\) The Stock Market is not as Expensive, nor Growth as Low as it Appears, Chuck Jones, Forbes.com, 12/27/15
Meanwhile, other fundamental factors underlying the expansion remain conducive to growth. We earlier referenced the benign state of the financial spandex. In addition, millennials (greater in number than baby boomers) are finding work, household formations are rising as are wages, hours worked, and overall employment, and as we’ll discuss soon, the environment remains ripe for innovation across wide swaths of the economy.

**False props removed? Economic stagnation ahead?**

Did the Fed’s bond buying and zero interest rate actions create an artificial economic environment? Have *false* props underneath the economy (and stock prices) now been removed, with economic stagnation similar to what Japan has experienced the past 25 years upon us?

Short term interest rates administered by the Fed at artificially low levels have indeed created a very challenging risk/reward profile for most bond investments (see interest rate history Chart nearby). But we do not find the *false* economic expansion argument consistent with what we hear from our bottom-up, “ear-to-the-ground” process of talking to companies and evaluating corporate business progress.
First, it is true companies and consumers have indeed taken advantage of lower rates by refinancing debts at lower rates. The Fed’s actions also essentially enabled a recapitalization of the banking system to healthy levels. This is all part of the process to a healthier, slimmer-fit spandex condition that now exists.

Secondly, there has been substantial growth in corporate earnings over the course of this expansion. The earnings growth, by and large, is simply reflective of “real” economic commerce. Real people are buying real goods at T.J.Maxx and Home Goods. Starbucks is selling coffee to real customers. And, Ecolab is helping real restaurants and hospitals manage their water and cleaning needs. Similarly, real jobs have been created and real incomes are growing, even if at a modest pace.

We would be very worried if this activity was powered by unsustainable accumulation of debt and stretched financial spandex, but that does not appear to be the case for the reasons noted earlier.

To recap events; the Financial Panic of 2008 created significant economic trauma. The Fed did not repeat the catastrophic mistakes of their Great Depression counterparts who let the banking system collapse in the early 1930s. Instead, the contemporary Fed fulfilled its lender-of-last-resort role in the heat of the panic and mended the busted seams of financial spandex as the financial system reeled³.

As the U.S. financial system healed and recovered, the Fed became convinced a self-sustaining economic expansion is underway, and is appropriately moving away from no-longer warranted crisis policies. (See nearby Yellen Index chart. The chart depicts the “dashboard” of indicators Fed Chair Yellen monitors).

Failure by the Fed to “normalize” monetary policy would risk, in our estimation, the ultimate creation of large-scale excesses that would sow the seeds of recession.

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³ It is not clear, by the way, that Japanese policymakers ever took similar financial system healing actions, as stories of “zombie” Japanese banks and companies persist.
Implicit in the *false* aspect angst is the view that when it comes to the business expansion, the only game in town is the Fed. We couldn’t disagree more.

**Peak oil was the mantra, now it’s peak ideas and peak innovation?**

The term, “secular stagnation” was coined in the late 1930s by Harvard economist Alvin Hansen. Hansen was part of FDR’s “Brain Trust”, and he was considered by some as America’s John Maynard Keynes.

His stagnation lament reflected frustration that the concerted expansion of government intervention in the economy during the 1930s produced precious little progress in reducing unemployment or creating a strong economic recovery.

With their prescription for growth not working, Hansen (and others) concluded something else must be wrong with the economy.
As historian Jerry Muller notes in his terrific book⁴:

“Analysts of very diverse political hues concluded that the era of dynamic capitalism was over and that the United States and other ‘mature economies’ had entered into a period of long-term economic stagnation. Some argued that there were no new technologies in sight for consumers to buy. Others feared that natural resources were nearing exhaustion, or that slowing population growth translated into a lack of consumer demand.”

In Muller’s chapter about one of Hansen’s Harvard contemporaries, Joseph Schumpeter (who had a very different perspective as we’ll see), Muller notes:

“Schumpeter noted equally severe depressions had come and gone in the past and the elusiveness of strong recovery in the 1930s could be explained: ‘difficulties incident to the adaptation to a new fiscal policy, new labor legislation, and a general change in the attitude of government to private enterprise’. All these made the depression worse and most serious of all was the unnecessary epidemic of bank failures.”

“The popular notion that technological possibilities had been exhausted because no major innovations were clearly in view missed the fact that under capitalism ‘technological possibilities are an uncharted sea’; there were possibilities that lay beyond the present horizon and would transform productivity as radically as had the coming of electricity since the turn of the century.”

“From time to time, critics asserted that the creative powers of the market were at an end, that there were no more opportunities left to exploit, that the technological frontier had been reached, that natural resources were running out. A popular claim in the 1930s, it was repeated by the Club of Rome in its 1972 report, ‘The Limits to Growth.’”

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⁴ Jerry Muller, The Mind and the Market: Capitalism in Western Thought. Knopf Doubleday Publishing Group
“This, as Schumpeter indicated, was a mirage. The notion that natural resources (for example) represent an objective limit on capitalism proved false, because the history of capitalism, as Schumpeter observed, is of finding new ways to make use of formerly insignificant resources.”

Doesn’t this sound familiar (except the bank failure epidemic thankfully!) within today’s context?

We think economic progress since that time shows that Schumpeter was right, and Hansen’s outlook seriously underestimated the potential and power of innovation. We believe innovation, and its impact on productivity growth, are being underestimated today in a similar manner.

But we also think Schumpeter’s definition of natural resources needs to be expanded. Another economist, Julian Simon, pointed out that the ultimate natural resource is human ingenuity. And it is the constant application of the ingenuity in a never ending search for ways to make life better that drives innovation, productivity growth and the general standard of living.

The ultimate resource in any economy is not the inanimate stuff such as land or petroleum or gold or iron ore but instead, the human mind that is free to innovate.

Julian Simon

Most importantly, because of technology there has never been a time when human ingenuity can mingle among minds and gain traction so easily and quickly. As Stanford technologist Vivek Wadhwa recently noted:

“Never before has all of humanity been connected in this way. This will be particularly transformative for the developing world.”

“Knowledge has always been a privilege of the rich; tyrants rule by keeping their populations ignorant. Soon, everyone, everywhere, will have access to the ocean of knowledge on the Internet. They will be able to learn about scientific advances as they happen. Social media will enable billions of people to share their experiences and help one another. Workers in the remotest villages of Africa will be able to offer digital services to the elite in Silicon Valley. Farmers will be able learn how to improve crop yields; artisans will gain access to global markets; and economies based on smartphone apps will flourish everywhere.”

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5 Vivek Wadhwa, 2015 was a tipping point for six technologies that will change the world, Washington Post, 12/28/15
Put an ear-to-the-ground at the bottom-up level and here’s some of what you may hear:

- “A locomotive today is a rolling data center. An aircraft engine is a flying data center. This is producing terabytes of data every day. This data can be used to drive better fuel efficiency, better (operational) performance, better environmental performance. We can take the same technology and do it in our plants.”  
  
  Jeff Immelt, GE CEO

- “The Industrial Internet (‘internet of things’) will bring about a profound transformation of the economy. It will blur the traditional distinction between manufacturing and services. Businesses are already rethinking the value they offer to their customers: no longer products, but efficiency, productivity, everything ‘as a service.’”

  “Together with advanced manufacturing, the Industrial Internet will redefine economies of scale, enabling micro factories and the democratization of manufacturing. As it transforms key infrastructures and services, improving the delivery of energy, transportation, healthcare, education and more, digital innovations will also have a multiplier effect on economic growth and human development—laying the basis for even greater outcomes for society. The opportunities to generate this productivity are right in front of us. Industry is the engine of economic growth, touching close to one-half of global economic activity—and probably more; and the value created by Industrial Internet solutions is additive”.
  
  *The Moment for Industry*, Marco Annunziato, October, 2015

- “(Our goal) is to mine and refine the world’s vast new natural resource of Big Data.”
  
  Ginni Rometty, IBM CEO

- “The next key trend is ‘big data’ analytics. Big data analytics are especially important because of their potential to dramatically increase returns on invested capital. This could be the most disruptive theme to traditional industrial companies because of the new competitive dynamics. We particularly see these trends in fleet management, machine optimization, precision agriculture, and automation and autonomy in mining.”
  
  William Blair & Company

- “Google, in collaboration with NASA, says it has a quantum computer that works. Google claims the D-Wav 2x is 100 million times as fast as any of today’s machines. It could theoretically complete calculations within seconds to a problem that might take a digital computer 10,000 years to calculate.”

  “Imagine NASA being able to use quantum computers to optimize (in real time) the flight trajectories of space missions, FedEx being able to optimize its delivery fleet of trucks and planes, an airport being able to optimize its traffic control grid or a Big Pharma company being able to optimize its search for a breakthrough new drug.”
  
  *Chicago Tribune*, January 6, 2016
More minds than ever before are busy working to change the way the world works in favorable ways. And as one of the quotes above suggests, cloud computing, big data analytics, and advanced manufacturing are putting amazingly powerful tools of innovation into the reach of more and more minds (“democratization” of everything). Billions of dollars of computing power and design capabilities are now available at relatively low cost subscription prices via initiatives at Adobe, Amazon, Ansys, Google, Microsoft, Oracle, and PTC.

Additional context as to why innovation may be hard to see at any point in time is offered by economic historian Robert Higgs:

“We must remember, too, that major productivity gains often result from a series of minor improvements. The spectacular technological advance captures everyone’s attention, but ultimately the small, unspectacular advances may have an even greater importance.”

Companies that are able to provide benefits from the innovation initiatives underway will prosper and generate corporate results that will attract investor attention. These fundamentals will provide pushback and resilience to a world focused on fear, uncertainty and doubt.

In a larger sense, while tumbling prices in natural resources are presently creating havoc for some companies, economic sectors and countries, the ultimate natural resource—the most valuable natural resource of all time—the collective human mind—will offer resilience and opportunities through economic progress.

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