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WEALTH MANAGEMENT INC.

Kleinburg Private Wealth Newsletter

The value of advice increases over time
Difference in household financial assets attributable to financial advice
No advice
4-6 years of advice
7-14 years of advice
15+ years of advice
1.58x
1.99x
2.73x

http://www.

Zoom: 1d 5d 1m 3m 6m YTD 1y 5y 10y All
Feb 27, 2009 - Oct 22, 2014 +2941.54 (204.1%)
The depths of The Great Recession
"Beware of a Double Dip Recession" - Forbes, March 11th, 2010
These 23 Charts Prove that Stocks are Heading for a Devastating Crash" - Forbes, July 1st, 2014
"U.S. Economy Is In a Recession Right Now, Hussman Says" - WSJ, June 11th, 2012.
"The Top 12 Signs That The U.S. Economy Is Heading Toward Another Recession" - Zero Hedge, June 3rd, 2014
"Is U.S. Already in a Recession?" - Time.com, Oct 1st, 2012
"Time to Say It - Double Dip May Be Happening" - NY Times, Aug 4th, 2011
Our recent little dip.
2500
2000
1500
2009
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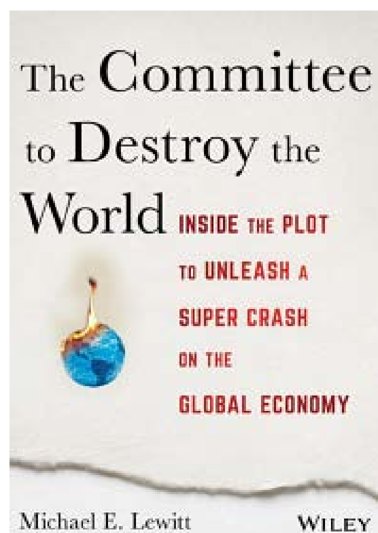
The Committee to Destroy the World
INSIDE THE PLOT TO UNLEASH A SUPER CRASH ON THE GLOBAL ECONOMY
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The Way I See It

Manulife Investments

INVESTMENT NOTE

August 3, 2016

Does the Dual Mandate Even Matter Today?

'I am the wisest man alive; for I know one thing, and that is that I know nothing'

Plato, the Republic

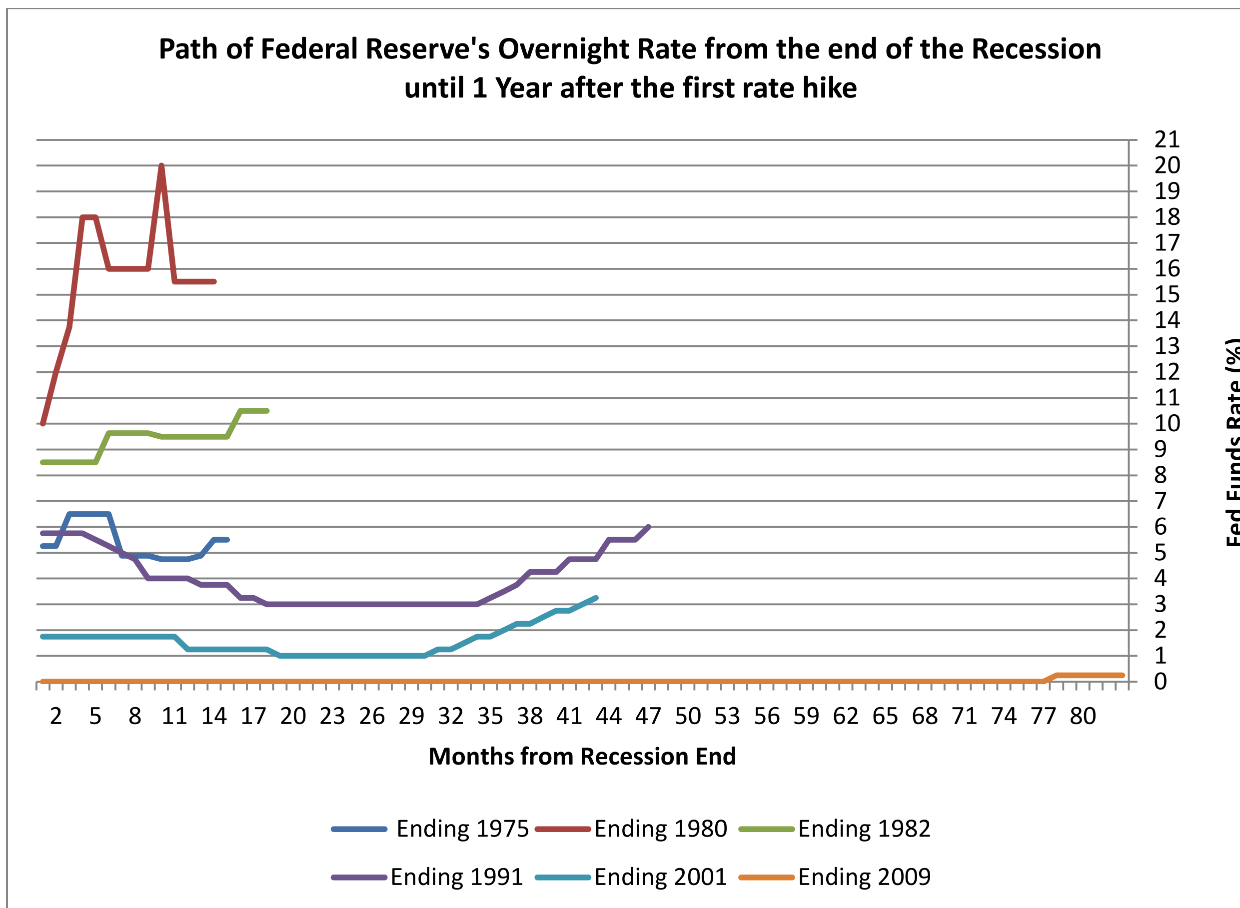
If economists and strategists had previously felt confident in their ability to predict the path of the Fed Fund's rate based on employment and inflation, seven months following the first rate hike since 2006, confidence may have given way to confusion. It has become clear that using the Fed's dual mandate to gauge the path of rates, which itself was a manifestation of the economic environment more than 40 years ago, no longer appears to be as relevant based on the evidence of action, or lack thereof.

This Investment Note represents the views of **Macan Nia** of Manulife Investments

Macan Nia, Sr. Investment Strategist, Capital Markets & Strategy, Manulife Investments

Between 1970 and 1980, inflation in the U.S. as measured by the Personal Consumption Expenditure Index (PCE - which is the Federal Reserve's preferred measure) was extremely volatile, ranging from a low of 2.7% in 1973 to a high of 10.2% in 1975. Over the same period, employment was weak with the unemployment rate having more than doubled from 4.2% in 1970 to 9.0% in 1975 before retreating again by 1980. In this environment, the Federal Reserve was concerned with stagflation (stagnant growth with high inflation) which resulted in a change to the Fed's mandate by the US Congress. In November 1977, the Federal Reserve was given a 'dual mandate' with a focus of *'the goals of maximum employment, stable prices, and moderate long term interest rates'*. As a result, the path of each subsequent tightening cycle was a function of the dual mandate.

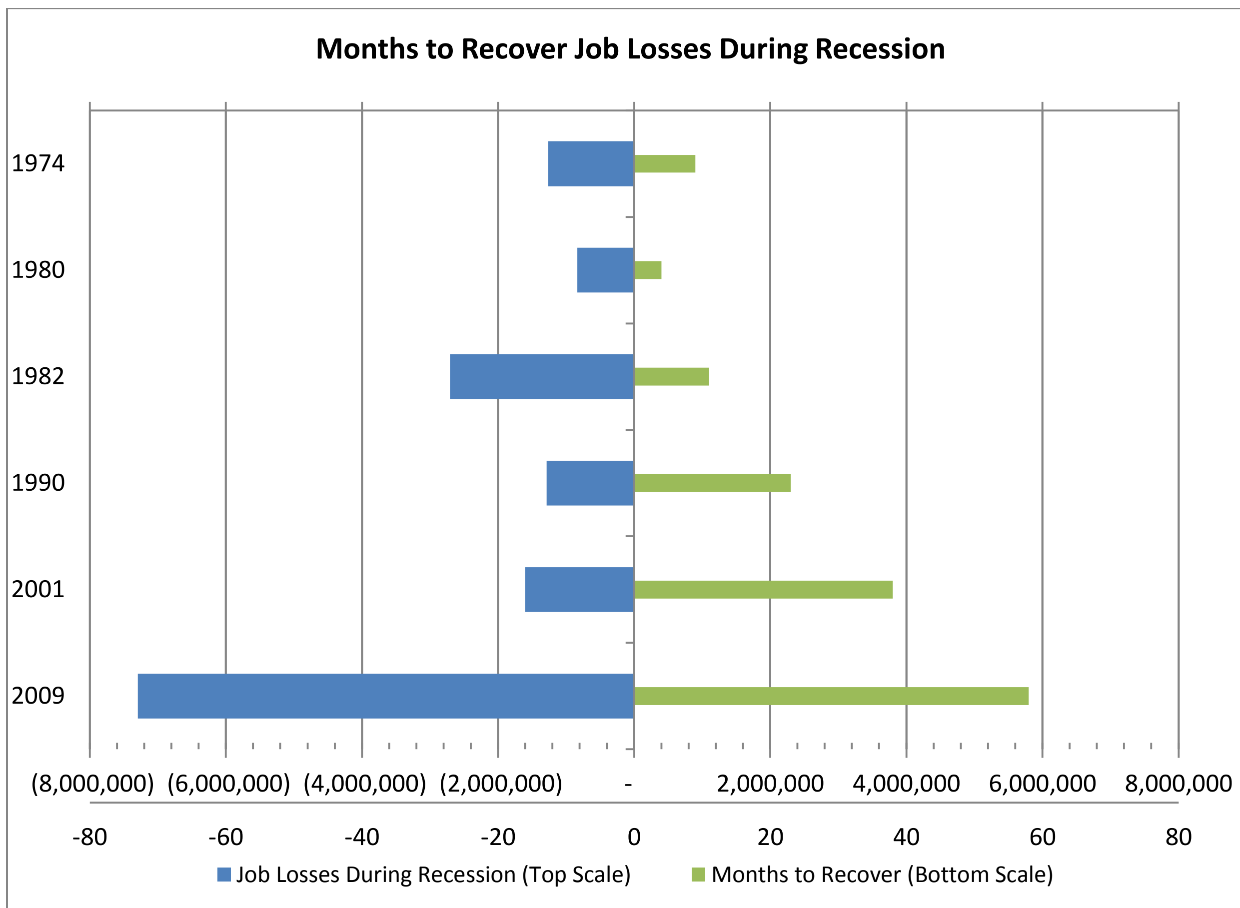
Since the mid 1970's, the U.S. had experienced six recessions ending 1975, 1980, 1982, 1991, 2001 and 2009 followed naturally by six recoveries and six shifts by the Fed from an easing cycle to a tightening cycle. It is clear that the current tightening cycle is evolving differently from the past. The chart below illustrates the path of the Fed's overnight rate from the end of each recession (as identified by the National Bureau of Economic Research - NBER) through to twelve months after the first rate hike. Two points stand out. First, in the current cycle the Fed has waited an extraordinary longer period to raise rates (prior to December 2015 hike, the Federal Reserve last raised rates in May 2006). And second, rates have fallen with each cycle to new historical lows. As strategists, given this unprecedented monetary policy, we find ourselves asking: *'is the Fed's current path justified by its mandate'*, and if not *'has the Fed's mandate implicitly changed'?*



Source: Bloomberg, Manulife Investments as of June 2016

From *an inflation perspective*, in the minutes of the January 2012 FOMC meeting, the committee stated that targeting a rate of inflation as measured by Core Personal Consumption Expenditure (PCE) of approximately 2%, would achieve its inflation mandate. Since the end of the Great Recession, the average inflation rate has been approximately 1.5%. Since January 2012, inflation has averaged 1.6%. Although inflation is averaging below the 'target' rate, historical Fed policy would suggest inflation is at a level that would support a rate increase. For example during the six years after the 2001 recession, inflation averaged 1.9%, while the Fed Funds rate increased from 1.75% to 4.5%.

From an *employment perspective*, economists can argue whether the economy is operating at 'full capacity' or not. However, the absolute number of jobs created and the drop in the unemployment rate since the Great Recession from an historical perspective may also justify a higher Fed Funds rate. The chart below shows the number of jobs lost during each U.S. recessionary period and the length of time (in months) it took to recover. The job losses in 2008 of 7,296,000 was equal to 95% of the job losses experienced during the previous five recessions combined. It took approximately 5 years for the US economy to regain the job losses of the 'Great Recession'. However since that point, the US economy has created an additional 4,830,000 jobs and the unemployment rate has fallen from 9.5% at the end of the recession to 6.2% by the full job recovery to 4.9% currently. The current rate of inflation of 1.9% as measured by the PCE and an unemployment rate of 4.9% coupled with first time jobless claims of 253,000 might justify a higher overnight rate than the current 0.25% based on prior Fed action post-recession.

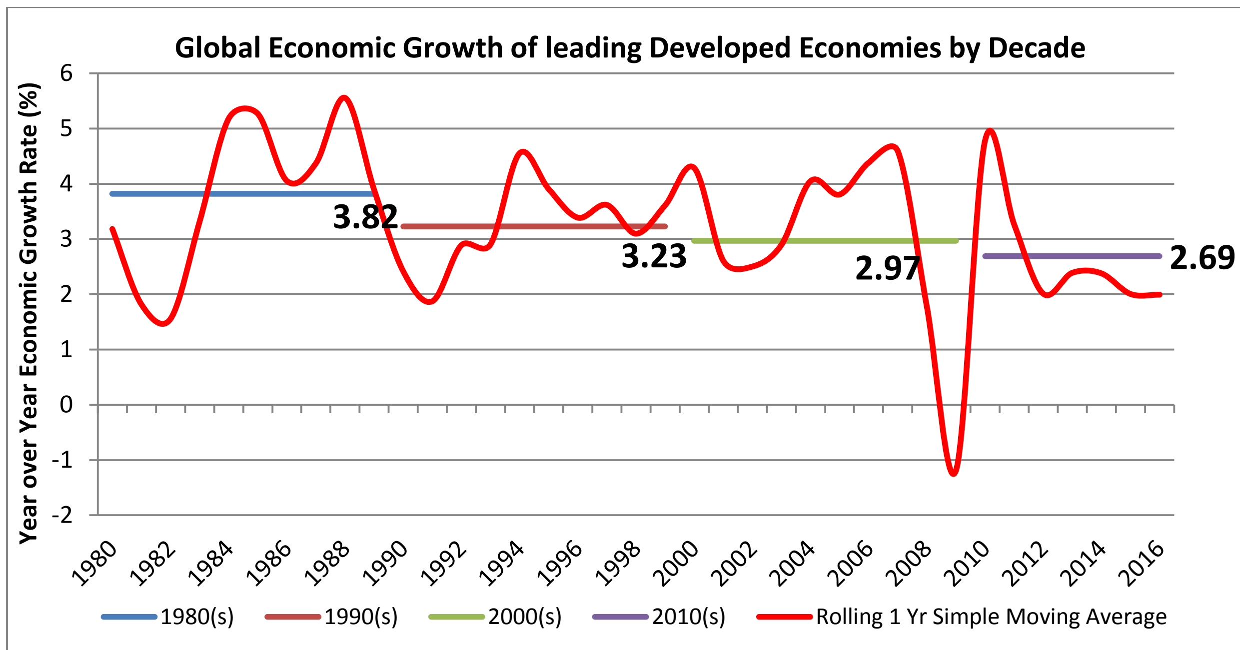


Source: Manulife Investments; Bloomberg, as of June 2016

Despite this view, our team believes that it is possible that the lower bound of the Fed fund's rate will not surpass 1.0% through the next three years. It comes down to what we believe the Fed should do with what recent behavior suggests the Fed is likely to do. We believe the Fed's dovish attitude is a function of the new economic environment characterized by historical low global growth rates and the closer integration of the global financial system that has occurred over the past couple of decades.

The New Global Economic Environment

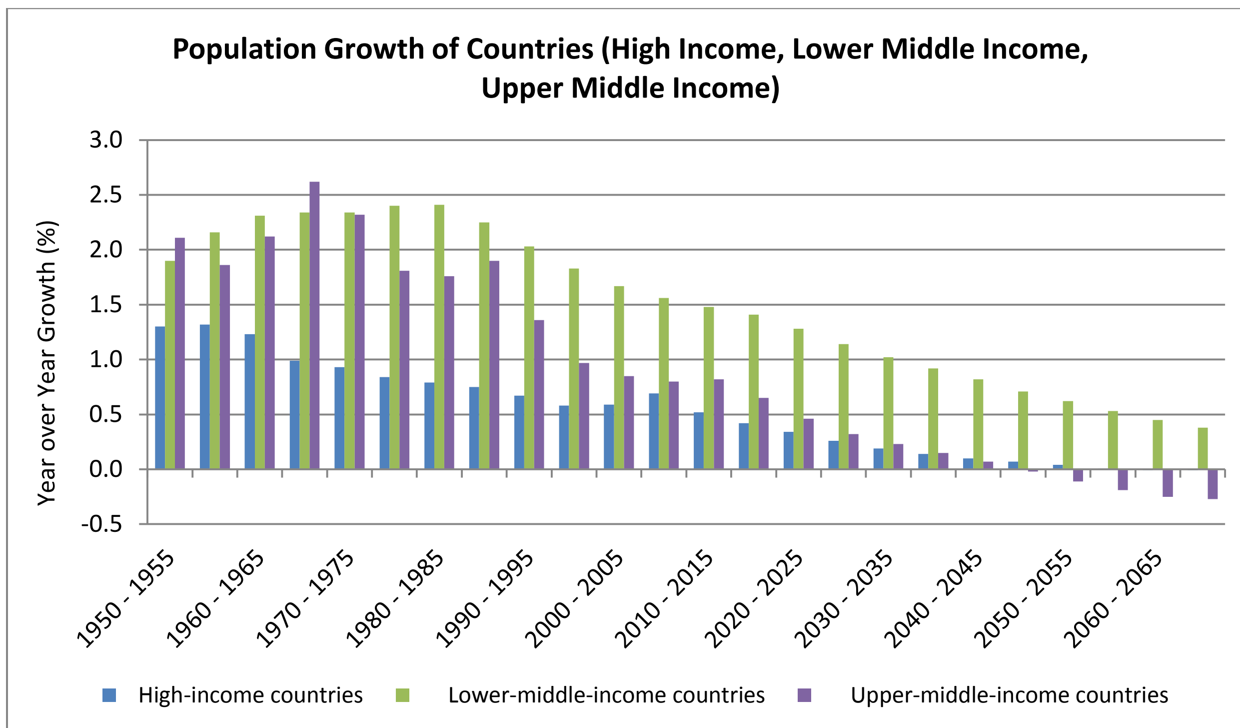
Since 1980, the world has seen slower average economic growth in each subsequent decade. According to the International Monetary Fund (IMF), in 2016, the major economies' growth rate (60% of world GDP) will be approximately 2.0%. With the exception of the current decade, each prior decade since 1970 has experienced a recession. Given our view that we are nearing the end of the current business cycle, we believe the probability of a recession over the next couple of years has increased which will likely depress the average global growth rate below the current 2.69% since 2010.



Source: Manulife Investments, International Monetary Fund

What are the factors that have contributed to slower growth? From a big picture perspective, since the 1980's, population growth in high-income and upper-middle income countries has slowed. Over this period, high income population growth has fallen from 0.8% to 0.4% year-over-year, whereas in upper middle income countries it has fallen from 1.7% to 0.6%. According to the United Nations Department of Economic and Social Affairs, over the next ten years, the rate of population growth for high income and upper middle income is expected to decline further to 0.2% and 0.3% respectively.

Not only are developed markets populations growing slower, the populations of country's that will drive future growth are getting older faster. The developed market economies of the U.S., Japan and U.K. that drove economic growth since the 1960s grew older at a slower rate than the emerging market economies of today. For example, according to the UN, the time required for the percentage of the population aged 65 to double to 14% took 65 years for the U.S., 45 years for the U.K., and 25 years for Japan. Today, it is estimated to be 25 years for the population over 65 to double in China, 20 years for Brazil and 18 years for South Korea. Said differently, the population drivers of economic growth today are getting older a lot faster than those of the past. Aging populations in developed and emerging markets may lead to slower global consumption growth. In developed countries, retired populations spend between 30-40% less than the working age population. In emerging countries, according to S&P demographic analysis, spending is even lower given the lack of social safety programs.



Source: United Nations, Department of Economic and Social Affairs

The Integration of the Global Financial System

Although the Federal Reserve has a dual mandate that is US-centric, it has become increasingly more challenging for the Fed to operate without consideration for the global economy given the high degree of inter-dependency. Last August, Fed chairman Janet Yellen in her press conference was very explicit in noting that interest rates would have increased if she and other members of the FOMC committee were not concerned with fragile market and economic conditions outside the US, most notably in China. At that time, China cut its daily reference rate by 1.9% which resulted in extreme volatility in its domestic stock markets. In a more recent example, Yellen cited at a conference that the Brexit vote on June 23 was a reason for the Fed to delay raising rates.

The Fed has also been mindful of its monetary policy decision given the low yield environment globally. According to Fitch, there are approximately U.S. $13 trillion dollars of negative yielding developed sovereign bonds, this amounts to 1/3 of all developed market sovereign bonds. Of the remaining 2/3 earning a positive yield, half of those are U.S. Government bonds. The Fed acting as the only major central bank with a tightening monetary bias puts upward pressure on the U.S. dollar. In addition to a slow global growth environment, a rising U.S. dollar will further place pressure on those 49 countries that have their local currency pegged to the U.S. dollar.

We believe the Fed wants to return to a 'normalized' investment environment. Given the slower growth environment, it has become increasing difficult to quantify what 'normalized' rates are. What we know is that global populations are not growing as fast, and are aging rapidly. For those who are working in these rapidly aging countries, their wage growth is less likely to match that of their parents because of a slower economic growth environment. In this scenario, spending may contract and inflation expectations will be further subdued resulting in an even lower for even longer interest rate environment.

We can argue based on the Fed's mandate and the economic data that the Fed could have raised rates. And perhaps in hindsight the last couple of years offered better opportunities to do so. However, given the current trends in demographics and weaker global growth, we believe the longer the Fed waits, the less opportune the environment and the more volatile the market reaction.

A rise in interest rates typically causes bond prices to fall. The longer the average maturity of the bonds held by a fund, the more sensitive a fund is likely to be to interest-rate changes. The yield earned by a fund will vary with changes in interest rates.

Global events have resulted, and may continue to result, in an unusually high degree of volatility in the financial markets, both domestic and foreign.

Currency risk is the risk that fluctuations in exchange rates may adversely affect the value of a fund's investments.

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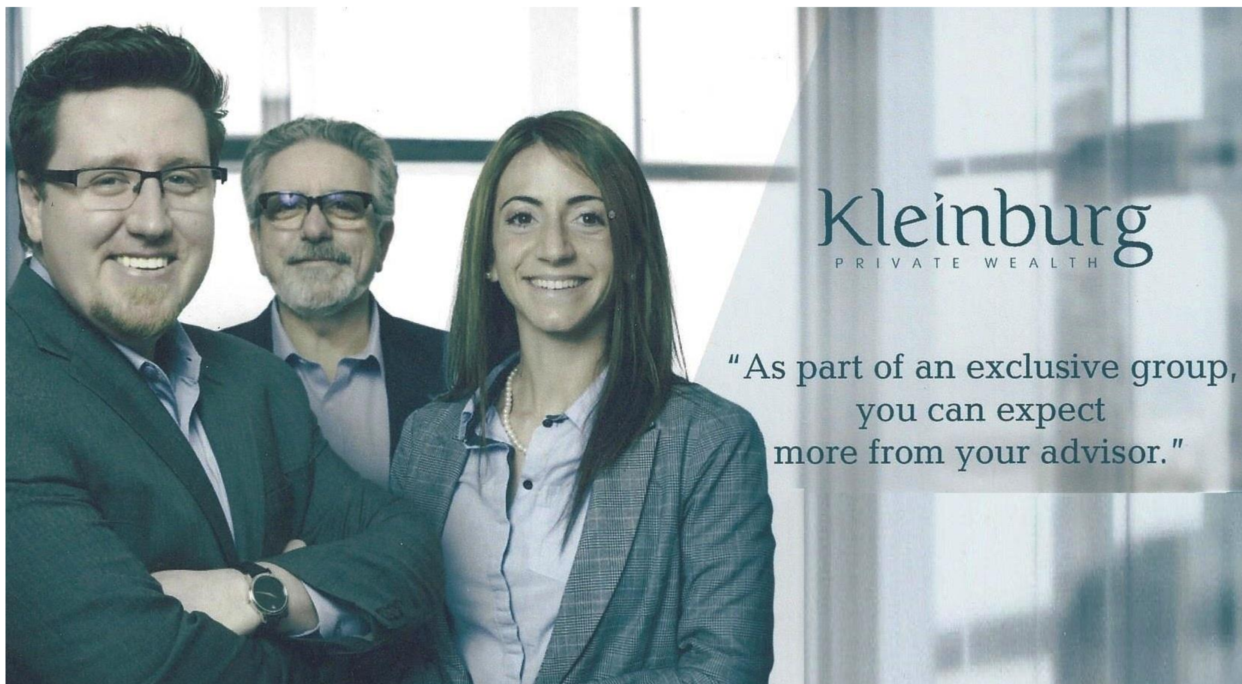

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