

## Running in Place

According to the official statistics, the economy laid an egg in the year's first quarter, growing at a measly 0.1% annualized rate. Fortunately for them, the government's statisticians get three tries at figuring the economy's growth, and this was only the first, "advance" GDP report, when some of GDP's inputs are not yet known, and require estimation. The revised GDP print, which will be published toward month-end, is widely expected to be negative. This would represent the first negative growth quarter for the economy in three years.

By and large, investors have given the economy a pass to start the year, owing to the long and harsh winter season that affected broad swaths of the country. Companies were quick to the weather confessional in first-quarter earnings reports, and common sense would tell us that the season's particularly foul weather had a negative impact on business at stores and restaurants, on outdoor construction, and on supply chains generally. Now, in the middle of the second quarter, economists and investors alike are scrutinizing current economic data, and widely expecting signs of a rebound. Should the data disappoint, we need to consider the possibility that the recovery has slowed meaningfully.

## A Consumer Check-In

As goes the US consumer, so goes, largely, the economy, and we thought it worthwhile to

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discuss the state of the household. It's a mixed bag of news, with some bright spots and some challenges. On the encouraging side, **jobs data have continued to improve; the economy is adding jobs, and fewer people are being laid off.** Incomes are growing (disposable income advanced 3.3% in the first quarter) and households are spending (personal consumption expenditures were up 3.0%). Notably, the quarter showed outsized spending jumps in utility (6.0%; blame the winter) and health care expenses (9.9%). Within the housing sector, rising prices have helped to improve consumer balance sheets. Last, higher prices in financial markets have boosted the net worth of investor households, although those gains are distributed unevenly, with wealthier households benefitting disproportionately.

Despite the gradual betterment in the household sector, challenges also persist. Foremost is the overall sluggish pace of gains in employment and wages. We are now over six years removed from the onset of the Great Financial Crisis, and we have yet to surpass the number of people working in jobs today (145.7 million employed)

versus then (146.3 million, at year-end 2007). The current unemployment rate of 6.3% is not as healthy as it appears, as it excludes the large number of labor force dropouts. Annual wage gains among the employed of 3% or so are barely keeping up with the official inflation statistics, let alone what many of us experience in our personal lives. Food prices, in particular, are poised for sharp increases this year across a host of products, including beef, pork, fruits and vegetables (and coffee, which some of us consider a primary food group).

Long a bane to the economy, **health care costs are a growing hidden undertow to many household budgets.** The Affordable Care Act has required insurers to offer broad coverages in all health plans they offer – in some cases, driving up the direct monthly cost for insurance (which is purchasing more comprehensive insurance for the consumer), especially in the individual, non-group market. In addition, among employer-provided health insurance, a steady trend has been declining premium support by the employer, with an increasing obligation on the worker. Workers are required to pay more of a steadily-rising cost. Last, the growing numbers of high-deductible health plans, which feature lower monthly premiums in exchange for a higher deductible borne by the consumer, have put a contingent liability on the consumer—in other words, if someone gets sick, the first few

thousand dollars of health care expenditure will come from the consumer’s wallet before *any* health insurance kicks in to help pay bills. For a household of modest means, such expenses could be catastrophic. Taken together, these trends in health care economics have amounted to a substantial risk shift from plan providers to the health care consumer. Last quarter’s nearly 10% rise in household outlays for health care is hardly sustainable. We are monitoring this trend closely.

## The Credit Conundrum

A review of the consumer would not be complete without a survey of credit conditions. **For the US economy, a cycle of credit expansion goes hand-in-hand with economic growth.** Simply put, when more people borrow money to buy “stuff,” goods and service providers get busy. *Their* suppliers get busy, and so on, as the wheels of commerce turn. Likewise, when credit trends are sluggish, a consumer-driven liftoff to stronger growth is harder to achieve.

You can think of consumer credit in the economy as falling into one of three buckets: mortgages, revolving credit (credit cards), and non-revolving credit (car loans, student loans, and other term debt). Here is a summary table of the three buckets:

US Consumer Indebtedness, 2007-2013 (Data in \$Millions)							
Credit Type	2007	2010	2011	2012	2013	Total Change, 2007-2013	Annualized Rate of Chg.
Home Mortgage	9,748	9,120	8,895	8,596	8,578	-12.0%	-2.1%
<b>Consumer Credit</b>							
Credit Cards	839	730	704	679	683	-18.6%	-3.4%
Car Loans	815	711	734	783	863	5.9%	1.0%
Student Loans	548	812	874	966	1,080	97.3%	12.0%
Other	422	341	330	317	317	-24.9%	-4.7%
<b>Total Consumer Debt</b>	<b>12,372</b>	<b>11,713</b>	<b>11,537</b>	<b>11,341</b>	<b>11,521</b>	<b>-6.9%</b>	<b>-1.2%</b>

Source: Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit, February 2014

Mortgage-related borrowing comprised about 75% of household debt balances at the end of 2013, and has trended down consistently in the years following the 2008 financial crisis. Debt has been paid down through normal loan amortization, additional principal pay down, and has been written off through foreclosures and short sales. Consumer borrowing through mortgages (i.e., “cash out” refinancing) was a significant prop to consumption through the last two decades, but has curtailed significantly following the financial crisis.

Credit card borrowing, also, has retrenched significantly post-crisis, down an average of 3.4% annually since 2007. As with mortgages, lower card balances are the result of paydowns by consumers and write-offs of bad debt by the card lenders.

Car loans have remained steady. The average age of cars on the road remains near record highs, and the consumer, out of necessity, has had to remain a borrower in the market for autos.

A cursory glance at the consumer debt table reveals **one of these things is not like the other**. Student debt has been rising at a fearsome clip, now exceeds one trillion dollars, and is a particularly double-edged sword, both to the borrower and to the economy as a whole. For most students, some degree of borrowing is a necessity in affording higher education, and spent in the right degree programs, can be a terrific investment. Perversely, college becomes more expensive as people can borrow widely to afford it. The availability of loans to finance school tends to drive up its price. Unlike other forms of debt, student loans are not dischargeable; they will be with their borrowers until they are paid. Student loan debt service will come at the expense of other big-ticket purchases by young

consumers. Already, we are seeing below-average ownership rates for homes and autos by young people.

On balance, our consumer-driven economy is showing predictable signs of maturity, and *above-average economic growth is harder to achieve without a coincident cycle of credit expansion*. What will get credit moving again? The improving (though not perfect) jobs picture is perhaps the most hopeful precursor. Jobs will beget incomes and spending, and should release a substantial bout of pent-up consumer demand into the economy.

### A Brief Update on Our Strategy

The stock market has been flattish thus far this year. Depending on the market segment, stock prices are modestly higher (large cap) or lower (small cap). Notably, high valuation stocks have suffered a sharp correction, with names in social media, “new tech,” and biotechnology all taking a beating. Bonds have been the year’s surprise, with rates falling and prices gaining. To begin 2014, the strong consensus was for higher interest rates, and as is often the case, the market has thus far returned a result to frustrate a great number of investors positioned for something else.

Despite present concerns over slowing economic growth, **valuations continue to support the stock market**. The stock market is not especially dear, particularly in light of low inflation and low interest rates. The S&P 500 trades at under 16x forward earnings. With the first-quarter earnings season nearly complete, profits have advanced over 5% from the year-ago quarter. Heading into earnings season, expectations were for about a 1% gain.

Still, **we expect modest returns in coming months.** Last year's strong stock market gains came primarily from P/E expansion, and much less from actual earnings growth. It is entirely normal to expect a consolidation of prior gains, and we are seeing such a period now. The stock market is churning, and there is more volatility than is apparent by just looking at index averages, which have not moved much.

**For those investors fearing a correction, we have news: we're having one.** Markets can correct in time, price, or both. In either case, a correction allows prices (i.e., what we pay for assets) to align more squarely with values (what economic value we receive.) We are correcting in time, and pockets of the broad market (e.g., the aforementioned high-valuation, momentum stocks) are most certainly correcting in price. We see little that is atypical about current market action.

**We are optimistic that capital spending will improve meaningfully in coming quarters.** Capital spending has remained muted in the years following the financial crisis, as companies have made due with existing resources. Capacity utilization within the economy (78.6%, as of April) has steadily moved toward the 80% level that normally serves as a trigger for increased business spending to expand and otherwise modernize production. Capital spending tends to have significant multiplier effects and would serve as an excellent tonic to economic growth.

**We remain positioned, overall, for continued economic expansion within our client portfolios.** Recent allocation moves have included investments to the technology, health care, and asset management sectors. We have reduced our exposure within the consumer staples and utility sectors, which offer an unappealing combination of high valuations and relatively low growth prospects.

Scott C. McCartney, CFA  
Chief Investment Officer  
[scottm@ascentwp.com](mailto:scottm@ascentwp.com)

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