1919 INVESTMENT COUNSEL

Weekly Market Insights

Dow Jones: 17573 YTD +8.10% | **S&P 500:** 2031 YTD +11.84% | **NASDAQ**: 4632 YTD +12.07%

November 10, 2014

Politics, Economics and History

Lots of interesting thoughts for the week. Two things come to mind immediately, one history, one coming to fruition as we write. The first is the destruction of the Berlin Wall. There are so many important ramifications that they defy a short paper like this, but certainly there would be no EU, no European currency and much less freedom in Europe. The second is we, Legg Mason Investment Counsel, are now 1919 Investment Counsel. We not only have changed our name but our affiliation. We have now partnered with Stifel Financial. You will all be getting more information about this in the very near future.

As we all know, the mid-term elections have finally come to an end, and the Republicans won a resounding victory. Although it is far too early to make any predictions with great confidence, we feel certain things will unfold. There are six items we feel have a good probability to occur. There will be no fight over the debt ceiling. Both sides now know that blocking the debt ceiling is a no-win game. It is very unlikely that we will have serious corporate tax reform. Any give-up of revenue will have to be made up elsewhere, and it is unlikely that both sides will come to an agreement. The strongest supply side advocates will argue that by freeing up corporate cash it will accelerate the economy so tax revenues will make up for the lost funds. But there aren't enough true believers. The Keystone pipeline will be signed. It is far more likely that the two main trade agreements, one with Asia and the other with Europe, will come to fruition. In fact it is quite possible the Senate will grant the President *fast track authority.* If history is a guide, there should be more cooperation between the executive and a legislative branch. This, of course, leads us to immigration. There is a good chance, at least better than 50-50, that an immigration bill will pass.

The economic statistics continue to be very encouraging in the United States. Manufacturing reports have been very good and are getting better. Repatriation of jobs back to America continues and the productivity of American workers is very good. This leads us to perhaps the most watched statistics of all—employment. They are very encouraging and wages are slowly beginning to rise. It is very instructive to examine unemployment in some detail. Both employment and participation rates are heavily dependent on education levels. For those Americans without a high school diploma, the unemployment rate is 8.4% and the participation rate is 44%. Those with some college the rates are 5.4% and 66% and college graduates 2.9% and 75%. Complexity of most jobs has grown so fast that it has shut out the undereducated. Most economists will tell you that new products, new business and advances in technology will create as many jobs as they destroy. This we believe is true, but the trade-off is lumpy. By this we mean there can be long lags between when jobs fall by the wayside and new jobs appear. This is compounded by the need to develop new skills. In the long run technological progress is great, but we should bear in mind Lord Keynes warning about the long run.

This, of course, leads us to Ms. Yellen and the Federal Reserve. When does this increase in economic activity lead to higher interest rates? Part of that question has been answered. The end of QE 3. Far more important is when does the Fed raise the Fed Funds rate? Our view remains the middle of 2015. We don't think it is earlier because Chairman Yellen is known to have a strong social conscience. We think it doubtful that she will move without being rock solid sure about the continued strength of the economy. Two important thoughts about the future of equities, both positive. First, many institutional portfolio managers are charged with beating the CPI and some percent such as CPI +3. Interest rates are so low (the 10-year Treasury below 2.5%) that they are forced into the equity as a yield vehicle. Second, CalPERS' decision to abandon hedge funds seems to put the ball back into the hands of the long-only crowd which, in our view, is very positive for equities.

The Week Ahead:

- **MONDAY**: Italy Industrial Production (m/m) expected at -0.20%
- **TUESDAY**: Russia Trade Balance expected at 15.7B, South Africa Manufacturing Production SA (m/m) expected at 1.90%
- **WEDNESDAY**: EC Industrial Production SA (m/m) expected at 0.70%, US Wholesale Inventories (m/m) expected at 0.20%, Japan Machine Orders (m/m) expected at -1.20%
- **THURSDAY**: Germany CPI (m/m) expected at -0.30%, France CPI (m/m) expected at -0.10%
- **FRIDAY**: US Retail Sales Advance (m/m) expected at 0.20%, US Retail Sales ex Auto and Gas expected at 0.50%, US Business Inventories expected at 0.20%