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ECONOMIC COMMENT – NOVEMBER 19, 2013

Since the beginning of 2013, the Standard & Poor's 500 Stock Price Index has gained some 25%, far outstripping the estimated 4.5% increase for overall economic activity – as measured by the GDP – and a similar advance projected for corporate profits after taxes. Equity prices, it would seem, have become disconnected, not only from the economy as a whole, but from corporate earnings as well. What accounts for the evident upsurge in investor confidence and sentiment?

To a considerable degree, the recent rise in equity prices has reflected the market's conviction that Federal Reserve policy will remain highly accommodative for some time to come. Put another way, fears of rising interest rates – and a decline in equity valuations – have faded in the wake of statements by Federal Reserve Chairman Bernanke and others indicating that a fundamental shift of monetary policy was unlikely any time soon.

The equity markets were cheered by news that real GDP in the third quarter of 2013 climbed at a yearly rate of 2.8% -- the largest quarterly increase since the third quarter of 2012. However, a large part of this gain – .83% – was attributable to an increase in the rate of inventory accumulation from $56.6 billion in the second quarter to an unexpected $86.0 billion in the third. Some part of this increase may well have been involuntary in the sense that sales failed to meet expectations. Should this be the case, we could well see a cut-back in the rate of inventory building during the fourth quarter and, as a consequence, a smaller increase in real GDP. In point of fact, real final sales of domestic product – a good measure of the strength of final demand in the economy – increased at a sluggish yearly rate of 2.0% in the third quarter, which was slightly below the increase of 2.1% in the second.

Investors were also encouraged by a larger-than-expected increase of 204,000 in payroll employment during October, as well as a substantial upward revision of 60,000 to the employment figures for August and September. It might be noted, however, that 46% of the October increase in employment was concentrated in just two industry categories – retail trade and leisure and hospitality. In other words, the October advance in employment, while very welcome, was somewhat less than broadly based.

In sum, we believe it would be very premature to conclude that recent statistics on economic activity are signaling a faster rate of GDP growth over the immediate months ahead. There is, in our view, a not insignificant possibility that next year's gain in real GDP will fall short of the 2½% increase now embedded in most forecasts of economic activity in 2014.

Meanwhile, the equity markets are being primarily driven by speculation as to when and how the Fed. will begin to scale back its controversial large-scale asset purchase program. From our perspective, a rising trend of equity prices, which, to a significant degree, is based on the expectation that Fed. policy will remain highly accommodative for an indefinite period of time, carries the risk of a stock market bubble – and a pull-back in equity prices. That risk, we believe, will increase as long as Fed. policy continues on a path of extreme monetary ease.

Our views are clearly at odds with those of Janet Yellen, who will be the next Chairman of the Federal Reserve. At her confirmation hearings before the Senate Banking Committee, Ms. Yellen played down the possibility that the current Fed. policy might be leading to bubble-like conditions in the stock market and elsewhere in the economy. We remain concerned, however, that the costs and risks of the Fed.'s present policy stance are far exceeding the benefits, which are now extremely small. Notably, we doubt that monetary policy can be effective in addressing the vexing problem of high unemployment which, to a considerable extent, is the result of technological innovation and globalization.

All in all, the current situation and outlook argues in favor of a circumspect approach to the economic markets.