NORTHWESTERN MUTUAL WEALTH MANAGEMENT COMPANY

MARKET COMMENTARY

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Applying the brakes on takeoff . . .

Older travelers like myself may remember the days when Lockheed was in the commercial aircraft business and manufactured a wide-body aircraft known as the TriStar L-1011.

Lockheed delivered 250 TriStars between 1968 and 1984, but today there are only three in service. The L-1011 was known for its vast structural weight and poor fuel consumption, plus its Roll-Royce engines were specially designed to get it off the ground. The one I had the chance to fly on never did.

My maiden voyage on the TriStar in the mid-1980s was supposed to be a routine flight from Phoenix to Chicago, but it was anything but routine. The pilots positioned the plane on the runway for takeoff, the engines roared and we began to accelerate. Three-quarters of the way down the runway, just as we were approaching takeoff speed, there was a loud shriek, and a plume of white smoke enveloped the entire 164 feet of fuselage. Apparently, the pilots locked up the brakes; the L-1011 was not designed to brake at full thrust, so the plane temporarily veered out of control before skidding to a stop at the end of the runway.

The passengers were in a state of shock as we were ushered back to the gate. It was several hours before the plane would be allowed to fly. You see, the brakes on a 500,000-pound L-1011 take a long time to cool after being locked up. It didn't matter much to me since I had no intention of getting back on that plane. Oddly, we were never informed as to why the pilots decided to abort the takeoff. Perhaps another aircraft crossed in front of us from an adjacent runway. Maybe a flock of birds appeared on the radar. The pilots might have received instructions from the tower or seen a warning light on their console. Bottom line: We'll never know.

U.S. economy hits the runway

As we get ready to begin the third quarter, it appears as if the United States economy is poised to take off for the umpteenth time since the financial crisis. Once again, the inflation hawks are calling for the Federal Reserve to apply the brakes and raise its benchmark rate, which has remained near zero since 2008.

Historically, at current employment rates, wages begin to accelerate. However, that hasn't happened yet. Isn't employment a lagging indicator? Are

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structural changes to employment distorting the data? As was the case with the L-1011, we may never know, but it's clear that the Fed intends to move away from its highly accommodative zero interest rate this year (even if, as its Chairwoman Janet Yellen has recently emphasized, at a snail's pace), and employment strength provides the necessary excuse.

Warning signs

The International Monetary Fund thinks that global conditions are too fragile for the Fed to advance. Economic growth in the developed world has been unable to attain escape velocity, primarily because debt levels remain high and demographic trends are unfavorable. Technological advancements also threaten the jobs of unskilled and uneducated workers. In addition, slower growth has resulted in wage pressures and a collapse in commodity prices, notably oil. Abundance, rather than scarcity, has been the prevailing trend. The risks of deflation, having abated temporarily, are still lurking. In sum, applying the brakes too soon may stall the modest progress that policymakers have made in restoring conditions to "normal" since the crisis ended.

Weighing the ups and the downs

The developed world is playing defense in an attempt to sustain higher standards of living relative to developing countries. In the absence of growth, policymakers have resorted to expanding entitlement programs, which are largely unfunded. Central banks have accommodated politicians by providing unprecedented liquidity, which is promoting greater wealth disparity. Without a larger pie to divide, constituents are forced to fight for their fair share. Lower interest rates are having the unintended consequence of promoting greater savings at the expense of consumption. In the plus column, the U.S. savings rate has doubled to 5.6% since the financial crisis, but with rates so low it takes more capital to reach the same savings goal.

In emerging markets, slower growth has led to the realization that it's going to take longer to improve lifestyles. Populations, however, are increasingly impatient. Social media has narrowed the information gap at the same time the economic gap is widening. The result is that real-time video feedback makes the difference between the haves and the have-nots seem more profound – and, in their eyes, unjust.

For years, U.S. investors believed in allocating equity investments to emerging markets, particularly China; Europe was viewed as a destination for fixed income investors; and foreigners have been attracted to U.S. investments, particularly in light of the strong dollar.

Economic conditions converge

For starters, central bank policy is diverging. The markets are again pricing in an interest rate hike by the Fed by year-end, and Russia and Brazil are in tightening cycles. Meanwhile, Europe, China, India, Indonesia, Turkey, Poland and Peru have recently eased policy.

So economic conditions are converging. Global growth is moving to a moderate pace of 2.5% growth throughout the developed world and 5% in the developing world, well below the latter's norm for the last decade or so. The slower pace of growth mitigates inflation risks and can favor fixed-income investments, particularly where growth is likely to slow, as is the case for the U.S., Russia, and Brazil. Europe and Japan should attract equity capital as growth prospects improve, but China is likely to disappoint. For most emerging markets, fixed income at current spreads appears more attractive than equity for the intermediate term.

A look ahead

This is the point of the cycle when policy errors tend to occur. Up until now the Fed was willing to overshoot and let things overheat. The Central Bank of Australia prematurely tightened in 2009 only to change course in 2011. The European Central Bank and Sweden tried to apply the brakes in 2011 and were forced to hit the accelerator in 2012. If you tighten too early, you risk an economic contraction that could be difficult to reverse. Confidence is fragile, and it takes time to restore it. Cooling off the brakes on the L-1011 is just the start of a long process of getting passengers comfortable enough to risk another takeoff.

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