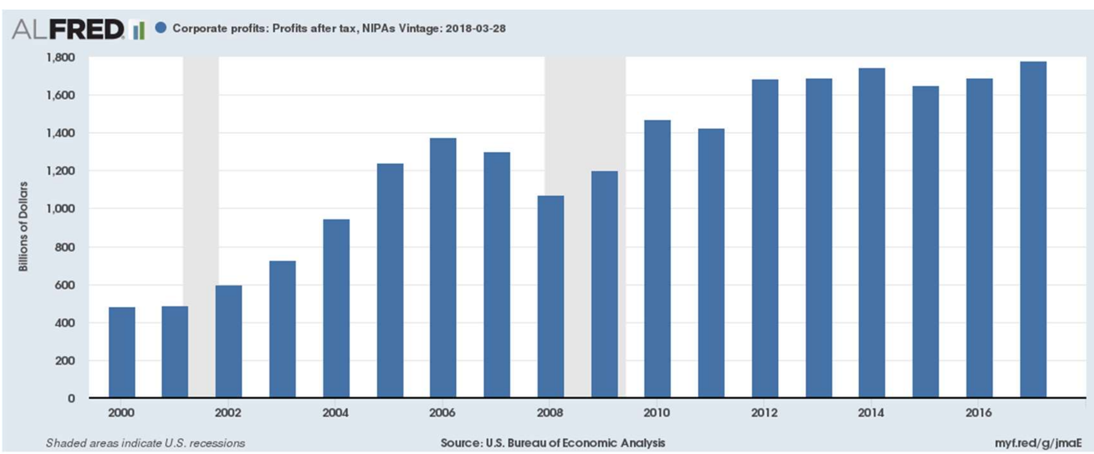
Financial Markets Perspective
April 2018

The Fiscal Policy Adjustment: Make America Great Again!

A New Experiment in Modern Capitalism

In the second quarter of 2016, our Financial Market Perspective entitled: "The Fiscal Policy Vacuum," highlighted that federal government policies to accelerate economic growth had been centered in monetary policy and low interest rates. Fiscal policy, federal government spending and taxing policies were not sufficient to accelerate domestic growth. The main thrust for growth during the years 2012-2016 were the advances of oil and gas hydraulic fracturing, otherwise known as "fracking." The resulting increase in domestic energy production contributed to a collapse in world oil prices and a reduction in oil imports.

Corporate America has benefited from lower interest rates by allowing it to refinance debt at lower levels and profited from unusually low inflation. These lower costs have contributed to an Industrial Renaissance in the Rust Belt states in the Midwest and Northeast. Also referred to as the "Manufacturing Belt," "Factory Belt" and "Steel Belt," this area prospered in the late 19th-20th century with the booming steel and iron industries. During this time the United States was focused on industrialization and globalization. Today, large chemical and plastic producing facilities have been born in the Midwest with the associated growth in jobs and wealth. After adjusting for the hit to energy-related companies due to the oil price collapse, corporate earnings have continued to accelerate as seen in the chart below.



Adjusting to a New Political and Economic Order

The economic policies of President Trump are diametrically opposed to the economic policies of the previous administration. For investors, the new policies favor stock market investments and the corporate sector. The first major policy initiative of the new administration was broad-based reductions in regulation—otherwise known as "Cut the Red Tape". While some regulations make sense, there are many that are time consuming and costly. These additional expenses end up increasing the prices consumers pay for goods and services. During his first year in office, the president has surpassed expectations for cutting regulations. Some estimates of savings due to these cuts are as high as nearly $2 trillion annually, which equates to savings of nearly $15,000 per household per year. Getting rid of complicated and unnecessary regulation creates a simpler system that contributes to all Americans' ability to spend or save more. Small business owners also benefit from more growth, investment and productivity.

The second important initiative was tax reform—otherwise known as the "Tax Cuts and Jobs Act". The overhaul is forecast to raise the federal deficit by nearly $2 trillion over the coming decade. The law cuts corporate tax rates permanently and individual tax rates temporarily. These cuts will likely benefit both corporations and workers and result in more wealth and income. These benefits are already showing up in record consumer and business optimism, rising employment and an upturn in compensation. One of the metrics we monitor in our stock selection process is out-year earnings expectations. In a recent evaluation of the stocks on our Approved List, almost 70% of these companies have had their earnings forecasts raised by Wall Street analysts.

The latest experiment in "Making America Great Again" is President Trump's threat of imposing tariffs on steel and aluminum imports. These tariffs and other import penalties are designed to benefit domestic producers at the expense of consumers. While financial markets recently convulsed at the thought of another 1930s type of economic decline, the president's progress in seeking unbiased, reciprocal trade agreements is finally beginning to gain traction. The jury is still out on whether the deal-making president will pull off more favorable trade agreements and as we wait to find out financial markets are experiencing amplified volatility.

The recent agreement between President Trump and Congress to increase spending this year to a record level of $3.76 trillion is another step to provide stimulus to offset a "tighter" Fed policy that is increasing short-term interest rates. The president's forecast of a $392 billion deficit associated with this budget will add additional stimulus to an economy that is already expected to grow by more than 2.5% for the balance of the year.

Trade Protection and Tariffs

Financial markets have a long memory. When tariff conversations come up, we often hear of trade wars, a global economic recession or worse. The reason is that the Great Depression was accelerated by a trade war between Europe and the U.S. On one hand, the tariff advocates say that they must step in and protect U.S. producers while, on the other hand, the trade war theorists tell us that any type of trade restriction will invite retaliation by our partners. As we said in two Market Missives written in March, all nations have some form of protection in place—mostly a function of industry lobbyists. To get a clearer picture as to what happens with trade barriers, here is a quote from the late Milton Friedman as reprinted in a Wall Street Journal "Notable and Quotable":

"Let us suppose, for a moment, that the Japanese flood us with steel. That will reduce employment in the American steel industry, no doubt. However, it will increase employment elsewhere in America. We will pay for that steel with dollars. What will the Japanese do with the dollars they get for the steel? They aren't going to burn them. They aren't going to tear them up. If they would, that would be best of all, because there's nothing we can produce more cheaply than green pieces of paper. And if they were willing to send us steel, and just take back green pieces of paper, I can't imagine a better deal!

But they're not going to do that. They're not stupid; they're smart people. They're going to use those dollars to buy goods and services. They're going to spend them. In the process of spending them, they may spend them directly in the United States, and that directly provides employment in the United States. They may spend them in Brazil or in Germany or in China or anywhere else. But whoever gets them in turn is going to spend them. So, the dollars that we spend for the steel will find their way back to the U.S. as demand for U.S. goods and services. You will have less employment in the steel industry; you will have more employment in the industries producing the goods we export. Overall, total employment will not be affected. But overall, the American consumer will be benefited, because he will get the steel more cheaply, and the goods made from the steel more cheaply, than he otherwise would. That's the benefit to the American consumer…

You very often bring out the logic of an argument by carrying it to an extreme. You know you could have a great employment in the city of Logan, Utah, of people growing bananas in hothouses. If we had a high enough tariff on the import of bananas, it could become profitable to build hothouses and grow bananas in those hothouses. That would give employment. Would that be a sensible thing to do?...

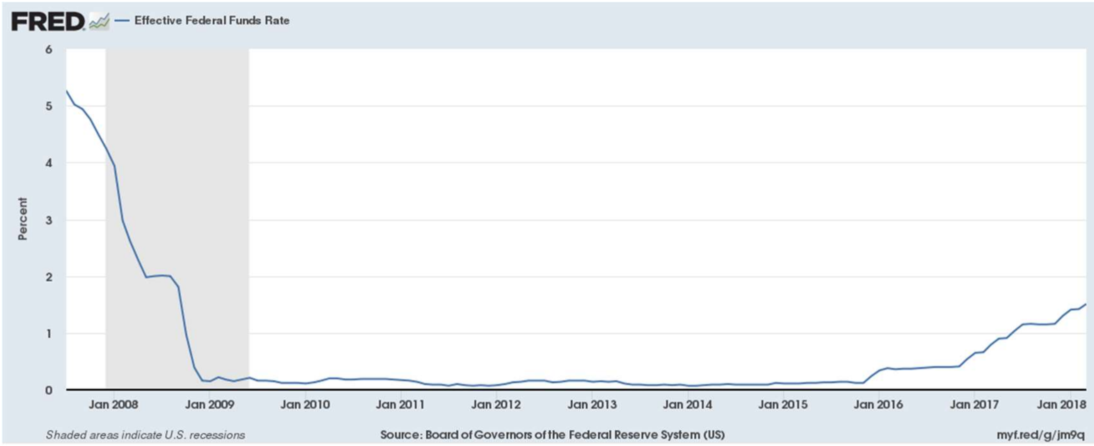
Now with respect to the charge that the Japanese government is subsidizing the export of steel. Number one, it's very dubious that it's true, but suppose it were true. Then that would be a foolish thing for the Japanese to do from their own point of view. But why should we object to their giving us foreign aid?"

As we write this perspective, negotiations are underway to change the policies with our trade partners to "level the playing field." If we can get our partners to lower their trade barriers, the benefits will accrue to both U.S. producers and consumers. However, if trade barriers are not renegotiated, there will likely be continued volatility in financial markets.

Interest Rates, Inflation and Fed Policy

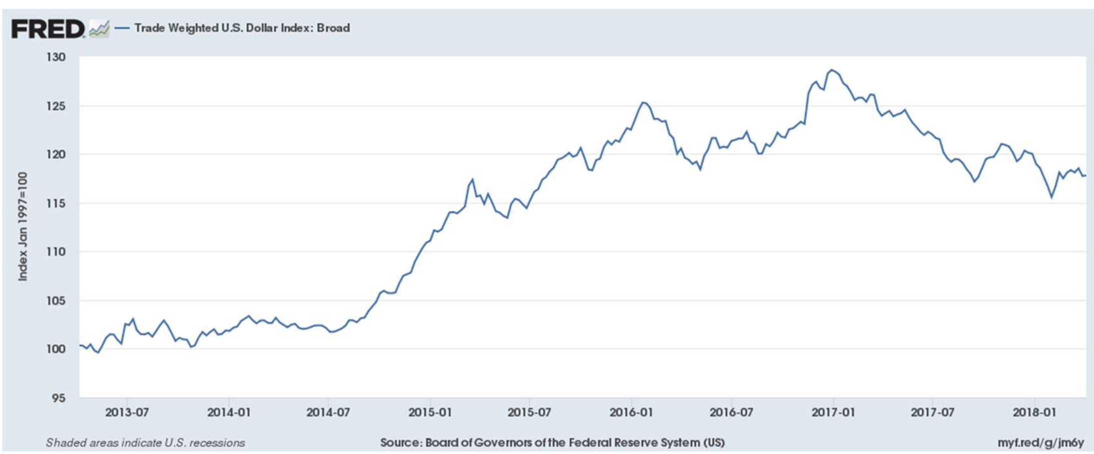
The Federal Reserve's mandate is to maximize employment, stabilize prices and control inflation. Since the economic recovery is in its 8^{th} year and unemployment is at 4.1%, Fed officials decided it was time to begin raising interest rates. For the fifth time since the financial crisis of 2008, the Federal Reserve has increased interest rates another quarter of a point to a range of 1.25% to 1.50%. These increases mean that consumers will pay higher rates on loans, mortgages and credit cards. More importantly, these rate hikes signal that the central bank is confident in the strength of the economy and they are ready to push rates back up to more normal levels. The chart on the following page depicts the fed funds rate and how the Fed kept rates so low for so long.

In February, the new Fed chairman, Jerome Powell, told Congress that the central bank remains on track to continue increasing interest rates gradually to keep the economy functioning smoothly and since fiscal policy is becoming more stimulative, inflation would rise this year and stabilize around the Fed's 2% target.



On the other hand, long-term interest rates (as measured by the 10-year government bond) have not risen much. At the beginning of the year the yield was 2.46% and at the end of the first quarter the rate was 2.74%, an increase of slightly more than one quarter of one percent. This small increase is telling. Given the length of this business cycle, one would expect to see indications of rising inflation expectations - as measured by rising long-term interest rates.

Ironically, both tariffs and higher interest rates contribute to inflation, as do government regulations. The small increase in long-term rates suggests that inflation is not a threat in the intermediate term. Another likely contributor to inflation is a weaker dollar. After falling in value for all of 2017 (shown in the chart below), the dollar has stabilized so far this year—reducing the threat of inflation.



Additionally, when oil prices rise, as they have over the past 12 months, prices of imports rise accordingly and contribute to inflation. However, it appears oil prices are stabilizing in the $60-$65 range, taking pressure off the price of oil's contribution to inflation.

The Federal Reserve looks at the data and sees a growing economy, lower unemployment and moderate inflation. As a result, the outlook is for higher interest rates as the Fed attempts to handle inflation before it gets out of control. Given that inflation is not surging and is not expected to do so, Fed actions on the interest rate front are likely to move in slow motion.

Financial Market Whirlwind

The first quarter of 2018 was characterized by violent swings in equity markets after a solid gain in 2017. We call it the Charlie Brown quarter as seen in the zig-zags in his t-shirt. January started out with continued gains in equity prices as most major market indices eclipsed previous records. Optimism over the president's tax cut plan and rising corporate profits provided the story behind the "Goldilocks Economy" and expectations for even greater stock market gains through the end of 2018.

February turned out to be a reversal of the gains of January as a hawkish Federal Reserve policy, fears of a North Korean nuclear confrontation and political turmoil turned investor optimism to pessimism and broad market indices retraced most of January's gains.

As the fear of a North Korean confrontation dissipated, markets rallied again taking the NASDAQ index back to record highs in mid-March. President Trump then made the surprise announcement about steel and aluminum tariffs and the market turned down again. To complicate matters, two "Modern Day Disruptors" (see below) came under pressure, prompting fears of government intervention and increased regulation.

Many market observers view recent swings as a sign of a consolidation/correction in a continuing long-term bull market in stocks. The fourth quarter revision in real GDP to 2.9% up from 2.5% indicates that the underlying economic fundamentals are intact.

Investors are mesmerized by the recent wide swings in the stock market. Back in the day, (and we won't say what year) a ten point move in the DJIA during a session would be considered an eye-opening event. Today 100, 200, and even 500-point swings are within a "normal" daily range. These price fluctuations are accelerated by traders and large financial institutions that trade on smaller market moving events. Market volatility was low for most of 2017 but has returned with a vengeance in 2018.

Modern Day Disruptors

Not all stock market investors are benefitting from an improving economy. Several behemoths (notably Amazon and Facebook) that dominate their industries have recently come under scrutiny for different reasons. Amazon has changed the face of retailing and continues to be at the forefront of developing the retail model while forcing smaller companies to either merge or go out of business. The company's Web Services arm controls a little more than a third of all cloud-computing capacity while it's Prime Service streams Oscar-winning movies. Additionally, the company just acquired Whole Foods Markets to branch out its Marketplace business line. Overall, Amazon enjoys a dominant footprint in one area of the market and uses that footprint to leverage its way into other markets. Recently, President Trump unleashed a tweet storm against Amazon expressing his concerns about the company's state tax collection practices, what it pays the U.S. Postal Service for deliveries and the "fake" Washington Post (which is owned by Amazon's founder and CEO). These threats are undermining the confidence of Amazon's investors and have wiped off more than $60 billion in market value.

Facebook is also facing a crisis after admitting that Cambridge Analytica may have information on nearly 87 million Facebook users without the users' knowledge. Most users thought that Facebook was essentially an internet tool to communicate with friends and family. Politicians are up in arms over this invasion of privacy and financial markets have recoiled. As a result, Facebook's stock has been pummeled, shaving more than $80 billion in market value as of this writing. There could be major implications for the company's business model which is based on selling user data to app developers and advertisers. The company has stated that they will try to limit what kind of information third-party apps will be able to collect. The company will no longer allow apps within their service to see personal information about users, such as religion, political views, relationship status, education, work history, fitness activity and what books, movies and music users have consumed. The important point about these two cases is how much the government will intervene in situations like these, which industries will be affected and how investors will respond.

Conclusions

The fundamental underpinnings for a continuation of the bull market in stocks remains intact. The short-term problem is that there have been several one-off events that have triggered increased trading volatility and wider stock market swings. International tensions coupled with prospective government intervention in corporate management have constrained growth expectations of a few large companies and contributed to increased volatility in the stock market. Short-term reactions such as these justify being a long-term investor.

We remain encouraged by the prospect of a faster growing economy due to tax cuts and increased government spending. While the Federal Reserve will be leaning against faster growth, their policies so far have had a minimal effect on the economy although there has been some weakness in various bond investments. While some investors fear a surge in inflation, there are few indicators that inflation is likely to significantly increase. Ironically, the justification for tariffs is the excess global production of steel and aluminum, which ultimately leads to lower, not higher prices.

As our favorite chief market strategist Tony Dwyer said: Time to buy the “Whoosh.” The next few months that may contain multiple “whooshes and ramps” will be no different. Each will feel like the fundamental backdrop is at risk, only to realize that the economy driving tailwinds still exist. These tailwinds include:

- solid global growth;
- accelerating domestic activity;
- improved capital spending;
- rising real household median incomes; and
- strong employment.

Amen!

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