Division & Opportunity

John M. Gustafson – 30 September 2017

"Discussion is an exchange of knowledge; and argument an exchange of ignorance." - Robert Quillen

As the tumultuous month of September brings the quarter to an end, our financial markets continue to chug higher in almost blissful ignorance to the daily headlines and breathless reporting on the television of our many ills. Thankfully the continued social-unrest continually driven by the Tweeter-in-Chief has failed to cause any financial damage. In fact, I'm going to keep any and all politics out of this quarter's note that don't directly deal with economic or financial market issues.

The biggest discussion throughout most of 2017 has been fearful hand-wringing about stock-market overvaluation. I'd like to put that into a little perspective and compare our current environment to that of the late 1990's, which most of us remember - and also reiterate as to why we diversify over multiple asset classes and countries / regions of the globe.

Currently the S&P 500 sits at approximately a 16 price-to-earnings ratio (PE) - the all time peak was 24 times earnings at the height of the internet bubble - around the turn of the century. If you eliminate those outliers, (the dot-com era) the historic-average PE ratio is 14.5 and the peak is 21, so even without that bubble / outlier, we are on the high end of the curve but nowhere near a bubbly-peak. And if the tax breaks in the wind do ad a few points of economic growth in the near future, this can remain the case for multiple quarters ahead. Remember, we are never in a static environment...

One other characteristic, slightly different than at the recent peaks, is the distribution of the overall market average return. Back in the late 90's, there was a year that the S&P rose more than 20%, but because of the way most averages are weighted, the reality was that 18 stocks (all technology) accounted for 101% of that return - the remaining 482 did zero. (or slightly less than zero) The current markets show positive returns nicely dispersed across 8 of the 11 industry grouping. Very reasonable balance and again, not "bubbly."

Now that we've looked at the statistics, let's go back to more of the touchy-feely / intuitive view as to why we continue to grind higher. *Everyone* is looking for a bubble! (despite the mathematical argument I just outlined against it) The articles on most of the major financial websites as well as the print-options talk about the risks of a drop almost daily. That is NOT the behavior of the media or the public near a peak.

Back in 1999, we had commercials about tow-truck drivers owning private islands and interviews with day-traders on TV and in the Journal. In 2007, we had multiple shows on financial TV about flipping houses and nobody batted an eye. Now, all we hear are about is what could go wrong, strange indicators of doom from the chartists and a general lack of belief in what we're seeing. Those are not the same, frothy environments that lead to disaster. That also doesn't mean we won't see a normal correction at some point - it simply means that it is unlikely to be disastrous without an outside shock. (assassination, nuclear exchange with a rogue nation, etc.)

Another logical argument against a bubble is the Federal Reserve. After years and years of basically propping up the bond market and keeping rates low with their purchases, they finally feel confident enough in our economy to start to let their balance sheet return to a more normal level. This has also been described in outrageous and fearful terms but may not be as impactful (or hurtful) as once feared.

First, the Fed wold not have moved at all if they felt there was slightest risk of a recession - we have been discussing and debating this policy change for the past several years. Fed Chair Yellen said there is a "high standard" for stopping the liquidation of their assets once underway. That is absolutely true - it would signal a pending disaster and an immediate and critical vote of no-confidence to our economy. In fact, if the White House wants to make sure there are no market disruptions or confidence issues caused by the Fed, Janet Yellen should be re-nominated in order to keep a "Dove" in the chair. Stay tuned...

In terms of hard numbers and what kind of impact we're talking about to the bond market, the Fed's balance sheet is $4.5 Trillion currently and expected to fall to around $3 Trillion. Still significantly higher than a decade ago, because the economy has grown and their reserves and those of the banking system are calculated using that metric. Also, it may not put the pressure on rates expected simply because banks will be forced to buy treasuries for "quality" assets on their balance sheets as those metrics shift as well.

The big news out only days before I sit here writing is of course, tax reform. This is one area where the President and his staff do have significant expertise and one of the few subjects Trump can speak about coherently. There has been tons of spin in the media since the announcement - both good and bad - but here's my take:

The White House proposal is just that, light on details, but specific in intent as to how they would like to change the system. The biggest cut proposed is to take the top corporate rate from 35% down to 20% and it has been called a "red line in the sand" by the White House and Paul Ryan. Democrats as a rule never seem to like the sound of cutting taxes to large companies, but I always have to ask, "who do you think creates all of these jobs we would like?" The Government can either be slightly difficult to deal with or completely impossible - this is a step toward making it only slightly difficult to do business and create jobs. If this cut can be partnered with some sort of incentive to repatriate earnings parked abroad because of the tax burden, it is a home run in terms of economic growth waiting in the wings. And that kind of growth is not short term. Once those companies commit, it's a long-cycle move.

The rest of the plans, geared more toward individuals does seem to have good intentions and is loaded with plenty of "give-ups" for negotiation purposes. The most interesting proposal that I'm looking forward to seeing is the lower tax brackets. The President basically said that the first $24,000 of income for a married couple would not be taxed. However, much of the media has taken this to mean the standard deduction was being increased, which only really helps those who don't itemize. Those are two very different ideas and it will be interesting to see what is actually in the bill once politicians and lobbyists get their hands on it.

On the "give up" front, I would be very surprised if a final bill lowers the top rate for individuals and also if the estate tax goes away fully. Those proposals seem to be in there clearly to allow negotiation to get the Corporate cut and other stimulative pieces in the bill. The argument against the "death" tax is always farms and family businesses - things that can be easily defined for exemption with means-testing and such if they really want to solve that problem.

Also, Mnuchen has been saying for months that tax reform will be done this year. Not sure that's possible, but at least it seems to be something that everyone in the do-nothing Congress agrees is a priority after spectacularly flailing and failing when it comes to healthcare reform.

An interesting wildcard on the horizon, steadily creeping closer are the 2018 midterm elections... I haven't fully looked into the House polls and such (which would be wildly incorrect at this point anyway) but the likelihood of a drastic change in the Senate is fairly unlikely. Regardless

of what chaos the President causes or threatens, the mix of Senators up for reelection doesn't lend itself to much drama other than the Republicans picking up a couple of seats. Of the 33 Senators on the ballot next year, 25 are Democrats (likely because of Obama in 2012) and 10 of them live in states where Trump won last year. It will be an interesting test to see if Trump can swing the Senate more in his favor, but again it is unlikely to go the other way. At this point it appears as if things will remain the same or the GOP will pick up a few seats - the House will be the real test. Stay tuned...

The final ongoing political battle that will affect the markets are the labor force issues we are experiencing. Those of you who may remember a microeconomics class from college know that "full economic employment" is thought to be somewhere between 4%-6% unemployment. Sounds counterintuitive, but the reality is that there will always be a segment of the workforce who can't perform the jobs available or who are not in the correct area to land one. That is where we sit currently and have since the middle of 2016.

Here is where campaign rhetoric and populism has the ability to bog down any fiscal benefits from tax reform. There are certain areas of the country with hundreds if not thousands of jobs that simply can't be filled - either because of pure lack of bodies (construction jobs in hurricane areas, for example) or because of a lack of specific skills. This is the reason we need "legal" immigrants and the constant sniping back-and-forth is detrimental to the health of our economy. The media characterizes one side as not wanting to allow anyone into the country (not true) and the other side as seemingly being fine with the idea of no border controls whatsoever. (also not true)

As mentioned, if this issue isn't ironed out, it almost won't matter what else is done in D.C. - the growth fire simply won't light and worse yet, no company will repatriate a ton of cash if they can't deploy it to enhance their operations for lack of a proper labor force - either in numbers, skill set, or both.

A strange holdover problem from the 2008 financial crisis helps to feed this issue as well. The American workforce used to be very mobile - willing and able to move to opportunity. When things fell apart in '08, that mobility was halted and hasn't yet returned to prior form. Real estate has become more normalized, but nowhere near the historic averages. Simply another item on our radar as we continue to monitor our strategy and trim the sails as necessary.

Thank you, as always for your trust and your business - Cheers!