Moore's Law for Politics & Society

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Back in the mid-1960's Gordon Moore, the co-founder of Intel noticed that computing chip capacity had basically been doubling every two years since their invention as widespread use grew. His theory was that this pattern would continue - smash-cut to 50 years later and he's been correct the entire time.

This pattern of rapid change has also been appearing over the past decade in news, politics and the economy. The current President pumps the Twitter bellows and pours accelerant on the fire of change whenever he can. However, dealing with people rather than silicon chips can make things not as set in stone and perception doesn't always meet reality. It is why our current time has been dubbed the "post truth era."

Despite the political noise to the contrary, the U.S. economy has risen consistently since falling into the abyss of 2008. The pace was slow because of the excessive, uneconomic regulatory environment imposed under the Obama administration. The passage of the Trump tax cuts last year as well as the flurry of Executive Orders, basically undoing much of the regulation, has pushed us to max economic capacity in the short term.

Taken individually, either action would have strongly pushed the throttle on our economy, but both implemented together have been like rocket fuel. So, what's the problem? After a solid year in 2017 a slight pause to digest the gains was expected, but we are now halfway through 2018 and are almost completely flat other than the large technology companies. To me, it appears very similar to 1999 - almost all of the total return in the S&P this year is concentrated in a small group of large technology stocks. Not quite as dangerously concentrated as '99, but not great, from a "healthy market" perspective. Unlike the tech bubble of the 90's, the current situation can be summed up in one word – tariffs.

Just as businesses were making plans to spend their vast amounts of retained and repatriated wealth after the tax cut, global trade has been turned on its head, sapping confidence and halting long-term thinking. With trade war threats popping up daily, outlining dramatic changes both on the American side and from foreign retaliation, companies simply can't make long-term plans - or the plans must now change to deal with the new barriers. And like many things in current politics the devil is in the details.

Let's look at one of the President's favorite targets in his Twitter blasts, automobile tariffs in China. The number he quotes is "cars" from China to the U.S. are charged to 2 ½% tariff, whereas American cars being exported to China are charged a 25% tax. Those numbers are theoretically correct, however it very specifically says “cars,” because if you dig deeper on the laws, any trucks being imported from China into the US are also charged 25%. And the reality is that for every one car coming from China to the U.S. there are six cars going the other way. Finally, almost none of the cars coming from China are actually Chinese branded cars, the majority of them are built by Volvo.

I’m not interested in turning this into a tit-for-tat political argument; I’m merely trying to point out that when it comes to complex economic systems, broad facts are more important than insignificant minutia. Also, because of the current labor tightness in America it’s not as if we have the excess capacity to simply just start selling China extra goods and services. They would have to be taken from another customer - simply agreeing to “buy more things from the U.S.” doesn’t really solve anything, especially when many of the raw materials to produce goods here in the U.S. initially come from China anyway. These trade wars are nothing but political nonsense to throw raw meat to ardent supporters and the end result, if politicians don’t come to their senses, is going to be a significant slowdown in not just the American economy but also to economies around the globe.

Large, multinational corporations can work their way around tariffs and eventually find other suppliers. That doesn’t mean that those raw materials will come from America either, they simply may not come from China. What would be more effective from an economic policy standpoint rather than straight tariffs and taxes? Policy that encourages supply-chain diversification - especially from a “national security” perspective. There is no simple, easy fix to issues this complex.

Who is going to be truly hurt if this continues? Small companies in the U.S. who source their base materials from China or other foreign countries that cannot afford the hit to their profit margins. If you throw any sort of leverage into their financial mix, they might just be forced out of business. It will be interesting to hear those stories begin to percolate going in the fall if things don’t change. Stay tuned…

Most people have heard of the Hawley – Smoot tariff bill of 1930. It was also a political boondoggle by Republicans to claim they were “fighting for American jobs.” The long title of the bill is, “An act to provide revenue, to regulate commerce with foreign countries, to encourage the industries of the United States, to protect American labor, and for other purposes.” (Is it just me, or are these Bill-titles just self-aggrandizing nonsense?) Most economists agree that this law alone didn’t cause the Great Depression, but it deepened the crisis and also prevented a quicker recovery. Barriers were of course put up in almost immediate retaliation by trading partners around the world. Sound familiar?

The dangerous irony is that politicians almost 100 years later are still trying to convince the rank-and-file voter that trade wars can simply be won without significant interim damage to both sides. A concerning fact for any supporter of the President should be that Sen. Sherrod Brown of Ohio, someone who couldn’t be farther to the political left, is currently running ads that are 100% in line with the President’s protectionist tweets. Sen. Brown joyously describes how he has voted “against NAFTA” and almost every other “bad trade deal” throughout his Senate career. Politics does make strange bedfellows…

As mentioned at the beginning of this note, the President spent his first year pouring rocket fuel onto the economic fire, but is now using an equally powerful fire extinguisher. If this trade rhetoric continues to ramp higher I will become significantly less confident in the stock market over the intermediate term. All the repatriation of cash is going to be used for stock buybacks and dividends, rather than expanding businesses - the strategic planning environment is cloudy and returning funds to shareholders is always popular. This should be able to keep things plodding along in the markets for awhile, but eventually that ammo will run out.

The second major concern that could put cap on economic growth is unemployment. America is currently in a situation where there are more posted job openings than there are people who are considered unemployed. Remember, to be considered “unemployed” (in an economic sense) you have to be “actively seeking employment” – those who are voluntarily out of work or retired are not. A significant factor that’s difficult to deal with is that where the jobs are located is not necessarily where the people who need them live. Simple tax policy can’t fix that. This of course, gets us into the sticky wicket / hot button issue of immigration. Yet another area where the screaming media and politicians (mostly those on the left at this point) are causing the most harm.

People streaming over the border by the thousands illegally should easily be seen as a completely different issue than allowing in highly skilled and productive foreigners to help drive our economy. However, the signal-to-noise ratio is such currently that both sides are painted to be absolute in their positions of everyone *in* or everyone *out*. Again, putting politics aside I’ll leave this topic without further elaboration so as not to cloud my message with emotional reaction. I will say, if immigration policy isn’t corrected, there is almost no chance of sustained GDP growth greater than 3%, regardless of the global trade situation.

The final hurdle to continued growth in 2018 is interest rates. As you know, the significant rebalancing of our portfolios near the beginning of the year was partially constructed to reduce interest rate sensitivity as well as take advantage of, rather than be hurt by, rising rates. A growing economy brings inflation - period. Inflation remains quite moderate overall at this point, though the screaming headline is a significant rise in oil prices pushing up prices at the pump. (It is good news for us, since our oil investments have been bit of a drag the past couple of years, they now seem to be perking up nicely and delivering capital appreciation along with their big dividends.)

Wages are a real concern. Having remained flat for over a decade we are now seeing large bumps because of the aforementioned tight labor market, especially in labor-intensive service industries. Everyone reading this in Hilton Head Island has seen, heard or read of the effects in the hospitality industry. Businesses there are being forced to offer increases of 20% to 40% just keep the lights on and serve their customers effectively.

Another area where the current administration may run into trouble… Larry Kudlow, economic advisor to the President and former TV talking-head, made rare, quite pointed comments in an attempt to signal the Fed that the White House would appreciate them avoiding any more rate hikes. That sort of thing is generally not done.

Central bankers around the world, at least in democratically controlled nations such as ours, Great Britain, the European Union, etc. are expected to be left alone by politicians, allowing them to simply focus on the health of their native economies and banking systems. Plenty of comments were made in these notes that Ben Bernanke was the reason we climbed out of the 2008 abyss - it was *in spite* of Congress and the Obama Admin, not *because of* them.

This is also a risk I raised back at the beginning of this year when the President appointed his favored pick to be the Federal Reserve chairman, even though he was a philosophical twin of the sitting Chair. Janet Yellin probably couldn't be happier right now… Regardless of what causes any potential slowdown in the third or fourth quarter of this year (trade war, government shutdown over immigration, interest rates, etc.) the tweet storm on Pennsylvania Avenue is going to wash over the bow of the SS Jerome Powell if the Fed continues to raise interest rates to ward off damaging inflation. An easy scapegoat for political cover…

So what do all these concerns mean for our portfolios? Going back to Moore's law and the rate of change in politics and society currently it could mean nothing as we tack away from the rocks - or it could blow up into perfect storm of disaster. We have an economic cushion – which may be why the push is on using such potentially damaging tools. However, things can't remain this uncertain forever without significant problems. And so far, the only issue President Trump has surrendered on was the policy of children illegally crossing the border. There isn't a "moral outrage" angle on trade to change his mind. No drastic changes are required to long-term investments yet, but it's not time to whistle past the graveyard either. It's a time to be vigilant and separate noise (political posturing) from real economic effects.

Another constantly changing variable that deserves our attention is the voting landscape heading into the midterm elections. If the talk of trade wars settles a bit and the economy does keep chugging along, the Democrats continuing move further to the ideological left can't be a wining message in the voting booth. To quote James Carville back in the 1990s, "It's the economy, stupid."

Thinking even longer-term, something that should concern Republicans is that so far the Trump Presidency, in terms of actual legislation passed into law, is basically the same as President Obama. Both burned substantial political capital to pass one significant bill into law early in their first term and then not much else made it past goalie (Congress) thereafter. It's why President Trump has been able to make such significant changes in terms of the regulatory environment. The same thing could happen in 2024 unless some of these policy changes actually become law. Fingers crossed…

Enough concern for now. Heads down - moving forward…
Thank you for your continued trust and ongoing business. Cheers!