Palmetto Wealth Management

Political Disconnect

John M. Gustafson – 31 December 2019

For the past decade in America, Washington politics have driven our economy. Primarily because we looked into the abyss in 2008 after sophisticated financial engineering blew itself to pieces and massive Government tools were brought to bear to pull us out. This also brought with it tremendous rhetoric from party extremes that would swing things to and fro.

Now, however, the markets actually seem to be ignoring the clown show inside the Beltway and purely reacting to financial information - possibly with a slight blind eye to dangers down the road. Just in the past six months we've gone from hand-wringing about an imminent recession (debunked in these notes more than once) to acting almost as Pollyanna in thinking that nothing coming from Washington can sink the ship.

This was a spectacular year in terms of total returns as we launched off the bottom from the 8 week bear market that ended on Christmas Eve 2018. It was driven mostly by tech and healthcare stocks in the S&P 500, but it was still broadly positive. The only news that truly seems to hold sway over volatility for the U.S. stock markets is the trade war with China. Not Impeachment, not the bubbling problems in the Middle East, not the Fed - it's just the trade war that moves the short term needle. A positive report sends things flying; a negative tweet that contradicts the positive report brings things quickly back to earth. Other than that, the sound economics continue to push us onward and upward.

The regular daily tweet-watch from the White House that could drive the markets has also been almost completely muted. It's as if the boy has cried wolf too many times and now it's simply background noise because the pattern remains the same. Lots of screaming, name-calling and threats - then nothing actually happens in the end. Step one - create a perceived problem. Step two - blame the other team. Step three - change course and "solve" the problem created and take credit for it. Most folks now just yawn and look for actual news.

So what are my concerns for 2020? Well, with all of this political discord in the background, companies have been reaping the financial rewards of the continually growing economy (now in its 126th month of expansion) coupled with the corporate tax break of 2017 but haven't been making any strategic expansion plans. Currently, things are not “bubbly” from a valuation standpoint - not cheap either - but we are quickly running out of room for growth.

Why? A few themes we’ve touched on previously… With unemployment this low, there are simply not enough people to fill the jobs necessary to maintain current growth rates for many companies. And the aforementioned trade war with China that changes weekly makes it almost impossible to make long-term, capital intensive expansion plans, regardless of actual capacity needs.

Do I surmise that this will crater the economy and send us spiraling into recession in the next couple of quarters? No, but I don’t believe we will see growth accelerate beyond the rate we’ve seen for the past decade. 1 ½% on the low end and 2 ½% on the high end. That is fine for a mature economy like ours, but that also isn’t likely to drive stock market returns like 2019 going forward - unless there is another short-term correction as we had last year.

In 2008, President Obama had the benefit of coming off the historic bottom created by the ’08 housing (bond market) crisis, dubbed the “Great Recession,” but many anti-business policies put in place kept the brakes on potential growth quite a bit.

Trump then arrives in 2016, pushes through the massive corporate tax cut and starts reversing all of Obama’s Executive Orders with his own - thus throwing fuel on the fire of economic growth. However, he also almost immediately launched a completely uneconomic trade war with China, taxing the heck out of Americans for poor corporate business decisions made over the past several decades, thereby also applying the economic brakes almost as effectively as President Obama.

I’ve been down the tariff-road ad-nauseum in these notes and don’t need to do it again this quarter - however there is an editorial in today’s (Dec 31st) *Wall St. Journal* entitled, “How Tariffs Hurt Manufacturing” that further outlines how the losses outweigh any gains, if you simply haven’t heard enough from me.

What might change? For one thing, 2020 is obviously an election year and who knows what kind of political favors get thrown around by the unforeseen strange bedfellows of American politics. Those jokers have never been more divided, but the one thing they all agree on is the *need* to be reelected.

Also, since Trump has been impeached by the House and awaiting trial in the Senate - he needs a “deal;” some sort of positive news to distract and let people overlook any real or perceived offenses. “Phase one” with China probably isn’t much other than a partial return to the pre-tariff world, and the damage to the farm-belt can’t be reversed in a short period of time, but we know how the White House will spin it. Most business folks will likely ignore the announcement (Currently slated for Jan 15th) as this is a completely fomented problem, but the media cycle will be won during the trial and that’s all that matters in current American politics.

There are a few potential 2020 headwinds that have nothing to do with politics that bear watching as well. Bullish sentiment is at fairly strong levels amongst retail investors as of late. “Fade the public” is a familiar wagering term, but can also apply here. Similar to the “inverted yield curve,” it is an indicator that can flash caution more often than is correct, but something else worth watching nonetheless.

Looking more closely at this issue, when responding to media surveys people speak as if they are quite bullish on stocks, however equity fund / ETF inflows still don’t show anything crazily to the stock-bubble side. In fact, bond inflows actually remain ahead for the year - especially strange in this low-yield environment.

One part of the economic picture that truly makes no sense - and is somewhat political - the fact that we have historically low interest rates, historically low unemployment (to the point it hinders future growth as mentioned above) and tax collections hitting records every quarter, yet we are currently running almost trillion-dollar deficits as far as they eye can see. This isn’t a revenue problem, despite the political narrative - it is a spending problem. One unlikely to be sorted out in an election year in this divided Congress. Someday it will matter a great deal, it’s simply not normal to have an economy this good and run these kinds of deficits. It doesn’t match up with history at all. (Without a world war) Not an imminent threat, but it’s like being on a long-term, bad diet. Eventually the doctor will have to intervene… (Perhaps a great case for term limits in Congress to truly halt this nonsense, but that’s not a topic for this letter.)

Lastly, from the risk side of the story, the market seems to be having a bit of a blow-off top these past few weeks - so don’t be surprised if the first quarter of 2020 is a little sluggish. If something significant is signed with China, that could change, but I think current trade news is baked into the cake at this point. Much will hang on the Senate trial with not much else to drive the news cycle and consumers seemed to gorge at Christmas this year - which is always a drag on early-year spending. More of a short-term bump rather than a cyclical change at this point - just another data point to monitor.

What can keep this party going? Again we return to politics… The divisions are so deep right now from every reason you can imagine that the thought of significant changes in spending or economic policies leading up to the election is a non-starter. From a business standpoint, at least it’s not becoming more-uncertain, even if there are still many wildcards to be played. It remains the “devil we know.” We have all lived in this noisy environment for so long that our personal filters are all becoming more highly-tuned to rhetoric over reality.

That said, external military forces in Iran, DPRK and their new allies in Russia & China can always serve up a nasty surprise. (As I write, they are holding joint war games in the Gulf of Oman to send the U.S. a message.) The temperature is rising as our known enemies become more friendly and once again the word out of D.C. is mixed depending on the side of the aisle on which you sit.

From what I've read the thought of a truly unexpected act of aggression isn't terribly likely, but the low-level, simmering of tensions has not improved either as our enemies and allies shift their positions in relation to the U.S.

I hope I don't sound too doom & gloomy for 2020, I'm simply wired that way. When things are going poorly, I'm looking for the positive way out and when things are rocking and rolling as they are now, I'm looking for possible problems. I like to think of myself a "zagger" and work to avoid the euphoria and despair that these wild market swings project into the world. An old quote seems appropriate to our actions here, "There are three sides to every story - yours, mine & the truth."

With all the noise and bias in what I have always called "the screaming media," even in the business press, we will continue to sift through the rubble and make our non-emotional moves and grind toward long-term success.

Thank you as always for your business and trust. Here's to a fun a prosperous 2020 for us all - the Roaring Twenties are upon us once again! Please reach out with any questions or needs.

Cheers!