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# The Farr View

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**DID YOU SEE US?**

Michael Farr is a regular Contributor on CNBC. He frequently appears on CBS Radio, NPR, Associated Press Radio, and The Nightly Business Report. He is quoted in The Wall Street Journal, USA Today, Forbes, The Washington Post, and many others.

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To learn about the services that we provide, please contact us:

**Farr, Miller & Washington**
1020 19th Street, NW, Suite 200
Washington, DC 20036
(202) 530-5600
(800) 390-3277 toll-free
(202) 530-5508 fax
invest@farrmiller.com
www.farrmiller.com

## "It's the Economy Stupid!"

There has been a lot of rhetoric over the past several months about the need to enact fiscal stimulus in order to induce higher rates of economic growth. Policymakers from both political parties (to varying extents) have voiced their support for initiatives that would cut corporate and individual tax rates, allow for the repatriation of corporate cash held overseas, and allocate up to $1 trillion in taxpayer dollars for infrastructure improvements. Most Republicans in Congress would also like to increase military spending, reduce the regulatory burden on businesses (including the banking sector), and repeal and replace the Affordable Care Act. Finally, there is some degree of support in Washington for protectionist trade and immigration policies designed to stimulate domestic job growth and increase wages for US workers. The goal of all these initiatives, they say, would be to accelerate real (inflation-adjusted) economic growth from an average of about 2.2% since the end of the Great Recession (June, 2009) to a sustainable 3% or even 4%.

It is imperative to understand that real economic growth can come from just two sources: 1) growth in aggregate labor hours across the economy; and 2) growth in labor productivity, or the amount of goods and services produced by one hour of labor. From 1950 through 2000, the economy grew at an average inflation-adjusted rate of about 3.6% annually – right in the middle of the Trump administration's target range for the future. This historical growth rate consisted of about 1.6% annual growth in aggregate labor hours combined with a little over 2% annual growth in labor productivity. Can this performance be replicated in today's economy?

Let's start with productivity. The 2% average growth in productivity from 1950-2000 was the result of large and sustained investments in technological innovation and labor-saving equipment, higher educational attainment, improvements in worker health and well-being, and large-scale spending on infrastructure, to name just a few of the drivers. Generally speaking, these types of productivity-enhancing investments can take years to bear fruit. However, as various internet-

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related applications were adopted in the years leading up to the Great Recession, productivity growth did accelerate to 2.6% from 2000-2008. So it is possible.

Since the end of the Great Recession, though, growth in labor productivity has slowed to an average annual rate of just 1% over the past eight years (mid-2009 through mid-2017). Most economists attribute the deterioration in productivity to a relative lack of corporate investment in R&D and labor-saving equipment resulting from high labor slack (ie, utilizing cheap labor rather than new equipment), declining educational standards, infrastructure neglect, and an increase in chronic health afflictions such as drug abuse and obesity. Unfortunately, reversing long-term trends such as these could take years of sustained investment.

Shifting now to labor hours, the solid 1.6% average growth over the 50 years from 1950-2000 was made possible by several long-term positive influences as well. These influences included the baby boom (spike in fertility rates), a steady inflows of immigrants, longer life expectancies, better working conditions, improved worker health, better pay and benefits, and a sharp increase in labor participation rates (most notably due to more women joining the labor force). Unfortunately, the pendulum for most of these factors has begun to swing in the other direction. Labor growth has decelerated meaningfully as folks have been leaving the labor force in droves (retiring baby boomers, frustrated job-seekers), more companies have sought cheaper labor outside the US, immigration has decreased, and part-time jobs have replaced full-time gigs. Part of the problem has clearly been cyclical, as some percentage of folks that have left the labor force (or would like full-time work instead of part-time) would surely come back under the right circumstances. However, there is considerable disagreement among economists about this issue.

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So, like the current trends in productivity, the current trends in labor hours are not encouraging. Citing data from the Pew Research Center, a Wall Street Journal article by Greg Ip estimated that "at current immigration rates, the working-age population will grow just 0.3% per year in the coming two decades (compared to +1.4% annually from 1965-2015). With half a million fewer immigrants per year it grows just 0.1%, and with 1 million fewer, the working-age population shrinks by 0.1% per year."

Given the new presidential administration's strong proclivity to protect US workers through tougher trade and immigration policies (including the deportation of some illegal immigrants), combined with continued low growth in labor productivity, it's hard to see how we reach the target of 3%-4% economic growth anytime soon. In fact, the current trends in labor hours and productivity point to annual GDP growth of about half that range (1.5%-2.0%).

Optimistic economists are pinning their hopes on: 1) a reversal of the decline in the labor participation rate from over 67% in the late 1990's to less than 63% today; and 2) aggressive fiscal stimulus (tax cuts), which would ideally lead to improved consumption and a new corporate investment cycle. The former could be challenging, obviously, given the aging of the labor force (retiring baby boomers). But the latter could prove challenging as well. Putting aside the question of whether tax reform can get through Congress, aggressive fiscal stimulus at this point in the economic cycle could spark a nasty bout of inflation.

Most economists agree with an economic tenant called the Phillips Curve, which says that there is an inverse relationship between the rate of inflation and the unemployment rate. At the current unemployment rate of 4.2%, which is below the natural rate of unemployment, wages are expected to start rising in earnest any time now. And when they do, the Fed will likely have to raise interest rates more aggressively in an effort to prevent the economy from overheating. These interest-rate increases could offset the benefits of the tax cuts.

Further complicating matters are the structural deficits caused by an expected surge in entitlement spending. The combination of decreasing fertility rates, hordes of retiring baby boomers, and longer life expectancies will cause a spike in federal deficits and debt as the ratio of workers to retirees is expected to drop from about 2.8x in 2013 to 2.1x in 2030 (U.S. Social Security Administration). As entitlement spending increases, the federal government will have fewer resources to fund productivity-enhancing investments like education and infrastructure.

For our part, we think that placing stricter limits on immigration is misguided as it would clearly have negative implications on longer-term economic growth. Immigrant labor is needed not only to drive current economic activity, but also to help fund the entitlement benefits (Social Security and Medicare) of retiring baby boomers. In addition, we continue to advocate for changes to Social Security and Medicare to both ensure that those programs are solvent and available for future generations as well as to provide near-term flexibility to invest in infrastructure, education and new technologies (artificial intelligence, renewable energy, biotechnology). We think these investments are imperative in helping to reverse the crippling decline in labor productivity.

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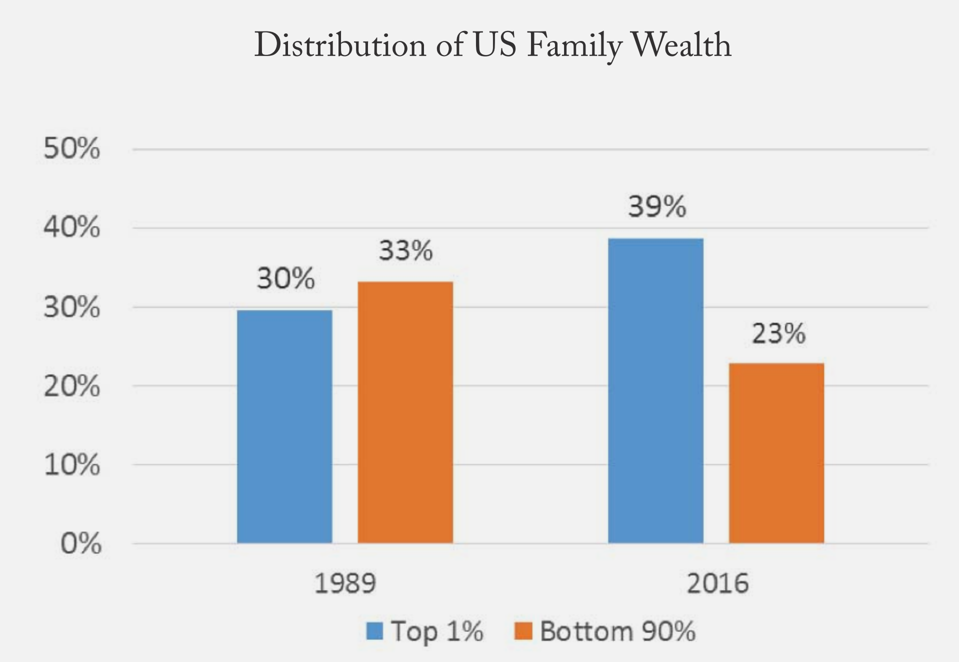
## Economic Inequality

I know we've harped on this topic for a long time, but we continue to believe that this issue represents a huge albatross around the neck of the economy. Late in the third quarter we received new data from the Federal Reserve in the form of its triennial Survey of Consumer Finances (SCF). While some of the data within the report was encouraging, the overall take-away for us was that the problem of economic inequality continues to worsen. According to the Fed, the wealthiest 1% of American families claimed 30% of total wealth in 1989 while the bottom 90% of families claimed 33%. If we look at the data for 2016, the percentage of wealth claimed by the top 1% has increased to 39% - well above the 23% claimed by the bottom 90% of families. We think that these figures, in a nutshell, help explain much of the rise in middle class frustration and dissatisfaction over the past many years. We think this issue deserves more attention by the Fed and Congress as they determine the course of monetary and fiscal policy. Sustainably higher rates of economic growth are only possible when the benefits of growth become more widely distributed. As always, please remember that this is purely an economic consideration rather than a social judgment or political comment.




*Source: Federal Reserve*

## Onward and Upward

I am very pleased to report that assets under management (AUM) at Farr, Miller & Washington surpassed $1.4 billion during the third quarter. It seems like just yesterday that we reached the $1 billion mark in 2013. We certainly hope that our continued growth is a reflection of the confidence that all of you have placed in us, and we do not take the responsibility lightly. We have added several new faces through the years to ensure that clients receive the same dedicated attention that they have come to expect from us. At the same time, the same core investment team remains in place. We look forward to many more years of growth, and we hope that you remain with us for the ride. As always, if you have family or friends who might benefit from our services, we would greatly appreciate the introduction.

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