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THE FARR VIEW

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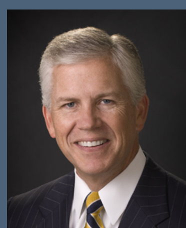

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Wow, what a year! We endured political dysfunction, a vicious hurricane season, and geopolitical uncertainty beyond anything we've seen in decades, and yet stock prices continued higher with virtually no volatility. Call it a "goldilocks" economic backdrop or simply the markets' propensity to climb a wall of worry – either way, we'll take it! The bond market, for its part, remains solidly bid in the face of three formidable forces: improving economic data; the ongoing removal of Fed monetary accommodation; and the recently passed tax cuts. Simply stated, low interest rates remain the lifeblood of the economy and capital markets.

We can attribute much of our good fortune to inflation, or more accurately, the lack thereof. Continued low levels of inflation have confounded not only the Federal Reserve, but also elected officials who have been making solemn efforts to boost middle-class incomes. But it was not to be in 2017. Despite the creation of 17 million jobs and a decrease in the unemployment rate from a high of 10.0% in October, 2009, to its current rate of 4.1%, wage growth has barely budged during this recovery. To put some numbers to it, average hourly earnings have grown at a paltry rate of just 0.5% annually since October, 2009, after adjusting for inflation (Bureau of Labor Statistics). Such low wage growth during an economic recovery is a fairly unique phenomenon.

A central tenet of economics is that as demand increases and supply decreases, prices will rise. This really hasn't happened in the labor market. In fact, the lack of wage inflation over the past several years has many economists questioning an economic concept called the "Phillips Curve." The Phillips Curve says that there is an inverse relationship between unemployment and inflation. In other words, as the ranks of the unemployed successfully land jobs, employers will have to pay more to fill their openings. And as wages rise, more widespread inflationary pressures begin to take hold throughout the economy. Simple enough, right? So why isn't it happening?

In a recent Market Commentary, sent via email, we discussed some of the factors that have put a lid on wage growth during this recovery. In the interest of space, we would refer you to that discussion, which can be found on our web site (www.Farrmiller.com). Suffice it to say that there are both structural and cyclical

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factors that have increased the bargaining power of US employers and decreased the bargaining power of US workers. However, now that much of slack in the labor force has been reduced, we think it is more likely than not that wages will start to increase at a faster pace. We would caution, though, that we do not believe we are on the precipice of sharply higher wage growth, the likes of which many expect to result from the recently enacted tax reform bill.

To be sure, some portion of the corporate tax-cut windfall will find its way to middle-class workers over the near term. We've all heard the news stories about individual companies granting holiday bonuses upon the passage of the tax legislation. However, employers are not going to increase payrolls and raise wages simply because they receive a tax windfall. Remember, companies have been generating record profits and cash flow in recent years. In fact, corporate profit margins have seldom been so high. Yet companies have elected to use their profits not to increase wages or otherwise invest in growth, but rather to buy back stock, raise dividends and make acquisitions. These actions have been good for stock prices, but not so good for workers. Unfortunately, we don't believe that cuts in corporate tax rates will really change that calculus. The vast majority of employers will need to see an improvement in demand for their goods and services before they make meaningful investments in labor and other productive capacity.

Encouragingly, though, the near-term outlook for the economy appears to have improved decisively since this time last year. While the Fed continues to remove policy accommodation at a steady pace, the positive impact of tax reform and the "wealth effect" of higher asset prices should be able to offset the effects of moderately higher interest rates - at least for the time being. The big question is how much of this economic improvement is already reflected in stock prices, but let's put that on the back burner for now.

Instead, let's turn our attention to longer-term challenges. Notwithstanding the positive near-term impact of the tax cuts, we have three lingering concerns about the economy (and therefore the trajectory of corporate profit), in the out years. To a certain extent, these are issues that need to be addressed with some urgency if we hope to lay the foundation for continued economic prosperity for future generations. However, we would caution that there is no magic elixir. These problems will require sacrifice, perseverance and a spirit of collegiality among our leaders that we haven't seen in quite some time.

Three Challenges

The first issue is that we remain heavily dependent on low interest rates as a result of both irresponsible spending, especially by the federal government, and overly aggressive monetary accommodation by the Federal Reserve. Nearly nine years of near-zero interest rates have led to: 1) the accumulation of record levels of economy-wide debt; 2) inflated asset prices; and 3) the effective pulling-forward of future demand (and therefore of economic growth). There is really no other way to frame it than to say that we are borrowing from tomorrow's prosperity, and we have been for quite some time.

In recent decades, the federal government has expended huge resources on its response to the Financial Crisis, our extended participation in foreign wars, two rounds of tax cuts, and unaffordable entitlement programs. Nobody in government wants to address the elephant in the room, which is that Medicare and Social Security benefits must be scaled back if those programs, and the federal government, are to remain solvent. Furthermore, addressing the problem of entitlements now would create much more financial flexibility to invest in things like infrastructure, education, and renewable energy – investments which are needed to improve our competitiveness and flagging productivity growth.

The Federal Reserve, through its unprecedented suppression of interest rates, has deliberately inflated asset prices as well as encouraged the assumption of more debt. As a result, there has been a staggering $42 trillion increase in aggregate household net worth in less than nine years. Which brings me to our second challenge, which is the ever-increasing gap between the "haves" and the "have-nots." While housing and stock prices have rebounded beyond anyone's wildest hopes, middle-class incomes have been stagnant for the better part of the past 20 years. And because the vast majority of stock-market wealth is held by a small percentage of wealthy investors, most of Americans have been missing out on the party.

The combination of stagnant wages and rising costs for necessities (like health care, child care, education and housing) means that large swaths of the population are getting squeezed just as happy days continue on Wall Street. The feeling of disenfranchisement in the US is starkly evident in our increasing political polarization, and we don't believe tax reform will adequately address the issue. Many, if not most Americans, are faced with the reality that they must live more modestly and save more if they ever hope to retire. And our young people and future generations may still find that their living standards will not match those of their parents and grandparents. This is not a recipe for societal harmony. We firmly believe that more people must feel they have access to the American dream.

Our third major challenge is that we have not adequately invested in, or implemented policies to support, long-term economic growth. Consider the following:

- Rather than shoring up the federal government's fiscal situation and addressing entitlements, we have provided tax cuts for businesses and the wealthy that are expected to add $1.4-$1.5 trillion to our deficits over 10 years;

- Rather than implementing fiscal and monetary policy that support sustainable long-term economic growth, our policies continue to encourage the assumption of debt, create moral hazard and perpetuate the boom/bust cycles of the past 20+ years;
- Rather than addressing the rising cost of higher education and improving our public school system, we are falling further and further behind the rest of the world in terms of educational achievement;
- Rather than collaborating across the aisle to find reasonable solutions to our health care crisis (including the scourge of opiate addiction), we continue to suffer from a complicated and unwieldy system;
- Rather than encouraging responsible immigration in order to grow our work force, we are taking steps to evict "Dreamers" and making it more difficult, for example, for high-skilled workers to acquire or renew H1-B visas;
- Rather than strengthening our trade agreements, we have opted out of the Trans-Pacific Partnership and have threatened to pull out of NAFTA;
- Rather than investing in our dilapidated infrastructure (perhaps funded by a gas tax), we keep kicking the can down the road;
- Rather than investing in the development of sustainable, clean energy alternatives, we are allowing other countries to take the lead.

In a nutshell, we continue to avoid hard decisions that may lead to some short-term pain but will surely provide a better long-term outlook. Still, I have not lost faith that we can unite and conquer our challenges. I am especially encouraged that long-overdue tax cuts on the corporate side will allow U.S. companies to compete more effectively in the global marketplace. Though our companies are flush with cash following years of steady profit growth, the private sector remains the best engine (by far) for the creation of jobs and higher incomes. With some more effective policies that incentivize growth investments, especially in industries that will create the high-paying jobs of tomorrow, there is no question that we can improve the outlook for future generations.

Stocks

Stocks are expensive – there is no getting around that. But they could easily get more expensive. Alan Greenspan made his famous "irrational exuberance" comment in December, 1996 - a year in which the Dow Jones Industrial Average topped out at 6,561. From there, the DJIA blew through 8,000 in July, 1997, then proceeded to rise to its high of 11,723 in January, 2000. Is there a lesson to be learned here? Yes! It's that we have no idea what the stock market will do over relatively short periods of time.

What we do know is that stocks have been an extremely reliable way to build wealth over the long term. Taken from the January 4, 2018 edition of The 10th Man, by Jared Dillian: "We ran some numbers here internally, and if by pure chance you began your investing career in the summer of 2007, and put it all in the S&P 500, you've annualized at about 6%. If by pure chance you began your investing career at the lows in 2009, you have annualized…16.5%. That is a massive difference, entirely due to luck." Yet you still would have earned that 6%, EVEN IF you're timing was horrible! The lesson? Remain invested!

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