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THE FARR VIEW

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DID YOU SEE US?

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CNBC

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"The worst thing you can possibly do in a deal is seem desperate to make it. That makes the other guy smell blood, and then you're dead. The best thing you can do is deal from strength, and leverage is the biggest strength you can have."

- Donald Trump,
Trump: The Art of the Deal

Volatility's Return

2018 has brought a sea change in the capital markets. While the month of January saw a continuation of the optimism and complacency so characteristic of the markets in 2017, volatility returned with a vengeance in February. In 2017, the average daily change in the S&P 500 was 0.3%. Since the beginning of February, the average daily move has risen to an unusually high 1.1%. As I write, stocks are a couple percentage points above this year's lows, but the indices are still hovering close to correction territory (down 10% from the peak). This doesn't appear to qualify as a transitory, garden-variety correction. The volatility seems likely to stick around for a while. Why have investors become so skittish all of the sudden, especially in the face of an improving economic backdrop? From where I sit, there appear to be several investor concerns.

Rising Interest Rates

The initial swoon in stock and bond prices came very early in February when the major indices fell around 10% in a little over a week. Perversely, the impetus for that "correction" was positive economic

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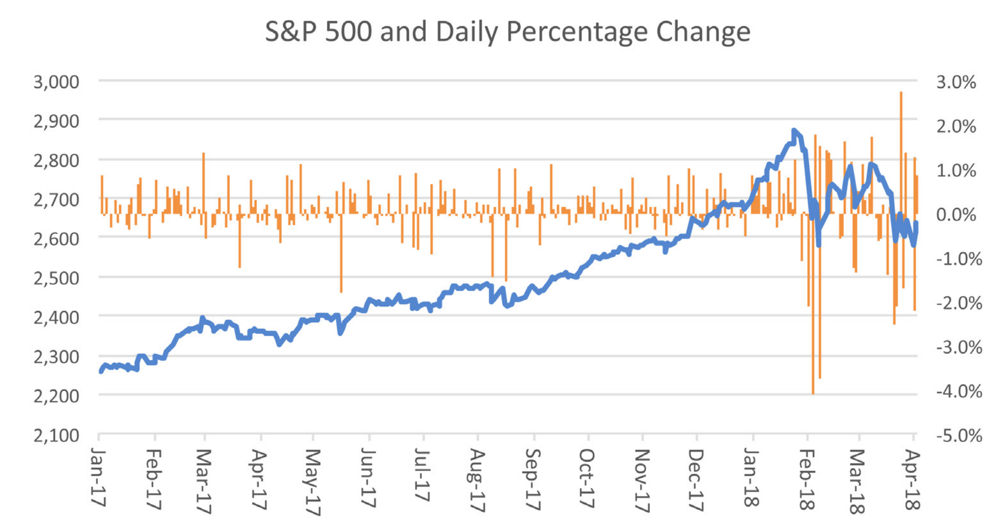

Source: Bloomberg

data. To be sure, economic data had been coming in fairly strong for many months. But the one elusive piece of the puzzle had always been inflation, and more specifically, wage inflation. The relative lack of middle-class income growth has been an albatross around the Fed's neck for most of the nine-year-old economic recovery. But it also provided the Fed with justification for maintaining highly accommodative monetary policy (read: low interest rates). So when we received two data points in early February that suggested wage growth is accelerating, investors became fearful that the goldilocks investment environment – characterized by low inflation, low interest rates, rapidly rising corporate earnings, and most important, a highly accommodative Fed – could be coming to an end.

One of our overarching concerns about the economic recovery has been its heavy dependence on artificially low interest rates (the other concern being economic inequality). Rather than keeping the pedal to the metal for the past nine years, we think the Fed should have begun the process of unwinding its unprecedented monetary experiment much sooner. As it currently stands, though, Fed efforts to avoid falling behind the curve in fighting the (real or perceived) threat of rising inflation could have much more negative side effects. Why? Well, the first reason is that the long period of artificially low rates has caused economy-wide debt to surge to very high levels. The Fed's decision to suppress interest rates for so long effectively amounted to a policy of addressing the problem of too much debt by encouraging more debt. As interest rates reset higher in the future, the need to service high levels of debt will act as a formidable tax on our economic growth potential.

The second reason is that the Fed's accommodative monetary policy has effectively resulted in the borrowing of demand (and prosperity) from the future. As the cost of borrowing increases, demand for goods and services bought on credit is likely to diminish and act as a drag on growth. And the third problem has manifested over the past couple of months: the Fed's suppression of interest rates drove asset prices to frothy levels, leaving them and the economy vulnerable to nasty corrections.

Aside from Fed interest-rate hikes, there may be other factors conspiring to send interest rates higher. The most obvious is the threat of inflation. Now that much of the slack has been wrung out of the labor market, companies will increasingly be forced to raise wages in order to attract qualified employees. Better economic growth and the recently passed tax legislation should also put upward pressure on wages, and these wage increases could cause more widespread inflationary pressure throughout the economy. Higher inflation causes interest rates to rise.

A final factor likely to send interest rates higher is an expected mismatch between the supply of and demand for US government debt. The combination of tax reform and the profligate spending legislation is expected to lead to a surge in federal budget deficits in the coming years. In fact, a newly released report from the non-partisan Congressional Budget Office (CBO) estimates that the Treasury will begin running $1 trillion-dollar deficits again as early as the year 2019. At the same time, the Social Security trust will no longer be a source of cash for the Treasury as beneficiary payouts to retiring baby boomers begin to exceed tax receipts. As a result of these trends, the Treasury will be required to issue massive amounts of new debt in the coming years to cover the surging deficits, refinance maturing debt, and fund Social Security shortfalls. These issuances will dramatically increase the supply of Treasury debt hitting the marketplace. Compounding the supply pressures, we know that the Fed would like to reduce its $4 trillion+ bond portfolio as part of its "policy normalization." At the very least, the Fed will no longer be a source of demand for Treasury debt. Meanwhile, it has been suggested that China could potentially retaliate to recent US trade actions (which we discuss below) by reducing its holdings and/or new purchases of US Treasury bonds. It doesn't take a Harvard economist to understand that if the supply of US Treasury bonds is surging while the demand drops off, prices will decline and interest rates will rise. (Remember that bond prices and yields have an inverse relationship).

Trade

By most accounts, the factor responsible for our most recent bout of stock-market volatility is the fear of trade-war escalations. It is true that the tariffs and quotas implemented to date cover but a small fraction of our total foreign trade. However, wars have to start somewhere, and it's possible that President Trump's initial actions toward China may ultimately be viewed as the Lexington and Concord for a much wider conflict to come. First, let me say that the President is justified in his concerns about Chinese trade practices. China is undoubtedly guilty of abuses such as intellectual property theft, government subsidies for its companies, restrictions on foreign competitors entering its

markets, dumping, currency manipulation and inadequate labor standards. But the President's tactics, including public threats and lashings, may not be the best way of addressing the problem if he wants to ensure capital-markets stability. As the President is unlikely to change his stripes, increased volatility may become the norm.

The risks of engaging in a trade war with China are substantial. The first risk is that China provides many cheap consumer products that enable struggling middle-class folks to stretch their paychecks. Chinese companies also supply US companies with a lot of their manufacturing inputs, including components, parts as well as raw materials. As such, slapping tariffs on Chinese goods could ultimately lead to higher prices for US consumers. Without better wage growth, those price increases could sting. The second risk is that China is our third-largest (and fastest growing) destination for exports. Therefore, any retaliatory tariffs by the Chinese government could result in lower US exports and reduced profitability for US multinational corporations. And finally, China buys a massive amount of US Treasury bonds. In fact, the country is the largest foreign investor in US Treasuries. Given the large expected increase in our budget deficits, it doesn't make a lot of sense to pick a fight with our largest bond investor. Losing this source of US Treasury demand could lead to significant increases in interest rates.

There are those who believe that President Trump's tough trade rhetoric is simply a negotiating tactic. Indeed, there is some evidence to support this notion as Trump has exempted several countries from the initial round of steel and aluminum tariffs. In addition, despite the bluster, we have not yet pulled out of NAFTA. In fact, there have been reports of some progress on NAFTA renegotiations. Is President Trump crazy like a fox? That's the $20 trillion question.

The Decline of the FANGs?

A third factor that has caused stock-market volatility is an apparent government backlash against a group of stocks that have led the markets higher in recent years. Commonly referred to as the FANG stocks (Facebook, Amazon, Apple, Alphabet (parent of Google), Netflix, and sometimes the likes of Tesla), these companies have a combined market capitalization of nearly $3 trillion. Given their massive size, these stocks had a hugely disproportionate effect on many of the major indices as the stocks stumbled earlier this year. Much of the decline can be attributed to the threat of regulatory backlash over issues such as the misuse of consumer data and unfair competitive practices. In any case, if the current concerns linger, the loss of FANG leadership could remain a significant overhang for the overall markets.

The rapid decline in the FANG stocks this year can be partly attributed to the lofty valuations at which most of these stocks have consistently traded in recent years. Jimmy Cliff had it right when he sang, “The bigger they come, the harder they fall, one and all.” This is why we at Farr, Miller & Washington incorporate a heavy valuation component in the analysis of potential portfolio holdings.

Chaos Theory

Last but not least, we surmise that a certain amount of the markets' recent volatility is self-inflicted, and it therefore can be relatively easily remedied. There is clearly a perception of chaos in Washington as we get the daily news reports surrounding the Mueller investigation and the constant churn of personnel at the highest levels of

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the federal government. Markets did not like the departure of the previous Director of the National Economic Council, Gary Cohn, because he is a very smart and accomplished individual. But more than that, markets dislike uncertainty in general. We think that for the sake of market stability, the establishment of a core, permanent economic team would be well received.

Some Cause for Optimism

But the news certainly isn't all bad. The government's tax cuts and roll-back of regulations have led to dramatic improvements in business confidence. In fact, confidence among business executives and consumers alike has seldom been so high. Business fundamentals are also quite sound at the moment, with analysts projecting nearly a 20% increase in S&P 500 earnings this year, followed by almost 10% growth in 2019. The upcoming earnings season is likely to restore some investor confidence, and, at least for the immediate future, we see no threat of a recession.

There is also some cause for optimism in other areas. The government appears to be making progress on its renegotiation of NAFTA. It also appears as though the threat of ISIS is close to being eradicated, and North Korea appears to be willing to come to the table with regard to its nuclear arsenal. Notwithstanding the noise and confusion, we as investors must assign some probability that the administration's strong-arm tactics, while highly unusual, could succeed - at least in some instances.

Over the intermediate term, we would need to see broader income growth before we become more constructive on the economy and stocks (at today's valuations). We think the tax legislation was ill-conceived as it does not provide enough relief for middle-class folks and will likely lead to an exacerbation of economic inequality. Further, some of the new administration's other economic policies, such as protectionist trade measures, greater restrictions on immigration, and surging budget deficits, are unlikely to be supportive of more robust and sustainable economic growth. Finally, given the economy's dependence on ultra-low interest rates, further significant increases in rates will be very hard for the economy to overcome.

Misleading Data

Given the importance of consumer to the US economy, it is imperative to get a good read on the factors that influence consumers' financial health. This is especially true as both monetary and fiscal policy can be heavily influenced by incoming consumer data. Unfortunately, much of the data upon which those decisions are made can be misleading. Consider the monthly data we get from the Bureau of Economic Analysis for Personal Income and Personal Spending. These are aggregate figures that tell us nothing about who is actually doing the earning and spending. The same is true of the Federal Reserve's quarterly Household Net Worth figures. All too often economists assign equal value to gains driven almost entirely by the well-to-do as compared to gains that are more broadly dispersed.

Study after study has revealed that the lion's share of the economic gains since the Great Recession have gone to the richest among us, and that economic inequality is at its worst levels since the eve of the Great Depression in 1929. This trend has been exacerbated in recent years by Fed monetary policy, which by all accounts has goosed asset prices for those who own the assets. According to a recent paper by New York University economist Edward Wolff, the richest 10% of American households own over 84% of the total stock in the US market. The study also found that almost half of US households don't own any stocks at all. The problem with such pronounced economic inequality is that money is not getting into the hands of those most likely to spend it. At the same time, prices for non-discretionary goods and services are rising faster than overall inflation, leading to a continued squeeze on the middle class. Until and unless more middle-class folks begin to participate in the economy's upside, we will maintain our cautious posture.