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The Farr View

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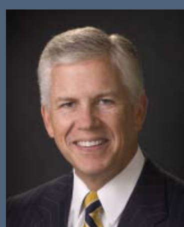

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Founded in 1996 by investment managers with decades of respected experience in the field, Farr, Miller & Washington combines analytical and management excellence with accessibility and close client contact. Our focus is on providing conservative long-term portfolio management to individuals and institutions in the Washington, D.C. area and across the nation.

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Political Chaos

Oh, how I need a vacation away from Washington! Supreme Court confirmations, the Russia investigation, FBI infighting, trade wars, anonymous editorials, tell-all books, nuclear brinksmanship, sex scandals, palace intrigue – it never stops! Of course, we at Farr, Miller & Washington are staunchly apolitical. We care about politics only in so much as it affects our clients' investments. On that score, things seem to be going just fine. Investors are generally supportive of the Trump administration's "market-friendly" economic policies, and it appears they have become inoculated against the daily distractions coming out of Washington. But that doesn't mean the complacency will last forever. And while the short-term impact of President Trump's economic policies on the markets has been positive, the longer term implications of Trumponomics are much more uncertain.

Killing the Goose that Lays the Golden Egg?

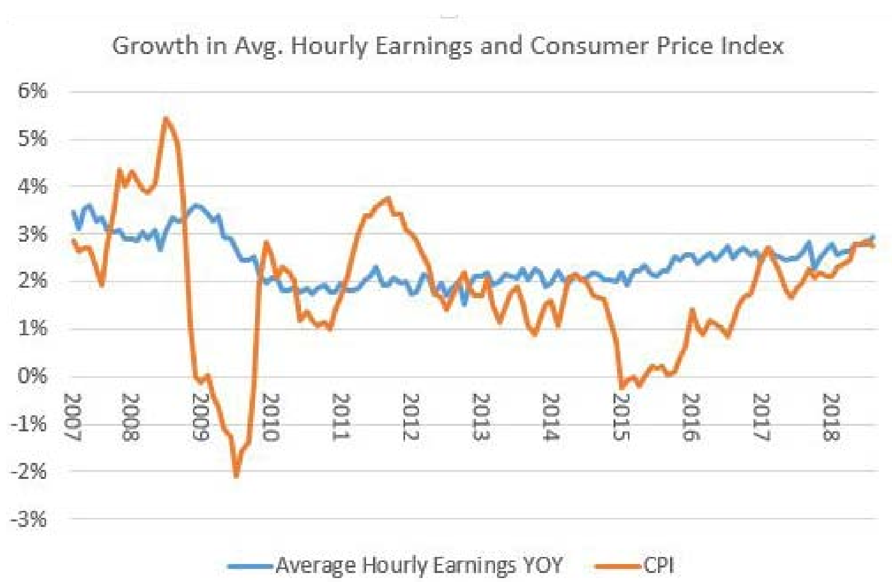
We've said for years that (artificially) low interest rates have served as the fuel for massive bull markets in risky assets like stocks and real estate. We still believe this to be true. So how do we reconcile the fact that asset prices continue to go up in the face of rising interest rates? The answer is simple: fiscal stimulus. The one-two combination of tax cuts and higher government spending has boosted economic growth and goosed corporate earnings, offsetting the effects of higher interest rates. If the stimulus weren't enough, the economy is also benefiting, by most accounts, from a more relaxed regulatory environment. The big question now, though, is how sustainable will these gains be? In our view, the answer to that question will depend on how much of the tax and spending windfalls "trickle down" to the middle class. Gains in incomes, wealth and spending have been far too concentrated at the very top for far too long. Sustainably higher rates of economic growth will require participation from a broader spectrum of the population.

There are good reasons to believe that the fortunes of middle-class families may be starting to change. Now that the unemployment rate has dropped to below 4%, employers will likely be forced to pay higher wages to attract qualified workers. At the same time, the reduction in the corporate tax rate from 35% to 21% could release pent-up investment spending, providing better job opportunities. Lower tax rates on the personal side are also providing much-needed relief for many struggling middle-class families. And recently revised data from the Bureau of Economic Analysis suggests the personal savings rate, at 6.6% of disposable income, is well above previously reported levels and much closer to the long-term average. A higher savings rate is positive because savings represent a source of future spending. Finally, many prospective borrowers, viewed as bad credit risks in the

Continued

wake of the Financial Crisis, are finding better access to credit now that lending standards have been relaxed.

Yet there is also some cause for concern. While wage growth has picked up, much of the gains are being offset by higher inflation. Middle-class families don't gain any purchasing power if their wages fail to keep pace with inflation. The effects of rising inflation are especially burdensome given that price increases have been more pronounced for less discretionary goods and services like energy, housing, health care, child care, and education. Unfortunately, the Fed is becoming more vigilant about inflation just as wage growth is starting to pick up in earnest. Recent commentary suggests the Fed remains firmly on the path to policy normalization, which means interest rates will likely continue to rise. If so, the recent liberalization in lending standards, and coincident surge in business and consumer debt, could end up backfiring as debt service becomes much more onerous. And this says nothing of the Herculean challenge that Treasury Secretary Steve Mnuchin will face as he seeks to meet the massive funding needs of the federal government against the backdrop of rising interest rates.



Sources: Bureau of Labor Statistics

The Twenty Trillion-Dollar Question

The question everyone wants answered is 'Will the Fed make a policy mistake by hiking interest rates too far and too fast, thrusting us into a recession?' In our view, the odds are clearly rising. Aside from the obvious dampening effect that higher interest rates will have on an economy heavily in debt, there are other issues the Fed must consider:

- **Will the tax cuts translate into more than simply a one-time boost to economic growth?** A lot is riding on the president's fiscal stimulus, especially given the unorthodox timing at so late in the economic cycle (we discuss below). The premise behind the initiatives was that corporate America had become uncompetitive due to relatively high tax rates and burdensome regulation. These shackles had been stifling business investment and therefore inhibiting growth in jobs, wages and the economy at large. Republicans believe the tax cuts will unleash the animal spirits and lead to a virtuous cycle of investment, job growth and higher demand. But if the tax cuts are not successful in priming the corporate-investment pump, the US will be left with a lot of debt and not much to show for it. So far the evidence is mixed.

- **How much influence will slower economic growth outside the US have on domestic economic growth?** Slower growth outside the US has a direct impact on domestic growth through lower exports and corporate profits. But a growing divergence in growth can also have a destabilizing effect on the global currency and capital markets. Emerging-market currencies, stocks and bonds, in particular, have plummeted in recent months. The capital flight from the EM's poses an especially large problem for EM entities that have issued a massive amount of debt in US dollars. In a worst-case scenario, the EM debt problem could prove contagious and trigger another financial crisis. The Fed must account for this risk.

- **Will further strength in the US dollar help the Fed achieve its goal of tightening financial conditions?** The Fed interest-rate hikes to date have led to sizable gains in the US dollar, and a strengthening dollar has a negative impact on US exports, corporate profits, and the economy at large. Dollar strength also creates deflationary pressures in the US, which will serve to offset some of the gathering inflationary pressures. The Fed must determine if the recent dollar strength, coupled with previous rate hikes and slowing global growth, will tighten financial conditions enough that the economy won't overheat.

- **Will higher interest rates eventually lead to a correction in asset prices?** Since the end of the Financial Crisis, stock-market bulls have consistently cited the low interest-rate environment as the strongest justification for lofty stock prices. For our part, we continue to believe that asset prices have been far too dependent on ultra-low interest rates for far too long. Though there are few signs at present, continued interest-rate increases could finally start to have an impact on asset prices, similar to the "Taper Tantrum" that occurred when the Fed first embarked on its policy normalization process in 2013. Sizeable stock-market losses could lead to a negative wealth effect, which might impact consumer spending and slow the economy.
- **Will the Fed tolerate an inversion of the yield curve?** One of the most reliable predictors of recessions, an inverted yield curve, continues to worry some voting members at the Fed. An inverted yield curve refers to a situation whereby the cost of borrowing for a long period of time decreases below the cost of borrowing for a short period of time. As such, an inverted yield curve is a signal that inflation, interest rates, and economic growth are likely to fall in the future. Will the Fed continue to hike short-term rates if it becomes clear an inverted yield curve will result?
- **How much retrenchment in the housing market will the Fed tolerate?** The housing market has displayed clear signs of fatigue as decreases in affordability and limited supply continue to affect activity in the sector. Though housing is not as important to the overall economy as it once was, decreases in housing activity (construction, turnover, home improvement spending, etc.) and decreases in housing affordability still have an impact on the economy.

Our suspicion is that the Fed may be late to conclude that the economy cannot withstand significantly higher interest rates. It will be especially hard for the economy to reach escape velocity given our massive accumulation of debt. The notion that "interest rates are still low compared to historical averages" is not valid. The only thing that matters is where borrowing costs are relative to recent history. The yield on the 10-year Treasury note has risen sharply from its low of 1.36% in mid-2016 to its current level of around 3.20%. According to data from the Fed, our economy has a total debt load of over $65 trillion, much of which is either short-term or variable-rate. Federal government deficits are rising rapidly, entitlement spending is set to surge, and our friends at the Treasury have failed to use the low-rate environment to extend durations on the public debt. Blame for this predicament can be justifiably distributed to both sides of the political aisle. Unfortunately, though, the can has been kicked down the road for so long that growing our way out of the problem appears to be a tall order.

Getting Bang for the Bucks

As discussed above, the US economy is exhibiting a fairly predictable near-term acceleration in response to a heavy dose of fiscal stimulus. But there are legitimate questions as to the sustainability of this economic strength due to both the timing and potency of the stimulus.

From a timing perspective, the tax cuts and spending increases are fairly unique for two reasons: 1) they come very late in an economic cycle, and 2) they will work to offset or "sterilize" the Fed's efforts to slow down the economy. To re-emphasize, there were very valid reasons for wanting to reduce corporate tax rates. The tax code had been unfavorable to American businesses and therefore had been encouraging businesses to engage in undesirable activities like moving operations outside the US. We are also seeing some companies increase wages and accelerate investment as a result of the tax cuts. But adding stimulus going in to the 10th year of an economic expansion could cause the economy to overheat, making the Fed's job of containing inflation much more difficult. If the Fed finds itself "behind the curve" in its inflation-fighting mission, it could feel compelled to raise interest rates much more quickly.

The other concern from a timing perspective is what the tax cuts and spending increases will do to the federal government's deficits and debt. It is generally agreed that the government's most important role with regard to the economy is to minimize the depth of economic downturns through increased spending during recessionary times. Given the decrease in tax revenue during recessions, the government is also usually expected to run large deficits in the process of stabilizing the economy. Now, however, the federal government is choosing to run very high deficits during relatively prosperous times, which will leave less fiscal ammunition to support the economy during the next downturn.

The ultimate potency of the fiscal stimulus is also subject to debate. To be sure, we have seen a nice bump in consumer spending, business investment and corporate earnings over the past few quarters. But the tax cuts do little to boost what has been sorely lacking: steady gains in labor productivity. Increases in labor productivity are the lynchpin of higher middle-class incomes. Without productivity gains, it is very hard to imagine how the rising tide will lift all boats. So, given the decision to tolerate high deficits this late in this cycle, we think the money would have been better spent by investing in areas that improve worker productivity, like education, training, infrastructure, worker health & well-being, and emerging technologies like Artificial Intelligence, machine learning, green energy, biotechnology, etc. We think the economic benefits, to include higher middle-class incomes, from investments like these would have been more potent and durable. Instead, the tax cuts are, by and large, going to exacerbate the problem of economic inequality.

The bottom line is that debt levels are at disturbingly high levels, especially going into the tenth year of an economic expansion. Even worse, the debt we have incurred, at the corporate and government levels, looks unlikely to improve our long-term economic growth outlook. We mentioned above that some companies are using the tax windfall to invest in employees and future growth initiatives. But far more companies have used the windfall (and big increases in debt) to increase dividends, buy back stock and make acquisitions. A recent article in *The Wall Street Journal* said the following:

> *A new survey of 152 companies by executive-recruitment firm Korn Ferry International revealed 14% were putting part of their tax-cut savings into base salary increases. A poll of 1,500 companies by consulting firm Mercer LLC showed 4% are redirecting tax savings to budgets for bigger paychecks in the coming year. And in a survey of more than 1,000 companies published by human-resources consulting firm Aon PLC, 99% said the tax cuts weren't prompting them to increase minimum wages.*

If you believe, as we do, that middle-class prosperity is the key to better economic growth, these statistics are not very encouraging.

Complacency

After a very volatile first quarter, we have seen a return to extreme levels of calm and complacency in the markets. Corporate profits look great, but they are fueled, in part, by tax cuts and stock buybacks. And though we are encouraged by the recent improvement in the economic data, it remains unclear whether the momentum can carry into next year and beyond. At this point, expectations for next year appear high to us, especially given the slowdown in the global economy (outside the US), rising interest rates, the strength in the dollar, the slowdown in housing, and the trade-related and political uncertainty. Furthermore, sustainably higher rates of economic (and therefore earnings) growth will likely require more participation from the middle class.