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The Farr View

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DID YOU SEE US?

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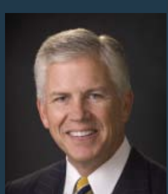

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The Economy

The US economy has become increasingly bifurcated. With decades-low unemployment and rising wages, the consumer is holding up well. Even lower-income workers are finally beginning to more fully benefit from the labor market's strength. Business investment, on the other hand, has generally been subdued and choppy. Rather than invest in future growth, many companies opted to use the 2017 tax-cut windfall to buy back their own stock. The stock repurchases were successful in reducing share counts and goosing earnings on a per-share basis, but they did little to move the economy forward. Another glaring bifurcation in the economy is that the manufacturing sector, which makes up about 12% of the US economy, appears to have slowed dramatically even as the services economy, where so much of the consumer's disposable income is spent these days, is alive and kicking. We expect that the net effect of these offsetting trends will be a reduction in economic growth from 2.9% in 2018 to closer to the 2% trend that has prevailed for most of the recovery from the Great Recession.

Economic growth around 2% is not bad. But it's also not likely to be enough to satisfy the Trump administration, which has been promising growth rates of 3% or better on a sustainable basis. It is now becoming clear that despite massive tax cuts, government spending increases and reductions in regulation, the pump still hasn't been primed. And sustained growth rates of 3%+ are unlikely to be realized any time soon. In our view, the domestic economy continues to be affected by several negative influences: 1) growth outside the US has been weak; 2) we have failed to adequately invest in productivity-enhancing areas like infrastructure, education, health care, and emerging industries like green energy, AI, machine learning, and biotechnology; 3) economic inequality continues to worsen; 4) rising government and corporate debt levels have created a dependence on low interest rates, which threatens to reduce the capacity for future investment; and 5) policy risks are mounting. Since we've discussed most of these issues in detail in the past, I would like to expound on a few of the policy risks that I believe will act as an anchor on economic growth in the years to come.

One obvious explanation for the weakness in manufacturing and business investment is the ongoing uncertainty associated with the government's trade policies. Few corporate managers are willing to commit to large capital investments prior to the resolution of these multiple trade disputes. After all, even companies that don't export their products are likely to use imported goods for some portion of their own finished goods or services. But for me, the decision to tackle some of the long-standing trade grievances is not what is troublesome. It's plain to see that China, and possibly other countries, have taken advantage of certain aspects of our trade relationships. These issues must be rectified at some point, and the chances

...Continued

are that a pragmatic President Trump will ultimately compromise on the eve of an election. My bigger concern is that even if comprehensive trade agreements are reached with China and others, the Trump administration has shown a remarkable propensity to renege on previous deals made with its friends and foes alike. Whether it be the TPP, NAFTA, the Paris climate agreement, the Iran nuclear deal, or the Indian preferential trade agreement, the strength of the US government's credibility has been watered down significantly. Can corporate America be certain that any new trade agreements will not be revisited when it is politically expedient to do so? Suffice it to say that constantly changing the rules of the game surely has a dampening effect on business confidence and the willingness to invest. Long-term investment and planning require a stable environment so that risks can be properly assessed.

Another headwind that the US economy may increasingly contend with is a shortage of labor. We've heard for years about how companies needing highly skilled workers are unable to find them. But now, with unemployment at 3.7%, more widespread labor shortages are likely to become a much bigger problem. The problem will be magnified in the coming years by very low fertility rates and waves of baby-boomer retirements. Unfortunately for many companies, the Trump administration has made it a priority to tighten our immigration laws at a time when labor will be most needed to extend the economic expansion. In a best-case scenario, the labor shortages could provide a continuation of the wage gains we've seen, but at the expense of corporate margins. In a worst-case scenario, the Fed will be forced to react to rapidly rising wages by aggressively raising interest rates, which could very likely cause the next recession.

The Fed & Inflation

The Fed, for its part, appears ready to respond to the trade concerns and weak business investment the only way it knows how: with rate cuts. But businesses aren't foregoing investment because the cost of money (ie, interest rates) is too high. Businesses have been flush with cash for years, especially following the tax-cut legislation. Is it realistic to think that more interest-rate cuts will stimulate a surge in business investment? The definition of insanity is doing the same thing over and over and expecting different results. Rather than expecting more business investment, it's more realistic to expect that interest-rate cuts will cause more of the same: higher asset prices, more debt, and the continued the exacerbation of economic inequality. The Fed should not embark upon a new rate-cutting cycle lightly.

The big debate at the Fed right now is the extent to which the recent drop in inflation is transitory or something more systemic. It seems as though Chair Powell continues to hedge his bets. He now says he still expects inflation to return back to the Fed's target of 2%, but at a slower pace. Still, the Federal Reserve appears to be drawing incrementally closer to the right conclusion, in our opinion, that low inflation is a global phenomenon. Even with unemployment at 3.7%, excess capacity outside the US is one major factor suppressing price levels. But does this mean we need to revert back to emergency levels of monetary stimulus? For the better part of ten years the US economy has fallen short of 2% inflation and yet hasn't slipped into deflation. It is certainly a concern, but I do not see why, after ten years, it is suddenly an emergency.

We firmly believe that the Fed's central role in fine-tuning every economic soft patch must eventually come to an end. This cycle needs to be broken. Monetary policy is a very blunt instrument that was not designed to cure all economic ills. The Fed's constant and conspicuous presence as the economy's (and investors') safety net has actually created a great deal of our troubles over the past 25 years. The Fed's actions have created asset bubbles, exacerbated economic inequality, caused the accumulation of excessive debt, extended lifelines to economically unviable companies, and, possibly worst of all, created a major dependence on low interest rates. It's time to see what the world looks like with a less engaged Federal Reserve.

One additional policy risk we are watching quite closely is the extent to which the Fed remains impervious to political pressure. President Trump's attacks on Chair Powell have been fairly relentless in recent weeks. The president would like the Fed to lower interest rates so that the economy heats up and asset prices rise before the election next year. The Fed, ever vigilant, wants to be sure that easy money won't lead to

a surge in inflation. More importantly, though, the Fed wants to ensure that it maintains, at all costs, its independence from political pressures. Powell knows that if market participants cannot trust an independent Fed to guard against the kinds of inflation surges we've see in the past, then we have much bigger problems. Will the Fed relent to the pressures from 1600 Pennsylvania Avenue?

Fiscal Conservatism is Officially Dead

It is no secret that the federal government is spending well beyond its means. This has pretty much been the case since the turn of the millennium, spanning the past three presidential administrations (both Democratic and Republican). In President Bush's first year in office, the government actually reported its fourth straight annual budget surplus, with the first three occurring under President Clinton. However, the fiscal situation deteriorated thereafter as the government had to contend with three big challenges: the bursting of the dot.com bubble, a recession in 2001, and the attacks of September 11, 2001. The government responded with two rounds of tax cuts in 2001 and 2003, and these cuts were effective in boosting the economy. Unfortunately, though, they also contributed to a sharp rise in federal budget deficits. Upon leaving office, the Bush administration had presided over a total of $2.5 trillion in cumulative budget deficits over eight years.

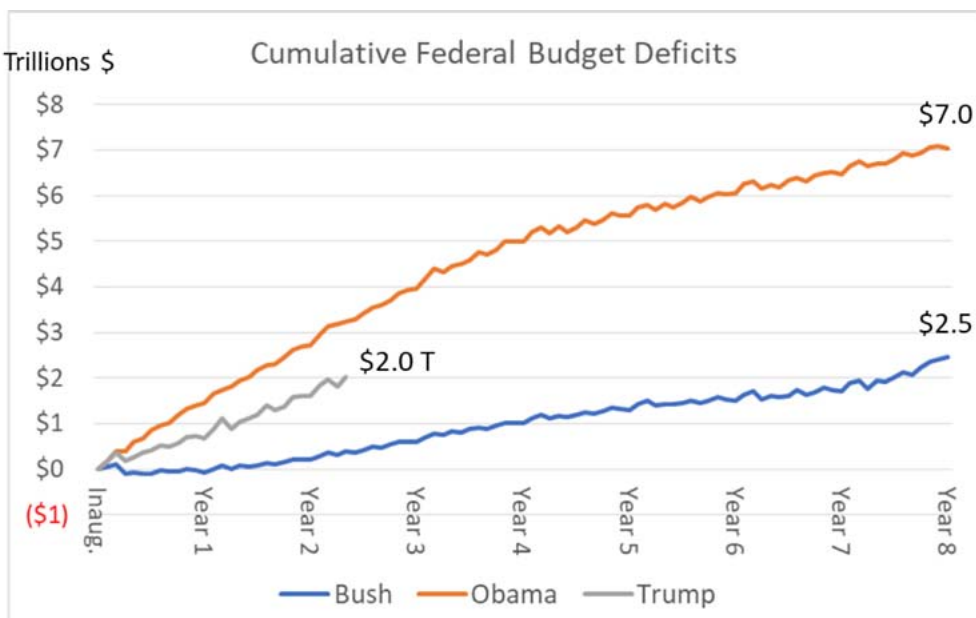
President Obama, faced with the worst economic downturn since the Great Depression, turned on the spigot in earnest. A combination of lower tax revenue, surging transfer payments, stimulus spending, and more tax cuts caused federal budget deficits to balloon beyond any in history. And the deficits continued throughout his presidency as the economy could never really achieve escape velocity without heavy fiscal and monetary support. By the end of his eight years in office, President Obama had racked up $7.0 trillion in cumulative deficits – a massive sum.

Budget deficits over President Trump's first 2+ years in office are on a trajectory more similar to that under President Obama than President Bush. Since his inauguration in January, 2017, the Trump administration has already presided over a cumulative $2.0 trillion in budget deficits. These deficits are mostly attributable to the passage of the Tax Cuts & Jobs Act (TCJA) in December, 2017, as well as a surge in government spending, particularly on defense. Unlike the Bush and Obama presidencies, however, the deficits incurred during the Trump years have not resulted from a response to any crisis. In fact, the economy had been growing at a steady pace of 2%+ and the employment rate was 4.1% when the TCJA was passed in December, 2017.

Renowned economist John Maynard Keynes postulated that the federal government should boost spending during periods of economic weakness in order to support economic recovery. However, he also said that government largesse should be avoided during times of prosperity so that there will be resources available when the economy inevitably deteriorates. If Keynes' widely accepted theories are correct, we have veered significantly off course. The capacity to respond to the next crisis or economic downturn may be severely impaired by the large deficits we are currently running.

The cumulative deficit over the past three presidencies is $11.5 trillion. You will see in the chart below that the Trump presidency is off to an ominous start from a budget perspective. Is it possible that the tax cuts will ignite the animal spirits and faster growth will more than make up for the lost tax revenue? Sure, I guess. But it's not happening so far. In fact, the economy appears to be reverting back to its trend growth rate of 2%, meaning that the stimulative impact of the tax cuts may have been fleeting. And slower economic growth will not produce the tax revenue that had been expected to offset the lost revenue from tax cuts.

It's highly unlikely that the deficit situation will be addressed any time soon.



Source: US Department of Treasury.

Emboldened by the recent sharp drop in interest rates, President Trump and Congress seem completely unfazed by the rising deficit and debt. In fact, about the only thing the parties seem to agree on is the need for an up to $2 trillion infrastructure spending bill. It is also being reported that President Trump is mulling a cut in capital gains taxes, the large majority of which will go to the top 1%. When does it all end?

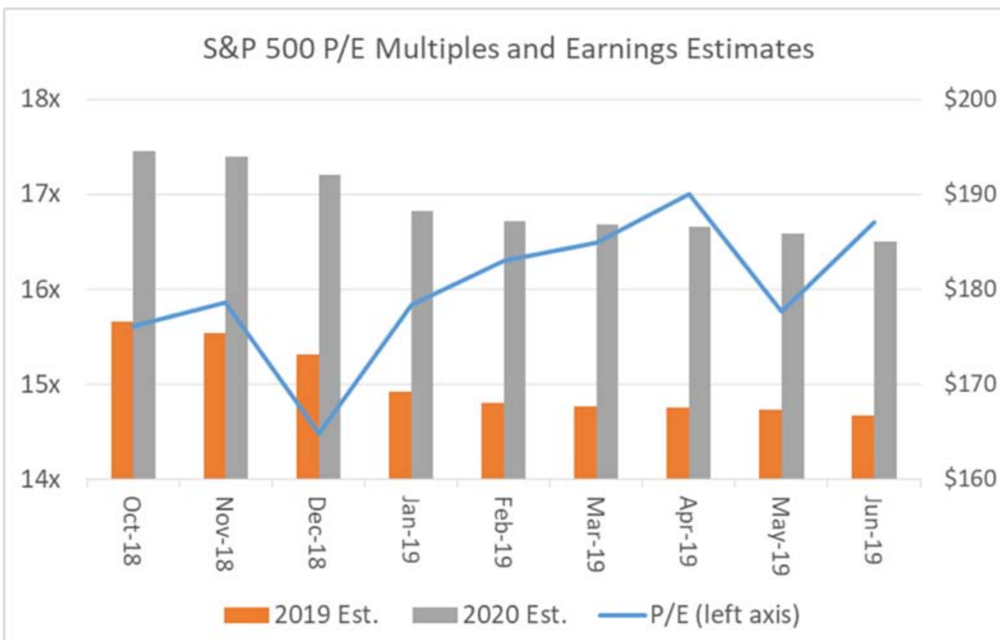
That raises the question, what happens when the laws of economics break down completely? As noted, long-term interest rates have been falling dramatically in recent months in the face of sharply rising deficits. It now costs the federal government just 2.0% to borrow for 10 years, down from a recent high of about 3.25%. Usually, when the demand for something rises dramatically, its price increases as well. Apparently not for the federal government.

And if you think that is bad, consider this. Austria just issued a 98-year bond with an interest rate of just 1.17%! With central banks aggressively attempting to stoke inflation, does anyone out there actually believe this is a good investment? (Hint: if it is, we are in for some trying times) The more likely explanation is that investors in these bonds think they'll be able to sell them at a higher price in the near future as interest rates continue to fall, an investment strategy known as the "Greater Fool Theory." In any case, these market "dislocations" are one side effect of many years of sustained central bank influence, and they make us nervous.

The Markets

The same contradictory signs that we wrote about in the second quarter edition of The Farr View remain firmly in place today, just more so. The bond market is signaling potential trouble ahead as rates continue to drop, the yield curve has become inverted in some spots, and credit spreads have widened out, albeit modestly. The stock market, on the other hand, sees nothing but smooth sailing. Commodities are a mixed bag, with some, like weakness in copper and strength in gold, signaling possible danger. And the dollar is firm, also suggesting a preference for safety.

It is important to point out that, after a brief respite in the month of May, stock prices are rising and we are again testing all-time highs in the face of decreasing earnings expectations. This means that investors have been willing to pay more for each dollar of earnings. The pros call this "multiple expansion" as the ratio of stock price to earnings (P/E) is increasing. Generally speaking, it would be preferable to see earnings growing simultaneously with stock prices. But not unlike countless bull markets in the past, the market continues to "climb a wall of worry." Indeed, perhaps the best bull case for stocks right now is the fact that there are so many disbelievers. In addition, President Trump's unwillingness to settle the China trade dispute keeps the Fed in dovish posture, while the prospect of settling the dispute prior to the election could very likely serve as a positive catalyst for stocks as well. In any case, nobody can predict short-term movements in the markets, so staying invested is the best policy!



Source: Factset

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