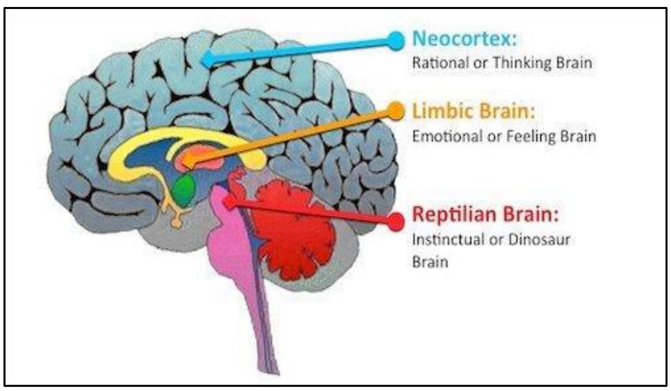
Ivory's Economic Outlook

FALL 2018 • IVORY JOHNSON; CFP®, CHFC; FOUNDER; DELANCEY WEALTH MANAGEMENT, LLC

It is the goal of every Englishman to make it all the way to his grave without becoming embarrassed.
John Cleese, English actor, comedian, screenwriter, and producer.

In the early 90's when life was simple and I was still cool, several friends and I went to a D.C. nightclub with our girlfriends. For whatever reason a male patron made an inappropriate gesture towards my friend's date, and when my buddy protested, he got sucker punched by a couple of guys we didn't know.

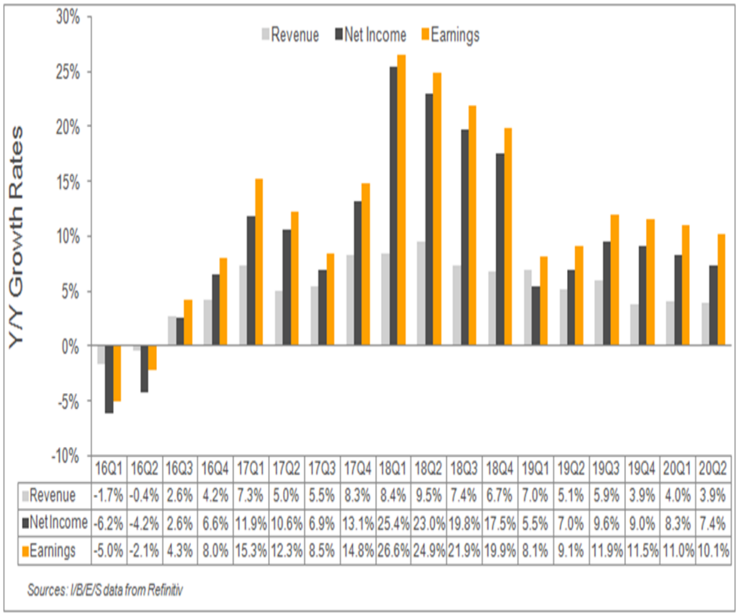
Upon hearing the news I feared we would pursue them and a fistfight full of false bravado would ensue. Fortunately one of our friends was a Navy SEAL home on leave who said in a calm voice "we don't know how many of them there are, their route, the terrain or whether or not they're armed. We can't go". Very much relieved that I didn't have to prove my suspect Lower East Side street cred, I grabbed a drink, went dancing and had a wonderful time.



It seems that the brain is divided between the limbic system, neocortex and reptilian brain. The latter controls our animal instincts that help us survive. Fight, flight, food and reproduction are all governed by the reptilian (or primal) brain. The amygdala in the limbic system, however, controls emotion and under stress will hijack the neocortex that makes the rational decisions. This tends to generate survival behavior when a rational response would be better suited.

I can say with a degree of certainty that Navy SEALs are trained to minimize the amygdala under stress. In an instant he convinced agitated young men filled with testosterone to swallow their pride and live for another day. Investors (and advisors) do not have that level of training and on occasion rely on survival instincts.

Lo and behold, studies routinely show that money is the number one source of stress for Americans, frequently generating biologically predictive financial behavior. The reason some give excessive amounts of money to family members at their own expense is because the prehistoric brain doesn't want to be kicked out of the tribe that millions of years ago provided food and shelter. Others live beyond their means to demonstrate that old scars of poverty have been removed. Depression survivors are known to hoard. You'd be surprised how emotional we are about money.



	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2
Revenue	-1.7%	-0.4%	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	7.4%	6.7%	7.0%	5.1%	5.9%	3.9%	4.0%	3.9%
Net Income	-6.2%	-4.2%	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	19.8%	17.5%	5.5%	7.0%	9.6%	9.0%	8.3%	7.4%
Earnings	-5.0%	-2.1%	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	21.9%	19.9%	8.1%	9.1%	11.9%	11.5%	11.0%	10.1%

Sources: I/B/E/S data from Refinitiv

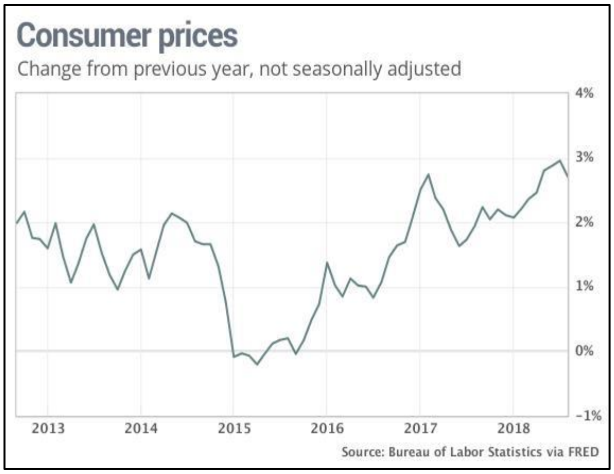
In this sense, investors are all too familiar with the narrative that nothing goes up forever and now there's talk that trade wars, Trump and the Federal Reserve will cause the market to crash. Veterans of the 2000 and 2008 crises remember what that felt like, and while the market rebounded both times, who's to say it will do so again when they are 10 years older and that much closer to retirement. Our brain has not changed, even if the circumstances are different. The current environment does not resemble 2008, one predicated on opaque investments and clinically irresponsible debt, but the fear of a market decline is natural all the same.

The neocortex would likely retort that GDP growth has increased on a rate of change basis for nine straight quarters and has likely peaked. Earnings growth is also beginning to decelerate. Sure, earnings have been good, but not compared to what was reported last quarter, declining from 24.9 percent growth to 21.9 percent this quarter with 56/500 companies reporting as of this writing[i]. This is not the boogey man; it's called the end of a cycle.

At the same time inflation has decelerated, peaking three months ago at 2.7 percent on an annual basis after a three year ascent[ii]. The Producer Price Index has declined for the last three months in real terms. Oil prices have begun to move lower despite Iran sanctions and political turmoil in South American oil producing states.

Macro-economic tourists and media outlets would have us believe otherwise. Let's start with President Donald Trump, the man responsible for singlehandedly destroying free trade with tariffs. The truth is he has delivered $20 billion in additional tariffs[iii], and with respect to retaliation, we paid $34.5 billion in tariffs in 2017[iv]. This, mind you, in a $20.4 trillion economy. Even if the prices of imported goods increase, the rising dollar will have a muting effect. Will some businesses be harmed? Sure. But let's not get carried away.

Remember when the pundits were concerned that renegotiating NAFTA would cause a big upheaval in trade with Canada and Mexico? Well, when the dust settled the new NAFTA deal (USMCA) was all but identical to the Trans Pacific Partnership negotiated by the previous administration[v]. The GOP simply used threatening anti-trade rhetoric to play to their base and then signed the deal that was already on the table. It was a good political move; give credit where credit is due.



The most recent culprit for market volatility is the Federal Reserve, now being blamed for stirring up trouble with interest rate hikes. The six rate hikes since December 2015 that didn't crash the market notwithstanding, one can make the case that that rising rates reduces the present value of future revenue and lowers valuations. What's being ignored is that short term rates are being impacted much more than long term rates, a sign that the market is beginning to believe growth and inflation are both slowing, which weighs on stocks much more than any Fed policy.

My Navy SEAL friend told me that he once had sobering advice for a nervous soldier in the field: give up any hope of coming home alive and consider yourself dead. He knew they were in clear danger, that they had every right to be scared, but that unless they lived in the present they wouldn't be able to function and that put the entire team at risk. Misreading the market is not dying literally, but it is the death of self-image, ego and business relationships.

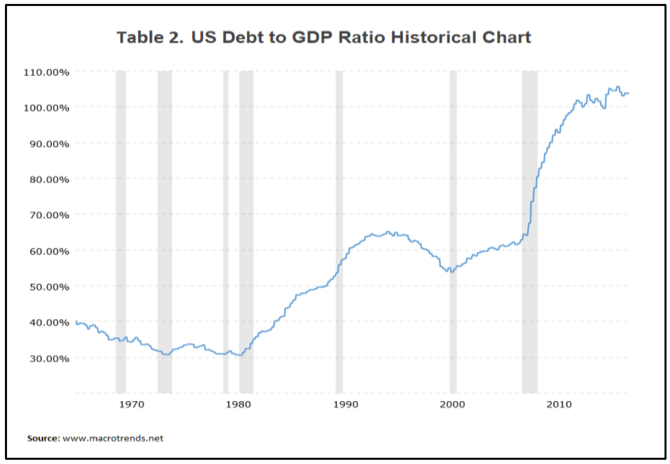
In November of 2007 I wrote an article for Ebony magazine where I suggested that we would soon have a credit crisis because I knew 36 percent of the bond market was collateralized by mortgages and credit card debt[vi]. I knew that 10 percent of disposable income was the consequence of cash out refis and that vague investments were on the balance sheets of our largest banks. Or said another way, it was a train wreck waiting to happen.

Watching the market decline 50 percent over the coming year, even though my clients fared much better, was a traumatic event and the reptilian brain filed that away as a danger. Instead of claiming a victory, I questioned why I wasn't more proactive. Eckhart Tolle writes in the "Power of Now" that "the obsessive need to be right is an expression of a fear of death". Turns out that on a number of occasions I've been too afraid to die.

Nevertheless I thought that GDP growth and inflation would slow in the 4th quarter, signaling a change in the investment weather. I surmised that in this climate we would want to own utilities, real estate investment trusts, healthcare and consumer staples instead of growth stocks. The emerging markets and financial sectors seemed to be in a bad place, so making money when they lost value looked like an opportunity. Knowing when to rotate would always be the problem, but the process began months ago and we're very much alive.

Truth be told, a far bigger concern is the size of our national debt, because that too is a train wreck waiting to happen, even if nobody has a clue of when it will come to pass. For a little housekeeping, Uncle Sam owes $21.6 trillion and the deficit just jumped by 17 percent[vii]. Once you account for social security, Medicare, Medicaid, the military and interest on our debt, pretty much everything else has to be borrowed.

Way back when life was simple for Baby Boomers and they were still cool, Reagan convinced the country that borrowing money would promote economic growth. What we forget on our way back to the well of make-believe is that the debt to GDP ratio was 30 percent in the early 1980's and The Gipper had headroom[viii]. Today the debt to GDP ratio is 105 percent. Moreover, the recent tax cut is expected to increase the debt by another $1.5 trillion[ix], and that's assuming the economy continues to grow over the next 10 years with the individual tax breaks disappearing in 2026 (the corporate tax cuts are permanent). We will also have to pay growing entitlement expenses. And if you think it's just the U.S., take a peak around the world and Uncle Sam looks relatively frugal – debt in the emerging markets (including China) has increased from $9 trillion in 2002 to $63 trillion in 2017[x].



The neocortex would remind us that wealth never disappears, it only shifts. Now would not be the time to build a bunker and buy canned goods. Worst case scenario the IMF would come to the rescue of the central banks the way the central banks came to the rescue of the Wall Street banks in 2008 who came to the rescue of Long Term Capital Management in 1998 when the collapse of a $126 billion hedge fund threatened the global financial system[xi]. The self-esteem cemetery must be jammed packed.

Investors should keep their wits about them and play the cards on the table. We have slowing growth and inflation. Also, Europe and emerging markets should be avoided until further notice because they got to where we seem to be headed two quarters ago. Some asset classes do well in this environment and I've already taken a position in them. The national debt may be a problem down the road, although lets allow Mr. Market to weigh in before we take preventative measures.

Our experiences in life, some more traumatic than others, will often cause the brain to sound the alarm and bring us back to a place of comfort. We would all be wise to identify how and why we make these decisions to become more financially astute. Or said another way - it's time the neocortex lets the reptilian brain know who's boss.

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The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

[i] S&P 500 Earnings Dashboard; 10/17/18; Reuters

[ii] Consumer inflation climbs again in August, CPI shows, but pace of increase slows; Marketwatch.com; 10/13/18

[iii] Trump administration announces list of tariffs on $200 billion in Chinese goods, CNBC.com; 7/10/18

[iv] You're already paying tariffs on clothing and shoes, and have been for almost 90 years, CNBC.com; 4/6/18

[v] Trump's big fight with Canada over dairy gets the US only $70 million more than TPP trade deal, CNBC.com; 10/2/18

[vi] How the Mortgage Crisis is Affecting You; Ebony Magazine; November 2007

[vii] U.S. Government Deficit Grew 17% in Fiscal 2018, Wall Street Journal; 10/15/18

[viii] Federal Reserve Bank of St. Louis

[ix] Trump Signs $1.5 Trillion Tax Cut in First Major Legislative Win; Bloomberg.com; 12/22/17

[x] The emerging market crisis is back. And this time it's serious; CNBC.com; 9/4/18

[xi] The Epic Story Of How A 'Genius' Hedge Fund Almost Caused A Global Financial Meltdown; Business Insider; 7/10/14