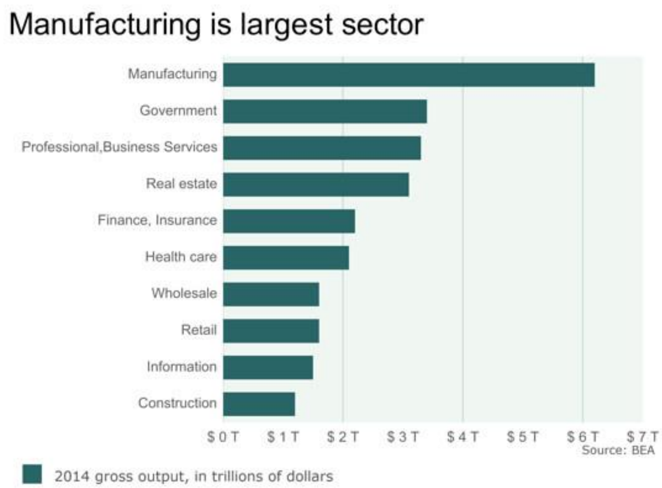
Ivory's Economic Outlook

SPRING 2017 • IVORY JOHNSON; CFP®, CHFC; FOUNDER; DELANCEY WEALTH MANAGEMENT, LLC

In America, events can move from the impossible to the inevitable without ever stopping at the probable.
Alexis de Tocqueville, French historian

Several years ago my son came to the office on a Saturday morning, for what reason I cannot altogether recall. He immediately touched my computer screen, which prompted me to let him know that this was not something to play with - it was my work machine. There are times in life when we begin to feel old, and when a 14 year old says "dad, it's a touch screen", the days of being cool come to a swift an unceremonious end.



Such has been the case for factory workers. Sure, it's nostalgic to demand the return of old jobs, but manufacturing output has doubled over the last three decades in large measure because technological advances paved the way for more efficiency that claimed five million jobs that have been lost since 2000[i].

A sea change is not unique to manufacturing. I graduated with a finance degree in 1988 when Paul Volcker was the Federal Reserve chairman, passed my CFP exam in 1997 when life was much easier and I could still do more than the middle aged two-step on the dance floor. The things I learned in the mountains of Pennsylvania have become obsolete one economic cycle at a time, and will continue to be outdated until fundamental analysis and macro-economic data stops the music as it has done so often in the past.

Sometimes change is difficult to grasp. There's a sense that things will be as they once were and everyone will know that capital goods ordered and price earnings ratios still rule the day. And while all of these things matter, like the ability to remember phone numbers and admit mistakes, they're just not as important as they used to be.

It should come as no surprise, therefore, that robotic trading, algorithms and high frequency trading make up the majority of the volume on the NYSE[ii]. Driverless tractor trailers might be 5-10 years away, but buying and selling stocks on auto pilot has arrived. These computer programs, for good or for bad, do not care much about dividend coverage ratios and consumer confidence models.

What matters instead are automated entry and exit points determined by mathematical outputs. If a stock opens at $11, goes to $12 midday and closes at $11.50, that graph will look different than the stock that stayed at $12 – one showing more momentum than the other. This is known as stochastics, and when graphing different time frames, when certain lines overlap, that can be a buy or a sell signal to a computer program.

U.S. Election Guide to Markets

	Trump wins	Clinton wins	Democrats Sweep
Stocks	Negative with increased volatility, especially rate-sensitive equities. Longer term, infrastructure stocks outperform.	Relief rally after recent slump on Trump's rise. Drugmakers, banks underperform on regulatory fears.	Smaller relief rally, bigger downside for drugmakers, banks. Longer-term upside for infrastructure and downside for financials.
U.S. Dollar	Down vs. developed currencies, especially Swiss franc, Japanese yen in flight to safety. Up against others, especially emerging ones on protectionism fears, with Mexican peso taking biggest hit. Later, greenback may strengthen on tax cuts, spending increases.	Up vs. developed currencies as focus shifts to Fed raising rates. Neutral against most emerging-market ones, but peso and maybe Russian ruble will strengthen.	Up even more for advanced currencies on increased spending, possibly after initial shock.
U.S. Treasuries	Initial flight to safety would drive prices up, yields down. Tax cuts and spending may later shift money to equities, pushing bond prices down, yields up, even more so if isolationism prompts other countries to unload Treasury holdings.	Risk-on would drive prices down, yields up, especially in initial relief rally. Longer term, not much impact.	Prospects for more spending would drive prices down, yields up.
Commodities & Energy	Very positive for gold, other precious metals as havens. Anti-Iran rhetoric bodes well for oil prices; pro-coal stance bad for natural gas. Copper may rise on infrastructure stimulus.	Climate change, environmental agenda bad for oil and coal, good for renewables.	Same, if not more so.
Emerging Markets	Negative, except for Russia, due to skepticism on trade deals. Mexico, Southeast Asia, China may be most vulnerable. India, Indonesia less so due to robust economies.	Very positive due to increased appetite for riskier investments with bigger potential payoffs.	Same as if Clinton wins.

Source: Bloomberg reporting — Bloomberg

This naturally creates patterns that on occasion can repeat themselves. Think of a sound wave, which is the pattern of disturbance caused by the movement of energy traveling through a medium. This configuration tends to reach similar high and low points, such that one could draw a horizontal line at the top and the bottom. Should one be in the market to purchase a stock moving in a similar pattern, it would behoove them to be familiar with its direction. Keep in mind that there are several other indicators that also warrant attention.

In February I noticed that a chip company was trading at the low end of its risk range and the stochastic indicators were reversing to the upside. I wouldn't fashion myself as a technology expert, touchscreens notwithstanding, but I did know that there was a tight supply and heavy demand for the DRAM and NAND memory chips manufactured by the company[iii]. Either data point would be attractive on its own merits, but coupled together suggested a reasonable entry point.

With that said, if you want to make God laugh, make plans. A fool proof investment strategy does not exist, which is unfortunate, because all of us experience time sporting a dunce hat at some point in our careers. Of the thousands of publicly traded stocks, few have a pattern that is discernable. There are other times when everything lines up and an analyst downgrades a stock out of the blue. Just because you see stars doesn't mean you're in love; you might have bumped your head. It is helpful, however, to coordinate conventional methods with the current landscape to give yourself the best chance of success.

For the last 27 years my friends and I from the freshman year dorm visit Penn State for a football game and a festive tailgate. What started as eight or nine guys eating hotdogs cooked on a grill lifted from the garage of somebody's unsuspecting parents has evolved into Big Bill's RV with two gas grills. Shrimboat Johnnie brings seafood (obviously), Wingo has bourbon, Paul buys the Irish whiskey and I make the chili and curry chicken. I could go on, but you get the point.

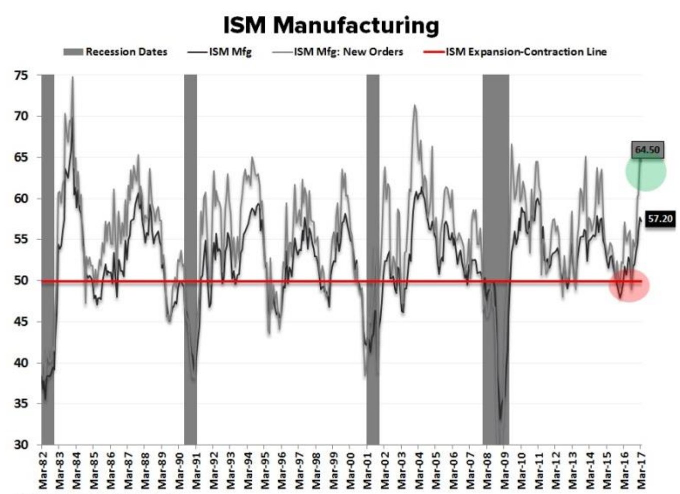
Last year we were in the stands for the Ohio State game to witness the biggest upset of last year's college football season. Penn State managed to block a kick and run it back for a touchdown setting off pandemonium inside Beaver Stadium. It was the highlight looped time and again on ESPN, perhaps because nobody could grasp what just happened.

I also paid attention to the number of lawn signs, bumper stickers and "Make America Great Again" hats while I was there because it was a month before the election and Pennsylvania was a battleground state. In the 2012 general election, President Obama beat Mitt Romney by five percent in the commonwealth state, but a funny thing happened in the 2016 primaries – the Republican turnout had increased by 62 percent while the Democratic turnout declined by 21 percent.

Voter participation in the 2012 election was 65 percent of registered voters in Pennsylvania[iv], or 5.7 million people, and with the Democrats leaning heavily on identity politics, boasting how many minority voters (who made up 12 percent of the state population) supported their candidate, it was clear what could happen in a state where roughly a third of the voters were independent. In the end, Secretary Clinton received almost as many votes as did President Obama in 2012, but not enough to overcome the additional 290,299 votes cast for her counterpart.

For what it's worth, Ohio has a similar demographic as Pennsylvania and the Midwestern Democratic voters in Michigan and Wisconsin where not all too pleased with the trade agreements championed by Secretary Clinton. In short, it was not just conceivable that Donald Trump would win the general election, but mathematically probable. Not only had disgruntled Bernie voters caused friction within the party, but no candidate in the modern era had ever become president after losing both Ohio and Pennsylvania.

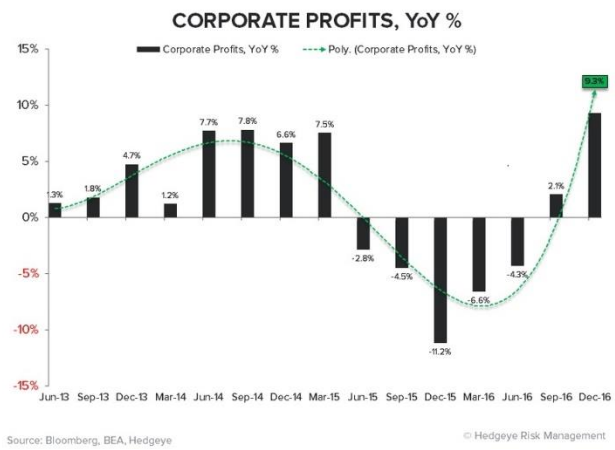
President Trump's victory was not an upset; it was actually somewhat predictable. Nevertheless, the prospects of him occupying the White House were seen as Armageddon on Wall Street. To begin, he had little government experience and was not known for his bedside manners - anything was likely to come out of his mouth. If there's one thing the markets don't like, its uncertainty.



This led to predictions that the market would react negatively to his election. Bloomberg went so far as to suggest gold, long bonds and other safe haven assets if he managed to acquire 270 electoral votes. Having suspected President Trump's election, it reminded me of one of my father's sayings: sometimes you're so smart you're stupid. The fact is Bloomberg was wrong and all of their proposed safeguards against pending doom got crushed.

In the immediate aftermath of his election, the playbook was spot on, until it wasn't. Over the next several weeks the market went on what was coined the "Trump Trade", fashioned as stocks rallying on the expectation of economic growth now that the ACA would be repealed, corporate taxes would be reformed and infrastructure spending would boost economic growth.

So here we are, some six months later still waiting for the big legislative success that served as a basis for so much optimism in November. Not unlike the person who threatens to call his lawyer when everyone knows he does not have an attorney, the GOP was unable to pass a viable alternative to Obamacare after seven years of colorful rhetoric, and without that, the odds of a quick reform of taxation seems less and less likely.



Nevertheless, while the economy was slowing last year without any reaction by the markets, this year we have experienced economic growth and so far so good. After all, U.S. economic growth fell from 3.3% year-over-year in the first quarter of 2015 to 1.3% in the second quarter of 2016. After bottoming out, growth is rebounding once again with 4th quarter 2016 U.S. GDP growth at 2% year-over-year.

Meanwhile, the manufacturing index is surging and corporate profits are rebounding. If you'll recall, profits had previously declined for three straight quarters, something that had not happened without a market crash during the history of the stock market. It seems investors dodged a bullet because it was never fired. Of course, the same experts who counselled investors that the sky would fall with a Trump victory now think the rally is exhausted, or said another way, nobody knows for sure.

To be clear, the Penn State football team returned a lot of talent in 2016 and showcased a full complement of athletic scholarships in the wake of NCAA sanctions that justifiably threatened the viability of our football program. Beating Ohio State would have been an upset if we didn't go on to win the Big Ten Championship, scoring an average of 37.5 points a game – it was not a fluke.

Truth be told, the turnaround happened because we installed a new offensive game plan known as the "read option" once it became obvious that three yards and a cloud of dust didn't work anymore. If we're being honest, the fans care more about the results on the scoreboard than how a mobile quarterback induces the linebackers to move out of position with a fake handoff that opens up the passing lanes.

There's nothing wrong with macroeconomic and fundamental analysis, just as teams will still run the football up the middle. Nevertheless, one must use conventional tools with new approaches in an effort to stay competitive. Nostalgia has its place and that place may no longer reside in the financial markets.

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[i] Think nothing is made in America? Output has doubled in three decades; MarketWatch; 3/28/16
[ii] High-frequency traders in charge at NYSE; Financial Times 1/26/16
[iii] Micron profits from memory shortage, expects party to continue; MarketWatch; 3/24/17
[iv] As far as voter turnout, 2012's got nothing on 2008; Newsworks; 11/7/12