Ivory's Economic Outlook

SPRING 2019 • IVORY JOHNSON; CFP®, CHFC; FOUNDER; DELANCEY WEALTH MANAGEMENT, LLC

"What's the subject of life - to get rich? All of those fellows out there getting rich could be dancing around the real subject of life."
Paul Volcker, Former Federal Reserve Chairman

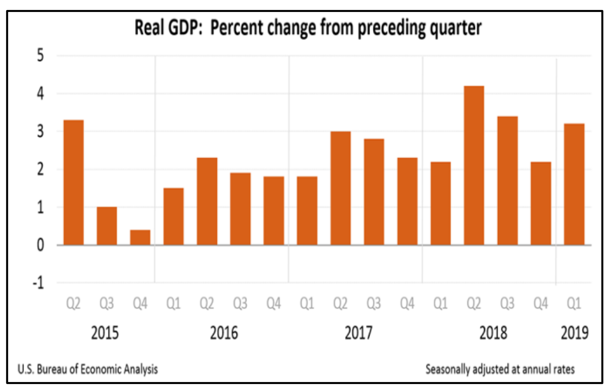
My son has a new girlfriend in college who's majoring in pre-med and going to school on a full ride. She's also very pretty, or so he tells me, and so he accepted an invitation to spend Easter Sunday with her family in Birmingham Alabama. Knowing what I know I recommended he trim the beard, get a real haircut and make sure his tools are in the trunk because her father won't look kindly on unkempt suitors who can't change a tire.

Within minutes of arriving, her dad asked him to jumpstart his other daughter's car because the battery had died. I knew pops drained the battery in advance of the new visitor because I would have done the same thing. My son was satisfied with his alleged "man skills" and appeared to enjoy his time in the Deep South.

The truth is we don't always get a fair deal. If anyone judged me by my 1987 era flat top haircut, my opportunities may have been limited, internships and a finance degree notwithstanding. And so what, nobody said life was fair, especially my dad who made me get a haircut when I got home from college.

By all measures economic growth has been slowing, and by that I don't mean a recession, it's just that we're not growing as fast as we once were. We grew at 2.2% in the 1st quarter of 2018[i], 4.2% in the 2nd quarter[ii], 3.4% in the 3rd quarter[iii] and 2.6% in the 4th quarter[iv], all of which represents a downward trend. Given these and other sets of data, it was probable that the 1st quarter 2019 growth would be below 2%, except according to the Department of Commerce we grew at 3.2%[v].

There's an old saying, usually uttered by CPA's, that figures lie and liars figure. Insurance companies are famous for selling policies by illustrating unreasonable growth rates over a 30 year time frame. Pensions are underfunded in part because they artificially inflated the growth projections when unions demanded more benefits. The trustees simply increased the assumed rate of returns, which reduced the required contributions to the pension and that freed up the cash to provide better health care benefits or pay raises. In Harvard business school they call this smoke and mirrors.

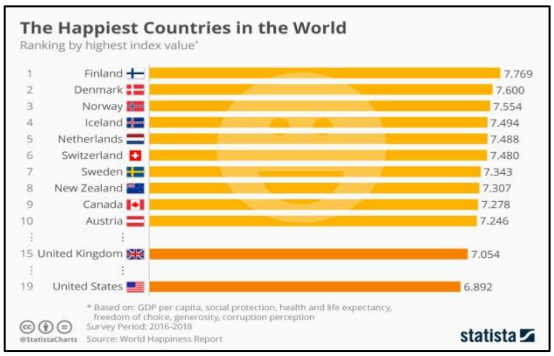


It turns out the GDP numbers were subject to the government's own rendition of creative accounting. When you hear GDP being reported, they're reporting economic growth in that year's dollars. That requires them to first calculate all of the changes in prices that have occurred during the year. If prices increase by 10 percent, when you divide that into GDP priced in last year's dollars, the reported GDP looks smaller than if prices only went up by five percent. This is known as the deflator.

Lo and behold the inflation numbers used in the deflator were not the source used for previous quarters, but a much lower (and arbitrary) number[vi]. Had they used the traditional inflation number, GDP would have been less than 1.6 percent, roughly half of what was reported. Harvard has a term for this technique as well.

The book "21 Lessons for the 21st Century" describes how the global elites formulated three grand stories that claimed to explain the past and predict the future of the entire world. The Second World War eliminated the fascist story, the communist story collapsed in the 1980's and only the liberal story remained, one that celebrates political rights, economic opportunities and personal liberties. It is the arch enemy of tyrant governments that restricts the movement of individuals, ideas and commerce.

Humans, however, are much better at inventing tools than using them. Complicated derivatives and adjustable rate mortgages seemed like a good idea at the time, but were seen in a different light after the 2008 financial crisis. Moreover, many middle class families found themselves, and their circumstances, at odds with globalization, artificial intelligence and the commoditization of their occupations. To put it plainly, liberalism is not working for everyone and we are witnessing firsthand how terrifying it is to have no story at all.



Part of the problem is Americans became obsessed with how much stuff we can accumulate, confusing net worth for self-worth. The United States is the wealthiest country in the world and ranks 19th on a list of happiest nations[vii]. We have in many instances forgotten that our passions and sense of purpose are the point of the entire exercise and identifying these goals should outrank late model vehicles and finished basements.

In a perfect world we would pay more attention to the things that make us happy, like hobbies, interests and relationships, but our world is shaped by policies that create the means at the expense of the meaning. The Federal Reserve's mandate is to control inflation and maximize employment. It is a sound premise to believe we are more content with a good job and spending power that affords us the ability to do things that are fulfilling. Over the course of time, however, it has morphed into a wonder drug for financial assets that has Wall Street addicted to cheap money and profit margins, things that have less to do with happiness than we think.

Last year we were told that the Fed would raise interest rates and reduce the size of the punch bowl used to juice a once struggling economy. It seemed that the economy was booming and needed to cool off. What ensued was a significant market decline and 41 days without a single high yield bond being issued. The Fed responded by changing their tune on rate hikes and the market quickly rebounded.

The economy was still producing jobs and inflation was actually decelerating, although the Fed's mandate now demands they address the stock market and not just the market participants. There's nothing wrong with the tool, it's just being used for a different purpose. What should be a great story of liberalism that permits business cycles to run their course and motivate workers to adjust to changing environments has devolved into the Federal Reserve handing out fifth place trophies to Wall Street when their trophy case is already full.

Every quarter companies tell us how much money they earned during earnings season. In my world I pay attention to whether the earnings are accelerating or decelerating, much like I do with GDP. Lo and behold, earnings increased by 24% in the 3rd quarter[viii], 14% in the 4th quarter[ix] and as of this writing they're up 2% in the 1st quarter of 2019[x]. Once again, this usually isn't that big of a deal if you're aware that it's happening and the implications that may follow.

The same would hold true for companies who spent over $4 trillion on stock buybacks over the past ten years. To put that into perspective, we're talking about the same amount of money allocated to Quantitative Easing and represented all net new purchases of stocks since the financial crisis[xi]. Let me rephrase that: there have been essentially no other buyers of equities over the past decade besides the companies themselves, even as liquidity has fallen to record lows, courtesy of low interest rates that made it feasible for companies to borrow money and acquire the shares.

The point is the Fed, Wall Street and sympathetic bureaucrats can massage the numbers until the cows come home, but the cows are still coming. The markets will eventually react to a slowing economy that has traditionally (and currently) rewarded certain sectors that we've owned for the last nine months. There's no sense panicking or making it more complicated than it is, particularly when there's plenty of complicated stuff to fix.

For the past two years the U.S. and China has been engaged in a war of words over trade. It seems that both sides have threatened (and in some cases implemented) tariffs on foreign goods. Any time the two largest economies butt heads it's bound to cause uncertainty, even if non-agriculture CFO's are unfazed. Most domestic companies suggest that the unfolding drama doesn't concern them because the Chinese abuse of intellectual property is a far more pressing problem[xii].

In any event, all negotiations are a function of leverage and the fact is twenty percent of Chinese exports come to the U.S. and they need us more than we need them[xiii]. There is also a matter of their banking system that is already on shaky ground. During the financial crisis, our banks had $1 trillion in equity, $17 trillion in loans and lost $800 billion. We were able to recapitalize the banks because we have the Federal Reserve and can print money. Problem solved.

China on the other hand has $50 trillion in loans with $2.6 trillion in equity. According to the IMF, however, seven percent of those loans are non-performing[xiv]. Assuming they get 80 cents on the dollar, that would wipe out all of their equity, and unlike the U.S. they can't print their way out of it. The more they devalue their currency, the more expensive it is to buy oil and pay for education abroad. I believe these two things to be true: China is not our biggest concern and communism is a really bad idea.

The only reason failed trade talks affect the market is because tariffs cause inflation and that increases the odds that the Fed would raise rates in response. This just goes to show that developed nations have come to depend on printing money and strip-mining the balance sheets of well-run companies to solve their problems. We outlasted fascism and communism only to have liberalism challenged by the weight of its own success.

The truth is America needs to focus on the national debt, pensions and entitlement spending; the economy will take care of itself. In that sense, we'll stay focused on what we know and avoid the temptation to ignore the same math that served us well last year during extreme periods of volatility. I'll confess that it's boring, but the truth is not much has changed. The economy went on vacation and all you got is this newsletter.

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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

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[i] US first-quarter growth slowed more than estimated, weighed down by the weakest consumer spending in nearly 5 years; CNBC; 6/28/18

[ii] US economy logs best performance in nearly 4 years; CNBC; 8/29/18

[iii] US third-quarter economic growth revised down to 3.4%; CNBC; 12/21/18

[iv] Fourth-quarter GDP increases 2.6%, better than expected; CNBC; 3/1/19

[v] US economy grows by 3.2% in the first quarter, topping expectations; CNBC; 4/26/19

[vi] Why Did Rates Fall On The 'Strong' GDP Print?; Seeking Alpha; 4/30/19

[vii] This is the world's happiest country in 2019; CNN; 3/26/19

[viii] Corporate profits are reaching their peak and history shows that's bad news for the stock market; CNBC; 11/5/18

[ix] Earnings Help Steer Stock Market's Recovery; Wall Street Journal; 2/24/19

[x] The feared 'earnings recession' is not showing up in the first-quarter numbers; CNBC; 4/29/19

[xi] Stock Buybacks Aren't Bad. They're a Symptom of a Larger Problem; Bloomberg; 2/6/19

[xii] The truth about Trump's China tariffs: Many major US companies didn't think they were still a big deal; CNBC;5/7/19

[xiii] Why the U.S.-China trade deficit is so huge: Here's all the stuff America imports; MarketWatch; 5/10/19

[xiv] IMF