Ivory's Economic Outlook

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

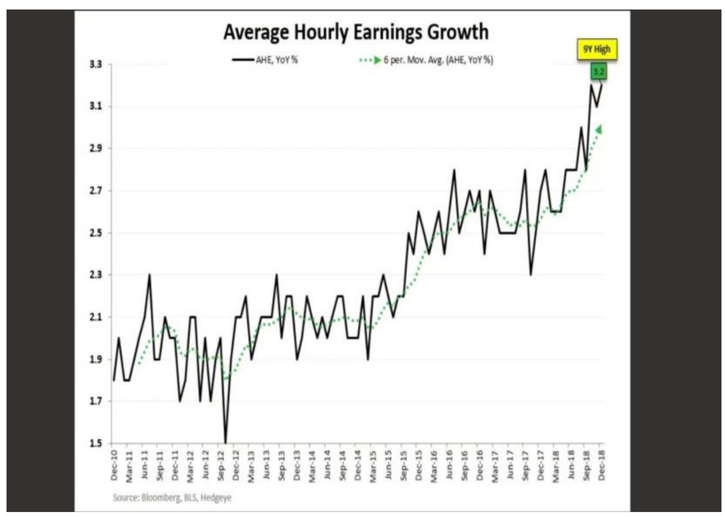
"You're not going to make Hemingway better by adding animations"
Jeff Bezos, Amazon CEO

I returned home from college in August of 1988 when flat top haircuts and CD players were all the rage. One of the first conversations I had with my dad was not career advice, but rather a six month deadline on when I had to move out of the house and get my own place. He reasoned that two grown men couldn't live under the same roof. Old school had struck again. It was time for me to leave the nest.

Life is a series of patterns that revolve around lessons we are meant to learn. My go-to song is John Coltrane's *Summertime* on the *My Favorite Things* album. He begins by blowing his brass sax with a violence reserved for hurricanes. Meanwhile, the bass, the piano and drums each follow his lead, all desperately trying to keep pace. One by one the instruments stop playing. First the sax, then the piano and then the drums are the last to flee the scene until we're left with only the bass whispering in the background.

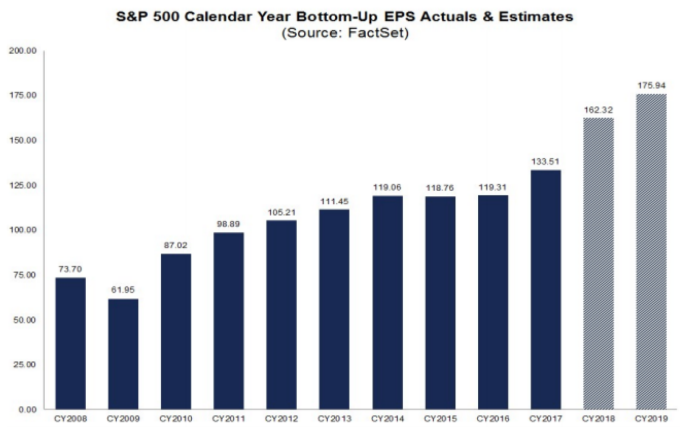
This is the gloomiest part of the song; the time when you lost your job, a lot of money or a loved one. Fortunately it doesn't end here; it rarely does. First the drums come back, then the piano and then the hurricane reappears to indicate redemption in the form of Trane blowing blue notes with all of his fury – you made it through the hard times. Hallelujah.

Suffice it to say nobody is playing the saxophone these days and I'm not sure I hear the piano either. After GDP grew from 2.2 percent in the first quarter of 2018 to 4.2 percent in the 2nd quarter, it decelerated to 3.4 percent in the 3rd quarter. By the time you get this newsletter it's likely that the 4th quarter numbers are below 2 percent. Inflation has also slowed noticeably, so much so that the Fed has recognized they can't hike rates as planned, a well-received bit of news for a market beginning to doubt itself.



More recently investors have been buoyed by good news in the form of positive job numbers and wage growth that coaxed a solo from Wall Street's magic horn. The problem is they're not part of the band. When wages increase, corporate profits get squeezed and then "heh, let's fire Bob". Wage growth is a lagging indicator that the economy is decelerating, not a sign of better things to come.

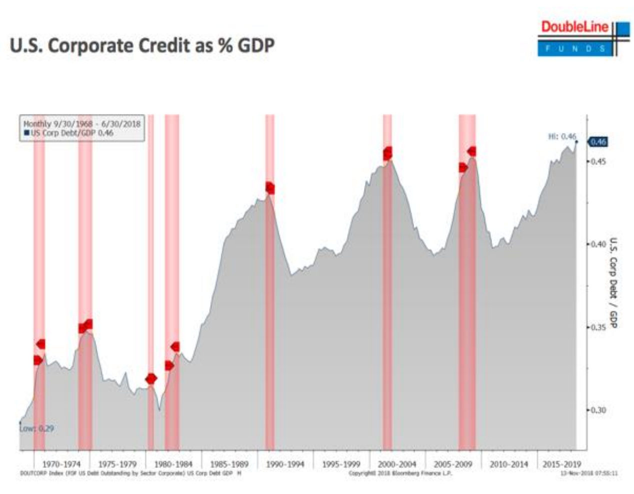
Investors who've never listened to Trane were blindsided in the 4th quarter when the S&P 500 dropped by 13.6 percent. Who can blame them when the New York Times suggested the economy was strong because jobs and wages moved higher in August[i]. Goldman Sachs followed suit and claimed the economy was growing at twice the rate of their estimate in September[ii]. It would appear that there are easier things to do than pick the top of the stock market, and as you well know, picking the bottom isn't one of them.



Decelerating growth and inflation only tells part of the story. I worked at a bank as a Trust Officer, helping high net worth clients establish estate plans and referred them to our proprietary money management platform. If I had a great quarter, they would raise my target. Once I surpassed that target, management raised it again. This pattern continued until I figured out the hustle - they'd burn us out and put somebody else in the same seat.

In that same vein, earnings season is upon us and the bar is set exceedingly high. After nine straight quarters of GDP growth on a rate of change basis, it will be difficult to satisfy the unreasonably high expectations. It's that big once in a blue moon deal you worked on for several years that finally came through and the subsequent look on your face when management told you to do it again by 20 percent more than the year before. The corporate tax cut is the sugar high that the district's best salesperson won't repeat any time soon.

The second law of thermodynamics says that whenever energy is transformed into a useful form, it also produces useless energy as a degraded by-product, known to laypeople like myself as unintended consequences. Over the last few quarters companies used that extra tax cut money to buy back their own stock, responsible for a per share 2nd quarter 2018 earnings increase of 25 percent over the previous year[iii]. In earlier years they could borrow the money at low interest rates and spend over 50 percent of their net income on buybacks once you take stock issuance into account[iv]. Lo and behold, corporate debt has surged to over $9 trillion in the last ten years[v]. What could go wrong?



Many of us have simply developed habits that determine behavior patterns predicated on complacency. In fact, social media has made a fortune from it. Habits are behaviors done with little or no conscious thought and give us the ability to focus our attention on other things by storing automatic responses in the brain. They form when the brain actively stops deliberating on what to do next.

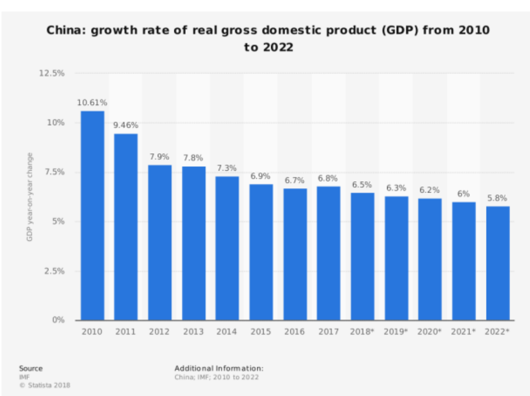
The book "*Hooked*" suggests the reason so many people are glued to their phones is because social media has figured out how to influence customers to use their product on their own, again and again, without relying on calls to action such as ads. Instead of being a vitamin, they provide painkillers and an itch to go along with them. Not only do they solve a problem, but cause pain when you don't use their product, and before you know it you're hooked.

They're more scientific than you think because they manufacture triggers that provide the basis for sustained behavior and communicate the next action the user should take. That's why users crave social acceptance to avoid social rejection. Got another like? Click. Got a friend request? Who's it from? Heaven forbid you miss something (like a rush of endorphins). Studies show that users open certain apps when they're bored, a tell-tale sign of digital addiction.

Investors are likewise hooked on headlines and optimism. We crave positive outcomes and the sailboats shown on retirement planning advertisements. The agony of being left behind demands that something scratch that itch. Everyone knows losing money causes more pain, but Wall Street can't make money selling vitamins.

Some of us are lucky to avoid habit forming investment behavior. Warren Buffet is widely recognized as one the greatest investors of our time. In the book "*The Warren Buffett Way*" he explained why he famously avoided internet stocks, suggesting he didn't understand them and they had no economic moat to protect them against competitors. He initially caught flack for missing out on the party, but as is always the case, wily old Warren proved his naysayers wrong.

Now the naysayers are up to their old tricks again. Apparently Warren Buffett owns 252.5 million shares of Apple, which recently announced that they're not selling quite as many cell phones in Asia as expected and lowered their sales guidance[vi]. It was bound to happen. Every year my son asks me for a new cell phone, but now that they're selling for $1,000 a pop he didn't even bother to ask. #OldSchool.



There's more to it than just the price. The Chinese economy has slowed considerably, and that's just what they're telling us. They reported that economic growth decelerated to the slowest rate in 10 years at 6.5 percent, although it's now assumed to be sub 6 percent because weak domestic demand signals structural problems in the Chinese economy[vii].

A trade deal won't increase domestic demand for Chinese products any more than trade tensions are causing volatility in the market. The bounce we've seen since the beginning of the year is optimism that a deal will reflate growth and inflation. The reality is trade tensions have nothing to do with the end of a business cycle and the anticipated trade deal doesn't reflect the rosy picture promoted by the headlines.

For those of you keeping score at home, China's exports just suffered their biggest decline in two years and it had nothing to do with declining exports to the United States - they actually racked up a record trade surplus with Uncle Sam[viii]. Instead it seems that goods shipped from China to the rest of the world fell by more than four percent in December, in part because Europe's economy has slumped to the lowest level in four years[ix].

Truth be told, President Trump had nothing to do with the recent sluggish activity, he just happens to be the president when the cycle is slowing. Before you eat dinner somebody has to cook it. As much as investors would like to microwave an economic outcome, the Federal Reserve is the only outfit that believes such a thing possible.

In that sense, there's not much left for us to do but let the cycle play itself out. To the extent that we got defensive in the back half of last year, hallelujah, chalk one up for the good guys. We'll likely want to hold real estate investment trusts, utilities and bonds until the data changes. Sooner or later Trane's going to make that brass sax spread the gospel, but only when the cycle is worthy of redemption and that won't happen until GDP and inflation changes their tune.

In other news, Warren Buffett has one helluva jazz collection.

He'll be just fine.

---

[i] In a Sign of the Economy's Strength, Jobs and Wages Moved Higher in August; New York Times; 9/7/18
[ii] Goldman: Economy growing at 'twice our estimate' of its potential; CNBC; 9/10/18
[iii] Share Buybacks Help Lift Corporate Earnings; Wall Street Journal; 9/23/18
[iv] Are Buybacks Really Shortchanging Investment?; Harvard Business Review; April 2018 Issue
[v] A $9 trillion corporate debt bomb is 'bubbling' in the US economy; CNBC; 11/21/18
[vi] Apple Makes Rare Cut to Sales Guidance; Wall Street Journal; 1/2/19
[vii] China's current GDP growth is likely less than 6%, economist says; CNBC; 1/8/19
[viii] China's exports just suffered their biggest decline in two years; CNN; 1/14/19
[ix] Eurozone growth slumps to lowest level in more than four years; The Guardian; 10/30/18