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The Wind is at Our Back

John Burke | March 2017

As many of you know, when clients start asking about a particular market issue or topic, we typically publish a piece explaining our take on that subject – for distribution to all. This time around, the most common questions typically involve the Trump administration. We believe everyone has received enough information about Donald Trump, so this time we are going to make an exception and not write about him…at least not directly. Besides, we're not sure we can provide clarity on his ultimate impact on investors.

We would like to comment on some 2017 investments themes.

Runners have a saying - if you don't know where the wind is, it is at your back. The point being that if you don't feel the wind, enjoy it because it is helping. Once you change direction, you will likely feel the wind, and only then realize how good it was when it was at your back.

Certainly, this applies to investors right now. The Dow Jones is regularly setting new highs. Unlike last year, foreign stocks, especially emerging market stocks, are also doing well. Even bond investors, who did not have a good year last year, appear to be happy with returns in 2017. Many of you have commented to us that surely, this means that trouble is ahead.

Unfortunately, unlike runners, we don't know when we are going to change direction and feel the wind in our face. There is plenty to worry about - large amounts of government debt, talk of a global trade war, perhaps even inflation. But as John often says, in his 30 year career, he has never heard the "all clear" bell ring. There are always things to worry about, but there are usually (2008 being a notable exception) things to be optimistic about.

Productivity - Can We Do More with Less?

Before we detail our concerns about the economy and markets, we can tell you one thing we are NOT concerned about - the fact that markets seem to be setting new highs every day. From 1987 until 2000, the Dow Jones set a new high an average of 47 times per year. Stock prices are generally based on earnings, realized or projected. Corporate earnings rise much more often than they fall, if for no other reason because of inflation. Therefore, what was abnormal was the time the markets spent NOT setting new highs. Stock returns have been abnormally low. Since January 1, 2000, stock returns have averaged less than 5% per year. From the great depression to the year 2000, stock market returns averaged more than twice as much.[1]

Some have said that low returns are the new norm. We know this - that productivity growth has also been extraordinarily low since 2000. This is not a coincidence. Corporations have a hard time earning more without becoming more efficient.

Productivity can only grow in one of three ways – 1) more people are working, 2) people are working more hours, or 3) people are getting more done with their time spent working. Since baby boomers are retiring faster than new workers are entering the marketplace, and because immigration trends are down (with or without Trump), we know productivity increases must result from either 2) or 3) above. Since stocks rise and fall with earnings, and since earnings are tied to productivity, stocks prices will only grow at higher rates if we work more hours or work more efficiently.

The concerns we have and the opportunities we see are therefore based on productivity concerns.

Zero Sum Game

In his brilliant book titled "Sapiens," Yuval Noah Harari provides a brief history of human progress over the last 10,000 years. Some of his perspectives are very interesting. One is that economic progress was at a near standstill for over 2000 years, traced from when humans learned to farm (instead of hunting and gathering) until about 500 years ago. One could fall asleep around the time of Roman rule and awaken around 1500 AD and get along fairly easily. Transportation, war weaponry, homes and entertainment did not change much.

But then around 500 years ago, economic progress leaped. If one fell asleep 500 years ago and awoke today, they would have a very difficult time coping. According to Harari, the key innovation was economic. People and governments realized that the world did not have to be a zero-sum environment. Around 500 years ago, the three significant events that changed this were 1) the movement of governments away from feudalism 2) the huge uptick in trade between nations and 3) the invention of the corporation.

While the economic benefits of the end of feudalism are clear to all of us (who are not kings), the benefits of increased trade and of corporations are less clear. In fact, many have begun to question whether societal costs outweigh the benefits of international trade and the corporate structure. But we believe that understanding the benefits of these two economic elements is crucial to understanding both the risks and the opportunities for today's investors.

In a zero-sum world, countries that get better can only get better at the expense of other countries. This seems to be the thinking of many people today, including a number in the Trump Administration. We believe that global trade is not a zero-sum game. In fact, countries that closed their borders have always suffered. Communist countries, and there were many of them before the collapse of the Berlin Wall, all closed their borders. Closed borders keep out ideas, new product innovations and immigrants willing to do work that citizens will not. Most communist led economies failed, and not least of all because they closed their borders.

Increased global trade means a free exchange of ideas that lead to better ways of making things, to better products, and to competition. Competition leads to growth, and a lack of competition hurts growth. Increased global trade also allows countries to specialize. Brazil has become the leading exporter of paper because the trees used to manufacture paper grow faster in Brazil. China became the world's leading silk grower because of centuries specializing in that trade. The same could be said about French wine, Italian olives, and German cars. Increased global trade also allows countries with a surplus of commodities, like oil, to trade with countries with a different surplus, like agriculture products.

We understand that some people may suffer from global trade, but we believe those fears have been greatly exaggerated. Most manufacturing job losses have come not at the expense of Mexicans or Chinese workers, but because of automation. Further, the benefits of cheap prices for goods like clothing and manufactured goods seldom get any media coverage, but have gone a long way in raising the standard of living in our country.

We believe that current trends against global trade present our greatest economic danger. If trade wars erupt, productivity will suffer. If productivity suffers, so too will world economic growth.

On the other hand, we believe that one of the great opportunities is with corporations. We mentioned earlier that the invention of the corporation was one key to economic growth in the last 500 years. The corporate structure allows for risk taking. It allows investors to pool together capital to create wealth - think Apple. Steve Jobs would not have been able to turn the computer into a device that greatly improves lives without the investor capital needed to create computer factories.

Yes, Steve Jobs became very wealthy, but NOT at the expense of anyone else. In fact, his brilliance led to greater wealth for many, many people. But his risk taking would not have been possible without the corporation. Before the invention of the corporation, people who borrowed money and failed wound up in debtor's prison. No one took the risk of inventing and creating.

We have been living in a world where corporations face more regulation, including U.S. law that taxes corporations for profits made outside the country. The U.S. is the only country in the developed world that does this. Further, the U.S. has the highest corporate tax rate in the developed world. Corporate tax reform will make it easier for companies to invest.

In fact, one of the things that stood out in the fourth quarter earnings reports, is that companies are starting to spend more money on technology. Computer, semi-conductor and telecom companies all experienced surprising sales growth. This could lead to increasing productivity, economic and earnings growth and with it, stock price appreciation.

As an aside, we have been concerned that since 2000, technology has been an economic drag. In the '90's, the technology industry created cell phones, computers with enough speed and memory to become personal devices and the internet. These introductions contributed enormously to productivity. Both the economy and stocks benefitted. Since then, the major new technology products were smart phones and social media. We don't think we are being curmudgeons when we say that these introductions were as likely to hurt productivity at work as they were to help.

To list one tragic example, Allstate, the leading car insurance company, just released a study that showed the extent that drivers are using smart phones while driving. According to Allstate, 36% of people admitted to texting while driving while 29% admitted to using the internet while driving.[2] This compared to 31% and 13% of drivers in the same survey done in 2009. And those were the people who admitted to texting and internet surfing while driving!

This has led to an increase in traffic fatalities. According to the National Highway Traffic Safety Administration (NHTSA), fatalities increased by 7.2% in 2015 alone. NHTSA also reported that traffic accidents have increased. Compared to 2009, there are now more than 1 million more accidents per year.

If people are using their smart phones while driving, we think it is likely that they are using their smart phones in unproductive ways at work as well. This is why we think the technology changes since 2000 have been just as likely to hurt productivity as help. We think this might be changing.

In the fourth quarter, the greatest positive earnings surprise by sector was in semi-conductor companies. The trend towards putting semi-conductors in all things is exploding (IoT – the Internet of Things). Cars are becoming computing machines as well as transportation devices. Things like glasses, watches, and even bathroom scales can now connect with our smart phones and/or personal computers.

We believe that some of the best opportunities lie in the technology sector and in the ability of technology companies to contribute to economic growth. Combined with changes in tax laws that allow greater corporate freedom, we believe that this could lead to sustained economic growth.

One of the companies investing significantly in technology is JP Morgan. JP Morgan CEO Jamie Dimon recently said that "The US economy may be building momentum. Looking ahead, there is opportunity for good, rational and thoughtful policy decisions to be implemented, which spur growth, create jobs for Americans across the income spectrum and help communities."[3]

At a recent investment conference that John attended, he listened to an investment manager who had gotten his clients completely out of the market in 2008. The manager, whose investment style is very conservative, had to admit that even he saw good signs in fourth quarter earnings and in economic numbers. The caveat is that the market has, to some extent, already priced in changes to the tax laws and corporate regulations. If those changes don't occur, the market will not like it.

To summarize, our concern is about trends that will hurt global trade, and the opportunities lie in circumstances leading to the ability of corporations to invest and operate more efficiently.

We will keep a close eye on China because we believe that China's economy may well be the canary in the coal mine, given their status as the major benefactor of global trade. We will also watch closely the earning trends in the technology sector. We think the economy will only expand if led by technology stocks.

Please call us if you would like to discuss our concerns or the opportunities that we see.

1 *Investopia*: Average returns can be defined very broadly or more narrowly. The average return for the S&P 500 will differ from the average return for technology stocks. Likewise, the average return for the total bond market will differ from the average return on U.S. Treasury notes. The time period under consideration also influences average returns. For example, while the stock returned an average of 11.31% from 1928 through 2010, it returned an average of 3.54% from 2001 to 2010.
2"Smartphone Use Lifts Car-Insurance Rates", *The Wall Street Journal,* February 21, 2017, pg. A1 & A10
3 "Record-breaking rally is bet on US economy", *Financial Times,* February 18, 2017, pg. 13