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Market Note

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# Volatility & The Path Forward

With many places up north essentially skipping spring and jumping right into summer weather, our winter "season" where friends from the frozen north spend time in paradise with us is winding down. Almost every morning I see a car carrier loading up on the side street near our office. We had a particularly busy "season" at ICA and as such we ran short on time to publish a *Market Note* for the March and April months. We'll try to make up for that in this May issue.

Since the major market equity indexes reached new all-time highs in the month of January, the bull market has been disrupted by a myriad of disturbances. We've had the passage of a new tax regime, the outbreak of a trade war between the United States and its largest trading partner, China, elevated tensions with North Korea that seem to have resulted in an opportunity for a peaceful solution to the growing nuclear threat, and of course continual partisan political folly. Just to name a few. It's been enough to prevent global equity markets from definitively breaking out to the upside. Let's take a few issues in more detail.

**Tariffs**

The Chinese have not played fair. No big revelation there. Disrespecting trade secret and intellectual property laws has been going on for a long time. China sneaks steel and aluminum into the U.S. via Brazil. China has long manipulated their currency to keep their export driven economy powering along.

Whatever the sins of the past the overall goal of trade negotiations should be freer markets globally. Citizens of all nations benefit from free trade. Some will be better than others at producing a particular good or service. If Chinese researchers discovered a ground breaking cancer treatment would we not want unfettered access to it? Of course we would.

In terms of the negotiations between the U.S. and China it's important to note that the Chinese position isn't as strong as some commentators have stated. Last year China exported $506 billion to the U.S., while the U.S. only exported $130 billion to China. U.S. tariffs on Chinese goods would be devastating to the Chinese economy.

China knows businesses all around the world want access to their enormous market to sell goods and services. They use this knowledge against businesses, silently expecting them to accept the abusive unfair playing field offered. Some businesses accept this as a cost of doing business in the Chinese market and some refuse to play the game. For this reason, a crackdown on abusive Chinese trade practices may serve to create a freer market for global trade and that's certainly a worthy end game.

To provide tangible proof of these dynamics when the Trump Administration first announced plans to impose tariffs on the import of steel and aluminum the performance of emerging market stocks (of which China is the largest component country) dissipated from recent strength. Last week when initial trade terms proposed by the United States were rejected publicly by China, Chinese equities once again tumbled. Why? Because China is not an internally consumer driven economy. Chinese companies depend on free access to foreign markets (the U.S. is the largest) to sell their goods and services.

I also believe there is frequent overreaction to trade deficits between the U.S. and China. In reality it is a goods deficit, not an overall deficit when financial assets are also considered. The goods trade imbalance is offset by the purchase of U.S. treasury securities by the Chinese. And let's be clear. The Chinese don't buy U.S. treasuries out of the kindness of their hearts to balance the trade deficit, it is important for them to own these securities as support for their currency globally. They are, after all, still an emerging market economy.

As an investor this concerns you because emerging market economies have been doing quite well over the past 15 months or so and are more attractively priced than U.S. equities. As good as U.S. stocks performed last year, emerging market stocks performed better and have much more room for additional upside. Hang in there with international exposure.

**Taxes**

The official name of the new tax legislation that was signed into the books in December by President Trump is *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*. The shorter, and more common name is the *Tax Cuts and Jobs Act*.

There are many provisions in the legislation so I will focus on just two of the more important ones. First, the act lowered the corporate income tax rate in an effort to level the playing field between domestic-based companies and their foreign-based competitors. It was also an effort to prevent more so-called tax inversions where a U.S.-based company, mergers with a foreign-based company to avoid the higher corporate tax rate.

In general, it is smaller and mid-sized companies that have traditionally paid taxes at the highest rate. Large conglomerates like GE and Johnson and Johnson have historically paid federal income taxes at rates well below the highest bracketed rate. Therefore, lower taxes could result in better after tax earnings for smaller companies. From a velocity of money perspective, more after-tax income in the hands of companies could also lead to increases in capital spending some companies may have held off on previously. Small to mid-cap stocks in the U.S. have outperformed large caps so far in 2018.

However, I don't think this is due to taxes alone. In addition to a bump in earnings from lower taxes smaller U.S. companies tend to get more attention when the value of the U.S. dollar increases. After a decline in 2017, the dollar made a turn up in value versus a basket of relevant world currencies, complementing the reduction in anticipated corporate taxes due for 2018.

Another economic dynamic from a change in tax regimes that lowers taxes, is putting more disposable income in the hands of consumers. Unlike China, the U.S. economy is consumer driven. For example, so-called flow through entities such as Subchapter S Corporations, Partnerships and Limited Liability Companies can now take a deduction to their taxable flow through income of 20% of eligible earnings of the business. There are limitations and exceptions to the new tax law but many private businesses will benefit, potentially putting more disposable income into the wallets of U.S. consumers.

As my daughter likes to quip, "it's not all rainbows and lollipops". 2018 will be the first year the new tax law is in effect. It remains to be seen if the net effect will be all positive on the economy. There is still the issue of federal deficits. If the new tax law and other economic growth drivers don't yield the intended results of lower tax rates on a larger tax base (smaller percentage of a larger pie theory) the economic engine could stall out.

**Looking Forward – GDP and Stock Prices**

I've read and heard many commentators point to the fact that the market capitalization (share price x number of shares outstanding) is greater than GDP (gross domestic product) and by this measure stocks are over-valued. Closely related to this notion is that corporate profits have grown faster than GDP in the U.S. By logic then the value of corporate equity shares are over-valued. While I think there is some informative value in these measures, they are not being interpreted correctly in many cases.

Without going into the painful detail of a full blown economics lesson understand that GDP is comprised of both public sector (government spending) and private sector production creates a misleading standard reported figure for GDP. Roughly 45% of the standard GDP measure is derived from the public sector data and the other 55% from private sector productivity results. The 45% figure includes spending by federal, state and local governments. This is an add-in many omit incorrectly but is reflected in the standard GDP number reported. Because our tax dollars fund public spending the impact of government (public) direct spending is larger than it seems.

One could argue quite successfully that productivity growth in output from the government or public sector is poor (or even negative) when compared to what is very strong productivity growth among the private sector. Therefore, when the two segments are combined the public sector drags down the average between the two readings. So, in fact, by a measure of private sector productivity growth alone corporate profits don't seem so overdone and nor do stock prices seem so expensive. Not cheap, but not expensive.

The other issue associated with the standard GDP measure is that it only measures the final outcome or sale. For instance, when you buy a new computer the GDP measure of output only includes the final sale price of the computer and not the business to business transactions that occurred to make that computer. A less known measure that should be used instead is ***gross output***.

Gross output for the fourth quarter of 2017 was $34.5 trillion, while GDP was $19.7 trillion. Gross output was nearly double GDP. When using this total measure of productivity in the U.S. economy suddenly stocks looks more attractive relative to economic output for the country.

Markets don't always move as they should in the short term. They respond to human emotion and behavior, hence the study of *behavioral finance* that is embedded in much of our work. We attempt to capture some of the more extreme moves in investor behavior through our technical indicator based signaling algorithms. At the same time, we are mindful of too much whipsaw resulting in higher friction or trading costs. It's a balance of downside protection but at a reasonable cost.

There will always be risks to bull markets, and there will always be recessionary troughs in the business cycle, some deeper than others. At this point in time, reputable sources with solid track records we study and follow to compare to our own work, do not indicate a looming bubble or near term recession. As always we remain vigilant on your behalf so you can spend your time doing the things you love to do and have meaning in your life.

Until next time I wish you and your family a happy and healthy summer!

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