Talk of Trade War, an Aging Economic Expansion, Regulation and the Market

A Registered Investment Advisor

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"Big enough to deliver, small enough to care"

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As all of you are likely aware, most diversified investment portfolios were down last quarter for the first time in a while. Market volatility has returned after an historic period of record lows in realized and implied volatility for most major market averages. Talk of tariffs, new regulations governing privacy and data usage, how sales taxes are collected, and the discussion of abusive monopolies, have added to the day to day speculation. What's really going on?

Let's start with the *potential* Trade War. A recent article in Marketplace described it best, "A game of macroeconomic chicken".[1] The main target of the US in the potential trade conflict is improving trade with China. The headlines discuss tariffs on many goods from steel to clothing. Investors expecting higher prices for cost of goods sold resulting from these higher taxes leads to lower share prices because of discounting the potential lost profits. Consumers and shareholders alike have enjoyed the cheap overseas labor provided by the Chinese and other developing nations. The low cost of overseas production has caused a fundamental change in US industry and corporate profits. The market becomes skittish at the thought of a disrupted supply chain, higher production or sourcing costs and the psychological malaise of "what could be next". The long term impact of a few tariffs, if enacted, on the US economy is minimal. The discussion appears to be more political than economic. Portfolio managers are using it as an excuse to take profits and rebalance their portfolios.

In several of our past issues I have pointed out the growing dominance of a few technology companies and their influence on the stock market indexes. In the July 17, 2017 issue of Triweekly "The Numbers – They're Official & Stuff" I reviewed how overwhelming their influence had become on indexes. At the time I penned the article, five companies (Apple, Alphabet, Facebook, Amazon and Microsoft) made up 11.5% of the S&P 500 index's market capitalization and 25% of its return year to date. It was even worse when you looked at the Nasdaq 100, they accounted for 42% of it, 42%!!! Their influence on the market's rise and fall has only increased in the 9 months since then. In fact, if you exclude Apple, the average PE for the remaining four, based on their trailing 12 month earnings is 101.7, compared to the rest of the S&P 500 at 25.6x. Looking at the four's projected earnings, as all good investors do, it is still 57.2x vs. 17.6 for the rest of the S&P 500.[2] This leads many portfolio managers to conclude (myself included), that tech is expensive, the rest of the market, not so bad. These tech companies have a huge influence on all stocks. A recent example is, Facebook, which is not a Dow component, was down 7% on March 19, 2018. One might conclude that the S&P and NASDAQ, which both contain Facebook, should be down, but the DOW, not so much. That day the DOW fell more than 300 points. These big companies also dominate corporate profits. Of the nearly 4000 publically traded companies, the top 100

[1] https://www.marketplace.org/2018/04/04/economy/so-what-does-trade-war-mean-us-economy

[2] https://www.marketwatch.com/story/these-4-tech-giants-should-make-you-think-twice-about-this-market-2018-03-22

(measured by market cap) account for 84.2% of US public company profitability at the end of 2015.[3] To date these big tech firms have faced little in the realm of government regulation. Issues surrounding data security, inaccurate, fabricated or false news stories, search manipulation and monopoly like practices are beginning to draw the attention of government regulators. We have routinely pointed to the fact that investing in market cap weighted indices overexposes ones portfolio to the fortunes of a very small universe of companies. Any misstep in earnings or new government regulations leaves an index investor vulnerable.

What's really going on? I think the primary source of recent volatility investors are experiencing is the aging economic expansion together with the Federal Reserve's decision to normalize interest rates and end their bond buying program. The current economic expansion began in June of 2009, and at 105 months old, is the second longest on record. The only expansion to last longer was from March 1991-March 2001 (120 months).[4] The current expansion is somewhat unique given the depth of the downturn both the economy and the markets experienced in 2008-09. What does make it truly unique is the unprecedented measures our Federal Reserve and their counterparts around the world undertook to turn the markets and world economy. Domestically, the Fed dropped the Fed Funds rate to 0% and bought huge amounts of treasuries and mortgage back debt. Their counterparts around the world followed suit but added corporate debt too. Creating demand where there was very little. The net result was rates for all types of debt, fell to, or near to record lows. This allowed companies, banks and governments to issue huge amounts of cheap debt that was immediately purchased by a central bank. Faced with falling rates, savers and investors sought out alternatives to the CD's, government bonds and high quality corporate bonds they were accustomed to purchasing. Their money found its way into stocks and lower quality, higher yielding bonds. Their buying has pushed prices of equities and high yield bonds, around the world, to near record levels. The coordinated efforts of the world's central banks has been successful. Capital found its way to many companies and struggling economies. The world's economies have recovered significantly. Domestically, our Federal Reserve has reduced its bond purchases and started raising rates. Many of the Fed's world counter parts have signaled their programs will be tapered soon. This change in the demand dynamics for debt has started to move interest rates higher. This is not necessarily a negative, but can cause volatility as the market, not central banks, begins to determine the winners and losers. It is important to remind yourself, and especially your clients, that volatility is part of investing and economic expansions and contractions are part of life.

The LCA portfolios are constructed based or rigorous academic research and we follow specific predetermined guidelines for security selection and portfolio construction. We believe that this disciplined approach gives our advisors and their clients a higher probability of success. Warren Buffett has a famous quote, "Only when the tide goes out do you discover who's been swimming naked."[5] We intend to keep our trunks on here.

[3] https://www.marketwatch.com/story/these-4-tech-giants-should-make-you-think-twice-about-this-market-2018-03-22
[4] https://en.wikipedia.org/wiki/List_of_economic_expansions_in_the_United_States
[5] https://www.brainyquote.com/quotes/warren_buffett_383933

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Ask your Relationship Manager for a copy of "The Educated Investor" written by Robert Lindner.

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