

## Does Cutting Interest Rates Send the Wrong Message?

By: Brandon Ross, CMT

There has been a lot of speculation regarding what the Federal Reserve should do in their upcoming meetings. President Trump has been one of the most vocal critics of the Fed, and has stated that he wants interest rates lowered to keep the economy growing. His entire administration has backed him up on this, and the market seems to agree: it's time to lower interest rates. Jerome Powell, the leader of the central bank, has already told investors the Fed will do what needs to be done to keep the expansion going. Many believe July is a live meeting, and the Fed will likely cut the Federal Funds rate by 25 basis points, but the bigger question is what type of message does this send?



There are signs that a rate cut may be needed to keep the economy expanding. The downward trend in unemployment has stalled, manufacturing PMI's have slowed over the last quarter, and the global economy is showing signs of trouble as well. President Trump's trade policies are creating a lot of uncertainty around the globe, which may lead to a stall in economic growth. Lower interest rates could certainly help in this scenario, and it could spur enough growth to keep the U.S. expansion going. However, the Fed will be sending messages to different parts of the economy with such a move.

The first message is towards investors. The Fed is implicitly giving the market a "put option" in that rates will be lowered, if the market starts to slip. This is a great thing if you are an investor. It means we can take on more risk, and if troubles arise, the Fed will do what it can to help out. It also enables President Trump

to continue his aggressive trade policies. The Fed will act as a brake if his trade policy starts to hurt the economy. In essence, this will allow him to take further risk, which may lead to further problems down the road.

The second message goes out to the rest of the economy. If interest rates are cut here, won't they be cut again? Historically, a second rate cut occurs within 6 months 81% of the time. Markets are already pricing in two rate cuts this year and market participants are expecting it. This is where the potential problem lies. If the future expectations are for lower interest rates, there is a tendency for decisions to be delayed. If you are expecting cheaper interest rates, why would you take out a loan now when you can wait for a cheaper loan within the next six months? Future expectations may create a negative feedback loop that stymies growth now, because it makes more economic sense to wait. The bigger question is actually how much "dry powder" the Fed has to stimulate growth – previous rate cutting cycles have typically started with rates above 4%.

We are now in the longest economic expansion in U.S. history in terms of time, but not in terms of strength. There are going to be signs of trouble this far into the cycle, whether it is trade policy, growth slowdown, rising income levels or a number of other issues. The common theme is that this leads to a blanket of uncertainty around the globe leaving many to wonder what will happen. A premature reduction of interest rates may reinforce the level of uncertainty, and that behavior may ultimately lead to this expansion's downfall.

From an investment perspective, equity markets are starting to react like "bad news is good news for the market" again, as it increases the probability of a rate cut. We think that this misses the forest for the trees, as it would be much more beneficial for equities, and investments overall, if the economy and earnings continue to grow, and rate cuts are never needed at all.

# “Relax kid...the world is always coming to an end and there is always a world crisis!” - *Men in Black*

By: Henry Pizzutello, Chief Investment Officer

Many business investors love to hear the latest “news.” As someone who spends a significant amount of time in front of price quotes and scrolling headlines, I have always viewed the news as integral to the investment process. However, it has become more evident to me that the modern news cycle is more of a waste of time than it is helpful and, at times, it can be downright harmful. In this sense, the news and specifically financial news is not “news” at all but rather a focus on immediate events that likely makes rational thought more difficult. Legendary journalist Eric Sevareid once observed that “the biggest big business in America is not steel, automobiles, or television. It is the manufacture, refinement, and distribution of anxiety.” This comment made more than 50 years ago encapsulates the mood of today’s investment market perfectly.

The current bull market started on March 9, 2009. The S&P 500 had dropped to a close of 676 - 77% lower than its current level. Some would say that this performance is not surprising, given that the Federal Reserve increased their balance sheet by 400% and kept rates close to 0%. What is surprising, for those of us who have invested in financial markets prior to the financial crisis, is how much anxiety and worry has gone along with the rise. We do not see the heady intoxication that surrounded internet stocks in 2000-2002. There isn’t a hubris regarding infallible “portfolio insurance” that pervaded markets during 1987. Instead, what we see today could be considered a broad cynicism that “this can’t go on forever” and that “this party is going to end badly”. Indeed, this is likely the result

of the two 50% declines that markets have experienced over the past twenty years, which can be considered one of the worst periods in modern finance history. In the internet era of conspiracy theory, many investors believe the bull market of the last ten years has been little more than a party trick that will be revealed, in the end, to be illusory.

The silver lining for investors, of course, is that this level of skepticism might mean that the bull market will last longer than anyone thinks possible. There is a famous quote regarding market cycles - “Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria” – that seems apropos for investors today to take note. The financial press is constantly presenting skeptical views regarding the current bull market and economic expansion. Much of this skepticism has been voiced over the past five years, a period where the US market has risen almost 100%. Despite enormous evidence to the contrary, no one quite believes it’s real or that it can last.

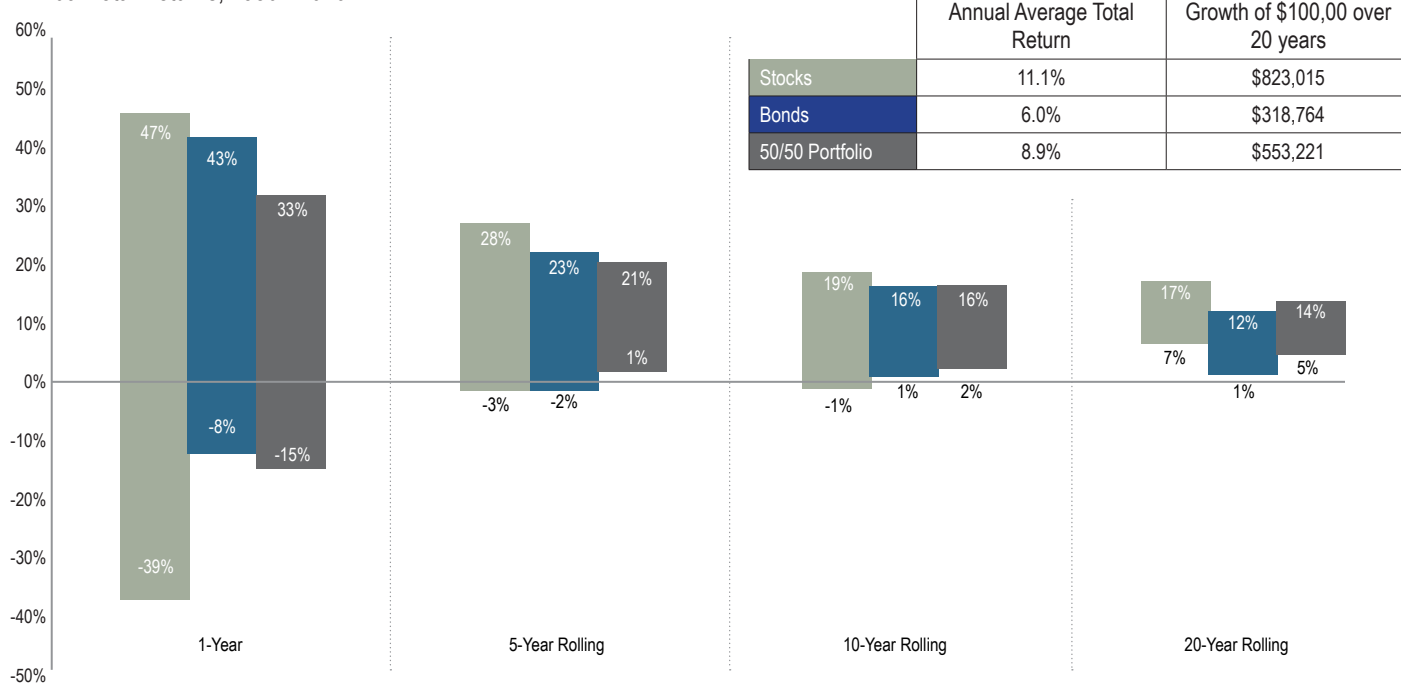
But of course the reasoned counter-argument is “Just because it hasn’t happened yet doesn’t mean it won’t someday” – and that would be absolutely correct. If you are thinking that the market could still fall 10%, you are right, because it actually happens frequently. Since 1980, the S&P has fallen an average of 14% during the course of the year, and even if you take out the 5 worst years, (1987, 2001, 2002, 2008 and 2009), the average intra-year fall during a bull market is still 10.8%. So not only is a 10% fall possible, it is probable. The “news cycle” would have you think that the next 10% correction is the start of the next Great Financial Crisis – possible, but not probable if you look at history.

Historically over the past 193 years, US equities have suffered an annual loss greater than 20% just 9 times, a “base rate” of 4.7%. The “base rate” is the probability you would assign to an outcome if you knew nothing other than how often it was statistically likely to happen. Of course, nineteenth century data has little relevance to current investors, but since 1980, the S&P has closed higher 76% of the time and suffered an annual loss of less than 3% an overwhelming 84% of the time. Over



## Range of Stock, Bond and Blended Total Returns

Annual Total Returns, 1950 - 2016



the past 40 years there have been two instances where the S&P lost more than 20% annually (2002 and 2008) – again about a 5% base rate percentage. Interestingly, during 1987 and the “Black Monday” market where equities lost 22% in a single day, the S&P finished UP 2.3% for the year.

However, a focus on annual return data is not the best metric for successful long-term investing. The chart above shows the range of returns for equities, bonds, and a 50/50 portfolio over different rolling time intervals since 1950. If you are seeing this for the first time, it is somewhat shocking to see how the variability of the returns changes when the investment time horizon shifts from one year to five years. While it would be expected that the overall return variance would decrease over time, the surprise is in the component breakdown of the numbers. Looking at equity returns, the 5 year upside return was 57% of the one year, **but the loss component was only 7.5% - and only 3% on an absolute basis**. Over longer periods of 10 and twenty years, the absolute risk of loss on average essentially disappears.

These facts are regularly ignored in the decision making process during a market downturn. The “news cycle” influences the mind to believe that every 10% correction as the beginning of something much worse, even though a 10% fall is a fairly regular occurrence during bull markets.

There is no shortage of things about which one can worry. However, the current policy mix appears broadly supportive of further economic prosperity and market gains. The most important development has been the Fed’s reassurances this year regarding monetary policy as the central bank exits quantitative easing and excessively low interest rates. It is also important to look at real interest rates, which account for inflation, rather than nominal rates. With the real federal-funds rate at about 0.5%, monetary policy is not especially tight. Once again, an historical analysis shows that of the eight recessions that have occurred since 1960, exactly **none** has started with a “real fed-funds rate” of less than roughly 2%.

With the S&P 500 off to its best start since 1991, it is reasonable to expect a pause in the upward trajectory of stocks. But with the market trading at 17 times 2019 earnings expectations (down from 19 a year ago) and 10- year Treasury notes yielding 2.0%, the actual risk-reward profile of the market is still favorable.

Does this mean that there is no risk over the long-term? Of course not. But it does suggest that a reasoned and quantifiable look at actual probabilities and statistics is a better way to determine whether the events of the day are “noise” or news”.



# 2019 China & 1989 Japan By Robert Borden, CFP®, EA

For those of us old enough to remember, the US had two primary adversaries in the 1980s – one military the other economic. The Soviet Union and the Cold War were still in the common lexicon and Japan was the fastest growing developed economy in the world. As the Japanese gobbled up US assets throughout the 80s it was capped off with the acquisition of Manhattan's Rockefeller Center in 1989 by Mitsubishi. Much as China is viewed today Japan was viewed then as an economic juggernaut with a realistic shot at becoming the largest economy in the world. Annual growth rates in the 1970s and 1980s regularly exceeded 5% and Japan had the second largest GDP behind only the US and by 1990 per capita GDP was one of the highest in the world. The Nikkei 225 hit an all-time high on December 29, 1989 of 38,957. So what happened? Looking back, we know that the following decade became known as “The Lost Decade” in Japan and even during the first decade of the 21st century the economy was stagnant for the most part. Japan's GDP today is just under \$5 trillion while it stood at \$3.1 trillion in 1989. US GDP was \$5.6 trillion in 1989 compared to \$21 trillion today<sup>1</sup>. As of 2018, Japan's national debt to GDP ratio is 234%<sup>7</sup> – highest in the world.

As the Japanese economy was in relative decline China's was accelerating. Chinese GDP was \$360 billion in 1990 compared to \$13.6 trillion today<sup>1</sup>. Much as was the case for Japan in 1989 popular culture and the news media has come to view China as a juggernaut that will soon be the largest economy in the world. So, what are the similarities and differences between Japan 30 years ago and China today? The obvious difference is the sheer size of their workforces – China's population is 1.4 billion compared to Japan's 123 million in 1989<sup>6</sup>. Additionally, China remains a communist nation with a command and control economy. The Communist Party began opening up the country to some foreign investment in the late 1970s which accelerated in the following two decades. However, the price to get in was often forced joint ventures with state-owned companies. Chinese manufacturers have been engaging in rampant intellectual property theft going back to the 1980s when they were copying everything from American CDs to software. Today it happens much more rapidly – at its extreme Chinese copies hit the market on Alibaba and Amazon before inventors can patent, produce and sell their products. Technology patents are completely disregarded. Fundamentally, the source of Chinese growth over the last 40 years is simply human and natural resources as well as the government's refusal to honor and enforce global intellectual property laws. The cost of labor is cheap due to the large population and therefore both foreign and local companies can manufacture products at a low cost.

Besides the aforementioned economic conditions that have persisted in Japan over the last three decades the other factor contributing to their

economic decline is an aging population. In 1990 Japan's median age was 37 years, today it is 47 years. By 2050 it is projected to be 53<sup>1</sup>. Today, the US and China have a virtually identical median age, 37 for China vs. 38 for the US. However, China's media age is forecast to reach 43 as soon as 2030 and 48 years by 2050 while the US median age will be approximately 41 in 2050, just slightly higher than where it is today<sup>1,5</sup>. Japan experienced declining birth rates in the 70s and 80s as the country became wealthier and more women entered the workforce. China, on the other hand, implemented a mandated one child policy in 1979 before eliminating it in 2015 once the future demographic headwinds became apparent. Additionally, China has one of the highest male to female ratios in the world due to the preference for male offspring. Since 2015 the birth rate has remained low as the *one child policy* may have changed cultural habits and norms permanently.<sup>2</sup>

This is not to say that China's economy won't continue to expand over the next several years. However, it is highly unlikely to ever experience per capita GDP approaching developed nations and may experience a rapid slowdown in the coming years. Unlike what many pundits breathlessly exclaim there is no certainty that China will ever surpass the US as the largest economy in the world. An aging population, lack of innovation and a communist system that doesn't allow for the free flow of capital are all working against them. President Trump's tariffs may simply speed up the process. There are many other countries prepared to supplant China's manufacturing base including India and Vietnam. Both countries are much younger than China with more favorable demographics. While reported growth rates in the US and other developed economies are extremely accurate Chinese growth rates are calculated differently. The Brookings Institute published a white paper in March 2019 titled *A Forensic Examination of China's National Accounts*. They pointed out that growth data is largely based on data provided by local officials and that they are rewarded for meeting growth and investment targets. The Chinese government agency responsible for compiling the data is the *National Bureau of Statistics*. Ultimately, they as well as most other government agencies have every incentive to pump up growth numbers. The authors estimate that this inherent bias has resulted in real growth between 2008 and 2016 that is 2% lower than the official growth rate on an annual basis.

1. Statista.com

2. South China Morning Post: *China's birth rate falls again, with 2018 producing the fewest babies since 1961, official data shows* Sidney Leng, 1/21/19

3. South China Morning Post: *China's debt ratio hits record high as efforts to offset US trade war mean 'there is no such thing as a free lunch'* Orange Wang, 5/30/19

4. Brookings Papers on Economic Activity: *A Forensic Examination of China's National Accounts* Wei Chen, Chinese University of Hong Kong, Xilu Chen, Chinese University of Hong Kong, Chang-Tai Hsieh, University of Chicago Zheng (Michael) Song, Chinese University of Hong Kong. 3/8/19

5. The Pew Research Center: *Aging in the U.S. and Other Countries, 2010 to 2050*

6. The World Bank

7. World Population Review