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> With 2½ trillion dollars of monetary stimulus from the world's central banks, we still need tax cuts and boosted infrastructure spending to expand the U.S. and global economy? Seriously?
>
> -- John Mauldin, December 2017

March 31, 2018

Dear Clients:

February delivered the first down month in *sixteen months*. While the selling was a knee-jerk reaction to a brief uptick in wages, the severity of the decline was blamed on a collapse in esoteric, speculative trading products linked to the VIX (CBOE Volatility Index), just some of the many derivatives traders employ to amplify returns. The financial crisis was buried long ago in investors' collective memory and its lessons long forgotten, but the severity of the reaction accompanying one relatively small family of derivatives serves as a stark reminder of the linkages across trading instruments back to the stock market.

The episode was described by one market observer as "a case where the volatility tail wagged the stock market dog", but the nature of the decline should not be so easily dismissed. We discussed market structure and fragmentation in a recent client communiqué and noted that "the market will, under duress, begin to adversely affect what should otherwise be orderly". And furthermore, "these structural fissures will not likely disappear as the specter of rising interest rates, quantitative tightening, increasing debt levels, and rudderless policy begin to take root."

Rising volatility goes hand in glove with rising uncertainty and follows a historic, one-way, no-volatility, can't lose market rally. It consequently prompts the question: will the next five years be like the past five years and, if not, how do you participate differently? Considering the quote at the top, the degree of help the U.S. economy still requires after so many years of government interventions and shenanigans is informative. This problem is further compounded by the fact that the Federal Reserve's preferred model for employment and inflation has continually failed to confirm their avowals, begging the question of how much control over these key economic variables the Fed really has.

The question most frequently raised in client meetings lately is "what gives?" Are wages *really* rising fast enough to force inflation higher? And if so, how can we explain the less-than-electric rate of consumption growth this late in the cycle? Does this constitute a legitimate read-through to the overall health of the consumer? As is common with the unscientific concepts backing economics and human behavior, there is no singular answer or outcome…but we will endeavor to sketch out the basics.

Building on the theme of change and how investor assumptions are being challenged, two items of interest have materialized that directly impact the investment community: the inauguration of protectionist measures with the potential to touch off a widespread trade war, and objections to the excessive reach and dominance of America's Big Four Tech Titans. These developments are in their infancy but as we have seen in recent quarters, this administration moves frenetically across issues. As we launch into our observations and anecdotes from this first quarterly trip **West of the Hudson** ™ in 2018, we begin with the big enchilada -- wages, debt, and savings -- the drivers of consumption.

- Does Health Equal Wealth?

Thanks to the slow, steady grind in consumption, the U.S. economy has recovered much of its mojo over the last few years. As the primary engine of growth, the American consumer accounts for some 70% of U.S. GDP. As such, maintaining and growing consumer spending is *vital* to maintaining and growing the economy. Despite the high rate of employment however, the rate of income growth has not increased accordingly and is, without doubt, the single biggest question mark in economic circles. So, despite a tsunami of often-conflicting data to parse, we are still left to ask, "How is the consumer doing?" There are many ways to unpack this sausage, but from our perch, consumption is funded with money from only three sources: wages, debt and savings. We will therefore limit ourselves to these data sets.

1. Income: Wages are rising, finally, but at a crawl. It has been a long slog to get annual hourly earnings growth back to the levels of prior to the financial crisis now ten years past. Against the backdrop of just 4.1% unemployment, wages are growing at only 2.5% (versus some 4.4% pre-crisis). Despite years of unending claims that this number would grow (and with it, inflation), upward wage pressures have failed to materialize. So for now -- looking at the income part of the consumption equation -- unless we magically see wage growth move sharply higher, it is hard to see income *alone* as being the key driver of a continued increase in consumption.

2. Household Debt: Prior to the financial crisis, U.S. consumers had accumulated US$14.4 trillion dollars' worth of aggregate household debt, 75% of which was mortgage debt. Auto, credit card, and student loan debt made up the rest. In the years following, households deleveraged with total debt falling steadily for four years until 3Q 2012. Since then, borrowing has ramped up so that aggregate household debt now stands at US$15.3 trillion -- *higher* than the pre-crisis peak and 14% greater than the 2012 trough (Federal Reserve 4Q 2017 Flow of Funds). It is amazing that the myth of a deleveraging consumer still exists! There is always room for more borrowing (of course) but with interest rates moving higher, servicing household debt loads may well become increasingly burdensome. While mortgage debt is on the rise again, the increase in household debt since the 2012 trough has been driven by the *non-mortgage debt components*: student debt has increased 44% to $1.38 trillion, while auto loans have increased 58% to $1.22 trillion. Credit card debt has increased just 24% to $830 billion, but this has been in the face of increased use of debit cards, which is not debt, but rather draws directly on savings, bringing us to point #3.

3. Savings: The personal savings rate tracks the percentage of disposable income saved by consumers (the amount left over after all taxes and mandatory obligations). At year-end 2017, the personal saving rate was 2.5%, its lowest point in more than a decade and well below the average level of 6.0% that prevailed from 2009 through 2015. The pronounced downward trend in the personal saving rate over the last two years shows that consumers have already been drawing on savings to support consumption expenditures. While it is theoretically possible that the saving rate could decline to 0%, we would argue that against the backdrop of insipid wage growth and an increasing debt burden, further declines in the personal saving rate and further savings-driven consumption growth are not sustainable. And, as we saw in 2008/09, the initial consumer reaction to economic turmoil is to increase their savings and spend less.

There are alternative ways to dissect the purchasing power of consumers but the data indicates that spending has sustained because households have been borrowing more and saving less. Absent a material spike in wages (which would give rise to a host of other issues), conditions are not conducive to a significant rise in consumption. The wild card missing from this thought experiment is the recent tax cut legislation (as regressive as those cuts are), but we imagine escalating core costs -- rent, health care, tuition, food, debt-servicing -- will consume much of what has been offered. Only the passage of time will provide concrete evidence, and with interest rates on the rise we again have to question how clear the logic is to this line of thinking.

- An Economic Relationship Breaks Down

Despite the backdrop of relatively full employment, the less-than-robust state of the consumer outlined above leads to the next investor query: where's the inflation? Economist William Philips is best known for his studies of employment and inflation data and his work, which identified an inverse correlation between the rate of unemployment and inflation. High levels of unemployment are associated with low inflation while low levels of unemployment are associated with high inflation. This relationship -- the "Philips Curve" -- has for years guided monetary policy at central banks.

The Philips Curve is credited with driving the Fed's post-financial crisis quantitative easing (QE) policy. The economy was in recession, unemployment climbed to 10%, and massive amounts of capital were required to offset the collapse in the "velocity of money". The ghost of John Maynard Keynes was conjured and the Fed stepped into the breach. As constructed, and as instructed by the assumptions of the Philips Curve, the Fed held that the QE model would feed investment and consumption. A virtuous circle of growth and employment would arise and, following the accepted doctrine, higher employment would stimulate wage increases as well as broader inflation and thereby allow the Fed to raise interest rates. In yet another example of economic theory over-hyping actual outcomes, unemployment has fallen significantly, but inflation remains stubbornly low. Has the Philips Curve model broken down?

Many well-regarded, non-Fed-affiliated economists say the missing inflation is structural, reflecting three broad trends: 1) widespread consolidation over time (combined with a war on unions) has left workers with minimal bargaining power; 2) the globalization of labor and supply chains has kept a lid on wages and input prices; and 3) the explosion in an emerging market middle class has given rise to local producers and supply chains that compete with U.S. companies. These trends have collectively reduced production costs and, with further advances in automation, continue to gain strength despite the populist urgency to turn back the clock. It's not that wage growth is non-existent and we may well see inflation at some point, but it is a far cry from the expectations presumed by Mr. Philips' curve. Perhaps the assumptions just need updating, but with the structural concepts cited above, the Philips Curve is looking increasingly like a relic of a pre-globalization construct.

- Planning for the Future by Longing for the Past

Along with the indomitable American consumer and the doctrine of the Philips Curve, another article of faith that is under the microscope is America's position as the champion of free trade -- now being challenged by the relentless call for protectionism. After much bluster, this quarter marked the official launch of the president's nationalist trade agenda. While his first move was meant to reward his comrades in steel, aluminum, and coal, his main antagonist -- China -- represents just 2% of total U.S. steel imports. So a second China-specific scheme was hatched, threatening IT, electronics, telecommunications, apparel, and toys.

Many Americans long for a return to the glory days of the 1950s, 60s and 70s when manufacturing jobs were the bedrock of the middle class -- a sentiment which underscores the president's popularity. His basic pitch for a trade war is that protecting manufacturing jobs will stimulate income growth and increase standards of living. This supposition -- that a decline in manufacturing jobs has engendered a drop in the standard of living -- is a well-trod and enduring myth in conservative economic circles. Unsurprisingly, it happens to be demonstrably false and lacks supporting data!

Also unsurprising is that, despite the rhetoric that American manufacturing is "failing", U.S. output today is *greater* than at any time in the 20th century -- aka the "good old days". This output is achieved with 25% fewer firms/plants (Economic Policy Institute, 2015) however, giving politicians cover. But this is a testament to decades of investment by U.S. companies in the technology economy -- *not* off-shoring to low-cost locales. This has kept prices low, consumption high…and America Great.
While median incomes stagnated from 2001 to 2015, it is supremely simplistic to look at this income malaise and declare the answer lies in forced re-shoring. You will be hard-pressed to find a *credible* economist of any persuasion that thinks a trade war is effective policy -- let alone "easy" and "winnable".

With steel for example, only a tiny portion of companies/workers benefit from tariffs and higher prices. The overwhelming majority of workers are in downstream industries and a prolonged tariff war which forces steel prices higher is more likely to hurt manufacturing output and employment than to help. It also introduces the risk of retribution and escalation with other nations levying tariffs on our economic well-heads -- agricultural, technology, and industrial products -- where none previously existed.

China's strength in the production of so many goods means U.S. importers are unlikely to procure any short-term substitutes. This is especially true in electronics: the U.S. imported 42% of its electronics from China in 2017, including four of five new cellular phones (The Peterson Institute, AEI).

A backwards-looking policy of trade protectionism arrives at a moment when the rest of the world is marching forward. As we discussed in our 4Q 2017 letter, an additional one *billion* global consumers are expected to join the consumer ranks over the next decade and tapping into this demand growth requires knowing exactly where and how to compete. Markets in China, India, and Africa represent enormous prizes, but they have dizzying regional, ethnic, linguistic, and income diversity that requires localization. Trade barriers will harm U.S. multinationals ability to traverse these 21st century complexities.

Multinationals moved operations offshore to tap new growth opportunities and to be closer to the markets they serve. It is sound business practice to do so and we as a nation and investors are far better for it. The opportunity set continues to dwarf what Americans can consume domestically, but a trade war will disrupt corporation's ability to participate and constitutes a threat to American companies' heretofore presumed primacy in those technology-intensive growth industries of the future.

- (Regulatory) Winter is Coming

Despite investor assumptions of the continued meteoric rise and unimpeachable dominance of Americas' technology champions, another subject of concern is the sudden political assault on our tech sector's crown jewels. We have all participated to some extent in the spectacular rise of these Internet titans -- Alphabet, Facebook, Amazon and Apple -- as they continue to revolutionize the way consumers behave. These companies have created platforms central to our lives, whether at work, socializing, or shopping, and by dint of their raw intellect, imagination, and dogged determination the founders of these Big Four Tech Titans (BFTTs) have attained quasi-mythical status.

These platform companies produce colossal profits, lending even more legitimacy to the phenomenon that the BFTTs have become. Collectively, these companies and their $119 billion in trailing 12-month pre-tax earnings account for 5% of total revenue of the S&P 500, 8% of the profits, and 11% of the total market index capitalization. In 2017, the BFTTs accounted for 20% of the S&P 500 index's increase.

As we all know, the BFTTs collective success stems from the disruptive nature of their platforms. They have dislocated, and in some cases decimated, entire industries and the associated jobs. To date, Apple has routed the handset market, displaced PCs, and obliterated the record industry. Alphabet/Facebook have captured essentially *all* digital advertising, crowded out traditional advertising, and captured most of the profits from news, media, entertainment and travel. Amazon has unleashed the retail apocalypse, taken over book publishing, moved into food, consumer staples and is, possibly, poised to disrupt retail pharmacy *and* banking. In short, these four companies have supplanted entire industries and the people they employ. They were therefore already under the microscope to some degree.

So what comes next is text book. Following a year marked by the debut of a hard-nosed administration and the assertive demands of populist movements across the world, the vast and growing power of the BFTTs over markets and society is in the spotlight and concerns are metastasizing along three fronts: 1) further disruption to industries/employment; 2) privacy and data collection; and 3) the political backdrop.

The jobs-impact story has certainly garnered the most handwringing but there is an emergent focus on the deleterious effects these platforms are having on our communities, especially the young. The murmurs concerning the "insidious" design of these platforms -- engineered to keep people connected for protracted periods -- are growing. And data privacy has vaulted to the top of the public sphere as the BFTTs become increasingly adept at hoovering up the ample data their products and platforms generate, allowing them to refine the advertising, products, and services their customers see. As the information generated by users and collected by the platform providers continues to grow, so has the potential for an invasion of privacy and abuses of customer information (see the current Cambridge Analytica scandal).

This in turn has fed an increasingly audible chorus from Washington lawmakers. While the regulatory spotlight has long been on the BFTTs in Europe, U.S. politicians have taken a much kinder view of their homegrown champions. With the rise of the politics of populism however, there has been a marked increase in negative attention from politicians of all stripes at every level. With the administration ever-spoiling for a fight, would it be surprising if they decided to pick a fight with one (or more) of the BFTTs? What better way to re-burnish the president's champion-of-the-little-guy credentials than to take on a technology whale? Is a concerted anti-trust push far behind? We think not.

It is hard to see antitrust as a material risk, but it pays to think big with elongated election cycles and a disruptive administration. As things stand, antitrust would be difficult to prosecute because the standards of antitrust law are hopelessly outdated. M&A is still couched in terms of "horizontal" and "vertical" mergers harkening back to Rockefeller's Standard Oil (horizontal) and Carnegie's Carnegie Steel (vertical). The BFTTs' push into adjacent markets often defies such linear characterization and would be better described as "diagonal". While their emergence has not been as straightforward as their robber-baron forbearers, they are nonetheless geared towards market dominance. In terms of "harm to the consumer" and "prices paid", these giants actually offer many of their services for free and the bundling of multiple different services together therefore requires a new litmus test for "market power".

The debate over potential remedies is well underway, from regulating these services as "utilities", the hammer of forced separation, or forcing them to license their patents to all comers (Bell Labs, 1956). It is difficult to know how this will all play out, but it is quite reasonable to expect that given the recent accumulation of investigations, hearings, tax actions and public anxiety over the BFTTs broader role in society, regulatory winter might be coming.

- Conclusion

Having covered so much ground -- the public's ability to maintain consumption, another faltering economic model, looming trade wars, and regulatory populism -- and how the shifting landscape is challenging investor assumptions previously taken as articles of faith -- we hesitate to write more! But we want to close by addressing the ever-present "so what" that is always in the back of investors' minds.

We began this letter by noting the market was down for the month of February -- *its first down month in the last sixteen*. What is more remarkable is that the market had had only one negative-return quarter over the last *five years*. Now it's two. Markets have a long term average of being up 66% of the time and down 33% of the time, so the current 90%/10% skew not only deserves mention, but it amplifies the uncertainty the above topics convey. So we ask again, as investors, do you believe the next five years will reflect similar dynamics and provide similar returns as the last five years?

Those answering in the affirmative will cite simulative tax reform, rising corporate profits, low interest rates, low unemployment, and subdued inflation as reasons to keep doing what they are doing. The markets have shown they can handle bouts of volatility and the shadow of a sustained and prolonged reversal is mere fantasy. The rising tide of the last five years has floated all boats and has been easy on investors -- sell the stock pickers and buy the index! Managing and growing wealth has never been so easy and the future will provide more of the same.

The push back is that a broad range of evolving issues could drive an environment of increasing volatility and uncertainty. The market rally is entering its tenth year, still near record highs and at historically full valuations; global monetary policy has begun to tighten and the risks of a “tightening tantrum” have grown; sovereign and corporate debt levels have become excessive; political gridlock is worsening; geopolitical risks are intensifying; and the potential for a trade dispute has just been introduced.

As we see it, this is NOT an environment where one wants to own the entire S&P500 universe, but an opportune time for reverting to a more considered allocation where stock picking enables you to participate as the markets expand, but protect some of those gains when gravity eventually takes hold again and the percentage of up/down markets reverts to its historical norm. We are always happy to discuss what an active portfolio looks like as we manage for today but prepare for tomorrow.

From our families to yours, we wish you all a peaceful and prosperous spring.

Yours truly,

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