Market Update – *Trump Trade Trepidation*

by David A. Jaffe, M.D.

The Bull continued to run on Wall Street in the first quarter, though below the surface, tectonic plates were shifting. Hopes for tax reform, infrastructure spending, and a more business friendly regulatory environment faded as the initial Republican health care initiative failed and investors were forced to accept the possibility that the new administration may not get everything they’ve tweeted about. Companies that lay brick and mortar yielded to virtual brick and mortar (Amazon and others of the technology sector), as investors moved their focus to companies buoyed by confident consumers. Meanwhile, financial service companies gave back some of their big gains of late 2016.

Despite the shift in investor sentiment, the financial markets have been, in a word, *boring.* The Chicago Board of Exchange (CBOE) Volatility Index, or “VIX”, logged its second lowest quarterly average ever, while the daily gyrations of the Dow Jones Industrial Average (DJIA) were at their lowest ebb since 1965. The U.S. economy is showing signs of strength; consumer and small business optimism are at multi-year highs. In this environment, the PASI composite stock portfolio ended the quarter with a healthy gain of 5.69%, modestly trailing the 6.07 return of the S&P 500 (both include reinvested dividends). The S&P 500 is once again being buoyed by the high-growth, high P/E companies such as Amazon and Netflix, great businesses but with stratospheric stock valuations driven more by enthusiasm than fundamentals. It remains our view that such valuations carry too much risk for our client accounts.

Interest rates, which rose in the fourth quarter of 2016 on the belief that the new administration’s policies would be inflationary, moderated in the first quarter of 2017. Investors typically weigh the implications of Federal Reserve policy – while higher rates eventually put a damper on economic growth, a cautious Fed is viewed as a sign that the Board Governors perceive weakness in the economy. In March, the Fed announced their third rate hike since December of 2015. After holding rates close to zero for years following the “Great Recession”, investors currently choose to view Fed tightening as a vote of confidence in the economy and future growth.
Eight plus years into this bull market, the most common question posed at meetings has been “how much longer can this last?” As always, the best answer is that no one knows … the bull can continue to charge for weeks, months, or years. Trying to position one’s investments in anticipation of a market correction has been demonstrated time and again to be a losing strategy. At PASI, we make every effort to protect your financial security by holding a prudent mix of stocks and bonds tailored to the individual client, with modest cash reserves for those taking regular distributions. In this way, we believe we can minimize the impact of the inevitable volatility inherent in owning stocks, especially for those in or nearing retirement. It’s a strategy that has served our clients well for forty years.

A Framework for Government Economic Policies
by Nathan Polackwich, CFA

What follows is a basic framework that I hope will help PASI clients better understand the impact of major government tax and trade policies on the economy. I fully concede that on the surface this sounds boring! But if you'll bear with me, I'll show how one simple concept explains a good part of the global economic turbulence we've witnessed over the past 40 years.

Our framework begins with the foundation that trade benefits nations by 1) allowing each to specialize in what they do best, increasing total global output, 2) transferring new skills and ideas, and 3) fostering political alliances through increased economic ties. These ideas aren't controversial. The question, however, is whether trade can hurt nations' economies when imbalances – specifically, trade deficits – persist between trading partners. Of course, like many of life's questions, the answer is, "it depends."

Let's start with the U.S. economy from the inauguration of George Washington to the end of the 19th century. These were years of astonishingly rapid growth and change. The country needed massive infrastructure investments like railways and bridges, but lacked the savings to finance such spending. Investment capital was also scarce because the U.S. suffered from a relatively under-developed and unstable financial system.

Positively, at that time foreign investors in Europe, particularly Great Britain and Holland, had less attractive investment opportunities and more developed financial markets and so were willing and able to provide America with the financing it required. So, we can say that

United States Investment > Savings
Europe Savings > Investment

Note that in a world where capital moves freely, the savings and investment of an individual country don't have to equal. But for the entire world, all savings must equal all investment. So,

Global Economy Savings = Investment

Here's the tricky part of the framework – A country's trade balance equals its exports minus its imports. And if you import more than you export, the result will be a trade deficit. Of course, if a country buys more from other countries than it sells it must obtain foreign financing. Thus,
foreign savings must flow from countries running trade surpluses to countries with trade deficits. So we can say that countries with trade deficits invest more than they save, while countries with trade surpluses save more than they invest. This gives us the following accounting identity.

**Exports – Imports = Savings – Investment**

This is the heart of our framework. Note, for instance, that if a country increases its investment levels, imports must rise relative to exports. Why? Well, let's say America decides, as an extreme example, to use half its workforce to put solar panels on every U.S. home. This would be an astronomical increase in investment spending. But it would also mean that American production of other goods would drastically fall. Thus, we'd have to import those goods from foreign sources. In addition, with lower U.S. goods production, we'd also probably export less.

As noted earlier, prior to the 20th century, the U.S. took excess foreign savings and invested the money in businesses and growth-supporting infrastructure. Necessarily, because we invested more than we saved, we also ran a trade deficit. Was this trade deficit bad for the U.S. economy? Absolutely not! Yes, we borrowed money from foreign countries, but we used the money to profitably invest in ourselves. We were able to repay our loans and ended with far more wealth than we otherwise would have.

So, then, are persistent trade deficits O.K.? For 19th Century America, the answer was yes. Today, however, the situation is different. Our financial markets are no longer under-developed. Further, as our economy has matured, we don't have the kind of unusually large investment needs that would require foreign financing.

Yet despite these realities, bizarrely, today we run large trade deficits with emerging market countries, particularly China. This means China saves more than it invests while the U.S. invests more than it saves. Given that China is a less-developed emerging market with presumably superior growth prospects, this situation defies logic. So why is it happening?

Well, historically investment opportunities drove changes in the trade balance. For instance, 19th Century America had tremendous growth potential that European investors found alluring. Thus, American investment attracted European savings, which resulted in a U.S. trade deficit. In recent decades, however, rather than investment attracting savings, global trade flows have often been driven by excess savings seeking a home. For instance,

1. In the 1970s the Organization of Petroleum Exporting Countries (OPEC) accumulated more money than they could spend (excess savings) by causing oil prices to skyrocket. They deposited these savings at international banks. Lacking compelling alternatives the banks plowed the money into Latin American countries despite those economies possessing insufficient profitable investment potential. Unsurprisingly, by the early 1980s those countries’ debt levels had ballooned, eventually culminating in what became known as the Latin American Debt Crisis.

2. From 2003-2005 Germany introduced labor reforms that effectively increased taxes on workers while cutting corporate taxes. Wage growth declined and corporate profits soared. German companies found themselves flush with cash (excess savings). Why didn't they invest those savings in the German economy, expanding their businesses? – Because their customers, German households, had seen their wage growth hurt by tax hikes so consumer demand was
weak. Thus, German companies' excess savings simply ended up on German banks' balance sheets. Ultimately, the cash found its way to economically weaker European countries like Portugal, Italy, Ireland, Greece, and Spain (collectively, the PIIGS). Debt levels in these nations rose dramatically, ultimately leading to a financial crisis and surging unemployment.

3. China has kept its interest rates at an unnaturally low level for years. This policy represents a huge subsidy to Chinese businesses and penalty to its households. The result is that Chinese companies generate enormous excess profits (savings) that exceed the country's overall investment needs. Where has the money gone? Mainly to the U.S.

Thus, 21st Century America is the recipient of foreign savings and runs a trade deficit just like 19th Century America. The difference this time, though, is that we don't really need the money. How is our economy affected? Let's return to our framework:

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\text{Exports} - \text{Imports} = \text{Savings} - \text{Investment}
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An increase in the U.S. trade deficit with China implies that American investment must rise and/or savings must fall. Investment can either be productive (profitable) or unproductive. Early America had an abundance of productive investment opportunities. But 21st Century America, being far more developed, has less. That means we're likely to squander Chinese savings on foolish investments like, for instance, an enormous housing bubble (which we experienced from 2004-2007). This sort of unproductive investment ultimately reduces our wealth.

A trade deficit with China could also cause our savings to fall. How? Unemployment would rise, as Chinese goods displace those produced in America. Or, instead of using Chinese savings for productive investment, we could blow all the money on non-productive consumption like big screen TVs, vacations, etc. Either way, a fall in U.S. savings would also hurt our economy.

We can now think through the implications of different tax and trade policies.

**Increasing trade barriers to close the trade deficit** – This would help the U.S. economy as savings would rise (from increased U.S. employment) and unproductive investment and consumption would fall. Unfortunately, our trading partners would respond with their own trade barriers, reducing our exports and negating some if not most of these benefits. A better plan would be to attack the root of the problem and encourage China (perhaps with the threat of trade barriers looming over them) to let their interest rates rise to more appropriate levels. This would naturally reduce their savings rate and thus China's trade surplus with the U.S.

**Increasing infrastructure investment** – A jump in infrastructure spending would help the U.S. economy so long as it's productive. Note, however, that an increase in U.S. investment spending necessarily means an increase in the U.S. trade deficit (remember our framework). Thus, the simultaneous goals of large infrastructure spending and a lower trade deficit are contradictory. Still, as discussed earlier, so long as we're investing the money productively, running a trade deficit isn't necessarily bad.

**Cutting business and income taxes and paying for it with lower Federal spending** – A reduction in the corporate tax rate would cause business profits (savings) to rise. Income tax cuts that largely benefit the wealthy would also mainly be saved (rather than spent on consumption),
as the wealthy tend to just save income windfalls. Positively, as our framework shows, this rise in savings would help close the trade deficit. On the other hand, the combination of big infrastructure investment plus tax cuts would cause the Federal budget deficit to surge.

Tax cuts, then, come with a tradeoff – either the trade deficit rises (no tax cuts) or the budget deficit rises (tax cuts). But under no circumstance should the government pay for such tax cuts by cutting spending on services that benefit the poor, like food stamps or Medicaid, as poorer households' consumption of goods and services would plummet. Since consumption represents 70% of the U.S. economy, the impact on growth would be considerable. Further, weak consumption would also lower companies' incentive to invest their excess profits on business expansion.

In truth, there are no simple answers here. Every economic policy decision comes with problematic tradeoffs, every action a reaction. Any politician who suggests the solutions are clear and easy is either uninformed or (less charitably) being dishonest.

**Alphabet: What’s in a Name?**
By: Christopher M. Brown, MBA

You may have noticed a strange new company in your portfolio called Alphabet. Surprise! It’s actually your Google shares in disguise. In 2015, Google underwent a restructuring creating a parent company called Alphabet, a reference to the many different parts of the company. Google has always been a search engine and advertising business at its core but over the years it's grown into a company with diverse interests ranging from self-driving cars to drone delivery. The idea was to create a holding company model, similar to Warren Buffet’s Berkshire Hathaway, separating the core Google business from the company’s other ventures. The new umbrella structure will give each business unit a CEO and the independence to develop their own strategies and brands. This should make the company more entrepreneurial and less bureaucratic, with the potential for promising companies to remain or be spun off someday. Meanwhile, the company’s founders, Sergey Brin and Larry Page, will still be the firm’s chief architects, monitoring the entire firm’s progress and handling capital allocation decisions.

The best part of the plan is that it finally brings clarity and accountability to the firm. For years Google has been a profligate spender, pouring billions into non-core projects and “moonshots,” masking the firm’s true profitability. With Alphabet now reporting in two financial segments, core and non-core, investors can marvel at the highly profitable and impressively growing legacy Google business which includes search, maps, advertising, YouTube, and the Android operating system.

The core Google division pulls in around $80 billion a year in advertising revenues, a true powerhouse with over 80% global market share in the online search market. This accounts for 90% of Alphabet's revenue and 100% of their $24 billion in operating income. With those kinds of profits, losing a few billion a year on their other business ventures looks reasonable.

The remaining other ventures housed under the Alphabet umbrella include Google Cloud (cloud computing service), Nest (the connected home products company), Fiber (high-speed Internet service), Calico (anti-aging and associated diseases), Google Ventures and Google Capital, and
Google X, a semi-secretive innovative research lab that has developed projects such as self-driving cars, wing drone delivery service, and Google Glass.

One promising venture is Google Cloud, which sells raw computing and data storage power as virtual services. The division is currently ranked #4 in the public Infrastructure as a Service (IaaS) cloud market and has invested over $11 billion in the past few years as it plays catch-up with market leaders Amazon, Microsoft, and IBM. According to Gartner group, the IaaS market is projected to grow 38.6% in 2017 and reach $34.6 Billion. IaaS is the fastest growing segment in the $200+ billion global cloud services market. Google Cloud service boasts over one billion end-users, through the products and services that other companies run on its servers. Customers include Home Depot, Snapchat, Spotify, and Coca Cola. The IaaS cloud market is expected to grow more than 25% annually through 2020.

Even though most of Alphabet’s more revolutionary projects are not generating profits or even revenue, the potential upside is staggering. For example, Alphabet’s self-driving car technology project targets a market estimated to be valued in the tens of billions of dollars within the next 10–15 years.

Currently at 21.6X 2017 earnings (ex-cash), PASI feels Alphabet shares are attractively priced, trading at a slight premium to the overall market multiple and below many of its internet peers. With Google at its core and new financial discipline, Alphabet appears well positioned to continue growing its main business while chasing its “moonshot” projects.

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