EPIC INVESTMENT MANAGEMENT

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Cracks In The Foundation

Now that the silly season of election primary posturing is upon us, it is no surprise that the assault on capitalism has intensified from Democrat contenders and pretenders alike. If we add it all up -- from free college tuition, to Medicare-for-all, to doubling the minimum wage, to reparations for descendants of slaves, to breaking up technology companies -- it's a wonder that there would be anything left of our free market economy.

Not that there is such a thing as a free service or benefit from our government, any more than there is pixie dust or an Easter bunny. The targeted beneficiary may not pay a price, but the taxpayer or business surely does, without fail.

Beyond our millionaires and billionaires, capitalism itself has become a target, and it is more than just pandering for votes. Nearly half of Americans are now 'takers', receiving more in government benefits than they pay into the system via taxes. As has been cautioned, when we cross the 50-percent threshold -- into a firm majority of takers, with less incentive to work, and more promises of 'free stuff' from Washington -- our model of free enterprise may be lost.

On its own this development may be no revelation. So here is the head-scratching, plot-twisting surprise in this story: the frontline of American Capitalism is cracking.

Consider the Business Roundtable, an association of chief executive officers from America's leading companies. Its stated purpose is to promote a thriving U.S. economy and expanded opportunity for all Americans through sound public policy. The companies represented total more than 15 million employees in every state, with over seven trillion dollars in combined annual revenues, and a who's who of chief executives.

Until recently, promoting a thriving U.S. economy meant supporting pro-business ideas and policies, with companies unabashedly pursuing higher profits. After all, as the late Nobel-laureate economist Milton Friedman famously pointed out, the purpose of a business is to make money.

In his oft-cited 1970 New York Times article, Friedman wrote:

> "In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to

conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom. Of course, in some cases his employers may have a different objective. A group of persons might establish a corporation for an eleemosynary purpose -- for example, a hospital or school. The manager of such a corporation will not have money profit as his objective but the rendering of certain services.

In either case, the key point is that, in his capacity as a corporate executive, the manager is the agent of the individuals who own the corporation or establish the eleemosynary institution, and his primary responsibility is to them."

For the better part of five decades, this dictum held true; and if ever there was an institution to uphold its ideals, it was, or should have been, the Business Roundtable, and its high-profile chief executives.

No more. In a highly publicized break from its past, the association recently proclaimed that there is a new purpose to American business, excerpted here:

"Business Roundtable today announced the release of a new Statement on the Purpose of a Corporation signed by 181 CEOs who commit to lead their companies for the benefit of all stakeholders -- customers, employees, suppliers, communities and shareholders.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders.

We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.

- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.

- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.

- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.

- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

> Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."

Shareholders, whose role is to provide capital, and nothing more, now seem to rank last among equals.

According to Adam Smith, who knew a thing or two about economics: "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities, but of their advantages."

Surely the members of the Business Roundtable are familiar with this idea, just as they are aware of the various stakeholders within their realm. Fortunately, the self-interest of a business confers benefits upon its customers, employees, and community; there is no inherent conflict. But the key point is the primacy of a company's financial motivation, to maximize shareholder value by seeking higher profits. This is the essence of capitalism, what distinguishes the US, the most successful and generous nation on earth, from much of the world and its impoverished history. On this point, no ground should be ceded.

And what has come of the Roundtable's olive branch?
This stump-speech reply, from candidate Elizabeth Warren:
"There's a whole bunch of core issues, like raising the minimum wage, and giving unions more power, and more regulations over financial institutions, and canceling student loan debt, and a wealth tax, that the majority of Americans -- not just the majority of Democrats, the majority of Americans -- are on board."

Followed weeks later by:
"What would really 'suck' is if we don't fix a corrupt system that lets giant companies like Facebook engage in illegal anticompetitive practices, stomp on consumer privacy rights, and repeatedly fumble their responsibility to protect our democracy."

The new, 'enlightened', principles of the Business Roundtable smack of a giant suck-up to socialist politicians, who will grab what has been offered and ask for more. Well, they already have. Nothing good will come of it.

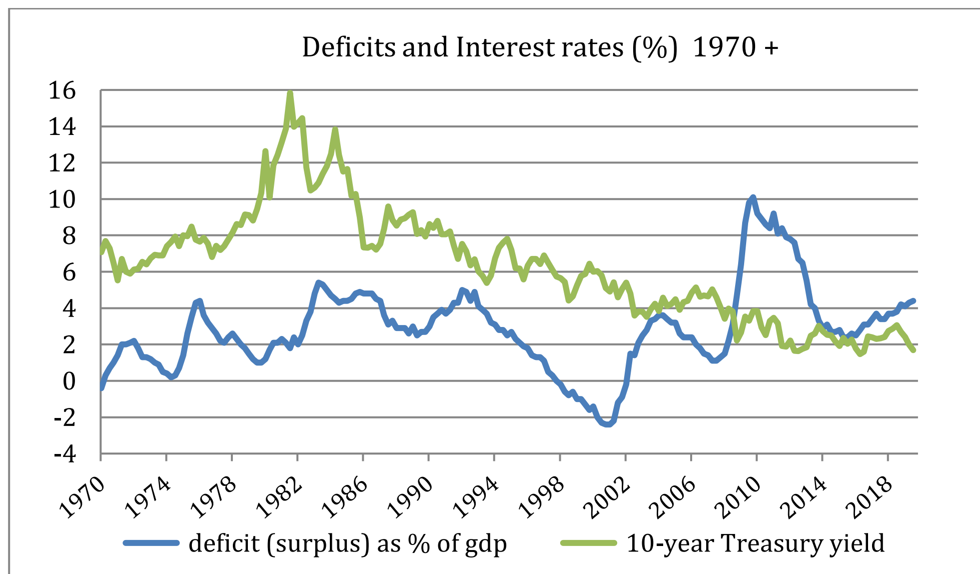
The New Budget Math

A trillion dollars isn't what it used to be, at least when it comes to runaway federal budget deficits. According to a recent report by the Congressional Budget Office, the annual US budget deficit will widen to one trillion dollars and remain above that threshold for as long as a budget analyst can see. The cumulative deficit over the next decade is expected to total 12 trillion dollars. By comparison, it took our nation over two centuries to accumulate its first 12 trillion dollars in debt. Then again, a dollar isn't what it used to be either.

The worsened budget outlook is due to recent legislation that raised spending levels, a White House-Congress compromise where everyone's spending priority was granted. The good news is that the effect of this spending spree was moderated by expectations of lower interest rates, which reduce borrowing costs to the federal government. When you owe 22 trillion dollars, lower rates account for more than a rounding error. And now our government has its own incentive to maintain low interest rates.

Which brings us to the real story: not that spending is out of control, but that it doesn't seem to matter anymore. In large economies such as the US, Europe, and Japan, governments run large deficits, issue debt to finance their spendthrift ways, and domestic and foreign institutions, along with central banks, buy the debt. For institutions, this is nothing new. Where it has really gone awry is in the action of central banks, wherein one part of government issues debt, and another absorbs it. This has become a shell game where nobody acts responsibly (Germany excluded), and markets play along.

For decades we have been warned that large deficits create an excessive supply of debt, a market imbalance that must drive higher long-term borrowing costs. The concept is easy enough to understand; it's just no longer true.



Growth, Value, and Wall Street's Easiest Job

A wise friend from Wall Street reminds us that years ago a gentleman used to show up on financial news networks with the easiest job of all. He would explain the prior day's market moves, with absolute certainty. And why not? After all, anyone can describe yesterday's weather without a smidgeon of doubt.

If stocks rose in the face of higher interest rates, it must have been confidence in the economy driving prices higher. If stocks fell, it was due to fears of tightening financial conditions. A week later, conditions might reverse, but no matter, Wall Street always has a narrative to fit what already occurred. Of course, he never told us was what would happen tomorrow. He also never explained that prices rise when there is an imbalance of purchase orders to sell orders; that is, more buyers than sellers. At times these money flows might relate to his explanation, at other times they certainly did not.

Present-day Wall Street has a new narrative, so often repeated it is almost a cliché. It says growth stocks outperform value stocks in a slow growth environment, such as today, because growth companies do not need a favorable backdrop to achieve their financial targets. They simply grow organically, through good times and bad; whereas value stocks represent economically-sensitive businesses in need of a tailwind.

While it all sounds sensible enough, the idea has enough holes in it to be labeled as 'bunk'. For instance, the 1990s were a period of great prosperity, with one brief recession followed by strong, extended, non-inflationary growth. This should have favored value stocks, yet growth stocks trounced value, culminating in the tech bubble at decade's end. The turn of the century brought the opposite condition, marred by sluggish growth even before the great recession. Nevertheless, value stocks outperformed for seven consecutive years, from 2000 through 2006. Both these extended periods went against the popular narrative.

There's more. Last year, in the strongest year of economic expansion since the recession, growth company profit gains edged out value, by 23 percent to 22 percent, a virtual toss-up. Still, growth stocks outperformed value by almost seven percentage points. In 2017, value company profits outpaced growth profits by 14 percent to 10 percent, yet growth stocks outperformed by over 16 percentage points, a staggering spread.

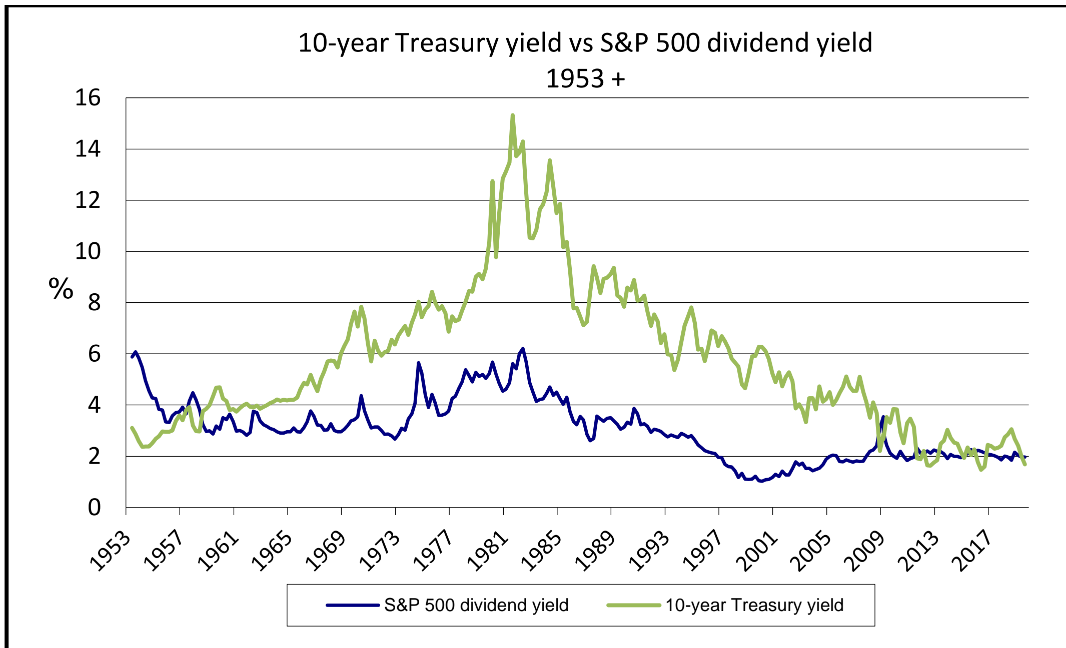
Year to date, it is more of the same, as growth stocks have outperformed value by 600 basis points. Is it earnings driven? Nope. Growth company earnings are lower year-to-date, while value company earnings are higher. Story de-bunked?

If the economic backdrop does not explain the profit picture, and if profits do not align with stock prices, where does this leave us? No doubt growth stock investors believe they are positioned for higher long-term earnings growth, and they are correct. Over the past 25 years, growth company earnings have compounded at 6.7 percent per annum, while value earnings have compounded at 6.3 percent. But before we go all-in on the growth stock frenzy, we should ponder: Is this minor differential worth today's 50 percent growth stock valuation premium?

Chart du Mois

In the past few months, markets have returned to the unusual condition wherein the dividend yield on the S&P 500 is higher than the yield on the 10-year Treasury note (1.96 percent vs 1.67 percent). This condition disappeared for 50 years after 1958, was supposedly dead and buried, and only re-emerged during and after the financial crisis.

History says this indicates stocks are cheap, bonds expensive. Alternatively, it suggests something is amiss -- most likely in the global bond market. It may be that both conclusions are correct.



Tidbits...

OECD projects global growth of just 2.9 percent for 2019, slowest advance in a decade.

European Central bank cuts benchmark interest rate to -50 basis points, renews Quantitative Easing bond-buying program.
Federal Reserve cuts rates for second time this year, retains prospects of further cuts.
Central banks back to playing superhero in response to slowing growth.

Raising minimum wage to 15 dollars per hour would cost 1.3 million jobs, while boosting wages for 17 million Americans, says Congressional Budget Office study.

France approves Digital Services Tax, targeting large US tech companies.
California legislature re-classifies gig economy contract workers as employees, raising costs for Lyft, Uber, DoorDash and others.
Oregon ballot initiative calls for limiting number of check-out kiosks in grocery stores, as battle intensifies between high minimum wages and business productivity initiatives.
Technology companies, uses, become popular targets.

Justice Department approves merger of wireless companies T-Mobile and Sprint, after opposing deal during prior administration.
CBS and Viacom, formerly combined companies, then separated, agree to re-unite in merger.
Investment bankers' dream client.

Struggling department stores Macy's and J.C. Penney expand merchandise by offering used clothing.
Luxury retailer Barney's New York files bankruptcy.
Fast-fashion retailer Forever 21 files bankruptcy.
No way out for many traditional retailers.

White House raises stakes in trade war with China, imposes additional tariffs, labels China a currency manipulator, then partially delays tariffs' effective date.

Danish bank offers mortgages with negative interest rate, paying home buyers to borrow.
Germany issues 30-year bond with zero interest, priced to guarantee negative returns.
15 trillion dollars of global debt is priced with negative yields.
Centuries of financial theory and practice tossed on its head.

Johnson & Johnson loses first opioid epidemic case, is ordered to pay 572 million dollars.
Opioid maker Purdue Pharma files bankruptcy amid nationwide lawsuits over addictions, overdoses.
Multiple deaths are linked to vaping, as popular alternative to cigarettes comes under scrutiny.

US housing starts, building permits, hit 12-year highs as low interest rates, under-supply, spur activity.
Regardless of headlines, it's not so bad out there.

Source:
Bloomberg
BusinessRoundtable.org
HBR.org
The Wall Street Journal