Notes on the Week Ahead

August 12, 2019

Investing for the Middle Run

I have always been a middle-distance runner, a fact for which I must credit the Dublin bus service of my school days. Dublin was supposed to be a bus-friendly city and the main roads all had bus stops every quarter of a mile or so, with buses scheduled to arrive every few minutes. However, that is not exactly how it worked.

When cursing the bus system, I imagined the drivers sitting around at the depot finishing a cup of tea or a game of poker when one would solemnly get up and announce: "Right lads – let's hit the roads." Whereupon, they would all drive off in unison, in a great herd of green double-decker buses.

Of course there was no timing the herd and I would often arrive at the bus stop just as the herd moved off, facing the prospect of a twenty-minute wait for the next group. Nor was running all the way to school an option – the natural humidity of the Irish climate made that a distinctly liquid and uninviting choice. So often, I would just hoof it on to the next bus stop, trusting that with slow traffic and fast legs I could beat the herd. If that didn't work, it was another 400 yards to the next stop – perfect interval training for a middle-distance runner.

I think this serves me well today as, while many strategists and financial advisors talk about investing as a marathon, it is essentially a middle-distance discipline.

It certainly isn't a sprint.

Despite the prevalence of year-end targets, the truth is that it is almost impossible to forecast the twists and turns of a market over the space of a few months. If anyone questions that, consider how many forecasters predicted a 20% drop in the S&P500 between September and December of last year and then a 29% surge by late July of this year.

But nor, realistically, should investing be thought of a marathon. Of course, investors mostly have long-term goals. However, it is perfectly reasonable and logical to change strategy every few years as markets evolve and personal circumstances change.

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And it is particularly important to have a middle-distance perspective on investing today.

The short-run outlook looks stormy.

As the economy slows and trade tensions rise, the Fed has begun to cut interest rates. As of this morning, futures markets have priced in two more rates cuts for this year and an additional cut in the first quarter of 2020, in an explicit bet that the Fed won't be able to stick to the mild "mid-cycle adjustment" suggested by Chairman Powell at the end of July. With central banks in an easing mode around the world, the U.S. 10-year Treasury yielded just 1.73% by the close of business on Friday, with 10-year TIP yields down at just 0.08%.

That last statistic is worth pondering. Although the nominal 10-year bond yield is below the current rate of core CPI inflation, the behavior of bond investors might be rationalized by assuming a lower rate of inflation going forward. But if the TIPs yield is just 8 basis points, it means investors are willing to defer real consumption for a decade for a cumulative real return of less than 1%.

While the bond market reaction seems extreme, there is good reason for concern in the short run. Even without trade uncertainty, the U.S. economy would have downshifted to slower growth as the stimulus from the 2017 Tax Act faded and the economy bumped up against a chronic shortage of workers in a full-employment economy. Added to this, the threat of higher tariffs appears to be slowing the global economy, and thus U.S. exports, as well as acting as a drag on investment spending.

Numbers due out this week should show stagnation in Housing Starts and Industrial Production, slower growth in inventories, moderation in the pace of Retail Sales and a decline in Consumer Sentiment. CPI Inflation should be relatively stable. However, with the global economy lagging and the U.S. economy decelerating, corporate profits over the next few quarters are likely to grow at a low single-digit pace at best.

Even with this, the S&P500 is only down 3.5% from its all-time high of July 26th, and sports a forward P/E ratio of 16.6 times, above its 25-year average of 16.2 times. Given this, and rising recession worries, a further selloff in stocks seems quite possible.

It is also easy to be pessimistic about the long-term outlook, given the long-term corrosive effects of over-easy monetary policy.

Appropriate interest rates play a critical role in a free-market economy, directing capital to its most efficient uses and starving the more fanciful ideas of businesses and individuals of financing. They also act as a check on unrestrained government borrowing, as budget directors fret about interest costs. Sometimes, of course, this means that good ideas die for lack of financing. However, for the most part, appropriate interest rates keep economies out of trouble.

Today, however, years of super-low interest rates have enabled some companies to take on too much leverage and governments to run even bigger budget deficits and there is every reason to believe that this will get worse in the years ahead. Some, including the proponents of Modern Monetary Theory, say that this can't be a problem because inflation remains low and stable.

However, it is critical to recognize that one of the key reasons for low inflation is that so much of the nation's income is being received by wealthier households who tend to buy proportionately more stocks and bonds and proportionately fewer consumer goods and services than their less fortunate brethren. Indeed, the very reason that the government can sell 10-year TIPs at 8 basis points, is that rich investors are so unwilling to spend that almost any interest rate will tempt them to save.

According to research by Thomas Piketty, Emmanuel Saez and Gabriel Zucman, the top 10% of households now earn roughly 50% of the pre-tax income in the United States and own over 75% of the wealth[1][2]. To put this in perspective, if ten representative people walked into a 7-Eleven this afternoon, one of them would have the same income and three times the wealth as the other nine combined.

Both income and wealth inequality have risen very sharply since the 1980s and this acts to restrain aggregate spending, since, according to consumer expenditure surveys, the highest-earning 10% of U.S. households spend only 76% of their after-tax income while the other 90% spend 102%[3].

This reality is fueling populism in America, as it is around the world, and, governments in the future will be tempted to boost the budget deficit further to help out poorer and middle income households with higher spending or tax cuts. However, while the rich won't spend, governments and poor and middle-income consumers would if given a chance. In this scenario, the inflation that has vanished from developed nations for many years could easily reappear. If this happens, and interest rates rise sharply in response, investors could get hurt by higher taxes, higher interest rates and economic disruption all at the same time.

But the distant future, like the last few miles of a marathon, always looks painful.

In the middle run, that is, over the next few years, the U.S. economy may grow slowly but could well avoid recession. The real economy has become more stable over time and the banking system is far better capitalized than a few years ago, reducing the risk of a repeat of 2008. There are few signs of an economic boom anywhere that could turn into an economic bust. And if the real economy moves forward slowly with low inflation, low interest rates could still make stocks and real estate look attractive relative to anything offered by fixed income markets. Even if the economy were to enter and exit recession, there are areas of the U.S. and particularly international equity markets that look cheap from a valuation perspective and could well provide healthy returns.

And for now, this is probably what investors should focus on. While the short run is difficult and the long run is scary, financial markets still present opportunity for middle-run investing.

[1]See Income Inequality in the United States, 1913-1998, by Thomas Piketty and Emmanuel Saez, The Quarterly Journal of Economics, February 2003, page 11, with data updated through 2017.

[2]See Wealth Inequality in the United States Since 1913: Evidence from Capitalized Income Tax Data, by Emmanuel Saez and Gabriel Zucman, The Quarterly Journal of Economics, May 2016, page 553.

[3]See Consumer Expenditure Survey, 2017, Bureau of Labor Statistics Website, BLS.gov

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