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Economic & Financial Research

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Hello,

This letter is coming a quarter early but given the volatile times I wanted to write it now. There have been a few articles recently about the strength of the economy, the deficit and the stock markets that I have found informative. I also had the opportunity to attend a speech by Martin Feldstein on the state of the economy. My conclusion regarding the current state of the U.S. economy is that it is strong but fragile and the stock market is overpriced.

The U.S. economy is booming. We have the lowest unemployment rate since the 1960s, the rate of GDP growth was over 4% in the second quarter and inflation remains low. In addition, income tax rates were cut at the beginning of 2018 for corporations and many individuals, and the federal government has increased fiscal spending on defense and other areas. As a result consumer spending has been strong, consumer sentiment is up, small business optimism has risen, corporate earnings have jumped and the stock market has risen strongly.

However, life is not as rosy as that sounds. There are several factors that should concern us. First, the Federal Reserve maintained an extremely accommodating policy for almost ten years with the Real Federal Funds Rate being negative for years. This also has contributed to asset prices being high as people seek higher returns in a period of low yields. The Fed is now in the position of tightening. This is important for two reasons. First the economy is strong and we need to protect against rising inflation. For the first time in years, inflation is at or slightly above the Fed's target level. Second, the Fed must increase rates and reduce its holdings of debt now while the economy is strong, otherwise, when the next recession comes, they will be unable to ease rates and support the economy.

The Trump administration with its tax cuts and increased spending has created a fiscal stimulus that is expanding budget deficits. The deficit as a percentage of Gross Domestic Product is projected to approach 4% this year and grow larger next year. This is a level that has occurred several times in the past. In 2010 it reached almost 10% and was about 4% in the early 80s and 90s. The difference is all three of those periods were during and coming out of recessions. It is uncommon to increase our budget deficit to this extent during a strong expanding economy.

The result of a strong economy with increasing inflation and large deficits is that long-term interest rates will rise. This will make bonds more attractive as an alternative to stocks causing a market that is already high to decline. This will cause a reduction of trillions of dollars in household wealth and reduce consumer spending. Higher long-term interest rates will also make borrowing more expensive, discouraging businesses from taking out loans and slowing the housing market due to higher mortgage rates.

Higher long-term rates could push the economy into a recession. Unfortunately, with short-term rates currently low and the government already running large deficits, there is limited ammunition to fight the recession. It could cause the next recession to be longer and deeper than average.

Another threat to our economy would be extended tariffs and trade wars. I do believe Trump's threatening negotiation technique can be productive and that as the strongest economy in the world, we have had a generous foreign policy for decades. This is particularly true when dealing with China. I do not think we need to use tariffs to affect trade. To me the much bigger issue is the taking of U.S. technology. If Trump's real goal is to change how China steals our technology outright or requires foreign companies to share their technology in order to do business in China, I am supportive. I hope he has smart advisors and he listens to them.

One last point, a justification for the corporate tax cuts was that it would encourage companies to increase their investment in research and development. Long-term this would result in increased long-term growth. I was a fan of the corporate tax cut as it brought the U.S. rate down from one of the highest in the world to about average. It has resulted in improved corporate earnings. Another benefit is that companies can be more efficient as taking actions to reduce taxes is less important. Unfortunately, it does not appear to have increased R&D spending nearly as much as it has increased company stock buybacks. There is no long-term benefit to a company's future growth from stock buybacks, only an increase in stock price due to a reduction in the number of shares outstanding.

Below is a chart of the S&P500 covering the years 1990 – 2018. There are three lines. The yellow line is closing share price, the blue line is annual sales per share and the red line is annual earnings per share. Over a long period of time these lines should be basically parallel. What I would like to point out is that recently the gap between the blue (sales) and yellow (price) lines is very large by historical standards. It means stock prices are high relative to corporate sales and earnings. We would expect this gap to shrink, either by a large increase in sales or a decline in stock prices. The more likely is a significant decline in prices.

Sincerely,

Will Wrean