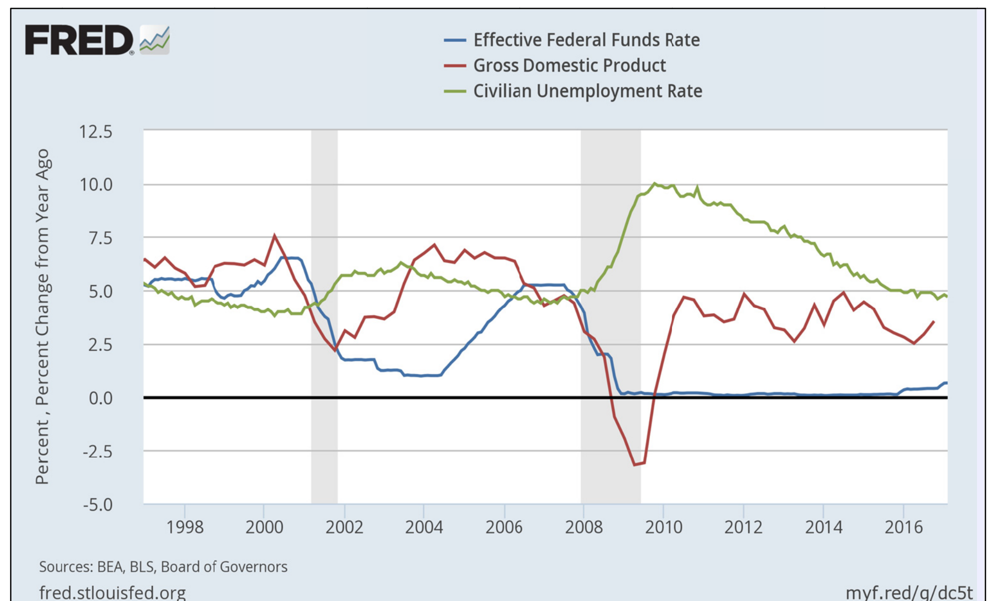
The Long & Short of It
Quarterly Newsletter
First Quarter 2017

Fed up with the Fed

Despite all the sensationalism-seeking scare tactics of the media and Washington, little actually happens that meaningfully impacts wealth creation. One could watch paint dry and see more action than our aging baby boomer-driven, over-regulated, debt-laden, toxic/partisan Washington-on-ice economy. It's not that things are so bad. It's just that people know they should be better. Today's "walking dead" economic cycles last longer but growth rates continue to move lower. There is no rising tide to lift all boats.

Waiting for the Fed to stumble seems to be investors' best bet for some economic excitement. At first glance, the Fed's dual mandate of low unemployment and low inflation appears achievable. But while unemployment has declined to levels where significant further improvement is unlikely, inflation driven by wage and salary rate gains becomes more likely. Historically, very low levels of unemployment increase the potential for a recession. Wages rise as employers chase after fewer workers. Inflation follows, resulting in tighter monetary policy. The Fed has raised the Federal Funds rate three times since 2015, from near-zero to near 1%. So are we on the edge of our seats? Is recession right around the corner? Not likely.



The unemployment rate has room to drift even lower without causing inflation. The large numbers of underemployed and temporarily out-of-the-labor-force workers could return to work, keeping wage rates steady and preventing them from driving inflation higher. Inflation watching, while not thrilling theater, is useful if it helps investors anticipate when the Fed will be forced to tighten monetary policy in earnest. Historically, equity markets have not had large moves down in anticipation of a recession unless the Federal Funds rate has risen above the growth rate of Nominal Gross Domestic Product (GDP). The accompanying chart shows the civilian unemployment rate, the Federal Funds interest rate, and the GDP growth rate. From this chart, it does not appear that Fed Funds (blue line) will rise above GDP (red line) any time soon.

Goldilocks Growth and Gridlock

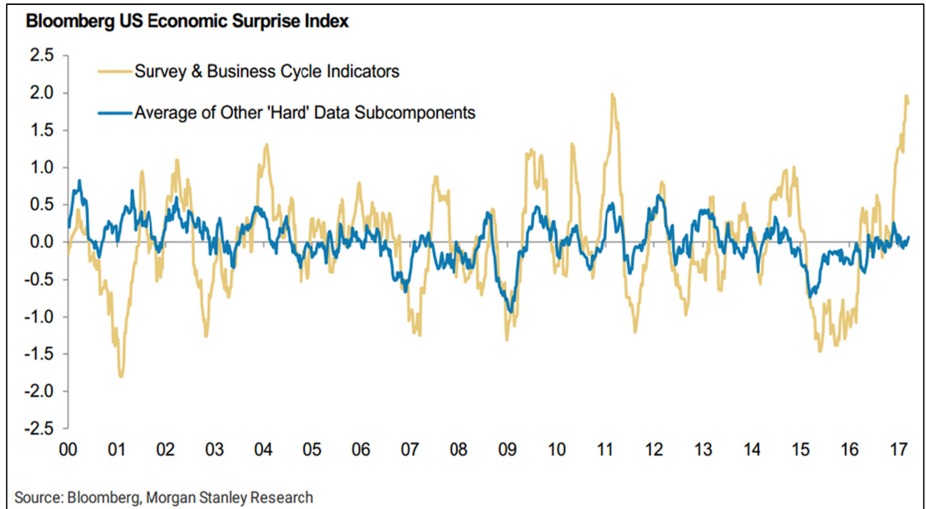
The broad confidence and optimism following the election of Donald Trump have reached extraordinary highs, prompting a post-election rise in stock prices. Survey and business cycle indicators are at record levels especially when compared to "hard" data that reflects actual economic activity (see chart on next page).

These high expectations have created a Goldilocks dilemma. As we mentioned in last quarter's letter, Washington isn't so easily impressed with a new president and his agenda. Politicians will likely continue to dig in their change-resistant heels, casting a shadow over the optimistic outlook. While Washington

gridlock is typically bullish for stocks, disappointing the market's expectations is not. This is when trying to time the market can be quite challenging.

To become policy in Washington, pro-growth ideas need wide consensus. These ideas must also avoid stimulating significant inflation. It seems too much to hope for this late in an economic expansion, but "impossible" is often an unsafe word in a bull market.

We will continue to watch for inflation and/or for Washington's policy makers to make substantive changes to policy. The future is always opaque at best, but Washington's inertia should never be underestimated.



We will also continue to do what we love: value individual company stocks, one at a time, in a market that is mostly efficient, most of the time, and look for non sequiturs that turn a stock into an investment opportunity. For now, American consumers seem to be the best hope for a positive surprise, given that they're carrying less debt than both government and corporations, and are thereby better positioned to borrow and spend.

Retailers currently being punished for their "brick-and-mortar burdens" may therefore present an opportunity. The negative consensus regarding their prospects sounds a lot like the early 2000 dot-com era conversations that prematurely predicted the demise of retail stores due to online shopping. Clearly, online business is an influence because old-guard retail companies are struggling. But shopping is an American pastime. Brick-and-mortar retailers won't just go away. Most will survive and some will even thrive by redesigning stores to better meet the needs of the evolving consumer, improving online presence, and reengineering warehousing practices. A good business with a clean balance sheet, a solid plan for adaptation to new challenges, low multiples, and deeply negative consensus toward the company and its industry—these are the elements we seek to add to client portfolios for their ability to both enhance returns and mitigate risk.

Thank you for the opportunity to serve your family and your portfolios.

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