Quarterly Insights

October 2018

Challenges to Growth

Strong economic fundamentals continue to fuel domestic growth at a rate that only a few years ago seemed unattainable. By extension US stock market performance persisted in the face of rising interest rates, escalating trade disputes, rising inflation, and investor concern over the age of the bull market- now the longest in history.

The Congressional Budget Office expects the budget deficit for fiscal year 2018 to amount to approximately $800 billion - the largest since 2012. The Tax Cut and Jobs Act of 2017 is largely responsible for the increasing deficit which has some advisors concerned. The flip side is that the tax cuts have undeniably added to economic growth which is crucial to future tax receipts. And yet, perhaps, offsetting all of that is the impact on the deficit of higher interest rates.

It is possible that tax receipts at the end of the current fiscal year will end higher than the previous year. Government spending has yet to be addressed but that is an issue which neither political party is willing to touch. That problem is longer-term in nature and it is always ignored during positive economic environments. Ultimately, the combination of annual deficits and governmental debt coupled with higher interest rates becomes a larger and larger part of US economic output which will inevitably crowd out the private sector.

A more near-term concern to the market is ongoing trade disputes which have been characterized by the U.S.'s often threatening rhetoric. As much as that bothers investors, the Trump administration's success with Mexico and Canada has quelled some of the discomfort this seemingly in your face negotiating strategy relies upon. The "USMCA" also limits independent trade deals that might weaken the agreement. It clearly sets the stage for the U.S. – China trade fight.

In September, the US imposed tariffs on an additional $200 billion worth of Chinese goods. When combined with the earlier $50 billion in tariffs, more than half of all Chinese imports to the US are now subject to some form of duties. In response, China retaliated by stating they had "no choice" but to impose tariffs on $60 billion of US exports to China. They also reduced tariffs on non-US imports to China during the quarter. Undeterred, President Trump instructed US Trade Representative Robert Lighthizer to craft the next round of tariffs for a possible addition of $267 billion worth.

How and when the trade conflict ends remains uncertain. What is known though is that some US businesses are expressing concern. In a letter to the Trump administration, Walmart stated the impact of the new tariffs, "will be to raise prices on consumers and tax American business and manufacturers…As the largest retailer in the United States and a major buyer of US manufactured goods, we are very concerned about the impact of these tariffs would have on our business…" Given what is at stake, we believe that high level trade talks will resume venting pressure and will open the door for a resolution.

One now ancient Wall Street adage about the Federal Reserve was "two steps and a stumble". When the Fed raised rates twice, it spelled trouble for the market. That was from a time when the Fed acted in secret and communication was veiled. Now, and after 10 years of monetary experimentation, any Fed move on interest rates is known well in advance. To the surprise of no one this quarter, the Fed Funds Rate was pushed up 25 basis points to a range of 2.00% to 2.25%. Another rate hike is projected in 2018 and three more hikes are on the table for 2019. Importantly, the Fed dropped the language stating "monetary policy remains accommodative" signaling they are anticipating stronger economic growth and a normal Fed Funds rate environment. We believe this process is a positive for our predominately short term bond positions and we very much appreciate the rising rates offered in money market funds.

A pervasive dynamic of the current market environment is that investors do not appear concerned with unprofitable companies. Last year 76% of Initial Public Offerings (IPOs) were unprofitable the year before their IPO, which is above the 40-year average of 38% according to Jay Ritter at the University of Florida. Only the year 2000 had a higher percentage of 81%.

In some sectors, investors are valuing companies not on their profitability, but rather the perception they will be able to disrupt incumbents with a "winner-take-most" business model. The hallmark of this has been Amazon which has a market capitalization of $976 billion and over the past 20 years has recorded a total of $8 billion in profits. This pales in comparison to Apple, at a similar size market cap of $1.07 trillion and has made $327 billion over the same period.

Even staid industries are at risk of being disrupted. Clayton Christensen of Harvard Business School believes cost-effective online education will disrupt the traditional college model. Further he predicts online education will bankrupt 50% of the 4,000 colleges in the US within 10 to 15 years.

The current focus on market share growth rather than profitability has made for a challenging investing environment for value investors. Value investors favor buying companies below their intrinsic value or the present value of cash flows an owner could expect to receive. Valuing and investing in unprofitable high growth companies goes against the grain of most value investors, but history has shown that those with discipline have been rewarded.

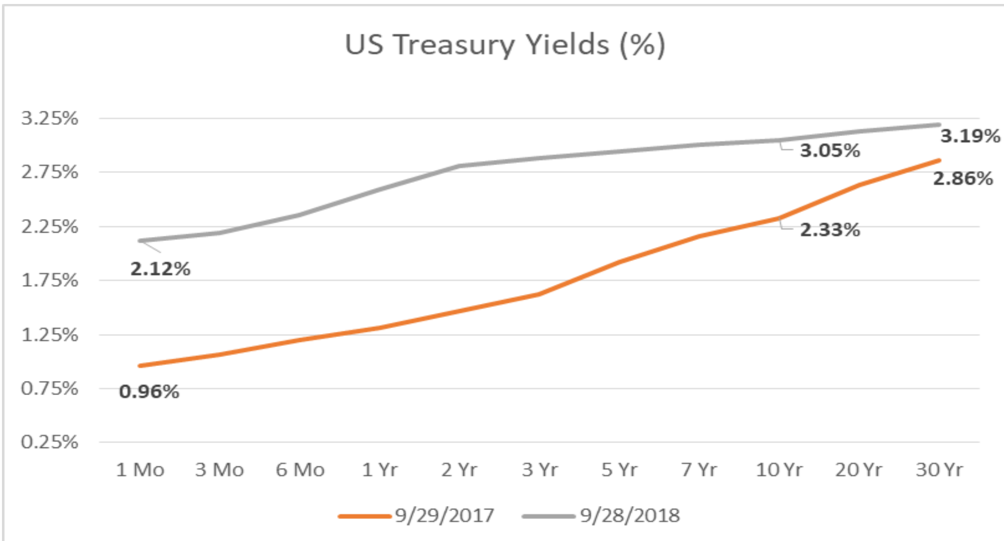
Volatility has been elevated year to date. However, on balance the economy and the equity markets have thus far taken the visible risks in stride. We are also encouraged by what we see, but as always remain balanced as environments can change quickly.

- Jerry McQueen & Todd Fungard

US Treasury Bills As a Strategic Investment

The Federal Reserve has raised the Federal Funds Rate three times this year and has signaled their intention to continue to do so in the future. This has caused fixed income securities in the shorter end of the yield curve to be become more attractive relative to the longer term instruments.

As a result, short term interest rates now provide investors the opportunity to earn reasonable rates of return on high quality, liquid, low duration fixed income securities. For example, short term US Treasury bills with 6 month maturities offer yields of approximately 2.35%. These securities serve as a good complement to our current municipal bond strategy as the rising interest rate environment continues to unfold.



In some instances, short term US Treasury Bills will replace maturing municipal securities. For example, at its most expensive point this year in late July, a two year AAA-rated municipal bond was yielding only around 60% of a comparable US Treasury note with a similar maturity. For some clients, we are able to add both liquidity and a greater rate of return on an after-tax basis by reinvesting the municipal bond maturity proceeds in US Treasury Bills. Treasury bills can also provide a liquid alternative to money market holdings for those clients with short term cash needs.

For more information about McQueen, Ball & Associates and our products and services please contact us at 610-954-0400 or by email at info@mcqueenball.com

McQueen, Ball & Associates, Inc.

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