Quarterly Insights October 2017

Rates, Robots, and North Korea

With the S&P 500 now up 14.24% for the year, the equity markets continue to be fueled by improving economic fundamentals and a low interest rate environment. The rise has been unusually steady without even a minor correction (-5%) over the last year. While low volatility is not a concern in and of itself, we continue to actively rebalance our portfolios while holding a longer range view that market corrections are inevitable.

One change that could spark general uncertainty is the Federal Reserve's decision to unwind the bond portfolio it created through their Quantitative Easing strategy. In 2008, the Fed embarked on an unprecedented effort to stimulate economic growth by suppressing long-term interest rates via a large scale bond buying program.

The program resulted in the Fed owning a $4.2 trillion bond portfolio made up of Treasuries and Mortgage-Backed Securities. The Fed now owns roughly 29% of the mortgage bonds issued by government-related entities and 17% of the Treasury market.

As the economy found its footing, the Fed eliminated its Quantitative Easing plan and now has plans to reverse the bond purchase process. Of course, this is unprecedented and no one is certain what (if any) disruption the change will cause. A few points worth noting are: the Fed will move slowly; they will be transparent in their actions; and they will not be actively selling bonds, but rather allowing bonds to mature and not reinvesting the proceeds.

Shrinking the Fed balance sheet will act as a tightening mechanism which can put upward pressure on longer term interest rates. At the same time, the Fed has signaled a strategy of regularly pushing the short term Fed funds rate higher. With the economy at full employment, the Fed feels that higher inflation is on the horizon although proof of 2% inflation is hard to find. So which is the right policy? Let inflation rise and then react or tighten now to contain the inevitable? Rising interest rates serve as a warning sign to investors. With this in mind, we remain defensively positioned within our portfolios.

Aside from economic fundamentals, many exogenous factors keep investor anxiety high. Nuclear conflict between North Korea and the U.S. is unthinkable and thoughtful people hope that the U.S. and China can resolve the issue before it escalates further. Some have posited that the North Korea-U.S. stalemate has, at its root, the underlying economic clash between the U.S. and China. Some believe that hard line Chinese communists are using North Korea as a tool in seeking trade concessions with the Trump administration. These issues are, by nature, unpredictable and we wouldn't change our strategy in an attempt at guessing the outcome. We are hopeful that the motive of self-preservation will prevail and ultimately defuse the situation.

At home, President Trump's tax reforms are beginning to take center stage. The goals are to simplify the tax code, provide tax relief for middle-class Americans, improve the competitiveness of American businesses and, lastly, allow offshore funds to be repatriated and reinvested into the American economy.

Significant changes of the proposal include: doubling of the standard deduction (to $24,000), three tax brackets (down from seven), corporate tax rate of 20%, max tax rate on partnerships/ s-corps of 25%, and the elimination of the deduction for state and local taxes. The latter mostly impacts those in high income tax states such as California, New Jersey, and New York. What will get passed remains to be seen, but we are encouraged by the spirit of the reform.

Another topic concerning the future that is interesting from both a humanitarian as well as investing perspective is that of Artificial Intelligence or AI. Tesla CEO, Elon Musk, recently tweeted, "If you're not concerned about AI safety, you should be. Vastly more risk than North Korea." Self-driving taxis and trucks could replace 4.28 million jobs in the United States alone. Switching to cashier-free shopping could target an additional 3.4 million. It's not just blue-collar jobs under threat either—name an occupation and you can be assured someone is considering a robot to replace a human.

Ominous headlines concerning AI paint a dark picture of the future with large unemployable masses. We tend to be more optimistic about the future with reason. History has proven pessimists wrong on this subject time and again. For instance, in 1870, farmers made up 50% of the U.S. labor force; as of 2008 it is less than 2% without any net reduction in employment. Tractors and modern farming equipment greatly increased the efficiency of farming requiring significantly less people. However, one of the reasons net employment levels stayed the same is that young people are forward looking and will avoid careers whose future looks dim (i.e., driving careers).

In addition, entire fields we cannot imagine will exist 50 years from now. No one in 1967 could have imagined a career in Cybersecurity existing or, for that matter, the existence of the internet. While predicting what the future looks like is nearly impossible, we feel reasonably assured that people will still be working. What they will be doing is another discussion entirely. Warren Buffet may have best summed this topic up in February, "If one person could push a button and turn out everything we turn out now, is that good for the world or bad for the world? You would free up all kinds of possibilities for everything else."
—Jerry McQueen & Todd Fungard

Indexing and Capital Gains

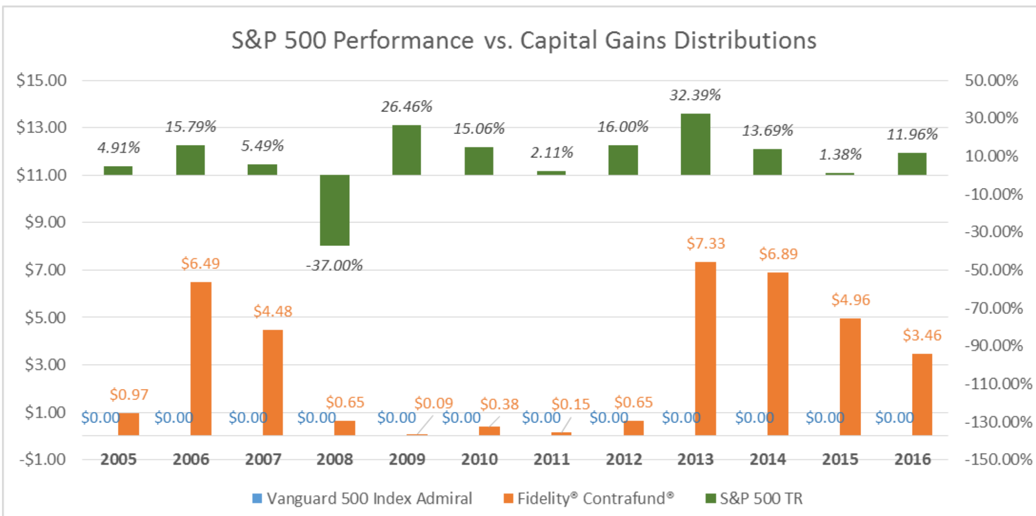
Ben Franklin taught us nothing in this world is certain except death and taxes. With the bull market well into its eighth year, investors are beginning to think about unrealized capital gains; particularly those held by index funds. Along with their low costs and ability to track the broad market, index funds are well-known to be tax-efficient investments.

The tax efficiency of an index fund is largely due to the investments being passive in nature. The index fund buys stocks according to predetermined rules. (The most popular type of rule is a market capitalization weighted index—i.e., the biggest stocks have the largest weightings within the index.) The index fund will only trade to rebalance per the rules or to accommodate investors who are either entering or leaving the fund.

This is in contrast to active managers who are buying and selling within the fund to try to generate additional performance, but who are, at the same time, generating capital gains which get distributed at the end of each year. In normal times this leads to index funds generally being tax-friendly investments.

As passive funds have now garnered a much larger part of the U.S. market share (28.5% according to a February '17 report by Moody's; undoubtedly larger at the time of this writing), some have begun to wonder if the historic tax efficiency of indexes will remain during the next bear market as they sell to meet redemptions. For instance, 40% of the Vanguard S&P 500 Index Fund's $568.6 billion in assets are represented by unrealized capital gains. Below is a chart comparing the S&P 500's annual performance to the capital gains distributions of the Vanguard S&P 500 Index Fund and the Fidelity Contrafund, which is one of the largest actively-managed funds in existence.

You will notice immediately that despite several years of market gains and through the 2008 correction, the index fund has never needed to distribute a capital gain. The reason is that there are several mitigating factors which help index funds retain their tax efficiency: 1) They own multiple tax lots and will sell the highest cost tax lots first; 2) The funds may still receive positive cash flows during downturns offsetting the amount they need to sell to meet redemptions; 3) A downturn cuts the unrealized capital gains and, in turn, reduces the realized gains when raising cash for redemptions.



In practice, the Vanguard S&P 500 mutual fund did not distribute any capital gains throughout this period despite having similar unrealized capital gains exposure to today. Either way, the benefits of incorporating indexing into our strategy are not outweighed

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

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