Perspective

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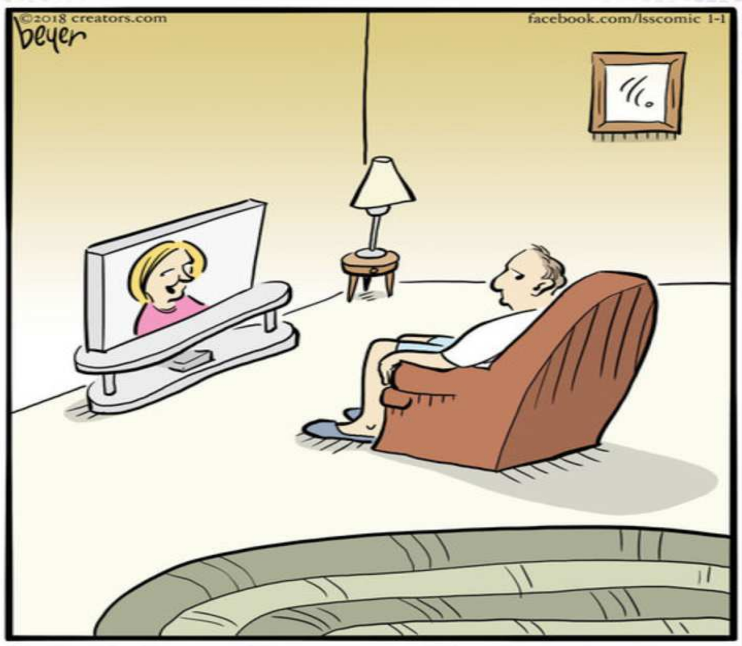
In This Issue . . .

- ✓ The contrast between *headline* news and *stock market* news was significant last year.
- ✓ It's left some in an *optimiserable* state of mind.
- ✓ Expect more stock market volatility in the New Year.
- ✓ But improving economy and corporate earnings should allow stock prices to continue to climb the wall of worry.
- ✓ Economies are enormously complex, dynamic systems where human behavior is extremely important.
- ✓ As a result, lots of hard-to-measure variables drive the economic growth process.
- ✓ Economic models often underestimate the importance of the hard-to-measure factors.
- ✓ Tax reform and easing of regulatory burdens offer pro-growth incentives to invest, take risk, and work hard; particularly for the small businesses.
- ✓ Another great escape of sorts underway?
- ✓ What about the Fed, inflation, and interest rates?

Ring in the New (Experiments)

Ring out the old, ring in the new. While we hope 2018 will ring in a "happy ***news*** year" as suggested in the following cartoon, investors would rather not ring out 2017's rewarding return environment.



"Thanks for watching a recap of the top stories of 2017. We hope you have a happier news year."

The *contrast* last year between *headline news* and *stock market news* is fascinating and, for some, hard to reconcile.

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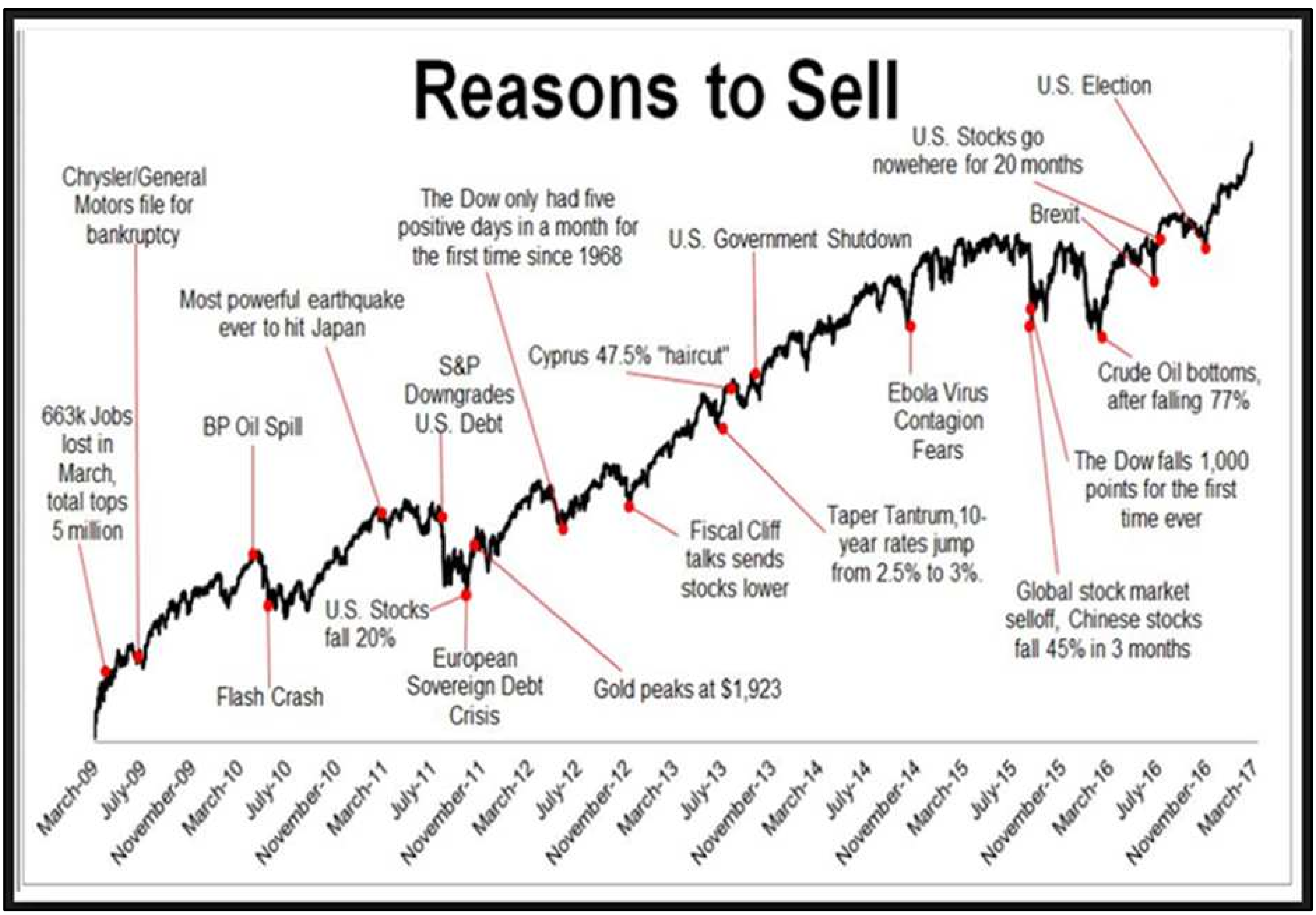
This contrast has driven some investors into an *optimiserable* state of mind as the cartoon below suggests.

With signs that the pace of the economy may at last be picking up from its underwhelming trend of the past several years, the *optimiserable* now fret the economy will "overheat". The *optimiserable* also fear that as sure as the ceremonial ball dropped in cities around the world to usher in the New Year, the proverbial "other shoe" will soon drop on stock investors.

Our take on this situation?

Set-backs ("corrections") in the stock market's advance can indeed happen at any time. Investors should expect them. As Chart 1 reflects, setbacks and volatility are the price paid for very rewarding returns over time.

Chart 1: This is the top in the market, no this is, no this is…

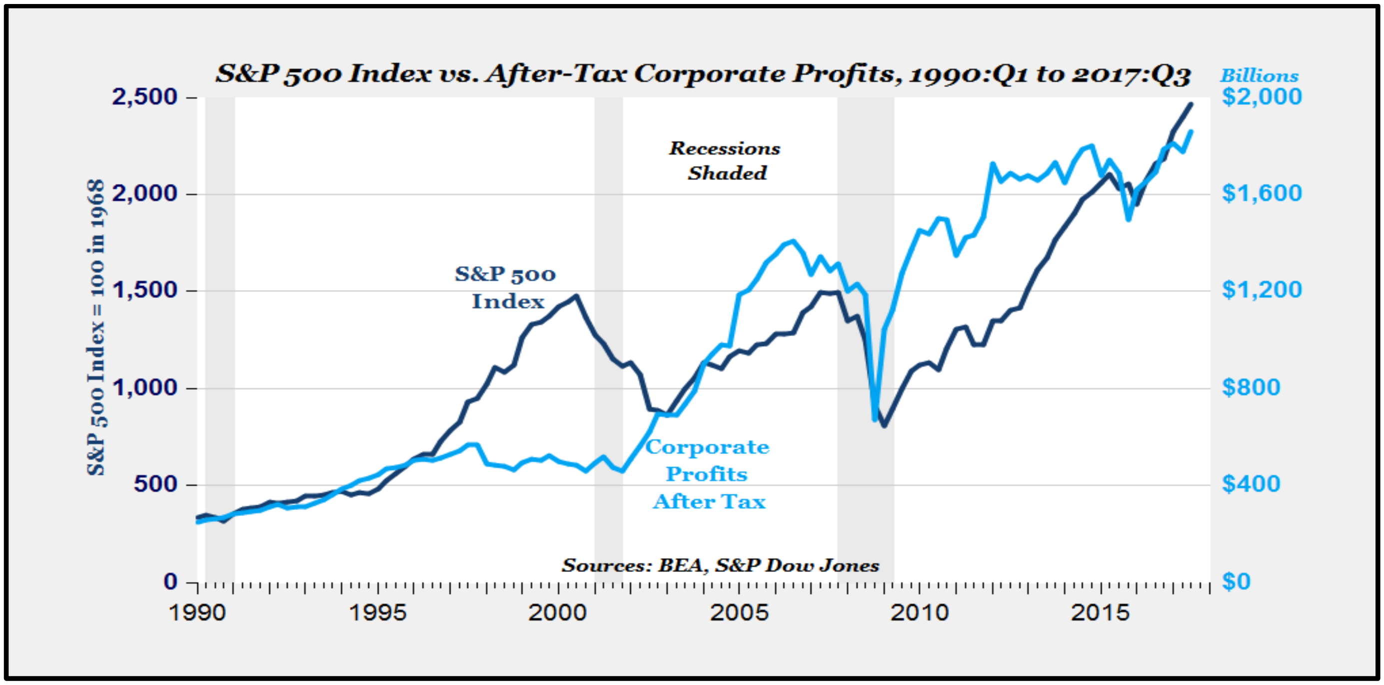


Source: Demogronomics

Stock market volatility was incredibly low in 2017. Investors should expect the New Year to be more challenging.

But, unless and until the underlying fundamentals (economic growth and corporate earnings uptrend) begin to materially deteriorate, probabilities strongly support the expectation that the stock bull market has more room to run and stocks will continue to climb the proverbial "wall of worry" (see Chart 2). Improving fundamentals also suggest stock price corrections will likely be recovered in relatively short periods of time.

Chart 2: Corporate earnings are the locomotive underlying stock prices



More, bigger-picture context

Historian Angus Deaton—who won the 2015 Nobel Prize in Economics—who we have referenced on prior occasions, last year provided some perspective about the current state of things that we found worthwhile.

He wrote[1]:

> *"In these gloomy and uncertain days, when long-held certitudes about government, politics and international relations are all under challenge, it is tempting to think that everything is falling apart—or in one fine phrase, that the world is going to hell in a handbasket."*
>
> *"Indeed, today's world presents much to be concerned about. But we should always remind ourselves of where we are and how we got here before we make dire predictions. The key fact is that the world is better now than it ever has been—which is entirely consistent with it being under serious threat."*

[1] *Thinking about Inequality*, Angus Deaton, Cato's Letter, Spring 2017

"Today, (for example) globalization is often seen as a negative force, threatening jobs in rich countries and making people feel that they have lost control of their lives and their children's destinies. Yet globalization is responsible for the greatest reduction in poverty the world has ever seen."

"The world distribution of income has narrowed as erstwhile very poor people have moved from the bottom to something like the middle. Life expectancy has risen almost everywhere…especially over the past 60 years."

"These improvements have taken a long time to be sure. There have been awful setbacks. But humanity has been through much worse than what we see today and progress has always resumed. ***The deep causes of progress—the Enlightenment, the scientific revolution, and the desire to have a better life—are constant protectors of prosperity and are not readily destroyed****."*

Deaton continues:

"The guiding metaphor in my book, The Great Escape, is the movie starring Steve McQueen, which is set in a German POW camp, where several hundred prisoners dig tunnels through which to escape. The book, like the movie, is about the ***indomitable urge for freedom*** *and the impossible hurdles that it's capable of overcoming."*

"…after the escape is over and those who were left behind think about whether they too should try to escape, the inequality (that's arisen) between them and the escapees provides a demonstration of what is possible, so that ***those who thought it couldn't happen now realize that perhaps it can, even for them. This is how progress happens. A few individuals break the mold, and that helps other follow. I think of innovation and invention today in the same way****—they create inequality, but with positive consequences. To be against that sort of inequality is to be against progress itself."*

Another great escape underway?

Economics has largely become a quantitative field of study. Armed with sophisticated math and statistical techniques, the primary focus is typically on "factors" that can be quantified. When it comes to economic models for growth and innovation, relatively easy-to-measure things like land, labor and capital, are emphasized.

In contrast, Deaton, and other economic historians that we've mentioned before, like Schumpeter, Hayek, Friedman and, more recently, McCloskey, Mokyr and Easterly, acknowledge that the easier-to-measure factors do play a role in economic growth and innovation. But hard-to-measure variables may well be the most critical ingredients in the growth process.[2]

Economies are enormously complex dynamic systems where human behavior is extremely important. As Deaton suggests, economic freedom is one such crucial ingredient for growth. With freedom comes incentive to "try". With freedom human ingenuity is unleashed.

[2] A worthwhile and interesting review of the works of these economists is provided in *Cents and Sensibilities, What Economics Can Learn from the Humanities*, by Gary Saul Morson and Morton Schapiro, Princeton University Press, 2017.

News from the real world economics lab: Growth occurs when freedom is allowed to bloom

ECONOMIC FREEDOM AND ECONOMIC GROWTH

	Economic Freedom Rank			Real GDP Per Capita (PPP $)		
Country	1995	2015	Change	1995	2015	% Change
Estonia	57	10	+47	11,362	27,329	141%
Lithuania	80	13	+67	9,357	26,971	188
Romania	118	20	+98	10,546	20,538	95
Bulgaria	101	48	+53	8,446	17,000	101
Poland	90	51	+49	11,300	25,299	124
U.S.	4	11	−7	39,476	52,790	34

Sources: Fraser Institute, World Bank THE WASHINGTON TIMES

Also important in the economic progress dynamic are the rule of law and institutions supportive of growth. Cultural and social attitudes are crucial as well. Support and respect has to be present for those who "break the mold", take risks and succeed, as well as those that try and don't succeed.

Since the turn of the New Millennium, and increasingly since the Financial Panic of 2008, the U.S. government has adopted policies that—no matter how well intentioned—cast a wet blanket on economic growth. Much as helicopter parenting can stunt the development of children, intrusive government policies stunt risk taking and economic dynamism by reducing economic freedom and stifling ingenuity.

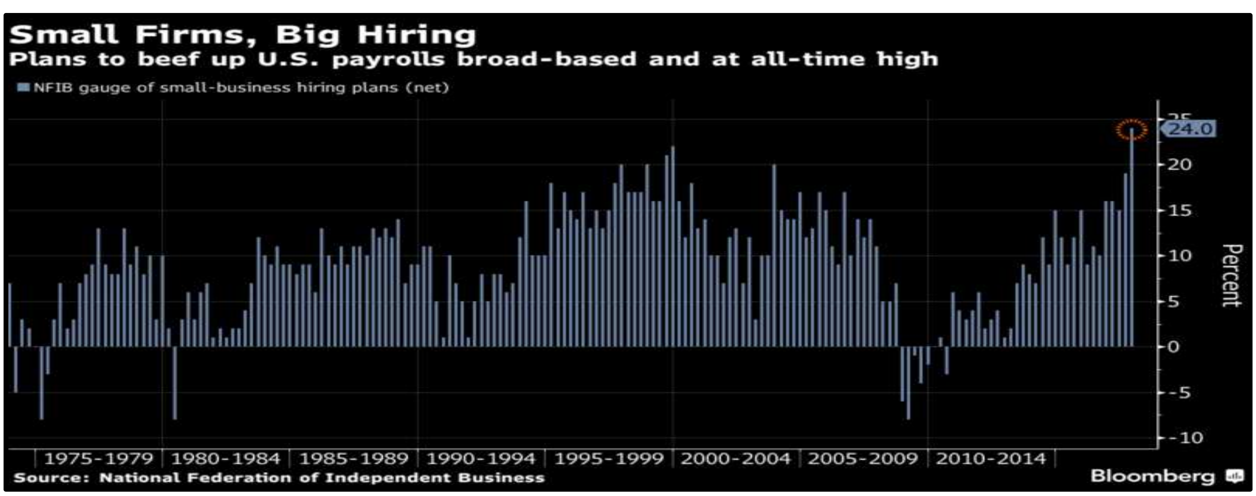
Viewing the present situation through the lens of the necessary ingredients for economic growth, we believe ***an escape*** from the pervasive fear, uncertainty and doubt and risk-aversion that's loomed especially large since 2008 is underway.

The stock market—a pretty good leading indicator of economic change—is beginning to reflect the turn to a more growth-supportive environment. At the margin, economic freedom is now increasing, and a major reduction in federal regulatory burdens is unfolding. Tax reform—while not anywhere close to ideal—offers pro-growth incentives to invest, take risk, and work hard; particularly on the corporate side.

Lower U.S. corporate tax rates lift the competitive ante across the global marketplace. In addition, U.S. companies can now focus on their underlying businesses with significantly fewer tax-driven business decisions like so-called inversions or inefficiently keeping cash abroad to avoid double taxation on overseas profits.

Chart 3: Small business hiring kicking into gear?

Importantly, small-business tax relief looks significant. And small businesses are typically the biggest generator of new jobs.



While the headline news remains focused almost exclusively on the 500+ elected officials in Washington D.C. and the seven voting members of the Federal Reserve, it is a mistake to underestimate the power of the "bottom up" actions within much of the country's population of 325 million.

As Deaton noted earlier, ***the desire to have a better life*** is a powerful force. Every morning most of the 325 million (not to mention the "other" 7.3 billion people around the globe) get up to pursue a better life for themselves and/or their family. An environment more supportive of this desire may not get captured in economic models, but therein lies the potential for favorable "upside" surprises.

What about the Fed, inflation and interest rates?

The Federal Reserve (Fed) is about to undergo leadership change. Jay Powell will replace Janet Yellen as the Federal Reserve Chair. As a voting member of the Fed for a number of years, Powell is regarded as a "known commodity". He has always voted Yellen's way so policy continuity is widely expected.

Some *optimiserables* are concerned that Powell lacks a PHD in economics. As our earlier comments about the field of economics suggests, this is not necessarily a bad thing. We also note that the last Fed Chair without a PHD was Paul Volcker. He is (rightly) now regarded as a Central Bank rock star for helping slay inflation back in the early 1980s.

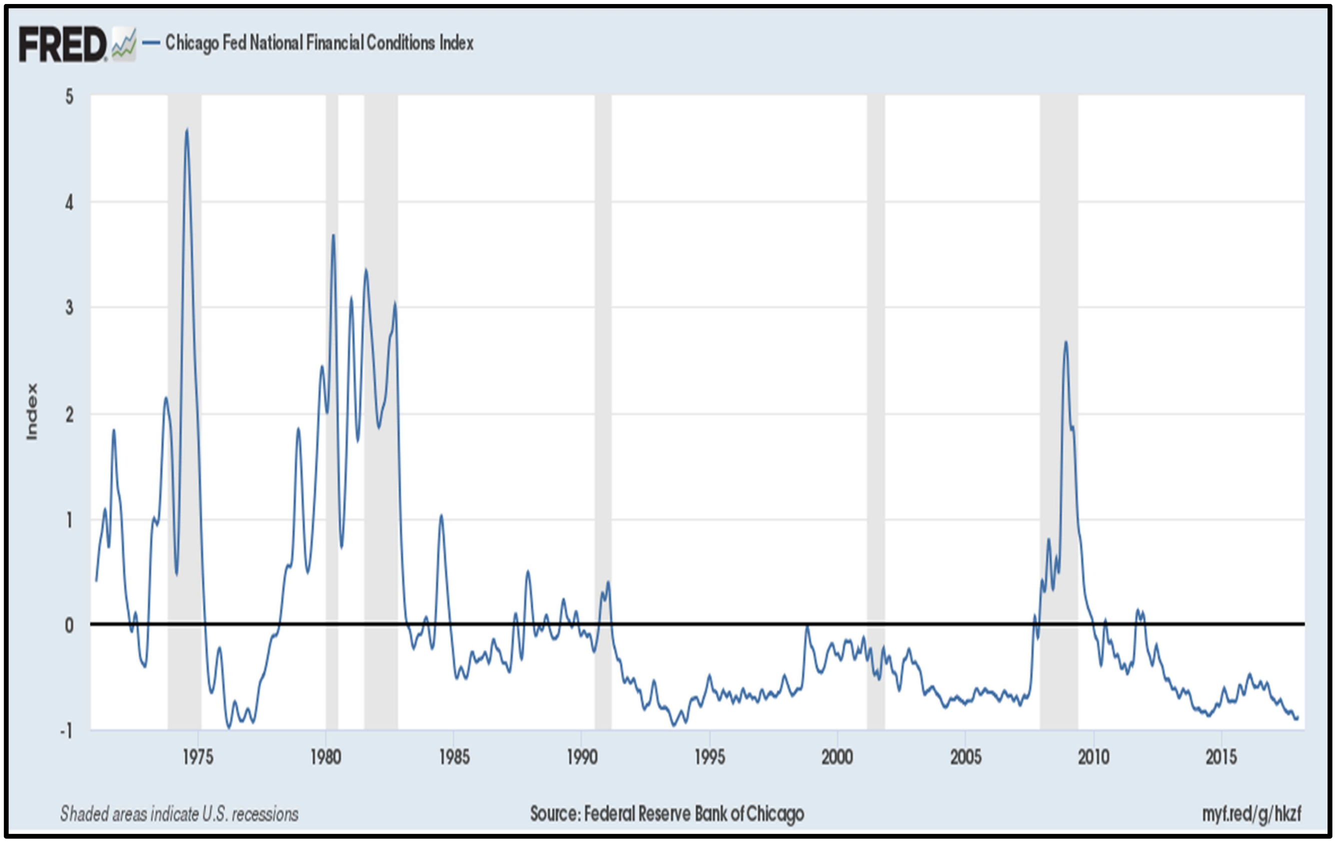
Speaking of inflation, what about the concern expressed earlier that the economy could overheat and inflation will become a problem? Won't the Fed have to continue to raise interest rates and dramatically shrink their balance sheet holdings of bonds to combat inflation? And in doing so, won't they be sowing the seeds of the next recession?

This is a risk that requires constant vigilance.

We continue to believe the odds do favor a rise both in inflation and interest rates. But as always, context matters. Interest rates and bond yields remain very low by historic standards. Some rise from current levels remains likely in our estimation. Also, rising rates/yields will likely be for a good reason—because growth proves to be better than generally expected.

Furthermore, current Fed policy continues to move from "ultra-to-extremely" accommodative for growth. As the indicator in Chart 4 suggests, even as the Fed has recently raised interest rates under their control, monetary conditions remain a long way from being sufficiently "tight" to restrict financial system liquidity and putting the economic expansion at risk.

Chart 4: Fed policy position: above the 0 line=tight policy, below=easy policy



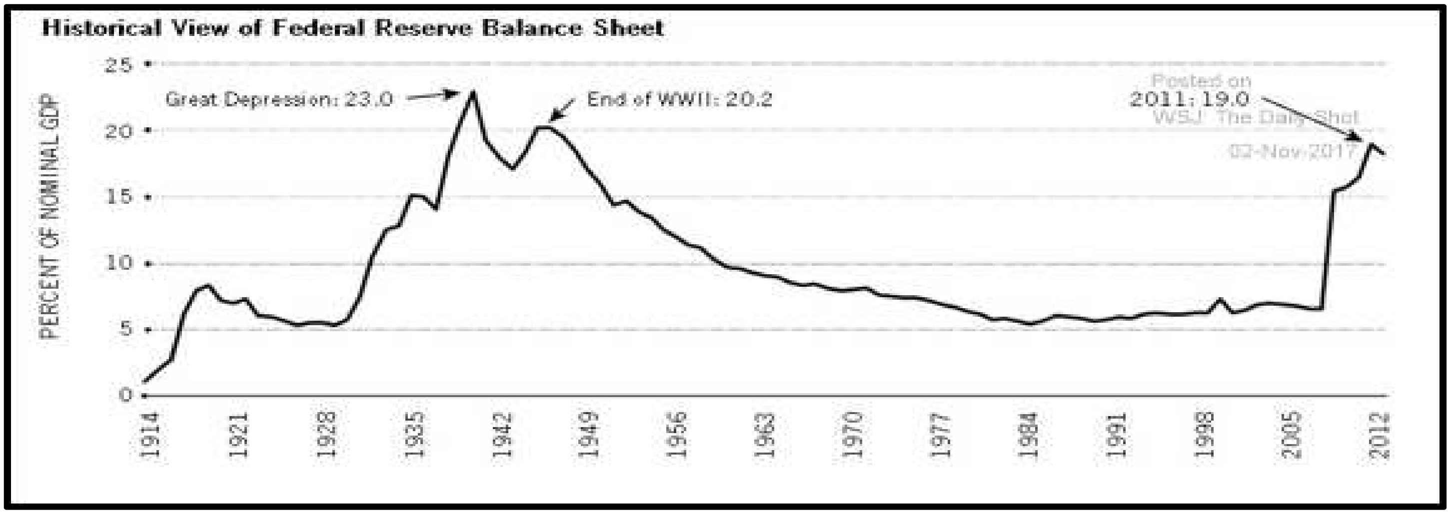
The economy also does not seem particularly inflation prone. While the so-called Millennial demographic group outnumbers the Baby Boomers, their increase relative to the total U.S. population is not likely to create the demand shock that the Boomers triggered in the inflationary 1970s and early 1980s.

In addition, whereas material goods used to define commerce, the emergence of the "digital economy" means growth is triggering less stress on physical resources.
As the firm Demogronomics notes:

> *Technology is collapsing multiple channels of cost. Just when the experts tell us we have reached the limit—well, we find some more reaching to be done. In sync with the slow and steady integration of the next generation into the work-force, we should continue to see lighter than expected inflation.*
>
> *(Millennials) are a very deflationary force. They are all tech, all seamless, all short-cuts and all about efficiencies and cutting out waste.*

A less-inflation-prone economy should allow the Fed to gradually reduce the size of its balance sheet. Refer to Chart 5 on the following page.

Chart 5: There is precedent for the Fed reducing the relative size of its balance sheet



More private sector experiments ahead

Besides being a refrain for the New Year—*ring out the old, ring in the new*—when applied to economics it sounds a great deal like Schumpeter's creative/destruction dynamic. These phrases seek to describe the way economic progress unfolds.

Innovation represents experimentation. If the experiment "rings in" some better new product or service into the marketplace that proves more pleasing to consumers, it "rings out" (displaces) the old way of doing things. Think smart phone cameras vs. Kodak, Paypal vs. cash, Netflix vs. Blockbuster, and Amazon, Walmart, TJX vs. Sears.

Experimentation and risk taking go hand in hand. As we alluded to above, the emerging backdrop appears more conducive for experimentation. This is happening, by the way, while many new technology tools that we've discussed before, such as cloud computing, big data analytics, Internet of things, software simulations, Blockchain, and digital payment systems have been maturing.

An environment more supportive of investments and risk taking promises to accelerate the adoption of these new technology tools. A popular saying making the rounds is that the future is already here; it's just not evenly distributed. More widespread adoption should change this condition. As it does, productivity growth, the economy, the general standard of living, and investors should benefit.

In the New Year, in the economy, **Ring in the New (Experiments**)!

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