# Now, What??

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A recent e-mail from one of my closest friends ended with, "Have a thoughtful Thanksgiving." After 65 years of close friendship, I quickly appreciated the fact that he knows me well, and that yes, almost all my free time is spent listening, talking, watching, and thinking about what the future will bring for the market, and, more importantly, our country.

A quick "timeout" to give thanks for family, friends, and country, seemed appropriate, as it is the Thanksgiving season. The many fond memories gave way to a somewhat analytical replay of my 50 years in this investment profession.

The year was 1968 as I entered the "Big Apple" for my seven months of schooling and training. The Cuban Missile Crisis was still fresh on my mind. World War II was a mere remembrance of 20 years and the Great Depression (before my time) was within a 30-year history span.

Richard Nixon and Hubert Humphrey were locked in a presidential battle and the Dow Jones Industrial Average was at an all-time high of 1,000 with a price-to-earnings (P/E) ratio of 16x. The Vietnam War was in full intensity and the market's main concern was federal spending on a war and Lady Bird Johnson's highway initiative. "Guns & Butter" debates made the headlines and campus riots broke out over the war itself. "The pop culture" came into being with the open use of marijuana, LSD, and sex at the Woodstock Festival. The hippie generation came into our lives but it was not a significant voter issue.

The market fell 40% in 1970 because the Federal Reserve raised rates and brought on a recession. It fell 52% in 1973-74 because of Watergate and worries of impeachment that might endanger our Constitution. I remember buying the likes of IBM, Johnson & Johnson, and Eastman Kodak (then a "blue chip") for five and six times earnings. The Market today would have to fall 50% to 12,000 Dow in order to repeat this occurrence.

I remember the abandonment of the gold standard by Richard Nixon and the currency crisis surrounding that event. All the while, the long held Democratic Congress kept enacting new entitlements. Dollar weakness combined with the high level of social spending for Medicare, food stamps, social security, school lunches, etc., required massive amounts of borrowing. This led to higher inflation and higher interest rates. Paul Volker was appointed to be a tough head at the Federal Reserve and money began to tighten. I purchased a lot of Treasury Bonds in portfolios paying 15% interest rates. Today these bonds pay 3%....times have changed.

Richard Nixon left the Whitehouse with the Dow Jones at 585 and the nation's morale and confidence at an all-time low. Spending, however, continued as Democratic majorities went back to the Keynesian playbook of spending and taxing in a belief that it would make things better.

Gerald Ford, was drafted into office and to his credit, gave us a much needed steady hand at the helm. He stood up to the wasteful inclination to spend by using the veto pen on every bit of unnecessary legislation that made its way to the President's desk.

It became apparent that habitual spending was becoming a long term problem as entitlements automatically called for greater and greater borrowing. When social security was installed, no one envisioned that Congress would spend the FICA tax revenues on other causes, rather than saving them to pay for future benefits. Today, we have to borrow to keep these benefits funded. The same is true for Medicare. I remember Ted Kennedy's final speech for Medicare on the Senate floor when he asked, "What are we concerned about? This Medicare legislation will never amount to more than $1 billion?" HAH!

Over my career, I have come to realize that spending continues to increase regardless of which party is in control. Much of this is structural, in that there is only a small part of the budget that is truly discretionary. The rest is consumed by a growing number of government employees and the increased cost of entitlements. On the discretionary side, Democrats typically cut defense spending to divert the money to stimulus packages and more long-lasting government programs. They increase tax rates, hoping to pay for these initiatives. Republicans, on the other hand typically spend on defense, hoping to rebuild a depleted military, while cutting taxes, hoping to grow the economy and realize the increase in tax revenue that goes with that growth. One thing is certain…spending always continues to increase.

Over the years the size of government had increased dramatically. The number of people working for the Environmental Protection Agency…or ISIS, or the food stamp program, or Medicare were added to the structural deficit. Jimmy Carter replaced Gerald Ford and predictably, the defense department was gutted and taxes were increased. The market continued to struggle under the 1,000 Dow Jones level that had been reached a decade earlier. Interest rates rose to all-time highs and money flowed to tax shelters for higher returns. Stock investors experienced several double digit declines during the decade and bond investors lost money due to constantly increasing interest rates. These were not good years.

Ronald Reagan entered office launching the "Reagan Revolution," featuring lower tax rates and fewer deductions. Lower tax rates meant that rates of return on capital and wages were increased and the markets responded with a 35-year bull market that took the Dow from 1,000 to 25,000. Investors gradually adjusted their determinates of value upward to reflect the lower tax rates. Donald Trump's most meaningful contribution to this bull market has been the lowering of corporate taxes from 35% to 21%, coupled with wholesale deregulation, which in effect is also a tax cut. The market responded with a 7,000 point increase after his election.

There have been two Democratic presidents during that 35-year time frame. Predictably, income tax rates were increased, but to nowhere near the levels existing prior to the Reagan Revolution. In fact, Bill Clinton signed into law a significant tax cut on capital gains. The income tax hikes were subsequently reversed by Republicans George Bush and Donald Trump. But spending took an enormous leap with "shovel ready everything" being tried.

The structural deficit continued to increase steadily during this 35-year bull market. The installation of the unearned income tax credit and Obamacare and the rampant use of food stamps contributed to the structural deficit and further borrowing.

This use of debt is not just a U.S. phenomenon. Global debt has increased to nearly $250 trillion. The credit crises of 2008 was met with coordinated Central Bank intervention through the printing of money and zero or negative interest rate policies around the world. Investors in high quality bonds fared well during these years as artificially low interest rate policies created a large capital gain for bond holders.

The stock market since 2008 was also given a "wind at its back" through a zero interest rate policy adopted by the Federal Revenue which actually "printed" money to support the economy. This was true not just in the U.S. but across the globe as central bankers became accommodative in an organized effort. The global economies responded as borrowing continued at a rate far exceeding the rate of economic growth, putting the World's economy in a precarious, leveraged position. Central Bankers around the world are now responding to the debt explosion in a coordinated effort to “normalize” the situation.

So there you have it. The facts show that the economy is growing around the world and especially in the U.S., where tax cuts are achieving a growth rate that the previous administration said was unattainable.

We have a Fed Chairman who is raising rates in an effort to “normalize” interest rate policy. Inflation is not a problem and therefore, not a reason to raise rates.

The facts also tell us that more growth legislation is improbable as the newly elected Democrat majority will not pass pro-growth legislation in the House of Representatives.

Is the stage set for a repeat of prior cycles, where there is a Fed induced slowdown because of interest rate policy? Perhaps.

Is the stage set for tax hikes and more big government legislation? Not likely, as the Senate will never go along with such legislation and neither would the President.

Will military spending be cut in favor of social spending? Perhaps military spending could run into trouble in the House. The latter is improbable because the Republican Senate would never agree to such legislation. The military could be held hostage as part of an attack on Donald Trump, but this is not a certainty.

Lastly, could tariffs be detrimental to our growth? Perhaps, but the extent of any damage so far is minimal. This issue is still evolving and we hope that global leaders opt for a solution sooner, rather than later.

The market decline to date has probably discounted all these points. A drop of nearly 2,000 points in the Dow average reflects the sum of all of these fears.

Investors are quickly responding to any news relating to Federal Reserve policy, tariff policy, or government policy, and this explains the extreme volatility that we are experiencing. Excellent corporate earnings and economic strength continues, but the market is still worried about something else.

When studying the technical view of the market, most indicators have turned negative. We appear to be making a “top” formation, but we will not call it a top until all indicators turn negative. Should that occur, a top would indicate a longer term change in market direction. We would necessarily respond to a completed top formation, rather than engage in the guessing game of how low can it go? A change of direction would imply the beginning of a downward trend, and that’s enough for us. Our technical picture at this point suggests an upside range of +20% and a downside range of -50% from here. It clearly suggests that it is worth waiting for confirmation before reacting. In the meantime, we are waiting in a fairly defensive posture through what may simply be a correction.

There are two other worries that occupy much of our thinking and focus at Cadinha & Co.

Our first concern surrounds the effects of an escalating trade war. In this event, we can expect global economic growth to come to a halt as the level of trade slows. Debt obligations most likely cannot be met as borrowers rely on a healthy economy to provide the income for debt service and repayment. With the high present level of debt, the probability of debt default is elevated, and so is the specter of resulting asset sales conducted by lenders. The aftermath would be an experience akin to the Great Depression of the 1930’s. History has taught us that Trade Wars are often a precursor to real wars, God forbid. We hope that the leaders of the world learned the same lesson and come to a compromise to circumvent this entire issue.

The second worry is that this country changes from a free market, capitalistic society to one embracing socialism and redistribution of wealth. I have been aware of this trend for many years and our country's acceptance of some policies that could only have come from socialistic roots is troublesome. These simple acceptances become popular core beliefs that lead to more similar acceptances.

Rather than go on and on about the many destructive policies and thinking, let me just state that it is happening more frequently. The rhetoric has become more frequent and bold. Candidates for public office have successfully run on pro-socialistic platforms. In fact we have had two recent presidents in office who have declared "pay your fair share" to the wealthy, who, by the way were already paying a higher income tax than other Americans. Never mind, as Americans ignored that fact and elected the president who promptly raised taxes on the high earners. The other president laid to rest the long-held belief in hard work and perseverance as the way to the American Dream. Contrary to these beliefs, he declared that all successful entrepreneurs were simply lucky in their achievements. Such rhetoric enforces the view that financially successful Americans don't deserve their wealth as they were just lucky.

Presently we are enjoying an economic boom riding on the back of tax cuts and deregulation. Estate taxes have been lowered and all is well…perhaps for two years. Donald Trump has been a one-of-a-kind president who has functioned as a lightning rod, attracting the charge from the liberals and their friends in the media. One has to seriously ask what kind of environment we can expect if the seat of power changes in two years. The very bombastic nature of President Trump further elicits responses that are emotional and equally bizarre in nature. A shift in power could bring with it an emotionally charged change that could include retribution - which could get nasty.

The lesson learned over my 50 years is that money always moves away from an environment that is oriented toward high taxes, high regulation, and confiscation in nature. Money quickly moves to safety, where taxes are minimal and regulations are few. This is why our dollar has been strong and our markets are up. A change in our environment could precipitate a capital outflow to another safe haven.

It is our job to monitor this situation very closely and to make critical decisions on your behalf. While we hope that these concerns never come to pass, we are prepared to make the asset shifts necessary to take advantage of almost any situation.

A happy holiday season to all.

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Harlan J. Cadinha
Chairman and Chief Strategist