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Looks Like We Made It

In our last update we recounted a prediction we made six years ago. Back in 2014 we wrote that the current decade would probably see **no** major financial calamities. Market participants were so shell-shocked from the financial crisis of 2008 that the typical animal spirits of greed and mania were not nearly as present. Without this "fuel" the sadly normal process of the stock market "over doing it" and then crashing back to earth was much less likely to play out. That type of prediction was a first for us. In every previous decade we have been able to identify the one "big problem" of the era.

In this past summer's update, we also mentioned that we only had six months left to go for our "no problems" prediction to be proven correct. Well, since nothing financially dreadful has happened, it is now official. As Barry Manilow once said, *Looks Like We Made It*. Wait... did I just admit to knowing a Manilow song??

Over the past year we have also been reminding readers of two old stock market adages:

Don't fight the tape

Translation: It is usually unwise to be too pessimistic about stocks when the general trend is up.

Don't fight the fed

Translation: It is usually unwise to be too pessimistic about stocks when the U.S. Federal Reserve is lowering interest rates and printing money.

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By the way, both of these factors can work in reverse of course.

So, another decade of investing is in the history books - and what a decade it was! Sure, stocks had a few 15 to 20% hits, one as recently as twelve months ago, but the pain was limited. Those medium-sized drops weren't so bad now, were they? Actually yes... yes they were. Ok, but the temporary damage could not compare to the previous decade, where the market suffered two 50% crashes, sadistically separated by a full five years, as if to spread out and lengthen the pain. Compared to that, the last ten years have been a cake-walk. Nevertheless, even small market drops of a few percentage points, seemed to elicit knee-jerk reactions and panic attacks from investors. They seemed blind to the fact that from 2010 onward, the skies have been quite blue. Heck, we even made it all the way through the decade without a recession - not even a mild one. Ok, ok, that's partially because the first five years of this economic expansion were so anemic.

But whatever, we'll take it. We're not complaining.

Fun fact: From the 1700's onward, the U.S. has *never* had a decade without a recession... until now!

It was disheartening to watch the naysayers over the past ten years, as many missed out, to one degree or another, on the extremely good returns. If they participated at all, it was half-heartedly and with much trepidation, selling at any hint of bad news. Each up-leg was seen as an opportunity to sell as they continually waited for the next big problem to strike. That big problem never came along and after every pause or normal correction, another up-leg ensued.

It was hard to blame them for being gun-shy post financial crisis. But this is precisely why we must always exercise discipline and not invest with our feelings. Look at the data. Analyze the evidence. Control your risks. Play it safe... but *play it*. As long as you commit your money to assets that make sense (reasonable prices, good cash flow, low to moderate debt levels, etc.), then it's often best to ignore the prognosticators of stock market direction and simply invest to whatever degree your risk tolerance permits. Who knows when we will get another decade this good?

We do **not** think the 2020's will be able to compare. Much of the fuel that has propelled this current bull market is unlikely to repeat. For instance:

1. Much of the worldwide spending in recent years has been fueled by massive debt increases. This pertains to both government debt as well as corporate debt. Global

debt levels pushed over $250 trillion mid-way through 2019.[1] The world cannot keep borrowing to fund its spending forever – but it can obviously do so for a very long time!

2. Much of the corporate borrowing has been used to buy back stock shares. This is not a bad idea when stock prices are low, but it is perhaps not the best use of corporate capital during normal times, let alone when prices are lofty. More worrisome is the thought of what might happen to stock prices if/when this ample source of buying power reaches its limit and ceases to be a tailwind.

3. Some of the increases in corporate profits over the last few years have come from the lowering of the U.S. corporate tax rates. These rates went from a world topping 40% down to 21% (slightly below the world average). While it seemed reasonable to bring our country's tax bracket back towards average, this move will not provide the same boost to earnings *growth* as it did the first year it was enacted.

Another, more simple reason that the next decade might not compare to the last, is that stock prices are not so cheap anymore – at least for many of the large U.S. stocks that make up most of the market indices. This is especially true for a significant number of the technology giants and many tech-stocks in general. As we have said many times however: High prices *alone* do not necessarily mean that the market will fall any time soon. Nevertheless, there *is* a *very* strong correlation between how expensive stocks are **currently** and how well the market will do over the **following ten years**. So, we had better temper our long-term expectations. Famed value-stock investor Warren Buffett, whose stock, Berkshire Hathaway, has mostly treaded water for the past two years is sitting on $128 billion in cash, apparently waiting for something more interesting (cheaper) in which to invest.

Ray Dalio, who runs the world's largest hedge fund[2], and is generally considered to be the "smartest person in the room," recently commented about how frothy things are getting:

"...more companies than at any time since the dot-com bubble don't have to make profits or even have clear paths to making profits to sell their stock because they can instead sell their dreams to those investors who are flush with money and borrowing power." [3]

But don't despair, all is not lost. We are having little trouble finding interesting investments. There are many areas in both the stock market as well as other asset classes that look good.

Value stocks are far cheaper than the market in general. Economically sensitive stocks (think materials and energy) are down dramatically in the last few years in spite of the bull market. Some small companies are relatively cheap and foreign stock markets have been as exciting as watching paint dry for the last five years. Even many of the tech stocks are "reasonable" when viewed in relation to the amount of cash flow and earnings they are producing.

Some investors actually believe that the world governments, especially the United States, cannot allow interest rates to rise nor allow stocks to fall. They feel that our highly indebted country is quite economically vulnerable to any kind of shock. They further think that the powers-that-be will do whatever it takes to keep up the status quo. How in the world would we be able to service our $23 trillion national debt if rates went from 1.75% back up to 4%, let alone 6%? Of course, the government can't control everything, but for the time being they will try mightily to keep the party going and the investor-class safe and sound.

Others are predicting an eventual boom in **real** assets, as the price of financial assets (stocks and bonds and cash) may have over-shot. With world population still tacking on 220,000 people every day, the demand for goods and services certainly won't abate. Combine this higher demand for tangibles with the world's current propensity to print money, and the **price** of real things just might start to accelerate. China's "Belt and Road Initiative" is an extremely ambitious trans-continental infrastructure project that could be a major driver of this trend. That is, if they don't run out of money before they start.

So, as you can see, there are many possible ways to make money in the coming decade.
So, as you can see, there are many possible ways to lose money in the coming decade.

What else is new?

How to Beat a Chess Master in Five Moves

Perhaps the biggest issue of the next decade will be the attempt to solve the inequality problem. Not since the Great Depression has the gap between the wealthy and the working class been so wide. The cause is anything but simple and the solution will be anything but easy.

This issue could cause tectonic shifts for investors. As a nation, we "back-burner" this dilemma at our own peril. It is quite easy to blame the phenomenon on the billionaire-class and the wealthy citizens of our country. However this is not only counterproductive, but misses the mark in terms of causation. Importantly, if the problem is misdiagnosed accidentally or for political gain, any proposed solution will be flawed. Stock and bond investors will soon have their fingers in the air trying to determine exactly which way the winds of change will blow. Subtle differences in how this problem is tackled could spell large differences in the fate of certain investments. Not-so-subtle differences of approach could be game-changing.

So, just what are the true causes of the inequality gap? Here are a few that will need to be addressed if a real fix is in the cards:

1. The Technology Revolution 2.0

With the rise of robotics, big data, smarter apps, automation, and artificial intelligence, the working class has been under assault by the technology revolution. It's now much easier for consumers to spend their money (or borrowed money) using the very same technology that just made their skill-sets and their jobs obsolete. Furthermore, much of this technology has enabled business models that employ cheaper foreign labor. The shareholders of these companies as well as the software programmers and hardware engineers are reaping the rewards. The average workers? Not so much.

2. To the Winner Goes All the Spoils

In physics and finance, as well as in life in general, there exists a phenomenon called a power law. As one variable changes, another variable changes exponentially. For example, the larger a city's population, the far fewer number of such cities will exist. The same holds true for athletes' paychecks. The New York Yankees are rumored to have just signed pitcher Gerrit Cole to a nine-year contract worth $324 million.[4] Players with even slightly lesser ability, however, should not start celebrating. No one is going to pay much to see the 1,000th best pitcher in the world, even though that person's talent is *way* beyond average. Mr. 1000, who might be 85% as good as Gerrit Cole, does NOT get a contract for 85% of $324 million. That's not how power laws work. The *best* players don't just get "the most" money, but rather "most of" the money. This is a big problem for workers of any profession in the digital age. What if the best math teacher in the world could eventually deliver their lesson via the internet to an unlimited number of students for full college credit? What happens to the 200th best math teacher in the world? What about the 84,000th best?

3. Family & Education

Why did I put these two factors together? I did so because disciplinary disruptions are affecting the quality of education to a much greater degree than in the past and that factor is heavily influenced by parental interactions and involvement. My teacher clients tell me that the state of the public schools, in terms of the teaching environment, is totally out of control. Many troubled students swear like sailors (1945 vintage sailors, mind you) and physically intimidate the teachers. Of course, today's discipline is never much harsher than "now, now Johnny…" as fear of parental lawsuits permeate the local school districts. This is far from my grade school days back in the 1970s when the nuns would have used a *slightly* harsher disciplinary method. "Now Now Johnny" is going to have a terrible time making progress in a workforce increasingly dominated by power laws. Parents who understand this law, either literally or instinctually, will increasingly look to private schools for their children – if they can afford it. They will also take very active roles in their children's overall education. But what about financially poor or single-parent households? Will their children not fall further and further behind?

Don't even get me started on financial education. Hint: It's terrible, as evidenced by the student loan statistics and the U.S. population's credit card balances.

Each of these three factors and many more are the **actual** causes of the widening inequality gap.

Why should the "Haves" care about the "Have-Nots?" Well, if helping your fellow human is not motivation enough, trust me when I tell you that it will be in *everyone's* own long-term financial interest to do so.

From many of the Haves' point of view however, it's not their fault that the Have-Nots are not "playing the game" all that well. Many Haves believe that the system is so dysfunctional and the bureaucracy so deep, that it is far too difficult to make any significant changes. How can a Have fix the school/parenting problem? How can a Have stop the technological revolution? Didn't you see the movie Terminator or the Matrix??

Sadly, the attitude of the Haves can become jaded; it can be one of "what's the point of trying to change the system?" So, they throw some money at their favorite charity and fund their pet philanthropic projects and then they just go right back to their day to day lives; they keep playing the game. It's the path of least resistance.

This will not go on forever.

The Have-Nots really don't care WHY they are losing this game. No one that is working overtime while still making little financial progress cares about power laws. They just know they need something different. Then along comes social media to dump jet-fuel on the fire. Finger pointing, name calling, selfie competitions, etc. Everyone *else* looks to be having such a wonderful life!

When many unfunded financial promises start coming due for collection, those looking to collect might learn that their "assets" (think bonds and pension payments) are contingent on someone else's ability to pay back their debts. What if those that owe can't pay back money they don't have? With this backdrop it becomes very easy to sell pitchforks and torches to the mob and then "sic" them on the Haves (especially those oddities - the billionaires). Little good will come of this.

So what does all this have to do with my header **"How to beat a chess master in five moves?"** Well first of all, let me explain how to actually do that. It's easier than you might think:

Move One: You play *Pawn to c3.*

Move Two: Pull a gun on the chess master and tell him to play *Pawn to d6.*

Move Three: You play *Queen to b3.*

Move Four: Make sure your gun is still clearly visible, then instruct the chess master to play *Pawn to h6*.

Move Five: *Queen to a4*. Checkmate! You just beat a chess master! Congratulations.

When the Have-Nots get sick of playing a game they can't win … they will stop playing that game. They will play a different game - a game that they *can* win. They will dump the chess board on the floor. Remember that nice chess board you bought at that wonderful shop you saw when you were skiing at Aspen for Christmas ten years ago? You know, the board that you practiced on every day for a decade? You got really really good at THAT game.

But the Have-Nots don't like that game. Perhaps they would have been great at it given the chance. But they never got that chance and now they are changing the rules.
They might play a new game called Modern Monetary Theory (MMT). It's all the rage right now in certain academic circles. MMT's premise is since the government can print money at will – let's just do that. Then, one way or the other, let's give that money to the people. Alright, alright … it's a tiny bit more complicated than that I guess, and it sounds mildly less crazy when described by "experts." But basically, that's how it works.

All sarcasm aside for a moment, I must concede that for the past ten years the U.S. *has* been printing an awful lot of money and giving it all to the banks and/or buying up bonds in order to artificially keep interest rates low. This has worked incredibly well for those of us who own financial assets like stocks and bonds but not so much for the middle-class workers. So, if the Federal Reserve can print money and give it to the banks, why can't they print money to rebuild the country's failing infrastructure? That might just get the cash to the intended recipients (the spenders) better than running the money through the banks or pushing up the stock market.

According to Ray Dalio (the hedge fund manager I mentioned earlier) the battle of where to get the needed money to pay our national bills will play-out as follows:

Since there isn't enough money to fund these pension and health care obligations, there will likely be an ugly battle to determine how much of the gap will be bridged by 1) cutting benefits, 2) raising taxes, and 3) printing money… This will exacerbate the wealth gap battle. While none of these three paths are good, printing money is the easiest path because it is the most hidden way of creating a wealth transfer and it tends to make asset prices rise…

… the rich/poor battle over how much expenses should be cut and how much taxes should be raised will be much worse. As a result, rich capitalists will increasingly move to places in which the wealth gaps and conflicts are less severe and government officials in those [jurisdictions] losing these big taxpayers will increasingly try to find ways to trap them.[5]

However we might think about this issue morally and politically, our portfolios demand that we think about it from an investor's viewpoint – from a risk mitigation viewpoint. It will very likely set the stage for which companies and which asset classes (stocks, bonds, cash, international investments, gold, or commodities) will be winners and which will be losers over the next ten years.

How precisely should we operate in such an investment environment?

- <u>We will want to be more flexible</u>. Stocks are unlikely to go straight up, so having a sound sell-discipline will be important. We may need to be more opportunistic, locking in shorter-term profits when they arise and then holding cash until we find another bargain.

- <u>We will need to adapt to potentially abnormal conditions</u>. There is a chance that the already low U.S. bond interest rates could follow the Japanese and European rates down to sub-zero %. We do NOT plan on buying any such bonds and would need to re-think fixed income investing to some degree.

- Eventually market participants might get sick of printed money policies and shun financial assets altogether. We might need to lean more towards real and tangible investments like gold, commodities, or real estate.

- The technology revolution will be with us for some time, but some of our winning holdings (big tech) could come under increasing anti-trust pressure by the government. That might actually be a plus for some of them, others it would hurt. But the productivity boom that is happening because of technology will **still** be a substantial driving force for many investment trends. Our investments will need to stay in sync with these trends.

Another strong possibility is that higher taxes will eventually be imposed on any citizen with the means to pay more.

Two Pennies for Your Thoughts

Another method of closing the wealth gap could very well be higher taxes. Many new and creative ways of taxing the populous are being floated around today. One idea is taxing the capital gains on your investments whether or not you actually book the profit.[6] As the law stands now, investors only pay taxes on gains *after* they sell an asset and make a profit. A different proposal is to double the tax rate on long-term gains for higher brackets, including a jump from 23.8% to 59.8% for the very wealthy. Both of these proposals would dramatically affect many investment strategies currently used by most investors. That in turn could cause unintended volatility.

Yet another new tax idea is the so-called wealth tax. It even comes with the catchy slogan "only two cents," which has played well to receptive crowds over the last few months. But something tells me that the joke would be lost should Bill Gates and friends each send 2¢ personal checks to the IRS. That's because, at least in the case of Bill and Melinda Gates, by asking for "2¢", the proponents really *want* $3.23 billion in extra taxes from the Gates family… every year… for the rest of their lives.

This "asset tax" would work much like property taxes do now, but on every type of asset, including IRAs and assets held by minor children. Fortunately (or unfortunately?) this tax will not affect most of us – it starts at 2% on all assets over $50 million and jumps into high-gear on assets over $1 billion. This is in addition to any income taxes, corporate taxes, dividend taxes, and capital gains taxes these individuals already pay.

The idea is problematic. Many of the assets in question are illiquid, hard to value, and quite difficult to sell in fractional amounts. Public company stocks are easier to liquidate, but the price and value of those companies could be affected if major owners were forced to sell each year in order to cough up the tax money.

How much money would the proposed asset tax raise? It's estimated that it would bring in around $250 billion per year.[7] That assumes, however, that the wealthy don't take any defensive measures. It also assumes that the forced selling, caused by the tax bill itself, won't drive down the value of the very assets being taxed. For context, remember that for fiscal year 2019 the U.S. likely spent $1 trillion **more** than it made collecting taxes (yes that was trillion with a "T"). That's a deficit **four times** as large as the money this new tax is estimated to produce. It seems to me the U.S. budget deficit is more of a spending problem. The past ten years have seen federal over-spending (budget deficits) *average* around $840 billion per year.

Another thing to remember is that many billionaires have already pledged to *give* much or most of their fortunes to charity. The Gates (of Microsoft fame) have pledged to give away the "vast majority" of their $110 billion net worth. They have already started doing some amazing work on neglected global disasters such as malaria and global sanitation (watch "Inside Bill's Brain" on Netflix if you get a chance).

Might not Bill and Melinda Gates spend their money more wisely than governmental bureaucrats?

A few months ago, Stanley Druckenmiller, one of the top investors of all time, gave an interview on CNBC. He warned of trying to solve the wealth gap issue the wrong way with dangerous economic policy choices. He warned of babies and bathwater:

"The narrative about inequality **is** correct – but one piece of the story is left out: it's that everybody is doing better. Unfortunately, the people that are really accelerating [are the wealthy]. So I don't believe the way to solve this is... just let's ruin everything and then everybody will be worse off - but we will be more equal."

Lest one might think - *that's exactly what a greedy billionaire would say!* – it may be best to first consider that Druckenmiller and his wife Fiona, are two of the country's top philanthropists. He is Chairman of the Board of the Harlem Children's Zone and they are the primary sponsors of the New York City AIDS walk. Back in 2009 the couple made the largest charitable contribution in the entire country for that year. It would only be fair then, that we hear-out a man who puts his ample charitable money where his mouth is. On the subject of *closing the inequality gap the smart way*, he says:

"The only way you get out of inequality is with education at the early level and giving everybody in this country a shot."

Twenty-five years ago, Druckenmiller was convinced by pioneering anti-poverty educator Geoffrey Canada that educating the inner-city children of Harlem (and eventually the nation) was the only real way to lift the poor out of poverty. Not a quick fix by any stretch of the imagination, but the correct fix (at least one of them). The famed investor has often said that backing Geoff Canada was the best investment he has ever made. The program serves 13,000 kids in 100 blocks of central Harlem and is now being tested nationwide.[8] (See classroom photo below.)[9] The results have been remarkable. But this is just one local fix, in one city, on one of the numerous root causes of the problem.

Will our country be able to come together, get to the roots of the inequality issue, and fix them with common sense, brainpower, and hard work? Or will we come together merely to argue, blame, and fight with each other?

We will be watching very closely, since the answer to that question will speak volumes as to how well or how poorly the stock, bond, and gold markets will perform over the upcoming new decade. If our country cooperates and works to fix the issue, stocks should do well. If we hide our heads in the sand and keep playing the current game, more and more money will need to be printed. That could initially cause investments like stocks and bonds to keep rising for a while longer but eventually gold would be the safer haven.

Which future will it be?

No one really knows for sure – but just between us……

…you might want to buy a little gold.

If you would like to hear from us more often than every six months, feel free to **check out our video library** on our website **(morgiawm.com)** or our YouTube channel.

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As always, please call or email with any questions and/or comments. On behalf of Tony, P.J. and the rest of Morgia Wealth Management, thank you for your continued confidence.

Sincerely,

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1. www.CNBC.com, Global Debt Surged to a Record, 11/15/19
2. https://www.investopedia.com/investing/biggest-hedge-funds-world/ (As of 6/25/19 Ray Dalio's Bridgewater had $122 billion under management. 2nd largest is AQR with just under $70 billion.)
3. www.marketwatch.com Founder of World's Biggest Hedge Fund Warns of Big Squeeze
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