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COMMON CENTS

Something to Think About

This week, I had a brief discussion with a very bright individual regarding future economic growth and potential investment opportunities in the United States. His comments were in complete alignment with my thoughts: moving forward, there will be two types of companies which will matter: 1) disrupters, which are companies providing technologies, products, and/or services which fundamentally change our lives and how we conduct business, and; 2) base, which are those providing the essentials of our day to day lives.

Frankly, we agreed this is already the way it is.

Intuitively, there will be a small number of true disrupters, which means there were be a lot of base companies. As a result, the competition between the latter will simply be for market share, as opposed to absolute growth in any one economic sector. By the time the dust settles and the smoke clears, a large segment of current corporate America will be, as Charles Dickens might have said, "without a situation." The trick will be choosing the likely winners and avoiding the losers, but make no mistake about it: unless the government gets involved and/or there is an evaporation of capital in the global economy, there will be an enormous amount of consolidation in the US economy over the next decade as corporate Darwinism weeds out those 'stuck in the middle' firms.

Historically, this would suggest there would be an enormous amount of merger & acquisition activity, and there might be. However, I believe it is more likely the healthier firms in an industry will be far more apt to let lagging firms fail on their own, as opposed to buying their capacity. Why? Because there is already 'too much' capacity in much of the economy. Currently, Sears Holdings is a perfect example.

As a matter of disclosure, I have never purchased any form of investment in Sears during my career, either for myself or clients. Further, Oakworth does not hold securities in the company on its books or in client accounts. With that said, given all of Sears' problems, why hasn't someone gobbled them up at a fire sale price? The answer would seem to be: because the company doesn't offer anything of value to stronger players in the retail space, and the sector would arguably be healthier if the process of competitive elimination removed Sears' capacity. In so many words and ways, Sears is a zombie company, and the US will see more of them moving forward.

Obviously, this isn't a startling or terribly insightful revelation to folks who read economic newsletters, at least occasionally. However, most people don't, and the news of, say, Sears' store closures seems to come as a shock to local newspaper reporters and politicians. What? Why? What about those jobs and what that means to the community?

Therein lies the rub.

If the next couple of decades play out the way I think they will, the problems in the US will be more societal than economic. After all, all of this consolidation will result in a lot of people losing their jobs. Eventually, the economy will develop new industries, services, and products which will absorb these job losses, but it will take some time for many people to find employment which will pay them what they had been paid at their prior zombie employer. Obviously, this will cause some short to medium-term dislocation on the individual level, if not necessarily on a macro one. Why

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not on a macro level? Well, because this restructuring of the US economy will not be immediate; it will be a process with a small lag in job absorption as it unfolds.

For instance, Sears will continue to shed stores and jobs until it, quite frankly, no longer can. The process might take 6, 12, 24, 36, or 60 months. At this time, who knows other than CEO Ed Lampert? And he ain't telling even if he does know. There is a real possibility the thing goes to $0 in 3 years, and Lampert's hedge fund buys up whatever assets it wants to continue the brand (if even desirable) or lease out to other companies? Right now, if I were making a book, I would venture a guess SHLD will stumble through as best it can until 2020. Hopefully, those folks who lose their jobs between now and then, there will or should be plenty, will be able to find other employment in the interim.

Of course, this has always happened and will always happen. I submit the difference this time is the shedding of excess capacity in various economic sectors, even as those sectors continue and even grow. Retail is an obvious example, but there are others. Americans aren't going to quit buying stuff, far from it. They will just buy it differently, and in a more concentrated manner. So, retail will grow, in aggregate dollars, but capacity and employment opportunities will shrink.

If that seems counterintuitive, consider the US economy was largely agrarian up through the end of the 19th Century. Since that time, in both absolute and relative terms, fewer people physically produce the food we eat in this country. However, 'we' grow much more today than we did, as agribusiness in the US has shifted from smaller farms, which could produce at slightly above subsistence, to enormous commercial ones which can produce vast quantities of excess. Fewer farms, in aggregate, mean fewer farms, even as the amount and value of our farm output has grown in absolute terms. You can thank technology, better fertilizers and irrigation, and, well, genetically modified seeds which all have increased yields per acre. All of those are disrupters.

Now, think about that seem thing happening across any number of economic sectors over the next 10-20 years. Over that time, we will likely have 2-3 recessions and maybe, probably, even a financial hiccup. The latter shouldn't be as severe as the one in 2008, at least as I type. Combined, they will exacerbate the inevitable, and restructure the US economy in the process. A lot of people will not enjoy in the long-term benefits of this, and will wrongly believe their 'market value' is or exceeds the 'market value' of the last chair in which they sat. On the flipside, a lot of people will, and will see their market values increase commensurate with their adaptability and willingness to accept change.

It should be an extremely interesting time for historians and academic economists. It will NOT be for the un and semi-skilled workforce, politicians of all stripes, and communities which fail to adapt their governance and educational systems to attract disruptive businesses and their employees.

As far as investing is concerned, the low hanging fruit and path of least resistance is to assume the technology sector will lead the charge, and I think it will. However, our definition of 'technology' will morph moving forward to incorporate those companies which use technology to disrupt their respective industries. Two current examples of this are Tesla and Amazon. The former is technically an automotive company, and the latter is, believe it or not, classified as a 'consumer discretionary' stock. However, why do investors like the two companies and are willing to pay significantly higher multiples for them when compared to the remainder of their respective, official economic sectors? For example, is it Tesla's cars? Or is it the technology behind them? Is it because Amazon sells a lot of stuff, or how it has adapting technology to do so?

As a result, you can reasonably anticipate the creation of 'disruptive company' exchange traded funds and mutual funds. Initially, these will be somewhat actively managed, and compared to proprietary benchmarks. Over time, this will become more standardized across the investment industry, and the 'disruptive sector' will become a more passive play, just like everything else. Intuitively, as more money flows into this 'sector,' there will be less flowing into the remaining ones, which will or could hasten the decline and demise of zombie companies. It also could mean a bubble in some stocks, but not necessarily whole economic sectors...at least not the traditional ones.

Heck...that disruptive sector ETF and index are such good ideas, maybe I/we will look into starting one. Reed, Steiner, and Adam? You guys game? Ha.

Whew. Well, at least that is what I think today, but I doubt I am going to change my mind any time soon.

Something to Think About Cont.

Now, I would be remiss if I didn't discuss this week's market volatility. This driving force behind this was/is the scandal, if that is the right word, involving Jim Comey, the Russians, Michael Flynn, and the White House. What a political mess, huh? But is it an economic and/or financial one? Well, that is a different question altogether.

Instead of reinventing the wheel, let me simply cut & paste the column I submitted to the Montgomery Advertiser for this upcoming Tuesday. Here goes:

> Last week, a reporter called to ask my thoughts about the ongoing scandal in Washington surrounding former FBI Director Jim Comey, the Russians, and the White House. Is it enough to cause the stock market to crash? In so many words, my response was simple: "only if it causes a slowdown in economic activity and a corresponding drop in corporate profitability. Absent that, long-term, no."
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> Obviously, his follow up question was whether the turmoil would put the Administration's tax reform proposals in jeopardy on Capitol Hill. Basically, would the rest of the GOP jump from a sinking ship, or something along those lines? That was fair enough, and I hope my response was as well: "I have a better chance of being named Pope by Christmas than that package has of getting through the Congress as is." Not surprisingly, that quote didn't make it into his column.
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> In truth, I probably came across as amazingly cavalier, and we will see if he calls me again anytime soon.
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> Having helped start a company from scratch, I have a hard time imaging a significant percent of US businesses and entrepreneurs are putting major initiatives on indefinite hold in anticipation of meaningful tax reform. Yeah, that would be great, but corporate America has a job to do right now, and can't hit the snooze button in the hopes of would have, could have, and should have out of a bunch of politicians.
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> To be sure, I am certain a diligent reporter can find a CFO or CEO somewhere who will say they are waiting to see what happens in Washington before adding capacity or embarking on a venture. However, a company's tax bill is ordinarily a reflection of its success, or lack thereof. It isn't, or shouldn't be, the driving force behind long-term corporate strategy. If it is, perhaps the company should consider selling itself or revamping its business model, because whatever is it is doing must not be working all that well.
>
> If Washington does pass meaningful tax reform this year, it will be gravy for corporate America. More money will hit the bottom line than originally expected. However, if our economic well-being hinges on political campaign promises, well, we were headed into the ditch anyhow. Put another way, if Michael Flynn's alleged backroom discussions with some Russians is the straw that breaks the back our $19 trillion economy, I can only imagine what would have happened if he had gone out for cocktails with some North Koreans.

Disclosure

Something to Think About Cont.

> It would be complete Armageddon, that's what. Admittedly, I don't find politics fascinating, and I don't live in a major media center. So, perhaps I don't see the slippery slope so many are. Frankly, I have too much other stuff to worry about.
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> Now, I really am being cavalier.
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> With this all said, I would be completely remiss if I didn't I say I want these distractions to vanish, as well as the tweets from 1600 Pennsylvania Avenue. I confess I found some of them to be pretty amusing in the beginning, and I am probably not alone. Several months later, I suspect the Administration is losing, or has lost, a lot of political capital by venting its spleen in such a public manner. Further, the tweets seem to be so much fodder for the media gristmill, which only causes the carousel to spin that much faster.
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> So, economic collapse? Not from this supposed scandal, but it is dizzying.

Now, the column is supposed to be 600 words, and it is with my tagline which I didn't paste here. If I had extra space, I would have incorporated something like the following somewhere in the article:

> Even if businesses and investors don't get the much anticipated tax reform, no one expects taxes and regulations to go UP, do they? Essentially, the worst case scenario is stasis, and corporate America can live with that. We just get another year like last year and the year before that.
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> Think of it this way: you live in a nice house. The house up the street is on the market, and is a little larger and nicer than yours. A real estate agent promises they can make it an even swap for you. Do you like that? Sure, who wouldn't?
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> So, how do you react when they come back and say they can't make it happen for you at this time? Do you throw a temper tantrum and burn your house to the ground? Of course not

...but...but…but, hasn't much of this year's rally been about the potential for meaningful tax reform? Yes, it has. If 'we' don't get it, I would fully expect the markets to dip back and then potentially stabilize at the valuations just before the election. Further, interest rates would fall with the stock market sell-off, making stocks a little more attractive relative to traditional interest generating alternatives at the time.

According to my Bloomberg, the trailing P/E ratio on the S&P 500 was right at 20x at the end of October 2016. Currently, the Earnings Per Share of the S&P 500 is an estimated 112.26. Multiply 20 by 112.26 and you get 2,245.20. As I type, the index is 2,388.52. As such, we could see an index 'reset' about 6% back from where we are currently trading, which is slightly higher than where we started the year AND significantly less than the capital gains tax bill you would have to cut if you liquidated your stock portfolio to avoid this pullback.

Basically, we would give back what we have gotten thus far this year, and then wait until the next earnings season. Given the weaker dollar that would accompany a 6% stock drop and lower interest rates, multinational corporations would be able to translate their foreign profits back into more US dollars, thereby increasing earnings per share and driving down the P/E ratio….making stocks, well, you get the picture. In the end, political scandals are just that: political. Money is money.

In case you haven't guessed, it is pretty outside and I am in a good mood.

Have a great weekend.