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Third Quarter 2019

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Reggae-nomics

Ronald Reagan had Reaganomics or Voodoo Economics. Japan now has Abe-nomics, the plan of Japan's Prime Minister Shinzo Abe. But the latest hit is Reggae-nomics! The Reggae economic songs are now a hit in Jamaica.

Keep de rates dem low...stable and intact
So consumers can buy ...
We no want it too high
We no want it too low...

This is what's happening in the world of economic policy. Jamaica is trying to educate the public on how the economy works, something that most college grads in the U.S. can use. But it seems as if the economic PhDs around the world that are making policy today know less than the singing Reggae stars. They are just making stuff up and experimenting with policies to see what might happen. Unfortunately, we don't know.

We are in a place that we have never been before. Reagan's Voodoo Economics was about lowering taxes and deregulation to spur growth. It was controversial but simple, and it is a key component of Trump-enomics. But throw in negative interest rates, huge amounts of government debt, tariffs, Brexit and a great deal of central bank intervention, and we have a mess. Politicians have been stepping in to control an economy that even the experts can't figure out.

The Markets

The stock market peaked just over a year ago after responding favorably to the Trump tax cuts. For the past 12 months it has been a roller coaster, and we are now back to almost exactly where we were in late September 2018. A lot has gone on since then. After an interest rate spike in October, rates have dropped by 50% to near historic lows, Brexit has been put on hold, tariff policies have made no progress and now we are running into an election year that looks like it will be

(See Reggae page 2)

Wall St. Journal 10-17-19

The Jamaican Inflation Dance
Whatever happened to the good old fashioned Rain Dance?

Good News - More Zeros!

First, it should be noted that I updated my web page. It's been in the works for a while. The address is the same, as referenced above, but it's in a more modern format.

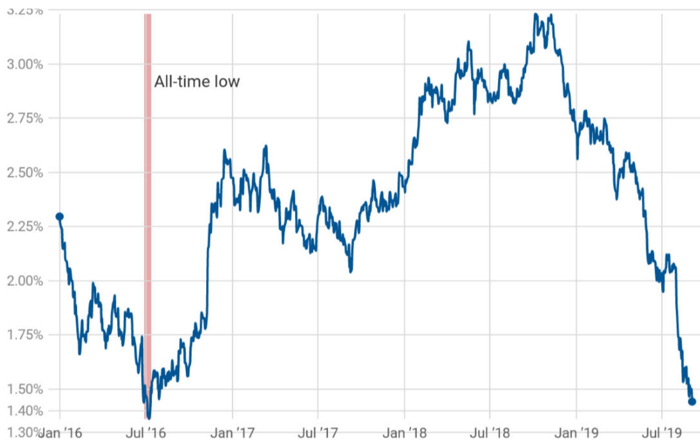
I was having breakfast with another investment advisor, and at one point we started to talk about trading commissions. He mentioned that he had just been to a meeting where a firm, called Robin Hood, was offering no commission trading. We joked a little about how they could make money. A few hours later it came across the news that Schwab would begin zero commission trading in mid October. Currently, an online trade is $4.95. About an hour later, T.D. Ameritrade matched it and went to zero. Then several other firms followed. So now, zero transaction fee trading is the new normal. This is for stocks and exchange traded index funds.

Going back many years, you had to pick up the phone and talk to someone. A stock trade could have cost $150, which is why you needed a fairly sizable account to even buy stocks!

In 1971, Charles Schwab was the first to offer "discount brokerage services". Unlike a regular broker, where you discuss the stock and the broker would make a recommendation, a discount broker simply places the order. They do not solicit orders. It is up to the customer to decide what to buy or sell. For this reason the transaction fee was greatly reduced. Shortly thereafter other firms started to offering discount services, most of

(See Zeros page 2)

(Reggae from page 2)



The 10 year Treasury is back to its historic lows.

worse than the last one. With all of this, the stock market continues to dive and bounce back. With all the turmoil and uncertainty behind the scenes, it is hard to believe it has done so well.

Debt

Both the national debt and the annual deficit have continued to grow. We were at 21 trillion in federal debt in March 2018. We are now over 22 trillion. The annual *deficit* is close to a trillion dollars a year. So the federal government is spending almost a trillion a year more than it is bringing in from tax revenues. So far, investors are not paying much attention to that.

Corporate debt, consumer debt and student debt are at record levels. These have all continued to increase over the past year. But in spite of this, consumer spending is considered to be strong. Since the consumer represents almost 2/3 of the economy, that is good news and continues to offer a lot of hope for stock investors.

Unemployment

The unemployment rate is at record lows that have not been seen since the early 1960s. It stands at about 3.5%. Some economists argue that this number could be a little fuzzy and not mean as much as it did even 10 years ago. The unemployment rate is based on people that are "looking" for work and the active labor pool has shrunk. But that being said, this is good news.

It should be noted that the baby boom generation is retiring at a rate of about 10,000 per day. Most of them have meager savings. The retirement plans that people had in the 70s and 80s are no longer in existence. It is quoted that a majority of retirees have something like $50,000 in savings and are now heavily dependent on social security, which may average about $1,500 per month.

(See Reggae on page 3)

(Zeros from page 1)

which have been absorbed by other firms.

In 1992, Charles Schwab was also the first to offer the trade of "no load" mutual funds commission-free on their platform. This was a huge breakthrough. Shortly after they opened the door to that, a number of other firms copied the model. Now it is commonplace. As an advisor, I use Schwab and Ameritrade for funds, ETFs and stocks. They provide good service and support since I can't use everyone.

When a stock is traded there has always been some revenue made on the "spread" between the bid and ask when a trade is executed. This cost has always been there and will not change from before. Brokerage firms are heavily regulated to make sure they get best pricing when they fill a trade for a client, and the spreads here are decimals.

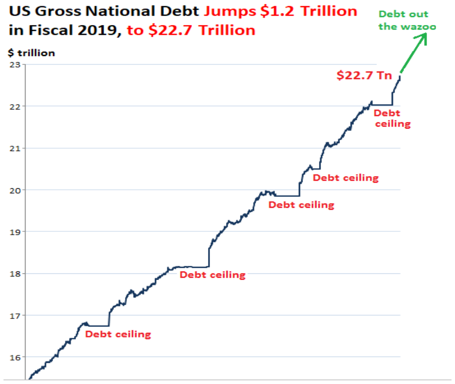
But the additional trading commission as charged by the broker to the client is now lost when the firms went to zero commissions. This is why the stocks of all firms that went to zero trading commissions plummeted as soon as the announcement was made. Ameritrade was down over 20%. Schwab only derives about 7% of its total revenue from trading fees, but its stock was also down about 11%.

I suspect that a lot of this has to do with vast changes in technology. Money moves at lightning speed through various electronic exchanges almost instantly. Over the years the speed of these executions has increased and will continue to do so.

Some have said that zero fees will encourage a lot more day trading, which is really not good for a customer because it usually does not result in a profit that is worth the work. But maybe this is good for Schwab because now they will end up just executing more electronic trades. At the same time Schwab and a lot of these firms offer other services that include banking, margin loans, cash accounts, and various forms of portfolio management services. So by hooking in a client, they have the opportunity to offer other services to generate more long term revenue.

For clients of the discount firms, it is a win. It just lowers the cost of investing. The overall cost of investing has dropped exponentially over the past decade and it only puts more money into an investor's pocket. Unfortunately most investors don't know about it and many are working with the same high cost products that were out there 25 years ago. Our objective is to keep overall costs as low as possible so all of this is really good news!

(Reggae from page 2)



But let's say a retiree did well and saved a million dollars. If they are conservative and not comfortable investing outside of a money market account, a 2% yield would generate only $20,000 in income. Because of this, it is difficult to depend on a lot of spending from this group. At the same time, the college educated segment of the younger generation is saddled with debt so there is less money to buy homes and other luxuries. This is all a concern for future consumption, but for now the numbers indicate the consumer is still doing well.

U.S. and International Interest Rates

This is where it gets interesting. As the months go by we keep seeing many of the developed European and Asian countries, such as Germany and Japan, dip into negative interest rates. The German "bund" is –.50%. This is happening throughout Europe and has been the norm in Japan for some time. It has always been the case that lowering rates would allow for easy borrowing and stimulate an economy. But they ran out of positive rates to lower. Negative rates should have the same impact. It should discourage investors from purchasing debt and encourage investors to take risk in businesses to get out of their lingering recession. In Japan this is the policy of Abe-nomics. It has had moderate results. Their stock market has mostly held up, but it has not really helped with inflation. As the Reggae song goes: "when it *(inflation)* too high, you gonna cry, when it's too low ...economy can't grow". They know their stuff!

In the U.S., we are struggling to maintain a 2% inflation rate. That is high compared to the rest of the world, but, with all we have done to stimulate inflation, economists are baffled why it is not higher. If stimulus polices are reduced (ie: higher rates), they are very concerned things will deflate.

One reason the economies in Europe can't grow may be due to the fear that the European Union is (potentially) in danger of breaking up. All of Europe is waiting to see what will happen with Britain (Brexit) . Although Britain is not part of the European currency (the euro), it is part of the European Union. If Britain moves out, it may set an example or create a model that other countries might follow. If Italy, for example, followed Britain, it would exit not only the European Union, but also the euro. So any business that was done with Italy in euros may be jeopardized. Italy would need to convert to a new national currency, like the old lira, and the conversion ratio (now unknown) could translate into big losses. So a better bet is to buy a negative rate government bond that is backed by a euro that has a better chance of surviving the breakup because the remaining member countries would guarantee the investment. This guarantee is worth getting back less money than the original investment— hence the negative rate. Ironically, the uncertainty of what will happen just makes matters worse. It slows the individual economies and drives them deeper into recession. Delaying Brexit does not help.

But for U.S. stocks, this can be good news! The concept of having low interest rates here in the U.S. will spur U.S. investors to invest in stocks......at least for a while. Since our economy is still strong and not in a recession, a dividend paying stock is better than a 2% bond. So for now, low interest rates are still good for stocks and it appears that the Federal Reserve will drop rates another 1/4% at the end of the month.

Federal Reserve Issues

There is a lot of pressure to drop rates because U.S. rates are so high relative to the rest of the world. But at some point, as the Fed pushes rates lower, it loses its ability to drop rates significantly if (or when) a real recession or crisis occurs. Some argue that the Fed is wasting interest rate cuts while the economy is still good and fear that if the U.S. slips into recession we may start to look more like Europe. In recent statements, the Fed

(See Reggae on page 4)

(Reggae from page 3)

Chair, Jerome Powell, indicated that future cuts may not have the impact they once did.

On the flip side (of the Reggae Album) there is one other thing to consider. If we avoid a recession and interest rates do rise at some point, which they should, it will significantly increase the annual payment on our growing National debt. A 2% increase on 22 trillion of debt translates to a 440 billion, or almost half a trillion increase to our annual interest payment! Our current annual deficit is now close to a trillion—so add another half trillion to that and it's hard to see how we can survive higher rates.

Finally, since we are on the subject, there are some credibility issues with the Fed. This past month, the Fed screwed up on a technical transaction. It caused overnight interest rates to spike up to 10% one evening because, in simple terms, it forgot to put enough cash in the overnight lending box—which is like the ATM for banks. So between this incident, and the fact that it appeared to raise rates too quickly last October and then was forced to lower rates again this year, the Fed's clout is a bit tarnished. At the same time Donald Trump continues to call for the Fed chairman's head.

Politics

I have had many people ask about the impending impeachment and all the other political drama that is dominating the news media. In general terms, history indicates that stock investors are concerned about corporate profits and not politics. But this time there may be a different twist given the election year.

The big cloud over the market is the trade war. A solution to this will drive the markets higher. It doesn't matter necessarily what the solution is. Industries can adjust if they know what they are dealing with. Right now it is an unknown and, like the Europeans waiting for Brexit, we are waiting for tariffs. It seems that if Trump wants to be re-elected, he needs to have a good showing in the stock market. If he missteps with the trade war, the markets will tank and that will heavily jeopardize his chances of staying in office. The call for impeachment can help or hurt him. It may give him an incentive to make a good deal with China to cancel all of the impeachment noise out. Or, China may decide to be more difficult and delay the deal making in order to put more pressure on him to concede to something less favorable or hold off until elections are over. Meanwhile, some of the proposed policies by potential candidates are not in the Reggae song—like giving everyone a $1,000 per month paycheck. Sounds more like Voodoo-nomics.

Conclusion

On the glossy cover, our economy looks good. But the U.S. is the last man standing. We are the only major economy that is in good shape. Behind the scenes, especially overseas, economies are sinking and the solutions are elusive. We are about to head into an election year and the rhetoric will keep the markets on edge. The good and bad news is that we have never seen interest rates so low and low rates leave investors with stocks as a decent choice. At this point, the stock market is betting that Trump will come up with a tariff solution with China, interest rates will remain low and the markets will boom. Meanwhile, we should all do the Inflation Dance.....and don't forget the Tariff Dance Maybe the gods will look favorably upon us!

Enjoy the Holiday Season!

John R. Ruocco