The Quarterly Report

A QUARTERLY PUBLICATION OF IRON CAPITAL ADVISORS | Spring Issue | April 2018

This is Why We Can't Have Nice Things!

INSIDE STORY

Have you seen what children and dogs do to furniture?

IRON CAPITAL ADVISORS

3355 Lenox Rd., Suite 925, Atlanta, GA 30326

T 800.417.3804 | F 678.805.0534 | www.ironcapitaladvisors.com

This is Why We Can't Have Nice Things!

Have you seen what children and dogs do to furniture? My family moved into our home in 2010. Our previous house had no formal living room; the entire downstairs was three big rooms – a big kitchen, a big dining room, and a great room. Our new house had a more traditional living room and a cozy den, and when we moved in my wife was excited to finally use some of the living room furniture she had inherited from her parents. We later added two chairs from my parents.

I love our living room. Most of the furniture is antique and all of it has meaning to us. There is something cool about that, which we have largely lost in a society that now buys entire rooms of new furniture, all at once. It does, however, have one downside: nothing matches. We could fix that, as it is simply a matter of getting chairs and sofas reupholstered. We almost did it once, but a wiser, more experienced soul stopped us. She said, "You have small children and dogs, you can't have nice things."

I was reminded of that sage advice earlier this year. A colleague and I were enjoying a very nice dinner in Mobile, AL. If you like seafood and are ever in Mobile, you have to go to Felix's Fish Camp Grill. We were discussing the state of the union, as it were, and the unusual turn our politics had taken. Congress had passed tax reform and the stock market was at all-time highs. We came to the conclusion that if he desired, President Trump could cruise through the rest of his term and then walk away being remembered as a successful one-term president. Vice President Pence could run for office and no matter your politics, at least we would be back to more usual candidates.

I will admit to being one of those who is still not convinced that Donald Trump ever really wanted to be president. I could be wrong, but I wonder if this all just started as a publicity stunt and then suddenly he started winning. But back to our point. You can have whatever political views you wish, but the U.S. presidency is won and lost based on the economy. Ronald Reagan did not win 49 states in 1984 because California and New York used to be "Red" states. Most people – the ones who don't talk about politics – vote based on how they feel, and how they feel is largely based on how they are doing economically. The tax reform which had just passed is going to stimulate the economy. If Trump could avoid any disasters, things should be going well in 2020. That could give him a graceful exit, if he wants it, and set the stage for more traditional candidates to run a more traditional presidential election.

Then things ran off the rails because of tariffs and a war on international trade. This brings to the forefront important questions which many of us thought we had long since passed having to answer: Why is trade so important? Why shouldn't we "protect" our industries by using tariffs?

> *Until we grow up and learn our lesson as a nation, our economy will be a lot like my living room.*

The instinct to build walls against foreign products is understandable. There are few things harder on humans than change. It was hard when fewer and fewer workers were needed on the farm and many people were forced to leave their small communities to get work in the big manufacturing centers. Romanticizing the old days of rural life was an American pastime long before those manufacturing jobs started giving way to the service and information economies. Change is tough, and when it seems to be forced upon us by nameless faceless "foreigners," it is easy to think that we can just stop it from happening by putting up barriers to trade.

Of course, hiding behind barriers is no way to face life's challenges. We know that personally, but this is true nationally as well. We may be nostalgic for old cars, but do we really want to live in Castro's Cuba? That is what a society who builds walls against the outside world looks like.

Those who support trade barriers often argue that we have such a large trade deficit. They fret that the trade deficit is a horrible thing – after all it is called a deficit, and deficits are by definition bad, right? Usually that is true, and in my opinion this unfortunate label causes a great deal of confusion. In fact, during the presidential campaign Trump often referred to the trade deficit in terms of us losing.

Is that really true? Having a trade deficit means that we export less than we import. In other words, we are sending the rest of the world a relatively small amount of stuff, and for that stuff they are sending us back a large amount of stuff. We are giving a little and getting a lot. Who's winning this game again?

It is at moments like this that we mourn the loss of people like Milton Friedman, who could accurately describe economic issues in a way most everyone could understand. In 1978 he spoke on this issue. At that time, it was Japan who was the foreign disruptor instead of China. This is what Friedman had to say, "Let's suppose, for a moment, that the Japanese flood us with steel. That will reduce employment in the American steel industry, no doubt. However, it will increase employment elsewhere in America. We will pay for that steel with dollars. What will the Japanese do with the dollars they get for the steel? They aren't going to burn them. They aren't going to tear them up. If they would, that would be best of all, because there's nothing we can produce more cheaply than green pieces of paper, and if they were willing to send us steel, and just take back green pieces of paper, I can't imagine a better deal!"

Talking about the art of the deal. If we could get steel, aluminum and everything else we need for nothing more than green pieces of paper, that would be awesome. Economists know, of course, that currency is just a convenient store of value. In truth, what we are doing is bartering. We provide the world today with most of its technology, and in return, we get the products we desire. If they take fewer things from us than we get in return, then they get to hold dollars. What are they going to do with dollars?

Have you ever taken something back to a store and all the store will give you is a store credit? It is aggravating, isn't it? You may not wish to buy anything else in that store. What you really want is your money back so you can go anywhere. With international trade, this is the way local currency works. China takes dollars. Dollars are like store credits, they eventually have to be used here if you want your value.

Today the U.S. is the largest, most trusted "store" in all of the world. That means our store credits can be traded, because there really isn't anyone who wouldn't want to take them, but even if China uses those dollars to buy stuff from Brazil, what is Brazil going to do with them? Ultimately there are only two things that can be done with dollars: they are either used to purchase U.S. goods, or they are used to invest in the U.S. If we have a trade deficit, then we have a matching investment surplus. That is good for our economy.

There is a reason why trade deficits peak during economic booms and bottom during economic downturns. Of course, all we have discussed thus far is what a trade deficit is and how it really is not a bad thing. We have not mentioned the benefit of low-cost steel. Yes, this hurts the steel industry, but it helps every industry that uses steal and most importantly, it helps the consumer through lower prices. I believe this gets lost on many people, usually because of the very arguments one may have heard from the steel industry regarding these latest tariffs. "We are only

» *Continues on next page...*

REVIEW *of* ECONOMY

The 4th quarter 2017 GDP growth came in at 2.9 percent marking three quarters in a row of better economic growth. We may finally be breaking out of the so-called new normal, and the impact of tax reform has not hit yet.

The official unemployment rate remained at 4.1 percent in March. The labor market keeps improving and perhaps more importantly we are seeing wage growth of 2.7 percent. That is an encouraging sign.

Inflation is at 2.2 percent based on the latest consumer price index report. Core inflation stands below the Fed target at 1.8 percent. The inflation worries have not come true as of yet and we doubt they will. +

REVIEW *of* MARKET

What a wild ride. For the quarter the S&P 500 was down just 0.76 percent but how we got there was the real story. Volatility is back. Growth outpaced value for the fifth quarter in a row. The Russell 1000 Growth index finished up 1.42 percent, while its value counterpart was down 2.83 percent.

Bonds dropped during the quarter as interest rate crept higher. The Barclays U.S. Aggregate Bond index ended down 1.46 percent. High yield bonds ended the quarter down 0.94 percent.

International stocks suffered as well. The EAFE index finished down 1.41 percent while the MSCI Emerging Markets index ended the quarter up 1.47 percent. +

MARKET *forecast*

Volatility has returned and is likely to stay. We are still positive on the markets for the year as the economy and corporate earnings are still strong. Those are the things that really matter. In the meantime any threat of a trade war or other political unrest will continue to cause day to day fluctuations.

Small company stocks should do well. Emerging markets still look attractive as do international stocks.

Bonds remain our biggest concern over the long term and will until the yield on the 10 year treasury exceeds 3 percent. It has gotten closer but is still not there. +

» *Continued –*

adding a small amount to every car." It is just a small amount, after the small amount that was added for the passenger air bag, and the small amount that was added for the emissions
standards, etc.

Lots of government-mandated items on cars are individually desirable, and all of them add just a little cost. But, when added up, the average car now costs more than half of the average family's total income. This is what economists call rent-seeking, and it is one of the biggest dangers of an intrusive government. Every tariff brings large benefits to a few, in our example the steel industry, and brings small injury to the many. This creates a passive majority and a very active minority, which wins the day at the expense of the majority.

In our case steel workers win and consumers lose. Who are the consumers? Everyone. That means everyone, including (ironically) the steel workers. Of course, it is noble to defend steel workers – we all love the iconic image of blue-collar, middle class America. So, let's change our example, and instead of tariffs on steel, let's say we are talking about bailing out banks. Suddenly this begins to look totally different. Let's say we want to protect Wall Street bankers from the Chinese at the expense of everyone else in America. That doesn't have the same political appeal, does it?

Benefiting a sympathetic group over the rest of us seems very different from benefiting an unsympathetic group, but in fact it is not. Our founders understood that. It wasn't about replacing a bad king with a good one. It was about not having a king at all. It is about creating a system of checks and balances where hopefully the greater good can win out over selfish interests.

What is the greater good? Politicians like to see everyone as part of some definable group. They wish to silo us, divide and concur as it were. If they do group us together it is often as workers. This seems to be Trump's vision; he is for the workers. Economists, on the other hand, see everyone as consumers. After all, the primary reason individuals go to work is to be able to consume. Most would choose not to work if consumption was possible without it, hence the retirement planning industry of which I am a part. If this were not the case, I would not have a job.

The irony is that most of us are workers and all of us are consumers, yet workers' interests and consumer interests are not always aligned. When in doubt, I say do what is right for the consumer. Do what is right for everyone. The healthier the consumer, the more they will consume, and the more good jobs there will be for all of us workers. They might be in the steel industry or they might not. That should be up to the consumer to decide.

This is what we have always done at Iron Capital. Our clients are our primary concern, and the more we successfully focus on our clients (the consumers), the more we (the workers) benefit. A few years ago we changed our business model to become strictly referral-only. We do not spend an ounce of energy marketing our firm or selling our services. We focus entirely on taking care of our current client base. Once we did that, we ended up doing more new business than we had ever done in the past, because our clients are far better at selling our services than we ever were. This works for many other great businesses, and it can work for our nation as it has in the past.

Until we grow up and learn that lesson as a nation, our economy will be a lot like my living room: a place where we just can't have nice things.

Warm Regards,

Chuck Osborne

CHUCK OSBORNE, CFA
Managing Director