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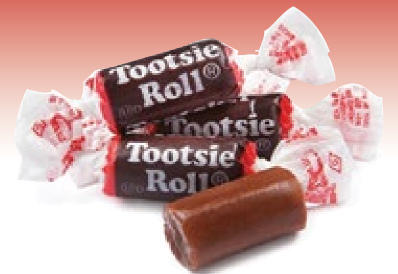
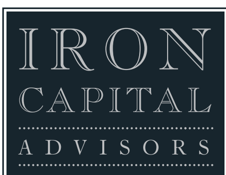
TOO MANY TOOTSIE ROLLS

INSIDE STORY

THE LAW OF DIMINISHING RETURNS





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TOO MANY TOOTSIE ROLLS

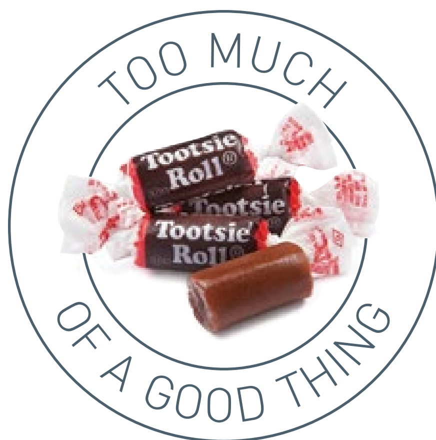
THE LAW OF DIMINISHING RETURNS

What kid does not like Tootsie Rolls? I know I liked Tootsie Rolls when I was young. In fact, I loved them. I couldn't get enough of them… until my Mom took me on a trip to visit my oldest sister. She was out on her own and we were going to visit her for a few days. My sister had a candy jar full of Tootsie Rolls. I don't remember if I asked for permission or if I thought I was being sneaky, but I ate a lot of Tootsie Rolls that day. I ate and I ate and then…well let's just say I didn't feel so good.

To this day I can't stand the thought of ever eating a Tootsie Roll. Even writing this is making my stomach a little queasy. However, I learned a very valuable lesson that day: the economic law of diminishing returns. It was an important lesson.

If one were to look up the law of diminishing returns he would see something boring like an explanation about why incremental productivity gains of adding an employee get smaller with every employee added. If a company has only one employee then adding a second doubles productivity. Adding a third will increase productivity by a third, etc. These types of explanations, while accurate, are probably why so many don't understand or like economics.

Fortunately for me I had some good teachers who brought these concepts alive. The laws of economics are not just about bean-counting at some fictional company or make-believe nation. They are real and they impact our lives in much the same ways of the laws of physics. Diminishing returns are everywhere, including the ingestion of candy. The first bite is always the best and no matter how good something tastes, eventually your body will say, "no more."



Kids today don't even know what a newspaper is, let alone a newspaper vending machine. For those of us that remember these contraptions, there is a reason those machines were structured differently than drink vending machines. The value of some items diminishes faster than others. A second Coke might not be as good as the first, but it is still pretty good; a second newspaper is worthless. Once one has read it she is done with it. That is why the old newspaper vending machines opened up and allowed anyone who wished to take every single paper for the price of one. Other than the occasional Good Samaritan who would take them all out and place them on top of the machine allowing others to enjoy a free paper, or the unscrupulous entrepreneur who would take them all and re-sell them, most people would take their one paper and leave the stack inside. That would not likely be the case with a drink machine.

This also works with exercise. There have been many studies out recently saying that a short burst of strenuous activity is better than hours and hours on a treadmill. There have been studies showing that excessive exercise can even be harmful to one's longevity. Of course our culture is full of such warnings: "Too much of a good thing." "Everything in moderation." Grandma may not have had a degree in economics, but she understood the law of diminishing returns.

It is really too bad that Grandma is not a central banker. The law of diminishing returns impacts many parts of our lives but it is most obvious with economic decisions. (It is an economic law after all.) Central bankers learned many years ago that they could stimulate economic activity by lowering interest rates. The theory is pretty simple: Interest rates represent the cost of borrowing money. The lower that cost, the more willing one might be to borrow money. That money would be used for many activities from buying houses to starting a new business. If the central bank could lower the cost of borrowing, then all kinds of people might be more willing to borrow and use those funds to produce economic activity.

Why is this important? This realization gave government two tools to use in its ongoing effort to control the direction of

the economy: The government could use fiscal policy, which is the ability to tax its citizens and spend that money on various projects; or it could use monetary policy, which is the ability to manipulate the amount of money in the system through interest rates.

Both tools are about putting more money into the system. The government could lower taxes, which would allow people to keep more money and therefore spend more. It could increase spending, which would put money directly where the government wanted it. It could also lower interest rates, allowing for more borrowing of money. Through the 20th century governments tried all of the above. They found that the third tool, lowering interest rates, was actually the most effective way to stimulate the economy.

Governments did not, however, count on the law of diminishing returns. The last time any government around the world saw fit to go the other direction – to actually slow the rate of growth in the money supply – was when Paul Volcker was appointed Chairman of the Federal Reserve by President Jimmy Carter. Volcker raised interest rates in an effort to combat inflation. Mortgage rates, which today are around 3.5 percent, topped out at 18.5 percent during Volcker's tenure.

His war on inflation did two things. One, it worked in defeating inflation and stabilizing the value of the dollar. Two, it set up an interest rate environment where central bankers could constantly lower rates for more than 35 years. Rates have been dropping ever since and today much of the world actually has negative interest rates. Switzerland's rates actually went negative all the way out to thirty years. People are buying Switzerland's bonds knowing that they will get less money back should they hold on until maturity. This is simply amazing and is probably the biggest market story of our generation.

How did we get here? So much of it has to do with politics. To claim that central bankers are not influenced by politics would be quite naïve. However, the other control government has, fiscal policy, is governed directly by politicians. There is politics and then there is professional politics. As a result there are lots of politicians who are fans of so called Keynesian economic policy. John Maynard Keynes was a famous economist in the early part of the 20th Century who theorized that governments could stimulate the economy through running budget deficits, aka spending more money than they have. Politicians love that. The only problem with this is that Keynes also said the budget should balance during normal periods and the government should actually run a surplus during boom times in order to pay for the deficits. The politicians didn't do so well on those fronts.

In addition, politicians often don't agree on how such deficit spending should be spent, or even generated. Should the government tax less or spend more? They usually compromised and decided to do both. This has led to an abdication of any reasonable fiscal policy in much of the developed world, which means the government has only one weapon left: monetary policy. For almost a generation this has been possible because rates got so high in the early 1980s that there was a lot of room to lower, and lower, and lower rates. Now those guns are empty as well.

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REVIEW *of* ECONOMY

The economy just slugs along while forecasts bounce from overly fearful to overly optimistic. First quarter GDP was up 1.1 percent. We expect the second quarter number to be higher but still in our new-normal range. Brexit has us in the overly fearful mode, but in reality nothing has changed of significance.

The official unemployment rate is 4.9 percent in June. Jobs growth has become lumpy as we had a horrible report in May followed by a very good report in June. Again, expectations move wildly as reality remains stable.

Inflation has been flat with CPI coming in at 0.2 percent in May. The Fed remains on hold after their first interest rate hike last year. After Brexit it is unlikely to see the Fed raise rates this year. +

REVIEW *of* MARKET

We are in a global bear market. One wouldn't know it looking at the S&P 500 which finished up 2.5 percent for the quarter. But the rest of the world continues to struggle.

Bonds rallied during the quarter up 2.21 percent. High yield bonds ended the quarter up 5.78 percent. There has been a strange combination of a flight to safety and a flight for yield. Much of the developed world now has negative interest rates on government debt. It is hard to know what that means but it is likely that it will not end well.

The BRIC countries (Brazil, Russia, India, China) are down 18.6 percent over the last year. The Eurozone is down 15 percent. Italy is down 28 percent. The world equity markets excluding the USA are down 12.35 percent and that is after a strong rally the last week of the quarter. The rest of the world has seen a bear market. The question is, has it bottomed? +

MARKET *forecast*

Volatility is likely here to stay for a while. As frustrating as that is, we remain confident in the longer term. Valuations on equities are attractive on the whole and the economy is still chugging along. It is a rough ride but we still believe it will end in a positive direction.

Emerging markets have real economic issues but valuations have become very attractive. Small company stocks are finally getting back into normal valuation bands. Caution is in order but that is a good long term sign.

Bonds remain our biggest concern over the long term, but they are still a shelter in the storm when the market does go down. +

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Further, as the law of diminishing returns would predict, they do not appear to be working. Once we reached zero interest rates central banks began so called quantitative easing, which is the actual government purchase of its own debt. That didn't work, again diminishing returns.

Now we have negative rates. This has the potential of ending as badly as my little tootsie roll binge. So what are we to do? What do we do as citizens and what do we do as investors?

As citizens we need to remember that there is another way that government impacts our lives and influences economic growth. Government makes the rules. Often lost in conversations about the economic miracle that was the 1980's and 1990's in our country is the role of regulatory reform. This was started by Jimmy Carter and continued by Ronald Reagan and eventually Bill Clinton. How powerful is this force?

When I was young rail roads and the phone company were both heavily regulated. Jimmy Carter freed the phone company but not the rail roads. When I was young everyone had one of two phones. They did not go with you when you left the house and long distance phone calls were incredibly expensive. Today, our phones fit in our pockets, and they run an entire Internet economy which was not even a dream forty years ago. Trains, on the other hand, still look the same. Regulation has an enormous impact on growth.

The problem with reforming regulation is what economists call rent-seeking. Unlike fiscal policy and monetary policy, which impact everyone who either pays taxes or receives government aid, and everyone who has borrowed any money (in other words, everyone), regulation has a large impact on the industry being regulated but a negligible impact on most. This gives rise to an effort by those impacted to use their resources to influence regulation through lobbying efforts. Economists refer to this as rent-seeking; people on the political right call it cronyism; and those on the left call it rigging the system. Poor regulation slows the economy and moves what rewards still exist increasingly toward those who are skilled at seeking rents. In 1962 Milton Freidman showed that the more regulated a society becomes, the more inequality exists. This is logical. After all, the more regulated a society, the more important it is to be connected and able to influence regulation. In other words, rent-seeking is a vicious cycle which leads to more and more rent-seeking…until an economy grinds to a halt as ours did in the 1970s, and as Europe's is now, thereby forcing reform.

As investors we must hope for improvements but plan on living in the world as it is. Political risk is alive and well. We must now pay attention to the future of economic alliances such as the European Union. We must pay attention to the political landscape of an industry. We have to think about whether the government will be friendly to this company or not. This may be unfortunate but it is our current reality.

It also makes it that much more important to look at every investment from the bottom-up. We need to know what we own and why we own it. In a world where so much is out of our control we have to focus on getting right that which is in our control. One way or the other, the world will learn (again) the lesson of diminishing returns. Hopefully we learn it the easy way and begin to see real reform, not only here at home but throughout the developed world. Or we might get sick. If we do, it will pass and then perhaps a lesson will be learned. I know I'll never eat a Tootsie Roll ever again.

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