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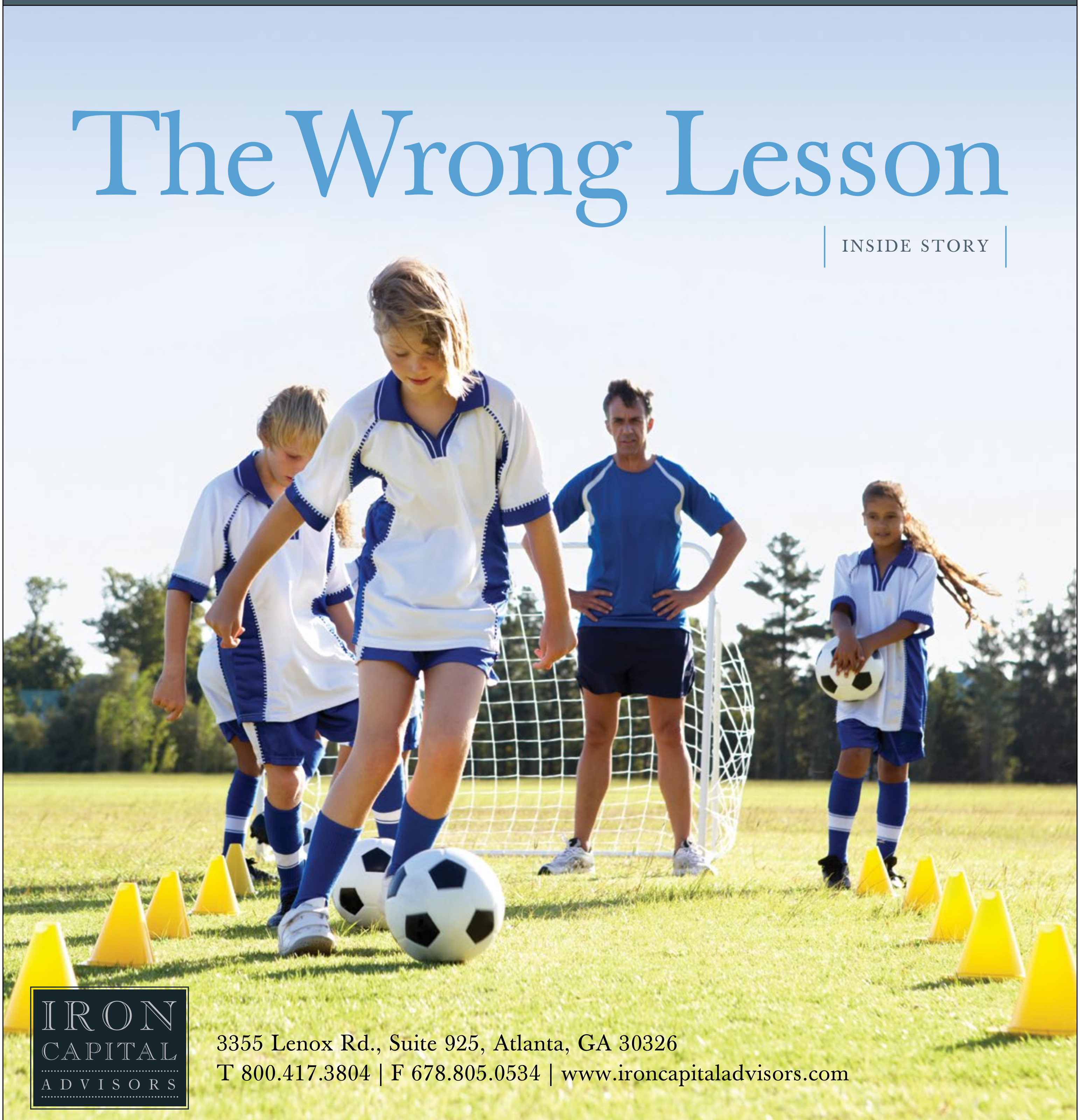
The Wrong Lesson

INSIDE STORY



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The Wrong Lesson

How does a baby learn to walk?

This is a question I often ask at the beginning of every season when I coach youth sports. The answers I get are often entertaining, but seldom do I get the answer I'm seeking. I will hear, "By putting one foot in front of the other." I might hear, "Mommy helps him." However, I seldom hear the real answer: A baby learns to walk by falling down, and as any parent could tell you, they fall down a lot.

We learn from our mistakes. That is the point of the lesson. It does not take long for young boys and girls to learn that mistakes are bad. Human nature being what it is, the natural response to mistakes is to deflect or deny, but what one needs to do is own his mistakes so he can then learn from them. Many adults are still working on owning their mistakes. As a coach I preach this all the time. Learn from our mistakes, and make only new mistakes.

That is the secret to improving at any endeavor. There is one potential problem: What happens when we learn the wrong lesson? This past spring I was coaching my daughter's soccer team. One of her teammates was inbounding the ball and threw the ball in from the side of her body instead of over her head. Kids do this a lot because they have a dominate hand and that is the hand they throw with. It is not natural to everyone to throw the ball directly over one's head with both hands. I stopped to point out the mistake. We have a ritual called CLaPing for mistakes. The C stands for claim the mistake, the L stands for learn from the mistake, and the P stands for play through the mistake.

So, I blew the whistle and we clapped for this girl's mistake. I asked her what she thought the mistake was, and she said something I did not expect. She thought someone else should have thrown in the ball. We straighten that situation out, and the player in question learned how to throw the ball in properly, but it made me think. All this emphasis on learning from mistakes is great, but what happens if they learn the wrong lesson?

This is an easy trap to fall into. It is especially easy when dealing with economic issues. Economics is part art and part science; that is what economists will tell you anyway, and I guess there is some truth to that in the sense that it is at least partially mathematical. The problem with soft sciences like economics is that there is no actual way to test theories using the scientific method. For those who have blocked out their middle school science projects (whether from boredom or years of therapy), here is a quick reminder: The scientist comes up with a hypothesis. To test the hypothesis, the scientist sets up an experiment.

The hypothesis might be that fertilizer makes plants grow faster. To determine if that is the case, the scientist will grow two plants, one fertilized and the other not. To make sure that it is the fertilizer that is making the difference and not some other variable, a good scientist will ensure everything is the same except for the fertilizer: same type of plant, same soil, same exposure to sunlight, etc. That way, the scientist can know that she is seeing the difference that fertilizer makes. The plant that does not get the fertilizer is known as the control group. It is a vital element of the scientific method.

A False Lesson: *high taxes do not slow economic growth.*

There are no control groups in economics. Economics is not done in a laboratory; it takes place in the real world. When we make an economic decision, such as buying a house, we cannot set up an alternative universe in which we didn't buy the house. Years later, we may see the purchase of the house as a great decision or a big mistake, but the truth is we have no way of knowing what our lives would be like had we not purchased that house, and don't underestimate the importance of that purchase.

It probably will not surprise our clients and friends to learn that in my life, I have owned just two houses. We preach long term and we practice what we preach. My wife and I purchased the second of those houses nine years ago and I now believe that both of my home purchases have been good decisions. Due to the nature of my work, and this newsletter, you all are probably thinking about the financial impact of my purchases. My home purchases have been fortunately well-timed in that regard. My first home was purchased before the Federal Reserve (Fed) fell in love with low interest rates, so I benefitted from the inflating of the housing bubble. My second home was purchased close to the lows in real estate caused by the bursting of said bubble. So, as home ownership goes, I've done well.

But, that isn't what I'm talking about. My daughter, who was born six weeks after we moved into our current house, spends most of her days at home playing with her best friend, who happens to be a neighbor. Being our neighbor is the only connection the two girls have – her friend goes to a different school, a different church, etc. If we had not purchased this house, we would not know this family, and my daughter would have a completely different best friend. What a difference that would make in her childhood.

The house we purchased impacts many aspects of our lives which have nothing to do with the simple math of real estate investment. I believe we have made good choices, but the truth is I have no way of knowing what our lives would be like had we made a different decision. Economic choices are dynamic and impact more than we realize.

If this is true in the simple example of buying a home, imagine what various impacts economic policy decisions have on our society. We tend to want to compartmentalize our politics, as we do with everything else, but in the real world everything impacts everything else. We can't separate foreign policy from economic policy from social issues because it all touches everything. This also makes it difficult to isolate a particular policy and know if its impact is positive or negative. In other words, there are no control groups, and learning the wrong lessons is very easy.

In the 1950s, '60s, and '70s, we had very high tax rates. According to the Bradford Tax Institute, income tax rates peaked in 1944 when we had a 94 percent tax bracket. Through the next 30 years the highest bracket was 70 percent. The 1950s and 60s were a time of great economic expansion for the United States; many now point to this and claim that high taxes do not slow economic growth.

That is a false lesson, desperate for a control group. Two larger forces were impacting our economy at that time in our history. First, in the aftermath of War World II, the United States was the only industrialized nation which had sustained no damage to our industrial capabilities. Every single one of our "competitors" was having to completely rebuild. To this day, our primary ally, Great Britain, remains a shadow of what it was prior to the war. We were the only show in town and as we all know, that kind of competitive advantage can mask many inefficiencies.

In addition to our global industrial advantage we had our entire Armed Forces full of soldiers and sailors coming home to start families: The baby boom. These families created this new place called the suburbs and an entirely new stage of human life known as the teenage years in which, unlike any generation to come before, parents subsidized childhood consumerism. Lessons from the War translated to technological advances in our homes. What began with dishwashers and air

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REVIEW *of* ECONOMY

The 1st quarter 2019 GDP growth came in at 3.1 percent which was much higher than expectations. The second quarter of the year is estimated to be a little slower, but this continues to be the best sustained growth we have seen in the U.S. in a very long time.

The official unemployment rate is 3.7 percent in June. This is the longest sustained under 4 percent rate since the 1960s. Wages are growing at 3.1 percent which means real wage growth.

Inflation is 1.6 percent based on the latest consumer price index report. Inflation has gone down as wage growth has remained the same. This means real wage growth is increasing. +

REVIEW *of* MARKET

Markets continue to run. For the quarter the S&P 500 finished up 4.30 percent and small company stocks represented by the Russell 2000 index were up 2.10 percent. Growth once again outpaced value.

Bonds rallied as well. The Barclays U.S. Aggregate Bond index ended up 3.08 percent. High yield bonds rose 2.50 percent.

International stocks were also positive. The EAFE index finished up 3.97 percent while the MSCI Emerging Markets index ended the quarter up 0.74 percent. +

MARKET *forecast*

The economy continues to outperform predictions and so does the stock market. Even with the S&P 500 up 18.71 percent year to date we remain cautiously optimistic. Cautious because markets never go up in straight lines, but optimistic because things remain better than what is priced in.

Small company stocks and value stocks are well overdue to come into a cycle of out-performance. With the economy outperforming one would think this is a matter of when and not if. Emerging economy stocks are also attractive and the best managers in this space are doing much better than the indices would indicate.

Bonds once again are overpriced and not likely to perform well. +

» *Continued –*

conditioning ended with personal computers in everyone's homes, just like a young Bill Gates dreamed.

When I was in college, one of my professors liked saying that the economy was stronger than any government. This is what he meant. When a country has historic global competitive advantages and you combine that with booming demographics, policy will be overwhelmed.

That all came to a screeching halt in the 1970s. The rest of the world had caught up, and the baby boom was over. Price controls, which President Nixon thought we could get away with (because it was the kind of thing we had been getting away with), led to one of my most vivid memories of the '70s: gas lines. One hasn't really lived until he has roasted in the sun sitting on the nice vinyl seats in a pea-green Pontiac Ventura with the windows rolled down and the air conditioning off because you were afraid of running out of gas before you could get to the pump...which would happen from time to time and was actually why I was in my sister's car in the first place. I would have to get out and push while she steered, if we didn't make it.

Another memory of that time was the purchase of my first suit. My father took me to a men's store where he bought his suits and introduced me to the salesman who helped him. While I was being measured for alterations my Dad asked our salesman why he was not the manager. He had worked at the store for a long time. The gentleman informed us that he had been offered the role multiple times. He turned it down because the raise that would come with the promotion would put him in a higher tax bracket and he would end up taking home less money.

High tax rates hurt the economy; that means they hurt people, and mostly they hurt people who are trying to move up in the world. They are a hurdle. We finally learned that lesson and in the 1980s, we got tax reform. Thirty years of economic prosperity followed, even though all the outside benefits we enjoyed in the 1950s had long since gone.

Today, we are addicted to low interest rates. The policy disasters which led to the 1970s caused, among other things, high inflation. To finally kill that problem, the Fed raised interest rates. I can remember getting double-digit growth on bank certificates of deposits. Ever since, central banks have been able to stimulate the economy by lowering interest rates…until now. As of my writing, interest rates on German 10-year bonds are negative 0.37 percent and Japanese bonds pay negative 0.14 percent. So if an investor loans money to Germany or Japan for the next 10 years, she will get back less than she loaned them.

Does all of this lowering of interest rates work? The truth is, we don't really know. The Fed claims to have saved us in the financial crisis, but could that have been a false lesson? We don't know what would have happened if the Fed and other central banks around the world didn't lower interest rates to historically low levels, because there are no control groups in economics. What is interesting is that the low interest rates of today are like the high tax rates of the 1950s and 1960s in that their purpose is to fund unsustainable government spending. Then it started as paying for the war and morphed into paying for the "Great Society." Today we are largely paying for the unfunded promises of yesteryear's politicians. Only time will tell, but ultimately it seems like a similar end will have to come.

The market is all for cuts in interest rates, but that very well may be a false lesson.

Warm Regards,

Chuck Osborne

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