THEN THERE WERE TWO

In near every business cycle clues can be found for the next one. No great expertise is needed as it often comes down to the cost and availability of money, the cost and availability of energy and whether the world will likely consume the supply of goods so produced. The latter is reflected in stock prices. Two of the Big Three, currencies and oil, are sending fairly clear signals. Stock prices, sadly, are distorted by current Federal Reserve experiments to save the world and stimulate growth.

These issues have created a pair of unintended consequences and they are the topic of this Quarterly Outlook.

If we look at each of the Big Three issues in turn and, in particular, at the world they are creating, some insights into the nature of the next cycle might be gained.

OIL

Oil is down in price primarily because outside of the U. S. the global economy is still well into a significant slowing and demand remains weak. At the same time, we here in the States are producing enough new oil from shale as to soon become totally independent and thus adding to world supply.

The global slowing will likely continue so long as Europe cannot trigger a recovery. A recovery with sanctions imposed on Russia is near impossible, as Germany keeps trying to tell her neighbors.

China, and thus Asia, faces the burst bubbles of housing and credit, so they are unlikely to trigger a global recovery.

OPEC, the biggest oil-producing consortium, was the straw that broke oils' back. All the forces noted above were in place so that when OPEC said they would not cut production, oil did the only logical thing – in the face of falling world demand and rising world production – it fell in price.

As we run out of cheap oil, there is still a logic to oil not being here at $50/barrel or so. It is still abundant globally, but the easy work to find it is done. A floor, if you will, exists to oil prices and all the comments noted about recoveries and recessions are accomplishing one thing: complacency. Down, and so what, it's all to good effect for us – seems to be the attitude. But not down forever.

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Oil, I think, will trade in this $100 to $40? window to the great delight of traders. The big liquidity pools – pools of ultra-cheap money – levered to play these swings, will begin to dry up as rates move up. In the meantime, plan on complacency from consumers and, I think, significant volatility in oil prices given the variables of pool liquidity, supply adjustments and erratic demand. One measure of consumer complacency is rising gas-guzzler sales, making economy cars cheaper in an effort to sell them. Not helping electric car sales either, I note.

The point is, shale has changed the energy-supply game for the better and, I suspect, for a good long time to come. Many mergers, bankruptcies and environmental issues are yet to come, but shale is not going away. Energy, in a word, is cheaper for the foreseeable future. That is very important to the entire supply chain of goods, transportation, exploration and, particularly, to all the oil by-products such as vinyl and plastics, medicine and clothing. I wrote of shale as a solution a few years back; what I ignored then was that it was a global resource, not just Michigan, my Michigan.

CURRENCIES

One place we surely do not see complacency is in currencies. The drop in the ruble, the Euro and the yen has been fast. Much of the drop reflected the rout in commodity prices beyond just oil. Too many nations are heavily (and often singularly) dependent on their base commodities. Ore to China from Australia, timber from tiny Asian nations, rare metals from Africa – the list is long and their lifeblood is tied near totally to global demand and, particularly, Chinese demand.

Chinese damage here is extensive. Her supercharged, credit-driven growth created false demand models for many of her supplier nations. China tended to “buy it all” . . . buy raw materials well in excess of current need. The tendency to think China would continue to grow at 8% or 9% “for the foreseeable future,” as one Wall Street report put it was, at best, delusionary. We, of course, flooded the world with cheap money and in so doing provided the capital for many nations and firms to expand to meet this ostensibly new level of demand.

The process of trying to meet miscalculated world demand for raw materials led many nations and firms to borrow excessively to expand. The result is now damage to their individual currencies as they devalue them in an effort to keep growing to pay down those loans. The loans were made in dollars in most cases and, of course, the stronger dollar compounds their problem.

The “first world” nations are also suffering. The long-term view for the yen is bad. Rallies will happen, even strong ones, but the trend is still towards 200 to the dollar. The same for the Euro – there is no way to stimulate demand while buried under labor and social welfare laws and programs that discourage investment, discourage growth and only attract the world’s needy as immigrants.

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There is no complacency in currency markets save for ours towards our dollar. The strongest in years, the dollar is viewed by many as somehow recovered from its long cycle of cheapening. I suspect it is primarily reflecting the collapse of all the other major currencies.

This complacency, this new dollar worship, is troubling to me for its lack of fundamentals. In a new Congress, it might be partially justified if some growth-inducing changes take place, but the “if” is the point. I remain cautiously optimistic around the dollar and await confirmation from hoped-for changes in taxation and regulation.

STOCKS

Then there are stocks. Complacency rules. Companies will certainly make more money with the twin drivers of lower energy costs and improving consumer demand. The problem is, much of that is already in stock prices. Stocks have had it pretty good. Massive layoffs, miniscule wage gains, share buybacks and all those games have contributed mightily to rising earnings on darn near zero sales growth. I am certain corporate management is now intensely focused on their lack of top-line growth as they run out of options to boost earnings. They are, by now, aware they are in new territory, know they are vulnerable and know there is little historic precedence or experience they can personally call on.

There are other input costs that management knows are coming and that is adding to their concerns. Yes, energy is cheaper, but wages and interest rate increases lurk in the immediate shadows. I think back to the cash-for-clunkers con job and remind myself that stealing from a “future” to boost a “present” does not change the longer-term trend, be it cars or wages. Today’s CEO knows this in his gut in spite of Federal programs still claiming otherwise.

The interest rate rise, when it comes (sooner than June), will raise the discount rate investors apply to future stock earnings and prices. Not a lot, but a drag, nonetheless, and a drag on corporate earnings. They know that, too.

In the face of fully valued companies facing at least two rising internal costs we have investor complacency. We have complacency to currency issues beyond our shores and complacency toward the impact of lower oil prices on poor nations (with a bit of “so there” to the terrorist nations and their bankers).

We can make a few conclusions. If you wish to invest in collapsed emerging or secondary stock markets because they seem cheap you should, simultaneously, currency hedge. One assumes such investments are just that and not trades.

If you wish to play in the oil-price game, I wish you great luck. If you think Europe is on the road to recovery, well, you haven’t been paying attention to the Signals at all.

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Speaking of Signals and the possibility they are real, what can we conclude? To my mind, the Signals of investor complacency are valid, the Signal of expanding currency wars is valid, the Signal that oil is range-bound is valid and the particular complacency Signal from most firms that their existing business models will suffice is valid. Suffering has already begun in the solar energy space, the ethanol-as-fuel space, the windmill space and, sadly, in the use of nuclear power as a long-term solution. Suffering will spread.

AND SO? Which gets us all exactly what? The end product of all the new shale output, cheap money, massive overcapacity, devaluation of currencies and collapsing commodity prices is, simply, deflation. That is the current critical element. It's in pockets, not yet universal, as California home prices demonstrate: New highs in Silicon Valley and still down in Fresno. We have some deflation in gas, not so much in packaged food; some in clothing, not so much at the high end. Prices are very much range bound, though. The point is that deflation or its precursor, price stability, has also set the stage for, of necessity, radical change. This pair of economic trends, price stability and price deflation, defines the moment.

To pause for a moment, I think it important to ask just what is so bad about price stability? Japan has had years of it, and deflation, too, following her boom cycle. That boom, by the way, far exceeded any we have seen in the last 30 or 40 years.

Japan, however, prevails. Standards of living are high; there are no shortages of core items like food or energy. It's not pure price stability, it drifts lightly to deflation and it is disturbing if you are trying to grow as they are. Her solutions to growth, though, do not come from inflation as she is discovering. Inflation, in fact, gets you far worse. You get shortages. You get price hikes on the hour. You get hoarding. You get neighbor against neighbor. In deflation, you get inconvenience. You have to pay your debts with deflating dollars – good for the bank, bad for you. Japanese citizens know all the good and bad of this; we are learning it.

The brutal discovery is how disruptive deflation is on the business struggle for profits. Deflation opens many new doors, induces many new business models. As established firms and industries struggle for profits, struggle to find a way to grow, to survive, they become vulnerable just in the trying. They are at greater risk of losing suppliers, of losing credit lines and, most critically, of losing key employees. These employees, who see a different way for their firm or industry, are tired of minimal wage gains. They often see their firm from the shop floor better than their managers. They are the feedstock to all the new firms being created. These losses, and so many more we could list, are what make the firm vulnerable. For a bit of proof of their genuine concern we need look no further than their manipulation of "profits" in share buybacks and borrowing to pay for stockholder quiet with larger dividends.

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We had grown weak prior to 2007-2008. We did not have broad economic stress, we had far less anxiety and, accordingly, no ongoing impetus to change the way we did business. We frankly thought most every "good" firm could weather recessions and move on.

Change, therefore, was not likely. Oh, it occurred in bits and pieces, but the very idea of change can do two things – make what is even more entrenched and ultimately less relevant, or change can improve the situation. Many firms became more entrenched in what they were about. *They confused sensitivity to events, which is how they saw it, to vulnerability to events, which many missed*. They thought that the firm (or the economy) was but a slightly complex machine to be managed.

Then came 2007-2008 and stress and anxiety and diminished confidence and, as the prior text laid out, today's world of nascent deflation.

The business world can no longer resist change as it did – accepting it now, perhaps from desperation, perhaps from exhaustion, perhaps from the insight of hard experience. Change will now come as the unintended consequence of deflation.

What change, what disruptions seem likely? Where will new businesses, new profits, come from? A new phone? A self-driving car? TV wherever you wish? Doubtful, very doubtful. No, we have set the stage first for disruptive change to core industries. The new kids on the block are Deflation and Price Stability.

I am thankful to Catherine Wood, a long-time friend and student of Art Laffer, for the thought line that follows. It is the very nonlinear result from the trauma of the last 6 or 7 years. I call it nonlinear as opposed to traditional "evolving" business responses – these changes are revolutionary, not evolutionary. Traditional measures of economic activity do not pick this up.

To many observers, auto sales and housing are the most visible indicators of core economic health.

But what happens if sharing services like Zipcar or UBER grow to, say, 2.5% to 5% of all household car usage? Auto sales fall and in 5 years are closer to 8 million units annually versus the current 16-17 million. This would occur in spite of a much better economy. Where did THIS come from? Who sensed what weakness? Was it no wage gains again? Perhaps boring products? Maybe the taxi as a rolling slum? In any case, we now have a

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major alternative to existing car-sales/taxi-industry business models. The likely trigger? A decision by consumers made during the last 7 years of debt reduction to husband scarce resources – to spend less, to save more.

Often two cars are the result of moving to the first home in the suburbs. Rethinking that is the issue – why two? The current cost to own and operate a personal car is about $0.76 per mile. This includes gas, depreciation, financing, parking, insurance, maintenance, taxes, registration and tire replacement.

Household vehicles appear more and more to be stranded assets. High cost, but used 4% of the time on an average 24-hour day. Various studies show sharing services increase utilization 8- to 12-fold. You may find sizeable savings by just calling UBER. Cars may well grow cheaper in response . . . but don't hold your breath . . . see prior about change.

In any case, transportation as service, not status, is the point. And a secondary result is parking. If shared vehicles became the choice for, say, 60% of the personal vehicles out there over, say, 20 years, that would free up roughly 740 million parking spaces, lots, municipal garages and the like. At today's values, that's some $13 trillion in real estate available to repurpose. Ironically, here in California, near every garage is already another use – we have no basements – but nationwide, garages alone become an interesting subject. Home ownership is also to be explored as renting becomes more attainable.

Municipalities would lose parking fees – but gain revenue from the sale of municipal lots and, utlimately, gain real estate tax income when they are repurposed.

Then there are robots. Oxford University did a study that suggested roughly 47% of all jobs in the U. S. labor force will be automated over the next 10 to 20 years. This will greatly increase productivity, but leave a significant need for education and retraining. Automation will lead to a double in output per worker – a serious game changer when the additional near $12 trillion in GDP growth is created. I suspect this trend grew out of the firms' need to manage out of control pension and medical expense, as many have suggested.

Who gets the benefits, the savings, becomes the question. The potential for both higher wages for the skilled and lower prices for the consumer exists. Here, in particular, the power of price stability or slight deflation is driving decision making that was not needed when inflation gave the firm room to increase prices. Now the pressure for profits is pushing an entirely new, faster level of automation where before it was fundamentally optional. The point? Growth with technology at a far, far higher level than before and yielding more income and tax revenue spells reduction of our debt load and potentially higher stock valuations. The efficient survive . . . to our benefit of lower prices.

The strongest marriage of technology and science is in health care. Not digital doctors' records or cloud-based patient histories, but the human genome.

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Sequencing DNA is slowly unlocking the secrets and course of illness and death. The time to sequence a single human genome is collapsing. Less than 10 years ago, sequencing one human genome cost $10 million and several months. Today, the cost is about $1,000 and one day on a computer.

So far, only 40,000 or so human genomes have been sequenced since the first whole one was done in 2000. By 2020, estimates are that some 50 million will be on file. Add another 5 or 10 years and the majority of humans on the globe will have been sequenced.

With health care at 17% of GDP and rising aggressively, the ability to detect and determine what disease risks an individual faces over their lifetime (and drug-related side effects) will greatly improve both disease management and disease prevention. The impact on rapidly-accruing unfunded retirement medical liabilities will be positive. Longer lives will also further aggravate underfunded pension plans to the ultimate elimination of defined benefit programs and increased personal responsibility to provide for retirement. Financial service models have barely begun to solve this issue in a mutually beneficial manner.

Of all the industries facing radical change, banking may be both the largest and the most vulnerable. The industry has not changed its business model for nearly a century, is viewed as “needed but not liked” and is considered, sometimes unfairly, to be rapacious. Consumers face ATM fees rising, transaction fees of 2% to 5%, maintenance fees and, in the case of Western Union, an 8% fee for remittances.

Then, rather quickly, the concept of cryptocurrencies arrived and their charges are next to nothing. Yes, it’s early and bitcoin muddied the waters badly, but the idea is here to stay. Companies like Dell, DIRECTTV, Overstock and Expedia now accept cryptocurrency payments. Think electronic currency, not the daily trading value of bitcoin.

The impact on bank-deposit growth, bank lending and even Federal Reserve Monetary Policy is just beginning to be seen. Cryptocurrency, unlike Fed monetary policy, has limits to its creation because that is critical to both its security and usefulness. As we all know, the Fed is free to do as it sees fit – grow or shrink dollars, incur debts that are mitigated by new dollar printing and so on. The cryptocurrency world is controlled by its users who, by their use or lack of use, establish the validity of the medium. It is in all users’ best interest to maintain the core value the transactions are based on. If it sounds like the attributes of gold, you are beginning to see its potential.

To quote Ms. Wood:

> “The tech and telecom bubble got one big idea right: General purpose technology platforms were going to “converge” and have a major impact on every economic sector, changing the way the world works. The idea was right . . . but 10 to 15 years too early. The broadband build-out was egregious, (*for example: Ed*) but the collapse in pricing . . . laid the foundation for cloud computing . . .

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> Not only will these disruptions change the relevance and meaning of economic statistics (*productivity: Ed*.) that policymakers use as guides, but they might change the course of government policy. <u>What the bubble mindset did not contemplate was the potentially profound impact that declining cost curves and algorithms might have on fiscal and monetary policies around the world</u>." (Emphasis added)

From the struggle for profits came price wars up to and including the very currency each nation uses. The lack of inflation has forced existing businesses to either radically change their operating model or close their doors. Next will be small countries, then radical change in large ones, as Japan has begun.

In this country, long existing industries, from taxicab consortiums to banking, from carmakers to insurance companies, are now facing price and service competition, satiated consumption of existing products, a bias against consumption for its own sake and customer product disenchantment at the very time they are seeing earnings flatten. One might conclude this perfect storm of events was fueled by the American consumer who, wiser and alarmed by the last 7 years, has changed consumption habits in a very fundamental way.

Deflation has been the encompassing word. It has become a trigger for new industries, new providers, new services. Once again, all economic activity has both long- and short-term consequences. This is but the latest. To the nations with entrepreneurs, a can-do attitude and a belief in tomorrow will come the spoils. How can you not be optimistic for this nation in a time of great change? More to come . . .

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