September Commentary

Lead, Follow, or Get Out of Your Own Way

If anyone had been lulled into a sense of complacency because the market was humming along so nicely, I can only imagine that last month got their attention. After seven straight months of positive returns for the stock market, was it too much to ask for just one more? Apparently, it was. After a mostly uninspired market for much of September, investors “gave up the ghost” in the last week of the month as the S&P 500 had a -3.30% total rate of return. It felt like cleaning up and taking out the garbage after a successful dinner party, only worse. So, what happened? Would it sound crazy if I said complacency was a contributing factor and that investing had become too easy?

From October 2020 through the end of August 2021, the S&P 500 returned over 40%, experiencing only one monthly swoon in January of this year. The Federal Reserve was busy flooding the financial system with liquidity, the Treasury was spending money it did not have, interest rates hovered near rock bottom levels, and investors did the most prudent thing: they invested in stocks. As I have written in previous newsletters, U.S. stocks are the most reasonably valued of all overvalued asset classes. If that is true, then why did the markets react so irrationally last month? We can surmise there were a few reasons: the Fed potentially tapering their asset purchases, the mess with Evergrande in China, delays with the massive infrastructure package, continued dysfunction in Washington, slightly softer (but still strong) economic data, to a myriad of other “worries.” There were a lot of potential cracks in the wall of worry, that is, if you are prone to worrying.

“Worrying is like a rocking chair. It gives you something to do, but doesn’t get you anywhere.” – Erma Bombeck, American humorist and writer.

With that in mind, have you ever been in a situation where everything seemed easy, perhaps a little too easy? You were in the zone and a little too comfortable? You know that round of golf where you did not make any mistakes? Me neither, but stick with me. That trip to the casino where you could not lose. A game night with family or friends where you dominated every game. There are countless examples, and the one thing in common among them all: you were not worrying, questioning your good fortune, or overanalyzing why it was happening. That is, until you started doing so, and what happened next? Things were not quite as easy, were they? You somehow managed to get in your own way and mess things up!

I do not consider myself much of a worrier; however, as I have shared in past issues, I seem to have a fair number of opinions about myself with which others do not necessarily agree. So, discounting my flawed self-assessment history, it is most likely that my wife passed the “worrying” trait to one of our sons. He has told me on one occasion that he worries about messing up while attempting various tasks. So, being a good parent and looking for another fleeting opportunity to prove my worth as his dad, I ask him what normally happens when he worries, and his answer usually proves prophetic. His worrying about the "flawed" outcome often comes to fruition. My fatherly admonishment: "stay focused on the process and forget about the results." However, too often my non-parental machismo kicks in and I smugly ask, "So, why do it? What did worrying get you?"

"A day of worry is more exhausting than a week of work." – Sir John Lubbock, renowned British banker.

The question you might be asking yourself while reading this is: "are you honestly saying that worrying was the reason the stock market took one in the shorts in September?" Indeed, that is exactly what I am saying. I believe investors began worrying things were going too smoothly and that led to the sell-off. After all, what fundamentally changed in the U.S. economy or markets during September to cause a 4.65% drop in the S&P 500? The Fed did not start tightening credit, the yield curve did not invert, the cash market did not stop operating efficiently and economic data did not fall off the proverbial table. So, what has fundamentally changed in the markets, financial system, or the economy to warrant such a bad month? The answer is simple: absolutely nothing. Moving forward, the current earnings season is extremely important and will likely set the tone in the market for the remainder of the year. Because of this, we are setting aside last month's pullback and focusing on making money during the remainder of the year. Hey, if we liked stocks before September, we must really like them now, right?

Is Capitalism That Bad?

Last month, as part of the proposed Infrastructure Bill, House Democrats are asking for an increase in the top corporate tax rate from the current 21% to 26.5%. Supporters have been quick to declare these new higher rates remain well below the 35% level in place prior to the Tax Cuts and Jobs Act enacted by the Trump administration. The rationale for these tax increases is that Congress desperately needs the additional revenue to pay for all the money it has spent and intends to spend moving forward.

As with just about everything in life, someone will get stuck with the bill, and I am afraid that someone will be you and me. Aspiring academics in philosophy departments in countless Ivy League universities might think the big, bad corporations will bear the brunt of these additional tax costs, but that is simply not the case. Who really thinks company owners and stockholders will simply shrug their shoulders and accept lower profits and a sharp decrease in earnings? I am 100% convinced they will not.

Let me pose this simple question: is a company (or a household) better able to control its revenues or expenses? There is only one logical answer: expenses. After all, if companies could control their revenue, they would simply always grow their top line faster than the bottom line. Easy peasy lemon squeezy, right? Wrong. Companies post losses, declare bankruptcy, and even go out of business quite often because their revenues do not match, much less exceed, their expenses. I may not be a business owner, but I know it is much easier to control household spending than it is to increase take-home earnings each month. Controlling household spending is as important, right, honey?

It seems quite logical then, if the proposed changes to corporate taxes take effect, most corporations will simply tighten their "expense" belts. This is not a guess; it is a promise. Businesses are no different than individuals in this regard: the more the government takes, the less they have to spend on or for themselves. It is not terribly complicated. With this likelihood as a backdrop, CFOs around the country will need to get creative in order to make up for this lost money because of higher taxes. These dollars must come from somewhere and you can be assured it will not come from the pockets of company shareholders. If shareholders need and expect to get a 10% rate of return, then 10% is what they will demand. And believe me, that does not mean a 10% return minus the increase in Federal income taxes. You can call this greedy if you want; however, that does not make it any less true. Think of it this way: If company A does not generate the necessary earnings required of shareholders but company B does, guess where investors money will flow? Everything else being equal, I will give you a hint, it is not company A. If we are being perfectly transparent, do any of us want to earn less on our investments because the Federal government has managed to amass a mountain of debt that is $28.4 trillion high, and now wants even more money?

"You cannot negotiate with people who say what's mine is mine and what's yours is negotiable." — President John F. Kennedy.

I would like to end this month's issue with a portion of the transcript from an interview that Nobel Prize recipient and renown American economist Milton Friedman did on Phil Donahue's daytime talk show back in 1979:

Phil Donahue:

"When you see around the globe the maldistribution of wealth, the desperate plight of millions of people in underdeveloped countries, when you see so few haves and so many have-nots, when you see the greed and the concentration of power, did you ever have a moment of doubt about capitalism and whether greed is a good idea to run on?"

Milton Friedman:

"Well, first of all, tell me, is there some society you know that doesn't run on greed? You think Russia doesn't run on greed? You think China doesn't run on greed? What is greed? Of course, none of us are greedy. It's only the other fellow who's greedy. The world runs on individuals pursuing their separate interests. The great achievements of civilization have not come from government bureaus. Einstein didn't construct his theory under order from a bureaucrat. Henry Ford didn't revolutionize the automobile industry that way. In the only cases in which the masses have escaped from the kind of grinding poverty you're talking about, the only cases in recorded history are where they have had capitalism and largely free trade. If you want to know where the masses are worst off, it's exactly in the kinds of societies that depart from that. So that the record of history is absolutely crystal clear that there is no alternative way, so far discovered, of improving the lot of the ordinary people that can hold a candle to the productive activities that are unleashed by a free enterprise system."

Phil Donahue:

"But it seems to reward not virtue as much as the ability to manipulate the system."

Milton Friedman:

"And what does reward virtue? Do you think the Communist Party Commissar rewards virtue? Do you think Hitler rewarded virtue? Do you think American presidents reward virtue? Do they choose their appointees on the basis of the virtue of the people appointed or on the basis of their political clout? Is it really true that political self-interest is nobler somehow than economic self-interest? You know, I think you're taking a lot of things for granted. Just tell me, where in the world you will find these angels who are going to organize society for us."

Interesting, isn't it? Over 40 years later and we are still having the same debate about which economic system is best. The more things change, the more they stay the same.

Until next month, take care and be sure to check out our First Forward Podcasts at FirstAmBank.com.

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