Basis Points – September 13, 2018

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Above the Fold

- Warren Buffett spoke yesterday on *CNBC*. The network is commemorating the 10-year anniversary of the Lehman Brothers collapse, which is seen by most as the seminal event in the Great Financial Crisis of 2008. While Buffett does not see specific signs of a new asset bubble that is ready to pop at this time, he noted that another financial crisis is inevitable at some point. He stated, "Well there will be one sometime, due to human nature, jealousy and greed. People start being interested in a stock or sector because it's going up, not because they understand it or anything else. But the guy next door, who they know is dumber than they are, is getting rich and they aren't. And their spouse is saying, 'Can't you figure it out too?' It is so contagious. So that's a permanent part of the system."
- A time-honored metric that market strategists use to gauge the internal health of the current stock market is by looking at the transportation sector stocks. The health of economic growth can be measured by looking at the companies in the railroad, air freight, trucking and airline industries. These companies have their fingers on the pulse of the economy, and their data can show how actual products are moving around the country and the globe. The Dow Transportation index measures these important industries, and the index hit an all-time high this week, indicating broad strength in all these transportation areas. While not a perfect indicator, rarely does the market see a major top when the Transports hit new highs.

Three Things

- Does strong sector performance tend to persist? Fundstrat reviewed S&P 500 sector performance since 1926 to see how the three best-performing sectors through the first eight months of each year performed in the last four months of the year. They found that sector performance does persist into year end. If you bought the best three sectors year to date through August 31, and held them through the end of the year, these sectors outperform the index as a whole by 150 basis points. Conversely, if you bought the three worst-performing sectors through August 31, those sectors have continued to lag the market by 60 basis points through the end of the year.

- We have noted before that growth in wages for workers like we are seeing now is a positive development, as U.S. workers have seen stagnant pay growth over the past decade. Also, when consumers earn higher incomes, they tend to spend that extra money, which is great for overall economic growth. But how much is too much? The Jobs report last Friday showed that wages have risen 2.9 percent over last year. We know from the past that economic growth is not hurt until wage growth hits a 4.0 percent rate, so we have a ways to go before it is time to worry about rising costs for corporations. In fact, since 1965, when wages have grown in the range of 2.77 percent to 3.23 percent, 12-month forward S&P 500 returns have averaged 15.2 percent, and have been positive 92 percent of the time.
- Small business optimism continues to surge. In August, the small business optimism index jumped to an all-time record at 108.8. Plans to increase employment also climbed to record highs, while plans to make capital expenditures over the next three to six months rose to the highest level since 2006. Inflation pressures seem to be leveling off, as the percent of small firms planning to raise prices remained steady, and only 2 percent of firms cite inflation as the single-biggest problem for their business.

Did You Know – You Can't Make This Stuff Up

A tariff is a tax that a government charges to its own domestic companies when a product is sold that is imported from another country. The amount of the tax is then typically added to the price of the product when sold to the end consumer. The government receives the tax money from the tariff, and the end domestic consumer pays that tax. In theory, tariffs protect domestic industries as the tax causes the end sales prices of imports to be more expensive relative to domestically produced goods. The actual effect of a tariff, however, is that the benefits of tariffs accrue to a small group (the domestic manufacturer) at the expense of a large group (the end consumer who must pay more for the good).

A good example of this winner and loser offset was seen earlier this year when the White House imposed tariffs on washing machines made in Asia by Samsung and LG, and then sold in the United States. Whirlpool, a U.S. company, was in favor of the tariffs, as it would make competing products more expensive, so Whirlpool would then benefit from higher sales. This is typically not the result of a tariff, however. Let's say that a Samsung washer/dryer sells at Home Depot for $950 and the Whirlpool version sells for $1,000. After a $100 tariff, the Samsung product would then sell for $1,050, so Whirlpool should win that price battle. However, in the real world, Whirlpool would then also raise its price win that price battle. However, in the real-world, Whirlpool would then also raise its price to $1,050, to increase its profit margin. So, the only loser in the end is the consumer. A small number of workers at Whirlpool would benefit, due to presumably higher sale prices. However, the American consumer would pay the price, as washing machine prices for all sellers would rise by the amount of the tariff. A small group of people with a strong lobbying voice wins, while a large group of consumers with no voice and no large incentive to complain, loses.

Which brings us to the U.S. steel industry news this week. The steel lobby has had a powerful voice in D.C. for 75 years, and has always lobbied for tariffs on imported steel, to protect its place in the global market and its workers' jobs. Earlier this year, the White house slapped tariffs on foreign-produced imported steel, to protect domestic steel worker jobs. The resulting tariffs have increased the price of steel 30 percent for all its end users, such as Deere tractors, Carrier Air Conditioners and Boeing planes. Steel workers gained as they have kept their jobs, while the end consumers have paid higher prices for all goods made from steel. This week, workers at two of the biggest U.S. steelmakers are threatening to go on strike. They are demanding higher compensation from the steel companies, who they say are benefiting from the higher steel prices that the tariffs have made possible. Steel factories have added workers this year and have made higher profits from raising prices after the tariffs went into effect, and the steel workers want some of the spoils. The workers who may not even have jobs without the tariffs now want higher pay for these jobs due to the benefits to their employer *from* the tariffs. The steel unions have authorized a strike this month if an agreement for higher wages is not reached soon.