COHO PARTNERS, LTD.
Economic Commentary

Third Quarter 2019

"Moreover, it is just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress."

--Alan Greenspan, 1998

We enter the final quarter of the decade with a greater panoply of global and domestic events of consequence, some self-inflicted, than we have witnessed since the financial crisis. Quickly decelerating global growth exacerbated by tariff and trade wars; the continuing Brexit saga; heightened geopolitical tensions with Iran and North Korea; pro-democracy protests in Hong Kong against mainland China are now combining with an impeachment inquiry into President Trump that further threatens what remains the longest economic expansion in U.S. history.

The growth rate of the U.S. economy is losing speed. The question becomes can the economy engineer a soft landing and wobble around growth in the 1%-1.5% range while avoiding a recession. In aviation, stall speed is the slowest pace that a plane can fly while still maintaining a level flight. The economic equivalent is when growth in the economy is no longer self-sustaining. With the manufacturing, agricultural and even transportation industries either in or entering a recession, fully 20% of the economy is contracting.

Whether this elongated expansion can continue will likely depend upon the U.S. consumer continuing to maintain a pace of spending that offsets the slump in these areas and increases confidence in the business community to continue investing and hiring. But due largely to the effects of the trade war, that confidence is plummeting, and businesses remain extremely wary of investing in the face of escalating trade tensions.

In early October the most recent 3Q CEO Confidence Index from the Conference Board was released. As the chart below from Pictel Asset Management shows, the index declined nine points to a level of 34, the lowest reading since 1Q 2009.

The index had peaked at 68 in 1Q 2017 during the early enthusiasm for the policies of the Trump administration. That has reversed. CEOs indicate they have curtailed investment and expect the trade war will have a lasting impact on their businesses. This is consistent with an expected further decline in capital expenditures through 2020 and a likely decline in corporate profits.

Wikipedia defines game theory as the study of mathematical models of strategic interaction between rational decision-makers. Attempting to apply this to the current conflict between President Trump and President Xi Jinping would logically suggest that as we approach the election season of 2020 in the United States, the motivation of our administration would be moving towards an agreement. But the strength of our hand may have changed recently from the one that seemingly emboldened our administration in early 2018.

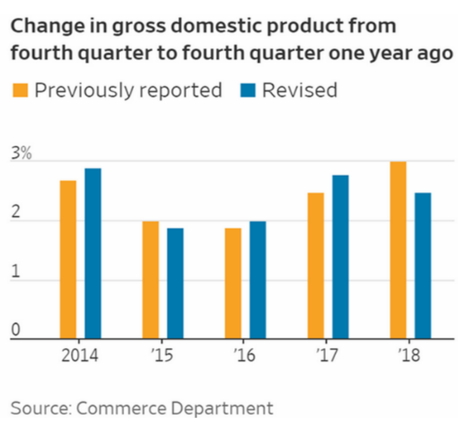
Hu Xijin is a Chinese journalist and editor of the Global Times, a state-controlled newspaper in the People's Republic of China. On the morning of October 3rd, he tweeted the following: "US economy is not as promising as the White House brags. With no huge untapped potential, no major science/tech innovation in recent years. Its exuberance has been built on fragile balance of financial game, but it still launched a trade war. More terrible consequences will come."

China may smell rising desperation in Trump with the impeachment inquiry accelerating and recent data confirming a manufacturing recession amid a slowing economy. We have become less optimistic on such a resolution and certainly one with substance. It is becoming more likely this is not just a trade war but rather the early stages of a new, and potentially long, cold war. Much of the administration wants to contain China economically and ensure the place of the United States as the dominating power in the world. We are not sure that China can compromise here so an empty trade deal is possible but not likely one that would limit the goals of each country. The battlefield of the new cold war appears to be technology and it is hard to see compromising positions on each side.

UNITED STATES:

Before updating the more contemporaneous data on the economy, it is helpful to review the base from which this growth is from. Major revisions by the Bureau of Economic Analysis (BEA) to a lot of critical economic areas paint a different picture of recent growth than had been previously assumed and depict a slowing pace of growth that commenced earlier than previously understood.

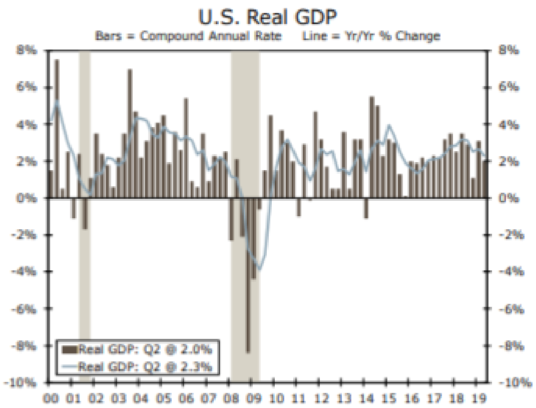
Gross domestic product (GDP) was revised from 2014 through 1Q 2019 in late July with the most recent 2018 growth rate lowered from the administrations target of 3% to 2.5% due to lower business investment and exports than had previously been estimated (see annual revisions on chart below).

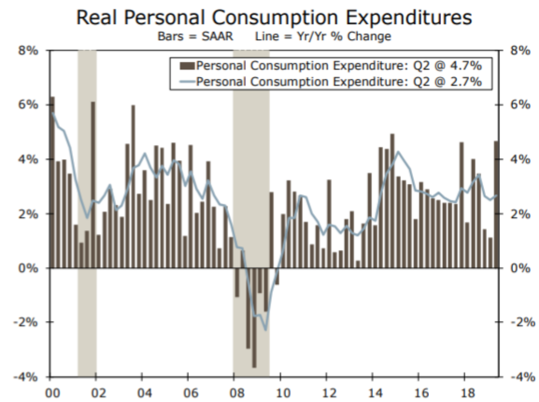


This is the same growth rate that the economy enjoyed for the entire period 2013 to 2018 and compares with a 2.3% average growth rate for the decade-long expansion. By contrast the previous expansions from 2001-2007 and 1991-2001 achieved rates of growth of 2.9% and 3.6%, respectively.

The final reading for real GDP in 2Q was a gain of 2.0% at an annualized rate (a/r) bringing the year-over-year growth rate to 2.3% continuing the slowing the economy has witnessed since the apex in annual growth in 2Q of 2018 following the peak impact of the tax cut (see charts below from Wells Fargo).

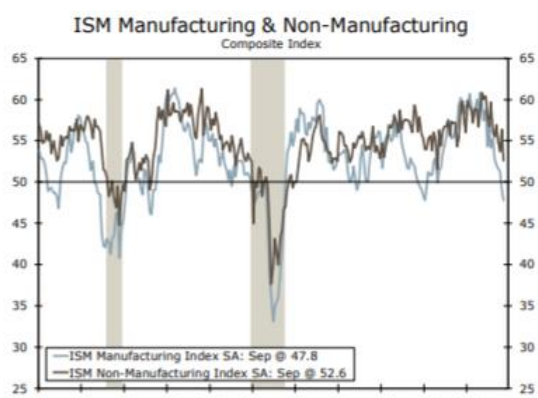
Showing the critical role the consumer continues to play in economic growth, personal consumption expenditures were revised higher to a whopping 4.55% annualized pace, which is the fastest pace in four years. In short, the PCE data show that the American consumer is alive and well, at least through most of the first three quarters of the year.





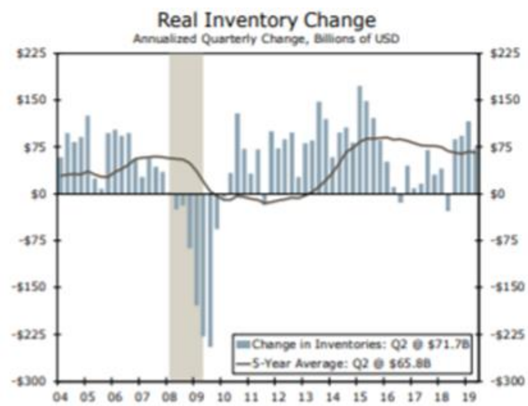
Though much of the economic data has been slowing, the most alarming has been from the manufacturing sectors. Though trade rhetoric may have been turned down a notch in September, with both China and the U.S. offering up certain tariff exemptions and announcing the resumption of trade talks in October, it was perhaps too little, too late. The surveys from the Institute for Supply Management (ISM), an association with over 50,000 members in over 90 countries that does monthly surveys to assess the state of manufacturing and services in our economy reflect a deepening concern.

The reading on manufacturing for September showed virtually all subcomponents below the level of 50 (indicating contraction) with the headline number to 47.8, the lowest level since June of 2009. While many continue to correctly note that manufacturing is no longer as large a component of our economy as decades past and only accounts for about 12% of GDP, there are second level impacts such as transportation (someone has to move the products) that increase the negative impact on growth and employment. As of now, this pullback is consistent with a slowdown in the broader economy and not yet at the level indicating recession which generally is in the 45 area. Trade concerns remain the dominant issue with export orders falling to a new cycle low of 41, a level only breached in the last 30 years during the 2008-2009 crisis. (see blue line on the Wells Fargo chart below which shows both the manufacturing and services readings)



Services are now the bulk of our economy and the August reading of the non-manufacturing ISM of 56.4 gave false hope to this area remaining quarantined from the manufacturing downturn. That was quickly dispelled with the September release showing a drop of 3.8 points to 52.6, a three-year low. Of greater concern was the reading on the subcomponent employment index dropping to 50.4 the lowest since 2014. A potential slowdown in hiring inserts some fragility into the outlook for consumer spending as labor income looks at greater risk of slowing at the same time consumer confidence has wobbled. The risk of factory weakness spilling over to consumer spending and the service sector continues to rise. Not only is hiring slowing, but consumers are facing modestly higher costs and maybe more as tariffs are set to hit many consumer goods over the next quarter.

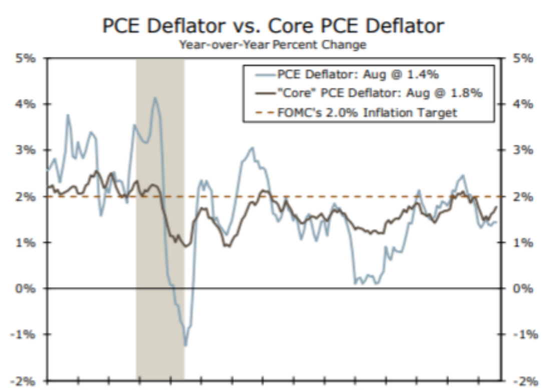
Inventories are a critical input into the GDP calculation based on the rate at which businesses add-to or draw-down capital stock. It is calculated not at a level but rather the increase versus the prior quarter. Therefore, even if inventory growth is positive, it can still detract from GDP growth if less positive than the prior quarter. These are notoriously difficult to forecast and are subject to large revisions. We note this as the largest quarterly inventory changes of the past three years occurred in each of the past four quarters (see chart from Wells Fargo below).

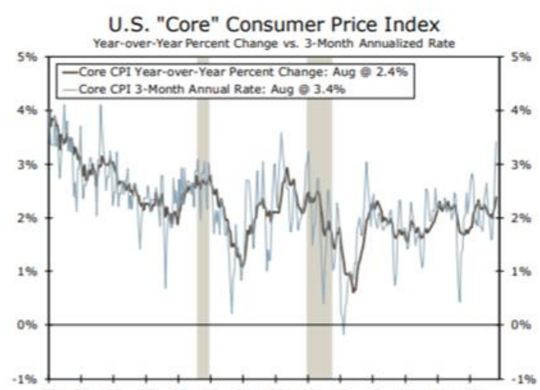


There’s a case to be made that the recent build is at least in part intended and not due to burgeoning demand, as the escalating trade war over the past year may have led businesses to stockpile in anticipation of supply chain disruptions or higher input prices. Even without a major decline in consumer demand, the stage is set for inventories to act as a drag on GDP growth over the next few quarters. The consumer is critical here and the pace of hiring and wage growth may dictate the direction of consumer spending.

INFLATION:

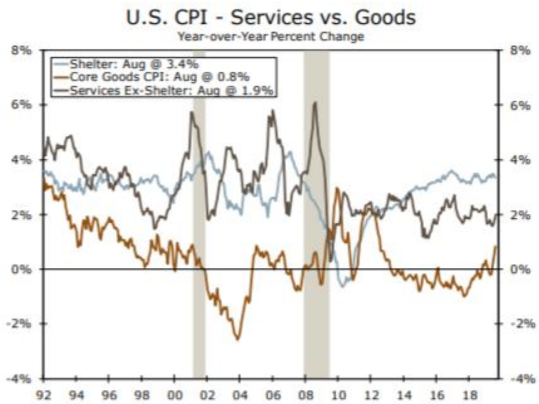
The Fed’s preferred measure of inflation, the core PCE deflator, continued to rise with the most recent reading for August up to 1.8% on a year-over-year basis approaching the long stated 2.0% target (see charts below from Wells Fargo).





Looking at the more popular metric for inflation, the Consumer Price Index (CPI) for August, prices excluding food and energy rose 0.3% for a third consecutive month, pushing the three-month annualized pace of core inflation to a 13-year high of 3.4% and 2.4% over the past 12 months. As we had noted in our prior commentary, inflation is clearly firming on a cyclical basis.

One of the primary reasons for the recent increases in prices stems from the reversal of the disinflationary impact of core goods prices that increased again in August and are now up 0.8%y/y, the largest one-year gains since 2012. Very little of this increase is likely due to tariffs on consumer goods coming from China as this rising trend of core goods prices started in late 2017 (see chart below from Wells Fargo). With services inflation consistent around 2% we continue to expect inflation to elevate modestly over the next quarter.



The drone attacks on Saudi Arabian production facilities in the second week of September brought oil back into the spotlight spiking both Brent Crude and WTI over 10%. Prices through the end of September (as about 75% of production came back on-line) returned close to the previous levels and we have seen little impact on overall inflation readings. While that price bump may have been temporary, this event brings geopolitical risk for oil prices back into the equation.

While consumers have been spared in the early rounds of tariffs, there is increasingly less scope for companies to absorb tariffs as rates climb well into double-digits and more consumer goods from China become directly exposed. As a result, consumers could face a dual hit to real spending power with tariffs beginning to push up core inflation, while energy is no longer a source of disinflation.

THE FEDERAL RESERVE:

The dual mandate of the Federal Reserve established by the U.S. Congress is to maximize employment alongside the stabilization of prices (inflation). With the current unemployment level plumbing near 50-year lows, the narrative has long shifted to moving prices higher towards the 2% target.

We noted above that the two most common inflation indicators, the CPI and PCE are either above or within shouting distance of the desired levels. In fact, a very good argument is made by Peter Boockvar of the Bleakley Group that the method by which inflation is calculated is dramatically understating the impact of rising prices on consumers.

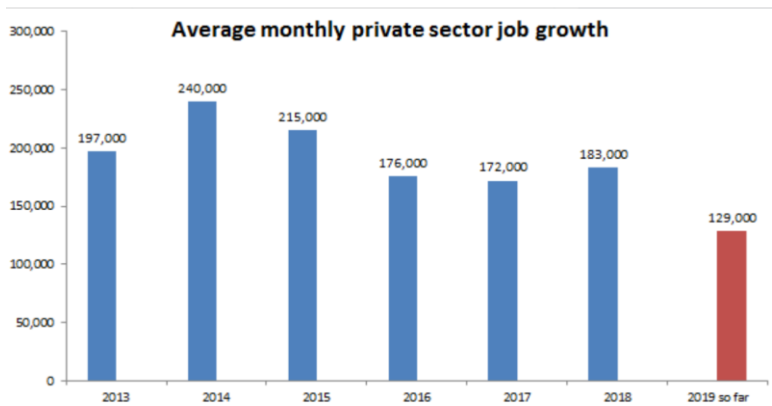
The government employs hedonic adjustments to the inflation data to attempt to capture the improved safety and technology features that may then offset any actual price increases. There is little question that new autos, for example, have features that cars of only a few years ago did not. According to the CPI data, the total price increase for a new vehicle over the last five years has only increased 0.6% while automotive resource company Edmunds notes the average price of a new vehicle has increased 14% over that time frame. While there is little doubt that the consumer gets more car, the fact is the purchaser pays the higher price.

With both employment and inflation basically under control, the focus of the Fed appears to have morphed to concerns of the inter-connectedness of the global economy and mitigating the impact of the ongoing trade war and China's slowdown to Europe's seeming descent towards recession. The two recent rate cuts may be more about the positive second-order effects that a rate cut may have to jump start global economic activity rather than the direct impact on the U.S. economy.

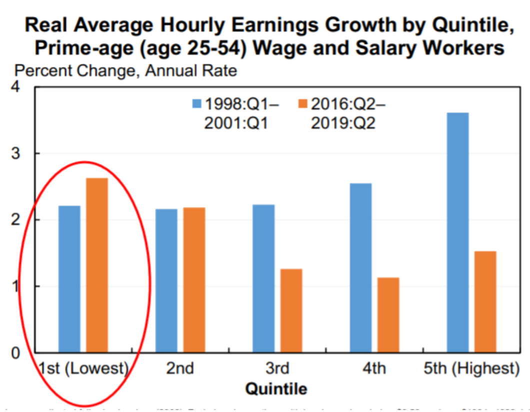
Global monetary authorities are clearly walking a fine line between protecting the economic expansion and trying to promote asset bubbles. Their actions indicate a greater concern is in preventing an economic downturn and we now look for two more rate cuts in both October and December.

EMPLOYMENT & WAGES:

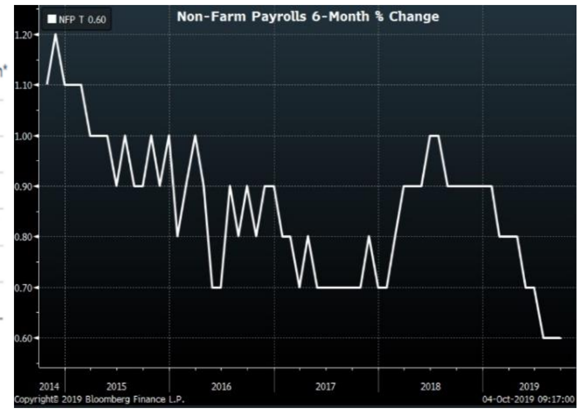
Employment and wage growth will continue to be a critical measure to watch in determining the extent of the economic slowdown. Following some dramatic declines in the employment components of the ISM Manufacturing and Services surveys, the markets breathed a sigh of relief with the release of the September nonfarm payrolls report. The unemployment rate fell to a fresh 50-year low of 3.5% and we are currently in the midst of an incredible 108 consecutive months of jobs growth, the longest such streak in history. Though clearly slowing, the extent of the softening was muted with the 3-month average of private payroll growth (removing the temporary impact of Census hiring by the government) at 119K from a 2019 average of 129K (see chart below from Trending Economics). Still, this level remains way below the 2018 average of 183K private payroll jobs but depicts an economy where growth is downshifting but not collapsing.



Though average hourly earnings disappointed with a 0% monthly increase and a decline to a 2.9%y/y pace, the wage gains that we are seeing are inuring to the lower income quintiles that have a much higher marginal propensity to consume. The chart below from the Kennedy School of Government compares the wage trends for the prime-age cohort in orange over the last three years versus a three-year period during the stronger economic expansion of the late 90s. Wages are clearly benefitting the lower income quintiles.



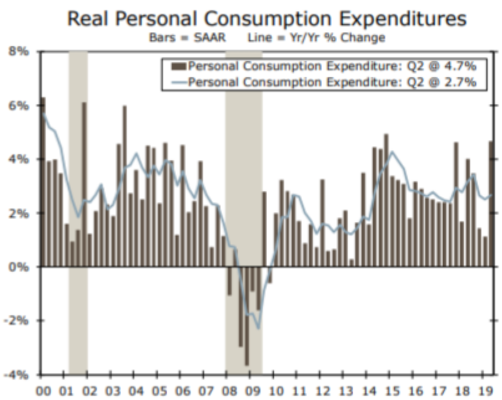
However, these measures of employment are lagging indicators. We prefer to look at trends. The last time the unemployment rate touched 3.5% was in December of 1969. A recession started in January of 1970. Employment is clearly softening and has been for longer than had been assumed. The revisions we noted earlier to GDP also applied to the job market and show that growth in hiring started to slow far earlier in 2018 (see chart below). The revisions will be official in February of 2020 but are estimated to have reduced job growth for the 12-month period ending in March of 2019 by over 500K jobs! The revisions lowered the pace of employment growth over that period from 2.5%y/y to 2.0%y/y. The chart below on the right now shows that the 6-month annualized pace is down to a 0.6%a/r.



With qualified workers scarce, employers first look to reduce the pace of hiring and then reduce overall hours. This is happening now and the chart below from Gluskin Sheff depicts the decline in aggregate hours worked on a 6-month annualized basis. We anticipate job growth to slow further in 4Q to a pace of less than 100K new hires per month.

CONSUMER:

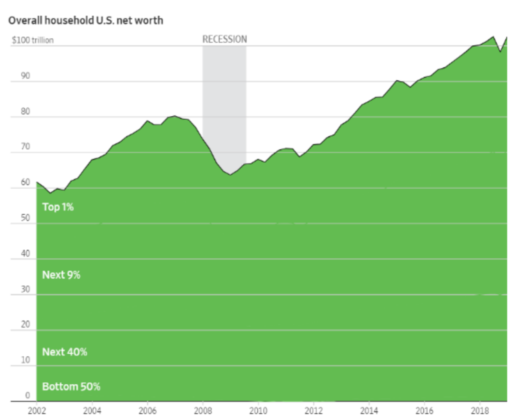
While manufacturing, transportation, agriculture and a few other industries are either already in recession or slowing quickly, the U.S. consumer has continued to hold up his and her end of the bargain. After two quarters of slower spending following the large market drawdown in 4Q 2018, the consumer reappeared powerfully in 2Q with consumption increasing from a pace of just over 1% in 1Q to a torrid 4.6% pace on an annualized basis (chart on top of following page from Wells Fargo). With consumption representing about 70% of the GDP calculation, this spending pace accounted for about 150% of the 2.0% 2Q growth rate with the remaining inputs subtracting from the overall reading. This increased the year-over-year pace of spending to 2.7%, a level still slightly south of the pace of the last five years.

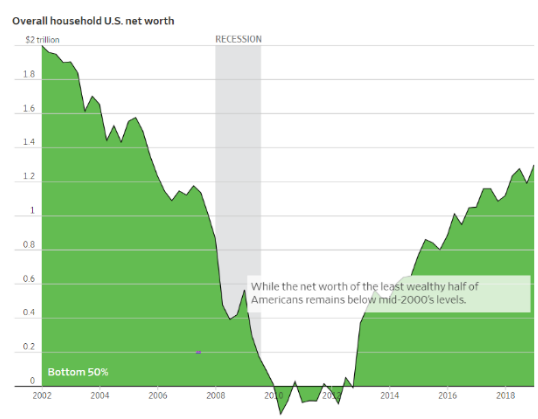


The consumer will remain critical to the fortunes of the U.S. economy over the next few quarters. While job and wage growth has been strong, they are clearly moderating. Paradoxically, the desire of central banks to spur spending via the transmission mechanism of low or even negative rates may be causing just the opposite effect. With interest rates near historical lows, generating the dollars needed for retirement no longer is available via safe, secure investments. We feel this is causing the savings rate to spike to levels rarely seen late in an economic cycle (see chart from Wells Fargo above on right) that usually depicts large savings drawdowns. While to many, signs of rising savings (future consumption) are a good thing, and we agree historically, we feel this may be sending a different message. One that may show a spending reversal should the ephemeral confidence levels deteriorate. This is the area in which we will remain focused.

Moving from the income statement side of the consumer to the balance sheet shows a very enlightening story that has both economic and political implications as the decade long expansion driven by a booming stock market and rising home prices has increased aggregate household net worth (total assets less total liabilities) to record levels. However, this windfall has bypassed most Americans.

As the chart below right from the Wall Street Journal shows, the bottom 50% of U.S. households as measured by total net worth just recently regained the wealth lost during the Great Recession yet remain 32% below the inflation-adjusted levels of 2003 according to data from the Federal Reserve. Meanwhile, the top 1% of households by this metric have more than doubled their net worth during this period. We believe this to be one of Fed Chairman Powell's greatest concerns as a recession coming soon could be devastating for those who have barely recovered from the last one.





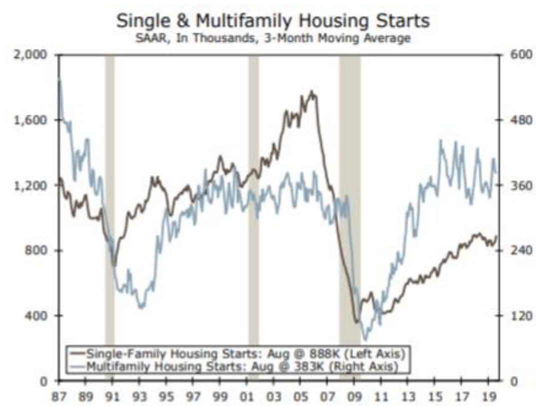
HOUSING:

Federal Reserve Chairman Jerome Powell has been facing a housing conundrum. Through July, the market had been in a 15-month slump, with home price gains and sales having slowed dramatically and permits to build new dwellings slumping by 6.6% to the lowest level in more than two years. This despite a big drop in market interest rates thanks to the Fed's dovish pivot earlier this year.

As the Federal Reserve focuses more upon incoming data to determine the efficacy of monetary policy, the most interest sensitive areas of the economy take on greater significance. Though we continue of the opinion that lowering the cost of debt further is pushing on the proverbial string, housing data from August finally generated a positive response from recent interest rate cuts.

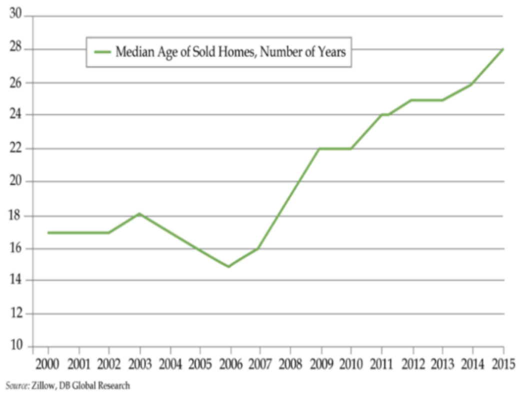
As can be seen in the charts below from Wells Fargo, the impact of a roughly 130-basis point decline in mortgage rates has finally boosted sales and lower short-term rates are helping homebuilders offset challenging costs. Higher builder confidence and an improving trend in single-family permits indicate that new home construction is finally beginning to catch up to the higher pace seen in new home sales.

Total housing starts jumped 12.3% to a 1.36 million-unit pace, the highest since June 2007. Though the headline number was inflated to a large extent by a 32.8% surge in multifamily starts, the all-important single-family starts numbers were quite solid, rising 4.4% to a 919,000-unit pace, the highest since January 2019. Only three times in this long and gradual housing recovery have we seen single-family construction at a higher pace than in August. After dragging on overall GDP growth for six straight quarters, residential investment is finally poised to boost growth in the third quarter. However, we remain circumspect as to the continuation of this welcome trend.



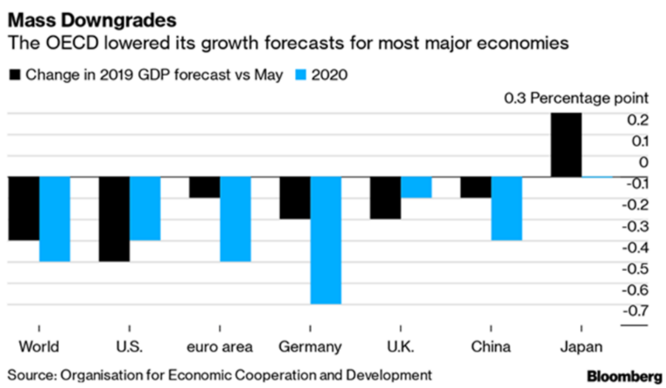
The National Association of Realtors index (NAR) shows that housing affordability is now at the lowest level since before the financial crisis despite a dramatic slowing in overall home price appreciation from a 6.8% annual rate in March of 2018 to the current 2.0% level. Years of home price gains exceeding wage growth will take a while or a recession to reverse and a recession is exactly what Powell hopes to avoid by lowering benchmark interest rates that are already near historic lows. Builders remain cautious and continuing to face pressures of available lots, municipal impact fees that raise the cost of construction and challenging labor shortages alongside rising wages. Consumer confidence remaining high in the face of continued political and economic uncertainty will be critical over the near term for this trend to continue.

Over the longer term, we view this picture more optimistically for homebuilding. As the chart on the top left of the next page from the real estate data base company Zillow indicates, the median age of existing homes that have sold has almost doubled from 2006 to almost 28 years of age and may be another negative consequence of extremely low interest rates. Yield hungry investors both public and private have entered the business of buying new homes to rent out leaving an aging capital stock behind. Due to many of the constraints noted previously, homebuilders have not filled this void and we now are faced with housing starts per capita near all-time lows (see chart on right of following page).

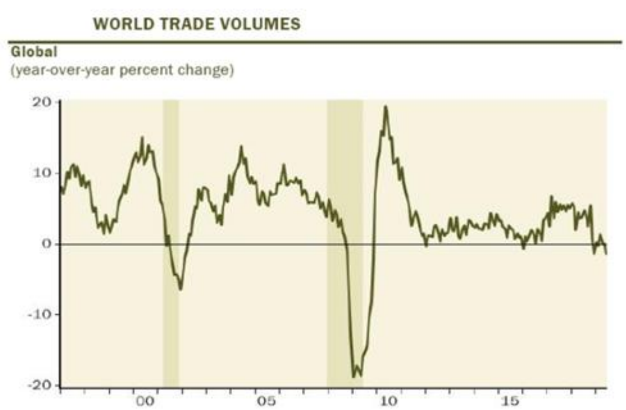


INTERNATIONAL:

Economic growth around the world continues on a gradually slowing path with underwhelming economic performances of many major developed economies. With Brexit concerns lingering and unresolved and the escalation of U.S.-China trade tensions, the impact of monetary easing by several major central banks has only had a muted impact in terms of stabilizing and strengthening global economic activity. As the chart below shows, the Organization for Economic Cooperation and Development (OECD) again lowered their estimate for global GDP for 2019 to 2.9%. This is down from 3.6% last year.



As we noted in our opening paragraph, the world appears to be splintering with the trade and currency war between the U.S. and China as the epicenter due to the impact on global trade. Global trade volumes have now declined on a year-over-year basis, an occurrence rarely seen outside of a recession (see chart below from Gluskin Sheff).



EUROZONE:

The ISM index outside of the United States is often referred to as the PMI (Purchasing Mangers Index) and is very useful as a contemporaneous look at manufacturing and services in the economy. As we await further data on actual growth in 3Q in the Eurozone, the PMI releases for September depict a region teetering near recession. In September, the region's manufacturing PMI fell to 45.6, the lowest level since 2012, while even the usually more resilient services PMI dropped to 52.0. As a result, the Eurozone September composite PMI fell to 50.4 and a drop in the composite PMI below 51.0 has often been a precursor to, or a signal of, a Eurozone economy in recession (see chart below from Wells Fargo). With the most recent release of GDP for 2Q at only 1.2% year-over-year, the risks over the next few quarters are increasing.

In response to the weakening data, The European Central Bank (ECB) eased monetary policy in early September, moving forward with a slew of measures in another in their seeming unending efforts to ignite growth and inflation in the Eurozone economy. These measures included cutting its deposit facility interest rate further into negative territory, restarting its asset purchase program to buy €20 billion per month, introducing a tiered interest rate system for banks in an effort to mitigate the effects of negative rates as well as more favorable lending terms for its Targeted Long-Term Refinancing Operations (TLTRO) program.

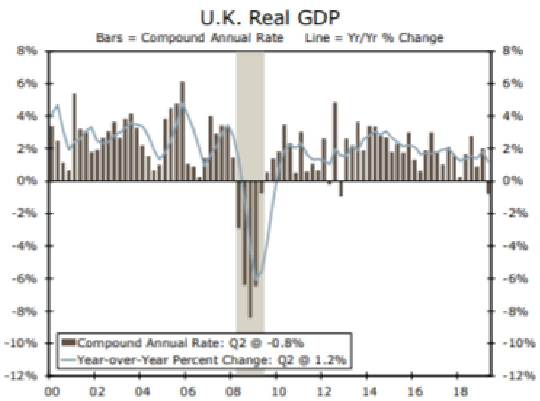
Aside from the monetary responses, the ECB also released updated GDP and inflation forecasts, with the new projections suggesting the Eurozone economy could remain under pressure over the next year. The ECB lowered its GDP projections to 1.1% and 2% for 2019 and 2020 respectively. They also lowered their inflation forecasts to 1.2% for the full year 2019 and to 1.0% in 2020. Two weeks later, the release of the September inflation readings underscored their concern with the headline CPI reading for the month dropping to 0.9% y/y, the lowest since November of 2016.

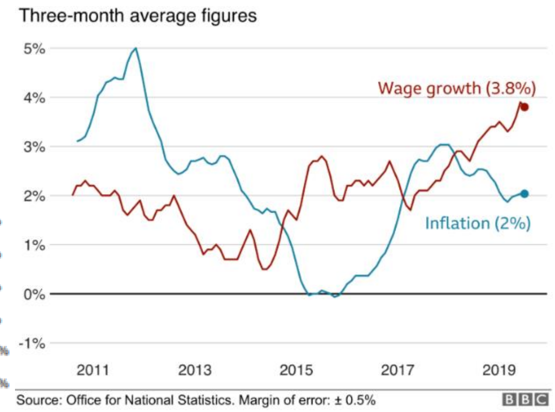
UK:

On September 23rd, the UK Supreme Court ruled the suspension of Parliament by British Prime Minister Boris Johnson to have been illegal placing the odds of any no-deal Brexit in peril. Parliament has already passed legislation intended to prevent Britain from leaving the European Union without an agreement, but Mr. Johnson continues to insist that Brexit will happen at the end of October, with or without a negotiated settlement.

Despite the Brexit uncertainties, the U.K. economic data had remained resilient throughout much of the first half of 2019. However, the most recent figures suggest growth in the industrial sector has softened and 2Q GDP moved into contraction (see chart on top left of following page from Wells Fargo).

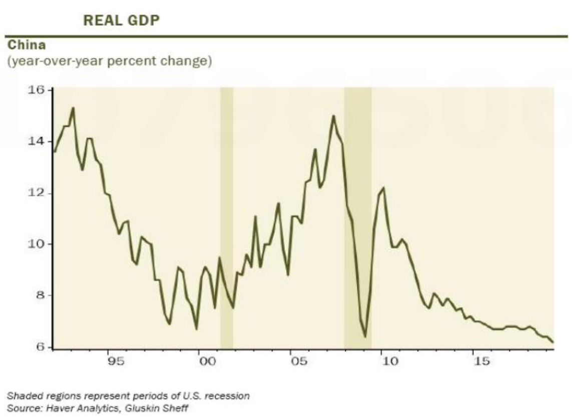
Despite the industrial slowdown, the consumer remains in solid shape. The most recent data available from August show the core CPI index still below the preferred target of 2% but at 1.7% is not a cause for concern by the Bank of England. Much of that is due to the benefit that the consumer is enjoying as wage growth continues to rise, strongly outstripping the cost increases noted. On a three-month annualized rate, wages are now rising 3.8% with the headline inflation gauge around 2% (see chart below right).





CHINA:

Real GDP for China came in as expected at +6.2% y/y in 2Q slowing from the 6.4% pace of 1Q (see chart below left). This represented the weakest performance since this data was first aggregated in 1992 and was more pronounced on a quarter-over-quarter basis that would annualize to a 5.6% rate of growth and the weakest since 4Q 2008. Inflation continues to moderate though within a narrow range as the chart below right shows.

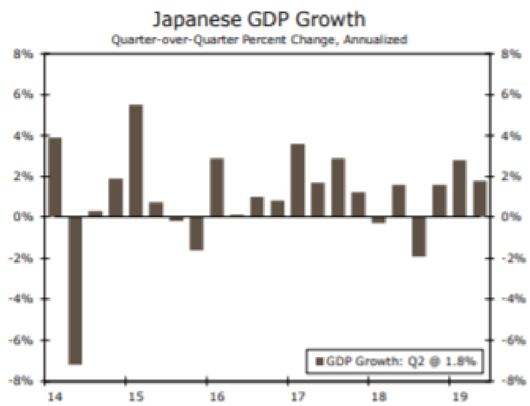


Is China undergoing a secular decline in growth owed to an aging demography and a weak financial system or just facing ongoing production shifts out of the country due to tariff concerns? The answer to these questions gives insight into how they perceive the ongoing trade war with the U.S. Many of the problems that China faces are structural in nature. An aging demography and a government that is over-indebted and still subsidizing “zombie”, state-owned enterprises are all hindering efforts to stimulate the economy. The trade war is exacerbating the concerns.

China views the best way out of this scenario is clearly to innovate and that is where the battlefield of technology to which we earlier referred needs to be fought. Whether investing in R&D, people and infrastructure or just engaging in intellectual property theft, China is clearly focusing more aggressively on growing their technologies.

JAPAN:

Japan's economy was up and down during 2018, contracting in two quarters throughout the year and narrowly avoiding recession. In the last two years the output has remained far more stable and this year the economy has performed more strongly. In 1Q, Japan's economy grew at an annualized pace of 2.8%, representing the fastest quarterly growth since 3Q 2017, while in 2Q the economy expanded at a downwardly revised 1.3% annualized (see chart from the initial release from Wells Fargo below).



This recent revision reflected lower capital expenditure growth as manufacturers addressed a slowing global growth environment and trade war. Japan's exports to China fell 10% in June y/y though exports to the U.S., which has recovered its spot as Japan's largest overseas market, rose 5%. Japan is also fighting its own trade battle with South Korea, restricting exports to its neighbor over what it says are national-security grounds. South Korea calls it retaliation for political disputes between the countries.

Of significance is that recent economic performance has been increasingly driven by domestic demand, which grew 3.0% a/r in 2Q and a little over 1% in 1Q. Though they pale in comparison to those of the U.S., these are relatively strong domestic demand numbers for Japan, while final consumer spending has improved to start the year as well. In the second quarter, private consumption expanded at 2.5% a/r, also the strongest growth rate since mid-2017.

Domestic consumption strength may be fleeting, however, as the long-telegraphed increase in the VAT consumption tax from 8% to 10% went into effect on October 1. While Prime Minister Shinzo Abe has affected certain counter measures to mitigate the impact of the sales tax increase, a similar hike in 2014 (from 5% to 8%) sent consumption into a tailspin leading to a contraction in GDP of 7.1% in one quarter alone. While the new rate applies to nearly all goods and services (most food is exempt), the government has pledged to use about half of the projected revenues to fund free childcare. This, in turn, could further increase the labor force participation of women in the work force thus increasing sustainable growth in the economy.

MARKETS:

Shrugging off any concerns of rising global tensions, increasing political uncertainty and a slowing economy, the capital markets continued a positive pace in 3Q though slowing a bit from the prior trend. In 3Q, the S&P 500 inched forward by 1.7% moving the year-to-date gain to 20.5%, the largest first three quarter gain since 1997. Still placing this surge in perspective shows that the index is less than 2% above the levels of one year ago and only 3.6% above the closing values of late January of 2018. Returns for the quarter, however, were far more concentrated in larger capitalization companies in the U.S. as the Russell 2000 index of small cap domestic companies declined -2.4% for the quarter though still ahead by 14.2% for the year.

Returns outside the U.S. continued to struggle on a relative basis with the MSCI-EAFE index of developed international companies retreating by -1.1% in 3Q though still up a more modest 12.8% in 2019. The MSCI Emerging Market index lost -4.25% during the period and are up 5.9% for the year.

The fixed income space has also enjoyed a strong year as interest rates have plummeted with the Barclays U.S. Aggregate bond index up 2.3% for the quarter and 8.5% for the year led by a daunting, near 20% gain in long-term U.S. Treasuries. Despite rising concerns of corporate debt risk, the credit space continued to attract investors searching for yield with the Barclays High Yield index gaining 1.3% in the quarter and 11.4% so far this year.

As we approach a critical election year, we feel the market may be ignoring the potential impact of a major change in leadership and philosophy. The chart below from Gluskin Sheff depicts the corporate profits versus labor income division that has increasingly favored corporate America for over three decades and more so since 2000. This is a chart that resonates with the electorate. According to research from Survey Monkey, more than 2/3rds of potential voters, including a majority of Republicans, support some kind of wealth tax.

Such a radical shift in tax policy is likely to also include increases in top marginal tax rates for both individuals and corporations and possibly dividends and capital gains. If this becomes more likely, one can expect savings rates to rise further as individuals institute precautionary measures and suppress spending and investment. We feel this to be a rising probability yet to be discounted in the capital markets.

Though trade uncertainty is at the forefront, the litany of concerns investors face has clearly increased the risks of recession. At Coho Partners, we always seek to build a resilient portfolio that can generate good relative performance regardless of the geopolitical or macroeconomic environment providing strong upside participation should markets continue to rise while offering downside protection should one or more of the issues above lead to market weakness.

Sincerely,

Rick S. Wayne, CFA

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