August 2, 2018

Talk of tariffs and trade wars is dominating the current news cycle. Have you ever wondered about the history of tariffs? Or want to understand how they are impacting the economy today? In this quarterly letter we break down the history of tariffs in the U.S. as well as share our economic and market outlook which despite the scary headlines is still relatively rosy. We will also dive into the question of paying off debt versus building savings. And, as always, we give an update on what is happening at Albion Financial Group.

As the mercury climbs in Salt Lake City we hope you are enjoying the last days of summer wherever you are.

Sincerely,

The Albion Team

A Ten Thousand Foot View of the Current Tariff Debate

Trade wars and tariffs have been in the headlines for several weeks impacting discussions in boardrooms and living rooms around the world. Many economists are opining about the potential impacts of the proposed and recently implemented tariffs, but how do the tariffs today fit in the context of U.S. trade history? First, a bit about tariffs. Tariffs are a tax imposed on imported goods or services from another country. They serve the purpose of sheltering a domestic industry from foreign competition by making the foreign goods more expensive for domestic consumers.

Tariffs have been around as long as nation-states and commerce have existed. The first tariff law in the U.S. was the Tariff of 1789 which was implemented to generate revenue for the federal government and to protect domestic workers and industries. Prior to 1789, under the Articles of Confederation, individual states sought to impose their own tariffs on imported goods. The 1789 act assessed a duty of fifty cents per ton on cargo of foreign owned or foreign built ships but only six cents per ton tariff on American owned ships. Interestingly this provision favoring U.S. ships still exists today for shipping between U.S. ports. It has been in the news as U.S. commonwealths such as Puerto Rico find themselves paying higher shipping rates from U.S. ports due to the lack of competition from foreign firms.

Tariffs were the greatest source of federal revenue, at times approaching 95%, until the income tax was established in 1913. Between 1789 and 1914 the debate about the correct level of tariffs remained heated. In general, Democrats favored tariff rates sufficient to fund government but no higher while Whigs and Republicans favored higher tariffs to protect American workers and encourage American business. Following the implementation of the income tax in 1913, tariffs have generally trended lower and today are quite low.

The three main reasons tariffs are imposed today are to protect budding new industries, to protect aging and/or inefficient industries, and to protect against dumping – when a foreign company sells products in the export market at a price below their cost or at a price below what they charge for the same products in their own market.

Tariffs can be implicit or explicit. An explicit tariff is a clear fee assessed on imported services and products. Implicit tariffs are rules that prohibit the import-export of certain items - for example, some nations disallow importing of genetically modified foods which serves to protect their farmers from foreign competition. China requires foreign companies that manufacture in China to share ownership of their endeavors with a Chinese firm and transfer their technology to this jointly owned entity.

If every country had the same labor laws, environmental laws, governmental structure and business regulations then tariffs would likely not be an issue. But that is not the way the world works. Each country has its own set of laws and values and will work to protect them. For example, France has placed a high value on its rural agrarian countryside and has implemented trade barriers to keep such areas from being wiped out by U.S. agribusiness. For the last several decades China has implemented trade barriers both to allow budding businesses to incubate and grow and to remain in control of what is still a single party authoritarian economy. The U.S. has implemented hundreds of protectionist measures through a variety of tools from tax breaks to regulatory restrictions which raise the bar for potential new entrants, to outright tariffs on imports. According to the Center for Responsive Politics, $3.37 billion was spent on lobbying Congress in 2017 most of which was focused on legislating an advantage for a specific company or industry.

Tariffs and other restrictions on free, fair, unfettered trade have existed as long as commerce has existed. The current headlines regarding trade practices, while unsettling, are not new. History has taught us that countries will continue to view trade policies from the lens of enlightened self-interest. However, it has also taught us that open markets with free and fair trade promote global economic growth. And, as the saying goes, rising tides lift all boats.

Economy & Markets

Economic growth endured in the second quarter. U.S. output, jobs, and consumption are all expanding at a pace that suggests both a healthy and balanced economy. Meanwhile inflation – while drifting up some – remains relatively benign. Likewise, corporate profits continue to expand hitting yet another high watermark. In fact, profit growth for the most recent reporting period experienced the fastest growth since 2010. Nonetheless, as we've stated before, this pace of profit growth simply cannot be maintained over the long-run. Corporate tax cuts should provide some boost this year nevertheless core earnings *growth* is likely to moderate into the single-digits at some point.

Too, the global economy as a whole is growing albeit at a gentler pace. For the past eighteen-months the global economy has been in a fairly coordinated upturn. This is unquestionably good for business and for stocks. Perhaps the biggest threat to this expansion however is a trade war. Our current view is that it is just too early to have conclusive evidence on how tariffs are impacting companies and the general economy. And, while we surely claim no edge in prediction, over the short-run we do think it is impacting business and investor *confidence*. How this ultimately flows through to private sector production, jobs, and investment remains unclear. Generally speaking things like tariffs typically filter through the economy with a lag. If these trade spats escalate and, worse yet new tariffs are put into place, then it may in time pressure American business creating some rather negative downstream economic effects. We are watching developments closely.

In June, the Federal Reserve raised rates for the second time this year. A burning question in the financial markets has been will they stop at three, or do a fourth hike in 2018? We don't know, but what we do know is that rates remain low in the context of history and that is good for the economy and stocks. With the Fed's regular pace of rate hikes these days the short-end of the Treasury yield curve is lifting faster than the long-end. The result has been what's referred to as a "flattening" yield curve. Many are paying attention. We are as well, though with little unease for now. The good news is that rising short-term rates boost returns on cash instruments and shorter duration fixed income securities.

Valuation on the stock market remains fair – neither overvalued nor undervalued by our estimation. At approximately 16.5x forward S&P 500 earnings, and with low interest rates and modest inflation,

stocks appear firmly grounded in reason. And yet despite the body of facts it seems bears and pundits alike continue vigorous hand wringing over an alleged "expensive market." Let them. It is our view that if a bear market were to suddenly arrive (which we don't anticipate) it won't be due to valuation.

There also seems to be some discussion lately around the notion of only a handful of overbought stocks providing all of the year's market gains. The insinuation from this narrative is that we have very narrow market leadership. And that's scary. We don't. And it isn't. Most indicators of market participation suggest it is quite broad and crosses various industry groups and market caps. Second, even if you were to believe this tale, what's perhaps most amusing is that none of it – narrow market or broad – actually matters. Markets go up on wide participation, as well as slim. And they can fall on either. Decades worth of data prove this. It's not predictive of anything. So why do so many believe this? Well, as Morgan Housel observes *people tend to care more about something 'making sense' than they care about something being right*. And so it goes.

All told, the *Albion four pillars (Economic Growth, Inflation, Interest Rates, and Corporate Earnings)* that we look to in evaluating the current state of the stock market remain supportive. We carry on in our belief that owning great businesses through investment in U.S. stocks is a worthwhile endeavor.

Planners Corner

Credit cards are a major part of personal finance in the U.S. There are over 450 million credit card accounts in the U.S. and this number continues to grow as we become a cashless society. Credit cards can be handy and efficient, but they also allow us to easily spend beyond our means. There is over $830 billion in credit card debt in the U.S. and this number continues to grow. As Americans work to tackle credit card debit the following question often arises: Should I pay off my credit card or build savings?

Often, it makes sense to focus on paying off debt first given the high interest rate on most credit cards (9-21%). The interest charges per month can make it difficult to climb out of a debt hole especially if you only make the minimum payment. Even if you don't have a cash reserve, getting out from under the burden of debt make sense.

Debt consolidation is also an option to consider. In certain situations consolidating all of your debt onto a card or line of credit with the lowest available interest rate makes sense in an effort to pay down your balance more quickly. At some point a "divide and conquer" strategy can be useful too. By allocating a portion of your income to debt payments while slowly building up your cash reserves, you'll be covered for the next unanticipated expense without reaching for your credit card.

Saving and spending is very psychological. You need systems in place that will help you reach your goals.

Albion Community

Another new name to the Albion team is Sara Dewey. Sara joined us this year as an Associate Wealth Advisor to support Wealth Builder Advisor Danielle Gregory as well as the firm's marketing and outreach initiatives. Sara takes pride in her attention to detail and desire to build quality relationships with clients; skills she honed while working in customer service and consulting with clients in the luxury kitchen market.

As a culinary school graduate, most of Sara's spare time is spent cooking, baking, and exploring Salt Lake City's local culinary scene. Sara truly enjoys all aspects of cooking, from shopping local farmers markets to sharing her food with friends and family. Outside of the

kitchen, Sara's time is spent indulging her true crime media addiction, participating in hot yoga classes, camping, and playing Settlers of Catan.

In other Albion news, our next Women of Albion event is our Health and Wealth Workshop which will take place at the Clubhouse (formerly known as the Women's Literary Club) on Thursday, October 4th. On the surface health and wealth may seem like unrelated topics, but in this day and age with busy lives and stressful schedules, there is a symbiotic relationship between the condition of your body and your bank account. More information to come. Please join us and bring your friends!

Macroeconomic Highlights from the Second Quarter

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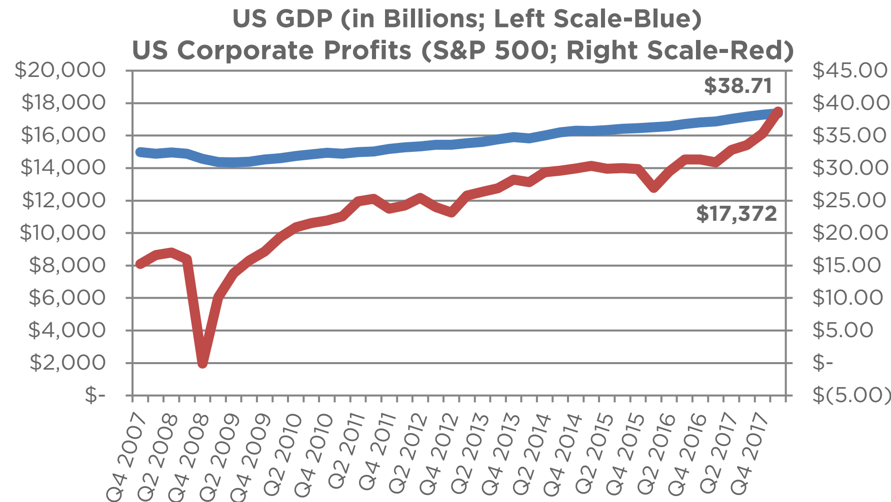
UNITED STATES GDP ANNUAL GROWTH RATE



Steady economic growth endures and S&P 500 corporate profits continue to swell. Broad-based earnings hit yet another record high in the most recent reporting period. The general economic data – output, labor market, private sector balance sheets, and sentiment – are conducive to a sturdy economy. With that said, fresh threats of protectionist trade policies, tit-for-tat tariffs, and the risk that all of this could escalate bear watching as it could have an impact on the economy.

UNITED STATES INFLATION RATE

Using the Fed's preferred measure, inflation remains balanced with the most recent data showing a pace still below the Fed's 2% target. Additional measures like CPI have picked up some, while various other inflation-oriented information have begun to warrant closer attention. We continue to closely monitor the pace of inflation against the preponderance of data. On net, our opinion is that general price growth remains in check and shouldn't run 'hot' anytime soon.

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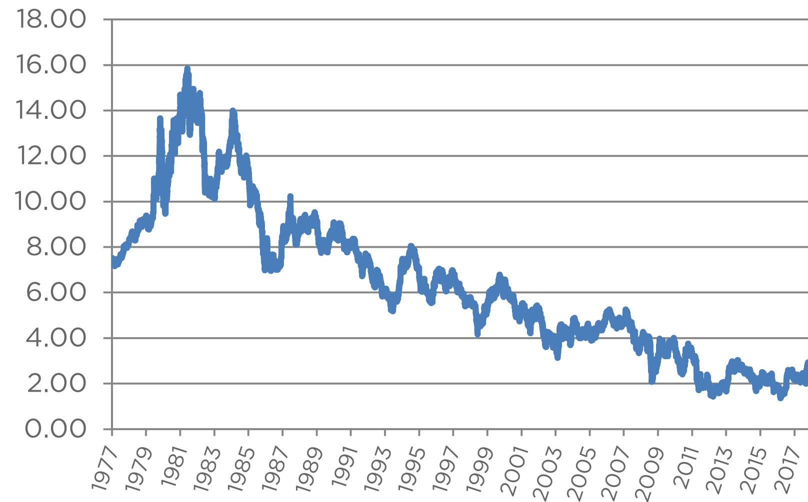
UNITED STATES 10 YEAR TREASURY YIELD



FORWARD 12M P/E RATIO: 10 YEAR

In June, the Fed hiked their target rate an additional 0.25%, the seventh such hike since the Fed began raising rates. Concurrently, the Fed continues to reduce the size of their large balance sheet by allowing mature Treasury bonds to “run off” without replacing them. Our thinking is that this behavior should – all things equal – result in longer-term yields gradually rising. And to some degree we are in fact seeing this occur (since last fall). Nonetheless interest rates remain quite low, which is a positive for both stocks and the economy.

At approximately 16.5x forward earnings, the P/E on the S&P 500 is neither undervalued nor overvalued by our estimation. In fact, we reason that at this level, and with low rates and tepid inflation, valuation on the stock market remains attractive as long as the economy and earnings continue to expand.