Basis Points July 17, 2018

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Above the Fold

Netflix reported earnings after the market close last night and missed its own forecasts by more than a million subscribers in the second quarter. The stock is trading down 13 percent today, as investors worry that the subscriber growth miss may be a sign that the site's strong momentum may be slowing. Netflix added 670,000 domestic customers, below its guidance of 1.2 million subscribers, and it added 4.5 million international customers, short of its guidance of 5 million. Netflix blamed its subscriber miss on bad internal forecasting, and said that the miss was not due to business reasons like price increases. Netflix has been spending billions on content for its streaming site to lure and keep subscribers, and last week Netflix scored 112 Emmy Awards nominations, more than any other television network and breaking a streak that HBO held onto for 17 years.

U.S. consumers watch Netflix more than any other platform, including basic cable and broadcast networks. The company released 452 hours of original programming in the second quarter, an increase of 51 percent from the same time last year. Consumers love and use Netflix so much that even higher pricing hasn't stopped them from streaming movies, TV shows and Netflix original content. Netflix has hiked the price of its standard streaming service in the U.S. by 39 percent in the past four years, but the domestic subscriber base still rose 62 percent over that time.

Three Things

1. Volatile equity markets in the first half of 2018 has even hurt the inflow of investor funds into index funds and ETFs, passively managed investments that have attracted a steady flow of investor funds over the last nine years. Net inflows into U.S. index mutual funds and index ETFs dropped to $3.4 billion in June. That was the lowest amount of new monthly money for these funds since early 2014. For the first six months of 2018, passive inflows were down 44 percent, compared with the same period a year earlier. The drop-off in investor cash flowing to lower cost index investment vehicles during 2018 is the result of political uncertainty, trade and tariff threats, and concerns that the bull market could end soon.

2. Hold onto your wallets folks, as your hard-earned nest-egg is your grandkids' retirement plan. Bloomberg reports that a survey of 1,000 mass affluent young adults between the ages of 18 and 22 shows that 63 percent of respondents say that financial stability in retirement will depend on them inheriting money. Not only are more members of Generation Z betting on an inheritance, but more think it may come from someone other than their parents. It is true that a wave of money is expected to be passed to younger generations in the next few decades, as an estimated $30 trillion could find its way to heirs over the next 30 or so years. But those beneficiaries may have to wait a long time, as life-spans continue to increase every year. Survey analysts attribute the relatively large number of Gen Z-ers who expect to inherit money from friends and family as unique to the demographic. They've grown up in a sharing economy, using such things as Airbnb, Uber and crowdfunding, so why wouldn't they have some sort of shared way with friends and family to finance their future.

3. Barron's recently published a thoughtful case that shows why the expiration date for the current bull market may be mid-2020. At that point our economy would have been growing for 11 years, and would be the longest economic expansion in U.S. history. They note that the current economy has been juiced by the tax cuts and fiscal-spending package, a stimulus that should last about another year from now. Just as its effects are fading, the Fed will be continuing to push interest rates higher and shrinking the $4 trillion Fed balance sheet. Put these two factors together and you have an economic drag large enough to slow the economy enough for a recession in mid-2020. Global economic growth could also be pinched if the European Central Bank begins raising rates in 2019, as it has indicated this year that it might. Gone by 2020 as well may be the large cash hoard from repatriation of offshore cash that large companies have been using to buy back their own stock and spend on capital expenditures. These are all reasonable assumptions, and this scenario may end up being accurate. However, for all the time that investors spend worrying

about bear market risks sometime in the future, portfolio adjustments based on fear have typically been at the expense of also missing out on the gains during bull markets. The success of a long-term wealth plan is not dependent on continually anticipating a market crash, and zigging and zagging based on emotions. Diversification among asset classes and strategies allow a thoughtful wealth plan to grow over time, and that diversified portfolio of asset classes are appropriate whether there is a recession tomorrow or three years from now.

Did You Know – A View from London

While visiting London last week, I wandered through the Imperial War Museum for a few hours. This museum was founded in 1917, and it was intended to record the civil and military war effort and sacrifice of Britain and its empire during the First World War. It then expanded to include the events of World War II. The carnage and destruction that these two world wars wreaked on Europe, only 20 years apart, is a stark reminder as to why the idea of a European Union was formed in 1947 and why it is still a great idea today, even after 71 years of peace on that continent. As Americans, we have the luxury of going to war when we want to. Europeans, for hundreds of years did not get that choice, as their neighbors could invade at any time, and often did. Peace and harmony is not Europe's natural state, and never was before the EU. Europe is similar in land mass to the United States, but encompasses 50 countries, all having somewhat unique cultures, laws and political systems. The potential for conflict in this small geographic region has been apparent over recent centuries, and events frequently erupted into bloody and costly regional conflicts. The idea for the EU, NATO, IMF and Marshall Plan all arose out of the ashes and destruction of World War II, and have kept peace in the region ever since. The EU was founded on the hope that significant economic interdependence would make further European wars impossible. With all the talk about NATO recently, some have argued that the idea of NATO is antiquated, and whether the U.S. bearing the cost of the common defense is "fair" or not. The United States does pay more than its fair share for the defense of NATO countries, but this fact is not a flaw in the system, it was a founding principle of NATO. This is how post-war statesmen designed it, as it ensured the absence of a great European power which could lead to conflict. By design, the idea of NATO ensures a permanent U.S. military dominance over Eurasia, while uniting Europe under the protection of the U.S.

Only America, and the massive military and economic power that it can exercise, could have pacified and unified Europe under its direction. NATO article V, which declares that an attack on one member country is an attack on all members, was created so that the weakest member would enjoy the same security as the strongest. Since World War II, U.S. troops have been deployed in Eurasia to ensure that the continent cannot be dominated by a single power again. And the U.S. has large military assets in Europe so there is no need for countries there to begin local arms races that could end in war. The U.S. does spend 4 percent of its GDP on defense, while most NATO countries spend less than 2 percent. But the alternative, such as Germany spending 20 percent of GDP on aggressive expansion of its military forces, has been proven to be a much worse outcome for its neighbors and for the U.S. in the long run. And we would rather have Europeans spending their money on U.S. goods and services, rather than digging trenches and spilling blood in their fields again. A U.S.-backed umbrella of security over a historically volatile continent has worked well for generations, and should not be abandoned as younger generations forget the destruction and conflict of the past.