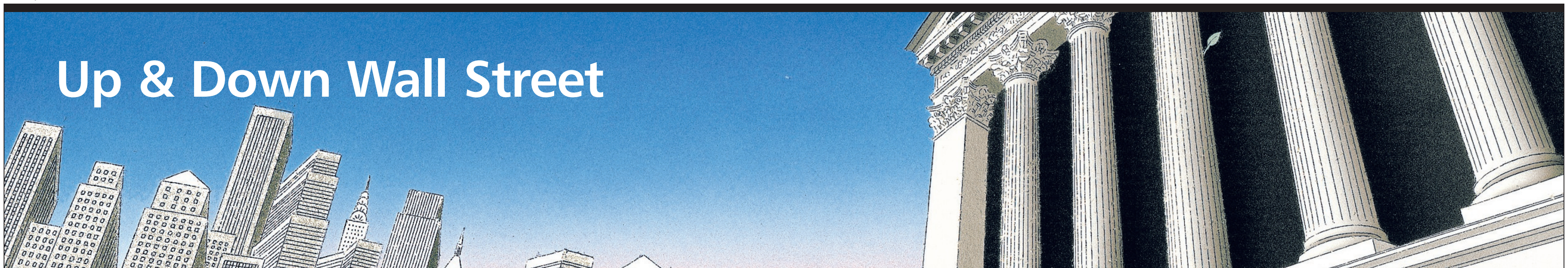

21st Century Tulips

by Randall W. Forsyth

IT WAS 50 YEARS AGO TODAY SGT. PEPPER TAUGHT THE band to play, if that can be believed by aging baby boomers. It seems only yesterday that we were listening to the Beatles' iconic album of the Psychedelic '60s while driving around in our VW Beetles, Mustangs, Minis, or Fiat 500s. *Plus ça change* and all that.

The release on Friday of the newly remastered version of *Sgt. Pepper's Lonely Hearts Club Band* on the occasion of its half-century anniversary inspired more than a bit of déjà vu. But it was more about partying like it's 1999, as in the immortal anthem of the late, great Prince.

Instead of internet stocks, Bitcoin was the center of attention. The crypto-currency has taken flight and taken hold of the public's imagination like the dot-com bottle rockets before the turn of century.

Bitcoin has taken hold of the public's imagination like the dot-com bottle rockets did in the late '90s.

The story of bootblacks offering stock tips in the 1920s is the oft-told fable warning of the Great Crash. My experience relates to my commuter train, where topics of conversation typically are the polite ones about kids and work—except when markets heat up. On one memorable ride in the late 1990s, I listened to a quite exuberant passenger chatting rather too loudly on his cellphone, a device far from ubiquitous then: "Do you have Sun Microsystems? It split again. Life is goooood!"

Sun would increase 100-fold to a split-adjusted peak over $309 a share by 1999. Between 1988 and 2000, Sun's stock split six times, including twice in 2000 alone. Then came the dot-com crash. In 2007, there was a 1-for-4 reverse split, after which it was acquired by **Oracle** (ticker: ORCL) for $9.50, some 300 bucks below its peak.

What brought that to mind was the overheard conversation of a couple of fellow travelers last week, in which one extolled the potential of Bitcoin, whose price has gone parabolic in recent days. Bitcoin has more than doubled since mid-April, from under $1,200, to a peak around $2,800 Thursday, before settling into a range between $2,052 and $2,583 Friday. Where it stops, nobody knows, although it was trading around $2,300 at this writing.

The favorite way to play at home is the **Bitcoin Investment Trust** (GBTC), a fund that's supposed to track 1/10th the price of the crypto-currency. But the trust's closing price of $405 on Friday represented a 76% premium over Bitcoin's intrinsic value (if you believe Bitcoin has such a thing).

There probably is great potential for electronic currencies not controlled by governments. But for something to be a viable medium of exchange or store of value, it needs stability, which clearly is not evident. Bitcoin's fans claim it is a technology and not something that can be valued like a stock, which probably echoes conversations in Amsterdam coffee houses in the 1600s to rationalize paying any price for tulip bulbs.

There also was an echo of such exuberance, rational or not, in the stock market as it hit records again last week. The Nasdaq Composite ended Friday at a record, with a 2% gain for the week, while the Standard & Poor's 500 index added 1.4% on the week, also a record, and the Dow industrials ended just shy of their peak, but advanced 1.3% on the week.

What's striking is the role played by the biggest technology leaders, again reminiscent of the dot-com era. According to Bespoke Investment Group, **Apple** (AAPL), **Facebook** (FB), **Amazon.com** (AMZN), **Microsoft** (MSFT), and **Alphabet** (GOOGL) accounted for 4.6 of the 7.89 percentage-point gain this year in the S&P 500. Through Thursday, S&P data maven Howard Silverblatt calculated, the top 15 S&P 500 stocks generated half of the big-cap benchmark's year-to-date increase. (What has changed is that Amazon and Alphabet both flirted with $1,000 share prices, while two decades ago stock splits were all the rage.)

Besides *Sgt. Pepper's* release in 1967, we are coming up on other "seven" anniversaries, some unlucky. In 1987, the stock market was cruising for the bruising it would suffer in October. In 1997, the Thai baht would be the butterfly whose wings would set off a maelstrom culminating in the Long-Term Capital Management hedge fund's failure the following year. And in 2007, June would see the failure of two Bear Stearns funds that played with mortgage derivatives, which in retrospect kicked off the financial crisis that precipitated the Great Recession.

The bullish exuberance contrasts with the monetary and fiscal backdrops, however. The Federal Reserve is in tightening mode, on track for at least one and possibly two interest-rate hikes this year (echoes of 1987 and 2006, presaging the crises). On the fiscal front, the budget proposal from the Trump administration was attacked for its draconian spending cuts. In fact, Moody's Investors Service on Friday wrote that it not only fails to improve the U.S. fiscal position, but

Up & Down Wall Street *continued*

would worsen it more quickly than the credit-rating agency had anticipated.

To the extent that the stock market's new highs are based on optimism about the administration's fiscal policies, a splendid time can't be guaranteed for all.

SIMPLIFY, THEN EXAGGERATE. IT'S AN old ploy used by many plying my trade, so it may take one of us to know when someone is using it.

The New York Times Magazine ran a piece a couple of weeks ago asserting that inequality in America can be explained by differences in homeownership, and that the tax code is responsible for this. Specifically, the mortgage-tax deduction allowed the middle class and higher to accumulate wealth in a manner not available to those who don't buy and own their homes.

A simplification and an exaggeration, to be sure.

The author cites data that the average homeowner's net worth is 36 times that of the average renter, \$194,500 versus \$5,400. But could the causality run the other way? It requires wealth to accumulate the down payment for a house, and income to qualify for a mortgage, both of which many renters lack. But no matter.

The crux of the piece was that the mortgage-interest deduction benefits those able to own homes. As Tom Donlan pointed out in his editorial on April 22, tax benefits, such as the MID, are massive forms of backdoor federal spending. The MID is far from the most egregious—an estimated \$68 billion in the fiscal year beginning on Oct. 1, compared with the value of about \$235 billion for employer contributions for employee health care and insurance.

The real problem is that the MID helps those who need it least. The bigger your mortgage and the higher your tax bracket, the more the deduction is worth, which is the main criticism leveled against it. (That said, the top 1% of taxpayers paid 39.5% of federal taxes in 2014, the most recent year for which data are available, so those who render the most unto Caesar also save the most from the MID.)

President Donald Trump's tax-reform proposal also would double the standard deduction, which would further reduce the number of homeowners who would find it worthwhile to itemize and take the MID. At the same time, the higher standard deduction benefits renters who, besides possibly lacking the wherewithal to become homeowners, also might prefer not to be encumbered with a house absent the lures offered by Uncle Sam.

Viewed alternatively, the MID represents government intervention in the economy that distorts incentives, misallocates resources, reduces productivity and economic growth, and (this should really bother the administration) increases the trade deficit. At the margin, the subsidy provided by the MID encourages more people to buy bigger, more expensive houses. In the process, that increased demand funnels capital into a sector of the U.S. economy that has seen absolute declines in productivity in recent years—home-building.

The Financial Times last week pointed out that U.S. home builders started work on the same number of houses as they did 25 years ago, but with 36% more workers, a sign of lower productivity and contradicting the assertion that the industry is being held back by labor shortages. The FT concluded that, in the past half-century, home builders have become 35% less efficient than the rest of the economy.

That might not shock anyone who has watched and waited as a construction project dragged on long past the projected deadline. But policies that attract capital to this unproductive economic sector deprive capital for more-productive ones. That, in turn, drags down overall productivity, helping to keep the economy in the slow lane.

If demand for investment, including artificially stimulated housing, exceeds domestic savings, capital must be imported by tapping global savings. Those capital inflows then result in a deficit in the current account balance of payments, which mainly consists of the trade deficit. (The capital account must equal the current account; it is an accounting identity.)

In other words, Americans' desire for McMansions, subsidized by the tax code, results in borrowing from abroad to pay for them. Foreign investors bought \$236 billion of U.S. agency securities in the 12 months ended in March. These consist mainly of securities from Fannie Mae and Freddie Mac, the government-sponsored enterprises, to support housing finance.

To be sure, this is a simplification and an exaggeration. But when Congress gets around to tax reform, perhaps the sacred cow of the MID shouldn't be spared. Liberals and conservatives can agree that at least some reduction in the current \$1 million limit for a couple should be considered as part of a pro-growth package to incentivize productive activity. ■

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