1853 William Penn Way, Suite 9 · Lancaster, PA 17601 · 717 735 0013

APRIL 2018 INVESTMENT COMMENTARY

TRADING ALGORITHMS MEET THEIR MATCH – REALITY TELEVISION STYLE GOVERNING

2017's calm and rising markets are looking more like they were largely a result of a "sugar high" following the election of Donald Trump. I wrote in the November 2016 commentary following the Election Day, "The base case relies upon the pro-growth initiatives of the Trump administration coming to fruition with the help of the narrow Republican majorities in Congress and the most contentious aspects of the new administration's stated policy initiative being blocked or significantly watered down. It is possible that this new administration will end up being an equal opportunity antagonist when it comes to the more establishment constituencies of the two major parties. If this should occur, the markets will need time to adjust to a less predictable and post-partisan Washington DC." In retrospect, I believe that the markets in 2017 became myopically focused on the pro-growth initiatives promised by the Trump Administration. The equity markets, with the cooperation of international markets, which were reacting to improving local economies, became self-fulfilling in 2017. Investors in the U.S. appeared to get caught-up in the euphoria and largely attributed the buoyant markets to the "Trump Growth Agenda," which the White House fully reinforced by cheerleading the markets whenever the opportunity presented itself.

The second part of my quote from the post-election day commentary above discussed an assumption that the more contentious aspects of the Trump agenda would be blocked or watered down by the checks and balances of the system largely held true until February 2017. The Trump Administration had a very tumultuous beginning characterized by sloppy personnel choices, amateurish policy roll-outs, embarrassing leaks, and very little legislative success up until the tax cut legislation was passed in December 2017. The markets ignored this chaotic first year and were seemingly driven higher by the hope of tax reform and the strength of economic and earnings growth that began accelerating just after the election in 2016, following a long and tumultuous election season. All of this created a market sentiment where good news was good news, and bad news was ignored.

Markets are now re-calibrating and are finally beginning to price in political, policy and economic risks that were enthusiastically swept under the rug last year. Exuberance, animal spirits, whatever you choose to call an upward, momentum-driven market, can draw investors into a false sense of security as long as the tide is rising. Warren Buffett has alluded to the danger of such markets in the past when he has stated that "only when the tide goes out do you discover who has been swimming naked." Equity markets are complex organisms, and it is not unusual for investors to confuse a strong market with a healthy market when upon closer inspection strength is a function of groupthink, short-termism, and greed, not fundamentally driven opportunity.

Let me be clear; I am a passionate defender of the foundation of well-functioning markets, which is fundamental price discovery. As a discretionary asset manager, I am an active contributor to the critical function of price discovery every time that I screen for mispriced securities to purchase or sell what I assess to be over-valued investments. This exercise of price discovery is not reliant upon a particular market environment. A market environment such as we currently are experiencing can make price discovery derived opportunities more plentiful.

My view is that the current heightened volatility is the flip side of the historically low volatility that characterized the markets in 2017. Whereas the equity markets essentially saw the investing environment through rose-colored glasses in 2017, today those same markets are now focused on risks that were well known last year but were ignored because of 2017's upward momentum. It only took one ten percent correction to wake the market up to the risks that had been previously ignored. Now that the focus is squarely on economic risks such as tariffs and trade agreements, a potentially more hawkish Federal Reserve Chairman, and the overall headline risks surrounding an increasingly more combative and chaotic U.S. President, the markets are naturally going to be exhibiting much greater volatility. This volatility does not have to be of great concern to most fundamentally driven investors. Fundamentally driven investors do not need volatility to provide a warning shot across the bow to remind them that parts of the market are unhealthy in terms of valuation, growth assumptions, and perceived risks. On the other hand, for investors who have simply been chasing last year's best-performing stocks, ETF's and mutual funds, this volatility should be seen as a warning to sober up and take valuation and diversification seriously.

Seven Summits Capital portfolios are built one security at a time, with each security having been thoroughly researched. With the assistance of our research partners' resources, we develop fundamental assumptions and valuation metrics which provide us with an opportunity thesis. This opportunity thesis guides the buy/sell decisions for each security. An opportunity thesis generally spans an investment time horizon that is long-term. With each portfolio constructed with well researched individual securities, portfolios are built to weather the inevitable unpredictability of market cycles and the occasional bout of high volatility, normal market corrections and even the inevitability of bear markets.

All of the noise and associated uncertainty introduced into the world economy and geopolitical order over the last seventeen months following the unexpected election of Donald Trump was bound to rankle the capital markets. Donald Trump as a private citizen and candidate kept himself in the media spotlight by making controversial statements and being uninhibited by decorum and customary social norms. This style worked very well for him to garner television ratings, however as a governing style, unpredictability and hyperbole appear to be reaching a critical mass that has recently manifested itself through market volatility and Executive Branch personnel turnover.

Many investors model macro assumptions in order to generate forecasts upon which to invest. Last year, tax reform was the one large macro assumption that dominated investment forecasts. Once this event came to fruition, the assumption of tax reform driven economic growth and higher corporate earnings went from an assumption to reality. Therefore, the market's focus has now turned from the prospect of tax reform induced earnings and economic growth to worry about the risks that could reduce or derail the benefits of the tax reform legislation. The threats of trade protectionism through tariffs and the renegotiation and/or canceling of long-standing trade agreements are the most overt risks that the markets are discounting. On the monetary policy front, the new Federal Reserve Chairman, Jerome Powell, a non-economist, introduces change and uncertainty after ten years of consistent leadership under Ben Bernanke and his Vice Chair and successor, Janet Yellen. Chairman Powell is now responsible for navigating Federal Reserve policy during a time when interest rates are set to rise, labor markets are extremely tight, and rising inflation expectations are beginning to gain traction.

It is no wonder that our capital markets are becoming very unsettled. In many respects, 2017 represented the "buy the rumor" stage of the post-Trump Presidency, and 2018 represents the "sell the news" stage.

On April 4th I woke up to the U.S. Dow Jones futures indicating that the Dow index would open down by more than 500 points based upon concern over Chinese trade retaliation announced overnight in response the Trump administration's escalating tariff threats levied against that country. By mid-day, the markets, after trading down over 500 points, began to recover and the Dow Jones ended the day up over 200 points. Stock market volatility over the last two months has been remarkable, and that is why I am addressing it in this commentary. This current volatile market environment is not one that is uninvestable, in fact, this volatility provides significant opportunity if you spend your time looking for very attractive security price levels created by market over-reactions. However, what can get an investor in trouble during periods such as we are witnessing is reacting reflexively to abrupt market moves. As investors, we do not choose the market environment; we manage through differing levels of volatility and sentiment-driven trading by maintaining our focus on the more predictable longer-term fundamental metrics.

We may not realize it, but we are witnessing an unprecedented level of uncertainty in the "age of Trump." His undisciplined and chaotic communications style is now driving markets, threatening long-standing alliances and putting both our friends and foes in an uncertain state of flux. The current market firestorm has been created by the President's brinksmanship style of negotiating trade policies and concern over his totally inappropriate attacks on Amazon and Jeff Bezos. In a market environment driven day-to-day by algorithmic trading programs that trigger off of news flow and data points, the unpredictability and hyperbolic one-upmanship style of the President can have the effect of temporarily shortcircuiting the algorithms. I almost feel sorry for all of those Ph.D. mathematicians who have to design trading algorithms in the age of reality television style governing.

CURT R. STAUFFER
(C) 717 877 7422
(O) 717 735 0013
cstauffer@ssummitscapital.com