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JANUARY 2017 INVESTMENT COMMENTARY

MARKETS ARE FEELING THE TRUMP PLACEBO EFFECT; WE SEE VALUE IN HEALTHY SKEPTICISM

I have written many commentaries over my career and in retrospect there were a handful of periods of time when I felt that I was bearing witness to a historic pivot point in the markets. One of the most memorable pivot points occurred 93 months ago in March 2009. Not only did the Dow Jones Industrial Average hit a cycle low of 6,547 on March 9th, but this low also marked the bottom of a market crash that reversed ten years of appreciation. This period of time also saw the election of a new President. Severe pessimism engulfed our country and the world, while the modern financial system, the domestic automotive industry and the solvency of many everyday Americans seemed to hang in the balance. The new President at the time, like President Elect Trump, defied conventional wisdom by defeating the presumptive favorite in his own party's primary, Hillary Clinton and then he went on to defy the odds and won the general election. Our political system as in the midst of significant change and no President since Franklin D. Roosevelt had assumed the office of the President during a more precarious economic time.

I remember dedicating more time than ever reading to drown out the pervasive noise of investor sentiment. I wrote my March 2009 commentary in late February and made the following statement:

> *"We are bucking the pessimism spiral that has engulfed the markets. We are investors, and we see more value in many of the securities that we own or are buying today than we have ever witnessed in our careers."*

In that February 2009 commentary, I mentioned ten reasons for my contrarian sense of optimism. One of those ten reasons was what advice that some of the most successful long-term investors alive at the time were giving regarding market conditions. My statement on that subject was:

> *"Our research indicates that without exception, every legendary investor who garnered that descriptive by achieving superior results for his or her clients over a period of 20, 30 or 40 years sees the current market environment as the opportunity of a lifetime to purchase valuable assets at multi-generational low prices. (e.g. Warren Buffett, Jean Marie Eveillard of First Eagle Funds, Martin C. Whitman of Third Avenue Funds, Chris Davis of Davis Funds, Bruce Berkowitz of the Fairholme Fund, and John Gunn of Dodge and Cox Funds)."*

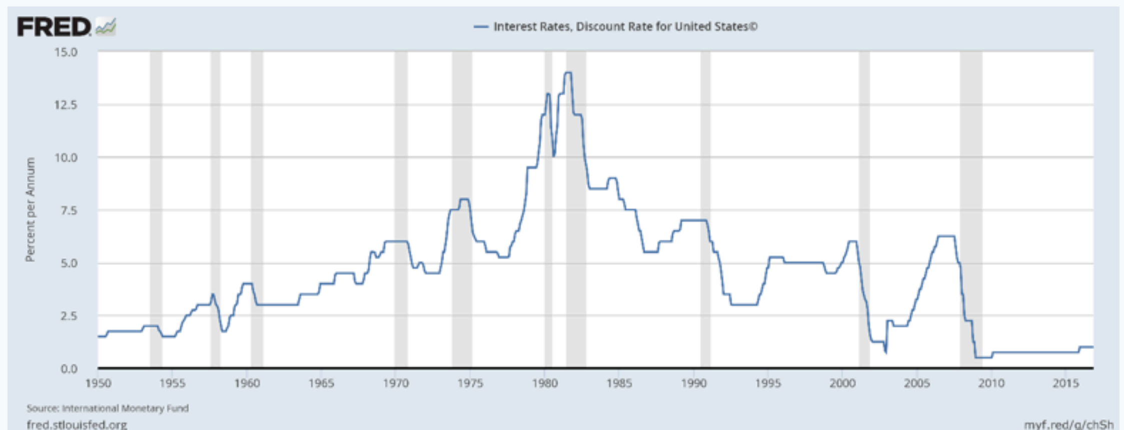
Remarkedly, over the last 93 months, the Dow Jones Industrial Average has almost tripled in value. The bull market that began in March 2009 is now entering its eighth year, and this ranks it as the second longest post-WWII stock market advance. The longest bull market occurred between 1987 and 2000. For the current bull market to eclipse the 1987 to 2000 advance, the current market will have to avoid a 20% decline until June 2021.

Looking back to the inauguration period of 2009 and what the mood of the country was at that time versus the mood of the country today, there are both parallels and stark contrasts. The parallels are the ascendance

of a long-shot candidate to the office of the President, and significant division within the country between those who are hopeful and those who have significant reservations. The contrasts are mostly in the areas of economic and market cycles. In early 2009, the economic and market cycles were sitting at levels that can only be characterized as extreme lows. Additionally, monetary policy, as a reflection of the economic cycle and financial crisis, was positioned for a continuation of extraordinary accommodative actions for an indefinite period of time. Today our economy and the stock market are sitting at the opposite ends of the spectrum, by comparison. Over the last seven years, employment growth has been consistently positive versus the substantial monthly job losses that were occurring in late 2008 through mid-2009. The labor force is tight today with an unemployment rate of 4.7%, and inflation is on the rise. This compares to a 10% unemployment rate and periods of deflation immediately following the financial crisis. Lastly, monetary policy has transitioned from overly accommodative to the early onset of what appears to be an indefinite period of tightening.

Unlike the period when I wrote that "we are bucking the pessimistic spiral," I do not believe that the stock market rally since Donald Trump's election and the corresponding wave of optimism represent a pivot point for the market. However, I do believe that investors need to temper their optimism surrounding the impact of perspective tax cuts, corporate cash repatriation, and fiscal stimulus as these factors pertain to near-term economic growth and corporate earnings. The market's move since the election is more akin to a placebo effect in that President Elect Trump's prescriptions for our economy are still being developed and are certainly not yet showing any concrete efficacy with which to justify the prevailing shift in investor sentiment.

David Rosenberg, former Chief Economist of Merrill Lynch and current Chief Economist for Gluskin Sheff & Associates, was extensively quoted in a short commentary for the December 26, 2016, edition of Barron's titled A Faith-Based Rally?. Rosenberg stated, "It's time to take a bite out of a reality sandwich." He claims that "markets are overreacting to hypothetical conjecture and a whole lot of hope." Similar to what I had mentioned above, Rosenberg's comments in Barron's reminded readers where our economy and markets are within their respectful cycles and stated, "I've never found there to a President that's powerful enough to influence an economic cycle." The commentary cites a 52 cent increase in gasoline prices since the election, spiking mortgage rates, and the run-up in the value of the U.S. dollar as meaningful headwinds to the economy as we enter 2017. The commentary ended with a history lesson and a reminder from Rosenberg of who has the most influence on our economy. The history lesson centered on President Reagan's first two years in office. During this time, President Reagan signed a huge tax cut bill. In spite of this large supply-side fiscal stimulus, the economy fell back into recession thereafter and the stock market dropped more than 20%. Rosenberg states that the person to blame for that 1981-1982 recession should be the Chairman of the Federal Reserve. He says, "no one is more powerful than the individual who runs the Fed." One can see what Rosenberg is referring to in the Federal Reserve Bank of St. Louis chart below:



The chart above shows the Federal Reserve controlled Discount Rate as illustrated with the blue line and periods when the U.S. economy was in recession, which are the shaded vertical areas.

I cannot agree with Rosenberg more strongly about the power of monetary policy when it comes to economic expansions and recessions. Based on my experience and the work performed by Paul Kasriel, former Chief Economist of Northern Trust, monetary policy is more closely correlated with economic activity than fiscal policy. Dr. Kasriel wrote about this in his November 21, 2016, commentary titled Do Larger Deficits Stimulate Spending? Depends on Where the Funding Comes From. In this commentary, Dr. Kasriel examines, from a historical perspective, the correlations between increases/decreases in federal budget deficits (fiscal stimulus/austerity) and Gross Domestic Product (GDP) versus the same in response to monetary policy. As David Rosenberg reminded readers in Barron's commentary, Dr. Kasriel quantified the strong positive correlation between the expansion/contraction of the monetary supply through what he calls "thin-air credit" and changes in GDP. He conversely illustrated a negative correlation between deficit spending during periods of tax cuts and/or increases in fiscal spending and subsequent changes in GDP. The negative correlation associated with fiscal policy and GDP equated to a .36 correlation coefficient and the positive correlation coefficient associated with monetary policy, and GDP was .53. A perfect positive correlation would result in a 1.00 correlation coefficient. Dr. Kasriel ended his commentary by stating "there may be rational reasons why the U.S. equity markets rallied in the wake of Donald Trump's presidential election victory. But an expectation of faster U.S. economic growth due to a more "stimulative" fiscal policy is not one of them unless the larger budget deficits are financed with thin-air credit. Fed Chairwoman Yellen, whether you know it or not, you are in the driver's (hot?) seat."

Once again looking back to prior commentaries, during the period that preceded the financial crisis, I reviewed a commentary that I wrote in June of 2008, titled Here There and Every Where. In this commentary, I referenced mainstream economists, investment strategists, and government policy makers who appeared oblivious to the very real threats that were apparent to me within the economy, financial system and markets. I stated, "there are countless examples over the last 12 months of very highly regarded strategists, economists and government officials trying to downplay the very real risks that we view as a threat to our clients assets." In this same commentary, I also, once again, quoted Paul Kasriel from his March 2008 Northern Trust economic commentary known as the Econtrarian. The title to that month's Econtrarian was "It's So Over for Household Spending." Dr. Kasriel wrote "households have been running deficits – i.e., spending more than their after-tax income – since just before the peak in the NASDAQ stock price index. There are only two ways to spend more than you earn – borrow and/or sell assets. Households have been doing both to fund their recent deficits. These two deficit-funding sources will dry up in the coming years, which will force households to, at least, *attempt* to begin running surpluses again. Regardless of whether they are successful in their attempt to run surpluses, growth in household spending on goods, services and tangible assets, such as houses, is bound to slow significantly in the coming years." I reference this pre-crisis commentary and Dr. Kasriel's influence on my outlook because he was one of the very few economists who issued a warning to those who sought out experts with a track record of objective truth telling.

Moving back to current times, Dr. Kasriel's December 2016 commentary, which I will not delve into at length, is titled If You Think the Pace of Economic Activity Is Weak in 2016, Just Wait Until 2017. Dr. Kasriel summarized his tutorial on "thin-air credit" and its effect on economic growth by stating, "Based on published data so far for Q4:2016, the Atlanta Fed is forecasting real GDP annualized growth in this current quarter of 2.4%, down from the previous quarter's 3.2% annualized growth. With the current growth in thin-air

credit already very weak and likely to get even weaker after the Fed contracts the monetary base more in order to push the federal funds rate 25 basis points higher, real and nominal U.S. economic growth is likely to slow further in the first half of 2017." I cannot remember a time over the last fifteen years of following Dr. Kasriel's forecasts when he has failed to provide valuable and accurate insight into future economic growth patterns. It is concerning that the stock market's behavior over the last two months indicates that market participants are expecting 2017 to be a better year economically than 2016. Maybe President Trump and his cadre of billionaires, along with the most conservative Congress in history, will end up being able to defy economic truisms and the course of the economic cycle, proving both Dr. Kasriel and David Rosenberg wrong?

I would not advise one to take that wager in the form of making significant changes to their investment portfolio composition.

What I know for sure is that my 20 years of money management experience causes me to be very skeptical of the market when it is acting as if "it's different this time." There are times to increase bullish investment positioning or conversely to become overly cautious. However, the market tends to be a contrary indicator of such times. The aforementioned quotes from my commentaries written just before the financial crisis and the sentiment that I expressed near the bottom of the market are perfect examples of the benefit of looking beyond the market for direction. There is significant wisdom in Warren Buffett's famous quote of "Be Fearful When Others Are Greedy and Greedy When Others Are Fearful."

I wish everyone a happy and prosperous 2017. As a long-term investor I inherently view the future optimistically, however I will always have a healthy level of skepticism when it comes to fluctuations in short-term market sentiment. For me a valid investment thesis requires a clear outlook hinged upon the fundamental tenants of economics, capitalism, and value creation.

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