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MARCH 2017 INVESTMENT COMMENTARY

THE ELEPHANT IN THE ROOM

Let's talk about the elephant in the room. Eight years ago equity markets were more over-sold than most investors alive at the time had ever experienced. The economy was in a period of sharp contraction, and the U.S. was bleeding many hundred thousand jobs per month. Investor sentiment, as a result, was signaling extreme pessimism and corporate bonds were changing hands at discounts which reflected widespread bankruptcy risk. Over the last eight years, the U.S. economy recovered, and its growth in absolute terms and jobs created has outperformed the vast majority of other developed nations with a backdrop of slow global growth. The broad U.S. equity indexes have tripled in value during this time, and in retrospect, it is easy to identify that the bull market in stocks that began in March 2009 was underpinned by fundamental factors such as corporate earnings growth and a steady, albeit slow and durable economy.

Today, we find ourselves investing during an environment where broad equity market valuations are no longer inexpensive; job creation has backed off the strong trend established between 2010 and 2015 but remains strong enough to keep the unemployment rate in the sub-5% range. Today's broad equity market appears to be pricing in a significant ramp up in economic and corporate earnings growth over the next several years. This premise appears to hinge upon the prospect of a historically large personal and corporate tax cut, foreign profit repatriation, significant reductions in business regulations, and lastly a very large infrastructure spending plan. Over the last several commentaries I presented an economic argument that the most impactful force on the rate of growth in U.S. GDP is monetary policy, as opposed to fiscal policy (tax cuts & government spending). We have been in a period of contracting monetary stimulus since the fall of 2015 when the Federal Reserve ceased quantitative easing. Over the last 15 months, we have seen two hikes in the Federal Funds Rate, and the current expectation is that we will see three additional rate hikes in 2017. Thus, I remain unconvinced of the argument that we are on the cusp of a meaningful ramp in GDP growth rates. I remain unconvinced that any of the proposed fiscal policy proposals will meaningfully impact the current limitations that weigh on the U.S. economy's potential growth rate. I have discussed potential GDP growth rates numerous times over the last eight years. I wrote the following in April 2014 regarding future GDP growth expectations:

> *Regarding the current stubbornly slow recovery from the 2008-09 recession, I am not surprised that the U.S. economy is struggling to achieve a 3.0% annual GDP growth.*

I have not once in the last eight years gave any credence to those who argued that the U.S. economy's inability to grow as it did in past expansionary periods was self-inflicted. I believe that many people who argue that the United States can once again sustain an annual GDP growth

rate of 3-5% are ignoring fundamental economics, the law of large numbers, and for that matter, the last two and a half decades. I looked at five-year rolling averages of expansionary periods during the 1990's and 2000's. During the very strong economic expansion between 1992 and 2000, the five-year rolling averages of nominal GDP growth rates derived from the Bureau of Economic Analysis (BEA) annual GDP growth rates ranged from 3.37% to 4.30%. Following the 2002 recession, a large tax reform plan that cut individual tax rates across the board, and a stimulative debt-fueled housing bubble, the five-year average nominal GDP growth rate through 2007 was just 2.86%. Overly-burdensome corporate regulation did not characterize either of these expansionary periods. Furthermore, both of these periods benefited from unique factors that are not present today, such as baby boomers being in their peak earning years during the 1990's and loose lending standards that propelled significant borrowing and spending during the mid-2000's.

The bottom line is that 3-5% sustainable real economic growth is not a realistic expectation regardless of what tax cuts, infrastructure, and military spending plans are finally passed into law. The only way to pay for a large expansion of fiscal stimulus in a budget deficit friendly way is to utilize very aggressive dynamic budget scoring based on an assumed growth-driven expansion of tax revenue. Without a meaningful ramp up in sustained economic growth, the presumed growth driven tax revenues will come up significantly short, and our long-term deficit crisis will worsen. There are various outcomes that could unfold depending upon legislative action over the next twelve months, and the least likely outcome is the one that primarily retail investors are pricing into today's equity markets.

Nikolaos Panigirtzoglou of JP Morgan who tracks funds flows is quoted in the "Up & Down Wall Street column published in the March 6, 2017, Barron's. Mr. Panigirtzoglou stated that "so-called retail investors had been driving the stock rally. Institutions this year have kept their equity exposures unchanged or have pared them, according to the bank's indirect tracking of their stances. Individuals, in contrast, have been buyers of ETF's and driving the rally". It is informative to ask ourselves whether or not these individual investors were eager buyers of equities in 2009 & 2010 when equity investment opportunities were far more compelling? History shows that retail investors in large numbers were scared out of the equity markets in 2009 and have been very cautious ever since, until now. The apparent retail investor exuberance going into the ninth year of a bull market is something that should raise a lot of caution flags for more experienced investors.

The preceding discussion begs the question of what prudent long-term investors should do today? I believe that answer of what to do in any given market environment is risk management. For a long-term investor, risk management is not market timing or significant changes to strategic asset allocations. Risk management for a long-term investor comes down to security selection. When systematic risk is elevated, one should have heightened sensitivity to the margin of safety, correlation management (diversification), as well as a slightly higher cash level than normal. At Seven Summits Capital we normally do not hold more than 2-3% in cash in portfolios. In today's environment, I believe that an allocation to cash/ultra-short bonds and/or "market neutral" investment vehicles of between 4-5% is prudent. Given broad market valuation levels, the probability that future economic and corporate earnings will not live up to market expectations, as well as a geopolitical environment in the western world that is more uncertain and unstable than at any time since President Truman was in office, a slightly more cautious approach is warranted.

We find ourselves living during a pivotal moment in history that will likely be studied by historians very far into the future. The world order, organized through the leadership of the U.S. and its allies following WWII is at risk from an emergent strain of nationalism. The liberal democratic western world order rebuilt a war-torn Europe, created the state of Israel, helped relegate aggressive nationalistic powers such as Germany and

Japan to history, and brought to a conclusion the remnants of colonialism. This world order ushered in sixty years of unprecedented levels of prosperity, millions of people were freed from authoritarian rule, and Communism was contained and ultimately repudiated with the fall of the Berlin Wall and dissolution of the Soviet empire.

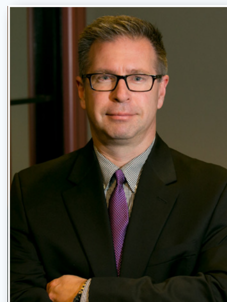
Going unnoticed from an investment standpoint is that greater western alliance is being challenged. This alliance, dominated by the United States sowed the seeds of freedom around the world, cultivated a robust middle class and built a globalized economic system that guaranteed the dominance of western ideals is currently under assault from both external and internal forces.

A combination of globalization and unprecedented innovation has shrunk the world from a commerce standpoint. This global marketplace has contributed to economic and military alliances which have relegated major continental scale wars to history, pulled millions of people out of generational poverty on a scale that is unparalleled in human history. This co-dependent economic construct has also been disruptive, and its speed of change has been accelerated by the rapid pace of innovation. The speed of this disruption has led to unintended social and economic discontent. Like many other times in history when social and economic discontent has been on the rise, political divisions widen, and the populist appeal of simplistic solutions to complex issues threaten the status quo.

Today's stock market is not reflecting any of the preceding risks. In fact, the equity markets are telling an entirely different story. I have never found any convincing evidence that short periods of stock market performance provide investors with useful information for prudent long-term investors. If anything, extreme moves in the market, up or down over the short-term, can be exploited by contrarian investors as they often reflect excess greed or fear. The S&P 500 has advanced approximately 9% since the Presidential election last November. I would not necessarily characterize this advance as extreme. However, the advance has occurred in the face of growing uncertainty when viewed in the context of the subject matter discussed within this commentary.

In summary, I have discussed various times over the last year, or more, the problems associated with the valuation of the broad domestic equity market relative to secular growth trends and economic fundamentals.

The current bull market advance is now entering its ninth year. According to Federal Reserve, we are approaching full employment and productivity growth remains stubbornly low. The stock market's recent resilience in the face of growing geopolitical uncertainty is likely a reflection of optimism regarding meaningfully higher economic growth going forward, period. If meaningfully higher economic growth does not transpire, which I do not expect, the optimism being displayed by equity investors is unwarranted. Even though broad market valuations and retail investor exuberance remains below extreme levels, the caution light is flashing yellow and heightened risk management is prudent.



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