Commentary
by Steve Henningsen
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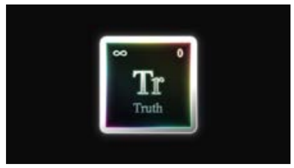
Truth



"Truth is so obscured nowadays
and lies so well established
that unless we love the truth
We shall never recognize it."
–Blaise Pascal

"The further a society drifts from the truth, the more it will hate those that speak it."
–George Orwell

"People everywhere confuse what they read in the newspaper with news."
–J. Liebling, Journalist

"The goal of education is the advancement of knowledge and the dissemination of truth."
–John F. Kennedy

I've read a lot over the past decade about rare earth elements and their importance to many modern technologies, including consumer electronics, battery storage, clean energy, and advanced transportation. However, in my mind, *Truth* is the rarest element of all and seemingly growing rarer by the day thanks to the deliberate distortions via modern-day mass media, coupled with the immediacy of the internet. (And Mr. Pascal thought things were bad back in the 17th century!) It's true that disinformation and propaganda have been with us since Octavia launched a campaign against Mark Anthony, but there is a huge difference today when something can be blasted around the globe in seconds via Facebook, Snapchat or Twitter compared to the days of the pony express. For some reason, many people seem to assume that if they read it, whether in the newspaper or a blog, then it must be true. And if that weren't bad enough, now some technology companies are trying to program the way our brain works through "Brain Hacking."

"Inadvertently, whether they want to or not, they are shaping the thoughts and feelings and actions of people. They are programming people. There's always this narrative that technology's neutral. And it's up to us to choose how we use it. This is just not true."
– Tristan Harris, former Google product manager via 60-Minutes

The 60-Minutes interview didn't surprise me much, as all you need to do is watch a group of teenagers walking down the street or adults sitting around a coffee shop to see that technology has taken over many a person's thoughts and activities. What does this have to do with truth and investing? After all, Madison Ave has been trying to influence our buying behavior for decades now. Well, this is a whole new level of influence beyond which car brand to buy, but encompasses a side of which political spectrum to fall and whether a government action is acceptable. The world is awash with Fake-News stories as we saw at play throughout social media in the U.S. Presidential election and other recent geopolitical events.

In my world of finance, I have seen the truth obscured, stretched or even purposely misrepresented, whether it's through corporations' generous use of Non-GAAP accounting practices or central banks' direct manipulation of asset prices via Quantitative Easing and Negative Interest Rate policies. In my opinion, it seems central bankers use the media (CNBC, Wall Street Journal, and even Twitter) to try and lead markets on their policies and now we even have politicians taking to social media in an attempt to persuade their constituents.

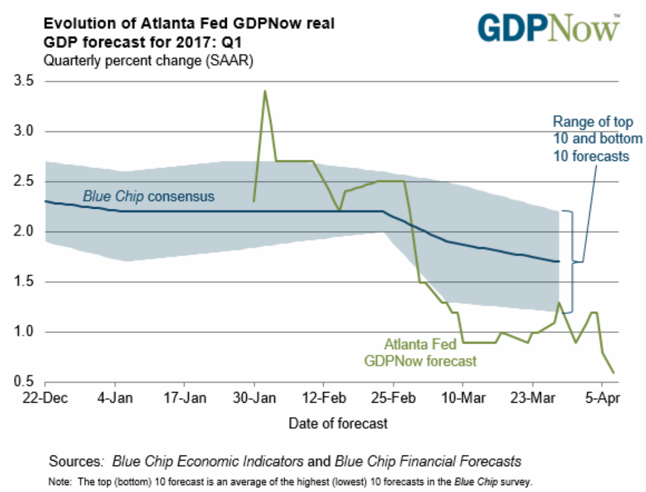
"The general population doesn't know what's happening, and it doesn't even know that it doesn't know."
-Noam Chomsky

If I had a wish before I die, it would be that I would be taken into a room and told the truth as to what is really going on in the world – a look behind the wizard's curtain, so to speak. I'm not sure if I could handle the truth, but it might help me better understand what's ailing our country. A country with an epidemic opiate problem and millions living paycheck to paycheck. Investment writer John Mauldin recently referred to this environment in his article, Angst in America:

"There's a general sense in much of the developed world that we're headed for more difficult times. Deficits increase, unemployment rises, and the benefits of the future – or at least the future that is already here (to paraphrase William Gibson) – have been unevenly distributed throughout society. It is not just in voting patterns that you can recognize the sense of malaise. You can see it in the economic numbers and in a lot of the psychological/sociological research."
–John Mauldin, Angst in America, March 19th, 2017

He goes on to explain that, "A huge swath of the country was experiencing a yawning disconnect between the reality of their daily lives and the supposedly growing economy touted by politicians and media pundits." Yes, the average-Joe feels the disconnect, which could be one reason why we have the unconventional President Trump in office.

Even the economy itself seems conflicted these days, as highlighted in Steven Russolillo's Wall Street Journal article, Sentiment vs. Reality: The Economy Is Telling Two Different Stories. The subtitle was: "The difference between what people say about the economy and actual economic performance is at a record." Without a doubt, investor and business confidence rose after Trump was elected, as hope often does after elections, but the gap between "soft" and "hard" data has grown since. Survey- based reports, such as the ISM report, have been stronger these past few months but hard economic data reports, such as consumer spending, auto sales, and GDP reports, have been weaker. Most interesting has been the GDP reports, as many had anticipated better growth this year. However, the Atlanta Fed releases an estimate every few weeks of the upcoming quarterly GDP number and the most recent was 0.6 %. As you can see to the left, estimates were for close to 3% at the beginning of the year and even if it gets revised higher, one has to wonder why it's so off at the moment.



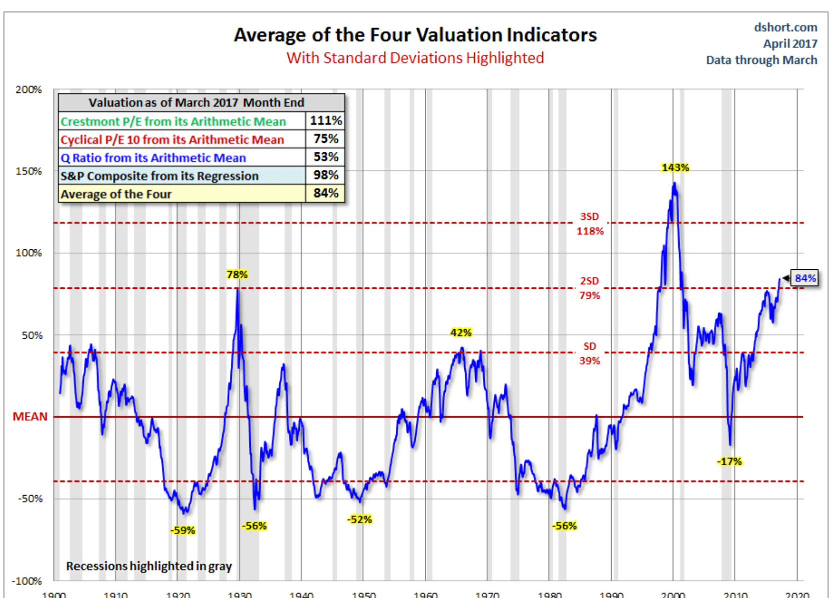
Honesty is such a lonely word
Everyone is so untrue
Honesty is hardly ever heard
And mostly what I need from you
–Billy Joel, Honesty

Could some of the malaise that has seeped into the American psyche be due to the fact that there seems to be a different set of rules for those in government and Wall Street? It infuriates me that hardly anyone has gone to jail after the 2008 financial crisis. When people point out that at least the banks paid billions in fines, do they know that the banks made almost a trillion during the same period? It seems like a new bank manipulation scandal comes out every other month, including the recent news of the Bank of England being accused of rigging the libor rate. Here at home, the president of the Federal Reserve Bank of Richmond, Jeffrey Lacker, resigned the other week after admitting he leaked information to a financial analyst back in 2012. Nonetheless, given his position, he won't face any charges or lose his pension. You or I on the other hand would probably be looking at serious jail time.

"I'm sick and tired of hearing things from
Uptight short sided narrow minded hypocritics
All I want is the truth, just give me some truth"
–John Lennon, Gimme some truth

We then get to JP Morgan's CEO, Jamie Dimon, in his recent annual letter where he points out, "Something is wrong in the U.S… Since the turn of the century, the U.S. has dumped trillions of dollars into wars, piled huge debt onto students, forced legions of foreigners to leave after getting advanced degrees, driven millions of Americans out of the workplace with felonies for sometimes minor offenses and hobbled the housing market with hastily crafted layers of rules." While this has been obvious to many of us, it's another thing coming from the head of the largest Wall Street Bank. In my opinion, it is rather ironic and hypocritical coming from someone whose industry has helped put America in its current state.

"The problems of state and local pensions are cumulatively huge. The problems of Social Security and Medicare are each huge, but in 2016 neither candidate addressed them, and today's White House chief of staff vows that the administration will not "meddle" with either program. Demography, however, is destiny for entitlements, so arithmetic will do the meddling."
–George Will, America's Predictable Pension Crisis, National Review



Another administration, another kick of the can! It seems to me that nobody wants to face the truth that our pension and entitlement systems are grossly underfunded. Yet as Mr. Will points out, arithmetic will pull back the covers on this 800-pound gorilla soon enough.

It certainly doesn't help the pension situation that investors are positioned in a stock market that is currently the second highest valuation in its history. (For those who wish to read more about the meaning of this chart and other ways of viewing the current excessive valuation of the stock markets, John Mauldin did a recent article on it here.)

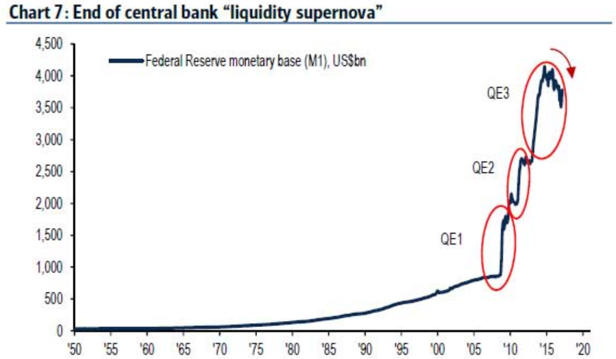
Admittedly, many of us have been concerned for several years, and the stock market has continued to rise. Timing is always a difficult matter when dealing with the human psychology of greed and fear, but throw in the central banks' unprecedented liquidity policies, and it's even more difficult to predict. Just because stocks are historically expensive doesn't mean they can't become even ***more*** expensive. (I faced this leading up to the 2008 financial crisis as well, although not to this frustrating extent.) I'm also aware that on any day President Trump could announce a significant restructuring of our tax code, freeing up billions and billions of capital, which could extend the markets further. However, there are some signs that the central banks' easy money policies are nearing their end.

Liquidity Tap being closed?

"Some participants viewed equity prices as quite high relative to standard valuation measures."
–Fed Minutes, Released 4-5-17

No, this wasn't Steve warning about stock valuations, but Federal Reserve members from their recent March meeting. Even more interesting, it was mentioned that the Fed might begin reducing its balance sheet before the end of the year. As one can ascertain from this chart, the Fed grew its balance sheet from less than $1 trillion dollars before the financial crisis to $4 trillion at its peak. The question that should be on investors' minds is how the Fed plans on letting the air out of the balloon when most realize that the air in the balloon was a large catalyst for the rise of the stock markets.

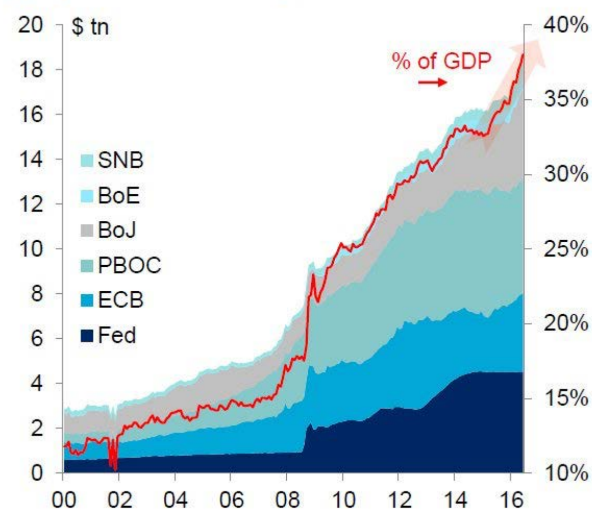
Chart 7: End of central bank "liquidity supernova"



Source: BofA Merrill Lynch Global Investment Strategy, Federal Reserve

More and more and more!

Aggregate balance sheet of large central banks, $tn & % of GDP



Source: Citi Research, Haver.

And this is a global phenomenon, as central banks have bought up almost $20 trillion dollars globally. While Japan, Europe, and Switzerland are still adding to their coffers, there is increasing chatter that, like the Fed's, their programs will also need to end soon. What the effects on the global bond and equity markets are is anyone's guess, as many of these policies have never been tried before. From my prospective, it seems the central bankers are proceeding by experimentation. While some see risks from the deleveraging, others see the possibility of central banks just maintaining the status quo. Either way, the Fed's decision to raise interest rates has put pressure on other central banks as to how they can proceed with their own policies.

The China and Russia Convergence Continues

"The system that the world has relied on for self-governance for the last three-quarters of a century is pretty much at the end of its fiscal life"
–Gen. Michael Hayden, Be Ready for Worldwide Shakeups, Palm Beach Daily

As the above article points out, he was referring to the post-World War II financial system that resulted from milestones, including the Bretton Woods Conference and the International Monetary Fund. I have been discussing the impending realignment of the global monetary system for several years now, and nothing I have read dissuades me from this belief. Conversely, all one has to do is read articles from outside the United States to see that Russia and China are still working together to distance themselves from the U.S. dominated financial system. Two recent articles can be found here and here.

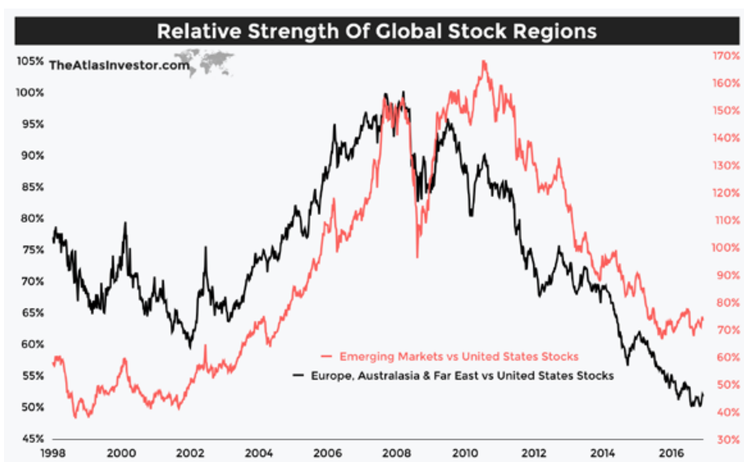
Blame it on the lies that killed us, blame it on the truth that ran us down
You can blame it all on me, Terry, it don't matter to me now
-Bruce Springsteen, Backstreets

Is the truth so scary, that many would rather live in denial or strike back at those who openly discuss these risks, labeling them conspiracy theorists or pessimists? I believe that over the next 18 months, some truths will come to light and we shall be ultimately better for it. Unlike the dark backstreets in Bruce's world, the truth won't run us down.

Portfolio Ponderings

"When nothing happens for a long time, people begin to assume that nothing ever happens. But something always happens in the end."
–Steve Lagavulin, writer

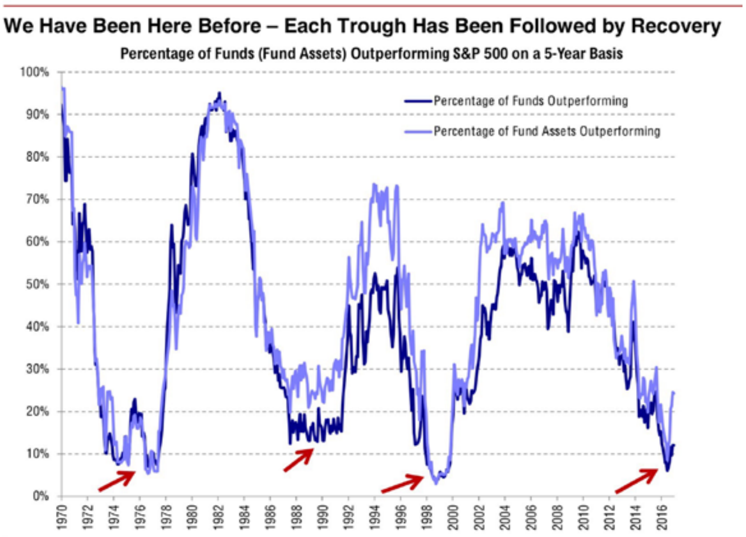
While many of the concerns I have voiced in the past have not come to fruition (yet?), the risks, even if ignored for now, still lie beneath the surface. Whether or not they break the light of day, we shall have to see, but I feel we are closer to a recognition of the truth than we were a mere year ago.



As many of you know, I'm a believer in cycles. In the financial world, mean reversion is the theory suggesting that prices and returns eventually move back toward the mean or average. As shown in this chart, international markets outperformed domestic markets for much of the 2000's, while that trend has reversed since 2010. With U.S. markets currently trading at much higher valuations than foreign markets, my belief is that over the next 5+years, foreign markets will outperform domestic as valuations adjust. What this means for our portfolios is that I will shift more towards foreign-stock markets over the next 12 months. I'm a bit more cautious short term, given the upcoming French elections and increased saber-rattling with Russia, but the direction seems clear to me. At some point ahead, I envision reducing some of our precious-metals positions and reallocating the cash to international markets.

"The demographically-driven, credit-driven popularity of financial asset markets over the last generation, combined with loss protection provided by exogenous market forces (i.e., central bank "puts"), have given financial asset markets the patina of risk-free sanctuaries. They are anything but. The truly unintended consequence passive investors will discover (soon, we think) – is that beta investing is not saving. Investing in financial asset markets remains speculative…now more than ever."

-Paul Brodsky, Populism In Our Time - "The Status Quo Is The Fundamental Problem"



Note: For details, see Fig. 1 on page 2. Source: CRSP, Bloomberg, Robert Shiller data, Instinet research

Another trend that I believe will be reversing soon is the movement towards indexing. To be clear, I am a big fan of indexing, because it can be an inexpensive, tax-efficient way to capture the returns of asset classes or specific industries. However, like many fashions, it can go too far and get too popular. This chart shows that most "active" managers underperform the markets (S&P 500 Index here) when the general trend of the stock market is up, as it has been over the past several years. When the markets turn down, however, this reverses as active managers have the ability to hedge or hold cash while the indexes decline. No guarantees, of course, but the environment seems to present the opportunity. As Paul stated above, many investors have been lured into the passive world over the past few years given the market's low volatility and upward trend. While I believe that it would be best to lean away from indexing of domestic markets given current valuations, I wouldn't be against passive investments in the international markets.

"Three things cannot be long hidden:
the sun, the moon, and the truth."
-Buddha

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