Palmetto Wealth Management

Anger Management

John M. Gustafson – 30 December 2018

"Angry people want you to see how powerful they are… loving people want you to see how powerful You are." - Chief Red Eagle (*William Weatherford*)

After a wild and crazy 2017 that defied logic at times, 2018 clearly said, "Hold my beer…" A year that began with a strong market has ended by continuing strong rhetoric that has finally resulted in uncomfortable volatility and fear for the future. The last time we had a quarter this bad (even after last week's rebound rally) was the third quarter of 2011 - and if you recall, that flop was also caused by the mismanagement of the U.S. economy coming from inside the Beltway.

Back then, it was the Tea Party throwing their weight around and hinting at the option of America simply refusing to pay its debts. As you can probably recall, the resulting destruction of confidence (with the corporate debt crisis of 2008 still fresh in everyone's minds) gave us a violent reminder via the stock market that words matter. By the way, if this theory is ever floated in an early-morning Twitter-rant, we will sell everything.

Smash cut to 2018 and most of the volatility and agita of late has been caused by those in power failing to understand simple economics, continuing to press invalid points, changing direction on a whim and simply creating an environment where companies can't make any long term plans. Whee!

Stock buybacks just exceeded $200 billion for the first time in a quarter – you can't make long-term plans as a "tariff-man" wages a trade war. The 2017 tax cuts worked as promised and repatriated billions of dollars to corporate coffers in America, but planning has been shelved for many capital projects until more clarity is calculable in the future.

Buybacks will certainly shore up earnings on a per share basis in the future, but they don't really stimulate long term growth. Opening a plant in America to produce goods you may or may not be able to sell to former allies is not being a good steward for your shareholders. Corporate executives understand far better than members of Government who it is they truly serve and act accordingly. Unfortunately because they have competition and are far easier to remove form their comfy seats.

"A fool gives full vent to his anger, but a wise man keeps himself under control." – Proverbs 29:11

As of this writing, we are witnessing the quintessential battle of the unstoppable force (POTUS) versus the immovable object. (Congress) And it is why I have embraced a moniker a friend bestowed upon me earlier this year - I'm "bipartisan" - I hate both sides of the aisle and all of their ridiculous dysfunction and rhetoric. I don't care where you sit currently, there is literally nothing positive for our Country or the economy occurring by either party in D.C. (Remember, our focus here is investment and economics, not general policy.)

"Holding on to anger is like grasping a hot coal with the intent of throwing it at someone else; you are the one who gets burned." - Buddha

I went into great detail last quarter about the historical folly of "winning" a trade war, so I'll spare you that rant. Instead, I'd like to focus in on the real problem when it comes to our current investment markets.

As we have long discussed in these missives, the markets don't love good news and hate bad news (empirically) - the dangerous aspect of finance is uncertainty. It is why the earlier example of even the hint of the U.S. somehow failing to repay its debts caused such a catastrophe. You can't value a situation previously considered absolutely impossible.

This is the issue with the Chinese trade war we are currently experiencing - the odds are not incalculable, they are literally unknowable. Just because the perception is that China has "more to lose" doesn't mean they don't have the resolve at the top to stay the course. This is the game-theory arm of economics and can be illustrated best by a game of chicken.

Both cars are barreling toward each other, both sides understand that if you choose to "drive" rather than "turn" it can result in a total loss. However, the outcome is based on who wants the win more despite the potential disastrous outcome. Sometimes the person with "more to lose' actually has more resolve to seek a win.

Either way, you cannot predict the outcome of an ego-driven game like this based solely on who has more to lose because the stakes for both are actually quite similar. Bottom line, this will dominate the news for the coming months - both positively and negatively. If both decide to "turn" the markets will likely explode upward, but if both decide to see it through… Well, you get the point.

Unknown information can be analyzed and speculated upon (or hedged against) - whereas unknowable information is the very definition of uncertainty when you reside in the world of managing risk and assessing potential outcomes.

It is partially why we pulled a good measure of cash to the sidelines during the last rebalance in October. The political rhetoric ahead of the election was causing too much noise and the safe move was to avoid it. There will certainly be dramatic changes to the political landscape in the coming months. We will be looking to see if there is a shift toward a more normal world of "known unknowns" or continue down the path toward "unknown unknowns" i.e. "unknowable" options.

"Anger gets you into trouble, ego keeps you in trouble." - Amit Kalantri

A more recent event that caused quite a bit of dislocation on Christmas Eve was the Treasury Secretary's ham-fisted attempt to calm things down - only to cause more concern. Until his tweet about calling banks to make sure all felt they were still solvent and willing to lend, nobody (and I mean NOBODY) had even thought that another 2008 credit crisis was in the cards. These market moves have simply been viewed as an old Bull banging up against bad trade policy and a Fed attempting to control inflation - period. And as outlined here many times before, everyone is always looking for the thing that blew up last time, and it's rarely the cause of problems in the future. We are great at solving old problems - it's looking ahead where regulators fall short.

The real ridiculousness of making these phone calls to surprised bankers is that the Federal Reserve already has this kind of information and makes it public monthly. It's called the "Senior Loan Officer Opinion Survey on Bank Lending Practices." Possibly the use of a report from the Fed is not the correct answer for Secretary Mnuchin's boss and he had to attempt to reinvent the wheel.

One true villain in the recent unbelievable market volatility is a scourge I outlined at length way back in April of 2014 in a note entitled, "Seesaw, Margery Daw…" - High Frequency Trading. Basically, legalized frontrunning of market orders. One can literally see when the machines are operating at full song. If things are going badly, HFT accelerates them downward - if things turn upward and cross certain barriers mathematically calculated by the algorithms, HFT throws gasoline onto the fire.

Both were in evidence just last week. Christmas Eve (the worst ever) was a bad day that completely fell apart late. Boxing Day fought off a continued slide early and once recovery was secured after noon, exploded higher for the largest point-jump in history - with most of the rise coming in the last 90-minutes of the day. These unbelievable moves occurred on successive trading days. Humans simply can't move and change that quickly. The old market saw that "Bears take the elevator but Bulls take the stairs" feels somewhat antiquated these days.

If you are patient in a moment of anger, you will escape one hundred days of sorrow. – Chinese Proverb

With all of this risk outlined, what could be a positive for the New Year? The economy for one, despite reports of impending doom and recession is truly still chugging along nicely. Uncertainty may be putting a damper on expansion at this point, but current operations are moving along nicely. Ironically the real cap on our current economic expansion may be legal immigration.

America is at a point where there are more job openings than available workers, but there is also an issue of dislocation. Many people are simply not in the area where the new jobs are located. This is also a current political fallacy - new jobs are not being dropped into the hollers of West Virginia and the poor, uneducated (rural) areas of the country.

However, places like Columbus, Dallas, Northern Virginia, and even the tax-heavy Pacific Northwest are absolutely *booming* because of the availability of educated, skilled employees and useful infrastructure to move goods.

A solution might be to bring the mountain to Mohammed and could be an area where those in D.C. may actually agree. Infrastructure projects to further connect forgotten areas could be a boon for those economies and popular amongst voters. Such legislation may be even more likely now with a divided government, simply because everyone likes to shovel money back to their districts and the deficit hawks have all been silenced. Stay tuned…

Also, there could be an agreement with China. As outlined above, it is simply unknowable because of the players involved, but if the tariffs suddenly go away and both sides can claim victory… Hold onto your hats!

Finally, with oil suddenly in a glut and the price falling precipitously, it's like handing American consumers another tax cut - which we know will be spent. It also helps the Fed justify hitting the pause button on its rate-raising path. (They probably would have done that last week, but politics got in the way to the point they *had to* continue with their tightening path so as to retain their global credibility.)

We're at a point now where "savers" can earn a somewhat decent return for the first time in over a decade, but the burden in the credit markets for homes and corporations is still far below any historical average. Complaining about current rates is simply a diversion.

"Do not be quickly provoked in your spirit, for anger resides in the lap of fools." – Ecclesiastes 7:9

The bottom line, when it comes to investments and current plans, we're comfortable with the adjustments made in October (our downside volatility has been about half of the markets) but will continue to adjust (raise / deploy) cash levels as the future unfolds. It's an uncomfortable time for sure, but a somewhat natural occurrence based on the age of our economic recovery from '08 and the age of the Bull. This too shall pass…

Thank you as always for your business. Here's to a great 2019 - Happy New Year!