



Chaos Theory

John M. Gustafson – 30 September 2020

Civilization begins with order, grows with liberty, and dies with chaos. - Will Durant

This quarter's market-missive was actually roughed-out and titled well before we tuned into the dumpster fire on television Tuesday evening. With a desire to remain relatively neutral and out of the partisan split in current American grievance and tribal politics, I will attempt to frame that picture in terms of our portfolios, with a near to intermediate term outlook.

After what we've been through in 2020 America, our economy does have some concerning long-term damage. However, the broad stock market has rallied to a slightly positive position YTD in spite of where we are in reality, primarily because the market is anticipating what *should* happen – in spite of recent D.C. inaction. Also, large companies are still drunk on stimulus payments along with an historically accommodative, boundary-pushing Federal Reserve, who currently never misses a chance to tell us that the spigot will be turned up to 11 for the foreseeable future.

The dark clouds a revealed as we attempt to come out of the snap-recession are the many small businesses that remain in deep trouble. Large corporations have the ability to borrow cheaply, outsource their supply chains away from the US (or at least form multiple areas) and also maintain the ability to operate on skeleton or distant staffing.

Most small businesses don't have the margins available to run at anything other than 50%-75%+ capacity without significant losses. They also don't have the ability to just eat it, run a deficit and power through to the other side. There will be "the other side" and the "new normal" at some point, but we're not likely to enter the next chapter until several more quarters.

No one wants advice - only corroboration. - John Steinbeck

I'm certainly not complaining about the fact that our portfolios have recovered into positive territory after the spring break and our moves made early have worked. *But*, the economics of unemployment, small business failures and the lack of another stimulus bill leads me to believe we are hovering at stall speed and likely to see a significant slowing as we near the election day.

Many of the jobs furloughed temporarily at first (almost 35 million at the peak) have become permanent over the past six weeks leaving close to 8 million on the sidelines - despite claims of the great, V-shaped recovery. As bragged about here previously, Columbus is the "fashion

capital of the Midwest” - well, about 1000 jobs from some of the largest fashion companies became permanently lost in mid-August. These weren't hourly store employees either. These were mid-level analyst and management jobs that paid anywhere from \$60k - \$150k+-very white, not blue collar. Not easily replaceable and certainly not smoothed over by unemployment benefits, even with the now-expired extra \$600 per week.

Disney also joined the fray with the announcement of 32,000 theme park employees – mostly part time – will be permanently furloughed in the next few weeks. The airlines are reportedly next and who knows after that if things remain stalled. The overriding theme is that the drop was swift, about two-thirds have recovered, but we have clearly now hit a soft patch. And because of the damage, there are now less people employed in America versus four years ago, despite having a historic, record number employed to begin this year.

There was renewed talk over a second stimulus bill by Pelosi and Mnuchin that drove markets higher today, but by the afternoon, McConnell made that seem, once again, unlikely. It appears as though the GOP has decided they are returning to their “fiscal conservative” roots, despite spending like drunken sailors over the past three years of largesse. Remember, we don't have a revenue problem – tax revenues, despite the corporate cut, were at record levels each quarter, right up until COVID hit – but the Feds still spent it all and then some.

The battlefield is a scene of constant chaos. The winner will be the one who controls that chaos, both his own and the enemies. - Napoleon

Another blow to American prosperity still comes from China. As we have pointed fingers and taxed Americans with tariffs, they have methodically looked elsewhere across the globe to wield their influence.

They are now one of the most significant investors in developing Africa. A continent that many have eyed for years, but haven't made any progress. The Chinese, however, not only have plenty of capital to make deals to build infrastructure and keep their economy running at home, they willingly provide workers and training to get things off the ground locally.

This isn't just significant for an investment standpoint (yet) but it is very significant when it comes to U.S. leadership in the world. As we become more isolated, they continue to grow their influence. I've never been a defender of China and their oppressive regime, but we need to learn to better handle the Dragon or we will be permanently knocked from our perch atop the world.

When I began in the investment business in the early 1990's, China's economy was roughly 1/10th of the U.S. - they are now approximately 80% of our size. They will not be brought to heel with the blunt instrument of tariffs. We need to figure a new solution and it will take time.

It has been very truly said that the mob has many heads, but no brains. - Antoine Rivarol

Another current risk is a big controversy we hear about almost daily – mail-in ballot fraud.

In reality, there are only 9 states (plus D.C.) who are mailing ballots – unrequested – to all registered voters – the target of the President’s latest attacks. They are: VT, CA, NJ, HI, WA, OR, UT, CO, NV & D.C. That’s it, that’s the list. Does it feel like those states will touch off “massive fraud beyond anything we’ve ever seen?” Let’s have a look...

There are basically two groups (and one outlier) of these all-mail states, those that Trump wouldn’t win no matter what: VT, D.C., CA, NJ, HI, WA & OR – and those that he would likely win, no matter what: UT & NV. Even if the two he would normally win are “stolen” via ballot fraud – that totals 12 Electoral votes. (Out of 535 with 270 needed to win the election.) The only toss up is CO – and that is 9 Electoral votes.

It is only significant to give cover to lawsuits and other disruptive nonsense by a group of people who clearly think they are going to lose bigly in November. Actions clearly speak louder than words, especially in politics. This is chaos brewing...

Political chaos begins with the decay of language... one can probably bring about some improvement by starting at the verbal end. - George Orwell

By now it is probably quite clear that election is my highest concern... Regardless of the actual reason, there have been very few market dislocations as difficult to navigate and shocking daily as Bush v. Gore back in the fall of 2000. And that was a fight between two lifelong gentlemen politicians who accepted the words of the court and moved on once the battle was over. We clearly don’t have that right now. This isn’t speculation or hyperbole based on clear statements from each of the current candidates.

The greater danger for most of us lies not in setting our aim too high and falling short; but in setting our aim too low, and achieving our mark. - Michelangelo

So, where does this leave us and our strategy to navigate these stormy seas? The old adage of, “He who panics first, panics best.” and “Discretion is the better part of valor.” both seem to have worked for us this year and appear to be a good strategy once again as we creep closer to election day.

If you recall, fairly early in the crisis, we did a full rebalance, pulled certain international exposures and raised significant cash. That allowed us to get hit by the tsunami with less damage and stay ahead of the recovery.

We are at a point now where that appears to be the correct action once again. Despite the fact that our “cash” holdings are currently yielding less than 1% and still at fairly elevated levels for most portfolios, it is better than taking a huge loss because of the uncertain transfer of power in the most powerful country in the world.

We are operating under the Will Rogers principle - “I am more concerned with the return *of* my money, rather than the return *on* my money.”

Please don't think of this as trying to time the market – think of it more as a prophylactic, like wearing a mask. If it helps, that's great – and it certainly *won't* hurt. As we have experienced together through the years – and especially this one – the markets neither *hate* bad news nor *like* good news as much as they absolutely fear the unknowable.

At some point in the next couple of months I believe that is where we will be and I'd rather be proactive and wrong, giving up a few shekels to the upside, rather than bounding forward into a buzz saw.

We're clearly not pulling completely out, that is never my style. (Investing is like using a rheostat, not a light switch.) But I don't want to put anyone in a position where they can't finish the ride or the stress becomes too great – those bailouts are *always* at the wrong time.

I'm working on the allocation weighting tweaks currently and will implement the moves in the next couple of weeks and will continue to hope we have a decisive election victory within a few days of November 3rd. If that's the case, we will still have plenty of exposure to enjoy the upside, but if we don't, we will have powder dry to participate once things are truckly settled. Remember, *hope* is not a strategy.

“Every great change is preceded by chaos” - Deepak Chopra

On a positive note, there are three things that could occur that will make my caution totally wrong and will trigger an immediate, more bullish adjustment back into the market.

First, there is a definitive, unquestionable victory for one of the candidates by the morning of November 6th. (Either one, it doesn't matter – the uncertainty is the real short-term danger.)
Second, the Congress passes a significant stimulus package with another round of direct payments, state and local government relief and more small business forgivable loans (more specific than the previous program) sometime in the next couple of weeks.
Third, no additional violent conflicts break out in the current hot spots.

Our economy was strong - growing for 127 months before ending in January of this year. Our country will be once again - and we need to stay in the game for the long haul.

Thank you as always for your trust and your business Stay safe & healthy and we'll talk to you again soon. Cheers!

A handwritten signature in black ink, appearing to read "J.M. Artale". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.