Perspective

John M. Gustafson – 3 April 2016

As the first quarter of 2016 comes to an end, and we ease into the second, there is a good feeling around the office that the scenarios outlined in the January comments have come true. I don't want to hurt my shoulder patting myself too heartily on the back, but it will be enjoyable to take a brief look at what was wrong near the end of 2015, why things changed so abruptly, and what is likely happen going forward.

If you recall, as 2016 began, oil had fallen from around $100 per barrel 18 months ago, all the way down to near $30, with the folks at Goldman Sachs predicting a continuing enormous drop into the low $20s. That may have been the height of panic… Two facts were outlined in our note that have proved critical to the change; 1) even the Saudi's were having trouble keeping their budgets in-line with oil as low as it was, and 2) the fact that oil is priced in US dollars, a currency that had done nothing but strengthen for months. Just as when oil was well over $100, with predictions of it going to $150+ was mainly caused by a severely weakened dollar and a tightness of supply, the opposite of course holds true. The very strong dollar and plenty of supply resulted in the massive drop. This has always been a glut of supply, NOT as crashing demand. (Although the Bears continued to pound the "pending global recession" thesis for months in the face of continued data that simply did not agree.)

Since early January the US dollar has weakened slightly, not dangerously so, but enough to ease up on oil prices. The second thing that happened is that the Saudi's did blink and at least softened their tone regarding continued heightened supply. As much as they would like to continue to punish the Iranians (and even the US shale producers) even Kin Salman does not have a limitless supply of cash to fund their domestic social programs that keeps his family in power.

The fact that oil has risen 50%, to the upper $30's, doesn't sound like news great for the global economy; however it is more an instability issue rather than an actual price-point issue that has caused a lot of the problems. It is a common belief that oil prices north of $40 makes it profitable for almost any producer. This has also had a massive calming effect on the high yield bond markets, as the fear of massive defaults by debt-laden drillers has fallen sharply.

The other issue is that after bouncing off the panic bottom, prices have seemingly stabilized in a somewhat narrow range for the past few weeks which the markets welcome more than anything. Certainty, even if it's bad news, can be valued properly. Uncertainty, even if the outcome may be wildly positive, does nothing but cause chaos - pricing mechanisms simply don't work well in that environment.

Another slight but significant change in sentiment is around the idea of the aforementioned chance of global recession. Many pundits who were excoriating the Fed for raising rates in such a precarious environment – even as small as the rate increase was – have quieted their commentary slightly. Unemployment (or job creation) has continued to be robust, despite what you continue to hear from the political stump. (more on that later) Corporate earnings look decent – certainly not on fire – but good. And GDP, both at home and abroad, continues to trend upward. Not a wildly inflationary environment to cause the Fed to raise rates significantly over the next 12 months, but clearly not a recession. As continually outlined in these missives, slow growth is NOT recession.

I don't think what's making everyone feel badly is simply the political blather emanating from either side of the aisle as we stumble towards electing a new President - I think that with modern communication we can truly see how bifurcated and different everyone's opinions truly are. I'm not even professing that this is a new societal development; I'm simply stating that with current technology, as in many other facets of our lives, we are now more aware of the differences and insulate accordingly. Also, the fact that we are all so connected appears to make these differences starker and reinforce each position.

The most famous example of what I'm trying to outline is likely from *The New Yorker's* movie critic 40+ years ago, Pauline Kael, who famously exclaimed (while fully enmeshed in her upper West side, Liberal neighborhood) "I can't believe Nixon won, I don't know anyone who voted for him." I know the actual quote is much lengthier, but this is the generally accepted summary of her feelings at the time.

This is truly a great example of something known in psychology as "confirmation bias." It is also one of the reasons, which I've read in several studies, that when an intelligent person makes an error, it tends to be grander and much farther off the path than a less intelligent person – simply because the more intelligent person is better at finding confirmation for their beliefs, rather than being completely open-minded. (It's one of the things I wrestle with constantly while viewing the markets and managing your portfolios.)

Now to bring this into the context of trying to explain the recent markets and the wild action… We have more and more information constantly at our fingertips, which would lead you to believe that folks would make more fully informed decisions. However, most people become quite good at reading and listening to only the opinions of those who fit their personal narratives – not only the internet allows this, but 25 cable news channels live on it. A theme that is blatantly obvious in our current political environment and also quite prevalent when it comes to investments.

The sheer volume of opinions available means that you can find as many as you want that agree with what you already believe, completely ignoring those from the opposition, even though they are equally prevalent. Google any news event or current investment strategy and there will be hundreds extolling the virtues on opposite side of each proverbial fence.

So, what does this all mean to our portfolios? It means, from a personal standpoint, that I will likely always continue to write these commentary pieces at least quarterly, because they force me to try and see both sides of the current environment – politically and in terms of the markets – because of the diverse readership and my broad pool of clients, for whom I work. We're neither Fox news nor MSNBC around here, and we're not preaching to the choir – I know there are both Nixon and McGovern supporters reading these words.

Enough philosophy for today, on to the business at hand… Because we seem to have survived the storm in oil and now believe the Fed is once again our friend, the path forward from a business standpoint seems less fraught with peril. Though the dark cloud of politics, an ongoing theme in these notes for almost 7 years now, will still be causing chaos for the next seven or eight months as we move through a few more primaries, the conventions and onward to the general race.

Back in January my discussion was around the Republican clown-car still fully functioning - we now have a completely different barrel of monkeys on our hands. (or at least a different dynamic surrounding said monkeys) Also back at the beginning of 2016 the repartee between Bernie Sanders and Hillary Clinton was fairly genteel and that too has recently changed drastically.

Most interesting is that the two candidates who bring out the biggest negative reaction from his / her opposition, and looked unstoppable back in early January, are now looking much less likely to be the actual nominees. The GOP appears ready to burn down its own house over Trump and allow whichever Democrat is nominated to waltz into the White House. A blatant, desperate attempt to retain their shadowy, backroom power... As I've said all along, the one saving grace of Trump's candidacy, regardless of what ridiculousness comes out of his mouth, is the fact that he will not be owned by anyone in the shadows, as will every other candidate running.

Hillary herself seems to be waning in popularity as more and more Democrats feel that their electoral process is rigged as well. Not to mention the fact that her information security breaches while at the State Department continue to be actively sifted through by the FBI. Stay tuned…

Which candidate would be better for our investments? A very tangled web for sure that I shall attempt to uncoil…

The biggest wildcard of course is Donald Trump. He's the 21st century bloviating, narcissistic, self-promoting, P.T. Barnum reincarnated. A man that makes Bill O'Reilly seem demure. If he survives the scheduled knife fight at the Republican convention and chooses his running mate wisely, (i.e. Southern or Western Republican Governor / Senator, with a good record and lots of experience - and preferably a minority or a woman) I think he would immediately leap into the favorite spot in the general election. If he fails to learn from history and picks a "Maverick" – well, we all know how that story ends… Such a development may not be a positive initially for the markets, since nobody really knows what he could accomplish, (if anything) especially depending on what kind of wedges are driven into the Republican Party during this battle.

If any other person that hasn't won the vast majority of votes and / or delegates during the primaries comes out of the convention with the nomination they have zero chance. (Which is why I would be shocked if Paul Ryan were dumb enough to entertain the idea if asked.)

At this point, assuming politics takes over and no matter what the FBI finds, the Justice Department chooses to do nothing, the math simply doesn't work for Bernie. Hillary will then become the immediate favorite for the White House against anyone except Trump. In that situation, I think the markets will simply grind sideways - Clinton and Obama are almost the same person when it comes to political philosophy. Although, Hillary probably knows how to pull the levers of the machine to move her agenda forward a little better than the current President.

The other wildcard is still everyone's favorite socialist from Vermont. If outside events do cause Clinton to have to back away I think Bernie may be a true threat to anyone on the GOP side. He appears to be the only person that truly motivates the Millennial's to come out and vote for their grandfather. (I kid!) In this instance, because of his proposed heavy tax-and-spend agenda, of which he makes no secret, I think the market reaction would be incredibly negative in the short term. In the long-term I don't believe much will change. The bifurcated world we live in (as outlined earlier in this note) will make it awfully hard to pass into law items that far off the reservation. I think he would be a one-termer…

Going forward with our portfolios, all parts are continuing to be evaluated to ensure everything still fits in line with our political and worldview. Also, now that we are on the other side of the abyss we will likely perform a full rebalance sometime in the spring. Although, I'd like to wait a few more weeks to see which of the political scenarios I outlined become more likely, simply to try and minimize short-term surprises.

I hope everyone has had a great 2016 so far and feels better about financial issues now than the past couple of quarters. Corrections are never fun but always necessary and I am glad we've been able to make some sense out of the events of the past two months.

Thank you for your business, ping me with questions - here's to a great year ahead.
Cheers!